



Lethame Capital Management
Technology : Research : Investing

Mercantilism Revisited: China, the Dollar, and the Renminbi's Missing Appreciation

Conventional Wisdom Holds that the 10-Year US Treasury Yield Is the Most Important Price in Global Markets — We Argue a Different Price is the Most Important and Has Been Wrong for Almost Thirty Years

September 2026

Executive Summary

China's economic transformation since the beginning of this century is difficult to overstate. When China joined the World Trade Organization in December 2001, its economy was only around one-eighth the size of the United States in nominal dollar terms. Today, China's economy is roughly two-thirds the size of the United States and approximately the size of the entire European Union at prevailing market exchange rates. On a purchasing-power-parity basis, China is already larger than the United States.

Yet one of the most important relative prices in the Chinese economy has changed surprisingly little. At WTO accession, the renminbi was effectively pegged at approximately USD 1 = CNY 8.28. Today it trades near CNY 7 — nominal appreciation of less than 20% against the dollar despite extraordinary productivity convergence.

A conventional Balassa–Samuelson framework^{1,2} suggests we might ordinarily have expected substantially greater real exchange-rate appreciation from an economy undergoing China's degree of convergence. An illustrative calculation developed in this note points toward a counterfactual exchange rate in the vicinity of:

USD 1 = CNY 4.5–5.0

This is not a forecast, nor an assertion of a uniquely “correct” exchange rate — it is an analytical counterfactual. The more important question is why the renminbi matters. The standard interpretation of China's trade surplus frames it as a contest between nations. Michael Pettis's framework³ suggests a more revealing divide:

Producers, governments and owners of capital versus households and workers

China's persistently high savings rate and low household-consumption share reflect an economic model that has historically transferred income and purchasing power from households toward businesses, government and investment. Because ordinary households consume a larger share of income than corporations, governments and wealthy asset owners, this distribution mechanically raises aggregate savings relative to consumption. When national savings exceed what can be productively invested domestically, the difference must appear as a current-account surplus:

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$$CA = S - I$$

China therefore exports not only manufactured goods but also excess savings. Those savings must be invested abroad, and this is where the dollar system becomes critical: if Chinese policymakers wish to prevent the resulting foreign-exchange proceeds from appreciating the renminbi, those proceeds must largely remain invested in foreign-currency assets — historically, and overwhelmingly, in US dollar securities. China's surplus and America's deficit are, in this sense, two sides of the same global balance sheet, with distributional consequences operating within both economies.

1. China's Transformation Since WTO Accession

The appropriate starting point is the scale of China's transformation. At the beginning of this century, China's nominal economy was only around one-eighth the size of the United States:

$$1/8$$

Today it is approximately two-thirds the size of the United States in nominal dollar terms, and roughly comparable in size with the entire European Union:

$$2/3$$

Measured at purchasing-power parity, China is already larger than the United States. In little more than two decades China has moved from being a large developing economy to one of the two dominant economic powers in the world. It is now:

- the world's second-largest economy at market exchange rates;
- the largest economy on a PPP basis;
- the dominant global manufacturing power;
- a central consumer of energy and raw materials; and
- one of the world's largest trading nations.

Such an extraordinary increase in relative economic size and productivity, would normally be associated with substantial real exchange-rate appreciation. Yet the nominal renminbi has moved remarkably little. That apparent disconnect is the starting point for this note.

2. WTO Accession and the Renminbi

China formally joined the WTO on 11 December 2001.⁴ At the time:

$$USD\ 1 \approx CNY\ 8.28$$

The exchange rate subsequently remained almost completely fixed until July 2005. Today, with USD/CNY near 7, the nominal appreciation since WTO accession is only approximately:

$$1 - (7 / 8.28) \approx 15.5\%$$

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At CNY 6.8, it is approximately 18%. That is an unusually modest currency adjustment for an economy that has moved from roughly one-eighth the size of the US economy to approximately two-thirds its size or in another comparison effectively increasing from the size of Italy to the size of the European Union. The obvious question is what might have happened to the renminbi had China's extraordinary productivity convergence been permitted to express itself more fully through relative prices and the exchange rate.

3. The Balassa–Samuelson Counterfactual

The Balassa–Samuelson effect provides a conventional framework. As productivity rises rapidly in a developing country's internationally traded sector, wages in that sector rise. Labour mobility causes wages to increase elsewhere in the economy, including sectors where productivity improvements are smaller. Prices of non-traded services consequently rise relative to internationally traded goods, and the country's real exchange rate appreciates — through nominal currency appreciation, higher domestic inflation, or a mixture of the two.

Frankel's own application of this framework to the renminbi⁵ draws directly on Rogoff's cross-sectional survey of the purchasing-power-parity literature:

*"Rogoff's (1996) regression estimates that for every 1 percent increase in a country's real per capita income (in a cross-section), its real exchange rate is stronger by 0.366 per cent. Notwithstanding the relatively good fit of this univariate regression ($R^2=.42$) there are some substantial outliers."*⁶

China's relative PPP income per capita has increased approximately fourfold since the beginning of the century. Using Rogoff's point estimate of 0.366:

$$4^{0.366} \approx 1.66$$

This implies an equilibrium real-exchange-rate appreciation of approximately 66% relative to 2001. Applied mechanically to the 2001 peg:

$$8.28 / 1.66 \approx 4.99 \Rightarrow \text{USD } 1 \approx \text{CNY } 5.0$$

Allowing for the outliers Rogoff himself flags in what is, after all, a univariate cross-sectional regression — and for the relative inflation accumulated since 2001 — we treat CNY 5.0 as the upper, least-appreciated end of an indicative range rather than a point estimate:

$$\text{CNY } 4.5\text{--}5.0 / \text{USD}$$

Again, this should not be interpreted as a precise estimate of fair value. The importance is the direction and scale: China has experienced extraordinary productivity convergence without experiencing anything resembling the nominal exchange-rate appreciation one might normally associate with it.

4. The Exchange Rate Is Also a Distributional Variable

Exchange rates are commonly discussed as prices affecting exporters. That understates their importance. Consider a Chinese household earning CNY 450,000. At USD 1 = CNY 7, this represents US\$64,286 of international purchasing power. At USD 1 = CNY 4.5, the same nominal income represents US\$100,000.

The exchange rate therefore affects not only the competitiveness of Chinese manufacturers but the quantity of foreign goods and services Chinese workers can purchase with their wages. An artificially weak currency favours producers of internationally traded goods relative to consumers of internationally traded goods:

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Weak RMB $\Rightarrow$ higher producer competitiveness + lower household international purchasing power

That observation provides the link between the exchange-rate question and Pettis's broader analysis of China's economic structure.

5. Pettis: Persistent Surpluses Begin with Domestic Income Distribution

Pettis's central insight is that persistent trade surpluses frequently originate not in trade policy itself but in the domestic distribution of income.⁷ National output is ultimately distributed between workers and households, businesses, government, and wealthy households and owners of financial assets — and those sectors have very different consumption propensities.

Ordinary workers tend to consume a relatively large share of incremental income. Corporations consume essentially none of their retained income. Wealthier households tend to save a greater proportion of incremental income than poorer households, and governments may retain or invest income rather than transferring it directly into household consumption. Consequently, a transfer of income away from workers and ordinary households toward businesses, government or wealthy asset owners raises aggregate national savings — a high national savings rate need not reflect extraordinary thrift by individual households; it can simply reflect the distribution of national income.

China is an unusually important example. Its household-consumption share of GDP remains exceptionally low by international standards. Policies that have historically contributed to transferring income or purchasing power away from households have included:

- wages growing more slowly than productivity;
- financial repression and low household deposit returns;
- subsidised credit to producers;
- land and property arrangements favouring local government;
- weak social-security provision;
- producer subsidies;
- state-directed investment; and
- exchange-rate management.

The result is a system in which production substantially exceeds the purchasing power made available to households to consume that production.

6. The Savings Identity

The accounting identity is:

$$CA = S - I$$

where CA is the current-account balance, S is national savings and I is domestic investment. China historically absorbed a remarkable amount of its excess savings through extremely high investment, but productive investment opportunities are not unlimited. Once S exceeds I, the remaining savings necessarily appear as a

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current-account surplus. This means China's trade surplus is not simply a story about competitive factories — it is also the external manifestation of domestic savings exceeding domestic investment.

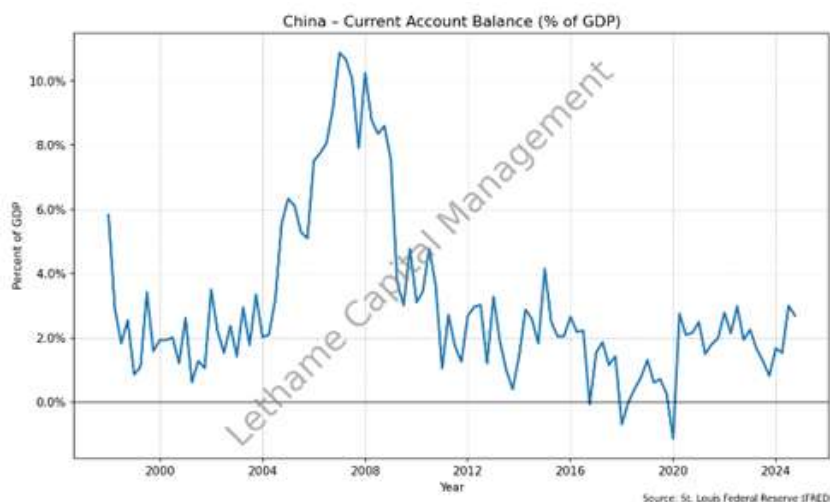


Figure 1: China – Current Account Balance (% of GDP)

Source: Federal Reserve Bank of St. Louis (FRED).⁸

The identity is visible directly in the data. China's current-account surplus widened from low single digits in the early 2000s to a peak of over 10% of GDP in 2007–2008 — an extraordinary imbalance by international standards — before compressing sharply after the Global Financial Crisis as domestic investment absorbed a larger share of savings. The surplus has since oscillated in a lower, though still persistently positive, 2–4% range, underscoring that S continues to exceed I on a structural rather than cyclical basis.

7. China Exports Savings as Well as Goods

Suppose China exports US\$100 billion more goods and services than it imports. China has delivered US\$100 billion of net real resources to foreigners, and it must receive something in exchange. If it does not use those proceeds to purchase additional foreign goods and services, it must instead acquire claims on foreign assets. Conceptually:

$$\text{Current-account surplus} = \text{net foreign asset acquisition}$$

China's trade surplus is therefore accompanied by an export of savings: it sends foreigners goods and receives foreign financial claims in return. This is critical to understanding the relationship between China and the dollar system.

8. Why China Cannot Simply Sell the Dollars Without Consequence

One might ask why China needs to keep accumulating dollar assets rather than simply selling the dollars it receives. It can — but doing so changes the exchange rate. If Chinese exporters sell incoming US dollars in the foreign-exchange market to buy renminbi, they create supply of USD and demand for CNY. Everything else equal:

$$\text{CNY appreciates}$$

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This is precisely the natural adjustment mechanism one would expect from a large persistent trade surplus: a rising currency gradually makes Chinese exports more expensive and imports cheaper, and the surplus tends to diminish. If policymakers do not want that appreciation to occur, they must take the other side of the transaction — the PBOC or another state institution effectively purchases the incoming dollars and supplies renminbi, suppressing the exchange-rate pressure. But the state now owns the dollars, and those dollars must be invested somewhere:

Trade surplus → pressure for CNY appreciation → (if resisted) FX intervention → accumulation of foreign currency

⇒ accumulation of foreign assets

This is why reserve accumulation and exchange-rate suppression are economically inseparable. China is not legally “forced” to own Treasuries, but if it wishes simultaneously to run persistent external surpluses, prevent the resulting foreign currency from pushing CNY significantly higher, and maintain enormous liquid reserve balances, it is effectively constrained to hold a very large portfolio of foreign-currency assets.

9. Why So Much of That Portfolio Has Historically Been in Dollars

China can diversify — into euro-denominated bonds, sterling, yen, foreign equities, property, commodities, direct foreign investment and sovereign wealth assets. But scale matters. China has accumulated foreign-exchange reserves measured in trillions of dollars, and few financial markets can absorb capital of this magnitude while simultaneously providing liquidity, convertibility, low credit risk, enormous market depth, readily available collateral, and the ability to transact without dramatically moving prices.

The US Treasury market is uniquely suited to this role. The choice confronting Chinese authorities has therefore historically been less “do we like US Treasuries?” and more “if we wish to prevent the renminbi from appreciating while accumulating trillions of dollars of reserves, what financial market is capable of absorbing the resulting assets?” The answer has overwhelmingly involved the dollar system, creating something approaching a circular relationship:

China suppresses CNY appreciation → accumulates USD → buys dollar assets → recycles capital into the US

That recycled capital is the financial counterpart of China’s external surplus.

10. The Dollar Constraint

Suppose China decided to reduce its dollar exposure substantially. Selling US dollar assets and purchasing renminbi would weaken the USD and strengthen the CNY — reducing China’s export competitiveness while increasing Chinese household purchasing power. In other words, escaping the dollar position would itself tend to produce the exchange-rate adjustment China had previously resisted.

China can of course switch dollar assets into euro, yen or other foreign assets without immediately buying renminbi, but the global scale problem remains: there is no obvious alternative reserve market with the combination of size, liquidity and institutional capacity of the US dollar market. China therefore faces something resembling a self-created reserve constraint:

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Persistent surplus + resistance to RMB appreciation $\Rightarrow$ persistent foreign-asset accumulation

This is worth emphasising because it explains why China's holdings of American assets should not be interpreted simply as confidence in US economic policy — they are partly the endogenous consequence of China's own exchange-rate and growth model.

11. Pettis's Reversal of the American Trade-Deficit Story

The standard story runs: Americans save too little, so America needs foreign savings, foreigners finance America, and the US runs a trade deficit. Pettis argues causality can operate in reverse. China and other surplus economies generate savings exceeding domestic investment; these savings must be exported; and the United States, possessing the world's dominant reserve currency and deepest open capital markets, absorbs a disproportionate amount of global excess savings. Foreign excess savings flow into US assets, producing a US capital-account surplus. But balance-of-payments accounting requires:

Capital-account surplus $\Leftrightarrow$ current-account deficit

The United States therefore cannot absorb unlimited foreign excess savings while independently choosing its trade balance. The trade deficit is the other side of the capital inflow.

12. China's Surplus Creates a Deficit Somewhere

Globally:

$$\sum CA = 0$$

One country's surplus must be matched by deficits elsewhere. If China runs a US\$500 billion current-account surplus, the rest of the world collectively must run US\$500 billion of deficits. This does not imply a dollar-for-dollar bilateral relationship — international trade and capital flows are multilateral; China may acquire European assets, European investors may acquire US assets, and a different country may ultimately run the corresponding trade deficit. But globally the identity is unavoidable, and a persistent Chinese surplus therefore requires deficits elsewhere. Because the United States is unusually willing and able to absorb global capital, a disproportionate share of that adjustment ultimately occurs there.

13. How America Adjusts

For the United States, $CA = S - I$. If CA is negative, then S must be less than I. Suppose foreign capital enters the United States but does not cause a corresponding increase in productive domestic investment — then US savings must decline. The adjustment can occur through several channels:

- Household borrowing — lower interest rates and abundant credit encourage households to borrow and consume.
- Asset prices — foreign purchases of financial assets increase valuations, producing wealth effects that reduce household saving.
- Fiscal deficits — government borrowing absorbs foreign savings.

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- Exchange rates — capital inflows support the dollar, weakening the competitiveness of US tradable industries.
- Employment — if demand does not adjust sufficiently through borrowing or fiscal policy, the external imbalance may instead appear as reduced domestic production and employment.

The point is fundamental:

US low savings may partly be an outcome of foreign capital inflows rather than their original cause

14. Countries Do Not Win or Lose — Sectors Do

The conventional narrative asks whether China benefits at America's expense. That is too crude. The economically relevant question, forcefully argued by Pettis, is which sectors in China benefit, and which sectors in America bear the corresponding adjustment.

Within China, the historic growth model tends to favour exporters, manufacturers, state-owned enterprises, corporate profits, government and owners of capital, with relative costs falling on workers, households, depositors and consumers. China as a whole has unquestionably become enormously wealthier, but persistent external surpluses can coexist with households receiving a smaller share of national output than would occur under a more consumption-oriented economic structure.

Within the United States, benefits can accrue to consumers of inexpensive imported goods, financial asset owners, borrowers, and businesses benefiting from low financing costs. Costs may be concentrated among manufacturing workers, tradable industries, communities exposed to import competition, future taxpayers if adjustment occurs through fiscal deficits, and younger or poorer households if capital inflows disproportionately inflate financial and property assets. The imbalance is therefore not best understood as China winning and America losing; it is more accurately:

The structure of Chinese income distribution creates an external imbalance whose adjustment is then distributed unevenly across sectors in the United States

15. The Global Distributional Circuit

The entire mechanism can be represented in one chain. In China: income shifted from households toward producers, the state and capital → household consumption suppressed → national savings elevated → S exceeds I → current-account surplus → accumulation of foreign financial assets, and, if CNY appreciation is resisted, official reserve accumulation concentrated in dollar assets.

In the United States: foreign capital inflow → capital-account surplus → current-account deficit → and, if productive investment does not rise sufficiently:

Lower private savings / higher debt / fiscal deficits / asset inflation / manufacturing adjustment

These are not separate economic stories. They form a single international accounting system.

16. Why the Renminbi Matters to Rebalancing

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A substantial renminbi appreciation would simultaneously increase Chinese household purchasing power, reduce the renminbi price of imports, reduce exporters' international cost advantage, make production for domestic consumption relatively more attractive, transfer real income from producers toward consumers, reduce excess national savings, diminish the current-account surplus, and reduce China's requirement to accumulate foreign assets. This is why an exchange rate of CNY 4.5 rather than CNY 7 would represent far more than an FX-market event — it would alter China's internal distribution of real purchasing power.

17. The CNY 4.5–5.0 Counterfactual

The illustrative Balassa–Samuelson range is:

$$USD/CNY = 4.5-5.0$$

versus approximately USD/CNY = 7 today. At CNY 4.5, one renminbi would have approximately 56% greater dollar purchasing power than at CNY 7; conversely, one dollar would buy approximately 36% fewer renminbi. Other things equal, this would make imported commodities, foreign travel, foreign technology and international services cheaper for China, while making Chinese exports more expensive abroad. Most importantly, it would increase the real consumption claim of Chinese household income on global output — precisely the direction of adjustment required to rebalance China's economy away from excessive dependence on manufacturing, investment and external demand.

18. China's Real Rebalancing Problem

China is commonly said to “save too much”. A better description is that Chinese households receive too little of what China produces to consume a normal share of national output. The appropriate policy response therefore need not be to persuade households to become less prudent — it is to increase the household share of GDP. Mechanisms could include:

- higher wages relative to productivity;
- stronger pensions and healthcare;
- direct household fiscal transfers;
- higher returns on household savings;
- reduced producer subsidies;
- reform of local government finance;
- reduced reliance on investment as a growth engine; and
- real exchange-rate appreciation.

All of these move income or purchasing power toward households. As consumption rises and savings fall, $S - I$ falls, and consequently:

$$CA \downarrow$$

The external imbalance shrinks as the internal imbalance is corrected.

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19. Investment Implications

First: CNY is a distributional asset price. An appreciation of the renminbi would redistribute purchasing power from the tradable-production sector toward Chinese households. It should not be viewed solely as a currency-market event.

Second: China's manufacturing surplus may eventually encounter a political constraint abroad. If Europe, the United States and other economies become less willing to absorb China's excess production, adjustment must occur domestically.

Third: higher Chinese investment is increasingly difficult as the solution. China already invests an exceptionally large percentage of GDP. Further property, infrastructure and manufacturing investment may produce diminishing economic returns. The sustainable solution increasingly points toward household consumption.



Figure 2: China vs United States – Investment (Gross Capital Formation), % of GDP

Source: World Bank (World Development Indicators).⁹

The scale of the gap is the point. Chinese gross capital formation has run at 35–46% of GDP for three decades — roughly double the US ratio throughout — and has stayed above 40% even as growth has slowed. An investment share this large, sustained this long, is close to a structural ceiling in any economy; it is difficult to argue China can close its savings–investment gap by investing still more.

Fourth: RMB appreciation can facilitate that adjustment. A stronger renminbi simultaneously raises household real purchasing power and reduces the subsidy implicit in an undervalued exchange rate to the export sector.

Fifth: this creates asymmetric long-term FX risk. For much of the post-WTO era, Chinese policymakers resisted appreciation because the development model favoured manufacturing and exports. If the political-economic objective changes toward raising household consumption, currency appreciation could eventually become a policy objective rather than a policy failure — a possibility potentially underappreciated by markets accustomed to viewing China primarily through the lens of depreciation risk.

There is already tentative evidence that Chinese corporates are positioning for this shift at the margin. Reports that Chinese manufacturers increasingly prefer USD-denominated invoicing for imported inputs — rather than RMB-fixed contracts — are consistent with firms retaining exposure to further appreciation rather than hedging it away, and with the well-documented “leads and lags” pattern in which importers delay dollar purchases and exporters accelerate them when a currency is expected to strengthen. That behaviour is itself mildly self-reinforcing, and is a small but concrete signal that market participants are pricing in continued convergence toward something closer to the CNY 4.5–5.0 range rather than a stable plateau near 7.

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Conclusion

At the beginning of this century, China's nominal economy was only around one-eighth the size of the United States. Today it is approximately two-thirds the size of the US economy and roughly comparable in size with the entire European Union; measured at purchasing-power parity, China is already larger than the United States. Yet during this extraordinary economic convergence, the renminbi has moved only from approximately 8.28 to 7 against the dollar.

A simple Balassa–Samuelson counterfactual suggests that an exchange rate closer to:

CNY 4.5–5.0/USD

might not be unreasonable had China's relative productivity convergence been allowed to appear more fully through its exchange rate. But the central conclusion is broader than currency valuation. China's persistent external surplus can be understood partly as the consequence of a domestic system that distributes an unusually large share of national income toward corporations, government, investment and owners of capital, and an unusually small share toward household consumption. That raises savings; when those savings exceed domestic investment, China must export the difference, and the corresponding foreign-exchange earnings must be invested abroad.

China is not literally required to buy US Treasuries. But if the authorities wish to prevent those foreign earnings from being converted into renminbi — and thereby appreciating the currency — they must accommodate the foreign currency somewhere on China's balance sheet. At China's scale, that has meant accumulating enormous portfolios of foreign financial assets, historically dominated by the dollar system. This creates the apparent paradox of China exporting goods to the United States and then lending much of the proceeds back to it. But it is not really a paradox: the financial flow is the necessary counterpart of the trade flow. China supplies excess production and receives financial claims; America receives excess production and supplies financial claims. This leads directly to Pettis's central insight:

China's surplus and America's deficit are two sides of the same global balance sheet

The resulting gains and losses should not primarily be understood at the level of countries — they are distributed between sectors within countries. Chinese manufacturers, government and owners of capital can benefit at the expense of Chinese household purchasing power. American consumers and asset owners can benefit from cheap goods and abundant capital, while manufacturing workers and tradable industries bear a disproportionate share of the adjustment. The deeper imbalance is consequently not China versus America, but:

Who earns the income from production, who has the purchasing power to consume it, and who is ultimately required to absorb the resulting excess savings

Seen through this lens, the renminbi is not merely an exchange rate. It is one of the prices connecting China's domestic income distribution, its household-consumption deficit, its extraordinary manufacturing surplus, its accumulation of foreign assets and the persistent external deficit of the United States. And this is why a future Chinese rebalancing toward households could have implications far beyond China itself: if China allows workers to consume a materially larger share of what they produce, China's savings surplus must diminish, its trade surplus must diminish with it, its need to accumulate foreign assets diminishes, and the corresponding

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requirement for the rest of the world — particularly the United States — to run offsetting deficits diminishes as well. In that sense, the ultimate resolution of the US-China trade imbalance may lie less in tariffs or trade negotiations than in the distribution of income inside China itself.

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