ISSN 2616-5902 Vol. 8, Issue 7: 94-98, DOI: 10.25236/AJBM.2026.080713

# Circulation and Collaterals of China's Currency

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***Abstract:*** *The issuance mechanism of our currency before the 1990s was not very mature, and a stable and reliable long-term mechanism was not formed in the exploration stage. Before 1994, the issuance of money was dominated by the state's plan. The amount will be put in as much as the country plans to produce. Then, after 1994, the issuance of money was mainly dominated by the demand for credit, and the essence of the issuance of our currency was actually debt, which meant the issuance mechanism after the 1990s was much bolder and totally different with the previous age.*

***Keywords:*** *Foreign Exchange; Real Estate; Corporate Debt; National Debt; Collateral*

## 1. Introduction

After 1994, our currency has different characteristics at different stages in terms of the backups for releasing. So, how to distinguish these different stages? The core lies in where does the credit of the claim come from, or where does its collaterals come from? In order to vividly show the difference between collaterals, we have to refer to the balance sheet of the central bank, that is, the People's Bank of China (PBOC). So far, the underlying collaterals of our currency is divided into three categories: the first one is foreign exchange; the second one is corporate debt; and the third is government bonds, namely, national debt. These three debt items on the central bank's balance sheet rightly correspond to the three largest asset items on the balance sheet respectively.

## 2. From Foreign Exchange to Corporate Debt

### *2.1 Back-up of the Value of Corporate Debt*

Before the 1990s, China's monetary system was still not mature, since the economy was controlled totally by the central government and the money output was done according to the economic plan. After the market economy was established around the mid of 90s, a credit-driven monetary system was built with commercial banks and non-banking institutions became the main sources of supplying of credit (money) , whereas the central bank being the source of supplying of fundamental currency. But the banks and non-banking institutions will not create value by themselves. They can only create value indirectly through lending and investing in enterprises and individuals who are the real sources to make money. In other words, the essence of these money-making mechanism is actually corporate debt. But what is the main real assets to support the corporate debts, besides production line or intellectual property rights, the amount of which in China is far less than the amount of debts could correspond? The answer is: real estate[1].

When real estate was particularly popular, commercial banks had a large number of real estate enterprises' claims in their hands. At the beginning, it was only real estate enterprises involved, because back then, many producers or many money demanding parties were this kind of enterprises. Therefore, the credit at that time was actually based on land finance, or the credit at that time was based on the expansion of real estate. Looking from the negative side, the disorderly expansion of real estate enterprises had increased the cost of people's living and led to a continuous decline in the fertility rate, nevertheless from the positive point of view, land finance had helped China to solve the currency chaos since 1994. In another word, China has established its own banking system and credit and monetary system with the lands and houses as the deep down backed-up assets. Without this money-output system, China's currency would still be in a state of chaos[2].

### *2.2 The Background of China's Relying on Land Finance After 1994*

We can quickly explain that in the early stage of the transformation from the planned economy to the

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market economy: during the old time, ordinary people had no money in their hands to spend, whereas entrepreneurs had no assets to expand the production or businesses, because in the era of planned economy, the lands and houses belong to the public family, and therefore, banks did not dare to lend money to enterprises, individuals, ordinary people and entrepreneurs as well, who did not have reliable collaterals. If there are no collaterals, how can you lend, right? But after the lands and houses (whether for commercial, industrial or personal living purposes) were well recognized as high-priced and qualified assets after privatization, people suddenly had collaterals for banks to lend them money. Moreover, the banks considered the lands and houses as the most reliable collaterals, compare with the production line or raw materials, for first of all, there is no way to move the lands and houses. Together with this immovable nature, the lands are relatively easy to assess and widely accepted in case the debt is not paid. These two unique characteristics make the lands and houses almost the best collaterals in the eyes of the banks, especially those in the biggest cities as Shanghai and Beijing. This quickly help banks and the market to build confidence to give loans to those who have lands and houses. Therefore, before the age of corporate debts or national debts (in the form of government bonds) as collaterals, the internal circulation of China's currency relied on real estate was successfully built. But what was the external circulation at that time? That was, the export: through exporting products to other countries, people earned foreign exchange and then sold them to the commercial banks for yuan, who later on sold to PBOC by law. In turn, PBOC generated fiat currency according to the amount of foreign exchange bought in. And after that, the commercial banks gave loans to people who owned lands and houses, or production line as well, as collaterals to loans, and who later probably bought more real estate or built more production line by loans. So, the export and real estate were the two paradigms of internal and external circulation during the 1.0 stage of our currency, which helped China to establish a large amount of infrastructure, and a most comprehensive and perfect industrial chain throughout the world, in turn, these infrastructure and industrial chain helped to generate more foreign exchange, loans, houses and lands. Without this circulation, China would not be able to become a manufacturing powerhouse.

## 3. National Debt as A Collateral

### *3.1 The U.S Counterpart*

The United States is a very typical example. The fundamental problem between the US dollar and U.S. debts is not what assets the US dollar anchors, but the endless borrowing of the U.S. government. Whether the US dollar is anchored to gold, oil, or minerals, there is no way to solve the fundamental problem. As long as the United States does not reform the economic system, and as long as the United States does not reform the tax system, there will always be problems with the US dollar and U.S. debts. On one hand, the U.S. government borrows endlessly, while on the other hand, there are limited resources and energy. No matter how these two things are anchored, there will be problems sooner or later if the debt is increasing constantly in a way far beyond its resources and production ability can handle. The U.S was once the largest creditor in the world before or right after World War II, based on its awesome natural resources, most advanced technologies and most advanced system for creation, innovation and entrepreneurship, and more important, spirit of hard work (on production line) quite relevant to their people's believe in God. However, when such a great country takes every beautiful thing for granted, and everybody including the president himself gradually becomes believing in money only, besides the truth that the largest creditor has already become the largest debtor, another Roman Empire's inevitable decline, together with the collapsing of the currency, is doomed to happen. Even if AI becomes successful on business sense just couple of years away, even if Trump successfully binds the US dollar to mineral resources or oil in the future, it will only treat the symptoms but not the root cause. It can only solve the urgent problem, rather than the fundamental issue that the production line of most of its living stuffs will probably never come back to the U.S. This factor alone is not only a devastating blow to keep its inflation always under 2% in order to print more dollars to dilute its massive debts, but also a sign that the U.S has lost its capability to build things for living or maintaining its military deterrence capability which is an important element (besides the advanced technologies and political and economic systems) to keep the dollar as the biggest part of foreign exchange in many central bank's reserve[3].

### *3.2 The Chinese Way of Using National Debt as A Collateral*

It should be emphasized that many people think our currency cannot anchor the national debt. It is true in terms of the Banking Law which specifically stipulates that the central bank cannot buy the national bonds (this will be illustrated in details later) in order to prevent a catastrophic result shown up

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80 years ago. But in fact, since August 2004, the central bank has been openly buying and selling government bonds on the secondary market. Moreover, if you make a comparison between China's finance and Germany's finance in 2014, you will find out that the Germany's lifting of its debt ceiling, is fundamentally the same when it comes to the issue of currency output mechanism, as China's increasing the trading of government bonds at that year. The central bank's choice to openly buy and sell government bonds on the secondary market shows that China's monetary policy framework has gradually transformed towards modernization, accompanied by China's ability to regulate the government bond market, and China's confidence in sufficient resources and industrial capability to pay back government debts issued as the form of bonds [4].

### *3.3 Emulating the Fed to Lift Bond Liquidity is Highly Implausible*

It is a widespread online speculation that China is embracing treasury bond fiscalization: however, this is merely a public conjecture. This distrust stems from a profound shift in public sentiment: previously, citizens trusted the government to act in their interest, while today many assume that official policies carry hidden downsides. Objectively, however, the PBOC's bond purchases represent routine monetary policy operations, not a precursor to surrendering monetary independence to fiscal authorities. This raises a pivotal question: if this constitutes standard monetary policy, what strategic objectives is the central bank pursuing? Economists have advanced two dominant hypotheses. First, the PBOC is emulating the Federal Reserve to boost treasury bond market liquidity. Second, the central bank is injecting liquidity via counter-cyclical quantitative easing amid unique economic headwinds.

However, the first theory — emulating the Fed to lift bond liquidity — is highly implausible. China's secondary treasury bond market remains small in scale. As a major counterparty purchasing large bond volumes, the PBOC's entry could either invigorate market trading or suppress private liquidity; the outcome is deeply uncertain. This approach amounts to using a sledgehammer to crack a nut. Moreover, to replicate the Fed's liquidity framework, China would first need to drastically expand its overall treasury bond stock — a market expectation entirely absent from current sentiment. For these reasons, liquidity enhancement is unlikely to be the primary motive.

This leaves the second hypothesis: is the PBOC rolling out quantitative easing? Several counterarguments undermine this claim. For one, the PBOC already boasts a full suite of liquidity injection tools, including open-market reverse repos, Medium-term Lending Facility (MLF), Pledged Supplementary Lending (PSL), and Temporary Lending Facility (TLF). Purchasing treasury bonds is an entirely redundant mechanism for liquidity provision. For another, China retains at least two percentage points of reserve requirement ratio (RRR) cut headroom. Judging by the pace and scale of recent RRR reductions, large-scale monetary expansion over the next two years can easily be achieved via further reserve ratio adjustments, a far simpler channel than secondary-market bond buying. There is no logical rationale to adopt a more cumbersome alternative.

By pre-allocating fixed funding volumes through treasury bond transactions, the central bank effectively issues a massive credit line to the finance ministry as advance capital preparation, implying the Ministry of Finance will launch major policy initiatives imminently. This interpretation draws from historical precedent. The PBOC has conducted large-scale treasury bond purchases on three prior occasions, all in 2007: January, August, and December. In January 2007, the central bank's claims on government debt surged from 1.5828 trillion yuan to 2.72984 trillion yuan. The rationale behind the January purchases was never officially disclosed and remains opaque to outside observers, yet the August and December operations had clear stated objectives: providing capital to the Ministry of Finance to purchase foreign exchange as seed funding for China's sovereign wealth fund. All three 2007 bond-buying rounds explicitly supported the Ministry of Finance's policy priorities.

## 4. The Necessity and Legal Restraints of Using National Debt as A Collateral

### *4.1 Using National Debt as A Collateral is A Proactive Risk Preparedness*

It was stated in the previous part that to label this model of using national debt as a collateral to issue currency as a way of "treasury bond fiscalization", is a misunderstanding. This move is much like the central bank issuing a huge credit card to the Ministry of Finance as a special monetary tool, which signals the Ministry of Finance may roll out major initiatives in the near term, which really is a proactive risk preparedness[5]. Then the question turns out to be: Why does the central bank step in to buy treasury bonds directly? Why is this action analogous to handing the finance ministry a credit card? And what

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exactly is the Ministry of Finance planning to do?

In every country and throughout all historical periods, the Ministry of Finance has an unlimited appetite for funds from the central bank, a fact easy to grasp. After all, finance ministries are perpetually short of money, while central banks theoretically possess unlimited liquidity. To put it figuratively, the Ministry of Finance is like a ravenous glutton, and the central bank a slab of pork belly. Central banks worldwide are inherently vulnerable and require institutional safeguards. China's central bank has long been pushed around by the Ministry of Finance. Back in 2018, a senior official from the central bank publicly criticized the Ministry of Finance in the media, accusing it of acting in bad faith. This was a high-profile turf war, and the tensions between the two authorities had long spilled into the public eye[6].

Moreover, the central bank always ends up taking the blame. To break this doomed cycle, Britain launched a fiscal revolution in the 18th century, establishing a constrained treasury bond system to shield its central bank; nations across the globe followed suit. After all, institutional frameworks worldwide are built through constant cross-country emulation. Today, major economies all operate under rule-based limits on treasury bond issuance, and China is no exception.

### *4.2 The Core Institutional Safeguards for Central Bank Independence*

First, Article 29 of the *Law of the People's Republic of China on the People's Bank of China* stipulates that the People's Bank of China (PBOC) shall not provide overdrafts for government fiscal spending, nor directly subscribe to or underwrite treasury bonds or other government securities. This legal provision explicitly bars the central bank from purchasing treasury bonds in the primary market. Legally speaking, the Ministry of Finance cannot unilaterally demand direct central bank bond purchases. Meanwhile, Article 23 of the same law empowers the PBOC to trade treasury bonds on the open market to implement monetary policy. In other words, while the law prohibits direct primary-market bond purchases, it permits secondary-market transactions to adjust monetary conditions under legitimate policy objectives, which means current legislation fully authorizes this practice.

These two statutory clauses constitute the core institutional safeguards for central bank independence. Some viewers may raise doubts, claiming the Chinese government could disregard legal constraints, alleging authorities routinely overlook laws when dealing with ordinary citizens. This logic is flawed: citizens lack institutional leverage, and accessing legal redress carries prohibitive barriers. By contrast, the PBOC holds equal bureaucratic standing with the Ministry of Finance, rendering legal provisions fully enforceable, which means the weight of law shifts based on the parties involved. Furthermore, central bank officials strongly resent unlawful fiscal demands (which has been stated in the previous paragraphs) for it functions like a commercial entity required to balance revenues and expenditures, with its financial performance tied to the career evaluations of its leadership. Rejecting unreasonable fiscal requests is therefore a core daily responsibility for central bank administrators.

This explains why a PBOC director publicly denounced the Ministry of Finance in 2018. Under existing legal limits, the Ministry of Finance can only extract minor fiscal concessions at most. If the state intended to turn the central bank into an unrestricted fiscal wallet, it would first need to revise current legislation to strip the PBOC of its institutional independence as an unavoidable legal hurdle.

## 5. Conclusion

Though on surface the currency reform in China, from chaos to using foreign exchange as a collateral, from corporate debts generated largely by real estate to national debts as collaterals, is experimented in the similar way as the western counterparts, it's of utmost importance to distinguish the difference between them, that is, the former has the strongest production capability worldwide, whereas the latter don't, except some high-end production area like Boeing, ASML or LVMH, which only benefits a small part of the labor force. But still, China's currency needs to face the same problem as the dollar or Euro, namely, too much debt as collateral will sooner or later erode the value of the fiat currency, whether in the form of direct financing form capital mainly coming from the securities market or indirect financing form money mainly coming from the banking sector.

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