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Sept. 13, 2016

Prasad: Despite yuan's meteoric rise, dollar will dominate

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The international finance community is on the brink of what Cornell economist Eswar Prasad calls “a momentous event.”

On Oct. 1, the International Monetary Fund will add China’s currency, the renminbi, to its elite basket of reserve currencies. This international stamp of approval means the renminbi – and its unit, the yuan – meets the IMF’s standard of being “freely usable” in the global economic system, allowing it to join the euro, yen, pound and dollar in the A-list basket.

It’s a significant milestone in the renminbi’s growing international credibility, which Prasad outlines in his newest book, “Gaining Currency: The Rise of the Renminbi.”

In the book, Prasad describes how far China has progressed in promoting the renminbi as an international currency, the broader implications of the renminbi’s elevated status for the global monetary system, and in particular what the implications for the dollar might be.

“Many people have argued that if China’s economy keeps growing and perhaps matches the U.S. economy in size, and if China reforms and liberalizes its financial markets and economic structure, maybe the renminbi can rival not just the euro or the yen but even the U.S. dollar,” said Prasad, the Tolani Senior Professor of Trade Policy at the Charles H. Dyson School of Applied Economics and Management.

But, he argues, this hype about the renminbi’s rise to global dominance is overblown.

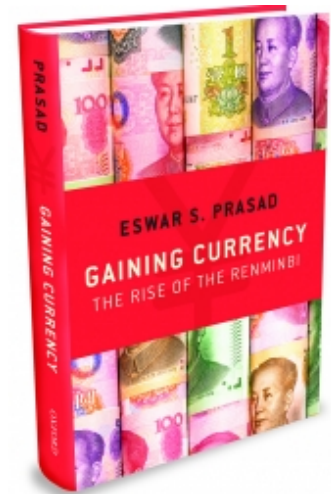
In “Gaining Currency” Prasad describes how China has promoted its currency as an international player by taking steps to liberalize, broaden and deepen its financial markets. China has become more open to financial flows, both into and out of the country, for example. And the government has allowed market forces to somewhat determine the exchange rate, said Prasad, who was previously chief of the IMF’s China Division.



Prasad

Prasad predicts that, as China's economy grows and its footprint in international trade and finance expands, the renminbi will play a more prominent role as a payment currency – that is, a currency intermediating financial and trade transactions across countries. The renminbi now accounts for a small but quickly growing share of global financial transactions, he said.

And the renminbi's rise to the status of a global reserve currency is “happening before our eyes,” he said. “Many central banks around the world – 34 at last count – have signed local currency swap lines with the People's Bank of China, which means they have access to renminbi should they need it.”



He predicts the renminbi will have a spectacular rise over the next decade or so. It could progress from accounting for barely 1 percent of global foreign exchange reserves now to perhaps 10 to 15 percent.

But then the renminbi will plateau, Prasad predicts; the global finance community will not perceive it as a safe-haven currency.

“In order for the renminbi to be considered a safe place for investors to put their money in times of turmoil, foreign investors and domestic investors in China must have trust in China,” he said. “And that is missing.”

To build that trust, China needs political and legal institutions similar to those of safe-haven countries in Europe and of the United States and Japan. China is missing a democratic form of government with multiple checks and balances. It needs an independent and trusted central bank like the Federal Reserve. And China also would require a legal framework where the rule of law takes precedence over the Chinese Communist Party, and not vice versa.

“This is where China falls short,” said Prasad. “Even if China moves forward with economic reforms, the present leadership has made it abundantly clear that broader legal, political and institutional reforms are off the table.”

What does that mean for the dollar?

“The renminbi may slightly erode – but will in no serious way challenge – the dollar's status as the dominant global reserve currency,” Prasad said.

Oxford University Press will publish “Gaining Currency” in October.

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