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# Will The Chinese Yuan Ever Displace The Dollar?


*Chinese 100 yuan notes in Beijing. (Credit: Fred Dufour/AFP/Getty Images)*

Shanghai is China's richest and most important commercial city. Interesting about it is that as of 1978, a mere 15 skyscrapers dotted its largely empty skyline. Back then China was an intensely poor, communist (in the literal sense) country. But as of 2006, and after a few decades of economic liberalization, Shanghai's skyscraper count had increased to 3,780. In 2017, the number of tall buildings surely exceeds what seemed enormous in 2006.

Though China remains a poor country by developed world standards, to visit is to see people who are very much in a hurry. They want to live like we do, and they're working incredibly hard to get there. *China is for real*. For those who claim it's a creation of "easy credit" (an oxymoron if there ever was one – credit is always and everywhere difficult to attain) thanks to its central bank and state run banks, they should think again. Figure that lots of countries have central banks, along with politicized credit allocators, but few can claim even a fraction of the stunning growth that is plainly visible to anyone lucky enough to visit the rapidly advancing country.

Eswar Prasad, a professor of trade policy at Cornell University, has published an important new book on China's economic rise; albeit through the prism of its currency: the yuan, or the Renminbi, or as Prasad references it, the RMB. Up front, it should be said that Prasad's *Gaining Currency: The Rise of the Renminbi* is a very informative book, and it's mostly very good.

Prasad is clearly well connected within the economics profession. Endorsers of his book include former Fed Chairman Ben Bernanke, Harvard economist Kenneth Rogoff, and former Treasury secretary Lawrence Summers. This is mentioned early on as a way of addressing what would understandably turn off perhaps more than a few potential readers. How could what's a very worthwhile and informative read have the endorsement of three economists who are so frequently ridiculous?

It's a good question. My own speculation is that they agreed to endorse Prasad's book without actually having read it. This is assumed simply because Prasad's book is decidedly not ridiculous. It's once again very informative, and while Prasad on occasion lapses into nauseating "economist think," he's quite a bit more serious than the trio mentioned. Lest we forget, Bernanke is convinced that economic growth causes inflation despite centuries of evidence that reveal soaring growth as the greatest foe of rising prices. In Rogoff's case, his modern war on cash has him concluding that the best cure for recessions is rampant spending despite the tautology that entrepreneurs can't be entrepreneurs without access to savings. As for Summers, though books could be written about his silly assertions about government spending driving economic growth (I guess the politicians in Haiti missed this memo), it's hard to forget his mind-numbingly obtuse conclusion that Japan's tragic 2011 earthquake would stimulate economic growth there thanks to the spending required to rebuild all the wealth and lives destroyed. In Summers' defense, a poll of credentialed economists would reveal a nearly unanimous and horrifyingly dim belief that all the killing, maiming and wealth destruction that took place during World War II revived the global economy; the U.S. economy most notably.

The economics profession of the modern day is decidedly unserious, so much so that it took a while to open Prasad's book. Having recently read and reviewed the comically bad *Phishing for Fools* by Nobel Laureates George Akerlof and Robert Shiller, I wasn't exactly eager to commit more precious time to another book widely praised by economists. Thankfully I dismissed my recurring nightmare that includes a read of Akerlof's alleged insights only to open up *Gaining Currency*. I'm glad I did. So will the readers of this column if they can get beyond the individuals who endorsed Prasad. His book is one that I'll be referring to for a very long time.

Prasad begins by providing the reader with a brief, but highly interesting history of China's experience with currencies. In a book full of fun and interesting facts, the reader learns that while the RMB was introduced in 1949, China was the first country to use paper money. Interesting to some will be why. Prasad explains that rising Chinese prosperity during the Song dynasty (960-1279) made it "increasingly cumbersome and impractical to use these heavy coins for business transactions."

Money is a *measure* despite what modern economists worshipful of floating currency values tell us, so while China moved to paper money out of convenience hundreds of years ago, the Song government understood that money's only purpose was as a ruler, or measuring rod. As Prasad put it, the Song government resisted private money given its belief that "only the government could ensure a reliable supply of a currency stable enough to support economic activity." Wise minds can and surely will continue to debate the public versus private money concept, but the good news is that Prasad fascinatingly reports that there were some currency dissenters inside China many centuries ago. While the Song government should be cheered for understanding what neither economists nor politicians understand today (that money is a measure which facilitates exchange and investment, *and nothing else*), it's encouraging to read that Confucian scholars disagreed with the notion of government-issued money. Prasad writes that they felt "the market would compel private issuers of money to maintain its value." It says here the Confucians were right. Private sector players expertly create for us computers, Wi-Fi and navigation gadgets (GPS) that seamlessly guide us when we're lost, and odds are they could issue money that would hold its value. They would because market discipline enforces good behavior. While the U.S. Treasury can consistently devalue the dollar only for us to keep accepting what is the world's currency, Visa, Amex and Walmart couldn't so easily devalue their currencies. Competition would keep them honest.

Speaking of devaluation and currency instability, Prasad very helpfully notes that the Song dynasty "was eventually weakened by monetary instability" only for it to give way to the Yuan dynasty. Yet it too was eventually felled by devaluation. Prasad writes that "Reckless issuance of large quantities of paper money undermined confidence in the currency..." Lenin, Mises, Keynes and others all understood what Prasad is reporting: if you want to turn society upside down on the way to tantrums in the citizenry that invariably force changes at the governmental top, debauch the currency. It's so basic. People go to work in order to get what they don't have, and the money they earn amounts to the "tickets" (to take a word from John Stuart Mill) that they accept in return for their toil, and that represent their demand for what they don't have. In that case, is it any wonder that citizens lose it when their money is devalued? Economists generally think it's low rent to talk about the price of anything in gold, but the dollar plummeted in gold terms from 2001 to August of 2011, and is still quite a bit weaker than it was when the 21st century began. The latter in mind, Lenin, Mises and Keynes might not be too surprised by Donald Trump's recent victory, not to mention a globally frustrated electorate. Figure that the world remains on an implicit dollar standard despite the end of Bretton Woods in 1971, so when the U.S. Treasury devalues the greenback, it's a global event. As Prasad himself notes, "most countries that manage their currencies, especially those in Asia, tend to use their own currency's value relative to the dollar as the benchmark." Devaluation wrecked the regimes of the past, and it still does now. The difference is that most economists nowadays talk excitedly about the alleged good that comes from devaluing the money that people earn. Again, the profession has become ridiculous in modern times.

All of the above speaks to a needless analytical weakness within *Gaining Currency*. Having established the logical truth that currency devaluation is the greatest enemy of political stability, Prasad then contradicts himself. At the beginning of Chapter 2 he strangely writes that "Trying to cheapen a domestic currency's value relative to that of other currencies can actually help boost exports and, therefore, offset weak domestic demand and raise GDP growth." It was as though Akerlof, Bernanke, Rogoff and other typical economists entered Prasad's body all at once; that or Chapter 2 was written by some misguided teacher's assistant in Prasad's employ. Here the book is humming along informatively, then Prasad reverts to discredited "economist think." What a waste.

Addressing what is false, cheapened currencies aren't the path to export nirvana for the simple reason that shrinkage of the measure logically drives up the cost of imported inputs necessary to create the final good in the first place. It also can't be forgotten that transportation costs necessarily rise (a dollar in 2016 buys quite a bit less fuel than did a buck in 2001) to reflect the debased currency, as do labor costs; workers generally don't sit back and allow their pay to be eviscerated without protest. Most crucial of all is the basic truth that investment in productivity enhancements is the single best way to drive down the price of anything, and investors are buying future currency income streams when they commit capital to investment in productivity enhancements. Yet devaluation logically makes it quite a bit less likely that investors will put capital to work in the first place.

In short, Prasad gets it all wrong about devaluation. *Needlessly*. One wonders if he simply forgot that Japan had some of its best export years into the U.S. right as the yen was soaring over 200% against the dollar from the 1970s through the 1980s. If devaluation were the driver of GDP growth, then Mexico, Argentina and Zimbabwe would list among the richest and most dynamic countries in the world. In fact, devaluation is anti-growth and anti-falling prices simply because it's anti-investment.

A few pages later Prasad writes that "'intervention' in the foreign exchange market limits domestic currency appreciation and therefore improves a country's trade balance by limiting imports and propping up exports." There's so much wrong with the previous statement. Back to reality, a rising currency would at least in nominal currency terms reduce the cost of production and shipping, and boost the very investment that would once again bring down prices. Good money is an investment lure, and by extension it's a muscular price chopper. Not to Prasad. In his analysis, rising currencies bring on all manner of horrid outcomes, while devaluation is less than costless. But that's simply not true. More realistically, a falling currency necessarily reduces the investment necessary to bring down prices to begin with. As for a country's trade balance, there's no such thing. What Prasad is writing about is an accounting abstraction. Countries don't trade; rather individuals trade. And their trade balances, *as a rule*. They run "trade surpluses" with their employers, and then their reward if they're really productive is massive "trade deficits" with their favorite clothiers, carmakers, restaurants, hoteliers, airlines, etc.

The strange thing about Prasad's unfortunate lurch into "economist think" is that while a stable currency was by his own reporting essential in the China of 1,000 years ago, in modern times good, stable money has somehow become a liability in his eyes. Of course, in order to defend what is absurd and indefensible, Prasad sadly reverts to the silly "truth" accepted by economists that devaluation is good for the economy. The problem is that an economy isn't some blob, it's just a collection of individuals. And just as individuals are not made better off when the purchasing power of the money they earn is diluted, neither is an economy better off. Forgotten by Prasad is that an economy isn't some machine that attains "balance" thanks to floating currencies; rather an economy is just individuals producing so that they can get. Money in an economy properly defined remains what the Song government felt it was, what the Confucians felt it should be, and what Adam Smith said about it: "the sole use of money is to circulate consumable goods." Once this is properly understood, or remembered, all this talk of devaluation, strength, weakness, and trade balances quickly goes out the window. Trade always balances, *by definition*. In what is still a very good book, Prasad needlessly weakens it with a persistent argument throughout that currency devaluation is a principal driver of exports that boost prosperity. More realistically, imports are paradoxically (at least to economists) the biggest driver of exports. Stating the obvious, countries that are importing a lot are logically exporting a lot.

The book is also weakened by Prasad's occasional reference to the "over" and "under" valued RMB. But that's like saying the inch is sometimes too long and sometimes too short. An inch quite simply *is*, as is a foot and a minute. Fiddling with the exchange value of money can't change the on-the-ground reality. Money is what we need to facilitate trade and investment. Nothing else. Prasad's history of China's currency situation makes the latter quite obvious, only for the Cornell professor to stray from what is basic economics as he talks about the RMB's gradual evolution into a global currency.

Returning to Prasad's early point that much of Asia (and realistically much of the world) benchmarks its money to the dollar, he reminds readers of what people like president-elect Donald Trump would prefer that voters forget: that China officially pegged the RMB to the dollar in 1994. This is important when we consider the silly commentary from Trump and others about a "weak" RMB. Sorry, but the RMB has long been pegged to the dollar. When the latter is weak, so is the RMB. When it's strong, so is the RMB. Prasad also reminds the reader (what this reader would give to have members of the Trump administration's protectionist wing read *Gaining Currency*) that from 2005 to 2014, the RMB rose 25 percent against the dollar. All this runs counter to what we heard from Trump during his presidential campaign. Still, Prasad and other economists perhaps deserve some of the blame in light of their floating money worship, not to mention their talk of money that is "over" and "under" valued. In going to great lengths to deprive modern money of its singular purpose as a measure or concept, they hand demagogues the words and catch-phrases that inform ridiculous economic commentary.

Prasad is ultimately discussing the path of the RMB to reserve currency status. It's not quite there yet, but it's getting there. While the dollar accounts for 64 percent of global reserve currency holdings, and the euro 21 percent, the RMB was up to 1.1% as of 2014. It's in the conversation. Prasad writes early on that the non "market determined" exchange rate of the RMB is a barrier to it becoming more of a reserve currency, but it seems he gets the story backwards. While the RMB's peg to the dollar isn't absolute a la 1994, it's still pretty tight. And that's the problem when we consider the dollar's 21st-Century volatility. Money is most useful when it's stable. Prasad intuitively knows this from his early analysis of China's currency history. Assuming Chinese monetary authorities move in the direction of RMB-price stability (whether through a gold definition, or more intriguingly private money issuance), odds are the RMB's use as a reserve currency will increase. One can only hope. Treasury's oversight of the dollar has been atrocious over the last 16 years to the logical detriment of the global economy. A better, more stable RMB would perhaps force Treasury to get serious.

One other weak point of the book was Prasad's all-too-typical assertion that the U.S. economy recovered more rapidly from the 2008 thanks to the Fed printing "large amounts of money rapidly" alongside a U.S. government that "used fiscal policy aggressively." That's just silly. And Prasad surely knows why. The Fed quite simply can't increase so-called "money supply" where economic activity doesn't already rate it. If he doubts this, he need only ask himself how long the dollar proceeds from Fed purchases of bonds from Baltimore, Compton, or Buffalo, NY banks would stay in all three locales as performing loans. After that, simple logic tells us that Paul Ryan and Nancy Pelosi can't allocate precious resources extracted from the real economy as well as Warren Buffett, Bill Gates and Jeff Bezos can. Prasad's already good writing would be so much better if he weren't so eager to be conventional at times. And if he might throw statistics aside in favor of common sense. Simply put, neither the Fed nor Congress can allocate resources more effectively than can the private sector. As for this notion that the economy will halt if Congress won't spend what savers will not, let's be serious. Recessions when left alone correct quickly precisely because people spend less such that their savings morph into the very investment that powers the recovery. As for saving that doesn't become investment, banks don't take in deposits to stare at them lovingly; rather banks pay for deposits only to lend them out immediately. To save isn't to *not consume* as economists think. In truth, when we save our consumption is shifted to someone else eager to consume. Getting more specific, notions of "export-led growth" are utterly nonsensical. We're exporting so that we can import. *Always*.

Yet despite the quibbles with commentary that Prasad is seemingly too smart to associate himself with, *Gaining Currency* is otherwise very good. If readers are willing to look beyond the conventional economist-speak previously discussed, they'll come away much more informed. Prasad provides readers with an interesting overview of Chinese currency history, and then offers myriad fun facts and commentary about the impact of S&P downgrades on U.S. and Japanese debt (it's not what you'd expect), how Chinese investors get around rapidly eroding capital controls, why Treasuries are so attractive to global investors (it's not necessarily a quality thing), along with the exciting development of China's "shadow" financing system.

And while Prasad is plainly an optimist about China's future, he describes as "far-fetched" the notion that the RMB will eventually overtake the dollar as the world's reserve currency. I hope he's wrong. One way he could be proven wrong is if China's monetary authorities seek what economists like him strangely decry: stability of the unit as a measure of value. If Chinese monetary authorities ditch the dollar in favor of currency stability, watch out. What is 1.1% reserve penetration will quickly soar. The problem is that Prasad and his esteemed colleagues recoil at the very RMB stability that would give the dollar serious competition, all the while serving as a massive investment lure into China.

Of course, all of the above helps explain why a very good and informative book isn't great. Simply put, the wise thinking that informed Prasad's explanation of early Chinese currency history (when stability as a measure of value was crucial) went out the window when he set out to tackle the present. This doesn't mean *Gaining Currency* wasn't highly informative despite Prasad's occasional migration into the absurd, but it does mean the book wasn't as excellent as it could have been. Readers should read *Gaining Currency* with an eye on learning a lot, but with eyes wide open to how much better it could have been had Prasad ignored the economists in favor of common sense about why the Chinese first introduced money to begin with.

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