Project Syndicate

Global Bookmark

Could the Renminbi Challenge the Dollar?

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Barry Eichengreen, Arnaud Mehl, and Livia Chiţu, *How Global Currencies Work: Past, Present and Future*, Princeton University Press, 2017

Eswar S. Prasad, *Gaining Currency: The Rise of the Renminbi*, Oxford University Press, 2016

Cynthia Roberts, Leslie Elliott Armijo, and Saori N. Katada, *The BRICS and Collective Financial Statecraft*, Oxford University Press, 2017

WASHINGTON, DC – "Follow the money," goes the saying. And, in fact, the money – that is, the changing roles of the renminbi and the US dollar – is perhaps the best way to understand the rise of China in a world dominated by the United States. Over the last ten years, the dominant economic story was about Chinese exports reshaping global trade. But the story of the next ten years could be about China's emerging role at the heart of global finance.

Renminbi usage has clearly been growing in recent years, owing to the impressive growth of the Chinese economy and efforts by Chinese financial officials to expand the currency's global footprint. China already settles a quarter of its own exports in renminbi, and has designated renminbi clearing banks and swap lines abroad, including in New York. South Korea, Poland, and Hungary have begun to issue renminbi-denominated sovereign debt. And even the tradition-bound Bundesbank has announced plans to include renminbi in its currency reserves.

To be sure, drug dealers in movies still seem to prefer suitcases full of dollars, not yuan; and global investors still pour into US Treasuries whenever they get the jitters.

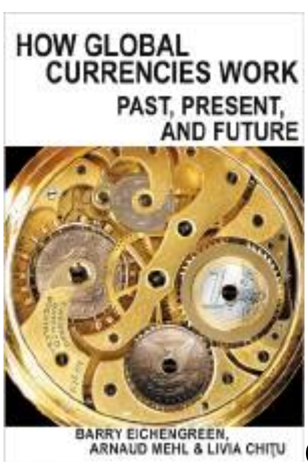
If you had to pick one bank in which to stow your life's savings for the next 25 years, it wouldn't be in China. Yet in the long run, political dysfunction and unpredictability in the US could start to undercut the dollar as the world's currency of last resort. "America First" may win votes, but it's not a particularly good slogan for selling bonds to foreign investors.

Still, as the three recent books reviewed here show, the ascent of the People's Currency (the literal translation of "renminbi") will depend on more than sustained GDP growth. China will have to pursue difficult economic reforms if the renminbi is to become a safe haven in times of crisis, rather than merely an instrument for trade and portfolio diversification. Even then, global investors might be wary of a currency that is backed by an authoritarian government with few checks on its leaders. There is a reason why even the nineteenth-century Rothschilds preferred lending to constitutional monarchies rather than fickle absolutist regimes.

By the same token, much will depend on China's foreign policy in the years ahead. China has too large a stake in the current global financial architecture to want to topple it. But Chinese leaders are clearly rankled by the dollar's overwhelming dominance and its power as a means of financial sanction. That means they will be looking for ways to create banking and payment alternatives that can attenuate America's post-war financial supremacy.

Looking Backwards

How Global Currencies Work, by Barry Eichengreen of the University of California, Berkeley, and European Central Bank economists Arnaud Mehl and Livia Chiţu, is an ambitious and fascinating analysis of the rise and fall of international currencies in the twentieth century. In addition to providing a detailed account of the past, the authors offer educated suggestions about what will happen in the coming decades, to demonstrate that when it comes to global currencies, nothing is inevitable.



One of the book's important contributions is to economic history. The authors have painstakingly filled many of the gaps in the conventional understanding of currency usage, particularly for the periods just before and after World War I. This extraordinary effort leads them to challenge what they call the “traditional view” about international currencies: namely, that network effects tend to protect a single currency in its dominant position.

As the authors point out, merchants and investors might opt for a currency because everyone else is using it, but that doesn’t mean the currency’s position is forever secure. After all, narrow spreads in foreign-exchange markets and widely available hedging products have made it much easier than in the past to move from one currency to another, just as Apple and Microsoft computer files eventually became interchangeable after years of PC domination.

In fact, America’s economy overtook Britain’s in 1870, but the sterling network, reinforced by the British Empire, remained dominant. The dollar emerged only in spite of these network effects, owing to the establishment of the US Federal Reserve System in 1913, and the elimination of restrictions against foreign bank branches in the US. By excluding the British Commonwealth’s artificially protected financial flows, Eichengreen, Mehl, and Chiţu show that dollar-denominated bonds overtook sterling as early as 1929.

But they also suggest that more than one dominant currency can co-exist comfortably, as the dollar and the pound did until the end of World War II, and as the dollar and the euro seem to do today. Moreover, they contend that a system of multiple dominant currencies might actually be more stable, because several issuers can share the burden of generating safe, liquid assets during crises.

Looking Ahead

So, what should we expect to see in the decades to come? One currency that may have lost its shot at dominance is the Japanese yen, owing to its particular history. In the early post-war period, Japanese authorities deliberately limited the yen’s circulation abroad, first to supercharge domestic capital investment, and later to manage the exchange rate. When Japan finally did try to internationalize the yen, its efforts were cut short by the economic downturn of the early 1990s, which turned into the “lost decade,” and then became the “lost quarter-century.” By the time Japan emerged from its extended malaise, it had stronger financial supervision and more open markets, but the renminbi had stolen the yen’s thunder.

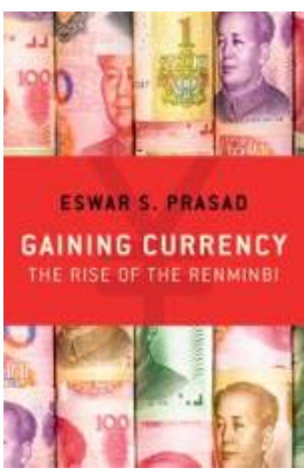
For its part, the European Union launched the euro in 1999 as part of a project to bind member states closer together and create an integrated market. At first, EU officials were of two minds about an international role for the euro, with Germany deeply suspicious of anything that might hamper anti-inflationary monetary policy. Yet the size of Europe’s economy and its strength as a global trade hub have made the euro second only to the dollar, even after the sovereign-debt crisis that began in 2009.

How Global Currencies Work suggests that the dollar’s continuing dominance is neither inevitable nor necessarily desirable. But that doesn't mean the renminbi will have an easy ascent. Although its use has expanded substantially in trade, bond issues, and sovereign reserves after just two decades of Chinese international economic engagement, China's unreliable or illiquid financial markets remain a major impediment.

China's leaders would do well to remember that the dollar did not emerge internationally until it had the support of a well-functioning, highly efficient financial system. More than merely avoiding internal economic crises, Chinese policymakers will need to pursue painstaking reforms to strengthen domestic debt markets; otherwise, China's economy will never be able to absorb massive global financial flows, as a true safe-haven currency must. At a minimum, this will require improvements to corporate governance and regulatory transparency, and better enforcement of the rule of law. But it also might necessitate more fundamental political change.

The Long Game

Of course, none of this needs to be settled quickly. And as Eswar S. Prasad of Cornell University demonstrates in *Gaining Currency: The Rise of the Renminbi*, China excels at the long game. Prasad's book is an excellent monetary history of China. He notes that the Chinese developed the first paper currency as early as the seventh century, thanks to their earlier inventions of both paper and the first moveable-type printing presses. When Marco Polo visited Kublai Khan in the thirteenth century, he discovered the wonders of what was probably the first fiat currency. The paper money of the Yuan Dynasty was backed by both the ruler's reputation and the threat of execution for any subject who refused to accept it as legal tender.



Today, the Communist Party of China (CPC) has imbued the renminbi with symbolic importance, and methodically pushed for its acceptance beyond China's borders. China's capital account is not formally open. But, as Prasad shows, the government has enacted various reforms – both *de jure* and *de facto* – to open capital flows gradually, while still giving authorities breathing room to strengthen domestic institutions and pursue financial-market reforms.

Prasad also offers a careful analysis of China's exchange-rate liberalization, a process that is often caricatured and misrepresented in US political debates. To be sure, China was clearly engaging in some form of protectionism in the years before 2005, when its exchange rate was fixed. But Prasad reminds us that China resisted the urge to weaken the renminbi in the wake of the 1997 Asian financial crisis, when all of its regional competitors were forced to devalue their own currencies.

The renminbi has since passed a significant milestone. In 2016, the International Monetary Fund agreed to include it among the major currencies that determine the value of its international reserve asset, the Special Drawing Right. That same year, China established the Asian Infrastructure Investment Bank, which allows it to lend outside the scope of the US-dominated Bretton Woods system, and in tandem with its massive Belt and Road Initiative to build infrastructure – and exert political influence – across Eurasia.

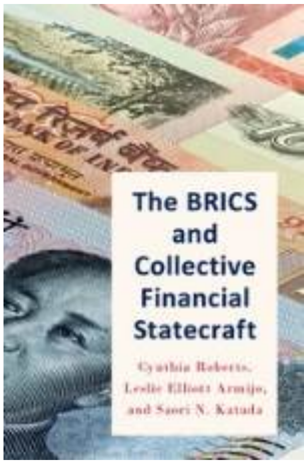
Prasad does not rule out the possibility of the renminbi achieving global-reserve status. He would agree that China's underdeveloped domestic financial markets could derail its ascent. But he points out that Chinese monetary authorities' careful management of the capital account and exchange rate could suffice to internationalize the currency, even if structural reforms and institutional reconfigurations prove more difficult.

Even if the renminbi does emerge as a new global reserve currency, however, Prasad doubts that it can displace the dollar as a financial safe haven. Central banks and sovereign wealth funds will hold renminbi if it reduces the volatility of their holdings, but global investors are not likely to rush into Chinese assets during times of crisis.

Unruly Upstarts

Whereas Prasad examines the renminbi's role in China's global political agenda, Cynthia Roberts of Hunter College, Leslie Elliott Armijo of Simon Fraser University, and Saori N. Katada of the University of Southern California view it from the perspective of China's relationship with the other BRICS countries: Brazil, Russia, India, and South Africa.

In *The BRICS and Collective Financial Statecraft*, the authors open a window onto the dynamics of financial diplomacy as seen from Moscow, São Paulo, New Delhi, and Pretoria. Given that the Chinese economy is twice the size of the other four BRICS combined, the reader should not be surprised to learn that policymakers in all of these capitals base their decisions largely on what is happening in Beijing.



The BRICS bloc emerged improbably from an acronym in a 2001 Goldman Sachs research report by Jim O'Neill. Improbably, because it comprises very different political economies, from Brazil and India's free-market democracies to Russia and China's centralized autocracies. South Africa, for its part, was added later, and brought still more diversity, though not much economic weight.

Despite their differences, the BRICS countries have held formal meetings since 2006, and found common ground in their resentment of Western – namely American – domination of global financial rules and institutions. If there is one thread that binds them together, it is that they are all "sovereignty hawks": they want to keep developed countries out of their internal affairs.

According to Roberts, Armijo, and Katada, the BRICS can claim some modest successes in the global financial system. They have spearheaded limited reforms within the World Bank and the IMF. They have come together to resist the widening use of financial sanctions, particularly by the US. And they have established nascent alternative institutions such as the New Development Bank and the BRICS Contingent Reserve Arrangement, which is meant to provide emergency liquidity to member states.

On occasion, the BRICS will put on a show of multilateralism to cloak what are in reality Chinese goals, not least internationalization of the renminbi and reforms to the Bretton Woods institutions. But on other occasions, BRICS countries, particularly Russia and India, have used the forum to moderate some of China's geopolitical ambitions.

The authors show that, at the end of the day, while the BRICS countries do not want to be too accommodating of the Western-led financial system, they have too much at stake to want to topple it. For China, this translates into a two-pronged agenda. It will modify existing geopolitical alignments and increase its own international influence within the current system when and where it can. At the same time, it will explore alternative payment systems and liquidity arrangements, just in case those prove useful at some point.

Brass Tacks

History shows that no single country or economy can remain dominant forever, and that change sometimes comes rapidly, such as when the dollar replaced sterling in the early twentieth century. But history also shows that the world can live comfortably with more than one dominant currency, which implies that the euro, the renminbi, or even the yen could share the stage with the dollar in the decades to come.

Whether the renminbi joins the global currency club will depend less on international institutions than on China's domestic policies. For the renminbi to become a true global currency, it needs the support of deep, liquid financial markets, which may take decades to develop, even if the Chinese economy continues to grow without interruption. And if Chinese assets are to become a trusted safe haven in times of crisis, the country will probably need to enact political reforms that go well beyond what the current CPC leadership envisions. Then, and only then, should you consider putting your retirement savings in a Chinese bank.

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Writing for PS since **2016**

11 Commentaries

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