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BUSINESS & ECONOMICS

# IF THE YUAN COMPETES WITH THE DOLLAR **CLASH OF THE CURRENCIES**

**The yuan's rise will challenge America, but not before  
China changes**

**W**HEN will the yuan rival the dollar? Many in China think it only a matter of time. Chen Yulu, a leading economist, says it will take 15 years. Wei Jianguo, deputy head of a major think-tank, puts it at 20. Officials are more circumspect: currency internationalisation will be a long process, its pace determined by the market, says Zhou Xiaochuan, the central-bank governor. Outside China, opinions are more divided.



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it will never get there.

What difference would it make if China's currency did vie with the dollar for global pre-eminence? Scholars have looked for clues in the transition from the pound to the dollar, but that took place around the middle of last century in a very different context. The dollar and the pound were both convertible into gold at fixed rates, making the leap of faith for those switching from one to the other much less of a risk. Today, reserve currencies are not backed by gold. Their value is more slippery—a function of supply and demand.

What is more, the shift from the pound to the dollar reflected a passage of economic power, one that had started many decades earlier, between two allies with shared democratic values and economic ideas. China's leaders talk of the yuan's internationalisation in peaceful terms. A more diverse monetary system will breed financial stability for the world, they say. But China's rise poses a bigger threat to America than America's did to Britain. For all the paeans to mutually



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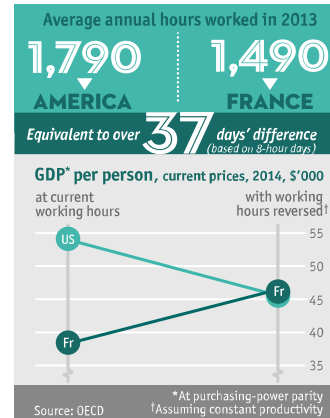
with a statist approach to the economy.

Some in China thus take a darker view of how competition between the yuan and the dollar will play out. Song Hongbing, author of “Currency Wars”, a conspiracy-laced series of books, foresees America fighting the yuan every step of the way. That has been shown to be wrong, so far. Over the past five years China has built a network for yuan-trading around the world, and America has not tried to thwart it. But a glimpse of the potential for conflict came last year when America tried, unsuccessfully, to persuade its allies to stay out of the Asian Infrastructure Investment Bank, launched by China. America is pushing for a Pacific trade deal that excludes China. And it is striking that among the many yuan-trading hubs established by China, from London to Singapore, the one glaring hole in the network is New York.

America has good reason to worry about the yuan. Its emergence as a credible alternative

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and North Korea have had bite because of the dollar's centrality to global finance. Some 45% of all cross-border transactions are denominated in dollars. So any bank with international business needs access to the American banking system, to clear payments or manage cash. And for that it needs an American licence, which means it had better heed the sanctions. China knows how potent this is. In 2013, after America hit North Korea's main foreign-exchange bank with sanctions, Bank of China stopped serving its North Korean client. In 2012, at the height of American pressure on Iran, China grudgingly cut imports of Iranian oil.

The dollar's political leverage will dissipate as the yuan goes global. China is already close to launching a system for processing cross-border yuan payments. Although described blandly as a platform for facilitating transactions, its consequences could over time be far-reaching. It will allow banks and companies to move money around the world on a financial superhighway



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using the China International Payment System (CIPS) and for what. The threat of exclusion from the American financial system will start to lose its force. And China would have a new tool to propagate its way of thinking. When heads of state meet the Dalai Lama, the Tibetan spiritual leader regarded by China as a separatist, they may find their banks placed on the CIPS blacklist. This tactic would damage the yuan's standing if used too liberally, but the mere threat of punishment might be enough for China to get its way.

A global yuan would also win China more respect. China has shown that it wants to be seen as a good citizen of the world at times of trouble. In 1997-98, during the Asian financial crisis, and in 2008-09, during the global one, it locked the yuan in place against the dollar. This reassured other countries that it would not use depreciation as a crutch for its economy. As international use of the yuan increases, China will be in a position to do more, by serving as backstop to the global



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## Yuan-upmanship

When Lehman Brothers collapsed in 2008, the Federal Reserve provided emergency swap lines to banks around the world. If a crisis hits in two decades' time, China could play a similar role. It is assembling the framework to lend such support by establishing currency swaps with many nations, from Argentina to Russia.

The economic consequences of the yuan's rise would be momentous. The “exorbitant privilege” that goes with being the issuer of the dominant currency would ebb for America. Because there is so much demand for dollar assets—more than 60% of all global central-bank reserves are held in dollars—America and companies based there can sell bonds for higher prices than they could otherwise. Since bond yields move inversely to prices, this means it costs less for Americans to borrow—so it is easier for the government to fund its deficits and for firms to raise money.

How much is this exorbitant privilege worth?

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percentage point lower in the early 2000s thanks to the dollar's status. America is also able to issue all its debt in dollars. The currency mismatch that often triggers debt crises in smaller economies is thus off the cards; the Federal Reserve can simply print more dollars to pay off the government's liabilities. The benefits add up to \$100 billion a year for America, estimates the McKinsey Global Institute.

But there are also downsides. Demand for the dollar as a reserve asset means the currency is stronger than it would otherwise be, making it harder for American exporters to compete. McKinsey found this lops as much as \$60 billion off GDP. Net, America still gains 0.3-0.5% of GDP a year thanks to the dollar's status.

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When the yuan rivals the dollar, China will eat into this pie. Investors from other



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would drive up American interest rates and weaken the economy. Researchers have shown that the Fed can mitigate but not fully counteract this effect by buying the bonds sold by foreigners. The upshot is that America would have to work harder to retain the confidence of global investors, perhaps leading it to rein in government debt.

But the changes required of China would be even more dramatic. In his account of how the dollar remained the world's pre-eminent currency despite being at the centre of the global financial crisis, Eswar Prasad, an economist at Cornell University, explains that its strength resides in America's institutions. Deep financial markets, a robust legal system and a generally transparent political process underpin the dollar. Faith in these make America and its currency a haven.

China would have to build a similar complement of institutions to persuade investors that the yuan is as reliable. It would need to make its currency truly convertible, stop intervening in its exchange rate and build





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they recently crashed shows how far China is from developing a mature financial system. China would also, like America, need proper rule of law. This would require allowing courts to go against the wishes of the Communist Party, something unthinkable for now. And through all this, China needs to keep its economy marching forward. Stagnation would undermine the yuan's appeal.

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United States Britain China

## 1820-1913

### America's economic surge

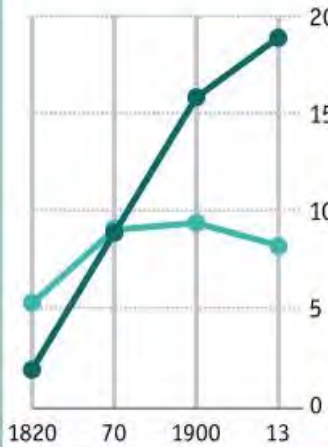
US economy takes off, yet the pound remains the world's dominant currency

## 1913

### Founding of the Federal Reserve

The central bank's formation makes the dollar a viable currency for global trade

Share of world GDP, %



## 1950-60

### The dollar takes control

Share of currencies in globally disclosed foreign-exchange reserves, %



## 1978-79

### China begins economic reforms



## 1995-2014

### China trades its way to power

Merchandise exports, as % of world total



## 2015-2030

### ...the next chapter?

China passes America as the biggest economy and overhauls its market structure. The yuan starts to rival the dollar





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could in theory engender greater economic stability. America and China might compete to make their respective currencies more attractive by demonstrating sound fiscal and monetary policies. The exorbitant privilege would become an extraordinary responsibility. But there would also be new risks — “more room for friction and accidents”, says Alan Wheatley, editor of a recent book about reserve currencies. With the dollar’s status in doubt, there might be damaging uncertainty about where to turn for a safe harbour when the next financial tsunami strikes.

How likely is any of this to happen? The dollar has a huge incumbent’s advantage. Political gridlock in Washington risks chipping away at that, as might excessive use of the sanctions that reserve-currency status allows America. Much will depend on Chinese policy. The key is to make China’s financial system as deep, open and trusted as America’s. That is a long-term project, but China can speed things up a little with



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bond market.

China's record over the past five years, when it began to promote yuan internationalisation, is impressive. The share of Chinese cross-border trade settled in yuan rose from nothing in 2009 to 22% last year. It is now the fifth-most-used currency for international payments. The IMF is debating whether to adjust its special drawing right, a basket of reserve currencies, to include the yuan. Still, this is a far cry from its rivalling the dollar. Some 50 central banks have invested reserves in yuan, but only in small amounts. Foreigners hold \$200 billion in Chinese stocks and bonds; they have 80 times more—\$16 trillion—in American securities. For now, the yuan is a bit player on the global stage. But at the start of the 20th century, so was the dollar.

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