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China and the dollar

Yuan small step

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The dollar's role as the world's main reserve currency is being challenged

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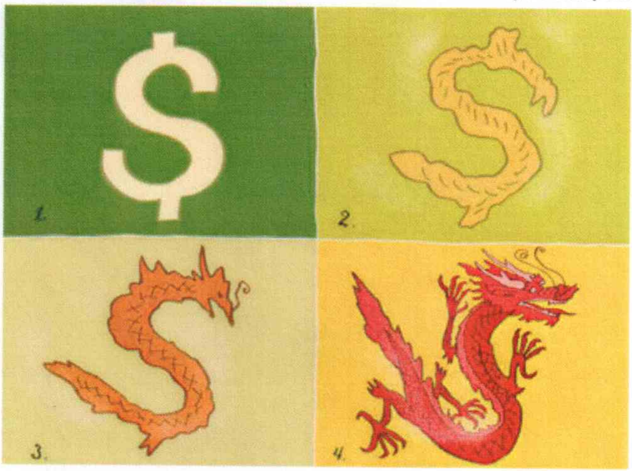

THE Chinese used to call dollars *mei jin*, which means "American gold". Buying black-market dollars was considered the safest way to protect one's savings. Yet in June when Tim Geithner, America's treasury secretary, told students at Peking University that China's official holdings of Treasury bonds were safe, the audience laughed. Faith in the greenback is waning.

In the build-up to the annual summit of G8 countries, which began on July 8th in the Italian city of L'Aquila, officials in China, Russia and India all called for an end to the dollar's dominance in the international monetary system. Dmitry Medvedev, Russia's president, declared on July 5th that the dollar system is "flawed"; his central bank has been reducing its dollar holdings. The People's Bank of China (PBOC), China's central bank, repeated its call for a new global reserve currency in June and is now taking the first steps towards turning the yuan into a global currency.

Beijing is particularly influential in this debate. The dollar accounts for 65% of the world's foreign-exchange reserves (see chart), only slightly less than a decade ago and well ahead of the euro's 26% share. Three-quarters of all reserves are in the hands of emerging economies; China alone holds one-third of the global stash.

So China has particular cause to worry that America's massive printing of money in response to the financial crisis will undermine the value of its dollar reserves. There is much domestic anger about the potential losses China may face as a result of its lending to rich Americans. The government would like to diversify out of dollars: its new purchases of Treasury securities have fallen sharply this year. But any attempt to dump its stock of dollars would risk triggering a plunge in the currency. Instead, officials are mulling two ways out of the "dollar trap": persuading the world to adopt a new global currency and encouraging the international use of the yuan.

In an essay in March, Zhou Xiaochuan, the governor of the PBOC, argued that basing the international financial system on a national currency will tend to exacerbate global imbalances. The dollar's reserve-currency status let America borrow cheaply, causing the country's credit and housing bubbles to persist for longer than they otherwise would have. Mr Zhou proposed that the world should replace the dollar with a global reserve currency, the SDR (Special Drawing Rights). Created by the IMF in 1969, and now based on the weighted average of the dollar, euro, yen and pound, the SDR was designed as a reserve currency but never took off. SDRs today add up to less than 1% of total reserves.

Under Mr Zhou's plan the amount of SDRs would be hugely increased and the basket expanded to include other currencies, notably the yuan. Mr Zhou also proposes an SDR-denominated fund, managed by the IMF, into which dollar reserves could be exchanged for SDRs. Countries could then reduce their dollar exposure without pushing down the dollar (although it is unclear who would bear any exchange-rate losses).

Brazil, India and Russia have backed Mr Zhou's proposal. But the SDR is unlikely to become a reserve currency any time soon. It would take years to develop SDR money markets that are liquid enough to be a reserve asset. Although the IMF's executive board approved the first issuance of SDR-denominated bonds on July 1st, as the fund attempts to boost its resources, the bonds can only be bought and traded by central banks, not by private investors.

China's alternative ploy is to promote the yuan's use in international trade and finance. Starting on July 6th selected firms in five Chinese cities are now allowed to use yuan to settle transactions with businesses in Hong Kong, Macau and ASEAN countries. Foreign banks will be able to buy or borrow yuan from mainland lenders to finance such trade. In June Russia and China agreed to expand the use of their currencies in bilateral trade; Brazil and China are discussing a similar idea.

The PBOC has also signed currency-swap agreements with Argentina, Belarus, Hong Kong, Indonesia, Malaysia and South Korea. The central bank will make yuan available to pay for imports from China if these countries are short of foreign exchange. In another recent move, Hong Kong banks are now allowed to issue yuan-denominated bonds, a step towards building an offshore yuan market.

Qu Hongbin, an economist at HSBC, predicts that by 2012 nearly $2 trillion of annual trade (over 40% of China's total) could be settled in yuan, making it one of the top three currencies in global trade. Others reckon this is too optimistic. Although Chinese firms are keen to invoice in yuan, trading partners will be more reluctant. There is no real forward market for the yuan, making it hard to hedge risk, and it is not accepted by most other countries.

The yuan will be used more widely for trade over the next decade but the idea that the yuan can become a reserve currency in the near future is ridiculous, says Arthur Kroeber at Dragonomics, a research firm based in Beijing. Not only does China lack the economic and political track record required to underpin a reserve currency, but its currency is not fully convertible. China would need to scrap capital controls so foreigners could invest in yuan assets and then freely repatriate their capital and income, but the government is wary of moving too quickly. A reserve currency also requires a deep and liquid bond market, free from government interference. This, says Mr Kroeber, implies a big retreat from China's state-led model of credit allocation.

Even if China immediately scrapped capital controls the yuan would be unlikely to challenge the dollar as a reserve currency for years. The dollar did not replace sterling until half a century after America's economy had overtaken Britain's. America's GDP is around three times as big as China's, and its total trade is still larger.

Both the SDR plan and measures to internationalise the yuan also seem to assume that China's problem is simply that too many of its reserves are in dollars. But China's real problem is that it is running a persistent current-account surplus; in order to keep the yuan closely tied to the dollar it has to keep buying more dollar assets. If China really wants to reduce its exposure to the greenback it must allow the yuan to rise. It would incur a loss on its existing reserves but stem future losses. But so long as China maintains its current exchange-rate policy, it is, ironically, helping keep the dollar dominant.