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Abstract:
The U.S. dollar has dominated the international monetary system since the end of World War II. While the U.S. economy has generated weak growth since 2009, and accumulated a large sovereign debt, the dollar's status as an international medium of exchange and reserve currency has not diminished. The Chinese renminbi (RMB), however, barely visible in international trade or financial flows just three years ago, appears to be blossoming. China is now the world's largest trading nation, and more corporations, particularly in Asia, are beginning to invoice their business in RMB. The Chinese regime is calling for a reform of the international monetary system to expand the internationalization of the RMB. Speculation has begun about whether the U.S. dollar could be supplanted by the RMB. Such a development would jeopardize the enormous economic advantages that the U.S. has enjoyed by possessing the world's dominant currency. Moreover, it would signal a relative decline in American prestige and global leadership. The answer to the dollar's potential decline is not to seek obstacles to China's or any other nation's economic success, but to change fiscal and monetary policies at home in order to maintain the dollar's competitiveness.

The U.S. dollar has dominated the international monetary system for approximately 70 years. While the U.S. economy has generated weak growth over the past six years and accumulated a large sovereign debt, the dollar's status as an international medium of exchange and reserve currency (currency held by foreign central banks) has defied the odds and has not diminished.

On the other hand, the Chinese renminbi (RMB),[1] barely visible in international trade or financial flows just three years ago, appears to be blossoming. China is now the world's largest trading nation, and more corporations, particularly in Asia, are beginning to invoice their business in RMB. The Chinese authorities are calling for a reform of the international monetary system to expand the internationalization of the RMB, and have recently created a number of international and regional financial institutions, which, if successful, could significantly expand the use of it.

This contrast of recent years has led many to speculate that the U.S. dollar could be supplanted by the RMB. Such a development would jeopardize the enormous economic advantages that the U.S. has enjoyed by virtue of possessing the world's dominant reserve currency. Moreover, it would signal a relative decline in American prestige and global leadership.

Indeed, the dollar's reserve status has its challenges. But if it loses its status, it will not likely be the RMB that replaces it. The RMB's rise has been greatly exaggerated, and its current presence in global trade settlement and central bank reserves is still minuscule. At any rate, the answer to the dollar's potential decline is not to seek obstacles to China's or any other nation's economic success, but to change fiscal and monetary policies at home in order to maintain the dollar's competitiveness.

The Renminbi's Emergence on the Global Stage

While there have been a large number of factors propagating the use of the RMB in recent years, China's status as a trading giant is the most significant. China's share of world exports has risen from 3.9 percent in 2000 to 12.4 percent in 2014.[2] China surpassed the United States as the world's largest trading nation in 2013, a position the U.S. had held for six decades. China is now the world's largest exporter and the second-largest importer after the United States. China is now the largest trader among approximately 75 economies in the world.

Almost nonexistent 10 years ago, the Chinese bond market is now the world's third largest. Much of this expansion has consisted of the growth in the corporate bond market.

In December 2014, the RMB surpassed the Canadian and Australian dollars to become the world's fifth-most-used currency for trade settlement.[3] According to Deutsche Bank, in 2013, 17 percent of China's trade was settled in RMB, up from almost nothing in 2009.

Chinese outbound foreign direct investment (FDI) is also increasing the use of RMB because it is the predominant settlement currency for Chinese investment abroad. According to The Heritage Foundation and American Enterprise Institute's China Global Investment Tracker, Chinese outbound FDI increased from just $10.1 billion in 2005 to $86.3 billion in 2013.[4] China is already the world's sixth-largest outbound FDI investor, and this figure is expected to grow steadily in the coming years as part of China's "going out" strategy.

In the attempt to bypass the U.S. dollar as a medium of exchange, since 2009 China has signed currency-swap agreements with Indonesia, Argentina, Malaysia, Hong Kong, Singapore, South Korea, New Zealand, and the United Arab Emirates, among others.

There are no official aggregate records of central bank holdings of RMBs, in part, because they constitute a very small fraction of global reserves. However, more countries have recently begun to include RMB assets in their official reserves. For example, the Azerbaijan State Oil Fund, known as Sofaz, plans to invest $500 million in yuan (RMB) assets this year.[5] The Reserve Bank of Australia plans to put 5 percent of its reserves in RMB bonds, and Nigeria's central bank currently holds about 10 percent of its assets in the currency. In 2012, the Bank of Japan announced its acquisition of roughly RMB65 billion worth of Chinese government bonds, and in September 2014, the British government decided to issue RMB-denominated bonds.[6]

China's size is giving it more influence in international institutions. Several years ago, Beijing made a $43 billion contribution to help recapitalize the International Monetary Fund (IMF). China is also getting closer to being included in the weightings of the IMF's special drawing rights (SDR)—a form of international reserve asset defined as a weighted average of four major currencies. In late 2014, China was the force behind forming the New Development Bank, an international financial institution founded by the BRICS countries—Brazil, Russia, India, China, and South Africa. The bank, in particular its IMF-like liquidity-support function, is still in development. If fully realized, the bank (along with inclusion in the SDR basket of currencies) should give Chinese financial institutions greater access to the world's large international financial transactions.

Hong Kong has been the major driving force in the internationalization of the RMB. Hong Kong has been the center of the "dim sum" bond market, which are bonds issued outside China but denominated in RMB. McDonald's became the first nonfinancial multinational corporation to issue "dim sum bonds" to fund its investments in China. Construction-equipment giant Caterpillar was quick to follow.[7]

Almost nonexistent 10 years ago, the Chinese bond market is now the world's third largest at about RMB36 trillion (about $5.8 trillion). Much of this expansion has consisted of the growth in the corporate bond market.[8]

Formed last year, the Shanghai-Hong Kong Stock Connect allows foreign investors to buy mainland stocks from Hong Kong, and mainland investors to buy foreign stocks through the Hong Kong exchange. If successful, the exchange should increase the global demand for RMBs.

According to John Tsang, Hong Kong's current finance minister, at the end of July 2014, Hong Kong's RMB liquidity pool amounted to more than 1.1 trillion yuan.[9] That is 3.5 times more than the level at the end of 2010. Last year, banks in Hong Kong handled RMB trade settlement totaling 3.8 trillion yuan—10 times that in 2010.

The Advantages of a Reserve Currency

It was Charles de Gaulle who first complained publicly about the power of America's reserve currency. It is now the BRICS countries who are trying to reform the international monetary system to "dethrone" the dollar. The benefits of an international reserve currency include:

- **Seigniorage**—the difference between the face value of money and its production cost. It is perhaps the least understood advantage, but one that provides the largest monetary gain. It currently costs 12.5 cents to print a $100 bill. That bill, however, can be used to purchase real goods and services worth $100 in the market. What this means at the policy level is that the Federal Reserve can essentially print money to buy real assets, as it has done with its quantitative easing policies.

- **Low interest rates.** The reserve-currency countries have the ability to run up fiscal debts denominated in their own currency at relatively low interest rates.

- **Convenience.** It is more convenient for a country's exporters, importers, borrowers, and lenders to be able to deal in the country's own currency than in foreign currencies. Doing so reduces transaction costs as well as foreign exchange risk.

- **More business for banks and other financial institutions.** It stands to reason that U.S. banks have a comparative advantage in dealing in dollars, and Chinese banks in dealing with RMB.

- **Political power and prestige.** Britain's gradual loss of reserve currency status coincided with its gradual loss of political and military preeminence.[10]

The Chinese authorities have been increasingly pushing for the internationalization of the RMB (and eventual reserve-currency status) because they realize it can provide enormous economic benefits:

- As residents of the largest trader in the world, there would be great advantages for Chinese firms to limit their foreign exchange exposures and reduce transaction costs if they are able to transact internationally in their own currency.

- The People's Bank of China could have an independent monetary policy (allowing its exchange rate to adjust), permitting monetary policy to adjust to domestic conditions.

- The Chinese government as well as private-sector financial institutions would enjoy lower borrowing costs without exchange-rate risk because they would be able to issue domestic-currency-denominated bonds.[11]

- If large countries issue RMB-denominated bonds, Chinese authorities can hold those bonds without exchange-rate risk. This would represent a significant improvement over holding dollar-denominated U.S. government bonds that may lose value if the RMB appreciates against the U.S. dollar.[12]

- Another reason some have cited in favor of pursuing RMB internationalization is that the process provides an opportunity for "reform by stealth." Observers have argued that RMB internationalization is not an end goal for China's leaders, but provides a convenient pretext and motivation to pursue financial liberalization and market reforms.

The Disadvantages of a Reserve Currency

There are a number of downsides to establishing and maintaining a reserve currency that may give the Chinese pause. These include:

- Using a domestic currency as an international reserve currency requires expanding the supply of currency abroad, usually by running large trade deficits.

- Internationalization can lead to larger fluctuations in the demand for the reserve currency. As a consequence, central banks are naturally concerned that a reserve currency will make it more difficult to control the domestic money supply.

- A reserve currency allows a country to borrow at lower interest rates—which reduces pressure on fiscal discipline, as has been apparent in the United States.

- Reserve currency status increases the global demand for a country's currency, leading to exchange-rate appreciation, an element contributing to the cost of exports.

- Achieving reserve currency status puts pressure on the central bank to take the effects of its actions on world markets into account, rather than focusing exclusively on domestic objectives. Federal Reserve chairs Ben Bernanke (former) and Janet Yellen (current), for example, faced pressure from developing countries over the possible impact of tighter U.S. monetary policy on their own economies.

The Attributes of a Global Reserve Currency

There are a number of critical factors to be met for a particular currency to achieve global currency reserve status. First, the size of a country is paramount, as measured by either gross domestic product (GDP) or trade. The second is the degree of confidence in the value of the currency as measured by the long-term trend of its exchange rate. This is largely a function of the long-term rate of inflation and the issuing country's position as an international creditor (or debtor).[13] In the early stages of becoming a reserve currency, a trade surplus is necessary since it is the only way foreign residents may need the currency. Usually, a trade surplus leads to that country becoming a net creditor. Third, and no less important, is the size, depth, and openness of the country's financial markets, including the bond, equity, foreign exchange, and derivative markets.

Some additional conditions must be met before a currency can obtain reserve status. In addition to winning the confidence of foreign residents as an excellent store of value, it must provide enough liquidity to meet international demand for trade settlement. That is, a sound currency outflow mechanism is crucial in the process of currency internationalization. China may have to do what the United States has done these past three decades: provide the world with liquidity through a current account deficit. For China, this implies turning its current account surplus into a deficit.[14]

As mentioned, China has witnessed an enormous surge in outbound direct investment in recent years. In fact, outbound direct investment is expected to exceed inbound direct investment as early as this year. This would reduce China's need to run a trade deficit (or smaller trade surplus) as a means to increase the availability of RMB abroad.

The Rise of the U.S. Dollar

How did the dollar become the world's reserve currency, and at what rapidity? An analysis of this sequence may provide a clue to the RMB's potential for reserve status in the future.

At the beginning of the 20th century, the British pound was the dominant reserve currency in the world. Historians estimate that approximately 60 percent of the world's trade was invoiced in sterling in the late 19th century. In 1899, the share of pounds in known foreign exchange holdings of official institutions was almost two-thirds, more than twice the total of the next nearest competitors, the French franc and German mark.[15]

At the outbreak of the First World War in 1914, the dollar, like the renminbi today, played an inconsequential role in international trade settlements despite the fact that the United States was the largest trading nation. The dollar also played a minor role as a currency in which to denominate international bonds, even though the U.S. turned from capital importer to capital exporter after 1890.

Prior to 1913, the dollar's lack of status was not due to the size of the U.S. economy, which had surpassed Great Britain's by 1872. Rather, the country lacked financial markets that were deep, liquid, dependable, and open.[16] The U.S. also lacked a central bank to act as a lender of last resort.

The conventional wisdom is that it took the dollar a very long time to dethrone the British pound after the U.S. became the largest economy, trader, and a net creditor. It is widely believed that the dollar did not supplant sterling until shortly after World War II. This would put the time lag between obtaining strong fundamentals for internationalization and actually becoming the world's dominant reserve currency between 60 years and 80 years. The inertia is said to result from the network externalities that are intrinsic to the choice of currency just as they are in the choice of language. One decides to use the dollar for the same reason that one decides to learn English: Everyone else has done it.

The conventional wisdom, however, does not match reality. According to economist Barry Eichengreen,

> In a span of just ten years, between 1914 and 1924, the dollar surpassed sterling as the leading global reserve currency. More trade was invoiced and financed in dollars than in sterling. More international bonds were denominated in dollars and floated in New York than were denominated in sterling and floated in London. A larger share of global foreign exchange reserves was in dollars than in sterling. The dollar thus moved from a position of negligible importance in the international sphere to become [if not yet the dominant currency, as it would after World War II,] the leading international and reserve currency in a span of just ten years.[17]

How could this shift occur so quickly? The catalyst for this metamorphosis was World War I. During the war, as the U.S. was becoming the world's ordnance factory, it was extending expansive credit to Great Britain and other allies. This lending quickly reversed the creditor-debtor relationship and greatly strengthened the demand for dollars. As Great Britain fell into debtor status, the world's financial capital moved from London to New York. In short, it was World War I that started the rapid internationalization of the dollar.

The United States took concerted steps to internationalize the dollar, authorizing private financial institutions to branch out abroad and creating a central bank to act as market maker and provide liquidity to the market in securitized trade credits. There was also the argument that internationalizing the dollar would enable New York and U.S. banks to secure a larger share of the available international financial business.[18]

U.S. Dollar Still Dominates. By most macroeconomic indicators, the dollar's status as the dominant reserve currency should be in serious jeopardy. The U.S. government's gross debt is now approximately 100 percent of GDP. Future unfunded liabilities from entitlement spending are approaching \$100 trillion.[19] The aggressive use of unconventional monetary policy has swollen the central bank's balance sheet from \$900 billion in 2007 to \$4.5 trillion in 2015 and greatly expanded the monetary base. The U.S. economy has grown below 3 percent for nine consecutive years, an unprecedented period of subpar growth.[20]

The dollar's greatest asset is the size, depth, and openness of America's financial markets, including the bond, equity, foreign exchange, and derivative markets.

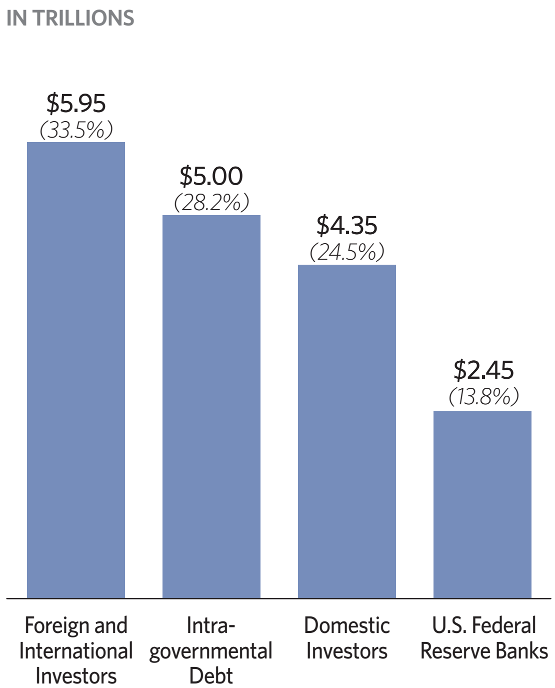
All these factors should have weakened the dollar's reserve currency appeal, but nothing can be further from the truth. In fact, foreigners have sharply increased their holdings of U.S. financial assets. Since the end of 2006, foreign investors have purchased \$3.5 trillion in Treasury securities. They now hold \$6 trillion in U.S. government securities, up from \$1 trillion in 2000. The private share of government debt (that which is not owned by the U.S. government) now stands at 56 percent. In some respects, then, the dollar's role as the dominant reserve currency has strengthened since the Great Recession.[21]

The dollar's greatest asset is the size, depth, and openness of America's financial markets, including the bond, equity, foreign exchange, and derivative markets. Jonathan Anderson of Emerging Advisors Group calculates that global investors have access to \$55 trillion worth of American assets, including bonds and stocks. They can also get their hands on \$29 trillion worth of euro-denominated assets and \$17 trillion of yen-denominated assets. But when it comes to Chinese assets, just \$0.3 trillion or so are open to foreign investors. This puts the RMB on a par with the Philippine peso, notes Anderson.

There was no decline in dollar holdings in the years after the recession, and they currently account for 61 percent of global reserve holdings. The U.S.

CHART 1

Diversity of U.S. Financial Market



Source: U.S. Department of the Treasury, Bureau of Fiscal Service, "Ownership of Federal Securities," September 2014. http://www.fiscal.treasury.gov/fsreports/rpt/treasBulletin/current.htm (accessed June 1, 2015); USgovernmentdebt.us, "US National Debt and Deficit History," http://www.usgovernmentdebt.us/debt_deficit_history (accessed June 1, 2015).

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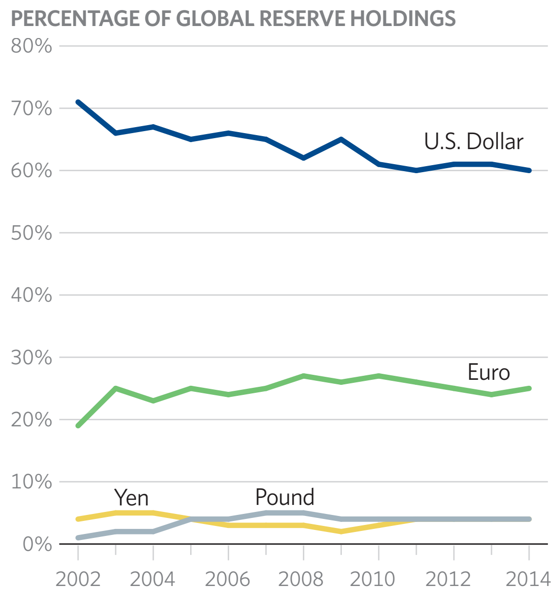
CHART 2

U.S. Dollar Dominates Global Currencies

Of the $11.7 trillion in assets held by central banks and sovereign wealth funds internationally, the majority of the declared holdings are in U.S. dollars.



Source: International Money Fund, "Currency Composition of Official Foreign Exchange Reserves (COFER)," http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf (accessed May 28, 2015).

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dollar is used in 87 percent of all foreign exchange transactions in foreign exchange markets that exceed $5 trillion per day.[22]

Currently, U.S. dollar holdings dwarf those of the Chinese RMB. According to the IMF, in 2012, central banks and sovereign wealth funds held $11.7 trillion in assets. According to Standard Chartered, the large majority of declared holdings are in dollars and euros, with only RMB300 billion ($48 billion), less than 0.5 percent of total reserves.[23]

With the U.S. relative economic decline and debt accumulation over the past two decades, how has the dollar maintained its global hegemony? It cannot be explained by trade alone. Unlike in China, dollar credit in financing and settling international trade far exceeds the U.S. share of international trade. The primary reason can be attributed to the unparalleled breadth and depth of the U.S. financial markets. For over half a century, U.S. Treasury bills and bonds have provided a unique combination of safety and liquidity unmatched by any other country. Paradoxically, America's growing debt, at least until now, has enhanced rather than weakened the dollar's reserve status because its size has provided the only safe vehicle for global savings.

The U.S. military umbrella has also bolstered the political stability and security environments of countries with large dollar holdings, such as Saudi Arabia, Qatar, South Korea, Japan, and the United Arab Emirates. In fact, America's role as security guarantor in the Pacific has also served as the necessary backdrop for China's economic rise and emergence as a principal buyer of U.S. government bonds.

America's democratic institutions also give the dollar an advantage over the RMB. Beijing's bureaucrats are not as transparent or as accountable to the financial markets as Washington's politicians.

Last, but certainly not least, with foreign central banks and financial institutions holding enormous volumes of U.S. Treasury securities (the Chinese and the Japanese currently hold approximately $1.2 trillion and $1.3 trillion, respectively), they have a strong incentive to keep the value of the dollar from collapsing.

Lessons from the Japanese Yen

After the collapse of the Bretton Woods regime in the early 1970s, there was clearly an opportunity for the Japanese yen to become a global reserve currency. Economic growth was one of the strongest in the world, inflation was low, the current account ran a large and consistent surplus, and the yen appreciated significantly against the U.S. dollar during much of the post-war period. By the 1980s, as the world's second-largest economy, Japan seemed to satisfy the attributes of owning a global reserve currency.

The yen, however, failed to ever reach mid-single digits of global foreign exchange reserves during the post-war period. The question is why, given its economic fundamentals. In 1990, the yen was the trade settlement currency of 14.5 percent and 37.5 percent of Japan's import and export trades, respectively. The lesson might be instructive to the time path and prospects of the internationalization of the RMB.

There are two distinct reasons why the yen failed to challenge the U.S. dollar. First, during the 1970s, Japan was reluctant to liberalize its domestic financial markets and capital controls for fear of excessive capital inflows or outflows. The central bank of Japan was also concerned about the destabilizing consequences of capital inflows and the reduced control over monetary policy. Second, the Japanese economy fell into a protracted stagnation in the early 1990s, which continues to this day. Reflecting its economic decline, Japan's share of global exports has declined from 6.1 percent in 1990 to 1.2 percent in 2013. Today, the yen's share of global currency reserves is approximately 3 percent.

RMB Potential. Since 2009, the Chinese authorities have gradually initiated a process of internationalizing the RMB. The probability that China will succeed in promoting the RMB to at least regional reserve currency status is significantly higher than it was for Japan.

First, China's economy is larger, having overtaken Japan's in size in 2010. It is likely to be significantly bigger by the end of this decade. China is the world's largest trading nation, having surpassed the U.S. in 2013. It is the world's largest exporter and second-largest importer.

Second, despite developing nation status, China is already promoting internationalization, whereas Japan was reluctant when it was roughly at the same stage of economic development in the early 1970s.[24]

> Internationalization of the RMB may have more success regionally than globally. After all, the euro does not seem to have challenged the dollar's reserve status.

In recent years, there has been a rapid trend of Asian neighbors linking their currencies to the Chinese RMB to manage their exchange rates. This is a natural consequence of China becoming the top trading partner for many Asian countries. Increasingly, many Asian countries now possess RMB assets to limit the volatility of their currencies with respect to the RMB.

Greater use of the RMB in the future is possible given the recent establishment of the New Development Bank (NDB), the Asian Infrastructure Investment Bank (AIIB), and the "One Belt, One Road" initiative. The NDB was set up as an alternative to the World Bank and IMF to foster greater economic development and financial cooperation among the five BRICS countries. It will be headquartered in Shanghai. The AIIB is being established, largely with China's backing and capital, to support regional infrastructure projects in Asia. It will likely be headquartered in Beijing. One Belt, One Road refers to a vision encompassing two massive economic infrastructure initiatives linking Asia, Africa, and Europe, one by sea, one by land.

Changing global trade patterns also opens doors for RMB internationalization. Over the past 10 years, the global share of emerging economies in exports increased from 34.2 percent in 2000 to 49 percent in 2012, and their import share increased from 30.3

percent in 2000 to 44.8 percent in 2012.[25] In order to avoid the exchange rate risk of major international currencies, such as the dollar, the euro, and the yen, the RMB will be in huge demand in the settlements of trade between China and other emerging economies. This diversification of trade should help promote the process of RMB internationalization.

However, internationalization of the RMB may have more success regionally than globally. After all, the euro does not seem to have challenged the dollar's reserve status. Rather, it has remained a strong regional international currency. The RMB may likewise achieve a regional international status within Asia, but not upset the dollar globally.

The commodity sector also has the potential to spur the internationalization of the RMB. China is the largest commodity importer in the world. Nearly one-third of China's imports are commodities, and iron ore, coal, crude oil, and soy beans together make up to almost 20 percent of that third. Almost all global commodity trade is currently denominated in dollars, so even a modest redenomination of China's commodity trade into RMB would substantially boost RMB trade.[26]

U.S. Treasury bonds are the most liquid assets in the world, which is one of the prime reasons the dollar is the world's leading reserve asset.

Lastly, there is a large impression among economists that, over time, the RMB will appreciate against the dollar as it approaches the purchasing-power-parity value of the U.S. economy. Since global traders and investors are concerned about returns, this would increase the demand for RMB denominated assets.

RMB Obstacles. Despite the recent growth and potential for internationalization of the RMB, it faces enormous obstacles in obtaining international reserve status or replacing the dollar as the dominant global reserve currency. As of today, the RMB's presence on international financial markets remains minimal.

While more U.S. corporations are switching to using the RMB to pay for imports from China, the absolute size of RMB settlement between the U.S. and China is far less impressive than the growth rate. Just 2.4 percent of payments between the U.S. and China/Hong Kong were settled in RMB in April of 2014, up from 0.7 percent in April 2013.[27]

According to the Bank for International Settlements, the RMB accounts for less than 1 percent of average daily turnover in global currency markets. International-payments system SWIFT[28] reported that the RMB was used in only 0.3 percent of global payments. The overall value of approved Qualified Financial International Institutions (foreign institutional funds) accounts for only 0.8 percent of total market capitalization in China.

As mentioned, while China's fixed-income market is now the third-largest in the world, it is a fraction of the size of the United States'. The sum of the bonds issued by corporate, financial, and government entities in the U.S., by comparison, exceeds $25 trillion.[29] Moreover, the majority of Chinese bonds are held to maturity by domestic investors, which reduces their liquidity and their value to central banks. U.S. Treasury bonds, on the other hand, are the most liquid assets in the world, which is one of the prime reasons the dollar is the world's leading reserve asset.

China's achieving global reserve currency status will require a complete overhaul of its current economic model. A comprehensive liberalization of China's financial markets is necessary to develop sufficient liquidity—essentially the ease of moving funds. In The Heritage Foundation/*Wall Street Journal 2015 Index of Economic Freedom*,[30] China ranks a dismal 131st place of 178 in financial freedom. China will also have to add depth to its capital markets—creating many more options for investment—by issuing government bonds of various maturities. This is essential because government bonds are benchmark safe (risk-free) assets, and many financial entities require the possession of safe and liquid assets. Other fixed-income securities, such as corporate and mortgage-backed bonds, cannot be priced properly without the benchmark of safe assets. Government bonds at various maturities promote corporate bond markets, which in turn are crucial to preventing overreliance on the banking system—a common feature of Asian financial systems.[31]

Because China's financial markets still lack sufficient depth and liquidity, complete internationalization of the RMB—and therefore, reserve status—is not a realistic scenario in the near future.

Protection of the banking sector has stifled broader financial market development. Total domestic credit provided by the banking sector has consistently been larger than the size of the equity and bond markets combined. Developing more robust domestic bond and equity markets will be necessary before the RMB can become widely used. The Chinese government should also reduce its share in the ownership of commercial banks, which it currently dominates.

Interest rates also have to be fully deregulated. Currently, deposit and lending rates are set by the state. Interest rates set by the market would reflect economic realities and would decrease the probability of future insolvencies in the banking system and reduce capital flight out of RMB-denominated assets.

Every reserve currency in modern history has been the currency of a liberal democracy.

Opening up China's financial market to foreign financial institutions is also a necessity for the internationalization of the RMB. Foreign financial firms are still largely blocked out of the Chinese market, which inhibits the trade flows of the RMB. Relative to foreign financial institutions, Chinese banks are generally viewed as inefficient and unprofessional. Opening up the financial sector to foreign competition would eventually improve their financial performance and increase global demand for RMB.

China's domestic financial market is still at a rudimentary stage of development, and the capital account is still tightly controlled, restricting the amount of RMB that can circulate freely across borders. The RMB cannot become a reserve currency until capital controls are completely lifted. Before lifting capital controls, however, domestic markets must be deepened and banks would have to be placed on a purely commercial footing. Otherwise, capital flows that may be large compared with China's current domestic market size could upset monetary policy or systemic stability. To accommodate the volatility of capital flows, exchange rate flexibility will also have to be enhanced.

Political considerations could also likely hold back the use of the RMB as a reserve currency given that every reserve currency in modern history has been the currency of a liberal democracy. Rule of law assures investors that they are safe from asset expropriation. Expropriation has been employed in Russia in recent years, which is essentially a one-party state. China's one-party state will remain an obstacle for RMB internationalization.

Equally critical is the fact that despite China's rapid growth over three decades, there remains a large disparity in competitiveness and economic freedom between them and the international currency-issuing countries. In the *2015 Index of Economic Freedom*, China is ranked 139, below Pakistan and Bangladesh. Foreign manufacturers operating in China have almost no Chinese competitors, so there is no need to use the RMB for pricing.

While China is the world's largest trading nation, its individual enterprises are surprisingly small, with low industry concentration. More than 75 percent of China's export enterprises are small businesses.[32] They also lack indigenous innovation and strong company brands. Such a trade structure weakens China's power in business-to-business transactions with large multinationals. It is a correlation of factors that favors the use of the dollar, and retards the internationalization of the RMB.

The Dollar's Future as a Global Reserve Currency

What is the likely outlook for the dollar's dominant reserve status? Many had predicted the dollar's demise during the most recent economic crisis (2008–2009) given that it had first started there. However, the U.S. recovery subsequently has been much stronger than that of the other major developed countries, and its reserve status has remained solidly stable.

While China could easily surpass the U.S. in GDP (measured at current exchange rates) within a decade, the U.S. will still remain the world's second-largest economy. The U.S. is the world's second-largest trading nation, and total trade has increased from 15.2 percent of GDP in 1990 to 23.3 percent of GDP in 2014.[33] These conditions bode well for the future of the dollar.

As emerging markets continue to rise, however, the U.S. will unavoidably account for a declining fraction of global GDP, reducing its ability to supply safe and liquid assets on the scale required. It is logical to believe that other currencies will fill this void.

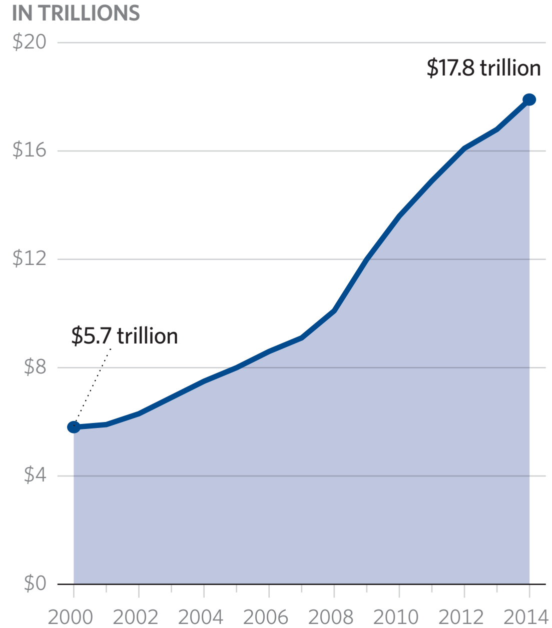
By far the greatest threat to the dollar's reserve status is the U.S. budget deficit and projected federal unfunded liabilities. In surplus as recently as the late 1990s, the U.S. budget deficit currently exceeds 100 percent of GDP. The federal debt has more than tripled since the turn of the millennium. Worse yet, according to the U.S. Debt Clock, the total value of future unfunded liabilities is $96 trillion—$812,000 per person. This does not include state liabilities, and some economists consider the figure to be considerably higher.

By far the greatest threat to the dollar's reserve status is the U.S. budget deficit and projected federal unfunded liabilities.

If this current scenario persists, it is clear that American debt will fail to hold its value. While it is difficult to predict when this will occur, if sovereign debt fails to hold its value, investors will lose confidence and the dollar will likely lose its global reserve status. But the RMB is not likely to fill the void any time soon.

CHART 3

Federal Debt More than Triples Since Turn of the Millennium



Source: U.S. Department of the Treasury, Bureau of Fiscal Service, "The Debt to the Penny and Who Holds It," http://www.treasurydirect.gov/govt/reports/pd/pd_debttothepenny.htm (accessed May 28, 2015).

SR 171 heritage.org

Conclusion

The last time a Chinese currency was used as an international medium of exchange was four centuries ago, when China's share of global GDP was approximately 30 percent, the country was a major global trading power, and Chinese copper coins circulated throughout East Asia to India and beyond.[34]

During the Great Recession, which started in the United States and produced trillion-dollar budget deficits, many predicted the demise of the dollar's reserve status. So far, this prediction has not materialized.

While the RMB is the fifth-most-used currency in international payments (up from 20th place at the start of 2012), the Chinese currency still accounts for a mere 1.4 percent of global payments, compared with the dollar's 42.5 percent. Given that many of those deals are just transfers between Chinese companies and their subsidiaries in Hong Kong, there is much less even to this than meets the eye.

As this *Special Report* has discussed, there is a historical precedent where a dominant reserve currency (pound sterling) was replaced by a minor reserve currency (the U.S. dollar) over a short period of time. In order for the RMB to replace the dollar as the world's reserve currency, two things would have to happen.

First, Chinese authorities would have to significantly open up their financial system to market forces, which includes completely opening up the country's capital account to allow money to flow freely in and out. Perhaps for all the reasons discussed, Beijing is moving entirely too slowly in this process.

Second, the U.S. would have to continue mismanaging its own fiscal situation to the point of making an alternative to the dollar desirable. This is a distinct possibility. While the near defaults over the past few years did little to hurt the U.S. dollar's reserve status, at some point it will, unless significant, if not draconian, measures are taken to rein in future entitlement expenditures. (China has its own growing debt problem that could also derail the RMB's future reserve status.)

There is not much prospect for the RMB replacing the dollar as the world's reserve currency in the foreseeable future. That, however, does not mean the world does not have other options. There is room for more than one international reserve currency. The dollar's meteoric rise between 1914 and 1924 did not require sterling's immediate demise. It is possible that the dollar and the RMB could coexist, providing both hedge and liquidity for the financial markets and central banks.

One thing, however, seems certain: No reserve-currency country, including the U.S., will be able to finance its current account deficit as freely as the U.S. did in the years leading up to the Great Recession. If the financial markets read a reserve-currency country as behaving irresponsibly, in the manner the U.S. did before and after the financial crisis, the markets will naturally curtail the rate at which they accumulate those reserves, and find an alternative. The fate of the dollar's status and all it means to American prestige and global leadership is in America's hands. The RMB is not the threat to the dollar.

Washington is.

Endnotes

1. Renminbi is the name of the currency. In Mandarin Chinese, it means "the people's currency." The yuan is the unit of account. In the U.S., the dollar is both the name of the currency and the unit of account.
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14. International Monetary Institute at the Renmin University of China, "Internationalization of the RMB," 2013, p. 154.
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