CHINA'S WORLD

Reality Check on Yuan's Threat to Dollar's Supremacy

Despite Hype, Bets Chinese Currency Would Challenge Greenback No Look Ill-Conceived

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A $100 banknote is placed next to 100 yuan banknotes in this October 16, 2010 file picture illustration taken in Beijing. *Reuters*

BEIJING—They once seemed like the safest bets in international finance: First, that the Chinese currency, the yuan, would keep rising against the dollar; and second, that the yuan was set to challenge the greenback's global primacy.

The first bet has just blown up. The yuan's retreat against the dollar in the past few weeks has reversed a steady upward march—35% since 2005—that offered almost guaranteed returns.

That is not to say the Chinese currency won't resume its advance at some point. Its fall since mid-March, when the Chinese central bank allowed greater trading volatility, has renewed suspicions in Washington that China may be manipulating its currency for trade advantage.

But there is every likelihood that over the longer term the renminbi, as it is also known, will continue to appreciate, albeit on a much more gradual trajectory, and that the dollar will decline. In the short term, expect ups and downs.

The second bet, that the yuan's inexorable rise threatens the supremacy of the almighty dollar, now looks like ill-conceived, too.

The fact that this notion gained such widespread credence in the first place speaks to the exaggerated sense among many investors of China's strengths and, more to the point, of America's weaknesses.

It's not hard to see how the idea took root. Hadn't the global financial crisis exposed the frailties at the core of the American financial system? And didn't China's response to the crisis--one of the biggest economic stimulus packages in history--demonstrate its awesome financial firepower?

There was a gathering conviction—a hope, perhaps--that the country responsible for almost tanking the world economy would get its comeuppance in the form of a reduced status for the dollar, and an enhanced role for the yuan. The dollar would be knocked off its pedestal.

In fact, almost the opposite has transpired. The dollar is mightier than ever. As for the yuan, to be sure its use in international trade and financial transactions is expanding quickly. But as a store of value—a place where international investors can safely squirrel their wealth—it's gone virtually nowhere.

In a new book called "The Dollar Trap," Eswar Prasad, a Cornell University professor and former head of the China desk at the International Monetary Fund, explains the paradox behind the dollar's recent strength. It turns out that in international finance, everything is relative, including risk. And despite America's manifest shortcomings—fiscal deficits stretching as far as the eye can see, executive greed, political gridlock—the U.S. "has become the primary global provider of safe assets," writes Mr. Prasad.

Even at the height of the global crisis that started in 2008, international investors gathered up their funds and headed straight for the eye of the storm—the U.S. itself. Instead of plunging, the dollar jumped.

Mr. Prasad's analysis, of course, is a sobering commentary on the state of the rest of the world outside America.

In fairness, though, investors couldn't have found adequate shelter in the yuan even had they wanted to. Despite all the hype about the yuan's growing stature, the universe of yuan assets in which global funds can invest is minuscule. And size matters when it comes to measuring the importance of international currencies.

The economist Jonathan Anderson of the Emerging Advisors Group reckons that in mid-2013 the total stock of security assets denominated in dollars—equities and bonds—freely available to international investors was worth $56 trillion; assets denominated in euros were worth $29 trillion; in yen, $17 trillion, and in sterling, $9 trillion.

And yuan assets? A mere $250 billion, or about 0.1% of the total, roughly similar to the Philippine peso.

To be sure, foreign investors have very limited access to China's domestic markets because of strict capital controls (Hong Kong offers the deepest pool of offshore yuan assets.) But those markets are relatively underdeveloped; equity markets are stunted by the widespread perception that they operate like casinos, corporate bond markets have been held back by an enduring reliance among companies on bank borrowing to fund expansion. Even if China dismantled all controls overnight, Mr. Anderson estimates it would boost the supply of available yuan assets only to $6.5 trillion.

And there is no prospect of that happening--for precisely the reason that limits the attractiveness of the yuan as a currency haven: China's financial system is too shaky. Open the doors and the risk is that more money will flood out than flow in, further undermining the system's stability. That is why Chinese leaders talk boldly about throwing open the capital account but take only cautious steps.

"The likelihood that the renminbi can achieve any 'meaningful' share of global portfolios in the foreseeable future is close to zero," Mr. Anderson writes in a recent report.

Some countries, including Australia, have added modest quantities of the yuan to their foreign-exchange reserves. But for the yuan to rival the dollar as a reserve currency, the bar is high—perhaps prohibitively so, according to Mr. Prasad's analysis.

Among the critical underpinnings of the dollar—factors that make investors sleep easier at night--Mr. Prasad lists America's transparent system of democracy, political checks and balances, and the rule of law to which even the executive is subject. These are all concepts that the current Chinese administration under President Xi Jinping emphatically rejects.

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