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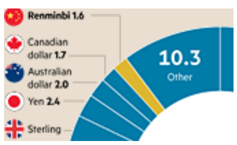
Even Beijing balks at price to pay for renminbi to become a reserve currency

By Martin Wolf Author alerts

For the first time since industrialisation began two centuries ago, the world's largest economy seems certain to be that of a non-western developing country run by the communist party.

This raises many questions. Among them is the potential role of its currency, the renminbi. Will it displace the dollar? Should the Chinese authorities want it to? Should the rest of the world want this? My tentative answer to all three is: no.

The dollar and the renminbi



China's economy is huge and a hugely influential. On one measure – gross domestic product at purchasing power parity (which adjusts for the differences in purchasing power of money across borders) – China has the largest economy in the world. Unless its economy is derailed, it will surely have the largest economy on any measure by the early 2020s.

China is the world's largest exporter of goods and second largest importer. For its size, it has an open economy, with a higher ratio of trade to GDP than the US. China also holds the world's largest foreign exchange reserves, now worth $4tn, an almost unbelievable 40 per cent of the country's GDP.

Yet the size of the economy or of trade do not determine whether the rest of the world will want China's liabilities to be among their principal reserve assets.

True, China's role in trade makes it attractive to hold renminbi, largely as a means of payment. Such balances for transactions are becoming substantial. China has itself promoted greater use of the renminbi for such purposes. It has done so by allowing its use in trade settlement, permitting people to borrow renminbi, letting some people hold offshore renminbi accounts and setting up bilateral currency swap lines with other central banks.

Yet the requirements for foreign currency reserves are rather more demanding. In his book, *The Dollar Trap* , Eswar Prasad of Cornell University lays out three conditions for a currency to become a widely-used reserve currency: free convertibility; internationalisation; and a floating exchange rate. The last is a modern requirement. In the 19th century, the pound sterling was used in reserves because it was as good as gold and more rewarding. But the other two conditions are essential.

Tracking China's currency

This interactive graphic shows changes in the present value of the renminbi

Inevitably, therefore, the world's principal reserve currencies have been supplied by open, law-governed market economies with deep and liquid capital markets and at least reasonably stable public finances. China is not such a country. Indeed, the fact that it holds vast amounts of the liabilities of other countries as reserves strongly suggests it does not think the renminbi is a satisfactory reserve asset.

True, China's public finances look to be in good shape, although the costs of managing recent financial sector excesses and weaknesses in local government finances are as yet unknown. The bigger concerns lie elsewhere. As Prof Prasad remarks, "the capital account is becoming increasingly open in de facto terms, but the government is far from allowing the extent of free flow of capital that is typical of reserve currencies".

The exchange rate, through freer to move than in the early 2000s, is still heavily manipulated, as shown in the continuing accumulation of reserves. The less free the exchange rate, the greater the risk that free flows of capital could prove destabilising.

Internationalisation is a yet deeper issue. Chinese financial institutions and markets are not yet capable of integrating with the rest of the world without danger of instability.

Behind this lies a further problem. For the authorities, the financial system is an instrument of control that they will be unwilling to give up, particularly as they are concerned about economic, social and political instability. Yet even if Beijing did liberalise the financial system and allow free movement of capital, it would find it hard to persuade other governments that it could be trusted to honour financial commitments in all circumstances.

As China can offer little legal protection, it must ask for trust in the good will of its communist rulers. One has to doubt that will suffice to displace the credibility built up by the dollar over many decades. Thus, it is unlikely the renminbi could replace the dollar as a reserve currency in the foreseeable future. China would have to be transformed, economically and even politically, for that to happen.

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Would such a transformation be in China's interests? In the long run, possibly, though the advantages to the US of creating the world's leading reserve asset are often exaggerated. In the shorter run, it would risk substantial economic and political disorder.

Would the emergence of the renminbi as a reserve currency be good for the rest of the world? The advantage would be more choice. The disadvantage could be yet more instability, as confidence swung from the dollar to renminbi and back again. The age of the renminbi might yet come. But it is unlikely to be soon. That might be no bad thing.

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