THE DOLLAR AS THE DOMINANT GLOBAL RESERVE CURRENCY

A THREAT TO FINANCIAL STABILITY?

Policy Report

February 2020

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TABLE OF CONTENTS

Executive Summary

Today, the US dollar is the world's dominant, if in practice also the sole, reserve currency. This makes financial stability across the world hostage to swing in the dollar and hence to America's economic fortunes. How Asian economies manage this tension, and whether an alternative reserve currency will emerge to buffer the safety-net, will be important determinants of their convergence with advanced economies.

The understanding of this challenge has to start with the renminbi and its chances of rivalling the dollar because, just as China's dominance in global trade defined the last two decades, its emergence at the heart of global finance could define the next two decades.

Inclusion of the Renminbi in the SDR Basket

When, in November 2016, the IMF decided to admit the Chinese renminbi as the fifth member of the elite group of currencies — the dollar, euro, sterling pound and yen — that constitute the reserve currency basket of the IMF known as Special Drawing Rights (SDRs), the Chinese authorities were a triumphant lot. For, after all, inclusion of a new currency in the SDR basket is an unusual event — the last big shake-up happened in 1993, when the euro was created.

The Chinese lobbied hard for membership of the SDR club. To support their case, they implemented some difficult reforms at home — they opened up a part of the domestic bond market to other central banks and liberalised the setting of interest rates on bank deposits. Most notably, in August 2015, they restructured the renminbi exchange rate regime, taking it off the dollar peg and setting a transparent formula for determining its daily reference rate. This was a decision that rattled the global currency markets even as it was aimed at convincing the IMF that the exchange rate was henceforth going to be market driven.

The irony of the IMF seal of approval was its timing; it came after what was a tumultuous year for the renminbi. The Chinese decision to devalue the currency by two per cent prior to its depegging in August 2015 brought it under a severe speculative attack. Investors, both domestic and foreign, bet against the yuan, believing that the authorities would further devalue it in order to support a slowing economy. To combat the speculation, the central bank was plunged into an energetic defence of the currency through capital controls and aggressive intervention in the currency market.

The SDR recognition triggered a host of questions about the renminbi. Will it now jockey to share the stage with the dollar? Is knocking the dollar off its pedestal what the Chinese really want? If not, why did they push so hard for SDR recognition? For its part, will America thwart the renminbi challenge or just give in nonchalantly? What will the implications of this face-off be for China, for America and for Asia's convergence with the rich world? This paper attempts to address these questions.

Will the Renminbi Challenge the Dominance of the Dollar?

The rise of China in global trade starting in the 1990s made the ascendance of the renminbi as a reserve currency a tantalising prospect. That speculation gained further ground with the belief that it was the Chinese stimulus effort in the aftermath of the Lehman collapse in September 2008 that saved the global economy from a total meltdown. For many Sinophiles around the world, the question is no longer whether, but when, it might actually become a reserve currency.

But a reality check is necessary. Even as the IMF imprimatur is a significant endorsement for the Chinese currency, opinion continues to be divided on whether it is significant enough to prop the renminbi as a serious challenger to the dollar.

One View — Renminbi Cannot Displace the Dollar

The view at one end of the spectrum is that admission into the SDR basket is more symbolic than substance. The SDR, it is argued, is an obscure reserve asset created under the aegis of the IMF and is no more than a unit of account. A true currency has to be a claim on someone; the SDR is not a claim on anyone, not even the IMF. It is little used in international trade and finance, and official SDR-denominated assets must still be converted to the constituent currencies to be usable.

Furthermore, the argument goes, being included in the SDR basket is neither a necessary nor a sufficient condition for being a reserve currency. Up until 1981, the SDR comprised 16 currencies (including, mysteriously, the Iranian rial), many of which fell short of being acceptable as reserve currencies. On the other hand, the Swiss franc is still widely held as a reserve asset despite not being part of the SDR.

There are also doubts about whether the renminbi can meet the exacting requirements of a reserve currency. The IMF evaluation was made on relatively narrower considerations — just two, to be precise. The first was that the currency issuing country has to be a large exporter, a test that China met quite easily. In the five years to 2015, Chinese exports averaged 11 per cent of global exports, placing it third in the global ranking, behind America and the European Union.

The second criterion — that the currency has to be widely used and freely usable — was open to a more subjective judgement. The IMF decided in favour of China after taking into account the impressive gains made by the renminbi in global trade and finance: in 2014, the renminbi ranked seventh in terms of holdings in countries' official reserve assets, eighth by way of use in both international debt securities and cross-border payments and eleventh by way of volume of trades in spot currency markets.

The sceptics contend that the renminbi's ranking in global trade and finance — seemingly impressive — masks its minuscule shares. In 2014, it accounted for only 1.1 per cent of global official reserve assets, only 1.8 per cent of global debt securities and just 0.8 per cent of spot market trade volumes, trailing way behind other SDR currencies on all these indicators. The renminbi's lag is particularly pronounced in foreign currency trading; even as it is actively traded in London during Asian trading hours, it barely registers in North America.

Even if the renminbi were to rapidly gain ground on all these indicators as it might be expected to, it will still not be up to rivalling the dollar as a medium of exchange or a store of value, not to speak of becoming a safe haven in times of crisis. China will have to implement painful reforms to establish credibility for its exchange rate management and financial market regulation. Even then, global investors will be wary of tying their fortunes to a currency that is backed by an authoritarian regime with few checks on its leaders.

The Opposite View — Renminbi Can Displace the Dollar

Interestingly, renminbi optimists on the other side of the divide use the same data and facts to argue the opposite. Their main point is that the renminbi's prospects must be evaluated not so much on a snapshot of its present position but rather on its trajectory. On virtually all criteria — spot market trade volumes, cross-border payments, size of renminbi denominated international debt securities and its share in official reserve holdings — the global footprint of the renminbi has been expanding. In cross-border payments, for example, the renminbi accounted for 2 per cent of the global total in 2015, up from virtually zero five years earlier, making it the fifth most used currency. The share of renminbi in countries' official reserve assets improved from 0.7 per cent in 2013 to 1.1 per cent in 2014, with even the conservative Bundesbank announcing plans to include renminbi in its currency reserves.

China has methodically pushed for making the renminbi acceptable beyond its borders. It already settles a quarter of its exports in renminbi and has designated renminbi clearing banks and swap lines in New York and a host of other centres. In June 2013, the United Kingdom became the first G-7 country to set up an official currency swap line with China, and, by 2014, 25 countries had done so. With the IMF seal of approval, these trajectories are bound to improve further as central banks and international investors become more confident about holding denominated assets and traders become more confident about invoicing and settling in renminbi.

Dollar as the Sole Dominant Reserve Currency — A Threat?

Underlying this debate on the rise of the renminbi are two collateral issues. The first is that the dollar is the world's dominant reserve currency, and this excessive dependence on a single currency is a threat to global financial stability, as had become starkly evident in the aftermath of the Lehman collapse in 2008.

As far as currency markets go, the aftermath of the crisis actually presented a bizarre situation. The United States was the epicentre of this huge crisis, the deepest since the Great Depression over 80 years ago; its financial markets had seized up with extreme anxiety and panic; several of its big-name financial institutions were on the brink of collapse and the US economy seemed headed into a fierce recession. All this should have sapped confidence in the dollar and the dollar should have plunged as a consequence.

Exactly the opposite happened — the dollar actually appreciated. The reason for this counter-intuitive surge in the dollar was not far to seek. The extreme uncertainty in financial markets following the Lehman collapse in September 2008 drove investors around the world to withdraw their investments and return to the safe haven of the United States, in the process pushing up the dollar exchange rate. The flip side of this capital exodus was a severe dollar shortage everywhere outside the United States which threatened the smooth functioning of global payment systems and exacerbated financial vulnerability.

These post-Lehman developments and anxieties consolidated the growing view that the cause of global financial stability will be better served if the world had an alternative to the dollar. In fact, in 2011, when France was the chair of the G-20, President Nicolas Sarkozy had even appointed a task force with a mandate to find a solution to the reserve currency issue. The message to the task force, not too unsubtle, was to identify ways in which the euro could be positioned as an alternative to the dollar. That campaign lost its momentum even before it began as the eurozone sovereign debt crisis erupted in full bloom in late 2011, calling the very existence of the euro into question. The euro has survived the crisis, but the crisis showed that it is unlikely to be a potent threat to the dollar until the eurozone agrees on a full banking union and joint bond issuance.

That leaves the renminbi as the only credible alternative to the dollar.

What, in Fact, Do the Chinese Want?

The second collateral issue in the context of the renminbi's rise is understanding what exactly the Chinese want. Do they want the renminbi to challenge the dollar's dominant position or is their aspiration less ambitious — just to deepen the internationalisation of the renminbi for improving their advantage in global trade and finance?

Much speculation on the issue was triggered by a March 2009 essay by Zhou Xiaochuan, then governor of the People's Bank of China, in which he highlighted the dangers to the global financial system of relying on a national currency for international payments and settlements, arguing that the issuing central bank would hold global financial stability hostage to its domestic policy goals.[1] Although Zhou did not explicitly mention the US dollar, the essay clearly showed that the Chinese were rankled by the dollar's overwhelming dominance and its power as a means of financial sanction.

The Chinese remonstration seems to have been timed for maximum impact. Coming as it did when the world was in the depths of a financial crisis caused by excesses in the US financial system and just ahead of the crucial London G-20 meeting (April 2009) to discuss the global crisis, the Chinese call was interpreted as a charge sheet against the dollar and a demand for a greater say for emerging markets in managing international finance.

Curiously, Zhou did not pointedly push for the renminbi; instead, he argued for a more diversified financial system that would aid financial stability. In particular, he suggested that the current system be replaced by a super-sovereign reserve currency such as the SDR, whose basket should be expanded to all major economies, accompanied by the institution of a settlement system between the SDR and other currencies so it could be used in international trade and financial transactions.

China's apparent lack of commitment to developing the renminbi as a credible alternative to the dollar raises questions about its willingness to implement difficult reforms to meet the criteria of a reserve issuing country. In particular,

1 "Zhou Xiaochuan: Reform the International Monetary System: Essay by Dr Zhou Xiaochuan, Governor of the People's Bank of China, 23 March 2009", *BIS Review* 41/2009, https://www.bis.org/review/r090402c.pdf

the exchange rate must be flexible and market driven, its capital account must be open, its banking system regulation should be credible and its financial markets should be deep and liquid. Does the privilege of issuing a reserve currency justify such pain?

American Reaction to the Ascendance of the Renminbi

What of the American perspective?

It is true that America supported the inclusion of the renminbi in the SDR, but that support must have been motivated by a variety of self-interested reasons. America must have calculated that the SDR status will make it harder for China to resort to mercantilist policies and, in particular, manipulate its currency for export advantage. The SDR regimen will also enjoin China to keep its financial markets open, thereby opening up business opportunities for US financial firms. Also, America has leveraged its dominant position in the IMF to hold sway over global financial markets. In such circumstances, if China got a stake in the SDR, it would be less strident in attacking the primacy of the IMF and thereby of America's influence exerted through the IMF.

But what if China begins to uses the SDR imprimatur to challenge the dollar's pre-eminence? How will America respond should such a threat come to pass?

The stereotype world view is that America enjoys an "exorbitant privilege" by virtue of issuing the world's dominant reserve currency. Since the reserve currency status raises the demand for dollar-based assets, the American government and its corporates can raise debt at a lower cost, making it easier for the government to finance its deficit and for the corporates to improve their competiveness.

America, for its apart, has been dismissive of this exorbitant privilege argument. It maintains that, far from being an exorbitant privilege, the reserve currency responsibility has in fact been an exorbitant obligation. To redeem this responsibility to the rest of the world, America has been obliged to keep the global financial system awash with dollar liquidity — a phenomenon that textbook economics calls the "Triffin paradox" — which meant keeping the dollar stronger than it should have been. This has exacted a heavy toll on American exports and consequently on American growth and welfare.

As this debate underscores, there are costs and benefits to being an economy issuing the reserve currency but it is difficult to determine the precise cost–benefit balance over time.

But to evaluate the costs and benefits arising from issuing the world's dominant reserve only from an economic dimension will be misleading. The dollar dominance gives America enormous political leverage as well. Take American sanctions against Iran or North Korea, for example. They are heeded by international banks because they all need access to dollars and hence access to the American banking system. They know that any defiance will cut off that access, crippling their business.

America has so far tried to appear nonchalant to any putative challenge to the dollar. It has argued, although not explicitly, that the dollar is the dominant reserve currency not because it has been anointed as such through an international agreement but because it has been anointed as such by the global financial markets, based on the strength and resilience of the American economy and the credibility of American institutions.

Is America's nonchalance just a facade because it does not see the renminbi as a credible threat? Will it not put up a stiff fight should the renminbi challenge become realistic and begin to erode its economic and political leverage? The counterfactual is not clear. What is clear though is that the Chinese authorities are not going to aggressively push the renminbi to rival the dollar. All they want is to deepen the internationalisation of the renminbi to increase their advantage in global trade and finance — which they see as a project quite distinct from positioning it as a reserve currency.

Renminbi Toppling the Dollar — A Thousand-mile Journey?

The world of course will be better served by a global financial system with multiple poles. Such a system will engender financial stability and also act as a check on America using its reserve currency clout for political leverage. But such a multipolar system is unlikely to emerge anytime soon. As Eswar Prasad, professor at Cornell, says in his book *Gaining Currency*,[2] the dollar's strength stems not just from America's economic might but also from the strength of America's institutions of governance. For the renminbi to inspire the trust and confidence required to be a dominant reserve currency, China will need to build not just deeper and more open financial markets but also a transparent political process and a robust legal system and rule of law. Even in the unlikely event of the Chinese putting their mind to challenging the dollar, it will be a long haul.

[2] Eswar S. Prasad, *Gaining Currency: The Rise of the Renminbi* (New York: Oxford University Press, 2017).

Even a thousand-mile journey, as Mao said, has to start with a single step. China has already taken several steps on this long haul. Whether it will go all the way to pushing the renminbi as a reserve currency will be a key determinant of China's ascendance in the global sweepstakes.

About the Author

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