PROJECT SYNDICATE
THE WORLD'S OPINION PAGE

ECONOMICS

ESWAR PRASAD
Eswar Prasad, former head of the IMF's Financial Studies Division, is Professor of Economics at Cornell University and a senior fellow at the Brookings Institution. He is the author of The Dollar Trap.

MAY 14, 2014

The Dollar is Still King

ITHACA – Scarcely a week passes without news about the ascendance of China's currency, the renminbi. But China has a long way to go before its currency can rival – let alone displace – the US dollar as the dominant global reserve currency.

To be sure, China already plays a significant role in international trade and finance, with major financial centers like London and Frankfurt eagerly lining up for renminbi business. Recent speculation that China's economy may soon be as large as America's has boosted this interest further, causing many to believe – whether ruefully or gleefully – that the renminbi will soon dominate.

Moreover, the Chinese authorities have launched a raft of reforms aimed at opening the economy and making it more market-oriented, and have announced plans to liberalize interest and exchange rates and continue to ease restrictions on cross-border capital flows. All of this will strengthen the renminbi's claim to reserve-currency status.

But China is missing one crucial ingredient: the world's trust. To achieve currency dominance, China needs more than economic and military might; it requires a broader and more credible set of public and political institutions. And it is here that the US shines – at least relatively speaking.

This was never more apparent than in the aftermath of the global financial crisis. Even though America's financial markets nearly collapsed, its public-debt levels rose sharply, and the Federal Reserve was forced to undertake massive monetary expansion to support the economy, the dollar strengthened relative to most other currencies.

That is because global investors seeking a safe haven automatically turn to US Treasury securities in times of global financial turmoil. Foreign investors now hold more than $5.7 trillion of these low-yielding securities, not to mention large quantities of other dollar assets. And the dollar's share in global foreign-exchange reserves has held steady since the crisis.

This can be explained partly by the fact that the United States boasts the world's deepest and most liquid financial markets. But the most important factor supporting America's currency dominance is the institutionalized system of checks and balances that operates among the executive, legislative, and judicial branches of its government.

Trust in US public institutions is rooted in the open and transparent democratic process that underpins them. Freedom of expression and unfettered media bolster this confidence, not by highlighting the system's strengths, but by exposing its weaknesses, which can subsequently be corrected through responsive, rule-based mechanisms.

With the US government forced to answer to its citizens, it is unlikely to resort to inflationary debt financing. In fact, about $4.5 trillion of US federal debt is held by domestic investors, including retirees, pension funds, financial institutions, and insurance companies – groups whose considerable political clout ensures that no administration would risk allowing inflation to spin out of control.

The US legal system – independent from the executive and legislative branches of government – further supports the dollar's global role. While one might quibble about the complexity of US laws and regulations, it cannot be said that they are not applied relatively consistently.

This contrasts sharply with China's single-party system, in which the level of government accountability is much lower. Official corruption, for example, has become so entrenched that President Xi Jinping has made an anti-graft campaign a central objective.

The reality is that, despite China's economic heft and low central-government public debt, foreign investors are unlikely to trust China with large sums of money. Capital inflows – which will undoubtedly increase in the coming years – are driven largely by investors' interest in diversification and high yield, rather than the country's image as a refuge from troubled financial markets elsewhere, especially given that China's financial markets are relatively underdeveloped and beset by considerable risks.

Of course, some foreign central banks have signed currency-swap agreements with China and even hold small amounts of its currency in their reserve portfolios. But these actions may be less a sign of the renminbi's inevitable march toward global dominance than a low-cost bet on its likely emergence as a widely accepted international currency. And countries' desire to maintain good relations with China, owing to its rising economic power, cannot be discounted.

Depending on how soon China opens up its capital account and develops its financial markets, the renminbi could become a significant reserve currency in the near future. But it will not contest the dollar's supremacy unless China's leaders align the country's political and legal institutions with its economic reforms.

http://www.project-syndicate.org/commentary/eswar-prasad-on-why-china-s-renminbi-will-not-become-the-dominant-global-reserve-currency-anytime-soon

© 1995-2014 Project Syndicate