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Is China Ready to Challenge the Dollar?
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In the wake of the global financial crisis much has been written about the extent to which the United States can continue to play its role as the world's predominant economic power and whether the emerging BRIC economies, particularly China, are poised to challenge the current financial and economic architecture. In recent months, speculation has focused on the future of the U.S. dollar, due largely to comments by senior Chinese officials that have led some commentators to conclude that the Chinese are ready to ditch the dollar and usurp its role as the world's reserve currency with the *renminbi*.

Although such headlines make thrilling copy, it would be a mistake to conclude that China is ready to ditch the dollar anytime soon, let alone supplant the dollar's reserve role with the *renminbi*. For one thing, Beijing has accumulated around $1.4 trillion in U.S. dollar reserves and is keen to avoid any precipitous decline in the dollar's value – which would devalue its own holdings. Beijing is unlikely to shoot itself in the foot. As for China's supposed designs to replace the dollar with the *renminbi* as the primary reserve currency, some commentators seem to be confusing three distinct concepts: currency internationalization; achieving reserve currency status; and being the dominant global reserve currency. It can take decades for a currency to internationalize and some currencies become internationalized without ever becoming fully established as reserve currencies – like the Swiss Franc or Japanese Yen.

As the largest holder of U.S. debt, however, Beijing is clearly nervous about the prospects of a weaker dollar and is taking steps to carefully diversify its dollar reserves. As the initial effects of the crisis began to be felt, and clearly concerned about the policy risks associated with the U.S. dollar, the head of China's central bank published a series of articles calling for a new reserve currency system to be managed by the IMF. In March, Premier Wen Jiabao took the highly unusual step of declaring publicly that China was "worried" about its dollar reserves.

These signals from Bejiing have been matched by action. Putting its money where its mouth is, China has begun to spend its dollars on overseas acquisitions and investments, especially in natural-resource related ventures, in an effort to shift holdings to more stable investments. In this vein, China has also signed a series of deals with Russia, Brazil, and Ecuador to secure oil deliveries and is filling up its strategic petroleum reserves. Certainly, in doing so China is publicly signaling its concerns about U.S. inflation and a weaker dollar to the Obama administration. China's tough stance also plays well to its domestic audience – it puts the spotlight on Washington as the main cause of the economic crisis and takes it off Beijing.

Still, these recent purchases actually spent only a fraction of China's dollar reserves. The bottom line is that, given the interdependence of the U.S. and Chinese economic systems, as long as the United States is China's number one export destination, the country will continue to accumulate U.S. dollar reserves as fast as it can spend them; in the short-to-medium term it has little option but to continue to invest them largely in U.S. debt instruments – neither Europe nor Japan have bond markets deep enough to absorb China's investments. That is why, after a dip in April that set off alarm bells in currency markets world-wide, China's U.S. Treasury purchases subsequently picked up. Reports of the dollar's death have thus been both exaggerated and premature.

That said, China has begun implementing a longer-term strategy to reduce its exposure to policy risk associated with U.S. dollar holdings. Beijing has begun the protracted process of internationalizing the *renminbi* with the aim of assuming a principal role in directing the future of the international financial system. It began by launching a series of pilot schemes expanding the use of the *renminbi* in the settlement of cross-border trade and international trade. The most high-profile step has been the conclusion of six currency swap agreements. In the wake of the financial crisis, countries such as Argentina, Indonesia, and South Korea are facing a short-term liquidity problem – that is, their central banks do not have enough U.S. dollar reserves – so conducting bilateral trade with China while bypassing the U.S. dollar is an attractive option for them. Turning the *renminbi* into a settlement currency is the first in a series of steps toward internationalization.

However, it could take another decade before the *renminbi* would be eligible as a reserve currency, if it ever will. China will have to overcome a series of obstacles before that happens, not least of which is making the currency fully convertible, and there is no clear timetable for that to happen. China will also have to convince investors that its financial system is trustworthy and its economic system stable over the long term. Policymakers will also have to allow China to run a current account deficit to ensure an adequate supply of *renminbi* to satisfy global demand, something that China's government is far from prepared to do at this point. While according to our sources there is apparent consensus among China's top leadership regarding the initial steps that have been taken, the content, scope, and pace of future *renminbi* internationalization remain very much up for debate.

What does this imply for the U.S. dollar? Perception is reality in volatile currency markets; the dollar dips to new lows against other currencies whenever it is reported that China wants discussions of a new global reserve currency. Such knee-jerk reactions underscore the need to separate rhetoric from reality on this issue. As noted above, Beijing is undoubtedly readjusting its investment strategy in order to diversify its immense dollar reserves. It has also begun the protracted process of *renminbi* internationalization and will continue to raise its international profile in pushing for reform of the global financial and economic architecture, including reserve currency reform. However, behind all the smoke and mirrors, the bottom line is that the United States is the number one destination for Chinese exports and, as transactions will remain denominated in dollars, the country will continue to build up its dollar reserves; given its vast holdings and limited investment options, Beijing has little choice but to continue to support the U.S. dollar. Although in the short-to-medium term the economic impact on the U.S. dollar will remain limited, the geopolitical sands are undoubtedly shifting. Beijing has put the world on notice that it is going to use its economic weight, financial resources, and growing geopolitical influence to ensure that China and other BRIC economies have a larger say in designing and operating any future international and economic system.