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Reserve currencies: Renminbi not yet ready to challenge the dollar

By Robert Cookson

Renminbi centre: the UK Treasury wants to make London the leading international centre for trade in the Chinese currency

It has become conventional wisdom among many prominent economists, bankers, and politicians that the Chinese currency is on a path that will inevitably make it a global reserve currency to rival the US dollar.

So great is the excitement around the future international role of the renminbi that George Osborne, UK chancellor, in January launched an initiative to help London become a global hub for renminbi foreign exchange trading.

Writing in the Financial Times last September, Arvind Subramanian, a senior fellow at the Peterson Institute for International Economics – in an article titled “Coming soon: when the renminbi rules the world” – declared: “internationalising the renminbi has been set in irreversible motion”.

However, contrary to popular perception, the renminbi's rise is by no means guaranteed and could take decades, if it happens at all.

China is certainly big, representing about 10 per cent of global gross domestic product, and growing fast. It will overtake the US as the world's biggest economy by 2027, according to estimates by Jim O'Neill of Goldman Sachs. But China's size does not mean its currency is about to challenge the dollar or the euro – or even the yen or the pound – any time soon.

For the renminbi to become a reserve currency, one that is held by central banks as part of their foreign exchange reserves to guard against balance of payments crises, Beijing will need to implement sweeping reforms.

At present, China retains strict controls on its capital account. Under current regulations, people and companies can only move renminbi in and out of the Chinese mainland through a limited number of channels, such as trade deals, and investments that have been approved by the state.

By retaining these restrictions, the Communist Party is able to exert control over key aspects of the Chinese economy, including the exchange rate, interest rates, and the allocation of capital through the state-owned banking system.

Eswar Prasad and Lei Ye wrote in a recent report for the Brookings Institution: "The renminbi is unlikely to become a prominent reserve currency – let alone challenge the dollar's dominance – unless it can be freely converted and China adopts an open capital account."

The question is whether Beijing's unelected policy makers have the political will to dismantle China's capital controls, given that doing so would remove much of their power over the domestic economy.

While Beijing has removed restrictions on some types of cross-border flows of the renminbi in recent years, the currency is still a long way from being fully convertible. There is no doubt reforms can have big effects. Chinese companies now settle about 10 per cent of their international trade deals using the renminbi, just two years after they were permitted to do so by mainland authorities.

But investment flows are still small because China's financial markets are still nascent and foreigners have only limited access. In March, China gave Japan permission to buy up to Rmb65bn ($10bn) of Chinese government bonds, a sum that amounts to less than 1 per cent of Japan's foreign exchange reserves, which are mainly held in US dollars.

If central banks are to hold the renminbi as a significant part of their reserves, they will need much greater access to Chinese assets. And for the renminbi to challenge the dollar, China's financial markets would need to become as broad, deep, and liquid as those of the US, a process that would require both time and substantial reforms.

Even after sweeping reforms, however, the renminbi's ascendance would not be guaranteed.

Consider Japan, an economy almost exactly the same size as China. Unlike its neighbour, Japan has both an open capital account and deep and liquid financial markets. Back in the 1980s, the Japanese government made it a stated policy to "internationalise the yen", and many observers expected the currency to challenge the dollar as a reserve currency.

Over the past four decades the Japanese yen has taken on a bigger role in global financial markets. Nonetheless, compared with currencies of other developed countries, its international usage and acceptance is "rather low", says Dickson Ho, an economist at the Hong Kong Trade Development Council.

Only about 40 per cent of Japan's exports and 20 per cent of imports are settled in yen. The yen now accounts for less than 4 per cent of official global foreign exchange reserves, according to the International Monetary Fund, down from a peak of 8.5 per cent in 1991.

By contrast, the US dollar and the euro account for about 62 per cent and 26 per cent of global reserves respectively.

If Japan's experience is any guide, it shows China has scope to expand global use of the renminbi for trade and investment.

Challenging the dollar as a global reserve currency, however, is another matter.