Meltdown 101: Will China global currency idea fly?

By CHRISTOPHER S. RUGABER – Mar 24, 2009

Map

WASHINGTON (AP) — China's central bank has called for the creation of a new global currency as an alternative to the dollar, in the latest sign of that country's growing assertiveness on the international stage. But would the idea even work?

Economists said the proposal is feasible, at least in the long run, but faces a number of hurdles, such as getting private companies to accept it.

Two key U.S. economic policymakers appeared to dismiss the idea during a congressional hearing Tuesday. Treasury Secretary Timothy Geithner and Federal Reserve Chairman Ben Bernanke were asked by Rep. Michele Bachmann, R-Minn., if they would "categorically renounce the United States moving away from the dollar." Both said they would.

Here are some questions and answers about China's proposal for a new global currency.

Q: Does China want to get rid of the dollar and other currencies?

A: No, Americans wouldn't be expected to give up the dollar, nor would China give up its yuan, for that matter. The idea is to create an international currency that China and other countries could use to hold trillions of dollars in reserves.

China has more than $1 trillion in U.S. Treasuries and other government securities, analysts estimate — and the country doesn't keep all of that money in its own currency because that would cause inflation. Also, by buying assets in dollars, China keeps the yuan from strengthening too much against the U.S. currency — which would make its goods more expensive to American consumers and hurt Chinese exports.

But as the U.S. government ramps up spending to stimulate the economy and assist the battered financial sector, Chinese officials are worried that inflation will result — and that would erode the value of their dollar holdings, economists said.

"They would dearly like to tear themselves away from the embrace of the U.S.," said Eswar Prasad, an economics professor at Cornell University.

Q: So, how would this new currency work?

A: China's proposal would greatly expand the use of an obscure type of currency created by the International Monetary Fund in 1969 known as "special drawing rights," or SDRs. The SDR was originally pegged to the dollar but is now based on the value of four different currencies.

SDRs are mostly used for accounting purposes by the Washington-based IMF, which advises governments on economic policy and lends money to help countries having difficulties paying off their debts. But under China's proposal, the SDRs would have a much broader role and would be used for international trade, commodities pricing, and other functions.

For the idea to work, the IMF would have to decide how much more of the SDRs would be created, a process that could be easily politicized, said Nicholas Lardy, a senior fellow at the Peterson Institute for International Economics.

In addition, using the SDRs for international trade and commodities pricing would require that private companies accept the new currency. That is "a huge hurdle to overcome," Lardy said.

Q: So why is China pushing this now?

A: The Chinese government is trying to influence the agenda of an April 2 meeting of world leaders in London, economists said. China wants to change the subject from its currency policy to what it sees as failures by the United States to regulate its banking system. Many U.S. politicians say China has kept its currency artificially low in order to keep its exports cheap.

"This is a carefully orchestrated attempt to shift the debate," Prasad said.

Q: What impact would it have if the dollar stopped being the world's primary reserve currency?

A: Americans would likely pay higher interest rates on everything from houses to cars, Lardy said. The demand for U.S. Treasury securities — that is, investments in U.S. debt — from countries with large reserves has kept the rates on those securities low, and that feeds through to other interest rates.

That might not be all bad, Lardy points out. Had China bought fewer dollars in the past decade, mortgage rates wouldn't have gotten so low, which might have kept the housing bubble from growing so large. (When rates are low, borrowers can afford to spend more on homes — which pushes prices up.)

Q: What about existing alternatives to the dollar, such as the euro?

A: Many countries do hold some euros as part of their reserves. But Doug Rediker, an international finance expert at the New America Foundation, noted that euro-denominated bonds are issued by numerous European governments, rather than a central authority, and some of those governments are not as reliable a credit risk as the United States. That makes euro bonds less attractive investments, Rediker said.

Still, Lardy and other economists point out that China has other options besides seeking a new currency __ it isn't being forced to buy dollars and could slowly diversify its holdings if it chose to do so.