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China renminbi as reserve currency: yuan a bet?

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By Pedro da Costa

China's importance to the global economy makes it difficult to believe the role of the yuan in foreign exchange will not continue to expand. Will that dominance advance sufficiently to make the Chinese renminbi one of the world's reserve currencies? A [new study](#) ^[1] from the Brookings Institution suggests that in the long run, the ascendance of the yuan to reserve-currency standing is likely. It notes that of the six largest economies in the world, China is the only one whose currency does not have reserve status. But the road to getting there will be long and tortuous, the study warns, and there will be plenty of potholes.

Getting there will require overcoming two main challenges, according to Eswar Prasad and Lei Ye, who authored the report:

Sequencing of capital account opening with other policies, such as exchange rate flexibility and financial market development, to improve the cost/benefit trade-off.

Financial market development – strengthening the banking system; developing deep and liquid government and corporate bond markets, as well as foreign exchange spot and derivative markets.

That's another way of saying that China's exchange rate policy, which many in the United States argue has been to keep the yuan artificially low in order to boost exports, is actively standing in the way of a bigger role for the yuan in international trade.

How will this gradual – sometimes glacial – process of adjustment unfold? Prasad envisions the following steps:

The government's medium-term objective, which we believe will be achieved in the next five years, is an open capital account but with numerous "soft" controls. This will allow the currency to play an increasingly significant role in global trade and finance, but in a manner that allows the government to retain some control over capital flows.

The renminbi will be included in the basket of currencies that make up the International Monetary Fund's Special Drawing Rights basket within the next five years.

Although China's rapid growth will help promote the international use of its currency, its low level of financial market development is a major constraint on the likelihood of the renminbi attaining reserve currency status.

The renminbi will become a reserve currency within the next decade, eroding but not displacing the dollar's dominance.

But given China's robust growth rates in recent years, why would it want to change the way it does things? Prasad offers some reasons:

Attaining reserve currency status has intangible benefits, including prestige, as well as tangible ones. A reserve currency earns seigniorage revenues from abroad —inflation reduces the value of foreign (and domestic) investors' holdings of the currency – and provides easier access to cheap foreign financing of debt issued in the domestic currency, a privilege that in the case of the U.S. has been called an "exorbitant privilege."

To the extent that this status results in a greater denomination of trade transactions in China's own currency, domestic importers and exporters would face lower currency risk. The potential costs of having a reserve currency include reduced control of the currency's external value and possibly a more volatile exchange rate. This status in principle entails a greater burden of responsibility because domestic monetary policy has more spillover effects to other economies.

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