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China's dollar delusion

Dethroning the US dollar as the world's most powerful currency might not be in China's long-term interests

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The People's Bank of China recently reiterated the need for a global currency to rival the US dollar – through a vastly expanded role for the Special Drawing Rights (SDRs) of the IMF. The issue was highlighted at the recent summit of Brics – the group comprising Brazil, Russia, India and China – and is likely to come up again at this week's G8 meeting.

China is right in thinking that the global meltdown is due partly to abuse of the dollar's reserve currency status by the United States. But this has been aided and abetted by China's own mercantilist policies that have created huge current account surpluses and excess liquidity. China's search for an alternative international reserve currency is touched with irony: the drug pusher is pushing the addict to reform itself.

But is the proposal in China's self-interest? That may seem an odd question, given that the proposal is seen widely as serving two Chinese purposes. The first is to warn the US to avoid policies that would lead to a crash of the dollar, and so inflict huge valuation losses on the dollar component – estimated at $ 1.2 trillion – of China's foreign exchange reserves. Having created a dollar hoard through its mercantilist policies, China seeks to preserve the value of its hoard.

The second and more important purpose is political. By calling for a greater role for SDRs at the expense of the dollar, China seeks to reduce the political and financial power of the US. For much the same reason, China's move has been backed by Russia, Brazil, India and other developing countries that have long chafed at the de facto dollar standard. These countries are far from being admirers of the IMF, but think they would be better off having some say in an IMF-backed currency than none at all in the US currency.

China must know that the creation of a totally new and powerful international currency is a pipe-dream. The dollar is strong because the US had a huge domestic economy and the ability to tax its citizens to honour its obligations. The IMF has no GDP and no tax capacity. But China feels that an expanded SDR role could be a half-way house that

The dollar's dominance will be reduced only when some other country emerges with a large enough GDP and tax capacity to compete with the US in providing a reserve currency. That country is obviously China itself. Right now China is still a developing country, but in perhaps little more than a decade it will become a high income country, and its GDP will begin approaching that of the US. Its total GDP already exceeds that of Germany. In terms of fiscal management, it has outperformed both the US and Europe. As China becomes wealthier, its economic focus will shift from exports to domestic consumption. At some point it will find it better to stop micro-managing its exchange rate, and instead float its currency, like all major economic powers.

Historically, countries have moved from having "soft" currencies to "hard" (international traded) currencies after running current account surpluses for a significant period, and hence emerging as creditor countries. The UK achieved creditor status in the 1800s and the US in the early 1900s, and the markets rewarded them with hard-currency status. They retained that status even when they later ran deficits.

China has now achieved creditor status. And, consciously or otherwise, its latest moves are pushing it towards a hard currency. It seeks to make Shanghai an international financial center. It has entered into yuan swap arrangements with several countries, including Brazil and Argentina. And it seeks the strengthening of the Chiang Mai initiative to create a regional Asian pool of swappable foreign exchange reserves. These three moves constitute unilateral, bilateral and regional moves in the direction of a hard currency. If China admits to itself where this road is leading, its attitude towards SDRs will change. Once it becomes a hard-currency country, it will find no advantages — and see clear disadvantages — in reducing the role of hard currencies and expanding that of SDRs. It will be where the US is today.

China's current SDR gambit is myopic. In trying to check US influence today, it might unwittingly be building a straitjacket for itself tomorrow. Of course, China could strive right now for a major role for the SDR, and repudiate that in the future when the yuan moves towards becoming a reserve currency. But that would be crassly expedient. Instead, why not prepare for the day when the US and Europe call for international fiat money to reduce the dominance of the Chinese yuan?