

# Yuan as a dominant currency



This essay expresses my humble opinion on the idea of the displacement of the U. S. dollar by the Chinese currency, Yuan as the dominant currency in the global financial system, the possibilities of it occurring, reasons of why Yuan should displace the U. S dollar which include the benefits of internationalisation of Yuan to the Chinese onshore and offshore companies, foreign companies, global importers, investors, China, and of course to the rest of the world.

Although it remains uncertain and questionable, I believe that China could displace the U. S. as the world's strongest economy, and that the Yuan, Chinese currency may become the world's global currency, or even replace the U. S. dollar as the dominant currency. It could even happen in our lifetimes. But, it will be a slow and long process that may result in a U. S. dollar decline, not a collapse. Also, I do believe that the Yuan should replace the U. S. dollar as the dominant currency in the global financial system, as the internationalisation of Yuan can bring numerous benefits not only to individuals, but corporations and governments worldwide as well.

In the aftermath of the GFC (global financial crisis), the status of the U. S. dollar as the world's reserve currency has gradually come into question. Heady money printing practices by the Fed of the United States has weakened the value of the U. S. dollar as many countries have considered in diversifying their assets into other currencies in order to diversify their currency risk, causing the reliability of the U. S. dollar to be questionable.

The question then remains in which other currency is strong enough to substitute the U. S. dollar as the dominant currency in the global financial

system. In spite of the crippling debt and undermine fundamentals in the United States, one of the main reasons why the U. S. dollar still continues to dominate is due to the fact that other countries have their own share of issues as well. And thus, the dollar's strength is more relative. But recently, there have been “rumours” and talks that the Yuan/ Renminbi, the Chinese currency has the ability to supersede U. S. dollar as dominant currency in the global financial system and being the top reserve currency around the globe.

China is currently the world's biggest manufacturer and exporter as well as its second largest economy according to ChinaDaily[http://www.chinadaily.com.cn/china/2014-03/02/content\\_17315230.htm](http://www.chinadaily.com.cn/china/2014-03/02/content_17315230.htm). Yet its currency, Yuan, which is still cautiously managed by the Chinese government, only has a small percentage of market shares which is substantially behind the U. S. dollar, and is hardly being traded on foreign exchange markets. However, the trading volumes are gradually increasing. During the last quarter of year 2013, the Yuan overtook the euro and became the second most used currency in the global trade finance after the U. S. dollar, based on the Society of Worldwide Inter-bank Financial Telecommunication. Since then, it became the 9<sup>th</sup> most traded international currency around the globe, according to a financial report created by the Bank of International Settlements. Some economists and analysts forecast that the Chinese currency will continue to rise in the next few decades. All the signs mentioned above indicate that the Yuan is gaining greater stature to be a more stable and suitable dominant currency.

One of the great reasons why the Yuan should replace U. S. dollar as the dominant currency is the stability of Yuan. The steady economy growth of <https://assignbuster.com/yuan-as-a-dominant-currency/>

China for the past few years has almost proven its currency, Yuan a steady and safe currency to invest in. People may argue that the euro, yen, British pound could serve as a strong currency that can be the dominant currency as well; however, most of these economies have not been doing great since 2008. This is especially clear in Europe, where a sovereign debt crisis is brewing, and Japan, where a robust recovery from the last two decades has been put on hold by a combination of several incidents like nuclear power disasters, the spill over from the weak European economies and the 2007 U. S. financial crisis.

The internationalisation of Yuan will occur before Yuan becomes the dominant currency. Therefore, the benefits of globalised Yuan can be solid arguments in why should Yuan replace the U. S dollar as dominant currency.

There are many benefits when Yuan is internationalized. China has started to loosen its control for its financial markets recently and slowly opening up access to the onshore markets. In the year of 2007, the Chinese government started to issue RMB-denominated bonds, notes, and funds, which are named as “ dim-sum bonds” in Hong Kong. Since year 2009, companies located in Mainland China have been able to perform cross-border trade in Yuan. This enables any onshore companies in China to reduce their transaction costs, speed up payments, and ensure for a better management of foreign exchange risks. “ In the longer term, this will and can obtain wider benefits.” says Professor Yeh, associate professor of the Department of Finance at the Chinese University of Hong Kong. For instance, this will enable the companies to lower down the price of their products or services, and pass on the cost savings to the customers.

On the other hand, the use of Yuan undoubtedly benefits foreign companies including the U. S. companies as well. Many U. S. companies such as McDonald's, have taken advantage to issue RMB-denominated bonds in China and Hong Kong to save companies a fortune in terms of interest and transaction costs. Moreover, issuing RMB-denominated bonds is a great way to hedge currency risks as well. Given the slow economy growth in the western countries, holding a RMB-bond can diversify the currency risk imposed by the U. S dollar and euro. RMB- denominated bonds are a good financial instrument for companies to conduct business in China in protecting them from any fluctuations in currency values in the future.

More advantage in using Yuan in conducting business with the Chinese is the discounts that Chinese business leaders may provide if a business transaction is deal in Yuan. According to the HSBC's research, 56 per cent of Chinese business leaders would offer discounts to their trading partners for transactions performed in Yuan for up to three to five per cent.

U. S. multinationals with business operations in China can also benefit when they perform transactions in Yuan, as it enables them to centralize their management of foreign exchange. Instead of managing their foreign exchange exposure in China, they could centrally manage it in a regional or global centre in New York, Singapore or even Hong Kong, for instance.

Next, China is a top import and export market for many countries around the world including the U. S., according to ChinaDaily USA [http://usa.chinadaily.com.cn/epaper/2014-05/08/content\\_17493372.htm](http://usa.chinadaily.com.cn/epaper/2014-05/08/content_17493372.htm). It was also the biggest recipient of foreign direct investment in the first six months of year 2012,

based on HSBC research. According to <http://www.cfr.org/china/uneasy-us-chinese-trade-relationship/p10482>, the trade between China and the U. S. is healthy. As a matter of fact, 77 per cent of U. S. business leaders claimed that they do import from China and 49 per cent claimed that they have export partners in China, according to a survey performed by HSBC. Since the U. S. has the largest percentage of international trading activities with China, the U. S. could benefit from the use of Yuan in conducting their trading business with China.

For the benefits of importers, performing trade activities with the Chinese trading partners in Yuan relates to pricing. When U. S. dollar is accepted as payment in trading transactions, the Chinese companies usually factor in the foreign exchange risk by adjusting their price. By completing the payment in Yuan, the importers stand a better chance to negotiate for a lower price or even obtaining better trade terms. Moreover, invoicing in Yuan helps to increase the supplier base in China importers too, as the Chinese companies appreciate this practice a lot. With a bigger supplier base from which to choose, the importers obtain a bigger bargaining power in negotiating price and terms.

On the same hand, a globalised Yuan brings several advantages to international investors as well. International investors could diversify their investment and currency risk by investing into other currency like Yuan, rather than just the U. S. dollar or euro. The modern portfolio theory states that the more unrelated assets you have, the less impact of currency risk will be encountered through diversification (<http://www.sec.gov/investor/pubs/assetallocation.htm>). Just like any democracy, at least two <https://assignbuster.com/yuan-as-a-dominant-currency/>

parties are needed to achieve balance. The same goes to international currencies, with an extra option to invest in, investors could enjoy the diversification advantage. Today, U. S. dollar is the dominant currency; therefore, U. S. domestic fiscal and monetary policy has significant effect outside and inside the United States. If there is more international currency, then there would be more choices and investors will be less susceptible to U. S. policy decisions.

While the impact caused by the 2007 global economic crisis did not affect a huge number of Chinese investors, but the fallout has been serious, as values of the savings around the world have plummeted. The 2007 financial crisis has a great impact on the mind-set of international investors, especially, about the safeness of the dollar. National banks, China's included, have experienced the fall of the value of their foreign currency reserves significantly, as the dollar and euro weakened during the crisis period. Therefore, more choices of international reserve currencies can provide better checks and balances, which are very essential to monetary policy makers around the world, showing the benefits of Yuan being internationalised and as a dominant currency.

Furthermore, if Yuan ever became the dominant currency, it would allow China, which holds substantial amount of money reserves, to be less dependent on foreign currency reserves, and therefore less affected by the currency fluctuations. Moreover, a globalised Yuan could bring direct financial benefits to China in the form of seigniorage as well. Seigniorage is the profit made by a government by issuing their currency with the difference between the fair value of the money and the cost of producing it,

explained by (investopedia)<http://www.investopedia.com/terms/s/seigniorage.asp>. So if the fair value of the money is greater

than the cost of producing it, the money, then China will enjoy a financial gain. Some economists even estimate this could amount up to USD of 2.5 billion a year.

Other than seigniorage, if Yuan became the dominant currency, China could also enjoy further benefits, including prestige, lower borrowing costs for the government, corporations, and households, and a much lower if not zero probability of a debt and financial crisis.

The dominance of Yuan would bring obvious benefits to China, which includes a lower risk of capital loss triggered by a depreciation of the U. S. dollar or euro. What about the effects to the Europe, United States, and other countries? Firstly, since the Western economy is not performing well recently, if the benefits from the dominance of the Yuan helps to convince the Chinese to buy more of their debt, it could aid to hold down their borrowing cost, indirectly billing them out from the poor economy.

Secondly, with a greater Yuan flexibility, China will worry less about the capital loss on its foreign exchange holdings. As such, China would be more willing to hold on to their fixed exchange rate regime. This could benefit not only to China, but to all the countries that perform trading activities with China as well. During the 2008 GFC, China decided to change back to a fixed exchange rate regime after implementing a semi-floated currency regime for a short couple of years <http://www.investopedia.com/articles/forex/08/pegged-vs-floating-currencies.asp>. This decision aided

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the Chinese economy to emerge 2 years later relatively well. Since then, China has been trying to control its economy from growing too fast. If a floating exchange rate regime is used by China, American demand for Chinese goods would definitely force up the exchange rate and inflate the price of the Chinese goods, causing the Chinese goods less desirable eventually <http://www.netplaces.com/economics/foreign-exchange-and-the-balance-of-payments/to-fix-or-float-that-is-the-question.htm>. This is undoubtedly important to the Western governments. Thus this should be considered worth facilitating.

However, some might believe that the United States would never tolerate the humiliation with its government debt denominated in a foreign currency. But if the U. S. does, it certainly would not be the first country to do so. Most countries denominated their debt in foreign currency whenever they need to make borrowings from the international capital market. Furthermore, history reveals that the U. S. is very pragmatic. History also shows that the U. S. has denominated part of its government debt in foreign currency before, mostly the deutsche mark, a German currency before the adoption of euro, in the 1970s. In any case, everyone has to weigh the benefits and the costs for doing everything. In my opinion, the benefits outweigh the costs in this case.

To a certain extent, an international role for the Yuan seems inevitable. How often and widely a currency is used and traded around the globe is generally a function of how significant and important its home country is to the world economy. In the 19th century, while the British Empire reigned supreme, the British currency, Pound was recognised as the top international currency. Ever since World War II, the role of Pound has been substituted by the U. S.

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dollar, as the U. S. is currently the world's largest economy. Now that China is catching up rapidly with a stable economy growth that placed itself second after the U. S., the potential of its currency may progress to a point where it substitutes U. S. dollar as a global currency. If the growth continues at its current pace, it is possible that China's economy could surpass the United States' within the next two decades. Therefore, there is a strong reason to believe that Yuan could replace the U. S. dollar and dash into the big league of international currencies. [http://www. bloomberg. com/news/2010-08-16/china-economy-passes-japan-s-in-second-quarter-capping-three-decade-rise. html](http://www.bloomberg.com/news/2010-08-16/china-economy-passes-japan-s-in-second-quarter-capping-three-decade-rise.html)

However, the Yuan is still currently far from that league. As a matter of fact, it can hardly be found in the world currency markets. The chief reason is cause by the Chinese policy. The Chinese Government restrictions restrain the Yuan from being traded freely around the globe or being fully convertible into other currencies in almost all financial transactions. The Chinese currency value is pegged to a basket full of currencies which are most probably dominated by the U. S. dollar and is only permitted to adjust each day within an allowed and narrow band. With such limitations, the potential of Yuan cannot progress very far. [http://content. time. com/time/world/article/0, 8599, 1911671, 00. html](http://content.time.com/time/world/article/0,8599,1911671,00.html)

Nevertheless, it is believed that the Yuan could be one of the world's top currencies and may be able to fully convertible sometime in the future. Therefore, I believe that the Yuan could serve as a potential hedge against the U. S. dollar as the dominant currency to the world.

In conclusion there are numerous advantages as for Yuan to be the dominant currency, including the stability of Yuan compared to the U. S. dollar, benefits of globalisation of Yuan to the Chinese companies, foreign companies, international importers, investors, China, Europe, United State and other country around the world. Thus, I do believe that the Yuan should replace the U. S. dollar as the dominant currency in the global financial system.