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China's Yuan: The Next Reserve Currency?

Skeptics have dismissed Beijing's talk of de-emphasizing the U.S. dollar, but China is making moves that could soon lead to a convertible yuan

By [Steve LeVine](#)

Are the Chinese finally getting serious about loosening their ties to the dollar—and even replacing the greenback with the yuan as the global economy's reserve currency? The evidence is mounting that they are.

For the last two months, China's leadership has been complaining about the country's dangerous dependence on the dollar. Beijing holds \$2 trillion in dollar assets, accumulated through years of exports to America and massive purchases of Treasuries by the Chinese government. If Washington can't rein in its mounting budget deficit, both Treasuries and the greenback could weaken considerably—and the Chinese could be big losers as a result.

The Chinese began generating attention on the issue in March, when Chinese Premier [Wen Jiabao said he was worried](#) that the country's dollar assets could slide. Ten days later Chinese central bank chief [Zhou Xiaochuan suggested replacing the dollar](#) as the international reserve currency. One idea, Zhou said, was to replace the dollar with a basket of currencies supervised by the International Monetary Fund.

FREE CONVERTIBILITY FOR THE YUAN?

Skeptics said the Chinese were merely talking. The dollar is too entrenched as the international currency of choice, with the U.S. by far the world's largest economy, went the thinking. And in any case, the Chinese act so deliberately that, even if they did wish to elevate the yuan globally, they wouldn't do it in the short or medium term. Finally, if the Chinese were to bring the yuan into competition with the dollar as a medium of international trade, they would have to turn the yuan into a convertible currency whose value would be dictated by the market, with traders, investors, governments, and companies around the world freely buying and selling it. Such a loss of control, said many Western investors, would never be allowed by the authoritarian Chinese. It would mean lowering all kinds of financial trade barriers, allowing foreign access to Chinese securities markets and more. No way.

Now some observers are changing their tune. China's financial moves during the last two months have persuaded Western experts that the nation's leadership intends to make the yuan freely convertible into other currencies—the first big step toward open confrontation with the dollar—within a few years.

Why have perceptions started to change? Last month, Beijing completed the last of a series of so-called currency swaps—providing yuan to other central banks for use in trade with China—with Argentina, Hong Kong, Indonesia, Malaysia, South Korea, and others. These arrangements theoretically removed any need for these trading partners to use the dollar as an intermediary currency in dealing with China. Last week, Beijing denominated a bilateral trade deal with Brazil in the two countries' currencies, rather than in dollars; the value of the agreement was not specified. The value of the other agreements comes to \$95 billion. By way of comparison, U.S.-Chinese trade amounted to \$333 billion in 2008.

MIND THE DOLLAR'S "SAFE HAVEN ASPECT"

Big hurdles remain for the Chinese. Making the yuan freely convertible is one: Major central banks would be loath to hold any large sums of any currency—the purest definition of a reserve currency—if they could not sell or trade it without limitation. Another is the absence of a large market for yuan-denominated bonds. One key sign of acceptance

as a reserve currency would be if Western countries such as the U.S. purchased bonds denominated in yuan and sold at market rates. Until now, yuan-denominated bonds have been sold only by Chinese banks, along with multilateral banks such as the Asian Development Bank and International Finance Corporation, and the bonds have been sold only in China.

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