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Change in the Global Currency: A Qualitative Study on How the Chinese Renminbi Might Replace the US Dollar

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ABSTRACT

This paper explores the reasons and evidence that show that the Chinese Renminbi might overtake the U.S. dollar as the global currency in the near future by studying both economic and political factors. The strength of the Chinese Renminbi and China's soft power over the rest of the globe is growing while according to various macroeconomic indicators, the U.S. dollar is declining in value. Data from the World Bank, the International Monetary Fund (IMF) and other sources was used to investigate the changing value and strength of each of the currencies and also question the need for a global currency with the advent of Central Bank Digital Currencies (CBDCs).

Keywords: ***Global currency, CBDCs, Chinese Renminbi, U.S. dollar, macroeconomic indicators, fiat currency, quantitative easing.***

Subject: Economics

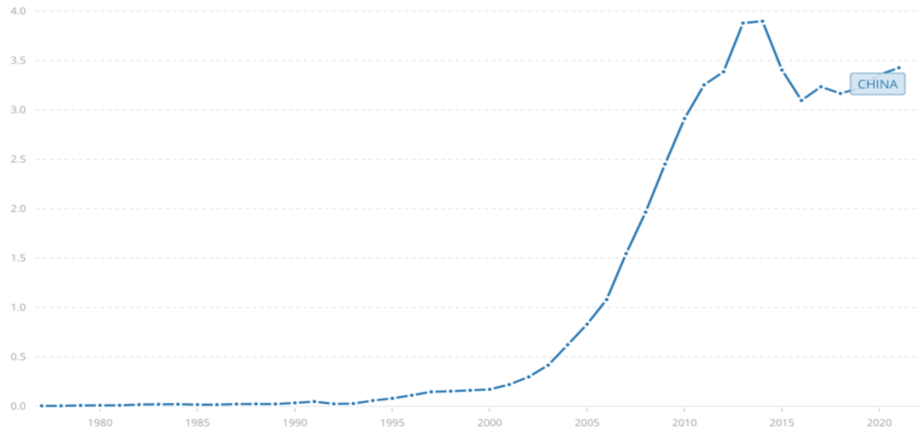
INTRODUCTION

China holds approximately $3.3 trillion of US dollar reserves (Figure 1), close to a multi-year high, and the total US Dollar reserves held by all countries across the world is US$ 7.08 trillion (World Bank, 2022). The dollar index hit a low of 91 in 2021 (Bloomberg, 2021), indicating the growing weakness of the currency. The dollar index is the movement of the US dollar against a basket of six currencies. It shows the relative strength of the US Dollar. The US trade deficit is at US 107 billion as of March 2022 which is creating growing pressure on the US Debt situation which is adversely impacting the intrinsic value of the currency.

The above statistics indicate the growing pressure on the global reserve currency, the US Dollar. Furthermore, the geopolitical tensions in Ukraine and Russia might be the start of the decreasing influence of the American greenback as the global currency. We will review the growth of the US economy, the acceptance of the US Dollar as a global currency, and recent trends to evaluate whether the American greenback still holds the aces to retain its apex currency, or if there is a challenger lurking in the form of the Chinese Renminbi.

The Ascent of The US Dollar as Global Currency

According to IMF, as of Q4 of 2021, 7087.14 billion US dollars were held as foreign exchange reserves, which is 54% of the total foreign exchange reserves held by various central banks around the world. Around 90% of foreign exchange trading involves the U.S. dollar. This is because the US dollar is the global currency.

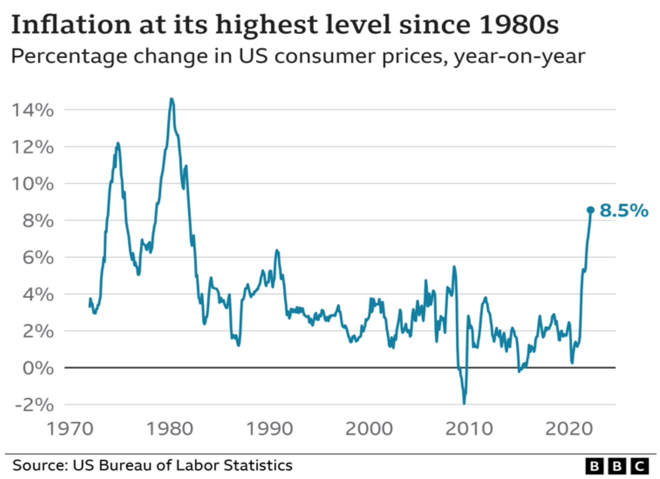


The US dollar served as a global currency that ensured exchange rate stability, hence invigorating global trade. It first became a generally accepted currency post the Bretton Woods Agreement (of 1944), a framework established by a group of 45 nations (that conceived the IMF) for international economic cooperation. The countries pegged the value of their currencies to the U.S. dollar instead of to gold and the United States agreed to keep the value of the dollar in terms of gold. Aided by stupendous growth in the US economy, the dollar built on its strength to become a globally accepted currency over the years.

The Increasing US Debt and Trade Deficit Due to Quantitative Easing

The US Economy grew fastest post World War II and reached its peak in the 1980s. The Federal Reserve (the USA's central bank) - a.k.a. the Fed - has kept the US economy out of recession by employing various monetary policies and has been aided by growing global trade in terms of the US Dollar as the global currency. Significant threats to the currency have occurred twice in the last 20 years. The first one was the 2008 financial crisis when the Fed chose to use quantitative easing i.e., printing more US Dollars to drive the economy out of the woods. The Fed bought 2.1 trillion worth of treasury bonds between 2008 and 2010. The second instance was the covid pandemic in 2020 when there was degrowth in the economy due to lockdowns across countries with a 3.5 trillion-dollar quantitative easing.

Quantitative easing (QE) in layman's terms is printing more currency notes to increase the money supply and drive up the aggregate demand in the market. The downside of this monetary policy is that a larger number of notes in circulation leads to inflation - which results in a decrease in the intrinsic value of the currency. QE being used as an instrument to get the economy out of trouble leads to a huge amount of long-term damage on the macroeconomic indicators which is reflecting with the US Dollar in the recent years.



The United States has been importing more than it is exporting, which has resulted in a rise in their trade deficit.

Further, caused by unsustainable spending habits, their budget deficit reaching a record $3 trillion in September 2021 (Bureau of The Fiscal Service). This caused a steep decline in the relative strength of the U.S. dollar. The country is also experiencing a 40-year high inflation of 8.6% as of June 2022, (Al Jazeera, 2022) implying a fall in the value of the dollar and an increase in its volatility, making it less reliable as a global currency.

The Impact of China's Growing Political and Economic Influence on the Renminbi's Power

There are multiple reasons why the Chinese Renminbi is seen as a potential replacement for the US dollar as the global currency. Being a manufacturing hub, China has a huge trade surplus - US$ 676.7b in 2021 (Statista), and hence larger foreign exchange reserves. This results in an increase in the demand for the Renminbi. Through strategic investments in smaller economies, China is expanding its political and economic influence across continents (The Economic Times, 2020). For example, it invested in the Belt and Road Initiative (BRI), in order to optimize trading with other countries (Swiss Re, 2020). As more countries trade with China, its currency would become more generally acceptable. Also, their political influence is increasing with more countries across the world becoming reliant on Chinese investment for the growth of their economies.

Questioning the Necessity of a Global Currency

With easier access to data for policy analysis and research, central banks across countries are more prudent in their investments compared to in the 80s and 90s (IMF, 2022). Moreover, with the growing popularity of digital currencies and digital transfers, the need for physical notes has significantly reduced in the last decade. Central Bank Digital Currency (CBDC) is a digital payment instrument. It is legal tender issued in a digital form by the central bank in lieu of physical notes. With the advancement of technology, it is expected that physical notes will soon become obsolete. Digital transfers across central banks of potential ledgers maintaining and reflecting real-time balances have become the new norm. CBDCs might be one of the reasons for the reducing need of a single global currency. The growing contribution of eastern economies to the global GDP and the revival of the economies of India and the ASEAN countries will increase the influence of Asian economies on a global level. While China will probably continue to push for hegemony in the global currencies, there is a possibility of the US and the West diversifying their trade to other Asian economies in order to curtail the influence of China. This is especially seen post-covid, where economies like Bangladesh, Vietnam, and India are seen as beneficiaries of the China + 1 policy of western manufacturers.

Other Factors Influencing The Renminbi's Claim to Become a Global Currency

In addition to the growing adoption of CBDCs and the shift in the trade balance, there are other fundamental factors that will make it difficult for the Renminbi to claim its status as the apex currency in the near future. Firstly, access to Chinese data is restricted. Most central banks today prefer the Fed's transparency on the monetary policy, with 8 Federal Open Market Committee meetings every year. Detailed minutes provide a clear view on the Fed's view of the dollar which adds to countries' trust in the currency. China will not only need to start publishing data but will also need to garner the trust of other nations on the integrity and transparency of their data. Secondly, the Chinese Renminbi is still pegged (manage-pegged) to the US Dollar against the free float nature of the dollar. Moving to the free float of the Renminbi is expected to significantly strengthen the currency making exports from China less competitive.

CONCLUSION

In conclusion, while the macroeconomic and political factors clearly indicate a growing shift away from the US Dollar, it is not necessarily translating into a shift towards the Chinese Renminbi. The fundamental requirement of central banks across the world is stability and trust in their investments. Although the Renminbi seems to be better positioned to challenge the dollar, the Chinese central bank has to take steps to build transparency and trust, to make it attractive for central banks to hold the renminbi as their reserve currency. There is also potential for the growing acceptance of CBDCs that might eliminate the need for a global currency and hence, completely change the dynamics of world's currency markets. Overall, the economic aspect of the world will see an interesting next couple of decades as either of the above scenarios, or maybe a new disruptive idea similar to CBDCs can change the fundamentals of global trade?

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