

Paper 2 - Final

ENGL 1200

### US Dollar verse Chinese Yuan: A Global Currency Cat Fight

The U.S dollar is an internationally recognized and well used form of currency. However, just because the US dollar has been this global monetary benchmark does not secure its position as the premier internationally recognized currency indefinitely. In all actuality, the US is in trillions of dollars of debt and that means that its greenbacks are starting to lose value in the domestic and international market. So what exactly does this mean for the world's economy? While the US has faced economic turmoil in the last forty years, most recently with the Great Recession of 2007, one potential economic juggernaut has started to emerge and could possibly joust US and the dollar from its high horse; China and its Yuan. Furthermore the dethroning of the US dollar by the Yuan is a scenario debated highly in the economic field in regards to its feasibility. However, if other countries agree to adopt the Yuan as the new main international currency then not only would China be launched into an international, macroeconomic spotlight but the US would lose a huge instrument of power globally. Even though it is incredibly unlikely to happen without several worldwide, political changes, a new internationally recognized currency would change every nation's economy and revitalize the forum of exchange completely, leaving a completely unpredictable economic and political future.

The US dollar is not the first global reserve currency to ever emerge on the scene. In fact, global currencies have changed over the centuries, depending on who was in power and who had the most gold. At one point the Chinese Liang was internationally recognized then the Greek drachma which passed the torch off to the seventeenth century Dutch Guilder and after several hundred years the US dollar filled the spot (Helmut, 2011). However the beginning of the most modern idea of an international default currency occurred in the nineteenth century due to the introduction of central treasuries and banks because of the

emerging global economy at the time (Dawnay,2001). The development from previous international currencies to the US dollar had much to do with the right timing.

As history has it, after the Second World War proved to be the window of opportunity the US dollar needed. The establishment of the most current default currency, the US dollar, did not emerge until after WW2 (Dawnay, 2001). The current international financial system was established and guaranteed by the formal agreement to the Bretton Woods System by forty four of the world's most powerful and industrialized countries at the time (Historical Perspective of Reserve Currency Status of U.S. Dollar, 2009). This conference that met in Bretton Woods, New Hampshire was designed to set up an International Monetary Fund (IMF) and World Bank (Cohen, 2013). Members of the IMF were then assigned quotas of base funds to provide depending on global economic importance. This subscription was decided to be paid by every country in 25% of gold, which was mutually accepted as payment by countries internationally, and then 75% of their own country's currency to create a global lending and borrowing pool (Cohen, 2002). The establishment of the IMF played a huge part in global economic development and set the stage for more evenly currency exchanges to occur.

Yet after only two years, this pool of international funds was drying up. So, the US stepped in and poured its own capital in to save the IMF. In doing so, this action significantly aided in the US dollar becoming an internationally recognized form of currency because the majority of countries were using it to pay debts and back their own banks (Cohen, 2002). The reason the US was able to step in like this was due to its booming economy after WW2 in comparison to the majority of the world (Helmut, 2011). After the US stepped in to save the IMF and World Bank, countries started using the US dollar in their countries because it was trusted globally and as international trade increased, more and more products started being priced in US dollars on the global market (Chey, 2011). Additionally, according to The Economist writer John O'Sullivan, "The dollar is the world's main currency in part because commodities, such as oil, are bought and sold in dollars, and because it is the default for trade invoices where the currency of one trading

partner is not used.” (O’Sullivan, 2014). The US was in a major power position after WW2 and due to the nation’s financial stability, the US dollar rose to internationally reserve currency status.

However a lot has changed in the world, economically and politically, since the US dollar’s rise to power. Over the decades, the global market has witnessed several nations rising to economic power via industrialization and increased trade (Kirby, 2014). One of the fastest growing countries in the global market is China due to its fiscal policy of significantly deregulated capitalism and booming international trade industry (Mallaby, 2012). China’s actions in the last twenty years are what have launched it and its currency, the Yuan, into international limelight. At the beginning of 2002, China began liberalizing its markets in order to make China’s market a more attractive one to invest in (Chey, 2012). The establishment of the Qualified Foreign Institutional Investor and Qualified Domestic Institutional Investor programs in China in 2002 further freed up the markets for example (Chey, 2012). More people and firms, internationally, began to gravitate towards the Chinese market because this deregulation offers attractive ways to increase profit that may not be available in other countries, like the US.

As more foreign money started pouring in to China’s markets, the national currency, the Yuan, has gained value on an international scale. The Yuan’s heightened value is due to the increased international capital that now exists in China’s reserve banks (Hung, 2013). Since the majority of the world trades with China, the country possesses immense amounts of various capital in its own banks which then translates into value behind its national currency, the Yuan (Matsushita, 2007). From 2003 to 2013, China’s economy quadrupled, valued in US dollars ironically, to 9.2 trillion dollars; branding China the world’s second largest economy (Boesler, 2013). If this trend keeps going due to China’s attractive and deregulated markets, the Yuan would only increase in value and stability due to China’s immense international currency reserves and possibly even start rivaling the US dollar as the global currency default.

Yet timing is everything in most situations, including the current Yuan verse dollar showdown that is occurring. The US dollar has been struggling to maintain its own value on a global scale for years now due

to its own temperamental business cycle economy (Picardo, 2011). The rise of the euro has also poked at the US dollars value, even superseding it in the last decade (James, 2011). The Euro's exchange rate value may be more comparable to the US dollar but the currency has no reason to dethrone the US dollar because the members of the European Union trade heavily with the US and are allies, politically, as well (Dawnay, 2001). Yet China is not a strong ally of the US and more interested in just trading with the nation; their political agendas are too opposite for them to every see eye to eye completely hence why if China can rival the US in power economically, it will (Shah, 2011). China has the US in its back pocket economically; according to Arvind Subramanian, senior fellow at the Peterson Institute for International Economics and Centre for Global Development, as he stated in a viral debate put on by The Economist that, "China holds \$2 trillion of dollar reserves and is troubled by the US Federal Reserve's notably loose monetary policy and by America's rapidly rising public debt."(O'Sullivan, 2014). China knows that the US dollar is not a very stable form of currency, which troubles not only China but the rest of the world; furthermore opening up an opportunity for a more stable currency, the Yuan, to become the global default.

Most things are easier said than done, including making a new global default currency. China would have to move mountains in order to obtain such international status for its Yuan. Yet the first step has already been taken; starting in the early 2000's China started moving away from the US dollar by internationalizing the Yuan within Asian markets (Jola, 2011). With the success of incorporating the Yuan into the offshore Hong Kong market, China was testing to see how viable the Yuan was in other markets (Mallaby, 2012). More recently, China's Five Year Plan that began in 2011 pursued to increase domestic demand for the Yuan instead of the US dollar which therefore increases their national currency's legitimacy (Jola, 2011). In addition, Shanghai has now been recognized as a premier financial center for Asian markets, further showcasing China's amazing economic growth (Bhat, 2013). The positive response the Yuan has received in Asian markets has begun to verify its creditworthiness in Asia but not necessarily the rest of the world.

Even with China's increased international trading, the push for its own currency, and the success of the Yuan in the Asian markets, the country is far from the top. The US is still dominating economically; China's economic size is only one-third of the United States' size. Furthermore, China's gross domestic product is predicted to still only be half of the US's in the year 2020 (Boesler, 2013). These facts are intensely significant because in contrast to when the US dollar began to escalate to its international currency status, its economy was the largest in the world (Historical, 2009)! Furthermore, the Yuan is primarily only accepted within Asian countries meanwhile because of the US's political power and global recognition after WW2, the US dollar was accepted globally (O'Sullivan, 2014). The US dollar's value may fluctuate but the nation's influence globally is a huge blockade against the Yuan. The US is still a major super power of the world, in all respects, and threatening to steal a tool of power away from it will evoke unwanted economic strains that could lead to political struggles down the road (Helmut, 2011). Moreover Bank of America Merrill Lynch strategist John Shin points out, "The need for an international currency depends on its usefulness as a reserve, a vehicle currency for intervention, and as an anchor for a currency peg, all of which the U.S. dollar clearly holds unique significant value." (Boesler, 2013). In addition, one of China's hugest markets is the US and by internationalizing the Yuan it would create tension with the US and therefore trade between both countries (Mallaby, 2012). China is simply not strong enough to withstand being exiled from the US economically because it tried to get the Yuan to take the spot of the US dollar under international economic scrutiny.

However if the Yuan were to become the new internationally accepted form of currency, a lot would have to happen. The US's influence globally would have to diminish severely over time as China's global economic influence sky rocketed simultaneously, thus creating a perfect storm of sorts (Chey, 2012). Markets around the world would have to cross over to Yuan based exchanges, even down to the most rudimentary levels. Companies and firms of all sizes would have to be able to adopt to trading in terms of the Yuan and become very familiar with China's monetary policies (O'Sullivan, 2014). Yet as China gains

immense amount of economic strength, the country would also become a political super power due to its hand being in everyone's purses. China would have to start making incredible moves, politically, in order to gain momentum for its currency; their political ideologies would have to gain support from around the world- which doesn't seem too popular at the moment (Cohen, 2013). Besides, currently China is the largest foreign creditor to the US, holding 1.2 trillion dollars in US treasury bonds (Hung, 2013). The only way China could ever be free enough to support the Yuan fully as becoming the international default currency is to get free of the US dollar, which obviously would take some time because China owns so many of the US's treasury bonds. Researchers, politicians, and experts in these various fields have gotten too caught up in hypothesizing about possible consequences and have overlooked the political- economic forces at work that make China so privy to US Treasury bonds (Hung, 2013). The main reason China even has campaigned for the internationalization of the Yuan, that is currently known at least, is to make it a buffer against the constant swings of the US dollar (Kirby, 2014). In order for the Yuan to replace the US dollar as the international currency, a perfect storm of economic and political US downfall would have to be timed flawlessly with Chinese growth. Fortunately for American, this is very unlikely to happen in the near future.

However if the Yuan were to gain global currency accreditation, then much more than just economic policy change would be at stake. China's political policies are significantly different than the United States' political values. The Chinese government is extremely oppressive compared to the US's government, often ruling by use of fear (Shah, 2011). China's Communist Party first rose to power in 1949 and along came authoritarian rule (Matsushita, 2007). Freedoms that are so common to American's are simply non-existent in China; political dissenters are often thrown in jail as the government's way of peace keeping. Foreign media is frequently banned if any critique of China is found, the press is extremely regulated, and expression of any thought that is critical of China's government is made at the spokesman's own risk (Shah, 2011). These examples showcase major political policies China could possibly force onto

the rest of the world if it gains such global power via the Yuan being established as the premier international currency, none which seem too appealing.

The Yuan's potential to become the global currency instead of the US dollar is highly debated. So many factors have to go in favor of China, most importantly a situation resembling the United States post WW2 but dubbing China as the unofficial winner would have to occur in order for the Yuan to replace the US dollar. China has taken several steps and shows signs of continuing towards making this possibility a reality yet that is only part of the puzzle. Meanwhile the United States remains an economic and political super power that the majority of nations, those being democratic at least, accept along with the US dollar. There are numerous events, predictable and unpredictable, that would have to align in order for the Yuan to take the place of the US dollar in global markets; none of which seem to be happening anytime soon. A heavy dose of luck and perfect timing would be necessary for the Yuan to legitimately be able to take on the US dollar.

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