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US Dollar vs. RMB – bipolar currency regime possible

By Horst Loechel

The Western Russia sanctions have increased the desire for an alternative to the US dollar in many countries, because they also affect the settlement of foreign exchange transactions. This benefits the Chinese yuan (renminbi) on its way to becoming a global currency.

After the global financial crisis of 2007 and 2008, China started to internationalize its currency, the renminbi (RMB) or yuan, first as a trade currency and later also as a reserve currency. This process was initially successful and culminated in the official inclusion of the RMB in the International Monetary Fund's (IMF) special drawing rights on 1 October 2016.

However, the stock market crash of 2015, which spilled over into the foreign exchange markets, led to a sharp devaluation. The Chinese central bank PBoC tried to control the devaluation pressure by unilaterally and surprisingly devaluing the RMB by almost four percent on two trading days in quick succession. The attempt backfired. A massive capital flight was the result. It cost China around one trillion dollars in currency reserves to halfway calm the situation at the beginning of 2016.

The internationalization of the renminbi has come to a standstill since this episode. From the Chinese perspective, the liberalization and internationalization of the RMB have not paid off. Instead, it has resulted in a loss of control over its own currency that has hurt more than the loss of ambitions to develop the renminbi into an international reserve currency on par with the US dollar. China thinks strategically and has time.

Russia sanctions make China think twice

The Russian invasion of Ukraine has radically changed the situation. Not because of the invasion itself but due to the Western sanctions, which are known to involve freezing Russian currency reserves and excluding Russia from the SWIFT international payment system. This has raised fears in many emerging economies that they, too, could be hit by such sanctions in the future.

China itself still holds around three trillion US dollars in foreign exchange reserves, with a significant amount in US treasury bonds. It is no coincidence that the country has systematically reduced this stock over the last six months. In parallel, Beijing is lending US dollars to third countries with the agreement that repayment will be made in RMB.

But other countries are also considering this direction. Brazil’s President Lula emphasizes that the BRICS countries must reduce their dependence on the US dollar. Apparently, the states are already in first talks on what an alternative to the dollar could look like. The same goes for the ASEAN states, which recently decided to settle their trade in regional currencies. Currencies and finance have apparently become a weapon in the geopolitical struggle, threatening the unchallenged supremacy of the dollar.

The numbers confirm the trend: Chinese-Russian trade, which almost doubled last year to around 200 billion US dollars, is now largely billed in renminbi. Settlement takes place via the cross-border settlement system CIPS (Cross-Border Interbank Payment) set up by China. So far, only 79 financial institutions are connected to the system. For SWIFT, it is 11,000, but the number of CIPS is rising steadily.

Future currency battle USA vs. China

Within the SWIFT system, too, the settlement of transactions in renminbi has almost doubled since the Russian invasion, accounting for nearly five percent of all cross-border trade transactions worldwide. Around 50 percent of China's foreign trade is now conducted in renminbi.

However, the US dollar continues to dominate with a share of about 85 percent, while the euro as a trading currency only has a six percent share and will soon be overtaken by the RMB. The dominance of the dollar is attributable to third-country trade in dollars. However, it is by no means impossible that the renminbi will catch up in this respect as well. The peace agreement between Tehran and Riyadh brokered by China could be a herald of such changes.

However, the pinnacle of an international currency is its role as a reserve currency, held by central banks and global financial institutions to remain solvent under all circumstances. Here, the renminbi lags even further behind. Only just under three percent of global currency reserves are renminbi, while the dollar accounts for around 60 percent. Although, the share of the renminbi was just one percent in 2016.

Incidentally, the euro currently has a share of 20 percent as a reserve currency. This, like the low share as a trading currency, shows that the euro is not really an international reserve currency that could challenge the dollar's status. Just as the EU is not a global player, neither is the euro as a currency. The battle on the global currency front is being fought between the US and China.

Little doubt about bloc formation

But it is doubtful that the renminbi could replace the US dollar as the international reserve currency in the foreseeable future. It lacks free, cross-border capital flows. And the administered exchange rate is also a hindrance. For example, the dollar's current weakness is not offset by holding more renminbi reserves; instead, central banks are increasing their gold holdings.

On the other hand, there can be little doubt that we are heading for a world of renewed bloc formation – like it or not. During such a geopolitical reordering, a bipolar or even multipolar monetary system could emerge. Under such a scenario, a loss of importance of the US dollar's role as the international reserve currency seems inevitable over time.

The question is how high and how fast the loss of significance will be. This also depends crucially on whether the Chinese leadership does its homework and further liberalizes both capital movements and the exchange rate. After all, you can only have one of the two: the renminbi as the international reserve currency or the current exchange rate regime.

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