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RENMINBI INTERNATIONALIZATION:

A CONFLICT OF STATECRAFTS

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ABSTRACT

For nearly a century, the US dollar has reigned supreme as international money. Today, however, the greenback is under attack as never before by the Chinese yuan, also known as the renminbi (RMB), the "people's currency." In effect, two currency statecrafts have come into conflict. China, the rising power, is making every effort to erode the dollar's dominance; Washington, the incumbent, must in turn decide what it is prepared to do, if anything, to counter the RMB's rise. Who is winning? Success in a conflict of statecrafts can be measured in two ways – in terms of policy measures effectively implemented on the supply side of the market or in terms of substantive impacts on behavior on the demand side. By the first metric China's record of accomplishment to date has been impressive -- but not by the second. Yet over the long haul the yuan may still become a serious rival. Ironically, if that outcome comes to pass, it will be due less to the effectiveness of Beijing's statecraft than to the failure of Washington's.

For nearly a century, the US dollar has reigned supreme as international money. In the absence of a truly global currency issued by a world central bank, markets and governments are forced to make use of one or more national currencies to serve international roles. For the global economy this is undoubtedly a Good Thing. An international money greases the wheels of world commerce. But currency internationalization is a Good Thing for the issuer as well – the country that provides the international money. In practical terms, the United States derives substantial benefits from the greenback's widespread use. At issue is nothing less than the global balance of power. The dollar's popularity adds to America's ability to exert influence and project force across the globe. Political economists, echoing the bitter words of one-time French president Charles De Gaulle, call this the nation's "exorbitant privilege."

Today, the greenback is under attack as never before. Challenges to dollar supremacy are nothing new, of course. Over the last half century several currencies have seemed poised to surpass America's money -- including West Germany's old Deutsche mark (DM), the Japanese yen, and at the dawn of the new millennium, Europe's new joint money the euro – only to fade over time. None managed to topple the greenback from its rank at the peak of the global monetary hierarchy. But now a giant new rival looms on the horizon – the Chinese yuan, also known as the renminbi (RMB), the "people's currency." Many see the yuan as the greenback's most serious challenger ever, perhaps even destined in time to take over as number one.

In key respects, the RMB's challenge is unprecedented. Unlike previous challengers, China is not an ally of the United States. Quite the contrary, the proverbial Middle Kingdom is a global rival with obvious Great Power aspirations. The contest is not friendly sport. Rather, it is integral to what many see as a broad historical transition – an epochal confrontation between a still dominant but weakening status-quo power and an ambitious but not-yet-ready-for-prime-time revisionist power. As part of its geopolitical agenda, China clearly has made internationalization of its currency a strategic goal. Whereas earlier rivals to the dollar actually resisted wider use of their money, Beijing by contrast welcomes and promotes a greater role for the RMB. China, too, want an exorbitant privilege.

How much privilege? The full extent of China's ambition is unknown, perhaps uncertain even to the country's own elite. While some in Beijing might be content to settle simply for an RMB that more or less matches the dollar in an emergent multi-currency system, others may dream of a day when the yuan fully eclipses the greenback, taking over top spot for itself. The Middle Kingdom's ultimate goal is unclear. But either way, the government's immediate motivation is manifest. The people's currency is to become a money worthy of a Great Power. In effect, the Chinese have challenged the greenback to a duel. One can almost hear them shouting from behind their Great Wall: "Yuan a fight?"

Overall, the competitiveness of an international money may be said to depend on two key factors – first, the issuing country's material capabilities, its underlying power resources; and second, its ability to convert capabilities into effective action, which is a matter of statecraft. The focus of this essay is principally on the latter – two currency statecrafts in conflict. China is making every effort to erode the dollar's dominance; Washington in turn must decide what it is prepared to do, if anything, to counter the RMB's rise. In terms of capabilities, most experts agree, the advantage is all to the greenback, which is backed by power resources that – so far, at least – greatly outstrip anything available to the yuan. But in terms of statecraft, China has shown a determined and nimble strategic sensibility that arguably is leagues beyond anything

that we have yet to see come out of Washington. Both sides seem well equipped for a momentous battle.

Who is winning? Can the outcome be predicted? Success in a conflict of statecrafts can be measured in two ways – in terms of policy measures effectively implemented on the supply side of the market or in terms of substantive impacts on behavior on the demand side. By the first metric China's challenge would seem a great success -- but not by the second. To date, the greenback has remained supreme in actual use. Yet over the long haul the yuan may still become a serious rival. Ironically, if that outcome comes to pass, it will be due less to the effectiveness of Beijing's statecraft than to the failure of Washington's.

CHINA'S CHALLENGE

Among international currencies, China's yuan today is still a minor player – a money of growing promise but not yet unquestioned acceptance. But if Beijing has its way, ascent to the top ranks of the currency hierarchy will not be long in coming. China's government has clearly chosen to promote the widest possible use of the RMB. The goal of internationalization is openly acknowledged and has been pursued with imagination and tenacity.

Commitment

No precise date can be identified when China first leaned toward the goal of internationalization. Public discussion among Chinese academics began as early as the late 1980s, following the first successes of the market reforms initiated by Deng Xiaoping in 1979. Increasingly, scholars debated the pros and cons of wider use of the RMB (Peng et al. 2015). What were the costs and benefits? What conditions would be required? What consequences could be anticipated? Little doubt was expressed about the desirability of internationalization. That the RMB was destined for greatness was essentially taken for granted. The question was simply what should be done about it. What reforms were needed? What would be the proper sequencing of interventions? And how quickly should the authorities move? For years, however, the government equivocated, seemingly unsure whether the time was yet ripe for decisive action. Even after the shock of the Asian financial crisis in 1997-98, policy remained hesitant.

A key turning point seems to have been reached in 2006 with publication of a report on "The Timing, Path, and Strategies of RMB Internationalization" by a study group set up by the People's Bank of China (PBOC), China's central bank (PBOC Study Group 2006). "The time has come for promotion of the internationalization of the yuan," the study group argued. Internationalization "can enhance China's international status and competitiveness significantly [and] will increase its influence in the international economy." China will "have a greater say" and will enjoy "a rise in power standing." We "should take advantage of the opportunity," the report concluded. Internationalization is "an inevitable choice."

By then, evidently, many in China's leadership had come to the same conclusion. Within government circles a distinct shift of mood was soon apparent. After long vacillation, Beijing committed to making internationalization of the people's currency a top policy goal, and a concerted strategy was put into motion with that lofty ambition in mind. The RMB was launched on a Long March toward global status, reminiscent of the Long March that was so

pivotal in the Communist Party's victory in China's civil war. Enlightened statecraft would see to it that the proverbial Middle Kingdom would now have a money worthy of a Great Power.

Not that Chinese elite opinion is unanimous. In fact, divisions over the issue in Beijing have long been evident (Helleiner and Malkin 2012; McDowell and Steinberg 2016). On the one side are factions led by the PBOC who see internationalization as a means to push forward with liberal financial reforms. Many also are spurred by the 2008 global financial crisis, which highlighted the vulnerability of Beijing, with its vast hoard of dollar reserves, to a sudden shift of exchange rates (Zhao and Song 2009). In the Chinese literature this became known as the "dollar trap" (Yu 2010). Internationalization of the RMB would help reduce dependence on America's greenback. But on the other side are an array of producer interests and banking institutions, many of them state-owned, that have long benefitted from the government's firm controls over interest rates and credit allocation. Domestic cleavages are probably the reason why, to this day, there has never been a formal declaration anointing internationalization as official Chinese policy.

Judging from Beijing's actions, however, it is abundantly clear which way the prevailing wind has blown. By late 2009, as one informed observer put it, "The Chinese Government obviously changed its mind and became enthusiastic about RMB internationalization" (Zhang 2009: 24). By 2011, according to an influential advisor to the PBOC (as reported by Dow Jones News Service, 17 February 2011), internationalization had assumed a place "at the heart of China's financial strategy." More recently, it seems, the pace of the process has slowed somewhat, as Beijing has struggled to cope with a decelerating economic growth rate. But even so, no one doubts that internationalization remains the government's preferred currency strategy.

Implementation

But how was Beijing's ambitious strategy to be implemented? Up to the time of the PBOC's Study Group report, China had one of the most tightly controlled currencies in the world, hemmed in by all manner of exchange restrictions and capital controls. How could cross-border use of the RMB be encouraged if the money was not yet readily convertible? Moreover, the country's leadership knew that there was no successful model in recent history for promoting an international currency. They had no road map to help guide their actions. Not surprisingly, therefore, the government's statecraft has been noticeably risk-averse, a careful choreography stressing gradualism above all. Following Deng Xiaoping's dictum to "cross the river by feeling the stones," tactics have been developed incrementally in multiple small steps. China's ruling Communist Party is no stranger to the idea of a Long March.

Effectively, internationalization of the yuan has been pursued along two interrelated tracks (Subacchi 2017). One track focuses on cultivating use of the currency in foreign trade. At the official level swap agreements have been arranged with an increasing number of foreign central banks, facilitating expanded use of the RMB as a means of payment (Liao and McDowell 2015). By mid-2016 some three dozen agreements had been signed totaling more than RMB 3.3 trillion (c.$480 billion). At the private level, regulations have been gradually eased to permit more import and export transactions to be settled in yuan, bypassing traditional invoicing currencies like the dollar. The second track focuses on use of the RMB in international finance as a store of value. Emphasis has been placed on the development of active markets for yuan deposits and yuan-denominated bonds, mainly "offshore" in Hong Kong, the former British

crown colony that is now a "special administrative region" of China. Along both tracks, initiatives have been implemented patiently in finely calibrated phases.

To date, the trade track has seen more progress than the finance track. By 2016, some 30 percent of Chinese trade was being settled in yuan -- up from essentially zero less than a decade earlier – though it might be noted that most of the increase was local. As much as 70 percent of the trade settled in yuan is between Mainland China and Hong Kong and amounts to little more than a shuffling of cash between mainland enterprises and their own offshore subsidiaries. Nonetheless yuan invoicing is gradually spreading, supported by agreements designating selected clearing banks for RMB trades in nearly a score of financial centers around the world. These include not only neighboring East Asian outposts like Singapore, Seoul, Taipei, and Tokyo, but also others further afield such as Doha, Frankfurt, Zurich, London, and Toronto. Offshore clearing banks act as a conduit with China's domestic banking system to settle RMB payments outside the mainland. According to the Society for Worldwide Interbank Financial Telecommunications (SWIFT), which processes global financial transactions, the yuan in 2016 rose to fourth place among the world's top payments currencies, with an almost two percent share of global payments. Separately, the Bank for International Settlements (BIS) reports that the currency's share of aggregate turnover in the global foreign-exchange market fully doubled between 2013 and 2016, from two percent to four percent (BIS 2016).

Results on the finance track, by contrast, while not insignificant, have been rather less impressive. For the most part Beijing has proceeded with care, relying heavily on Hong Kong's established position as a leading financial center. With its own currency and capital markets, Hong Kong offers a useful offshore laboratory for experimenting with innovations that the leadership is not yet prepared to introduce "onshore" on the mainland. As frequently noted (Frankel 2011), this is, to say the least, an unusual pattern. Never before has any government sought deliberately to develop an offshore market for its currency while still maintaining strict financial controls at home. In effect, Beijing is drawing up its own road map, depending on the Hong Kong Monetary Authority (HKMA) – de facto, Hong Kong's central bank and chief financial regulator – to act as its faithful proxy. Under the HKMA's tutelage the markets for both yuan deposits and yuan-denominated bonds (known as "dim sum" bonds) have grown considerably, but aggregate sums remain small. Yuan deposits in Hong Kong have never exceeded RMB 900 billion ($130 billion), and the volume of dim sum issues has been limited. From 2009 to 2015 the total value of dim sum bonds came to just 443 billion renminbi ($65 billion). Both numbers are minuscule by international standards.

A noteworthy milestone was reached in late 2015 when the yuan was formally admitted into the basket of currencies used by the International Monetary Fund (IMF) to set the value of its synthetic reserve asset, the Special Drawing Right (SDR). This was an honor previously accorded only to the dollar, euro, pound, and yen, and was the subject of much discussion (Wang 2015). Many doubted whether the RMB had yet met the necessary criteria for inclusion. Reservations were overcome, however, by a vigorous campaign mounted from Beijing. China's hope, clearly, was to trigger increased use of its currency as a reserve asset, which until now has remained limited. According to one knowledgeable source (Liao and McDowell 2016), as many as three dozen central banks have invested in yuan-denominated claims in recent years. But accumulations are small. In total, the RMB still accounts for no more than a microscopic one percent or so of global reserves.

Despite such milestones, therefore, it is fair to say that the RMB still has a considerable

way to go to match Beijing's highest aspirations. Achievements have been considerable and most likely will continue into the future. But on neither track has the yuan yet come anywhere close to challenging the dominant position of the dollar. In the foreign-exchange market the greenback appears on one side or the other of 88 percent of all trades, some 22 times the RMB's share. In global reserves, the dollar's share is 65 percent as compared with the yuan's one percent. The disparities remain enormous. Paola Subacchi (2017) is not far off in describing the RMB today as – still -- something of a "dwarf currency."

Motivation

What explains China's choice of strategy? Other options, after all, were possible. A dramatic contrast may be drawn with the policies chosen by West Germany and Japan back in the 1970s and 1980s, when their currencies too seemed set to pose a challenge to the dollar. In neither West Germany nor Japan was internationalization promoted. Rather, in each case it was actively resisted (Cohen 2015: ch. 5). Why has China been different?

Two factors would appear to be most critical: *geopolitics* and *autonomy*. China's choice of strategy, when compared with that of West Germany and Japan earlier, suggests the overriding salience of these two factors. Resistance to internationalization naturally goes hand in hand with *domestic stabilization* -- a drive to achieve or maintain a high degree of monetary order at home. Promotion, conversely, goes hand in hand with *geopolitical ambition* -- a drive to build or sustain a prominent position in the community of nations. A safe generalization is that for any country whose currency begins to gain international popularity, *the choice of strategy is based, first and foremost, on a trade-off between geopolitics and autonomy*. In the imagery of Leslie Armijo and Saori Katada (2015), the choice is between a *sword* and a *shield* – between an instrument of international influence and an insulation against external pressure. China, plainly, is more interested in a sword.

Consider the role of geopolitics. At the time that each of their currencies first began to gain international appeal, West Germany and Japan could be regarded as rising powers in the global system, just as China is today. All three countries were the beneficiaries of seemingly miraculous economic growth, and all were seen as emerging leaders in their respective regions. Yet of the three, only China has openly welcomed the prospect of currency internationalization and chosen to campaign actively on its behalf. The other two, by contrast, resisted. Much of the difference, it seems clear, turns on the role that each of the three nations saw itself playing in the great game of world politics.

Neither West Germany nor Japan, during the years of their currencies' ascendance, harbored any noticeable Great Power ambitions. Devastating defeat in World War II had left both of them more or less content to shelter under the security umbrella provided by the United States and to concentrate instead on rebuilding their broken economies. Beset by historical memories, neither had any wish to do anything that might seem threatening to their neighbors. For the Germans, this meant submerging themselves in broader collective arrangements like the European Community, now known as the European Union (EU), and the North Atlantic Treaty Organization (NATO), where their relative weight would be less conspicuous. For the Japanese it meant accepting the restraints of its postwar constitution, imposed during the US occupation, which limited Japan's reborn military to a purely defensive posture. Neither nation was looking for a new sword – a new means for projecting power abroad. Hence neither showed much

interest in the enhanced capabilities that might result from internationalization of their currencies.

Contrast that with China, whose geopolitical aspirations arguably are much less modest. Admittedly, given the secretive nature of Chinese politics, no one outside the ranks of the country's close-knit leadership can really know for sure what Beijing's ultimate goals are in foreign policy. Analysts argue endlessly about whether China is a more or less conventional power, prepared to accept the continuing legitimacy of the existing world order; or rather is more of a revisionist state looking for a radical transformation of the international environment – a new global system based on "Chinese characteristics" (Goldstein 2005; Gurtov 2013; Rapkin and Thompson 2013; Shambaugh 2013). The debate remains unresolved. But whatever Beijing's long-term intentions may be, it is evident that with economic success has come a drive to regain the rights and privileges that have long been regarded as the Middle Kingdom's natural due. After what they recall as a "century of humiliation" at the hands of the barbarian West, the Chinese are set on a "peaceful rise" to renewed Great Power status. China's leadership has made no secret of its desire to gain a larger measure of influence in global affairs. In that context, an internationalized yuan has naturally been valued because of what it could add to the country's geopolitical capabilities. As the PBOC Study Group said, China would enjoy "a rise in power standing." The contrast in this regard between China's bold aspirations and the earlier self-restraint of West Germany and Japan is telling.

Or consider the factor of *domestic monetary stability*. Here too the contrast between China and the others is telling. For both West Germany and Japan back in the 1970s and 1980s, the issue of monetary autonomy was paramount. Any attraction that currency internationalization might offer as a possible sword seemed to them to pale in significance relative to the perceived risk of a weakened shield against increased inflation or exchange-rate volatility. In each case the authorities had long relied on monetary policy as their principal instrument to maintain stability at home, and they were reluctant to allow anything that might threaten their policy autonomy. For them, therefore, resistance rather than promotion seemed the logical choice.

For China, by contrast, interest in a shield was secondary. At the outset, Beijing already had solid financial protection – a monetary Great Wall, as it were – in a panoply of controls and restrictions that was far tighter than anything ever imposed by West Germany or Japan. It was understood, of course, that future reforms might increasingly compromise policy independence, at least at the margins. But given the measures long in place, policy makers simply did not see fit to prioritize the risk to the same extent as did West Germany and Japan. Less worried about domestic autonomy, the Chinese could afford to focus more on the role that the yuan might possibly play in extending their country's external influence.

Herein, then, lies the explanation for China's choice of strategy. Reassured as they were by the defense commitments of the United States, West Germany and Japan could afford to concentrate on the management of the economy at home. For both, autonomy trumped influence. But for China, a rising nation intent on restoring its Great Power status, the calculus tilted the other way. Since monetary stability at home was a less urgent concern, emphasis could be placed instead on considerations of power and prestige abroad. An ambitious promotion strategy logically followed.

AMERICA'S RESPONSE

To date, China's currency statecraft has been implemented with notable skill. But that is only half the story. The future of the RMB will not be determined by the Chinese alone. Much depends as well on how the United States responds to the Middle Kingdom's challenge. Geopolitics is about the *conflict* of statecrafts, not just one country's unilateral actions. It takes two to duel, even if one party may be reluctant to fight.

No one can doubt the formidable material capabilities that America brings to the contest. So far, though, Washington has shown little interest in mounting much of an organized defense against the yuan, despite the greenback's manifold advantages. US currency statecraft has been largely passive, leaving the initiative to the Chinese.

A negotiated currency?

The RMB is of course not the first money to challenge the dollar. But in the eyes of many experts it threatens to be the greenback's most serious rival to date. "China's growing size and economic dominance are likely to translate into currency dominance," predicts one prominent economist (Subramanian 2011: 5). "The renminbi could surpass the dollar as the premier reserve currency well before the middle of the next decade." Echoes another influential commentator (Zweifel 2014), "The era of the renminbi is upon us." In effect, under pressure from the yuan, the dollar is thought to be slipping from dominance at the peak of the global hierarchy into a possibly painful decline. America's currency is faced with an unprecedented challenge.

Yet Washington's response until now has been remarkably nonchalant, a policy of more or less deliberate *non*-action – a reactive rather than pro-active form of statecraft. In another era, this was known as "benign neglect." Essentially, benign neglect means sitting back and letting market actors and foreign governments decide the fate of the dollar. In the face of the RMB's challenge, little has been done by Washington to protect the greenback's longtime exorbitant privilege; nor, from all appearances, has any serious consideration been given to the alternative of a managed retreat along the lines of what Britain did with the pound sterling in the 1960s and 1970s (Schenk 2010). Instead, despite the combative tone of China's currency statecraft, official US policy has remained adamantly neutral.

Not everyone sees it that way. Among some observers there is a perception that Washington has actually tilted more toward resistance, working hard to sustain international use of the dollar. Increasingly, it is said, the greenback is becoming what Susan Strange (1971a, 1971b) years ago called a "negotiated" currency – a money forced to rely on diplomatic bargaining or informal understandings to sustain foreign use. "Questions about the role of foreign political support in sustaining the dollar's international position have grown," asserts Eric Helleiner (2009: 76), suggesting that the greenback can by now be considered to have at least "partial negotiated status." Financial elites in key emerging market economies seem overwhelmingly persuaded that "the dollar is increasingly sliding from top to negotiated international currency" (Otero-Iglesias and Steinberg 2013: 328).

But such perceptions are mistaken. If the United States has opted to resist the Chinese challenge, it has done so in the most modest manner possible. In principle, two classes of pro-active strategy are available to a government hoping to persuade actors to stay loyal to its money – policies that may be either *indirect* or *direct* in their implementation (Helleiner 2008; Cohen

2015). An indirect strategy aims to maintain the market appeal of the country's currency, targeting all users whether at the private or official level. The idea is to explicitly *cater* to preferences on the demand side of the market. A direct strategy, by contrast, is aimed at governments and relies more on traditional instruments of statecraft – carrots and sticks – to *alter* existing preferences on the demand side of the market. In Washington today we see no commitment at all to an indirect strategy to defend the dollar and only the faintest interest in anything more direct.

An indirect strategy to defend the dollar could take several forms. Ostensibly "sound" monetary and fiscal policies, for instance – meaning high interest rates and low budget deficits – could be implemented to keep up confidence in the greenback's future usefulness and value. Financial development might be emphasized to offer lower transactions costs or greater liquidity. Or network externalities could be promoted by lowering import barriers and opening new trade markets. In Helleiner's words (2008: 362): "Politics can help determine international currency standing through these indirect channels of influencing confidence, liquidity, and transactional networks in ways that influence the economic choices of both market and state actors." Amidst the dysfunctional polarization of politics in contemporary Washington, however, none of these alternatives can be easily counted on. Fights over the Federal budget have already led to one downgrade of America's credit rating and could lead to more. If anything the dollar's brand is being tarnished, not burnished, by the antics of American politicians. The US system of governance today does not appear to treat the reputation of the greenback as a high priority.

Nor is there much trace of a more direct strategy to help defend the currency. Certainly we know of no inducements being offered or punishments threatened to persuade foreign authorities to keep using the dollar. As Helleiner concedes (2008: 368), "scholars have produced little evidence so far of any explicit deals between the US and dollar supporting countries." Some hints of discomfort with China's ambitions were occasionally evident during the presidency of Barack Obama, but nothing like any sort of formal resistance; and President Obama's successor, Donald Trump, has given little sign that the future of the greenback is likely to rank high on his policy agenda.

In reality, therefore, benign neglect does not seem an inaccurate way to characterize US currency strategy. The contrast with China's unabashedly assertive statecraft could hardly be greater.

Motivation

What explains America's choice of (non)strategy? China's determined search for power and prestige is bound to come, in large degree, at the dollar's expense. Yet Washington has remained largely passive. Why?

We can probably rule out fear or intimidation. It is doubtful that the world's "last remaining superpower" could be cowed so easily. Likewise, we can rule out an indifference to the attractions of economic statecraft in general. Some observers argue that Washington has abandoned economics as an instrument of foreign policy. In the words of one recent study, "economic techniques of statecraft have become a lost art in the United States .... the use of economic and financial instruments as tools of statecraft has become an orphaned subject" (Blackwill and Harris 2016: 1, 6). But that flies in the face of much evidence to the contrary suggesting otherwise. In practice, US policy makers have shown little reluctance to make use of

economic tools as both carrots and sticks. Friends and allies have been the beneficiaries of a wide range of economic aid programs; enemies and adversaries have felt the sting of all kinds of trade and financial sanctions. Daniel Drezner (2015: 755) is undoubtedly closer to the truth when he declares that, in fact, "This is the golden age of economic statecraft."

So if there is no principled reluctance to make use of economic statecraft in so many other instances, why is there so little resistance to China's currency offensive? A cognitive explanation would appear to make sense. Specifically, the United States seems to have fallen prey to what Giulio Gallarotti (2010) calls the "power curse" – the risk that an accumulation of power may, in time, actually act to diminish a state's capabilities. In Gallarotti's words (2010: 9), "the quest for power often creates the seeds of its own destruction." Countries become victims of "power illusion" – a growing misperception of how strong they really are. Complacency sets in. Vulnerabilities may come to be underestimated; capacities may be wasted; countervailing actions and other negative feedbacks may be discounted. A case can be made that America's passivity in response to the RMB's challenge is an example of power illusion.

Not that complacency is entirely unjustified. The dollar still enjoys many undoubted strengths. Indeed, no other currency comes even close to matching the ample power resources that back the greenback – America's still massive economy and importance in world trade; its extraordinarily well developed financial markets; its widespread network of foreign policy ties and extensive military reach; and its undoubted commitment to effective monetary management and the rule of law (Cohen 2015: ch. 7). By most measures of international use, the dollar outdistances every other money by a wide margin and continues to do so despite loose talk of an emerging multipolar system (Cohen 2015: ch. 6). Moreover, as indicated, America's currency has easily shrugged off previous challenges from the likes of the Deutsche mark, yen, and euro. Though the RMB rivalry may be the most serious yet, the greenback's competitive advantage remains enormous.

But it is clear that there are vulnerabilities as well, and they are growing. Most at issue are America's persistent payments deficits and mounting overhang of external debt. Half a century ago the United States was the world's biggest net creditor. In the aggregate, the nation's claims abroad (including private-sector investments as well government assets) far exceeded foreign liabilities. Even as late as 1980, the US net international investment position was still a positive $360 billion. But starting in the 1970s, America's current account turned negative, gradually adding to net foreign liabilities. In 1986, the balance of international indebtedness turned negative for the first time in the post-World War II period by a modest $27 billion, and has worsened ever since. By 2000 net debt had passed $1.3 trillion. By 2016, it had reached an astronomical $8 trillion. Asks Alan Wheatley (2013: 13), an economic commentator: "How much more debt can the US accrue without undermining ... the very confidence in the dollar that makes those securities so appealing in the first place?"

No one with any familiarity with the vagaries of financial market psychology would dare predict the precise moment when confidence in the dollar might collapse. But passivity in the face of such a risk would appear to be a case of blatant over-confidence born of a lifetime of entitlement. After decades of deficits, Washington seemingly has come to take its exorbitant privilege more or less for granted. Indeed, most Americans would seem to share the cynical view of John Connally who, shortly after taking office in 1971 as Richard Nixon's secretary of the treasury, famously told a group of European finance officials that the dollar "is our currency, but your problem." Only rarely do US politicians or voters ever pay attention to the standing of

the greenback when thinking about fiscal or monetary policy. As David Calleo (2009: 186-187) has ruefully commented, "Americans, it appears, have grown deeply habituated to our exorbitant postwar privileges.... Instead of consuming less and exporting more, we prefer exporting more dollars." Old habits are hard to break.

CONFRONTATION

The stage is set, then, for a classic confrontation. On the one side is a rising power openly committed to doing all it can to move currency preferences in its favor. On the other side is an incumbent largely content to rely on its money's established strengths to preserve its exorbitant privilege. The duel is well under way. How are the two sides doing?

Success in a conflict of statecrafts can be measured in two ways – in terms of policy measures effectively implemented on the supply side of the market or in terms of substantive impacts on behavior on the demand side. By the first metric, to date, China's record of accomplishment is quite impressive -- but not by the second.

On the supply side, Beijing has managed skillfully to widen the appeal and availability of the RMB. It has established an extensive network of currency swap agreements and designated clearing banks for the RMB. It has helped nurture offshore markets for yuan deposits and yuan-denominated bonds. And of course it was able to gain admission for the people's currency into the SDR basket at the IMF – a notable contribution to the RMB's reputation. And all of this has been done in less than a decade.

But that is not the best way to measure success when statecrafts collide. In practical terms, currency choice is determined not on the supply side of the market, but rather on the demand side. It is one thing to target currency users, whether private or official; it is quite another to actually modify their behavior. As the ancient adage says, you can lead a horse to water but you can't make it drink. Actors must be *persuaded* to switch from one currency to another. That means that in judging effectiveness we should focus not so much on policy initiatives as such but rather on their tangible consequences -- what substantive impact they may have on relevant behavior. Results, after all, are what the game is all about. By that metric, China's accomplishments to date ring rather more hollow. For all of Beijing's efforts to shift currency choices, the yuan remains a dwarf, far behind the dollar in every category of actual use.

Admittedly, initial gains of market share seemed considerable, particularly on the trade track. But the speedy growth rates for most uses largely reflected a small base at the start and in some sectors are already beginning to decelerate. Indeed, a peak of sorts appears to have been reached in mid-2014 following a surprise devaluation of the RMB. The size of the devaluation was small – only 1.9 percent – but the effect on expectations about the currency's future value and usefulness was massive. Since 2014 yuan deposits in Hong Kong have fallen by a third, and capital flight from the mainland has forced the PBOC to spend more than $1 trillion of its reserves to prop up the exchange rate. Additionally, in a reversal of its previous policy of gradual capital-account liberalization, Beijing has imposed new rules to curb the flow of RMB offshore for conversion into dollars. For the moment at least, the pace of yuan internationalization appears to have more or less stalled. Optimistic predictions of a new "era of the renminbi" demonstrate, more than anything else, the dangers of simplistic straight-line extrapolation.

In fact, judging from actual results, it is the United States that can make the stronger

claim to success up to this point. In a vivid demonstration of path dependence, the demand side of the market has in most respects remained persistently loyal to the dollar. The Chinese have tried hard to promote their currency. But they have yet to be in a position to offer advantages attractive enough to persuade many actors to bear the potentially high cost of switching to the RMB. Inertia has favored the incumbent.

Strikingly, therefore, America's passive posture, relying on the greenback's enduring appeal, has so far proved remarkably robust. We are reminded of the wily "rope-a-dope" game plan made famous by boxer Muhammad Ali in his notorious "Rumble in the Jungle" with George Forman. Pretending to be trapped against the ropes, Ali goaded his opponent into raining down one ineffective punch after another until Forman was utterly exhausted. Ali was then able to move in for the kill. In that case, success was by deliberate design. In the case of America's currency the outcome may be more fortuitous but, so far at least, is nonetheless convincing. Like Forman, Beijing has put up a flurry of heavyweight blows, but the dollar is still standing tall.

THE FUTURE

The duel, however, is not yet over. The contest can be expected to continue for a long time to come, and the new "era of the renminbi" may yet arrive. Ironically, if the RMB does begin to do better, it will be due less to the effectiveness of Beijing's statecraft than to the failure of Washington's.

China's weak hand

Why has China not been more successful? The answer lies in a relative lack of monetary muscle to counter America's "rope-a-dope" tactic. The Middle Kingdom's statecraft has been astute but is handicapped by significant deficiencies in terms of relevant power resources. Beijing is playing with a comparatively weak hand.

This is not a matter of inadequate cognition. In overall design, Beijing's strategy actually seems very well framed to achieve the enhanced influence and prestige that the PBOC Study Group set as its goal back in 2006. Research suggests that a currency's roles in trade, financial markets, and central-bank reserves are paramount in contributing to its issuer's external capabilities (Cohen 2015). As it happens, these are precisely the roles that are being promoted by China's dual-track approach. The finance track is critical to establishing the RMB's appeal as an investment medium, which in turn is an essential step toward attaining reserve-currency status. And the link between the two store-of-value roles is the trade role, owing to the vital part that the currency denomination of trade plays in determining which among several investment currencies will emerge as a favored reserve asset. Whether by chance or design, Beijing seems to have gotten its basic strategy right. The Hong Kong and Shanghai Banking Corporation summarizes succinctly: "First trade, then investment; and after that, reserve currency status. That is the road map for the renminbi in a single sentence" (2011: 5).

But do the Chinese have the right power resources to make their strategy succeed? The picture is mixed. On the positive side, the country certainly has the economic size needed to encourage more use of the RMB, especially for trade purposes. A broad transactional network stands out as China's trump card: the principal strength that Beijing brings to the table. Thanks

to the reforms of the last thirty years, China's economy is already a giant among nations – the second largest in the world – and could surpass the United States in as little as another half decade. China is also now the world's leader in exports and second biggest market for imports, and dozens of countries now count the Chinese as their largest trading partner. Despite some decline of trade volumes in 2015 and 2016, there remains no doubt about the Middle Kingdom's massive gravitational pull in global commerce.

Another strong card is China's growing network of foreign policy ties, which Beijing has cultivated through strategic investments and bilateral aid programs as well as by way of its wide array of currency swap agreements. Steven Liao and Daniel McDowell (2016) have ably demonstrated that investments in the yuan for reserve purposes have been strongly influenced by political alignments with the Middle Kingdom. The more governments identify with Chinese foreign-policy preferences, Liao and McDowell find, the greater their tendency to diversify reserves into the RMB. And there is also no doubt that China's leadership has established an admirable track record of monetary management. Inflation has not been allowed to pose any threat to the value of the people's currency.

In other respects, however, Beijing's hand is considerably weaker. Utmost in many minds is the autocratic nature of China's domestic political regime, which is so different from the more democratic forms of governance that prevailed in all previous cases of currency internationalization in the modern era. In this respect, China does not inspire a high level of confidence. To date, Beijing has shown little regard for the sanctity of property rights or faithful enforcement of contractual obligations. The country's governance structure is not known for transparency or accountability. Quite the reverse, the ruling Communist Party has always been dictatorial in nature and often arbitrary in behavior. In its survey of global governance indicators, the World Bank (2016) recently ranked China in just the 44th percentile for the rule of law, while Transparency International (2015) places China no higher than 83rd among 168 nations in its corruption index. Indeed, over the medium term, it is not even clear whether political stability in China can be assured.

China's rulers do not deny the issue. Indeed, at the annual meeting of the Communist Party's central committee in late 2014, under the leadership of President Xi Jinping, the governance problem was noted and a formal commitment made to firmly establish the "rule of law" by the year 2020. In practice, however, there was less here than meets the eye. The Party clearly did not have Western-style democracy in mind. "We absolutely cannot indiscriminately copy foreign rule-of-law concepts and models," declared the Central Committee. The goal, it seemed, was to refine party control, not dilute it. As *The Economist* (1 November 2014) commented: "Official English translations refer to the importance of the 'rule of law.' But Mr. Xi's tactics appear better suited to a different translation of the Chinese term, *yifa zhi-guo*: 'rule *by* law.' His aim is to strengthen law to make the party more powerful, not to constrain it." In this light, only the most sanguine of investors or central banks would see today's China as a safe haven for their assets.

Nor are many encouraged by China's vast military buildup, which is clearly designed to project coercive power well beyond the country's borders. Rather than volunteer formal or informal security assurances, as the United States has done for many of its allies, Beijing has increasingly chosen to act more like a bully, aggressively asserting what it regards as its core national interests. That has been most notable in the East China Sea and South China Sea, where expansive territorial claims have embroiled the country in disputes with a number of nearby

states. In East Asia, the expansion of Beijing's military reach is seen as anything but reassuring. Few neighbors share China's nostalgia for the idealized tradition of a regional tributary system, with the Middle Kingdom at its center, as prevailed centuries ago. Beijing's historical sense of entitlement is widely resented.

Most salient of all is the primitive quality of China's financial sector and its isolation from capital markets elsewhere. For all the success of the Chinese economy since reforms began, domestic financial institutions remain rudimentary at best. Equity and bond markets are still unable to provide the depth, breadth, and resiliency that are so prized by investors and central banks. Liquidity is low, asset prices are volatile, and the volume of high-quality securities is small. For the yuan's share of global reserves to rise much at all from its present one percent, foreign monetary authorities would have to acquire an implausibly high proportion of Chinese government debt, given the current size of the market. To realize a seven percent share of global reserves, foreign holdings of government debt would need to increase to one third of the total outstanding. To realize a 20 percent share, the entire stock of public debt would be held by foreigners (Steil and Smith 2016). Only a modest one-half percent of all international debt is currently denominated in RMB.

Moreover, the onshore financial sector remains largely cut off from the offshore world by Beijing's monetary Great Wall. Investment funds can be moved in or out of the country only through authorized banking institutions and only with approval from the relevant agencies. Formally, the yuan is still an inconvertible currency for most capital transactions. Observers generally agree that without major reforms to develop and open the financial sector, prospects for the RMB as an investment currency or reserve asset will remain limited (Prasad 2017; Subacchi 2017). In the words of noted economist Jeffrey Frankel (2011: 13): "If China is not yet ready to liberalize its domestic financial markets [and] to legalize capital inflows... then full internationalization is probably a long way off."

On balance, therefore, it is clear that there is good reason – several good reasons, in fact – why the yuan has remained a dwarf currency. Though Beijing holds some strong cards, its hand is not commanding. China still lacks some of the power resources that help to make a money competitive at the international level. If the government's strategy is to prove more successful in the future, the hand will have to be played masterfully.

To their credit, China's leaders seem to understand what might be needed to compensate for their currency's deficiencies and have acted accordingly. But as indicated, Chinese statecraft has been pursued with considerable caution, stressing gradualism above all. At the official level, for instance, the appeal of the yuan for many foreign governments has been enhanced by Beijing's build-up of a network of currency swaps and designated clearing banks as well by as its successful campaign to include the RMB in the SDR basket. But in each of these efforts the pace has been deliberately slow and measured. Likewise, at the private level the usefulness of the yuan as an investment currency has been improved via a series of programs intended to open the domestic financial sector more to both inflows and outflows of capital. But here too the process has been prudent and incremental. For nonresidents there are now arrangements known as QFII (for qualified foreign institutional investors) and RQFII (for renminbi foreign qualified investors), which permit a widening range of foreign investors to buy and sell limited amounts of selected stocks and bonds inside China. Conversely, for residents there are schemes like QDII (for qualified domestic institutional investors), R-ODI (for renminbi overseas direct investment), and QDLP (for qualified domestic limited partnership), all designed to enable some domestic

investors to add foreign assets to their portfolios. And most recently, in 2014, a new scheme was added to this "alphabet soup of programs" (Subacchi 2017: 130) in the form of an innovative direct link between the Shanghai and Hong Kong stock exchanges – the so-called "Shanghai-Hong Kong Stock Connect" – which aims to allow both foreign and domestic investors to move funds between the two exchanges in a less restrictive manner. No one can doubt that China's currency statecraft has been busy – but it has been at a speed that is largely of Beijing's own choosing.

The reason is evident. If Beijing is to fully address its currency's deficiencies, it will have to institute reforms that go straight to the heart of the Communist Party's distinctive model of political and economic management. It would have to make the country's governance structure more transparent and accountable, with more emphasis on genuine respect for property rights. It would have to tone down elements of nationalism and revisionism in foreign policy, to reassure apprehensive neighbors. And above all it would have to put more effort into cultivation of a truly efficient and open financial sector, in order to enhance the RMB's appeal as a store of value. All of these steps would risk seriously eroding the party's authority and grasp on power. More rule of law would mean less rule *by* law. Less emphasis on nationalism would dilute one of the party's key claims to legitimacy. And more financial liberalization would weaken a critical tool of leadership control – the government's long-standing ability to manage monetary and financial conditions. Domestically, monetary control has meant direct authority over interest rates and the availability of credit, enabling the state to allocate resources to favored borrowers and to minimize its own funding costs. Command is exercised through regulated deposit and lending rates, quantitative credit guidance, and bond market rationing. Internationally, control means a closed capital account and managed exchange rate. Financial repression, as economists call it, is a vital cog in Beijing's machinery of political autocracy.

It is hardly surprising, therefore, that even as China has adopted RMB internationalization as a goal, it has proceeded cautiously. Beijing's currency statecraft operates under some deeply rooted domestic constraints. The hope, plainly, is to be able to encourage wider use of the yuan abroad without seriously threatening party control at home. To say the least, that requires a delicate balancing act. In effect, the government has been trying to promote internationalization on the cheap – to make as few concessions as possible in terms of financial or political reform, hoping that the nation's economic size alone will manage to do the job. Whether a compromise strategy like that can work effectively over the long haul remains an open question.

America's weaker response

The irony is that for all the weakness of Beijing's hand, RMB internationalization could ultimately succeed on a broad scale – less because of Chinese cleverness; more because of US complacency. America's "rope-a-dope" tactic has worked until now. The dollar is still globally dominant. But for how much longer can the United States rely cavalierly on its exorbitant privilege without a risk of blowback? With the advent of the Trump administration in Washington, the answer may be: Not long.

The dangers of America's sense of entitlement have long been evident. A collapse of confidence in the dollar is an ever-present threat. We have always known that skittish investors or risk-averse central banks could, at any moment, suddenly flee to other currencies. But much

depends on the quality of US policy, which has long been questionable. For decades the United States has been living beyond its means, relying heavily on the popularity of the greenback to finance its persistent payments deficits. US policy makers have exploited the borrowing capacity afforded by the dollar's worldwide acceptability to postpone adjustments indefinitely. Arguably, therefore, the fate of the dollar rests first and foremost on what goes on in Washington. As Barry Eichengreen (2011: 162) puts it, "the plausible scenario for a dollar crash is not one in which confidence collapses on the whims of investors ... but rather because of problems with America's own economic policies."

With the arrival of Donald Trump, these dangers will almost certainly intensify. Even before the new president was elected, he carelessly rattled the markets by suggesting that Washington should negotiate with its creditors to buy back much of its foreign-held debt at a discount – in effect, a partial default on trillions of dollars of liabilities, intended to reduce the burden of debt service for American taxpayers. Foreign investors and central banks rightly recoiled with horror. Even the hint of a default would jeopardize the US government's credit rating and raise the cost of future borrowing. Even more egregious are Trump's protectionist promises to put "America First," which smack of xenophobic nationalism and a conspicuous disregard for the interests of others. The new president has pledged to bring millions of jobs back to the United States by ramping up import tariffs and canceling trade agreements. If protectionism truly is on the agenda, can capital controls be far behind? Trumpian mercantilism could just be the final straw for the greenback.

That does not mean that we should soon expect a massive run on the dollar, with everyone suddenly stampeding to the exits. A doomsday scenario like that is far too sensationalist. More likely is a prolonged bleeding out, as America's financial rivals seek to make their own currencies more attractive and accessible. Above all that includes China, with its pro-active currency statecraft. Over time, the result could well be a slow-motion drift away from the dollar – death by a thousand cuts -- and with it a fading of Washington's long-standing exorbitant privilege.

CONCLUSION

In summary, it is clear that the RMB's challenge to the dollar is real. China is determined to promote internationalization of the people's currency to the fullest extent possible. Though much has been accomplished in terms of policy initiatives, substantive impacts on behavior to date have been limited, mainly because Beijing has been playing with a relatively weak hand. All that could change, however, if US policy remains as complacent as it has in the past. The more the Trump administration presses forward with its mercantilist agenda, the more likely it is that over time the greenback will lose ground to the yuan. The new president's "America First" policies will end up scoring an own-goal.

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