

INTERVIEW

For yuan to be the new dollar, China needs democracy: Eichengreen

University of California scholar 'struck' by resilience of American currency



Professor Barry Eichengreen says every true international and reserve currency in history has been a currency of a political democracy or a republic, with real political checks and balances. (Photo courtesy of the International Monetary Fund)

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BERKELEY, U.S. -- The world has seen multipolar monetary systems before, and there can be more than one dominant currency, said Barry Eichengreen, professor of economics and political science at the University of California, Berkeley, in a Nikkei interview.

The Chinese yuan, or renminbi, will inevitably play a larger role in the international system, but every true international and reserve currency in history has come from a democracy or republic with real checks and balances, Eichengreen said.

Will the yuan ever become an international currency? Edited excerpts from the interview follow.

Q: You have suggested that the international currency order will become more multipolar. What would such a monetary system look like?

A: We have seen multipolar international monetary systems before. The gold-standard system was not organized entirely around the pound sterling. In fact, the French franc and the German mark were both consequential international currencies. And, in the 1920s and '30s, the dollar and the pound sterling were of roughly equal importance.

There is a misapprehension that the pound sterling was the only consequential international currency before 1945 and the dollar has been the only one thereafter. That's a misconception.

The argument that you can have only one dominant currency at a point in time -- today it's the dollar, and in the future it will be China's currency -- is based on the idea that network externalities are incredibly strong, that it pays to use the same currency for cross-border transactions that everyone else is using, so everyone ends up with the same solution, which currently is the dollar. And one could imagine a tipping point at some time in the future when the system tips toward a different currency, like China's.

This may have been true once upon a time, but it's no longer true today. It's very low-cost to compare prices denominating in different currencies, to exchange money from one currency to another, that these network effects are no longer as strong as they have been in the past, because of advances in technology.

Your smartphone can tell you what the exchange rate is right now, and you can use a variety of apps to trade those currencies, as well.

Q: China's rise is a new element, but the dollar continues to be the key currency.

A: The United States was such a powerful geopolitical player, and it provided the nuclear umbrella for Europe and for Japan. It meant that European and Japanese governments were willing to support the dollar, and that helped preserve the dollar's role.

Things are different now. But, what I was struck by is that the dollar had the ultimate stress test during the [President Donald] Trump years. Trump threw into doubt all these presumptions about whether the U.S. was a reliable alliance partner or not, and this led the Europeans to establish indexes and tried to develop alternatives to the dollar.

They didn't go anywhere. The dollar's role was not eroded by the erratic behavior of Mr. Trump. So, if Trump's behavior won't undermine the dollar's role, it doesn't seem to me Biden's is likely to. Biden is responsible for big budget deficits now, but he's also responsible for better relations with European leaders.

We learned from the Nixon shock that the international role of the dollar did not simply depend on the fact that the dollar was linked to gold, at \$35 an ounce. The international role of the dollar has survived for another half-century, after that link was cut.

In the 19th century, we thought central bank credibility depended on preserving a fixed price of gold, and that idea was imported into the Bretton Woods system. But now we know that central bank credibility rests on much more. Communications, having a credible operating strategy, being able to communicate it in words.



Eichengreen speaks with Nikkei in Berkeley, California. (Photo by Masahiro Okoshi)

In China, they have to do two things. Number one, more financial reform, so that they can remove their remaining capital controls and make it easier for foreigners to get in and out of their financial markets and assets. Number two, they have to answer the question of whether their political system is compatible with reserve currency status.

It's unclear that the renminbi can ever become an international currency, because China would have to become a political democracy.

Every true international and reserve currency in history has been a currency of a political democracy or republic, with real political checks and balances. The United States, Great Britain, the Dutch Republic before that, and the republican city-states with independent legislatures -- Genoa, Venice, Florence.

So long as [China's] Politburo has unlimited powers, people will be reluctant to hold a significant fraction of their reserve assets in Shanghai. And that will limit the importance of the renminbi.

The question is, how far does China have to go in the direction of political and institutional reforms? Would it be enough to make the [People's Bank of China] an independent central bank? Would that be compatible with the Chinese political system? So, that, to my mind, raises a real question about whether the renminbi will be a consequential international currency 10 years from now or 20 years from now.

Q: How long do you think it will take for the international currency system to change?

A: Were someone like Trump to be elected in 2024 and the U.S. were to really weaponize the dollar, and U.S. policy were to become more erratic and U.S. defense alliances were to fray, that would accelerate the time frame. And, if none of that happens, I think the transition will go slowly, because it will take time, a lot of time, for viable alternatives to develop.

Q: Previously, the Chinese government was eagerly pursuing the internationalization of their own currency. Maybe 2015 to 2016 was the peak of those efforts. After that, they changed their own minds. Why is that?

A: Right. So, what happened in 2015, of course, was this volatility in the stock market.

They had been liberalizing in order to enhance use of the renminbi and accelerate the process of renminbi internationalization, and they learned that if you liberalize too quickly before you've strengthened supervision and regulation of your banks and financial markets, the stock market, bad things can happen.

So they slowed down at that point. They concluded correctly that there were more important things to do than simply internationalize the currency.

Different people in China had different views of why they should internationalize the renminbi.

One view was [that] every first-class country should have an aircraft carrier and it should have an international currency. That "because we're a great country, we should now have a great international currency as well."

They were reminded in 2015 that there are other ways to demonstrate that you're a great country.

There were some people who thought that pushing to internationalize the renminbi would be a way to force the pace of domestic financial reform, force people to accept faster domestic financial reform, "because if we liberalize cross-border payments in order to encourage use of our currency, bad financial things will happen unless we simultaneously strengthen our financial markets."

This was a way of doing financial reforms through the back door. That's the wrong way of going about things, and that's what they learned in 2015, that if you try to force the pace of domestic financial reform by opening the capital account of the balance of payments, encourage the international use of the currency, you may not get the fast financial reform that you'd hoped for, and then, instead, you can get volatility and instability, and that's what they got in 2015.