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Will China's digital currency end US Dollar dominance?

Were the world to decide to shift their dollar reserves to any other currencies, the country likely to benefit most in terms of production of real output would be the US on account of a depreciating dollar

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The successful launch and growing usage of China's Central Bank Digital Currency (CBDC), the Digital Currency Electronic Payment (DCEP), has triggered an intense debate among economists and commentators over whether this marks the beginning of the end of dollar dominance in international trade and financial settlements. While there are those who believe that this is indeed the case given China's growing share in world trade and the possibility of DCEP becoming a common platform for digital currencies among several of its trading partners, there are others who think that DCEP *per se* is inadequate to challenge the dollar – which presently accounts for 80% of cross-border invoicing and 60% of international reserves – and there is little possibility that the renminbi will replace the dollar in the foreseeable future. Before taking a stand on this debate, it is important to be clear what dollar dominance entails and the conditions which gave rise to it. Only then can we be sure we are posing the right questions, let alone having an opinion on the issue of the renminbi, DCEP, and dollar dominance.

50 years ago, in August 1971, US President Richard Nixon, closed the gold window, ending the long era of fixed exchange rates under precious metal (gold or silver) standards and the post-war Bretton Woods system. Although countries, including the US, had long before Bretton Woods stopped the conversion of their currencies to gold or silver *internally*, under the Bretton Woods system, the US promised to convert dollars *held by foreign central banks* to gold at a fixed rate of $35/ounce. Further, countries had to devalue or revalue their currencies if they had chronic BOP imbalances and exchange rates fluctuated more than +/-1% of the par value. So, for instance, the sterling pound was devalued in 1949 by 30% from $4.09 to $2.80 per pound. The German mark and Japanese yen were revalued upwards sharply in the 1960s. In spite of these adjustments in par values, the Bretton Woods system suffered from a fundamental flaw captured succinctly by the Triffin dilemma: the US would have to perpetually run autonomous balance of payments (BOP) deficits to feed the world adequate dollars as the international medium of exchange, thereby eroding confidence in the reserve currency (dollar) over time. It was this phenomenon that ultimately led Nixon to go back on the US promise to convert dollars to gold.

The abandonment of the Bretton Woods arrangement and the regime-change from fixed to floating exchange rates did not, however, unseat the dollar as the international currency. One might have expected that with floating exchange rates, all BOP disequilibria would be automatically corrected through exchange rate movements rather than putting pressure on internal adjustments through recessionary contraction or inflation in domestic economies. However, many countries adopting export-led growth strategies including Japan and the Asian Tigers, followed by China, realized that engagement with the US market (whose share of world GDP was around 25% in the 1970s) was essential to achieve their economic objectives. Even India, where tech exports have been an important of engine of growth, the US alone absorbs more than 60% of its total tech exports. And for this growth strategy to be successful, free market exchange rates were not appropriate, intervention to ensure depreciated domestic currencies vis-à-vis the dollar was required.

While path dependency, the development of Eurodollar markets, the size and complexity of the US economy, as well as political stability, are important factors that led to the continuance of dollar dominance post-Bretton Woods, the switch of the dollar to a fully fiat currency in 1971 seemed to have actually increased confidence in the dollar with the uncertainty over adequate gold reserves no longer relevant. There are nonetheless two questions that need to be answered: first, why did the US 'agree' to run BOP deficits to provision the rest of the world with adequate liquidity to finance international trade and investment and second, why did the rest of the world continue to allow the US to gain 'exorbitant privilege' from dollar dominance wherein they were actually exporting real output in exchange for financial claims (Treasury bonds) on the US?

It is important to remember that in the 1970s, the erstwhile USSR and USA were still in the grip of the Cold War, both seeking global hegemony. Unless the US gave countries the opportunity to access its markets to propel rapid growth among their allies, a tilt towards the USSR remained a strong possibility. This made the US willing to run BOP deficits. On the other side of the equation, the countries seeking rapid growth through exports were more than willing to trade real goods and services for US dollar bonds so that their own currencies would remain depreciated and exports could be sustained. The exporting countries tolerated the US's 'exorbitant privilege' only because US markets gave their own countries the opportunity for rapid growth. Moreover, in the longer term, dollar reserves would give them access to resources from across the world. China is a clear example of a country that followed this neo-mercantilist strategy.

Keeping this background in mind, we now return to our question. Will the widespread use of DCEPs globally enable the Chinese renminbi to dethrone the dollar? Let us suppose that a growing number of countries actually begin to use the renminbi for international settlements and consequently also decide to switch their reserves from dollars to renminbi. This will result in massive sale of dollars and purchase of renminbi, consequently depreciating the dollar and appreciating the renminbi. This is exactly what China countered all these decades through accumulation of dollar reserves: an appreciating renminbi and diminishing export competitiveness. In fact, were the world to decide to shift their dollar reserves to any other currencies, the country likely to benefit most in terms of production of real output would be the US on account of a depreciating dollar – something that they have been striving for by threatening many countries, China foremost, as 'currency manipulators'.

More important than asking whether DCEPs will trigger the end of dollar dominance and rise of the renminbi as the dominant international currency is to ask whether China actually wants this to happen. And how will they prevent the threat posed by DCEPs in inducing this possibility? The only other solution open to China, if it does let the renminbi attain dominance, would be to accept BOP deficits in order to provide the world with adequate liquidity. Continued demand for renminbi will cause its appreciation to such an extent that even export competitiveness through productivity increases will be inadequate to stem the world's thirst for international liquidity.

This is the exorbitant cost that must be borne for an exorbitant privilege.

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