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# Is the renminbi the next global currency?

**Geng Xiao, director of the Brookings-Tsinghua Center for Public Policy, discusses how divergent growth rates of the Chinese and US economies will erode the hegemony of dollar—but not right away.**

**The US dollar's run** as the world's stable currency has stumbled with the recent financial crisis. Waiting in the wings is the renminbi. But according to economist Geng Xiao, it's still in China's—and the world's—best interest not to dump the dollar just yet. In this video interview, Geng Xiao, director of the Brookings-Tsinghua Center for Public Policy, explains why China needs time to push through difficult economic reforms at home before it can allow its currency to float freely against the dollar. McKinsey Publishing's Clay Chandler conducted the interview with Xiao in Hong Kong.

**The *Quarterly*:** *The United States has long held that the currency of China is undervalued, that it gives an unfair advantage to Chinese exporters, and that it costs Americans jobs. Authorities in China beg to differ; they say that it helps to preserve stability. Can you help us to understand the arguments on both sides of this debate?*

**Geng Xiao:** There's no argument about the imbalance: China has the trade surplus, US has the trade deficit. So both sides want to improve that. But the question is how. From the American perspective, the emphasis is on the short-term adjustment through price and through the exchange rate. So the US wants a quick adjustment in RMB exchange rate, and that means appreciation so it can correct the trade imbalances.

But the Chinese put more emphasis on medium- and long-term structural and institutional change. So that's the debate. It's very difficult for the exchange rate to correct the trade balance. And on the other hand, there are some negative consequences of the exchange-rate uncertainty.

Foreign investors, including American investors, want to invest in RMB assets because of the expectation of RMB appreciation. This is what we call "hot money." And these capital flows are creating a lot of bubbles in the property market, in the stock market.

And that creates difficulties for China's central bank in terms of monetary policy making. So you can see that there are a lot of concerns from the Chinese side about using the exchange rate to correct the trade balance. Some prices are so high in China. Some are so low. So you need a benchmark. China needs a benchmark so that the price can be compared to the global price, to the price structure, which is compatible with efficiency. So that's why price reform is more important than exchange-rate change. Exchange-rate change would not really change the inefficiencies in the use of energy, for example, because people will still waste energy. Even though you change the exchange rate, the internal subsidies are still there. So I think the point is that China needs to eliminate a lot of these structural distortions, structural inefficiencies. And then if there's little distortion, I think a floating exchange rate will apply and will be useful for China.

**The *Quarterly*:** *What are these reforms and how long will they take?*

**Geng Xiao:** China has already started a lot of its reforms. But it's going to take anywhere from 5 to 10 years' time, really, for China to correct its distortions—land reform, reform of the energy sector, state-owned-enterprise reform, and social welfare. During the last 30 years, most of the tradable-goods prices have become more or less consistent with the global price structure. Only the nontradable sectors still have a different price structure compared to the global price structure.

So the nontradables are the key. And you have to understand, nontradable prices in China have to be lower than in the United States because China still is a developing country and still has low productivity. Only when the productivity of China's nontradable sector reaches that of the United States will the two countries' price structures converge. And that is a long process.

It actually is in America's interest to allow China to carry out structural and institutional reforms instead of exchange-rate change. Let me explain why. China is not really competing with the United States. Even if you change the exchange rate, it will have very little impact on US trade deficit because the US is going to buy from some other countries. US people should realize that in the past, the US production was largely for American consumers. But because of the global financial crisis, American consumers are not consuming.

So in the future, the US needs to produce for consumers from emerging markets, like China. That's the key. They need to think about what to sell to Chinese consumers—not just Chinese consumers in China but also Chinese consumers who will go out and spend in the United States.

**The *Quarterly*:** *China is now sitting on a stash of something like $2 trillion in foreign-currency reserves. How much larger can this get?*

**Geng Xiao:** If China actually followed the advice of the US and allowed the RMB to continue to appreciate, I would say that China will continue to increase its foreign-exchange reserves, because that bubble, that expectation generated by the holding of RMB, nobody can predict. It can be $4 trillion, you know, $6 trillion.

I think as time goes on, China can do a lot in terms of diversification. But there's a limit, because if there is expectation on RMB appreciation, you will get even more reserves. And most of the reserves start with the US dollar, because that's the most liquid, the most stable currency. So I don't see that there's any way that China can significantly reduce its holding of the dollar assets, because the world is just basically dominated by the dollar. In that sense, you know, I don't think there's much choice for China. But if pushed hard, China can always do more. And even marginally, a little bit more is going to have a big impact in the market.

I think the worst scenario is that China allows this RMB appreciation expectation to continue. So more and more people try to hold RMB. And that generates more and more foreign-exchange reserves.

And then China also wants to diversify from the dollar to other assets. All this is going to create a huge amount of disturbance, not just in the market but also pressures on the US Treasury. And that's entirely unnecessary. I think the most effective way is for China to tolerate moderate inflation, which would certainly allow real appreciation of the Chinese currency, which would contribute to the rebalancing of the global economy and also would encourage Chinese people to hold the dollar, because the RMB will have much higher inflation than the dollar.

And China, when its economy is growing 10, 15 percent a year, I think a 5 percent or 7 percent inflation rate is entirely normal. And once that happens, I think China will have, actually, a shortage of foreign-exchange reserves because people will want to hold dollar assets. And they will want to invest overseas. And that is going to create a balance. Right now, though, it is not a balance. It's a [temporary] solution. Everybody wants to dump US dollars and hold RMB. And not just Chinese. The entire world, everybody in the world, wants to hold RMB. And that's really a danger.

**The *Quarterly*:** *Does a global financial crisis have any bearing on China's ability to diversify out of US dollars?*

**Geng Xiao:** Well, I think it's not in China's interest to dump the dollars that they are holding. Because that would hurt China as a whole. China is a net holder of dollar assets. And I think more importantly, China actually benefits tremendously from the two-way capital flows, you know, the US investment in China, which helps to improve China's investment efficiency. The problem is that the US has this authority as a global currency. But US monetary policy is entirely focused on the domestic policy, in the domestic unemployment.

So, that creates an intrinsic problem. In principle, US monetary policy should take care of global stability. The interest rate for the global economy cannot be zero. But, effectively, if the US is adopting a zero-interest-rate policy, the whole world is going to be flooded with cheap money. That's the fundamental problem. China is having difficulty dealing with that problem because US interest rates are zero. And China is flooded with hot money. But for China, there aren't many alternatives.

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**The *Quarterly*:** *So, what do you foresee for the US dollar? Will it continue in its current role as the dominant global currency? Or is that role soon to come to an end?*

**Geng Xiao:** Well, if you look at the history, I think this will happen, definitely. It's just a matter of time. In the past, we had the gold standard. We had the pound. We have the dollar. And just think about it, if the Chinese economy continues its growth at the current pace, the Chinese economy will be the biggest in the world. And if you think about the reforms in China in 10, 20 years' time, China will be able to finish all the reforms. And the Chinese economy would be a modern market economy, and the RMB will become one of the important reserve currencies, just like the US dollar.

**The *Quarterly*:** *Professor Xiao, thank you so much for joining us and sharing your views.* o

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