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Currency Competition or Currency Wars: The USD vs. the EURO vs. RMB

A lecture by Prof Gunter Dufey

21 November 2018

Dr. Dufey began his talk by laying the context for the currency competition between the USA and China. He commented that the US tends to weaponize the role of the US dollar (USD) against its enemies as well as allies by restricting access to the international financial system based on the USD. No international bank can do business without having efficient access to the dollar. The issue of the international role of the three currencies—USD, the Euro, and Renminbi (RMB)—have become more complicated with the rise of China.

Dr. Dufey started with some basic concepts underpinning his talk. Currencies are essential as a means of payment because otherwise exchange would be on a barter basis. The currency is a national item; some countries do not want them to be used outside of their country. Government issued fiat money has become the prevailing means of payment. Central banks operate at the optimum rate, which means creating money at the same speed as the economy grows. Dr. Dufey explained that money has national character that is regulated by two sets of laws.

The first is that the central bank has monopoly on printing money and keeping supply in line with the market at the optimum rate. Producing more money is not necessarily a good thing as it can drive inflation. Another is legal tender loss, which means that by law, giving someone a certain amount of local currency in exchange for goods or service provided extinguishes the debt otherwise accrued. In order to determine the right amount of money in local currency to be paid, exchange rates cannot be arbitrary. Such laws exist only within the borders of the countries.

However, when it comes to the international use of currencies, Dr. Dufey emphasized that the absolute size of trade volume matters. The volume of transactions made in London before the war made it the first financial center and the British pound became the international currency. After World War 2, it was replaced by USA. Using the currency of another country as a way of payment is not guarded by any international treaty.

Dr. Dufey pointed out that currency internationalization has three dimensions. Firstly, both partners in cross-border transactions—both trade and investment—tend to prefer their own currency; thus the result depends on bargaining power to decide who takes on the fx risk. Secondly, the parties frequently agree on a compromise of using the currency of a third country. Hence, the extent to which a currency is used for transactions among other countries encompasses the wider concept of currency internationalization. And thirdly, on an exceptional basis, countries adopt the currency of another country as their domestic means of payment.

Dr. Dufey pointed out that currency internationalization cannot be forced but it must be earned. Besides volume of transactions, four other factors determine which national currency becomes the vehicle of international transactions and they are: assurance of non-resident convertibility (the freedom to open transaction accounts outside of one's country), an efficient money market, and stability of purchasing power of said currency. The last factor is the time zone effect. These are the factors that transactors consider in choosing the currency of transaction.

Moreover, all central banks have foreign exchange reserves to affect the value of their currencies against others. Many banks will keep their reserves in the vehicle currency, which is the US dollar in today's world. Even China has reserves in USD. However, there have been significant changes in the global monetary environment. In terms of size of economy, the US is no longer the clear forerunner as the EU, and more recently, Japan and China, have started to increase their output. Hence, the Euro, Japanese Yen (JYP) and the Chinese RMB have gained in importance over the years.

The use of a currency for trade is closely related to its use as a safe store value. This means a single dominant currency is sought after for stability of financial markets. So far, use of the US dollar is dominant in pretty much all major types of transactions in the international system from debt and loans, to foreign reserves.

In his outlook for the Euro, Dr. Dufey said that in the foreseeable future, it will still be second to the dollar. Volume-wise, it can compete with North America (USA + Canada) and it has purchasing power that is on par with the dollar as well as convertibility.

However, there are questions about membership status, which threatens the stability of the region. Moreover, financial markets in Frankfurt and Paris cannot compete with New York, especially after Brexit. Lastly the time zone in Europe is six hours ahead of the US, which makes it inconvenient for many parts of the world such as Latin America to trade with them.

China has the advantage of size in its population but Dr. Dufey says its currency faces problems in internationalization. Deng Xiaoping's reforms have liberalized the Chinese economy but it was not extended to the financial sector, which remains under government control. Hence, there is a vast shadow financial sector that threatens transparency and stability. Non-convertibility also means that both residents and non-residents cannot move money easily out of China. Complete liberalization of the financial market will not happen as long as China wants to have political control over its financial system.

Dr. Dufey asks, what might China get out of currency internationalization of the RMB? The Chinese believe their currency should be more aligned with the ascending status of China in the world. Hence, technocrats see the need for a financial system that efficiently allocates resources better than the political planning process, in order to attract more investors for future growth. China is coming close to this point of being an attractive place for investment; hence, actors like People's Bank of China are working on backdoor entry for financial reform.

He also said that one of the advantages of internationalization is in seigniorage revenue, which means money printed for non-residents to buy generates revenue for the country. However, there are also some disadvantages of internationalization. The steady demand of foreigners for liquid assets in the currency drives up its value (exchange rate) causing pain to export industries and fostering imports, hurting import-competing industries. Moreover, their financial system becomes subject to external shocks (macro-economic instability) and settlement risk for financial institutions and potential risk to taxpayers are taken by the USD because of their currency.

There are now 60 countries in the world that have small reserves of RMB bonds. The RMB is also now included in the Special Drawing Rights (SDR), which is the counting currency of the IMF. Even though this has no effect on the financial market, it satisfied China's desire for recognition. However, the RMB is still far from acquiring a stronger role as an international currency. China now allows, in Hong Kong banks, buying of the RMB where the two groups who are most interested in buying them are foreign companies and investors. Dr. Dufey said the CNH market is a free market, while the CNY market is under the People's Bank of China (PBOC) tight regulation. Hence, a situation of one currency, two exchange rates arises.