Research Paper

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Renminbi Internationalization: A Conflict of Statecrafts

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Summary

- China seeks to establish the renminbi as an international currency to rival – or even, in time, overtake – the US dollar. With its near-ubiquity in financial markets, the dollar has long enjoyed a unique status as the dominant global reserve currency, providing the US economy with many benefits as a result. China, the rising power, is making every effort to erode this dominance using a combination of policy innovation, cautious financial liberalization and diplomacy – ‘currency statecraft’, in other words. Washington, the incumbent, must decide what, if anything, it is prepared to do to counter the renminbi’s rise. In effect, two currency statecrafts have come into conflict.

- China is intent on establishing itself as one of the world’s leading powers. Internationalization of the renminbi is an integral part of that ambition. China’s pursuit of renminbi internationalization has followed two interrelated tracks to date: one focusing on the use of the renminbi in foreign trade; the other focusing on the currency’s use as a store of value in international finance.

- Washington has shown little interest thus far in mounting an organized defence of the dollar’s privileged status. US currency statecraft has been largely passive, leaving the initiative to the Chinese. The main reason seems to be a complacency born of decades of the US taking the dominance of its currency for granted.

- Judging by the effectiveness of its policies on the supply side of the market, China has accomplished quite an impressive amount already in its efforts to promote renminbi internationalization. The authorities have managed to widen considerably the appeal and availability of the renminbi for both trade and financial purposes.

- However, that is not the best way to measure success when statecrafts collide. A better indicator is the extent to which a currency is actually used. The renminbi still lags far behind the dollar in every category of international use. China has played a weak hand skilfully, but it is handicapped by significant deficiencies in terms of material capabilities and market penetration.

- Over the long haul, the renminbi may become a serious rival to the dollar. Ironically, if that outcome is achieved, it will be due less to the effectiveness of Beijing’s statecraft than to a failure of Washington’s. With the recent election of Donald Trump to the US presidency, the risk of such failure is increased. If the US adopts ill-advised economic, financial and trade policies (including protectionism, for example), this could prompt a prolonged, slow-motion drift away from the dollar by investors and central banks.

Introduction

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 positive thing: an international currency facilitates cross-border commerce, and is central to the functioning of financial markets. Internationalization is also good for the currency's issuer: the US derives substantial economic benefits from the dollar's widespread use – including reduced transaction costs and lower interest rates. Just as importantly, the dollar's popularity renders it a vital instrument of international power, enabling the US 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 dollar is under attack as never before. Challenges to its supremacy are nothing new, of course. Over the past half century, several currencies – including West Germany's old Deutsche Mark, the Japanese yen and, at the dawn of the new millennium, the euro – have seemed poised to surpass the dollar, only to fade over time. Now a new rival looms on the horizon – the Chinese renminbi (translation: 'people's currency'), also known as the yuan. Many see the rise of the renminbi as the most serious challenge to the dollar yet. They believe the Chinese currency is perhaps even destined in time to take over the dollar's pre-eminent role in international markets.

In key respects, the renminbi's challenge is unprecedented. Unlike previous pretenders, China is not an ally of the US. Quite the contrary, it is a global rival with obvious great power aspirations. This contest 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 underdeveloped 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 resisted wider use of their currencies in world markets, China welcomes and actively promotes a greater role for the renminbi. In other words, Beijing wants its own exorbitant privilege.

How much privilege? The full extent of China's ambition is unknown, perhaps uncertain even to the country's elite. While some in Beijing might be content to settle for a renminbi that more or less matches the dollar in an emergent multi-currency system, others may dream of a day when the renminbi fully eclipses the dollar as the leading global reserve currency. Either way, the Chinese government's immediate motivation is manifest: to develop an international currency worthy of its great power aspirations.

The competitiveness of an international currency may be said to depend on two factors. The first is the issuing country's material capabilities and underlying 'power resources': these include the size and sophistication of its economy; the extent of its connections with the global economy; the liquidity, depth and resilience of its financial markets; and its military and diplomatic assets. The second is the issuing country's ability to convert capabilities into effective action, which is a matter of statecraft. This essay[1] principally focuses on the latter factor. It examines the dynamics of China's statecraft versus that of the US, looking not only at the drivers and effects of currency policymaking (or lack thereof) in both countries over the past few years, but also at the long-term prospects of the renminbi emerging as a serious rival to the dollar.

China is making every effort to erode the dollar's dominance. Washington, in turn, must decide what, if anything, it is prepared to do to counter the renminbi's rise. In terms of capabilities, most experts agree that the advantage is all to the dollar, which is backed by power resources that – so far, at least – greatly outstrip anything available to the renminbi. 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.

China's challenge

Among international currencies, China's renminbi today is still a minor player – a currency 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. The Chinese government has clearly chosen to promote the widest possible use of the renminbi. 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 made renminbi internationalization a national policy goal. Public discussion among Chinese academics began in 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 renminbi (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 *per se*. That the renminbi 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 it was the right time for substantive policy change. Even after the shock of the Asian financial crisis in 1997–98, Chinese policy remained hesitant. A turning point was seemingly reached in 2006 with publication of a report entitled '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

[1] This essay draws on, and in part reproduces, Chapter 7 of a collection of original essays co-edited by the author and published in 2014. Cohen. B. J. (2014), 'The Yuan's Long March', in Cohen, B. J. and Chiu, E. M. P. (eds), *Power in a Changing World Economy: Lessons from East Asia*, London and New York: Routledge, pp. 144–59.

will enjoy ‘a rise in power standing’. We ‘should take advantage of the opportunity’, the report concluded. Internationalization, it said, 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 renminbi a top policy goal, and a concerted strategy was put into motion to effect it.

Not that Chinese elite opinion is unanimous on the merits of promoting the renminbi as a global currency. In fact, divisions over the issue in Beijing have long been evident (Helleiner and Malkin, 2012; McDowell and Steinberg, 2016). On one side are factions, led by the PBoC, that see internationalization as a means to advance liberal financial reforms. Many members of these factions are also motivated by a desire to reduce the country’s exposure to a sudden shift in exchange rates. This vulnerability – highlighted by the 2008 global financial crisis – stems from China’s vast holdings of US dollar-denominated reserves (Zhao and Song, 2009) and is known in the Chinese literature as the ‘dollar trap’ (Yu, 2010). Internationalization of the renminbi would help reduce China’s dependence on the dollar.

On the other side of the debate is a faction opposed to renminbi internationalization. It is made up of an array of producer interests and banking institutions, many of them state-owned, that have long benefited from the government’s firm controls over interest rates and credit allocation. Domestic cleavages on these issues are probably the reason why, to this day, there has never been a formal declaration of internationalization as official Chinese policy.

Judging from Beijing’s actions, however, it is abundantly clear which side is prevailing in the debate. By late 2009, as one informed observer put it: ‘The Chinese government obviously changed its mind and became enthusiastic about RMB internationalization.’ (Zhang, 2009: p. 24) More recently, it seems, the pace of the process has slowed somewhat as Beijing has struggled to cope with decelerating economic growth. Even so, no one doubts that internationalization is now the government’s preferred currency strategy.

Implementation

How was Beijing’s ambitious strategy to be implemented? Up to the time of the PBoC study group’s report, China had one of the most closely managed currencies in the world, its use circumscribed by all manner of exchange restrictions and capital controls. How could cross-border use of the renminbi be encouraged if the currency 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 roadmap 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.

Effectively, internationalization has been pursued along two interrelated tracks (Subacchi, 2016). One track focuses on cultivating use of the currency in foreign trade. At the official level, China has arranged swap agreements with an increasing number of foreign central banks, facilitating expanded use of the renminbi as a means of payment (Liao and McDowell, 2015). By mid-2016 some three dozen agreements had been signed, totalling more than RMB 3.3 trillion (about $480 billion).[2] At the private level, regulations have been gradually eased to permit the settlement of more import and export transactions in renminbi, bypassing traditional invoicing currencies such as the dollar. The other track focuses on use of the renminbi as a store of value in international finance. Policy in this area has emphasized the development of active markets for renminbi deposits and renminbi-denominated bonds, mainly in the Hong Kong 'offshore' market.

To date, there has been more progress on the trade track than on the finance track. By 2016, some 30 per cent of Chinese trade was being settled in renminbi – up from essentially zero less than a decade earlier – though it might be noted that most of this increase was local. As much as 70 per cent of the trade settled in renminbi is between mainland China and Hong Kong, and amounts to little more than a shuffling of cash between mainland enterprises and their offshore subsidiaries. Nonetheless, renminbi invoicing is gradually spreading, supported by agreements designating selected clearing banks for renminbi trades in close to 20 financial centres around the world. These include not only Asian cities such as Singapore, Seoul, Taipei and Tokyo, but also financial centres further afield such as Doha, Frankfurt, Zurich, London and Toronto. Offshore clearing banks act as conduits with China's domestic banking system to settle renminbi payments outside the mainland. According to the Society for Worldwide Interbank Financial Telecommunication (SWIFT), which processes global financial transactions, in 2016 the renminbi rose to fourth place in the global list of payments currencies, accounting for almost 2 per cent of transactions. Separately, the Bank for International Settlements (BIS) has reported that the currency's share of aggregate turnover in the global foreign exchange market doubled between 2013 and 2016, from 2 per cent to 4 per cent (BIS, 2016).

Results on the finance track, 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 financial centre. With its own currency and capital markets, Hong Kong offers a useful offshore laboratory for experimenting with innovations that the Chinese leadership is not yet prepared to introduce 'onshore' on the mainland. As frequently noted (Frankel, 2011), this is an unusual pattern to say the least. Never before has any government sought deliberately to develop an offshore market for its currency while maintaining strict financial controls at home. In effect, Beijing is drawing up its own roadmap, depending on the Hong Kong Monetary Authority (HKMA) – Hong Kong's chief financial regulator and de facto central bank – to act as its proxy. Under the HKMA's tutelage, the markets for both renminbi deposits and renminbi-denominated bonds issued offshore (known as 'dim sum' bonds) have grown considerably, although the aggregate sums involved remain small. Renminbi deposits in Hong Kong have never exceeded RMB 900 billion ($130 billion),[3] and the number of dim sum bond issues has been limited. From 2009 to 2015, the value of dim sum bonds came to just RMB 443 billion ($65 billion). Both figures are minuscule by international standards.

A milestone was reached in 2016 when the renminbi 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 honour previously accorded only to the dollar,

[2] At an exchange rate rate of RMB 6.86:US$1, Reuters (2017), 'Currencies Quote', 27 February 2017, http://www.reuters.com/finance/currencies/quote?srcAmt=3300&srcCurr=CNY&destAmt=&destCurr=USD (accessed 27 Feb. 2017).
[3] Reuters (2017), 'Currencies Quote'.

euro, pound and yen, and was the subject of much discussion (Wang, 2015). Many doubted whether the renminbi 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; until now such use has remained limited. According to one knowledgeable source (Liao and McDowell, 2016), as many as three dozen central banks have invested in renminbi-denominated claims in recent years. But accumulations are small. In total, the renminbi still accounts for no more than 1 per cent or so of global reserves.

It is therefore fair to say that the renminbi still has a considerable way to go to match Beijing's aspirations for its internationalization. Achievements have been considerable and most likely will continue into the future. But on neither track has the renminbi yet come close to challenging the dominance of the US dollar. In the foreign exchange market the dollar appears on one side or the other of 88 per cent of all trades, some 22 times the renminbi's share (BIS, 2016). And the dollar still accounts for about two-thirds of global reserves. The disparities remain enormous. Paola Subacchi is not far off in describing the renminbi today as still something of a 'dwarf currency' (Subacchi, 2016).

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 in the 1970s and 1980s, when their currencies also seemed set to challenge the dollar. In neither West Germany nor Japan was internationalization deliberately promoted. Indeed, both countries actively resisted this path (Cohen, 2015: ch. 5). Why has China been different?

Two competing forces would appear critical: geopolitical ambition and the imperative of economic policy 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 an agenda of domestic stabilization – a drive to achieve or maintain a high degree of monetary order at home. Its 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, the choice is between a 'sword' and a 'shield' – between an instrument of international influence and an insulation against external pressure (Armijo and Katada, 2015). 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 were regarded as rising powers in the global system, just as China is today. All three countries were/are the beneficiaries of seemingly miraculous economic growth, and all were/are 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.

Much of the reason for this difference turns on each nation's perception of its role in world politics. Neither West Germany nor Japan, during the years of their currencies' ascendance, harboured any noticeable great power ambitions. Devastating defeat in the Second World War had left both countries more or less content to shelter under the security umbrella provided by the US and to concentrate instead on rebuilding their economies. Their historical roles as aggressors meant that neither had any wish to do anything that might seem threatening to their neighbours. For Germany, this meant submerging itself in broader collective arrangements such as the European Community, now the European Union, and NATO, where its relative weight would be less conspicuous. For Japan, it meant accepting a post-war constitution, imposed during the US occupation, that limited the military to a purely defensive role. Neither nation was looking for a proverbial new 'sword' – a new means of projecting power abroad. Hence neither showed much interest in the enhanced capabilities that might result from internationalization of its currency.

The geopolitical aspirations of China, on the other hand, are arguably much greater. Admittedly, given the secretive nature of Chinese politics, no one outside the leadership can 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 whether it is more of a revisionist state looking for a radical transformation of the international environment and 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 China has long regarded as its 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, the prospect of an internationalized renminbi is naturally seen as valuable, because of what it could add to the country's geopolitical capabilities. As the PBoC study group said, it would allow China to 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.

Consider also the issue of domestic monetary stability. Here, too, the contrast with China is telling. For both West Germany and Japan in the 1970s and 1980s, monetary autonomy was paramount. To them, any potential geopolitical advantage that currency internationalization might offer seemed insignificant relative to the perceived cost that it implied – a reduced ability to restrain inflation or respond to exchange-rate volatility. In each case the authorities had long relied on monetary policy to maintain financial stability at home, and were reluctant to allow anything that might threaten this policy autonomy. For them, therefore, resistance to currency internationalization seemed the logical choice.

For China, however, the imperative of protecting its economy and financial system against external market volatility was a secondary consideration. From the outset, Beijing already had solid financial protection – a monetary 'Great Wall', as it were – in the form of a panoply of controls and restrictions far tighter than anything ever imposed by West Germany or Japan. It was understood, of course, that future reforms might compromise policy independence, at least at the margins. But given the measures long in place, policymakers did not prioritize the risk to the same extent as did West Germany and Japan. Less worried about domestic financial autonomy, the Chinese could afford to focus more on the role that the renminbi might play in extending their country's external influence.

Herein, then, lies the explanation for China's different approach to currency internationalization. West Germany and Japan, reassured by the defence commitments of the US, could afford to concentrate on domestic economic management. For both countries, this autonomy trumped global 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, it could emphasize 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 renminbi will not be determined by the Chinese alone. Much will also depend on how the US responds to the challenge posed by the rise of the renminbi. Geopolitics is about the *conflict* of statecrafts, not just one country's unilateral actions. It takes two to duel, even if – as this essay explains – one party may be reluctant to fight.

A negotiated currency?

In the eyes of many experts, China's successes to date in the conflict of statecrafts should be of considerable concern to the US. 'China's growing size and economic dominance are likely to translate into currency dominance,' predicts one prominent economist (Subramanian, 2011: p. 5). 'The renminbi could surpass the dollar as the premier reserve currency well before the middle of the next decade.' Another influential commentator (Zweifel, 2014) echoes, 'The era of the renminbi is upon us.' In effect, under pressure from the renminbi, the dollar is thought to be slipping from global dominance into a possibly painful decline.

Yet Washington's response until now has been remarkably nonchalant, a policy of more or less deliberate *non*-action – a reactive rather than proactive form of statecraft. In another era, this was known as 'benign neglect'. In the financial policy context, this essentially means sitting back and letting market actors and foreign governments decide the fate of the dollar. In the face of the renminbi's challenge, Washington has done little to protect the dollar's 'exorbitant privilege'; nor, from all appearances, have US policymakers given any serious consideration to the alternative of a managed retreat along the lines of Britain's policies on 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 tilted more towards resistance, working hard to sustain international use of the dollar. Increasingly, it is said, the greenback is becoming what Susan Strange years ago called a 'negotiated' currency, forced to rely on diplomatic bargaining or informal understandings to sustain foreign use (Strange, 1971a, 1971b). 'Questions about the role of foreign political support in sustaining the dollar's international position have grown,' asserts Eric Helleiner, suggesting that the dollar can by now be considered to have at least 'partial negotiated status' (Helleiner, 2009: p. 76). Financial elites in key emerging markets seem overwhelmingly persuaded that 'the dollar is increasingly sliding from top to negotiated international currency' (Otero-Iglesias and Steinberg, 2013: p. 328).

But such perceptions are mistaken. If the US has opted to resist the Chinese challenge, it has done so in the most restrained manner possible. In principle, two classes of proactive strategy are available to a government hoping to persuade market participants to stay loyal to its currency: policies that are *indirect* in their implementation; and those intended to have a *direct* effect on their targets (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 central banks 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. It could involve implementing ostensibly 'sound' monetary and fiscal policies to maintain confidence in the dollar's future usefulness and value – for instance, by setting interest rates at moderate levels sufficient to offer attractive returns, and by running low budget deficits. It could emphasize financial development to lower transaction costs or boost liquidity. Or it could involve the promotion of broader use of the currency for trade invoicing and settlement by lowering import barriers and opening new export markets. In Helleiner's words: '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.' (Helleiner, 2008: p. 362) Amid 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 dollar as a high priority.

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

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

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: p. 1, p. 6). But much evidence suggests otherwise. In practice, the US has shown little reluctance to make use of economic policies as both carrots and sticks. Friends and allies of the US have been the beneficiaries of a wide range of economic aid programmes; its enemies and adversaries have felt the sting of all kinds of trade and financial sanctions. Daniel Drezner is undoubtedly closer to the truth when he declares that, in fact, we are in 'the golden age of economic statecraft' (Drezner, 2015: p. 755).

So if there is no principled reluctance to make use of economic statecraft in so many other instances, why have US policymakers shown so little resistance to China's currency offensive? A cognitive explanation would appear to make sense. Specifically, the US seems to have fallen prey to what Giulio Gallarotti calls the 'power curse' – the risk that an accumulation of power may, in time, diminish a state's capabilities (Gallarotti, 2010). He adds that 'the quest for power often creates the seeds of its own destruction' (Gallarotti, 2010: p. 9). 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 feedback may be discounted. A case can be made that America's passivity in response to the renminbi's challenge is an example of power illusion.

Of course, a measure of confidence in the dollar is by no means misplaced. The dollar still enjoys many undoubted strengths. Indeed, no other currency comes close to matching the ample power resources that back the US dollar – 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 currency by a wide margin and continues to do so despite loose talk of an emerging multipolar system (Cohen, 2015: ch. 6). Moreover, as indicated, the US currency has easily shrugged off previous challenges from the likes of the Deutsche Mark, yen and euro.

But it is clear that there are vulnerabilities as well, and that they are growing. The biggest issues are the US's persistent payments deficits and mounting external debt. Half a century ago, the US was the world's biggest net creditor. In aggregate, the nation's claims abroad (including private-sector investments as well government assets) far exceeded its foreign liabilities. Even as late as 1980, the US net international investment position was still a positive $360 billion. But starting in the 1970s, the country's current-account balance turned negative, gradually adding to net foreign liabilities. In 1986, the US's balance of international indebtedness turned negative for the first time in the post-Second World War period, reaching a modest $27 billion. It has worsened ever since. By 2000 net debt had passed $1.3 trillion. By 2016 it had reached an astronomical $8 trillion. As Alan Wheatley, an economic commentator, asks: '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?' (Wheatley, 2013: p. 13)

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 reckless. After decades of deficits, Washington has seemingly come to take its exorbitant privilege 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 pay attention to the standing of the greenback when thinking about fiscal or monetary policy. As David Calleo has ruefully commented (Calleo, 2009: pp. 186–87), '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 favour. On the other side is an incumbent largely content to rely on its currency's established strengths in order 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 policies effectively implemented on the supply side of the market, or in terms of substantive impacts on behaviour on the demand side. On the first measure, China's record of accomplishment to date is quite impressive. On the second, however, it is not doing so well.

On the supply side, Beijing has skilfully widened the appeal and availability of the renminbi. It has established an extensive network of currency swap agreements and designated clearing banks for the renminbi. It has helped nurture offshore markets for renminbi deposits and renminbi-denominated bonds. And, of course, it has managed to get the renminbi added to the IMF's SDR basket – a notable contribution to the Chinese currency's reputation. 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 modify their behaviour. As the saying goes, you can lead a horse to water but you can't make it drink. Investors and other economic 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 on their substantive impact on market behaviour. When assessed on that basis, China's accomplishments to date are more limited. For all of Beijing's efforts to shift currency choices, the renminbi remains far behind the dollar in every category of actual use.

Admittedly, the renminbi's initial gains in market share seemed considerable, particularly on the trade track. But speedy growth rates for most uses of the currency largely came from a low base, and in some sectors growth is already beginning to decelerate. Indeed, a peak of sorts appears to have been reached in mid-2015, following a surprise devaluation of the renminbi. The size of the devaluation was small – only 1.9 per cent – but its effect on expectations about the currency's future value and usefulness was massive. Since then renminbi 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 renminbi into offshore markets for conversion into dollars. For the moment, at least, renminbi internationalization has 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 US that can make the stronger claim to success up to this point. In a vivid demonstration of 'path dependence' – the way in which past behaviour conditions future behaviour – 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 renminbi. Inertia has favoured the incumbent.

The future

The contest between the US and China for currency supremacy is not yet over. It can be expected to continue for a long time to come, and the new 'era of the renminbi' may yet arrive. Ironically, if the renminbi does begin to challenge the dollar's global dominance more strongly, this will be due less to the effectiveness of Beijing's statecraft than to the failure of Washington's.

China's weak fundamentals

Why has China not been more successful? The answer lies in a relative lack of monetary muscle. Chinese statecraft has been astute, but it is handicapped by significant deficiencies in terms of relevant power resources. Beijing is operating with comparatively weak fundamentals.

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 renminbi's appeal as an investment asset, which in turn is an essential step towards attaining reserve-currency status. And the link between these two 'store of value' roles is trade, owing to the vital function that the currency denomination of trade plays in determining which among several investment currencies will emerge as a favoured reserve asset. Whether by chance or design, Beijing seems to have got 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.' (Hong Kong and Shanghai Banking Corporation, 2011: p. 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 renminbi, especially for trade. A broad transactional network stands out as China's principal strength. Thanks to the reforms of the last 30 years, China's economy is already the second-largest in the world and could surpass that of the US in as little as another half decade. China is also now the world's leader in exports and second-biggest market for imports, with dozens of countries now counting China as their largest trading partner. Despite some decline in trade volumes in 2015 and 2016, there remains no doubt about China's massive gravitational pull in global commerce.

Another strength is China's growing network of foreign policy ties, which Beijing has cultivated through strategic investments, bilateral aid programmes and a wide array of currency swap agreements. Steven Liao and Daniel McDowell have ably demonstrated that investments in the renminbi for reserve purposes have been strongly influenced by other countries' political alignment with the Chinese government (Liao and McDowell, 2016). The more governments are sympathetic to Chinese foreign policy preferences, Liao and McDowell find, the greater their tendency to diversify their reserves into renminbi. 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 currency.

In other respects, however, Beijing's underlying position is considerably weaker. Utmost in many minds is the autocratic political regime, so different from the more democratic forms of governance that have prevailed in other countries associated with currency internationalization in the modern era. In terms of the political, legal and regulatory attributes that might reasonably be expected of a country aspiring to play a central role in the global financial system, China does not inspire a high level of confidence. To date, Beijing has shown little regard for the sanctity of property rights or for 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 behaviour. A World Bank survey of global governance indicators recently ranked China in just the 44th percentile for the rule of law (World Bank, 2016), while Transparency International places China 79th out of 176 nations in its corruption perceptions index (Transparency International, 2017). 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 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* 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 zhiguo*: "rule by law". His aim is to strengthen law to make the party more powerful, not to constrain it.' (*The Economist*, 2014) In this light, only the most sanguine of investors or central banks would see today's China as a safe haven for their assets.

Many are also disconcerted by China's vast military build-up, which is clearly designed to project coercive power well beyond the country's borders. Rather than volunteer formal or informal security assurances, as the US 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 neighbours share China's nostalgia for the idealized tradition of a regional tributary system, with the Middle Kingdom at its centre, as prevailed centuries ago. Beijing's historical sense of entitlement is widely resented.

Most salient of all is the underdeveloped state 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 prized by investors and central banks. Liquidity is low, asset prices are volatile, and the volume of high-quality securities is small. For the renminbi's share of global reserves to rise much from its present level of 1 per cent, foreign monetary authorities would have to acquire an implausibly high proportion of Chinese government debt, given the current size of the market for such instruments. For example, to realize a 7 per cent share of global reserves, foreign holdings of Chinese government debt would need to increase to one-third of the total outstanding. To realize a 20 per cent share, the entire stock of public debt would need to be held by foreigners (Steil and Smith, 2016). Only a modest one-half per cent of all international debt is currently denominated in renminbi.

Moreover, the onshore financial sector remains largely cut off from offshore markets by capital controls and other restrictions. Investment capital can be moved into or out of the country only through authorized banking institutions, and only with approval from the relevant agencies. Formally, the renminbi 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 renminbi as an investment currency or reserve asset will remain limited (Prasad, 2017; Subacchi, 2016). In the words of noted economist Jeffrey Frankel: '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.' (Frankel, 2011: p. 13)

On balance, therefore, there are several good reasons why the renminbi has remained underdeveloped as an international currency. China's leaders, to their credit, seem to understand what might be needed to compensate for these deficiencies, and have acted accordingly. At the official level, for instance, the appeal of the renminbi 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 renminbi in the SDR basket. But in each of these efforts the pace of change has been deliberately slow and measured. Likewise, at the private level the usefulness of the renminbi as an investment currency has been improved via a series of programmes intended both to open the domestic financial sector more to inflows of capital and facilitate outflows from it. But here, too, the process has been prudent and incremental. For non-resident investors there are now arrangements known as QFII (for 'qualified foreign institutional investors') and RQFII (for 'renminbi foreign qualified institutional investors'), which permit a widening range of foreign institutions to buy and sell limited amounts of selected stocks and bonds inside China. Conversely, for resident investors there are schemes such as QDII (for 'qualified domestic institutional investors'), R-ODI (for 'renminbi overseas direct investment'), and QDLP (for 'qualified domestic limited partnerships'), all designed to enable some domestic institutions to add foreign assets to their portfolios. And most recently, in 2014, a new scheme was added to this 'alphabet soup of programs' (Subacchi, 2016: p. 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 with fewer restrictions. No one can doubt that China's currency statecraft has been busy – but, as indicated, it has been conducted at a speed 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 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 neighbours. 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 renminbi's appeal as a store of value. All of these steps would risk eroding the party's grasp on power at home.

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 favoured 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 a managed exchange rate. 'Financial repression', as economists call it, is a vital cog in Beijing's machinery of political autocracy. It is not at all clear how much political authority the ruling class is prepared to sacrifice for the sake of renminbi internationalization.

Beijing's currency statecraft thus operates under some deeply rooted domestic constraints. The hope, plainly, is to encourage wider use of the renminbi 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 make as few concessions as possible in terms of financial or political reform, hoping that the nation's economic size alone will support internationalization. Whether a compromise like that can work effectively over the long haul remains an open question.

America's weaker response

The irony is that for all the fundamental weaknesses of China's situation, renminbi internationalization could ultimately succeed on a broad scale. America's relatively passive currency statecraft has worked until now. The dollar is still globally dominant. But for how much longer can the US rely on its exorbitant privilege without a risk of blowback? With the policy uncertainties created by the new administration in Washington, the answer may be: not for 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. Much depends on the quality of US policy, which has long been questionable. For decades the US has been relying on the popularity of the dollar to finance persistent payments deficits. US policymakers 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 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' (Eichengreen, 2011: p. 162).

With the arrival of Donald Trump in the White House, these dangers will almost certainly intensify. Even before the new president was elected, he carelessly rattled markets by suggesting that Washington should negotiate with its creditors to buy back much of its foreign-held debt at a discount – in effect, partially defaulting on trillions of dollars of liabilities – in order to reduce the burden of debt servicing on the US taxpayer. 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 (Cohen, 2016). 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 US by raising import tariffs and cancelling trade agreements. If protectionism truly is on the agenda, can capital controls be far behind? Trumpian mercantilism could just prove to be the decisive blow to the dollar's primacy in the global financial system.

That does not mean that we should soon expect a massive run on the dollar. That is far too sensationalist a scenario. More likely is a slow-motion drift away from the dollar as the US's financial rivals – above all, China – seek to make their own currencies more attractive and accessible.

Conclusion

In summary, it is clear that the renminbi's challenge to the US dollar is real. China is determined to promote internationalization of its currency to the fullest extent possible. Though it has accomplished much in terms of policy initiatives, substantive impacts on market behaviour to date have been limited, mainly because Beijing has been playing with a relatively weak hand – reflecting both its underdeveloped financial system and the continuing ubiquity of the dollar in international markets. All that could change, however, if US policy remains as complacent as it has been in the past. The more the Trump administration presses forward with its mercantilist agenda, the more likely it is that over time the dollar will lose ground to the renminbi.

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