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View: A growing obsession to drop dollar may create opportunities for China's yuan

Synopsis

According to latest IMF estimates, 59.8% of global exchange reserves holding are still in dollars. The euro is a distant second with 19.7% of global exchange reserves holding. The Japanese yen (5.3%), British pound (4.6%) and China (2.8%) follow. In fact, looking at some of China's trading partners and the yuan's value of trade suggests the US uses 2.83%, Russia 2.25% and France 1.99% of global yuan.

Over the last month, many commentators have been writing obituaries of the dollar. Their argument is that **China**, the second-largest **economy**, is increasingly convincing world's largest suppliers of energy to **trade** in yuans instead of dollars. This will, apparently, usher the demise of the 'petrodollar'.

Petrodollars, earned by oil-selling countries, are used to trade with other countries. China and Russia are now trying to break this US/dollar hegemony. Other emerging-market economies such as Brazil, India, Iran and, of late, France have now agreed to trade in their own currencies. This August, Brics will be meeting in Durban, South Africa, to discuss new global reserve assets instead of the dollar. Russia is already trading energy with India and China in rupees and yuans. Saudi Arabian Oil Group (Aramco) is building a $10 billion oil refinery in China, the **transaction** taking place in yuans. France and China finalised the first-ever deal on 65,000 tonnes of liquefied **natural gas** (LNG) in yuans.

Doomsayers feel that the immediate impact of shunting out the dollar can be drastic - the dollar losing value, with governments and central banks apparently losing interest in investing in the US treasury bill, and an imminent crash in the US stock market and, subsequently, the economy. But data has another story to tell.

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Traders prefer the dollar to the more unstable yuan. Also, there is strict **capital** control in place that restricts the ability of businesses to move money in and out of China, holding the yuan back from gaining traction as a global **currency** for doing **business**.

Interestingly, considering the last two years, the Chinese currency continued to depreciate against the dollar. Given that China and the US are each other's largest trading partners - even while being at each other's throat - one expected that a higher bout of **inflation** in the US would make the yuan appreciate. But between Q1 FY2021 and Q1 FY2023, the yuan per dollar depreciated from 6.45 to 6.87.

It means that there are other factors at play. For instance, the productivity level in the US is still ahead of China's. There is no indication of US GDP contracting with the economy growing by 3.2% and 2.6% in Q3 and Q4 FY2022, respectively. Furthermore, the job market data is looking strong. The US **unemployment** rate of 3.6% is still below the non-accelerating inflation rate of unemployment (Nairu) - the lowest level of unemployment that can occur in the economy before inflation starts to inch higher - which is at 4.6%.

The recent blip in the US banking sector - Silicon Valley Bank (SVB) and Signature Bank collapses - have only made things turn in the right direction. Investors and depositors are now shifting their money to large banks. Large banks with assets of more than $250 billion are mandated to take 'stress tests' - proving their ability to withstand adverse economic conditions - conducted by the US Federal Reserve. This means that these large banks have better-quality mortgage and other business loans with a lower probability of default. Remember, SVB and Signature Bank were not subjected to 'stress tests' as their asset holdings were much less than $250 billion.

So, why this new-found obsession to give up - and give up on - dollars? The West and the US are increasingly moving away from fossil fuels. In fact, both the EU and the US are bringing in new regulations that will make it harder for emerging economies in Asia, Africa and South America to trade with the EU and the US.

Take the Carbon Border Adjustment Mechanism (CBAM) in the EU, and Inflation Reduction Act (IRA) in the US, both of which are aimed towards aligning trade rules with climate change-mitigation policies pursued by developing countries. In fact, the Russia-Ukraine war has nudged the West to move further and quicker towards adopting green energy.

On the other hand, China, alongside emerging economies in South America and Africa, continues to be a big market for fossil fuels, something the oil-producing nations of Iran, Russia and Saudi Arabia cannot afford to neglect. So, baby steps for the Chinese currency are, indeed, being taken. But it will be a while before the new King Yuan arrives.

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