The Dollar and the Dragon

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Of the many factors affecting US-China relations, economics and trade is at the core. An issue that has fundamentally remained unchanged for the past decade is China's large US dollar reserves. A bargaining chip on both sides is used by politicians and society alike to color US-China relations, but should this change dramatically, it could end up hurting both sides.

For several years, American officials have pressed China to revalue its currency. They complain that the undervalued renminbi represents unfair competition, destroying American jobs, and contributing to the United States' trade deficit. How, then, should US officials respond?

Just before the recent G-20 meeting in Toronto, China announced a formula that would allow modest renminbi appreciation, but some American Congressmen remain unconvinced and threaten to increase tariffs on Chinese goods.

America absorbs Chinese imports, pays China in dollars, and China holds dollars, amassing $2.5 trillion in foreign-exchange reserves, much of it held in US Treasury securities. To some observers, this represents a fundamental shift in the global balance of power, because China could bring the US to its knees by threatening to sell its dollars.

But, if China were to bring the US to its knees, it might bring itself to its ankles in the process. China would not only reduce the value of its reserves as the dollar's value fell, but it would also jeopardize America's continued willingness to import cheap Chinese goods, which would mean job losses and instability in China.

Joseph S. Nye, Jr., "The Dollar and the Dragon," Project Syndicate, Jul 12, 2010, https://www.project-syndicate.org/commentary/the-dollar-and-the-dragon?barrier=accesspay.

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Judging whether economic interdependence produces power requires looking at the balance of asymmetries, not just at one side of the equation. In this case, interdependence has created a "balance of financial terror" analogous to the Cold War, when the US and the Soviet Union never used their potential to destroy each other in a nuclear exchange.

In February 2010, angered over American arms sales to Taiwan, a group of senior military officers called for the Chinese government to sell off US government bonds in retaliation. Their proposal went unheeded. Instead, Yi Gang, China's director of State Administration of Foreign Exchange, explained that "Chinese investments in US Treasuries are market investment behavior, and we don't wish to politicize them." Otherwise, the pain would be mutual.

Nevertheless, this balance does not guarantee stability. There is always the danger of actions with unintended consequences, especially as both countries can be expected to maneuver to change the framework and reduce their vulnerabilities. For example, after the 2008 financial crisis, while the US pressed China to let its currency appreciate, officials at China's central bank began arguing that America needed to increase its savings, reduce its deficits, and move toward supplementing the dollar's role as a reserve currency with IMF-issued special drawing rights.

But China's bark was louder than its bite. China's increased financial power may have increased its ability to resist American entreaties, but despite dire predictions, its creditor role has not been sufficient to compel the US to change its policies.

While China has taken minor measures to slow the increase in its dollar-denominated holdings, it has been unwilling to risk a fully convertible currency for domestic political reasons. Thus, the renminbi is unlikely to challenge the dollar's role as the largest component of world reserves (more than 60%) in the next decade.

Yet, as China gradually increases domestic consumption rather than relying on exports as its engine of economic growth, its leaders may begin to feel less dependent than they now are on access to the US market as a source of job creation, which is crucial for internal political stability. In that case, maintaining a weak renminbi would protect the trade balance from a flood of imports.

Asymmetries in currency markets are a particularly important aspect of economic power, since they underlie global trade and financial markets. By limiting the convertibility of its currency, China is avoiding currency markets' ability to discipline domestic economic decisions.

Compare, for example, the discipline that international banks and the IMF were able to impose on Indonesia and South Korea in 1998, with the relative freedom of the US—bestowed by denomination of American debt in dollars—to increase government spending in response to the 2008 financial crisis. Indeed, rather than weakening, the dollar has appreciated as investors regard the underlying strength of the US as a safe haven.

Obviously, a country whose currency represents a significant proportion of world reserves can gain international power from that position, thanks to easier terms for economic adjustment and the ability to influence other countries. As French President Charles de Gaulle once complained, "since the dollar is the reference currency everywhere, it can cause others to suffer the effects of its poor management. This is not acceptable. This cannot last."

But it did. America's military and economic strength reinforces confidence in the dollar as a safe haven. As a Canadian analyst put it, "the combined effect of an advanced capital market and a strong military machine to defend that market, and other safety measures, such as a strong tradition of property rights protection and a reputation for honoring dues, has made it possible to attract capital with great ease."

The G-20 is focusing on the need to "rebalance" financial flows, altering the old pattern of US deficits matching Chinese surpluses. This would require politically difficult shifts in consumption and investment, with America increasing its savings and China increasing domestic consumption.

Such changes do not occur quickly. Neither side is in a hurry to break the symmetry of interdependent vulnerability, but both continue to jockey to shape the structure and institutional framework of their market relationship. For the sake of the global economy, let us hope that neither side miscalculates.