

Will China Become The World's Reserve Currency?

SYNOPSIS

- Fear mongers now claim that the U.S. will soon be replaced by China as the world's reserve currency, and investors are asking about the validity of such an assertion.
- There is certainly a chance that China attains a "reserve" status for its currency, but hurdles remain and markets probably won't be impacted one way or the other.
- Even if China gains this coveted status, the U.S. will not lose its place as the world's reserve currency anytime in the next several decades.

THE LATEST AND GREATEST FROM THE FEAR MONGERS

A "reserve currency" is one that is held by governments and institutions in very large quantities to facilitate international transactions. Since the 1940s, the most widely accepted reserve currency has been the U.S. dollar (USD).

For example, a country that imports most of its energy would need to have access to dollars in order to pay for oil, since international oil contracts are almost always priced in USD due to its perceived value, safety, and convertibility.

One of the more prevalent conspiracy theories making the rounds across the internet these days, instigated by the fear mongers, predicts that the dollar will lose this status by the end of the year, which will subsequently drive our economy down into a deep depression.

Their thesis goes something like this: The International Monetary Fund (IMF) is voting this

October on whether to add the Chinese currency, known interchangeably as both the Yuan and Renminbi (RMB), to its basket of currencies that are designated with "reserve" status.

Once China is included, countries will quickly dump their USD reserves in favor of RMB, which would then lead to the demise of our economy due to rampant inflation.

Don't believe me? Conduct a Google search on the subject, and you will be inundated with fabricated stories of an impending dollar collapse. Some have even filmed videos that look like fake talk shows in the same manner used by TV infomercials in the 1990s (until the government banned most of them).

While it is true that the IMF could grant China with reserve status in October, the rest of this thesis is pure garbage and intended to do nothing more than scare the American public for the sole purpose of profit.

In order to set the record straight, let's walk through why China could not possibly replace the U.S. as the world's reserve currency anytime in the next several decades.

CHINA COULD CERTAINLY ACHIEVE "RESERVE" STATUS

Before we discredit the fear mongers and expose their fraudulent ways, the first step is to explain the International Monetary Fund's role and why they matter so much.

The IMF is an international organization created back in the 1940s as a way to foster global monetary



cooperation, secure financial stability, facilitate international trade, and assist in global economic growth.

The IMF executes its mandate through various services and levels of support for member nations. For example, the IMF is one of Greece's largest creditors, and they have given the country several billions of dollars over the years to help get their economy back on track.

Another function of the IMF is to set recommended guidelines on the use of currencies by central banks across the world. They currently recognize four currencies in a basket that is weighted based on their prominence and availability.

The four currencies and weightings assigned by the IMF are the US dollar (USD) at 42%, the Euro (EUR) at 37%, the UK pound sterling (GBP) at 11%, and the Japanese Yen (JPY) at 9%. Together, they make up the overwhelming majority of global international currency reserves.

Subsequently, they dominate international bond markets and global financial transactions because most countries have an ample supply of these currencies and are willing to accept them as payment for goods and services (think about the oil example above).

China desperately wants to be included in this cohort, because the "stamp of approval" from the IMF deems their currency safe to use. They applied for reserve status back in 2010, but the IMF denied them because China would not allow access to their currency in a manner that was conducive to foreign ownership.

As a result, China's new leadership has undertaken impressive reforms over the past eighteen months to

end corruption, strengthen their middle class, but most importantly open their financial markets for increased foreign ownership.

There is a big difference between the IMF adding the Yuan to its basket of currencies and the Yuan actually replacing the dollar as the world's reserve currency.

The IMF will vote once again this October on whether they will include China's RMB into this highly coveted basket of reserve currencies, but there are numerous hurdles that still remain:

- **Freely Usable:** The IMF requires that a currency not only be important in terms of its share in global trade, but also that it is "freely used," a term further broken down into "widely used" and "widely traded." China has made tremendous effort to move forward in this context, but the IMF may still need to see more progress here.
- **Manipulation:** China manipulated their currency for years in order to make their exports attractive, and their economy benefitted along the way. However, the IMF has little tolerance for direct currency manipulation and will keep a close eye on the current administration, particularly as their economy slows from years past.
- **Communist Roots:** China's recent equity market intervention in the past several weeks has most likely damaged their image by showcasing their harsh communist roots. The IMF will need to feel confident that China will allow their markets to operate freely.



Despite these potential hurdles, the IMF appears to want to include China. In fact, the IMF has publicly stated that they now consider the Yuan to be fairly valued, and that including China is not a question of “if, but when.”

NOTE: *Politics will play a big part in the decision. The U.S. currently accounts for 17% of the vote at the IMF, and our leaders may not be so inclined to do anything for a country that continues to partner with our enemies, steal our intellectual property, and hack our computer systems on a daily basis.*

However, the real question to ask is if it is a bad outcome for the U.S. if the IMF does grant China reserve status. I would argue that the good could outweigh the bad for three reasons:

1. **Playing Nice:** China has spent the past twenty plus years manipulating their currency and waging financial warfare on much of the developed world. If the IMF were to approve them, they would no longer be allowed to act in such a manner. In effect, all eyes would be on them closely watching their every move.
2. **Healthier Global Economy:** The decision could also potentially lower borrowing costs and facilitate overseas expansion by Chinese companies, which would be helpful for the Chinese economy. Since the world relies on China's economy more than in years past, the global economy is better off with a stronger and healthier Chinese economy.
3. **Deploying a War Chest:** China could begin to use a portion of their enormous foreign exchange reserves in a far more efficient manner to stimulate economic growth both in China and globally.

Simply put, a decision by the IMF to include the currency of the world's second largest economy is not

necessarily a bad outcome for the global economy.

THE USD IS GOING NOWHERE

Ultimately, it's hard to say if the IMF will grant China the reserve status they so desire. Making a call on a vote by a bureaucratic institution riddled with political motives that often defy any semblance of logic and reasoning is analogous to betting on black at the roulette wheel.

However, where I am absolutely certain is that the U.S. dollar will remain the world's reserve currency for five reasons:

1. **Must be Desirable:** The USD is the most widely accepted, trusted, and stable currency in the world. Traits like these take decades to reverse, and given the current strength of our economy and currency, any turnaround is even more difficult to imagine.
2. **IMF Will Start Small:** If the IMF does include the Yuan, its weighting in the basket will most likely reflect their current share of global payments. Currently, the Yuan accounts for just 2.2% of global payments versus 45% for the dollar. The IMF will then wait until late 2020 before deciding on changes to the weights of each currency in the basket. Hence, it's going to start quite small and stay there for some time.
3. **Commodities Use Dollars:** Nearly all commodities are priced in USD for the reasons mentioned above. Therefore, if a company in Malaysia wants to buy a barrel of oil from Saudi Arabia, that transaction will need dollars to complete. Rewriting these contracts or forming new ones would take time and equal trust in a replacement currency.
4. **Track Records Matter:** Although the recent reforms enacted by the Chinese government are very encouraging, they still have a long way to go to convince the world that they are truly



committed to allowing markets determine the value of their currency. They must instill trust that they will refrain from market manipulation, and that level of trust will take several years to develop.

5. **Must be Available:** The world's reserve currency must be both "desirable" and "available." Meaning, not only do people need to see real value in the RMB, they also need to be able to acquire it with ease. Even if the IMF approves China in October, their government could not possibly supply the world with enough RMB and then make it readily available in any timeframe shorter than a few decades.

NOTE: *The reasons for the difficulty in supplying enough RMB are extremely technical and beyond the scope of this piece. However, it took the U.S. several decades to achieve its status as the world's reserve currency, so a challenger would likely need even longer to supplant such a strong incumbent.*

The bottom line is that there is a big difference between the IMF adding the Yuan to its basket of currencies and the Yuan actually replacing the dollar as the world's reserve currency. China still has a very long way to go in developing its debt markets before its currency can achieve such a title, and any decision by the IMF to include them in October will do nothing to negatively impact the U.S. economy.

Sincerely,

A handwritten signature in black ink, appearing to read "Mike Sorrentino".



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