China’s success at signing up so many countries as founders of the new Asian Infrastructure Investment Bank, despite American concerns, has fueled a
popular narrative of waning U.S. economic influence.

In the big picture, this is a sideshow.

The real contest for global economic sway doesn’t hinge on the infrastructure bank, the International Monetary Fund or even international trade. It focuses instead on the financial world, where China is seeking to turn its currency, the yuan, into a rival to the dollar, by far the world's most important currency.

The U.S. accounts for just 23% of world economic output, but 43% of all cross-border financial transactions are denominated in dollars, as are 63% of known global central-bank reserves. Not every country needs the IMF or trades with the U.S., yet every country needs access to the global financial system, and that system largely transacts in dollars.

This has several obvious domestic advantages: for one, the U.S. government and its companies can borrow cheaply in their own currency. It also gives the U.S. extraordinary strategic leverage, which it has used to devastating effect.

In 2005, the U.S. accused a small Macau-based bank of aiding North Korea’s money laundering, drug trafficking and nuclear proliferation. Fearful of losing access to the U.S. financial system, other banks stopped doing business with it, cutting off North Korea's access to the proceeds of its illicit business.

In 2012, after the U.S. threatened to blacklist any bank that helped Iran’s central bank sell the country’s oil, Iran’s oil exports promptly plummeted. Federal and state law-enforcement officials have ordered global banks to pay billions of dollars in penalties for facilitating money laundering for terrorists and drug traffickers and helping countries such as Iran and Cuba evade sanctions. Since the alternative is losing license to operate in the U.S., they comply.

During the financial crisis it was the Federal Reserve, not the IMF, that acted as the world's lender of last resort, printing and lending trillions of dollars to cash-strapped foreign banks.

A reserve currency doesn’t get that status by decree; it must be earned. Over time private and public investors have developed the confidence and habit of storing their wealth in American bank deposits or Treasury bonds, invoicing imports and exports in dollars, issuing and trading stocks and bonds in New York, and settling disputes in American courts.
It wasn’t always so. While the U.S. economy surpassed Britain’s in size by the late 1800s, international use of the dollar lagged far behind use of the pound sterling because U.S. financial markets were so underdeveloped. American banks typically couldn’t do business across state lines much less international borders, and New York lacked London’s deep, liquid market for trade acceptances—IOUs to finance merchandise trade. With the creation of the Fed in 1913, though, banks would open foreign branches, and the Fed fostered a market for trade acceptances in New York. By the late 1920s the dollar had surpassed sterling as a reserve currency, notes economic historian Barry Eichengreen.

Thus, a country needs at least two things to issue the dominant reserve currency: a big economy and a deep, sophisticated and open financial market. China has the first, but not the second. It’s trying to change that.

The yuan can now be traded in 14 places outside China. It is used to pay for nearly 25% of China’s merchandise trade. And foreign investors can own up to $1 billion of Chinese stocks and bonds. China is now lobbying for the inclusion of the yuan in the basket of currencies that comprise the IMF’s own currency, the “special drawing right,” or SDR.

The yuan remains a long way from being a genuine reserve currency. Since the SDR is only used within the IMF, the yuan’s inclusion is largely symbolic. As Eswar Prasad of Cornell University notes, China has made more progress opening up to foreign investors than providing those investors with something to own.
Central banks that want to hold dollars can choose from trillions of dollars of easily traded, safe Treasury bonds. Nothing comparable exists in euros or yen, much less yuan, and it’s not clear China wants that to change. The more yuan foreigners hold, the less control China has over its exchange rate and its financial system. Much of the rise in yuan holdings outside China in recent years was a bet on the currency strengthening, bets that will be called off if China weakens the currency to bolster flagging exports.

Still, the U.S. would be wise not to take the challenge lightly. If the U.S. overuses its sway over the financial system in pursuit of narrow foreign-policy goals, it could encourage private investors and countries to seek alternatives—eroding its leverage.

“Once the yuan becomes an alternative to the dollar, rules of the game begin to change,” says Juan Zarate, who helped implement financial sanctions while serving in George W. Bush’s Treasury department.

The yuan is still many years away from being that alternative. But if China takes the right steps, the change in fortunes could be swift. Just ask the British.

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Corrections & Amplifications

The U.S. accounts for 23% of world economic output. An earlier version of this column incorrectly cited the total as 18%.