China Has ‘Grand Scheme’ for Yuan’s Role, Prasad Says (Update1)

By Bloomberg News

July 3 (Bloomberg) -- China’s call for a new world reserve currency is part of a “grand scheme” to reduce the dollar’s dominance and increase the yuan’s role, said a former senior International Monetary Fund official.

“The Chinese want to reduce U.S. dominance in international currency markets,” Eswar Prasad, a senior fellow at the Brookings Institution in Washington, said in an interview in Beijing. “They are trying to create the momentum for a switch away from the dollar, even though this may have only limited impact in the short run.”

China has this year signed 650 billion yuan ($95 billion) of so-called currency swaps with nations from Argentina to Belarus and said yesterday that it will allow companies to use the yuan to settle cross-border trade. People’s Bank of China Governor Zhou Xiaochuan urged the IMF in March to move toward creating a “super-sovereign reserve currency.”

“China’s a major trading nation and it just makes total sense for it to reduce its reliance on the dollar,” said Sean Callow, a senior currency strategist at Westpac Banking Corp. in Sydney.

Former Chinese Vice Premier Zeng Peiyan highlighted today the nation’s concern at the risks posed by a global financial system dominated by the dollar, urging more oversight of countries issuing reserve currencies.

‘My Problem’

Fiscal and current-account deficits must be supervised as “your currency is likely to become my problem,” he said in a speech in Beijing. Zeng is the head of a research center under the government’s top economic planning agency.

The dollar traded at $1.3996 per euro as of 10:23 a.m. in London, from $1.4003 yesterday in New York, headed for a weekly gain on speculation that the global recession will be prolonged.

China is concerned that the dollar’s dominance as a reserve currency may prevent the yuan getting a foothold in future, Prasad said in the June 30 interview.

Premier Wen Jiabao has said he is “worried” about the nation’s $763.5 billion in Treasury holdings as record U.S. debt issuance threatens to weaken the dollar.

China seems to have a “grand scheme to start pushing alternatives to the U.S. dollar,” Prasad said. Policy makers want it to have “its rightful place on the world economic stage,” he said.

The IMF’s so-called Special Drawing Rights will emerge as a key part of its strategy to establish the yuan’s global presence, Prasad added.

SDRs are a unit of account, rather than a currency, calculated according to a basket of currencies consisting of the dollar, euro, yen and pound.

‘Revolutionary’ Step

Zhou has called for all major currencies to be given weightings in the SDRs, suggesting that gross domestic product could be used as a way to determine weightings. China is the world’s third-largest economy by GDP behind the U.S. and Japan.

It’s possible some day to take the “revolutionary” step of making SDRs a reserve currency, IMF first deputy managing director John Lipsky said July 1.

If China convinces Asian nations that SDRs will evolve into a reserve currency with a yuan weighting, “then it may make sense for countries in the Asian region to start thinking right now about holding the yuan as a reserve asset,” Prasad said. “It’s a very clever way of trying to use something that everybody knows can happen only in the medium term -- by that I mean 10 years -- to start creating a dynamic right now for the yuan to become a sort of implicit reserve currency.”

Asian developing countries have “powerful incentives to build up yuan assets” because their trade with China is likely to increase, Prasad said.

The dollar's dominance is secure for at least two or three years, Prasad said. Beyond then, a challenge is "very likely," especially if the U.S. continues to have a large current-account deficit and "its public debt levels rise sharply," he said.

Prasad was head of the IMF's Financial Studies Division from 2005 until 2006, and from 2002 until 2004 he headed its China division. He is a professor of trade policy at Cornell University.

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