Chinese central banker says US dollar should be replaced as global reserve currency

Andre Damon
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Zhou Xiaochuan, head of the Chinese central bank, yesterday called for the replacement of the US dollar as the global reserve currency.

Zhou's comments, published Monday in both Chinese and English on the central banks' website, represent a stepping-up of economic tensions between the two countries as the global financial and economic crisis deepens.

"The price [of maintaining the current regime] is becoming increasingly high, not only for the users, but also for the issuers of the reserve currencies," Zhou said.

He continued, "The frequency and increasing intensity of financial crises following the collapse of the Bretton Woods system suggests the costs of such a system [the dollar reserve regime] to the world may have exceeded its benefits."

The sharpness of Zhou's speech is startling. The impact of the statements will be to raise further questions as to the stability of the US dollar. The Chinese authorities hold some $2 trillion in foreign reserves, two thirds of which is placed in US assets. Any crisis of confidence in the US dollar threatens the value of Chinese holdings.

One can only conclude that US policy is coming into such sharp conflict with the interests of other countries, particularly China, that they feel compelled to make such statements despite the potential consequences to their own holdings.

On Wednesday, the Federal Reserve introduced a huge money creation scheme, by means of which central bank would buy $1.15 trillion in securities, including $300 billion in long-term government debt. While this policy would ostensibly prop up the value of US Treasury notes—something the Chinese government is interested in—it does so by potentially diluting the value of the US dollar and thus China's holdings.

The US dollar plunged immediately after the Fed announcement, falling 4.5 percent against the euro in two days, and significantly against every other major currency.

Referring to Zhou's comments, Qu Hongbin, chief China economist for HSBC, told the *Financial Times*, "This is a clear sign that China, as the largest holder of US dollar financial assets, is concerned about the potential inflationary risk of the US Federal Reserve printing money."

In response to the financial crisis, the American ruling class has announced a series of massive bank bailouts, the most recent detailed by US Treasury Secretary Timothy Geithner on Monday. These bailouts of the financial elite itself will be funded through the issuance of debt, flooding world markets with hundreds of billions in US Treasuries.

In creating massive quantities of debt, the US is relying on the unique position of the dollar as world reserve currency, a position it has held since the end of the Second World War. Because of its central importance in world trade and financial transactions, there is a continuous demand in world markets for dollar-denominated assets.

The unique position of the US dollar also allows the Federal Reserve greater latitude in printing money to cover its obligations. The Fed's announcement last week amounts to a declaration that it will create enough money to purchase assets with a value approaching the entire dollar holdings of the Chinese central bank.

The Chinese government is caught in a bind. On the one hand, it knows that US policy is potentially inflationary, that the prospect of a massive dollar crisis is very real. It would like to find a way to lessen its dependence on US debt. On the other hand, any moves by the Chinese in this direction could spook the market and precipitate the very crisis it fears.

These contradictions were expressed in remarks by Hu Xiaolian, a vice governor of the Chinese central bank, who sought to offset Zhou's remarks by reassuring investors that China would continue to finance US government debt. "Investing in American Treasuries, as an important part of our foreign exchange reserve management, will continue," she said.

"US Treasuries are an important part of our foreign exchange reserves. So we naturally care about the security and investment return on US Treasuries," she told a news conference.

The effect of a Chinese pullout from the US government debt markets would be catastrophic, the economic equivalent of a doomsday device. The vice-governor's comments—and they are undoubtedly calculated to come off this way—may be interpreted as: "We don't want to blow up the world, but we can."

Zhao's statement comes amid escalating worldwide tensions over economic policy in the run-up to the G20 meeting next month. Last week, Reuters reported that a source within the Russian government told it that Russia, China, Brazil, and India have secretly discussed moving from the dollar reserve.

"They [China] did not formally put forward their position for the G20 summit [of financial ministers earlier this month] but unofficially they had distributed their paper regarding the same ideas [the need for the new currency]," the source told Reuters. The more-developed nations were "allergic" to the idea, said the source.

Russia possesses the world's third-largest store of foreign reserves, about half of which are in dollars.

Even before the Federal Reserve had made its latest announcement, the Chinese government had expressed concerns over the valuations of its holdings. Most prominently, Chinese Premier Wen Jiabao voiced his concerns earlier this month that the value of dollar-denominated Chinese government assets.

"President Obama and his new government have adopted a series of measures to deal with the financial crisis," Wen said. "We have expectations as to the effects of these measures. We have lent a huge amount of money to the US. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried."

He called on the United States to "maintain its good credit, to honor its promises and to guarantee the safety of China's assets."