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China wants you to want its money, but there's just one really big flaw in that plan

By Gwynn Guilford | @sinoceros | March 14, 2014

Can the yuan take on these global currencies? *Reuters/Kacper Pempel*

On Mar. 11, Zhou Xiaochuan, China's central bank chief, sparked optimism about reform of China's capital account when he said that China would let markets set interest rates as soon as a year from now. This is part of Zhou's larger project to make the yuan a widely used international currency, he said—something often referred to as "internationalization."

Many believe that, as the Chinese government carries out financial and economic reforms—of which interest rate liberalization is one of the biggest—the Chinese yuan will fast come to rival the dollar as the go-to currency of the global monetary system.

And in some ways, they're probably right, says Eswar Prasad, an economics professor at Cornell University and former head of the IMF's China division. But it's the reforms that the Chinese government refuses to discuss that prevent the yuan from becoming a safe haven investment currency, Prasad argues in his new book, *The Dollar Trap*. And that's one of the factors that will keep the dolhttps://qzprod.wordpress.com/wp-admin

/post.php?post=182798&action=editlar as the dominant global reserve currency for some time to come.

It's not that the yuan's significance isn't rapidly rising. The pace of China's growth and its dominance in global trade mean that countries are already falling over themselves to set up "swap lines," bilateral exchanges of emergency currency reserves between central banks. "Both as a unit of account and a medium of exchange these swap lilnes presage a shift in the dollar's role," Prasad says, referring to trade settlement and denomination of global commodities prices.

"[This] signifies the sheer prowess of China in terms of its share of world trade," he says. "I think it speaks to how the world seems to perceive China as a country that'll be good to have on your side."

But when it comes to the third and final function of money—a store of value—the yuan can't hack it, argues Prasad. To threaten the dollar's status as a store of value, it has to have appeal as a "safe haven" investment destination the way the US and the dollar is now. Meaning, investors have to accept it as a "predictable, low-risk destination for investment when safety matters more to them than yield."

Many investors will be willing to stomach China's weak legal framework or the risks of expropriation. But they'll do so in order to profit from China's growth, not when they need something safe to sink their money in. For that, investors want markets backed by open, transparent institutions, Prasad argues.

Those, however, would threaten the secrecy-enshrouded political decision-making mechanisms the Party favors. What's more, it has explicitly divorced economic liberalization from legal and political reforms, says Prasad, pointing to the Party's recently issued "Document No. 9," which flagged "seven perils" the Party needed to be vigilant against in order to preserve its authority. Those included Western constitutional democracy, Western concepts of democracy and human rights, freedom of the press, promotion of neoliberal free market concepts and a conception of civil society that privileged individual rights.

The quality of institutions is what many miss when they liken the yuan's imminent rise to the dollar's eclipsing of the sterling in the early 20th century.

"There's a lot of discussion about this battle between the dollar and [yuan] now, and the dollar and the sterling back in the 1900s—many have argued the same thing could happen now," says Prasad. "The crucial difference is that at that time, the US and the UK had very similar qualities of public institutions. China doesn't have that."

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