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YOUR MONEY

China Steps Up, but Its Currency Still Has Dues to Pay

Strategies

By JEFF SOMMER DEC. 5, 2015

The dollar lost a bit of its exalted status last week and the Chinese renminbi gained some luster. That was the straightforward meaning of an announcement in Washington by the International Monetary Fund, which decided to admit the renminbi to an exclusive group of elite currencies.

But global markets told quite a different story: The renminbi remained no more than a promising but relatively inconsequential currency, while the euro weakened and the dollar remained at the center of world events, with effects that rippled through the world economy.

To make sense of these apparently conflicting pictures, first examine the I.M.F. decision on the renminbi. It was long awaited and, in some ways, portentous, signaling China's growing political clout, if not the ascendance of its currency.

The international organization decided that for the first time, the Chinese currency would join the dollar, the euro, the Japanese yen and the British pound in a prestigious, if obscure, club: The big four currencies together form a global reserve asset known as the I.M.F.'s Special Drawing Rights (S.D.R.) basket. Next October, the renminbi will become the fifth member.

S.D.R.s aren't a currency, but they can be used as a claim on currencies in the basket, indirectly bolstering the role of the renminbi as a potential reserve currency. While this doesn't have much day-to-day significance right now, it certifies that China's currency, which could barely be traded on world markets only a few decades ago, has already come a long way. In order to qualify for inclusion, an S.D.R. member needs to be the currency of a major exporter, and the renminbi certainly is that.

The other main qualification is ticklish: A currency needs to be "freely usable." Using a strictly technical definition, the I.M.F. declared that the renminbi meets that test, even though its price doesn't move freely in currency markets and it isn't traded or held nearly as much as the other major currencies.

The I.M.F. acknowledged that "challenges" remained for the renminbi and stressed "the importance of continuing and deepening" the financial and economic reforms that have taken place in China. These reservations are substantial.

Nonetheless, Xinhua, the official Chinese news agency, said quite correctly that the I.M.F. decision amounted to "landmark recognition" of China's growing economic power. In order to make room for the renminbi in its S.D.R. basket, the I.M.F. shrank the other four currencies, especially the euro. The dollar lost a little of its stature.

But if the renminbi's rise in status signaled the incipient decline of the dollar, you wouldn't have known it from the action in the foreign currency markets, or from any other major markets last week. The dollar did fall against the euro on Thursday, after the European Central Bank issued policy guidance that surprised some traders. But if anything, the almighty dollar, as Washington Irving once called the greenback, retained every bit of its global importance.

It was striking that on the very day of the I.M.F.'s announcement about the renminbi, the dollar actually rose to an 11-year high against major currencies, according to Bloomberg trade-weighted data. And on Wednesday, the value of the dollar reached new heights.

It was bolstered by comments from Janet L. Yellen, the Federal Reserve chairwoman, suggesting that the Fed would soon raise short-term interest rates after holding them close to zero for nearly seven years. Ms. Yellen's testimony before Congress on Thursday added to that general conviction in the markets, though the dollar briefly gave up ground against the euro after the European Central Bank in Frankfurt loosened monetary policy less than had been expected.

Still, the market consensus remains that diverging policies in Europe and the United States will solidify a trend that has been underway for many months: The euro will weaken further and the dollar will grow ever stronger.

What's more, the rising dollar over the last year has already had profound effects. It has helped account for the drop in commodity values, which are commonly priced in dollars. The soaring greenback has also pummeled producers of coffee, cotton, copper, zinc, oil and gold, and it has punished many commodity-producing nations, like Brazil, Russia, Saudi Arabia and Canada.

At the same time, the dollar has helped put a lid on inflation in the United States, the Federal Reserve said last week in the periodic survey of American economic conditions known as the beige book. "The strong dollar put downward pressure on prices," the Fed said. It also concluded that the dollar had hurt the competitiveness of American exporters and contributed to weakening global economic demand.

And in earnings calls with financial analysts, a range of American companies reported that the dollar had created significant headwinds for their businesses, and was likely to do so in 2016. As Goldman Sachs reported in its most recent beige book — a survey of corporate America that it periodically performs: “A strong U.S. dollar continued to weigh on earnings, particularly for companies with significant international exposure.”

Those effects are widely expected to strengthen, not weaken, in the months ahead. The dollar remains the main currency in which the world does business. It accounted for more than 43 percent of foreign currency turnover in 2013, the most recent I.M.F. figure, compared with less than 17 percent for the euro, the second-most-widely-used currency. At 1.1 percent, the renminbi barely showed up on the radar.

Still, the renminbi is being traded frequently in Asia, the I.M.F. found, if not much in Europe or North America. And because China is already among the world’s biggest exporters — it is the biggest, by some measures — it has leverage to shift commerce toward the renminbi rather than the dollar.

China has already demonstrated that a small shift in the value of the renminbi can have major effects on global markets. In August, it announced that it would allow the renminbi to float in a broader range — a shift that helped China receive the benediction of the I.M.F. last week — but when the currency briefly lurched downward, world currency, stock and commodities markets fell sharply.

In Beijing last week, Yi Gang, deputy governor of the People’s Bank of China, said the bank intended to “keep the renminbi’s exchange rate stable at a reasonable level,” yet would also gradually allow the currency to move more freely. Those goals may prove to be difficult to achieve simultaneously. Having disrupted the markets only recently, China could do so again.

But China’s rising status at the I.M.F. could have a calming effect. It will lead to a small rebalancing of global reserves at central banks, which are likely to begin to modestly increase their renminbi holdings. Eventually, the renminbi could become a haven in times of trouble, a place where investors seek security, not a currency from which people flee, as has recently been the case.

In order to achieve that transformation, the renminbi will have to become much more freely and dependably usable than it already is. It is becoming more important and will undoubtedly grow in stature. But the dollar remains at the fulcrum of world trade and global economics.

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