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Stephen was asked by The Economist to participate in an online debate with Arvind Subramanian, senior fellow jointly at the Peterson Institute for International Economics and the Centre for Global Development, on whether or not the yuan will be the world's main reserve currency within ten years.

Please find the opening remarks, rebuttals, and concluding remarks below.

The moderator's opening remarks

Sep 20th 2011
John O'Sullivan

On September 12th the Italian Treasury sold €6.5 billion of five-year bonds at an interest rate of 5.6%. Demand for the bonds was weak even at such steep yields: there were only 1.3 times as many bids as there were bonds sold. In a typical auction the demand for bonds might be twice the amount on offer.

Contrast the struggle to hawk Italian bonds with the successful auction a few weeks earlier of 20 billion yuan ($3.1 billion) of Chinese government paper in the yuan's offshore market in Hong Kong. The yield was a miserly 0.6%, yet there were more than four times as many bids as there were bonds for sale.

Foreign investors are keen to buy yuan-denominated bonds for exposure to the big and burgeoning Chinese economy as well as to a likely appreciation of the yuan. There is also a desire to diversify out of the bonds of rich-world countries with large public debts. The troubles in the euro area have now taken in Italy, the world's third-largest bond market, so there are few safe stores of value for investors to park their money in. The fledgling international market for yuan in Hong Kong is catering to a market that seems likely to grow rapidly, and the yuan may soon take its place in the world's foreign-exchange reserves alongside the dollar and the euro.

Arvind Subramanian reckons the yuan's rise is overdue. China is already the world's second-largest economy, its biggest exporter and is a large net creditor to other countries (only Japan has more foreign claims). By the end of the first world war, America had achieved similar dominance on these gauges of economic muscle—GDP, trade and net assets. And by the mid-1920s, the dollar had overtaken sterling as the world's main reserve currency. Precedent suggests the yuan will be the leading currency within a decade, and not merely a junior partner to the dollar and the euro.

The obstacles seem formidable, as Mr Subramanian acknowledges. As much as investors complain about the failings of the dollar (in which 60% of global reserves are held) no other currency can match it in terms of the depth and liquidity of its capital markets. Investors can easily buy and sell Treasuries without having a big effect on bond prices. They are confident they can always get their hands on dollars. China, by contrast, does not yet allow yuan to flow freely into and out of China. Its bond market is controlled by the government and is largely illiquid.

The rapid development of the offshore yuan market shows that China is clambering over these hurdles, says Mr Subramanian. The size of its offshore bond market may reach $230 billion this year from next to nothing a few years ago. The vested interests in keeping China's financial system closed, and its currency cheap, can be overcome by an appeal to national prestige. Having the world's main reserve currency would be a prize that would outweigh the costs to exporters and state-backed financiers. The alternative is for China to be stuck with an export-led growth model that is running out of road.

Stephen Jen sees the logic of the yuan becoming a reserve currency one day but thinks it very unlikely that it will topple the dollar. China's economy may soon surpass America's but size is not a powerful determinant of reserve-currency status. There are almost as many francs as yen in foreign-exchange reserves, but Switzerland's economy is just one-twelfth the size of Japan's. China has bulk but it cannot yet offer the liquid financial markets, tried-and-trusted economic engine, and political stability needed to convince countries to hold their rainy-day money in yuan.

Nor will the dollar be easily pushed aside, says Mr Jen. Incumbency is a huge advantage. America overtook Britain as the world's largest economy in the 1870s, yet the dollar did not emerge as a serious reserve currency until the mid-1920s. The dollar is the world's main currency in part because commodities, such as oil, are bought and sold in dollars, and because it is the default for trade invoices where the currency of one trading partner is not used. Such conventions are not easily junked, says Mr Jen. The dollar's demise has often been predicted but has not yet materialised. It recovered after its share of reserves slumped in the 1980s. The euro's challenge is petering out.

China must do everything right, and America everything wrong, for the dollar to be supplanted by the yuan, argues Mr Jen. By contrast, Mr Subramanian believes the yuan's rapid rise cannot be prevented by America. What do you think?

The proposer's opening remarks

Sep 20th 2011
Arvind Subramanian

The yuan will be the world's main reserve currency because the fundamentals are moving strongly in China's favour. To be sure, there are considerable obstacles, but China is slowly yet steadily taking steps to overcome them, because it has a political incentive to do so. Consider in turn the fundamentals, the obstacles, and the political economy.

Fundamentals
The fundamental economic determinants of reserve currency status are the economic size of a country—encompassing GDP, trade, and external financial strength—and whether the country has a record of preserving the currency's value through low and stable inflation. The historical experience of the sterling-dollar transition suggests that once a country becomes economically dominant in this broad sense, currency ascendancy follows within about ten years (this point, which differs from the conventional view that the lag is close to 70 years, is elaborated in my forthcoming book).

Today, China is close to overtaking the US in this broad sense. Its trade is as large, and although its economy is smaller, it is a net creditor while the US is a large net debtor. Moreover, the yuan is a very attractive store of value because its exchange rate is expected to rise for some considerable time, whereas the dollar's value has been declining steadily. As a result, the yuan's attractiveness is becoming evident. Nigeria and Chile among other central banks have indicated that they want to hold yuan in their reserves, not just as assets but also to satisfy private-sector demand for settlement purposes, a demand that is growing rapidly as countries intensify trade links with China.

Obstacles
But China is far from creating the policy and market environment for the yuan to become a reserve currency. China's capital account is still largely closed and the yuan still is not convertible and freely available to foreigners; its financial system is repressed and government-controlled; and its financial markets lack the depth and sophistication needed to provide liquidity that is critical to make a currency attractive to hold and trade. In these circumstances, how could foreign governments or private players make payments in yuan, hold yuan assets, or denominate economic transactions in yuan?
And there are reasons why China's financial and exchange markets remain closed. Any move to internationalise the yuan will undermine government control over the financial system and will lead to a rise in the yuan which will be opposed by exporters and domestic industries that benefit from the cheap currency policy.

Political economy
The yuan can rise in status only if China's policymakers overcome these obstacles.

In fact, this process already has been set in irreversible motion, in a distinctively Chinese manner. The process is micro-managed, interventionist and enclave-based: not a day seems to pass without some foreign transaction, entity, or country being granted greater but selective access to the yuan. Just last week an initiative was launched to promote London as a possible offshore yuan trading center to complement similar plans for Shanghai and Hong Kong. As a result of this opening, gross bond issuance in yuan is expected to reach between $180 billion and $230 billion in 2011, from virtually nothing just a few years ago.

What is the guarantee that these reforms will continue, especially since there are serious vested interests in favour of the status quo? The answer is that the Chinese authorities will need a politically sustainable exit sometime soon from the country's decades-old growth strategy based on keeping the currency undervalued. Impetus for an exit could stem from the belief that an export-led strategy makes China vulnerable to a downturn in the world economy as in 2008; or from the potential fiscal losses that the build-up of reserves will entail; or from the need to use a strong currency as a tool for combating inflation. Internationalising the yuan is one option.

As China moves away from mercantilism, and as the yuan appreciates, there will be stiff opposition from the tradable sector and the government-owned financial sector. To overcome it, the Chinese authorities will play up the benefits of international reserve status of the yuan. The argument will be that the economic losses and dislocation costs from currency appreciation will be outweighed by the gains to national prestige—which China has cared deeply about throughout history—from encouraging the yuan to rise to reserve currency status and overtake the dollar as the world's currency standard. "Renminbi Rules" could prove to be the slogan of, and even a lifeline for, China's policymakers as they seek their difficult but desired exit from the mercantilist status quo.

The opposition's opening remarks

Sep 20th 2011
Stephen Jen

The global financial crisis of 2008 has made it tempting to discount the long-term prospects of everything American. As America's economic, political and military dominance appears to weaken, many argue that the dollar may soon lose its hegemony as a reserve and international currency. At the same time, due in part to the powerful rise of China in the past decade, some believe the yuan could soon become a major reserve currency, and perhaps challenge the dollar in that role within the next decade.

While the rise of China's economy and the growing international role of the yuan are compelling generational trends, it would be a mistake to underestimate the durability of the dollar as the dominant reserve currency and overestimate the speed with which the yuan could become a dominant reserve currency. Here are four thoughts.

1. It is a mistake to think that reserve-currency dominance has much to do with the relative size of the economy. In purchasing-power parity terms, China's economy is already 70% that of America's, and is projected to surpass it by 2016. Some have argued that, because of the size of the Chinese economy, the yuan will, almost as a matter of course, become the dominant reserve currency. However, looking at the various reserve currencies in the world, there does not appear to be a tight relationship between the size of an economy and its reserve-currency status. For example, the American economy is slightly smaller than that of the euro-zone in terms of nominal GDP, yet its share in global reserves is more than twice as large. Switzerland's economy is 8% of Japan's, yet the Swiss franc, as a reserve currency, has almost as big a market share as that of the yen. The yuan accounts for 0% of the world's reserves: it is much harder to manufacture a reserve currency than it is to manufacture goods. Without a stringent application of the rule of law, accounting transparency and sufficient liquidity in the underlying markets (eg, bonds and equity markets), it would be difficult for emerging markets economies to "make"—by mandate or by size—their currencies reserve currencies. Fixating on the size of the economy in this discussion is like judging the value of a car based only on its top speed, ignoring other criteria such as handling, reliability, safety and comfort.

2. It is a mistake to underestimate the difficulties in making a reserve currency. It is difficult to be the hegemonic reserve currency of the world. Importantly, the issuing country must have (a) liquid capital markets, (b) a relatively stable economic regime, (c) a sustainable political regime and (d) a mighty military force. Neither the euro-zone, nor China, nor Japan, nor Russia meets all four of these criteria. China may have an enviable production-export industrial complex, but it does not yet have a yield curve that is meaningful or viable. In fact, in many emerging markets, the development of the capital markets has in general lagged badly behind the development of the real sector—this is like someone having the upper body of a body builder but the legs of a 12-year-old boy. Why else would China—supposedly the future issuer of the dominant reserve currency in the world—need to have $3.5 trillion in reserves for self-insurance purposes?

3. It is a mistake to underestimate the incumbency advantage. The half-century lag between America (in terms of the size of its economy and trade) surpassing Britain and the dollar finally replacing sterling as the leading reserve currency is a reminder of the immense power of economies of scale. Children around the world—even those in China—are eagerly learning English, not because English is necessarily superior to French or Mandarin Chinese, but because nearly everyone else in the world speaks English. The dollar is "English in the currency world". Similarly, it makes sense to price commodities in the most widely used currency in the world—the dollar; it would be odd to mandate that oil and gold be priced in SDRs (Special Drawing Rights), just so that we could be politically correct or "democratic". According to the Bank for International Settlements' Triennial Report on the currency markets, for the past 15 years, the market share of the dollar in cross-border transactions has remained unchanged at around 85%, despite globalisation and the multipolarism of the global economy, and the yuan currently accounts for about 0.3% of the total currency turnover, despite the size of the Chinese economy. International money is used for three reasons: as a unit of account, a medium of exchange and a store of value. Doubters of the dollar may be unduly fixated on the last feature, and may underappreciate the importance of the first two features.

4. It is a mistake to write off the dollar, again. The IMF's COFER (Currency Composition of Official Foreign Exchange Reserves) data on the currency composition of the world's reserve holdings show an almost straight-line decline in the dollar's market share as a reserve currency, from around 71% in 2001 to around 61% now. Some commentators are basing their gloomy predictions on the fate of the dollar on this trend. This could be a mistake, for the dollar has, in the past, experienced an even more dramatic loss in its reserve-currency status but fully recovered a good part of those losses. In 1976, the dollar had a market share of 87% in global reserves, but due to competition from the Japanese yen and the Deutschmark this market share collapsed to only 50% by 1990. Back then there was also talk of the dollar imminently losing its hegemonic status to the yen and the DM. However, the dollar subsequently regained much of its market share when the yen fell out of favour. In retrospect, writing off the dollar was premature. Some of the commentators making the same mistake now were not long ago arguing that the euro would soon supplant the dollar.

From a multi-decade perspective, the Chinese yuan or an Asian currency unit that is centred on the yuan will almost certainly become a major reserve and international currency one day. But for the yuan to supplant the dollar as the hegemonic reserve currency in the world within the next decade, China will need to "do everything right" and America will need to "do everything wrong". While the former seems likely, the latter is unlikely, at least not within the next decade. The experience of the last 10 years taught us not to under-estimate the Chinese; the experience of the last 100 years taught us not to under-estimate the Americans.

The moderator's rebuttal remarks

Sep 23rd 2011
John O'Sullivan

Both Arvind Subramanian and Stephen Jen know what it takes to be the issuer of a reserve currency. It needs economic muscle, big and liquid financial markets and the trust of international investors. Or as our guest contributor, Barry Eichengreen, puts it, a reserve currency needs scale, liquidity, stability and security. Where our debaters disagree is on how quickly, if at all, China can meet these criteria.

In his rebuttal, Mr Subramanian takes on four of Mr Jen's objections to the yuan becoming a reserve currency quickly. The first is that size of GDP is not much of a guide to reserve-currency success. True, says Mr Subramanian. But his measure of economic heft is broader and includes having a big share of world trade and being a large international creditor. It was not until the 1920s that America overtook Britain on all three counts (it had been the world's largest economy since the 1870s). China will soon top America on these three gauges, says Mr Subramanian. It should also soon become top dog in foreign exchange, too.

He agrees with Mr Jen's second challenge, that a reserve currency issuer requires "soft infrastructure"—liquid markets, a sound economic engine, political stability, and so on. China is working on that, says Mr Subramanian. He also agrees that the dollar has the huge advantage of incumbency in terms of the pricing of traded goods and commodities. But he thinks China's exporting might means it can quickly make inroads to the dollar's territory, especially with its customers in Asia. And once a tipping point is reached, the dollar might fall quickly.

Mr Jen's fourth opening point is where the meat of the debate is to be found (it is certainly the issue that has raised the feistiest comments from the floor). For the yuan to displace the dollar, China has to manage things perfectly and America has to screw up badly. Of course, says Mr Subramanian, there is always a risk of a major upheaval in China. Yet China's policy touch has been quite assured—in contrast to America, which is on a seemingly inexorable path to fiscal ruin.

Mr Jen homes in on two strands of argument in his rebuttal: that China's economic muscle is on its own enough to determine the yuan's victory over the dollar; and that the prestige that goes with issuing the world's reserve currency is a big enough prize to mean China will make the changes needed to ensure it happens. China is a big economy largely by dint of its population. It is not yet rich in terms of per-person income. It also faces a demographic turning point in 10-15 years' time. When Japan started to get old (at a point when it was a lot richer than China), the yen's challenge to the dollar started to fade too, says Mr Jen.

China may be big but it is not nimble, he argues. It is hard to imagine a country where the prices of credit, energy and foreign exchange are fixed becoming a storehouse for the world's savings in a matter of years. Mr Jen also points to the

Triffin dilemma: an issuer of a reserve currency is required to be a supplier of global liquidity. But how can foreigners easily accumulate yuan to hoard as foreign-exchange reserves unless China starts to run trade deficits?

Mr Jen seems least convinced about the idea that the yuan's international prestige will be a sufficient spur to action for China to fast-track reforms of its financial system. It would be a risky strategy—out of character for China's cautious technocrats. There is also a danger of repeating the mistakes of European monetary union, of promoting a currency when the conditions are not yet ripe. "Overreaching for the sake of national pride does not sound like a strategy China should pursue," writes Mr Jen.

So far, the voting is roughly three-to-one against the motion. Many agree with the thrust of one commentator that trust and transparency weigh in the dollar's favour (a special mention to the sceptical wag who notes there is more chance of the drachma becoming a reserve currency in ten years). The issue raised by Cohiba9 is one that has not been discussed so far but is pertinent: with so many dollars stuffed in central-bank vaults, how quickly could any currency reasonably expect to displace it?

The proposer's rebuttal remarks

Sep 23rd 2011
Arvind Subramanian

Stephen Jen makes four important points:

1. Size of GDP is not all in determining a reserve currency.

2. It also requires "soft infrastructure", including liquid capital markets, a relatively stable economic regime, a sustainable political regime and a mighty military force.

3. There are strong incumbency advantages reflected in the "half-century lag" between the rise of the American economy and the ascendancy of the dollar to reserve-currency status.

4. The dollar's decline and the yuan's rise depend on America doing everything wrong and China doing everything right.

He is right that the size of GDP is not all. In fact, an economy needs to be more broadly dominant in terms of trade and external financial strength. On these counts, China, with its rapidly growing trade and the fact that it is the world's premier and unsurpassed creditor, looks very dominant; America looks weak for the foreseeable future, given its fiscal, external and growth problems.

Note too that the error that most analysts make is to focus on size and then claim that there was a half-century lag between the rise of the US economy and that of the dollar. This is historically inaccurate. In a broader sense, Britain retained its dominance through the first world war and beyond because its trade remained larger and external finances stronger than those of America into the 1920s. And indeed the dollar overtook sterling, as Barry Eichengreen and Mark Flandereau's 2008 discussion paper has shown, in the mid-1920s. Sterling's international role persisted thereafter in large part for political reasons because Britain promoted trade and exchange agreements with its colonies that induced the latter to hold sterling rather than switch to dollars. Correcting for these factors, the real lag in the rise of the dollar was only ten years.

Mr Jen has a point about the soft infrastructure. But the case of Japan is illuminating here. When Japan was a rising power and dominant in Asia, the yen began to be used as a reserve currency, even though Japan had less-developed capital markets and no army to speak of. Then, when the country's dominance faded, so did its reserve-currency status. Now China is the dominant power in Asia; it is the main trading partner of most of the key Asian countries. This example suggests that China's currency will gain in stature, notwithstanding that it lacks some of the factors that Mr Jen alleges are preconditions.

Moreover, the Chinese situation is changing rapidly. Just as they have done with the hard infrastructure of roads and railways, the Chinese authorities are currently building an advanced soft infrastructure. Not a day seems to pass without China announcing some new initiative to internationalise the yuan, and the political incentives are in place to continue the process.

Yes, the dollar has an incumbency advantage. But as trade within Asia becomes increasingly centred on China, it will start to make sense to denominate that trade in yuan (ie, use the yuan as a unit of account). And since the yuan is already a good store of value, it will soon also become a medium of exchange. Once these conditions are in place, it will make sense to use the yuan as a reserve currency, starting in Asia and then spreading to the rest of the world. And the flip side of incumbency must also be remembered: once a tipping point is reached, the transition to the next equilibrium is very swift.

Because the economic fundamentals are moving strongly in China's favour, I would argue that as long as there is no major political or social upheaval (which cannot be ruled out, of course), and as long as China posts a reasonable rate of growth and continues its policy reforms, the default is in favour of the yuan's rise.

And on the other side, Mr Jen seriously underestimates America's predicament: because of its over-indebtedness and because persistent short-term problems (unemployment, idle capital) can morph into long-run ones, its medium-term growth prospects look bleak. Meanwhile, the entitlement explosion and political polarisation suggest that the long-term fiscal position is fragile. And above all, America has now a long-entrenched "middle class problem", comprising a number of related pathologies: stagnating median income, rising inequality, declining social and economic mobility, problems in education, and competition from China and India even at the upper end of the skill spectrum. It is not at all obvious that we should be more bearish about China's economic fundamentals than those of America.

To use Mr Jen's metaphor, China has an overbuilt upper body with the legs of a 12 year-old. Doesn't it make sense to think that eventually the legs will develop, rather than the upper body wither? In that case, its reserve-currency status will eventually fall into line with its underlying economic "fundamentals".

And, if you really want to look back, as Mr Jen does, one conclusion leaps out from history, as Ian Morris points out in his recent book, "Why the West Rules for Now?": China was the dominant power for nearly 1,000 years until the 1500s. So, never underestimate the Chinese.

The opposition's rebuttal remarks

Sep 23rd 2011
Stephen Jen

In his opening statement, Arvind Subramanian presented a long list of challenges China faces, from the complex technicalities of financial-market liberalisation to daunting political and economic challenges. I could not agree more with these concerns. Indeed, Mr Subramanian seems to have more concerns than reasons supporting his conclusion. To me, neither of the main arguments he makes—the economic bulk of China being a necessary and sufficient condition, and China's presumed pursuit of national prestige at the expense of its industries—is that persuasive.

I will take a step back and propose that the discussion may need to be broadened: rather than debating "when" the yuan might rival the dollar, I suggest that we also think about the "why" and the "how", before coming back to the question of "when".

Why
Why does China want to nurture the yuan to be the dominant reserve currency in the world? As an ethnic Chinese, I sincerely hope this is not because of "national prestige", as Mr Subramanian suggests. The euro zone is a compelling example of what can go wrong when political hubris is placed before economic rationality and practicality. Making the yuan the dominant reserve currency in the world is not like going for a gold medal in the Olympics; there are important economic and financial consequences. Overreaching, for the sake of national pride, does not sound like a strategy China would or should pursue.

Further, it should be stressed that the world may have too much "official foreign reserves". Our calculations show that, out of the $7 trillion in official reserves held by the euro zone, close to $4.5 trillion may be considered excessive, ie, in excess of what a country would traditionally want to hold in foreign reserves. Part of the excess reserves was accumulated for self-insurance purposes following the Asian currency crisis of 1997, and part has been the result of Asia's currency policy of quasi-pegs vis-á-vis the dollar. As the dollar has depreciated in the past decade, Asian central banks have had to buy massive amounts of dollars to maintain this de facto dollar peg. One reason euro-zone central banks have begun to diversify out of the dollar is precisely because their reserves are too high. Fixating on the dollar losing its hegemony misses the point that the cause of the diversification is problematic.

Moreover, these foreign reserves are not particularly good financial investments. After the great recession, as Germany is mired in disinflation and the euro-zone in inflation, for the first time in recent history, Asian central banks are running a negative carry on their reserve holdings. We calculate it is costing China about $110 billion a year in negative carry to hold their reserves. In general, we see merit in the notion that the savings surplus countries have distorted incentives in the rest of the world through their abnormal accumulation of foreign assets. Just because a country can make money does not mean that it knows how to invest the wealth.

In short, why China would want to have a world-dominating currency is unclear, and such an objective is inconsistent with its huge and still growing foreign-reserve holdings. The angst about the dollar losing its hegemony is partly due to Asia's foreign reserves being too large in the first place.

How
Mr Subramanian also touches on the challenge of China's moving away from mercantilism. I agree this is a key challenge facing the country in the coming decade. Related to this is the "Triffin dilemma": that the world's reserve currency needs to be issued by a country that runs large, protracted current-account deficits, in order to provide sufficient international currency for the world to use. Mr Subramanian may want to comment on when he thinks China will run persistent large savings deficits.

Another key challenge is demographics. China's economic size may have just surpassed that of Japan, but China's per-person income is only one-tenth of Japan's. In 10-15 years, China is expected to hit a demographic turning point that is no less sharp than what Japan has experienced. This puts China at risk of getting old before getting rich. Extrapolating from the experiences of the past decade while not accounting for the powerful demographic headwind China will face seems odd.

I would also add that China faces yet another challenge: policy "ideological" transition. Capitalism rests on trust in prices doing the work to equilibrate supply and demand, whereas communism distrusts prices and trusts quantity controls. While on the surface China may seem like a capitalist society, there are prevalent macroeconomic price controls. First, the price of money is controlled: China does not yet have a meaningful yield curve. Interest rates are the prices of money and liquidity, and they are still mostly pre-set. Second, the prices of energy input are subsidised. Third, the price of the currency is distorted. In other words, three of the most important macroeconomic prices in China are controlled. For China to be able to develop a liquid and viable financial sector, it will have to have more trust in prices than in quantity.

When
My guess is that China will only consider granting full capital-account convertibility to the yuan when it has reached its equilibrium level. Doing so prematurely would lead to a spike, and possibly an overshoot, in the value of the yuan. But if the yuan is made convertible only when it has reached its equilibrium level, it may no longer

appreciate with certainty. Investors may be mesmerised by the yuan partly because it seems only to appreciate and never to depreciate. But, ironically, if foreign investors are allowed to buy and hold yuan, that will be precisely the moment when the future direction of the yuan becomes unclear.

The debate on "when" has more meaning if the "why" and the "how" are also discussed. My reading of China's policies in the past two decades is that none has been implemented so that the country could "show off": there are economic reasons for every macro and development policy in China. Having a robust economy and broad-based prosperity and eradicating poverty are how China shows off. For the coming decade, China could show off by engineering a successful transition from mercantilism, developing a robust financial sector and dealing with the demographic headwinds. Creating a trophy currency at the expense of other objectives would be putting the cart before the horse.

The moderator's closing remarks

Sep 28th 2011
John O'Sullivan

It is to their great credit that our two protagonists have not turned a debate about the yuan into a different debate about the long-term prospects for China's economy. Both seem similarly optimistic on that front. In his closing statement, Arvind Subramanian argues that, on his conservative assumptions (ie, 7% annual growth, not the 10% rate of the past decade), China will account for a fifth of world output in 2020, which will make it a bigger force than America, whatever happens there. His opponent, Stephen Jen, is similarly optimistic in his summing up: "There is no debate on China's bright prospect in the foreseeable future."

On one point, at least, the debaters agree. So where do they differ? Mr Subramanian believes the next stage of China's economic development will both determine and be helped by the establishment of its currency as the global standard. By contrast, Mr Jen thinks the yuan's use outside China's borders is incidental to the economy's success—and it would in any case struggle to dislodge the dollar, so powerful are the advantages of incumbency.

The nub of Mr Subramanian's case since the start of the debate has been that reserve-currency status is determined by economic dominance. He reiterates this in his summing-up. China is already the world's biggest exporter and its second-largest economy (after America) and net creditor (after Japan). Just imagine, he asks, how China might dominate the world economy in ten years' time. The logic of "convergence"—that countries with low per-person incomes can catch up with rich countries by copying their technology, know-how and policies—implies that China will be an even bigger force than today. That increased muscle implies a bigger (indeed dominant) role for the yuan.

He agrees with Mr Jen that this would require a freeing-up of China's financial system but he is convinced that this will happen. The yuan will first become a regional standard, then a global one, as the network effects of its use grow steadily more powerful. The more Asian trade is settled in yuan, the more foreigners will want to hold it. Chinese banks will want a slice of the business of providing yuan to foreigners and so will push for further liberalisation of China's capital controls. Chinese businesses, too, will want to move money freely in and out of China so they can expand abroad.

In short, China's economy won't stand still in the next decade; so why would its financial system? Finance must be reformed if China is to keep growing. And financial reform will help the yuan become a world currency. Indeed "the yuan becoming a global currency will help sell these changes," argues Mr Subramanian.

Mr Jen agrees that the yuan will be used increasingly to settle trade in Asia. But that would still leave the yuan a long way from becoming a reserve currency. Only a tiny fraction of currency turnover (one-fiftieth on his reckoning) is for trade settlement. Most foreign-exchange transactions are to finance capital flows—the cross-border buying and selling of securities or companies and the currency hedging that goes with that. So the yuan might replace the dollar on Asian export invoices; but the dollar will remain the standard for capital transactions—even in Asia.

And don't underestimate the power of incumbency in a networked market, says Mr Jen. He alludes to the dominance of the English language as a global standard and how difficult it is to dislodge it: "I will accept I am wrong on this argument when Japanese and Indonesian children start to learn Mandarin rather than English, and officials in Asia converse in Mandarin rather than English as they set up the currency-settlement arrangements," he writes.

Our debaters agree that China's prospects look bright even if they disagree about what that means for the yuan's fate. But what about America's economy? Mr Jen thinks that the debate (not so much this debate as the general debate) about the potential demise of the dollar is coloured by pessimism about America's ability to rouse itself from its current economic and political malaise. Yet he believes that "none of the problems in America are insurmountable". Mr Subramanian suspects America has lost its mojo. But even if it recovers it, he says, China will still have more muscle in a decade's time. So the yuan will topple the dollar whatever America does. The weight of opinion is against him, so far. But there is still time to register your vote.

The proposer's closing remarks

Sep 28th 2011
Arvind Subramanian

The moderator rightly summarises the difference between Stephen Jen and me as this: will China make the necessary changes over the next decade to allow the yuan to eclipse the dollar? Mr Jen thinks not, because there is a lot to do, including changing two major macroeconomic prices—interest rates and exchange rates—and liberalising China's financial system. I think it will.

Mr Jen and others are not facing up to what the world will look like in ten years' time. Consider a relatively favourable scenario for America. Suppose that it successfully surmounts its problems and grows by a relatively healthy rate of 2.5%, while China's growth slows to just 7% from its current trend rate of 10%. Why might this 7% growth be feasible? Because in 2020, China's standard of living would only be about one-third that of the United States, leaving considerable scope for catch-up.

Even on these conservative assumptions, by the end of the decade China will be dominating the global economy. It will account for 21% of the world's GDP (at purchasing power parity) compared with under 15% for America; its trade will be

40% greater than America's; and China will probably remain the world's largest net creditor.

We need to imagine the impact such changes will have on the global economic system. In the scenario outlined, it is likely that Asian trade would be predominantly yuan-denominated. If so, much of Asia's trade financing would shift progressively to yuan because it would be settled in yuan. Will China's banking system remain static in the face of these changes? Will it not want to increase its overseas yuan operations? Similarly, won't more and more Chinese industrial companies want to expand overseas? In short, demand will grow for the Chinese government to allow a progressive trade and financial globalisation of the Chinese economy.

Will the government agree? As Mr Jen points out, opening up the capital account will require dismantling the current economic model, based on repressed interest rates and an undervalued exchange rate. Is this likely to happen over the next decade? Yes. The authorities' own recent five-year plan calls for doing just this. The reason is that the current economic model is politically and economically unsustainable. Subsidised credit has led to an abnormally high ratio of investment to GDP, and to incentives which favour using capital over labour. As a result, the wage share of GDP has collapsed to less than 50%, one of the lowest ratios in the world. Improving social welfare and avoiding overinvestment that could damage the financial system will require reversing this decline. And this requires ending the subsidies to capital. Once that happens Chinese firms will want to borrow abroad, putting further pressure on the government to wind back capital controls.

In other words, China will make the needed economic and policy changes not because policymakers want reserve-currency status for the yuan—that will not and cannot be their aim. Rather, these changes—which will happen for internal reasons—will facilitate the yuan becoming a reserve currency. And the yuan becoming a reserve currency will help sell these changes.

But what about the Triffin dilemma—the current-account surpluses? Don't they need to vanish? A country does not have to run current-account deficits to issue the reserve currency. Remember that America and Britain were running current-account surpluses when their currencies were dominant. What a reserve-currency country must do is to have an open capital account, so that foreigners can have access to its currency. And as just mentioned, this is very likely to happen.

Some have asked what will happen to the vast dollar holdings around the world. The history of the sterling-dollar transition provides a clue. There will be market-driven changes—from traders, investors and others—in the relative demand for dollar and yuan over the next ten years. These can happen gradually. In fact, they have already begun: central banks are diversifying into yuan, and traders are using, denominating and settling progressively in yuan. Very recently, India allowed some of its companies to raise financing in yuan. The flood is coming.

Above all, I would claim that there is a failure of imagination here on the part of the yuan-doubters, who remain in the vice-like grip of the mindset and mental habits of the present. Keynes identified this tendency: "We assume that the present is a much more serviceable guide to the future than a candid examination of past experience would show it to have been hitherto. In other word, we largely ignore the prospect of future changes about the actual character of which we know nothing."

The opposition's closing remarks

Sep 28th 2011
Stephen Jen

In participating in this interesting debate, I have gained more clarity and become more entrenched in my own thinking about this subject. I think the very question of whether the yuan will supplant the dollar as the dominant reserve currency in the world within a decade misses some key points about the state of the global economy, and about the key characteristics that define China. This question of "when" is a typical Western way of thinking about the issue, and not something that is consistent with the Chinese mindset. The debate reminds me of typical conversations between the teacher and the grasshopper in the classic American TV series "Kung Fu", where the grasshopper keeps asking when he can attain certain achievements and statuses, while the teacher keeps stressing the importance of patience, hard work and humility.

In many ways, I am hearing such a conversation, in which the grasshopper (with all due respect to Arvind Subramanian, The Economist, the general Western readers and commentators) is interested in the "when", whereas the teacher (in this case the policymakers in China) wants to better understand the "why" and the "how", and prefers to defer the question of when, which will be answered in due course without the Chinese officials ever providing an answer. The yuan may or may not supplant the dollar as the hegemonic reserve currency in the world within a decade, but the fixation on the question of when is not a particularly Chinese way of thinking about things.

The teacher and the grasshopper
As an ethnic Chinese, I am immensely proud of what China has accomplished in the past decade. I still recall how, in my student days, my more fashionable classmates were busy studying Japanese to maintain their cool status, while I was busy learning English, thinking that my knowledge of Mandarin Chinese was probably never going to be that useful. How times have changed.

In the past decade, China has risen with quiet confidence: never boasting about what they were going to achieve, the Chinese quietly did things and let the results do the talking. The scale of the eradication of abject poverty in China in the past decade is nothing less than spectacular. The consequences of this include greater social order, ethnic cohesion (China has very diverse ethnicities) and domestic political stability. Internationally, the rise of China has inspired other emerging economies to become more confident. Further, general economic prosperity in China has encouraged risk-taking, which is the fuel that propels entrepreneurship, innovation and productivity. Moreover, the seemingly single-minded focus on the build-up of infrastructure and education assures China's future competitive standing in the world.

This is why I find the argument that China should try to make the yuan the number one reserve currency to enhance its national prestige an odd and dangerous idea. It is odd because it is a typical grasshopper thought—a rash trait that is not valued in the traditional Chinese culture; it is dangerous because it sounds like what the founding fathers of the euro zone were thinking 15 years ago.

"Horse before the cart, not the other way around, grasshopper," says the teacher.

Rivalry v. dominance: respect the economies of scale

The definition of foreign official reserves needs to be clarified before we can have a valid conversation on diversification and reserve currencies. The world has massively large excess reserves. My calculations suggest that more than half of the world's $10 trillion in official reserves are excessive. Conceptually, one could divide up the official reserves as having two tranches—a liquidity tranche and an investment tranche—with the latter being invested in the way a sovereign wealth fund (SWF) might invest: in equities, other emerging market currencies, etc. If the term reserves is properly defined as the part of the foreign reserves that is needed to meet liquidity requirements, the dollar still absolutely and definitively dominates, since potential speculative runs on the won, yuan, real and rupee will take place through the dollar, not through any other currency.

But if the Asian central banks have accumulated more reserves than they need for liquidity purposes and they diversify the excess reserves into non-dollar and assets other than sovereign bonds, it would be misleading to conclude that this is due to the dollar and US Treasuries losing their shine as reserve assets, since these assets are technically no longer strictly reserves. I think some may have confused cause and effect in this discussion on the dollar and reserves. I believe that the overaccumulation of reserves by Asia is a major policy mistake whose negative consequences will become clear over time.

Mr Subramanian argues that the yuan could start to gain increasing returns to scale through its use in regional trade settlements. This has indeed been China's policy. But it is probably wrong to conclude from this that the yuan could rival the dollar in Asia. According to the latest BIS triennial survey on the currency markets, the daily turnover in these markets is about $4 trillion. Of this, only 2% of the flows is directly related to the settlement of international trade in goods and services, while 98% is related to cross-border capital flows. In other words, the ratio of capital flows to trade flows in total global currency transactions is 50:1, an increase from 35:1 15 years ago. While the dollar may lose its international status as a trade-settlement currency within Asia, it will take much more for it to lose its capital-flow settlement-currency status in Asia, as the dollar is still the dominant currency for capital flows.

Mr Subramanian's argument is correct, but it applies to only 2% of total currency flows. I will accept that I am wrong on this when Japanese and Indonesian children start to learn Mandarin rather than English, and officials from various countries in Asia converse in Mandarin rather than English as they set up the currency-settlement arrangements.

Before the European debt crisis, several commentators had used the same arguments for why the euro would one day supplant the dollar as the dominant reserve currency in the world, and would first become the settlement currency in Europe, and maybe eastern Europe. Europe's population size, its economic size and the imminent demise of the American empire were all used as arguments. Contrary to these confident predictions, the euro now accounts for less than half the dollar's market share as a reserve currency—and much of the rise of the euro has been due, ironically, to China's buying, and the euro zone is at risk of collapsing.

Premature to declare the imminent collapse of the American empire

The current debate on the yuan and the dollar is not about China versus America. Nor is it a discussion about the dismal state—economically, politically and perhaps militarily—in which America finds itself. Rather, it is a debate about whether Americans, as a people, still have the tenacity and the resilience to emerge from the mess they are in. There is no debate on China's bright prospects in the foreseeable future. However, I contest Mr Subramanian's suggestion that Americans are soft, confused and no longer inspired. None of the problems in America are insurmountable. Just decade ago, America had great fiscal statistics; it is not clear to me that fiscal prudence and global competitiveness can never be restored there. America still leads the world in innovations and higher education. All it takes, in my view, is for the Americans to rediscover their hard Calvinistic core.