Dollars, BRICS And The China Trap

Beijing is acting determinedly to end the reign of the US currency

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Earlier this month the BRICS countries (Brazil, Russia, India, China, South Africa) agreed at their summit meeting in Sanya, China, to establish mutual lines of credit in local currencies. On the face of it, this is an innocuous effort by the world's fastest growing countries to strengthen their mutual relationship. However, in the context of the emerging global power relations, this is yet another important step in the Chinese initiative to end the reign of the dollar as the world's single reserve currency.

Two years ago i wrote in these columns about the Chinese campaign to dethrone the dollar. Shortly before the G20 London summit, China's central bank governor announced that the dollar should be replaced by SDRs. This was a shrewd approach. About half of China's foreign exchange reserves of $2 trillion are reportedly held as dollar denominated assets, as indeed are large chunks of the reserves of many central banks. This large exposure implies that any major depreciation of the dollar would severely erode the value of these assets. At the same time, large diversification of these reserves away from the dollar is not an option. Such a move itself would trigger a sharp depreciation of the dollar. But the exchange rate of SDR is a weighted average of a basket of convertible currencies, and a swap of dollars for SDRs at a predetermined exchange rate would allow China, and other countries, to significantly reduce their dollar exposure without any erosion of the value of their reserves. Of course, it would also end the reign of the dollar.

At the time, most analysts dismissed the Chinese initiative as impractical and unworkable. However, China has taken several strategic steps to carry forward its agenda through alternative routes. It has established currency swap arrangements with several developing countries, which protects their trade with China against the risk of their currencies depreciating. The initial value of these arrangements was quite modest, less than $100 billion. However, during the past two years, the volume of these arrangements would have grown significantly and could eventually cover the entire trade of these countries with China. Reportedly, Russia has also adopted the same approach. China is also leading the initiative for an Asian Monetary Fund. The IMF vehemently opposed the idea when it was originally mooted by Japan during the Asian financial crisis. However, the idea was revived a year later as the Chiang Mai initiative of the ASEAN + 3 (China, Japan, Korea), and finally became a reality when the fund was launched in 2009, this time with IMF support. The initial capital of the fund was quite modest. However, this fund could eventually be scaled up to cover the entire foreign exchange risk of total intra-ASEAN + 3 trade.

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Greenbacks are going strong, but don't count on them in the future

On top of these earlier moves, China has now led the latest initiative to establish mutual lines of credit in local currencies to protect intra-BRICS trade from foreign exchange risk. The volume of this trade is only around $230 billion at present, but as a measure of potential, it is noted that the BRICS countries together account for over 15% of world trade, worth over $4.5 trillion. Thus, China has led the establishment of three overlapping circuits of non-dollar trade-cum-currency protection arrangements covering the BRICS countries, the ASEAN+3 countries, and many developing countries of Africa and Latin America.

These arrangements are in their embryonic stages at present, and the volumes are small. However, these are the most dynamic and fastest growing countries of the world today, and trade among them is growing much faster than the average rate of growth of global trade. In other words, the road map for these non-dollar trade and currency arrangements could eventually lead to virtually the whole of world trade barring trade with and among the countries of Europe and North America. Were that to happen, the reign of the dollar would be over, and the question of whether or not it can be replaced by SDRs would no longer be relevant.

Such a scenario may sound quite implausible today, a bit of economic 'science fiction'. But we must remember that the basic institutional arrangements for such an outcome are already being put in place. In the early 20th century, when Britain was still the dominant imperial power, the pound sterling was the reigning reserve currency of the world. But Britain was already a tired imperial power. As its power waned, bled especially by two world wars, it didn't take very long for the US and France to end the reign of the pound. Is it then so unrealistic to imagine that as US power wanes, the reign of the dollar as reserve currency will be replaced by SDRs, non-dollar currency swaps, local currency credit lines for trade and other such arrangements?

How should India prepare for such an outcome? India should embed itself in the currency arrangement being forged for the BRICS countries, and strive to join the embryonic Asian Monetary Fund to take full advantage of opportunities arising from these initiatives. At the same time it must remain mindful that North America and the EU will remain important trading partners in the foreseeable future.

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