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The yuan collapses while the US dollar remains the world's reserve currency



Most headlines recently have mentioned the US dollar collapse. However, the DXY Index, which considers the US dollar mostly against the euro and the yen, is **higher** than the average of the 2009–2023 period and, despite the recent correction, stands above the July 2023 low.

Furthermore, the nominal trade-weighted dollar index stands at 125 at the end of this article, which is significantly higher than the 2009–2023 period average and higher than a year ago.

Demand for US dollars and US debt remains robust, according to the Bank for International Settlements, and the latest figures of demand for 10-year Treasuries show a solid 2.67 times bid-to-cover, higher than the average of 2023 and 2022.

Thus, headlines suggesting a global loss of confidence in the US dollar seem more than exaggerated.

Investors should be significantly more concerned about the real collapse in markets, as the Chinese yuan has **slumped** to 20-year lows against the US dollar.

This new historic low is happening despite the People's Bank of China's iron grip on the exchange rate fixing and the world's largest capital controls.

Many investors attribute this weakness as an engineered measure to boost competitiveness and adapt to rising tariffs.

However, we must remember that the PBOC has conducted a consistent policy of gold purchases, and the currency should have benefitted from the strength in gold holdings and, if it had existed, a shift out of the US dollar. Furthermore, the best way to reduce the impact of tariffs is a strong currency, not a weak one.

The US dollar remains the world's reserve currency

In the latest figures, the US dollar remains the world's reserve currency, accounting for 58% of global foreign reserve holdings, far outpacing the euro (20%) and all other contenders, including China's yuan (2%), **according** to the Dollar Dominance Monitor.

The US dollar is still used in 88% of foreign exchange transactions and 54% of export invoicing, compared to 7% and 4%, respectively, for the yuan, and 31% and 30%, respectively, for the euro. You must remember that all these percentages add up to 200%, as all global currency transactions include two currencies.

What makes a world reserve a currency?

Challenging the US dollar's reserve currency status is very difficult, as it requires more than a strong economy or ample gold holdings. To have a world reserve currency, a country needs investors, legal security, ample liquidity, and a transparent banking system.

A reserve currency must be backed by an open, transparent market and independent institutions that provide checks and balances

A reserve currency must be backed by an open, transparent market and independent institutions that provide checks and balances, limiting political interference and strengthening confidence in the currency.

The yuan cannot currently become even a contender for global reserve currency because the issuing country should maintain open financial markets, allow free movement of capital, and support an independent and transparent legal system.

China cannot reach reserve currency status if it maintains capital controls, currency exchange rate fixing, a government-dependent legal system, and a closed financial sector.

Combining the currencies and central banks of the BRICS nations is ineffective because their

financial systems lack openness, and their issuers' independence and legal frameworks are weaker than those of the United States.

Furthermore, the euro has significant challenges as well because it is the only large currency in the world with redenomination risk in case any country leaves the euro area, and the European Union's legal and investor security frameworks are solid but not as open as the United States institutions.

The dollar's supremacy

All these factors make it very difficult for any currency to challenge the US dollar as the world reserve currency.

However, the only thing that can really destroy the US dollar as the world's reserve currency is the United States fiscal and trade policy.

If the United States continues to overspend and its twin deficits remain unsustainable, the supply of US dollars to the world will exceed demand as global investors lose confidence in the issuer's solvency.

The dollar's supremacy is rooted in six essential qualities of a reserve currency: economic size, deep and liquid financial markets, full capital account convertibility, a trusted legal system, political stability, and the network effects of widespread international use, according to the Bank for International Settlements.

The confidence in the US's system can be eroded by an irresponsible fiscal policy and an unsustainable trade deficit

The United States consistently meets these criteria, but the confidence in its system can be eroded by an irresponsible fiscal policy and an unsustainable trade deficit.

The United States may have a small fiscal and trade deficit precisely because it is the world

reserve currency, but excessive twin deficits will create the opposite effect; it would put the reserve status at risk.

That was the path that the United States had been taking since 2021, and it was an unsustainable fiscal and trade situation motivated by irresponsible policies.

Trading partners are reluctant to fully embrace the yuan

China has tried to strengthen the international use of the yuan with the Cross-Border Interbank Payment System (CIPS) and support of central bank digital currencies (CBDCs) through projects like mBridge designed to facilitate yuan-based transactions and reduce reliance on the dollar.

However, all these efforts have had a minimal impact on a global scale, as the legal and financial freedom and independence characteristics of the Chinese financial system have not improved significantly.

Similar BRICS initiatives, such as the BRICS Cross Border Payments Initiative (BCBPI) and the Grain Exchange, are created to facilitate trade settlement outside the dollar system.

China's capital controls are an insurmountable burden that prevents the yuan from becoming a global reserve contender

All this may help reduce the underweight position of the yuan relative to the scale of the Chinese economy, but it cannot challenge the reserve status of the US dollar because of the impediments that Chinese legal, investor security, and financial systems create.

China's capital controls are an insurmountable burden that prevents the yuan from becoming a global reserve contender. Additionally, the Chinese, Russian, Indian, Brazilian, and South African legal and regulatory environments are less transparent, independent, and predictable

than those in the United States.

Furthermore, even strong trading partners are reluctant to fully embrace the yuan, concerned about increasing dependence on a geostrategic rival, according to Dollar Dominance Monitor.

Dominant yuan would lead to dependence on the Chinese government

Many nations understand that US dollar dominance does not mean dependence on the US government, but a dominant yuan would inevitably lead to dependence on the Chinese government.

A financial system and central bank that are as independent from the government as possible are also critical factors for being a reserve currency. This is why questions about the ECB's independence also limit the options for the euro.



You cannot be a world economic leader and reserve currency without independent institutions and economic freedom - Daniel Lacalle

The reason why the media does not report on the record lows of the yuan against the dollar as often and alarmingly as a correction of the US currency is because most analysts and reporters fail to see the implications.

This weakness means that the economy, despite its strengths, is not the beacon of growth and stability that is often portrayed.

The yuan's record lows against the dollar highlight the strength of the US dollar in the global financial system and the significant problems facing China's financial and monetary structure.

Furthermore, a weak yuan is a bad omen for the world economy, as it discounts the enduring weaknesses of the build-and-export overcapacity and working capital challenges of the Chinese economic system. It is changing, but it will take time.

Unfortunately, the yuan weakness also shows the concerns about an economic and legal system that has been closing instead of opening barriers.

You cannot be a world economic leader and reserve currency without independent institutions and economic freedom. The only thing that can demolish the US reserve currency's status is irresponsible spending, twin deficits, and indebtedness from the US government.