China at the Crossroad: Creating the Asian Single Currency or Internationalizing RMB

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Abstract: *I am going to concentrate my concern on the discussion of the diversification of the existing world currency system, because in the view of the majority of Chinese economists it is closely linked to the future directions and destinations of China's domestic financial reform, to China's policies regarding Asia's financial collaborations, and to the positioning of RMB in the world in the coming years. It is almost commonly accepted among Chinese economists that China is on the way to form its international financial strategies that contain three objectives: properly re-visiting the Bretton Woods system in today's context, actively pushing foreward the region-wide financial cooperation of an Asian single currency as a core, and gradually internalizing RMB.*

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Today, the world is plagued by the financial crisis which started two years ago in the United States. Different from the Asian financial crisis in 1997, the current one occurred in the most developed economy of the world and spread contagiously to the rest of the globe. Despite the fact that recent data suggests some healing process after many sizeable stimulus packages taken by the decision-makers of major economies, it is still hard to expect for a really strong recovery.

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One silver lining of the crisis comes from the fact that people began to look seriously for the causes of how the world's financial system went wrong. Gradually, attention has been paid to the two pillars of the existing global financial framework. The first pillar is the global financial institutions such as IMF, World Bank, as well as the Basel Committee on Banking Supervision (BCBS), and so on so forth. The current crisis has demonstrated that all the above-mentioned international institutions are not fully capable of keeping the world's financial system well functioning. Therefore, there are growing discussions about the ways of how to improve the functioning of those international financial institutions. However, my focus will exclusively touch upon the other pillar: the US dollar-dominated world currency system with the dollar acting as both transaction and reserve currency, and the last source of liquidity of the world.

Years ago, there was a saying that the whole world but the US tries to produce everything which can be purchased in dollar while America's major job is to print dollars. The words do tell somewhat truth although it is a little bit exaggerated. Here people would ask: How on earth can these happen?

There are several factors explaining why the US dollar has played a dominant role worldwide in the past six decades. First of all, the world does need an international currency to facilitate trade and investment among economies. Secondly, America generates enormous GDP with the size as big as three times that of the second biggest economy in the world. Thirdly, the US has an efficient and flexible financial system with a deep and open financial market. Fourthly, the US dollar has been confronted with relatively weak competition from either euro or Japanese yen. Fifthly, the so-called network effect of the key currency has greatly helped dollar dominate the world currency system. Last but not least, the US dollar has been substantially backed up by the US superb political, military power, and the so-called soft power.

Accumulatively, the USD-dominated global financial system has become problematic when people began to complain that the Fed monetary and dollar policies have been usually formulated in the US interest while paying little attention to the welfare of the rest of the world. At the same time, people turn to be less confident in the US financial system due to its ill regulation and get increasingly worried about the future value of the dollar caused by the US unprecedented expansionary fiscal and monetary policies. As a result, a sort of consensus has been reached: the ongoing crisis is providing the world with a good chance to get the eroded global financial framework fixed.

For instance, we could create a supra sovereign reserve currency, a warmly echoed proposal made by China's Central Bank governor Mr. Zhou Xiaochuan in March 2009. We could also take measures to strengthen global financial oversight, to enhance the regional financial cooperation, and to promote diversification of international currency system.

Here I am going to concentrate my concern on the discussion of the diversification of the existing world currency system, because in the view of the majority of Chinese economists, it is closely linked to the future directions and destinations of China's domestic financial reform, to China's policies regarding Asia's financial collaborations, and to the positioning of RMB in the world in the coming years.

What I am going to talk about will be based on the researches conducted by Chinese economists who are very much concerned about the future role of RMB in Asia and in the world. Having carefully studied more than fifty papers or articles, I found that the majority of them seem to believe that a post-dollar era is not only likely but also has been on the horizon. During the period between 2010 and 2030 humankind would witness a tri-polar international currency system with USD and EURO and an Asian united currency or one of the Asian economies' currencies as three foundations.

The hopeful, if not a wishful, tri-polar international currency system could probably bring about benefits for the world as a whole in ways of helping to reduce the systemic risk of the international financial system, to discipline the policy makers of those countries whose currencies are key currencies, to restore the balance between real economy and money economy, and to lower transaction costs when people do business across the borders.

It is almost commonly accepted among Chinese economists that China is on the way to form its international financial strategies which contain the following three objectives: properly re-visiting the Bretton Woods system in today's context, actively pushing forward the region-wide financial cooperation with the creation of an Asian single currency as the core, and gradually internationalizing RMB. Here, the last two objectives are closely relevant to what I am concerned with.

Since the outbreak of the Asian financial crisis in 1997, the countries in this region have made many progresses in cooperating with each other. For the purposes of avoiding another financial crisis and protecting their economies from collapsing when outside shocks arrive, people in Asia tried to advance cooperation in many ways. They used to think about establishing an Asian Monetary Fund（AMF), they worked out the Asian Currency Unit (ACU) by following the steps of the European Currency Unit (ECU), they created the Asian Bond Fund（ABF), they put the Chiang Mai Initiative (CMI) into effect, they enlarged CMI and made it a multilateral instead of a bilateral mechanism by setting up a reserve pool. Besides, they discussed in depth the possibilities of coordinating each country's monetary and exchange rate policies, and some of them put forth an ultimate goal for Asian currency collaboration and named the future Asian single currency ASIRO.

When Chinese economists talk about the future Asian key currency or currencies, there emerge two possible destinations: number one, a Euro-like unified Asian currency represents Asia to join the tri-polar global currency system; number two, RMB represents Asia to join the tri-polar global currency system with Japanese yen acting as a foil to RMB. Accordingly, there are three choices facing China: to firmly enhance the regional cooperation aiming at the creation of an Asian single currency; or to strongly expedite the process of making RMB one of the international key currencies; or by taking a long-term view, to deeply involve in the region-wide cooperation conducive to RMB internationalization in the long run.

Now let me elaborate the possible roadmaps of RMB internationalization planned by some Chinese economists. Step one: making RMB a pricing currency. Step two: making RMB a settlement currency. Step three: making RMB a reserve currency. From the geographical perspective, RMB would better go international sequentially to HK and Taiwan first, then to the neighboring areas, then to the region, and finally to the globe. The whole process of RMB internationalization, as they estimate, will take 15-30 years.

Why the majority of Chinese economists are in favor of RMB internationalization? Apart from the facts that China's relative economic influence has increased significantly along with the financial crisis and some wishful seigniorage may accrue from it, the reasons they give can be roughly summarized as follows:

The first reason is that China should play a financial role which is proportionate to its economic weights both in Asia and in the world. China's GDP accounts for 6.8% of the world total in 2008 calculated in market exchange rate, its exports and imports make up 9% and 8% of the world total respectively in 2008 with its trade dependency as high as 70%. However, more than 90% of China's imports and exports are priced and settled in US dollars while the share of RMB as reserve currency in the world is nearly zero. Justin Lin, the World Bank chief economist estimated earlier this year that China's economic output in PPP would surpass the U.S. in 2020 and become the largest economy in the world. Angus

Maddison, a prominent expert on economic historic statistics, forecasted the time when China exceeds the U.S. in terms of output in PPP would be 2015. By market exchange rate China is very likely to become the second biggest economy in the world in 2009 thanks to a possible 5% economic contraction of Japan. All of those figures have shown a contrasting gap between China's meaningful economic weights and its meaningless financial influence, which ought to be narrowed down.

Secondly, the domestic market-oriented reform can gain extra firepower by pushing forward RMB internationalization. History tells us that for any successful currency internationalization several preconditions need to be met. This means that China's exchange rate policy should become more flexible, its interest rate mechanism should be more market-based, the pace of fully opening up its capital account should be accelerated, its financial market should be further liberalized, and China should do much more to upgrade its financial regulation and macro monetary policy making. China's entry into WTO has already set a very good example of this kind.

The third point they make is that people are becoming less and less patient because the Asian financial cooperation moved forward so slowly that its future is getting bleaker and bleaker. They listed the obstacles that hindered the financial cooperation in this region: similarities of each country's economic and trade structure; lack of political trust among Asian economies, especially among bigger ones; unsupportive or even negative reactions of the US, the failure of establishing the Asian Monetary Fund is a typical example of this kind; reluctance for most Asian countries to concede their monetary sovereignty as the Euro Area members ever did; difficulties in allocating weights to various economies with contrasting size and growth momentum when devising and scheduling the possible currency or monetary collaborations. Naturally, the fact that the foreign exchange reserves in this region since 1997 Asian financial crisis have substantially increased is regarded as a strong support of their arguments.

The fourth reason why they support RMB internationalization is relating to the establishment of a more balanced and stable global financial system. An internationalized RMB could help provide a new investment tool for the world, could help dilute the financial or currency risks, could help constrain the global dominant currency or currencies from behaving irresponsibly, could help pave the way for incorporating RMB into SDR reserves basket, and could help strengthen financial collaboration in Asia. In one word, RMB internationalization will be conducive to global financial stability and development.

The fifth advocating point comes from the judgment that China's financial and banking situation has been much improved and will continue to get more mature and sophisticated. Today, all eighteen major commercial banks in China have satisfied the minimum capital requirement of 8 percent, while 5 years ago, we had only 8 banks that met that requirement. The ratio of non-performing loans of major commercial banks has reduced to 2.4% in 2008, compared to the figures of 20% nine years ago. China has already introduced QFII and QDII and is on the way to expand them continuously. The treasury bonds market and stock markets in China are becoming much deeper and more flexible along with the budgetary revenue being on rise dramatically. Meanwhile, China's gigantic foreign exchange reserves (US$ 2.1 trillion in March 2009) is a reliable guarantee for those who would hold RMB as official reserves or invest in RMB denominated assets.

The last reason for promoting RMB internationalization lies in the fact that it is somehow a result of a natural process which has already begun. Nowadays, RMB is spontaneously circulated in HK and other neighboring economies, and it has become one of payment or settlement currencies in Vietnam, Thailand and Pakistan. RMB saving accounts are available in Chinese Taiwan, Bangladesh, Malaysia, Indonesia, the Philippines, Singapore and Korea. China's central bank has so far signed currency swap agreements valued RMB650 billion with the financial authorities of Korea, HK, Belarus, Malaysia, Argentina and Indonesia. There are evidences showing that some Asian economies have more or less targeted RMB as an invisible currency anchor. One recent meaningful policy measure is that China made experiments of the cross-border trade RMB settlement in Shanghai and four cities in Guangdong province in April 2009.

In today's China, RMB Internationalization is really a subject under heated debate. Those who oppose RMB internationalization in general and a sudden and quick one in particular thoughtfully stated that the preconditions for it are far from being mature. For the time being and in the near future both China's economic aggregate and non-economic influence is not big enough. There are many domestic obstacles or hurdles that may hinder China's long-term growth and do make those rosy pictures about China's future not look that bright. It is true that a convertible RMB might be indispensable for a currency's internationalization. But it is by no means an easy task for China to entirely open up its capital account. It is commonly accepted that currency convertibility remains as a two-edged weapon. As far as exchange rate is concerned, nobody fully knows the consequences when RMB freely floats according to market demand and supply, let alone the fierce bargaining over exchange rate policy among different vested interest groups. Here, what they try to clarify is that China has a long way to go to catch up with the developed economies in respect of the sophistication and size of the financial market, of financial regulation, and of macro monetary management.

In the eyes of those who disagree to internationalizing RMB, the efforts to do so run in the opposite direction to regional cooperation. Saying so is not only because regional cooperation becomes trendy in today's world, but also because only a united Asia can survive the fierce competition and eventually emerges as the third pole of the future tri-polar world. By referring to the successful experiences of the Euro history, and by drawing lessons from the Asian financial cooperation in the past decades, they remain confident that Asian peoples will definitely find a win-win solution to move towards an Asian currency by deepening their financial collaboration.

The experiences of yen internationalization are not supportive for internationalization of a sovereign country's currency. Based on various researches, a number of Chinese economists come to conclusions that at least five factors contribute to the failure of yen internationalization: high level of dollarization in Asia, which means that partially substituting the widely used dollar may increase the transaction costs; Japan's huge trade surplus with its Asian trade partners, which made its Asian trade partners difficult to hold yen-denominated assets; dramatic fluctuation of the exchange rate between yen and dollar, which made other Asian economies skeptical of yen's credibility; Japan's bilateralism in trade and exchange rate policy; backlash from the US because yen internationalization would be detrimental to one of the core interests of the United States.

There would be some unfavorable aftermath caused by currency internationalization. The so called Triffin Dilemma is one of the well-known unwanted consequences, then comes the so called Trilemma, which means there is no way to simultaneously keep exchange rate stable, capital movement free, and monetary policy independent. Counteraction resulting from challenging the vested interest groups just as Japan met with decades ago should be seriously taken into account by China. More fluctuation in exchange rate and assets prices could be brought about in large part by hot money or massive speculations, and a potential long-term pressure on RMB to appreciate may result from the increasing overseas demand for RMB. All of the above-mentioned negative impacts might lead to social-political instability in China.

For the time being China is standing at the crossroad: either to let RMB go international independently, aiming at making RMB one of the world's key currencies, or to spare no efforts to make RMB play an indispensable role in the process of Asian financial collaboration. Although at present Chinese economists seem overwhelmingly to be on the side of internationalizing RMB, I am myself of the opinion that the direction and destination of RMB will be highly path-dependent. Any changes in the policies of foreign governments, any developments of global market's preference for payment and reserve currencies, any improvements or deteriorations in the domestic financial market in China, among other things, may exert vital impact upon the determining the directions or courses of the RMB's future movement. No matter which direction or course China is going to take, the changes in the role played by RMB will definitely be a historical event for the world financial or currency system in general, and for China and its neighboring economies in particular.