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China and the Emergence of a Multipolar Currency Regime

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This paper will examine the global currency regime of the future and the Chinese influence in this most important policy arena. It will focus on the US Dollar decline as the reserve currency and the potential of the Renminbi becoming a reserve currency.

Introduction: Revisiting the Asian financial crisis of 1997

The Asian Financial Crisis began in 1997 when Thailand was forced to devalue its currency after it had exhausted its foreign currency reserves in an effort to defend its currency peg from speculators and investors keen to 'cash out'. The transition from a pegged currency to a free floating one caused the Thai Baht to lose half its value. The Thai Baht had been pegged at 25 Baht to the US Dollar and was devalued to 56 Baht to the US Dollar on 2 July 1997.

As investor confidence collapsed throughout Asia, Indonesia; South Korea; the Philippines and Malaysia all found themselves affected and their currencies significantly devalued.[1] Many factors were cited as causes of the Asian Financial Crisis.[2] Some commentators see China's currency devaluation, and subsequent export growth, as one of the main causes.[3]

It is generally accepted that the increase in interest rates in the United States made the US Dollar more attractive to short term investors. This led to an outflow of capital from the affected countries as international investors preferred US investments. This outflow, coupled with a slowdown in exports, severely affected the current account balance of these economies and led to devaluation. With local business and financial sector borrowing heavily denominated in US Dollars, devaluation and the lack of short-term capital (which had fled to the United States) led to a credit squeeze in the affected countries. This plunged many of them into recession. Other factors have also been highlighted as causes of the crisis, such as herd mentality by currency traders and speculation.

After the Asian Financial Crisis, there was academic and political discourse[4] about the impact of a possible devaluation of the Renminbi and the negative global consequences this would have.[5] An appreciation or floating of the Renminbi would have important consequences for growth and stability in China and knock-on effects on the rest of Asia. Due to China's lack of sound financial and sound banking systems and the inherent structural problems that China faces, a significant appreciation of the Renminbi, as Goldstein and Lardy[6] suggest, would lead to lower economic growth. The consequences on China's banking sector, due to its high amount of non-performing loans, would most likely lead to increasing deflationary pressures on an economy just emerging from deflation. Asset bubbles would most likely arise as well; foreign direct investment would drop as investors flock to lower-cost competitors.

The debate on China's currency valuation and its effect on global trade imbalances can be seen as a distraction from the root causes of this imbalance. China's comparative advantage of cheap labour allows it a stronger hand when dealing with its trading partners, and the various fiscal policies implemented by its government make its exports much more competitive than any benefits an undervalued currency would confer. Since a sharp appreciation in the Renminbi would have dire consequences on the world economy, this would demonstrate the effect the Chinese currency has on the global financial market.

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[1] Milne, A. (2009) *The fall of the House of Credit: What Went Wrong in Banking and What can be Done to Repair the Damage?* Cambridge: Cambridge University Press.

[2] Blustein, P. (2001) *The Chastening: Inside the Crisis That Rocked the Global Financial System And Humbled the IMF*. New York: Public Affairs Books.

[3] Weisbrot, M. (2007) *Ten Years After: The Lasting Impact of the Asian Financial Crisis*. London: Center for Economic and Policy Research.

[4] Gang, F. (2006) *Currency Asymmetry, Global Imbalances and Rethinking of the International Currency System Global Imbalances and the US Debt Problem - Should Developing Countries Support the US Dollar?* Fondad, The Hague.

[5] Liew, L.H. (2003) *The Role of China's Bureaucracy in its No-Devaluation Policy during the Asian Financial Crisis.* Japanese Journal of Political Science, 4(1), 61-76

[6] Goldstein, M. and Lardy, N. (2008) *Debating China's Exchange Rate Policy*. *Policy Analyses in International Economics*. Washington D.C.: Peterson Institute for International Economics.

The Asian Financial Crisis of the late 1990s taught China and its neighbouring countries that it is better to have large amounts of reserves as an insurance mechanism in the face of the volatilities generated by the speculative capital flows inherent to the Dollar-dominated international monetary system, which is based mostly on flexible exchange rates and free movement of capital.[7] Secondly, this amount of reserves acts as a deterrent mechanism against diplomatic pressure from Washington calling for the appreciation of the Chinese Renminbi. The US has asked China to appreciate its currency in many different ways, but China has resisted the pressure, not least because it can always threaten to stop buying US debt. In this regard, China has increased its autonomy. It has been able to delay its adjustment costs for some time and it has avoided the pressure coming from the US.[8]

The following sections will focus on the US Dollar decline as the reserve currency and the potential of the Renminbi becoming a reserve currency.

The Decline of the US Dollar as the Global Reserve Currency

A significant portion of the Quantitative Easing (QE) package introduced by the US in the aftermath of the crisis has sparked asset bubbles in emerging economies. This has prompted a tightening of capital controls. The Federal Reserve describes its policy of QE as a low interest rate policy whose aim it is to stimulate employment and economic growth. The QE programme makes money from bond purchases and within five years it has more than tripled its balance sheet to more than $3.6 trillion. This makes the Federal Reserve's behaviour more akin to that of a hedge fund, with the remit of creating financial stability, rather than a central bank.[9]

In addition, QE is US Dollar negative. As such, it exacerbates so-called 'currency wars' pushing the global economy all the closer to the slippery slope of competitive devaluations, trade frictions and protectionism.[10] The US government has taken on massive additional contingent liabilities through its bail out/underwriting of the US financial system. Together with the foreseeable increase in actual Federal government liabilities, because of vastly increased future Federal deficits, this implies the need for a future private-to-public sector resource transfer that is politically unfeasible without recourse to inflation. The only alternative is default on Federal debt. There is little doubt that the Federal authorities will choose the inflation and currency depreciation route over the default route.[11]

A reserve currency has to be stable to be effective and, for some time now, it has been clear that the US Dollar is losing the confidence of global markets.[12] Confidence in the health of the US economy, and therefore the US Dollar, could eventually plunge because of continued large US current-account deficits, an unstable banking sector and an expansionist monetary policy. Chinn and Frankel claim that rankings of international currencies change only very slowly, but when they change they do so with a bang.[13] Although the United States surpassed the United Kingdom in economic size very early on (between 1860 and 1875 depending on estimates), the US Dollar did not surpass the

[7] International Monetary Fund (IMF). (2010)'*Reserve Accumulation and International Monetary Stability*', Strategy, Policy and Review Department., 13 April

[8] Zhou, X. (2011) '*On Savings Ratio'*, Financial Stability Review (Banque de France), 15, 165-9

[9] Andrew Huszar was the Federal Reserve official who implemented the policy of QE. He resigned when he realized that the real purpose of QE was to drive up the prices of the banks' holdings of debt instruments, to provide the banks with trillions of Dollars at zero cost with which to lend and speculate, and to provide the banks with "fat commissions from brokering most of the Fed's QE transactions." Huszar, A. (2013) *Confessions of a Quantitative Easer*, Wall Street Journal, 11 November

[10] Roach, S. (2010) "*Time to revamp the Fed's flawed mandate*", Financial Times, 22 November

[11] Eichengreen, B. (2011) *Exorbitant Privilege: The Rise and Fall of the Dollar*, Oxford and New York, Oxford University Press

[12] Ryan, J. (2012) "*The Dollar: Exorbitant or* ***Extortionate Privilege",*** Social Europe Journal, 26 April

[13] Chinn, M. and Frankel, J. (2007) *Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?* in Clarida, R. (ed) *G7 Current Account Imbalances: Sustainability and Adjustment,* NBER Report. University of Chicago Press, 283-321.

Pound as the major international currency until 1945.[14] The potential geopolitical implications of such a projected shift away from the US Dollar are immense.[15]

The US should consider two changes in the current international monetary order. First, the increasing role of the Euro based on a collective European economy as large as the United States' and with capital markets as extensive in most respects. The Euro already rivals the US Dollar in some domains, such as currency holdings and private bond placements, and will become a full competitor whenever the Eurozone countries adopt a more integrated fiscal policy. Second, the Renminbi is likely to acquire a significant international role once China allows it to be converted for financial as well as current account transactions and eases capital controls.

The next section will focus on this last point.

Will the Renminbi become a Reserve Currency?

There has been increasing pressure on China's officials to sell Chinese-held US Dollars. This would include, as a key part of an effective reform, the introduction of a new international reserve currency.[16]

China entered into a very large currency swap agreement with the Eurozone. The swap deal will allow more trade and investment between the regions to be conducted in Euro and Renminbi, without having to convert into another currency such as the US Dollar. This agreement will result in a reduction of US Dollars being used in trade between China and Europe. China currently owns about $1.3 trillion of US debt, and this enormous exposure to US debt is starting to become a major political issue among the country's leadership.[17]

A pressing question is therefore how it might diversify its assets. Increasing political tensions have given rise to fears that it might get rid of this huge bulk of securities and precipitate a US Dollar crash. In August 2007, a Chinese official indeed reminded the world that Beijing was in a position to provoke a 'mass depreciation' of the US Dollar if it decided to do so. China's authorities have so far shown few signs of attempting to weaken the US Dollar. China is the world's largest US Dollar investor, and no one else would have less interest in seeing the value of the US currency plummet.

On 13 March 2009, China's Premier Wen Jiabao expressed concerns about the future of the US Dollar, the currency in which most of his country's official reserves are denominated. His remarks provoked contrasting reactions among US economists. Some, like Fred Bergsten of the Institute of International Economics, exhorted the US government to take Wen's concerns seriously and listen to Beijing's suggestion to create a substitution account in the IMF, which would allow Fund members to exchange unwanted US Dollar balances for Special Drawing Rights (SDRs) as part of a gradual process to replace the US Dollar with a supranational reserve currency over the long run.[18]

According to other US economists, such as Paul Krugman, China had fallen into a trap of its own making due to its past reluctance to adopt a more flexible exchange rate policy. Since any attempt by China or any other country to

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[14] Ibid.

[15] Eichengreen, B. (2009) *The Dollar Dilemma: The World's Top Currency Faces Competition*. Foreign Affairs, September/October

[16] Chang, L. (2013) "*US fiscal failure warrants a de-Americanized world*", Xinhua News Agency, 13 October

[17] Buell, T., Davis, B. and Trivedi, A. (2013) "*ECB to Create Currency Swap Line with China Central Bank*", Wall Street Journal, 10 October

[18] Bergsten, C. F. (2009) *We Should Listen to Beijing's Currency Idea*. Financial Times, 8 April.

diversify away from the US Dollar too much or too quickly would have been self-defeating, there was no immediate threat to US or world financial stability.[19]

There are three reasons why China might worry about a decline in the value of the US Dollar that would depreciate the value of their Treasury bill holdings. First, the US government is racking up huge debts in its efforts to climb out of recession and purge the financial system of toxic assets. Massive government debt is a sure-fire means to put downward pressure on a nation's currency value. Second, printing money is a means to relieve temporarily some of the debt problems. However, this always leads to an inflation problem in the long term, which again places a declining bias on the US Dollar. Third, US interest rates are at exceptionally low levels. This will reduce the attraction, for international investors, to hold US Treasury Bills, bonds and notes once the need for 'safety' is deemed to be less pressing.

There are already signs that the 'safety' effect may be waning. It appears that China is preparing to take a diversification- and risk-minimising strategy by purchasing other assets such as gold.[20]

China, along with other countries, continues to raise questions about the dominance of the US Dollar and the need for an alternative monetary system. According to Zhou, the problem is not that China has saved too much and sent its saved money to the US, lowering interest rates there and thus encouraging the American population to overspend and overbuild and overbuy houses.[21] The source of the problem, Zhou explains, is that by issuing the main international currency, the US does not have to abide by the laws of macroeconomics.[22] There is no disciplinary mechanism that ensures that the twin (current account and budget) deficits of the US are kept under control.[23] As the largest foreign US creditor, China reduced holdings of US Treasury debt in December 2013 by $47.8 billion to $1.27 trillion, the largest decline since December 2011, according to the US Treasury Department. China's resolve to reduce its US Dollar exposure has intensified after political fights in the United States over the debt ceiling. They have reinforced worries that the United States could unintentionally slip into a situation where it will default on its obligations.[24]

China's leadership will have to make a hard choice between two different approaches: the US Dollar or the German Euro approach. On the weight and strength of the US economy and military power after the Second World War, the US Dollar was able to topple the Pound Sterling and become a global and dominant currency while pursuing an independent macroeconomic policy. If China followed the US Dollar approach it would mean China pursuing a strategy of having the Renminbi used as an international currency in parallel to the US Dollar, the Euro and, perhaps, the Yen. The second option would be the German Euro approach: currency regionalisation through a series of concrete steps (e.g. a regional currency mechanism like the Exchange Rate Mechanism) in the direction of a single currency replacing a number of individual currencies. If China were to follow this approach, it should involve itself in a fully-fledged monetary union in Asia and, in the final stage, the Renminbi would be diminished and replaced by a new Asian single currency.[25]

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[19] Krugman, P. (2009) *China's Dollar Trap.* New York Times, 2 April.
[20] Waldmeir, P. (2009) *Beijing bets on bullion to diversify foreign reserves*. Financial Times, 7 May.
[21] Bernanke, B. (2005) 'The Global Saving Glut and the US Current Account Deficit', Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10.
Bernanke, B. (2010) 'Rebalancing the Global Recovery', Sixth European Central Bank Central Banking Conference, Frankfurt, November 19.
[22] Zhou, X. (2009) 'Reform of the International Monetary System', Speeches, People's Bank of China, 23 March.
[23] Zhang, M. (2009) 'China's New International Financial Strategy amid the Global Financial Crisis", China & World Economy, 17(5), 22-35.
[24] Orlik, T. and Davis, B. (2012). *'Beijing Diversifies Away from US Dollar.'* Wall Street Journal. 2 March.
[25] Gao, H. and Yu, Y. (2011) '*Internationalisation of the Renminbi.*' Bank for International Settlements Papers, no. 61.

Zhou's declaration of geopolitical intent to supplant the US Dollar with SDRs, the IMF's unit of account, into a super-sovereign reserve currency never gained momentum even though it remains for some, including John Williamson, an elegant solution to the problem of excessive dependence on the US Dollar. The idea of the super-sovereign reserve currency would be to create a reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies. This is a clear sign that China, as the largest holder of US Dollar financial assets, is concerned about the potential inflationary risk of the US Federal Reserve printing money.[26] The SDR is unlikely to be a practical alternative to the US Dollar. In theory, countries can purchase liabilities issued by the IMF that are linked to the SDR. If the objective is to diversify out of US Dollars, reserve managers can achieve it more efficiently by directly increasing their holdings of Euro, Yen and Sterling (the other currencies to which the SDR is linked). However, Beijing's initiative has made China's desire to shape a new monetary order clear.[27]

However, what role will the Renminbi play in the global financial markets in the future? Will it ever become a reserve currency? Until 20 years ago, the Renminbi was so domestic in its use that foreigners in China were supposed to use vouchers called 'foreign-exchange certificates' instead. Starting from scratch in 2009, China was settling 12% of its trade in its own currency by 2013. China is encouraging the use of the Renminbi in overseas investment and is providing ever more official aid and loans in its own currency. The Renminbi is circulating more widely in neighbouring countries, just as the US Dollar is in Latin America and the Euro is in Eastern Europe and North Africa. In Mongolia, the Renminbi accounts for 60% of the local cash in circulation. Some central banks already hold a small chunk of their countries' foreign-exchange reserves in Renminbi. Economists even talk of an emerging 'Renminbi bloc', encompassing China, Hong Kong, Taiwan and the ten members of the Association of South-East Asian Nations. By October 2013, the PBOC had spun a web of nearly 2.2 trillion Renminbi in credit lines with more than 20 central banks around the world since 2009, including the ECB and the Bank of England. These are designed to keep Renminbi-denominated trade running in case liquidity dries up and to lay the foundations for deeper monetary integration with the signatory countries. In the same vein, at least ten central banks, including those of South Africa, Australia, Nigeria and Malaysia, have invested part of their reserves in Renminbi bonds. Offshore Renminbi markets have sprung up in London, Singapore and Frankfurt. These shifts, which are more symbolic than substantive at present, will develop critical mass over time and have the potential to start transforming the global monetary system. The globalisation of the Renminbi seems to be picking up momentum. However, to be eligible for reserve status, several prerequisites have to be fulfilled.

- *Convertibility*: The Renminbi is slowly becoming convertible and more accepted as a currency. Restrictions have been eased on cross-border remittances of the Renminbi for settlement. There has been issuance of Renminbi-denominated bonds in Hong Kong and by foreigners in the mainland and some selected banks offer offshore Renminbi deposit accounts. The birth of an offshore Renminbi market, principally in Hong Kong,[28] also gives China the chance to monitor the impact of banking and currency reforms in a semi-controlled environment. That is a valuable experience for the day when China opens up its domestic financial markets, which many say is Zhou's strategic aim in pushing the internationalisation of the Renminbi. There have also been currency bilateral swap lines with other central banks globally.

[26] Eichengreen, B. and Frankel J. (1996) *The SDR, Reserve Currencies, and the Future of the International Monetary System* in Mussa, M., Boughton, J. and Isard, P. (eds) *The Future of the SDR in Light of Changes in the International Financial System.* Washington D.C.: International Monetary Fund.

[27] Zhou, X. (2009) *'Reform of the International Monetary System',* Speeches, People's Bank of China, 23 March.

[28] In April 2014, a long-stalled agreement linking the Hong Kong and Shanghai stock exchanges and allowing trading to be settled in Renminbi got a green light. The market in Renminbi-denominated "dim sum" bonds issued offshore (mainly in Hong Kong) is growing. Some 18% of China's foreign trade is now settled in Renminbi, a proportion which the Hong Kong Monetary Authority expects to reach 30% in 2015.

- *Liquid financial markets*: The Renminbi needs broad, deep, and liquid financial markets so that international investors will have access to a wide array of financial assets denominated in its currency. China has relatively shallow and underdeveloped government and corporate bond markets. Many other securities and derivatives markets are still developing.

- *Stability*: The Renminbi value needs to be reasonably stable. It is important for reserve currencies to trade freely at market-determined exchange rates. China still has a tightly managed exchange rate, which will become increasingly hard to manage as the capital account becomes more open.

- *No capital controls*: The Renminbi needs to be easily tradable in global financial markets with no restrictions on capital flows. China is gradually and selectively easing restrictions on both inflows and outflows. The capital account has become increasingly open in de facto terms, but extensive capital controls still prevail.

Conclusions

The decline in the international role of the US Dollar is caused by persistent current account deficits combined with a long-term decline in the US Dollar's exchange rate, and perhaps imperial overreach, too. The projected speed at which the US Dollar will lose its predominant position as a global reserve currency depends on the US Treasury fiscal policy. Chinese and European leaders frequently emphasise US responsibilities for the stability of the US Dollar as the premier reserve currency.

Are the US Dollar's days as the global reserve currency over? No, but they are numbered. In the past a strong and open US financial system helped facilitate the US Dollar's international use. While a connection naturally exists between the US Dollars' role in trade and the growth of an accommodating financial structure, US financial markets had the reputation of being innovative and relatively free of tighter regulation. Their breadth and depth enhance the liquidity of US Dollar-denominated assets. Moreover, as US trade expands and US financial markets grow, more and more foreign financial firms, even ones not located in the US, offer US Dollar-denominated products. All this makes holding US Dollars convenient and transacting in US Dollars relatively easy.

Arguably, what ultimately defines the US Dollar's dominant status is the US government's fiscal capacity to back the Federal Reserve's provision of US Dollar liquidity at times of crisis. This capacity is certain to decline as the global economy expands and demand for US Dollar assets increases; the United States will inevitably see its reserve-currency monopoly eroded. It could therefore only be a matter of time before the global monetary system becomes multipolar.

China has now decided to start looking for a smooth exit from the game. The Central Bank of China announced that it is no longer in China's favour to accumulate foreign-exchange reserves. The internationalisation of the Renminbi will include its use in settling trade and financial deals, where the Chinese currency is already well advanced, and the liberalisation of China's capital account so that the Renminbi can be freely converted with other currencies at market rates. Without that convertibility, much deeper domestic financial markets and a floating exchange rate, the Renminbi will not reach global reserve currency status.

The global economy is already close to operating with three regional exchange rate anchors, the US Dollar; the Euro; and the Renminbi, so the transition to a multipolar system could occur sooner than is sometimes asserted. Nevertheless, given the importance of financial deepening and integration in the internationalisation of currencies, any shift will still be gradual.

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