SAIS CHINA STUDIES

Student Working Paper Series

FALL/2009

Meredith Champlin

From People's Money to International Currency: Internationalization with Chinese Characteristics

This paper was prepared for the course "Research Seminar: China and the Global Financial Crisis," with Pieter Bottelier.

Comments on this draft may be addressed to the author, Meredith Champlin: champlinml@gmail.com.

Against the backdrop of the current global financial crisis, Chinese officials have urged for reform of the international financial system, increased regulation and oversight of the financial sector in developed countries, and expanded use of Special Drawing Rights (SDRS) as well as China's currency, the renminbi (RMB or yuan). Much of China's concern stems from the risks associated with its extraordinary U.S. dollar holdings. Indeed, the dollar's value has fluctuated since the start of the financial crisis in September 2008. The dollar's decline has sparked debate in China about how much of its reserves should be held in dollar-denominated assets (presently estimated at about two-thirds), as well as the increasing exchange rate risk of holding a national currency as a reserve currency. In March, Governor Zhou Xiaochuan of the People's Bank of China, the central bank, issued a provocative statement calling for reform of the international financial system to promote SDRs as an alternative to the U.S. dollar for international reserve holdings.

At the same time, China itself has come under renewed pressure to revalue its own exchange rate. From finance ministers in Europe and Japan to the managing director of the International Monetary Fund (IMF), China has been criticized for reestablishing the RMB's informal peg to the dollar, thereby effectively depreciating the RMB along with the dollar in recent months.[1] In response, Chinese officials have signaled that they will continue to reform the exchange rate mechanism. Echoing the policy of the People's Bank of China (PBOC), Vice-Foreign Minister Zhang Zhijun recently commented that, "China will increase the flexibility of the RMB exchange rate at a controllable level in the future based on the market demand and with reference to a basket of currencies." (China Daily, November 2009) Yet, China has also urged greater monetary policy prudence on the part of developed nations, particularly the United States. In recent statements, Chinese officials have pressed the United States to maintain the value of the dollar and tighten monetary policy so as to prevent a new asset bubble and ease inflationary pressures.

Following the onset of the international financial crisis, the Chinese Communist Party (CCP) has pushed forward two policy responses: internationalization of the RMB and reform of the international financial architecture. This paper will assess these strategies, with particular emphasis on the prospects for, and implications of, RMB internationalization. The first section will briefly review Zhou Xiaochuan's proposal, while the second section will provide a snapshot of the current international situation. Sections III and IV will then take a closer look at indications of the RMB's internationalization in general and the regionalization of the RMB in Asia specifically. Following this, I will provide my own analysis of the RMB's internationalization. In my view, RMB internationalization faces many hurdles. Thus, China's approach mirrors that of all its economic reforms, namely incremental steps coupled with experimental phases and pilot schemes. Additionally, China has learned several lessons from the Asian financial crisis and the current financial crisis. I assert that these lessons are shaping its vision of financial regulatory reform and the international financial system. Finally, I will

[1] On July 21, 2005, the PBOC unpegged the RMB from the dollar and revalued the yuan by 2.1 percent to 8.11 per dollar. The PBOC pursued a managed floating exchange rate based on market supply and demand with reference to a basket of currencies, and the yuan was allowed to rise or fall 0.3 percent a day against the dollar from a reference rate set every morning by the PBOC. In 2007, the yuan's daily trading band against the dollar was widened to plus or minus 0.5 percent. Following the global financial crisis, in July 2008 the PBOC informally repegged the RMB to the dollar.

conclude my analysis with some brief observations about the implications of China's policy approach.

INTERNATIONALIZATION OF THE REMINBI (RMB)

On March 23, 2009, the People's Bank of China released a statement by Governor Zhou Xiaochuan, calling for the dollar's replacement as the dominant world currency and the creation of "an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run."(Zhou) Contrary to Federal Reserve Chairman Bernanke's savings glut thesis,[2] Zhou Xiaochuan argues that basing the international financial system on a national currency – the U.S. dollar – exacerbated global imbalances, leading to the current financial crisis. Also, referencing the Triffin Dilemma, Zhou cautioned the international community about the dangers of permitting a national currency to become the dominant international reserve currency. The Triffin dilemma states that any national monetary authority issuing the de facto international currency will create either too much liquidity or too little liquidity. The United States, as the reserve currency nation, must run a current-account deficit to provide liquidity to the international monetary system. Yet, at the same time, the United States should be prudent enough to run a current account surplus so as to maintain confidence in the dollar, or at least the country should not run large and persistent deficits that undermine confidence in the dollar. One proxy for how the United States is managing the dilemma is the value of the dollar in foreign exchange markets. (Carbaugh and Hendrick) In this regard, the dollar's recent decline, falling nearly 22 percent since 2002 based on the Federal Reserve's trade-weighted dollar index, may signal decreasing confidence. [3] (Gongloff, November 2009) Likewise, China's official statements urging the United States to protect the value of the dollar reflect a growing concern over its own U.S. dollar investments.[4]

Zhou's statement received considerable attention both in China and internationally, stimulating debate on whether SDRs could serve as a supra-national currency for reserves. The SDRs, created by the IMF in 1969 to support the Bretton Woods system, were designed to be used in conjunction with the dollar and gold for the settlement of payments deficits. In other words, SDRs are international reserve assets used to supplement IMF member countries' official reserves. While the use of SDRs as an international reserve currency never gained traction – representing less than 1 percent of total reserves today – SDRs continue to serve as a unit of account of the IMF and as potential claims on the currencies of IMF member countries. (Carbaugh and Hendricks). In Zhou's essay, however, he proposed the following reforms to expand the international use of SDRs: "(1) make the SDR convertible into other currencies, (2) promote the use of the SDR for commodity pricing, investment and corporate book-keeping, (3) create SDR-denominated tradable financial instruments, (4) update the formula used for the

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[2] See: http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/

[3] Indeed, some go beyond Gongloff's estimates, for example Carbaugh and Hendrick write, "For most of this decade, the United States has struggled to maintain the dollar's value. Against major currencies, the dollar depreciated by about 33 percent during 2002-2009."

[4] Pieter Bottelier writes, "Although [Zhou Xiaochuan's] proposal may have been partly motivated by domestic politics, it does reflect deep-rooted concern in China that the international financial crisis and subsequent U.S. responses to it could undermine the purchasing power of the dollar." (Bottelier, China Brief, May 2009)

allocation of new SDRs by the IMF, (5) update the valuation base of the SDR by including other currencies in its base (presumably including the RMB)[5], and (6) promote confidence in the value of the SDR by shifting from a purely unit-of-account or calculation-based system to a system that is backed by real assets such as a reserve pool." (Bottelier, April 10, 2009)

In addition to calling for greater use of SDRs for international reserves, Zhou suggested that countries should be permitted to trade in their existing reserves for SDRs at a specific exchange rate or to turn over a portion of their reserves to be managed directly by the IMF. This is not surprising given China's heavy reliance on dollar-denominated assets in the country's reported $2.27 trillion dollar reserve holdings. (Poon, December 2009) Indeed, China is stuck in a "dollar trap": any future fall in the dollar could mean a significant capital loss for China, and yet diversifying out of dollars could drive the value of the dollar down, triggering a capital loss. (Krugman) Indeed, Zachary Karabell writes that "with so much invested in the U.S., China can no more tolerate a severe U.S. implosion than Americans can. Any action taken by China to imperil the economic stability of the U.S. would be an act of mutually-assured destruction." (Karabell) Thus, two possible exit strategies for China are to persuade the world to adopt SDRs as the new super-sovereign global currency or encourage the internationalization of the yuan.[6]

STATE OF THE WORLD: CURRENT INTERNATIONAL SITUATION

China's "dollar trap" leaves the country's leaders in a bind: either they can diversify away from dollar-denominated holdings and take a potential capital loss from the ensuing depreciation of the dollar or China can maintain its dollar assets and let the market determine the dollar's value. Indeed, senior Chinese officials have expressed concern about the dollar's value since the onset of the current financial crisis. In November 2009, Finance Minister Xie Xuren stated that "the nations that issue key reserve currencies should maintain the value of their currencies and exchange-rate stability, preventing negative spillover effects." (Poon; Xinhua) Since China owns approximately $1 trillion in U.S. assets,[7] concern that the dollar's declining value, in addition to its growing fiscal deficit and loose monetary policy, will erode the value of China's reserves is justified. Yet, even though China worries about its dollar exposure risk, the PBOC has continued to purchase U.S. treasuries, albeit shifting somewhat into shorter-term treasury bills.[8] (See Chart 6) In section VI, I argue that the approach China seems to have taken to get out of its "dollar trap" is to deliberately and incrementally regionalize the use of the RMB and begin to diversify its reserves out of U.S. dollars.

<u>Strong Dollar or Strong Yuan?</u>

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[5] The value of the SDR is defined by a basket of currencies, including the dollar (44 percent), the euro (34 percent), the yen (11 percent), and the pound (11 percent). (See: Carbaugh and Hendrick) The weights reflect the level of exports and imports of the four countries during the previous five years, and they are reviewed every five years by the IMF.

[6] For an interesting take on this, see Mallaby.

[7] According to Pieter Bottelier, China's central bank and other government-owned financial institutions, including China's sovereign wealth fund (CIC) hold an estimated $1.5-1.6 trillion in U.S. dollar denominated financial assets. (China Brief)

[8] In May, China added $38 billion in US treasuries, bringing its total holdings to over $800 billion, the Treasury Department reported.(Kutner, 2009); See also Bradsher.

The Chinese government has been concerned with the dollar's volatility since the outset of the financial crisis. (Chart 1) When the crisis emerged, the dollar strengthened by more than 10 percent, as investors de-leveraged and shifted into safer and more liquid investments such as U.S. treasuries. As financial markets have recovered, though, the dollar is beginning to depreciate, falling back toward its pre-crisis level. (Boone and Johnson; Shah) Treasury Secretary Geithner has consistently reassured international partners that the United States is committed to a strong dollar. Yet, the appropriate value of the dollar over longer time horizons is difficult to pinpoint: the dollar's worth is based on a complex web of shifting and interlocking factors, including trade balances, government spending, interest rates, inflation, and economic growth. (Gongloff, October 2009) Also, for the United States, many argue that a weaker dollar will contribute to global rebalancing by reducing the current account deficit through increased U.S. exports. However, the relationship between exchange rates and the trade balance is complex. For example, the U.S. trade deficit with China increased by 33 percent between 2005 and 2008, while the dollar fell between 18 and 22 percent against the yuan. (Gongloff, November 2009) Likewise, the widening of America's post-Plaza Accord trade deficit with Japan is also instructive.[9]

For China, after some progress was made when the PBOC un-pegged the RMB from the dollar in 2005, allowing it to appreciate 21 percent, the central bank has kept the exchange rate at about 6.83 to the dollar since July 2008. Thus, as the dollar depreciates, so too does the yuan (in real effective terms). The World Bank reports that China's nominal effective exchange rate (NEER) depreciated 7.6 percent this year due to the informal peg to the dollar. (Chart 2) This has been difficult for its neighbors in Asia, many of which have intervened in currency markets to stem their own appreciation. (Roman) Since March, the dollar – and by extension the yuan – has fallen 24.3% against the South Korean won, 10.4% against the Singapore dollar, 7.7% against the Thai baht, and 9.3% against the Malaysian ringgit. (Frangos)

While IMF Managing Director Dominique Strauss-Kahn has recently called for China to address its "undervalued" currency, however, not everyone at the IMF agrees with him. The IMF's 2009 public information note, which summarizes Article IV consultations with China, reported that while some Directors "supported the view that the renminbi remains substantially undervalued…a number of other Directors pointed to the methodological difficulties of making exchange rate assessments." That said, many economists have estimated the significant undervaluation of the RMB. Morris Goldstein and Nicholas Lardy of the Peterson Institute for International Economics contend that the yuan is undervalued by 15-25 percent.[10] China has

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[9] Michael Pettis notes that, "many analysts have long pointed to exchange-rate manipulation as a quick fix for trade imbalances, or the gap between what a country produces and what it consumes. When the Japanese and German currencies soared in value against the dollar after the Plaza Accords of September 1985, many analysts thought that these countries' trade surpluses with the U.S. would decline. They were partly right. The German trade surplus with the U.S. declined. But even though the value of the yen doubled, Japan's trade surplus surged."

[10] In his introductory chapter, Dr. Lardy asserts that "any methodology that defines the equilibrium exchange rate for the renminbi as the real effective exchange rate that would produce 'balance' in China's global current

deflected criticism of its currency policy, preferring to focus attention on its role in global economic recovery. However, the PBOC did change the wording in its quarterly monetary policy reports this year, dropping the line about keeping the yuan "basically stable" and adding that foreign exchange policy would take into account "international capital flows and changes in major currencies." (Economist, November 2009)

New Reserve Currencies?

The proposal for enhanced use of SDRs has not succeeded in garnering much attention apart from an agreement by the IMF to issue SDR-denominated bonds (see: Batson, July 2009), and many difficulties remain before SDRs can truly be transformed into a viable alternative to the dollar. The question as to whether the U.S. dollar should remain the dominant reserve currency, however, has continued to prompt debate. Even World Bank president Robert Zoellick cautioned the United States against assuming that the dollar would continue unchallenged as the international reserve currency. (Dunphy)

A reserve currency is a currency that is held in significant amounts by governments and financial institutions as a means to pay off international debt obligations or as part of their foreign exchange reserves.[11] Factors that make specific currencies desirable for reserve holdings include the country's share of world output and trade, macroeconomic and political stability, and deep and liquid financial markets. (Wu, F.; see also Hu, F.) In 2008, the IMF reported that the U.S. dollar comprised 64 percent of (allocated) exchange reserves.[12] The euro comprised roughly 24 percent, followed by the yen and pound, each with below 5 percent of the total. (See Chart 3) The U.S. Treasury estimated the dollar's share at 62.5 percent, with the euro at 27 percent.[13] What is remarkable is not only the proportion, but also how consistent these shares have remained since the euro was introduced in 1999. (Chart 4) There has been relatively no adjustment out of the U.S. dollar over the last decade. This suggests a fair amount of inertia in the composition choice of international reserves by central banks. Despite the relatively stable composition, the euro and the yen – and more recently the SDR and RMB – have been touted as potential challengers. Yet, neither currency has been able to increase their share in overall reserves.

In terms of overall size, the euro area, which includes the European countries who use the euro or coordinate their currencies with the euro, had a combined gross domestic product of $15 trillion dollars in 2008, or roughly equal in size to the United State. Indeed, the euro is the most actively traded currency after the dollar and, as noted above, comprises about 26 percent of international reserves. In 2006, the number of euro notes in circulation surpassed the number of

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account position, or in its basic balance, or in its overall balance-of-payments position, yields the qualitative conclusion that the renminbi is significantly undervalued." (Lardy, pg. 3)

[11] See: http://www.investopedia.com/terms/r/reservecurrency.asp

[12] Allocated exchange reserves make up about 75 percent of total international reserves. For an explanation of the accounting methods, see: http://www.imf.org/external/np/sta/cofer/eng/index.htm

[13] In fact, the Treasury estimates that demand for dollar reserves has outpaced euro reserve holdings, and that the shift in the relative weights from 1999 to 2008 reflects only the relative values of the currencies rather than a shift in preference. See: http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/Appendix%201.pdf

dollars in circulation, reflecting its growing role as a local transaction currency. (Carbaugh and Hendrick) Finally, the European Central Bank (ECB) is credible in its commitments to target inflation and maintain price stability.

Despite the positive attributes of the euro, several economists question the stability of the eurozone, noting the strict limits on debt ratios and fiscal deficits. Recent editorials have even questioned whether the euro can withstand the current economic crisis. The largest limitation to the euro, however, is the development of deep and liquid financial markets. Europe does have sophisticated and well-developed financial markets, however, the bond markets in Europe remain differentiated and fragmented.[14] This limits the types of assets foreign banks can hold as reserves, and therefore makes the euro a less optimal reserve currency compared with the dollar. Finally, the ECB itself is reluctant to share a greater role with the dollar. This Fall, the ECB reported that the global financial crisis has had little effect on the dollar's preeminence in international financial markets, and that the financial crisis had left the shares of major international currencies in financial markets "broadly unaffected." (Perry and Smith) It seems likely, then, that the euro will maintain its share of global reserves but will not challenge the dollar in the near-term.

Unlike the ECB, the Bank of Japan actively encouraged the international use of the yen during the 1980s and 1990s. Following the Asian financial crisis, Japan took a number of steps to promote the use of the yen within Asia – much as China's PBOC is suggesting today with the RMB. Unfortunately Japan's prolonged economic stagnation and underdeveloped yen money and capital markets have limited the internationalization of the yen.[15] Thus, its share of total reserves is unlikely to exceed its 1990s peak of 8-9 percent.

INDICATIONS OF THE RMB'S INTERNATIONALIZATION

Since Zhou's proposal to promote SDRs has not gained traction, another key strategy for managing the risks associated with China's dollar holdings is encouraging the RMB's internationalization. According to the IMF, international currencies play a role in foreign exchange trading, trade invoicing, and financial investments. They also function as an exchange rate anchor and as a reserve currency for governments. (Cohen, 2009) Moreover, international currencies should meet the three standard functions of money – medium of exchange, store of value, and unit of account.

Since the onset of the current financial crisis, Chinese officials have indicated a desire for the RMB to become an increasingly international currency, but expanding the international use of a currency is not synonymous with making a currency an international reserve currency. (Kroeber) Thus, internationalization is often an incremental process in which the currency takes on the following functions: settlement currency, vehicle currency for third-party trade or foreign

[14] Brendan Kelly writes, "By most accounts, the liquidity and sophistication of euro financial markets are also fast approaching those of U.S. dollar markets. However, euro bond markets remain segmented between its 16 member countries, with varying credit worthiness and thus pricing." (Kelly, pg. 12)

[15] According to Kelly, the key structural obstacles for the yen's adoption as a reserve currency are the inferior liquidity of the yen money market in relation to the U.S. dollar, primarily due to transaction taxes and the undersupply of government treasury bills. (Kelly, pg. 12)

exchange transactions, unit of account, and finally reserve currency. (Chinn, see also: Kelly, Brandon) While challenges to the RMB's use as a reserve currency remain, it is possible to evaluate indications of the RMB's process of internationalization.

RMB AS A SETTLEMENT CURRENCY

The primary indicator of the RMB's increasing use internationally is its role as a settlement currency for international trade, particularly in Asian regional trade. The Chinese government has adopted two policies to drive the international use of the RMB for trade: first, a pilot RMB settlement program; and second, a series of currency swap agreements with counterpart countries. Clearly, one purpose of these trade settlement programs is to limit the increase in U.S. dollars entering China through the trade account.

RMB Settlement Scheme

Over the past year, the Chinese government has developed a series of RMB trade settlement schemes between cities and firms in the mainland with trade partners in Hong Kong, Macau, and Southeast Asia. The PBOC has also signed agreements with neighboring countries including Vietnam, Myanmar, Russia, and Mongolia to allow settlement of the bilateral trade account in their domestic currency or RMB. (Xinhua, March 2009) On his recent visit to China, President Luiz Inácio Lula da Silva announced that Brazil and China had agreed to settle trade deals in their respective currencies.

In December 2008, China announced pilot programs to settle trade deals in RMB at the firm level between Guangdong province and the Yangtze River Delta and the two Special Administrative Regions of Hong Kong and Macau. In addition, a similar arrangement was outlined for exporters in Guangxi Zhuang Autonomous Region and Yunnan Province to settle trade in RMB with their ASEAN trade partners. (China Daily, November 2009) In his government work report in March 2009, Premier Wen Jiabao confirmed the trial operation of settling trade in RMB with Hong Kong and Macao. (China Daily, March 2009) Moreover, during the March 2009 meeting of the Chinese People's Political Consultative Conference (CPPCC), Vice Governor of the PBOC Su Ning reported that the PBOC would reduce "institutional obstacles for cross-border trade settlement in the yuan." (China Daily, March 2009)

Furthermore, in April, China announced another pilot program to settle cross border trade in RMB in five cities, including Shanghai, Guangzhou, Shenzhen, Zhuhai, and Dongguan. (See also: Wu, Friedrich) These settlement trails allow a small number of export firms – the number was limited to 400 in September 2009 – to settle with trade partners in yuan. (Batson, September 2009) What is not surprising is that these five cities represent China's exporting powerhouses and are the key drivers of much of China's economic growth. Also, Shanghai and Guangdong province are politically important regions for China's leadership.

The RMB settlement program will benefit export companies in China by reducing the exchange rate risk due to fluctuations in the value of the dollar, which is the currency used to quote prices for most imports and exports. Moreover, as many of China's imports from Southeast Asia, Hong

Kong, and Macau are intermediate goods, trade settlement in RMB will help to stabilize the production costs of final goods being processed or assembled on the mainland.

One precedent for China's trade settlement program comes from Japan's experience internationalizing the use of the yen. (Batson, September 2009) Andrew Batson notes that Japanese companies were successful in convincing trading partners to do business in the yen rather than the dollar, but that the use of yen in trade was limited. Indeed, the share of Japan's exports settled in yen has ranged from 35 to 40 percent for the past twenty years, whereas imports settled in yen account for only 20 to 25 percent of total imports. (Batson, September 2009) Japan's experience may prove instructive for China, and suggests that trade settlement in the RMB will only play a marginal role in the internationalization process. Still, some scholars assert that "increased use of the RMB as international settlement currency should make it easier for China to flexibilize its exchange rate management and thus reduce the need for large-scale domestic sterilization of excess liquidity in domestic banks. It should also facilitate accelerated opening of China's capital account and movement towards full convertibility of the RMB." (Bottelier, April 2009)

While the RMB trade settlement policy is an important first step in internationalizing the use of the RMB, it is not yet clear whether the policy has been successful. First, technical issues remain. In March, Zhou Xiaochuan stated that the PBOC would issue a policy statement for facilitating yuan settlement because there were still obstacles related to the transaction systems of banks and regulating policies. According to one report, there are two ways for commercial banks to provide yuan-based settlement services. A Chinese bank can either entrust a foreign bank to be its agent bank or deputize its overseas branch to offer RMB account-based services. (Lan, April 2009) In November, the Bank of China (Hong Kong) announced that it had signed the Agreements for Clearing and Settlement of Renminbi (RMB) Trade Settlement with commercial banks in Southeast Asia, including Bank of China Bangkok Branch, Bank of China Manila Branch, Bank of China Jakarta Branch, Bank of China Singapore Branch, and Bank of China (Malaysia) Berhad. (Xinhua, November 24, 2009) Therefore, in addition to providing a wide range of RMB services such as deposits, foreign exchanges, remittances, bonds, and trade finance for corporate clients, signatory banks will be able to participate in the RMB Interbank Money Market in Hong Kong and provide other RMB businesses as approved by the regulatory authorities. (Xinhua, November 24, 2009)

Unfortunately, it is still not clear how much RMB settlement is, in fact, occurring at this point. According to the PBOC, from July to mid-September, total trade value settled in RMB under the pilot scheme amounted to only 70 million yuan. (Ng) Since the RMB is not freely convertible on the capital account, settlement remains difficult. This is because foreign counterparties may not have access to RMB to pay for goods imported from China. Also, banks continue to convert payments into dollars, euros, or other convertible currencies. (Lan, May 2008) Finally, because the pilot program is voluntary, firms decide whether or not they want to participate. According to reports, many firms outside of China do not want to quote prices or receive payment in RMB because there is no forward market for the yuan, making it difficult for firms to hedge risk. (Economist, July 2009)

Though there is disagreement with this assessment, HSBC economist Qu Hongbin predicts that by 2012 over 40% of China's total trade could be settled in yuan. (Economist, July 2009) Despite complications in the program thus far, the direction is clear, and once the appropriate mechanisms are in place, there should be an increase in companies using this as a settlement option.

Currency Swap Agreements

In addition to the RMB trade settlement program, China has also announced currency swap agreements with countries as wide-ranging as Argentina, Belarus, Hong Kong, Indonesia, Malaysia, and South Korea. (McNally) Since December, the PBOC has signed a total of $95 billion dollars (650 billion yuan) worth of currency-swap agreements. (See Chart 5; Peaple; Hsiao) In addition to mitigating exchange-rate risks arising from trade settlement in the dollar, these currency swaps are intended to provide much-needed liquidity to foreign central banks. This is particularly important for the Hong Kong Monetary Authority, as the PBOC can adjust the liquidity ceiling to provide additional RMB liquidity when needed. (Ng) For the other countries, the currency swaps inject RMB into the financial system, and local firms importing Chinese goods can pay for them with yuan borrowed from domestic banks rather than dollars. Indeed, since the yuan is not freely convertible, there is little other use for it than for trade transactions. (Peaple)

The swaps with Korea, Malaysia, and Indonesia also reflect the growing influence of regional monetary policy coordination and the continuing development of the Chiang Mai Initiative (CMI). The CMI was established in 2000 to encourage bilateral swap agreements between the ten members of the Association of Southeast Asian nations plus China, Japan, and South Korea (or ASEAN+3).[16] In the wake of the Asian financial crisis, the CMI was viewed as a method to enhance self-help and support mechanisms in East Asia, as well as lay the groundwork for enhanced financial cooperation and reform of international financial institutions. (Henning, pg. 2) Indeed, at that time, Japan proposed the development of an Asian Monetary Fund (AMF) to rival the IMF and provide financial sector support in Asia during future crises. (Hyong-Kyu, pg. 457) The proposal did not succeed, but the CMI has continued to mature.[17] In 2005, the ASEAN+3 finance ministers launched the second stage of the CMI, doubling the nominal size of the swaps to $83 billion.[18] The following year, the ASEAN+3 countries began to work on multilateralization of the CMI, and have reached agreement on many of the key elements, including “the total size ($120 billion), the form of funding (self-managed reserve pooling), the legal modality (legally binding single contractual agreement), and the proportion of contribution

[16] In December 1997, the Association of Southeast Asian Nations (ASEAN) and three northeast Asian countries—Japan, China, and South Korea— established the ASEAN+3, a forum for coordinating cooperation among the participant countries, which they institutionalized in 1999. (See Hyong-kyu)

[17] For example, China first signed a $2 billion currency swap agreement with South Korea in June 2002; the two countries increased the swap amount to $4 billion when they extended the agreement in 2005. A new agreement, signed in December 2008, further increases the amount to $26 billion (180 billion yuan) and allows for direct exchanges between the yuan and Korean won. (Shi Yongming)

[18] According to Henning, eliminating double-counting and removing arrangements that have mostly symbolic value reduces the total swap amount to $50 billion to $60 billion. See: Henning, pg. 2.

between ASEAN and the three Northeast Asian countries (20:80)." (Hyoung-Kyu, pg. 452; see also Henning, pg. 4)

Despite being considered outside of the CMI framework,[19] the recent swap agreements illustrate the significant amplification of the bilateral coordination in the wake of the current financial crisis. Indeed, I will argue in the following sections that the lessons of the Asian financial crisis played a role in the current economic crisis, and strengthened bilateral financial ties between the ASEAN+3 countries. Also, as in the RMB trade settlement program, China's currency swaps aim to increase international circulation of the yuan in Asia. In developing the CMI and proposing the AMF, Japan sought to facilitate the internationalization of the yen by encouraging neighboring countries to use the yen for more transactions.[20] Clearly this is a policy goal of the Chinese government as well.

RMB AS A STORE OF VALUE

Since the yuan is not fully convertible on the capital account, the market for yuan-denominated assets is limited. To address this problem, the Chinese government has been actively promoting the yuan bond market in Hong Kong. Prior to this year, the sale of yuan-denominated bonds was limited to Chinese banks, along with multilateral banks, including the Asian Development Bank and International Finance Corporation. Also, bonds were only sold within China. (LeVine) In September 2009, China issued 6 billion yuan ($880 million) of sovereign bonds (often referred to as Panda Bonds). While state-owned banks had already sold nearly 22 billion yuan ($3.2 billion) of bonds in Hong Kong since 2007, HSBC and the Bank of East Asia became the first foreign banks to raise yuan in Hong Kong. (LeVine; Bloomberg)

In this sense, Hong Kong is poised to serve as a key financial intermediary for the RMB's expanded use abroad. Indeed, Hong Kong has benefited from the one country, two systems policy, which has allowed it to manage its financial system with few interventions by the Chinese government. Since 2004, reforms were instituted to begin the process of integrating the two financial systems. On February 25, 2004, the PBOC began to allow Hong Kong banks to open individual deposit, exchange, remittance, and bankcard services. This was followed by RMB business in Macau at the end of 2004. In January 2007, the central bank allowed mainland financial institutions to issue yuan-denominated financial bonds in Hong Kong. (Beijing Review, March 13, 2008) And, integration has intensified during the crisis: reports for 2008 indicate that

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[19] "Recently, East Asian central banks have announced several new swap agreements outside the ambit of the CMI. In December 2008 the three countries in Northeast Asia announced (a) an increase in the size of one of the Japan-Korea swaps from the equivalent of $3 billion to the equivalent of $20 billion and (b) the establishment of a new China-Korea swap equivalent to roughly $26 billion. In concluding these agreements, Japanese and Chinese officials appeared to be responding to the extension of a $30 billion swap agreement to Korea by the US Federal Reserve. China subsequently also extended two local-currency swap arrangements, one to Hong Kong equivalent to about $34 billion and the other to Malaysia equivalent to about $13.5 billion." (Henning, pgs. 2-3)

[20] According to Hyoung-kyu, Japan's BSA with China is denominated on Japan's side not in dollars but in yen, marking the first time the yen has been used as the key currency in such an agreement. (Hyoung-kyu Chey, pg 461)

yuan deposits in Hong Kong increased 86 percent to 56.1 billion yuan ($8.2 billion). (McMahon) According to the China Daily, Hong Kong will operate as a parallel yuan market rather than just serving as an overseas yuan settlement hub. To make this system work, there must be an adequate yuan-asset market in the city to provide "sufficient investment outlets for yuan holders on the one hand and financing channels for overseas importers on the other." (Ng) The first step for this is the expansion of yuan-denominated bonds; the next step may be to allow the trading of locally-listed shares in yuan.

The September bond issue of 6 billion yuan in government debt is relatively small compared to Beijing's overall outstanding government debt of 6.3 trillion yuan. It is also quite small relative to the United States Treasury market of nearly $7.5 trillion dollars (51 trillion yuan). (McNally) Nonetheless, the increased international use of the RMB as a transaction and international settlement currency will also promote it as a store of value, even before full convertibility on the capital account. (Bottelier, April 2009) Moreover, by creating an offshore market for yuan financial instruments that foreign central banks and investors can trust, the RMB will become more attractive for investors for financial diversification. Chinese government bonds issued overseas and perhaps bonds issued by Chinese state firms and banks with quasi-sovereign guarantees could provide the pricing benchmarks, liquidity, and security that an internationalized market for yuan needs to develop. (McNally)

In addition, the yuan bond market also mitigates the exchange rate risk of China's dollar-denominated reserves. In an article in the influential business magazine, Caijing, Yu Yongding, a public intellectual and economist with the Chinese Academy of Social Sciences, proposes the benefit of Panda bonds, namely reduction in U.S. dollar-denominated reserve assets through the sale of these assets to private banks. Using the example of the Asian Development Bank (ADB), he writes, "the ADB can issue 10-year Panda bonds in the Chinese interbank bond market, using proceeds to purchase U.S. dollars from China's central bank. In the end, ADB would receive a sum of liquid dollar funds and pressure on China's central bank due to mounting dollar reserves would be reduced." (Yu) In his view, Panda bonds are a critical tool for diversifying the PBOC's dollar holdings without driving down the value of the dollar on the foreign exchange market. It is not yet clear whether this is, in fact, what has happened after the September 2009 bond issuance.

While the expansion of yuan-denominated bonds may signal a move to liberalize the sale of additional financial assets and increase the yuan's international use, there are still considerable challenges in terms of overall capital market development. Despite liberalization of the current account in the mid-1990s, which makes the yuan convertible for trade transactions and conditionally for foreign direct investment (FDI), the yuan is not convertible for the majority of portfolio capital transactions.[21] Thus, China has lower equity and bond market capitalizations to GDP ratios relative to the issuing countries of the other major global currencies. According to Deutsche Bank Research, China's equity and bond market capitalizations only make up 5.9% and

[21] China achieved convertibility for the RMB under the current account in December 1996. However, the original policy goal of achieving capital account convertibility by 2000 has been quietly abandoned, in part due to the intellectual backlash against the idea of free capital mobility in the aftermath of the Asian Crisis in 1997-98. (See Fred Hu, Cato Journal)

2.4% of the world's equity and bond markets, respectively. (Wu, F.) Moreover, a web of regulatory barriers restricts access to China's capital markets. Business Week reports that in terms of inward portfolio investments to China, the average amount between 2003 and 2007 represented less than one percent of total portfolio investments globally. (Wu, F.)

The Chinese government has begun to experiment with greater liberalization, but these reforms are incremental and slow so as to not overburden a still fragile banking and financial system. One development was the introduction of Qualified Foreign Institutional Investor and Qualified Domestic Institutional Investor (QFII and QDII) programs to allow two-way cross-border portfolio investment flows. Additionally, there may be further reform next year: according to Guo Shuqing, former head of the State Administration of Foreign Exchange, the yuan will be made convertible by 2010 for about 70 percent of the 43 capital transaction items under the IMF classification. (Wu, F.) If the reduction in restrictions on capital transactions facilitates investment in yuan-denominated assets by foreign investors and central banks, then China will greatly enhance the internationalization prospects of the RMB.

RMB AS A UNIT OF ACCOUNT

A third indication of the RMB's international use is the extent to which the yuan serves as a unit of account. Often this is conceived of in terms of using a currency for commodity pricing. Indeed, in Zhou Xiaochuan's proposal, one of the main recommendations was to use the SDR rather than the dollar to price commodities. While pricing in SDRs is unlikely in the near future, pricing commodities in RMB or with a basket of currencies including the RMB could become more popular. Earlier this year, there were reports that oil producing countries in the Middle East were in secret talks with France, Russia, China, and Japan to replace the dollar in oil trading with a basket of currencies. (Davis and Curran; Roman) Although the talks turned out to be fabricated, the question of whether the dollar will remain the currency in which oil and other primary commodities are priced is extremely relevant given the dollar's recent volatility.

McKinnon's hypothesis, named for economist R.I. McKinnon, states that specialized manufactured products tend to be invoiced in the exporter's currency, while undifferentiated primary products tend to be invoiced in a major international currency. (Kelly, pg. 8) Therefore, given China's huge demand for primary commodities from oil to timber to precious metals, it stands to reason that China could begin to assert its leverage on pricing of these commodities. Indeed, by 2005, China had become the world's leading consumer of most major metals as well as agricultural products. (Kelly, pg. 9) Up to now, pricing commodities in RMB has not yet happened; however, this area presents an opportunity for China to advance the use of its currency for specific commodity trade transactions.

Another recent development has been the pricing of new sales contracts in RMB. COSCO Corp. (Singapore) Ltd., a Singapore-listed Chinese shipbuilding company, reported that it would quote sales contracts in RMB. This is the first time a large Chinese company has officially announced a policy of quoting in RMB rather than in dollars. The company's president Ji Haisheng stated that quoting in RMB would help to mitigate the risks of a volatile dollar. (Lan, May 2008) Beijing Review also reported that Yiwu Jindelai Plastics Packaging Co. Ltd. (YJPP) in Zhejiang

Province would quote export contracts in RMB as well. Again, it is too early to know whether this will become a trend, but it may signal growing confidence in the RMB.

RMB "REGIONALIZATION"

What is clear in analyzing China's policies to internationalize the RMB is that the primary focus in the short-term is encouraging the RMB in regional trade and financial transactions. This is supported by a recent statement by Xia Bin, the president of the Financial Research Institute of the Development Research Center of the State Council, who commented that "China is not pursuing the optimum target of complete internationalization of the RMB, but a suboptimal one: gradual regionalization of the currency." (Hsiao)

As with the Japanese yen, the RMB's promotion in Asia is quite logical. In terms of trade volume, ASEAN and northeast Asia are vital trading partners for China. According to the Asian Development Bank, of the top ten source countries for China's imports, six are located in Asia: Japan, Korea, Malaysia, Singapore, Thailand, and the Philippines. As well, of the top ten destination countries for China's exports, four are located in Asia: Hong Kong, Japan, Korea, and Signapore. (See Chart 7) Moreover, the yuan is expected to play a larger role in regional trade when the China-ASEAN Free Trade Area (CAFTA) becomes effective in January 2010. According to Xu Ningning, executive secretary general of the China-ASEAN Business Council, "CAFTA, which boasts the largest population among all the world's FTAs and allows zero tariff on 90 percent of products traded between China and ASEAN, will quicken the process of renminbi regionalization." (China Daily, November 23, 2009)

Zhang Yuyan, an academic at the Chinese Academy of Social Sciences, noted that "a favorable balance of trade with China is a prerequisite for surrounding nations to use the RMB as a reserve currency." (Hsiao, Russell) Due to China's rapid growth over the last decade, it has replaced the United States as the main export market for Asian countries. Data from China's General Administration of Customs showed trade between China and ASEAN has grown over the last decade to a high of $231.07 billion dollars in 2008. This year, ASEAN overtook Japan to become China's fourth largest importer.[22] For Malaysia and Indonesia, the expanded use of the RMB for trade settlement may significantly reduce the transaction costs for trade. Indeed, this would be important as China is Malaysia's fourth largest import and export partner, and Indonesia ranks China as their fourth largest export destination and their second largest import source. South Korea is another key trading partner with China. China is South Korea's largest trade partner and South Korea is China's sixth largest partner. Therefore, Chinese policy to expand the RMB's use as a trade settlement currency, as well as the bilateral swap agreement with South Korea, will "improve short-term liquidity conditions in their financial systems, promote bilateral trade and advance their economic development." (Shi Yongming).

Expanding the RMB's use in Asia also helps to mitigate the exchange rate risk of the U.S. dollar. Thailand's deputy minister recently stated that because the yuan was a very stable currency, expanding its use could help reduce risks faced by ASEAN countries in using the dollar in trade with China. (China Daily, November 23, 2009) As noted earlier, the dollar's value has been quite volatile as a result of the global financial crisis. There are challenges, however, to

[22] See: http://www.chinadaily.com.cn/bizchina/2009-12/08/content_9142125.htm

promoting greater use of yuan in ASEAN countries. For the most part, RMB settlement is mainly adopted in border trade, which accounted for only 10 percent of China-ASEAN bilateral trade. (China Daily, November 23, 2009) That said, if the RMB grows in acceptance within the region, and begins to circulate in a larger area, it will develop a network effect which will enhance its internationalization beyond the region. (Zhang, R., pg. 52)

In addition to challenges noted above, the greatest obstacle for RMB internationalization is the lack of convertibility on the capital account. In March, Wu Xiaoling, deputy director of the Financial and Economic Affairs Committee of the National People's Congress, conceded that "whether a currency could be internationalized depends on its convertibility and the country's national economic strength. So there is still a way to go for renminbi's internationalization." (Xinhua, March 2008) For China to move from trade settlement currency or regional currency to a truly international reserve currency, it will need to open its capital account to allow foreigners to invest freely in onshore yuan financial assets, as well as freely repatriate both earnings and capital. (See: Kroeber)

Yet, assuming that China does succeed in making the RMB fully convertible, achieving RMB internationalization presents certain dilemmas for the Chinese leadership. First, the loss of direct oversight and control over the financial system – particularly credit allocation decisions – will be difficult. Indeed, some argue that Chinese leaders prefer the ambiguity of the current financial system since it allows them to intervene with administrative commands when needed. (McNally) Second, the Chinese government is concerned about subjecting the still-fragile financial system to large capital flows both in and out of the country. The advantages, however, very well may outweigh these costs.

ASIAN FINANCIAL CRISIS AND CURRENT ECONOMIC CRISIS: LESSONS LEARNED?

In this section, I argue that the lessons from the Asian financial crisis have reemerged in the wake of the current economic crisis, and China is once again evaluating its macroeconomic reforms. Looking at both the Asian financial crisis and the current economic crisis, I have identified the following three basic "crisis lessons" China has learned: liberalizing the capital account is risky, financial regulation is critical, and stability is preferred over volatility (especially with regard to exchange rates). During the Asian financial crisis, the Washington Consensus – expanding the role of market forces, reducing the role of the state in the economy, promoting transparency through rule of law, and assuring free trade and free movement of capital – was the dominant paradigm. (See Hellmann, pg. 835) We may find, however, that new ideas, inconsistent with this paradigm, are developing out of the current economic crisis.

Capital Account Liberalization

One of the lessons of the Asian financial crisis was that rapid liberalization of the capital account could trigger excessive capital flows both into and out of a country. In this view, developing Asia suffered as a result of IMF policies to liberalize capital accounts before critical banking and financial sector reforms were completed. Clearly, in retrospect, many economists have argued that the policies of the IMF and World Bank were incorrect or at least inopportune. Joseph

Stiglitz writes that "it has become increasingly clear that financial and capital market liberalization – done hurriedly, without first putting into place an effective regulatory framework – was at the core of the [Asian financial crisis]." (Stiglitz) Moreover, Chinese officials have drawn a similar lesson from the current crisis: speculative capital flows are destabilizing. In the case of the United States and Europe, risky financial investments (and poorly understood financial products) played a significant role in undermining global financial markets. Therefore, in my view, China will remain quite cautious with regard to capital account liberalization in the near term. Yet, just as following the Asian financial crisis, the Chinese government will push through much needed reforms, albeit on an incremental level.

Following the Asian financial crisis, China initiated extensive reforms of its own banking system. This was largely because the Asian experience demonstrated that, "…financial system reform is the most sensitive and difficult part of the whole process of system change; if mistakes are made in this area, with its deep roots in the everyday lives of the whole population, they threaten the whole socio-political fabric." (Nolan, pg. 49) According to Nick Lardy, the Chinese government undertook the following reforms: large-scale public recapitalization of the state-owned commercial banks; implementation of tougher asset classification and provisioning guidelines; creation of the China Bank Regulatory Commission; reductions in the number of bank branches and bank employees; stock exchange listing of four state-owned commercial banks; and, sale of bank shares to strategic foreign partners. (Lardy, pg. 12) Yet, the government maintained tight controls over financial flows in the capital account, despite liberalizing the current account in 1996. These controls promote inward foreign direct investment and discourage other forms of inflows, especially portfolio debt. (Prasad, pg. 86) Capital controls also shield the domestic banking system from competition by restricting the entry of foreign banks and by making it difficult to repatriate capital. Eswar Prasad asserts that "China's approach to exchange rate policy and capital account liberalization may indicate a desire to maintain stability on the domestic and external front, and the large stock of foreign exchange reserves resulting from these policies may insure against vulnerabilities arising from a weak banking system." (Prasad, pg. 86)

Whether the PBOC and State Council feel that China's banking and financial systems are strong (or healthy) enough to survive capital account liberalization is not clear. Even scholars disagree, with some arguing that "opening the capital account to inflows and outflows could also be an important catalyst to developing the domestic financial sector," (See Prasad, pg. 89) while others claim that the appropriate sequencing is to start with banking reform and finally liberalize the capital account. (See Lardy, pg. 15) Either way, the current financial crisis will likely delay the process of liberalization as banks focus on stimulating economic growth through investment activity. Still, the push to internationalize (or regionalize) the RMB may be the first step in a longer-term process of liberalization. Indeed, prior to the financial crisis, the Chinese government did not appear to have a policy on the convertibility of the RMB, and yet now it must consider that prospect much more seriously.[23]

Financial Regulation

[23] See Bottelier

A second "crisis lesson" is the need for more effective financial regulation, particularly in developed markets. Chinese officials have called for greater regulation and discipline in the United States and Europe. A number of prominent Chinese officials and public intellectuals have also suggested that the cause of the current financial crisis was not a savings glut as proposed by Federal Reserve Chairman Bernanke but rather fiscal irresponsibility and ineffective regulatory oversight in the United States. Indeed, China's official media has framed the current financial crisis as "…the result of developed countries' lax financial regulation, excessive consumption and their lasting monopoly on the international financial system." (Xinhua) Moreover, at the joint IMF-World Bank meetings this year, Yi Gang, director of the State Administration for Foreign Exchange, criticized the failure of international financial institutions when he proclaimed that "the failure of major international financial institutions to issue timely early warnings highlights the consequences of its misfocused (sic) surveillance. Only through the acceleration of fundamental reforms will the major international financial institutions be able to discharge the mandate assigned to it by its member countries."(Yi)

Thus, in the wake of the financial crisis, Chinese officials have proposed needed reforms to the international financial architecture. One key element is for China to play a larger role. In fact, during the Chinese People's Political Consultative Conference (CPPCC) in March, a Hong Kong delegate asserted that China "must play an active role in the reconstruction of the international financial order." (China Daily, March 2009) Yi Gang also remarked to the IMF-World Bank meeting that, "the persistently misaligned quota shares and underrepresentation of emerging market and developing countries hamper Fund governance and even-handed surveillance. It undermines Fund legitimacy and effectiveness." Throughout the crisis, China's official statements have focused on the need to include China – and emerging markets – more fully in the international financial system. As well, its support for the G20 forum over smaller gatherings (G8 or G2) has opened the discussion of global finance and oversight to a much broader group of countries. China's official media reported that "as emerging markets have substantially increased their weight in the global economy, especially after the subprime crisis exploded, the G7 cannot effectively address international economic issues, and its replacement by the G20 conforms with the tide of history." (Love)

Beyond indicating a desire to have a larger voice in the international financial system, China has also questioned the appropriate role of government intervention in the market. In my opinion, a key lesson China has drawn from the crisis is a reinforcement of the critical role government should play in the market. This is a challenge to the neoclassical economic orthodoxy of Adam Smith's invisible hand and the primacy of markets. The Chinese response to the current crisis reflects its view that government should play a more important role in supervising, regulating, and even directing the market. Indeed, its rapid recovery in the wake of the crisis as other countries lag behind may lend some support to China's view.

Stability

The final "crisis lesson" is the value of stability, particularly with respect to exchange rates. In the literature on the Asian financial crisis, China is lauded for maintaining its tight peg with the dollar and not devaluing the RMB. The stability of the yuan is credited for helping with Asian

recovery. In the current financial crisis, China has kept the yuan stable against the dollar by re-pegging the RMB in July 2008.

Stability is also related to capital account liberalization. The Chinese government is justified in worrying that liberalization of the capital account may cause instability in the banking and financial system. As Joseph Stiglitz writes, "capital market liberalization is systemically associated with greater instability, and for good reason: capital flows are markedly pro-cyclical, exacerbating economic fluctuations, when they do not actually cause them." Stiglitz also argues that there is increasing volatility following liberalization, particularly with short-term capital flows, and therefore, an appropriate regulatory framework is a necessary precondition.

Moreover, there is mounting evidence that capital account liberalization heightens the risk of currency crisis – one reason why Asian central banks have been so active in amassing foreign exchange reserves following the Asian financial crisis. Barry Eichengreen suggests a variety of policy responses for central banks to operate in the 'messy middle,' or between complete convertibility and strict capital controls. Eichengreen also advocates liberalizing financial markets prior to opening the capital account. He notes that "liberalization of the capital account thus should not precede recapitalization of the banking sector, significant strengthening of prudential supervision and regulation, and the removal of blanket guarantees." (Eichengreen) This is clearly the strategy that the Chinese have adopted.

A final thought on stability: China's policy to maintain an undervalued currency and promote the export sector also relates to concerns about social stability. Job creation is critical to the Chinese Communist Party, and the export sector has served as a key driver of employment growth, particularly for unskilled workers who migrate from central and western China to work in labor-intensive industries in coastal areas. According to one scholar, "…the Chinese leadership sees maintaining employment – particularly in the urban centers along the coast, where much of the development of the foreign invested manufacturing sector has occurred – as a 'prerequisite for maintaining social stability, and perhaps even its grip on power.'" (Kaplan, pg. 1192) Should the export sector lose its competitive advantage, its employment generation capacity will also be jeopardized. Without alternatives in place in the service sector or other industries, China's government may face a crisis of legitimacy – as its legitimacy in the post-reform era has hinged on steady economic growth. Indeed, the relationship of political instability with financial crisis is long-standing: Marx noted that "since the commencement of the eighteenth century there has been no serious revolution in Europe which has not been preceded by a commercial and financial crisis." (Nolan, 2005, pg. 8)

CHINA'S STRATEGY: REGIONAL INCREMENTAL INTERNATIONALIZATION (RII)

These three "crisis lessons" have contributed to what I argue is China's strategy of regional incremental internationalization (RII). The Chinese government's policy to gradually promote the international use of the yuan should come as no surprise to anyone who has studied China's reform path. From the outset of economic reforms in 1978, Deng Xiaoping and his successors

have followed a careful path of "groping for stones to cross the river."[24] Before each reform is initiated on a national level, experimental pilot programs are developed. Just as with the RMB internationalization scheme, pilot reforms are most often initiated in Shanghai and Guangdong province. Pilot programs are important as they enable the government to modify policies on a small scale if problems arise, and flexibly adjust the pilot rather than the full-scale program. As Harry Harding noted, "potential reform programs are adopted and implemented in selected sectors, regions, or enterprises in order to judge their effectiveness and feasibility. Those that succeed can then be adopted on a wider basis, while those that fail can be abandoned or modified, without inflicting much damage on the overall reform effort." (Harding, pg. 87) Deng Xiaoping, himself, argued that China was engaged in an experiment of reform. He said, "for us, it [reform] is something new, and we have to grope around to find our way…Our method is to sum up experience from time to time and correct mistakes whenever they are discovered, so that small errors will not grow into big ones." (Harding, pg. 87)

Thus, in economic reform, the principle has been consistent experimentation before widespread adoption of a particular policy. (Nolan, 2004, pg. 3) This approach is evident in the RII of the RMB as well. Each step – from currency swap agreements with trade partners to the expansion of yuan-denominated assets –begins to ease the CCP's macroeconomic control, but only within strict parameters. Of course, expanding the RMB's use abroad and making it a more viable international currency will result in pressure to revalue the yuan's exchange rate and loosen the remaining capital controls. For now, though, the Chinese government remains cautious. In March, Yi Gang told the official Chinese media that while it was possible that the global financial crisis would facilitate the process of making the yuan internationally accepted, there was no need to *push* for that (emphasis added). Therefore, it is likely that China will continue to grope for stones to cross the river, encouraging reform of the international system – and the RMB's role in it – on an incremental basis.

IMPLICATIONS AND CONCLUSIONS

China's approach – regional incremental internationalization –reflects the Chinese government's continued hesitancy for widespread and rapid reforms. Indeed, the lessons from past economic crises warn against pushing the RMB too far, too fast. Therefore, I do not anticipate either a major shift in China's RMB exchange rate policy in the near-term, nor complete liberalization of the capital account in the next few years. Instead, I believe that Chinese officials will muddle through, or grope for stones to cross the river, managing China's economic recovery before considering any changes to the present exchange rate policy.

Over time, China's approach to RMB internationalization should allow for incremental substitution away from dollar-denominated reserve assets, thus digging China out of its "dollar trap." As Yu Yongding suggested, the sale of panda bonds to foreign financial institutions could help the PBOC decrease its dollar reserves. Also, expanding the RMB regionally through currency swaps and trade settlement programs will enhance its acceptance in Asia and create network effects. If successful, it will also reduce somewhat the increase in U.S. dollars accruing on the trade account. The pilot programs described in section III will also reduce transaction

[24]The Chinese idiom is the following: 摸着石头过河

costs related to trade and finance in Asia, which is a win-win for China and its regional trading partners. Finally, the RII approach will improve the banking sector's performance by allowing banks to profit from increased transactions and intermediary business as well as the creation of RMB derivatives without intense competition from foreign competitors. In other words, China can promote banking and financial sector reform – to develop deep and liquid RMB markets – before fully opening the capital account and allowing foreign competition in the domestic market.

China's policy of incremental regionalization also reduces global exchange rate risk because it will not test the international system while it is still emerging from the crisis. Were China to liberalize its capital account and aggressively push for RMB internationalization, global markets would respond in unpredictable ways. Beyond the impact this would have on the dollar, speculative flows of hot money into China, as well as the political and economic effects of a large RMB appreciation, would likely prove destabilizing for the PBOC and Chinese government. On the downside, the incremental nature of China's policy means that it will take considerable time before real progress is achieved. This lag between slight regionalization and true internationalization of the RMB (and corresponding exchange rate appreciation) exposes China to the risks of a potential dollar collapse. It also heightens inflationary pressures – particularly in foodstuffs and oil – as China's monetary policy relies on blunt administrative measures rather than more sophisticated tools such as interest rate adjustments. Incremental reform of China's exchange rate system will also seriously limit global rebalancing efforts.

Conclusions

Since Zhou Xiaochuan first proposed an overhaul of the international economic system and replacement of the dollar as the de facto international reserve currency, the majority of commentators have focused on whether the yuan could, in fact, challenge the dollar. In my view, this is premature. First, the consistency in the composition of international reserves over the last decade suggests extraordinary inertia, as well as considerable network and liquidity advantages for the U.S. dollar. Second, the experience of the euro and yen demonstrate the critical importance of deep and liquid financial markets. At this point, China has a long way to go before its financial markets are considered deep and liquid. Finally, China has not liberalized its capital markets, thus restricting the convertibility of the yuan. Therefore, I believe that while the ascent of the RMB will occur over time, it will be a very long time before the RMB truly rivals the dollar.

In my opinion, what should be the focus of attention is the willingness – indeed eagerness – of China's leaders to share responsibility for the international financial system. If China wants to become a key player in international finance, then the United States should welcome its expanded role. In fact, just as joining the World Trade Organization exposed China's trade policies to international appraisal, so too would China's expanded role in the IMF and other financial institutions expose its monetary policies to international review. In the end, RMB internationalization and China's stepping out in international finance are good for the U.S. dollar and the American economy. They should, therefore, be encouraged by U.S. policymakers.

Chart 1: Volatility of U.S. Dollar during Financial Crisis (2008-2009)

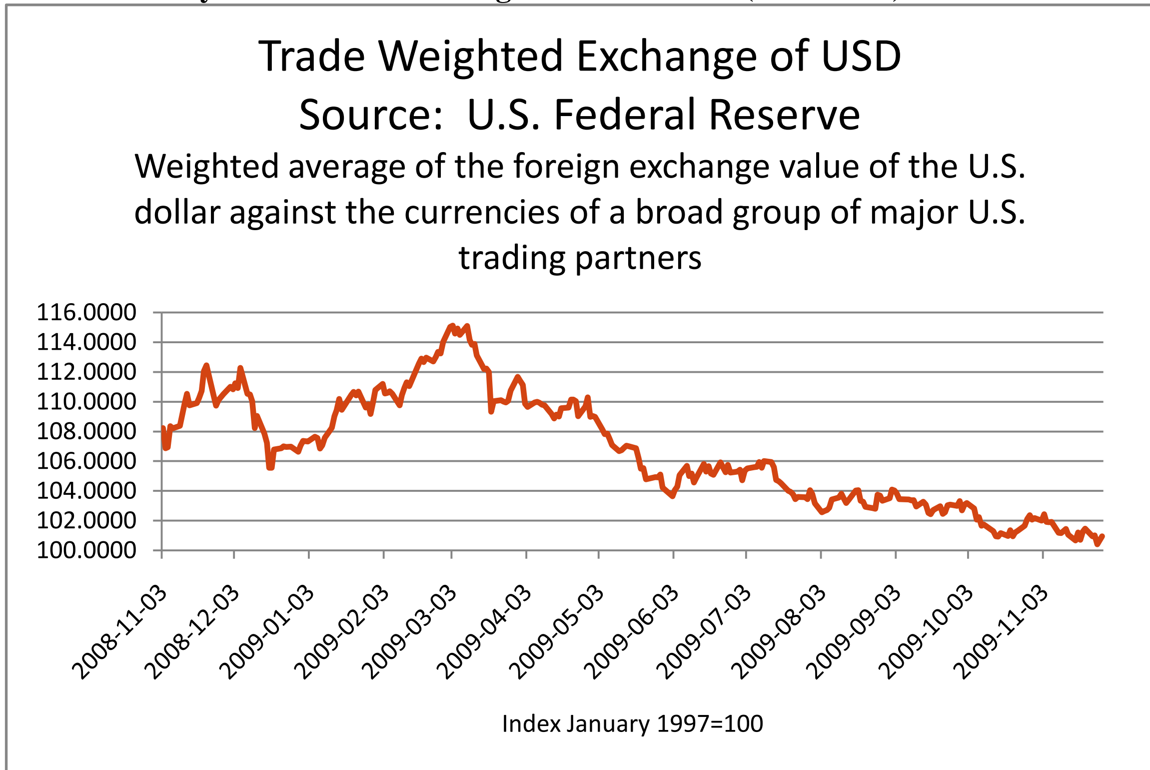


Chart 2: Nominal Effective Exchange Rate for RMB (2008-2009)

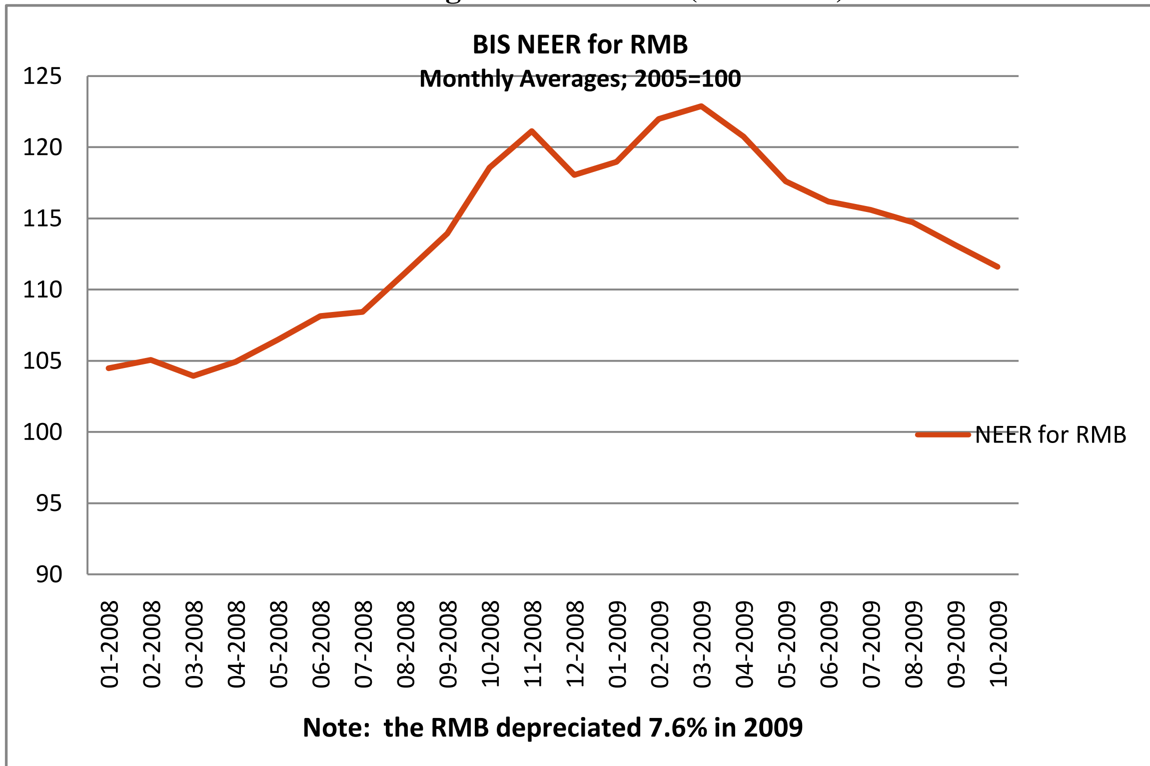


Chart 3: Composition of International Reserves by Currency (2008)

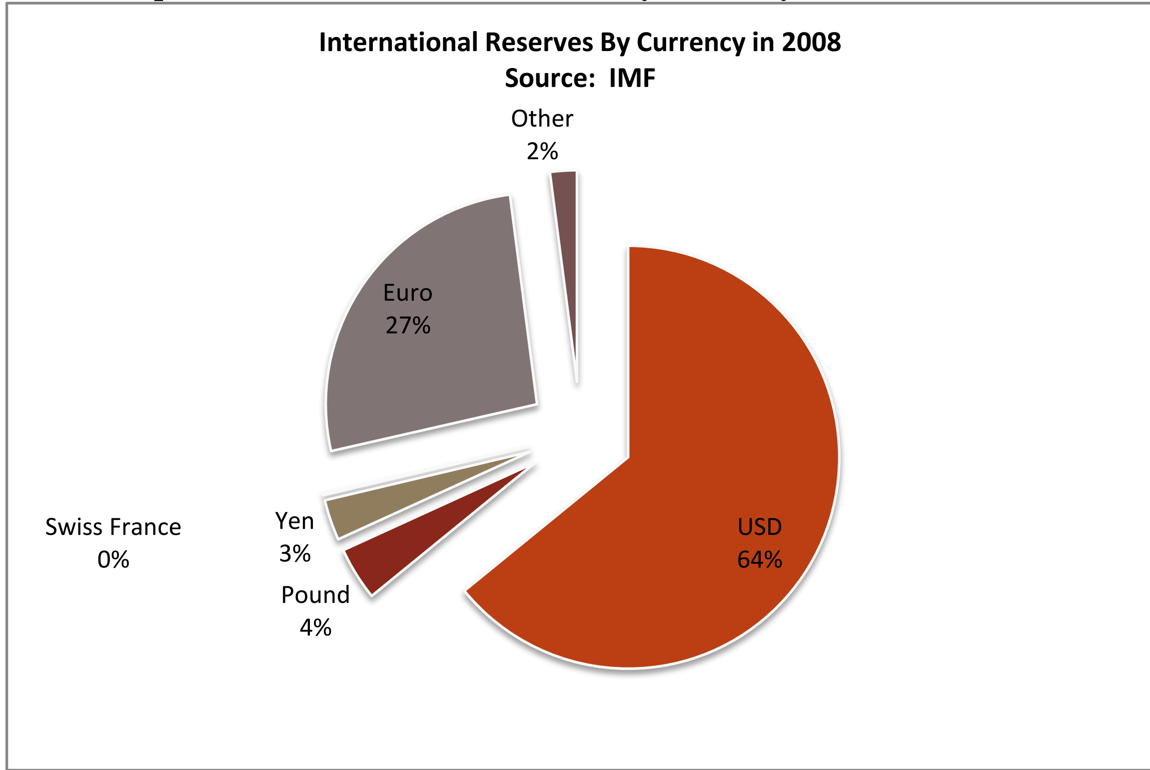


Chart 4: Stability of International Reserve Composition

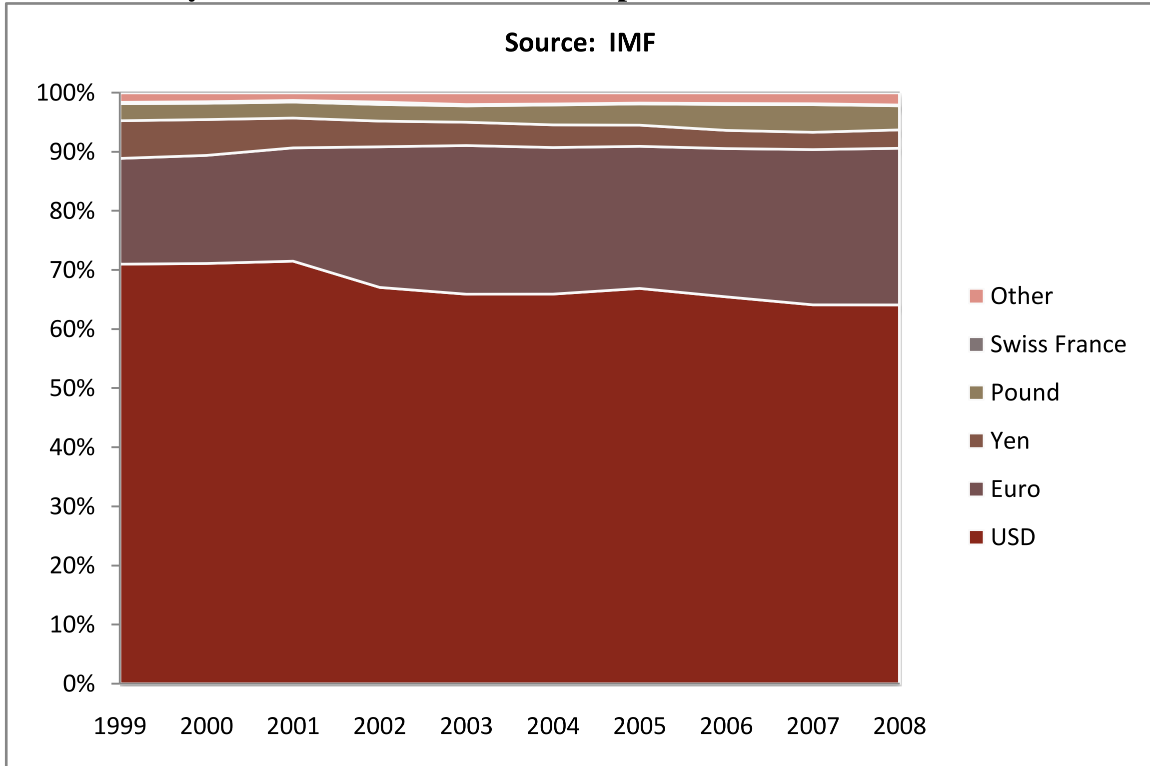


Chart 5: Currency Swap Agreements

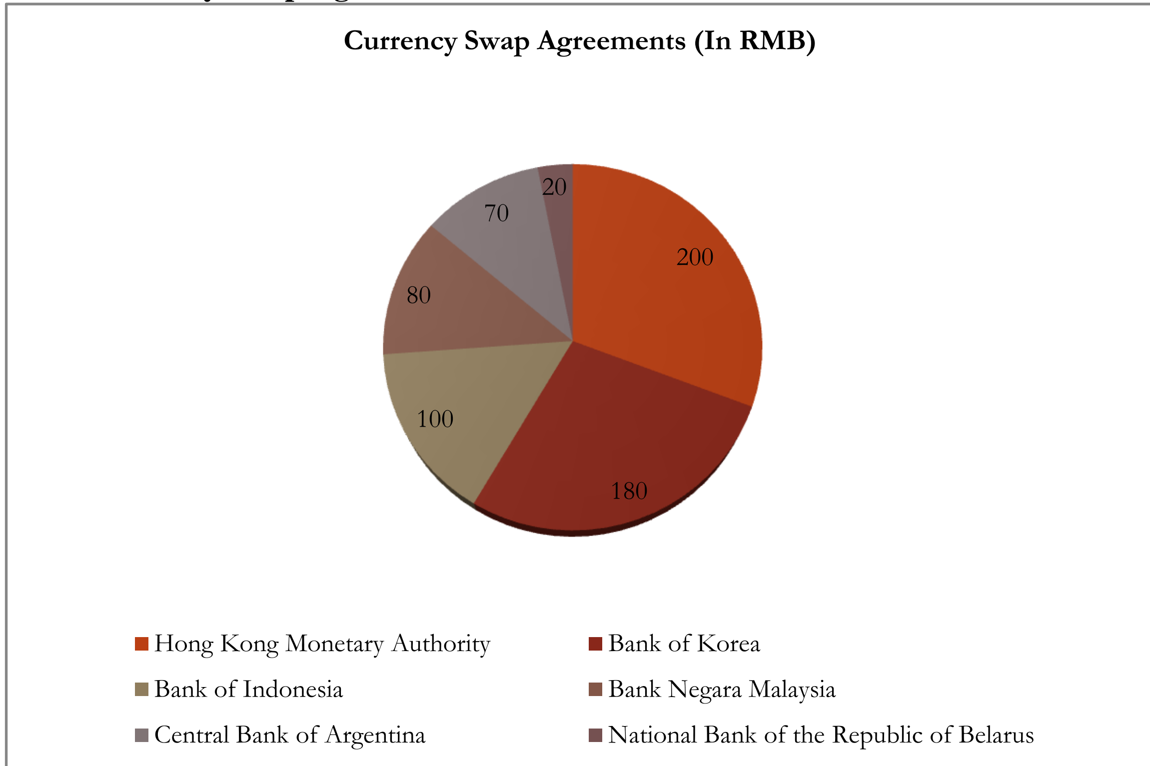


Chart 6: Growth of China's Foreign Exchange Reserves in 2009
It is estimated that roughly two-thirds of China's reserves are held in U.S. dollar-denominated assets

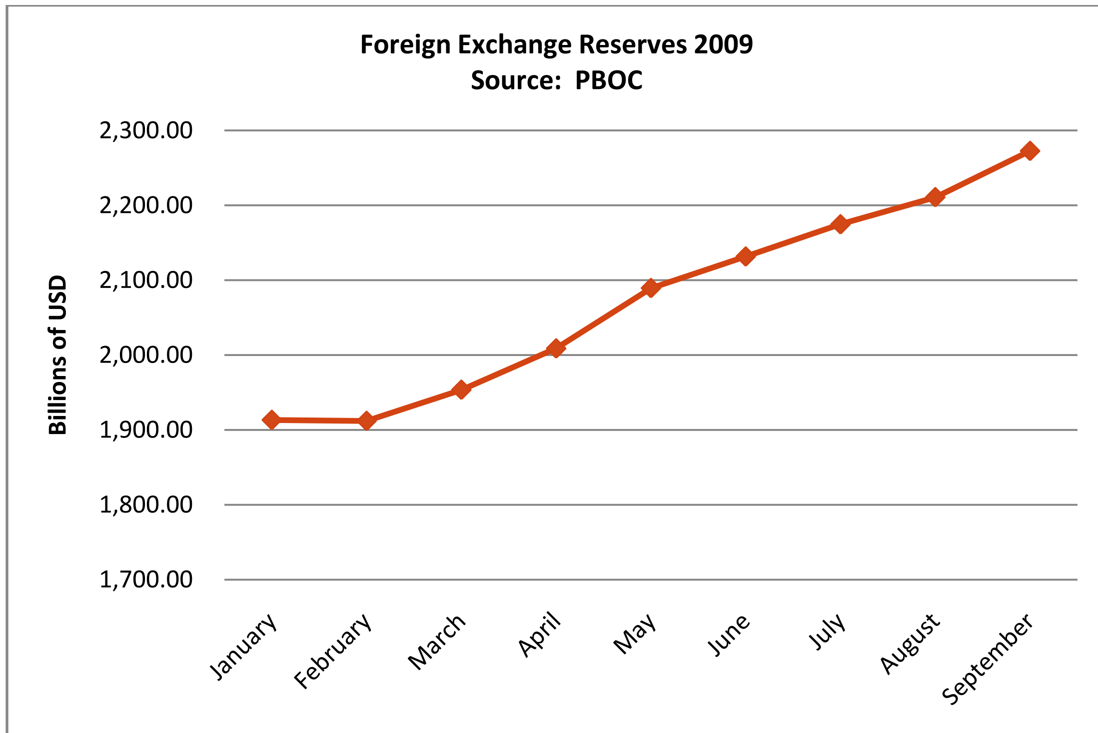
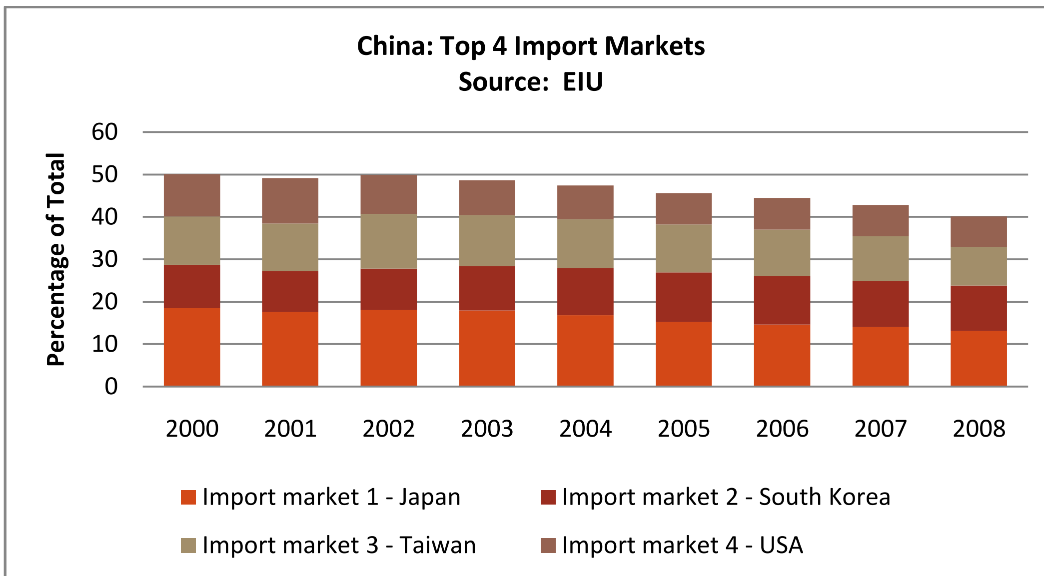


Chart 7: China's Top Import and Export Partners



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