

Viability of an Alternative Monetary System: The Growing Influence of the Renminbi

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Roadmap to presentation

1. Contradictions with current International Monetary System
 2. Signals of Paradigm Shift In the IMS?
 3. Is it worth for the RMB to become an international currency?
 4. Which steps are being taken to that end?
 5. Conflicts of interest: US
 6. Conflicts of interest: China
 7. Medium-Term Consequences of a multipollar IMS
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1. Contradiction with the Existing International Monetary System (IMS)

- The US has gone from being a net lender since WWII to becoming a net borrower whereas China has turned into a creditor country with strong growth, low debt in proportion to GDP and large current account surpluses.
 - With the onslaught of the 2008 global financial crisis, world attention is heavily focused on China's massive stock pile of US dollars in foreign exchange reserves.
 - The Chinese government is understandably very concerned about the safety of its investments in the United States, but has continued to accumulate US dollars, as the Euro is perceived as even less stable than the US dollar in as far as it seems the crisis has not yet fully unfolded and some countries are specially affected (at some point even fears of some countries existing the euro)
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1. Contradiction with the Existing IMS (II)

- To offset this vulnerability, policy makers in Beijing are pushing for a greater role in the international financial architecture
- China's position can be taken as a warning signal to the United States rather than as any sort of immediate threat or demand for global monetary policy reform as the US can veto.
- In the short run, the existing monetary structure is unlikely to change, but cracks in the system are more visible and it is only a matter of time before the US dollar's influence as the dominant foreign exchange reserve is offset by re-emerging China.

2. Signals of Paradigm Shift In the IMS?

- The British Pound was the main reserve currency until replaced by the US dollar when the British Empire declined.
- Early signals in the 21st century suggest that the US dollar is losing ground but it is hard to know whether such process will accelerate
- The introduction of the euro as currency of the largest economic region in the world did not threaten the hegemony of the dollar although it offered an alternative international currency over and above what the DMark had offered
- The yen has lost ground as a consequence of Japan's lost decade and China's emergence.
- The RMB has not yet been any threat to any other international currency (notwithstanding China's already large size in the global economy) for a very simple reason: it is not a convertible currency!
- Things are starting to change but only slowly.
- The RMB will start to find its place in the international monetary system in a peculiar way given its non full convertibility basically driven by official support in an experimental way

Evolution of the international monetary system

Period	Monetary System	Key Challenges	Assessment	Causes for Transition to the Next Period
1999-2008	No-System (Bretton Woods II)	Global Imbalances	Some emerging economies (particularly China) peg their exchange rates to the USD. Expansionary domestic policies in the U.S. (or savings glut in Asia) provoke large current account deficits in the U.S.	Protectionism? Financial shock? Asian Monetary Union? Euro as International Money?
1985-1998	No-System (Currency Crises)	Crises in Emerging Economies	Emerging economies in Latin America and East Asia suffer currency crises due to the combination of fixed exchange rates and expansionary domestic policies and/or Original Sin (debt denominated in USD)	Emerging countries switch to floating regimes or begin to cumulate dollar reserves as a buffer against future shocks
1973-1984	No-System (Floating-rate Dollar Standard)	Inflation	Unsuccessful attempts to combine independent domestic policies (monetary and fiscal) with a managed float of the exchange rate.	De-facto decoupling of interest rates between the Euro zone and Europe (free floating).
1950-1970	Bretton Woods	Price Stability	Fixed peg to the dollar (nominally pegged to the price of gold) that provided price stability. Monetary policy could be independent as long as capital controls existed	Excessive profligacy by the U.S. to support their military and social programs conflicted with anti-inflationary efforts by periphery countries.
1918-1939	Interwar Instability	Price Stability	Early attempts to reinstitute the Gold Standard that failed with the Great Depression and that resulted in Beggar-thy-Neighbour policies.	Conflict between expansionary policies against the depression and deflationary policies to keep parity
1880-1939	Gold Standard	Price Stability	Fixed peg to the price of gold. This provided price stability but not independent monetary policy	World War I. The expansion of the democratic franchise, which made it more difficult for governments to resort to deflationary policies to keep exchange rate parity

Source: BBVA Research Department: 2008

3. Is it worth for the RMB to become an international currency?

- In order to know whether a currency's internationalization brings benefit to a country, it is important to assess benefits versus costs
 - Very different views across countries (i.e., Germany vs US).
- The benefits are"
 1. Seniorage
 2. Benefit of last resort at international level
 3. Savings for private sector when operating abroad
 4. Larger financial power (international financial centers, etc)
- The costs are:
 1. The potential lack of control of the money supply
 2. Domestic policies being influenced by foreign needs
 3. Furthermore, in the transition (while opening up the capital account), a wealth of risks are taken

4. Which steps are being taken to that end?

- China is moving in several directions to support an international role of the RMB
- Most of the measures are only a declaration of interest than an actual change
- The few that imply action are very much constrained by the lack of convertibility of the RMB and the understandable fear by Chinese authorities to move fast in the liberalization of the RMB
- ***It is important to note that other governments have tried to impose their currencies as international vehicles and they have not always been successful***

4. Which steps are being taken to that end?

Among the three major functions of an international currency, the RMB is moving in the private sphere first

<u>Currency functions</u>	<u>Public Actors</u>	<u>Private Actors</u>
<u>Reserve of value</u>	International Reserves	Asset portfolios (currency substitution)
<u>Means of payment interventions</u>	Vehicle currency for Forex intervention	Currency of settlement in commercial and financial transactions
<u>Unit of account</u>	Anchor currency for exchange rate pegging	Unit of account in organized markets

Source: P.Kenen (1983)

4. Which steps are being taken to that end?

a. Embryonic official use

- Participation of RMB in SDR
- Currency swaps with 6 countries
 - All Asian except Argentina and Ukraine
 - These swaps had a crisis prevention objective but, actually, they could only have been used for trade settlement
 - Not used so far

4. Which steps are being taken to that end?

b. The RMB for asset portfolios: RMB bond issuance in HK

- Since 2007, a few mainland Chinese banks were permitted to sell renminbi-denominated bonds in Hong Kong, totalling 22 billion yuan.
 - ICBC, CDB, etc
- More recently, foreign banks incorporated in Mainland China can issue RMB bonds in Hong Kong
 - HSBC (China) and Bank of East Asia (China) have already issued 2 billion and 4 billion RMB respectively.

4. Which steps are being taken to that end?

b. The RMB for asset portfolios: RMB bond issuance in HK (II)

- The total RMB bond issuance in HK amounted to RMB 35 billion, which is trivial compared to RMB 4 trillion bonds that the banks have issued onshore as of 2008, but it still marks a brand new promising market.
- The expectation of a large RMB appreciation has increased the demand for these products enormously
 - Reduction of pressures for capital inflows

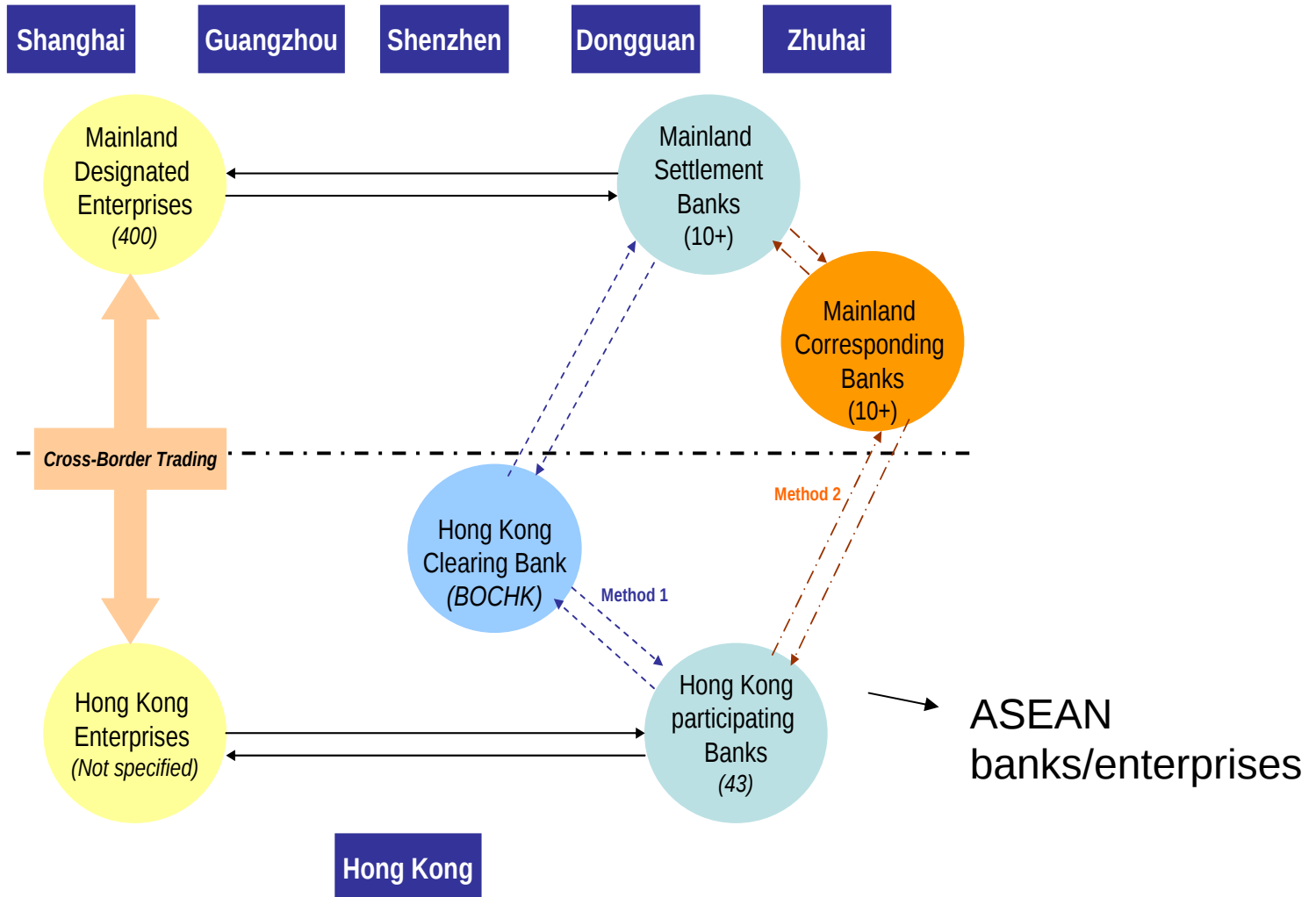
4. Which steps are being taken to that end?

c. Currency of settlement: focused on trade

- On July 6 2009, the pilot scheme for cross-border trade settlement in Renminbi was jointly launched by the Mainland China and Hong Kong authorities.
- 400 Mainland designated enterprises in Shanghai and Guangdong, will be able to use RMB as the transaction currency when trading with designated non-Mainland enterprises in Hong Kong

4. Which steps are being taken to that end?

c: RMB trade settlements



4. Which steps are being taken to that end?

c. Where to obtain the RMB liquidity for RMB settlements

- Currently, apart from obtaining RMB from customers' deposits, Hong Kong participating banks can also obtain RMB either through:
- Interbank transactions using available RMB liquidity in HK
- Through access to the RMB market on the mainland, subject to certain limits
- Currency conversion through the clearing bank in HK

4. Which steps are being taken to that end?

c. Main changes in terms of RMB settlements in HK

- Now firms which are non HK residents can hold accounts in RMB
- Any trade-related transaction can be conducted in RMB in HK (and in ASEAN countries linked to HK banks)

5. Conflicts of Interest -USA

- The steps that China is taking are really minor but the declarations by Chinese authorities show the way.
 - Currencies are very much influenced by expectations
 - Pushing for the fall of the dolar makes no sense if there is no currency that can substitute it!!
- The US will resist the fall of the US as international currency as this would:
 - Substantially reduce the ability of the US to inexpensively finance its budget and trade deficits
 - Make borrowing more expensive for the US
 - Permit changes in commodity prices to affect the cost of imports to the US

6. Conflicts of Interest - China

- If China really wants to transform words into facts it needs to take more actions:
 - Remove restrictions on money entering and leaving its borders
 - Make the currency fully convertible for trade transactions
 - Make its bonds market more liquid and transparent
 - Overcome the political barrier in collaborating with Japan
- All these things cannot be done soon
 - Not only not feasible, also risky

7. Medium-Term Consequences of a multipollar IMS

- It seems clear that the RMB cannot substitute the dollar as an international currency any time soon.
- However, there is a need to find a complement to the dollar
- This is more likely to happen at a regional level given that the economic forces are also regional (multilateralization is close to death after with Doha's failure and this crisis has only accelerated this trend)
- Although very much limited by non convertibility, China is finding ways to support the RMB as potential regional currency at least as a laboratory level.
- If China were to support this trend further with all its consequences (full convertibility of the capital account), it may want to use it as a soft power tool
- It is unlikely that China follows Germany in terms of huge subsidization of neighboring economies but it can take some cheaper moves with still large upside in terms of soft power
 - Generalization of currency swaps
 - Financing packages for Asian economies in crisis accompanying the IMF