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China's Push for a New Global Monetary Order

by Ulrich Volz

In recent months, Chinese authorities have repeatedly called for a new global monetary order that depends less on the U.S. dollar. In March, for instance, Chinese Premier Wen Jiabao expressed concern about the value of China's large holdings of U.S. assets and demanded that the U.S. government take measures to guarantee its "good credit."

Also in March, just before the London G-20 Summit, the People's Bank of China (PBOC), published a paper by Zhou Xiaochuan, the PBOC governor, on its Web site in which he asked for a new "super-sovereign" international reserve currency "that is disconnected from individual nations" to secure global financial stability and facilitate world economic growth. He proposed that a more prominent role should be given to Special Drawing Rights (SDRs), a basket of currencies used by the International Monetary Fund (IMF) as a unit of account, suggesting that SDRs could replace the dollar as main reserve currency in the medium term.

AFP Photo / Raul Arboleda
Chinese Central Bank Gov. Zhou Xiaochuan speaks during a conference in Medellin, Colombia, March 28.

More recently, in its Financial Stability Report for 2009, published in June, the PBOC reiterated Gov. Zhou's position. Emphasizing that it sees serious defects in a global monetary system dominated by one currency, the PBOC writes that "to avoid the shortcomings of sovereign credit currencies acting as reserve currencies, we need to create an … international reserve currency that can maintain the long-term stability of its value."

With the U.S. financial sector in shambles, and the U.S. government taking on unprecedented amounts of debt to revive the economy, it is quite understandable that the Chinese worry about the stability of the dollar. China is today facing a dilemma that is nicely described by the words of John Paul Getty: “If you owe the bank $100, that’s your problem. If you owe the bank $100 million, that’s the bank’s problem.” The only difference here is that the U.S. government owes much more to China than $100 million. About 65%-70% of the $2.3 trillion that the Chinese authorities hold are invested in U.S. assets. This totals about $1.5 trillion in U.S. assets, of which at least half is invested in Treasury bonds, and another $500 billion in U.S. government agency bonds. This makes China by far the largest creditor of the U.S. Official U.S. data suggest that in 2008 alone, China lent around $400 billion to the U.S.

The Chinese authorities find it hard to explain to its domestic public why a relatively poor developing country is lending so much to one of the world’s most affluent economies. Yet the reason is pretty straightforward. The decision to peg the yuan to the dollar in 1994 initially helped achieve macroeconomic stability, but with a growing trade surplus and appreciation pressure on its currency it also forced the PBOC to intervene in the foreign exchange markets to maintain the yuan’s parity with the dollar. While the accumulation of foreign reserves – the complement to China’s ever-growing current account surplus – has been regarded as virtuous and as an insurance against currency crisis, it has increasingly created problems.

First, the continued intervention has caused an expansion of monetary aggregates in China, which, among others, created inflationary pressure and contributed to the bubbles in property and stock markets. Despite capital controls, the PBOC has been severely restricted in the conduct of autonomous monetary policy.

Second, the continuous accumulation of dollar assets has created a situation that Ronald McKinnon, an economics professor at Stanford University, has dubbed “conflicted virtue” – a situation in which an appreciation of the yuan against the dollar would cause significant negative balance sheet effects. To avoid these, the PBOC has to continue intervening in the foreign exchange market, making the problem even more severe. While the PBOC has officially relinquished the dollar peg in July 2005 in favor of a peg to an undisclosed basket of currencies, and subsequently allowed for a modest appreciation against the dollar, the conflicted virtue problem persists.

For the time being, the Chinese authorities have simply no choice but to cling on to their dollar holdings. Any indication that they might dump their dollar assets would most certainly cause a massive dollar crisis, so they would cut off their own nose to spite their face. Paradoxically, they will even have to increase their dollar reserves to prevent their existing reserves from losing value. In an already famous remark made in New York in February, Luo Ping, a director general at the China Banking Regulatory Commission, said “We hate you guys. Once you start issuing $1 to $2 trillion … we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do.” Indeed, in spite of the Chinese misgivings about deteriorating U.S. government finances, Mr. Luo asserted that China would continue to buy U.S. Treasuries.

The vocal criticism of loose U.S. fiscal and monetary policy is hence more of symbolic nature. For one, Chinese policy makers need to assure the domestic public that they will “defend” China’s hard-earned reserves – responding to public outrage at heavy losses with previous investments, such as the one that China Investment Corporation has incurred in its investment in the U.S. private equity firm Blackstone that it invested in just before the bubble burst. And second, the Chinese demands for a new international reserve currency are a blunt reminder directed at the U.S. Treasury and the Federal Reserve Bank that China, the U.S.’s largest creditor, is worried about the stability of its assets. They fear that reckless fiscal and monetary policies of the U.S. authorities could deflate the value of their assets.

While it is apparent that the dollar's role as international lead currency cannot be changed on command, it is worth taking the Chinese concern about the shortcomings of the international monetary system seriously. In his paper, Gov. Zhou rightly pointed out that the Triffin dilemma, named after Yale economist and Nobel Laureate Robert Triffin, still exists: The country issuing the main international reserve currency will find it difficult to maintain internal price stability while at the same time providing sufficient global liquidity. While SDRs will hardly provide an adequate alternative to the dollar, for the time being, it would be desirable to move towards a multipolar currency system.

With the advance of the euro, a first step in this direction has already been taken. Over the medium term, one might well envisage other regional currency blocs emerging—in East Asia among others. However, any currency that could seriously rival the dollar would need to be backed up by large and liquid financial markets, and not even the euro area is qualified in this respect, let alone East Asia.

Against this backdrop, initiatives like the recent announcement that Brazil and China will work toward using their own currencies in trade transactions rather than the dollar are mostly symbolic and will meanwhile hardly affect the international role of the dollar. Whether or not the dollar will maintain its pole position, and whether or not the U.S. will preserve its "exorbitant privilege" of being able to finance its current account deficit in its own currency, remains mostly in the hands of the U.S. administration. As long as it will resist the temptation to inflate away its debt, markets will have little incentive to replace the dollar as the world currency with another currency, be it the euro, SDRs, or any other newly created multilateral or supranational currency.

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