Dollar, Euro, Yuan, SDRs? Some Thoughts on the Evolution of the International Monetary System

Ulrich Volz, SOAS, University of London & DIE

Workshop “Towards a Sustainable Global Financial System”
IASS, Potsdam, 8–9 December 2012

Deutsches Institut für Entwicklungspolitik
German Development Institute
d·i·e

SOAS
University of London

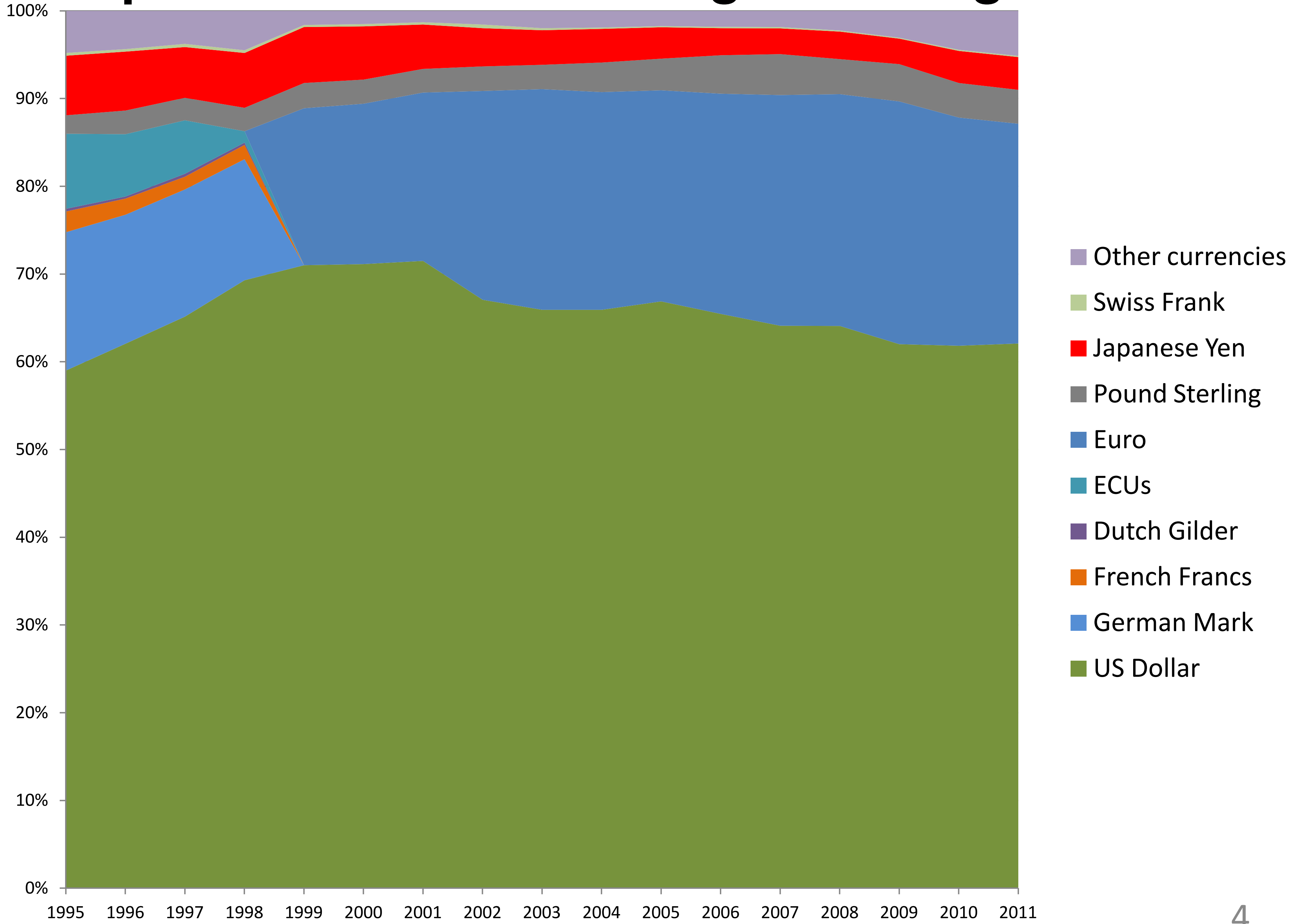
"What is the future of money in an increasingly globalized world economy? The question is crucial. Though seemingly technical in nature, the management of money in fact is anything but neutral in its implications for the distribution of wealth and power across the globe. Whoever controls money gains access to real resources—goods and services of all kinds—which in turn are key to attaining economic and political advantage. For citizens of any country it matters greatly whether currency will be governed by recognized state authorities or by others, by friend or by foe, at home or abroad. Will the privilege that money represents be handled responsibly or exploitatively? Will currency be a source of prosperity or conflict? The future of money affects us all. It is our future."

— Benjamin Cohen (2004): *The Future of Money*, Princeton University Press, p. xiii

Which currency/currencies will dominate the world economy in the future?

- The US dollar has dominated the int'l monetary system since it replaced the Pound Sterling as the major reserve currency in the middle of the 1920s (Eichengreen & Flandreau, 2004)
- Discussions in the 1980s and early 1990s on a dominance of the Japanese yen (e.g., Burstein, 1988) and until 2009/2010 on the euro (e.g., Chinn & Frankel, 2007)
- Against the backdrop of a weak US economy, there has been much talk about the Chinese renminbi (RMB) replacing the US dollar as the world's leading currency
  - Subramanian (2011: 1): "the renminbi could become the premier reserve currency by the end of this decade, or early next decade"

Composition of official foreign exchange reserves



Source: IMF COFER, April 2012

Is China challenging the role of the US dollar?

- Chinese criticism of “reckless” fiscal and monetary policy on the side of the US
- Diversification out of the dollar?
- Support for a supra-national reserve currency?

The discussion on Chinese capital account liberalisation and an internationalisation of the RMB has intensified

- Since 2008, 18 central bank swap arrangements involving China, new initiatives announced at BRICS Summit
- New 3-step plan for capital account opening and RMB convertibility by the People’s Bank of China (PBOC)

Against this backdrop, this presentation aims to

- look at the potential of the RMB to become a major international reserve currency that could rival the dollar,
- discuss whether China's call for an end of the dollar's dominance is reflected by policy,
- whether proposals for a supranational reserve currency would find China's support (beyond lofty speeches),
- and highlight the importance of national politics and geopolitical considerations

The potential of the RMB to become a major international reserve currency

The international monetary system is characterised by currency competition and a hierarchy of currencies

Conditions for key currency status

- Political stability as precondition for establishing a track record of relatively low inflation and low inflation variability
- Credible fiscal institutions as basis for a noninflationary monetary environment
- Credible monetary regime with strong, (de facto) independent central bank with clear monetary policy objective to anchor inflationary expectations
- Surplus in the trade and current account helps to create expectations of an appreciation of the national currency
- Economic size – larger economies offer more diversification possibilities
- Attractiveness increases with transactional liquidity, which is dependent on the existence of well-developed and broad financial markets that offer a wide range of short and long-term investment opportunities and fully operating secondary markets

Does China fulfill these conditions?

- Not yet, but China certainly has the potential to elevate the RMB to key currency status, given its economic size and generally inflation averse leadership
- Major bottlenecks at the moment:
  - lack of deep and liquid capital markets
  - the RMB is not fully convertible
  - the capital account is still tightly regulated
- Without a further opening of the capital account and convertibility of the RMB, the latter cannot assume a major international role besides being an invoicing country in regional trade

How long will it take?

- Theoretically, the necessary policy reforms can be implemented fairly rapidly
- Taking into account the historical experience of the US dollar, which went from having no international role to being the leading international currency in less than a decade (Eichengreen, 2011), we could see the RMB rise to key currency status very quickly
- But in practice the reform of the capital account and convertibility of the RMB are hotly contested issues in China since these reforms are linked with reform of the domestic financial sector

Goal of capital account liberalisation was put forward in the 12th Five-Year Plan outlining the policy for the years 2011-15

- The authorities have provided no details on how quick liberalisation should proceed and how far it should go

Discussion on capital account liberalisation has intensified with a new PBOC blueprint for an accelerated opening of China's financial sector launched in February 2012

- Next three years: loosening of direct investment controls and a liberalization of capital flows out of China to "take advantage of lower valuations for Western companies"
- Next three to five years: deregulation of commercial credit controls and increase in foreign renminbi-denominated lending by Chinese banks to raise the renminbi's global status
- Five to ten years: gradual opening up trading of real estate, stocks, and bonds to foreign investors
- By the end the third phase, China would have achieved a great (and yet unspecified) degree of convertibility of the renminbi

Why should China care about RMB internationalisation? – benefits

- Political prestige of issuing a global key currency
- Benefits for Chinese firms if they can use the domestic currency for international transactions since they can shift exchange rate risk to their trading partners and hence need not hedge against exchange risk
- As the international use of the RMB expands, international loans and investments will be increasingly executed through Chinese financial institutions, which would also help to boost Shanghai as an international financial center
- China would earn additional seignorage through the international use of the RMB

Implications/cost of currency internationalisation

- Greater international use of a currency implies that international demand for that currency will increase beyond what is need for domestic use, which will tend to drive the currency's value → effect on export competitiveness
- For China, full RMB internationalisation/convertibility would eventually also imply an end to the dollar link, which may (or may not) result in a significant appreciation against the US dollar
  - The Chinese export industry, supported by the powerful National Development and Reform Commission ,has been opposing this
- In general, a currency's greater international use will compromise monetary policy independence as it makes more difficult for the central bank to control domestic monetary supply
  - In China, monetary policy has already been compromised by the current dollar arrangement – the PBOC has been constrained in effectively using interest rate policy, which has led to negative real interest rates for deposits
- Opening the capital account would require domestic interest rate reform – which will benefit the economy at large, but hurt the beneficiaries of the current system

Implications of interest rate reform

- Negative real interest rates for deposits are in effect an implicit "financial repression tax imposed on Chinese households" (Pettis 2012: 9)
- For Chinese banks the negative real deposit rates have been like subsidies
- Low interest rates have benefited state-owned enterprises (SOEs), which have enjoyed monopoly privileges and which have been able to secure cheap funding from the state-owned banking system
- The major banks and SOEs are hence strongly opposing financial market reform
- Private small and medium enterprises, in contrast, have been in disadvantage – they have been calling for speeding up reforms

Reformers vs. defenders of the status quo

- The government would have to give up much of its influence over the domestic banking system, which thus far has been one of its most powerful tools in steering the economy
  - This would weaken the powerful National Development and Reform Commission , which is responsible for state-owned firms as the "quasi-central planning" agency under the State Council
  - Would enhance the PBOC's power
- The PBOC uses the goal of RMB internationalisation to push domestic financial and monetary reform in response to domestic opposition

Is China's call for an end of the dollar's dominance reflected by policy?

What did the PBOC do since Governor Zhou's proposal in March 2009?

- China purchased around US$1.4 trillion foreign exchange reserves
- The RMB appreciated by 5.3% against the US dollar
- Anecdotal evidence of gradual diversification out of dollars into gold, euro, ...
- No more mentioning of SDRs, all talk on RMB internationalisation

Would proposals for a supranational reserve currency find China's support?

Will the RMB be included in the SDR?

- Yes, but only after capital account liberalisation
  - Pressure by other G20 will not speed this up

Will China support a larger role for SDRs once the RMB is included?

- Yes, but only as far as it does not constrain China's monetary and exchange rate policy

Will China support the establishment of an int'l clearing union?

- Unlikely
  - Keynes vs. White, bancor vs dollar, deficit country vs surplus country

Some concluding thoughts

Still open outcome of Chinese financial market reform debate

- Current political transition has intensified discourse between reformers and defenders of the status quo
- Financial market reform is likely to happen, but the speed is open
- The Chinese government is risk-averse, and there is no pressure to liberalise the capital account quickly – especially not at times of an instable world economy and excessive global liquidity seeking returns in emerging economies
- Capital account liberalisation can be thus expected to proceed very gradually

Long-term perspective

- RMB clearly has the potential to become a global lead currency (there are already signs that the RMB is becoming a regional lead currency)
- Speed of RMB internationalisation will depend on *internal* political economy
- Role of RMB will also depend on whether China will act as a responsible actor in the multilateral financial system
- Role of euro will depend on progress with financial integration
- Role of US dollar will depend on long-term non-inflationary monetary and fiscal policies and health of financial system