As of April 2010

Renminbi Policy and the Global Currency System

Huang Yiping*
China Center for Economic Research
Peking University
(yhuang@ccer.pku.edu.cn)

[**Abstract**] The global currency system is likely to change significantly after the global financial crisis, but decline of the U.S. dollar may be a gradual process. These would impact the People's Republic of China's (PRC) renminbi policy, which, in turn, may generate feedbacks on the global system. The PRC may be able to help achieve a smooth and orderly adjustment of the global currency system, through steps such as gradual increase in exchange rate flexibility and gradual diversification of foreign reserve investment. It could also promote IMF's SDR by linking renminbi to it. The global crisis is likely to accelerate, not to slow, renminbi policy liberalization. And an internationalized renminbi may play very important global and regional roles, provided that the PRC successfully improves monetary policy mechanisms.

Key words: Global currency system, renminbi, U.S. dollar, reserve currency, Asian currency

---

* This paper is prepared for Asian Development Bank's second project meeting on "The Future Global Reserve System: An Asian Perspective" on March 16-18, 2010, in Tokyo. An earlier version was presented at the project's kick-off workshop on September 16-17, 2009, at the Columbia University in New York and a joint workshop on a similar subject by the Asian Development Bank and the Asian Development Bank Institute on October 30, 2009, in Manila. The Author would like to thank participants of those workshops for helpful comments. Wang Bijun provided capable research assistance.

Renminbi Policy and the Global Currency System

Introduction

The 2008-09 global financial crisis could be the beginning of the end of the U.S. dollar's (USD) ruling of the global economy. But USD probably will not exit from the global stage in the perceivable future. On the contrary, it may remain as one of the world's leading currencies in decades to come. However, it is probably not possible for USD to simply continue its global roles of the 20th century. Some changes to the international currency system now look inevitable.

However, how will the future system look like is still highly uncertain at this stage. In part it depends on changing composition of the global economy, including the relative changes of old and new economic powers. Reform of the global currency system coincides with rise of the Chinese economy in the global economy. The People's Republic of China's (PRC) decisions on its own currency or global currency issues would have important implications for evolution of the international system.

In the meantime, the potential changes of the international currency system should also be of significant interests to the (PRC). First, the USD has been the most important foreign currency, often a key reference parameter, for the PRC's external economic relations. The PRC's renminbi (RMB) exchange rate policy during the entire reform period was managed closely against the movement of USD.

Second, given that the PRC is the world's second largest economy, next only to the United States, and is also a very open economy, compared with its large economy peers, international trade and investment transactions are naturally critical for the PRC. Therefore, it has strong vested interest in ensuring smooth reform of the international financial system.

Third, the PRC's large foreign exchange reserves have become a "hot potato" at hands of the policymakers. Since a dominant portion of the reserves is in USD-denominated assets, any fluctuations in USD exchange rate have significant implications for the value and purchasing power of the reserves. For the past several years, the PRC has been trying to diversifying foreign reserve investment away from the USD assets. Perhaps it is time for the PRC to contemplate more fundamental changes to its policies toward exchange rate, trade, current account and foreign exchange reserves.

And, finally, for years the PRC has been making effort trying to liberalize the exchange rate regime and open up the capital account. The potential evolution of the global currency system should have important implications for the PRC's policy choices. The Chinese policymakers probably felt more urgency to push forward their own reforms lately, evidenced by accelerated liberalization steps during the 2008-09 U.S. financial crisis. Such reforms, again, may influence future path of the global currency system.

In this paper, we attempt to examine the dynamic interactions between evolution of the international currency system and reform of the RMB policy. Our central argument is that interactions between these two processes are a two-way street. Global changes may affect the PRC's reform. And Chinese policy choices may also have feedbacks on transition of the global system. We have five specific conclusions:

- The current global financial crisis and the potential decline of USD will have major impacts on how the Chinese economy, especially its external economy, operates. And this likely will accelerate, not slow, the RMB policy reform;
- Meanwhile, Chinese decisions, such as its favor of a supranational currency over USD, could help shape the future of the global currency system; and while the Chinese leaders strongly reject the G-2 proposal, the essence of a G-2 may soon become an important mechanism for some international economic issues;
- The PRC's policy choices on exchange rate flexibility, capital account liberalization and foreign reserve diversification may also impact future path of USD and evolution of the global reserve system;
- While singling out RMB exchange rate issue for global or bilateral rebalancing purposes can be counter-productive, the worst of the PRC's current account imbalance problem may already be behind us, given expected reforms of RMB policy and continued decline in domestic cost distortions.
- An internationalized RMB might play a role in the future global currency system. More importantly, it could also emerge as a strong candidate for the new "Asian currency", alongside the Asian currency unit (ACU), Japanese yen (JPY) and Indian rupee (INR).

The rest of the paper is organized as follows. The next section briefly examines three possible scenarios of the future global currency system: (1) business-as-usual; (2) multi-reserve system; and (3) a new supranational reserve currency. Section three looks at the PRC's policy options for rebalancing the external sector, liberalizing exchange rates and freeing up the capital account. Section four analyzes potential roles for RMB, including as one of the global reserve currencies and as the new Asian regional currency. And the final section provides some concluding remarks.

Three Possible Scenarios

Increasing recognition of the difficulties for USD to continue as the dominant global reserve currency is probably a result of the 2008-09 global financial crisis. But, the dollar problem was also behind development of the subprime crisis. This was best characterized by the "Triffen dilemma". Globalization and associated growth of international economic transactions increase offshore demand for USD, which imposes larger current account deficits on the U.S. Meanwhile, higher current account deficits in the U.S. significantly reduce global investors' confidence in USD. The conclusion is that a global monetary system based on a national currency as its reserve currency is not sustainable.

However, there are also challenges about validity of this dilemma under new economic conditions. It was argued that current account deficit is not the only avenue for supplying USD. In theory, the U.S. could supply USD liquidity while maintaining a balanced net international position by borrowing and lending the same amounts. The real challenge underlined by the "Triffen dilemma" is a national central bank's credibility supporting the global reserve currency without the backing of gold. There are plenty examples of conflicting interests between a national currency and a global reserve currency.

In any case, most experts and policymakers now agree that, going forward, the role of USD in the global economy is likely to change after the financial crisis, which implies evolution of the global monetary system. What is unclear so far is which future course these changes will take. This is, in fact, a subject of heated debate among not only the world's leading thinkers but also political leaders. In this paper, we would like to suggest three possible scenarios:

- Continuation of U.S. dollar as the dominant global currency;
- Emergence of a multi-global currency regime; and
- Creation of a supranational international currency.

These three scenarios need not to be always mutually exclusive from one another. In my humble view, they can represent three different phases in transformation of the global currency system: U.S. dollar continuing as the major global currency in the near term, formation of a multi-global currency system in the medium term and creation of a supranational global currency in the long run.

Scenario I. Continuation of U.S. dollar as the dominant global currency

It is important to distinguish terms of "global (or international) currency" and "reserve currency". Although these two terms are often interchangeable in economic discussions, we use "global currency" in a more broad definition. A global currency normally has three functions:

- Store of value;
- Medium of exchange; and
- Unit of accounting.

Meanwhile, a reserve currency mainly refers to the first of the above three functions, as a means for investment, although in most cases a reserve currency would also play the roles of medium exchange and unit of accounting.

Current discussions about decline of the U.S. dollar focus mainly on dollar's weakening role as a reserve currency, i.e., store of value. It isn't clear that dollar's roles as medium of exchange and as unit of accounting will also decline rapidly in the short term. The key reason for this is not so much about the fundamentals underscoring dollar's global function. Rather a lack of viable alternative is a more important explanation.

Even for the function of store of value, U.S. dollar's disadvantages relative to other reserve currencies such as euro, pound or yen are not overwhelming in the near term. True, the U.S. economy has weakened substantially since the beginning of the current financial crisis. But economic conditions in euro area, U.K. and Japan are even weaker.

There is also positive development in the U.S. economy that favors continuation of the current dollar regime, at least in the short term. A key cause for collapse of confidence in the U.S. was very large external deficits. But the U.S. current account deficits already declined from around 7% of GDP before the crisis to around 3% currently, which is certainly more sustainable. If this 3% level can be sustained in the coming years, it would reduce expectation for persistent depreciation of USD and remove an important obstacle for USD to continue its global roles.

Scenario II. Emergence of a multi-global currency system

Although U.S. dollar may continue to play a very important role in the global system, its relative importance is likely to decline. Therefore an alternative scenario is a multi-currency sysem. At the moment, the currencies that are likely to play greater roles alongside U.S. dollar include euro (EUR), British pound (GBP) and JPY. Other important currencies may also emerge over time, depending on evolution of the global system and reforms in individual economies. One of such currencies could be RMB.

A multiple system based on national currencies still does not solve the "Triffin dilemma" problem. However, it certainly lessens the degree of the problem by reducing deficit pressures on a single country. For instance, if EUR, GBP, JPY and even RMB can constitute greater portions of the world's foreign exchange reserves, it might be possible for the U.S. to maintain its current account deficits at manageable levels.

In a way, diversification of the global reserve currency system has already been an on-going process. The beginning of that process probably coincided with the official launch of the EUR at the end of 1990s. According to IMF data on allocated reserves, the share of USD assets in developing economies foreign exchange reserves dropped from slightly above 70% at the beginning of 1999 to around 60% at the start of 2009 (IMF 2009).

The "three islands of stability" or "G-3" (USD, EUR and JPY) monetary union proposed by Bob Mundell could be a special case of the multi-global currency regime (Mundell 2002). At the moment, JPY is still a junior partner in the global currency system. It is substantially under-represented were JPY to be the representative currency for Asia. A more fundamental question, of course, is whether JPY is the most appropriate currency to represent the Asian economies at the global currency table.

Scenario III. Creation of a supranational international currency

A multi-global reserve currency regime, however, still does not resolve the fundamental conflict between national monetary policymaking and global reserve system operation. The UN Commission on Financial Reforms identified a number of problems with national currency serving as the global reserve currency (UN Commission 2009):

- *Instability*: As holdings of the reserve currency accumulate over time, confidence in its value as a store of value is likely to wane;
- *Self insurance and deflationary bias*: While many developing countries attempt to build up foreign reserves for self insurance, as the result of current account surplus, there is a reduction in global aggregate demand; and
- *Inequalities*: The current system results in developing countries transferring resources to the industries countries that issue the reserve currency; and

Interestingly, the UN Commission argues that a multiple reserve currency system may be worse than a single reserve currency system since it adds an additional element of instability to a purely U.S. dollar-based system. The Commission believes that not only is a new global reserve system desirable, but the current crisis also provides an ideal opportunity to overcome the political resistance.

The debate about supranational international currency was recently revived by the People's Bank of China (PBOC) Governor Zhou Xiaochuan in early 2009. In an essay on

"Reform of the International Monetary System", published ahead of the London G20 summit, Governor Zhou proposed to transform IMF's Special Drawing Rights (SDR) into a true global currency (Zhou 2009). He designed a number of concrete steps to achieve this goal, including:

- Improving distribution of SDR among all IMF members and increasing the size of its issuance;
- Expanding usage of SDR in international economic transactions, such as establishing settlement relations between SDR and national currencies, promoting use of SDR as a unit of accounting in international trade, commodity pricing, investment and corporate bookkeeping, creating assets priced in SDR and expanding SDR's reference basket to include all major international currencies; and
- Forming SDR-priced open-ended funds to manage pooled foreign reserves.

If Governor Zhou's proposal is more of a long-term plan, the UN Commission's proposal for a global reserve currency aims at first solving the short-term problem of lack of a credible reserve currency. One approach proposed is for the countries to agree to exchange their own currencies for the new currency, the International Currency Certificates (ICC), which could be SDRs, and vice versa. This is equivalent to a system of worldwide "swaps" among central banks. And thus ICC would be fully backed by a basket of currencies of all members.

Another approach proposed is for international agency in charge of creating global reserves to issue ICC and to allocate it to the member countries. There would be no "backing" for ICC, except the commitment by the central banks to accept it in exchange for their own currencies. This would give the ICC the character of an international reserve currency.

RMB Policy Reform

For the PRC, it may be desirable to slow down the pace of reserve accumulation in order to lessen burdens of preserving the value foreign exchange reserves. This means reduction of current account surplus, which, incidentally, is currently at the heart of the debate on global rebalancing. And this is one important reason why RMB exchange rate policy issue suddenly rose to prominence again in late 2009 and early 2010.

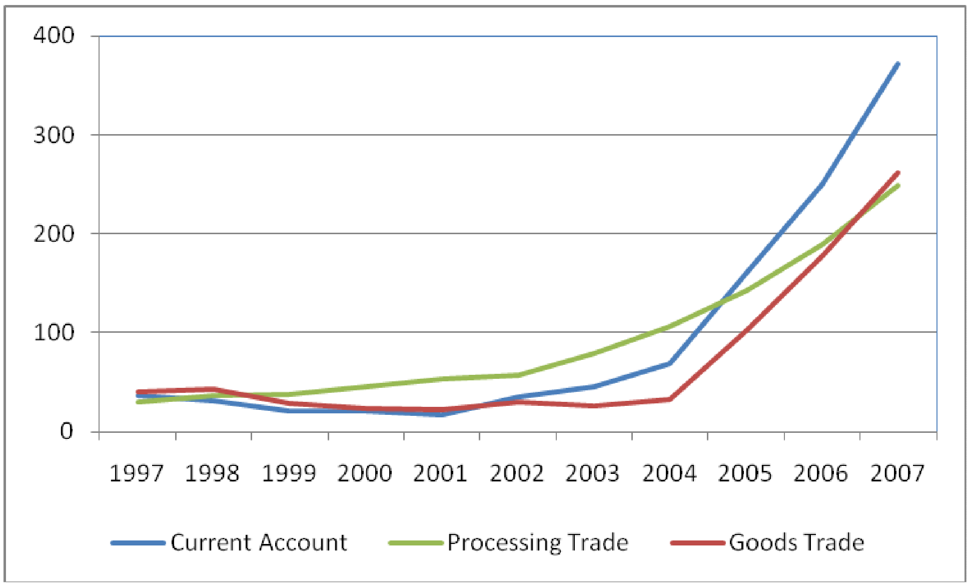
A related reason is concerns about job opportunities in the PRC's trading partners. For instance, some politicians and economists argue that by depressing the value of RMB, the PRC boosts its exports and steals others' jobs. They further argue that if the PRC continues to resist currency appreciation, then America and other countries should apply protectionism measures to counter the effects of the undervalued RMB (see, for instance, Krugman 2010).

It is certainly in the PRC's own interest to increase its exchange rate flexibility and internationalize the currency. This is critical not only for the PRC's own macroeconomic management but also for rebalancing of the global economy. But singling out the RMB exchange rate in discussion of global imbalances could prove counter-productive.

Can RMB appreciation effectively reduce global imbalances? Or in the minimum, can RMB appreciation significantly reduce the PRC's current account surpluses? It is useful to first make clear an important assumption: RMB will unlikely experience dramatic rise in the very short term. First, fundamentally the Chinese reform follows the gradualism approach. Second, the real economy is probably not ready to handle sharp currency movement. And, finally, the Chinese government also has to entertain domestic political interest as well as foreign political pressures.

Decomposition of trade surplus confirms that in 2005-07 processing trade accounted for about 100 percent of total merchandise trade surplus or 75 percent of current account surplus (see Chart 1). Unfortunately, processing trade is often less sensitive to variations in exchange rate, as substantial portions of inputs are imported. So modest currency appreciation might do little to change the external surpluses.

Chart 1. Current Account, Processing Trade and Merchandise Trade Surpluses, 1997-2007 ($ Billion)



Source: Economic Information Network Data Co. Ltd.

Between 2004 and 2007, but the PRC's current account surpluses surged from 3.5 percent of GDP to 10.8 percent during the same period. Therefore, it might take more than modest currency appreciation to reverse the PRC's current account imbalances. Expectation for RMB appreciation to resolve America's job and external deficits could even be more disappointed. Were RMB appreciation to stop Chinese exports to the U.S., the market vacuum would likely be quickly filled with products from other low-cost countries.

What further complicates the picture is wide disagreement about the extent of RMB undervaluation. Generally there are three ways of measuring equilibrium exchange rates. The first is derived from purchasing power parity. The second is based on a set of economic characteristics. And the third is inferred from the external imbalances (Clive and Williamson 2008). While most economists agree that RMB is probably undervalued, there is significant difference in identified degree of that undervaluation. For instance, Goldstein and Lardy (2009) pointed out that, assuming that half of the PRC's current account surplus in 2008 were to be eliminated, RMB was probably undervalued by only 12-16 percent at the end of that year.

The PRC's large current account surpluses are fundamentally rooted in its unique reform approach: the asymmetric market liberalization. While the product markets are almost completely freed, heavy distortions remain in factor markets. These distortions generally depress factor prices and production costs. As a result they artificially raise production profits, increase investment returns and improve competitiveness of Chinese exports. Therefore, such distortions enhanced GDP growth performance. But they strengthened investment and exports even more. This was why the growing imbalances, both internal and external, accompanied extraordinary growth performance during the reform period (Huang 2010).

In a more recent study, Huang and Tao (2010) attempted to quantify cost distortions for 2000-2009 (see Table 1). Such efforts are apparently subject to criticisms as accurate measurement is almost impossible. But the estimates they put together do reveal some interesting features. For instances, capital was by far the most important factor in overall distortion of factor costs. This probably explains why overinvestment was so difficult to control during the reform period. Again, labor cost distortion increased recently, despite loosening of controls over migration, because migrant workers' pay did not keep up pace with urban workers' pay.

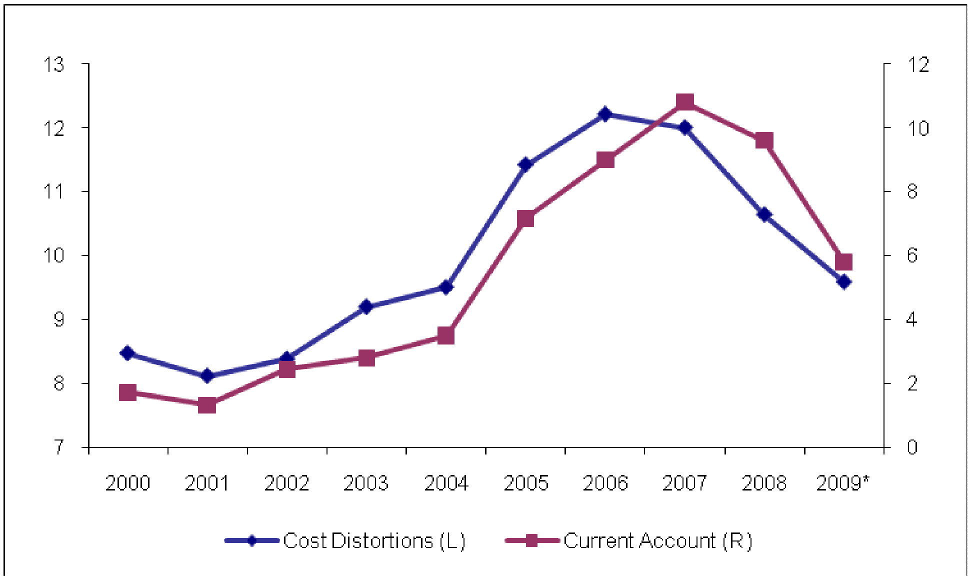
Table 1. Estimated Factor Cost Distortions in the PRC, 2000-2009 (% GDP)

	Labor	Capital	Land	Energy	Environ	Total	Current Account
2000	0.1	4.1	0.5	0.0	3.8	8.5	1.7
2001	0.2	3.9	0.5	0.0	3.5	8.1	1.3
2002	0.8	3.9	0.4	0.0	3.3	8.4	2.4
2003	1.0	3.8	1.1	0.0	3.3	9.2	2.8
2004	2.0	3.1	0.9	0.6	3.0	9.5	3.5
2005	2.4	3.0	1.3	1.7	3.0	11.4	7.2
2006	2.7	3.1	2.0	1.6	2.8	12.2	9.0
2007	3.2	3.6	1.2	1.6	2.4	12.0	10.8
2008	3.6	3.4	1.0	0.7	1.9	10.6	9.6
2009*	2.7	3.5	0.9	0.7	1.8	9.6	5.8

Note: * Estimates for 2009 are very preliminary based on estimates for other years and available information for 2009 and are subject to major revision when new information is available.
Source: Huang and Tao (2010).

The most interesting finding was estimates of overall cost distortions, which matched movements of the current account surprisingly well during that period (see Chart 2). The existing literature already proposed a number of hypotheses to explain the PRC's large current account surplus, including saving and investment gap, policies pursuing strong GDP growth, industrial relocation and currency undervaluation. While these are all relevant factors, cost distortion provides the best explanation to recent surge and decline in current account imbalances.

Chart 2. Cost Distortion Estimates and Current Account Balance, 2000-09 (% GDP)



Source: CEIC Data Company and authors' estimation.

This finding reinforces the argument that in order to address the PRC's current account surplus problem, or the global imbalance problem, it is best to take a more comprehensive approach focusing on structural reforms, rather than focusing exclusively on the RMB. The good news is that the government already started to do this. It has recently adopted measures to liberalize resource prices. It is also taking steps to reduce distortions to labor, capital and environmental costs.

If the cost distortions estimates offer any guidance about the future, they suggest that the worst of the PRC's external imbalances are probably behind us, unless the distortions rebound sharply again. But we realize that at least part of the moderation of current account surplus in 2008 and 2009 was imposed weakening of external demand. And certain recovery of the surplus may be possible once the global economy is back on more solid footing.

If anything, the global financial crisis is likely to accelerate, not to slow, the RMB policy reform. The Chinese authorities "froze" RMB's bilateral exchange rate against USD at the beginning of the global financial crisis. In the meantime, they also accelerated steps liberalizing restrictions on RMB's role in international transactions. For instances, The Ministry of Finance issued the first 6 billion yuan RMB-denominated government bonds in Hong Kong, China on September 28, 2009. RMB is now used for settlement of international transactions with some neighboring economies, mainly ASEAN, Hong Kong, China and Macau.

Actions on both fronts were probably driven by the same trigger: the quickly worsening global financial crisis. In an uncertain world, the policymakers opted for a soft peg to ensure certain degree of "stability". At the same time, the crisis also highlighted the urgency of RMB internationalization, especially if USD was on the journey of decline. The problem is that the Chinese reformers often emphasize too much on "stability". For instance, every year, the monetary policymakers indicate their intention of keeping the exchange rate at “basic equilibrium levels”. However, if the exchange rate started with a disequilibrium position, then exchange rate “stability” could mean significant instability.

Alongside exchange rate reform, the process of RMB internationalization may also gather momentum quickly. The PRC already achieved current account convertibility at the end of 1996. During the past years, the authorities took further measures to liberalize the capital account. For now, restrictions on capital transactions remain mainly in three areas: direct investment (mainly outward investment), debt financing (both ways) and portfolio flows (especially stock market investment). The leaders are confident with speedy liberalization in the first two areas. Controls over stock market investment flows could stay longer. But the PRC already has in place qualified foreign institutional investors (QFII) system and qualified domestic institutional investors (QDII) system. These should not become important hurdle for internationalization of the currency.

While it is easy to see where the policies are moving toward, it is extremely difficult to predict the likely timing of the critical events. However, if anything, the global financial crisis probably brought forward, rather than delayed, Chinese leaders’ timetable for RMB reforms. If all reforms are implemented smoothly, we could see a convertible RMB within five years.

Future International Roles of RMB

A convertible currency does not necessarily equate to an international currency. There are many freely convertible currencies in the world that are hardly recognized outside their own borders. Whether or not RMB will become an international currency depends on acceptance of the international economic community. But exactly on that measure, RMB may have better chance of becoming an international currency given the potential significance of the Chinese economy and some degrees of acceptance of RMB in the region.

Even before it becomes freely convertible, RMB is already well received in many economies, particularly in the PRC’s neighboring economies. For most Asian central banks, RMB exchange rate is already one of the most important parameters for their exchange rate policy decisions. Currently RMB accounts for about 15 percent of the Federal Reserve’s currency basket for USD. A few central banks already adopted RMB as a part of their foreign exchange reserves. Russia and Taipei,China are the new comers on that list. There is very clear evidence that a new “Yuan (RMB) Block” is in the making, if not already made.

Can RMB potentially become one of the world’s most important global reserve currencies? The answer is probably yes, given the Chinese economy’s openness and its global significance. As long as the Chinese economy continues its rapid growth, RMB’s appreciation trend may also sustain. All these will provide good supports for RMB to function as an international currency: unit of accounting, means of settlement and store of value.

But RMB also has a long list of obstacles to overcome before it can become a prominent international currency. In this regard, the PRC may learn from recent international experiences, including EUR’s successful story and JPY’s unsuccessful story. For RMB to become an important global currency, the PRC will need more transparent and better quality monetary policymaking, including an independent central bank. The PRC will need to build true interanti0nal financial centers, which again requires deeper economic integration with the rest of the world, better legal protection for property rights, and free flows of economic and political informati0n.

One important gap needs to filled for RMB to play an important international role is improvement of monetary policymaking mechanism. Currently important monetary policies are still decided at the State Council. PBOC serves more like a policy advisory body. But over time, monetary policy process needs to be more professional and transparent. And this probably involves changes in three important areas. First, PBOC should probably become more independent in deciding monetary policies.

Second, there have been confusions about monetary policy objectives. The PBOC Law introduced in 1995 sets stable currency value as the only policy objective. But policymakers sometimes list four objectives: growth, employment, prices and balance of payment. The number of policy objectives greater than number of policy instruments is mathematically impossible and often causes confusions in the markets.

Finally, the authorities will need to reduce use of administrative measures such as “window guidance” and “credit controls” and rely more on conventional measures like central bank interest rates. Administrative measures are sometimes effective but are often inaccurate. It is impossible to fine-tune policy adjustments.

In any case, developing an international currency can only be done in the long run. Making RMB a dominant international currency probably is also not Chinese leaders’ immediate ambition. What may be reachable in the medium term, say in ten years, is for RMB to become a dominant currency in Asia. Current policy efforts trying to internationalize RMB all focus on its regional roles, at least as a first step.

This may also fit Asia’s demand for a dominant regional currency. Whichever direction the international monetary system is heading, Asia is under-represented in the global currency system. Today, JPY is Asia’s only important international reserve currency. According to the IMF data, JPY-denominated assets accounted for only 4.2% of advanced economies’ foreign reserves and 1.6% of developing economies’ foreign reserves in the first quarter of 2009 (IMF 2009). Unfortunately these shares declined in recent years. This is certainly not compatible with economic weights of not only Asia but also Japan.

It is difficult to argue that as Asia’s economic weight increases, its currencies’ share in global foreign exchange reserves should also rise. Traditionally, much of Asia is a part of the “dollar block”. But as the future of dollar dimmed and economic interdependence among Asian economies intensifies, a natural question arises if Asia, one of the “three islands” in Mundell’s terms, should have its own international, or at least regional, currencies that are compatible with its growing global economic importance?

Some twenty years ago, JPY was Asia’s hope. Indeed, movements of some Asian currencies, particularly Korean won (KRW) and New Taiwan dollar (NT$), were closely correlated with those of JPY. But that relationship broke down during Japan’s “lost decade”. Instead, a new trend emerged in recent years: Asian central bankers pay more and more attention to RMB exchange rate in make their own exchange rate policy decisions.

After the Asian financial crisis in 1997-98, Asian leaders made significant efforts on regional financial and monetary cooperation, such as the Chiang Mai Initiatives. They have launched two Asian Bond Funds to facilitate development of regional bond markets. They have signed multiple bilateral currency swap agreements to protect themselves from potential future international currency liquidity difficulties. They have pooled some foreign exchange reserves to fight future risks of "sudden stop of financial flows". They have established dialogues among national leaders, finance ministers and central bank governors to discuss important issues related to regional financial and monetary integration.

As the global currency system became more volatile and Asian economies turned increasingly integrated, the need for some exchange rate coordination mechanisms also rose. The logical arguments for such mechanism were rooted in Mundell's original thoughts about EUR and subsequent proposal of "three islands of stability". But they are probably best articulated for the case of Asia by Kawai (see, for instance, Kawai 2008).

But so far, where the future regional currency regime will go remains an open question. If currency integration is the name of the future game, then perhaps the other two "islands of stability", America and Europe, offer two different models. The "euro model" is centered on creation of the euro, a supranational currency. This model is dependent on political will and coordination among national leaders (and the public). The "dollar model", on the contrary, is more driven by the market. Since the U.S. is such a dominant economy in America, neighboring economies voluntarily link their currencies to the USD and become parts of the "dollar block". The U.S. did not take any action to push for regional currency integration.

Strategic thinkers in Asia already set their eyes on the long-term goal of establishing an "Asian dollar", much the same way as Europe established the euro. Again, Kawai laid down a road map for regional currency integration, through creating "Asian currency unit (ACU)" based on a basket of regional currencies, as the first step (Kawai 2008). The ultimate goal is to follow the footsteps of EUR to unify the regional currencies into a single supranational regional currency.

Benefits of making Asia a single common currency area are obvious. As intraregional economic transactions become increasingly important, a single currency regime would help remove much of the exchange rate uncertainties and, therefore, reduce transaction costs for companies and households within the region, which depends on international trade and investment than any other regions of the world. A single currency region would also facilitate further economic and financial integration.

But hurdles for creating a common currency basket or ACU are also much higher in Asia today than those for Europe when it first established the European Currency Unit (ECU). These hurdles are reflected in different sizes of economies, different stages of economic development and different cycles of economic growth within the region. For instance, Japan, the largest economy and the only regional economy with a major international reserve currency, shares more similarities with industrial economies than with its developing economies neighbors within the region.

The changing political and economic relations between Japan and the PRC may also constitute key obstacles for any formal exchange rate arrangement. Wing Thye Woo argues that while Japan has a keen interest in making a regional exchange rate regime as soon as possible, the PRC probably has strong disincentive in entering any formal arrangements now, given that it is going to be the region's dominant economy soon (Woo 2009).

An alternative avenue for regional exchange rate coordination or monetary integration is through emergence of a dominant regional currency, which could be JPY or RMB or even Indian rupee (INR). But if the PRC is going to become the world's largest economy in the coming decade or two, then Asia might go down the road of "dollar model" of currency integration: Asian central bankers pay more and more attention to RMB exchange rate and eventually become parts of the "yuan block". But this also hinges on the PRC's successful continuation of rapid growth and smooth transformation of RMB into a global currency.

Therefore, Asian exchange rate policy cooperation or monetary integration will likely remain an open-ended game for the time-being (Huang 2009). But it is in the best interests of all members of the region for them to continue financial cooperation and integration that they started after the Asian financial crisis, regardless the future model of monetary integration.

Policy Implications

Despite more than thirty years' extraordinary performance of economic growth and its growing significance in the global economy, the PRC maintained a relatively low profile on most global issues. Chinese leaders have been following the principle of peaceful development laid down by the reform architect Deng Xiaoping decades ago. But this is gradually changing, mainly because whatever Chinese does always generates significant implications for the rest of the world.

In fact, the PRC's global influence has grown so much that some international scholars proposed "G-2" framework for the United States and the PRC jointly manage international affairs (Bergstein et al 2008; Zoellick and Lin 2009). Chinese leaders routinely rejected the notion of G-2 and preferred multilateral frameworks such as the United Nations and G-20. This was probably a rational response. To a large extent, the PRC is not yet ready to play a dominant role in global affairs.

Nevertheless, foundations for effective G-2 decision process are already being laid. Even though multilateral frameworks are useful and possibly preferred, agreements between the U.S. and the PRC increasingly becomes a critical condition for successful resolution of many important international issues, such as global rebalancing and climate change. The PRC will have to take more responsibilities in global economic affairs. It may still favor use of multilateral frameworks, but it will also have to engage increasingly in direct negotiations with the U.S.

Indeed, the PRC is already a major stakeholder in the global currency system or, more broadly, the global financial system. The interactions can contain at least three dimensions:

- Changes in the global currency system affect the PRC's policy options;
- The PRC could benefit from smooth transition of the global system; and
- Chinese decisions also have feedbacks on international currency system.

It's true that the PRC's desire to reform the RMB policy was driven mainly by its own interests. But importantly, the risk of possible disruption to the global currency system probably raised urgency of RMB reforms in the PRC. This has already been clearly evidenced by policy development in the wake of global financial crisis.

While changes to the global system now look inevitable, it is in the PRC's best interest that such as transition is smooth and orderly. This can be illustrated by high dependence of the PRC's international trade, investment and foreign reserves on USD. More importantly, the PRC may be able to help make such process less disruptive. For instance, if USD could not escape the fate of long-term decline, the PRC can probably support a smooth transition by diversifying away from USD-denominated assets only gradually and by increasing flexibility of RMB exchange rates.

Again, if the PRC is serious about creation of a supranational currency, such as SDR, in the future, it should actively support related initiatives, including those recommended by the United Nations Commission on Reform of International Monetary and Financial System (Commission 2009). For instances, one of the possible intermediate steps for the PRC to boost the international role of SDR is to make SDR a key reference for the PRC's exchange rate policy, through mechanisms such as outright peg or crawling peg. At the same time, it could also advocate expansion of the SDR basket beyond USD, BRP, EUR and JPY. In order for any of these efforts to be fruitful, cooperation of the U.S. is vitally critical, which, again, highlights the importance of implicit G-2 mechanism.

The most important contribution the PRC can make in the short- to medium-term is to increase exchange rate flexibility and internationalize the currency. This is first of all critical for maintaining macroeconomic stability and sustaining the PRC's rapid growth. Both of these should provide important supports to the regional and global economy. An internationalized RMB may also provide an option for the global currency system, at least in the medium term.

The PRC's support is critical for any regional exchange rate coordination or currency integration initiatives. And it is in the best interest of the PRC to facilitate such integration. In our view, however, the best strategy for regional currency integration is an open-end approach. There are two possible paths currency integration can take, a tightly managed "Asian dollar" (based on ACU) path or a loosely coordinated national currency approach. Candidates for dominant national currencies may include JPY, RMB or INR.

It may be argued that the current political and economic conditions may favor the second approach centered on a national currency. But the fact is that we do not need to make a decision now. It is best to keep all options open. Efforts on institutional building for future currency integration, such as macroeconomic surveillance and reserve funds, should begin.

Whichever specific forms regional currency integration would take, the PRC will need to work actively with other regional economies. Lots of efforts have already been made by regional leaders, including the ASEAN+3 framework. However, any successful regional initiatives, including adoption of either ACU or RMB to be the dominant regional currency, will be conditional on better cooperation between the PRC and Japan. As a rising global power, the PRC can perhaps be more proactive and generous in its economic dealings with Japan.

References

Bergsten, C. Fred, Charles Freeman, Nicholas Lardy and Derek J. Mitchell, 2008. *China's Rise: Challenges and Opportunities*, Peterson Institute of International Economics, Washington D.C.

Goldstein, Morris and Nicholas R. Lardy. eds. 2008. *Debating China's Exchange Rate Policy*. Peterson Institute for International Economics, Washington D.C., U.S.

Goldstein, Morris and Nicholas R. Lardy, 2009, *The Future of China's Exchange Rate Policy*, Peterson Institute for International Economics, Washington D.C., U.S.

Huang Yiping. 2009. "Strategies for Asian Exchange Rate Policy Cooperation". Paper presented at the ANU/CASS Conference on Asian Financial Integration. May 14-15, 2009. Chinese Academy of Social Sciences, Beijing, China.

Huang, Yiping and Kunyu Tao, 2010, "Causes and Remedies of China's External Imbalances", Paper prepared for the conference on "Trans-Pacific Rebalancing" on March 3-4, 2010, in Tokyo, jointly organized by the Asian Development Bank Institute and Brookings Institution.

IMF. 2009. "Currency Composition of Official Foreign Exchange Reserves (COFER)". International Monetary Fund. Washington D.C., U.S. (http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf)

Kawai, Masahiro. 2008. "Toward a Regional Exchange Rate Regime in East Asia". *Pacific Economic Review*. 13(1): 83–103.

Kawai, Masahiro and Fan Zhai, 2009, "China-Japan-United States Integration Amid Global Rebalancing: A Computable General Equilibrium Analysis", *Journal of Asian Economics*, 20(6): 688-699.

Krugman, Paul, 2010, "Chinese New Year", *New York Times* (Opinion page), January 1, 2010.

Mundell, Robert A. 2002. "The Sixth Lord Robins Memorial Lecture: Reform of the International Monetary System", in Robert A. Mundell and Paul J. Zak (eds). *Monetary Stability and Economic Growth: A Dialogue Between Leading Economists*. Edward Elgar, U.K.

UN Commission. 2009. "Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System". United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development. June 24-26, 2009. New York. (http://www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf)

Woo, Wing Thye. 2009. "China and International Financial Reform". in Ross Garnaut, Ligang Song and Wing Thye Woo (eds). *China's New Place in a World in Crisis*. ANU E-Press, Canberra, Australia, and Brookings Institution, Washington DC, U.S.

Yu Yongding. 2006. "Global Imbalances and China". Finch Lecture, October 17, 2006, Melbourne University, Australia. This paper was later published in *Australian Economic Review*, 40(1): 1-33.

Yu Yongding. 2009a. "The Road Map of Reform of the International Monetary and Financial System". Reference prepared for the U.N. Commission of Experts on Reforms of the International Monetary and Financial Systems, New York, U.S.

Yu Yongding. 2009b. "China's Policy Responses to Global Economic Crisis and Its Perspective on the Reform of International monetary system". Paper presented at the Asia Europe Economic Forum Conference, July 7-8, 2009, Kiel Institute of World Economy, Kiel, Germany.

Zoellick, Robert B.and Justin Yifu Lin, 2009, "Recovery rides on the 'G-2'", *Washington Post*, March 6, 2009.

Zhou Xiaochuan. 2009. "Reform of the International Monetary System". Paper published on the official website of the People's Bank of China. March 23, 2009. Beijing, China. (http://www.pbc.gov.cn/detail_frame.asp?col=4200&id=279&keyword=&isFromDetail=1)