

The Rise of China and the International Monetary System

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Macro Economy Research Conference
“China and the Global Economy”

Hosted by the Nomura Foundation

Tokyo, 13 November 2012

Outlines

- 1. Introduction**
- 2. Resilience of the US dollar and the euro**
- 3. Rise of China and the RMB**
- 4. Asia's Choice: Strategic cooperation**
- 5. Conclusion**

1. Introduction

- Transformation of the international monetary system: (a) Nixon shock in 1971; (b) creation of the euro in 1999; (c) GFC and EZFC and Rise of China/RMB
- What is the future of the international monetary system?
- The US dollar has been surprisingly resilient and the euro is expected to survive
- Will the rise of China make the RMB one of the global key currencies to define a future tripolar monetary system?
- What should Asia do to create its own currency zone?

2. Resilience of the US Dollar and the Euro

Resilience of the US dollar despite the US economy's relative decline and the crisis

- The relative share of the US economy in the world economy has been shrinking, initially due to the recovery of Europe and the rise of Japan, and more recently due to the rise of BRICs
- The role of the US dollar as the global key currency has been declining over time
- Easy monetary policy and persistent fiscal deficits in the US could threaten the confidence in the US dollar
- But, the dollar's role has been surprisingly resilient: it is still held as the most preferred international assets, including for private purposes and as official foreign exchange reserves (Table 1, Table 2)

Table 1: Currency distribution of reported foreign exchange market turnover (% shares of average daily turnover)

| | 1989 | 1992 | 1995 | 1998 | 2001 | 2004 | 2007 | 2010 |
|-------------------------------|------|------|------|------|------|------|------|------|
| US dollar | 90.0 | 82.0 | 83.3 | 86.8 | 89.9 | 88.0 | 85.6 | 84.9 |
| Euro | -- | -- | -- | -- | 37.9 | 37.4 | 37.0 | 39.1 |
| Japanese yen | 27.0 | 23.4 | 24.1 | 21.7 | 23.5 | 20.8 | 17.2 | 19.0 |
| Pound sterling | 15.0 | 13.6 | 9.4 | 11.0 | 13.0 | 16.5 | 14.9 | 12.9 |
| Australian dollar | 2.0 | 2.5 | 2.7 | 3.0 | 4.3 | 6.0 | 6.6 | 7.6 |
| Swiss franc | 10.0 | 8.4 | 7.3 | 7.1 | 6.0 | 6.0 | 6.8 | 6.4 |
| Canadian dollar | 1.0 | 3.3 | 3.4 | 3.5 | 4.5 | 4.2 | 4.3 | 5.3 |
| Hong Kong dollar | -- | 1.1 | 0.9 | 1.0 | 2.2 | 1.8 | 2.7 | 2.4 |
| Swedish krona | -- | 1.3 | 0.6 | 0.3 | 2.5 | 2.2 | 2.7 | 2.2 |
| New Zealand dollar | -- | 0.2 | 0.2 | 0.2 | 0.6 | 1.1 | 1.9 | 1.6 |
| Korean won | -- | -- | -- | 0.2 | 0.8 | 1.1 | 1.2 | 1.5 |
| Singapore dollar | -- | 0.3 | 0.3 | 1.1 | 1.1 | 0.9 | 1.2 | 1.4 |
| Norwegian krone | -- | 0.3 | 0.2 | 0.2 | 1.5 | 1.4 | 2.1 | 1.3 |
| Mexican peso | -- | -- | -- | 0.5 | 0.8 | 1.1 | 1.3 | 1.3 |
| Indian rupee | -- | -- | -- | 0.1 | 0.2 | 0.3 | 0.7 | 0.9 |
| Russian rouble | -- | -- | -- | 0.3 | 0.3 | 0.6 | 0.7 | 0.9 |
| Chinese renminbi (RMB) | -- | -- | -- | -- | 0.0 | 0.1 | 0.5 | 0.9 |

Source: BIS

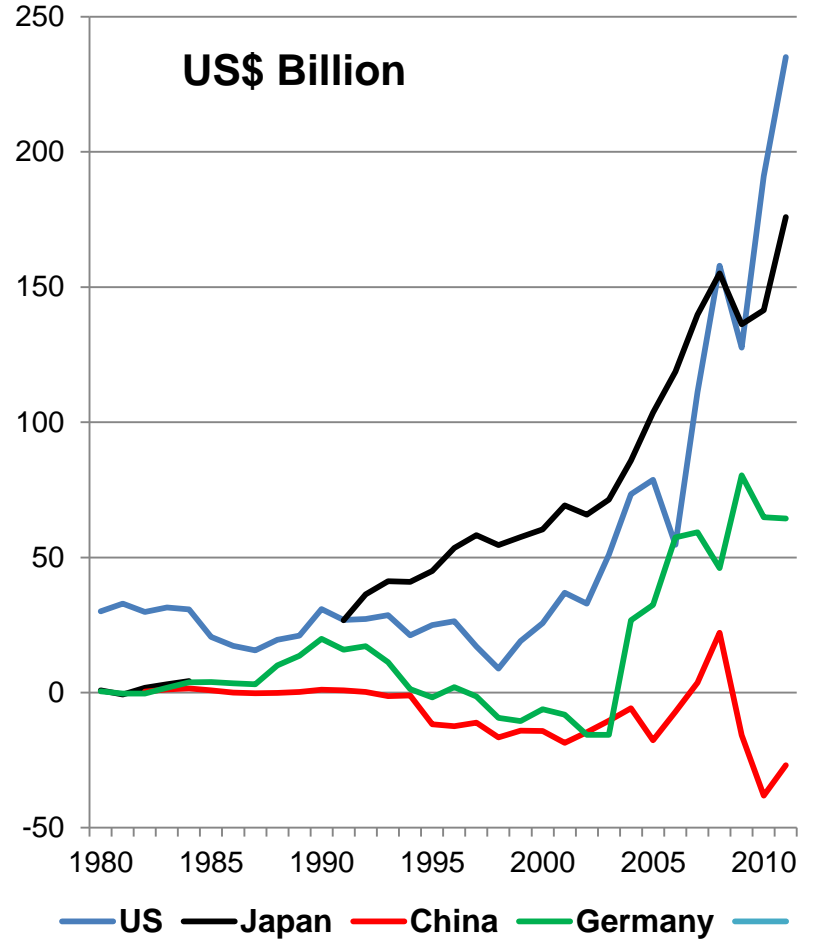
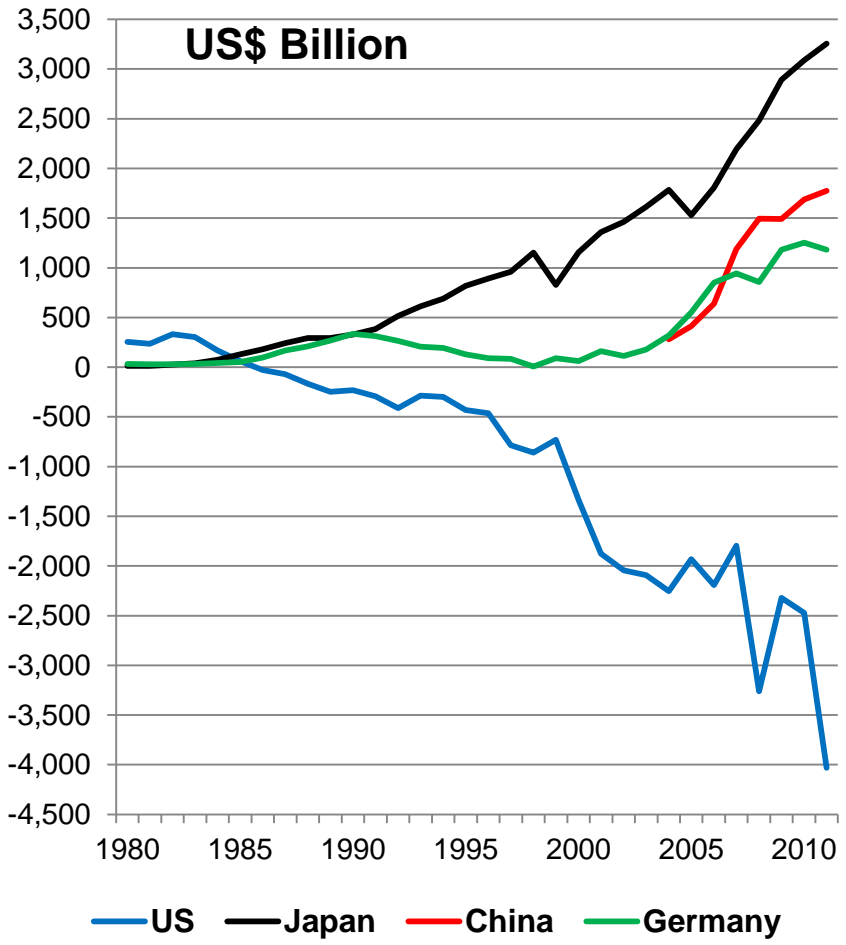
**Table 2: Currency distribution of official
foreign exchange reserves
(% shares of total allocated reserves)**

| | 1990 | 1995 | 2000 | 2005 | 2010 | 2011 |
|---------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| US dollar | 50.3 | 59.0 | 71.1 | 66.9 | 61.8 | 62.2 |
| Euro | -- | -- | 18.3 | 24.1 | 26.0 | 25.0 |
| Pound sterling | 3.2 | 2.1 | 2.8 | 3.6 | 3.9 | 3.8 |
| Japanese yen | 8.2 | 6.8 | 6.1 | 3.6 | 3.7 | 3.5 |
| Swiss franc | 1.3 | 0.3 | 0.3 | 0.1 | 0.1 | 0.1 |
| Deutsche mark | 17.4 | 15.8 | -- | -- | -- | -- |
| French franc | 2.3 | 2.4 | -- | -- | -- | -- |
| Netherlands Guilder | 1.0 | 0.3 | -- | -- | -- | -- |
| ECU | 9.6 | 8.5 | -- | -- | -- | -- |
| Other | 6.7 | 4.8 | 1.5 | 1.7 | 4.4 | 5.4 |
| Total allocated reserves | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| (\$US Billion) | (n.a.) | (1,034) | (1,518) | (2,844) | (5,126) | (5,645) |
| Unallocated reserves | | | | | | |
| (\$US Billion) | (n.a.) | (355) | (418) | (1,476) | (4,101) | (4,557) |

Reasons for the resilience of the US dollar

- The US is still the most dynamic economic power in the world as the source of innovation and technology advancement
- The US dollar financial market is open, deep, broad and liquid without any other parallel in the world—an important source of resilience of its value in the height of the Lehman shock in the fall of 2008
- The investment income balance of the US is not in the red despite the US being the largest net debtor country—high rates of return on foreign assets and low rates of return on domestic assets held by foreigners
- The “network externalities” and incumbency “inertia” of the US dollar

Net international investment position and investment income balance



Source: IMF

The euro and the eurozone crisis

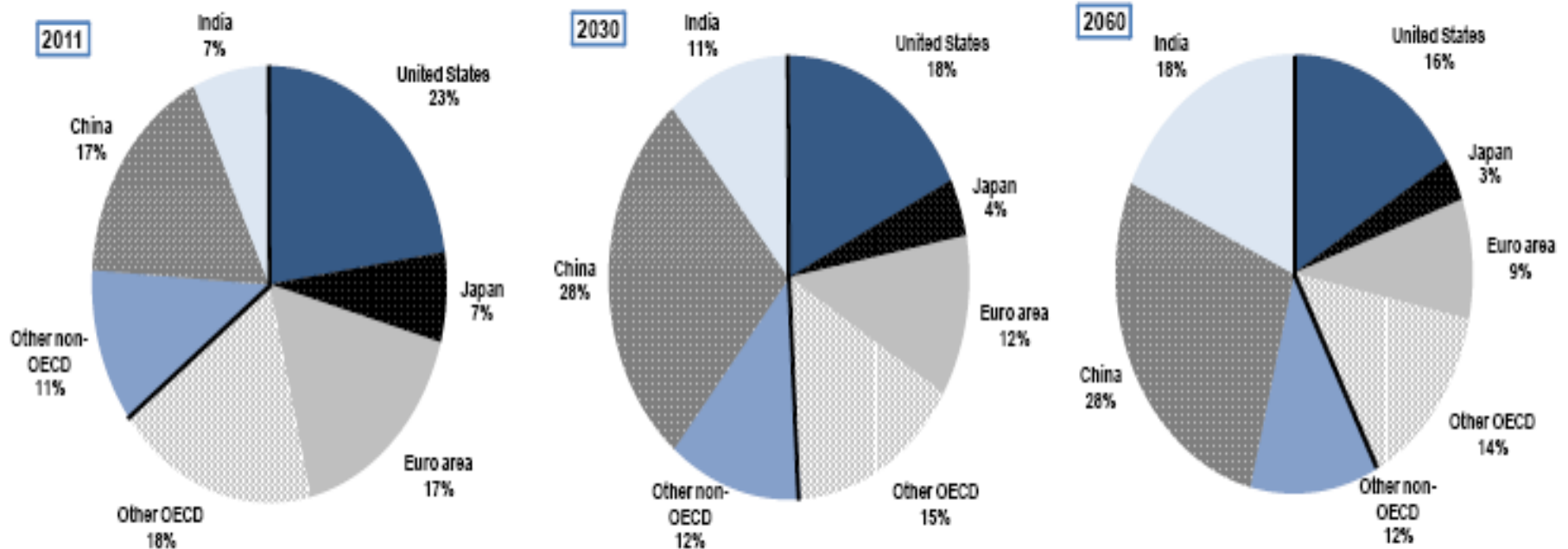
- The euro was created in 1999 following 50 years of European integration efforts
- Its launch has expanded the *de facto* euro area which is tied more strongly to the euro than the US dollar
- But in 2010, the eurozone financial crisis erupted due to the lack of:
 - mechanisms to contain intra-eurozone financial imbalances
 - institutional support for a monetary union; no fiscal union, no banking union, no financial safety nets
- Now the euro member countries are working to strengthen the euro system to avoid its collapse
- The euro will likely remain as No.2 global key currency

3. Rise of China and RMB

- China surpassed Japan in nominal GDP at current international dollars (PPP) in 2002 and at current US dollars in 2010
- China is expected to surpass the US in nominal GDP at international dollars (PPP) in 2017 and at current US dollars in the latter half of the 2020s, according to IMF
- ADB projects China to surpass the US at 2010 constant GDP in the first half of the 2030s
- OECD projects the economic size of China, based on 2005 PPPs will far exceed that of the US in 2030
- Will the rapid rise of China make the RMB the third global key currency in the world and the one that parallels the euro and the US dollar anytime soon?

Major changes in the composition of global GDP

Percentage share of global GDP in 2005 PPPs



Note: Global GDP is taken as the sum of GDP for 34 OECD and 8 non-OECD G20 countries.
Source: OECD, "Looking to 2060: Long-term global growth prospects," *OECD Economic Policy Papers*, No. 03 (November 2012)

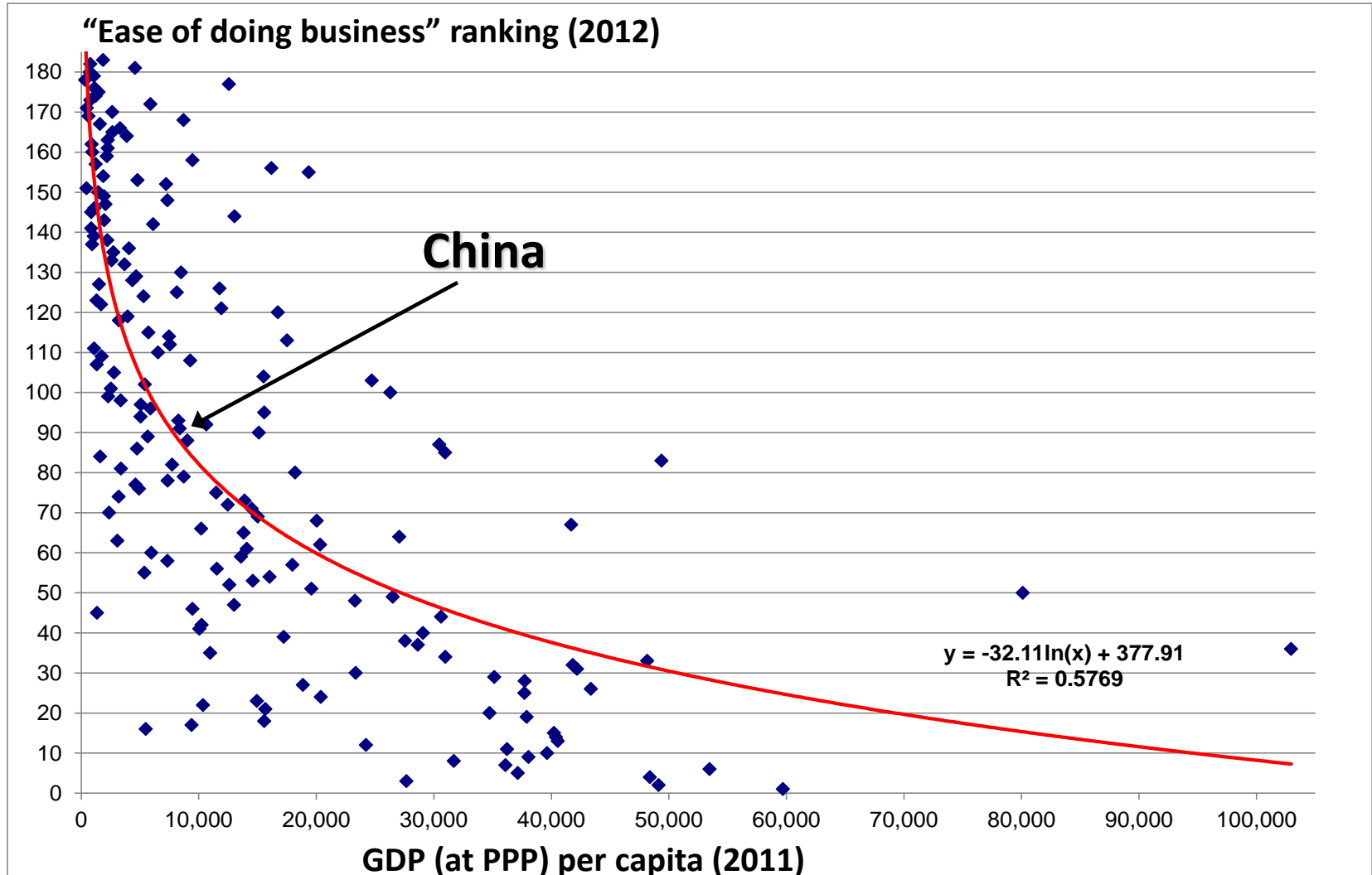
Positives for the RMB

- China's prospective size in its economic size and its status as a dominant trading nation in the world
- Policies to promote RMB internationalization, including the use of offshore markets in Hong Kong

But

- A currency that lacks a liberal, open financial market (or requires prior approval) can never become a dominant global currency, in an age with competing international currencies
- A currency pegged to the US dollar cannot function as an independent global key currency
- Heavy state intervention in economic affairs, lack of rule of law, and weak institutions (commensurate with per capita income) are negatives
- Uncertainty about political transition

“Ease of doing business” as a proxy for institutions



Challenges for RMB internationalization

- Achieving **capital account convertibility** is a critical challenge, which requires a liberal and open financial market and capacity to regulate and supervise the financial system:
 - No capital control and no exchange control over the RMB globally, and over foreign currencies domestically
 - Financial liberalization and opening, including market-determined interest rates, entry & business scope, etc
 - Effective financial market regulation and supervision
 - Avoidance of financial crisis and its lasting impact
- Introducing **exchange rate flexibility** against the US dollar and the euro

To become a dominant global key currency, capital account opening and flexible exchange rates are not enough:

- An international financial center with a deep, liquid financial market for the RMB, supported by conducive infrastructure (English, expertise)
- Established rule of law and trust in institutions (such as an effective judiciary system, an independent central bank with transparent decision making; responsible fiscal authorities; and prudent financial regulator)
- Political transition to an open democracy
- Overcoming the US dollar's network externalities and inertia

This suggests a long, difficult road ahead for the RMB to become a global key currency

4. Asia's Choice: Strategic Cooperation

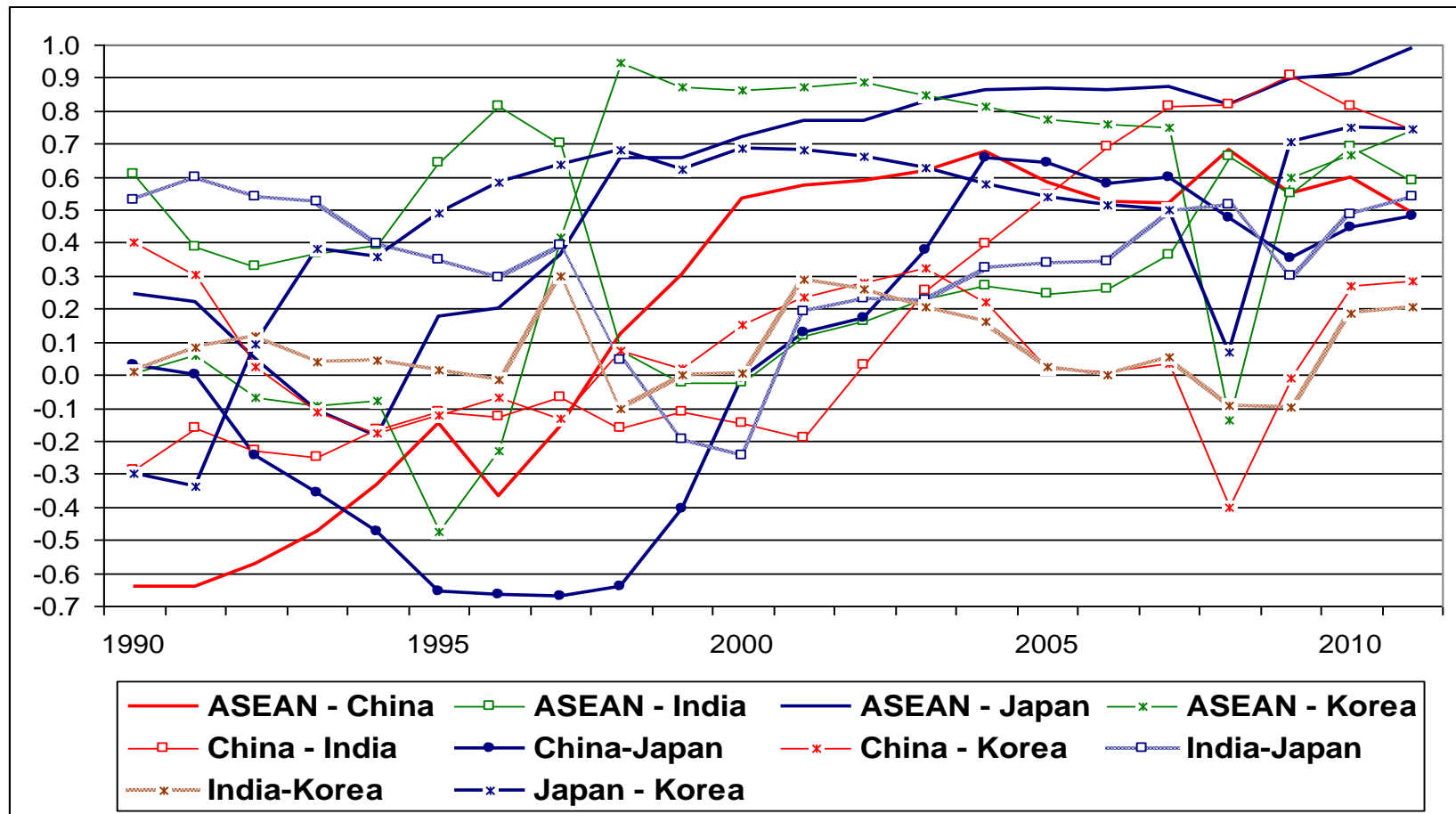
Market-drive economic integration

- Trade and investment integration, leading to the formation of the regional production network and supply chains
- Financial integration making progress, but limited relative to trade & investment integration
- Deepening macroeconomic synchronization: rising correlations of GDP growth rates within Asia

Lack of exchange rate policy coordination

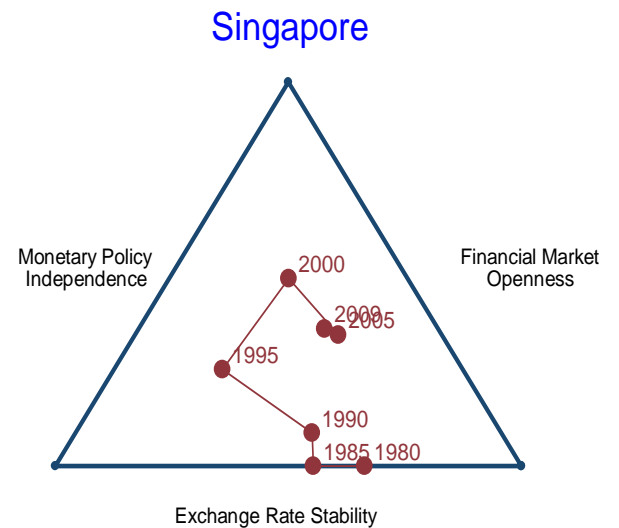
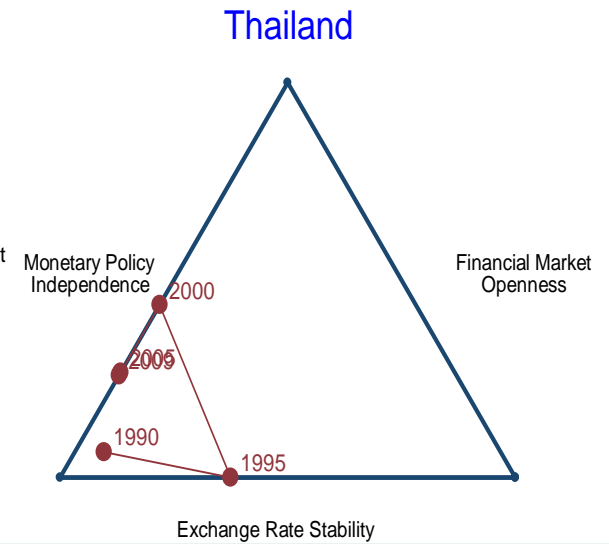
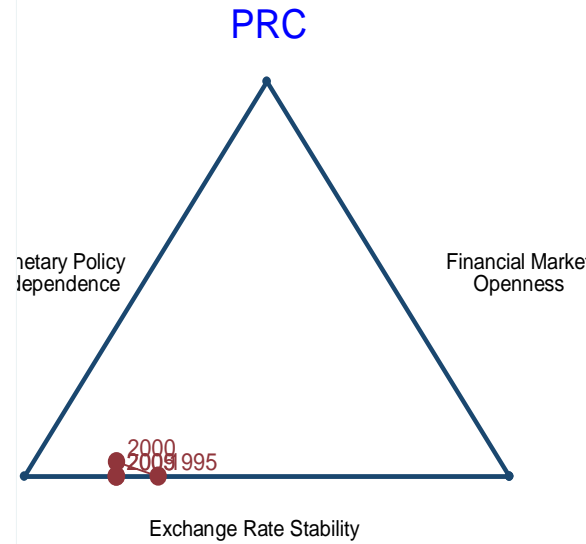
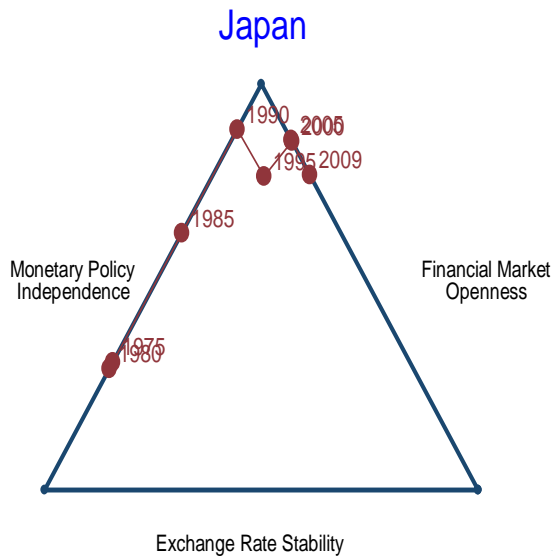
- Despite deepening regional economic integration in Asia, there has been no official attempt or policy discussion to achieve intraregional exchange rate stability

Figure 2: Rising GDP growth rate correlations among Japan, China, ASEAN & India (10-year moving windows)



Source: International Monetary Fund, *World Economic Outlook*, database

Diversity of exchange rate regimes in the trilemma triangle



Source: Ito and Kawai (2012)

Why strategic currency and financial cooperation in Asia?

- The RMB may not become a nominal anchor currency in Asia anytime soon; yet achieving relative stability of intraregional exchange rates (or avoiding the kind of volatility observed for the yen-won bilateral exchange rates) is increasingly desirable
- This suggests the importance of embarking on serious policy dialogue for informal exchange rate policy consideration
- Strategic cooperation between China and Japan and among ASEAN+3 countries will be essential to support the creation of an independent currency zone in Asia
- Without it, Asia may continue to be half built with the US dollar

Strategic cooperation-1 among China, Japan and Korea

- Use of local currencies for bilateral trade; making the RMB (and the yen & the won) a significant invoicing and settlement currency for trade—parallel to ASEAN's efforts
- Mutual holdings of sovereign debt as foreign exchange reserves
- Development of direct foreign exchange markets among the three countries
- Promotion of Shanghai, Tokyo and Seoul as international financial centers

Encouraging central bank competition to gain market credibility—also a useful way for monetary stability in Asia

Table 3: Top-10 global financial centers

(Global ranking)

| Financial Centers | Mar 2007 | Sep 2007 | Mar 2008 | Sep 2008 | Mar 2009 | Sep 2009 | Mar 2010 | Sep 2010 | Mar 2011 | Sep 2011 | Mar 2012 |
|-------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| London | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| New York | 2 | 2 | 2 | 2 | 2 | 2 | 1 | 2 | 2 | 2 | 2 |
| Hong Kong | 3 | 3 | 3 | 4 | 4 | 3 | 3 | 3 | 3 | 3 | 3 |
| Singapore | 4 | 4 | 4 | 3 | 3 | 4 | 4 | 4 | 4 | 4 | 4 |
| Tokyo | 9 | 10 | 9 | 7 | 15 | 7 | 5 | 5 | 5 | 6 | 5 |
| Zurich | 5 | 5 | 5 | 5 | 5 | 6 | 7 | 8 | 8 | 8 | 6 |
| Chicago | 8 | 8 | 8 | 8 | 7 | 8 | 6 | 7 | 7 | 7 | 7 |
| Shanghai | 24 | 30 | 31 | 34 | 35 | 10 | 11 | 6 | 5 | 5 | 8 |
| Seoul | 43 | 42 | 51 | 48 | 53 | 35 | 28 | 24 | 16 | 11 | 9 |
| Toronto | 12 | 13 | 15 | 12 | 11 | 13 | 12 | 12 | 10 | 10 | 10 |

Source: City of London Corporation and Long Finance, *The Global Financial Centre Index*, various issues.

Strategic cooperation-2 among the ASEAN+3 countries

- Strengthen regional economic and financial surveillance (ERPD) in the region
- Establish an Asian monetary fund (AMF) by stepping up the CMIM (size expansion, IMF delinking) and the AMRO
- Further develop and deepen local-currency bond markets
- Create an ACU (a basket of ASEAN+3 currencies and the HK dollar) to facilitate ERPD, Asian bond market development and broader regional monetary & financial cooperation
- Expand membership to include India, Australia and New Zealand

Regional policy dialogue for intraregional exchange rate stability

- To achieve macroeconomic & financial stability with volatile international capital flows, Asian economies need to have greater exchange rate flexibility vis-à-vis the US dollar and the euro
- An increasingly integrated Asia will also need more stable intraregional exchange rates
- It is not easy to agree on rigid exchange rate policy commitments at least for now, but the authorities can strengthen policy dialogue to avoid excessive volatility of intraregional exchange rates
- Asian authorities may:
 - choose similar exchange rate regimes and thereby reduce excessive volatility of intraregional rates
 - use ACU indexes for surveillance & policy dialogue

5. Conclusion

- The world is heading toward a tripolar currency system, centered around the US dollar, the euro (if it survives), and an Asian currency
- It is premature to conclude that RMB will become Asia's dominant key currency and even one of the global key currencies anytime soon
- It depends on the pace and depth of China's domestic reforms (particularly institutional) and on the resilience/weakness of the US dollar
- Asia should strengthen strategic financial and currency cooperation, including the promotion of RMB internationalization
- An Asian currency unit (ACU) could be an anchor for regional policy dialogue and exchange rate coordination

Thank you
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