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Rebalancing trade and capital flows

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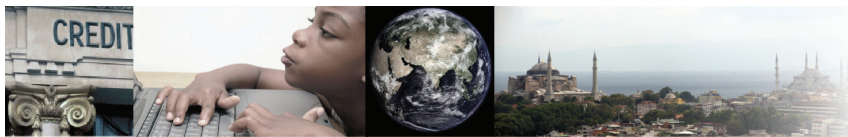
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The Global Economy

Rebalancing Trade and Capital Flows

The Challenges

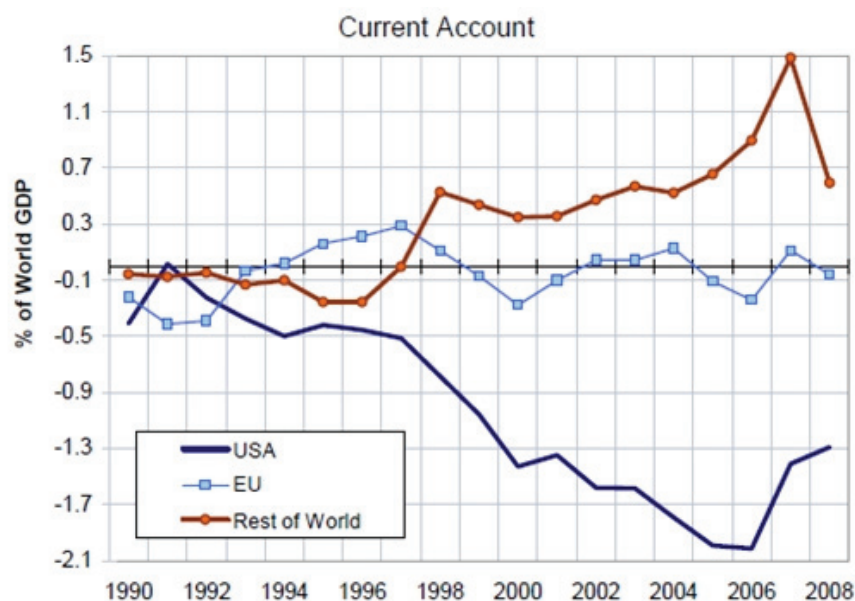
It has been argued that recent trade and capital flows are unsustainable and thereby threaten future global economic stability. In particular, emerging markets remain heavily dependent on consumer demand in North America and Western Europe.

If this consumer demand grows more slowly in the future—due to the unwinding of household debts, the influence of higher risk premia on investment and the effect of rising national debt on government expenditures—does the emerging economies' strategy of export-led growth have a future? What needs to be done to stimulate domestic demand for the four billion people in the emerging markets?



What would be the impact of rebalancing global trade flows across the different emerging markets, such as China, India, Latin American countries and South Africa? Who is more likely to gain or to lose from that rebalancing and what should the policy response according to their different economic structures, degrees of openness and socio-political institutions be like?

If global trade and capital flows were rebalanced sustainably, what implications would this have for the future of reserve currencies? Can the dollar retain its reserve currency status while enabling global financial capital to flow to the most profitable investment opportunities and global trade to flow where it is needed most? What reserve currency regime is required for sustainable trade and capital flows?



Source: Caballero (2009)



Proposed Solutions

Pablo E. Guidotti

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Rebalancing trade and capital flows: An emerging markets perspective

A number of economists have argued that global imbalances—existing since the mid-1990s—are an important cause of the global financial crisis erupted in late 2007. Two main arguments have been emphasized in this view. First, global imbalances have contributed to the build up of the financial bubble that erupted in the crisis by inducing an extended period of exceptionally low world interest rates (the “great moderation” and the “savings glut” hypotheses). Second, global imbalances resulted in an inefficient process of reserve accumulation by many emerging market economies (EMEs), induced by excessive savings (particularly in the case of China).

Hence, to the extent global imbalances reflected an inefficient or unsustainable process, then this view concludes that the recovery from the global crisis requires a rebalancing of current account and financial flows. In particular, as demand growth falls in the advanced economies, reflecting lower expected growth and the need for deleveraging, demand growth should increase in emerging market economies in order to avoid a new global slowdown. A corollary is that EMEs’ currencies should strengthen in real terms vis-à-vis their advanced economies’ counterparts.

In contrast with the above view, I share the opinion of those who emphasize the role of weak financial regulation and supervision as the principal factors leading to the global crisis, downplaying the macroeconomic role played by global imbalances. Although there is no doubt that a sustained period of low world interest rates may have stimulated financial innovations directed mainly at regulatory arbitrage, it’s still the role of regulators and supervisors that should come heavily into question (as it certainly has!) and no so much the macroeconomic conditions prevailing in the years preceding the global crisis.

There is no clear evidence that global imbalances reflected an inefficient or unsustainable process. First, the evolution of the global imbalances during this decade largely reflected the adjustment to the significant changes in commodity prices and, in particular, oil prices. In this respect, the entire widening of the advanced economies’ (ADVEs) current account deficit can be accounted for by a corresponding widening of the current account surplus of fuel-exporting countries up to 2008, the reverse being true in 2009 and 2010. This aspect of the global imbalances is not inconsistent with the (efficient) role that the international capital market is expected to play in smoothing the impact of real shocks.

Second, after the financial crises experiences of the 1990s, EMEs’ needed to deleverage. Sustainable debt-to-GDP ratios have proven to be significantly lower than those EMEs had at the beginning of this decade, and there is still room for further reductions. In this respect, it is crucial to keep in mind that the “flight to quality” effects continue to play against EMEs’ even when the financial turbulence originates in the ADVEs.

Third, China’s large savings rate may be explained in a significant portion by the lack of a public or private social security system of the sort found in western democracies. Fourth, the quality of capital inflows to EMEs’ has improved, and the policy frameworks in these economies have strengthened significantly. In this context, the significant reserve accumulation by EMEs in the present decade does not appear to be inefficient but, rather, it reflects the right precautionary policy approach in an international context which remains highly volatile.



Hence, when discussing policy recommendations from the EMEs' perspective, I am not convinced that it is desirable to promote fiscal stimulus in these economies. Moreover, I find it dangerous to call for a reduction in international reserve holdings. On the contrary, further reserve accumulation may be required to insulate EMEs from additional vulnerabilities emerging from the resolution of fiscal crises in some of the ADVEs. Most EMEs' accumulated reserves because of its potential role in reducing their vulnerability to capital market shocks. This accumulation has been facilitated by current account surpluses but it would have happened anyway reflecting the fact that policymakers all recognize today the importance of dealing with liquidity risk at the economy's level.

Having said this, there is a question as to whether EMEs can do more to improve their resilience to capital market disruptions. On the one hand, the continued enhancement of the IMF's toolkit to deal with systemic liquidity crises is in my view extremely important. On the other hand, it has been suggested that the creation of regional arrangements may contribute to improve EMEs resiliency. The principal issue here is whether regional arrangements can be effective in crisis situations that are highly correlated at a regional level.

One possible improvement to regional arrangements is the establishment of an EMEs instrument that pools a portion of the reserve holdings for the purpose of dealing with potential capital market disruptions; let's call this instrument the Emerging Markets Reserve Fund (EMRF). The EMRF could be set-up initially by the EMEs participating in the G-20, and then opened up to other EMEs.

In this proposal, participating economies would pool a portion of their international reserve holdings in the EMRF and, in exchange, would have the possibility of drawing up to a given percentage of their contribution in additional resources from the EMRF when needed. In order to differentiate this instrument from the IMF's emergency financing, access to EMRF resources should be automatic (with no conditionality or policy surveillance), but it should be explicitly collateralized with future reserve holdings in order to ensure adequate protection of EMRF resources. The use of this collateral reflects the fact that, on the one hand, the level of reserves tend to recover significantly after a crisis has subsided and, on the other hand, reserves tend to have immunity against possible attachments by private creditors. As usual, the rationale for the explicit seniority being given to EMRF resources comes from the emergency character of their use. In this sense, this collateral arrangement can be seen as an explicit version of the "senior creditor status" enjoyed by the IMF based on its "lending into arrears" policy.

As indicated earlier, the usefulness of the EMRF rests on the assumption that, as the policy frameworks in EMEs continue to grow stronger, there will be scope for less correlation among EMEs in the wake of capital market volatility. At the same time, its creation would also reflect the increasingly changing status and role of EMEs in the world economy.

Kyung Wook Hur

Korean Ambassador to the OECD

1. Introduction

Global imbalance in trade and capital flows is becoming an increasingly serious problem, and has become a pressing issue in every economic forum since the breakout of the current global crisis. The solution to this issue is directly related not just to the resolution of trade conflicts between surplus and deficit countries, but to the sustainability of the world economy itself.

Some economists claim that the global imbalance is caused by a "savings glut" on the part of trade-surplus countries, while others attribute it to overspending in deficit countries. Various possible solutions have been suggested, ranging from exchange rate adjustments in surplus



countries to structural reform in both surplus and deficit countries. While these options are well worth exploring, they often overlook the strong incentive many emerging economies have to accumulate a significant level of external reserves in order to safeguard against sudden reversals of capital flows. In fact, the volume and the volatility of international capital flows both have increased rapidly with globalization and deregulation. Until and unless we address this motivation to accumulate reserves, it is unlikely that trade imbalance can be curtailed to a sustainable level.

Considerable evidence supports this view. First, emerging economies with no internationally convertible currency often find themselves victims of volatile capital flows, despite strong economic fundamentals. The current global crisis is a case in point. While it did not originate in emerging markets, and their direct exposure to subprime mortgage was negligible, many emerging economies with sound macro-economic fundamentals and policies still suffered from massive capital flight. Korea, for example, experienced an outflow of almost US\$70 billion in capital during the four months following the collapse of Lehman Brothers in August 2008. Second, countries with larger reserves generally fared better in the recent crisis, while countries with insufficient reserves suffered severely during the last Asian currency crisis. These facts reinforce the already strong incentive emerging countries have to accumulate reserves, regardless of the significant opportunity and operational costs associated with doing so. It is no coincidence that reserves of Asian countries increased at a faster rate after the Asian financial crisis in 1997.

The direct solution is to control the volatility of capital flows themselves; however, the regulation required to do so would impede efficient allocation of resources. An indirect method is to mitigate volatility by such means as imposing a Tobin tax. There is, however, no international consensus on this issue, and it is not part of the upcoming G20 agenda. So we must explore another means of protecting economies against the sudden whims of capital flows.

There should ideally be an international lender of last resort to help countries overcome temporary liquidity problems. Currently, with no such lender in the international financial system, strengthening the IMF's capacities in this arena offers the best practical solution.

The global Financial Safety Net (FSN) which Korea has proposed is intimately related to rebalancing the trade flows. It is a complement to precautionary reserves and, over time, may also become a partial substitute. Without a valid alternative such as this system, emerging market countries will continue to rely on the accumulation of foreign exchange reserves, which would eventually hamper the rebalancing of trade flows in the process.

Finally, although the FSN was originally conceived to help emerging economies with no convertible currencies, it would also help advanced countries with convertible currencies in temporary liquidity difficulties stemming from contagion effect.

2. Strengthening the global FSN: A solution for coping with imbalance

As 2010 chair of the G20, Korea proposed the FSN as a discussion issue, which was formally endorsed as a new agenda item by the G20 in April. The FSN is essentially a mechanism designed to assist countries in managing sudden stops or reversals of capital flows due to external shocks. It will allow emerging markets to react to these shocks without having to accumulate reserves, and is therefore closely connected to any solution to the global imbalance in trade and capital flows.

To move this project forward, the G20 established an Experts Group. Based on the Group's work to date, leaders agreed at the Toronto Summit in June to discuss concrete policy options to strengthen the FSN at the Seoul Summit in November.

In light of these considerations, beginning the Executive Board meeting in April, the IMF has developed options for reform of its lending toolkit. These changes aim to strengthen the IMF's general framework for dealing with systemic crises, as well as to make its crisis prevention



instruments more available. In August the Executive Board approved a set of reforms to expand its capacity to assist member countries in preventing crises, including the critical elements of enhancing the Flexible Credit Line (FCL) and establishing a Precautionary Credit Line (PCL). Discussions on strengthening the IMF's framework for dealing with systemic risks are ongoing.

While welcoming the decision by the IMF Board to improve FCL and introduce PCL, we continue to focus on the remaining issues. First, the on-demand basis of current financial safety nets still entails the first mover disadvantage, since countries are reluctant to approach the IMF in fear of giving negative signals to markets prone to overreact. Second, when economies across globe are struck by a "systemic shock," more pre-emptive and coordinated action is necessary. The Global Stabilization Mechanism (GSM) is a key element to any solution, and should be included in the FSN package.

3. Introducing the GSM

The GSM is a framework that enables the IMF to proactively channel liquidity to members affected by a spreading systemic event. It complements other bilateral and regional liquidity support arrangements, and generally enables the Fund to proactively, unilaterally and simultaneously provide financial assistance to members, thus boosting global liquidity when required with no stigma effect. The major components of the GSM are as follows:

- Make a unilateral offer of financial assistance to eligible members to address the first-mover problem.
- Activate short-term liquidity instruments available only in systemic events.
- Temporarily increase limits based on adequacy of resources.
- Temporarily double first credit tranche to 50% of quota compared to current 25%.

4. Concerns and solution

Careful design of the GSM system can allay concerns about its inclusion in the FSN package. The concerns expressed, and possible solutions to them, are as follows:

Risk of moral hazard. One worry is that greater access to crisis financing may increase the risk of moral hazard. With careful design, however, these risks need to be no greater than those already inherent in the IMF's current role in offering financial assistance to countries encountering sovereign financial difficulties. In principle, FSNs are provided only to countries with sound economic policies while they are experiencing external shocks of a global, as opposed to an internal nature. As long as that is the case, moral hazard could easily be minimized.

As an instrument to manage crisis contagion, the GSM in particular will be used only under exceptional circumstances. The short-term duration of the credit line, as well as its focus on countries with sound policies affected by external systemic shock, provide important safeguards against moral hazard.

Resources for FSN. The accessibility of the IMF as crisis insurer rests heavily on its ability to mobilize adequate resources. Funding the FSN, however, may require a shift in thinking about how the IMF's resources are allocated. In the past, the IMF's lending facilities (such as the SBA) were typically accessed to help with crisis resolution following a shock. Going forward, a certain degree of resource re-allocation may be appropriate to accommodate the IMF's expanded toolkit of crisis prevention mechanisms. Ultimately, effective crisis prevention instruments could replace the need for disbursement arrangements by limiting contagion and controlling capital flow volatility.



To relieve concerns regarding the possible depletion of IMF resources, and to help ensure lending discipline, an aggregate cap on the total amount of financing available through the IMF's crisis prevention toolkit could be set. This cap would trigger a review of facilities. An ad hoc review would also be triggered whenever aggregate commitments outstanding under the FCL and PCL reach a certain predetermined level. We can also consider separate triggers for GSM commitments.

Global FSN instruments do not necessarily require vast or unlimited resources to be effective. For example, during the 2008 crisis, the swap lines provided by the US Federal Reserve, the European Central Bank, the People's Bank of China, the Bank of Japan and others were highly effective in restoring market confidence, even in cases where such swap arrangements were subject to relatively low caps.

Another way to increase financial resources is to establish a coordination mechanism with other multilateral institutions, regional financing arrangements, and major central banks. The coordination with regional financing arrangements, for instance, could be modeled on the recent Fund-supported program with European Union members as part of the European Stabilization Mechanism. In Asia, the Chiang Mai Initiative could serve a similar purpose.

5. Conclusion

Trade imbalance is closely linked to the reserve accumulation of emerging economies as a form of self insurance. In the absence of more effective and attractive crisis prevention options, emerging economies are most likely to continue to increase their reserve levels, making it difficult to mitigate global imbalance.

The costs of reserve accumulation are not limited to the countries holding them, but indeed have global implications, since holding excess reserves diverts resources from other productive uses, such as consumption and investment, with higher potential for returns and growth stimulus. This worldwide impact underscores the importance of instituting a strengthened global FSN. The improvement of FCL and the introduction of PCL are positive steps, yet they would be insufficient in times of systemic crises such as the one we are experiencing today. While more innovative solutions are under consideration—such as strengthening the Fund by enabling it to lend against collateral, to provide sovereign guarantees and to purchase sovereign bonds in the market—these measures would require challenging consensus-building and additional political commitment.

Consequently, I propose making steady progress on the GSM before the Seoul Summit. It remains the most practical solution to reducing trade imbalance to a sustainable level and boosting investment and consumption in the long term.

Annex 1: Set of IMF reforms

1. Enhancements to the Flexible Credit Line. The FCL, which is a crisis prevention and resolution instrument dedicated to countries with very strong fundamentals and policies, was refined by: (i) increasing the duration of the credit line (FCL arrangements can now be approved for either one year, or two years with an interim review after the first year); (ii) removing the implicit access cap of 1,000% of quota (access decisions will be based on individual country financing needs); and (iii) strengthening procedures by requiring early Executive Board involvement in assessing the contemplated level of access and the impact of such access on the IMF's liquidity position.
2. Establishment of the Precautionary Credit Line. This new crisis prevention instrument is designed for countries with sound fundamentals and policies but moderate vulnerability. As with the FCL, approval of PCL arrangements is based on qualification. The PCL features streamlined ex-post conditionality (at a minimum monitored through semi-annual



program reviews) focused on reducing any vulnerability identified in the qualification assessment. Access under PCL arrangements is frontloaded with up to 500% of quota made available on approval of the arrangement and up to a total of 1,000% of quota available after twelve months.

Maria Christina Terra

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- Better insurance mechanisms, with credit lines to prudent countries in balance of payments distress. This could help lowering the necessity of reserve accumulation for crisis insurance motive. Moral hazard issues should be considered in designing conditionality for credit access.
- Increase US public saving. This would help rebalancing US current account.
- Decrease Chinese private and public savings to rebalance Chinese current account. To decrease private savings, the Chinese government should develop a social insurance system.
- Governments in developed countries should use regulatory policies to prevent large current account deficits, as done in developing countries when capital inflows are perceived as too large.
- Policies to lower the costs and increase the supply trade finance, such as improving the regulatory environment and reinstate a statistical base for trade finance.

Ignazio Visco

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1. The role of macroeconomic policies in the global crisis

Policy responses to the global crisis have helped stabilize confidence and limit the threats of financial instability, but at the cost of a huge accumulation of public debt. This could potentially lead to a higher cost of borrowing if markets were to become concerned about its sustainability, and of a protracted period of very low policy interest rates and abundant liquidity, which may end up fuelling new asset price bubbles, thus building up the conditions for the next crisis.

In order to reduce the risk that again in the future a combination of distortions may lead to large and destructive financial crises, it is essential to address both macroeconomic and financial policy failures. Important changes in financial market regulation and banking supervision are already being introduced. In the macroeconomic area, an effort is being conducted to strengthen the coordination of economic policies in the context of the G-20.

Beyond exiting from exceptional expansionary policies, the global economy will face the challenge of adapting to an extended period of higher private saving in the advanced economies, where the process of deleveraging is still at its early stages. A shift to a more sustainable global pattern of demand is needed, with important policy implications to facilitate this adjustment over the medium term. Policy frameworks should adjust to allow for stronger growth in private demand in economies with substantial external surpluses that have accumulated large reserve positions over the past several years. In other words, the composition of global demand will need to shift in order to deliver strong, sustained and balanced global growth, as in the G-20 intendments. Supply-side policies and structural reforms will be important to support potential growth-which may have been damaged by the crisis.

One may wonder what would have happened to the global economy had this policy framework been implemented in due time. Such a counterfactual scenario has been studied by Catte



et al. (2010) who show that, if a substantial and globally coordinated demand rebalancing had been undertaken in the early 2000s, internal and external imbalances would not have accumulated to the extent that they did (Catte, P., P. Cova, P. Pagano, and I. Visco (2010). The role of macroeconomic policies in the global crisis. Banca d'Italia, Occasional Papers, No. 69, July). In particular, the scenario considered contemplates tighter monetary and supervision policies in the United States and an increase in domestic demand in major surplus economies. The latter would have been the result of wealth effects obtained through productivity enhancements in the nontradable sector in advanced surplus economies and of policies aimed at directly rebalancing growth towards domestic demand—such as measures that reduce households' precautionary savings and reforms of corporate governance which decrease retained earnings, coupled with exchange rate appreciation—in emerging economies. Even though it is difficult to say whether in that scenario the financial crisis might have been avoided, its propagation would likely have been less destructive, as both the US financial system and the global economy would have been less vulnerable to it. Specifically, US housing prices would not have expanded at the same pace as they did and the pattern of current accounts would have been better balanced.

Overall, the results of such a counterfactual scenario highlight the complementarity of policy actions in deficit and in surplus countries with respect to the correction of both internal and global imbalances. Notwithstanding announcements about the importance of coordination and cooperation in the design and development of crisis strategies, in practice, countries have proceeded to adopt policies that appear to be national in character. Strengthening multilateral coordination to mitigate global distortions remains a priority. The issue of cooperation extends beyond the design and implementation of stabilization policies and appears particularly relevant in managing exchange rate flexibility.

2. Exchange rate flexibility and financial flows

For countries in surplus, the rebalancing toward domestic demand should normally be accompanied by an exchange rate appreciation to help re-direct production toward nontradables and part of the additional absorption toward imports. The consequent terms-of-trade gains would help stimulate domestic consumption. In principle, an effective exchange rate appreciation can be achieved in different ways depending on the exchange rate regime. Greater exchange rate flexibility could, for example, take the form of exchange rate fluctuation within a moving (e.g., gradually appreciating) target band, defined with reference to either the dollar or a currency basket. It is possible to imagine a wide range of variants of this regime depending on the width of the band, the speed of appreciation, the composition of the basket and whether the margins of the band are “hard” or “soft,” as well as depending on the degree of pre-commitment to each of these parameters.

In the case of China, for example, while the appropriate size of the renminbi's appreciation will depend on considerations of macroeconomic balance in the context of the ongoing demand rebalancing, the degree of exchange rate flexibility could be used as part of the authorities' strategy for addressing the need to manage the effects of capital inflows while preserving domestic macroeconomic and financial stability. For countries facing large capital inflows, greater exchange rate flexibility may represent the most effective line of defense, reducing the need to accumulate official reserves. The main challenge posed by capital inflows for fixed-exchange-rate countries is to prevent them from feeding excessive growth in domestic credit, asset market booms and inflationary pressures, given the difficulty of fully sterilizing the domestic effects of reserve accumulation in a context of limited development of the internal financial market.

While a crawling peg does not provide greater monetary autonomy than a fixed exchange rate (it may even require maintaining lower interest rates than those in the anchor currency), exchange rate flexibility—even within the limits of a fluctuation band—introduces a perception of two-way exchange risk, which should help discourage one-sided speculative bets on a



renminbi appreciation. This buffering effect will be greater if the fluctuation band is sufficiently wide. Such a regime would allow greater leeway for an autonomous monetary policy: A rise in domestic interest rates would normally be associated with a more appreciated exchange rate within the fluctuation band, and thus with greater scope for future depreciation; it would not, therefore, trigger capital inflows if the band is credible.

A possible second line of defense in the face of excessive capital inflows, particularly when these are a structural phenomenon, could be greater liberalization of capital outflows. This should be part of a broader process of fostering domestic financial development, both in order to ensure an efficient allocation of the country's huge pool of savings and to support China's increasingly globalized and sophisticated companies. Related to this broad project is also the objective of enhancing the role of the renminbi as an international currency. In this context, the introduction of some degree of exchange rate flexibility (possibly increasing over time) can be seen also as a way of gradually allowing domestic investors and firms to familiarize with the management of exchange risk. Here the interaction with financial market development is important: As domestic firms and banks become exposed to currency risk, they need to be given access to markets where they can hedge against it. On the other hand, liquid derivative markets are unlikely to develop unless a demand for hedging exists. At the same time, the development of deep and open markets in a broad range of renminbi financial instruments—an essential condition for China's currency to take on a major international role—requires a switch of the monetary policy strategy from quantitative targets to the use of the interest rate and open market operations. This requires financial deregulation and the development of a liquid secondary market for government bills and bonds, so that the latter may act as a reference to price riskier private assets.

3. Reserves and the international monetary system

Over the past decade international reserve holdings have become increasingly concentrated in the hands of emerging market countries, and have grown well above traditional “precautionary” norms (e.g., in terms of months of imports or as a ratio to short-term external debt). As well, global reserves have remained concentrated in a few currencies, particularly the US dollar, whose share in global reserve assets far exceeds the share of the US in the global economy. These developments are a symptom of unsolved problems in the underlying international monetary system (IMS).

Large-scale reserve accumulation has significant costs at both the national level (in terms of foregone consumption and investment, or quasi-fiscal deficits incurred when reserve accumulation is financed or sterilized with debt offering higher yields) and the global level. Beyond the traditional motives for holding reserves (such as smoothing out the impact on consumption of shocks or ensuring inter-generational equity for oil producers), recent large-scale reserve accumulation has been driven by two main factors: (a) growing and volatile capital flows—and the related need to insure against international liquidity shocks for countries with an only limited financial intermediation capacity; and (b) the absence of automatic adjustment mechanisms in global imbalances—policies aimed at maintaining an undervalued exchange rate can persistently put off adjustment for surplus countries. As long as reserve issuing countries are willing to incur debt to purchase their imports, an export-led strategy leading to persistent current account surpluses and reserve accumulation remains a feasible policy option. However, as economies relying on undervalued exchange rates and demand from reserve issuers grow larger, a purely domestic adjustment for the reserve issuers becomes increasingly difficult.

Both “precautionary” and “non-precautionary” reserves have a bearing with IMS stability, but require a different treatment. To reduce the world demand for precautionary reserves, the definition of benchmarks to gauge the adequacy of precautionary reserves, such as IMF guidance on “desirable” ranges of precautionary reserve levels based on country circumstances, could be helpful. To address the other underlying driver of reserve accumulation



(capital flow volatility), countries could agree, also with the help of the IMF, on a new multi-lateral framework for managing capital flows. This framework should (i) cover all types of capital flows; (ii) specify the benefits of capital account liberalization under specific circumstances, as well as the need of appropriate measures to contain excessive movements if and when necessary; (iii) discourage systemic countries from adopting comprehensive capital controls that may generate greater capital flow volatility elsewhere, or are used in place of policy measures aimed at decreasing global current account imbalances; and (iv) encourage countries to take concerted actions to limit volatility of capital flows. This would require substantial enhancement of financial data gathering at the national level, as well as more timely monitoring of capital flows at a supra-national level.

Countries' perceived need of precautionary reserves is not entirely independent of the amount of IMF resources they can count on in case of trouble. Substantial progress has been made in recent times, with the creation of a new precautionary facility for countries with sound fundamentals and policy frameworks and the tripling of Fund resources. Further improvements are being debated to encourage the use of IMF precautionary tools and broaden the perimeter of their potential beneficiaries. Yet, as IMF lending remains attached to some form of "conditionality," countries may still prefer accumulating reserves, which are available immediately and unconditionally. A more ambitious option would be to do without IMF conditionality, and allow the Fund to lend to solvent countries against collateral (in the form of high-quality assets possessed by the borrower), on a temporary basis and at penalty rates. This would require an amendment to the Fund's Statutes, since lending against collateral is not currently allowed by the Articles of Agreement.

The search for incentives to reduce "non-precautionary" reserves explained by one-sided foreign exchange intervention remains problematic, as IMS stability is likely to be of second order importance to countries' own near-term interests. At a bare minimum, a "shared understanding" would be required among surplus and reserve issuing countries on the stability requirements of the system and on how their behavior can undermine its stability. This understanding could be achieved either informally—at the G-20 level, through the "framework for strong, sustained and balanced growth"—or in a more institutionalized context for international cooperation such as the IMF. A concerted, non-coercive approach would be surely preferable to one based on "penalties" (including a threshold on "excess" reserves or automatic taxes on persistent current account imbalances for reserve issuers). This approach should contemplate: (i) for reserve accumulating countries, a move towards flexible exchange rates and a significant reduction of foreign exchange intervention, or the abandonment of their pegs to national currencies; (ii) for reserve issuers, the adoption of a macroeconomic (fiscal) policy framework to sustain credibility of their currencies and the IMS as a whole. More ambitiously, steps could be taken to strengthen the global reserve system by (iii) enhancing the role of the SDR. This said, both in the G-20 and IMF settings the question remains as to how to make countries accountable ex post for the implementation of these understandings.

A more diversified allocation of reserves among existing (or newly created) assets could, in principle, reduce global and individual exposure to risks stemming from economic shocks and policies of a single country, and provide more stable stores of value by increasing reserve issuers' incentives to pursue sound policies. Reserve diversification is a market-driven process that is unlikely to evolve rapidly without active promotion of the official sector. In addition, in the absence of greater policy coordination between reserve issuers to manage their exchange rates within acceptable ranges, a multi-polar system (with several reserve currencies operating as broad substitutes) may entail greater exchange rate volatility, especially in the transition phase. Thus, the diversification process should be managed in a smooth and transparent way, to avoid large swings unwarranted by economic conditions. The Fund could (i) promote greater transparency and an only gradual adjustment in the currency composition of reserves, (ii) engage with potential major reserve issuers to help remove the obstacles to a broader use of their currencies, and (iii) assist emerging market countries to pool and securitize part of their



sovereign debt into a new composite asset, to be held as reserve asset by the members of the pooling arrangement.

Finally, and certainly more open to discussion, the SDR may offer a number of potential advantages as a new element (if not a currency) of a multi-polar system. Being a basket of major currencies, it diversifies the currency and interest rate risks of its constituent currencies, and this would be especially important to cope with greater exchange rate volatility in a system with no dominant currency. Another advantage would be to align global “monetary conditions” (i.e., the reference rates off of which risky assets are priced) more with global conditions than with conditions in any single economy—all the more so if the basket were broadened. Finally, if countries with a current account surplus pegged to the SDR basket rather than to a national currency, the currencies of deficit countries could depreciate vis-à-vis others in the basket.

However, for the SDR to become a viable reserve currency, its supply should be increased significantly, and deeper and more liquid markets for this asset would be needed (currently there only exists an “official” market for SDRs). Over the years, SDR allocations have been regularly resisted by major IMF members. The development of a private SDR market would facilitate the process of diversifying reserve composition. Moreover, if the private SDR market were sufficiently liquid, it would become possible to carry out foreign exchange intervention directly in SDR. This might encourage countries to set their exchange rate vis-à-vis the SDR rather than the dollar. It would take time to ensure that a liquid, broad and diversified private market for the SDR develops, although the Ecu experience suggests that it could also prove highly successful. An important limitation that needs to be taken into account, however, is the absence of a lender of last resort in SDR. Market agents would always need to ultimately rely on the central banks issuing the four constituent currencies of the SDR basket.

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The existing international monetary system: Vulnerabilities and reformation

Abstract: The current international monetary system is basically a “3-ring structure” dominated by the US dollar which does not only fail to resolve the “Triffin dilemma”, but also causes cyclical depreciation of the US dollar and current account deficits of its own. Each cycle is more or less reflected by global economic imbalances. However, the United States has a unique “Wealth-generating mechanism” that benefits itself from the cyclical depreciation at the expense of other countries. There are six major dilemmas in current international monetary system. It is necessary to establish the three pillars for the new system, and it is a general trend that RMB will be internationalized and become one of the three pillars.

Key words: international monetary system, six dilemmas, three pillars for new system, RMB internationalization

1. *The US dollar-dominated international monetary system leads to global economic imbalances*

1. *The fundamental features of the current international monetary system*

(a) The US dollar is the core of the current international monetary system.

In 1973, the United States unilaterally abandoned the Bretton Woods System. After A few years of the market turmoil, the international monetary system gradually returned to the dollar-dominated system. After the mid-1970s, there were only a few international currencies such as German Mark (later the Euro), Japanese Yen, British Pound, and Swiss Franc that keep floating against the US Dollar. However, currencies of emerging countries were not inter-



nationalized, and they were forced to peg to the US dollar. After the Asian financial crisis in 1997, the East Asian countries restored the fixed exchange rate regime, and hence strengthened the central status of the dollar.

(b) The current USA-dominated international monetary system is basically a “3-ring structure.”

The United States is the “core country” as it is located in the center of the ring structure. To some extent, the US Fed acts as the “global central bank” because its monetary policies have dominant power and the privilege to artificially export the US dollar. Countries that adopt floating exchange rate regime, known as intermediate floating exchange rate, are located in the middle of the ring structure, including the European Union, Japan, Canada, Australia and some other Latin American countries, which rarely intervene in the foreign exchange market. The last group is called “peripheral pegging countries”, which adopts fixed exchange rate regime and locates in the outer layer of the ring structure, including China, South Korea, Hong Kong, Taiwan and Southeast Asian countries. These countries hold a large amount of foreign exchange reserves.

(c) Multi-level and multilateral coordination is needed to adjust the interests of the three groups.

In the current international monetary system illustrated as the Figure-1, the three groups are in unequal positions, and the relationships between them are also different. Specifically speaking, “Core countries” and “intermediate floating countries” interact with each other mainly through capital account, while “core countries” and “peripheral pegging countries” interact with each other through current account. Consequently, the US and Europe become financial partners while the US and Asia become trading partners. To change the pattern of global economic imbalances, we must enhance multilateral coordination and give full play to the role of the Group 20 (G20), International Monetary Fund (IMF), World Bank and World Trade Organization (WTO), etc. Bilateral games between China and US will not be able to effectively balance the interests of the three groups in the “ring structure.”

2. *The US Dollar serves as international currency and causes cyclical depreciation and US current account deficits*

Since the establishment of Bretton Woods System in 1944, the US has acted as the “core country” in the international monetary system. As an international currency, the US dollar is not only unable to resolve the “Triffin dilemma,” but also causes US current account to vary cyclically. United States export dollars through trade deficits and force its currency to depreciate against other currencies when trade deficits accumulate to certain level. Because of the depreciation, US current account returns to balance and the US starts to export dollars through trade deficits again. As a result, a peculiar periodic cycle that can be presented as “trade deficits (imbalance) → depreciation (balance) → repeated deficits (repeated imbalance) → repeated depreciation (repeated balance)” has been formed: Each cycle is reflected by periodic imbalances. Since the mid-1960s, the dollar has experienced three periodic cycles. More details can be described as follows.

The first periodic cycle occurred between the mid-1960s and the late 1970’s. At that time the US trade surplus was decreasing continuously. By 1971, the US current account balance to GDP ratio dropped below zero for the first time. The US exported dollars mainly through foreign investments to other countries and large trade surpluses was accumulated in Western Europe. In the 1970s, the Bretton Woods System collapsed amid the oil crisis which led to substantial depreciation of the dollar and relieved the US current account deficits. The average ratio of current account balance to GDP remained at zero with slight fluctuations.

The second periodic cycle occurred between the 1980s and the mid-1990s. The US current account balance dropped again to the level of $-3\% \sim -4\%$. Japan and some major European countries in this cycle became the largest surplus countries. However, the “Plaza Accord” in



1985 made the dollar depreciated sharply against Japanese Yen and German Mark and other currencies. In the early 1990s, the US current account was rebalanced again.

The third periodic cycle started from the mid-1990s and it has not been ended yet. Especially after the Asian financial crisis, the US current balance to GDP ratio dropped all the way down: -1.6% in 1997, -3.2% in 1999, -4.5% in 2002, then -5.7% at the end of 2004. The US current account deficits accounted for 75% of the global current account surpluses and China has become the country with the largest trade surpluses in this cycle.

In the most recent periodic cycle, the scale of trade imbalances has become larger that covered more regions and countries. The new characteristics led to severe global economic imbalances, particularly the China-US economic imbalances, which resulted in financial instability on a world-wide basis, especially in emerging markets, and has sowed the seeds of global financial and economic crises.

3. *The United States successively “generates” wealth in mysterious ways by taking advantage of the dollar’s status*

(a) The United States has a unique “wealth-generating mechanism.”

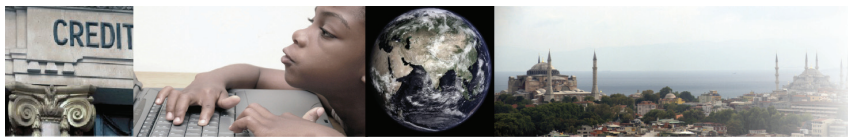
Americans are used to consume and are reluctant to save. The US household saving rate has remained around zero or even negative for years. However, US investors received unprecedented returns and risks were hidden by the cycle of “financing → purchasing financial assets (assets accretion) → more financing → purchasing new financial assets (assets accretion again).” Since 1990, the wealth accumulation of rising US stock prices and house prices has created a “wealth effect” which boosted US consumption and economic growth. Besides, the US has the privilege to distribute US banknotes to the rest of world without restraint. In the past 10 years, with China’s integration into globalization, China has not only become a production base for the US manufacturing sector, but has become a de facto US bank. The US uses dollars to purchase cheap goods from China, and then China exchanges these US Dollars with US Treasury bills. This process forms an excellent bilateral circulation of commodities and currencies.

(b) US huge external debt strangely disappeared

The circulation of goods and currencies between China and the United States is well operated through the US developed financial system. A large amount of China’s savings is transferred to United States through China’s investment on US T-bills, part of which is used to support US to successively purchase products from China; and part of which flows back to China in the form of FDI and hot money. By this means, the United States not only suppresses domestic inflation but obtains high returns on investments in China. The United States is a country of borrowing to live that experiences fiscal deficits and current account deficits almost every year and keeps running the “double deficits” policy. In recent years, the United States has large current account deficits with a rising trend. In theory, the total amount of US gross external debt should increase gradually. However, it has de facto unusually remained stable at between 2.2 and 2.4 trillion US Dollar. In the past four years, the annual increase in the amount of US current account deficits was about 400 to 600 billion. Since 2005, this number has increased to more than 700 billion and in 2008 after the financial crisis it has surpassed 1 trillion US dollars. However, the total amount of US external debt declined instead of increase. In other words, the huge US external debt strangely disappeared.

(c) Three channels to make the US external debt disappeared strangely.

The first channel is the dollar depreciation. As a result of the unfettered printing of the dollar by the Fed, the dollar comes to state of long-term depreciation, which is de facto debt repudiation. The second channel is the accretion of the US assets through high returns from the US foreign investments. For example, the United States borrows dollars from China through issuing treasury bills at little cost, and then invests the dollar in highly profitable sectors in China in the form of FDI, which rewards them more than 10% return. The third channel is the depreciation



of the US external debt. When the dollar depreciates, the dollar assets held by foreign governments is about to shrink values. This is how the United States engages in capital operation on global basis, very “impressive” indeed!

2. *Six major dilemmas of the international monetary system and prospect of reform*

1. *Six major dilemmas under the current US-dollar-dominated international monetary system*

(a) The new Triffin dilemma

The concept of “new Triffin dilemma” was suggested by Robert. N. McCauley in 2003. By analyzing capital flows between the US and East Asian countries, McCauley argues that the US needs East Asian capital to sustain current account deficits through low-cost debt. In other words, East Asian countries become “sub-banks” of the US. However, the supply of the US dollar from these sub-banks depends on the US FDI in East Asian countries as well as the US current account deficits. Once the US current account deficits become unsustainable, the amount of the dollar flowing back to the US will shrink and in turn influence the US financial market.

Therefore, the international trade is essentially a game in which the US issues dollar bills, and the other countries produce commodities to exchange dollar bills and finally these bills flow back to the US. In other words, the stability of the existing international monetary system relies on stability of the US dollar, while the dollar stability depends on the US balance of international payments. However, as the supply of international liquidity depends on the US current account deficits, the US privilege of “seigniorage” will further expand the US current account deficits and affect balance of international payments as well as international status of the US dollar. That is the “new Triffin dilemma.”

(b) The N-1 problem

In terms of the coordination mechanism of international balance of payments, any region composed of N countries with free capital flow and fixed exchange-rate regime will encounter “the N-1 problem.” In such kind of region, given N-1 countries holding fixed exchange rate policies, there is one degree-of-freedom left. Therefore, theoretically, there will be one currency which can artificially determine its internal and external values. How to distribute and use this degree-of-freedom is called “the N-1 problem.” There are three major solutions as follows:

The first solution is asymmetric solution. The Nth country is assumed to use the degree of freedom and implement its monetary policy independently, while other N-1 countries are responsible to maintain fixed exchange rate. The Nth country is thus the ‘core country’, while other N-1 countries are “periphery countries” as their monetary policies depend on that of the core country. As a result, they have to passively maintain fixed exchange rate and interest rate parity.

The second solution is symmetric solution. The N countries use the degree-of-freedom together and share the responsibility of maintaining N-1 fixed exchange rates. In other words, this is to establish a single super-sovereign currency. There is no “core country” or “periphery countries.” This solution can be achieved through members’ joint coordination or through establishment of a common central bank that implements a unified monetary policy.

The third solution is to introduce the N+1th independent variable that is called “external anchor” or “super-sovereign independent currency.” By pegging their currencies to the external anchor, N countries experience fixed exchange rates with each other. Furthermore, the price of the “external anchor” is determined by external factors, while the N currencies are determined by internal factors, and thus producing a compatible system.



Overall, the first solution has been implemented in the current international monetary system, while the second and third solutions are still at the theoretical level.

(c) The problem of “conflicted virtue”

The concept of “conflicted virtue” or “the effect of conflicted virtue” was suggested by Ronald McKinnon in 2004. McKinnon indicates that currency mismatch, i.e., the “conflicted virtue” will take place in any creditor country which is unable to lend in home currency. East Asian countries with high saving rates tend to maintain current account surpluses that will lead to an increase of foreign claims. However, East Asian creditor countries are unable to lend in home currencies. Amid the rise of foreign claims, there will be two results: As the US dollar claims accumulate, US dollar asset holders in East Asian countries increasingly worry about that this trend will push home currency towards appreciation. Meanwhile, as some East Asian countries continually maintain their trade surpluses, debtor countries will accuse them of artificially manipulating their currencies at unfairly low levels.

Consequently, there comes the problem of “conflicted virtue.” The more complaints are raised from trade-deficit countries, the more pressure is imposed on home currency towards appreciation, and the stronger expectation on home currency appreciation is from domestic US dollar asset holders. This process will then lead to a currency run through self-fulfilling mechanism. So long as there is currency run, the country will find itself in a dilemma that is difficult to select appreciation or depreciation of its currency. If currency appreciates, the economy will ultimately fall into a liquidity trap with deflation and zero interest rate bound. If not, the country will suffer from trade sanctions by foreign countries and then incur enormous loss. However, for creditor country with its home currency as international currency, the problem of “conflicted virtue” does not exist.

(d) Various US dollar traps

The first is the trap of economic development model. The “periphery countries” generally prefer US dollar reserve and most of them have adopted an export-oriented strategy. Finally, there comes an economic development model over-relying on exports but with insufficient domestic demand.

The second is the trap of foreign exchange reserves. The “periphery countries” with a great amount of US dollar assets will fall into a dilemma that the increase in US dollar reserves will lead to higher exchange rate risks, while the reduction in US dollar reserves will cause US dollar depreciation and shrink of US dollar assets.

The third is the trap of investment loss. The “periphery countries” mainly purchase US treasury bills with the yield of 2%~4% as the major channel for investment of foreign exchange reserves. In addition, these countries have paid expensive costs in finance, environment and society to attract FDI. Moreover, although some of these countries have higher saving rates, these savings cannot be converted into real investment due to inefficient investment channels.

The sovereign-debt crises in UAE and Greece uncovered the tip of the iceberg of the global sovereign-debt crisis. Currently the greatest systemic financial risk in the world is that the US is heavily in debt. The US gross debt has reached 12.3 trillion US dollar and the expenditure on the payments of debt interests, social security, health insurance and other welfare will account for 80% of overall federal income by 2020. In fact, the US government has been insolvent for a long time and the expenditure cut has become inevitable. Without US dollar’s international status, the US government would have already gone bankrupt. In other words, the whole world has been kidnapped by the US dollar and the US liabilities.

(e) The ratchet effects of the current financial crisis

The ratchet effects of the current financial crisis mean that the US-dollar-dominated international currency system exacerbates the accumulation and spread of financial risks. According to Stiglitz (2002), over the last 25 years before 2002, about 80~100 countries had experienced financial crises. The features of these crises are as follows: Firstly, financial



crises in certain periphery economies are closely related to the US macroeconomic policies, such as the Mexican and Asian crises in the 1990s, and their financial risks can only spread between each other, but is hard to affect the US.

Secondly, the US financial risks and financial crises mainly arise from its own reasons, but these risks and crises have easily spread around the world through channels of trade, finance and confidence, such as the 2008 global financial crisis. Financial markets of developing countries have always been the main speculative target of international capitals. It should be noticed that the US dollar always played the role of global 'safe harbor' and the US was the major beneficiary of the crisis during almost each financial crisis,

(f) The global excess liquidity

Under the US-dollar-dominated international monetary system, the US monetary policy leads to periodic depreciation of the US dollar, global excess liquidity, and then global inflation. In recent years, the fundamental reason of dramatic increase in global oil and commodity prices is over-issues of the US dollar. Since the US dollar was cut loose from gold in 1973, US dollar exchange rate has been negatively correlated with the prices of commodities, gold and crude oil. In the half year after the outbreak of the 2008 financial crisis, the amount of the US monetary base has risen by over 1 trillion US dollar, which sowed the seeds of global inflation, speculation of overseas hot money and financial instability.

2. Prospective reform approaches

XiaoChuan Zhou (2009), the governor of the Chinese central bank, believes that the aim of international monetary system reform is to create a super-sovereign reserve currency. He indicates that establishing an international currency unit proposed by Keynes is a bold initiative that requires extraordinary political vision and courage. In addition, because the Special Drawing Rights (SDR) has features and potentials of acting as a super-sovereign reserve currency, Zhou suggests promoting reform of the SDR distribution system. From this perspective, both Zhou and Keynes are idealists given their insightful but infeasible ideas. At present, the urgent mission for the international monetary system reform is to break the monopoly of the US dollar and establish a brand-new multi-polar international monetary system.

(a) To promote international financial institutions reform

First is to strengthen organizational function of IMF and members' coordination of monetary policies. Second is to reinforce the important role of the World Bank in stabilizing the existing international financial system. Third is to establish a lender of last resort on world-wide basis. Fourth is to establish a BIS-centered financial risk warning system.

(b) To improve the existing international financial regulatory system

Specific steps include: to enhance information transparency; to strengthen over the monitoring of hedge funds; to strengthen the supervision of offshore financial industries; to limit leverage ratios; to prevent excessive financial innovation; and to improve the capacity and execution of financial regulators.

(c) To reinforce international cooperation and coordination in terms of economic and financial issues

First is to coordinate the relationships between developed and developing countries, to protect and support developing countries and regions. Second is to coordinate the relationships among developed countries. Third is to improve cooperation and coordination in terms of international financial issues, such as business condition, internal control, market discipline and financial regulatory.



(d) To strengthen China's participation in the reform

First is to promote the transparency of the IMF decision-making mechanism. Second is to coordinate monetary policies among Asian countries referring to the EU experiences and then to form a competitive structure of "three pillars" including the US dollar, the Euro, and RMB. Under this competitive situation, it will be easier for the EU and the US to accept reform plans proposed by China, and it will finally strengthen the discourse, the right to know as well as the power of rule-setting of developing countries in the international financial system.

3. Establishment of new "three pillars" for international monetary system

At present, the US-dollar-dominated international monetary system is extremely unreasonable and unstable. It is urgent to establish the "three pillars" for new international monetary system. Based on historical and present experiences, a unified currency system in East Asia which is known as the "Asian dollar" lacks the reality basis. It is a general trend that RMB is becoming the international currency and one of the three pillars.

1) Chinese feasible countermeasures to the decline of US dollar

The 2008 global financial crisis is definitely not only a simple periodic and localized financial crisis, but a crisis of "Anglo-Saxon model" of the capitalist mode of production, a crisis of the "Washington consensus" and especially a crisis of the US-dollar-dominated international monetary system. During the 1998 Asian financial crisis, western countries ascribed it to "crony capitalism," the over-sized banking sector in the financial system, the weak role of capital market in allocating financial resources and inadequate financial supervision.

Meantime, US has acted as a teacher to propagandize the "Anglo-Saxon" financial model all over the world. Compared with Japanese model, German model and East Asian model, "Anglo-Saxon model" had been considered the most perfect financial model with universal value. Developing countries have to humbly reconstruct their financial systems based on this model. Ironically, teacher himself suddenly made serious mistakes before students finished their papers.

China, on behalf of the East Asian countries, needs to take warning and adjust strategic and economic structure as soon as possible. Otherwise, such kind of the global financial crisis can be expressed by the Chinese proverb that "a fire on city wall brings disaster to the fish in the moat" and will be repeated periodically. China is supposed to redesign its national financial structure from a strategic perspective.

First of all, dependent status of the RMB on the US dollars should be changed. With RMB closely linking to US dollar, Chinese economy tends to lose international competitiveness. This could be learned from commonwealth countries that suffered from the decline of British pound. Now, RMB has been no longer pegged to the US dollar. Instead, it has been pegged to a basket of currencies, switching from fixed exchange rate regime to manageable floating exchange rate regime. China would accelerate the RMB internationalization by experiencing RMB appreciation on a gradual basis.

Secondly, China needs to gradually get rid of the dependency on US economy, by shifting economic development strategy from export-led to domestic demand-led. Based on the manufacturing industry, Chinese policies include: to develop the emerging industries and modern services, to optimize the industrial structure, to promote the geographical diversification of trade and to develop the intra-regional trade and investment in East Asian countries to build the mechanism of endogenous growth. At present, the Free Trade Area (FTA) between China and ASEAN has already been established, and Japan and South Korea are expected to participate in the near future.

Thirdly, the allocation of Chinese foreign assets needs to be optimized. China should ease capital controls on residents and business so that the private sector can play a main role in



overseas investment, which supports the strategy of “going abroad” for Chinese enterprises to implement overseas mergers and acquisitions. This is conducive to the establishment of overseas energy and resource bases, expansion and optimization of overseas assets, and appropriate increase of the euro, Japanese yen holdings and positions in commodity in order to achieve diversification of reserve assets and to avoid risks of the US dollar depreciation.

Fourthly, China needs to strengthen international financial cooperation. China could act as a leader in Asian countries. A unified voice is expected to be delivered by East Asian countries to the world. It has been and will be a right path for East Asian countries to strengthen cooperation in the fields of reforming international monetary system, and supervising sovereign wealth funds so that they will obtain complete information, discursive power and independency of decision-making. Moreover, they could together claim that US should take responsibilities and prevent unfettered currency depreciation.

2) *Enhance RMB internationalization*

Currency internationalization is the result of market selection, and the economic power determines the strength of currency. With the rise of Chinese economy, it is the right time for RMB internationalization.

First of all, RMB has to get rid of the tight relationship with US dollar. China used to adopt fixed exchange rate regime pegging to US dollar to maintain the stability of RMB exchange rate. This was helpful at the first stage of RMB internationalization. But in the long run, this will limit such process since it lacks independence. Now, the RMB exchange rate regime has been reformed, and China will keep pegging to a basket of currencies, and gradually get rid of the impact of US dollar.

Secondly, the “three-step” strategy needs to be put forward. At the first step, RMB is circulated and used in the surrounding regions of China. At the second step, RMB engages in large-scale trade and financial settlement, which has been known as RMB regionalization. At the last step, RMB becomes an international reserve currency. Actually, in the “three-step” process, RMB gradually serves as a currency of international settlement, international investment and international reserve, which are the three major functions of international currency.

Thirdly, RMB needs to pursue the right path from the regional currency to the international currency based in Asia. By relying on cooperative mechanism of East Asian “10+3”, RMB internationalization requires RMB to improve influence in Asia-Pacific, to actively participate in the Asian monetary cooperation, to increase the share of RMB used in the regional trade, and to gradually penetrate into financial and investment market. Moreover, building more channels and generating relevant mechanisms are required as well to satisfy conditions of RMB to be reserve assets.

Fourthly, the international monetary functions of RMB should be actively cultivated. China could encourage bilateral trade and investment with RMB. Meanwhile, commitments that the overseas holders of RMB are able to freely convert RMB into US dollar needs to be provided. The ideal result is that more countries are willing to accept RMB. By now, the approximate amount of China's foreign exchange reserves is 2.45 trillion US dollars, so China has the ability to fulfill her commitments.

Fifthly, unnecessary foreign exchange controls need to be eliminated gradually. Relaxation of capital controls is the inner need of economic development, and strict exchange controls have impeded the process RMB internationalization. China's economic rise and improvement of macro-control capacity have increased the risk resistibility of capital account. RMB convertibility should be gradually put into practice.

Sixthly, Shanghai and Hong Kong should perform functions of international financial centers. The serious problem in RMB international settlement is the lack of RMB in the foreign market. Referring to experiences of “Marshall Plan” and overseas loans in Japanese yen, money must



be “lent”. In addition, more feasible plans are suggested, for example, developing off-shore financial services in Shanghai and Hong Kong, accelerating the launch of international board of Shanghai stock exchange and encouraging foreign companies to list A-share and issue RMB bonds on the Shanghai Stock Exchange and Hong Kong Stock Exchange.

Seventhly, the circumfluence mechanism of overseas RMB needs to be established. If there is no normal channel for circumfluence of overseas RMB, it would flow back to China illegally, which results in active trading of illegal private banks and smuggling currency. This not only threatens China’s financial security, but also impedes RMB to be regarded as a reserve currency in neighboring countries and regions. In addition to expanding the use of RMB in cross-border trade, China should promise that overseas RMB can be used to purchase Chinese goods and government bonds, and directly invest in China.

Eighthly, Hong Kong dollar is proposed to link to RMB. There has been a tighter economic relationship between Hong Kong and mainland China. Hence, the fact that Hong Kong dollar was pegged to US dollar for a long time is not only adverse to the economic development of Hong Kong, but also against RMB internationalization. The currency that Hong Kong dollar is pegged to should switch from US dollar to RMB by Hong Kong Special Administration Region Government.

3) *Prospects for RMB internationalization*

RMB internationalization is on the way, but in general, it is still at the early stage. International currency always serves as a medium of exchange, a unit of account and a store of value in the international trade, which is expected to occur in third-party transactions without involvement of China. By now, labor migration is the main force to push RMB flow across border, which means RMB tends to be more popular in places inhabited by a large number of Chinese people. However, in the international financial market, RMB is merely a trading symbol applying to Non-Deliverable Forward, etc. It cannot be employed for international settlement, and is independent of international cash flow. Therefore, RMB internationalization still has long way to go.

The US-dollar-dominated international monetary system has been modified. The fact of decline of Japanese yen and the lack of Asian currencies is far from matched to the “three pillars” of global economy. China is expected to become the second largest economy in the world in 2010 and the new situation needs RMB to be one of international currencies in urgency. Furthermore, East-Asian trade liberalization and investment facilitation need a medium of exchange to deepen financial cooperation and to form regional monetary integration, which provides an opportunity for RMB regionalization. China is becoming the Asian economic leader who has the responsibility to promote regional economic development and expand the role of Asia.

There is a dispute of monetary hegemony between Japanese yen and RMB in East Asian financial cooperation. In the short term, China should actively participate in the “10+3” financial cooperation and promote RMB integration to Asian financial system. In the long term, different from Japan, China does not have historical problems on issues of politics and diplomacy in East Asia. The responsible attitude of Chinese Government has gained recognitions from most countries and brought about good reputation.

In the upcoming decade, RMB has the potential to be the same influential as Japanese yen, British pound and other secondary international currencies. With appropriate operational strategy in the right direction, RMB, the US dollar and the Euro are likely to form the “three pillars” of international monetary system in the mid-21st century.

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