CHINA ANALYSIS

REDBACKS FOR GREENBACKS: THE INTERNATIONALISATION OF THE RENMINBI

ABOUT

Strategic culture, power balances and the analysis of geopolitical shifts are a long-standing Chinese obsession. Academic institutions, think tanks, journals and web-based debate are growing in number and quality. They work to give China's foreign policies breadth and depth.

China Analysis introduces European audiences to the debates inside China's expert and think-tank world, and helps the European policy community understand how China's leadership thinks about domestic and foreign policy issues. While freedom of expression and information remain restricted in China's media, these published sources and debates are the only available access we have to understand emerging trends within China.

China Analysis mainly draws on Chinese mainland sources, but also monitors content in Chinese-language publications from Hong Kong and Taiwan. Reports from Hong Kong and Taiwan reflect the diversity of Chinese thinking, with occasional news and analysis unpublished in the mainland.

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Introduction
by François Godement

Although capital controls have never been lifted in China, the interactions between its economy and global currency markets are now huge. China has seen it all once before – during the Asian financial crisis in 1997. But the interdependence between China and the world economy has grown infinitely larger since then. In effect, while China's economy has become internationalised, the global economy has become Sinicized. Not only does China hold nearly $3 trillion of foreign currency reserves (including $400 million that it accumulated in the three months to September 30), it has also become a world-wide supplier of soft loans and investment.

When Beijing raises domestic interest rates, this has an immediate worldwide impact on stocks, because investors believe that a higher cost for Chinese capital will depress the international economy. Conversely, the global bubble created by Chinese – and Asian – purchase of a nearly limitless amount of dollars fuels price and asset inflation back into China.

It is therefore no longer good enough to cite the remaining lead of the West, or China's relatively low per capita GDP, or the past example of Japan's growth running into a wall since 1990. China's growth model is completely different, and coincides with an unprecedented globalised economy.

Expectations of convergence have been frustrated

Given this new situation of interdependence, many monetary experts have deduced that China's currency was bound to be internationalised – starting with flexible exchange rates and upwards re-evaluation and ending with free convertibility. In March 2010, the Chinese dropped hints to that effect, and in July, a policy change was announced. On this issue as on others, observers have often concluded that China's convergence with global standards was the inevitable outcome. This just happened to coincide with the needs of China's main economic partners – the industrialised countries which have become leading importers of Chinese exports and the emerging economies which compete with China for exports.

However, facts on the ground have resisted the expert consensus, and expectations of convergence have been frustrated. China's currency hasn't really moved up from the dollar peg that was set in 2008. The renminbi – or "redback", as it is sometimes called in China - did appreciate between 2005 and 2008 relative to the dollar – but because the dollar was bottoming at the time, the terms of trade did not change with Europe. This largely explains why China's trade surpluses have rebounded – as well as capital inflows, driven by expectations of a re-evaluation yet to come. Many economists argue that China's low currency has nothing to do with its export strength, and comes instead from global imbalances, with America's need for imported capital requiring a permanent capital fix from China. In sum, China cannot but buy dollars - and that's what keeps the renminbi down. So why do China's leaders (and recently even Premier Wen Jiabao in Brussels) somberly predict a severe downturn and huge unemployment if the renminbi were to rise?

It's the geopolitics, stupid.

Perhaps they know something that international economists don't. Although China's economic policy rides the market, it seeks at all costs to avoid being overwhelmed by the market. The research in this issue of China Analysis shows the strong geopolitical basis that underpins China's monetary and financial policies. This is not only a function of China's regime and past ideology – although they do play a role, of course – but also has to do with its history. Having been on the losing side of currency conflicts for a century and a half, it has a tradition of using money – and financial institutions - as a tool and not as an end in itself. It builds on the negative experience of Japan, which was compelled to give up its dollar anchor in 1985. Chinese economists are probably getting Japan's experience wrong, because they think it erred by internationalising its currency when in fact Japan stopped half-way. But they are right in judging that China can succeed where Japan failed. Simply because of the scale and growth in China's economy, it might just be able to resist the trend towards a universal Bretton Woods system of floating exchange rates.

The sources analysed in this issue not only cite historical examples (most fascinatingly, Germany and the D-mark zone in the decades of post-war European economic growth). They also repeat a familiar script by implying that investors will by themselves find the road to China's "peach garden" without any need for Chinese convergence and convertibility. China indeed became the emerging world's number one destination for industrial investment while retaining many of its controls. Today, a two-tier Chinese money market allows foreigners – from Malaysia's central bank to hedge funds – to invest in the renminbi, and that is a big step forward from China's swap agreements with its raw material suppliers of the previous two years.

G20 = G1 + 19

This has consequences for the ongoing debate in the G20 about the reform of the monetary system. It remains hard to imagine that, in the long term, China could become the number one global economy and the world's main capital centre without convertibility. Like limitless trade surpluses, this would simply beg rejection by China's partners and break the system. India, for example, has been much closer to prevailing monetary rules, and is resisting mercantilist monetary games. So is Japan, if not Korea. But China is in no hurry. Every year that it keeps its capital controls and a significant surplus position, while the Western economies grapple with the difficulties of their open economies, and competing emerging economies struggle against re-evaluation, it buys time for Chinese hypergrowth.

If China can retain capital controls and the opacity of its capital flows, it implies that the renminbi is building considerable strength outside the world's monetary system rather than inside it. Of course, China pays taxes: to the world's monetary mint, the Federal Reserve, and to the world's tiny public bank of last resort, the IMF, by agreeing to increase its reserves. It also hedges against its excessive dollar reserves. This now includes investing in the public debt of EU member states, buying European infrastructures and propping up Chinese state firms with soft loans – for example, to build a motorway in Poland as it does in Africa.

China's general monetary policies and its stand on the international system are a function of its geopolitical perceptions. Its practical investment choices rest more on business calculations. As an example of the latter, one of our sources in this issue indicates that the Chinese consensus on Europe's economy has been quite negative – there was only one positive view of Europe, which suggested that the situation provided opportunities for low cost acquisitions. Of course, China's commercial diplomacy is keen to highlight a linkage between good political relations and business deals by China. Europeans should realize that Chinese choices are in fact quite cautious and diversified all over the global map. China's new interest in European public debt and investment will not obviate the need for a European economic strategy to deal with China.

1. The renminbi: "Our currency, your problem"

by François Godement

Sources:
Xiandai Guoji Guanxi, no. 6, 2010, pp. 1-19:
Ma Xiaojun, "Considerations on the current international financial situation from the standpoint of international strategy".[1]
Jiang Yong, "The RMB: China's currency, the world's problem".[2]
He Zhicheng, "The nature of exchange rates and reforming the exchange mechanisms of the RMB".[3]
Huang He, "Some of the constraints on internationalising the RMB".[4]
Fu Mengzi, "The economic and strategic dialogue between China and the USA: looking beyond the exchange rate".[5]
Wang Yuanlong, "The thesis on the undervaluation of the RMB has little basis".[6]
Ding Zhijie, "We must actively promote the inclusion of the RMB in the Special Drawing Rights (SDRs) basket of currencies".[7]
Chen Daofu, "The regionalisation of the RMB must be speeded up".[8]
Lin Limin, "Peaches and plums have no need to speak, the world comes to them by itself".[9]

China's experts cannot decide whether internationalising the Chinese currency is an opportunity, a necessity, a problem or a trap. Xiandai Guoji Guanxi's report is the result of a seminar held at the China Institutes of Contemporary International Relations (CICIR) on 4 June 2010. It offers a range of contrasting perspectives on internationalisation, which look at the problem through the lens of political economy, geopolitics, and even gut-feeling politics, rather than through theoretical and quantitative economics, an approach that is more or less dismissed in the report. In the introduction on behalf of the international strategy centre of the Party central school, Ma Xiaojun says that experts in international relations need to take economic and financial matters into consideration in their writing, but he stresses that economists and financial experts must learn how to undertake "strategic research" if they are to make a useful contribution to their country's great projects (大政方针, *dazheng fangzhen*). He also sets the limits of the discussion: nobody is saying that the United States can be replaced as the head of the international financial system.

The writers display a wide range of opinions – and of temperaments. He Zhicheng, an old timer from the Agricultural Bank of China, argues that exchange rates reflect the comparative value of labour and that free-floating rates are a "trap" for China, because they let foreign contractors determine the value of Chinese labour. A Toyota employee, for example, earns 800 yuan (120 dollars)a month in Dongguan and 28,000 yuan (4,200 dollars) in Japan. He says the Americans are deceitful in their pursuit of speculative money: "in 2007 they engineered the fall of the dollar, and you had to buy euro, while in 2010 it is the opposite". In contrast, Huang He, a young economics professor at Fudan, uses the theories of liberal economics in setting conditions for internationalising the renminbi. He thinks that even though the non-convertibility of China's capital holdings may be a firewall that has so far protected the Chinese economy, it is also an Achilles' heel inhibiting the country's international financial expansion.

There is an equally wide gap in opinion and expression between Jiang Yong, an expert in economic security, Ding Zhijie, a professor of finance. Jiang champions the so-called redback (红币, *hongbi*) against the US greenback, adapting in support of his argument a well-known saying: "the renminbi is China's currency, and the world's problem".[10] He mocks the mathematical models with their "ridiculous" notion of balanced rates that claim to "demonstrate" that the renminbi is undervalued: "American national interest is the mathematical model here!" Ding, on the other hand, relies largely on official IMF documents in calling for a full integration of the Chinese currency as a major international reserve currency. This integration would have to start with the reserves held by the IMF, and, he says, would mean first significantly revaluing the Chinese currency upward.[11]

Despite their different approaches, He Zhicheng, Huang He, Jiang Yong, and Ding Zhijie are all in favour of the internationalisation of the renminbi. Jiang Yong thinks internationalisation would offer a way of escaping blackmail and reserve currency manipulation by the United States, and sees it as a strategic option "as important as New China's becoming a nuclear power". Ding Zhijie believes

1 Ma Xiaojun is a professor at the Centre for Strategic Research at the Central Party School.
2 Chen Fengying is head of the China Institutes of Contemporary International Relations (CICIR) Institute of World Economic Studies. Jiang Yong is director of the CICIR Centre for Economic Security.
3 He Zhicheng is a senior economist on the board of the Agricultural Bank of China.
4 Huang He is a post-doctoral associate professor at the College of International Relations and Public Affairs at Fudan University.
5 Fu Mengzi is a researcher and assistant chairman at the CICIR.
6 Wang Yuanlong is an economics professor and researcher at the Tianda Institute (Hong Kong).
7 Ding Zhijie is co-director of the College of Finance at the Chinese University of Economics and Foreign Trade.
8 Chen Daofu is director of the Institute of Financial Studies at the Centre for Development Studies, the State Council of the PRC.
9 Lin Limin is a researcher at the CICIR and chief editor of its journal. His article title, 桃李无言，自成蹊 (*taoli wu yan, zi cheng xi),* is a maxim taken from the biography of General Li Guang (2nd century BC) in the *Historical Memoirs* by Si Maqian (translated in its entirety into French by Alexandre de Chavannes and reissued by Maisonneuve, Paris, 1967). Under the Han dynasty, Li Guang fought against the nomadic Xiongnu confederacy.
10 The remark that the dollar is "our currency, your problem" was attributed to the Treasury Secretary, John Connolly, when the Nixon administration abandoned the gold standard in 1971.
11 In March 2010, when China seemed about to announce a movement towards floating exchange rates, Ding Zhijie put forward the idea of fixing the exchange value of the RMB against a basket of currencies measured by their relative weight in international trade. See "China leans towards yuan float", Caixin online, 17 March 2010, http://www.marketwatch.com/story/china-leans-toward-yuan-float-2010-03-17.

that the leading member countries of the IMF are opposed to China's rising power in the organisation. He says that when some African countries proposed the inclusion of the renminbi as a currency for Special Drawing Rights (SDR), the leading members "invented" the need for the "freedom of use of the renminbi" as a precondition. Ding says that since in 2005-2009 China was one of the top five trading nations and Britain was not, the pound sterling should be dropped from the SDR basket when conditions are reviewed before the end of 2010, and the renminbi should be included. To get round the inevitable Western veto, Ding proposes widening the basket to include the currencies of eight of the ten major trading powers. This would include the Canadian dollar, the Korean won, and the Russian rouble. It would exclude the Hong Kong dollar, because it is too close to China, and the Singaporean dollar, since that territory refuses to let its currency be internationalised.

All of the essays share a common set of assumptions. China's influence within the global economy and markets will continue to expand. The power of the United States and Europe, who are often referred to as the "leading countries" of the financial system, is in decline. Even so, the role of the United States in the Western financial system has grown throughout the crisis. It remains more than ever the lynchpin of the system, whatever its own economic difficulties. Internationalising the renminbi will help China's influence to grow; it will strengthen the international mobility of its capital and so enhance its investments. It will reduce the vulnerability of its reserves, mitigate the impact of the huge fluctuations in the dollar exchange rates, decrease the power of Western financial centres, and create revenue for China from transactions in its currency. But rapid internationalisation could have its own drawbacks, and some methods of carrying it out could prove dangerous. Changes in the international monetary system tend to be prolonged and perilous, as can be seen from the history of the euro and the Japanese yen.

Some of the authors may not fully accept all of these principles, but they are generally careful to mask their doubts. On the dangers of internationalisation, though, opinion is more clearly divided. The magazine's editor, Lin Limin, exposes what must have been the real heart of the debate when he writes that the economists were equally split – seven against seven – for and against the internationalisation of the renminbi. With an adroit sidestepping of the controversy, he concludes that economic analysis has really yielded all it can, so it is time to move on to a political decision. So, the central theme of the report is the political implications and strategy of internationalisation. But it is clear that the Chinese experts have profound misgivings about, and serious criticisms of, the international monetary order, both now and as it was in the past. Even if internationalisation is not really up for debate, the contributors have much to say about the flexibility and the free exchange rates of the renminbi, two issues that are central to their concerns about internationalisation.

One point of contention is the necessity of a move from the current floating but managed exchange rate – which is pegged to the dollar, although the experts rarely mention that – to a free-floating rate. The writers argue that this move is not needed to internationalise a currency and could even be viewed as a trap. Several of the contributors rehearse the history of the Bretton Woods system from its inception in 1944 to its end in 1971, when the gold standard was abandoned. The international supremacy of the dollar was built during this period and became the global standard after 1971. But, the contributors say, its dominance rested on the United States' control over raw materials, especially oil. The idea that exchange rates are fixed through the markets in response to rational criteria is a myth of quantitative economics, repeated by subservient Chinese economists trained in the West.

The truth, according to these contributors, is that, since 1944, the dollar has lost 97% of its value against gold. The US has repeatedly made abrupt and rapid variations in the value of the dollar against other major currencies – some of the writers put this margin at 30% per year – in the service of its own economic interests. Some even say that the troubles of the yen and the euro were in fact due to American revenge-seeking. They claim that the US eviscerates anyone who challenges its monetary supremacy, the central pillar of its economic hegemony, and at the same time creates large exchange variations for its own profit. So, the argument goes, most countries reject the floating rate, seeing it as what it is – a mechanism for plunder.

Internationalising the renminbi will help China's influence to grow; it will strengthen the international mobility of its capital and so enhance its investments.

All the contributors see the experience of Japan as an experiment in the internationalisation of the yen, although it is generally considered that Japan imposed considerable restrictions on internationalisation. Japan has always refused to have its trade transactions calculated in yen, preferring instead to benefit from the unofficial dollar area of East Asia.[12] The Chinese approach is the opposite: it is trying to replace the dollar with the renminbi as the currency for doing business with its trade partners.

Jiang Yong proposes a solution somewhere between external and internal use for the renminbi: the "redback" should be the currency for commercial settlements, investments, and reserves for both sides of the Taiwan Strait, thus becoming "the currency of greater China". But he conveniently forgets to mention the need to find a place for the Hong Kong dollar, a currency that provides considerable support for China's capital account. Chen Daofu says that before the advent

12 See "Why has the yen failed to become a dominant invoicing currency in Asia? A firm-level analysis of Japanese exporters' invoicing behaviour", by Takatoshi Ito, Satoshi, Kiyotaka Satoo, and Junko Shimizu, *NBER Working Paper* no. 16231, July 2010.

of the euro, Germany was able to internationalise the deutschmark without entirely giving up control over capital movements and without going over completely to a floating exchange rate. Ding Zhijie calls for Article 8 of the IMF to be amended so that the currencies joining the SDR basket would only have to make their current accounts, and not their capital accounts, convertible.

There is another series of obstacles that are unique to China which make the internationalisation of the renminbi a risky undertaking. China has to deal with its domestic economic imbalances and its pockets of under-development. The banking system and the Central Bank of China suffer from a lack of experience in managing reserves. Chinese investors have little confidence in the economic policies of their country and its central bank, because China has neither an independent banking system nor a credible policy on interest rates. And many are concerned about the country's rising inflation.

Huang He points out that the large personal fortunes of individuals have played a huge role in the Chinese economy. According to the 2010 edition of the China Rich List, which received wide coverage in the Chinese media, there are currently more than 550,000 households with more than 100 million yuan; over 1,900 with more than 1 billion yuan; and 140 private fortunes of more than 10 billion yuan (1.5 billion dollars).[13] Altogether, private wealth exceeds the value of the country's foreign exchange reserves. According to a report from the agencies handling visas for the Beijing region found that the number of people who departed for the USA on an investor's visa had risen from 500 to 1,000 during the year 2009.[14] Chen Daofu speaks of the "opportunism" of Chinese capital holders, as well as their lack of confidence in Chinese economic and monetary policy.

Still, the internationalisation of the renminbi seems inevitable. Chen Fengying says that the Chinese economy will continue its rapid growth, mainly thanks to the expansion of the environmental industries and renewable energy. He cites "Plan 125" as laid down in China's 12th Five-Year Plan.[15] Like Ma Xiaojun, Chen believes in a Schumpeter cycle of innovation to re-launch the global economy – and he thinks China will drive it. Quoting from an IMF study (for which he does not give a reference), he says that by 2015 China will account for 11.5% of the global economy and will hold 19% of the world's foreign exchange reserves. But it will run up a deficit, owing to a boom in domestic consumption that Chen thinks will happen as other areas approach the standards of living currently enjoyed by the inhabitants of the large urban centres. In China's cities, the average income is 10,000 dollars, and this level will become the norm. Chinese enterprises will have to increase their foreign investments, so as to guard against protectionism and the rise in the value of their currency. So, China needs the renminbi to be strong – or, in other words, convertible.

What path should the renminbi take to internationalisation? The evidence of current trends along with the perspectives put together by these writers point to a direction for the renminbi that is very different from other currencies' experiences, with the exception perhaps of the pound sterling at the height of the British Empire. The renminbi must first become a currency for commercial trade, and later for investment, loans, and reserves, with China's regional trade partners, and with other countries with state-run economies. These partners will benefit from access to China's market for financial investments.

Chen Fengying, Chen Daofu, and Lin Limin all advocate this route, which would entail a gradual *de facto* internationalisation, avoiding the disadvantages of free convertibility and the corresponding loss of sovereignty. China must set up a zone of influence that would take in some of its regional partners but would not be definable simply as a geographical area. Some of the countries of Asia will resist coming together under China's influence, whether because they want to maintain their own identities, or due to political ideology or because of economic considerations. They will insist on remaining linked to the dollar zone; they would resent any move by China to set up its own zone on the pattern of the dollar zone, and China would end up being isolated (Lin Limin). Besides, the contributors have a wide-ranging list of possible partner countries within and outside Asia, including not only Korea, India, Indonesia, Malaysia, Mongolia, Russia, and Vietnam, but also Argentina, and even Iceland.[16]

Since China's partners do not think of it a market economy, it can pragmatically and silently build up a diffuse monetary zone of its own. Chen Daofu quotes the poet Du Fu: "The rain silently moistens the surroundings" (润物细无声, *runwu xi wusheng).* This kind of internationalisation by stealth is based on the requirements of political realities – any other approach could see internationalisation swiftly "stifled in the cradle" (被扼杀在摇篮里, *bei esha zai yaolan li).* Chen says that China must retain control over exchanges between its domestic economy and the outside world, along with its restrictions on foreign currency holdings by Chinese enterprises. At the same time, China must provide the renminbi with an external market – and so anchor the country in its own de facto currency zone.

Zhang Zihai goes into more detailed planning, although a number of his colleagues would not agree with his scenario for internationalisation. Between 2010 and 2020,

13 The Hurun Report or China Rich List, founded in 1999 by a former foreign trader, Rupert Hoogewert, available at www.hurun.net.

14 出入境中介机构协会 (*churu jing zhongjie jigou xiehui),* association of the organisations handling exit visas.

15 "Plan 125", a part of the 12th Five-Year Plan (2011-2015), will give priority to renewable energy technologies, the fight against climate change, clean vehicles, and the military industries.

16 Mentioned by Lin Limin. Thanks to the Icelandic financial crisis, China has gained a foothold there, with an eye to possibly tapping the natural resources of the Arctic.

the renminbi would become the currency for regional trade and trade with state-run economies. This would necessitate both regional co-operation and co-operation with the IMF. From 2020 to 2030, the renminbi would be used to fix prices and work as a regional trade currency, within an area extending from greater China to ASEAN + 1 (which, significantly, leaves out Japan). The renminbi could be allowed to fluctuate more within a stable monetary zone and a regional reserve system could be built. From 2030 to 2040, the Chinese currency would be used for all financial settlements, on an equal footing with other major currencies like the dollar and the euro. Its value would fluctuate in relation to the dollar and the euro, but it would be anchored in a fixed exchange zone and would represent between 20% and 25% of all global reserves.

Lin Limin ends with a play on Clemenceau: the economy is too serious to be left to the economists. The creation of an independent international reserve currency as proposed by Zhou Xiaochuan in March 2009 is not a realistic prospect.[17] China has no interest in following the American model in letting its currency be used for the benefit of the international community. The German model is showing its limitations, and the Japanese model has failed. China has its own domestic priorities, as well as ideological conflicts with its trading partners. The time is not yet right – at the moment, the internationalisation of the renminbi has stalled, as the Chinese economy continues its rapid ascent.

China should therefore pursue its course of "peaceful ascent" *(*和平崛起, *heping jueqi)* and should "hide its talents and bide its time" (韬光养, *taoguang yanghui).* It must follow its own path, flowing separately (曲径通幽, *qujing tongyou,* a metaphor drawn from the pathways of a classical Chinese garden). This Chinese model will by its example cause the rest of the world to adapt to it – because "peaches and plums have no need to speak, the world comes to them by itself".

17 Governor of the central bank, the People's Bank of China.

2. Internationalisation without convertibility

by Thomas Vendryes

Sources:
Ge Huayong, "The renminbi must be in the Special Drawing Rights basket of currrencies", *Reform in China, Zhongguo gaige,* 2010, no. 10.[18]
Gao Haihong, "Prospects of the renminbi becoming an international currency", *Shijie Jingji yu Zhengzhi,* 2010, no. 9.[19]

The subprime mortgage crisis has made international monetary relations a key topic of discussion in Chinese political and academic circles. Gao Haihong says that Zhou Xiaochuan, governor of the central People's Bank of China, outlined the Chinese position in a speech on 23 March 2009, ahead of the G20 meeting in London in April on coordinating a response to the international financial and economic crisis.[20] One of the major causes of the crisis, according to Zhou, was the deregulation of the international monetary system and the dominance of the dollar since the Bretton Woods agreements. So, if the international economic environment is to be stabilised, the international monetary system needs to be reformed and the power of the United States must be reduced. The ideal solution would be a multilateral negotiated agreement, involving, for example, the introduction of a supranational reserve currency (超主权储备货币, *chaozhuquan chubei huobi).* Gao Haihong notes from the beginning of her article that such a solution is extremely unlikely but says a multipolar monetary system must emerge, whether negotiated or not – and this necessarily implies the internationalisation of the renminbi.

Since Zhou's speech, there has been much debate about the gains, the costs, the conditions, and the timetable for the internationalisation of the Chinese currency within an international monetary order, whether established through negotiations or not. A new theme has emerged from these discussions, corresponding to a new political demand from the Chinese government: the integration of the renminbi into the basket of currencies that fix the value of the IMF's Special Drawing Rights (SDRs).[21]

Ge Huayong thinks that making the renminbi an element in the SDRs would solve some of the imbalances in the current international monetary system. It would also strengthen China's influence in world monetary and financial affairs.

18 Ge Huayong is the director of the organisational department of the Party committee and the personnel department at the Bank of China.
19 Gao Haihong is a researcher for the Institute of Global Politics and Economy at the Chinese Academy of Social Sciences, and she is director of the research bureau on international finance.
20 Zhou Xiaochuan, "Reforming the international monetary system", a speech delivered on 23 March 2009, available in English at http://www.pbc.gov.cn/english//detail.asp?col=6500&col=4200&ID=279.
21 According to the Japanese newspaper Sankei Shimbun, quoted in Reuters, 'China wants yuan in SDR in 2015: report', 6 March 2010, http://www.reuters.com/article/idUSTRE6250LC20100306.

He notes that the SDRs were created in 1969 within the fixed exchange parities agreed at Bretton Woods as credit instruments capable of functioning as a reserve currency. The idea was for the IMF to set up some "paper gold" (纸黄金, *zhi huangjin)* that could replace the US dollar as a reserve currency if the dollar should ever fail. The method of determining the value of the SDRs has varied. At the beginning, the value was fixed in relation to the gold standard, the mainstay of the Bretton Woods system, so that one unit was worth exactly one US dollar. Since 18 September 1980, SDRs have been backed by a basket of currencies including the US dollar, the Japanese yen, the pound sterling, the German mark and the French franc (with the mark and the franc being replaced by the euro in 1999). Every five years the composition of the basket – that is, the nature and relative weighting of the component currencies – is revised. So, China would demand that its currency be included in the basket of currencies in the revision of 2015.[22]

According to Ge Huayong, there would be two benefits of including the renminbi in the SDRs. In terms of the global system, the inclusion of the renminbi and potentially the currencies of other emerging countries could strengthen the representativeness of the SDRs and increase the diversity of the reserve currencies. This would improve the stability of the international monetary system as a whole and encourage balanced growth in the global economy. For China, it would allow the renminbi to be internationalised as part of multilateral negotiations, thus reducing the tensions inherent in China's inevitable emergence on the international monetary scene.

However, there is a major obstacle preventing the IMF and the member states from agreeing to this development. The renminbi does not meet the two criteria for a currency's inclusion in the SDRs' currency basket. It is not a "trading currency" (贸易货币 , *maoyi huobi),* meaning one that is used for international trade and is available on the exchange markets, nor is it a "freely usable currency" *(*可自由使用的货币*, ke ziyou shiyong de huobi).* Ge Huayong acknowledges that an opening up of China's capital account is necessary, but he focuses on spelling out the institutional means that the People's Republic has at its disposal to have the rules changed, or at least interpreted in its favour. In this way, the renminbi could join the basket of currencies while still maintaining strict control over the movement of capital and the exchange rate of the Chinese currency.

Gao Haihong agrees with Ge's summation. She insists that opening China's capital account and the free convertibility of the renminbi must not be preconditions for its internationalisation. Internationalisation must take place anyway – or rather, it must continue, since initial agreements towards it have already been signed, in the form of bilateral and regional accords that have gradually extended the role of the renminbi as a currency for trade between China and its economic partners. This gradual extension of the renminbi's geographical operational zone must be accompanied by an increasing liberalisation of the movement of capital.

These two articles are representative of current political and academic thinking in China on international monetary relations and the internationalisation of the renminbi. They show a real dissatisfaction with the current functioning of the international monetary system, and especially with the dominant role of the dollar. China has been calling for a meaningful change to the system since the beginning of 2009, most notably at the G20 summits. This in itself is a healthy development from the viewpoint of China's partners, because a debate on international monetary relations is needed, and also because, as Ge Huayong says, it shows China's willingness to prove that it is looking for areas of mutual interest with its main partners. China seems to want to search for a multilateral, negotiated resolution to today's monetary conflicts.

The authors often seem to see monetary status as an essential good in itself, because they have a very political perception of the dynamics at work. This is particularly clear in the case of the debate about including the renminbi in the IMF Special Drawing Rights. As Ge Huayong writes, China believes that this will give the renminbi an international status, and that it will increase its role as a reserve currency, even if the free usage of the renminbi remains under strict constraints. But, he says, this belief is confusing cause with effect. A currency like the euro or the dollar is not in demand as a reserve currency by central banks because it participates in the SDRs, but because it is reliable and liquid, that is to say, easily exchangeable. Ge Huayong himself observes that fears over the health of the eurozone and the US economy have led to a rise in the demand for Canadian and Australian dollars and for Swedish kronor as reserve currencies – currencies which are not part of the SDR basket and are in demand because they are freely available on the international markets for use by the central banks. So it is a mistake to believe that the renminbi can become a major reserve currency without accepting the conditions set by the IMF for its inclusion in the SDR currency basket. The IMF's conditions are not simply arbitrary rules – they are just the factors that make a currency into a reserve currency.

A multipolar monetary system must emerge, whether negotiated or not - and this necessarily implies the internationalisation of the renminbi.

These two articles, like much of the other writing on this topic, reveal a skewed perception of the costs and benefits of internationalising the Chinese currency. Gao Haihong says that the benefits are obvious and numerous. They range from protection from fluctuations in exchange

22 ibid.

rates to the development of financial markets through gains from seigniorage. The costs, he says, are "very difficult to identify". But one foreseeable and important aspect of internationalisation is the loss of autonomous control over domestic monetary policy. The discussion on internationalising the *renminbi* takes place in the context of a period of extreme caution for China in monetary policy. At the height of the global crisis in the summer of 2008, the Chinese authorities decided to re-establish what was in effect a fixed parity with the dollar. But the American government thought the rate set was too low, which has led to a major disagreement between the US and China. As American demands that China revalue its currency, China says that fixing the value of a currency is a matter of domestic policy, and that such a revaluation would be too risky for the Chinese economy because of the effect it would have on growth and employment. Current Chinese policy is clearly very far from allowing any relaxation of the rules governing the uses of the renminbi, the one condition that is essential for its internationalisation; China's policy concerns seem to be national, not multilateral.

The repeated calls from Chinese political and academic circles for a reform of the international monetary system make it clear that they think the international system is unsatisfactory. But aside from the creation of an international currency, which may be an "ideal" solution but, as Gao Haihong says, not very realistic, Chinese thinkers advance few real and credible proposals. As for the discussion on internationalising the renminbi, it is focused for the most part on the two concerns of making the Chinese currency a major world currency and at the same time strictly controlling its value and its uses. These two objectives are more in conflict than most experts on the subject – including Gao Haihong and Ge Huayong – seem to believe.

3. China must avoid the fate of Japan

by Mathieu Duchâtel

Sources:
Ye Tan, "The currency wars: making concessions abroad calls for domestic stability", *21 Shiji jingji baodao,* 13 October 2010.[23]
Zhang Liwei, "A sign of immediate monetary contraction is needed to win room for manoeuvre in the current situation of international rivalry", *21 Shiji jingji baodao,* 12 October 2010.[24]
Shen Jianguang, "The debate over the yuan exchange rate must be depoliticised", *Xin shiji,* 12 October 2010.[25]

China's economic analysts often use the same old saying to describe the currency war: "Channel the flood waters away to a neighbouring country" (以邻为壑, *yilinweihe).* China considers the ongoing disagreement to be entirely America's responsibility. Zhang Liwei calls it "currency terrorism" (货币恐怖主义, *huobi kongbu zhuyi*) and describes American pressure for revaluation as a "long-term strategic challenge" (战略性打击, *zhanlüexing daji*) – he says American hegemony is based in monetary supremacy, which is undermined by China's growing economic power. Zhang points out that the replacement of the pound sterling with the US dollar after the Second World War as the currency for international settlements marked the end of the transition of power from Britain to the US. The US is employing the same methods against the renminbi as it used against the pound, but this time, it is using its power defensively instead of offensively. The Federal Reserve's weak dollar policy is a direct attack on the strategic interests of China. If the renminbi continues to follow the downward movement of the dollar, the other emerging markets will increase the upward pressure on the renminbi. This will jeopardise the BRIC alliance, along with its call for reform of global economic governance.

Ye Tan is more measured. She suggests that the pressures on the renminbi are relative, and that all major economies are subject to this kind of pressure. She says that a revaluation of the renminbi would create a large number of losers among the same countries that are calling for a higher exchange rate, since they would lose an important source of income. Countries affected would include those hoping to sell expensive technology to Beijing, as well as those who want to reduce their debt to China.

Shen Jianguang says that the debate in China has been over-politicised. Most commentators are just repeating the same thing: "We must not capitulate to American pressure". He says that China needs to get back to a purely economic

23 Ye Tan writes economic editorials and edits the "ideas" columns for the National Business Daily, *Meiri jingji xinwen*.
24 Zhang Liwei is a member of the editorial board of 21 Shiji jinji baodao.
25 Shen Jianguang is chief editorialist for Mizuho Securities and a frequent editorial contributor.

and financial way of looking at the problem, which means re-establishing some basic truths. First, there is no such thing as a "rational and ideal" exchange rate for the renminbi. Every attempt to calculate this ideal valuation comes up with a different result: some economists find that the renminbi should be re-valued by 20% or 40% not undervalued, while others believe that it should not be re-valued at all. China needs to stop thinking about the exchange rate in terms of the dollar and the current political gamesmanship with the United States, and instead should look at the renminbi in relation to a basket of currencies. The majority of observers, Shen says, forget that between July 2005 and the financial crisis in July 2008, the renminbi remained quite stable against the dollar in the context of a floating exchange rate pegged to a basket of currencies.[26]

Second, revaluation does not necessarily mean lowering exports, according to Shen. Between July 2005 and July 2008, a time of appreciation for the renminbi, Chinese exports grew rapidly. The key factor in export growth is the capacity of importing countries to absorb the level of imports, which is only marginally dependent on the exchange rate. Shen finishes by saying that China is overestimating the advantages of a fixed exchange rate over a floating exchange rate. Being pegged to the dollar does not protect the renminbi from the fluctuations of other currencies in relation to the dollar, which can have a significant impact on Chinese exports – although here, Shen contradicts his previous argument on the tenuous links between exports and the exchange rate. The Asian crisis showed that when exports are falling, fiscal pressure on public finances increases, because China has to sustain its foreign trade. As China gradually relaxes its restrictions on the movement of capital, Shen thinks that maintaining a fixed exchange rate leaves it without any room for manoeuvre in its monetary policy – an observation which runs counter to China's current monetary policy.

All the contributors fear that China will repeat the Japan scenario of 1985. In 1985, the Plaza Accord on depreciating the dollar against the yen and the West German mark was signed between Japan, the US, the UK, France and West Germany, following discussions at the G7. After the Accord, the yen appreciated rapidly, which contributed to the formation and burst of an asset price bubble that sent Japan into a decade of recession. Ye Tan contends that Japan was a victim of the United States' monetary offensives - and China will be next. Pressure on the renminbi, the economists think, will not decrease as long as the American economy remains without a foundation for sustainable growth, and they feared that history would be repeated at the G20 meeting in Seoul in November 2010. The chairman of the summit, Lee Myung-bak, accepted the inclusion of monetary issues on the agenda for discussion. Given the failure of the annual meeting of the IMF and the decision of the WTO not to act as referee, Ye asks, could the Seoul summit see a repetition of the 1985 G7 scenario, leading to the signing of a similar multilateral agreement and a significant upwards revaluation of the renminbi? The greater risk was more likely to be the paralysis of the G20. But for China, currency revaluation remains a fundamental problem: whatever the consequences of the G20 summit, the Chinese government will still have to address it.

Chinese analysts think that an upward movement of the renminbi would increase the risk of inflation, which reached 3.4% in September and 4,4% in October. Zhang Liwei calls on the government to take immediate preventive measures by making a strong political stand and taking practical measures to reduce the money supply. It is imperative, he says, that the rise in the consumer price index stays below 4%. If that ceiling is broken, the central bank must react immediately by raising the reserve ratios for banking institutions. Potential real estate bubbles should be headed off by adjusting taxation and interest rates. Investment has been overly concentrated on infrastructural projects and many local governments have dangerous levels of debt; any fall in the dollar would threaten to exacerbate these two phenomena. If the Chinese government does nothing, prices in China will rise in parallel with international prices, which are going up because of the dollar's decline. Raw materials and agricultural products are particularly affected. Ye Tan thinks that a sudden revaluation upwards of 20% to 40% in the value of the renminbi would amount to a "destructive shock" (毁灭性打击, *huimiexing daji*) for the Chinese economy. But a gradual rise also presents inflationary risks. If China says that it is allowing a gradual rise, it might lead to short-term speculative investment betting on a rise in the renminbi. So, a gradual rise could limit China's monetary policy options.

Pressure on the renminbi will not decrease as long as the American economy remains without a foundation for sustainable growth.

China and other emerging markets have limited options, all of them dangerous. Ye Tan thinks that the emerging countries face a dilemma every time the Americans launch a new offensive on exchange rates, which she says, amounts essentially to a "pursuit of exporting economies with high growth rates". If these countries do not increase their exchange reserves, they could find themselves in an insolvency crisis like the one in Asia in 1997-1998. But if they increase reserves rapidly and in large amounts, they risk raising the value of their currency and eroding their export competitiveness.

Ye says that the Chinese government is trying to avert this scenario by building a social security net and stimulating consumption. But she believes that this plan will have limited success. Even if the social security system is redesigned to

26 In reality, in July 2005, the renminbi was not indexed in terms of a currency basket; it was only the band of its daily fluctuations that was widened. Consequently, every day without exception it reached its upper limit, right up until July 2008.

provide universal coverage, the government will still have to raise expenditure on primary education, and even in that case, the effects on consumption would still be minimal. In rural areas, social security provisions of 100 yuan per month would have very little effect on consumption, and it would have very little chance of holding back either inflationary pressure or upward pressure on the renminbi.

Ye Tan thinks that China must turn the pressures on the renminbi exchange rate to its advantage. She thinks that current monetary pressures could be leveraged to bring about the internationalisation of the renminbi, the liberalisation of the Chinese financial system, and the adoption of a monetary policy independent of the power of the executive. Ye Tan sees an independent monetary policy in particular as crucial – it could provide a future firewall for the economy of China. She recommends reform based on the German model (以德国汇率市场化为师, *yideguo huilü shichanghua wei shi*), drawing on lessons taken from the mistakes of Japan's monetary policy in the 1980s and 1990s. After the signing of the Plaza Accord, the mark continued to appreciate, but unlike Japan, Germany did not experience a bubble. So, the key to liberalising the exchange rate of the renminbi is proper regulation of the financial market.

Ye sets out priorities for liberalising the Chinese financial market. Currency reserves must not be fully controlled by the bureaucracy – Chinese savers should have easier access to them. More treasury bonds in renminbi should be issued, and controls over foreign currency operations should be relaxed. This should put an end to the "embarrassing" (尴尬, *ganga*) situation of repeated capital losses on investments in foreign currency markets. Qualified Domestic Institutional Investors (QDII) are the only vehicles through which (certain) commercial banks are allowed to invest on the foreign currency markets, and in 2009, they experienced a large escalation of losses - according to Ye, mostly through incompetence. With clearer and more liberal financial regulations, China's best financial experts would stop leaving the country and Chinese assets abroad could be better managed. Ye says that excessive taxation on the private sector is responsible for the difficulties China's industries are facing in dealing with the upward pressures on the renminbi and for the complexity of industrial restructuring. Entrepreneurs have no incentive to invest their profits in financial products, and instead prefer to put their money in real estate. Only a comprehensive reform of the financial system can help the renminbi, like the mark before it, to regroup, transform and emerge as a stronger currency.

Sheng Jianguang's criticism of the monetary debate as "over-politicised" leads him to propose immediately indexing the renminbi against a basket of currencies. He thinks that the "currency war" is the gravest challenge to China's growth that the country has faced for decades, and that the risk of a return to a scenario "like the 1930s" cannot be ruled out. Sheng says that a revaluation of the renminbi poses serious domestic risks, because most Chinese entrepreneurs get a return on investment of between 2% and 3%. However, China must adapt its monetary policy to the new international reality, and it can still make the best of the situation. At the moment, upward pressure on the renminbi comes from four factors. In spite of the weakness and fragility of the recovery in the industrialised countries, Chinese exports are growing and the surplus exceeds expectations. Domestic demand is still robust and concerns about the possibility of a harsh landing have dissolved. The liberalisation of financial products denominated in renminbi has speeded up. And the renminbi is falling in relation to other currencies, aside from the dollar. But the relaxation of China's controls over the movement of capital could bring about a resolution, if it is accompanied by a gradual liberalisation of the renminbi. China has to give up its "flotation phobia" (浮动恐惧, *fudong kongju*) so it can respond to the "currency war" that the Americans have launched. The risk is manageable, and diversifying its international holdings could even help China reduce the risk of inflation.

4. Europessimism in the Chinese press

by François Godement

Sources:
He Fan, "The Greek crisis and China's counter-measures", *Jingji guancha bao, 21 May 2010.*[27]
Chen Jibing, "The euro crisis and the diversification of China's currency reserves", *Shanghai shangbao, 25 May 2010.*[28]
Xie Guozhong, "The euro crash", *Xin Shiji, 24 May 2010.*[29]

In the second half of May 2010, as Greece descended into crisis and the markets lost faith in the euro, Chinese commentators competed to outdo each other in pessimistic pronouncements about the future of the eurozone. He Fan writes from a financial and macroeconomic perspective, citing, for example, Europe's declining economic competitiveness. He also touches on political matters: like other Chinese authors, he thinks that the differing interests of the eurozone's member states are likely to lead to its dissolution. Xie Guozhong's forecast, meanwhile, is ideological and bordering on the apocalyptic. He says that the American crisis of 2008 symbolised the fall of unregulated capitalism, and draws a parallel between the 2008 crash and the forthcoming collapse of the European welfare state, towards which he thinks the Greek crisis was the first step. He praises the performance of the major emerging economies, which, it seems, can do no wrong. But not even the successes of the emerging economies will be enough to rebalance the world economy; in fact, Xie concludes by predicting an outbreak of uncontrollable global inflation. Chen Jibing is the only journalist among the commentators, and his opinions are a little more considered. He underlines the connection between crisis in Europe and slowdown in Chinese exports. He says that the attitude of the Chinese monetary authorities is "neither to sell off nor to buy" the euro and European assets, and he points out that a stabilisation of the European currency would offer Chinese interests an excellent, though risky, opportunity to establish a foothold in European capital.

Whatever their differences in critical rigour, these analyses have the same underlying concern: the crisis in Greece and the ensuing crisis of the euro, as Europe hesitates its way through the various steps towards a decision on intervention, common guarantees, and possible participation in a European Monetary Fund (EMF). Even without knowing the figures from the Bank for International Settlements (BIS) published at the end of June 2010, the Chinese authors describe - with some justification - an extensive degree of European interdependence, in terms of sovereign debt and of a general view that Northern Europe has made very large loans to the South. They all agree that the adoption of a plan for guarantees was not enough to restore confidence, although He Fan and Chen Jibing note that it did at least provide a short-term solution. Xie Guozhong even titles one of his subheadings: "Save [Greece]? No, save yourselves!" None of the authors expect that there will be a long-term solution to the Greek crisis without further twists and turns.

Beyond their common theme, the articles have many differences. He Fan is extremely pessimistic about the future of the eurozone. Not only is there no escape from restructuring the Greek debt, but a greater crisis is on the way – and if he appears to make no distinction between the situations of Portugal and Spain, it is because he believes that the whole of Europe is heading for a sovereign debt crisis like the one in Latin America in the 1980s, which required concerted global action. He is fairly relaxed, though, about the repercussions of this crisis outside the eurozone, and does not expect it to have much effect on the United Kingdom or the United States. China is of course affected by declining demand for its products in the European market, but it should not intervene directly to support Greece or Europe. It can, however, provide "indirect support". It can increase the numbers of tourists it sends to Greece, it can make commercial purchases, and it can encourage its enterprises to expand overseas (走出去, *zouchuqu)* through acquisitions in Greece. Global growth will be slightly affected, but there is no threat of a second recession or a new world financial crisis. He Fan does not think that any of this will lead to a decrease in international pressure for a revaluation of the renminbi.

The second Sino-American strategic and economic dialogue, which took place at the end of May 2010, was to include a common declaration on the stability of the euro.

Chen Jibing talks about the dilemma that China faces because of the new interdependence between China and Europe now that Europe is China's main export market. He says that the European crisis has put an abrupt stop, at least for the time being, to China's policy of diversifying foreign reserves, which it began in the second quarter of 2009. He notes with some irony that the second Sino-American strategic and economic dialogue, which took place at the end of May 2010, was to include a common declaration on the stability of the euro. In the short term, China has had no option since March but to return to its massive purchases of US debt. Chen says that to help out China, Russia and South Korea have promised to follow suit, and that even the US debt held by Japan grew in the first quarter of 2010. The choice of reserve currencies is very limited; the Japanese yen, for example, has not yielded a return for a long time. He concedes, though, that European measures may restore some stability to the euro, which would create opportunities for a round of acquisition activity

27 He Fan is a researcher for the Institute of Politics and the Global Economy at the Chinese Academy of Social Sciences.
28 Chen Jibing is the leading editorial writer for the Shanghai *Commercial Daily.*
29 Xie Guozhong is an administrative officer for Rosetta Stone Capital Ltd and former chief economist for Asia with Morgan Stanley..

on European capital, or what he calls "risk shopping" (冒险血拼, *maoxian xuepin*). China can resume its policy of buying euros in the future, entering the market at an advantageous level. The Chinese investor should neither buy nor sell euros at the moment, but should continue to keep an eye out for opportunities.

Xie Guozhong offers a more radical perspective, evoking other forecasts of the end of capitalist models from unrestrained Anglo-Saxon capitalism to the European welfare state. In his long and sometimes wordy analysis, with its frequent references to the disintegration of the euro, the eurozone and European integration as a whole, he enumerates all the negative elements of what he describes as a series of "snares". Speaking of what he calls the snare of deflation, he says that because of its own measures to cut expenditure, Europe will not be able to reduce its deficits in a period of recession, unlike the "IMF methods" applied to Asia in 1997 in a situation of global growth. He cites as a negative factor the lack of competitiveness in the non-industrialised countries of southern Europe. But he also believes that northern Europe's diminished competitiveness in the automotive and machine-tool industries, in particular, will also lead to a fall in purchasing power and a sovereign debt crisis. In any case, northern and southern Europe are interdependent, which is why he calls the euro "a two-headed monster".

Meanwhile the UK, where public debt is higher in percentage terms than it is in Greece, is taking measures to support the competitiveness of its export trade but it "has nothing to export" and retains only the semblance of an industrial base. Xie Guozhong concludes by predicting trouble for the United States. By monetising its public debt, it has created a wave of inflation that will overwhelm deflation driven by falling demand. Xie foresees a new global crisis – but he says nothing about its consequences for China and gives no thought to the response that it calls for.

These gloomy predictions are not the product of any defensible economic analysis. But, with some relish and without apparent regret, they hint at the possible disappearance of Europe, which is particularly striking in an influential journal often considered to be liberal. The lesson for those in the Old Continent is that greater speed and visibility in dialogue and common action is imperative – because the contagion of panic, evoked by these writers and others like them, could very easily start to affect European deliberations.

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