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Is the Renminbi the New Dollar? Chinese Monetary Policy and the Global Reserve Currency System

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Summary

- Amidst global economic uncertainties, the perceived problem of an undervaluation of the RMB is a perennial refrain. A trade war loomed with the US threatening to impose punitive tariff mechanisms which threatened to trigger a global currency war. Meanwhile, China's current resource-intensive manufactures are already trading at wafer-thin margins and any drastic RMB appreciation is likely to cause catastrophic job losses and social instability.
- The RMB has in fact appreciated by some 55% since China's first currency reform in 1994. Like the experience of appreciation of the Japanese yen following the Plaza Accord, this magnitude of appreciation has not reversed China's exports or Western imports.
- Analysts have suggested a three-stage approach of how China could move to a market-determined exchange rate and an open capital account. However, as China is a very large country in rapid transition, an independent RMB exchange rate policy is important to grapple with the multi-faced challenges of social dynamics and geopolitics.
- In any case, with rising social tensions, China is changing course in the 12 Five Year Plan (2011-15), towards a higher-quality, more balanced and more sustainable growth model geared to much higher domestic consumption.
- This promises to diminish her current account surplus and foreign currency reserve over time. While China is ready to liberalize her financial services and to seek a role for the RMB as it becomes more internationalized, she is likely to allow only gradual and measured currency appreciation in tune with the changing times.
- China, however, would remain extremely cautious in giving up too soon the protection of a non-convertible capital account in an uncertain world, if past traumatic experience is any guide.

CII Introduction: Andrew Leung, international and independent China specialist, focuses on monetary policy in China and its potential implications. He argues that any drastic appreciation of the Renminbi (RMB) is likely to cause catastrophic job losses and social instability in the country. As a consequence, Leung argues that China must retain an independent RMB exchange rate, allowing for only gradual and measured appreciation. He also argues that China should retain the protection of a non-convertible capital account given Asia's past experience with capital flight. Leung does, however, think that China is ready to liberalise its financial services sector.

Amidst global economic uncertainties, the perceived problem of an undervaluation of the RMB is a perennial refrain. A trade war loomed with the US threatening to impose punitive tariff mechanisms which threatened to trigger a global currency war. Meanwhile, China's current resource-intensive manufactures are already trading at wafer-thin margins and any drastic RMB appreciation is likely to cause catastrophic job losses and social instability.

The RMB has in fact appreciated by some 55% since China's first currency reform in 1994. Like the experience of appreciation of the Japanese yen following the Plaza Accord, this magnitude of appreciation has not reversed China's exports or Western imports. Goldstein and Lardy of the Petersen Institute have suggested a three-stage approach of how China could move to a market-determined exchange rate and an open capital account. However, as China is a very large country in rapid transition, an independent RMB exchange rate policy is important to grapple with the multi-faced challenges of social dynamics and geopolitics. In any case, with rising social tensions, China is changing course in the 12 Five Year Plan (2011-15), towards a higher-quality, more balanced and more sustainable growth model geared to much higher domestic consumption. This promises to diminish her current account surplus and foreign currency reserve over time.

While China is ready to liberalise her financial services and to seek a role for the RMB as it becomes more internationalised, she is likely to allow only gradual and measured currency appreciation in tune with the changing times. China, however, would remain extremely cautious in giving up too soon the protection of a non-convertible capital account in an uncertain world, if past traumatic experience is any guide.

The dynamics of a Currency War

Following similar legislation introduced during the Bush Administration[1], a Currency Manipulation Bill with threatening punitive tariffs was passed on Capitol Hill in September 2010 with a large majority. With a record-high unemployment rate, depressed wages, and struggling exports, President Obama continued to appeal to China-bashing emotions in his State of the Union address on 24 January, 2012. His senior officials have also been keeping up the pressure on the Chinese currency in the run-up to the presidential election.

Meanwhile, rounds of quantitative easing (QEs) have been dragging down the value of the RMB which is indirectly linked to the dollar, making the Chinese currency seem even more undervalued.

To safeguard competitiveness, other exporting countries such as Japan and Brazil have intervened to keep their currencies from rising too much against a depreciating dollar. Along with the European Central Bank and the International Monetary Fund, India has joined in the chorus for a stronger RMB. 'Beggar-thy-neighbour' policies are in vogue.

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China's response is that it would not be fair for the RMB to appreciate alone while the US is allowing the greenback to plummet. Moreover, China and the US are essentially not competing in the same kinds of goods and services. Even if Chinese products were entirely priced out of the American market, not many American jobs would be saved as US consumers are prone to buying low-priced substitutes from other developing countries[2].

The RMB has appreciated by some 55% since China's first currency reform in 1994. This has not helped US exports or reduced Chinese imports. There is a similar story in the appreciation of the Japanese yen under the Plaza Accord in 1985.

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[1] *"The Future of China's Exchange Rate Policy",* Petersen Institute for International Economics, Washington D.C, July 2009, Congressional Currency Bills pp.77-81.

[2] China's exchange rate policy: a yuan-sided argument, *The Economist,* 19 Nov 2009 (accessed on 26 Feb 2011).

Additionally, a great deal of China's exports has imbedded imported foreign parts, components, materials, proprietary technologies or services. RMB appreciation will lower the costs of such imports. So the RMB would have to appreciate even more drastically to have the intended effect.

Moreover, ever-lower 'China prices' demanded by global merchandisers like Walmart have depressed profit margins of Chinese products to wafer-thin levels, often well below 5%. Drastic RMB appreciation will drive many Chinese manufacturers out of business, resulting in massive unemployment and social instability. This will be a catastrophe not only for China, but also for the world's consumers, suppliers and distributors.

The workings of China's currency and monetary regime

Prior to China's open-door policy in 1978, the RMB was kept extremely high, at RMB1.86 to the dollar, designed to support 'import-substitution'. After China switched to an export-oriented economy, the exchange rate dropped to RMB5.8 to the dollar by 5 July 1986.

From 1994 to 2001, the RMB *appreciated* against the dollar by a total of 18% at an average of 3% annually, without undermining export competitiveness. On July 21, 2005 China ended the fixed RMB-dollar peg, switching to linkage with a basket of currencies, including the US dollar (mainly), the Euro, the Japanese yen, and the Korean won.

Between July 2005 to the end of 2008, the RMB was allowed to appreciate again by 21% against the dollar. However, during this period, China's current account surplus continued to surge.

On June 19, 2010, the RMB reverted to a managed floating exchange rate regime with reference to a basket of currencies. Under this regime, the RMB spot exchange rate can move intra-day +/- 0.5% from central parity.

Theoretically, an undervalued currency leads to an ever-increasing current account surplus and foreign exchange reserve. The excess liquidity requires regular sterilization via the sale of central bank bills and increases in commercial banks' reserve ratio requirements. This acts as a tax on these banks. To prop up their commercial viability, the margin above the deposit rate has to be kept wide. As low lending rates are needed to spur economic growth, the deposit rate has to be kept even lower under a mandated interest rate regime. As speculation on upward adjustment of the RMB became a one-way bet, there is a great deal of caution in raising interest rates as it often attracts difficult-to-sterilize disguised speculative capital inflows.

An analysis by Morris Goldstein and Nicholas Lardy of the Petersen Institute for International Economics[3] finds that in 2003, when China's global current account surplus stood at 3% of GDP, the estimated RMB undervaluation was 15-20%. By 2007, when China's global current account surplus reached 11% of GDP, the undervaluation was 'conservatively' estimated at 30-40%.

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According to Goldstein and Lardy, the existing currency regime has a number of economic disadvantages, such as:

- monetary policy inflexibility;
- eschewed investment decisions towards manufacturing at the expense of services;
- hindered transition to a more consumption-driven economy;
- reduced household income (of which interest receipts are an important component in China), impeding progress towards a truly commercial banking system; and
- monetary disequilibrium, perpetuating China's external imbalance.

The two authors recommend a gradual three-stage approach to move to a free-floating exchange rate system - during a global recession; following global recovery; and after China's current account surplus has drastically shrunk.

Initially, during a global recession, China should avoid competitive devaluation and any tax rebates for resource-intensive exports; increase expenditure on physical infrastructure; and expand social outlays in education, health and pensions. The RMB should continue to

[3] *"The Future of China's Exchange Rate Policy"*, Morris Goldstein and Nicholas Lardy, Petersen Institute for International Economics, Washington D.C, July 2009, pp. 87-96.

appreciate by 4-5% a year while the daily exchange rate fluctuation limit should be raised to 1 or 1.5%.

During the subsequent stages, the RMB should appreciate sufficiently rapidly to eliminate large current account surpluses in 3-4 years. The government should reduce exchange intervention and sterilization; gradually allow dual capital flows; initiate interest rate liberalisation; and support central bank independence with an inflation targeting mandate.

It is evident that China's own approach so far has already embodied virtually all the ingredients of the first stage of the Goldstein-Lardy recipe. However, it is by no means certain that China will necessarily follow the other more drastic prescriptions in the way recommended for the subsequent stages.

China jealously guards her monetary and exchange-rate flexibility as a powerful tool for social stability.

First, China jealously guards her monetary and exchange-rate flexibility as a powerful tool for social stability. Second, while an inflation-targeting monetary policy may serve to counteract boom-and-bust cycles[4], a rigid inflation targeting approach is now subject to serious debate following Europe's mounting sovereign debt crisis. Third, learning from bitter domestic and international experience, China remains sceptical about any one-size-fits-all recipe for problem solving. As a market economy in rapid transition, China is more wedded to '*groping for stepping stones in crossing a river'*.

The economy is more than economics

In the November 2010 issue of *China Analysis*, a publication of the European Council on Foreign Relations, Francois Godement *et al.*[5] revealed a panoply of geopolitical considerations advanced by leading Chinese academics. While there is agreement on the need for RMB internationalisation, some view this as a means to escape perceived currency manipulation by the United States as the issuer of the world's most preferred international reserve currency.

The idea that the RMB exchange rate, a vital tool for economic and social stability, should be left entirely to a Western-dominated global marketplace in accordance with some academic criteria is regarded by some in China as a Western myth of quantitative economics.

For background, an April, 2005 article *Our Currency, Your Problem* for the Hoover Institution penned by Niall Ferguson[6] is instructive. He reckoned that the Bush administration's tax cuts and a global war on terror were financed by a multibillion-dollar overdraft facility at the People's Bank of China (through China's massive purchase of Treasury bills), which he called "a Chinese tribute to the American Empire'. In April, 2009, Paul Krugman, a New York Times Op-ed columnist and Novel Prize laureate, called this China's '*Dollar Trap*'[7].

As Godement points out, 'since 1944, the dollar has lost 97% of its value against gold …… in the service of its own economic interests'. No wonder on 13 March, 2009, Premier Wen Jiabao openly aired his worries about China's trillion-dollar investment in US Treasuries.[8]

It may be a sign of China's rising economic nationalism but US monetary policy is seen by some in China as 'a mechanism for plunder' under a US "economic hegemony".[9] The idea that the RMB exchange rate, a vital tool for economic and social stability, should be left entirely to a Western-dominated global marketplace in accordance with some academic criteria is regarded by some in China as a Western myth of quantitative economics.

RMB internationalisation barring immediate capital account convertibility

Against this background, it makes perfect strategic sense for China to internationalise the RMB. The following

[4] What Monetary Policy Does China Need?, Marvin Goodfriend, Professor at the Tepper School of Business at Carnegie-Mellon University and Eswar Prasad, and Chief of the Financial Studies Division in the IMF's Research Department, posted on *Global Vision*, a global markets and poverty alleviation website run by Mercy Corps, 19 July, 2007, (accessed on 27 Feb 2011).

[5] *"Redbacks for Greenbacks: The Internationalization of the renminbi*", Francois Godement et al., *China Analysis*, European Council on Foreign Relations and Asia Centre, November 2010.

[6] Our currency, Your Problem, Niall Ferguson, Hoover Institution, Standford University, 30 April, 2005 (accessed on 27 Apr 2011)

[7] China's Dollar Trap, Paul Krugman, *New York Times*, 2 Apr 2009 (accessed on 27 February, 2011).

[8] China's Leader Says he is 'Worried' Over U.S. Treasuries, New York Times, 13 March 2009 (accessed on 27 Feb 2011).

[9] See Michael Hudson's controversial book, *"Super Imperialism - The Economic Strategy of American Empire"*, Pluto Press, New Edition March 2003, which offers a no-holds-barred elucidation of a plausible "American Grand Design" to rule the world through calculated "Monetary Imperialism"

regional and international developments are beginning to unfold:

- With China as the centre of Asia's regional production and supply chain, the use of RMB for international settlements with China's trade partners worldwide is gathering pace as China's economy is growing to become the world's largest, probably by the end of this decade.
- As of 13 March 2012, Japan announced a plan to acquire US$10.3 billion worth of China's treasury bonds as part of its foreign currency reserve, following Malaysia and Chile. As the greenback is perceived to continue to lose value, the trend of including RMB-denominated Chinese treasuries in foreign currency reserves will probably accelerate. This option may become increasingly attractive to energy exporting countries such as Russia and the Middle East.
- With support from Beijing, Hong Kong is being developed as the premier offshore financial centre for RMB internationalisation, including the issuance of "dim sum" bonds and other RMB-denominated financial instruments. RMB bank deposits in Hong Kong have been rising rapidly to RMB627 billion in March 2012. It is expected to jump to six trillion by 2020, much more than the deposit base of the Hong Kong Dollar, with implications for Hong Kong's current US dollar peg.
- Singapore is positioning itself as a regional offshore financial centre for the RMB. So is London. This would further support the internationalisation of the Chinese currency.
- Continuous diversification of China's outbound surplus capital is leading to more Chinese mergers and acquisitions of assets across the globe, expanding RMB commercial relationships internationally.
- China is on track to continue to liberalise her financial sector, such as the qualified foreign institutional investor (QFII) and the qualified domestic institutional investor schemes[10], allowing for a freer inflow and outflow of RMB funds for investment purposes.

This way, China is quietly extracting herself from the 'Dollar Trap' by creating an international monetary zone of her own.

[10] See a good description of these schemes on Wikipedia: Qualified Domestic Institutional Investor and Qualified Foreign Institutional Investor.

However, China's capital account non-convertibility has proved its usefulness during recent global financial crises when it shielded China from much of the cross-border financial tsunami. In the light of increasing international financial uncertainty, China is unlikely to be in a hurry to discard this protection.

Global reserve currency system

On the other hand, China is becoming anxious for a more stable international currency system. The clarion call was first sounded by Zhou Xiaochuan, the Governor of the People's Bank of China on 23 March, 2009[11], referring to the need to address the so-called '*Triffin Dilemma*'[12]. Zhou proposed using Special Drawing Rights (SDR) of the IMF to replace the US dollar as a primary reserve currency.

...China is quietly extracting herself from the 'Dollar Trap' by creating an international monetary zone of her own

While it is debatable whether the SDR is the ideal solution, the historic American credit-rating downgrade and the doubtful future of the dollar as a stable long-term storage of value are likely to revive this debate. As China's economy is slated to overtake the US economy by 2018 (*The Economist*) or 2027 (Goldman Sachs)[13], the day when the RMB emerges as at least one of the world's reserve currencies no longer seems too far away.

Global economic imbalance

Underlying the above discourse is the root cause of many of the world's crises and conflicts – a systemic global economic imbalance. Well before the financial crisis, Asian exporting countries' mounting surpluses were fed into the West's financial system through investment in US Treasuries, supporting perennially low interest rates and easy credit. The latter has been exotically-leveraged under the imperative of financial innovation to feed an unbridled consumption era built on an inflated housing bubble. This in turn pushed up Asian countries' exports and surpluses, with

[11] Zhou Xiaochuan's Statement on Reforming the International Monetary System, *Council on Foreign Relations* (accessed on 27 Feb 2011).

[12] In the 1960s, a Belgian-American economist Robert Triffin outlined the potential conflict of interest between what is desirable for the reserve-currency issuing country and what is best for maintaining global currency stability. This is known as the "Triffin Dilemma".

[13] Jim O'Neill, China could overtake US economy by 2027, *The Daily Telegraph*, 16 Mar 2012 reiterates the date of 2027 as assessed by Goldman Sachs earlier (accessed on 16 Mar 2012).

the result that more was invested in US Treasuries to fund even more debt-driven consumption. In short, the West, particularly the US, is over-consuming while China and some other surplus countries are over-saving.

Meanwhile, China has been rebalancing her economy towards domestic consumption. Studies by Credit Suisse and Mckinsey have highlighted the burgeoning consumer market in China and how it will account for a lion's share of global consumer growth in the coming decades[14]. By 2025, China's consumer market will be driven by 350 million more urbanites in 221 new cities, according to a McKinsey study[15].

...China has been rebalancing her economy towards domestic consumption. Studies ... have highlighted the burgeoning consumer market in China and how it will account for a lion's share of global consumer growth in the coming decades.

Concurrently, notwithstanding quantitative easing, Americans are now beginning to save more as people prefer to pay down their debt rather than burning their fingers again with reckless debt-driven consumption. So a global rebalancing may already be taking place, according to Stephen Roach, Chairman of Morgan Stanley Asia[16].

Conclusion

According to China's Rich List 2010, there are more than 550,000 households with private wealth more than 100 million RMB. Yet, China is still a very poor country, with per capita income ranking amongst some of the poorest countries in Africa. Some 170 million Chinese people still remain at or below the poverty line of $1.25 a day.

In this economic divide, there is rising discontent due to galloping food prices, irregular land grabs, labour disputes, pollution, corruption, inequality, and social injustice. With a more educated and internet-savvy middle class, smouldering grievances may threaten to ignite a fire, as what has been happening across the Middle East.

China is beginning to switch to a more equitable and sustainable development model in the new Five Year Plan (2011-15). If realised, the transformation will diminish China's current account surplus, moderate her foreign currency reserve, and reduce incessant pressures for RMB appreciation.

To promote consumption and investments of a growing middle class, China stands to benefit from gradual currency appreciation, financial system liberalisation, a more flexible interest rate regime, and freer outward and inward capital flows.

It is no coincidence that a raft of reform measures is proposed in a recent 468-page study report jointly compiled by the World Bank and the Development Research Centre (DRC) of the State Council. Many of these measures are designed to improve the efficiency, equity, and sustainability of China's system of allocation of resources, echoing the spirit if not the letter of the Goldstein and Lardy studies mentioned above. These reforms measures are essential if China is to escape the "Middle Income Trap"[17] and to become a "*Modern, Harmonious, and Creative High-Income Society*" by 2030[18].

Nevertheless, as the existing world order is now being challenged with a rising China, the waters ahead remain uncharted. Moreover, with an aging population profile, China is likely to grow old become getting rich. During the nation's challenging development trajectory, while she is set to redouble efforts to boost the RMB's status as an international currency, liberalise her financial system and redress the socio-economic and ecological imbalance of her economy, China is likely to remain extremely cautious in not giving up too soon the financial protection of a non-convertible capital account.

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[14] For example: J F. Garner, *The Rise of the Chinese Consumer: Theory and Evidence",* John Wiley & Sons, 2005 and " The Value of China's Emerging Middle Class" in the *McKinsey Quarterly*, 2006.

[15] *"Preparing for China's Urban Billion", McKinsey Global Institute*, March, 2008

[16] Stephen Roach, *Next Asia: Opportunities and Challenges for a New Globalisation,* Wiley, 2010

[17] In his Opening Remarks on 3 Sep 2011 at the Conference on *China's Challenges for 2030* in Beijing, Robert B. Zoellick, World Bank Group President, wanted to understand how China could avoid the so-called "Middle Income Trap" – that stage when many countries in South East Asia and Latin America when reaching about $3,000 to $8,000 per capita income seem to stall in productivity and income growth.

[18] China 2030 – Building a Modern, Harmonious, and Creative High-Income Society, a study jointly undertaken by *The World Bank* and the *Development Research Center of the State Council*, the People's Republic of China. The report was released on 27 Feb 2012. Weblink to the conference edition.

Andrew K. P. Leung SBS, FRSA is an international and independent China Specialist with over 40 years professional experience covering Hong Kong and Mainland China. He is a China Futures Fellow selected worldwide by Berkshire Publishing Group, Massachusetts and is on the Brain Trust of Evian Group, a Lausanne-based think-tank. Andrew was founding Chairman of the China Group of Institute of Directors City Branch, London. Andrew served as Advisory Board Member of China Policy Institute, Nottingham University and on the Governing Council, King's College London until 2010. He helped set up Standard Chartered Bank's first merchant-banking subsidiary in Hong Kong (1983), oversaw the trans-migration of industries into China as Deputy Director-General of Industry; a month-long US-government sponsored visit to brief Fortune 50 CEOs on China beyond Tiananmen Square (1990); and acting as Editor-at-Large in an international consultancy on China's energies. Andrew was awarded Hong Kong's Silver Bauhinia Star (SBS) and has been in the UK's *Who's Who* since 2002.

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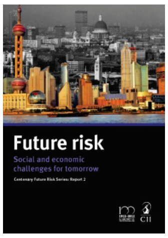

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In the economic landscape, Western governments have to make tough choices in balancing a taxation system that promotes economic growth with dwindling resources with which to provide a safety net. Walter Stahel of the Geneva Association calls for a fundamental rethink of taxation policy in favour of supporting the economy's most important asset: its labour.