A Perspective of the World Economy in the Coming Years

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Outline

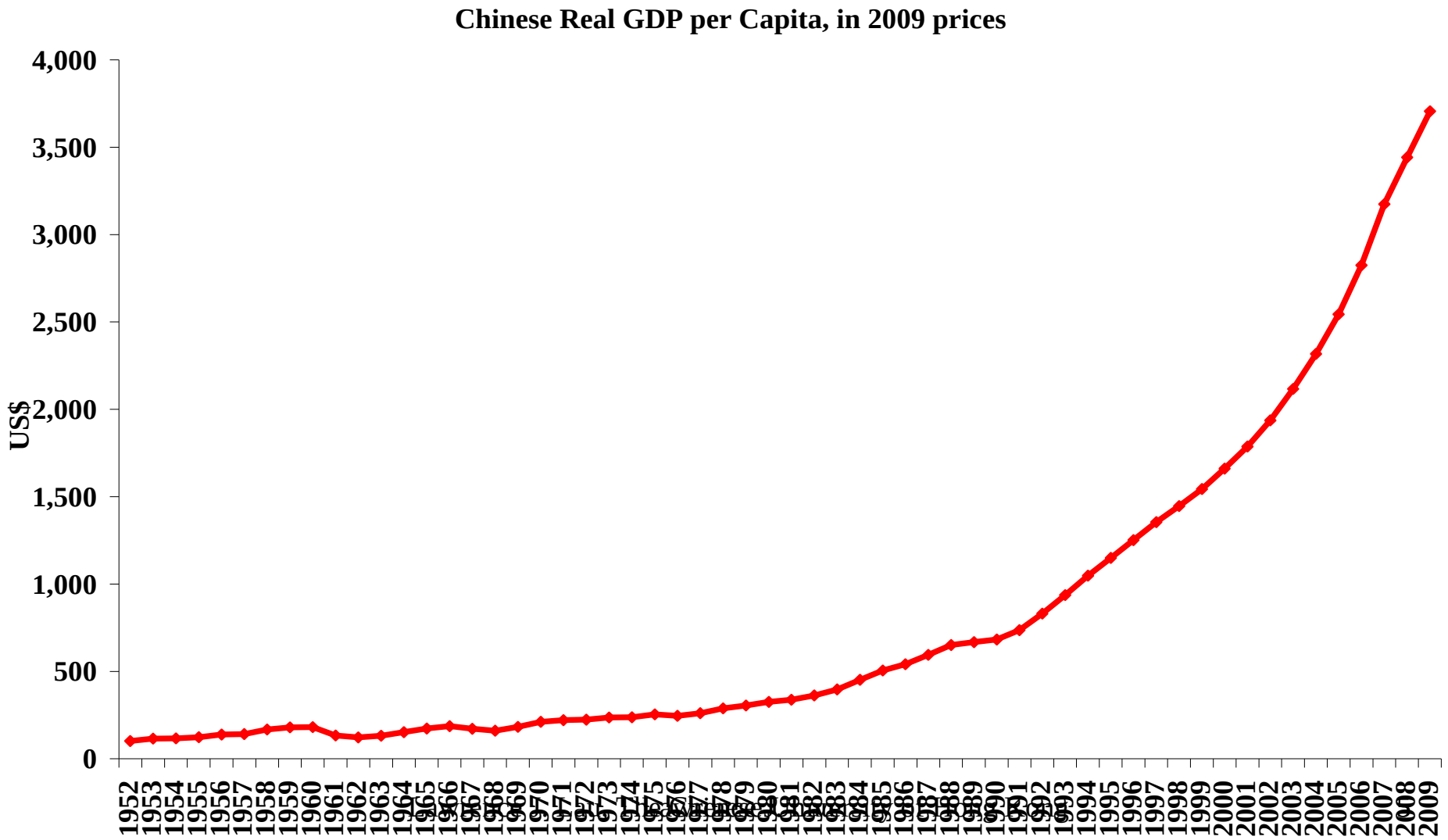
- Introduction
- The Evolution of the World Economy
- A New International Monetary Order
- Concluding Remarks

Introduction

- China has made tremendous progress in its economic development since it began its economic reform and opened to the World in 1978. China is currently the fastest growing economy in the World—averaging approximately 10% per annum over the past 30 years.
- Between 1978 and 2009, Chinese real GDP grew 18 times, from US$277 billion to US$4.99 trillion (2009 prices) to become the third largest economy in the World, after the U.S. and Japan. (Chinese GDP has actually surpassed Japanese GDP in real terms in mid-2010.) During the same period, Chinese real GDP per capita grew more than 13 times, from US$288 to US$3,706.
- By comparison, the U.S. GDP (approx. US$14.12 trillion) and GDP per capita (approx. US$45,918) were respectively 2.8 and 12.4 times the comparable Chinese figures in 2009.

Chinese Real GDP in US$ Since 1952 (2009 Prices)

Real Chinese GDP per Capita in US$ Since 1952 (2009 Prices)



Introduction

- The Chinese economy has survived the East Asian currency crisis of 1997-8 as well as the global financial crisis of 2007-9 reasonably unscathed. The 4-trillion Yuan economic stimulus package launched by the Chinese Government in November 2008 has been quite effective in maintaining Chinese economic growth. The Chinese economy will not be seriously affected by the current financial crises developing in some of the member countries of the European Union.
- The Chinese economy grew 9.1% in 2009 and 11.1% year-over-year in the first half of 2010 even as the European and U.S. economies remained in recession. The rate of growth for 2010 is likely to be no less than 9%.
- If current trends continue, Chinese real GDP will approach the level of U.S. real GDP in approximately 15 years' time--around 2025.

Introduction

- However, despite its rapid growth, China is still a developing economy in terms of its real GDP per capita (US$3,706 in 2009). An economy is generally considered to be developed if its GDP per capita exceeds US$10,000 (if we take into account inflation, this threshold should probably be much higher).
- It will probably take 20 years, till around 2030, before China joins the ranks of developed economies, achieving a per capita real GDP of US$10,000, and probably another 20 years, till around the middle of the 21st Century, before China reaches the same level of real GDP per capita as the United States, (bear in mind that in the meantime, the U.S. economy will also continue to grow, albeit at rates significantly lower than those of the Chinese economy and that the Chinese population will reach a peak around 2035 and then begin to decline slowly).

Introduction

- While many problems have arisen in the Chinese economy within the past decade— for example, income disparity, environmental degradation, inadequate infrastructure and corruption—it is fair to say that everyone has benefited from the economic reform and opening since 1978, albeit to varying degrees, and few want to return to the central planning days.
- China is one of the very few socialist countries that have made a smooth transition from a centrally planned to a market economy. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

The Economic Fundamentals

- Long-term economic growth of a country depends on its rates of growth of the primary inputs—(tangible or physical) capital and labour—and on technical progress (or equivalently growth of total factor productivity)—that is, the ability to increase output without increasing inputs.
- The rate of growth of tangible capital depends on the rate of investment on structure, equipment and physical infrastructure, which in turn depends on the availability of national savings.
- The rate of technical progress depends on investment in intangible capital (principally human capital and R&D capital).

The Economic Fundamentals

- Chinese economic growth during the past 30 years has been underpinned by three factors:
- (1) A consistently high national savings rate--which means that the domestic savings are sufficient to meet the domestic investment needs without relying on inbound foreign direct or portfolio investment or foreign loans;
- (2) An unlimited supply of surplus labour—there is no shortage of and no upward pressure on the real wage rate of unskilled, entry-level labour; and
- (3) A huge domestic market of 1.3 billion consumers with pent-up demand for housing and transportation and other consumer goods and services (e.g., education and health care), enabling the realisation of significant economies of scale in production and in investment in intangible capital, including innovation, based entirely on domestic demand.

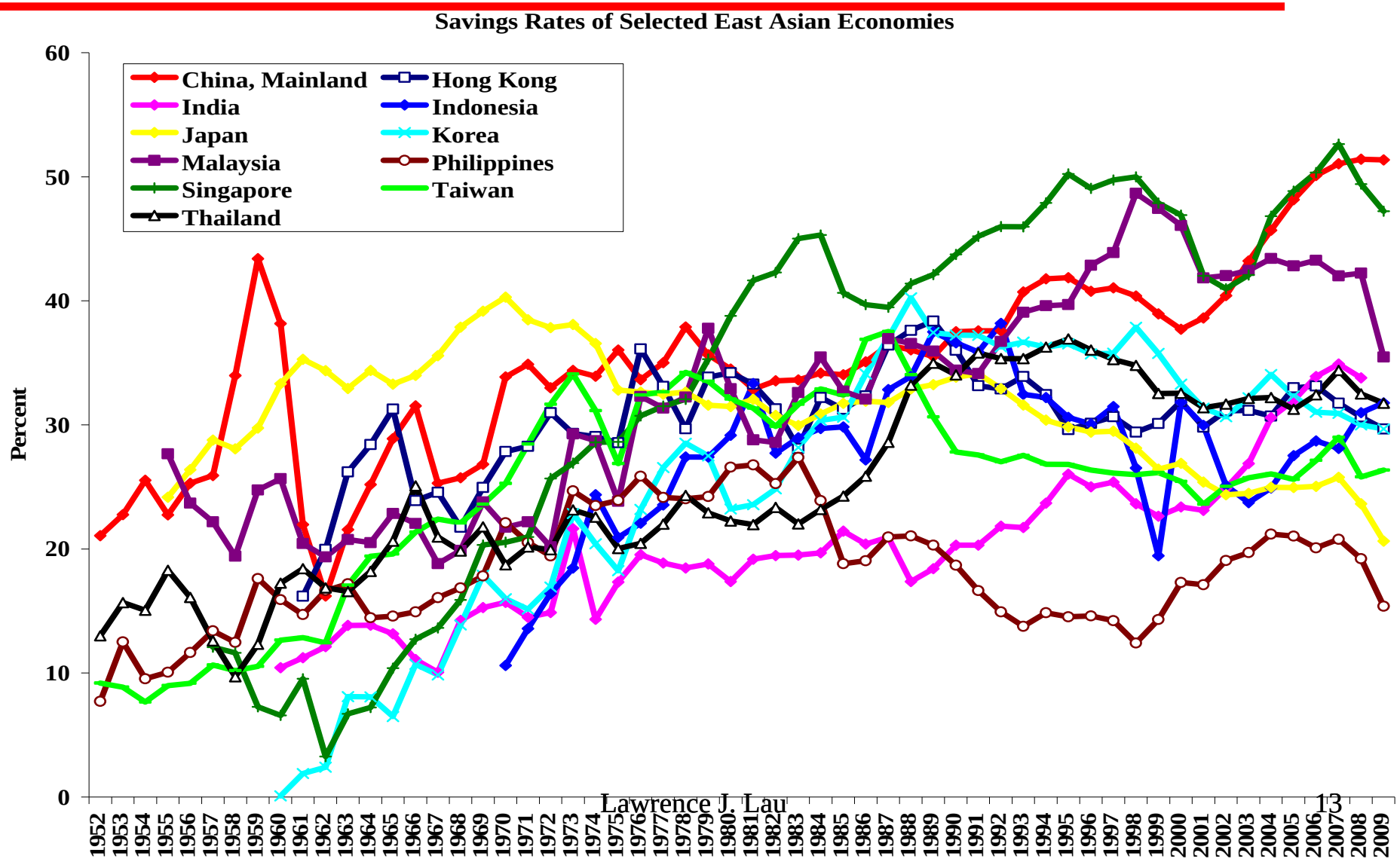
The Economic Fundamentals

- Except for short early start-up periods, the Chinese national savings rate has always been high, on the order of 30% and above. It has stayed around 40% since the early 1990s and has at times approached or even exceeded 50% in more recent years.
- A temporarily high national (and household) savings rate can be the result of the rapid growth of real GDP (and real household income) and the lagged response of consumption—it takes time for the growth of consumption to catch up to the growth of income.
- However, a consistently high national savings rate also means, among other things, that the Chinese economy can finance all of its domestic investment needs from its own domestic savings alone, and does not have to depend on the more fickle foreign capital inflows (foreign portfolio investment or foreign direct investment) or foreign loans.

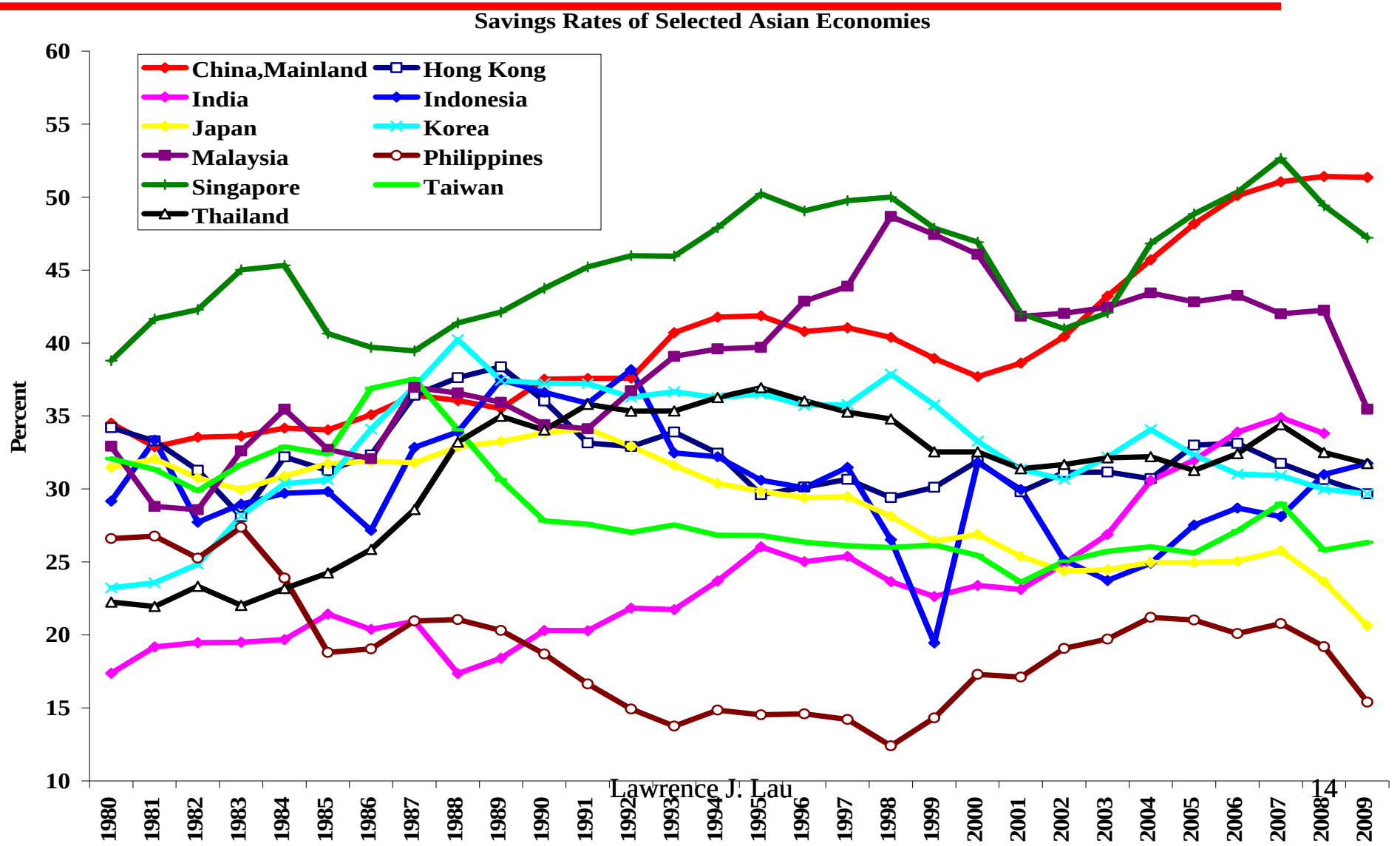
The Economic Fundamentals

- Almost all East Asian economies, with the possible exception of Philippines, have high national savings rates. What this means is that the domestic savings in each economy are sufficient to meet the domestic investment needs for sustained economic growth without relying on inbound foreign direct or portfolio investment or foreign loans.

Savings Rates of Selected Asian Economies (1952-present)



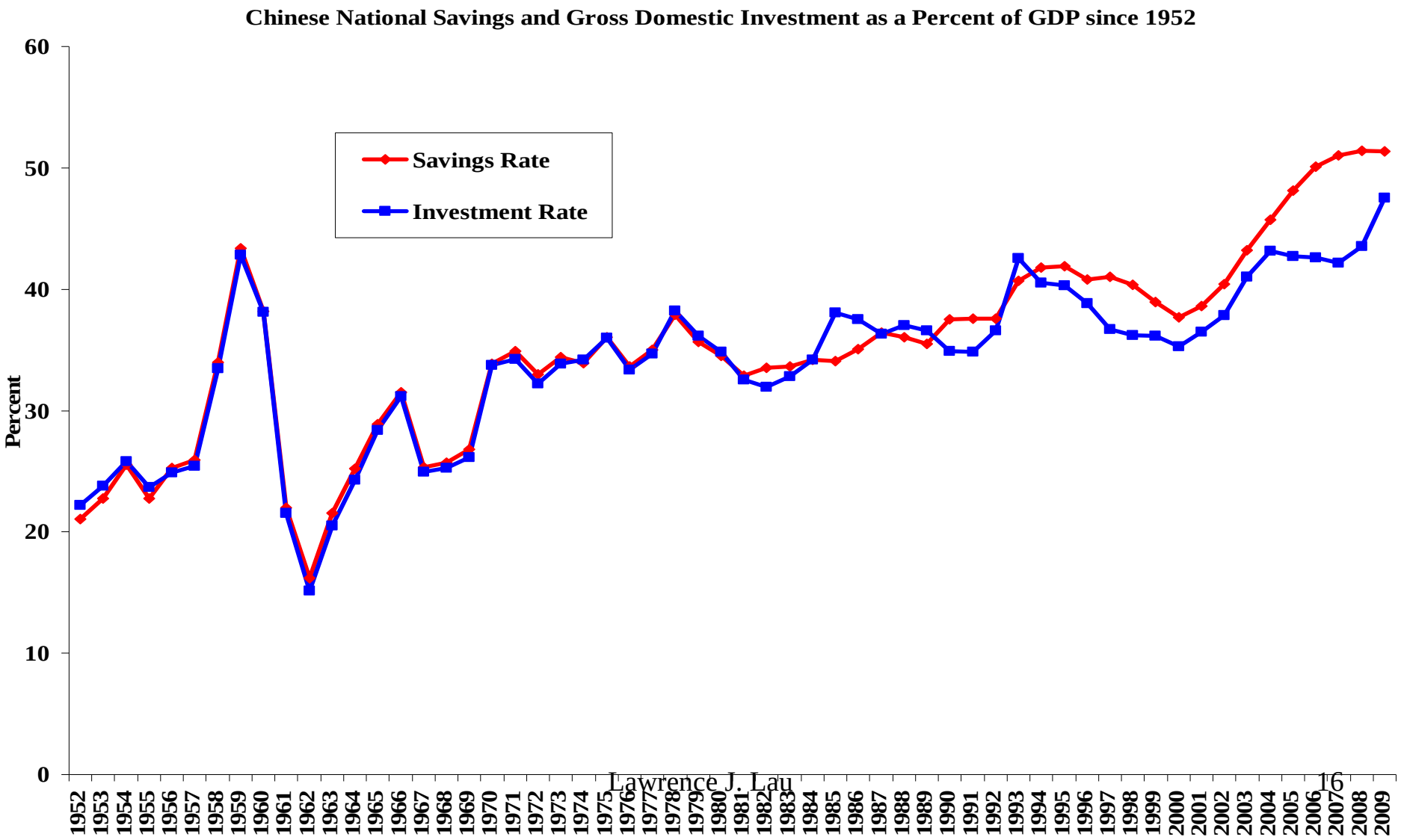
Savings Rates of Selected Asian Economies (1980-present)



The Economic Fundamentals

- A country with a high national savings rate does not need to rely on foreign savings—does not need to borrow abroad and bear the potential risks of a large, and often interruptible, foreign-currency denominated debt.
- With new resources being made available each year from new savings, enabling new investments to be made, the necessity of restructuring and redeploying existing fixed assets is greatly diminished (thus making it more possible to avoid creating losers).
- Moreover, with a high national savings rate, the non-state-owned sector (which is generally more efficient) can grow without significant, possibly socially disruptive, large-scale privatisation of the state-owned sector.

Chinese National Savings and Gross Domestic Investment as Percents of GDP



The Economic Fundamentals

- The huge potential domestic market of 1.3 billion consumers greatly enhances the productivity of intangible capital (e.g., R&D capital, goodwill). The fixed research and development costs of a new product or process can be easily amortised over a large market. The benefits of investment in goodwill, e.g., brand-building, are much greater in a large market.
- The huge potential domestic market also enables active Chinese participation in the setting of product and technology standards and sharing the benefits of such standard-setting.
- Brand-building is a pre-requisite for Chinese enterprises to re-orient themselves to take advantage of the huge domestic market. It is true that brand-building requires resources, but it also enables the owners of brand names to have much higher profit margins than enterprises that do only OEM (original equipment manufacturing) business.

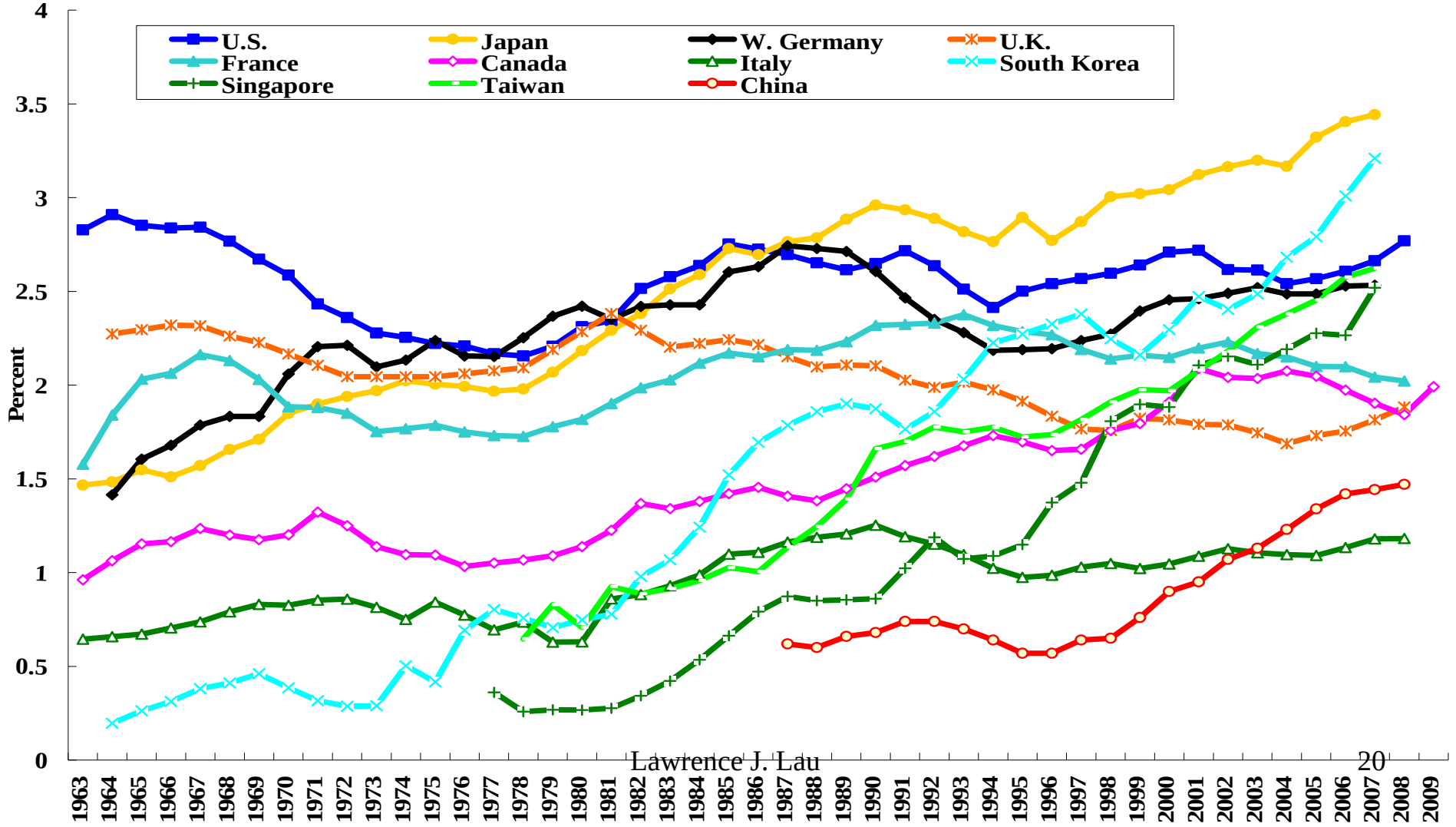
The Economic Fundamentals

- Sustained investment in R&D is essential for technical progress in an economy.
- China has been catching up rapidly in investment in R&D but still lags far behind both in terms of absolute value and as a percent of GDP.
- The percent of GDP invested in R&D is expected to increase to 2.5% by 2015. By comparison, Japan and South Korea invest more than 3% of their GDPs in R&D annually. The United States has on average invested almost 3% of its GDP in R&D since the late 1950s.

China's R&D Expenditure and Its Share of Chinese GDP

R&D Expenditures as a Ratio of GDP: G-7 Countries, 3 East Asian NIES & China

Figure 8.1: R&D Expenditures as a Percentage of GDP: G-7 Countries, 3 East Asian NIEs and China

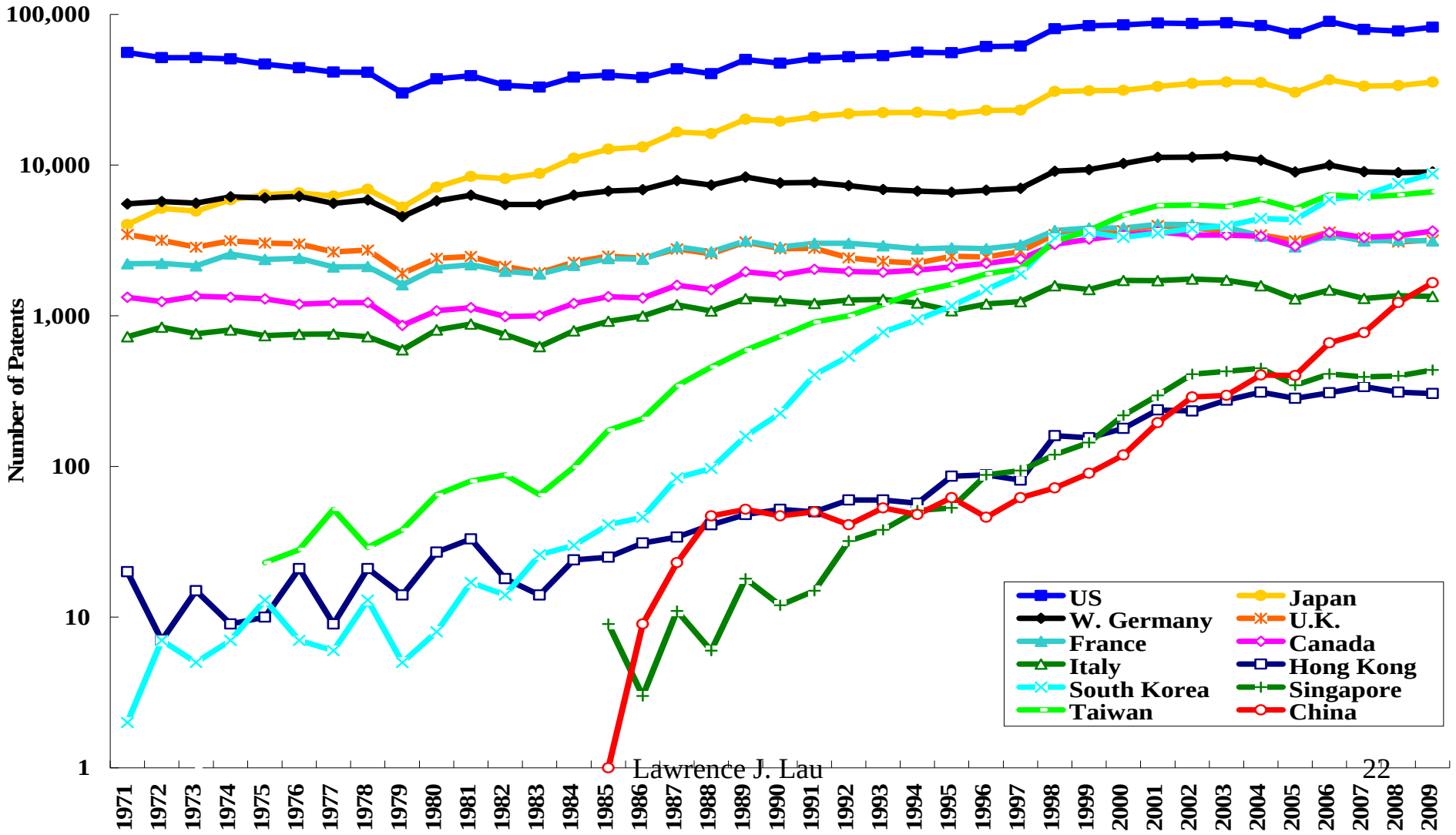


The Economic Fundamentals

- One indicator of the potential for technical progress (national innovative capacity) is the number of patents created each year. In the following chart, the number of patents granted in the United States each year to the nationals of different countries, including the U.S., over time is presented. The U.S. is the undisputed champion over the past forty years, with close to 100,000 patents granted each year, followed by Japan. (Since there are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries, the comparison across them is fair.)
- The number of patents granted to Chinese applicants each year has increased from 1 in 1985 to approximately 1,000 patents in 2009.
- South Korea and Taiwan are still ahead of China in terms of the number of patents granted in the U.S., averaging approximately 8,000 patents a year each.

Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs & China

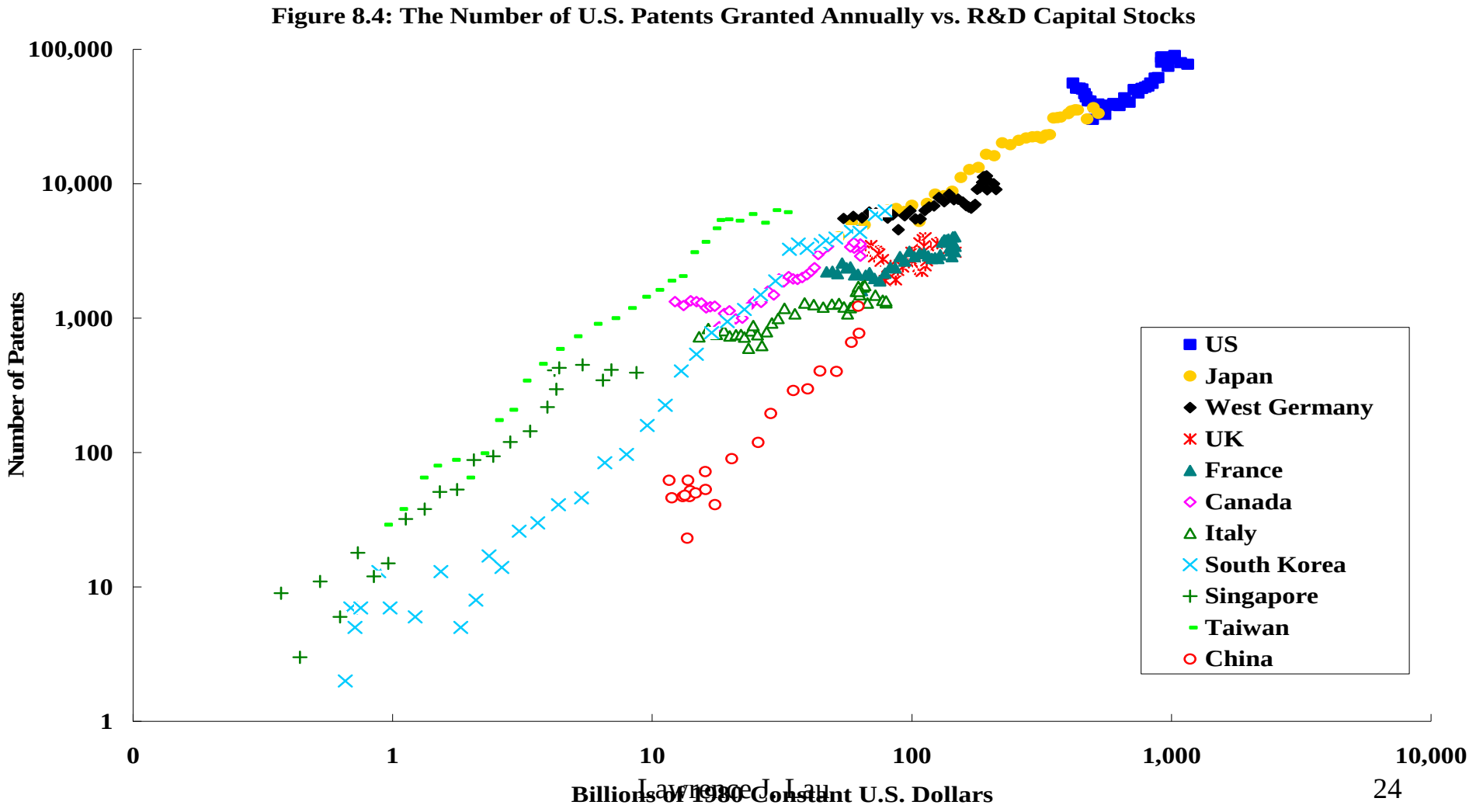
Figure 8.3: Patents Granted Annually in the United States: G7 Countries, 4 East Asian NIEs and China



The Economic Fundamentals

- The stock of R&D capital, defined as the cumulative past real investment in R&D less depreciation of 10% per year, can be shown to have a direct causal relationship to the number of patents granted (see the following chart, in which the number of patents granted is plotted against the R&D capital stock for each country and each year).
- Because China has had both a much lower R&D investment to GDP ratio and a much lower GDP than the United States and other developed economies in the past, it will take more than a couple of decades before Chinese R&D capital can catch up to the level of U.S. R&D capital (and hence to the number of patents granted each year).
- China also lags behind the U.S. in terms of human capital even though its enrolment in tertiary educational institutions has greatly expanded in recent years.
- Chinese efficiency in the generation of patents in the U.S., also lags behind the other East Asian newly industrialised economies in terms of the number of patents granted for given levels of R&D capital.

Patents Granted in the United States and R&D Capital Stocks, Selected Economies



The Economic Fundamentals

- In addition to a high national savings rate, a large pool of surplus labour, a huge domestic market, and rising investment in intangible capital (human capital and R&D capital), China also has the advantage of relative backwardness:
  - The ability to learn from the experiences of successes and failures of other economies;
  - The ability to leap-frog stages of development (e.g., the telex machine, the VHS video players, the fixed landline phones); and
  - The possibility of creation without destruction (e.g., online virtual bookstores like Amazon.com do not have to destroy brick and mortar bookstores which do not exist in the first place).
- An abundance of scientific and technical manpower the cost of which is a fraction of the cost in developed economies.

The Metaphor of the "Wild Geese Flying Pattern"

- The metaphor of the "wild-geese-flying pattern" of East Asian economic development over time (Kaname Akamatsu (1962)) suggests that industrialisation will spread from economy to economy as the initially fast-growing economies, beginning with Japan, run out of surplus labour and face labour shortages, rising real wage rates, and quota restrictions on their exports.
- Thus East Asian industrialisation spread from Japan to first Hong Kong, and then Taiwan, and then South Korea, and then Southeast Asia (Thailand, Malaysia, Indonesia), and then to Guangdong, Shanghai, Jiangsu and Zhejiang in Mainland China. During this industrial migration, the large trading firms such as Mitsubishi, Mitsui, Marubeni and Sumitomo of Japan and Li and Fung of Hong Kong played an important role as financiers, intermediaries and managers of logistics and supply chains.

The Metaphor of the "Wild Geese Flying Pattern"

- This metaphor applies not only to East Asia but also to China itself. Within China, industrialisation will begin first in the coastal provinces, regions and municipalities and then migrate and spread to other provinces, regions and municipalities in the interior. As the coastal provinces, regions and municipalities slow down in their economic growth, the central and western provinces, regions and municipalities will take their turn as the fastest growing areas in China. China as a whole will be able to maintain its high rate of growth for many years to come.

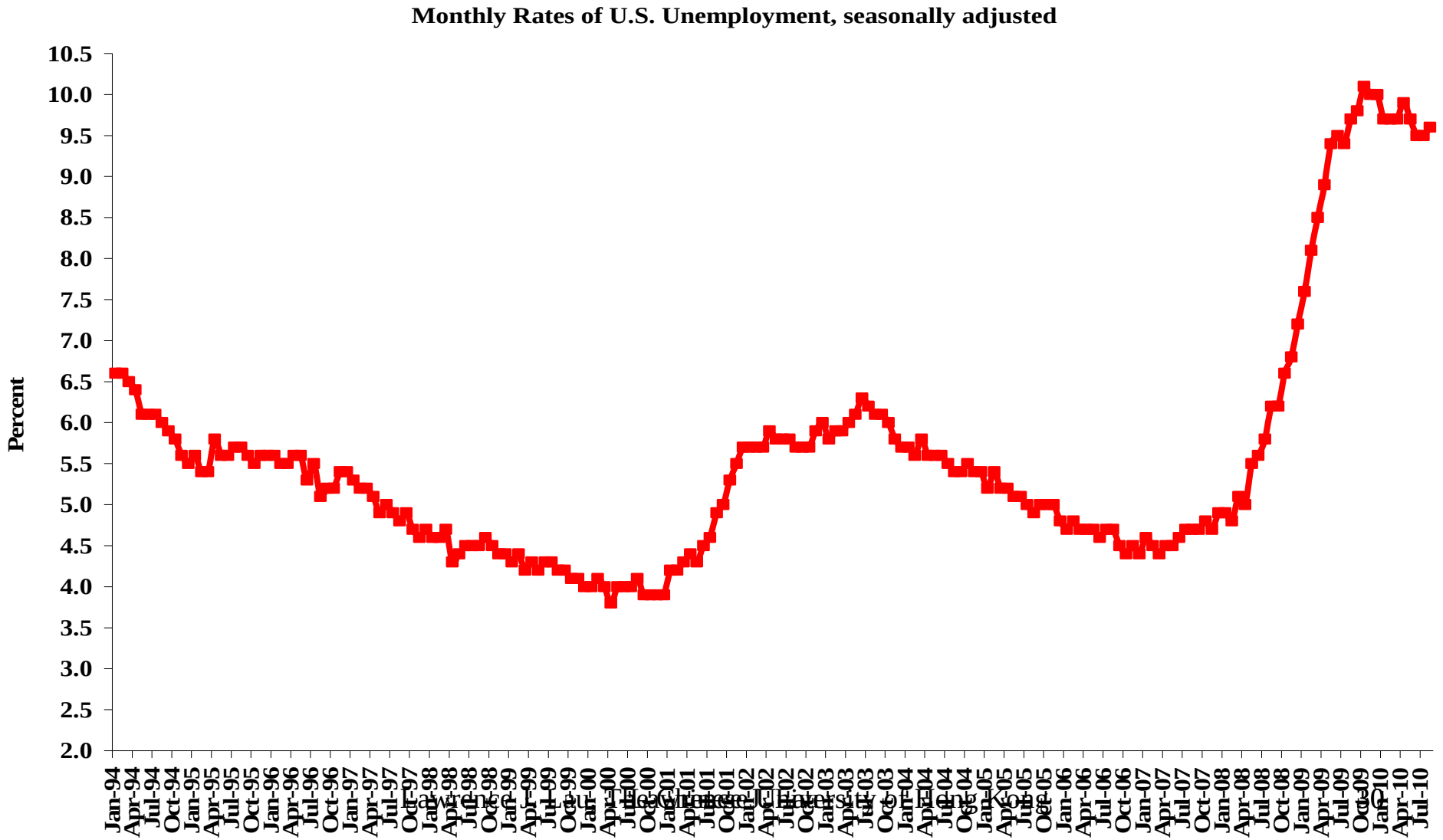
The Evolution of the World Economy

- Near-term outlook for the U.S. economy
- The changing distribution of World GDP
- The partial de-coupling hypothesis
- The projected distribution of World GDP

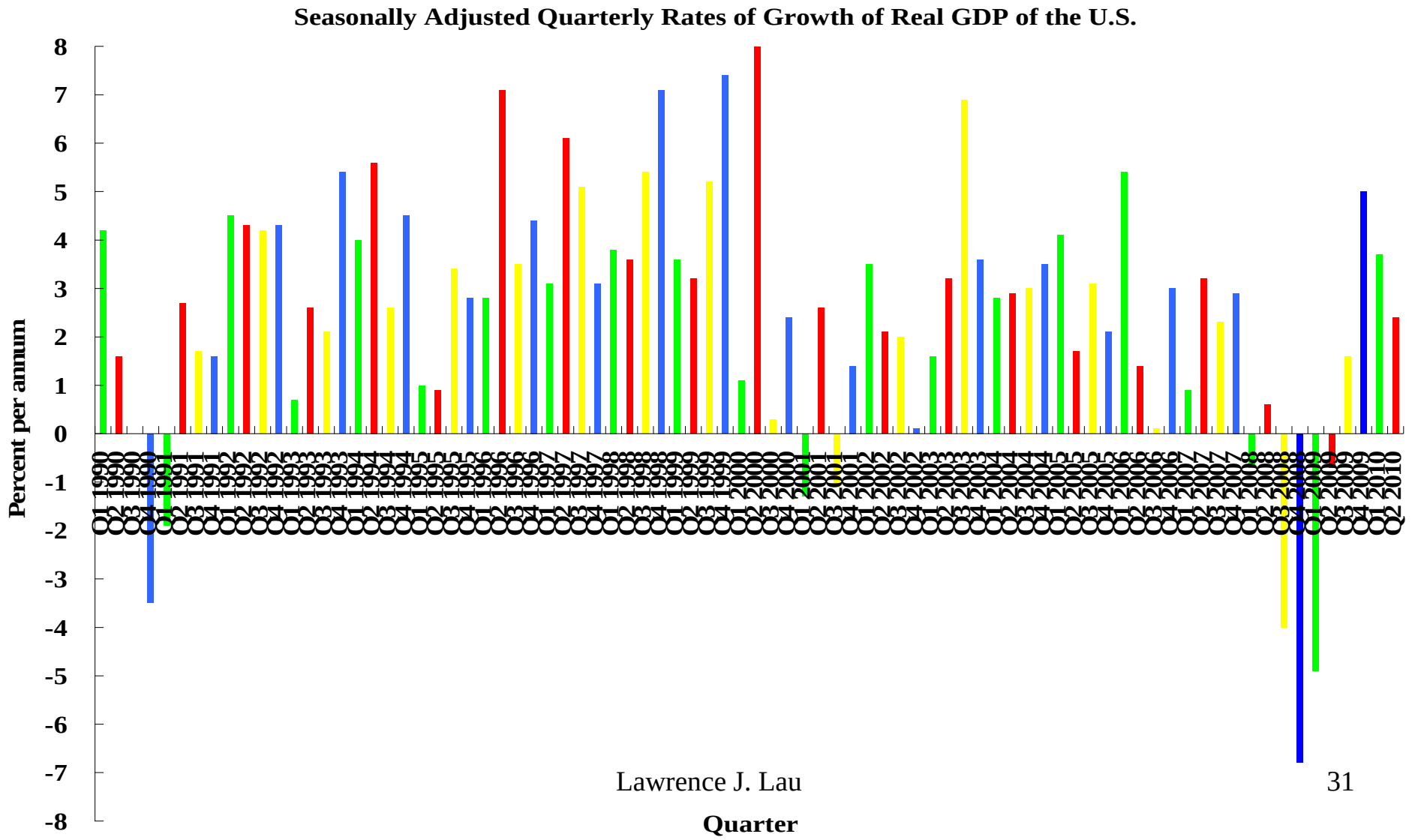
Near-Term Outlook for the U.S. Economy

- The unemployment rate has remained stubbornly high—hovering just below 10%.
- Despite the recently announced end of the recession in mid-2009, the rate of growth of real GDP has been declining.
- The rate of growth of personal consumption has remained hesitant.
- The rate of inflation, as reflected by the consumer price index and the GDP deflator, has remained tame.
- However, banks are not lending; firms are not investing; and households are not spending. This is a formula for continued economic stagnation.

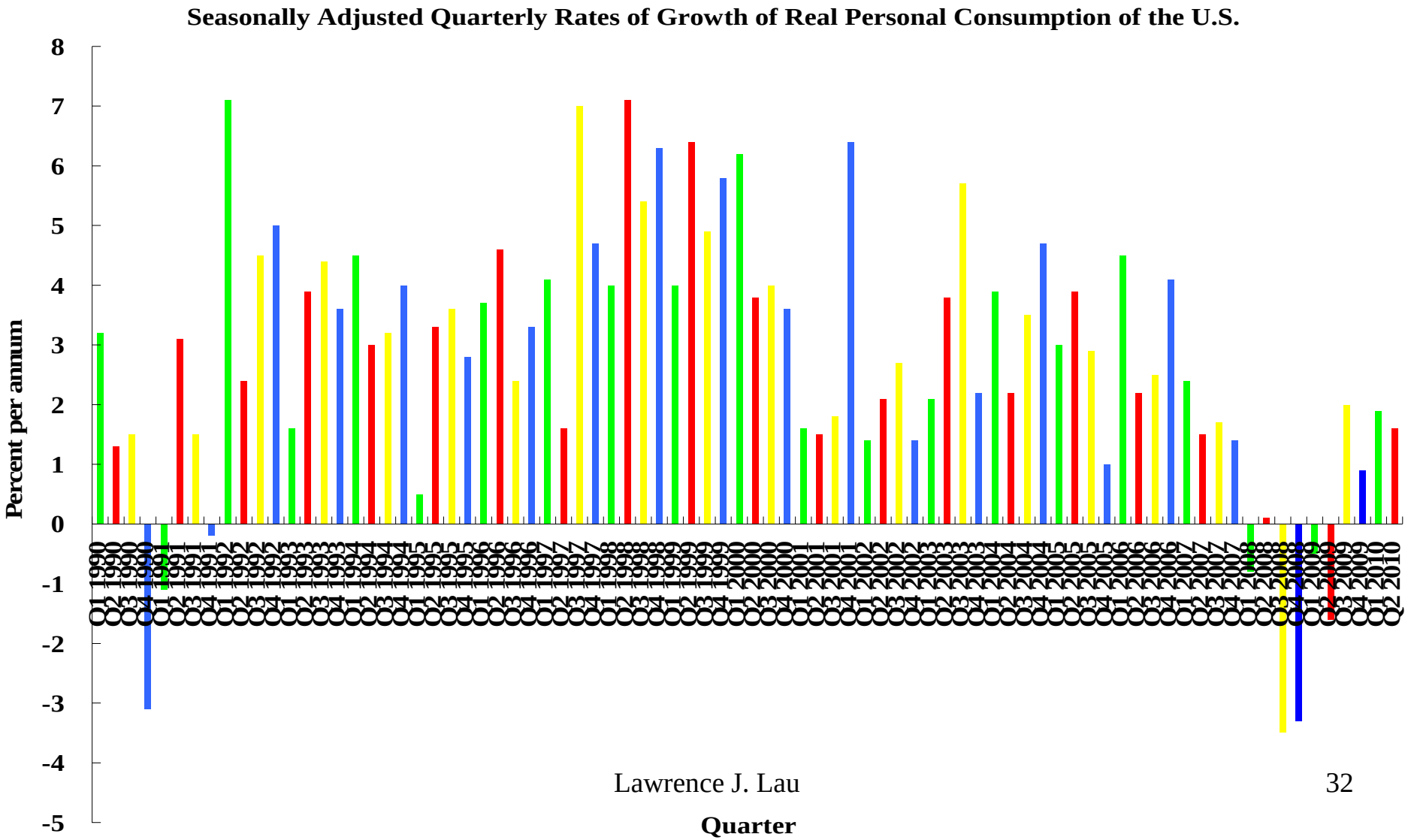
U.S. Unemployment Rate Seasonally Adjusted



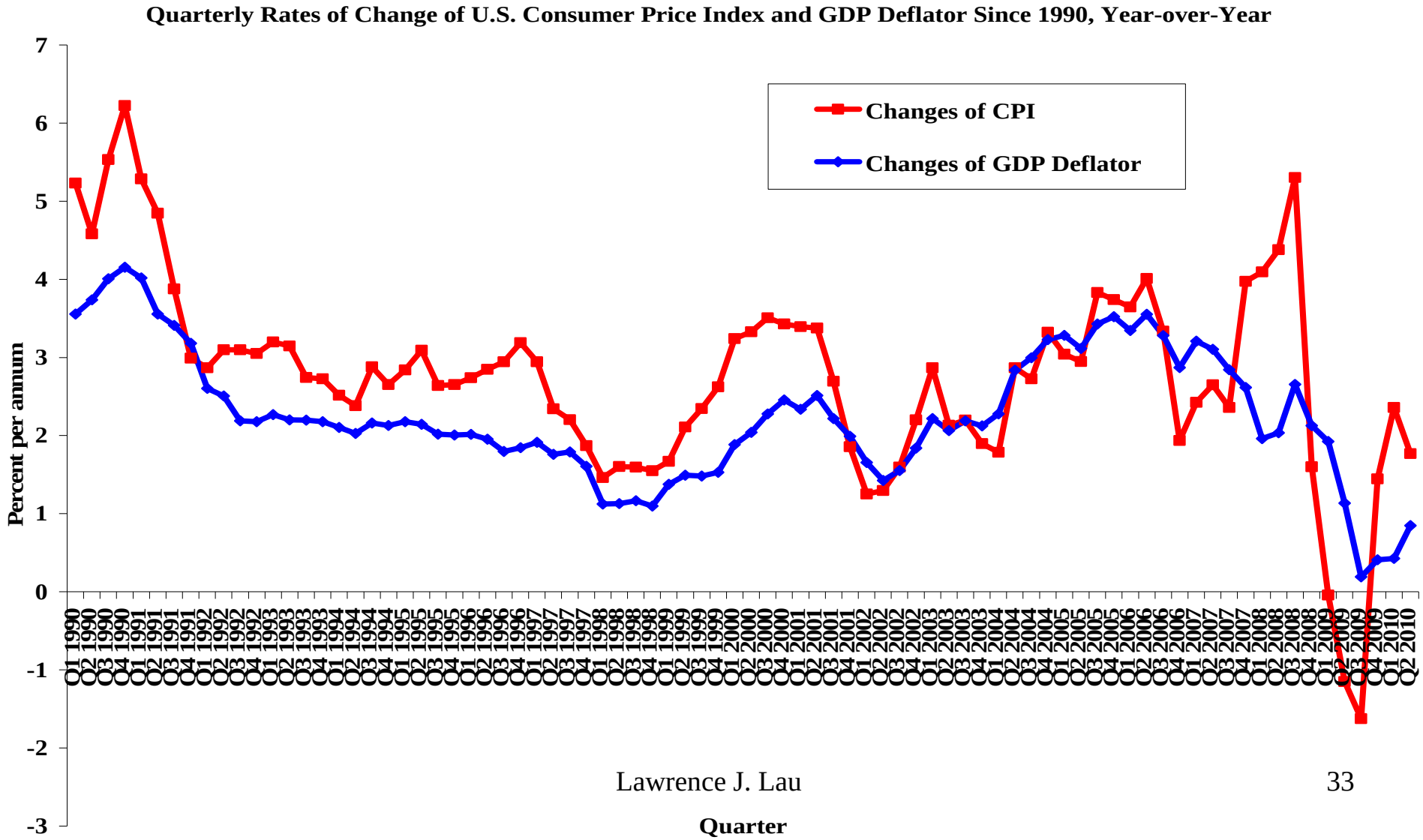
Seasonally Adjusted Quarterly Real Rates of Growth of U.S. GDP



Seasonally Adjusted Quarterly Real Rates of Growth of U.S. Personal Consumption



Quarterly Rates of Change of U.S. CPI & GDP Deflator



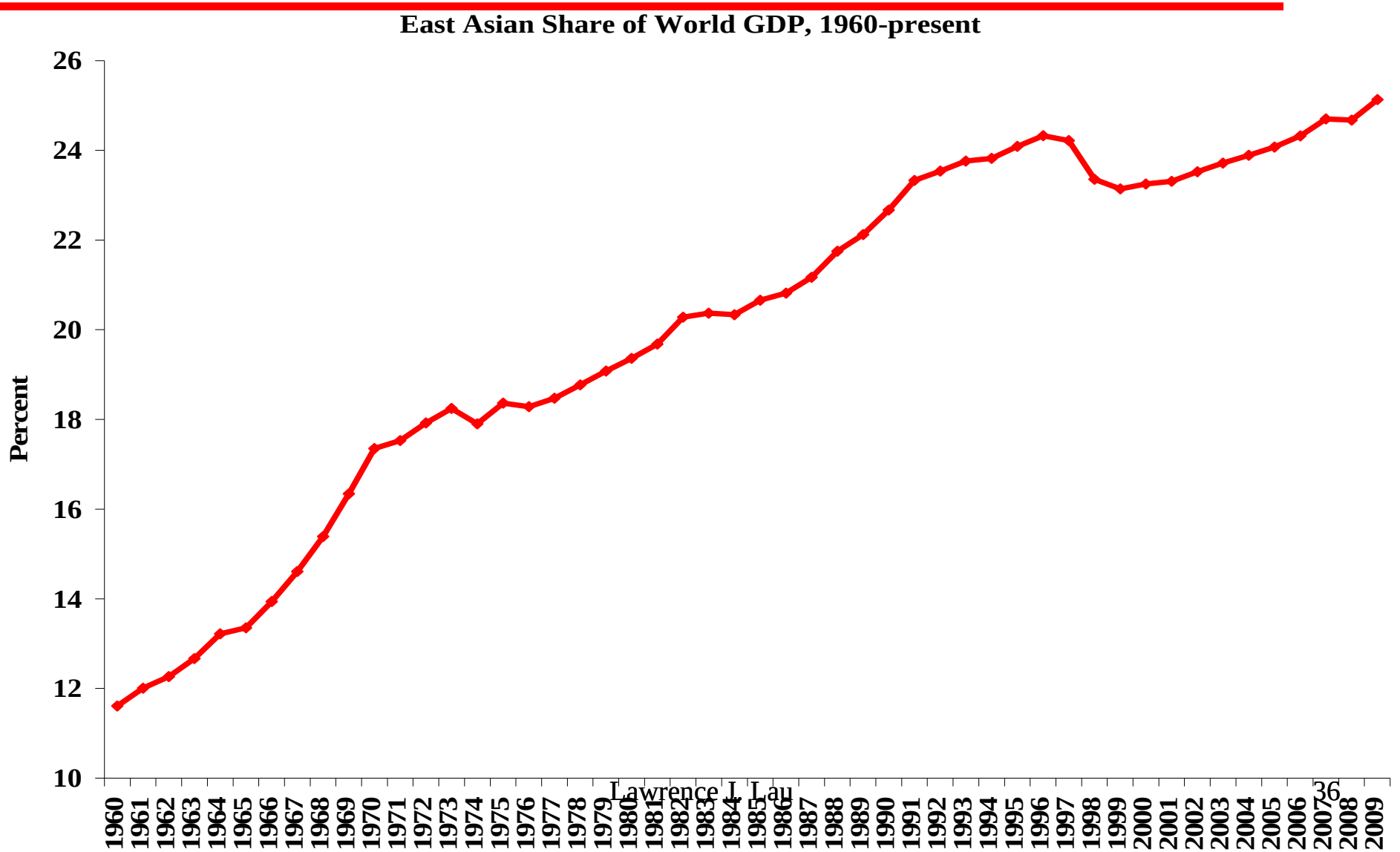
The Changing Distribution of World GDP

- East Asia is taken to mean the 10 ASEAN countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (including Hong Kong, Macao and Taiwan), Japan, and South Korea), that is, approximately, all the territories east of Bangladesh and west of the Pacific Ocean.
- In 1960, East Asian GDP, comprising of the GDPs of the 10 ASEAN countries + 3 (China (Mainland only), Japan, and South Korea) was just over 10% of World GDP and Chinese GDP was less than 1%.
- Today, East Asian economies account for approximately a quarter of World GDP, comparable to the size of the U.S. economy and that of the Euro Zone, and China (Mainland only) accounts for approximately 7%.

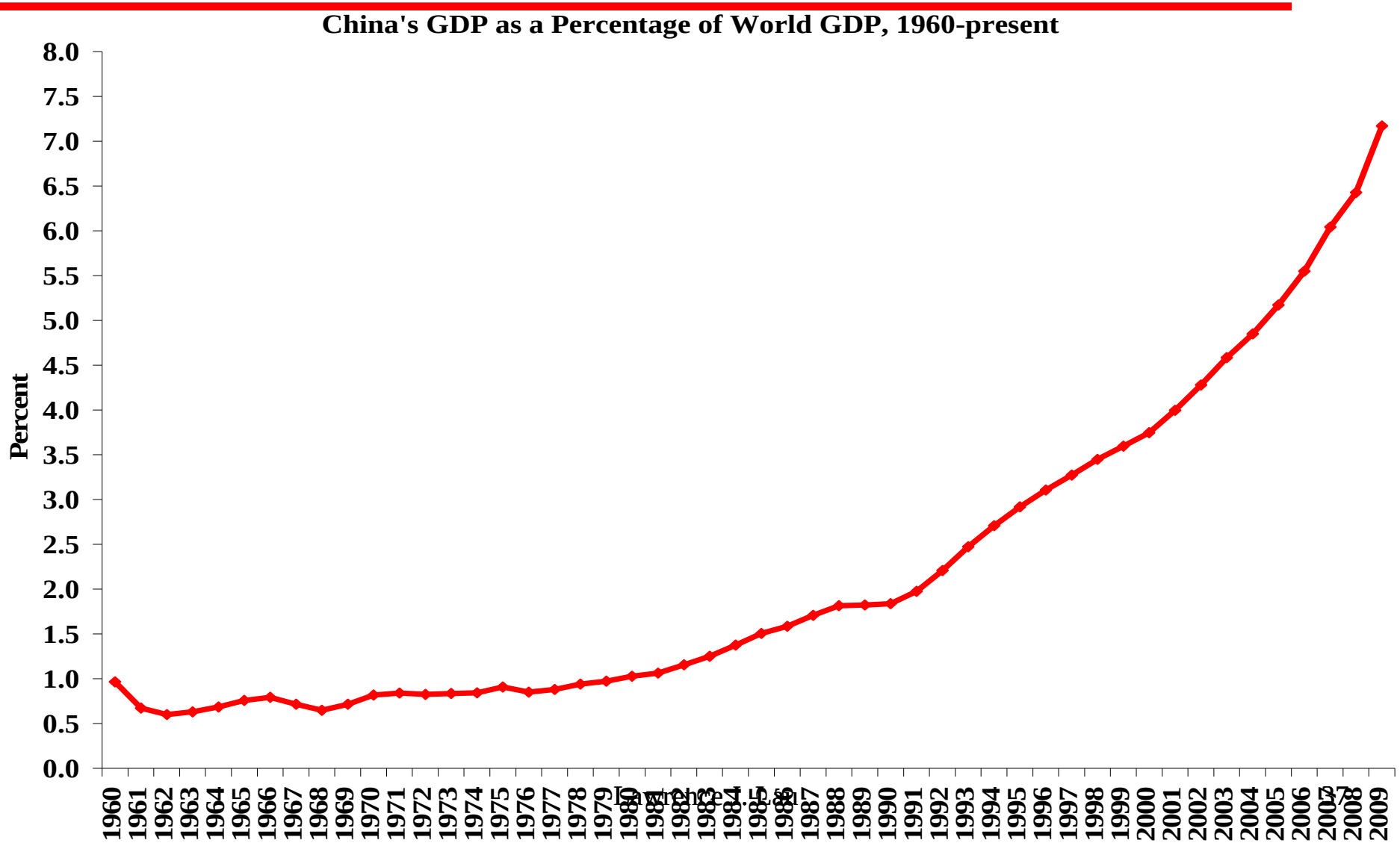
The Changing Distribution of World GDP

- However, East Asia and China are still not large enough to turn around the whole World. (The talk about G-2 is pre-mature.)
- In the following charts, East Asian and Chinese GDP as percentages of World GDP since 1960 are respectively presented. Both show very strong trends of growth over the past half a century.

East Asian Share of World GDP, 1960-present



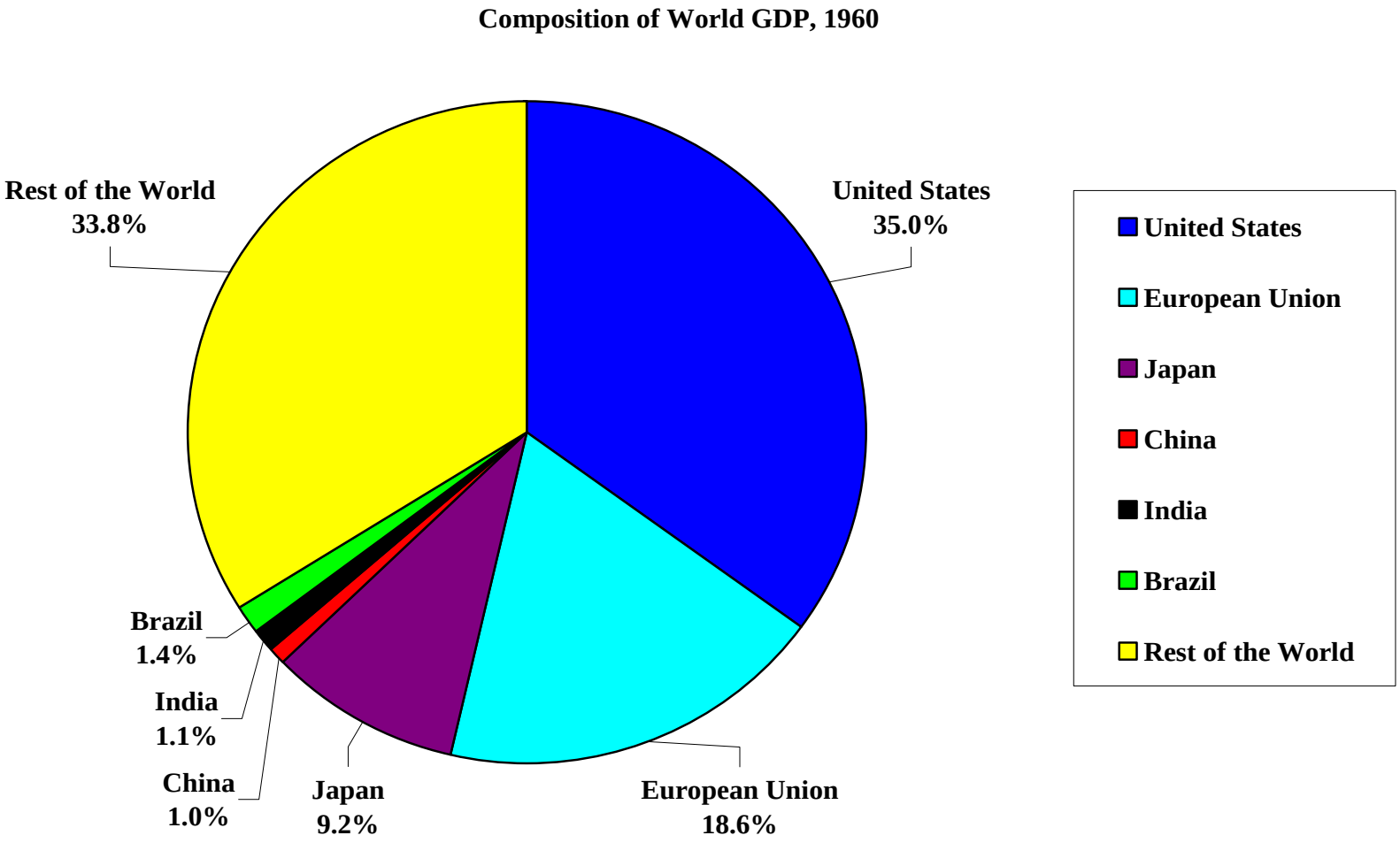
China's Share of World GDP, 1960-present



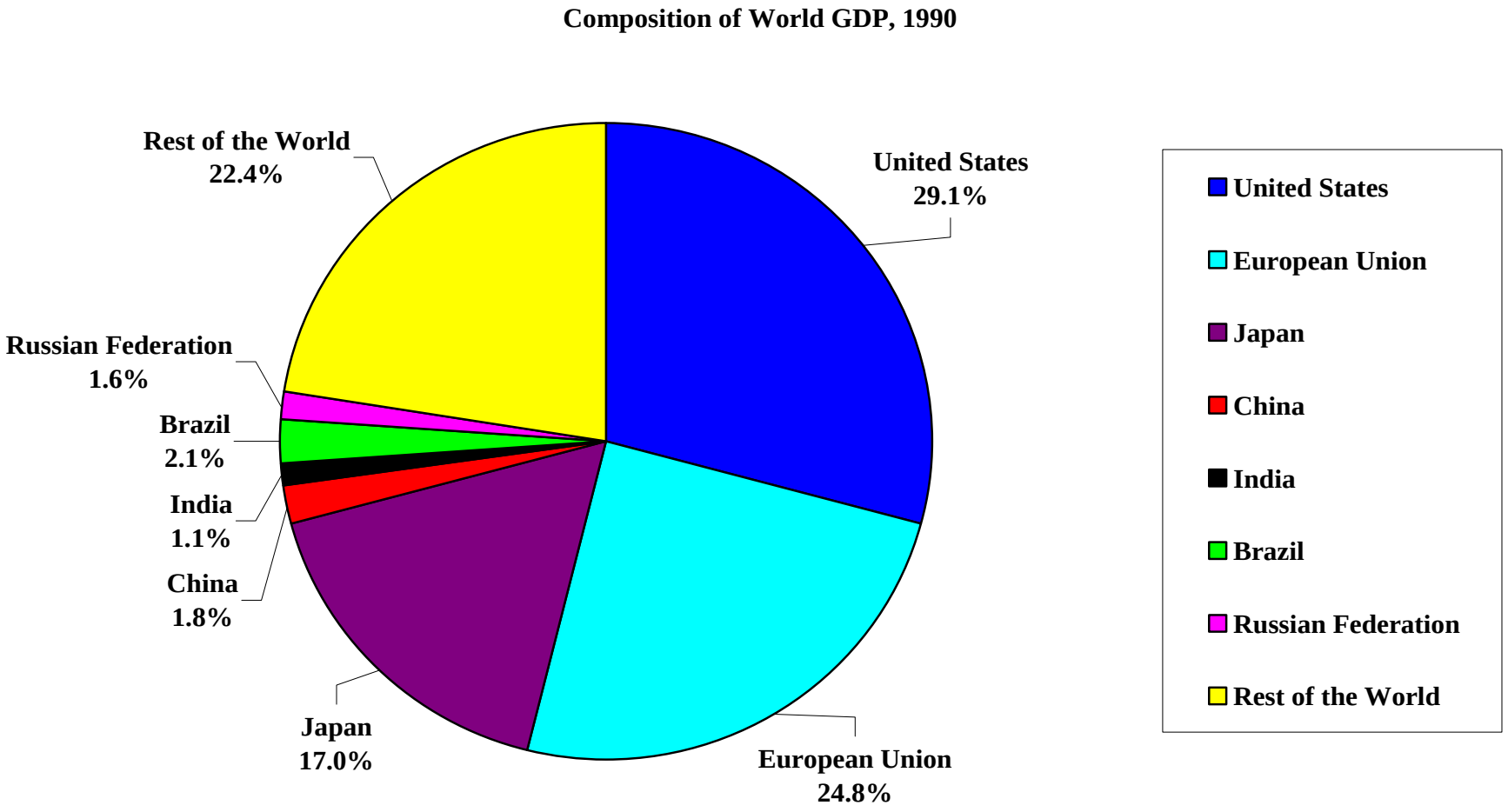
The Changing Distribution of World GDP

- In 1960, the United States accounted for 35% of World GDP; today, it accounts for approximately a quarter of World GDP.
- In 1960, the European Union accounted for less than 20% of World GDP; today, after having expanded to include more than twenty European countries, it accounts for approximately a quarter of World GDP.
- In 1960, Japan accounted for less than 10% of World GDP; by 1990, Japanese share of World GDP had risen to just below 18%. However, today, Japan accounts for less than 8% of World GDP, the same as China.
- Today, Brazil, Russia and India (the other three BRIC countries in addition to China) together account for 5% of World GDP.
- The BRIC economies (Brazil, Russia, India and China) have all been growing significantly faster than the developed economies of European Union, Japan and the United States over the past decade.

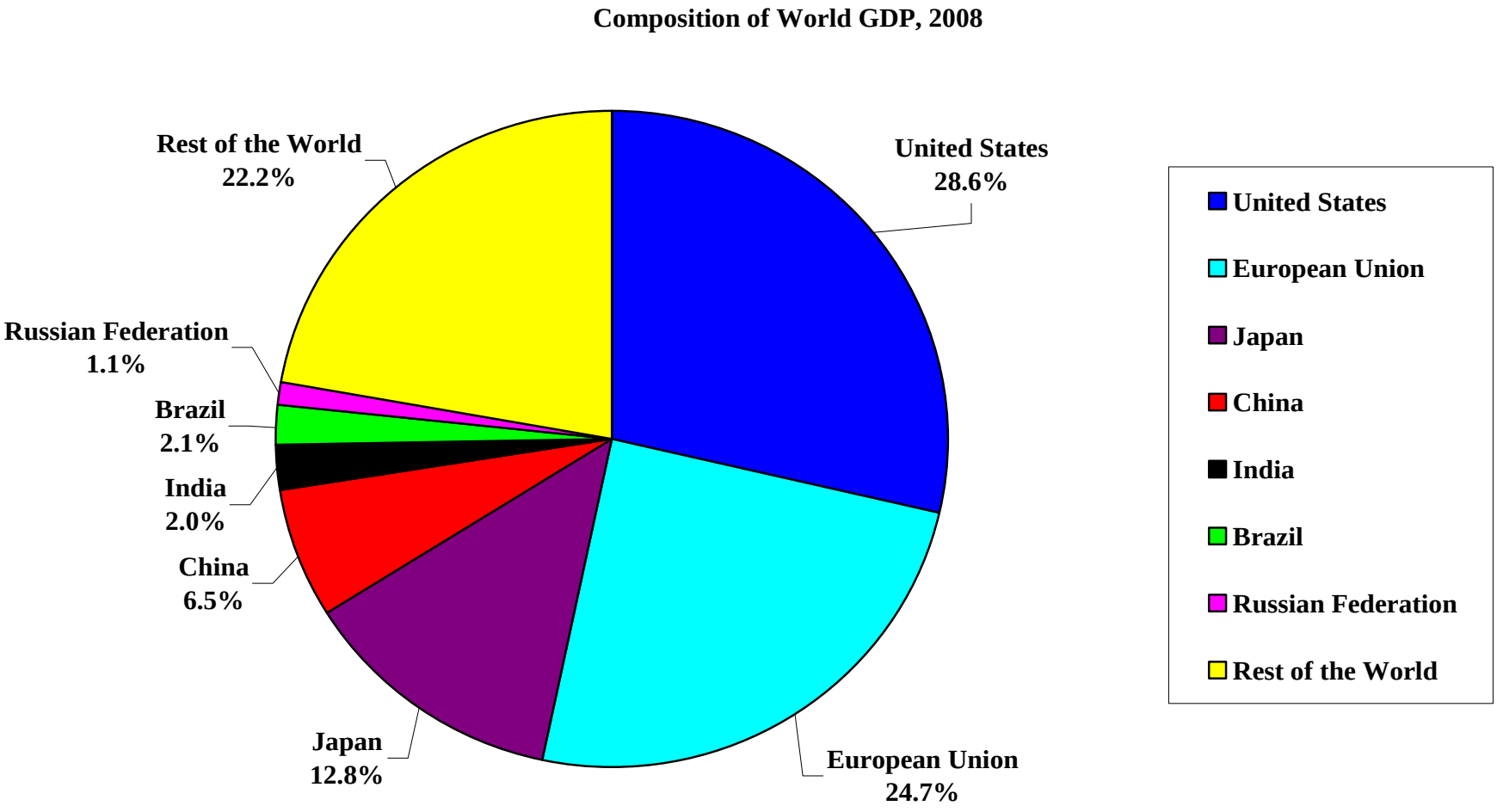
Composition of World GDP, 1960



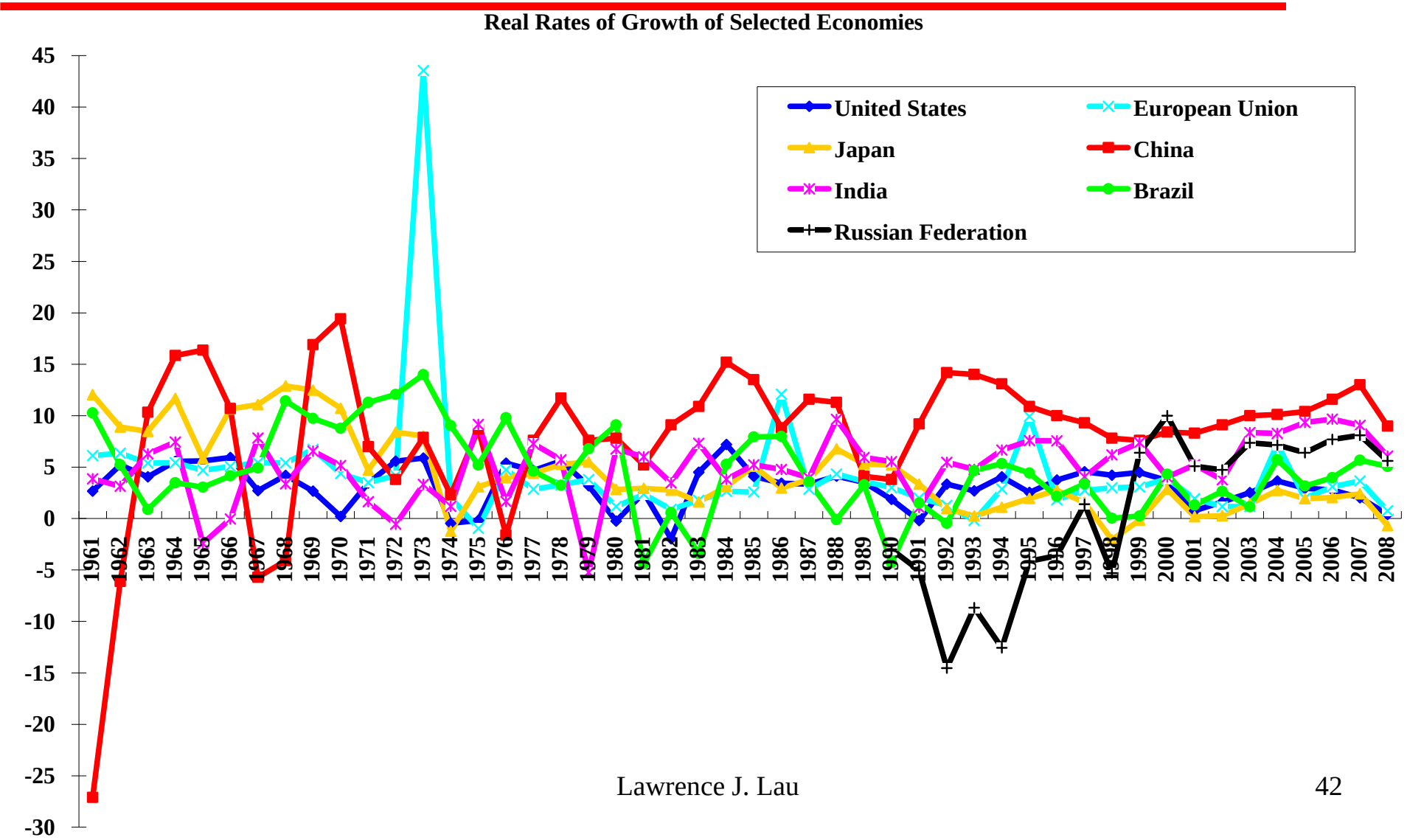
Composition of World GDP, 1990



Composition of World GDP, 2008



Real Rates of Growth of Selected Economies



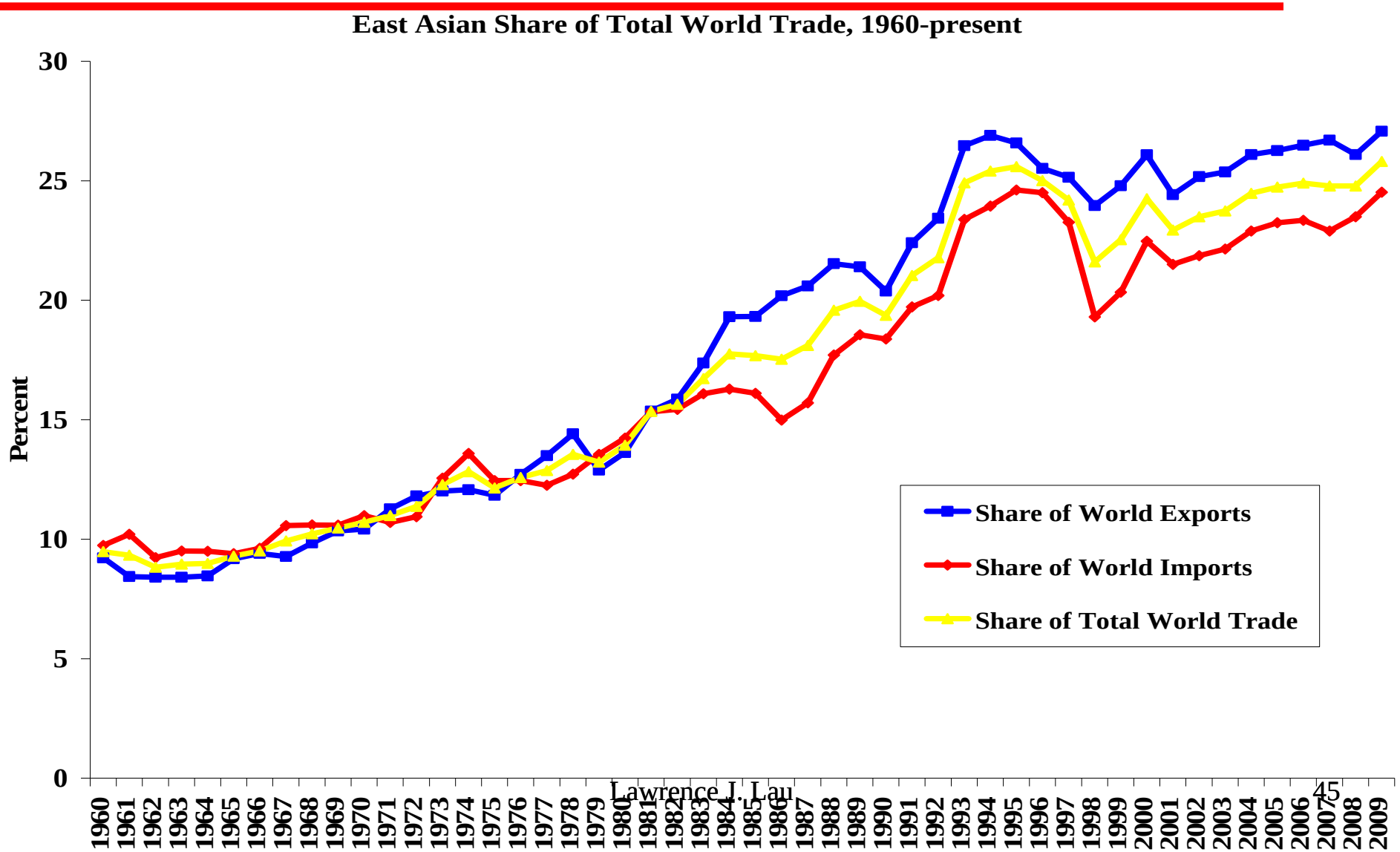
The Partial De-Coupling Hypothesis

- The “Partial De-Coupling Hypothesis” says that while East Asia is not immune from the effects of the economic recession in North America and Europe, it can nevertheless continue growing, albeit at somewhat lower rates, even with economic contraction in North America and Europe.
- Partial de-coupling is a consequence of the economic centre of gravity of the World gradually shifting to East Asia from the United States and Western Europe and within East Asia from Japan to China (but the shifts are still continuing).

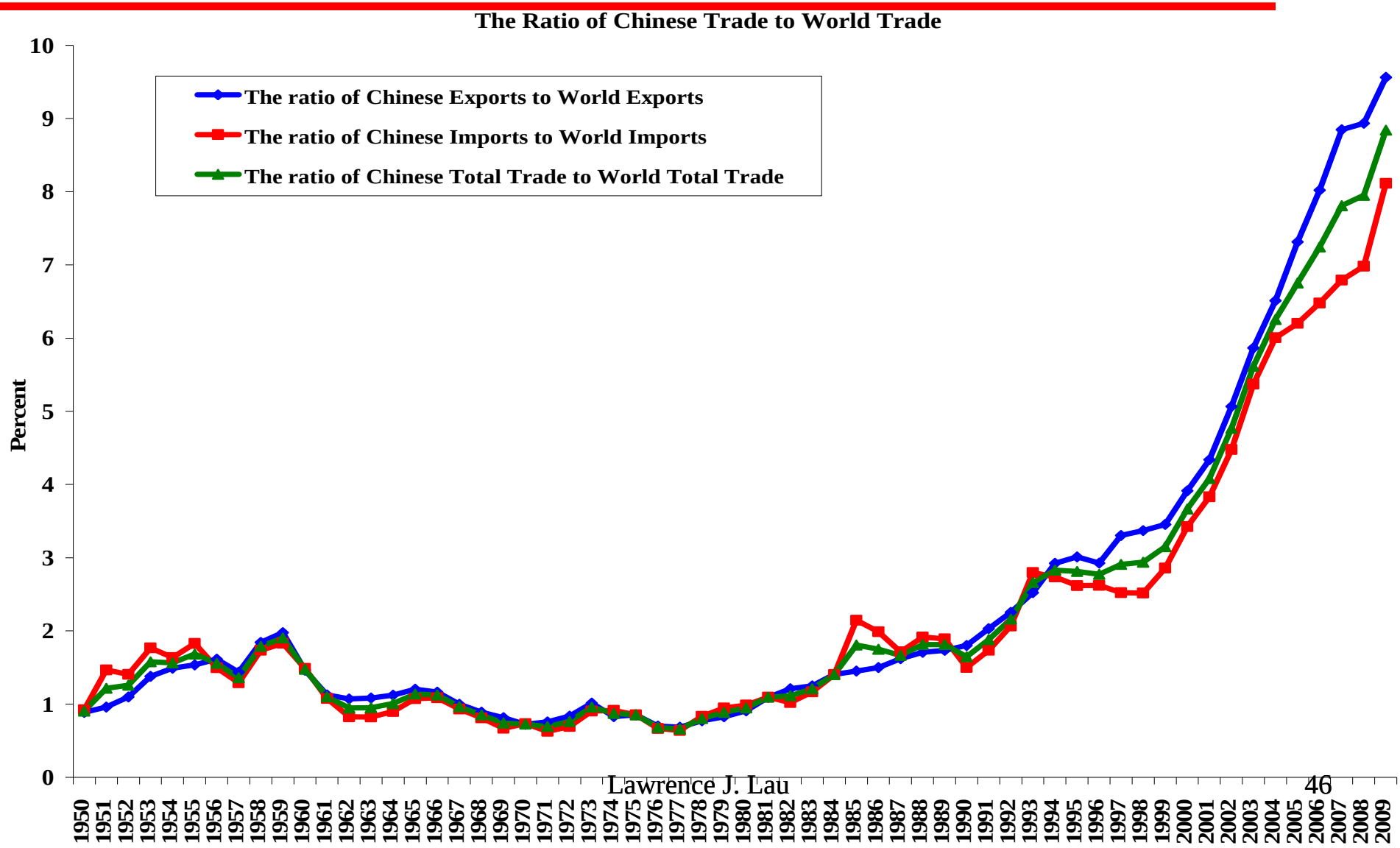
The Partial De-Coupling Hypothesis

- East Asian shares of World exports, imports, and international trade have also grown from approximately 10% in 1960 to a quarter in 2009, paralleling the growth of East Asian share of World GDP (see the following chart).
- The emergence of the Chinese economy on the global market was the one most important new development during the past three decades. Chinese shares of World exports, imports and international trade have also grown rapidly. Chinese exports and imports have risen from approximately 1% of World exports and imports in 1960 to approximately 10% of World exports and imports in 2009.
- China has become the second largest trading country in the World, after the United States. China accounts for one-third of East Asian international trade today. China has also replaced Japan to become the largest importing country in East Asia and the most important export market for almost all East Asian economies and runs trade deficits vis-à-vis almost every one.

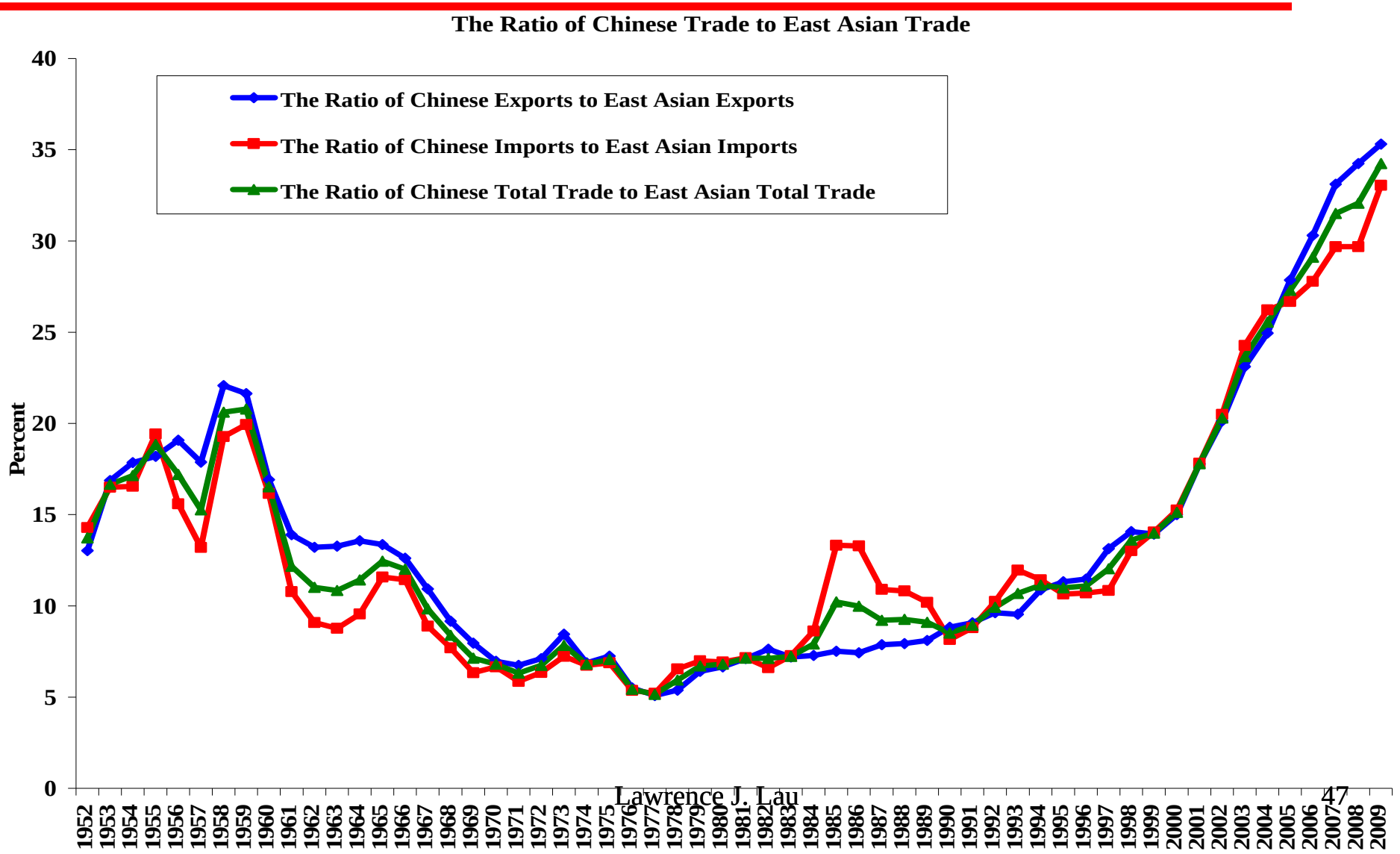
The Rising Share of East Asian Trade in Total World Trade, 1960-present



The Share of Chinese Trade in Total World Trade, 1950-present



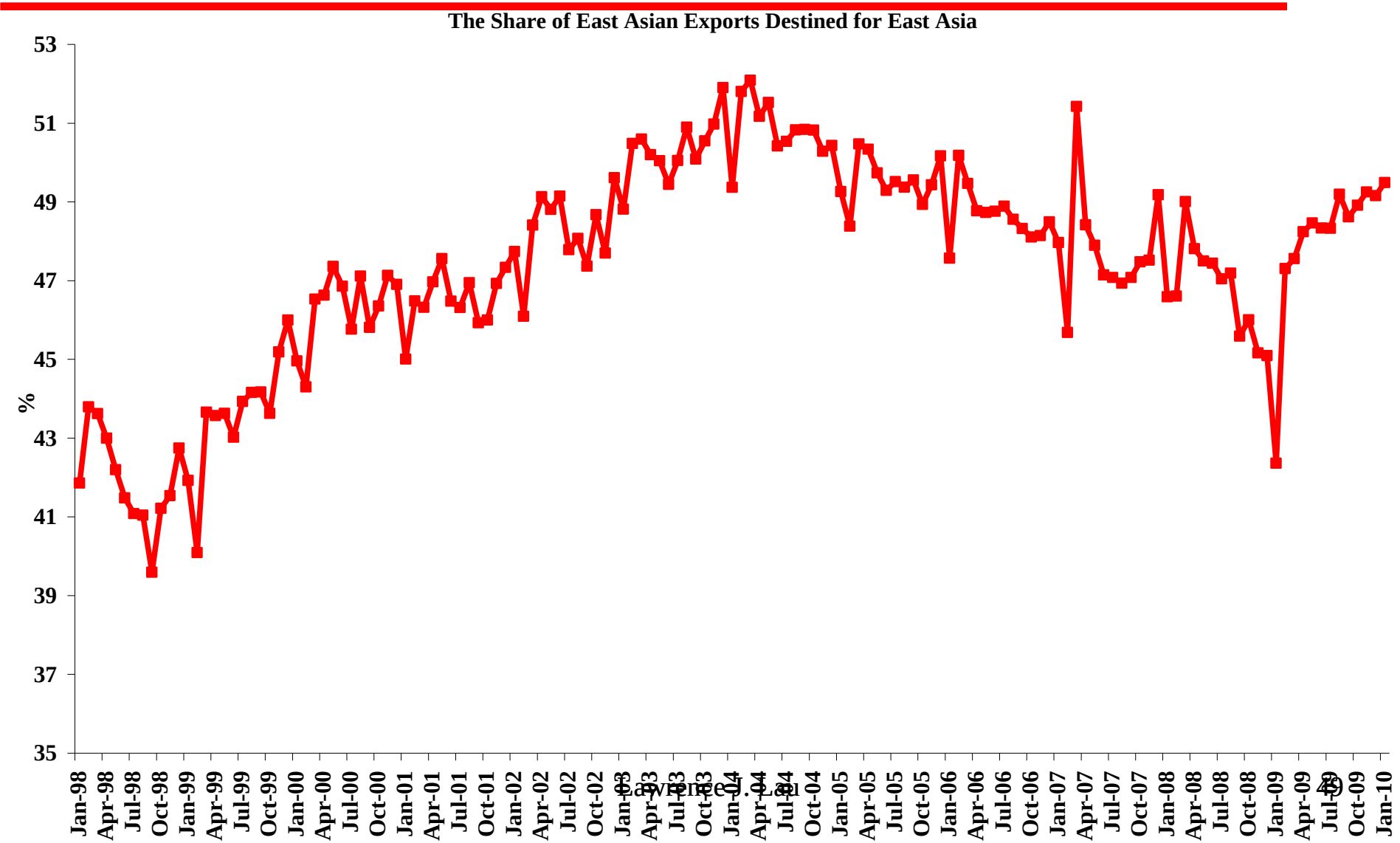
The Share of Chinese Trade in Total East Asian Trade, 1952-present



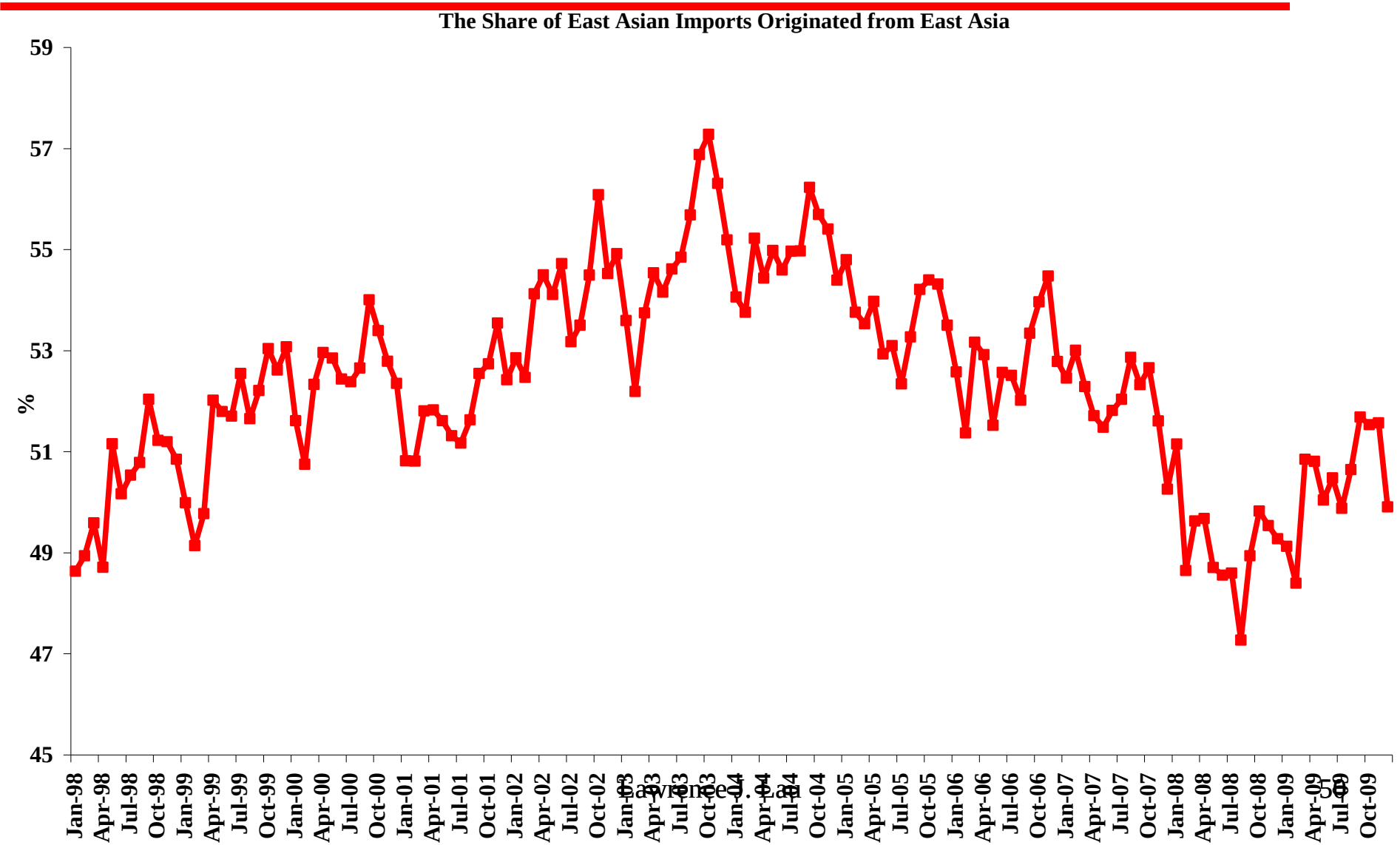
The Partial De-Coupling Hypothesis

- Because of the rapid economic growth of China and the rest of East Asia outside of Japan, and the demand and supply that such economic growth has generated, the East Asian economies now trade more with one another than with economies outside of East Asia, including the United States. By the late 1990s, approximately half of East Asian trade is among East Asian economies (see the following charts).
- And while much of the trade consists of raw materials, components, and semi-finished goods which are further processed for exports to developed economies ultimately, much of it has also found itself into the final demands of the domestic markets.
- This is a sea change compared to say thirty years ago when most of the East Asian trade was between East Asia and the United States and Western Europe and not within East Asia itself.

The Share of East Asian Exports Destined for East Asia



The Share of East Asian Imports Originated from East Asia



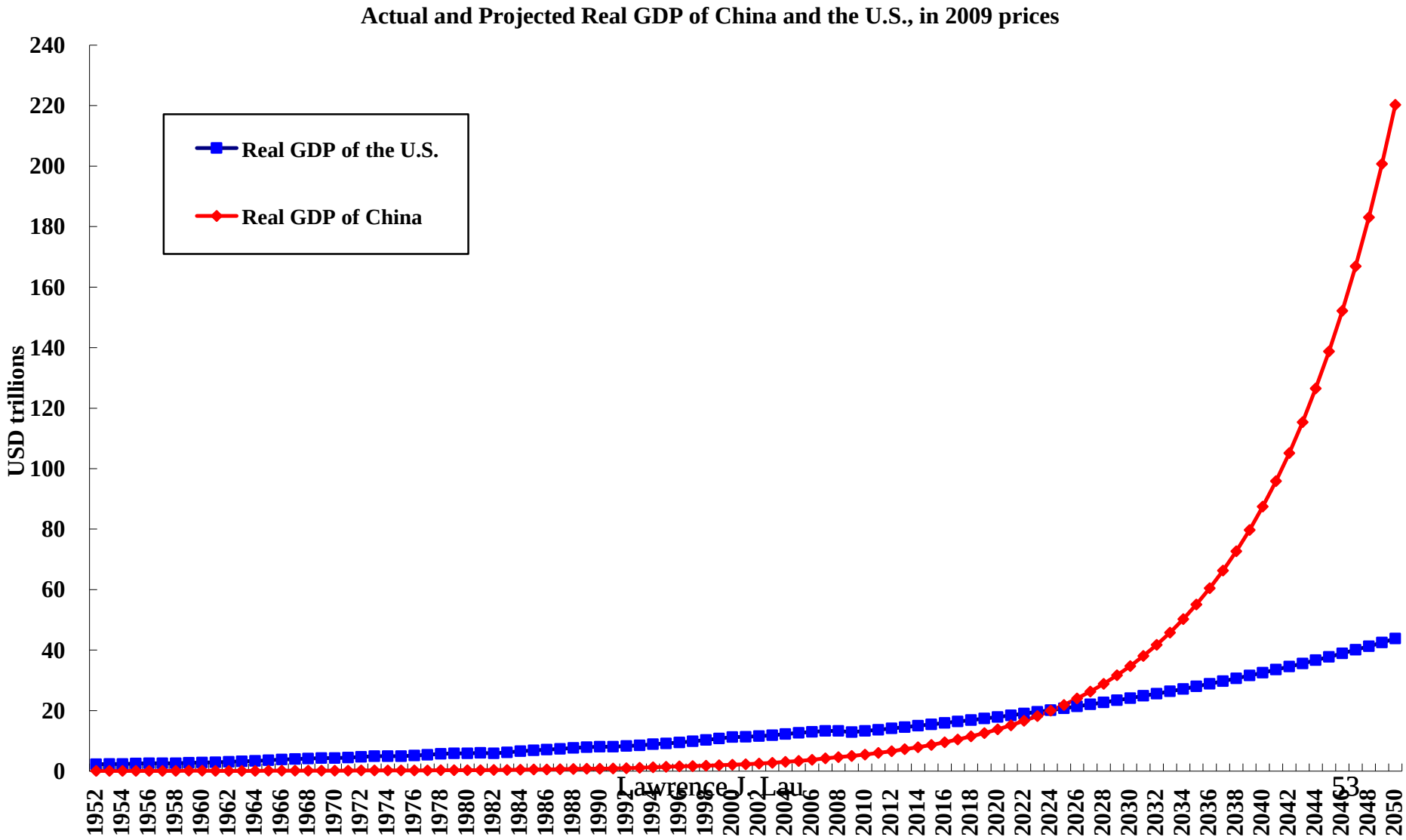
The Partial De-Coupling Hypothesis

- As a result, interdependence of the East Asian economies has been rising sharply over the years and East Asian dependence on the United States and Western Europe has declined.
- Interdependence of the East Asian economies will rise even further within the next five to ten years as East Asia becomes the only region with a high rate of economic growth and as the ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) become increasingly realities.

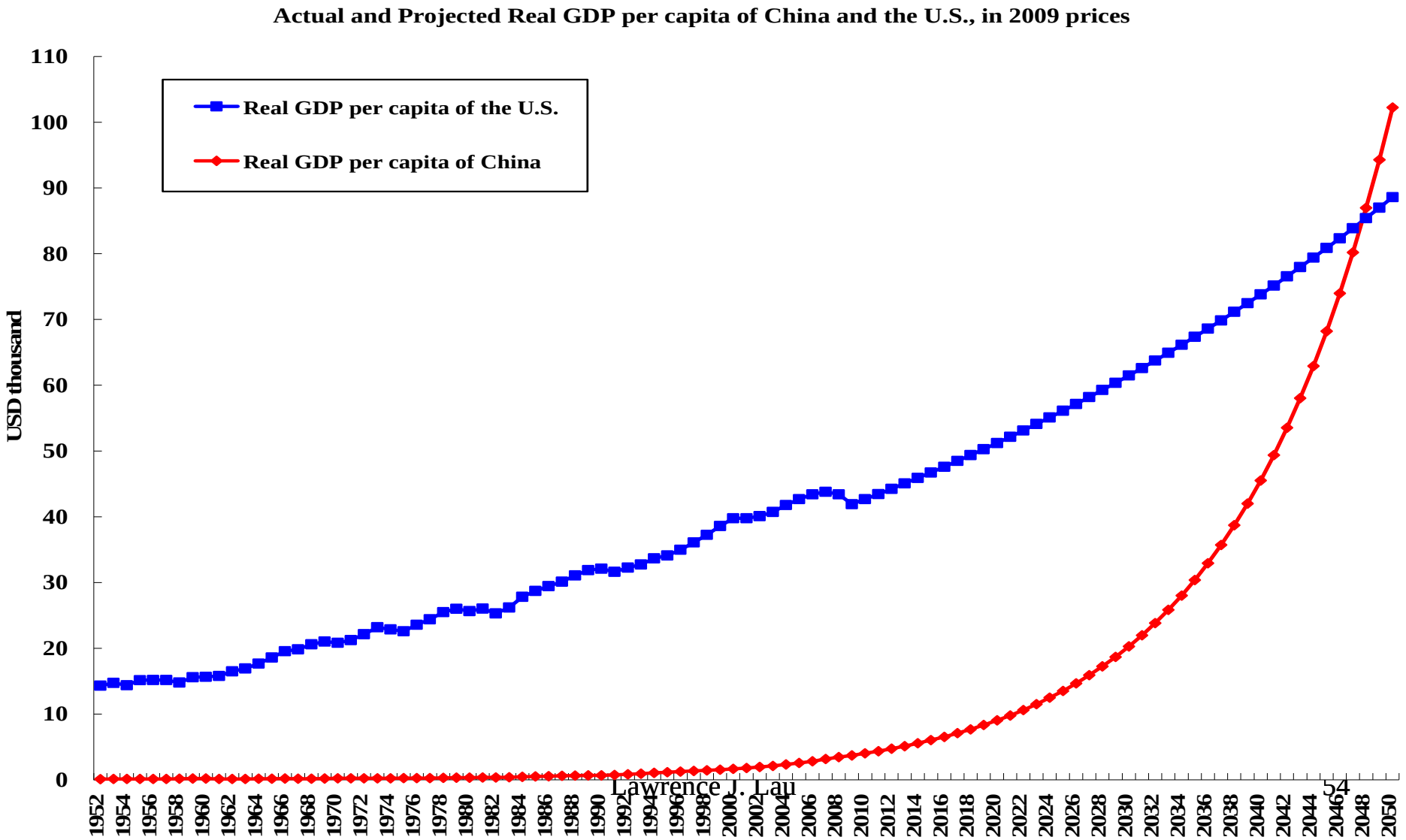
The Projected Distribution of World GDP

- Given the current trends in rates of economic growth, East Asia as a whole will surpass the United States in terms of aggregate GDP with China perhaps contributing the highest proportion of the total by 2015.
- Chinese GDP will catch up with U.S. GDP by 2025, when each will account for approximately 15% of World GDP.
- It is projected that Chinese GDP per capita will catch up with U.S. GDP per capita by 2050, at which time Chinese GDP will be approximately five times that of the U.S. and will account for between a third and a half of World GDP (depending on the growth rates of other economies, especially the developing economies of today).
- This is what gives credence to the idea of partial "de-coupling" of the World economies—that the Chinese and East Asian economies can continue to do reasonably well despite the current economic problems in the developed economies of Europe and the U.S..

Actual and Projected Chinese and U.S. Real GDPs



Actual and Projected Chinese and U.S. Real GDP per Capita's



A New International Monetary Order

- Is the current (U.S. Dollar-centric) international monetary system sustainable?
- The internationalisation of the Renminbi
- A “Bank for Intra-Asian Settlements”

Is the Current International Monetary System Sustainable?

- International trade and other international transactions are normally denominated and settled in a limited number of currencies principally because the citizens of most countries do not wish to accept or hold the currencies of other countries than the few recognised as “reserve” currencies (e.g., US$, Euro, Japanese Yen, Swiss Franc, British Pound). (Gold is possibly an exception.)
- Two countries trading with each other may not trust each other’s currency, so that unless the bilateral trade is completely balanced and a straight barter is possible, they will need to use the currency of a third country which both of them trust and are willing to accept and hold. This currency often turns out to be the US$.

Is the Current International Monetary System Sustainable?

- Reserve currencies such as the U.S. Dollar add value by enabling international transactions, in particular trade transactions, that otherwise may not take place. Without the use of the U.S. Dollar or a similar medium, many countries will be limited to doing only barter trade with one another. The U.S. has thus contributed to the World economy by being a principal provider of the international liquidity needed to support international trade and capital transactions.
- The major share of international trade, including the trade in crude oil and major commodities, as well as international capital transactions, are denominated and settled in U.S. Dollars. The U.S. Dollar is widely accepted and hence widely used as the medium of exchange in the denomination and settlement of international trade and capital transactions. As world trade and capital flows grow, the demand for U.S. Dollars as transaction balances increases.

Is the Current International Monetary System Sustainable?

- The central banks and monetary authorities of many countries maintain foreign exchange reserves in the form of assets in the major reserve currencies as essentially international transaction balances that may be used to pay for imports from countries unwilling to accept their own currencies, as well as the principal and interest on their foreign-currency denominated loans.
- The United States has been providing this liquidity to the World by running large annual trade deficits and paying for these trade deficits with U.S. Dollars, which are retained as foreign exchange reserves by the central banks and monetary authorities of many countries and regions.

Is the Current International Monetary System Sustainable?

- However, it is far from clear whether the U.S. is willing and able to continue to be the supplier of the principal international liquidity of the world by running large trade deficits. If not, the future sustainability of the U.S. Dollar as the principal medium of international exchange is in doubt.
- If, in response to the 2007-2009 global financial crisis, the United States manages to reduce her trade deficit with the World to zero, or even better, to achieve a trade surplus in the future, there will be a reduction at least in the growth of the supply of U.S. Dollars outside of the U.S. for the settlement of international transactions and for official foreign exchange reserve purposes. Unless alternative mechanisms for the settlement of international transactions are developed, the growth of international trade and capital transactions will be constrained by the lack of adequate international liquidity.

Is the Current International Monetary System Sustainable?

- One alternative is for the world to return to the gold standard, so that countries settle differences in their trade balances in gold.
- Another alternative is for one or more currencies to assume the role as principal reserve currencies (e.g., the Japanese Yen and the Renminbi). But then these countries must be willing and able to do so.
- Yet another alternative is to develop a new multilateral mechanism for the clearing and settlement of international transactions largely in terms of local currencies first regionally and perhaps eventually globally.

The Internationalisation of the Renminbi

- What do we mean by the "Internationalisation of the Renminbi"? It can mean many different things:
- The Renminbi is used as a "unit of account" in international transactions, e.g., trade between Mainland China and Hong Kong, which may be denominated in Yuan.
- The Renminbi is used as a medium of exchange outside of Mainland China, sometimes as an alternative to the local currency of legal tender (e.g., Hong Kong, Macau, Laos).
- The Renminbi is used as a store of value outside of Mainland China (e.g., Hong Kong).
- The Renminbi is fully convertible, that is, both "current accounts" convertible and "capital accounts" convertible—both inbound and outbound capital controls are lifted.
- The Renminbi and Renminbi assets are held by foreign central banks as a reserve currency.

The Internationalisation of the Renminbi

- The Renminbi has been current accounts convertible since 1994. However, it has not become fully capital accounts convertible. There still exist both inbound and outbound capital controls in China. Some categories of capital movements require prior government approval. But individual Chinese citizens can remit up to US$50,000 per person overseas each year, with few questions asked.

The Internationalisation of the Renminbi

- The willingness to accept and to hold a non-local currency depends, but not exclusively, on whether the currency is fully convertible. A person may be quite willing to accept and to hold a non-local currency if he or she knows that the next person he or she comes across is also likely to accept and hold the currency. There can be wide general acceptance without full convertibility.
- Even though the Renminbi is not de jure fully convertible, it has gradually become de facto convertible in many economies in East Asia because of its wide general acceptance. For example, the Renminbi is widely accepted and used in Hong Kong, Macau, Laos, Myanmar, and other border areas even though it is not legal tender in these places.

The Internationalisation of the Renminbi

- The benefit to the issuing country of a reserve currency is in the seigneurage. The issuing country can pay for its imports by printing money (or what amounts to more or less the same thing, bonds). The country receiving the money and/or bonds puts them into its foreign exchange reserves and continues to hold them as assets. So the issuing country is able to acquire real goods of real value with essentially pieces of paper which it can print at will—a great bargain.
- Reserves are normally accumulated and held in the receiving country for a long time, to the benefit of the issuing country. It is only when the receiving country decides to spend the money to buy goods and services from the issuing country or elsewhere that the issuing country has to export real goods and services to the receiving country in exchange.

The Internationalisation of the Renminbi

- The "cost" to the issuing country is that in order to benefit from seigneurage, it must in general run a trade deficit. (If it has a chronic trade surplus, it does not need to print money (or bonds) to pay for its imports and other countries will have a hard time acquiring its currency.) A country with mercantilist tendencies does not like to run trade deficits and hence may not want its currency to become a major reserve currency.
- A currency can be fully convertible without becoming a principal reserve currency, that is, being widely held by central banks. For example, the Hong Kong Dollar and the Singapore Dollar are both fully convertible, but are not principal reserve currencies, in part because of lack of demand by other central banks; and the Japanese Yen is not a principal reserve currency because of the lack of willingness on the part of Japan to supply large quantities of Japanese Yen to the World.

The Internationalisation of the Renminbi

- A further "cost" is the possibility that the receiving countries of a currency may decide at some point, for economic or other reasons, to stop holding this currency and sell the currency and the bonds they hold, potentially creating havoc to the exchange rate of the currency and the financial markets of the issuing country.
- Of course, if the issuing country is "too big to fail," as in the case of the United States, it is another matter altogether. The central banks in the World cannot afford to liquidate its U.S.$-denominated assets without incurring significant damages to themselves.

The Internationalisation of the Renminbi

- Chinese trade with East Asia is approximately 35% of its total international trade. It is expected that the use of the Renminbi for the denomination and settlement of international trade and capital transactions in East Asia will gradually become very common, to the point that it may cover almost all of Chinese international trade within East Asia with the possible exception of Japan. This trade alone amounts to more than US$1 trillion each year, with most of it currently denominated in U.S. Dollars.
- Chinese international trade with the United States and Europe, with oil exporting countries in the Middle East, and with India and Russia, may continue to be denominated in either the U.S. Dollar or the Euro.
- Chinese international trade with Africa and Latin America may well be denominated in Renminbi especially Africa if China becomes the major donor of development loans to Africa.

The Internationalisation of the Renminbi

- Approximately 20% of Japanese imports and 35% of Japanese exports are denominated in Japanese Yen. Applying a similar ratio, say 30%, to Chinese international trade with East Asia, this would amount to a shift of approximately US$300 billion from U.S.$-denominated trade to Yuan-denominated trade each year.
- The U.S.$ balances that will be needed as working capital by East Asian exporters and importers will be significantly decreased and the Renminbi balances correspondingly increased.
- If the same ratio is applied to all Chinese international trade, the amount of Yuan-denominated Chinese trade can potentially be as high as US$750 billion.

The Internationalisation of the Renminbi

- Currently, the cost of hedging against exchange rate fluctuations of the Renminbi is high and can only be done in the non-deliverable-forward market. That is one reason why even though it is now possible for the settlement of Chinese trade transactions in Renminbi, only a very small proportion of Chinese trade is denominated and settled in Renminbi. The most recent estimate is that it amounts to US$10 billion a year, less than 0.5% of aggregate Chinese international trade.
- However, it is inevitable that the volume of international trade denominated and settled in Yuan will rise significantly, especially if a forward market develops for bona fide international exporters and importers.

A "Bank for Intra-Asian Settlements"

- There are also other alternatives, for example, creating a mechanism and framework so that East Asian economies, both developed and developing, can denominate and settle their international transactions with one another with their local currencies.
- One model was provided by the European Payments Union (1950-1958). In the aftermath of World War II, when all the major economies in Western Europe were still recovering, West German exporters were reluctant to accept French Francs, French exporters were reluctant to accept the German Mark, and both German and French exporters were reluctant to accept the Italian Lire. They would all accept the U.S. Dollar (the only accepted reserve currency), which was then in short supply in Western Europe. The growth of international trade within Western Europe was thus quite constrained.

A “Bank for Intra-Asian Settlements”

- With the assistance of the United States Marshall Plan, the European Payments Union (EPU) was established by the Organisation for European Economic Cooperation (OEEC) in July 1950, with the Bank for International Settlements acting as its agent, to solve the problem of insufficient international liquidity (U.S. Dollars).

A "Bank for Intra-Asian Settlements"

- The basic idea of the European Payments Union is for countries to settle their balances on a net basis rather than on a gross basis, both chronologically and geographically. For example, Country A may have a trade surplus with Country B today but it may have a trade deficit with Country B tomorrow. They need only to settle the net difference over a period, say, a month. This minimizes the amount of U.S. Dollar balances needed for the settlement. For another example, Country A may have a trade surplus with Country B, and Country B may have a trade surplus with Country C, and Country C may have a trade surplus with Country A. They need only to settle the consolidated net balance across all pairs of countries participating in the payments union. Again, this also minimizes the amount of U.S. Dollar balances needed for the settlement.

A “Bank for Intra-Asian Settlements”

- The European Payments Union was quite successful and intra-West European trade doubled within a relatively short period of time.
- The European Payments Union was replaced by the European Monetary Agreement in December 1958 when convertibility of the Western European currencies was finally restored.

A “Bank for Intra-Asian Settlements”

- It may become necessary for China and the World to devise alternative mechanisms for the denomination and settlement of international transactions other than the use of reserve currencies such as the U.S. Dollar.
- Chinese international trade accounts for one-third of East Asian international trade. Thus, if the settlement of Chinese trade with other East Asian economies can be done in Renminbi and the respective local currencies, the need for the use of other reserve currencies to finance these transactions will be significantly reduced. Recent bilateral swap agreements between the People’s Bank of China and other East Asian central banks make invoicing and settlement of international trade transactions in local currencies instead of reserve currencies such as the U.S. Dollar and the Euro possible.

A "Bank for Intra-Asian Settlements"

- Moreover, the East Asian central banks are now flush with foreign exchange reserves. Continuing accumulation of foreign exchange reserves is no longer necessary for East Asian economies—in fact, the continuing increases in the foreign exchange reserves in the East Asian economies are beginning to present a problem for macroeconomic control.
- For East Asian economies it is now possible to consider creating an institution similar to the Bank of International Settlements, say, a "Bank for Intra-Asian Settlements," to facilitate settlement of Intra-East Asian international transactions in their local currencies rather than the U.S. Dollar or the Euro. This makes it unnecessary to continue accumulating foreign exchange reserves in U.S. Dollars or in Euros, and in turn makes it much less important whether these economies have trade surpluses vis-à-vis the United States or the European Union or the rest of the World.

Concluding Remarks

- Chinese GDP will probably catch up with U.S. GDP in approximately 15 years, some time around 2025, with U.S. and China each accounting for approximately 15% of World GDP.
- It will probably take another 20 to 25 years, before the middle of this Century, for Chinese per capita GDP to reach a level comparable to that of the then U.S. per capita GDP. If and when that happens, Chinese GDP will be approximately five times that of U.S. GDP.
- International trade will continue to be somewhat important, but not critical to the growth of the Chinese economy. Exports as a share of Chinese GDP will probably continue to decline over time, as befitting a large, continental economy.

Concluding Remarks

- The partial de-coupling of global economic growth is a new phenomenon. But with the continued economic growth of not only China but also India, supported by their respective internal demands, East Asia should be able to manage even as the U.S. economy slows down and goes into a recession.
- Continuing economic integration of the East Asian economies is inevitable—East Asian economies now trade more with one another than with either United States or Europe and are likely to continue to do so, especially given the economic problems being faced by the United States.

Concluding Remarks

- China will be internationalising the Renminbi gradually and in a planned and orderly manner. It has already made a beginning by allowing the Renminbi to be used on a voluntary basis as an accounting and settlement currency in its international trade with selected countries and regions.
- Paradoxically, the global financial crisis of 2007-9 has accelerated the pace of internationalisation of the Renminbi.
- In time, perhaps within the next five years, the Renminbi will become fully convertible, in the sense that both inbound and outbound capital controls will be effectively lifted. However, it is possible that short-term capital flows, which are of little economic benefit to the recipient economies, may continue to be under some form of control.

Concluding Remarks

- It is in China's interests to maintain a relatively stable exchange rate. However, it is not in China's long-term interests to have the Renminbi pegged rigidly to the U.S. Dollar. For the same reason, it is not in China's long-term interests to have the Renminbi pegged rigidly to a basket of foreign currencies.
- China must maintain the flexibility to manage its exchange rate—it is too important a price to be left completely to a market full of potential speculators. China should therefore maintain a "managed floating exchange rate." Just recall what happened to the exchange rates of East Asian economies during the East Asian currency crisis of 1997-1998.

Concluding Remarks

- Adjustment of the exchange rate can depend on many factors: the long-term trade balance, the rate of inflation relative to those of other major trading partners, public confidence, etc. It is expected that the Chinese international trade with the World will be essentially balanced in the future.
- However, relative stability of the Renminbi exchange rate is beneficial to the continued development of the Chinese economy. It is also beneficial to the other East Asian economies. It also enhances the potential benefits from using the Renminbi as a store of value.

Concluding Remarks

- While it is in the interests of China and East Asian economies to reduce their dependence on the U.S. Dollar as a unit of account and medium of exchange for international trade and capital transactions among themselves, given the current state of the World economy, it is also not clear whether it is in Chinese best interests to have the Renminbi become a major reserve currency like the U.S. Dollar and the Euro. To become a major reserve currency that is widely held by central banks elsewhere in the World, China will likely have to run a significant trade deficit. Moreover, there is also the risk of other central banks deciding to dump the currency at inopportune moments.

Concluding Remarks

- It is therefore also in China's best interests to seek other alternatives to the use of the US$ as a principal medium of exchange for the conduct of international transactions. It may not be through making the Yuan an international reserve currency; it is possible to develop a clearing and settlement mechanism within East Asia based on local currencies.
- A Bank for Intra-Asian Settlement can facilitate the settlement in local currencies in the same way the Bank for International Settlement facilitated settlement among Western European countries in their own currencies after World War II.
- If the East Asian economies can settle their trade accounts in their local currencies, it would be a major step towards their further economic and financial cooperation and integration.