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The International Monetary System and the Renminbi

by

Joseph Yam

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Institute of Global Economics and Finance
The Chinese University of Hong Kong
13/F, Cheng Yu Tung Building, 12 Chak Cheung Street, Shatin, Hong Kong

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Joseph Yam GBM, GBS, CBE, JP

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The US dollar

1. I am sure many of you, like me, are anxiously awaiting the outcome of the FOMC meeting that is being held these two days in the US, specifically on whether the FED will undertake QE2. I rate the likelihood of the FOMC responding to the slow down in the pace of recovery in output and employment in the US by further easing monetary conditions as quite high. FED officials seem to have been keen lately to manage market expectation. There were, notably, the press releases and the FOMC minutes of the August and September meetings, the Jackson Hole speech on 27 August and the Boston speech on 15 October, both by Chairman Bernanke, and the comments by William Dudley, President of the New York FED in September.

2. QE2, which is just the first of three options outlined by Chairman Bernanke and which will likely take the form of a further significant expansion of the balance sheet of the FED through the purchase of longer-term securities, appears quite likely. The amount and the pace to be adopted, however, are anybody's guess. The second option of using communication to help ease financial conditions is also likely; new wording would probably be used to replace the familiar "exceptionally low levels for the federal funds rate for an extended period". In his two recent speeches, Chairman Bernanke did give some hint by referring to "keeping the target for the federal funds rate low for a longer period than is currently priced in markets", which falls short of moving formally onto inflation targeting. I think it is sensible for the FED not to have its hands tied too much. The third option of lowering the interest on excess reserves (IOER), which appeared in the Jackson Hole speech but disappeared from the Boston speech, seems unlikely now. Apart from the concern over

the possible adverse implications of such an option for the liquidity of the federal funds market, I imagine the FED will probably want to keep something up its sleeves and not be seen to be running out of tools.

3. We will of course know in the early hours of tomorrow our time on what, if any, action will be taken by the FED, if indeed its concern over the pace of recovery in output and employment is serious enough to justify action. And then we will need to wait and see if the action of further easing will be helpful in achieving what the FED sets out to do. There is some skepticism in the market, given the Japanese experience, and the view that one simply cannot achieve much pushing with a string. There is also considerable worry about the implications of further easing by the FED, and the consequential international capital flows that it may generate, for monetary and financial stability in the rest of the world, in particular, in the emerging markets. I certainly hope that emerging market economies will be able to cope, whether through currency appreciation, exchange market intervention, temporary capital controls, macro prudential measures to contain bubbles and supervisory measures to limit their damage on the financial system and the economy should the bubbles burst. I also hope that, in the mean time, the further easing will boost both domestic demand in the US and external demand for US products to an extent that prevents the US economy going back into recession.

4. As a central banker, albeit a retired one, I really envy the ability of the FED so boldly to administer heavy doses of monetary stimulus, even though there is, as far as I can observe, a serious lack of successful examples, at least in terms of promoting sustainable economic recovery through quantitative easing. On the contrary, there is an abundance of examples in history on the debilitating consequences of countries resorting to the printing press, where confidence in their currencies inevitably broke down. Interestingly, with the FED now buying a lot more US Treasuries – fresh purchases or replacing other financial assets bought earlier to support the financial system – there is the further, unhelpful impression that the FED is monetizing budget deficits. Yet the US dollar, though weaker, is holding its ground as the main pillar of the international monetary system, serving as the medium for international transactions and a store of wealth.

5. But I do not believe that this degree of freedom with which the FED can print money without seriously affecting international confidence in the US dollar is something that the FED can enjoy forever. I certainly hope to see sustainable economic recovery appearing in the US soon, so that the FED at least does not need to deploy the remaining tools, if any, up its sleeves and, better still, exit from monetary easing quickly, and well before the patience of those active in the global currency market wears out. A breakdown of

confidence in the reserve currency of the world is simply not something that is in anybody's interest, other than those playing the market for short term gains. Fortunately, it seems that the credibility threshold is still some distance away, as the market kindly attests, helped by the repeated emphasis on a strong dollar policy, whatever it means, by the US Treasury. But this very high degree of freedom is probably specific only to the United States, deriving from the fact that it is the largest economy in the world and, arising from that, the US dollar being the reserve currency of the world. Indeed, the combination of economic numbers now seen in the US – balance of payments deficit, budget deficit and debt as a percentage of GDP, the unemployment rate, etc – would have long sent the currency (if it is freely convertible) of any lesser economy down the drain, not to mention at the same time engaging in quantitative easing that risks being interpreted as the monetization of budget deficits.

The euro

6. Across the Atlantic, the diversity of the social and economic characteristics and behavior of the many countries tied together in monetary union has, under the continuing influence of the financial crisis originating from the United States, worked to undermine the credibility of that union. A sovereign debt crisis erupted earlier in the year, raising doubts about the viability of the financial systems of some members of the union, in particular the viability of the banking systems that have large exposures in those member countries and substantial holdings of their sovereign debt. Thankfully, the situation has since been stabilized by the very large European Financial Stability Facility, the program by the European Central Bank to buy securities and the results of the stress tests carried out on the banks. China also provided comforting support in continuing and possibly increasing its holdings of European sovereign debt, including those issued by Greece. And modest growth has been recorded in Europe. But, notwithstanding the tremendous efforts being devoted, there is as yet no clear solution to a structural problem that has been brought into sharp focus by the sovereign debt crisis. This concerns the sustainability of monetary union without an effective mechanism to ensure fiscal discipline in individual countries or an arrangement for fiscal support to be provided across countries within the union.

7. It may be that the crisis, or what might have otherwise happened, had the supranational rescue package not been put in place, has served as a valuable lesson for all concerned, so that fiscal discipline will, in the fullness of time, be credibly and extensively re-established within the euro zone to the satisfaction of the market. On this I am not particularly optimistic. The potency of financial markets, under the heavy weight of global liquidity generated by quantitative easing, is to be respected. This is particularly so when

they do not always behave in a rational manner, not to mention the dangerous tendency of their occasionally adopting a predatory character. They are not particularly patient either. I am aware of serious efforts, not just in Europe but worldwide, to introduce regulatory reform, which hopefully would have the effect of harnessing financial market potency for promoting sustainable economic growth, while maintaining monetary and financial stability. However, if national laws are to be effective in regulating financial activities that are increasingly global in nature, there is a need for a high degree of international cooperation and coordination. Although the international standard setting bodies are working hard under the guidance of G-20 and the Financial Stability Board, each jurisdiction has its own pre-occupations and political considerations. And against crisis conditions, each jurisdiction would understandably give priority to addressing domestic issues. As a result, there is not a lot of international consistency in the regulatory reform measures introduced lately. This would encourage regulatory arbitrage on an international dimension and possibly making it even more difficult to harness the potency of international finance.

8. Meanwhile, there is strong emphasis in euro land on fiscal consolidation, which can of course be very painful for those with hardly any economic growth, high unemployment and enormous public debt to service. Whether the pain, with or without external help, justifies the benefit of remaining in the euro zone is eventually for the people of each country to decide. But at some point of time, the re-introduction of the domestic currency at a weaker exchange rate that enhances competitiveness and spurs economic growth may become a relatively more attractive option. This would move the probability of a breakup of the euro away from zero. Fiscal consolidation can, of course, be made less painful if there are arrangements for mutual fiscal support, for example fiscal transfers, within the euro zone. But then, whether the economically stronger countries are willing to carry the undefined burden in order "to keep it all together", so to speak, is again for the people of those countries to decide. This is particularly so when the exchange value of the one currency – the euro – is judged by some to be too weak for the stronger countries, possibly creating a different set of problems for them. There too, pressures for the re-introduction of the domestic currency at a stronger exchange rate, enabling these problems to be solved effectively and the burden to carry the others to be relinquished, may develop too. This would definitely move the probability of a breakup of the euro sharply away from zero.

9. This may sound rather like doomsday to some of you. If so, I offer my apologies. But I would like to go a little further. Financial market nowadays are very efficient in telescoping the future into the present and correspondingly pricing it, even though it is a very misty and distant future, and looks like a once in a century event. All you need is for a

trigger to bring the issues of concern into sharp focus, and the market would react violently, possibly generating a movement that is unstoppable. When that happens and you have your money denominated in the euro, sitting there somewhere in euro land in the form of a deposit with a bank incorporated in a particular jurisdiction, you may wonder what will you get instead when your deposit matures – the deutschemark or the drachma? I know what you would like to get, in the unlikely event that this occurs; and if you have the habit of managing risks prudently, you may start to express a preference in the country of incorporation of your bank and the location of your deposit. And if your preference is translated into risk management action, deposit migration within the euro zone may occur to such an extent as to be destabilizing, thus precipitating the unlikely event you seek to protect yourself against.

The yen

10. The circumstances surrounding the US dollar and the euro are, I am sure, one reason why the yen has been so strong. This is notwithstanding Japan having lost two decades in terms of economic growth and the rather high frequency of changes in leadership. There is also recurring deflation, currently a debt-to-GDP ratio of over 200%, the highest among the large developed economies, very low interest rates and very low yields for financial assets. Indeed, when investing large amounts of sovereign wealth, diversification of currency risks is an important consideration. And when you are talking about, say, over US$2.6 trillion to be invested, and increasing, a modest diversification, or even merely a shift in the allocation strategy at the margin, can move already nervous markets significantly. This is particularly so when the information is somehow disclosed, perhaps in the interest of promoting market transparency and efficiency. Herding behavior and volatility then followed, regardless of economic fundamentals, and traders have a lot of fun, which regrettably has long been the character of the foreign exchange market.

The International Monetary System

11. Ladies and gentlemen, the international monetary system that we have today is supported by these major currencies, in the sense that they are used extensively as mediums of international transactions and store of wealth. They are the pillars of the international monetary system. These currencies attained their status as international currencies and reserve currencies largely because of the economic size of the countries concerned. When other countries trade with these countries, rather naturally, the currencies of these larger countries, being freely convertible currencies, are used conveniently for settling payments.

By extension, foreign reserves, given their traditional role of ensuring that there are adequate financial resources to buy essential goods from overseas in the event of a domestic crisis, are held in assets denominated mainly in these currencies. But economic size and currency convertibility are not the only pre-conditions for a currency to become an international currency and a reserve currency. It also needs to be supported by economic fundamentals that are sound enough for the maintenance of currency stability and international confidence on a sustainable basis. This is where, I fear, the existing pillars of the international monetary system are found lacking. Yet these pillars have to carry a lot of weight. The international monetary system is becoming very heavy under the influence of quantitative easing. I simply fear that there may be too much of wobbly movements of those pillars, or exchange rate volatility, to the extent of risking a collapse of that system.

12. This is a worrying scenario, particularly to the many smaller economies that are in the habit of making use of these international currencies to conduct their international transactions and holding their sovereign wealth in assets denominated in those currencies. For China, with about US$ 2.64 trillion of foreign reserves, a 10% depreciation in the exchange rates of these currencies against the renminbi, or a 10% appreciation of the renminbi against those currencies, means a loss of US$264 billion in renminbi terms. Yet there are currently no meaningful alternatives for diversification. Even the talk of diversification may be counter-productive, in that it may again lead to the materialization of the risks that one sets out to manage. This exchange rate risk, arising from the major international currencies not being supported by sound economic fundamentals, is not just limited to the management of sovereign wealth. It is inherent in all international transactions, in the current account or the capital account, for as long as those currencies continue to serve as the predominant mediums of payment and settlement.

13. There seems little doubt that the international monetary system needs fixing. The difficult question, as always, is how. As I mentioned earlier, the US enjoys a high degree of freedom to print money as part of its domestic macroeconomic policies to stimulate its economy. With its currency being the predominant reserve currency, the US is not subject to the same degree of fiscal and monetary discipline imposed on other countries by the global financial market. It also pays very little, if any, attention to the adverse extra-territorial effects of these policies. The foreign currency value of the enormous amount of US dollar denominated assets held by others is not exactly a matter of concern to the US administration. I am glad, however, that the stability of the international monetary system is attracting increasing attention. President Sarkozy, for example, recently expressed the views that the world has become multi-polar and could no longer be dominated by a single currency, and that exchange rate instability poses a major threat to global economic growth. He further

pledged that, when France takes over presidency of the G-20 next year, the G-20 will be used as a forum for international debate on these issues. Indeed, only ten days ago, the G-20 finance ministers and central bank governors at their meeting in South Korea agreed that "the advanced economies, including those with reserve currencies, will be vigilant against excess volatility and disorderly movements in exchange rates".

14. I certainly hope that international consensus on reform measures for enhancing the robustness of the international monetary system would emerge before it is too late. Ideally, the currency that serves as the medium of international transactions and the store of wealth ought to be a currency that is free from the influence of domestic policies of any country. There is of course the SDR that can play this role. But the political reality is that the countries with their currencies, to a varying extent, currently playing that role are unlikely to agree to any proposals to activate the SDR in this way. This would mean losing seigniorage, subjecting themselves to tighter fiscal and monetary discipline than would otherwise be the case, eroding the international competitiveness of their financial institutions, reducing international demand for assets denominated in their currencies, and increasing the costs of borrowing in those currencies. I note, however, that the Managing Director of the International Monetary Fund, in his concluding remarks at a conference held in May this year on the international monetary system, mentioned the option of seeking "a more prominent role for the IMF's Special Drawing Right (SDR)" in strengthening the international monetary system. I certainly look forward to seeing developments on this front.

15. Interestingly, the IMF MD also mentioned the option of "a gradual move to a more multi-polar reserve system over time". He also said that "on the near term, there are no clear contenders to match the depth and liquidity of the US dollar market", which I entirely agree. He further said that "more widespread use of alternative reserve assets, e.g. euro or yen or renminbi-denominated, could be encouraged, as could enhancing EM assets". He added that "a multi-polar system may not enjoy the network effects of broad use of a single (sound) money, but the presence of alternatives provides a safety valve from unsound policies of any single reserve issuer". Even more interesting is the fact that these comments by the IMF MD were preceded by the phrase: "bearing in mind the need for pragmatism".

The renminbi

16. Indeed, pragmatism dictates that the best way of achieving results in strengthening the international monetary system is to encourage "the more widespread use of alternative reserve assets". With the euro and the yen, to varying degrees, already serving that purpose,

where encouragement is needed most is therefore in the use of the renminbi. China is now the second largest economy and trading partner in the world, and the largest foreign reserve holder. In terms of international transactions, China already is responsible for an important share of the global total. And China is growing at a much more rapid pace than the US, the euro zone and Japan. On the basis of conservative assumptions on economic growth and currency appreciation, the size of China's GDP will overtake that of the US in less than 20 years. It makes simple sense to encourage the more widespread use of the renminbi as a medium for international transactions and as a store of wealth.

17. There is an abundance of literature, both at the policy and academic levels, on the pros and cons of internationalizing the renminbi. There is no need for me to rehearse them here again, other than to point out that the balance of the pros and cons is clearly for internationalization. And this conclusion is reflected in efforts on the part of China to move the renminbi in that direction. Many have pointed out the pre-requisite that the renminbi should first become freely convertible but, at the same time, also sounded warnings on the associated risks of capital account liberalization, given that the potency of international finance has time and again proven to be quite difficult to harness. The editorial of the Financial Times on 27 August 2010 contains the following comment: "A reserve renminbi would have to be fully convertible, on the capital account as well as the current account. But this would imply opening up China to the whims of global capital – precisely what it has been protecting itself against (as its huge foreign exchange reserves attest). Freer capital flow may also prove destabilizing for domestic banks, creating liquidity bubbles in good times and choking off the credit supply as conditions deteriorate. No longer would the banking sector be an effective instrument of macroeconomic policy, as it has been during the crisis with government-induced lending sprees. It would be a source of, and not a remedy to, increasing economic volatility."

18. I am sure that this well articulated concern has been very much in the minds of the leadership in Beijing. There is therefore repeated emphasis on gradualism, controllability and the ability to take the initiative generally in financial reform and specifically in the internationalization of the renminbi. In any case, given the precarious state of the international monetary system, perhaps there is a need to think outside of the box on this important matter. Is free convertibility really a pre-requisite for the internationalization of the renminbi, as many have assumed? Should there be a distinction between free convertibility, where no question is asked and no forms are to be filled in, and full convertibility, in that convertibility for the full range of current account and capital account transactions is allowed? In other words, is convertibility conditional upon the money being used for approved purposes and subject to regulatory scrutiny not full convertibility? It is

certainly a lot less risky. Are there effective ways of curbing the "whims of global capital" while moving towards full convertibility? In any case, "whim", according to a dictionary, means "a sudden idea or wish, often unreasonable". If these whims of global capital are unreasonable, should they be allowed or unchecked? For the major freely convertible currencies, roughly 95% of the turnover in the foreign exchange market arises from trading and position taking by those active and making a living in that market, and only 5% of the turnover arises from genuine economic transactions such as import and export trade. Do we need the 95% turnover characterized by frequent, and possibly predatory and destructive whims to facilitate price discovery in the foreign exchange market?

19. This is not an attempt to challenge the supremacy of the free market; just a gentle reminder that market freedom can be subject to abuse and therefore should not be taken for granted, as we learnt quite well in this region in the financial crisis of 1997-98, when free markets became markets that were freely manipulated. In the financial liberalization needed to internationalize the renminbi, it is advisable for China to be cautious and be selective in identifying priority areas. One prudent approach is to make use of Hong Kong, where there is a high degree of market freedom, as an off-shore renminbi market, conduct experiments there and develop and modify the strategy for further internationalizing the renminbi in response to market signals. As long as the off-shore market, through formal payment system linkages that facilitate regulatory monitoring, functions as a satellite system and not on a standalone basis, the risks to monetary and financial stability in the on-shore market are well manageable. If necessary, the risk management measures can take the form of restraints on renminbi denominated activity as conditions for the provision of renminbi payment and settlement services by the People's Bank of China. I am glad to see that this approach has now been firmly adopted, having had the opportunity of promoting and working on it over the years when I was Chief Executive of the Hong Kong Monetary Authority.

20. There is definitely demand off-shore for the greater use of the renminbi as a medium of transaction and as a store of wealth. It is for China to respond proactively to this demand if the renminbi is to be internationalized and the risks that the structurally unstable international monetary system are posing to China to be prudently managed. From a strategic perspective, this involves intensifying action on two fronts. First is to enhance further the mobility of renminbi funds and financial instruments between the on-shore and off-shore markets. Second is to enlarge the scope of renminbi convertibility in the off-shore market, in terms of the caps on and the coverage of activities. One may think that the renminbi is already freely convertible in Hong Kong, given the absence of exchange control policies, which is something mandated in the Basic Law. This is indeed the case. But

because not all renminbi transactions off-shore qualify the banks correspondingly accessing, through the renminbi payment and settlement system, the on-shore renminbi market to square open positions in the renminbi against foreign currencies, the scope of renminbi convertibility off-shore in Hong Kong is de facto subject to constraints of a contractual nature. There is room for further relaxation of these contractual constraints by the Mainland authorities. But I should add, in this connection, that those renminbi activities that are not subject to these contractual constraints, for example, the use of the renminbi for IPOs and stock trading in Hong Kong, as an alternative and not as a replacement for the Hong Kong dollar, are free to be introduced and developed. I would, for a change, urge the service providers in the financial system to be a little more imaginative. It is by enriching the off-shore renminbi market that the renminbi can be meaningfully internationalized and the renminbi can play a meaningful role in the international monetary system.

Joseph Yam, GBM, GBS, CBE, JP
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