The Future of the Renminbi

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Introduction

- 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.)
- Most of the international trade, investment and loan transactions of the World today are denominated and settled in U.S. Dollars (except for transactions occurring within the same common-currency areas). The U.S. Dollar is widely used, insofar as international economic activities are concerned, as a unit of account, a medium of exchange, and a store of value.

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- However, this has not always been the case. For example, the trade of goods and services across borders can from time immemorial be conducted on a straight barter basis. Goods and services simply change hands, more or less simultaneously, and no payment, and hence no currency, is involved. The questions of the credit-worthiness of the traders and the strength of the currencies do not arise. Of course, barter trade has its well-known limitations.

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- At a later stage, precious metals, such as gold and silver, which were and still are widely accepted in many societies, are used as media of exchange and stores of value. Silver, for example, was used as a medium of exchange in China until the Twentieth Century. The degrees of purity of the gold and silver were often an issue.

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- When paper, or "fiat", money was introduced by different countries as legal tender, international traders began to be concerned about the strengths of the different currencies and about their respective abilities to preserve exchange value or purchasing power. The redeemability of a paper currency in gold or silver then became an important issue. Eventually, the Gold Standard was evolved under which central banks of countries undertook to redeem their currencies held by other central banks in gold at pre-agreed parities.

Introduction

- After World War II, the Bretton-Woods system was put in place, under which the exchange rates of the currencies of different countries which subscribed to the system were fixed relative to one another (within a rage of plus or minus 1%). Countries had the obligation of redeeming their currencies held by other countries in gold, or in equivalent acceptable currencies such as the U.S. Dollar.
- Countries with persistent trade deficits would eventually run out of gold, and would need to devalue their currencies relative to gold; countries with persistent trade surpluses would revalue their currencies relative to gold. United States was committed to redeem U.S. Dollar balances for gold at a pre-agreed price, initially at US$35 an ounce. Thus, the U.S. Dollar was considered to be "as good as gold."

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- However, after 1971, the U.S. Government would not redeem U.S. Dollars for gold any more. Nevertheless, for many countries, the U.S. Dollar remained the risk-free safe currency that they would prefer to use for their international transactions.
- For example, two countries may wish to trade with each other, but neither has confidence in the currency of the other, 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$. Without U.S. Dollars, trade between them might not have taken place.

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- Thus, the U.S. Dollar provides a genuinely useful service to the World as a widely accepted international medium of exchange and a store of value. For providing this international liquidity, the U.S. is also rewarded with seigneurage, that is, the ability to mint (print) money (and bonds) and use them to purchase real goods and services around the World, just as a central bank of a country that issues domestic money is rewarded with seigneurage domestically. In other words, the U.S. has the privilege of exchanging real goods and services from other countries with pieces of paper.

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- Of course, ultimately, these U.S. Dollar balances (and bonds) accumulated by the different recipient countries can and will be used by them to purchase goods and services from the U.S. as well as from other countries willing to accept U.S. Dollars. So, in principle, their trade with the U.S. can be balanced intertemporally.
- Moreover, under some circumstances, it may actually be beneficial for a trade-surplus country to accumulate and hold U.S. Dollar-denominated assets (or for that matter, other foreign-currency-denominated assets). For example, it may currently have a relatively young population so that it consumes less than it produces and the foreign assets accumulated at the present time will eventually enable it to consume more than it produces as its population ages and dependency ratio rises in the future.

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- The basic risk in holding U.S. Dollar balances and U.S. Dollar-denominated assets lies in the uncertainty in the real value of the U.S. Dollar in the future. Can the purchasing power of these U.S. Dollar-denominated assets be preserved over time? If so, then holding them long term would be quite attractive. If not, then holding U.S. Dollar-denominated assets long-term may be risky.
- That is why long-term Treasury Inflation-Protected Securities (TIPS), issued by the U.S. Treasury, should prove to be particularly attractive for central banks of other countries holding U.S. Dollar-denominated assets as part of their official foreign exchange reserves. They are safe and liquid, and because of their inflation-protected feature, have relatively stable capital values.

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- More recently, however, whether the U.S. is able to continue to fulfill the role of the principal provider of international liquidity has come into question for two major reasons.
- First, the potential supply of U.S. Dollars for international transactions purposes depends on the rate of outflow of U.S. Dollars from the U.S., which in turn depends in part on the U.S. running significant trade deficits. However, the United States may no longer be willing or able (or both) to run a large trade deficit post the global financial crisis. To the extent that the U.S. begins to run a smaller trade deficit, or even a trade surplus, the rate of increase of U.S. Dollar balances held by the rest of the World will decline and perhaps even turn negative, other things being equal. (Of course it also depends in part on how fast the U.S. Federal Reserve Board increases the U.S. money supply.)

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- Second, the willingness and the need of the rest of the World to continue to accumulate and to hold U.S. Dollar balances has also begun to decline. The willingness has declined because of a not so optimistic outlook for the U.S. economy, especially on the fiscal side, and the expectation of a significant devaluation of the U.S. Dollar in the medium to long term. (Of course, if the U.S. Dollar balances could be inflation-protected long-term, it would be a different matter.) The need has also declined because of the possibility of denominating and settling international transactions in other currencies, including the own currencies of the trading partner-countries.

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- Moreover, since 1971, exchange rates of currencies are no longer fixed relative to one another but fluctuate daily. It is, however, not clear that this "market system of exchange rate determination" has been effective in the reduction of persistent trade surpluses and deficits, especially when compared to the Bretton-Woods system.
- The exchange rates themselves have in the meantime become excessively volatile and unpredictable, driven by short-term speculative capital flows. The uncertainty of relative exchange rates has become a deterrent to the growth of international trade and long-term cross-border investment, both direct and portfolio.

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- Thus, it may have become necessary for the trading countries of the World to devise alternative mechanisms for the denomination and settlement of international transactions other than the use of major international reserve currencies such as the U.S. Dollar. Moreover, there may also be a need to consider new arrangements for individual economies to adjust to persistent trade imbalances, both positive and negative.

The International Monetary Order

- The rapid growth of international trade and investment in the World during the past two decades has significantly increased the demand for international liquidity.
- The World economy has been dependent on the United States to supply the international liquidity (international money supply) to support international transactions in trade and investment and for any other purposes.
- The international transactions balances used by most economies consist of U.S. Dollars held as foreign exchange reserves in their respective central banks and monetary authorities, which in turn have mostly been earned through trade surpluses with the United States and other economies.

The International Monetary Order

- The critical question is:
- Is the current (U.S. Dollar-centric) international monetary system sustainable?
- (1) Will the supply of international liquidity continue to be adequate without the U.S. continuing to export U.S. Dollars?
- (2) Will central banks around the World be willing to continue to hold a large proportion of their foreign exchange reserves in a currency that is expected to devalue over time?
- (3) Are there viable alternatives to the use of the U.S. Dollar as an international currency?

The International Monetary Order

- 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 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. 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. As World trade and capital flows grow, the demand for U.S. Dollars as transaction balances increases.

The International Monetary Order

- The central banks and monetary authorities of many countries and regions 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 International Monetary Order

- 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.

The International Monetary Order: The Alternatives Before Us

- (1) One alternative is for the World to return to the gold standard, or the gold-exchange standard, under which one or more currencies may be redeemable in gold at pre-agreed parities by the respective central banks so that countries can settle in their trade imbalances effectively in gold.
- (2) A second alternative is for one or more of other currencies to assume the role as major reserve currencies (e.g., the Euro, the Japanese Yen and the Renminbi). But then these countries must be willing and able to do so.

The International Monetary Order

- (3) A third alternative is the introduction of a super-sovereign currency such as the "Special Drawing Rights (SDRs)".
- (4) A fourth (regional) alternative is to allow settlement in the own currencies of the trading partner countries, coupled with the introduction of a multilateral settlement mechanism similar to what the Bank for International Settlements did for the Western European economies in the 1950s for the East Asian economies.
- All of these alternatives have their pros and cons, which will be discussed below.

The International Monetary Order

- A related issue is whether the relative exchange rates between currencies should be allowed to continue to fluctuate freely on a daily basis, or should be limited as to their ranges of fluctuations as under the previous Bretton-Woods system. (Under the Bretton-Woods system, the relative exchange rates are fixed to within a one-percent range, but can be flexibly adjusted upwards or downwards on occasion in response to persistent trade surpluses or deficits.)
- And since the relative exchange rates are to be fixed in the short run, in order to discourage short-term speculation, there should be some form of controls on short-term capital flows (for example, a Tobin tax).

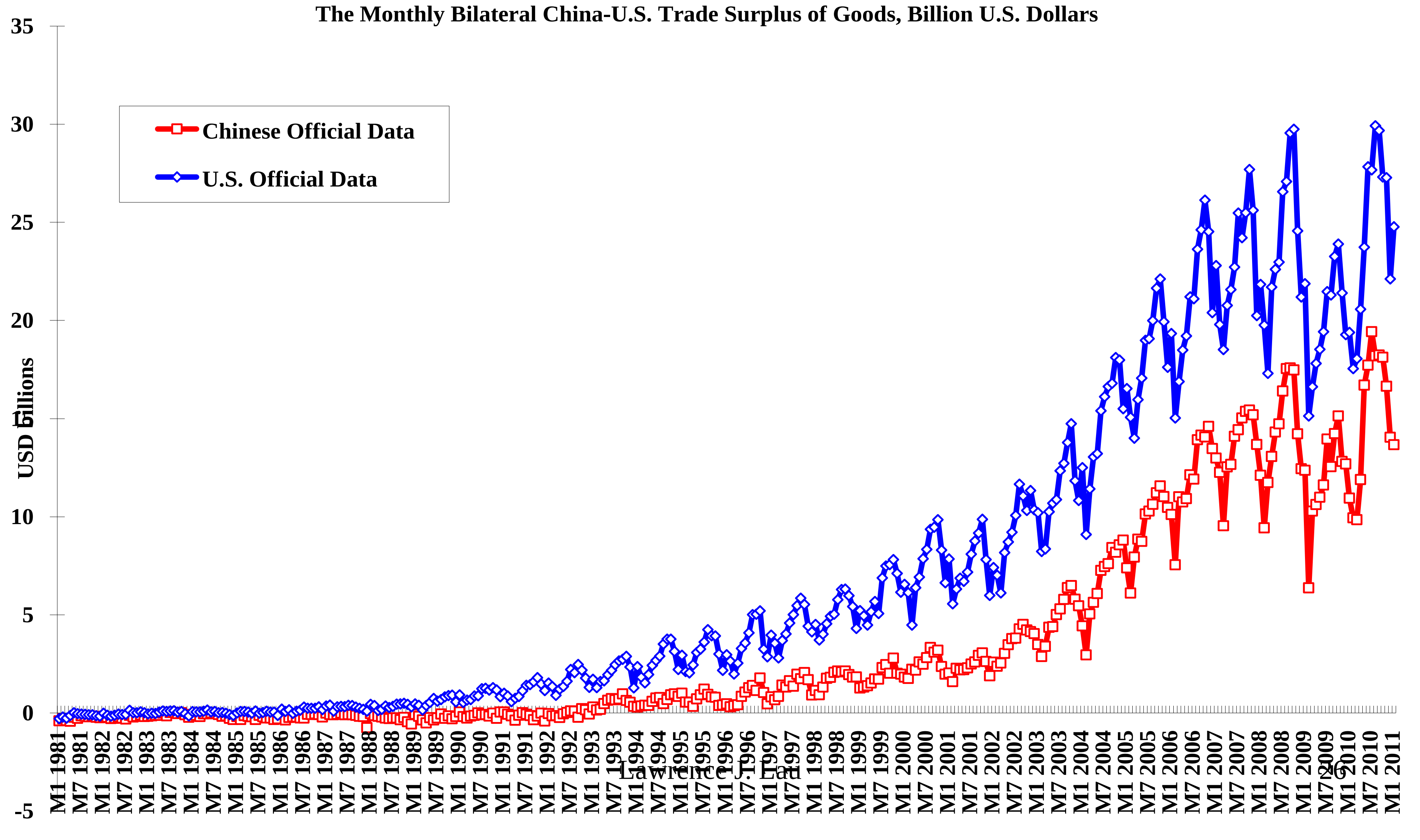
Is the Renminbi (Yuan) Under-Valued?

- The currency of a country is considered under-valued if the country runs persistent surpluses in trade in goods and services combined vis-à-vis the entire World. It is considered over-valued if it runs persistent trade deficits vis-à-vis the World.
- A bilateral trade surplus, even a persistent one, says nothing about whether a country's currency is under-valued because it may still have a near zero or even negative trade balance vis-à-vis the entire World. Most oil-importing countries have persistent bilateral trade deficits with oil-exporting countries. And that does not necessarily mean the currencies of the oil-importing countries are over-valued relative to the respective oil-exporting countries.

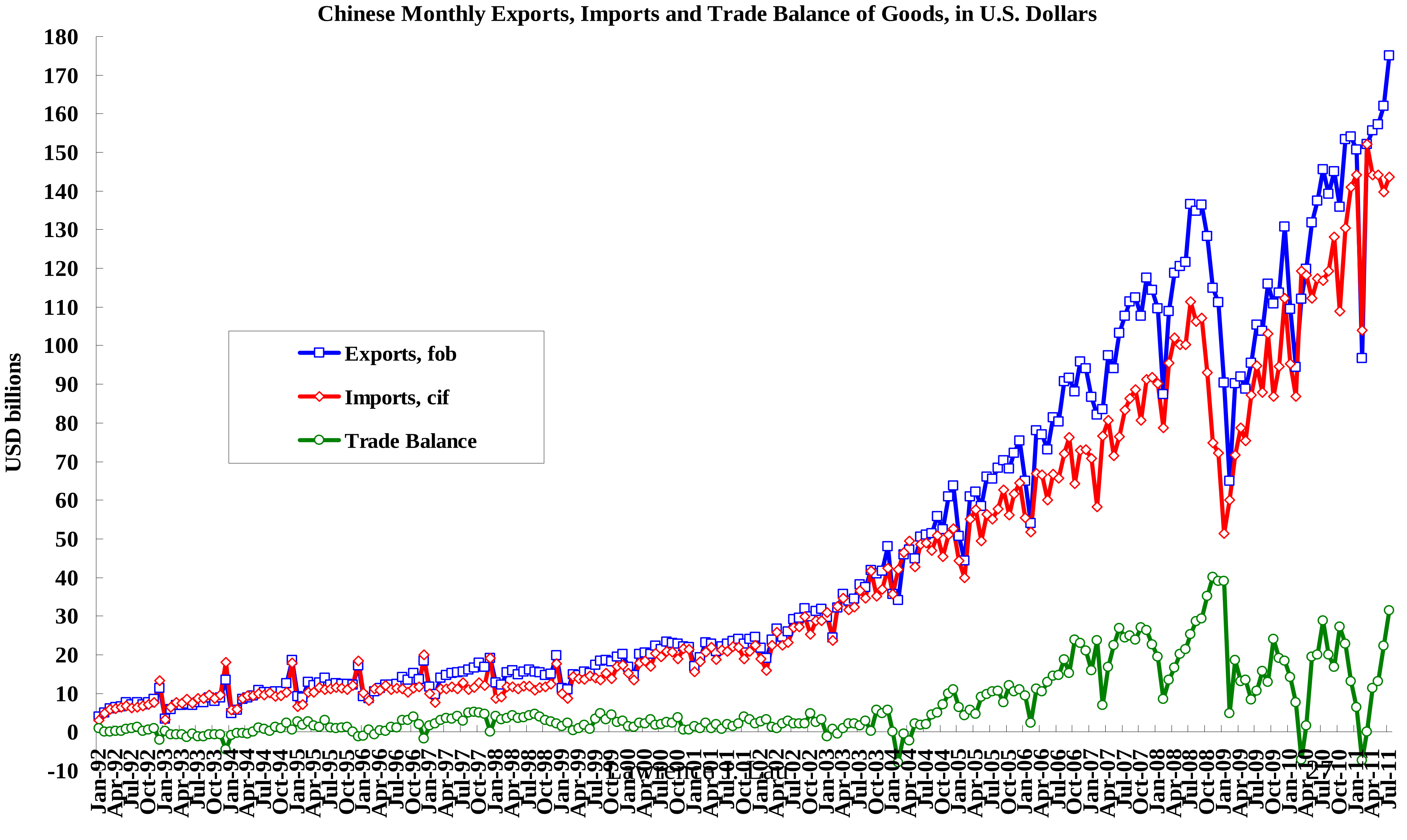
Is the Renminbi (Yuan) Under-Valued?

- During the past two decades, China has run persistent significant trade surpluses vis-à-vis the United States (see the following Charts). (The Chinese official data and the U.S. official data differ because the U.S. data includes as Chinese exports Chinese re-exports through Hong Kong, but the trends are similar.)
- However, with the World as a whole, China has had essentially balanced trade in goods and services except for the period since 2005 (see the following Charts). Thus, if there were any under-valuation of the Renminbi, it would have to be during this period since 2005 and not before.
- The Chinese trade surplus vis-à-vis the World reached a peak in 2008 when it began to decline. In 2009, it fell almost 35 percent, and became once again relatively insignificant beginning in 2010. In 2011, the Chinese trade surplus has continued its decline and even turned negative in the first quarter.
- Thus, the Chinese trade surplus has been far from persistent.

China-U.S. Monthly Bilateral Trade Balance in Goods, Bill. US$



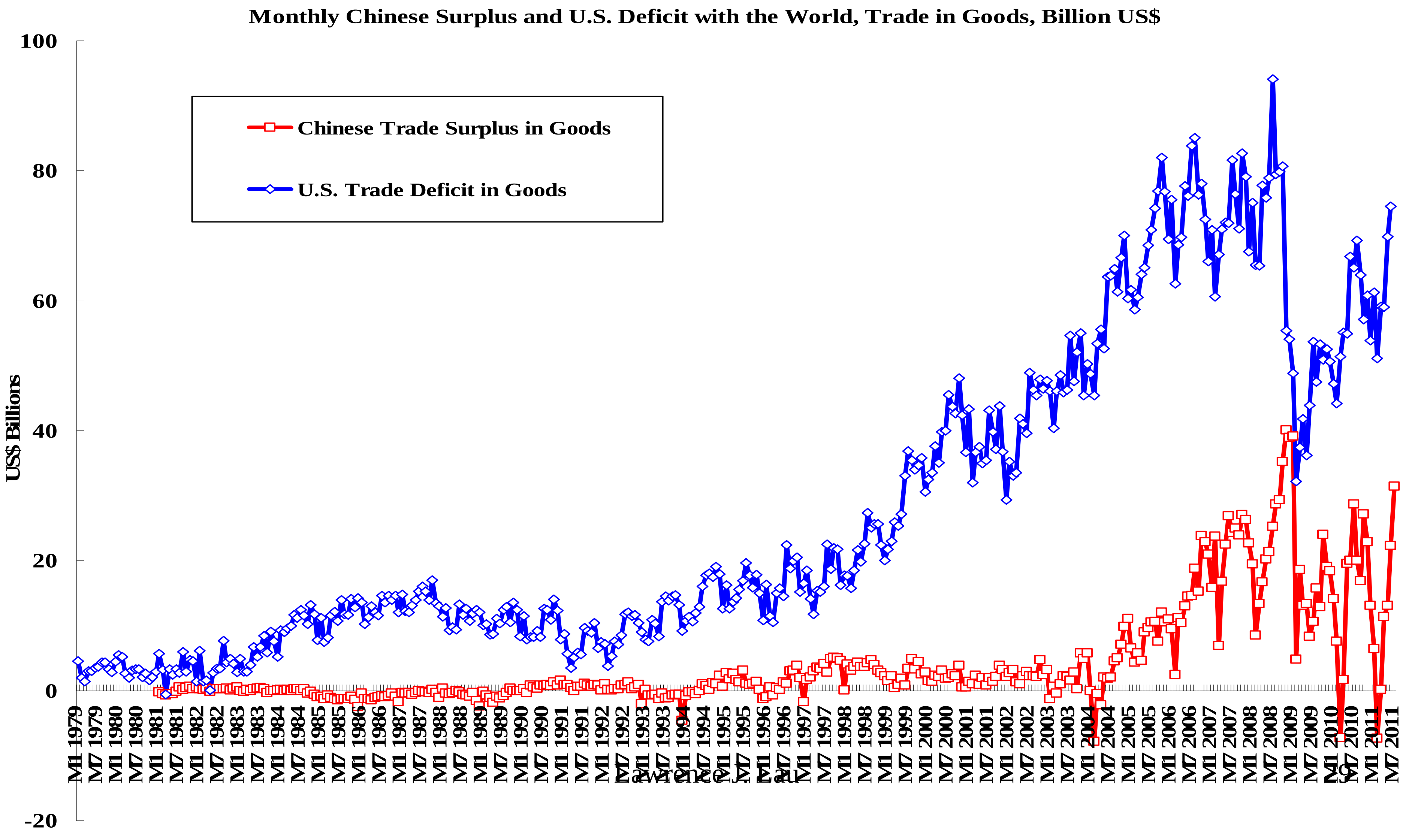
Chinese Monthly Exports, Imports and Trade Balance, US$



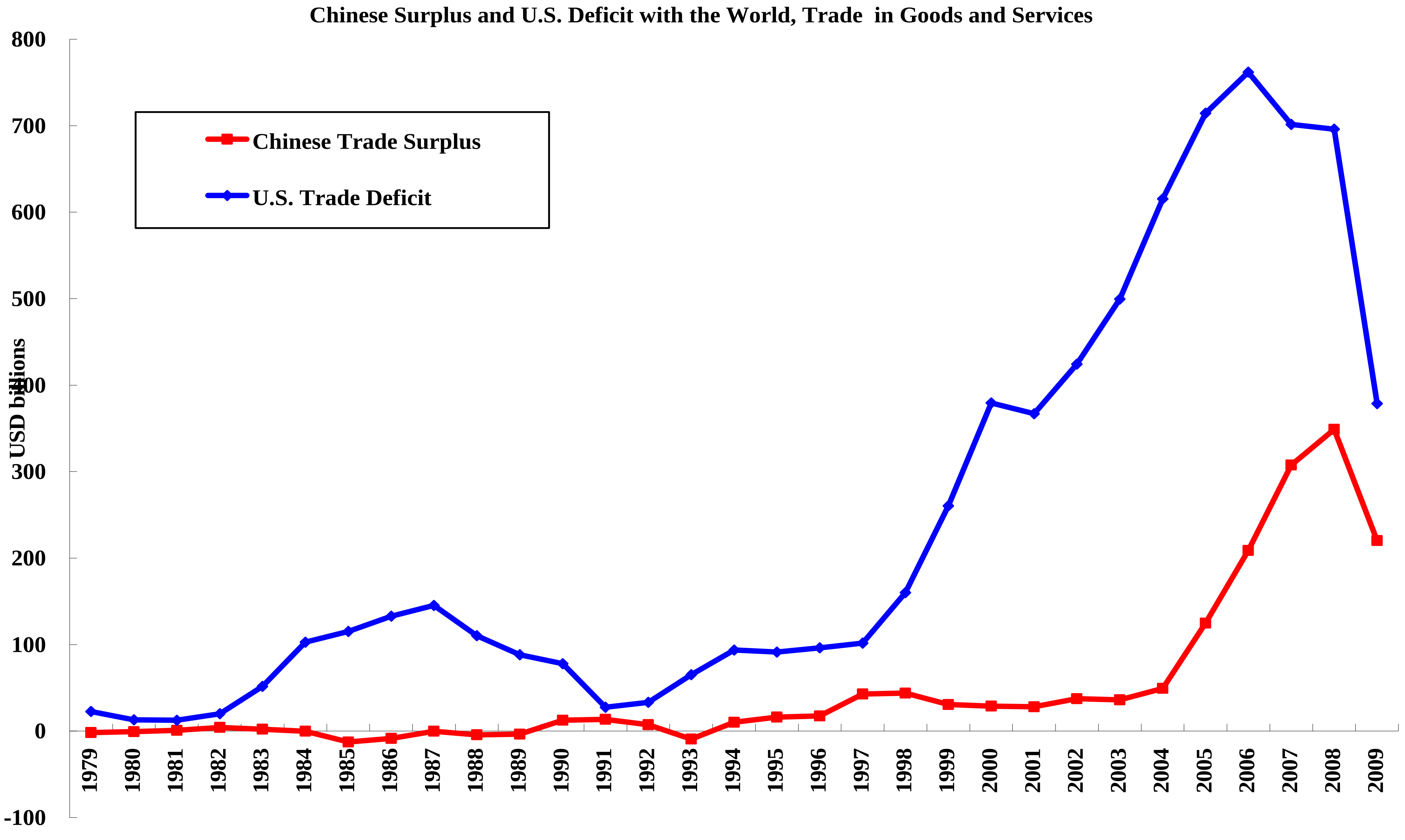
Is the Renminbi (Yuan) Under-Valued?

- In contrast, the large U.S. trade deficit with the World existed since 1997, long before China began to have a trade surplus with the World, in 2005, and has persisted despite the global financial crisis (see the following Charts). What this means is that while there is evidence that the U.S. Dollar might have been over-valued, there is no evidence that the Renminbi is under-valued today.

Monthly Chinese Surplus and U.S. Deficit with the World, Trade in Goods, Bill. US$



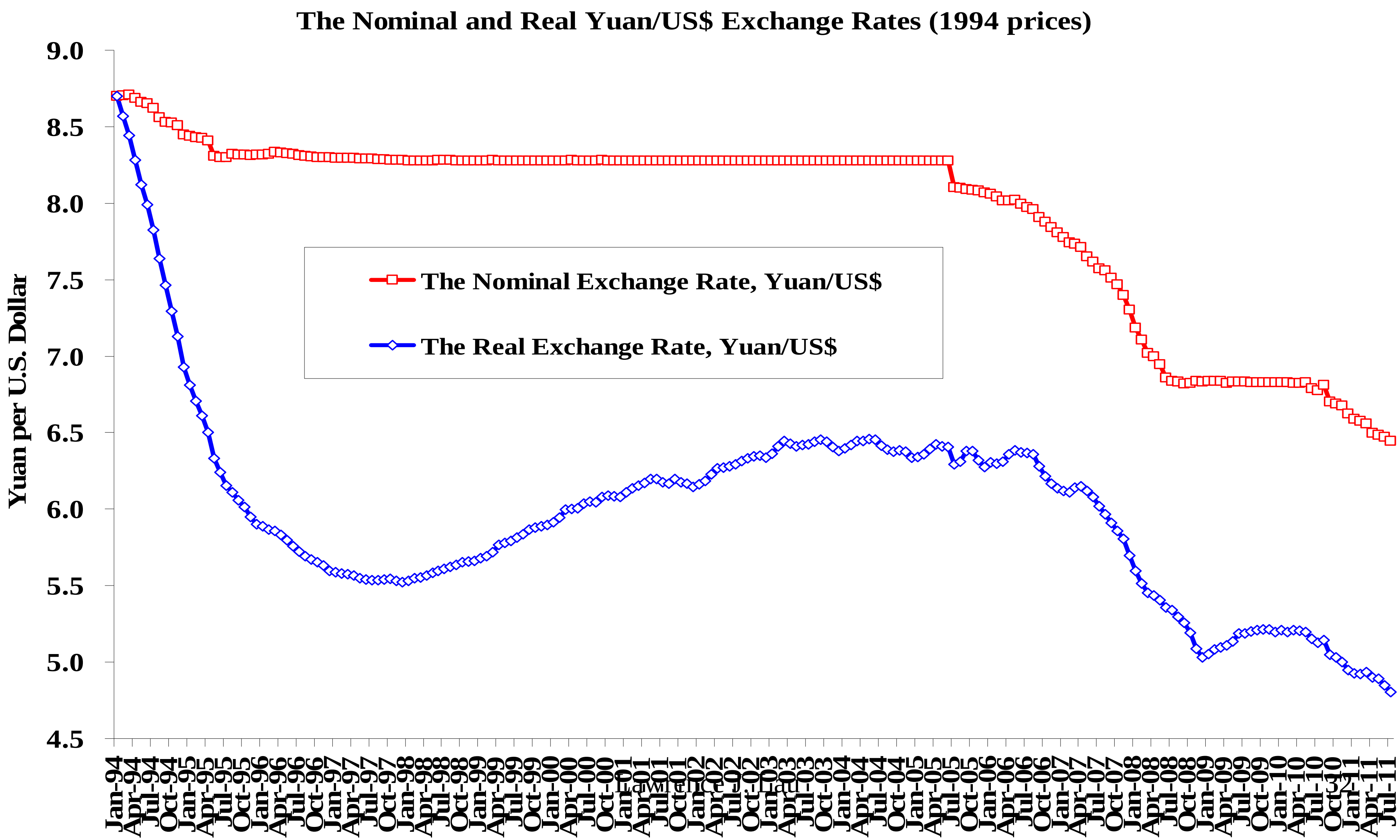
Chinese Surplus and U.S. Deficit with the World, Trade in Goods and Services



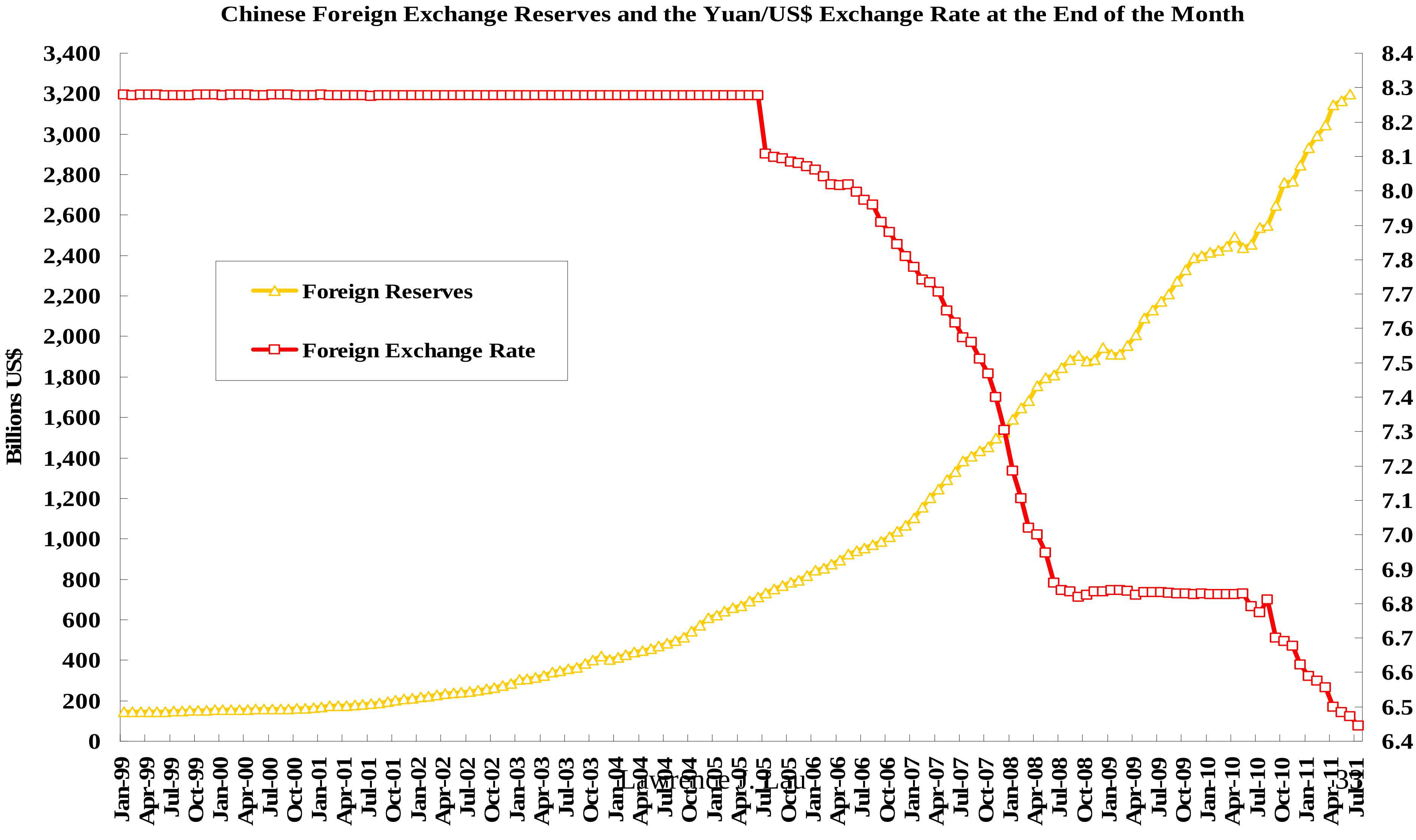
Is the Renminbi (Yuan) Under-Valued?

- In 2005, when the Chinese trade surplus began to rise, the Renminbi was freed from its de facto peg to the U.S. Dollar in July and appreciated altogether 20 percent in nominal terms and 25 percent in real terms relative to the U.S. Dollar until interrupted by the collapse of Lehman Brothers in the United States in mid-September 2008.
- The Renminbi then resumed its steady appreciation in early 2010.

The Nominal and Real Yuan/US$ Exchange Rates



Chinese Foreign Exchange Reserves and the Yuan/US$ Exchange Rate



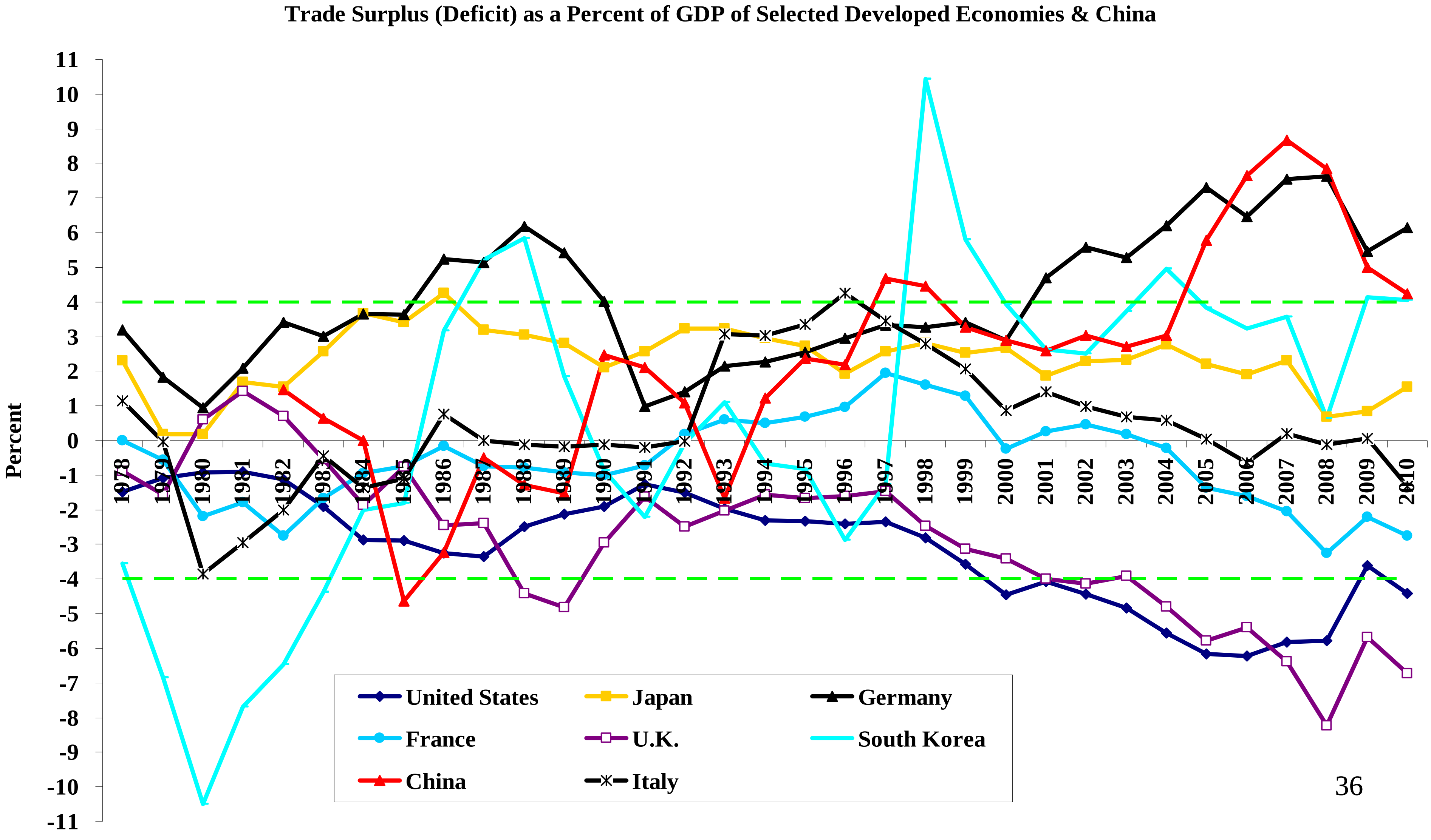
Is the Renminbi (Yuan) Under-Valued?

- A key objective of China's Twelfth Five-Year Plan (2011-2015) is to reorient the economy to domestic demand, which should result in approximately balanced international trade.
- The long-term goal of the Chinese Government is to reduce the Chinese trade surplus vis-à-vis the World to zero.
- Precisely because continuing adjustments have been taking place, in both the trade surplus and the exchange rate, the Chinese trade surplus vis-à-vis the World will be transitory and cannot be characterized as "persistent".
- If the current trend continues, the goal of zero annual trade balance can probably be achieved in a couple of years, without necessarily any large adjustment in the nominal Yuan/U.S. Dollar exchange rate.

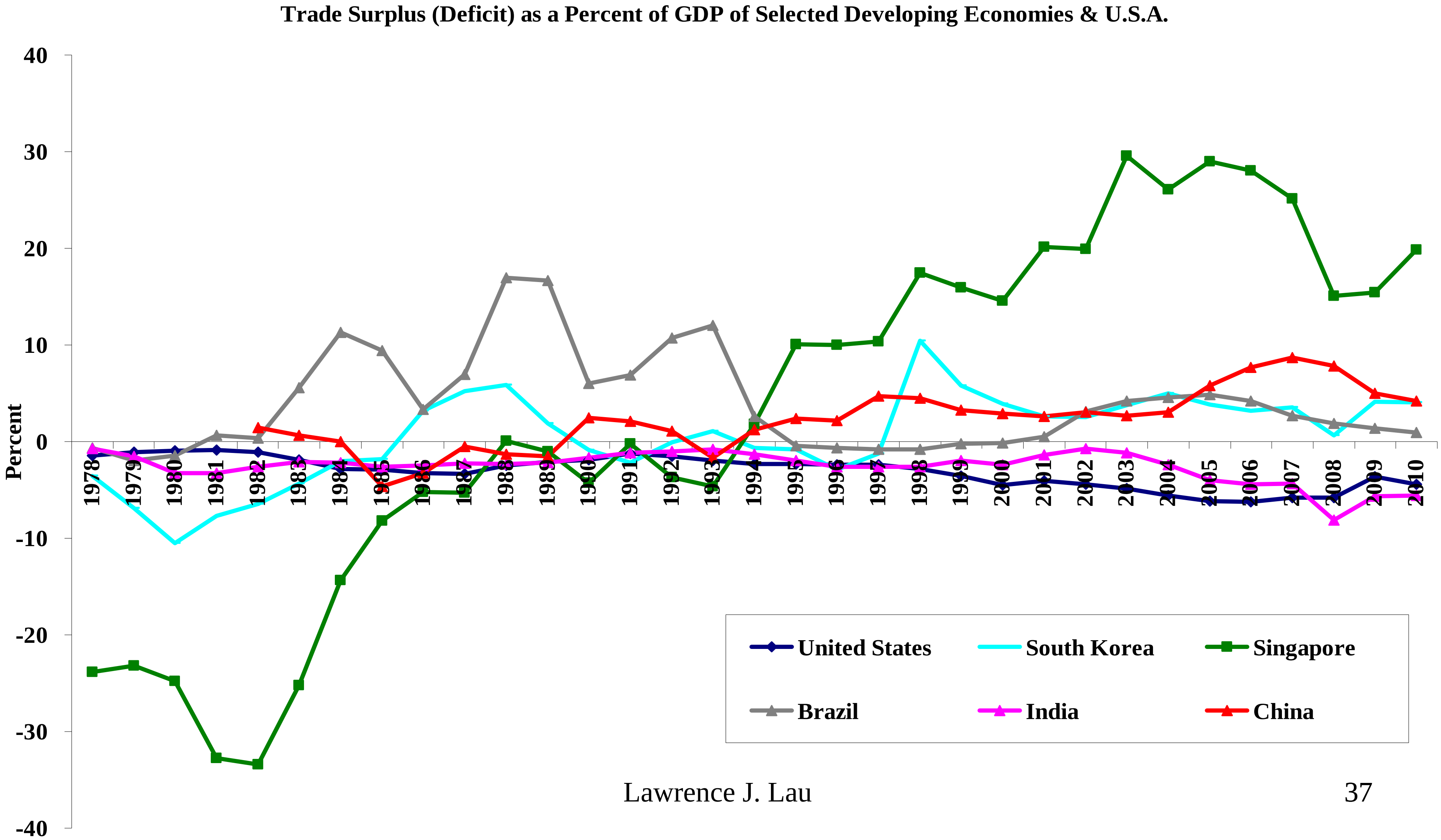
Is the Renminbi (Yuan) Under-Valued?

- By the end of 2010, the Chinese trade surplus fell to only 3 percent of its GDP. China should also have no difficulty in meeting the U.S.-proposed benchmark for a trade balance vis-à-vis the World of 4 percent of a country's GDP, surplus or deficit (see the following charts).
- If China is able to maintain an approximate balance of trade in goods and services combined under conditions of free trade (World Trade Organisation rules), its exchange rate should not be considered under-valued or over-valued, and no artificial large adjustment should be necessary.

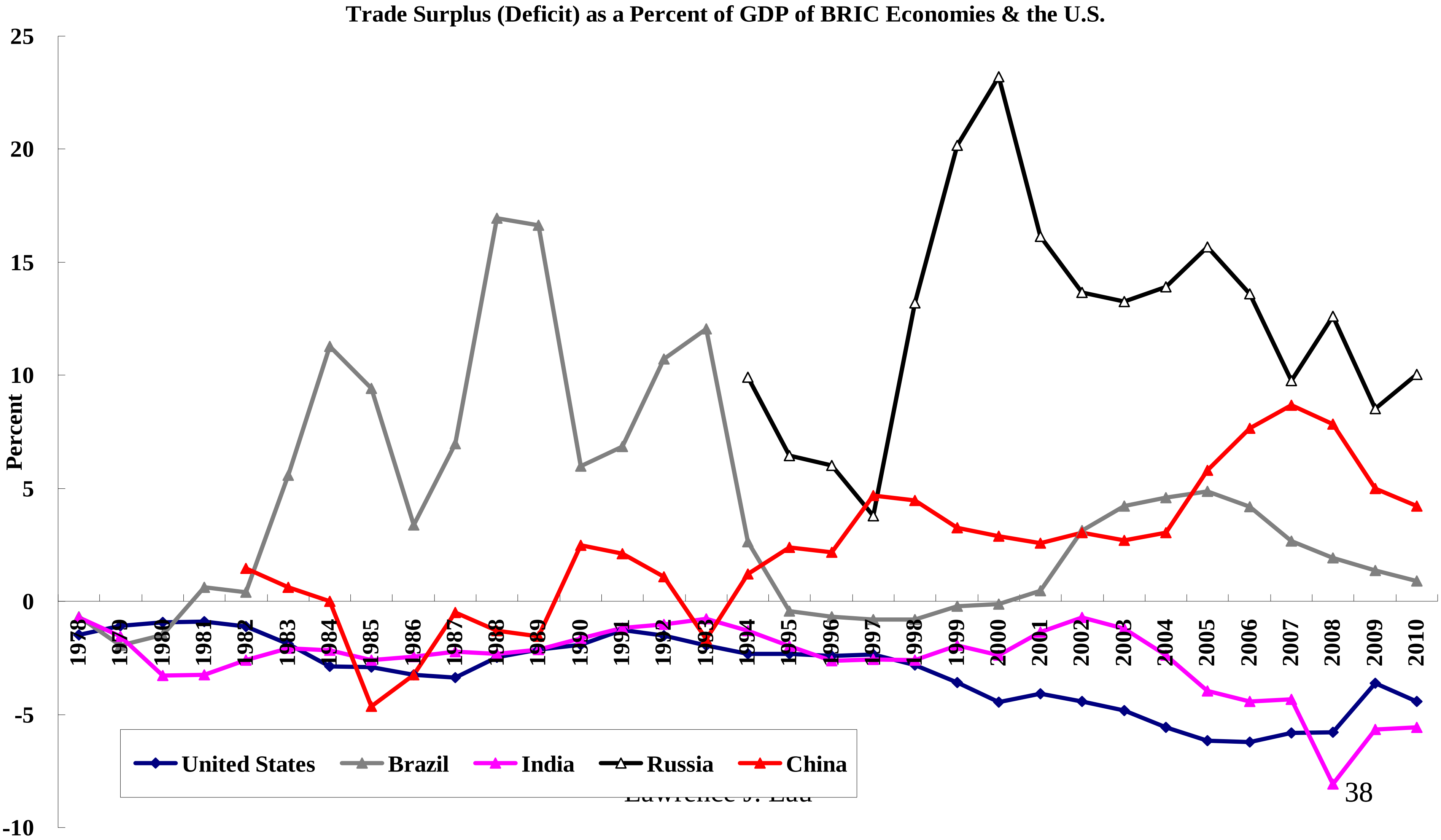
Trade Surplus (Deficit) as Percent of GDP, Selected Developed Economies & China



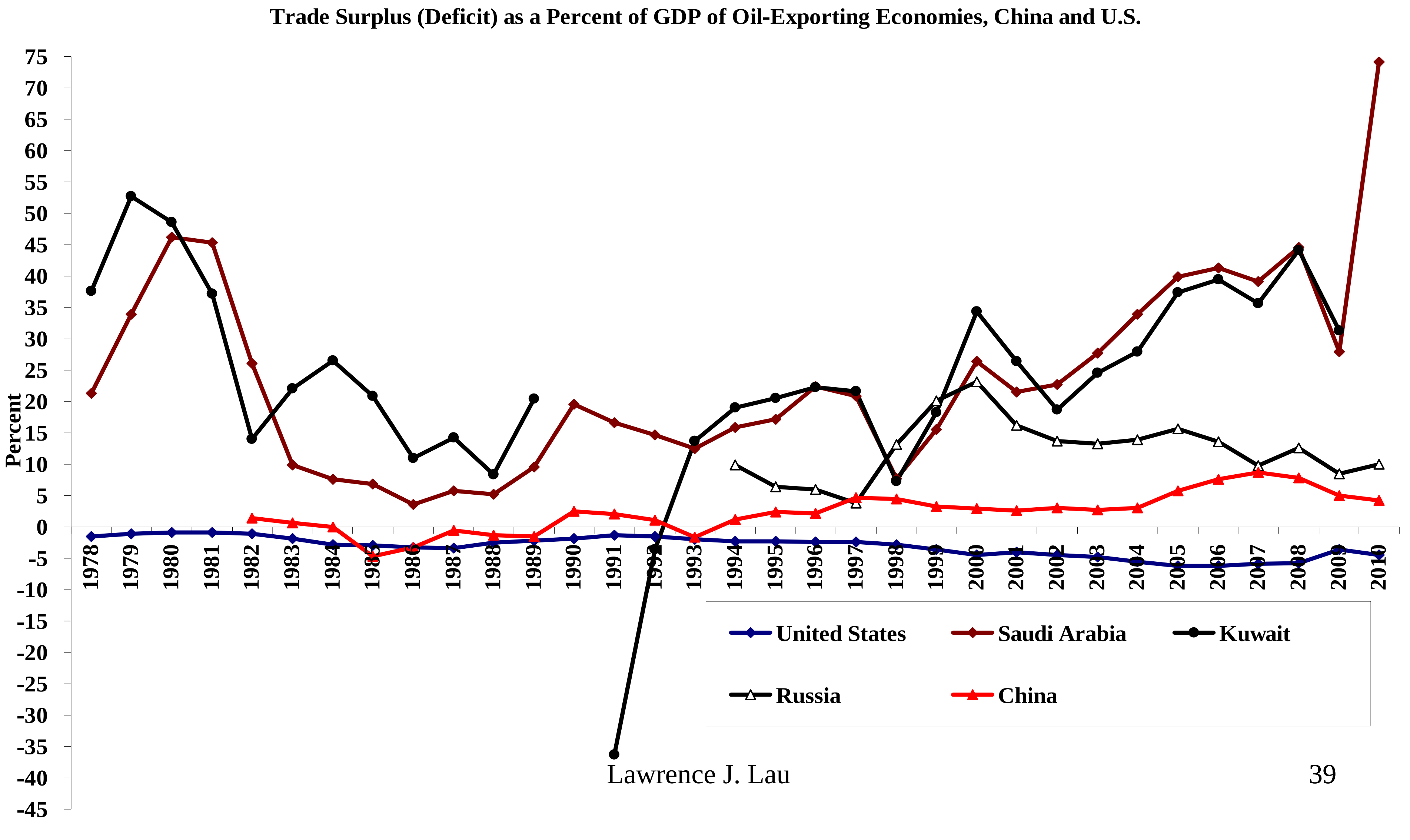
Trade Surplus (Deficit) as Percent of GDP, Selected Developing Economies & U.S.A.



Trade Surplus (Deficit) as Percent of GDP, BRIC Economies and the U.S.



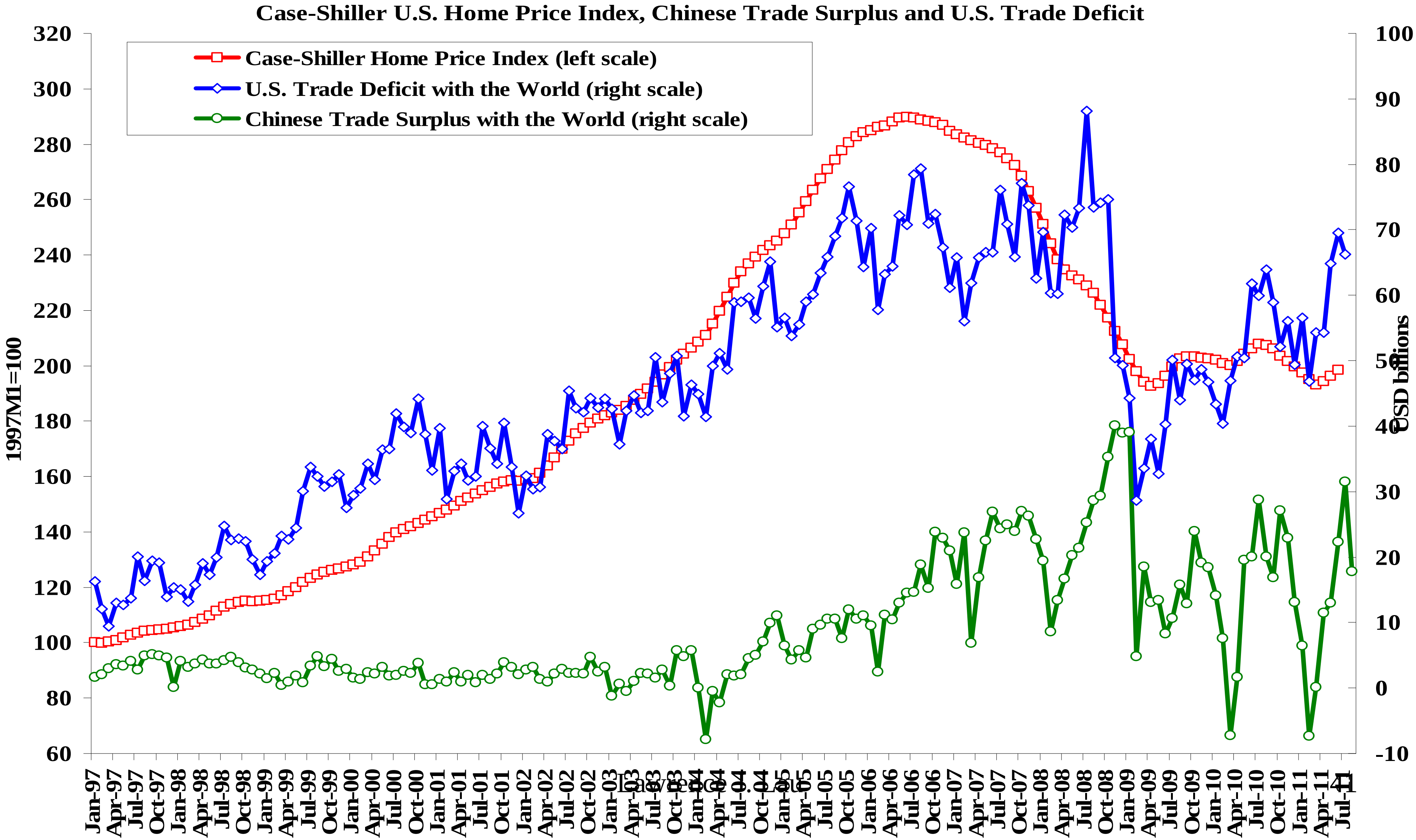
Trade Surplus (Deficit) as Percent of GDP, Oil-Exporting Economies, China and U.S.



Is the Renminbi (Yuan) Under-Valued?

- The Chinese trade surplus has also been blamed as the source of the global imbalances that enabled the speculative bubble in the U.S. real estate market, and the consequential growth of the sub-prime mortgage loans, the failure of which caused the global financial crisis.
- However, the property price bubble in the U.S. began to build up in 1997, long before China had any trade surplus, which only began in 2005.
- On the contrary, the property price bubble in the U.S. correlated very well with the U.S. trade deficit vis-à-vis the World.

Case-Shiller U.S. Home Price Index, Chinese Trade Surplus & U.S. Trade Deficit, Bill. US$



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 "settlement" currency in international (trade and capital) transactions. (Just because a transaction is denominated in a certain currency does not necessarily imply that the transaction must be settled in that same currency.)

The Internationalisation of the Renminbi

- 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 and Renminbi-denominated assets are held by foreign central banks as a reserve currency.
- The Renminbi is fully and freely convertible, that is, both "current accounts" convertible and "capital accounts" convertible—all inbound and outbound capital controls are lifted.

The Internationalisation of the Renminbi

- The Renminbi has been current accounts convertible since 1994. However, it has not yet 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$50,000 per person overseas each year, with few questions asked.
- In Hong Kong, residents can convert HK$ into Renminbi or vice versa up to 20,000 Yuan per individual bank account per business day.

Full Convertibility and the Renminbi as a Reserve Currency

- While it is true that the Renminbi is not fully convertible, it may nevertheless be maintained as part of foreign exchange reserves by an economy as long as there is a credible commitment by the People's Bank of China to convert any Renminbi presented by a foreign central bank into U.S. Dollars or Euros or any other so-called "hard" currencies. Foreign central banks can hold the Renminbi for potential transactions purposes with China or other economies willing to accept the Renminbi.

The Internationalisation of the Renminbi

- The willingness to accept and to hold a non-local currency depends on whether the currency is convertible, but it does not need to be fully or freely convertible, in the sense of a total absence of capital controls on the part of the non-local currency-issuing country.
- A person or a firm may be quite willing to accept and to hold a non-local currency, fully convertible or not, if he (it) knows that the next person (firm) he (it) comes across is also likely to accept the currency.

The Internationalisation of the Renminbi

- Thus, even though the Renminbi is not de jure fully or freely convertible, it has gradually become de facto convertible in some economies in East Asia because of its wide general voluntary acceptance. The Renminbi is today widely accepted and used in Hong Kong, Macau, Laos, Myanmar, and other border areas as a medium of exchange and a store of value even though it is not legal tender in these places.

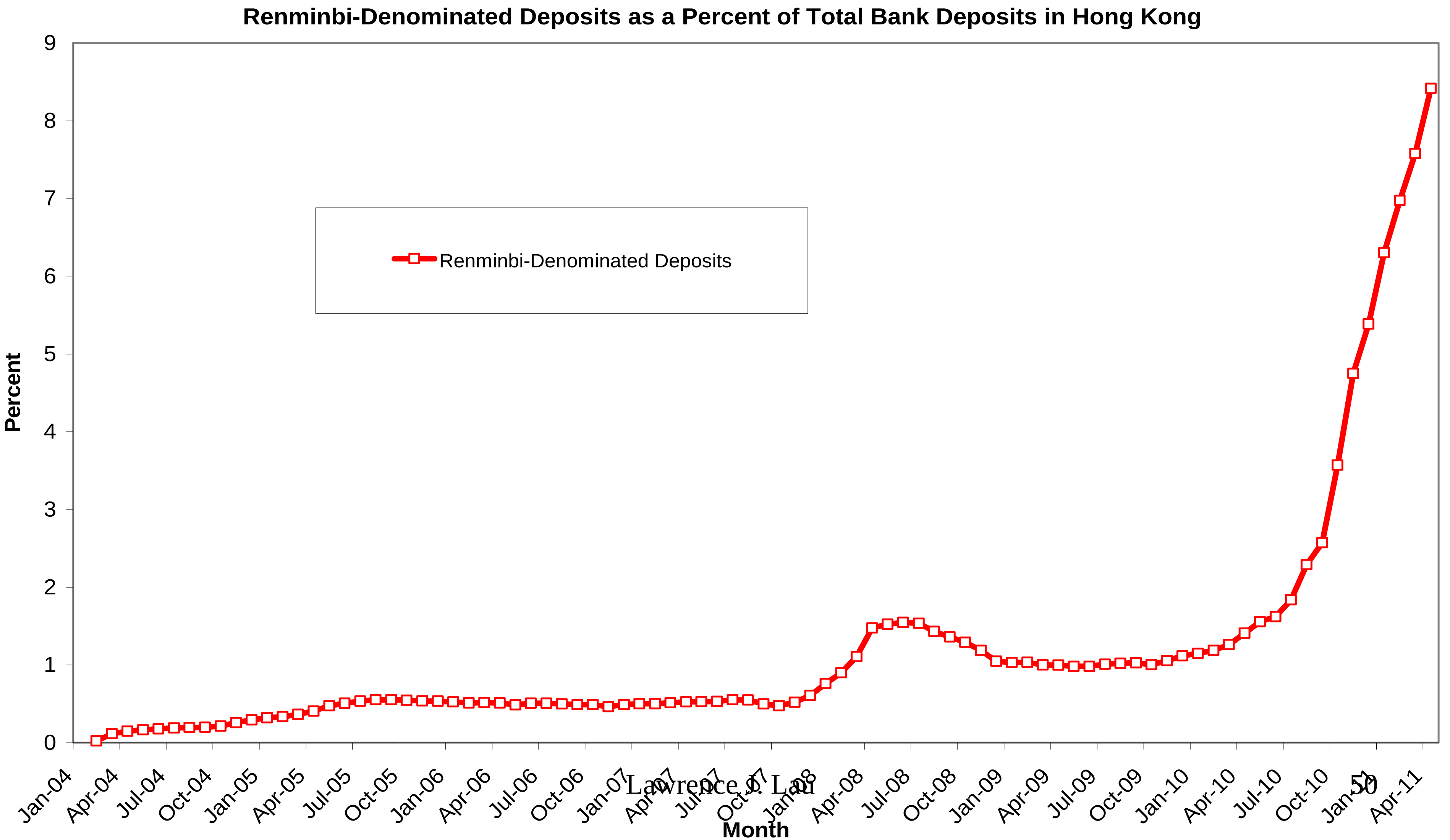
The Internationalisation of the Renminbi

- Similarly, whether a currency can be used in the denomination and settlement of international trade and capital transactions depends on its acceptability to the parties of the transactions. It will be acceptable if there are other ready potential users of the currency.
- Thus, for example, an overseas exporter to China may be quite willing to accept Renminbi as payment as long as it knows that importers of Chinese goods and services in its country can use the Renminbi balances to pay for the imports.
- A non-local currency will be even more acceptable if the central bank issuing the currency is committed to its redemption or exchange into other "hard" currencies such as the U.S.$, Euro or Yen, inflation-index bonds, or even gold with other central banks through prior agreements.

The Internationalisation of the Renminbi

- Thus, the elimination of all forms of capital controls is not necessary for the Renminbi to be used as a medium of exchange in cross-border transactions.
- It is therefore possible for there to be wide general acceptance of a non-local currency even in the absence of its full convertibility.
- For example, in Hong Kong, Renminbi bank deposits held by Hong Kong residents (including firms) have grown rapidly in the past couple of years to almost 9% of total bank deposits in all currencies, attesting to the willingness of Hong Kong residents to accept and to hold the Renminbi (see the following Chart).

Renminbi Deposits as a Percent of Total Bank Deposits in Hong Kong



The Renminbi as a Trade Settlement Currency

- Chinese exporters and importers in selected provinces, municipalities and regions have been permitted to settle their international trade transactions in Renminbi in Hong Kong since 2009 on a voluntary basis, by mutual agreement between the exporter and the importer in each case. The practice will have been extended to the whole of Mainland China by the end of 2011.
- Settlement in Renminbi is welcomed by both exporters and importers because it reduces transactions costs. For example, an importer on the Mainland can pay an exporter in Thailand directly in Renminbi, without having to convert it into U.S. Dollars first and hence also without having to assume any exchange rate risk. While it is true that a Thai exporter may have to convert the Renminbi into Thai Baht, but there is only one currency conversion, from Renminbi to Baht, instead of two currency conversions, first from Renminbi to US$ and then from US$ to Baht.

The Renminbi as a Trade Settlement Currency

- Moreover, the Thai exporter may prefer to denominate its exports to China and settle in Renminbi, because the Renminbi is expected to appreciate relative to the US$ over time.
- Similarly, an exporter on the Mainland may prefer to denominate and settle in Renminbi because it reduces both transactions costs and exchange rate risk.
- Approximately 35% of Chinese international trade is conducted with East Asian economies. Potentially, the Renminbi can be used as a settlement currency by Chinese exporters and importers with their trading partners in East Asia on a voluntary basis.

The Renminbi as a Trade Settlement Currency

- Chinese imports from East Asia except Japan amount to US$300 billion a year. If these imports alone can be settled in Renminbi, the requirement of foreign exchange reserves at the People's Bank of China for transaction purposes can be significantly reduced.
- Similarly, Chinese exports to East Asia except Japan amount to more than US$300 billion a year. To the extent that the importers in these East Asian economies can obtain Renminbi (for example, from their exporters), they may also be able and willing to pay for their imports from China in Renminbi.
- If this happens, the US$ assets held in the foreign exchange reserves of their central banks for transactions purposes can also be reduced.
- For comparison, approximately 20% of Japanese imports and 35% of Japanese exports are denominated and settled in Japanese Yen.

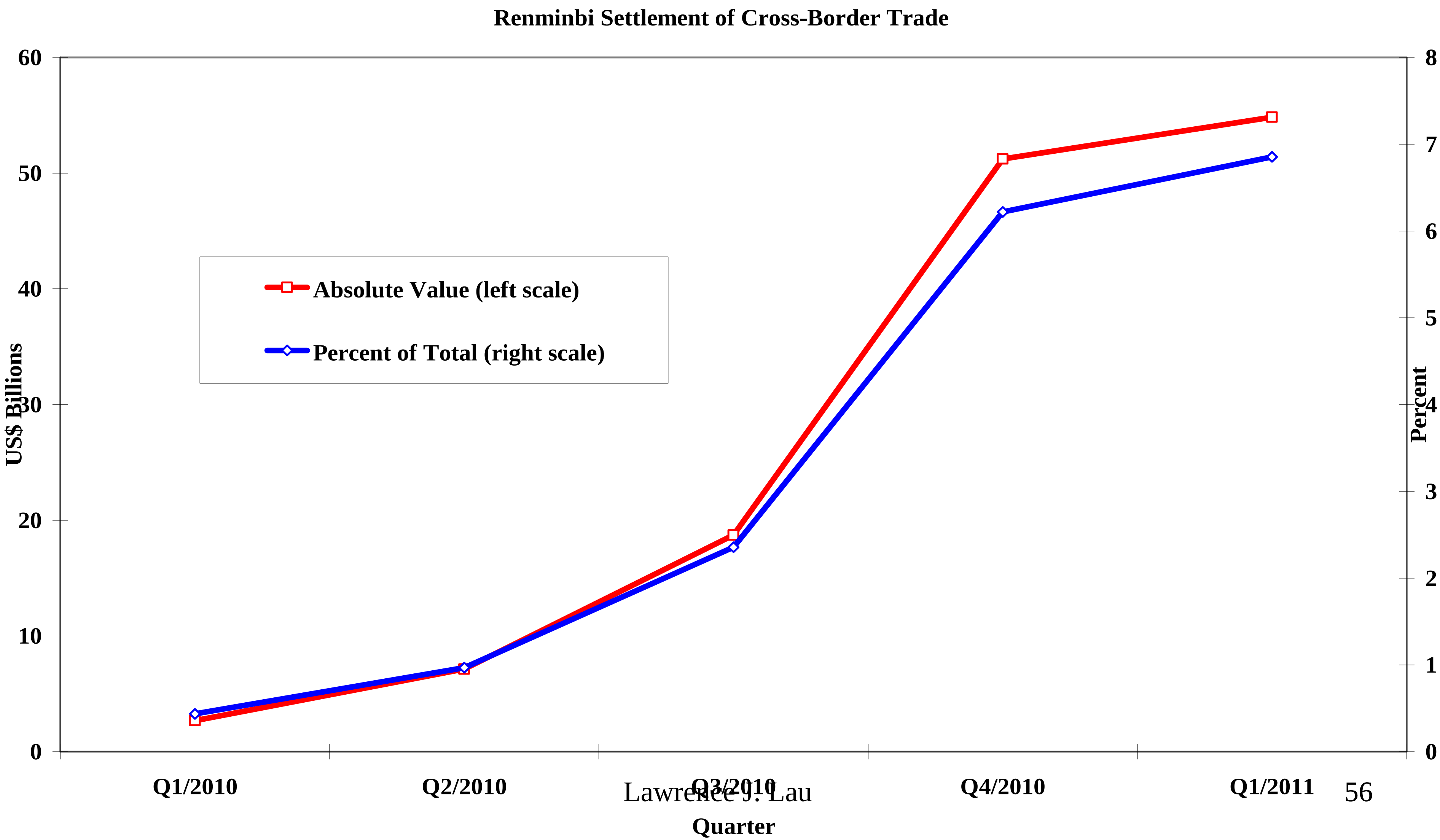
The Renminbi as a Trade Settlement Currency

- Moreover, if other East Asian economies, such as Hong Kong, Indonesia, South Korea, Malaysia and Thailand also use the Renminbi as their settlement currency for trade amongst themselves, it would further reduce the demand for U.S. Dollars for international transactions purposes and hence the proportion of the foreign exchange reserves that the central banks of these economies hold in terms of U.S. Dollar-denominated assets.
- Almost all the East Asian economies run trade surpluses vis-à-vis China, and hence should have ample supplies of Renminbi to conduct trade among themselves so they so choose.
- However, it may also increase demand of these central banks for Renminbi-denominated assets to be held as part of their foreign exchange reserves.

The Renminbi as a Trade Settlement Currency

- The proportion of Mainland Chinese international trade settled in Renminbi has grown rapidly from 2.5% for 2010 as a whole to 7% as of the end of the first quarter of 2011 (see the following Chart). This proportion is expected to increase further in the future, especially as a bureaucratic problem having to do with tax rebates for exports that in effect prevented some Chinese exporters from accepting Renminbi for payment has been resolved.

Renminbi Settlement of Cross-Border Chinese International Trade



The Renminbi as a Trade Settlement Currency

- Thus far, trade settlement in Renminbi is predominantly for Chinese imports, accounting for approximately 90%. In order for Renminbi settlement to be more widely used by Chinese exporters, overseas importers must be able to have access to Renminbi themselves. This will take some time but as exporters to China in these economies are paid in Renminbi, their Renminbi balances will in principle be available for the importers.
- Moreover, it can be anticipated that Chinese exporters will eventually offer two prices—one in Renminbi and one in U.S. Dollars (which would take into account the expected appreciation of the Renminbi) for overseas importers to choose so as to minimise their exchange rate risks.

The Renminbi as a Trade Settlement Currency

- 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 and only for relative short durations.
- This is another reason why even though it is now possible for the settlement of Chinese trade transactions in Renminbi, only a relatively small proportion of Chinese trade is denominated and settled in Renminbi.
- The use of the Renminbi as a trade settlement currency may be facilitated by an offshore forward market for Renminbi established by or under the authority of the People's Bank of China (China's central bank) with participation restricted to bona fide exporters and importers to and from China.

The Renminbi as a Trade Settlement Currency

- Moreover, if other East Asian economies, such as Hong Kong, Indonesia, South Korea, Malaysia and Thailand also begin to use either their own currencies or the Renminbi as their settlement currency for trade amongst themselves, it would further reduce the demand for U.S. Dollars for international transactions purposes and hence the proportion of the foreign exchange reserves that the central banks of these economies hold in terms of U.S. Dollar-denominated assets.
- It is likely that the Renminbi will eventually be used for the settlement of cross-border transactions among East Asian economies because all of them have trade surpluses vis-à-vis Mainland China and hence will have ready access to Renminbi balances.

The Renminbi as a Trade Settlement Currency

- 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$600 billion 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 probably continue to be denominated mostly in either the U.S. Dollar or the Euro.
- Chinese international trade with Africa and Latin America may well be partially denominated in Renminbi especially Africa as China becomes the major source of development aid and loans to Africa.

The Renminbi as a Trade Settlement Currency

- Recently, the Ministers of Finance of China, Japan and South Korea, meeting on the sidelines of the Asian Development Bank annual meeting in Hanoi, issued a statement to the effect that they would study the use of their own currencies in trade settlement with one another.
- Trade settlement in the own currencies of the trading partner-countries is straightforward if the bilateral trade is basically balanced. A problem arises only when there are persistent surpluses or deficits. The central bank of the surplus country will wind up holding the currency of the deficit country. What can be done to reassure the surplus country that it will not lose out by holding the currency of the deficit country for more than a short term?

The Renminbi as a Trade Settlement Currency

- What is needed are credible commitments through mutual agreements by the respective central banks concerned to convert the currencies of their respective countries presented by another central bank into U.S. Dollars or Euros or any other so-called "hard" currencies, or even gold at a pre-agreed parity, or its own inflation-indexed bonds.
- With such assurances, central banks will feel comfortable holding the currencies of the other countries for potential transactions purposes.

Renminbi as an International Reserve Currency

- Even if the Renminbi is not fully convertible in the sense of a total absence of inbound as well as outbound capital controls, it may nevertheless be maintained as part of foreign exchange reserves by the central banks and monetary authorities of other countries and regions as long as there is a credible commitment through mutual agreements by the People's Bank of China to convert any Renminbi presented by a foreign central bank into U.S. Dollars or Euros or any other so-called "hard" currencies, or even gold at a pre-agreed parity, or its inflation-indexed bonds. Foreign central banks can then hold the Renminbi for potential transactions purposes with China or other economies willing to accept the Renminbi.
- Such mutual agreements will go a long way to reassure the central banks of surplus countries that they will not lose out in terms of purchasing power, which is ultimately what really matters.

Renminbi as an International Reserve Currency

- The People's Bank of China already has bilateral currency swap agreements in place with the central banks or monetary authorities of Argentina, Belarus, Hong Kong, Indonesia, South Korea, Malaysia and Mongolia and more such agreements are expected to come.
- In principle, other central banks of economies that wish to use their own currencies for trade settlement can make similar commitments.
- If trade settlement in own currencies turns out to be a widespread and durable arrangement, it may supplant the use of the U.S. Dollar as the principal international trade settlement currency in East Asia eventually.

Renminbi as an International Reserve Currency

- There are both pros and cons for a country’s currency to be used by other countries as a major international reserve currency.

Renminbi as an International Reserve Currency

- The benefit to the issuing country of a major international 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.

Renminbi as an International Reserve Currency

- The “cost” to the issuing country is that in order to benefit from seigneurage, it must in general run a trade deficit or become a net long-term purchaser of foreign assets. (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.) And the larger the trade deficit, the larger the benefit. However, 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.

Renminbi as an International Reserve Currency

- A currency can be fully convertible without becoming a principal reserve currency, that is, without 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.

Renminbi as an International Reserve Currency

- A further “cost” is the possibility that as a currency becomes widely held by the central banks of other countries as part of their foreign exchange reserves, it is subject to the risk that the foreign central banks holding its currency and assets denominated in its currency may decide at some point, for economic as well as non-economic reasons, to stop holding this currency and sell all the assets denominated in this currency that they hold, potentially creating havoc to the exchange rate of the currency, the interest rate and the financial markets of the country issuing the currency.
- 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 their U.S.$-denominated assets without incurring significant damages to themselves.

Renminbi as an International Reserve Currency

- The Japanese Yen is fully convertible but the Japanese Government has not promoted its use by other countries as a major international reserve currency. Japan is unwilling to entertain the possibility of a persistent and large trade deficit. It is also not willing to assume the risk of the other central banks of East Asia potentially dumping its bonds on the market because of political considerations.
- Whether the Renminbi will eventually become a major international reserve currency remains to be seen, as there are both costs and benefits for a country's currency to be used by other countries as a major international reserve currency.
- At the present time, Hong Kong, Singapore and South Korea have all been considering investing part of their foreign exchange reserves in Yuan-denominated securities to diversify its portfolio, even though the Yuan (Renminbi) is not yet fully convertible.

A Super-Sovereign Currency

- A real question that faces a super-sovereign currency is whether it will be accepted widely, not the least by the men in the street. One super-sovereign currency, the Euro, is accepted and used widely, but it is legal tender and is accepted by everyone as a medium of exchange in the Euro Zone. A non-European can also use the Euro to buy goods and services, at least within the Euro Zone, and hence is also willing to accept and hold it. Where can someone with a new World currency such as the SDR use it and what can this person buy with it? This goes back to the acceptability question.

A Super-Sovereign Currency

- A more difficult question is which organisation controls the quantity of the new World currency to be issued and its initial allocation among the different countries.
- In the case of the Euro, the European Central Bank is the controlling organisation for the issuance of the Euro, designated by treaty among the countries in the Euro Zone.
- In the case of the Special Drawing Right (SDR), which is constituted as a basket of sovereign currencies, the subsequent adjustments in the composition of the basket as well as the allocations of newly issued SDRs are additional problems that may not be easily resolved.

A Super-Sovereign Currency

- For the Special Drawing Right (SDR), or a new super-sovereign World currency, the question of exit must also be considered. If one country opts out of the system, and presents the SDR or the new World currency for exchange for say the underlying constituent currencies, can the issuing organisation perform? Can the issuing organisation demand that the issuing countries of the constituent currencies come up with the amounts of the respective currencies? Can the issuing organisation enforce its demands if one or more of the issuing countries balk? Without a super-sovereign organisation with legal authority, like the European Union, it would be very difficult for the SDR or a new World currency to succeed.
- Similar problems will afflict the introduction of an Asia-wide or East Asia-wide super-sovereign currency.
- It is probably easier to go back to the gold standard. After all, gold is widely accepted everywhere.

A Super-Sovereign Currency

- It is therefore probably more likely that the World will be entering a period during which multiple currencies are used and held as international reserve currencies, especially since relative exchange rates are so volatile.
- If relative exchange rates are reasonably stable, there is really no need for an artificial super-sovereign currency. However, relative exchange rates can only be stabilised if short-term international capital flows are appropriately controlled, regulated, or at least reduced.

Options for East Asia:Trade Denomination and Settlement in Own Currencies

- An alternative to the denomination and settlement of international transactions in a international reserve currency such as the U.S. Dollar is the denomination and settlement in the own currencies of the trading partner countries.
- China, Japan and South Korea, if they so wish, can denominate and settle international trade transactions among themselves in their own respective currencies. For example, on an entirely voluntary basis, Chinese exporters to Japan can quote their prices and invoice in either Chinese Yuan or Japanese Yen, as may be mutually agreed individually between them and the Japanese importers. The same applies to Japanese and Korean exporters—each of them can choose to invoice in the own currencies of either the exporting or the importing country.

Options for East Asia: Trade Denomination and Settlement in Own Currencies

- We shall describe an arrangement under which two East Asian trading-partner countries, for example, China and Japan, can settle their international transactions in their own currencies, on a voluntary basis, without using the currency of a third country (generally a major reserve currency).
- Japanese importers will then pay the Chinese exporters in either Japanese Yen or Chinese Yuan. They should have no problem paying in Yen. They can also acquire Chinese Yuan at the market exchange rate from the Bank of Japan, Japan's Central Bank, which is also committed to buy Chinese Yuan at the market exchange rate from Japanese exporters who have chosen to be paid in Chinese Yuan.

Options for East Asia:Trade Denomination and Settlement in Own Currencies

- It is possible that the Bank of Japan may wind up with more Yuan than it desires to hold, in which case it can present the excess Yuan balances to the People's Bank of China (China's Central Bank). The People's Bank is committed to "buy" back these excess Yuan from the Bank of Japan. It will first of all use its own excess Yen balances to do so; and if these are not enough, it can buy back the excess Yuan with gold at a pre-agreed parity, or U.S. Dollars, or other "hard" currencies, or even inflation-protected Yuan bonds, as have been mutually agreed before hand and subject to the choice of the Bank of Japan.
- Similarly, if the People's Bank of China winds up with more Yen than it desires to hold, it can use these Yen balances to purchase, for example, inflation-protected Yen bonds.

Options for East Asia:Trade Denomination and Settlement in Own Currencies

- Thus, under such kind of arrangement, when China and Japan trade, they will not require the use of a third currency for the settlement of the transactions, saving the currency conversion costs and reducing the levels of foreign exchange reserves required to be maintained for international transactions purposes.
- Such an arrangement will reduce the demand for U.S. Dollars as official foreign exchange reserves on the part of the Central Banks of the two countries. They will most likely maintain balances of each other's currency as part of their official foreign exchange reserves.

Options for East Asia:Trade Denomination and Settlement in Own Currencies

- Chinese exporters and importers have in the past been settling their international trade transactions in major foreign currencies such as the U.S. Dollar, Euro and Yen. However, Chinese exporters and importers in selected regions in China have been permitted to settle their international trade in Renminbi since 2009 on a voluntary basis, by mutual agreement between the exporter and the importer in each case. The practice will be extended to the whole nation by the end of 2011.
- Japanese exporters and importers are free to choose their invoicing currencies, and subject to mutual agreement between the Bank of Japan and the People's Bank of China on swapping the two currencies, can also proceed to denominate and settle their trade transactions with China in either the Yen or the Yuan.

Options for East Asia:Trade Denomination and Settlement in Own Currencies

- The arrangement described above can be extended to between any two trading partner-countries in East Asia by voluntary, mutual agreement.
- The exporters and importers of both trading partner countries will be given the choice of denominating and settling their international trade transactions in the own currencies by mutual agreement on a case-by-case basis.
- The central banks of both countries will commit through mutual agreement, to redeem its currency held by the other central bank in terms of other hard currencies (e.g., US$ or Euro), gold, or its inflation-indexed bonds, which will go a long way to reassure the central bank of the surplus country that it will not lose out in terms of purchasing power, which is ultimately what really matters,

Options for East Asia:Trade Denomination and Settlement in Own Currencies

- Of course, the attractiveness of holding inflation-indexed bonds of a foreign country by a central bank depends on whether the index chosen accurately reflects the degree of inflation of the prices of goods and services in the foreign country.
- It is probably too difficult for a central bank to monitor the accuracy of the index of inflation of a foreign country. However, if inflation-indexed bonds are also widely held by the domestic citizens of a foreign country, one can count on these citizens to monitor the accuracy of the inflation index because they have every incentive to do so as well as the political power to ensure that inflation is measured accurately in that country.

Options for East Asia:Trade Denomination and Settlement in Own Currencies

- If trade settlement in own currencies turns out to be a widespread and durable arrangement, it will supplement and may eventually even supplant the use of the U.S. Dollar as the principal international trade settlement currency.

Options for East Asia: A “Bank for Intra-Asian Settlements”

- There is also another alternative framework to enable and facilitate the denomination and settlement of international transactions of East Asian economies, both developed and developing, with one another in their respective local currencies.
- One such model is 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.

Options for East Asia: 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).

Options for East Asia: 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 minimises 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 minimises the amount of U.S. Dollar balances needed for the settlement.

Options for East Asia: 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.

Options for East Asia: A "Bank for Intra-Asian Settlements"

- 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 of macroeconomic control for the East Asian economies.
- 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 own 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.

Options for East Asia: Maintaining Relative Real Parities

- Volatility and long-term instability of relative exchange rates is a serious impediment to international trade and long-term cross-border investments, including both direct and portfolio investments, much more so than tariffs and other protectionist measures. With volatile exchange rates, one does not know whether one should export or import, or where one's production facilities should be located.
- Volatile exchange rates also tend to destabilise the real economies as well as reduce their real rates of growth.

Options for East Asia: Maintaining Relative Real Parities

- A stable exchange rate contributes to the orderly domestic economic development of an economy and to its active participation in the global economy as a trading partner and as either a cross-border investor- or an investee-country.
- If the exchange rates were not so volatile, it would not matter so much in which currency international trade is denominated and settled. (Whether a currency will be used as a store of value is a different matter.)
- Stability of exchange rates is not necessarily the same as fixed exchange rates. The challenge is how to achieve flexibility without excessive volatility.

Options for East Asia: Maintaining Relative Real Parities

- Timely interventions and the creation and maintenance of stable and sustainable expectations in the foreign exchange markets are therefore both necessary and beneficial.
- During the 1997-1998 East Asian currency crisis, the Chinese Government kept the Yuan/US$ exchange rate unchanged despite strong market sentiments and speculation that it should/would devalue. The Chinese decision was an important factor in the subsequent stabilisation of the crisis and the speedy recovery of the East Asian economies.

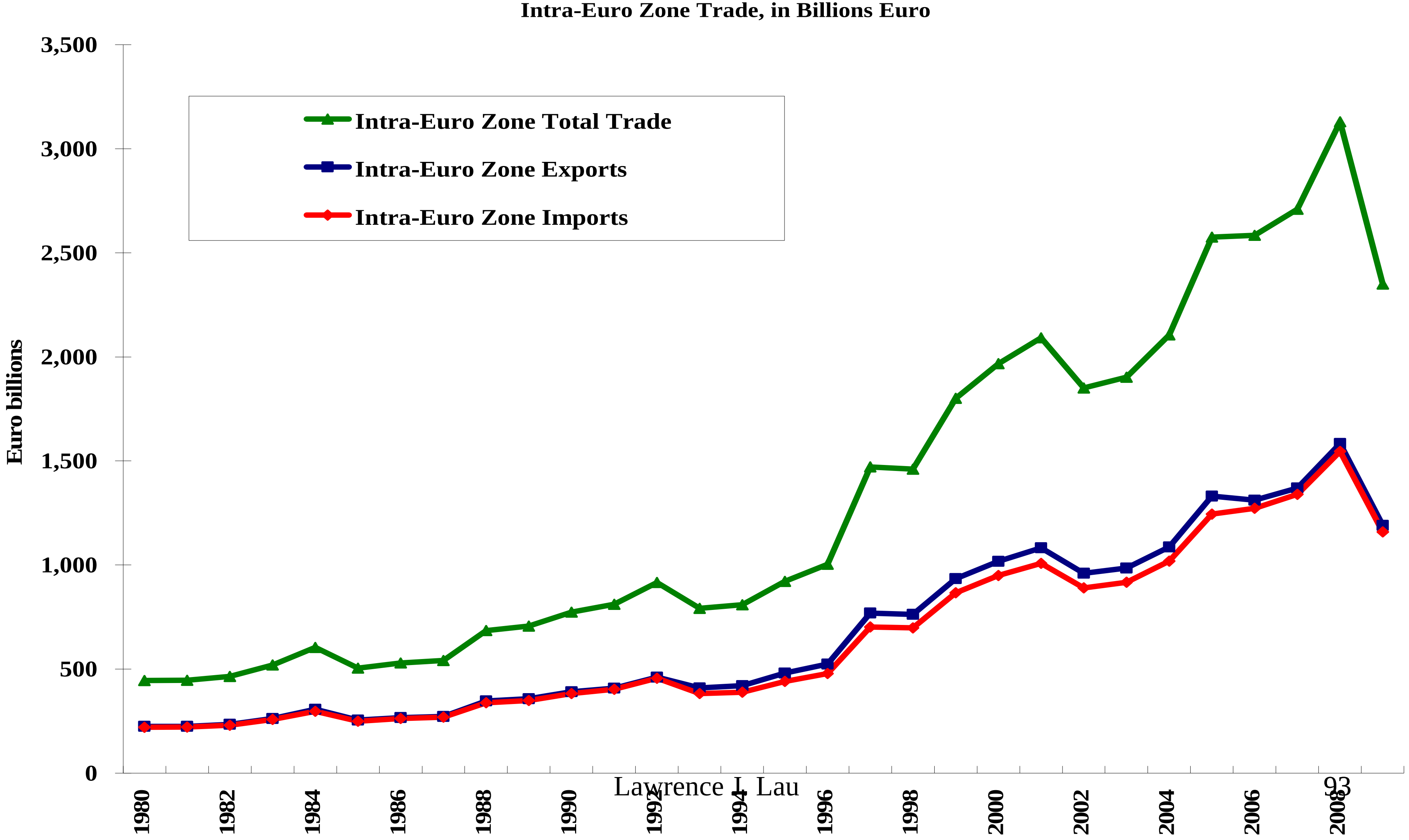
Options for East Asia: Maintaining Relative Real Parities

- More recently, in the aftermath of the Tohoku Earthquake and Tsunami in Japan, the Group-of -Seven (G-7) countries have seen it fit to intervene in the Japanese Yen market to stabilise the Yen/US$ exchange rate—a recognition that excess exchange rate volatility is harmful not only to Japan but also to the World and moreover, it is too risky to leave it to the market "to take care of it."
- Even more recently, the Swiss National Bank has also decided to set an upper bound of 1.2 Euro per Swiss Franc on the exchange rate of the Swiss Franc.

Options for East Asia: Maintaining Relative Real Parities

- Stable relative exchange rates, especially relative real exchange rates, among economies can enhance the international trade and investment flows among them significantly, much more so than a free trade area or a common market among them.
- The introduction of the Euro as a single currency for countries in the Euro Zone (due to Prof. Robert Mundell) is a good example—intra-Euro Zone trade tripled to approximately 3 trillion Euro (or US$4 trillion) after the introduction of the Euro in the late 1990s even though there had been no tariffs among the major countries in the Euro Zone since the 1960s (see the following chart). This demonstrates the power of a single, unified currency.

Intra-Euro Zone Trade, Billions Euro, Pre-and Post the Introduction of the Euro



Options for East Asia: Maintaining Relative Real Parities

- Relative exchange rates have been extremely volatile in recent years. No one disputes the usefulness of exchange rate flexibility in the adjustment of persistent trade imbalances, but it is hard to see how such a high degree of volatility benefits anyone except the currency traders and bankers.
- The fluctuations in the relative exchange rates are largely unrelated to the economic fundamentals of the economies. For example, in 2010, the Euro went from a high of over 1.4 US$ per Euro to a low of 1.15 US$ per Euro and then back again to 1.4 a couple of times. Did this reflect the relative economic fundamentals between the United States and the Euro Zone? Could this have been good for the Euro Zone, for the United States, or for the World?

Options for East Asia: Maintaining Relative Real Parities

- The volume of foreign exchange transactions in the World is huge—currently it may be estimated at approximately US$1.5 quadrillion annually.
- This volume is far too large than can be justified by the "real" international transactions, that is: international trade, foreign direct investments, and foreign portfolio investments (even if we take into account that the stocks of the direct investments and portfolio investments can be much bigger than the annual flows and that they may possibly require hedging).

Options for East Asia: Maintaining Relative Real Parities

- The total annual worldwide international trade flows amount to US$20 trillion in 2010, or less than 1.5% of total annual foreign exchange market turnover in 2010.
- Of the total annual worldwide international trade flows, only those conducted in a different currency from either the exporting country or the importing country need to be funded in foreign exchange or hedged.
- For example, intra-Euro Zone international trade, amounting to some US$4 trillion in 2010, will be conducted entirely in Euros and does not generate any demand for foreign currency or hedging.
- If the intra-common currency area international trade is netted out, the total annual worldwide international trade flows that require currency conversion may be estimated at approximately US$15 trillion.

Options for East Asia: Maintaining Relative Real Parities

- If we assume two currency conversions per international trade transaction, and in addition, two currency hedging transactions, that is, by both the exporters and the importers invoicing and settling in a third currency, the total volume of such foreign exchange transactions should not exceed four times the total annual international trade flows among countries not using a common currency of US$15 trillion or US$60 trillion.
- However, because traders in the U.S. and the Euro Zone will settle the trade in their own currencies and do not need to exchange or hedge twice, the total volume of such foreign exchange transactions should be less than US$60 trillion, which is only 4% of the total annual global foreign exchange market turnover.

Options for East Asia: Maintaining Relative Real Parities

- Worldwide total international foreign portfolio investment outflow reached a peak of US$3 trillion in 2006 and currently runs at a rate of US$1.5 trillion a year. Cumulative worldwide foreign portfolio investment outflows since 1994 amount to approximately US$16 trillion.
- Worldwide total international foreign direct investment outflow reached a peak of US$2.5 trillion in 2007 and currently runs at a rate of a little more than US$1 trillion a year. Cumulative worldwide foreign direct investment outflows since 1994 amount to approximately US$24 trillion.
- The stock of total foreign investments, both direct and portfolio, may require one-way hedging to the extent that they are investments in a currency other than the currency of the investment-originating country.

Options for East Asia: Maintaining Relative Real Parities

- If we add up all of the above—that is, the foreign exchange transactions that are generated by the flows of international trade and the stocks of foreign portfolio investments and foreign direct investments—we obtain US$100 trillion, which is less than 7% of total annual global foreign exchange market turnover.
- There is therefore far too much "pure" speculation in the foreign exchange markets, by investors who purchase spot, forward or future foreign exchange purely for its capital gain potential and not for settling any underlying current or future transaction or hedging the value of any underlying asset or liability.
- It is fine if people like to gamble, but it is not fine when such gambling have major real effects impacting on third parties.

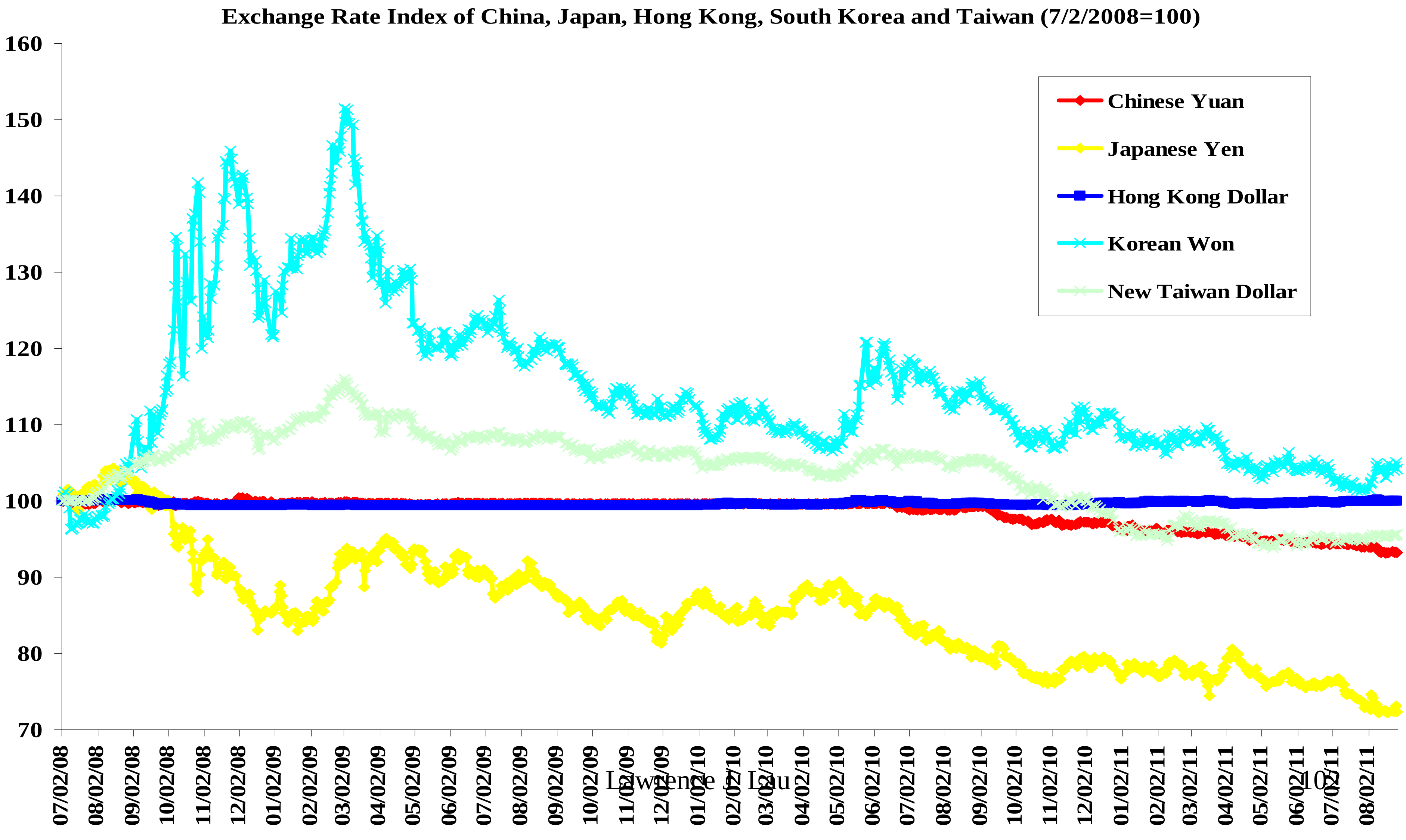
Options for East Asia: Maintaining Relative Real Parities

- Moreover, exchange rate volatility, as opposed to exchange rate flexibility, does not benefit anyone except the currency speculators. The economic benefits of a daily fluctuating exchange rate freely determined in the market are exaggerated. In any case, the foreign exchange markets are also subject to manipulation by the major banks and currency speculators who dominate the markets.

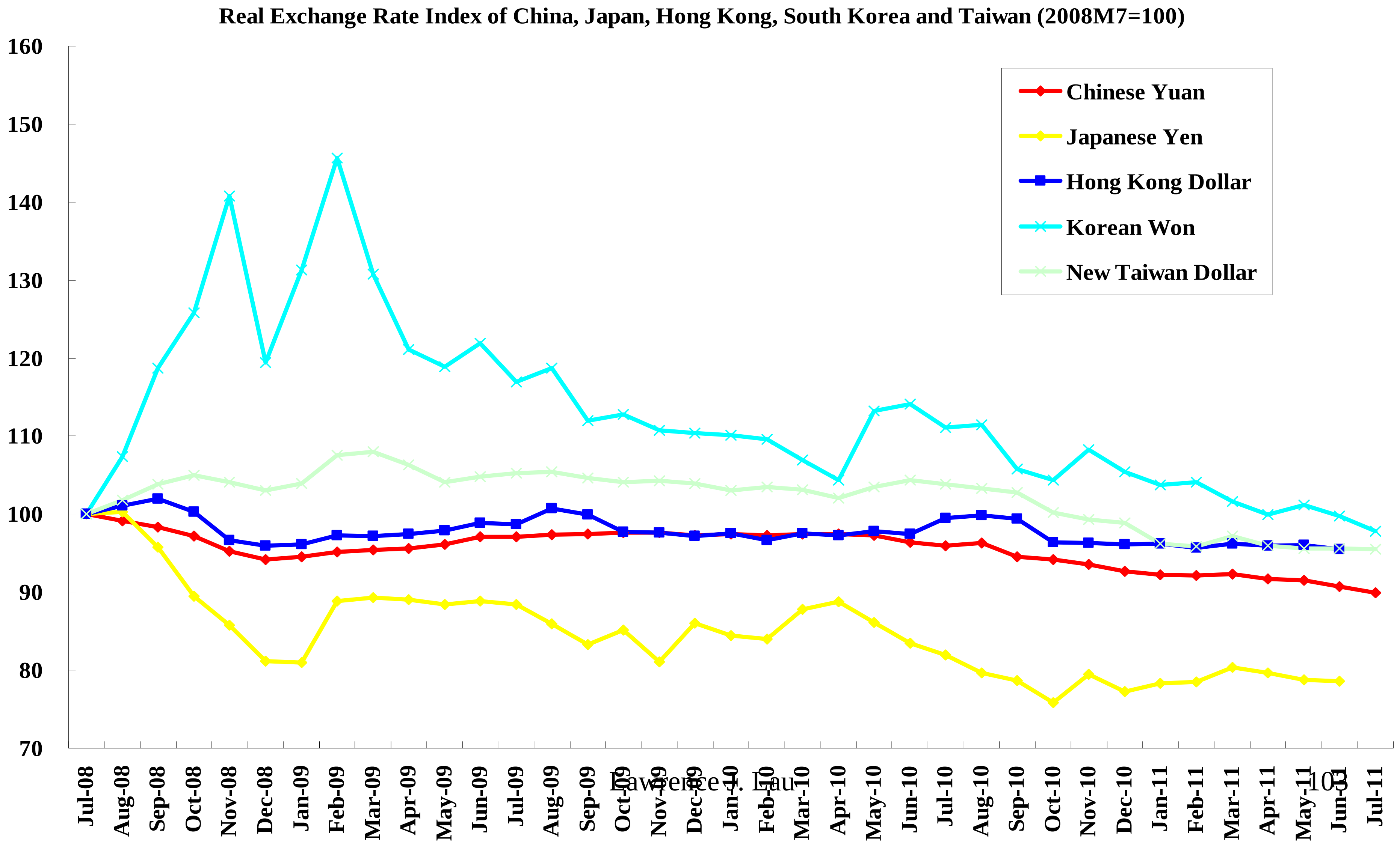
Options for East Asia: Maintaining Relative Real Parities

- It will be beneficial for East Asian economies, beginning with China, Japan and Korea, to maintain the relative real parities of their exchange rates—in other words, to maintain the relative real purchasing power of each currency in the other currencies so that 1 Yuan will always purchase the same quantity of real goods in Japan and South Korea (and similarly for 1 Yen and 1 Won).
- In fact, the real (as opposed to the nominal) exchange rates of China, Japan and South Korea tend to move together in the time frame of a year (see the next two Charts), so that maintaining relative real parities is not inconsistent with the actual behaviour of the exchange rates.
- A common policy of maintaining relative real parities would have smoothed out the fluctuations and reduced the unnecessary volatility in the relative exchange rates.

Exchange Rate Index of China, Japan, Hong Kong, South Korea and Taiwan (7/2/2008=100)



Real Exchange Rate Index of China, Japan, Hong Kong, South Korea and Taiwan (2008M7=100)



Options for East Asia: Maintaining Relative Real Parities

- The central banks of these economies can intervene in the foreign exchange markets to maintain relative real parities within relatively narrow bands in a way that is incentive-compatible with the interests of their respective exporters. (This is an idea due to Prof. Robert Mundell.)
- The principal instrument used for intervention by each central bank is the purchase of the currencies of the other economies with its own currency in the foreign exchange markets. Note that such interventions are not macroeconomic in nature and do not imply nor are they implied by nominal or real exchange rate targeting or inflation rate targeting for the economy as a whole.

Options for East Asia: Maintaining Relative Real Parities

- For example, if the real Yuan/Yen exchange rate, that is, the Yuan/Yen exchange rate adjusted for the relative rates of inflation of the two countries, rises too much from the agreed relative real parity, Japanese exports to China will become more expensive in China relative to domestic Chinese goods and hence be disadvantaged. In this case, the Bank of Japan should intervene by buying Yuan with Yen, driving up the Yuan relative to the Yen, so that each Yen will be worth fewer Yuan.
- Similarly, if the real Yuan/Yen rate becomes too low, Chinese exports to Japan will be disadvantaged, then the People's Bank of China should intervene by buying Yen with Yuan.
- The same mode of behaviour should also be followed by the other central banks. This way, the relative real parities among the currencies of the participating economies can be kept within relatively narrow pre-agreed bands.

Options for East Asia: Maintaining Relative Real Parities

- Of course there is a question of which index of inflation should be used in the calculation of the real exchange rate parities. I believe either the GDP deflator or the Consumer Price Index would work. But all economies should agree to use the same type of deflator. Ideally, it should be the same index of inflation used to index inflation-protected bonds issued by the countries concerned, if any.
- If the East Asian economies, or any sub-group thereof, can come to an agreement to maintain relative real parities of their currencies, but allow them to be collectively flexible with respect to other currencies, it will not only greatly enhance international trade flow, long-term cross-border investment as well as international division of labour among themselves, but also facilitate adjustment of their exchange rates vis-à-vis other currencies, such as the U.S. Dollar and the Euro, in response to persistent imbalances. This is because none of the participating economies will be disadvantaged vis-à-vis other economies in terms of export competitiveness.

Options for East Asia: Regulating Short-Term International Capital inflows

- The observed exchange rate volatility today is largely unrelated to international trade flows or to direct investment flows, which have been quite stable on the whole. It may be related, in part, to short-term portfolio investment flows. However, it is mostly caused by the volatile short-term (defined as less than 12 months) speculative international capital flows.
- Moreover, exchange rate volatility in itself also in turn attracts further speculation from hedge funds and other speculators taking advantage of the volatility to speculate on short-term exchange rate changes, and hence may lead to even more short-term international capital inflows or outflows and even greater exchange rate volatility.

Options for East Asia: Regulating Short-Term International Capital inflows

- The theory of comparative advantage shows that two economies trading with each other voluntarily will both benefit, although possibly to varying degrees. This is the intellectual basis for supporting international trade, and in particular, free international trade.
- It is also well demonstrated that foreign direct investment undertaken in the absence of special privileges for the investor will always benefit both the investor-country and the investee-country. The same argument applies to long-term foreign portfolio investment.

Options for East Asia: Regulating Short-Term International Capital inflows

- However, there is no similar argument in favour of short-term international capital movements, with the exception of short-term trade-related financing. It is simply an article of faith that the freer the movement of capital, the better.
- Moreover, short-term non-trade related capital inflows that can be withdrawn at short notice do not really benefit the destination country. On the contrary, they may do it significant harm, as the East Asian currency crisis of 1997-1998 and numerous Latin American currency crises amply demonstrated.

Options for East Asia: Regulating Short-Term International Capital inflows

- The problem with short-term capital inflows is that they cannot be usefully deployed in the destination country. When they are used to finance long-term investment in the destination country, they invariably lead to trouble because of maturity mismatch which is further exacerbated by the currency mismatch.
- However, as they flow in and out of the destination country, they cause the exchange rate of the destination country to become excessively volatile, inhibiting the flows of cross-border trade and long-term investment.

Options for East Asia: Regulating Short-Term International Capital inflows

- It is also not clear what good short-term capital outflows do to the origin country. (Under "Quantitative Easing II" of the U.S., if the liquidity created by the U.S. Federal Reserve Board had stayed in the U.S., it might have done the U.S. economy some good; but since most of it flowed out of the U.S., it is not clear whether and if so how it benefitted the U.S. economy.)
- Thus, through taxation (for example, a "Tobin" tax on cross-border and cross-currency area financial transactions), a period of sequestration or "quarantine", or other means, short-term capital inflows should be discouraged at the same time that long-term capital flows, both inbound and outbound, should be encouraged.
- Expected stability of the exchange rate itself will help to discourage short-term capital inflows or outflows.

Options for East Asia: Regulating Short-Term International Capital inflows

- The Tobin tax, originally suggested by the late Prof. James Tobin, Nobel Laureate in Economic Sciences, was originally defined as a tax of say 0.5% on all spot conversions of one currency into another. The tax is intended to put a penalty on short-term financial round-trip excursions into another currency.
- By minimising unnecessary short-term capital flows, the volatility of relative exchange rates can be reduced. It will therefore also facilitate the maintenance of relative real parities, for example, among China, Japan and South Korea. Stable relative real exchange rates can in turn encourage the growth of international trade, long-term cross-border direct investment and division of labour among the three countries.

Concluding Remarks

- The international monetary order is in need of restructuring.
- It is 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 times.
- There are, however, other alternatives than the use of Renminbi as another major international reserve currency.

Concluding Remarks

- Paradoxically, the global financial crisis of 2007-2009 has accelerated the pace of internationalisation of the Renminbi. 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.
- In time, perhaps within the next five years, the Renminbi will become effectively 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 and regulation.

Concluding Remarks

- There is little empirical evidence that the Renminbi (Yuan) is significantly under-valued today. If China is able to maintain an approximate balance of trade in goods and services combined under conditions of free trade (WTO conditions), then there is no reason for a substantial adjustment in its exchange rate.
- 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." China should remember what happened to the "market-determined" 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.
- Relative stability of the Renminbi exchange rate is beneficial to the continued development of the Chinese economy and also to the other East Asian economies. It also enhances the potential benefits from using the Renminbi as a store of value.

Concluding Remarks

- China and other East Asian economies should consider the following possible measures as alternatives to the current system of settlement of international transactions.
- (1) Denomination and settlement of the international trade in goods and services as well as other international transactions such as investment and loans among themselves in the own currencies of these economies, with any net surplus/deficit settled among their central banks in terms of inflation-protected securities in the currencies of the respectively deficit countries;

Concluding Remarks

- (2) The establishment of a multilateral settlement mechanism within East Asia, say 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 in the aftermath of World War II.
- (3) Maintenance of relative real parities among the currencies within relatively narrow pre-agreed bands so as to promote long-term trade and cross-border investment and division of labour among the three countries. (Such an arrangement will also facilitate a common adjustment to imbalances outside the participating economies, since none of them will be relatively disadvantaged in terms of competitiveness by a simultaneous adjustment in their exchange rates with respect to another foreign currency such as the U.S. Dollar.)

Concluding Remarks

- (4) Formulation and implementation of a common policy regulating short-term capital inflows originating from outside these economies so as to reduce their potentially destabilising effects on the foreign exchange, credit and asset markets of these economies, but welcoming long-term cross-border capital inflows as well as outflows. Reduction of short-term speculative capital movements will also facilitate the maintenance of relative real parities among the currencies.

Concluding Remarks

- 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.