What Makes China Grow?
中国经济增长动力探源

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Lecture III
The Internationalisation of the Chinese Economy

Outline

- Introduction
- China in the Global Economy
- The Evolution of the Renminbi Exchange Rate
- The Adequacy of the Official Foreign Exchange Reserves
- The Internationalisation of the Renminbi
- Alternatives to the US$-Centric Clearing and Settlement System
- Concluding Remarks

Introduction

- The internationalisation of the Chinese economy involves both inbound and outbound flows of trade and investment. Trade flows include the exports and imports of both goods and services. Investment flows include both inbound and outbound direct and portfolio investments and loans and credits.
- All of these international transactions must be cleared and settled in currencies acceptable to the transacting parties. Prior to 2010, almost all Chinese international transactions with the West have been settled in U.S. dollars.
- The internationalisation of the Renminbi is an objective of the Chinese Government. In what follows, we analyse the prospects of the internationalisation of the Renminbi and suggest several possible approaches to promote it.

China in the Global Economy

- There are four important developments in the global economy during the past four decades. They are:
- (1) The reform and opening of the Chinese economy and its participation in the world since 1978, enhancing both global supply of and demand for goods and services;
- (2) Economic globalisation, increasing international trade, direct investment and portfolio investment around the world;
- (3) The fragmentation of production, made possible by advances in information and communication technology, giving rise to widely dispersed international supply chains and international division of labour; and
- (4) The rise of the internet economy as a marketplace for both sellers and buyers.

China in the Global Economy

- These developments have resulted in:
- The centre of gravity of the global economy, in terms of both GDP and international trade, has been gradually shifting from North America and Western Europe to East Asia and South Asia, and within East Asia from Japan to China. The shift is still on-going, with both China and India being currently the fastest-growing economies in the world.
- Close to 1 billion people worldwide (740 million in China alone) have been lifted out of poverty as a result of this economic globalisation.
- The internet economy augments the variety of choices, increases competition and reduces transaction costs, including search costs.
- Each and every economy has benefitted in the aggregate.

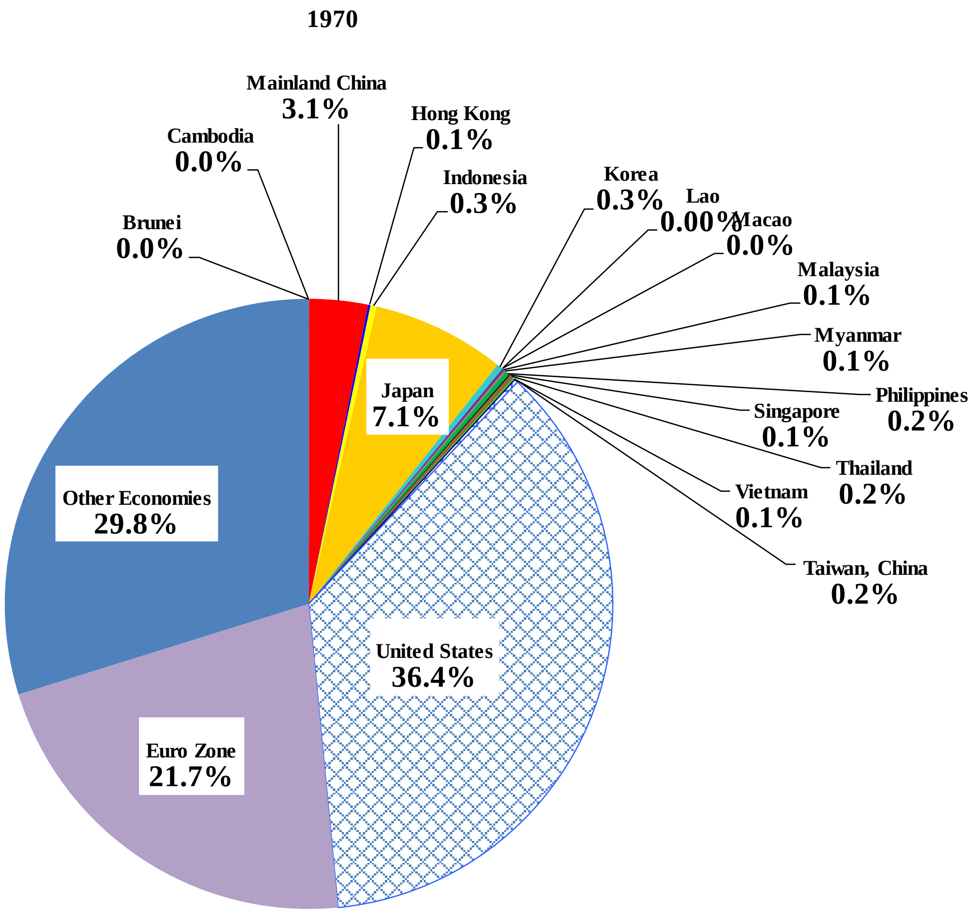
China in the Global Economy: The Shifting Center of Gravity of the Global Economy

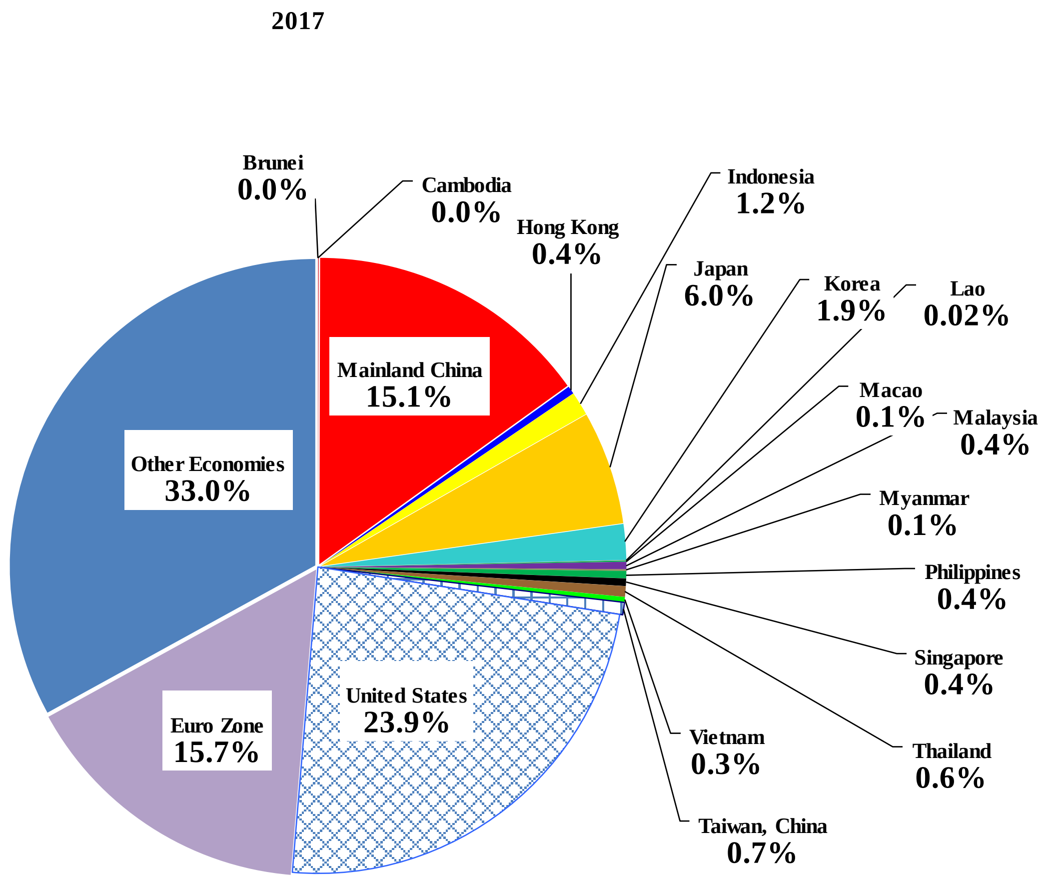
- In 1970, the United States and Western Europe together accounted for almost 60% of world GDP. By comparison, East Asia (defined as the 10 Association of Southeast Asian Nations (ASEAN)--Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam--+ 3 (China including Hong Kong, Macau and Taiwan, Japan and the Republic of Korea)) accounted for only approximately 10% of world GDP.
- Hong Kong, the Republic of Korea, Singapore and Taiwan are also known collectively as the East Asian "Newly Industrialised Economies (NIEs)".

China in the Global Economy: The Shifting Center of Gravity of the Global Economy

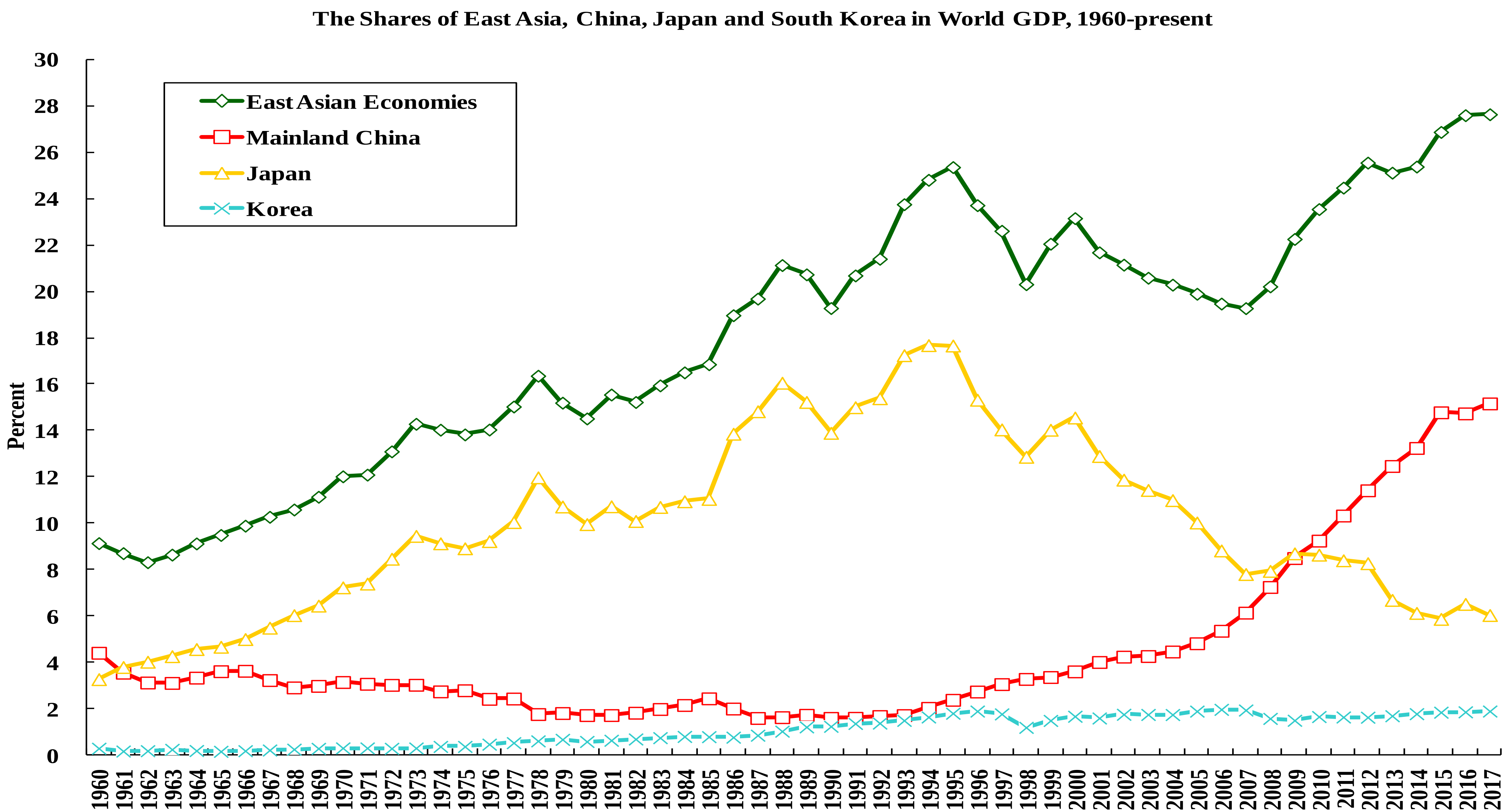
- By 2017, the share of United States and Western Europe combined in world GDP has declined to approximately 40% whereas the share of East Asia has risen to around 28%.
- The Japanese share of world GDP declined from a peak of almost 18% in the mid-1990s to 6.0% in 2017 while the Mainland Chinese share of world GDP rose from 3.1% in 1970 and less than 4% in 2000 to over 15.1% in 2017.

The Distribution of World GDP, 1970 and 2017, US$





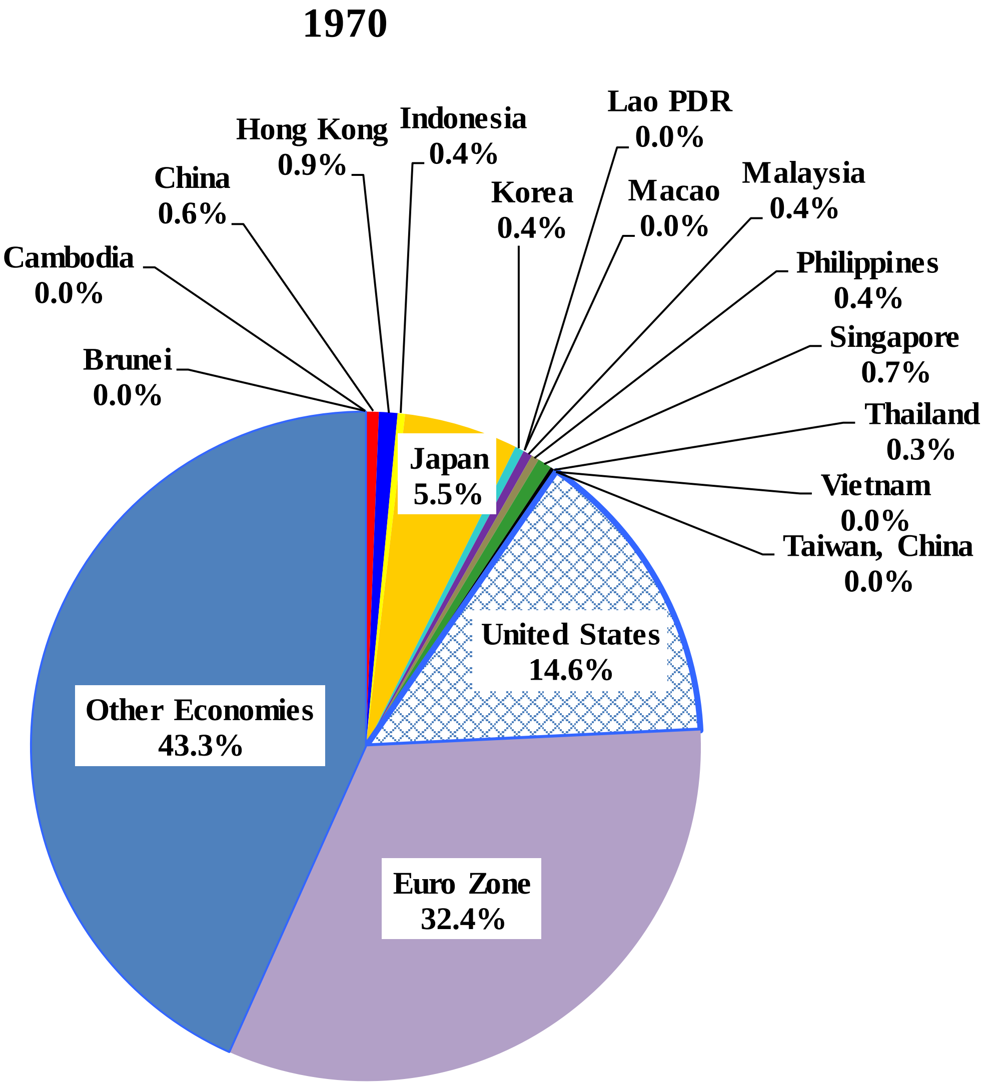
The Shares of East Asia, China, Japan and South Korea in World GDP, 1960-present

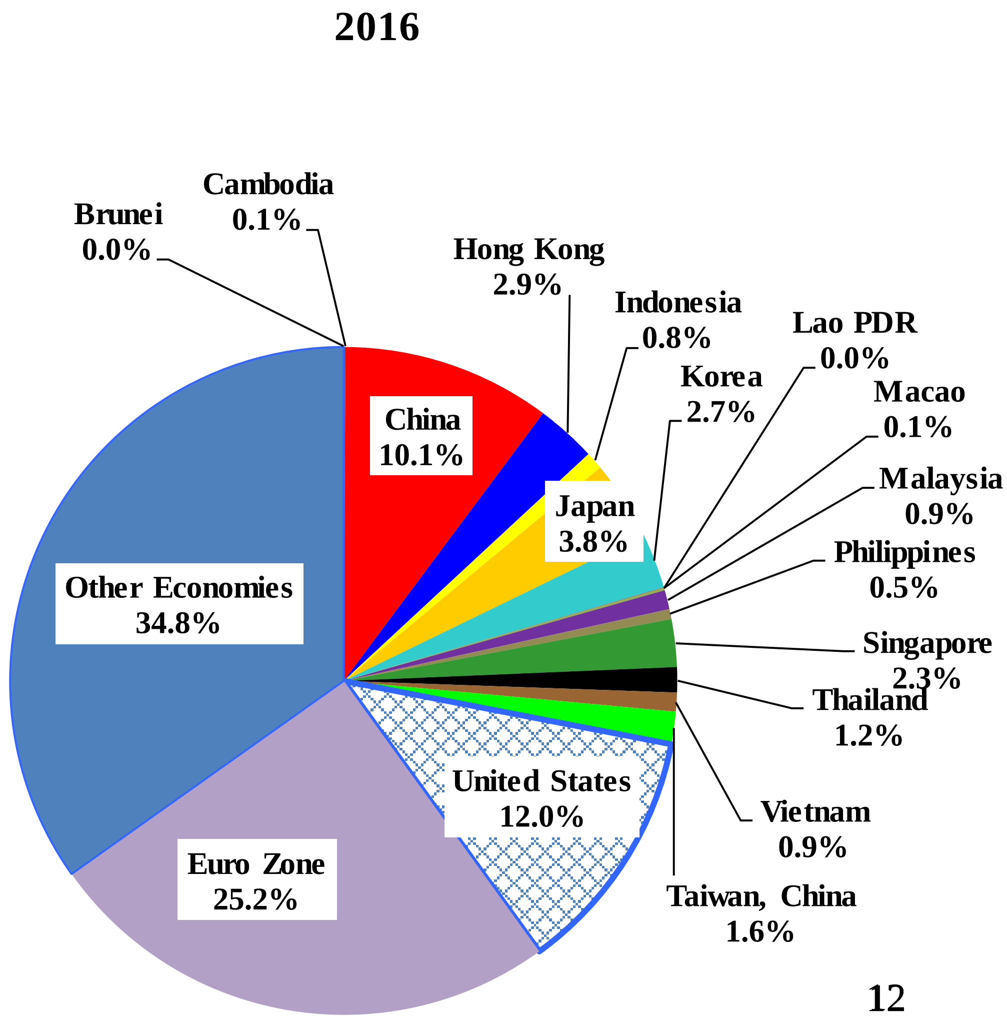


China in the Global Economy: The Shifting Center of Gravity of the Global Economy

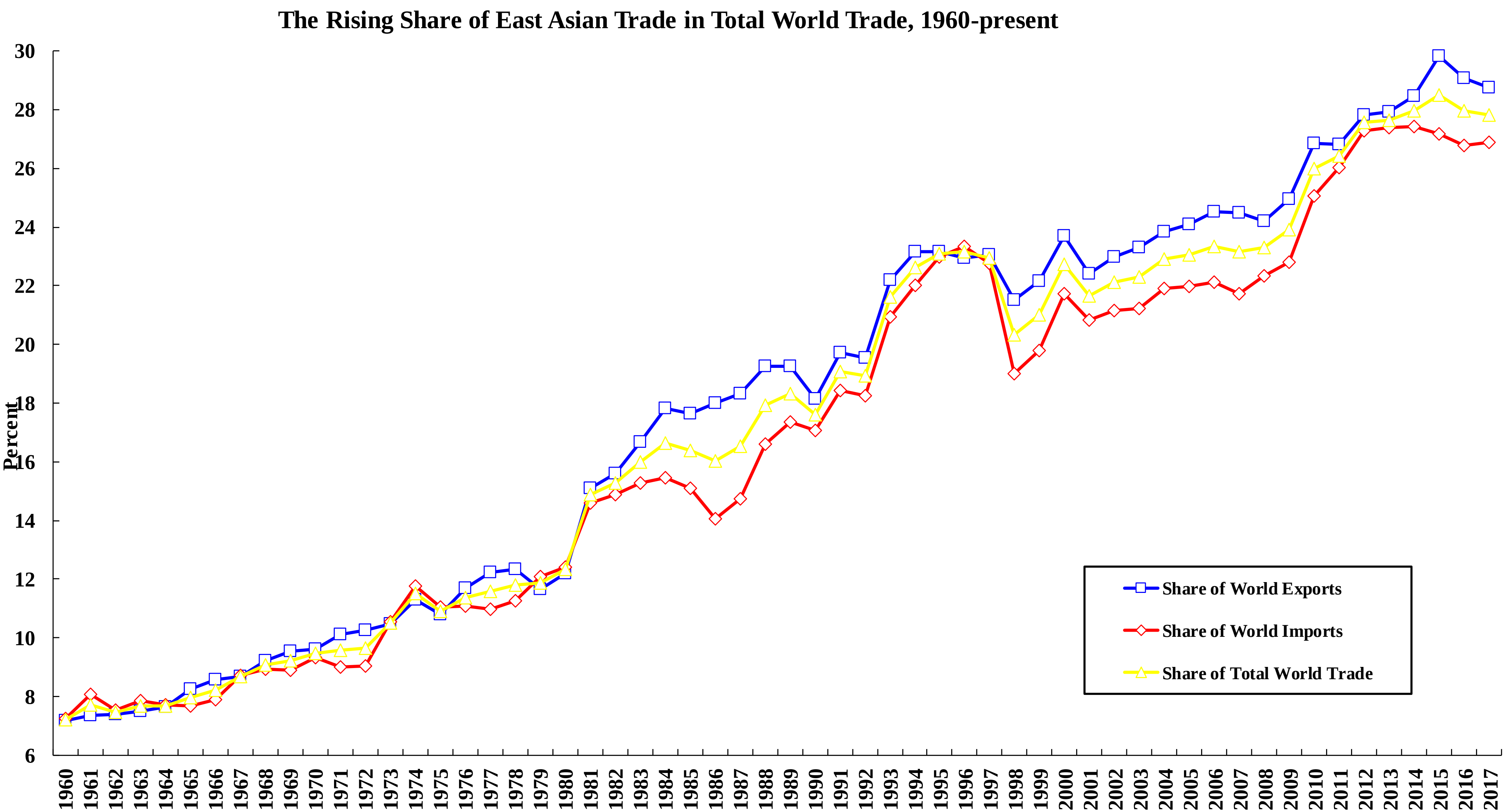
- In 1970, the United States and Western Europe together accounted for almost 47% of world trade in goods and services. By comparison, East Asia accounted for 9.5% of world trade.
- By 2017, the share of United States and Western Europe combined in world trade has declined to 36.5% whereas the share of East Asia has risen to almost 27.8%.
- The Mainland Chinese share of world trade rose from 0.6% in 1970 to 10.2% in 2017. The growth in Chinese international trade may be attributed in part to adoption of current-account convertibility of the Renminbi by China in 1994, accompanied by a significant devaluation of the Renminbi, and to Chinese accession to the World Trade Organisation (WTO) in 2001.
- Since 2015, Mainland China has also been the largest trading-partner country of the U.S., surpassing Canada.

The Distribution of International Trade in Goods and Services, 1970 and 2016

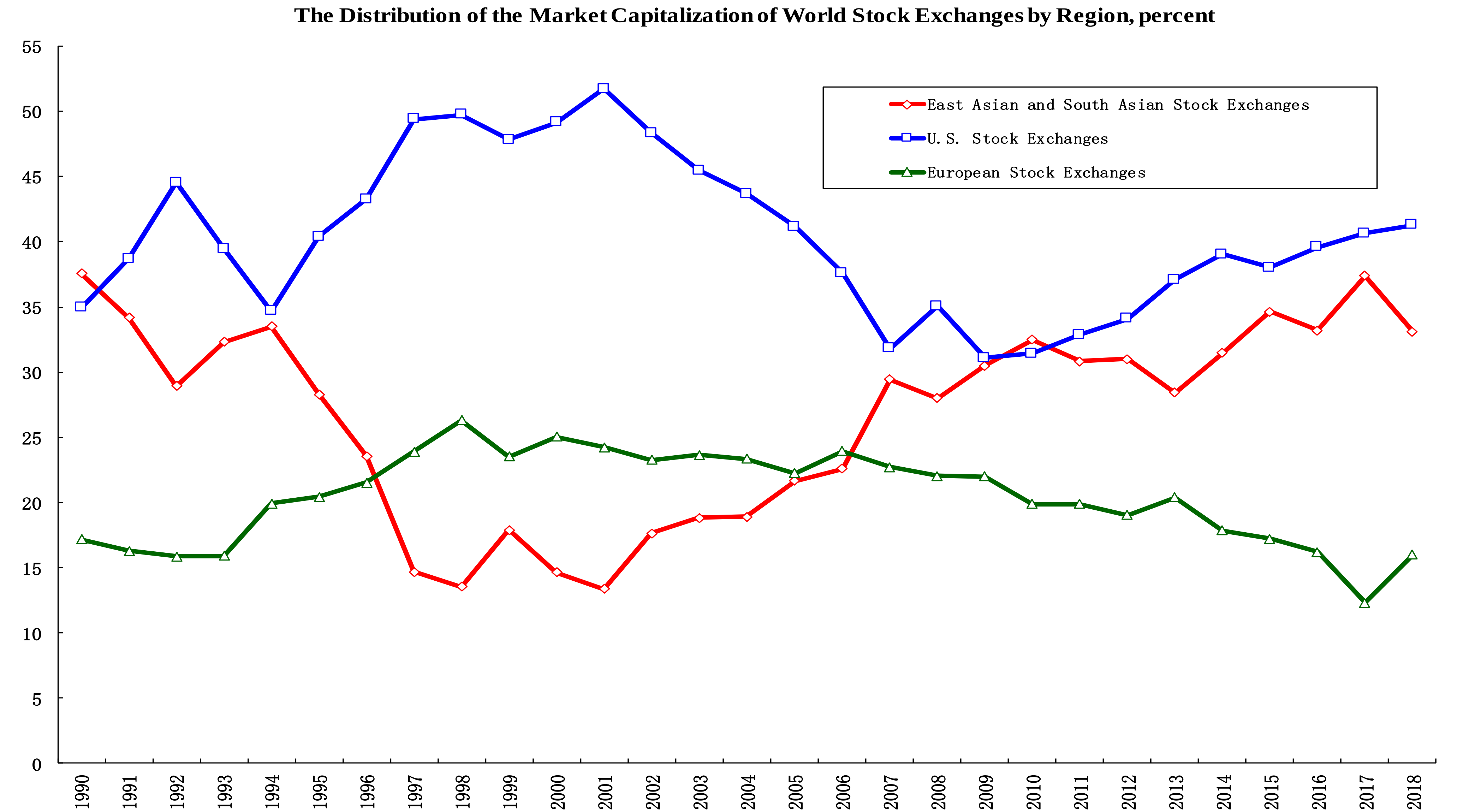




The Rising Share of East Asian Trade in Total World Trade, 1960-present



The Distribution of the Market Capitalization of World Stock Exchanges by Region, percent



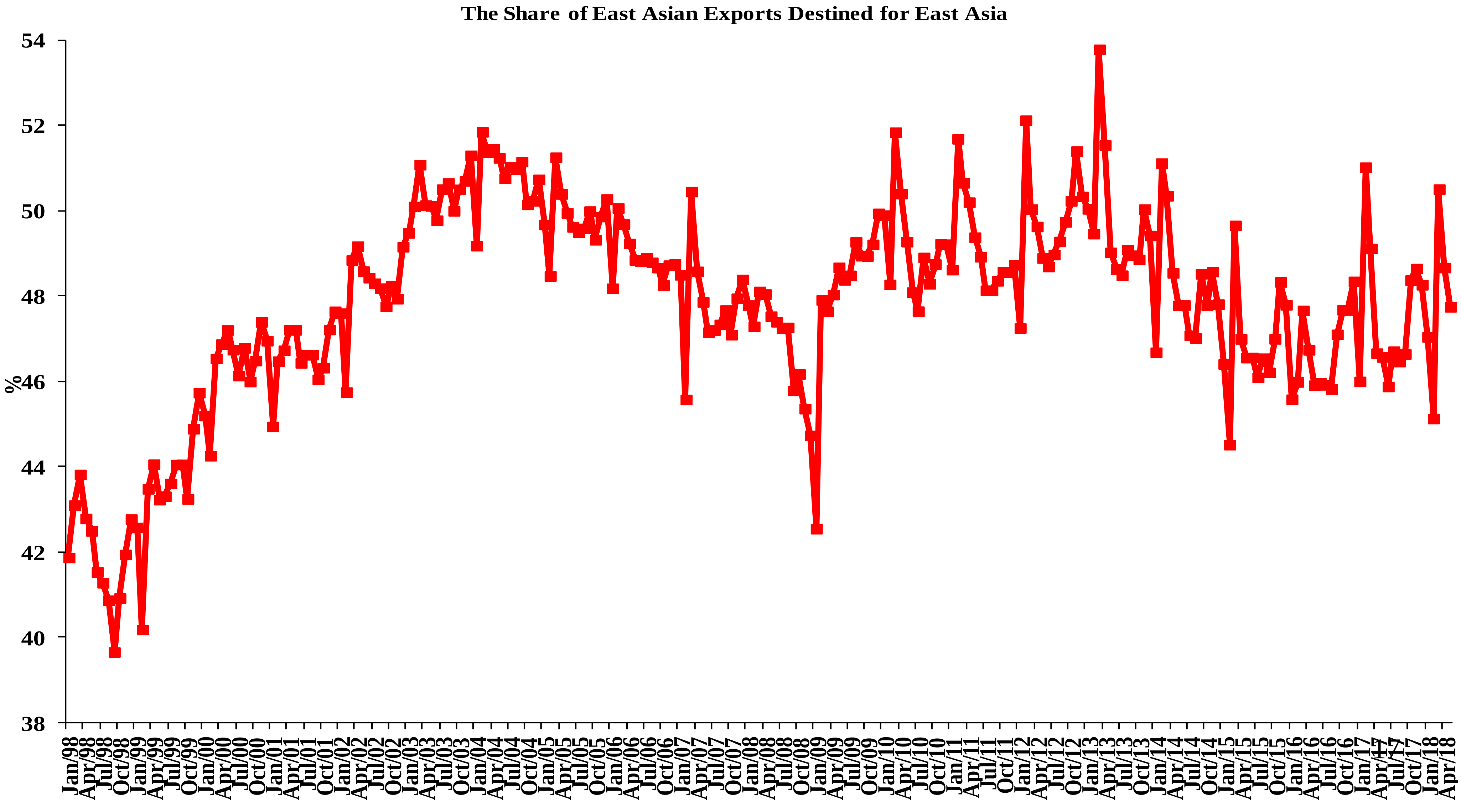
China in the Global Economy: The Partial De-Coupling Hypothesis

- Throughout the 2007-2009 global financial crisis, as well as the subsequent European sovereign debt crisis, the East Asian economies continued to do reasonably well. Mainland China, in particular, has been able to maintain its real rate of growth above 6.5% since 2007, lending credence to the "Partial De-Coupling Hypothesis", that is, the East Asian economies can continue to grow, albeit at lower rates, even as the U.S. and European economies go into economic recession.
- This partial de-coupling can occur because of the shift of the economic centre of gravity of the world from the United States and Western Europe to Asia (including both East Asia and South Asia) over the past four decades.

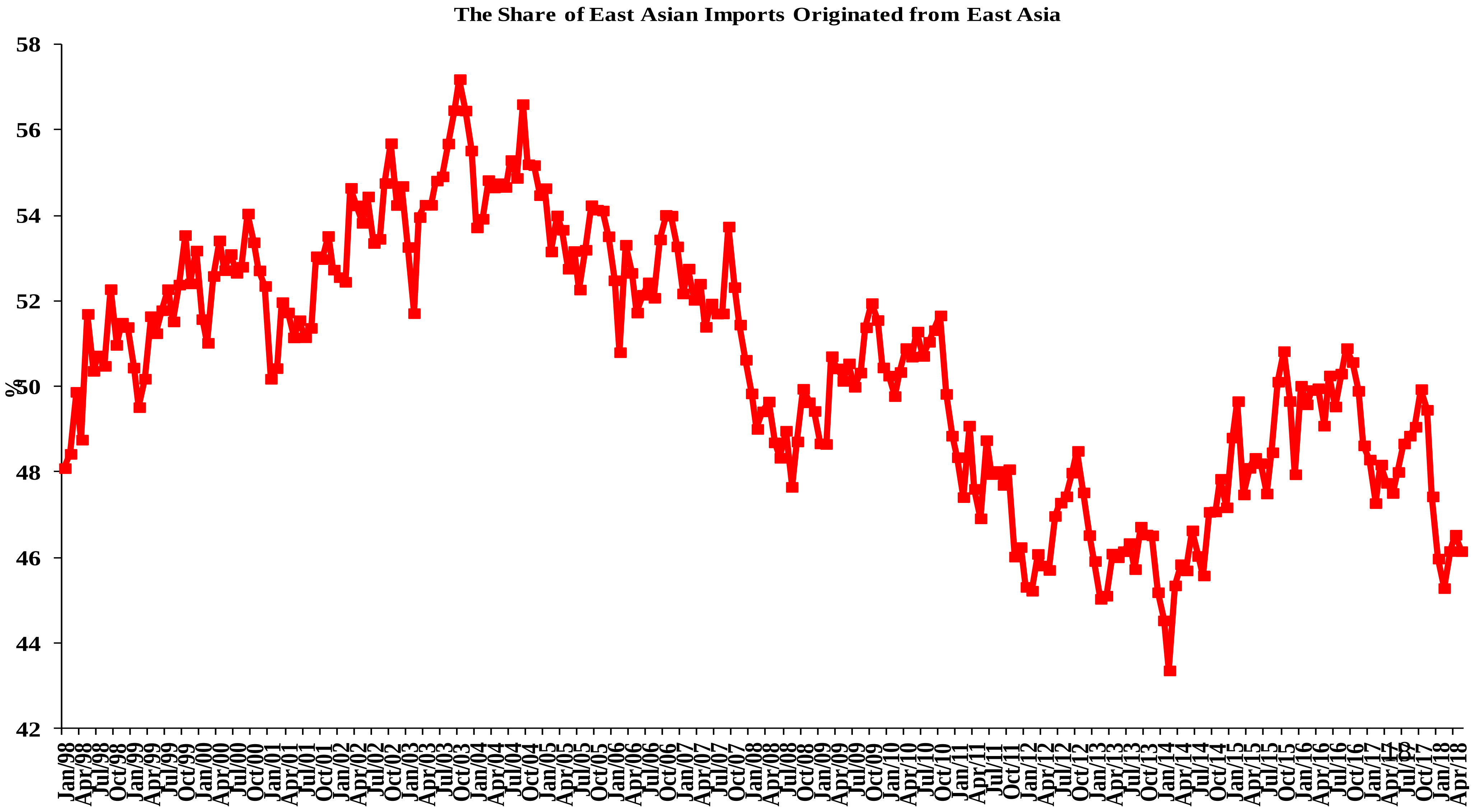
China in the Global Economy: The Partial De-Coupling Hypothesis

- A particularly interesting development is the rise in intra-East Asian international trade. The share of East Asian exports destined for East Asia accounts for 50 percent of total East Asian exports at the present time. This is a sea-change compared to 30 years ago when most of the East Asian exports were destined for either the United States or Western Europe.
- Similarly, the share of East Asian imports originated from East Asia has also stayed around 50 percent.
- China is now either the most important or the second most important trading-partner country of all East Asian economies.

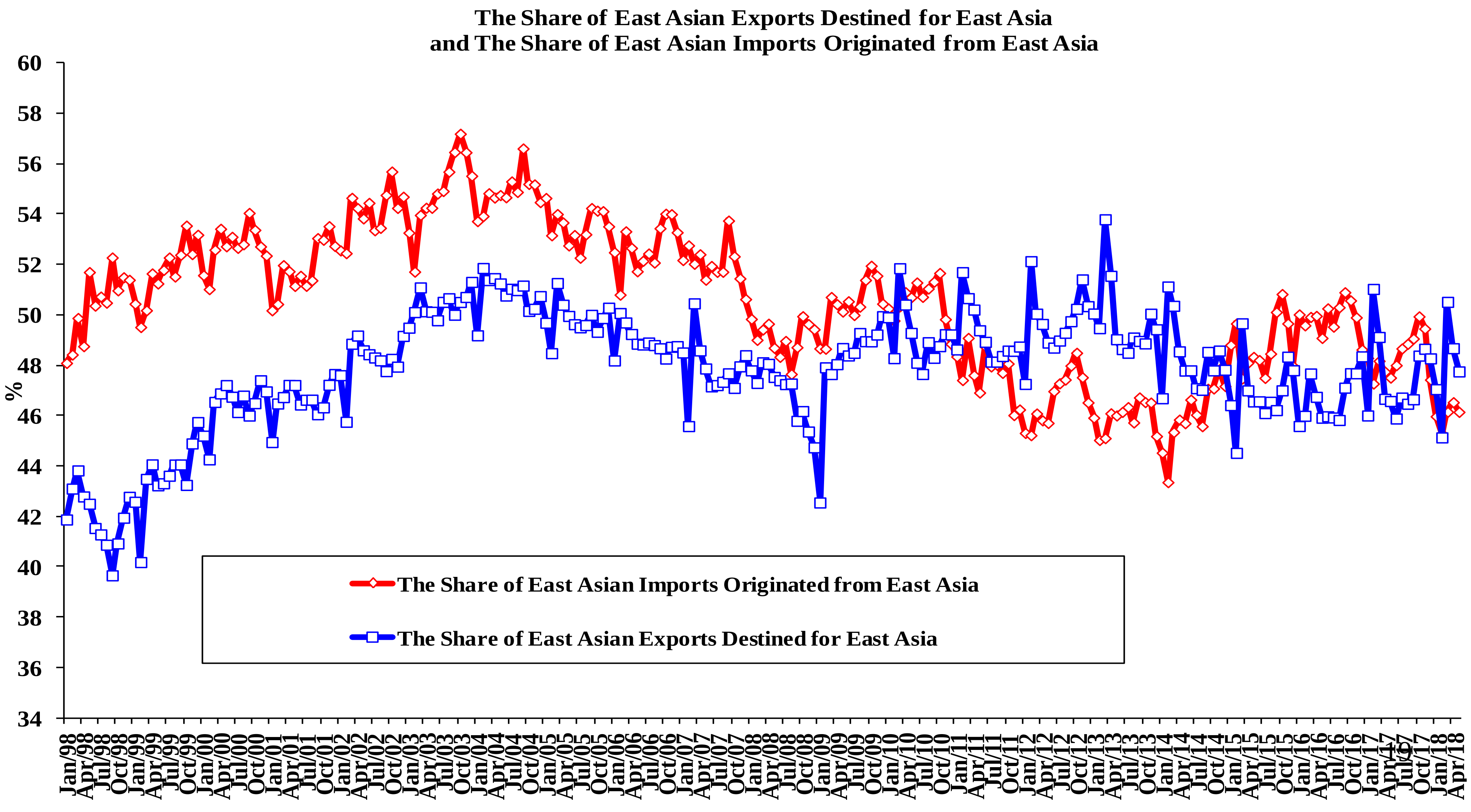
The Share of East Asian Exports Destined for East Asia



The Share of East Asian Imports Originated from East Asia



The Share of East Asian Exports Destined for East Asia and The Share of East Asian Imports Originated from East Asia



China in the Global Economy: The Importance of Trade with China

	Chinese Rank as Trading Partner of Country/Region	Rank of Country/Region as Trading Partner of China	U.S. Rank as Trading Partner of Country/Region	Rank of Country/Region as Trading Partner of U.S.
Japan	1	3	2	4
Republic of Korea	1	4	2	6
Hong Kong, China	1	2	4	10
Macau, China	2	75	4	118
Taiwan, China	1	5	2	11
ASEAN COUNTRIES				
Brunei	2	94	10	113
Cambodia	2	58	5	70
Indonesia	1	19	4	24
Laos	2	80	5	155
Malaysia	1	17	3	22
Myanmar	1	46	12	88
Philippines	1	28	3	33
Singapore	1	12	2	13
Thailand	1	18	3	21
Vietnam	1	10	3	18

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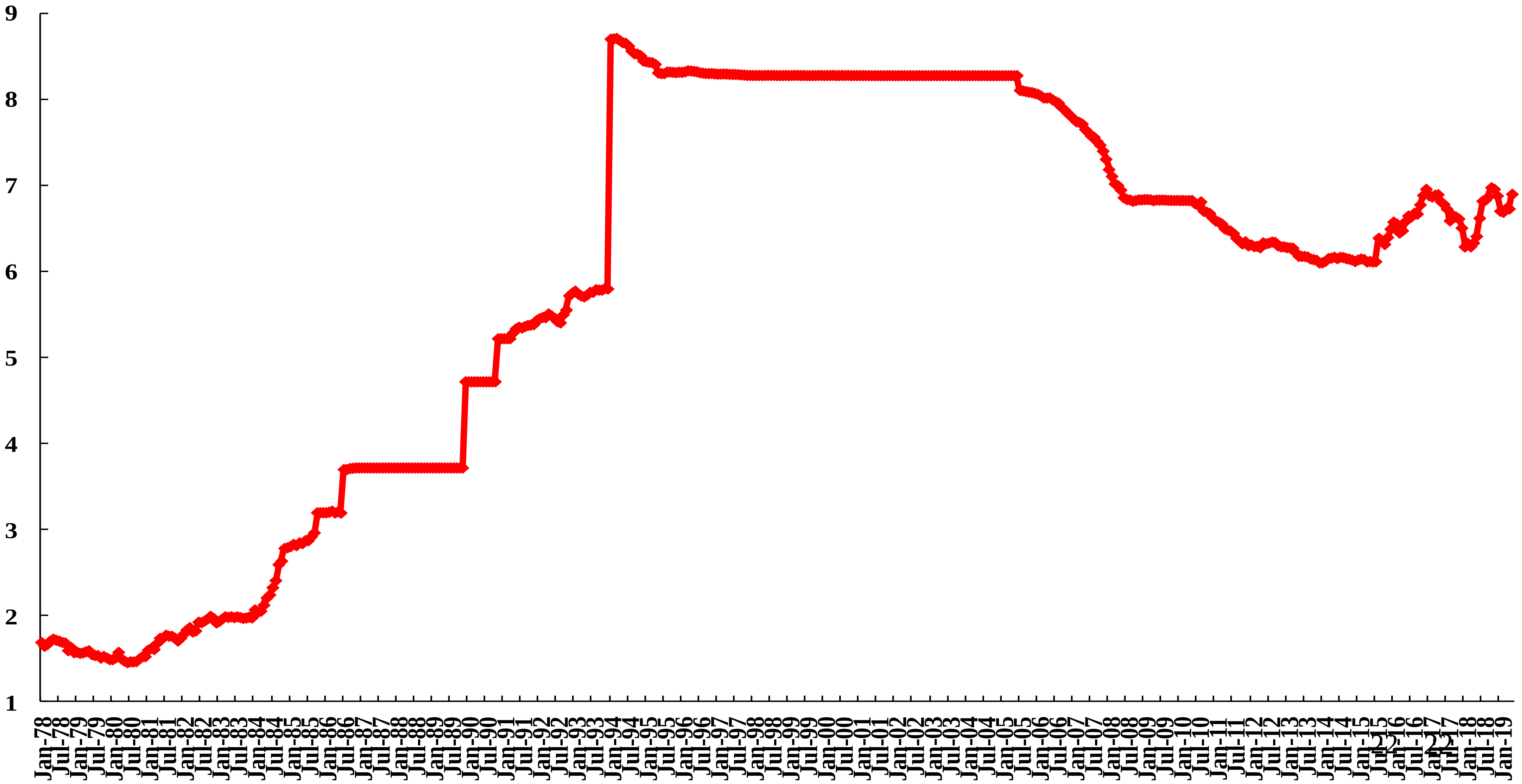
The Evolution of the Renminbi Exchange Rate

- The exchange rate of the Renminbi, the Chinese currency, was approximately 1.7 Yuan per US$ in January 1978. This was vastly over-valued and was one of the reasons for the introduction of the "foreign exchange certificate (FEC)". Goods can be purchased with the FEC at a lower price. So it was a de facto way of maintaining a dual exchange rate.
- Between 1978 and 1994, the Renminbi went through quite a few devaluations and had multiple exchange rates. In particular, there was an "adjustment" market in which exporters with foreign exchange proceeds can sell them to importers with approved import permits at an auction price.
- In January 1994, the multiple exchange rates were finally unified at 8.7 Yuan per US$ and full current-account convertibility was implemented. However, foreign exchange export proceeds must be sold to the People's Bank of China.

Nominal Exchange Rate of the Renminbi, Yuan/US$, 1978-present

Nominal Exchange Rate of the Renminbi, Yuan/US$, 1978-present



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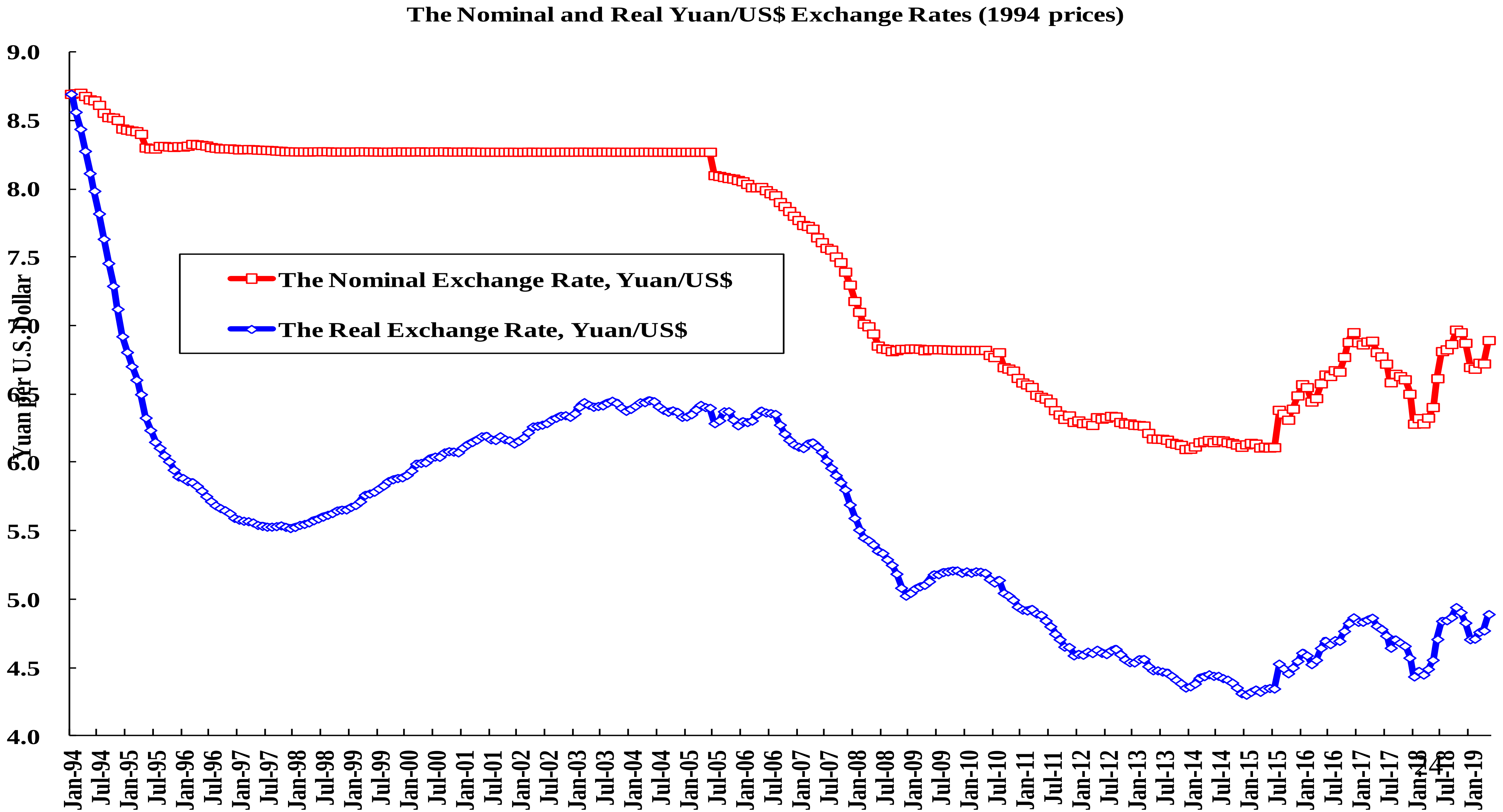
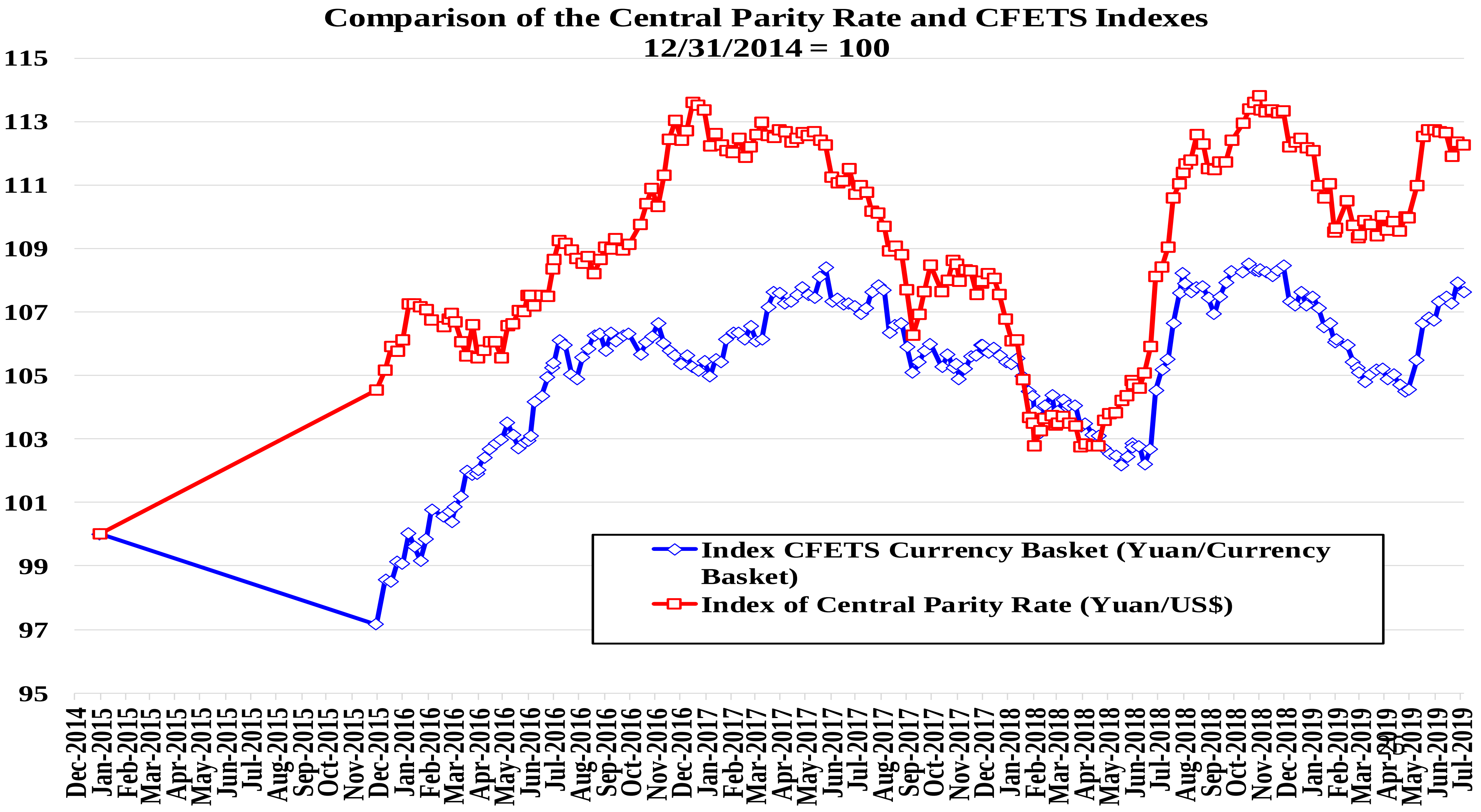
The Evolution of the Renminbi Exchange Rate

- The Renminbi was included in the Special Drawing Rights Basket of currencies in October 2016.
- The Renminbi no longer follows the US$. Instead, the Renminbi exchange rate uses as a reference the China Foreign Exchange Trade System (CFETS) trade-weighted currency basket exchange rate index. Its movements have been much closer to this trade-weighted exchange rate index.
- Capital-account convertibility is a long-term goal.

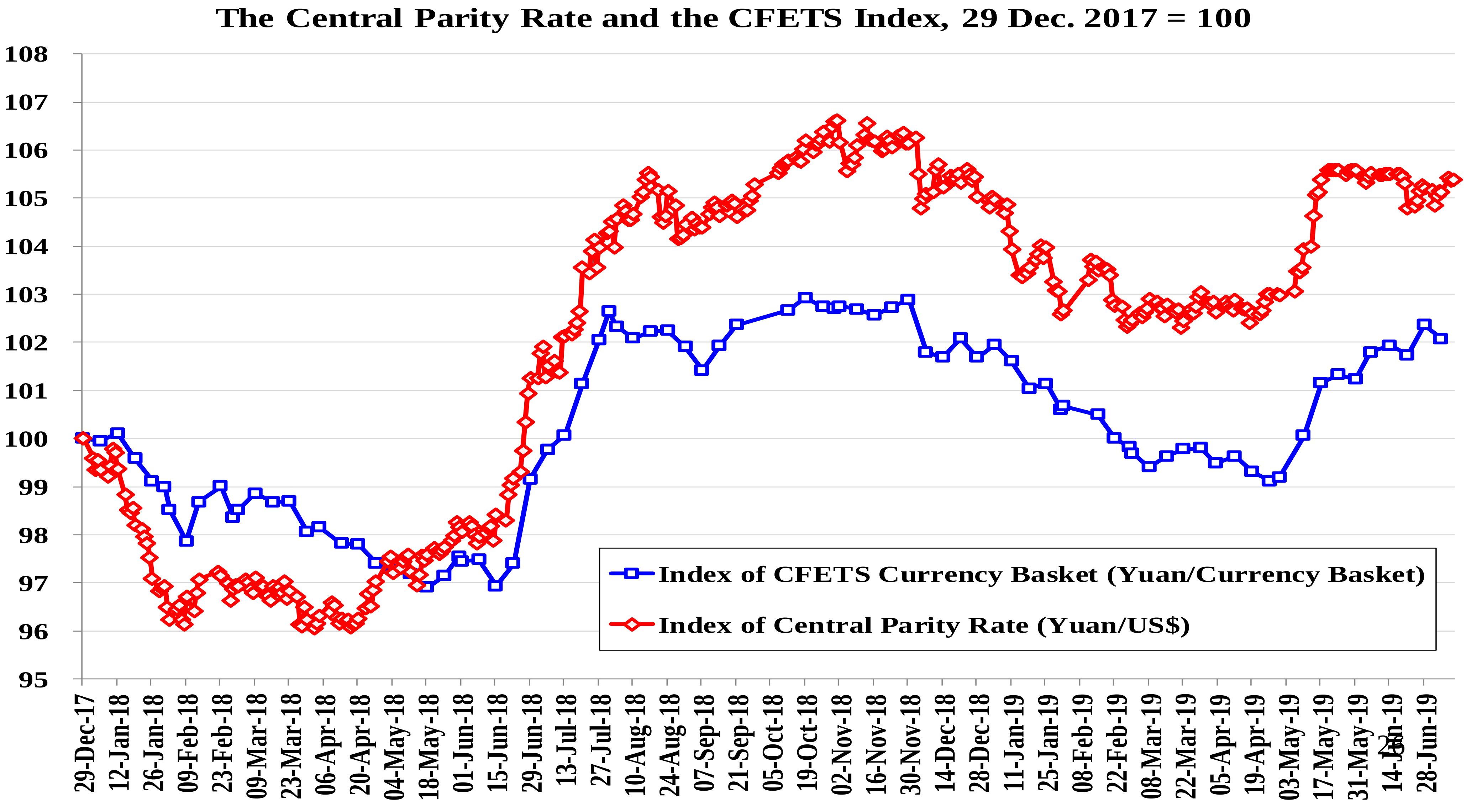
The Nominal and Real Yuan/US$ Exchange Rates



Comparison of the Central Parity Rate and CFETS Indexes (31 Dec. 2014 = 100)



The Renminbi Central Parity Exchange Rate and the CFETS Index



The Adequacy of the Official Foreign Exchange Reserves

- China today has the largest official foreign exchange reserves today, over US$3 trillion, managed by the State Administration of Foreign Exchange (SAFE), which is under the direction of the People's Bank of China, the central bank of China..
- In 1995, Prof. Jungsoo Park (currently Professor of Economics at Sogang University Seoul) and I presented a paper at the World Meeting of Project LINK, in Pretoria, South Africa, titled "Is There a Next Mexico in East Asia?". In that paper, we predicted that South Korea and Thailand were the most vulnerable to a Mexican style currency crisis. The same paper was presented in 1996 to Mr. DAI Xianglong, the then Governor of the People's Bank of China. Sure enough, the crisis broke out in Thailand on 1 July 1997.
- Subsequently, Prof. Isabel Yan (currently Professor of Economics at City University of Hong Kong) and I published a model for the prediction of currency crises. (Lawrence J. Lau and Isabel M. Yan (2005), "Predicting Currency Crises with a Nested Logit Model," Pacific Economic Review, Vol. 10, No. 3, 295-316.

The Adequacy of Foreign Exchange Reserves: Risks of Short-Term Capital Flows

- While economic theory tells us that voluntary international trade between two countries benefits both trading partners and voluntary foreign direct investment benefits both the investor- and the investee-countries, there is no theory which says that short-term capital flows are necessarily good for either the origin or the destination country.
- Exporters, importers and long-term cross-country direct and portfolio investors all prefer relative stability of the exchange rate. Short-term capital flows can cause significant volatility of the exchange rate and transient asset price bubbles and disrupt international trade.
- Moreover, when short-term foreign capital is utilised in an economy for longer-term purposes, it invariably leads to problems down the road because of maturity mis-match and currency mis-match.

The Adequacy of Foreign Exchange Reserves: Risks of Short-Term Capital Flows

- Foreign exchange transactions nowadays total approximately US$5 trillion a day. The total value of international trade, including trade that does not require currency conversions such as trade within the Euro Zone or other common currency areas, is approximately US$40 trillion a year.
- The net payments from the importers to the exporters may therefore be estimated at approximately US$20 trillion a year, an amount that can be covered with just four days of foreign exchange trading!
- Are all these foreign exchange transactions necessary for the world economy to function? While these foreign exchange transactions are clearly beneficial to and profitable for the commercial banks, are they helpful or harmful to the world economy as a whole?
- Short-term investors like to speculate (gamble) and commercial banks behave like casinos—they provide the platform for “gambling” on exchange rates and always make money!

The Adequacy of the Official Foreign Exchange Reserves

- The adequacy of the official foreign exchange reserves depends on the quantity of <u>net</u> foreign exchange reserves held by the central bank compared to the potential current foreign exchange liabilities.
- These liabilities include the value of six months of imports of goods and services, the value of the foreign-currency-denominated debt principal due within the next 12 months, and the value of interest payments on all foreign-currency-denominated debt due within the next 12 months. (To this should also be added the value of liquid portfolio investment held by foreign investors.)
- It is important to note that foreign-currency export proceeds are not included as a credit. In a time of potential crisis, exporters will delay or even postpone indefinitely the repatriation of their foreign-currency proceeds.

The Adequacy of the Official Foreign Exchange Reserves

- It is extremely important to distinguish between short-term and long-term debts. Short-term debts will become due and need to be repaid. In a time of potential crisis, short-term debts are unlikely to be rolled over and bond issues to refinance such debts will find little subscription.
- A short-term loan has little benefit. Borrowing short to finance long is always a mistake. Maturity mismatch is a major source of potential financial crisis.

The Adequacy of the Official Foreign Exchange Reserves

- It is also extremely important to distinguish between local–currency and foreign-currency denominated debts. Foreign-currency-denominated debts require foreign exchange proceeds for repayment. Local-currency debts can be repaid with local currencies, which can be supplied by the local central bank as necessary.
- When the revenue is in the domestic currency and the debt is in a foreign currency, there is a currency mismatch.
- Short-term foreign-currency denominated debts should be discouraged unless they are self-liquidating, that is, tied explicitly to exports which generate foreign-currency revenues.

The Adequacy of the Official Foreign Exchange Reserves

- A further consideration is whether the debt is held by domestic or foreign investors. If it is held mostly by domestic investors, then the repayment will just continue to circulate within the economy and will constitute just a redistribution among different investors.
- Most Japanese public debt and almost all Chinese public debt are in local currencies and held by domestic investors.
- A family analogy is helpful. If the public debt is entirely or almost entirely denominated in the local currency, and is almost entirely held by domestic households and institutions, it can be compared with intra-family debt. Consider a family with a father, a mother and a son. The son borrows from the father. The father demands repayment. The son asks the mother to help. The mother asks the father for money and gives it to the son. The son repays the father with the money. Thus the money is recycled. This can last a long time, especially if the domestic rate of interest is low.

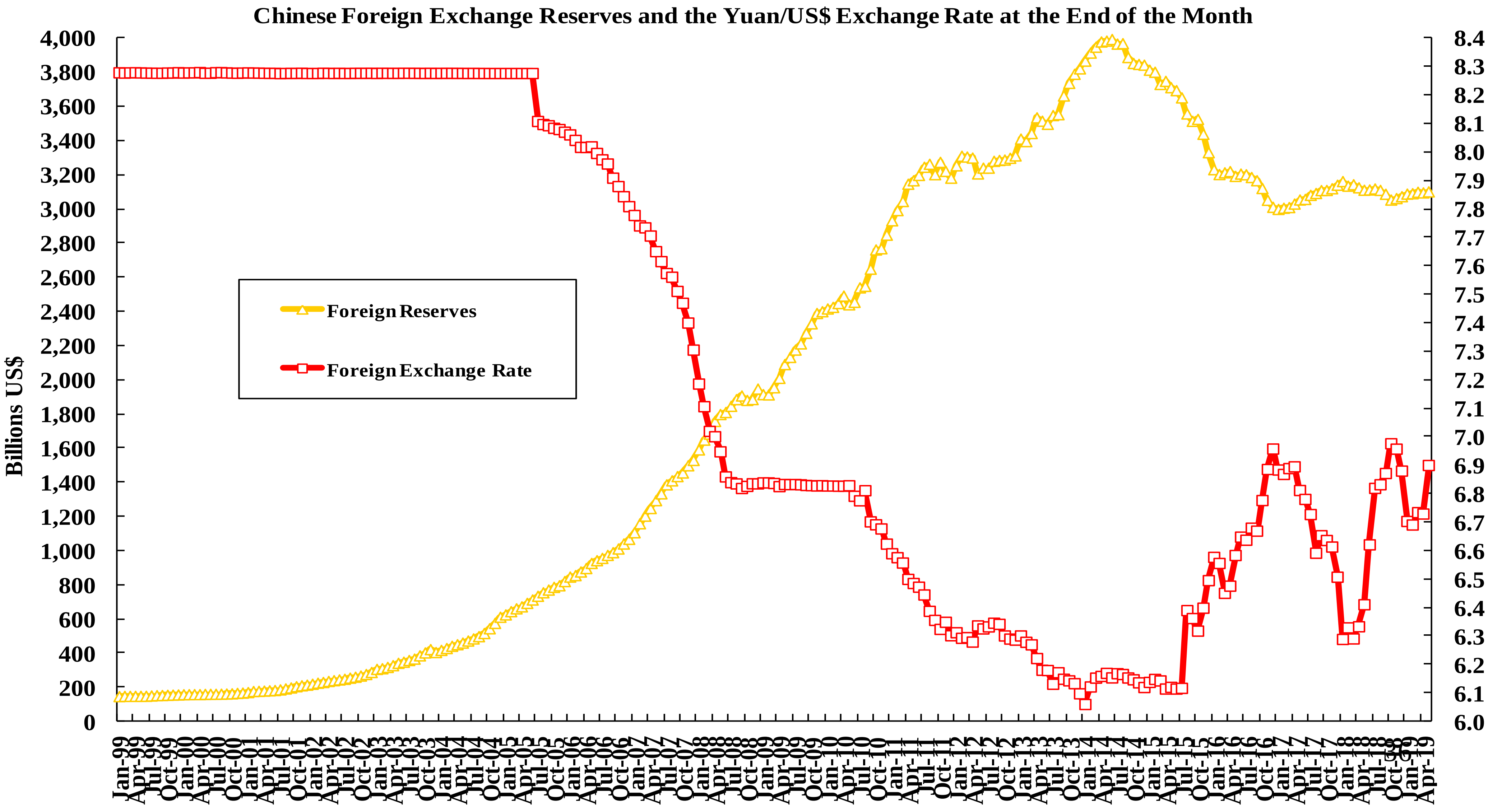
The Adequacy of the Official Foreign Exchange Reserves: Possible Solutions

- Short-term capital flows can be discouraged by
- (1) the imposition of a Tobin tax on cross-border capital flows (current-account flows will be exempted). This was proposed by the late Prof. James Tobin, Nobel Laureate in Economic Sciences.
- (2) the imposition of a minimum duration requirement, say, one year, as employed by Chile and other countries, before the capital can be used for other purposes. (The distributed ledger technology (the block-chain technology) can be used as an instrument to enforce a minimum duration requirement.)

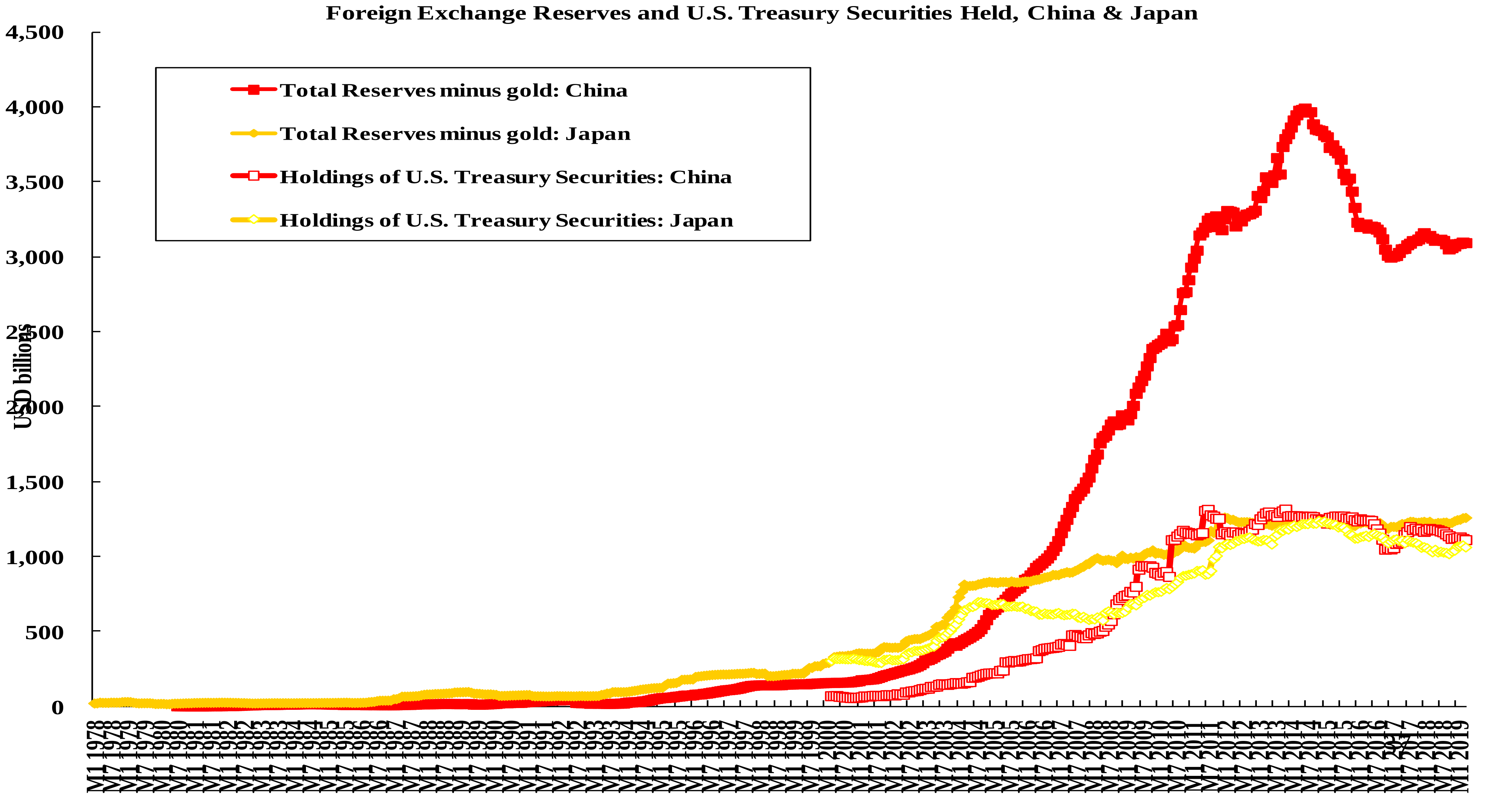
The James Tobin Proposal for a Financial Transaction Tax

- A proposal has been made by Prof. James Tobin, Nobel Laureate in Economic Sciences, for a financial transactions tax. It can be applied to cross-border and cross-currency capital account flows to reduce the short-term cross-border and cross-currency flows of hot money without discouraging the long-term direct and portfolio investment flows.
- The basic idea is to impose a tax, of say 1%, on all capital account flows across the border (or currency). For a long-term direct investor, with an investment time horizon of five years, the cost of the tax is only 0.4% per annum, which can be readily absorbed.
- For a currency speculator planning to make a round-trip in a month, the cost is 24% per annum, making the transaction not worthwhile.
- The truth is that exporters and importers of goods and services, and inbound and outbound direct and long-term portfolio investors also prefer a relatively stable exchange rate. Reducing short-term capital account flows can reduce the volatility of the exchange rate.

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



Foreign Exchange Reserves and U.S. Treasury and Agencies Securities Held, China & Japan



The Adequacy of the Official Foreign Exchange Reserves

	Foreign exchange reserves in 2017 (as of end of period) (in million US$)	Value of imports of goods and services in 2017 (in million US$)	Total short-term foreign debt (due within a year) in 2017 (in million US$)#	[(6 months of imports of goods and services + total foreign currency debt due within 12 months)/total foreign exchange reserves]
China	3,139,949	2,208,418	1,099,040	0.70
Japan	1,202,609	818,877	2,592,164	2.50
Republic of Korea	379,477	576,913	115,923	1.07
Hong Kong, China	431,296	638,819	1,047,200	3.17
Macau, China	20,170	16,121	0	0.40
Taiwan, China	451,500	299,616	169,247	0.71
Brunei	2,941	4,336	0	0.74
Cambodia	11,105	17,169	1,778	0.93
Indonesia	124,143	189,464	48,988	1.16
Lao PDR	1,162	5,925	591	3.06
Malaysia	98,938	237,465	87,684	2.09
Myanmar	4,910	22,128	916	2.44
Philippines	71,598	133,989	14,275	1.14
Singapore	277,813	488,516	1,064,335	4.71
Thailand	194,048	268,565	58,397	0.99
Vietnam	48,693	227,631	21,895	2.79

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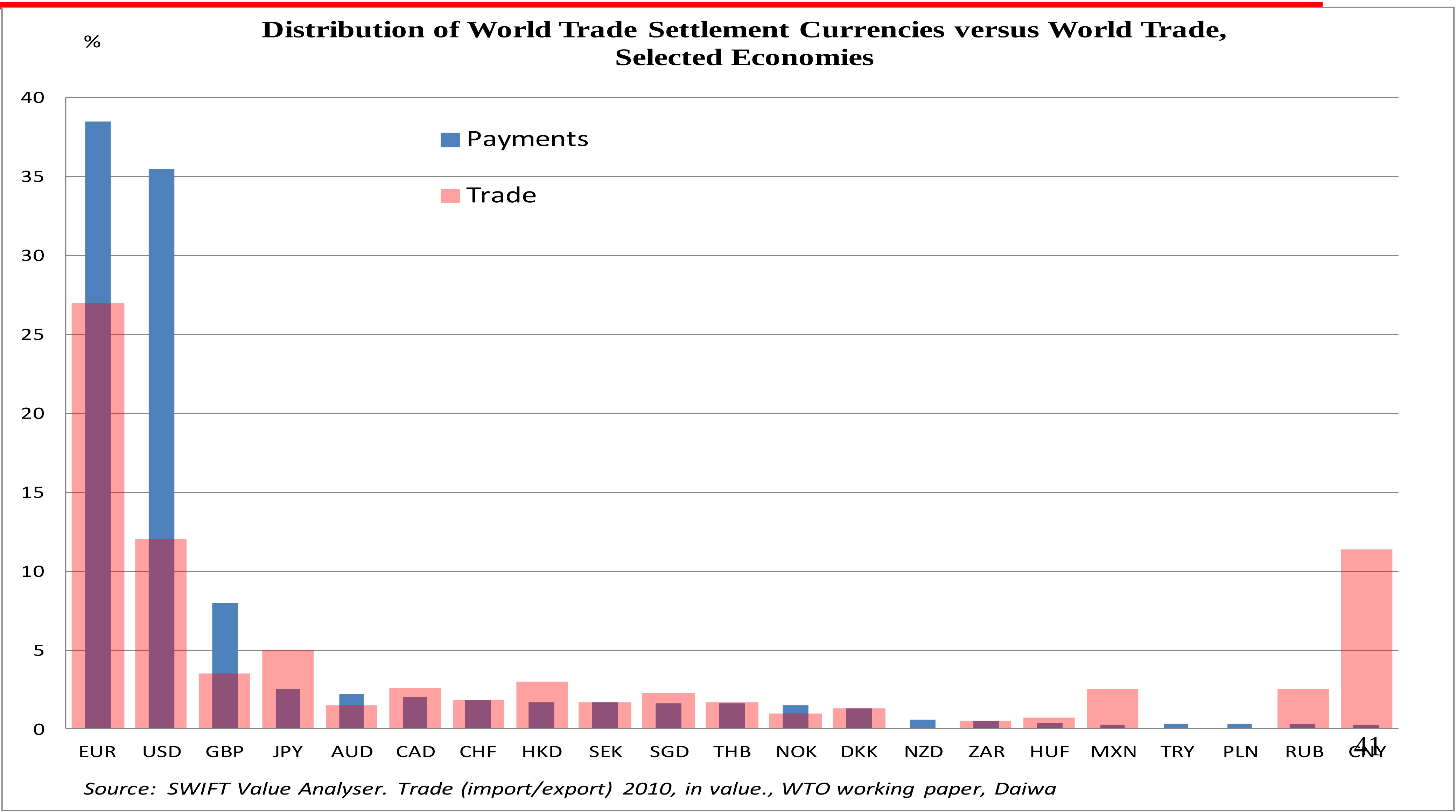
The Internationalisation of the Renminbi

- The use of the Renminbi for invoicing, clearing and settlement of Chinese international trade. This can grow if the People's Bank of China offers to sell forward Renminbi to bona fide foreign importers importing goods from China. This minimises the risks for the foreign importer and the transaction costs of the Chinese exporter.
- The use of the Renminbi for invoicing, clearing and settlement between third countries other than China

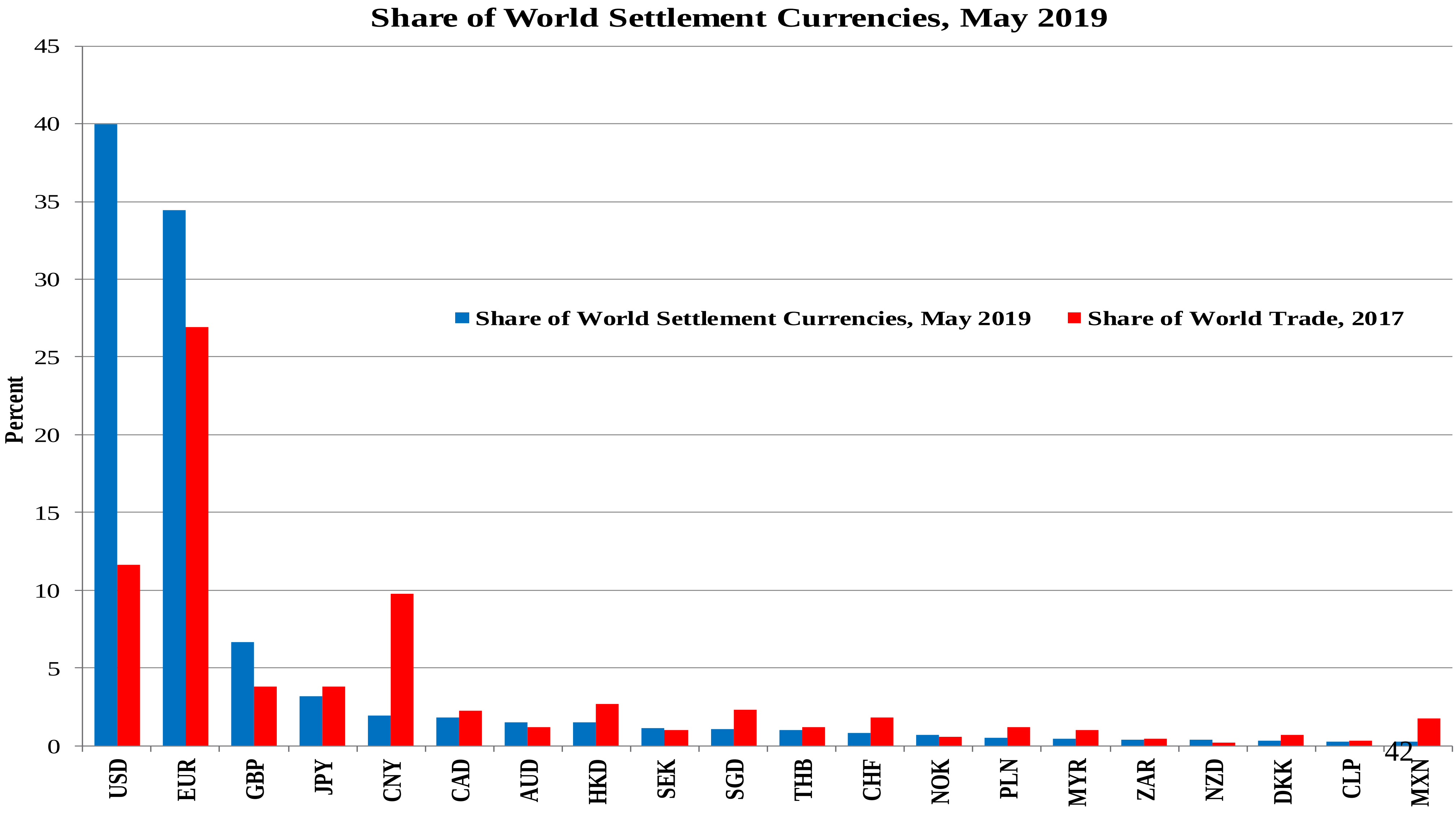
The Use of the Renminbi for Invoicing, Clearing and Settlement

- It is useful to examine the changes over time of the use of different currencies in world payments. In the next couple of charts, the shares of the top twenty currencies used in world settlement in 2010 and 2019 are presented in blue columns in the order of their relative sizes from left to right, starting from the highest (using data from SWIFT), and compared to the shares of the respective country or region in world trade presented in red columns.
- An economy's share of world trade is an important, but not the only, determinant of whether its currency is widely used as a medium of international exchange. Every economy prefers to use its own currency for the settlement of its international transactions because it minimises both risks and transactions costs.

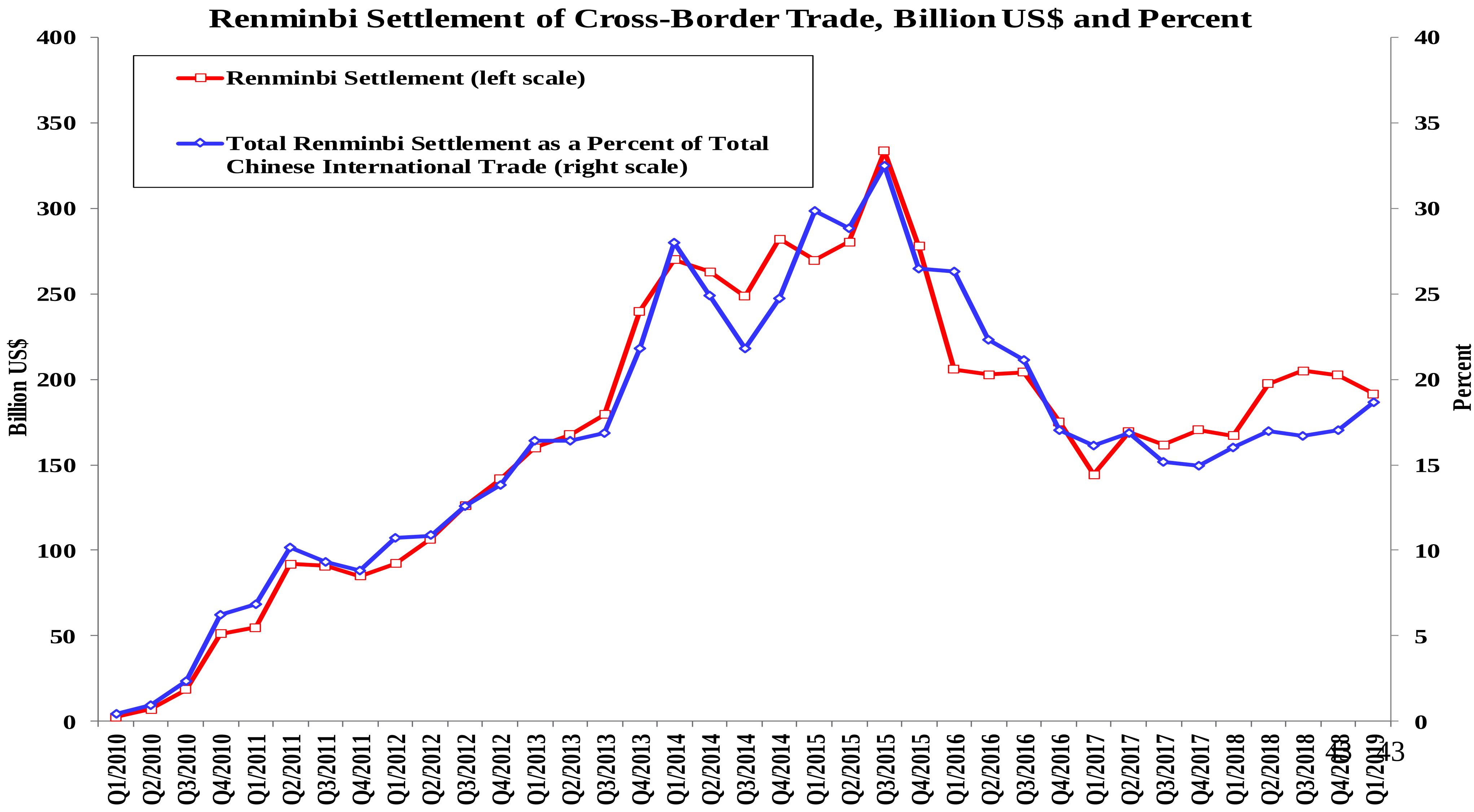
Distribution of World Trade Settlement Currencies versus World Trade, 2010



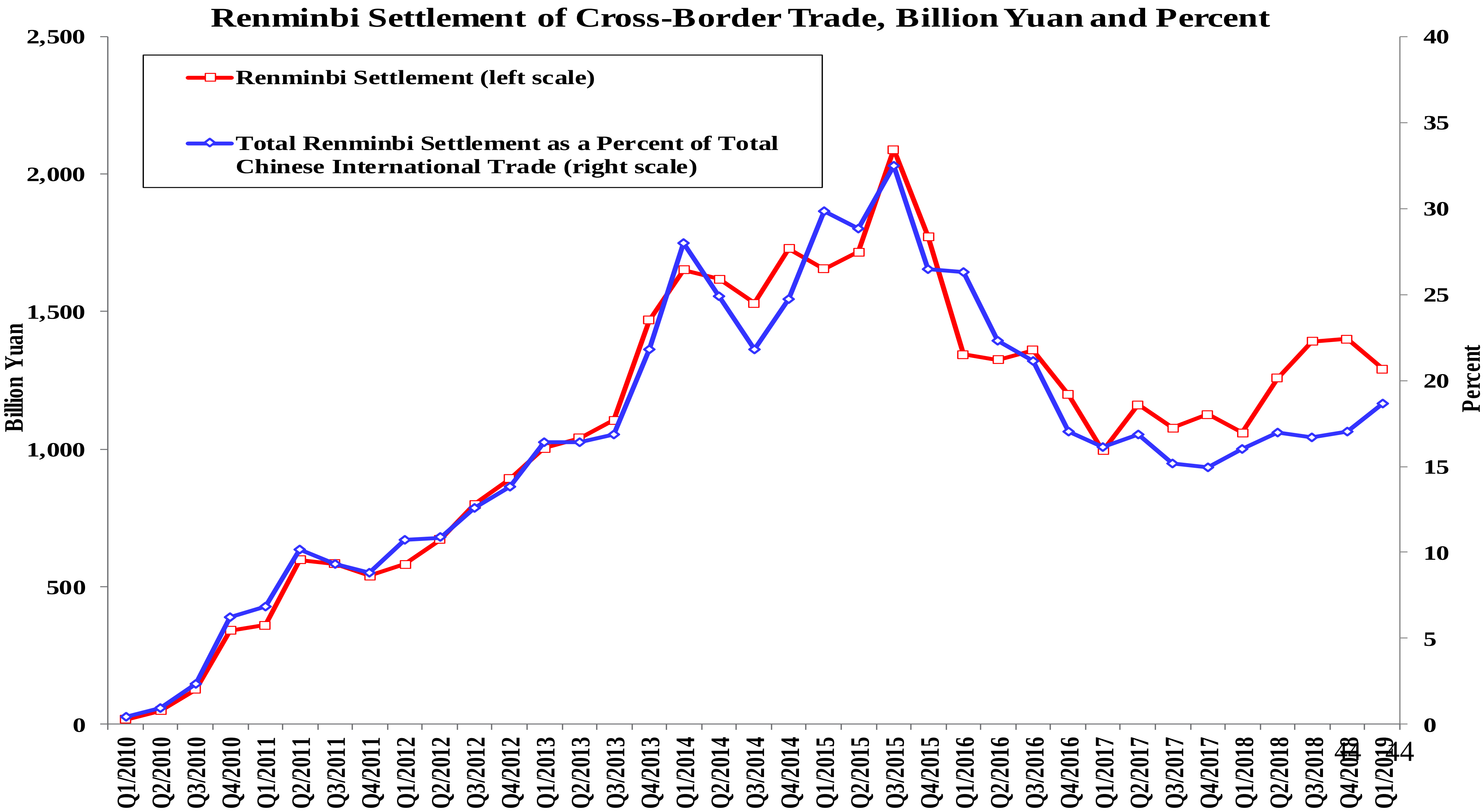
Distribution of World Trade Settlement Currencies versus World Trade, May 2019



Renminbi Settlement of Chinese Cross-Border Trade, Billion US$ and Percent



Renminbi Settlement of Chinese Cross-Border Trade, Billion RMB and Percent



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The Use of the Renminbi between Countries Other Than China

- In this case, the Renminbi acts an international medium of exchange for the two countries. It will have a similar role as the US$ in the settlement of international transactions among countries other than the U.S.
- However, the other countries can have Renminbi to hold in their official foreign exchange reserves only if they run balance of payments surpluses with China, which may be due to either a current account surplus or a capital account deficit (capital inflow from China) or both with China.
- China may have to be prepared to run large trade deficits in order that its currency can be used as in international medium of exchange among third countries.

Alternatives to the US$-Centric Clearing and Settlement System

- Seigneurage and the U.S. Dollar
- The Benefits of Own-Currency Invoicing, Clearing and Settlement
- The Bank for International Settlements (BIS) Model
- Region-Wide Exchange Rate Coordination
- The Robert Mundell Proposal for Bilateral Exchange Rate Stabilisation

Alternatives:
Seigneurage and the U.S. Dollar

- There are significant benefits for the issuing country of a currency being used as a medium of international exchange between other pairs of trading countries. They include:
- The ability of paying for real imports with pieces of paper (either money or bonds). This is call seigneurage and is similar to the seigneurage enjoyed domestically by the central bank or the monetary authority that has the legal power to supply money.
- This also enables the issuing country to run significant trade deficits and to enjoy low borrowing costs.
- Its currency is likely to become a “safe haven” currency, so that at the first sign of any trouble in the world, capital will flee to that currency. The issuing country will therefore benefit whenever there is trouble in the world.

Alternatives: Seigneurage and the U.S. Dollar

- Since the collapse of the Bretton Woods system in 1971, when the U.S. unilaterally severed the link between the dollar and gold, the U.S. Dollar has become the most favoured international medium of exchange as well as safe-haven currency. This is because most trading-partner countries do not trust each other's currency, and hence rely on a third currency, typically the U.S. Dollar, to denominate, settle and clear their international transactions.
- As a result, the U.S. Dollar has become the most commonly used currency for clearing and settling international transactions.

Alternatives: Seigneurage and the U.S. Dollar

- The U.S. Dollar now accounts for more than 40 percent of the world payments even though the U.S. itself accounts for only slightly more than 10 percent of world trade, followed by the Euro, which accounts for 30 percent of world payments, while the Euro Area accounts for 25 percent of world trade. The Renminbi accounts for only 2 percent of world payments even though China also accounts for more than 10 percent of world trade.
- The benefit to the U.S. as the provider of international "money" is that it can pay for its imports by simply printing U.S. Dollars or U.S. bonds and can therefore run a persistent trade deficit (US$550 billion in 2017; cumulatively US$12 trillion since 1980). The current account deficit was lower, at US$450 billion in 2017.)
- The current value of the seigneurage may be estimated at approximately US$360 billion a year based on the assumption of a 3% spread between short-term U.S. Treasury securities and the rate of return earned by U.S. assets abroad.
- Seigneurage is not the only benefit. It also enables the U.S. to exercise extraterritorial judicial authority.

Alternatives:
Seigneurage and the U.S. Dollar

- However, in order to enjoy the benefits of seigneurage, the country providing the international medium of exchange must run a significant and chronic trade deficit, putting downward pressure on the exchange rate. This is also sometimes identified as “Triffin’s Paradox”.
- Of course, the firms and households of the international money-issuing country can also use the currency to acquire real assets abroad.
- This is one of the reasons why Japan has not promoted its Yen as a major international currency. (There is the additional risk that countries holding Japanese Yen-denominated bonds may decide to dump these bonds whenever the Japanese Prime Minister visits the Yasukuni Shrine.)
- It may not be in the interests of China to have the Renminbi eventually play a similar role as the U.S. dollar today.

Alternatives: The Benefits of Own-Currency Invoicing, Clearing and Settlement

- There are many benefits in being able to use an economy's own currency for invoicing, clearing and settlement of its international transactions.
- (1) Reduction of currency risks—only one of the transacting party is at risk;
- (2) Reduction of transaction costs—only one currency exchange is necessary; and
- (3) Reduction in the need for central banks to maintain large foreign exchange reserves as the local currencies can be used to settle and clear international transactions.
- These advantages apply to all economies, and not just to China. The use of own-currency for the invoicing, clearing and the settlement of a country's international transactions should be welcome by all countries.

Alternatives: The Benefits of Own-Currency Invoicing, Clearing and Settlement

- In the longer run, it is desirable that all economies should be able to not only settle and clear their current transactions in their own local currencies but also issue debt in their own respective local currencies. Again, an international platform may be necessary, with partial guarantees or undertakings by the major economies under appropriate conditions, e.g., by offering for sale non-transferrable credit default swaps on these bonds to bond purchasers (and only bond purchasers).
- The advantage for an economy being able to borrow in its own currency is that it is no longer subject to the difficulties of a currency mis-match as it is able to service and repay its debt in its own currency.
- However, in order to protect the purchaser of these bonds, the bonds should be indexed to the local inflation rate, so that whatever happens to the exchange rate, the purchaser will always have a real rate of return.
- These bonds should also be available in the borrowing economy so that there is local supervision and pressure by the local citizens against an intentional default on the part of the government.

Alternatives: The Bank for International Settlements (BIS) Model

- The BIS model for Western European clearing and settlement in the 1950s.
- A Proposal for a Bank for Intra-Asian Settlements.

Alternatives: A Proposal for a Bank for East Asian Settlements

- East Asia has been the fastest-growing region during the past four decades.
- East Asia is defined as the 10 Association of Southeast Asian Nations (ASEAN)--Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam--+ 3 (China including Hong Kong, Macau and Taiwan, Japan and the Republic of Korea).
- Hong Kong, Republic of Korea, Singapore and Taiwan are also known collectively as the East Asian "Newly Industrialised Economies (NIEs)".

Alternatives: A Proposal for a Bank for East Asian Settlements

- Throughout the 2007-2009 global financial crisis, as well as the subsequent European sovereign debt crisis, the East Asian economies continued to do reasonably well. Mainland China, in particular, has been able to maintain its real rate of growth above 6.5% since 2007, lending credence to the "Partial De-Coupling Hypothesis", that is, the East Asian economies can continue to grow, albeit at lower rates, even as the U.S. and European economies go into economic recession.
- This partial de-coupling can occur because of the shift of the economic center of gravity of the world from the United States and Western Europe to Asia (including both East Asia and South Asia) over the past four decades.

Alternatives: Region-Wide Exchange Rate Coordination

- It is unlikely that there will be a common currency like the Euro for the East Asian region in the foreseeable future. However, some regional (real) exchange rate coordination may be possible.
- To the extent that exchange rate coordination is possible, it may facilitate the adjustment of exchange rates vis-a-vis a currency outside the region, such as the U.S. Dollar.
- Each economy by itself is reluctant to change its exchange rate either upwards or downwards vis-a-vis the U.S. Dollar. If it appreciates with respect to the U.S. Dollar, no other economies will follow, and it will lose market share in the export market. If it devalues with respect to the U.S. Dollar, everyone else will follow, and it will gain no advantage. Thus, exchange rates tend to be sticky.
- However, if every economy in the region coordinates to appreciate (or devalue) at the same time vis-a-vis the U.S. Dollar, no one is advantaged or disadvantaged by the move, and thus an adjustment is easier and more likely.
- Stable exchange rate parities can increase trade among trading partners (see the example of the Euro Area).

Alternatives: The Robert Mundell Proposal for Bilateral Exchange Rate Stabilisation

- A proposal has been made by Prof. Robert A. Mundell, Nobel Laureate in Economic Sciences, sometimes referred to as the Father of the Euro, for the efficient and incentive-compatible mutual exchange rate coordination between two trading partners.
- Basically the idea is for the two trading partners to agree on a range of fluctuation for their relative exchange rate, say 5% up or down from an initial central rate.
- Take for example, China and Indonesia. When the Indonesian Rupiah is too strong and threatens to exceed the upper limit of the band, the Bank Indonesia (the Central Bank of Indonesia) will buy Renminbi with Rupiah, driving up the Renminbi exchange rate relative to the Rupiah. When the Rupiah is too weak and threatens to breach the lower limit of the band, the People’s Bank of China will buy Rupiah with Renminbi, driving up the Rupiah exchange rate relative to the Yuan.

Alternatives: The Robert Mundell Proposal for Bilateral Exchange Rate Stabilisation

- The Mundell proposal was originally made for the stabilisation of the Euro-US$ exchange rate. It can of course be used for the stabilisation of the Yuan-US$ exchange rate or the Yuan-Euro exchange rate.
- The stabilisation of the Yuan-Euro exchange rate may turn out to be beneficial for both China and the Euro Zone in terms of increasing their mutual trade and direct investment and even portfolio investment.
- In the limit, a Euro-Yuan bloc may develop.

Concluding Remarks

- Despite the potential problems, the existing international monetary system has actually served the world economy reasonably well. Moreover, there is no immediate substitute in sight. Thus, there should not be a revolutionary change.
- However, there is a need to enable settlement and clearing in local currencies in the long run, which was the situation under the original Bretton Woods system. Settlement in local currencies is not only beneficial to developing economies but also has the potential of enhancing the stability of the entire international monetary system.
- The People's Bank of China, with its huge foreign exchange reserves and the rising use of the Renminbi internationally, can play an important role in bringing greater use of local currencies in international settlement of transactions.

Concluding Remarks

- The Renminbi should not follow the U.S. Dollar but should move with reference to a basket of currencies. Thus, it is likely to devalue with respect to the U.S. Dollar when the U.S. Dollar strengthens relative to the other currencies, but appreciate with respect to the U.S. Dollar when the U.S. Dollar weakens relative to the other currencies. The net effect is a more stable and less volatile Renminbi exchange rate compared to the U.S. Dollar exchange rate, which will encourage other economies to make great use of the Renminbi both as a medium of international exchange and a store of value.
- In the medium term, perhaps a prudently applied Tobin tax can reduce exchange rate volatility and excessive short-term capital flows and actually enable greater confidence in market-determined exchange rate mechanisms. China can lead the way for other developing and emerging economies by adopting a Tobin tax.

Concluding Remarks

- Within the next ten years, the Renminbi should be able to become the third most important currency for world payments.
- The Renminbi can also play an important role in the financing of infrastructural projects under the Belt and Road Initiative.