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Work-in-Progress Report

China's RMB Internationalization Strategy: Its Rationales, State of Play, Prospects and Implications

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1. Introduction

The international monetary system (IMS) is currently in flux because, as history has shown, reserve currencies come and go. The pound sterling ceded its position as the leading reserve currency to the US dollar in the mid-1920s,[1] and since then, the greenback has reigned over the international monetary system. When the euro was finally launched on January 1st, 1999, it was considered an epoch-making event within the IMS. As Nobel Laureate in economics, Robert Mundell, expressed it: "The introduction of the euro will challenge the status of the dollar and alter the power configuration of the system."[2] Although the Euro was to become the currency of more than 300 million people in Europe, it remained an invisible currency, used only for accounting purposes, during the first three years of its existence, until euro cash was introduced on January 1st, 2002, thereby replacing the banknotes and coins of the Eurozone's national currencies.[3] Central banks began to increase their euro holdings, which led some observers to wonder whether "the euro could challenge the dollar's status as the world's top reserve currency."[4] The euro's share in global foreign-exchange reserves started at 17.9 percent in 1999, hitting a peak of nearly 28 percent in the third quarter of 2009.

The rather smooth sailing of the euro, however, hit a snag when the Eurozone's debt crisis erupted in 2010, causing the currency to lose some appeal. Euroscepticism gained traction. "The crisis in Greece and the debt problems in Spain and Portugal have exposed the euro's inherent flaws," argued Harvard economist, Martin Feldstein. The currency was "bound to fail," Feldstein continued, because unlike "the United States able to operate with a single currency, despite major differences among its fifty states," Europe has none of the "three key economic conditions that allow the diverse US states to operate with a single currency: labor mobility, wage flexibility, and a central fiscal authority."[5] Although the euro remains the second largest reserve currency, the Eurozone crisis and the ongoing global economic crisis caused the euro's share of total reserves to continue to go down. Its share decreased from 27.6% in 2009, before the outbreak of the Eurozone crisis, to 19.9% (compared with 64.1% for the dollar) in 2015.

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[1] Barry Eichengreen and Marc Flandreau, "The Rise and Fall of the Dollar, or When did the Dollar Replace Sterling as the Leading Reserve Currency?" prepared for the conference in honor of Peter Temin, Cambridge, May 9, 2008, p. 21.

[2] Robert A. Mundell and Armand Clesse, *The Euro as a Stabilizer in the International Economic System* (New York: Springer, 2012), p. 57.

[3] European Central Bank, "Use of the euro," https://www.ecb.europa.eu/euro/intro/html/index.en.html

[4] Ira Iosebashvili and Min Zeng, "King Dollar Reaffirms Its Global Supremacy," *The Wall Street Journal*, March 31, 2015, http://www.wsj.com/articles/dollar-share-of-global-foreign-exchange-reserves-rises-1427815826

[5] Martin Feldstein, "The Euro's Fundamental Flaws: The single currency was bound to fail," SPRING 2010 *THE INTERNATIONAL ECONOMY*, pp. 11-12.

To complicate matters further for the euro, in a referendum held on June 23rd, 2016, the United Kingdom voted to leave the European Union. Although the UK is not a member of the Eurozone, the UK's 'Brexit' vote, according to one observer, "lays bare fears that a spreading political backlash against Europe's longstanding political order could pose a renewed threat to the survival of the shared currency."[6] It was predicted in *WSJ* that, "Brexit would deliver a profound geopolitical shock that would reignite doubts about the future of the single currency."[7] Former Federal Reserve Chair Alan Greenspan portrayed a gloomy picture of the UK's historic vote to exit the EU by saying that the "euro currency is the immediate problem", because "it's failing".[8]

Nevertheless, it is too early to tell precisely what impact the Brexit, if and when it happens, could have on the integration of the EU and, for that matter, on the euro. Since triggering Article 50 of the Treaty on the European Union, which sets out the procedure to be followed should a Member State decide to leave the European Union, formally "starts a two-year clock running," it would in any event "take a minimum of two years for the UK to leave the EU",[9] as *The Telegraph* notes. However, political and economic uncertainty would continue to hang over the EU as a whole, and the Eurozone, in particular, at least until such time as the fallout from the Brexit referendum has settled.

One can, therefore, argue that the euro will not be in a position to replace the dollar as the dominant international currency anytime soon unless the Eurozone countries can come up with effective ways to address the euro's inherent flaws, as mentioned above. There are also other players in the league of international currencies, such as the pound sterling and Japanese yen, which play third fiddle so to speak. In the case of Sterling in particular, the UK's recent Brexit decision "wouldn't just weaken the pound - it would jeopardize its status as a reserve currency used in world trade," according to the S&P Global Ratings.[10]

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[6] William Watts, "Will the euro survive Brexit aftermath?" *Market Watch*, June 24, 2016, http://www.marketwatch.com/story/how-brexit-triggers-new-worries-about-the-survival-of-the-euro-2016-06-24

[7] Simon Nixon, "Brexit May Be Bigger Risk for Eurozone Than U.K.," *Wall Street Journal*, April 6, 2016, http://www.wsj.com/articles/brexit-may-be-bigger-risk-for-eurozone-than-u-k-1459976571

[8] Christine Wang, "Alan Greenspan Calls Brexit 'the Tip of the Iceberg,' Says Euro is Failing," *CNBC*, June 24, 2016, HTTP://WWW.NBCNEWS.COM/STORYLINE/BREXIT-REFERENDUM/ALAN-GREENSPAN-CALLS-BREXIT-TIP-ICEBERG-SAYS-EURO-FAILING-N598426

[9] Matthew Holehouse, "What happens now the UK has voted Brexit - and what is Article 50?" *The Telegraph*, June 25, 2016, http://www.telegraph.co.uk/news/2016/06/24/britain-votes-to-leave-the-eu-what-happens-now-that-brexit-is-a/

[10] Anooja Debnath, "Pound May Lose Its Reserve Currency Status on Brexit, S&P Warns," *Bloomberg*, May 26, 2016, http://www.bloomberg.com/news/articles/2016-05-25/pound-may-lose-its-reserve-currency-status-on-brexit-s-p-warns

Thus, the conventional wisdom is that the current dollar-based international monetary system may continue to muddle through for the foreseeable future, at least until such a time as it becomes untenable. Nevertheless, the need is becoming more acute to expeditiously adjust to the tectonic changes that have occurred in the global economic and financial landscape since the collapse of the Bretton Woods arrangements in the early 1970s. "As America's economic supremacy fades, the primacy of the dollar looks unsustainable,"[11]declared *The Economist* in its edition of October 3rd, 2015. In fact, the 2008-9 global financial crisis dealt a major blow to the current IMS. The international system is, by its nature, a living organism, and the IMS is no exception. Its very survival and prosperity depend on how it can adjust to the changing circumstances in a timely and appropriate manner. It is against this backdrop that another currency, the Chinese RMB, is waiting in the wings to play in the major league of international currencies.

It was a relatively short time ago that the Chinese government started the RMB internationalization process. Following up on its commitment, as early as 1993, to "achieve full currency convertibility by the end of the century," China began "removing capital account restrictions gradually and established current account convertibility in November 1996" (Bottelier and Dadush, 2011). The 1997 Asian financial crisis, however, led China to "drop its full-convertibility target," which resulted in a lull in China's RMB internationalization drive.[12] China's accession to the WTO in 2001 provided a fresh catalyst for the Chinese economy to grow exponentially, which helped create a favorable environment for the RMB's internationalization to firmly take root.

In 2009, China emerged as a new trading superpower, having become the world's largest exporter and second largest importer. China's meteoric rise grabbed global attention in 2011, a year that marked the 10th Anniversary of China's accession to the WTO, when it became the world's second largest economy. (See Figure 1).[13] China's GDP (gross domestic product) increased four times, from less than 10 trillion yuan (US$ 1.6 tn.) in 2001 to 40.1 trillion yuan (US$ 6.3 tn.) in 2010. Its foreign exchange reserves soared to US$ 2.9 trillion in 2010, up 12 times from US$ 212.2 billion in 2001. The country's trade in goods also surged, from US$ 509.8 billion in 2001 to nearly US$ 3 trillion in 2010, with exports jumping nearly five times and imports up 4.7 times. As history suggests, one of the key requirements for a true

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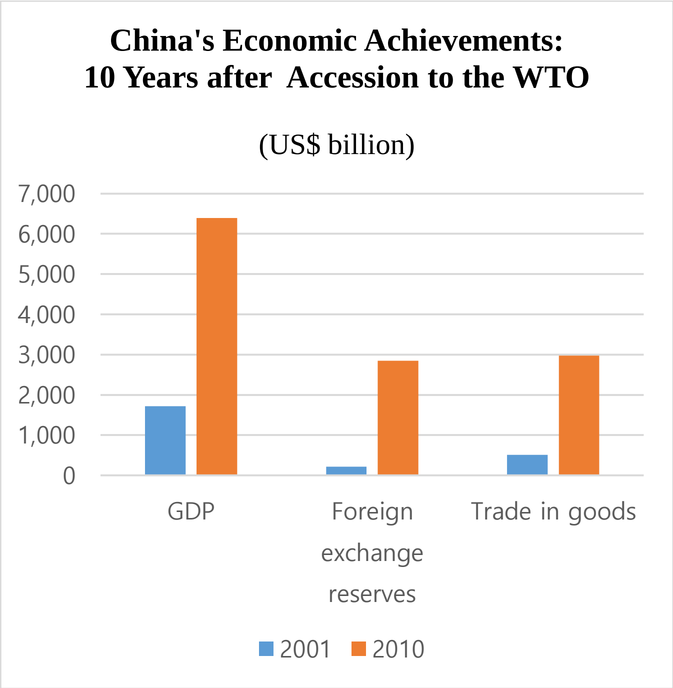
[11] "Dominant and dangerous: As America's economic supremacy fades, the primacy of the dollar looks unsustainable," *The Economist*, October 3, 2015, http://www.economist.com/news/leaders/21669875-americas-economic-supremacy-fades-primacy-dollar-looks-unsustainable-dominant-and

[12] Pieter Bottelier and Uri Dadush, "The Future of the Renminbi as an International Currency," Carnegie Endowment for International Peace, June 22, 2011, http://carnegieendowment.org/2011/06/02/future-of-renminbi-as-international-currency

[13] "China's economic achievements since WTO accession," *China.org.cn*, December 12, 2011, http://www.china.org.cn/business/2011-12/12/content_24129157.htm

reserve currency is the size of the home economy; this "must be large relative to others, which makes it important to its trading partners", according to HSBC.[14] Along the same lines, the export criterion, which acts as a 'gateway', "has been part of the SDR methodology since the 1970s"[15]that the IMF applies in determining currencies that qualify for the SDR basket. Therefore, China's increasing share of world trade and GDP, as shown by the above figures, has been creating a fertile ground for RMB internationalization.

Figure 1.



Source: *China.org.cn*

It was indeed the 2008-9 global financial crisis that presented new challenges and opportunities for the Chinese leadership with regard to the internationalization of the RMB.[16] That crisis helped trigger China's efforts to internationalize its currency on multiple fronts, efforts that paid off when the Executive Board of the IMF decided to include the RMB in the SDR basket on November 30th, 2015. It was, as Christine Lagarde, Managing Director of the IMF, put it, "an important milestone in the integration of the Chinese economy into the global financial system." [17] It also marks a watershed moment in the RMB

[14] "Renminbi as a reserve currency," *HSBC Central Banking*, http://www.centralbanking.com/central-banking-journal/advertisement/2357296/renminbi-as-a-reserve-currency

[15] "Factsheet: Review of the Special Drawing Right (SDR) Currency Basket," IMF, April 6, 2016, https://www.imf.org/external/np/exr/facts/sdrcb.htm

[16] Masahiro Okoshi, "China aims to expand non-dollar economic bloc through increased yuan transactions," *NIKKEI Asian Review*, January 20, 2015.

[17] "IMF's Executive Board Completes Review of SDR Basket, Includes Chinese Renminbi," *IMF*

internationalization process. On October 1st, 2016, the RMB will be included in the SDR basket as a fifth currency, along with the US dollar, the euro, the British pound and the Japanese yen.

As was the case with other policies, the Chinese government has pursued RMB internationalization in a pragmatic, careful and gradual manner as preached by China's late leader, Deng Xiaoping. As Deng famously said at the Third Plenum of the 11th CPC National Congress in 1978, "It doesn't matter if a cat is black or white, so long as it catches mice." He is also frequently quoted as saying, "Cross the river by feeling the stones." Deng was trying to emphasize the need to "stay grounded, incremental, feel (its) way forward even amidst uncertainty," whenever China is "moving forward in new directions."[18] Since the RMB's internalization is "tied up with many complex domestic and geopolitical considerations," the Chinese government is "working towards multiple objectives." (Eswar Prasad, 2016)[19] They do heed Deng's general guidance, and will continue to do so.

The RMB's steady rise as a major international currency through its ongoing internationalization may have significant implications, not only for the current IMS but also for the Chinese economy and other economies across the world, especially the Asian economy, at a time when the world economy and the international financial architecture are at a crossroads. Bearing this in mind, this paper aims to take an overall look at the RMB's internationalization process, in light of which it will reflect on the future prospects of that process, its impact on the IMS, and the implications for the dollar as the dominant reserve currency, as well as likely future challenges and responses.

The paper is structured as follows: Chapter 2 reviews the reasons behind RMB internationalization, while Chapter 3 highlights the Chinese government's intended measures for taking its RMB internationalization strategy forward. Chapter 4 takes stock of the progress that has been thus far made in the RMB internationalization process, and Chapter 5 considers the implications and ramifications of RMB internationalization for the dollar. Chapter 6 addresses such issues as the dawning of a multi-polar monetary system, whether the RMB will replace the dollar as the leading reserve currency, and the related challenges and opportunities for the US economy. Chapter 7 offers a conclusion.

Press Release No. 15/540, November 30, 2015, https://www.imf.org/external/np/sec/pr/2015/pr15540.htm

[18] Steve Clemons, "China's Steve Jobs Debate and Deng Xiaoping," *The Atlantic*, November 7, 2011, http://www.theatlantic.com/international/archive/2011/11/chinas-steve-jobs-debate-and-deng-xiaoping/248080/

[19] Eswar S. Prasad, "CHINA'S EFFORTS TO EXPAND THE INTERNATIONAL USE OF THE RENMINBI," Report prepared for the U.S.-China and Security Review Commission, February 4, 2016, p. 98.

2. Rationales for RMB Internationalization

China's efforts to internationalize the RMB are, as Paola Subacchi (2010) points out, "unprecedented", because it had to start the process with "no road map or past experience to rely on." China is indeed the first emerging country to seek to join the club of international currencies, unlike most other countries that had "fully developed before they started to internationalize their currency." According to Subacchi, "Past experience also shows that convertibility and the opening of a capital account have always preceded the international use of a currency," which does not seem to be the case with China.[20] Alex He (2015) observes that, "This is an unusual pattern, as it defies the logic of classic economics, which states that a currency's internationalization comes with the requirements of a liberalized capital account, a fully market-based exchange rate formation regime and an unregulated interest rate being met."[21] In addition, what makes the Chinese case intriguing is that China's RMB internationalization policy has been pursued to "respond in some way to the risks and the problems it faces"[22](Miriam Campanella, 2014).

Under these circumstances, according to Subacchi, the added challenge for the Chinese leadership was that with no road map to guide the process in hand, they had to navigate uncharted waters because they were pursuing "two apparently conflicting objectives that seem(ed) to be simultaneously at stake": China wished to increase the international use of the RMB while, at the same time, maintaining "a gradual approach to capital account convertibility through the slow liberalization of long-term flows and the protection of China's most vulnerable domestic sectors."[23]

Since the RMB internationalization process is such a high-stake policy experimentation, it would be worth taking a careful look at the reasons behind the Chinese government's decision to start the process in the first place. As stated earlier, the Chinese leadership was taking on the challenge with multiple objectives in mind.

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[20] Paola Subacchi, "'One Currency, Two Systems': China's Renminbi Strategy," CHATHAM HOUSE, *International Economics*, October 2010, IE BP 2010/01, p. 2.

[21] Alex He, "Domestic Sources and RMB Internationalization: A Unique Journey to a Major Global Currency," CIGI Papers No. 67, May 2015, p.3.

[22] Miriam Campanella, "The Internationalization of the Renminbi and the Rise of a Multipolar Currency System," ECIPE Working Paper No. 01/2014, p. 3

[23] Paola Subacchi (2010), op.cit., pp. 4-5.

2.1. Trade Facilitation

First and foremost, RMB internationalization would be one of the most effective tools with which to promote trade. As mentioned in our introduction, China's meteoric rise to trading superpower status is to a large extent attributable to China's accession to the WTO in 2001. Within a decade, China's trade in goods soared almost sixfold, from 509.7 billion dollars in 2001 to 2,974 billion dollars in 2010.[24] This trend further accelerated over time. In 2013, China became, for the first time, the world's biggest trader in goods, overtaking the US with a record trade volume of 4.16 trillion dollars (Exports: $2,209 billion, Imports: $1,950 billion).[25] It also made sense to promote the use of the RMB in view of the trade pattern, particularly in Asia, because "almost half of China's large trade share of GDP is processing trade," where "parts and components originating from other East Asian countries are assembled in China for export to the West"[26] (Huang and Lynch, 2013). Therefore, it makes economic sense to conduct such transactions invoiced and settled in RMB, instead of the dollar, as long as the trade involves movement of products within the region, and not between them and the US.

It is against such a backdrop that promoting cross-border trade settlements in RMB was considered a practical way of further boosting international trade, by helping Chinese exporters and importers to cut transaction costs and minimize foreign-exchange rate risks associated with the use of the dollar.[27] Transactions in RMB would also absolve them from the need to hedge the exchange-rate risk, particularly at a time when the exchange rate of the dollar tended to fluctuate considerably. Over the long term, the RMB internationalization policy was expected to enable Chinese firms to expand their market share by making them more competitive in an increasingly competitive marketplace.

Such benefits can also be enjoyed by foreign enterprises that have close trade ties with China. Likewise, they too can reduce transaction costs and exchange risks by using RMB rather than the dollar or other third currencies, which will result in further facilitating the use of RMB in trade settlements in the future.

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[24] "China's economic achievements since WTO accession," *China.org.cn*, December 12, 2011, http://www.china.org.cn/business/2011-12/12/content_24129157.htm

[25] Jamil Anderlini and Lucy Hornby, "China overtakes US as world's largest goods trader," *The Financial Times*, January 10, 2014, http://www.ft.com/intl/cms/s/0/7c2dbd70-79a6-11e3-b381-00144feabdc0.html#axzz46D9f9L7q

[26] Yukon Huang and Clare Lynch, "Does Internationalizing the RMB Make Sense for China?" *Cato Journal*, Vol. 33, No. 3 (Fall 2013), pp. 573-574.

[27] Qu Hongbin, Sun Junwei and Donna Kwok, "The rise of the redback: A guide to renminbi internationalization," *HSBC, China Economics*, November 9, 2010, p.17.

It is also important to understand that increased settlements in RMB will not only promote trade, but also help catalyze RMB internationalization by creating a forward momentum for the process. This is because as RMB-based trade between China and its trading partners grows, the RMB's role as a reference currency will also increase, which will lead to a further expansion of the so-called Yuan bloc. This currency bloc could potentially go beyond a regional boundary to the global level, which will help the RMB become a major international currency (see Chapter 5 for further elaboration on this point).

2.2. Taming the Inflation Monster

A second motive is related to the Chinese leadership's growing concern over domestic inflation. In *The Economic Consequences of the Peace* (1919), J.M. Keynes condemned inflation in the harshest possible terms by saying:

> "Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency…Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."[28]

With the rapid development of the Chinese economy, domestic inflation pressure was building up fast. The challenge was how to bring growing inflation under control before it got worse. [Broad money, which comprises currency, demand and time deposits, remains a principal indicator for inflationary pressure and guide for monetary policy.[29] For a period of seven years, from 2007 - just before the onset of the global financial crisis - to 2013, the

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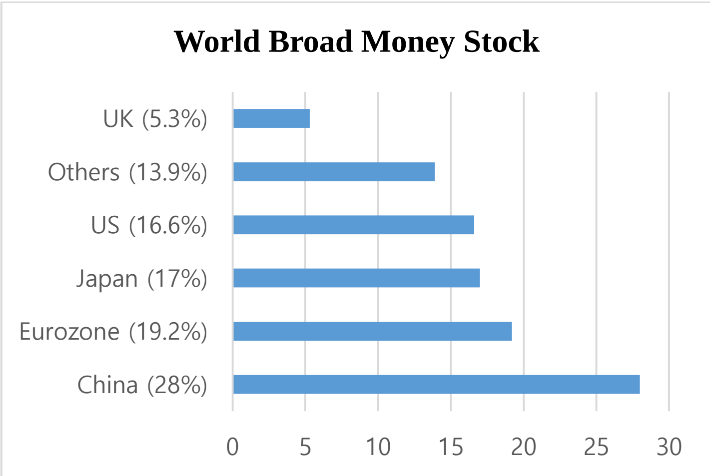
[28] *The Economic Consequences of the Peace* (1919), as reprinted in Keynes' Collected Writings, Vol. II. London: Macmillan, 1971, pp. 148-149; In this regard, Thomas Humphrey argues, "Once highly regarded for his brilliant path-breaking analysis of the causes of mass unemployment in the Great Depression of the 1930s, he is now given low marks for his views on inflation. Popular folklore has it that he was largely unconcerned with inflation from the start, that his subsequent preoccupation with unemployment led him to ignore it altogether, and that, as a result, he favored expansionary measures to eliminate unemployment regardless of their inflationary consequences. Since his death in 1946 his name (or at least the label "Keynesian") has been linked to such inflationist slogans as "full employment at any cost" and "money doesn't matter." …far from being an inflationist, Keynes deplored inflation, warned repeatedly of its evils, and recommended restrictive demand management policies to prevent it. Keynes was always concerned with inflation." (Thomas M. Humphrey, "KEYNES ON INFLATION," Federal Reserve Bank of Richmond, *Economic Review*, JANUARY/FEBRUARY 1981, p.3).

[29] Ousmène Jacques Mandeng, "The Chinese money wall," *Milken Institute London Summit*, October 28, 2014 (revised), http://www.ousmenemandeng.com/comments/14-10-28-chinese-money-wall.html

world broad-money stock increased by US$23.9 trillion, of which China represented US$12.9 trillion. This latter figure is bigger than the broad money created by the rest of the world combined, which amounted to US$11 trillion (Figure 2), thus accounting for more than half of the world's broad-money stock. In 2013, China represented 28 percent of world broad money supply, compared with 19 percent for the Eurozone, 17 percent for Japan, and 16.6% for the US, as shown in Figure 2 below.[30] China thus became the world's largest money-printing country.

Figure 2.



Source: Ousmène Jacques Mandeng

Accordingly, the world broad-money share of the four countries/regions – the US, Eurozone, Japan and the UK - whose currencies are included in the SDR basket, continued to drop from 82% in 2000 to 73% in 2007, and to 58% in 2013.[31] As of December 2015, China's M2 reached 139.23 trillion yuan, which amounted to 206% of the country's GDP (67.67 trillion yuan)[32] As Figure 3 shows, China's M2 has rapidly increased since 2004. In particular, it increased threefold over the seven-year period between 2008 and 2015. Inflationary pressure continued to mount with domestic money supply reaching dangerous levels. Various factors, such as fiscal stimulus measures, a domestic credit boom fueled by the state-owned banking system's huge lending with encouragement from the government, the central bank's issuance of lots of RMB, and the role played by an extensive and loosely regulated shadow banking system, all played a part in the dramatic rise in China' liquidity.[33]

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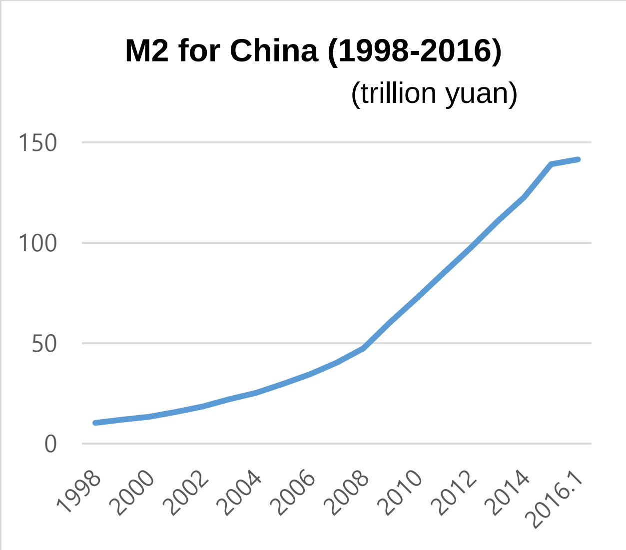
[30] Ibid.

[31] Ibid.

[32] "China's Economy Realized a Moderate but Stable and Sound Growth in 2015," National Bureau of Statistics of China, 19 January, 2016; http://www.stats.gov.cn/english/PressRelease/201601/t20160119_1306072.html

[33] Steve Johnson, "China's money supply growth dwarfs the rest of the world," *The Financial Times*,

Figure 3.



On top of that, China's growing trade and current-account surpluses have added impetus to the jump in broad money as the central bank's purchase of dollars from Chinese exporters results in the issuance of more Renminbi. The enormous inflow of foreign exchange of this type leads to an increase in money supply outside the control of the central bank.[34] In addition, the Chinese leadership became more concerned about China's ballooning stockpiles of foreign reserves (Figure 4) because these reserves, mostly parked in dollar-denominated assets, were "no longer harbored in safe havens after the 2008 global financial crisis"[35](Qiao Yu, 2013). Furthermore, the unsavory truth is that although the US is accused of exporting inflation to the rest of the world by printing dollars, China serves as "a perfect ally," by "making a choice to import inflation"[36] It is suggested that the People's Bank of China (PBoC) is actually "choosing to cede control over its domestic monetary policy to the Federal Reserve," by "pegging the yuan to the dollar."[37]

September 25, 2015, http://www.ft.com/intl/cms/s/3/c85cb7b0-62a1-11e5-9846-de406ccb37f2.html#axzz46bHqf357; Keith Bradsher, "With China Awash in Money, Leaders Start to Weigh Raising the Floodgates," *The New York Times*, January 15, 2014

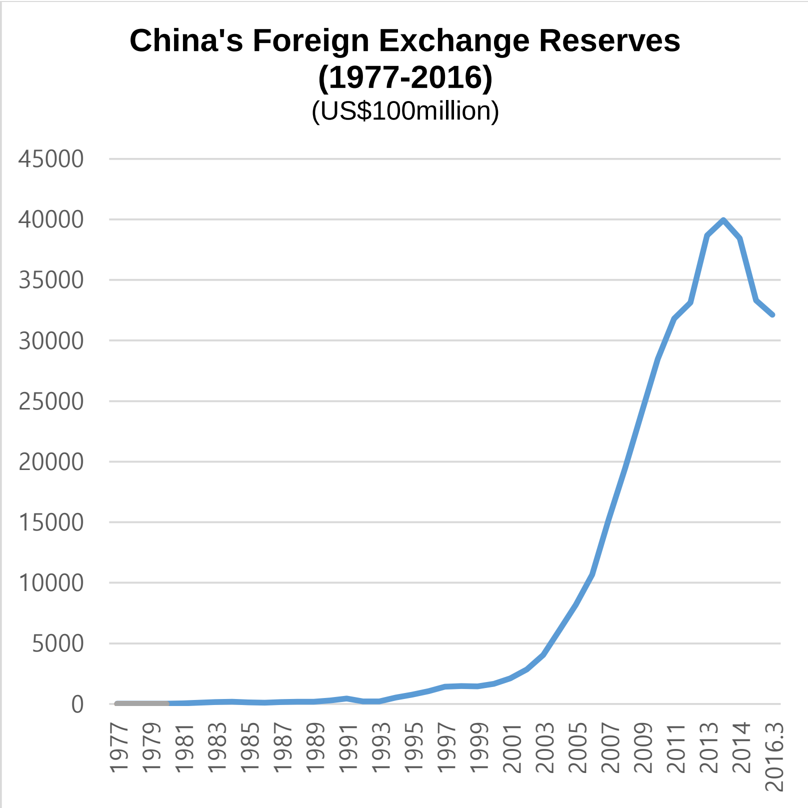
[34] Steve Johnson, "China's money supply growth dwarfs the rest of the world," *The Financial Times*, September 25, 2015; Gregory C. Chow, *China as a Leader of the World Economy* (World Scientific: 2012), p. 9.

[35] Qiao Yu, "Relocating China's Foreign Reserves," *Brookings Institute Paper*, November 21, 2013; http://www.brookings.edu/research/papers/2013/11/21-relocating-foreign-reserves

[36] Caroline Baum, "China Can Just Say 'No' to One American Export;" *Bloomberg*, January 21, 2011; http://www.bloomberg.com/news/articles/2011-01-21/china-can-just-say-no-to-one-u-s-export-commentary-by-caroline-baum

[37] Ibid.

Figure 4.



Source: PBoC

The challenge now facing the Chinese government is how to tame inflation and, especially, how to take care of the foreign reserve-induced inflationary pressure. Under these circumstances, the central bank can adopt sterilization or other contractionary monetary policies in order to control what is called “passive money supply”, generated by the increase in foreign reserves. The PBoC tried to control liquidity by using a variety of measures, which include “open market operations (involving the issuance of central bank bills and short-term repurchase operations), raising required reserve ratios, and non-market tools such as transferring deposits from the commercial banking system to the central bank and window guidance (moral suasion)”, as well as “foreign exchange swaps with big commercial banks as a tool for controlling liquidity”[38] (Chenying Zhang, 2010).

However, sterilization comes at a cost: first of all, if the PBoC continues sterilization to address growing foreign reserves, this means that it will need to keep issuing more debt, which may “drive up the interest rates on the PBoC bills.” Secondly, it will result in the RMB appreciating against the US dollar, which could not only contribute to a net capital loss in domestic currency terms, since the PBoC bills are denominated in RMB and the foreign

[38] Chenying Zhang, “Sterilization in China: Effectiveness and Cost,” The Wharton School, University of Pennsylvania, Finance Department, September 2010, pp. 11-14.

reserves in US dollars,[39] but can also affect China's exports.

In this regard, the US government blamed China for its foreign exchange policy. In February 2010, Janet Yellen, the then President of the Federal Reserve Bank of San Francisco (FRBSF), argued, "To offset the drag from declining exports, Chinese policymakers quickly put into place expansionary policies on a massive scale." She continued, "In China's case, increased exchange-rate flexibility could mitigate growing inflationary concerns, and also act toward easing global imbalances and encouraging the development of the household sector, a shift the Chinese government now officially says it wants."[40] Any fundamental change in the foreign exchange regime will, however, require a careful approach in terms of timing, speed, and implications because it will have a great impact on the economy as a whole.

Considering all this, it is suggested that RMB internalization can be a pragmatic and effective tool since it aims to create and increase a demand for Renminbi-denominated assets that are available for foreign investors. This will help "offset the domestic influx of Renminbi," thereby reducing "the chances of unwanted inflation."[41] It is also worth noting here that huge overseas demand for dollar-denominated assets has helped keep inflation as low as possible in the United States, even though "the Fed has been inflating the dollar massively."[42] RMB internalization could actually help China to avoid importing inflation.

2.3. Response to the Fed's Quantitative Easing (QE): *Getting out of the "dollar trap"*

Another reason can be found in China's response to the 2008-9 global financial crisis. In 2008, when the world was hit by the crisis, China recorded a trade surplus of US$ 298.1 billion. The corresponding figures for foreign direct investment (FDI) in China and for China's current surplus were US$ 92.4 billion and US$ 426.1 billion, respectively.[43] This helped China's foreign exchange reserves to increase to US$ 1,946 billion in 2008.[44] The

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[39] Ibid., p. 28.

[40] Janet L. Yellen, "Hong Kong and China and the Global Recession," *FRBSF Economic Letter*, 2010-04, February 8, 2010, http://www.frbsf.org/economic-research/publications/economic-letter/2010/february/hong-kong-china-global-recession/

[41] JC Collins, "How China is deleveraging from the USD (FREEPOM)," *Philosophy of Metrics*, January 13, 2016, http://philosophyofmetrics.com/how-china-is-deleveraging-from-the-usd-freepom/

[42] Patrick Barran, "Why It Matters If the Dollar Is the Reserve Currency," Mises Institute, March 7, 2015, https://mises.org/library/why-it-matters-if-dollar-reserve-currency

[43] "National Bureau of Statics of China," http://www.stats.gov.cn/english/Statisticaldata/AnnualData/

[44] "China's foreign exchange reserves, 1977-2016," April 7, 2016, http://www.chinability.com/Reserves.htm

fact that up to 75% of its foreign reserves were held in US dollar denominated assets[45] was a big concern for the Chinese leadership. Chinese officials were getting more frustrated in realizing that China's financial dependence on the US had become so great that the "*People's Republic*" was even dubbed "*the T-bills Republic.*"[46]

This concern only grew bigger as the 2008-9 global financial crisis and Great Recession played out. In March 2009, Wen Jiabao, the then Chinese premier, publicly expressed worries over China's significant holdings of US government and agency debts, because a considerable portion of China's national wealth would be subject to "the value of the dollar and changes in US economic policies," which was beyond their control.[47] As a result of the US's highly expansionary monetary policy - *Quantitative Easing* (QE) - and fiscal largess in the aftermath of the global financial crisis, China became more concerned about the eventual depreciation of the US dollar and the inflationary risk.

A growing consensus in Beijing was that one of the fundamental reasons for China's falling into the "dollar trap" was because its own currency – the renminbi – was not yet an international currency.[48] Chinese policymakers saw the benefit of "intensifying the use of the RMB in place of the US dollar" as an effective way of distributing "the specific currency risks on China's international balance sheet, especially its large and increasing foreign exchange exposure to the US dollar"[49] (Miriam Campanella, 2014). Due to a combination of China's rapidly accumulated export earnings in dollars and government controls on outward investment by domestic corporations and households, most of the dollar receipts would continue to end up being recycled out of the country through just one channel - the central bank's FX reserve accumulation. As a practical solution to this problem, the Chinese government decided to pursue the RMB's internationalization in earnest, while gradually loosening controls on capital outflows.[50]

In fact, the collapse of world trade in 2008 and 2009, which occurred at a pace not seen since the Great Depression, prompted some to wonder if the global financial crisis would lead to 'deglobalization' - a reversal of the globalization that had characterized the past three

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[45] Jijo Jacob, "China's Dollar Trap: Foreign Exchange Reserves Hit $3.8tn," *The International Business Times*, January 15, 2014, http://www.ibtimes.co.uk/chinas-dollar-trap-foreign-exchange-reserves-hit-3-8tn-1432428

[46] Paul Krugman, "China's Dollar Trap," *The New York Times*, April 2, 2009, http://www.nytimes.com/2009/04/03/opinion/03krugman.html?_r=0

[47] Andrew Batson, "China Takes Aim at Dollar," *The Wall Street Journal*, March 24, 2009

[48] Qu Hongbin, Sun Junwei and Donna Kwok (2010), op.cit., p.10.

[49] Miriam Campanella (2014), op.cit., p. 3

[50] Qu Hongbin, Sun Junwei and Donna Kwok (2010), op.cit., p.10.

decades.[51] One of the main reasons was that trade finance was severely affected by the financial crisis. According to International Chamber of Commerce (ICC) surveys:

> (i) it became more difficult to raise money to finance trade in the aftermath of the Lehman Brothers collapse,
>
> (ii) the supply of trade finance remained constrained both in value and in volume in 2008–09, and
>
> (iii) the weaker emerging economies were hit first (e.g. Bangladesh, Pakistan and Vietnam), although fast-growing developing economies also suffered from the contraction in trade finance.[52]

Given some estimates that about 80 to 90 percent of global trade relies on trade finance, and that most of this finance is short-term in nature, access to trade finance is an important determinant of a firm's ability to export.[53]

Although the global financial crisis dealt a blow to China's exports, it also provided a ***r****aison d'être* for facilitating the use of the RMB. China's exports, which had been on the rise, decreased by nearly 14% during 2009, from US$ 2,563 billion to US$ 2,208 billion. This was largely due to the drop in overall global demand, but reduced trade finance was also blamed. Starting with a currency-swap agreement with the Bank of Korea that was concluded on December 12th, 2008, the PBoC wasted no time in signing similar agreements with the central banks of China's major trading partners. In addition to providing emergency liquidity, these currency-swap lines would also serve as a conduit for giving the domestic importers of China's swap partners PBoC loans to pay for imports from China.[54] These actually helped enhance the profile of the RMB.

2.4. Catalyst for the Reform of the International Monetary System

On September 15, 2008, Lehman Brothers, the fourth-largest investment bank in the US, filed for bankruptcy, an event that heralded the abrupt end of the golden era of investment banking. The ensuing global financial crisis plunged the world economy into the Great Recession, the worst since the Great Depression of 1929. The epicenter of the global financial earthquake

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[51] "The Financial Crisis, Trade Finance and the Collapse of World Trade," Globalization and Monetary Policy Institute *2009 Annual Report*, Federal Reserve Bank of Dallas, p.4.

[52] "Trade Finance during the Great Trade Collapse," Editors Jean-Pierre Chauffour and Mariem Malouch, The World Bank, June 2011, p.9.

[53] Globalization and Monetary Policy Institute *2009 Annual Report*, op. cit., p.9 and p.13.

[54] Qu Hongbin, Sun Junwei and Donna Kwok (2010), op. cit., p.14.

was none other than Wall Street, which lended voice to the argument for urgent reform of the dollar-based IMS.

A fourth motive is based on the expectation that the RMB internationalization process will serve as a catalyst for reform of the IMS. In an essay posted on the People's Bank of China's website on March 23, 2009, Zhou Xiaochuan, the governor of the PBoC, proposed the replacement of the US dollar as the world's leading currency with a new international reserve currency. The goal, he said, would be to create a reserve currency "that is disconnected from individual nations". To replace the current system, he suggested "expanding the role of special drawing rights (SDRs)," a unit of account used by the International Monetary Fund.[55] In an article in the November/December 2009 issue of the Foreign Affairs Magazine, Fred Bergsten of IIE concurred by saying, "Dr. Zhou's suggestion or a similar change to the international monetary system would be in the United States' best interests, as well as the rest of the world's."[56] Joseph E. Stiglitz, Nobel laureate economist, chimed in, arguing:

> "The current system is not only bad for the world, it is bad for the United States, too. Like it or not, out of the ashes of this debacle a new and more stable global reserve system is likely to emerge, and for the world as a whole, as well as for the United States, this would be a good thing. It would lead to a more stable worldwide financial system and stronger global economic growth."[57]

Mr. Zhou's remark was seen as an indication of the Chinese government's intention to seek to ensure the RMB's early inclusion in the SDR basket as a top priority, which would help expand the role of the SDR and, eventually, create an environment conducive to the reform of the IMS. To this end, the Chinese leadership was determined to push ahead with the RMB internationalization process. In this regard, in an article in the Financial Times of November 8th, 2010 entitled, 'The G20 must look beyond Bretton Woods II', Robert Zoellick, President of the World Bank, surprised the world by proposing:

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[55] Jamil Anderlini in Beijing, "China calls for new reserve currency," *The Financial Times*, March 24, 2009, http://www.ft.com/intl/cms/s/0/7851925a-17a2-11de-8c9d-0000779fd2ac.html#axzz46IxYQExc;

Jonathan Wheatley, "Brazil and China in plan to axe dollar," *The Financial Times*, May 19, 2009, http://www.ft.com/intl/cms/s/0/2120e2b0-440c-11de-a9be-00144feabdc0.html#axzz46IxYQExc

[56] Fred Bergsten, "The Dollar and the Deficits: How Washington Can Prevent the Next Crisis," *FOREIGN AFFAIRS* (November/December 2009)

[57] Joseph E. Stiglitz, "Farewell to the Dollar as the World's Currency of Choice," *The Washington Post*, August 30, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/08/28/AR2009082802111.html

> Fifth, the G20 should complement this growth recovery programme with a plan to build a co-operative monetary system that reflects emerging economic conditions. This new system is likely to need to involve the dollar, the euro, the yen, the pound, and a renminbi that moves towards internationalization and then an open capital account. The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values. Although textbooks may view gold as the old money, markets are using gold as an alternative monetary asset today.[58]

Zoellick's proposal drew global attention. To begin with, the timing of the proposal was meaningful because it was put forward just before a potentially acrimonious G20 Summit scheduled in Seoul, Korea, on November 11th and 12th. On November 3rd, the Federal Reserve announced a second round of quantitative easing (QE2) that would "purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month."[59] In the run-up to the upcoming G-20 Seoul Summit, that policy "fed acrimony among leading economies in the Group of 20" and, particularly, upset China and Germany, both major exporting nations that "decried the Fed's quantitative easing - effectively printing money - which is weakening the dollar."[60] Against this background, e Zoellick, as chief of one of the Bretton Woods institutions, provided food for thought for leaders of the G-20 with his proposal to build a "co-operative monetary system that reflects emerging economic conditions" (see above).

Secondly, although he surprised the world with his proposal that leading economies should consider adopting a "modified global gold standard" to guide currency rates,[61] Zoellick may have been trying to highlight the need to "draw China into the international monetary system" rather than to "actually revert to an anchor role for gold, which most economists and central bankers see as unrealistic"[62] In short, one can say that it was indeed his recommendation that they should work together to build a cooperative monetary system reflecting new realities in the global economic landscape, and that the RMB should be part of this new cooperative monetary system, together with the four currencies currently comprising the SDR basket -

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[58] Robert Zoellick, "The G20 must look beyond Bretton Woods II," *The Financial Times,* November 7, 2010, http://www.ft.com/intl/cms/s/0/5bb39488-ea99-11df-b28d-00144feab49a.html#axzz46IxYQExc

[59] "Press Release," Board of Governors of the Federal Reserve System, November 3, 2010, http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm

[60] "World Bank chief surprises with gold proposal," *Reuters*, November 8, 2010,

[61] Ibid.

[62] Paul Taylor, "Analysis: Zoellick's currency plan highlights dollar angst," *Reuters*, November 8, 2010, http://www.reuters.com/article/us-g20-gold-zoellick-idUSTRE6A73DG20101108?mod=related&channelName=ousivMolt

dollar, euro, yen and pound.

The Chinese government has attempted to seize each and every opportunity to emphasize the need for reforming the IMS. Along these lines, it has made concerted efforts for the RMB to be included in the SDR basket as soon as possible, while accelerating the RMB international drive. Chinese President Xi Jinping took advantage of the G-20 Summit held in Antalya, Turkey on November 15th, 2015 to make the case for the inclusion of the RMB in the SDR basket by saying, "It will help to lift the representativeness and attraction of the SDR, improve the international monetary system, and safeguard global financial stability."[63] Two weeks later, on November 30th, these efforts finally paid off when the IMF decided to give the green light to the RMB.

It has also been argued that the rationale behind China's drive for reforming the current IMS has to do with its own interest. A realistic consideration that may come into play is that it is difficult for China to get out of the so-called 'dollar trap' unless the current dollar-based IMS is reformed. The reason is that the pace and degree of China's diversification away from the dollar is limited by the current IMT, where the dollar still dominates in transactions, asset holdings and official reserves.[64] "Before an alternative is developed to challenge the central role of the dollar as the dominant reserve currency," it would be hard to "envision China holding less than 50 percent of its official reserves in dollar assets - even in the medium term"[65]

2.5. Geostrategic Considerations

A country with a dominant reserve currency can enjoy enormous economic benefits, especially in terms of the ability to finance huge deficits in its own currency, as was notably pointed out in the 1960s by Charles de Gaulle, the then President of France, in his complaint about America's "exorbitant privilege." Such currency also provides political benefits. As Benjamin Cohen (2003) points out, one of the gains that is "'hard' geopolitical power derives from the monetary dependence of others." This advantage enables an issuing country to be "positioned to pursue foreign objectives without constraint or even to exercise a degree of coercion internationally."[66] As Robert Mundell (1993) once argued, "Great powers have

[63] "Xi Jinping Attends the 10th G20 Summit and Delivers Important Speech," *Xinhuanet*, November 16, 2016, http://www.g20.org/English/image/201511/t20151123_1404.html

[64] Zhang Ran, "Can China diversify its foreign holdings?" *China Daily*, July 13, 2009, http://www.chinadaily.com.cn/china/2009sed/2009-07/13/content_8468816.htm

[65] Ibid.

[66] Benjamin J. Cohen, "The Geopolitics of Currencies and the Future of the International System," Department of Political Science University of California at Santa Barbara, Paper prepared for a conference on The Geopolitics of Currencies and Oil, Real Institute Elcano, Madrid, 7 November

great currencies."[67] The Chinese leadership, on the one hand, knew full well the desirability of having their currency, the RMB, ascend to the status of an international currency befitting the rise of China as a global power.

On the other hand, in addition to their economic concern over the value of their hordes of dollar assets, China is also, according to Cohen, "well aware of the role played by the dollar in underwriting US geopolitical privileges," making "no secret of their resentment of what they call Washington's global 'hegemony'"[68] Thus, the RMB internationalization primarily aimed at making the Chinese currency a major reserve currency was also worth pursuing as a way of advancing China's geopolitical goal.

Once the RMB internationalization process started in earnest, a forward moment began to emerge. Thanks to its close economic ties with China, East Asia has been especially susceptible to this process. China had, as Gaulier et al (2005) observe, become a "production base for East Asian firms since the mid-1980s", when China began to be "involved in international production sharing with Asian economies."[69] As Kurien and Geoxavier (2013) state, "A rising RMB" has helped China to "enhance its political and economic status across East Asia," which, "in turn, has provided a strong impetus to further internationalize the currency."[70]

2003. p. 5.

[67] Robert A. Mundell, 1993, "EMU and the International Monetary System: A Transatlantic Perspective," *Austrian National Bank Working Paper 13* (Vienna).

[68] Benjamin J. Cohen, "The Future of Reserve Currencies, Finance & Development," September 2009, Volume 46, Number 3, http://www.imf.org/external/pubs/ft/fandd/2009/09/cohen.htm

[69] Guillaume GAULIER, Françoise LEMOINE, and Deniz Ü NAL-KESENCI, "China's Integration in East Asia: Production Sharing, FDI & High-Tech Trade," *CEPII, Working Paper No 2005-09*, June 2005, p.12.

[70] Jacob Kurien and Bernard Geoxavier, "Roadmap for the RMB Internationalization: Navigating the Rise of China's Currency," *2014 Issue/Articles*, May 2, 2013, http://harvardkennedyschoolreview.com/a-roadmap-for-rmb-internationalization-navigating-the-economic-and-political-challenges-to-the-rise-of-chinas-currency/

3. The RMB Internationalization Strategy and Key Implementation Efforts

It is difficult to identify the precise date when China first decided to pursue the goal of RMB internationalization. Nevertheless, it seems that the publication in 2006 of a report entitled 'The Timing, Path, and Strategies of RMB Internationalization' by a study group set up by the People's Bank of China (PBoC) can be considered a "key turning point" (Benjamin Cohen, 2012) in China's Long March toward this process, since the PBoC is arguably the main driver of the RMB internationalization strategy.[71] The report suggested that then was the time for promoting the internationalization of the RMB. As mentioned earlier, the 2008-9 global financial crisis prompted the Chinese leadership to start the Long March in earnest. In the meantime, in August 2011, a group of Chinese officials and researchers presented a roadmap in a book entitled '*RMB internationalization: Origin and Redevelopment*', which provided some clues on "just how Beijing will relax its hold on the yuan and turn it into a fully convertible currency."[72] In this chapter, we will review China's long march toward RMB internationalization.

When China's policymakers were trying to figure out how to move forward with RMB internationalization, they may have given some serious thought to the following factors that usually arise with regard to the internationalization of a country's currency:

- First of all, the classic three functions that money serves domestically "can be transferred to the level of international money."[73] These include "medium of exchange," "unit of account," and "store of value" (Jeffrey Frankel, 2012). As the following 3x2 taxonomy (three roles for two types of foreign actors)[74] shows, an international currency can be used: (1) as a medium of exchange, or 'vehicle', in private transactions, and as an 'intervention' currency by central banks; (2) to 'invoice' trade and to serve as a 'peg' in terms of the par values for exchange rates; and (3) to

[71] Benjamin J. Cohen, "THE YUAN'S LONG MARCH," May 2012, p.4.

[72] Koh Gui Qing and Kim Coghill, "Factbox: How will China internationalize the yuan?" *Reuters*, August 24, 2011, http://www.reuters.com/article/us-china-yuan-factbox-idUSTRE77N1XG20110824

[73] Jeffrey Frankel, "Internationalization of the RMB and Historical Precedents?" *Journal of Economic Integration*, 2012-Center for Economic Integration, Sejong Institution, Sejong University; p.330, www.hks.harvard.edu/fs/jfrankel/RMBintnztnJEI2012pg329~365.pdf

[74] Benjamin J. Cohen, *The Future of Sterling as an International Currency* (London: Macmillan, 1971) and Paul R. Krugman, "The International Role of the Dollar: Theory and Prospect," in *Exchange Rate Theory and Practice, ed.* John F. O. Bilson and Richard C. Marston (University of Chicago Press, 1984).

hold liquid assets denominated in that currency by private agents - the banking role - as well as by central banks as a 'reserve'.[75]

Table 1. The Six Roles of an International Currency

	Private	Official
Medium of Exchange	Vehicle	Intervention
Unit of account	Invoice	Peg
Store of value	Banking	Reserve

Source: 'The International Role of the Dollar' (p.263)

- The internationalization of a country's currency usually involves three stages: becoming a 'trading' currency, an 'investment' currency, and finally an international 'reserve' currency, as shown by the history of major currencies such as the pound sterling and the dollar.[76]
- The mere fact that an international currency is one that is used outside one's own country means that "the greater the use, the more it merits the description of a reserve currency"[77] (Arvind Subramanian, 2011). Since "trade appears to be a much more important determinant of reserve currency holdings," a wider use in transactions by the private sector of a particular currency is more likely to make it "attain reserve currency status."[78] As a practical matter in pursuit of the RMB internationalization policy in terms of sequencing, it is important to understand that "improving the scope and ration of the RMB settlement" should be a "fundamental step to internationalization," which will "also create an ideal environment for the RMB to act as an international investment and reserve currency"[79] (IMI & Renmin Univ., 2014)

Bearing all this in mind, the Chinese government has pushed ahead with its RMB internationalization strategy. This strategy can be summarized as a three-pillar one. The main objective of the first pillar is to promote the use of the RMB in trade settlements as well as RMB-denominated financial transactions. The second pillar centers around China's

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[75] Paul R. Krugman, "The International Role of the Dollar: Theory and Prospect," in *Exchange Rate Theory and Practice, ed.* John F. O. Bilson and Richard C. Marston (University of Chicago Press, 1984), p. 263, http://www.nber.org/chapters/c6838

[76] International Monetary Institute and Renmin University of China, *The Internationalization of the Renminbi* (Routledge, 2014), p.16.

[77] Arvind Subramanian, "Eclipse: Living in the Shadow of China's Economic Dominance," PIIE, September 2011, p. 53.

[78] Ibid., p. 61.

[79] International Monetary Institute and Renmin University of China, op. cit., p.16.

outreach efforts aimed at building a global web of RMB financial infrastructure and networks, which will give further impetus to the international use of the RMB, thereby continuously creating a favorable environment for RMB internationalization. The third pillar is related to China's intention to push the reform of the current dollar-based IMS, while eventually advancing its objectives in Pillars I and II. The topics addressed in each pillar are as follows:

RMB Internationalization Strategy

Pillar I: Promoting the Use of the RMB

A. Facilitation of RMB Trade Settlements

B. Financial Reforms and Capital Market Opening: "Crossing the River by Feeling the Stones"

- *Launching RMB Banking Services*
- *Liberalizing Bank Deposit and Lending Rates*
- *Cultivating Bond Markets*
- *Facilitating RMB Inflows and Outflows*
- *Opening the Foreign Exchange Market*

Pillar II: Building Global RMB Financial Infrastructure and Networks

A. Establishing Infrastructure and Mechanisms for Facilitating Wider RMB Use

- *Building a Global Network of RMB Trading and Clearing Centers*
- *Starting Direct RMB Trading*
- *Expanding a Network of Bilateral Swap Agreements (BSAs)*
- *Launching the China International Payment System (CIPS)*

B. Expanding FTA Networks

C. Launching the One-Belt-One-Road (OBOR) Initiative

Pillar III: Accelerating Momentum for the New IMS

A. Expanding a Regional Financial Structure

• *The Chiang Mai Initiative (CMI)*

• *Chiang Mai Initiative Multilateralization (CMIM)*

B. Launching Development Banks

• *Asian Infrastructure Investment Bank (AIIB)*

• *BRICS New Development Bank*

• *Inter-SCO Development Bank*

C. Inclusion of the RMB in the SDR Basket

3.1. Pillar I: Promoting the Use of the RMB

A. Facilitation of RMB Trade Settlements

As noted earlier, making concerted efforts to ensure a wider use of the RMB in international trade transactions is the first important step in driving forward the goal of RMB internationalization. Increased trade settlements in RMB have set in motion a virtuous cycle: they will help "expand the currency's circulation and acceptance in overseas markets," which will, in turn, support "its wider use in outward investment." Foreign enterprises will "ultimately need to invest the renminbi they accrue in trade settlement," which will help facilitate the "development of more sophisticated capital markets either in offshore renminbi centers or the mainland"[80] (Qu Hongbin et al, 2010).

As early as March 2003, the PBoC and the Russian central bank signed the Banking Settlement Agreement on Border Trade.[81] The PBoC continued to sign similar agreements with its counterparts in China's neighboring countries, including Mongolia, North Korea, Vietnam, Myanmar, Laos, Pakistan and Nepal. Although their scope was somewhat limited to trade in the border areas between China and its neighbors, it was meaningful in that these arrangements opened the door for the RMB to be used in trade settlements. The Chinese government quickly moved forward. On December 14th, 2008, the Standing Committee of the State Council made an important decision. Under the Cross-border Trade RMB Settlement Pilot Project, the Chinese authorities allowed selected companies, known as mainland designated enterprises, or MDEs, in five cities across China (Shanghai, Guangzhou,

[80] Qu Hongbin, Sun Junwei and Donna Kwok (2010), op. cit., p.15.

[81] Ji Shaoting and Cheng Yunjie, "Global downturn chills RMB, ruble settlement in Sino-Russian trade," *xinhuanet.com,* June 19, 2009, http://news.xinhuanet.com/english/2009-06/19/content_11570296.htm

Zuhai, Shenzhen and Dongguan) to invoice and settle in RMB their trade transactions with Hong Kong, Macau, and the Association of Southeast Asian Nations (ASEAN).

The pilot program to expand the renminbi's role in trade settlement marked a crucial milestone in the process of RMB internationalization.[82] This was significant particularly in view of the selection of the domestic and foreign targets for its application:

- First of all, the Chinese government carefully chose Chinese cities and regions in light of their active involvement in foreign trade.[83] Their selection for the pilot scheme was meaningful in that, as pointed out earlier, promoting RMB trade settlements was also an effective way of "slowing China's dollar accumulation," at a time when China's foreign reserves were growing "at a pace of US$ 334 billion per year since 2005, with the trade surplus and net capital inflows contributing 63% and 25% to the increase, respectively."[84] Especially, since the regions covered by the pilot programme "account for over 40% of China's total exports," "the impact on trade income in dollars is likely to be substantial in coming years, though renminbi settlement in imports may offset some of this impact."[85]

- Secondly, the selection of ASEAN was timely and appropriate. Economic relations between China and the 10-member ASEAN were poised to grow rapidly because the China-ASEAN Free Trade Agreement, which was "by far the single most important FTA that China (had) yet reached, and…the only multilateral one",[86] was about to come into force in 2010. China has been ASEAN's largest trading partner since 2009, while ASEAN has been the third largest market for China since 2011. This choice quickly paid off in two important ways. It contributed to rapidly increasing the trade volume between China and ASEAN, which has soared from US$39.5 billion in 2000 to around US$450 billion in 2015, with the figure being expected to reach

[82] Qu Hongbin, Sun Junwei and Donna Kwok (2010), op. cit., p.15.

[83] "RMB Cross-border Settlement," *treasurytoday.com*, April 2010, http://treasurytoday.com/2010/china/issue3/rmb-cross-border-trade-settlement;

Huang Xiaopeng, "New move takes yuan closer to global status," *China Daily*, April 20, 2009, http://www.chinadaily.com.cn/bizchina/2009-04/20/content_7694047.htm

[84] Qu Hongbin, Sun Junwei and Donna Kwok (2010), op. cit., p.18.

[85] Ibid.

[86] "China's Growing Ties with ASEAN Opens up New Opportunities for Foreign Investment," *China Briefing*, August 7, 2015, http://www.china-briefing.com/news/2015/08/07/chinas-growing-ties-with-asean-opens-up-new-opportunities-for-foreign-investment.html

US$1 trillion by 2020.[87] Such a close economic relationship has also helped the yuan to "quietly emerge as the dominant currency in the region. The currencies of Indonesia, the Philippines, Singapore, Thailand, and Malaysia are seen "tracking the yuan more closely than the dollar since at least 2010 or earlier,"[88] since "a currency could co-move with the RMB because it is integrated with China in terms of common supply chains."[89](Subramanian and Kessler, 2013).

On July 1st, 2010, the trial scheme was expanded to cover 20 pilot areas (four municipalities, including Beijing, Tianjin, Chongqing, Shanghai, 12 provinces and 4 autonomous regions). About a year later, on August 23rd, 2011, it was extended to the entire nation.[90] On top of that, China made another big step forward on March 20th, 2012. Beijing allowed all China-based importers and exporters to settle trade in RMB by lifting previous restrictions that required domestic goods exporters to acquire PBoC designation before conducting RMB-based settlements.[91]

The first pillar in the RMB internationalization thus began to take firm roots. As a result, trade settlements in RMB rapidly increased, from 506.3 billion yuan in 2010, to 7.23 trillion yuan in 2015 (Figure 5).

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[87] "China actively backs ASEAN in 25 years of relations, says Cambodian scholar," *Global Times (Source: Xinhua)*, May 18, 2016, http://www.globaltimes.cn/content/983772.shtml

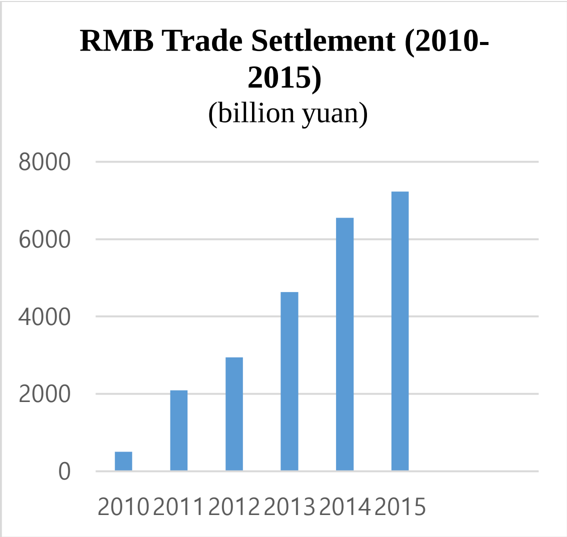
[88] Cornela Zou, "Yuan gaining currency in ASEAN bloc," *China Daily*, July 11, 2014, http://www.chinadailyasia.com/asiaweekly/2014-07/11/content_15148397.html; Arvind Subramanian and Martin Kessler, "The Renminbi Bloc Is Here: Asia Down, Rest of the World to Go?" Peterson Institute for International Economics, WP 12-19, August 2013, p.9 and p.30 (Table 10)

[89] Arvind Subramanian and Martin Kessler, "The Renminbi Bloc Is Here: Asia Down, Rest of the World to Go?" PIIE, WP 12-19, August 2013, p.13.

[90] "China extends cross-border trade settlement in yuan to entire nation," August 24, 2011, http://en.ec.com.cn/article/newsroom/newsroomtrade/201108/1159037_1.html?COLLCC=233250956&

[91] Vivian Ni, "China Allows Companies to Settle Trade in RMB," *China Briefing*, March 20, 2012, http://www.china-briefing.com/news/2012/03/20/china-allows-companies-to-settle-trade-in-rmb.html

Figure 5.



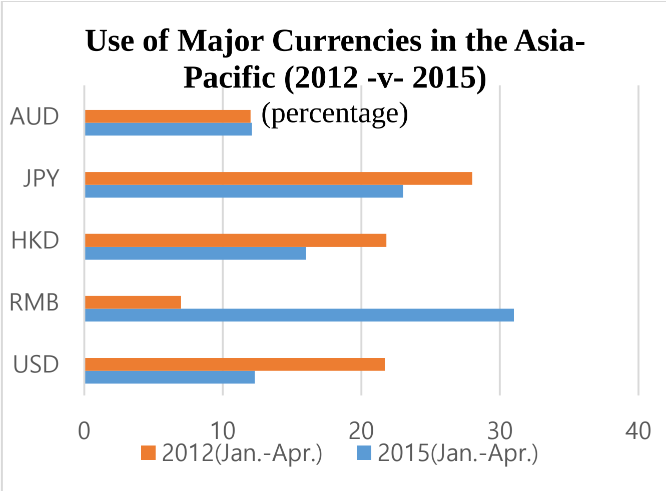
Source: PBoC

The Chinese government has also taken various complementary steps that could create a synergy effect with its RMB-based trade promotion policy (in Chapter 3, we will elaborate on those points). Firstly, China wasted no time in concluding bilateral currency-swap arrangements with Korea and other major trading partners. Secondly, it made concerted efforts to expand its FTA network. Finally, on October 8th, 2015, China introduced the Cross-border Interbank Payment System (CIPS).

In the first half of 2015, the RMB became the main currency for payments between China and the rest of the Asia-Pacific region, according to SWIFT, with the Chinese currency being used in January-April of 2015 for 31 percent of payments between China (including Hong Kong) and the rest of the Asia-Pacific region, up from seven percent back in April 2012. (The corresponding figures in January-April 2015 for the US dollar, the Hong Kong dollar, the Japanese Yen, and the Australian dollar were 12.3%, 16%, 23%, and 12.1%, respectively.) According to James Kynge, writing in the *Financial Times* in 2015, "The shift demonstrates that the Asia-Pacific region is at the forefront of the renminbi's gathering acceptance as a currency for international trade settlement and investment."[92] (Figure 6)

[92] James Kynge, "Renminbi tops currency usage table for China's trade with Asia," *The Financial Times*, May 27, 2015, http://www.ft.com/intl/cms/s/3/1e44915c-048d-11e5-adaf-00144feabdc0.html#axzz49yXBjg3M

Figure 6.



Source: SWIFT

Cross-border trade settlements denominated in the yuan amounted 29.4% of China's total trade in 2015. They are expected to climb to over 50 percent of China's total trade by 2020.[93]

B. Financial Reforms and Capital Market Opening: *"Crossing the River by Feeling the Stones"*

You can't have your cake and eat it too," goes the old adage. In the international economic realm, there is a similar reference: the 'impossible trinity'. According to this theory, it is impossible to have all three of the following at the same time: a fixed foreign exchange rate, free capital movement, and an independent monetary policy. Being well aware that "moving beyond this 'impossible trinity' is difficult to manage, as witnessed in some of the Southeast Asian economies during the Asian financial crisis of 1997," the Chinese leadership will undertake reforms at a slow, steady pace, as they move to full capital count convertibility and facilitate "both outbound and inbound financial investments through loosening regulations"[94] (Phyllis Papadavid, 2016).

From the perspective of Chinese policymakers, Hong Kong was considered the perfect testing ground for these policy reforms. In addition to "its sophisticated financial markets,

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[93]Wang Jun, "Spotlight on the Yuan: A Yuan cross-order interbank payment system is expected to accelerate the currency's quest to go international," No. 43, *bjreview.com*, October 22, 2015, http://www.bjreview.com/Business/201510/t20151019_800040545.html

[94] Phyllis Papadavid, "China's balancing act: Why the internationalisation of the renminbi matters for the global economy," *Overseas Development Institute Report*, January 2016, pp. 5-6.

along with strong supervisory and other institutions," Hong Kong's "status as an international financial center" could also help facilitate the dramatic transformation of the RMB into an international currency, at least in Asia.[95](Eswar Prasad, 2016) Under the 'One Country, Two Systems' principle, Hong Kong was also a natural offshore testing platform for China.[96] Bearing in mind the need to 'cross the river by feeling the stones,' the Chinese authorities began to take a series of measures on multiple fronts, which are explained below.

Launching RMB Banking Services

Banking services are vital to economic activity. As such, launching RMB banking services is one of the key steps to be taken in RMB internationalization. Some of the important developments are as follows:

- First of all, on November 18th, 2003, the PBoC announced its agreement with the Hong Kong Monetary Authority to provide clearing arrangements for banks in Hong Kong that engaged in four types of personal renminbi business: deposit-taking, exchange, remittance, and bank cards.[97] It was like shooting a flare into the sky in light of establishing a legitimate channel that would allow renminbi cash circulating in Hong Kong to flow back to the Mainland. 'Personal' renminbi business was scheduled to commence in 2004. The Bank of China (Hong Kong) Limited was chosen and appointed as the Clearing Bank for renminbi business in Hong Kong. On 25th February, 2004, banks in Hong Kong launched RMB deposit-taking, currency exchange, and remittance services to customers.[98]

[95] Eswar Prasad (2016), op. cit., p.55; "Full text: Chinese State Council white paper on 'One Country, Two Systems' policy in Hong Kong," *The South China Morning Post*, June 10, 2014, http://www.scmp.com/news/hong-kong/article/1529167/full-text-practice-one-country-two-systems-policy-hong-kong-special

[96] "Full text: Chinese State Council white paper on 'One Country, Two Systems' policy in Hong Kong," op. cit. (The Chinese State Council white paper mentions "The central government supports Hong Kong in launching individual use of RMB, issuing RMB bonds and conducting trials of RMB settlement in cross-border trade, thus consolidating Hong Kong's position as a leading offshore RMB market."); "Renminbi Internationalization- The Role of Hong Kong," BEA (Bank of the East Asia), *The Economic Analysis*, October 2012 ("Since Hong Kong is a part of China, the seamless communication between regulatory authorities and the financial community of the two places allows prompt policy adjustment according to the market conditions. This helps to build an effective firewall for the Mainland financial system, making Hong Kong an ideal place to launch pilot programmes for offshore Rmb business,"); Yin-Wong Cheung, "The Role of Offshore Financial Centers in the Process of Renminbi Internationalization," Asian Development Bank Institute, No. 472, April 2014, pp. 6-7.

[97] "Renminbi banking business in Hong Kong," Hong Kong Monetary Authority Quarterly Bulletin, March 2005, p.22.

[98] Ibid., p.23.

- China's accession to the WTO in 2001 was also of great help because on December 12th, 2006, China began to provide full national treatment for foreign banks under its WTO agreement. Foreign banks, after being incorporated locally, were permitted to engage in the same range of financial services as Chinese banks, including taking retail RMB deposits, and they are regulated and supervised in the same way as domestic banks.[99]

- In 2007, China began to take a number of additional steps to promote the international use of the RMB, in most cases using Hong Kong as the platform. These included[100]:
    - Permitting the settlement of trade transactions using RMB;
    - Easing restrictions on cross-border remittances of RMB for settlement;
    - Allowing the issuance of RMB-denominated bonds in Hong Kong and other offshore financial centers;
    - Permitting selected banks to offer offshore RMB deposit accounts.

- Finally, on January 20th, 2009, China and Hong Kong signed a three-year currency-swap deal worth 200 billion yuan (US$28.6 billion). This was a swift response to the global financial crisis triggered by the bankruptcy of Lehmann Brothers in September 2008. This arrangement would "bolster investor confidence in Hong Kong's financial stability" and also "help promote the development of yuan-denominated trade transactions between Hong Kong and the mainland," explained Zhou Xiaochuan, governor of the PBoC.[101]

These measures helped catalyze the growth of RMB banking services in Hong Kong. RMB customer deposits and certificates of deposit issued by banks in Hong Kong continued to increase. (Figure 7) By October 2015, they together amounted to around RMB1 trillion yuan.[102]

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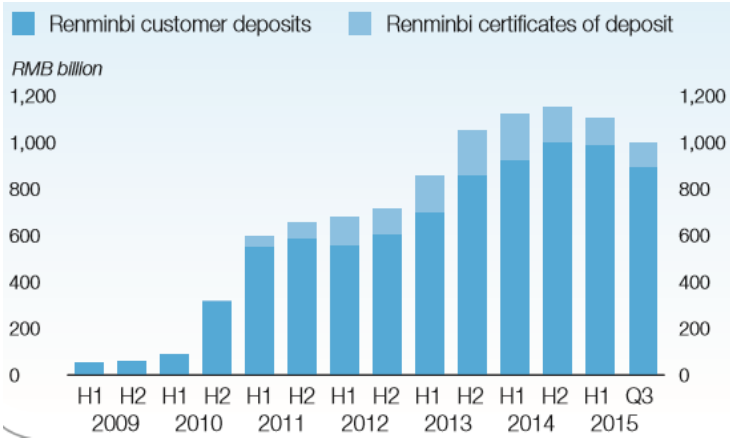
[99] "Financial Services in China: An Overview and Assessment of Reforms and Market Openings with Recommendations for Further Progress," The US-China Business Council, 2006, P.4.

[100] Eswar Prasad (2016), op. cit., p.55.

[101] "Mainland, HK sign currency swap deal," *The China Daily*, January 20, 2009, http://www.chinadaily.com.cn/china/2009-01/20/content_7414759.htm

[102] "HONG KONG: The Global Offshore Renminbi Business Hub," Hong Kong Monetary Authority (HKMA) Booklet (Last revision date: 12 February 2016), p.5

Figure 7. Renminbi Deposits in Hong Kong[103]



Source: Hong Kong Monetary Authority (HKMA) Booklet (Feb. 2016)

In December 2010, the state-owned Bank of China Ltd went so far as to offer yuan trading to its US customers. This was seen as a sign that Beijing may increasingly promote the use of the Chinese currency in major financial centers.[104] In addition to Hong Kong, China has been making efforts to build a global web of RMB clearing centers since 2003 with the goal of making its currency more attractive to foreign customers.

Liberalizing Bank Deposit and Lending Rates

China's financial system remains bank-dominated, and the state directly controls most of the banking system.[105] Beijing has long controlled domestic allocation largely through state-owned banks, while maintaining strict controls on bank lending and deposit rates. The *Wall Street Journal* noted in 2013 that this practice helped "supercharge China's growth" by disproportionately "channeling loans to state-owned enterprises and other big businesses" as well as "maintain wide profit margins for banks."[106] However, Chinese policymakers began to realize that "policies that favor the banking sector relative to the rest of the financial system" and, especially, the long-held interest rate policy that "inhibited competition" by arbitrarily "setting a floor for lending rates and a ceiling for deposit rates", would greatly undermine China's efforts to develop its financial markets and to take forward RMB

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103 Ibid.

104 Gertrude Chavez Dreyfuss and Saikat Chatterjee, "Yuan to spread as Bank of China lets U.S. customers trade RMB," *Reuters*, January 12, 2011, http://www.reuters.com/article/us-usa-china-yuan-idUSTRE70B11S20110112

105 Eswar Prasad (2016), op. cit., p.39.

106 Lingling Wei, "Beijing Lending Shift May Force Banks to Raise Capital Removal of Floor on Loan Rates Is Seen Hitting Smaller Lenders Hardest," *The Wall Street Journal*, July 21, 2013, http://www.wsj.com/articles/SB10001424127887324144304578619662099198992

internationalization[107] (Eswar Prasad, 2016).

There are both structural and practical reasons for that. First of all, in "the sequencing of capital account liberalization," China needs to "proceed with interest rate liberalization, exchange rate flexibility, and capital account opening in an integrated way." (Eichengreen and Kawai, 2014) Thus, the domestic interest rate structure will become untenable because, as Eichengreen and Kawai wrote, "the freer financial capital is to flow in and out of an economy, the more problematic interest rate floors and ceilings become."[108] Also, some of the benefits accruing from "interest rate liberalization" could include intensifying completion in the banking sector in the direction of 'increasing efficiency', thus "helping to reduce the flow of funds to 'shadow banking' systems such as through wealth management assets and local government financial platforms, which potentially contribute to the buildup of financial vulnerabilities", and "encouraging enterprises to concentrate on a smaller number of efficient investment projects and allowing private firms and households to have greater access to bank financing."[109]

The Chinese authorities began to act on bank interest rate liberalization. On July 19th, 2013, China's central bank removed a government floor on the interest rates banks can charge their clients for credit. Financial institutions were allowed to price loans at whatever level they want. The move was, as *The Wall Street Journal* put it, "part of a broader effort by China to overhaul its financial system."[110] However, the central bank was determined to move in a more cautious and gradual manner in respect of controls on bank deposit rates, which "reflects policymakers' concerns on banking sector conditions, and goals to minimize negative impacts on China's banking sector and ensure financial market stability."[111] Further changes to deposit rules were considered the 'riskiest' part of liberalization, when the PBoC announced its decision to lift controls on bank lending rates back in July 2013.[112]

It took about two years after having scrapped the lending interest rate floor before the PBoC finally removed the last ceiling restriction on deposit rates, in October 2015. During this

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[107] Eswar Prasad (2016), op. cit., pp. 40-41.

[108] Barry Eichengreen and Masahiro Kawai, "Issues for Renminbi Internationalization: An Overview," ADBI Working Paper Series, No. 454, January 2014, Asian Development Bank Institute, pp.11-12.

[109] Ibid., p.12.

[110] Lingling Wei (2013), op. cit.

[111] "China's Interest Rate Liberalization Reform," *Asia Focus*, Country Analysis Unit, Federal Reserve Bank of San Francisco, May 2014, p.2.

[112] China Takes 'Riskiest' Step by Ending Deposit-Rate Controls, *Bloomberg*, October 23, 2015, http://www.bloomberg.com/news/articles/2015-10-23/china-takes-riskiest-step-by-scrapping-deposit-rate-controls

period, the PBoC continued to gradually raise the deposit rate ceiling from 1.1 of benchmark rates to 1.2x (on November 22nd, 2014), to 1.3x (March 1st, 2015); and then to 1.5x (May 11th, 2015). Meanwhile, a crucial moment came via an IMF progress report of 4th August, 2015 that "determined China hadn't implemented liberalization reforms the IMF had demanded - and that Chinese President Xi Jinping had long promised", *The Foreign Policy* noted in 2015. It observes that "China took the hint" and moved quickly to take several steps.[113] On October 23rd, 2015, the PBoC announced its decision to scrap the ceiling limits on all deposit interest rates, marking the completion of interest rate liberalization. This move was a milestone in interest rate liberalization in that it represents a policy paradigm shift from a tightly controlled system to a market-oriented one.

Cultivating RMB Bond Markets

Another important development has been the rapid growth of the RMB-denominated bond market. On January 14th, 2007, the PBoC allowed domestic financial institutions to issue RMB-denominated bonds, better known as CDB, in Hong Kong, subject to approval. On July 9th of the same year, the Chinese Development Bank (CDB), a Chinese policy bank, became the first issuer of dim sum bonds worth RMB 5 billion in Hong Kong. Total issuance was initially very small, amounting to RMB 10 billion in 2007, RMB 12 billion in 2008, and RMB 16 billion in 2009. The dim sum bond market has grown rapidly since 2010, when, according to Jenny Yee Wong (2012), the "Chinese government expanded the dim sum issuer pool beyond mainland financial institutions to include multinational corporations and international financial institutions as well as mainland non-financial companies."[114] Until July 2010, only Chinese and Hong Kong banks were allowed to issue bonds denominated in yuan.

The appetite for dim sum bonds began to surge for a couple of reasons. First of all, notes *The Washington Post* in 2011, "foreign companies with China operations" found it "advantageous to raise yuan in Hong Kong" because Hong Kong offered 'bargains' in the form of lower borrowing costs than those in China, thanks to the "Hong Kong dollar's peg to the US dollar and its near-zero interest set by the US Fed." In addition, "speculation by investors betting that the yuan (would) appreciate against the dollar" was also "fueling demand for dim-sum bonds from those unable to access mainland markets."[115]

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[113] David Francis, "Is China About to Gain Entry to the IMF's Currency Country Club?: International Monetary Fund and Chinese officials are hinting the renminbi, Beijing's currency, is about to be recognized as one of the world's premier bank notes. Is this a reward for China's economic liberalization?" *Foreignpolicy.com*, October 26, 2015, http://foreignpolicy.com/2015/10/26/is-china-about-to-gain-entry-to-the-imfs-currency-country-club/

[114] Jenny Yee Wong, "Development of Dim Sum Bonds in Hong Kong's Offshore RMB Market," Nomura Research Institute, Ltd., lakyara vol. 152, November 12, 2012, pp.1-2.

[115] Fion Li, "'Dim Sum bonds' are fueling China's currency rise," *The Washington Post*, November

The Chinese government's policy shift concerning dim sum bond issuance was also in line with China's latest push for RMB internationalization and its 'go global' strategy since the 2008-9 global financial crisis. On December 8th, 2008, China released "several opinions of the General Office of the State Council on Providing Financing Support for Economic Development." This 30-point paper clearly set out policies aimed at "encouraging the issuance of renminbi bonds in the Hong Kong market by Hong Kong-based enterprises and financial institutions operating in mainland China (Article 13)," and "supporting the development of renminbi business in Hong Kong (Article 22)," which Wen Jiabao, the then Chinese Premier, confirmed again in his report on government activities delivered to the National People's Congress in March 2009.[116]

Just like 'dim sum' food, it makes business sense to accommodate different issuers in order to make the newborn dim sum bond more attractive. The following 'window-opening' developments in four areas - corporate, international organizations, foreign governments, and the Chinese government - could capture the evolution of dim sum bonds:

- **July 7th, 2010:** Hopewell Highway Infrastructural Ltd., a Hong Kong-listed company, announced the issuance of RMB-denominated bonds worth RMB 1.4 billion in Hong Kong, becoming the "first corporate" dim sum bond issuer. On August 19th, 2010, McDonald announced the issuance of RMB bonds worth RMB 200 billion, making its debut as the "first multinational" corporation issuing RMB bonds.
- **October 19th, 2010:** The Asian Development Bank (ADB), as noted *The Financial Times*, made "the first deal of its kind by a supranational agency" by throwing its weight behind Hong Kong's fledgling renminbi-denominated bond market, raising RMB 1.2bn ($180m).[117] On January 5th, 2011, the World Bank issued its first RMB bonds in Hong Kong, joining a growing number of borrowers tapping the new debt market. In March 2014, the International Finance Corporation issued Renminbi-denominated Bonds worth RMB 1 billion on the London Stock Exchange, this becoming "the largest (issuance) on the London Stock Exchange by a multilateral institution."[118]

19, 2011, https://www.washingtonpost.com/dim-sum-bonds-are-fueling-chinas-currency-rise/2011/11/15/gIQAML23cN_story.html

[116] Chi Hung KWAN, "Stepping up Efforts toward Renminbi Internationalization," RIETI (Research Institute of Economy, Trade, and Industry), April 6, 2009, http://www.rieti.go.jp/en/china/09040601.html

[117] Robert Cookson, "ADB issues landmark renminbi bond," *The Financial Times*, October 19, 2010, http://www.ft.com/intl/cms/s/0/5ca536cc-db7a-11df-ae99-00144feabdc0.html#axzz43K6qXFio

[118] "IFC Issued 1 Billion Renminbi-Denominated Bond on the London Stock Exchange to Support Internationalization of Chinese Currency," IFC, http://www.ifc.org/wps/wcm/connect/region__ext_content/regions/western+europe/news/ifc+issued+

- **November 6th, 2013:** Canada's western province of British Columbia issued one-year offshore RMB-denominated bonds, raising RMB 2.5 billion. This marked the 'first issuance' of offshore RMB bonds by a foreign government. On October 14th, 2014, the UK government chimed in by issuing a three-billion sovereign bond in RMB, becoming the first Western country to do so and issuing what was seen as the largest ever non-Chinese RMB bond.
- **October 20, 2015:** The People's Bank of China itself came forward as a seller of one-year RMB-denominated bills, raising RMB 5 billion (approximately $800 million) in a deal that was more than six times subscribed. This transaction was called a "milestone in the internationalisation of the renminbi" by *The Financial Times*, being the "first debt offering in any currency from the PBoC outside China."[119] This "first ever offshore RMB bond issuance" by the PBoC would "help promote the offshore use of the currency as well as cross-border trade and investment"[120] (Eswar Prasad, 2016).

The dim sum bond market in Hong Kong, which is by far the largest RMB bond market outside the mainland, has continued to grow fast over the past several years. The outstanding stock of these bonds in Hong Kong amounted to RMB 367 billion at the end of October 2015.[121] Other RMB bond markets include Singapore, Taiwan and the United Kingdom. These will compete with each other to increase their share of the growing dim sum bond pie. In the process, they will also try to make the most of their own advantages to offer dim sum menus tailored to their target customers. Figure 8 shows the rapid growth of the dim sum bond market in Hong Kong since 2010.

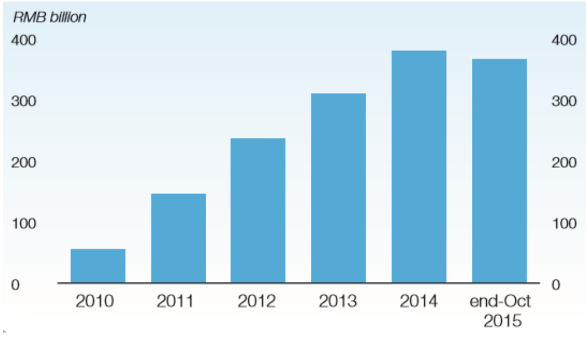
1+billion+renminbi-denominated+bond+on+the+london+stock+exchange+to+support+internationalization+of+chinese+currency

119 Elaine Moore and Gabriel Wildau "China completes first London debt sale," *The Financial Times*, October 20, 2015; http://www.ft.com/intl/cms/s/0/01bfe6aa-76e1-11e5-8564-b4bb9a521c63.html#axzz43K6qXFio

120 Eswar Prasad (2016), op. cit., p.57.

121 HONG KONG The Global Offshore Renminbi Business Hub, op. cit., p.10.

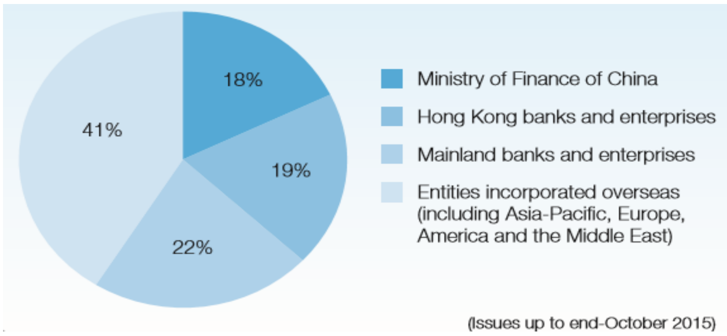
Figure 8. RMB bonds outstanding in Hong Kong



Source: Hong Kong Monetary Authority (HKMA) Booklet[122]

It is important to note that, as Figure 9 shows, 41 percent of RMB bond issuers in Hong Kong are entities incorporated outside the mainland and Hong Kong, while a similar portion (40 percent) of the outstanding stock of RMB bonds is accounted for by mainland government agencies, banks, and enterprises. This indicates, notes Prasad, that "multinational companies from countries such as Germany, South Korea, and the United States apparently view these bonds as an affordable way to raise RMB funds that can in principle then be used to fund investments and other operations in China."[123]

Figure 9. RMB bonds in Hong Kong, by type of issuer



Source: Hong Kong Monetary Authority (HKMA) Booklet[124]

Two relevant points are worth noting. One is that, as observed *Bloomberg* in 2015, Chinese companies expanding overseas, "prodded by the government's 'Go Global' or 'Going-out' policy", will seek to "diversify funding to expand their investor base," which will in turn encourage these Chinese borrowers to "raise offshore yuan, even if the coupon is similar, and use the proceeds for acquisitions offshore."[125] This means there is further scope for growth

[122] Ibid.

[123] Eswar Prasad (2016), op. cit., pp. 56-57.

[124] HONG KONG The Global Offshore Renminbi Business Hub, op.cit., p.11

[125] Justina Lee, "Talk of China Dim Sum Bond Market's Death Is Greatly Exaggerated," *Bloomberg,*

down the road in the overseas dim sum market. The other point is that as a result of Beijing's permission for foreign companies to issue RMB-denominated bonds, they will see less need to bring dollars into China to fund their investments, which will in turn help China to avoid amassing dollar assets, thereby reducing its reliance on the dollar.

As shown in Figure 10, the rapid growth of the dim sum bond market in Hong Kong seemed to stop abruptly in 2005 with total dim sum bond issuance dropping by almost one half, from US$ 33.4 billion in 2014 to US$ 17.4 billion in 2015.

Figure 10. Annual Dim sum bond issuance (2007-2015)[126]

Source: Dealogic

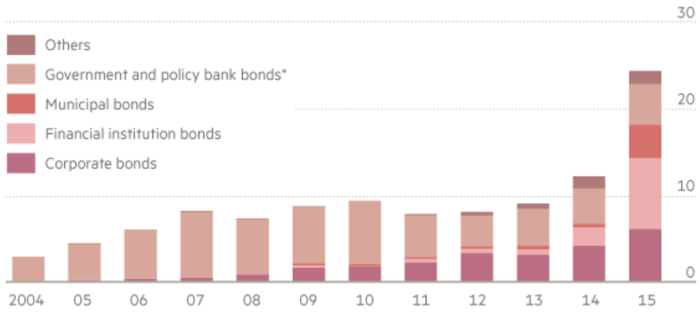
On the contrary, the onshore bond market increased to CNY 14.6 trillion in 2015, representing both a 24-percent year-on-year increase from 2014 and a doubling, in three years, from CNY 7 trillion (US$1.06 trillion) in 2012 (See Figure 11 below). This shows the bond market on the mainland growing relentlessly in size and sophistication.[127] The onshore market is almost 30 times bigger than the dim sum bond market, which stands at CNY 523 billion.

April 24, 2015, http://www.bloomberg.com/news/articles/2015-04-23/talk-of-china-dim-sum-bond-market-s-death-is-greatly-exaggerated

[126] Chris Wright, "China: Currency contortions threaten dim sum," *Euromoney.com*, February 2016; http://www.euromoney.com/Article/3526039/China-Currency-contortions-threaten-dim-sum.html

[127] Ibid.

Figure 11. China's onshore bond issuance (2004-2015)[128] (RMB trillion)



Source: Moody's Wind

There are two explanations for the sudden drop in demand for dim sum bonds in 2015,[129] as noted in the *Financial Times*, Firstly, the launch of the Shanghai-Hong Kong Stock Connect in November 2015 encouraged "investors in Hong Kong to divert RMB 148bn ($23.8bn) into mainland-listed equities, leaching cash away from credit markets." Secondly, would-be corporate issuers inside China find it easier to secure financing on the mainland thanks to the PBoC's recent measures aimed at coping with the slowing economy. A series of cuts to interest rates and reserve requirement ratios have helped boost liquidity in the domestic financial system, which has led to reduced borrowing costs for Chinese companies and the diminishing attractiveness of offshore renminbi markets as a funding source.

Thus, any talk of the dim sum bond market's woes down the road is greatly exaggerated. Furthermore, the Hong Kong market will, according to *Bloomberg*, pick up for the following reasons:[130] To begin with, ongoing RMB internationalization will continue to boost the dim sum bond market in Hong Kong. On top of that, global firms, which made up 41 percent of dim sum issuance in 2005, still prefer using offshore markets to raise yuan than issuing so-called 'panda bonds,' which are onshore debt sold by non-Chinese companies on the mainland. They feel uncomfortable with the lack of comprehensive rules on the issuance of panda bonds, and with the need to alter financial statements to fit China's system just for a bond sale. Lastly, following up on the government's 'going out' policy, there will be a growing number of Chinese companies willing to try expanding overseas. These companies will also seek to diversify funding to expand their investor base.

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[128] Steve Johnson, "China bond market shake-up seen to attract trillions of dollars," *The Financial Times*, March 2, 2016, http://www.ft.com/intl/cms/s/3/a671d29c-dfc0-11e5-b67f-a61732c1d025.html#axzz43K6qXFio

[129] Josh Noble, "Dim sum bonds run out of steam," *The Financial Times*, June 1, 2015; http://www.ft.com/intl/cms/s/0/e19d7ad6-080e-11e5-9579-00144feabdc0.html#axzz46raSdHbo; Justina Lee (2015), op. cit.

[130] Justina Lee (2015), op. cit.

In the meantime, it is worth noting some of the Chinese government's concerted efforts at developing its domestic bond market. On October 13th, 2005, the Chinese government allowed the Asian Development Bank (ADB) and the International Finance Corporation (IFC) to issue RMB-denominated bonds, valued at RMB 1bn and RMB 1.13bn respectively, on the interbank bond market, making them the first international financial institutions to issue Panda bonds.[131] On November 10th, 2006, the IFC made a second Panda Bond issuance worth RMB 870 million (US$147 million).[132] On December 7th, 2009, the ADB followed suit by issuing, for the second time, Panda bonds worth RMB 1bn. The Chinese government, particularly the Ministry of Finance, provided full support for the successful launch of the Panda bonds by these international development organizations because it was "strategically significant." "The significance of the birth of the Panda Bonds does not lie in their size, but rather it is an important strategic deployment of China's financial markets to international participants," it was pointed out by Cao Honghui, director of the Chinese Academy of Social Sciences, International Financial Research Institute.[133] Their participation "ushered in useful international experience and management skills in bond issuance, particularly in disclosure, documentation, and deal management," just as China was opening up its capital markets.[134]

"A little-reported rule change by China's central bank last week could unleash trillions of dollars of foreign investment into the country," reported the *Financial Times* on March 2nd, 2016. "Foreign institutional investors, including commercial banks, insurance companies, asset managers and pension funds, have been given the green light to invest in China's domestic interbank bond market *en masse*, without being limited by fiddly quotas," which means that the PBoC "effectively threw the previous access rule book out the window" by opening up the bulk of the Rmb 48tn ($7.3tn) onshore credit market, according to the report. "This change", it was noted, 'should trigger significant portfolio repositioning among global investors," with a predicted foreign investment of $1.3tn into China's onshore credit market over the next five years.[135]

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[131] James Areddy, "Chinese Markets Take New Step with Panda Bond," *The Wall Street Journal*, October 11, 2005; "ADB, IFC mark inaugural Panda Bond issue," *People's Daily*, October 19, 2005; "IFC Pioneers Renminbi Bond Program in Hong Kong SAR to Finance Private Sector Projects in China," *IFC News*, October 19, 2010, http://ifcext.ifc.org/IFCExt/pressroom/IFCPressRoom.nsf/0/C2378816A9C39A79852577C1004E15E1

[132] "IFC Pioneers Renminbi Bond Program in Hong Kong SAR to Finance Private Sector Projects in China," op. cit.

[133] "IFC's Role in China's Financial Sector Transformation," IFC, November 12, 2012, p. 76

[134] Ibid., p. 77.

[135] Steve Johnson (2016), op. cit.

Facilitating RMB Inflows and Outflows

Given the huge size of China's capital markets, which remain among the world's largest, and with its equity market standing at around US$8.5 trillion in market capitalization - making it the second-largest globally behind the US - as well as its bond market being the world's third-largest behind the US and Japan with more than US$6 trillion in outstanding capital, the liberalization of China's capital markets will continue to present unrivalled opportunities for both domestic and international players, while allowing overseas openings for mainland-based investors.[136] The Chinese authorities have been opening the country's capital account to both inflows and outflows in a "controlled and calibrated" manner[137] (Eswar Prasad, 2016). To do this, a number of policy schemes have been put in place. The following are the major initiatives[138]:

(i) For capital inflows: *Qualified Foreign Institutional Investor (QFII) Scheme* (launched in 2002) and *Renminbi Qualified Foreign Institutional Investor (RQFII) Scheme* (2011);

(ii) For capital outflows: *Qualified Domestic Institutional Investor (QDII) Scheme* (2006);

(iii) For two-way capital flows: *Free Trade Zones (FTZs)* - Shanghai FTZ (launched in September 2013) and three new FTZs in Guangdong, Tianjin, and Fujian (April 2015), *Shanghai-Hong Kong Stock Connect* (2014), *Mutual Fund Connect* (July 2015), and *Shenzhen-Hong Kong Stock Connect* (2016)

Some of these schemes are worth mentioning here because they may have the effect of directly promoting the use of the RMB:

- First of all, the Chinese government launched the RQFII program in late 2011, two years after it began its RMB internationalization. RQFII allows financial institutions to use offshore yuan to invest in the mainland's securities markets, including in stocks, bonds and money market instruments. This is the key difference between RQFII and its cousin, the QFII scheme, launched in 2002, which requires foreign investors to first convert their foreign currency funds into RMB before purchasing equities and securities on the mainland. Compared with QFII, RQFII has many advantages since it has far fewer restrictions on investment targets and cross-border yuan movement.

[136] "Navigating China's capital markets - Opportunities and trends," *HSBC Malaysia*, October 7, 2015, https://globalconnections.hsbc.com/malaysia/en/articles/navigating-chinas-capital-markets-opportunities-and-trends

[137] Eswar Prasad (2016), op. cit., p. 13.

[138] Ibid. [p. 13 (for a summary of these schemes) and p.15-p.22. (for a more detailed description of each of them)]

Thus, the expansion of the RQFII scheme is poised to see faster yuan flows into China since it is now much easier for investors to enter the country than via the older QFII program.[139] A global web of RQFII networks has taken shape. Since 2014, the scheme, for which only Hong Kong subsidiaries of Chinese financial institutions were eligible at first, has been expanded to additional Hong Kong banks and asset managers and, more recently, to financial institutions in other countries, including the United Kingdom, Singapore, South Korea, Malaysia, France, Germany, Australia, Switzerland and Canada. As of May 2016, China's State Administration of Foreign Exchange (SAFE) had dished out an aggregate of RMB 502 billion in RQFII quotas to more than a dozen nations and regions, including the UK and France, with the Hong Kong market getting the highest share of 270 billion yuan.[140] On June 7th, 2016, the PBoC announced in Beijing on the sidelines of the US-China Strategic and Economic Dialogue that "China will give a 250 billion yuan ($38 billion) investment quota to the US", which is the largest after Hong Kong, "as part of the nation's efforts to expand the use of the yuan overseas."[141] Meanwhile, on January 13th, 2011, the PBoC allowed qualified domestic enterprises to invest in foreign countries directly using the yuan.[142]

- As another way of extending its "experimental, learning-by-doing approach to reforms to the capital account liberalization program," China set up the pilot Free Trade Zone (FTZ) in Shanghai on September 29th, 2013, and continued to establish three new FTZs in Guangdong, Tianjin and Fujian in April 2015. Going beyond Hong Kong, China is trying out these FTZs as "islands of capital account convertibility within China." These zones are being used as testing grounds inside China in order to gain firsthand know-how in executing "a greater degree of capital account openness but in a controlled manner, by limiting it to specific geographical areas."[143] Some of the key features of the FTZs that are being tested out may have some impact on the Chinese leadership's decision regarding the RMB's internationalization. These are as follows[144]: (i) without seeking approval from the

[139] Michelle Chen, "CNH Tracker-Expansion of China's RQFII scheme to draw more yuan inflows," *Reuters*, July 9, 2014, http://www.reuters.com/article/markets-offshore-yuan-idUSL4N0PI0TS20140710

[140] Zhang Ye and Chu Daye, "China grants US $38 billion investment quota," *Global Times*, June 8, 2016, http://www.globaltimes.cn/content/987497.shtml

[141] "China Gives First Investment Quota to U.S. to Boost Yuan Use," *Bloomberg News*, June 7, 2016, http://www.bloomberg.com/news/articles/2016-06-07/china-to-give-38-billion-rqfii-quota-to-u-s-in-first-ever-move

[142] "Chronology of RMB Going Global," *Xinhua*, December 2, 2015, http://english.cri.cn/12394/2015/12/02/4182s906611.htm

[143] Eswar Prasad (2016), op. cit., p. 19.

[144] Ibid., p. 20.

PBoC, banking institutions within the zone are free to process cross-border RMB settlements under current accounts and under direct investment for entities; (ii) companies within the zone are allowed to borrow RMB offshore, although these funds cannot be used outside the FTZ and neither can they be invested in securities or used for extending loans; and (iii) voluntary foreign exchange settlement by foreign-invested enterprises (FIEs) within the zone is permitted, allowing FIEs to convert foreign currency in their capital accounts into RMB at any time.

- On November 17th, 2014, the *Shanghai-Hong Kong Stock Connect* (the "Shanghai Train") was officially launched as another channel for cross-border equity investments by a broad range of domestic and international investors. The program allows mainland Chinese investors to purchase shares in select Hong Kong and Chinese companies listed in Hong Kong (Southbound investment), and lets foreigners buy Chinese A shares listed in Shanghai (Northbound investment) in a less restrictive manner than had previously been the case.[145] The *Shanghai-Hong Kong Stock Connect* marked the biggest opening up of China's stock markets to the wider world so far. The program allows global investors to buy up to 300 billion yuan ($45.61 billion) worth of Shanghai-listed stocks, and mainland Chinese investors to buy a reciprocal 250 billion yuan of stocks listed in Hong Kong.[146] This new initiative is significant in that all trades on the connection must be done in RMB since mainland investors use RMB to invest in Hong Kong stocks, while Hong Kong and overseas investors must also use RMB to purchase stocks in Shanghai. Another benefit, noted commentator Evelyn Cheng in 2014, would be that this transaction "will not impact the onshore RMB exchange rate or China's foreign exchange reserves," because "unlike the QFII and QDII schemes, the RMB exchange will happen offshore."[147] The Chinese government considers the initiative as a "substantial step forward for internationalization of the yuan" and expects "the yuan's global status" to "undoubtedly be strengthened as overseas investors need to acquire offshore yuan before they can invest."[148] In the meantime, China is working to launch the second

[145] Ibid., p. 21.

[146] Gregor Stuart Hunter, "Stock Connect Sees More Inflows Into Hong Kong Than Shanghai: Trading link launched in 2014 to encourage foreign investment in China" *The Wall Street Journal*, January 20, 2016, http://www.wsj.com/articles/stock-connect-now-sees-more-inflows-into-hong-kong-than-shanghai-1453297879; "China Spotlight: What is a "Basically Open Capital Account, Chinese Style?"," Institute of International Finance, June 22, 2015, https://www.iif.com/publication/html-publication/china-spotlight-what-basically-open-capital-account-chinese-style

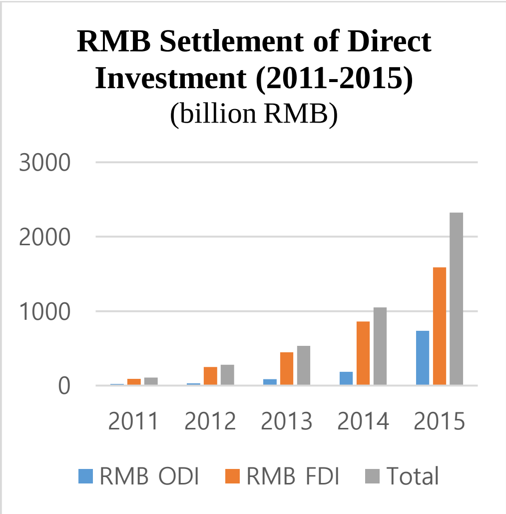
[147] "Shanghai-Hong Kong Stock Connect is a big step in a long journey," May 8, 2014, https://www.hkex.com.hk/eng/newsconsul/blog/140508blog.htm; Evelyn Cheng, "A new way to get in on Chinese stocks," *CNBC*, October 7, 2014, http://www.cnbc.com/2014/10/07/

[148] "Shanghai-HK stock link to bolster yuan's internationalization," *Xinhua*, November 17, 2014,

cross-border trading initiative, the *Shenzhen-Hong Kong Stock Connect* (the 'Shenzhen Train'). On March 16th, 2016, Chinese Premier Li Keqiang reiterated the Chinese government's commitment to launch the Shenzhen Train this year.[149] This connection "will let offshore investors access many of China's technology and high-growth shares."[150]

In addition, China has streamlined both the approval process in the use of the RMB for outward FDI by Chinese enterprises and the use of the RMB for inward FDI by foreign investors in China since 2011. The PBoC launched the RMB Outward Direct Investment (RMB ODI) initiative through issuing the Administrative Measures for Trial Program of RMB ODI in January 2011, and the RMB Foreign Direct Investment (RMB FDI) initiative in October of the same year, a "step toward the government's goal of internationalizing its currency."[151] As shown in Figure 12, RMB-denominated and -settled FDI has since risen rapidly. RMB FDI soared to RMB 1,587.1 billion in 2015, from RMB 90.7 billion in 2011, while RMB ODI also increased substantially from RMB 20.2 billion to RMB 736.2 billion.

Figure 12.



Source: PBoC, Bank of China

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http://english.gov.cn/news/top_news/2014/11/17/content_281475011589162.htm

[149] "China to launch Shenzhen-HK Stock Connect this year: Premier Li," *Xinhua,* March 16, 2016, http://english.gov.cn/premier/news/2016/03/16/content_281475308598090.htm

[150] "China Said to Mull Shenzhen-Hong Kong Link Approval Before July," *Bloomberg News,* April 16, 2016, http://www.bloomberg.com/news/articles/2016-04-20/china-said-to-mull-shenzhen-hong-kong-link-approval-before-july

[151] "China to allow foreign direct investment in yuan," October 14, 2011, *Xinhua,* http://news.xinhuanet.com/english2010/china/2011-10/14/c_131191939.htm

Opening the Foreign Exchange Market

China's foreign exchange regime has evolved since the adoption of market-oriented economic reforms and the creation of its opening-up policy in 1978, reflecting political and economic developments both at home and abroad. In line with its export-oriented strategy, China had practiced a dual exchange-rate system until 1993. On January 1st, 1994, China unified the official and market rates at 8.70 yuan per dollar under a 'floating exchange-rate system'. This effectively devalued the yuan's official rate by 40 percent. Since then, there have been three watershed moments that had a great impact on China's foreign exchange regime: the 1997-8 Asian financial crisis, China's WTO accession in 2001, and the 2008-9 Global Financial Crisis.

The following is a summary of the developments surrounding these milestone events, which have significant implications for RMB internationalization:

- During the Asian financial crisis of 1997-98, China maintained a steady exchange rate against the dollar, despite ample pressure to allow depreciation. During the crisis, the US, Japan and other countries urged China "not to devalue the yuan, fearing it could trigger a chain reaction."[152] China's positive response, according to *The Economist*, "bolstered the yuan's credibility."[153]
- Although China continued this practice until July 2005, pressure had been continuing to build regarding renminbi appreciation since China's accession to the WTO in 2001. China's liberalization of foreign direct investment flows after its WTO accession and its surging trade surplus from 2003 brought about the "so-called twin surpluses (current and capital account surpluses)," which helped mount renminbi appreciation pressure.[154] China's trade surplus with the US was also rapidly increasing, which fed uneasiness especially in the US Congress. There was a growing sense that "a major cause of the rapidly growing US trade deficit with China (was) currency manipulation," given that "China (had) tightly pegged its currency to the US dollar at a rate that encourage(d) a large bilateral trade surplus with the United States,"[155]noted the EPI (Economic Policy Institute). Against this backdrop, in July 2005, the PBoC

[152] "A Timeline: The Chinese Yuan's Journey to Global Reserve Status", *Bloomberg News*, December 1, 2015, http://www.bloomberg.com/news/articles/2015-11-30/a-timeline-the-chinese-yuan-s-journey-to-global-reserve-status

[153] "China's exchange-rate policy: Currency peace," *The Economist*, February 21, 2015, http://www.economist.com/news/finance-and-economics/21644205-devaluing-yuan-would-do-china-more-harm-good-currency-peace1997

[154] Edward K.Y. Chen and Wendy Dobson, *Financial Development and Cooperation in Asia and in the Pacific* (Routledge, 2014), p. 175.

[155] Robert E. Scott, "The China Toll," Economic Policy Institute, EPI Briefing Paper #345, August 23, 2012, p.4.

introduced a “managed floating exchange-rate mechanism,” under which the RMB’s value would be determined by market demand and supply as well as with reference to a basket of currencies. On May 21st, 2007, in an effort to introduce a “floating exchange rate regime” on a gradual basis, the PBoC widened the floating band of the RMB’s trading prices against the US dollar in the interbank foreign exchange market from 0.3 percent to 0.5 percent, which means that on each business day, the trading price of the RMB against the US dollar in the interbank foreign exchange market may fluctuate within a band of ±0.5 percent around the central parity released on the same day.

- In July 2008, just before the Lehmann Brothers collapse that triggered the 2008-9 Global Financial Crisis, the PBoC moved to reinstitute the RMB’s hard peg to the dollar, which was relaxed again in June 2010.[156] On April 12th, 2012, the PBoC widened the daily fluctuation band of the RMB-dollar exchange rate from 0.5 percent to 1.0 percent. It was the first such movement almost five years after the PBoC had adjusted the band from ±0.3 percent to ±0.5 percent in May 2007. On March 17th, 2014, the PBoC further widened the band to ±2 percent. It is important to understand that all this has been taking place within a broad framework of the RMB’s internationalization, which has begun in earnest since the onset of the 2008-9 Global Financial Crisis.

On top of all that, as part of its efforts to open the capital market, China has also sought to gradually open the foreign exchange market. One of the key developments is to allow the RMB to be directly traded against major currencies. On January 22nd, 2010, China began this process first with Russia by launching direct trading between the yuan and the Russian ruble on the inter-bank foreign exchange market. A series of similar arrangements was made with the Japanese Yen (June 1st, 2012), the British pound (June 19th, 2014), the euro (September 22nd, 2014), along with other currencies. China’s RMB is currently traded directly against major currencies, including the US dollar, the euro, the British pound, the Japanese yen, the Swiss Franc, the Australian and New Zealand dollars, and the Russian ruble.[157] On September 10th, 2015, China opened its domestic foreign exchange market to overseas central banks, making it easier for other nations to hold yuan assets.[158]

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[156] Eswar S. Prasad (2016), op. cit., p. 27.

[157] “China to Start Direct Trading Between Yuan, Swiss Franc: PBOC,” *The Wall Street Journal*, November 9, 2015, http://www.wsj.com/articles/china-to-start-direct-trading-between-yuan-swiss-franc-pboc-1447062300

[158] “China Opens Onshore Currency Market to Foreign Central Banks,” *Bloomberg News*, September 10, 2015, http://www.bloomberg.com/news/articles/2015-09-10/china-to-allow-foreign-central-banks-in-onshore-currency-market

With regard to 'the Impossible Trinity,' countries such as the United States and the United Kingdom "largely have relinquished their exchange-rate controls to maintain free movement of capital and an autonomous monetary policy", *China Briefing* noted in in 2012, whereas China "chose to sacrifice the free cross-border flow of capital to keep a fixed exchange rate and control money supply."[159] China's balancing act will continue.

[159] Jens Petersen, "Chinese Currency Controls and the Liberalization of the Renminbi," *China Briefing*, http://www.china-briefing.com/news/2012/08/17/chinese-currency-controls-and-the-liberalization-of-the-renminbi.html

3.2. Pillar II: Building a Global RMB Financial Infrastructure and Networks

One vital factor in speeding up the internationalization of the RMB is the creation of an international environment that can help the RMB to become widely accepted and used. In short, it is important for China to further promote the currency's network externalities while the government continues to make progress in important areas, including the opening up of the capital market, a flexible exchange rate, and financial market development. Such an environment will also set in motion a virtuous circle where RMB-based trade and investment settlements will be further catalyzed, in turn leading to further acceleration in the RMB internationalization process.

Bearing this in mind, the Chinese government has been working assiduously to build a global web of RMB financial infrastructure and networks. China's strategy in Pillar II can be broken down into three key themes:

1. China has been working to put in place a variety of mechanisms aimed at securing a wider use of the RMB both bilaterally and internationally. These include: (i) the establishment of a global network of renminbi trading and clearing centers; (ii) the beginning of renminbi direct trading; (iii) the conclusion of bilateral swap arrangements (BSAs), and (iv) the launching of the CHIP (China International Payment System)
2. The country has sought to expand its FTA network.
3. China has proposed its grand-scale 'One Belt, One Road' initiative. If realized, this initiative will connect sixty nations across four continents, which could potentially create huge demand for the Chinese currency.

This Chapter will review each of the above from the perspective of their respective implications for RMB internationalization.

A. Establishing an Infrastructure and Mechanisms for Facilitating Wider RMB Use

In this section, three fundamental objectives of China's RMB internationalization strategy will be discussed. First of all, China's efforts to enhance the function of the RMB as a medium of exchange are related to the establishment of both RMB trading and clearing centers and the launch of direct trading between the RMB and other major currencies. Secondly, China's continued expansion of BSAs is aimed at furthering the supply side of its strategy by providing RMB-based liquidity though bilateral swap arrangements (BSAs). Lastly, the launch of the CHIP is related to the institutional side of China's strategy.

Building a Global Network of RMB Trading and Clearing Centers

In order to keep expediting the use of the RMB abroad, it is necessary to build and expand a network of offshore RMB trading and clearing banks. Given the enormous potential of the offshore RMB business, financial centers around the world have been eager to explore the possibility of setting up the infrastructure for competing for their share, with China looking for overseas Reminbi business hubs. Establishing RMB business hubs in "leading Western financial capitals like New York would mark another milestone," according to one *WSJ* article, in China's RMB internationalization process.[160] Moreover, it is in China's interest to launch more offshore RMB centers across different geographic locations and time zones because, as one Asian Development Bank Institute (ADBI) commentator points out, this will "increase the global RMB liquidity and business opportunities," thereby helping to "increase the degree of the RMB's international acceptance."[161] It is against such a backdrop that the global offshore RMB settlement and clearing infrastructure began to quickly take shape.

Table 2 shows that as of June 2016, China had established a total of 16 offshore RMB centers for clearing RMB transactions. These include seven in the Asia Pacific (Hong Kong, Macao, Singapore, Taiwan, Thailand, South Korea, Malaysia, and Australia), six in Europe (Germany, Great Britain, France, Switzerland, Luxembourg and Hungary), three in the Americas (Canada, Chile, and Argentina), and one in the Middle East (Qatar).

Table 2. Global network of RMB Offshore Clearing Centers (excluding Hong Kong and Macao).

Date of Bank Appointment		Country	Bank Appointed
2012	December 11	Taiwan	Bank of China
2013	February 8	Singapore	ICBC
2014	June 18	United Kingdom	China Construction Bank
	June 19	Germany	Bank of China (Frankfurt)
	July 4	Republic of Korea	Bank of Communications of China (Seoul)
	September 23	France	Bank of China (Paris)
	September 23	Luxembourg	ICBC (Luxembourg)

[160] Justin Baer, "Wall Street Group Pushes Trading of China's Yuan in U.S.," *The Wall Street Journal*, Nov. 29, 2015, http://www.wsj.com/articles/wall-street-group-pushes-trading-of-chinas-yuan-in-u-s-1448845202

[161] Yin-Wong Cheung, "The Role of Offshore Financial Centers in the Process of Renminbi Internationalization," Asian Development Bank Institute, No. 472, April 2014, p. 14.

	November 14	Qatar	ICBC
	November 17	Canada	ICBC (Toronto)
	November 17	Australia	Bank of China (Sydney)
2015	January 8	Thailand	ICBC
		Malaysia	Bank of China
	Jan. 21 (signed)	Switzerland	TBA
	May 26 (signed)	Chile	China Construction Bank
	Sept. 17 (signed)	Argentina	TBA
	October 2 (signed)	Hungary	Bank of China
Total		**16**	

Source: PBoC

Note: Two special RMB centers, Hong Kong (December 2003) and Macao (September 2004), have been in operation since the early 2000s.

In this regard, the following points are worth noting. First of all, the list not only spans a wide geographic distribution of countries, but also covers almost all major international financial centers except New York. However, New York is expected to join the pack in the near future. On November 30th, 2015, former New York City Mayor Michael Bloomberg announced the launch of a group to be chaired by him that will push to establish a clearing hub for China's renminbi currency in the United States. This was a follow-up to the agreement in September 2015 between President Obama and President Xi: “The United States and China look forward to continuing to discuss mechanisms to facilitate renminbi trading and clearing in the United States.”[162] "Advancing a mechanism to trade the Chinese currency in the United States will improve the competitiveness of US companies, while furthering America's financial sector and economy” said Bloomberg.[163] Thomas J. Donohue Sr., president and CEO of the US Chamber of Commerce, threw his weight behind this group by saying, “This is a unique opportunity to foster closer ties between the United States and China, which is critical for a healthy global economy,” as well as commenting that, “Creating a Chinese currency trading mechanism in the US makes it easier for American businesses to sell goods in China and will help the Yuan evolve into a free-floating currency.”[164]

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[162] “FACT SHEET: U.S.-China Economic Relations,” Press Release, The White House, Office of the Press Secretary, September 25, 2015, https://www.whitehouse.gov/the-press-office/2015/09/25/fact-sheet-us-china-economic-relations

[163] Sam Forgione, “Michael Bloomberg to chair group to establish yuan clearing in U.S.,” *Reuters,* November 30, 2015, http://www.reuters.com/article/china-yuan-bloomberg-idUSL3N13P5ED20151130

[164] Romain Racoussot, “Renminbi: A Long Road to Internationalisation,” *Macro Research Group,* February 1, 2016, https://macroperspectives.org/2016/02/01/renminbi-a-long-road-to-

"Building on President Xi's visit to Washington last fall, both sides agreed on a policy framework for the private sector to enhance RMB trading and clearing capacity in the United States," U.S. Treasury Secretary Jacob J. Lew said in Beijing on June 7, 2016, on the sidelines of the U.S.-China Strategic and Economic Dialogue.[165] "This will support the competitiveness of the U.S. financial and corporate sectors and improve U.S. investors' access to China's onshore capital markets," he further noted. Indeed, the establishment of an RMB clearing center in New York is enormously significant both in symbolic terms and in substance, in that it would be tantamount to completing a global web of RMB clearing hubs.

Secondly, these RMB clearing centers scattered across the world should be competing among themselves for a bigger share of the rapidly growing RMB business pie. Nevertheless, they are "not necessarily competing directly with each other", since each of these centers "serves different purposes," while "fulfilling different roles", as Jeremy Grant observes in the *Financial Times*.[166] For example, Singapore could provide a lot of "hedging and liquidity solutions for corporates" as well as develop "wealth management products" catering for potential Chinese investors, while continuing to provide a "conduit for use of the renminbi in Southeast Asia, building on the Asian city state's position as a regional *entrepot* since the 19th century."[167]

On the other hand, London, the world's largest foreign exchange trading hub, despite facing competition from other European RMB hubs such as Frankfurt and Luxembourg, will continue to play a role as a "big renminbi FX trading center", as another *FT* commentator notes.[168] As a time-honored, premium international financial center, London could also provide sophisticated, tailor-made RMB business services in the western hemisphere and beyond. That being said, however, the UK's vote on June 23rd, 2016 to leave the European Union "threatens to redefine Britain's growing financial services relationship with China, which has agreed to a number of joint projects as part of the China-UK Economic and Financial Dialogue (EFD) program to deepen economic ties between the two counties, based largely on the UK's membership of the EU," observes Reuters.[169] The stake is indeed high

internationalisation/

[165] "China Gives First Investment Quota to U.S. to Boost Yuan Use," *Bloomberg News*, June 7, 2016, http://www.bloomberg.com/news/articles/2016-06-07/china-to-give-38-billion-rqfii-quota-to-u-s-in-first-ever-move

[166] Jeremy Grant, "Battle is on for offshore renminbi market," *The Financial Times*, July 29, 2015, http://www.ft.com/intl/cms/s/2/4b9725c8-15d3-11e5-be54-00144feabdc0.html#axzz4AH4HQcPv

[167] Ibid.

[168] Philip Stafford and Delphine Strauss, "China agrees to London renminbi clearing bank," *The Financial Times*, March 2, 2014, http://www.ft.com/intl/cms/s/0/cc2c8eb4-b4d9-11e3-9166-00144feabdc0.html#axzz4AH4HQcPv

[169] Michelle Price, "Brexit puts UK-China financial services linkages at risk," *Reuters*, June 25, 2016,

because "Britain has sold itself to China as its 'best friend in Europe', marketing the country's premier financial services industry and its function as a gateway to the EU single market." [170] According to the Bank of England, the Grexit "could risk unraveling financial services agreements that have helped turn Britain into Europe's financial powerhouse, accounting for a quarter of all EU financial services income."[171] In addition, London serves as a key European offshore center for the internationalization of the yuan." For this reason, the Chinese leadership will continue to carefully watch the Grexit movement.

In this regard, it is important to understand that China did not put all its eggs in one basket. London is a major offshore launching pad for RMB internationalization, but there are 15 other RMB clearing centers across the globe and, importantly, another one in New York that will soon be launched as another key RMB settlement center. Considering all this, London may be expected to render its best efforts to maintain its sheen as a major international financial hub and, by the same token, an important offshore RMB centre, while the UK proceeds with its Article 50 negotiations on the terms of the actual Brexit with other EU members – that is, if and when it decides to trigger Art. 50 – over the next couple of years.

Starting Direct RMB Trading

On December 25th, 2011, China and Japan announced a wide-ranging currency agreement. They agreed to "promote the use of the yuan in trade and investment" between them and specifically to "promote direct yuan-yen trade, rather than converting their currencies first to dollars, and also for Japan to hold yuan in its foreign-exchange reserves, which are now largely denominated in dollars", it was reported in the *Wall Street Journal*. If realized, this agreement could have great implications not only for economic relations between the world's second- and third-largest economies, but also for the RMB internalization program *per se*, since a wider use of the RMB in their bilateral trade and investment, particularly in view of the fact of "about 60% of all China-Japan trade being currently settled in the dollars", would "limit somewhat the use of the dollar in Asia, the world's fastest growing region."[172]

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ttp://www.reuters.com/article/us-britain-eu-financial-china-idUSKCN0ZB06V

[170] Ibid.

[171] Michelle Price, "In Asia, financial firms wake up to Brexit risks, begin contingency planning," *Reuters*, April 22, 2016, http://in.reuters.com/article/britain-eu-asiapacific-idINKCN0XJ12F

[172] Lingling Wei, Bob Davisa, and Takashi Nakamichi, "Tokyo and Beijing Agree on Currency Pact," *The Wall Street Journal*, December 27, 2011, http://www.wsj.com/articles/SB10001424052970203391104577121983605242196; Toru Fujioka, China, "Japan to Back Direct Trade of Currencies," *Bloomberg*, December 26, 2011, http://www.bloomberg.com/news/articles/2011-12-25/china-japan-to-promote-direct-trading-of-currencies-to-cut-company-costs

Part of that agreement got implemented on June 1st, 2012, when China and Japan began direct trading of Chinese yuan and Japanese yen in Tokyo and Shanghai. This direct trading between the RMB and the yen marked the first time for the RMB to be traded directly against a currency other than the US dollar. The move would bring tangible benefits, including lowering currency conversion costs (and, by extension, transaction costs) and reducing settlement risks for the financial institutions involved, as well as facilitating the use of both the Japanese and Chinese currencies in their huge trade and financial transactions. Moreover, it would also help, over time, to diminish their dependence on the US dollar.[173]

Keeping those benefits in mind, China has actively moved ahead to direct trading between the RMB and other major currencies. On June 18th, 2014, the PBoC announced direct trading of the yuan against sterling. It was welcomed as "another important step toward internationalization of the Renminbi"[174] (*Xinhua*, 2014). About three months after that, on September 29th, the PBoC allowed the RMB to be directly traded against the euro in the interbank market for the first time. This was, according to the *WSJ*, considered a "significant step in the RMB's globalization", in that it "brings together the RMB with the world's second-most actively traded currency."[175] The euro was thus added to the list of currencies that are already traded directly against the RMB, which include the US dollar, the Japanese yen, the British pound, the Australian and New Zealand dollars, the Russian ruble and the Malaysian ringgit. In effect, the addition of the euro means the completion of the direct currency trading network with the four major international currencies comprising the SDR basket.

The PBoC continued to expand this direct currency trading mechanism by making similar arrangements with Singapore in October 2014, with Switzerland in November 2015, and with the Republic of Korea in February 2016. The move with Singapore would help the island nation to be able to build a yuan offshore center on the island[176], while the announcement in early November 2015 that the Swiss franc would become the seventh major currency that could bypass a conversion to US dollars and be directly exchanged for yuan, was considered helpful given the IMF was to review the RMB's inclusion in the SDR basket towards the end

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173 Lu Hui, "China starts direct currency trading with Japan," *Xinhua*, June 4, 2012, http://news.xinhuanet.com/english/china/2012-06/04/c_131629478.htm

174 "Direct yuan-sterling trade begins," *Xinhua*, June 18, 2014, http://www.china.org.cn/business/2014-06/18/content_32705717.htm

175 Wynne Wang, "China Allows Direct Trading of Yuan, Euro in Interbank Market: Move a Major Step in Yuan's Internationalization," *The Wall Street Journal*, September 29, 2014, http://www.wsj.com/articles/yuan-euro-direct-trading-permitted-by-china-central-bank-1411985313

176 Boby Michael, "China Picks Singapore Dollar as Ninth Currency to Directly Trade Against Yuan," *The International Business Time*, October 27, 2014, http://www.ibtimes.co.uk/china-picks-singapore-dollar-ninth-currency-directly-trade-against-yuan-1471916

of the same month.[177] In the meantime, the launching of the direct trading of the RMB would further increase bilateral trade and investment[178], which was seen as another shot in the arm immediately after the Korea-China FTA that took effect in December 2015.

Expanding a Network of Bilateral Swap Arrangements (BSAs)

The PBoC's recent rush to conclude bilateral swap arrangements (BSAs) can be considered part-and-parcel of China's RMB internationalization strategy. The 2008-9 global financial crisis prompted Beijing to move aggressively to build a network of BSAs aimed at facilitating wider acceptance and use of the RMB in international trade and finance. As Table 3 shows, as of June 2016, the PBoC had signed a total of 34 BSAs with central banks in countries across the world. The total amount of these BSAs stands at the equivalent of half a trillion dollars.

Table 3: Bilateral Swap Arrangements between China and other countries (2008-2015)

Country	Date	Amount (RMB bn.)	USD equivalent (bn.)
Republic of Korea	December 12, 2008	180	27.3
	October 26, 2014	360	54.6
Hong Kong	January 20, 2009	200	30.4
	November 27, 2014	400	60.7
Malaysia	February 8, 2009	80	12.1
	April 18, 2015	180	27.3
Belarus	March 11, 2009	20	3.0
Indonesia	March 23, 2009	100	15.2
	October 1, 2013	100	15.2
Argentina	April 2, 2009	70	10.6
	July 18, 2014	70	10.6
Iceland	June 9, 2010	3.5	0.5
	October 14, 2013	3.5	0.5
Singapore	July 23, 2010	150	22.8
	March 7, 2013	300	45.5
New Zealand	April 18, 2011	25	3.8

[177] Fion Li, "China to Allow Direct Conversion Between Yuan and Swiss Franc," *Bloomberg*, November 9, 2015, http://www.bloomberg.com/news/articles/2015-11-09/china-to-allow-direct-conversion-between-yuan-and-swiss-franc

[178] "China, South Korea to launch direct trading of yuan/won," *Reuters*, February 26, 2016; http://www.reuters.com/article/us-china-yuan-

	May 22, 2014	25	3.8
Uzbekistan	April 9, 2011	0.7	0.1
Mongolia	April 19, 2011	5	0.8
	March 20, 2012	10	1.5
	August 21, 2014	15	2.3
Kazakhstan	June 13, 2011	7	1.1
	December 14, 2014	7	1.1
Thailand	December 22, 2011	70	10.6
	December 22, 2014	70	10.6
Pakistan	December 23, 2011	10	1.5
UAE	January 17, 2012	35	5.3
Turkey	February 21, 2012	10	1.5
Australia	March 22, 2012	200	30.4
	April 8, 2015	200	30.4
Ukraine	June 26, 2012	15	2.3
Brazil	March 26, 2013	190	28.8
United Kingdom	June 22, 2013	200	30.4
Hungary	September 9, 2013	10	1.5
Albania	September 12, 2013	2	0.3
ECB	October 10, 2013	350	53.1
Switzerland	July 21, 2014	150	22.8
Sri Lanka	September 16, 2014	10	1.5
Russia	October 13, 2014	150	22.8
Qatar	November 3, 2014	35	5.3
Canada	November 18, 2014	200	30.4
Nepal	December 25, 2014	Unknown	Unknown
Surinam	March 18, 2015	1	0.2
Armenia	March 30, 2015	1	0.2
South Africa	April 10, 2015	30	4.6
Chile	May 25, 2015	22	3.3
Tajikistan	September 7, 2015	3	0.5
Total Amount		**3,162**	**482**

Sources: PBoC and other participating central banks

Notes: The U.S. dollar equivalent amounts are based on the June 22, 2016 exchange rate of 6.59 RMB per dollar. The table shows only the dates of the initial arrangement and the latest arrangement (where the initial arrangement has been renewed).

BSAs are not a new animal in the history of cooperative relations among central banks. The US Federal Reserve ('the Fed'), which engaged in its first swap transaction with the Bank of England in 1925[179], negotiated, in the early 1960s, a currency swap network between the central banks of the major industrial economies that lasted decades.[180] The 2008-9 global financial crisis also induced the Fed to quickly set up BSAs with 14 central banks (the European Central Bank and 13 other central banks, in Switzerland, Japan, England, Canada, Australia, Sweden, Denmark, Norway, New Zealand, Brazil, Mexico, Republic of Korea, and Singapore). The Fed, in the words of Daniel McDowell (2011), took "extraordinary action to address global dollar scarcity" through these dollar-swap lines, being "uniquely positioned to act as ILOLR (international lender of last resort), given the dollar's international role and its monopoly on printing the currency."[181]

In fact, the PBoC had signed a number of swap lines with other Asian central banks in the past. However, the BSAs that it began to sign since the 2009-0 global financial crisis are fundamentally different both in nature and scope from previously concluded ones:

> First of all, the average size of China's recent swap lines is much bigger than its old ones signed between 2001-3, as shown in Table 4 below (for comparison purposes, only some of the swap agreements are listed.). The current BSAs are approximately 10 times larger than the previous ones.[182]

Table 4: China's Bilateral Swap Arrangements (BSAs): Old -v- New

Old (2001-2003)			New (2008-)		
Date	**Country**	**Amount (US$bn)**	**Date**	**Country**	**Amount (RMB/US$bn)**
Dec-01	Thailand	2	Dec-11	Thailand	70/10.6
Jun-02	Korea	2	Dec-08	Korea	180/27.3

[179] "East Asia Financial Cooperation, The Chiang Mai Initiative," Institute for International Economics (IIE), p. 16. ("Benjamin Strong provided $200 million in gold to the Bank of England against sterling to facilitate the reestablishment of the pound's pre-World I gold parity. This transaction set the legal precedent for such arrangements by the Fed.")

[180] Steven Liao and Daniel E. McDowell, "Redback Rising: China's Bilateral Swap Agreements and RMB Internationalization," *International Studies Quarterly* (2014) 1–20, http://www.academia.edu/3129424/Redback_Rising_China_s_Bilateral_Swap_Agreements_and_RMB_Internationalization

[181] Daniel McDowell, "The US as 'Sovereign International Last-Resort Lender': The Fed's Currency Swap Programme during the Great Panic of 2007-09," *New Political Economy*, 11 March 2011, pp. 8-9 and p. 19.

[182] Qu Hongbin, Sun Junwei and Donna Kwok (2010), op. cit., pp.40-41.

Renewed			Oct-14		360/54.6
Oct-02	Malaysia	1.5	Feb-09	Malaysia	80/12.1
Renewed			Feb-12		180/27.3
Dec-03	Indonesia	1	Mar-09	Indonesia	100/15.2

Source: HSBC and PBoC

Note: The U.S. dollar equivalent amounts are based on the June 22, 2016 exchange rate of 6.59 RMB per dollar.

Secondly, as the size of the recent swap lines suggests, [their purpose has been gradually shifted away from the provision of emergency liquidity to normal operational use - trade settlement.][183] This also has to do with China's motive to internationalize the use of its currency. Moreover, given China's global stature in trade, the network of China's BSAs has become global, which is different from China's earlier experiment with BSAs. When Chinese exports fell dramatically in 2008, Chinese policymakers concluded that while this was largely due to the drop in global demand in the aftermath of Lehman Brothers in September of 2008, the collapse of trade financing which was associated with the global "shortage of US dollars"[184] was also responsible, as the *BIS Quarterly Review (2009)* observes. The PBoC's response was to intensify its efforts to sign bilateral currency swap agreements with other central banks to insure against a repeat of such events.[185] Moreover, given China's global stature in trade, the network of China's BSAs has become global, which is different from China's earlier experiment with BSAs.

Thirdly, what is most important is that the bilateral swap arrangements China has signed since 2008 are "designed to facilitate settlement in renminbi." For example, the BSA between China and Pakistan specified that "the use of currency swap agreements should be based on either bilateral trade or direct investment transactions."[186] Thus, it is also seen as an "attempt to bypass the US dollar as a medium of exchange"[187] (William Wilson, 2015).

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[183] Ibid.

[184] Patrick McGuire and Goetz Von Peter, "The US dollar shortage in global banking," *BIS Quarterly Review*, March 2009, pp. 57-59.

[185] Miriam Campanella (2014), op. cit., p. 3.

[186] Cindy Li, "Banking on China through Currency Swap Agreements," Federal Reserve Bank of San Francisco, October 23, 2015, http://www.frbsf.org/banking/asia-program/pacific-exchange-blog/banking-on-china-renminbi-currency-swap-agreements/

[187] William T. Wilson, "Washington, China, and the Rise of the Renminbi: Are the Dollar's Days as the Global Reserve Currency Numbered?" Heritage Foundation Special Report #171 on China, August 17, 2015, http://www.heritage.org/research/reports/2015/08/washington-china-and-the-rise-of-the-renminbi-are-the-dollars-days-as-the-global-reserve-currency-numbered

In addition, it is important to encourage foreign central banks to use RMB as their reserves in order to advance China's RMB internationalization strategy. China is also making efforts to achieve this objective through the conclusion of BSAs, as Barry Eichengreen (2012) notes.[188] Although the amounts involved in the BSAs are currently relatively small, they would further enhance and promote the RMB's profile as a viable currency for other central banks.

Launching the China International Payment System (CIPS)

On October 8th, 2015, China introduced the Cross-border Interbank Payment System, known as China International Payment System (CIPS). CIPS is aimed at addressing many of the existing problems facing cross-border renminbi payments, with a number of expected benefits:[189]

1. CIPS provides one-point entry by participants and a central location for clearing renminbi payments, as well as allowing participation by both onshore and offshore banks and providing direct access to the China National Advanced Payment System (CNAPS). These features reduce the need for banks to navigate complicated payment pathways via offshore clearing hubs or through correspondent banks.
2. CIPS is a real-time gross settlement system, meaning that banks immediately settle payments between each other on a gross rather than a net basis. This reduces credit risks that can arise in systems where payments are netted before settlement.
3. Payment messages sent within CIPS are written in both English and Chinese. This eliminates the necessity for translating messages into Chinese before they can be transmitted to CNAPS.
4. CIPS uses the ISO20022 messaging standard, a widely used international messaging scheme for cash, securities, trade and foreign exchange transactions. CIPS will also use SWIFT bank identifier codes, rather than CNAPS clearing codes. These factors will allow CIPS to smoothly process payments flowing between offshore banks using SWIFT and mainland banks using CNAPS.

In short, CIPS is, according to Deutsche Bundesbank, "designed to provide an infrastructural buffer for the expected growth in RMB transactions and only clears offshore payments denominated in that currency." Thus, it can be regarded as a "complementary measure to assist the ascent of the renminbi to global reserve currency status."[190] This cross-border

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[188] Barry Eichengreen, "When Currencies Collapse: Will We Replay the 1930s or the 1970s?" *Foreign Affairs* (January/February 2012), p. 130.

[189] Nicholas Borst, "CIPS and the International Role of the Renminbi," January 27, 2016, http://www.frbsf.org/banking/programs/asia-program/pacific-exchange-blog/cips-and-the-international-role-of-the-renminbi .

[190] "Renminbi clearing in Frankfurt and additional developments relating to offshore clearing," Deutsche Bundesbank, https://www.bundesbank.de/Redaktion/EN/Standardartikel/Tasks/Payment_systems/rmb_clearing_fra

renminbi payments system CIPS "will put the yuan on a more even footing with other major global currencies like the dollar - CIPS is expected to use the same messaging format as other international payment systems - and helping to promote the currency in global trade where the dollar reigns supreme."[191] As such, the new system would become "a big step in its drive to boost international use of the Chinese currency"[192], according to the *Financial Times*. On March 25th, 2016, CIPS received further support when it signed a memorandum of understanding on a cross-border interbank payment system with SWIFT.[193]

B. Expanding FTA Networks

The 'economic territory' of a country has been defined as "the geographic territory administered by a government within which persons, goods and capital circulate freely."[194] Various trade deals at bilateral, regional and multilateral levels serve as channels for countries to seek to expand their economic territory. Free-trade agreements (FTAs) will lead to trade expansion, among others, between FTA partners. Growing bilateral trade will most likely spur the need and propensity for invoicing, settling and financing trade in their currencies on the part of businesses within the FTA partners. Thus, China's expanded FTA network would also greatly complement China's efforts to take forward its RMB internationalization agenda.

It was not until after the country's WTO accession in 2001 that the Chinese government began to actively build its bilateral and regional free-trade agreement (FTA)/Comprehensive Economic Partnership Agreement (CEPA) network. China initially focused its efforts on concluding FTA/CEPA deals with its neighbors and countries in the Asia Pacific. Between 2003 and 2007, China signed CEPAs with Hong Kong and Macao, while successfully concluding FTAs with ASEAN, Pakistan and Chile.

The US participation in the TPP (Trans-pacific Partnership) negotiations in 2008 not only

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nkfurt.html

[191] Michelle Chen, "China's international yuan payment system pursues world finance," *Reuters*, October 8, 2015, HTTP://UK.REUTERS.COM/ARTICLE/UK-CHINA-YUAN-CIPS-IDUKKCN0S20VG20151008

[192] Gabriel Wildau, "China launch of renminbi payments system reflects Swift spying concerns," *The Financial Times*, October 8, 2015; http://www.ft.com/intl/cms/s/0/84241292-66a1-11e5-a155-02b6f8af6a62.html#axzz42gUJPwlD

[193] "SWIFT and CIPS sign memorandum of understanding on cross-border interbank payment system," *SWIFT*, https://www.swift.com/insights/press-releases/swift-and-cips-co_sign-memorandum-of-understanding-on-cross-border-interbank-payment-system-cooperation

[194] "International Merchandise Trade Statistics: Concepts and Definitions," Revision 2 (United Nations Publications, Sales No. E.98.XVII.16) para. 64

helped to increase China's interest in the TPP negotiations, but also provided an opportunity for China to review its FTA strategy. Various views were expressed in China over Washington's real intentions behind joining the TPP negotiations. Some suggested the US's desire to "boost its domestic economy via increased exports in the Asia Pacific region", while others perceived Washington's 'geopolitical' or 'strategic' motives to advance its recent 'pivot to Asia', in order to "contain China's rise in East Asia" or to dilute "China's influence in the Asia-Pacific region." Still others saw the US agenda as seeking to "interfere with East Asia's regional economic integration" and eventually to become "the dominant economic power in the region" by "gaining the upper hand over China."[195]

Beijing concluded that it would be in its best interest to actively push for its own FTA strategy; as Li Wei, President of the Development Research Center of the State Council, pointed out in a keynote speech at the Asian Financial Forum in January 2012, "the Chinese government's unswerving policy is to accelerate the development of free-trade areas with China's major trading partners in Asia."[196]

As a result, since 2008, China has made continued efforts to expand its FTA network by concluding a series of FTAs with its trading partners in the Asia Pacific, such as New Zealand, Singapore, Peru, Taiwan, the Republic of Korea, and Australia, as well as in other regions, including Switzerland, Iceland and Costa Rica. China played a key role in helping launch two important regional free trade initiatives – the trilateral Korea-China-Japan FTA and the RCEP involving ASEAN plus six other countries (Korea, China, Japan, India, Australia and New Zealand) – that were started in November 2012. China currently has 14 FTAs /CEPAs which are in operation, while undertaking another five trade deals as Table 5 shows.[197]

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[195] Guoyou Song and Wen Jin Yuan, "China's Free Trade Agreement Strategies," *THE WASHINGTON QUARTERLY* (Fall 2012), pp. 108-109; Zha Daojiong, "China's Economic Policy: Focusing on the Asia-Pacific Region," *China Quarterly of International Strategic Studies*, Vol. 1, No. 1, pp. 98-99.

[196] Guoyou Song and Wen Jin Yuan, op. cit., pp. 111-112 and p. 116

[197] "China FTA Network," Ministry of Commerce, PRC, http://fta.mofcom.gov.cn/english/index.shtml

Table 5: China's FTA Network

Conclusion/under Negotiation	FTA/CEPA Partner	Status
Conclusion (14)	Hong Kong	CEPA signed in 2003
	Macao	CEPA signed in 2003
	ASEAN	FTAs in goods, services and investment took effect in July 2005, July 2007 and January 2010, respectively.
	Chile	FTA in goods became effective in October 2006, while FTA in services took effect in August 2010.
	Pakistan	FTA in goods and investment became effective in July 2007, while FTA in services took effect in October 2009.
	New Zealand	FTA took effect in October 2008
	Singapore	FTA signed in October 2008
	Peru	FTA took effect in January 2010
	Costa Rica	FTA took effect in August 2011
	Taiwan	ECFA (Economic Cooperation Framework Agreement) signed in June 2010; Service Trade Agreement signed in June 2013; Agreement on Goods Trade under negotiation
	Iceland	FTA took effect in July 2014
	Switzerland	FTA took effect in July 2014
	Korea	FTA came into force in December 2015
	Australia	FTA took effect in December 2015
Under Negotiation (7)	GCC	FTA negotiations launched in April 2005; Seventh round held in May 2016
	Norway	FTA negotiations launched in September 2008; Eighth round held in September 2010
	Maldives	MOU on Launching the Negotiation of China-Maldives FTA signed in October 2015
	Korea-China-Japan	FTA negotiation launched in November 20, 2012; Tenth round held in June 2016
	RCEP	Negotiations launched in November 2012;

		Thirteenth round held in June 2016
	Sri Lanka	Second round held in December 2014v
	Gerogia	Second round held in May 2016
Under Consideration (5)	India, Columbia, Moldova, Fiji, and Nepal	Joint Feasibility Study being undertaken

Source: "China FTA Network," Ministry of Commerce, PRC

In the meantime, on December 17th, 2015, China's State Council released guidelines on accelerating implementation of its free trade agreement (FTA) strategy, with the aim of gradually fostering a "global free trade network." According to the guidelines, the near-term goal of China's FTA strategy is to "promote negotiations with neighboring countries and liberalize trade in existing free trade areas," while, in the longer term, China aims to "expand the network to cover all neighboring countries and regions, countries within the Belt and Road network, most emerging economies, big developing countries, major regional economic groups, and parts of the developed world."[198] If realized, it would certainly give a big boost to China's RMB internationalization strategy.

C. Launching the One-Belt-One-Road (OBOR) Initiative

On September 7th, 2013, Chinese President Xi Jinping took advantage of his state visit to Kazakhstan to propose to build an "economic belt along the Silk Road," a trans-Eurasian project stretching from the Pacific Ocean to the Baltic Sea. Within one month, on October 3rd, 2013, he used another occasion - his state visit to Indonesia - to propose a "new maritime silk road.".[199] The so-called 'One Belt, One Road' initiative came to light. (Figure 13) The initiative is indeed ambitious, given that it will potentially involve an area that covers "55 percent of world GNP, 70 percent of global population, and 75 percent of known energy reserves."[200]

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198 "China aims to expand global FTA network," *China.org.cn*, December 18, 2015; http://www.china.org.cn/china/2015-12/18/content_37346008.htm

199 "'One Belt and One Road,' Far-reaching Initiative," *Chinafocus.com*, March 26, 2015; http://www.chinausfocus.com/finance-economy/one-belt-and-one-road-far-reaching-initiative/

200 "'ONE BELT, ONE ROAD': CHINA'S GREAT LEAP OUTWARD," European Council on Foreign Relations, *China Analysis*, June 2015, p. 1.

Figure 13. One-Belt-One Road Initiative

Source: "'One Belt and One Road', Far-reaching Initiative," *Chinafocus.com*

As the map shows, under the grand theme of 'One Belt, One Road' (OBOR), something like a recreation of China's traditional Silk Road aims to provide land and maritime connectivity from China, through Asia and the Middle East, to Africa and Europe, thereby linking 60 nations across four continents.

China has since moved fast to implement this initiative. In December 2014, China pledged to contribute US$ 40 billion to the Silk Road Fund. President Xi Jinping was quoted as saying that the goal of the Silk Road Fund is to "break the connectivity bottleneck" in Asia, while the fund, together with the new AIIB (Asian Infrastructure Investment Bank), would "complement, not substitute" existing lending institutions.[201] On February 16th, 2015, the Silk Road Fund became operational.

If realized, the OBOR initiative could have huge implications not only for China's economic and geopolitical interests, but also its RMB internationalization strategy:

> To begin with, it would enable Chinese companies to successfully carry out the Chinese government's 'going out' strategy through helping them to establish foreign trade strongholds or production bases along the routes covered by the initiative. It could provide a practical solution to China's growing problem of surplus production capacity, and also help resuscitate China's 'Go West' policy by promoting the economic development of the western regions of the country.[202]

[201] Jeremy Page, "China to Contribute $40 Billion to Silk Road Fund," *The Wall Street Journal*, November 8, 2014, http://www.wsj.com/articles/china-to-contribute-40-billion-to-silk-road-fund-1415454995

[202] "'ONE BELT, ONE ROAD': CHINA'S GREAT LEAP OUTWARD," European Council on Foreign Relations, *China Analysis*, June 2015, p. 9; Vixtorian Ruan, "China's new Silk Road plan builds on failed Go West drive," *The South China Morning Post*, June 2, 2014,

Secondly, the initiative could allow the Chinese to cope with the "*de facto* containment effects" of the US's policies towards them, including the Obama administration's 'Pivot to Asia strategy'. It could also provide China with "better access to energy and food" in such a way that would address Beijing's concern over "transportation routes controlled by the US military", especially, in view of the fact that "about 80 percent of China's oil imports go through the Strait of Malacca, crowded and under the control of the US military and non-Chinese commercial entities."[203]

Last but not least, the OBOR project could create huge demand for the RMB along its routes because it will be carried out in such a way as to enhance 'five connections': trade, infrastructure, investment, capital and people. Bilateral trade between OBOR countries and China accounts for roughly a quarter of China's total foreign trade. The OBOR initiative will expedite China's bilateral trade and investment activity with these countries along the OBOR route, which will in turn enhance interest in pricing commodities in renminbi on both sides.[204] According to *Bloomberg*, since "China's state banks are already lending big to countries along the new routes, the expansion of China-backed finance could propel Beijing's quest for greater international stature for the renminbi."[205] In 2015, "nearly half of all overseas contracted projects signed by China were along the Belt and Road," while "Chinese enterprises invested in 49 countries along these routes, with total investment reaching US$14.8 billion, or 12.5 per cent of China's total non-financial ODI."[206] According to a special report released in November 2015 by the Standard Chartered Bank, "official financing" for the OBOR infrastructure initiative, which consists of a network of overland roads and rail routes, oil and natural gas pipelines, and other infrastructure projects, "could top one trillion USD in the next decade."[207] "The

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http://www.scmp.com/business/economy/article/1523471/chinas-new-silk-road-plan-builds-failed-go-west-drive

[203] Shuaihua Wallace Cheng, "China's New Silk Road: Implications for the US," *YaleGlobal*, May 28, 2015; Simon Denyer, "China bypasses American 'New Silk Road' with two if its own," *The Washington Post*, October 14, 2013, https://www.washingtonpost.com/world/asia_pacific/china-bypasses-american-new-silk-road-with-two-if-its-own/2013/10/14/49f9f60c-3284-11e3-ad00-ec4c6b31cbed_story.html

[204] Cecily Liu, "Chinese OBOR–linked investments to boost RMB internationalization," *chinadaily.com*, November 2, 2015, http://www.chinadaily.com.cn/world/2015-11/02/content_22350361.htm

[205] Michael Schuman, "China's New Silk Road Dream," *Bloomberg*, November 26, 2015, http://www.bloomberg.com/news/articles/2015-11-25/china-s-new-silk-road-dream

[206] "Rising to the challenge, shaping a different future," Speech by Stuart Gulliver Group Chief Executive, *HSBC Holdings plc*, HSBC China & RMB Forum Hong Kong, 7 April 2016.

[207] "Special Report - Economics: Asia growth: Who matters most?" Standard Chartered Bank, November 12, 2015, p. 23.

recent establishment of the Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB), in which China is the biggest shareholder, should also boost Chinese investment in the region," the bank further notes.[208]

Increased trade and Chinese investment – leveraging its huge foreign exchange reserves - as well as more Chinese companies going global under the implementation of the modern-day Silk Road network initiative will "add support for RMB internationalization." As one Chinese media organ recently put it, "RMB Internationalization Spreads Wings with 'Belt and Road' Strategy."[209]

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[208] Ibid.

[209] "'One Belt, One Road' and RMB internationalization serve global interest," *Xinhuanet.com*, October 9, 2015, http://news.xinhuanet.com/english/2015-10/09/c_134695173.htm;. "RMB Internationalization Spreads Wings with 'Belt and Road' Strategy," *Chinafocus.com*, June 8, 2015, http://www.chinausfocus.com/finance-economy/rmb-internationalization-spreads-wings-with-belt-and-road-strategy/; Cindy Tian, "APEC: China Drives Agenda for a More Integrated Asia Pacific," December 8, 2014, http://www.edelman.com/post/apec-china-drives-agenda-integrated-asia-pacific/

3.3. Pillar III: Accelerating Momentum for the New IMS

As the previous section demonstrates, the Chinese government has 'gradually, steadily, and aggressively, where necessary,' pushed ahead with its RMB internationalization strategy by taking a variety of measures under Pillars I and II that are designed to further promote the actual use of the RMB as a currency for trade and investment vehicles, as well as to build and expand the offshore RMB infrastructure and networks. The third pillar of its strategy is related to China's unswerving efforts to reform the current IMS, to which the Chinese leadership has given top priority since the RMB internationalization strategy began in earnest in 2009.

On January 16th, 2011, at a time when China and the stature of its currency, the RMB, were getting the world's renewed attention in the aftermath of the global financial crisis and the Global Great Recession, and ahead of his visit to Washington, Hu Jintao, the then Chinese President, had a joint interview with the *Wall Street Journal* and the *Washington Post*. During that interview, Hu called the present US dollar-dominated currency system a "product of the past" and highlighted moves to turn the yuan into a global currency.[210] In an interview with the *WSJ* on September 22, 2015, just before he embarked on his first state visit to the United States since his taking office, Chinese President Xi Jinping replied to the question, "Is China trying to rearrange the architecture of global governance, away from the US and toward China?" by saying that[211]:

> "The global governance system is built and shared by the world, not monopolized by a single country…Many visionary people hold that as the global landscape evolves and major transnational and global challenges facing mankind increase, it is necessary to adjust and reform the global governance system and mechanism… Such reform is not about dismantling the existing system and creating a new one to replace it…Rather, it aims to improve the global governance system in an *innovative way.*"

From the perspective of the Chinese leadership, the reform of the current IMS is intertwined with its goal of RMB internationalization. This section shows how the Chinese government has been trying to improve the current IMS in an "innovative way", as President Xi indicated.

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[210] Andrew Browne, "China's President Lays Groundwork for Obama Talks," *The Wall Street Journal*, January 17, 2011, http://www.wsj.com/articles/SB10001424052748703551604576085803801776090

[211] "Full Transcript: Interview with Chinese President Xi Jinping," *The Wall Street Journal*, September 22, 2015, http://www.wsj.com/articles/full-transcript-interview-with-chinese-president-xi-jinping-1442894700

A. Expanding a Regional Financial Structure

The Chiang Mai Initiative (CMI)

China has made continued efforts to build up momentum for improving the current IMS in a steady and sophisticated manner. One of the innovative ways of doing this, in Beijing's eyes, is to refurbish the existing regional financial structure and to establish a new one, while reflecting the economic situations in and around Asia. The *Chiang Mai Initiative (CMI)* of 2000, a multilateral currency swap arrangement among the ASEAN+3 (Korea, China and Japan), offered an opportunity for China to move in this direction.

Being "profoundly resentful of their treatment by the international community during the 1997-98 crisis," the leaders of ASEAN invited the leaders of China, Japan and South Korea to attend the ASEAN+3 Summit held in Kuala Lumpur, Malaysia, in November 1997.[212] In the next such summit held in Hanoi in 1998, China proposed to regularize meetings among deputies from ASEAN+3 finance ministries and central banks, in order "to explore possibilities for cooperation."[213] More attention and efforts, particularly at the top level of the ASEAN+3 countries, enabled the ASEAN+3 finance ministers in their meeting held in Chiang Mai, Thailand in May 2000 to agree to launch the *Chiang Mai Initiative (CMI).* In their joint ministerial statement, they said: "In order to strengthen our self-help and support mechanisms in East Asia through the ASEAN+3 framework, we recognized a need to establish a regional financing arrangement to supplement the existing international facilities." The Initiative involved an expanded ASEAN Swap Arrangement that would include all ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among the ASEAN countries, China, Japan and the Republic of Korea.[214]

The initiative was meaningful. To begin with, as mentioned earlier, the CMI was the product of "the region's disaffection with the International Monetary Fund (IMF), stemming from the 1997–98 crisis,"[215] as well as of ASEAN's outreach to the three Northeast Asian countries. (Henning, 2009 and Sussangkarn, 2011) Therefore, the nature of the CMI as a 'self-help' financial safety net in Asia could reduce Washington's influence over Asia in the

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[212] "EAST ASIAN FINANCIAL COOPERATION, The Chiang Mai Initiative," Institute for International Economics (IIE), p. 11, http://www.iie.com/publications/ chapters preview/345/3iie3381.pdf

[213] Ibid.

[214] "The Joint Ministerial Statement of the ASEAN + 3 Finance Ministers Meeting," 6 May 2000, Chiang Mai, Thailand

[215] C. Randall Henning, "The Future of the Chiang Mai Initiative: An Asian Monetary Fund?" Peterson Institute for International Economics, *Policy Brief Number Pb09-5*, February 2009, p.1; Chalongphob Sussangkarn, "Chiang Mai Initiative Multilateralization: Origin, Development, and Outlook," *Asian Economic Policy Review (2011)*, p.206.

future, while giving more say to the three Northeast Asian countries, especially, China. On top of that, the CMI would provide an institutional framework for the regional set of bilateral currency swap agreements (BSAs) to evolve depending on the situation. By the same token, the amounts involved in the BSAs can be changed more easily "once an agreement is in place than negotiating an entirely new agreement."[216]

The Chiang Mai Initiative Multilateralization (CMIM)

Over time, it became clear that the CMI should be further upgraded to adjust to the rapidly changing economic and financial landscape, particularly, in Asia. In 2007, it was agreed to improve the CMI and turn it into a 'multilateral' agreement, the *Chiang Mai Initiative Multilateralization (CMIM)*. The global financial crisis triggered by the Lehman collapse in September 2008 caused global liquidity to contract massively, which prompted urgent action to ensure that the CMIM can function as an effective regional financial safety net.

On December 28th, 2009, *the Chiang Mai Initiative Multilateralization* (CMIM) agreement was signed. As one CSIS report notes, "among the ASEAN+3 nations, China has always actively pushed for the BSAs" – a network of bilateral swap agreements among the ASEAN+3 nations signed under the CMI – "to evolve into a 'multilateral mechanism.'"[217] China apparently concluded that the CMIM would serve its interests "from a wider economic as well as a geopolitical perspective."[218] Given the rapidly growing exports from Southwestern China to ASEAN countries that had increased more than fourfold from US$1.04 billion in 2000 to US$4.26 billion in 2007, building a financial safety net for its ASEAN neighbors would make economic sense. In addition, the same report points out, "support for an ASEAN foreign reserve pool" would enable China to advance its strategic interests as well. As a practical approach to its "diplomatic charm offensive…through actively participating in regional and multilateral organizations", including the CMIM, China could give the impression that "it (was) a constructive partner in the international community and a reliable bilateral partner."[219]

China could also make the most of Hong Kong as it attempted to turn the CMI into the CMIM. Hong Kong was "already a *de facto* participant in the pre-CMIM process", according

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[216] "EAST ASIAN FINANCIAL COOPERATION, The Chiang Mai Initiative," Institute for International Economics (IIE), p.24; C. Randall Henning, op. cit., p.2.

[217] Wen Jin Yuan and Melissa Murphy, "Regional Monetary Cooperation in East Asia Should the United States Be Concerned?" *A Report of the CSIS Freeman Chair in China Studies*, CSIS, November 2010, p.2.

[218] Ibid., p.4.

[219] Ibid.

to Kaewkamol Karen Pitakdumrongkit.[220] In her book, *Surviving the Turbulence* (2015), Pitakdumrongkit contends that given Hong Kong's expertise in financial technicalities as one of the major financial centers in the region and the world, together with its special bond with mainland China, the island's actual participation was also expected not only to "strengthen Beijing's leverage over the crafting of the agreement details," but also to enable China to continue to play a key role in the future evolution of the CMIM. In addition, "bringing Hong Kong into the CMIM" was significant for China since it was "part of Beijing's 'RMB internationalization'", and was, effectively, a key offshore testing ground for that internationalization. Given China's intention "to use Hong Kong as a regional channel to increase the use of its currency through the network of CMIM's currency swap arrangements by the latter," Hong Kong's inclusion in the CMIM would make meaningful contributions to the RMB internationalization effort in the future.[221] Thus, Hong Kong's inclusion in the CMIM was a success for China.

The CMIM has continued to evolve since it took effect on March 24th, 2010. The key elements of the CMIM are[222]:

(i) The establishment of the fund aimed at providing short-term liquidity assistance to the members of the CMIM countries during a serious financial crisis, which started with US$120 billion and doubled to US$240 billion;
(ii) The introduction of the CMIM Precautionary Line (CMIM-PL), a crisis-prevention mechanism modeled after the IMF's crisis-prevention facility, and of a crisis resolution facility called CMIM Stability Facility (CMIMSF);
(iii) The implementation of the IMF de-linked portion - an amount of CMIM allowed to be taken out without a link to IMF programs as a way of strengthening the members' ability to deal with a crisis – which was raised from 20 to 30 percent with the possibility of its being further increased;
(iv) The establishment of the ASEAN+3 Macroeconomic Research Office (AMRO).

The above evolution of the CMIM may have had a significant impact on the reforms of the IMF, thereby helping RMB internationalization. Indeed, it was perceived that the CMIM

[220] Kaewkamol Karen Pitakdumrongkit, *Negotiating Financial Agreement in East Asia: Surviving the Turbulence* (Routledge, 2015), p.61

[221] Ibid.

[222] "ASEAN+3 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS' MEETING SUCCESSFULLY CONCLUDES," Press Release, Ministry of Strategy of Finance, Republic of Korea

and the AMRO had set the stage for the institutionalization of East Asia regionalism.[223] As had been shown throughout the CMIM process, China's leadership could enhance its influence in Asia, which could in turn provide maneuvering room for China as Beijing actively proceeds with its RMB internationalization, at least in East Asia. In fact, this multilateral initiative in Asia has been described as "still a work in progress," with its future trajectory involving "both technical sophistication" and "politics."[224] Historical and territorial disputes among ASEAN+3 member countries, among other concerns, have hamstrung the efforts of its members to develop a strong fund, something like the Asian Monetary Fund.[225] The AMRO should change its modus operandi in order to effectively carry out its mandate as the CMIM's arm for surveillance.

However, it is not clear at this stage, observes Evelyn Goh (2016), "whether China (or Japan) will be able to lead a more demanding surveillance process and (be) willing to pay the political price for using this channel of influence."[226] Nevertheless, the achievements of building and institutionalizing an Asia-wide financial crisis response architecture should not be underestimated. The AMRO is intended "not to be a substitute for the IMF", but "to enhance objective monitoring by supplementing the IMF especially its Short-term Liquidity Facility"[227] (P.B. Rana, 2012). However, this should not be construed as ruling out the possibility that the AMRO might be compelled to act on behalf of the IMF in Asia further down the road unless the latter should continue reforms to remain relevant.

The IMF has responded positively with its "2010 Quota and Governance Reforms," which cleared the last hurdle with the approval of these reforms by the US Congress in December 2015. "This is the biggest shake-up since the IMF and the World Bank were set up to manage the post-World War Two economy," which, according to a BBC report at the end of 2015, would lead to China's voting rights rising from 3.8% to 6%, and IMF resources doubling to about $660bn.[228] "Along with the passage of the Trade Promotion Authority and the conclusion of negotiations on the Trans-Pacific Partnership trade agreement this year,

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[223] Pradumna Bickram Rana, *Renaissance of Asia: Evolving Economic Relations Between South Asia and East Asia* (World Scientific, 2012), p.36.

[224] Kaewkamol Pitakdumrongkit, "Where to now for the Chiang Mai Initiative Multilateralisation?" August 28, 2015, http://www.eastasiaforum.org/2015/08/28/where-to-now-for-the-chiang-mai-initiative-multilateralisation/; William W. Grimes, "The Asian Monetary Fund Reborn?: Implications of Chiang Mai Initiative Multilaterlization," *Asia Policy*, Number 11, January 2011, pp. 103-104.

[225] John D. Ciorciari, "Chiang Mai Initiative Multilateralization: international politics and institution-building in Asia," *Asian Survey*, Vol.51, No.5, September/October, 2011, pp. 926-952

[226] Evelyn Goh, *Rising China's Influence in Developing Asia* (Oxford University Press, 2016), p.229.

[227] Pradumna Bickram Rana, *Renaissance of Asia: Evolving Economic Relations Between South Asia and East Asia* (World Scientific, 2012), p.36.

[228] "IMF reforms clear last hurdle with US adoption," *BBC*, December 19, 2015, http://www.bbc.com/news/business-35141683

the IMF reforms reinforce the central leadership role of the United States in the global economic system and demonstrate our commitment to maintaining that position." said US Treasury Secretary Jacob Lew.[229] Christine Lagarde, Managing Director of the International Monetary Fund (IMF), welcomed the US adoption: "The reforms significantly increase the IMF's core resources, enabling us to respond to crises more effectively, and also improve the IMF's governance by better reflecting the increasing role of dynamic emerging and developing countries in the global economy."[230]

In a sense, the adoption of the IMF reforms could be seen as a development strengthening China's efforts to nudge the IMF and its key players into reforming the current IMS through pushing ahead with such initiatives as the CMIM and the AIIB (Asia Infrastructure Investment Bank), as was indicated by the PBoC statement that the reform "will improve the representation and voice of emerging markets and developing countries in the IMF and is conducive to protecting the IMF's credibility, legitimacy and effectiveness".[231] This will eventually contribute to creating an international environment conducive to RMB internationalization.

B. Launching Development Banks

China's alleged efforts to complement the existing development-side regional and international institutions – ADB and World Bank – have been taking shape through pushing for the establishment of the AIIB (Asian Infrastructure Investment Bank), the BRICS New Development Bank, and the SCO development bank. These efforts could be seen as part of China's overall strategy aimed at reforming the global governance structure as well as creating offshore demand for the RMB, both of which would in turn provide a fertile ground for the advancement of Beijing's RMB internationalization agenda.

Asian Infrastructure Investment Bank (AIIB)

In his address to the Indonesian parliament on October 2nd, 2013, Chinese President Xi Jinping said, "There is no one-size-fits-all development model in the world or an unchanging

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[229] "Treasury Secretary Jacob J. Lew on Final Passage of the Omnibus Spending Bill," US Treasury Press Release, December 18, 2015, https://www.treasury.gov/press-center/press-releases/Pages/jl0312.aspx

[230] "IMF Managing Director Christine Lagarde Welcomes U.S. Congressional Approval of the 2010 Quota and Governance Reforms," *IMF Press Release* No. 15/573, December 18, 2015, https://www.imf.org/external/np/sec/pr/2015/pr15573.htm

[231] "IMF reforms clear last hurdle with US adoption," *BBC*, December 19, 2015, http://www.bbc.com/news/business-35141683

development path" and "China will propose the establishment of an Asian infrastructure investment bank."[232] "(He) surprised his hosts (and even some of his own officials) with the announcement of a new proposal," reported *The Economist* on October 4th, 2013. "The outlines of this are so far rudimentary. But the basic idea is clear enough: to harness some of China's vast financial resources and the expertise acquired in the spectacular modernization in recent decades of China's own infrastructure in order to improve it elsewhere in the region," said the paper.[233] According to the Asian Infrastructure Investment Bank (AIIB), it "was envisaged to promote interconnectivity and economic integration in the region and cooperate with existing multilateral development banks." As a "multilateral development bank (MDB)", it "will focus on the development of infrastructure and other productive sectors in Asia, including energy and power, transportation and telecommunications, rural infrastructure and agricultural development, water supply and sanitation, environmental protection, urban development and logistics, etc."[234]

Since the proposal was first laid out by President Xi, Beijing has undertaken a range of bilateral and multilateral discussions and consultations to work out core principles and key elements for establishing the AIIB. In October 2014, twenty-two Asian countries gathered in Beijing to sign a Memorandum of Understanding (MOU) to establish the AIIB. On April 15th, 2015, the Asian Infrastructure Investment Bank (AIIB) was officially launched in Beijing. Almost two months later, on June 29th, 2015, a total of 57 prospective founding members got together in Beijing to attend a ceremony to sign the articles of agreement founding the AIIB, "conspicuously absent" from which, notes the *New York Times*, were "the United States and Japan, the leaders of the World Bank and the Asian Development Bank, the institutions that were created after World War II to build a Western-designed global financial architecture."[235]

The founding and opening of the AIIB have significant implications for the global economic governance system and for RMB internationalization:

- First of all, Beijing's push for the AIIB has been driven by its desire to help change the global economic governance system. There is a view, articulated by one article

[232] "Speech by Chinese President Xi Jinping to Indonesian, 2 October 2013, Jakarta, Indonesia," ASEAN-China Center, October 3, 2013, Parliamenthttp://www.asean-china-center.org/english/2013-10/03/c_133062675.htm

[233] "An Asian infrastructure bank: Only connect," *The Economist*, October 4, 2013, http://www.economist.com/blogs/analects/2013/10/asian-infrastructure-bank-1

[234] "What is the Asian Infrastructure Investment Bank?" ASIAN INFRASTRUCTURE INVESTMENT BANK, http://euweb.aiib.org/html/aboutus/AIIB/?show=0

[235] Jane Perlez, "Xi Hosts 56 Nations at Founding of Asian Infrastructure Bank," *The New York Times*, June 29, 2015, http://www.nytimes.com/2015/06/30/world/asia/xi-jinping-of-china-hosts-nations-at-asian-infrastructure-investment-bank-founding.html?_r=0

in *Foreign Affairs* in July 2015, that "the AIIB was born out of two main grievances about the World Bank and the IMF shared by China and less-developed nations." One grievance is about these countries' 30-year-long "low voting powers," and, as a result, their "disproportionately low influence in both policy initiatives and lending programs," while the other grievance concerns "the conditionality of IMF and World Bank loans."[236] Being aware of this, China has proposed the AIIB "as both rival and partner to existing institutions such as the World Bank and Asian Development Bank."[237] From the perspective of China, the establishment of the AIIB would encourage these institutions to change their *modus operandi* in such a way that will be "consistent with the evolving trend of the global economic landscape" as well as to "help make the global economic governance system more just, equitable and effective," as was pointed out by President Xi Jinping at the official opening of the bank in Beijing on January 16th, 2016.[238] The fact that around sixty nations, including such major economies as Great Britain, Germany, France and Switzerland, have joined the AIIB could be seen as lending more weight to the argument for such reform.

- Secondly, the creation of the bank makes a lot of economic sense for China at a time when it seeks, as the *Financial Times* says, "to find more profitable investment channels for its foreign-exchange reserves, which are now mainly invested in low-yielding US treasuries."[239] In the meantime, the Asia Pacific region needs both significant new financial resources and an institution whose exclusive focus will be on infrastructure building. According to ADB estimates, "The gap between available funding and needed funding is approximately $800 billion annually," which goes far beyond the funding capability of both the World Bank and ADB for infrastructure in the region. Given that the ADB, once dubbed 'Asian Dams and Bridges,' "lists infrastructure as just one of 10 strategic priorities in its 'Strategy 2020' plan," the establishment of "another institution focusing exclusively on infrastructure" would be in the interest of the Asia Pacific region as it could "allow the ADB to turn towards other regional priorities and needs."[240] Thus, the establishment of the AIIB was seen

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236 Rebecca Liao, "Out of the Bretton Woods: How the AIIB is Different," *Foreign Affairs*, July 27, 2015, https://www.foreignaffairs.com/articles/asia/2015-07-27/out-bretton-woods

237 Gabriel Wildau and Tom Mitchell, "China's new Asia development bank will lend in US dollars," *The Financial Times*, January 17, 2016, http://www.ft.com/intl/cms/s/0/762ce968-bcee-11e5-a8c6-deeeb63d6d4b.html#axzz47A6fTghE

238 "Signing of AIIB agreement is historic step: President Xi - the translated version of the full text of his address: Address by President Xi Jinping of China, At the Inauguration Ceremony of the Asian Infrastructure Investment Bank, Beijing, 16 January 2016," *Xinhua*, January 16, 2016, http://news.xinhuanet.com/english/2015-06/29/c_134365817.htm

239 Gabriel Wildau and Tom Mitchell (2016), op. cit.

240 "The Asian Infrastructure Investment Bank," *CSIS, Critical Questions*, March 20, 2015, https://www.csis.org/analysis/asian-infrastructure-investment-bank

to meet all these needs.

- Thirdly, one of the key unanswered questions concerns what currency will be used to fund infrastructure projects to be undertaken by the AIIB. Some pundits predict that "China will push for broader use of the yuan at the AIIB and the Silk Road Fund, as part of efforts to promote the yuan as an international currency."[241] Since "one main function of the AIIB will be to facilitate the internationalization of China's currency – the renminbi (RMB)," the next US President "will face the challenge of managing the domestic politics of Chinese currency with Congress and constituents,"[242] suggest others. In this regard, on December 1st, 2015, Jin Liqun, the president-elect of the AIIB, said "the US dollar (would) be the operating currency of the bank but the institution (would) consider financing requests in other currencies, including the yuan."[243] This could be seen as opening the door for RMB-denominated funds to be used in AIIB-initiated infrastructure projects. One possibility is that the AIIB will use the US dollar "in the early stages" and then "gradually move to a mix of the yuan and the dollar."[244] If realized, this would give an enormous boost to the RMB's internationalization in view of the size of funds and the countries involved under the AIIB framework.

On September 22nd, 2015, ahead of his visit to Washington, Chinese President Xi Jinping said in his interview with the *Wall Street Journal*: "As an open and inclusive multilateral development agency, the AIIB will complement other multilateral development banks. In addition to Asian countries, countries outside Asia, such as Germany, France and the UK, have also joined the AIIB. China welcomes the US to join the AIIB. This has been our position from the very outset."[245]

The fact that "the Bretton Woods institutions proved crucial for the US dollar" indicates that "institutional power is a game changer for reserve currency status", according to Phyllis

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[241] Cary Huang, "China seeks role for yuan in AIIB to extend currency's global reach," *The South China Morning Post*, April 27, 2015, http://www.scmp.com/news/china/economy/article/1766627/china-seeks-role-yuan-aiib-extend-currencys-global-reach

[242] Mercy A. Kuo and Angelica O. Tang, "China's AIIB and the US Reputation Risk," *The Diplomat*, April 16, 2015, http://thediplomat.com/2015/04/chinas-aiib-and-the-us-reputation-risk/

[243] Michael Martina, "China-backed AIIB to lend $10-15 bln a year for first five years: president-designate," *Reuters*, December 1, 2015, http://uk.reuters.com/article/china-aiib-idUKL3N13Q1T620151201

[244] Cary Huang (2015), op. cit.

[245] "Full Transcript: Interview With Chinese President Xi Jinping - China's President offers written answers to questions from The Wall Street Journal," *The Wall Street Journal*, September 22, 2015, http://www.wsj.com/articles/full-transcript-interview-with-chinese-president-xi-jinping-1442894700

Papadavid (2016). Likewise, the Asian Infrastructure Investment Bank could also provide such institutional power for the RMB if it can "catalyze investment and enable emerging powers to divert resources away from the IMF."[246]

On June 24th, 2016, ahead of a gathering of its founding shareholders for its first annual meeting in Beijing on June 25th and 26th, 2016, the Asian Infrastructure Investment Bank, which is, the *FT* notes, "still in its 'start-up' phase with an initial staff of just 50 people", approved its inaugural four projects with total funding of $509m.[247] These projects include[248]:

> "A loan of 165 million dollars to bring power to rural Bangladesh; a 216.5 million-dollars loan to improve Indonesian substandard housing, which is expected to be co-financed by the World Bank (WB); a loan of 100 million dollars to finish building a motorway in Pakistan, co-financed by the Asian Development Bank (ADB) and Britain's Department for International Development (DFID); and a 27.5 million-dollar loan to upgrade a road in Tajikistan, co-financed by the European Bank for Reconstruction and Development (EBRD)." (*Xinhua,* June 2016)

Most of the multilateral development bank's initial projects are expected to be "ones already led by other institutions such as the World Bank, Asian Development Bank and European Bank for Reconstruction and Development", according to the bank, "partly because of the AIIB's current manpower constraints."[249]

Over time, the bank will continue to expand its own initiated projects through "learning by doing" such initial 'co-finance' projects, while hoping "to have more than 100 people on its payroll by the end of the year and be fully staffed by the end of 2018 with about 500 employees."[250] The Chinese government could also be expected to use the bank to support the OBOR initiative as indicated at the opening ceremony on June 25th by Chinese Vice Premier Zhang Gaoli, who said that "China hopes the AIIB can be actively involved in the development of countries along the 'Belt and Road.'"[251]

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[246] Phyllis Papadavid, "China's balancing act: Why the internationalisation of the renminbi matters for the global economy," January 2016, p. 13.

[247] Tom Mitchell, "AIIB gathers for inaugural annual meeting," *The Financial Times*, June 24, 2016, http://www.ft.com/cms/s/0/828ff06c-39e7-11e6-a780-b48ed7b6126f.html#axzz4CjStjx2g

[248] "AIIB board of directors approves first loans ahead of inaugural annual meeting," *Xinhua,* June 25, 2016, http://www.china.org.cn/china/Off_the_Wire/2016-06/25/content_38745151.htm

[249] Tom Mitchell (2016), op. cit.

[250] Ibid.

[251] "AIIB 1st annual meeting: First batch of loans worth over $500 mln approved," *CCTV,* June 26, 2016, http://english.cctv.com/2016/06/26/VIDEQBw0xA8VXCWmn82pRN5T160626.shtml

The BRICS New Development Bank

Today, the BRICS countries account for "about 25% of global GDP, 35% of total international reserves (with China at over US$4 trillion), 25% of total land area, and around 42% of the world's population."[252] On July 15th, 2014, leaders of the emerging economies of Brazil, Russia, India, China and South Africa (BRICS) announced the 'Fortaleza Declaration' as an outcome of their sixth BRICS summit, held in Fortaleza, Brazil. Through the declaration, they announced "the signing of the Agreement establishing the New Development Bank (NDB), with the purpose of mobilizing resources for infrastructure and sustainable development projects in BRICS and other emerging and developing economies (EMDCs)" in view of the fact that "BRICS, as well as other EMDCs, continue to face significant financing constraints in addressing infrastructure gaps and sustainable development needs."[253] The key elements of the New Development Bank (NDB) are as follows[254]:

(i) **Purposes:** The purpose of the Bank is to mobilize resources for infrastructure and sustainable development projects in BRICS and other emerging market economies and developing countries, in order to complement the existing efforts of multilateral and regional financial institutions for global growth and development.

(ii) **Membership:** The membership is open to members of the United Nations, in accordance with the provisions of the Articles of Agreement of the New Development Bank, and to both borrowing and non-borrowing members.

(iii) **Capital:** The New Development Bank was to have an initial subscribed capital of US$50 billion and an initial authorized capital of US$100 billion. The initial subscribed capital was to be equally distributed among the founding members.

(iv) **Voting power:** The voting power of each member would equal its subscribed shares in the capital stock of the Bank.

(v) **Provision of Currencies:** The Bank, in its operations, may provide financing in the local currency of the country in which the operation takes place, provided that adequate policies are put in place to avoid significant currency mismatches.

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[252] Nasser H. Saidi, "The BRICS Bank Signals the End of the American Financial Empire and U.S. Dollar Hegemony," *The Huffington Post*, July 21, 2014, http://www.huffingtonpost.com/dr-nasser-h-saidi/the-brics-bank-signals-th_b_5604294.html

[253] "Sixth BRICS Summit - Fortaleza Declaration," Ministry of External Affairs, Government of India, July 15, 2014, http://www.mea.gov.in/bilateral-documents.htm?dtl/23635/Sixth+BRICS+Summit++Fortaleza+Declaration

[254] "Agreement on the New Development Bank," July 15, 2014, Fortaleza, Brazil, http://ndbbrics.org/agreement.html

At the summit, the BRICS leaders also announced the "signing of the Treaty for the establishment of the BRICS Contingent Reserve Arrangement (CRA) with an initial size of US$100 billion."[255] "This arrangement will have a positive precautionary effect, help countries forestall short-term liquidity pressures, promote further BRICS cooperation, strengthen the global financial safety net and complement existing international arrangements," said the declaration. The Agreement is designed to provide "a framework for the provision of liquidity through currency swaps in response to actual or potential short-term balance-of-payments pressures." Unlike the New Development Bank (NDB), the CRA is structured to be funded 41 percent by China, 18 percent from Brazil, India, and Russia, and five percent from South Africa.

In this regard, it is worth noting the following four observations in terms of the rationales behind the push for both the NDB and CRA, as well as the implications for the Bretton Woods system and the dollar as the world's dominant reserve currency:

- Firstly, as noted in the *Washington Post*, "long-standing dissatisfaction with Bretton-Woods institutions has pushed BRICS towards a developing-country alternative to global development finance."[256] A similar example, as discussed earlier, is the Chiang Mai Initiative (CMI) among the ASEAN+3 countries that was launched "in the early 2000s, partly as a reaction to a widely perceived failure of the IMF to stop currency speculation during the Asian Crisis."[257] The Fortaleza Declaration "clearly indicates the BRICS countries' growing unhappiness with dragging reform efforts within the IMF by saying, "We remain disappointed and seriously concerned with the current non-implementation of the 2010 International Monetary Fund reforms, which negatively impacts on the IMF's legitimacy, credibility and effectiveness."[258]

- Secondly, deepening South-South economic cooperation over the past couple of decades has also convinced BRICS and other EMDCs that it would be in their interest to have an institution such as the NDB, based on their own initiative. Such institutions could assist them better in marshalling resources for their infrastructure and sustainable development projects, particularly under the circumstances where South-South foreign trade has recently seen "unprecedented growth" – with China, Brazil and India all becoming larger donors, while the "value of South-South trade

[255] "Sixth BRICS Summit - Fortaleza Declaration," Ministry of External Affairs, Government of India, op. cit.

[256] Raj M. Desai and James Raymond Vreeland, "What the new bank of BRICS is all about," *The Washington Post*, July 17, 2014, https://www.washingtonpost.com/news/monkey-cage/wp/2014/07/17/what-the-new-bank-of-brics-is-all-about/

[257] Ibid.

[258] "Sixth BRICS Summit - Fortaleza Declaration," Ministry of External Affairs, Government of India, op. cit.

now exceeds North-South trade by some $2.2 trillion - over one-quarter of global trade." Considering all of this, the *Washington Post* says, one can argue that "these BRICS institutions are partly just the result of a two-decades long process of greater economic engagement by and among developing nations."[259]

- Thirdly, what is most intriguing is that "The New Development Bank is meant to mirror the World Bank, and the CRA will be set up similarly to the IMF." In fact, as a July 2014 article in *Bridges* comments, the push for this recent initiative has emerged "largely from the desire to move away from a long-standing dependence on the IMF and the World Bank."[260] Or, as one Chinese pundit put it, "The establishment of the NDB and CRA is a serious and profound challenge to the current Western-led international economic order and global financial system."[261]

- Lastly, it is also important to note, as does John Manning in his 2015 article, *The Importance of the New Development Bank*, that the NDB could pose a serious challenge to the US dollar's global stature "through the lack of reliance on the US dollar," because the BRICS plan is to "lend in domestic currencies," unlike the "World Bank, which only lends in dollars."[262]

On July 21st, 2015, the NDB was officially opened in Shanghai. "Our objective is not to challenge the existing system as it is but to improve and complement the system in our own way," Kundapur Vaman Kamath, the NDB's first President, said. Revealing his meeting with the AIIB in Beijing, Mr. Kamath also announced the NDB's decision to set up a 'hotline" with the AIIB to discuss issues, and to forge closer ties between "new institutions coming together with a completely different approach."[263] Thus, the recent developments, including the establishment of the AIIB and the NDB, should raise "testing questions about the current lending model followed by the IMF, the World Bank and other Western-led development banks and how they should respond."[264] The unequivocal message is that the

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259 Raj M. Desai and James Raymond Vreeland (2014), op. cit.

260 "BRICS Countries Launch New Development Bank," ICTSD, *Bridges*, Volume 18, Number 26, July 17, 2014, http://www.ictsd.org/bridges-news/bridges/news/brics-countries-launch-new-development-bank

261 Pang Xun, "The New Development Bank: Not Merely a Bank," Carnegie-Tsinghua Center for Global Policy, August 14, 2014, http://carnegietsinghua.org/publications/?fa=56752

262 John Manning, "The Importance of the New Development Bank," International Banker, May 26, 2015, http://internationalbanker.com/banking/the-importance-of-the-new-development-bank/

263 Brenda Goh, "'BRICS' bank launches in Shanghai, to work with AIIB," *Reuters*, July 21, 2015, http://in.reuters.com/article/emerging-brics-bank-idINKCN0PV07Z20150721

264 John Manning (2015), op. cit.

NDB and the CRA would try to fill the shoes of their role models, the World Bank and the IMF, should the latter not be able to evolve enough to reflect the world's rapidly changing economic and development dynamics and needs in an appropriate and swift manner.

So, what are the implications of all this for China? As mentioned earlier, the establishment of the NDB will help push the reform of the global economic governance structure, which Beijing also wishes to accomplish. A second implication is related to the RMB's internationalization. In its press release of 25th March 2016, the NDB announced that it is "launching its first fundraising drive with a yuan or renminbi-denominated bond targeting investors in China, expecting to raise 3-5 billion yuan ($460-767 million) in the second quarter of this year." It added, "For China, fundraising in yuan is important because it will take forward its agenda for internationalizing the renminbi."[265]. China's leadership role, therefore, in the launch of the NDB and the CRA will help Beijing's efforts to push for reforms of the global economic governance structure as well as to further promote the internationalization of the RMB.

Inter-SCO Development Bank

China, together with Russia, and four other Central Asian countries (Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan), founded the Shanghai Cooperation Organization (SCO), an intergovernmental organization, in Shanghai in 2001.[266](Figure 14)

Central Asia is strategically and economically important to China, and it is, therefore, no wonder that "Beijing has long been using the Silk Road discourse in the context of Central Asia," according to *China-US Focus*, as evidenced by the fact that the "President of China Xi Jinping presented the Chinese vision of Silk Road Economic Belt in Kazakhstan in 2013."[267]

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[265] "BRICS BANK TO KICK-OFF FUND RAISING WITH YUAN DENOMINATED BONDS IN CHINA," *NDB Press Release*, March 25, 2016, http://www.ndb.int/brics-bank-to-kick-off-fund-raising-with-yuan-denominated-bonds-in-china.php

[266] Eleanor Albert, "The Shanghai Cooperation Organization," Council on Foreign Relations (CFR), *CFR Backgrounders*, Updated on October 14, 2015, http://www.cfr.org/china/shanghai-cooperation-organization/p10883 ("Originally formed as a confidence-building forum to demilitarize borders, the organization's goals and agenda have since broadened to include increased military and counterterrorism cooperation and intelligence sharing. One of the organization's primary objectives is promoting cooperation on security-related issues, namely to combat the 'three evils' of terrorism, separatism, and extremism. The SCO has also intensified its focus on regional economic initiatives like the recently announced integration of the China-led Silk Road Economic Belt and the Russia-led Eurasian Economic Union. The six member states occupy territory that accounts for three-fifths of the Eurasian continent and have a population of 1.5 billion, a quarter of the world's population. In addition to the six member states, the SCO has two new acceding members, Indian and Pakistan, four observer nations, and six dialogue partners.")

[267] Kemel Toktomushev, "The Silk Road Economic Belt's Impacts on Central Asia," *China-US Focus*, May 8, 2015, http://www.chinausfocus.com/finance-economy/the-silk-road-economic-belts-

Figure 14. Shanghai Cooperation Organization (SCO) Membership Map[268]

In 2001, China proposed the establishment of an inter-SCO Development Bank as a smaller, regional version of the World Bank and the International Monetary Fund. Moscow's concern that "the institution would cede full control to Beijing as its dominant financier" has prevented the Chinese initiative from materializing as yet.[269] On December 15th, 2015, Chinese Premier Li Keqiang proposed "six platforms for SCO cooperation" in the 14th Prime Ministers' meeting of the Shanghai Cooperation Organization (SCO) held in Zhengzhou, capital of central China's Henan Province.[270] Calling for "improving the financial cooperation mechanism," Premier Li said, "China will consider the establishment of an SCO development bank with related parties when the time is ripe, while promoting the Asian Infrastructure Investment Bank (AIIB) and New Development Bank for the BRICS to support SCO members' projects." He also proposed to establish "a regional trade cooperation mechanism".

Although it remains to be seen when the time will be ripe for the establishment of the inter-SCO development bank, Beijing is likely to make continued efforts to make that happen in a steady and subtle manner.

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impacts-on-central-asia/

[268] Eleanor Albert (2015), op. cit.

[269] Ibid.; William Piekos and Elizabeth C. Economy, "The Risks and Rewards of SCO Expansion," Council on Foreign Relations (CFR), July 8, 2015, http://www.cfr.org/international-organizations-and-alliances/risks-rewards-sco-expansion/p36761

[270] "China proposes six platforms for SCO cooperation," *Xinhua*, December 15, 2015, http://news.xinhuanet.com/english/2015-12/15/c_134920075.htm

C. Inclusion of the RMB in the SDR Basket

As already detailed in previous sections, the Chinese government has made concerted efforts to have its currency included in the SDR basket. There are a number of reasons for this:

- First of all, on March 23rd, 2009, Zhou Xiaochuan, the governor of the PBoC, proposed “replacing the US dollar as the world's leading currency with a new international reserve currency” that would be “disconnected from individual nations.” He also put forward the idea of “expanding the role of special drawing rights (SDRs).”[271] On November 15th, 2015, the Chinese President Xi Jinping also emphasized that the inclusion of the RMB into the SDR basket will help to “improve the international monetary system and safeguard global financial stability.”[272] These statements can be interpreted as suggesting that “China’s strategic view is for a ‘multi-polar’ world where the US is just one player rather than a hegemon,” according to *Bloomberg News*, which then goes on to say, “Globally recognized reserve status,” through the inclusion of the RMB in the SDR basket, “makes that a step closer, at least on the currency front.”[273]

- SDR status will, observes *China-US Focus*, be tantamount to recognizing “China’s ever-rising status in the global economy and financial market.”[274] As such, [“official designation and unofficial recognition of the country’s currency carries large symbolic weight.” As noted by *State Street Global Advisors*, “In addition to prestige, it could also increase China’s influence, particularly in Asia, as close trading partners may choose to peg their currencies to the RMB.”[275]

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271 Jamil Anderlini, “China calls for new reserve currency,” *The Financial Times*, March 24, 2009

272 “Xi Jinping Attends the 10th G20 Summit and Delivers Important Speech,” *Xinhuanet*, November 16, 2016, http://www.g20.org/English/image/201511/t20151123_1404.html

273 “Why China Wants Yuan to Be the World’s 5th Reserve Currency,” *Bloomberg News*, March 23, 2015, http://www.bloomberg.com/news/articles/2015-03-23/why-china-wants-its-yuan-to-be-the-world-s-5th-reserve-currency

274 Yi Xianrong, “Why Should the Renminbi Be Included in the SDR Basket?,” *China-US Focus*, Jun 25, 2015 http://www.chinausfocus.com/finance-economy/why-should-the-renminbi-be-included-in-the-sdr-basket/; Marc Chandler, “The Real Reason China Wants Yuan in IMF's Basket: Beijing wants its currency added to the SDR mechanism for status reasons, not to benefit its exports,” *CaixinOnline*, November 10, 2015, http://english.caixin.com/2015-11-10/100872535.html

275 Elliot Hentov and George Hoguet, “After RMB inclusion in the SDR: Why does China want the RMB to be a reserve currency?” *State Street Global Advisors*, 2015, p.3.

- One of the two criteria for inclusion in the SDR basket is the RMB's 'freedom of use'. Any SDR currency should be widely used for the payment of international transactions and traded in major foreign exchange markets. *Bloomberg* reports that, to this end, the Chinese government had to "press on with plans to open its capital account - a reform that stands to shake up industries and the way Chinese companies do business."[276] Just like former Chinese premier Zhu Rongji, who "used WTO admission criteria to pursue economic reforms in order for China to accede to the WTO in 2001," Zhou Xiaochuan, governor of the People's Bank of China, may have likewise used the RMB's potential inclusion as a tool for undertaking such difficult domestic reforms. In fact, "the SDR inclusion implies the endorsement of the RMB's international role by the IMF and can be a catalyst for RMB internationalization,"[277], which is fully in line with China's RMB internationalization strategy, according to *The Institute for New Economic Thinking* in 2015.

- Last but not least, since the SDR basket inclusion represents "a validation of efforts over the past few years to liberalize financial markets and free up flows of funds into and out of China's capital markets", this "could strengthen the credibility of Beijing's economic reformers against more conservative elements in the Xi Jinping administration."[278] This could have the effect of encouraging the Chinese authorities to push for further reforms and liberalization.[279]

Five years ago, China made its first move towards the RMB's inclusion in the SDR basket. It failed because the RMB was judged "not freely convertible" at the time. In order to meet this criterion, the Chinese government has taken a series of measures as discussed in previous sections. This means that the IMF's milestone decision of 30th November 2015 was not made out of the blue. The Chinese economy has emerged as "the world's third-largest exporter (in the past five years)", which makes China meet "the first inclusion criterion".

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276 "Why China Wants Yuan to Be the World's 5th Reserve Currency," *Bloomberg News (2015)*, op. cit.

277 He Fan, "The SDR is the Catalyst for China's Currency Internationalization," The Institute for New Economic Thinking, December 7, 2015, *https://ineteconomics.org/ideas-papers/blog/the-sdr-is-the-catalyst-for-chinas-currency-internationalization*

278 Shawn Donnan and James Kynge, "Boost for China as it joins IMF elite," *The Financial Times*, December 1, 2015, http://www.ft.com/intl/cms/s/0/d5ac853a-978a-11e5-95c7-d47aa298f769.html#axzz4ArQIt5ne

279 Wendy Wu, "adding China's yuan to IMF's SDR basket will spur the currency towards further reform: Efforts for the yuan to be added to IMF basket has helped push it towards further liberalisation," *The South China Morning Post*, November 30, 2015, http://www.scmp.com/news/china/economy/article/1885310/rise-renminbi-how-adding-chinas-yuan-imfs-sdr-basket-will-spur

Thanks to the impressive progress made in the areas of financial reforms and capital market liberalization, effective from October 1st, 2016, the RMB was determined by the IMF to be "freely usable, thus meeting the second criterion for basket inclusion."[280]

The inclusion of the RMB in the SDR basket could also be seen as a double-edged sword. The SDR inclusion does not automatically confer reserve currency status nor does it mean the completion of the RMB's internationalization. As the above rationales behind China's push for SDR inclusion unequivocally suggest, the IMF decision should also be seen as a strong encouragement for China to commit to further accelerating its financial reforms and capital market opening. With China's liberalization of its capital flows speeding up, Beijing will "encounter the trilemma of international finance - the 'impossible trinity'", as one commentary in *East Asia Forum* in January 2016 points out. It continues, "Essentially, any country in the world can choose to have two out of the three following policy objectives: free capital movement, a fixed exchange rate and monetary autonomy. They cannot have all three."[281] Under the "new normal" in the Chinese economy, the challenge that the Chinese leadership is likely to face along the road to the RMB's rise as a major international reserve currency will be much greater than it was before the SDR inclusion.

Over time, China will face new pressure on multiple fronts, according to the *Wall Street Journal*. Firstly, "China's pledges to loosen its tight grip on the currency's value and open its financial system will come under new scrutiny." Secondly, "inclusion would put pressure on the central bank to offer the same degree of clarity and transparency that the US Federal Reserve, the European Central Bank and other vital institutions strive for." Thirdly, "while IMF inclusion is largely symbolic, it could open Beijing to criticism of its financial policies when the IMF conducts its five-year review of the currencies in its basket."[282]

It is like the genie coming out of the bottle, and it remains to be seen how the Chinese leadership will respond to accommodate the new realities for which they have fought. It is also worth noting that the decision to add the RMB to the SDR basket was a wise move by the IMF because it would help the much criticized international organization to avoid a further blow to its reputation.

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[280] "IMF, Factsheet: Review of the Special Drawing Right (SDR) Currency Basket," April 6, 2016, https://www.imf.org/external/np/exr/facts/sdrcb.htm

[281] Peter C Y Chow, "What the RMB in the SDR really means," *East Asia Forum*, January 4, 2016, *http://www.eastasiaforum.org/2016/01/04/what-the-rmb-in-the-sdr-really-means/*

[282] Lingling Wei, "IMF Move Would Pressure China on Management of Yuan," *The Wall Street Journal*, November 29, 2015, http://www.wsj.com/articles/imf-expected-to-name-chinas-yuan-a-reserve-currency-1448769634

4. Stocktaking of RMB Internationalization

The internationalization of China's RMB is still a work in progress. This Chapter assesses where Beijing's RMB internationalization currently stands. A brief stocktaking exercise is made, drawing on a traditional set of criteria, followed by a reality check. Each of the following criteria for a reserve currency indicates the "progress the RMB has made towards attaining that status"[283]:

> (i) *Economic size:* China now accounts for 16 percent of the world's gross domestic product (17 percent if measured by purchasing-power parity rather than market exchange rates) and 10 percent of world trade in goods and services. In 2014-2015, it is estimated to have accounted for about one-third of world GDP growth.
>
> (ii) *Open capital account:* The capital account has become increasingly open in de facto terms, but there are a number of capital controls still in place.
>
> (iii) *Flexible exchange rate:* China has, over time, increased the flexibility of the exchange rate and, in principle, permitted market forces to play a bigger role in foreign exchange markets. Despite these changes, the country still has a closely managed exchange rate, which will become increasingly hard to control as the capital account becomes more open.
>
> (iv) *Macroeconomic policies:* China has a lower ratio of explicit public debt to GDP than most major reserve currency economies and has maintained moderate inflation in recent years.
>
> (v) *Financial market development:* A country must have broad, deep and liquid financial markets so that international investors will have access to a wide array of financial assets denominated in its currency. China's financial markets have become large but are highly volatile, poorly regulated, and lack a supporting institutional framework.

According to Prof. Eswar Prasad (2016), "China measures up favorably in the first four areas." On the other hand, in the fifth area of "financial market development and stability", which "could be the crucial determinant of how the RMB measures up against the other reserve currencies," more progress would be in order. Nevertheless, it is clear that China has made impressive headway in this area as well, "in part as the result of policy actions by the Chinese government and in part because of the sheer size and growing role of China in international

[283] "Eswar Prasad, "China's economy and financial markets: Reforms and risks [Editor's note: On April 27, Eswar Prasad testified before the U.S. China Economic and Security Review Commission on the status of market-oriented economic reforms in China.]," Brookings, April 27, 2016, http://www.brookings.edu/research/testimony/2016/04/27-china-economy-financial-markets-prasad

trade and finance."[284]

That being said, as Miriam Campanella (2014) observes, it is important to understand that "we may become blind to actual developments if we approach RMB internationalization in the same way as we discuss."[285] As mentioned earlier, the RMB's internationalization is "unprecedented." Therefore, it would be meaningful to make a reality check as to how the RMB internationalization process has progressed in terms of the RMB's steady rise as a major international reserve currency. To get a real sense of this, the following section reviews the latest developments in five key areas: ① Performance in global trade finance currency and RMB Trade Settlements; ② Global profile as a Payment Currency; ③ Foreign exchange market turnover; ④ Debut as a foreign reserve asset; and ⑤ The RMB's inclusion in the SDR Basket.

4.1. Performance in Global Trade Finance and RMB Trade Settlements

Emergence as the World's Second Most Used Currency in Trade Finance

According to recent SWIFT data, "RMB usage in traditional trade finance - Letters of Credit and Collections - grew from an activity share of 1.89% in January 2012 to 8.66% in October 2013, propelling the RMB to being the second most used currency in this market."[286] Ranking "behind the USD, which remains the leading currency with a share of 81.08%," the RMB "overtook the Euro, which dropped from 7.87% in January 2012 to 6.64% in October 2013 and is now in third place," shows the data (see Figure 15). "The RMB is clearly a top currency for trade finance globally and even more so in Asia," observed SWIFT's Asia Pacific section of payments and trade markets.[287]

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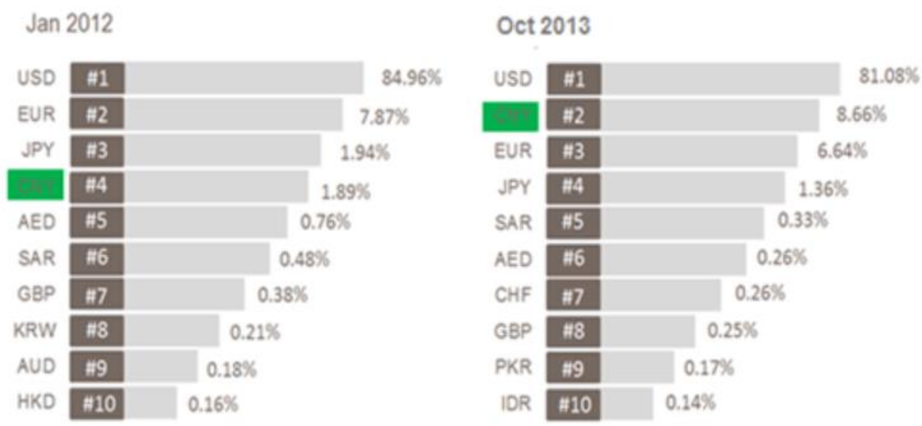
[284] Ibid.

[285] Miriam Campanella (2014), op. cit., pp. 2-3.

[286] "RMB now 2nd most used currency in trade finance, overtaking the Euro," *SWIFT Press Release*, Brussels, December 3, 2013, https://www.swift.com/insights/press-releases/rmb-now-2nd-most-used-currency-in-trade-finance_overtaking-the-euro

[287] "China's yuan surpasses euro as 2nd most-used currency in trade finance: SWIFT," *Reuters*, December 2, 2013, http://www.reuters.com/article/us-markets-offshore-yuan-idUSBRE9B204020131203

Figure 15. The RMB's Rise as the Second Most Used Currency in Trade Finance



Source: SWIFT

The RMB has since consolidated its number two position in global trade finance. According to SWIFT data released in February 2015, "RMB activity share for Documentary Credits (DC)" - more commonly known as Letters of credit - which are widely used instruments to finance trade flows across Asia, "rose from 7.32% in January 2013 to 9.43% in January 2015, consolidating its number-two ranking."[288] Another noteworthy development is that even though the RMB is still way behind the number-one currency, the US dollar, the RMB "has eaten into the dollar's share with it losing around 3% over the last 2 years."[289]

Given China's position as the world's largest trading nation since 2013, the RMB's share in global trade finance is expected to continue to rise.

Continued Expansion of Trade Settlements in RMB

It was only about six years ago, in 2009, that China started RMB cross-border trade settlements with baby steps, namely a pilot scheme initially launched in five Chinese cities. This type of settlement has since seen rapid growth. Its volume reached a staggering 7.23 trillion yuan in 2015, with its share of China's total trade expected to climb to over 50 percent of China's total trade by 2020.[290] As discussed earlier, the continued expansion of China's

[288] Roger Aitken, "Chinese RMB Consolidates Second Most Used Currency Ranking For DC Trade Transactions, *Forbes*, February 28, 2015

[289] Ibid.

[290] "Half of China's total trade to be settled in yuan by 2020-HSBC CEO," *Reuters*, March 26, 2015, http://uk.reuters.com/article/uk-china-yuan-offshore-idUKKBN0MM0EL20150326; "China Financial Statistics 2015," *inventariandochina.com*, March 2, 2016, https://inventariandochina.com/2016/03/02/china-financial-statistics-2015 /

FTA network, including the Korea-China FTA and the China-ASEAN FTA, is expected to further increase RMB-denominated trade settlements between Chinese companies and their counterparts in Beijing's FTA partner nations.[291]

Table 6: RMB Trade Settlement, 2009-2015 (billion yuan)

Year	2009	2010	2011	2012	2013	2014	2015
Total Amount	3.6	506.3	2,090	2,940	4,630	6,550	7,230

Source: PBOC

According to a recent RMB survey by HSBC, a global bank actively engaged in RMB-based banking services, foreign companies doing business with their Chinese counterparts could enjoy "multiple benefits" through settling their trade transactions in RMB.[292] These might include[293]:

- Lower transaction costs by virtue of not paying a foreign exchange cost
- Mitigating exchange rate risk
- Opening new business opportunities and winning more business
- Reduced prices, given that over half of Chinese businesses surveyed said they would cut their prices by up to 5% to deal in RMB
- Facilitating long-term arrangements, (fixing prices in RMB means fewer price negotiations and adjustments down the line when exchange rates change)
- Opening new business opportunities for smaller and medium-sized enterprises (a switch to the RMB also opens up a new layer of smaller Chinese suppliers who may prefer the ease of using their own currency or be reluctant to take on the dollar exposure.)

HSBC's annual RMB Internationalization Study of 2016 - a global survey of over 1,600 decision-makers at international companies in 14 markets, aimed at exploring the attitudes to, and use of, the RMB by these decision-makers – finds that "nearly seven in 10 US businesses plan to buy and sell more goods with China in the next 12 months, and a growing number of US business leaders are open to using RMB to do so."[294] The report goes on to say,

[291] Euijin Jung, "Korea's Recent Financial Integration with China," Peterson International Institute for Economics, December 14, 2015
[292] "What does the internationalisation of RMB really mean for businesses?" *HSBC Global Connections*, September 9, 2014, https://globalconnections.hsbc.com/singapore/en/articles/what-does-internationalisation-rmb-really-mean-businesses
[293] Ibid.
[294] Kevin Quinn, "Expanding US-China Trade Opens Leaders' Minds to RMB," *HSBC Global Connections*, May 20, 2015, https://globalconnections.hsbc.com/us/en/articles/expanding-us-china-trade-opens-leaders-minds-rmb

"Although US business leaders are discussing the opportunities of trading with the RMB, only 10 percent of US businesses have actually used the Chinese currency to settle cross-border trade. That's lower than the global average of 17 percent." The survey then concluded, "China's currency has only been available for international trade since 2010, and many business leaders are still in wait-and-see mode. However, as time passes, we expect that larger numbers of business managers will become more comfortable with the RMB and take advantage of the expanding trade flow opportunities."

4.2. The RMB's Rise as the World's No. 5 Payments Currency

The RMB's stature as a world payments currency has rapidly risen since the Chinese government officially launched its policy to internationalize the RMB in 2009. According to SWIFT, the RMB has evolved against other major currencies from being #35 in October 2010, moving up to #17 in October 2011 and to #13 in January 2013. In November 2014, the RMB "overtook the Canadian and Australian dollar as a global payments currency" to take position "behind the Japanese Yen, British pound, Euro and US dollar. The currency then broke into "the top five as a world payments currency."[295]

As we can see from Figure 16, in March 2016, the RMB remained stable in its position as the fifth most active currency for global payments by value, with a share of 1.88%, behind the dollar (43.09%), the euro (29.83%), the pound (8.0%), and the Japanese yen (3.27%).[296]

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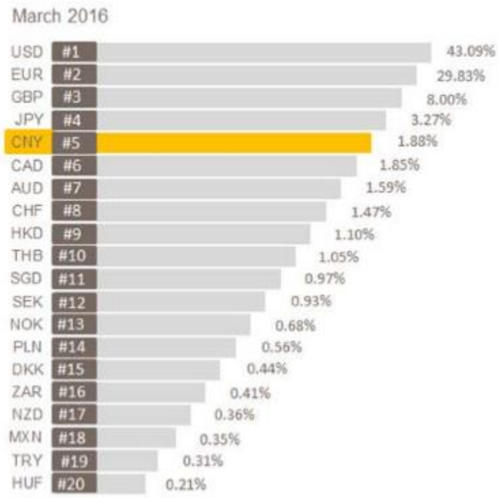
[295] "Trend or hiccup – could the internationalization of the RMB be stalling?," *SWIFT RMB Tracker*, 25 November 2011; "RMB breaks into the top five as a world payments currency," *SWIFT*, January 28, 2015, https://www.swift.com/insights/press-releases/rmb-breaks-into-the-top-five-as-a-world-payments-currency.

[296] "UK jumps ahead of Singapore as the second largest offshore RMB clearing centre," *SWIFT's latest RMB tracker*, 28 April 2016

Figure 16: The RMB's Share as an International Payments Currency (2016.3)



Source: SWIFT[297]

In October 2015, the RMB "surpassed the Japanese yen to become the world's fourth-most-used payments currency, despite an unexpected devaluation and concerns about slowing Chinese growth." The SWIFT indicators "confirm the renminbi's journey in becoming an international currency."[298]

4.3. Rapid Advancement in Global Foreign Exchange Markets

"The extent to which a country's currency can also be used in international financial transactions" affects the choice of that "currency for denomination and settlement of trade flows"[299] (Eswar Prasad, 2016). Thus, the turnover of the RMB in global foreign exchange markets is a useful index in assessing the pace of RMB internationalization.

As shown in Table 7, the RMB now accounts for 2.2% of all turnover in foreign exchange markets. This amount is small in relative terms, as compared with both the total turnover, which is 200 percent since each transaction involves two currencies, and the other four currencies comprising the SDR basket – the US dollar (87%), the euro (33.4%), the yen (23%) and the pound (11.8%). Nevertheless, Prasad points out, "it represents a considerable

[297] "UK jumps ahead of Singapore as the second largest offshore RMB clearing centre," April 28, 2016, *SWIFT's latest RMB tracker*

[298] Gabriel Wildau, "Renminbi overtakes Japanese yen as global payments currency," *The Financial Times*, October 6, 2015, http://www.ft.com/intl/cms/s/0/bb54b4f0-6bf2-11e5-aca9-d87542bf8673.html#axzz47gm7ud00

[299] Eswar Prasad (2016), op. cit., p. 64.

increase over a relatively short period, especially for a currency that is not freely convertible."[300] The Bank for International Settlements (BIS) gave a positive assessment by saying that "The role of the renminbi in global FX trading surged, in line with increased efforts to internationalize the Chinese currency," thereby becoming "the 9th most actively traded currency in 2013."[301]

Table 7: Global Foreign Exchange Market Turnover by Currency

(selected currencies, in percent)

Currencies/Year	**2001**	**2004**	**2007**	**2010**	**2013**
US dollar	89.9	88.0	85.6	84.9	87.0
Euro	37.9	37.4	37.0	39.1	33.4
Japanese yen	23.5	20.8	17.2	19.0	23.0
Pound sterling	13.0	16.5	14.9	12.9	11.8
Australian dollar	4.3	6.0	6.6	7.6	8.6
Swiss franc	6.0	6.0	6.8	6.3	5.2
Chinese RMB	0.0	0.1	0.5	0.9	2.2
Russian ruble	0.3	0.6	0.7	0.9	1.6
Indian rupee	0.2	0.3	0.7	1.0	1.0
South African rand	0.9	0.7	0.9	0.7	1.1
Brazilian real	0.5	0.3	0.4	0.7	1.1
All currencies	**200**	**200**	**200**	**200**	**200**

Source: BIS Triennial Central Bank Survey[302]

Note: The percentage shares of individual currencies sum to 200% instead of 100% because two currencies are involved in each transaction.

The RMB's turnover, which "soared from $34 billion to $120 billion," was "mostly driven by a significant expansion of offshore renminbi trading."[303] The newly-launched China International Payment System (CIPS) will help RMB turnover in global FX markets to continue to rise because the system, according to *Thomson Reuters FX Exchange 2015*, "will remove common processing challenges encountered when trading renminbi, placing it on a

[300] Ibid.

[301] "Triennial Central Bank Survey Foreign exchange turnover in April 2013: preliminary global results," Monetary and Economic Department, Bank for International Settlements (BIS), September 2013, p.5.

[302] Ibid., p.10.

[303] Ibid. p.5.

more level footing with other global currencies."[304] The increased RMB turnover in global FX markets will in turn further promote the currency's global stature as well as advancing the RMB's internationalization, being that, as Prasad tells us, "foreign exchange market turnover is a good indicator of a currency's potential for developing into a vehicle currency."[305]

4.4. The RMB's Debut as a Reserve Asset

As shown in Table 8, the primary reserve currency used worldwide is the US dollar, followed by the euro, the Pound sterling, the Japanese yen, the Canadian dollar, the Australian dollar, and the Swiss franc. The euro's share has continued to rise since its launch in 1999 with 17.9%. Reaching its peak in 2009 with 27.6%, it has begun a downward spiral since the Eurozone debt crisis that erupted in 2010.

Table 8. Currency Composition as Official Foreign Exchange Reserves (COFER) (%)

Currency/Year	**'95**	**'96**	**'97**	**'98**	**'99**	**'00**	**'01**	**'02**	**'03**	**'04**	**'05**	**'06**	**'07**	**'08**	**'09**
US dollar	59.0	62.1	65.2	69.3	70.9	70.5	70.7	66.5	65.8	65.9	66.4	65.7	64.1	64.1	62.1
Euro	-	-	-	-	17.9	18.8	19.8	24.2	25.3	24.9	24.3	25.2	26.3	26.4	27.6
Deutschmark	15.8	14.7	14.5	13.8	-	-	-	-	-	-	-	-	-	-	-
Pound sterling	2.1	2.7	2.6	2.7	2.9	2.8	2.7	2.9	2.6	3.3	3.6	4.2	4.7	4.0	4.3
Japanese yen	6.8	6.7	5.8	6.2	6.4	6.3	5.2	4.5	4.1	3.9	3.7	3.2	2.9	3.1	2.9
Canadian dollar															
Australian dollar															
Swiss franc	0.3	0.2	0.4	0.3	0.2	0.3	0.3	0.4	0.2	0.2	0.1	0.2	0.2	0.1	0.1
Others	13.6	11.7	10.2	6.1	1.6	1.4	1.2	1.4	1.9	1.9	1.9	1.5	1.8	2.2	3.1

[304] Joel Clar, "GROWTH CURRENCY," *Thomson Reuters FXExchange 2015*.

[305] Eswar Prasad (2016), op. cit., p. 64.

Currency/Year	**‘10**	**‘11,**	**'12**	**‘13**	**‘14**	**‘15**
US dollar	61.8	62.3	61.1	61.0	63.1	64.1
Euro	26.0	24.7	24.3	24.4	22.1	19.9
Deutsche mark	-	-	-	-	-	-
Pound sterling	3.9	3.8	4.0	4.0	3.8	4.9
Japanese yen	3.7	3.6	4.1	3.8	3.9	4.1
Canadian dollar			1.5	1.8	1.9	1.9
Australian dollar			1.5	1.8	1.8	1.9
Swiss franc	0.1	0.1	0.3	0.3	0.3	0.3
Others	4.4	5.4	3.3	2.90	3.2	3.0

Source: IMF[306]

The RMB has begun to make its debut on the scene of foreign reserve assets since the Chinese authorities launched the RMB internationalization drive in 2010. The surge in RMB-denominated trade settlements over the past several years, “a trend enthusiastically supported by Beijing as a means to push its long-declared goal of having a global reserve currency, commensurate with the dollar, the yen and the euro,” has, the *Financial Times* reports, propelled “renminbi on route to global reserve currency.”[307] A number of central banks across the globe have got into the RMB game by starting to hold part of their foreign exchange reserves in renminbi. The list of central banks that have RMB assets as their reserve portfolios or plan to do so includes those in the Asia-Pacific region (Australia, Malaysia and Pakistan), in Europe (Austria, Great Britain, Russia and Switzerland), in Africa (Nigeria, South Africa and Tanzania), and in Latin America (Chile). As shown in Table 9, 38 respondents reported holding RMB denominated assets, comprising 1.11 percent of total OFA (Official Foreign Currency Assets). This level puts the RMB in seventh place.[308]

306 “Currency Composition of Official Foreign Exchange Reserves,” IMF, March 31, 2016, http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4

307 Charles Clover, “Trade propels renminbi on route to global reserve currency,” *The Financial Times*, July 29, 2015, http://www.ft.com/intl/cms/s/2/29ee3136-1ffc-11e5-ab0f-6bb9974f25d0.html#axzz47oN47Usf .

308 “REVIEW OF THE METHOD OF THE VALUATION OF THE SDR—INITIAL CONSIDERATIONS,” IMF, August 3, 2015, p.23.

Table 9. Official Foreign Currency Assets by Currency (2013-2014)

(US$ million)

Currency/Year	**2013**			**2014**		
	Amount	**%**	**R/C***	**Amount**	**%**	**R/C***
Total Holdings in Currencies	6,779,830	100%	130	6,738,534	100%	130
SDR Basket Currencies	6,276,719	92.58%		6,214,838	92.23%	
US dollar	4,158,921	61.34	127	4,290,576	63.67	127
Euro	1,603,467	23.65	109	1,417,328	21.03	108
Pound Sterling	287,967	4.25	108	274,569	4.07	109
Japanese yen	226,364	3.34	87	232,370	3.45	88
Non-SDR Basket Currencies	503,112	7.42%		523,696	7.77%	
Australian dollar	151,027	2.23	79	142,451	2.11	78
Canadian dollar	133,863	1.97	84	133,870	1.99	85
Chinese RMB	45,359	**0.67**	**27**	74,612	**1.11**	**38**
Swiss franc	16,078	0.24	73	15,366	0.23	69
New Zealand dollar	16,906	0.25	27	15,214	0.23	29
Swedish kroner	13,820	0.20	45	13,225	0.20	48

Source: IMF Survey of Member Countries (2015)[309]

Note: "*Reporting Countries; the above list includes the top ten currencies.

The official inclusion of the RMB in the SDR basket as of October 1st, 2016, the continued expansion of China's economic and financial networks and initiatives, including bilateral, currency swaps, FTAs, OBOR, and AIIB, and increased RMB-based trade and investment flows, will continue to increase both demand for and supply of the RMB, which will in turn encourage foreign central banks to add more RMB-denominated assets to their reserve portfolios.

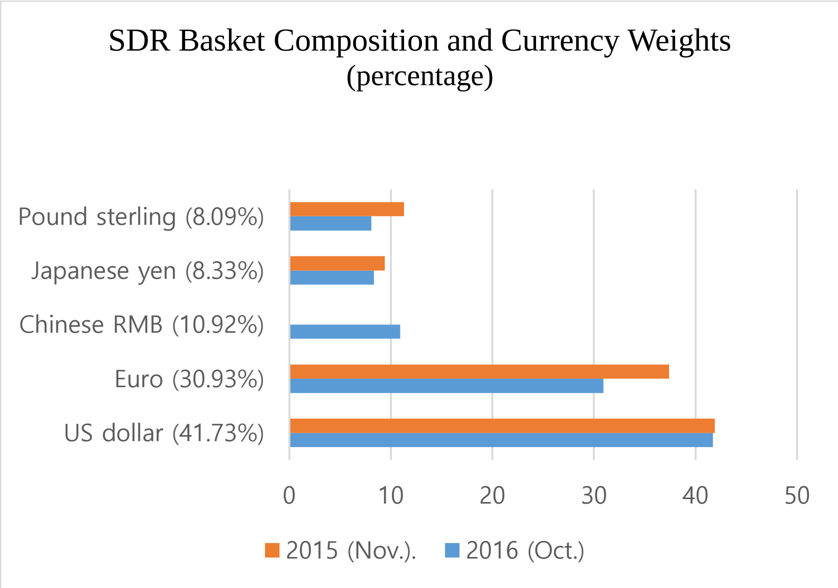
4.5. Emergence as the Third Weightiest Currency in the IMF SDR Basket

On November 30th, 2015, the IMF decided to include the Chinese currency renminbi (RMB) in the SDR basket: "This is the first time in over 15 years that the list of currencies

[309] "SURVEY ON THE HOLDINGS OF CURRENCIES IN OFFICIAL FOREIGN CURRENCY ASSETS 2015," IMF (The IMF has conducted an ad–hoc survey of member countries on their holdings of currencies in Official Foreign Currency Assets. The ad-hoc survey was conducted during April-May, 2015, and requested end-position data for 2013–2014.)

comprising the SDR has been altered," said the IMF.[310] As of October 1st, 2016, the RMB will emerge as the third currency in terms of weight in the SDR basket, with 10.92% of the total, which is above the Japanese yen (8.33%) and the pound sterling (8.09%), but behind the dollar (41.73%) and the euro (30.93%).[311] (See Figure 17)

Figure 17.



Source: IMF[312]

The emergence of the RMB as the third weightiest currency in the IMF SDR basket may have significant implications:

- First of all, the RMB's addition to the SDR basket, which has been hitherto composed of currencies of advanced economies, could send out a positive signal that the international monetary system led by rich Western countries is "changing," at a time when the "slow progress in IMF governance reforms" is seemingly blamed for creating "an even bigger gap with the transforming global economy"[313] (Policy Alternative Research Institute).

[310] "IMF SDR BASKET: Chinese Renminbi to Be Included in IMF's Special Drawing Right Basket," IMF Survey, December 1, 2015, http://www.imf.org/external/pubs/ft/survey/so/2015/NEW120115A.htm

[311] "Factsheet: Review of the Special Drawing Right (SDR) Currency Basket," IMF, April 6, 2016, https://www.imf.org/external/np/exr/facts/sdrcb.htm

[312] Ibid.

[313] Naoyuki Shinohara, "Yuan's SDR inclusion signals change in international financial system,"

- Secondly, the RMB's joining of the elite club of international currencies is expected to serve as a catalyst for furthering its internationalization, since it will substantially increase RMB flows. Given that the IMF decision was "clear recognition that the RMB belongs within the highest levels of global finance and that access to capital markets in the PRC, both onshore and offshore, has broadened significantly in the eyes of independent bodies," the inclusion could "lead to cumulative foreign inflows of as much as CNY 6.2 trillion by 2020," suggested the latest research by the Standard Chartered bank.[314]

- Thirdly, the inclusion will help increase global reserve demand for the RMB enormously. In this process, the RMB weighting of 10.62% in the SDR basket could serve as a guidepost. Cecily Liu wrote in *The China Daily* that "Global institutions, including sovereign wealth funds," would "adjust the weightings of their foreign currency holdings" and "in particular, countries that export energy to China such as Russia and the Middle East will adjust their renminbi reserve holdings to support the private sector, as the new weighting will be a better reflection of their trade relations with China."[315] AmCham in China observes that: "The IMF's decision to add the Chinese yuan to its portfolio will likely be widely replicated by central banks, fund managers, global investors and individuals, dramatically increasing capital inflows in the long term. The total expected capital inflows to the RMB – from the IMF to public and private investors – could reach hundreds of billions of US dollars in RMB assets by 2020. "[316] In this regard, [one estimate suggests that the inclusion "may lead to a US$500bn reserve demand for yuan," because the RMB's share of global foreign exchange reserves "could eventually reach around five percent (from the current one percent)." This means that central banks' dollar and euro holdings are likely to be trimmed from their reserve portfolios.[317] During the next five years this

Policy Alternative Research Institute, December 16, 2015, http://pari.u-tokyo.ac.jp/eng/media/nikkeiasianreview151216.html

314 "RMB Investors Forum White Paper: Rise of Next Generation China Access - May 2016, Standard Chartered Bank, p.12

315 Cecily Liu, "Yuan on the move," *The China Daily*, December 4, 2015, http://europe.chinadaily.com.cn/epaper/2015-12/04/content_22625298.htm

316 Evan Schmitt, "All Eyes are on the RMB: The world watches as China grooms the yuan to be a global currency," AmChamChina, January 19, 2016, http://www.amchamchina.org/news/all-eyes-are-on-the-rmb

317 Jamie McGeever, "China's SDR inclusion may lead to $500 bln reserve demand for yuan," *Reuters*, Oct 26, 2015, http://www.reuters.com/article/global-reserves-china-idUSL8N12Q2PK20151026; Zhu Haibin, "Implication of yuan's coming inclusion in SDR," *Shanghai Daily.com*, November 19, 2015, http://www.shanghaidaily.com/business/finance/Implication-of-yuans-coming-inclusion-in-SDR/shdaily.shtml

could result in an inflow of $350 billion.[318] In fact, the inclusion will lead to the creation of new demand for the RMB and may have the effect of encouraging countries having strong trade relationships with China to not only trim their dollar and euro reserve holdings, but also to use the RMB more broadly in their trade and financial transactions, instead of the dollar and the euro. (This implication will be further discussed in the next Chapter.)

318 Evan Schmitt (2016), op. cit.

5. RMB Internationalization and its Potential Impact on the Dollar

As described in Chapter 4, the RMB has already made itself felt on the international scene as a currency that is becoming more widely used for international trade and investment. The process of the RMB's internationalization, which will eventually lead to the rise of the RMB as a major international currency, has much to do with China's concerted efforts to reduce its current over-reliance on the dollar in a steady and substantial manner. This may have significant implications for the US. With this in mind, Chapter 5 takes a careful look at three relevant topics: (i) the emergence of the 'RMB bloc in East Asia' and its possible impact on both the 'East Asian dollar standard' and RMB internationalization at global level, (ii) China's dollar de-pegging and its implications for the dollar, and (iii) China's dollar deleveraging trend and its significance for the dollar as well as for US-China economic relations.

5.1. The East Asian Dollar Standard versus the RMB Bloc in East Asia

McKinnon and Schnabl (2004) observe that "before the 1997/98 Asian crisis, East Asian economies, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand, had pegged their exchange rates to the dollar" because "their common peg to the dollar provided an informal common monetary standard that enhanced macroeconomic stability in the region."[319] China also joined this informal 'East Asian dollar standard' in 1994 "when it unified its foreign exchange market and adopted a stable peg to the dollar," as they further note, while only Japan was the "outlier" as "a 'pure' floater with wide fluctuations in the yen/dollar exchange rate."[320] Despite some blame having been heaped onto the dollar pegs for contributing to the Asian financial crisis, countries in the region again resorted to the East Asian dollar standard after the crisis by "pursuing similar low-frequency exchange-rate strategies with respect to the dollar, but to different degrees."[321]

As such, the 'East Asian dollar standard' could endure for several reasons. Firstly, East Asian countries could still expect to piggyback 'macroeconomic stability from the dollar' by pegging their currencies to it. Secondly, "close trade and investment relations among East Asian countries" motivated them to continue the practice because the 'East Asian dollar standard' was seen as providing an "important regional public good" in the form of "a high degree of intra-regional exchange-rate stability in the East Asian region"[322] (Ulrich Volz,

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[319] Ronald McKinnon and Gunther Schnabl, "The East Asian Dollar Standard, Fear of Floating, and Original Sin," Review of Development Economics, 8(3), 2004, p. 331.

[320] Ibid.

[321] Ibid., pp. 356-357.

[322] Ulrich Volz, "RMB Internationalisation and Currency Co-operation in East Asia," Department of

2013). The "increasing fragmentation of value chains," which "led to an increase of trade flows in intermediate goods among Asian partners, especially in the manufacturing sector,"[323]also necessitated an environment of stable exchange rates. Thirdly, on the other hand, East Asian economies were also competitors for exports. Given that there was no anchor currency other than the dollar and that East Asian economies, including China, were pegging their currencies to it (to varying extents), they found it easier and more useful to manage the competitiveness of their export sectors by managing their exchange rates vis-à-vis the dollar.[324] Fourthly, after the Asian financial crisis, most East Asian economies began to accumulate large amounts of foreign exchange reserves, mainly in dollar-denominated assets. Thus, according to Ulrich Volz of SOAS University of London, "it still (made) sense to stabilize against the dollar in order to avoid large balance-sheet effects in case of exchange rate changes."[325]

However, over the past couple of decades, the economic and trade landscape in Asia and elsewhere has undergone a tectonic shift, which has caused the 'East Asian dollar standard' to lose some of its appeal. Subramanian and Kessler (2013) highlight the emergence in East Asia of the RMB as both "an important reference currency" and "the dominant reference currency (in the sense of exhibiting the greatest co-movement among all possible reference currencies - dollar, euro, yen and RMB), eclipsing the dollar." According to them, this represents "*de facto* an unambiguous RMB currency bloc in East Asia", where "the dollar's dominance as reference currency is now limited to Hong Kong (by virtue of the currency board regime), Mongolia, and Vietnam" while the RMB "dominates in relation to the more economically significant countries."[326]

One good indication in this regard, according to recent SWIFT data, is the fact that "the Chinese currency is the currency most actively used in Asia Pacific for payments with China and Hong Kong." [327] The Chinese currency moved from second position in 2014 "to the top" in 2015 as the "currency used in Asia Pacific to do business with China and Hong Kong." (Figure 18)

Economics, SOAS, University of London and German Development Institute, September 5, 2013, p.4.

323 "Trade patterns and global value chains in East Asia: From trade in goods to trade in tasks," WTO, 2011, p.15.

324 Ulrich Volz (2013), op. cit., p.5.

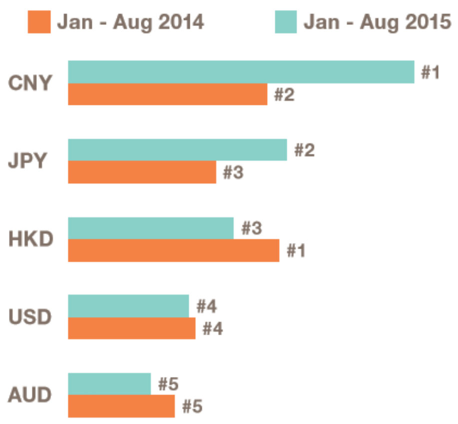
325 Ibid.

326 Arvind Subramanian and Martin Kessler, "The Renminbi Bloc Is Here: Asia Down, Rest of the World to Go?" Peterson Institute for International Economics WP 12-19, Revised August 2013, pp. 8-9.

327 "Renminbi's stellar ascension: Are you on top of it?" *RMB Tracker Sibos 2015 Edition*, SWIFT, p. 4.

Figure 18. Currency weight evolution within Asia for payments with China and Hong Kong (2014-2015)

(*Payments sent and received with CN and HK, by value*)



Source: SWIFT Watch

It is important to delve into the reasons behind such a remarkable paradigm shift because it will provide insights into whether and how the RMB will become a major international currency. Obviously, most of the reasons for the endurance of the 'East Asian dollar standard' are relevant to the rise of the RMB as the new anchor currency in East Asia as well. The reasons are as follows:

1. Primarily, the driving force is the fundamental shift in the economic dynamics in East Asia. The rise of China as an economic powerhouse not only in Asia but also in other parts of the world, as well as China's enthusiastic pursuit of the RMB's internationalization since the onset of the 2007-8 global financial crisis, have galvanized the change. In particular, according to Miriam Campanella (2014), "since 2010, China's trade, investment and aid in Asia have expanded rapidly: it has become the most important export destination for most of the region's economies."[328] Given the situation, it is "not surprising that the use of the RMB is rising" in trade and other transactions, thereby helping the RMB to overtake the US dollar as the exchange rate anchor currency in East Asia within a very short time span.[329]
2. The emergence of 'Factory Asia' centering around China and of the deepening vertical specialization pattern in Asia have both given further impetus to the birth of the RMB currency bloc in East Asia. Yukon Huang (2015) notes that "Nearly half of China's trade is processing-related" and, therefore, large amounts of imported parts and components from other East Asian countries are assembled in China for

[328] Miriam Campanella (2014), op. cit., p. 10.

[329] Ibid., p.11.

export to the west.[330] This production-sharing network incentivizes both Chinese companies and their foreign counterparts to use the RMB more widely in order "to improve trade efficiency and reduce exchange-rate risk in intra-regional trade."[331] According to the WTO, "in 2009, trade in intermediate goods was the most dynamic sector of international trade, representing more than 50 percent of non-fuel world merchandise trade and 64 percent of the total imports of the Asian region."[332] A 2014 ADB report noted that Asian global value chains (GVCs) continued to be upgraded as countries in the region made various efforts to remove obstacles to GVCs and to reduce costs for intra-regional trade: among these were trade facilitation measures such as the introduction of single windows for improved border clearance, joining the WTO Information Technology Agreement (ITA), and signing a series of trade agreements after 2000.[333] In particular, China's accession to the WTO in 2001 and the China-ASEAN FTA (completed in 2004) provided a great deal of trade facilitation support.[334] Thanks to these developments, intraregional trade in Asia has seen a remarkable growth over the past couple of decades. According to the WTO, over half of its total exports (52 percent) were sold within Asia in 2014.[335] In addition, "China's trade deficits with most of its network partners" could also encourage Beijing "to settle payments in renminbi" while "its partners will hold it as a reserve currency."[336] It is against such a backdrop that the currency of China, the center of Asian economic integration, began to emerge as a new reference currency in Asia.

3. As explained earlier, one of the reasons for the endurance of the 'East Asian dollar standard' is that China is not only an important trading partner, but also a formidable competitor for exports for other East Asian economies. Thus, it is a "rational and imperative" option for central banks in East Asia to seek "to co-move their exchange rates with the RMB" in order to address concerns over the cost-competitiveness

[330] Yukon Huang, "Beijing's Drive to Make the Renminbi a Global Currency is Misguided," Carnegie Endowment for International Peace, August 26, 2015, http://carnegieendowment.org/2015/08/26/beijing-s-drive-to-make-renminbi-global-currency-is-misguided/if68

[331] Ibid.

[332] "Trade patterns and global value chains in East Asia: From trade in goods to trade in tasks," WTO, 2011, p.15.

[333] Richard Pomfret and Patricia Sourdin, "Global Value-Chains and Connectivity in Developing Asia - with a particular focus on the Central and West Asian region," ADB, ADB Working Paper Series on regional economic integration, No. 142, November 2014, pp. 8-9.

[334] Ibid.

[335] "WTO International Trade Statistics 2015, SPECIAL FOCUS: WORLD TRADE AND THE WTO: 1995-2014," World Trade Organization, p.27.

[336] Yukon Huang (2015), op. cit.

difference with China.[337] "In a context where the RMB appreciates," a useful strategy for competitor countries is "a flexible peg to the RMB" because it can allow them "to appreciate their currency in order to limit inflation, while retaining competitiveness"[338] (Subramanian and Kessler, 2013).

4. As also indicated earlier, another major reason for the endurance of the 'East Asian dollar standard' was the desire to jump on the bandwagon of "macroeconomic stability imported from the dollar" by pegging their currencies to the dollar. Under these circumstances, Washington's fiscal stimulus and QEs in the aftermath of the 2008-9 global financial crisis and the Great Recession may have worked in such a way as to make them feel less inclined to piggyback such macroeconomic stability as had resulted from dollar-pegging, thereby contributing to weakening the 'East Asian dollar standard.' In the meantime, "The progressing internationalization of the RMB will at some point imply the complete delinking of the RMB from the dollar," according to Volz, which will, he says, "effectively bring an end to the East Asian dollar standard," [339] of which China has been at the center

The big question now is how the emerging RMB bloc will progress. Subramanian and Kessler (2013) argue that the RMB bloc is "not just an East Asian phenomenon but also a broader trade phenomenon," which "suggests the potential for a global RMB bloc beyond Asia with trade as a driving force."[340] Indeed, the "reference currency status" is, according to Campanella (2014), significant in that it "could signal the RMB's passage to an international currency or that it can stabilize as an anchor currency."[341]

All of this suggests that China's RMB internationalization strategy has achieved remarkable progress. Meanwhile, more recent developments, including the emergence of the so-called 'RMB bloc' and the IMF decision in November 2015 to include the RMB in the SDR basket, appear to present the Chinese leadership with a hard choice between whether to "pursue a strategy of having the RMB used as an international currency *in parallel to* the US dollar and the euro" or to settle for "currency regionalization"[342] (Campanella, 2014).

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[337] Miriam Campanella (2014), op. cit., p.12.

[338] Arvind Subramanian and Martin Kessler (2013), op. cit., p.3.

[339] Ulrich Volz (2013), op. cit., p.10.

[340] Arvind Subramanian and Martin Kessler (2013), op. cit., pp. 12-14.

[341] Miriam Campanella (2014), op. cit., p.12.

[342] Ibid., p.13.

5.2. China's Dollar De-pegging

Given that "the US dollar is used as the invoice currency for oil exports," debates have recently surfaced in some countries about "whether this could or should be changed."[343](Christoph Fischer, 2011) This relates to the question that some oil exporting countries might try to withdraw from the US dollar bloc through stopping the use of the US dollar as their invoice currency, which means 'de-pegging' their currencies from the dollar.

In May 2007, Kuwait, a member of the Gulf Cooperation Council (GCC), removed its currency peg to the US dollar "to prevent the sliding dollar increasing the cost of imports, which has stoked inflation to more than four percent, double the historic average."[344] In January 2016, the *Financial Times* reported "a surge in speculation that Saudi Arabia, the world's largest oil producer, could be forced to abandon the riyal's 30-year-old peg to the US dollar" because of its being so affected by the "dramatic slide in crude prices."[345] The report continued, "Yet the dollar pegs most under strain are those elsewhere in the Arabian peninsula, particularly Oman and Bahrain," while "the uber wealthy United Arab Emirates could yet be the first of the six Gulf Cooperation Council countries to break its tie to the greenback." In the meantime, in November 2015, the People's Bank of China "signaled its intention to change the way it manages the yuan's value by potentially easing its loose peg to the US dollar and instead letting it track the currencies of its broader trading partners."[346]

If realized, according to the *WSJ*, such changes "could have broad repercussions for currency markets - such as reducing China's demand for dollars - as well as for investors and global trade."[347] As indicated earlier, the RMB internationalization process is also closely connected with the Chinese currency's de-pegging from the dollar, which could have significant implications for the latter currency:

- First of all, as Meissner and Oomes (2008) note, the pegging and de-pegging

[343] Christoph Fischer (Deutsche Bundesbank), "Currency Blocs in the 21st Century," Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, Working Paper No. 87, July 2011, p.28. http://www.dallasfed.org/assets/documents/institute/wpapers/2011/0087.pdf.

[344] Simeon Kerr, "Kuwait abandons US dollar peg," *The Financial Times*, May 20, 2007, http://www.ft.com/intl/cms/s/0/9d84e376-06ef-11dc-93e1-000b5df10621.html#axzz4BD0WoNhH

[345] Steve Johnson, "Gulf currency pegs: Oman, Bahrain seen as most under threat," *The Financial Times*, January 14, 2016, http://www.ft.com/intl/cms/s/3/87f532a2-b94e-11e5-b151-8e15c9a029fb.html#axzz481CaesfY

[346] Lingling Wei, "China's Central Bank Signals Intention to Loosen Yuan's Peg to Dollar," *The Wall Street Journal*, December. 11, 2015, http://www.wsj.com/articles/chinas-central-bank-signals-intention-to-loosen-yuans-peg-to-dollar-1449843879

[347] Ibid.

process of one country's currency sets in motion "network externalities" that serve as an "important determinant of anchor currency choice."[348] In this process, trade integration plays a key role because the decision that a country makes in choosing a particular anchor "depends positively on the amount of trade with other countries that use that anchor." It is also important to note that "anchor currency decisions" are expected to be governed by "not simply trade with the country that issues the anchor currency, but also trade with all the bloc members."[349] Furthermore, a combination of bandwagon and cascade effects could also be expected to occur because "once a few important countries let go of (a particular anchor currency), their trade partners could do the same."[350] This finding could have significant implications for the dollar in view of the fact that when China – a country that not only belongs to the dollar bloc, but is also the world's dominant economic power – de-pegs its currency from the dollar, its trading partners would follow suit.

- Furthermore, de-pegging from the dollar or shifting away from a dollar peg to a managed float regime would reduce demand for reserve dollars since those countries that do so will need to hold fewer dollars as reserves.[351] As the PBoC has indicated, if China actually moves away from a dollar peg to a currency basket, it would not only help reduce "China's demand for dollars" but also "demonstrate China's determination to make the yuan a global currency, with a value determined more in line with other major currencies, and to step out of the dollar's shadow as the world's *de facto* currency."[352]
- Last but not least, a recent BIS report suggests that "the higher the co-movement of a given currency with the dollar, the higher the economy's dollar share of official reserves," and that "two thirds of the variation in the dollar share of foreign exchange reserves is related to the respective currency's dollar zone weight."[353] The important implication of this observation is that countries belonging to the "RMB currency bloc in East Asia" as suggested by Subramanian and Kessler (2013) "might hold a substantial share of renminbi,

[348] Christopher M. Meissner and Nienke Oomes, "Why Do Countries Peg the Way They Peg? The Determinants of Anchor Currency Choice," IMF Working Paper WP/08/132, May 2008, p.4 and pp.30-31

[349] Christoph Fischer (2011), op. cit., p.11,

[350] Christopher M. Meissner and Nienke Oomes (2008), op. cit., pp.12-13,

[351] Tony Arnerich, Jillian Perkins, Travis J. Pruit, and M. Lynn Spruill, "Going Global: Why understanding currency diversification within a global portfolio is important for U.S.-based investors," Arnerich Massena & Associates, Inc., December 2007, p. 13.

[352] Lingling Wei (2015), op. cit.

[353] Robert Neil McCauley and Tracy Chan, "Currency movements drive reserve composition," BIS, 7 December 2014, http://www.bis.org/publ/qtrpdf/r_qt1412e.htm

perhaps not too far from their currencies' renminbi zone weights."[354]

5.3. China's Dollar-deleverage

As the 2015 BIS annual report notes, "The US dollar continues to play a dominant role in international trade and finance, alongside the euro." It continues:

> "As a means of exchange, the dollar is on one side of no less than 87% of foreign exchange market transactions. More than half of world trade is invoiced and settled in dollars, pointing to the greenback's pre-eminent role as a unit of account. At 63%, it maintains almost three times the share of the euro in foreign exchange reserves. Its share in both official reserves and private portfolios is sustained by the scale of what can be termed the 'dollar zone' of economies whose currencies move more closely with the dollar than with the euro. At half or more of world GDP, the dollar zone is far larger than the US economy, which is less than a quarter."[355]

This dominance of the dollar in international trade and finance could change enormously as the Chinese government actively pursues its RMB internationalization strategy. As the IMF points out, "Reserve currency issuers as well as countries with standing central bank swap lines are unlikely to need sizable reserves for precautionary purposes, as they can create assets which can be swapped into any other currency at any time."[356] Thus, as the process of the RMB joining the reserve currency ranks through the active implementation of the internationalization strategy picks up speed, particularly after the RMB's inclusion in the SDR basket as of October 1st, 2016, the need to manage China's huge foreign reserves at appropriate levels will grow bigger.

For example, as of May 2016, US foreign reserves amounted to US$ 42,627 million, while those of the ECB (European Central Bank), the United Kingdom and Germany stood at US$ 53,275 million, US$ 11,107 million, and US$ 37,200 million, respectively.[357] *The Telegraph*, a British newspaper, once reported, "The size of Britain's total foreign exchange reserves - used to defend the pound during a financial crisis - ranks outside the world's top 20

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[354] Ibid.

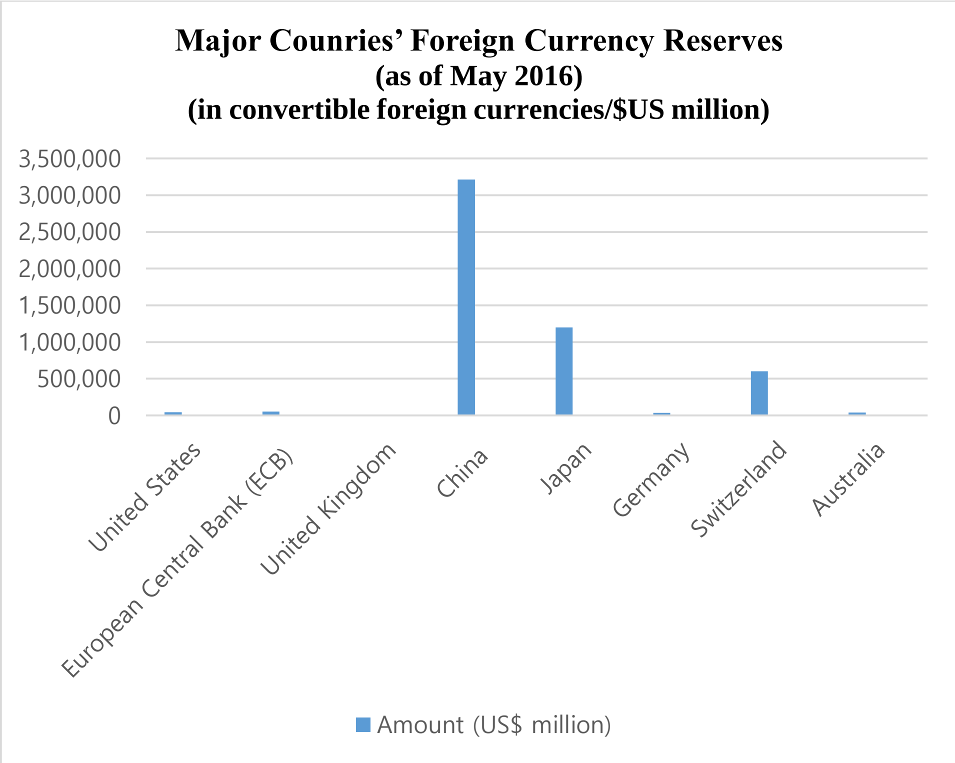
[355] "The international monetary and financial system," BIS 85th Annual Report, 28 June 2015, pp.84-86, http://www.bis.org/publ/arpdf/ar2015e5.htm#box5A

[356] "ASSESSING RESERVE ADEQUACY - SPECIFIC PROPOSALS," IMF, April 2015, pp. 13-14.

[357] "Data Template on International Reserves and Foreign Currency," IMF, May 18, 2016, Liquidityhttps://www.imf.org/external/np/sta/ir/IRProcessWeb/colist.aspx

nations behind Poland and the Philippines."[358] Compared with them, those of China and Japan are much bigger: China's foreign reserves recorded US$ 3.2 trillion while Japan's amounted to US$ 1.2 trillion. (See Figure 19 and note that the foreign reserves of the US, the ECB, the UK, Germany and Australia are, by comparison, almost invisible.)

Figure 19



As discussed in Chapter 2, the Chinese government also needs to appropriately manage its foreign reserve levels in order to cope with domestic inflation pressure associated with those enormous reserves. Considering all this, the Chinese government has sought to make the most of its huge foreign reserves in such a way as to diversify its foreign reserve portfolio by reducing its dollar-denominated assets as well as to implement its going-out strategy.

Given the large proportion of China's foreign exchange reserves invested in dollar-denominated assets, China's efforts to diversify its foreign reserve portfolio and to reduce its foreign reserve stock will eventually lead to de-leveraging its dollar assets, which could have

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358 Andrew Critchlow, "Britain holds less foreign currency reserves than Poland, says Deutsche Bank: UK foreign reserves rank 24th in the world at just $70bn, Deutsche Bank research shows," *The Telegraph*, April1, 2014, http://www.telegraph.co.uk/finance/currency/10736803/Britain-holds-less-foreign-currency-reserves-than-Poland-says-Deutsche-Bank.html

a deep ripple effect on the dollar-based international monetary system and the global economy as well. As such, this is an extremely sensitive and important issue. Therefore, China's dollar de-leveraging should be done in a discreet and gradual manner. This section first reviews the question of how much in foreign reserves a country's central bank should hold. Then, it addresses the Chinese government's multifaceted efforts in dealing with its huge foreign reserves.

First of all, the question of how much of a country's foreign reserves are at the optimal or reasonable level is always tricky, as the IMF acknowledges when it says, "Assessing the appropriate level of reserves to hold is challenging - not just because of the multiple roles played by reserves, but also because of the complexity of quantifying external risks across countries."[359] A recent news report provides a glimpse into the level of China's foreign reserves: "The US$ 3.33 trillion it has is enough to cover the country's imports for over 20 months, well above the usual benchmark of six months. It's also more than enough to cover all outstanding short-term debts."[360] China's reserves are almost triple the size of Japan's total, which is the world's second-biggest. According to China's official Economic Information Daily, "A reasonable size for China's forex reserves should be around $2 trillion based on imports, the outstanding balance of foreign debt, M2, and some international strategies. The bottom line for FX reserves is that they should be sufficient to pay for foreign debt and three-month imports"[361]

Considering the above estimates, there is still much room for Beijing to further reduce its foreign reserves. China's continuing trade and current account surpluses - China's 2015 current account as a percentage of GDP was the largest since 2010 at 2.72% while in dollar terms, the current account was a record US$293 billion, mostly thanks to a swelling trade surplus of 3.42% of GDP"[362] - should be helpful to it. China has sought to make the most of its foreign reserves by starting to shed its dollar assets. In the following paragraphs, we will look at the growing need to deal with China's foreign reserves and Beijing's concrete measures.

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[359] "BALANCE OF PAYMENTS CRISES: IMF Unveils New Way of Assessing Country Reserves," IMF Survey, April 24, 2015, http://www.imf.org/external/pubs/ft/survey/so/2015/POL032515A.htm

[360] Zhou Xin, "A trillion-dollar question on China's forex dilemma: just how low should its reserves go?" *The South China Morning Post,* January 8, 2016.

[361] "Bullet: China Press: A reasonable size for China's forex...," Market News Intl Fixed Income Bullets, February 29, 2016, https://eresearch.fidelity.com/eresearch/markets_sectors/news/story.jhtml?storyid=201602291916MKTNEWS_BULLETS__13BD_b20a&provider=MKTNEWS_&product=BULLETS_&category=forex&sourcePage=article&gic=402010

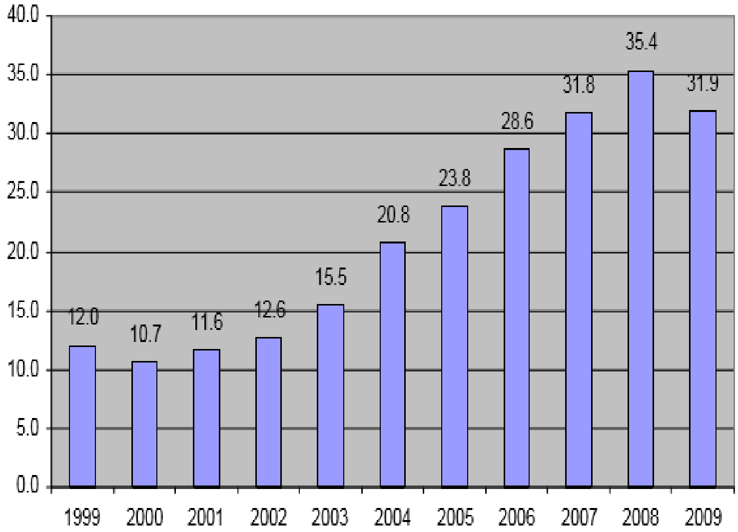
[362] "Data Template on International Reserves and Foreign Currency," IMF, May 18, 2016, Liquidityhttps://www.imf.org/external/np/sta/ir/IRProcessWeb/colist.aspx

The growing need to deal with China's foreign reserves

Large sums of current account surpluses and inward FDIs helped China's foreign reserves to soar to US$ 2.4 trillion in 2009, from just US$ 201 million in 1993. As explained earlier, with expanding stockpiles of foreign reserves, domestic money supply was increasing to a dangerous level and inflationary pressure mounted, thus making it imperative for Beijing to decentralize a significant portion of its foreign reserves in order to address these challenges.[363] (see Figure 20)

Figure 20. Funds outstanding for Foreign Exchange Reserves in China, 1999-2009

(as % of M2 supply)



Source: PBoC / study report by Yu-Wei Hu[364]

In the meantime, as shown in Table 10, China held US$ 1.2 trillion worth of US securities as of June 2008, accounting for 11.7% of the total US securities held by foreigners. It invested heavily in long-term debts, including long-term treasury securities and long-term bonds issued by GSEs (Government-sponsored enterprises) such as Fannie Mae and Freddie Mac, which accounted for almost 90% of its total investment in US securities. This was a source of particular concern to the Chinese government.

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[363] Qioa Yu, "Relocating China's Foreign Reserves," Brookings Institute, November 21, 2013, http://www.brookings.edu/research/papers/2013/11/21-relocating-foreign-reserves

[364] Yu-Wei Hu, "Management of China's Foreign Exchange Reserves: A Case Study on the State Administration of Foreign Exchange (SAFE)," European Commission Directorate-General for Economic and Financial Affairs Publications, Economic Papers 421, July 2010, p.12.

Table 10. Top 3 Foreign Holders of US securities

(US$ billion/end June 2008)

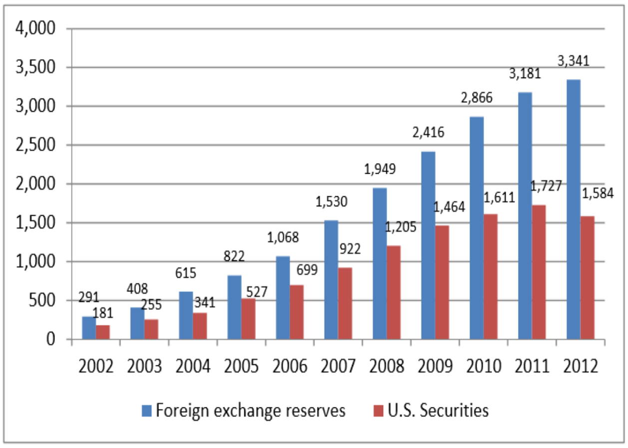
	Equity	LT treasuries	LT govt. agency debt	LT corporate debt	ST debt	Total
Japan	199	568	270	149	66	1,250
China	100	522	527	26	30	1,205
UK	376	45	26	394	24	864
Total	2,969	2,211	1,464	2,820	858	10,322

Source: US Department of the Treasury

In 2009, China became the largest holder of US treasury securities. As of November 2009, China held US$ 789.6 billion worth of US treasuries, while Japan ranked second with US$ 757.3 billion worth. Given this trend and the composition of its foreign reserves disproportionately tilted toward dollar-denominated assets (see Figure 20), China's concern about its dollar assets grew since the onset of the 2008 global financial crisis.

Figure 20. China's Foreign Exchange Reserves and Holdings of U.S. Public and Private Securities (2002-2012)

(US$ billion)



Sources: U.S. Treasury Department/ CRS Report for Congress[365]

On March 13th, 2009, Wen Jiabao, the then Chinese Premier, expressed his concern during a news conference by saying: "We've lent a huge amount of capital to the United States, and of

[365] Wayne M. Morrison and Finance Marc Labonte, "China's Holdings of U.S. Securities: Implications for the U.S. Economy," CRS Report for Congress, August 19, 2013, p.6.

course we're concerned about the security of our assets."[366] On March 24th, 2009, the governor of the People's Bank of China, Zhou Xiaochuan, did not mince his words in echoing Premier Wen's sentiment by calling for the replacement of the US dollar as the international reserve currency with a new global system based on the expanded role of the SDR Special Drawing Rights.[367]

With the global financial and economic crisis deepening, factors such as rising foreign reserves and associated problems - including growing inflationary pressure - and low returns on its investments, particularly against the background of the weakening US dollar, made the Chinese government feel the urgent need to manage its foreign reserves more efficiently.[368] In July 2010, the State Administration of Foreign Exchange (SAFE) published its investment guidelines: "The nature of China's foreign exchange reserves requires that their operation and management adhere to the principles of security, liquidity, and increases in value, among which security is the primary principle."[369] The Chinese government began to aggressively utilize its foreign reserves in such a way that would diversify its foreign reserve portfolio by reducing dollar assets, increase investment returns, and help Chinese firms advance into overseas markets.

Together with SAFE, the China Investment Corporation (CIC), a sovereign wealth fund formed by the Chinese government in September 2007 as a way to diversify its massive foreign reserves and to enhance returns on these holdings, also began to actively implement the Chinese government's new mantra. The *WSJ* reports that the CIC, which has emerged as the world's fifth largest sovereign wealth fund with more than $650 billion in total assets, is "closely watched both as a major source of capital for projects as well as a glimpse into China's perspective on the world economic outlook."[370]

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[366] "Premier 'worried' about safety of China assets in US," *China Daily*, March 14, 2009, http://www.chinadaily.com.cn/china/2009-03/14/content_7578931.htm; Wayne M. Morrison and Finance Marc Labonte, "China's Holdings of U.S. Securities: Implications for the U.S. Economy," *CRS Report for Congress*, August 19, 2013, pp. 10-12.

[367] Jamil Anderlini, "China Calls for New Reserve Currency," *The Financial Times*, March 24, 2009, http://www.ft.com/intl/cms/s/0/7851925a-17a2-11de-8c9d-0000779fd2ac.html#axzz4BD0WoNhH

[368] Yu-Wei Hu (2010), op. cit., pp. 11-15.

[369] Eiichi Sekine, "Moves by China to Improve How It Manages Its Foreign Exchange Reserves," Nomura Journal of Capital Markets, Autumn 2011 Vol. 3 No. 2, pp. 5-7; "FAQs on Foreign Exchange Reserves(I)," State Administration of Foreign Exchange (SAFE), July 20, 2010, http://www.safe.gov.cn/wps/portal/!ut/p/c4/04%20_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwN_f0tXA08zR9PgYGd3Yx8fE_2CbEdFAM9sw9Y!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/state+administration+of+foreign+exchange/safe+news/13818d8048659b229ee5be057866611e

[370] Lingling Wei, "China's CIC Gearing Up Investment in Overseas Assets," *The Wall Street Journal*, March 27, 2015, http://www.wsj.com/articles/chinas-cic-gearing-up-investment-in-overseas-assets-

The 'Go Global' Strategy and Outbound Foreign Direct Investments (OFDIs)

The history of China's OFDI is rather short, but remarkable. The development of China's OFDI has been fueled by the top-down policy and strategy of the Chinese government, "basically mirroring the process of its reform and opening up" on the economic front."[371] As Rosen and Hanneman (2009) observed, "The rapid growth of Chinese OFDI is also a result of Chinese economic necessity."[372] As explained above, tackling rapidly-rising foreign reserves and their associated inflationary pressures was among such economic necessities.

Indeed, it was in 2000 that China's OFDI was given an opportunity to leapfrog as part of the country's national strategy. The then Chinese Premier, Zhu Rongji, officially formulated the 'Go Global' policy in his annual policy address during which he encouraged Chinese companies to invest abroad. As the architect of China's accession to the WTO in 2001, he envisioned 'Go Global', or 'going out', "as being a platform for Chinese firms to become more competitive in the world economy.[373] Being written into China's overarching 10th Five Year Plan (2001-2006) as one of the key areas necessary for China's path to globalization, the policy's objective was to set the stage for certain Chinese companies to compete with the best foreign companies to break through to the ranks of the global Fortune 500.[374]

As Changhong Pei and Wen Zheng (2015) observe, "It was in the 2000-2009 period that the 'Go Global' strategy gathered momentum as relevant ministries, commissions and administrations issued a series of policy incentives aimed at promoting outbound foreign direct investment (OFDI) in response to the call for implementing the 'Go Global' strategy."[375] Another big policy boost came in July 2009 when Wen Jiabao, the then Chinese Premier, declared, "We should hasten the implementation of our 'going out' strategy and combine the utilization of foreign exchange reserves with the 'going out' of our enterprises."[376] China's huge wherewithal would be put to best use as a means of supporting the advance of Chinese firms into overseas markets.

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[371] Changhong Pei and Wen Zheng, *China's Outbound Foreign Direct Investment Promotion System* (Springer, 2015), pp.12-13.

[372] Daniel H. Rosen and Thilo Hanemann, "China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications," *PIIE Policy Brief* Number Pb09-14, June 2009, p.7.

[373] Heino Klinck, "The Strategic Implications of Chinese Companies Going Global," The Foreign Military Studies Office (FMSO) at Fort Leavenworth, Kansa, p.5.

[374] Ibid., p.6.

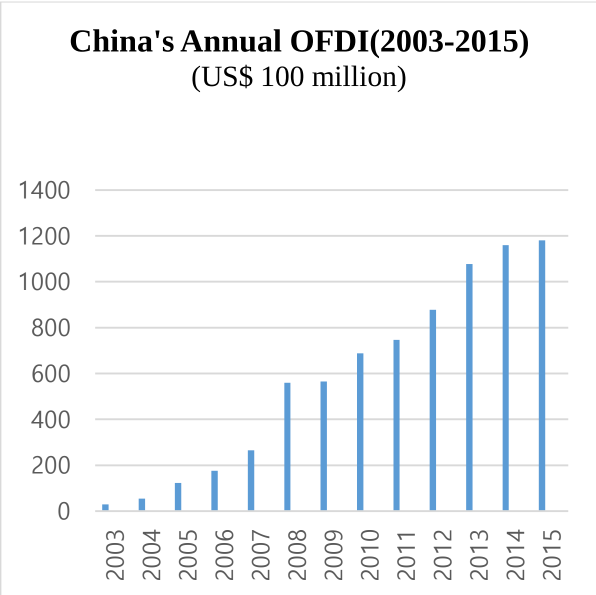
[375] Changhong Pei and Wen Zheng (2015), op. cit., p.9.

[376] China's "going-out" strategy, *The Economist*, July 21, 2009.

The 'Go Global' policy has started to show tangible outcomes, although outward investment still pales in comparison with inward investment. In barely a decade, Chinese OFDI has grown spectacularly. As was noted in the *FT* in 2015, "It has gone from virtually nothing to more than $100bn year, launching China into the top three exporters of direct investment globally."[377] China is poised to "become one of the world's biggest cross-border investors by the end of this decade, with global offshore assets tripling from $6.4 trillion now to nearly $20 trillion by 2020."[378]

In 2015, China's nonfinancial outward direct investment reached US$ 118.0 billion, hitting a new record high, up 14.7% year-on-year, realizing a growth of 13 consecutive years at an annual rate of 33.6%. As shown in Figure 21, over the past 13 years, China's annual OFDI has soared from a meager US$2.9 billion in 2003 to US$ 118.0 billion in 2015, with the total stock of China's OFDI also rapidly increasing from US$ 39.3 billion to US$ 894.5 billion during the period.[379]

Figure 21.



Source: Overseas Direct Investment, China Statistics Yearbook

[377] Jamil Anderlini, "China to become one of world's biggest overseas investors by 2020," *The Financial Times*, June 25, 2015, http://www.ft.com/intl/cms/s/0/5136953a-1b3d-11e5-8201-cbdb03d71480.html#axzz47gm7ud00

[378] Ibid.

[379] "Official of the Department of Outward Investment and Economic Cooperation of the Ministry of Commerce Comments on China's Outward Investment and Economic Cooperation in 2015," Ministry of Commerce (MOFCOM), People's Republic of China, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201602/20160201251488.; "China on an outbound investment spree," *The Business Times*, 21 July 2015; https://globalconnections.hsbc.com/singapore/en/articles/china-outbound-investment-spree

There are some notable trends in China's efforts to expand OFDI in tandem with its 'Go Global' policy:

- First of all, the nature and scope of China's OFDIs over time reflecting the trajectory of China's economic development. In the 1980s, the focus of China's OFDI was on facilitating the government's export strategy through such activities as opening trade outlets and representative offices, and developing export channels. Since 1990, China's OFDI is fast climbing the ladder of foreign direct investment by "transitioning from lower levels of investment to higher" and more sophisticated ones as China has shifted its focus from "sending business representatives to field offices, to investing in new businesses, including greenfield type investments, to M&A and indirect equity investment." [380](Pei and Zheng, 2015).
- With the rapid growth of the Chinese economy, the internal dynamics have fueled China's huge energy needs. A combination of factors, including booming investment in energy-intensive heavy industry, massive urbanization involving commercial and residential real-estate construction - each year, over 10 million people are reclassified from rural to urban, most of them moving physically to new places and homes - and soaring production of consumer goods and services for both home and abroad, have all produced a huge demand for key natural resources, such as oil, iron ore, copper and aluminum.[381] China's leading OFDI loan motive, therefore, is natural resources acquisition, which is responsible for 81% of China's OFDI loans since 2002.[382] Chinese companies have made major acquisitions of mining and other natural resource companies in Australia, Canada and parts of Africa.[383]
- China became interested in "snapping up 'physical assets'" instead of "buying European or US debt,"[384] it was reported in 2012. This is in line with China's overall OFDI strategy under which Beijing's "second-largest

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380 Changhong Pei and Wen Zheng (2015), op. cit., p.13.

381 Daniel H. Rosen and Trevor Houser, "China Energy: A Guide for the Perplexed," *China Balance Sheet*, a Joint Project by the Center for Strategic and International Studies and the Peterson Institute for International Economics, May 2007, p.4 and pp, 6-16

382 Amos Irwin and Kevin P. Gallagher, "Exporting National Champions: China's OFDI Finance in Comparative Perspective," Global Economic Governance Institute, the Frederick S. Padee Center for the Study of the Longer-Range Future, June 2014, p.18

383 Nargiza Salidjanova, "China's Foreign Exchange Reserves and Holdings of U.S. Securities," *USCC Economic Issue Brief* No. 2, March 21, 2014, p.4.

384 Benjamin Kang Lim and David Stanway, "China power giants flex muscles abroad," *Reuters*, February 9, 2012.

> OFDI lending motive is increasing market share", while "the third OFDI motive is acquiring advanced technology through M&A."[385] Chinese brands like Haier (home appliances), Huawei (telecommunications), and Lenovo (personal computers) are seeking to tap global markets, in part through direct investment abroad.[386] The 2010 Eurozone crisis provided a good opportunity to further expand investments in Europe, particularly in the heavily-indebted so-called PIIGS countries (Portugal, Ireland, Italy, Greece and Spain).[387] Despite "a lot of skepticism within the Communist Party, but also in Chinese public opinion, about China sinking money into European reserve assets," it was considered that "lending a hand to Europe could prove a golden opportunity for China to increase its financial and political clout, and make it more of an equal among giants on the Continent."[388]

"In 2015, new investment in Europe was up 28 percent on the $18bn registered in 2014, a smaller increase than 2014's doubling of the 2013 figure, while Chinese direct investment in the Eurozone was up 37 percent in 2015, rising to $17.1bn from $12.5bn."[389] Investment in the US was also up 17 percent on 2014's $12.8bn. (See the next Chapter for further elaboration on Chinese investment in the US)

Chinese buyers struck a record $112.1 billion of cross-border deals in 2015, up 57% from 2014.[390] This was impressive because, as one *Business Insider* article commented, "China's large state-owned enterprises (SOEs) played a less active role in 2015 M&As compared to their mid-2000s heyday as President Xi Jinping's wide-ranging anti-graft investigations turned several officials cautious about making big decisions."[391] In 2016, Chinese companies have already begun to notch up deals. On January 15th, 2016, General Electric

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385 Amos Irwin and Kevin P. Gallagher (2014), op. cit., p.19.

386 Nargiza Salidjanova (2014), op. cit., p.4.

387 Wieland Wagner, "Capitalizing on the Euro Crisis; China Expands Its Influence in Europe, *The Spiegel*, December 14, 2010, http://www.spiegel.de/international/world/capitalizing-on-the-euro-crisis-china-expands-its-influence-in-europe-a-734323.html

388 Liz Alderman and David Barboza, "Europe Tries to Lure Chinese Cash to Back Rescue of Euro," *The New York Times*, October 28, 2011, http://www.nytimes.com/2011/10/29/world/asia/europe-seeks-chinese-investment-in-euro-rescue.html?_r=0

389 Claire Jones, "Chinese investment in Europe hits $23bn record," *The Financial Times*, March 10, 2016, http://www.ft.com/intl/cms/s/0/c1155e72-e5e0-11e5-a09b-1f8b0d268c39.html#axzz47gm7ud00

390 Laura Board, Why China Is an M&A Machine, *TheStreet*, February 29, 2016, http://www.thestreet.com/story/13475224/1/why-china-is-an-m-amp-a-machine.html

391 Denny Tomas, "Chinese companies spent over $100 billion on foreign deals this year for the first time ever," *The Business Insider*, December 22, 2015, http://www.businessinsider.c /r-after-fueling-1-trillion-asia-deal-spree-chinas-ma-set-to-hit-new-heights-in-2016-2015-12

Co. agreed to sell its appliance unit for $5.4 billion to Chinese manufacturer Haier Group. That deal was significant for the Chinese company, which is looking to expand its products into homes around the world, because, as observed in *WSJ*, it "will broaden Haier's customer base and distribution channels."[392] It "could also sharpen Haier's credibility in the US, where Chinese brands are perceived as low quality." On February 3rd, 2016, China National Chemical Corp. agreed to buy Syngenta AG, a Swiss pesticide and seed maker, for more than $43 billion in cash, *Bloomberg* reports, "as the state-backed company (extended) its shopping spree with what would be the biggest acquisition by a Chinese firm."[393]

This year's tally is on pace to exceed 2015's record $123.9 billion. The reason that Chinese firms enthusiastically rushed overseas from early 2016 seems to be, according to *Bloomberg*, that "bubbles in China's housing and stock markets leave them with limited investment options domestically", while the Chinese government "has encouraged enterprises to 'go out' and help promote the yuan's internationalization."[394] The Chinese, it appears, like to "upgrade themselves fast by buying assets, techniques and patents."

In what has been called the 'Third Wave' of Chinese outbound direct investment (ODI), the focus has been on companies in developed economies, especially in the high-tech and services sectors, unlike "previous waves that have focused on supporting developing economies and investing in commodities and extraction industries."[395] Moving away from China's early investment pattern, which mainly focused on energy and natural resource assets in developing countries, Chinese investors are, the *Financial Times* reports, "increasingly looking to the US and Europe for fresh opportunities."[396] In addition, the new trend is that "China is buying what it wants instead of just what it needs", which "has led to a much broader trend in outbound acquisitions, where private companies have joined the state-run ones in targeting assets abroad."[397]

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392 Laurie Burkitt, Joann S. Lublin, and Dana Mattioli, "China's Haier to Buy GE Appliance Business for $5.4 Billion," *The Wall Street Journal*, January 15, 2016, http://www.wsj.com/articles/chinas-haier-to-buy-ge-appliance-business-for-5-4-billion-1452845661

393 "ChemChina Offers Over $43 Billion for Syngenta," *Bloomberg News*, February 3, 2016, http://www.bloomberg.com/news/articles/2016-02-03/chemchina-offers-to-purchase-syngenta-for-record-43-billion

394 Fox Hu and Jonathan Browning, "Chinese Firms Are Deep in an Overseas Shopping Frenzy," *Bloomberg*, January 21, 2016, http://www.bloomberg.com/news/articles/2016-01-21/chinese-firms-mind-the-value-gap-and-prowl-for-deals-overseas

395 "China on an outbound investment spree," *The Business Times*, 21 July 2015; https://globalconnections.hsbc.com/singapore/en/articles/china-outbound-investment-spree

396 Jamil Anderlini (2015), op. cit.

397 Arash Massoudi, Don Weinland, and James Fontanella-Khan, "China groups seal record trove of M&A deals," *The Financial Times*, March 31, 2016, http://www.ft.com/intl/cms/s/0/9583e8ea-f70c-

Dollar deleveraging

Since the "People's Bank of China prints/borrows RMB to purchase the dollars which have accumulated in its foreign exchange reserves," "In order to reduce these USD denominated reserves," it "has to sell USD from its foreign exchange reserves to buyback RMB from circulation."[398] In 2015, China sold a record $510 billion of FX reserves. The lion's share of that came from $292 billion in sales of US Treasury debt, followed by $92 billion in sales of US stocks, $3 billion of US agency bonds, and $170 billion of non-US assets.[399] This would indicate that the Chinese authorities are 'deleveraging' their dollar reserves.

China has been engaged in a variety of activities that could result in reducing its dollar-denominated assets, or 'dollar deleveraging':

- First of all, as declared, Beijing's continued implementation of the 'Go Global' strategy - aimed at helping Chinese firms to advance into overseas markets - through using its foreign reserves could lead China to deleverage dollar assets from its reserve holdings. The more aggressively the Chinese authorities utilize the country's foreign reserves, the more they are able to divest dollar assets from their reserve holdings, given China's foreign reserve portfolio with a substantially high dollar share.
- The progressing RMB internationalization could also affect dollar deleveraging since it will encourage China, its trading partners, and foreign investors to more widely use the RMB, instead of a third currency, in trade and financial transactions. In particular, China's move towards a target of 50% RMB settlement of all its trade will enable it to reduce its foreign reserves to a great extent, which will in turn lead to a substantial drop in the country's dollar holdings. One obvious implication of the RMB's rise as a trade settlement currency and, eventually, as an international reserve currency, is that China will increasingly engage in international trade without using foreign currency. Thus, as Jan Dehn (2015), an international investment manager, puts it, "the link between China's trade balance and its foreign exchange reserves is broken - in the same way that there is no relationship between the US trade balance and US FX reserves."[400]

11e5-803c-d27c7117d132.html#axzz4BD0WoNhH

[398] JC Collins, "How China is Deleveraging from the USD (FREEPOM)," *Philosophy of Metrics*, January 13, 2016, HTTP://PHILOSOPHYOFMETRICS.COM/HOW-CHINA-IS-DELEVERAGING-FROM-THE-USD-FREEPOM/

[399] Jamie McGeever, "China FX reserve sell-off to soon move beyond U.S. Treasuries: BAML," *Reuters*, January 11, 2016; http://www.reuters.com/article/us-global-markets-china-idUSKCN0UP1VI20160111.

[400] Jan Dehn, "The RMB trade settlement effect," *Weekly Investor Research*, Ashmore Group, April 7,

- As discussed in the previous chapter, China has recently signed numerous bilateral currency-swap agreements with major trading partners that bypass the dollar. Moscow and Beijing have also set up ruble-yuan swap facilities that push the greenback out of the picture
- A fourth factor is that China's recent agreements with Russia and other members of the BRICs (Brazil, Russia, India, China and South Africa) could also enable it to reduce its reliance on the dollar. (i) On November 22nd, 2010, the then Russian Prime Minister Vladimir Putin and the then Chinese Premier Wen Jiabao, meeting in St. Petersburg, caused a great deal of discussion in financial markets when they announced that Russia and China had decided to use their own national currencies for bilateral trade, instead of the US dollar.][401] Less than a month later, on December 15th, 2010, the RMB started trading against the ruble in the Chinese bank market in Shanghai, which marked the first time that the yuan had traded outside of China and Hong Kong. The Russian Moscow Interbank Currency Exchange also started RMB–ruble trading. This RMB/Ruble direct-trading arrangement was also seen as pushing the greenback out of the picture. (ii) On April 14th, 2011, the development banks of the five BRICS nations agreed in principle to establish mutual credit lines denominated in their local currencies, as opposed to dollars.[402] Although setting up local-currency credit lines may yet prove to be of more symbolic than practical importance, it nevertheless showed the BRICS members' concern about the long-term fate of the dollar resulting from America's large trade and budget deficits. (iii) On May 21st, 2014, Beijing and Moscow struck a US$400 billion deal, under which Russia will supply 38bn cubic metres (bcm) of gas to China over a 30-year period from 2018. As noted by *The Telegraph*, a British newspaper: "If Russia's 'pivot to Asia' results in Moscow and Beijing trading oil between them in a currency other than the dollar, that will represent a major change in how the global economy operates and a marked loss of power for the US and its allies." The article went on to say, "If Russia and China now decide to drop dollar energy pricing totally, America's reserve currency status could unravel fast, seriously undermining the US Treasury market and causing a world of pain for the West. This won't happen tomorrow or next year. It's unlikely even by 2020. But by announcing this deal, Russia and China turned the screw half

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2015.

[401] Jack Perkowski, "The Internationalization of The Yuan," *Fobes*, February 23, 2012, http://www.forbes.com/sites/jackperkowski/2012/02/23/the-internationalization-of-the-yuan/#6b37ed8a273e; Su Qiang and Li Xiaokun, "China, Russia quit dollar," *The China Daily*, http://www.chinadaily.com.cn/china/2010-11/24/content_11599087.htm

[402] "BRICS sign framework pact for local currency credit lines," *Reuters*, April 14, 2011, http://www.reuters.com/article/brics-credit-idUSL3E7FE0AV20110414

a twist more."[403] Despite the details of the deal being scant, it seems the oil exports could be traded in local currencies, thus bypassing the US dollar - the traditional currency used in oil trades and considered to be the international reserve currency of choice.[404]

[403] Liam Halligan, "Russia-China gas deal could ignite a shift in global trading: Russia is increasingly looking east to China as a trading partner - and that could mean an end to the dollar's dominance as a petrocurrency," *The Telegraph*, May 24, 2014, http://www.telegraph.co.uk/finance/comment/liamhalligan/10854595/Russia-China-gas-deal-could-ignite-a-shift-in-global-trading.html

[404] Matt Clinch, "What Russia-China relations mean for the dollar," *CNBC*, May 27, 2014, http://www.cnbc.com/2014/05/27/what-russia-china-relations-mean-for-the-dollar.html

6. RMB Internationalization and the Future of the IMS

It is true that with the RMB's rapid rise as an important international currency as a result of expedited RMB internationalization, there is growing interest in and heated debate over how this new phenomenon affects both the dollar-based international monetary system (IMS) in general and the stature of the dollar as the world's dominant reserve currency in particular.

In its paper of February 2016, the IMF observes that although "today's IMS has displayed great strength, the 2008/09 crisis revealed considerable weaknesses in the IMS, which provided impetus for reform."[405] Emphasizing the need to "evolve with the global economic and financial landscape," it also highlights that "landmark structural shifts in the global economy, and associated instability, have typically catalyzed fundamental changes of the IMS."[406] The big question, then, is how the IMS should evolve in order to adjust to the tectonic changes taking place in the global economy. In this regard, this Chapter discusses three key issues:

- The dawning of a multi-polar monetary system
- Whether the RMB will replace the dollar as the dominant reserve currency
- How the US should respond in order to maintain the current status of the dollar

6.1. The Dawning of a Global Multipolar Currency System

Fred Bergsten (2009) supports a system of multiple currencies because it functioned smoothly for several decades before World War I. "Competition between national currencies under the system" is also "likely to improve economic policies and performance by forcing market discipline on the governments and central banks behind these alternative currencies," Bergsten notes.[407] Indeed, the rapid rise of the RMB as a candidate for a major international currency has helped to heat up the debate on the reorganization of the international monetary architecture. The IMF's decision, on November 30th, 2015, to include the RMB in the SDR basket provided added momentum in this regard. As the IMF put it, the decision was significant as it marked "an important milestone in the integration of the Chinese economy into the global financial system," while reflecting "growing international use and trading of renminbi."[408] The move represented a major step along the path of the RMB's internalization, since the redback is currently about to take another leap forward, this time into the "realms of the world's central banks," after starting, in the words

[405] "STRENGTHENING THE INTERNATIONAL MONETARY SYSTEM - A STOCKTAKING," IMF, February 26, 2016, p. 1., p.4. and p.7.

[406]. Ibid.

[407] C. Fred Bergsten, "The Dollar and the Deficits: How Washington Can Prevent the Next Crisis," Article in *Foreign Affairs* (November/December 2009), Volume 88 No. 6.

[408] IMF SDR BASKET: Chinese Renminbi to Be Included in IMF's Special Drawing Right Basket," IMF Survey, December 1, 2015, http://www.imf.org/external/pubs/ft/survey/so/2015/new120115a.htm

of Peter Wong of HSBS, as a "tourists' currency" and then as a currency used by "traders and bankers."[409]

This clearly shows that the IMS is rapidly moving towards a multi-polar, or perhaps, more precisely, a tri-polar system, with the RMB "intensifying its anchor role and shaping a regional currency bloc in Asia" (Miriam Campanella, 2014).[410] Indeed, it is safe to say that the IMF's vote of confidence over RMB internationalization and the RMB's third largest weight in the SDR basket, only after the dollar and euro, can be seen as the dawning of a multi-polar monetary system.

An international monetary system based on three major currencies - the dollar, euro and RMB, as indicated by the new SDR weighting – could be a realistic option, as Subacchi and Driffill (2010) note.[411] It could appropriately reflect three centers of gravity in the global economy that can be represented by "a world of regional trading blocs – Europe, Asia, the Americas – alongside a still preeminent dollar," while addressing the so-called Triffin Dilemma by "providing the necessary liquidity without the constraints imposed by a single primary reserve currency system."[412] As Benjamin J. Cohen observes, under "a broader multi-currency system," the United States would find it harder to "act in arbitrary, unilateral fashion."[413]

Along these lines, Charles Wolf (2016) proposes the idea of providing a shared role for the RMB in respect of future global financial architecture because it "might actually have complementary as well as competitive effects on the dollar."[414] He goes on to say, "Recognizing the scale as well as the weaknesses of China's economy" including "the yuan's small scale in international finance…the key idea underlying possible yuan-dollar complementarity can be summarized in three propositions linking domestic monetary policy both in the US and China to the global currency role." Because "frequent and protracted recourse by the United States or China to 'aggressive monetary policy' (AMP)," such as the introduction of near-zero nominal short-term interest rates and QE (quantitative easing), "often has serious destabilizing, disruptive, and unintended effects, both within the country pursuing AMP and in other ('third') countries," Wolf notes, sharing the role of dominant global reserve currency would result in "discouraging AMP's frequency and disruptive

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[409] Peter Wong, "RMB inclusion will shake up financial order," *HSBC*, December 8, 2015, http://www.about.hsbc.com.hk/news-and-media/rmb-inclusion

[410] Miriam Campanella (2014), op. cit., p.14.

[411] "Beyond the Dollar Rethinking the International Monetary System," A Chatham House Report edited by Paola Subacchi and John Driffill, March 2010, p. ix. and p. 5.

[412] Ibid.

[413] Benjamin J. Cohen, "THE COMING GLOBAL MONETARY (DIS)ORDER," p. 8.

[414] Charles Wolf, Jr., "China's Yuan as a Reserve Currency: Boon or Bane for the Dollar?" originally appeared in *The Weekly Standard* on June 13, 2016, http://www.rand.org/blog/2016/06/chinas-yuan-as-a-reserve-currency-boon-or-bane-for.html#

effects." He then concludes, "Establishing a system in which two reserve currencies compete with each other to affect global decisions about reserve holdings may therefore lead to greater financial stability than the present dollar-dominated system.".[415] In short, argues Fred Bergsten, a regime other than the current one will lead the world economy to speed up urgently needed 'rebalancing', thereby reducing the risk of future crises.[416]

Such a debate clearly demonstrates that the RMB is poised to sit alongside the US dollar and the euro, as vindicated by the IMF's recent decision to include the RMB in the SDR basket, which will further catalyze RMB internationalization. China's growing dominance in the global economy in terms of its current and future share of global GDP and of global trade, "good gauges of currency dominance," would suggest "an important global role for the RMB" (Phyllis Papadavid, 2016)[417]. SWIFT's indicators also "confirm RMB's journey in becoming an international currency."[418]

It is against this backdrop that Britain's shock vote to leave the European Union on June 23rd, 2016 posed an enormous new challenge not only for the pound sterling, but also for the euro and, by logical extension, for the tri-polar or multi-polar monetary system. Brexit is going to be "very damaging for the UK, potentially quite damaging to Europe,"[419] Adam Posen, president of PIIE, points out. Of particular concern is that Brexit "could lead to further political fragmentation in many countries, boosting support for Eurosceptic and separatist parties, and making it even harder to form stable governments," which "would have an economic impact as it would raise fresh questions about the capacity to deliver vital reforms, leading to lower estimates of future growth and productivity and higher political-risk premiums,"[420] *Reuters* notes. Such a political debacle could negatively affect the status of the euro as a major international currency.

Notwithstanding this, the silver lining is that Brexit could also provide a rare opportunity to try to address some of the weaknesses facing the euro through "agreeing plans for Eurozone-wide common bank deposit insurance and pushing ahead with plans for greater fiscal integration" as contained in the 2015 Five Presidents' Report.[421]

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415 Charles Wolf, Jr. (2016), op. cit.

416 Fred Bergsten, "Why world needs three global currencies," *The Financial Times*, February 15, 2011, http://www.ft.com/intl/cms/s/0/d4845702-3946-11e0-97ca-00144feabdc0.html#axzz499Hy6OK7

417 Phyllis Papadavid (2016), op. cit., p. 13.

418 "Renminbi's stellar ascension: Are you on top of it?" RMB Tracker Sibos 2015 Edition, p.2.

419 Pedro Nicolaci da Costa, "Brexit Is Huge Blow to UK Economy, Global Standing: Adam Posen," PIIE, June 24, 2016, https://piie.com/blogs/realtime-economic-issues-watch/brexit-huge-blow-uk-economy-global-standing-adam-posen

420 Michelle Price, "In Asia, financial firms wake up to Brexit risks, begin contingency planning," *Reuters*, April 22, 2016, http://in.reuters.com/article/britain-eu-asiapacific-idINKCN0XJ12F

421 Ibid.; "Completing Europe's Economic and Monetary Union, Report by Jean-Claude Juncker in

On the other hand, "China is also closely watching and weighing the impact of the possible United Kingdom leaving the European Union,"[422] as The *People's Daily*, a Chinese news media, notes, in terms of Brexit's potential impact on Beijing's efforts to internationalize the RMB. The importance of London as a key offshore RMB hub has grown enormously over the past few years, during which time, says DBS Group Research, "the UK has made great strides in establishing yuan linkages and developing capabilities."[423] As the second largest offshore yuan centre (after Hong Kong), London helps execute "an estimated US$39 billion of yuan deals daily," and "40% of all payments between the UK and China/Hong Kong are now made in yuan," while "yuan-denominated bonds issued in London are traded with ease across the EU."

Therefore, one can argue that Brexit could impact the pace of RMB internationalization. However, Brexit would not be enough to reverse the recent forward momentum of the RMB's internationalization given that other RMB centers across the world, particularly Singapore and New York, would be happy to take on a bigger role in lieu of London. Once the British people had voted 'Out' of the EU, the next big question became, 'When will Brexit happen?' Some pundits argue that the Brexit drama is not over yet. "Like all good dramas, the Brexit story has been shocking, dramatic and upsetting," but "its ending is not yet written," writes Gideon Rachman in the *Financial Times*, claiming, "Yet there are already signs that Britain might be heading towards a second referendum rather than the door marked exit."[424] According to him, Boris Johnson, a leader of the Leave campaign and a former

close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz," European Commission, June 22, 2015, pp. 10-15; "Five Presidents' Report sets out plan for strengthening Europe's Economic and Monetary Union as of 1 July 2015," European Commission - *Press release*, http://europa.eu/rapid/press-release_IP-15-5240_en.htm (The Report sets out three different stages for turning the vision of the Five Presidents into reality: Stage 1 or "Deepening by Doing" (1 July 2015 - 30 June 2017): using existing instruments and the current Treaties to boost competitiveness and structural convergence, achieving responsible fiscal policies at national and euro area level, completing the Financial Union and enhancing democratic accountability; Stage 2, or "completing EMU": more far-reaching actions will be launched to make the convergence process more binding, through for example a set of commonly agreed benchmarks for convergence which would be of legal nature, as well as a euro area treasury; Final Stage (at the latest by 2025): once all the steps are fully in place, a deep and genuine EMU would provide a stable and prosperous place for all citizens of the EU Member States that share the single currency, attractive for other EU Member States to join if they are ready to do so.)

[422] "Why is China concerned about Brexit?" *People's Daily Online*,June 23, 2016, http://en.people.cn/n3/2016/0623/c90000-9076549.html

[423] "New Fronts for Yuan Internationalisation," DBS Group Research, June 27, 2016, https://www.dbs.com/aics/templatedata/article/generic/data/en/GR/062016/160627_economics_new_fronts_for_yuan_internationalisation.xml

[424] Gideon Rachman "I do not believe that Brexit will happen," The Financial Times, June 27, 2016, http://www.ft.com/cms/s/2/8f2aca88-3c51-11e6-9f2c-36b487ebd80a.html#axzz4Crvzmyrt

Mayor of London, “hinted at his real thinking back in February, when he said: ‘There is only one way to get the change we need - and that is to vote to go, because all EU history shows that they only really listen to a population when it says No.’”[425]

Assuming, however, that Britain does proceed with an Article 50 notice, the EU withdrawal negotiation should be a long and arduous process. As John Cassidy, writing in *The New Yorker* just after the referendum result explains, “If and when the UK government invokes Article 50 of the Lisbon Treaty of 2007,” it could take “at least two years of negotiations about the terms of Britain’s future relationship with Europe.”[426] Most important is that if and when Article 50 negotiations should start, Reuters observes, “much will depend on the nature of the revised relationship between the UK and the remaining EU Member States."[427]

In light of all this, it is too early to tell how the Brexit episode might play out and what impact it could have on the stature of the euro and on RMB internationalization. However, one can argue that particularly given the steady rise of the RMB, the irreversible trend would be for the IMS to evolve into a multi-polar or tri-polar system further down the road, as suggested by an interim report released in June 2016 by the ECB. “The medium-term decline in the shares of both the euro and the US dollar may suggest a trend towards greater multipolarity in the international monetary system,” the report notes, because “official holders of foreign exchange reserves have increasingly diversified into non-traditional reserve currencies since the onset of the global financial crisis.” [428]

The challenge now, therefore, is how the international community will cope with the ‘dawning of a new tri-polar global monetary system’ in a manner that will ensure the sustainable development of the global economy.

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[425] Ibid.
[426] John Cassidy, “Why Brexit Might Not Happen at All,” The New Yorker, June 27, 2016, http://www.newyorker.com/news/john-cassidy/why-brexit-might-not-happen-at-all
[427] Michelle Price, “Brexit puts UK-China financial services linkages at risk,” *Reuters*, June 25, 2016, http://www.reuters.com/article/us-britain-eu-financial-china-idUSKCN0ZB06V
[428] “The international role of the euro,” Interim report, ECB, June 2016, p.5.

6.2. Will the RMB Replace the Dollar?

How long it will take before the Renminbi becomes fully convertible? Will the Chinese currency dethrone the dollar as the world's dominant reserve currency? If so, when? These are some of the hot topics and frequently-asked questions regarding RMB internationalization. Behind all of these is the fundamental question: what advantages can the country of a key reserve currency enjoy? Benjamin Cohen (2003) provides some clues[429]:

> "Not surprisingly, all this international and foreign-domestic use of the dollar appears to translate into considerable advantages for the United States, both economic and political…four distinct gains (that) may be cited (are) the potential for *seigniorage*, the increased flexibility of macroeconomic policy that is afforded by the privilege of being able to rely on one's own money to help finance foreign deficits, the gain of status and prestige that goes with market dominance, and the gain of 'hard' geopolitical power that derives from the monetary dependence of others."

As such, it is critically important for the United States to ensure that the dollar will continue to play a key role in the IMS as the world's dominant reserve currency. Therefore, it is natural that the question of whether and when the RMB will replace the dollar as the world's premier reserve currency would emerge as a topic of heated debate. To answer this question, it would be necessary and desirable to first take a careful look at whether the Chinese currency will be able to become an international reserve currency both in name and substance. Barry Eichengreen (2012) argues that "enabling the yuan to rival or supplant the dollar and the euro in the financial sphere" will require China to "eliminate essentially all restrictions on financial inflows and outflows and move to a fully flexible exchange rate."[430] Eichengreen goes on, "Simply put, the Chinese government would be compelled to fundamentally transform not just the country's development model but its entire approach to foreign relations," which, he predicts, is "an unlikely scenario, at least in the coming decade." This indicates that although the RMB's internationalization has progressed to a substantial degree and is even speeding up, there is still a long and bumpy way ahead. In a nutshell, more than a few things need to be addressed before the RMB becomes a fully-fledged international reserve currency.

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[429] Benjamin J. Cohen, "The Geopolitics of Currencies and the Future of the International System," Department of Political Science University of California at Santa Barbara, Paper prepared for a conference on The Geopolitics of Currencies and Oil, Real Instituto Elcano, Madrid, 7 November 2003. pp. 4-5.

[430] Barry Eichengreen, "When Currencies Collapse: Will We Replay the 1930s or the 1970s?" *Foreign Affairs*, January/February 2012, p. 131.

It is for this reason that the then Chinese President Hu Jintao acknowledged in his joint interview with the *Wall Street Journal* and the *Washington Post* in January 2011, ahead of his visit to Washington, that making the Chinese currency a fully-fledged international currency "will be a fairly long process," while calling attention to China's accelerating effort to expand the role of the RMB.[431] *China 2030*, a report that the World Bank and the Development Research Center of the State Council of China jointly released on February 27th, 2012, also expresses a similar view by saying that "China's growing weight in world trade, the size of its economy, and its role as the world's largest creditor will make the internationalization of China's renminbi inevitable, but its acceptance as a major global reserve currency will depend on the pace and success of financial sector reforms and the opening of its external capital account."[432] Bearing in mind that the "many prerequisites for an open capital account were the main reason why many European countries took nearly 20 years after the collapse of the Bretton Woods system to achieve full capital account liberalization," the report further notes, "In the case of China, therefore, a relatively prudent approach, stretching over many years, is recommended in transitioning safely to a more open and efficient financial and exchange-rate system."[433]

Problems associated with heavy capital inflows to emerging market economies (EMEs) were "particularly serious in the past when some EMEs violated the 'impossible trinity' by simultaneously pursuing a *de facto* dollar peg, free movement of capital, and an independent monetary policy."[434] The lessons learned hard by some Asian economies during the Asian financial crisis of 1997 should encourage China to remain circumspect as it moves towards full capital account opening and facilitates the deepening of its financial markets through loosening regulations with a view to making the RMB a major international reserve currency.

Being aware of the high risks involved, China has taken a gradual approach to capital account liberalization since 1996, and the remaining capital controls are mainly used to regulate short-term capital movements.[435] China is expected to continue to do a balancing act, while carefully weighing the benefits of further expediting RMB internationalization over the risks

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[431] Andrew Browne, "China's President Lays Groundwork for Obama Talks," *The Wall Street Journal*, January 17, 2011, http://www.wsj.com/articles/SB10001424052748703551604576085803801776090

[432] "China 2030, Building a Modern, Harmonious, and High-Income Society," World Bank and Development Research Center of the State Council, People's Republic of China, 2012, p.7.

[433] Ibid., p. 63.

[434] "Opening remarks by Mr. Peter Pang, Deputy Chief Executive of the Hong Kong Monetary Authority," at the conference on "Diverging Monetary Policies, Global Capital Flows and Financial Stability," 15 October 2015, http://www.bis.org/review/r151027e.htm

[435] Yu Yongding, "The forces driving RMB internationalisation," The East Asia Forum, January 5, 2014, http://www.eastasiaforum.org/2014/01/05/the-forces-driving-rmb-internationalisation/

associated with its financial reforms and capital account opening.

A February 2016 interview with Zhou Xiaochuan, Governor of the PBoC, provides a glimpse into how the Chinese government will proceed with reforms in the future since the IMF decided to include the RMB in the SDR basket in November 2015. Noting that, “For a country as big as China, to achieve the reform goal may require a considerable period of time,” Zhou pointed out that “one should take decisive actions when windows of opportunity open up, but refrain from reckless moves in the absence of such windows.”[436] He emphasized that China is “pragmatic, patient and determined with (its) goals, but do not target to move in a straight line toward reform goals.” Zhou then continued, “The process of yuan internationalization will move forward like waves do.”[437] This signals the Chinese government’s intention to make continued efforts to internationalize the RMB in a steady, careful manner, while keeping in mind Deng Xioping’s instruction: “cross the river by feeling the stones.”

The extent to which China deepens its financial market development, opens capital accounts, and makes its currency freely convertible will eventually determine whether and when the RMB can attain fully-fledged reserve currency status. This process will take time because the Chinese government is known to take a gradualist approach to RMB internationalization as substantiated by Governor Zhou’s above remarks.

That being said, in international trade and finance terms, the RMB is “already well on its way to becoming a widely used currency” (Eswar Prasad, 2016).[438] Therefore, continued progress in the financial sector and other market-oriented reforms will likely enable the RMB to become an important reserve currency “within the next decade, perhaps eroding but not displacing the dollar’s dominance.”[439] Although there are several reasons for this, it is “more fundamentally” because “no other country is likely to achieve the dominance that the US economy acquired in the aftermath of the Second World War” (Subacchi and Driffill, 2010)[440].

Thus, a more pertinent question might be what the US should do to maintain the dollar’s dominant status, which is the topic of the next section.

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[436] Wang Shuo, Zhang Jiwei and Huo Kan, “Transcript: Zhou Xiaochuan Interview,” *CaixinOnline*, February 15, 2016, http://english.caixin.com/2016-02-15/100909181.html

[437] Ibid.

[438] Eswar Prasad (2016), op. cit., pp. 104-105.

[439] Ibid.

[440] “Beyond the Dollar Rethinking the International Monetary System,” (2010), op. cit., p. 4.

6.3. The US Responses: Challenges and Opportunities

There are a number of yardsticks with which to determine whether the currency of a country is suited to international currency status. Four key determinants are generally recognized. (Prasad, 2016)[441]:

(i) First and foremost, the size of the domestic economy and international trade always matter, as witnessed by the history of international currencies. The mere fact that the country enjoys a large share of international trade and financial transactions is always a big boost to its currency's eligibility for international currency status.

(ii) The extent of development of the country's financial markets is another key yardstick. Whether its government allows capital inflows and outflows to be made openly and freely matters greatly for both domestic and international investors.

(iii) The country's international currency status is also rooted in the international community's confidence that the value of its currency would not be subject to erratic fluctuations so that other countries can piggyback its macroeconomic stability.

(iv) A fourth yardstick is network externalities. The greater the level of overseas use of a currency, the more likely it is to become an important international reserve currency, as was the case with the English language.

It is safe to say that no country other than the US can meet the second criteria. As pointed out in the previous section, this is the major reason that the RMB cannot replace the dollar as the world's dominant reserve currency in the near future unless China fulfills this requirement. However, there seems to be a growing sense that the degree to which the US accommodates the first, third, and fourth factors has decreased over time. Accordingly, one can argue that the ability to maintain the dollar's dominance as the key international reserve currency depends on how Washington can increase the level of fulfillment of those requirements.

To this end, the ensuing sections discuss the priority policy agenda issues that have often been raised, and which the US government would have to aggressively address. These include issues related to growing fiscal deficits, current account deficits, trade, and investment. Given the purpose of this paper, these issues are discussed within a broad context of RMB internationalization and its implications for the dollar and the US economy.

"When written in Chinese," commented (the then) Senator John F. Kennedy at the Convocation of the United Negro College Fund in Indianapolis in April 1959, "the word 'crisis' is composed of two characters - one represents danger and one represents

441 Eswar Prasad (2016), op. cit., pp. 333-335.

opportunity."[442] How the US responds to its challenges will become critically important not just for its own economy, but also for the world economy.

A. Taming the 'Deficit Gorilla' in the Room: Budget and Current Account Deficits

Benjamin Cohen (2003) notes that the benefits accruing to the country of an international reserve currency, which benefits are likely to be at their greatest in the early stages of cross-border use when confidence in that currency is at a peak, may later be eroded when "external liabilities accumulate increasing supply relative to demand…particularly if an attractive alternative comes on the market."[443] Cohen goes on to point out, "Foreign holders may legitimately worry about the risk of future depreciation or even restrictions on the usability of their holdings."

This statement alludes to the fact that it is critically important for the US government to secure the continued confidence of the international community in the dollar particularly at a time when potentially attractive alternative currencies, such as the euro and the RMB, exist on the market.

In this regard, Fred Bergsten (2009) warned in the aftermath of the 2008-9 Global Financial Crisis that "the US government's continued failure to responsibly address the fiscal future of the United States will imperil its global position as well as its future prosperity."[444] As a way to cope with this, he recommended that the US should "initiate new policies" aimed at tackling ballooning "budget deficits and external deficits" and should also "build the foundation for a sustainable US economy over the long haul," while continuing with efforts to recover from the current crisis.[445]

Figure 22 shows that the US current account deficits have continued since 1992. The US annual current account deficit had soared almost nine-fold from US$ 51.6 billion in 1992 to US$ 463.0 billion in 2015, reaching a peak of US$ 806.7 billion in 2006.

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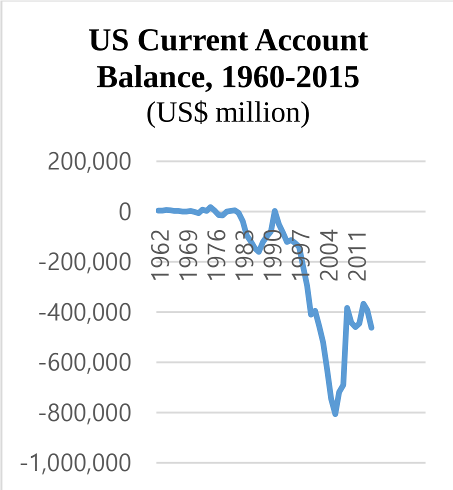
[442] "John F. Kennedy Speeches, Remarks at the Convocation of the United Negro College Fund, Indianapolis, Indiana, April 12, 1959," John F. Kennedy PRESIDENTIAL LIBRARY AND MUSEUM, http://www.jfklibrary.org/Research/Research-Aids/JFK-Speeches/Indianapolis-IN_19590412.aspx

[443] Benjamin J. Cohen (2003), op. cit., P.5.

[444] C. Fred Bergsten (2009), op. cit.

[445] Ibid.

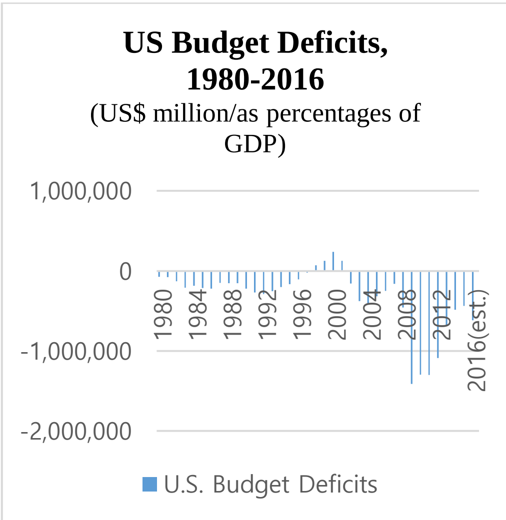
Figure 22.



Source: BEA[446]

Figure 23 shows the widening budget deficits since 1980. The budget deficit has soared from US$ 73.8 billion in 1980 to US$ 438.4 billion in 2015, having reached a peak of US$ 1.3 trillion in 2011.[447]

Figure 23.



Source: OMB, White House[448]

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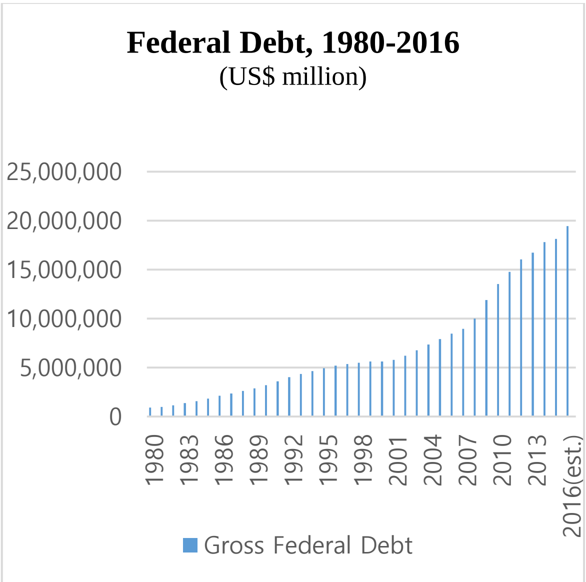
[446] Table 1. US International Transactions (1960-2007), Release Date: June 16, 2016, Bureau of Economic Analysis (BEA), US Department of Commerce; Table1.2. US International Transactions, Expanded Detail (1999-2015), Release Date: June 16, 2016

[447] "Historical Tables, Table 1.1.-Summary of Receipts, Outlays, and Surpluses or Deficits (-): 1789-2021," Office of Management and Budget, White House, https://www.whitehouse.gov/omb/budget/Historicals; "Historical Tables, Table 1.2.-Summary of Receipts, Outlays, and Surpluses or Deficits (-) as Percentages of GDP: 1930-2021," Office of Management and Budget, White House, https://www.whitehouse.gov/omb/budget/Historicals

[448] Ibid.

It has become abundantly clear that the US ought to urgently address these deficits in order to keep the dollar's dominance intact. Barry Eichengreen (2013) emphasizes that "the fate of the dollar ultimately hinges on US budgetary policy."[449] Arvind Subramanian echoes this concern by saying, "Should America's inability to restrain its fiscal and current account deficits persist even if the flood of capital into the dollar from foreign governments ebbs, the shift will only be accelerated", because **"**reserve currency status is not just about economic size and trade but about investors' faith in policy credibility."[450] It is also suggested that "the US budget deficit, which currently exceeds 100 percent of GDP, together with a huge sum of unfunded liabilities totaling $96 trillion, is considered 'by far the greatest threat to the dollar's reserve status.'"(William Wilson, 2015)[451] As shown in Figure 24, the US federal debt has soared since 1980. Within less than four decades, it has skyrocketed almost twenty-fold from US$ 909 billion in 1980 to US$ 18.1 trillion in 2015. The figure is still rising, with the estimated federal debt for 2016 amounting to US$ 19.4 trillion.[452]

Figure 24.



Source: OMB, White House[453]

[449] Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (Oxford: Oxford University Press, 2011), p. 163.

[450] Alan Beattie, "Currencies: Strength in reserve," *The Financial Times*, February 8, 2011, http://www.ft.com/intl/cms/s/0/c1cd29c2-33c9-11e0-b1ed-00144feabdc0.html#axzz48Dc7Lk1X

[451] William T. Wilson, "Washington is; Washington, China, and the Rise of the Renminbi: Are the Dollar's Days as the Global Reserve Currency Numbered?" The Heritage Foundation, Special Report #171 on China, August 17, 2015.

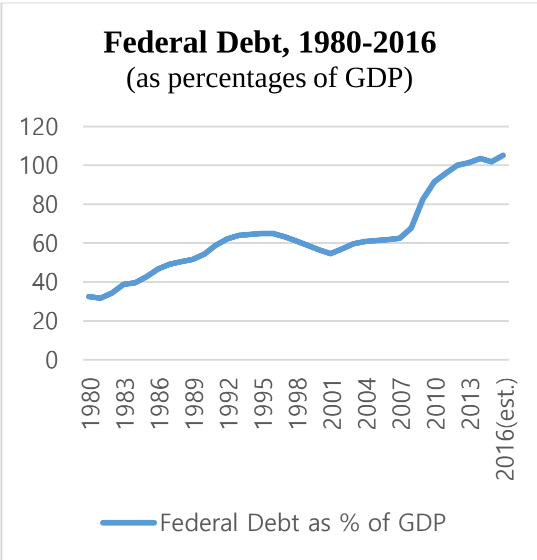
[452] Historical Tables, Table 7.1-Federal Debt at the End of Year: 1940-2021, Office of Management and Budget, White House, https://www.whitehouse.gov/omb/budget/Historicals

[453] Ibid.

The incidence of the pound sterling giving way to the rising dollar substantiates such claims. The dollar was able to dethrone sterling to emerge as the leading international reserve currency in a span of just ten years between 1914 and 1924, mainly because Great Britain was reduced to a debtor nation after borrowing huge sums from none other than the US to finance its war spending during the First World War.[454] The ratio of British debt to GDP (gross domestic product), which had been a mere 29 percent on the eve of the First World War, skyrocketed during the Second War. It had, in fact, soared to 240 percent by the end of the war, as a result of which, according to *History Today*, "a nation that had in the 1920s controlled a quarter of the earth's territory and population was, in Keynes' words, facing a 'financial Dunkirk.'"[455] It was against this backdrop that the pound sterling was forced to abdicate, completely ceding its role as the world's dominant reserve currency to the US dollar.

As shown in Figure 25, the ratio of US federal debt to GDP (100.1 percent) broke the 100% mark in 2012 for the first time since 1947. After the US entry into the Second World War in December 1941, the ratio rose fast from the then 49.5 percent to 114.9 percent at war's end in 1945, through a peak of 118.9 percent in 1946, to 107.6 percent in 1947. From its recorded 96.0 percent in 1948, it then continued to decrease to 31.7 percent in 1981 before it began to go up again.[456] What is of particular concern is that the current federal debt, which recorded US$ 18.1 trillion in 2015, is expected to increase further. The federal debt for 2016 is estimated at US$ 19.4 trillion, with a federal debt to GDP ratio of 105.2 percent.

Figure 25



454 William T. Wilson (2015), op. cit.

455 "The Dunkirk Diplomat," *HistoryToday*, June 2013, p. 45.

456 Table 1.2.-Summary of Receipts, Outlays, and Surpluses or Deficits (-) as Percentages of GDP: 1930-2021," Office of Management and Budget, White House, https://www.whitehouse.gov/omb/budget/Historicals

Carmen Reinhart and Kenneth Rogoff (2011) claim that, across a broad range of countries and historical periods, economic growth is at risk of declining significantly when a country's public debt, referred to as gross central government debt, reaches the threshold of 90 percent of GDP.[457] The US federal debt to GDP ratio has continued to hover above this threshold since 2010 when it reached 91.4 percent. (Figure 25) "One can argue that the United States can tolerate higher levels of debt than other countries without having its solvency called into question," Reinhart and Rogoff surmise, and they go on to assume that that is probably the case: "Perhaps soaring US debt levels will not prove to be a drag on growth in the decades to come," they state, but they also caution us that "however, if history is any guide, that is a risky proposition and over-reliance on US exceptionalism may only prove to be one more example of the this-time-is-different syndrome."[458]

Trust is the key in any international currency, as was the case with the dollar. In the immediate postwar period, trust in the greenback was so great that the dollar was considered as 'good as gold,' thereby encouraging huge acquisitions of dollar-denominated assets. Taming the huge and fast-growing 'deficit gorilla' in the room is the key to maintaining the international community's confidence in the greenback, thereby keeping its status as the world's dominant reserve currency. In effect, it is worth noting, "The fate of the dollar's status and all it means to American prestige and global leadership is in America's hands" (William Wilson, 2015)[459].

B. Expanding Economic and Trade Networks: *Pro-active, Forward-looking Action Agenda*

As described in the previous chapter, China's rapidly rising share in global trade and, even more particularly, in intra-regional trade in Asia, has provided a fertile ground for RMB internationalization to gain added momentum. In this regard, Arvind Subramanian (2011) notes[460]:

> "A surprising finding - and one somewhat different from the results in the literature - is that trade appears to be a much more important determinant of reserve holdings. This is consistent with the view that reserve currency status derives in turn from private-sector behavior – that is, the more the private sector desires, uses or denominates transactions in a particular currency, the more likely it will attain reserve currency status."

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[457] Carmen M. Reinhart and Kenneth S. Rogoff, "A Decade of Debt," *NBER Working Paper* No. 16827, February 2011, pp. 26-35.

[458] Ibid., pp. 41-41.

[459] William T. Wilson (2015), op. cit.

[460] Arvind Subramanian, *Eclipse: Living in the Shadow of China's Economic Dominance*, (Washington D.C: Peterson Institute for International Economics, 2011), p.61.

The RMB bloc in East Asia is not only a reality, but also serves as a catalyst for promoting RMB internationalization elsewhere. China's deepening trade relations with the Asian region and other parts of the world will enable banks and financial institutions, which serve as facilitators between Chinese businesses and their foreign partners, to expand the connectedness of the RMB. This is important because, as observed by SWIFT, "the internationalization of the RMB depends upon the broader connectedness of the community."[461]

As a corollary, it is vitally important for the United States to continue to augment trade with its major trading partners, while at the same time expanding cooperation networks, including trade agreements, with them. This will not only bring real benefits to the US economy, but will also provide a realistic and sustainable solution for the US in its efforts to preserve the role of the dollar as the world's key reserve currency. Furthermore, given the shaky foundations underpinning the global economic recovery due to the ongoing Great Recession, it is crucial that the grave mistakes of the past are not repeated, such as the Smoot-Hawley Tariff Act of 1930 which, many economists believe, contributed towards both the intensity and length of the recession that followed the 1929 stock market crash. [462]

It is, therefore, worth taking a close look at what 'expansion of both trade and trade networks' means for the US and, by logical extension, for the dollar.

The Growing Importance of Trade for the US Economy: 38 million jobs depending on trade and 11.5 million jobs supported by exports

The WTO notes that, as seen in Figure 26, "despite the financial crisis, the share of world trade in GDP is much higher today than it was 20 years ago."[463] Given that "the average share of exports and imports of goods and commercial services in world GDP increased significantly from 20 percent in 1995 to 30 percent in 2014 (in value terms)," the international trade watchdog further declares, "today's GDP is highly influenced by international trade."

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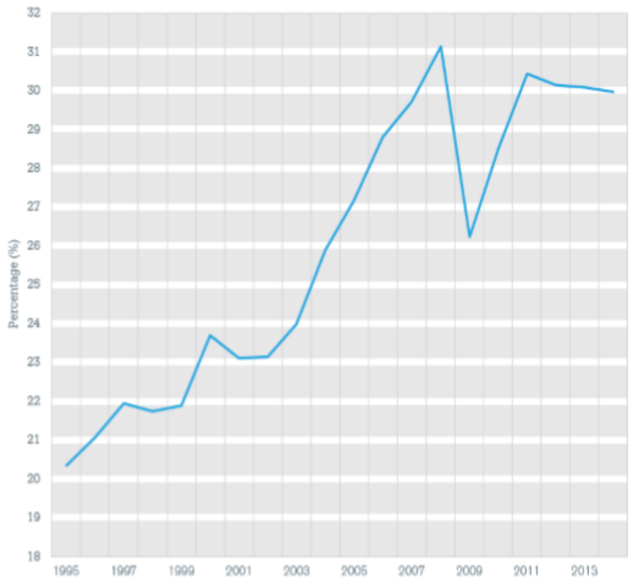
[461] "Renminbi's stellar ascension: Are you on top of it?" SWIFT, RMB Tracker Sibos 2015 Edition, p.3.

[462] Shawn Donnan, "Trade: Into uncharted waters," *The Financial Times*, October 24, 2013, http://www.ft.com/cms/s/0/4dc2ab0e-3805-11e3-8668-00144feab7de.html#axzz4DVMLLWqy

[463] "International Trade Statistics 2015, SPECIAL FOCUS: WORLD TRADE AND THE WTO: 1995–2014," p.17.

Figure 26.

Ratio of trade in goods and commercial services to GDP (1995-2014)



Source: WTO[464]

The United States is not only the world's largest economy, with a GDP of US$ 17,947 billion, but also the world's largest trading nation, with exports in goods and services of more than US$ 5,022 billion in 2015.[465] As can be seen from Table 11, the trade share of the US GDP has continued to increase from 19% in 1981 to 28% in 2015.[466]

Table 11. Trade share of US GDP, 1981-2015

Year	1981	1985	1990	1995	2000	2005	2010	2011	2014	2015
Share(%)	19	17	20	22	25	26	28	31	30	28

Source: The World Bank

This bears out that as the leading trading nation in an increasingly interconnected and globalized world, international trade has grown more important for the US economy over the

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[464] Note: Trade to GDP ratio is estimated as total trade of goods and commercial services under BPM5 (exports + imports, balance of payments basis) divided by GDP, which is measured in nominal terms and with market exchange rates.

[465] "National Income and Product Accounts, Gross Domestic Product: Fourth Quarter and Annual 2015 (Third Estimate)," Bureau of Economic Analysis, US Department of Commerce, March 25, 2016, http://www.bea.gov/newsreleases/national/gdp/2016/gdp4q15_3rd.htm; "US INTERNATIONAL TRADE IN GOODS AND SERVICES April 2016," US Census Bureau US Bureau of Economic Analysis NEWS, June 3, 2016

[466] "Trade (% of GDP)," The World Bank, http://data.worldbank.org/indicator/NE.TRD.GNFS.ZS

years. The United States Trade Representative (USTR) touts the benefits of trade for the US by noting that[467]

> "Trade is critical to America's prosperity - fueling economic growth, supporting good jobs at home, raising living standards, and helping Americans provide for their families with affordable goods and services. In 2013, US goods and services exports supported an estimated 11.3 million jobs. Every billion dollars of goods and services exports supported nearly an estimated 5,600 jobs and an estimated 25 percent of all manufacturing jobs are supported by exports."

The US Chamber of Commerce echoes this position by noting that "America cannot have a growing economy or lift the wages and incomes of our citizens unless we continue to reach beyond our borders and sell products, produce and services to the 95% of the world's population that lives outside the United States."[468] It goes on to say, "More than 38 million Americans' jobs depend on trade and small businesses represent 97% of all exporters." Since "trade is critical to the success of many sectors of the US economy…(as well as) an inevitable part of the world in the 21st century…(we) cannot turn our back on international trade," emphasizes the Chamber.[469] Robert Lawrence, Professor of International Trade and Investment at Harvard Kennedy School, concurs with this view by saying that "one way to boost" the US median household income, which has been stagnated for decades, "could be to reap more gains from trade," given that trade "supports higher-paying jobs, increases the innovation and productivity growth that are necessary to support sustained increases in living standards and also expands the purchasing power of consumers."[470]

According to a recent study released in April 2016 by the ITA (International Trade Administrations), "American jobs supported by exports were an estimated 11.5 million in 2015."[471] Among these were "an estimated 6.7 million jobs supported by goods exports." Every billion dollars of goods exports supported 5,279 American jobs. Goods exports from Texas, California, Washington, Illinois, and New York supported 41% of all US jobs

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[467] "Benefits of Trade," USTR, https://ustr.gov/about-us/benefits-trade.

[468] "The Benefits of International Trade," US Chamber of Commerce; https://www.uschamber.com/international/international-policy/benefits-international-trade-0

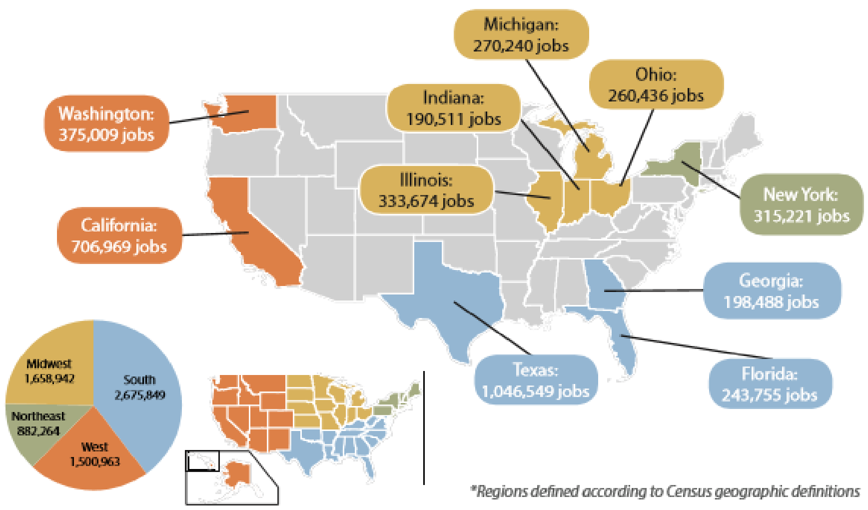
[469] Ibid. and "International Trade and Investment," US Chamber of Commerce, https://www.uschamber.com/international-trade-and-investment

[470] Robert Z. Lawrence, "Why the TPP has benefits for workers that far outweigh its costs," *World Economic Forum (WEF)*, April 14, 2016, https://www.weforum.org/agenda/2016/04/why-the-tpp-has-benefits-for-workers-that-far-outweigh-its-costs/

[471] Chris Rasmussen, "Jobs Supported by Exports 2015: An Update, Office of Trade and Economic Analysis, International Trade Administration, Department of Commerce, April 8, 2016, pp.1-5.

supported by goods exports in 2015.[472] Figure 27 shows "10 states whose goods exports supported the most jobs."

Figure 27. Ten States Whose Goods Exports Supported the Most Jobs in 2015



Source: ITA[473]

Dwindling US Market Share

Despite the growing importance of international trade for the US, Washington's market share of world merchandise exports has continued to noticeably decline over the past several decades, from 21.7% in 1948 to 8.8% in 2014. (Table 12) During the same period, Germany and China continued to increase their market share, while Japan's share continued to rise to reach a peak in the early 1990s before starting a continuous downward slide.

Table 12. Share of world merchandise exports by selected economy, 1948-2014 (percentage)

Year	1948	1953	1963	1973	1983	1993	2003	2014
US	21.7	18.8	14.9	12.3	11.2	12.6	9.8	8.8
Germany*	1.4	5.3	9.3	11.7	9.2	10.3	10.2	8.2
China	0.9	1.2	1.3	1.0	1.2	2.5	5.9	12.7
Japan	0.4	1.5	3.5	6.4	8.0	9.8	6.4	3.7

Source: WTO[474]

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[472] "Export-Related Jobs, Jobs Supported by State Exports 2015: Infographic," Office of Trade Policy & Analysis, International Trade Administration, 2016, http://www.trade.gov/mas/ian/employment/

[473] Ibid.

In the meantime, as shown in Table 13 below during the same period, the US market share of world merchandise imports has not changed much, ranging from 13.0% in 1948 to 16.9% in 2003 and to 12.9% in 2014.

Table 13. Share of World merchandise imports by selected economy, 1948-2014
(percentage)

Year	1948	1953	1963	1973	1983	1993	2003	2014
US	13.0	13.9	11.4	12.3	14.3	15.9	16.9	12.9
Germany	2.2	4.5	8.0	9.2	8.1	9.0	7.9	6.5
China	0.6	1.6	0.9	0.9	1.1	2.7	5.4	10.5
Japan	1.1	2.8	4.1	6.5	6.7	6.4	5.0	4.4

Source: WTO[475]

This would suggest that the US make concerted efforts to increase its share of world merchandise exports; this, in turn, would require more active engagement in trade with Asia, which is Washington's second largest export market with 27.1% of its total exports in 2014, only second to the North American region at 34% in the same year.[476] The need for the US to redouble its efforts to substantially increase its trade with Asia is given added urgency in light of the fact that its economic importance as the world's most dynamic region is set to grow further down the road, as described in the next section.

Why the US should further strengthen its trade relations with Asia

Asia, the growth engine of the world economy, comprises more than 4.4 billion people (60% of the world's population), and accounts for 40 percent of the global economy. Over the next four years, it stands to deliver nearly two-thirds of total global growth.[477] As such, Asia's importance in the global economy is already felt and set to grow even higher in the future.

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[474] International Trade Statistics 2015, SPECIAL FOCUS: WORLD TRADE AND THE WTO: 1995–2014," "Table 1.5: World merchandise exports by region and selected economy, 1948, 1953, 1963, 1973, 1983, 1993, 2003 and 2014," p. 42.; Note: * Germany's figures refer to the Fed. Rep. of Germany from 1948 through 1983

[475] Ibid., "Table 1.6: World merchandise imports by region and selected economy, 1948, 1953, 1963, 1973, 1983, 1993, 2003 and 2014," p. 43.

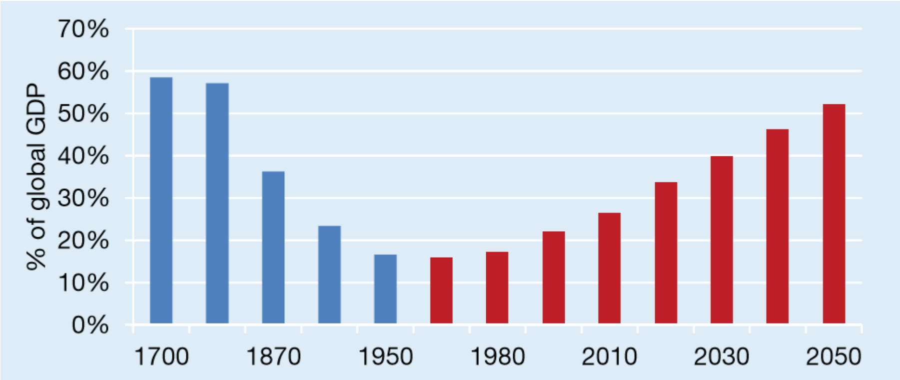
[476] "International Trade Statistics 2015, SPECIAL FOCUS: WORLD TRADE AND THE WTO: 1995–2014," Table 1.12: Merchandise trade of the United States by origin and destination, 2014, WTO, p.49.

[477] "Asia's Advancing Role in the Global Economy," speech by Christine Lagarde, Managing Director, International Monetary Fund, New Delhi, India, March 12, 2016, https://www.imf.org/external/np/speeches/2016/031216.htm

A study by the Asian Development Bank (2011) predicts:

> "If it continues to follow its recent trajectory, by 2050 its per capita income could rise six-fold in purchasing power parity (PPP) terms to reach Europe's levels today. It would make some 3 billion additional Asians affluent by current standards. By nearly doubling its share of global gross domestic product (GDP) to 52 percent by 2050, Asia would regain the dominant economic position it held some 300 years ago, before the industrial revolution." (Figure 28)[478]

Figure 28. Asia's share of global GDP, 1700-2050



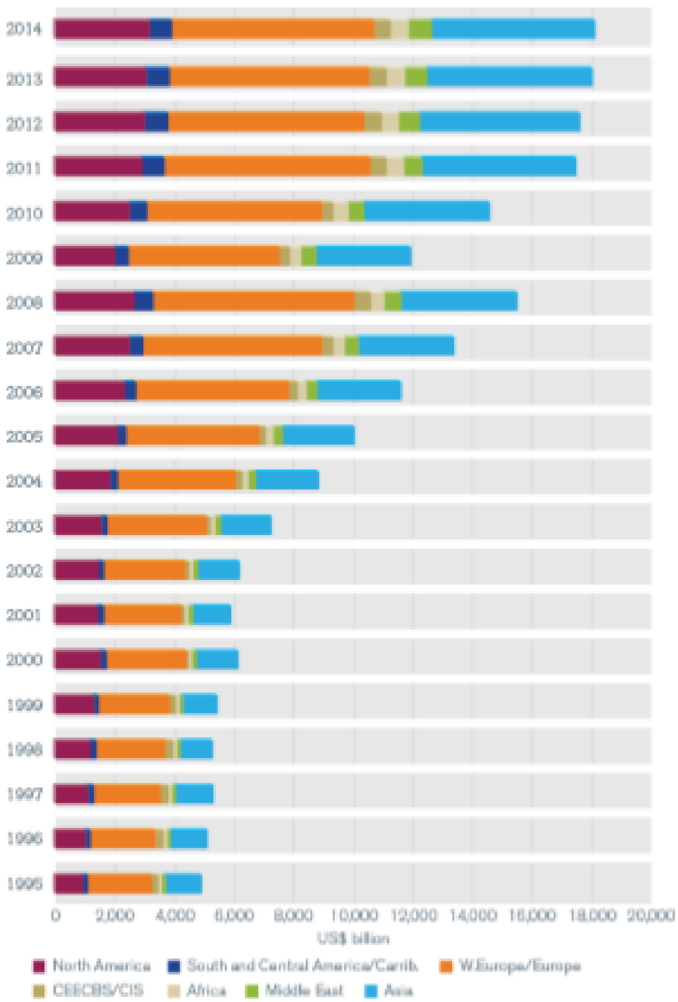
Source: ADB ("Asia 2050: Realizing the Asian Century")

With the strong growth of world merchandise trade, Asia's share has also significantly increased over the years. According to the WTO (2015), world merchandise exports (excluding significant re-exports from Hong Kong and China) have climbed over the last two decades to US$ 18,494 billion in 2014, almost four times the value of US$ 5,018 billion recorded in 1995. In 2014, Asia represented almost a third of the total of world merchandise trade, with world merchandise exports to Asia amounting to US$ 5,465 billion.[479](Figure 29)

[478] "Asia 2050: Realizing the Asian Century," Executive Summary, Asian Development Bank (ADB), August 2011, p. 3.

[479] "International Trade Statistics 2015, SPECIAL FOCUS: WORLD TRADE AND THE WTO: 1995–2014," World Trade Organization (WTO), 2015, p. 24.

Figure 29. Destination of world merchandise exports by region, 1995-2014

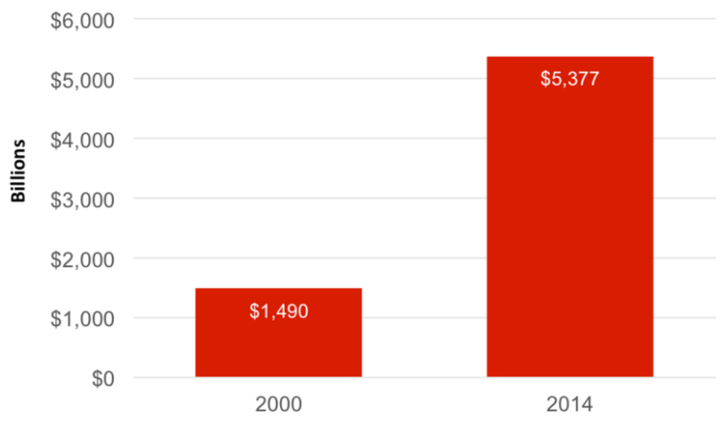


Source: WTO

Notwithstanding this, one can argue that in recent years, the US has not made the most of these new business opportunities offered by the rapidly expanding Asian market. Nowhere is this phenomenon more apparent than in Asia's import market over the past decade and a half. Between 2000 and 2014, as we can see from Figure 30, the import market of A15* grew by 261% from $1.5 trillion to $5.4 trillion.[480]

[480] Jay Chittooran, "Losing Ground in Asia: Why the US Export Market Share Has Plummeted," Thirdway.org, August 5, 2015, http://www.thirdway.org/report/losing-ground-in-asia-why-the-us-export-market-share-has-plummeted; *'A15' means 15 Asian economies which refer to "10 ASEAN countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam), South Korea, China, Japan, Hong Kong, and Taiwan."

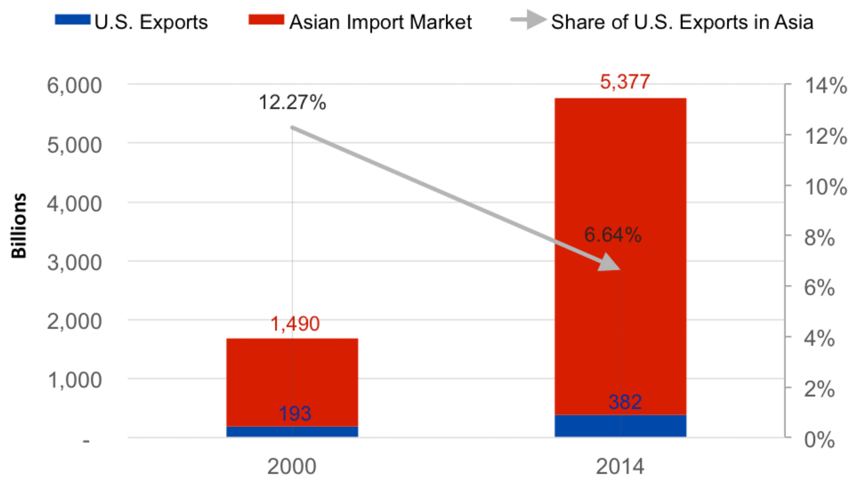
Figure 30. The growth of Asia's Import Market, 2000-2014



Source: Thirdway.org

On the contrary, the US market share in the import market of A15 fell by 46%, the biggest drop of any of the 25 largest exporters into Asia except Japan. Despite American exports to Asia doubling (growing from $193 billion in 2000 to $382 billion in 2014), this happened because the overall Asian import market grew at almost triple that rate. In short, the share of US exports in the Asian import market shrank to just 6.6% of that market in 2014, from 12.3% in 2000.[481] (Figure 31)

Figure 31. US Exports and the Asian Import Market, 2000-2014



Source: Thirdway.org

Figure 31 above speaks volumes about how much room there is for the US to substantially increase its exports to the fast-expanding Asian market, depending on how the US

481 Ibid.

government and businesses can respond in order to satisfy the constantly evolving tastes and preferences of their Asian customers. In this regard, it is also worth noting that the bulk of the spectacular growth of the 'global middle class', the locomotive driving global economic growth, will come from Asia. One OECD estimate puts the number of the global middle class at "1.8 billion in 2009, with Europe (664 million), Asia (525 million), and North America (338 million) accounting for the highest number of people belonging to this group."[482] It continues, "The size of the global middle class will increase from 1.8 billion in 2009 to 3.2 billion by 2020 and 4.9 billion by 2030," and "the bulk of this growth will come from Asia: by 2030 Asia will represent 66% of the global middle-class population and 59% of middle-class consumption, compared to 28% and 23%, respectively in 2009."

What to do?

Given the Asia Pacific region's potentially huge economic opportunities as well as its ever-growing geopolitical and strategic significance, the Obama administration has attempted to actively engage in that part of the world since it declared the 'Pivot or Rebalance to Asia Policy' in 2011. One of the most effective steps that the US government could take to advance its economic and trade interests would be to expand its economic territory by concluding meaningful bilateral, regional and multilateral trade deals with its major trading partners.

In fact, the US Chamber of Commerce touts "US free-trade agreements (FTAs), which cover 20 countries" as bringing "tremendous benefits." [483] Although "these countries represent approximately 6% of the world's population outside the United States," they serve as a market for "nearly half of all US exports." Therefore, "US FTAs do an outstanding job making big markets even out of small economies," highlights the US Chamber of Commerce. Elizabeth Economy, Director of Asia Studies at the Council on Foreign Relations (CFR), said in her congressional hearing on March 31st, 2016, that, "If not underway already, the USTR should initiate dialogues with other nations interested in joining the TPP, such as the Philippines, Taiwan, South Korea* and China."[484]

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[482] Mario Pezzini, Director, OECD Development Centre, "An emerging middle class," http://www.oecdobserver.org/news/fullstory.php/aid/3681/An_emerging_middle_class.html

[483] "The Benefits of International Trade," US Chamber of Commerce

[484] Elizabeth Economy, Director, Asia Studies, Council on Foreign Relations (CFR), "Objectives and Future Direction for Rebalance Economic Policies, Before the US-China Economic and Security Review Commission, United States Senate/ United States House of Representatives 2nd Session, 114th Congress, Hearing on China and the US Rebalance to Asia," March 31, 2016, http://www.cfr.org/china/objectives-future-direction-rebalance-economic-policies/p37720; *South Korea is currently the only country in the world, which has an FTA with three megaeconimies: the US, the EU, and China.; Robert Lawrence, Professor of International Trade and Investment, Harvard Kennedy School, argues that "between 2017 and 2030, the annual benefits from TPP are between 12 and 100 times the costs. Moreover, after 2030, the TPP becomes the gift that keeps on giving, since,

This would enable the US to further broaden its engagement in the Asia Pacific, thereby promoting "network externalities," which could in turn help the US dollar.

C. Attracting Foreign Investments

It is generally accepted that investment - in particular, foreign direct investment (FDI) - plays an important role in powering the economic growth and development of nations, both developed and developing. The mere fact that FDI flows across the world have grown remarkably over the past several decades clearly indicates that many countries, especially developing countries, have been keenly interested in attracting FDIs by taking a series of measures aimed at removing barriers to inbound and outbound FDI flows, because FDIs have been generally seen as one of the key elements in their national strategy for economic development. The active 'go-global' strategy pursued by the private sector has also contributed much to this phenomenon. Considering all this, such a trend is expected to further accelerate in the future, which in turn will intensify competition among nations for a greater share of the global FDI pie.

This segment describes the recent trend of foreign direct investment in the United States (FDIUS) and the benefits of FDIUS for the US economy, including the implication of increased FDIUS for the dollar, as well as a recent increase in China's FDIs, particularly in the US.

The declining US share of world FDI stock

A 2014 study by UHY, the international accountancy network, found that "the USA is lagging behind most major economies in terms of its ability to attract foreign direct investment."[485] According to the report, over the five years from the global credit crunch of 2008 through

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once the economy has adjusted, the economy simply reaps the annual benefits that grow with the volume of trade. Moreover, by expanding the size of markets and keeping companies on their toes, TPP could expand innovation and raise economic growth as well." (See "Why the TPP has benefits for workers that far outweigh its costs", available at https://www.weforum.org/agenda/2016/04/why-the-tpp-has-benefits-for-workers-that-far-outweigh-its-costs/); According to Peter A. Petri (PIIE) and Michael G. Plummer (Johns Hopkins University and East-West Center), the TPP will "increase annual real incomes in the United States by $131 billion, or 0.5 percent of GDP, and annual exports by $357 billion, or 9.1 percent of exports, over baseline projections by 2030." (See "The Economic Effects of the Trans-Pacific Partnership: New Estimates," available at https://piie.com/publications/working-papers/economic-effects-trans-pacific-partnership-new-estimates)

[485] "USA Needs to Do More to Attract Foreign Direct Investment," *UHY*, January 30, 2014, http://www.uhy-us.com/News-Events/vw/1/itemid/255 (The study looked at net FDI inflow over the last five years in 33 major economies around the world, measuring how successful they have been in attracting FDI compared to their GDP.)

2012, the United States attracted FDI equal to just 6.6% of its GDP (USD$1.043 tn.), while on average, countries around the world managed to attract FDI worth 17% of their GDP" during the same period.[486]

A related study on FDI into the US, in the form of a 2016 report by the OII (Organization for International Investment), observes that the global financial crisis and Global Recession had "a direct influence on inward direct investment transactions," and that foreigners dramatically reduced their investments in the US in 2009 by more than half since the previous year."[487] As shown in Figure 32, FDIUS has since fluctuated. In particular, FDIUS recorded $112 billion in 2014, the weakest year over the past decade, largely the result of British Vodafone's divestment of Verizon, which was worth $130 billion.[488] "Because of the sharp contraction in FDIUS inflows in 2014", the United States, "for the first time, fell from its position as the world's preferred investment location to third place behind China and Hong Kong that year."[489]

In 2015, however, the US saw "record inflows worth $380 billion, an increase of more than 250 percent…(which) partly reflects the exceptionally low level of inflows to the United States in 2014," the UNCTAD's World Investment Report 2016 notes.[490] According to that report, in the United States, "almost 70 per cent of FDI inflows were in manufacturing", with just nine percent in finance and insurance.[491] Europe (77 percent of inflows), Japan (11 percent) and Canada (seven percent) were among the major sources of the FDIUS inflows in 2015.

[486] Ibid.

[487] "Foreign Direct Investment in the United States 2016 Report," Organization for International Investment, p.3.

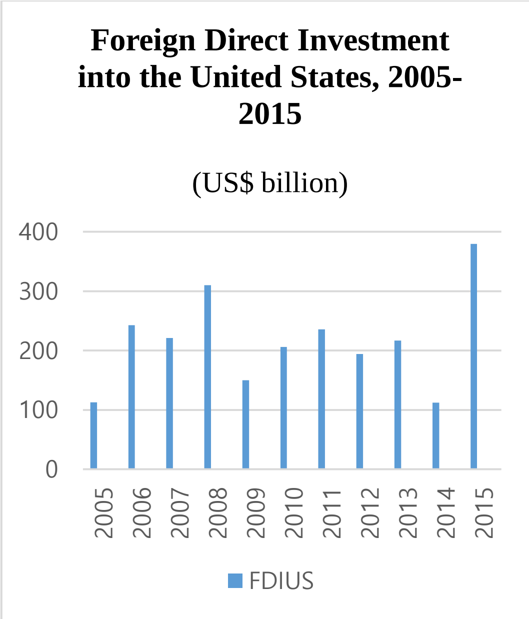
[488] Ibid.

[489] Ibid., p.1.

[490] "World Investment Report 2016 (*WIR16*), Investor Nationality: Policy Challenges," UNCTARD, June 22, 2016, p.67.

[491] Ibid.

Figure 32.



Source: FDI in the US 2016 Report and WIR 2016 (*WIR16*)

The US share of global inward FDI stock "has shrunk as competitors vie for investment dollars by opening their economies to global investors," according to the OII report.[492] In 2015, the United States held 22.4% of the world's inward FDI stock, a noticeable drop from 37.2% at the start of the 21st century, as shown in Table 14.[493]

Table 14. US Share of Worldwide Inward Stock of Foreign Direct investment 2000, 2010 and 2015

(US$ million)

Year	Global Inward FDI stock	US Inward FDI stock	US Share (%)
2000	7,488,449	2,783,235	37.2
2010	20,189,655	3,422,293	17.0
2015	24,983,214	5,587,969	22.4

Source: World Investment Report 2016, UNCTAD (p. 200)

Nevertheless, the United States remains an attractive destination for foreign capital because it offers many advantages. The OII report states, "First, and perhaps most important, the

492 "Foreign Direct Investment in the United States 2016 Report," Organization for International Investment, p.2.

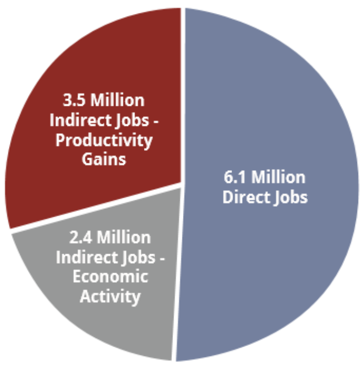
493 "World Investment Report 2016 (*WIR16*), Investor Nationality: Policy Challenges," UNCTARD, June 22, 2016

United States has one of the most open markets and investment climates in the world," while holding other advantages, such as an unrivaled consumer market, a skilled and productive workforce, an entrepreneurial culture of innovation and risk taking, and a transparent regulatory environment. [494] Therefore, it would make much sense for the US to do more to attract FDI, particularly in view of the potential benefits that inward FDIs will bring for the US economy and for the dollar.

What benefits will inward FDIs bring for the US economy and the dollar?

A report by the ITA (2016) notes that, as shown in Figure 34, "in 2013, majority-owned US affiliates of foreign firms employed 6.1 million people" while there were 2.4 million jobs indirectly attributable to foreign firms and a further 3.5 million to technology spillovers from foreign firms.[495] "A total of 12 million jobs (are) attributable to FDI in the United States," the report concludes.

Figure 34. Jobs attributable to FDI in 2013



Source: ITA[496]

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[494] "Foreign Direct Investment in the United States 2016 Report," Organization for International Investment, p.2.

[495] Julian Richards and Elizabeth Schaefer, "Jobs Attributable to Foreign Direct Investment in the United States," Industry and Analysis Economics Brief, Office of Trade and Economic Analysis of the International Trade Administration (ITA), February 2016, p. v. and pp. 12-13.

[496] "Jobs Attributable to FDI: Infographic," Office of Trade Policy & Analysis, International Trade Administration, February 2016, http://www.trade.gov/mas/ian/employment/; (i) 6.1 Million reflects the number of US workers who are directly employed by majority foreign-owned firms (ii) 2.4 Million includes jobs attributable to the economic activity of majority foreign-owned firms, including jobs in those firms' supply chains, jobs attributable to higher incomes, and other economic effects (iii) 3.5 Million includes jobs attributable to productivity gains in the manufacturing sector

The US government emphasizes the importance of attracting inbound foreign direct investment by saying, “Inbound foreign direct investment funds a number of physical assets, including production plants, research and development (R&D) facilities, sales offices, warehouses, and service centers.”[497] While this “can take the form of a ‘greenfield’ establishment that creates something from scratch or a merger or acquisition (M&A) of a sufficiently large stake in an existing enterprise,” the report points out that, “Whatever the form, it ultimately translates into output, jobs, exports, and R&D on American soil.”[498]

The US Chamber of Commerce also takes the view that, “To generate jobs and growth, the United States must attract foreign investment while actively supporting US investment abroad,” because “international investment is a two-way street.”[499] The Chamber further points out the critical role that international investment, like trade, plays in promoting American jobs and competitiveness, by noting:

> “Above all, it is important to keep in mind that investment flows into the United States as well. Foreign companies have invested $2.8 trillion in the United States and directly employ more than 5.8 million Americans with an annual payroll of more than $400 billion. US affiliates of foreign-headquartered companies purchase more than $1.8 trillion in inputs from local suppliers and small businesses and account for more than one-fifth of all US merchandise exports.”[500]

In addition to the potential benefits for the real economy of the United States that could accrue from increased FDIs in the US, these could also have the effect of boosting the confidence of international investors in the way the US economy is managed, in light of the fact that “whether the United States will retain its status as the world’s most attractive investment location depends largely on future macroeconomic and financial conditions.”[501] Therefore, it could eventually help support the dollar’s position as the dominant reserve currency.

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[497] “FOREIGN DIRECT INVESTMENT IN THE UNITED STATES,” a report prepared by the Department of Commerce and the President’s Council of Economic Advisor, October 2013, p.7. and p.11.

[498] Ibid.

[499] “The Benefits of International Investment,” US Chamber of Commerce, https://www.uschamber.com/report/benefits-international-investment

[500] Ibid.

[501] “Foreign Direct Investment in the United States - 2014 Report,” Organization for International Investment, p.1.

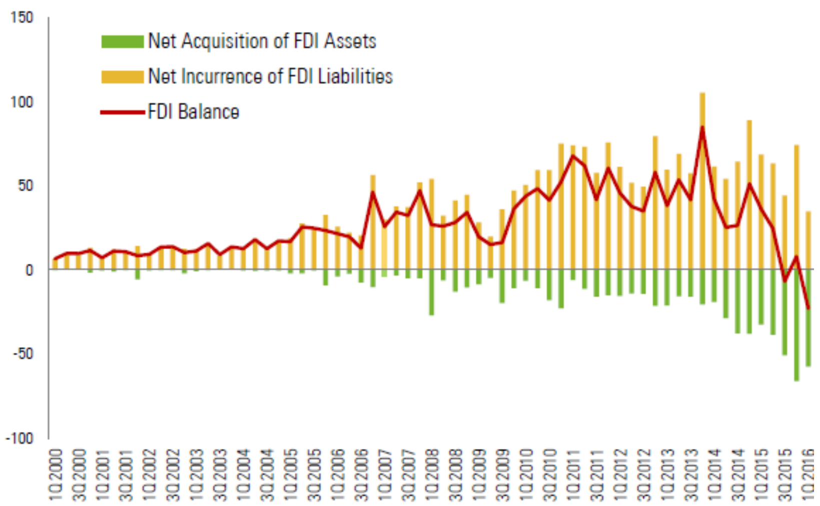
China's soaring outbound FDIs

FDI into China began to rise with China's opening-up policy in the early 1980s and has continued to soar since its accession to the WTO in 2001. By 2015, China's FDI stock had grown to more than $2.8 trillion, thereby, in the recent view of Thilo Hanemann and Daniel Rosen "reflecting its attractiveness as a competitive manufacturing location, a large consumer market and an attractive emerging market with double-digit growth and a gradually appreciating currency."[502] In the meantime, outbound FDI (OFDI) activities by Chinese companies have recently started thanks to a series of measures taken within a broader framework of RMB internationalization and the government's 'Go Global' strategy. However, OFDI activities have only begun to be visible since late 2005 and the amount has been significantly smaller than inbound FDI.

As a result, China has run an FDI surplus every year since the beginning of data recording in 1982. FDI inflows experienced a temporary drop during the 2008-9 global financial crisis before picking up again. (Figure 35) From 2010 to 2014, China's FDI surplus averaged $200 billion per year seeing that, as Hanemann and Rosen observe, "foreign investors were attracted by world-beating economic growth, a fast-growing middle class and a one-way currency bet." [503]

Figure 35. China's recent Foreign Direct Investment (FDI) balance, 2000-2016

(Quarterly Balance of Payments data, US$ billion)



Source: State Administration of Foreign Exchange (SAFE) of China/ Rhodium Group[504]

[502] Thilo Hanemann and Daniel Rosen, "Lower for Longer: The New Normal of China's FDI Balance," Rhodium Group, June 17, 2016, http://rhg.com/notes/lower-for-longer-the-new-normal-of-chinas-fdi-balance

[503] Ibid.

[504] Ibid.; Note: *2016 Q1 data are preliminary

These long-standing patterns have changed dramatically since the second half of 2015. In Q3 of 2015, China's BOP recorded its first quarterly FDI deficit (-$6.7 billion) in three decades. This phenomenon is largely due to Chinese companies' active outbound FDI activities for the past few years, as we can see from Figure 35. They feel growing pressure to go out and explore new business opportunities, given China's increasingly 'new normal' situation as well as Beijing's blessings in the form of its encouragement and continued relaxation of restrictions on outbound FDI flows.

Growing and diversifying Chinese investments in the US

As far as inbound capital flows and FDIs are concerned, a couple of important recent changes can be seen:

- Although "in the heyday of the US financial boom, financial derivatives bolstered US capital inflows," according to the US-China Economic and Security Review Commission, "now, traditional forms of investment predominate."[505] The Commission goes on to say, "Portfolio investments - in funds, treasury bonds, and other debt securities - account for over half of US foreign liabilities." While "direct investment, comprising about one-fifth of US foreign liabilities, is also growing at a fast rate," the Commission further notes that "within the direct investment category, the ratio of equity investments is rising."[506]
- While industrialized countries are still the main source of FDI to the United States, emerging markets as a source are growing, and their share can be expected to increase further with the decline of institutional and structural barriers in those countries.[507] In addition, the 2008-09 global crisis was a "particularly important inflection point for China as China helped to keep the world afloat in a situation where global ODI activity was badly hit. Although global ODI fell by 43% in 2009, Chinese ODI into developed markets, boosted by government financial support, leaped threefold.[508]

Although China's recent investment in the US could also be seen from this general perspective, it is important to note that RMB internationalization and Beijing's announced

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[505] Iacob Koch-Weser and Garland Ditz, "Chinese Investment in the United States: Recent Trends in Real Estate, Industry, and Investment Promotion," US-China Economic and Security Review Commission, February 26, 2015, p. 8.

[506] Ibid.

[507] "FOREIGN DIRECT INVESTMENT IN THE UNITED STATES," a report prepared by the Department of Commerce and the President's Council of Economic Advisor, October 2013, p.11.

[508] "Chinese Investment in Developed Markets: An opportunity for both sides?" a report by The Economist Intelligence Unit, commissioned by HSBC, May 18, 2015, p.4., http://www.gbm.hsbc.com/insights/globalisation/chinese-investment-in-developed-markets

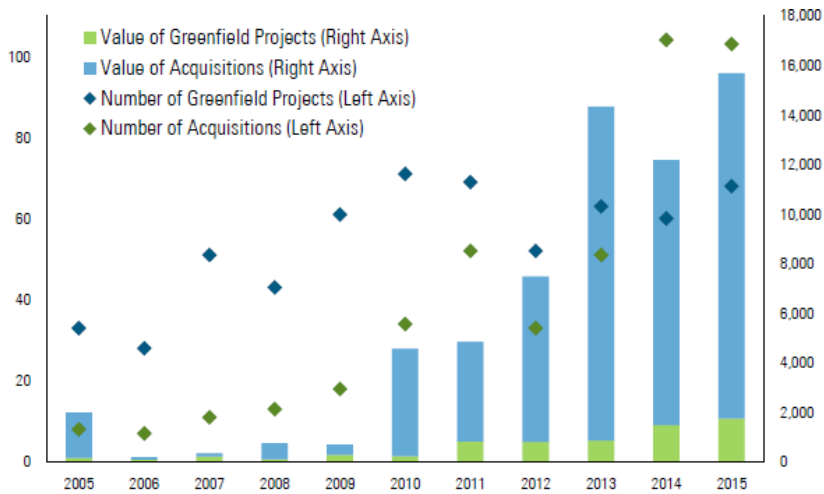
policy guideline aimed at diversifying and putting to good use its huge, mostly dollar-based, foreign reserves may have a great impact on its investments overseas, particularly in the US. This is because, as Prasad (2016) notes, the various policy reforms that the Chinese government undertakes in order to push ahead with its RMB internationalization strategy could also "create significant changes in China's economy and the patterns of its capital inflows and outflows, both in general and more specifically from and to the United States."[509]

With the progressing internationalization of the RMB, some notable changes are already occurring in the volume and composition of China's investments in the United States:

- First and foremost, China's FDI flows have increased remarkably over the past several years. A watershed moment in two-way investment flows between China and the US came in 2013 when for the first time FDI flows into the United States exceeded US FDI flows into China. In 2015, China posted a new record level of USS$ 15.7 billion, up 30% from the previous year. M&A activity was particularly strong with 103 deals worth $14 billion.[510] Figure 36 shows that China's investment in the US has soared since it began to pursue RMB internationalization in earnest in 2010.

Figure 36. Chinese FDI Transactions in the United States, 2005-2015

(Annual Figures: Number of deals/US$ million)



Source: Rhodium Group[511]

[509] Eswar Prasad (2016), op. cit., p.102.

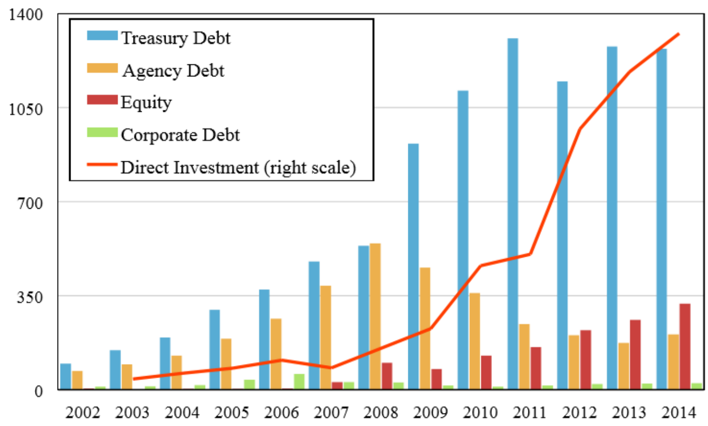
[510] Thilo Hanemann and Cassie Gao, "Chinese FDI in the US: 2015 Recap," *Rhodium Group*, January 19, 2016, http://rhg.com/notes/chinese-fdi-in-the-us-2015-recap

[511] Ibid.

- Another noticeable change has been in the composition of China's investments in the United States. "Shifting away from policies that intensify reserve accumulation" enables China to continually "change the structure of its foreign investments"[512] (Prasad). The China Investment Corporation (CIC), which as China's sovereign wealth fund aiming to become a leading global asset manager has been under strong and constant pressure to yield profitable returns on its investments, has been aggressive since it was founded in September 2007 in terms of both investment and international presence.[513] Direct competition between the China Investment Corporation (CIC) and the State Administration of Foreign Exchange (SAFE), both of which have always felt compelled to produce higher returns on their respective investments, would also continue to push both of them to move aggressively into investments that offer higher-yielding assets than US-Treasury or government bonds of other reserve currency economies. As a result, the share of equity holdings in China's investment portfolio has continued to increase over the past several years, marking contrast with other types of securities. Figure 37 shows this trend.

Figure 37. Breakdown of China's Investment Position in the United States

(US$ billion)



Source: Eswar Prasad (2016)[514]

[512] Eswar Prasad (2016), op. cit., pp. 101-102.

[513] Yu-Wei Hu, Management of China's foreign exchange reserves: a case study on the state administration of foreign exchange (SAFE), European Commission Directorate-General for Economic and Financial Affairs, Economic Papers 421, July 2010, pp. 14-15.

[514] Eswar Prasad (2016), op. cit., p.101; [Source: Bureau of Economic Analysis and US Treasury International Capital System/ Notes: This chart shows the position of China's direct investment and other types of securities holdings in the US Except for direct investment, all other categories are based on data at end-June each year. Data on China's direct investment position are unavailable before 2003.]

- Thirdly, China's direct investment in US real estate was negligible until 2010. However, it has since grown so dramatically and visibly that China quickly earned the title of 'Biggest Foreign Investor in the US Real Estate Market', with investments in the residential and commercial sectors totaling $110 billion between 2010 and 2015.[515] In fact, this represents "a global trend" according to Iacob Koch-Weser and Garland Ditz (2015), given that "Chinese outbound investment in this sector increased 200-fold between 2008 and June 2014."[516] Outside the United States, China has concentrated its property acquisitions in London, Hong Kong and Singapore. A recent study by the Asia Society and Rosen Consulting Group projects that Chinese direct investment across existing US commercial real-estate assets and residential purchases (excluding new development projects) could cumulatively total at least $218 billion, from 2016 through 2020, while beyond 2020, Chinese investment in US real estate could accelerate further.[517]
- Another factor worth noting is that, as seen from Figure 36, Chinese investors in the United States prefer to buy existing assets through M&A, rather than create new assets through greenfield investment.[518] The reason, according to a report commissioned by HSBC, is that "it is much quicker to get skills and technologies by buying them in, rather than developing them independently and internally" in light of the fact that "greenfield projects do not in and of themselves entail acquisition of new technologies".[519]
- Last but not least, a dramatic shift has occurred in the composition of investors in that the private sector now dominates Chinese investment in the United States. As shown in Figure 38, privately-owned companies now account for 84% of total investment, up from 19% five years ago, while investments by Chinese state-owned firms and sovereign players have dropped sharply.[520] This trend is related to the decision made during the third

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[515] Alexandra Pacurar, "Why China Will Keep Pumping Capital into the US Real Estate Market," *Commercial Property Executive*, https://www.cpexecutive.com/post/why-china-will-keep-pumping-capital-into-the-us-real-estate-market/

[516] Iacob Koch-Weser and Garland Ditz, "Chinese Investment in the United States: Recent Trends in Real Estate, Industry, and Investment Promotion," US-China Economic and Security Review Commission, February 26, 2015, p. 9.

[517] Kenneth Rosen, Arthur Margon, Randall Sakamoto, and John Taylor, "Breaking Ground: Chinese Investment in US Real Estate," an Asia Society Special Report produced in collaboration with Rosen Consulting Group, *AsiaSociety*, May 2016, p.10, http://asiasociety.org/breaking-ground-chinese-investment-us-real-estate

[518] Iacob Koch-Weser and Garland Ditz (2015), op. cit., p. 9.

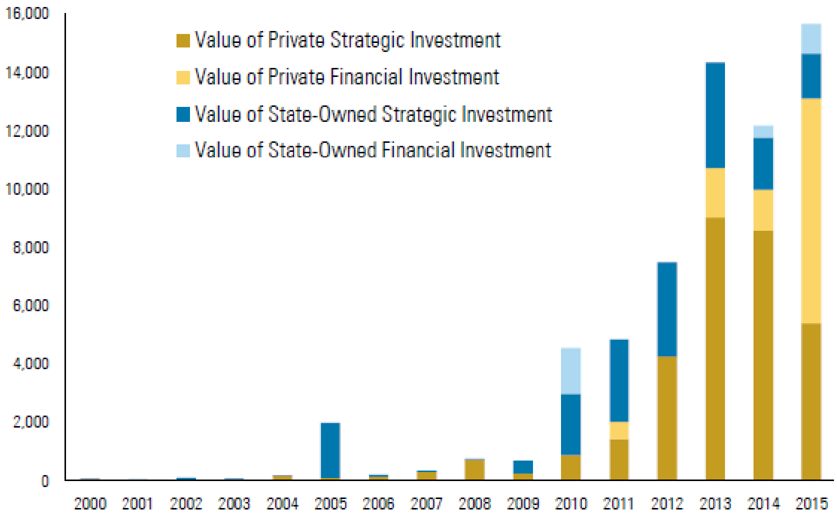
[519] "Chinese Investment in Developed Markets: An opportunity for both sides?" *a report by The Economist Intelligence Unit, commissioned by HSBC*, May 18, 2015, p.11.

[520] Thilo Hanemann and Cassie Gao, "Chinese FDI in the US: 2015 Recap," January 19, 2016.

plenum of the ruling Chinese Communist Party in November 2013 that SOEs should increasingly have to compete on a level playing field with private companies.[521] Private enterprises are, therefore, expected to "play a more and more important role in the process of the nation's outbound direct investment activities," so that "they will probably surpass SOEs as the major force of China's investment wave."[522]

Figure 38. Chinese FDI Transactions in the US by Ownership, 2005-2015*

(Annual figures: US$ million)



Source: Rhodium Group[523]

Note: *Data are preliminary and subject to adjustment

Promoting bilateral FDI flows between the US and China

Chinese FDI into the US is set to reach a new high in 2016 by investing $20 to $30 billion, mainly through mergers and acquisitions, compared with a record $15 billion last year and $11.9 billion in 2014. Nevertheless, investments by Chinese firms in the US are still much smaller, in terms of total stock and annual volume, than those by firms from Japan, the UK, Luxemburg, Canada and other advanced economies. Only one-eighth of China's $120 billion in outward investment in 2015 went to the US.

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521 "Chinese Investment in Developed Markets: An opportunity for both sides?" (2015), op. cit., p.4.

522 Wei Tian and Ding Qingfen, "Private investors play bigger role overseas," *China Daily*, August 31, 2012, http://www.chinadaily.com.cn/ business/2012-08/31/content_15722433.htm

523 Ibid.

However, this will quickly change. China's investment in the United States is maturing in terms of both aggregate capital flows and local deal-making.[524] Chinese FDI flows into the US will grow rapidly as China continues to plow less into commodity-rich developing countries in an effort, says the *WSJ*, to "shift the economy toward technology, services and greater consumer spending."[525] As the Chinese government takes steps to further relax restrictions on outbound investment, more Chinese companies are likely to arrive on US shores, even as those already present reinvest their profits in business expansion. At the same time, wealthy Chinese individuals are flooding into the US property market in search of lucrative assets and the opportunity to live and work outside China.[526]

It is important to further promote bilateral investments for both economies. Therefore, it represented an important step in the right direction when, in Washington DC on September 25th, 2015, the leaders of both countries agreed to further promote bilateral FDI flows across the Pacific through committing "to intensify the BIT negotiations and to work expeditiously to conclude the negotiation of a mutually beneficial treaty."[527] They also agreed that, "The United States and China (would) commit to limiting the scope of their respective national security reviews of foreign investments (for the United States, the CFIUS process) solely to issues that constitute national security concerns, and not to generalize the scope of such reviews to include other broader public interest or economic issues."[528] On March 31st, 2016, Elizabeth Economy of CFR pointed out in her Congressional hearing on 'China and the US Rebalance to Asia' that the next administration should make the realization of a BIT with China a top priority, which would be one of the most effective ways to advance US economic interests in the Asia Pacific.[529]

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[524] Iacob Koch-Weser and Garland Ditz (2015), op. cit., p. 25.

[525] William Mauldin, "China Investment in US Economy Set for Record, But Political Concerns Grow," The Wall Street Journal, April 12, 2016, http://www.wsj.com/articles/china-investment-in-u-s-economy-set-for-record-but-political-concerns-grow-1460422802

[526] Iacob Koch-Weser and Garland Ditz (2015), op. cit., p. 25.

[527] "FACT SHEET: US-China Economic Relations," *Press Release*, Office of the Press Secretary, The White House, September 25, 2015, https://www.whitehouse.gov/the-press-office/2015/09/25/fact-sheet-us-china-economic-relations

[528] Ibid.

[529] Elizabeth Economy (2016), op. cit.

7. Conclusion

Even though the international monetary system is continuing its shift from the dollar-based system to a tripolar one, which is believed to adequately reflect the recent fundamental changes of the global economy, the dominance of the greenback will remain unchallenged for the foreseeable future. Nevertheless, "a transition to a more secure order will be devilishly hard," as The *Economist* argued in 2015, because "the alternative reserve currencies are flawed."[530] This flaw, together with the tendency of governments to resist "any step that might disadvantage their separate economies or the interests of key domestic constituencies," makes it very difficult to reform or replace the current IMS quickly, however urgent the need may become (Benjamin Cohen, 2013).[531]

In the meantime, as Paola Subacchi (2010) notes, it is important to attempt to reform the system in a gradual and careful manner in order to "ensure the sustainability of the system and avoid its collapse – with all the related shocks and costs that this might entail." This could appropriately address "current concerns about the imminent collapse of the IMS and dollar-based system," which will help create a "breathing space" for "wider reforms" of the system.[532]

Thus, global coordination is both necessary and desirable as the international community tries to grapple with the issue of reforming the current IMS and other global challenges, including the strengthening of the multilateral trading system. This section provides insights into global efforts to address these issues and concludes with a brief observation of "Chimerica."

Global Coordination: The emergence of the G-20 as the premier forum for international economic and financial governance

It was the 2008-9 Global Financial Crisis and Global Recession that awakened the world to the need to adjust international economic governance to the new realities in an urgent and coordinated manner. Indeed, the crisis highlighted the fact that the world economy had become much more integrated and intertwined, as a result of the globalization that international trade and cross-border capital flows had set in motion particularly since the end of the Cold War in the late 1980s. Now, countries, regardless of their level of economic

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530 "Dominant and dangerous: As America's economic supremacy fades, the primacy of the dollar looks unsustainable," The Economist, October 3, 2015, http://www.economist.com/news/leaders/21669875-americas-economic-supremacy-fades-primacy-dollar-looks-unsustainable-dominant-and

531 "Benjamin J. Cohen, THE COMING GLOBAL MONETARY (DIS)ORDER," in *Global Governance at Risk* (Cambridge: Polity Press, 2013) by David Held and Charles Roger, p. 41

532 "Beyond the Dollar: Rethinking the International Monetary System," (2010), op. cit., p.7.

development, had come to the realization that their economies were "more vulnerable to financial contagion, policy 'spillovers' and economic imbalances"[533](Paola Subacchi and Stephen Pickford, 2015). Especially, unlike the past crises, the nature and scope of the crisis made it essential to involve emerging markets in an internationally coordinated response (Malcolm Knight, 2014). [534]

Against this backdrop, the G-20 emerged as the premier forum for international economic and financial governance since its first summit in Washington, DC on November 14-15th, 2008. Global governance has become "more broadly based and legitimate," since key emerging markets, including China and India, are, according to Marco Lo Duca and Livio Stracca (2014), being "represented and contributing to decisions at the global level."[535] The G-20 is well suited to rise up to global challenges, including responding to the global financial crisis, with its membership representing around 85 percent of global gross domestic product, over 75 percent of global trade, and two-thirds of the world's population.

Notwithstanding this, the G-20's track record so far has been mixed. As Subacchi and Pickford observe, a variety of factors have affected the effectiveness of the G-20 in such a way that makes it more difficult for those nations to achieve substantial progress on reform of the Bretton Woods institutions. These factors include "radically different visions" among G-20 members of "the group's role and for that of the international financial institutions in managing the global economy," as well as some structural flaws such as "the need for consensus and the 'rotating presidency' format."[536]

In the meantime, the IMF has also found it increasingly difficult to function as the "proper locus of international economic cooperation." In particular, comments James Boughton (2016), the recent "rise of the G-20 as the dominant outside group has rendered the IMFC virtually powerless to play an independent role in determining IMF policies or advising on the direction of financial policies."[537]

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[533] Paola Subacchi and Stephen Pickford, "International Economic Governance: Last Chance for the G20?" Chatham House, International Economics Department, November 2015, p. 2.

[534] Malcolm D. Knight, "REFORMING THE GLOBAL ARCHITECTURE OF FINANCIAL REGULATION THE G20, THE IMF AND THE FSB," CIGI PAPERS NO. 42, September 2014, p.17.

[535] Marco Lo Duca and Livio Stracca, "The effect of g20 Summits on global financial markets," Working Paper Series No 1668, April 2014, ECB, p. 2.

[536] Paola Subacchi and Stephen Pickford (2015), op. cit., p. 4. and p. 5.

[537] James M. Boughton, "Is There a Future for International Monetary Cooperation? CIGI Commentary," April 25, 2016; https://www.cigionline.org/publications/there-future-international-monetary-cooperation

Therefore, there is a growing need for the G-20 and the IMF to work closely together in marshalling global cooperation and coordination, as and when necessary, as the world community continues to come to grips with global challenges, particularly, the reform of international economic and financial governance, in an effective and timely manner.

Constructive rebalancing of the relationship between the IMF and the G-20

What is encouraging, according to Subacchi and Pickford (2015), is the fact that "There is room in the international economic governance architecture for the G-20 as well as the international organizations, and they are at their most effective when they work together."[538] A constructive rebalancing of the relationship between the IMF and the G-20, and their roles in improving the IMS, is both necessary and desirable. Doing so would generate synergy between these two important groups, because the former (G-20), the premier group forum for international economic and financial governance comprising a select group of leaders, can "implement major changes in the strategic policy direction to meet unforeseen developments," while the latter (IMF), a "universal, treaty-based official international financial institution, provides regular, consistent policy advice to its members.[539]

In this regard, it is worth noting US Treasury Secretary Jack Lew's recent remark highlighting the importance of continuing global coordination and cooperation among all countries and groupings both within the G-20 and between the G-20 and the IMF. He said:

> "A major reason that the global financial crisis that began in late 2007 never turned into a second Great Depression is that the United States and other countries coordinated their efforts through the IMF and the G-20".[540]

Given that countries tend to seek to narrowly prioritize their own interests to the detriment of others, particularly at times of economic difficulty like the one the world is currently going through, the mere introduction of a new multipolar currency regime would not guarantee the stability of the current IMS. Thus, it is important to continue to make concerted efforts to secure global coordination in order to avoid "just magnify(ing) the present deficiencies of the currency regime" (Miriam Campanella, 2014).[541]

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538 Paola Subacchi and Stephen Pickford (2015), op. cit., p.6.

539 Malcolm D. Knight (2014), op. cit., p.18.

540 Lew, Jacob J. 2016. "America and the Global Economy: The Case for US Leadership." Foreign Affairs May/June 2016 Issues, April 11, 2016; https://www.foreignaffairs.com/articles/united-states/2016-04-11/america-and-global-economy?campaign=Lew

541 Miriam Campanella (2014), op. cit., p. 14.

Strengthening the Multilateral Trading System

A main justification for creating the GATT (General Agreement on Tariffs and Trade), one of the three key elements of the Bretton Woods system, in the post-war period was the widely-held belief that hostile trade blocs had contributed directly to the Great Depression of the 1930s and the outbreak of the Second World War (John Ravenhill, 2014; WTO World Trade Report 2011).[542] This highlights the critical importance of promoting global cooperation and coordination not only in the international monetary system, but also in the multilateral trading system represented by the WTO (World Trade Organization), especially at a time when the Global Recession, the greatest ever since the Great Depression, still persists.

Indeed, the WTO multilateral trading system is currently at a crossroads, as was once again witnessed at the WTO's most recent Ministerial Conference, held in December 2015 in Nairobi, Kenya. The WTO's Doha Round of negotiations, launched in 2001, remains at an impasse. Members are divided over such questions as to where the WTO should be headed, whether so-called new issues and approaches should guide WTO negotiations in the future, and how these relate to the old issues and approaches. To make matters worse, the recent rise of mega-regional trade negotiations, such as the Trans Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP), has posed serious questions about the WTO's role as a negotiating forum for trade liberalization (Simon Lester, 2016).[543]

In fact, the establishment of the post-war multilateral trading system did not diminish the attraction of bilateral or regional approaches to trade arrangements and led instead to a period of creative interaction and, sometimes, tension between multilateralism and regionalism.[544] It is important to understand that bilateral and regional approaches to trade arrangements should be managed in such a way as to serve as a major driving force for the progress of the multilateral trading system, thereby completing and strengthening it. This is, according to Lester, because "trade liberalization is most beneficial when carried out multilaterally."[545] It would be such a setback both for the economies of the WTO member countries and for the global economy as a whole, as well as for the principle of free trade, were all governments not to work closely together to make the WTO multilateral trading system relevant. The 19th century French Liberal economist Frederic Bastiat said, "When goods don't cross borders, armies will." It is critically important that major economies should pool their wisdom and

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[542] John Ravenhill, *Global Political Economy* (Oxford University Press, 2014), Fourth Edition, p. 177; "The WTO and preferential trade agreements: From co-existence to coherence," World Trade Report 2011, WTO, p. 5.

[543] Simon Lester, "Is the Doha Round Over? The WTO's Negotiating Agenda for 2016 and Beyond," CATO Institute, FREE TRADE BULLETIN NO. 64, February 11, 2016., p.1

[544] "The WTO and preferential trade agreements: From co-existence to coherence," World Trade Report 2011, WTO, p. 5.

[545] Simon Lester (2016), op. cit., p.3.

redouble their efforts to ensure that the WTO multilateral trading system can successfully carry out its missions, before it is too late.

Chimerica or Chimera

In 2007, Niall Ferguson, a British historian, and economist Moritz Schularick, coined the word "Chimerica", referring to a combination of 'China' and 'America', to describe the symbiotic relationship increasingly dominating the world economy. In 2015, Fergusson recalls that:

> "Before the 2008 financial crisis, Chimerica was a marriage of opposites. China saved, exported and lent. America consumed, imported and borrowed. For a few heady years, the odd couple were happy together. Not only did the glut of Chinese savings lower the cost of capital, the glut of Chinese workers reduced the cost of labor. Every asset class on the planet rallied. But the unbalanced economic relationship between China and America posed a threat to global financial stability. That was our point in 2007: Chimerica was a chimera."[546]

"Surprisingly, the 2008 financial crisis didn't lead to a Sino-American divorce, despite mutual accusations of monetary manipulation," Ferguson continues; "instead, like any couple who spend long enough in each other's company, the 'Chimericans' grew ever more alike."[547] As an Asia Society Special Report (2016) describes, the United States and China, as two global powers with different but partially overlapping spheres of influence, are bound to have geopolitical disagreements going forward.[548] These potentially conflicting views could be considerably mitigated as both countries become more integrated economically. "At a macro level, the more the two economies are intertwined – with significant investment flows in both directions – the greater the imperative to deescalate any potential confrontations that would not only be destructive from a humanitarian perspective but also from an economic perspective," the report further emphasizes.[549]

During the open session of the eighth US-China Strategic and Economic Dialogue (S&ED), held in Beijing on June 6th, 2016, with both a "Strategic Track" and an "Economic Track," US Secretary of State John Kerry stated, "Now, we have a chance – we really do – to define a new relationship," while emphasizing, "We have an inescapable responsibility – a shared

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546 Niall Ferguson, "Chimerica and the Rule of Central Bankers," *The Wall Street Journal*, August 27, 2015, http://www.wsj.com/articles/chimerica-and-the-rule-of-central-bankers-1440717632

547 Ibid.

548 Kenneth Rosen, Arthur Margon, Randall Sakamoto, and John Taylor, "Breaking Ground: Chinese Investment in US Real Estate," an Asia Society Special Report produced in collaboration with Rosen Consulting Group, *AsiaSociety*, May 2016, p. 100.

549 Ibid.

duty – to lead in the direction of stability, prosperity, and peace."[550] Highlighting that it is "a time when ideas of a zero-sum game and conflicts and confrontation must give way to common development and win-win cooperation," the Secretary of State also noted the importance of redoubling joint efforts in order to try to manage differences "in a pragmatic and constructive fashion by putting ourselves in each other's shoes" because, "in this world of diversity," where "differences among countries are just natural," it is "most important to refrain from taking the differences as excuses for confrontation."[551] Mr. Kerry further noted that since "the vast Pacific should be a stage for inclusive cooperation, not an arena for competition," the United States and China "may work together to foster a circle of common friends that is inclusive rather than exclusive," and that both countries "should play such a role that they will build and maintain prosperity and the stability of this region." [552]

Indeed, the interdependence between the world's two largest economies has become greater. Given the weighty status of 'G-2,' the need for them to work closely together in handling an unending list of challenges both at regional and global levels has also become more acute and urgent. Henceforth, there are ample reasons for redoubling efforts, through increased bilateral trade and investments, to translate the concept 'Chimerica' into reality, and not 'chimera.'

It is against such a backdrop that the 11th G-20 Summit scheduled to be held in Beijing in September, 2016 – the timing would appear most intriguing given that the summit will be held after the UK's Brexit vote in June and immediately prior to the RMB's official debut as one of the five SDR currencies on October 1st – is both significant and meaningful because it will provide a rare opportunity to reflect on the progress made so far and on how to further promote global coordination on international economic governance and other important global challenges.

[550] "S&ED Opening Session Remarks: Remarks by John Kerry, Secretary of State," US Department of State, June 6, 2016, http://www.state.gov/secretary/remarks/2016/06/258091.htm

[551] Ibid.

[552] Ibid.

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