EABER East Asian Bureau of Economic Research
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Newsletter

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## Analysis

### The future of the international currency system and China's RMB

**Yiping Huang**

The global financial crisis could mark the beginning of the end for the US dollar's dominance over the global economy. But this end is not yet in the foreseeable future. The US dollar will remain one of the world's most important currencies for many years to come. But the difficulties in maintaining the US dollar's role as a global reserve currency are large, and are best characterised by the 'Triffin Dilemma'. As growing international economic transactions increase offshore demand for US dollars, the US current account deficit necessarily grows. But the high deficit diminishes global investors' confidence in the dollar. In sum, the international currency system is going to change.

These changes are important for China: Firstly, the US dollar has been the most important foreign currency for China's external economic relations. Should the US dollar begin its long decline, China will need to find an alternative. Secondly, international trade and investment transactions are critical for the Chinese economy. Therefore, it has a vested interest in ensuring that international financial system reform is moving ahead smoothly. Thirdly, China's large foreign exchange reserves have become a 'hot potato'. Since a large portion of the reserves is in US dollar denominated assets, any fluctuations in the US dollar exchange rate have significant implications for the value and purchasing power of the reserves. And finally, China is moving toward liberalisation of capital accounts and internationalisation of the renminbi (RMB).

The evolution of the international currency system will have implications for reform of China's RMB policies. The RMB could play a greater role in the international economy in the future, if its own reforms are smooth and successful. The conclusion is that a global monetary system based on a national currency as its reserve currency is not sustainable.

In this discussion, I look at three possible scenarios.

The first scenario is continuation of the US dollar as the dominant global currency. Current debate surrounding the decline of the US dollar focuses mainly on the dollar's weakening role as a reserve currency. It isn't clear that the dollar's roles as medium of exchange or unit of accounting will decline rapidly in the short term. The key reason for this is not so much because the fundamentals underscoring the dollar's global function are solid. Rather, there is a lack of viable alternatives.

The US dollar's disadvantages relative to other reserve currencies – the euro, pound and yen – are not pressing in the near term. The economies that are strengthening their positions in the global system are mainly those from the emerging market world, such as China and India. Unfortunately, these economies do not offer any feasible substitutes to the US dollar as a global or reserve currency in the short term.

Further, a key cause for collapsing confidence in the US economy was very large external deficits. But if the US current account deficit of 3 per cent could be sustained in the coming years, it would allay fears of the persistent depreciation of US dollar and remove an important obstacle to the US dollar continuing to play its global role.

The second scenario involves the emergence of a multi-global currency system. A multiple system based on national currencies still doesn't solve the 'Triffin dilemma'. But it certainly lessens the severity of the problem by reducing deficit pressures on a single country. For instance, if other major currencies constitute greater portions of the world's foreign exchange reserves, it might be possible for the US to maintain its current account deficits at manageable levels.

The 'G3' (dollar, euro and yen) monetary union proposed by Bob Mundell in 2002 could be a way forward for the multi-global

## Paper of the Month

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China Update Book Launch, April 2010, Beijing.

APEC Roundtable Workshop, April 2010, Washington D.C.

Climate Change in Asia Conference, June 2010, Canberra

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currency regime. Clearly, Mundell's ultimate goal is to achieve a global currency. But at least during the transition, as Mundell points out, it may be the case that these three international currencies dominate.

A third scenario is creation of a supranational international currency. In 2009, the UN Commission on Financial Reforms identified a number of problems with a national currency serving as the global reserve currency.

Interestingly, the UN Commission argued that a multiple reserve currency system may be worse than a single reserve currency system, since it adds an additional element of instability to a purely US dollar-based system. The Commission believes that not only is a new global reserve system desirable, but that the global financial crisis also provides an ideal opportunity to overcome political resistance.

People's Bank of China (PBOC) Governor Zhou Xiaochuan's proposal last year to transform the IMF's Special Drawing Rights (SDRs) into a true global currency aims at solving the short term problem of a credible reserve currency. One approach proposed by the Commission is for countries to agree to exchange their own currencies for International Currency Certificates (ICC), which could be converted into Special Drawing Rights, and vice versa.

But whichever direction international monetary system reform is heading, Asia is under-represented in the global currency system. Traditionally, much of Asia was a part of the 'dollar bloc'. But as the future of the dollar dims and economic interdependence among Asian economies intensifies, the question arises: should Asia have its own currencies, regional or international, that better reflect its growing global economic importance?

Strategic thinkers in Asia have already set their eyes on the long-term goal of establishing an 'Asian dollar', much the same way as Europe established the euro. Masahiro Kawai laid down a road map for regional currency integration, first creating an 'Asian currency unit (ACU)' based on a basket of regional currencies, with the ultimate goal of unifying regional currencies into a single supranational regional currency.

But there is an alternative. The RMB could emerge as Asia's dominant regional currency. This hinges on the successful continuation of China's rapid growth and the smooth transformation of the RMB into a global currency.

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In this context, China has actively participated in international financial system reform, through both intellectual debate and policy development. Further, Chinese policy-makers are more positive about the role played by existing international financial architectures, such as the IMF and the World Bank, than many of their East Asian counterparts. But, objectively speaking, the track records of these global institutions, especially the IMF, remains subject to question.

In sum, it is difficult to predict how soon the RMB will become an international currency. This depends largely on the pace of liberalisation. But it is clear that moves towards liberalisation that will assist that development have been accelerating in recent years.

If all these reforms move forward smoothly, then we can expect the RMB to become an international currency within a relatively short timeframe. But only time will tell as to what role it will play in a future international monetary system.

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