Reform of Global Reserve System and China's Choice[1]

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1. Why the Regime should be Reformed?

The existing global reserve system is not only unstable but also unequal. It has three flaws. The first is its inherent instability, which was correctly described as *Triffin Dilemma* by Robert Triffin in 1961. i.e. the issuing countries of reserve currencies cannot maintain the value of the reserve currencies or the stability of its exchange rate while providing sufficient liquidity to the world. The financial history in the past three and half decades indicated that the US dollar has found very difficult to keep itself stable as a main reserve currency. With the large amount of current account deficits, US dollar suffered significant depreciation repeatedly, particularly in the beginning to 1970s, the mid of the 1980s and the period of 2002-2005. In each period, the large depreciation of the US dollar triggered financial turmoil and even economic recessions.

The second one is that there is a conflict between the target of monetary policy of reserve currency issuing country based on its domestic macroeconomic stability and the global need for reserve currency supply (Zhou, 2009). Moreover, any significant change and mistake in monetary policy of reserve currency country may have an unexpected and very often negative consequence to the rest of the world. Actually, the conflict may also be interpreted as a serious failure of policy coordination between reserve creating countries and reserve holding countries. Under the dollar-center regime, basically neither any single country nor IMF can cast any significant impacts on the US monetary policy or other macroeconomic policies.

The failure of the policy coordination has repeatedly brought financial instability to the relevant countries or even the entire world. For instance, the surge of US interest rate in the early 1980s resulted in the great shortage of liquidity and eventually triggered the international debt crisis. In contrary, the ease of the monetary policy during the 2002-2005 created a lot of the dollar reserve supply and accordingly caused the continuous dollar depreciation.

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The recent global imbalance possibly is a latest example of the above conflict. Among the main interpretations for the recent global imbalance, based on the analysis by various economists, the most important ones may include excessive consumption in the United States, excessive savings in China and other East Asia countries which are basically results of unsophisticated domestic financial market and other structural weakness, and the new framework of international trade pattern, etc.. However, it should be noted that the dollar-center reserve system does play an important role. With an *exorbitant privilege* of the dollar, United States had been keeping its monetary policy ease and accordingly indulging current account deficits in the first half of this decade. Actually, the loose money supply policy adopted by Mr. Alan Greenspan not only caused global imbalance but also became one of the main reasons for the sub-prime crisis.

The third flaw is that the dollar-center reserve currency system has a tendency to encourage capital move from poor countries to rich countries, as correctly discussed in the Stiglitz Report (Stiglitz Commission, 2009). Though it is not necessarily the case, United States does have been a net capital import country since the late 1980s, with a much clear and accelerated trend in the past few years. After the financial crisis in 1997, Asian emerging market economies tend to hold more precautious foreign exchange reserves in the form of American treasure bill for preventing themselves from speculative attacks. The ratio of non-gold reserve to GDP rose from 3% in the end of 1980s to more than 30% in recent years. Among them, China is most aggressive. By the end of 2010, the ratio is about 55%, amounting to USD 2.8 trillion in absolute value.

2. **How to Reform the Regime?**

On the eve of G20 summit meeting in London early this year, Dr. Zhou Xiaochuan, the governor of People’s Bank of China, made a proposal in the famous short article advocating that the current global reserve regime should be reformed by augmenting the role of SDR. He believes that a synthetic currency such as SDR should replace US dollar as a main reserve currency in the future, because only an overriding sovereign currency can overcome Triffin Dilemma and other related problems and then help avoid the global financial instability. Almost simultaneously, the Stiglitz Commission, a commission of experts convened by the President of UN General Assembly on Reforms of the International Monetary and Financial System, made a similar call for deep reforms of the global reserve system.

Whether the SDR can become a principal reserve currency will depend on its supply and demand. In the supply side, a regular augment should be foremost important. After the SDR was initiated in 1969, it was allocated twice in the 1970-72 and 1979-81, totally amounting to USD 21.4 billion. In 2009, IMF decided to greatly enhance SDR allocation equivalent to USD 250 billion, following the suggestion of G-20 London summit. Even including the amount newly allocated, the stock of SDR is only an equivalent to about 5% of the global non-gold reserves in total. If the SDR can be issued and allocated in equivalence of USD 150-300 billion each year according to the proposal by Stiglitz Report, then its stock will reach a level of about 50% of the non-gold reserve ten years later.

Although the allocation of SDR equivalent to USD 250 billion is a big break through since it was created, it is believed that the augment is mainly for combating economic recession. Therefore, whether it can become a regular issuing mechanism is still unclear (Williamson, 2009). Since the increase of allocation of SDR may challenge the principal role of US dollar, it should be reasonable to speculate that United States is unlikely to have much incentive to push the reform. *Given the current governance of IMF, it should be necessary to accelerate the reform of IMF and make its governance more reasonable, widely representative and more democratic.*

In the demand side, how to make the SDR more attractive might be a big challenge. Since it came forth, SDR has been a kind of credits given by the IMF that can be converted into dollars and other currencies at the IMF, and can only be used in official transactions among member countries. But they cannot be directly used to intervene in foreign-exchange markets; they cannot be used in other transactions in which central banks and governments engage either. Therefore, for a long time, the SDR is not an attractive unit for official reserves.

Substitution account might be a good tube for increasing the attractiveness of SDR. In a dollar-centered system, the substitution account in IMF would make the SDR become a portfolio choice available to reserve holders. It would enable a reserve holder to convert some of its dollar holdings into SDR and vice versa. One of the further advantages would be reducing the pressure that US dollar may confront with when the States' current account deficits seemingly become uncontrolled and the dollar becomes a hot potato.

Besides, for making the SDR more attractive, it should be useful for IMF itself or by encouraging member countries to issue SDR-denominated bonds. It is noted that the issuer will have to pay a price, since investors in these bonds would initially demand a novelty premium at least in the first few years. But the price should be considered an investment in a more stable international system (Eichengreen, 2009). Moreover, IMF should play a role of market maker even bear some relevant costs.

Furthermore, creating an active SDR market by extending the use of SDR into commercial area might be a useful step. Liquidity is the most important factor for market participants to consider. As a latest example, despite the sub-prime crisis and economic recession of the American economy, dollar securities remain the principal form of reserves only because of the unparalleled depth and liquidity of US markets. And due to the relatively less liquid, even the euro can't challenge the dollar as the principal reserve currency. Notably, if an active market of the SDR finally comes into being, then the SDR will be easier to become an attractive portfolio.

It is reasonable to believe that SDR's becoming dominant reserve currency will take a long time. During the transitional period, US dollar may continue to be the main reserve currency though euro and some other currencies are likely to play increasingly roles. In other worlds, a multi-reserve currency regime will not disappear in the short term and even in the mid-term. In order to reduce the global imbalance and systematic financial risks, significant reforms of IMF's governance and more productive macro-economic policy coordination through G20 and other platforms should be deadly needed.

3. International Usage of Renminbi: A Reasonable Choice for China

Owing to the fact that the multi-reserve currency regime would be more realistic in the short term and even in the mid-term, extending Renminbi's international usage therefore should be a reasonable choice for China. Actually, China has started to expand the international usage of its currency or so-called RMB internationalization since the outbreak of the sub-crime crisis. In 2008 and 2009, China signed eight currency swap agreements with six Asian countries and two countries from the rest of the world. The total amount of RMB swapped reached 803.5 billion. The currency swaps are expected to facilitate foreign enterprises' operation and their financial needs in China, help settle bilateral trade, and even make RMB as a reserve currency.

In April 2009, the Chinese government decided to experiment invoicing cross-frontier trade in RMB. In July, some trade companies in five experimental cities were allowed to invoice in RMB in their cross-frontier trade with Hong Kong, Macau and some ASEAN countries. Several months later, 20 provinces were allowed to join the same experiences and restrictions on foreign countries were lifted. In 2009, cross-frontier trade invoiced in RMB reached RMB 23 billion. Also in 2009, RMB deposits in Hong Kong were over RMB 100 billion. The cross-frontier RMB invoiced trade in the first half of 2010 has been 18 times higher than the second half of 2009. Besides, the Chinese government issued RMB 6 billion renminbi denominated government bonds in Hong Kong in 2009. In addition, foreign banks are allowed to participate in Chinese domestic bond market with their RMB holdings.

The international usage of Renminbi should be beneficial to mitigate the flaws of the existing global monetary system and therefore enhance the global financial stability. First, if Renminbi eventually becomes a part of the multi-reserve currency regime, the problem with Triffin Dilemma could be alleviated in some degree. Second, when more currency competitions are present, the main reserve currency issuing county may become more careful with its monetary policy, particularly the abuse of ease monetary policy. Accordingly, the global imbalance may be alleviated.

The international usage of Renminbi is likely to be a new vehicle of the Asian monetary and financial integration, which could be an important part of the ongoing reform of the global monetary system. While more and more currency swap agreements, intra-regional trade and investment are denominated in RMB, Asian countries will have an increasingly strong motivation to keep their currencies pegged to RMB and eventually make RMB an important reserve currency in this area. When RMB becomes a most important currency for denomination, pricing and store in value, the chance for Asian countries to create a fixed exchange regime or single currency zoo may largely increase.

At the national level, China may also gain some benefits. Besides the sharing in seigniorage with other reverse currency issuing countries, China may largely reduce its currency mismatch in its external trade and investment, which would improve the productivity of enterprises and reduce the macro-economic instability. Moreover, as a further step of opening up, the RMB internationalization will most likely push forward China's domestic economic reform, particularly the financial market; because a more opened economic structure would request more institutional domestic reform according to the related experiences in China over the past decades.

In order to extend renminbi's international usage, China should allow more firms and companies to invoice trade in renminbi and increasingly issue RMB denominated government bonds abroad (at least in the 10+3 net countries). However, to make the RMB internationalization long endure and more sustainable, China should accelerate its domestic financial reform, especially liberalization of the interest rate, greatly improve the liquidity of financial market through strengthening financial innovation in instruments and institutional arrangement and increase the openness of the financial sector through allowing more freely entry of qualified foreign banks and non-bank financial institutes. For mitigating the systematic financial risks resulting from the financial liberalization, strengthening the financial supervision and regulation is definitely needed. Besides, it should gradually liberalize its capital control, particularly reduce the restriction on overseas investment and eventually make renminbi convertible. *Of course, it would be dangerous if China remove restriction on capital outflows too fast. Unless it has a sophisticated domestic financial market and effective financial regulation, China should not entirely open its capital account even though such a reform is critical to the increase of international usage of renminbi.*

Given the relatively strict capital control at the present and it may continue to exist in the next decades or so, as an alternative in some degree, China may push forward the internationalization of RMB by encouraging the development of offshore RMB market. For years, Hong Kong has been an offshore RMB center although the market scale is small. It seems reasonable to predicate that Tokyo, Singapore, Bangkok and other cities in the ASEAN countries should play important roles in the development of offshore RMB market, since most of these cities own well-developed financial markets and institutions. Besides, based on the experiences with banking facilities in

New York in the end of 1970s, China may also set up similar Banking Facility in Shanghai or Shenzhen a special liberalized zone in the onshore market.

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