

# Is China Ready to Challenge the Dollar?

## Internationalization of the Renminbi and Its Implications for the United States

A Report of the CSIS Freeman Chair in China Studies

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*Library of Congress Cataloguing-in-Publication Data*

CIP information available on request.

ISBN 978-0-89206-590-5

### **The CSIS Press**

Center for Strategic and International Studies

1800 K Street, NW, Washington, DC 20006

Tel: (202) 775-3119

Fax: (202) 775-3199

Web: [www.csis.org](http://www.csis.org)



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# IS CHINA READY TO CHALLENGE THE DOLLAR?

## INTERNATIONALIZATION OF THE RENMINBI AND ITS IMPLICATIONS FOR THE UNITED STATES

*Melissa Murphy and Wen Jin Yuan*

### Introduction<sup>1</sup>

Amid the fallout from the global financial crisis, much has been written about the extent to which the United States can continue to play its role as the world's predominant economic power and whether the emerging BRIC economies,<sup>2</sup> particularly China, are poised to challenge the current financial and economic architecture. In recent months, speculation has focused on the future of the U.S. dollar, largely due to comments by senior Chinese officials that have led some observers to conclude that the renminbi (RMB) is "set to usurp the US dollar" as the world's reserve currency.<sup>3</sup> Such speculation reached fever pitch during the BRIC summit held in June 2009, with one commentator opining that delegates to the meeting "emerged with a pointed gun aimed at the U.S. dollar."<sup>4</sup>

Although such headlines make thrilling copy it would be a mistake to conclude that China is ready to ditch the dollar anytime soon, let alone seek to replace the dollar with the renminbi as a reserve currency. On the contrary, Beijing has accumulated around 1.4 trillion in U.S. dollar reserves and is keen to avoid any precipitous decline in the dollar's value—which would in turn devalue its own holdings. Reflecting China's concerns, a statement issued at the end of the BRIC summit did not in fact contain any call to develop a new reserve currency.<sup>5</sup> Moreover, as Arthur Kroeber of the *China Economic Quarterly* points out, many commentators tend to confuse three distinct

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<sup>1</sup> The authors would like to thank the Chinese scholars who agreed to be interviewed for this report. We have respected their preference to remain anonymous and therefore do not cite them by name.

<sup>2</sup> The so-called BRIC economies are Brazil, Russia, India, and China. The BRICs, a term first coined by Goldman Sachs economist Jim O'Neill in 2003, accounted for 42 percent of the world's population, 14.6 percent of global GDP, and 12.8 percent of global trade volume in 2008.

<sup>3</sup> James Quinn, "China's Yuan 'Set to Usurp US Dollar' as World's Reserve Currency," *Telegraph.co.uk*, May 14, 2009, <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/5325805/Chinas-yuan-set-to-usurp-US-dollar-as-worlds-reserve-currency.html>.

<sup>4</sup> Sheldon Filger, "BRIC Summit Sees End of Dominance of U.S. Dollar," *Huffington Post*, June 17, 2009, <http://www.huffingtonpost.com/sheldon-filger>.

<sup>5</sup> Vladimir Isachenkov, "BRIC Calls for Diverse Reserve Currency," *Washington Times*, June 17, 2009, <http://www.washingtontimes.com/news/2009/jun/17/bric-calls-for-diverse-reserve-currency/>.

concepts when interpreting China's recent moves—currency internationalization; achieving reserve currency status; and being the dominant global reserve currency<sup>6</sup>—leading them to reach erroneous conclusions about the status of the renminbi. (See text box on following page.)

Though China is still a long way off from challenging the U.S. dollar's global reserve currency status, as the largest holder of U.S. debt, Beijing is undoubtedly nervous about the prospect of a weaker dollar and is taking steps to diversify its reserves, as well as to internationalize the renminbi. There also seems little doubt that in the next decade China will emerge as a major player in the international financial system. Given the strategic geopolitical and economic implications of these developments, the following report attempts to provide a clearer understanding of what is motivating Beijing's current moves, where its policy is likely headed, and the implications for the United States.

## Beijing Signals Its Concern

In private meetings with their U.S. counterparts, Chinese officials have taken every opportunity to voice their fears that the Obama administration's loose monetary policy and heavy deficit spending in the wake of the financial crisis could generate inflation, thus eroding the value of Beijing's massive dollar reserves. Despite the impact of such comments on already jittery currency markets, senior officials have been making them in public as well. For example, Premier Wen Jiabao chose an annual news conference at the National People's Congress meeting held in March 2009 to go public about his worries regarding the safety of Chinese assets in the United States. In a rare moment of candor for the typically cautious premier, Wen told the world's media that “we lent such a huge fund to the United States and of course we're concerned...to speak truthfully, I am a little bit worried.”<sup>7</sup>

Some 10 days later, China's central bank governor Zhou Xiaochuan published the first of three articles calling for reform of the global financial system, specifically for creating “an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies.”<sup>8</sup> While not specifically referring to the dollar, Zhou envisages the creation of a “super-sovereign reserve currency” to be managed by the International Monetary Fund (IMF),

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<sup>6</sup> Arthur Kroeber, “Time to Stop Talking of Renminbi as Reserve Currency,” *Financial Times*, May 26, 2009, <http://blogs.ft.com/dragonbeat/2009/05/26/time-to-stop-talking-of-renminbi-as-reserve-currency/>.

<sup>7</sup> “Premier Worries about Safety of Chinese Assets in U.S.,” Xinhua, March 13 2009, [http://news.xinhuanet.com/english/2009-03/13/content\\_11005049.htm](http://news.xinhuanet.com/english/2009-03/13/content_11005049.htm).

<sup>8</sup> Zhou Xiaochuan, “Reform the International Monetary System,” People's Bank of China, March 23, 2009, <http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=178>.

## What Is a Reserve Currency?

**Internationalization of a currency** is aimed at promoting the widespread use of a currency outside the original country in which it was created in order to conduct transactions between sovereign states. The level of currency internationalization is determined by the demand other countries have for that currency. This in turn depends on the amount of business that is performed between the countries and/or the perceived value of the currency as a good store of value. Achieving reserve currency status is a longer-term and more difficult goal to achieve.

**A reserve currency** is a currency held in significant quantities by numerous governments and international institutions as part of their foreign exchange reserves. It is also the international pricing currency for products traded on the global market, such as oil and gold. A currency will only achieve reserve status if people want to hold it—requiring confidence in the issuing country’s financial markets and currency mobility (i.e., free convertibility). The U.S. dollar is the most widely held reserve currency in the world today. For several decades, the dollar has been the dominant global reserve currency, as an average of two-thirds of total allocated foreign exchange reserves worldwide have been in U.S. dollars (see below).

**Pros and Cons.** Reserve currency status permits the issuing country to purchase commodities at a marginally lower rate than other nations, which must exchange their currency with each purchase and pay a transaction cost. It also permits the government issuing the currency to borrow money at a better rate, as there will always be a larger market for that currency than others. However, in a fiat currency world (unlike the gold and quasi-gold standard), the dominant reserve currency nation will almost certainly be a net debtor: as the reserve nation’s principal reserve asset is its debt securities, other countries must have current-account surpluses to invest in those debt securities, so the reserve nation itself must be willing to run a current-account deficit. A fundamental question for China is whether it is willing to radically alter its trade and economic policies and assume the considerable external liabilities that would come with achieving even ordinary reserve status for the renminbi.

### Evolving Composition of Foreign Reserves

	1980	1984	1990	1996	1999	2002	2005	2008
Dollar	67.2%	65.8%	49.1%	62.1%	71.0%	67.1%	66.9%	64.0%
Euro	n/a	n/a	9.6%	7.1%	17.9%	23.8%	24.0%	26.5%
Pound	2.9%	2.8%	3.2%	2.7%	2.9%	2.8%	3.6%	4.1%
Yen	4.3%	5.4%	8.2%	6.7%	6.4%	4.4%	3.6%	3.3%
Mark	14.8%	12.1%	17.5%	14.7%	n/a	n/a	n/a	n/a
Franc	1.7%	1.1%	2.2%	1.8%	n/a	n/a	n/a	n/a
Other	5.9%	10.9%	10.2%	4.9%	1.8%	1.9%	1.9%	2.1%

Sources: For 1995–1999 and 2006–2008, IMF, “Currency Composition of Official Foreign Exchange Reserves”; for 1999–2005, ECB, “The Accumulation of Foreign Reserves.”

which would “gradually replace existing reserve currencies.”<sup>9</sup> In its annual financial stability report, China’s central bank reiterated its criticism of reliance on the world’s current reserve currencies, warning the United States about its loose monetary and fiscal policies, and calling for closer supervision of those countries that issue reserve currencies.<sup>10</sup>

There is certainly a measure of political theater being played out here. During his visit to Beijing in June, Treasury Secretary Timothy Geithner was at pains to assuage Chinese concerns, telling a television audience that the United States is “very committed to make sure that when recovery is established, that we go back to living within our means, that we bring our fiscal deficits down to a sustainable level, that we unwind and reverse these exceptional measures that we’ve taking in the financial sector.”<sup>11</sup> Following his visit, Geithner said that China had agreed with the United States that the dollar would remain the world’s main currency reserve “for a long time to come.”<sup>12</sup> And, contrary to expectations, China did not back Russia’s attempt to mount a challenge to the dollar as the world’s reserve currency at the BRIC summit later that month.

While China’s “talking down the dollar” managed to shift global focus from pressuring Beijing on appreciation of the renminbi to pressuring Washington on the dollar, the calculated risk had much to do with Chinese domestic politics. As one Chinese scholar explains, amid the financial crisis—particularly falling exports and rising unemployment—the Chinese leadership has been “eager to figure out a way to assuage the public’s dissatisfaction. Openly talking the dollar down is a good way to transfer the public’s outrage towards the United States.”<sup>13</sup> The Chinese media has been unsparing in its criticism of the United States and put the blame squarely on Washington for the current financial crisis. In publicly calling out the United States, the leadership was applauded for defending China’s interests and “through arousing economic nationalism could rid itself of its own responsibility for the crisis in China.”<sup>14</sup>

Although reports of the dollar’s death have thus proved premature, the Chinese government’s pronouncements should not be dismissed as purely political. China’s vast reserve of U.S. dollars has exposed it to significant risk and it has a pressing economic incentive to readjust its international investment strategy. At the same time, as noted above, the government’s policy is being formulated amid a lively domestic public debate regarding not only who is to blame for the financial crisis, but also the future of the U.S.-dominated global financial system and what role a Beijing should play in rebuilding the international financial and economic architecture.

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<sup>9</sup> Ibid.

<sup>10</sup> Peter Garnham, “China Repeats Criticism of Dollar Dominance,” *Financial Times*, June 26, 2009, <http://www.ft.com/cms/s/0/f2236be4-6239-11de-b1c9-00144feabdc0.html>.

<sup>11</sup> “Geithner Says US Concerned about the Deficits,” China Economic Net, June 2, 2009, [http://en.ce.cn/World/biz/200906/02/t20090602\\_19227963.shtml](http://en.ce.cn/World/biz/200906/02/t20090602_19227963.shtml).

<sup>12</sup> “China Sticks with Dollar,” CNN Money, June 2, 2009, <http://cnm.money.printthis.clickability.com>.

<sup>13</sup> Interview with university scholar, August 16, 2009.

<sup>14</sup> Ibid.

## “Currency Wars”

One theory of the financial crisis that has proved popular is that it is the result of a “conspiracy” between politicians and bankers in the United States who have purposely unleashed a “currency war” in order to forestall China’s rise. One leading Chinese magazine ran a cover story entitled “Is the Financial Crisis a Conspiracy?” in which it interviewed Song Hongbin, a former Wall Street financial analyst and author of the book *Currency Wars* (China CITIC Press, 2007).<sup>15</sup> (See text box below.) Although the book was dismissed by mainstream scholars when it was published, it has proved to be a bestseller. And, credible or not, such conspiracy theories have helped to further fuel economic nationalism among the Chinese public<sup>16</sup> in ways that can impact official government policy. According to one report, Vice Premier Wang Qishan, who oversees China’s financial affairs, recommended that his staff read Song’s book.<sup>17</sup>

### Currency Wars

In his book, Song Hongbin charges that the U.S. Federal Reserve is actually a “private central bank” manipulated by a handful of Western private bankers. Song argues that these global financiers have been the “winners” in a number of historical events, including the two World Wars and the Great Depression. Moreover, Song claims that Japan’s economic recession in the 1990s and the Asian financial crisis in 1997 were the result of “currency wars” initiated by this small group of global financiers.

The author also predicts that China’s “economic aircraft carrier” will not sail smoothly as the country could be the next target of this cabal of global financiers. He warns that the country’s huge foreign exchange reserves could “shrink” sharply in value if the Yuan is forced to revalue rapidly (or from a rapid depreciation of the U.S. dollar). To avoid losses that could be incurred through a “currency war,” Song advises China to convert its international reserves into precious metals such as gold.

Song’s views have subsequently received wide airing in China’s official and unofficial media outlets. In April 2009, China’s national television news channel aired a program devoted to the topic of currency wars. During a panel discussion, Journalist Lu Xiaobo said “the currency of a nation reflects political, economic, as well as military power...the currency war is a war without

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<sup>15</sup> “Jinrong Weiji Shi Yi Ci Hemo” (The Financial Crisis is a Conspiracy), *Liaowang*, October 28, 2008, [http://www.lwdf.cn/oriental/cover\\_story/20081027165357889.htm](http://www.lwdf.cn/oriental/cover_story/20081027165357889.htm).

<sup>16</sup> For background on the rise of economic nationalism in China, see Melissa Murphy, *Decoding Chinese Politics: Intellectual Debates and Why They Matter* (Washington, D.C.: CSIS, 2008).

<sup>17</sup> Wu Zhong, “China’s Yuan in Conspiracy Crossfire,” *Asia Times*, November 6, 2008, [http://www.atimes.com/atimes/China\\_Business/JK06Cb01.html](http://www.atimes.com/atimes/China_Business/JK06Cb01.html).

smoke.”<sup>18</sup> Economist Xiang Songzha criticized the U.S. dollar’s status as the world’s reserve currency, arguing that “in the currency world, the absolute power of one nation will inevitably cause corruption.”<sup>19</sup>

The majority of Chinese intellectuals do not subscribe to such conspiracy theories. However, few leading Chinese economists are content with China’s complicity with the status quo. Indeed a number have been critical of China’s own policies and are calling for change. Writing in the influential magazine *Caijing*, Wang Xiaolu, director of the National Economic Research Institute, opines that “this financial crisis at least taught us some basic economic principles worth keeping in mind. These principles are well grasped even among uneducated people, but our elites, especially we economists, have almost forgotten them.”<sup>20</sup> Wang adds that given China’s “very close relationship with the U.S.” it has “already lent them half of China’s foreign exchange reserves” and “gotten into a spot where we have to keep lending to protect our previous investments. But by handing out more dollars, we tie ourselves to a leaking boat.”<sup>21</sup> Wang advises the government to diversify its reserves, decreasing the amount of U.S. Treasury holdings and increasing those of gold and other strategic material reserves. Echoing this theme, Li Lianzhong, director of the Economy Bureau of the CPC Central Committee Policy Research Office, said that China needs to raise the proportion of the gold reserve in its total international reserves.<sup>22</sup>

In addition to calling for diversification of China’s reserves and reducing reliance on the U.S. dollar, others have pressed the government on internationalization of the renminbi, although scholars remain divided on the mechanics of the process and where it is leading, which will be discussed in more detail below. It is also important to note that the debate is not confined to academic circles. According to a survey conducted by Sina Finance, a popular Web site in China, among 368,701 respondents, 73.2 percent are worried about the safety of China’s huge amount of U.S. dollar reserves; 89.8 percent support using a “super-sovereign reserve currency” to end U.S. dollar hegemony; and 95.3 percent showed their strong dissatisfaction with the U.S. Federal Reserve “overprinting money.”<sup>23</sup> It is against this backdrop that the government has cautiously begun the process of diversifying its reserves, including increasing commodity holdings, gradually

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<sup>18</sup> “CCTV—[Fang Tan] Quan Qiu Huobi Zhanzheng” (Dialogue: Global Currency War), CCTV.com, April, 10, 2009, <http://finance.cctv.com/20090410/106234.shtml>.

<sup>19</sup> Ibid.

<sup>20</sup> “Analysis: How to Allocate China’s Foreign Exchange Reserve,” *Caijing*, March 6, 2009, <http://english.caijing.com.cn/2009-03-06/110114234.html>.

<sup>21</sup> Ibid.

<sup>22</sup> Li Lianzhong, “Renminbi Guoji Hua Yao Yi Huangjin Zuowei Chubei Jichu” (The Internationalization of the Renminbi Should Use Gold as the Reserve Standard), *Wai Hui Tong*, June 26, 2009, <http://www.forex.com.cn/html/c646/2009-06/1144275.htm>.

<sup>23</sup> “Is it Possible to Use a ‘Super-Sovereign Reserve Currency’ to End U.S. Dollar Hegemony?” ongoing, online survey as of July 30, 2009, <http://survey.news.sina.com.cn/voterresult.php?pid=31974>.

internationalizing the renminbi, and becoming more assertive in promoting reform of the international financial system.

## Diversification of Reserves

The problem for Beijing is finding something it can buy with its dollars that will hold value over the long term. One way the government is preparing to get out of the box is by “going out.” In July, Premier Wen reportedly told Chinese officials that Beijing would deploy its foreign reserves to help facilitate the acceleration of overseas investment and acquisitions by Chinese companies, thereby diversifying from investment in short-term financial assets to investment in long-term corporate assets.<sup>24</sup> Commenting on the announcement, the cochairman of the China Development Bank, Chen Yuan, told reporters that “everyone is saying we should go to the western markets to scoop up [underpriced assets]...I think we should not go to America’s Wall Street, but should look more to places with natural and energy resources.”<sup>25</sup>

Beijing is indeed aggressively pursuing diversification into commodities, particularly oil. At the beginning of the year, China signed deals with Russia and Brazil in which it agreed to lend dollar reserves in order to secure other strategic assets. The deal with Moscow involves a \$25-billion loan from the China Development Bank to Russia’s Rosneft and Transneft in return for secured oil deliveries for the next 20 years. The deal with Brazil involves a similar loan of \$10 billion to develop deep-water oil reserves and for Petrobras to supply crude to China’s oil companies over the next 10 years.<sup>26</sup> In August, China signed a deal with Ecuador to secure supplies of oil over the next two years in return for advance payment of \$1 billion.<sup>27</sup>

Beijing has also moved rapidly to stock its strategic petroleum reserves (SPR), spending its dollars and taking advantage of the drop in oil prices at the same time. In February, the National Energy Administration announced that it would build 8 new SPR bases by 2011, bringing China’s total to 12 bases.<sup>28</sup> In August, it was announced that reserves had reached 12 million tons, the equivalent

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<sup>24</sup> For a discussion of China’s “going out” policy, see “Issue in Focus: China’s ‘Going Out’ Investment Policy,” *Freeman Briefing*, May 27, 2008, <http://csis.org/publication/freeman-briefing-may-27-2008>; Jamil Anderlini, “China to Deploy Foreign Reserves,” *Financial Times*, July 21, 2009, [http://www.ft.com/cms/s/0/b576ec86-761e-11de-9e59-00144feabdc0.html?ncklick\\_check=1](http://www.ft.com/cms/s/0/b576ec86-761e-11de-9e59-00144feabdc0.html?ncklick_check=1).

<sup>25</sup> Ibid. Beijing’s negative experience with the Unocal bid and domestic criticism over previous bad investments in the United States (e.g., Blackstone) could also influence how and where Chinese companies “go out.”

<sup>26</sup> Wenran Jiang, “China Makes Strides in Energy ‘Go-out’ Strategy,” *China Brief* 9, issue 15 (July 2009).

<sup>27</sup> Naomi Mapstone, “Ecuador in \$1 Billion Oil Deal with China,” *Financial Times*, August 17, 2009, <http://www.ft.com/cms/s/0/577ac3ca-8b61-11de-9f50-00144feabdc0.html>.

<sup>28</sup> Sun Xiaohua, “China to Bolster Oil Reserves,” *China Daily*, March 2, 2009, [http://www.chinadaily.com.cn/bizchina/2009-03/02/content\\_7524427.htm](http://www.chinadaily.com.cn/bizchina/2009-03/02/content_7524427.htm).

of 30 days of reserves, from its prior 21-day supply. China is aiming to have 100 days of reserves by 2020.<sup>29</sup>

In a further diversification into commodities, Hu Xiaolian, vice governor of the central bank and head of the State Administration of Foreign Exchange announced in April that China had boosted its gold reserves to 1,054 metric tons, up 454 metric tons since 2003, making China the world's fifth-largest holder of gold.<sup>30</sup> It was also reported that the State Reserve Bureau plans to buy 1 million tons of aluminum, 400,000 tons of copper, and 400,000 tons of zinc and lead to be put into reserves in the coming three years. In December 2008, the State Reserve Bureau (SRB) purchased 290,000 tons of aluminum and decided to buy another 300,000 tons in February 2009.<sup>31</sup>

Outside of commodity and other investments, Hu Xiaolian also announced that China was willing to buy as much as \$50 billion in bonds issued by the IMF. The bonds would be denominated in special drawing rights (SDRs), a quasi-currency used by the IMF, whose use as a reserve currency China has been promoting.<sup>32</sup> (See text box on following page.) Meanwhile, when using dollar reserves to buy U.S. bonds, China has begun to recycle the money from the sale of long-term U.S. bonds and park it into short-term U.S. Treasury notes.<sup>33</sup> Alarm bells went off in April, when U.S. Treasury data showed that Beijing owned \$763.5 billion in U.S. securities, down from \$767.9 billion in March, the first cut in its overall holdings since February 2008.<sup>34</sup>

However, China's holdings of U.S. treasuries resumed growth to reach \$801.5 billion in May. This underscores the fact that, despite any diversification of its reserves, in the short to medium term the Chinese government has little recourse but to continue to invest in U.S. treasuries. As neither the euro nor the yen are backed by a deep bond market, the United States remains the only one large enough and liquid enough to handle China's large-scale investments. Besides, any sign of a major Chinese sell-off and drop in the dollar's value would only result in a corresponding decline in Beijing's assets. Luo Ping, director-general of the China Banking Regulatory Commission,

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<sup>29</sup> "China Stocks Up on Oil," CCTV, August 22, 2009, <http://english.cctv.com/program/newshour/20090822/102608.shtml>.

<sup>30</sup> "Should China Increase its Gold Reserves?" *China Daily*, May 11, 2009, [http://www.chinadaily.com.cn/bw/2009-05/11/content\\_7761511.htm](http://www.chinadaily.com.cn/bw/2009-05/11/content_7761511.htm).

<sup>31</sup> "China to Reserve Aluminum, Copper, Zinc, Lead in 3 Years," *China Mining*, April 20, 2009, <http://www.chinamining.org/News/2009-04-20/1240188159d23744.html>.

<sup>32</sup> Andrew Batson, "China Willing to Buy as Much as \$50 Billion in IMF Bonds," *Wall Street Journal*, June 6, 2009, <http://online.wsj.com/article/SB124419697110288633.html>.

<sup>33</sup> Huang Jingyi, "Zhongguo Wai Chu Jinji Taoli Meiyuan Bianzhi Xianjing" (China's Foreign Reserves Escape the Depreciating Dollar's Trap), *Xin Lang Caijing*, May, 26, 2009, <http://finance.sina.com.cn/roll/20090526/07462861101.shtml>.

<sup>34</sup> AFP, "PRC Decision to Reduce US Treasury Holdings Said Showing Concern," June, 17, 2009.

## Special Drawing Rights

### What are Special Drawing Rights?

The special drawing right (SDR) is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies: the U.S. dollar, the euro, the yen, and the pound; SDRs can be exchanged for freely usable currencies. Following a special allocation on September 9, 2009, the amount of SDRs increased from SDR 21.4 billion to SDR 204.1 billion (currently equivalent to about \$317 billion). The determination of the currencies in the SDR basket and their amount is made by the IMF Executive Board every five years. The next review will take place in 2010.

The SDR is neither a currency, nor a claim on the IMF; it is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members; and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions. In addition to its role as a supplementary reserve asset, the SDR serves as the unit of account of the IMF and some other international organizations. (IMF Factsheet, <http://www.imf.org/external/np/exr/facts/sdr.htm>.)

### Limitations as a Reserve Currency

Replacing the U.S. dollar with SDRs as the new global reserve currency remains highly impracticable: creating and managing monetary policy on a global scale through the IMF would be a major challenge yet without a system of global governance SDRs will remain merely the sum of other currencies. Moreover, how will the IMF provide the level of liquidity required of a reserve currency? A reserve currency must be deliverable to central banks and other players who want to acquire it, which the United States does by running persistent trade deficits.

Other things to consider: The financial assets in major banks and financial institutions remain denominated largely in the dollar and euro; at present, SDR-denominated accounts are not available from commercial banks and there is a lack of global banking support for consumers (private individuals and businesses) of the SDR. As a result, there is little support for SDRs in the global financial system, and they are not widely accepted for transaction. In addition, the basket of currencies making up the SDRs has been losing value against secondary currencies such as the RMB and rupee; the SDR is itself another "weak" currency.

expressed Beijing's frustration: "Except for U.S. treasuries, what can you hold?... We know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do."<sup>35</sup>

The fact is that, for the foreseeable future, China's economic growth will depend in large part on exports, and it will rely on the United States as its major trading partner. At least in the short term, China will continue to run a trade surplus and accumulate dollar reserves; it has little choice

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<sup>35</sup> Andreas Lorenz, "Held Hostage by Weak Dollar," *Der Spiegel*, April 1, 2009, <http://www.spiegel.de/international/world/0,1518,616765,00.html>.

but to invest those reserves mainly in U.S. Treasury bonds. According to Li Zhongmin, research fellow at the Chinese Academy of Social Sciences (CASS), “the scale of China’s foreign reserve is too big and the U.S. Treasury bonds market is the only market that China can invest its foreign reserves.”<sup>36</sup> However, by sending “signals” to the United States that China plans to diversify its international reserves, observers believe Beijing is hoping to gain more bargaining power on setting prices when purchasing U.S. Treasury notes.<sup>37</sup> In July, responding to Chinese pressure, the U.S. Treasury expanded the issuance of inflation-protected treasury securities, even though they are an expensive way for the United States to borrow money.<sup>38</sup>

## Internationalization of the Renminbi

While there appears China can do little to decrease its exposure to fluctuations in the dollar in the short to medium term, the government is seeking to reduce its vulnerability over the long term in ways that may impact the status of the renminbi viz the dollar. In particular, it has recently taken steps to internationalize the Chinese currency, including expanding the use of the renminbi in the settlement of cross-border and international trade and concluding a series of high-profile currency swap agreements.

Since 2003, the government has allowed some limited use of the renminbi in cross-border trade being conducted in Yunnan, Guangxi, Heilongjiang, Liaoning, Jilin, Inner Mongolia, and Xinjiang.<sup>39</sup> According to one report, since 2006 over 90 percent of annual border trade in Yunnan has been settled in renminbi.<sup>40</sup> Banks in Hong Kong began offering banking services in renminbi in 2004, including, deposits, currency exchange, remittances, debit and credit cards, and personal checking. The value of renminbi deposits outstanding stood at RMB54.4 billion at the end of June 2009, a 348 percent jump from RMB12.1 billion at the end of 2004.<sup>41</sup>

As China’s currency is already being used in trade and current account transactions in Southeast and Central Asia, as well as in Hong Kong and Macau, in December 2008 the State Council decided to formalize such transactions by launching two pilot schemes to allow selected

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<sup>36</sup> Huang Jingyi, “Zhongguo Wai Chu Jinji Taoli Meiyuan Bianzhi Xianjing” (China’s Foreign Reserves Escape the Depreciating Dollar’s Trap).

<sup>37</sup> “Wang Qishan Ling Jun, Gaodiao Yinjie Huobi Zhanzheng” (Wang QiShan Leading the Fight: Actively Preparing for a Currency War), IFeng.com, March 30, 2009, <http://finance.ifeng.com/news/video/20090330/492962.shtml>.

<sup>38</sup> Rob Copeland and Maya Jackson Randall, “U.S., in Nod to China, to Sell More TIPS,” *Wall Street Journal*, August 6, 2009, <http://online.wsj.com/article/SB124951450326009277.html>.

<sup>39</sup> “China May Allow Yuan Settlement with ASEAN,” *Business Times*, July 1 2009, <http://www.businesstimes.com.sg/sub/storyprintfriendly/0,4582,2339951,00.htm>.

<sup>40</sup> “Survey of Renminbi Circulation in Border Areas,” *Liaowang*, April 16, 2009, [http://www.lwdf.cn/oriental/cover\\_story/20090416101438124.htm](http://www.lwdf.cn/oriental/cover_story/20090416101438124.htm).

<sup>41</sup> “Renminbi business in Hong Kong,” *Half-Yearly Economic Report 2009*, Government of the Hong Kong Special Administrative Region, <http://www.hkeconomy.gov.hk/en/pdf/box-09q2-4-1.pdf>.

companies to settle trade using the renminbi in place of the dollar. One scheme is centered on trade between China's export engines the Pearl River Delta and Yangtze River Delta and Hong Kong and Macau. The other scheme covers trade between Yunnan and Guangxi and the Association of Southeast Asian Nations (ASEAN).<sup>42</sup> By April, it was reported that some 400 Chinese companies had won approval to conduct foreign trade using renminbi.<sup>43</sup> In June, it was also announced that China and Brazil had reached an "initial understanding" to gradually eliminate the dollar in bilateral trade, which is estimated to reach \$40 billion in 2009.<sup>44</sup> A similar agreement to move toward settling bilateral trade in their respective currencies was reached earlier in the month between Beijing and Moscow.<sup>45</sup>

In a major step toward developing an offshore currency market and supporting renminbi internationalization, the State Council has also begun to allow financial institutions registered in Hong Kong to issue renminbi-denominated bonds. According to some commentators, "it is a good opportunity to further internationalize the renminbi at a time when the major currencies of the world are growing weaker and the renminbi is stable and becoming more widely recognized."<sup>46</sup>

## Currency Swaps Agreements

One of the most high-profile steps China has taken recently in this regard is the conclusion of six currency swap agreements with Argentina, Belarus, Hong Kong, Indonesia, Malaysia, and South Korea, respectively. Since the G-20 summit in November 2008, the People's Bank of China (PBOC) has signed bilateral currency swap arrangements totaling RMB650 billion (\$95 billion) including: a framework agreement signed with the Bank of Korea involving RMB180 billion on December 12, 2008; a formal agreement signed with the Hong Kong Monetary Authority involving RMB200 billion on January 20, 2009; a formal agreement signed with the Bank Negara Malaysia involving RMB80 billion on February 8, 2009; a formal agreement signed with the National Bank of the Republic of Belarus involving RMB20 billion on March 11, 2009; a formal agreement signed with the Bank of Indonesia involving RMB100 billion on March 23, 2009; and a

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<sup>42</sup> Ibid.

<sup>43</sup> Lu Jianxin and Jacqueline Wong, "China Launches Yuan Trade Settlement Scheme," Reuters, July 6, 2009, <http://www.reuters.com/articlePrint?articleid=USTRE5651CH20090706>.

<sup>44</sup> "Brazil-China Bilateral Trade in Real and Yuan Instead of US Dollar," Mercopress, June 29, 2009, <http://en.mercopress.com/2009/06/29/brazil-china-bilateral-trade-in-real-and-yuan-instead-of-us-dollar>.

<sup>45</sup> Toni Vorobyova, "Russia, China to Boost Ruble, Yuan Use in Trade," Reuters, June 17, 2009, <http://www.reuters.com/article/companyNewsAndPR/idUSLH72167820090617>.

<sup>46</sup> "Hong Kong Companies to Issue RMB Bonds," *China Daily*, December 16, 2008, [http://www.chinadaily.com.cn/bizchina/2008-12/16/content\\_7311292.htm](http://www.chinadaily.com.cn/bizchina/2008-12/16/content_7311292.htm).

## Currency Swap Agreements

The currency swap agreements recently signed between China and the other emerging markets involve a trading agreement on exchanging a stipulated amount of renminbi (RMB) principal and a stipulated amount of foreign currency principal within a prescribed period of time. Both parties shall, when the agreement becomes effective, do the exchange at the stipulated exchange rate on the date specified and, when the agreement expires, make a reverse exchange at the same exchange rate and the same amount of principal on the date specified.

Taking the recent agreement between China and Argentina as an example: The PBOC agreement with the Central Bank of Argentina involves a RMB70-billion transaction. The agreement set a stipulated exchange rate between the renminbi and Argentine peso. China will exchange renminbi with Argentina and receive the peso according to the stipulated exchange rate at the beginning date of the agreement. Based on the current situation, the agreement will allow the two central banks to inject the swapped amount in a foreign currency into its domestic financial system, which will be borrowed by domestic commercial entities to pay for imports from the other country. In this way, China and Argentina can bypass the dollar as a medium of exchange when conducting bilateral trade.

framework agreement signed with the Central Bank of Argentina involving RMB70 billion.<sup>47</sup> (See text box above.)

In the wake of the financial crisis a number of emerging markets, such as Argentina, Indonesia, and South Korea, are facing short-term liquidity problems, that is, their central banks do not have enough U.S. dollar reserves to cover demand by traders. China, on the other hand, has no such liquidity problems. Conducting bilateral trade while bypassing the U.S. dollar is, therefore, an attractive option. According to President Hu Jintao, one of the main purposes of China initiating its currency swap agreements is to “encourage regional financial cooperation and enhance China’s capability of providing liquidity assistance to others.”<sup>48</sup>

Another economic rationale for concluding the currency swaps and trade-financing agreements is that it will help to secure China’s future supplies of much-needed natural resources—as well as tin, natural gas, and timber.<sup>49</sup> Argentina is a source for lead, zinc, tin, copper, iron ore, and other

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<sup>47</sup> People’s Bank of China, “Strengthen Regional Financial Cooperation and Actively Conduct Currency Swap,” March, 31, 2009, <http://www.pbc.gov.cn/english/detail.asp?col=6400&ID=1299&keyword=currencyswap>.

<sup>48</sup> Ibid.

<sup>49</sup> “Indonesia Natural Resources,” IndexMundi, December 18, 2008, [http://www.indexmundi.com/indonesia/natural\\_resources.html](http://www.indexmundi.com/indonesia/natural_resources.html); “Malaysia Natural Resources,” IndexMundi, December 18, 2008, [http://www.indexmundi.com/malaysia/natural\\_resources.html](http://www.indexmundi.com/malaysia/natural_resources.html).

## Has the Panda Snared the Bear?

China has spent much of the past decade engaged in a worldwide diplomatic “charm offensive,” deploying its economic might to secure much-needed natural resources and expanding its “soft power” influence as a result. This latest move into the complex politics of Eastern Europe is qualitatively different; China’s economic and diplomatic rationale for doing so is far from clear.

In the great game of geopolitics, news that China was extending its reach into what Russia regards as its “sphere of privileged interest” in the former Soviet Republics has been largely interpreted by Western commentators as a move against Moscow on the global chessboard. To the contrary, many Chinese scholars view the move as aimed against the West, particularly the European Union, which unveiled its “Eastern Partnership” project in May. The project offers a range of economic incentives to former Soviet Republics including Belarus and Moldova, with the unstated geopolitical goal of reducing Russia’s influence in the region.

According to Mei Xinyu, analyst at the Chinese Academy of International Trade and Economic Cooperation, Beijing is worried that an economic crisis in Belarus will further destabilize the region, particularly relations among Belarus, Russia, and the European Union. In providing Belarus with economic aid, China reportedly wants to avoid further interference in the region from Western nations. (“Economic and Political Considerations of Currency Swaps,” *Oriental Morning Post*, March 13, 2009, <http://finance.sina.com.cn/review/20090313/07115970939.shtml>.)

In an interview, a CASS scholar said that Moldova had been encouraged to pursue European integration, but “by providing a huge loan to Moldova, Beijing is showing support for Russia to keep the EU out of the Caucasus.” (Interview with CASS scholar, August 10, 2009.)

Meanwhile, Chinese newspaper *Huanqui Shibao* reported that “Chinese scholars have hit out at an article in the *Financial Times* they perceive as sowing discord between China and Russia with issues concerning loans to Moldova.” (“Media reports ‘fomenting’ China-Russia discord criticized,” *Huanqui Shibao*, July 30, 2009, <http://world.globaltimes.cn/europe/2009-07/452615.html>.)

natural resources.<sup>50</sup> Although South Korea does not supply China with natural resources, it is one country with which Beijing runs a trade deficit: China imports large amounts of raw materials and intermediate goods essential for supporting its export sector. Aiding South Korea to overcome its short-term liquidity problem is therefore in China’s best interests.

When it comes to Belarus, however, the economic rationale is less clear and China’s larger geopolitical motivations come into view. The amount of swapped currency between China and Belarus is RMB20 billion, which is equal to 340.3 percent of the total amount of the annual bilateral trade between the two countries. As a result of the financial crisis, Belarus is on the verge of bankruptcy; with a population of only 10 million its public debt has reached \$4.31 billion. In

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<sup>50</sup> “Argentina Natural Resources,” IndexMundi, December 18, 2008, [http://www.indexmundi.com/argentina/natural\\_resources.html](http://www.indexmundi.com/argentina/natural_resources.html).

July, China agreed to loan Moldova, another cash-strapped former Soviet republic, \$1 billion.<sup>51</sup> Beijing reportedly agreed to “guarantee financing for all projects considered necessary and justified by the Moldovan side,” essentially underwriting the entire economy of a tiny nation that has a budget of only \$1.5 billion.<sup>52</sup> This comes on the heels of an announcement by Chinese president Hu Jintao that Beijing will provide a \$10-billion credit loan to member states of the Shanghai Cooperation Organization to shore up their economies amid the global financial crisis.<sup>53</sup> (See text box on previous page.)

China first used currency swap arrangements to further both its economic interests and geopolitical agenda in 2001, when it signed the first of four swap agreements with ASEAN nations Indonesia, Malaysia, Thailand, and South Korea under the Chiang Mai Initiative. (See text box on following page.) According to the PBOC, the currency swap with Bangkok was a “reflection of China’s commitment to actively participate in the regional cooperation, to help maintain financial stability of Thailand and of this region, as well as to promote the traditional friendship with Thailand.”<sup>54</sup>

While in China the currency swaps are viewed as a good way to diversify its huge dollar reserves,<sup>55</sup> for some foreign observers, the swaps are further evidence that “the Chinese are on an unmistakable path toward challenging the dollar”<sup>56</sup>—conflating steps toward internationalization of the currency with achieving reserve, then global reserve, currency status.

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<sup>51</sup> Louis O’Neill, “China Gains a Foothold in Russia’s Backyard,” *Financial Times*, July 28, 2009, <http://www.ft.com/cms/s/0/b3d9079e>.

<sup>52</sup> M.K. Bhadrakumar, “China Dips its Toe in the Black Sea,” *Asia Times*, August 1, 2009, <http://www.atimes.com/atimes/China/KH01Ad01.html>.

<sup>53</sup> China to provide 10-billion-dollar loan to SCO members,” Xinhua, June 16, 2009, [http://news.xinhuanet.com/english/2009-06/16/content\\_11552439.htm](http://news.xinhuanet.com/english/2009-06/16/content_11552439.htm).

<sup>54</sup> People’s Bank of China, “The Central Banks of China and Thailand Signed Currency Swap Agreement,” December, 6, 2001, <http://test/pbc.gov.cn/publish/english/955/1960/19601/19601.html>.

<sup>55</sup> Huang Jingyi, “Zhongguo Wai Chu Jinji Taoli Meiyuan Bianzhi Xianjing” (China’s Foreign Reserves Escape the Depreciating Dollar’s Trap).

<sup>56</sup> Steve Levine, “China’s Yuan: The Next Reserve Currency?” *Business Week*, May 26, 2009, [http://www.businessweek.com/globalbiz/content/may2009/gb20090522\\_665312.htm?chan=top+news\\_top+news+index+-+temp\\_top+story](http://www.businessweek.com/globalbiz/content/may2009/gb20090522_665312.htm?chan=top+news_top+news+index+-+temp_top+story).

## The Chiang Mai Initiative

Following the 1997 Asian Financial Crisis, countries were eager to strengthen regional financial cooperation in order to prevent future financial crises and to maintain regional financial stability. According to the PBOC, it was at China's suggestion that, in 1998, the 10 ASEAN countries and China, Japan, and Korea (the so-called 10+3) set up a financial cooperation mechanism known as the Chiang Mai Initiative, which aims to strengthen policy dialogue and establish a credit facility.

The Chiang Mai Initiative was adopted at the 10+3 financial ministers meeting in May 2000 and was the first substantive measure in strengthening financial cooperation. Its main intent was to enlarge the size of the original ASEAN countries' currency swap facility, while setting up a bilateral currency swap network among the 10+3 nations, so as to help member countries overcome short-term balance of payments difficulties and stabilize financial markets.

As Brendan Kelly, in a Pacific Forum CSIS article points out, however, the internationalization of a currency is a multi-stepped and prolonged process that involves: first, becoming a settlement currency; second, a vehicle currency for third-party trade or foreign exchange transactions; third, a unit of account in commodity pricing; and finally acting as a reserve currency.<sup>57</sup> As the renminbi is still not fully convertible—and with no clear timetable for convertibility in place—the impact of China's recent moves will remain limited. Despite the hyperbole, from an economic perspective, internationalization of the renminbi remains at an initial stage and achieving reserve currency status is still some years away.<sup>58</sup>

From a geopolitical perspective, however, the impact of reserve diversification and renminbi internationalization might be more immediate. While ignoring recent calls emanating from Moscow to directly challenge the U.S. dollar, Beijing has begun to assert its preferences regarding reform of the global economic and financial architecture. China's economic weight, financial resources, and growing geopolitical influence put teeth into the statement issued at the end of the BRIC summit in June that called for a "greater voice and representation of emerging and developing economies in international financial institutions."<sup>59</sup> Given the long-term geopolitical as well as economic implications of renminbi internationalization, therefore, it would be prudent to examine where the Chinese government's policy is headed and how it is likely to impact the dollar.

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<sup>57</sup> Brendan Kelly, "China's Challenge to the International Monetary System: Incremental Steps and Long-Term Prospects for Internationalization of the Renminbi," *Issue and Insights* 9, no. 11 (June 2009), [http://csis.org/files/publication/issuesinsights\\_v09n11.pdf](http://csis.org/files/publication/issuesinsights_v09n11.pdf).

<sup>58</sup> Ibid.

<sup>59</sup> "BRIC Summit Calls for Reform of Financial Institutions, New World Order," Xinhua, June 17, 2009, [http://www.china.org.cn/international/2009-06/17/content\\_17964448.htm](http://www.china.org.cn/international/2009-06/17/content_17964448.htm).

## Looking Ahead

The opaque world of Chinese politics makes deciphering policy choices all the more difficult. Nevertheless, from close monitoring of Chinese media and interviews with Chinese sources, it is possible to offer some initial observations. First, rather than following any predetermined “roadmap,” the Chinese leadership appears to be taking former leader Deng Xiaoping’s advice to “cross the river by feeling the stones” in pursuing internationalization of the renminbi; continued, cautious, and gradual implementation of new policies through a series of pilot experiments can be expected. Second, the content, scope, and pace of renminbi internationalization remain very much up for debate. According to an article in the party paper *Renmin Ribao*, China

...must realize that the internationalization of the renminbi cannot always go smoothly and be accomplished right away...the renminbi’s trip outside the country is still at an early stage.... One misstep from a lack of caution could bring irrevocable losses.... How to prevent financial risks and ensure the stability of China’s financial system will become issues that cannot be ignored.<sup>60</sup>

According to Chinese sources, there is apparent consensus among the top leadership regarding the initial steps that have been taken toward renminbi internationalization. President Hu Jintao told the G-20 summit in November 2008 that China would “enhance its capacity to provide liquidity assistance, improve regional financial infrastructure and make the best use of regional liquidity assistance mechanisms.”<sup>61</sup> The PBOC launched the series of six currency swaps soon after the summit concluded. Although China’s central bank is the “nominal” player in the currency swap agreements, according to Chinese media reports, Vice Premier Wang Qishan initiated the current policy.<sup>62</sup> As one Chinese economist pointed out, unlike the U.S. Federal Reserve, the People’s Bank of China is not a truly independent institution; Zhou Xiaochuan remains under the leadership’s supervision and is only a policy executor. “[I]n Western countries, reforms in the financial market are usually led by the central bank. Therefore, the Zhongnanhai leadership circle decided to use the PBOC to announce the reform.”<sup>63</sup>

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<sup>60</sup> “Cross-Border Yuan Trade First Step for Renminbi Internationalization,” *Renmin Ribao*, July 3, 2009, <http://english.cri.cn/6909/2009/07/07/2041s499305.htm>.

<sup>61</sup> People’s Bank of China, “Jiaqiang Quyu Jinrong Hezuo Jiji Kaizhan Huobi Huhuan” (Strengthen Regional Financial Cooperation, Proactively Open Currency Exchange), March, 31, 2009, <http://www.pbc.gov.cn/detail.asp?col=100&ID=3156&keyword=%BB%F5%B1%D2%BB%A5%BB%BB>.

<sup>62</sup> “Wang Qishan Ling Jun, Gaodiao Yinjie Huobi Zhanzheng” (Wang QiShan Leading the Fight: Actively Preparing for a Currency War), IFeng.com, March 30, 2009, <http://finance.ifeng.com/news/video/20090330/492962.shtml>. In August, the *South China Morning Post* reported that Wang Qishan was to head a new task force that would come up with proposals for internationalization of the renminbi; see “Plan Sees Yuan as World Currency,” *South China Morning Post*, August 31, 2009.

<sup>63</sup> Telephone interview with leading Chinese university economist, June, 16, 2009.

However, within Chinese intellectual circles there is a divergence of views on renminbi internationalization, especially whether it can be realized in the foreseeable future and the prospects for making the renminbi a reserve currency. As a number of Chinese intellectuals also serve as informal government advisers on policy issues, their views are worth examining.

A number of Beijing-based intellectuals believe the government should actively pursue renminbi internationalization with the eventual goal of achieving reserve currency status. This view is popular with the Chinese public, particularly its vocal netizens, and has as much to do with nationalism as economics.<sup>64</sup> Famous CASS economist Wu Jinglian has backed PBOC governor Zhou Xiaochuan's call to reform the world's currency regime. Wu believes China "should try to increase the influence of renminbi," noting that it has "already taken some actions, such as signing currency swap agreements with other countries as well as using RMB as the settlement currency in international trade with some other countries."<sup>65</sup> Cao Honghui, a fellow at CASS, notes that "China's recent efforts could allow neighboring countries to bypass the U.S. dollar as the settlement currency and set a milestone for the RMB to become a reserve currency."<sup>66</sup> Ding Zhijie, from the University of International Business and Economics, believes that "the currency swap agreements are an important step towards RMB internationalization" and will help the "RMB to become one of the major currencies in the world."<sup>67</sup>

Well-known CASS economist Yu Yongding argues that "the internationalization of RMB is inevitable" and believes China has "a lot to do, such as increasing the amount of RMB in international trade as a settlement currency and providing RMB denominated loans to other countries."<sup>68</sup> According to Beijing University's Zhang Weiyong, today's China resembles the United States 100 years ago and "as long as China sticks to the reform towards market economy,

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<sup>64</sup> China's netizens or "Internet citizens" are a group of highly motivated, vocal Internet users—predominantly young, male, educated, and fiercely nationalist.

<sup>65</sup> Hong Qihua and Liu Dan, "Wu Jinglian Li Ting Zhou Xiaochuan: Xu Dui Meiyuan Faxing Jizhi Shang Tao" (Wu Jinglian Bolsters Zhou Xiaochuan: It's Time to Adopt a Supervision Mechanism on the Issuance of the US Dollar), SOHU.com, March 30, 2009, <http://business.sohu.com/20090330/n263080295.shtml>.

<sup>66</sup> Wang Yu et al., "Xinwen Fenxi; Toushi Renminbi Guoji Hua Lujing Tu" (News Analysis: Seeing through the Course of the Internationalization of the Renminbi), Xinhua, April, 8, 2009, [http://news.xinhuanet.com/fortune/2009-04/08/content\\_11152274.htm](http://news.xinhuanet.com/fortune/2009-04/08/content_11152274.htm).

<sup>67</sup> Gao Chen, "Pin Qian Huobi Huhuan Xieyi Renminbi Guoji Hua Maichu Guanjian Yi Bu" (Repeated Signings of the Currency Exchange Agreement, Internationalization of the Renminbi and Important Step Forward), Xinhua, April, 2, 2009, [http://news.xinhuanet.com/fortune/2009-04/02/content\\_11117072.htm](http://news.xinhuanet.com/fortune/2009-04/02/content_11117072.htm).

<sup>68</sup> "Renminbi Guoji Hua Zhu Tui Ziben Shichang Jiankang Wending Fazhan" (Internationalization of the Renminbi Helps Jumpstart Capitalist Markets' Stability and Development), *Zhongguo Jingji Wang*, February, 14, 2009, [http://finance.ce.cn/stock/gsgdbd/200902/14/t20090214\\_14216348.shtml](http://finance.ce.cn/stock/gsgdbd/200902/14/t20090214_14216348.shtml).

China will become the largest economy in the world in the next 20 to 30 years and RMB will become a major currency.”<sup>69</sup>

Outside Beijing policy circles, however, views are less sanguine. A number of scholars question whether it is in China’s best interests to internationalize the renminbi at this juncture. Others question not only the pace of reform but also the efficacy of using financial instruments such as currency swaps to pursue internationalization. Some scholars also ask whether China is ready to fundamentally alter its trade and economic policies in order to achieve reserve currency status, particularly its willingness to run a trade deficit.

Shanghai economist Ya Fu argues that it is impossible for the Chinese government to pursue renminbi internationalization without opening China’s capital market and allowing the renminbi to become a fully convertible currency under the capital account. Furthermore, he opines that “if currency swap agreements allow the Chinese government to push the process of RMB internationalization, then the currencies of Hong Kong, Argentina, Belarus, Indonesia, and Malaysia are all internationalized through this process. This kind of logic is ridiculous.”<sup>70</sup>

According to a recent article by Tian Li of Harbin University and Sun Lijian of Fudan University, in the process of internationalization, the renminbi will have to undergo three stages: becoming a settlement currency; an investment currency; and finally a reserve currency. Tian and Sun believe that of the three stages, the second—becoming an investment currency—is of most importance. However, even if the renminbi becomes a settlement currency in the foreseeable future, they hold that it will be impossible for the renminbi to become an investment currency without China first opening its capital market.<sup>71</sup>

Hua Min, director of the Institute of World Economy at Fudan University, warns that it is very risky for China to push renminbi internationalization at this juncture. According to Hua, in order to internationalize, the renminbi will first need to become a major settlement currency in international trade. However, the renminbi is still currently pegged to the U.S. dollar, “that is, the RMB is an infiltrated currency.”<sup>72</sup> Hua holds that “China has no other choice but to build up a

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<sup>69</sup> Zhang Weijin, “Gang Bi Zai 20 Nian Nei Huo Jiang Xiaoshi” (The Currency of Hong Kong Will Disappear within 20 Years or the Near Future), *World Economist*, May, 25, 2009, <http://economist.icxo.com/htmlnews/2009/05/25/1383990.htm>.

<sup>70</sup> “Huobi Huhuan yu Renminbi Guoji Hua neng Hua Deng Hao Ma?” (Can Currency Exchange and the Internationalization of the Renminbi Be Equal to Each Other?), *Shanghai Zheng Quan Bao*, April, 10, 2009, <http://forex.jrj.com.cn/2009/04/1005144052038.shtml#>.

<sup>71</sup> Tian Li, “Zhuan Jia: Huobi Huhuan ‘Huan’ Bu Chu Renminbi Guojihua” (Expert: Currency Exchange Cannot ‘Exchange to’ Internationalization of the Renminbi), *Zhongguo Xinwen Wang*, <http://www.chinanews.com.cn/cj/zbjr/news/2009/02-06/1552061.shtml>.

<sup>72</sup> “Renminbi as an International Trade Settlement Measure Can Only Go So Far,” *Shanghai Zheng Quan Bao*, May, 6, 2009, [http://www.sinotf.com/GB/International\\_Settlement/1201/2009-5-11/5OMDAwMDAyNDc5OA.html](http://www.sinotf.com/GB/International_Settlement/1201/2009-5-11/5OMDAwMDAyNDc5OA.html).

huge dollar reserve, otherwise under the fixed exchange rate regime, China would easily suffer from a foreign exchange crisis.” Moreover, Hua argues that China has no reason to open its capital account: “due to the lack of domestic demand, China is mainly relying on the export sector to boost its economic growth rate”; therefore, the Chinese economy “is less stable than those who mainly rely on their domestic demand to drive the economy. The high transaction cost of RMB and low macroeconomic stability of China means that it is very difficult for the RMB to even become a major settlement currency.”<sup>73</sup> Finally, Hua concludes that it will be very difficult to push renminbi internationalization without fundamentally changing China’s economic structure. Hua warns: “if we want to let the RMB become a major settlement currency soon, we need to push the process of economic restructuring quickly, which might lead to a serious imbalance between China’s economic structure and endowment limitation. This will finally cause great losses in economic well-being.”<sup>74</sup>

Chai Qingshan of the China Society of International Finance also points out the risks to economic stability, noting that internationalization would “weaken the state’s ability to regulate and control economic targets including commodity prices, GDP growth rate, and others.”<sup>75</sup> Moreover, he argues that the responsibility of supplying the renminbi externally would worsen China’s balance of trade payments, and the country could face the so-called Triffin dilemma.<sup>76</sup> Chai warns it will “destroy the stability of China’s economy, making the financial market and macro-economy more susceptible to fluctuation and even turbulence.”<sup>77</sup>

Another Shanghai economist believes that lessons should be drawn from the internationalization of the Japanese yen: The yen became a major settlement currency a decade ago, however, Japan has failed to push internationalization because its capital market is “too naïve” compared to the offshore financial markets in London and New York.<sup>78</sup> This economist points out that Japan’s capital market uses an indirect financing method based on the civil law system—that is, using banks as the intermediary to connect borrowers and lenders, setting strict regulations, and closely supervising market transactions. This is opposed to the direct financing method used in the United States and Britain, which is based on the common law system in which borrowers and

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<sup>73</sup> Ibid.

<sup>74</sup> Ibid.

<sup>75</sup> “Caution Needed about Internationalization of the Renminbi,” *Liaowang*, April 9, 2009.

<sup>76</sup> Ibid. The Triffin Dilemma: the use of a national currency as global reserve currency leads to tension between a country’s national monetary policy and global monetary policy. Fundamental imbalances in the balance of payments result, specifically in the current account. In the case of the United States, for example, to maintain all desired goals, dollars must overall flow out of the United States but also flow into the United States, which cannot both happen at once.

<sup>77</sup> Ibid.

<sup>78</sup> Telephone interview with Chinese economist on June 22, 2009.

lenders settle their deals individually without interference from a third-party commercial bank.<sup>79</sup> As a result, the mobility of the yen is low, and yen-based financial assets are not popular among investors. “Failing to become an investment currency leads to the failure to become a reserve currency.”<sup>80</sup> As China uses the same civil law–based system as Japan, this economist suggests that “even if China gradually opens its capital market, it can only adopt the same financing method as Japan.” And, as the “process of learning from Japan alone might take more than one decade,” he believes that “internationalization of the RMB is actually impossible.”<sup>81</sup>

## Impact on the Dollar: Perception versus Reality

Perception is reality in volatile currency markets: the dollar dipped to new lows against other currencies when it was reported that China had asked for discussion of a new global reserve currency to be on the agenda of the G-8 summit held in July 2009. Such knee-jerk reactions underscore the need to separate rhetoric from reality on this issue. As noted above, Beijing is undoubtedly readjusting its investment strategy in order to diversify its immense dollar reserves. However, the fact remains that the United States is the number one destination for Chinese exports and, as transactions are still denominated in dollars, the country will continue to build up its dollar reserves. Given its vast holdings and limited investment options, Beijing has little choice but to continue to support the U.S. dollar. Even China’s recent headline-grabbing series of currency swap agreements account for less than 5 percent of its U.S. dollar reserves. Given the risk in signing such agreements—Argentina, Indonesia, and South Korea have all suffered banking crises and government defaults in the past decade—the Chinese government is unlikely to invest too large an amount in these investment vehicles in the future. Meanwhile, the advanced economies will continue to look to the United States—whose currency has mobility and free convertibility—rather than to China when conducting currency swaps.

Moreover, three distinct concepts should not be confused when analyzing China’s moves: currency internationalization; achieving reserve currency status; and being the dominant global reserve currency. While China has begun a gradual process of internationalization, that in itself is a protracted three-stage process, which will require the renminbi to become a settlement currency, then an investment currency, before finally becoming a reserve currency. In the short to medium term, therefore, there will be limited economic impact on the U.S. dollar.

The longer-term impact remains to be seen; all indications are that there is little consensus within Chinese policy circles on the content, scope, and pace of future renminbi internationalization. At a minimum, Beijing will have to consider the following:

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<sup>79</sup> In effect, there is no freedom of contract in a civil law system, that is: the freedom of individuals to agree among themselves the terms of their own contracts, without government interference.

<sup>80</sup> Telephone interview with Chinese economist on June 22, 2009.

<sup>81</sup> *Ibid.*

- Opening the capital market, allowing full renminbi convertibility, and moving to a floating exchange rate regime: A reserve currency held by the central bank of every country needs to be fully convertible. The renminbi remains pegged to the U.S. dollar and not freely convertible for transactions under the capital account. As a financial asset, the quality of the renminbi is inferior because it has no “mobility” and it remains unqualified to be a reserve currency.
- After the capital market is opened, reforming the civil law system in financial market regulation: using direct financing rather than indirect financing methods.
- Reforming China’s economic structure: transforming from an export-driven economy to an economy that relies mainly on domestic consumption. It will not be possible for China to open its capital market, eliminate the peg to the U.S. dollar, and let the currency be freely convertible for transactions as long as it remains heavily dependent on its export sector for economic growth. In order for the export sector to remain competitive, China has to continue pegging the currency to the dollar (in this way undervaluing the renminbi). Moreover, as a reserve currency, China would have to be prepared to face a fundamental change in its balance of trade payments in order to supply the renminbi externally.
- Further reform of China’s banking and financial system: An opening of China’s financial markets will expose its banking and financial institutions to more foreign competition, as well as require further reform of its regulatory and governance system to bring it up to accepted international standards.

Although in the short to medium term, the economic impact of renminbi internationalization on the U.S. dollar will be limited and its long-term impact remains to be seen, the geopolitical impact may be felt more immediately. Beijing has put the world on notice that it is going to use its economic weight, financial resources, and growing geopolitical influence to ensure that China and other BRIC economies have a larger say in designing and operating any future international financial and economic system.

In the meantime, the benefits to the United States of its status as issuer of the de facto global reserve currency are immense. While preserving this enviable status in perpetuity is impossible, exerting efforts to prolong its status for as long as possible is nevertheless in the best interests of the United States.

## About the Authors

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