

## REFORM OF THE INTERNATIONAL MONETARY SYSTEM BASED ON SPECIAL DRAWING RIGHTS AND ITS IMPLICATIONS FOR ASIA

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*Abstract.* In the midst of the current global economic crisis, China's central bank governor came out with a proposal to reform the international monetary system based on special drawing rights, contrary to the general expectation of the international community. Although many believe the announcement was politically motivated to address the dollar problem, the reform idea may have important bearings upon the future evolution of the economic integration of Asia. This paper reviews the implications of the reform proposal for the Asian region.

### 1. CURRENT ECONOMIC CRISIS AND SPECIAL DRAWING RIGHTS

Since its creation in 1969 and the subsequent thorough discussions on international monetary reform by the Committee of Twenty (C-20) between 1972 and 1974, special drawing rights (SDR) have attracted relatively limited attention in the international finance community apart from occasional abortive attempts for its general allocation. As a result, so far a cumulative total of SDR21.4bn (equivalent to approximately US\$33bn), which occupied only 0.47% of the global total reserve at the end of 2008, has been allocated to members (IMF, 2009d). In addition to the adoption of a floating exchange rate and the increasing importance of private capital flows, this was because sufficient global liquidity (foreign exchange reserves) has been provided by continuing US balance of payments deficits, especially after the East Asian currency crisis in 1997–1998.

As the current financial crisis has spread to more emerging economies, through several channels, including the fall of exports, (IMF, 2009a) the SDR has become a matter of great interest to the international community. As a matter of fact, the liquidity shortage, at one stage, became a major concern even among some Asian countries, including Korea and Indonesia, although Asian countries as a whole have been more robust to the financial crisis than emerging countries in other regions, in terms of several macro and financial indicators (IMF, 2009b). Indeed, the IMF feared in an earlier paper that 'continued weak demand and tighter financial sectors in Asia could lead to a surge in corporate distress that could feed back into Asian banks' (IMF, 2009c, pp. x). Against this backdrop, an SDR allocation of \$250bn was requested of the IMF, as part of a US\$1.1tn plan agreed at the G20 summit in London in April 2009.

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Another striking development was China's reform proposal, announced before the G20 summit in London, to create an international reserve currency that is disconnected from individual nations and to broaden the scope of using SDR.

## 2. CHARACTERISTICS AND GENERAL ALLOCATION OF SPECIAL DRAWING RIGHTS

The SDR is an interest-bearing international reserve asset created by the IMF in 1969 to supplement other reserve assets of member countries. Subsequently, in 1978, the objective of making the SDR the principal reserve asset was added to Article VIII. After an allocation, members can hold their SDR as part of their reserves or may choose to sell part or all of their SDR to obtain freely usable currencies either through transactions by agreements or through the designation mechanism. It had been argued by many economists that the Breton Woods par value system had an inherent flaw, called the Triffin Dilemma, where using a national currency as a reserve asset results in either a dollar shortage or a dollar crisis. In particular, with the declining supply of the gold, it was feared that 'growing inadequacy of world reserves would be most likely to lead to a new cycle of international deflation, devaluation and restrictions, as it did after 1929' (Triffin, 1961, pp. 70).

On 28 August 2009, a general allocation of SDR, equivalent to US\$250bn, was approved by the Board of Governors.<sup>1</sup> The allocation, which is approximately 74% of its quota, is to strengthen the global financial safety net, by providing significant unconditional financial resources. The equivalent of nearly US\$100bn of the new allocation will go to emerging markets and developing countries, of which low-income countries will receive over US\$18bn.<sup>2</sup>

The Board paper estimated the long-term global need for reserves, using standard metrics of reserve coverage (imports, short-term external debt and broad money), for emerging and developing countries excluding China and fuel exporters, at US\$400–900bn over the next 5 years and at US\$1.3–2.0tn over the next 10 years (IMF, 2009d). The paper mentions several sources to meet the long-term global need for reserves in the above projections, including net private capital flows, self-insurance through current account surpluses or markets borrowing and official support, such as bilateral swaps and the Flexible Credit Line.

Therefore, it is implicitly assumed that the SDR100bn to be allocated to emerging and developing countries is not meant to fill the gap between demand for and supply of reserve assets, and that national currencies will have a continuing role to play to increase liquidity in the interim. From Table 1, it is evident that between 2001 and 2007, total world reserves rose from SDR1741bn to SDR4110bn, an increase of SDR2369bn or US\$3744bn, with SDR = US\$1.576. Much of the increase in total reserves was concentrated in

<sup>1</sup> An additional allocation of US\$33bn followed on 9 September, to enable all new members to participate in the SDR system, as the amendment of the Articles became effective after 10 years.

<sup>2</sup> A number of proposals for selective allocations of SDR, including proposals of a general allocation, combined with agreements by industrial countries, on a voluntary onlend of their allocated SDR to the IMF for the use of developing countries, have been made in the past. Japan's then Finance Minister Hashimoto proposed such a scheme in 1991 and the author drafted the Japanese proposal.

*Table 1. Evolution of total reserve, US current account and imports (US\$bn)*

Item/Year		1996	2001	96 ⇒ 01	2007	01 ⇒ 07
Total reserve	All countries (BnSDR)	1694	2188	+708	6 495	+3744
		(1178)	(1741)	(+563)	(4 110)	(+2369)
	Developing countries (BnSDR)	861	1281	+528	4 919	+3309
		(599)	(1019)	(+420)	(3 113)	(+2094)
Cumulative current account	China			+123		+1259
	US (annual average)			△1460		△3858
	China			(△290)		(△643)
Imports CIF	All countries	5299	6351		14 123	
	Developing countries	1897	2174		5 846	
Total reserve/ imports ratio	All countries	0.32	0.34		0.46	
	Developing countries	0.45	0.59		0.84	

As total reserves were expressed in special drawing rights (SDR), figures are converted into US dollars. Difference in total reserves is calculated by multiplying the change in SDR value with the SDR/dollar rate at year end. CIF, Cost, Insurance and Freight.

Source: IMF, 2008.

developing countries, amounting to US\$3309bn, of which China held 28%. Growth in total reserves exceeded the expansion of imports in the 6-year period, as the total reserve/import ratio edged up. During the same period, the cumulative US current account deficits added up to US\$3858bn, roughly corresponding to the increase in total reserves. Therefore, it can be observed that the US current account deficits, annually US\$643bn on average between 2001 and 2007 (4.5–6.6% of GDP), have been a major source of reserve liquidity for many developing countries that have tried to increase reserve buffers as an insurance policy in the aftermath of currency crises in 1997–1997 and 2001–2002. This global imbalance has also enabled many Asian countries to enjoy export-led growth strategies. This pattern was different from the period between 1996 and 2001, when the annual average US current account deficit was a more modest US\$290bn (2.8–3.7% of GDP).

To understand the implications of China's proposal centred on SDR, it is necessary to look back briefly at the evolution of the SDR. The SDR was initially defined as equivalent to 0.888671 grams of fine gold, which was equal to US\$1. The interest rate on the SDR was fixed at the relatively low level of 1.5%, due to its character as paper gold. After the collapse of the par value system, the SDR was redefined in 1974 as a basket of currencies of 16 members. The interest rate on SDR was defined as a weighted average of interest rates on short-term market instruments in France, Germany, Japan, the USA and the UK. The 16-currency SDR basket provided a poor unit of account because it included some currencies that were not widely traded. As a result, in 1981 the valuation of the SDR was simplified to the same 5-currency basket on which the SDR interest rate was based, whereas the interest rate itself was raised to 100% of the market rate. In the revision of the SDR basket on 1 January 2001, the IMF formalized the requirement that a currency selected for inclusion in the basket be

‘freely usable’, in accordance with the criteria specified in Article XXX(f), meaning a currency widely used to make payments for international transactions and is widely traded in the principal foreign exchange markets. The most recent review took place in November 2005, effective 1 January 1 2006 (initial new weight: euro 34%, Japanese yen 11%, pound sterling 11%, US dollar 44%). The next 5-year review by the Executive Board will take place in late 2010.

### 3. CHINA’S PROPOSAL

#### 3.1. *Outline of the proposal*

In March 2009, the Governor of the People’s Bank of China, Mr Zhou Xiaochuan, proposed a new reserve currency system centred on strengthened SDR (Zhou, 2009).

His paper first recognizes ‘the outbreak of the crisis and its spillover to the entire world reflect the inherent vulnerabilities and system risk in the existing international monetary system’. It then mentions the policy dilemma of the key currency country and the ‘Triffin Dilemma’ of using a domestic currency as international currency. Second, it proposes to create an international reserve currency that is disconnected from individual nations, referring to ‘bancor’ proposed by Keynes, back in the 1940s, and the creation of SDR in 1969. The paper furthermore states that ‘when a country’s currency is no longer used as the yardstick for global trade and as the benchmark for other currencies, the exchange rate policy of the country would be far more effective in adjusting economic balances. And this will significantly reduce the risks of a future crisis and enhance crisis management capacity’. Third, by emphasizing the need to be guided by a grand vision, it calls for a general increase in SDR allocation, as well as a broadening of the scope of using SDR, including promotion of the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping. The proposal advocates that the basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies and that the allocation of the SDR can be shifted to a system backed by real assets. Fourth, it makes a proposal for entrusting part of the member countries’ reserves to the centralized management of the IMF, to lay a foundation for increasing SDR allocation to gradually replace existing reserve currencies with the SDR.

#### 3.2. *General observation of the proposal*

Granting the global imbalance was a contributing factor to the recent economic crisis, it may be fair to say that even under a more symmetrical international monetary system, with a stricter adjustment mechanism, the current financial meltdown, which was triggered by unregulated creation of massive dubious financial products and excessive risk-taking and leveraging by financial institutions and funds, would have occurred.

It also needs to be recognized that China’s proposal includes or implies technically and politically complicated matters that would require four gigantic steps:

- 1 Dispose of massive US dollar holdings by China; in practice, it would be a daunting task just to replace existing reserve currencies with SDR.
- 2 Reduce still sizable current account surpluses of China and current account deficits of the USA to a manageable and sustainable proportion.
- 3 Eliminate market perception of undervalued currency for the yuan.
- 4 Embark upon a full scale reform of the international monetary system centred on the SDR at one point of time.

In particular, reducing the role of the dollar and broadening the scope of using SDR is a very complex task, as was evidenced at the time of C20 deliberation on fully fledged international monetary reform, involving finance ministers, their deputies and central bank governors, between 1972 and 1974, with the determination and passion to restore stability in the system after the collapse of the Bretton Woods system.<sup>3</sup> Taking an example of multicurrency intervention or SDR intervention, although some lesson could be drawn from the experiences of the European Economic Community snake, a definite conclusion was not reached due to technical difficulties (Gyohten, 1975). Furthermore, it would be difficult to form a political consensus to leave the control of international reserve assets to the management of a super-national entity (Okamura, 2009). Miller (2009, pp. 2) suggests that: 'embracing the SDR will result in a loss of transparency', as the IMF is far more opaque than the Federal Reserve. In any case, for the foreseeable future, the status of the yuan needs to be resolved first.

### 3.3. *Political objectives of the proposal*

Since the proposal was put forward, a number of observers have described it as politically motivated. In addition, it has been commented critically as not being based on reasonable economic grounds:

- 1 'Much of it is for political purpose, internationally and domestically' (Michael Pettis, in a *Daily News Analysis* interview with Vembu (2009a)).
- 2 '... the proposal was an indication of Beijing's fears that actions being taken to save the domestic US economy would have a negative impact on China' (Anderlini, 2009).
- 3 'China's preferred alternative currency reserve – the SDRs – are a big myth. They were used only occasionally' (Omakar Goswami, in a *Daily News Analysis* interview with Vembu (2009b)).
- 4 'China's move was probably an attempt to "seek an escape from the dollar trap"' (Garnham, 2009).

<sup>3</sup> In the final report of C20, Outline of Reform, in June 1974, Part 1 (The Reform System) recorded the outcome of the Committee's discussion of international reform and indicated the general direction in the future. Part 2 (Immediate Steps) set out steps to be taken immediately in the face of oil crisis. The number of areas within which agreements have not been reached on some important aspects were treated in the Annexes for 10 items. SDR was treated in several annexes: Annex 3, Exchange margin and intervention, illustrated a system based on SDR intervention as an option. Annex 7 was on a substitution account, Annex 8 was on SDR allocation and cancellation, and Annex 9 is on valuation of the SDR. This showed that agreement on enlarged the role of SDR was difficult to obtain after the long debates.

Indeed, the Chinese Government may have needed to address the unwanted dollar problem in a strategic way to allay concerns within China. However, the long-term intention and implications of the plan for China and Asia should not be overlooked.

#### 4. ECONOMIC OBJECTIVE AND IMPACTS

##### 4.1. *Prevent the weakening of the US dollar and warn against the abuse of privilege*

The current global imbalance is a problem caused by excessive consumption or budget deficits on one side, and excess saving on the other, as well as from the misalignment of currencies on both sides. The end result was an accumulated reserve of US\$2tn on the part of China, of which US\$776bn was held in US Treasury bonds. Deficit financing of US\$1.27tn was needed for 10 months from October 2008, on the part of the USA. Therefore, China could hold legitimate concerns regarding the value of the US dollar. The USA needs to focus on the smooth funding of government bonds. In reality, it would be interesting to know against which currency the dollar weakening is a headache for China, as the yuan is still considered undervalued and is expected to appreciate against all major currencies, despite a cumulative 20% appreciation against the US dollar since 2005.

By drawing its reform plan to replace the US dollar into the SDR, China might have provided an effective warning against the vulnerability of a key currency country and reminded the USA of the need to maintain certain discipline in their fiscal and monetary policy management. The joint press release on the first round of the US–China Strategic and Economic Dialogue held in Washington in July 2009 mentioned measures to increase savings in the USA and the contributions of consumption to GDP growth in China (US Department of the Treasury, 2009b, pp. 2). While referring to ‘relative prices to lead to more sustainable and balanced trade and growth’, it noted the US commitment ‘to reducing the federal budget deficit relative to GDP to a sustainable level by 2013’ (US Department of the Treasury, 2009a, pp. 1–2).

##### 4.2. *Changing the composition of reserve currency without disruption*

The IMF explains in conjunction with the general allocation of the SDR that some members might choose to sell part or all of their allocation to other members in exchange for hard currency, for example, to meet balance of payments needs, whereas other members might choose to buy more SDR as a means to reallocate their reserves. In this case, China could buy, in theory, a substantial portion of SDR allocated to other members if they wish to have hard currency instead of holding SDR. However, even if all developing countries wished to sell SDR (to obtain hard currency and pay SDR charges) to China (to dispose of the dollar and receive SDR interest rates) this would still amount to 5% of the total reserve of China.



The new framework for issuing note denominated in SDR to strengthen the IMF's capacity, announced on 1 July 2009, will also be helpful. China had expressed its intention to invest up to US\$50bn. The IMF would issue notes with a maximum maturity of 5 years at times when loan disbursements are made to members, and once purchased by member governments or their central banks, the notes would be tradable with official sectors and 15 multilateral institutions.

If the cumulative general allocation of the SDR, or SDR-denominated assets are too small relative to the level of reserves held by China, a possible solution would be the consideration of the use of the substitution account discussed in the 1970s, which could be the fourth element of the Chinese proposal. This idea has recently been mentioned repeatedly by Fred Bergsten of the Peterson Institute for International Economics, including his contribution to *Financial Times* on 8 April 2009 and was earlier recommended by IMF Managing Director Witteveen in 1978 (Solomon, 1982) to address the needs of member countries to change the composition of reserve, without causing turmoil in the foreign exchange markets. According to Robert Solomon, the central issue was how the substitution account could earn sufficient incomes from the dollar holdings to compensate for interest payments of SDR-denominated obligation and who would bear the exchange rate losses from the mismatch of assets and liabilities of the substitution account. By April 1980, the negotiations had been deadlocked. The surge of US interest rates in the early months of 1980 and the stronger dollar might have eliminated the urgency for the creation of such an account (Solomon, 1982). Given this history, the substitution of unwanted dollars would not be easy.

## 5. LONG-TERM IMPLICATIONS FOR THE ASIAN REGION

### 5.1. *Adjustment mechanism and growth*

What seems to be lacking in the Chinese proposal is the recognition that the plan is implying more discipline in the management of global imbalance itself. In the Keynes Plan of April 1943 (Keynes, 1943, pp. 22–3), 'A member State shall pay to the Reserve Fund of the Clearing Union a charge of 1 per cent (and additional 1 per cent), per annum on the amount of its average balance in bancor, whether it is a credit or a debit balance, in excess of a quarter (a half) of its quota'. Therefore, the Keynes Plan is structured on the premise of a level balance by means of a charge for both deficit and surplus countries, as well as adjustment of foreign exchange in accordance with a certain formula.

In the context of the current economic crisis, many have urged Asian countries to reduce dependency on exports and to rebalance growth toward domestic demand. The Asian Development Bank (ADB) emphasizes that 'the region's sharp slowdown underlines the risks of excessive dependence on external demand' (ADB, 2009, pp. 7, 53–6). The IMF put forward a similar statement (IMF, 2009c).

Although a long-term consequence of China's proposal concurs with these arguments, in the short term and median term, a stricter adjustment mechanism

might not be realistic and beneficial for Asian countries that are trying to escape the current global economic recession. If a tighter adjustment process is implemented, which is in reality unlikely in the near future, the growth in Asian countries will be primarily driven by the increase in private consumption, once government expenditures and officially supported investment programs are normalized.

### 5.2. *Internationalization of the yuan*

It might sound rather strange that the Chinese proposal, while referring to a future reserve currency system with a greater role of the SDR, lacks a description of the role to be played by the yuan or of the internationalization of the yuan.

To the extent relevant in considering the future evolution of the yuan, a brief description of the history of the internationalization of the yen might be informative. According to Fujioka, a former ADB President (1981–1989) and ex-Ministry of Finance official who was an early promoter of internationalization, the internationalization of the yen had been a taboo subject in the Ministry of Finance and the Bank of Japan until 1970s, and with the slowest development of internationally open short-term yen markets in the process of internationalization of the yen, the proportion of the yen in the world reserve assets was nearly nil in 1970 and was only 2.7% in 1975 (Fujioka, 1994). The internationalization of the yen called for the liberalization of yen transactions both on asset and liability sides among non-residents, and this in turn necessitated the deregulation of cross-border capital transactions. It was feared that with a fixed exchange regime, this would undermine the effectiveness or the freedom of monetary policies. The second concern was related to liberalization of regulated capital and financial markets, where the inertia of regulations had been stronger.

The international role of the yen was first sparked in discussion regarding a new international monetary system in the wake of the adoption of a floating exchange rate in 1973. In 1980, a thoroughly revised Foreign Exchange and Foreign Trade Control Law went into effect, with a view to effectively promoting Japan's cross-border monetary flows. In 1983, the internationalization of the yen and the liberalization of financial and capital markets were formally identified as major policy objectives in the Comprehensive Economic Measures adopted by the government. Those matters were central issues in the US–Japan Yen Dollar Committee Report in 1984. In the same year, the principle of real demand related to future transactions in foreign exchange was abolished. In 1985, the Council on Foreign Exchange and Other Transactions (Foreign Exchange Council) mandated by the Minister of Finance submitted a report entitled 'Internationalization of the Yen'. In 1986, Tokyo offshore markets were created.

Despite these developments, throughout the 1970s and 1980s, both Japan and European countries accepted the internationalization of their domestic currencies as a natural development, but otherwise adopted a relatively passive stance toward this development. After this time, a series of liberalization of financial



and capital markets took place, culminating in Japan's 'Big Bang' in 1998, with an aim to promote Tokyo as an international financial centre on par with New York and London. It needs to be mentioned that strong leadership of then Prime Minister Hashimoto and Vice Minister of Finance for International Affairs Sakakibara pressed hard against the remaining resistance.

The Council report in 1999 recognized, on the international front, that one of the causal factors of the Asian currency crises was the overdependence on the US dollar, and that the emergence of the euro called for a reconsideration of the role of the yen (Foreign Exchange Council, 1999). The Council report of 1999, while referring to the promotion of the national interests of Japan, highlights the contribution to the stability of the international monetary system, in recognition of the threat of the viability of the virtual single key currency system based on the dollar. The internationalization of the yen was viewed to represent the provision of international public goods. This was in sharp contrast with the still cautious attitude of the European Central Bank toward the increasing role of the euro as a key currency for fear of a surge in the value of the euro, and more or less with the Chinese Government, which is yet to articulate the future role of the yuan in the international financial system.

The Study Group for the Promotion of the Internationalization of the Yen issued follow-up reports in 2001 and 2003 (Foreign Exchange Council, 2001, 2003), but since then a systematic review of progress has not been made, partly due to subsequent progress made to eliminate obstacles to internationalization, and probably influenced by the bursting of the bubble and the subsequent lost decade of the Japanese economy.

The Japanese experiences of the internationalization of the yen can be summarized as follows:

- 1 It took more than 5 years, after the international role of the yen was first sparked in discussion before foreign exchange controls were liberalized in principal (1979).
- 2 It took another 5 years before the internationalization of the yen was formally pursued (1985).
- 3 It took an additional 10–15 years before the financial and capital markets were more fully liberalized, symbolized as the 'Big Bang', with the completely liberal Foreign Exchange Control Law (1998–1999), although these steps might have been taken earlier.

If China were considered to be more or less following the experience of Japan, with a different sequencing, it would be a matter of time, past the taboo period, before the country more formally embarks upon internationalization. If we consider the recent move of China to implement experimental regional settlement of the yuan in some limited regions or the monetary reform proposal as an event sparking the discussion of internationalization, by around 2014 China might decide to pursue gradually the internationalization of the yuan in some of the three dimensions of an international currency: For private sector use, the yuan may be used in invoicing currency (standard of value), in transaction or

settlement currency (medium of exchange), and more or less as asset currency (store of value). The first two items are related to the development of financing denominated in the yuan and asset currency is dependent on the circulation of the yuan outside China and the degree of liberalization of inward portfolio investments. For monetary authority use, the yuan might be pegged or referred (standard of value) for neighbouring countries, but might not be an intervention currency (medium of exchange) with limited use for reserve currency (store of value). The process could be much faster if within 5 years, the market perception of the undervalued currency for the yuan were to disappear, with more flexible exchange rate movements. This is not unrealistic given the yuan's movement since July 2005.<sup>4</sup> By around 2019, the internationalization of the yuan might be more fully and formally pursued as a policy objective, with freer foreign exchange control. A Chinese Big Bang might not occur until 2024 or beyond. However, there is a view suggesting that the yuan could make up more than 3% of global reserves by 2020, the target date for Shanghai (Xhang Guangping, Vice-Head, China Banking Regulatory Commission, Shanghai). China could also make use of Hong Kong as an offshore market for experimental yuan-denominated transactions, as it floated 5 year sovereign bonds in September 2009.

In this respect, it might appear odd that the proposal does not mention the internationalization of the yuan in trade, and instead highlights the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping. In reality, several sources have reported recently that China expanded yuan settlement agreements in early July from border zones to its largest financial centres, including Shanghai, Guangzhou and Hong Kong, and that in mid-July the leaders of Russia and China agreed to expand use of the ruble and yuan in bilateral trade to lessen dependency on the US dollar. In fact, HSBC stated that 'the internationalization of the renminbi was long overdue, given China's rising economic power' (Garnham, 2009, pp. 23).

### 5.3. *Full convertibility as a freely usable currency and the creation of an international financial centre*

The Chinese proposal also envisions more key currencies in the basket of SDR, which is contrary to its evolution toward fewer currencies in the basket described above. It is not clear if it is the intention of the Chinese Government to become the major economy to be included in the basket of SDR. The next 5 year review by the Executive Board will take place in 2011, and after that in

<sup>4</sup> Before July 2005, several economists and observers, including the US Congress, believed that the yuan had been undervalued in the range of 20–40%. In a recent study by (Chang (2008)), it was in the range of 25–36%. However, the study by Cheung suggested that the real exchange rate effect on overall trade flows is relatively small and that exchange rate policy alone will not be sufficient to reduce the Chinese trade surplus (Cheung *et al.*, 2009). A study by (Zhang, 2009) also show that the ongoing exchange rate appreciation has had little effect on the trade imbalance, citing the recent work of McKinnon that emphasizes the investments and savings gap between the USA and China.

2016. If China is serious about enhancing the use of and the valuation of the SDR, it must bring the yuan to a status closer to the freely usable currency at some stage.

Therefore, implicit or explicit, China will be driven more forcefully to move toward liberalizing foreign exchange control and liberalizing financial and capital markets. Indeed, a grand design or a road map for international monetary reform should enable the authority to pass a timely judgment against the resisting domestic pressures. In this respect, as mentioned above, the creation of the Shanghai International Financial Center, targeted for 2020, could be another driving force toward liberalization. There is a view suggesting that the big change as regards international reserves is the arrival of the Chinese yuan as a fully convertible currency; however, this might take more than a decade. The future rival of the dollar would therefore be the yuan, not the SDR (Aiyar, 2009). China seems to be a driving force in the IMF in terms of the reform of the international monetary system, but it might have to decide sooner or later when the yuan will become a freely usable currency, to enhance its leadership role.

#### *5.4. Regional currency integration including a regional monetary unit or an Asian currency unit*

The Chinese proposal to create financial assets denominated in SDR makes us wonder if China is seriously considering the stability of regional currencies or the creation of a regional basket of currencies, sometimes called a regional monetary unit (RMU) or an Asian currency unit (ACU), similar to the European currency unit in the Asian context.

In the European context, that there is a rivalry between the SDR and the euro: The Warsaw convention, which regulates liabilities for international carriage of persons, luggage or goods by air, uses SDR to value the maximum liability of the carrier.

Earlier, in Japanese academic circles, three cases had been considered for the composition of currencies in ACU (Kondo, 2003): (i) that composing of Asian currencies only; (ii) that composing of Asian currencies, the dollar and the euro: and (iii) that composing of Asian currencies and the dollar. In the context of ASEAN +3 (China, Japan and Korea) Finance Minister meetings, various research groups have discussed the merits for economic and financial stability of introducing a RMU as a basket of Asian currencies and have suggested that the RMU could provide a framework for specifying exchange rate objectives as part of a formal effort to coordinate exchange rate policies in East Asia. In Chow (2008), broad issues pertaining to basket weight structure, as well as care to be taken that the basket is not dominated by currencies that are misaligned, and the roles of anchor currencies are analyzed. It is pointed out that there are doubts regarding whether the region is ready to formally coordinate exchange rate policies. The paper also recognizes that 'for a RMU promoted as a market instrument, a narrow basket consisting of convertible currencies only is required. In comparison, a basket based on a wider

grouping is more suited for a RMU used in exchange rate surveillance' (Chow, 2008, pp. 6). Earlier, an ADB Institute Discussion Paper by Kawai (2007), while showing the prospects or road map of regional exchange rate policy coordination in three steps, leading to the introduction of an Asian Snake or exchange rate mechanism, considered three options, evolving from: (i) a G3 currency basket comprising the US dollar, the euro, and the yen; (ii) a G3-plus currency basket comprising the US dollar, the euro, the yen and emerging East Asian currencies; and (iii) an ACU – an appropriately weighted basket of East Asian currencies including the yen, yuan, won, baht, ringgit etc. It recognized that 'the yuan's international role will rise over time, but decades will have to pass before it becomes fully convertible and can assume an international currency status' (Kawai, 2007, pp. 13–6).

So far, the discussion among policy-makers on the ACU has not progressed a great deal for lack of political determination and due to political complexity. However, in conjunction with the Chiang Mai Initiative Multilateralisation (CMIM), amounting to US\$120bn, respective weights among ASEAN +3 were politically settled, at 20 : 80 in May 2009 (China including Hong Kong, 32%; Japan, 32%; Korea, 16%; Indonesia, Malaysia, Thailand, respectively, 3.975%; the Philippines, 3.066%). There is some hope that the agreed share will be a basis for future discussion on ACU.

Granting it is not realistic for ASEAN +3 to form a common currency in the foreseeable future, once the ACU is formulated with several Asian major currencies, this could assist policy authorities in the conduct of their exchange rate policies by serving as a surveillance indicator for regional exchange rate policy coordination. ADB President Kuroda in his earlier publication thought along these lines (Kuroda, 2005). However, it is still to be seen whether China will follow seriously the formation of an ACU in the years to come or whether will consider it more realistic to promote the use of SDR in the Asian context. Concrete progress has been made in term of the Asian Bond Markets Initiative (ABMI), which is an attempt to reduce dependency on short-term foreign currency-denominated financing by developing local currency bond markets in the region, after the agreement at the ASEAN+3 finance minister meeting in August 2003. A series of issuance of local currency-denominated bonds have taken place and the Credit Guarantee and Investment Mechanism is being established as a trust fund of the ADB with an initial capital of US\$500m, to be effective by the time of the 2010 finance minister meeting. The ASEAN+3 Research Group is conducting two studies, including 'Ways to Promote Trade Settlement Denominated in Local Currencies in East Asia', endorsed by the finance minister meeting.

In any case, if an ACU or an RMU is formally agreed upon during an ASEAN+3 finance minister meeting, it would be a breakthrough for the ABMI and the stability the regional currencies. The internationalization of the yuan should contribute to this process, and would encourage more regional use of major local currencies.

In this respect, it should be recognized as a noteworthy development that newly elected Prime Minister of Japan, Yukio Hatoyama, advocated regional

currency integration in his recent contribution to the *New York Times* (Hatoyama, 2009). This could mean that an ACU will no longer be a matter left to academic circles in Japan.

## 6. CONCLUSION

Although there remain daunting tasks of dealing with the excess dollar problem and adjustments of global imbalances, including more flexibility of the yuan, the grand vision of China's proposal should drive China to move faster toward increasing the role of the yuan in the international monetary system, which will contribute to the stability of Asian currencies, leading to a more rapid economic integration of the Asian region.

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