

RMB Internationalization and Its Implications for Financial and Monetary Cooperation in East Asia

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Abstract

This paper emphasizes the importance of the denomination of financial assets rather than trade invoicing as a long-term determinant of an international currency. China needs to liberalize and open its financial system and make the RMB fully convertible, and to adopt a more flexible exchange rate system to speed up its currency internationalization, for which China could follow either a global or regional approach. The global approach is a riskier and more unpredictable strategy because it would demand a scope and timeframe of financial liberalization that is likely to be beyond China's institutional capacity over the coming decade. There are two options that could be taken in following the regional approach. One is creating an ASEAN+New 3 (the Chinese Mainland, Hong Kong, and Taiwan) RMB bloc and the other is liberalizing China's financial industries and internationalizing the RMB by playing a leading role in East Asia's economic integration within the framework of ASEAN+3. This paper concludes that the latter is a more realistic and effective approach for China.

Key words: ASEAN+New 3, ASEAN+3, financial liberalization, RMB bloc,
RMB internationalization

JEL codes: F33, F36, G01

I. Introduction

China has become the second largest exporter and will soon become the second largest economy worldwide. Although it has not been immune to the recent financial crisis, the deepest global economic slump since the 1929 Great Depression, China's economy is expected to grow by more than 10 percent in 2010, by far the highest rate of growth in the world. China is perceived as a growth engine capable of leading the recovery of the global

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economy. It has run up a large surplus on its current account year after year since it embarked on an export-led growth strategy early in the 1980s. It had accumulated a foreign exchange reserve amounting to more than US\$2tn as of the end of 2008, approximately 65 percent of which is held in US Treasury bills and bonds.

Although it has become a dominant player in international trade and has a large and sprawling financial system that boasts some of the largest banks in the world, China remains in the backwater of underdeveloped finance. Despite their size in terms of assets and liabilities, none of China's banks measure up to the clout of major western banks in international financial intermediation. This discrepancy might explain in part why China believes it needs to hold a large amount of foreign exchange reserves as a buffer against external shocks.

Since the eruption of the 2008–2009 global economic crisis, which has eroded the supreme position of the US dollar as a global medium of exchange and a reserve currency, questions have been raised as to whether the RMB could be internationalized and assume a more global role commensurate with China's growing economic might in the long run. Most who have written about the RMB's global role believe that it has the potential to become a major international or reserve currency, although they are quick to point out that realizing this potential is a different matter altogether as it will take many years, if not decades, for the RMB to meet the preconditions of a reserve currency comparable to those of either the US dollar or the euro.

Much of this pessimistic assessment of the future role of the RMB is based on China's financial sector, which is heavily regulated and closed to foreign lenders and borrowers, and the rigidity of its exchange rate system. Chinese policy-makers have made it clear that they intend to rectify these weaknesses to build a modern and efficient financial system,¹ and, in fact, have taken a few preliminary steps towards internationalization of the RMB.

The purpose of the present paper is to analyze the RMB's internationalization path that China is likely to choose and its implications for financial and monetary integration in East Asia. Section II briefly examines the steps China has recently taken to lay the foundation for internationalization of the RMB. This is followed in Section III by a discussion on long-term determinants of reserve currency that emphasizes the importance of finance in currency internationalization. China could take either a global or regional approach in internationalizing the RMB. The latter consists of two alternatives: forming an ASEAN+New 3 currency bloc and leading monetary and financial cooperation within the existing framework of ASEAN+3.

¹ Chinese Premier Wen Jiabao "called for deepened reform of the financial sector so as to enhance its sustained and healthy development." See "Wen calls for more financial reform," *China Daily* (1 March 2007).

The global approach is analyzed in Section IV and the advantages and disadvantages of the two regional options are examined in Sections V and VI. Section VII concludes the paper.

II. First Few Steps for RMB Internationalization: Long Way to Go

An international currency is a domestic currency that is used and held outside its home country as a medium of exchange, unit of account and store of value for transactions between nonresidents (Kenen, 2009). Judging by this definition, the RMB is not an international currency. However, in several recent papers, it is argued that the RMB will assume a greater role commensurate with China's growing economic influence on the world stage, although the nature of its role and the amount of time it will take to become a global currency are unclear (Chen and Peng, 2007; Cooper, 2009; Dobson and Masson, 2009; Eichengreen, 2009; Gao and Yu, 2009; Peng *et al.*, 2009; Wyplosz, 2010).

The recent interest in the RMB's potential global role in part reflects the erosion of status of the US dollar as the dominant reserve currency. The emergence of the euro as another reserve currency, although still a distant second to the US dollar, has raised the question of whether there is room for a third reserve currency for East Asia, much like the euro for Europe. Just about everyone who has written on the future of the RMB suggests that it will take many years for China to meet the conditions prerequisite to an international currency. This is well understood by China's leaders: Chinese Premier Wen has stated that "we need to have an appropriate view of ourselves when pushing forward the internationalization of RMB," adding that "it will take time for the RMB to fully become an international currency."²

Although at present the RMB does not qualify as an international currency, since early 2000 it has become much more visible as a regional currency in East Asia. Riding on the rise of China as the regional hub for intraregional trade in East Asia, the RMB has been increasingly used as a substitute for local currencies and for trade settlements in a number of East Asian economies. If the current trend continues, the RMB has the potential to grow into another regional reserve currency: one that could challenge the dominance of the US dollar and the euro in the future. In fact, Peng *et al.* (2009, pp. 19–20) present empirical evidence showing that: "the RMB has already become a significant force impacting the exchange rates of the Asian currencies and in terms of a reserve currency model and

² "It takes time for the RMB to fully become international currency: Chinese Premier," *Xinhuanet*, 11 September 2009.

counter-factual show that the RMB's potential as a reserve currency would be comparable to that of the Japanese yen and the British pound if the Chinese currency were to become a fully convertible currency today."

An international currency has to satisfy a number of institutional and economic conditions that encourage its extensive use in global transactions in goods and services as well as in financial instruments. In this regard, many analysts agree that the RMB meets few of the requisite conditions. In realization of this limitation, Chinese policy-makers have taken a few but significant steps in 2009 to eventually set up the RMB as a reserve currency. If successful, this transformation would reduce the dependence of many of East Asia's emerging economies on the US dollar for trade settlements and reserve holding. As part of this internationalization endeavor, China has allowed cross-border trade between Hong Kong and other cities in East Asia, as well as the five mainland cities in China, Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan, to be settled in RMB.

This limited opening of RMB invoicing of exports and imports was complemented by the issuance of RMB-denominated sovereign bonds amounting to RMB6bn to offshore investors in Hong Kong on 28 September 2009 in a move to help mainland borrowers raise funds in the offshore bond market. Although China does not need any offshore funding and the amount is small, the issuance has been received as a significant development signaling the intention of the Chinese Government to provide foreign investors with an attractive means by which to hold RMB and to create an offshore market to set the benchmark "risk-free" interest rate for RMB debt instruments, thereby paving the way for further issuance by mainland companies. This market creation follows a previous semi-public issuance of RMB bonds. Five state-owned Chinese banks, including the Bank of China and China Construction Bank, have issued RMB bonds in Hong Kong since 2007. Earlier in 2009, HSBC became the first foreign bank to issue RMB bonds (panda bonds) in Hong Kong, and in December the Asian Development Bank sold a RMB1bn panda bond.

The issuance of RMB sovereign bonds has come on the heels of China's currency swap programs with seven economies: Argentina, Belarus, Hong Kong, Indonesia, Malaysia, South Korea and Russia. China is also considering a similar currency swap arrangement with Pakistan and Thailand, which would make the total currency swap amount more than RMB800bn. The currency swaps allow China to receive RMB instead of dollars for its exports to those economies, thereby expanding the use of the RMB as a trade settlement currency.

These measures are significant moves towards China's currency internationalization but not enough to encourage wider use of the RMB as an international settlement currency. China needs to do a lot more: it should adopt a more flexible exchange rate system, accelerate the opening of its capital account and make the RMB fully convertible. How soon and how

rapidly would the Chinese authorities be able to carry out these reforms? Few people would hazard a guess, but it would not be surprising if it took many years, if not many decades (Eichengreen, 2009).

III. Long-term Determinants of Reserve Currency Status

1. Importance of Financial Asset Denomination

Most of the long-term determinants of reserve currency are well known (e.g. Chinn and Frankel, 2007; Kenen, 2009; Park and Shin, 2009). A country with a large share in global output and trade has comparative advantage in attaining the international status of its currency. Equally important is confidence in the value of the currency and stability of the home country. Much of the erosion of the reserve currency status of the US dollar has been precipitated by its sustained depreciation and the large current account deficit the US economy has accumulated. Network externalities (economies of scale and scope) are also an important condition for an international currency. Like domestic money, an international currency will be more easily accepted and widely used if other countries are using it.

An efficient and open financial system that comprises deep and liquid money and capital markets in the home country constitutes a critical condition for an international currency because such a system helps increase the usage of its currency for denomination of globally traded financial assets and its share in international financial intermediation. Countries hosting international financial centers like the ones in New York and London would naturally have advantages in enhancing the global status of their currencies.

There is a vast literature on the determinants of an international currency for trade invoicing, but very little written on the denomination of financial assets. According to Chinn and Frankel (2007), wider international usage of a currency for invoicing trade helps the currency to be used to invoice financial transactions as well. They do not explain why there is such a linkage. A possible explanation is that a widely used currency such as the US dollar meets the scale and financial conditions for an international currency. For example, borrowers and lenders of a country for which trade is invoiced in US dollars would prefer to conduct their cross-border financial transactions in the same currency to access wide and deep international financial markets, where much of the intermediation is conducted in terms of the US dollar. Countries with a net debtor position might also be able to hedge the currency risk they are exposed to by denominating both trade and financial transactions in the same currency. For instance, when the dollar depreciates, the domestic currency value of their exports in dollars falls, but so does their foreign debt burden. In the opposite case, their foreign debt burden rises, but so does the domestic currency value of their exports.

However, in reality, there does not seem to be a clear linkage in the choice of currency between trade invoicing and financial denomination. The pound sterling and the Swiss franc are more widely used as reserve than trade invoicing currencies. The Australian and New Zealand dollars are internationalized, but are mostly borrowing currencies. In general, if a country's financial markets are underdeveloped and closed, past experiences suggest that, other things being equal, its currency will not be used for invoicing and denominating for either trade or financial instruments. In contrast, the currencies of countries with well developed and open financial markets are likely to be used for financial denomination, although not necessarily for trade invoicing. The yen has declined in importance as a global unit of account and store of value. As argued below, much of this decline can be attributed to the slow pace and limited degree of financial market opening. In general, a greater usage for financial denomination rather than trade invoicing appears to be a much more important qualification for a major international currency.

At the end of 2007, the total value of the global economy's financial assets was estimated to be US\$170tn (McKinsey, 2008). The volume of the turnover of these financial assets is, of course, much larger. Daily turnover of the world's currency markets was close to US\$2tn a day and global turnover for the year as a whole amounted to US\$175tn in 2009. In contrast, the total value of global trade (exports plus imports) amounted to US\$32tn in 2008 (WTO, 2009). This means that the status of an international currency largely depends on its usage as a unit of account for denominating financial instruments. The importance of the finance denomination is further corroborated by the rise of the euro.

Although there are no recent data available, Kamps (2006) shows that during the first 5 years of the euro its share in invoicing trade continued to grow, both for EU-25 countries and for non-euro area trade by European Monetary Union countries. In the latter case, the share of the euro jumped from 20.1 percent in 1999 to 27.7 percent 5 years later. In the Asia-Pacific region, the euro's share grew slightly in export invoicing, but remained unchanged on the import side. However, when it comes to financial invoicing, the rise of the euro has been spectacular. The share of euro denomination of international money market instruments shot up to 33.7 percent immediately after the introduction of the currency in 1999, from 17.3 in the preceding year, and gradually rose to 45.2 percent 10 years later, mostly at the expense of the US dollar. During the same period, the euro's share in denomination of international bond and notes also soared to 48 percent from approximately 27 percent.

Much of the increase has resulted from financial market integration in Europe, suggesting that financial denomination has led much of the euro's ascendancy as an international currency. The euro has also muscled in to replace to a growing extent the US dollar as a dominant reserve currency. In 1999, the share of the euro in global reserve holdings amounted to a little over 15 percent. Ten years later, the share had almost doubled.

For a long time, international financial intermediation has been dominated by developed nation commercial and investment banks, securities firms and insurance companies. Although these developed nation financial institutions were in part responsible for the near meltdown of the global financial system in 2008, their grip on international finance is not likely to wane in any fundamental sense simply because they enjoy the enormous advantage of network externalities. As long as its financial institutions are unable to join the tight network created by the giants of global finance, there will be limits to the extent that China can increase its share of cross-border financial transactions and the use of the RMB as an international currency.

2. The Japanese Experience

In their efforts to expand the global role of the RMB, the Chinese authorities will undoubtedly search for a roadmap for their internationalization strategy from the past experiences of other countries. Gao and Yu (2009) consider the evolution of the US dollar and the euro as the two successful cases of currency internationalization that might provide guidance to China. The authors define the US post-war approach as “global,” but Europe’s pre-euro approach as “regional.” Before settling on either approach, China should learn from the experiences in its own backyard, in particular the unsuccessful experience of the yen internationalization.

Japan had worked for internationalization of its currency for two decades beginning in 1984. Not surprisingly, Japan had almost the same motives for the yen internationalization as China does now for the RMB. In the early 1980s, the status of the yen in international transactions was neither on par with the economic might of Japan nor with its largest net creditor position. Japanese policy-makers were leading the campaign of persuading the public of all the advantages enjoyed by reserve currency countries, as their Chinese counterparts might do in the future. Japan had also harbored an ambition of making the yen a reserve currency subsidiary to the US dollar, as well as Asia’s regional currency. The yen had the potential to contribute to Asia’s economic stability and to supplement the US dollar in sustaining the stability of the international monetary system (Takagi, 2009). Chinese policy-makers would make the same arguments.

According to Takagi (2009, p. 9), at the end of 2003, the international status of the yen remained where it had been two decades earlier and the Japanese policy-makers came to the conclusion that “any further attempt to internationalise the yen or the Japanese capital markets would be futile.” Some of the problems associated with the unsuccessful yen internationalization Takagi elaborates should be a reminder to Chinese policy-makers that they could stumble across the same problems. In particular, two of these problems offer valuable lessons to China.

First, Japan failed to rally cooperation among Asian countries to accept the role of the yen as an international currency in the region. Second, the big bang financial reform of 1998 did not improve the status of the yen. In conclusion, Takagi (2009, p. 11) points out that “dictating the world’s choice of key currency cannot be a feasible objective of any country’s domestic public policy.” However, the yen internationalization was not a total failure as under its banner Japan has been able to overcome domestic opposition to financial liberalization and opening.

Although there is little to disagree on in Takagi’s assessment, he does not emphasize one important aspect of Japan’s unsuccessful attempt at the yen internationalization. By the early 1980s, Japan had succeeded in opening its financial system and making the yen fully convertible. However, since then Japan has not been able to internationalize its financial industries. Despite the fact that its economy is the second largest in the world, Japan has failed to nurture a world class financial center somewhere on its soil. None of the Japanese commercial banks made the list of top ten global retail global commercial banks in 2008 (Business Insight, 2008).³ None of its banks belonged to the top ten global investment banks (Reuters, 2008). Despite the fact that Japan has been a major supplier of savings to the rest of the world, its financial institutions have been confined in their business to the periphery of global financial intermediation. Back in 1995, the share of international bond notes denominated in yen was more than 16 percent; in 2008 it was less than 3 percent. Japanese financial institutions have failed to obtain network externalities.

IV. Global Approach to RMB Internationalization

In internationalizing the RMB, there are two approaches China could follow: one is a global strategy and the other is a regional one. In the former, the ultimate objective is for the RMB to attain status as an international currency comparable to the US dollar and the euro. China’s policy to enlarge its currency swap network might be seen as evidence of China’s preference for globalization of the RMB.

As Eichengreen (2009) points out, China might not have to participate in any regional monetary union to attain the economic and financial scale that is a prerequisite for an international or global reserve currency. Instead of trying to emulate the European approach to a regional monetary union, all it has to do is wait. The longer it waits, the greater will be

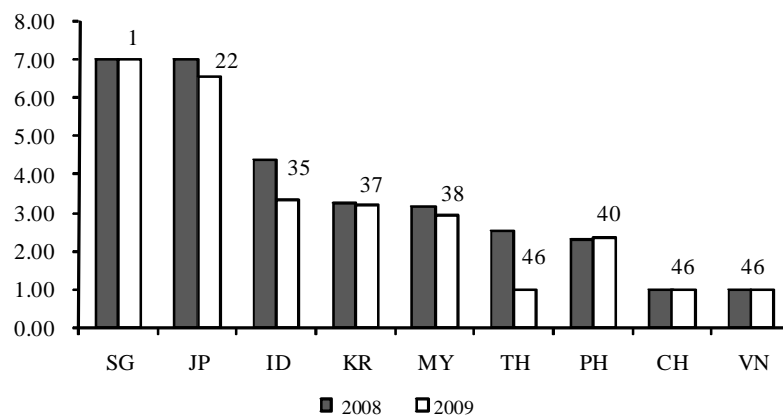
³ The list includes two Chinese banks: Industrial and Commercial Bank of China and China Construction Bank.

its economic position in the region. The RMB will eventually emerge as East Asia's dominant currency.⁴ Chinese policy-makers might also prefer the global approach as it would be easier to inspire and mobilize political support for speeding up financial reform under the banner of globalization of the RMB.

China can wait, but it will have to wait for a long period of time. At this stage of financial development, according to the indices developed by the World Economic Forum (2009), China is at the bottom of the ranking of East Asian economies in terms of the degrees of capital account liberalization and domestic financial market liberalization (Figures 1 and 2). Starting from such an underdeveloped level, following a global approach to internationalizing the RMB will be a long and uneven road marked by relapses and obstacles set up by domestic opposition.

If China keeps up with the current rate of growth, it could easily double its GDP within a decade. Even then, China will not have realized an economic scale large enough to challenge the dominance of the US dollar and the euro. Assuming that the US and the EU economies grow 2.5 percent annually for the next 10 years, within a decade China's economy will become approximately half the size of these two economies in terms of GDP (Table 1). There are also structural characteristics of its trade that are likely to limit the use of the RMB

Figure 1. Capital Account Liberalization Index

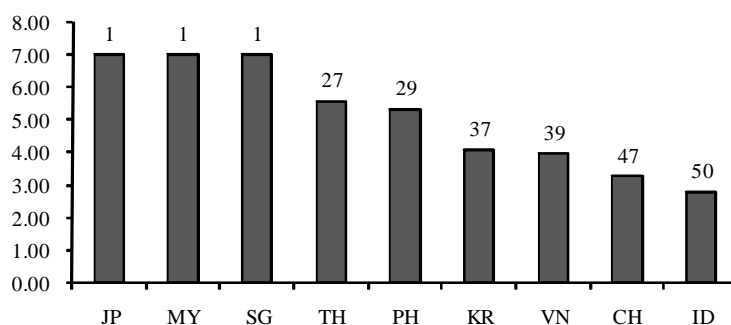


Sources: World Economic Forum (2008, 2009).

Note: The number on the bar indicates the rank among the 52 sample countries. SG, Singapore; JP, Japan; ID, Indonesia; KR, Korea; MY, Malaysia; TH, Thailand; PH, the Philippines; CH, China; VN, Vietnam.

⁴ To quote Eichengreen (2009, p. 67), "There are plenty of other reasons why a pan-Asian monetary union is unlikely, but the RMB's own prospects as an international currency are yet another one."

Figure 2. Domestic Financial Sector Liberalization Index (2009)



Source: World Economic Forum (2009).

Note: The number on the bar indicates the rank among the 52 sample countries. SG, Singapore; JP, Japan; ID, Indonesia; KR, Korea; MY, Malaysia; TH, Thailand; PH, the Philippines; CH, China; VN, Vietnam.

Table 1. Size of GDP: China, US, Europe, and ASEAN +3^a

	2007 (US\$bn)	2008 (US\$bn)	2010 (US\$bn)	2015 (US\$bn)	2020 (US\$bn)
China	3382.445	4327.448	—	—	8654.896
Japan	4380.393	4910.692	5109.084	5640.842	6227.945
ASEAN+3	10 103.270	11 670.01	7739.391	8841.013	18 776.340
USA	14 077.650	14 441.43	15 172.520	17 166.320	19 422.110
Euro area	12 328.020	13 646.37	14 337.220	16 221.250	18 352.850

Note: ^aAuthor's estimates using 2008 exchange rates.

It is assumed that: (i) China doubles its GDP over the next 10 years; (ii) the USA, the Euro area and Japan grow 2.5 percent on average annually; and (iii) ASEAN and South Korea grow at an annual average growth rate of 4.5 percent.

as a trade invoicing currency.

The structure of intraregional trade in East Asia is often compared to a conveyor belt carrying parts, components and other intermediate inputs produced by Japan and other Asian economies to China for assembly and exports to the rest of the world.⁵ In this

⁵ Prema-Chandra (2009) argues that international product fragmentation, the cross-border dispersion of component production/assembly within vertically integrated production processes, is an important driving force of the deepening intraregional trade integration in East Asia. Because the bulk of these exports to China represent a derived demand for China's exports to the USA and the EU, when China's export figures are adjusted, the USA is still an important export market for ASEAN+3.

conveyor system, China serves as an export platform where it imports more from other East Asian economies and exports more to the rest of the world. Over time, the volume of intra-industry trade in the region will increase, but China will not be able to change its trade structure much to reduce its exports to the USA and Europe, which are expected to be denominated in US dollars or euros. As long as export payments are in these reserve currencies, much of China's import payments are likely to be made in the same currencies. A large share of China's imports consists of oil and other raw materials, which are denominated in US dollars.⁶ Most East Asian countries, which import more from other regions and have been running surpluses in their trade with China, would remain reluctant to invoice their exports and imports in RMB unless they had access to RMB denominated financial instruments.

On the financial side, the problem will be more serious. As in the case of the euro's ascendancy, the wider use of the RMB will fundamentally be predicated on the progress in financial liberalization and opening China can achieve. Would China be able to realize full convertibility of its currency, reform its policy, and construct the institutions and market infrastructure needed to build a world class open financial system over the next decade? It is possible, but China's experience with financial liberalization in the past suggests a relatively low probability for such an achievement. China has been striving to develop liquid securities markets to open to foreign investors and to make the RMB fully convertible for financial as well as merchandise transactions for more than a decade, but it has not made much progress (Eichengreen, 2009). Most analysts agree that it will take more than a decade for China to establish a financial regime that satisfies most of the financial prerequisites for a reserve currency (see Cooper, 2009; Dobson and Mason, 2009; Eichengreen, 2009; Wyplosz, 2010).

From the perspective of the Chinese policy-makers, there might not be any rationale in following a particular timetable of financial reform solely for RMB internationalization. Indeed, it is difficult to believe that RMB internationalization would be high on the list of priorities of economic policy objectives, in particular if the liberal reform including privatization of state-owned banks would deprive the Chinese planners of using finance as an instrument of industrial and development policy that they have relied on to propel China's economic ascendancy. However, China's efforts to internationalize the RMB should not be underestimated. Chinese policy-makers are determined to set forth with the RMB internationalization. How long will the internationalization of the RMB take? It will largely depend on the internationalization strategy China chooses.

It is true that once the RMB is internationalized, China will not have to hold as much in

⁶ A similar structure of Japan's trade also helps to explain a disproportionately small share of trade invoiced in yen as opposed to US dollars. See Chinn and Frankel (2007).

reserves as it does now and would benefit from some of other advantages of having an international currency. The RMB internationalization could also signal China's commitment to reforming unipolarity of the international monetary system dominated by the US dollar (Zhou, 2009). However, it is not clear whether these objectives could outweigh some of the disadvantages associated with currency internationalization that China will have to bear (see Kenen, 2009). China might not be ready to phase out its industrial policy, for which its main instrument is control over domestic financial institutions and markets. Another difficulty of the wait-and-see strategy is that in the absence of any domestic or foreign pressure China might not be able to set either a goal or a pace for financial liberalization. Therefore, following the global approach runs the risk of undermining China's leadership in East Asia as China could be portrayed as being insensitive to regional solidarity and economic integration or as uninterested in leading the formation of an East Asian free trade area (FTA) or strengthening the existing regional cooperative arrangements under ASEAN+3.

V. Regional Approach to RMB Internationalization: Creating an ASEAN+New 3 RMB Bloc

If the global approach is not a viable option, would there be a regional strategy that is a realistic alternative for China's currency internationalization? There might or might not be, depending on the regional dimension of the RMB internationalization to be chosen. China could pursue internationalization of the RMB beginning with its use as a regional invoicing currency for trade and cross-border financial transactions in East Asia. As countries in its neighborhood develop deeper trade, investment and financial ties with China, they would have incentives to use more RMB for transaction purposes and as reserve holdings than previously. Some of these countries might opt to anchor their currencies to the RMB or to peg their currencies to baskets of major currencies in which the RMB has a larger weight.

In the event that China decides on a regional strategy, it has two options to consider. China might move to create an RMB bloc among the members of ASEAN+New 3, which includes ASEAN 10, the Chinese Mainland, Taiwan and Hong Kong SAR. Alternatively, it could take advantage of ASEAN+3 as a framework for RMB internationalization (ASEAN+3 approach). China's size advantage will favor China in forming an RMB bloc. This advantage could also help China lead monetary cooperation and financial integration in East Asia: a process that might elevate the RMB as the dominant unit of account and store of value in the region.

The creation of the RMB bloc has several appealing features for Chinese policy-makers. One feature is that the bloc formation is likely to be a rather natural evolutionary outcome of trade expansion and geographical proximity among trade partners in the region.

With the rapid growth of China's trade with its neighboring countries, the amounts of the RMB circulation in Mongolia, Korea, Vietnam, Laos, Myanmar, Cambodia and Nepal, not to mention in Hong Kong SAR, have multiplied since early 2000. The RMB has become in part a substitute for local currencies in these economies. There has also been a marked increase in two-way trade between China and ASEAN, much of which has been at the expense of their exports to Japan. In 1998, ASEAN sent 3.2 percent of its total exports to China. Ten years later, that share skyrocketed to 10.6 percent. A similar upsurge has taken place on the import side. The ASEAN–China FTA, which comes into effect in 2010, is expected to give a further boost to the two-way trade. The FTA will then tend to create market forces favoring formation of a natural currency bloc dominated by the RMB among ASEAN+New 3. If they saw the RMB as a potential candidate for a leading international currency, most ASEAN members would be swayed to use it for trade invoicing and financial denomination. Over time, the Chinese currency might complement and gradually replace the US dollar and serve as an anchor to tie their currencies in East Asia.

Another attractive feature is that in establishing an RMB ASEAN+New 3 bloc although China will need to deregulate and open its financial markets, the extent of financial liberalization and opening required will not be as extensive as with following either the global or ASEAN+3 approach. All China might have to do is to create financial instruments in RMB that other members of ASEAN+New 3 can invest in, if they run surpluses in their trade with China, or borrowing facilities in case some of them incur trade deficits with China.

For Chinese policy-makers, the bloc formation might be the most realistic and expedient approach they could adopt (Dobson and Mason, 2009). However, this strategy has its share of disadvantages. Some of the detractors of the ASEAN+New 3 RMB bloc might question whether the grouping would constitute an optimal currency area. Judging by the standard criteria for a common currency area, it is not (Park, 2007). However, this is not a serious issue. When activated, the ASEAN–China FTA will contribute to synchronizing cyclical movements of the member economies of ASEAN+New 3. Furthermore, as shown by Frankel and Rose (1998), the traditional criteria for membership of a common currency area are not as binding as they are often made out to be as forming a monetary union can be an endogenous process. Because the economic structure is likely to change *ex post* to bring about closer co-movements of output of the members that participate in a monetary union, countries that do not qualify, on the basis of traditional criteria such as symmetric output shocks and labor mobility, as members of a monetary union *ex ante* could justify their entry into the union *ex post*.

Even if ASEAN+New 3 can become an optimal currency area, the bloc strategy poses other challenges to the Chinese policy authorities. Foremost is that the region is not large

enough to serve as an economic base from which China can launch the elevation of the RMB as an international currency. Inertia and complacency on the part of the policy-makers could set in to weaken incentives for financial liberalization, thereby delaying financial reform and eventually frustrating China's efforts to globalize the RMB. In the short run, China might need to stabilize the RMB exchange rates vis-à-vis the US dollar and the euro to improve ASEAN investors' confidence in China's currency. For the foreseeable future, the RMB is expected to remain strong vis-à-vis other major reserve currencies. This expectation will increase the demand for the RMB.

However, if the RMB is likely to appreciate against the US dollar, the euro and the yen, ASEAN member states would be reluctant to let their currencies increase in value vis-à-vis the US dollar by linking their currencies to the RMB. The USA, the EU, and Japan still account for more than 36 percent of ASEAN's total exports. China will find it increasingly difficult to adhere to its rigid exchange rate system, which is inconsistent with its long-run objective of RMB globalization. However, in the absence of well developed financial markets for derivative products and other hedging instruments, exchange flexibility might not help to build confidence in the RMB. Herein lies China's dilemma.

Finally, the RMB bloc formation will be opposed by both Japan and Korea, which have also established FTA with ASEAN. It will derail, if not bring to an end, regional economic integration through the ASEAN+3 process. It is also unclear how many of the ASEAN member states are prepared to sacrifice some of their monetary sovereignty by anchoring their currencies to the RMB. Although ASEAN states need the vast export market China promises more than ever, some of them might harbor reservations about participating in a currency bloc to be dominated by a non-democratic super military power.

VI. Regional Approach to RMB Internationalization: Leading ASEAN +3 Wide Monetary Cooperation and Integration

Another regional approach involves China undertaking steps towards RMB internationalization as part of its strategy toward economic integration in East Asia. In this alternative strategy, China sets the timelines and scope of the RMB internationalization within the regional cooperative framework of ASEAN+3. It is argued in this section that in leading the expansion and consolidation of ASEAN+3, China will be able to chart a course of its currency internationalization that will be more manageable and effective in speeding up financial reform and internationalization of the RMB than the other approaches.

1. China and ASEAN+3

Like all other regions, East Asia has been hit hard by the 2008–2009 global economic crisis. For more than 6 months after the collapse of Lehman Brothers in September 2008, all East Asia nations except for China were buried deep in a recession precipitated by the US subprime crisis. The US Fed was busy pumping more dollars into the global financial system, but investors all over the world gripped with the uncertain outlook of recovery and a lack of confidence in the financial market were taking their dollars back to safe haven US Treasuries. This flight exacerbated liquidity shortages in East Asia.

Although they held more reserves than what the Greenspan–Guidotti–Fischer rule prescribes and their exchange rates were more flexible than before, most East Asian emerging economies were not able to fend off the crisis. Once they were perceived to be susceptible to speculative attack, foreign investors started to dump their holdings of all sorts of East Asian assets. Under these circumstances, no amount of foreign exchange reserves holdings appeared to have been enough to keep speculators at bay (Park, 2009).

While many of East Asia's emerging economies were battling with the liquidity crisis, the EMU members were immune to such a crisis as they had access to the lending facilities of the European Central Bank (ECB): a de facto lender of last resort for the union. Without access to liquidity services from either the US Fed or the ECB, East Asia's emerging economies were hard pressed to secure reserve currency liquidity, which was rapidly disappearing. The high costs they had to pay for scarce liquidity, which was equivalent to a non-reserve currency discount, worsened the crisis. In some countries such as Korea, the shortage triggered a run on their central bank reserves.

This crisis experience has underscored the need to create a liquidity safety net, if not a regional or global lender of last resort. In the absence of such a net, a non-reserve currency discount would put East Asia's emerging economies at a competitive disadvantage vis-à-vis their counterparts from reserve currency countries in international financial intermediation. However, it is unlikely that the crisis will garner enough global support for constructing such a net. Under these circumstances, a regional arrangement such as the Chiang Mai Initiative Multilateralization (CMIM) has gained renewed importance as an alternative source of liquidity support.

The two regional arrangements under ASEAN+3, the CMIM and the Asian Bond Market initiative (ABMI), were designed to foster monetary and financial cooperation in East Asia. The CMIM is organized to provide a collective line of defence against currency turbulence by providing liquidity support; the ABMI is in place to reduce currency mismatches and to build deep and resilient regional capital markets, which should reduce both the frequency and impact of financial disturbances. In the long run, it was initially expected that they would lay the foundation for monetary integration in the region.

However, the CMIM has failed to lend weight to monetary cooperation and integration and the ABMI has not been effective in deepening financial integration in the region, largely because China and Japan have failed to provide the needed leadership. Now that the 2008–2009 global financial crisis has proven that the existing buffers at both the national and the regional level in East Asia, including large self-insurance against external financial shocks such as the US subprime crisis, are grossly inadequate, both China and Japan should rise to the challenge of mitigating the impact of external financial turbulences on East Asia by supporting the strengthening of the CMIM and the ABMI. As argued below, for China, the two initiatives could serve as an appropriate regional framework for obtaining the economic and financial scale China needs to internationalize the RMB.

2. ASEAN+3 as Framework for the RMB Internationalization

Countries belonging to ASEAN+3 account for almost 20 percent of the global GDP. As shown in Table 1, assuming China can double its GDP within a decade, the region will become as large as either the USA or the EU in terms of the size of GDP by 2020. If the members of ASEAN+3 were to agree on a free trade area where China is a dominant partner, the economic size of the grouping would be large enough to accommodate the rise of the RMB as a major international currency. The ABMI and the CMIM could also serve as vehicles of financial reform for domestic market deregulation and market opening and, hence, internationalization of the RMB. Compared to the global and ASEAN+New 3 approaches, this alternative has several advantages.

As noted earlier, the ABMI was launched as part of regional cooperative efforts to construct deep and liquid regional bond markets in East Asia by integrating the region's domestic bond markets. To this end, the initiative attempts first to improve the efficiency and the liquidity of domestic bond markets of individual countries through financial deregulation. These individual markets are then to be integrated into large regional bond markets by removing regulatory restrictions on cross-border financial transactions. The market liberalization and opening will not, however, be sufficient to facilitate cross-border financial investments unless regional financial market infrastructure that includes a regional system of clearing and settlement, regional credit guarantee institutions, hedging facilities and regional credit rating agencies is also constructed. The infrastructure construction will also need to be accompanied by harmonization of legal and regulatory systems, domestic clearing and settlement systems, market practices, rating standards, accounting and auditing practices, and withholding taxes on bond coupon payments across the countries in the region. Eventually, Asian bond markets will be integrated into global capital markets, but retain the feature of being specialized in trading and issuing of bonds denominated by regional currencies.

To make any headway in constructing efficient regional bond markets through the ABMI, the member countries will need to agree on a region-wide plan for deregulation of cross-border financial transactions, where different countries will have the same target but with different speeds of adjustment and timelines for financial restructuring. By participating in and leading the implementation of the ABMI, China might develop and carry out its own plan for financial market deregulation and opening seen to be consistent with its level of financial development and supported by other members. ASEAN states have agreed to a plan that involves integration of their financial markets and systems over the next 5–10 years. Now that the ASEAN–China FTA is in effect, China might consider developing a similar plan with a pace of reform faster than or in line with that of ASEAN.

The Chinese authorities might also find it easier to dissuade domestic opposition to the reform by articulating the need to play a more active role in regional integration as the largest economy in East Asia. An integrated regional bond market will need to be supported by regional financial centers where various financial instruments in regional currencies including the RMB are listed and traded. Compared to other countries, China has natural advantages in hosting a large financial center. It is a fast growing economy and a net creditor with a huge capacity to supply capital to firms in other countries.

The ASEAN+3 approach has other advantages. China will not venture into uncharted territory in leading economic integration in East Asia as it can learn from the European experience. If China decided to follow the European path, playing the role of the pre-euro Germany, where the EMU countries took a series of concrete steps before creating the euro and replacing all the individual members' currencies along the way, it would actively participate in enlarging and consolidating the existing regional initiatives of ASEAN+3.⁷ With the backing of ASEAN+3 it could have more leverage in managing its economic relations with the USA and the EU. For example, should the ASEAN+3 member countries consolidate their representation in international financial institutions, China will command a greater voice in setting its agenda and priorities.

China will also find rationale in the strengthening of the CMIM as a regional liquidity supporting system. By enlarging the size of the pooled reserves and streamlining the drawing procedures, the CMIM could serve as an effective liquidity support system and, hence, as a more reliable regional buffer against external shocks credible to the market. To the extent the CMIM helps to stabilize regional financial markets, it could complement regional financial integration through the ABMI. In the long run, it could be nurtured as the

⁷ According to Gao and Yu (2009, p. 5), "China should involve itself in a full-fledged monetary union among ASEAN+3 members and the RMB would be self-diminished and replaced by a new single Asian currency at the final stage."

forerunner of a regional monetary fund if the members were more amenable to pooling their monetary sovereignty. However, before setting a lofty goal of adopting a single currency or creating an Asian version of the ERM as a framework for exchange rate policy cooperation, China and other members of ASEAN+3 should follow an evolutionary path to monetary integration.

In this evolutionary process, different members need to be allowed initially to adopt different exchange rate systems. Some of the ASEAN+3 members might continue to peg their currencies to various baskets that include the RMB and other major currencies, whereas China and other countries might opt to internationalize their currencies. The yen will remain a free floating currency. Diversity of the exchange rate systems and lack of exchange rate policy coordination would invariably lead to a great deal of volatility of regional currencies. Before trying to work out a cooperative arrangement for stabilizing regional currencies, however, China should take the lead in forming an ASEAN+3 FTA. This is a critical first step to be taken towards harnessing regional monetary cooperation, because freer trade in the region is bound to create market pressure on the ASEAN+3 members to stabilize intra-regional exchange rates. If enough pressure was built up, the members would be compelled to restructure the CMIM as an institutional arrangement for monetary cooperation by following in the footsteps of the EMU evolution. In this process, the RMB might evolve as a major international currency in East Asia to which other members may want to anchor their exchange rates.

As pointed out earlier, China, Japan and South Korea have all established similar free trade pacts with ASEAN. Trade integration among China, Japan and Korea through the formation of a three-country free trade area would then give new life to an ASEAN+3 FTA. China has been active in advancing the idea of creating what is known as a China, Japan and Korea (CJK) FTA. In principle, both Japan and Korea support the idea, but in reality they believe differences in trade structure, the degree of protection of domestic industries, and non-tariff trade barriers, not to mention the political system, are too formidable to establish a CJK FTA. However, the idea of creating a CJK FTA has recently received renewed support by the leaders of the three countries. This development might support China in internationalizing the RMB through the ASEAN+3 process.

The future of ASEAN+3 will, to a great extent, depend on the future of Sino–Japan relationships. The China–Japan cooperation is crucial in leading the process of economic and financial integration in East Asia, as the France–German alliance has played a central role in the integration and cooperation process in Europe. China and Japan have been competitors rather than collaborators as they have different interests and, hence, different strategies for economic integration in East Asia. Realizing their alliance, the two countries could soften their positions to compromise on an institutional setting and augmentation of

the existing financial architecture of East Asia. Furthermore, this competitive relationship is likely to undergo a fundamental change. According to Ikenberry and Kupchan (2010), Japan has begun to travel down the road taken by Europe after the fall of the Berlin Wall. As Japan deepens its bilateral relationship with China, the two countries might finally be able to attain rapprochement in the same way that France and Germany have managed to build self-sustaining regional peace.

VII. Concluding Remarks

China has embarked on a long and difficult journey to internationalize its currency. If China can remain on its rapid growth path, as widely expected, within a decade it might be able to support a major international currency that can replace in part the role of the US dollar and the euro as reserve currencies. However, this prediction is predicated on China's ability to reform its financial system. The RMB will not be widely used unless China gets its financial sector in order by opening up its financial markets to foreign borrowers and lenders and deregulating cross-border financial transactions. It will also have to increase the flexibility of its foreign exchange rate regime and make the RMB fully convertible.

Now that China has become a major economic power whose policies can influence the course of development of the global economy, Chinese planners might be tempted to follow a global approach to the RMB internationalization that will seek to attain a currency status comparable to that of either the US dollar or the euro. This paper argues that China would be better advised to pursue a regional strategy.

Over time, market forces generated by freer trade between ASEAN and China are likely to lead to the development of a natural currency bloc among ASEAN+New 3, where the RMB is expected to emerge as the anchor currency. However, such a bloc formation is not currently part of China's plan. In fact, China needs a larger regional framework, such as an ASEAN+3 for a platform to elevate the RMB to a regional or global currency. Such a framework for deeper regional economic integration would provide an ideal setting where China could develop a modern and efficient financial system, which is an essential condition for a global currency.

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