Beijing and the International Monetary System

The Spring Fund Bank meetings were held in Washington recently. The big news was that emerging markets rejected IMF's plan to guide capital controls. No wonder of course: its acceptance would have meant appointing an atheist as the Pope!

The last month or so also witnessed a number of initiatives on the part of Beijing towards reforming the International Monetary System. The first was a meeting in Beijing organized by the Columbia University and the Central University of Finance and Economics. The consensus that emerged was in favour of a greater role for the SDR as the principal reserve currency. This was also the theme of a G20 seminar in Nanjing, which was attended by President Sarkozi of France, the current Chairman of G20. Talking about the SDR, it is high time that the Chinese yuan is included in the basket given China's status as the world's largest exporter and manufacturer, the world's second largest economy, and its reserves. (The basket presently consists of the dollar, the euro, the yen and the pound.) Some western countries object on the grounds that the yuan is not yet fully convertible, nor is its exchange rate determined by the market: they are forgetting history. The SDR scheme was launched in 1969 as a means to increase global liquidity, at a time when the world was in an era of fixed exchange rates. When SDR became a basket of currencies, practically no currency in the basket, other than the U.S. dollar, was fully convertible on capital account.

Coming back to events hosted by China, the next was a BRICS Summit: the "S" comes with the addition of South Africa to Brazil, Russia, India and China. (The acronym was originally coined by Goldman Sachs economists more than a decade back, but it caught on as a short form for fast growing, large emerging economies.) In the statement issued at the conclusion of the meeting, the Summiteers gave a call for "*more attention to the risks of massive cross-border capital flows now faced by the emerging economies*." They also warned that "*excessive volatility in commodity prices, particularly those for food and energy, poses new risks for the ongoing recovery of the world economy …. The regulation of the derivatives market for* *commodities should be accordingly strengthened to prevent activities capable of destabilizing markets*”. While BRICS continue to attract attention, one doubts whether it would become an influence in global policy making *as a Group,* with no ideological, geographical or racial affinities. One corollary of the Summit was that development banks in the BRICS countries agreed to facilitate and expand the system of settling trade in local currencies, thus circumventing the dollar, which is an important part of Beijing’s agenda.

The fact is that many emerging market currencies are attracting trading interest in off-shore markets. As per the analysis recently published in the BIS Quarterly Review March 2011, many emerging market currencies, including the Chinese yuan and the Indian rupee, had larger trading volumes in “strictly off-shore” markets than the “onshore” market. Meanwhile, Beijing continues to push the role of its currency in invoicing trade, and is encouraging the establishment of another offshore centre for yuan trading in Singapore. (Hong Kong already has a flourishing market in the mainland currency.) Latest data suggest that China’s effort to popularize the use of yuan are working: about 7% of China’s foreign trade in the first quarter of 2011 was denominated in the yuan, as compared to just 0.5% in the first quarter of 2010. Barry Eichengreen (*Exorbitant Privilege*) believes that China is following the path taken by the Federal Reserve almost a century back in popularising the use of the dollar internationally. The then global currency, namely the British pound, was eventually replaced by the dollar by the end of the Second World War. Will history repeat itself, hopefully without a war?

The risks of dependence of the global economy on the U.S. dollar were underscored during the last couple of weeks, with the IMF warning that the U.S. lacks credibility in terms of its ability to reduce its massive deficits and debt. This was followed by S&P downgrading its outlook on U.S. sovereign debt from stable to negative, for the same reasons. The immediate provocation for these concerns arises from the impasse between the Republican-controlled Congress and the Democratic President over how to go about reducing the debt. Even The Economist criticized the Republican plan since “*too much of the gain goes to the rich, and too much of the pain is felt by the poor. Some of …*(the) *figures are* (also) *deeply suspect.”* One relatively painless via media may be to increase the retirement age in parallel with increased life expectancy, and reduce the cost of social security.

S&P may achieve a faster reduction of the dollar's global role than any number of seminars and meetings in China: but this may mean a weakening of the dollar against other reserve currencies and this could cost China heavily, given the level of its dollar-denominated assets.

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