Implications of Renminbi Internationalization for the U.S. and the Global Economy

(With Reference to Wu Yi, Being Manufactured in China, Yang Rui, Deng Xiaoping and Avoiding the Middle-Income Trap)

Remarks before the 21st Century China Program
at the University of California, San Diego

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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I am honored to speak at this conference on the internationalization of the renminbi. It is a very timely topic, particularly since China has recently accelerated the pace of currency reform. Before I delve into these weighty matters, however, I'd like to mention my embryonic connection to the People's Republic of China (PRC).

'Manufactured in China'

In 1948, my father, accompanied by my mother, was sent to Shanghai to collect a dollar payment owed to the U.S.-based Spazier Chemical and Soap Co. They left the Peace Hotel and Shanghai right before the People's Liberation Army closed the port, my father with payment in hand and my mother with child; I was born in Los Angeles five months later. It is thus no exaggeration to say that I have literally had an interest in China my entire life, something that my Chinese interlocutors have wryly noted. When I was deputy U.S. trade representative helping Charlene Barshefsky negotiate China's accession to the World Trade Organization (WTO), Madam Wu Yi—the tough-as-nails "Iron Lady" of China—used to say, "I like Ambassador Fisher because he was manufactured in China."

Susan [Shirk], I am grateful for your invitation to let a lifetime China watcher speak here today.

This afternoon, I will discuss the prospects for the internationalization of the renminbi and conclude with some thoughts on the implications for the United States going forward. For those of you who are up-to-the-minute in touch with all matters Chinese, I trust nothing I say will make its way into Yang Rui's microblog or feed the suspicions of the editors of the *People's Daily* (and please note that I am from Texas, not Oklahoma!).[1, 2] I seek neither to "demonize" nor impose a "colonial" view on China, nor do I wish to fawn over her. My comments today merely draw upon the facts, from lessons learned as a student of economics and from my personal experiences in China.

Most of you are aware that China announced a series of foreign exchange policy measures in the past couple of months. The renminbi's daily trading band around the U.S. dollar has widened from 0.5 percent to 1 percent. In addition, HSBC recently placed 2-billion-yuan bonds in London, the first renminbi bond issue outside mainland China and Hong Kong.[3] China now allows some domestic banks to hold overnight long positions of renminbi. In other words, these banks can short foreign currencies, such as the dollar, if they wish. All of these policy changes demonstrate China's determination to reform its exchange-rate policy and, I believe, its ultimate ambition to transform the renminbi into a leading global currency.

In the long run, a fully convertible currency and flexible exchange-rate regime are good for both China and the world economy. These recent reforms, then, are welcomed as a step in the right direction. However, overhauling a country's exchange-rate regime and inspiring confidence from

international investors are lengthy processes, and Chinese policymakers must bear in mind the risks associated with capital account liberalization. Before discussing some of these risks, I would like to first offer my take on the Chinese economy from a broader perspective.

Crossing the River by Touching the Stones

China has undergone two crucial stages of transformation that have seen its economy progress from a closed and centrally planned system to one more open and fueled by the private sector. The first stage occurred in the early 1980s, when Deng Xiaoping shifted the country's attention from extreme political ideology to economic development. Following his famous arguments that "poverty is not socialism" and "to be rich is glorious," China's domestic production became more responsive to dictates from the market than from the political power structure.

The second stage arrived in 2001, when China joined the WTO and became more actively engaged in global production activities. China's international trade exploded, and the country quickly ascended to become the world's largest supplier of manufactured goods.

I am grateful to have played roles, however minor, in both of these remarkable transformations. As mentioned, I served as deputy U.S. trade representative in the Clinton administration from 1997 to 2001 and was a member of the team that negotiated the bilateral accords for China's accession to the WTO. In the late 1970s, I served in the Carter administration as coordinator of policy planning and assistant to Treasury Secretary Michael Blumenthal, helping to normalize the China–U.S. trade relationship.

On Feb. 23, 1979, Secretary Blumenthal and his team—which included me as his faithful chef de cabinet—flew to Beijing to meet with Deng Xiaoping and other senior government officials. The mission of the trip was to settle the counterclaims between the U.S. and China stemming from the communist takeover in 1949. Soon after that change, the PRC seized railroad stock and other U.S. assets invested in Chiang Kai-shek's government. In retaliation, the U.S. froze the assets of Chinese account-holders in U.S. banks. Obviously, normal trade was impossible without resolving this dispute. After arduous negotiations with Deng and Finance Minister Zhang Jin-fu, we sealed a preliminary deal to settle these counterclaims on March 1, 1979, and on that very day, reopened the U.S. embassy in Beijing.

Here are two of my favorite mementos from that negotiation. The first is our joint negotiating "team" picture. The young fellow towering over Deng Xiaoping is me, if, indeed, anybody could "tower over" what some historians consider the leading transformational figure of the 20th century.[4]

The second is the cover photo on the March 3 issue of the *People's Daily*. This picture depicts Chairman Hua Guofeng, Mao Zedong's placeholder successor, escorting Secretary Blumenthal (left), Undersecretary Tony Solomon (who later became president of the Federal Reserve Bank of New York) and, behind them, me and the rest of our delegation into the Great Hall of the People.

华总理会见布卢门撒尔部长

指出中美友好关系会一步一步地向前发展

新华社北京二月二十八日电　国务院总理华国锋今天下午会见了美国财政部长布卢门撒尔及其随行人员，同他们进行了友好的谈话。华国锋总理说，发展中美友好关系，是两国人民的共同愿望，对两国人民都有利。他指出，中美友好关系会一步一步地向前发展。他相信，布卢门撒尔部长的这次访问，将会把中美两国的友好关系和经济贸易往来继续推向前进。

布卢门撒尔部长说，几天来，我们的会谈进展十分良好。我们已经就密切美中两国的经济关系奠定了基础。布卢门撒尔部长转达了卡特总统对华国锋总理的特别问候和最良好的祝愿。

华总理请布卢门撒尔部长回国后转达他对卡特总统、蒙代尔副总统和其他美国朋友的亲切问候。

美国驻中国联络处副主任两效位参加了会见。

会见时在座的有国务院副总理余秋里、财政部部长张劲夫、外交部副部长章文晋等。

* * *

华国锋总理会见美国财政部长布卢门撒尔。
新华社记者　钱嗣杰摄

邓副总理会见并欢宴图哈米

邓副总理会见杰·哈蒙德

宾主进行了热情友好的交谈

新华社北京二月二十八日电　邓小平副总理今天下午会见埃及总统萨达特的特使、负责总统府事务的副总理哈桑·穆罕默德·图哈米，同他就中东形势、国际形势和一些重大国际问题广泛地交换了意见。黄华外长、何英副外长参加了会见。

新华社北京二月二十八日电　邓小平副总理今天晚上在欢迎埃及总统萨达特的特使哈桑·穆罕默德·图哈米副总理的宴会上，重申中国政府和人民始终不渝地站在埃及、巴勒斯坦和其他阿拉伯人民一边，坚决支持他们为收复失地和恢复巴勒斯坦人民的民族权利而进行的正义斗争，强烈谴责以色列犹太复国主义坚持侵略的顽固立场。

邓副总理在祝酒时谈到图哈米副总理一九七七年访问我国一年多来国际形势的巨大变化。他指出，同一九七七年相比较，世界形势不是更缓和而是更紧张了。新的不安和动乱不断出现，尽管情况错综复杂，但是，只要稍加注意，人们总是可以发现那个超级大国谋求霸权主义是世界动乱不安的总根子。他强调说：一年来的事实更加清楚地告诉人们，霸权主义是世界最危险的战争策源地，是危害世界和平、安全和稳定的根源。

他指出，埃及政府和人民在萨达特总统领导下，为维护国家主权、尊严和阿拉伯民族权利，同霸权主义处心积虑要分裂阿拉伯民族、孤立埃及的阴谋进行了艰巨的斗争。他说：最近，萨达特总统重申了

新华社北京二月二十八日电　邓小平副总理今天上午会见了美国财政部长布卢门撒尔加州州长杰·哈蒙德和夫人一行。宾主进行了热情友好的交谈。

美国驻中国联络处参赞孙学礼参加了会见。

中国人民外交学会会长郝治青会见时在座。

杰·哈蒙德州长一行是应外交学会会长的邀请于二月二十四日到京的。二十五日郝治青会长会见并宴请了他们。

○ 邓副总理

China has experienced tremendous change since those photos were taken 33 years ago. During our trip to Beijing in 1979, we barely saw any cars on the street other than our own motorcade. The best data we have estimates that China produced only 5,000 cars in 1980, most all for officialdom. In 2009, China surpassed the United States in the annual volume of auto output and sales for the first time. In 2010, more than 9.5 million passenger cars were manufactured in China, while auto sales reached 18.5 million units in 2011.

Deng's economic reforms have fueled the rapid expansion of China's economy. During our settlement-of-claims discussions, Deng said during an informal session what he later repeated publicly in Guangdong: "It doesn't matter if the cat is white or black as long as it catches mice." Well, China has caught plenty of mice—gross domestic product (GDP) per capita in 2011 is more than 14 times greater than what it was in 1980.[5] China is now the second-largest economy in the world.

Along with these remarkable achievements, what has impressed me deeply about the Chinese has been their willingness to adopt and adapt. China started down the road to economic reform in the early 1980s by allowing private production in rural areas. After the fall of the Berlin Wall, the collapse of the Soviet Union and economic liberalization in India in the 1980s and 1990s, it became clear that the centrally planned economic model was unsustainable. As a response, the pace of reform in China accelerated in the 1990s. The PRC removed its state-owned enterprises from many sectors to foster private activity and removed migration restrictions to encourage labor mobility across regions, especially to coastal areas and, most recently, inland.

While the people of China are eager for economic reform, policymakers are usually more cautious. This emphasis on balance and patience is captured by Deng's famous dictum to "cross the river by touching the stones." Such gradual changes have thus far worked very well for China, compared with many countries that attempted a quick switch from a centrally planned economy to a market-based system. In the last 20 years, China hasn't fallen prone to bouts of crises that plagued many of its emerging-economy counterparts. Its GDP growth rate has remained at 8 percent or above for most of the past three decades.

Inflection Point: Avoiding the 'Middle-Income Trap'

China, however, now finds itself at another inflection point. Many emerging markets experience rapid economic growth when they first open to the global economy. The reallocation of labor and other resources in these countries toward the sectors in which they have comparative advantages results in rapid productivity gains. An inflow of new technologies and the capital to finance their adoption also moves the country's production to higher frontiers and often brings about explosive economic growth. Except for a few notable exceptions, such as Japan and South Korea, many emerging economies have been unable to sustain this pace of expansion, slowing sharply long before their per-capita income approaches levels seen in advanced economies such as the U.S.—enveloping them in what some economists call the "middle-income trap."[6]

In the last few months, many business operators and economists have shared with me their concerns regarding rising labor costs in China. Several provincial governments have dictated some dramatic mandatory minimum-wage increases—in 2011, Chongqing mandated an increase of 32 percent, Shandong 26 percent and Beijing 20 percent. According to a recent report from the Boston Consulting Group, by 2015 the total labor cost savings of manufacturing in China will only be about 10 to 15 percent when labor productivity is taken into account.[7] After factoring in

transportation costs and operational efficiencies, it has become more economical for some manufacturing companies to shift production to other low-cost countries, such as Vietnam and Mexico and, in some cases, even to the United States. Indeed, with increasing frequency, I've noticed news articles documenting tire, steel, appliance and even television manufacturers shifting production back to the U.S.[8] These increasing labor costs indicate that the pool of competitively priced labor in China may be close to drying up and that economic growth sustained by simply reallocating labor to the sectors where China enjoys a comparative advantage is nearing an end.

Consequently, China will likely have to rely on increasing economic efficiency to maintain rapid growth because an economic growth model based primarily on investment for export is presumed unsustainable in the long run. This begs the question: How can Chinese policymakers facilitate increases in economic efficiency and change the growth model? Prudent first steps lie in harnessing creative destruction and promoting competition to boost efficiency in overregulated sectors dominated by state-owned enterprises.

Reforming the Financial Sector

To that end, reforming China's financial sector is a critical step in providing long-run growth sustainability. Lessons and warnings from other emerging economies, whose lack of financial sector efficiency and transparency keeps them mired in the middle-income trap, are well known. China's economic miracle may face the same pitfall if it does not reform its financial sector.

This process of liberalization was codified in China's accession to the WTO. Upon entrance, China agreed to liberalize its financial sector, and timetables and deadlines were negotiated on when pre-WTO restrictions on foreign ownership and access to foreign and local-currency markets would expire. China agreed that within five years of WTO accession, foreign financial institutions would be permitted to provide services to all Chinese clients and geographic restrictions on where these institutions could conduct business were to be lifted. China has fallen behind on this schedule; many of the hurdles foreign firms faced before China's accession to the WTO remain.

China's recent foreign exchange policy reforms, such as the announcement of the People's Bank of China (PBOC) authorizing direct renminbi–yen trading, are small steps in the right direction, and I expect China to continue crossing this river, albeit by feeling the stones along the way. After all, it is hard to imagine that the world's second-largest economy will maintain a fixed exchange rate and a tightly controlled capital account forever.

Internationalizing the Renminbi

I have two convictions regarding the internationalization of the renminbi and China's capital account liberalization. First, I believe China should accelerate changes to improve the quality of domestic financial institutions before relaxing many of its capital account restrictions. Second, I expect China will adopt a posture of gradualism when internationalizing its currency.

Unlike trade liberalization, the consequences from capital account reforms are more nuanced. Capital account liberalization increases the efficiency of the global economy by allowing international capital to flow to the country that needs it most. However, rapid cross-border capital flows may also deal a severe blow to an individual country's capital account, unleashing a dynamic that can end in tears—predicating a financial crisis followed by a prolonged and painful

recession. Examples of the danger of unsustainable international capital flows to emerging economies abound— in much of Latin America throughout the 1980s and in the downturns in Mexico and some Asian countries in the 1990s. As the recent financial crisis demonstrated, even so-called advanced economies are not immune. The last thing we want to see is a similar crisis in an economy the size of China's.

History teaches that the benefit of capital account liberalization depends on the maturity of the domestic financial sector, with more developed, well-regulated structures yielding greater rewards from greater capital account openness. When a country has relatively deep financial markets to handle the ebbs and flows of rapid capital movements, it is less vulnerable to financial crises, especially if those markets are properly regulated. High-quality, prudently regulated financial institutions also help direct capital inflows to those sectors with the highest productivity. However, if institutions are weak and structurally unsound and regulation is precarious, liberalization can be a bane rather than a boon to economic growth. We have experienced this even in the deepest and most advanced marketplace in the world—the United States.

Is China Ready to Proceed?

We know the conditions under which capital account liberalization turns out well for emerging economies, but the trillion-dollar question remains: Is China ready to face the full implications of these reforms?

China has made moderate progress upgrading its financial sector over the past 20 years. However, several concerns remain, making the outcome of liberalization unclear. Right now, the most important price in the Chinese financial marketplace—the interest rate on bank loans—is not yet fully determined by the market. Just yesterday, the PBOC gave banks some leeway for lending rates, announcing that they will be allowed to lend at as much as 20 percent, from 10 percent, below the official rate. But, essentially, the PBOC still dictates both interest rates charged and the amount of loans commercial banks can make.

Moreover, China's securities markets, especially for bonds, are less developed than other major financial markets. In 2011, the outstanding stock of debt securities issued domestically amounted to $26.3 trillion in the U.S., compared with just $3.3 trillion in China. Bond liquidity remains very low in China; in fact, most debt securities are held until maturity and never traded. China's equity market is also relatively small and shallow. The capitalization of the Shanghai and Shenzhen stock exchanges is about 80 percent lower than the combined market capitalization of the New York Stock Exchange and Nasdaq Stock Market. Indeed, in many areas of financial market depth and breadth—foreign exchange turnover, exchange-traded derivative contracts, funds management assets, hedge fund assets and private equity—China trails not only the United States, but also Britain, Japan, France, Germany and Singapore.

It should be acknowledged that China has undertaken significant steps to reform its banks. Some, especially those that are publicly listed, operate similarly to their western counterparts. However, many loans are still dictated by administrative policy orders rather than by economic efficiency. State-owned enterprises usually have easier access to credit and more favorable loan terms than private enterprises receiving loans from state-owned banks. To increase banking sector efficiency, China should remove entry barriers to allow domestic private banks to enter and equally compete with state-owned banks. The "big four" state-owned banks dominate the

Chinese banking industry, and their too-big-to-fail status and explicit government support undermine market discipline, just as Fannie Mae, Freddie Mac and the too-big-to-fail banks do here in the United States.

Allowing more domestic competitors in the banking sector can help alleviate this issue. In the case of China, policymakers will need to operate state-owned banks based on a robust, prudentially regulated but profit-seeking model to fully embrace market reforms and the competition from domestic and foreign private banks that such reforms entail. On May 26, the China Banking Regulatory Commission relaxed some restrictions for private investors to participate in the banking sector. I was pleased to see such changes and hope China's policymakers follow up with additional reforms to encourage transparency and fair competition in the banking sector.

In addition to China's present domestic financial market infrastructure, the current domestic and international economic landscape is hardly hospitable to rapid capital account liberalization in China.

Following the global financial crisis in 2008, the Chinese government stimulated its economy with a 4-trillion-yuan package, or about $585 billion, an intervention far more aggressive than that chosen by any other major economy, especially relative to China's GDP. The stimulus package cushioned the country's economy from the collapse of international demand for Chinese exports, but it also created unpleasant effects that policymakers must now confront. Inflationary pressures have eased following the PBOC's tightening monetary policy in the last two years. However, asset bubbles in the real estate market and mounting local government debt remain serious threats to China's financial outlook.

Lurking in the Shadows…

During the recent credit boom fueled by the 4-trillion-yuan fiscal stimulus, off-balance-sheet lending by banks and private loans by nonbanks exploded. This shadow-banking lending activity accounted for an estimated 20 percent of China's total loans in 2011. With the cooling of the real estate market and with slower economic growth likely in the near term, a large share of these loans could turn bad. And because these loans took place outside the view of regulators, the effect of a sudden disruption in repayment is virtually impossible to predict.

On the international front, the sovereign debt crisis in the euro zone has resulted in much uncertainty and volatility in global financial markets. Should there be, say, a sudden and messy change in the participants in the economic and monetary union, a chain reaction might ensue that could result in some unpleasant responses. Just two weekends ago, for example, the Swiss National Bank warned that it is considering capital controls on foreign deposits if Greece leaves the euro zone. Clearly, any policy shifts affecting China's capital account must recognize the current fragility of global financial markets.

Implications for the United States

I would like to conclude my remarks with a few thoughts on the implications for the United States of an internationally traded renminbi.

My erudite friend, Barry Eichengreen, will speak to you tomorrow morning. I will leave in-depth analysis for the future prospects of the U.S. dollar in his capable hands. Suffice it to say that for

now, the U.S. dollar enjoys an "exorbitant privilege" as the dominant international currency. Despite the best efforts of the Congress of the United States to fritter away that privilege through reckless fiscal policy, I do not expect the supremacy of the dollar to face an immediate challenge.

It takes time for a major global currency to emerge and even more time for it to become dominant. Until recently, the dollar had no serious competitors for that status. But the creation of the euro—despite its current pathology—and the rise of new, ambitious economies like China threaten to challenge the dollar's dominant role, and the privileges that come with that dominance, at some point.

Yet, it is important to remember that dominant global currencies benefit from inertia, and old habits die hard. Standard practices and norms evolve only gradually when people use a currency in international transactions over a long period, and it takes time to convince businesses and central banks that a new currency is worth holding in significant magnitudes. The liquidity and the stability of the currency, and the government behind that currency, are kept under close watch to see if it will pass the muster as an effective store of value and medium of exchange on a global scale. However, once a currency is chosen as the global currency, it inherits a major incumbency advantage. For example, the U.S. economy overtook the U.K. economy in the 1870s, but the U.S. dollar required at least another 50 years to replace sterling as the most important global currency. Today, more than 80 percent of all global commercial foreign-exchange trades involve the dollar on at least one side of a transaction.

I do not claim that it will necessarily take more than 50 years for the renminbi to arise as a major global currency; things move more rapidly in the modern world. However, I think it safe to say that such a change will not happen overnight or even within the next decade. Besides, there is no reason for the Chinese to rush their ambition. Doing things right almost always turns out to be better than doing them quickly.

Presently, the only viable alternative to the U.S. dollar in terms of deep, liquid markets is the euro. But unless you're from the planet Mars, you know that the euro zone has its own difficulties. Despite the fiscal misfeasance in Washington, dollar-denominated government debt has remained what I have called on several occasions the "best-looking horse in the glue factory." But relative performance is hardly comforting. And it is noteworthy that euro-denominated German bunds trade at a yield below that of U.S. Treasuries. We shouldn't underestimate the political will among Europe's leaders to put in place measures that will ensure that the euro comes through its present crisis, or the determination of Chinese authorities to promote the renminbi to the status of a global currency. Ultimately, we face a very real risk of having formidable competitors to the dollar in the sweepstakes for sovereign investment.

In the past 30 years, China's economy has radically transformed from a closed and centrally planned system to a more-open and dynamic powerhouse that relies increasingly on market-based principles. Progress was made by accumulating single small steps in economic reforms, and China's consistent and robust GDP growth lends credence to this policy of gradualism.

Now China's economy is at another crossroads. I expect that China will continue to take measured steps to liberalize its capital account and internationalize its currency. To reap the benefits of a more-open capital account, the most pressing challenge confronting China is reforming its domestic financial sector by permitting competition from the private sector and

allowing the market to determine asset prices such as interest rates. Such changes can help China avoid falling into the middle-income trap and enhance sustainable economic growth.

The seemingly inexorable rise of China and the sheer size of its economy imply that the renminbi may someday play a role similar to that of the dollar. At present, it plays a very limited role on the international stage. But that role has gradually grown over time and will increase further as China's already-large presence in the global economy expands. As Chinese policymakers lay the groundwork for the continued internationalization of the renminbi, our nation's fiscal authorities must bear in mind that there may one day be viable alternatives to the dollar and U.S. Treasury debt as *primus inter pares*. The status of Treasury debt as the safest, most liquid and most desirable of all sovereign debt should not be treated as a foregone conclusion.

The privileges that status affords us will only be preserved if our fiscal authorities learn to budget responsibly. They must do so in a manner that provides our engine of economic prosperity—the private sector—with incentives to adapt and expand our economy, which in turn, anchors global confidence in America. Taking fiscal responsibility—and operating our central bank in a manner that maintains the purchasing power of the dollar—are key to defending and extending the unique position in global financial markets that the United States enjoys, and can continue to enjoy, even if China continues successfully crossing the river by touching all the right stones, catching still more of the globe's economic mice and becoming "gloriously" richer.

Thank you.

Notes

[1] Yang Rui is host of China Central Television's show "Dialogue." He writes a microblog that reportedly has more than 800,000 followers.

[2] See "Before China's Transition, a Wave of Nationalism," by Andrew Jacobs, *New York Times*, May 25, 2012.

[3] The renminbi is the official name for the Chinese currency; yuan is the unit of currency. The relationship is similar to that of the sterling/pound. The terms renminbi and yuan are used interchangeably.

[4] A superb biography of Deng Xiaoping can be found in Ezra Vogel's recent book, *Deng Xiaoping and the Transformation of China*, Cambridge, Mass.: Belknap Press of Harvard University, 2011.

[5] GDP per capita is based on 1990-yuan GDP per person, obtained from the International Monetary Fund.

[6] See "Beware the Middle-Income Trap," *The Economist*, June 23, 2011.

[7] "Made in America: U.S. Manufacturing Nears the Tipping Point," by Harold L. Sirkin, Michael Zinser, Douglas Hohner and Justin Rose, Boston Consulting Group, March 2012.

[8] From the *Wall Street Journal*, see "U.S. Market Shines Brighter," by Kate Linebaugh and James R. Hagerty, Feb. 8, 2012; "U.S. Manufacturing, Defying Naysayers," by John Bussey, April 19, 2012; "Indiana Steel Mill Revived with Lessons from Abroad," by John W. Miller, May 21, 2012; "Once Made in China: Jobs Trickle Back to U.S. Plants," by James R. Hagerty, May 21, 2012; "Detroit's Wages Take on China's," by Timothy Aeppel, May 22, 2012.