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Internationalization of the Renminbi (Yuan) and its Impact on East Asia

—the importance of risk control in the internationalization of the yuan —

TOMOYUKI NAKAGAWA

Institute for International Policy Studies

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In recent years, due to the changes in the environment surrounding China's yuan, there have been calls for revaluation of the currency in the near future. Chapter One of this paper examines the debate in terms of both advantages and disadvantages of the demands together with the response from the Chinese government to date and the timing that a change is most likely to occur. Chaper Two discusses the need for risk control in exchange between East Asian currencies and the risks in the internationalization of the yuan. Of relevance to development of a new currency system for East Asia is the question about whether the region should have its own currency. The benefits and demerits to a unified currency, as well as the problems in consensus-building, are examined. The paper concludes with recommendations for East Asian nations, particularly China and Japan, for making progress in resolving currency issues.

Introduction

Since autumn of 2002, calls for China to (1) revalue the exchange rate of the yuan, (2) review the exchange system (the dollar peg), and (3) liberalize capital transactions have intensified in Japan, the US and Europe, and vigorous discussion has ensued in forums such as international conferences. To summarize the discussion so far, demands for revaluation of the exchange rate lack validity, but the need to review the exchange system and liberalize capital transactions is clear. Under pressure from a number of countries to change its system, China appears to be resisting; however, it is acutely aware that such measures will be indispensable to the growth of the Chinese economy. Although some domestic problems remain, it is possible that China will soon take the plunge and internationalize the yuan.

Given China's enormous economic clout, the internationalization of the yuan would have a profound effect on other East Asian countries, compelling them to confront the risks inherent in the flotation of a new currency and to bolster their crisis management systems. The possibility that political and economic tensions between the US and China will arise in the future must also be taken into account.

In order to deal with these changes, East Asian countries must first review the excessive dependency of their currency systems on transactions via the dollar, and develop markets for direct transactions between East Asian currencies (including the yuan) and for hedging against risk. They must also consolidate in advance their plans for dealing with these changes, so as to avoid any repeat of the Asian currency crisis that might result from instability of the yuan due to China's domestic structural problems. Japan and China, the two key countries in this process, must take the lead and swiftly embark on joint research on a new currency system.

Chapter 1 Debate on revaluation of the yuan

1. Changes in the international environment surrounding the yuan

In recent years the environment surrounding China's yuan has changed greatly. Capital inflow is increasing against the background of China's increasing current account surplus, vigorous foreign direct investment in China by the US and other countries, the reversal in interest rates margins (yuan interest rates now exceed low-interest dollar deposit interest rates), and other factors. In the domain of illicit capital transactions too there has been a discernible shift from outflow from China to inflow to China. With the above, China's foreign currency reserves have grown sharply. (In the course of 2003 alone, foreign currency reserves increased by 116.8 billion dollars.) By the end of December 2003, China's foreign currency reserves stood at 403.2 billion dollars, higher than those of any other country in the world except Japan (whose reserves stood at 673.5 billion dollars in December 2003).

As a result, the expectation throughout the exchange markets since fall 2002 has been that since the yuan is low relative to China's economic strength, it might be revalued upward in the near future. For example, non-deliverable forward transactions carried out in Hong Kong since fall 2003 have assumed that the yuan exchange rate would be revalued by 5%-7%.

In addition, increased levels of cheap imports from China have generated economic friction in certain US and Japanese industrial sectors, and have led to increased pressure from industry associations and other groups demanding that something be done, such as a review (that is, a revaluation) of the yuan exchange rate. As a consequence of such activism, China was assailed throughout 2003 by increasing demands from all sides—including foreign governments—that it review the exchange rate of the yuan (specifically its administration of the dollar-peg policy), and the capital transaction system. Vigorous discussion ensued both at international conferences and in bilateral negotiations.

2. Demands that China review its systems

The demands that China review its exchange system and other mechanisms can be broadly classified into three categories: (1) revaluation of the yuan exchange rate, which is considered unreasonably low as a result of the dollar-peg policy; (2) changes to the exchange system—demands for a more flexible Chinese exchange policy in accordance with its economic clout that specifically urge China to abandon its dollar peg policy and switch to a floating exchange rate system; (3) liberalization of capital transactions, which are currently strictly regulated by the Chinese authorities.

The objectives of, and background to, the first category (revaluation of the yuan against the dollar) differ fundamentally from those of the second and third categories (change in the exchange system and liberalization of capital transactions). The principal objectives of the first category of demand are to reduce the unfair disparity in current account balances by reducing China's level of cost competitiveness, and to relieve trade friction. However, it is not yet clear whether the value of the yuan will rise or fall if the demands in the second and third categories are met. The main objectives of the second and third categories are to ensure that China (having attained a considerable degree of international economic clout) shoulders the same responsibilities as the advanced nations in fiscal and economic matters and establishes conditions that allow fair competition, and to encourage China to switch to a market-based system so as to avoid further distortion of its macro economy resulting from its unreasonable dollar peg policy.

This paper will attempt to summarize the various demands made of China throughout 2003 based on the above classification, using as an example the debate in the US.

2-1 Discussion in the United States Congress

Discussion in the United States Congress has focused on the first category of demand—revaluation of the yuan exchange rate against the dollar. In July, several senators, including Senator Charles Schumer and Senator Elizabeth Dole, requested that the US Treasury Department investigate whether the Chinese government was unfairly undervaluing the yuan in order to make Chinese exports more competitive. The House of Representatives Committee on Small Business also requested that Secretary of the Treasury John Snow urge the Chinese government to switch to a floating exchange rate system. September saw the introduction of four bills, including a draft resolution (co-sponsored by Representative Phil English) requesting that China switch to an exchange system based on market economics and abide by the norms of the international trade system, and a bill (co-sponsored by Senator Schumer) requesting that China revalue the exchange rate and review the management of its currency, and mandating the imposition of a 27.5% tariff on imports from China, should it fail to do so.

Against the backdrop of these actions in Congress, some scholars and research organizations have conducted analyses which suggests that the yuan is undervalued against the dollar by between 15% and 40%. Moreover, industry organizations have asserted that US unemployment has been exacerbated by the actions of China, Japan, and other Asian countries deliberately and unfairly undervaluing their currencies, and these assertions have had considerable effect. In fact, however, according to numerous reports, large US companies that have production facilities in China or that are heavily committed to Chinese markets seem apprehensive about the potential disadvantages of a revaluation of the yuan. It is thus unreasonable to suppose that US industry and special-interest organizations will doggedly continue their calls for a revaluation of the yuan.

As well as implying that China needs to review its systems, the actions of the US Congress and the opinions of certain academics described above also suggest that the issue of the close linkage between the dollar and other Asian currencies, such as those of Japan, South Korea, and Taiwan, must also be addressed. For example, in testimony before Congress, Morris Goldstein of the Institute for International Economics, a US think-tank, asserted that unless the yuan is revalued, it will be impossible to carry out the exchange rate realignments that are required to correct balance-of-payments disparities with Asia and other regions, and that resolution of the yuan problem represents the first step in pursuing US currency policy towards Asia.

2-2 Action by the US government

The demands that the US government and the Federal Reserve Board (FRB) have made to the Chinese government and the People's Bank of China fall into the second and third categories— namely, demands for changes to the exchange system and for liberalization of capital transactions. They are not demanding that China revalue the yuan. This position frames the US government's sober assessment that China's balance-of-payments surplus with the US is not the main cause of the US's international balance-of-payments deficit. The US has issued strong demands to China in international forums such as the G7 and APEC. With the up-coming US presidential election, it might appear on the surface that the repeated statements by President Bush and Secretary Snow urging China to make tangible progress towards a floating exchange system have been made to achieve short-term results and improve Bush's chances for re-election. However, the basic stance of the US government may be designed to avoid misalignment in the medium-to-long term.

The thinking of the government and the FRB has been clearly revealed in congressional testimony before both the Senate and the House of Representatives. Giving testimony before Congress, FRB chairman Alan Greenspan warned that if China, which has increased its economic clout and which now attracts enormous volumes of capital, continues its dollar peg policy, there is a danger that its domestic monetary system will become greatly distorted. He went on to state that, in order to obviate this danger, China must switch to a floating exchange system. Under-Secretary of the Treasury John Taylor also expressed this view, adding that China must also attempt to relieve upward pressure on the yuan from the market by relaxing controls on capital outflow.

The US government is expected to apply political pressure to China to keep up the momentum for reform of its exchange system, while at the same time negotiating realistic measures for pursuing this course.

3. The validity of the demands and their advantages and disadvantages

3-1 Revaluation of the yuan against the dollar

The demands for a revaluation against the dollar are of questionable validity. Firstly, it is not clear what the appropriate level of the yuan against the dollar should be. Secondly, there may be little advantage in a revaluation of the yuan for developed countries such as Japan and the US.

In the first place, it is difficult to divine the appropriate exchange rate theoretically. There is a wide range of estimates of the degree to which the yuan is undervalued (as discussed above). Based on the yuan's purchasing power, organizations such as the World Bank and the IMF estimate that it is undervalued by about 80%, whereas various US academics place the figure at between 15% and 40%. The validity of all these estimates is open to question. Among other criticisms of China, there is an entrenched view that China's international competitiveness was unfairly boosted by the massive official devaluation of the yuan (by approximately 30%) in 1994. However, it has been pointed out that at the time the official devaluation was in line with existing conditions and was in recognition of the fall in the market price of the yuan, and that the effects of this substantial devaluation were small.

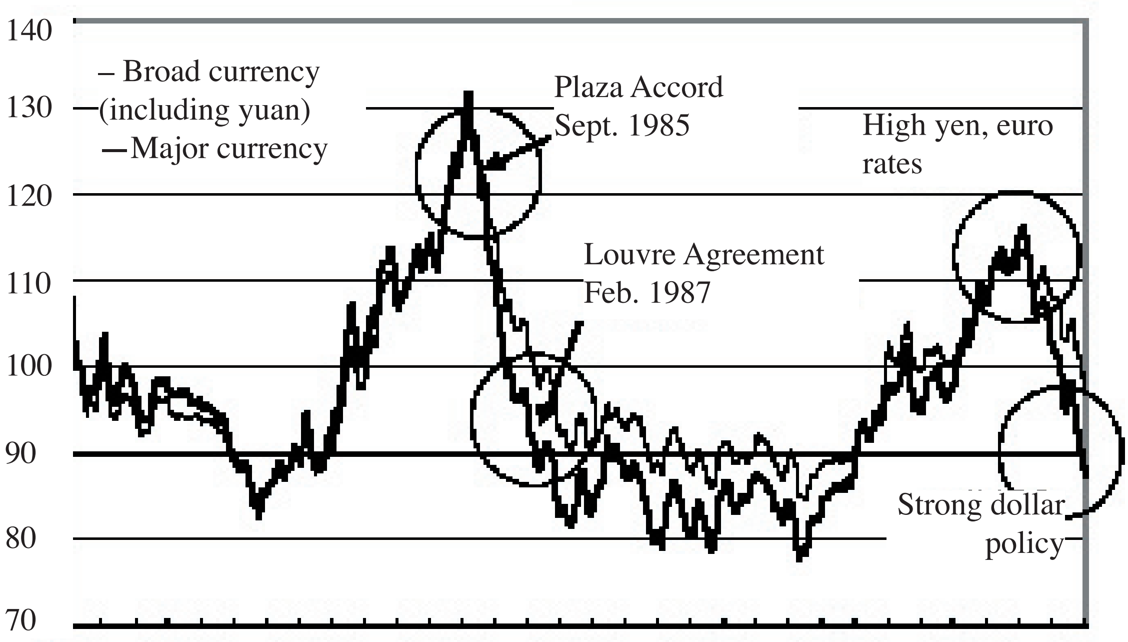
From the outset, demands for a revaluation of the yuan have played to a large extent on the dissatisfaction of industries forced to contend with imported goods made in China. However, the US government, academia, and the IMF have all concluded that a revaluation of the yuan would not alleviate the US balance of payments deficit.

Even among companies and researchers, there is growing recognition that, for international companies with manufacturing and sales facilities in China, the downside of revaluation would be impossible to ignore. In fact, the main cause of the sharp increase in the level of exports from China is the growth in exports from the manufacturing facilities of foreign companies in China—goods exported by foreign companies recently account for approximately half of China's exports. By comparison, the increase in the level of exports by Chinese companies is unremarkable. Revaluation of the yuan would lead to increased processing and production costs at manufacturing facilities in China. Hence, if the yuan were significantly revalued, companies would be forced to review their production facilities and alter their direct investment programs.

Thus it is not a well thought-out policy for developed nations to demand a revaluation of the yuan solely in order to protect certain industrial sectors and to retain their industrial competitiveness with China. Of course, in the case of the US, the clamor of dissatisfaction from industry, which is losing out to Chinese products in a price war, cannot be ignored from a political standpoint. Thus, demands for revaluation of the yuan are likely to continue, due to internal political considerations in the developed nations. In reality, however, this issue does not represent a *sine qua non* in trade negotiations, but is simply a bargaining chip that can be used to exact compromises from the Chinese side.

3-2 US government policy on the yuan

When the issue of adjusting the value of the yuan is viewed from a slightly different perspective, the medium-term policy goals of the US government become clearer. There is a view among researchers in international finance that the real effective dollar rate set by the FRB is key to an understanding of US currency policy. In fact, at past critical junctures in US currency policy, such as the Plaza Accord and the Louvre Agreement, the real effective dollar rate has zigzagged between the two extremes of a strong dollar and a weak dollar.



Transition of the effective dollar rate

Source: FRB

Judging from recent movement in the real effective dollar rate, the dollar had already entered a decline in 2002 and 2003 in the face of the rise in the value of the yen and the euro against the dollar. From this perspective, strong demands for a revaluation of the yuan acquired added significance for the US in 2003, a year that saw energetic international discussion of yuan revaluation. Consequently, for the US the current round of discussion on revaluation of the yuan can be viewed as a preparatory skirmish for future currency negotiations with China, in which the US is throwing some powerful initial jabs. In other words, an advance revaluation of the yuan would serve as a foundation for a future rebound in the real effective dollar rate. Assuming that the dollar's recovery follows the same 15-year cycle as in the past, serious moves for revaluation of the yuan will be made between 2010 and 2020.

3-3 Changes to the exchange system and liberalization of capital transactions

Considering China's domestic and foreign economic environment, changes to the exchange system and liberalization of capital transactions (the second and third categories of demand described in the preceding section) are key issues that require an active response from the Chinese government. This has been pointed out by many researchers—including Chinese researchers.

The reasons why changes to the exchange system are necessary are as follows: both an increase in domestic inflationary pressure due to excessive purchasing of foreign currency and distortion of monetary policy must be avoided; price information (including exchange rates) based on market values is required in order to create a favorable impression of investment in China; and with the growth of China's international economic clout, an environment of fair competition must be established through the adoption of a market-based exchange system.

The first of these points (avoiding problems such as inflationary pressure) is particularly important. Among other voices, FRB chairman Alan Greenspan and the IMF have expressed their concerns on this matter. For its own sake too, China must address this problem in order to maintain stable economic growth.

China continues to boast favorable industrial conditions featuring an abundance of cheap (but high-quality) labor, and to see a large influx of direct investment capital from investors who anticipate future market expansion. It can be assumed that this influx of capital will continue for the time being as the Chinese government pursues policies designed to sustain high growth in the run-up to the 2008 Olympics in Beijing and the World Expo 2010 in Shanghai. As part of this initiative, the Chinese government (in the form of the People's Bank) is buying large amounts of foreign currency to stop the yuan from rising. However, the concomitant flow of large amounts of capital into China is at the same time exerting inflationary pressure on the Chinese economy.

If the People's Bank continues to buy foreign currency in order to maintain the exchange rate, it is highly likely that before long it will become difficult to absorb the domestic surplus capital. There are fears that this irrational policy might increasingly distort the domestic economy and touch off a chain reaction: rapid inflation, followed by a rise in interest rates, followed by accelerated capital inflow and worsening domestic business conditions, followed by the exacerbation of various structural problems (such the disparity in earnings, problems at financial institutions, and problems with state-owned companies), followed by capital flight leading to internal political and economic instability. Some researchers also point out the illogicality of a situation in which China invests its foreign currency reserves in the form of low-interest US loans while Chinese companies are forced to pay high interest rates in order to obtain capital.

One reason why capital transactions must be liberalized is that relaxing the regulation of capital outflow will allow sudden increases in foreign currency reserves to be avoided. There is a second and even more pressing reason. In China it is now generally accepted that in order to sustain a high growth rate in an environment of global competition, China will have to ensure that Chinese companies are more internationally competitive. There is a growing sentiment that, to this end, Chinese companies need to be encouraged to set up operations overseas (that is, to establish foreign sales and production facilities, and to acquire technology through mergers and acquisitions) as a supplement to the technology transfers achieved through foreign direct investment into China. This sentiment is sparking increasing calls for lighter regulation of capital transactions.

3-4 The effect of exchange system changes and capital transaction liberalization on the yuan

It is not clear at present what effect changes to the exchange system and the liberalization of capital transactions would have on the level of the yuan. Even experts offer differing opinions on this topic.

Factors cited as potential causes of a rise in value include the current favorable situation for foreign investors (the current account surplus, low proportion of foreign debt, and abundant foreign currency reserves); vigorous inward foreign direct investment; and expectations of a rise in value. On the other hand, there is no shortage of factors suggested as potential causes for a decline in the value of the yuan. These include the risk of a deterioration in the current account balance, weaknesses in the financial system (such as problems associated with bad loans), the immaturity of Chinese capital markets (and their limited investment opportunities), rises in overseas interest rates such as those in the US, and the manifestation of pressure for foreign capital flight. For example, on top of the slowdown in foreign direct investment into China in the latter half of 2003, the Asian Development Bank is now forecasting that, as imports exceed exports due to increased domestic demand, China's current account balance to GDP ratio (which stood at +2.9% in 2002 and +0.2% in 2003) will go into the red and reach –0.1% in 2004.

For the past few years, discussion has focused on pressure to raise the value of the yuan. However, in the case of China there are many issues and uncertainties. If the current environment persists, there will be no smooth ride. In pursuing changes to the exchange system for the yuan and the liberalization of capital transactions, the Chinese government must bear in mind the possibility of capital flight and a fall in the value of the yuan, and must without fail put elaborate precautions in place while keeping a weather eye on movements in financial and capital markets.

4. The response from the Chinese government

In response to demands from various countries relating to the yuan, the Chinese government has so far refused to conduct a full-scale review of its systems. In justifying China's position, President Hu Jintao and Prime Minister Wen Jiabao have said that exchange policy is and should be determined according to China's level of economic development, its economic situation, and its international balance of payments; maintaining stability of the yuan not only sustains China's economic and financial development, it also contributes to the stability of the economies and financial situations of neighboring countries and the region, and lends stability to the world economy and the global financial situation. As recently as February 2004, Prime Minister Wen (at a national working conference on banking, securities and insurance) and Zhou Xiaochuan, the governor of the People's Bank of China (at a conference of People's Bank managers) both declared that they will gradually seek to improve the exchange rate formulation mechanism over the course of the year. However, their basic position emphasizing stability of the level of the yuan remains unchanged.

The Chinese government is thought to be maintaining a conservative attitude because the new Hu Jintao administration has up until now been finding its feet and is not yet ready to take momentous decisions; solving domestic structural problems (such as in employment, finance, and state-owned companies) is the top priority; the government is taking account of domestic sentiment that is resentful of political pressure from abroad; and the outbreak of SARS has cast a shadow of uncertainty over the climate for investment into China.

However, these facts do not signify that the Chinese government is half-hearted on the issues of change to the exchange system and the liberalization of capital transactions.

Even before the debate on revaluation of the yuan entered full swing in the international arena, the Chinese government had from the outset recognized the need for a review of these systems. In this context the government is keenly aware that in order to maintain high economic growth, it will have to make even greater use of foreign capital and improve the international competitiveness of Chinese companies. It thus appears that the government will have no choice but to liberalize capital transactions. The debate in the Third Plenary Session at the 16th National Congress of the Communist Party in fall 2003, and at the conference of People's Bank managers and other meetings in financial circles in February 2004, is testimony to the strong sense of crisis harbored by the Chinese government.

Meanwhile, the People's Bank has already published a research paper in China on the process for increasing the yuan fluctuation band, which proposes that the band be expanded in 2005 to allow the yuan to fluctuate against the dollar by ±5% compared to the previous day's value. Research is also proceeding on pegging the yuan to a basket of currencies. The Development Research Center of the State Council is also asserting the necessity of expeditious changes to the system.

On the other hand, the concern about capital flight overseas that underpinned the strict regulation of capital transactions is fading, due to recent increases in foreign currency reserves. Rather, it is now asserted that the current economic environment, which is favorable to other countries, represents a good opportunity for making changes to the system. There is also a widely held optimistic view of the potential side-effects of changes to the system, which holds that a rise in the level of the yuan would not harm China's comparative ascendancy, as it possesses an abundance of cheap labor.

In this light it appears that the Chinese government will take the initiative in making changes to the exchange system and liberalizing capital transactions. As for the time scale and the actual methods employed, the innately conservative Chinese government also includes a progressive faction which advocates setting a firm goal of revising the exchange system and liberalizing capital transactions simultaneously over the next five years or so, to cope with rapid changes in the international environment. The Chinese government is pursuing investigations into changing the exchange system and liberalizing capital transactions while simultaneously dealing with domestic structural problems, and there is every chance that within the next few years they will present concrete plans for doing so.

Though dramatic reforms are problematic at this time, there are cumulative results expected from smaller steps like those taken in 2002 and 2003—minor liberalization of capital transactions (relaxing regulations on taking foreign capital out of China, introduction of the QFII system, and institution of procedures for outward foreign investment), strengthening of the financial system (injecting public funds into the national bank), and allowing a greater range of fluctuation in the exchange rate.

5. Timeline for internationalization of the yuan

As has been seen, the US government (the Chinese government's toughest negotiating partner) is essentially demanding that China switch over to a floating exchange system in the medium term. It is thought that the US will continue to apply constant pressure on China; however, it is likely that negotiations will enter high gear between 2010 and 2020.

On the other hand, it is thought that the speed with which the Chinese government voluntarily gets to grips with this problem will essentially depend on how difficult it is for China to solve its own internal structural problems and how much progress it makes in doing so. Yet, given China's positive attitude towards engaging in this task (as described in the preceding section), it is also possible that within a few years the government could spell out a definitive course of action of some description—domestic political and economic considerations permitting. In fact, at the end of 2003 the government took bold steps to alleviate one potential internal structural bottleneck—the problem of bad loans. Measures included a generous injection into the national banks of capital drawn from foreign reserves. It is thus possible that the speed of change in China will surpass expectations.

Examples from the past may serve as an indication of future trends. Although the circumstances surrounding Japan and China differ, it is worth comparing the two countries' respective processes towards liberalizing foreign exchange and the balance of payments account. The table below shows record data for Japan in 1964 and China in 1996, when these countries adopted Article 8 of the IMF Articles of Agreement, forbidding restrictions on current account transactions. If these figures are compared, some interesting facts emerge.

	Japan		China	
1st year	1963 1964	Widened floating range of yen (0.5%→ 0.75%) Adopted IMF Article 8 Tokyo Olympics held	1996	Adopted IMF Article 8
5th year	1966 1967 1969	Loosened currency restrictions (up to USD500) Capital Account liberalization Step 1 Capital Account liberalization Step 2	1998 2001	Loosened foreign exchange business concentration rule Entered WTO in Dec.
7th year	1970 1971	Capital Account liberalization Step 3 Liberalized forex bank business abroad Loosened currency restrictions (up to USD1000) Temporary shift to floating rate system	2003	Calls for yuan revaluation
9th year	1973	Floating exchange rate system	2005	
16th year	1980	Abolition of all capital control	2006 2008 2010 2012	Total market access in accordance with WTO agreement Olympics in Beijing World Expo in Shanghai

Chronology of Japan and China after their adoption of Article 8 of IMF code

Source: Bank of Japan

After ascending to Article 8 status, Japan implemented a series of measures to liberalize capital transactions. Seven years later in 1971, it provisionally switched over to a floating exchange system. In 2003, precisely seven years after China became an Article 8 member of the IMF, international attention focused on revision of the yuan exchange system. In 1973 (nine years after its accession to Article 8 status) Japan switched over fully to a floating exchange system, and in 1980 (16 years afterwards) it fully liberalized capital transactions. China will pass the 16-year mark in 2012—after the end of the World Expo in Shanghai.

The above comparison offers no guarantee that China will fully liberalize capital transactions within the same time frame as Japan did. However, in this era of global competition, any Chinese delay in liberalizing capital movement will result in investment shifting to developing countries such as India and allow them to catch up rapidly. Statements by Chinese officials reveal that they are perfectly aware of the rigor of the world situation and it is entirely possible that the Chinese government will complete liberalization in a shorter time span than Japan did.

In the light of the conditions outlined above (such as the prevailing international environment and China's own domestic situation), it seems reasonable to assume that up until 2010 there will be a gradual improvement of international convertibility of the yuan (such as widening of the exchange fluctuation band and relaxation of the regulation of capital outflow), and that substantial changes will occur between 2010 and 2020.

Chapter 2 The need to control risks accompanying the internationalization of the yuan

6. Impact of internationalization of the yuan on East Asia

There are two key points when considering the impact on East Asia of internationalization of the yuan. Firstly, what effect would it have on US currency policy towards East Asia? Secondly, what effect would be created by newly trading on the international market of the currency of a country with enormous economic clout?

6-1 Effect on US currency policy towards East Asia

As seen in Chapter 1, it is not just the strong linkage between the yuan and the dollar that is the subject of controversy in the US, but also that between a number of East Asian currencies and the dollar. On its own, abolition of the yuan peg to the dollar cannot be expected to improve the US balance of payments situation, as factors such the US's IS balance problem and East Asian exports to the US (both directly and via China) continue to play a role. Thus, it is highly possible that increasing demands will be heard in the US for a reduction of the linkage between East Asian currencies and the dollar. In particular, it is thought that, as the real effective dollar rate swings sharply upwards again, a decline in the competitiveness of US industry (for example between 2010 and 2020) will represent a major problem. At that time it is possible that East Asian countries will be compelled to choose an alternative course, such as a completely floating exchange system or a new anchor currency (a basket currency, for example). The wrong response at this time could also bring about financial instability, as the result of a currency attack for example. To avoid this, East Asian countries should prepare for the inevitable adjustment between their currencies and the dollar and move forward with advance plans for a new currency system for East Asia.

6-2 Trading the currency of an economic giant

International trade by countries in East Asia has created an economic network that hinges on a division of labor with Japan and exports to the US market. As copious research has made clear, movements in the values of East Asian currencies within this network are closely linked to movements in the value of the dollar or the yen. Thus, when considering the exchange risks involved in international transactions, it has generally been enough to take into account the relationships between the yen, the dollar and the euro. Furthermore, neither markets for direct exchange between East Asian currencies nor markets for hedging against risk have been cultivated. It is possible, however, that the internationalization of the yuan will cause this relationship to fall apart.

The biggest difference between the yuan and other East Asian currencies is that the Chinese economy is blessed with an enormous domestic market. At present, exports and direct investors are increasing; however, China also has the might to form a future economic bloc quite distinct from Japan, the US, and Europe—one that would hinge on domestic demand. China also has economic policies and a business cycle that are unique to itself. Thus, if China moves closer to a floating exchange system and fluctuations in the exchange rate are determined to a larger extent by transactions in the market, the level of the yuan will be decoupled from the movements of the yen and the dollar, and the yuan may fluctuate as a result of conditions within China.

Considering how China's economic clout has grown (in terms of its market and manufacturing facilities), it is also possible that in time the yuan will come to rank as the fourth major trading currency in East Asia, after the dollar, the yen, and the euro. Notably, ASEAN nations and other countries are strengthening bilateral relations with China in various ways, such as by concluding free-trade agreements (FTAs). Their exports to China and reliance on Chinese capital are growing. Although it is still a far off dream, a number of researchers in ASEAN countries suggest that the prospect of East Asian regional economic integration centering on China is becoming more tangible. Fluctuations in the level of a yuan that is no longer linked to the dollar will have significant effects (both positive and negative) on the exchange rates and economies of East Asian countries.

Given the specter of these changes to the financial and economic environment, East Asian countries will probably need to strengthen their measures for responding to new currency fluctuation risks and their risk management capabilities as the yuan is internationalized.

6-3 State of risk management for exchanges between East Asian currencies

The internationalization of the yuan will thus increase the importance of risk management for exchanges between East Asian currencies. However, East Asian currency systems are not ready to cope with this.

Within the East Asian region, no markets have been cultivated for direct exchange between the various East Asian currencies. Settlement amounts in foreign currency transactions in East Asia are denominated for the most part in dollars, followed to a much lesser extent by yen, euros, Australian dollars, pounds, and Singapore dollars. Settlements denominated in East Asian currencies other than the yen are negligible.

The reason for this is two-fold: East Asian countries prefer the dollar for international transactions, and East Asian countries conduct two-stage transactions in their currencies using the dollar as an intermediary currency. For example, when an exchange transaction is carried out between the yen and the won, the exchange rate is determined by multiplying the yen/dollar exchange rate by the dollar/won exchange rate. Furthermore, by the time capital settlement has been fully completed and the yen converted into won, a transaction outside the East Asian region will have been interposed.

This use of the dollar as the intermediary currency in exchange transactions carries with it two kinds of risk for East Asian currency mechanisms. Firstly, from a practical point of view there are settlement risks due to the time differences between markets, since this type of transaction depends on transactions conducted in markets outside the region (which have no regard for the fact that they involve settlement between East Asian currencies). Secondly, in a more political vein, matters such as the formulation of exchange rates, crisis management, and the monitoring of exchange and capital transactions depend heavily on the US government and US markets.

For this reason, bilateral relations between the US and the nations of East Asia (relations that take no account of the relationships between East Asian currencies) have come to exert a strong influence, alongside the financial and economic conditions and policies of the region.

In the latter category of risk, Sino-US relations deserve particular attention. It is possible that in the future political, economic, and military friction will arise between an America that has increasingly tended towards unilateralism in the post-Cold War era and a China whose international clout is growing along with its economy. In one hypothetical scenario for East Asia, economic regional integration centering on China (possibly in tandem with Japan) develops, while security relations continue to revolve around the US, with the imbalance between these two polarized relationships creating tension. Even if conflict does not arise, if there are no systems in place for dialogue and policy coordination, there would be no cooperation on risk management between the respective currency authorities of the US and China. In short, the risk management mechanisms do not measure up. The over-reliance on the use of the dollar in transactions involving East Asian currencies (particularly in transactions involving the yuan) entails the risk that the latent antagonism between the US and China might spill over and destabilize the exchange rate. Hence, maintenance of the international political balance is also an important prerequisite for currency stability in East Asia.

The countries of East Asia must take the opportunity afforded by the internationalization of the yuan to think about forming a new currency system that can ensure stability in East Asia, while at the same time giving due consideration to the risks involved. They face the crucial choice of whether to persist with the use of the dollar as an intermediary currency in exchange transactions between the yuan and other East Asian currencies, or to set up new mechanisms and markets for currency transactions.

7. Risks in the unstable yuan

As internationalization of the yuan progresses, the influence of the yuan exchange rate on the fluctuations of other East Asian currencies will increase. Presumably the scale of capital movement will also increase considerably and mutually dependent relationships will become all the stronger as a result of the liberalization of capital transactions. East Asian countries must therefore strengthen their provisions for coping with eventualities such as economic destabilization resulting from a worsening of China's internal structural problems.

As numerous academic papers have pointed out, China suffers from a multiplicity of internal structural problems. These include problems with state-owned companies, bad loans, the lack of development of direct financial markets, budget deficits, problems arising out of regional differences, deflation, unemployment, environmental problems, limited resources and energy, and the risk of instability in the power structure inherent in China's progress towards democratization. Guarding against all the different types of risk is both complex and time-consuming. Dr. Charles Wolf, Jr. of the RAND Corporation in the US has suggested the possibility that a number of these risks might materialize simultaneously.

On the other hand, the Chinese government will be compelled to internationalize the yuan quickly in order to survive stern global competition. It is very possible that after solving its internal structural problems to some degree (though some remain), China will proceed with the internationalization of the yuan in parallel with its response to its internal problems. Hence, it is possible that in the course of the internationalization of the yuan China's internal problems might unexpectedly worsen, or that changes to the environment brought about by the internationalization process itself might exacerbate these internal problems. There is thus a significant risk that the yuan might become the target of a currency attack.

It is expected that if internationalization of the yuan proceeds, it will foster closer economic ties between China and East Asian countries—including Japan. However, if the yuan were then destabilized (for example, by a currency attack), the effects would be far-reaching. Fortunately, the lessons of the last Asian crisis have been taken to heart and a bilateral currency swap network based on the Chiang Mai Initiative is being established as a counter-measure. (By December 2003, this network amounted to a total of 36.5 billion dollars.) Bearing in mind the scale of China's international economic activity, however, the scale of any such crisis would be huge and its effects severe. Support structures should be both comprehensive and multi-tiered to the degree possible.

It will also be necessary to establish a basic infrastructure that allows crises to be averted before they occur and swift responses to be made to crises after they occur. To this end it will be necessary in non-crisis periods to acquire accurate information on China's markets and on its financial and economic trends, and to put together systems that can carry out detailed surveillance. It will also be important to create opportunities for frank dialogue between the Chinese government and the nations of East Asia on topics such as macro economic management.

Since the Asian crisis, East Asian nations have been keenly aware of the need to establish crisis management systems and have made a certain degree of progress in implementing counter-measures, such as those described above. Japan's government and central bank have played a leading role in establishing these systems. From now on the focus should thus probably be on accumulating case studies and drawing up contingency plans so that this framework can actually function in the event of a crisis. A particularly important part of that process will be to prepare plans for responding to specific scenarios, bearing in mind the possibility of currency crises involving the yuan between 2005 and 2010 or 2010 and 2020.

8. On the road to a unified currency for Asia?

The inevitable question posed regarding a new currency system for the East Asian region is "should the region have an Asian currency unit?" There would be both advantages and disadvantages to this, and the debate is yet to be resolved.

At the dawn of the twenty-first century, the international environment is undergoing profound change. In East Asia the trend towards regionalism is gathering steam against a backdrop of failed WTO talks, an increase in the number of FTAs concluded, the enlargement and diversification of the EU, and international opposition to US unilateralism. As part of this trend, voices are now often heard in East Asian countries asserting the need to aim for the establishment of an East Asian community, to introduce an Asian currency unit, to establish an Asian monetary fund (AMF), and to develop Asian bond markets. At a meeting of the ASEAN+3 finance ministers staged in August 2003, agreement was achieved on the development of Asian bond markets with the endorsement of the Asian Bond Market Initiative, and so tangible advances are now being made.

Judging from the lessons to be learned from the introduction of the euro, the introduction of a single Asian currency could bring with it numerous benefits: (1) the risks and costs inherent in exchange transactions between East Asian countries would be eliminated; (2) a unified presentation currency would encourage competition in financial markets and movement of assets within the region; (3) the increased bond liquidity that would accompany the creation of an Asian currency unit would accelerate the development of regional financial markets; and (4) the onus for maintaining exchange rate stability and financial order would be shared equally between the nations of the region. Furthermore, the enhanced European unity that represents the successful culmination of 50 long years of efforts to introduce the euro in Europe should serve to embolden the people of East Asia. Tackling the issue with long-term vision and strong political will would offer them the hope that it might be possible to establish a regional community in East Asia as well.

Naturally, fluidity and instability in the relationships between East Asian currencies between 2010 and 2020 due to the internationalization of the yuan represent a clear and present danger. However, the introduction of a single currency for Asia (or, as a preparatory measure, the introduction of a framework analogous to the ECU/EMS system) will take a long time. First, two goals must be achieved: (1) a consensus must be established among East Asian nations, equivalent to the EU's Treaty of Rome, regarding the necessity of establishing an East Asian community, and (2) numerous preconditions must be fulfilled in order to clear the way for work to begin in earnest. Without going into detail on specific issues, it should be noted that there are problems associated with both of these goals, some of which are described below. In particular, issues regarding consensus-building include problems relating to political systems, society, culture, and security. These aspects go to the very heart of how any regional community ought to be established (such as whether it would be better to establish a tight-knit community or a loose federation). If these problems cannot be solved, it will prove impossible to introduce a single Asian currency stably, and thus should not be undertaken. This too is a lesson that can be learned from the repeated bitter experiences of Europe.

Problems in consensus-building

- Lack of political will for the creation of a regional community.
- Differing political systems among the various nations involved, which include democratic nations, socialist nations, and military dictatorships.
- Differing cultures, social systems, and religions. In particular, the advisability of bringing Muslim and non-Muslim societies together. Problems with recognizing history.
- Security systems that depend heavily on bilateral relations with the US.

Preconditions for commencing work in earnest

- In comparison with Europe, there is huge disparity in the levels of economic development of East Asian countries and enormous diversity in their economic systems. As a result, numerous coordination measures will be required in order to fulfill the economic preconditions that are necessary for the introduction of a common currency. These include the following: (i) coordination of macro-economic policies and unification of the business cycles of the economies of the countries in the region; (ii) achievement of uniformly low inflation rates; (iii) establishment of economic soundness; (iv) achievement of stability in the relative values of the different currencies; and (v) establishment of a common market (freedom of movement within the region for people, assets and services, and capital).
- Revision of industrial structures that are heavily reliant on exports to the US.

It is vital to seize the opportunity offered by the internationalization of the yuan to review East Asian currency systems and to make progress in establishing a new framework. In light of the problems outlined above, however, it would seem inappropriate at present to embark on the introduction of a common currency for Asia as an immutable goal. Unstinting efforts should first be focused on addressing the most pressing issues at hand and establishing a framework that will enable countries to deal with the new exchange risks that will accompany internationalization of the yuan, and avoid currency crises. It would seem more appropriate to view the introduction of a common currency for Asia as a step that might be taken after internationalization of the yuan has been safely concluded, and to investigate this option as political and economic momentum for the creation of an East Asian regional community builds.

9. Realistic options

9-1 The trials and tribulations of ensuring stability of the yuan

The first method that comes to mind for countering the new exchange risks is to limit the yuan's fluctuation band. It seems that, as a matter of urgency, either the yuan's fluctuation band against the dollar should be widened under the existing fixed rate system, or an alternative method should be adopted whereby the fluctuation band is widened and the central parity level is gradually adjusted (this is known as a target zone system). This technique will probably be effective to a certain degree as long as agreement can be obtained from the US government on the level of the yuan against the dollar and regulation of capital transactions continues. Naturally, demands for a revaluation of the yuan from the US, Europe, and Japan are likely to continue, and, as the regulation of capital transactions is progressively relaxed, market pressures will inevitably intensify in anticipation of a revaluation of the yuan. As previously argued by a number of voices, including the IMF and various experts, resistance to market pressure by monetary authorities when the exchange rate approaches the upper or lower limit of the target band constitutes a problem. It is highly likely that this exchange system would sooner or later prove to be untenable for the Chinese economy, given its heavy dependence on overseas trade.

Alternative methods are a peg to a basket currency or a target zone system based on a basket currency. This latter system is referred to as the BBC (basket, band, crawling) method. This method is superior to the dollar peg. A peg to a basket currency based on criteria such as trade weighting would be conducive to stable relationships between the yuan, the yen, and other East Asian currencies. Compared to a single-currency (dollar) peg, this system would also be more likely to allay demands from the US government for a rate revaluation and to alleviate market pressures somewhat. Consequently, this method has attracted widespread endorsement from experts—including homegrown Chinese specialists.

Naturally, there are also problems with certain aspects of a currency basket peg system, such as the definition of the currency basket (whether trade weighting is used, and whether the weight of the dollar should be limited), the pegging technique (which currency should be used for interventions), transparency, and restrictions on domestic financial policies. In previous currency crises, basket-currency pegs have collapsed, and so this system does not constitute a secure framework capable of withstanding seismic shifts in the economic environment.

It would be no bad thing if China were to adopt a fixed exchange system like the one described above during the transition period in internationalizing the yuan, and thus preserve a certain degree of exchange rate stability. China would thereby gain time to build experience in ensuring currency stability. However, it would be a mistake to place too many expectations on Chinese adoption of a fixed-rate exchange system. Given the increased economic clout that China wields over other countries and the considerable risk of economic upheaval (such as a deterioration in China's domestic structural problems), it may well be that, once progress has been made on internationalization of the yuan, its level will fluctuate wildly—driven by these very factors that are unique to China. In any event, as a sovereign state China will decide for itself which exchange system it wishes to adopt. Other nations should not rely on China's decision.

9-2 Means of stabilizing currency systems in the East Asian region

With the emergence of a markedly fluctuating yuan, Japan and the rest of East Asia will in the near future face the risks of currency instability caused by pressure from US currency policy and domestic factors in China, and currency instability caused by changes in Sino-US relations. In this context measures must be devised for mitigating the new exchange risks, to whatever degree possible, and for avoiding a currency crisis.

As an initial counter-measure, markets must be established and developed for hedging against the risk of fluctuations in the yuan due to China's domestic problems. Due to China's regulation of capital transactions and its existing dollar peg policy, the only currently available method for hedging yuan transactions is the limited markets in Hong Kong and Taiwan, with vehicles like NDF (non-deliverable forward) transactions. In light of the predicted expansion of the yuan fluctuation band, dialogue with the Chinese government on refining this hedging method should commence as soon as possible.

This hedge vehicle is one that is normally set up independently by the private sector as the need arises. Even if it did not meet this special need, this vehicle might well have evolved naturally in the US market with the increase in dollar-yuan transactions. However, over-reliance on the US could mean that future changes in Sino-US relations might harm the stability of yuan transactions. Further, it would be ideal to obtain as much micro information as possible on the circumstances surrounding transactions and the main causes of fluctuation in the yuan, since it exerts such a strong influence on East Asian currencies. If markets were established in advance in locations where East Asian governments could control them to some degree in a crisis, there would also be an increased chance of combating the spread of a currency crisis. For this reason, markets allowing direct transactions between the yen, the yuan, and other East Asian currencies, and markets for hedging against the attendant risks, should be established and developed within the East Asian region.

Investigations have in fact already been carried out into the development of markets for bilateral transactions between the yen and other Asian currencies (for example, the won), and trials have even been conducted. However, these proved unsuccessful due to the following factors: the low level of demand for direct bilateral currency transactions (it is more convenient to transact exchanges via the dollar), the restrictions imposed by regulation of capital transactions, and the impossibility of expanding markets for bilateral currency transactions in order to internationalize the yen.

It is possible that under these circumstances internationalization of the yuan will bring about enormous change. As China experiences economic growth, the level of trade between East Asian nations and China will increase—approaching or exceeding the level of trade between these nations and the US. If the yuan becomes more internationalized and it becomes easier to use, it is also possible that demand for direct transactions might resurface. Further, a spread in awareness of the risk that exchange transactions may in the future be subject to the influence of Sino-US relations would also be a major factor in boosting demand for direct transactions between East Asian currencies and the yuan.

Japan and China must make use of this transformation and quickly establish a Sino-Japanese research association on East Asian currency systems. They must start to investigate the establishment and development of regional markets for direct currency transactions, focused on transactions between the yen and the yuan. Membership might then be gradually extended to other East Asian countries that support these objectives.

In order to establish and develop these markets, it will be necessary to address various issues at the outset. These would include a review of the regulation of capital transactions, which hinders growth in the level of transactions between East Asian currencies, and a review of the regulation of foreign currency. Comprehensive studies and reviews of regulations, tax systems, and market practices that push up transaction costs in the market must also be undertaken. It will also be necessary to reconcile government and private-sector perceptions regarding currency selection and how private companies should conduct exchange management. Countries will also have to relax regulations in order to facilitate transactions in hedge products, and establish benchmark indicators for all types of transactions. There should probably also be provision for the use of a basket currency as an intermediary currency in transactions involving East Asian currencies (in addition to provision for direct bilateral currency transactions), in case of a temporary lack of market liquidity.

The ASEAN+3 initiative for the development of Asian bond markets that is currently underway is effectively accelerating the development of bilateral currency transaction markets by establishing markets, providing benchmarks, increasing opportunities within the region for transactions in East Asian currencies (including basket currencies), and in other ways. The construction of a new East Asian currency system could be advanced organically along with these trends.

While creation of these markets is progressing, it will be necessary to establish a system of cooperation between East Asian nations in order to avoid a repeat of the Asian currency crisis. Since crisis management and cooperative systems are being established based on concepts such as the Chiang Mai Initiative, definitive counter-measures that anticipate a genuine crisis, such as a currency crisis caused by the yuan, must be drafted. If problems emerge, improved consultation between the countries concerned must then be facilitated. Having established markets for direct transactions between East Asian currencies, East Asian countries should then hold regular meetings at which (in addition to exchanging market information) they should examine these definitive crisis management plans and actively exchange opinions on macro policy operations in order to avert potential crises.

Conclusion

The nations of East Asia must avail themselves of the opportunity to construct a new currency system afforded by the internationalization of the yuan. They must address this issue urgently and substantively to be able to respond to a currency crisis originating in China between 2005 and 2010 or 2010 and 2020. The extent to which Japan—the most influential country in East Asia—can rise to this challenge will be crucial. This will also have a tremendous effect on the future of East Asian currency systems in the twenty-first century.

In addition to progress on currency measures, cooperation and trust between Japan and China are crucial. Unfortunately, relations between the two governments are currently rocky, due to sticking points such as the problem of visits to Yasukuni Shrine and problems with acknowledgment of history. With an eye to the future, the two governments would do well to spare no effort in attempting to resolve these issues. The hope is that they will then set about investigating the crucial issues that affect the economic stability of the East Asian region in the twenty-first century.

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