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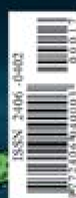

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THE PANDEMIC AND THE INTERNATIONAL MONETARY SYSTEM

CAN CHINA MOVE ON THE DOLLAR?

Zhao Ke

THE WORLD is at a crossroads, for the COVID-19 pandemic represents the most serious economic and social crisis since World War II. The "sudden stop" of economic activity worldwide has not only affected economic production and lifestyles in many countries; there is also a high probability that the pandemic will come to be seen as a key factor in determining the future of global trends in both economic and political domains. And at the center of global economic and political power lies the international monetary system, the future of which is almost certainly going to be deeply impacted as well.

THE FED'S ROLE

In the past two decades, the share of the U.S. dollar in the global credit market has further increased, and the scale of U.S. dollar debt has continued to grow. According to statistics from the Bank of International Settlements, the dollar debt of non-U.S. banks outside the United States has increased from $3.5 trillion in 2000 to $10.3 trillion in 2019. The U.S. dollar debt of non-bank institutions outside the United States has grown even faster: today the figure stands at approximately $12 trillion, which is almost twice that of one decade ago. By the end of 2019, the total U.S. dollar liabilities of banks and non-banks outside the United States had exceeded $22 trillion. In addition, U.S. dollar debt from the off-balance sheet is even larger: estimates suggest the figure could be as high as $40 trillion.

In this context, the COVID-19 pandemic has caused all kinds of market entities to sell U.S. dollar assets in order to "cash out" so as to avoid risks, which put high pressure on the offshore U.S. dollar market. Because non-U.S. financial institutions and non-financial institutions can neither be financed in the U.S. capital market nor receive financial assistance from America's monetary authorities, many countries faced the risk of depleting their dollar supply.

In the United States, the demand for hedging has caused large-scale redemption from money market mutual funds. In March 2020, the amount of redemption reached about $160 billion, accounting for 15 percent of the assets of said funds. This had a huge ripple effect on the entire financial market, especially for the commercial paper market, where institutional funds are its main investors. Money market mutual funds have suffered from large-scale redemption, which means that enterprises cannot issue bonds to obtain U.S. dollar funds to maintain normal operation. The resulting liquidity shortage has caused tremendous damage to the financial market and the real economy.

The role of the Federal Reserve as the global last resort lender has been further consolidated.

In order to alleviate the global "dollar shortage," the U.S. Federal Reserve launched in mid-March 2020 an unlimited and indefinite multilateral currency swap mechanism with the European Central Bank, the Swiss National Bank, the Bank of England, the Bank of Canada, and the Bank of Japan. A few days later, the Fed increased the frequency of swap operations with the aforementioned five central banks from one week to one day. One day prior to this last initiative, the Federal Reserve System had announced that it had reached $30 to $60 billion arrangements with the central banks of nine other countries, namely Australia, Brazil, South Korea, Mexico, Singapore, Sweden, Denmark, Norway, and New Zealand.

Moreover, the Fed launched a temporary repurchase agreement arrangement in late March 2020 in order to meet the U.S. dollar demand from countries outside the Fed's currency swap network. This allowed 170 foreign central banks and international institutions that hold accounts in the Fed's New York branch to join the repurchase agreements. This way, these institutions could temporarily use their holdings of U.S. Treasury bonds as collateral in exchange for U.S. dollar liquidity.

This was the first time that the Fed had allowed foreign central banks to exchange their U.S. Treasury bonds into U.S. dollars in the form of repurchase. This operation ensured that the Fed was able to further provide U.S. dollar liquidity to the world, which is in line with its "global central bank" function, serving as the world's last resort lender.

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As of mid-June 2020, the European Central Bank has received $145 billion through its currency swap agreement with the Federal Reserve. The Bank of Japan received $226 billion. The Bank of England received $38 billion. The Bank of Korea received $19 billion. The Swiss central bank received $11 billion. The Central Bank of Singapore received $10 billion.

Since then, the currency swap lines between the Federal Reserve and other central banks have decreased significantly, and the "dollar shortage" has been eased to a certain extent. In this situation, an institutionalized U.S. dollar system with the Federal Reserve at the core is being formed. This is an imbalanced system that includes "center-periphery edge." All told, through this institutionalized dollar system, the role of the Federal Reserve as the global last resort lender has been further consolidated.

Since the euro came into being, its proponents have argued that it is destined to become an international currency that can keep pace with the U.S. dollar, break the monopoly of the U.S. dollar, and inject new impetus into efforts to diversify the international monetary system.

EURO RECOVERY

Since the euro came into being, its proponents have argued that it is destined to become an international currency that can keep pace with the U.S. dollar, break the monopoly of the U.S. dollar, and inject new impetus into efforts to diversify the international monetary system. However, euro internationalization has not been that successful. In June 2020, the European Central Bank admitted that the current internationalization index of the euro was only 19 percent, a historically low level. In fact, the euro has still not recovered to its peak 2005-2006 level, which stood at 24 percent. Obviously, the leaders of the eurozone countries are not satisfied with the current degree of the euro's internationalization, and have emphasized that its international status should at least roughly correspond to the EU's weight in the global economy.

The bottleneck of the euro's internationalization lies in politics: a unified currency lacks the support of a fiscal union, and political integration lags behind currency integration. This inherent institutional defect makes the euro unable to obtain sovereign guarantees, which essentially makes it a currency without a country. This in turn makes the euro unable to guarantee sufficient confidence in the market, and its internationalization level is therefore considerably restricted. The "northern countries," represented by Germany, have always opposed the eurozone's fiscal integration out fear that this will turn the EU into a "transfer payment union" and a "debt sharing union," triggering the onset of a fiscal "moral hazard" in the eurozone countries, and weakening the internal driving force necessary to carry out structural reforms.

The leaders of the eurozone countries are not satisfied with the current degree of the euro's internationalization, and have emphasized that its international status should at least roughly correspond to the EU's weight in the global economy.

The COVID-19 pandemic may also drive Europe to form a new political consensus. The EU member states need unprecedented efforts and innovative ways to deal with the crisis in order to promote the integration, resilience, and transformation of the EU. Germany, which has always opposed the issuance of joint bonds, has undergone a fundamental change in its position in the face of the severe reality of the EU's economic recession and the loss of the Union's internal cohesion.

Thus, in mid-May 2020 Germany and France jointly initiated the establishment of a €500 billion Recovery Fund to assist the industries of EU member states that had been severely affected by the COVID-19 pandemic. The core content of the initiative is to issue bonds in the name of the European Union in the international capital market to finance the establishment of a recovery fund. In order to repay debts, the EU's fiscal autonomy has expanded and new taxes such as digital taxes or financial transaction taxes have been introduced as one source of debt repayment. The EU's 27 member states will guarantee the EU bond issuance based on their share of "contributions." After the funds are collected, the EU will issue subsidies to affected member states and industries, without repayment.

This initiative is "revolutionary" because it has essentially exceeded the legal authorization allowed by the various EU treaties. Although the German and French use the term "fund," they do so in order to carefully avoid the use of the term "common bonds" that would inevitably cause great controversy. The proposed fund is operated in a "fiscal integration" way, including the joint issuance of bonds, unified use of funds, and free transfer payments.

It should also be noted that at a special European Council summit that took place in mid-July 2020, member states passed a resolution to establish a recovery fund called "Next Generation EU" based on the German-French initiative.

The difference is that the fund scale was expanded to €750 billion, of which €390 billion are free allocations, and the remaining €360 billion are loans.

What the Recovery Fund revives is not only the "European economy," but also "European politics," which objectively compensates for the shortcomings of the euro system. This is reflected in three aspects as follows: First, fiscal integration has taken a substantial but ultimately small first step. The establishment of the Recovery Fund gives the European Commission the power to raise funds in the international capital market and to levy new taxes in the EU Common Market. Although there are still many restrictions on the scale, time, and scope, it has the key elements for a fiscal union.

Secondly, the Recovery Fund provides a safe asset covering the entire eurozone. For any currency to be taken seriously as international, it must provide safe assets for investors to hold and trade.

Currently, the distribution of safe assets in the eurozone is extremely uneven. Although they are all denominated in euros, only German government bonds can be considered to truly be safe assets. Once a crisis occurs, investors will rush to buy German government bonds and sell the bonds of peripheral countries. However, the size of German government bonds is limited and not enough to absorb the resulting huge liquidity. Such a scenario would not only cause price distortions in the financial market, but also put the euro in an uneven state.

Although they are all denominated in euros, only German government bonds can be considered to truly be safe assets. Once a crisis occurs, investors will rush to buy German government bonds and sell the bonds of peripheral countries.

The bonds issued by the Recovery Fund in the name of the European Union are jointly guaranteed by twenty-seven member states, which essentially creates a new type of safe asset that is not linked to a specific member state, but covers the entire eurozone. Although the scale of €750 billion is less than 5 percent of the U.S. Treasury bonds in circulation—and is thus still far from achieving the goal of creating a eurozone safe asset market with sufficient depth and breadth for global investors to participate in—the mere issuance of Recovery Fund bonds indicates that the EU has begun to move in the right direction.

Finally, the political cohesion of the EU is increasing. The essence of modern currency is government credit, and the euro's internationalization also depends on the credibility of EU-level macroeconomic and political policies. To some extent, the Recovery Fund has given EU institutions the leverage to coordinate the different interests of member states, implement EU policies, and promote the EU speaking with "one voice."

The use of the aforementioned funds has clear regulations: they are not to be used in traditional industries, but in green industries, the digital economy, and sustainable development. In addition, the distribution of funds is also linked to the domestic political agenda of each member state. If one of these introduces a policy or law that violates the common values of the EU, it will lose the EU's transfer payment.

Capital flow is the touchstone of confidence. Since mid-June 2020, the exchange rate of the euro against the U.S. dollar has risen sharply, exceeding 6 percent.

But let us not forget this critical point: capital flow is the touchstone of confidence. Since mid-June 2020, the exchange rate of the euro against the U.S. dollar has risen sharply, exceeding 6 percent.

A Chance for the RMB

Since the Chinese government launched the RMB settlement business for cross-border trade in 2009, the RMB has officially begun the journey of internationalization. The RMB is currently the fifth largest international currency in the world. As of 2019, the RMB ranks fifth in the currency composition of reserve assets held by member states of the International Monetary Fund with a market share of 1.95 percent, which was 0.88 percentage higher than when the RMB first joined the SDR basket in 2016.

In the past ten years, major breakthroughs have been made from scratch in the internationalization of RMB. The Chinese government has always taken a very cautious stance on the internationalization of RMB. In a sense, RMB internationalization is a "forced" policy choice taken in response to external challenges. The explanation is this: After the global financial crisis in 2008, the U.S. Federal Reserve began to implement a super-loose monetary policy, which put China's huge foreign exchange reserves at risk of "shrinking." Due to the awareness of possible risks that may arise from excessive reliance on the U.S. dollar in international trade and investment, the Chinese government has been actively promoting the internationalization of RMB since 2009.

Motivation behind the implementation of this policy was mainly to avoid external economic risks, whereas now,

in the face of increasing confrontation in international politics and the resulting intensification of geopolitical competition among major powers, we have seen how the United States has abused its financial advantages to strengthen its strategic competition with China. It has thus become necessary for China to now accelerate the internationalization of the RMB in order to avoid external political risks.

In the short term, the coronavirus crisis has strengthened the position of the U.S. dollar as an international currency. However, in the long term, the turbulence of the international monetary system could provide new opportunities for the internationalization of the RMB.

The COVID-19 pandemic has had a huge impact on the current international monetary system. In the short term, the coronavirus crisis has strengthened the position of the U.S. dollar as an international currency. However, in the long term, the turbulence of the international monetary system could provide new opportunities for the internationalization of the RMB. Three reasons come to the mind:

First, the resilience of the Chinese economy enhances the international appeal of the RMB. The Chinese government has brought the COVID-19 epidemic under control in a relatively short period of time. The Chinese economy was able to recover quickly and go back to a growth track simultaneously, which enabled China's economy to show strong resilience. In the second quarter of 2020, it rebounded sharply and grew by 3.2 percent. And so, China became the first of the world's major economies to restore economic growth under the shadow of the COVID-19 pandemic.

Secondly, the strengthening of the global financial safety net requires the RMB to play a greater role. The COVID-19 pandemic has shown that the global financial safety net has serious flaws. Certainly, the Fed played the role of a "global central bank" in this crisis and provided liquidity to other countries through currency swaps. However, the Fed only provided currency swaps to some countries, and its criteria for selecting currency swap countries was not transparent. This means that the countries not included by the Fed in its network could not and still cannot get timely assistance.

In this crisis, as the core institution of the global financial safety net at the multilateral level, the IMF has provided $100 billion in emergency funds to many developing countries and may mobilize up to $1 trillion in loans.

However, the financial needs of emerging markets and developing countries may reach up to $2.5 trillion dollars. In addition, due to the stringent requirements from the IMF aid release, many countries have been discouraged from seeking such support. The root cause of the failure of the global financial safety net is that the U.S. dollar is essentially the only global security asset. The U.S. is the only supplier and cannot print money indefinitely to meet external demand. This leaves the U.S. dollar always in short supply whenever a crisis comes about.

As the world's second largest economy, China is working to make the RMB into a main reserve currency and provides safe assets denominated in RMB for the global capital market.

The solution lies in the diversification of international reserve currencies. Other countries can also issue liquid global security assets so that central banks do not have to rely too much on the U.S. Federal Reserve to provide assistance in times of crisis. Through this, there will be multiple countries around the world to provide international liquidity. As the world's second largest economy, China is working to make the RMB into a main reserve currency and provides safe assets denominated in RMB for the global capital market. This method will make the international financial system more safe, and promote the internationalization of the RMB to more conform to the requirements of the times.

Thirdly, the political foundation of the international monetary system has undergone new changes. The formation of the international monetary system is not only the result of market forces, but also a kind of "politics among nations" and a concrete manifestation of the international political structure in the currency field. The status of reserve currency issuing countries originates from economic strength, but also depends on the support of major economies and, especially, political alliances.

The history of the evolution of the international monetary system shows that the close relationship between reserve currency issuing countries and their political partners can effectively increase their currency's share of global reserves. Conversely, if a reserve currency issuing country loses the political support of its allies—and even if it still maintains good economic fundamentals—the international status of its currency will inevitably suffer a negative impact.

Although the U.S. dollar is still the "dominant" reserve currency in the current international monetary system, the Trump Administration's "America First" foreign policy has weakened the multilateral international order established in the wake of World War II.

MORE CONFIDENCE NEEDED

The traditional view is that due to the existence of network externality, dominant reserve currencies have advantages and form natural monopolies. The traditional view also holds that it is difficult for a rising currency to challenge this status. However, recent empirical research shows that although network externalities exist, they are not strong enough to prevent other currencies from taking on more prominent roles.

A window has opened for China to seize the opportunity brought about by the loosening of the U.S. dollar system and actively promote a new round of higher-level and higher-quality RMB internationalization.

Under certain conditions, a rising currency can become a reserve currency in a relatively short period of time. There is no reason why the international monetary system needs to be limited to accommodating only one dominant reserve currency in the event that it can be shown that several international currencies can keep pace with each other. History vindicates this hypothesis. For example, although the British pound was the dominant global reserve currency before World War I, the French franc still accounted for 31 percent of global foreign exchange reserves in 1913, and the share of Germany's Goldmark was 15 percent. In 1913, international payments almost never used U.S. dollars, but just one decade years later, the U.S. dollar and the British pound were on par, with the U.S. dollar surpassing the British pound in 1929.

So in 1929, at the dawn of the Great Depression, the U.S. dollar accounted for 56 percent of global foreign exchange reserves—a figure that demonstrates the inaccuracy of the widespread belief that that the U.S. dollar only became an international currency after World War II. Therefore, in the face of a new trend of the evolution of the international monetary system under the pandemic, a window has opened for China to seize the opportunity brought about by the loosening of the U.S. dollar system and actively promote a new round of higher-level and higher-quality RMB internationalization.

China's economy has entered a new stage of high-quality development. Under the new situation, the path of RMB internationalization should be adapted accordingly rather than simply continuing the internationalization method of the past 10 years in which the expansion of RMB cross-border settlement has been the main focus. Instead, China should focus on raising confidence in the RMB, thus effectively enhancing its core attractiveness as a potential reserve currency.

Whether in an economic upswing or in a recession, the fundamental difference between reserve currencies and general sovereign currencies is that the former do not only facilitate cross-border payments for international trade and financial activities. More importantly, reserve currencies provide a confidence guarantee for such transactions such as: reserving high-quality products that are difficult to be replaced in currency issuing countries, acting as financial products of global safe assets, and taking global governance capabilities to assume international responsibilities.

Whether in the historical cases of the UK, America, or Germany, the time when their currencies became reserve currencies was also the day when their industrial competitiveness reached world-class levels.

Such confidence can come from the real demand for high-quality "Made in China" products. The initial impetus for the internationalization of a country's currency is trade: the real demand coming from other countries for the country's commodities, especially the demand from industrial products. Since a country's commodities have a considerable degree of irreplaceability, that same country has a stronger bargaining ability. This ability drives international buyers to use the country's currency as a means of payment to complete transactions, and forces other countries to reserve the country's currency to ensure the smooth progress of trade with that country.

Whether in the historical cases of the UK, America, or Germany, the time when their currencies became reserve currencies was also the day when their industrial competitiveness reached world-class levels. The two factors were synchronized. Therefore, the improvement of Chinese enterprises' innovation capabilities would enable them to provide differentiated and irreplaceable industrial products to the international market, thereby enhancing their bargaining power in designating a clearing currency when negotiating contracts. This is the most solid micro-foundation for RMB internationalization.

Heightened confidence should also come from understanding RMB assets as global safe assets. The world economy is always advancing in cyclical ups and downs, and the financial market is full of crises and turbulence, which is why global safe assets are in huge demand with investors—namely, out of risk aversion.

As a reserve currency, a country's currency should not only meet the demand for transaction convenience, but also meet the demand for security. The keys to this are: to provide stability for the turbulent global financial market, to have a

high-quality and high-level bond market, and to provide safe assets with sufficient liquidity for global investors. Conversely, the supply of large-scale safe assets has brought about strong support for the status of reserve currency.

China thus needs to accelerate the reform of its domestic financial market, expand the depth and breadth of this same domestic financial market, and attract global investors to hold RMB assets. This kind of reform is to act not only as an investment portfolio for profitability, but also as a safe asset for hedging purposes.

> *If a reserve currency issuing country loses the political support of its allies—and even if it still maintains good economic fundamentals—the international status of its currency will inevitably suffer a negative impact.*

Moreover, the status of a reserve currency does not entirely depend on the economic fundamentals of the issuing country. To a great extent, it depends on whether the issuing country can construct a world political and economic order that is conducive to peace and prosperity. In other words, the ability of shaping global governance indeed matters.

Judging from historical experience, the decline of a reserve currency's status is often not due to the fact that the issuing country is no longer economically strong. Rather, it is often due to the development of a situation in which the issuing country is no longer able to maintain the international order it has created, coupled with its weakening willingness and ability to perform international responsibilities.

Such factors tend to erode the confidence of other countries in the intrinsic value of the reserve currency in question. The British dilemma about maintaining its currency's international status after World War I is effectively the same as the American one at present. In contrast, since a number of important decisions were taken in 2012 during the Eighteenth National Congress of the Chinese Communist Party, the country has actively participated in global governance, actively taken on international responsibilities, put forward the Belt and Road Initiative, established a new type of international relations centered on win-win cooperation, adhered to the correct view of righteousness and benefit, and built a community with a shared future for mankind.

All told, these concepts, initiatives, and measures have received extensive attention from the international community. China continues to strengthen its capacity building and strategic investment in global governance whilst also building a global partnership network. This will provide a lasting impetus to the new round of RMB internationalization.