

A Grand Economic Strategy for Dealing With China

How to handle the internationalization of the renminbi, the Chinese currency.

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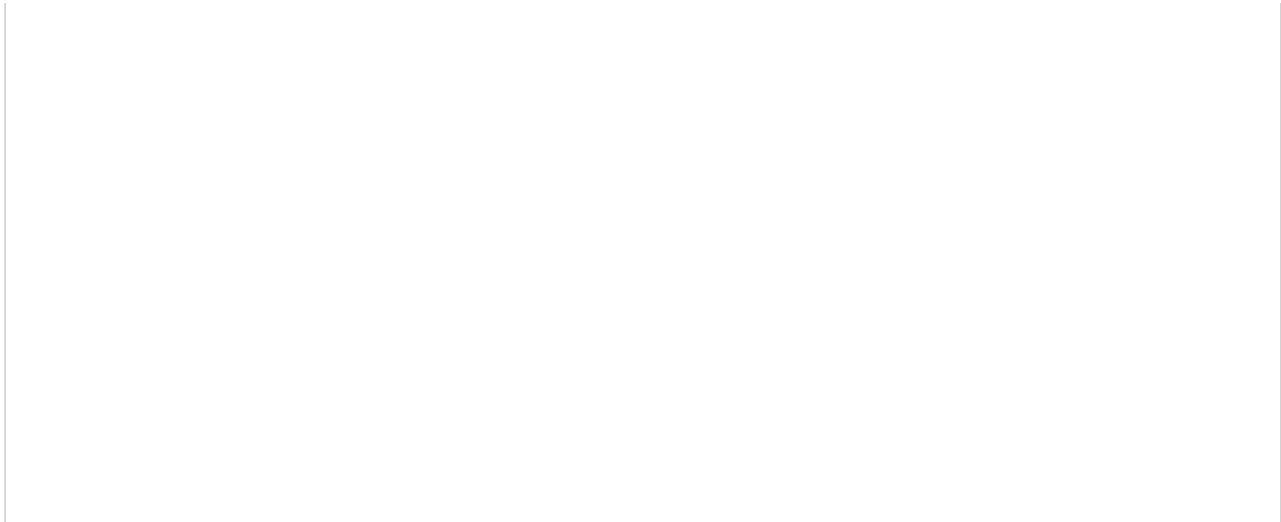
When I was on the State Department's policy planning staff in the 1970s, I had the rare opportunity to learn from two secretaries of state who I greatly admired, Henry Kissinger and Cyrus Vance. Each taught me how to frame big issues in very different ways. Whatever policy challenge I was working on, Kissinger always forced me to make the picture bigger and richer, to dig deeper into the background themes, and to make more connections to other issues. I remember, for example, writing a memo to him about upcoming multilateral trade talks, called the Tokyo Round, that he immediately sent it back with a note asking for a history of what we had learned from past negotiations, how the issues had changed, and whether the negotiations were organized to maximize U.S. leverage. Although Vance had extensive experience as a distinguished public servant, he, on the other hand, always behaved as the consummate Wall Street lawyer he once was. He wanted to focus almost exclusively on the concrete decision at hand and to understand every detail surrounding it. I recall preparing him for a cabinet meeting on foreign aid to India. I made a big deal out of the changing picture for America's overall economic assistance, as well as the future of U.S.-India relations. In response, he made me feel that the broad picture was a distraction. He wanted to focus solely on the pros and cons of what he needed to decide at the moment.

Two highly experienced and accomplished men, two ways of looking at the world. Kissinger saw policy through the broadest possible lens, and he wanted decisions to be embedded in long-term strategy. Vance looked at each decision on the merits. Each approach had its advantages, depending on the challenge at hand.

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I kept these two framing techniques in mind when thinking about an important decision facing U.S. President Barack Obama's administration over the next few months. The issue: Should the United States support the inclusion of the Chinese currency, the renminbi, or RMB, in the International Monetary Fund's composite currency unit called Special Drawing Rights, or should it argue for waiting another few years until China's financial system matures significantly? The IMF's executive board must decide this fall, and senior staff at the organization are preparing a recommendation now. Informal discussions among key governments have already begun. The future of the SDR and the RMB sounds like a narrow, technical question, and in theory, it could be dealt with that way. But I believe that the frame should be enlarged, and it should be part of a much broader global strategy for America's role in global finance more generally. In other words, in this instance I favor the Kissinger approach.

SDRs and RMBs

Here are three points to keep in mind.

First, the **SDR** was created by the IMF's members in 1969. It is a synthetic asset comprised of a basket of key currencies, weighted by relative values. Right now, it consists of the U.S. dollar, euro, pound sterling, and yen. The SDR can be created by the IMF to augment its member countries' reserves, supplementing existing currencies and gold. There are several criteria for inclusion in the SDR, some technical — such as how big a country is in international trade — and some more subjective, such as how freely usable its currency is in global finance. Inclusion requires a vote of the IMF executive board, made up of representatives of its member governments. Every five years, the IMF executive board reviews which countries' currencies are in the SDR and in what proportion. 2015 is one of those occasions, leaving just a few months from now to make a decision.

Governments can swap SDRs among themselves for hard currency, but they are not used in private transactions to finance trade and investment. The SDR was designed to enhance liquidity in the global monetary system, but in truth it plays a very minor role — far less than 5 percent of global official reserves. In fact, nothing the IMF does can confer real global status on a currency; that can happen only if private markets decide the currency is worthy and use it freely and widely. That said, when a currency is included in the composition of the SDR, it is elevated to a higher status and level of respectability, and it confers a seal of good housekeeping for a nation's financial system.

Secondly, by any standard China is a major force in the global economy, if not yet in global finance per se, and there is only one reason for arguing against including the RMB in the SDR — that China is not ready by virtue of incomplete financial reforms. A truly international currency should be usable for everything that currencies are used for around the world. It's not enough to be able to invoice trade in that currency, but domestic citizens must also be able to exchange it for foreign currency to invest abroad in all kinds of assets, such as buying factories, real estate, stocks, bonds, commodities. Foreign investors must be able to do the same inside China. Above all, China's markets must be reliably open so that foreign investors can enter and exist with no interference. In China, none of these conditions exist in full today.

To achieve this kind of deep, liquid, and open system, China would have to permit its domestic financial system to accommodate large ebbs and flows in foreign currencies. For example, it would need to deregulate its domestic interest rates so they reflect the supply and demand of funds. It would have to allow the exchange rate to move up and down in conjunction with changes in the global buying and selling of foreign exchange. It would be obligated to permit companies and banks to fail, and borrowers and lenders to go bankrupt, rather than having the government prop them up.

With regard to all these reforms, moreover, it is critical that China's domestic financial system be not only open but solidly regulated *before* the currency becomes fully deregulated. The proper sequencing of shoring up the home before all the doors to the outer world are opened is critical. Otherwise, sharp currency movements could create an economic crisis at home, as has been the case with many nations, such as Indonesia or South Korea, that didn't follow the domestic-first, international-second sequence. In those cases, exchange rate crises spread throughout their domestic economies and created deep, painful recessions.

To be sure, China is moving in market-oriented directions. It has instituted many important reforms. Going further is its stated goal, as well. But no one — not the IMF, the World Bank, or prominent academic experts — would deny that the administration of President Xi Jinping has a long way to go.

The third background point is this: China wants in *now*. Beijing believes it deserves to be included by virtue of its rising geopolitical power and the financial liberalization it has already accomplished, plus its detailed future commitments to do more. Being part of the SDR would enhance its global stature in financial circles. It would add momentum to Beijing's aim to make the RMB a major currency in global markets, commensurate with its GDP, its role in commerce, and its superpower aspirations.

In fact, the government started its campaign for inclusion as early as March 23, 2009, in the midst of the global financial crisis, when Zhou Xiaochuan, the head of the People's Bank of China, the country's central bank, gave a **high-profile speech** on the reform of the international monetary system that advocated putting the SDR at the center of global finance. On March 23 of this year, Premier Li Keqiang **told** the IMF's managing director, Christine Lagarde, that China wants in. Among Zhou's latest public lobbying attempts was this past April 18 when he **recounted** at an IMF conference all the steps China was taking to reform its domestic financial system to be worthy of having an international currency. It could well be, also, that after the humiliation of a spectacular stock market collapse these past few weeks, Beijing is especially riveted on securing a big win in international finance.

So, how should the United States proceed?

The Narrow View

A narrow view of the issue would ask the question whether China is, on balance, *ready enough*. It would weigh the consequences for the SDR and the IMF as if the answer is "no." It would reflect a view in the Obama administration that although the United States is not the all-powerful superpower it was, say, in the 1990s, it is still the single most important leader of a multilateral economic system, and it must support the principles of an open market-oriented, but well-regulated global financial system. On these grounds, Washington could take one of three positions.

It could, as a first option, push for the postponement of a decision for a few years, asking China to accelerate the very reforms it has articulated, and asking the IMF executive board to conduct a review well before the next five-year deadline. Treasury Secretary Jack Lew could have been thinking about this possibility when he recently stated that China isn't quite ready and needs to do more. "China has expressed interest in having the RMB qualify for inclusion in the Special Drawing Rights basket," he **told** an audience in San Francisco on March 31. "While further liberalization and reform are needed for the RMB to meet this standard, we encourage the process of completing these necessary reforms." There is indeed a lot for China to do: allow foreign financial firms to compete in China on equal footing with domestic firms; remove more controls on incoming and outgoing capital; improve disclosure of information; address accounting fraud; and create fairer processes for arbitrating disputes.

A second possibility is that the United States could take a much tougher stance, saying that not only must specific reforms proceed but also something much bigger must change — the broader Chinese system. Here, Exhibit A is the current turmoil in the Chinese stock markets that has been reflected in a loss between mid-June and early July of some 3 trillion dollars or nearly a 30 percent drop in capitalization. The frenzied, broad-scale actions of the Chinese government to drive the market back up earlier this month have been a stain on China's market credentials, to say the least, demonstrating that the government is ready to intervene massively in a heavy-handed way, even in a situation where stock market gains for the year were two or three times the losses and showed no sign of threats to the economy. Thus, Beijing halted trading in the majority of stocks. In other cases, it banned shareholders from selling their shares. The central bank and state-owned banks intervened directly through intermediaries to prop up prices. The government launched an ill-defined campaign to prosecute short sellers, possibly to intimidate all sellers. These are just some of its interventionist measures.

Forget about whether foreign investors will again participate in the stock market with any enthusiasm for a long time to come; my guess is many will surely stay away. What is much scarier from the standpoint of global finance is that the government clearly feared that stock market gyrations could ignite widespread social instability and, in China's terms, threaten national security. It is a short jump from how Beijing approached its stock markets to the question of whether Beijing is ready to have an international currency now or in the near future. The government already has significant capital controls and says that many will remain in place as a matter of long-term policy. But in the event of serious RMB fluctuations, would the government tighten its grip on the currency even more? Would it prevent foreign investors from getting their money out? (For an excellent analysis of the profound questions raised by the stock market fiasco about Beijing's mindset, check out Orville Schell's July 16 [essay](#) in the *Guardian*.)

A third possibility for looking at the issue narrowly is to waive all these concerns about reforms and fundamental mindset and conclude that the diplomatic tussle with China over denying the RMB in the SDR isn't worth the aggravation — because the role of the SDR itself is so *de minimis* in international finance anyway. Just let it go, the argument would be. Save the powder for a different economic fight. In this scenario, the SDR issue would not be the occasion to do anything more than let it pass.

A rationale case for any of these approaches could be made. But I think any one of them standing alone would be a mistake, for it wouldn't do justice to America's extensive interests in the future of China's currency and how the RMB fits in the larger global picture.

The Broader View

Here is a broader, more strategic approach.

There is an excellent chance that if the United States proposes to keep China out, no matter how temporarily, it will be outvoted by the IMF executive board. IMF Managing Director Christine Lagarde has already made encouraging noises. This past May 26, for example, the IMF **declared** that after many years, the RMB was no longer undervalued, and Lagarde promised the Chinese leadership that entrance into the SDR was not "if" but "when." The statement and discussion of which it was a part read to me as if Lagarde was telling China it could count on her support for inclusion this year. According to news **reports**, Germany, Britain, France, and Italy appear to be on board, too. This all sounds reminiscent of how the United States became isolated when it opposed the establishment of Beijing's idea for an Asian Infrastructure Investment Bank, only to see virtually all major countries except Japan join, making a mockery of U.S. foreign policy.

A second issue that Washington should address in the context of dealing with the RMB is the future of international financial institutions at a time when China wants to have more influence in them, and failing that, stands ready to create new ones. Of course, U.S. influence on this issue has been seriously undercut by the failure of Congress to pass proposed legislation that has been languishing for five years, legislation that would change the voting structure of the IMF so that china and other emerging markets would gain a larger proportion of the overall votes. Hopefully, the Obama administration intends to make a Herculean effort to try again, for unless this legislation is passed, the United States' influence in the IMF will significantly erode.

Another important lens in thinking about how to handle the RMB's potential inclusion in the SDR is U.S.-China relations. Having the RMB be part of the SDR is very important to China. Trying to stop or delay it is likely to be futile. So why create these unnecessary waves? In the end, China having a truly international currency is also in the United States' interest because it causes China to become more fully integrated into the world. The more global the RMB is, the more international markets can act to discipline China's policies, sending shock waves by selling the currency when policies are off course and bidding up the currency when policies make good sense.

There is also the question of China's lack of full preparation for RMB internationalism. Allowing the RMB to join the SDR need not prevent the United States from continuing to press China on its reforms. On the contrary, being part of the SDR could put pressure on Beijing to up its game. It could act as an incentive to accelerate the U.S.-China bilateral investment treaty that the two countries have been working on, but too slowly. That accord would help open up the Chinese economy in very important ways, including giving U.S. financial firms equal footing in China with domestic companies. Nevertheless, contingency plans should be made in Washington and elsewhere to prepare for a financial crisis in China that spreads around the world. This could include scenario planning among not just the United States and China but also countries such as Japan and the UK.

Finally, dealing with the RMB should be seen in the context of America's vision for the future monetary and financial system, in which China will become a major participant, one way or another, sooner or later. It is inevitable that China will account for many trillions of dollars of new cross-border capital flows. For example, the [Asia Society Policy Institute](#), looking ahead just six years from now, estimates that China could unleash \$3.5 trillion dollars of outward-bound capital. That's almost 20 percent of the total 2014 U.S. stock market capitalization.

It is important for Washington to try to envision the future global monetary and financial system itself. Over the last two years, I have been interviewing dozens of the world's top central bankers, finance ministers, regulators, heads of international institutions, and financial CEOs about this question as part of a Yale University project, [The Future of Global Finance](#). I have not heard any comprehensive vision for international monetary and financial reform, and I furthermore detect that no one believes the international political conditions necessary for another "Bretton Woods" are anywhere in sight. On the other hand, a large number of participants in the project point to big problems in the system that we now have. Here are some of them: The absence of rules allowed huge trade and financial imbalances and was one cause of the 2009 financial crisis. The spate of international financial regulations in the last decade is changing the nature of capital flows, creating de-globalization that could undermine the world's productive capabilities by unnecessarily compartmentalizing finance into national enclaves. The need for a better framework for restructuring sovereign debt is palpable. There are enormous long-term investment requirements in the world — such as the need for environmental retrofitting of existing capital stock, not to mention building or modernizing other infrastructure — for which our increasingly short-term markets are inadequate. There is a need to increase crisis-management capabilities on a global scale, taking advantage of lessons learned in 2008 to 2009. On top of all this is the inevitable metamorphosis of the current system, so heavily based on U.S. dollars, to a multipolar system of several more key currencies. What should the rules for that system be?

It would be a significant accomplishment for the administration to create a blueprint for the future global financial system, or series of them, for international discussion. Within that, the role of the renminbi should be a critical focus. This blueprint, or blueprints, might focus on the world in 2025. They could be devised in consultation with experts from many countries and many professional arenas, and not just economists and private financiers but also historians, political scientists, and politicians. The idea would not be to provoke any decisions but to shape the global discussion. Washington should take the lead in this project while it still has the power to shape it. The United States should confer closely with China in advance, given the overall geopolitical implications, and make the Middle Kingdom a key partner in the endeavor.

Framing the decision the right way

Over the last decade, I have taught several different courses at Yale on global topics, including finance, managing multinational companies, and managing cataclysmic natural and man-made disasters. No matter the subject, I always begin with the Kissinger-Vance difference in framing a problem. It's vital, I say to my students, to draw the box in which the decision is contained with the right dimensions. Make it too small, and you can miss the problem altogether. Make it too big, and you drown in complexity. In the case of the RMB and the SDR, the box needs to be bigger than what might seem natural because the internationalization of China's currency will overtime transform global finance, and global finance is the circulatory system of the world economy. I'd advise the United States not to fight the RMB/SDR issue. Let China in this year. But the issue could be used as a springboard for much bigger things.

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