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The BRICs' Monetary Challenge by Brendan Kelly

Brendan Kelly (brendan.sean.kelly@gmail.com) served as Country Director for China Affairs in the Office of the Secretary of Defense from 2007-2009, and previously worked in the United States Senate and as a management consultant at Monitor Group in New York and Hong Kong. This paper is adapted from a new study, "China's Challenge to the International Monetary System: Incremental Steps and Long-Term Prospects for Internationalization of the Renminbi," which is available at the Pacific Forum CSIS website, www.pacforum.org.

On June 16, the leaders of Brazil, Russia, India and China met in Yekaterinburg, Russia for the first formal BRIC summit. The issue topping the meeting agenda was reform of the international financial and monetary system. The BRICs offered a counterpoint and challenge to the G7/G8, which has served as the world's economic "steering committee" for the past few decades and meets next month in Italy. Though light on substance, the BRICs' message was clear: these growing economies want greater voice and representation in international financial institutions, and to a lesser extent, a greater role for their currencies in the international trade and monetary systems.

Over the past several months, leaders from Russia, China, Brazil and other countries have expressed concerns regarding the value and stability of the dollar, and have called for reducing the world's dependence on the U.S. currency. As the BRIC countries account for 42 percent of global foreign reserves (and amount to about $2.8 trillion), their pronouncements have produced strong market reactions. Russia's leaders have offered the most provocative criticisms of the dollar: Ahead of the BRIC summit, Russian President Dimitry Medvedev said, "There can be no successful global currency system if the financial instruments that are used are denominated in only one currency. Today this is the case and the currency is the dollar." The BRIC communiqué issued a more subdued call for "a more diversified international monetary system" – no doubt reflecting China's caution and concern for the value of its dollar holdings.

After China eclipsed the U.S. in April as Brazil's largest trading partner, Beijing and San Paolo announced plans in May 2009 to settle their bilateral trade in *renminbi* and reals, bypassing the use of the U.S. dollar. On July 17, on the heels of the BRIC summit, Presidents Hu and Medvedev announced a similar agreement to expand use of the *ruble* and *renminbi* in their countries' trade. Today Russia accounts for just 5 percent of China's trade, but that is expected to grow: Russia's energy exports to China are hoped to reach $100 billion over the next 20 years, and Russian officials added that energy sales in *rubles* are a "strategic" issue for Russia. However, as none of the BRIC currencies are freely convertible, these plans are impractical in the short-term and their significance is more political than economic.

The most tangible manifestation of the BRICs' growing financial clout is the IMF's expected issuance of bonds denominated in Special Drawing Rights (SDR). People's Bank of China Governor Zhou Xiaochuan, with support from Russian officials, has been the most prominent advocate of an expanded role for the SDR, making the case most clearly in his March 2009 proposal to "Reform the International Monetary System." Russia and Brazil have pledged to buy $10 billion worth of the bonds each, while China is expected to purchase up to $50 billion, with another $10 billion anticipated from India. The SDR bonds will not be traded on the market, and will only account for a small percentage of the BRICs' foreign reserves, so their importance is also mostly symbolic.

Most observers remain skeptical that the SDR or any supra-national currency will ever seriously challenge the role of the dollar. Likewise, despite Russian ambitions, the *ruble's* volatility and structural weaknesses in the Russian economy make it a poor candidate for significant international use.

The *renminbi* is a more interesting case. China's growing economic weight and financial resources point to the *renminbi* playing an increasingly significant role in the international monetary system. Chinese policymakers have recently taken a series of steps to begin to reduce China's vulnerability to fluctuations in the dollar and gradually raise the status of the *renminbi* in international trade and finance. In addition to the trade settlement plans with Brazil and Russia, China has announced trials to allow exporters in the Yangtze and Pearl River Deltas to settle cross-border trade in *renminbi*; currency swap arrangements totaling $95 billion with six countries; reforms to increase liquidity and trading volume in the domestic currency market; and efforts to facilitate *renminbi* bond issuance in Hong Kong. All these plans face limitations, and are likely to have limited short-term impact. These measures are starting to add up though, and if China proceeds with gradual capital account and financial liberalization, the *renminbi* could start to play a meaningful international role sooner than experts anticipate.

The internationalization of a currency involves many incremental steps over time and includes multiple roles. For example, China will likely be able to invoice an increasing amount of its direct bilateral trade in its own currency, even in the absence of full capital account liberalization. China is also positioned, through its massive demand, for its currency to play an increasing role in the pricing and invoicing of commodities. Ultimately, increased availability and ease of use of short-term financial instruments, such as private money markets and bankers' acceptances, and deep, sophisticated foreign exchange markets and commodities futures markets, will play critical roles in determining the use of the *renminbi* as a settlement and vehicle currency in international trade.

Many uncertainties facing the Chinese economy and political system must be addressed before *renminbi*-denominated assets could approach the “safety” of dollar or euro reserve assets, however. Countries must have complete confidence that that they will be able to rapidly move significant quantities of money into and out of the reserve country’s markets in times of need – requiring, at a minimum, faith in the rule of law. Such international confidence also requires development of deep and highly liquid markets for short-term Chinese government securities, a condition that leads to a fundamental but often overlooked point – in a fiat currency world (unlike under the gold standard), as the principal reserve asset is a reserve nation’s debt, a dominant reserve currency nation must be a net debtor, or at least accumulate very significant external liabilities. Other countries must run current account surpluses so that they can invest in these debt securities. Such a reality would require dramatic changes to China’s growth model and trade policy. In addition it would contribute to rebalancing a global economy that is characterized today by huge Chinese current account surpluses and correspondingly large U.S. current account and fiscal deficits.

Indeed, if China’s leaders are serious about increasing the *renminbi’s* role as a reserve currency, this goal, with the many positive reforms required to achieve it – rather than undermining U.S. economic interests – might actually reinforce the Chinese government’s inclination to follow through on the domestic economic and financial reforms that U.S. economists and policymakers believe are essential for sustainable U.S. and global economic growth in the future.