INTERVIEW

Barry Eichengreen:

China financial turmoil

Barry Eichengreen is a Professor of Economics and Political Science at Berkeley and a former senior adviser to the International Monetary Fund. His 2010 book, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, focused on the issues we are discussing here.

TOE: You have long believed that the international monetary system would do better with more than one reserve currency, not just the dollar.

Eichengreen: The foundation for international monetary systems is safe and liquid assets. For many years, that has meant US treasury securities. As the world continues to become less US-centric economically, it has to become less US-centric financially. The US cannot all by itself provide enough safe and liquid assets to meet the global economy's needs.

A multi-currency system means that exporters will price more of their exports in euros or Chinese renminbi (RMB), as well as settle their trade and financial transactions in those other currencies. Central banks will hold other currencies as part of their reserves. Corporations will hold some of their liquidity in securities that are denominated in other currencies.

TOE: What would be the consequence if we did not move into more of a multi-currency-based system?

Eichengreen: A global liquidity shortage. Central banks would not be able to accumulate the reserves they need to feel secure and to intervene in international financial markets. Corporate treasurers would not be able to accumulate and hold enough of the internationally accepted liquid assets they need for foreign investment and trade finance. 21st century globalization would be at risk.

TOE: To what extent is this evolution already occurring?

Eichengreen: It is occurring, but at a glacial pace. The share of central bank reserves held in dollars has fluctuated at a little more than 60% for the last couple of decades. Adjusting the short-term exchange rate fluctuations, the dollar's share may have fallen by a 1 or 2 percentage points over this period. The dollar is involved in about 85% of all foreign exchange transactions worldwide. That's down a little bit from the late-1980s, when this data was first collected. The dollar still accounts for nearly 80% of total trade financing worldwide and 45% of the world's exports are still priced in dollars.

TOE: Is it meaningful that less than half of exports are denominated in dollars?

Eichengreen: Not really. Europe has always done a lot of invoicing in its own currencies.

TOE: The failure of this to change—even though people have been saying for decades that it should and would change—raises the question: maybe, it doesn't need to change.

Eichengreen: The reason those expectations have been disappointed is the failure of the obvious candidates for alternatives to make faster progress. 15 years ago, everybody said the euro would rival the dollar, but the euro has been deeply troubled. Now, the story is similar for the Chinese RMB. China is trying to build deeper and more liquid financial markets, but in the last few weeks, it's tightened a variety of capital controls because of the weakness of the currency and the instability of financial markets. On the other hand, up to now, the US has avoided the worst. We have raised the debt ceiling on Treasury debt and avoided alienating bondholders.

TOE: Let's assume the US Congress doesn't do something crazy, like refusing to raise the government debt ceiling. Do you see the adverse consequences as a slow corrosion of the system, and therefore slower global GDP and trade growth than with a multi-currency system? Or, do you see it resulting in some sort of crisis?

Eichengreen: Either scenario is possible. During the 1930s Depression, we saw the latter scenario as Britain devalued the pound in 1931, which caused a panic on foreign exchange markets and we got a global liquidity crisis. On the other hand, disenchantment about US budget deficits, US monetary policies, and disappointing US growth could play out more as a kind of slow motion grinding down of growth if other currencies did not play a growing role.

TOE: A couple decades back, people talked of the yen as a reserve currency.

Eichengreen: A true international currency has to have three attributes: size, stability, and liquidity. The yen didn't make it because it didn't have the stability. In the 1990s, the Japanese financial system didn't have the stability and now there are questions about the stability of the yen exchange rate with the push for depreciation. But there's also the issue of the size of the platform. The reason that the US, the Eurozone and China are the three most logical candidates is that their issuers are engaged in a lot of international merchandise and financial transactions. Japan has not been a growing economy for a while now. I think there can be a subsidiary role for subsidiary currencies, like the Swiss franc and the yen.

TOE: The *Wall Street Journal* had a front page article pointing out that world trade growth has been slower than global GDP growth for three years in a row. That is unusual compared to the last few decades, when globalization has led growth.

Eichengreen: This is a major mystery and I don't have a satisfactory explanation. There are a few factors to point to. There has been some murky protectionism. Trade credit has become harder to obtain in a variety of countries. China's slowing growth has a lot to do with this because China imports components in order to export final goods, and we count both the import components and the export of final goods. I think the logic for trade growing faster than GDP—a growing international division of labor—remains intact and we should expect to see trade growing faster than GDP again. The current aberration is a bit perplexing.

TOE: The International Monetary Fund

(IMF) has said that the RMB is no longer undervalued.

Eichengreen: The RMB looks appropriately valued at this point. China's current account surplus [the broadest definition of the trade surplus] has shrunk. The RMB has strengthened an awful lot on a real effective basis [i.e., adjusting for the difference between price changes in China and price changes in its trading partners].

The Chinese are serious about wanting to rebalance their economy away from excessive reliance on a trade surplus and move toward domestic spending. So, a weak exchange rate is no longer integral to their growth and development strategy as it was in the past. They have been saying this for long enough and consistently enough that I think they really mean it.

Right now, we're having a test. A weaker currency will do a little bit to boost their exports and boost their economic growth. Do they care more about economic growth or about rebalancing the economy? I think they are serious about the rebalancing part.

TOE: One of the things we learned from the 1997-98 Asian financial shock is that, when you want to do financial liberalization, sequencing is extremely important. There have been calls for China to liberalize the capital account on RMB movements [i.e., allowing people to freely buy and sell the RMB for capital and other financial flows, not just for trade]. That's one of the things the IMF says China has to do if the Chinese want the RMB to play a big international role. How do you think the sequencing would best be done?

Eichengreen: The best way is for China to go much further in strengthening domestic financial markets and regulation before opening the capital account further. The Chinese are going slow on capital account liberalization and trying to go as fast as possible with financial strengthening and development.

I do worry about any attempt to use capital account liberalization and RMB internationalization as kind of a lever to force faster domestic reform. There are people who say: open the capital account, let foreign banks in, because this will force the Chinese banks to modernize and respond to the chill winds of competition. I think that's dangerous. The Chinese would be better advised to first bring the shadow banking system into the light, privatize the state banks, make their stock market more transparent, and create a proper corporate bond market. After all that, then liberalize the capital account.

The Chinese leadership basically has the same view that financial strengthening at home must come first, but I worry that they have erred a bit in going too fast on the capital account liberalization and too slow on domestic financial reform. Still, Chinese policymakers have studied the 1997-98 financial storms, and they drew the right lessons.

TOE: One of the interesting things—which is being ignored in the US Congress—is that the Chinese spent an estimated $120 billion in August, and perhaps another $40-50 billion so far in September, to prevent the RMB from falling. So, they seem to prize stability. If they were to open up the capital account before strengthening their domestic financial system, would money flow in and raise the level of the RMB, or would it flow out and cause the RMB to fall?

Eichengreen: Many studies have concluded there's no way to tell. Until this summer, my view was that inflows and outflows would be pretty evenly balanced. At present, there's no question that the money would mainly flow out. Not so many people want to invest in China right now, and lots of Chinese have noticed that foreign financial markets are more stable, more liquid, and more transparent than their own. We would have the ironic situation where Congressional pressure on China to free its capital account would just lead to a weaker RMB.

TOE: I think there is a Chinese proverb: be careful what you wish for. In the absence of domestic financial strengthening, would we see a lot more volatility in net inflows and outflows, and therefore in the RMB rate, and whatever consequences that has for Chinese interest rates?

Eichengreen: Yes. More than a century of historical experience teaches that open capital accounts can be an engine of volatility, that capital flows can reverse on a dime, and that financial markets, economies, and political systems can find it hard to cope with the consequences. For an open capital account to be a positive for economic development, you need strong financial markets, strong financial institutions, and a strong political system.

TOE: What does all this mean in terms of timeframe for the RMB becoming a major global reserve currency?

Eichengreen: In my 2010 book *Exorbitant Privilege*, I said I could imagine that, by 2020 or so, the dollar might account for less than 50% of global foreign exchange reserves and other transactions; the euro maybe 30%; and the Chinese currency maybe 10-15%. I was too optimistic; it will probably take longer.

TOE: Is a multi-currency system sort of like fusion power: no matter when you make the forecast, it's always a couple decades away?

Eichengreen: If that's true, then I would worry where we will get the liquidity needed for global financial markets and global trade. It cannot only come from the US forever.

TOE: In their efforts to control both the RMB rate and the stock market, the Chinese government has not only intervened in markets, but also arrested investors and journalists. Do you think such actions stabilize things? Or, do they end up destabilizing them because they show how worried the government is, and how you can lose your ability to withdraw money just when you really want to?

Eichengreen: There is no question that, in the longer run, those steps are counterproductive. They will discourage international participation in Chinese financial markets. There may be some stabilizing effects in the short run. But, if you're trying to build deep, liquid, transparent, and credible financial markets, the Chinese actions are the opposite of what one would want.

Every first class international currency in history—and there have only been a few of them—has been a currency of a democracy or republic governed by the rule of law. People will tie up their money in the currency of a country only if the state cannot arbitrarily change the rules of the game overnight. I don't know whether the Chinese political system is compatible with their international currency ambitions. If not, how modestly or radically would the political system have to change?

TOE: Is that a question of having democratic elections, or just the rule of law?

Eichengreen: It's fundamentally a question of the rule of law. Are democratic and non-democratic political systems equally capable of enforcing and respecting the rule of law over time? I don't know the answer.