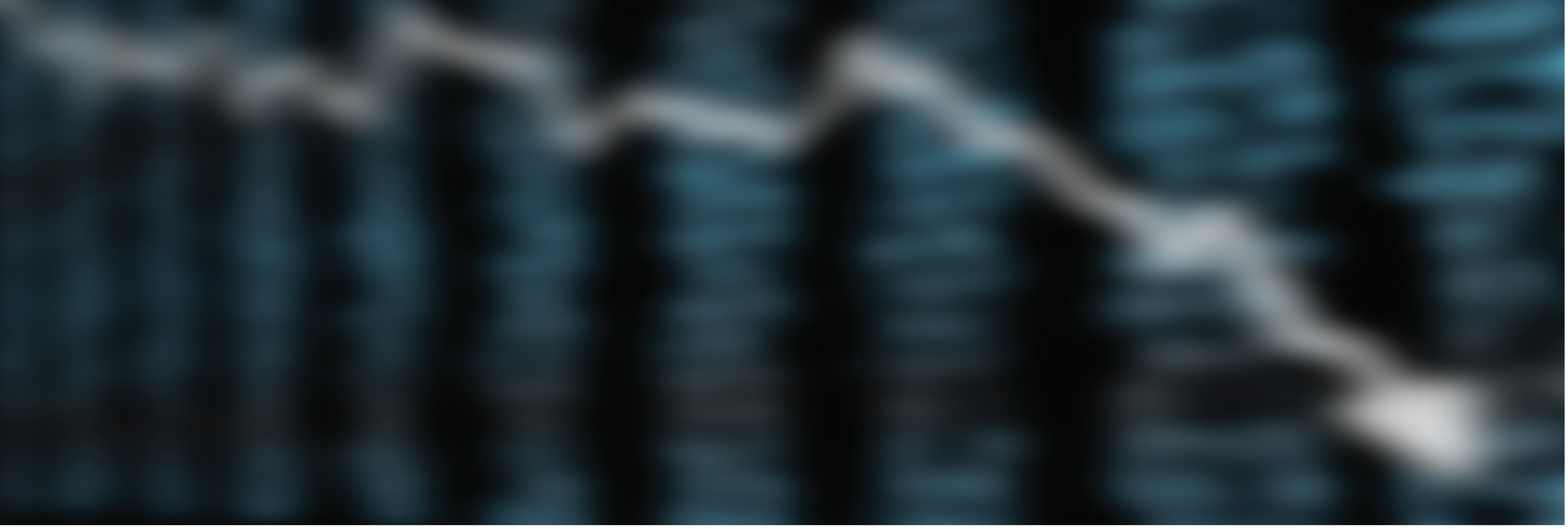

2007-08 Global Financial Collapse: Assessing Whether the Crisis' Impact Has Enabled China's Renminbi to Replace the US Dollar as International Reserve Currency

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Abstract

The 2007/2008 Global Financial Crisis has raised doubts about the sustainability of the US economy, which was long thought to be the basis of the US Dollar's (USD) international reserve currency status. At the same time, the rapid growth of China's global economic and political presence since the early 1990s, coupled with its tolerance against the Global Financial Crisis, has given rise to the speculation that the Renminbi (RMB) will eventually replace the USD as the world's dominant reserve currency. This paper analyzes whether the Global Financial Crisis has facilitated the RMB's rise to international reserve currency status, which is currently self-restricted by China due to its political and economic ties with the United States. We argue that the Global Financial Crisis has effectively facilitated the internationalization of the RMB, by accelerating changes in the U.S. economy that could eventually eliminate China's incentive to restrict the RMB's rise.

I. Introduction

The 2007/2008 Global Financial Crisis raised questions about the future of the U.S. economy and the sustainability of the US Dollar (USD) as the international reserve currency. The power to issue an international reserve currency carries substantial benefits as it generates a persistently high demand and overvaluation of the currency, which allows residents and businesses of reserve-issuing state to borrow relatively cheaply from foreign markets. Consequently, consumers are able to spend beyond the level they would otherwise be able to, leading to an improvement in their quality of life. Domestic businesses can expand more quickly, and the government can afford to spend more on projects that strengthen the state (e.g. military expansion). Hence an international reserve currency status can bolster the international economic and political power of the reserve-issuing state. The United States, as the world's largest economy and arguably the most politically influential state, has enjoyed this power since the end of World War II.[1] The USD currently stands unchallenged as the dominant reserve currency, composing more than 62% of total international foreign exchange reserves.[2]

[1] Kirshner, Jonathan. "Dollar primacy and American power: What's at stake?." *Review of International Political Economy* 15, no. 3 (2008): 418-438.

[2] International Monetary Fund (IMF). 2015. "Currency Composition of Official Foreign Exchange Reserves (COFER)". IMF eLibrary Data . Retrieved 26 Mar 2015 from http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4.

Theoretically, a reserve currency status has a material basis and is intimately linked to the economy of the reserve-issuing state. The Bretton Woods agreement of 1944 pegged the USD to gold (known as 'the gold standard'), based on the fact that the United States controlled two thirds of the world's gold reserve at the time. While the USD maintained its reserve status even after the termination of the gold standard in 1971, the gradual decline of the US economy has since often cast doubts on the economic basis of the USD - a notion that was only strengthened by the Global Financial Crisis and its deleterious impact on the US economy.

The future of the USD's reserve currency status grew suspect with the rising significance of China's currency, the Renminbi (RMB). Since the collapse of the Soviet Union in 1991, China's economy has grown exponentially to become the world's second largest, mainly driven by real production, capital investment, and trade. Many Asian states have already accepted the RMB as the de facto anchor currency,[3] leading to projections that the RMB could eventually replace the USD as the international reserve currency.[4] Given the immense economic and political benefits of issuing a reserve currency, such an outcome could ultimately lead to a shift in global influence from the United States to China.

The effects of the Global Financial Crisis have undoubtedly fostered an ideal global financial landscape for the RMB to replace the USD as the dominant reserve currency. For it to replace the Dollar, two conditions must be met simultaneously: (1) the RMB must satisfy the economic conditions of a reserve currency, and (2) the USD's reserve currency status must decline. The Global Financial Crisis generated economic and political outcomes conducive to both conditions being satisfied. This paper explains this phenomenon in three parts. The first section outlines what conditions are necessary for a currency to become an international reserve currency. The second section examines key economic variables to find that the RMB satisfies most of the necessary conditions to become a reserve currency. In contrast, an examination of the same variables for the United States reveals that, while the USD presently satisfies the conditions, the sustainability of its status quo is questionable. The third section takes a political view of the reserve currency status, and discusses how the Global Financial Crisis has influenced China's political relationship with the United States. China currently has the political incentive to abstain from challenging the USD's reserve currency status due to its strong trade ties with the United States. However, the Global Financial Crisis has accelerated changes in the U.S. markets that will ultimately eliminate such incentive.

II. The Conditions of an International Reserve Currency Status

An international reserve currency is any currency that constitutes a substantial share of the official reserves of central banks around the world.[5] However, a fiat declaration of a reserve status is not sufficient; an international reserve currency must fulfill the three functions of money (medium of exchange, store of value, and unit of account) in both the private and public sectors for non-residents. In order to do this, the currency must have three vital qualities: high confidence, high liquidity, and an extensive transactional network.

Both economic and political factors can give rise to these three qualities. There are four frequently cited economic factors. First is the size of economic output and trade, closely linked with the size of the economy as measured by gross domestic product (GDP). Second is an efficient and well-developed financial market. Third is macroeconomic stability, notably a stable inflation rate. Fourth is network externality and liquidity – in other words, how widely the currency is used in transactions.[6] Political factors, while equally as important, are more difficult to generalize. Helleiner (2008) outlines some major political factors that could influence a currency's confidence, liquidity, and transactional network; which include military strength, domestic and international security, and government regulations on financial markets.

[3] Ito, Takatoshi. "Influence of the renminbi on exchange rate policies of other Asian currencies." *Debating China's exchange rate policy, Peterson Institute for International Economics*, Washington (2008): 239-258.

[4] Huang, Yiping, Daili Wang, and Gang Fan. "Paths to a Reserve Currency: Internationalization of the Renminbi and Its Implications." Asian Development Bank Institute (ADBI) *Working Paper Series*, no.482 (May 2014).

[5] Blinder, Alan S. "The role of the dollar as an international currency." *Eastern Economic Journal* (1996): 127-136.

[6] Galati, Gabriele, and Philip Wooldridge. "The euro as a reserve currency: a challenge to the pre eminence of the US dollar?." *International Journal of Finance & Economics* 14, no. 1 (2009): 1-23.

III. An Economic Perspective on the USD and RMB

The status of China's economy reveals that the RMB has the potential to become an international reserve currency, considering China's GDP is the second largest after that of the United States, and has managed to grow at a rate above eight percent per year despite the widespread economic turmoil following the Global Financial Crisis.[7] Further, China has been relatively successful in keeping inflation rates stable — between 2.6% and 5.4% — since 2007, albeit with an exception of 2009 when the Recession reached its heights.[8] China has also pushed for policies that increase the RMB's network externalities, actively encouraging its use in international trade. For instance, in 2009 and 2010, China began allowing private sector trades with members of the Association of Southeast Asian Nations (ASEAN), Hong Kong, and Macau to be settled in RMB. As a result, China's total trade transactions in RMB increased from 1% to 16.5% between 2010 and 2013.[9] The RMB has also been increasingly used in offshore transactions, particularly in Singapore, United Kingdom, and Luxembourg. The Society for Worldwide Interbank Financial Telecommunication estimates that in 2014 offshore transactions in RMB increased by some 837% with total RMB payments constituting 1.72% of all global transactions, making it the seventh most commonly used currency in the world.[10]

Currently, the U.S. economy seems capable of supporting the dominant role of the USD, as its GDP is the largest in the world and nearly double that of China.[11] The Federal Reserve has maintained a relatively stable inflation rate since the Crisis[12], and the U.S. financial market remains as one of the largest and most comprehensive in the world, with the market capitalization of publicly traded companies alone being five times that of China.[13] Finally, the USD is the single most used and liquid currency in the world, and has already established an extensive network in the international community. Important commodities such as crude oil are denominated in USD in the international market, and some countries even choose to peg their currency to the USD.[14]

However, trends in the U.S. economy over the past twenty years have raised serious doubts about whether the status of the USD can be maintained. The current basis of American economic growth and Chinese economic growth are inherently different. China's growth over the past twenty years has been based on the expansion of its real economy primarily through exports and gross capital formation (gross domestic investment). Between 1991 and 2013, the size of China's exports increased from 16.1% to 26.4% of GDP, and its gross capital formation increased from 36% to 49% of GDP.[15] This expansion led to a series of high yearly trade surpluses, thereby enabling China to strengthen its role as an international creditor. Despite the Global Financial Crisis, China's net international investment position (NIIP) has remained consistently above $1.3 trillion per year.[16] On the other hand, the American real economy has declined over the past twenty years. Annual gross capital formation has remained stagnant around 20% of GDP from 1991 to 2007 (Figure 1), and NIIP has been negative since 1989 - representing the U.S. economy's growing dependence on foreign creditors.[17]

“ the U.S. economy must grow consistently at a rate of 3.5% per year to maintain investor confidence in the Dollar, the prospect of which has been undermined by the Global Financial Crisis. ”

[7] Galati, Gabriele, and Philip Wooldridge. “The euro as a reserve currency: a challenge to the pre-eminence of the US dollar?.” *International Journal of Finance & Economics* 14, no. 1 (2009): 1-23.

[8] World Bank. 2015. “GDP growth (annual %).” World Bank Open Data. Retrieved 26 Mar 2015 from http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

[9] Eichengreen, Barry, and Masahiro Kawai. “Issues for Renminbi Internationalization: An Overview.” Asian Development Bank Institute (ADBI) Working Paper Series, no.454 (Jan 2014).

[10] Society for Worldwide Interbank Financial Telecommunication (SWIFT). 2014. “RMB reaches record levels of payments activity between off shore centres.” *SWIFT RMB Tracker*, October 30. Retrieved 26 Mar 2015 from http://www.swift.com/about_swift/shownews?param_dcr=news.data/en/swift_com/2014/PR_RMB_records_offshores.xml.

[11] World Bank. 2015. “GDP growth (annual %).” World Bank Open Data. Retrieved 26 Mar 2015 from http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

[12] World Bank. 2015. “GDP growth (annual %).” World Bank Open Data. Retrieved 26 Mar 2015 from http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

[13] Chinn, Menzie, and Jeffrey A. Frankel. “Will the euro eventually surpass the dollar as leading international reserve currency?.” *In G7 Current account imbalances: sustainability and adjustment*, pp. 283-338. University of Chicago Press, 2007.

[14] O'Brien, Robert, and Marc Williams. *Global political economy: evolution and dynamics.* 4th ed. New York: Palgrave Macmillan, 2013. pp.174-17.

[15] Ibid.

[16] International Monetary Fund (IMF). 2015. “Currency Composition of Official Foreign Exchange Reserves (COFER)”. IMF eLibrary Data Retrieved 26 Mar 2015 from http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4.

[17] Ibid.

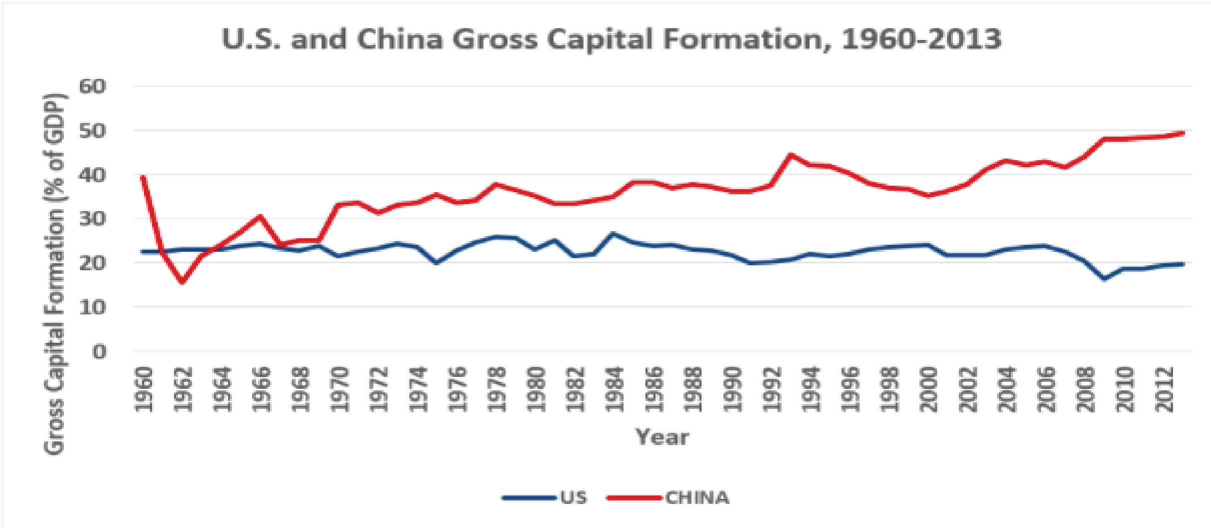

Figure 1. U.S. and China gross capital formation (gross domestic investment) since 1960. For the U.S., capital formation has remained largely stagnant since 1991, and dropped below 18% in 2008 for the first time since 1960. In contract, China's figures have been continuously rising. Figure created by author based on data from World Bank 2015e. "Gross capital formation (% of GDP)." World Bank Open Data. Retrieved 26 Mar 2015 from http://data.worldbank.org/indicator/NE.GDI.TOTL.ZS.

The Global Financial Crisis exacerbated these pre-existing trends, which undermined the USD's economic prowess. Between 2008 and 2009, U.S. gross capital formation experienced the single greatest drop since 1961 (Figure 2), and since then the recovery has been mediocre.[18] NIIP has worsened nearly four-fold from $-1.3 trillion before the Crisis to $-5.4 trillion in 2014, which is nearly 30% of GDP and greater than the annual gross capital formation.[19] Given such level of net borrowing (which tends to deter investor confidence), the U.S. economy must grow consistently at a rate of 3.5% per year to maintain investor confidence in the Dollar,[20] the prospect of which has been undermined by the Global Financial Crisis. Hence, from an economic standpoint, the consequences of the Global Financial Crisis have made the USD's decline more likely, and thus indirectly improved the prospects for the RMB 's rise.

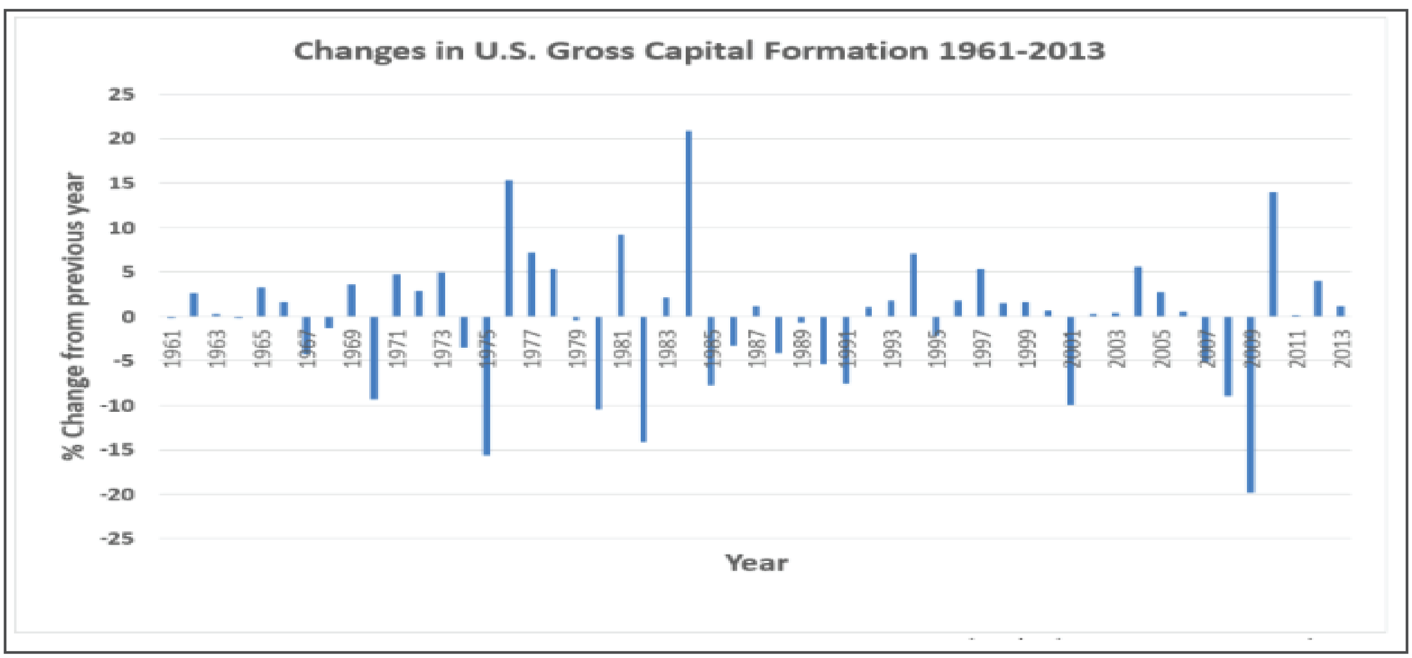

Figure 2. Annual percentage change in U.S. gross capital formation. Note the single greatest one-year decrease between 2008 and 2009, following the Global Financial Crisis. Figure created by author based on data from World Bank (World Bank 2015e).

[18] World Bank. 2015. "GDP growth (annual %)." World Bank Open Data. Retrieved 26 Mar 2015 from http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

[19] Bureau of Economic Analysis (BEA), United States Department of Commerce. 2014. "Table 1.1. U.S. Net International Investment Position at the End of the Period." Retrieved 26 Mar 2015 from http://www.bea.gov/iTable/iTable.cm?ReqID=62&step=1#reqid=62&step=6&isu

[20] Subramanian, Arvind. "The inevitable superpower: Why China's dominance is a sure thing." *Foreign Affairs* (2011): 66-78.

IV. A Political Perspective on USD and RMB

An international reserve currency status requires not only the economic strength of the reserve-issuing state, but also a certain level of political power.[21] In fact, it has been suggested that confidence in the USD is no longer based on confidence in the US economy. Rather, the Dollar is now a 'negotiated reserve currency', backed by other states due to political reasons unrelated to its inherent economic attractiveness.[22] In states such as South Korea, the support of the USD is political due to their military alliance with the United States. In other cases, political incentives stem from market forces.[23] The U.S. consumer market has established strong ties with several economies around the world, especially with China, to the extent that turmoil in the U.S. can ripple into economic, social, and even political unrest in China. China's export industry is one of the most important driving forces of its economic growth, and a decline in the export sector could profoundly impact China's domestic stability by triggering social and political unrest. Although a formal link has not been established, consecutive decline in China's export growth rate from 2010 to 2013[24] has coincided with major social unrest, including the 2010 Suzhou workers riot,[25] the 2011 Zengcheng riot,[26] and 2011 Chinese pro-democracy protests.[27, 28, 29] The United States, which at one point imported nearly a quarter of China's total exports, serves as an indirect yet important determinant of China's domestic security. Given this, scholars suggest that China has incentive to restrict the RMB's internationalization to keep the USD overvalued relative to the RMB. Hence the political landscape allows the U.S. consumer market to effectively suppress the RMB's rise.[30]

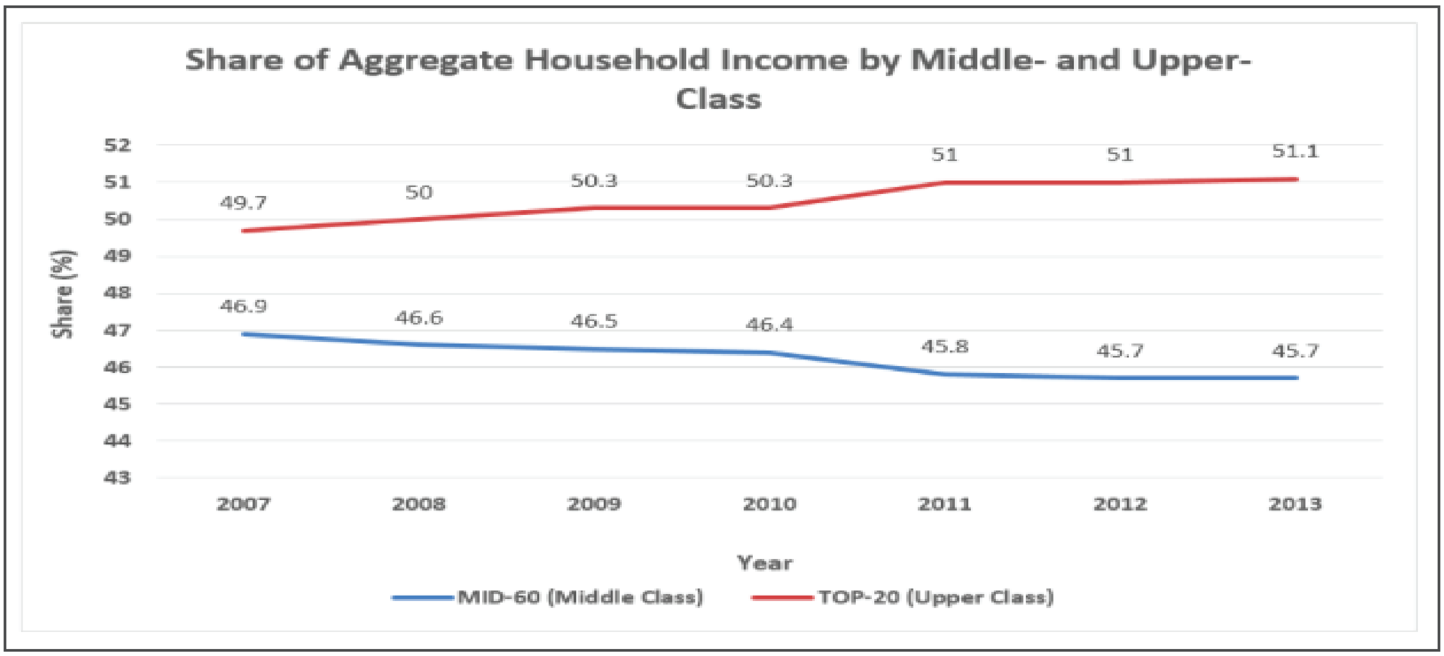

Figure 3. Trend in shares of aggregate income by households in the middle 60% on the income spectrum (middle class) and by those in the top 20% (upper class), since the Global Financial Crisis. Note widening gap. Figure created by author with data from U.S. Census Bureau "Table H-2. Share of Aggregate Income Received by Each Fifth and Top 5 Percent of Households, All Races: 1967 to 2013."

[21] Helleiner, Eric. "Political determinants of international currencies: What future for the US dollar?." *Review of International Political Economy* 15, no. 3 (2008): 354-378.

[22] Ibid.

[23] Ibid.

[24] 2015d. "Exports of goods and services (% of GDP)." World Bank Open Data. Retrieved 26 Mar 2015 from http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS.

[25] Pomfret, James and Kevin Soh. "Special Report: China's new migrant workers pushing the line." *Reuters*, Jul. 5, 2010. Retrieved 26 March 2015 from http://www.reuters.com/article/2010/07/05/us-china-labour-idUSTRE6640QD20100705.

[26] Pomfret, James. "Police use tear gas to quell riot in southern China." *Reuters,* Jun. 13, 2011. Retrieved 26 March 2015 from http://www.reuters.com/article/2011/06/13/us-china-labour-unrest-idUSTRE75C0KM20110613.

[27] Ramzy, Austin. "State stamps out small 'Jasmine protests' in China." *TIME*, Feb. 21, 2011. Retrieved 26 March 2015 from http://content.time.com/time/world/article/0,8599,2052860,00.html.

[28] Grammaticas, Damian. "Calls for protests in China met with brutality." *BBC News*, Feb. 28, 2011. Retrieved 26 March 2015 from http://www.bbc.com/news/world-asia-pacific-12593328.

[29] Jacobs, Andrew. "Chinese democracy activist is given a 10-year sentence." *The New York Times*, 25 Mar. 2011. Retrieved 26 March 2015 from http://www.nytimes.com/2011/03/26/world/asia/26china.html.

[30] Helleiner, Eric. "Political determinants of international currencies: What future for the US dollar?." *Review of International Political Economy* 15, no. 3 (2008): 354-378.

The Global Financial Crisis undermined the strength of the U.S. consumer market by facilitating the decline of the American middle class. China's exports to the U.S. are mainly low-cost, mass-produced goods whose main buyers belong to the middle class; in contrast, luxury goods used by the upper class (the top 20% income) constitute only a small part of China's exports. Thus, a decline in the purchasing power of the American middle class can significantly reduce the degree of influence that the U.S. consumer market has on China. The Global Financial Crisis has damaged the American low and middle classes more than it has the upper class households, mainly by reducing the supply of consumer credit which tends to be in higher demand in low and middle classes. This directly translated into a divergence of income between the three classes. Between 2007 and 2013, the difference between shares of aggregate income by the middle class and upper class households has increased from 2.8% to 5.2%, showing that the income gap has widened since the Global Financial Crisis (Figure 3). Inflation-adjusted median annual household income decreased from $56,436 in 2007 before the Crisis to $51,939 in 2013, leaving an average American middle class household with eight percent less income per year.[31]

In the short term, the U.S. will remain the largest buyer of China's total exports, and the decline of the American middle class will merely lead to fewer Chinese exports to America. Indeed, in 2009, a 2.5% decline in U.S. consumer spending coincided with a 10.2% decline in Chinese exports.[32] But in the long run, the decline of the middle class will eventually steer China away from the American consumer market, and signs indicate that this transition is already in progress. The United States' share of China's exports has constantly declined over time, falling from 23.44% of China's total exports in 2004 to 17.74% in 2011 (Figure 4). In contrast, China's exports to emerging markets such as India, Russia, and Mexico increased over the same period. This signals that China is slowly lowering its reliance on the U.S. market, and that the United States' indirect political influence on China is weakening. Once China becomes substantially less dependant of U.S. markets, it will no longer have the political incentive to keep the USD overvalued, at which point it has one less factor to consider before actively internationalizing the RMB. From this political perspective, it could again be stated that the Global Financial Crisis has increased the potential for RMB's rise.

Figure 4. Trend in China's export destinations. Note diminishing share of USA accelerates after 2007 while share of emerging markets increase. Figure created by author with Data from MIT Observatory of Economic Complexity.

[31] Federal Reserve Bank of St. Louis. 2015. "Real Median Income in the United States." *FRED Economic Research.* Retrieved 26 Mar 2015 from https://research.stlouisfed.org/fred2/series/MEHOINUSA672N.

[32] 2015d. "Exports of goods and services (% of GDP)." World Bank Open Data. Retrieved 26 Mar 2015 from http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS.

V. RMB Internationalization and Globalization

The internationalization of the RMB has powerful implications for the extent and direction of globalization in the future. The thirty years leading up to the Global Financial Crisis has been marked by an unprecedented growth of global trade, accelerated by the propagation of U.S.-led neoliberal policies and rapid developments in information technology. Advancement of globalization during that period served to polarize the economic relationship between the U.S. and China, generating a largely unilateral flow of capital from the U.S. to China. The abundance of cheap labor financed by an inflow of American capital during that period shaped China into the world's manufacturer of goods. The reserve currency status of the USD has undoubtedly played a large role in the development of this relationship, as an overvalued USD would allow American investors to buy a proportionally larger amount of RMB to invest in China.

But the recent internationalization trend of the RMB has the potential to change this historical direction of capital flow, and ultimately alter the dynamics of the global. For one, China may well assume the role as a global creditor, moving the world's manufacturing center from itself to other developing economies with relatively weak manufacturing centers and low-cost labor (e.g. Russia and Africa). In fact, the United Nations has already recognized China's rapidly growing contribution to Africa's infrastructure and manufacturing sector.[33] Second, China may become capable of exerting more political, economic, and cultural influences in countries across the globe, threatening American hegemony that has become the norm since the end of World War II. Third, the increased purchasing power of Chinese consumers associated with the RMB's reserve status will allow China to become the world's largest processed goods importer. Such economic prosperity can improve China's social infrastructure, China one of the main destinations for foreign human capital.

VI. Conclusion

This paper has explored how the 2007/2008 Global Financial Crisis improved the prospect of RMB's rise to global reserve currency status. First, it was shown that the RMB has most of the appropriate economic drivers necessary to become a global reserve currency. The fact that China's economy remained relatively stable despite the Global Financial Crisis demonstrated the durability of those drivers. Second, this paper argued that the Global Financial Crisis accelerated existing trends in the American economy, undermining the future of the Dollar's economic basis. Third, this paper argued that the decline of the American middle class, in the wake of the Global Financial Crisis, has accelerated the course of China's independence from U.S. markets in the long run. Such independence could significantly reduce the American political influence that has prevented China from further challenging the USD's reserve currency status. Combined, evidence suggests that the Global Financial Crisis has contributed to the decline of both the Dollar's economic and political bases, making it easier for RMB to replace it as the global reserve currency.

Of course, this by no means implies that the RMB's triumph over the USD is imminent. The United States still retains strong diplomatic ties (military or otherwise) with a sizeable portion of the world. In addition, China has yet to open its domestic financial market to foreign capital - a condition vital to a currency's internationalization process. Given the current extent to which China's government intervenes in the Chinese financial market, this is unlikely to happen without significant changes in China's domestic policies. Hence while the Global Financial Crisis ultimately worked in Renminbi's favor, a complete transition from RMB to USD is unlikely to take place in the near future.

[33] Kuwonu Franck. "Using trade to boost Africa's industrialization" Africa Renewal, 2015. Available 29 September 2015 at http://www.un.org/africarenewal/magazine/august-2015/using-trade-boost-africa%E2%80%99s-industrialization.

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