The Internationalisation of the RMB and the Positive Implications for World Development

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The Rise of the Washington Consensus

- Bretton Woods 1944: Link to the US dollar and gold
- Link to gold broken in 1971
- Since then 'petro-dollar': Political/military pressure on oil exporters to sell oil only against USD
  - Incentive to perpetuate reliance on oil for energy; oil wars
- In the early post-war years most developing countries adopted infant industry protection, import substitution and industrial policy
- However, due to significant debt and currency crises, since the early 1980s many came to rely on IMF and World Bank loans **(structural adjustment** programmes with '**conditionality**')
- These came with strings attached, enforcing the consensus view on economic development of the **Washington**-based institutions:

  IMF, World Bank, USAID, US Treasury, Inter-American Development Bank

The Washington Consensus on Development

- Key components of the Consensus Package for developing countries:
  - *(a) control inflation and reduce fiscal deficits (monetary and fiscal tightening);*
  - *(b) open their economies to the rest of the world through trade and capital account liberalization; and*
  - *(c) liberalize domestic product and factor markets through privatization and deregulation.*
- There is little doubt that the widespread adoption of these policy tools in the 1980s through to the 1990s shaped the global development discourse.
- Lee and Rhee (2003): there are 159 instances where countries experienced a currency crisis and joined independent IMF conditionality programmes between 1973 and 1994
- Much of the international lending to developing countries was in USD
- The world's central banks have held a large proportion of their reserves in USD

The Fall of the Washington Consensus on Development

- The Washington Consensus policies were based on the following claims:

1. Free trade policies will deliver economic growth and development, prosperity and economic independence – **“No trade policy needed“**
2. Free market policies are necessary and sufficient to ensure stable and sustainable economic growth and development – **“No development policy needed“**
3. Prices are key, since they move to equate demand and supply, delivering equilibrium: **“Markets are always right“**.

- These claims have proven to be **false**.
- Countries adopting the Washington Consensus policies did not develop well.

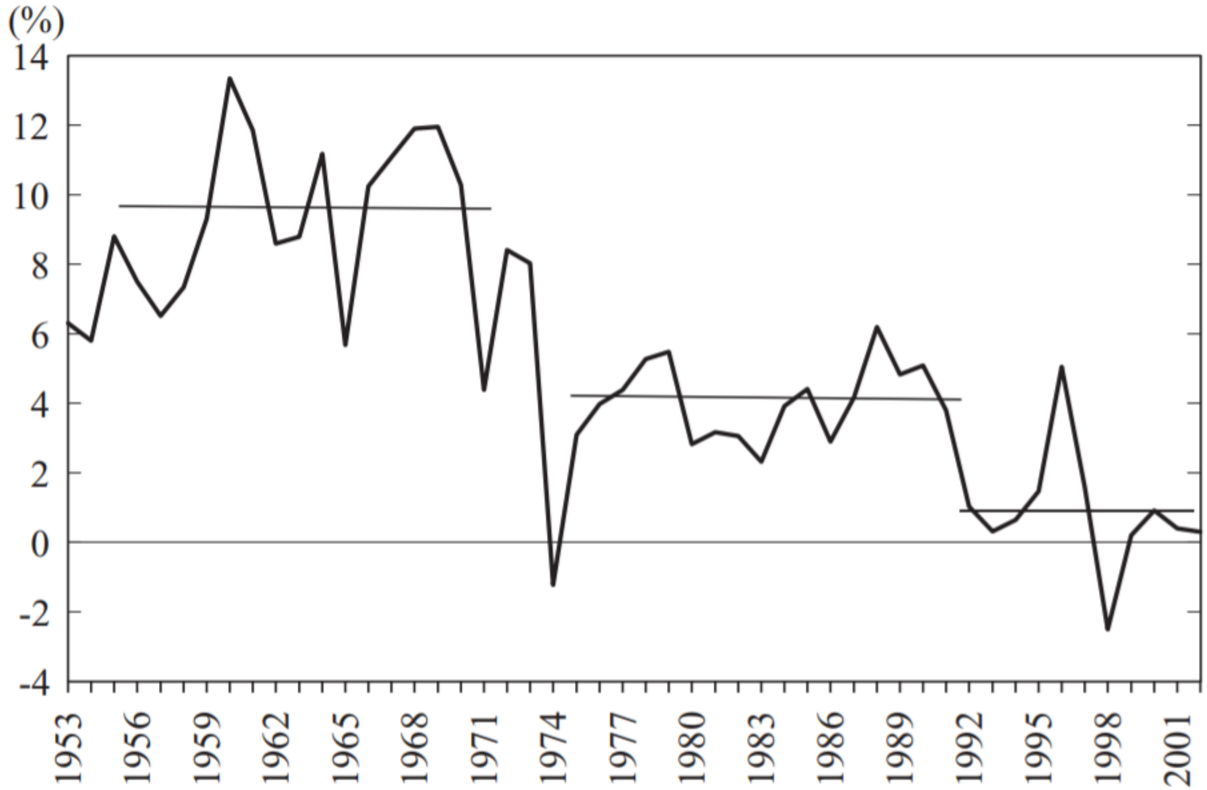
Which "Developing Countries" Have Ever Developed?

- In the 20th century, arguably only **a hand full of countries** have ever made a convincing transition from "developing country" status to "developed" economy.

- These are all in East Asia.

- **Japan**, **South Korea, Singapore** and **China** and its provinces have been delivering spectacular, double-digit economic growth, lifting millions out of poverty

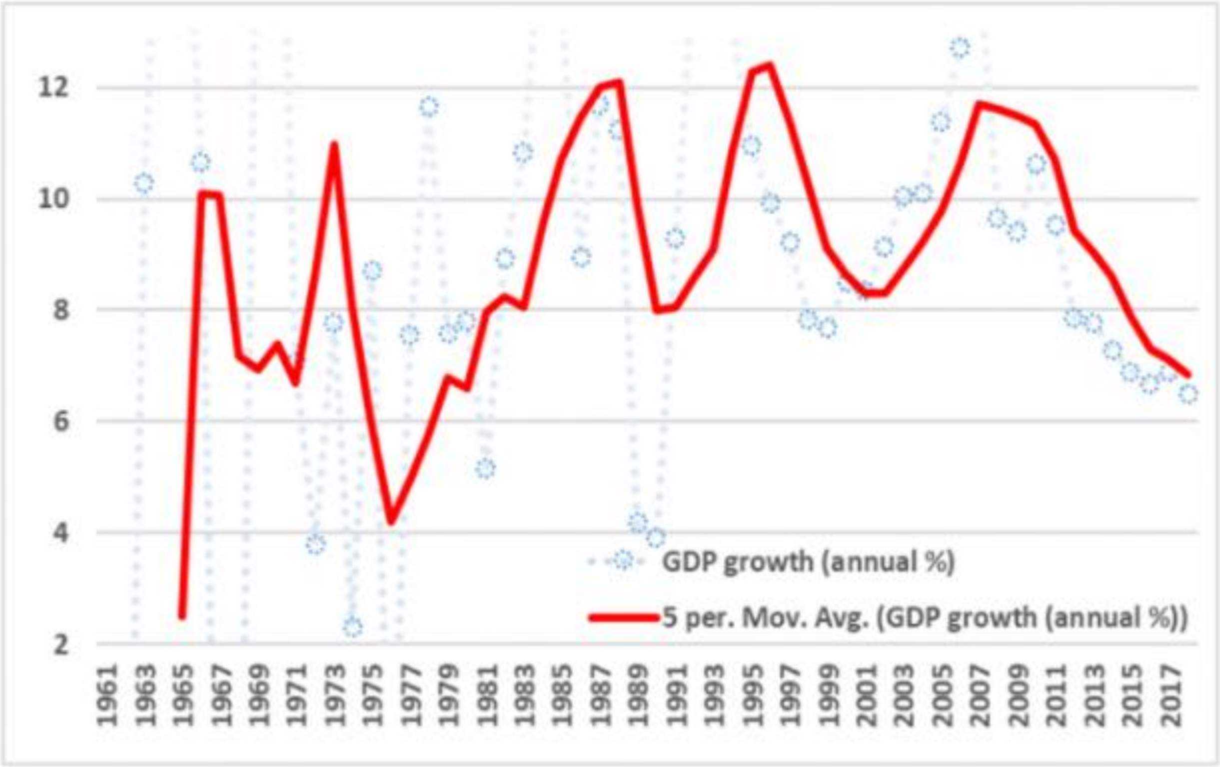
Japanese economic growth



Source: Cabinet office, *Annual Report on National Accounts*, various issues.

Korean economic growth

Chinese economic growth



Source: World Development Indicators

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How was such high growth achieved?

- At 10% GDP growth, national income is **doubled in 7 years**.
- Most economists in Europe and the US concluded that such high growth was due to deregulation, liberalisation, privatisation and allowing free markets and free trade to prevail – neoclassical economics allows no other explanation.
- In actual fact, the East Asian High Growth model adopted policies **contrary to and forbidden** by the Washington Consensus institutions

What was the Methodology of Deng Xiao Ping – the Methodology that created the most successful economy ever?

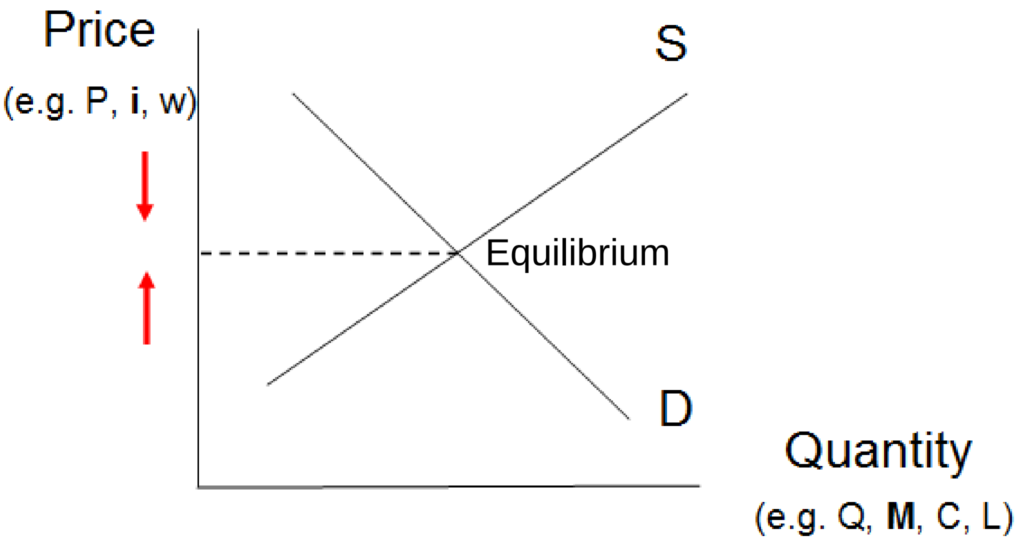
- Go back 40 years to the Third Plenum of the 11th Communist Party of China Central Committee in December 1978: The newly appointed Vice-Premier Deng Xiao Ping delivers a speech in which he urges the Party cadres to

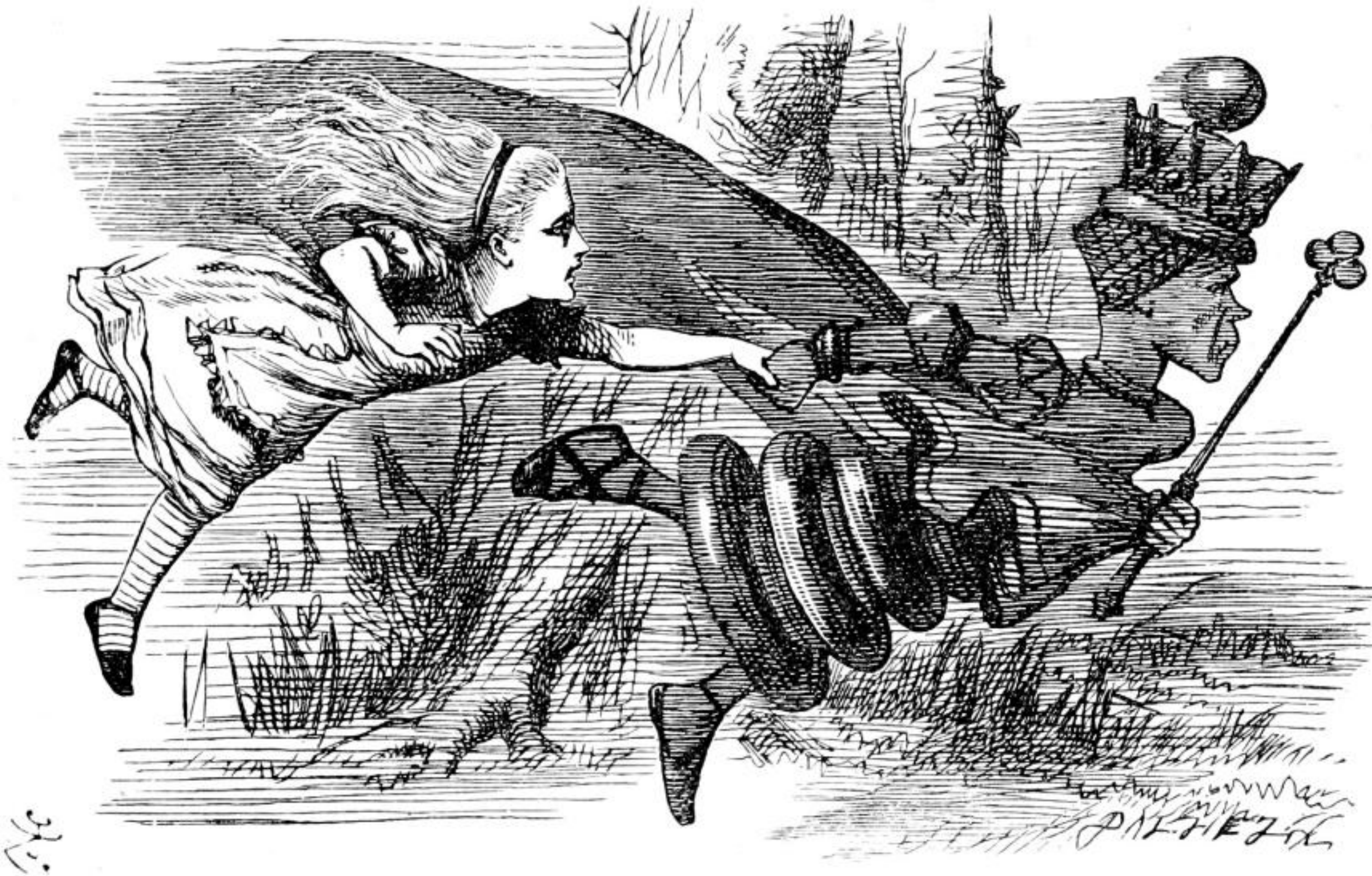
  "liberate their thinking" (from preconceived, i.e. unscientific ideas) and to "seek truth from facts."

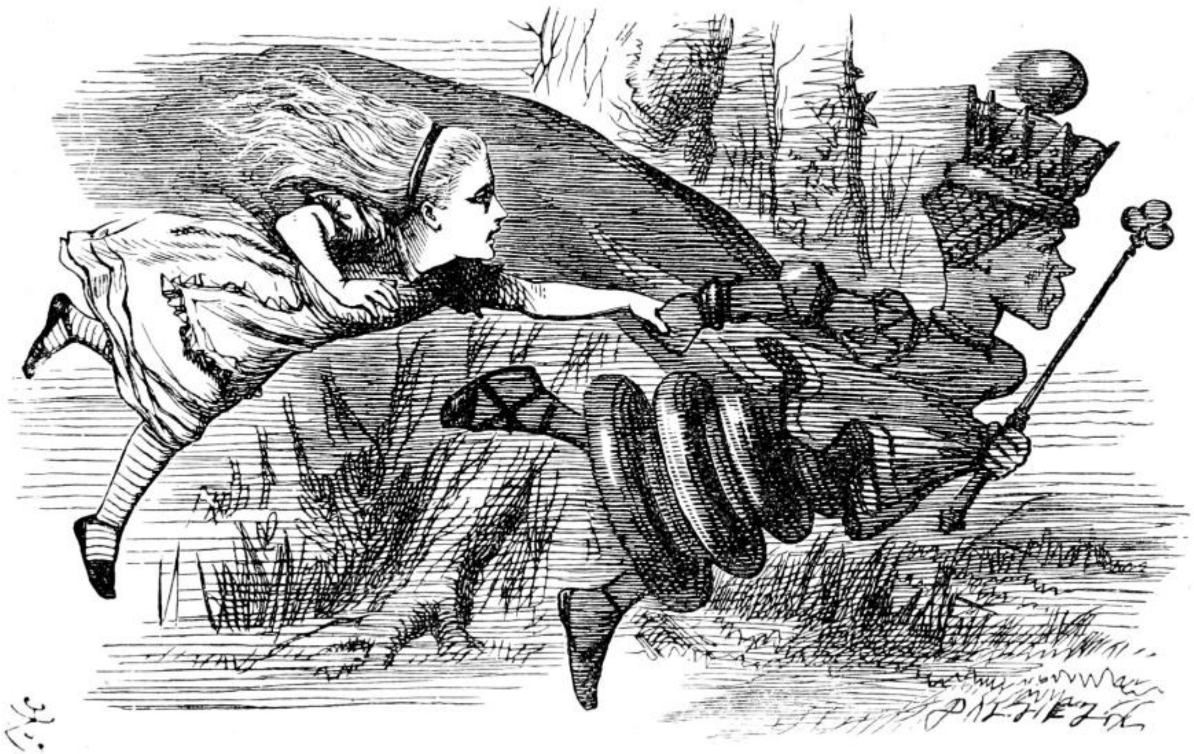
- In other words, Deng Xiao Ping's Reforms in 1978, which were **to change world history**, began with a **change in methodology**.
- Deng Xiao Ping **dropped evidence-free belief** in ideology or in assumptions and axioms. Instead, he insisted on basing all **state action henceforth on the scientific methodology** in the quest to find that type of "cat that catches the mice".
- This was a radical step in China.
- But it was – and remains – ***revolutionary* for Western economics, which still sticks to the ideological adherence to the Washington Consensus approach**

The Concept of Equilibrium: Derived from Theory
Theory: "Markets always clear and they are efficient."

- Assume: 1. Perfect information; 2. Complete markets; 3. Perfect competition; 4. Instantaneous price adjustment; 5. Zero transaction costs; 6. No time constraints; 7. Profit maximisation of rational agents; 8. Nobody is influenced in any way by actions of the others.
- **Then**: It can be shown that markets clear, as prices adjust to deliver equilibrium.
- Hence prices are key, incl. the price of money (interest)







Alice laughed. "There's no use trying," she said: "one can't believe impossible things."

"I daresay you haven't had much practice," said the Queen. "When I was your age, I always did it for half-an-hour a day. ***Why, sometimes I've believed as many as six impossible things before breakfast.****"*

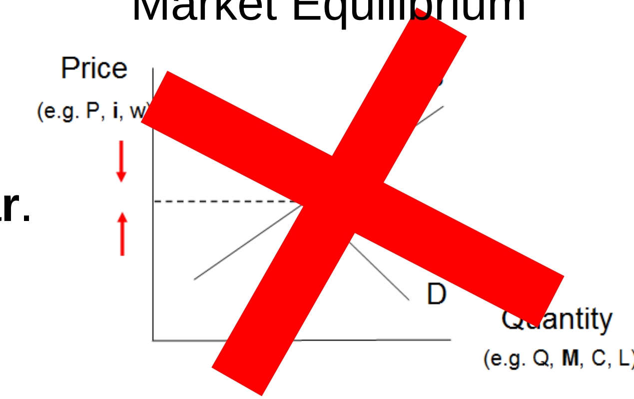
Lewis Carroll (Charles Lutwidge Dodgson), *Alice's Adventures in Wonderland*, 1865

Equilibrium: Not 'truth from facts', but Alice in Wonderland

Fact: We cannot expect markets to clear

- Assume: 1. Perfect information; 2. Complete markets; 3. Perfect competition; 4. Instantaneous price adjustment; 5. Zero transaction costs; 6. No time constraints; 7. Profit maximisation of rational agents; 8. Nobody is influenced in any way by actions of the others.
- If each assumption has a probability of 55% of being true, what is the probability of all assumptions being jointly true?
- $(55\%)^8 = 0.8\%$
- But the individual probability is **much** lower.
- Result: **Markets can never be expected to clear**.

Market Equilibrium



Rationing: Core of the New Paradigm

- If only one of the many assumptions does not hold, **markets do not clear**.
- Economics must recognise **pervasive disequilibrium as the dominant state**.
- What happens when markets do not clear (i.e. always)?
- **Demand does not equal supply. Markets are rationed.**
- Rationed markets are determined by **quantities**, not prices.
- The outcome is determined by **whichever quantity of demand or supply is smaller (**the **'short-side principle')**
- By adopting the **inductive scientific research methodology ('seeking truth from facts'),** we realise that **markets are not efficient**, as they are not even in equilibrium

Markets are rationed & determined by quantities

Implication: The hurdle for gov't intervention to improve market outcomes is much lower than thought

- Government intervention is a 'distortion' and 'inefficient' **only in the theoretical Alice in Wonderland-world of general equilibrium**.
- Once we "**seek truth from facts**" and recognise that all markets are always rationed, we also see that government intervention can quite easily improve market outcomes
- Because market outcomes in reality are not optimal. Since all markets are rationed.

The Chinese High Growth 'Economic Miracle'

- China's rapid industrialization had been so successful that it has become the largest economy in the world by purchasing power parity calculations by around 2015.

- It has also become the world's largest manufacturing economy and exporting economy in the 2010s, beating even German exports.

- Until 2001, China's FX reserves had been steadily rising for many years at below US$ 200 billion. But in the following years another US$ 100 billion was added every year, reaching even more exponential growth at the end of the decade, at US$ 4 trillion in mid-2015. **No other county in history could amass such a huge foreign reserve in only one decade.**

The Belt & Road/New Silk Road initiative and Transnational Development Policy

- With the failure of Washington-style policies, the world thus **looks to China for more useful and more helpful development policy initiatives**, based on the insights China gained from its own development

- The search for a new economic development strategy and the availability of finance for strategic and structural changes have allowed **China to formulate a new international strategy in the 2010s**.

- China's new international economic diplomacy is aimed at increasing connectivity and cooperation among countries along China's old maritime and overland trade routes, namely, the Silk Road Economic Belt and the 21st Century Maritime Silk Road ("**One Belt, One Road**").

The Belt & Road/New Silk Road initiative and Transnational Development Policy

- To realise the country's economic vision of One Belt, One Road, China spearheaded the establishment of the **Asian Infrastructure Investment Bank** (AIIB, Beijing) and the **New Development Bank** (Shanghai).

- The infrastructure facilities built under the Belt and Road Initiative will enhance local and regional connectivity

- When combined with local industrial policy, facilitated by the new opportunities of trade and exchanges, and funded by China or locally through the banking system, it offers a **more realistic chance to lift local populations out of poverty**.

The Internationalisation of the RMB

- China has been increasing the international use of the RMB (renminbi).
- As China's trade with the rest of the world has expanded dramatically over the last 15 years, the RMB has also internationalised and become a globally accepted currency enabling more cross-border capital flows.
- In February 2015, the RMB became the **second most used currency** for trade and services, and a **top-ten currency** in forex trading.
- The Belt and Road vision is to create the physical infrastructure, financial institutions and policy environment that will facilitate regional trade and cooperation, thus accelerating international use of the renminbi.

The Internationalisation of the RMB

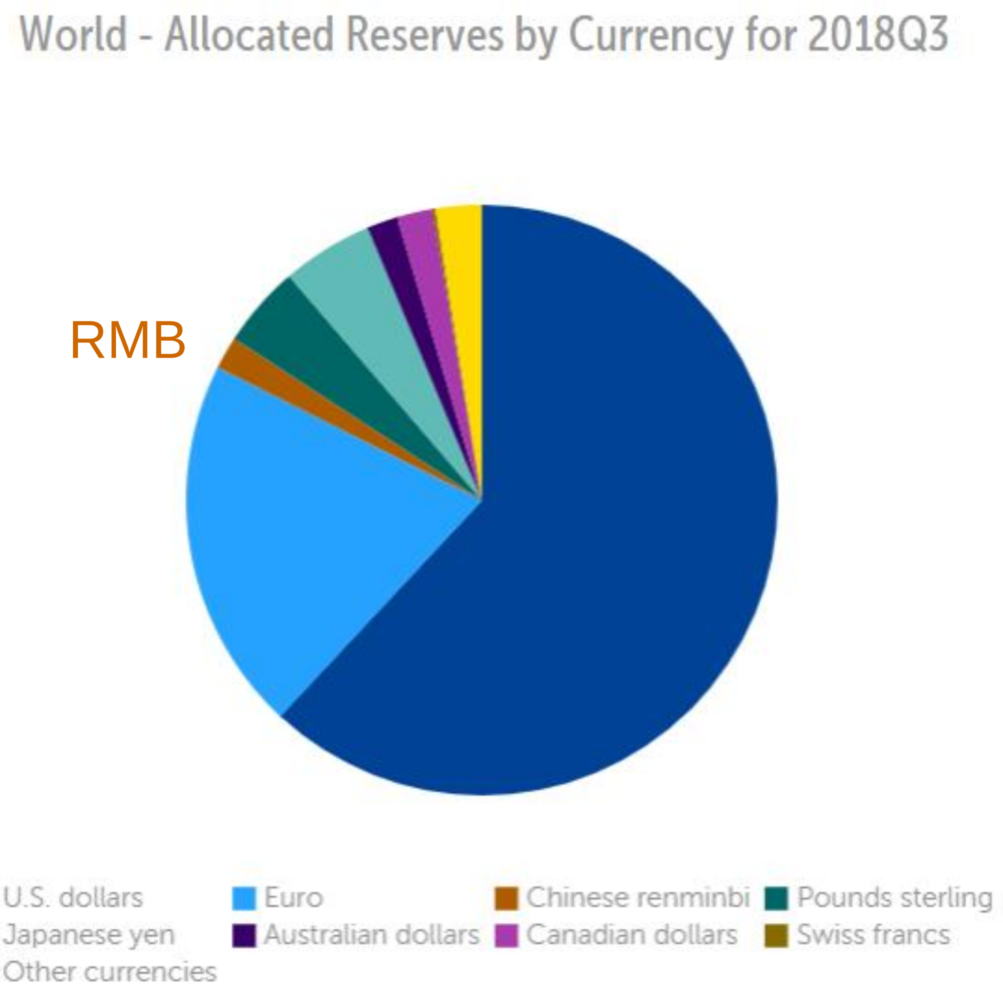
- In January 2017, the China Foreign Exchange Trade System (CFETS), the RMB trade-weighted basket system, added 11 new currencies to the existing 13 in the CFETS basket.
- Many of the newer currencies in the basket are those of emerging markets, some of which lie along the Belt and Road Initiative (BRI) routes.
- The BRI will **increase the trading volume**, increasing cross-border trading activity between China and the BRI countries. Thus the weighting of those BRI currencies may eventually increase further as the countries along the Belt and Road become more active trading partners of China
- Investors are parking more funds in the RMB, allowing it to function more like a reserve currency
- On 26 March 2018, China's crude oil futures was listed on the Shanghai International Energy Exchange. The futures contract is **denominated in RMB**. It is available to foreign investors, exchanges and petroleum companies.
- This marks a **turning point** in global **currency geo-politics**.

Currency composition of official foreign exchange reserves (COFER, IMF, Jan. 2019)

World (US Dollars, Billions)

	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Total Foreign Exchange Reserves	11,291.01	11,440.46	11,600.36	11,463.77	11,396.62
Allocated Reserves	9,642.76	10,014.04	10,401.81	10,514.87	10,705.45
Claims in U.S. dollars	6,125.43	6,280.61	6,530.54	6,560.94	6,631.09
Claims in euro	1,934.68	2,019.24	2,117.56	2,129.55	2,192.11
Claims in Chinese renminbi	108.16	123.47	145.67	192.97	192.54
Claims in Japanese yen	436.19	491.01	477.28	511.38	532.80
Claims in pounds sterling	433.28	454.12	486.12	469.71	480.83
Claims in Australian dollars	170.76	180.01	176.96	178.58	180.82
Claims in Canadian dollars	192.89	202.80	193.29	200.18	208.71
Claims in Swiss francs	16.53	18.09	17.93	16.60	16.59
Claims in other currencies	224.84	244.69	256.45	254.96	269.97
Unallocated Reserves	1,648.26	1,426.42	1,198.55	948.89	691.17

It's just the beginning – get ready for much growth



Some Conclusions

- China's spectacular economic development is a beacon to the world about what is possible if the right policies are adopted
- The Belt and Road Initiative is a co-operative initiative through which China is sharing its successful development strategy with a growing number of countries, whose economies are likely to benefit far more directly than under previous international development policies
- The internationalisation of the RMB helps to diversify Chinese foreign currency exposure and creates enormous opportunities for the world
- There is hope for Europe that closer co-operation with China will create a more balanced international position for European countries, which will create more opportunities for all