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Economic Crises, Currencies and Geopolitical Turning Points

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Summary

The serial financial crises have exposed deep fault lines in the international financial system to world scrutiny. It has led to a questioning of "the way things are" and prompted a search for a better and more stable global financial structure, probably one with multiple poles, echoing the restructuring taking place in the geopolitical order, the contours of which are very actively in the making. In which case, the debate on China's rise will inescapably include the currency dimension, and with it, a sharpened focus on the jockeying for a greater share of the global spoils, on which a currency's claim as an international reserve currency depends.

Introduction

Nothing in fiction can match the drama generated by the serial financial crises of the last two years, starting with the sub-prime crisis and the financial meltdown in the United States and United Kingdom, the global economic slowdown, and the Euro crisis. The Asian economies, having learnt the lessons of 1997, did relatively well during these sequential crises, which at times threatened runs on their currencies as well. But since all currencies cannot fall or rise simultaneously, the flight to safety ended yet again in the dollar, boosting its value. This was despite the main origins of the crises lying in the enormous problems accumulated in the US financial sector, although China was also blamed for maintaining structural current account surpluses which, invested in developed economy securities, fuelled the credit binge.

The crises therefore inevitably raised fundamental questions about the sustainability of the present international financial system, the international reserve currency in which huge imbalances had been allowed to accumulate, and the absence of oversight and self-regulation witnessed in the financial sectors of the developed economies.

It also re-fuelled the ongoing debate about the shift of power from West to East, which thus acquired a financial/currency dimension. The report by the US National Intelligence Council *Global Trends 2025: A Transformed World*,[1] recognised this: "…the global shift in relative wealth and economic power now under way—roughly from West to East—is without precedent in modern history. …These shifts … are deep and structural, which suggests that the resulting transfer of economic power we are witnessing is likely to endure." In his "Beijing Seeks Paradigm Shift in Geopolitics,"[2] the expert Willy Lam, as have many others, commented on "China's much-enhanced global clout in the wake of the world financial crisis, coupled with a marked decline in American… power."

Thus the BRIC Summit of 2010, in a clear reaction to the ongoing financial turmoil, called for exploring the idea of establishing regional monetary arrangements and other cooperation modalities among BRIC countries, including local currency trade settlement arrangements. In a March 2009 speech titled "Reform the International Monetary System," the Governor of the People's Bank of China, Zhou Xiaochuan, called for an *international reserve, super-sovereign currency* to secure global financial stability and facilitate world economic growth. Meanwhile, as the world groped to find enduring solutions, China had already begun to diversify its holdings and encourage greater use of its currency in bilateral trade transactions.

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1 www.dni.gov/nic/NIC_2025_project.html, *November 2008.*

2 *China Brief*, vol. 10, iss. 5, March 5, 2010.

It is not possible to do full justice to all aspects of the currency crises, on which detailed commentary exists. The focus here is on certain limited aspects in order to discern some patterns for discussion.

Impact on China

As the world's second largest economy, China's responses to the crisis are critical in determining outcomes. China was initially greatly affected by the contraction in its main export markets, but by injecting large stimulus packages into its economy, it created additional demand and staged a recovery. But the investment increases, particularly by over-indebted local governments, did not address the two fault lines – China's big internal debt and its structural current account surpluses,[3] a cause of friction with the United States.

Although the Chinese Government recently applied the brakes on further investment, problems for the medium-term remained, as many analysts including Derek Scissors, M. Pettis and Chanos concluded. Michael Pettis in fact questioned the conventional wisdom underlying the adage – too big to fail – in his article "Never short a country with US$2 trillion in foreign currency reserves."[4] Citing historical precedents, he concluded that there was no guarantee against such an outcome, although he did not substantiate what the process could look like, since China's huge external reserves and essentially closed capital account could effectively insulate it from externally induced "shorting". But given the amounts involved, it was clearly imperative for China to find a solution to its economic dilemmas. Otherwise, the assumption of automaticity of the much heralded shift of power and China's continued rise would have to be qualified.

During this period, the United States also ratcheted up pressure on China to revalue its currency, attempting to label China a currency manipulator. China countered that the crisis was one entirely of Western making and ostensibly rejected demands for revaluation, which were also reportedly put on the shelf because of the Euro's fall vis-à-vis the pegged renminbi.

A possible turning of tables could be seen in the fluctuations in the Euro's value following a late May 2010 *Financial Times* report that China's State Administration of Foreign Exchange (SAFE) had expressed concern about its euro-zone debt, and was accordingly reviewing its holdings of euro-zone bonds. This necessitated a denial by SAFE, which reiterated that China was committed to the diversification of its foreign-exchange reserves.

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3 According to the monthly Treasury International Capital (TIC) report, China famously holds around US$ 2.447 trillion of forex reserves including US $895.2 billion of US Treasuries (end March 2010), http://www.ustreas.gov/tic/mfh.txt.

4 http://mpettis.com/2010/02/never-short-a-country-with-2-trillion-in-reserves

This was followed by an interesting commentary in *China Daily*[5] which is worth describing for the information it contained. It gave the reasons for China maintaining its diversification policy while stating that dollar-denominated assets, mostly Treasury securities, were estimated to be around 70 per cent of the $2,447 billion foreign reserves managed by SAFE. It is rare that one gets such precise information on the composition of China's foreign exchange reserves from Chinese sources, even though the article purports to be the personal views of a visiting professor at a University. The article stated that SAFE denied that it was reviewing its $630 billion holdings of euro debt and that it would continue to diversify its foreign exchange reserve investments because "…the shortcomings of a concentrated basket become obvious… in the aftermath of the financial tsunami." Thus the "short term flight to safety could not mask the long term consequences of the huge US fiscal deficit" and it was "not in the Chinese interest to witness further deterioration of the euro which could destabilise the global recovery." Indeed, it was "in the long-term interest of China to diversify her foreign reserve holdings against the possible devaluation or depreciation of the greenback in the future. China should seize the golden opportunity to … reduce the USD-denominated asset exposure as well as to capitalize on the appreciation and to further diversify her reserves."

There was also speculation on whether China was now a net seller of US Treasuries, with each report causing fluctuations in the value of the dollar, but the balance of opinion/ evidence seemed to be that China was stuck with accumulating ever increasing balances in this regard, unless the two economies accelerated their efforts at restructuring their respective consumption and savings patterns.

Meanwhile, China was expanding its holdings of gold, SDRs and commodity stockpiles (as storehouses of value). Despite its denials, China had also probably curbed its enthusiasm for the Euro, which left other (long-term) options open – *gradually regionalising/ internationalising China's own currency/working simultaneously for more than one international reserve currency/working for a super-sovereign reserve currency which could be a mix of currencies and other assets. And the way China would go about it would be typical of China's successful reforms strategy: it would advance one step at a time, crossing the river by feeling for the stones underneath, as Deng Xiao Ping had advised.*

For example, eclipsed in the avalanche of commentary on the currency crises affecting the developed countries were China's moves for greater utilisation of its currency in external financial transactions. A study by two RBI economists Dr. Rajiv Ranjan and Anand Prakash, details the Renminbi's increased use in cross-border transactions. China has bilateral trade payments agreements with several neighbouring regions and countries (Shanghai,

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5 Wang Guanyi, "The smart euro-debt strategy for China," *China Daily* (Hong Kong edition), June 1, 2010, http://www.chinadaily.cn/hkedition/2010-06/01/content_9914071.htm

Guangzhou and Hong Kong and Malaysia, Indonesia, Brazil, Russia, Argentina, Belarus, and South Korea) including currency swap agreements between central banks. The Chinese Government is supporting Hong Kong as an offshore Renminbi trading centre.

In "Beijing's Diplomatic Offensive: "Marathon Autumn Diplomacy,"[6] Willy Lam mentions that the 8th meeting of SCO leaders agreed to tighten financial and trade cooperation to better combat the global financial crisis. Russia and China also stepped up economic collaboration with some transactions settled in renminbi and roubles. Willy Lam also cites sources saying that China was reportedly among other countries conducting unconfirmed talks with Middle East nations on pricing oil in US dollars and using instead a basket of currencies that included the Euro, the RMB and the yen. China's energy security strategy of establishing access to and control of major Eurasian, West and South East Asian energy resources and trans-Asian transportation networks – thereby reducing its strategic dependence on maritime transportation networks for its energy needs – thus fitted in well with its strategy for currency diversification / renminbi regionalisation / internationalisation.

It may be noted that Renminbi dealings under bilateral arrangements are said to be still miniscule, and as earlier mentioned China has to overcome formidable problems before it contemplates opening up its capital account, let alone aim for the status of an international reserve currency.

A European aside

The currency crisis started with Greece, engulfed the Euro and exposed the fault lines in the single European currency. One of the most potent transmission mechanisms – the power to switch currency holdings instantaneously – enabling local distortions, accumulated perhaps for decades in a national economy to suddenly trigger crises affecting an entire continent, necessitated an unprecedented intervention by the IMF in a *developed EU member country*. According to an article in the Wall Street Journal,[7] European bank exposure to sovereign debt in Portugal, Italy, Ireland, Greece and Spain totalled $2.8 trillion in end-2009, and Portugal, Spain, Ireland, Italy, perhaps Hungary and even the United Kingdom, could be next in line in view of their huge budget deficits / public debt. Eminent and long-standing experts like Martin Wolf did not rule out *the collapse of the Euro*.[8]

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6 Willy Lam, "Beijing's Diplomatic Offensive: 'Marathon Autumn Diplomacy'," *China Brief*, vol. 9, iss. 21, October 22, 2009.

7 Christopher Wood, "Don't Rule Out a Double Dip Recession," *The Wall Street Journal*, May 24, 2010.

8 Martin Wolf, "Eurozone plays 'beggar my neighbour'," *Financial Times*, May 18, 2010, http://www.ft.com/cms/s/0/58ebec36-62aa-11df-b1d1-00144feab49a.html.

Germany is one of the few countries in Europe with a strong industrial base and export economy, achieved after years of restructuring.[9] While German current account surpluses were accumulated at the cost of some of its Euro partners (Germany's biggest trading partner is the Eurozone itself), mirroring the China-US pattern, Germans were unhappy at the idea of propping up the weaker Eurozone economies, a feeling clearly shared in their ruling circles, judging by the reluctance with which Germany came around to the idea of an IMF/European bailout. The German Chancellor herself hinted that repeat defaulting countries should be eased out of the Eurozone. The PIIGS countries on their part charged that the common currency deprived them of the devaluation option as a means of correcting current account deficits.

Germany has not re-emerged from its European cocoon yet, but it *has* begun to look beyond. After all, Germany has growing links with rising Asia and the United States as well as with Russia from which it sources a large proportion of its energy supplies. Germany has gone against its smaller European allies in encouraging the building of direct German-Russian energy pipelines, and forged a distinctive line on the issue of stationing BMDs in Europe as well as Georgia and Ukraine joining NATO. Signs of relaxation in US-Russian ties and between Poland and Russia could also set the stage for long-term changes in the way Euro-Atlantic and European structures evolve. Could one of the aftermaths of the crisis and *ennui* with its burden lead Germany to re-think its attitude to the Eurozone and seek partnerships with a combination of different countries, thus raising its geopolitical profile and causing a shake up of current EU structures, policies and mechanisms? Or will it continue to seek EU solutions in an attempt to rejuvenate the European project?

India

India's adoption of stimulus packages in response to the crisis averted a slowdown. But the subsequent appreciation of the Rupee led to serious heartburn amongst indigenous manufacturers/exporters in India. Dani Rodrik, amongst others, had analysed how China used the dollar peg to maintain export competitiveness.[10] Interviews appeared in leading business papers bemoaning the loss of competitiveness in India's home market (for power equipment) vis-à-vis Chinese suppliers buoyed by a lower cost structure and a cheaper currency. This was echoed by the RBI Governor in an interview given to the Wall Street Journal on April 20, 2010. India's Finance Minister was also reported to have stated that

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[9] China has overtaken Germany as the world's biggest exporter. It has also overtaken Germany and Japan, earlier the third and second largest economies respectively, to emerge as the world's second largest economy.

[10] Dani Rodrik, "The Return of Industrial Policy," *Financial Times*, April 20, 2010.

China could soon give an indication of its policy on revaluation.[11]

On the whole, however, India emerged as one of the most balanced and high-growth economies in the world, thanks largely to a dynamic entrepreneurial sector and a well managed financial system under the auspices of the RBI. At present, the rupee cannot be said to be doing badly, despite the fact that India's foreign exchange earnings do not reflect a merchandise trade surplus. The Rupee's strength reflects the stable and dynamic growth achieved by the Indian economy despite the huge problems still waiting to be tackled. The private sector, some excellent public sector companies and a clutch of fine institutions have done their bit to impart momentum to the Indian economy. India's fiscal deficit though continued to plague efforts at restoring full financial balance.

The authors of the RBI study mentioned above concluded that India needed to take steps to increase the role of the Indian rupee in the region to catch up with the progress made by the Chinese Renminbi, but urged caution since India runs significant trade and current account deficits. It is entirely possible that if and when India is ready to make the rupee fully convertible, the renminbi may already have emerged as a stronger international currency. The World Bank chief is reported to have predicted that the Renminbi will become an international reserve currency by 2020. However, as stressed earlier, important reforms need to be carried out before China can achieve this goal and little can rule out India staying in the race.

Conclusion

The crisis drew attention to its structural origins inherent in a poorly managed global financial system and also its connections to persistent imbalances in individual economies and their mutual interactions. The trillion-dollar each rescue packages for the US and EU economies probably dwarfed anything made available to countries similarly in distress in earlier crises. Amongst its positive effects were that it spurred a search for a more sound global financial architecture (it is a pity there has not been simultaneously enough focus on reviving the stalled world trade negotiations, which could provide an easy and early catalyst to renewed growth). Achieving success may prove a Herculean task.

Against strong domestic opposition, the United States is trying to address the massive imbalances which are symptomatic of an unsustainable proclivity to dis-save and under-invest in building up its long-term primacy, as Larry Summers had pointed out in his speech

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11 Unni Krishnan and Kartik Goyal, "Pranab Mukherjee: China May Signal Yuan Move to Temper Global Criticism (Update2)," http://www.bloomberg.com/apps/news?pid=20601089&sid=aUUZ63bu3WXo.

at the Peterson Institute in 2004. There are also signs that it is fully aware of the need to support meaningful reform at the international level in order to curb the worst excesses of the current system, but also to obviate moves to dilute the importance of the dollar as the international reserve.

The incremental solution being explored by China may not lead to the desired results in the short term, as the world has experience with bilateral currency arrangements that end up distorting trade patterns and introducing inefficiencies. China ultimately needs to address its own imbalances as these have contributed to global imbalances. This could be a painful process as it would involve domestic restructuring which is never without reaction. But China is not allowing these problems to deter it from adopting a strategic vision for the evolution of the world financial system and to establish its place preferably at the centre or as one of the major poles.

The EU also should be in for a bout of soul searching and restructuring as countries like Germany re-examine the sustainability of maintaining their manufacturing cum export lead within a community of countries losing competitive advantage to the more dynamic economies in Asia and elsewhere.

Meanwhile other powers are rising – Turkey, Brazil, South Africa, even Poland – all with their own ambitions, memories and visions of past and future greatness.

The BRIC report puts India amongst the top three economies in 2050. It is hoped that the international financial system can be reformed so that it does not adversely impact India's growth prospects. Till then, a prudent firewall in terms of a partially closed capital account and a conservatively run, well-collateralised banking sector is the best insulation from its wild fluctuations. With the right policies, India may also look forward to the day when its economy is strong enough to sustain the Rupee as an international reserve currency.

Each country / region is looking at not only how to restore the balance but also at possible reforms in the global financial architecture, for which a number of proposals are floating around. The G-20 in Busan is reportedly near an agreement on proper collateralisation for major banks.[12] Despite the frailties of the Euro, there is also muted talk of moving away from over-dependence on a single international reserve currency.

Very clearly, the serial financial crises have exposed deep fault lines in the international financial system to world scrutiny. It has led to a questioning of "the way things are" and prompted a search for a better and more stable global financial structure, probably one

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12 Michael M. Phillips and Alex Frangos, "G-20 Is Nearing Accord on New Capital Rules," June 7, 2010, http://online.wsj.com/article/SB10001424052748704183204575287930895807598.html

with multiple poles, echoing the restructuring taking place in the geopolitical order, the contours of which are very actively in the making. In which case, the debate on China's rise will inescapably include the currency dimension, and with it, a sharpened focus on the jockeying for a greater share of the global spoils, on which a currency's claim as an international reserve currency depends.