3 Reform of the International Economic System:
What does China want?

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Introduction

The current international economic system, which was first established in the mid-1940s, contains three key features. First, the United States is a dominant leader in designing and enforcing the international economic rules. Second, the US dollar has been the cornerstone of the international monetary system, both before and after the breakdown of the Bretton Woods system. And finally, three international organisations—the International Monetary Fund (IMF), the World Bank and the World Trade Organisation (WTO)—are responsible for maintaining international economic order.

For more than half of a century, this system facilitated steady growth of the global economy. Recently, however, there have been growing calls for reform of the international economic system. Two important events, in particular, have strengthened these demands. The first has been the ascendancy of the emerging market economies, which naturally calls for some of these to move from the periphery to the centre-stage of international economic decision making. The second was the sub-prime crisis in the United States, which has raised serious questions about the future international roles of the United States and the US dollar.

The current international economic system is modelled mainly on the economic systems of the industrialised countries, especially that of the United States. It promotes free trade, free investment, free markets and strict market discipline. But the latest sub-prime crisis revealed some problems with the US system. Economists have since raised questions about the effectiveness of monetary policy, financial regulations and the international reserve system. While there might not be consensus about what should happen next, there is general consensus that this system needs to be adapted to suit the new global economic and market conditions.

The world economy is indeed very different today from more than 60 years ago when the current system was first set up. Towards the end of World War II, most developing economies collapsed, suffering from serious and widespread poverty problems. They received financial assistance for, and policy advice on, poverty alleviation and economic development from international organisations and industrialised countries; however, these developing countries made little contribution to the design and enforcement of international economic rules.

Today, however, the emerging market economies are already important players in the world economy. Of the world's 20 largest economies, more than half are emerging market economies. For instance, the five BRICS countries (Brazil, Russia, India, China and South

Africa) account for 42 per cent of the world's population and 18 per cent of global gross domestic product (GDP). Many emerging market economies have already begun to assert their influence in world economic affairs through the Group of Twenty (G20) summit process. It is now appropriate for the advanced and emerging market economies to work together in changing some of the international economic rules.

China is likely to play an important part in the transformation of the international economic system. China is already the second-largest economy in the world according to market-based GDP measures and might overtake the United States as early as 2013 according to the purchasing power parity-based GDP measure (Feenstra et al. 2011). China's international economic influences have grown exponentially, especially in international markets for labour-intensive manufactured goods, raw materials and commodities and foreign exchange.

This chapter focuses on the central question of the likely nature of Chinese participation in this international reform process. One critical question is: what does China want? We intend to answer this question based on our best understanding of the Chinese position on a number of selected important subjects, including the transformation of international governance, restructuring of international organisations, and reform of the international monetary system. But it is important to point out that these only represent our best interpretation of the official position, not the official position itself.

Our main arguments can be summarised as follows. First, China wants reform, not revolution, of the international economic system. It recognises that the world has become a multipolar system, with a number of large economies possessing significant influence on the world economy. But we share universal economic values, such as free trade and investment, and are keenly interested in working with the other major countries in building a 'harmonious world' (Hu 2007). While some existing rules are in urgent need of reform, we want to improve the existing international economic system, not abandon it.

Second, China sees the G20 as the best compromise between representativeness and efficiency for dealing with international economic issues and is interested in making it a permanent institution. The Sino–US partnership will probably be a cornerstone of China's international economic relations. But China is not ready to formalise the institutional arrangement of a Group of Two (G2) for global economic affairs. China promotes collaboration between the BRICS countries but regards it more as a platform for formulating policy positions among key emerging market economies, not as a parallel organisation alongside the G20.

Third, China is in favour of any restructuring initiatives that give more influence to emerging market economies within international organisations such as the IMF and the World Bank. While these organisations have made important contributions to China's economic reforms, their governance and rules should be reformed to better reflect the new reality of the world economy. International Monetary Fund reforms, for instance, should allocate more voting shares to the developing countries, give up the practice of appointing Europeans to its managing directorship, abandon the US veto power and set policies more appropriate for emerging market economies.

Fourth, China supports reforms of the international monetary system but sees avoiding the sudden collapse of the US dollar as critical. The transition of the global reserve system is likely to be a long-term process. China, the United States and the other major economies of the world should work together to ensure a smooth transition of the role of the dollar, which is critical for providing a stable global economic environment. China also wishes to internationalise the renminbi (RMB), which could eventually become part of a multi-reserve system.

Finally, as a responsible large country, China will also need to introduce reforms to its own economic system and take proactive action to support and sustain an open, fair and efficient international economic system. It can take leadership roles in some global economic areas such as economic rebalancing, the Doha Round and climate change. The setting of domestic policies should take into account the reaction functions of the other countries. China should move further towards a market economy by, for instance, introducing market-based interest and exchange rates and reducing the influence of the state on economic activities.

Changing the international economic order: revolution or reform?

'Keeping a low profile' in international affairs has been a key strategy set by Chinese leader Deng Xiaoping. Over the years, however, different interpretations of this strategy have emerged. Some have regarded it as a historical shift of foreign policy from confrontation to cooperation in international affairs, parallel with the transition in domestic policy from class struggle to economic construction in 1978. Others, however, have interpreted it as a way of buying time for economic development.

In October 2007, Chinese President, Hu Jintao, called for 'people of all countries [to] join hands and strive to build a harmonious world of lasting peace and common prosperity' (Hu 2007). This suggests clearly that cooperation is a long-term policy strategy for China. In December 2010, State Councillor Dai Bingguo published an article to articulate in more detail China's long-term policy positions in international affairs (Dai 2010). Specifically, he rejected the speculation that China might want to seek hegemony once it becomes industrialised. In other words, China wants to work within the existing framework. This principle should be applicable to areas of both foreign policy and economic cooperation.

The trouble, however, is that, as many international experts have observed, so far China has not articulated its official position on what it expects or wants from reforms of the international economic system. Perhaps a major exception was the proposal by Zhou Xiaochuan, Governor of the People's Bank of China (PBC), to transform the IMF's special drawing rights (SDR) in early 2009 (Zhou 2009). Even this proposal, however, has been regarded more as an academic exploration than a concrete policy recommendation.

The lack of Chinese vision for the future international economic system creates uncertainties for the reform process. A couple of factors might explain the lack of a Chinese version of the blueprint. The policy strategy that the Chinese policymakers adopted during their own economic reform was the so-called 'crossing the river by touching the stones'.

Given the spectacular failure of the central planning system in the pre-reform period, these policymakers presumably no longer have much faith in a 'blueprint'. After all, economic systems are not mechanical or biological bodies. Reformers have to frequently adjust their policy strategies, responding to new economic environments. The Chinese Government did not have a blueprint when it started economic reforms in the late 1970s and, given the subsequent success of these reforms, perhaps opting for no blueprint seems the optimal policy strategy.

More importantly, as China is a new power in the global economy, the question of reforming the international economic system is a new subject for Chinese scholars and officials. Recently, there have been some debates inside China regarding the future direction of the international economic system. Some have argued that maintenance of the status quo is in China's best interest, while (a minority of) others believe that it is time for China to change the rules for the world. Given the difference of opinions within China, it will likely take time for the Chinese leaders to assess the situation and formulate official positions.

One worrying development—alongside China's rapid ascendancy as a global economic power—is the growing nationalistic sentiment that has emerged in line with China's sound macroeconomic performance during the sub-prime crisis. Some scholars began to suggest that China should say no to the United States. This recommendation itself might not appear to be a major problem. But the underlying thinking is that China has been frequently bullied by US hegemony in the past half-century, and now it is payback time. This line of thinking is worrying since it advocates confrontation in international economic relations.

Dai's (2010) timely policy paper clearly rejects the argument that China should now challenge the existing world powers. In fact, most Chinese policymakers acknowledge that China is the main beneficiary of the existing international economic system. Without the open and favourable external environment, China would not have been able to achieve rapid economic growth for the past 30 years. Policy advice from the IMF and the World Bank, even if not always fully adopted, also helped China to avoid some major policy mistakes (Yi 2011). The continuation of some of the key features of this system, including free trade and the free flow of capital, is in the best interests of both China and the rest of the world.

It is not surprising that there are some tensions between China and the existing powers of the international economy. The first type of tension relates to potential conflict between existing and rising powers. As China is likely to overtake the United States to become the largest economy in the world in the coming decade or two, suspicions of the other party's intentions are common on both sides. In particular, transitions of world leadership from one nation-state to another in the past were often resolved through wars. Although such suspicions have not led to actual conflicts between China and the United States, they could cause difficulties for cooperation in the international economic system.

The second type of tension is ideological in nature. Unfortunately, many in the West still view China as a typical communist country. Such perceptions deepened in the wake of the global financial crisis as the state and state-owned enterprises (SOEs) gained more power over economic activities in responding to the crisis. As a result, many foreign and domestic experts are confused about the future direction of Chinese economic reform—in particular, whether China will move towards deepening market-oriented reform or reverse back to state control of the economy. These changes could also reduce trust between China and the rest of the world.

The third type of tension is typical between advanced market economies and emerging market economies with regard to the ideal economic system. Most advanced market economies believe in a free-market system with limited state intervention in economic activities, although clearly to a lesser extent in much of Europe than in the United States. During the past decades, most emerging market economies have adopted market-oriented reforms and consequently achieved remarkable economic growth. Many of them, however, remain cautious about completely liberalised markets, including the full liberalisation of their capital accounts, especially with regard to short-term capital flows.

These potential tensions require careful management through different arrangements at the bilateral, regional and international levels. Many of them can be eased through enhanced mutual understanding and deepened cooperation. In a globalised economy, the rise of China does not have to come at the cost of the United States or other major economies in the world; as evidenced in the past 30 years, this is not a zero-sum game. Together with the United States, China has a strong interest in supporting the thrust of the existing system and any positive suggestions for reforming the existing system initiated by China or other emerging market economies are likely to be in the interest of the United States as well.

Moreover, the differences between China and the existing major economic powers might diminish over time as China continues its reform and becomes more globalised and the world's ruling institutions themselves become a multipolar system. The IMF's recent decision to permit temporary use of capital-control measures is one such example.

China demands changes to the international economic system because it no longer reflects the reality of the world economy. It is also because it is no longer the most credible or efficient arrangement, given, for instance, the weakening position of the US dollar. And, finally, it is because the current system is not fair in some areas, such as the dominance of the United States and some European countries in international economic organisations. Reforms are urgently needed to give a stronger voice to the emerging market economies as a whole in international economic decisions. International economic rules should also better reflect new economic and market conditions, such as the complex array of financial products in global financial markets. The world also needs a new international reserve system that can support continued stable growth of the global economy.

The ultimate goal of the Chinese demands for reform is to make the new international economic system more representative, fairer, more efficient and more sustainable. China has no intention of completely rebuilding the system. It is not interested in developing a competing system alongside the existing one. The world economy has become more of a multipolar system and developing countries, including China, should have more influence on important international economic decisions.

International economic governance: G2, G7 or G20?

The main international architecture built in the postwar period centres on the UN system. Representing more than 200 country members, it is also the most democratic international organisation. The Bretton Woods system has two major economic institutions governing international economic affairs: the IMF, charged with the tasks of macroeconomic surveillance and financial stability; and the World Bank, devoted to poverty alleviation and economic development in developing countries. Alongside these there is the WTO, which helps maintain law and order in international trade in goods and services.

All these institutions have played important roles in facilitating world economic development in the postwar period. But they also have some important deficiencies. Since they operate mainly on consensus, it is often difficult to make decisions quickly. For instance, the five permanent members of the UN Security Council—the United States, the United Kingdom, France, Russia and China—all have veto power and often disagree with each other on some important decisions. This was especially so during the Cold War.

The Group of Seven (G7) was a response by the United States and its main allies to this undesirable situation. The United States, the United Kingdom, Germany, France, Japan, Italy and Canada formed a new group outside the UN/Bretton Woods system to decide on important global economic and political issues. These countries shared some common interests. They were all industrialised economies and democratic countries, and they were all strong political supporters of US leadership in global affairs.

Clearly, the G7 had a legitimacy problem, as it was not formed through multilateral arrangements (the G7 was later expanded to the G8 by including Russia after the fall of the Berlin Wall). That is why the group is often called the 'rich countries' club'. But for quite a long time, this representativeness did not cause any practical issues for the G7. After all, with more than half of the world's GDP, the G7 could make important decisions unilaterally. And these decisions in turn had a significant influence on the directions of the world economy, which are not necessarily consistent with the interests of other countries. The importance of the other economies, whether or not they also adopted the decisions of the G7, was marginal.

The well-known Plaza Accord was a good example of such a unilateral agreement. On 22 September 1985, the Governments of France, West Germany, Japan, the United States and the United Kingdom signed an accord at the Plaza Hotel in New York City to address the global imbalance problem. The accord required the major current account surplus countries, Japan and West Germany, to appreciate their currencies and to expand their fiscal spending, while the main deficit countries, the United States and the United Kingdom, depreciated their currencies and reduced their fiscal deficits. This agreement worked, at least temporarily, in reducing the imbalances.

Whether or not the Plaza Accord was a good arrangement was, however, a different issue. In retrospect, the accord focused on short-run currency and fiscal policies, but did not help root out the imbalance problems. Imbalance problems of all these major economies surged again in the following decades, contributing to the global imbalance problem the world faces today.

With the rapid growth of emerging market economies, especially China, during the past decades, neither the G7 nor the G8 is any longer an appropriate mechanism for international policy making. Another Plaza Accord by the G7 today, for instance, would be even less effective in addressing the global imbalance problem.

The World Bank estimates that, on a purchasing power parity (PPP) basis, China's GDP per capita was $6828 (international dollars) in 2009, instead of the US$3744 recorded in official statistics. According to the Penn World Tables (PWT) project, however, the PPP income data of the World Bank still underestimated Chinese income by about 20 per cent due to overestimation of price levels. Adjusting for this, China will overtake the United States to become the world's largest economy in 2013 (Feenstra et al. 2011).

The rise of the Chinese economy has fundamentally changed the structure of the world economy. The industrialised countries dominated the global economy in the past, but this is no longer the case. This was behind recent calls for the United States and China to form a Group of Two (G2) to manage world affairs (Bergsten et al. 2008; Zoellick and Lin 2009). The G2 is an innovative idea responding to the changing world economy. The joint leadership of the United States and China, representing the industrial and emerging market economies, respectively, certainly sounds more suitable for the new world economic reality.

Responses by the Chinese leadership to this proposal, however, have been quite negative, probably for several reasons. First, while it is already the second-largest economy in the world—thanks primarily to its large population—China is still a lower middle-income country. Its GDP per capita is still ranked ninety-fifth among the 180 countries covered by the IMF, and as such it is still a long way from the world economic frontier. China has by no means become a world economic leader. In other words, real economic conditions do not support China sitting at the head table of the world economy alongside the United States.

Second, China does not command the necessary support globally to become a part of a G2. For decades, China regarded itself as a member of the developing world. During the past decade or so, however, the interests of China and those of other developing countries have diverged significantly. While China shares some common interests with other emerging market economies—evidenced by cooperation at the BRICS and the Association of South-East Asian Nations Plus Three (ASEAN+3)—China does not enjoy a clear leadership role among the developing countries as the United States does among the industrialised economies. To a certain extent, sitting at the head table with the United States might actually weaken China's alliance with other emerging market economies.

Third, China is itself at the centre of confronting many global issues such as climate change and global imbalances. A G2 mechanism would probably make China the focus of these global tensions. A multilateral framework would be much more favourable for China—both for the purpose of negotiation and for eventual resolution of these problems.

Finally, China is not yet ready to be a key rule maker for the world economy. It is still learning about the existing rules. Some policy makers complain that China does not have a sufficient stock of talented people who can participate in international economic negotiations. Political constraints make Chinese participation in international rule making even more difficult. For instance, Chinese negotiators often do not have enough autonomy in closing deals with other partners at international forums. In short, China does not yet have the institutional capacity to become a key rule maker together with the United States.

These points, of course, do not mean that bilateral cooperation between China and the United States is unimportant. On the contrary, dialogue and cooperation between the world's largest industrial economy and the world's largest developing country are vital for management of important international economic issues. The Sino–US partnership is probably the most important bilateral relationship for not only China but also the world as a whole. The regular Strategic and Economic Dialogue is a good example of such a partnership in addressing bilateral issues.

For the reasons pointed out above, the Chinese Government favours the G20 mechanism for international economic governance. The G20 was originally established as a ministerial forum in 1999 in Germany, right after the East Asian financial crisis. At the height of the global financial crisis in late 2008, then US President, George W. Bush, called for a G20 summit in Washington, DC, to discuss collective actions against the crisis and recession. This started the biannual summit practice, which is already a powerful economic decision-making body. The G20 has made important progress in controlling financial risks, supporting economic recovery and reforming financial regulatory systems.

Like the G7, the G20 also has a legitimacy issue, as these 20 countries were not elected by other countries. But as former Australian Prime Minister Kevin Rudd once put it, the G20 is the best compromise between efficiency and representativeness. The G20 includes 11 developing-country members. Meanwhile, G20 countries account for more than 80 per cent of the world economy and population. They could make important decisions that are significant enough in influencing trends in the world economy.

Alongside the G20 process, the BRIC countries have also become an important group in international affairs. On 16 April 2009, leaders of Brazil, Russia, India and China held the first BRIC summit in Russia to discuss some international economic issues. Two years later, the leaders invited the President of South Africa to attend the BRICS summit in Sanya, China. The leaders agreed on a wide range of issues, including supporting reform of the global reserve currency system, advancing trade and investment liberalisation and promoting economic cooperation among themselves. It is still unclear if the BRICS will eventually evolve into a tightly structured international organisation like the G7 or the G20, but it could become an important caucus within the G20, helping to formulate policy positions for developing-country members.

IMF reforms: voting shares, senior executives and veto power

While the G20 summit has become a powerful mechanism for international economic decision making, it is not yet a normal international organisation. To become a permanent and stable economic institution, the G20 needs further development in at least two areas. One is management of the G20 summit's daily operations. And the other is the implementation and follow-up of G20 decisions. To achieve these, the G20 could set up a permanent secretariat. It could also utilise existing international institutions, such as the IMF, to implement its important policy decisions, such as financial regulation, monetary policy and macroeconomic surveillance.

But international organisations in their current forms are not well suited for carrying out such tasks. Taking the IMF as an example, its relations with many countries, especially those once hit by financial crises, are not smooth. During the East Asian financial crisis, the IMF provided financial assistance to those crisis-affected countries—mainly Indonesia, Korea and Thailand. But such assistance came with strict policy conditionality, which required these economies to tighten fiscal policies, raise interest rates and close weak financial institutions. Such measures probably pushed these economies deeper into recession.

These policies also cost the IMF precious confidence and trust among some policy makers in Asia. Some Asian leaders have since become uninterested in the international role of the IMF. When discussing regional monetary and financial cooperation issues in Asia, some officials made it clear that they would support any initiatives as long as these had nothing to do with the IMF. Another example was during the global financial crisis: when Korea needed external liquidity support in late 2008, it went to the Federal Reserve, not the IMF. This development significantly undermined the IMF's role as the global lender of last resort.

These bad experiences with the IMF are reflected in part in the organisation's rigid implementation of conventional economic beliefs: it is critical to enforce market discipline even at times of financial crisis in order to avoid moral hazard problems. Not closing down the insolvent financial institutions, for instance, would encourage excessive risk taking in the future. Such actions, however, destabilise social and macroeconomic conditions during financial crises. Fortunately, the IMF's policy position has already started to change. At the height of the sub-prime crisis in the United States, the Treasury Department injected capital into a number of large financial institutions to avoid the rapid spread of systemic risks.

These international organisations have, however, a deeper problem: they are dominated by the United States and other industrialised economies. Policy prescriptions have therefore often been drawn from the experiences of advanced market economies. Some of these policies are clearly not appropriate for developing countries and have generated painful consequences. For instance, the IMF generally discourages any restrictions on cross-border capital flows. Most developing countries, however, are not strong enough to withstand volatile short-term capital flows given the quality of their financial regulations and institutions. This is one of the reasons developing countries have experienced frequent financial crises in recent decades.

The developing countries do not have much influence on the decisions reached by most international economic institutions. For example, each country's SDR quota with the IMF is a weighted average of GDP (50 per cent), openness (30 per cent), economic flexibility (15 per cent) and international reserves (5 per cent). This formula obviously favours industrialised countries. The United States accounts for 17 per cent of the total voting share, which allows the United States to influence the decision making of the IMF.

Over the years, with the rapid growth in emerging market economies, the distribution of SDR quotas has become even more unequal. Western Europe is significantly over-represented relative to its economic weight. Before the global financial crisis, the BRIC countries combined accounted for 40 per cent of the world population and 15 per cent of global GDP, but their voting shares were only 12 per cent of the total. More importantly, of the 180 IMF members, at least two-thirds are developing countries and do not have any say in the IMF's decisions.

The good news is that the industrialised countries have already agreed to gradually reform the IMF system. The latest reform reallocated 6 percentage points of the voting shares from European countries to emerging market economies. After this reform, China has the third-largest voting share, after the United States and Japan. Brazil, China, India and Russia are all among the top-10 member countries of the IMF.

For many developing countries, however, IMF reforms are far from over. Despite the latest redistribution of SDR quotas, emerging market economies remain significantly under-represented. In particular, of the IMF's 24 executive directors, European countries still occupy four seats: the United Kingdom, Italy, Germany and France. Many Asian countries are demanding that these European countries give up at least two seats. The voting shares of the BRICS and other developing countries should also be further increased to give them greater influence on the organisation's decision-making processes.

Second, currently there are implicit rules that the World Bank appoints an American to be the president while the IMF nominates a European to be its managing director. Such practices are unfair and discriminatory. As international organisations, neither the World Bank nor the IMF should be allowed to appoint nationals only from specific countries to their highest positions. The selection process should focus more on the candidates themselves rather than their nationality.

And, finally, the United States is not willing to give up its veto power to make the IMF a true international organisation. This veto power indicates two presumptions. One, the IMF as an international organisation will continue to be dominated by the views of the United States. And, two, the United States has the best policy skills among members. The latest sub-prime crisis, however, revealed important deficiencies of the US financial system and its economic policy. Many developing countries have criticised the United States for its irresponsible policies, such as the quantitative easing (QE) monetary policy and its spill-overs to the world economy. While the United States will remain the most important member of the IMF for some time, it no longer makes sense to leave the final decision-making power entirely in its hands.

Alongside reforms of the IMF's governance structure, developing and industrialised-country members should start to work on the rules and policies. For instance, the IMF should monitor macroeconomic development and financial risks of all major economies without exception, including the United States. It should also look into the issue of expanding the SDR basket for possible inclusion of some emerging market economy currencies. It should review the conditionality terms, striking a balance between supporting economic stability and avoiding moral hazard problems.

The IMF potentially has an important role to play in the evolution of the international economic system, such as macroeconomic surveillance, financial regulation, global liquidity management and, possibly, certain functions of global central banking. All these, however, will be dependent on the successful transformation of the IMF itself, particularly its representativeness, governance structure and policy approaches. Recognising the rising importance of the emerging market economies relative to the industrialised countries should be an important part of that transformation.

Global reserve system: US dollar, SDR or renminbi?

The US dollar has been a cornerstone of the international economic system in the postwar period. The Bretton Woods system established in 1944 contained two important pegs: the US dollar was pegged to gold and most other currencies were pegged to the dollar. The Bretton Woods system broke down in 1971 when US President Richard Nixon de-pegged the dollar from gold as dollar supply outpaced the growth of gold. After that, most countries gradually shifted to flexible exchange rate regimes. But the US dollar remained the most important global reserve currency.

The international community's confidence in the dollar started to deteriorate from the late 1990s when the US twin deficits started to grow rapidly. During the early years of the twenty-first century, America's current account deficits continued to widen and its debt accumulated rapidly. Many experts argued that this was a result of the US Federal Reserve's loose monetary policy, especially low interest rates, which encouraged excessive consumption and investment (Eichengreen 2009). Some also attributed the problem to the so-called Triffen Dilemma: the growing need for the global reserve currency, the US dollar, required the United States to run increasingly large current account deficits, which eventually hurt investors' confidence in the dollar (Yu 2009).

This was the reason many experts continuously called for diversification of foreign reserves held by many governments and central banks around the world, especially in Asia. According to IMF data, the average proportion of the dollar assets in total foreign exchange reserves dropped by almost 10 percentage points during the 10 years before the sub-prime crisis. Some experts worried about a dollar crisis, as a result of competitive selling of dollar assets around the world. But the dollar crisis has not occurred. In fact, in the wake of the sub-prime crisis, the dollar appreciated as investors still regarded the United States as a safe haven at uncertain times.

Questions about the dollar's future role are, however, not likely to go away quickly. Zhou Xiaochuan's proposal of transforming the IMF's SDR into a supranational reserve currency was a response to the concerns about the current global reserve system (Zhou 2009). Zhou recommended several detailed steps for reform of SDR, including expanding the SDR basket, establishing official exchange rates between SDR and other major international currencies, using SDR in some international economic transactions, and issuing assets denominated in SDR. Later, the UN Commission of Experts on Financial and Monetary Reforms, chaired by Joseph Stiglitz, also presented a similar proposal to create a supranational reserve currency (UN Commission 2009).

The creation of a supranational currency is an intelligent idea to bypass the inherent conflict between global function and national policy of a global reserve currency. The idea can be traced back to Keynes (Zhou 2009). Special drawing rights, in particular, are a key subject in discussion of reform of the international monetary system at the G20 meetings.

The role of SDR could at least be expanded in areas of reserve investment and liquidity management. But as the first step, the basket—which currently includes the US dollar, the euro, the British pound and the Japanese yen—needs to be expanded to include some prominent emerging market economy currencies. The next adjustment, however, will not take place until 2015, with the last adjustment completed in 2010.

Yi Gang, the Deputy Governor of the PBC and Administrator of the State Administration and Foreign Exchange (SAFE), recently made a proposal for expanding SDR by first creating shadow SDR (Yi 2011). The IMF has two criteria for a currency to be included in SDR: the share of a country in global trade and the share of a country's currency in international financial transactions. According to these, China proposed that the IMF creates shadow SDR in 2011 by including additional currencies from the BRICS countries. It can then calculate the shadow SDR index or exchange rates and continuously adjust the weights in the following years. In 2015, the IMF could officially expand the SDR basket by including these emerging market currencies.

The creation of a supranational currency, even if it succeeds in the end, is likely to be a very long-term process. It would require individual countries to surrender their monetary sovereignty and to form a global central bank. These are difficult, if not impossible, requirements for the foreseeable future.

What is most likely to happen now is a multi-reserve currency system. On the one hand, the US dollar can no longer dominate the global financial system like it did during the past half-century. On the other hand, there is no readily available alternative to replace the dollar. Therefore, the US dollar might remain as one of the most important reserve currencies in the world, although its importance might decline over time. At the same time, some other currencies, such as the euro, will play greater roles (Huang 2010).

In a way, this has already been happening. During the past 10 years, the share of euro assets in global foreign exchange reserves increased steadily, alongside the decline of the share of dollar assets. One important question is whether the multi-reserve system has room for emerging market currencies to play roles. Currently, the reserve currencies are all from industrialised countries. But as the significance of emerging market economies increases, shouldn't these economies, particularly the BRICS countries, also play a part in the global reserve system?

The international role of the Chinese currency is a subject heatedly debated both in China and abroad. At the G20 workshop on the international monetary system in Nanjing in April 2011, for instance, most officials from the G20 countries agreed that the RMB should be included in the SDR basket. The sticky issue, however, is whether this inclusion should be conditional on capital account convertibility and exchange rate flexibility.

The internationalisation of the RMB was renewed during the global financial crisis. This was at least in part a response to the perceived dimming outlook for the dollar. From mid-2008, the PBC significantly narrowed the band of the RMB exchange rate but at the same time accelerated the pace of internationalisation of the currency.

Systemic reform of the RMB policy started from the beginning of 1994 when the PBC unified the market and official exchange rates and adopted the managed float regime. The RMB appreciated gradually in the following years, until the East Asian financial crisis. Following disruptions during the Asian financial crisis and the US sub-prime crisis, the RMB resumed a managed-float regime from 19 June 2010. But in general, the exchange rate remains very rigid and the currency is probably still undervalued—evidenced by large current account surpluses and rapidly accumulating foreign reserves.

In December 1996, the PBC announced to the IMF the realisation of current account convertibility. While the realisation of full capital account convertibility has been repeatedly delayed due to various external financial crises, steps towards capital account liberalisation have continued, including the adoption of the qualified foreign institutional investors (QFII) and the qualified domestic institutional investors (QDII) schemes for portfolio investment, the use of RMB for settlement of international economic transactions with neighbouring countries, and the establishment of an offshore RMB market in Hong Kong. In fact, some central banks, such as those in Thailand and Russia, have already started to hold RMB in their foreign exchange reserves.

But the RMB is still a long way from being internationalised. The PBC still intervenes heavily in foreign exchange markets and important controls remain on cross-border capital flows, especially outward direct investment, debt financing and portfolio investment. And, most importantly, it is up to the international market, not the Chinese authorities, whether or not the RMB will eventually become an international currency.

China clearly sees the need to reform the international monetary system. It is also interested in promoting internationalisation of the RMB. It is, however, in the best interest of China and the rest of the world to ensure a smooth transition of the global reserve system. In particular, China, the United States and other major economies should work together to support a stable US dollar. After all, the dollar is still the most important currency for China's external economic transactions and accounts for about 60 per cent of its more than $3 trillion foreign reserves.

China's demands, roles and responsibilities

We conclude this chapter by answering three questions relating to China's position on reform of the international economic system: what does China want? What can China offer? And what are China's own responsibilities?

What does China want?

China wants the transformation of the international economic system to reflect the new reality of the world economy, especially the increasing importance of emerging market economies. At the same time, China also wishes to preserve the positive features of the current system that have contributed to global economic prosperity during the past decades, especially the promotion of free trade, free flows of capital and globalisation. China has been the main beneficiary of the current international system and is keen to help improve it. China is not interested in building a completely new system alongside the existing one.

But the new international economic system should give more influence to emerging market economies and should pay more attention to the conditions of developing countries when making economic rules.

China supports the G20 process, which probably represents the best compromise between efficiency and representativeness. The G7 or G8—the so-called rich countries' club—is an institution of the past. China values the partnership with the United States but does not seek to institutionalise a G2 framework for international economic affairs.

International organisations should take on more global responsibilities, such as macroeconomic surveillance, financial regulation and global liquidity management. But before that they will also need to introduce reforms in order to become more representative, more efficient, more effective and fairer. The governance structure of international organisations should be changed to better reflect the growing importance of the emerging market economies. And the making of international economic rules should also pay more attention to the actual conditions of the developing countries.

The global reserve system is in urgent need of reform. Chinese officials recently proposed a shadow basket of SDR to include some currencies of the BRICS countries before the next official SDR adjustment in 2015. In the perceivable future, however, a multi-reserve system is more likely. China is interested in seeing the RMB play a part in the future, alongside the euro and some other currencies. For the time being, however, it is in the best interest of China, the United States and the rest of the world to ensure a stable dollar.

What can China offer?

As the largest and most dynamic emerging market economy, China can also contribute to the smooth reform of the international economic system. This is consistent with China's goal of working with other countries to build a harmonious world. As China has demonstrated in the past, in negotiations on the sticky issues of climate change and global rebalancing, it prefers to resolve problems through cooperation, not confrontation.

The Sino–US partnership is a necessary but not sufficient condition for international economic cooperation in many areas. The regular Strategic and Economic Dialogue between the two countries is an important platform for the two sides to exchange views on key bilateral and multilateral issues. China can also work with the other BRICS members to form emerging market policy positions and jointly push these proposals in global platforms such as the G20 and the IMF.

China can help support a stable dollar in foreign exchange markets, such as through smooth management of its large foreign exchange reserves. But this requires cooperation by the United States in the proper management of its fiscal and monetary policies. China can also assist the rebalancing process by proactively reducing its own current account surplus. It is probably also in China's own interest to contain trade protectionism around the world and to help conclude the Doha Round of trade negotiations.

What are China's own responsibilities?

First, as the world's second-largest economy, China needs to abandon its small-country mentality. Economic decisions made by any large countries should take into account the possible reactions of other countries. Exchange rate policy serves as a good example. Currency distortions in a small country do not have any impact on the rest of the world, but those in a large country such as China can cause significant changes in global trade and production structures.

Second, nationalistic sentiment is very harmful for China's further opening up to the outside world. In particular, conspiracy theories have been popular in discussions of external economic relations, especially those with the United States. If we cannot effectively minimise the influence of Cold War mentalities on international economic policy decisions, we will not be able to become a credible partner for other countries in reforming the international economic system.

Third, China should further promote liberalisation of its own economy and move closer to a market economy, including reforms of its exchange rate regime, capital account controls and distortions in other factor markets. At the same time, China should also promote private sector development and contain the influence of the state sector, especially in international economic areas. This is critical for supporting an open and efficient international economic system.

And, finally, it is probably also time for China to learn to work with the United States and other G20 members to provide public-goods services for the world economy. In line with China and the other emerging economies asking for more rights, they should also share more of the responsibility for maintaining a stable global economic environment, enforcing the international economic rules and assisting countries temporarily struck by unfavourable shocks.

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