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The impact of yuan internationalization on the stability of the international monetary system

Agnès Bénassy-Quéré [a,*], Yeganeh Forouheshfar [b]

[a] Paris School of Economics, University Paris 1, France
[b] University Paris-Dauphine, France

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ABSTRACT

We study the implication of yuan internationalization on the stability of the international monetary system. More specifically, we use a three-country, three-currency portfolio model to analyze the impact of yuan internationalization on exchange rates in the event of trade shocks, with stock-flow adjustment of the net foreign asset positions. We show that the internationalization of the yuan would lessen the response of floating exchange rates to asymmetric trade shocks as well as attenuate the distortionary impact of China keeping its currency pegged to the dollar. Conversely, yuan internationalization would amplify the impact of trade shocks on net foreign asset positions, albeit to a limited extent.

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1. Introduction

The US dollar has been the key currency of the international monetary system (IMS, hereafter) since World War II. The yen never succeeded in challenging the US currency as an international means-of-payment, unit-of-account or store-of-value currency. As for the euro, it has emerged mostly as a diversification and as a regional currency (European Central Bank, 2014). Such resilience on the part of the dollar was benign as long as the US economy was clearly dominant in terms of GDP, trade and financial markets: monetary pegs and reserve accumulation did not weigh much on global trade and capital flows. However the share of the United States in the global economy fell from 39% in 1960 to 22% in 2014. In 2014, countries running a fixed or managed exchange-rate regime (de jure or de facto)

* Corresponding author. Tel.: +144078219.
E-mail address: agnes.benassy@univ-paris1.fr (A. Bénassy-Quéré).

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with respect to the US dollar accounted for 18% of world GDP, with China alone (which the IMF classified as in a de facto crawling peg arrangement with the dollar) accounting for 12% of world GDP. [1]

The mismatch between a unipolar IMS and a multipolar real economy has at times been singled out as a key ingredient of the macroeconomic environment that led to the 2008–09 financial crisis (see e.g. Ivashina et al., 2012). Leading policy-makers have also argued that a unipolar IMS creates a deflationary bias, with all countries other than the key-currency issuer wishing to accumulate foreign-exchange reserves through current-account surpluses in order to self-insure against a reversal of gross capital inflows (see United Nations, 2009). However, the policy debate is mainly concerned with the Triffin dilemma (Triffin, 1960), which was initially phrased to show the internal inconsistency of the Bretton Woods system. It has since been revisited by Zhou (2009) and Fahri et al. (2011) in the context of the post-Bretton Woods system and taking into account emerging economies. According to Farhi et al., the growth of emerging economies and their appetite for liquid, riskless assets increase the demand for international liquidity, putting downward pressure on US interest rates and on the US current account. At some stage, international investors will either lose confidence in US solvency or fear massive monetization of US bonds, which would trigger a crash of the dollar. To avoid such an outcome, it would be advisable to develop alternative sources of international liquidity, either through the internationalization of other currencies or the development of Special Drawing Rights (Mateos y Lago et al., 2009).

Another strand of the literature focuses on the incentive a hegemonic country may have to ensure the stability of the system. Kindleberger (1973, 1981) argues that this could explain why hegemonic systems could be more stable, whereas Eichengreen (1987) suggests instead there is a risk the hegemon will abuse its position. According to Cohen (2009), monetary power fragmentation could involve both economic risks (e.g. increasingly antagonistic relationships between currency blocs, possibly leading to de-globalization) and geopolitical ones (e.g. weaker support for the US dollar coming along with weaker military protection from the United States).

Since the mid-1990s, China has taken significant steps toward the progressive internationalization of the yuan: it has allowed domestic exporters to invoice their cross-border sales in yuan; it has cautiously opened the gate to foreign capital inflows; it has developed bilateral swap agreements in yuan with foreign central banks; and it has liberalized the use of deposits in yuan in Hong Kong and London. Although internationalization still has a long way to go and will depend on reforms being carried out (see, e.g., Dobson and Masson, 2009; Eichengreen, 2011; Prasad and Ye, 2012; Yu, 2012; Cohen, 2014), it is noteworthy that the first steps were undertaken while the currency was still being carefully managed with respect to the US dollar. According to Vallée (2011), China could move far along the road of internationalization without switching to a free floating exchange-rate regime. However long the transition period, it is difficult to envisage a fully multipolar global economy without a considerable reshaping of the IMS (Angeloni et al., 2011; Bénassy-Quéré and Pisani-Ferry, 2011). Eichengreen (2013) considers that in the next decades, the yuan will likely play at least some international role, akin to that played by the Swiss franc, the yen or the euro today.

A multipolar monetary system would alleviate the Triffin dilemma by diversifying the sources of international liquidity. Furthermore, multipolarity could act as a disciplinary device, with investors being offered a choice between several currencies with equivalent liquidity features but issued by countries with varying depths of imbalances (Eichengreen, 2010; Kwan, 2001). Some authors have however argued that a multipolar monetary system could raise exchange-rate volatility since greater substitutability across key currencies would translate into more frequent and larger portfolio reallocations (United Nations, 2009).

Extensive literature on the impact of exchange-rate volatility on growth is available. On the theoretical side, Ethier (1973), Clark (1973) and Hooper and Kohlagen (1978) show that currency risks reduce trade volumes if firms are risk-averse regardless of whether hedging is available; and Pindyck (1991) and Demers (1991) argue that the irreversible costs associated with uncertainty reduce investment. However, there have been dissenting views (see Franke, 1991; de Grauwe, 1988 for opposite or ambiguous results). On the empirical side, the link between exchange-rate instability and trade,

[1] Authors' calculation based on IMF, Annual Report on Exchange Arrangements and Exchange Restrictions 2014, and World Bank GDPs in current dollar.

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