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THE RENMINBI'S ROLE IN THE GLOBAL MONETARY SYSTEM

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PARTICIPANTS:

Moderator:

GREG IP
U.S. Economics Editor
The Economist

Panelists:

DONALD KOHN
Senior Fellow
The Brookings Institution

ESWAR PRASAD
Senior Fellow, The Brookings Institution
Tolani Senior Professor of Trade Policy,
Cornell University

STEPHEN ROACH
Senior Lecturer and Senior Fellow of the
Jackson Institute, Yale University
Non-Executive Chairman of Asia, Morgan Stanley

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P R O C E E D I N G S

MR. IP: Welcome, everybody, to our panel discussion on the role of the RMB in the international monetary system. This is -- China and China's economy is always an interesting topic, but it seems like an especially interesting time right about now. I mean, the role of China in the world economy and the world political system just keeps growing and it's just pushing its way into the headlines.

Just this weekend, China of course joined Russia in vetoing a UN resolution on Syria. Next week, Xi Jingping the next leader of China visits the United States. And of course, who could forget this critical watershed event, the launch of the new China section in *The Economist*. Had to get that in.

But, all that said it's an extremely opportune time to be discussing this because obviously hand-in-hand with the development of a powerful economy like China is the development of its financial system, which is critical both to its own ability to evolve and how it relates with the rest of the world and the impact that Chinese development has on the rest of us.

So, Eswar has written this absolutely terrific paper. You should all have a copy now; we're going to talk about it today. I'm not going to dwell a lot on the biographies, but I just do want to introduce the panelists quickly.

On my far right is Don Kohn, former vice chairman of the Federal Reserve and scholar here at Brookings. On my direct right is Eswar, and on my left is Stephen Roach of Morgan Stanley. We're going to start with some brief informal comments from each of the panelists, and then we'll get into a discussion.

So, Eswar, why don't we start with you?

MR. PRASAD: Thank you, Greg, and thank you all for coming.

As Greg says, it's very hard to ignore China these days and China's rising presence on the world economic stage is especially prominent in terms of GDP, trade, and so forth. But what is particularly interesting, of course, is whether China's currency, the renminbi, is eventually going to rise to the level of prominence that the economy has.

So, this report tries to grapple with some of the issues related to the "internationalization" of the Chinese renminbi. And being the professor that I am, what I start off doing in the report is trying to clarify some concepts that I think are important for guiding the debate. I then talk about some of the steps that China has already taken towards promoting the international use of the RMB, and then we'll talk a little bit about the renminbi's role on the international stage, both present and the future.

So, first the concepts. Now, much has been said and written about China's currency, but it's useful to keep a few concepts in mind. The first is the notion of an international currency, one that is widely used in trade and finance transactions around the world. The second issue is one of a convertible currency, one that can be easily traded across national borders.

Now it turns out that neither of these is either necessary or sufficient for the other. There are many countries that have very convertible currencies but they don't have much of a role in the international stage and China, by contrast, is in fact getting its currency to play a role on the international stage even while it retains a large set of capital controls.

Now the third and most interesting concept of all is that of a reserve currency, and this is where issues related to the much-hyped showdown between the renminbi and the U.S. dollar start coming in to prominence. And it turns out that both the internationalization and the convertibility are essential aspects for the reserve currency. But, let's start with the internationalization process.

China has actually taken a number of steps already in terms of opening its capital account and in terms of the internationalization process. Over the last few years, China has actually reduced a number of the capital controls, but it's done this in an interesting way. Not by eliminating the controls altogether, but by relaxing them to a considerable extent. Now, even during this period when China has had a lot of controls in place, sometimes when the incentives for money to flow in or out of the economy have been great it has been happening. This is part of the reason why China has such a large reserve buildup.

China has, of course, been running fairly large trade surpluses over the last four or five years but there have been significant capital inflows as well. Some of it not ideally desired by the Chinese government because it imposes more pressure on the currency to appreciate, so the government has to intervene and recycle these dollars or other foreign exchange out of the economy, thereby building up reserves.

So China has, especially on the outflow side, liberalized considerably. In fact, it turns out that Chinese households are allowed to take out $50,000 per year -- which seems like a very open capital account, especially if you consider that the per capita income in China is about $5,000. But the key issue is that financial market development has not caught up yet to give this traction. In Washington, you can go down the street to your T. Rowe Price or Vanguard, buy a mutual fund that gives you foreign exposure. In China, securities market development hasn't quite caught up. So as we talk about this issue further, the nexus between domestic financial market development and this capital account liberalization process becomes really important.

So, while China has become more integrated through relaxation of capital controls and through de facto larger financial flows, on the internationalization side there have been a few very specific policy initiatives that the Chinese government has undertaken. Allowing trade settlement in renminbi through Hong Kong, allowing for renminbi-denominated bonds to be issued in Hong Kong, and by foreign companies on the mainland, allowing renminbi deposit accounts to be open in Hong Kong, and even in New York these days. So, there are many ways through which the Chinese government is actually trying to promote actively the use of the yuan.

Now if you look at the amounts involved in these transactions, the trajectory looks like this because you're starting from zero. The amounts involved are not very large yet, and there is a question about what these amounts really represent. Take trade settlement, for instance. About 8 to 9 percent of China's trade is now settled in renminbi through Hong Kong. It seems like a pretty impressive amount, but once you start breaking down the data it turns out that much of the settlement is actually on the import side. In other words, importers are very happy to receive renminbi because this is one way of going long on the renminbi if you expect renminbi appreciation. The amount of settlement in terms of exports is minimal, still.

If you look at the amount of renminbi bond issuance, a lot of it is by mainland companies tapping the Hong Kong market. So, one shouldn't get too dazzled by the numbers because at this stage, the actual amount of traction in terms of international aspects of the renminbi are still relatively limited, both in terms of quantities and in terms of who is participating.

Now, one other very interesting dimension is that China has set up local currency swap lines with a number of central banks, and this is an intriguing development because essentially what many central banks are doing is basically using the Chinese Central Bank as a way of getting liquidity at moments of crisis.

Now, part of this liquidity may be for trade settlement transactions, and in fact I was at a conference recently where I spoke to the Pakistani Central Bank governor and he was quite candid that initially, given the amounts are small, it's largely meant for trade settlement but the presumption is that China is going to become more important in terms of trade, the trade linkages are going to increase, and having China by your side -- especially the Chinese Central Bank -- be your friend is a very good thing in difficult times. So, this is really beginning to get a lot more traction.

So in the internationalization side we have progress. On the capital account liberalization side we have progress. So, where does this add up to in terms of the renminbi becoming a reserve currency?

Now here again it's useful to step back and think about the key criteria for a reserve currency. Size matters very greatly. China now accounts for about 10 percent of world GDP in market exchange terms. If you take PPP-based measures, China accounts for about 15 percent of world GDP, and accounted for about a quarter of world growth last year, and China now counts for about 10 percent of world trade. Pretty staggering numbers if you think about it one way, but the size dimension turns out to be important but not crucial. After all, if you think about an economy like Switzerland it's hardly a world juggernaut in terms of size but the Swiss franc still plays a fairly important role. Why? We'll get to that in a second.

The second issue is related to flexible exchange rates. Typically, reserve currencies tend to have market-determined and flexible exchange rates. Again, this used to be the old system but if you look at what's happening with the Japanese yen and the Swiss franc, it's not that obvious anymore. But still, exchange rate flexibility clearly is an important criterion, and so is capital account convertibility where as I said, China is making progress.

Macroeconomic policy is another important dimension because ultimately one wants to have a currency that one can believe in and having high levels of public debt or central banks that are not that concerned about inflation could lead to concerns about the erosion in the value of the currency, and that's not good for a reserve currency. Here again, the world has become a more complex place. If you think about countries in the West -- the U.S., the European Union -- these can hardly be seen to be paragons of macroeconomic stability. It hasn't hurt their reserve currency status yet, but it's a dubious issue, and on these fronts, actually China doesn't do that badly. The explicit level of public debt is not that high. Inflation volatility is actually not that far out of line with the advanced economies. So, in macroeconomic policies China doesn't seem to be that held back in terms of getting its currency to be a reserve currency.

Then, we come to the critical issue which is financial market development, and this is an issue which ultimately seems to swing the balance. Going back to the Swiss franc one, the reason why the Swiss franc is a reserve currency is because Swiss financial markets are deep and this is where China needs to make enormous progress still. This is an issue on which people like Nick Lardy have written. There is a very large reform agenda on the financial market development that I think is going to be critical, and once one starts thinking about it this way it's a matter not just of the internationalization or the reserve currency status of the renminbi, but China's own economic stability that really matters.

So, what does financial market development mean here? There are three aspects of financial market development we talk about in the report. One is breadth, a broad variety of financial markets; depth, a lot of instruments in those markets; and a good deal of liquidity or turnover in those markets. Each of these are important criteria, and China is making progress. The equity markets after their reform about three or four years ago have in fact started becoming much more liquid. All the foreign investors cannot easily invest in them yet, but the process is moving along. But it's the bond markets where really there has been very little action.

On the derivatives markets there has been some progress, but ultimately what international investors want from a foreign currency -- both central banks and private investors -- is a relatively safe and relatively liquid instrument, and that ultimately comes down to government bonds and corporate bonds.

Now, China has much less explicit public debt, like I mentioned, like the U.S., which is perhaps a good thing from the macroeconomic stability side but it doesn't mean that there aren't good instruments to hold, and the corporate bond markets haven't developed very significantly yet. So, unless we have much more stable development of the financial markets with effective regulation, it's hard to see the renminbi being able to really compete with any of the major reserve currencies as it is. So, I think that is going to be a primary constraint, but yet like I said there has been very significant progress.

So what ultimately are the prospects for China on the reserve currency franc and in terms of its presence on the international stage? As I mentioned, the currency is already getting enormous traction in terms of central banks arranging swap lines with the Chinese Central Bank, and more remarkably there is even some indication that some central banks around the world are beginning to hold the renminbi as part of their foreign exchange reserve portfolios. This is a little odd because the renminbi is not convertible, so technically those holdings cannot be counted as international reserves, and yet from the point of view of many central banks this is an emerging currency that is likely to pay at all, and just the future prospect seems to be enough.

So, Chile already holds some renminbi, a very small portion of its effective reserve portfolio, only about .3 percent, but it's there as part of the portfolio. Malaysia and a number of other Asian economies and, more recently, Japan have talked about holding Chinese government bonds as part of their reserve portfolios. So it hasn't happened yet, but it is happening.

Now, what is the ultimate goal that the Chinese are looking forward to? I think the reality is what I think we have seen in terms of various other reforms. In fact, a few years ago, (inaudible) and I had argued that the Chinese had undertaken this process of piecemeal reforms and of learning by doing in a variety of reforms, like fiscal reforms, and we had argued that exchange rate flexibility, capital account liberalization, other sort of issues where you can't move step-by-step, you have to do it in a big way. Well, guess what? As with many other things, the Chinese have proved us conclusively wrong because they are, in fact, going about it in a limited way, and of course having Hong Kong as a platform for taking these limited moves without full capital account convertibility is a very strong advantage that China has, and it is using that advantage very effectively.

What I think they are saying, ultimately, is capital account liberalization with Chinese characteristics. The objective, I think, is not really a fully-open capital account or what one might think of as free convertibility, where there are virtually no restrictions on capital inflows or outflows, but something closer to what some scholars have started talking about as full convertibility, which I think resonates much better with the Chinese government. That is, mostly relaxed capital account flows but with some administrative and other requirements still in place to control these flows to some extent.

So, will the Chinese renminbi really threaten the U.S. dollar and will it become of the SDR basket? I'll finish with these two issues. On the SDR, I think I would foresee that the SDR basket will come to include the Chinese currency within the next five years. As I argue in the report, this is because China doesn't really need the IMF but the IMF needs China, and this is one way in which I think the IMF can exercise a little more leverage over China in terms of what it's trying to represent to the international community's interest as being, and trying to get China to internalize the global repercussions of its policies. The IMF has recently changed their criteria for the SDR basket, and one can play fast and loose with these to some extent, and ultimately I think it's going to be a political question rather than a purely technical question about whether the renminbi is convertible or not. So, I think that's what is going to happen in terms of the Chinese renminbi.

Over the next 10 years, my suspicion is that the Chinese currency is going to become very close to convertible and is going to become a reserve currency. I strongly believe, however, that the U.S. dominance -- especially given the present state of China's financial market development and how long it takes for those financial markets to develop in an effective way -- suggests that what is likely to happen is that the renminbi will start displacing the dollar to some extent, and will erode the dollar's dominance but will in no way displace it.

Thanks.

MR. IP: Thank you very much. Steve, why don't we turn to you now?

MR. ROACH: Thanks, Greg, and thanks, Eswar. This is a fantastic paper and I have really nothing critical to say about it.

I will admit in the interest of full disclosure that in the past, I want to say, five months, I've read 25 papers on the RMB. There are too many papers on this topic. I would urge you only to read this one. This is by far the most comprehensive assessment of all of the various dimensions of this critical issue, from the internationalization capital account, liberalization, reserve status, and ultimately getting to the big question on convertibility.

I agree with Eswar's basic conclusion that this is a gradual process, consistent with the old dictum of -- I'll blow this -- crossing the river and feeling the stones. Moving gradually. The idea of a large, one-off radical shift in the currency regime violates many of the critical stability objectives of China that have been in place now for well over 30 years.

What I would like to stress in my brief comments is not to view this paper -- and, if you must, some of the others that have been written -- in a vacuum. And I would like to just offer -- well, I'd like to underscore the point that Eswar started with, and that is will the RMB's role rise to a level that's commensurate with its already impressive role in the global economy, and I think you could actually broaden that question out. As you are implying, will the evolution of China's financial markets in the broad sense rise to a role that's commensurate with China's newly-ascendant role in the global economy?

So, I want to just make three brief points that sort of pick up where you leave off in the final paragraph of your paper about raising questions about the role that the RMB will play in defining China's future course as an economy and as a participant in the broader global economy.

The first point I want to make is that the currency issue is a critical piece of China's own domestic reform agenda, and I think that the pro-consumption rebalancing of the Chinese economy that's underscored by the 12th 5-year plan that was enacted now about 11 months ago can only be enhanced by a market-based RMB appreciation. And that is very much related to points that were given -- this guy a lot of press today. But, Nick Lardy made very eloquently in his recent book, adding to RMB appreciation the liberalization of interest rates, especially for deposit accounts in China to end the financial repression. I think the combination of RMB appreciation and a deposit rate liberalization of China definitely would enhance the domestic purchasing power of a Chinese citizen and be an integral part of the pro-consumption policy agenda.

I think that the second point I want to make is that the reform of the renminbi is obviously -- has to be viewed as a critical piece of global rebalancing in the broad sense. The realignment of savings disparities between surplus savers like China and deficit savers like the United States. And I think as this rebalancing proceeds in economic terms and financial terms and in shifting to a more stable mix of global saving, it's inevitable that that will also engender greater discussion about what the post-dollar international financial system is going to look like. And Eswar raises and just spoke of some important characteristics of -- or alluded to some important characteristics as to whether or not China itself will play an active role in the post-dollar system. He's not making any predictions, nor am I, as to when it's going to happen, but just to stress inevitably -- whether it's a bipolar or a multi-polar system that features a more active role for SDRs -- we don't know that, but the days of a purely dollar-centric international reserve system at some point in the next 5 to 10 years, I would agree with you, are probably numbered.

The third point that I want to just end on is that to bring this debate and this discussion and this issue right back home, and that is that the reform of the Chinese currency should not be viewed as an answer to the economic problems of other nations, especially the United States. I worry that that is becoming an important feature of our own debate in this city, and increasingly so in this election year. RMB policy has become the lightning rod for U.S.-Sino tensions over the last, say, six or seven years, and I worry that we're getting closer and closer to the point in time where this issue may come to a head and lead to a major mistake in terms of our own politicized economic policies in the United States.

Yes, we know that we have a problem with unemployment in the U.S. The unemployment rate has come down in the last year, but it's still historically quite high, and what worries me is that politicians on both sides of the aisle view this as something to blame on China for its misaligned and unacceptable currency policy. And China, as Eswar documents in this paper with amazing detail, is making progress but making progress in a way that's commensurate with its own issues, as it should.

And the notion that we should force China into the big bang to fix things for American workers is an example of bad economics driving bad politics and bad policy. The United States in 2010 ran trade deficits with 88 countries. China was one of them, it was the biggest. By higher math, that leaves 87 other countries. We have a multilateral problem. We do not have a bilateral problem that can be adjusted by forcing pressure on one cross-rate or forcing pressure on one economy. We have a multilateral problem because we don't save as a nation, and unless we address our savings problem we squeeze the Chinese and the Chinese piece just goes somewhere else, most likely to a higher cost producer, and then ends up putting a tax -- a functional equivalent of a tax -- on hard-pressed American workers.

It's a slippery slope, and yet politicians on both sides of the aisle in the last -- I don't know, 15, 16 months -- have united in bipartisan support for anti-China currency bills. And we have two presidential -- well, we have one likely presidential candidate emerging on the Republican side who I believe devotes five pages in his economic platform to very strong anti-China policy. President Obama in his recent State of the Union address, I think, was very tough on China, mentioned China explicitly five times. So, in a political world where the two parties can't agree on anything except their common vilification of China, this is a worrisome development. And so, the currency lightning rod in America worries me.

Read this paper. You'll get a good sense of where China is going in a gradual and methodical way. It is out of step, though, with the way Washington views this policy and that is a worrisome disconnect for me. I'll stop on that point, Greg.

MR. IP: Thanks, Steve. Don?

MR. KOHN: Right. Thanks, Greg, and thanks, Eswar, for inviting me to be on the panel and for giving me the opportunity to read this terrific paper. I agree with Steve.

I haven't read 25 other papers, but this one was great. I really learned a lot.

MR. IP: You don’t have to.

MR. KOHN: I have a lot to learn.

MR. IP: You don't need to read them.

MR. KOHN: Okay, all right. Thank you for that permission.

I wanted to concentrate on the implications of the RMB's increasing internationalization and potential status as a reserve currency somewhere down the road. I think the U.S. -- and to pick up a little bit on some of what Steve was saying. I think the U.S. has a bit of a schizophrenic view here, right? Because sometimes this is presented as a win-loss kind of thing, a zero sum game. The extent that the Chinese RMB becomes a reserve currency the U.S. becomes less a reserve currency, this is somehow a negative for the U.S. At the same time, we have these other concerns about how our current account deficit and China's current account surplus.

So, my hypothesis here and what I want to talk about is that is in the interest of the United States and the global economy for China to continue to progress with the internationalization, the RMB, and the U.S. should actively encourage China to take the steps necessary to do that. It's not going to cure all the problems, but it's going to be helpful.

So, as Eswar said, the RMB is not going to replace the dollar anytime soon, but certainly the greater use of the RMB and international transactions could reduce the effects of the dollar being the world's reserve currency. As I thought about it, I thought that maybe -- in many respects, I think being the world's reserve currency is not such an exorbitant privilege and may not even be a privilege at all from time to time. It does save a transactions cost, reduce exchange rate risk, certainly, for domestic businesses. It probably allows less expensive borrowing by the U.S. and global markets, but that's at the expense of a higher exchange rate and a current account deficit.

This facilitates a higher standard of living for a while, allows the U.S. to live beyond its means for a while, but ultimately raises the Triffin dilemma. That is, the potential loss of confidence and abrupt adjustment if confidence and the desire to hold these dollar assets begins to erode, and recall if we'd had a panel here in the mid-2000s on what might threaten global financial system, it was worries about the dollar and the buildup of dollar assets abroad. Now that's not what happened, it was the U.S. housing market, but I think it's still -- there's a problem and one that needs to be addressed.

I do think becoming a reserve currency, a more internationalized currency, does imply greater exposure to economic and financial developments in the rest of the world. Exposure to external shocks and trade and capital flows and interest rates. And as Eswar's essay points out, the greater exposure of the financial system, the build up of risk, implies the need for a more robust regulatory and supervisory oversight within a market context. I think to some extent that's a lesson the U.S. did not heed enough. As we had massive inflows of capital into our system in the 2000s, we didn't take the regulatory steps necessary to make our system more robust to that kind of thing.

But for China, I think this would imply a far less ability to rely on the regulatory quantitative quasi-command and control policy techniques that it currently uses. So, I think a lack of clear net advantage is why many countries, including China, seem ambivalent about internationalization reserve currency status.

Now for the U.S., the concerns about being a reserve currency, potential negative effects were magnified and accentuated over the 2000s by the behavior of the Chinese authorities in massive foreign exchange intervention to hold down the exchange rate and encourage a policy of export-led growth. The uphill flows of capital held down interest rates in the U.S., contributed to the bubble in housing, inappropriate pricing of risk in financial markets. The artificially high dollar contributed to our current account deficit that got to 6 percent of GDP, and the associated build up of debt, and the U.S. was living beyond its means. China facilitated and, in fact, encouraged that.

I am not blaming the Chinese for our problems. The private -- in the housing market in particular. Private sector originators and purchasers of housing, securities, buyers and sellers of sub-prime mortgages, regulators, myself included, who didn't see the consequences of what was going on bear the primary responsibility, but I do think the current account deficit and the surplus that was, importantly, not entirely Chinese surplus, did put pressure on the private sector and the regulators who weren't up to it.

The combination of interest and exchange rates we actually had in 2003, 2007 were consistent with the U.S. producing approximately at its potential with low, stable inflation. But it wasn't sustainable, and a higher interest rate and a lower exchange rate would have yielded the same macroeconomic results but in a more sustainable pattern.

As the essay points out, the actions required to further internationalize the RMB are incompatible with continuing to pursue this export-led growth strategy and will lead to more balanced, sustainable growth pattern in China, the U.S., and globally and a more efficient allocation of capital and resources. As Eswar and Steve pointed out, the most important requirement is to deepen and open financial markets in China, giving investors more choices and the ability to move in and out of assets in liquid markets, and that ability would have to apply to both domestic and international investors.

Now, that requires an emphasis on the rule of law and reduced exposure to state-mandated restrictions, and an investor needs to be confident to hold an RMB security. The investor needs to be confident that the contracts will be fulfilled, and it implies more complete and open capital markets, and these complete -- more complete and open capital markets will compete business away from state-owned banks, forcing those state-owned banks to be reformed, to be put on a more businesslike footing, and the deepening of the financial markets are a necessary but not sufficient condition for increasing dependence on domestic demand as China shifts from export-led growth. Households and businesses in China need to be able to shift consumption and investment across time by being able to save and borrow at market-related rates if they're going to have the means and incentives to increase their current expenditures' domestic demand. And with open financial markets and capital flows, you can't fix both the exchange rate and maintain independent monetary policy.

China is a large country with its own growth and development trajectory will require its own monetary policy to achieve output and inflation objectives. U.S. monetary policy is not and will not be appropriate for Chinese objectives, and you can't -- the Chinese cannot expect the United States to run its monetary policy to achieve Chinese aims, despite all those complaints after QE2. It's just not going to happen. Therefore, the Chinese will need to allow the exchange rate to fluctuate, and they'll need to grant independence to the People's Bank of China to run an independent monetary policy aimed at macroeconomic stability.

Fluctuating exchange rate means smaller current account surplus. In China, a smaller current account deficit in the United States. It's better that the real appreciation of the RMB occur through movements in the exchange rate than it occur through higher wage and price inflation, which is what's happening now. It seems to me allowing the exchange rate to move is a more stable, sustainable situation than having domestic price and wage increases appreciate the exchange rate. It will produce better balanced growth and, hopefully, more sustainable growth, better allocation of capital globally and resources, reduce the uphill flow of capital, more net investment in China where returns should be high, less net investment in the U.S. where returns are relatively low. Alternatives to the dollar give more choices to reserve holders, should be faster discipline on the U.S. potentially, a less brittle, more stable global financial system.

So, my conclusion. Internationalization of the RMB is a win-win. The U.S. has been encouraging China to take the steps to make that happen and the U.S. should continue to encourage them. It's a long and difficult transition for China and for the U.S. to be less reliant on exports for them, less reliant on consumption and domestic demand for the U.S., but it's a journey that's well worth taking.

Thank you.

MR. IP: Thanks very much, Don. I'm going to ask the panelists a few questions, but I'd also invite all three of you to, you know, respond if you think you have something to add.

Eswar, I wanted to pick up on a point that Don's making here. That is to say, that having a reserve currency is not all positive. There are negatives, you know. In fact, Germany and Japan both resisted the internationalization of their own currencies because they were afraid that that would lead to depreciation, which would hurt their export-driven model.

What's the attitude of the Chinese leadership on this thing? I mean, because I could sort of sense a conflict there and you actually refer to this in your paper where you have these conflicting political constituencies on the one hand. The export sector which is very powerful politically doesn't want a strong yuan whereas the financial sector would because it goes hand-in-hand with a more liberalization. Where do you see that dynamic playing out? What does the Chinese leadership actually want?

MR. PRASAD: I would not presume to speak for the Chinese leadership.

(Laughter)

One interesting issue is whether this process is going to happen whether or not the Chinese government wants it, and my sense is that the government is actually adopting a very pragmatic approach to something that is happening de facto. The capital account is becoming more open de facto, and rather than trying to resist this to a great extent, they are trying to see how best to use this to their advantage. And having the renminbi play a greater role within the region, in particular strengthen and straighten financial links and, presumably, has some implications or political influence as well.

So, I think having the renminbi become a major currency does serve a variety of ends for the Chinese government, which is what the government is trying to respond to. But there are risks, as Don has pointed out. If you open up the capital account and start getting your currency to be a reserve currency, the demand rises for that currency and it's going to make it harder to maintain a managed exchange rate.

Now, there are independent reasons to make the currency more flexible, again as both Don and Steve have pointed out. There are issues related to domestic rebalancing that that needs to be done for. And one concern, especially from the academic literature, is whether China is getting the sequence wrong because one thing that the academic literature has pointed out -- and one can look at the Asian and Latin American crisis for this -- if you open up the capital account without having a flexible exchange rate you run into trouble. Many countries have had crises because of this, but there is an important difference.

One of the reasons many of those economies with managed exchange rates and open capital accounts ran into crisis was because they had a lot of external debt. In fact, Ian Krieger has written extensively about this issue, and this is a key concern. And this is where China is breaking the mold yet again because the amount of external debt that China has is very limited, and second -- $3 trillion, in effect -- the reserve buys you a lot of protection. So, the traditional concerns are not a problem, but I think in terms of sequencing if they move much more quickly with capital account opening and getting the currency to be a reserve currency, it does complicate domestic micromanagement if they don't move equally rapidly on the domestic reforms.

MR. IP: But do you think they have reconciled themselves to the notion that having a more consumer-oriented versus export-oriented economy means that they have to have a stronger exchange rate, and all the associated freedoms on the capital accounts that that implies?

Mr. PRASAD: As Don pointed out, it's happening. Given China's much greater productivity growth relative to its trading partners, the currency is going to appreciate whether you take it through the normal exchange rate or through inflation. It's going to happen, and as Don has pointed out if you take it through inflation there are fairly severe distributional consequences. Given that the Chinese government seems to have a very clear sense of where it wants to go in terms of its macroeconomics, as was clearly outlined in the 12th Five Year Plan, the big question is creating the consensus for domestic reforms that are necessary to support these objectives.

MR. IP: Don, do you want to add to that?

MR. KOHN: An additional thought. I wonder how this intersects with and interacts with the growth of the financial sector that's already happening outside the banking sector. So the kind of, I guess, a grey kind of sector. The private financial sector that seems to be growing.

And the Chinese authorities need to have some sort oversight over that sector, and whether you could somehow marry the freeing up of the capital account and the inflows of private capital with this sector that's already growing and integrate this into a real -- an overseen non-bank financial sector and accomplish a couple things at the same time would be an interesting issue.

MR. ROACH: Greg, I would just frame the question you posed slightly differently. I don't think that the Chinese leadership, current or new leadership, has got the highest priority on necessarily getting the currency regime correct. I think their highest priority is to stay the course of economic development, maintain social stability, and have an optimal path of surplus labor absorption through urbanization, rural urban migration, and the like.

I think they do have a view that the currency plays a role in this progression of economic development, but they're not sitting there saying that as we now change leadership for the first time in 10 years that the most important thing we've got to get right is the role of the renminbi in the international currency system. They will read your paper very, very carefully, but this is not the number one issue on their agenda.

MR. IP: Yeah, and you made this point about -- that the currency and the capital account are really not ends in and of themselves, they're simply handmaidens to larger goals where there's a reorientation of the economy towards consumption -- the maintenance of social stability. But it raises an interesting question. Can you foresee a high possibility that when those other goals change or when the leadership's perception of how to achieve or maintain stability changes, these reforms could come to a halt or even move into reverse?

I mean, or has China passed some point of no return where these liberalizations are on an inexorable forward path?

MR. KOHN: Well, you know, I think that's a good way to put it. And again, I would say that the currency is not the only option for China to modernize its financial system. And again, I want to stress the point.

I mean, if you had to read one other thing on China I would read Nick's book. Maybe that's it, at least for the time being. Because he does make the really important point that there is a tremendous amount of financial repression that's inhibiting consumer purchasing power in China that will make it very difficult to achieve the economic rebalancing that the Chinese leadership, current and future, has placed such a high priority on. I think that's an important and well-taken point.

MR. ROACH: I wonder how important the inflation problem is to driving the currency decisions. So, having to -- I mean, the leadership is very, very concerned about inflation and yet trying to control inflation without a central bank that can actually raise rates and allow the currency to appreciate is very, very difficult and requires the financial repression at the same time that markets are developing around the controlled markets.

MR. KOHN: Look, I think -- you know, this is your party so I'll shut up at this point. But I think you're right, inflation is critical and there's a lot of concern in China about rising inflation in the first half of 2011.

But I think the government has done a terrific job in addressing this incipient inflation problem through administrative actions aimed at the food issue, which accounted for about half of the acceleration of inflation through maybe a dozen increases in required reserve ratios in the banking sector, and then through monetary policy. Five rate hikes, and you know inflation has come down. It's still too high, but it's come down and I think your point is well taken and it's very much on the mind of the senior leadership in China.

MR. PRASAD: My sense also is that the balance of concerns are shifted a little more towards growth, especially given all the uncertainties in the external environment right now. And in particular, one of the issues about China's growth model which goes back to this rebalancing issue is that even in a period when China has been registering fairly good -- very good growth rates, the amount of net employment growth in the economy has been very, very modest and it's the export sector that really helps to generate jobs.

So, of course the other issues that presume that the Chinese policymakers see currency stability through is the stability of the rate relative to the dollar, and that's how we see it in Washington as well. But of course, the dollar has been fluctuating, and with it the currency's trade weight effective exchange rate has been fluctuating a good deal. And right now, with the dollar being strong the renminbi has gone up with it relative to other currencies, and they're very concerned about exports, especially right now and particularly with the leadership transition coming up.

As Steve says, the currency is not the key issue on their mind but it does end up becoming an important instrument in terms of the overall reform process, and my concern is that it could constrain the speed with which some of the other reforms are implemented and the speed with which this rebalancing act is managed.

MR. IP: There's a good line in your paper, Eswar, where you say that -- like when you're talking about the various paths by which, for example, the RMB can be incorporated into this special drawing rate of the IMF. You have a line where you say the IMF needs China more than China needs the IMF, and therefore it's almost more in the interest of the international community to encourage this process.

You almost kind of feel that a lot of what we talk about -- the internationalization of the RMB reflects what we really hope as opposed to what we expect, because it seems so much in the interest of the rest of the world. Given all of that, what can the rest of the world do to encourage this process? And touching on what Steve was remarking about, you know, the toxic politics of a U.S. election year where both Obama and the leading Republican candidate seem to have it in for China. Do you see any risk of that actually setting back the process or, conversely perhaps, hurrying it along?

MR. PRASAD: When it comes to the Chinese currency, there is hope and there is fear. The fear is that China is taking over the world and there is a fear that the renminbi is taking over international finance as well. I think that adds a dimension of fear, and there are enough people who have been parlaying to that fear the sense that the Chinese renminbi is going to overtake the U.S. dollar.

I think that is a largely premature story. It's good for the renminbi to develop, as Don has mentioned and Steve has alluded. I don't think this should be seen as a proposition that is going to hurt the rest of the world economy. If China does become more open, and if all the right things happen domestically, this is good for the world to have an additional reserve currency in there, and I think it's going to happen organically.

Having the renminbi become part of the SDR could create more obligations, and one of the issues of becoming a reserve currency is that you do get a little more of an obligation of whether the Fed really takes this obligation seriously when, as the rest of the world sees it, it imposes QE2 on the rest of the world is not clear. But, it does create a sense that a country's policies matter to the rest of the world, and therefore the rest of the world will be looking more carefully at the policies a country runs.

But ultimately, I think the issue does come down to one of China's own balanced economic development. But as the renminbi rises in prominence, I suspect especially if the currency stays tightly managed against the dollar, that is certainly going to heighten the tensions on the Hill here. Again as Steve has pointed out, this is an issue on which -- one of the rare issues on which there is unanimity among the Republicans and Democrats, at least in the lead-up to the election season. And with leadership transitions on both sides, this certainly has the potential to become a much more hot-button issue.

MR. IP: In a few minutes we're going to open it up to questions, so if you have a question please raise your hand and one of the staff here will bring you a microphone. I'm just going to go with one more question then hopefully we'll have a few questions ready to go from the floor.

Steve, I want to just sort of stick with that issue a little bit longer about the election implications here. So, Eswar has pointed out how the rest of the world shouldn't fear the liberalization of the yuan, but here you get sort of the sense that it can't happen fast enough for the Americans, right? So I'm curious to what you perceive -- especially in a transition year -- the risks of this pressure being brought to bear on China, whether from Congress, whether from the campaign backfiring and actually producing a perverse result.

MR. ROACH: Well, Greg, it really depends, I think, on one thing -- risk simplifying -- and that's the U.S. unemployment rate, which had a stunning fall. It certainly surprised me in the last year -- where are we now, 8.3 percent? I mean, each month I keep looking for a statistical bounce-back to compensate for what I think is a sharper than expected decline in the previous month, and it hasn't happened.

So, if the U.S. unemployment rate continues to fall, that's obviously great news for the Obama Administration but it's also -- I think would be very important in taking this RMB issue off the front burner as a bipartisan solution for problems bearing down on American workers.

My guess is that we're not going to sustain sharp declines in the unemployment rate in the U.S. month after month after month, and we have to be more realistic. So, I think this will be an important issue.

And you know, I would just go back to the point that Don ended on, and that is the zero sum notion versus the win-win notion. We, Republicans and Democrats alike, view China as a threat because of the trade deficit and the wage and job issues bearing down on American workers. I think we need to reframe this also as an opportunity.

The Obama Administration several years ago stated out an objective to double our exports in a five-year timeframe. Whether or not we do it, it still remains to be seen, but I would point out that our third-largest and by far most rapidly-growing export market is China, and so if we go down the slippery slope of slapping them with sanctions because they don't do the quick big bang on RMB revaluation, most likely they would reciprocate and make it very difficult for us to grow exports into our third-largest and most rapidly growing external market.

So, yeah. Unintended consequences if we stay the course we're on are a very worrisome development that could really come back to haunt this political assault on China.

MR. KOHN: I hope the Chinese watch what we do and not what we say.

So, I think that's going to be a very important distinction in an election year, and I hope -- join Steve in hoping we don't take a bunch of stupid steps that -- for short-run gain will be very costly to the long-run development of the global economic system.

MR. IP: It seems to me that from where I sit that in this country we -- especially who do a lot of talking and not a lot of doing. So I guess that's sort of a positive --

MR. KOHN: Well, I think in this case that's a very good thing.

MR. IP: We'll try to get some questions going here. Ann, why don't we start with you?

If you please wait for the microphone, state your name, and if possible direct your question to one of the panelists.

MS. KREIGER: Ann Kreiger, and I guess my question is basically to Eswar but also of interest to the others, too. You stressed financial repression so far, and that's still there clearly. Now, during the recession as I understand it -- and I'm no China expert at all -- much of the stimulus was performed through the banking system as they were ordered, basically, to make more loans as a stimulus package.

Now, if those as I understand it are becoming non-performing loans, isn't the government once again in a position of taking some of that over or forced to? And if it is, doesn't that then mean that the debt issue, which you sort of thought wasn't there, could arise depending on of course how things transpire otherwise?

Related to that, when the U.S. was the dollar reserve currency and running current account deficits way back when -- not recently -- there was a large literature in the international monetary stuff about the extent to which having more than one reserve currency could generate instability in the world economy. I've heard nothing of that discussion in terms of the potential for the renminbi, but I would have thought that should be a concern for everybody.

MR. PRASAD: So first of all, it is true that during the 2008/'09 financial crisis and the aftermath it was fiscal stimulus to a very limited extent, but to a far greater extent monetary stimulus through expansionary credit policies that kept the Chinese economy afloat, and it essentially meant lending going through the banking system that financed a huge surge in investment that kept the economy going. That's worked in reverse with the rebalancing objective of rebalancing the domestic demand to its consumption that the government has been talking about for a while, but those were desperate circumstances.

So an interesting question is: what happens if those desperate circumstances arise again? Perhaps if things end messily in the Eurozone. Now as you point out correctly, Ann, there is an overhang that comes from that credit expansion and the amount of policy room that the Chinese government may have to have another massive bank-financed, investment-led stimulus may be limited, but there is still enough room out there, because ultimately what matters in these difficult times is the amount of explicit public debt, and that is contingent -- that could come on the books, but it's not there on the books yet. And so long as growth can be kept going, if you have the economy growing in nominal terms somewhere between 12 and 15 percent, in 3 years the economy is about 50 percent larger. So, that is the hope of the Chinese, that they can keep this matching going enough.

But you're right that it creates enormous risks in the banking system, and they are quite cognizant about that. They've asked the banks to provision for about 180 percent of expected loan losses because they expect loan losses to be that much greater. It's a serious concern.

The second issue is about whether multiple currencies could lead to stability or instability. My own view having read that literature is that if the necessary consequence of having a uni-polar monetary system as a very large current account deficit, which finances bad policies in the dominant currency, that's not necessarily good for financial stability.

Now, it should be pointed out as I do in the paper that many of the other reserve currencies -- except for the UK -- the euro area is running a small current account surplus, so are Japan and Switzerland. So it doesn't seem to be essential for a currency to run a current account deficit. What is more important, again, is the availability of high-quality liquid assets, and I think that is going to become more important. So, I don't necessarily see the renminbi as increasing prominence and its role as a reserve currency adding greatly to financial instability. In some ways, I think might in fact help.

MR. IP: Another question? Yes, sir.

MR. ZANG: John Zang with CTI TV of Taiwan. Quick question. Chinese Vice President Xi Jinping is coming for a visit next week, as you have mentioned. How high on the agenda will the currency issue be? Thank you.

MR. IP: Steve, you want to try that?

MR. ROACH: Yeah, I don't think it's going to be high on his agenda but I think it will be high on his host's agenda. And it'll be an interesting opportunity to test Mr. Xi's ability to deal with a tough politicized international dialogue.

I suspect that he will definitely give assurances to President Obama that China is on a determined course for renminbi reform, but will urge the United States to put that issue in context and perhaps deal with some of our own problems that we need to address in this country, and there's a very long list of them.

MR. PRASAD: Actually, before we go on, Greg, might I ask Don about his views about the multiple currency issue that Ann raised? Because I'm very interested to hear and I suspect others are as well about whether having more reserve currencies is a good thing or could lead to instability?

MR. KOHN: I agreed with the way you answered the question, Eswar.

So, I do think that there could be some short-term instabilities from people shifting -- rebalancing portfolios over short periods of time in response to perceived disequilibrium, but it ought to help contain the longer-term instabilities that Eswar and Steve have talked about in the U.S. So, I think on balance it would be a good thing.

Now, one question. There have been, as Eswar pointed out it's not that the U.S. is the only international currency or the only reserve currency, and the euro -- at least until recently -- was an increasingly important reserve currency, was growing in portfolios of reserve-holding entities. Didn't seem to really help discipline the U.S. or China in terms of the longer-term problems.

So, I wouldn't -- I think it will help but it's certainly not the answer. It requires good policy actions on both sides to really cure these long-run problems.

MR. IP: Yes, over here.

MR. LIEBERTHAL: Thank you. Ken Lieberthal of Brookings. I very much agree with the sentiment of the panel that focusing on currency valuation is not the key to resolving U.S.-China trade issues and key to our future. I've thought that the currency issue tends to rise to the top in U.S. politics because it's such a seemingly simple issue to grasp and say that is the core of everything, if only they would do this, and it puts all the blame on the Chinese side.

Having said that, I guess primarily for Steve. If you could write the President's talking points for his meeting with Xi Jinping, what are the economic and trade issues you think he really should be raising and can usefully be raising?

Thank you.

MR. ROACH: I would really hope that U.S. officials would go to this point that America in a -- here we are now four years into a period where domestic consumption, personal consumption expenditures, has grown at an average annual rate of a half a point per year for four years. That we need a new source of growth, and at the top of that search for growth I think needs to be exports, and President Obama has correctly identified export-led growth as a real opportunity for the United States. So in the context of discussions with the next leader of China, market access -- especially in an era where China has introduced some arguably discriminatory government procurement policies, policies that favor indigenous innovation in China. That's fair game and I would negotiate hard in areas of market access and I would try to deflect the debate away from the currency, which is China's currency, the last time I checked, and is very much part and parcel of this gradual process that Eswar describes so well in this paper.

Yes, China has -- although it's come down in recent years, we can debate whether the improvement in the trade and current account surplus is cyclical or more structural, that those are issues for debate. There is a large imbalance on the Chinese side of the global imbalance equation, and Don alluded to this in his comments as well.

Can that imbalance or should that imbalance be addressed through significant, dramatic currency appreciation? Or is market access the better and more effective way for us to put pressure on China from our perspective? I'm definitely in favor of the latter. I think the currency realignment is not going to achieve results that are in our best interest in a short period of time.

MR. KOHN: I think it's a joint responsibility of the U.S. and China to prevent these adverse developments from occurring that would cut off trade, and the U.S.'s responsibility is to head off things that we might do that would interfere with trade. But, I think China has a responsibility, and I hope the new leadership understands the intense pressures that are here in the United States and the need for if not just freeing the currency up right away, the need for people here to see concrete steps taken towards the kind of internationalization of the RMB and the freeing up of the market that politicians here can point to in order to head off much worse things happening between the two countries.

MR. IP: Yes, right here.

MR. TAN: Thank you. Jon Tan from China's Xaixing Media.

I have two questions. The first one is, before China fully opened its capital account, and except for Hong Kong, where do you think is likely to be the next important offshore market for RMB? And my second question is for Donald. How do you see the possibility of RMB's over adjustment, and why?

Thank you.

MR. PRASAD: So on the first question; I think it's something that many financial centers in the region, of course, are looking at with great interest. The bigger question, though, is when the onshore development is going to take place because that is ultimately the big question for China. The notion of promoting Shanghai as an international financial center -- which my colleague Doug Elliot has written about as a matter of fact -- is something that is very much on the Chinese authorities' minds. And developing onshore markets is really the key because the amount of action you can have on the offshore markets is ultimately not going to work towards developing China's financial markets, which is what is ultimately necessary, although it helps the process of internationalization.

Singapore is laying some claim to trying to become an alternative to Hong Kong, but it's a little hard for me to predict because ultimately, this will be driven by policy choices by the Chinese government rather than any market-determined forces. So, Hong Kong serves as a very useful experimental center. If they can work with the Singaporeans, that could be an alternative market as well.

MR. TAN: How about Africa?

MR. PRASAD: Africa? As an offshore market, I don't think the financial markets in Africa have enough heft right now to be able to sustain much offshore activity, so I think we will see capital flows going from China to Africa, especially to lock in resources and to make investments for FDI. But I thought you meant development of offshore markets rather than capital flows.

Capital, I think, we will see fairly large amounts of capital going through private channels now that qualified domestic institutional investors are being encouraged to take more money out. Institutional investors are being encouraged to take more money out, and as a process of securities market development allows private investors to take money out for diversification purposes, I think we will see more outflows around the world. Not just in emerging markets, but also in the advanced economies where there are good assets to be picked up right now.

MR. KOHN: In terms of RMB overshooting, of course in a freely fluctuating exchange rate regime there's always a risk of overshooting fundamentals. I would think we're a long way from that now, in terms of the appreciation of the RMB.

Now, I do understand that the appreciation of the RMB and the reduced reliance on export-led growth has to occur together with greater reliance on domestic demand and the reforms necessary within China to have that happen. So, the Chinese might imagine that the RMB would be overvalued relative to their ability to generate domestic demand. I think it's really important that they can generate that domestic demand. And the risks, I think, of over overshooting in a freely-fluctuating exchange rate system are there but the risks of holding exchange rates and the allocated distortions of holding exchange rates at artificial levels are extremely expensive as well.

MR. IP: Yes, right there, please. Here, yeah.

MR. KOHN: Give him the other microphone.

MR. IP: Sorry, is there another microphone?

MR. CHELSKY: Jeff Chelsky from the World Bank. Eswar, you said that -- I mean, your projection is that within five years the RMB will be part of the SDR basket. At the same time, you said inclusion is largely a political decision rather than an economic decision, and clearly that's true in China's case in that decisions on convertibility, financial sector development, are political. You suggested at the IMF, this would also lean in the direction of inclusion. But the IMF doesn't make political decisions, it's major shareholders do. And if you look at its board the politics, in fact, would go against near-term inclusion until there's actually been real progress in China in terms of convertibility.

Do you think it's feasible that the domestic constituency could be developed within five years if those things could be achieved and that the politics in the international community would change within five years to allow the RMB to be included in the SDR?

MR. PRASAD: The last G-20 meeting was an important harbinger of things to come. President Nicolas Sarkozy, for his own particular interest, made a very strong pitch for the inclusion of the renminbi in the SDR basket. And there was a general sense among the G-20, if you read through the communiqué, that there wasn't wild enthusiasm but general agreement that there should be a move towards this.

And if you look at the IMF's own statement on this view last year, there was a sense that convertibility was seen as an important criterion. But in a paper put out this year, there have been a variety of different criteria that have been laid out, including for instance whether a currency is already held by central banks as part of their "reserve portfolios," and that is happening. So, many of these criteria can, in fact, be worked around to favor the inclusion of the RMB so the technical constraints won't be important.

Now, the U.S. could presumably put the kibosh on this. My sense is that if there was a view that by allowing China to have its currency be part of the SDR basket, this would create the right sort of circumstances where the international community could put a little more pressure on China to internalize the global consequences of its policy decisions. I think there could be an agreement towards that, because it's not obvious that including the renminbi in the SDR basket is going to hurt the U.S. a great deal. It will certainly move the renminbi in the direction of being a reserve currency, but I don't think it's necessarily going to stop it or help it a great deal one way or the other.

So ultimately, it will come down to a calculus about whether this becomes a tool through which the international community can exercise a little more leverage over China, which it utterly lacks right now.

MR. KOHN: Well, it seems to me --

MR. ROACH: Can I just ask you a question, Eswar? And that is, the governor of the People's Bank of China has made a proposal a couple of years ago that we move from a dollar to an SDR-based international financial system. How realistic do you think that is? Wouldn't that make this a more important discussion if that were to be the case?

MR. PRASAD: Right now, SDRs account for about 5 percent of global reserves. And even if there was to be an additional SDR allocation, it isn't going to be that much more.

The SDRs ultimately don't have fiscal backing and as Maury Obstfeld has pointed out, a currency without a fiscal backing is not going to have that much traction as a global reserve currency, especially when it comes to international trade --

MR. ROACH: Have you ever held an SDR?

MR. PRASAD: Sorry?

MR. ROACH: Have you ever physically held an SDR?

MR. PRASAD: I have not. I have touched a depiction of an SDR in the IMF, but no. The SDR does not formally exist, but in the minds of IMF officials, of which I was one until a while ago. It is still embedded in there.

I think it will have an effect if the RMB is included in the SDR basket, but if that happens I think it will happen as a package of a whole lot of other things happening, including the form of the IMF a greater -- an expansion of the SDR allocations, and so forth.

So, at the margin that by itself won't matter a lot, but I think the context in which it happens will be somewhat more significant.

MR. KOHN: So it would seem to me that the point of maximum pressure for reforms in China would come in order to join the SDR package, not once you're in it. And it's a little bit like WTO. What do you need to do to join? And opening up the trade accounts was an important piece of that.

So, I hope that the IMF does not loosen sensible criteria. Not every criteria that used to exist might be absolutely necessary in order to allow the RMB into the SDR. I think that if the Chinese see this as an important symbol of their growing importance in the global financial system, they will want to do what's necessary to join, and I'd rather hold them to good, credible criteria than loosen those criteria.

MR. IP: But, Don, just to interject a moment, I wonder if the WTO analogy really works because WTO ascension wasn't the end in and of itself of the Chinese, but all the most favored nation status that came with it.

MR. KOHN: Right.

MR. IP: And in the international monetary sphere, is there an equivalent to that? I mean, again going back to what you said, Eswar, is that the IMF needs the RMB more than the RMB needs the IMF. It's not clear what's in it for China to join the SDR. The very fact that People's Bank of China is going around saying let's internationalize the SDR suggests that they're trying to find some way to reduce the importance of the dollar without having to have its own currency step in and take that responsibility.

MR. KOHN: So I would say, if you want to accomplish that objective or reducing the importance of the dollar, you have to take some steps in order to have that done and there's probably a prestige aspect to this, a recognition aspect. So, I agree it's not nearly as important as the WTO from an economic development perspective, but there must be some carrot along here that we could use.

MR. PRASAD: But you're right, the Chinese have been very circumspect. I mean, they have put these ideas on the table, and you're right that they do want to get away from the sense that they are very dependent on the dollar and that the dollar continues to have this privileged role, but they're not willing to take the steps that are necessary to make their currency compete on a level footing.

And they understand, I think -- and rightly so -- that they need to get a lot of things squared up domestically, but having this issue on the table serves their purposes very well politically and in terms of getting other countries to start recognizing that this transition is going to happen and sort of prepare them for it.

MR. IP: It seems to me that reserve currency status must be a little bit like being a hero. I mean, some people -- some currencies are born reserve currencies, like the euro. Some achieve reserve currency status, like the dollar, and some have it thrust upon them, and that may in fact be the fate of the RMB.

I think we have time for a couple more questions. Yes, right here.

MS. WONG: Yeah, Kitty Wong with New Tang Dynasty TV. My question is, the United States has been trying to push China to become a more domestic-led economy but so far we haven't seen many changes. How do you think about the challenges China is facing in this aspect, and what's the trend in the near future?

Thank you.

MR. IP: Steve, do you want to tackle that one first?

MR. ROACH: Well, the U.S. has been trying to push China but China is also trying to push itself. Premier Wen Jiabao now nearly five years ago stated very clearly that while the Chinese economy is strong on the surface, beneath the surface it's unstable, unbalanced, uncoordinated, and ultimately unsustainable.

The 12th 5-year plan is a direct response to the Premier's own criticism of China and it does, I think, articulate a very clear agenda to move to a domestic demand economy. The question is not whether the pressure is coming from outside, but now the pressure is coming from the inside. And the answer to the question is how quickly China will move to embrace and enact the initiatives that have been fairly well-articulated in the 12th 5-year plan.

And you know, in answer to Ken's question that he posed to me earlier, this would be a terrific issue for President Obama to raise directly with Xi Jinping next week. And that is, what are you prepared to do concretely to implement this pro-consumption domestic demand stimulus that has been now enacted by the National People's Congress 11 months ago?

MR. IP: Yes.

MR. QUI: Thank you. Actually, my name is Don Qui with the China Review News Agency. Actually, it's a follow-up question for Mr. Roach.

A couple days ago Chinese Premier Wen Jiabao went to Guangdong and emphasized the importance of continuing reform in China, and he said that Deng Xiaoping's wishes of reform 20 years ago is still meaningful and significant for today's China. How would you interpret this claim?

You have a lot of context with the Chinese leaders. Do you think the next generation of Chinese leaders will settle the financial reform? Particularly when Li Keqiang and Wan Xixian, who have the economic background, may likely enter the highest levels of Chinese leadership.

Thank you.

MR. ROACH: Just to answer that -- so maybe we should let the other panelists answer -- but I just would underscore the fact that what I said at the beginning of this session, and that is that financial reforms for China are critical. This paper addresses the currency piece of them, but they will not occur in isolation. They must be set in the context of China's broader reform agenda, which you just asked about. So, they will go hand-in-hand, and I think the Chinese government, the leadership current and new -- they have a big agenda on their plate. It's a very complex and daunting set of challenges, and they must be viewed holistically. The currency will not move ahead in isolation from other, bigger, broader reforms that the Chinese government faces.

MR. IP: Oh, okay. Sorry. Morris?

MR. GOLDSTEIN: I'm Morris Goldstein from the Peterson Institute for International Economics. Lest anyone get the view that there's a unanimity of views on Chinese exchange rate policy across Massachusetts Avenue, let me just say for the record that I don't share the views of some members of the panel that the currency issue has gotten too much importance in U.S.-China relations. In fact, I think it's not gotten enough. But that's not really the key topic for today, which is the internationalization of the RMB. And there, too, I'd like to argue that how fast China's able to do that and move toward any kind of rivalry with the dollar depends a great deal on Chinese currency policy.

And the argument, in brief, is the following. If you want to make a step jump in the internationalization of the RMB, the RMB has to be more useable. That means it has to be useable more than it is on capital account transactions. If that is the case, then Chinese savers are going to have alternative saving opportunities. They're going to get a higher rate of return, and similarly Chinese borrowers are going to have other places they can borrow from, and so their rate of return is going to fall. That's going to put pressure on the Chinese banks this spring between deposit and lending rates. It's going to go way down, and that spread is now what drives a lot of the profitability in the Chinese banking system.

So, if the internationalization were to proceed a lot, the spread goes way down. Then, the Chinese banks are going to be much less willing to buy these sterilization bonds to soak up the liquidity from the exchange market intervention at low interest rates, and they're not going to be willing to deposit as much with the central bank also at very low interest rates.

So in the end, the way these things link together -- and it's another example of the sort of holistic nature of this reform process -- then you can't do this sterilization in the exchange market policy that you've been using in the past. So, if you're not willing to change fairly markedly on the exchange rate and sterilization policy, you can't make a big jump in the internationalization and reserve currency status of the RMB. So, I think that's the good news. You're not going to be able to do that.

The bad news is where I agree with Steve. I don't think is on the top of the agenda for the Chinese leadership. So aside from these technical developments that we see, I would be very surprised to see the internationalization really accelerate until the

Chinese leadership really is prepared to do serious reform on the financial repression and on exchange rate policy. As others have mentioned, my colleague Nick Lardy's book has laid out quite detailed.

MR. IP: Eswar, do you want to respond?

MR. PRASAD: It's usually a lot more fun to disagree with Morris than it is to agree with him, but I have to agree with the first part. These policies are linked together, and as Don and Steve have pointed out if you try to move forward with capital account opening with internationalization without the domestic infrastructure to support it it's not going to work.

So let me end with one final thought about where I think this is heading. As I said, the Chinese are approaching this in their own fashion. But perhaps there is what I like to think of as a Trojan Horse quality to this, because if the Chinese government can actually get the population and people who are actually working very well under the present system to sign onto this objective of the RMB becoming an international currency, becoming a global reserve currency, it becomes immediately apparent what needs to be done in order for that to happen and for it to happen safely, which will include a more flexible exchange rate, more independent monetary policy, a better financial system.

So perhaps what those reformers in the government are really trying to do is to push forward this as an objective because once the country signs onto that as an objective, then what needs to be done becomes much more clear, and perhaps it will be difficult to get around the Western interests and create space for those reforms.

MR. IP: That's terrific, thanks. A great way to end.

I'd like to thank the panelists for your very interesting, provocative comments. Eswar, I'd like to thank you for writing the only paper you need to read about the RMB, other than Nick Lardy's book. Thank you, everybody, for coming. (Applause)

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

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