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GAINING CURRENCY:
THE RISE OF THE RENMINBI

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PARTICIPANTS:

Moderator:

GREG IP
Chief Economics Commentator
The Wall Street Journal

Panelists:

ESWAR PRASAD
Tolani Senior Professor of Trade Policy and
Professor of Economics, Cornell University
Senior Fellow and New Century Chair in International Economics,
The Brookings Institution

CAROLINE ATKINSON
Head of Global Public Policy, Google
Former Deputy National Security Advisor, White House

BEN S. BERNANKE
Distinguished Fellow in Residence, Economic Studies
The Brookings Institution

JIN ZHONGXIA
Executive Director for China, International Monetary Fund
Former Director General of Research Institute, People's Bank of China

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P R O C E E D I N G S

MR. IP: Well, thank you very much, everybody, for coming. This is a really interesting event that we have planned here. I've been in economic journalism now for about 20 years, and I can't remember a time when the rise of China hasn't been an issue that we haven't all wondered about. And it's become especially intense in the last few years, because China now, you know, has outsized weight in the global economy, and everything it does has ripples here and abroad.

I mean, I just think back to, like, eight months ago, when we wondered whether the chaos surrounding its devaluation was doing to cause a recession here. So, it's times like this we really benefit from the depth and historical perspective from somebody like Eswar, who has been working on the -- has been studying and examining and advising on all the very complicated policy and economic issues surrounding financial and economic liberalization in China, and has been working on this for years.

He has summarized the history and the complicated dynamics behind this in a really interesting new book, which we are going to talk about today, Gaining Currency: The Rise of the Renminbi.

The format of the event today is that Eswar is going to give brief opening remarks, summarizing some of the thesis that he has in the book, and then we are going to have a conversation among all the panelists up here, on what we just heard, and then hopefully we'll have some time to hear from you and get a few questions going. So we'll start with you, Eswar.

MR. PRASAD: Where do I begin? It turns out, one can begin, a long, long time ago. What we are going to talk about today is the renminbi, which has in fact been China's currency only since 1949, when the People's Republic of China was formed. But in fact the history of paper currency goes way back, and in fact in chapter one of the book, I talk about ancient monetary debates in China that go back to 200 BC, when many of the issues that Ben and his colleagues grapple with these days, who should issue money, and most importantly how to preserve the value of money, were being debated by Chinese scholars in the Han era back then.

China also issued the first paper currency in the 7th Century, and then the first fiat currency in the 13th Century, and we know about this from the writings of Marco Polo who visited the court of Kublai Khan, and was stunned at this alchemy that he saw in the court of the Grand Khan, as he called him, because the Grand Khan just put his imprint on mulberry bark, which is what paper was made of at the time, and people around the land accepted it in exchange for goods and services.

So, how did Kublai Khan make his currency legal tender? Very simple. He passed a decree that anybody in his domain who did not accept the currency would be put to death. I don't think that's quite the strategy that Ben and his colleagues when they were at the Fed, were using to make the currency, the dollar strong, but at the time it certainly worked.

China also, soon after, had among the earliest hyper inflations, because the temptation to print paper currency in an undisciplined fashion was difficult to restrain. And China also had, as it turns out, one of the first literal currency wars. The Ko-Ming-Tang Government in the late 1930s had issued its own currency, set up its own central bank, but the Japanese had invaded parts of -- occupied parts of China, by that time they set up a puppet government in Nanjing. They also set up a central bank in Shanghai.

So the Ko-Ming-Tang went in and dynamited the branches of the Nanjing's Government's -- the reserve bank, and in turn, the Nanjing Government, which was a proxy government of the Japanese, went in, executed bank employees of the Ko-Ming-Tang-led Government, so it was a literal currency war. These days you don't have blood on the streets, it's blood in the corridors of Wall Street, but that was a real currency war.

But since 1949 the currency has come a long way, and on October 1, the IMF will officially anoint the RMB as an elite reserve currency on par at some level with the four other big currencies, the euro, the yen, the dollar of course, and the pound sterling, that are part of the IMF's SDR basket. So how has China accomplished so much in relatively little time, because the process and the project of making the RMB an international currency really got started only about four or five years ago.

So it's worth thinking about what has been achieved, what has not, and what the implications are for the Chinese economy itself. It's useful to distinguish among some concepts, and I am a professor, so I always start with concepts, which are very useful.

As an international currency, one that is used widely in trade and finance transactions around the world, the renminbi basically started at zero about five years ago, it didn’t have a presence. Today, China has about the fifth most-important payments currency, it accounts for about 3 percent of payment transactions settled through the SWIFT network. About 30 percent of China's trade transactions are settled in RMB, and China accounts for about 12 percent of international trade.

So, it's not a trivial number, but again, the numbers are not very large, but the trajectory is unmistakable, going from essentially zero to 3 percent in a period of four to five years suggest that big things may eventually happen. Then there is a concept of a reserve currency, one that is held by foreign central banks in their foreign exchange reserve portfolios.

Now, in the book I lay out some notions of what it takes to be a reserve currency. You need to have an open capital account so money can flow easily in and out of the country. You need to have a market-determined exchange rate, China doesn’t have this, but here is the remarkable thing. The Chinese currency is already a reserve currency even before the IMF anoints it as thus.

About 20 to 30 central banks around the world, countries like Chile in Latin America, Nigeria, South Africa in Africa, Austria, the U.K., and a whole host of economies in Asia, all already hold or plan to hold a part of their reserve portfolio in RMB.

There are 34 central banks around the world that have signed bilateral local currency swap arrangements with the People's Bank of China, giving them access to RMB credit.

So, de facto, the renminbi has already become a reserve currency. Now one thing that is necessary for the currency to move from being a small to a significant reserve currency, that you need well developed and well regulated financial markets. Foreign investors need to have access to renminbi-denominated instruments that they can acquire, that they can trade easily in and out of. China doesn't quite have that yet.

China is moving in that direction, and in fact, if you put together the corporate and government bond markets, the capitalization now stands about $7 trillion. By comparison the U.S. is at about $35 trillion, but China already exceeds many of the other reserve currency economies by this metric.

So China seems to be moving in the right direction in terms of making its currency more flexible, in terms of opening up its capital account, in terms of developing its financial markets. But I argue in the book that there is one very important ingredient that prevents or will prevent the currency from dominating, because there is a very persuasive narrative that without meeting the preconditions, the currency is already a reserve currency, so when it meets the preconditions it's going to take over.

I argue in the book that's not the case, because there is another concept which is very important, until the renminbi came along this was a concept that was different from that of a reserve currency. And that concept is that of safe-haven currency. One that foreign investors can turn to because they view the country, assets denominated in that currency as a place for safekeeping of funds during times of turmoil.

But to have status as a safe-haven currency, one needs foreign investors' trust. And I think what you need for that is a set of institutions, and by institution I mean something very specific, to engender the trust of foreign investors. You need an open and transparent form of government with institutionalized checks and balances. One needs trusted public institutions including an independent central bank that will protect the value of the currency, and you need the rule of law, so foreign investors know they will be treated fairly in the courts of law.

China doesn’t have any of this, and a signal that it is not going to have any of this. So my sense is that the RMB is going to erode to some extent, but in no way rival the dollar supremacy. But having said that, it's going to be a wild and interesting ride for the next few years to come, the currency is definitely going to make a mark in international finance largely driven by China's size, and importance in the world economy and in the world trading and financial systems.

So the RMB ultimately is going to rise if China plays its cards right, with economic and financial market reforms. But will it rule? To that my answer is, no.

MR. IP: Thank you very much, Eswar. And now just to briefly introduce the other panelists. On my far right is Jin Zhongxia who is he Executive Director for China's International Monetary Fund. Formerly he was the Head of Central Bank Research Institute at the People's Bank of China. And Ben Bernanke who is a Scholar here at Brookings Institution, before that he was Chairman of the Federal Reserve; and finally, Caroline Atkinson who is Head of Global Policy at Google but before that she was Advisor on International Economic Matters to President Barack Obama.

But I will start the questions by asking you a question, Eswar. And it's sort of like, it terms of the last point that you were making about this distinction between reserve currency and safe-haven currency. The big question as your book drives us towards is: Will at some point the RMB rival the dollar as the world's preferred reserve currency? And you raise important questions about what keeps it from achieving that status. What is standing between a reserve currency and safe-haven currency for the RMB?

MR. PRASAD: That China does seem to be moving forward aggressively with economic and financial market reform, although if you look at what has happened over the last year-and-a-half, one could make the case that some of these reforms had been very half-hearted, and very haphazard, which in turn has created a lot of turmoil in currency markets and equity markets. And I think there isn't the complete commitment to financial market reforms the way we might think of having a market work completely freely. And there is the good institutional framework to support these market-oriented reforms.

But again, even though China is moving forward with these reforms in a very haphazard way, I think the RMB could end up rivaling some of the reserve currencies such as the Japanese yen, the pound sterling, and perhaps even take a bite out of the euro. But the dollar has a lot going for it. Its size of financial markets plus a lot of institutions that work well, and one thing that China has made very clear, the President (inaudible) would have made it very clear that while they are committed to economic and financial market reforms, broader political, legal and institutional reforms are off the table.

But again, reading the press you might not quite get a hint of this, because there is a lot of discussion about the rule of law. But it's important to recognize that what China means by having the rule of law for it, it's not what some of us in this room might think of as the rule of law. What they mean is having property rights, and contractual rights being enforced in an efficient manner, and you need that for a market-oriented system to work well.

What is unlikely to happen is that the rule of law will not mean that the courts or the court system takes precedence over the Communist Party of China, and that’s what we might think of as the rule of law. So, I think on these dimensions it's very unlikely we'll see progress from China, and that’s why I think that China could become, if it plays its cards right, and I keep adding the qualifier, it's important, that it could become a significant reserve currency. But is it going to become safe-haven currency? It ain't going to happen.

MR. IP: But if can name just a few of the things that they have to do to sort of, like, getting towards that direction. You’ve talked about the rule of law, for example, what does foreign investor, or a foreign central bank that wants to hold RMB as reserve, what do they need to see in terms of judicial or legal stability to give them that comfort level?

MR. PRASAD: The key question that a foreign investor is interested in: are the rules of the game going to be changed for political reasons? There aren't that many countries in the world, we are in one where -- we are in the craziness of the political season, but there are institutionalized checks and balances in the system, and most importantly, you or I, or a foreign investor could take the U.S. Government to court if we feel that the law is not being followed properly by the U.S. Government, and very often the U.S. Government does lose.

So, if you think about a foreign investor wanting to be treated fairly, this becomes important. Why is it that we had a flood money coming into U.S. Treasury securities after the financial crisis, when the financial crisis started here? It's because foreign investors knew that they could move easily in and out of these instruments, and more importantly, the U.S. Government couldn't turn around and say, you, the foreign investors hold a lot more of our securities than our own investors, so we are going to put the torch to you. Because legally they can't discriminate among different classes of investors, and that creates trust.

So there are these elements, having an independent central bank, having a better legal system that I think are crucial that word "trust" to be there; and I don't think China is going to get there.

MR. IP: Ben, I'd actually -- Yes?

MR. BERNANKE: I just want to add, to make an observation. I agree with Eswar's prognosis that RMB is going to be a player, but not a big player in international reserves, for example, but I think we ought to say something about why is this important. I mean the presumption here is that this is a really big deal. I think actually that having a reserve currency is a mix blessing, you know.

And, for example, the United States doesn’t pay low interest rates because the dollar is the international currency, to the contrary, in times of great stress money flows into the U.S. and the dollar strengthens which is actually, you know, bad for U.S. exports, for example. So it isn't evident that China would have tremendous benefit from having the same role as the dollar, that the currency --

Rather it's very much symbolic, and as Eswar is suggesting, if the RMB does become the international currency it would indicate that China has met certain benchmarks of international role of institutions and the like, which will say, China has made great progress. But in fact, whether or not the RMB becomes the global currency, I don’t think is critical to China's development in any really fundamental way.

MR. IP: I would really like to ask you to assess how far China has come to having institutions that are what we associate with, you know, a credible financial system. And if I may, I'd like to recall something I heard you say when you were testifying on the Hill about a decade ago. You were asked -- You were being asked, I think, about the merits of investing in the Social Security Trust Fund in equities, and you pointed out the elementary kind of fact that the risk-adjusted return of equities is not higher than that of bonds.

And you said that if you had bought Russian stocks in 1917 you would still be waiting for your risk-adjusted return to reassert itself. So, given that, given your historical perspective, how far has China come in the direction of being the sort of economy with kinds of institutions that we can associate with a trustworthy currency?

MR. BERNANKE: Well, certainly it's come a long way in terms of its size and importance, and a huge part of the global growth is coming out of China. China is a big player in trade, one of the biggest players in trade and commodity flows, et cetera. But, you know, I agree, I think, essentially with Eswar. First that there's a lot needs to be done in terms of market liquidity and depth, the size and depth of liquidity and efficiency of Chinese financial markets is not yet, you know, in the same category.

And understandably because it still is an emerging market economy, so in terms of being able to buy and sell easily, the U.S. market, the European market, the U.K. markets are still much more liquid. And then beyond that the safe haven aspects that Eswar is talking about. So I think progress has clearly been made but, you know, until there is more open -- you know, a more market-dominated financial system, that there are some important barriers.

MR. IP: Thank you. Zhongxia, Ben just talked about why, having a reserved currency is not the same as having a desirable thing, and yet China clearly wants the RMB to be and internationally recognized reserve currency. Can you give some historical perspective of monetary affairs in China? Why is it so important to China that the RMB be in the SDR? And give us a historical perspective of why China is moving in that direction.

MR. SHONGXIA: I think based on my own experience, to participate in the internationalization process of the renminbi, what I can see is that this internationalization process has been entirely market driven, demand-driven, and a market-pushed process.

It is because of the need for the market participants to minimize the currency mismatch that they want to use the renminbi in foreign trade. And it is the desire that the authority wants to recycle -- needs to recycle the currency circulated in the offer market that has pushed, at least as a partial reason that has pushed the authority to open up its capital market to absorb the inflow of the renminbi-denominated money. So this, I think in my view, this is market-driven and a demand-driven process.

MR. IP: Just to follow up on that. Do you see the inclusion of RMB in the SDR as an accelerator or an impetus to push forward on other liberalization moves in the Chinese economy?

MR. ZHONGXIA: I think so, yes. If you look at the history, you can get some hint for the future. And in the process of the last two inclusions of renminbi into the

SDR basket, China has adopted a series of major reform steps, including liberalizing the interest rate, and improving its macroeconomic statistical framework; by joining the SDDS of the Fund which is a higher standard of macroeconomic statistical system.

Also by joining the COFER which is a survey of the members -- currency composition of its foreign exchange reserves, which was previously regarded as a national secret, but now it's become very transparent. And also China, in this process, opened its financial market, including the foreign exchange market, and bond market. Although this opening up is still partial, but it has been a major step, and we allow the entry of foreign central bank-like institutions, international financial institutions, and the Sovereign Wealth Management Fund.

And also, increasingly, commercial financial institutions to participate in our foreign exchange market, and also our interbank bond market. So all this, I think has been done in a determined way. So, in future, I think China will continue to reform and open up in this way, in this direction.

MR. IP: Caroline, I want to ask you about the process by which the RMB was brought into the SDR, and I believe the two main technical criteria was the size of the economy, and freely usable. And I think there are a lot of questions about whether the RMB met that second criteria, freely usable. And Eswar, in his book, talks about how, for the IMF, it wasn’t just strictly technical criteria at work, there is also a political desire to accommodate what China wanted.

Can you talk to me a little bit, from your perspective having been at the White House, interacting with the IMF and your counterparts around the world, about that process? Was the inclusion of the RMB in the SDR was strictly a technical exercise, or was it more than that?

MS. ATKINSON: Well, I think, having been a policymaker for a long time, but there were very few decisions that are strictly technical. But there are decisions that are mostly based on that that have a technical basis, and I think this one had a technical basis for sure. What was important I know to the United States at that time when I was working there, was that the second criteria and the freely usable, should be an important one.

I think it's also important, and it was important for the IMF as a policymaking body, and as a body that is representing the strength of the system, the economic and financial system in the world, it's important to have major economies represented in a proper way, and it was clear this was something that was of great importance for China.

And I think, also, for the other countries involved including the United States, others, and I can't speak for them anymore, to see -- and I liked what Ben said about joining the SDR being an important symbolic move -- it's important to see China accepting and wanting to be a part of obligations, responsibilities of the international financial system.

So, I don't think it was a controversial decision. I agree that the steps towards it in terms of opening up financial flows, opening up exchange rate transactions, and importantly, although it might not seem obvious, importantly becoming more transparent, with China's commitment to join the SDDS, and so on. Those were all important elements for those that were wondering how to strike the technical balance.

And I also would pick up on what Ben says about -- and I think there was a little bit of a disagreement there, was this just a purely market-led development, or was this something that was important symbolically? And I would certainly say that from the outside it seemed as if this was something that was important symbolically, something that's easy for political audience, the President and other policymakers to understand that you are becoming a currency of the kind that is recognized.

And I certainly know that in my experience people that I spoke to in the political sphere who might not have been able to tell what a freely usable currency was, or why one country was -- one currency was and another was not, could get the idea of:

Are you a reserve currency, and are you included in this basket?

And I think that it has been used in a good way, actually, by the IMF, by the People's Bank of China, by others, to promote the kinds of reforms that will make China's financial system stronger.

MR. IP: Eswar, what's your view on this? How closely do you think the IMF did adhere to the spirit in the letter of the requisite requirements of including RMB?

MR. PRASAD: On the technical requirements one could quibble, and I spent two or three pages in the book quibbling. But the broader points that I think Ben, Caroline and Zhongxia have brought up, is important. Ultimately, I think this decision is very good for China and for the IMF and the international financial system that it represents.

Why is that in China it's very difficult to undertake reforms, given that the system as it is presently structured, works very well for the large state-owned enterprises, the large state-owned banks, the provincial governments? But the notion of having a very specific objective that the leadership of the country and the people of the country could sign on to, the notion of a big, important country having a big, important currency, I think serve the PBOC very well in terms of being able to dislodge opposition to the reforms.

If one thinks about what was accomplished on the reform front in China over the last year-and-a-half; and Zhongxia listed many of these. Liberalizing the deposit rates, therefore freeing up the entire rate structure of banks, making the exchange rate ostensibly more flexible, putting in place and explicit deposit insurance system, all of these are about the financial system or capital markets, and most of these come off the checklist that the IMF set out for China.

So it was very good for the internal reform process and I think it's going to be good for the Chinese economy over the long run. It's also good for China to feel that it has more of a stake, more of ownership at the IMF. And so from the IMF, although perhaps it's not really an existential issue, it was still very important in terms of bringing onboard the emerging markets, which have felt are somewhat slighted over the years, in the sense they have that there is a somewhat unfair, unbalanced treatment between the emerging markets and the advanced economies.

Whether or not that is fair, that impression exists. And I think it was important also to see that having a big economy is recognized as taking its place among the economic elite, was very important; but ultimately, again, going back to what both Zhongxia and Ben have said, this is going to be a market-determined process.

The IMF can bless the renminbi, can elevate it onto a pedestal, but ultimately it's what happens in the Chinese economy, it's what happens with the Chinese financial markets that is going to determine the RMB status as a reserve currency. And perhaps this will capitalize the process and push it along, but it's not going to be enough.

MS. ATKINSON: Can I just comment that I remember a rather similar -- or some similar debates around the time of the introduction of the euro, some debates in the United States about, is the euro going to rival the dollar? Is it going to take over? And before that it was the Japanese yen, then the Japanese economy was the second-largest in the world, and there was a question about, well, maybe the yen is going to be the currency.

Leaving aside, as Ben raised the question, do we even want to have to be in the country that has a reserve currency. I think what we saw with, and what we've seen with the euro and the yen, and in a way also with the pound sterling, which has remained strong even though the economy is much smaller in relative terms; is that the nature of the financial markets as well as all of these other, and the economy and the rule of law.

All of those things, but including the more technical elements of, you know, the assets available, and so on, really matters to whether a currency sort of takes off and becomes -- We can see there are two tiers clearly at the moment between the dollar and then the other currencies. So it's not, in a sense, a new phenomenon to be thinking about, maybe this currency is about to go somewhere different.

MR. IP: But actually -- You've brought up the yen and the euro, and that actually brings me back to one of the early points, that Eswar raised, which is the distinction between -- the importance of institutions, right. So, one thing we can say about Japan and the European Union was that they did have rule of law, judicial independence, you know, a democratically kind of system of government, and so forth.

But actually as you pointed out, the Communist Party has made it clear that those are not the end game. So how significant is that distinction in terms of whether the RMB follows the path of the European or Japanese currencies on the way to reserve status?

MR. PRASAD: My sense is it's going to be a key determinant, again, given China's sheer economic size, it is going to become -- the RMB is going to become a reserved currency, but the question is: How far does it go, and where does it plateau?

Given China's importance in the international trade and finance, I think, again, that you could have the RMB becoming a significant international currency, perhaps accounting for as much as 10 percent of global foreign exchange reserves; but again, will it go beyond that to becoming a safe-haven currency and rivaling the dollar? I don't quite see that happening.

MR. IP: Thanks. We also talked about market forces, and Zhongxia you talked about how this is a market-driven process, and of the things we associate with a market-driven process, is a market-driven exchange rate. And last August, the Chinese authorities, August of last year, said that's what they were going to do.

And so there was a surprise announcement that the RMB would be allowed to have its value reflect market forces and interrupt, and it became a very chaotic process, as most of us remember. And to all intents and purposes, it looks like it's no longer market-driven; it's back to being fixed.

So, Ben, I'd like to ask you, is that a problem? I mean, the fact that China even now still closely manages the value of exchange rate in a way no other major economy really does, is that a problem for China, and how long can it stick with that regime?

MR. BERNANKE: Well, I think the flexibility would increase over time. I think that given the stage of development of China, and its institutions, I think that its current system is not unreasonable. I think it's a reasonable strategy. In contrast, before 2005, the renminbi appeared to be deliberately undervalued to give Chinese exports a global advantage. And associated with that was rapid acquisition of, you know, U.S. Treasuries, and other financial assets, and a large outflow of net saving from China, which also was, I think disruptive in some base.

So that was a set of arrangements that other countries objected to and, you know, frequently, in my role I was sometimes in the so-called strategic and economic dialogue, and we would argue with China that they should be letting their exchange rate be more flexible, and they should have less dependence on exports as a source of demand, they should be more balanced, use more domestic consumption and investment as a source of growth.

And they've moved in that direction. So, currently their current account surplus is much smaller than it was, they are more aligned to domestic demand, the value of the renminbi is much closer to what most people would think of as something in the range of equilibrium and although, of course, precisely where that is it's hard to tell. They are no longer accumulating significant reserves, in fact they've lose some reserves over the last year.

While the exchange rate is not fully flexible, it is market sensitive, and I think over time, they've guided it in the direction that market forces have been pushing it. So, what I think that over time that a still more flexible, more liquid foreign exchange market would be the right direction for them to go, I think currently the system they have is a reasonable one. The more important imbalances remain internal ones, consumption versus investment spending, services versus manufacturing, SOEs versus private sector, and so on. But on the exchange rate I think that they've made a lot of, they've made a lot or progress.

MR. IP: Zhongxia, did you want to comment on that?

MR. ZHONGXIA: I think in the past decade or two that the Chinese Government has always tried to strike a balance between the exchange rate flexibility and the exchange rate stability. So, as Ben touched upon this, the issue of 2005 reform, actually, at that time the renminbi, if we remember, it has a strong appreciation pressure, but people, they forgot that during -- or several years ago, just not very long ago before that, during the Asian financial crisis, the renminbi suffered a very severe, deep pressure.

At that time, the Premier Zhu Rongji announced that, so where we'll -- well keep the renminbi stable. So you can see that market condition changes, sometimes the currency face deep depreciation pressure, and sometimes it will turn into -- for the same level of exchange rate, nominal rate, the market condition will change into appreciation pressure, and the change may be quite dramatic.

So, my observation is that the Chinese authority, they have a very sincere intention to try to keep the stability of a -- try to keep or maintain a stable macroeconomic environment by trying to keep the exchange rate more or less stable. But at the same time, they had to -- they also want to respect the market's development.

So what they have done is just to iron out the short-term calculation. But if you look at the level of exchange rate from the medium and long term, it is still quite flexible.

MR. PRASAD: You have to hand it to China though. It's interesting that for years the U.S. Administration, the IMF, random economists like myself, were telling China, you should make your exchange rate more flexible. And they picked a perfect time to do it, when it was in their interest, and in the interest of nobody else. So the world then turned around and said, thank you for doing what we've been asking to do, but please don’t do it quite now.

But I think, one point that Jin Zhongxia and Ben have touched upon as very important, the intentions. There was a notion that was done on August 11, 2015, was a sort of desperate move to prop up the economy by depreciating the currency, I think there were much more honorable intentions at play. This is what the PBOC has for a long time wanted, because the whole point of having a flexible exchange rate is that it gives you much more room on domestic monetary policy, it gets around a lot of the complications in financial and macro sector policies that the PBOC has had to contend with.

So I think the intentions were very good, but unfortunately it was not implemented and communicated in quite the right fashion, and communication of course, is the challenged step virtually every central bank is facing these days. But I suspect that from the Chinese Government's point of view, and PBOC's point of view, in particular, a more market-determined exchange rate is a lot more sensible for China's economy.

MS. ATKINSON: But, Eswar, you said both that they picked exactly the moment that helped them. I would actually challenge that a little bit, because I don’t think what happened was very helpful for China, but also the intentions were honorable. I'm quite the intentions were honorable, but I also think there were real pressures at that point about what was happening with growth, and I think we can get into -- or it's important to bear in mind what Zhongxia said about, the goal should be balanced macroeconomic growth.

And I think that, as Ben pointed out, there was a period of time when it was not really balanced in China, and in fact there was a lot of dependence on exports to promote growth. Also there were a lot of imports in China was, in general, growing very rapidly helping to pull the world along. Right now we are in a slightly different phase of the global economy, and there were others, maybe in Europe, where current account surpluses are extremely large, and not China.

But I think there's still an issue about how does China move its overall economy to a more balanced position. And what role does the exchange rate, or the financial system -- the international exchange rate system, play in that move?

MR. IP: In fact, I wanted to ask Eswar. The point you make in your book generally is a very good one, I would recommend everybody to check this part out, especially, which is that China has always -- has this character of wanting it both ways. They want stability and they want market determination. But you know, those of us with the sort of (inaudible), and sort of like tradition, do not really believe those thing are compatible; that markets tend to be unpredictable and wild and volatile, that’s kind of the beauty of the mechanism.

It is not fundamentally compatible with stability, and you get the sort of sense that China's desire for market determination and stability is reaching a very sort of, like, tense and perhaps not sustainable coexistence. Don’t you agree? Or how much longer can this last, forever?

MR. PRASAD: There's just a grand experiment in the making, that as an academic it's fascinating for me to watch, as a policymaker it must be harrowing. What China is trying to do, is essential try to meld two fundamentally contradictory impulses, which is to let the markets work freely, but at the same time, maintain stability and control. Zhongxia referred to this.

And there is a line by a policymaker that I refer in this too, where he speaks about how it's important to follow the market, to fear the market, to trust the market and respect the market, but then he says, sometimes the markets behave like a herd of sheep, and then you have to step in to control the market. And that’s a fundamentally contradictory impulse, because if you say we need to let markets work, but once it's start getting out of hand, you are going to control the markets.

That creates a lot of unpredictability, and especially with this weak and situational environment that I spoke about, you get what we saw last year, a lot of volatility, in currency markets a lot of volatility, in equity markets, because markets don't quite know how to read the policy signals.

So I think, again, although my sense is still that the intentions in many of these dimensions, at least in the financial sector, are honorable. You are going to see a lot of stumbles and missteps along the way because the government wants the market to work well as a pricing mechanism, as a resource allocation mechanism, but it's still a little concern and want to maintain control.

MR. IP: Ben, did you want to add something to that?

MR. BERNANKE: I wanted to say that the August 2015 episode also illustrated the importance of clarity, communication and transparency. And the reason that was such a disruptive event was because people didn't understand it. What did it mean? Did it mean there was a weakening economy that was not evident in the statistics, for example?

And the Chinese have done better, in particular, earlier this year. At the G20, and so on, they began to clarify their regime, and that has been very helpful, it reduced a lot of the uncertainty about the course of the exchange rate. I think they could go further still. I mean I think there's still a lot of ambiguity about exactly how their -- you know, how the market is affecting the exchange rate? What is the role of the basket? What is the role of the dollar peg, and so on?

So, I think there's more they could do. You asked me initially about the exchange rate regime, I think that's one direction they could improve. The idea about the question, of market versus non-market, is a little bit misleading, because the exchange rate, of course, is the adverse of the monetary policy regime. To the extent the exchange rate is stabilized, it has implications for -- it puts restraints on monetary policy, in that respect, you know, there is in fact some scope to be consistent with market -- you know, market forces, and still have some control over the exchange rate, if you are willing to constrain monetary policy appropriately.

MR. IP: And do you think at this point, those particular constraints are helping or hurting China? Or, put another way; if they were to let the currency go, and not intervene, where would it go? And would that be a good thing or a bad thing?

MS. ATKINSON: It's more saying, it depends what they do with monetary policy?

MR. BERNANKE: Right. Yes, well this is putting a constraint on their ability to used monetary policy freely in an entirely expansionary way. And I've recommend, and as you know, in a blog post -- blog post that one way to deal with that problem is to have more emphasis on fiscal policy, which doesn’t have quite the same implications for the exchange rate, or the same direction of implications.

So, I think actually, that again, the combination of -- given the state of development the combination of the exchange rate regime, in the monetary policy, at least it's coherent, I think, at this point.

MR. IP: Zhongxia, can you tell us. Is it too soon to talk about what the final end game is, for the evolution of the RMB? Will it ultimately be a currency as freely used, and completely free of capital controls as the U.S. dollar is with the British pound sterling? Or will it be somewhere between here it is now, and that end point?

MR. ZHONGXIA: I think you are not wrong. China will eventually liberalize the capital account to a larger degree. And also the exchange rate will become much more flexible. But I think that will not take -- will happen in more steps. So, it will go through a gradual or evolutionary process.

MR. PRASAD: Actually one thing that may be of interest to the people here, I argue that the PBOC has nothing but honorable intentions, and Caroline is a bit skeptical about that defense.

MS. ATKINSON: No, no. I was just suggesting that what -- There was an internal contradiction in what you said.

MR. IP: Doesn't that partly depend on your definition of honorable intention? (Laughter) But there is some question about what the PBOC's regime actually is, because on August 11, 2015, there was the ostensible de-pegging from the dollar, and then in December we heard that currency's value was being managed against a basket, or with reference to a basket, as Ms. Reagan told us here on this very stage, some time ago.

But then the currency has continued to depreciate against the basket, so what is China's currency policy now?

MR. ZHONGXIA: I think the principle is that the exchange rate should be fundamentally determined by the market. And in this process the principle, you can see that it is based on the market supply and demand, and also take a reference to a basket of currency. So, we are saying that take a reference to a basket of currency, but we are not saying that we are pegged to this basket.

Because ultimately, it is determined by the market supply and demand, and in a period in which the major currency and their exchange rates are relatively stable, it will be easier for China to keep a stable exchange rate against a basket of currency. But if the exchange rate between the major currencies, all the major currency becomes very volatile, that will make the Chinese currency, makes the exchange rate against this basket stable, very difficult.

So, ultimately I think this is not the exchange rate of Chinese currency against other -- any single currency, or the basket currency depends not only on China itself, but also depends on how the other economy, how the market policy of the other central banks act.

MR. IP: And then another aspect going on here, which is the role of capital coming in and out of China, and when the IMF and the United States was trying to make evaluations of whether the exchange rate was fairly valued fundamentally, they were primarily looking at real factors, you know, GDP per capita, in terms of trade, et cetera, but as we know, for most currencies, the big drivers from month to month are capital flows, and since the -- you know, somewhat confused evaluation of August of 2015, China has experienced very large capital outflows.

And as you have described very well in the book, Eswar, many of these don't even show up in our normal definitions of capital flows. Maybe you could talk a little bit about that and how worried should we be, and does the volatility of capital flows fundamentally challenge the ability of the Chinese authorities to ever establish a market-determined exchange rate?

MR. PRASAD: It's a risky proposition. What has China has done flips the traditional order of reforms on its head. Logically it would be best to fix the financial system, to have a more flexible exchange rate and then move towards opening the capital account. That would be safer, that would be -- lead to a lot less risks in terms of volatile capital flows. But I think there is and this is the logic through what the Chinese did, although it has created a lot of volatility.

There was an opportunity last year to undertake a series of reforms. Some of these were mandated by the IMF, some the PBOC pushed, but I think the objective of all of this, was to push forward with the capital account opening in a manner that would impel certain reforms that are important domestically. I've refereed to this in the book as a sort of Trojan horse strategy.

Once you've move forward on capital account opening, it's going to create a lot of risks if you don't fix the financial system, and in particular, it creates competition for the banking system which, until then, until now, has had a captive source of deposits, which it could rely on, so there was no impetus for reforms. Have foreign investors come in to their corporate bond markets and the equity markets, brings more liquidity and debt, but also brings in better governance practices.

So I think the PBOC is drawing a very fine line here, because this could end up badly, and what we saw last year, I think suggests what would happen. But going back to the internal contradiction that Caroline pointed out, too; I think the problem, what set off all this turmoil was essentially the fact that they started off with not just allowing the currency to become more flexible, which I think people would have understood, and the currency would have depreciated, but starting with the 2 percent depreciation was what set off the panic.

Now, again that is perhaps not the right logic, but there is an internal logic to what they did. At the time the markets, the forward markets and what was happening to the currency within the band, was signaling about the 2 percent depreciation expectation by the market. So, I think the PBOC's view was, let's give the market what it wants, then we can let the currency fluctuate around that central parity.

The problem was that the 2 percent depreciation was anticipated by the market based on the assumption the PBOC wouldn't do anything. So when the PBOC did 2 percent, suddenly expectations flipped around, there was no communication, the press conference explaining the move, until it was 36 hours, which is a lifetime in financial markets, after the policy's announcement, and that has unfortunately created this negative currency depreciation capital outflow dynamic, because it came at a very sensitive time, when there were concerns about the Chinese economy.

So I think getting the intentions right is not good enough, getting the implementation and the communication right, as we've seen from this episode, is crucial. So, the capital account opening process I think has generated some of its own risk but -- and it's a very risky strategy, but I think it's the one thing that may, in fact, shake loose what is necessary for reforms in China.

MS. ATKINSON: But do you think -- Can I just ask if that process, which I think is similar, in a way, to the process of China joining the WTO, and then gradually and inexorably, some openness and changes were forced domestically, but it only goes so far, because it's also, again, possible to have other interferences with the free movement of goods. Do you think that these financial reforms, suppose the strategy succeeds in promoting financial reforms, even if it begins with the exchange rate, with the regime first, can feed into deeper reforms domestically? Or, is that where there's a conflict with government's goals?

MR. PRASAD: The answer to your well-framed question is no. And let me declare what I mean by that. I think what this process has been very good for is financial and capital account reforms. But the big concern I have about China, is not that are no reforms, but every reform that Zhongxia mentioned that I can point to, is about the financial system, is about capital account opening. We've seen very little reforms from the real side of the economy, especially state enterprise reform. We've seen very little in terms of institutional reform, not just the things I spoke about earlier.

But if you say you want the stock market to work well, first of all there is a question of how much room you are willing to give it, but in addition, you need some elements like you need a good corporate governance structure, you need good auditing and accounting standards, you need corporate transparency. If you don’t have those, the market becomes a casino.

And I think that that’s the fundamental problem right now, but this process has been very good for a very limited set of reforms, but for the other reforms that’s a crucial concomitance of financial sector reform. You don't have a framework, you don't have an effective advocate, and you don't have a sense of urgency. So this big imbalance building up in the economy, I think it's going to lead to a lot of turmoil in the years ahead.

MR. IP: Jin Zhongxia, will you respond to that?

MR. ZHONGXIA: Yes, yes, I will. I think that the process of the SDR Review has been -- Actually in my observation, was a very prudent, conscious process. For example, the IMF released several operational requirements, including saying that China should have some -- the risk management instrument in place. For example, the foreign exchange future market, and interest rate swap product that can be available in

China's capital market, financial markets.

So for these China managed to install all these instruments, make it ready before the inclusion of the RMB. So I think this process is very healthy process. We wish that we can see that the IMF didn't push blindly, that China just opened the market without considering the risk management. And China also take that very seriously -- seriously, and they established the necessary risk management arrangement or tools. So this is a very prudent process.

MR. IP: I would actually like to pick up on something you were talking about, Eswar. You said, we've been talking all along about reforms on the financial side of the economy, but what bothers you is the absence of reform on the real side of the economy, for example, state-owned enterprises, and one place shows I think is in like the debt statistics, we've seen an astonishing growth in China of non-central government debt, you see on the private enterprise side, the local government side.

And it's starting to show all the symptoms of a classic credit bubble, which, in the experience of Western countries always ends badly. My question to you, Ben, is you've seen that story before in other countries in your academic work, and as a policymaker. When you see China and these statistics, does that worry you? Where is China headed? Are they headed for some kind of destructive (crosstalk)?

MR. BERNANKE: It's an important issue that the amount of credit -- debt outstanding in China corporate, you know, government and so on, is very large, growing quickly, and the returns are diminishing. In other words, the amount of output being created by additional credit is declining. So that is a concern, but you have to understand, think about why it's a concern.

So we are not looking at, it seems to me, sort of a classic emerging market financial crisis situation, for a couple of reasons. One is that the debt -- a great majority of the debt is in fact in local currency in RMB. It's not like we have foreign lenders lending in dollars to the Chinese economy, what you see, primarily, is domestic

Chinese bank depositors, who are lending in RMB and deposits are sticky form, and getting some of the local currency.

So, you wouldn't expect this to collapse in a financial crisis. What it is instead, is that the large amount of debt outstanding is in some sense, the financial or paper analogue to what's happening on the real side. On the real side what we have much -- a lot of excess capacity in heavy industry, and in construction real estate, and so on. Inadequate -- with excess capacity means low returns, inadequate transition to services and the consumer-oriented production.

And so there's losses there's real economic losses there, and they are embodied in all of this paper which reflects, again, basically the fact that the government's fiscal policy and its development strategy has, in many cases, been implemented via the banking system, or via the debt markets.

So, ultimately the right way to think about much of the Chinese debt, is that it's ultimately in some sense the obligation of the government, one way or the other; either as the backstops to the banks, the backstops to the SOEs. And so they are going to have to work carefully to manage that and to allocate the losses according to banks, to SOEs and to the government.

The good news is that they have -- it's not going to be an immediate collapse type of situation, something you can work on over time, as part of the process of real side reform. And the other good piece of news is that the fiscal authorities have a lot of space that is that the official government debt, central government debt relative to GDP, is only like 40 percent, which is not particularly high by international standards.

But what they do need to do is, as part of the reform process they need to convert, or otherwise rationalize this credit structure, and allocate losses that correspond to the excess capacity and the low return industries. But as part of the reform process they should be able to manage that. But it's going to be tricky, they are going to have to continue to be closely attentive to it, but it doesn't look to me like it's an imminent timeline.

MR. IP: Zhongxia, do you want to -- what are your thoughts? I mean, you must get this question a lot. Does China have the means to avoid a debt crisis?

MR. ZHONGXIA: Of course, of course. I think China has -- (crosstalk) --

MR. IP: Any other answer would have been a headline I guess. (Laughter)

MR. ZHONGXIA: We discussed this issue, extensively with the IMF staff, when they drafted the Global Financial Stability Report, in which they make a whole chapter discussing on this issue. I think it is quite manageable. We discuss this issue in many details, including that the potential credit and risk and how -- what's the criteria when you classify the credit, which is -- and the risk.

And also, we calculate the possible losses, which may be -- even it is larger than the official declared NPL, even if it is larger than that, we can see the provisioning of the commercial banking sector, and also the current profitability, the profit level of the commercial banking sector as a whole, actually can quite easily, quite comfortable absorb the potential losses.

And this is -- By this we haven't mentioned that the possible backup by the government, and if you look at the government, as mentioned by Ben, the total government debt over GDP ratio, even if you include the local government contingent liability it is still low, lower than 60 percent. And it is lower than any major country in the G7. For example, Germany is the best in this indicator. It is over 70 percent, so I think China really has very comfortable room to deal with this issue.

MR. BERNANKE: Then if I could just add, that it is important going forward, just that they should stop using -- if they want the banking system to allocate credit in a market-determined way, it needs to stop being the channel of fiscal policy, and the government should more directly allocate fiscal funds.

MS. ATKINSON: And of course that will be complicated to choose which industries that it would be cleaner.

MR. BERNANKE: Yes.

MS. ATKINSON: It might also spur reform if individuals of the government were to cut, for example, payroll taxes, or other taxes to stimulate the economy through fiscal policy, rather than stimulate it through credit policy.

MR. IP: And I'm reminded of the analogue to Japan, for example, which set a current account surplus at the point that it entered a very long crisis. It never had like a Lehman moment until like well into the deflation of its bubble. What it did have was an enormous amount of mal-investment. A lot of, you know, real estate and construction that would be financed by very large debts in the banking system, and that mal-investment was a symptom and a cause of the slowdown in Japan's growth rate.

Is China facing a similar risk? Has China suffered through a long period of mal-investment because of the government-directed nature of economic growth? Is that the real problem? And how do you correct that?

MR. BERNANKE: Well it's not -- Yes, to some extent, obviously it's reflected in the excess capacity and the heavy imbalance between consumption and investment, for example. But it's not because of a bubble dynamic in Japan, which is basically a market economy, it's because of the political influences and the development decisions that have been made by the Central Government, and allowing markets to work, in this case, would probably give you a better allocation.

MR. IP: Do you want to add anything to that, Eswar?

MR. PRASAD: When somebody has just written a book they become very boring, no matter what question you ask them they say, it's in the book.

MS. ATKINSON: It's all about --

MR. PRASAD: It's in the book. But let me summarized my answer to this. I think in terms of the broader question about the crisis, I think both Ben and Zhongxia are right, it's unlikely that we'll see a financial meltdown, because there is enough room to absorb losses from the system. There is enough of a buffer, there isn't much external debt.

The key question -- I think there are two questions. One is, how expensive is it going to be to fix the problem? And it is going to be expensive and as Zhongxia pointed out, the IMF has estimates that if things are really bad in the banking system in terms of the NPLs, that the SOEs cannot pay back, that's going to lead to a fiscal cost of 5 percent of GDP. I think it could be somewhat higher, but that's a cost that can be managed.

The big question is whether, before that hit is taken, then government gets the economy moving in the right direction, and gets the financial system allocation the resources in the right fashion, because if the financial system is not fixed, then two things happen, number one, you have the problem growing even worse so the cost is going to be greater, and second you have a misallocation leading to either lower growth, or the wrong kind of growth.

So, I think the big question right now, the challenge the government faces, is whether, given that they have a little bit of breathing room, since some of the indicators are not terribly bad, whether they will use this room to start fixing the financial system, and this is where things become very complicated, because again, you can do things for the financial system, but if you don't reform the other parts of the economy then the problems don't really go away, the deeper problems remain.

MR. IP: I think we'd like to start broadening the conversation now. So, if you have a question, please raise your hand, we'll get a microphone to you. Please state your name and your affiliation. We'll all take a few questions down, and we'll go to the panelists. Starting with you, sir?

SPEAKER: Good afternoon. My name is Vitay Shinday, a Research Assistant of Professor Prasad, at Cornell University.

MR. PRASAD: I hope I trained you well, Vitay, we will see now.

SPEAKER: It's going to be a brutal one, I'm sure.

SPEAKER: You definitely have. My question was both to the Professor and Mr. Bernanke, because it has to do with the Fed. While working on this book, and as all of you've been mentioning, we are seeing some remarkable and important events and trends with respect to China. I was wondering what your opinion as to what extent these developments abroad as the Fed is calling them, should affect the Fed's decisions and discussions here at home, especially at this point in time.

MR. IP: The next question, this gentleman here on the aisle?

SPEAKER: Chung Ye from China Daily. I mean, does it make sense to hear the two presidential candidates still talk about, you know, blame China for currency manipulation, especially manipulation to keep it artificially low, while the pressure in China is really a downward pressure. I mean you have Chinese Premier going everywhere saying there's no basis for further devaluation.

I also want to ask Ben and Caroline, you were both in the government. Seeing that the U.S. White House until no longer, do you believe -- I mean, the RMB is grossly undervalued? Why is it that around, it seems to -- at some pointed about the White House actually called it very wrong? Thank you.

MR. IP: And another question right here.

SPEAKER: This is Hie Wang from China Institute. Deeper reforms including SOE reforms might mean large scale unemployment, and social chaos. Is this too big a price a pay?

MR. IP: Okay, great. We'll start with these ones. Let's start with the last question, I think is a very good one, Eswar. What is your view? I mean, everybody says Chinese reforms, but invariably when this happened, I think in the '80s, you know, with the first round -- and the '90s -- the first of reforms you get a lot of unemployed people. Where is the balance? Is that a price worth paying?

MR. PRASAD: I think the right question is: what are the reforms necessary to get the economy growing in a more sustainable fashion, without creating too many imbalances. And unfortunately the answer to that cannot be unitary, and once we fix the state-owned enterprises, yes, there is a lot of excess employment there, and you need to do something about the potential unemployment problem.

But as Ben pointed out, there is a lot of room in terms of fiscal space, and what China could be using a lot more effectively right now, rather than credit or monetary policy which, in China, roughly the same thing, it's to use fiscal policy more aggressively.

This would be good in terms of short-term demand management, and in terms of longer term growth rebalancing, if one could use some of that money to strengthen the social safety net and start investing in some expenditures that -- Or, using it for certain expenditures that could provide a buffer for this transition from, you know, state-managed economy to a private-sector-led economy, which is going to involve some turmoil.

So if you have fiscal space, one could use that a lot more effectively to buffer this but it's not going to be an easy process. Nobody expects reform to happen to overnight, and in a system which is so clogged up, any of these reforms can set off, you know, unexpected forces or outcomes, but I think there is no alternative to going forward on multiple fronts.

MR. IP: Zhongxia, could you also give us your input on that? I mean, to what extent is the possible social repercussions of reform a factor in the thinking of the Chinese authorities?

MR. ZHONGXIA: I think the state-owned -- SOE reform is very important in the Chinese economy. The reform may not -- may undertake various different forms. One extreme case is, let them go into bankrupt, another may be, we can arrange some merger and acquisition, and some other way is to just to do some restructuring. So the net result of these SOEs and the reform that have been affected by the overall restructuring, I think should -- can be managed, I think, under the government.

Also take effort, allocate resources to control the potential risks and the suffering in the real economy. For example, the government has identified the two sectors with excess capacity, like the steel and iron industry, and also the coal mining industry, the government allocated 100 billion yuan, as a fund to solve the unemployment issue that may be possible because of the restructuring of these state-owned enterprises in these sectors.

So, these are -- the central government may contribute some resources, and the local government will also contribute the corporations, the companies themselves will also bear the cost. So, I think if that is that process can be managed properly the risk should be or could be under control.

MR. IP: The first and second question I'm going to sort of like meld them together, because they are really related, and it has to do with effective China's policies on the rest of the world. The first fundamental question is: Is the Chinese currency still undervalued as so many of China's political critics say? And what effect, irrespective of that valuation question, are Chinese policies having on the United States and its other trading partners?

Ben, do you want to give that one a try?

MR. BERNANKE: Well, it's always hard to know exactly what the equilibrium exchange rate is, but we are not seeing large capital surpluses, we are not seeing large accumulation in reserves. So, I think the IMF and others who look at this think the RMB is much closer to the equilibrium certainly than it was 10 years ago. And the effects on the U.S. obviously, there's a lot more impact now than would have been, you know, 20 years ago when China was a much smaller economy.

I remember when I first joined the Federal Reserve Board, I remember a staff presentation at the -- this was in early 2000, it's about, what would be the impact on the U.S. of a slowdown in China? And the staff said, well, on the one hand, we don’t export that much to China, on the other hand, if China slows down, the oil prices will go down and that will be good. So the net factor was, if China slows down we don't care.

But now, of course, that is no longer true. Now we do care, for many reasons, and in particular because the world's financial markets are so integrated now, that China's slowdown even if its most direct effects are on, say, other emerging markets, it's going to affect risk taking, and risk preferences in financial markets and cause swings, potentially, in equity.

For example, we saw in August of 2015, that would have implications for the United States, and we saw in August of 2015 that the Fed was looking very carefully at the impact of -- even the potential slowdown in China, on financial markets, and therefore on the outlooks of the U.S. economy. So, clearly China's growth rate, its imports of commodities, its exchange rate, all those things are of global significance now, certainly.

MR. IP: And Caroline, this was a question that came to you all the time when you were in the White House. Were, or are China's policies hurting the United States?

MS. ATKINSON: I want to flip that around, just to say that I believe, and I think it's consistent with others here have said, and with the research and analysis, that policies that drive faster, stronger growth and more jobs in China, will also be good for the United States and for the global economy, provided that they are promoting a balanced growth.

Obviously policies anywhere that are just looking at promoting domestic demand and that -- I beg your pardon -- promoting export demand and not domestic demand, are in a sense taking away from the rest of the world, but policies that, including Ben's suggestion of fiscal policies that support transition, that support the economy as it becomes more domestic demand and consumption-led, are also good for the United States.

So I think that that’s the key and the concerns about the exchange rate that were often expressed by the United States, were really most acute before the exchange rate, renminbi had appreciated. And one could see that over time, the exchange rate did appreciate, so that it was -- sort for current account surpluses, shrank.

I think there's still a lot more that could be done domestically in China, but of course it needs, as Ben was suggesting, it needs to be done in a way that supports jobs and employment, but there's a lot more that could be done to make China's growth more balanced; which would be supporting social safety nets. I like the idea of there being tax cuts for maybe employment, and obviously that needs to be paired with a careful reform.

MR. IP: More questions. You had a question, I believe, yes. And anybody else, please raise your hand, we'll get the microphone to you. Sorry about that.

SPEAKER: Yes. Jim Baden with the Center for International Government Simulation. I wonder if you could say a little bit about the systemic implications of these developments. We have an international financial system that’s based on a small number of currencies that are widely traded, are freely usable, and managed in a transfer manner, and so on. And last year I think the IMF took a huge leap, if I might put it that way, and saying, even if China isn't all the way there yet, we think it's made so much progress it's likely to be there in a very short period of time.

But just as a thought experiment, suppose that all this new openness were to destabilize the Chinese economy, and then you saw a pullback from the progress that’s been made, so all of a sudden the renminbi is not really usable, it's not widely -- or by reserves anymore and so on. Now we have relapse, because it seems to me that the international financial system, and I haven't read anything, or heard anything, or people seemed to be addressing that risk. So, maybe I'm overstating the case, but I wonder if I could get your reactions.

MR. IP: Okay, there's another question right near you, I think I saw that -

- Yes. And then we'll have this woman over here.

SPEAKER: Thank you. My name is Matilde, I'm a research intern here at Brookings. And my question is more domestically focused. Given the increased goal recognition of the renminbi, do you think the United States will or should acquire a sizeable portion of the RMB as part of its foreign currency reserves, or is that not advisable at the current moment? Thank you.

MR. IP: And, do you still have a question? Could you bring the microphone up here, please, to this woman on the aisle?

SPEAKER: (Inaudible) for Mr. Zhongxia. You mentioned that the contingent liabilities of the local governments (inaudible) include the excess capacity -- (inaudible)?

MR. IP: If I could rephrase the -- interpret the question. Essentially if there's a severe slowdown in China and real estate values fall a lot, the government may be faced with much more contingent liabilities than it now thinks, if it has to bail out the banks. Has the Government of China thought about that? Is it worried about that? Does it have the capacity to bail out local governments and banks if there is severe distress in the real estate or other sectors of the economy now facing excess capacity?

MR. ZHONGXIA: I think in China, even the state-owned enterprises, they are independent market player. So there is no legal obligation, nominally, for the government to bail out entirely. But of course, government in this process they are considering to implement the restructuring and at the same time maintaining social stability, so that’s why the government try to establish or strengthen the social security network; in order to prevent over -- destructive process of this restructuring.

MR. IP: Eswar, did you want to give any thoughts on that? I thought it's something that you have come across a lot.

MR. PRASAD: Actually I prefer to deal with the other question that Jim (crosstalk), or the other interesting one. Jim is a fine historian so he's thought deeply about these matters. Let's be very clear about what's happening on October 1, 2016; which is just a few days away. The IMF will officially sort of Knight the RMB by putting the shoulder on, probably Zhongxia's shoulder.

But it's not going to be a game changer. It's not like there are portfolios around the world that are benchmarked to SDR so you are going to have a flood of money going into SDRs. As Zhongxia has correctly pointed out, ultimately this is going to be a market-determined outcome. The IMF, one could argue, on technical grounds perhaps, that play a little fast in rules, although again, with all the right intentions and motives, and I think it's going to be good for China.

The MSCI by contrast did not include the A shares into its MSCI Index, in its review in June. Why? Because they had a similar checklist, and they felt that China had met many of the elements of the checklist but not all, but moreover the investors abroad that the MSCI talks to were not convinced that China meant it. So they said, let's see how this works, and not just in principle, but in practice.

So there isn't going to be a flood of money going into SDRs, right now only the IMF and the BIS is sort of saying, no, maintain their balance sheet on SDR terms. So you will have a little more portfolio reallocation of central banks towards RMB, but ultimately the question is, whether China will have the right kind of growth and stability, whether China will have the right sort of financial regulatory architecture, well development financial markets, that will determine how much traction the RMB gets.

So I think all of these reforms that have been impelled by the inclusion in the SDR basket have been good for China, I hope they'll be good for the world economy as well if China gets things right. But I don't think it's going to be hugely disruptive to the international financial system for this reason.

Of course if China starts experiencing trouble for other reasons, as Ben and Caroline have pointed out, that's going to hurt all of us at some level because China is so important right now. But the SDR inclusion, by itself, is not going to be the reason we should panic.

MR. ZHONGXIA: Let me add two more points. I think the inclusion of RMB into SDR, is a milestone as said by the Managing Director of the Fund, for the RMB, a milestone for the RMB. But this is not the whole picture. In my view, based on my experience I can see that this is also an achievement of the so-called new multilateralism of the International Monetary Fund, which aims at integrating in an orderly way, the emerging market economy into the international financial and monetary system.

So this case shows clearly that the existing multilateral framework can be adaptive for the changing world economy, so this is first point. The second point is that, based on my experience, I think that constructive communication and corporation during the process of the SDR Review, has contributed positively to all the parties involved to accumulate mutual trust and mutual confidence.

That will be very positive, very helpful for maintaining the global financial stability and also for the entire international society in the long-term.

MS. ATKINSON: Yes. I would like to just agree that what's really important is to see -- and I think this has been a process going on for a long time, if I think back to the creation of the G22 and then the establishment of the G20. A process of making sure that major economies that may not be fully advanced, or industrialized yet, but are really important are a part of the governance of the international system.

And I think that certainly in the interest of those economies, and also in the interest of the system itself, because we will have a shared stake in that.

MR. IP: And an element to that question that also, I think, poses itself which is: Are these reforms reversible? Is China, having opened up, decides it doesn’t like what it sees, is it going to pull back. Or, more to the point, will it play the part that we expect of the large global player. I'm reminded of what Charles Kindleberger said about the breakdown of the international financial system in the '30s.

Great Britain could no longer be the stabilizer, and the United States would not. The global financial system works because there is a hegemony that basically takes upon itself the role as import of last resort as guarantor of the international financial system. Can China, or will China play that role? Eswar?

MR. PRASAD: I think you should thank the representatives of the hegemony campaign --

MS. ATKINSON: It is a job.

MR. BERNANKE: The U.S. played the role in the crisis and notably, and if I may so, the Federal Reserve acted as the lender of last resort in dollars to 14 other economies, not including China, but including other -- including some four emerging market economies. So, acting as lender of last resort, acting as the source of reserves that the U.S., at least in the crisis, did fulfill that role, and whether it will indefinitely in the future, of course is a great question.

I think just on this previous question, I mean, everything that was said about the SDR inclusion and its importance is true, nevertheless, it was still symbolic. Nothing real changed, but nevertheless it did indicate the willingness to work together, and it is very important that China be included in international institutions and the like.

So, in that respect symbolism is a real thing, but it was still symbolic, and there was a question about U.S. reserves; U.S. doesn’t have reserves, don't need them.

MS. ATKINSON: But the dollar --

MR. BERNANKE: The dollar --

MR. IP: Well, the U.S. does have some reserve.

MR. BERNANKE: A small amount of reserves, but --

MR. IP: Should the U.S. add some RMB to those reserves?

MR. BERNANKE: It's irrelevant; (laughter) symbolic again, yes.

MR. ZHONGXIA: Also, maybe one more point. I think the inclusion of renminbi into SDR, there is no room for complacency for China, I think, because we are fully aware that our modernization drive and our reform, market-oriented reform efforts are still in -- is a work in process. So there is still quite a lot to -- a lot of work to do, before China can become a highly developed country. So, this is a new starting point, if I can say that, for China as a reform and development in the future, rather than the end of China's reform and development.

MS. ATKINSON: Yes. And we are obviously at a time when openness and globalization is under a lot of threat and pressure, because feel that many people in many societies feel that they haven't benefited from it. So, I think that part of what one would want to see going forward, is that there is a greater sense of sharing of the benefits of globalization, technology and so one, and that openness.

I think how plays that role going forward will be important because it means, as you were saying before, that balance between stability and flexibility is going to be important. If you keep things stable for too long and too fixed a way, that stability becomes a source of instability.

MR. IP: There's a question back there.

MR. TALLEY: Ian Talley, Wall Street Journal. Far be it for me to disagree with the Chairman, but it seems to me that US' dollar hegemony has leveraged a great deal of power through sanctions, on Russia, Iran, or even some of the lender of last resort of credit lines that it's applied sometimes, particularly through time. But my question is about whether --

MR. IP: There is a question.

MR. BERNANKE: Well, the sanctions go through the financial system, has nothing to do with the dollar, it has to do with the fact that the United States financial institutions are so critical, and the U.S. markets are so critical, but we could be trading in Turkish lira, or whatever, but it would still be the same ability to sanction. The ability to serve as lender of last resort was a service provider, not a benefit.

MR. TALLEY: I shall not argue with you for reasons that you've just shown.

MR. BERNANKE: Fine.

MR. TALLEY: Perhaps we can take it up afterwards. But it seems to me, I wonder how much the IMF risks being co-opted by lending its legitimacy to China in this way. In the same way that perhaps the U.S. could be argued, lend China legitimacy by backing its accession to the WTO.

Caroline, you mentioned about balanced access, whereas China has been able to take advantage of that accession, and perhaps it hasn't been reciprocated in the same way that U.S. expected, therefore the U.S. is not willing to call market China -- a market economy right now. Is there a risk that China is able to take advantage of this legitimacy and not move forward on the reforms that it's supposed to encourage?

MR. IP: Caroline, do you want to tackle that?

MS. ATKINSON: Well, I'd rather sort of turn it around about, and think about what is the value, the real value for China and the rest of the world. What is the outcome of this move to join the renminbi? I think that we'll end up agreeing, which is probably not very good for a panel, but that the demonstration of China being willing to take on obligations and responsibilities as well, and being part of the system is a good thing.

The next steps will be, well, how does China proceed with the further reforms as you said, it's not over yet? And those reforms will, you know, be important in terms of China's broader role in the economies. Typically gone cautiously, but in a certain direction, I think part of the question that people are asking: Is that direction still assured now towards a greater openness?

MR. IP: All right everybody; I just need to take a minute or two if they want to share some final thoughts on that.

MR. ZHONGXIA: I think they are very right. I think the reform, the markets into the reform, actually is in the interest of the Chinese people themselves. This is a conclusion based on China's experience in the past 30 years, in the past 60 years, and in the past 100 years. And if you look even further, go to the history, deep history of China you can see that this is also consistent with many beliefs, many source that has a deep root in Chinese history.

As I said, actually, Prasad, he has a very good chapter in his book, talking about Chinese economic or monetary policy history. I think I just want to add two more things; one is that actually, Chinese currency was international currency in history. Several years ago when I visited museum of a foreign central banks in Asia, I discovered a surprise that in the 12th to 13th Century, the Chinese currency was widely accepted and circulated in that Asian country actually.

And another point is that in the 6th Century, Before Christ, a famous Chinese economist, and also philosopher, whose name is Guang Zhu, who argued that in the period of economic recession the Government or the King should increase the budget expenditure, fiscal expenditure, to implement some seemingly wasteful projects with a purpose to increase the employment.

So this is quite consistent with the modern Keynesian theory. (Laughter) And also in the -- about the same era, in Chinese history, there is another famous philosopher, whose name is Laozi, who advised the Government that they should rule b no intervention. This is a modern version -- this is the ancient version of the modern laissez-faire, or invisible hand.

So, if you look at the basic sort, the system of (inaudible), in China, there is a lot of similarity, or common ground, between Chinese people and the people in the West part of the world. And if you look at history, it is very useful by reading the history it's like qualitative regression. (Laughter)

So like the time series analysis, the longer the time series the better. So if you read the history, and not only the most recent (inaudible), but also the risk in several centuries ago, 2,000 years ago, and you draw a line, you will see what will happen in the future more accurately. (Laughter)

MS. ATKINSON: Maybe not here but --

MR. IP: Actually I leave the final -- We only have a couple minutes left, I leave the final word to you, especially will the world end up being happy that it accommodated China's entry into these institutions.

MR. PRASAD: I think ultimately it's going to be good for China and the world. It's going to be a rocky and very interesting ride ahead for the RMB. I have no doubt that there will be periods when the world when will think to itself, what have we done bringing the RMB into the international financial system in such a way. But ultimately it's going to be a reality has China becomes more important economically.

And as the other panelists have pointed out, bringing China to the table as a responsible member of the international community, and China has been taking a more constructive role, not just in economics, but in climate change issues, and so on. I think that’s a good outcome. So, it's going to be in interesting ride, but again, I think it's important for us not to get caught in the hype because there is a lot happening with RMB.

It seems to have gone a fairly long way in a very short period. It is now going to become, technically an elite reserve currency, but one should not read too much into these things, because a lot still remains to be done in China.

I'm also very grateful to the panelists, and you, Greg, for having come and help talk about the themes in my book. I also want to say one other thing; many people have said nice things about my book, including Zhongxia, including Ben writing an endorsement. But one very important person whose standards are far higher, my dear wife, actually read the book, she's not an economist, and she gave me the best endorsement that I could --

She read it carefully, and said, you know, it's not bad. To me that meant a lot more. It turns that I also found, ones loved ones are always the harshest. I found that despite all the care I put into the book I had many people proofread it, there is still one typo that comes early in the book.

So you know, I was sitting at home last week, because one of my interns just pointed this out, and my elder daughter, my 14-year-old, was very reassuring, she said, don't worry dad, nobody will get that far in the book. So, I hope that some of you get that far. But thank you very much.

MR. IP: I would like to say that I got that -- I finished the book. Before I read the book I knew that China had invented paper. When I finished the book I realized they invented paper money. And now because of this panel, I also discover they also invented helicopter money 2,600 years ago.

So, thank you, all of you for a very insightful panel. And thank you for coming. (Applause)

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