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THE DOLLAR HEGEMONY AND THE U.S.-CHINA MONETARY DISPUTES

by

XIONGWEI CAO

B.A. Zhejiang University China, 2001

A thesis submitted in partial fulfillment of the requirements
for the Degree of Master of Arts
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in the College of Sciences
at the University of Central Florida
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ABSTRACT

This thesis analyzes the current disputes between the United States and China over the exchange rate of the Chinese currency renminbi using an International Political Economy (IPE) analysis.

Monetary relations are not mere economic affairs, but bear geopolitical implications. Money is power. Money is politics. The pursuit of monetary power is an important part of great power politics. Based on this assertion, the thesis studies past cases of monetary power struggles between the United States and the Great Britain, the Soviet Union, Japan, and the European Union (EU), respectively. The thesis then investigates the dollar's status as the dominant international reserve currency in the current international monetary system, as well as the power that this unique status can generate and provide. The dollar's monetary hegemony has become the main characteristic of the current international monetary system and an important power source for continued U.S. hegemony.

The dollar's hegemony and the asymmetrical interdependency between the dollar and the renminbi are the source and the key basis for the recent U.S.-China monetary disagreements. The U.S.-China monetary disputes reflect not only each country's respective domestic interests and perceived benefits, but also the monetary power struggle between the two biggest global economies.

Predictions are also entertained for the future monetary relations between the two countries, as well as the geopolitical implications that this relationship may have for the U.S.-China bilateral relationship in coming decades.

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LIST OF ACRONYMS

ASEAN	Association of South East Asian Nations
BEER	Behavioral Equilibrium Exchange Rate
CASS	Chinese Academy of Social Sciences
CIA	Central Intelligence Agency (the United States)
CNN	Cable News Network (a U.S. media)
CNOOC	China National Offshore Oil Corporation
CNY	Chinese currency denomination yuan
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPE	International Political Economy
OPEC	Organization of the Petroleum Exporting Countries
PBC	People's Bank of China (the Chinese central bank)
PPP	Purchasing Power Parity
RMB	Chinese currency renminbi
SDR	Special Drawing Rights
TPP	Trans-Pacific Partnership
UK	The United Kingdom
U.S.S.R.	The Union of Soviet Socialist Republics (the Soviet Union)
WTO	World Trade Organization
WWII	World War Two

CHAPTER ONE: INTRODUCTION

This thesis tries to analyze the current disputes between the United States and China over the exchange rate of the Chinese currency (renminbi/RMB, or yuan/CNY). Exchange rate is not just a mere economic jargon, rather it is the exterior value of a national currency and may significantly influence trade, foreign investment and even the whole macroeconomic running of a certain state. The United States is the sole superpower enjoying all-around preponderance on world stage; while China has risen to be the second largest economy and the biggest exporter in recent years. The monetary disputes between the two sides will not only influence their respective economies, but will affect the bilateral political relations as well. A rising China is believed by many as a possible challenger to the U.S. hegemony in the future. The development of the bilateral relations between the “big two” will have far-reaching meanings for the future international political system. Therefore, the exchange rate disputes between the two powers definitely deserve close academic attention.

Since 2003, the issue of the exchange rate of the Chinese currency emerged to be one of the fierce diplomatic disputes between the United States and China. The disputes mainly focus on the renminbi’s exchange rate level against the U.S. dollar. The U.S. side believes that the Chinese government has artificially maintained its currency at a low level, benefiting unjustly from the trade with the United States and putting the latter on an unfavorable status in the bilateral trade. This policy is also believed to have caused

bankruptcies and job losses in the U.S. manufacturing sector. However, the Chinese side does not agree that its currency is undervalued and deems exchange rate choice a sovereign action. It also refuses to admit that the results happening in the United States are mainly because of the Chinese monetary policy. In the climax of the disputes, the U.S. Congress has even threatened to pass legislation to punish the “manipulator”, a name it labeled China, but China criticized this threat as a trade protectionist action.

In 2005, China announced to start a reform of its exchange rate regime and allowed the renminbi to appreciate against the dollar. It stopped the appreciation in 2008 re-pegging the dollar in the clouds of the global financial crisis. From June 2010 till the present, the renminbi is once again on a slow but steady rise against the U.S. dollar. However, the U.S. side still believes that the renminbi is to some extent undervalued, though it has regained around 30% value against the dollar since 2005. In October 2011, the U.S. Senate passed a resolution to urge the Obama administration to take punitive trade measures against the manipulators of exchange rate. Spokespersons of the Chinese Foreign Ministry, Commerce Ministry as well as the Central Bank congruously made tough talks on this action. It seems that the exchange rate issue will remain as a main diplomatic friction between the two states in the near future.

Is the renminbi undervalued? If yes, by how much? Is renminbi’s exchange rate the main reason to have caused the U.S. trade deficit with China? And has this deficit really led to the unemployment rate in the United States? Not only the two respective governments but also world famous economists have very different views on these questions. Surely, the

economic theories are not sufficient to explain these disputes, or could it provide us with specific answers to the above mentioned basic questions.

Currency issues are not economists' monopolization, but have also attracted political scientists' interests as well. When U.S. President Nixon lifted the peg between the dollar and the gold in 1971, which was widely known as the "Nixon Shock",¹ the Bretton Woods System collapsed. This sudden change caused serious economic and political outcomes across the globe. The dollar devalued significantly after the Nixon Shock, forcing other main currencies to devalue as well. Because of the sharp loss of the value of their dollar reserves earned from oil exports and the Arab-Israeli war, the furious member countries of the Organization of the Petroleum Exporting Countries (OPEC) administered the oil embargo in 1973. The chaotic changes in the international monetary system and the oil crisis seriously impacted the capitalist world and ended the glorious "Golden Age of Capitalism".² These events made political scientists to include economic issues such as exchange rate into their scope of studies. Since 1970s, political scientists and economists, such as Charles Kindleberger, Susan Strange, Robert Gilpin as well as many others, started to combine their economic and political analyses and created a new paradigm named International Political Economy (IPE). Studies of the monetary relations became an important part of the IPE paradigm. The diplomatic quarrels between the United States and

¹ The "Nixon Shock" was a series of economic measures taken by U.S. President Richard Nixon in 1971 including unilaterally canceling the direct convertibility of the United States dollar to gold that essentially ended the existing Bretton Woods system of international financial exchange.

² The "Golden Age of Capitalism" was a period of economic prosperity in the mid-20th century, which occurred mainly in western countries following the end of World War II in 1945, and lasted until the early 1970s. It ended with the collapse of the Bretton Woods system in 1971, the 1973 oil crisis, and the 1973–1974 stock market crash, which led to the 1970s recession.

other industrialized countries on exchange rate level in the 1980s were early precedent for today's disputes.

This thesis tries to explain the current Sino-American monetary frictions from the political economy perspective. Both national and international political economy analyses are used to see how domestic economic and political factors as well as international relations influence the current U.S.-China monetary disputes. After research, it was discovered that domestic factors such as interest groups, partisan influences, political institutions, public opinions, etc. have certain influences on the government's choice of exchange rate. Under the IPE analysis, the character of the current international monetary system and China's export-led development model can also significantly influence the regime and level of renminbi's exchange rate.

Based on early explorations of IPE scholars, subsequent political scientists, such as Jonathan Kirshner, regard money and monetary relations as an important part of state power, or in Kirshner's words, "monetary power" (Kirshner 1995). Benjamin Cohen, an economist-turned political scientist goes further and proposes that money bears geopolitical implications. The pursuit of monetary power is an integral part of great power politics and can influence world politics (Cohen 2003). In their eyes, monetary relationship is not merely an economic issue, but also a reflection of the power struggle between great powers.

Based on the above academic resources as well as some other analyses concerning monetary histories made by some American and Chinese scholars, this thesis studies past cases of monetary power relations between the United States and Great Britain, the Soviet

Union, Japan, and Europe respectively using the monetary power struggle perspective. The author tries to find out how the United States used monetary relations to serve its strategic benefits as well as how the state power could work for its monetary hegemony. History may repeat itself and from history we can draw lessons to make predictions on future. We can find similar characters in the current U.S.-China monetary relations with those of historical precedents.

The thesis then investigates the dollar's status as the dominant international reserve currency in the current international monetary system, as well as the power that this unique status can generate and provide. The dollar hegemony, a complicated operating mechanism based on the fiat national legal tender serving as a hegemonic international reserve currency, was totally different from the sterling's monetary hegemony. It has become the main characteristic of the current international monetary system and an important power source for continued U.S. hegemony.

The dollar's hegemony and the asymmetrical interdependency between the dollar and the renminbi are the source and the key basis for the recent U.S.-China monetary disagreements. The U.S.-China monetary disputes reflect not only each country's respective domestic interests and perceived benefits, but also the monetary power struggle between the two biggest global economies. The thesis then discusses possible strategies that the Chinese government may adopt to exit its dollar dependency, which will bear far-reaching geopolitical implications for the future relations between the two powers.

CHAPTER TWO: LITERATURE REVIEW

Before 2002, the renminbi exchange rate issue seldom attracted academic interest or public attention, because of China's relatively low Gross Domestic Product (GDP) level and small trade volume at that moment. However, since 2002, one year after China's accession to the World Trade Organization (WTO), some U.S. policy makers began to criticize China's exchange rate policy and their criticism began to draw a wide range of attention from all walks of life in both countries. The government of the United States was at the forefront of criticizing the Chinese monetary policy of artificially maintaining its currency undervalued and pressuring China to decouple from the dollar and allow the renminbi to float. The Chinese government insisted that its currency was not undervalued and rejected accusations from its counterpart on its monetary policy. The participation of the public media has further heated up this issue. Economists as well as political scientists have also joined the debate.

The Sino-American monetary disputes can be perceived from three different levels. The first level questions are merely economic questions, focusing on the exchange rate per se, such as whether the renminbi exchange rate is undervalued, or what exchange rate regime China should adopt, as well as whether the renminbi exchange rate has caused the trade imbalance between the United States and China. Most economists focus their attention on questions on this level, but they have offered very different answers to these questions. Exploring on the second level questions, some IPE scholars try to analyze the exchange rate

issue from both economic and political perspectives. They attempt to find out the political reasons behind all those quarrels or to assess the effects that the disputes may have on the politics and economies of both countries. The third level questions that a few political scientists, strategists and historians have put forward tend to perceive the diplomatic frictions on monetary issues as a state-to-state power struggle. In their views, the exchange rate disputes reflect geopolitical competition between a declining hegemon and a rising challenger.

First Level--On the Renminbi Exchange Rate Issue Per Se

First of all, exchange rate is a very specific, technical and complicated question of economics. Most economists and both governments mainly debate on the first level questions. In order to analyze the issue in a simple and clear way, I will deal with it by listing different views under various questions.

Question 1: Is the Renminbi Undervalued, and If So, by How Much?

The U.S. government believes that the renminbi is significantly undervalued. The Bush administration urged China to adopt a more flexible exchange regime to allow renminbi to float (Morrison and Labonte 2008). Though it did not point out that the renminbi is undervalued, the subtext was quite clear that the renminbi should be appreciated. The Obama administration has made its stance very clear that the Chinese currency exchange level should be raised as well as the exchange rate regime should be changed (Morrison and Labonte 2010). The U.S. Congress has proposed and passed around thirty

five resolutions on the renminbi exchange rate issue since the 109th through the current 112th term (Morrison and Labonte 2008, 2011a). Almost every resolution asserts that the renminbi is undervalued.

The Chinese government has admitted that its exchange rate regime needs reform, but it has never acknowledged that its currency is undervalued. On a press conference held after the annual session of the 11th National People's Congress in March 2010, Chinese Premier Wen Jiabao stated that the renminbi is not undervalued.³ This was one of the few clear statements made by Chinese high officials.

In both the American and Chinese academic circles, disputes remain on whether the renminbi is undervalued. The majority of the American economists believe that the renminbi is to some extent undervalued. The Nobel laureate Paul Krugman (2010b) regards that the renminbi is undervalued based on two points: China's ever-growing current account surplus and its purchase of \$1 billion per day to keep the renminbi exchange rate stable. Cline and Williamson (2009), Goldstein and Lardy (2009), Frankel (2006), Bergsten (2010) all agree that the renminbi is undervalued. However, some other famous economists, such as two Nobel laureates Joseph Stiglitz and Robert Mundell and a recognized Stanford professor (Ronald McKinnon) hold opposing views (Hufbauer et al, 2006).

Furthermore, even among those American economists who believe that the renminbi is undervalued, their opinions are differed on the level of its undervaluation. According to Morrison and Labonte (2011a), based on different methodologies, the following

³ BBC News Online, March 14, 2010. "China denies currency undervalued". <http://news.bbc.co.uk/2/hi/8566597.stm>

economists have different estimates on the extent of renminbi's undervaluation:

- 12% (December 2009) by Helmut Reisen with the Organization of Economic Cooperation and Development;

- 25% (December 2009) by Dani Rodrik of Harvard University ;

- 30% (April 2010) by Arvind Subramanian at the Peterson Institute for International Economics

- 40.2% (January 2010), 24.2% (June 2010), and 28.5% (April 2011) by William R. Cline and John Williamson at the Peterson Institute for International Economics; and

- 50% (October 2009) by Niall Ferguson (Harvard University) and Moritz Schularick (Free University of Berlin).

In China's academia, major economists, such as Justin Yifu Lin, chief economist of the World Bank; Li Yang, Director of the Institute of Financial Studies of the Chinese Academy of Social Sciences (CASS); Fan Gang, Professor at Peking University; Yi Gang, economist and top official of the Chinese central bank; Cheng Siwei, economist and former Vice Chairman of China's top legislature and; He Liping, Professor at Beijing Normal University, tend to support a stable exchange rate. However, there are also some distinguished economists, such as Yu Yongding, Director General of the Institute of World Economics and Politics with CASS; Lu Feng, Yang Fan, He Fan and Hu Zuli, regard that renminbi should be appreciated (Zhou 2010).

The main reason why economists have so many different views on the same subject is largely because that in economics there are various models and different assumptions

concerning how the exchange rate should be determined. As Cheung et al (2010: 79) stated: “the literature on the exchange rate misalignment, even when restricted to the renminbi, is voluminous and diverse”. They laid out the typology as follows: relative purchasing power parity (PPP); absolute purchasing power parity and the "Penn Effect"; the productivity approach and the behavioral equilibrium exchange rate (BEER) approach; the macroeconomic balance effect; the basic flows approach; an equilibrium approach. Indeed, there is no clear economic guideline “as to the appropriate level of the exchange rate” (Broz and Frieden, 2008: 594). Therefore, it is difficult to decide empirically whether the renminbi is undervalued or by how much it is undervalued. No theory holds one hundred percent truth on this issue.

Question 2: What Kind of Exchange Rate Regime Should China Adopt?

The U.S. government is not satisfied with the renminbi exchange rate level and believes that the reason for that problem is the defective exchange rate regime that China adopts—pegging the yuan to the dollar. It also seeks to persuade China to let the market decide the value of the renminbi, i.e. adopting a floating exchange rate system.⁴

Since 2005, top Chinese officials have expressed the Chinese government’s willingness to reform the renminbi exchange rate regime on various occasions. The Chinese Premier Wen Jiabao stated during a press conference in March 2011 that “[China] will continue to stick to the reform of the formation mechanism of the RMB exchange rate...

⁴ The Sydney Morning Herald, April 13, 2010. “Obama presses Hu on yuan exchange rate”.
<http://news.smh.com.au/breaking-news-world/obama-presses-hu-on-yuan-exchange-rate-20100413-s7ab.html>

[the renminbi exchange rate] reforms have aimed to adopt a market-based, managed floating exchange rate regime which is tied to a basket of foreign currencies instead of pegging to the U.S. dollar”.⁵ However, Wen has also asserted several times that “China will continue to perfect the renminbi exchange rate regime in a gradual, proactive and manageable manner”.⁶ In other words, China’s reform may continue on its own pace.

In the academic circle, differences also remain among economists on what exchange rate regime one specific country should choose. As Ghosh et al. (2002: 1) stated “[compared with exchange rate issue] few questions in international economics have sparked as much debate and yielded as little consensus,” exchange rate regime choice is a very controversial topic. Since Frankel (1999: 2) concluded that “no single currency regime is a panacea... [and] no single currency regime is best for all countries, and that even for a given country it may be that no single currency regime is best for all time”, Zhang and Zhang (2005) quoted him and argued that a floating exchange rate regime as suggested by the American government may not be a good choice for China at this moment.

Since the collapse of the Bretton Woods System, countries have adopted a wide variety of regimes, ranging from pure floats at one extreme to currency boards and dollarization at the other. In practice, only around forty countries in the world maintain a true floating exchange rate regime, and most of them are developed countries. More than 100 countries, most of which developing economies, fall under the ‘peg’ and ‘managed

⁵ China Daily Online, March 14, 2011. “China to increase flexibility of RMB exchange rate”.
http://www.chinadaily.com.cn/china/2011npc/2011-03/14/content_12167460.htm

⁶ New York Times, November 29, 2007. “China to Let Market Forces Weigh on Value of Yuan”.
<http://www.nytimes.com/2007/11/29/business/worldbusiness/29trade.html>

float' categories⁷, meaning that the central banks of these countries normally intervene in the exchange rate market in order to maintain its currency value at a certain level or fluctuating within a certain band (Ghosh et al, 2002)

Based on the situation of most developing economies' choice, some Chinese economists such as Gong (2010) argue that China is a developing country and should be regarded the same as other developing economies. Why would most developing countries adopt such exchange rate regime? According to Gong (2010), the unsymmetrical international monetary system should be blamed. The currencies of the developing countries are in an unfavorable position compared to the main international reserve currency. Developing countries have to adopt a fixed or managed float devaluation-prone exchange rate regime in order to accumulate foreign reserves to hedge potential risks, such as the oil price fluctuations, the solvency risks and sharp exchange rate fluctuations caused by speculations. The other explanation Gong provided is that through such exchange rate regimes, the developing countries can optimize resource allocation and promote economic growth, because such exchange rate helps to increase export and attract foreign direct investment. China also faces similar risks that many developing countries do. Therefore, it is justifiable for China to maintain a fixed exchange rate regime. Broz and Frieden (2001:322) believe that "the principal advantage of a fixed-rate regime is to lower the exchange rate risk and transaction costs that can impede international trade and investment". Since these developing countries are normally small and weak countries, they tend to take

⁷ See Appendix B

such measures to protect themselves.

However, Williamson (2004: 7) argues that there should be four conditions for a fixed exchange rate: 1) The economy is small and open; 2) The bulk of its trade is undertaken with the trading partner(s) to whose currency it plans to peg. 3) The country wishes to pursue a macroeconomic policy that will result in an inflation rate consistent with that in the country to whose currency it plans to peg. 4) The country is prepared to adopt institutional arrangements that will assure continued credibility of the fixed rate commitment. China definitely does not satisfy the first two conditions. Even if it can be counted as a developing country, China today is already the world's second largest economy and the biggest exporter; and it does not trade predominantly with the United States. Therefore, he believes that "China is not a natural candidate for a fixed exchange rate against the dollar" (Williamson 2004: 8).

Yu (2005) believes that the rapid increase of China's foreign exchange reserves testifies that the exchange rate regime is problematic and poses a threat to its own economy. China had already set goals to implement a managed float regime, but the Asian financial crisis made it decide to suspend the plan. In the climax of the Asian financial crisis, even when Japan devalued the yen significantly following the sharp decrease of the Southeast Asian nations' currencies, China maintained the value of the yuan and pegged the renminbi to the dollar. It was hailed as a regional stabilizer then. Yu believes that China is also a victim of speculations. Had it not been for the speculative capital, China might have already restored to a managed float system at an earlier time.

Eichengreen (2004) believes that it is the best time for China to exit from the peg. Moving to a managed float will be in China's own interest. McKinnon (2003) believes that China should keep pegging the dollar in order to play a regional stabilizer role in Asia. Other economists such as Frankel, Goldstein and Roubini believed that the renminbi exchange rate should be more flexible, but the process of reforming the regime should be gradual (Zhang and Zhang 2005).

Zhou (2011) argued that both the United States and Europe once maintained a fixed exchange regime under the Bretton Woods System and the European Monetary System respectively. Therefore, it is unjustifiable for them to blame China on the same choice.

Question 3: Is China a Manipulator?

Although U.S. Treasury Secretary Geithner said in January 2009 that President Obama believed China was manipulating its currency,⁸ the Obama administration does not list China as "currency manipulator" in the Treasury's biannual reports to the Congress on international economic and exchange rate policies. The Congress has passed several resolutions to pressure the Obama administration to name China a manipulator (Morrison and Labonte, 2011a). Chinese top officials have rejected this accusation.⁹ Chinese Premier Wen Jiabao has stated on many occasions that China does not intentionally pursue a trade surplus with its exchange rate policies.¹⁰

⁸ New York Times, January 22, 2009. "Geithner Hints at Harder Line on China Trade".

<http://www.nytimes.com/2009/01/23/business/worldbusiness/23treasury.html?pagewanted=all>

⁹ New York Times, January 24, 2009. "China Rejects Currency Manipulation Charge".

<http://www.nytimes.com/2009/01/25/world/asia/25beijing.html>

¹⁰ Reuters, June 26, 2011. "Chinese Premier says no intention of pursuing trade surplus".

<http://www.reuters.com/article/2011/06/26/britain-china-wen-idUSL6E7HQ04I20110626>

American economists do not agree with each other on whether it is viable to list China as a manipulator under international agreements. Could the United States legitimately bring a case against China over its exchange rate policy by citing Article XV(4)¹¹ in the General Agreement on Tariffs and Trade? Mattoo and Subramanian (2009) believe the prospects for challenging currency undervaluation are very poor. Hufbauer et al. (2006) think that the challenge is doomed to failure. However, Miranda (2010) believes that such a challenge is perfectly viable and has a reasonable chance of success. Mercurio and Leung (2009) regard China's foreign exchange policy consistent with Article XV(4). Ahn (2010: 139) concludes that any WTO resolution will be difficult to achieve because "the organization is not designed to deal with alleged exchange rate manipulation."

The International Monetary Fund (IMF) has jurisdiction for exchange rate questions. *Articles of Agreement* of the IMF stated that "a member shall not propose a change in the par value of its currency except to correct fundamental disequilibrium" (De Vries 1986: 100). Sanford (2011: 2) believes that "the IMF can exercise 'firm surveillance' but it cannot compel a country to change its exchange rate...in the end, the authority to make the change resides with the country alone."

Question 4: Renminbi's Exchange Rate Caused the U.S. Current Account Deficit?

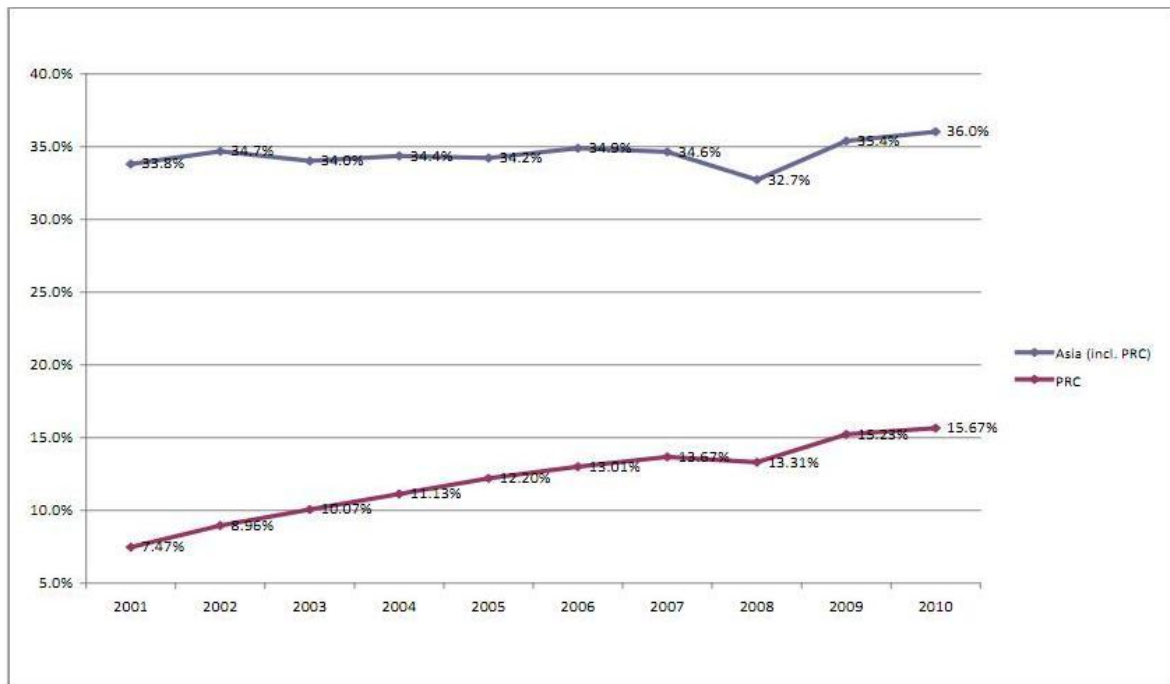
Has the renminbi's exchange rate caused the U.S. current account deficit? The U.S. government criticizes China on the renminbi exchange rate mainly because of the U.S.

¹¹ It provides: "Contracting parties shall not, by exchange action, frustrate* the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund"

increasing current account deficit with China (Wyplosz 2010). The Chinese government argues that the renminbi exchange rate is not the root cause of the U.S. current account deficit, which was mainly due to bilateral trade and investment structure.¹²

In the academic circle, almost all the Chinese economists refuse to believe the view that the renminbi exchange rate is the main cause of the trade imbalance between the United States and China, though some of them agree that the renminbi exchange rate is somewhat undervalued and needs appreciation (Yu 2010). Most of them believe the U.S. current account deficit is mainly because of structural reasons. The renminbi's appreciation will not help to bring down the U.S.'s current account deficit, because China's exports to the United States are mostly labor-intensive products which the latter has already outsourced to third world countries and does not produce anymore. From Figure 1, one can see that the imports from China only accounts less than one sixth of U.S. whole imports.

¹² PRC Foreign Ministry's website, September 23, 2010. "Premier Wen Jiabao Holds Talks with Personnel from the US Business, Financial and Academic Circles". <http://www.fmprc.gov.cn/eng/zxxx/t755597.htm>



Source: U.S. Bureau of Economic Analysis. International Economic Accounts. *U.S. International Transaction*

Figure 1: Share of U.S. Imports

Though the imports from China increase significantly in recent years, the U.S. total imports from Asia are relatively stable. This means that even if the United States cuts bilateral trade deficits with China by forcing the renminbi to appreciate, its overall current account deficit will maintain relatively stable with the outside world as a whole. The outsourced jobs will probably go to other developing nations and will not return to the United States. There is also evidence to suggest that much of the U.S. trade deficit from China comes from the many export-oriented U.S. multinational companies that have moved production to China to take advantage of its low labor costs. It is estimated that over half of China's exports come from foreign-investment enterprises in China (Morrison and Labonte 2011a).

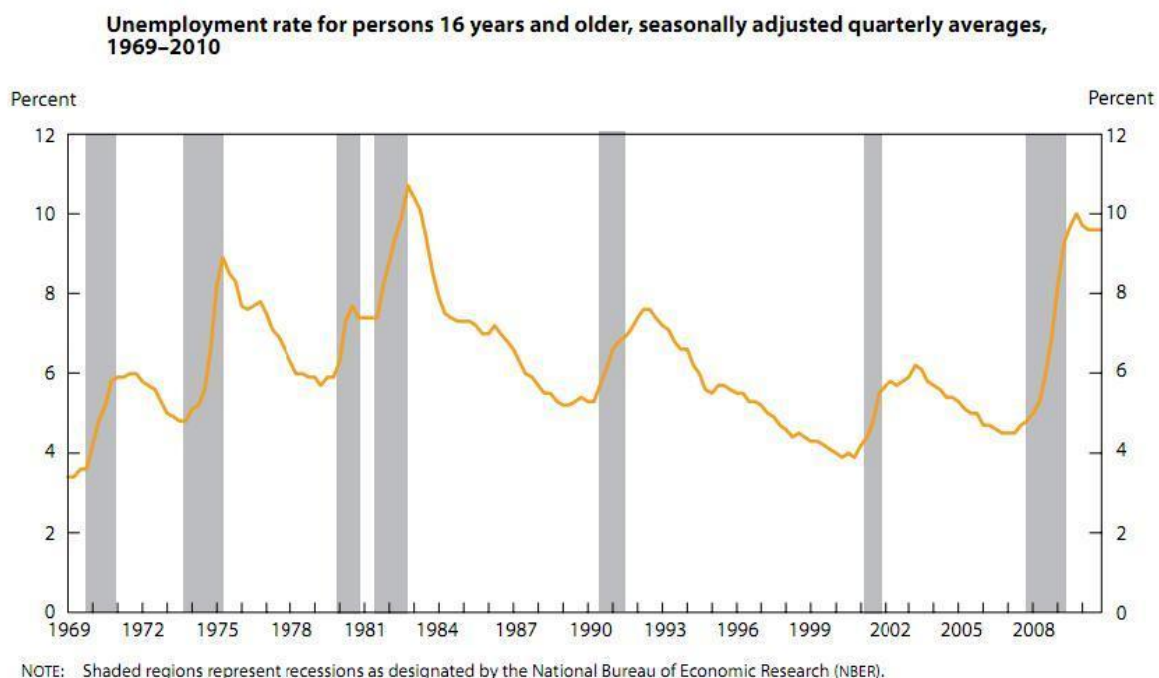
Paul Krugman (2010a) and Fred Bergsten (2010) have been the harshest among many

U.S. economists on criticizing China's exchange rate policy. They firmly believe that the main reason for U.S. trade deficit is the undervalued renminbi. In order to force China to appreciate its currency, both of them have suggested labeling China a "currency manipulator" and being tough with the Chinese government. However, there also remain some dissidents. Wyplosz (2010) believes it is difficult to establish a clear causality between the Chinese surplus and the U.S. deficit. He states that even if China insists on pegging the renminbi to the dollar and on preventing the real appreciation, finally inflation will deliver this appreciation. Reisen (2010: 62) points out that "the world is bigger than China and the US", and China's surplus can only fund around 30% of the U.S. deficit. He believes that "a rebalancing of the world economy will need reforms in China's social, pension and family policies rather than currency appreciation". Morgan Stanley Asia Chairman Stephen S. Roach states that the United States runs trade deficits with eighty-seven other countries including China. He believes that "without addressing the root of the problem--America's chronic saving shortfall--it is ludicrous to believe that there can be a bilateral solution for a multilateral problem."¹³

Since July 2005 until July 2008, renminbi appreciated about 21% against the dollar, a degree cannot be regarded as insignificant, but it seems that the appreciation has had very modest effects on China's trade surplus or the U.S. current account deficit. The U.S. trade deficit with China still rose by 30.1% (Morrison and Labonte 2011a). At the same time, "China's merchandise trade surplus increased from \$102 billion to \$297 billion, an increase

¹³ Gulfnews, October 31, 2011. "US trade imbalance stems from huge savings crisis".
<http://gulfnews.com/business/opinion/us-trade-imbalance-stems-from-huge-savings-crisis-1.920921>

of 191%, and China’s current account surplus and accumulation of foreign exchange reserves both increased by 165% over this period” (Morrison and Labonte 2011a: 18). In addition, there is no proof to support the idea that the appreciation has helped ease the unemployment situation in the United States. During the renminbi’s appreciation period (2005-2008), the U.S. unemployment rate maintained relatively stable (See Figure 2). However, it surged to a high level from 2009 following the financial crisis, during which China’s export to the United States dropped significantly by 17% (Eichengreen 2011). This means that the unemployment rate more depends on U.S.’s own economic situation rather than on the current account deficit with China.



Source: Monthly Labor Review, March 2011, U.S. Bureau of Labor Statistics.
<http://www.bls.gov/opub/mlr/2011/03/art1full.pdf>

Figure 2: U.S. Unemployment Rate

From the above literature review, we can find that economic theories contradict with each other on most basic and core questions concerning exchange rate. Both the U.S. and Chinese governments can at least present many reasonable explanations for the monetary policies they have adopted respectively. Furthermore, renowned economists in both countries cannot see eye to eye on most of the basic questions. Then why could the exchange rate quarrels still become a hot issue in the Sino-U.S. bilateral relations? Why would the American politicians once again pressure the Chinese government to revalue its currency? Economic factors are not sufficient to explain these disputes. It seems that we must dig deeper to find out more reasons behind those quarrels.

Second Level--Political Economy Analysis of the U.S.-China Monetary Disputes

The U.S. government has been very keen on the exchange rate of other currencies. It has used political pressure to force Japan and Europe to adjust their exchange rates against the dollar in the 1980s. From May 1992 to July 1994, the U.S. Treasury cited China as currency manipulator for five times based on the dual exchange rate system China adopted (Morrison and Labonte 2011a). Exchange rate issue between main trading partners is never a mere economic question in the present world; it can have far-reaching implications for a state's macroeconomic situation and national welfare. In Frieden's (1994: 82) words, "politicization of currency policy is an inevitable result of higher levels of international trade and payments". However, the Chinese government has stated several times that it is

against politicizing the exchange rate issue.¹⁴ It might be a good diplomatic rhetoric, but it is not possible to be realized in the real world. Exchange rate topic is of political importance given the wide range impact currency policy might have on various actors and on different aspects of the economy.

In the U.S. academic circle, IPE is a very robust paradigm in International Relations. Exchange rate and international finance has been an important part of the IPE studies since the 1970s. However, limited IPE analyses have been made on this issue. It might be partly due to the newness of this issue. In China, IPE is a relatively new scope of International Relations studies. There were only sporadic writings about the political economy of the renminbi exchange rate issue so far.

Kaplan (2006) borrows Frieden's model of analyzing the Latin American exchange rates and attempts to study the Chinese government's reluctance to revalue its currency from both the supply and demand perspectives. From a supply side perspective, he argues that the government does not want to risk pursuing a large-scale revaluation of the renminbi that might undermine the growth of the coastal manufacturing sector, which has been able to absorb large quantity of labor forces. Therefore, it has maintained the social stability which the Communist Party deems for its legitimacy of ruling. From a demand side perspective, he believes that the "manufacturing sector's strong performance has boosted the wealth and influence of coastal regional governments, spurring them to advocate for an extension of preferential exchange rate policies to their regions from the central

¹⁴ People's Daily Online, October 11, 2011. "Politicizing exchange rate harms China, US".
<http://english.people.com.cn/90780/7614319.html>

government” (Kaplan 2006: 1196). Kaplan denies the notion that the government is an objective entity in exchange rate decision and interest groups are the main bodies to influence that decision. The government itself, he believes, has its own considerations in the decision process.

Levy (2011) not only notices that different interest groups, such as labor unions and chamber of commerce, can influence the U.S. government’s stance on the exchange rate issue, but also grabs some new factors that will influence the Chinese government’s decision making, such as: China’s traditional diplomatic doctrine of noninterference, the popular nationalist sentiment that the government feels constrains to it, as well as the shift of Chinese leaders in 2012.

Freeman and Yuan (2011) take the institutional cleavages between the Chinese Ministry of Commerce and the People’s Bank of China as the dependent variables and discover that their different agendas can also have influence on China’s currency reform.

Zhang and Zhang (2005) have made early attempts in the Chinese academic circle to analyze the U.S.-China monetary disputes with a political economy perspective. After reviewing the major literature of economic analyses, they believed that economic theories are not sufficient to explain the exchange rate disputes. Then, they proceed to analyze the domestic and international political factors that may influence the disputes. They use “interest groups” and “government’s macroeconomic considerations” as two dependent variables in the domestic political economy analysis of the two respective countries. They find out that interest group lobbying and both governments’ consideration to develop the

economy and promote the employment have significant influence on the renminbi exchange rate disputes. From the international political economy perspective, they discover that the monetary disagreement is a game between the two states to pursue power and wealth in the international monetary system, which reflects the power structure of international politics. They also point out that the economic interdependency between the United States and China require the two to cooperate on the exchange rate issue. That is the reason why the U.S. government has withstood the pressure from the Congress and prevented the monetary quarrels from becoming a trade war. However, this interdependency is asymmetrical, meaning that China is in an unfavorable position.

Zhang and Zhang (2005) have made trail-blazing efforts in China in analyzing the monetary disputes with the political economy paradigm. However, their explorations may be primary. On the domestic level, they have mentioned that other factors, such as elections, partisan politics, might have influences on the exchange rate, but do not further explain the causality between these factors and the exchange rate. They mentioned that the international monetary system is a reflection of the international power structure and China is in an unfavorable position in the system, but they do not move forward in this direction.

He and Zhang (2005) use Charles P. Kindleberger's hegemonic stability theory and investigate the U.S.-China currency disputes from the perspective of the core-periphery structure of the international monetary system. After the collapse of the Bretton Woods System, the United States can no longer provide public goods to stabilize the international monetary system, but it still enjoys the great benefits that the dollar hegemony brings to it.

As it did in the 1980s to the Japanese and the Europeans, the United States pressures China to revalue its currency in order to cut its own costs of readjustment.

Other Chinese scholars have also contributed to this topic, but their efforts are not enough. Lu (2011) has noticed the U.S. elections have an important influence on the magnitude of the U.S.-China monetary disputes. Qing Wang (2010), Morgan Stanley's Chief economist for Greater China, also focuses on the interest group factor. He believes that the undervalued renminbi exchange rate is beneficial for the exporting corporations but harmful to various importing companies and the consumers in China. However, these exporting firms can be easily organized to lobby the bureaucracy in charge of promoting exports, while the scattered importing firms and individuals are very difficult to form an interest group to lobby the policy makers. Therefore, the exchange rate policy making is favorable to those who have channels to lobby. Liu and Yang (2010) believes that the renminbi exchange rate is just the scapegoat for the domestic problems that the United States faces. The global imbalance is structural and is not caused mainly by the renminbi exchange rate. The U.S. government does not have good measures to cut the current account deficit; it just diverts the domestic criticism from its inability to the renminbi exchange rate.

So far, the political economy analyses on the Sino-American currency relations are a little bit distant from systematic and comprehensive. However, as China rises to the world second largest economy and the diplomatic confrontation between the two governments on the exchange rate issue upgrades, more academic efforts are expected to be made.

Third Level--On the Geopolitical Implications of the U.S.-China Monetary Disputes

Some scholars believe that the current U.S.-China monetary disputes should be viewed in a bigger picture. Monetary relations bear geopolitical implications as well. Though these kind of academic explorations are scarce, they provide us with a new and interesting perception on monetary relations.

American scholars are more concerned with the implications of the decline of the United States and the rise of China. They treat the current Sino-American monetary disputes as a power struggle between the two great powers. Chinese scholars focus more on the power structure of the current international monetary system. The Sino-American monetary disputes reflect the confrontation between the core and the periphery.

Eichengreen (2011) believes that the world is moving towards multilateralism. The U.S. geopolitical influence as well as the dollar's status is on the decline. The dollar will maintain its status as the main reserve currency, but its predominance will be eroded. The international monetary system will witness the ascent of other reserve currencies such as the euro, the renminbi, or even the Indian rupee and the Brazilian real. He rejects the notion that China will use its dollar assets as a financial weapon, because using that weapon will hurt itself as well. He admits the renminbi's dependency on the dollar has been a weakness of China's diplomacy and the dollar's dependency on foreign loans will give the lenders leverage on its foreign policy. He believes that a weak dollar policy may help the United States to relieve its debt burden, but in the long run will undermine the dollar's credibility. Devaluation of the dollar and pressuring the renminbi to appreciate cannot resolve all the

problems that the United States faces today.

Layne (2011) understands that the United States is on the decline and the unipolar world is drawing to a close. Pax Americana will come to an end accompanied with the following three facts: new great powers rise, American's power is overstretched and U.S. relative economic power declines. He believes that the dollar's reserve currency role underwrites America's geopolitical pre-eminence; and if it loses that status, U.S. hegemony literally will be unaffordable. Today, the U.S. fiscal crisis hangs like the Sword of Damocles over its economic future, with the only escape being capital inflows from rising powers such as China, which is becoming more diplomatically confident and assertive based on its economic rise.

Song (2007) popularizes the term "currency wars" in China with his best seller of the same name. He explores the origin and development of the financial capital and believes that the international bankers have controlled the nation-states. In his view, Washington works for Wall Street's interests. The monetary disputes between China and the United States reflect the financial capitalists' motives to grab the wealth of the Chinese people. The U.S. pressure of urging China to open its capital market and to revalue its currency is a conspiracy of the financial capitalists. His theory is perceived by some economists as conspiracy theory,¹⁵ but he offers the Chinese a new perspective to look at the U.S.-China monetary relations.

Wang (2008) uses a neo-Marxist perspective to analyze the development of the

¹⁵ He Fan, an economist with China Academy of Social Sciences, labeled Song's book 'conspiracy theory' in the forward to the Chinese version of Barry Eichengreen's 2011 book *Exorbitant Privileges*.

United States' capitalism and concludes that it has entered an era of "fictitious capitalism", in which, the capital inflow to the U.S. market is of vital importance for it to maintain its global primacy. U.S. monetary hegemony becomes the most important pillar of the U.S. hegemony. The American military hegemony begins to work for the monetary hegemony. In order to maintain its monetary hegemony, the United States must knock down any potential competitors who will possibly challenge U.S. monetary hegemony. He believes that the Kosovo War and the Iraq War were fought to undermine the euro's expanding influence in Europe and the Middle East and to reduce the international investors' confidence in the European common currency.

So far, only a few scholars begin to look at the Sino-American currency tensions from the geopolitical perspective. One reason might be that the relationship between the money and power in world politics has been "a neglected area of study" (Kirshner 1995: 3). The other reason could be renminbi's relatively unimportant position. The renminbi today is far from an international currency. The monetary power struggle at the present stage is mostly the dollar's one-man show. However, the renminbi internationalization is believed to be a policy being promoted by the Chinese government. China will most probably have confrontations with the United States if one day the yuan rises to be an important regional currency and China forms a renminbi bloc with its Asian trading partners such as member countries of the Association of South East Asian Nations (ASEAN).

The above mentioned scholars have made primary but very forward-looking academic explorations on the current and future U.S.-China monetary relations. This thesis

will make further efforts based on these academic endeavors.

CHAPTER THREE: METHODOLOGY

My academic interest is focused mainly on the backgrounds and reasons of the current quarrels between the United States and China on the renminbi exchange rate issue, as well as in how the U.S.-China monetary interdependence come into being and its geopolitical meanings.

The international use of national currencies brings to the nation-states not only high reputation but tangible benefits as well. Nobel laureate Robert Mundell (1993: 10) once wrote “Great powers have great currencies.” The Roman denari, the Byzantine solidus, the seventeenth century Dutch guilder, the British sterling were all great currencies with splendid history of being an international currency. To pursue the status of international currency issuer becomes an integral part of great power politics. Henry Kissinger once noted: “Who controls the food supply controls the people; who controls the energy can control whole continents; who controls money can control the world.”¹⁶ In his best-seller book *Clashes of Civilization and the Remaking of World Orders*, Samuel Huntington (1997:81) identifies ‘own and operate the international banking system’, ‘control all hard currencies’ and ‘dominate international capital markets’ as Western civilization's main strategy for world domination. In the eyes of these strategists, money serves a strategic role for a great power.

The dollar has remained in the throne of dominant reserve currency for nearly 70

¹⁶ Engdah, F. William, *Crisis of the U.S. Dollar System*, Global Research, October 14, 2006: <http://www.globalresearch.ca/index.php?context=vaandaid=3482>

years. The dollar's hegemony has brought to the United States substantial economic and political benefits. However, the dollar's hegemonic status is not a natural result of the choice of the market. The United States has arduously pursued the status of monetary hegemon since the early years of the 1910s. After it achieved this status, it has used its predominant economic and military might to protect and expand its hegemonic monetary status in the post-World War II era. It has also led the post-war international community to establish relevant international institutions and rules to consolidate its benefits originated from the monetary hegemony. Other great powers, such as the Soviet Union, Japan and the EU, have made great efforts to internationalize their own currencies and hoped to obtain benefits that the international use of their currencies could bring to them. The expanding influence of their currencies would definitely challenge or even harm dollar's status in the international monetary system. The monetary relations between these states with the United States would largely reflect competition and power struggles of monetary influence.

The current and prospective U.S.-China monetary relations may equally demonstrate such characteristics of monetary power struggle. The renminbi, though not counted as an international currency yet, is estimated to become one of the three main international reserve currencies in the near future (Eichengreen 2011). As it emerges to be a great power and its currency starts to be used by foreigners, China will definitely begin to pursue the monetary power inherent in a great currency. However, it is very difficult to investigate the ways and means of monetary power struggle between the United States and China unless we look back in the history. The author thus uses four historical cases of monetary power

struggles between the United States and the Great Britain, the Soviet Union, Japan and the European Union respectively. Through close investigation and comparison, the author concludes commonalities and differences of the monetary power struggles in these four cases. The conclusion then is used to analyze and predict the current and future U.S.-China monetary relations.

This thesis therefore adopts a qualitative and comparative methodology of case study with a small number of samples (N=4, four cases). The case study methods “involve an in-depth, longitudinal examination of a single instance or event. They provide a systematic way of looking at events, collecting data, analyzing information, and reporting the results. As a result the researcher may gain a sharpened understanding of why the instance happened as it did, and what might become important to look at more extensively in future research. Case studies lend themselves to both generating and testing hypotheses” (Tutu 2010: 8).

The case study method is most usefully defined as the “intensive study of a single unit or a small number of units (the cases), for the purpose of understanding a larger class of similar units” (Gerring 2009: 95). According to Gerring, case studies are more useful “when the strategy of research is exploratory rather than confirmatory/disconfirmatory, when internal validity is given preference over external validity, when insight into causal mechanisms is prioritized over insight into causal effects, when propositional depth is prized over breadth, when the population of interest is heterogeneous rather than homogeneous, when causal relationships are strong rather than weak, when useful

information about key parameters is available only for a few cases, and when the available data are concentrated rather than dispersed.”

In the four cases that I choose, I take the U.S. dollar's status in the international monetary system and the U.S. monetary power as the independent variable. The status of other currencies and their respective monetary power is regarded as the dependent variables. The strategy of the research is exploratory and is hoped to generate hypotheses after the investigation of the four cases. Preference is given to case studies with a small number of cases over cross-case analyses with a large N. The relationships between the independent variable and the dependent variables are equally the monetary relations between the United States and the four states/organizations respectively. The causal mechanisms of the relationship between power and money are prioritized over the causal effects of that relationship. The thesis limits itself in the four cases and the depth of analyses is prized over breadth. The four cases are significantly different in the ways and means of bilateral monetary relations. The causal relationships between the dollar and the four currencies are strong rather than weak. The useful information about monetary relations is available only for a few cases and the available data are concentrated rather than dispersed. Therefore, a case study is useful and suitable here to analyze the issue.

Mahoney (2009: 2) believes that “findings [of the history] often provide insights that are useful for thinking about what might (or should) happen in the times to come.” If we use historical cases of such struggles as precedents, then we may draw useful insights and lessons for the current U.S.-China monetary relations. Conclusively, a methodology of

“comparative historical analysis” is also adopted hereafter to explore and compare the historical monetary power games with the present one.

Comparative historical analysis (or comparative historical research) is a method of social science that examines historical events in order to create explanations that are valid beyond a particular time and place, either by direct comparison to other historical events, theory building, or reference to the present day.¹⁷ Generally, it involves comparisons of social processes across times and places. Mahoney and Rueschemeyer (2003) think that comparative historical analysis has a long and distinguished history in social sciences. Founders of modern social sciences, from Adam Smith to Alexis de Tocqueville to Karl Marx, are believed to have used this method as a central mode of investigation.

Comparative historical analysis is a good method to analyze “big” questions (Mahoney and Rueschemeyer 2003). The four historical cases—the four relationships between the U.S. dollar and the sterling pound, the Soviet ruble, the Japanese yen and the euro respectively, serve great strategic benefits for their respective states and can be counted as “big” issues. The thesis examines how the U.S. dollar interacts with the four currencies in history and how the United States and the other four states struggle for the international monetary power. Based on that, conclusions will be generalized then to provide any useful information for the future dollar-renminbi relations as well as the U.S.-China relationship. History sometimes repeats itself and similar stories might happen again between dollar and the renminbi.

¹⁷ Mission of the Comparative and Historical Sociology Section of the American Sociological Association. www2.asanet.org/sectionchs/sectioninfo.html (Accessed 15 December 2011).

A Peaceful Power Transition? U.S. Dollar and Sterling Pound

After the Second World War, Great Britain ceased to be the monetary hegemon and the U.S. dollar overtook sterling as the hegemonic currency. Was there a peaceful transition of monetary hegemony from pound to dollar? Political scientists have used different theories to explain the peaceful power transition from the British Empire to the United States, such as the realist 'balance of threat' theory, 'balance of power' theory, and the liberalist 'democratic peace' theory or the constructivist 'identity models' (Feng 2006). IPE theory and the U.S. monetary hegemony can offer another explanation.

Although its GDP overtook that of Great Britain before the First World War, the United States still was not able to challenge Great Britain's hegemonic status whether militarily or monetarily. The dollar was not yet an international currency at that moment. The establishment of the Federal Reserve (Fed) in 1913 and the First World War greatly strengthened the dollar's influence. The former marked a strong central bank to support the currency; the latter provided the dollar a golden opportunity to enlarge its influence. After the First World War, the United States overtook the U.K. to be the creditor by successfully persuading the Germans to borrow from the United States to pay the war reparations, on which both the British and French depended to recover from the war-torn economies (Song 2011). The U.S. dollar, denominating the German debt, started to play the role as a main reserve currency. At the same time, the increase of U.S. export to Europe helped to form a wider use of the dollar in the European countries, which accelerated the process of the internationalization of the dollar. Because of these reasons, the dollar overtook the pound as

the top reserve currency around 1925 (Eichengreen 2001). That was the first monetary victory the United States won against the British Empire.

The second monetary victory the United States won against the U.K. was the Bretton Woods System that the United States produced mainly following its own design and rejecting the British proposals. The British delegation to the Bretton Woods Conference was headed by the legendary economist John Maynard Keynes, who proposed to artificially invent a new supranational currency—bankor, to act as the international reserve currency in the post-war era. His proposal was rejected by Harry Dexter White, then Secretary of the Treasury of the United States. Keynes' proposal definitely aimed at preventing the dollar from becoming the main reserve currency, that status the United States lost during the Great Depression. Keynes' miscalculation to give up the Imperialist Preference¹⁸ system further undermined the pound's main reserve currency status (Eichengreen 2011). The U.S. 'free trade imperialism' (Hudson 2003: 7) further secured the dollar's uncontested reserve status in the post-war era when its industrial products flooded into the world market.

The Suez Crisis witnessed the defeat of the British sterling in the third monetary power struggle against the United States. The British troops occupied the Suez Canal with French and Israeli troops in 1956. Instead of supporting the British move, the United States stood against the occupation. The British had thought that the Americans would support them to fight against Egypt, an ally of the Soviet Union and China then. The American's open demand for a withdrawal of the British troops from Egypt triggered an international

¹⁸ Imperial Preference was a proposed system of reciprocally-leveled tariffs or free trade agreements between the dominions and colonies within the British Empire

run of the pound, causing it to decline sharply. Finally, Great Britain gave in and pulled its troops out of Egypt in exchange of the U.S. support to get loans from the IMF. This marked the end of the British pursuit of independent foreign policy and its deeper dependence on the United States (Eichengreen 2011).

In my understanding, the Britain's inability to establish an international monetary system with the characteristics of "sterling hegemony" similar to the 'dollar hegemony' and the dollar's alternative status to the sterling pound was the main reason for the decline of the British Empire in the interwar years. Being lack of enough economic might and strength to borrow money from others, Great Britain was not able to finance its wars to protect its hegemonic status as the United States did after World War Two (WWII). The two nations did not fight militarily, but their struggle in the monetary arena lasted for decades.

Because the British did not lay its monetary hegemony on its debt in the interwar era like the United States did after WWII, its ability to finance war was limited. As Hudson (2003: 6) pointed out, "Britain's agreement to begin paying its war debts to the United States no doubt was inspired largely by its world creditor ideology of maintaining the 'sanctity of debt.' Yet this policy no longer was appropriate in a situation where Britain, along with continental Europe, had become an international debtor rather than a creditor." To the British, debt was a weakness, but in the case of the U.S., it was the source of power.

On the other hand, the dollar's rise to a main international reserve currency provided European continental nations an alternative to check the British monetary dominance. The United States was luckier because it has never met such a close challenger since 1945 as the

British had in the interwar years.

The United States might regard the U.K. as a political ally, but definitely not a monetary ally during the two world wars. According to Hudson (2003: 172), “even at the time Churchill made his famous Iron Curtain speech...in 1946... [U.S. Secretary of State] White noted that the future of the world would depend much more on friendly relations between the USA and the Soviet Union than between the USA and Britain.” In Roosevelt and White’s design for the postwar order, the U.S.S.R. had the opportunity to be a U.S. ally to check against U.K. and Germany. However, Roosevelt’s death and Truman’s succession as the U.S. president altered this design and led the world to a Cold War structure (Hudson 2003).

Soviet Empire Fell from the Petrodollar? U.S. Dollar and Soviet Ruble

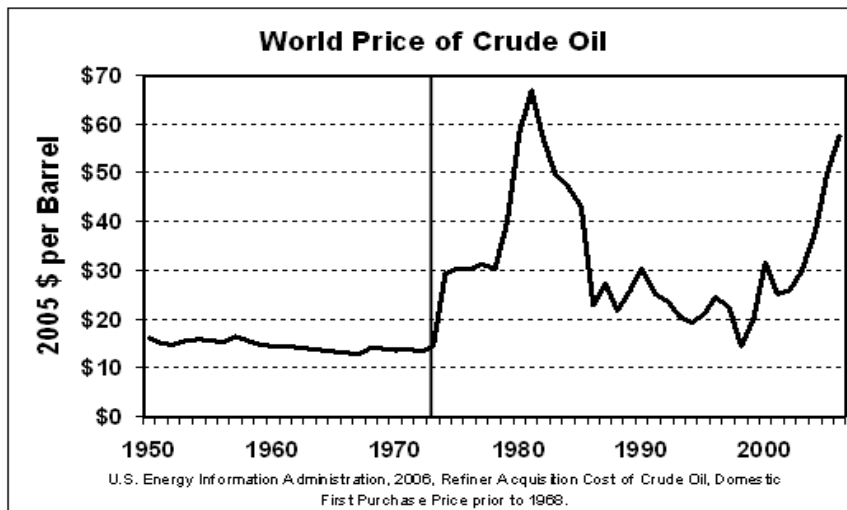
Soviet Union participated in the Bretton Woods Conference but finally decided to remain out of the system because the U.S. administration changed its strategy after Roosevelt’s death. The U.S.S.R. was regarded by Truman as a dangerous threat to the United States instead of a possible cooperator.

In the Cold War era, the United States and the Soviet Union (U.S.S.R.) competed not only in security and military field, but in economic and monetary arena as well. The Soviet Union started a competition with the United States of attracting some neutral states to its side by offering much more favorable aids to countries such as Egypt, Syria, India, and even Chili and Argentina. Soviet Union’s move to provide loans in ruble and open its market to

the products of these countries checked the dollar's sphere of influence (Song 2011).

Unfortunately, the Soviet Union had its Achilles' heel- the food shortage. Because of its economic strategy, the Soviet Union was able to build a strong industrial framework. However, that strategy seriously undermined its agriculture and thus made it increasingly more dependent on food import. According to Kennedy (1988: 490), "...a century ago Russia was one of the two largest grain exporters in the world. Yet since the early 1970s it has needed to import tens of millions of tons of wheat and corn each year.... [It] needs to pour out further billions of hard currency to import grain..."

At that moment, oil was already denominated in the dollar. Importers must use the dollar to buy oil, and exporters can only cash in the dollar with their oil. Remaining out of the dollar area, the Soviet Union was only able to purchase food with the petrodollar it earned from selling its oil export, therefore making it highly dependent on, and sensitive to, the oil price. The United States took advantage of this situation and used its influence on Saudi Arabia and the OPEC organization to successfully persuade them to expand the supply of oil, making the oil price plunge in the 1980s (Figure 3).



Source: David L. Greene and Paul N. Leiby, "Oil Independence: Realistic Goal or Empty Slogan?", Published on Senator Richard Lugar's webpage.

http://lugar.senate.gov/energy/links/commentary/08_greene_full.cfm

Figure 3: World Price of Crude Oil

The oil price jump gave the Soviet Union's economy a fatal attack. The oil export revenue shrank; the balance of payments and financial situation deteriorated; the food shortage exacerbated. It could not expand its deficits similar to the United States, and the high debt rate finally forced the Soviets unable to make both ends meet (Song 2011). Out of many analysts' expectation, the Soviet Union collapsed in 1991 without any external military interference. Political scientists have offered many explanations for this great change, but an analysis from the IPE perspective undoubtedly provides us a new but interesting way to look at this change.

Although there is no proof that the United States intentionally used the petrodollar recycling as a monetary weapon to hit the soft underbelly of the Soviet Union, the international monetary system with the dollar as the hegemonic currency had in fact played

that role. This proves that even the Soviet Union was to some extent dependent on the dollar hegemony.

The Sun Never Rises: U.S. Dollar and Japanese Yen

In the 1980s, Japan rose to be the world's second largest economy. Its economic success was largely due to the U.S. help. The post-war Dodge Line¹⁹ helped restart the war-torn Japanese economy. The Korean War and the Viet Nam War provided Japan with continuous U.S. orders for products, thus enabling it to prosper economically in the 1970s. However, its economy was largely dependent on the dollar hegemony system. Its "surpluses are turned over to the U.S. as reserves kept in Treasury bills, while savings have been turned over to U.S. brokerage firms and money managers..." (Hudson 2003: xvii).

Japan's economy was largely dependent on the export to the United States' market. Its trade surplus in the form of dollars must flow back to the United States to buy Treasury bills and other assets. Japan was also militarily dependent on the United States, making it unable to take an independent policy and was easily pressured by the United States to be cooperative. The sharp increase of the Japanese yen's exchange rate against dollar was a great loss of value of its dollar reserves. "The Plaza Accords of 1985 and the Louvre Accords the following year, obliged Japan's central bank to lower interest rates and inflate a bubble economy that burst in five years, leaving Japan a financial wreck, unable to challenge America as had been feared by U.S. strategists in the 1980s." (Hudson 2003:

¹⁹ The Dodge Line was a financial and monetary contraction policy drafted by Joseph Dodge for Japan to gain economic independence after World War II. It was announced on March 7, 1949.

28).

Being economically and militarily dependent, Japan, the closest economic competitor to the United States ever since 1945 (counting on its GDP on U.S. GDP share), was the weakest monetary rivalry the United States ever faced. The monetary dependence on the dollar hegemony should be blamed for the bursting of the Japanese asset bubble and its 'lost decade'.

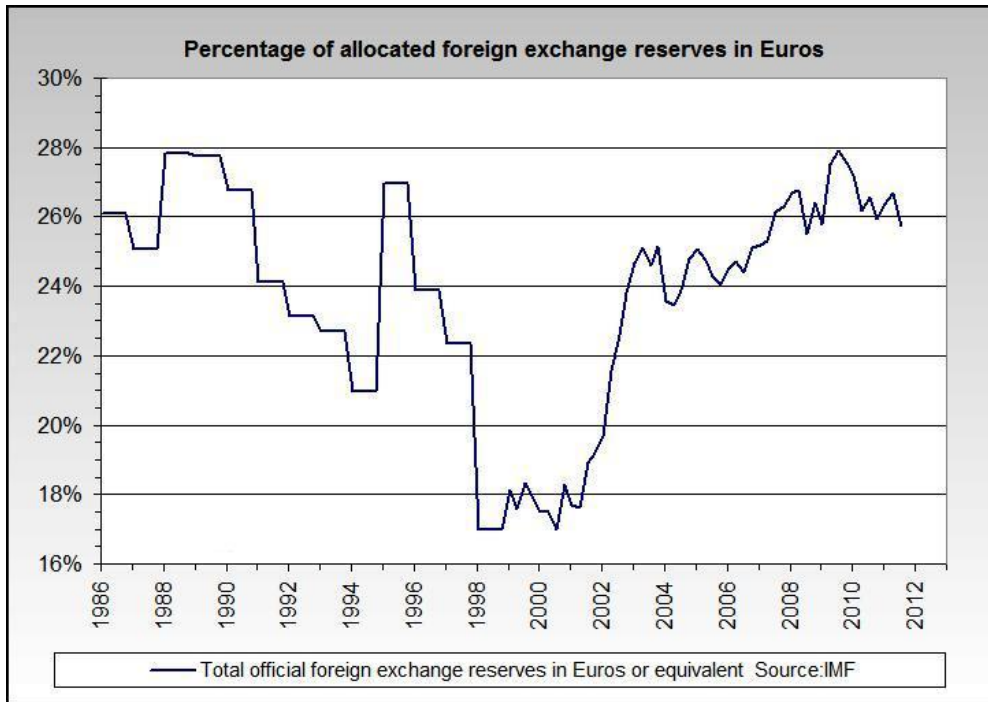
The Largest Competitor Ever: U.S. Dollar and Euro

The euro was regarded by Eichengreen (2011) as the largest competitor ever to challenge the dollar's hegemonic status. The EU's economic size is almost the same as that of the United States. Its export doubles that of the United States. It has a powerful central bank—the European Central Bank (ECB). Euro's share as an international reserve currency has reached 28% (Eichengreen 2011). However, the United States has used geopolitical weapons to defuse that challenge from the EU.

The first geopolitical war that the United States waged against the euro was the Kosovo War. Since the dollar hegemony system relies on a continuous inflow of capital to the U.S. market, thus making the deficit-based U.S. economy run normally. This mechanism heavily relies on the dollar's main reserve currency status. The euro's birth will bring potential threat to the dollar's hegemony. Therefore, the U.S. must act to put the euro on an unfavorable situation, so that international investment will flow to the United States (Wang 2008).

Confidence plays an important role in a reserve currency's status. Because of U.S. supreme military might, the dollar enjoys the name of 'safe haven'.²⁰ The basic problem of the euro is that it is not a sovereign currency (Eichengreen 2011). This assertion was clearly reflected in the debt crisis happening on the periphery countries of the euro zone in the last two years. The United States launched the Kosovo War at the end of 1998, just before the birth of the euro. Its military action clearly informed the world that a supranational currency without backing from a strong state cannot act as a safe reserve currency. As we can see from figure 4, before the euro came into being in 1999, the share of reserves held in euro zone national currencies dropped to a historical low. Huge outflow of capital was converted to dollar and went to the United States market (Wang 2008).

²⁰ CNN website. *Dollar: The 'Last Resort' Safe Haven*. August 2, 2011. http://money.cnn.com/2011/08/02/markets/dollar_outlook/index.htm



Source: “Composition of Official Foreign Exchange Reserves” on nowandfutures.com, http://nowandfutures.com/cb_watch.html#cofer, data from IMF

Figure 4: Percentage of Allocated Foreign Exchange Reserves in Euros

If the war was truly claimed as a “humanitarian war”, then Rwanda would have been in greater need than Yugoslavia to welcome the U.S. intervention in the 1990s. Therefore, the war was rather for U.S. geopolitical objective—to undermine the confidence in euro.

The Iraq War in 2003 was the first oil currency war, which will be explained later in chapter 4, but it was also a war waged against the euro. The oil-dollar link plays an anchor role for the fiat dollar. If one day oil is denominated in other currencies, the dollar hegemony will collapse. The United States was afraid that the OPEC countries might convert their dollar reserves into euro just as Iraq did in 2000. This explains one important reason for the Iraq war. That was vividly reflected in U.S. Congressman Ron Paul’s speech,

“the military might we enjoy becomes the ‘backing’ of our currency. There are no other countries that can challenge our military superiority, and therefore they have little choice but to accept the dollars we declare are today's ‘gold.’ This is why countries that challenge the system — like Iraq, Iran and Venezuela — become targets of our plans for regime change.”

Commonalities and Differences

After analyses and comparison of the four cases, commonalities and differences of the monetary relations in these cases are generalized.

Great nations have great currencies. In all of the four cases, the states are great powers in the international community. The hard power a state enjoys such as economic volume and military capabilities are the most important basis of monetary power. Great nation is a necessary but not sufficient factor for great currency. It means that all great currencies are issued by great powers, but great powers do not necessarily issue great currencies.

Great currency helps consolidate great nation status. The Great Britain lost its status as biggest economy at the end of the 19th century, but the sterling continued to play the hegemonic reserve currency till the end of the Second World War. In this light, the U.S. dollar will be the main reserve currency in the foreseeable future when the United States can still maintain the biggest economy.

Dollar Hegemony serves strategic benefits to the United States. The dollar hegemony

has brought to the United States great benefits. Because of this status, the United States was able to support and maintain its all-around primacy in the world.

To contain monetary competitors is a continued policy of the United States. No matter who, whether its allies or enemies, begins to challenge the status of the dollar, the United States will take necessary measures to contain and defuse that challenge.

Besides sharing the above commonalities, differences are obvious among the four cases. In the first case, the United States acts as a challenger and the Great Britain the hegemon. In the rest three cases, the United States plays the role as the monetary hegemon and the Soviet Union, Japan and the European Union challengers to the U.S. monetary hegemony. The United States sometimes uses monetary power to serve security and military benefits and sometimes uses military might to work for monetary power. The United States aimed at different targets in its monetary power struggle. In some cases, it directly deals with the competitor (Japan), but on some other occasions, it hits the periphery of the competitor (EU). In some of the cases, the monetary power struggles seem 'peaceful', while in others, the struggles have led to diplomatic confrontations and even geopolitical wars. In some cases, the monetary power is used as a tool to serve strategic benefits. On some other occasions, military actions help states secure monetary power.

After investigating the four cases, this thesis generates the main hypotheses of the thesis: the renminbi exchange rate is not a simple economic issue. The U.S.-China monetary disputes are a reflection of monetary power struggle between the two states. The future bilateral monetary relations will bear geopolitical meanings for the two states.

CHAPTER FOUR: THE DOLLAR HEGEMONY AND MONETARY RELATIONS

In the past two hundred years of human history, only two nations enjoyed monetary hegemony, Great Britain and the United States, whose money was the world's dominant currency for medium of exchange, unit of account and store of value. Possessing monetary hegemony gives the issuer of that currency both economic and political gains.

Great Britain lost its monetary hegemonic status when the gold-standard collapsed before the First World War. However, the United States did not establish its monetary hegemony directly on the ashes of the British Empire, although it had already jumped to be the world's biggest economy in 1872 (Eichengreen 2011). It was not until the end of the Second World War did the U.S. become the monetary hegemon under the arrangement of the Bretton Woods System. When Nixon de-pegged the dollar from gold in 1971, the U.S. dollar became a fiat money and a new system, the so-called 'dollar hegemony' mechanism, came into being. Today, the rest of the world is as dependent on the U.S. dollar hegemony as they were 60 years ago.

The 'dollar hegemony' is a sophisticated and complicated mechanism. It bases on the all-around supremacy of the United States in various fields, ranging from economic power to military muscle. 'Petrodollar' becomes an important anchor of the U.S. dollar, as compared to the role that gold played to the dollar before 1971. Theoretically speaking, the United States does not have to fear about its immense balance of payments deficit, the public debt or its huge military spending, as long as the United States maintained its

monetary hegemony (Liu 2003).

Because of dollar's 'exorbitant privileges', the United States can still maintain the status of the sole superpower in the world. Without dollar hegemony, an all-around supremacy of the American empire is impossible to endure. Therefore, the dollar hegemony becomes the most important part and core interests of the American empire.

A Brief History of the U.S. Monetary Hegemony

In human history, various currencies had acted as an international currency, such as "the Chinese Liang and Greek Drachma, coined in the fifth century B.C., the silver punch-marked coins of fourth century India, the Roman denari, the Byzantine solidus and Islamic dinar of the middle-ages, the Venetian ducato of the Renaissance, the seventeenth century Dutch guilder" (Mah-hui and Chin 2010: 109). However, none of the above currencies ever enjoyed a comparable worldwide monetary status as the British sterling pound or the U.S. dollar did.

When the Dollar Overtook Pound

When the dollar surpassed the pound as the top reserve currency is always a hot academic topic since the latter half of last century, especially during the years when the dollar was weak and the estimation for a competitor to come was on increase. In the last decade, when the euro emerged as the first ever serious competitor to the dollar, many scholars again used the history of the reversal of roles between the sterling pound and the dollar as a precedent for a possible future shift of the world's dominant reserve currency

from dollar to euro.

Many experts agree that the United States defeated Great Britain as the top currency issuer status and established its own monetary hegemony right after WWII (Chinn and Frankel, 2008). However, Eichengreen remains a dissident on this question. He believed the U.S. dollar surpassed the sterling pound as the top world reserve currency in 1924. But he also admitted that the dollar's largest reserve currency status did not last long because of the disastrous impact that the Great Depression added to the U.S. economy. The dollar's share in world reserve currencies dropped to around 20% in 1933 (Eichengreen 2011: 33). Therefore, consensus can be reached that the United States finally secured the dollar's uncontested leadership among international currencies at the end of the Second World War in 1945.

The dollar's road to the throne of monetary hegemony proved to be long enduring and with twists and turns. The U.S. economic size had surpassed that of Britain in as early as 1872. The United States became the world's biggest exporter in 1915 (Chinn and Frankel, 2008). However, its currency, the U.S. dollar, enjoyed a much weaker role relative to its economic power. One reason was due to the United States' unstable financial market. It was estimated that the United States experienced fourteen financial crises before the First World War (Eichengreen 2011). The other reason was that the development of the U.S. financial system lagged behind; one reflection is that the United States did not establish a central bank until 1913 (Chinn and Frankel, 2008). Therefore the United States could not, and at the same time did not want to expand the influence of its currency.

During the years following 1914, the United States came across the first golden opportunity in the history of its monetary expansion. The Fed was established at the end of 1913. A strong central bank now began to protect the U.S. economy from frequent financial crises. American banks were allowed to open branches overseas (Eichengreen 2011). More importantly, the First World War broke out. Because of the huge cost of the war, the British Empire was not able to maintain the gold standard any longer. It stopped the convertibility from pound to gold and other European powers followed suit. The status of the pound was greatly impaired. The U.S. stayed out of the war towards the end of the war and benefited from the sharp increase of exports to the warring states in Europe. The dollar was the only currency to remain convertible into gold at a fixed price in the 1920s (Chinn and Frankel, 2008). Compared to the devaluation of the pound, the dollar began to emerge as a major international currency; its use in international trade and finance widened increasingly. Because of these reasons, for the first time in history, the dollar overtook the pound as the main reserve currency in 1924 (Eichengreen, 2011).

However, the good days passed very quickly. The “Roaring Twenties” gave way to the “Great Depression” (Eichengreen 2011). In the most serious economic depression ever, the United States was hit badly. After the sharp shrinkage of the international trade, the dollar’s newly established status was seriously undermined. Then the Pound regained its hegemonic status in 1931. Eichengreen (2011) observes that most people neglected this fact that the dollar had once surpassed the pound as the top reserve currency. Most scholars tend to hold the view that the pound retained its dominant position, as key currency in the

interwar period, primarily due to inertia in such arrangements. But by 1945, the “dethroning was complete” (Chinn and Frankel 2008).

Monetary Hegemony under the Bretton Woods System, 1945-1971

As early as in 1944, when the allied forces were still fighting against the Axis states, the United States was already considering the reconstruction of the post-war world order. One of those efforts was the Bretton Woods conference, convened in the first three weeks in July 1944. Participants from 44 countries, including the Soviet Union, joined the conference. The conference mapped out the blueprint of the post-war economic and financial arrangement, most important of which was the monetary arrangement that the dollar would be pegged to gold at the fixed price of \$35 per ounce gold and that the currencies of the rest of the world would be pegged to the dollar at a certain fixed exchange rate (Eichengreen 2011). The International Monetary Fund (IMF) and the World Bank were created to help implement this arrangement, which was known as the Bretton Woods System.

When the Second World War ended in 1945, the United States emerged as the undeniable world leader, which possessed around two thirds of the world gold reserve and more than 50% of the world industrial productivity (Eichengreen, 2011). European powers were catastrophically damaged by the war, while the strength and wealth of the United States was greatly enhanced thanks to the fact that the war was away from the American continent and the sharp increase of exports of military supply products injected great dynamics into the U.S. economy (Song 2011). Finally, the dollar’s uncontested monetary

hegemony was secured. The U.S. dollar was an important part of the reserve of central banks because all the holders of the dollar knew that their reserve could be converted into gold anytime at a price of \$35 per ounce.

In the beginning years of the post-war era, the dollar was truly as good as gold. The world economy was eager for aid and investment in the form of dollars in order to recover from the colossal damages of the war. Therefore, a ‘dollar shortage’ appeared due to the dire need for dollar from other countries. The huge amount of dollar inflows of both aid²¹ and investment from the United States helped Europe and Japan restart their economic development after the war. However, as their economies recovered and even surpassed the pre-war level in the latter half of the 1950s, European countries, as well as Japan, accumulated substantial amounts of dollar reserves. At the same time, the U.S. balance of payments plunged to a \$3.5 billion gap in 1958 and to even larger deficits in 1959 and 1960. In 1960, for the first time in the Bretton Woods System’s history, the dollar reserves held by nonresidents surpassed the U.S. gold reserve, meaning that the dollars they held were not fully backed by gold, thus triggering concerns from international investors and central banks of dollar’s devaluation (Eichengreen, 2011).

That was a turning point. “Instead of talking about a ‘dollar shortage’, observers began to speak of a ‘dollar glut’ and excessive U.S. deficit.”²² In October 1960, the United States suffered the first serious dollar speculation attack. Large quantities of dollars were

²¹ Namely the Marshall Plan and the Dodge Line offered by the United States to help the economic recovery of the western European countries and Japan.

²² ‘Bretton Woods System’, Benjamin Cohen’s paper prepared for the *Routledge Encyclopedia of International Political Economy*. <http://www.polsci.ucsb.edu/faculty/cohen/inpress/bretton.html>

sold in the international market forcing a run for gold, putting great pressure onto the United States to maintain the \$35 per ounce gold price. The Gold Pool was set up as requested by the United States and joined by its allies in the following year, hoping to keep the price between gold and the dollar stable in the London gold market. However, this arrangement only survived seven years and the U.S. effort to stabilize the dollar again failed in March 1968. An emergent conference, held one day after the closure of the London gold market, was requested by the United States (Eichengreen 2011). In this meeting, a new system, called the two-tier gold system, was “set up to protect international monetary reserves from the pressure of higher gold prices; under a two-tier system, monetary gold used as reserves [held by central banks] would sell at a fixed price, and gold used as an ordinary commodity would sell at a freely fluctuating market-determined price.”²³ This system again collapsed only three years later in 1971, when President Nixon declared the closure of gold-dollar convertibility.

This situation actually had been expected by Robert Triffin, a Belgium-born economist at Harvard University, in his 1947 report to the Fed. He pointed out an intrinsic design flaw of the Bretton Woods system, which was later known as the ‘Triffin Dilemma’, in his popular book *Gold and Dollar Crisis*. If put into plain words, the Triffin Dilemma could be explained as: “if the United States stopped running balance of payments deficits, the international community would lose its largest source of additions to reserves. The resulting shortage of liquidity could pull the world economy into a contractionary spiral,

²³ Encyclopedia Britannica, ‘Two-Tier Gold System’
<http://www.britannica.com/EBchecked/topic/611363/two-tier-gold-system>

leading to instability. If U.S. deficits continued, a steady stream of dollars would continue to fuel world economic growth. However, excessive U.S. deficits (dollar glut) would erode confidence in the value of the U.S. dollar. Without confidence in the dollar, it would no longer be accepted as the world's reserve currency. The fixed exchange rate system could break down, leading to instability.”²⁴

Triffin’s prophecy finally became reality. On August 15, 1971, U.S. President Richard Nixon imposed a 90-day wage and price freeze, a 10 percent import surcharge, and, most importantly, "closed the gold window", ending convertibility between US dollars and gold (Eichengreen 2011). This unilateral action, taken by the United States, resulted from two main reasons. One reason was the U.S.’s excessive expansion of its military expenditure in the Vietnam War, which was estimated to cost the United States \$111 billion (Stephen 2010) and resulted in America’ excessive deficits. The other one was that foreign central banks, represented by the French administration under President Charles de Gaulle, continuously called for converting their dollar reserves into gold.

When the United States declared that the dollar could no longer be converted into gold, the other states accepted this fact and followed the U.S. to declare their money disconnected from any precious metals or assets. A new page of monetary history was turned. The world entered into a new era of fiat money which was backed by nothing.²⁵

²⁴ IMF, 2001, ‘The Dollar Glut’ in *Money Matters: An IMF Exhibit—The Importance of Global Cooperation* http://www.imf.org/external/np/exr/center/mm/eng/mm_cc_01.htm

²⁵ Mankiw, N. Gregory, 2008. *Principles of Economics*. pp. 659. "Fiat money, such as paper dollars, is money without intrinsic value: It would be worthless if it were not used as money."

A New Era of the Dollar's Hegemony

The year 1971 marked a watershed in the history of the U.S. monetary hegemony. Before that, the United States could run large deficits based on the dollar's main reserve currency status, but it was still under certain external constraints. To maintain the official price of the dollar is a legal responsibility of the United States. However, when the dollar's peg to gold was lifted, the United States enjoyed full autonomy in issuing its currency.

In the first few years following the collapse of the Bretton Woods System, the dollar was regarded all over the world as a "sick currency".²⁶ Many talked about the decline of the dollar's hegemony and the rise of Japanese yen and Duetsche mark. However, they were surprised by the fact that in the rest of the 1970s, the dollar was not given up by other states. Although its shares declined a bit in the composition of foreign reserves in the central banks, the dollar still remained the dominant reserve currency, means of exchange in international trade, and denomination of oil and other products. In a floating exchange rate system, countries need to keep dollar reserves to intervene the exchange rate of their national currencies (Eichengreen 2011).

When Paul Volker chaired the Fed in 1979, he began to deal with the problem of high inflation caused by a persistent over-issuing of dollars. Finally, the dollar started to be strong and its share in foreign exchange reserves tended to be stable, thanks to Volker's successful move to squeeze inflation (Eichengreen 2011). The strong dollar weakened the competitiveness of American products; therefore, in the middle of the 1980s, the United

²⁶ New York Times, July 04, 1973. *The Dollar's Tribulations; Currency Remains Essentially Strong But It Is Haunted by Errors of Past*, By Leonard Silk.

States successfully pressured its main allies, West Germany and Japan, to appreciate their currencies against the U.S. dollar by signing the Plaza Accord and the Louvre Accord.

The collapse of the Soviet Union and its ruble sphere provided the U.S. dollar with a whole new world full of opportunities. The United States gained handsome seigniorage revenues from the huge request for dollar reserves by the central banks of Russia and newly independent former soviet republics and satellite states. More importantly, U.S. investors benefited enormously from buying the high quality assets of the former Warsaw Pact countries. Finally, the U.S. dollar's influence occupied every corner of the world. In 1991, Japan was hit by a serious economic crisis triggered by the bursting of an asset bubble. The economic challenge from the U.S. closest competitor ever had finally failed. With the fall of its two main rivalries, the United States stood proudly as the sole superpower on earth, whose military might and economic size were far beyond those of any other country. This situation greatly strengthened the dollar's status as the hegemonic currency and attracted continuous inflow of international capital into the United States, who enjoyed a long term economic increase in the 1990s.

The 1990s also witnessed an important event in the monetary history, the birth of the euro, the first supra-national currency ever in modern times. When the cold-war-era traditional threat from the east disappeared, the European Union accelerated its unification step, and a common currency was an important fruition. Since WWII, the euro was the closest competitor ever to the U.S. dollar (Eichengreen 2011).

The bursting of the hi-tech bubble²⁷ in 2000 and the 9/11 terrorist attacks on the twin towers of World Trade Centre in New York exerted serious damage to investors' confidence in the U.S. dollar, whose hegemonic status was at the same time challenged by euro. The strong will and military might, in both the Afghanistan and Iraq War, won the hearts of international investors and central banks, so capital inflows returned and another boom in the U.S. real estate market came into being.

However, it again made foreign dollar holders more and more concerned that the U.S. military expenditure in the two wars in Afghanistan and Iraq surged, as well as the U.S. balance of payment deficits, during the second term of President Bush, persistently expanded. The 2008 financial crisis, triggered by the bursting of the real estate bubble in the United States, was regarded as the worst financial crisis since the Great Depression of the 1930s. The following measures taken by the Fed, namely the two rounds of quantitative easing (QE1 and QE2), might have ended the financial crisis and saved the U.S. economy from sliding into recession, but exacerbated the world economic situation and attracted criticism from all around the world. The dollar experienced the sharpest drop of exchange rate since the 1980s (see figure 5). Discussions about the demise of the dollar hegemony and the rise of the euro or even the Chinese renminbi became a hot topic within and outside academic circles. However, due to the weakness of the euro and the renminbi, the dollar can still enjoy its monetary hegemony in the foreseeable future (Eichengreen 2011).

²⁷ The hi-tech (or dot-com) bubble was a speculative bubble covering roughly 1995–2000 (with a climax on March 10, 2000, with the NASDAQ peaking at 5132.52 in intraday trading before closing at 5048.62) during which stock markets in industrialized nations saw their equity value rise rapidly from growth in the more recent Internet sector and related fields.



Source: Data from U.S. Federal Reserve Bank

Figure 5: Dollar Index in Recent Decades

Currency Internationalization and Dollar Hegemony

According to the Merriam Webster Dictionary, *hegemony* means ‘the social, cultural, ideological, or economic influence exerted by a dominant group.’²⁸ *Monetary hegemony*, thus, literally means the monetary influence exerted by a dominant state onto other states in the international monetary system. This dominant state is the monetary hegemon who possesses predominant influence in monetary issues internationally.

From the perspective of the three basic functions of money, medium of exchange, unit of account, and store of value (Greco 2001), the monetary hegemon usually owns a national currency which is the main medium of exchange of international trade, the unit of account

²⁸ Merriam Webster Online Dictionary: <http://www.merriam-webster.com/dictionary/hegemony>

for most important goods worldwide, and store of value for most other states. For example, about sixty-four percent of the world's official foreign exchange reserves are currently held in U.S. dollars; roughly 88% of daily foreign exchange trades involve U.S. dollars (Humpage, 2009). Oil, gold and other important goods are denominated in U.S. dollars. The international use of the dollar brings the United States remarkable economic benefits.

Benefits of an International Currency

What benefits the international use of a national currency may bring to the issuer has been an important topic of international political economy. First of all, direct economic gains can be achieved by the international use of a national currency, namely the seigniorage revenues, the inflation tax, the cheap credit the issuer can borrow, and the macroeconomic flexibility the issuer enjoys.

1. Seigniorage. In most times in human history, governments always controlled the monopoly of 'coinage'. The power to produce money is considered an integral part of sovereignty. Historically, seigniorage refers to the difference between the face value of a coin and its costs of production and mintage (Buiter 2007). In modern fiat money economies, where money is no longer supported by any precious metal, the issue of legal tender is generally monopolized by the state, and the difference between the face value of a currency note and its printing cost is seigniorage revenue. Because printing costs are almost zero, printing fiat money is therefore a highly profitable activity (Buiter 2007). At the international level, seigniorage refers to the gains generated whenever foreigners "acquire and hold

significant amounts of domestic money, or financial claims denominated in the domestic money, in exchange for traded goods and services” (Cohen 2010: 10) A report, published by the United States Treasury Department in 2006, concluded that “we estimate that nearly 60 percent of all U.S. banknotes in circulation, or about \$450 billion of the \$760 billion in circulation as of December 2005, is now held abroad” (U.S. Treasury Department 2006: 4). This means that the United States had gained around \$450 billion seigniorage revenues from the banknotes circulated abroad till 2005. It is estimated that the United States gained around \$10 billion each year by issuing additional currency to nonresidents who hold U.S. notes and coins (Dobbs et al 2009).

2. Inflation tax. When additional currency is pumped into the monetary system, it will normally trigger inflation, thus driving down the value of the money in the hands of the holders. Since money is just a symbol of IOUs, the losses of the holders of the money result in the deduction of the liabilities of the issuer of the currency, equally increasing the gains of the issuer. This process is similar to the levying of tax by a government; therefore it is named an inflation tax. On August 15, 1971, the day when U.S. President Richard Nixon declared the peg between the dollar and gold no more effective, one ounce of gold was still worth 35 dollars. Forty years later, the gold price surges to \$1740,²⁹ almost 50 times that of 40 years ago, suggesting the dollar devaluation to one fiftieth of its value in 1971. In the two rounds of quantitative easing in recent years, the Fed pumped more than \$600 billion liquidity into the monetary system (Hudson 2010), causing the value of the dollars held by foreign creditors to

²⁹ Data from www.goldprices.net

devalue sharply. The United States therefore levied a substantial amount of inflation tax and triggered a big wave of criticism from all around the world.³⁰

3. Cheap credit. The huge amount of the reserve currency held by foreign governments, public agencies, and private companies will not just sit there waiting for potential loss of value, because of the inflation of the currency caused by additional issuance. Part of that amount generally flows back to the monetary hegemon to earn interests, giving the government, companies, and households of the hegemon state great ability to raise capital more cheaply. When Britain became the monetary hegemon in the 1870s, London was the financial center of the world. This enabled Britain to run large trade deficits while maintaining current account surpluses. Britain then used its surplus funds to finance the rest of the world and obtained enormous income from playing that role (Steil and Hinds, 2009). It is estimated that large purchases of U.S. Treasury securities by foreign governments and government agencies have reduced the borrowing rate by 50 to 60 basic points over the past few years, bringing the United States about \$90 billion net borrowing benefit annually (Dobbs et al, 2009: 8).

4. Macroeconomic flexibility. Last, but not least, the macroeconomic flexibility may be considered another important benefit that the monetary hegemon can enjoy. In the commodity money era, when the currency was still backed by precious metal, the monetary hegemon could expand its ability to run balance of payment deficit. During the Vietnam War, the United States substantially expanded its deficit to finance the military expenditure without

³⁰ AOL Daily Finance, November 8, 2010. *G-20 Nations Criticize U.S. Fed's \$600 Billion QE2 Stimulus.* <http://www.dailyfinance.com/2010/11/08/g20-criticize-fed-600-billion-qe2-stimulus/>

having to worry too much about its balance of payment, due to its monetary autonomy. Jacques Rueff, then advisor to French President Charles de Gaulle, blamed this as “deficit without tears”.³¹ In the era of fiat money, the United States has taken off the shackles of gold from the U.S. dollar and possessed a theoretically limitless power to print money. After the 2008 financial crisis, the Fed kicked off two rounds of quantitative easing and drove up the national debt ratio to a GDP around 100%,³² higher than that of some PIIGS³³ countries. However, the United States is farther away from a debt crisis than her European counterparts and may launch a third round of QE (QE3) in the future.³⁴ Benjamin Cohen once observed on this issue: “America was effectively freed from external payments constraints to spend as freely as its leaders thought necessary to promote objectives believed to be in the national interest”.³⁵ Because of the above reason, this economic benefit can also shift into substantial political power.

Political Gains of an International Currency

The monetary hegemonic status can bring the hegemon not only enormous economic benefits, but substantial state power as well. Susan Strange observed long ago: “It is highly probable that any state economically strong enough to possess [an international money] will also exert substantial power and influence. The rich usually do” (Strange 1971: 222).

³¹ Edward Chancellor, *Time Will Tell If Deficit Can Be Without Tears*, Financial Times Online, July 5, 2009.

<http://www.ft.com/intl/cms/s/0/cbdc19e-6826-11de-848a-00144feabdc0.html#axzz1llk2OykZ>

³² U.S. Department of Treasury. <http://www.treasury.gov/resource-center/data-chart-center/tic/Pages/external-debt.aspx>

³³ An acronym referring to the five EU member countries suffering from euro debt crisis: Portugal, Spain, Italy, Ireland and Spain.

³⁴ *80% of Bond Managers Expect QE3 in 2012, Says JPMorgan*.

<http://www.zerohedge.com/news/80-bond-managers-expect-qe3-2012-says-jpmorgan>

³⁵ Cohen, Benjamin. “Bretton Woods System”, paper prepared for Routledge Encyclopedia of International Political Economy. <http://www.polsci.ucsb.edu/faculty/cohen/inpress/bretton.html>

Political scientist Jonathan Kirshner reminds us: “Monetary power is a remarkably efficient component of state power... the most potent instrument of economic coercion available to states in a position to exercise it” (Cohen 2003: 5). What kind of power the monetary hegemon would achieve from the international use of its national money? What kind of influence may it exert on other states?

First of all, the fact that the dollar is the dominant reserve currency of the world gives the United States almost limitless power to finance. This macroeconomic flexibility also means that only the United States, the monetary hegemon, can possess the “exorbitant privilege”, as then French Minister of Finance, Valéry Giscard d'Estaing labeled it (Eichengreen 2011). With this monetary hegemony, the United States theoretically can buy anything to any extent it wishes with the greenback papers, without having to worry about its liabilities, because more liabilities can be paid by newly printed dollars, which are basically worthless IOUs. This privilege opened the gate to limitless wealth for the United States as long as the foreign holders believe that others will accept the dollars exactly as they do.

This privilege bestows the United States great ability to assemble resources. In the Cold War era, the Soviet Union was not as lucky as the United States. Its soviet ruble was only circulating within its sphere of influence. When it established almost the same military muscle as the United States did, the Soviet Union, however, lacked similar ability to accumulate resources. There are many explanations about why the Soviet Union lost the Cold War. An interesting explanation contributes the reason to the Soviet Union's inability

to run large balance of payment deficits. Because of its increasing amount of food imports, the Soviet Union must sell its dollar or gold reserves to trade. At that moment, its reserves mainly came from its oil exports. However, the foreign reserve earned from oil exports was not able to satisfy the need of food supplies because of the low price of the oil in the 1980s, which exacerbated the domestic situation (Song 2011). Tragically, the powerful soviet empire survived Nazi invasion and American military pressure, but collapsed due to its shortage of food supplies and comparatively dwarfed ability of monetary control. On the contrary, the United States started two costly wars (the Korean War and the Vietnam War), but it could print as many greenbacks as it wanted to buy supply products from all over the world to support the military actions in the Korean peninsula and Vietnam. Though it experienced a dollar credit crisis after the Nixon Shock, the United States still remains a world superpower today.

Second, the monetary hegemon can exercise leverage over other states through its control of access to financial resources (Cohen 2010). As early as the 1960s, upon the request of the United States, the ‘gold pool’³⁶ was established in the London gold market in order to keep the dollar-gold price stable. However, this was “blatantly an asymmetrical arrangement, in which all the transfers went one way. It was an indication of the extent to which the structure of the system had other countries over the barrel” (Eichengreen 2011: 58). In the 1980s, after years of increase in the dollar’s exchange rate with other currencies such as the Japanese yen and German mark, the United States successfully persuaded

³⁶ The ‘Gold Pool’ was the pooling of gold reserves by a group of eight central banks in the United States and seven European countries that agreed on 1 November 1961 to cooperate in maintaining the Bretton Woods System of fixed-rate convertible currencies and defending a gold price of US\$35 per troy ounce by interventions in the London gold market.

Japan and Germany to appreciate their respective currencies. After the signing of the Plaza Accord in 1985, both mark and yen appreciated against the dollar, especially the latter. That was a reason many believed had triggered the asset price bubble in the Japanese market, which later on ended up in a serious recession, the so-called Lost Decade (Renaud 1995). In the US-Sino monetary dispute, the United States started to pressure China to appreciate its currency in 2002. After three years of pressure and diplomacy, China finally agreed to give up the peg of its currency to the dollar in 2005 and appreciated its currency around 20% until it re-pegged the renminbi to the dollar in 2008 in the wake of the financial crisis.

Third, the dollar hegemony can also bring the United States a source of soft power – reputation. As Cohen (2010: 10) stated “a position of prominence in the hierarchy of currencies can promote the issuing state’s overall reputation in world affairs – a form of what political scientists today call soft power”. The dollar’s wide international circulation did bring the United States a source of status and prestige, just as its language, English, has played the same role—a visible sign of elevated rank in the community of nations.

From the above examples, we can clearly see that possessing the monetary hegemony generates two dimensions of monetary power, autonomy and influence (Cohen 2010: 4). The former gives the United States “an ability to act freely, without external constraint (in effect, others letting you have your way), and the latter to “let others have your way”.

Characters for an International Currency and Barriers of Replacement

According to Dwyer Jr. and Lothian (2002), international currencies have four key characteristics: they have high unitary value; they have relatively low inflation rates for long time periods; they are issued by major economic and trading powers; and they became international monies by human action rather than by design. In addition, the two authors suggest that in recent centuries, international monies have been issued by countries with important financial markets to which foreigners have relatively free access.

Cohen (2010) has also made similar assertions of an international currency's essential attributes: first, widespread confidence in its future value backed by political stability in the country of origin; second are the qualities of "exchange convenience" and "capital certainty" -- a high degree of transactional liquidity and reasonable predictability of asset value the issuing state must be able to maintain the value of its currency in the future; third, a money must promise a broad transactional network, since nothing enhances a currency's acceptability more than the prospect of acceptability by others.

At present, it is truly difficult for many hard currencies to meet all the demanding conditions. Cohen (2010) believes only the dollar, the euro, and the yen can meet the requirements. The euro zone has an economy size almost as big as that of the United States. The EU is the largest trading entity as a single market. The problem in the euro zone today is that the member states have a common currency but not common fiscal policies. Different member states violated fiscal disciplines by issuing too many national debts denominated in euro, seriously undermining the international investors' confidence in the

future value of the common currency. The current debt crisis in Europe is a reflection of this weakness. The yen began to enjoy the status as an international reserve currency in the 1990s. However, its competitive devaluation in the climax of the Asian financial crisis has seriously harmed its reputation.

The demanding conditions are the most important barriers of replacement of a dominant international currency. Inertia is believed to be the other key barrier of replacement. A principle source of inertia is the pre-existence of already well-established transactional networks, which generate a well-documented stickiness in user preferences (Cohen 2010).

Therefore, many predict that the dollar can still maintain its status as the main reserve currency in the foreseeable future (Cohen 2010, Eichengreen 2011).

Dollar Hegemony—U.S. Privilege, Others' Problem

John Connally, the U.S. Secretary of the Treasury, once told his European counterparts that “the dollar is our currency, but your problem.”³⁷ As discussed above, owning monetary hegemony endows the issuing state of that money not only economic benefits, but political power as well. Connally’s expression vividly reflects the power that the United States owns from its monetary hegemony. Since then on, the international monetary system gradually became dependent on U.S. monetary hegemony, which, day by day, turned into U.S. privilege and, at the same time, the other’s problem.

³⁷ Ferguson, Niall, *Our Currency, Your Problem*, in Hoover Digest 2005 No.2. April 30, 2005
<http://www.hoover.org/publications/hoover-digest/article/6386>

Monetary Imperialism and Dollar Hegemony

Under the Bretton Woods System, gold and dollars were both reserve assets in foreign central banks and the dollar's value was pegged to gold, thus giving foreign holders of the paper money firm confidence in its value. In the years of the Korean War, when the United States ran deficits, foreign central banks were not really worried, because they could rest assured that the leader of the free world would promise its commitment to convert their dollar reserves into gold at any time requested. However, when U.S. deficits continued to inflate, confidence in the dollar's value collapsed; private investors and central banks made a dollar run at the end of the 1960s, which finally led to President Nixon's decision to stop the convertibility of dollar into gold in 1971.

In the years following the collapse of the Bretton Woods System, the dollar, without the backing of gold, did suffer from a confidence crisis. However, the United States started to find out that the greenbacks still played the role of main reserve currency. When the peg to gold was lifted, the dollar became a sheer fiat money, which was backed by nothing. On this basis, the United States government could enlarge its deficits to a much larger extent to finance its military actions in pursuit of its hegemony. This 'exorbitant privilege' of the U.S. dollar became the essence of the post-Bretton Woods monetary system. As for the possible consequences its excessive expansion of deficits might bring to the world, it is just someone else's problem. In short term, its huge deficits are not an Achilles' heel, but rather enhance its power of fund raising.

As early as 1972, a young American scholar had already studied the Bretton Woods

monetary system and anticipated the great changes the dollar-gold decoupling might bring to the world. In his book published that year, *Superimperialism: The Economic Strategy of American Empire*, Michael Hudson described the global free ride for America after it went off the gold standard, putting the world onto a paper U.S. Treasury-bill standard. Obliging foreign central banks to keep their monetary reserves in Treasury bonds forced them to finance U.S. military spending abroad, which was responsible for the U.S. balance of payments deficit at that time (Hudson 2003).

Hudson regarded this dollar mechanism as a new form of imperialism different from the British imperialism. He stated that “the vehicles for this super imperialism are not private international firms or private finance capital, but central banks. Through these international financial maneuverings the United States has tapped the resources of its Dollar Bloc allies. It has not done so in the classic fashion of a creditor extorting debt service, not so much via its international firms and their investment activities, and certainly not any longer through its export competitiveness and free competition. Rather, the technique of exploitation involves an adroit use of central banks, the IMF, World Bank, and its associated regional lending institutions to provide forced loans to the U.S. Treasury” (Hudson 2003: 385). The United States is “able to rule not through its position as world creditor, but as world debtor. Rather than being the world banker, it makes all other countries the lenders to itself. Thus, rather than its debtor position being an element of weakness, America’s seeming weakness has become the foundation of the world’s monetary and financial system” (Hudson 2003: 386).

In sum, the monetary hegemony so far the United States had established was a sophisticated and complicated mechanism centering on the Treasury bill standard. Central banks, IMF, and the World Bank become the vehicles of this mechanism. All the rest of the world relies on U.S. credit-creating power to develop their economies. Their dollar holdings devalued gradually, but there was no alternative way out of this dead-locked dollar circulation. With everyone clamoring for dollars, all the US had to do was print fiat dollars and other countries would accept them in payment for their exports. These dollars then flowed back into the US to be invested in Treasury Bonds and similar instruments, offsetting the outflow.

The following decades witnessed a world order ruled by this monetary imperialism almost exactly as Hudson had depicted. The U.S. continued to run a large budget and balance of payment deficits in order to finance its military race with the Soviet Union. More and more dollars were piled up in the central banks of European countries and Japan. By persuading Japan and European allies into the Plaza Accord and Louvre Accord, the United States was able to devalue the dollar significantly in the 1980s against the Japanese yen and Deutsche mark. Germany started to form a single currency union in Europe to hedge the risk of its dollar reserves, while Japan fell from the asset bubble triggered by the fast appreciation of its yen against dollar. When the Soviet Union lost the cold war in 1991, it was regarded as a remarkable victory for the United States due to its political and economic system and some scholars even hailed that as the 'end of history'.³⁸ With its monetary

³⁸ *The End of History and the Last Man* is a 1992 book by Francis Fukuyama, expanding on his 1989 essay "The End of History?", published in the international affairs journal *The National Interest*. In the book, Fukuyama argues that the

imperialism now expanded to every corner of the world, the United States was able to attract continuous, huge inflow of capital to boom the economic prosperity of the 1990s.

Thirty years after Hudson's assertion of the monetary imperialism, a Chinese-American scholar named Henry C.K. Liu published an article named "Dollar Hegemony Has Got to Go" on *Asia Times Online*³⁹ and popularized a new term *dollar hegemony* which was similar to Hudson's term of *monetary imperialism*. Liu observes: "The current international finance architecture is based on the US dollar as the dominant reserve currency... World trade is now a game in which the US produces dollars and the rest of the world produces things that dollars can buy... a dollar hegemony that forces the world to export not only goods but also dollar earnings from trade to the US."

Liu shared almost the same views that Hudson held; however, Liu pointed out that one more important feature of the dollar hegemony--petrodollar recycling, which Hudson did not include in his observation in 1972, when the dollar was not yet linked to oil. Liu pointed out that "...dollar hegemony, which is created by the geopolitically constructed peculiarity that critical commodities, most notably oil, are denominated in dollars. Everyone accepts dollars because dollars can buy oil. The recycling of petrodollars is the price the US has extracted from oil-producing countries for US tolerance of the oil-exporting cartel since 1973."

advent of Western liberal democracy may signal the end point of humanity's sociocultural evolution and the final form of human government.

³⁹ Asia Times Online, April 11, 2002. <http://www.atimes.com/global-econ/DD11Dj01.html>

Petrodollar Recycling: the Hidden Hand of Dollar Hegemony

There might be one loophole in Hudson's theory. If all the dollar-holding nations decided to gradually substitute their dollar reserves with buying natural resources rather than U.S. Treasury bonds and to form a common market outside the United States, can the dollar's reserve currency status be secured? Though those countries will suffer from some losses, it maybe is a possible exit strategy.

The U.S. designer of dollar hegemony had already put this scenario in their consideration and plugged this vulnerability by linking the dollar to oil. How could the linkage keep this dollar mechanism from collapsing? No one would doubt the importance of oil, as it is "not just the most important commodity traded internationally. It is the key industrial mineral, without which no modern economy works."⁴⁰ Therefore, it is a strategic resource that each country needs for their economic development. If oil is linked to the dollar, i.e. denominated in dollar, then everybody needs to use dollar to buy oil.

David Spiro (1999: 121) notes in his book, *Hidden Hand of American Hegemony*: "So long as OPEC oil was priced in U.S. dollars, and so long as OPEC invested the dollars in U.S. government instruments, the U.S. government enjoyed a double loan. The first part of the loan was for oil. The government could print dollars to pay for oil, and the American economy did not have to produce goods and services in exchange for the oil until OPEC used the dollars for goods and services. Obviously, the strategy could not work if dollars were not a means of exchange for oil. The second part of the loan was from all other

⁴⁰ Bulent Gokay, *Petrodollar became the essential basis for the US economic hegemony in the 1970s*, www.pravda.ru May 16, 2006. <http://english.pravda.ru/opinion/feedback/16-05-2006/80382-petrodollar-0/>

economies that had to pay dollars for oil but could not print currency. Those economies had to trade their goods and services for dollars in order to pay OPEC". After learning this oil-dollar relationship, we may better understand Kissinger's famous quotation: "Who controls the energy can control whole continents; who controls money can control the world."⁴¹

According to Professor Gokay's report, the U.S. government concluded a series of agreements with Saudi Arabia, known as the U.S.-Saudi Arabian Joint Economic Commission, in 1972-74, when the dollar was experiencing a confidence crisis. The United States promised to "provide technical support and military assistance to the power of the House of Saud in exchange for accepting only U.S. dollars for its oil. This understanding, much of it never publicized and little understood by public, provided the Saudi ruling family the security it craved in a dangerous neighborhood, while assuring the United States a reliable and very important ally in OPEC."⁴²

"Saudi Arabia has been the largest oil producer and the leader of OPEC. It is also the only member of the cartel that does not have an allotted production quota. It is the 'swing producer', meaning that it can increase or decrease oil production to bring oil draught or glut in the world market. As a result of this situation, Saudi Arabia practically determines oil prices. Soon after the agreement with Saudi government, an OPEC agreement accepted this, and since then, all oil has been traded in US dollars. Hence the oil standard became the

⁴¹ Engdah, F. William, *Crisis of the U.S. Dollar System*, Global Research, October 14, 2006

⁴² Bulent Gokay, *Petrodollar became the essential basis for the US economic hegemony in the 1970s*, www.pravda.ru May 16, 2006. <http://english.pravda.ru/opinion/feedback/16-05-2006/80382-petrodollar-0/>

dollar standard.”⁴³ The dollar hegemony mechanism linked with oil is an update and self-perfection of Hudson’s model. Several decades on, this mechanism worked well. The Saudis cooperated with the United States to control the oil price to achieve the latter’s geopolitical motives, including draining the Soviet Union’s dollar reserves.

However, after the birth of the euro, some countries were thinking of converting the petrodollar to the petroeuro, an action the United States would definitely not tolerate. Iraq was the first to take this move in 2000, which posed a serious threat to the dollar hegemony mechanism. As Youssef Ibrahim, a senior fellow of the U.S. Council on Foreign Relations, told CNN: “The Saudis are holding the line on oil prices in OPEC and should they, for example, go along with the rest of the OPEC people in demanding that oil be priced in euros, that would deal a very heavy blow to the American economy,”⁴⁴ In 2002, the former U.S. Ambassador to Saudi Arabia told a committee of the U.S. Congress: “One of the major things the Saudis have historically done, in part out of friendship with the United States, is to insist that oil continues to be priced in dollars. Therefore, the US Treasury can print money and buy oil, which is an advantage no other country has. With the emergence of other currencies and with strains in the relationship, I wonder whether there will not again be, as there have been in the past, people in Saudi Arabia who raise the question of why they should be so kind to the United States.”⁴⁵

From the above reports and explanations on dollar-oil linkage, we might easily

⁴³ Bulent Gokay, *Petrodollar became the essential basis for the US economic hegemony in the 1970s*, www.pravda.ru May 16, 2006. <http://english.pravda.ru/opinion/feedback/16-05-2006/80382-petrodollar-0/>

⁴⁴ Faisal Islam, *When will we buy oil in euros?* The Guardian/the Observe. February 23, 2003. <http://www.guardian.co.uk/business/2003/feb/23/oilandpetrol.theeuro>

⁴⁵ Faisal Islam, *When will we buy oil in euros?* The Guardian/the Observe. February 23, 2003. <http://www.guardian.co.uk/business/2003/feb/23/oilandpetrol.theeuro>

understand why the United States would invade Iraq in 2003. It was not either for weapons of mass destruction or for fighting terrorism, but rather the first “oil currency war”.⁴⁶ The United States must stop the dangerous move the Iraqi government had made and prevent its influence from spreading. Two months after the invasion, the Iraqi euro accounts were switched back to dollars.⁴⁷ Any potential move to euro taken by other states would be prevented by the United States. According to U.S. Congressman Ron Paul (2006), Venezuela's ambassador to Russia spoke of Venezuela switching to the Euro for all their oil sales in 2011, but “within a year there was a coup attempt against Chavez, reportedly with assistance from our CIA.”

In conclusion of this chapter, the dollar hegemony has been one of the pillars of the American hegemony and probably is more important than the other pillar, military dominance. William Clark (2005: 28) once commented: “Indeed, removing the dollar pillar will naturally result in the diminishment of the military pillar”. In the cold war era, the dollar’s reserve currency status served the U.S. military power by incessantly transporting resources to the latter. However, since the Kosovo War and the Iraq War, the relationship was reverse. The military power more and more plays a role of the guardian of the money. If any potential factor poses a threat to the operation of the dollar hegemony mechanism, the gigantic military machine might start, thus shifting the American hegemony from the ‘benign hegemony’ into a ‘dangerous hegemony’.

⁴⁶ William Clark, January 2003. *Revisited-The Real Reasons for the Upcoming War With Iraq: A Macroeconomic and Geostrategic Analysis of the Unspoken Truth*. <http://www.ratical.org/ratville/CAH/RRIraqWar.html#p2>

⁴⁷ Bulent Gokay, *Petrodollar became the essential basis for the US economic hegemony in the 1970s*, www.pravda.ru May 16, 2006. <http://english.pravda.ru/opinion/feedback/16-05-2006/80382-petrodollar-0/>

As China joined the WTO in 2001, it gradually replaced Japan as the U.S. main products provider. In about ten years' time, China piled up colossal volumes of dollar reserves exceeding \$3 trillion at the end of 2011.⁴⁸ At the same time, the United States experienced the worst ever financial crisis since 1930s in 2008-09. The QE policy that the U.S. government adopted drove the public debt to an alarming 100% GDP level. This has been eroding China's dollar reserves and causing widespread concerns on the security of its dollar assets. Top Chinese officials have already been talking about the reform of the international monetary system.⁴⁹ On the other hand, the U.S. Congress and government have been continuously blaming China "manipulating" its currency.⁵⁰ Will the bilateral financial quarrel be upgraded to a political struggle? Will the present "balance of financial terror"⁵¹ bring these two nations into common peace and prosperity or to a dangerous geopolitical confrontation, even military conflict?

⁴⁸ Source: State Administration of Foreign Exchange, People's Republic of China and the People's Bank of China

⁴⁹ Zhou Xiaochuan 2009. *Reform of the International Monetary System*. Website of Bank for International Settlements <http://www.bis.org/review/r090402c.pdf>

⁵⁰ Rick Gladstone. *U.S. Senate's Bill on Tariffs Angers China*. New York Times. October 4, 2011.

<http://www.nytimes.com/2011/10/05/world/asia/china-criticizes-senates-currency-manipulation-bill.html>

⁵¹ Joseph Nye *The Dollar and the Dragon*. Project Syndicate, July 12, 2010 <http://www.project-syndicate.org/commentary/nve84/English>

CHAPTER FIVE: THE U.S.-CHINA MONETARY DISPUTES

In recent years, the exchange rate of the Chinese currency has been a main topic of disputes between the United States and China. The U.S. side criticized China for ‘manipulating’ the currency exchange rate, which should be responsible for the U.S. trade deficits and the losses of jobs. The Chinese side rejected the accusations and stated that the appreciation of the renminbi would not help resolve the domestic problems in the United States.

Is the renminbi really undervalued? No one could give an empirically perfect explanation. Not only do politicians across the Pacific Ocean differ from each other on this issue, but also famous economists hold contradictory views. Even those, who agree that the renminbi is undervalued, hold very different views on how much it should be appreciated.

The exchange rate issue is never a pure economic issue. A method of political economy should be adopted to analyze this issue. The U.S.-China disputes on exchange rate reflect a monetary power game between the two biggest economies. Both the United States and China hope to adopt policies in accordance with their own national interests and receive as much economic and political gains in these exchange rate disputes.

The exchange rate issue is also a reflection of the international power structure (Zhang and Zhang 2005). Dollar hegemony is the main characteristic of the current international monetary system. The yen’s failure and euro’s success provided the renminbi two useful precedents of exit strategy from dollar dependency.

The United States may probably use different means of leverage to contain the renminbi's exit strategy, because it is of core interest to the dollar hegemony and the American empire. In certain circumstances, it might even use geopolitical weapons to undermine or halt the internationalization of the renminbi. Potential economic frictions or even security and military confrontations are possible to happen between the two states.

Backgrounds—The Chinese Exchange Rate Policy

Before 1994: Dual Exchange Rate System

After China adopted the policy of reform and opening-up to the outside world in 1979, its exchange rate policy was also under a certain kind of reform. The renminbi exchange rate to U.S. dollar was reduced significantly from 2.80 in 1985 to 5.22 in 1990. From 1985 till 1994, China maintained a dual exchange rate system as an ad hoc measure to gradually shift from a planned economy to a market economy (Yang 2005). That dual exchange rate system was made up of an official exchange rate system for trade settlement and a “relatively market-based exchange rate system that was used by importers and exporters in ‘swap markets’” (Morrison and Labonte 2011a: 2) to hedge the losses of the Chinese exporters in the trade conducted under the official exchange rate (Yang 2005). In 1994, the Chinese government started to reform that dual exchange rate system, aiming to “reform the foreign exchange management system, establish a managed float exchange rate system based on market and a unified foreign exchange market, and gradually make the renminbi a fully convertible currency” (Yang 2005: 63). The renminbi was actually pegged to the dollar at an

initial rate of 8.70 in 1994 and later on to 8.28 in 1997 and remained almost stable until July 2005. In 1996, the renminbi became convertible on a current account (trade) basis, but not on a capital account basis, which is still under strict control by the Chinese government today.

1994-2005: Pegging to the Dollar

From 1994 till July 2005, China kept pegging the renminbi to the U.S. dollar at an exchange rate of 8.28, which was mainly attempting to promote a relatively stable environment for foreign trade and investment in China, because such a policy, which was also adopted by many developing countries in their early development stages, could prevent large swings in exchange rates (Morrison and Labonte, 2011a). The mechanism of this exchange rate regime was described as: “the Chinese central bank maintained this peg by buying (or selling) as many dollar-denominated assets in exchange for newly printed yuan as needed to eliminate excess demand (supply) for the yuan. As a result, the exchange rate between the RENMINBI and the dollar basically stayed the same, despite changing economic factors which could have otherwise caused the yuan to appreciate (or depreciate) relative to the dollar. Under a floating exchange rate system, the relative demand for the two countries’ goods and assets would determine the exchange rate of the RMB to the dollar” (Morrison and Labonte, 2011a: 2).

2005-2008: China Reforms the Peg

On July 21, 2005, the Chinese government announced that the renminbi’s exchange rate regime would become “a managed floating system, based on market supply and demand

with reference to a basket of currencies”⁵² and that the exchange rate of the renminbi to the U.S. dollar would rise from 8.28 yuan to 8.11, an appreciation of 2.1%. From July 21, 2005 to July 21, 2008, the renminbi exchange rate against dollar appreciated steadily from 8.11 to 6.83, an appreciation of 20.8%.

2008-2010: Renminbi’s Appreciation Suspended and Resumed

In 2008, the situation of the financial crisis deteriorated, and many currencies devalued against the U.S. dollar. China narrowed renminbi’s floating band around mid-July 2008 (PBC 2011). In 2009, Chinese exports and imports fell by 15.9% and 11.3% over 2008 levels. Thousands of export-oriented factories went bankrupt in China’s coastal exporting bases. Around 20 million migrant workers lost their jobs in 2009 due to the effects of the global recession caused by the financial crisis (Morrisson and Labonte, 2011a). The renminbi/dollar exchange rate was maintained relatively constant at 6.83 through around mid-June 2010. On June 19, 2010, the People’s Bank of China (PBC), China’s central bank, decided to “proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility as the global economy stabilized and recovered” (PBC 2011: 5). The renminbi is again on a steady rise against the dollar.

From July 2005 till August 2011, the renminbi’s exchange rate with the dollar has gone up by 30.2%, and its real exchange rate rose by 23.1%. Though China still runs a surplus on its current account, the ratio between the current account surpluses to GDP gradually drops

⁵² Zhou, Xiaochuan, *Rules for developing a financial center and the reform of the RMB exchange rate regime* on the Website of the Bank for International Settlements. <http://www.bis.org/review/r050901f.pdf>

from its peak at 10.1% in 2007 to 5.2% in 2010 and 2% in 2011(PBC 2011). It seems that China is approaching the balance of payments equilibrium now.

A Political Economy Analysis of the U.S.-China Monetary Disputes

Obviously, exchange rate is not a simple economic issue, it is also a political one, because “it is the most important price in any economy...it affects all other prices... in most countries, policy toward the national currency is prominent and controversial” (Broz and Frieden 2008: 587). Susan Strange has noted earlier that “Decisions concerning the management of money substantially affect other matters of great political sensitivity” (Cohen 2000). Therefore, the choice of monetary policy often has deep political implications domestically, and the monetary management of major powers even has international significance.

At the same time, exchange rate is not solely decided by economic theories, as we have discovered in Chapter two. Unlike trade policy, which is supported by powerful economic arguments about the welfare of free trade, in currency policy, there is no clear economic theory for or against any particular level of exchange rate (Broz and Frieden, 2001). Kirshner believes that “in practice, economic theory is indeterminate in its ability to account for most monetary policy choices...[and] every choice about money reflects the outcome of a political contest” (Kirshner 2003: 647).

Therefore, the method of political economy has been utilized by some political scientists and economists to analyze the issue of exchange rate on both domestic and

international levels. On the domestic level, factors such as interest group and partisan pressures, the structure of political institutions, and the electoral incentives of politicians can have influence on the choice of exchange rate regime or the exchange rate level. On the international level, the character of the international monetary system is shaped by interaction among nation-states, especially the great powers, driven by their national interests (Broz and Frieden, 2001). And questions on the two levels interact with each other. In order to better understand the U.S.-China monetary disputes, such methods must be adopted.

National Political Economy Analysis

On the national level, domestic factors have influences on the choice of exchange rate regime, as well as the desired level of the currency. The U.S.-China monetary disputes, to some extent, are heavily affected by their respective domestic factors. According to the analysis model offered by Broz and Frieden (2001), interest groups, partisan influences, and political institutions may affect the choice of exchange rate regime and level. In the renminbi case, the U.S. side is concerned about the RMB exchange rate with the dollar, which is also the dollar's price in the RMB form.

The United States

Interest groups are affected by the exchange rate, which always has distributive consequences. For example, an undervalued RMB currency is harmful to American domestic manufacturers because a weak renminbi means high competitiveness of the

Chinese imported goods in the U.S. market and low competitiveness of the American exported goods in the Chinese market. However, low level of renminbi is beneficial to the American consumers and importers because they can buy Chinese goods at cheaper prices.

Globalization and out-sourcing have placed America on unfavorable conditions in its products' competitiveness, and the manufacturing industry faced severe unemployment problems. China's sharp increase in exports to the United States, since its accession to the WTO in 2001, has led to the latter's fast growing trade deficits, which becomes a good reason for the manufacturing industry to lobby the U.S. government to pressure the Chinese to appreciate its currency. It is believed that some organizations, such as the National Association of Manufacturers, American Textile Manufacturers Institute, and Coalition for a Sound Dollar have lobbied the U.S. Congress and both the Bush administration hard on this issue (Zhang and Zhang 2005).

Partisan influences also played a significant role in the RMB exchange rate issue. The character of American politics sometimes could make controversial topics a tool of the power struggle between the two parties. During the Bush administration, Democrats in Congress, represented by New York State Senator Schumer, had pressured hard on the Republican administration to label China as a 'currency manipulator'. Both parties may have same thoughts on the value of the Chinese currency, but they could also use this topic as a tool to blame their opponents for the domestic problems and win support from the constituencies. Especially during elections, China bashing is always a good tool, used by some candidates, to gain support. Mitt Romney, the leading Republican candidate, pledged

to "clamp down" on Beijing as a currency manipulator and openly threatened a trade war against China.⁵³ Therefore, the renminbi exchange rate issue could be extremely heated up in the election years. Politicians of the opposition party would seek to connect the high unemployment rate and the bad economic performance to the undervalued renminbi and criticize the ruling party's inability to put pressure on China. In order to show its firm commitment to the voters, the ruling party has to stand up to coerce China to make a concession, in order to refute the accusations made by the opposition party.

Political institutions and the interaction between them are counted as another factor affecting the exchange rate issue. The U.S. political separation of powers gives possibility for the power game between the Congress and the President on the renminbi exchange rate issue. The Congress has been more active than the administration by making dozens of resolutions and holding numerous hearings on this issue. For several times, the Congress has threatened to pass legislation to list China as 'manipulator' and punish China with high tariffs. However, the administration could always get the issue within control at the last moment, avoiding potential trade war with China. Congressmen represent their own constituencies, while the administration has to care about national issues such as the macroeconomic situation, employment, and trade deficits, as well as their relations with the dollar's exchange rate. The two institutions may share the same objective to pressure China to appreciate its currency, but they could also differ on the means of how to deal with the Chinese government. Similar to the partisan politics, the power game between the

⁵³ China Daily Online, February 8, 2012. "Xi's visit to boost Sino-US relations"
http://www.chinadaily.com.cn/china/2012-02/08/content_14555774.htm

legislative and administrative branches would somehow upgrade the exchange rate disputes between the United States and China.

China

China is much different from the United States in its domestic politics. However, interest groups, domestic stability, and pressure from the public may also affect the decisions taken by the Chinese government on the renminbi exchange rate issue.

So far, research on Chinese **interest groups** is very limited, but it is clear that interest groups are becoming more and more influential in the decision-making. Interest group lobbying is prevailing in the steel, electronic, and software industries in China. Exporters, especially the state-owned exporting enterprises, have deep influence on the exchange rate policy (Zhang and Zhang 2005). These enterprises are very sensitive to the change of exchange rate. A stable and weak renminbi is beneficial to their competitiveness.

Political Stability is another important factor that the Chinese government takes into consideration in exchange rate decision-making. The Chinese government firmly believes that China's 'reform and opening-up to the outside world' needs a peaceful international environment and a stable domestic environment. A sharp change in the exchange rate might have potential risks of triggering social instability, because this kind of change can possibly cause a wide range of exporting corporation bankruptcies and, thus, increase the unemployment level and cause instability. At the same time, the Chinese banking system is immature and unable to sustain potential financial fluctuations caused by currency appreciations. If the weak banking system is attacked, serious results such as those of the

1997 Asian financial crisis might happen (Zhang and Zhang 2005).

The **public opinion** also has certain influence on the exchange rate policy-making of the Chinese government. Since 2003, the renminbi exchange rate issue has become a focal topic of the public. Various scholars and different media have participated in the discussion of this topic. The public is in deep concern for the security of China's hefty foreign exchange reserve and holds a critical view towards the government's investment in U.S. agencies' (such as Fannie Mae and Freddie Mac) bonds and Treasury bonds. An appreciation of the RMB will result in huge loss of China's dollar reserve. The public's concern on the security of China's holding of the U.S. Treasury bonds could be reflected by the fact that when U.S. Treasury Secretary Tim Geithner told his audience that Chinese assets are very safe in a speech in China's Peking University in 2009, the audience burst into laughter.⁵⁴

Many Chinese also believe that Japan's 'lost decade' was a result of its mistaken exchange rate policy to sharply appreciate its currency under U.S. pressure. Therefore, they doubt that U.S. demand for a sharp appreciation of the RMB might be a hidden intension of containing China's economic rise. The Chinese government therefore is very cautious and discreet in making big decisions concerning exchange rate change. It has held several forums participated by world well-known economists and encouraged open debate in the society about the gains and losses of the renminbi exchange rate reform. The public opinion did, to some extent, check the policy-making of the Chinese government.⁵⁵

⁵⁴ Reuters online, June 1, 2009. <http://www.reuters.com/article/2009/06/01/usa-china-idUSPEK14475620090601>

⁵⁵ Interview with Huang Yiping. "China Can Mobilize the Public Opinion to Counter U.S. Pressure on Exchange Rate",

International Political Economy Analysis

According to Broz and Frieden (2008), analyses of international monetary regimes regard nation states as decision-making units and study how these units deal with standard *coordination* and *cooperation* problems. With the *coordination* problems, we need to understand the character of the current international monetary system. As for the *cooperation* problems, we should look at “purposive relations among states, including strategic interaction among governments, driven by their national concerns and constrained by the international environment” (Broz and Frieden 2001: 337).

Coordination and the International Monetary System

Unlike the Bretton Woods system, which is shaped by fixed exchange rate arrangement between the U.S. dollar and other currencies, the current international monetary system is based on a floating arrangement, as declared by the Jamaican Agreement. Most developed countries adopt such exchange rate regimes, with their currencies’ external values decided by the market. Most developing countries adopt an exchange rate regime with a peg to one single currency or a basket of currencies. This floating exchange rate system is mainly characterized by the principle that the market decides the price of the currency, and the governments usually do not intervene in the exchange rate market. However, major states still have to coordinate on this issue in certain international economic environments. In the 1980s, major industrialized countries coordinated their policies of appreciating the exchange rates of main currencies against the

U.S. dollar. After the 2008 financial crisis, the G20 member states jointly participated in coordinating with each other and worked together to avoid a competitive devaluation of their currencies.

The U.S. dollar sits in the center of the current international monetary system as the main reserve currency. Depending on this status, the United States exports large quantities of its national currency in exchange for goods and resources. The rest of the world trades their goods and resources for dollar reserves, aiming to stabilize their own currencies from any potential speculations and buy strategic products, such as oil, only denominated in dollars. As Henry C.K. Liu described, “world trade is now a game in which the United States produces dollars and the rest of the world produces things that dollars can buy.”⁵⁶ Therefore, this obvious character of the current international monetary system of ‘dollar hegemony’ and asymmetrical interdependence often witnessed *coordination* problems to be solved favorably towards the United States. In the 1980s, The United States blamed that Europe and Japan artificially maintained their currencies at low levels and unfairly benefited from the trade with the United States. The Plaza Accord, signed between the United States and other major industrialized countries in 1985, was the first main agreement on exchange rate coordination under the current international monetary system and mostly reflected U.S. benefits and strategies. Japan and Europe were pressured by the United States to substantially appreciate their currencies unilaterally to allow the U.S. dollar to devalue. Almost twenty years later, history repeats itself. Similar calls were made again by the U.S.

⁵⁶ Asia Times Online, April 11, 2002. <http://www.atimes.com/global-econ/DD11Dj01.html>

side, but this time the object was China.

This is the background for the current U.S.-China monetary disputes. The dollar's hegemonic status in the international monetary system bestows the United States with great flexibility and autonomy, while the renminbi's peg to the dollar exemplifies its dependency on this system, forcing China to passively coordinate with U.S. policies. Considering China's economic volume and its huge trade surplus, mainly from the trade with the United States, a fixed rate regime is very difficult for the two to coordinate with each other under this floating system. Therefore, disputes and frictions are bound to emerge between these two countries. Because of their different status in the system, the United States tends to play an active and aggressive role, while China is generally passive and defensive. As long as the current international monetary system does not change significantly or China does not reform its exchange rate regime, the disputes between them will remain an obvious presence.

Cooperation and the U.S.-China Monetary Disputes

As Broz and Frieden (2008: 590) have observed, "even a system as simple as the gold standard sometimes relied on agreements among countries to support each other's monetary authorities in times of difficulty." Therefore, explicit cooperation among its major members is necessary in order to keep this monetary system in shape.

U.S.-China monetary relations were most vividly described by Ferguson (2008) as 'Chimerica', a symbiotic financial symbiosis model of cooperation between the "world's sole superpower and its most likely future rival" (Ferguson 2010). He thought it as a strange

and odd relationship when he coined this term with a reference to the chimera, “the monstrous hybrid like the part-lion, part-goat, part-snake of legend” (Ferguson 2010). Within this bizarre relationship, the poor (China with an average income of less than \$2,000) did the saving and lending while the rich (the United States with an average income of more than \$34,000) did the spending and borrowing (Ferguson 2008: 335). He thought it was, for a time, “a marriage made in heaven” (Ferguson 2008: 336). Then, the 2007 financial crisis brought frictions and quarrels to the relationship, and he thought this happy marriage was going to an end (Ferguson 2010).

Ferguson’s term is a perfectly vivid expression of the financial cooperation between the United States and China under the current international monetary system. Both the United States and China truly benefited from this relationship. For China, the key attraction of this cooperation was its potential to propel the economy forward by means of export-led growth. Its exports in 2000 were around \$250 billion, but rose to \$1.3 trillion in 2008. China's current account surplus in 2001 was a mere \$17 billion when it entered the WTO. By the end of 2008, it was approaching \$400 billion. Its GDP in 2000 was around \$1 trillion, the world’s No. 6. Ten years later, it quadrupled and has surpassed France, Great Britain, Germany, and Japan to be the world’s No. 2 (Ferguson 2010).

As for the United States, gains from the cooperation were obvious and substantial. Most parts of the huge amount of dollars exchanged for Chinese goods flowed back to the United States, enabling it to consume more, save less, and still maintain low interest rates and a stable rate of investment. According to Ferguson’s (2010) calculation, between 2000

and 2008 the United States outspent its national income by a cumulative 45 percent, i.e., total U.S. spending over the period was 45 per cent higher than total income. Purchases of goods from China, in excess of income, accounted for about a third of over-consumption. Because of this relationship, the Americans could have lived beyond their means in the past decade. And for the same reason, the United States could wage two costly wars at the same time in the Middle East.

However, I do not agree with Ferguson that the relationship is going to an end. Though frictions and quarrels on renminbi exchange rates have become fiercer in recent years, both sides actually refrained from upgrading the disputes to a diplomatic confrontation or trade war. Especially after the financial crisis, both sides cooperated well under the G20 framework and maintained the disputes under control, because, so far, this relationship still serves as a more positive role to both parties. China cannot restructure its economic pattern from an export-dependent one to a domestic demand-dependent one overnight and it still needs the U.S. market for its future exports. The United States needs a steady inflow of capital from China “both to finance its deficit spending and private consumption, and to maintain the dollar’s position as the international economic system’s reserve currency” (Layne 2011: 156). So far, gains of cooperation still outnumber the costs of confrontation. In the short term, monetary cooperation will prevail in the U.S.-China relations.

However, in the long run, the benefits of this cooperation may gradually diminish, while costs or risks could increase. Rising concerns have been expressed by politicians and

scholars in both countries on this relationship (Morrison and Labonte, 2011b). Some U.S. policy makers have worried that China's large holdings of its securities could pose a risk to the U.S. economy if China stops purchasing the U.S. securities or attempts dumping a large share of its holdings. Others argue that China could use its holdings as leverage over the United States on economic and noneconomic issues. Chinese politicians have expressed concerns over the security of its U.S. debt. Both sides talk about negative scenarios in future cooperation, but do not mention the benefits from this relationship. If the two sides' future policy aims do not converge, disputes and friction will possibly emerge. If one side's gains gradually fade away and costs increase, it might cease to cooperate and the interdependency could collapse.

Future of the U.S.-China Monetary Relations And Its Geopolitical Implications

As discussed above, in the long run, the monetary relations between the United States and China may witness fluctuations and confrontations. Or possibly, the U.S.-China monetary relationship becomes a reason, source, and objective of great power rivalry between the two states.

Fundamental Flaws of the Current U.S.-China Monetary Relations

Though dollar is not backed by gold anymore, its role as the hegemonic reserve currency makes the 'Triffin Dilemma' continue to be a flaw of the current monetary system. The dollar's reserve currency status requires the United States to run a current account deficit to export dollars to the world, and a steady outflow of the dollar will drive down its

external price, i.e., the exchange rate against other currencies. However, the dollar's credibility as a store of value (reserve currency status) lies in its stable external price, but a devalued dollar will definitely cause concerns from those who hold the dollar reserves. More seriously, when faced with difficult economic situations, the United States tends to take unitary actions, such as quantitative easing measures, which erode the value of the dollar. This is the fundamental and structural reason for any future frictions between the two biggest economies in their monetary relations.

Within the U.S.-China monetary relationship, the two sides are not on equal footing. The dollar sits in the center of the system as the world's main reserve currency, enjoying all the benefits that the system may bring to it, while the renminbi is still distant from being an international currency and, to some extent, depends on the system as many other currencies of developing countries.

As discussed in chapter 4, the dollar's main reserve currency status enables the United States to act unilaterally in macroeconomic policy making. Since the hi-tech bubble burst in 2000 and the 9/11 terrorist attacks in 2001, the United States maintained an expansive fiscal policy in order to keep the economy booming and to finance the two anti-terrorist wars in Afghanistan and Iraq. It seemed that a 'weak dollar' strategy has been adopted by the U.S. authorities (see figure 5).

The dollar's devaluation could bring the United States tangible benefits, such as improving the competitiveness of U.S. goods and closing its current account deficit, stimulating the economy and avoiding potential recession, and, at the same time, lowering

America's external liabilities (Buiter and Rahbari 2011). To pressure China to appreciate its currency could help to ease the U.S. liabilities, as well as increase its revenues of investment in China since its debt is in dollars and its investment in China is denominated in renminbi. For example, if the renminbi were to appreciate against the dollar 20% (as it did in 2005-2008 period), in a short time the dollar would be devalued by 17% against the renminbi. The Department of the Treasury reported in September 2011 that China's Treasury securities holdings were \$1,174 billion as of May 2011.⁵⁷ Therefore, the United States could easily remove around \$200 billion ($1174 \times 17\% \approx 200$) external liabilities during that short period of time. At the same time, the U.S. investment in China from 2003 through 2009 was \$49.4 billion and could gain a 20% increase of return, around \$10 billion. Therefore, it is a good deal for the United States to pressure its creditors to devalue their currencies. Since 2005 until today, the renminbi's exchange rate against the dollar went up steadily from 8.29 to 6.29,⁵⁸ a 30% increase. The loss of value of China's dollar holdings is rather colossal.

China's monetary policy is also problematic. Although, pegging the yuan to the dollar can bring China some favorable results, such as creating a stable environment for its foreign trade, protecting the renminbi from future speculations and to some extent preventing the loss of its dollar reserves, the disadvantages and risks of that policy are also obvious.

First, China's monetary policy added to the domestic inflationary pressure. China maintained a strict control on capital flow. Under Chinese law, most foreign capital entering

⁵⁷ U.S. Department of the Treasury, *Major Foreign Holders of U.S. Treasury Securities*, May 16, 2011.

⁵⁸ Data from Bank of China on February 20, 2012. <http://www.boc.cn/sourcedb/whpj/>

the country must be converted into the renminbi, thus causing a sharp rise in China's money supply and resulting in serious inflation (Figure 6). To the Chinese government, high inflation is a serious issue, because it is directly connected to the daily life and welfare of 1.3 billion people. High inflation can also arouse concerns of social and political instability. To control inflation at a reasonable level is always one of the priorities of the Chinese government, but constant large inflow of foreign capital has partly offset the government's efforts to control the inflation.



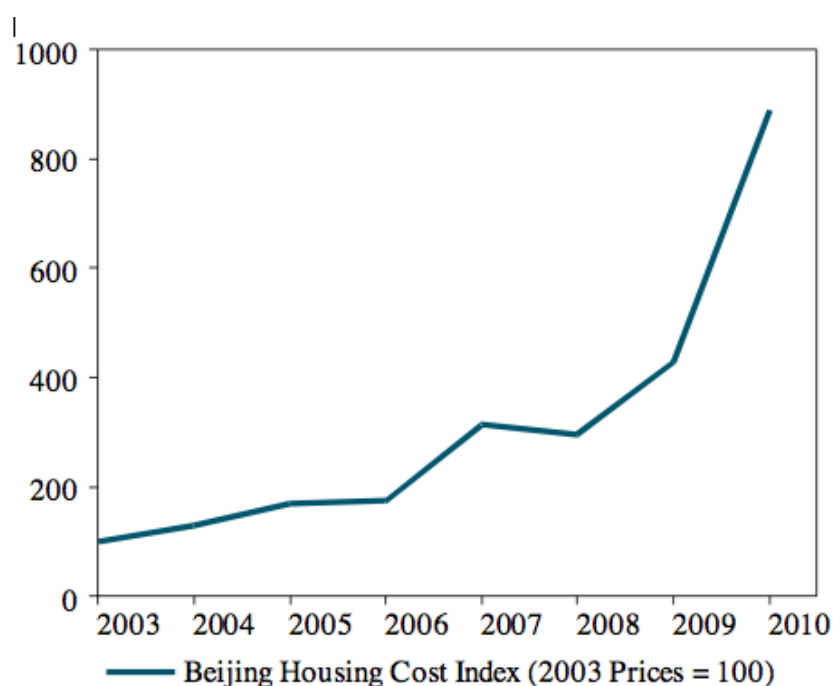
Source: Geoff Riley, May 12, 2008. "China Consumer Price Information." Published on Tutor2u.net.

<http://tutor2u.net/blog/index.php/economics/comments/chinas-inflation-problem/>

Cited from Reuters EcoWin. Data from IMF

Figure 6: China's Inflation Rate

Second, China’s monetary policy helped to drive up the asset bubble. China had a systematic overinvestment and an overextended banking system, because of the same above-mentioned reason—an oversupply of money. The real estate price bubble has reached a risky level as specialists warned (Wu, Gyourko and Deng 2010). From 2003 to 2010, the land price in China’s capital city has more than quadrupled (Figure 8). That situation compelled the Chinese central government to implement “the strictest regulation to date”⁵⁹ in 2010, in order to cool down the real estate market even at a cost of a slowing down its economy. Almost two years have passed, but this situation still remains in China today.



Source: Wu, Gyourko and Deng (2010) “Just how risky are China’s housing markets?” VoxEU, July 28, 2010. <http://www.voxeu.org/index.php?q=node/5353>

Figure 7: Real Constant Quality Residential Land Price Index for Beijing, 2003-2010

⁵⁹ Don Weinland, “[Commentary] China’s housing market: strictest regulation to date”, *China Election and Government*. April 26, 2010. <http://chinaelectionsblog.net/?p=4372>

Third, China's rigid policy of pegging the yuan to the dollar triggered a big wave of speculations, posing serious risks to the Chinese economy. Expectation of the future appreciation in the value of renminbi attracted a large inflow of financial capital into China, commonly referred to as "hot money". The amount of "hot money" pouring into China in 2008 was estimated to reach \$1.75 trillion (Martin and Morrison, 2008). The "hot money" exacerbates the already over-heated economic environment, pushing up inflation and inflating the asset bubble in China. Because of this reason, the Chinese government has been reluctant to appreciate its currency, fearing large quantities of foreign investment would escape the Chinese markets, with fat margins, thus leaving behind a similar mess as the speculative capitals had left in the Asian financial crisis.

The Chinese government now is faced with a dilemma. If it maintains the problematic monetary policy, it will become more dependent on the current international monetary system and its autonomy and flexibility in macroeconomic policies will be eroded. But if it appreciates its currency sharply, a big part of the value of its tremendous foreign exchange reserve will be lost. This situation was described by Eichengreen (2009) as "[China] is trapped by the magnitude of its current dollar holdings." John Maynard Keynes' famous remark comes to mind: "If you owe your bank manager a thousand pounds, you are at his mercy. If you owe him a million pounds, he is at your mercy" (Eichengreen 2009). Obviously, China is at the United States' mercy now.

In the long run, China must map out an exit strategy to withdraw from the so-called 'dollar trap'. Because of the above mentioned reasons, the Chinese government began its

monetary reform since July 2005, but in a very careful and discreet way. It halted the reform in 2008, concerned with impacts from the international financial crisis. It resumed its reform process in 2010.

The Future of Dollar Hegemony and Reminbi's Exit Strategy

In the foreseeable future, the dollar will remain as the main reserve currency, though its hegemonic status may be challenged from the euro, the renminbi or the IMF-issued Special Drawing Rights (SDR). According to Eichengreen (2011), the renminbi will become one of the three main reserve currencies in the not so distant future.

Future of Dollar Hegemony

The United States' hard power can still support the dollar's dominant reserve currency status. It is the largest economy and the biggest trader in the world today. Its GDP is almost two and half times that of the second biggest economy—China.⁶⁰ Its military might is second to none and its military spending surpasses that of the next ten states combined (Bouhan and Swartz 2011). The United States owns the deepest and most liquid financial market. All the above mentioned hardware can secure the dollar's incomparable advantage and may easily intimidate any potential challenge to dollar's reserve currency status so far.

Lack of alternatives to the dollar was another important reason for the lasting dollar hegemony (Eichengreen 2009). The Sterling and the Swiss franc are far from challenging the dollar because of the relatively small scale of the economies of their issuers. Japan has a

⁶⁰ Data from World Bank of GDP 2010. U.S. GDP=\$14.582 trillion, China GDP=\$5.879 trillion.
<http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf>

bigger economy, but it lacks willingness, as well as economic potential, to promote the yen as a main international reserve currency. The Chinese renminbi remains inconvertible so far and China does not have a deep and liquid financial market, which makes the renminbi not a possible international currency in the short run. The euro is so far the closest competitor to the dollar since WWII. However, it seems that this common currency has a fundamental flaw. The current debt crisis in the euro zone has clearly shown the flaw in the design of the euro. It is a currency without sovereignty. A former Belgian Prime Minister said recently that “a state can exist without a currency, but a currency cannot exist without a state”.⁶¹ The euro zone countries have a common currency, but not common fiscal policies. The euro zone member states need to further transfer sovereignty to a supra-national governance system overseeing the common currency. But this requires long-time bargains and consultations among the euro zone members. Fortunately, the EU has just embarked on this long march a few days ago. The 25 member states of the EU (excluding the UK and the Czech Republic) signed a fiscal treaty on March 3, 2012, committing their countries to tighter budget discipline.⁶² The last alternative to the dollar is the SDR, a pseudo-currency that some scholars compare to the language of Esperanto (Reisen 2009). The industrialized countries had made such efforts in the 1960s to shift their dollar reserves into SDRs, but failed finally. Though calls for a larger role of the SDR, as an international reserve currency, have been heard from officials in China and Russia, scholars tend to believe that it is not

⁶¹ The Global and Mail, Feb 02, 2012. “Ten years after the euro's launch: How could it have gone so wrong?” <http://m.theglobeandmail.com/report-on-business/economy/currencies/ten-years-after-the-euros-launch-how-could-it-have-gone-so-wrong/article2287088/?service=mobile>

⁶² European Voice, March 3, 2012. “EU leaders sign fiscal treaty”. <http://www.europeanvoice.com/article/2012/march/eu-leaders-sign-fiscal-treaty/73766.aspx>

likely to replace dollar in the near future (Humpage 2009, Reisen 2009, Chinn and Frankel 2008).

Inertia is another reason that the dollar can still play a main reserve currency role. This is a classic instance of what some scholars call “network externalities” (Goldburg 2010). The users stick to an international money because others are using it. The sterling’s reserve currency status was heavily undermined in the First World War, and Great Britain had already ceased to be the largest economy and biggest exporter before the war ended, but the sterling regained its dominant position as a key currency in the interwar era. This was primarily due to the inertia in such arrangements (Chinn and Frankel, 2008).

Based on the above analysis, it is very possible that the dollar will continue to be the dominant international currency in the foreseeable future. Dollar hegemony and dollar dependency will probably be the main characteristic of the current international monetary system in the decades ahead.

Renminbi’s Exit Strategy

China has already been aware that renminbi’s dependency on dollar was problematic. The future Sino-US monetary relations, if not changed, will bring various negative impacts to China’s economy in the long run. In order to make a better use of its huge foreign exchange reserves, while at the same time avoiding any sharp devaluation of its dollar holdings, China has to maintain the status quo but gradually implement the strategy of exiting renminbi’s dependency on dollar.

It would be a wise idea for China to materialize its dollar reserves now before

potential devaluation in the long run. In recent years, China has been searching around the world to purchase resources that its fast economic development needs. The past few years have witnessed Chinese firms buying natural resources in the Middle East, central Asia, Africa and Latin America. But China's large purchases of natural resources and its economic relations with some African countries were labeled by the United States as "neo-colonialism".⁶³ Chinese companies also wish to purchase assets in the United States, as the Japanese did in the 1980s. The Chinese largest PC manufacturer, Lenovo, purchased the IBM PC part in 2004. Privately-owned Chinese automaker Geely bought Volvo from Ford in 2010. But many similar deals were ruled out by U.S. policy makers due to national security concerns. Chinese companies such as CNOOC (a state-owned oil company), Haier (a privately-owned home appliance maker), and Huawei (a privately-owned telecommunications company), etc., were blocked in buying American firms because of noneconomic reasons.

China pursues an ambitious long-term objective of "the great rejuvenation of the Chinese nation".⁶⁴ As Nobel laureate Mundell (2003) said, great powers have great currencies; China is now the second largest economy and the biggest exporter. It is reasonable for it to bear the ambition to turn its money into one of the main international reserve currencies in order to serve its national interests and grand strategy. At present, China's reform of the monetary policies may bear some costs, but in the long run,

⁶³ The China Times, June 11, 2011. "Clinton Warns Africa against 'China's Neocolonialism'". <http://www.thechinatimes.com/online/2011/06/154.html>

⁶⁴ Xinhua News Agency, October 19, 2011. "Hu urges mainland, Taiwan to work together for rejuvenation of Chinese nation". http://news.xinhuanet.com/english2010/china/2011-10/09/c_131180661.htm

internationalization of the renminbi will serve a strategic role for China's rise, because of the economic and political benefits that an international currency can bring to its issuer. Europe's experience suggests that in order to become an international reserve currency, the renminbi must stop depending on the dollar and gradually build its reputation as a stable means of store of value for international investors.

Actually, China started to explore this possibility a few years ago. In 2006, a study group set up by China's central bank published a paper named "The Timing, Path, and Strategies of RMB Internationalization". Since the onset of the global financial crisis in 2008, it seemed that China has accelerated its pace of renminbi internationalization. Since 2008, China has signed currency swap agreements with 15 countries and regions, encouraging international use of the renminbi.⁶⁵ It has also loosened control on Chinese and overseas companies to buy off-shore and on-shore bonds respectively sold in Hong Kong and Shanghai. China's commercial banks have opened branches in various parts of the world.

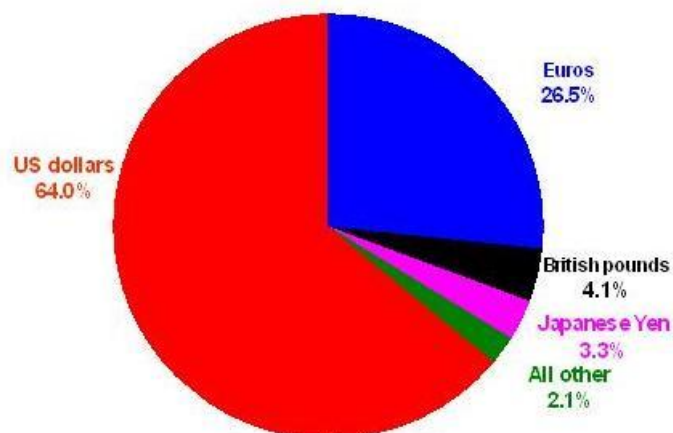
Based on the characters and prerequisites of an international reserve currency as discussed in Chapter 4, China can almost meet two: a large economy and big trade volume, and the ability to maintain the value of the currency. But on the third criterion—a deep and liquid financial market—China lags far behind. In order to meet this criterion, China must adopt significant reforms in its monetary policies to meet two important aims: 1) to make the renminbi a fully convertible currency and 2) to lift control on capital account. Li Daokui,

⁶⁵ China Daily Online, February 22, 2012. "China, Turkey sign currency swap deal"
http://www.chinadaily.com.cn/bizchina/2012-02/22/content_14664806.htm

an adviser to PBC, was quoted as saying last year that the renminbi will become fully convertible in five years.⁶⁶ The Chinese central government also pledged to turn Shanghai into a financial center no later than 2020 (Cohen 2012). If these two aims are to be achieved as planned, the renminbi is hoped to emerge as an international currency in 2020. However, based on China's strategic design and choice of means in its internationalization of the renminbi, Cohen (2012: 9) evaluated that "the progress towards the 'yuan tomorrow' is unlikely to be as smooth or as swift as many have predicted".

Cohen might not be regarded as a pessimist if we look back at the history of yen and euro's internationalization process. Both Europe and Japan faced the same problems and challenges that China faces today. They have done their utmost to advance the internationalization of their currencies since the 1980s. They went through hardships and setbacks, such as the bursting of the Japanese asset bubble and the European Currency Crisis in 1992. At present, the euro accounts for 26.5% of all international currency reserves (Figure 8). Europe has made profound success through monetary union, though uncertainties on euro's future still remains. But the yen is far less successful, with only a mere 3% of world currency reserves. Japan still relies heavily on dollar hegemony. It is the second largest holder of U.S. debt after China. If history does prove something, then the renminbi's internationalization might last for decades.

⁶⁶ Bloomberg News, September 26, 2011. "Yuan 'Fully Convertible' in 5 Years: Adviser"
<http://www.bloomberg.com/news/2011-09-25/yuan-may-become-fully-convertible-in-5-years-pboc-adviser-says.html>



Source: Humpage, Owen (2009). “Will special drawing rights supplant the dollar?” VoxEU.org. May 8, 2009. <http://www.voxeu.org/index.php?q=node/3538>. Data from IMF, *International Financial Statistics*, COFER data

Figure 8: World Reserve Currency Composition

Geopolitical Implications for the Future U.S.-China Monetary Relations

As discussed in Chapter 3 and 4, monetary relations bear geopolitical implications. The current U.S.-China monetary disputes are also a reflection of the great power politics between the two states. In the long run, if China forges ahead in renminbi internationalization, tensions will be increased, even confrontations are possible.

Past Models to follow?

In the four cases of power struggle via monetary relations discussed in Chapter 4, which could be a useful model for predictions of future U.S.-China monetary relations? The author’s estimation is that it would be largely following the Japanese model.

Could the “peaceful transition” between the Great Britain and the United States of monetary hegemony be a possible model for future monetary relations between the United States and China? Not very likely in the short run. The U.S. GDP surpassed that of Great

Britain in 1872, and it replaced the latter as the biggest exporter in 1915, but it finally secured its monetary hegemony 73 years later in 1945. The inertia of the incumbent international currency should never be underestimated. According to the most optimistic estimate, China would become the largest economy around 2028 (Layne 2011: 152). Based on the above pace of transition, China might possibly become the monetary hegemon around 2100. If the United States does not go to big wars, as the UK did in the two world wars, the Pax Americana may last much longer.

Although China is regarded by many U.S. analysts and policy makers as a potential rival, its monetary relations may not bear heavy confrontational characteristics as in the U.S.-Soviet monetary relations. The Soviet Union and its satellite states formed its own economic and political bloc and isolated themselves from the capitalist world. The two superpowers almost had no monetary cooperation at all. However, China maintains a close cooperation with the United States on monetary issue. Both sides are interdependent on this relationship. The future U.S.-China monetary power struggle may bear some confrontational elements but definitely will be more complicated than the U.S.-Soviet one. It could be both cooperative and confrontational.

Could the EU's common currency model provide China with any useful experience? The EU member states have shared values, similar cultures, and approximate political systems. However, in East and Southeast Asia, countries have very different political systems, ideologies, historical grievances, as well as territorial disputes. An Asian common currency seems very distant from the present situation.

The Japanese model of monetary relations with the United States could provide China with a rich experience base. China today shares many commonalities with Japan in the 1980s. Both nations relied heavily on an export-led economic model. Both were pressured by the United States to appreciate its currency. Both faced serious asset bubbles. And most importantly, both have accumulated huge amounts of foreign reserves, mainly in dollars. How did Japan manage to get out of this “dollar trap”? It purchased large quantities of assets in the United States, provided huge sums of aid packages to its neighbors, and encouraged an international use of its currency. So far, it seems that China is walking on the Japanese path to internationalizing its renminbi, but one thing remains very different. On security issues, China is not reliant on the United States, meaning that China will have much larger autonomy in making monetary policies, albeit its dollar dependency. Based on the same reason, China is regarded by the United States more as a rival rather than an ally. On its long march of renminbi internationalization, China will feel much more pressured by the United States than Japan did in the 1980s and 1990s. The most important lesson that the Japanese model could offer is that a sharp appreciation of its currency is very dangerous. This gives a good reason why China is always so careful in the decision making of its monetary policies. Therefore China’s future monetary relations with the United States will likely to follow the Japanese model. However, because of China’s larger autonomy, the Sino-American monetary relationship may be more confrontational and unpredictable than the U.S.-Japanese one.

Trail Blazing for Renminbi

As discussed above, although the yen's past experience can provide many useful materials for predicting future U.S.-China monetary relations, the renminbi might have to break a new path to its internationalization. Deeper and richer implications will result from the U.S.-China monetary power struggle than could have resulted from the Japanese model.

Both the United States and China are aware of the economic gains and losses in their monetary cooperation. In recent years, the United States has maintained a weak dollar policy and allowed the dollar to devalue significantly against other main currencies based on its large macroeconomic flexibility conferred by dollar's hegemony. At the same time, it ran large budget and balance of payments deficits. However, China's fixed exchange rate offset the benefits that this weak dollar policy could bring to the United States. This could be the first reason for the U.S.-China monetary disputes. The weak dollar policy serves a strategic role for the U.S. economy, but it is at the cost of the foreign dollar holders, among whom China is the largest. This might be the second reason for their disputes. Obviously, China is reluctant to be cooperative on the U.S. call to appreciate the renminbi, which will bring further losses to its dollar assets.

Besides the above-mentioned economic reasons, both sides might have geopolitical considerations in their monetary cooperation and disputes. The cheap and constant capital inflow from China is of great importance for the United States, especially when it was fighting the global anti-terrorist wars. This is why some analysts are criticizing the U.S. policy of relying on the capital inflow from China, a potential rival. At the same time, China relies heavily on the U.S. market for its exports; without this market, the substantial Chinese

economic rise could not be possible. This is the reason why both sides could avoid serious diplomatic confrontations, even in the climax of exchange rate disputes in the past decade. This cooperative trend is expected to be maintained in the foreseeable future.

However, China has long been seen as a potential rival to the U.S. global preeminence in the post-cold war era. China's quick economic rise in recent years has caused a wide range of concerns from the U.S. side. Although there is not sufficient proof that the U.S. pressure exerted on China over exchange rate issue is aiming to contain China's economic rise, analysts and scholars in China are debating heavily on this possible element. Many tend to believe that Japan's two-decade-long recession was primarily caused by its sharp appreciation of the yen under U.S. pressure. Objectively speaking, Japan's asset bubble burst and the following 'lost decade' was mainly a result of its own macroeconomic policy mistakes, but the sharp exchange rate change definitely played an important exterior role of inducing the asset bubble. Therefore, the U.S. Constant call on the renminbi's appreciation is widely regarded by Chinese strategists as a conspiracy to contain China's rise.

The United States is also vigilant on China's efforts to buy resources globally and, at the same time, to offer cheap and favorable loans to many developing countries. Recent reports have shown that American policy makers fear "China is using cheap rate loans to 'buy' influence among the left-leaning Latin American governments that are hostile to western interests".⁶⁷ Truly, China can diversify the investment of its huge foreign exchange

⁶⁷ Financial Times, February 15, 2012. "China lends more than \$75bn to Latin America". <http://www.ft.com/intl/cms/s/0/d9dc3d98-57ed-11e1-ae89-00144feabdc0.html#axzz1mSkPlqtE>

reserves, instead of buying U.S. Treasury bonds only. China's generous aid packages to poor African countries and low-rate loans to developing states will definitely promote its influence on these states.

The U.S. high-profile return to the Asia-Pacific region has been perceived by many analysts as a new move to check China's expansive influence in Asia. The newly released U.S. Pentagon "Strategic Guidance" document was thought by many media as a U.S. effort to "stand up to China".⁶⁸ It definitely infuriated some Chinese policy makers that the United States supported some Southeast Asian countries, who have territorial disputes with China on the South China Sea, to openly challenge China's position.⁶⁹ The Trans-Pacific Partnership (TPP), a free-trade agreement that the United States has been promoting hard in recent years, was regarded as a counter measure to China's economic and political influence in the framework of 10+3.⁷⁰ China is already the biggest trading partner of Japan, Korea, as well as the ASEAN bloc. So far, China has signed currency swap agreements with Korea, Malaysia, and Indonesia, promoting the international use of the renminbi in bilateral trade with these countries. If one day, all the 10+3 members trade in the renminbi, then it will sound a signal for the greenback's demise in East Asia. Even in the heydays of its booming economic development, Japan carefully promoted yen expansion in Southeast Asia, avoiding challenging dollar hegemony. Japan's proposal to set up a financial facility,

⁶⁸ The New York Times, February 18, 2012. "The End of American Intervention"
http://www.nytimes.com/2012/02/19/opinion/sunday/the-end-of-american-intervention.html?_r=1&sc=5&sq=new%20pentagon%20strategy&st=cse

⁶⁹ Council on Foreign Relations, October 11, 2011. "Growing U.S. Role in South China Sea"
<http://www.cfr.org/china/growing-us-role-south-china-sea/p26145>

⁷⁰ Ten ASEAN members (Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam) plus China, Japan and Korea.

dubbed as the Asian Monetary Fund, to help protect Southeast Asian countries against speculations after the Asian financial crisis, was quickly suppressed by the United States (Cohen 2003). China's monetary cooperation in East and Southeast Asia will surely cause rising concerns of U.S. policy makers.

So far, the renminbi has yet played an international role, but Eichengreen (2011) predicts that it will rise to one of the three main reserve currencies in the coming decades, though its influence will probably be limited in Asia. In 2009, the Governor of the People's Bank of China Zhou Xiaochuan proposed that the dollar should be replaced as the key international reserve currency by the SDR. Eichengreen (2011) believed that Zhou's real intention of saying this was to express China's dissatisfaction over the sharp devaluation of the dollar in recent years and to cover up China's ambition to internationalize its own currency.

China may push forward its renminbi internationalization as carefully as the Japanese did, because so far to maintain the status quo and to avoid challenging U.S. interests serves China's own interests. However, in the long run, China's further promotion of the international use of the renminbi will probably cause tensions in U.S.-China bilateral relations, as well as in the regional situation in East and Southeast Asia.

Cohen (2003) has predicted that there is a significant potential risk of direct confrontation between the EU and the United States in the Middle East. As discussed in Chapter 3, the Iraq War is regarded by some analysts as an "oil currency war" waged by the United States against the transition from petrodollar to petroeuro (Clark 2005). Based on

Cohen's logic, the author speculates that the current turmoil in the Mediterranean region (Tunisia, Egypt, Libya, and Syria etc.) also partly reflects the power struggle between Brussels and Washington to influence these countries to rely more on the dollar bloc or the euro zone. U.S. efforts to pursue regime change in this region could be regarded as a direct challenge to euro's influence in the traditional backyard of Europe, the so-called "euro time zone" (Cohen 2003: 8). From this perspective, the author is confident to predict that the United States might not directly confront China, but would attempt to undermine China's monetary influence, mainly in the Southeast Asian region.

CHAPTER SIX: CONCLUSION

This thesis has comprehensively analyzed the history, background, facts, reasons, as well as geopolitical implications of the current monetary disputes between the United States and China on the renminbi exchange rate issue. This research has achieved its goal by putting the disputes in the framework of monetary power struggle between the two states. The methodology of case study and comparative historical analysis has been used to compare past precedents of monetary power struggles and predict future monetary relations between the United States and China.

As a first step, this thesis studied four cases of monetary relations in history and compared their commonalities and differences, respectively. Then, it closely investigated the dollar hegemony, including its history, main characters, operational mechanisms, as well as geopolitical meanings. Dollar hegemony is the main character of the current international monetary system, without which it is not possible to discuss any bilateral monetary relations in the world. Thirdly, it touched the renminbi exchange rate issue by recalling the background of the yuan exchange rate, depicting the main points of their disputes, analyzing the reasons behind these disagreements using a political economic perspective. Fourthly, it concluded that the dollar hegemony and the asymmetrical interdependency between the yuan and the dollar are the sources and key basis for U.S.-China monetary disputes. Finally, it explored the geopolitical meanings of the current monetary disagreement and used the four precedent cases of monetary power struggle to predict the future U.S.-China monetary

relations.

Many of the explorations inside this thesis are not new. Most academic fruition focused their attentions on technical issues, i.e., the economic meanings of the exchange rate issue. However, more and more scholars are joining the debate now on how to perceive the exchange rate question from political perspectives. Based on the past academic fruition, the thesis has explored far into the future geopolitical implications of the monetary power struggle in one of the most important bilateral relations of the 21st century.

The thesis has reached its conclusion: the Current US-China monetary disputes are the results of the influences of respective state's domestic factors. Monetary disputes reflect a power struggle between the two states. The U.S.-China monetary relations will influence the future bilateral and international relations. The bilateral quarrels on the renminbi exchange rate have been and will continue to be an economic competition and power struggle between the United States and China.

The strengths of this thesis mainly lie in the rich paradigm that it uses—IPE—to dig into the real reasons and implications of the diplomatic frictions on the exchange rate issue. In the current IPE studies, there have not been many systematic analyses in the relations between money and power. Susan Strange is a pioneer. Followers such as Benjamin Cohen, Jonathan Kirshner have also made valuable contributions. However, on the political element of the money, there still remains much to be done (Cohen 2003). Based on the academic fruition of those forerunners, this thesis has made some beneficial explorations in this direction. However, these explorations could still be preliminary. At present, when the

renminbi is yet an international reserve currency, China and the United States can still maintain a cooperative situation in their monetary relations. But if one day the renminbi rises to be an important competitor to the dollar, many more materials can be collected and used to further the study of monetary power struggle.

One aspect that this thesis has not analyzed carefully is the speculative financial capitals, as well as their impact on the renminbi exchange rate regime and level. In the 1992 Pound Crisis and the 1997 Asian Financial Crisis, the world had witnessed the great destructive power that speculative capitals could exert. George Soros, dubbed as “the man who broke the Bank of England”,⁷¹ along with his hedge fund, knocked the UK out of the European Monetary System and at same time earned \$1 billion from the speculation of the sterling. The power of such organizations or individuals should never be underestimated. Besides Strange’s *Casino Capitalism* (1986) and *Mad Money* (1998), few analyses have touched the political elements of international speculative capitals. These speculative capitals may perch in one state and begin to influence the government to create favorable conditions for them. Today, China has already been suffering from speculative capitals. When China loosens its control on capital accounts in the future, these speculative capitals will have much more influence on China’s exchange rate policies. How international speculative capitals will impact the U.S.-China monetary relations definitely remains a future field of academic interests.

⁷¹ Encyclopedia Britannica Online, “George Soros”. <http://www.britannica.com/EBchecked/topic/554959/George-Soros>

APPENDIX A: DIFFERENT VIEWS OVER RMB EXCHANGE RATE

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	U.S. Government Opinion	Chinese Government Opinion
Q1	One country's current account balance is an important criterion to evaluate whether its exchange rate is reasonable. China's huge current account surplus is an indication that its currency is seriously undervalued. It is an important condition for China to cut its trade surplus through renminbi appreciation in order to reach global equilibrium.	The renminbi is not undervalued based on the following three facts: 1.China runs a current account deficit with Japan, Korea, as well as other southeast Asian countries; 2. 60% of China's exports come from foreign-funded enterprises and the surplus is originated from the processing trade projects; 3. U.S. restrictions on the high-tech exports to China contributed to the Sino-US trade imbalance.
Q2	China's non-flexible exchange rate regime is against the principle of fair competition of the market economy. The intervention policies adopted by the Chinese government, to stabilize the exchange rate level, are actually to maintain an undervalued exchange rate and gain unfair competitive advantage.	China's intervention in the exchange rate market is sought to maintain exchange rate stabilization. Whether under the Bretton Woods System or the early European Monetary System, The United States and Europe have adopted similar exchange rate systems. It is China's sovereignty to adopt what kind of exchange rate regime it feels best serves its economic interests.
Q3	Influence to the United States: to cut imports from China and increase exports to China; to increase employment opportunities and improve its external economic imbalances. Influence to China: Conducive to China's industrial upgrading and domestic demand; helps eliminate the risk of inflation and bubbles.	Influence to the United States: The United States does not produce those products imported from China, therefore the RMB appreciation will not help U.S. exports; it can only increase its import price or transfer the demand to other countries. Influence to China: to cause the increase of labor cost and decline of products' competitiveness; and, then, to cause a rise in corporate bankruptcies and unemployment and to obstruct China's economic rise.

Q1: Is the RMB undervalued?

Q2: What exchange rate regime China should adopt?

Q3: What are the influences of renminbi appreciation?

Source: Zhou 2010

APPENDIX B: EXCHANGE RATE REGIMES

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	Exchange rate regime	Countries & regions
No independent fiat	Dollarization (9)	Panama, East Timor, Ecuador, Kiribati, Marshall Islands, Micronesia, Palau, El Salvador, San Marino
	Eastern Caribbean Currency Union (6)	Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines
	CFA franc area (14)	Benin, Burkina Faso, Togo, Guinea-Bissau, Côte d'Ivoire, Mali, Niger, Senegal, Equatorial Guinea, Congo, Gabon, Cameroon, Chad, Central Africa
	Euro area (12)	Ireland, Austria, Belgium, Germany, France, Finland, the Netherlands, Luxembourg, Portugal, Spain, Greece, Italy
	Currency Board	Estonia, Bulgaria, Bosnia and Herzegovina, Djibouti, Lithuania, Brunei, Hong Kong
Peg	Pegged to single currency (47)	United Arab Emirates, Aruba, Egypt, Ethiopia, Netherlands, Antilles, Barbados, Bahamas, Pakistan, Bahrain, Belarus, Bolivia, Belize, Bhutan, Eritrea, Cape Verde, Guyana, Holland, Honduras, Zimbabwe, Qatar, Comoros, Kuwait, Latvia, Lesotho, Lebanon, Rwanda, Maldives, Malta, Macedonia, Mauritania, Namibia, Nepal, Sierra Leone, Seychelles, Saudi Arabia, Swaziland, Suriname, Solomon Islands, Trinidad and Tobago, Turkmenistan, Venezuela, Ukraine, Syria, Iraq, Jordan, Vietnam, China
	Pegged to a basket (5)	Fiji, Libya, Morocco, Samoa, Vanuatu
	Crawling peg (6)	Denmark, Cyprus, Slovakia, Slovenia, Tonga, Hungary
	Managed float (51)	Algeria, Afghanistan, Argentina, Angola, Papua New Guinea, Paraguay, Burundi, Dominica, Russia, Gambia, Colombia, Georgia, Kazakhstan, Haiti, Kyrgyzstan, Guinea, Ghana, Cambodia, Czech Republic, Croatia, Kenya, Laos, Liberia, Romania, Madagascar, Malawi, Malaysia, Mauritius, Mongolia, Bangladesh, Peru, Myanmar, Moldova, Mozambique, Nigeria, Montenegro, Sao Tome and Principe, Sudan, Sri Lanka, Tajikistan, Thailand, Tunisia, Guatemala, Uruguay, Uzbekistan, Singapore, Jamaica, Armenia, Yemen, India, Zambia
	Free float (25)	Albania, Australia, Brazil, Iceland, Poland, the Philippines, the Democratic Republic of Congo, Republic of Korea, Canada, the United States, Mexico, South Africa, Norway, Japan, Sweden, Switzerland, Somalia, Tanzania, Turkey, Uganda, New Zealand, Israel, Indonesia, the United Kingdom, Chile

Source: Gong 2010:4

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