Abstract: The global financial crisis has shown that the current international monetary system (IMS) suffers from an inherent flaw: it depends on US current account deficits for the provision of global liquidity. Under this arrangement, peripheral countries in the system have to accept periodically the debasement of the US dollar. Thus, there are some mutual incentives for the EU and China to reform the current IMS through cooperation. In principle, both are in favour of stable exchange rates and both are keen to constrain US macroeconomic profligacy. There have been some efforts toward those objectives between China and the European countries in the past years, especially during the French presidency of the G20 in 2011. However, there has been no significant progress achieved till now. On the European side, there is not a united and independent Europe which could act as a counter-balance to the US in the reform of the IMS. On the Chinese side, Beijing does not see Europe as a reliable partner because the latter is deemed as a major vested interest in the current regime. As a result, the French government has failed to focus the world’s attention on the reform of the IMS during G20 Cannes Summit, and the Chinese government has chosen a more unilateral way to internationalize its own currency.
1. Introduction

The global financial crisis initiated in the United States in 2008 has raised doubts about the efficiency of the current dollar-led international monetary system (IMS). Two main structural theories have been put forward to explain the crisis, each with their respective reform solutions. On the one hand, there is the ‘savings glut’ theory (Bernanke 2005; 2011), favoured by policymakers in Washington and great part of the Economics literature, which says that the unsustainable overleveraging in the US was induced by the recycling of dollar-denominated savings in surplus economies (especially the East Asian countries, including China) in triple-A safe US debt instruments. This constant inflow of large volumes of savings (a by-product of East Asian countries maintaining their currencies artificially low in a neo-mercantilist strategy of export-led growth) suppressed the interest rates on US debt and thus fostered over-consumption and over-indebtedness. To avoid a repeat of this mechanism, the proposed solution is to encourage countries like China to let its currency float freely so that the appropriate market equilibrium can be found and a rebalancing of the global economy can be achieved.

On the other hand, there is the ‘Triffin Dilemma’ theory (Zhou 2009; Padoa-Schioppa 2010; Bini-Smaghi 2011), favoured by policymakers in Beijing and a number of high profile European officials, which argues that the crisis is a product of the structural contradiction associated to any international regime dominated by a national currency. As Triffin (1960) explained already in the era of the Bretton Woods System when the dollar was still linked to gold, there is an inherent flaw in the dollar standard. In order to provide the necessary liquidity for the global economy, the US needs to run bloating current account deficits. The increase of this deficit, however, undermines the credibility of the global reserve currency. While for some time economists thought that the Triffin Dilemma was just a page in history books because it was only valid for a system linked to gold, the recent crisis signifies the vengeance of Triffin. Even in a system where the issuer of the main international currency, in this case the US, adopts a flexible exchange rate regime there is a limit to its liquidity provision. As current events have shown, by increasing its fiscal deficits and expanding substantially its monetary base the US enters the risk of undermining the credibility of the dollar as the global reserve currency. The solution thus is to find a mechanism that can
restrain US profligacy.

Influenced by this second theory, in the wake of the crisis policymakers of the BRICS (Brazil, Russia, India, China and South Africa) countries and the Eurozone have openly called for the end of the currently dollar-dominated IMS. Chinese and French officials have particularly been active in this debate. The President of China Hu Jintao, the Governor of the People’s Bank of China (PBoC) Zhou Xiaochuan, and the President of France Nicolas Sarkozy, have all declared that the flexible-dollar-system is a legacy of the past and that it needs to be revised. In principle, Europe and China have a number of shared interests in the reform of the IMS. Both are second-tier powers which advocate the creation of a more balanced, regulated and multi-polar monetary system. Both are suspicious of the benefits of unfettered financial markets (with the notable exception of the UK). Both have historically been in favour of a more coordinated exchange rate regime able to mitigate exchange rate misalignments detached from economic fundamentals. And both have resented the fact that the US is able to misuse its exorbitant privilege as the issuer of the global reserve currency. In other words, both China and Europe would like to create a mechanism that enforces macroeconomic discipline upon the US.

The main objective of this article is to first map and then analyse Sino-European collaboration in reforming the IMS, especially in the run up to and during the French presidency of the G20. The article is divided in four parts. The first section focuses on the flaws of the flexible-dollar-standard (FDS) from the point of view of the Economics literature. Here we explain that the Triffin Dilemma is still prevalent. The second part describes the power and governance structures of the IMS from an International Political Economy perspective. In this section we show that Europe has never stopped promoting a more balanced IMS but it has never been able to convince the US to move towards a multilateral arrangement. The creation of the euro is precisely an attempt by the Europeans to be better protected from so-called dollar-shocks. In the third part we try to map what has been hitherto Sino-European collaboration. Here we show how China and France have strengthened their diplomatic contacts due to the fact that both favour a more coordinated and multi-polar exchange rate regime. Finally, in the last part, we explain why EU-China collaboration has had little impact. The divisions among European countries, the reluctance by the US to enter into any kind of genuine negotiation towards reform, and the consequent lack of faith in the possibility of a multilateral solution in Beijing, have all contributed to
undermine French-led attempts to transform the IMS.

2. The flaws of the current international monetary system

The current IMS is a heritage of the Bretton Woods system. Therefore, the dollar still plays the role of global reserve currency. Under the current regime, the United States (US) exports dollar liquidity through its current account deficit and the peripheral countries accumulate huge foreign exchange reserves. Because the US has the most liquid, diversified and deepest financial market, it is natural for peripheral countries to invest a large proportion of their foreign exchange reserves back in US dollar denominated assets. Thus, the combination of current account deficit and capital account surplus makes the US feel no urgent necessity to make structural adjustment to relieve its external imbalance. As a result, the global current account imbalances have become more serious in the early 21st century and the US has become by far the largest debtor.

There is an insurmountable flaw in the current international monetary regime, which Robert Triffin (1960) identified long ago. To satisfy the global demand for safe international liquidity, the US must export more dollars through its current account deficit, which will result in the exacerbation of its current account imbalances and the accumulation of its external debts. However, as the deterioration of the US’ current account and net external debts increases, the dollar is facing an inevitable pressure to depreciate against other major currencies. If the dollar depreciates significantly, the foreign countries which hold gigantic investments in USD denominated assets will suffer huge capital losses.

Therefore, the stability and sustainability of the current IMS depends on whether peripheral official creditors will continue to buy USD denominated assets to finance the US current account deficit in spite of the rising of USD depreciating risks. If external creditors begin to stop buying or even sell-off the dollar denominated assets collectively, then the current regime may crash, which will result in the large depreciation of the dollar, the rise of US long-term interest rates, and even an economic recession in the US. However, if external creditors continue to buy USD denominated assets in spite of the potential risks of USD depreciation, the current regime could maintain its stability for some time.

Dooley, Folkerts-Landau and Garber (2003) argue that the current IMS could be very stable
because the peripheral countries will not shift their sovereign investments from USD denominated assets easily. Most of the East Asian countries pursue an export-driven growth strategy, so they will continue to purchase USD denominated assets to push down the exchange rate of their domestic currencies. This neo-mercantilist strategy could make the current IMS quite stable, in what has been called the Bretton Woods II regime.

Eichengreen (2004) challenges the idea of Bretton Woods II in the following aspects. First, the new peripheral countries (the East Asian countries) are less cohesive than the old peripheral countries (the Western European countries and Japan). Second, there are now more attractive alternative assets to USD assets, such as euro denominated assets. Third, the US has a much more serious current account deficit now than in the Bretton Woods regime of the 1950s or 1960s. Fourth, capital account liberalization makes it harder to control private asset portfolio adjustments. Fifth, because the domestic financial markets are more diversified and deregulated, low interest rates and abundant credit in peripheral countries will lead to inflation and asset bubbles. And finally, the East Asian countries are actively readjusting their growth strategies from export-oriented to domestic consumption-driven growth.

Moreover, after the US subprime mortgage crisis and the consequent global financial crisis (2008-2009), foreign official creditors are worrying even more about the safety of US government bonds. The bloating of the US sovereign debt might lead to domestic inflation and the dollar’s depreciation, which will cause huge capital losses for foreign central banks. As a result, there might be a large-scale shift from dollar denominated assets to euro denominated assets. Furthermore, if an economic or financial crisis breaks out in the US and the Eurozone (EZ) at the same time, international investors may shift their assets from dollar and euro to third assets such as gold and equity (Eichengreen and Flandreau, 2008).

Stiglitz and Greenwald (2010) point out that, besides the unsustainable global imbalances, the current IMS has some other flaws. First, the continuing accumulation of foreign exchange reserves by new emerging economies tends to weaken global aggregate demand. Second, there is a significant resource misallocation in a regime where poor countries lend

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1 However, as European debt crisis exacerbated in 2010 and 2011, the international capital flows flowed into US government bond market for deleveraging, which pushed down US government bond yields and pushed up USD exchange rate.
to rich countries at low interest rates and then borrow money back at much higher rates. Third, the major exchange rates, interest rates and international capital flows are very volatile under the current flexible-dollar-standard. Bénassy-Quéré and Pisani-Ferry (2011) add to this that, the balance-of-payments adjustment mechanism under the current regime is seriously asymmetric. Deficit countries other than the US assume most of the adjustment responsibilities, and the US tends to postpone the necessary adjustment once again based on its exorbitant privilege. We will come back to this mechanism in the next section focused on the political side of the debate.

It suffices here to add that there is a dilemma about whether the US should make prompt adjustment. On the one hand, if the US succeeds in reducing its current account deficit, there may be a lack of liquidity and demand in global markets. On the other hand, if the US keeps postponing necessary adjustment with the accumulation of US external debt, someday the creditor countries will lose their confidence in US sovereign credit and they will start to sell US dollar denominated assets collectively, which will result in the collapse of the current regime.

It should be pointed out that, there are still some economists who believe that the current dollar standard could be maintained only with some small renovations. McKinnon (2007) has discussed the sustainability of the FDS from a monetary approach. First, multilateral trade and capital flows need a common international currency. When a national currency becomes an international currency, it will enjoy economies of scale, institutional inertia and network externalities, which makes it harder for other currencies to displace it. Second, the dollar plays a role of monetary anchor for other countries to perform a sound monetary policy and to control domestic inflation. As long as America’s inflation is low and stable, there will be no constraint on the external debt of the US. Therefore, although the erratic US monetary and financial policies after the subprime crisis have arisen much criticisms in the US and abroad, the FDS is still a robust institution which is “too valuable to loose and too difficult to replace” (McKinnon 2010). Under his view, to maintain the current regime, US monetary and financial policies should be more internationalized to stabilize the domestic and global economy.

2 Instead of a persistent deflation tendency, Ocampo (2010) argues that because there are no limits for the United States to create international liquidity through issuing domestic currency, there is an inflation bias in the current IMS. Our view is that the international liquidity provision is pro-cyclical under the currency system. In booms there is excessive liquidity created which is inflationary, however in busts there is a deflationary liquidity crunch.
Similarly to McKinnon we argue that the dollar is malfunctioning in its monetary anchor role. After the global financial crisis, the Fed’s quantitative easing (QE) and twisting operation policies have undermined its reputation as a hawkish central bank.\(^3\) It is QE which has exacerbated not mitigated the inflationary pressures faced by emerging economies, and which has led the Brazilian Minister of Finance Guido Mantega to declare that the US has started a Currency War. The dollar may no longer be a stable monetary anchor after the global financial crisis. Just as Eichengreen (2005) has been arguing, the historical lessons drawn from when the USD replaced British sterling as the global reserve currency show that whether the USD can maintain its role as the reserve currency depends on whether the US government can avoid the further deterioration of the current account deficit, the exacerbation of external debts, higher inflation and the consequent dollar depreciation.

Nonetheless, despite the failures of the dollar as the anchor, Cohen (2009) strongly doubts that the euro can catch up or even overtake the dollar’s role as the global reserve currency even after the burst of the global financial crisis. The Eurozone (EZ) is not a perfect optimum currency area. There is a lack of coordination of national fiscal policies. There is no representative of European Economic and Monetary Union (EMU) with true authority to act on behalf of European countries before the international community. Furthermore, the burst of the European sovereign debt crisis revealed the above mentioned structural deficiencies of the EZ. Thus the current regime is not a two-pillar international currency system, but rather a one-and-a-half currency system (Cohen and Subacchi 2008).

Hence, there are two major ways to reform the current monetary system. One is to create a super-sovereign currency to function as the global reserve currency, which could be established on the basis of the IMF’s Special Drawings Rights (United Nations, 2009). The other is a multi-polar reserve currency system in which the dollar, the euro and the Chinese Renminbi play the roles of key pillars (Bénassy-Quéré and Pisani-Ferry 2011). Of course, there might be a middle ground which is a continuation of the status quo with some very minor and gradual adjustments. However, it will be very difficult for this third way to

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3 Since the start of the Quantitative Easing policy, especially senior officials from China and Brazil have in numerous occasions publicly criticized the extra loose monetary policy by the FED. Anonymous interviews conducted in spring 2009 in Beijing with senior Chinese officials and banking executives also point to the loss of credibility by the FED.
develop smoothly given the inherent global imbalances in the FDS and the related crises that it generates.

The establishment of a super-sovereign currency like the SDRs could eventually overcome the Triffin Dilemma, but everyone knows that it will be a long journey to create a world currency and a world central bank (Eichengreen 2011). The burst of the European sovereign debt crisis proves again that multilateral monetary integration will be a rugged road. The formation of a three-polar reserve currency system is a more realistic scenario. However, we are not sure whether a multi-polar currency system will be more stable than a single reserve currency system, as defended by Bénassy-Quéré and Pisani-Ferry (2011). For example, Stiglitz and Greenwald (2010) state that, a two- or three-currency reserve system may become more volatile than a single currency system, because the IMS may become much more volatile when the countries’ central banks and private investors begin to manage their reserve portfolios more actively.

Although there are some uncertainties about the direction of the evolution of the IMS in the future, leading French and Chinese scholars such as Bénassy-Quéré, Pisani-Ferry and Yu (2011) argue that, in the short term, there are still some concrete steps which should be taken to promote the reform of the IMS. First, a consensus should be established on exchange rates, capital flows and foreign reserves. Second, a better financial safety net should be constructed to stop the further accumulation of reserves by developing countries. Third, the SDRs currency basket should be expanded to include more currencies of emerging economies such as China’s Renminbi.

3. The Politics of Reform: China joins Europe in the push for change

After highlighting the problems of the FDS from the point of view of the economics literature, and before we enter into analyzing Sino-European efforts towards reform, it is appropriate to summarize first the evolution of the current IMS from the political angle. Indeed, political frustration about the US’ over-exploitation of its ‘exorbitant privilege’ is a longstanding phenomenon in Europe. In some ways, the criticisms aired in recent times by Chinese policymakers mirror those of Charles de Gaulle and Valerie Giscard D’Estaing in the late 1960s (Eichengreen 2008). Since those days, European officials have unsuccessfully tried to restrain US power in monetary affairs. As the International Political
Economy (IPE) literature has shown over the past decades (Strange 1987; Kirshner 1995; Henning 1998; Cohen 2006; Helleiner and Kirshner 2009), the US has been able to use its ‘dollar weapon’ to delay and, when necessary, deflect adjustment costs in the balance of payments.

Whenever the US has felt that the exorbitant privilege has gone too far and the associated Triffin Dilemma has reached destabilising levels, it has used its international monetary power (Cohen 2006) to force its trading partners to bear a greater burden of the adjustment costs. As Henning (1998) has documented, between the late 1950s and the early 1990s, the US used in several occasions its dollar weapon. Most of the times the tools used were a ‘benign neglect’ strategy in relation to a depreciating USD to regain competitiveness, and political pressure in order to force its trading partners (especially West Germany) to pursue a policy of reflation to stimulate domestic demand. The most significant ‘dollar shocks’ occurred in the early 1970s when the US decided to delink its currency from gold to regain competitiveness vis-à-vis its European competitors, and in the mid 1980s when the US forced the then up-coming economic power Japan (and to a lesser extent its Western European partners), to appreciate their currencies under the 1985 Plaza Accord.

All along, the US has followed the same strategy. As Nixon’s Treasury Secretary John Connally told his European counterparts when the US closed the gold window: “It’s our currency and your problem”. And this was especially true because in the midst of the Cold War for both the Europeans (especially for West Germany) and the Japanese the US was their security guarantor. Of course, the situation is now different. The Cold War has ended and China, the new economic and financial power, is militarily independent from the US (Chin and Helleiner 2008; Kirshner 2008).

Nonetheless, despite the geopolitical alliance with the US, the proliferation of dollar shocks over several decades motivated the Europeans to seek protection. Indeed, the creation of the euro is partly a consequence of US macroeconomic belligerence towards Europe (Henning 1998; Walter 2006; Eichengreen 2011). In order to avoid disruptive exchange rates movements and US macroeconomic bullying, by the early 1990s the small and mid seized European economies decided to pool their monetary policies together to acquire greater macroeconomic autonomy.
The regional route was chosen not least because previous attempts to reform the IMS failed. Over the decades, on the basis of their large voting power in the IMF, the Europeans were actively involved in the promotion of the IMF’s SDRs as an alternative reserve currency to the USD. They were also in favour of the creation of a substitution account at the IMF so that surplus countries could exchange their dollar reserves for SDRs without causing a plunge in the value of the greenback. But in both occasions when the topic was under serious consideration (around 1969 when the SDRs were created and in the late 1970s) the idea did not materialise because the US was able to kill the SDR-momentum with two master strokes based on domestic considerations but with significant externality effects. In the late 1960s and early 1970s, the Europeans wanted to generate more liquidity by expanding the issuance of SDRs, which ironically they duly received from the US by delinking the dollar from gold. In the late 1970s, instead, similarly to today’s worries in Beijing, the concern among Europeans was the value of the ever depreciating dollar, which the US also duly addressed through the ‘Volcker shock’ in 1979 (Helleiner 2010).

Despite these failed attempts to restrain US hegemony in monetary affairs, the track record shows that, even after the introduction of the euro, the Europeans have never stopped trying to establish a multilateral monetary order. One of their main objectives (and in this the Europeans side with their Chinese counterparts) has always been to avoid major volatility and misalignments in exchange rate movements. Right from the launch of the euro in 1999 the then Minister of Finance of Germany Oskar Lafontaine proposed target zones for exchange rates in what he termed “constrained flexibility” among the major international currencies. Interestingly, the then Minister of Finance of France Dominique Strauss-Kahn also favoured a system of enhanced cooperation to limit exchange rate fluctuations (Henning 2000, 2007).

These renewed European attempts to enhance coordination in managing the exchange rates and in curbing speculative flows, in an IMS that had just gone through the Asian financial crisis (1997-1998), were followed very closely by officials in Beijing. Indeed, they must have felt the same frustration as their European counterparts when the US refused to enter in any kind of negotiation regarding this topic (Xu 2000). It needs to be stated that Chinese policymakers have always disliked dollar unipolarity in monetary affairs, and thus they

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4 It is worth noting here that in autumn 2000 the ECB intervened, first in coordination with the other G7 partners and then on its own, to halt to depreciation of the euro (see Henning 2007).
have always welcomed the arrival of the euro as a counter-balancing project. Since its birth, Chinese policymakers have never deviated from the same line regarding the European currency. From Beijing’s point of view the euro is considered an irreversible step forward in the process of European integration and it is seen as a key pillar towards the establishment of a more balanced multipolar financial and monetary system. It is interesting to see how euro-optimism is well anchored in China (Xu 2007), while euro-scepticism is widespread in the US (Jonung & Drea 2009).

The question to be asked, however, is whether the euro has offered the EZ countries more protection against dollar shocks. Ironically, the answer might be that it has offered them too much protection. Through the euro, the EZ has certainly enhanced its autonomy. By issuing an international currency, liquidity access and consequently the power of delaying adjustments have been increased. Cheaper credit, thanks to lower public debt yields as a consequence of increased worldwide demand for euro-denominated assets, has permitted weaker economies in the EZ to enjoy a certain degree of the ‘exorbitant privilege’ and delay their structural adjustments (Bini-Smaghi 2011). Certainly, it can be argued that this was detrimental in light of the brutal adjustment processes that are currently happening as a consequence of the sovereign debt crisis. But this does not eliminate the fact that, similar to the US, the EZ periphery was able to run current account deficits larger than would have been possible without the euro.  

An internationally accepted euro, with more liquid financial markets, has also been useful to buffer exchange rate movements against the dollar. Even in the midst of the greatest crisis in the history of the euro, the movements have been relatively gradual in the past years. Thus, EMU has protected EZ member states from exchange rate disruptions, a conspicuous European feature in previous crises (Wyplosz 2009). The ECB has also become a respected global central bank with the capacity to provide unlimited liquidity to the EZ financial system when it is needed and to draw unlimited currency swaps with the FED, as was the case during the peak of the global financial and the European sovereign debt crises (Goldberg et al. 2011). In addition, when in 2010 and 2011 EZ periphery countries suffered a ‘sudden-stop’ in their balance of payments, the ECB was able to step in

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5 In 2007, the year before the crisis unfolded completely, the current account deficit for Greece was 14.1% of GDP, that for Spain 10%, for Portugal 9.5% and for Ireland 5.4%. In volume terms Spain, Italy, France and Greece (in this order) had in 2009 the biggest current account deficits of the world behind the US (IMF 2009).
to fill the external financing gap and thus make the adjustment process less abrupt (Merler & Pisani-Ferry 2012).

Finally, EMU has also given the EZ member states more protection against US influence in macroeconomic diplomatic negotiations. Before EMU the small and medium sized economies of the EU were vulnerable to US macroeconomic bullying because they had to deal with the big power individually. This has changed with the euro. Once the Europeans agree on one position (which is not always the case), it is more difficult for the Americans to convince them to change their behaviour. A good example of this was the recent spat at the G20 between the US and the Europeans in relation to continuing with expansionary policies to overcome the effects of the global financial crisis, as advocated by the Obama Administration, or starting with fiscal consolidation programmes, as defended by the Europeans, including the British.

Nonetheless, the truth is that the EZ is still taking a great deal of the adjustment costs coming from the US. Between 2002 and 2008, when the US used again its strategy of benign neglect in relation to a depreciating dollar (McKinnon 2010), the value of the European currency rose near 90% from $0.86 to $1.60. Given that by now almost all major trading partners intervene to devalue their currencies (China and the ASEAN countries have always done it, and since the crisis Japan, Brazil and Switzerland have followed the same strategy in what has been termed Currency Wars), most of the dollar depreciation necessary to rebalance the US current account has been absorbed by the euro, hurting predominantly EZ exporters. This trend will continue as long as the ECB continues with its orthodox anti-inflation policy.

It needs to be said here that exchange rate moves are always more harmful for the EZ than for the US for the US economy is far less open to the outside, and more flexible in its labour markets, two features that enhance its deflection power (Cohen 2006).\(^6\) It was no surprise then to see certain policymakers in Europe embrace recent Chinese calls for a reform of the IMS. This was particularly true for the French who have always disliked the US’ exorbitant privilege and who have persistently complained about the over-valuation of

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\(^6\) ECB (2010) data show that imports and exports represent only 24.9% of US GDP, while this share reaches 38.5% for the EZ. It is also widely acknowledged that the US economy is more flexible than the EZ, especially when it comes to labour markets and bankruptcy procedures. [http://www.ecb.int/mopo/eaec/html/index.en.html](http://www.ecb.int/mopo/eaec/html/index.en.html)
the euro.

Following this tradition, French President Nicolas Sarkozy decided that the reform of the IMS should be the highest priority during the French presidency of the G20 in 2011. To achieve this objective he also decided that France and China needed to strengthen their cooperation. However, as will be shown below this collaboration did not bring tangible results. The EZ has increased its autonomy through the euro, but by not speaking with one voice, it is incapable to change the rules of the game. China, on its part, has acquired more autonomy by accumulating more than $3 trillion foreign reserves and by keeping a tight control on its capital account and financial system so as to avoid through successful sterilization disruptive speculative capital flows from developed countries, but hitherto it lacks the diplomatic and financial sophistication to design an alternative IMS (Chin & Helleiner 2008; Chin & Wang 2010). In sum, the EZ and China have increased their autonomy vis-à-vis US monetary power but they are still a long way to transform this autonomy in actual political influence (Cohen 2008).

4. A Mapping of EU-China Collaboration up to Now

After the burst of the global financial crisis, Chinese top leaders became more active in making proposals about the reform of the IMS. On November 15, 2008, the Chinese President Hu Jintao delivered an important speech at the first G20 Washington Summit of Heads of States. He came up with two proposals, which reflect the Chinese government’s attitude on this topic. First, the reform of international financial organizations such as the International Monetary Fund and the World Bank should be advanced, and the representativeness and voting power of developing countries in such organizations should be increased. Second, the international currency system should be reformed, and a diversity of international reserve currencies should be steadily promoted (Hu 2008).

In April 2009, President Hu developed further China’s position on the reform of the IMS in his speech at the G20 London Summit. He requested that the international currency issuers should take responsibilities in maintaining the exchange rates between major currencies relatively stable (Hu 2009). At the G20 Toronto Summit, he pointed out further that, the G20 countries should speed up the adjustment of the IMF’s quota system, and more officials from emerging economies and developing countries should be promoted to take
high-level positions in the IMF and World Bank. The IMF should also strengthen its macro surveillance toward the macroeconomic policies of the countries which issue international reserve currencies (Hu 2010).

Parallel to this, in March 2009, the Chinese central bank governor Zhou Xiaochuan (2009) published a paper about how to reform the IMS, which aroused great interest in the international community. In his paper, Governor Zhou argued that the desirable goal of the reform should be to create a super-sovereign reserve currency disconnected from any individual nation, which could not only remain stable in the long run but also remove the inherent deficiencies caused by credit-based national reserve currencies. He even claimed that the IMF SDRs had the features and potentials to become a super-sovereign reserve currency. To strengthen the role of the SDRs, he suggested that member countries of the IMF should entrust part of their foreign exchange reserves to the centralized management of the IMF, which is very similar to the idea of creating a substitution account under the IMF favoured by the Europeans in the past.

On the one hand, President Hu’s speeches at the G20 Summits reflect China’s support for a multi-polar IMS in which the euro and the RMB could play the role of key currencies alongside the dollar. Governor Zhou’s paper, on the other hand, demonstrates that the Chinese government also agrees with the idea of creating a super-sovereign reserve currency such as the SDRs. Is there any intrinsic conflict between President Hu’s proposal of a multi-polar currency system and Governor Zhou’s proposal of a multilateral world currency? We do not think so. Indeed, the different statements made by the Chinese President and the central bank governor reflect the Chinese government’s open and pragmatic attitude toward reforming the IMS. Chinese officials are aware that it is very difficult to create a super-national reserve currency and that this will entail a long process. By contrast, the multi-polar reserve regime is a more realistic development. Therefore, President Hu’s and Governor Zhou’s opinions clarify China’s anticipation about the mid-term and long-term developments in the IMS, respectively.

Even though the Europeans as a bloc have not come out with a clear position on China’s calls for the reform of the IMS (signifying that the EU is not a united entity), the French Government has had a different approach. In July 2009 at the G8-G5 meeting in Italy, President Sarkozy supported Chinese attempts to reform the FDS by declaring: “We cannot
stick with one single currency…we’ve still got the Bretton Woods system of 1945…60 years afterwards we’ve got to ask: shouldn’t a politically multipolar world correspond to an economically multi-currency world?” After seeing how Chinese calls for reform were hardly addressed during the 2009 G20 presidency held by the United Kingdom, the French Government seemed to be determined to join China in its push to include the reform of the IMS on to the G20 agenda.

As Sarkozy would underline when proposing his agenda in August 2010, both France and China have always favoured the implementation of “mechanisms for avoiding excessive exchange rate volatility” and they have persistently called for a “debate on the international doctrine of capital movements”. In this same presentation he also disclosed that France and China were working together on the formulation of this agenda. Sarkozy made clear that there is the need for a “new framework for consultation of exchange rate developments”\(^7\) and that China should join the G7 meetings of finance ministers in this area. From this statement it can be inferred that France would welcome the presence of China given that in the current configuration of the G7 its influence is curtailed. The US, the UK, Canada and Germany are all countries which are skeptical about state dirigisme in exchange rate movements. Japan has traditionally been in favour of more intervention, but it does not want to confront the US. This leaves only Italy as a potential ally to France. With the entry of China in the G7, however, the balance of power would change.

However, China is very skeptical about French woos to join the G7. Chinese policymakers are not sure whether France is fully committed to a more managed exchange rate regime (as proposed unofficially but never stated officially in recent times)\(^9\) or whether it just wants to lure China into the G7 so that developed powers can apply more pressure upon Beijing to let the RMB float freely. As for now the Chinese government is firmly opposed to completely flexible exchange rates determined only by market forces (Hu 2010a, 2010b).

The Chinese Government’s proposal to avoid international exchange rate disruptions is rather as follows: The US, EMU, Japan and the UK should agree to a managed-floating exchange rate band. The Chinese RMB would remain pegged to the dollar. This would hold


\(^{9}\) Interview with French official in Paris, 20 March, 2012.
until China develops its financial markets. Once this is achieved, the RMB will start gradually its floating process, join the other strong currencies in the established band and consequently be part of the IMF SDRs basket, which hopefully will become the future reserve currency. It is striking how this proposal resembles the target zones proposed by Lafontaine in the late 1990s and still advocated today by Robert Mundell (2005; 2011). This is no coincidence. Mundell has been an adviser to China’s policymakers for some time. In principle, this type of proposal would certainly find some sympathy in France. Nonetheless, it is very doubtful whether the US, the UK and Germany would accept such a proposal.

While for many commentators, Sarkozy’s campaign to reform the FDS was mainly political theatre to gain public support before the French presidential election in 2012, it would be disingenuous to overlook the accomplishments of the French government. It is worthwhile highlighting here the Palais-Royal Initiative led by Michel Camdessus, Alexandre Lamfalussy and the recently deceased Tommaso Padoa-Schioppa, all high-profile former European officials. This expert group counted on the participation of a wide range of past and present officials from the G20 countries, including Hu Xiaolian, currently the vice governor of the PBoC.

These experts have agreed that the FDS has several flaws such as the lack of mechanisms to deal with global imbalances, the creation of destabilizing capital flows, excessive exchange rate fluctuations driven by speculation and the excessive accumulation of reserves. Matching these flaws, the solutions that they proposed to the G20 are: to increase the multilateral mechanisms of adjustment and surveillance; to adopt benchmarks based on macroeconomic fundamentals in order to avoid instability and misalignment in the exchange rates; to consider the adoption of capital controls when incoming flows are too destabilizing and, finally, to promote the use of the SDRs as an alternative multilateral reserve currency (Camdessus et al. 2011).

Indeed, the promotion of SDRs is a topic that has been again debated by the executive board of the IMF after receiving several technical reports (Cooper 2011; IMF 2011a). While acknowledging the technical and political challenges that SDR promotion faces, the directors of the board agreed to consider “ways to encourage the development of the SDR

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10 Interview with Chinese official in Beijing, 3 April, 2009.
as a unit of account for private and official transactions, particularly the potential for developing a market for SDR-denominated assets” (IMF 2011b), certainly a prerequisite if the SDRs want to have any chance to be globally appealing (Eichengreen 2011).

Nonetheless, the limits of Sino-French collaboration in pushing for reforms became clear when China organized in Nanjing an informal academic seminar about the reform of the IMS, coincidently with Robert Mundell (2011) as one of the presenters. The seminar was attended by the head of the IMF and the ministers of finance and central bank governors of the leading G20 countries. However, Chinese officials were not as enthusiastic as their French peers about the seminar. First, this seminar was held in Nanjing, not Beijing. Second, French President Nicholas Sarkozy attended, but Chinese President Hu Jintao did not. The highest-level Chinese official who attended was the vice Premier Wang Qishan. We do not know the specific reason. But a good guess may be that the Chinese government was not very optimistic about whether the G20 Cannes Summit would make great achievements in the reform of the IMS.

As a matter of fact, the Nanjing seminar showed that the first source of contention regarding the promotion of the SDRs is whether the Chinese RMB will be included in the basket soon. In this respect, the position of France is that the RMB should be included sooner rather than later. It has even established a task force with China to achieve this goal.11 The US, however, made clear in Nanjing (under the implicit threat of its veto power at the IMF) that this can only be achieved under three conditions: full convertibility of the RMB, full independence of the Chinese central bank and full opening of the Chinese capital account.12 It is needless to say that China will not accept these conditions in the foreseeable future.

The G20 meeting in Cannes in November 2011 was indeed a fiasco regarding the reform of the IMS. The talks concentrated on the European sovereign debt crisis. It was certainly ironic to see how France wanted to focus on fixing the IMS, when the real problems were to be found in the governance structure of EMU. In this summit European leaders where harshly criticized by both US and Chinese officials for not getting their act together in

solving the crisis. After the Europe Summit in October 2011, the CEO of the European Financial Stability Facility (EFSF) Klaus Regling visited Beijing, which was interpreted by the market as if the Europeans were trying to lobby the Chinese government, especially the Chinese sovereign wealth fund China Investment Corporation to buy more bonds issued by the EFSF.\(^\text{13}\) However, the Chinese government did not make any public comments after Regling’s visit. We think that the key reason why the Chinese government has been so cautious about providing assistance lies on the fact that the EZ countries have not come up with a concrete and comprehensive plan to fight the euro debt crisis.

5. Why the Impact of the Collaboration Has Been Limited So Far

In principle China and Europe should have significant common interests in reforming the current IMS. A more coordinated and multipolar reserve currency system could provide a more stable overall framework and enhance the RMB’s and the euro’s role as key international currencies. Furthermore, to urge the US government to pursue a responsible monetary policy and maintain a stable USD exchange rate would benefit both China and the European countries. But why has the collaboration between China and the EU had such limited impact? The final G20 communiqué issued after the Cannes Summit in November 2011 calls for the strengthening of IMF macroeconomic surveillance, for a common understanding of the use of capital controls by emerging markets and for a review of the composition of the IMF SDRs basket in 2015, but there has not been any breakthrough on constraining the US exorbitant privilege, on exchange rate coordination\(^\text{14}\), on the inclusion of the RMB in the SDRs basket or on the active promotion of the SDRs as the new international invoice and reserve currency.

From China’s Perspective

One explanation is that, the Chinese government is so pragmatic that it will not put too much attention and resources to a field in which it thinks that no great achievement can be


\(^\text{14}\) The communiqué actually states that the G20 should “move more rapidly toward more market-determined exchange rate systems”. This wording was first opposed by China, but finally American and European officials got their way, as disclosed by an EC official interviewed in Brussels, 29 March, 2012. This market friendly wording shows that the more managed exchange rate regime option is still a minority position in the European Union.
made in the short term. After the burst of the global financial crisis, the Chinese government began to redesign its international financial strategy in the following three aspects: the reform of the IMS, the promotion of East Asian regional financial cooperation, and the internationalization of the RMB (Zhang 2009). In relation to these three strategies, the Chinese government finds that to promote the reform of the IMS is the most difficult task, because it needs the collective action of all major countries. To promote RMB internationalization, though, is much easier because it only needs the consensus between Chinese corporations and their overseas counterparts about RMB settlements in international trade or investment, or the consensus between the Chinese central bank and foreign central banks to sign bilateral local currency swaps.

The perceptions about the relative difficulties of the different tasks determine the focus of China’s new international strategy. From 2009 till now, it seems that RMB internationalization has become the real focus of the Chinese government. On the one hand, the Chinese government put a lot of resources into the experiment of RMB settlement in cross-border trade. In 2011 the scale of RMB cross-border trade settlement reached 2.08 trillion RMB, which is threefold of the RMB settlement scale of 2010.15 At the same time, Hong Kong’s offshore RMB market has developed very fast since 2010. The proportion of RMB settled international trade to China’s overall international trade reached nearly 10% in 2011, and Hong Kong’s RMB deposit surpassed 600 billion RMB at the end of 2011 (Ma 2012). However, further RMB internationalization will face the following obstacles: the regulated capital account, the underdeveloped domestic financial markets, and the heavily managed interest rate and exchange rates.

Compared with the fast development of RMB internationalization, East Asian monetary cooperation has been slowing down after the establishment of the East Asian reserve pooling initiative amounting to USD 120 billion, and the creation of the Asian Macroeconomic Research Office (AMRO) located in Singapore, both efforts to multilateralize the Chiang Mai Initiative.16 The reason of the slowing down is that East Asian financial cooperation has always been crisis-driven. Once the threat of crisis vanishes, 

16 There are some news that the Asean+3 countries will expand the scale of reserve pooling from USD 120 billion to USD 240 billion on May 2012, available at http://www.thejakartaglobe.com/business/asia-set-to-double-reserve-pool-as-europe-squeezes-imf/507719.
East Asian countries lack the incentive to promote further regional financial cooperation.

The development in IMS reforms is even more limited. The reform of the IMF’s quota system tends to be very gradual, and the change of the international reserve currency regime is even slower. Nonetheless, after the burst of the global financial crisis, the IMF changed its attitude toward capital controls and encouraged emerging market countries to add capital control measures to their toolkit to manage short-term capital flows (Ostry et al. 2011). The Chinese government has embraced this initiative because the change in the IMF’s attitude legitimizes the Chinese government’s control on its capital account.

Another explanation for the lack of progress in the reforms is that, the Chinese government might think, perhaps mistakenly, that the European countries are the beneficiaries of the current IMS, and they have not very strong incentives to reform the current regime. As a major challenger of the current system, Chinese officials doubt whether they can establish a good cooperation with the Europeans, since the latter are perceived as one of the major defenders of the existing regime. Therefore, the Chinese government has begun to seek a closer cooperation with new emerging countries such as Brazil, India, Russia and South Africa (BRICS).

For example, the EU holds the largest share of quota and voting power (over 30%) in the IMF. Although the United States have a quota of 17% and could veto any important decision made by the IMF, the quota of the US is in accordance with the US economy’s share in the world economy. Therefore, to redistribute the quota and voting power of IMF more equally, the European countries must give up some shares. However, it will be very difficult for European countries to make such a concession. One possibility would be for the EZ to have a single representative on the IMF but the European countries are still too divided to come up with such a solution.

Another example is that, the position of managing director of IMF has always been taken by European candidates. After Dominique Strauss-Kahn resigned after the sex scandal, although some emerging countries recommended some candidates, another European, Christine Lagarde, finally took the position of managing director at the IMF. It seems that China was one of the biggest supporters of Lagarde to head the IMF. One reason is that the Chinese and French governments reached an agreement by which Beijing would support
Lagarde and in exchange Lagarde would make Min Zhu, a Chinese official and economist, her deputy. In this case Sino-French collaboration has brought some minor fruits.

From the European perspective

The principal reason why the Europeans are punching below their weight in their attempts to reform the IMS lies in the fact that they do not speak with one single voice on monetary affairs. This is a feature that frustrates Chinese policymakers when dealing with their European counterparts. As we have explained above, France has taken an active role in reforming the IMS, but France does not represent the EZ, let alone the EU as a whole. Germany and the UK are less revisionist powers. The UK is the historic partner of the US and therefore has no interest in constraining the exorbitant privilege of the US. Germany, on the other hand, is macro-economically speaking a virtuous country, with an impressively strong export sector, which is less exposed than exporters in France, Italy and Spain to an over-appreciation of the euro. Indeed, from a German perspective the value of the euro has been relatively low. Had Germany maintained the Deutsche Mark, its currency would have been much stronger and its export industry less competitive. Hence, Berlin does not have the same urge than Paris or Rome to change the status quo. Not least, because a strong euro helps to fight inflation, the principal worry from a German perspective.

These differences are reflected in how policymakers in these different European countries assess the current IMS. While in the UK and Germany the level of criticism is minor, in France and Italy there are more voices calling for change. A good representative of this was the late Tommaso Padoa-Schioppa (2010), a respected European official who was member of the ECB’s executive board from 1999 until 2006. In a paper written just months before his death he took clearly sides with Zhou Xiaochuan’s view that the principal source of instability in the IMS is the Triffin Dilemma.

He stated that the ideal of having a broad international regime of flexible exchange rates, as advocated by the Anglo-Saxon-dominated mainstream thinking in Economics, is an illusion. First, because enforcing flexible exchange rates on every country would be politically as constraining on national sovereignty as obliging them to stick to a regime of fixed exchange rates. Second, because market-determined exchange rates are not always perceived to be reflecting fundamentals. The recent intervention of the Bank of Switzerland to stop the rise
of the Swiss Franc vis-à-vis the euro is a good example. And thirdly, because the supposed
discipline that these free floating exchange rates will trigger upon economic policy does not
always materialize at the right time. The loss of competitiveness in the EZ periphery and
the lack of policy measures to overcome it in the past decade is another good example.

For Padoa-Schioppa the key problem is that in the current IMS there is no anchoring
mechanism able to enforce macroeconomic discipline upon the US and this creates
distortions. Hence, he would favour an intermediate system of ‘fixed but adjustable’
exchange rates, similar to the European Exchange Rate Mechanism (ERM) used before the
introduction of the euro. In this new configuration the IMF SDRs would play a similar
anchor role as the European Currency Unit, the ECU. Of course, this echoes the proposals
put forward by Mundell and the Chinese officials. The problem is that while this view finds
many supporters in France, it is not shared by the ECB, a powerful veto player in
determining exchange rate policy in the EZ (Henning 2007). For the ECB there is only one
primary objective: price stability. Therefore, it is reluctant to jeopardize this overarching
goal by adding another objective: exchange rate stability. By extension, this implies that
Germany is less inclined to favour more managed forms of exchange rate policy and in turn
this also means that the European Commission follows the same line.

We do not know how the aftermath of the global financial crisis, and the European
sovereign debt crisis, will change the debates in Germany and Europe at large. It is clear
that to palliate the crisis the ECB has gone over its limited mandate of price stability and
has taken on the task of ensuring macroeconomic and financial stability. This can mean that
a more active policy might be pursued. The new ECB president, the Italian Mario Draghi is
certainly more pragmatic and therefore less dogmatic in regards to following
Bundesbank-orthodoxy than his French predecessor Jean-Claude Trichet. Although, he is
an American trained economist so it is difficult to see him backing a more interventionist
exchange rate regime. Overall, with the crisis, the power of Germany has increased within
the EZ and this means that its position is reinforced.

Nonetheless, it is interesting to see how for the first time in years German policymakers
have openly criticized US monetary policy and shown their unhappiness about dollar

17 This was confirmed by an anonymous ECB official, interviewed in Cambridge, September 7, 2011.
18 See note 14.
unipolarity in the IMS. In 2008, in the midst of the global financial crisis, the then German Finance Minister, Peer Steinbrück, declared that “the US will lose its status as the superpower of the world financial system. This world will become multipolar”.19 In 2010 the German Economy Minister Rainer Brüderle declared that the FED’s QE policy was a manipulation of the exchange rate20 and his colleague, the Minister of Finance, Wolfgang Schäuble, defined it as “clueless”, and warned that the US was putting its leadership role in jeopardy by applying double standards. In his words: “It is not consistent when the Americans accuse the Chinese of exchange rate manipulation and then steer the dollar exchange rate artificially lower with the help of their printing press”.21 Further, in October 2011, in his appointment hearing before the European Parliament, the new German executive member of the ECB, Jörg Asmussen (2011) recognized that the neutrality of the ECB in relation to the internationalization of the euro should be revised because we are in a “transition towards a multipolar currency system”.

The truth for European reformers is that the US is unwilling to enter into any type of cooperation that might restrain its monetary sovereignty. Given its dominant role in financial matters and its veto power in the IMF, any reform of the IMS will have to be supported by the US. The US has therefore the power to block any attempt of reform. This can be observed by tracking Sarkozy’s positioning regarding the exchange rate regime. In October 2008, imminently after the collapse of Lehman Brothers, Sarkozy (2008) declared before the European Parliament that “the monetary system has to be rethought, between fixed exchange rates and no exchange rates at all. We’ve tried everything in the world. Can we, those of us in the rest of the world, go on financing the deficits of a leading world power without having any say? The answer is clearly no”. After proposing, with the implicit backing of China, in August 2010 his ambitious reform agenda for the French G20 presidency in 2011, he then went on January 2012 to meet US President Barack Obama to discuss his reform strategy. The US president’s rebuke must have been quite strong considering that Sarkozy (2011) returned to France denying three rumors that, paradoxically, he himself had helped to create: 1) that France favours fixed exchange rates; 2) that it wants to question the centrality of the dollar and 3) that it is proposing capital

controls. In subsequent months Sarkozy scaled down the tone of his reform ambitions.

6. Conclusion

The current IMS suffers from an inherent flaw. It depends on US current account deficits for the provision of global liquidity. The larger this deficit, the greater is the possibility of debasement in the value of the USD. This tension has long been acknowledged by policymakers in Europe, especially in France, and it is now openly voiced by policymakers in emerging markets, especially in China, which is the main creditor to the US.

The Bretton Woods II configuration whereby East Asian surpluses were recycled in USD denominated debt worked smoothly for some time, but the global financial crisis has shown that the Triffin Dilemma has not gone away. In order to overcome this flaw, Chinese policymakers have urged the international community to start a debate on the reform of the IMS. France, a country that has never hidden its frustration with the exorbitant privilege of the US, has picked up the call and made this topic one of its primary objectives for its G20 presidency in 2011. The aim of the French government has been to function as a broker between the distant positions of China and the US. In some ways, France is in an ideal position to achieve this goal. Like in Beijing, in Paris the creation of a totally flexible international exchange rate regime is seen as unfeasible and perhaps even undesirable. The establishment of an exchange rate regime based on target zones has been the unspoken dominant doctrine among French financial officials since the collapse of Bretton Woods. The problem is that they have never been able to convince their American counterparts about the validity of this doctrine.

This is the reason why France has avoided to present target zones as its official position in the current G20 negotiations. Paris does not want to confront Washington on this topic in a public manner, thus officially it sticks to the Anglo-Saxon view that flexible exchange rates is the ultimate goal. This ambivalent position is discomforting from the point of view of Beijing. Chinese officials are suspicious about the intentions of France. It is not clear whether it really wants to push for a more managed exchange rate regime or whether it wants China to join the G7 and to include the RMB in the SDRs basket in order to apply more pressure on Beijing to make its currency freely convertible.
As a consequence, China does not see Europe as a reliable partner in the reform of the IMS. First of all, the EU is not seen as a cohesive force but rather as a group of different countries with different national interests, which makes them very jealous about keeping their seats and influence in the IMF and the World Bank. As long as the UK, Germany, France and Italy or at least the latter three as the main economies of the EZ, do not speak with one voice in international monetary diplomacy, Europe will not have sufficient credibility. Secondly, the European countries are still seen as dependent on the US. Beijing would like to see a united and independent Europe that can act as a counter-balance to the US, but this is not happening. This is the reason why China has lost faith in the reform process and has started to internationalise its own currency. Given that the US is opposed to any multilateral agreement and the Europeans are too divided to apply pressure upon Washington, Chinese policymakers have decided to establish a multicurrency IMS out of their own efforts.

Increasingly, the favoured scenario both in Beijing and in Europe is a tripolar monetary system, in which the euro and the RMB gradually erode the supremacy of the dollar and the US’ exorbitant privilege. Although reluctant to save unconditionally a continent much richer in per capita terms, the Chinese leadership has repeatedly expressed its intention to support the long-term viability of the European currency. While it internationalises its own currency, China needs to have an alternative to a depreciating dollar, and the euro is the only other international currency with sufficient absorption capacity to diversify away from the dollar. China has for some time now gradually diversified some of its reserves in the European currency.

In case China achieves to make its currency the third global reserve currency, would a tripolar monetary system be more stable than the current? It is difficult to say. More competition could bring more efficiency because the Triffin Dilemma would be shared. However, more competition can also mean more volatility and more tensions. Fearing the latter, it is quite probable that the desire to achieve a multilateral IMS will continue, even though we are aware that finding a consensus will not be easy. As Padoa-Schioppa (2010:13) would put it in the reform of the IMS, “we need a flying object; inventing the airplane is a different matter altogether”.
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