

THE DYNAMICS OF THE SUCCESSION OF CURRENCIES IN THE 21ST CENTURY – A CASE OF CHINESE FINANCIAL LEADERSHIP?

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Introduction

Since the Industrial Revolution, the history of the world has changed in infinite aspects. The Middle Ages was marked by a low-growth period and almost no division of labor. The long-distance trade and the rise of a market-guide enterprise production defined the breakthrough of the capitalist system. The local governments autonomy and their relation to the king and enterprises would be fundamental, not only for Europe, but as a framework example to other economies. The mercantilist economic understanding dominated Europe after the Middle Ages, emphasizing trade balance surpluses and the role of exports as a development instrument. Mercantilism ruined at the end of the 18th century with a shift in Britain's economic system. The Industrial Revolution would emphasize property rights and economic openness as a means to increase productivity and trade efficiency.

Great Britain emerged as the economic and political power in the 19th century. After 1850, the gold overpassed the silver role in the monetary system, a movement that would support the creation of the gold-standard framework. In the post-1880 period, The Pound Sterling, as a consequence of economic circumstances and the gold-standard, rose as a key-currency in the sense countries could hold foreign exchange reserves to prevent liquidity risks.

In the 20th century, the United States would assume the role of protagonist in the international scenario. During the First and Second World

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War, the country provided goods to Europe, boosting its trade balance. Further, the United States inferred an important role in European reconstruction during the Post-War period. The United States Dollar would emerge as the most important key-currency, appreciating against the Pound Sterling mainly after the half of the 20th century. Therefore, since the end of the Bretton Woods system in 1971, the United States Dollar has maintained its position in the international scenario.

According to the World Bank (2019a), in 2018 China accounted for 18.34% of the world's population, while the United States, economic and financial power accounted for 4.3%. Further, the Chinese annual average GDP growth since 1978 accounts for 9.5% (World Bank 2019b), a circumstance that has elevated future perspectives to its economic power, its income standards, and its role in the global economy.

This article aims to investigate the necessary conditions for China to develop the Renminbi in the international scenario and to infer its current status in that progress. The main hypothesis is divided in: (1) an analysis of patterns in the internationalization of both the Pound Sterling and the United States Dollar; (2) an interpretation about how had China shifted from a poor economy to a high-growth open economy and its reforms aspects; and (3) an evaluation about the Chinese future steps between real and financial economy, in what extent they are associated with the balance of payments, and its future effects on the internationalization of the Renminbi.

All things considered, this paper is structured in this introduction, three sections ensuing to answer the main objective, and a conclusion. Section 2 intends to analyze the international economics effect and the theoretical presumptions. Section 3 investigates the history of the British pound and the US dollar hegemonies and the perspective of the Chinese development in terms of goods, money, and foreign exchange markets since 1978, and its aspect of gradualism towards a market-driven economy. Section 4 stresses the Chinese dichotomy between real and financial economy. Last but not least, conclusive commentaries are established.

Theoretical Discussion

In the 18th century, David Hume built up a structure involving exports, imports, and gold reserves. The specie-flow mechanism explains how reserves should naturally self-regulate - gold flows as a result from imports and exports should adjust prices and net exports to zero.

In this model, money is considered neutral. Thus, an exogenous

expansion in it would just increase prices. Suppose England imports more than it exports in relation to France. An outflow of gold from England would reduce its money supply and lead prices to deflation, reducing comparative prices to international economics. That scenario encourages France - facing an increase in money supply and consequently inflation - to import from England:

Nor is it probable, that the diminution of circulating money was ever sensibly felt by the people, or even did them any prejudice. The sinking of the prices of all commodities would immediately replace it, by giving England the advantage in its commerce with all the neighbouring kingdoms (Hume 1768, 363).

The Balance of Payments, BoP, is key to understanding exchange rate movements. Feenstra and Taylor (2012) argue that macroeconomic fluctuations are exposed by three interdependent markets: the goods market, the money market, and the foreign exchange market. These factors are associated to several variables - interest rate (i), investment (I), real money supply (M/P), real money demand (MD), domestic and foreign returns (DR and FR), exchange rate (e), and output (Y).

The forex market is the uncovered interest parity (UIP) attainment, “when the expected returns expressed in domestic currency are the same on foreign and domestic interest-bearing (money market) bank deposits”. (Feenstra; Taylor 2012, 270). Domestic returns should equalize foreign returns plus an expected rate of depreciation of the domestic currency. Consequently, a suppose decrease in domestic returns leads to a capital outflow to foreign markets, depreciating home currency.

Nonetheless, three distinct factors influence how the IS-LM-BP model interacts with those markets (goods, money, and foreign exchange): the exchange rate regime, capital flows, and monetary autonomy. The policy trilemma emphasizes that, in an international economics approach, policymakers face an impossible trinity. “They can attain only two of the following three policy choices: (1) a fixed exchange rate, (2) unrestricted international financial or capital flows, and (3) monetary policy autonomy, or independence”. (Salvatore 2013, 654).

Therefore, policymakers have three different options: (1) free capital flows and fixed exchange rate - domestic and foreign returns need to be equal, then monetary policy autonomy would be impracticable, (2) free capital flow and monetary policy autonomy - domestic and foreign returns would equalize through changes in a floating exchange rate regime, and (3) fixed exchange rate and monetary policy autonomy - the only possible way to maintain this

set of policies is restricting financial flows.

Simonsen and Cysne (2009) argue that, except in a purely floating exchange rate regime, the adjustment of the balance of payments occurs by extreme coincidence. Then, successive surpluses may be possible, and deficits can persist under international reserves or other compensatory capitals. The authors justify that those permanent shortfalls must be corrected by one of the following measures: (a) real exchange rate depreciation, (b) output shrink, (c) import restrictions, (d) export aid, (e) higher interest rate, or (f) capital outflow controls. The last two methods can be effective only in the short-run, due to the fact that a higher i adjusts BoP under an increase in financial liabilities, and a control to capital outflows may be a janus-faced method, considering that it may jeopardize capital inflows.

The dichotomy between the real economy (CA) and the financial economy (KA + FA) is even more visible when comparing emerging, rich, and poor countries. Simonsen and Notwithstanding, the authors argue that current account balance in some way feedback itself. A country with CA deficits adjusts its balance of payments receiving foreign capital. However, this inflow represents a future outflow of profit and earnings to previous external agents. Crowther (1957) suggests a theory in which countries can be divided in creditors and debtors, and capital importers or exporters. The creditor or debtor state refers to the primary income (NFIA). A country that accumulates positive net investment income is a creditor, whereas a negative net investment income refers to a debtor nation. The IMF (2009) argues that the investment income takes into account (1) income associated with the production process such as compensation of employees, and (2) income associated with the ownership of financial and other non-produced assets, such as returns of financial assets, dividends, interest, returns from direct investment. The capital status can be divided by countries with a negative capital account (capital exporters) and with a positive capital account (capital importers). The capital account balance is inversely proportional to the current account balance.

In the first stage, there is an accumulation of net external liabilities, due to a current account deficit, especially in response of a negative trade balance. The intermediate debtor starts to obtain trade balance surplus, but not in a sufficient amount to compensate net income sent to abroad. A mature debtor country holds a surplus in trade balance greater than net income sent to abroad, and starts to decrease its net external liabilities. In a certain instant, the country leaves the debtor state to a creditor one. In that moment, net external liabilities turns itself to net external assets as a result of resource transfers and the net income received from abroad. In the fifth step, trade balance deteriorates but in lower amount than the net income received from

abroad surplus. Then the country disposes of its foreign assets in the last stage, when the resource gap overpasses net income received from abroad (Simonsen; Cysne 2009).

Surpluses in BoP can be allocated in several ways. Generally, they are allocated in exchange reserves, that are claims on nonresidents in the form of: currency and deposits, securities, financial derivatives, or other claims (IMF 2019). Nonetheless, at the end of the nineteenth-century, exchange currencies “were held because governments borrowing in London, Paris, or Berlin were required by the lenders to keep a portion of the proceeds on deposit in that financial center”. (Eichengreen 2008, 22). Further, even if it was not required, the creditworthiness prevalence influenced borrowing countries to maintain those reserves.

The requirement of those claims increases whereas those currencies become liquid, trustful, and internationally manipulated. Peng and Shu (2010) argue that two separate concepts define the notions on international role of currencies: the distinction between domestic and international - in terms of the currency usage degree outside the currency area, and the international debt market - market of issuances by non-residents of a country or currency area. The authors discuss the function of the international debt in providing international role for a currency in terms of finance and investment. The authors conclude that the international debt market provides information to match with the functions of money matrix theory, which emphasizes currency features that can characterize a more internationalized currency.

Table 1 - The Matrix of International Currency Use

<i>A: Theorist's matrix</i>	Private use	Official use
Medium of exchange	Vehicle currency	Intervention currency
Unit of account	Quotation currency	Anchor currency
Store of value	Investment and financing currency	FX reserve currency
<i>B: Practitioner's matrix</i>	Use in financial markets	Use in third countries
	International debt markets	Exchange rate anchor, FX reserves
	Foreign exchange markets	Cash and parallel currency use
	International trade invoicing	

Source: Peng and Shu (2010).

Further, the authors measure the international role of specific

currencies. The evaluation is “based on both the size and the structural characteristics of each currency’s capital market and underlying economy” (Peng and Shu 2010, 11). Factors such as the size of economy, size of financial markets (debt market, stock market, derivatives market, FX exchange market), financial market regulation (disclosure, liability, supervision, access to equity, and financial market sophistication), size of state (property rights, freedom of corruption, state-owned enterprise investment, and share of government-owned banks), monetary issues (central bank independence, inflation volatility, and inflation absolute in a specific year), and trade barriers (freedom of regulatory trade barriers, international capital market controls, capital account openness, and freedom to own foreign currency bank account) are key points to a more internationalized currency. It is important to highlight that the global role of a currency, in that case, is directly proportional to the size of the market/economy, and to its liberalization/openness.

Evolution of the Pound, the Dollar and Recently the Renminbi

Clark (2007) foments the discussion that probably something systematic was avoiding early societies to reward from innovation. Property rights and a weaker power from the state could have broken this systematic process and enable individuals, and not groups, to make decisions of trade, allocation of values and search for their own wellbeing.

Ferreira et al. (2011) argue that, in fact, England had a set of laws protecting private property that could entail the right incentive to investment and innovation. Further, “those institutions did not exist, at that time, anywhere in the world.” (Ferreira et al., 2011). The increase in human capital and knowledge possibly was induced by an individual perspective to decide, given by that new systematic.

According to Ferreira et al. (2011), although private property rights were necessary to the Industrial Revolution, IR, it was not sufficient. The IR did not just bring good institutions, property rights and let innovation and the private initiate come in. It brought essentially a new wave of international trade, the first great globalization shock.

Whereas international trade took place, two concerns in the monetary system started to rise: global connections and network-externalities. An open economy tends to increase exports and imports share in national production, backdrop that connotes more trade between countries - nations better integrated. Subsequently, a common monetary standard is fundamental for reducing negotiating costs.

Up to the mid-19th century a bimetallic monetary system contained those network-externalities. According to Eichengreen (2008, 9), only Britain operated a gold standard, while “the German states, the Austro-Hungarian Empire, Scandinavia, Russia, and the Far East operated silver standards. Countries with bimetallic standards provided the link between the gold and silver blocs.”

The network-externalities narrowed when the gold standard became widespread in 1870. The Industrial Revolution innovations in Britain led the gold standard to emerge regionally, and, as a consequence of the global British economic leadership, it developed internationally. Besides necessary, these events were not sufficient to the pattern change. Prior to 1870, silver-based countries experienced instability in terms of silver supply. Silver discoveries in 1850 and Germany’s monetary policies were fundamental to explain the adherence of the Britain’s gold standard.

Since the 18th century, the United Kingdom experienced specific but cyclical events that would impact directly in the British currency, especially the Industrial Revolution and its innovations, and the British relevance in the global economy. Thus, the second half of the nineteenth-century would be crucial to the pound sterling to develop a huge influence in the international monetary system.

According to Thirlwall (1986), up to 1870 British trade data was really uncertain, although between 1854 and 1870 there are values declared by shippers. In the period post the mid-eighteenth century, Britain emerged as the global economic power, mainly in terms of commerce and industry. The production of manufactures brought by the Industrial Revolution innovations boosted its balance of trade. Therefore, British products crossing all over the world, especially in Europe and India, accentuated the first wave of globalization.

Britain changed its international influence from a great exporter and a debtor country to a creditor status. The current account balance even increased during the 19th century, and was essentially high before the WWI. That shift can be explained by high capital outflows as a response to surpluses in the trade balance. These transfers to other countries aim profitability under institutional investments in foreign assets. In a certain moment, these remittances come back to the home country in the form of income from abroad, impacting positively the NFIA. Then, a natural movement to an appreciation in the pound sterling took place.

The war necessities of credit expansion were the linchpin to the temporary abandonment of the gold-standard. The trilemma solution before WWI was designated to floating rates and capital controls. Then, exports

and imports as a percentage of world's GDP dropped significant levels, and monetary autonomy continued detached.

After WWI, the United States, that emerged as the leading country in terms of GDP at the end of the nineteenth-century, increased even more its trade balance surpluses. Britain and France pegged its exchange rate on the U.S. Dollar (USD) under depreciated rates, draining gold reserves, specially from the U.K, and the incorporated for recently created Federal Reserve. Further, Eichengreen (2008) points out that Britain, in the advent of the First World War, had to sell off larger part of its foreign assets, and creditor countries like Germany became dependent on imports from the United States, being reduced to a debtor status.

The pre-WWI environment was fueled with cuts in discount rates by central banks. Then, exchange rate depreciations reached high amounts over great part of Europe. According to Ammous (2018), during WWI, Austria's currency devalued 68.9%, Germany's 48.9%, Italy's 22.3%, France's 9.04%, and U.K.'s 6.63%. The 1920s was then marked by hyperinflation in countries like Germany, and a massive North-American production. In a scenario with monetary instability, exchange reserves lose credibility, and its holders migrate their claims to other financial assets. Eichengreen (2008) exposes the League of Nations function in replenishing reserves by loans, and a fortification of central banks independence. In that case, the loss of credibility empowered the return of the gold-standard. Several countries restored the gold parity between 1923 and 1927, and a new peak of countries on the gold-standard was reached in 1931.

The sterling suffered a crisis in 1931. In 1930, protectionism and higher tariffs to imports undermined world trade. The United Kingdom suffered instabilities facing a trade balance discharge due to a decline in exports. Higher discount rates could not contain reserves losses. Then, the Britain's drop of the gold-standard in 1931 would impact to a general suspension of convertibility.

In 1932, according to Eichengreen (2008), the monetary system divided by three: (1) gold-standard: Western Europe, United States, and Latin America, (2) proper currencies and exchange controls: Central and Eastern Europe, and (3) peg to sterling. Notwithstanding, with the Glass-Steagall Act, and the presidential victory of Roosevelt, the United States was "free" from the gold-standard impossible trinity, and increased monetary autonomy, under a system of floating rates.

The U.S. Dollar would be essential for the European reconstruction during and after the WWII. How it happened in the WWI, the United States trade balance would be boosted, and as a response of an adjustment

mechanism, capital outflows would perdure, alleviating pressures on the exchange rate.

Figure 1: U.S. Goods Trade Balance to GDP



Source: FRED.

The Bretton Woods system, according to Feenstra and Taylor (2012), would aim exchange rate stability to inspire the European reconstruction and the recapture of trade. Countries would peg their currencies to the U.S. Dollar, constituting it as a central currency, while it would be pegged to gold.

The reestablishment of the monetary system would move the dynamic center from Britain as the global economic and financial power to the United States. It is attractive to examine this movement not just as a political and transversal decision, but as a movement through cycles. The huge North-American economy and its shift from a debtor nation to a creditor nation, along with unrestricted capital flows, could allow a natural core movement. The appreciation of the USD over the pound sterling is evident after the Bretton Woods system.

Further, China would give its first steps towards fundamental institutional reforms. Tobin and Volz (2018) argue that China would start reforming its mono-banking system at the same time the Bretton Woods collapsed in 1971, and the competition from non-bank financial institutions and the emergence of global central banks and money center banks would emerge.

Garnaut and Song (2012) argue that at the end of 1978, 22nd of

December, the third plenary meeting of the Eleventh Central Committee of the Chinese Communist Party would be one of the most important meetings for China's economic future, in domestic and foreign fields. Subsequently that meeting, China would replace its economic and political core to a globalization-bias process.

Masiero (2006) extends the relevance of the third plenary meeting arguing the CPC conduction to modernizations in agriculture, industry, science and technology, and national defense. This modernization can be denominated as the Fourth Revolution, after other Chinese historical circumstances: the Republican Revolution (1911), the Communist Revolution (1949) and the Cultural Revolution (1966-76).

According to Garnaut et al. (2018), the Cultural Revolution had a terrible impact in China, in 1978 representing its brink of economic collapse. Lin (2013) indicates that China had been stuck in poverty for centuries. In 1978, the author exposed that its income per capita was US\$154 and it represented around one-third of the average in Sub-Saharan Africa. Further, its trade-to-gross domestic product ratio was less than 10%.

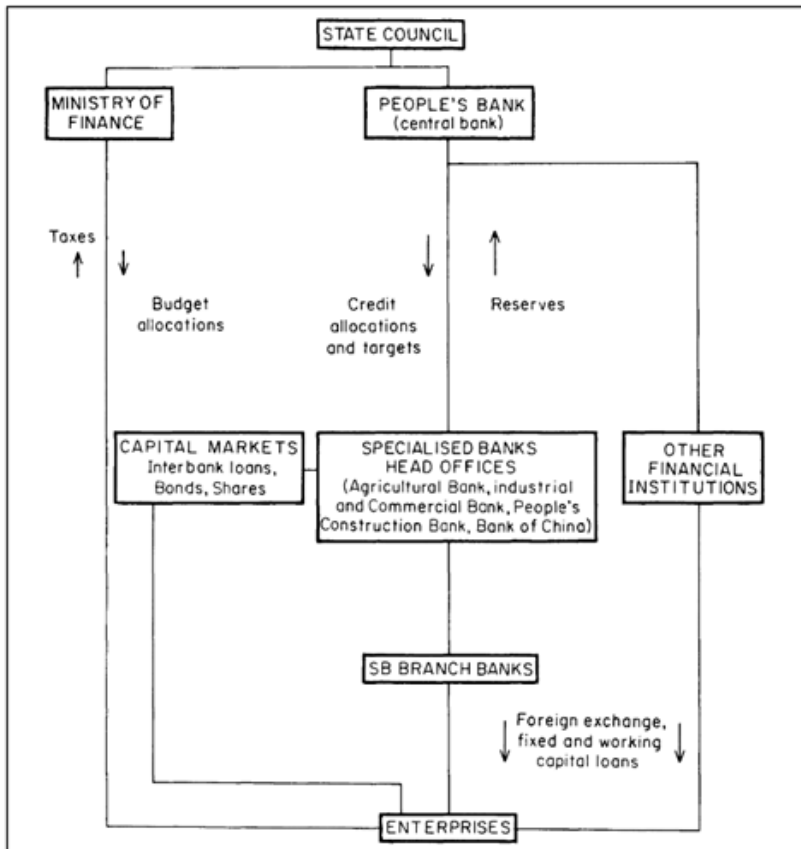
The anti-export inclination, the Chinese non-integration with the world, and the overvalued exchange rate of the Renminbi (RMB) undermined export incentives and import of technologies and production techniques. Garnaut and Song (2012) emphasize that in 1978 a trade system reform would be done gradually, intending specially an import substitution. According to the authors, the first stage of the trade system reform between 1978 and 1984 decentralized foreign trade authority by giving the right to municipalities, provinces, industrial sectors, and enterprises to conduct foreign trade.

The financial system is essential for public and non-public enterprises. Garnaut et al. (2018) argue that China was financially powerful at the turn of the twentieth century as it was an important international fund center. The authors argue that the *Silver Purchase Act* (1934), the Chinese war against Japan in 1937-45, and its civil war in 1946-49 shrunk the financial industry in China, centralizing the whole system in a monopolized institution, the Public Bank of China (PBOC), which acquired 93% of all Chinese financial assets in 1978. The socialization period after 1949 exacerbated the resistance for open financial markets.

The centralization of the monetary system and highly restrictions for the financial market inhibited money and credit to stabilize the monetary system. Tam (1987) argues that monetary authorities could not attain real economic growth also due to the fact that the volume control of the currency in circulation was inefficient to contain demand pressures on the supply of goods. Further, financial development was a necessary but not sufficient

measure to attain real economic growth.

Figure 2: China's Financial Framework, post-1984



Source: Bowles and White (1989)

Sit (1985) exposes that China intended to promote technical and economic exchange with foreign countries. To achieve this promotion, a social influence of capitalism was a price to pay. Hence, in order to maximize benefits and diminish this cost, the Chinese government proposed the establishment of Four Special Economic Zones, which would serve as specific areas for concentrated development and easier governmental control. The aversion to foreign capital flows could be contained through a special regulative structure that was outlined to conceive knowledge spillovers, and concentration of labor and technological import.

Property rights would relocate from local governments to enterprises.

The Property Rights Theory emphasizes that this shift occurs when local governments contribution to enterprises outcome decreases. Then, according to Taube (2002), unclear ownership rights have a tendency to set clear definition and distributions of property rights. A sharecropping system tends to substitute a fixed wage system. The author exposes that the residual profit retention rights are inclined to award the part that impacts more significantly business results. The system is associated with the fiscal feudalism policy accomplished before the breakout of the violence trap in the Middle Ages period.

Subsequently the three trade reforms mentioned earlier - decentralization of power and the weakening of the Foreign Trade Ministry (1979-84), tariff rates and monetary regime adjustments, and the GATT application (1985-86), and the contract system (1987-90) - the CPC would continue to incite changes in the trade framework.

The reform would aim three topics between 1991-93: (1) the GATT requirements for transparency, central planning, and export-licensing, (2) import management and control, (3) distortion of prices and exchange rate equilibrium. Garnaut and Song (2012) argue that the Chinese intention in that period was to incentivize a competitive environment for foreign trade involved enterprises.

The Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) would emerge respectively in 1991 and 1992. Garnaut and Song (2012) argue that non-tradable ownership shares were issued in 1984, on the employee share for Beijing state-owned department store. They argue, further, that prior to 1989 joint stock companies started to emerge, and during the 1990s, the capitalization in both stock exchange would rise as an important capital channel.

A new stage of the reform would take place after 1994, when “the PBC gradually narrowed the scope of credit control and introduced foreign exchange open market operations” (Guofeng 2015, 77). Further, Li (1997) argues that, in the 1993-94 period, the Chinese government announced a reduction of tariffs on almost three thousand items by an average of 8.8%. Additionally, an abolishment on all import substitution lists in 1987, and the unification of the exchange rate system in order to increase its currency convertibility by a managed floating exchange rate regime against a basket of foreign currencies were implemented.

Between 1994 and 1996, according to Geiger (2006), a crawling peg with higher trading bands was used, and led to an appreciation of the Renminbi from 8.7 RMB per USD to 8.3 RMB per USD. The author then argues that after 1994 the Chinese monetary policy aimed the stabilization of

the higher inflation rate, a significant economic growth, and an exchange rate target vis-à-vis the USD.

In 1995, the World Trade Organization (WTO) substituted the General Agreement on Tariffs and Trade. Chartier (1998) argues that the central government of China gained considerable political support in order to lower tariff rates and attract foreign investments by special treatments and concessions to investors, and decentralizing power to provinces, mainly after the 1990s. Then, the privatization and restructuring of the Chinese SOEs post-Asian crisis would be the fuse for its WTO accession in 2001.

The assent of the WTO to China represented the constancy of a gradual process to a market-driven economy. The country would avail the agreement to change its ownership framework and to follow an internationalization mode. According to Wakasugi and Zhang (2015), that mode would be similar to countries like the United States, Europe, and Japan, in the way exporters and non-exporters benefited from an increase in productivity.

The Chinese reforms that have started in 1978 “transformed it from a highly protected market to perhaps the most open emerging market economy by the time it came into the World Trade Organization at the end of 2001” (Lardy and Fellow 2003, 13). Also, China was converted in one of the best examples of a positive linkage between openness and economic growth.

At that moment, China has continued its path through trade liberalization, while it would reap benefits in terms of exports and agricultural productivity growth. Wakasugi and Zhang (2015) mention that in the first decade of the 21st century, it is well known that members of the WTO removed trade barriers by liberalizing and reestablishing their economies.

Although China had had a kind of immunity in front of the Asian crisis, the economic scenario, mainly the monetary, changed perspectives for China’s export and GDP annual growth. According to Wang (1999), the fact that the crisis decreased import demand from other countries had a huge impact in the export-based China. Further, the depreciation of those other countries’ currencies increased their competitiveness in the market, threatening the Chinese international market-share. In that time, the author argues that China resisted to depreciate the RMB, the reason that had shrunk FDI projects growth.

The international circumstances influenced China to take two economic instruments, (1) monetary and fiscal expansionism, (2) financial reform. Wang (1999) argues was pursued that the first one in order to stimulate domestic demand, whereas the second aimed a movement towards an economic and financial globalization. The author mentions that the

Chinese financial system was similar to those in other Asian countries, such as Thailand, Indonesia, Malaysia, and Korea, it could be diagnosed by “bank dominance of the financial system, lack of central bank autonomy, policy and political lending, accumulation of bad loans, and absence of a strong and disciplined equity market” (Wang 1999, 541).

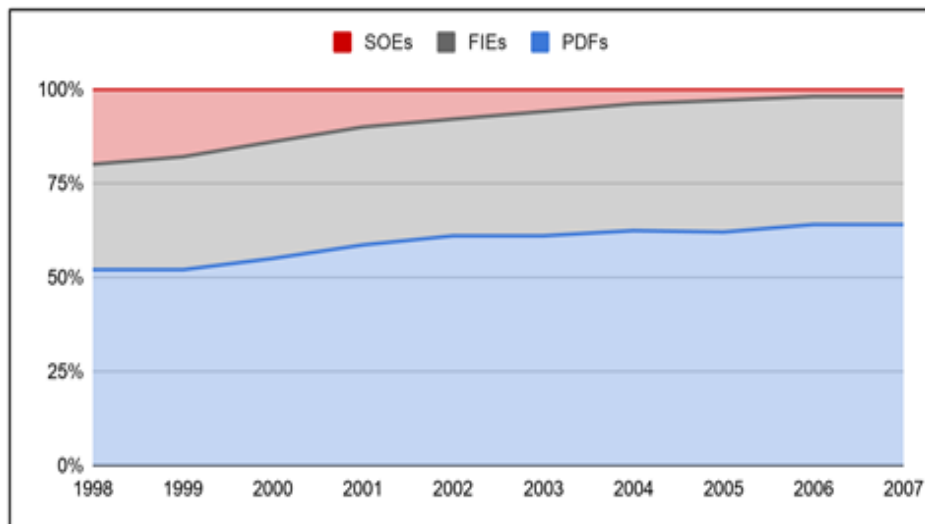
Huang and Wang (2011), and Ang and McKibbin (2007 apud Garnaut et al. 2018) developed a financial repression index that is fundamental to understand the Chinese financial system and gradualism after the Fourth Revolution. Garnaut et al. (2018) indicate the composition of the index: (1) real deposit rate, (2) interest rate control, (3) capital account control, (4) reserve requirement ratio, (5) state banks’ share in total lending, and (6) share of loans to SOEs.

At the beginning of the 21st century, the Chinese government besides the internationalization mode, adopted less trading restrictions, reduction of the special treatment that SOEs received compared to other enterprises, and the liberalization process WTO members would pursue.

The WTO controversy would be in terms of its effect in the agricultural sector as it exposes China to an open market and to global comparative advantages. Although the majority of the population lived in rural areas, 62.91% in 2001 according to the World Bank (2019c), the agricultural sector was composed by arable land scarcity and large labor supply. According to Garnaut and Song (2006), China’s per capita arable land was 0.11 per hectare, 43% of the world average. After the WTO, according to Garnaut and Song (2006), the Chinese agricultural comparative advantage declined at an accelerated rate, while agricultural imports grown at a greater pace than agricultural exports. The USDA (2016) demonstrates that China became an agricultural net importer from 2003, and after that period, imports had continued to grow at a greater pace than exports.

The asymmetric liberalization that created the dual-track system between the state and non-state sector has started to be reformed after the Asian crisis. Less trading restrictions and the distortive market and prices led China to reduce the special treatment to SOEs, and to let more efficient enterprises to flourish. Wakasugi and Zhang (2015) analyze the effect of the accession in the structural change in export decision of Chinese enterprises, and how it affected the ownership framework between foreign-invested enterprises (FIEs), private domestic firms (PDFs), and SOEs.

Figure 3: Number of Firms Composition (turnover higher than RMB 5 million)



Source: Wakasugi and Zhang (2015)

The Chinese entry to the WTO signified a huge change in terms of technological access, exposition of comparative advantages, improve in the trade balance, and a rapid economic growth. Garnaut and Song (2006) argue that after the WTO, the average annual growth of the GDP was more than 9.8% (2002-05). Also, the authors mention that China's foreign trade in the same period average annual growth was 28.6%. Further, according to the World Bank (2019d), the Chinese trade balance had an average annual growth of 55.1% between 2001 and 2007. Cui and Syed (2007) argue that the fundamental components for that improvement had been electronics, machinery, iron, steel, textiles, and chemicals.

The Succession of Currencies in the 21st Century

China's surpluses in the trade balance and its liberalization of the current account were analyzed in the previous section. The dichotomy between real and financial economy is essential to understand the role of a currency in the international scenario, as also its support for external and internal balances.

Geiger (2006) indicates that the PBC could reach its targets - inflation

stability, GDP growth and peg to the USD - through instruments with ratio (reserve requirements), instruments with interest rates (central bank lending rates), quantitative instruments (open market operations (OMO), and other instruments, such as central bank bills. China would shift considerably its monetary policy. The first key-point was the Asian financial crisis with the change in the Chinese exchange rate regime, and the second was the WTO entry, which intensified its liberalization of price controls and its use of indirect controls on the monetary system, such as central bank bills (a type of OMO).

Table 2: Chinese Monetary Instruments

Instruments of the PBC as the central bank	
<i>Indirect Instruments: Price-based</i>	
I.	PBC lending and deposit rates
II.	Discount and rediscount rate
III.	Reserve requirements
IV.	Open market operations
<i>Direct Instruments: Quantity-based</i>	
I.	Window guidance
II.	Direct PBC lending
III.	Capital controls
Other non-monetary policy instruments	
I.	Price controls
II.	Wage controls

Source: Geiger (2006)

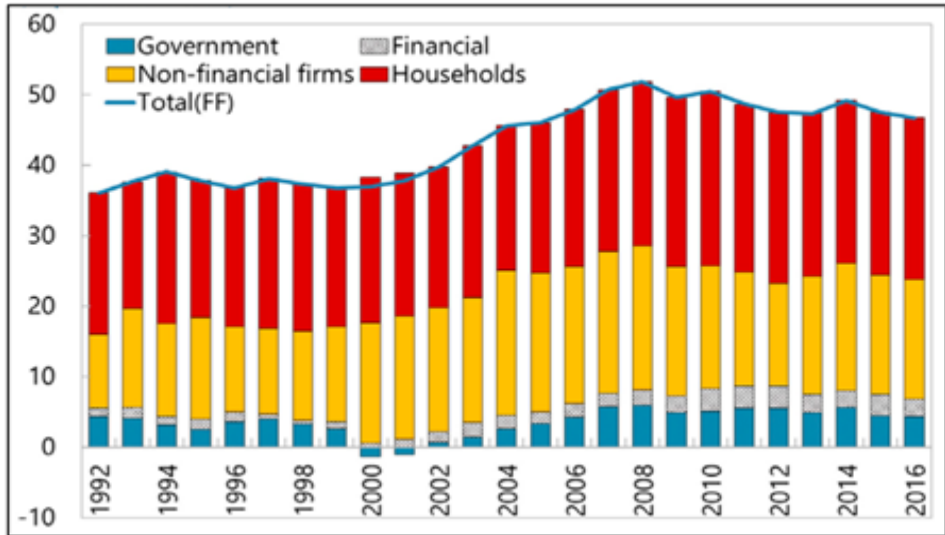
Governments can adopt FX intervention by two means: sterilized and non-sterilized interventions. Ng (2013) specifies that the non-sterilized type alters the monetary base and can jeopardize monetary policy goals, while the

sterilized maintain the monetary base at consistent levels with its established monetary goals. Suppose the Chinese government wants to depreciate RMB against USD, the non-sterilized would have 7 steps: (1) buy of USD assets and sell of RMB, (2) increase in RMB supply and USD demand, (3) depreciation of RMB against USD, (4) increase in the Chinese monetary base, (5) lower Chinese interest rate, (6) encourage more investment and less saving, (7) increase in inflation rate. China had opted for the sterilized method: (1) buy of USD assets and sell of RMB, and to counterbalance the impact of it in the monetary base, the government (2) “engage in contractionary monetary policy, such as selling government securities, to remove the excess renminbi supply from the domestic market” (Ng 2013, 5).

In that sterilization process, Ng (2013) argues that China had deepened its IIP in United States financial assets, mainly by holdings of U.S. Treasury and U.S. securities. Garton and Chang (2005) comment that in 2004 at least 80% of all the Chinese foreign exchange reserves were dollar-denominated. That composition infers risks for China as interest rates received (U.S. assets) by the Chinese government are lower than interest rates paid (Chinese bonds/bills). Further, the fact that the composition of China’s financial assets is given by foreign assets increases even more the country’s risks, whereas an appreciation of the RMB would reduce financial earnings.

Notwithstanding, according to Elliott and Yan (2013), the Chinese financial system differentiates from developed financial systems in the sense it assumes high levels of state ownership and control. “The five largest Chinese banks are majority-owned by the central government and there are significant government stakes in many of the other banks” (Elliott and Yan 2013, 3). Johansson (2012) demonstrated that state-owned commercial banks had a share of 48.47% in China’s banking assets, followed by joint-stock commercial banks (18.13%), rural commercial banks and credit union (10.73%), policy banks (8.63%), city commercial banks and credit union (7.09%), postal saving banks (3.35%), non-bank institutions (1.92%), and foreign banks (1.68%).

Figure 4: Chinese Saving Rate Composition (% of GDP)



Source: Zhang et al. (2018)

Interest control is evidenced by its manipulation during the sterilization process. Further, Xu (2018) argues that the Chinese interest rates and credit allocation had been majorly influenced by political rather commercial factors. Lardy (2012 apud Xu 2018) demonstrates that in some periods China presented negative real interest rates, in a result of the financial system rigidity. The author argues that in households interest income had been far lower than in more liberalized financial economies.

Liping and Evenett (2010) argue that the service sector serves as a sustainable architecture for international trade - provide inputs to production, such as capital and labor, generate knowledge, concentrate economic activity, and increase productivity. For the authors, the increasing share of the service sector, in general, (1) increase demand for labor, (2) increase wages, (3) exporting firms reduce their employment without an offsetting increase in productivity, (4) the share of other sectors decline, (5) manufacturing exports fall and the trade balance in goods worsen. According to the World Bank (2019e), in 2010 the average share of the service sector in value added to GDP was 54.42% in emerging countries, while China amounted for 44.18%. Understanding the role of the service sector and savings of households, it is important to point that households are important in terms of future consumption and service sector insertion, mainly if the economy displays dynamization in structural balancing.

The banking sector in China flourished stuck in the heavy industry development. As previously mentioned, the major share of state-owned banks privileged SOEs and other specific industry corporations in terms of favors and credit, “despite the fact that SOEs are on average less productive than private firms. In contrast, private firms have access to credit only at higher market interest rates.” (Liu and Spiegel 2019, 2). In addition, Tobin and Volz (2018) argue that the rural area lack access to adequate banking and financial services.

After 2005, China has allowed the Renminbi to float, increasing its trading bands, and accepting the effects of an increase in productivity. The accumulation of reserves leads China to expand its monetary base, fact that created inflationary pressures, and consequently caused real exchange rate appreciation. Chan (2018) argues that in a response of the sterilization costs, the Chinese government adopted an exchange rate based on a trade-weighted basket of currencies to diminish the real effective exchange rate effects of other currencies except for the USD.

Assuming an increase in the Chinese productivity, a RMB appreciation is inevitable. The essential capital controls to outflows, an anticipation of that appreciation is probable to occur through capital inflows, such as increasing amounts of inward FDI. If China shifts its interest rates to answer that scenario shift, internal balance would be in check. The capital controls under these circumstances, and possible inflows of FDI could bring monetary and financial instability: “a currency crisis that may trigger a banking crisis is a possibility” (Allen et al., 2015, 306).

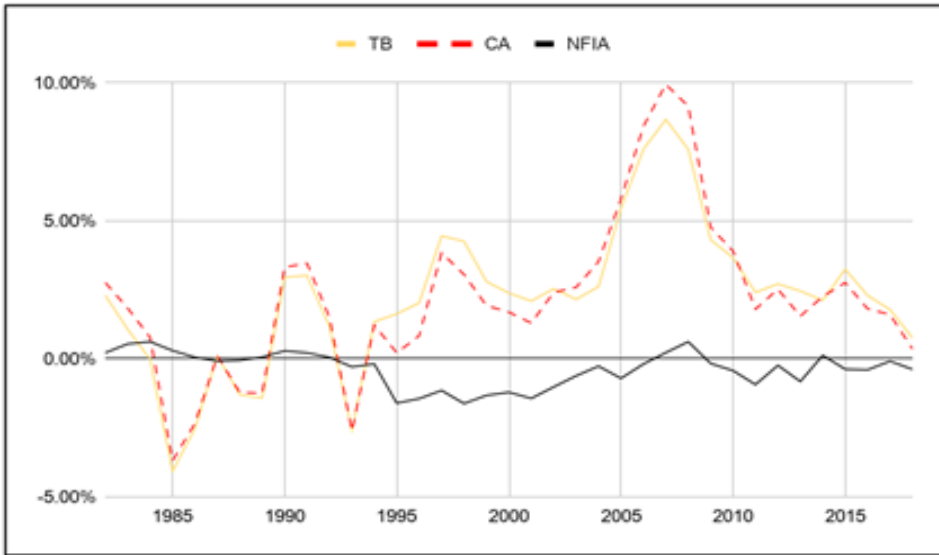
In terms of the financial account, the Chinese authorities may (1) expand financial repression, or (2) liberalize capital flows to contain instabilities and to maintain internal and external balance. According to Johansson (2012, 15), “financial repression may cause external imbalances due to the imbalance in the economic structure”. Actually, China’s inflows of FDI are essential for the manufacturing sector, to the maintenance of the SEZs and the TVEs, and to its function as one of the major China’s sources of investment. Then, limiting capital inflows may threaten domestic production. Notwithstanding, the liberalization of capital flows in China may incentivize massive capital outflows.

Relaxing capital controls can demonstrate a win-win policy between China and investors. According to Ito (2011), China could benefit from liquidity, deep markets for domestic financial products and increasing expertise in financial management and product development. Investors could have a more predictable and trustful market to invest, and access to a fast-growing economy in pursuance of financial returns.

A more flexible exchange rate requires specific functions to the capital account. As mentioned in section 4.1.2, China faces risks whereas it accumulates dollar claims in response of current account surpluses. McKinnon and Schnabl (2014) argue that the fact China does not lend in its own currency (RMB) can infer in currency risks: if China completely withdrew from the FX market, (1) China's CA surplus would be uncovered - financial institutions would not provide a matching liquid capital outflow, and (2) the RMB would appreciate indefinitely.

In terms of current account, a future appreciation of the RMB would infer in less competitive product for China. The TB would be reduced, and imports would emerge in a response of higher income per capita and attractiveness of foreign products prices. Thereafter, a TB contraction may be countervailed by an increase in the investment income (NFIA). Notwithstanding, China does not lend in RMB, factor that hamper the accumulation of claims and credit in RMB with other countries. Further, the high share of international transactions between China and United States increases returns discrepancies among them: the United States displays FDI outflows to China (U.S.'s assets, China's liabilities), and accumulate liabilities in treasury bonds and other governmental assets (U.S.'s liabilities, China's assets). The inconsistency framework acts in the sense the United States accumulate assets of a rapid-growing economy, whereas China accumulates claims of the most "reliable" economy in the international scenario, fact that dismisses risks and creates low-return assets. Capital account liberalization may emerge in place of a possible shrink in the trade balance, due to the necessity to increase the net factor income from abroad and the Chinese financial market liquidity in the international scenario.

Figure 5: China's Trade Balance, Current Account, and Investment Income to GDP (%) timelapse



Source: World Bank and author's calculation

A growing China with an open capital account would be able to benefit from international seigniorage in a greater extent, due to a larger dimension of the RMB in the global economy. An increment of the RMB supply held by other countries would increase in relation to its inflation, allowing a growing seigniorage revenue through time. Further, the exporter faces some risks in the foreign exchange market. First, the value of an ongoing production can suffer a contraction if an appreciation of the domestic currency occurs. Second, if the domestic currency is of great volatility, uncertainty can undermine international transactions in goods and services, due to the fact that exporters need to hold certain amounts of foreign currency for transactions. Also, a less international currency may require third-party currencies to trade with other countries. In the case of China, the USD is used to trade with developed and neighbouring developing countries. Therefore, the internationalization of the RMB may reduce foreign exchange risks and transaction of costs, and increase bilateral trade with neighboring countries (Peng and Shu 2010).

De Sousa and De Freitas (2018) discuss that the internationalization of the RMB is beneficial for China in the sense it could expand its economic influence, protect, and boost country's exports and investments. Peng and

Chu (2010) argue that an internationalization of the RMB may expand financial markets and financial institutions efficiency. The authors suggest that in the banking industry domestic commercial banks could reach international standards, would be able to marketize interest rates, diversify financial services, and modernize internal management systems. Further, the authors discuss the benefits to the internationalization of the security market - no nationality limitation on both investors and debtors - as a reflection of a developed financial system, and the internationalization of financial institutions - admission of foreign banks in the domestic financial system and autonomy for financial institutions to operate internationally.

The Global Financial Crisis (GFC) that happened between 2007-2008 would have a huge impact in the monetary system. The United States, country that pursues the dominant international currency, was responsible for a global financial instability. De Sousa and De Freitas (2018) argue that the GFC had simply accentuated the Chinese criticism to a dollar-based international monetary system, and in fact created incentives for China to implement an internationalization of the RMB.

China, in order to pursue a more internationalized currency, may follow four steps of liberalization (1) current account liberalization, (2) floating exchange rate regime, (3) financial development, and (4) capital account liberalization. The current account liberalization actually happened in the WTO accession in 2001. A floating exchange rate regime has gradually been implemented in China's monetary system, mainly since 2005, although in a response to the GFC the country had narrowed currency trading bands. Financial developed is required for internal factors and to support a capital account liberalization to allow China to acquire benefits from an internationalization of the RMB.

Further, if China accepts the fact that an increase in productivity should lead to an appreciation of the RMB, the country must develop its financial system to support the continuity of economic growth, may promote a more floating exchange rate regime to adjust domestic and foreign price levels and to reduce monetary intervention costs, and must open the capital account to guarantee an increase in the NFIA to countervail the appreciation of the RMB and its effects on the TB. The capital account openness requires a more developed financial system to avoid capital flight by discrepancies in international and domestic returns, mainly from households.

De facto, China has been going through this path. Deng Xiaoping's gradualism has not given a step back since 1978. According to Kwon (2015), China has adopted two different strategies without the full convertibility of the RMB after 2008: a global, and a regional strategy. The global strategy

aims to expand the RMB's circulation in international financial markets, also it encourages the use of the RMB as payment for exports and imports. The author argues that China launched in 2008 a pilot program between provinces and major cities of RMB settlement in trade. The program expanded to more provinces and cities, and to neighboring countries in 2010.

McCauley (2011) indicates that the Renminbi in 2010 started to operate in a trifurcated market, dividing the Chinese Yuan aspect: strictly offshore Chinese Yuan (NDF), onshore market Chinese Yuan (CNY), and the offshore market Chinese Yuan outside China (CNH). The author argues that trifurcated Renminbi can act as a bridge from a socialist to a market-driven economy, in the sense that the prices in the onshore and offshore markets differ, hence enabling signal sending from the offshore to the onshore market.

The global strategy included bilateral swap agreements (BSAs). McDowell (2019) argues that the technique was introduced in 1960s with the United States. The technique is simply an agreement in which parties exchange their currencies for a certain period and amount. The BSAs act like collateralized bonds: “the creditor holds the newly acquired foreign exchange while the borrower uses its newly acquired funds to address its financial needs” (McDowell 2019, 124). The author exposes 35 countries in which China had BSAs in 2017, with a total amount greater than 3 trillion RMB.

China's focus on the four internationalization elements have been followed by monetary and political authorities: current account liberalization, floating exchange rate regime, financial system development, and capital account liberalization. These elements must support China's progress through the Crowther's model, probably promoting its displacement from the third state of a mature debtor to a mature creditor status in future decades. A future negative trade balance after the fifth stage of the balance of payments cycle will allow the Renminbi to flow to other countries, at the same time China will allow countries to accumulate claims in the Renminbi in order to finance its current account deficits at the sixth stage of the cycle. These movements are crucial for the RMB internationalization, although not sufficient.

There are three school of thoughts on the future of the Renminbi. According to Harrison and Xiao (2019), the first school of thought expects the RMB to become an international currency alongside the USD. The second argues the importance of financial depth in determining a currency acceptability, fact that delay the RMB internationalization. The third discards the RMB potential for an internationalization, unless China “embarks on a broad range of financial system and economic reforms” (Harrison and Xiao 2019, 4).

The regional plan of China has prioritized a promotion of the

Renminbi in Asia. Chun and Kawai (2011) argue that this fact can differentiate the country from Japan, due to the fact that an internationalization of the yen might require the country to import more from East Asian countries in order to promote the currency in the region. The authors point out that Japan did not accept a reduction in the current account as a burden to internationalize the yen. China, adopting the four internationalization elements and adopting both regional and global plans, is presumed to increase the role of the RMB, accepting a contraction in the current account balance and moving to a more developed country in terms of financial economy.

According to the IMF (2019), the Currency Composition of Official Foreign Exchange Reserves (COFER) may suggest a weakening of the United States Dollar and the Euro in the international scenario. After 2008, from the allocated reserves, claims in currencies except in USD or Euro accounted for 10.02%. In 2018 the same composition increased to 17.63%, explaining a contraction of claims in USD and Euro from 89.98% to 82.37% in the same period. The effect can be explained by a devaluation of both currencies after the GFC. However, that event may have increased central banks tendencies to diversify portfolio investments. Eichengreen (2011) consents with that shift, at the same time he argues that China may increase its efforts to internationalize the RMB in a response to the USD and Euro aversion.

The future of China is unknown, notwithstanding “no one country in human history has ever grown so fast for so long as China did in the past three decades” (Lin 2013, 265). Further, Maddison (2010 apud Lin 2013) argues that the Chinese path on economic growth is similar to that of Japan, Singapore, Korea and Taiwan in the second half of the 20th century. If China continues to grow at the same pace, its economic size may surpass that of the United States in considerable scale. Eichengreen (2019) accentuates the importance of the size, liquidity, and stability for a potential international currency. China’s challenge on internationalizing the Renminbi is far greater than the United States’ on rising the USD against the Pound Sterling. The author mentions that the U.S. size of financial markets was already bigger than the Britain’s in 1920s.

Final Remarks

Since the Industrial Revolution, uncountable events had conducted the global monetary and economic system. This inquiry distributes these events in two generic periods: the first takes into account Britain’s economic and political dominance and the importance of the Pound Sterling. The second

focuses on a dollar-based monetary system, with the United States as the leading economy. Therefore, in that succession of events, a third period may develop in further decades. The main objective of this thesis was to investigate the conditions for China to internationalize the Renminbi and to infer how the country has progressed towards that circumstance.

After the 18th century, international economics became essential for national accountability and emerged as an essential mechanism to support economic development. Section 2 and 3 indicates that both Britain and United States trailed the same track through the Crowther's balance of payments cycles. In the first moment their trade balances supported a gradual increase in the current account, surpassing a negative primary income. The second moment shifts the surpluses in the real economy to deficits, at the same time the net factor income from abroad became positive, indicating a creditor status, and financial inflows took place.

At the beginning of the 21st century, China would continue to expand free economic zones and to focus on its real economy. Section 4 indicates that foreign exchange interventions to support an undervalued Renminbi created several consequences in terms of savings, inflation, and interest rates. That circumstances, alongside with an underdeveloped financial system created strains on a necessary upgrade in the tertiary sector, increased the importance of a shadow financial system and indirect channels for financing, and had started to narrow the potential levels of households future consumption.

Further, we conclude that China's increase in productivity must and in fact lead to an exchange rate appreciation. The relative decrease of external prices may gradually attenuate the Chinese trade balance, and consequently its current account balance. China is positioned in the third stage of the balance of payments cycle as a mature debtor country. An appreciation of the Renminbi and its consequences in the trade balance requires China to increase its net factor income from abroad to countervail a future negative trade balance. Since China presented twin surpluses in past years, a financial outflow is necessary to guarantee future returns and inflows of the primary income.

Further, the Chinese path may establish international characteristics to the Renminbi in the sense it increases China's size of economy and financial markets, decreases its financial market regulation and size of state, accentuate central bank independence, and stabilize inflation rates, and reduce trade barriers. The internationalization of the Renminbi may emerge as a consequence of the Chinese economic institutions and its gradual liberalization towards a market-driven economy.

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ABSTRACT

The evolution of the global monetary system since the Industrial Revolution can be divided into two periods. First, a period with Britain as the great economic and political power and the Pound Sterling as the most important international currency and a second, with the United States as the leading economy and a dollar-based international scenario. The relation between goods, money, and foreign exchange markets is important to understand patterns in terms of exchange rate and currency internationalization. Therefore, the Crowther balance of payments cycles may be important to identify these patterns and to serve as a standard of reference to investigate shifts in exchange rate, and their consequences on balance of payments movements. Since 1978, China has emerged as a strong candidate to assume the role of a protagonist in the global monetary system, displaying high and stable economic growth. This paper aims to investigate the necessary conditions for China to internationalize the Renminbi, local currency, and to infer its status in that progress.

KEYWORDS

Exchange Rate; China; Renminbi; International Financial System.

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