A Perspective of the U.S. Dollar after the Current Financial Crisis --Lessons from the Fall of the Pound Sterling and the Gold Standard after World War I[1]

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Abstract: Global imbalances have been one of the important and puzzling policy issues in the international policy arena since 2003. A global imbalance consists of a number of related and remarkable developments primarily in the United States (the U.S. hereinafter) and East Asia, namely, large U.S. current account deficits, large Chinese current account surpluses, a large accumulation of foreign reserves among the Asian countries, low global real interest rates, and the large current account surpluses of oil-producing nations. Such imbalances might be expected to point to substantial dollar depreciation and Chinese currency appreciation. This paper, by examining the history of the great powers, explores the possibility of a dying away of such global imbalances following the current financial crisis.

JEL Classification: F02, F31, F32

Keywords: Global Imbalances, Currency Depreciation/Appreciation, Financial Crisis, Foreign Exchange Rates

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1. Introduction

Global imbalances have been one of the important and puzzling policy issues in the international policy arena since 2003. A global imbalance consists of a number of related and remarkable developments primarily in the United States (the U.S. hereinafter) and East Asia, namely, large U.S. current account deficits, large Chinese current account surpluses, a large accumulation of foreign reserves among the Asian countries, low global real interest rates, and the large current account surpluses of oil-producing nations. Such imbalances might be expected to point to substantial dollar depreciation and Chinese currency appreciation. Many economists have predicted (or wished for) a fall in the dollar, but all have been disappointed – at least so far.

Clearly a number of different actors are present in the global imbalance phenomenon, and it is difficult to pinpoint a single cause that is most important. Dooley, Filberts-Landau, and Garber (2008) examine one view of an important minority regarding the origin and sustainability of global imbalances. They argue that the current situation of large U.S. current account deficits and large East Asian surpluses can be expected to continue for some time, since it is in the interest of all the relevant parties. Fukuda and Kon (2008) argue that a preference for dollar assets exhibited by East Asian countries can help explain the flows of Asian capital to the U.S.

This paper, by examining the history of the great powers, explores the possibility of a dying away of such global imbalances following the current financial crisis. Based on the experiences of the pound sterling in the 1920s after World War I, it is projected that the decline in the U.S.'s fundamental economic strength and the rise of China caused by the current financial crisis is expected to have a marked impact on the perceptions regarding the U.S.

dollar in the future. Similar to the U.S. economy's avoidance of the impact of World War I, China will become another great power due to her being largely unscathed by the impact of the current financial crisis.

2. The British Experience Following the First World War

The United Kingdom had intended to restore its currency to the gold standard in the 1920s following World War I. In realizing that a low interest rate would deteriorate the value of the pound, the governor of the Bank of England, Montagu Norman, insisted on lifting the rate even though this resulted in severe unemployment and the subsequent depression. In addition, the estrangement of the central banks that was brought about by the war also eroded the credibility of each country to commit to the gold standard. The Bank of England thus ceased to base the pound on its convertibility for gold and hence discarded the gold standard system in 1931. The willingness to hold the pound, both on the part of investors in the form of assets and by central banks as foreign reserves, was accordingly sharply reduced.

In fact, Britain's restoration of the pound's convertibility in 1925 is taken to mark the gold standard's resurrection and the devaluation of sterling in 1931 its demise (Eichengreen, 1992). Fearing that the capital flight from England and the devaluation of the pound sterling would harm Britain's status as an international financial center, the Bank of England raised the discount rate from 2.5% to 6% in 1925 to attract foreigners to hold sterling. This action significantly reduced the international competitiveness of Britain's industries, which finally led to a swelling of Britain's imports and a shrinking of her trade surplus. The gold reserve accordingly declined very quickly. It was obvious that the British government regarded defending sterling as its first priority, leaving behind the numbers of unemployed rose and economic conditions deteriorated. The unemployment rate in the U.K. was around 21.3% at the end of 1929. Shortly afterwards, the profits earned and wages paid by the industries plummeted and workers started to protest. When the public started to panic, they began to withdraw currency and gold deposits from the banks. On one occasion, within the space of less than one week, the Bank of England lost gold reserves amounting to forty million pounds. The bank was forced to terminate her obligation to exchange the pound sterling for gold bullion from the public. In 1931, the British government therefore announced it was relinquishing the gold standard system, which had been in existence since the 1870s.

It is difficult to say, as pointed out by Eichengreen (1992), how long these arrangements would have persisted in the absence of World War I. The War destroyed and distorted industrial capacity across Europe while stimulating manufacturing on other continents. London’s position was already eroding in the face of rapid growth abroad and the associated decline in Britain’s share of international trade. Table 1 shows that the shares of the U.K. in world trade gradually declined from 19% in 1900, to 15% and 14% in 1920 and 1930, respectively. The share of the U.K. in world industry dropped by 50% (from 18% to 9%), while that of the U.S. grew by more than 25% (from 31% to 39%) over the 1900 to 1930 period (Huang, 2002).

Table 1. The Economic Strength of the U.K. Declined in the Early 1900s

	The shares in world industry			The shares in world trade		
	1900	1920	1930	1900	1920	1930
U.K.	18%	14%	9%	19%	15%	14%
U.S.	31%	47%	39%	12%	14%	12%
Germany	16%	9%	11%	13%	8%	10%
France	7%	5%	7%	9%	7%	7%

Source: Huang (2002)

Table 2. Shares of World Industrial Output (1800-1900)

Unit: %

Nation / Year	1800	1830	1860	1880	1900
United Kingdom	4.3	9.5	19.9	22.9	18.5
France	4.2	5.2	7.9	7.8	6.8
German Confederation	3.5	3.5	4.9	8.5	13.2
Kingdom of Italy	2.5	2.3	2.5	2.5	2.5
Russian Empire	5.6	5.6	7.0	7.6	8.8
U.S.A.	0.8	2.4	7.2	14.7	23.6
Japan	3.5	2.8	2.6	2.4	2.4
China	33.3	29.8	19.7	12.5	6.2
India / Pakistan	19.7	17.6	8.6	2.8	1.7

Source: Kennedy (1987)

In fact, ever since the outbreak of the Civil War, the U.S. has become an economic giant. The ratio of the U.S.'s industrial output in the world, even though it was still far behind that of the U.K., almost reached that of France and exceeded those of the German Confederation and Russian Empire in 1860 (see Table 2).

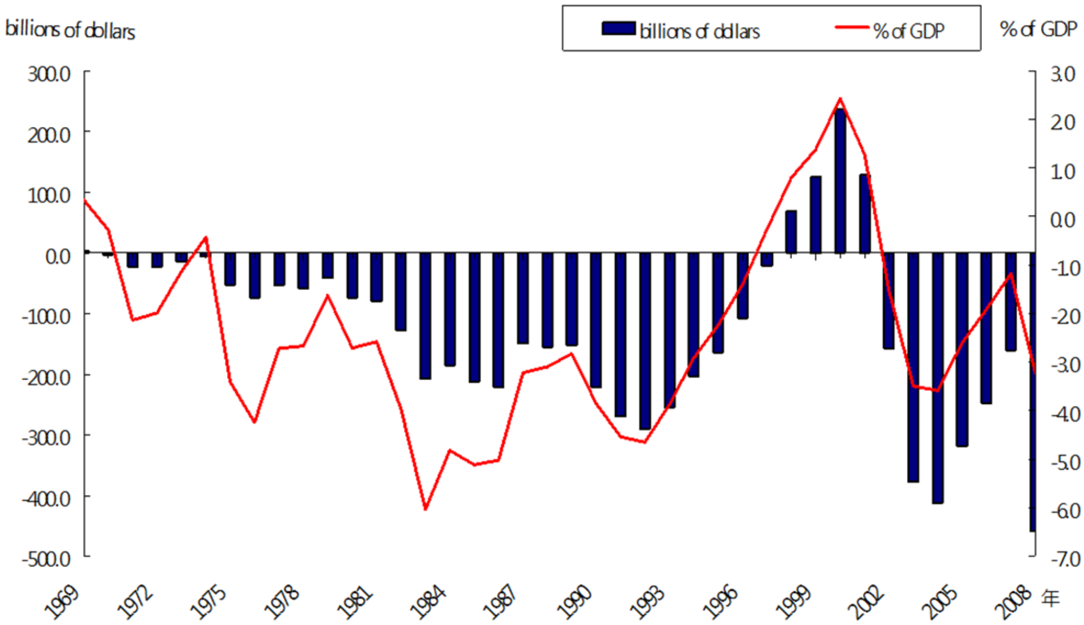
From 1860 to 1914, the exports of the U.S. increased seven times (from 0.334 billion to 2.365 billion U.S. dollars). At that time, however, most of the trade was still denominated in pound sterling (Kennedy, 1987). Due to the outbreak of World War I, which mainly occurred in Europe, the economic strength of the U.S. gradually surpassed that of the U.K. later on. The exports of the U.S. grew 2.6 times over the period from 1913 (2.8 billion U.S. dollars) to 1918 (7.7 billion U.S. dollars), and the trade surplus rose on average from 1914 to 1917 to five times what it had been before the war. Other than that, although the U.S. still owed 3.6 billion in foreign debt in 1914 right before the war, the U.S. replaced the U.K as the biggest creditor in the world in 1918, the second year after the war (Yamada, 2000). At that time, global financial assets, international reserves, and international settlements were expanding more rapidly than the resources of the London market and the Bank of England. This rendered foreigners hesitance to concentrate their foreign exchange reserves in sterling. This phenomenon is similar to the status of the U.S. dollar recently, which is explored in the next section. In addition, mounting diplomatic tension in Europe after the turn of the century also heightened the risks of concentrating reserves in London.

Some sets of wartime changes actually had profound implications for the world economy of the 1920s and 1930s (Eichengreen, 1992). For instance, the wholesale liquidation of foreign assets and the accumulation of new foreign liabilities transformed the structure of international finance. In addition, international trade was redirected, with European exports declining at the expense of the products of other parts of the world. Finally, domestic politics were restructured by the rise of labor, the extension of the franchise, and the reform of electoral systems. After World War I, the traditional basis for international cooperation was growing increasingly tenuous. The outbreak of hostilities caused by the war ended the gold standard system abruptly. In combination, these changes promised to fundamentally transform the international monetary system and the world economy once peace was restored.

3. The Fall of the U.S. and the Rise of China after the Crisis

Europe would not have been able to be restored after the war without the assistance of the U.S. The U.S. permeated the whole of Europe and the world through not only foreign direct investment but also foreign direct investment. Americans bought huge amounts of German and European government bonds at that time, just as China now holds tremendous amounts of U.S. treasury bonds. Due to the current financial crisis, the U.S. now needs sufficient capital to finance her enormous fiscal deficit, which is spent on bailouts, unemployment benefits and stimulus plans, etc. The American fiscal deficit will quadruple this year, from $459 billion in 2008 to $1.85 trillion (from 3.2% of GDP to 13.1%), according to the Congressional Budget Office (CBO) (see Figure 1).

Figure 1. US budget balance

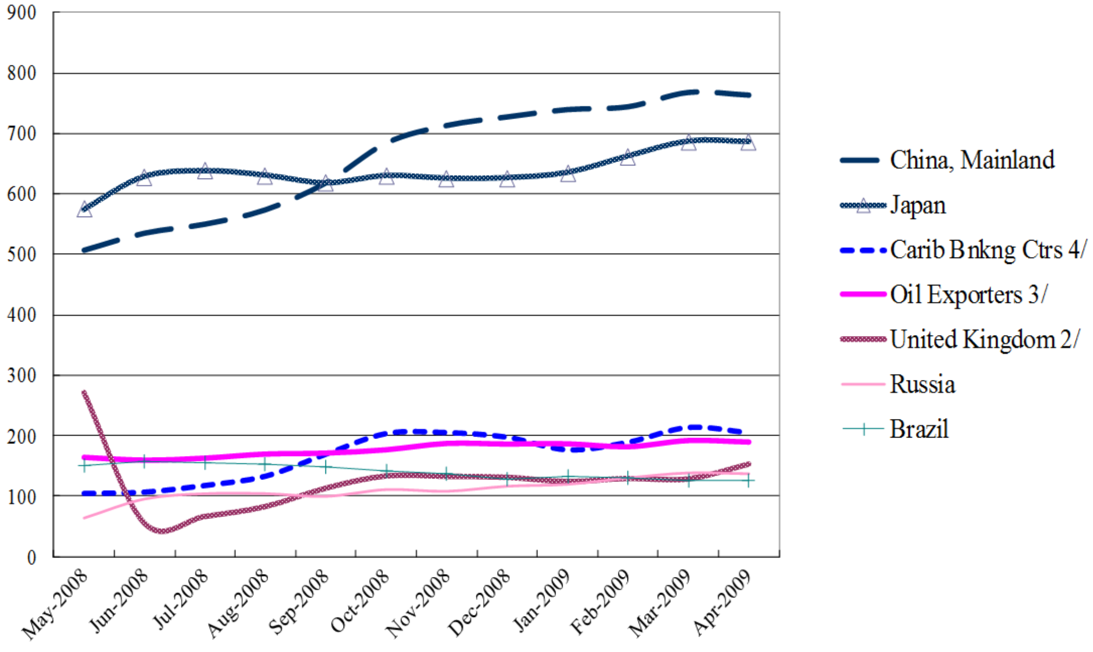


Source: Congressional Budget Office, U.S.A.

This tremendously huge fiscal deficit is also two times the highest previously recorded fiscal deficit since World War II, i.e., the 6% in the Reagan era. The CBO reckons the deficit will still be running at more than $1 trillion in 2019. It estimates that the accumulated debt of the U.S. will hit almost $19 trillion by then. It is obvious that it is hard for the U.S. to revive from the current financial crisis without the support of other countries with excess capital. Those countries with the largest amounts of foreign exchange reserves, including China, Japan and Russia, are also the countries holding most of the U.S. treasury securities. China surpassed Japan to become the biggest foreign holder of U.S. treasury securities in September 2008 (see Figure 2).

Figure 2. Major Foreign Holders of Treasury Securities

(in billions of dollars) Holding 1/at End of Period



Sources: Department of the Treasury/Federal Reserve Board, U.S.A., June 15, 2009.

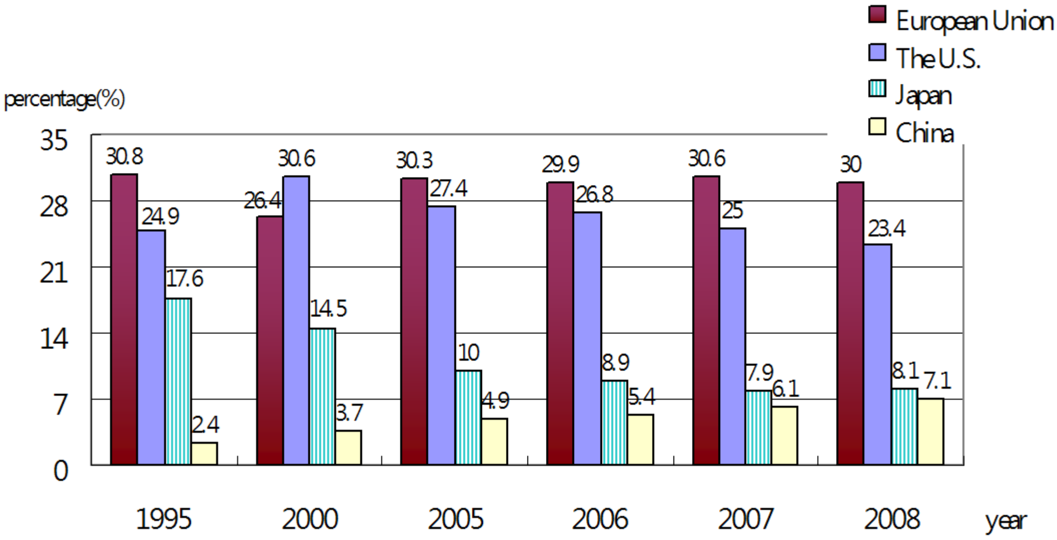
Notes:

1. Estimated foreign holdings of U.S. Treasury marketable and non-marketable bills, bonds, and notes reported under the Treasury International Capital (TIC) reporting system are based on annual Surveys of Foreign Holdings of U.S. Securities and on monthly data.
2. The United Kingdom includes the Channel Islands and the Isle of Man.
3. Oil exporters include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya, and Nigeria.
4. Caribbean Banking Centers include the Bahamas, Bermuda, the Cayman Islands, the Netherlands Antilles and Panama. Beginning in June 2006, they also include the British Virgin Islands.

Around ninety years ago, after World War I, the state of the world during that period was transformed from peace under the control of the U.K. to peace under the control of the U.S. By contrast, as analyzed below, China will probably catch up with the U.S. as the great power following the present financial crisis.

Since 1978, when China's Open-Door Policy reform was implemented, China has become the economy with the fastest growth in the world. Her economic growth rate within the last thirty years has been 9.35% on average (Table 3), which has made her share in world nominal GDP grow steadily from 2.4% in 1995 to 7.1% in 2008 (Figure 3).

Figure 3. Shares of World Nominal GDP



Source: Global Insight, May 2009.

Table 3. The Economic Growth Rate of China

Period	Average Growth Rate
1978-1987	8.98
1988-1997	9.63
1998-2007	9.33
Average (1978-2007)	9.30

Source: The International Centre for the Study of East Asian Development: East Asian Economic Perspective, Vol. 17, No. 1, Feb. 2006.

In 2007, China outstripped Germany to become the third largest economy in the world. Furthermore, the annual report of Japan’s Ministry of Economy, Trade and Industry has just indicated that Japan will lose her status as the world’s second largest economy in 2009 or 2010. China will replace Japan as Asia’s biggest and the world’s second largest economy. By contrast, the U.S.’s share in world nominal GDP has slipped gradually during this period, from 24.9% to 23.4%, as shown in Figure 3. Although the gap between China and the U.S. in terms of the respective amounts of GDP is still big, the amount of China’s exports has already exceeded that of the U.S. in 2007, and the amount traded will also soon exceed that for the U.S. (see Table 4).

Table 4. World Shares for Trade Amounts and Export Amounts

Unit: %

	U.S.		Germany		Japan	
	Trade amount	Export amount	Trade amount	Export amount	Trade amount	Exp amo
1997	14.90	12.99	8.99	9.67	7.13	7
1998	15.46	13.04	9.64	10.39	6.35	7
1999	16.14	12.97	9.31	10.03	6.67	7
2000	16.60	12.89	8.51	9.07	6.98	7
2001	16.33	12.68	9.05	9.94	6.44	7
2002	15.55	11.50	9.08	10.22	6.19	6
2003	14.31	10.34	9.57	10.73	6.03	6
2004	13.57	9.60	9.43	10.69	5.90	6
2005	13.46	9.35	8.97	10.08	5.66	6
2006	13.09	9.26	9.05	10.01	5.44	5
2007	12.19	8.96	9.16	10.23	5.10	5

Source: Ministry of Finance, R.O.C.

The close relationship between the U.K. and the U.S. in the early 20th century is similar to that for the U.S. and China nowadays. At that time, Britain exported her capital and industrial goods to the U.S., while it imported raw materials from the U.S. The close interaction between these two countries significantly stimulated the U.S.'s economic growth. Towards the end of the 19th century and during the early stages of the 20th century, the rise of the U.S. became the most critical transformation within the equilibrium of global power (Kennedy, 1987). By contrast, the U.S. has consumed large quantities of products from China in the past decade. China has then used the money earned from these exports to the U.S. to purchase the U.S. government notes and bonds, which have provided the production capital needed by the Americans. A new word "Chimerica,", which combines the two words "China" and "America", has emerged to symbolize the tight mutual dependence between these two countries[2].

Many people expect, following the outbreak of the current financial crisis, that the national strength of the U.S. will decline and the influence of China will rise in its place. China has been requested especially by the U.S., to enlarge her domestic demand while decreasing her exports to the world. Previous mutual dependence will probably fall apart once China successfully diversifies her reliance on exporting to the U.S. and enhances her trading relationship with other partners. More than that, China has also tried very hard to diversify her huge foreign exchange reserves by engaging in more outward foreign direct investment (FDI) and portfolio investment (FPI) in other countries. China has become active in adopting transnational mergers and

[2] The Chimerica theory was put forth one year ago by Professor Niall Ferguson of Harvard University and Visiting Professor Moritz Schularick of Cambridge University.

acquisitions since 2005. In 2007, transnational mergers and acquisitions in the world slowed down due to the outbreak of the sub-prime crisis. China's amounts of overseas mergers and acquisitions, however, surpassed those of her inward mergers and acquisitions for the first time in 2007. The spreading of the crisis in the middle of 2008 furthermore speeded up China's activities on global mergers and acquisitions. Once China shows less interest in U.S. treasury bonds, which is possibly concerned with a weaker U.S. dollar and a straitened fiscal situation in the U.S., the Chimerica phenomenon will finally disappear. Until then, the equilibrium of global power will readjust.

After the financial crisis, whether or not the Chinese Yuan will replace the U.S. dollar depends on the speed of the change in the national strength and financial development of the U.S. and China. Concern about rising government deficits and debt levels across the world together with a wave of downgrading of European government debt and the depreciation of Euro, for example, has created alarm on financial markets. Although the leaders of the 16-nation euro zone gave formal approval in the May of 2010 to a three-year, €110bn rescue plan to help Greece avoid a restructuring of its sovereign debt, market tensions remained high as the premium that investors ask to buy southern European 10-year government bonds soared to 973 basis points for Greece, 354 for Portugal and 173 for Spain. This turmoil caused by the European sovereign debt problem may also occur in the U.S. in the future, where the ratio of national debt to GDP is even higher than the euro zone countries as a whole. The strength of the U.S. dollar will have to face the challenge of the U.S. sovereign debt problem in the future.

For the Chinese Yuan to become an international currency, however, three preconditions have to be fulfilled: The Chinese Yuan must freely flow, the width and depth of China's domestic capital markets must grow to some extent, and the circulation of the Chinese Yuan all over the world must improve drastically. The Chinese Yuan nowadays, however, is not convertible. China's exchange rate and interest rates do not float freely yet. In addition, China's financial account and capital movements are still restricted. These circumstances lead us to conclude that the timing of the internationalization of the Chinese Yuan is still premature.

4. The Fall of the Gold Standard and the Rise of the Dollar Standard

Apart from analyzing the changes in the relationship between the great powers during the two above-mentioned periods, this paper attempts to explore whether the dollar standard system will reach its demise after the current financial crisis, just like the gold standard did following World War I. The evolution of each of these two international monetary systems is therefore carefully examined in this section.

In the mid-1800's, countries began adopting the gold standard as a way to standardize transactions in a blossoming world trade market. The gold standard is a monetary system in which a region's common medium of exchange is paper currency that is normally freely convertible into pre-set, fixed quantities of gold. By World War I, most countries were on the gold standard. Between 1914-1919, most countries suspended the gold standard so that they could print enough money to pay for their involvement in the war.

After the war, countries returned to a modified gold standard, but abandoned it during the Great Depression.

Under the dollar standard system, the U.S. dollar was used by most countries as the primary reserve asset, in contrast to the gold standard in which gold played this role. The dollar's role was formalized under the Bretton Woods monetary agreement of 1944. Other nations set official exchange rates against the dollar, while the US agreed to exchange dollars for gold at a fixed price on demand by central banks. This system, also called the quasi-gold standard, functioned well for a brief period. However, by about 1958, the initial worldwide dollar shortage had turned into an overabundance. With the too rapid growth of dollar credits around the world, gold backing of the dollar proved unsustainable. The Bretton Woods agreement collapsed in 1973, but it enthroned the dollar as the international medium of exchange. This unique role of the dollar continues to the present day.

Some characteristics of these two international monetary systems are discussed as follows to clarify their evolutionary process.

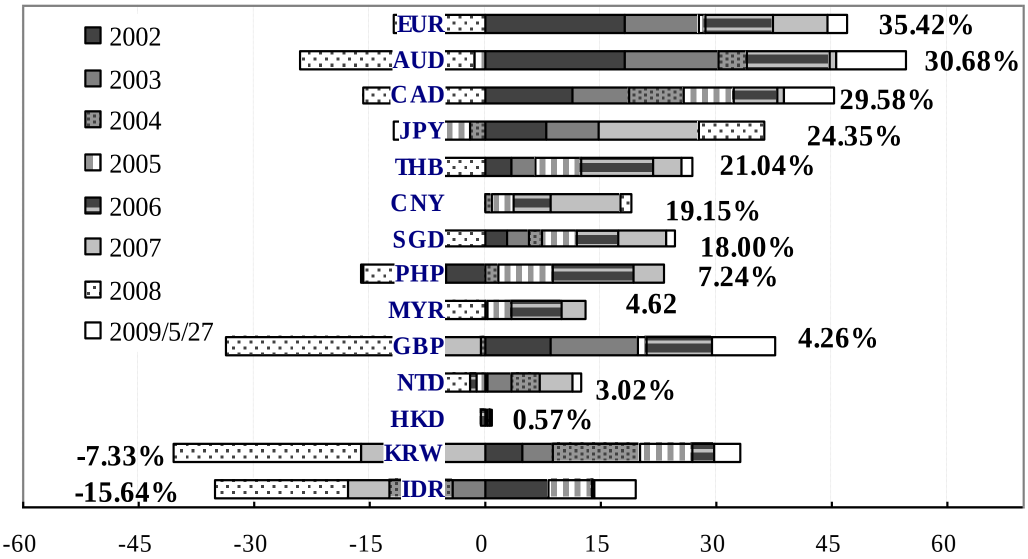
4.1. The deposit insurance mechanism was not established until the Great Depression:

To respond to the banking crisis caused by the Great Depression, the U.S. established the world's first deposit insurance corporation, the FDIC, in 1934. Since the U.K. and the U.S. abandoned the gold standard in 1931 and 1933, respectively, there was basically no deposit insurance mechanism in the era of the gold standard. However, deposit insurance has played a very important role in subsiding bank runs under the dollar standard system in recent decades. The mechanism of deposit insurance did give rise to stabilization effects during the current financial crisis while many countries one by one announced the provision of full coverage from deposit insurance institutions. It is thus reasonable to conclude that the mechanism of deposit insurance in each country prevented the further spread of the current crisis.

4.2 Is there an automatic adjustment mechanism for the trade imbalances?

Regardless of whether the gold standard or the quasi-gold standard system (i.e., the Bretton Woods system) was used, the large trade deficit was impossible to sustain because of the innate auto adjustment mechanism. Under the gold standard/ quasi-gold system, central banks retained discretion over when and how to intervene. However, the basic rules of the game were more or less followed: restricting credit in response to gold/U.S. dollar outflows and loosening it in response to inflows. Under the dollar standard system, by contrast, the U.S. borrowed from the rest of the countries in the world by printing money or issuing securities in terms of U.S. dollars, such as treasury bonds. The previous auto adjustment mechanism, which was capable of avoiding imbalance, lost its function when the U.S. discarded the convertibility of the U.S. dollar for gold in 1972. It was no longer necessary for the U.S. to face strict tests with respect to her trade deficit problem. In other words, the U.S. was, from 1972 onwards, able to pay for her import purchases by printing the same amount of currency bills or bonds without any required reserves. The amount of U.S. dollars in circulation all over the world thus began to surge tremendously. Once the national strength of the U.S. declines for sure, the value of the U.S. dollar will promptly start to fall. The gradual depreciation of the U.S. dollar since 2002 (Figure 4) has brought some forewarning of its long run decline, which is likely to deteriorate further due to the impact of the current crisis.

Figure 4. Exchange Rate between the U.S. and Each Country



Notes: The percentage point for each currency indicates the accumulated appreciation (+)/ depreciation (-) for each currency vis-à-vis the U.S. dollar since 2002. For example, the Euro (EUR) has appreciated vis-à-vis the U.S. dollar by 35.42% between 2002 and May 27, 2009.

4.3.The global money supply is not easily controlled under either one of these international monetary systems:

Under the gold standard system, the authorities were not able to control the global money supply due to the limited supply of gold in the world. Since the monetary base under this system mainly consists of gold, it was not possible for the global money supply to grow unless extra gold was mined from the ground. That is to say, gold reserves did not increase until new gold mines were found. It was argued at that time that the shortage of gold had severely restricted the growth of many economies.

Under the dollar standard system, the global money supply could not be controlled due to the U.S. trade deficit and fiscal deficit. Huge amounts of foreign exchange reserves, mostly accumulated through trade surpluses, propelled the purchasing power of the exporting countries and then flowed back to the U.S. to purchase U.S. assets. These inflows of capital further benefited the U.S. economy. Since the dollar standard is a paper money system, the world supply of money will be explosive as long as the U.S. dose not control the growth rate of U.S. dollar. The trade imbalance and complicated capital flows caused the system to go out of control and gave rise to an imbalance in the global money supply that still prevails today.

4.3. The credibility of the commitment to the gold standard or dollar standard system rested on international cooperation:

The gold standard system was established in the 1870s. International cooperation, which was already important as early as 1890, became increasingly frequent in the first decade of the twentieth century. Britain once played a central role in the organization of these cooperative ventures under the gold standard system. Britain's prominence in international financial markets permitted her to play a critical coordinating role and to exert a stabilizing influence in normal periods. The Bank of England served as international lender of last resort at that time. The bank's ability and willingness to orchestrate the operation of the prewar system had been responsible for its success. The International Monetary Fund (IMF), the Bank for International Settlements (BIS), and the central banks of G7/G20 under the dollar standard system played the same role as the Bank of England under the gold standard system. The central banks and related authorities of the G20 worked closely during the crisis. However, the central bank of China, as well as the central banks of some emerging economies, including Brazil and the members of Gulf Cooperation Council (GCC), have already expressed their hesitance to hold more U.S. dollar assets. Once the international cooperation for supporting the U.S. dollar begins to shake, the future of the dollar standard system will be highly threatened via the contagion effect and the global free flow of capital.

5. Possible Perspectives of the International Reserve System

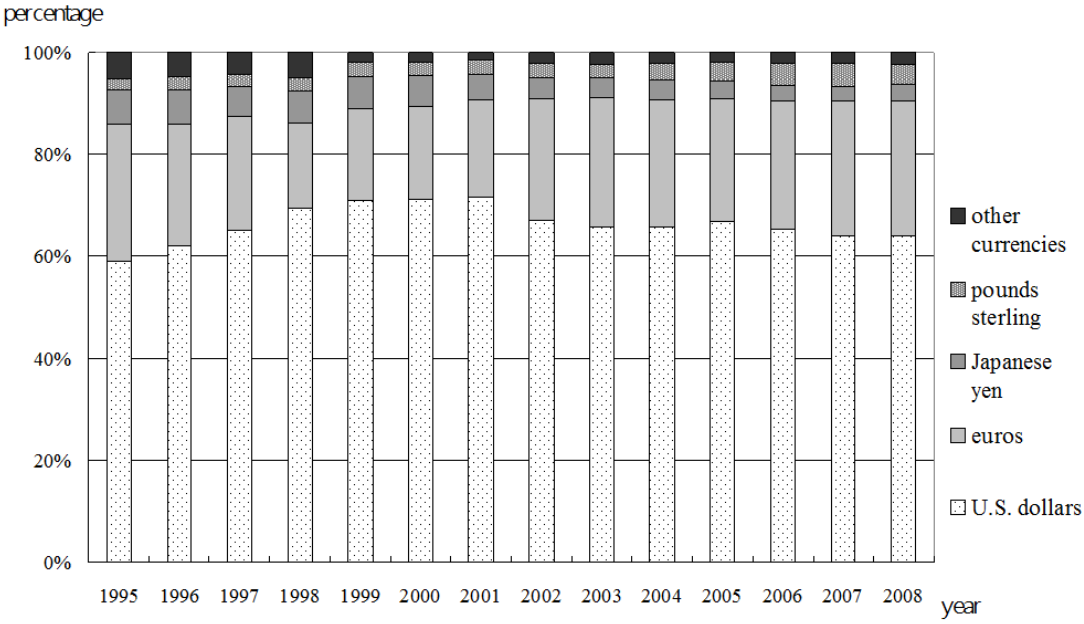
5.1. Intra-regional trading will become much more prevalent due to several factors:

(1). First, climbing oil prices, which will raise the transportation costs, together with environmental protection considerations will induce people to choose to purchase and sell within the region. If this is the case, the role that the regional currencies play will become more and more significant. Three big currency blocs, the U.S. dollar, the Euro, and the Chinese Yuan (renminbi), are expected to shape the balance of power in the future.

(2) As indicated in Figure 5, after climbing to a peak of 71.52% in 2001, the share of the U.S. dollar in the currency composition of official foreign exchange reserves has steadily declined to 64% in 2008. China, as the biggest foreign holder of U.S. treasury securities since September 2008[3], actually started to diversify her portfolio of foreign exchange reserves several years ago, as mentioned in the previous section. China, for instance, has increased her holding of gold by three-fourths since 2003. U.S. treasury securities have also been less emphasized in her portfolio content.

[3] China held $767.9 billion in U.S. treasury securities at the end of the first quarter of 2009, accounting for 6% of the $10.9 trillion total amount of U.S. treasury securities.

Figure 5. Currency Composition of Official Foreign Exchange Reserves (COFER)



Source: IMF

5.2. Suggestions as to the way to prevent the collapse of global monetary and financial systems include the following:

(1) Countries with trade surpluses should increase their domestic demand (for instance, increase consumption and investment), whereas countries with trade deficits should reduce their domestic demand (for instance, decrease consumption and increase saving). The former countries include most Asian countries such as China, Japan, Singapore, Taiwan, etc. The latter ones include the U.S., Australia, and so on. Faced with the current financial tsunami, however, each country has taken whatever measures have been necessary, mostly by lifting government expenditure to carry out stimulation programs, to counter the severe local recessions. U.S. Treasury Secretary Timothy Geithner recently emphasized that a sustained global recovery depends on the efforts of both the U.S. and China in overhauling their economies. His focus on the mutual dependence of the two countries has reinforced the shift in the

U.S.-China relationship since the financial crisis. U.S. pressure on China to boost its domestic demand -- and, Washington hopes, buy more U.S. goods – as well as to move to more market-based interest rates and prices have taken on increased urgency as the damage from the financial crisis has left the world with fewer likely sources of growth.

In fact, by putting forth its 10th Five-Year Plan during the 2001 to 2005 period, China has promoted a new strategy to propel China's economic growth. That is, it has switched from mainly relying on investment and exports to focusing more on consumption and then on domestic demand. During the first four years of China's 11th Five-Year Plan, China's exports and imports grew at a similar pace, which caused her external demand (i.e., net exports) to increase moderately. Up to 2005, however, the growth of China's exports (28.4%) significantly exceeded that of her imports (17.59%). In January 2009, China promised a $120 billion effort to give citizens better access to health care, which could very much reduce households' need to save. Establishing a sound social security protection mechanism as well as improving government efficiency is also necessary to reduce China's high saving ratio.

According to the projections made by Wang (2005), the ratio of consumption in China's GDP will gradually climb to more than 50% after 2010, whereas that of investment will remain at around 35% (Table 5). This will cause the sum of domestic demand, which includes consumption and investment, to increase slightly towards 99.9%. The share of exports in GDP, even though it will steadily rise to 35% in 2020, will not result in a significant increase in net exports ratio due to the simultaneous improvement in her imports. Allowing the Chinese Yuan to rise would be an important sign that

China is serious about boosting domestic demand, as has long been claimed by the U.S. A stronger currency could hurt China's exporters but would also raise its buying power in international markets, thereby encouraging imports. The ratio of net exports to total GDP is expected to be lower if China's government focuses more attention on increasing domestic demand following the financial crisis.

Table 5. GDP Components for China (2000～2020)

Unit: ％

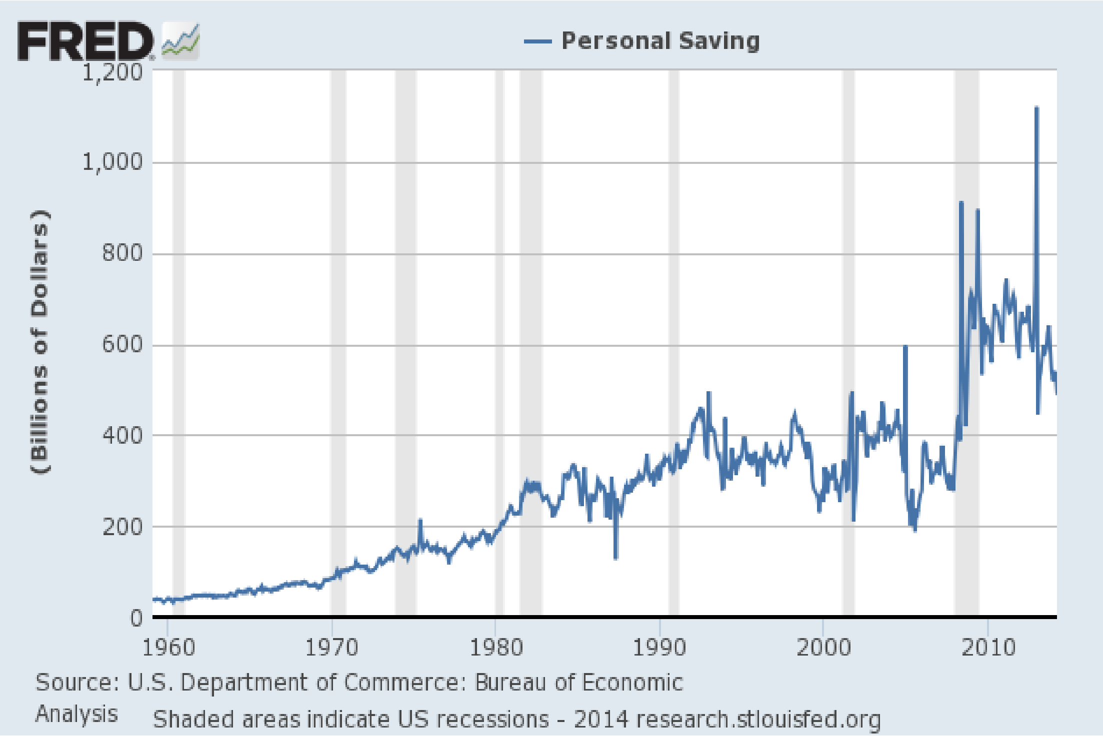
Year	2000	2005	2010	2015	2020
Private consumption	47.8	45.7	49.6	51.2	52.2
Investment	36.5	41.2	37.2	35.7	34.8
Government expenditure	13.0	12.6	12.8	12.9	12.9
Domestic demand	97.3	99.5	99.6	99.8	99.9
Exports	26.0	30.5	32.3	34.3	34.9
Imports	23.4	30.1	31.9	34.1	34.7
Foreign demand*	49.4	60.6	64.2	68.4	69.6

Source: Wang, 2005.

Notes: *Exports fulfill the demand from abroad. Imports, while they provide some demand from domestic markets, mostly fulfill the demand derived from re-exports, which basically provide the demand from abroad.

On the other hand, U.S. personal saving jumped abruptly after the outbreak of the financial crisis and has reached a fifteen-year high (Figure 6). Over spending via undue borrowing induced U.S. housing markets to slump, which then triggered the spreading of the current financial crisis. Americans have been forced to adjust their consumption behavior to allow them to pass through the impasse. Many economists expect U.S. personal saving to continuously increase, which is just the beginning of the current adjustment in American consumption behavior. The decline in consumption, which for long contributed more than 60% of U.S. GDP, will definitely drag the recovery of the U.S. economy. Lower consumption will, however, be helpful in reducing U.S. imports from abroad, which will then be beneficial for the U.S. economy. It will probably take three to four years, or at most five to six years, for Americans to fill the production gap caused by the current recession.

Figure 6. American Personal Saving Jumped after the Financial Crisis



Source: U.S. Department of Commerce: Bureau of Economic Analysis (http://research.stlouisfed.org/fred2/graph)

(2) John M. Keynes in the 1930s proposed imposing financial punishments on countries in possession of unbalanced current accounts, in order to ensure that such countries adopt necessary measures to restore their balance of payments to equilibrium. The amount of the punishment was proposed as being 1% of each country's deficit/surplus. This measure is supposed to bring about an effect through intimidation. Even if such a measure has no effect, the punishment percentage can be raised each year until equilibrium is restored.

(3) The governor of the People's Bank of China, Zhou Xiaochuan, proposed enhancing the Special Drawing Rights (SDR) mechanism within IMF in order to moderate international reserves. Nobel Prize Laureate Robert Mundell, who

is also well known as the father of the Euro, indicated that the Chinese Yuan should become an international currency. Mundell has proposed the idea of establishing an international foreign exchange reserve that includes the Chinese Yuan, with a 11% to 16% share, into the SDR's basket of currencies. The Chinese Yuan has in fact infiltrated Southeast Asia, is increasingly accepted internationally, and may one day directly challenge the status of the U.S. dollar.

6. Concluding Remarks

Whether or not the Chinese Yuan will replace the U.S. dollar after the financial crisis depends on the speed of the change in the national strength and financial development of the U.S. and China. For instance, current turmoil caused by the European sovereign debt problem after the financial crisis may also occur in the U.S., where the ratio of national debt to GDP is even higher than that of the euro zone countries as a whole. The strength of the U.S. dollar will have to face the challenge of the U.S. sovereign debt problem in the future.

For the Chinese Yuan to become an international currency, however, three preconditions have to be fulfilled: The Chinese Yuan must freely flow, the width and depth of China's domestic capital markets must grow to some extent, and the circulation of the Chinese Yuan all over the world must improve drastically. The up-to-date development leads us to conclude that the timing of the internationalization of the Chinese Yuan is still premature.

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