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Chen Yulu

Construction of Offshore Financial Market and RMB Internationalization

Edmond Alphandery

The Dynamics of Fragmentation in the Euro Zone: Theory and Political Implications

Also including

On Measuring Greenness: A New Enabling Metric, Please by Steve H. Hanke

Bretton Wood System Revisited – Dollar Standard and China's Role by Ronald I. McKinnon

The Case for a World Currency by Robert A. Mundell

Some Views on the Recent Development of Wealth Management Market by Pan Gongsheng

Hong Kong Can Ditch Dollar Peg by Joseph Yam Chi Kwong

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Introduction to the International Monetary Institute (IMI)

Established on December 20, 2009, IMI is a non-profit academic institution affiliated to China Financial Policy Research Center and the School of Finance of Renmin University.

Following the "general theory of macro-finance", IMI aims to become a world-class think tank, focusing on the studies of international finance, in particular the international monetary system and RMB internationalization. Despite its relatively short history so far, IMI has established itself as a leading research institution and important forum, where industry leaders, policy makers and academic experts from home and abroad share their insights and expertise.

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ROBERT MUNDELL

1999 Nobel Laureate
Professor of Economics at Columbia University
Member of IMI Advisory Board

Since 1974, Robert Mundell (born 1932) has been Professor of Economics at Columbia University in New York. After studying at M.I.T. and the London School of Economics, he received his Ph.D. from M.I.T. in 1956, and was the Post-Doctoral Fellow in Political Economy at the University of Chicago in 1956-57. He taught at Stanford University and The Johns Hopkins Bologna Center of Advanced International Studies before joining the staff of the International Monetary Fund in 1961.

From 1966 to 1971 he was a Professor of Economics at the University of Chicago and Editor of the journal of Political Economy; and from 1965 to 1975, he was (summer) Professor of International Economics at the Graduate Institute of International Studies in Geneva, Switzerland. For 1997-98 he was the AGIP Professor of Economics at the Johns Hopkins Bologna Center of the Paul H. Nitze School of Advanced International Studies.

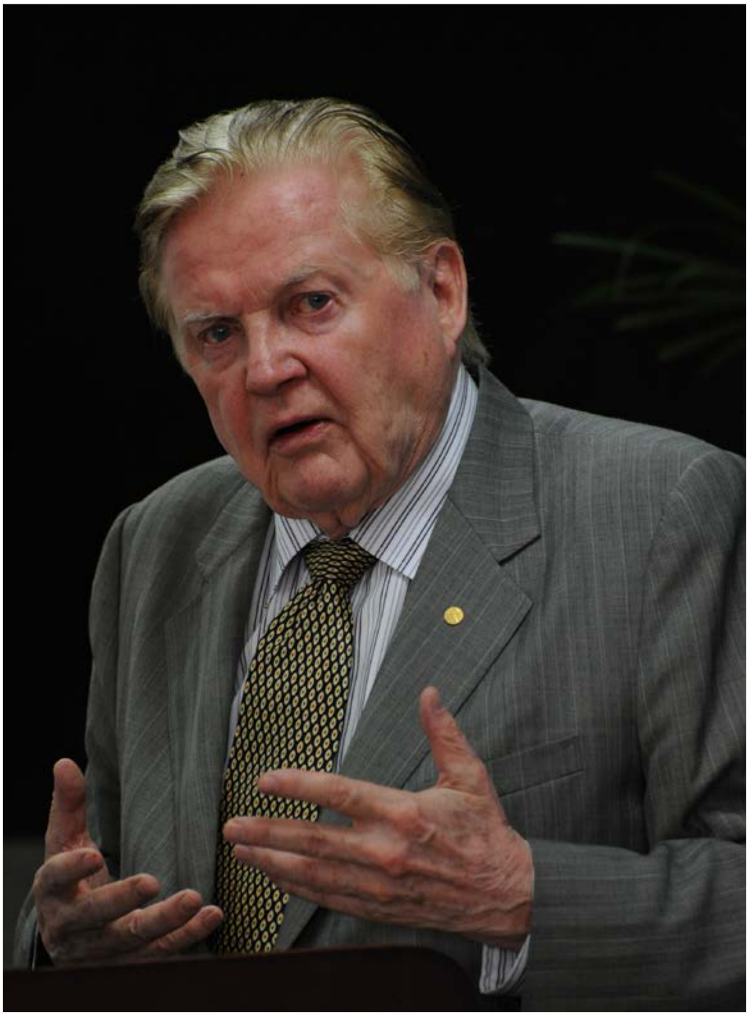
Professor Mundell has been an adviser to a number of international agencies and organizations including the United Nations, the IMF, the World Bank, the European Commission, and several governments in Latin America and Europe, the Federal Reserve Board, the US Treasury and the Government of Canada.

Mundell's writings include over a hundred articles in the scientific journals and the following books: The International Monetary System: Conflict and Reform, Man and Economics, International Economics, Monetary Theory: Interest, Inflation and Growth in the World Economy, The New International Monetary System (ed. with J. J. Polak) (1977); Monetary Agenda for the World Economy (ed. with Jack Kemp) (1983); and co-edited books Global Disequilibrium (1990); Debts, Deficits and Economic Performance (1991); and Building the New Europe (ed. with M. Baldassarri) (1992); Inflation and Growth in China (ed. with M. Guitian) (1996); and The Euro as a Stabilizer in the International Monetary System (ed. with A. Clesse) (2000).

He received a Guggenheim Prize in 1971, the Jacques Rueff Medal and Prize in 1983, the Docteur Honoris Causa from the University of Paris in 1992, an Honorary Professorship at Renmin University in China in 1995, the Distinguished Fellow Award from the American Economic Association in 1997, was made a fellow of the American Academy of Arts and Sciences in October 1998.

In 1999, he received the Nobel Memorial Prize in Economic Sciences.

This issue is proud to present



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CONTENTS

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International Monetary Review
October 2014, Vol. 1, No. 3-4

In Brief

Editor's Note:

Up to the end of September 2014, the advisory board members and academic committee members of IMI have been expressing their research opinions on monetary finance and economics through published articles and public speeches. The following is a summary of their research reviews.

Research Review by IMI Advisory Board Members

According to the paper "***The Dynamics of Fragmentation in the Euro Zone: Theory and Political Implications***" by **EDMOND ALPHANDERY**, four and a half years after the burst of the Euro crisis, the Eurozone economy seems to be doing better. In peripheral countries, economic growth is picking up and investors from abroad are coming back. Nevertheless there is no denying that serious obstacles to full recovery still exist. The Eurozone has yet to find the right path for a return to a sustained and robust economic growth. In order to ensure the smooth functioning of the Euro area and to prevent any further crisis, we can make the list of the missing pieces of the current Economic and Monetary Union framework. Comprehensive implementation of a "genuine" currency area should limit powers of Member states in terms of economic policies, and consequently to strengthen the capacity of the EU governing body to conduct an economic policy of its own for the whole Euro area; extend the European budget to a more significant size and therefore to transfer competencies from Member states to the EU level; build a true comprehensive Banking Union which facilitates the working of an integrated pan-European financial system; foster the single market, and to promote more flexible labor markets. He suggested five main lines of actions: fostering financial markets integration must be high on the agenda; the single market must be fully implemented in line with Mario Monti's 2010 Report to the President of the European Commission; make sure that Member states undertake the structural reforms to which they are committed in order to meet the Europe 2020 competiveness agenda and pursue consolidation of their public finances; put in place a policy which is addressing the North-South divide of the Eurozone; the Eurozone is in need of a more accommodative policy mix.

In his article "***On Measuring Greenness: A New Enabling Metric, Please***", **STEVE H. HANKE** pointed out companies around the world are scrambling to go green. Some are so desperate that they engage in "greenwashing". Many companies are, and have been, engaged in producing products and employing production processes that, by any definition, would qualify as green. The two generic methodologies used to determine what constitutes the so-called green investment grade are screening methodologies and green theme investing. Screening methodologies are ones that allow only the greenest companies through the screen. The green theme methodology is even cruder than screening. An investment is deemed green only if it fits into a pre-defined green designation. In order to firm up the green investment house's foundation, he proposes a methodology that is simple, transparent, and one that can be objectively replicated. Our metric is determined by starting at the origin of the supply chain. It is from that starting point that he measures the amount of greenness ultimately enabled by the production of a so called green enabler. Therefore, the green theme methodology results in little more than a loose, nominal – but important – designation. If a company can obtain a green designation, no matter how it is determined, that recognition of greenness enhances the firm's attractiveness to investors.

According to "***Bretton Wood System Revisited – Dollar Standard and China's Role***" by **RONALD I. MCKINNON**, since 1945, dollar standard has played two roles in the world economy: the controller of private international businesses and the regulator of domestic macro-economy. These two roles are complementary in this crucial monetary system. First, dollar, as the main denominating currency for commodities and developing countries' exports, facilitates international trade. Meanwhile, dollar's role as inter-bank trade currency lowers personal cost for multi-lateral forex payment. Second, as some foreign countries anchor their currencies with dollar, the exchange rate between them becomes the nominal anchor point – against the background of important anti-inflation financial reform. Ever since 1970s, however, some distressing economic dynamics has started to encroach on this second role – dollar's role as an anchor. The deposit rate in both private and public sector witnessed endogenous decline. With private deposit declining, the public deposit plummeted even faster which was reflected by federal deficit.

Since 1980, China has achieved impressive economic progress. China anchored its currency with dollar in 1994 and as a result China's macro economy was stabilized. This was possible thanks to the multi-lateral free forex trade arrangement under dollar standard. The extension of dollar-based trade unwittingly made China a pillar in dollar standard. The collapse of or damage to dollar standard would bode ill for China. So, what problems do we have to solve through negotiation? First, America should stop heaping critics on China for the appreciation of RMB. The critics are the products of forex trade balance theory, which is a wrong theory. Second, America should agree on the reduction of fiscal deficit and China should boost domestic consumption. To that end, both countries can formulate a combination of measures in terms of taxation and expenditure. If the two countries can coordinate with each other, forex fluctuation can be minimized, which means the exchange rate of both dollar and RMB can be easily stabilized. Third, the Fed should agree to raise dollar interest rate to a more normal level to alleviate the pressure of hot money inflow in China and other emerging economies. China should agree to gradually cancel capital control as the first step toward RMB internationalization and an open capital market. Fourth, both parties should express their good will in the negotiation and other areas including the flawed American anti-dumping law and the anti-trust and other suspiciously rule-disobeying regulations that China impose on highly competitive foreign enterprises.

In the paper "***The Case for a World Currency***", **ROBERT A. MUNDELL** stated the flexible exchange rate experiment has been a failure. The best test of any monetary system is the degree to which it avoids unnecessary changes in real exchange rates. These changes drastically reduce the gains from trade and disqualify the arguments ordinarily made for free trade areas and the customs unions. By this criterion, the worst period in history has been the period since generalized floating that began in 1973. All of the arguments made for flexible exchange rates have proved to be incorrect. Destabilizing capital movements have rocked the exchange rates between areas that have a high and consistent degree of price stability. Exchange rates consistently overshoot equilibrium, causing harmful shifts between traded and non-traded goods industries and in the levels of indebtedness of rich and poor countries. The dollar–euro exchange rate, first dropping by a large percentage and then rising by an even larger percentage over the past 20 years, between areas that have price stability, is sufficient proof that the markets are not working in a direction and degree that is conducive to economic welfare. The solution lies in creating an international currency that can be used by all countries for international trade purposes. A two-step process is envisaged: First, a convergence of the three or four major currency areas on a common unit of account, called the "DEY" for dollar–euro–yen or dollar–euro–yuan, with a joint Monetary Policy Council to determine monetary policy of the area. Countries could start with large margins and gradually reduce them to complete convergence. Second, the Board of Governors of the IMF (or its replacement) designate the DEY as the platform on which, in conjunction possibly with gold, it will build the new world currency, to be called the INTOR. Both the Keynes and White Plans called for a world currency. Political conditions were not ripe for its inclusion in the Articles of Agreement and that is one of the reasons why the great post-war monetary experiment of the fixed-exchange-rate international system broke down." Since the creation of the euro, the political configuration of the international monetary system has changed and the United States is no longer the unquestioned "dictator". It is now very much in America's interest, as well as the interests of the EU, Japan and China, to restore a new international monetary system that would be to the economic benefit of all countries.

PAN GONGSHENG pointed out in the article "***Some Views on the Recent Development of Wealth Management Market***", in recent year, people are impressed by the fast growth of wealth management market and the booming of internet wealth management. The fast growth of wealth management market shows the emergence of large demand against the background of fast economic and residential income growth. As to how to further develop our wealth management market and financial market, he offers following views. First, we should deepen the opening and reform in financial sector, reduce restrictions on financial market, and expand financial supply. The third plenum of the 18th national party congress made a roadmap for future reform and financial reform. To promote financial reform, we should construct a more competitive and inclusive financial sector, open financial sector both to the domestic and foreign market, and provide financial service with larger scale, better quality, and greater efficiency. Second, we should strengthen financial regulation, reduce regulatory arbitrage, prevent risks, and promote a sound development of wealth management industry. Practitioners in this area should be more aware of risks and more competent in managing risks. They should accept and respect financial regulation. In so doing, they are responsible for themselves and the society. And, of course, financial regulation should also be improved. Third, we should strengthen the discipline and self-constraint of financial market. We should strengthen compliance regulation including risk information disclosure of financial products, improve the rating system of products and investors and establish normal payment and clearance mechanism, accelerate the establishment of deposit insurance system, improve the exit mechanism for financial institutions, and educate financial institutions and investors to shoulder the risks by themselves.

JOSEPH YAM CHI-KWONG's recent paper "***Hong Kong Can Ditch Dollar Peg***" rehearses at length the arguments for and against the Hong Kong peg to the US dollar and the technical and legal mechanisms surrounding it. Although taking care to remain neutral, he raises doubts over peg's durability. He appears to justify his shift in stance by reference to changing circumstances. Thus he implies that the global financial crisis makes it desirable for the Monetary Authority to have more flexibility in the use of its assets than the peg arrangements allow. He goes on to question whether an international financial centre of Hong Kong's scale can operate 'with a domestic currency system that is not the national currency system of a much bigger economy'. The simple answer is that it can and it does, and there is no convincing reason why it should not continue to. In 2047, the Hong Kong dollar will inevitably be fused with the renminbi. Many expect it to happen sooner. Whether it does should depend on the timing of full renminbi convertibility, the People's Bank's record in conducting monetary policy, and the degree of structural convergence between the two economies.

Research Review by IMI Academic Committee Members

According to the article "***How should financial industry adapt to the new norm***" by **CHEN YULU**, China began to enter the new norm of "three period together", and there are lots of new situations and problems in this industry. Different from the slowdown of the real economy, the financial industry expanded rapidly when former policies were implemented. At the same time, financial sector's influences on real economy are weakening. The macro liquidity is sufficient, but the micro liquidity is strained. The total liquidity is expanding rapidly, while the financial structure has undergone significant changes. Influenced by the new financial products and financing mode, overall debt ratio and leverage rate grow larger, and the systematic risks also increase. Financial sector's capability in serving social innovation, industrial upgrading and production and consumption has decreased. We need to face the challenges directly, analyze the causes and features behind these new situations, reposition our financial strategies and policies, and find suitable solution to the "new normality".

First, these new situations are not only related to changes in the economic fundamentals and structure transformation, but also to former policies. Second, the "new norm" has not been fully unfolded yet. In the future, changes in the real economy will influence the financial fundamentals through many channels. Third, the "new norm" in China's economy will require China to reposition its financial strategies and policies to respond to the new strategic tasks.

On "2014 China Summit Forum on Internet Finance & the 1st 'Gold Internet' Awarding Ceremony of Shanghai Security Exchange", **BEN SHENGLIN** shared three of his views on ***international practices on financial innovation and internet finance***. First, the purpose of financial market is to serve the real economy and create wealth for the society. Only if financial activity can generate profit without reducing others' wealth or influencing the society, the activity can be useful. Second, he made the analysis of the reason for the emergence and booming of internet finance. The main reason is that traditional financial market is less "market-based", "internet-based", or "customer-oriented". The other reason is the absence of regulation in internet financial market and the existence of regulation in traditional financial market. Third, internet finance and financial innovation should comply with rules and regulations. They should both serve the real economy and create wealth for the society. In addition, we should control risks.

According to **CAO TONG** in the article "***A dilemma on whether to liberalize***

deposit interest rate", now our financial reform is in a crucial juncture and we are faced with three core tasks: interest rate reform, exchange rate reform, and capital control reform. In retrospect to market-based interest rate reform in other countries, we can conclude that the necessity for interest reform lies in its two roles. First, interest rate is the benchmark for the pricing of social economic activities. Second, interest rate is the benchmark for allocating social productive factors. The reform is difficult because people are pursuing the maximization of social profit but they do not know how to price loan and deposit interest rates. To solve this dilemma, in the past decade China has quickly made three interest rate benchmarks: first, the benchmark for central bank's rediscount rate; second, the benchmark for monetary market interest rate; third, the benchmark for bond market. In addition, another technical barrier of interest rate reform is the possible surging of interest rate after liberalization. China is the second largest economy, and to become the first one and dominate the world will certainly be a daunting task. This is a marathon and hindrance by others is to be expected. In this marathon, we should figure out how to follow the first one closely and take the right opportunity to surpass him. An early promulgated reform plan will guide market expectation, ensure self-adjustment of the market, and prevent the market from "getting lost". As the essence of interest rate reform is the redistribution of social wealth, at the early stage depositors may be benefited at the expense of debtors. So, when deciding when to reform, we should prioritize the interests of debtors and start the reform in stable period when enterprises' general cost rise is slight.

In the article "***Fiscal and taxation reform-let the central and local governments play their own parts***", **GUO QINGWANG** put forward three points in deepening the reform of fiscal and taxation systems. First, fiscal and taxation system is the fundamental and pillar in governing a country. Second, the direction of the reform is to establish a modern fiscal and taxation system. In terms of philosophy, "modern fiscal and taxation system" surpasses the previous "public fiscal and taxation". In his opinion, the modern fiscal and taxation system is established on the basis of socialist democratic system, and is in line with international regulations. So this system is suitable for our current and future socio-economic development. In terms of how to establish this system, we need to study the following three problems: first, define the border between market and government behavior; second, clarify the relationship between market pricing and public pricing; third, achieve "two stabilities". "Stabilize taxes" and "maintain the overall stability of current financial structure in central and local governments" are the scientific decision made by the party central committee from the perspective of our economic requirements and deepening reform.

To some extent, deepening the reform of fiscal and taxation system should base on stable taxes, and rationalizing fiscal revenue of central government and local government should base on maintaining the overall stability of current financial structure.

JI ZHIHONG has raised the following points in “***Continue to deepen the reform of the financial system***”. First, we should accelerate the reform of interest rate marketization according to both domestic and foreign economic and financial development status and conditions needed for reform, and also ensure risks are under control. Second, we should develop foreign exchange market, diversify foreign exchange products, and expand and fully develop foreign exchange market. Third, orderly push forward Renminbi capital account convertibility. We should further transform foreign exchange management mechanism, and make it easier for domestic entities to “go global”. We should allow residence to invest directly in overseas projects and assets to promote international payment balance. Forth, orderly lower the threshold for financial institutions to access the market, and allow private capital met certain criteria to set up small and medium sized banks and other financial institutions. By encouraging private capital to develop these institutions and increasing competitive supply, we can provide our people with more effective financial services. Fifth, we should push forward the reform of policy-based financial institutions, and complete sustainable operation mechanism. Policy-based financial institutions in China have a lot of problems, including incomplete governance structure, unclear business and financial rules, incomplete constrain mechanism, unsustainable development. Sixth, we should establish deposit insurance system and complete the market-based exit mechanism for financial institution. Seventh, we should continue to push forward reform and innovation in the bond market, and regulate development and two-way opening up. We should complete multi-level bond market system, and help to establish a sustainable, market-based financing mechanism for urbanization process. Eighth, we should properly deal with the relationship between financial innovation and regulation, and promote the sound development of internet finance. Ninth, we should accelerate the establishment of a unified, comprehensive, and shared financial statistical system, and formulate the financial statistical management regulation.

JIAO JINPU talked about ***protecting the rights and interests of financial consumers and investors*** in a recent interview. He put forward that there are some typical risks in financial consumption. First, there are a lot of misunderstanding between consumers and financial product providers. Second, risks for cross products.

The cross product refers to cross-financial business, and is also known as financial derivative. Nowadays, financial products are no longer limited to products provided by banks, or insurance and investment products. Then who will be responsible for the signal and transparency of potential risks? The obligations are yet to be clarified, and the right to interpretation often favors financial institutions themselves, not the consumers. But we should at least make sure they have equal rights. Third, in all these products, there are no basic regulations that protect the rights and interests of consumers. For example, the right to privacy and right to information should be included. Different consumers have different understanding towards risks. They should establish a correct attitude towards financial products. If they want a reliable product, they can invest in basic products provided by banks, such as deposit, bonds, and government bonds. If they dare to venture, they can buy stocks and other investment products. Now, the most important thing for us is to resume our work to further improve our complaint settling mechanism, promote financial knowledge, issue regulatory documents and complete financial infrastructure.

On the 2014 International Monetary Forum, **RAINER KLUMP** introduced the experiences and lessons in the internationalization of Deutsche mark. He holds that it takes Deutsche mark and subsequent Euro nearly a century to achieve internationalization, so ***the internationalization of Renminbi may still has a long way to go***. In this process, better leadership, decisions and suggestions are needed. After the collapse of the Bretton woods system, as an international currency, Deutsche mark gained momentum rapidly, because it had flexible exchange rates and it is not a systematic currency. As a result, it soon became one of the many reserve currencies in the world. The situation China now faces is similar to that of Germany. China is a powerful country with high industrial output and ever-increasing foreign exchange reserves, and thus China has a new appeal in currency policies, and China now also challenges the US-dominated international reserve currency system. At the same time, China needs to develop its off-shore Renminbi market. Thus, Europe will be a major destination in the future Renminbi internationalization process, and China can also learn from other European currencies in their previous internationalization process. In addition, in order to encourage its currency to go global, China should continue to expand and open up its financial institutions and financial markets, especially those domestic institutions and markets. Because only by opening up financial institutions and financial market, can China provide the important conditions and a crucial functional support for the current monetary status.

According to **IL HOUNG LEE** in his paper "***China's path to consumer-based growth: reorienting investment and enhancing efficiency***", based on this method, evidence shows that some types of investment are becoming excessive in China, particularly in inland provinces. In these regions, private consumption has on average become more dependent on investment (rather than vice versa) and the impact is relatively short-lived, necessitating ever higher levels of investment to maintain economic activity. By contrast, private consumption has become more self-sustaining in coastal provinces, in large part because investment here tends to benefit household incomes more than corporates. If existing trends continue, valuable resources could be wasted at a time when China's ability to finance investment is facing increasing constraints due to dwindling land, labor, and government resources and becoming more reliant on liquidity expansion, with attendant risks of financial instability and asset bubbles. Thus, investment should not be indiscriminately directed toward urbanization or industrialization of Western regions but shifted toward sectors with greater and more lasting spillovers to household income and consumption. In this context, investment in agriculture and services is found to be superior to that in manufacturing and real estate. Financial reform would facilitate such a reorientation, helping China to enhance capital efficiency and keep growth buoyant even as aggregate investment is lowered to sustainable levels.

According to **LIU JUN**'s article "***Stabilizing the unstable monetary policy***", stable monetary policy should be a long-term choice rather than a temporary solution. As the economy grows at a medium speed, neutral monetary policy is increasingly important. Economic restructuring requires the market to play a bigger role, and monetary policy should stay stable, neither tight nor loose, to avoid market turbulence. For China, quantitative tools are necessary because they suit China's conditions and market features: first, the banking system is the main transmission mechanism of monetary policy, where quantitative tools can have direct and clear effects; second, the bond market is underdeveloped, and price-based tools lack a highly marketized stage; third, in economic restructuring, the position of monetary focus on the economic aggregate , and is comparatively macro, so quantitative tools are more suitable. Independence is the precondition for stable monetary policy. The independence of monetary policy is based on the independence of the central bank, while the independence of the central bank is the precondition for its implementation of monetary policy. The foresightedness and predictability of monetary policy is highly relevant to stability. No statistics have proven that the more unpredicted monetary policy is, the better effects it will have. Monetary policy should never be mysterious; rather, it should be foresighted and predictable, and there must be a series of leading indicators for the market to predict its trend, so that market players can adjust to its requirements.

DAVID MARSH stressed in his speech ***The internationalization of RMB should make profits from assets*** that the flow of capital and the regulation of banks require prudent management and adjustment, this is vital to China's development. In terms of this, China is already on track. China has already become one of the engines, if not the only one, of the world economy. But at the same time, China is accumulating exchange reserves, which will cause payment imbalance. Many Chinese banks are reflecting on asset management, striving to realize more RMB-denominated assets in offshore RMB markets through RMB settlement arrangements in Luxembourg, London and other European areas. Only with such actions can they reverse the negative returns on investment in offshore markets, and win China the privilege that the US and the dollar enjoyed as the largest reserve currency in the past 40 to 60 years. Now we should allow diversified uses of RMB in offshore markets and increase the quantity RMB to gain scale advantage. Besides, the flow of RMB should be more stable and independent. We should allow overseas banks and financial markets to use RBM for international settlement in larger scales and in more diversified forms. This is conducive to China's economic flexibility and the growth of the Chinese financial market. Besides, we should grant increased freedoms to Chinese investors in outbound investment, so that both the public sector and the private sector can use RMB for overseas investment, this is also very important.

On 2014 International Monetary Forum, **HERBERT POENISCH** made a speech on ***RMB and offshore market construction***. He argued while most conference participants accepted the notion of offshore market construction as the only road for internationalization of RMB, this contribution raises some concerns regarding this route. Although the PBOC has designated a number of offshore trading centers for RMB and negotiated swap facilities with local central banks (see contribution by Lim, Korea Institute for International Economic Policy), we have yet not seen the adoption of one strategy for the internationalization of RMB as the official route.

By focusing on three aspects, history of offshore financial centers (OFC), theory and reality of offshore markets, and choices for China, we discuss the main characteristics of offshore markets and how to apply them in Chinese actual environment. First, through the history of offshore development, several concerns are discussed and explained by investigation. The lack of transparency appears to be the main focus in recent years. IMF and FSB both propose that OFC can only be tolerated if they are transparent and play by international rules. Against this backdrop, it is surprising that Chinese authorities would intend using OFC as a major pillar in the process of the internationalization of RMB. In reality, the interest rate and exchange rate differentials compared with onshore rates are ‘engineered’ in Chinese offshore market due to that arbitrage business between offshore and onshore market must be forbidden. Two unintended consequence will be caused that Chinese residents would borrow money to get lower interest rates and that monetary implication for China. For china’ choices, it is argued that presently the internationalization of RMB is over-regulated, stipulating the location as well as the eligible participants of this market (see ADBI Ceballos, Didier and Schmukler 2012). In this paper, it’s recommend to determine both, participants and location (ie. offshore financial centers) as a transitory arrangement and to stipulate only the eligible participants as the lasting solution.

According to **QU QIANG** in his recent speech ***The internationalization of RMB requires a sound and well-developed domestic financial market***, without which the currency and the financial assets priced by the currency will lack liquidity, and their values will become unstable. Therefore, there must be an appropriate internal financial system. The internal financial reform is the process of marketization, where the market plays a dominant role. Marketization requires the rule of law, transparency and adequate competition, and rejects monopoly by countries or transitional interest groups. Recently, the central bank said that we would achieve the marketization of interest rates in two years. In the real economy, if the real economic sector and the financial sector do not share equal positions, severe monopoly will cause a lack of free bargaining rights. These are the tough problems we have to face in domestic financial reform. Solving them would be an uphill battle rather than a piece of cake, because we have to deal with many factors behind them.

ALFRED SCHIPKE pointed out ***whether RMB can be added to the SDR currency basket does not merely depend on the opening of China’s capital account*** at the 2014 International Monetary Forum. How can a country’s currency be added to the SDR currency basket? IMF established two criteria, one of which is that the currency must be used in international trade. Now RMB has already become the second most widely used currency in the world, and China’s economic volume is expanding. Can RMB be used freely? This comes down to whether an open capital account is needed. The answer is no, because according to IMF’s criteria, whether RMB can be used freely depend on the importance of RMB or other currencies as bank debts, as international reserves or as currencies. The IMF's decision is not based on whether the country has an open capital account, but on whether the currency can be used freely. At the same time, Asia's integration is underway, and it will further develop. Modern business cycles will also be increasingly relevant, so we need a security net that goes beyond this region.

In the article "***Rebalancing growth in China: the role of the yuan in the policy package***", **ANOOP SINGH** stressed the Chinese economy has achieved a remarkable transformation over the span of three decades to becoming close to the world's largest economy. In recent years, cross-border settlement transactions have grown rapidly, investment vehicles denominated in RMB have expanded, and the People's Bank of China has established a network of bilateral local currency swap lines with other central banks. However, some risks may hide behind the relatively high-level outward growth strategy leading by Chinese economy's size and large presence in world markets today. Three key inter-related reforms, including exchange system reform, financial system reform and capital account opening, are discussed in detail herein, aimed at balancing china's growth model to sustain the growth momentum, and reinforce the trend towards a more international RMB. For exchange system reform, while steps have successively been taken, and the current account surplus has significantly been reduced, it is well recognized that further exchange system reforms are needed to help deepen progress in areas that would promote economic rebalancing. The reforms would lessen the need for monetary tools to be geared towards sterilizing foreign currency inflows and managing the currency by achieving the two-way movements in exchange rate. Second, financial liberalization implications such as implicit financial guarantees and shadow banking are focused in this paper. A higher domestic interest rate and cost of capital is favored by this paper. Third, we propose that capital account opening should occur only after the bulk of financial sector reform has been completed. And in China, as the domestic financial system becomes more market based, with fewer distortion of market clearing levels of credit and interest rates, China can start dismantling its still extensive system of controls on capital flows.

WANDA TSENG put forward in the article "***RMB to be included in the SDR basket by 2020***", international experience points to several factors that are important in a currency's internationalization and its successful rise as a reserve currency. These factors include: economic size and wide trade networks, macroeconomic stability, capital account convertibility, depth and liquidity of domestic financial markets (together with currency convertibility). First, China has certainly met the condition of economic size and centrality to global trade. Besides, China's growing economic size has been accompanied by a significant rise in its importance in global trade. As for macroeconomic stability, China has achieved high rates of economic growth with relatively low rates of inflation, especially in recent years. Third, the RMB is not convertible on the capital account; major controls remain in place, mainly on FDI, residents' external borrowing, and nonresidents' investment in domestic financial markets. Nevertheless, China has gradually and cautiously relaxed capital controls, notably in allowing increasing amounts of capital inflows (within specified quotas) under the QFII and capital outflows under QDII. Forth, while progress has been made with financial sector reforms over the past decade, China's financial system still has considerable distance to go before reaching the breadth, depth, and liquidity of those in the reserve currency countries. Some of the fundamental drivers for internationalization of the RMB are in place, based on China's economic size, growth potential, and trade linkages. However, modernizing and deepening the financial sector and gradually opening the capital account are still works in progress. While the RMB has gained ground as a currency for trade settlement, it still has some way to go to achieve the "widely used" and "widely traded" criteria in global financial transactions for an international currency.

According to the article "***Utilizing the silk road economic belt development to facilitate RMB***" by **TU YONGHONG**, developing the Silk Road Economic Belt is a new strategy of China to further open itself to the world under the new situation. This strategy is of great importance to sustainable development, and it provided a new path to facilitate RMB internationalization and improve financial strategies. The strategy could be a new pivot for RMB internationalization. There are real opportunities for China to seize the opportunity of the Silk Road Economic Belt development, and start to internationalize RMB by making it a quote currency in trade. In particular, there are two aspects for China to break through: promoting RMB-denominated settlement of energy products, and expanding direct RMB investment and loans. China is now the largest oil importer in the world; its huge purchasing power will make it possible to settle accounts with RMB in oil and gas trade between China and the Middle East. If this practice is made possible, RMB will become a currency for commodity trade, and there will be a qualitative leap forward in RMB internationalization. The Silk Road Economic Belt brings opportunities as well as risks. Therefore, we must formulate comprehensive plans to step up RMB internationalization with clear focuses. In the first phase, we should focus on Pakistan and Middle East countries; in the second phase, we should focus on cooperation with South Asia, Iran and Iraq; in the third phase, we should gradually shift our focus to West Asia and Europe.

In his speech at the 2014 China Summit on Development of Small and Medium Sized Banks and the Third Awarding Ceremony for Small and Medium Sized Banks, **WEI BENHUA** argued that the next ten years would witness rapid changes in Chinese capital market, which presents ***historic opportunities for small and medium sized banks***. He believes that China will further relax regulations on capital and financial market and hence more opportunities will emerge for small and medium sized banks. In order to give these banks more roles to play in the field of financial products, more market-oriented products should be invented. As for exchange rate regime, the formation mechanism of RMB exchange rate should be further improved and more types and products of foreign exchange transaction should be created, so as to allow them to explore more potential in foreign exchange business.

According to the article "***Active and appropriate development of private banks is of great significance***" by **XUAN CHANGNENG**, currently, active and appropriate encouraging private capital to invest in private banks is an important part of implementing the Party Central Committee and State Council's decision to comprehensively deepen reform. At the same time, it is of great importance to improve the structure of financial market, and better help financial system serve for real economy, especially for *"san nong"* (issues of agriculture, farmer and rural area) and small and micro businesses. The establishment of deposit insurance system is the prerequisite to developing private banks. Only when a deposit insurance system is established and the market-based exit mechanism for financial institutions is improved, institutional guarantees for private banks' regular and sound development can be achieved. From the experience of operating the deposit insurance system, in most cases, in order to better protect depositor's interests, sound institution's acquisition of badly performing institution should be encouraged. The deposit insurance system's role in defusing risks and stabilizing finance is fully proved in the global financial crisis. Currently, multilateral organizations are pushing forward a new round of financial reforms to further improve deposit insurance system and strengthen its role in preventing and defusing risks.

ZHANG JIE put forward in "***Budget constraint and choice in financial systems***", according to paradox of choice in financial systems, though centralized banks with relaxed budget constraint are weak at short-term items' screening and credit management, they can cover long-term items that concern a country's future economic growth. Therefore, the angle and method of assessing the performance of centralized financial institutions should be adjusted. At least theoretically, it is irrational to put centralized and decentralized financial institutions at two opposites, which may result in difficulty of replication and transplanting from one to another. If we draw on the theory and history of financial system's transition, we can discover that as the superstructure of financial operation, financial systems have a way weaker capacity to handle and worse compatibility with budget constraints than corporate systems. Therefore, when facing the issue of budget constraint, the rational choice is supposed to be improving the financial demand structure of fundamentals of microeconomics and then leading to financial supply, instead of trying to change the financial supply structure through adjusting financial system at the first place and then leading to financial demand.

According to the article "***Exploring new financial regulation models: principles of regulating internet***" by **ZHANG XIAOPU**, the rapid emerging of online finance has caught the eyes of all walks of life and increasingly become a supplement of regular financial system. The 12 principles of regulation on Internet finance include the following: Internet finance regulation should represent appropriate risk tolerance; dynamic proportional monitoring should be applied; principle-based regulations and rule-based regulations should be integrated; regulatory arbitrage should be prevented and continuity of regulation should be emphasized; systematic risks should be monitored and prevented; the data across the board should be monitored and analyzed; financial crimes should be cracked down; information disclosure should be improved and market disciplines should be strengthened; consumer education and protection should be increased; self-regulation should be reinforced; and regulation cooperation should be increased. Overall, financial regulation should be more open, inclusive and adaptive towards Internet finance. Encouragement and regulation, cultivation and prevention should be developed simultaneously. To maintain the stable operation of financial system, we should maintain a good competitive order to improve fair competition, and construct a three-dimensional safety net integrating market discipline, judicial intervention and external regulation.

In the meeting with Asean+3 Macroeconomic Research Office (AMRO) on 9 June 2014, **ZHANG ZHIXIANG** made a keynote speech. Regarding what are the main policy issues that need to be addressed for a more efficient international financial architecture. He believes that the legitimacy and governance are the most important policy issue for international monetary system reform. However, it is very unfortunate decisions in these years have not been implemented up to this day due to US congressional rejection to them. Reform of current reserve currency practice is another important element in reform of the international monetary system. Avoidance of abrupt and sharp fluctuation of exchange rate and violent movement of capital flows is very essential for promoting economic development and stability of financial market.

Regarding what role can RMB play, he argues that China, Japan and Korea together with 10 other Asian member countries of IMF can really play an important role in pushing forward the international monetary system reform. China has joined hands with 13 Asian member countries to build up currency swap arrangements which can provide not only a safety net but also a mechanism for stable exchange management to promote trade and economic development. It is believed that stronger financial collaboration among 13 member countries of IMF can not only provide stable environment for economic development in our region but also form a positive factor to promote international monetary system reform.

ZHAO HAIYING mentioned in her recent speech "***Foster leading investment banks with international competitiveness at the earliest***" that Chinese financial sector is more integrated with the global finance, which requires security companies to follow the global steps of manufacturing companies and provide globalized financial services. Chinese securities industry must retain a place in global financial system by taking fast steps and developing a number of modern investment banks with global competiveness, great brand influence and important systems. Mergers and acquisitions are important methods to optimize the structure of securities industry and foster world-leading investment banks. Based on the facts of Chinese securities industry and advanced market's experience of developing securities, the China's securities industry's future may face three paths. First, the importance of securities sector in Chinese economy will be significantly improved in the next decade. Second, China needs a few modern investment banks with global competiveness, great brand influence and important systems. Third, China's securities industry will become more diversified and differentiated. Overall, as the transformation of Chinese economy continues, capital market will play a larger role in resource allocation, and the securities industry will enjoy more opportunities in the process of transformation.

According to the article "***The internationalization of RMB—Chinese dream in currency world***" by **ZHAO XIJUN**, as an international currency, the base of RMB's function is transactions between economic entities, which includes trading and financial activities. The order for RMB to act as international currency is to first act as valuation, settlement and payment currency, then as investment and financial transaction currency, and finally as value reserve currency. Globally, RMB first serves for the transaction between residents and non-residents, and then between non-residents. The internationalization of RMB should emphasize on both trade settlement and financial transaction. As for RMB's internationalization, China's capital market shall at least play a decisive role in RMB assets allocation, serving as RMB's international center of liquidity, investment and financing, pricing, innovation, and risk management. All the resource allocation concerning RMB assets can be realized through multi-level capital market. Maybe when any investor can allocate the RMB assets freely, RMB can be a genuine international currency, and the Chinese dream of RMB's internationalization can be truly realized.

IMI International Monetary Review

Research Report

Construction of Offshore Financial Market and RMB Internationalization

By CHEN YULU

Editor's Note:

RMB internationalization is one of the most important national strategies. The Internationalization of RMB: Annual Report has been published annually since 2012, recording the actual course of RMB internationalization and deeply studying the key theories and policies of every stage.

This article is excerpt from the "Internationalization of RMB: 2014 Annual Report" which sets the topic on RMB offshore market construction. The research group has researched into the internal logic of the promotion effect offshore markets have on RMB internationalization, and focused on the implications and effects of the establishment and development of RMB offshore markets have on RMB internationalization. Combining with the current situation of offshore markets, the research group has discussed about the realistic path for RMB internationalization to follow under the circumstances that capital accounts are not fully open.

The Federal Reserve had declared the long-brewing exit from QE before Christmas in 2013. The recovery of the developed market economics is taking shape gradually. Nevertheless, the emerging markets suffer from economic imbalance repeatedly and face with uncertainty in their future development. Nearly 10 emerging economies have been defined as "vulnerable countries", and the vulnerability reflects on high domestic inflation, decreasing economic growth, current account deficits, capital flight, and exchange rate collapse, triggering concerns that the turmoil of emerging markets would cause another global financial crisis. Despite the wait-and-see attitude and the unease toward the market, the economy and currency performance of China are basically stable and the growth RMB Internationalization Index (RII) has maintained a strong momentum.

RII had ushered in the single digit era in2013, and reached 1.69 at the end of the year. RII increased as much as 84%, compared with 0.92 at the beginning of 2013. The index rose faster than 2012. Thrillingly, the "double drive" model—trade pricing and financial valuation to support cross-border use of RMB has taken shape. Therefore the driving force to internationalize RMB is further balanced.

The percentage of using RMB as pricing and settlement currency rose to 2.50% in the global trade of 2013, increasing by 60% for 3 years in a row, and it contributed to nearly half of this year's RII. China continues to take the lead in the world's import and export with the total trade volume of more than four trillion US dollars, and strives to explore new room for growth by bilateral trade as well as regional trade cooperation and development. Moreover, China has made continuous reforms and innovations in simplifying the examination and approval procedures and lowering the costs of local currency settlement, which has greatly boosted the confidence of the market participants from both home and abroad to use and accept RMB as pricing and settlement currency in the global trade.

By the end of 2013, the portion of RMB in the global capital and financial trade had reached 2.08%, contributing to 40% of this year's RII with a distinctly accelerated growth rate. Hereinto, the third class indicator, i.e. "RMB's share of the global direct investment", maintains skyrocketing and ranks the first in the RII indicator system with a very impressive performance of 5.28%. China is now the second largest FDI receiver and the third largest direct investor in the world. As the related policies become clearer, the fulfillment process of cross-border RMB direct investment becomes more standardized and convenient, and the cross-border RMB financial investment tunnels are broadened and improved gradually. As a result, more and more foreign and domestic enterprises and financial institutions are willing to use and accept RMB as pricing and settlement currency in the global capital and financial trade.

Many foreign government organizations, as well as enterprises and financial institutions in the international market showed in RMB. In November 2013, the Canadian local financial sector succeeded in selling AAA rating offshore RMB bonds to the world, which were very popular among the investors, and collected 2.5 billion yuan, setting a new issuing record of non-residential offshore RMB bonds. The subscription amount of the bond was far beyond expectation, within which the central banks and government financial institutions covered 62%. Foreign government institutions started to actually hold RMB position, showing that RMB, as a reserve currency, has undergone a historic change from being rejected to being recognized in terms of official acceptance. In 2013 alone, the monetary authorities of many countries and regions, including Australia, South Africa, Belarus, Bolivia, and Taiwan, demonstrated that they had brought RMB assets into their official foreign exchange reserves.

"Growth", "openness", and "reform" in the real economy laid the material foundation of international society's confidence in RMB, and a developed and improved offshore financial market solved the technical problems so that RMB can maintain international attraction. Therefore, the *Internationalization of RMB:2014 Annual Report* sets its research topic as "RMB offshore market construction and development".

The research group fulfilled the following tasks. The first, after sorting out the historical experience and related documents, the research group held in-depth discussion on the internal logic that the offshore financial market boosts currency internationalization, with focus on the significance and impacts of constructing and developing offshore markets in realizing RMB internationalization in the current stage. The second, through charrettes, field visits and questionnaires, the group thoroughly studied the current development of RMB offshore markets in places like HK, London and Frankfurt, and intensively discussed the existing problems and future prospects. The third, the group employed methods like logical deduction and empirical study to tentatively discuss the global layout of RMB offshore financial markets. In addition, the challenges and solutions to building RMB offshore markets were elaborated from two angles——"how to successfully build RMB offshore markets" and "how to minimize the negative effects of offshore markets".

The offshore financial market comes into being along with economic globalization and financial liberalization. The features of the offshore financial market, e.g., loose regulation, full competition, low trade cost, and high market openness, help it develop fast after its appearance to the major part of today's international financial market. The offshore financial market can offer convenience and safety when economic entities from different countries use a third party currency in trade. A sophisticated and efficient offshore market operating mechanism plays a very important part in consolidating a currency's international status. Though America suffers from a declining trade status, dollar remains the NO.1 international currency even after the US subprime crisis triggered the global financial tsunami. The key reason is that dollar has always been widely used in the third party transactions, so it takes the biggest slice in official foreign exchange reserve. To some degree, that is closely related with developed global dollar offshore markets all over the world's major international financial centers.

Equally, the international usage of RMB can only be achieved with the construction and development of offshore market. Fast-growing RMB offshore markets not only realize RMB's outflow under surplus condition, but also stimulate non-residents to use and hold RMB through diversified financial products and qualified services. Hence, the offshore RMB pool is gradually expanding. Different from US dollar and other international currencies, the appearance of RMB offshore market as well as the initiation of RMB internationalization process, both are ahead of the capital account convertibility. From the long run, only by capital account reform to bring about wider and deeper international usage can RMB grow into an important international financial trade currency and reserve currency. However, before the right time to open capital account, the RMB offshore market can actually function as a substitute to some degree for capital account convertibility. In other words, to construct and develop RMB offshore markets kept the risk of transnational capital flow within the finite offshore markets, and boosted RMB internationalization by loosing capital control in disguised form. Obviously, the current RMB offshore market development has created a valuable time window to push forward capital account reform in a composed, orderly and timely way. Therefore, RMB offshore markets have extra practical significance to the current RMB internationalization.

The international experience shows that the size of offshore transaction in the international financial centers determines the currency's international status. To some sophisticated international financial centers like London and New York, the initiative to develop RMB offshore business lies in market participants' own choices. And this automatic process can be very fast or on the contrary extremely slow. As for the long-term goal, RMB offshore transaction size and the percentage it takes in the sophisticated international financial centers can be considered as important standards to test whether or not RMB has already become one of the major international currencies. Yet, because of the global financial tsunami, the international financial centers are undergoing major adjustments. In particular, those emerging international offshore financial centers are competing fiercely against each other and fighting for RMB offshore businesses, in fear of failing to keep a head start. It means that it is possible for China to initiatively cultivate RMB offshore markets in some countries and regions. After a comprehensive study of all factors, i.e. trade, investments, geopolitics, cultures, institutional construction, etc., through the analytic hierarchy process, the global location research of RMB offshore financial center finds out that the preferred locations for China to actively build offshore markets are HK of Asia, Switzerland of Europe, Costa Rica of America, and Mauritius of Africa, among which, HK has the most distinct advantage.

HK is now the biggest RMB offshore market in the world. HK RMB offshore financial center is the main platform for RMB settlement in cross-border trade. Moreover, it attracts many enterprises, institutions, governments and monetary authorities from both home and abroad by the increasingly diversified RMB financial products, and therefore, the biggest offshore RMB capital pool is formed in HK as well. At the same time, of HK offshore market gradually shows its demonstration effect. In Asia-Pacific region, RMB offshore trade is also brisk in Singapore, Taiwan and Macaw, and other countries including Korea, Japan, Australia and Malaysia have already shown their active attitude. In Europe, London, Paris, Luxembourg, Frankfurt and Zurich raced to express their willingness to become the next RMB offshore financial center. In Africa and America, there are also many countries actively exploring the feasibility to build RMB offshore markets.

This report insists that efforts should be made to grasp the current favorable time window, make full use of historical opportunities like domestic economic restructuring, international offshore financial center adjustments and international market's searching for hedging currencies, and promote RMB internationalization by constructing RMB offshore markets. In this process, two kinds of relations need special attention.

Firstly, in the short run, the relation between offshore markets and the real economy should be handled properly, and the international strategy that RMB offshore markets shall serve the Chinese companies and financial institutions is underlined. The offshore market's importance in global resources allocation shall be paid attention to, the objective law to develop international financial centers respected, and the top-level design carried out under the principle of mutual benefit and reciprocity. China's trace of trade, investment and foreign development should be followed so that RMB offshore market distribution in every continent can be rationally mapped out. Different entering policies shall be adopted in the sophisticated international financial centers and the emerging offshore financial centers. RMB internationalization should be further promoted by developing offshore market, and RMB offshore market's internationalization capability of serving Chinese companies and financial institutions needs improvement.

Secondly, in the mid-long term, the relation between onshore and offshore RMB financial markets shall be managed to gradually realize the ideal model that the offshore price follows onshore market price. When the development of offshore financial markets hits a certain level, it might have some impact on domestic monetary policies, causing monetary deflation pressure or imported inflation. The offshore market trade complicates the interest and exchange rate determination mechanisms in the issuing countries of the international currency. So it can be deducted that as the global RMB offshore market is heading for maturation from growth period, China's monetary policy goals have to be shifted from quantity mode to price mode, and meanwhile challenges will be posed to anti-money laundering and other financial regulations and even to the effectiveness of the legal system.

The *Internationalization of RMB: 2014Annual Report* is the third annual report the research group has handed in. We have gradually widened our research views, and dug deeper in some specific problems as well. Our point of view on RMB internationalization strategic positioning and its realization route is becoming clearer after we contact and exchange views with counterparts from academic and business circles, financial experts, and government officials from different countries in the world. In summary, there are three main points. First and foremost, RMB internationalization must base on real economy internationalization. If the major players involved in foreign trade and investment are not homegrown transnational companies with competitiveness and influence in the international market, the domestic currency cannot offer sufficient confidence to the international community. As a result, the basis of its internationalization is too infirm to last. Secondly, China should take the historical chance of international financial center restructure to push forward the global layout of RMB offshore finance in an active and orderly manner. With a limited opening of capital account, the only way to maintain the liquidity of the RMB offshore market, and to improve its attraction to non-residents, is to carry out the strategic thoughts of "interaction between domestic and oversea market."Thus we can "walk with two legs": The first is to build RMB offshore markets, which are separated from domestic market; the second is to promote internationalization of domestic banks to extend the advantage of local currency business to the outside world. We should see that at least in the starting period of development of offshore market, it is necessary to insist that offshore financial business should serve the real economy. Developing an efficient offshore settlement system through designated clearing banks can bring up RMB internationalization level rapidly and stably. Finally, via the practices of deepening reforms and opening up of China (Shanghai) free trade area, we should actively boost the bilateral trade and financial cooperation, take the major opportunity created by silk road economic belt construction, enhance the mutual political trust, explore new space for China to develop foreign economy. Thus, new driving force as well as enormous positive power will be given to RMB internationalization.

Working Paper

The Dynamics of Fragmentation in the Euro Zone: Theory and Political Implications*

By EDMOND ALPHANDERY*

Four and a half years after the burst of the Euro crisis, the Eurozone economy seems to be doing better. In peripheral countries, economic growth is picking up and investors from abroad are coming back. Nevertheless there is no denying that serious obstacles to full recovery still exist. The Euro zone has yet to find the right path for a return to a sustained and robust economic growth.

In order to design the policies which the Eurozone has to implement, one must start by deciphering the forces which have been at work since the creation of the European currency. In my previous lectures in China, I already gave theoretical insights on these mechanisms, which I will use in this paper to build a more comprehensive explanation of the evolution of the Euro area during this period. This approach will lay the foundations which underpin my personal view on the policies that are presently being followed and on the measures that should be taken in order to improve the working of the Euro area.

In this paper, I will firstly give an assessment of the present economic situation in the Eurozone. I will then focus on the role of financial markets. Thanks to the use of a simple theoretical model which will rest on the working of a "genuine" currency area, I will show that their integration is a prerequisite but not a sufficient condition to having a "genuine" currency area. This analysis will lead me to make an appraisal of the integration process in the Euro zone and to conclude by some remarks on the orientations that in my view need to be pursued in order to speed it up.

1. The Aftermath of the Euro Crisis: Where Do We Stand?

When one looks at the overall picture of the Euro area economy four and a half years after the burst of the crisis, one may feel that the worst is behind us and that

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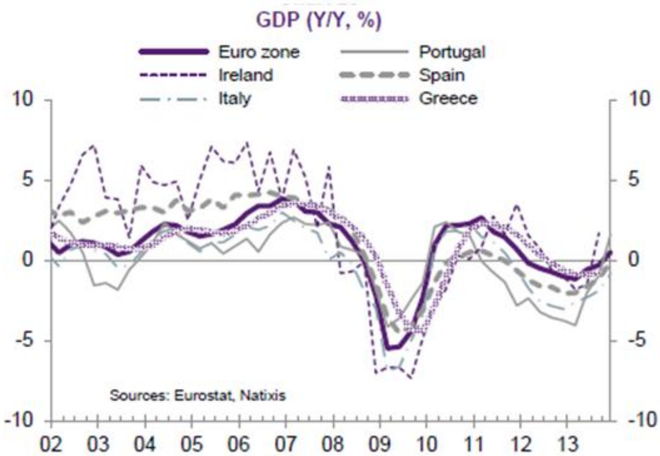
the Euro zone is back on the right track. There is in fact some good news which should not be underestimated.

1.1 Mood has dramatically improved

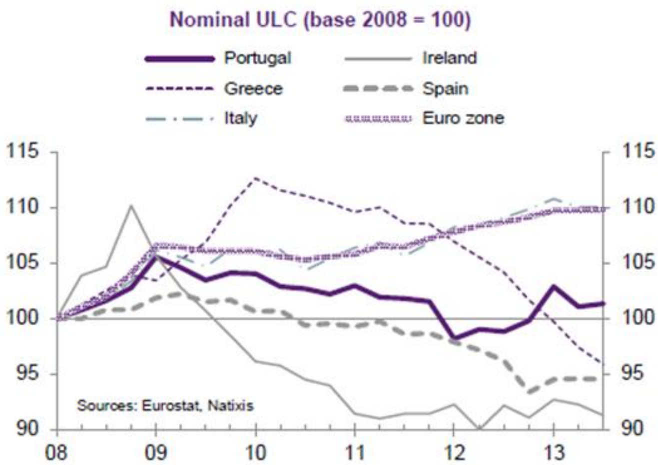
Economic growth has started to resume in the Euro area as a whole. In all peripheral countries growth is expected to return in 2014.

Chart 1



Furthermore, competitiveness has improved in the most embattled economies: nominal unit labor costs have decreased relatively to the Eurozone average in all peripheral countries (Italy excepted).

Chart 2



No wonder then that export is picking up in these countries (Greece excepted), and that their current account balance has moved back to equilibrium.

Chart 3

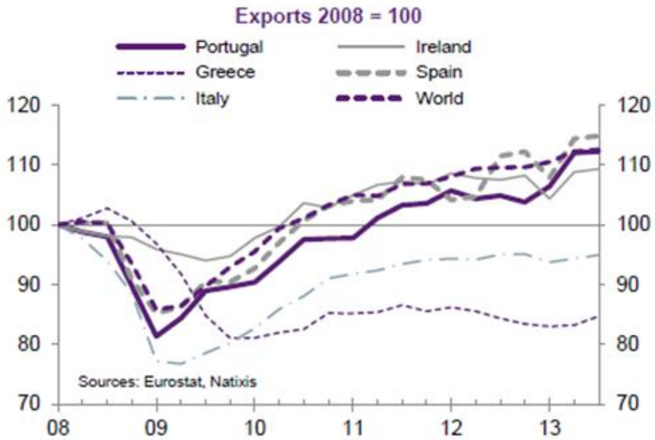
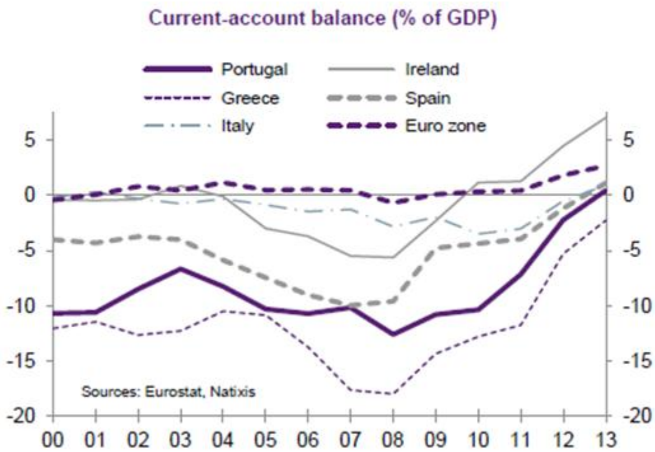


Chart 4



In peripheral countries, fiscal deficits, while not yet abiding by the stability and growth pact ceiling, have for most of them come back to their pre-crisis levels.

Chart 5

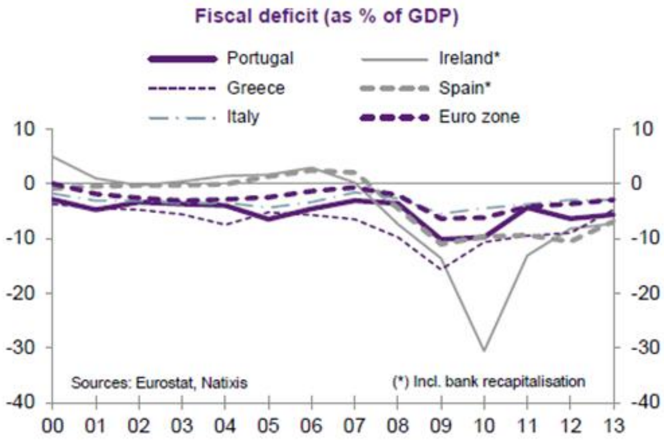
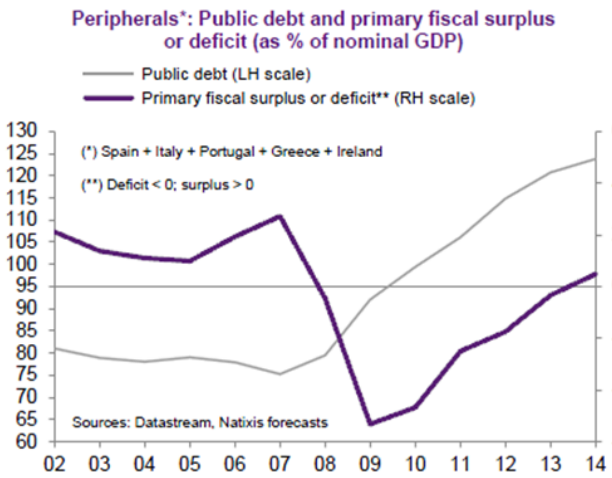


Chart 6



Investor's confidence has come back as can be seen on the sovereign yield spreads which have returned to their pre-crisis level in many peripheral countries.

Chart 7

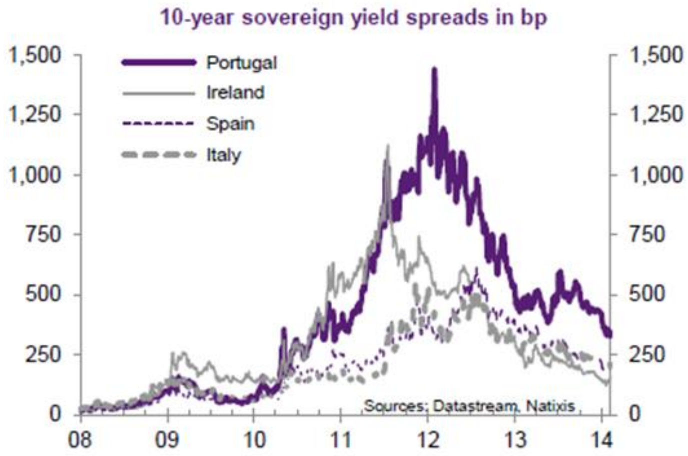
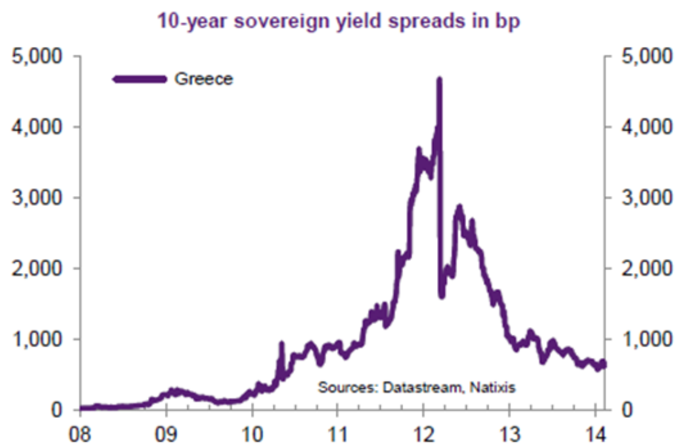


Chart 8



Last but not least, European parliamentary elections which saw a surge of Euro-skepticism in many countries have also shown the resilience of embattled governments in the periphery, except Greece. Despite the harsh economic reforms implemented in many countries, there has hardly been any real threat to the euro: anti-euro sentiment has been confined to the extreme right; the crisis has not dangerously dented the feeling of the public opinion in the Eurozone in favor of the European currency.

Nevertheless, there is no room for complacency.

1.2 Serious drawbacks still exist to a full recovery

Compared to the rest of the world, the prospect of the Eurozone economic growth remains sluggish.

Relative to the US, manufacturing production, productive investment and total employment lag behind.

Chart 9

Chart 10

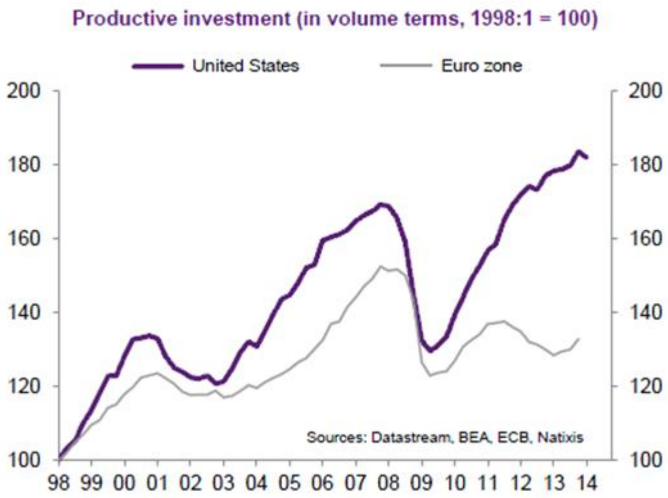


Chart 11

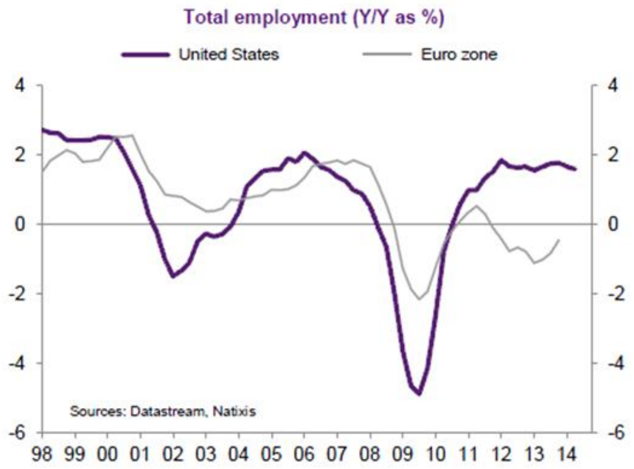
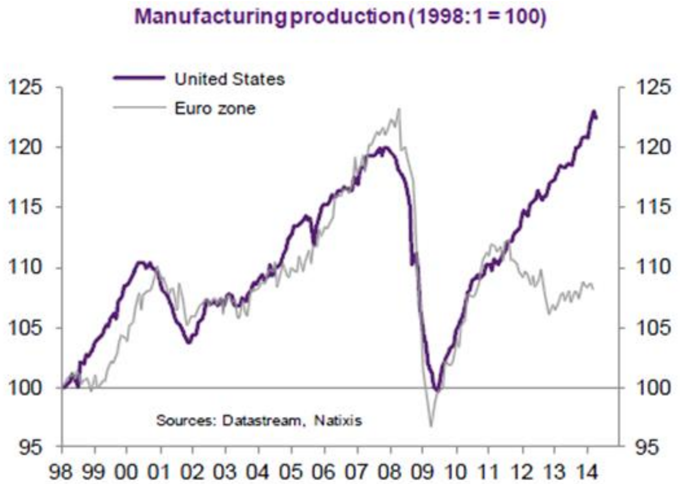
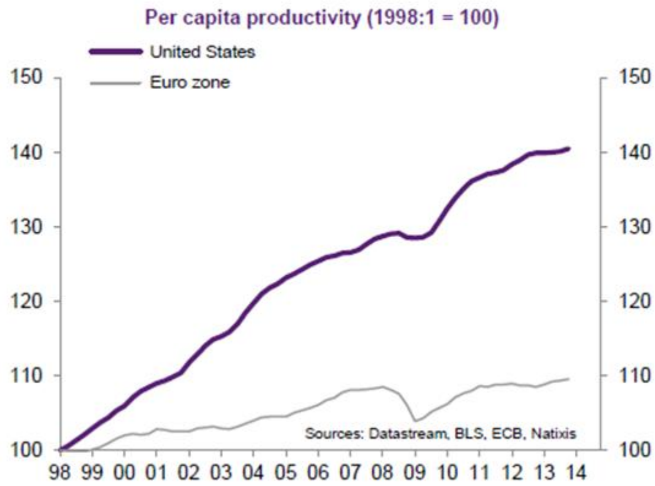


Chart 12



And productivity is still growing in the US more rapidly than in the Eurozone.

Chart 13



If we look now at the challenges that the Eurozone has to overcome, the three main concerns which we must heed in the first place are in my view the following:

1.3 The three major challenges facing the Eurozone

1.3.1 The first major issue rests on the insufficient dynamism of its productive sector: despite Germany's performance, total real corporate investment in the Eurozone taken as a whole doesn't really take off.

Chart 14

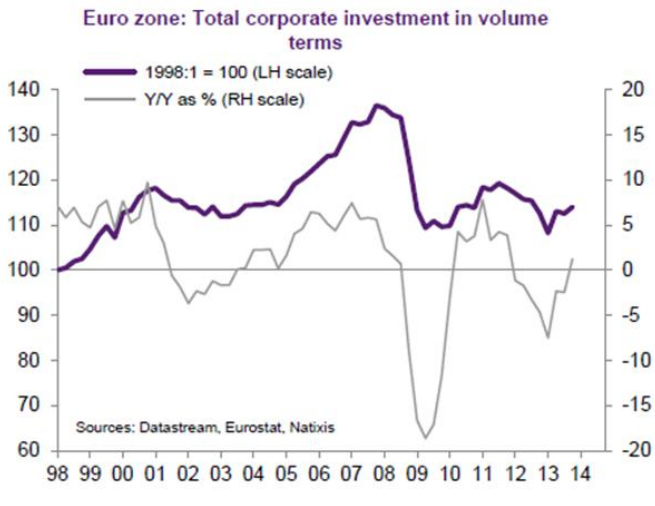
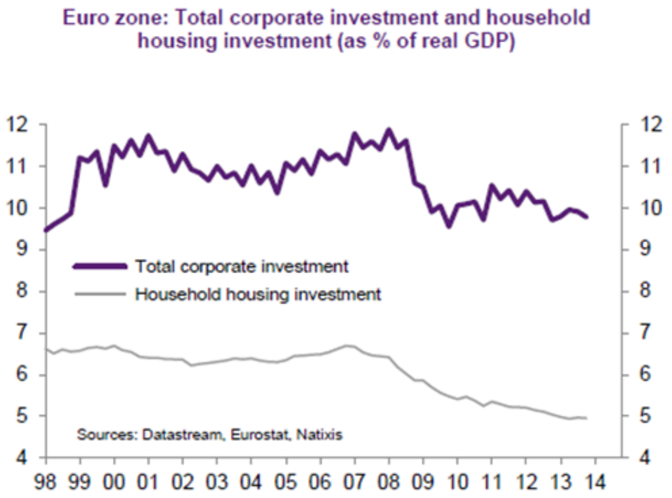


Chart 15



The level of debt (public and private) remains high, which leads to deleverage by firms and households prior to investment.

Chart 16

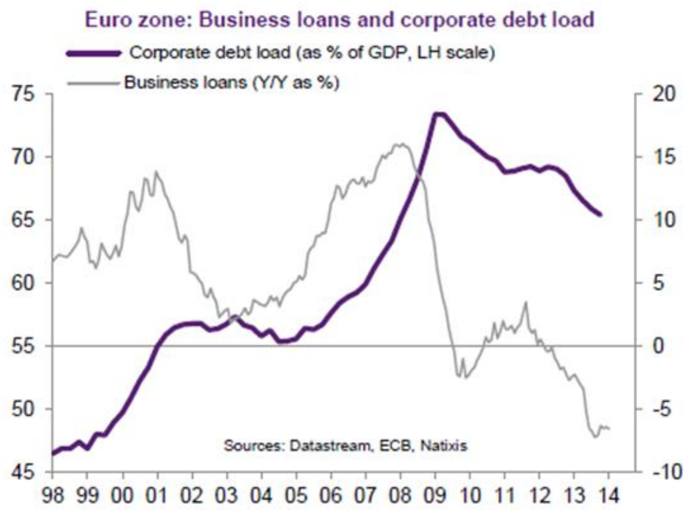
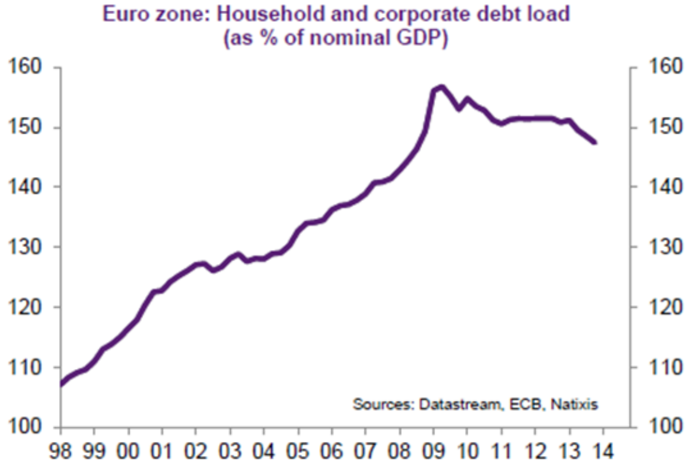


Chart 17



1.3.2 Heterogeneity is another major challenge. The North South divide is far from being overcome. It can be seen in the manufacturing production capacity and in per capita income of Southern countries relative to Germany.

Chart 18

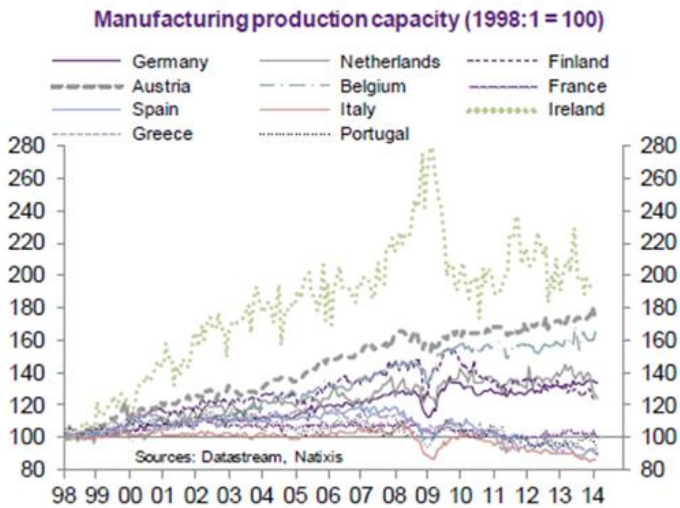
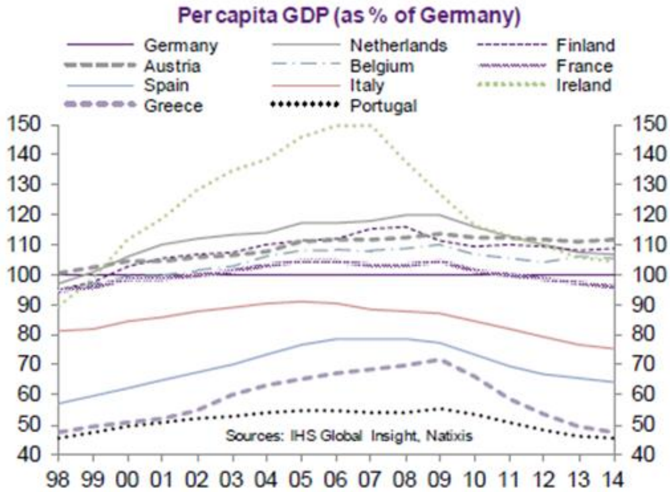


Chart 19



In all peripheral countries, the share of productive investment in GDP has decreased on average from 15% in 2008 to 11% in 2013. Productive investment fell sharply during this period and remains still low.

Chart 20

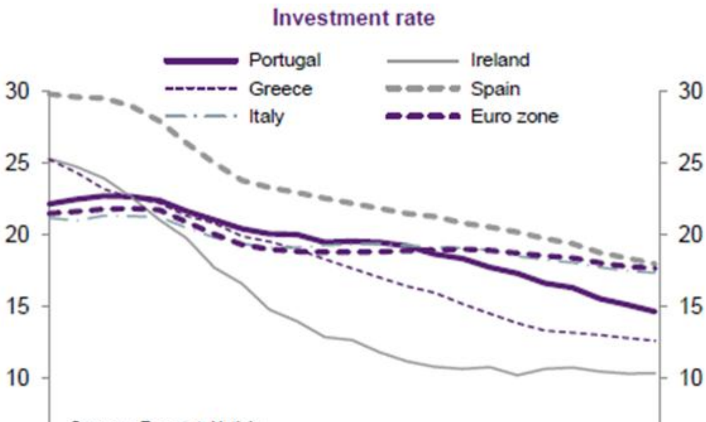
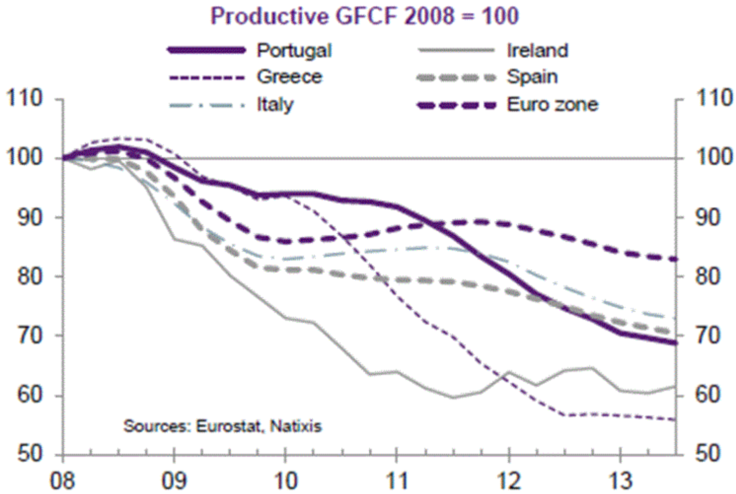
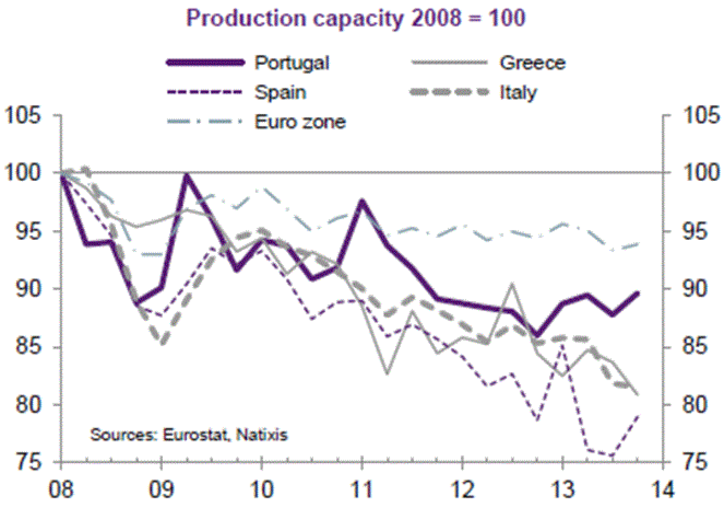


Chart 21



Production capacity has plummeted in all these countries (much more than the average in the Eurozone), therefore reducing their potential growth.

Chart 22



No wonder that their rate of unemployment has surged, sometimesskyrocketed (in Spain and Greece)and stayshigher than the average level of the Euro area.

Chart 23

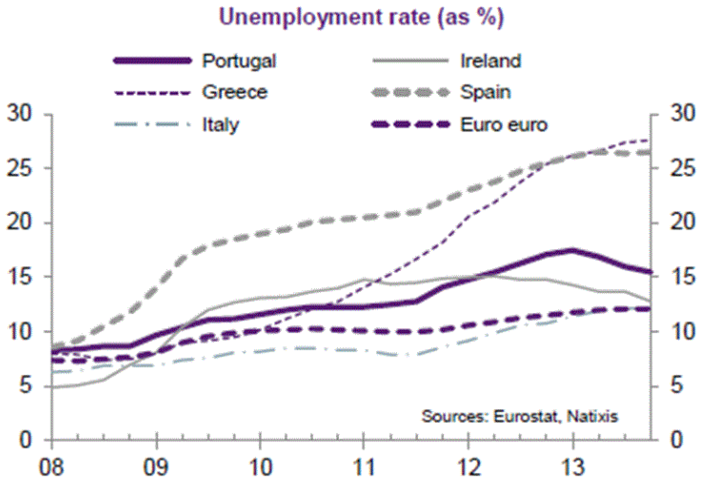
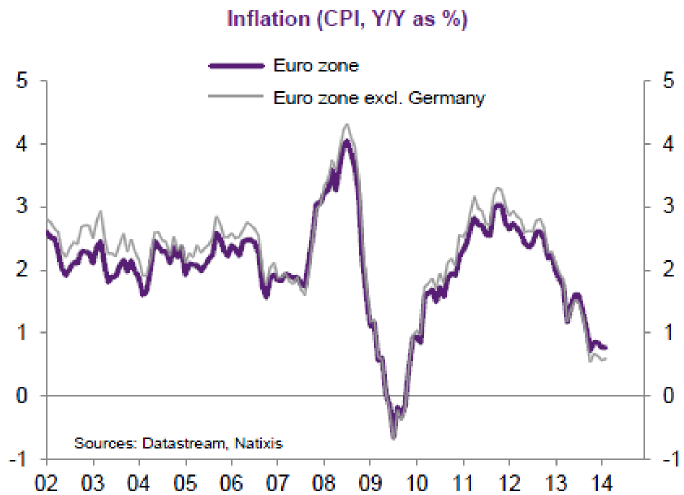


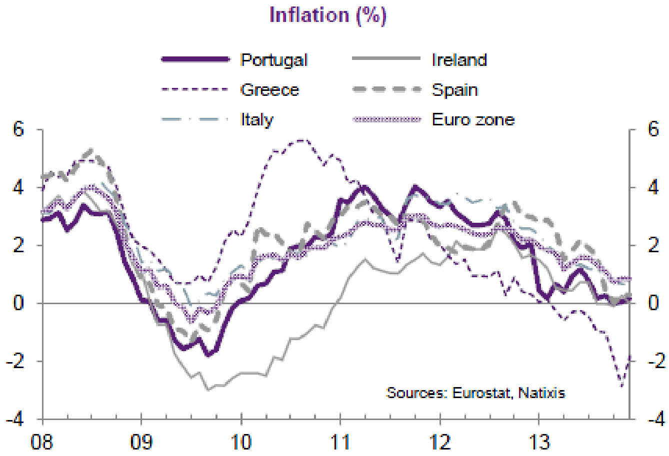
Chart 24



1.3.3 The last major challenge on which I deem necessary to point out concerns the current account of the Euro area, the exchange rate of the euro and the risk of deflation.

As a matter of fact, the price level is decelerating dangerously in the Euro area.

Chart 25



Price level is decreasing more rapidly in peripheral countries than in the core of the Euro area.

This evolution isnot only negative since it is improving the relative competitiveness of these economies. But we have to keep in mind that fall of imports which is a consequence of the decline of domestic demand is the main driver of return current accounts to equilibrium.

Chart 26

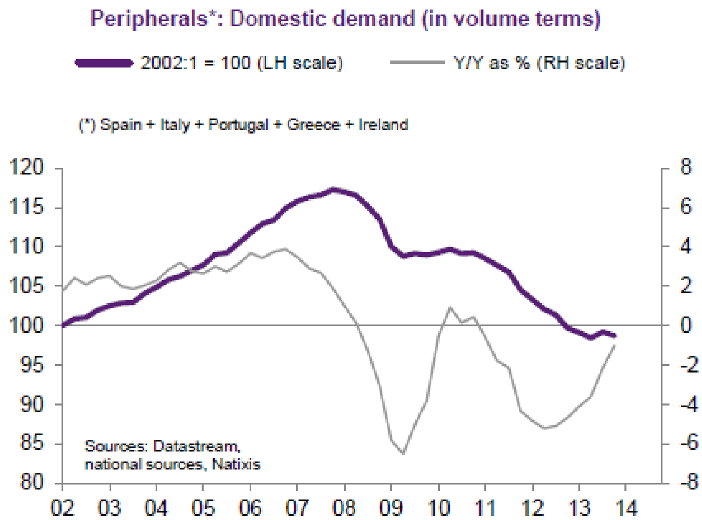
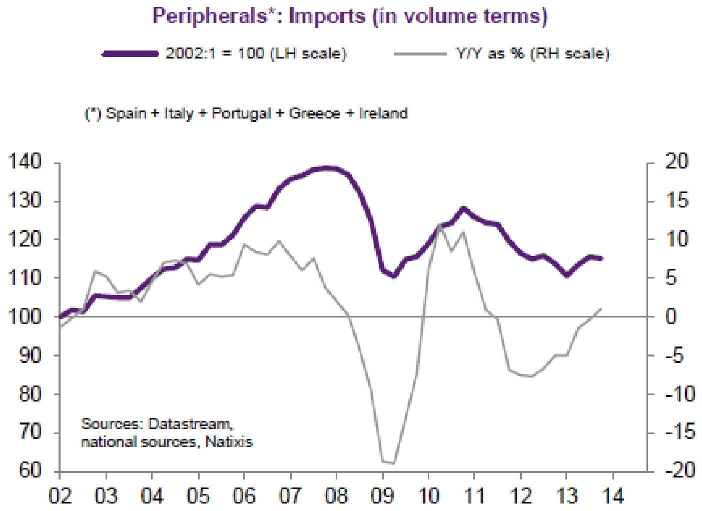


Chart 27



As for the Eurozone as a whole, while the monetary base is contracting, the stock of money does not increase and we observe a real "credit crunch" in the private sector.

Chart 28

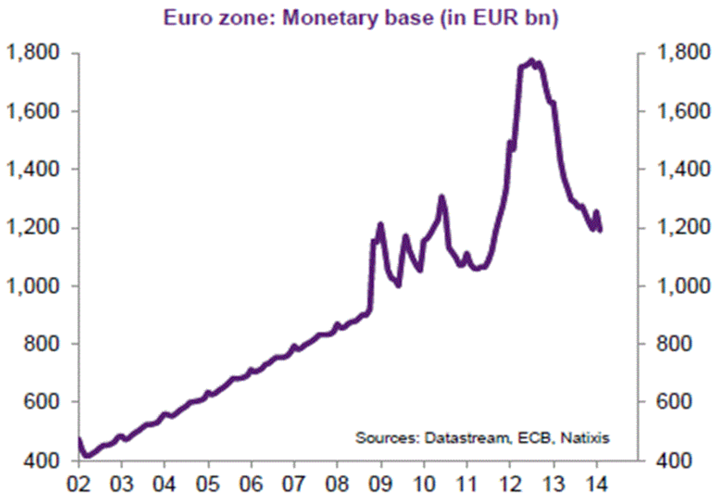
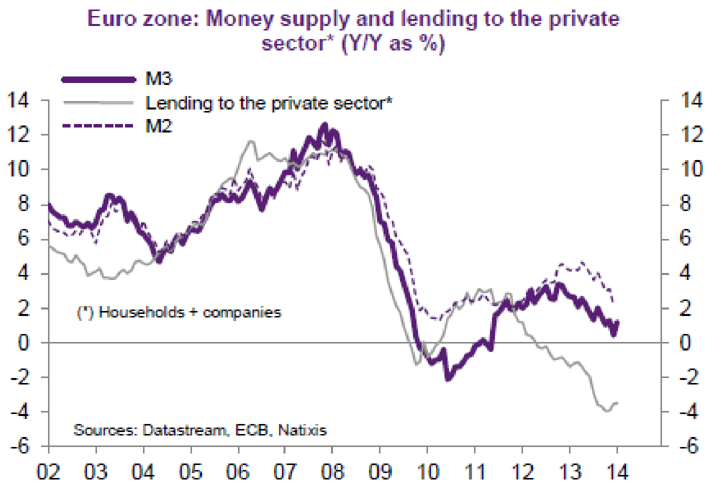


Chart 29



Concerning the value of the euro, its trade-weighted exchange rate is again on the rise. Import prices are declining, contributing therefore to the disinflationary dynamics.

Chart 30

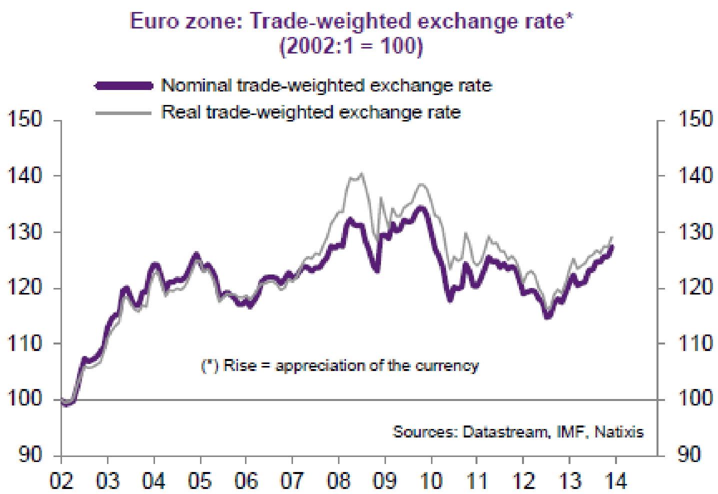
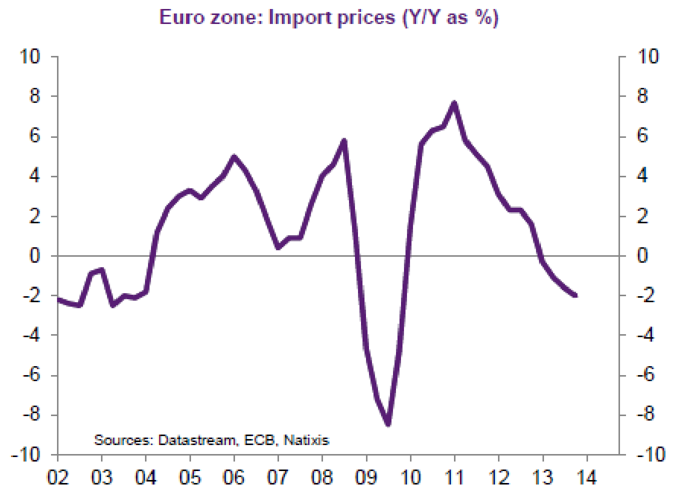


Chart 31



The Eurozone incurs a serious asymmetry problem with its current account. On the one side, countries of the South would be better off with a weaker Euro which would help boost their exports, their main engine for growth. But on the other side, Germany which posts a high current surplus sdoes not suffer from a strong euro. Its falling exports to Eurozone have been replaced by rising sales to the rest of the world.

Chart 32

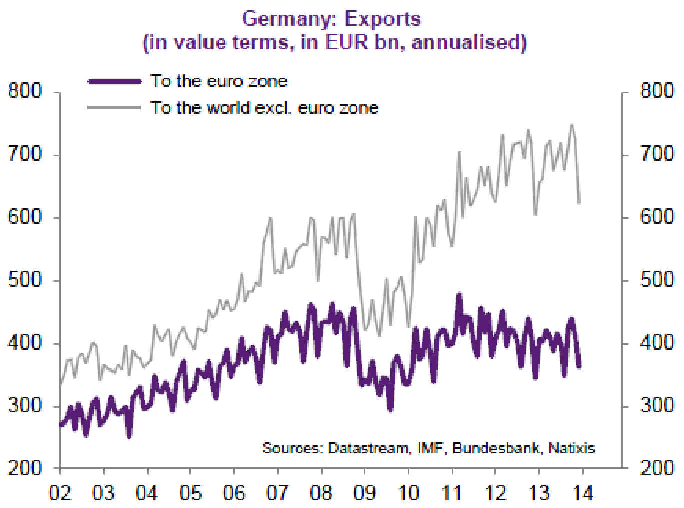
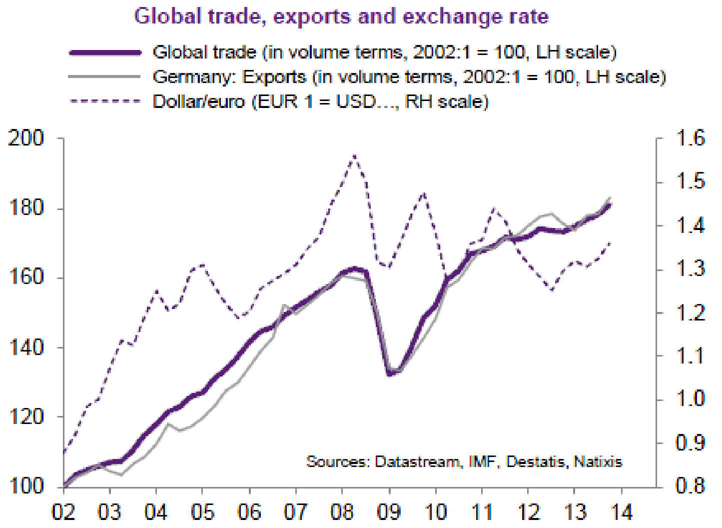


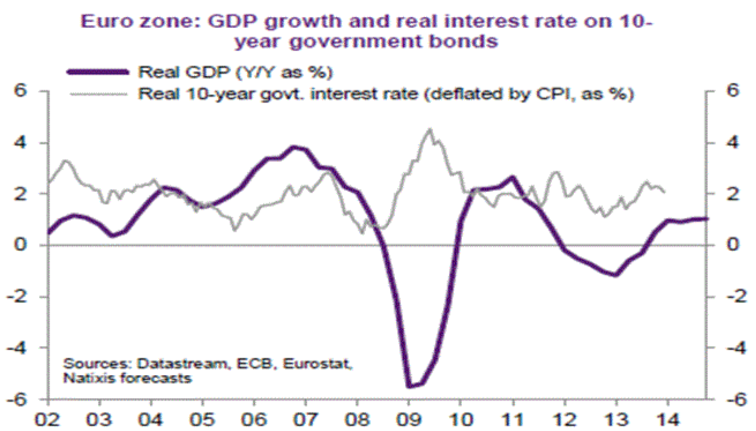
Chart 33



The Eurozone external surplus and the return of capital flows to peripheral countries sovereign markets help contribute to strengthening the European currency.

This disinflationary process entails another consequence: despite the low level of nominal interest rates, real interest rates in the Euro area remain relatively high. Contrary to the US, they are higher than the rate of economic growth, contributing therefore to endogenously raise the debt to GDP ratio.

Chart 34



The three challenges that I have described are all directly or indirectly related to fragmentation of the Eurozone. Before looking into the strategy to bring it back to a full recovery, let us try to have a comprehensive understanding of the mechanisms at work leading to this fragmentation.

2. A Theoretical Model of Currency Areas Fragmentation

Let us start by looking at the functioning of a “genuine” currency area as it functions in the US.

2.1 The macroeconomic dynamic model of a “genuine” currency area

Let us assume that two regions called North (N) and South (S) belong to the same (“genuine”) currency area which is supposed, for the sake of simplicity, to be always maintained in external equilibrium (the currency area is either a closed economy or has adopted a “pure” flexible exchange rate regime so that the current account of the currency area is always balanced). Assume that North has a structural surplus of its “current account” vis à vis South (its production is higher than its domestic demand), meaning in other words that domestic saving in North is higher than domestic Investment[1]. On the contrary, South has an excess demand (current account deficit) of the same amount.

In order to visualize with clarity how forces interact between North and South, we will use the usual macroeconomic graphical apparatus of market equilibrium between saving and investment (the supply of and demand for saving), and introduce the monetary equilibrium in the traditional Hicksian IS-LM model. This model will allow us to see interaction between the markets of goods and services (the “real” equilibrium), the financial market (the equilibrium between saving and investment) and the monetary market (the equilibrium between the demand for and supply of money).

We start from a position of general equilibrium (E) with an interest rate for which saving is equal to investment in the currency area as a whole (aggregate supply is equal to aggregate demand), while simultaneously the demand for money is equal to its supply (see graph 1). The only macroeconomic equilibrium which matters in this “genuine” currency union is the equilibrium for the whole area (North and South).

At equilibrium, investment in South is always financed through domestic saving

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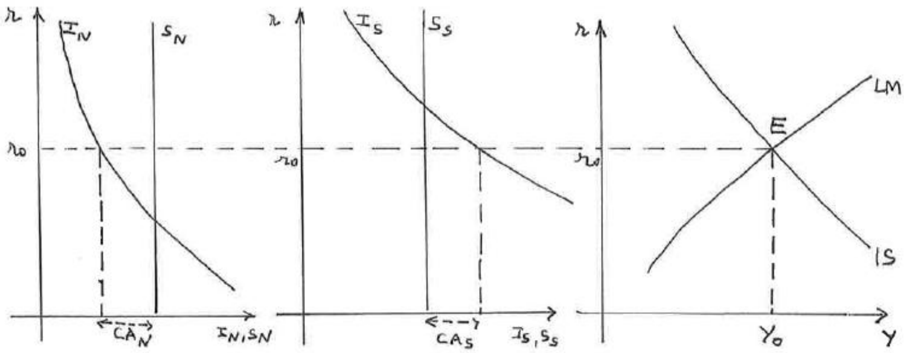
[1]Starting from general equilibrium: Y + M = C + I + G + X

We can write: (Y-T-C) +(T-G)=I + (X-M), Private saving (S – I) = Public saving (X-M)

Y being National income; C: Private consumption; I: private investment; G: public expenditures; M and X: imports and exports of goods and services; T: taxes, S: (private plus public) saving.

in South and the flow of saving coming from North which is the counterpart of the "current account surplus" of North. In North, equilibrium is obtained by the drain of saving from North to South. At equilibrium (E) on graph 1, saving and investment are equal both in South (through a net flow of capital from North to South) and North.

Graph 1



(North)
Sn: Saving in North

In: Investm**e**nt in North

(CAn): Current account surplus in North

(South)
Ss: Saving in South

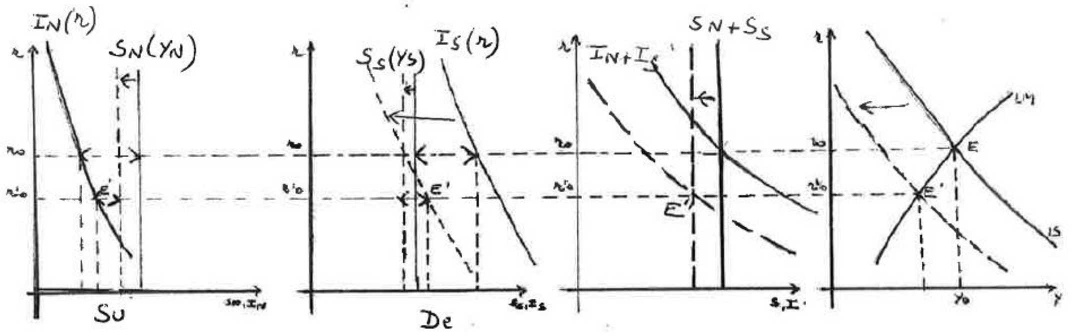
Is: Investm**e**nt in South
(CAs): Current account deficit in South)

(North and South)

In this "genuine" currency union, let us assume an asymmetric shock due for example to a fall in private investment[2] in South (graph 2): the investment curve in South shifts to the left in (II). How do we come back to general equilibrium?

[2] If we take the assumption of a fall in public expenditures, the saving curve would then shift to the left. A similar mechanism would be at work, but from a different starting point.

Graph 2



(N) (I) (S) (II) (N+S) (III) (N+S) (IV)

(Su): Current account surplus of North;(De): current account deficit of South

Since this shock represents a fall of aggregate demand in the currency area as a whole, one can see its impact directly in (IV): there is a downward shift of IS and a new equilibrium in the currency area at a lower level of economic activity and lower interest rate.

In each region of the currency area, impact is the following: fall in domestic demand in South leads to a decrease of income and therefore of domestic saving (the domestic saving curve in South (II) shifts to the left); it leads also to a corresponding decrease in exports of North to South which induces a fall of income in North, therefore of its domestic saving: the North domestic saving curve shifts to the left (I). We also have an impact of the fall of income in North on income in South (through reduction of its exports), and therefore of domestic saving in South which shifts again to the left (II).

At the new equilibrium (E) where economic activity is down both in North and South and interest rate is lower as well, North investment has increased along its investment curve while domestic saving is lower (I): North therefore posts a decrease in its "current account surplus" (II). In South, there is a corresponding decrease in "current account deficit". At the new equilibrium, "domestic excess saving" (current account surplus) in North is still equal to ("domestic excess investment") in South.

In a "genuine" currency area, thanks to the functioning of an integrated financial market between North and South, there is therefore a smooth transmission mechanism throughout the whole currency area of a shock which has hit any of its regions.

Correspondingly, any monetary policy impulse is transmitted to North and South:

an increase in the supply of money leads to a shift to the right of the LM curve and simultaneously to a shift to the right of both saving curves of North and South, leading to a new (internal and external) equilibrium at a lower interest rate with higher levels of investment and saving both in North and South.

The model which I have used here is the standard equilibrium mechanism which is in fact a simplification of the setting of a simultaneous microeconomic general equilibrium on all goods and services, financial and monetary markets. It tells us that in the case of a "genuine" currency area we don't have to bother about "current accounts" between regions which in fact are hardly looked upon.[3]

2.2 What went wrong in the Eurozone?

Before the creation of the European currency, countries which now belong to the Euro area, in particular those in its periphery were struggling to avoid falling into any significant current account deficit. With the emergence of the euro, the Euro area seemed to function as a "genuine" currency area: interest rate spreads between member states nearly disappeared. They converged to a unique interest rate. As described in graph 1, flows of capital were leaving North towards South: the building of excess demand in South due to low interest rates was matched by excess supply in North. During the first ten years of the euro, sustainability of current account deficit of the South was made possible thanks to excess saving in North which was the counterpart of exports of goods from North to South. This movement was not only fuelled by excess demand (public and private) in South, but by its lack of competitiveness due to wage increases incompatible with the rise of labor productivity.

After the burst of the global financial crisis as soon as 2009, financial markets started to question the value of sovereign debt in Portugal and Spain. After the disclosure of fiscal deficit in Greece, ratings of southern countries (and Ireland) started to move down (see table 1). This down grading reached in successive waves "intermediate countries" in 2011-2012 and a few "core countries" thereafter (table 1). Correspondingly interest rates spreads started to widen not only on sovereign bonds markets, but on all the segments of the financial markets as well.

Had we been living in a "genuine" currency Union, the asymmetric shock caused by the global financial crisis in the various parts of the Eurozone would have led to a fall of interest rate and a decrease of economic activity all over the Eurozone. Impact of the shock would have been distributed among Member states according to the model which I have previously described.

3 Except if one is interested in the distribution of productive capital and labour, and therefore of wealth amongst regions.

Chart 35 Standard & Poor's Eurozone Sovereign Ratings Since 1999

CORE COUNTRIES

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Austria	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA+ *(Jan)*	AA+	AA+
Finland	AA+	AA+ (Oct)	AA+	AAA *(Feb)*	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
France	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA+ *(Jan)*	AA (Nov)	AA
Germany	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
Luxembourg	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
Netherlands	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA+*(nov)*	AA+

INTERMEDIATE COUNTRIES

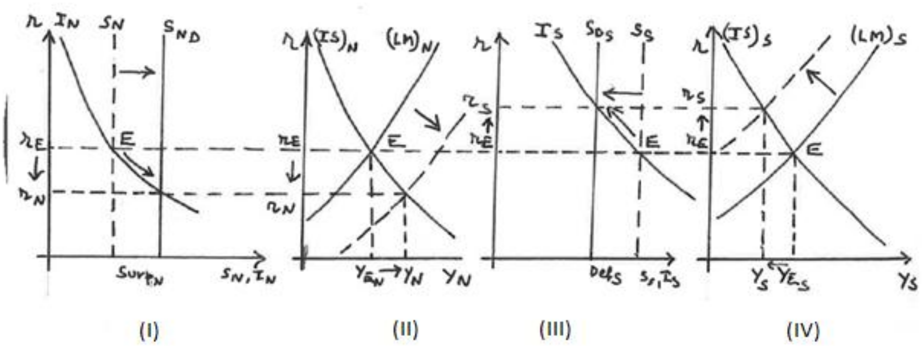
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Belgium	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA+	AA *(Nov)* AA+ *(Aug)*	AA	AA	AA
Estonia	A-	A-	A-	A-	A-	A*(Nov)*	A	A	A	A	A	A	AA- *(Aug)*	AA-	AA-	AA-
Malta	AA-	AA-	AA-	AA-	A+		A *(May)*	A	A	A	A	A	B *(June)*	A- *(Jan)*	BBB+	BBB+
Slovakia	BBB+	BBB+	A- (Oct)	A-	A-	A-	A *(Dec)*	A	A	A+	A+	A+		A *(Jan)*	A	A
Slovenia	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA- *(Oct)*	A+ *(Jan)*	A-	A-

PERIPHERAL COUNTRIES

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Cyprus	AA-	AA-	AA-	AA-	AA-	AA-	AA-	AA-	A *(July)*	A+ *(April)*	A+	A *(Nov)* A- *(Feb)*	BBB *(Oct)* BBB+ *(Aug)* A- *(Mar)*	BB+ *(Jan)*	CCC	B
Greece	A-	A-	A *(March)*	A	A	A	A	A	A	A	BBB+ *(Dec)* A- *(Jan)*	BB+ *(Aug)*	CC *(Jul)* CCC*(Jun)*B *(May)* BB- *(Mar)*	B- *(Dec)*	B-	B-
Ireland	AA+	AA+	AAA (Oct)		A+ *(June)*	A *(Nov)*	A	A	A	A	AA *(June)* AA+ *(Mar)*	A *(Nov)* AA- *(Aug)*	BBB+ *(April)* A- *(Feb)*	BBB+	BBB +	BBB+
Italy	AA	AA	AA	AA	AA	AA- *(July)*		A+ *(Oct)*	A	A	A	A	A *(Sept)*	BBB+ *(Jan)*	BBB	BBB
Portugal	AA	AA	AA	AA	AA		AA- *(June)*	AA-	AA-	AA-	A+ *(Jan)*	A- *(April)*	BBB- *(March)*	BB *(Jan)*	BB	BB
Spain	AA+	AA+	AA+	AA+	AA+	AAA	AAA	AAA	AAA	AAA	AA+ *(Jan)*	AA *(April)*	AA- *(Oct)*	A *(Jan)*	BBB-	BBB

In fact, due to its lack of integration, Euro area peripheral countries had to take the pain of mechanisms that enter into play in a fixed exchange rate system in countries which lose confidence of their creditors due to their excessive current account deficits. The dynamic forces which entered into play to bring peripheral countries back to external equilibrium can be described thanks to our standard model.

Graph 3



North South

Let us assume that fear of sovereign default which starts in one country (Greece) ends up spreading in other peripheral countries (graph 3). We then observe capital outflows from these countries back to the core countries. Saving curve in South shifts to the left (III) while the LM curve shifts to the left (IV) (due to outflow of capital, the supply of money decreases): interest rates in South increase. Simultaneously in North, as capital comes back the saving curve shifts to the right (I) while the LM curve is moving downwards (II) pushing interest rates down. During this process, the current account deficit of South decreases whereas economic activity is contracting and unemployment rising. In North, we observe on the contrary a decrease of the current account surplus, a rise of income and lower unemployment. The move stops when the need to borrow from South to North has disappeared, that is when current account in South is in equilibrium.[1]

We should not be surprised by this dynamics: it corresponds to the adjustment process which gets under way in countries living with a fixed exchange rate, which are under pressure of markets due to their unsustainable current account deficits. Our model is focusing on the action of the "real forces" (aggregate demand) for return to equilibrium. But the real exchange rate, can play as well. Even though in the euro

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[1] See appendix.

area the "nominal exchange rate" is unchanged, the "real" exchange rate is affected through differential between North and South in the evolution of price and wages. Both movements which have been at work can alleviate the downward pressure on economic activity and unemployment. A last comment on this model will be about the assumption made for the construction of our model which is that the current account of the whole euro area is always in equilibrium. As a matter of fact as already indicated, the Eurozone posts a surplus which comes mainly from Germany. Buoyant German exports contribute to sustain economic activity in the whole Eurozone and give birth to outflows of capital abroad. But a strong euro is an obstacle to more dynamic exports in South. Furthermore, sovereign bond markets in peripheral countries are attracting capital flows from abroad in search of yields. Inflows of capital in South alleviate the pressure on interest rates, but one should keep in mind that those capital flows are volatile, and should they leave those countries, spreads might be rapidly rising again. Both phenomena nevertheless do not change fundamentally the lessons to draw from the model which is the key role of capital flows between North and South in the explanation of the evolution of the Euro crisis.

3. Financial Markets and Fragmentation of the Eurozone

In his lecture on financial integration and banking union at the conference for the 20th anniversary of the establishment for the European Monetary Institute[2] Mario Draghi, the President of the European Central Bank, recalled that: *Financial integration and the single currency are in many ways two sides of the same coin. One fundamental reason for the single currency was to maximize the benefits of the single market for capital. And conversely, it was understood when the euro was conceived that integrated financial markets would be necessary for an effective single currency*"…

Compared to the United States which has a "genuine" currency union with integrated markets in the real, financial and monetary sectors, we lived in the euro area during the first ten years of the euro with markets which appeared to have become fully integrated in the monetary field due to the euro. The markets of goods and services were on an ongoing process of integration on the demand side (thanks to the "single market" policy carried out in Brussels and also due to the catalyst impact of the introduction of the European currency). But they were not being fully integrated on the supply side (due to wage disparities and discrepancies in the environment of firms in terms of tax, bureaucracy constraints and economic policies of Member states).

[2] Brussels, February 12th, 2014

The financial sector, despite the removal of all barriers to capital movements, was not fully integrated either. This point is outlined in a report prepared for an informal meeting of EU Finance Ministers which met in September 2013[3].

If retail banking and therefore bank credit had remained largely fragmented along national lines, thanks precisely to the introduction of the common currency the interbank market rapidly became integrated, while shares of foreign government bonds and of foreign corporate bonds increased "*by 23 and 29 percentage points, reaching 47 percent and 51 percent of the total holdings of government and corporate bonds respectively*).[4] But contrary to the US, inside the euro area cross-border financial activities remained limited: not only in retail banking but also on the stock market and on bond markets, market participants continued to proceed mainly inside their own national borders.

The euro crisis revealed the lack of integration. The first warning signal occurred precisely in the monetary realm itself when the interbank money market abruptly dried up in August 2007, forcing the ECB to provide liquidity to banks on a large scale.

Move towards a return to more fragmented financial markets started again after the burst of the euro crisis. The foreign share in total holdings of government and corporate bonds fell "*24 and 10 percentage points, standing at 22 percent and at 41 percent respectively"*. We have described in our model the consequences during the first ten years of the euro, of the underestimation by the markets of the discrepancies in sovereign risks between Member states. After the burst of the Greek crisis, their appraisal changed dramatically. The widening of interest rates on sovereign debt started to spread on bank credit to firms, mainly SMEs and to households, contributing to reinforce bank credit fragmentation along national borders. Fuelled by the fear that the euro might explode, this fragmentation led to great economic and financial disparities between Member states and made the adjustment process even more painful for peripheral countries. It was worsened by three idiosyncratic features of the Euro zone financial sector[5]:

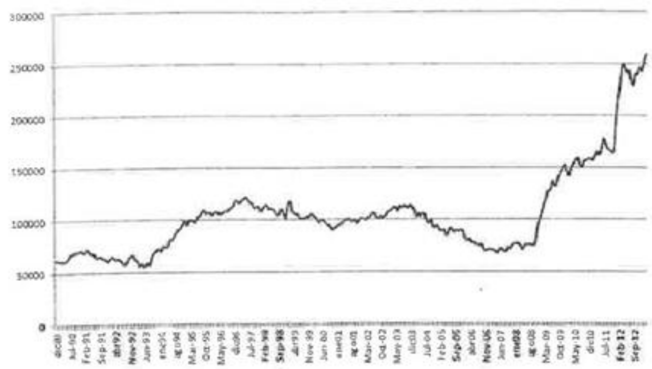
First, European banks traditionally hold a significant portfolio of public securities. Down rating of sovereign debt had an immediate impact on banks' balance sheets. All the more so since for many reasons (regulatory, liquidity management…) banks had refocused their holdings in public securities of their own country as shown in the following graph for Spain raising their dependency on its fiscal outlook.

But on the other side, "when the Irish government issued a blanket guarantee to

[3] André Sapir, Guntram B. Wolff, "the Neglected Side of Banking Union: Reshaping Europe's Financial System", note presented at the informal Vilnius ECOFIN September 14, 2013.
[4] *André Sapir, Guntram B. Wolff, Op. Cit.*
[5] I already outlined this point in my previous lectures in China.

protect its banks, it quickly transformed a banking crisis into a Sovereign debt crisis".[6] A "diabolic loop", according to Spanish economist Luis Garicano, is taking root in some countries. The European authorities are still far from breaking this vicious circle. On the contrary, new Basels III regulation is pushing banks to increase their portfolio of public securities.

Chart 36



Source: Bank of Spain. OTHER MONETARY FINANCIAL INSTITUTIONS 8.5 Assets. Domestic B) Aggregated balance sheet according to the euro area returns Debt securities: general government http://www.bde.es/webbde/es/estadis/infoest/a0805e.pdf

Second contrary to the US or the UK, at least before the announcement of *OMT operations* by the ECB there was a lack of a lender of last-resort on sovereign debt. In the former, if markets of sovereign debt are to dry up, everybody expects the central Bank to jump in. This mere prospect suffices to prevent any sharp rise in interest rates. In the euro area, absence of this lender of last-resort function is one of the explanations for the dangerous interest rates hikes in many peripheral countries.

Last but not least, the effect of the fragmentation of sovereign debt markets had spilled over the whole economy due to the importance in Europe of the banking sector for the financing of its economy (about 2/3) relative to the financial markets (1/3). The rise in the spreads of bank credit terms, which is heavily weighing on the financing of SMEs in the South, has contributed to the contagion of the fragmentation to the real sector.

Fragmentation remains the main problem of the Euro area. If due to capital inflows from abroad, pressure has diminished, we should not be fooled by reduction of interest rate spreads. Financial activities remain entrenched behind natural borders and the conditions for a smooth functioning of the Euro area which also require more integrated markets of goods and services and more flexible labor

[6] Richard J. Herring, The Danger of Building a Banking Union on a One-Legged Stool, in Political, Fiscal and Banking Union in the Eurozone, Florence European Institute, 2013

markets are not yet fulfilled. Sustainability of the Euro area cannot rely over time on the restrictive economic policies implemented in peripheral countries. As in any other currency area, discipline should come for the market forces themselves in the first place.

Concluding Remarks: Policy Recommendations

In order ensure the smooth functioning of the Euro area and to prevent any further crisis, we can now, thanks to our model, make the list of the missing pieces of the current EMU framework. Comprehensive implementation of a "genuine" currency area should bring us:

- To limit powers of Member states in terms of economic policies, and consequently to strengthen the capacity of the EU governing body to conduct an economic policy of its own for the whole Euro area,
- As a consequence, to extend the European budget to a more significant size and therefore to transfer competencies from Member states to the EU level,
- To build a true comprehensive Banking Union which facilitates the working of an integrated pan-European financial system,
- To foster the single market, and to promote more flexible labor markets.

The Euro crisis led us to become aware of the danger of the current framework. The Van Rompuy Report: "Towards a "genuine" Economic and Monetary Union", helped us to realize that the European currency needed more integration of the Eurozone if it were to become a "genuine" currency area. It is worth noting nevertheless in this respect that proposals for reform by Mr. Van Rompuy, the President of the European Council, have gone unheeded. There is a long way to go before we finally achieve this federal European Union which would provide EMU with a comprehensive "Economic leg".

It would be unfair to deny the many achievements of the European bodies in tackling the crisis since its beginning. But as the recent European polls have shown, the present mood of European public opinion does not favor more integration. Instead of fostering "more Europe", the Euro crisis has exacerbated national sentiments. At the eve of a change of team at the European Commission, let me tell you the orientation that in the present institutional setting I deem necessary to take in order to improve the functioning of the Euro area. I would personally suggest five main lines of action:

1. Fostering financial markets integration must be high on the agenda. We have to complete the Banking Union which is indispensable for overcoming fragmentation along national borders. If we want to give the economic recovery in the Eurozone a chance, it is crucial as well to combat the current "credit crunch" which doesn't come only from the demand side of the credit market. We therefore

also have to alleviate the pressure on credit distribution by banks due to the implementation of the new Basel III rules and also to the upcoming supervision framework. It is also crucial that we enhance the securitization activities of banks in order to facilitate the financing of the economy at a time when credit may remain tight for an extended period of time.

2. The single market must be fully implemented in line with Mario Monti's 2010 Report to the President of the European Commission. It is unfortunate to see that the orientations proposed in this report, which are crucial for the effective working of the Euro area, remain unheeded.

3. We have to make sure that Member states undertake the structural reforms to which they are committed in order to meet the Europe 2020 competiveness agenda and pursue consolidation of their public finances. In this respect, the European Commission's Macroeconomic Imbalance Procedure (MIP) needs to be fully applied to all the Member states without any exception.

4. We have to put in place a policy which is addressing the North-South divide of the Eurozone. In this respect, we should not hesitate to mobilize the structural funds of the European budget in favor of southern countries, and to allocate them for enhancing qualification of labor, improving the environment of firms and therefore fostering competiveness in the periphery. The ECB should play its part by acquiring credit assets from SMEs in order to facilitate their financing. We could also make use of public financial institutions to gather saving funds from the core of the Eurozone and recycle them to finance the private sector in the south.[7]

5. Last but not least, the Eurozone is in need of a more accommodative policy mix. At the present time, fiscal consolidation is pursued by all Member states due to the discipline framework put in place by European authorities. It is coupled with a monetary policy which, despite very low interest rates, remains relatively restrictive compared to other main Central Banks (the Fed, the Bank of England, the Bank of Japan). Due to the "credit crunch", the stock of money is no longer increasing. The strength of the euro brings down the price of imported goods. The price level in the euro area is down to 0,5% on a yearly average. The European Central Bank is aware of the deflationary risk ahead. On June 5th 2014 it has decided to lower its main intervention rate to the record low of 0, 15%. It has also imposed a negative interest rate on European Bank reserves held in its accounts. And it has not excluded if necessary to use unconventional tools of monetary policy akin to "quantitative easing", such as the purchase of public or private bonds or securitized credit on the markets. The ECB does not hide that it wants a weaker euro. It wants the banks to

[7] This proposal was suggested to President Van Rompuy in early 2014 by a team of the Euro50 group which I chair, composed of Jacques de Larosière, Olivier Garnier, Daniel Gros, Thomas Mayer and myself.

start supplying credit again, and it hopes to foster economic recovery to prevent the Eurozone from falling into the deflationary trap.

As you see there is much to do in the current framework to improve the situation of the Eurozone. Needless to say that any measure which could be undertaken in order to promote political integration of the Eurozone would be most welcome for the future of the European Monetary Union.

Appendix

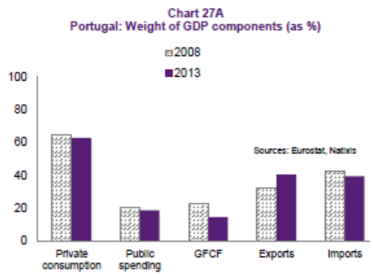
Looking at the evolution of aggregate demand in peripheral countries between 2008 and 2013 (Patrick Artus, Flash Economics March 18, 2014), we get the confirmation the adjustment fell mainly on private investment.

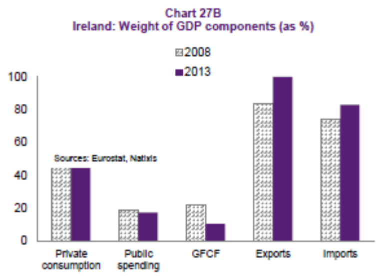
During the period ratio of private consumption and public expenditures to GDP remained fairly the same. Imports decreased everywhere (except in Ireland) while exports increased. Investment (GFCF) decreased in all these countries as well. Starting from the accounting equality:

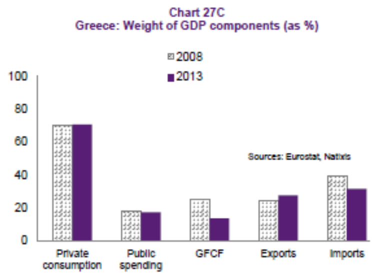
$Y + M = C + I + G + X$

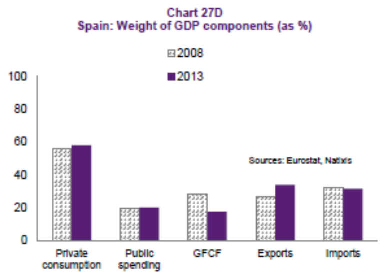
$C/Y+G/Y+ I/Y + X/Y – M/Y = 1$

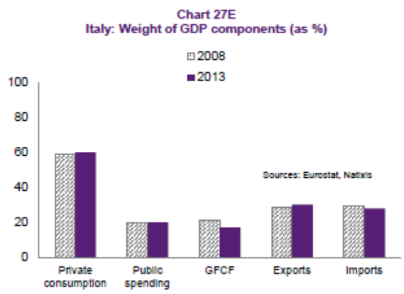
If $(C/Y + G/Y)$ is constant, then a rise of $(X/Y – M/Y)$ must be matched by a decrease of I/Y.











IMI News

2014 International Monetary Forum and Press Conference of "RMB Internationalization Report"

On July 20, 2014 International Monetary Forum and Press Conference of "RMB Internationalization Report" was held at Renmin University. The forum is co-hosted by Renmin University of China and Bank of Communications, sponsored by IMI, and co-sponsored by OMFIF, Goethe University Frankfurt, Korea Institute for International Economic Policy (KIEP), and Fung Global Institute. The report, themed construction of RMB offshore market, was interpreted by Chen Yulu, president of Renmin University. Given the current developments in offshore RMB market, he discussed the practical way of promoting RMB internationalization and rational distribution of the RMB offshore market when capital account is not yet fully open.

After the conference, IMI held an appointment ceremony of new committee members: Rainer Klump, Il Houng Lee (president of KIEP), Liu Jun (vice president of China Everbright Group), David Marsh, Herbert Poenisch (former senior economist at the Bank of International Settlements), Anoop Singh, and Wanda Tseng (former deputy director in the Asia and Pacific Department of IMF).

Opening Conference of "RMB Internationalization Report 2015"

On August 28, Opening Conference of "RMB Internationalization Report 2015" was held at Renmin University. Prof. Chen Yulu, editor of the Report, chairman of IMI Academic Committee, president of Renmin University, attended the conference. Experts and scholars discussed about selected topics, framework and methodology of the Report from both theoretical and practical perspective. The report themed RMB internationalization and construction of "Silk Road Economic Belt" and "Maritime Silk Road".

Roundtable on Money and Finance

Editor's Note:

Roundtable on Money and Finance is a high-level quarterly forum initiated by IMI. The forums of the four seasons are held in the second Saturday afternoon of each March, June, September and the next January respectively (adjusted for national holidays and special occasions). The forum invites financial experts home and abroad, discussing the reform of monetary finance, providing feasible suggestions and experience for China's international financial strategies. The previous keynote speakers include: Mr. WEI Jianguo, vice minister of the Ministry of Commerce; Mr. SU Ning, deputy-governor of PBC; Mr. Patrick Honohan, governor of Central Bank of Ireland; Mr. Yves Mersch, governor of Central Bank of Luxembourg; Mr. David Marsh, chairman and co-founder of OMFIF. Currently, the forum has become a significant platform for academic exchanges in the macrofinance, and has cast great influence among financial researchers and practitioners.

Roundtable on Money and Finance • Summer 2014

On June 14, Roundtable on Money and Finance • Summer 2014, co-hosted by IMI and Bank of Communications, was held at Renmin University, themed "RMB internalization and offshore market construction". Tu Yonghong, deputy director of IMI, delivered a report on dynamic outlook of RMB internationalization.

Roundtable on Money and Finance • Autumn 2014

On September 13, Roundtable on Money and Finance • Autumn 2014 was held at Renmin University. The Roundtable was themed "New Development Bank and New Patterns of International Monetary System". Attendees include Zhou Qiangwu, vice director of Asia-Pacific Finance and Development Center; Zhang Zhengxin, deputy director of International Department, PBOC; André Simas Magalhães, first secretary of economic sector, Embassy of Brazil to China; Vladimir Budko, counselor of Embassy of Russia to China, and Yuksel Gormez, economic counselor of Central Bank of Turkey. The discussion was centered on the background, functions and outlook of NDB.

IMI Biweekly Forum

Editor's Note:

IMI Biweekly Forum is a high-level biweekly forum established by International Monetary Institute of Renmin University. In the mode of keynote speech followed by comments from experts, the forum develops in-depth discussions on theoretical and practical issues in domestic and overseas financial area. The forum aims to facilitate academic exchange for young and middle-aged scholars by following international frontier, broadening theoretical perspective and deepening research cooperation.

IMI Biweekly Forum (No. 11): Changes in the Financial Regulation in View of the Supply/Demand of Financial Services

On May 11, IMI Biweekly Forum (No. 11) was held at Renmin University. Professor Zhao Xijun, associate dean of School of Finance, delivered a keynote speech on changes in the financial regulation in view of the supply/demand of financial services. He argued that financial regulators need to address several key issues, including too much emphasis on regulating agencies over their functions; supply over demands; administrative supervision over market discipline; harvest over innovation; as well as internal supervision over cross-border supervision.

IMI Biweekly Forum (No. 12): Impact of Silk Road Economic Belt on RMB internationalization

On the 12th IMI Biweekly Forum on May 25, Prof. Tu Yonghong, deputy director of IMI made a keynote speech on the impact of silk road economic belt on RMB internationalization. She included four paths of facilitating RMB internationalization during the building of Silk Road Economic Belt, and "opportunities and challenges under the new paths and some suggestions".

IMI Biweekly Forum (No. 13): Analysis on Shadow Banking, Credit Expansion and Systemic Risk

Prof. Qu Qiang, deputy director of China Financial Policy Research Center, delivered a speech on shadow banking, credit expansion and systemic risk on the 13th Biweekly Forum. He pointed out that it is crucial that shadow banking has a clear risk-taking body, a stable "value anchor".

IMI Biweekly Forum (No. 14): Media Sentiment and Inflation

On IMI Biweekly Forum (No. 14), June 29, Professor Zhang Chengsi from School of Finance of Renmin University talked about the political economy of media sentiment and contagion of inflation expectation. The speech was based on his recent paper which studies the inflation mechanism from the perspective of media sentiment and the role of public expectation in forming inflation.

IMI Biweekly Forum (No. 15): The New Economic Norm and Combination of Industry and Finance

On September 28, IMI Biweekly Forum (No. 15) was held in Renmin University. Prof. Ben Shenglin, executive director of IMI, professor of Zhejiang University, was invited as the guest speaker. He delivered a speech entitled “The New Economic Norm and Combination of Industry and Finance”. He pointed out that under the trend of informatization and globalization, the new economy has characteristics including differentiation, individualization, networking and high speed. New norm needs market selection mechanism and new ideas as well as developing a mature path for the new economic industry.

“Series of IMF History” Project

Editor’s Note:

Series of IMF History, with 11 volumes in total, is the most authoritative and circumstantial book series about International Monetary Fund. It is the first time for the series to be translated into English. IMI and China Finance Press are in charge of translation and editing respectively. The series is expected to be published by the end of 2015.

On September 25, the second plenary meeting of “Series of IMF History” Project was held at Renmin University. Attendees include Mr. Wei Benhua, member of IMI academic committee, team leader of the project; Mr. Wei Gejun, Director of China

Finance Press, team leader of the project; etc. Mr. Wei Benhua stressed the important role and historical significance of the project. Representatives from each group reported the work progress respectively and exchanged the difficulties and experience during the process.

International Exchange

Economists of the ASEAN+3 Macroeconomic Research Office (AMRO) Visit IMI

On June 9, economists of the ASEAN+3 Macroeconomic Research Office (AMRO) paid a visit to IMI who jointly organized Economic Consultation with AMRO. The attendees include Reza Siregar, the Group Head and Lead Economist of AMRO, Shunsuke End, economist of AMRO, etc. The meeting centered on the process of globalization of Renminbi, the challenges and inspirations, the role of Renminbi in the process of reform of international monetary system, and the regional monetary and financial cooperation.

Former French Minister of Finance Mr. Edmond Alphandery Appointed as Member of IMI Advisory Board

On June 24, the third Salon of General Theory on Macrofinance was held at Renmin University. Prof. Zhang Jie, director of IMI, issued Letter of Appointment to advisory board member Mr. Edmond Alphandery, president of Euro50 Group, former French Minister of Finance. Mr. Edmond Alphandery delivered a speech entitled the Dynamics of Fragmentation in the Euro Zone: Theory and Political Implications. Regarding the euro zone's economic performance since the European debt crisis, he believes that with the gradual recovery of economy, and restoration of investor’s confidence and capital inflows, the euro zone is moving toward recovery.

Senior Research Fellows of Financial Information Institute of PBoC Visit IMI

On September 25, meeting with senior research fellows of Financial Information Institute of PBoC was held at Renmin University. Experts and scholars from both parties attended the meeting. Prof. Tu Yonghong pointed out IMI would like to promote achievements in theoretical, empirical and strategic and application research areas. She expressed a warm welcome to all experts from PBoC, and expectations in cooperation in the near future. During the meeting, the two parties signed the cooperation agreement.

Call for Papers

International Monetary Review

International Monetary Review is an internal academic magazine sponsored by International Monetary Institute. Following the principle of including both Chinese and western merits with precise and practical academic spirit, International Monetary Review focuses on the cutting-edge theoretical researches in internationalization of RMB, reform of international monetary system, regional monetary and financial cooperation, China's international financial strategies, and other macro-financial theories and policies.
We welcome submissions by scholars, experts and practitioners in financial industry. Papers and articles should center on key financial issues and follow academic standard and scientific methodology. We welcome quality articles based on data analysis and theoretical model and other insightful articles with standard writing.

Prepare your article

General rule: Submitted manuscripts should be double-spaced texts in 10.5 point font, and formatted for paper of standard size with margins of at least 20mm on all sides. Pages should be numbered, and an abstract (of no more than 200 words), as well as keywords and complete author affiliations, should be included in the paper in the title page. A regular article should not exceed 50 pages.
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