WILL HISTORY REPEAT ITSELF? LESSONS FOR THE RMB

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Prepared for a workshop on the internationalization of the RMB,
Asian Development Bank Institute, Tokyo, 8 August 2013
(Word count: 10,837)
ABSTRACT

For many observers, internationalization is the RMB’s manifest destiny – an irresistible by-product of China’s remarkable economic success. But is such confidence warranted? Recent history has seen the emergence of other currencies that were also expected, at least for a while, to rival America’s greenback. These included the Deutsche mark (DM), the Japanese yen, and the euro (successor to the DM). Yet in the end their challenges faded. Will history repeat itself? Or will the RMB prove exceptional, the currency that finally managed to succeed where others failed? The aim of this essay is to see what lessons may be drawn from these earlier experiences for the anticipated internationalization of the yuan. Much can be learned from their stories – first, about what may drive the internationalization of a currency; and second, about what, ultimately, may set a limit to the process. The main message of my analysis is that the challenge of internationalization is formidable, involving some very demanding conditions. Contrary to predictions of the yuan’s “inevitable” rise, success is by no means guaranteed.
There is a lot of talk these days about the potential role of China’s national money, the yuan or renminbi (RMB), as an international currency. For many observers, internationalization is the RMB’s manifest destiny – an irresistible by-product of China’s remarkable economic success. Widespread use of the yuan is confidently said to be “inevitable” (e.g., Lee 2010; Subramanian 2011), challenging the long-standing dominance of the US dollar in the global monetary system. The RMB has embarked on a Long March toward world status, reminiscent of the historic trek back in the 1930s that was so pivotal in bringing the Chinese Communist Party to power in 1949. The only question, it seems, is how many years the Long March will take.

But is such confidence warranted? Recent history has seen the emergence of other currencies that were also expected, at least for a while, to rival America’s greenback. Yet in the end their challenges faded. None even came close to joining – let alone supplanting – the dollar at the peak of what I have elsewhere called the Currency Pyramid (Cohen 1998, 2004). Their status as international currencies remained secondary at best. Will history repeat itself? Or will the RMB prove exceptional, the currency that finally managed to succeed where others failed?

The aim of this essay is to see what lessons may be drawn from these earlier experiences for the anticipated internationalization of the yuan. Analysis will be limited to the period since World War II. During that period three historical antecedents stand out. These are the Deutsche mark (DM), the Japanese yen, and the euro (successor to the DM). Each in its time seemed destined for greatness, only to fall short. Much can be learned from their stories – first, about what may drive the internationalization of a currency; and second, about what, ultimately, may set a limit to the process.

The essay is organized as follows. After a brief introduction, each of the three antecedents will be examined in turn. In each case, analysis will address both economic and political factors bearing on the eventual outcomes. My aim is to identify the key determinants that might be thought to have either promoted or hindered internationalization over time. What factors contributed to the international appeal of each currency? What factors limited their competitiveness? Why, in the end, was each unable to mount a successful challenge to the dollar? A penultimate section will then spell out the main lessons suggested by these cases for the future prospects of the RMB. A final section concludes.
HISTORICAL ANTECEDENTS

It is axiomatic that a flourishing world economy requires some kind of internationally acceptable money. Otherwise, nations would be reduced to crude barter, severely curtailing gains from cross-border trade or investment. In the absence of a true world currency, however, backed up by a global central bank, participants have little choice but to rely instead on a limited selection of national currencies to play vital international roles. At any given time only a few currencies actually gain some degree of acceptance for use across borders. The conditions for successful internationalization are daunting, limiting the sample of historical antecedents that may be considered relevant to the aspirations of the RMB today.

Internationalization

Internationalization of a currency involves a multiplicity of roles, as specialists have long recognized. There is, in fact, a standard taxonomy for characterizing the roles of an international currency, which separates out the three familiar functions of money – medium of exchange, unit of account, store of value – at two levels of analysis: the private market and official policy. This adds up to six roles in all. Sources generally speak of the separate roles of an international currency at the private level in foreign-exchange trading (medium of exchange), trade invoicing and settlement (unit of account and medium of exchange), and financial markets (store of value). At the official level, we speak of a money’s roles as an exchange-rate anchor (unit of account), intervention currency (medium of exchange), or reserve asset (store of value). Though to some extent interdependent, each of the six roles is distinct in practical as well as analytical terms.

The scope of an international currency is defined by the number of roles it plays. Its domain is defined by its geographic range. At any given time, only a few national currencies tend to play any international role at all. Even fewer play all six roles, and even fewer still are used on a truly global scale. Since World War II, America’s greenback has clearly dominated in terms of both scope and domain. Its only near rival these days is the euro, presently the second most important currency in the world, with Japan’s yen a bit further back. Other currencies are also used across borders -- such as the pound sterling, Swiss franc, and Canadian and Australian dollars – but on a much more modest scale. These minor currencies can be found mainly in international banking or bond markets or to a limited extent in central-bank reserves.
The RMB, by contrast, has still gained little traction outside China. Despite current talk about internationalization, the yuan's role on the global stage has yet to be realized.

**Essential qualities**

Why are there so few international currencies? At the national level, the role of a money can be promoted by the coercive powers of the state. Sovereign governments can deploy legal-tender laws and related regulatory measures to compel residents to adopt the national currency for all legitimate monetary purposes. Within their borders, states enjoy a *de jure* monopoly. But at the international level, in relations between states, the capacity for coercion is more limited. Monopoly is replaced by competition, and agents must be *persuaded* rather than compelled to make use of a currency. The money must have qualities that enhance its appeal relative to other possible contenders. In short, the money must be *competitive*.

And what makes a money competitive? Both economic and political factors are involved. On the economic side, analysts agree that three broad attributes are essential. First, at least during the initial stages of internationalization, is widespread confidence in a money’s future value backed by political stability in the country of origin. Basically, this means a proven track record of relatively low inflation and inflation variability. It also means adequate protection of property rights and a respect for the rule of law. Second are the qualities of “exchange convenience” and “capital certainty” -- a high degree of transactional liquidity and reasonable predictability of asset value. The key to both is a set of deep and well developed financial markets, sufficiently open to ensure some degree of access by non-residents. A minimum level of convertibility for foreign transactions is obviously necessary if a currency is to be used internationally. And third, a money must promise a broad transactional network, since nothing enhances a currency’s appeal more than the prospect of acceptability by others. Historically, this factor has usually meant a growing economy that is large in absolute size and well integrated into world markets. Without at least some of these essential attributes, no money is likely to hold much appeal for international use.

On the political side, both domestic and international considerations play a role. Domestically, political stability and effective governance in the country of origin are critical. Potential users are unlikely to be attracted to a currency that is not backed by adequate protection of property rights and genuine respect for the rule of law. Nor will they be drawn to a regime that lacks a demonstrated capacity for successful policy management.
Internationally, the experience of the dollar suggests that geopolitics and security considerations may also be of considerable importance. At the private level, a militarily powerful nation can provide a “safe haven” for nervous investors (James 2009, ch. 5; Norloff 2010). A strong defense ensures a more secure investment climate. At the official level, currency preferences of governments may be influenced by broader foreign-policy ties—traditional patron-client linkages, informal security guarantees, or formal military alliances. Can it be an accident that with the conspicuous exception of China, most of the big dollar holders around the world are all formal or informal allies of the United States? The greater the ability of an issuing state to project power beyond its borders, the more likely it is that others will feel comfortable using its money.

Candidates

Few currencies are able to meet all these demanding economic and political qualifications. In some cases it is because, in practical terms, they fail to perform all three of the standard functions of money. They are not full-bodied moneys. That is especially true of so-called “artificial currency units” like the Special Drawing Right (SDR) of the International Monetary Fund (IMF) or Europe’s old European Currency Unit (ECU), which have existed primarily as notional units of account. Neither the SDR nor the ECU was ever available for use as a medium of exchange. The same was also true of the “transfer ruble” created by the former Soviet Union for denominating trade within the Soviet-led bloc of “socialist” nations before the end of the Cold War. Trade among bloc members was based on strict bilateral balancing. Monetary values were expressed in transfer rubles, but these existed solely for accounting purposes. Trade with non-bloc members was done entirely in dollars or other Western currencies. The ruble that was used inside the Soviet Union was tightly regulated and legally unavailable for transactions in foreign markets. Despite the Soviet Union’s geopolitical importance at the time, its national currency never had any real international standing.

In other cases, currencies are effectively disbarred by inconvertibility. Technically, Article VIII of the Charter of the IMF imposes a convertibility obligation on all Fund members. To this day, however, a majority of the IMF’s membership—mostly the least developed economies—still take advantage of a legal loophole afforded by the Charter’s Article XIV to prolong rigid exchange and capital controls. No one would ever consider any of their currencies credible candidates for internationalization.
Interestingly, China too still limits the convertibility of its currency. Even among observers who see internationalization as the yuan’s manifest destiny, a natural assumption is that a minimum level of convertibility for current and capital-account transactions must come first. It is not clear, however, whether convertibility must be absolute. A critical question posed by the RMB is how much convertibility is necessary to encourage international use. The answer, as we shall see, is not self-evident.

Among convertible currencies, many fail to appeal internationally because they lack one or more essential attributes. Some issuing countries may have a poor record on inflation or lack sufficient depth and liquidity in their financial markets. Others may simply not be big enough to offer a broad transactional network or project power effectively. And others may lack the requisite political stability or rule of law.

Incumbency also matters. Currency choice is notoriously subject to inertia owing to the often high cost of switching from one money to another. Why go to the trouble of adapting financial practice to a different currency unless you can be sure that others will make use of it, too? A challenger must not only match at least some of the qualities of existing international currencies. It must somehow offer advantages sufficient to persuade agents to risk making a potentially costly change. In practical terms, it is not easy to compete with a money that is already as well established as the dollar has been since World War II. The greenback enjoys undoubted incumbency advantages—not least, the fact that the language of its issuing country, English, happens as well to be the universal language of international business. The idea of converting from one money to another is less appealing if it also means switching from one language to another.

In recent experience, the number of currencies that have managed to achieve even marginal acceptance for cross-border purposes can be counted on less than the fingers of two hands. Over the post-World War II period, only the DM, yen, and euro have for a time been competitive enough to be considered potential rivals to the greenback. Much can be learned from the stories of these three antecedents.

THE DEUTSCHE MARK

At the end of World War II, the picture was clear. There was just one international currency of any consequence—the dollar. Within the so-called sterling area Britain’s pound, under heavy restriction, was still in use for some cross-border purposes but had already begun a long twilight decline to fringe status (Cohen 1971; Schenck 2010). Ironically, when the first
challenge to the greenback emerged, in the 1960s and 1970s, it came from a money that had not even existed in 1945 – the Deutsche mark. The DM was created in 1948 as part of a major economic reform in the Western zones of occupied Germany, presaging the inauguration a year later of the new Federal Republic of Germany (otherwise known as West Germany). By the 1980s the DM was firmly established as the second most important currency in the world, before being absorbed into the newborn euro in 1999. Both economic and political considerations played pivotal roles in the story.

**History**

The Federal Republic’s beginnings were not auspicious. Following the devastation of war, the country lay in ruin, its cities and industries largely destroyed. But then began the *wirtschaftswunder* – Germany’s economic miracle – which generated rapid growth and persistent export surpluses. By the end of the 1950s the Federal Republic could already be described as the leading economy on the European continent and the region’s pre-eminent monetary power. By the 1960s the DM’s internationalization was well under way. By the 1970s evidence of the currency’s growing prominence was manifest. Though never more than a distant second to the dollar, it was leagues ahead of all other currencies apart from Japan’s yen.

At the private level, the DM quickly emerged as one of the world’s most widely used currencies for both foreign-exchange trading and trade invoicing and settlement. In the foreign-exchange market, a currency’s share in total transactions indicates its importance as a “vehicle” for trades among third currencies. Comprehensive data on the currency composition of such transactions in the global market were hard to come by prior to a series of triennial surveys conducted by the Bank for International Settlements beginning in 1989. Earlier estimates for turnover in the interbank market in New York, released by the Federal Reserve Bank of New York, put the DM share of trades against the dollar in the range of 31-34 percent over the decade of the 1980s (Tavlas and Ozeki 1992: 32-34). The BIS surveys suggest that globally, in 1989, the DM was involved on one side or the other of 27 percent of all currency trades – far below the dollar’s share of ninety percent but well above that of any other money aside from the yen, whose share as a vehicle currency was comparable. (Since each foreign-exchange transaction has two sides, the total of shares adds up to 200 percent.) In 1998, just prior to the birth of the euro, the DM’s share of global currency transactions was up a bit to thirty percent (BIS 1999).
Similarly, by as early as 1980 the DM's share in the denomination of global trade was estimated at 13.6 percent, rising to 15.3 percent by 1992, some forty percent greater than Germany’s share of total world exports (Thygesen et al. 1995; McCauley 1997). Only the dollar, with a share close to fifty percent, accounted for a larger proportion of trade invoicing.

The DM also gained some popularity in financial markets. Most indicative is a composite index of the currency composition of international assets constructed at the BIS for the years 1980-1995 (Frenkel and Goldstein 1999: 712-713). This “international assets” aggregate combined holdings of bonds, notes, and cross-border banking claims for purposes of ready comparison. Over the period covered by the index, the DM attained a market share in the range of 14-15 percent. Again, this was second only to the greenback, though well below the dollar’s share of half or more.

At the official level, Germany’s currency was quickly adopted by a number of European neighbors as a de facto anchor for the exchange rates of their own currencies. Stability vis-à-vis the DM became a high priority, for reasons to be explained below. Correspondingly, Germany’s money also became the preferred intervention medium for neighboring central banks, mostly replacing the dollar. According to one informed source (Tavlas1991), the DM share of exchange-market interventions within Europe rose from some 25-30 percent in 1979 to as much as three quarters by the end of the 1980s. And that development in turn encouraged accumulations of DM in reserves, also in preference to the greenback. Estimates culled from various issues of the IMF annual report suggest that Germany’s currency came to account for anywhere from 12-16 percent of global reserves during the 1980s and 1990s.

Rise

What explains the successful rise of the DM? The roots of its internationalization lay in economics but were reinforced by politics. Two economic factors in particular stood out. One was Germany’s growing importance in world trade, which mainly affected the DM’s role as a medium of exchange and unit of account for private market actors. The other derived from Germany’s disproportionate influence on general macroeconomic conditions, particularly within Europe, which mostly affected the currency’s use at the official level. Both factors were amplified at the political level by the process of regional integration begun with the Coal and Steel Community in 1950 and Rome Treaty of 1955 – what has since been known as the “European project.”
Together, these economic and political considerations promoted a broad, albeit uneven scope to the DM’s internationalization. All six roles of an international currency were played to a greater or lesser extent. In terms of domain, however, the DM was quite localized, prevailing mainly in the Federal Republic’s natural hinterland around Europe. Elsewhere the currency was less competitive. The DM’s geographic range was regional, not global like the dollar’s.

Trade. As indicated, a broad transactional network, reflecting a large and open economy, is generally considered essential to the internationalization of a currency. That proposition certainly seems to be confirmed by the German case. There is little doubt that the increased use of the DM for trade invoicing and settlement was directly linked to the Federal Republic’s growing importance in international commerce, both as exporter and importer. By the 1990s Germany had become the world’s second-largest trading nation, with a share of global trade (exports plus imports) of around ten percent – well behind the United States but ahead of Japan. On the selling side, Germany ranked as second biggest exporter, with a pronounced comparative advantage in differentiated manufactured goods like machinery, transport equipment, and the like. These are the sort of products that, among advanced economies, typically are priced in the seller’s own currency. (The major exception to this norm was Japan, as we shall see below.) Conversely, on the buying side the large size of the Federal Republic’s domestic market gave German importers leverage to insist on denominating trade in DM, to avoid exchange risk. On both sides, therefore, use of the DM was stimulated.

The effect, however, was distinctly regional in scale, limited primarily to the Federal Republic’s immediate neighbors. In the broader global economy, Germany was by no means a giant among nations – only about one-fifth the size of the US market and equal to no more than 60 percent of Japanese GDP. Its place in the world was substantial but hardly overwhelming. Within Europe, however, the Federal Republic was dominant – about thirty percent bigger than France and forty percent bigger than Britain. In its own hinterland, Germany’s large market was bound to exercise a strong gravitational pull.

In turn, the regional bias was reinforced by the European project of integration. By the 1980s nearly the entire continent west of the Iron Curtain was drawn together by a network of trade agreements, reducing or eliminating barriers to commerce in the region. Some countries were full members of the so-called Common Market, known today as the European Union (EU). Others were effectively included under other accords. Europe’s increasingly close commercial ties naturally added to the weight of the regional leader’s currency. With barriers falling, intra-
European trade could logically be expected to grow faster than trade with countries elsewhere; and no economy was more important within the region than the Federal Republic. As nearby countries grew increasingly dependent on Germany, both as market and source of supply, it was only natural that they would be prepared to do more business in DM.

**Macroeconomics.** A record of low inflation is also considered essential to internationalization. That proposition too seems to be confirmed by the German case. The German public has a well known aversion to inflation, dating back to the hyperinflation that swept the country after World War I. A pronounced “stability culture” has long prevailed, fully reflected in the hard-line policies of the Federal Republic’s central bank, the Bundesbank. Throughout the post-World War II period, Germany consistently ranked among the least inflationary of all economies. And that preference in turn was bound to have a disproportionate influence on general macroeconomic conditions across Western Europe, given the Federal Republic’s central position in regional import and export markets. Neighboring states were driven to keep their own prices in line in order to avoid a loss of competitiveness relative to Germany. The imperative was to stop real exchange rates (nominal exchange rates adjusted for inflation differentials) from rising.

This meant that many European governments felt under pressure to match the DM’s high interest rates as best they could. It may have been a bit of a caricature to suggest, as some observers did, that the Bundesbank now in effect was making monetary policy for all of Europe – a simplification that came to be known as the “German dominance hypothesis.” Econometric evidence suggests a more nuanced picture, where interest rates often moved in tandem but were less than perfectly correlated (Von Hagen and Fratianni 1990; Laopodis 2001). But there is little question that a distinct asymmetry prevailed that looked very much like the sequential Stackelberg leadership model of game theory. The Bundesbank was the acknowledged leader. Other central banks then decided whether (or by how much) to follow German policy in response.

The same imperative also explains why stability vis-à-vis the DM became a high priority. Neighbors felt compelled to anchor their nominal exchange rates to the DM as a kind of check to their own inflationary propensities. As one informed commentary put it (Frenkel and Goldstein 1999: 720): “The gradual hardening of exchange rate commitments... became the mechanism by which previously high-inflation members chose to discipline their own monetary policies, and it was to the Bundesbank and its anti-inflationary credibility that these countries
turned for monetary policy leadership.” By the end of the 1980s the Bundesbank (1988: 14) was boasting that the DM “performs the function of a key currency, acting as a ‘stability anchor’ for the other pertinent currencies.”

It was only natural, therefore, that most interventions in Europe would be carried out in Germany’s currency and that a larger share of reserves would now be maintained in DM. And here too the impact was reinforced by the European project, which from the late 1960s onward featured repeated attempts to promote some form of regional monetary integration. First, in 1972, came the so-called “snake,” a common intervention system aiming to link the currencies of Germany and its Common Market partners together in a joint float. And then, when that experiment proved unsustainable, agreement was reached in 1978 to launch a new European Monetary System (EMS), designed in effect to create an improved “supersnake” for Europe. At the heart of the EMS was the Exchange Rate Mechanism (ERM), where in principle all interventions to sustain the joint float would be symmetrical within a matrix of bilateral cross-rates. In practice, however, the ERM soon evolved into something more like a spoke-and-wheel construct with Germany’s money at the center – a *de facto* DM zone. Studies show that by the 1980s almost all of Europe’s currencies were shadowing the DM to a greater or lesser extent (Bénassy-Quéré and Deusy-Fournier 1994; Frankel and Wei 1995).

**Limits**

Yet for all its achievements, German’s currency never came close to replacing the greenback at the peak of the Currency Pyramid. Even before its absorption into the euro, the DM had clearly reached its limit – a distant second to the dollar. Four factors, both economic and political, explain why.

First was sheer inertia, reflecting the dollar’s undoubted incumbency advantages in most parts of the world. Outside Europe, the DM offered no significant gains relative to the greenback. Only within the European neighborhood was Germany’s gravitational pull sufficient to make the DM truly competitive. Elsewhere, the dollar retained its traditional edge.

Second was the inaccessibility and relative backwardness of Germany’s financial markets, as compared with the global market for the dollar. Although convertibility of the DM for current-account transactions was introduced as early as 1958 (along with most other European currencies), a panoply of capital controls persisted until as late as the mid-1980s, restricting foreign participation; the financial system could hardly be described as open. Moreover,
institutional development was hindered by a variety of complex regulations and taxes. German bond and equity markets were notably thinner than corresponding markets in New York or London, offering a limited menu of financial instruments. Accordingly, trading in DM-denominated claims was narrow and expenses were high, hampering transactional liquidity. It was hardly surprising, therefore, that use of the Federal Republic’s currency as an investment medium, though not insignificant, would lag considerably behind its other international roles.

Third was a notable reluctance on the part of the German government to do much to promote internationalization of the DM. Indeed, until the early 1980s the Bundesbank actively sought to restrict cross-border use – for example, by exercising firm command over the issue of DM obligations in the external bond market (Neumann 1986: 110). At issue was control of monetary policy, so critical to Germany’s anti-inflationary stability culture. Public authorities feared that in time an undue constraint might be imposed on policy at home by an excessive accumulation of liabilities abroad – an apprehension that was widely shared by financial interests and other key constituencies across German society (Henning 1994). Over the longer term, it was thought, shifting currency preferences could generate much exchange-rate volatility and uncertainty, threatening both price stability and export revenues. At no point did the government take a pro-active stance on internationalization. If the DM was to emerge as a rival to the dollar, it would have to do it on its own.

Finally, there was the security dimension. The Federal Republic may have been a stable democracy with full respect for property rights and an earned reputation for effective policy management. But it was also a divided nation on the front line of the Cold War, hardly what might be considered a safe haven for investors. For quite understandable historical reasons, the German government was reluctant to rebuild a strong military machine capable of projecting power abroad, relying instead on the protection of the United States. Foreign governments, therefore, had no reason to look to Germany for leadership on security issues. If they were to be attracted to use the DM, it would have to be for economic, not political reasons. And as we know, the DM’s economic appeal was limited largely to the European region, setting a natural limit to the currency’s scope and domain.

THE YEN

In many ways, the story of the Japanese yen was similar. At the end of World War II, Japan too lay in ruin, its economy shattered and its currency virtually worthless. And then
Japan too enjoyed an economic miracle, sustaining growth rates from the late 1950s onward that were the envy of the world. By 1980 Japan’s GDP had come to be the second largest anywhere, bigger even than Germany’s, and the international standing of the yen was becoming well established. Yet Japan’s currency too ultimately reached its limit; indeed, more recently, it has in most respects gone into seemingly irreversible decline. Here too both economic and political considerations played pivotal roles.

**History**

The rise of the yen was impressive but uneven in both scope and domain. At both the private and official levels, the currency came to be used much more as a store of value than as a medium of exchange or unit of account. Geographically its reach, like that of the DM, remained primarily regional, for the most part limited to the nations of East Asia. Overall, the yen never managed to climb above third place among international currencies, behind not just the dollar but the DM as well.

The yen’s internationalization was most notable in financial markets, where persistent appreciation made the currency an especially attractive store of value. According to the composite index constructed at the BIS, the yen’s share of claims in international asset markets accelerated swiftly from little more than three percent in 1980 to some 12.4 percent in 1995 (Frenkel and Goldstein 1999: 712-713). Growth was especially rapid in the offshore bond market, where the proportion of new issues denominated in yen more than tripled between 1980 and 1995, from under five percent to above seventeen percent (Iwami 2000). By the 1990s the yen’s share of the bond market matched that of the DM, though both remained well short of the dollar. The Japanese currency was especially popular in the East Asian region, where the yen replaced the dollar as the predominant vehicle for foreign borrowing. Included, most notably, were larger neighbors like Indonesia, Korea, Malaysia, Philippines, and Thailand. Within Japan, non-resident holdings of both bank deposits and securities expanded steadily through the 1980s and into the 1990s.

Likewise, for central banks the yen became an attractive complement to the dollar or DM for purposes of portfolio diversification. IMF estimates suggest that during the 1980s and early 1990s the yen’s share of global reserves more than doubled, from just over three percent to close to eight percent. That was only half the portion accounted for by the DM but well ahead of any other currency. Once again the yen was favored most in East Asian nations, where the
currency’s share of reserves topped 17 percent by 1990 (Tavlas and Ozeki 1992: 40; Kawai 1996: 319-320).

For other uses, the yen’s performance was respectable but by no means overpowering. In foreign-exchange markets, the yen share of currency trades accelerated over the course of the 1980s to a peak of 27 percent in 1989 but never did surpass the proportion accounted for by the DM (BIS 1999). Here too the appeal was mainly regional. Japan’s currency was most favored as a vehicle in East Asia, in financial centers like Hong Kong and Singapore, where the proportion of business done in yen was considerably higher than elsewhere. Likewise, in the invoicing of global trade, available evidence suggests that there was some expansion of use, but from a very low base and again concentrated mainly in East Asia. The yen’s share in the denomination of trade more than doubled during the 1980s but in 1992 still accounted for less than five percent of the world total. That represented little more than half of Japan’s share of global exports (Thygesen et al. 1995).

Finally, there was the yen’s potential as a possible anchor for the exchange rates of other currencies. Over the course of the 1980s and into the 1990s there was much debate about whether – or to what extent – Japan and its neighbors might be coalescing into some kind of yen bloc, comparable to the emerging DM zone in Europe. In fact, most governments in the East Asian region preferred to maintain a managed float. Usually the float was in line with a currency basket of some kind, though the components of their baskets were rarely disclosed. Econometric analysis suggests that increasingly some of Japan’s neighbors – including, in particular, Korea, Singapore, and Thailand -- did begin to shadow the yen more closely, putting greater weight on the yen relative to the US dollar (Frankel 1993; Frankel and Wei 1995). But in no economy other than Korea did the yen actually surpass the greenback as an anchor, and no country ever pegged to the yen formally. If there was a yen bloc, it was a weak one. In the words of one contemporary analysis (Maehara 1993: 164): “From a policy perspective, it appears that the yen has not yet been perceived as a key regional currency to the extent that the deutsche mark is incorporated as an anchor currency in the European Monetary System.” Declared another source (Bénnassy-Quéré and Deusy-Fournier 1994: 138), more bluntly: “The yen zone is reduced to Japan.” Correspondingly, there was also very little increase in use of Japan’s currency for intervention purposes.

Rise
As with the DM the roots of the yen’s internationalization lay mainly in economics, though in the yen’s case – in contrast to the DM -- there was little reinforcement from politics. Unlike Europe, post-World War II Asia never sought any sort of formal integration; there was no local equivalent of the European project. Nor did the Japanese government at the time actively promote foreign use of its currency. Widespread adoption of the yen occurred in the absence of – not because of -- affirmative political support. Economic motivations dominated.

To begin, there was Japan’s enviable inflation record, confirming again the importance of monetary stability in the process of internationalization. Over the course of the 1980s Japan recorded the lowest price increases of any advanced economy. Annual inflation averaged about 2.6 percent, lower even than Germany’s 2.9 percent (Tavlas and Ozeki 1992: 9). At the same time, decades of trade surpluses had made Japan the world’s greatest creditor nation, even as the United States was becoming a net debtor. Together with the sustained strength of the yen’s exchange rate and a seemingly stable political system, these considerations were bound to make the currency an attractive store of value for investors and central banks alike. A strong demand for yen-denominated claims was assured.

In turn, a series of regulatory reforms supported increased access to a growing supply as well. During the first decades after World War II, Japan’s financial system was the most tightly managed of any industrial nation, inhibiting wider use of the yen. Domestic markets for equities and securities were relatively underdeveloped, and financial institutions were rigidly segmented. Beginning in the mid-1970s, however, a process of deregulation began, prompted in particular by a slowing of Japan’s economic growth. Interest rates were soon freed, encouraging investor appetite for a rapidly rising volume of public debt, and new markets were created or expanded for government liabilities, certificates of deposits, and other financial instruments. The traditional segmentation of institutions was relaxed and supervisory practices were strengthened, gradually increasing both exchange convenience and capital certainty.

Most importantly, capital controls were largely eliminated, opening the domestic system to greater foreign participation. Earlier, strict limitations on the movement of funds restricted both inward and outward investments, even though convertibility of the yen for current-account transactions was restored as early as 1964. But in 1980 non-resident access was eased by a new Foreign Exchange and Trade Control Law, which established the principle that cross-border capital flows should now be free unless specifically restricted. Subsequent years saw a gradual widening of the scope of allowable foreign activity in domestic banking and capital markets. Overall, the process of liberalization was by no means complete, as contemporary
accounts emphasized (Garber 1996). But cumulatively the government’s initiatives did suffice to increase Japan’s integration into world financial markets and to promote use of the yen for investment and reserve purposes.

Finally, there was the massive size of Japan’s economy and foreign trade, exerting a strong gravitational pull on markets elsewhere. Without the promise of a broad transactional network, the yen would never have become the third most popular vehicle in foreign-exchange trading, nor would East Asian governments have given it so much weight in the management of their exchange rates. In the 1980s Japan was seen as a new giant on the world stage, destined perhaps even to surpass the United States as a global economic power. The appeal of the yen for international use naturally followed. For many, it was only a matter of time before the currency would take its rightful place alongside the dollar and the DM at the peak of the Currency Pyramid (Kwan 1994; Hale 1995).

Limits

Yet it failed to happen. Here too, as in the case of the DM, a limit was eventually reached. Effectively, internationalization of the yen peaked at the end of the 1980s. Ever since, the currency has withered quietly like a dying plant. In banking markets, the yen share of cross-border claims has declined from 14 percent in the early 1990s to under four percent by 2010. Similarly, in bond markets the share has fallen from above 17 percent to under three percent. In currency markets the drop has been from 27 percent to 19 percent; and in central bank reserves, from near eight percent to under four percent. No one today speaks of Japan’s currency as a future number one (or even number two). What happened? In this instance, five factors may be cited.

First, once again, was the force of inertia. By the time the yen came on the scene in the 1980s, there were already two well established rivals – the dollar globally and the DM on its own turf in Europe. The incumbency advantages of these two currencies were hard to overcome. Outside East Asia, the yen offered no significant gains relative to either one.

Second was the crash of the Japanese market after the bursting of its so-called “bubble economy” in 1989. In ensuing years the country was plagued by stagnation, frequent recessions, and persistent price deflation, even as neighboring China charged ahead with growth rates in excess of ten percent a year. Over time the gravitational pull of the Japanese economy simply became less and less forceful.
Third was the unique pattern of invoicing in Japanese trade, which discouraged foreign adoption of the yen as a medium of exchange. Unlike most other advanced economies, Japan did relatively little of its overseas business in its own currency. Whereas in the United States virtually all exports were denominated in dollars, and in Germany 80 percent, in Japan the corresponding figure at the time was only some 30-35 percent. Most exports were denominated in dollars, reflecting the central importance of the US market as a destination for Japanese goods. The practice represented a rational “pricing to market” strategy to maintain market share in the United States. Only sales to developing countries tended to be denominated in yen. Over time, there was some increase in yen invoicing, mainly due to the growing salience of East Asia as an export market (Sato 1999). But as noted, even at its peak the currency’s share in global trade remained remarkably small.

Fourth was the role of public policy in Japan, which for years was notably unhelpful. Like the Germans, the authorities in Tokyo were long resistant to internationalization of their currency, which they too feared might in time impose a undue constraint on domestic monetary management. Some in the government did take a more positive tone. Most notable was the Council on Foreign Exchange and Other Transactions, an advisory body to the Ministry of Finance, which in 1985 called for further financial liberalization to enhance the yen’s international appeal. For the most part, however, the regulatory reforms of the 1980s were adopted reluctantly, partly to stimulate domestic growth, as indicated, but also as a grudging concession to the United States. Washington was pressuring Tokyo to liberalize its financial structure in hopes of raising demand for the yen. The idea was to engineer an appreciation that would improve the competitiveness of US goods vis-à-vis Japan. Yen internationalization was seen by most Japanese not as a goal to be sought but rather as a price to be paid to retain the good will of the Americans.

Interestingly, in the 1990s opinion shifted, as Tokyo struggled to come to grips with the country’s post-bubble downturn. Internationalization now became a declared policy objective, in hopes that it would help promote economic recovery at home (Grimes 2003). Most dramatic was a multi-year financial liberalization program announced in 1996, dubbed the Big Bang in imitation of the swift deregulation of Britain’s capital markets a decade earlier. Under the Big Bang all remaining capital controls were to be eliminated and a variety of other ambitious measures were scheduled, including tax reductions and increases in the range of available financial products. Especially after the Asian financial crisis of 1997-98, a concerted effort was made to promote broader use of the yen for a variety of purposes, guided by the
recommendations of a newly established Study Group on the Promotion of Yen Internationalization. But by this time it was too late. As economic stagnation dragged on, the government’s campaign failed to reverse the decline of interest in the yen. Defeat was admitted in 2003 when the strategy was officially abandoned. In the words of one Japanese observer, “it was clear that any further attempt to internationalize the yen... would be futile” (Takagi 2012: 83).

Finally, here too there was a security dimension. Like Germany, post-World War II Japan could be considered a stable democracy with full respect for property rights and effective policy management. Investors were probably attracted for those reasons. But as powerful as it was in economic terms, Japan lacked political means to influence the currency preferences of foreign governments. On the one hand, it was in no position to offer leadership on security issues. Limited by its Occupation constitution to a modest self-defense force, Tokyo was incapable of projecting military power beyond the country’s home islands. Indeed, Japan was itself obliged to seek protection under the security umbrella of the United States. On the other hand, there were no nations in the region prepared to follow Japan’s lead. Memories were still fresh of Tokyo’s wartime atrocities and prewar attempts to build an imperial Greater East-Asia Co-Prosperity Sphere. Here too, as in the case of the DM, it appeared that if others were to be attracted to use the yen, it would have to be for economic, not political reasons.

**THE EURO**

The last antecedent to be considered is the euro, Europe’s joint money. In 1999 the European Union (EU) began its grand experiment -- the new Economic and Monetary Union (EMU), with the euro as its centerpiece. Although still a story in progress, the contours of the tale are by now clear, bearing a strong resemblance to the experience of the yen (albeit on a more compressed time scale). After a fast early start following the euro’s birth, internationalization appears to have quickly reached a limit and in more recent years may even have gone into reverse. The euro, too, has been unable to mount a successful challenge to the dollar.

*History*

A fast early start was not unexpected, given the euro’s credentials. From the moment of its birth, Europe’s new money clearly enjoyed many of the qualities necessary for competitive
success on the world stage. These included a large economic base in the membership of the euro zone, initially numbering some eleven countries—including some of the world’s richest economies—and now up to seventeen (soon to be eighteen). They also included deep and resilient financial markets, unquestioned political stability, and an enviably low rate of inflation, all backed by a joint monetary authority, the European Central Bank (ECB), that was fully committed to preserving confidence in the currency’s future value. For many observers, it was only a matter of time before the euro would overtake the dollar as the world’s pre-eminent currency (Chinn and Frankel 2008; Papaioannou and Portes 2008). The global future of Europe’s money seemed secure. Hence it was no surprise that in the euro’s early days, international use seemed to expand exponentially.

Very soon, however, momentum slowed. The currency’s fast start appears to have peaked sometime around 2003-2004; thereafter, use for cross-border purposes leveled off at rates well below those enjoyed by the dollar. In effect, the euro did little more than hold its own as compared with the past aggregate market shares of EMU’s “legacy” currencies. Given the fact that Germany’s old DM had already attained a number-two ranking in global monetary relations, second to the greenback, anything less would have been a real shock. But beyond that, a limit does appear to have exerted itself. Straight-line extrapolation of the euro’s early acceleration far into the future does not seem to have been warranted.

Limits were evident in terms of both scope and domain. On the one side growth of euro usage was broad but, like the DM before it, sharply uneven across functional categories. The early expansion of international use was especially dramatic in the issuance of debt securities, reflecting the promised integration of Europe’s financial markets. There was also some modest increase in the euro’s share of trade invoicing and central-bank reserves. But in other categories, such as foreign-exchange trading or banking, the dominance of the dollar remained as great as ever. The ECB’s (2008: 7) polite way of putting this was that use of the euro turned out to be “heterogeneous across market segments.”

On the other side, domain turned out to be starkly bifurcated, just as it had been for the DM. For the most part, internationalization of the euro has been confined to countries with close geographical and/or institutional links to the EU and euro zone. These include the EU’s newest members, all destined eventually to join the monetary union, as well other candidate states (for example, Croatia or Montenegro) and non-member neighbors like Norway and Switzerland. They also include several nations around the Mediterranean littoral as well as a number in sub-Saharan Africa. Where trade and financial ties are deep, the euro obviously enjoys a special
advantage. But elsewhere, in stark contrast, scale of use drops off abruptly, and Europe’s currency remains very much in the greenback’s shadow. The evidence, concludes the ECB (2010: 7), clearly confirms “the strong regional character of the euro’s international role.”

Worse, in more recent years, some of the euro’s achievements have even been reversed as global crisis has lingered and Europe’s debt problems have multiplied. Given the adverse circumstances, says the ECB (2012: 7, 9), the currency has remained notably “resilient.” But that is at best a backhanded compliment, referring mainly to the relative stability of the euro’s exchange rate. In terms of actual use, key indicators have started to trend downward. The global share of debt securities issued in euros, for example, which had peaked at one-third in 2004, began to slide in 2009 and by the end of 2011 was down to no more than one-quarter (ECB 2012: 58). Similarly, the euro’s share of international reserves, which had exceeded 27 percent as recently as 2009, fell to below 24 percent by the end of 2012. Most of the decline, according to the IMF, was accounted for by developing countries, where central banks sold off some €45 billion of euros in 2012, cutting their holdings by eight percent. “Resilience,” plainly, is in the eye of the beholder. The best we can say, truthfully, is that it could have been worse.

**Limits**

The reasons for the euro’s early rise are clear; despite the skepticism of some, including myself (Cohen 2003), the currency’s credentials appeared obvious. Yet it failed to live up to potential. Why? Here four factors seem paramount.

First is the familiar force of inertia, which in this instance acted like a two-edged sword. Within the European region itself, where the DM already predominated, adoption of the euro as the DM’s successor was only to be expected. In the eyes of many, the euro was simply the DM writ large. Inevitably, the new currency would inherit the natural hinterland of the old. But beyond the immediate neighborhood the force of inertia worked the other way, to favor America’s greenback with all its incumbency advantages. In this respect, the euro was able to make no more headway than the DM or the yen before it.

Second has been the absence of any pro-active policy by European authorities to promote a major role for the euro. Like the German and Japanese governments before it, EMU has been at best ambivalent about internationalization. From the beginning policy has remained studiously neutral, neither discouraging nor encouraging wider use by foreigners. According to
an authoritative early statement by the ECB (1999: 31), repeated many times since, development of the euro as an international currency – if it was to happen at all – was to be a market-driven process, simply one of many possible byproducts of monetary union. Policy makers would take no action to directly enhance the currency’s appeal.

Third, once again, is the security dimension. How could EMU – a gaggle of states with limited military capabilities and divergent foreign-policy interests – possibly substitute for the global influence of the United States? How could others look to Europe for protection? As economist Adam Posen (2008: 80) comments: “The European Union, let alone the euro area itself, is unable or unwilling to offer these systemic or security benefits beyond a very limited area.” Echoes Bessma Momani, a political scientist (2008: 309): “While there are viable currency alternatives to the US dollar, there are no alternatives to the US military security umbrella.” Few governments saw any political interest in switching their currency allegiance to a weaker patron.

Finally – and perhaps most important of all – is the issue of the euro’s internal governance. For all their other limitations, this was never a question for the DM or yen. No one doubted that Germany and Japan were capable of effective policy management. But the euro, as the joint money of a club of sovereign states, is obviously different – a currency, in effect, without a country. A fundamental mismatch exists between the domain of EMU and the jurisdictions of its member governments, making decision-making problematic at best. Europe’s money is the product of an inter-state treaty rather than the expression of a single sovereign power. For outsiders, therefore, the currency can be considered only as good as the political agreement underlying it; and as recent experience in Europe has vividly demonstrated, the requisite agreement is often tenuous at best. Foreigners cannot be blamed for not wishing to put too many eggs into that fragile basket.

**LESSONS**

What lessons are suggested by these three cases for the future prospects of the RMB? Although the sample is admittedly small, much nonetheless can be learned from the prior experiences of the DM, yen, and euro. Given the Chinese government’s apparent determination to promote internationalization of the yuan, the lessons may be framed as a series of Do’s and Don’t’s for Beijing – Ten Commandments for the Long March toward world status.
1. **Don't underestimate the power of inertia.** International currency use is obviously path dependent. The playing field is not a *tabula rosa*; market actors and governments are already locked into certain patterns of behavior, institutionally and linguistically. Newcomers, therefore, start at a distinct competitive disadvantage that may be difficult to overcome. Inducing agents to switch is not impossible; the RMB’s three antecedents all showed that barriers to entry can, to some extent, be overcome. But the challenge, clearly, is daunting. The yuan must not be just as good as the dollar or other of today’s international currencies. It must, somehow, promise to be *better* than existing incumbents to surmount the powerful force of inertia.

2. **Don’t be passive.** Following from the first commandment, it would seem vital to actively support the internationalization process through public policy. That none of the RMB’s antecedents managed to achieve its full potential cannot be blamed entirely on the ambivalence or resistance of their issuing authorities; as indicated, many others factors were also involved. But the lack of official backing surely did not help. Affirmative government action may not be *sufficient* to bring the yuan to the top of the Currency Pyramid. But, arguably, it may be *necessary*.

3. **Don’t be too ambitious.** A global domain for the RMB, rivaling the worldwide reach of the dollar, may be a worthy goal, but it is unlikely to be immediately attainable. All three antecedents got their start in a specific region, building on close geographical and institutional linkages. A realistic pro-active strategy for the yuan would aim to consolidate a firm base in East Asia before reaching out to other parts of the globe.

4. **Do sustain price stability.** To be competitive, a currency must inspire confidence. The three antecedents confirm the importance in this regard of a record of relatively low inflation, especially for a money’s use as a store of value. The RMB is unlikely to hold much appeal to investors or central banks if its future value is not reasonably assured.

5. **Do maintain a reputation for effective policy management.** More generally, all three antecedents confirm the importance of stable and effective economic governance as a source of confidence. The early rise of each of the three currencies was associated with rapid
economic growth, trade surpluses, and high employment. In the cases of the DM and yen, it also helped that Germany and Japan emerged as major creditor nations. Non-residents had no reason to fear for the solvency of either currency. Conversely, the subsequent setbacks for the yen and euro were clearly attributable, at least in part, to stunning policy reversals – in one case, the bursting of Japan’s “bubble economy”; in the other, a wave of sovereign debt problems. Although for three decades China’s record of economic success was unmatched, more recently blemishes have begun to appear, including slower growth, rising labor costs, and accelerated levels of debt. Does China face its own policy reversal? Trust in the yuan will be damaged, possibly irreversibly, if Beijing is unable to keep the ship of state on an even keel.

6. **Do cultivate extensive trade relations.** For all three antecedents, a broad transactional network was critical to their early internationalization. Where a high proportion of the issuer’s exports were denominated in the home currency, as was the case for both the DM and the euro, extensive trade relations encouraged broader use for purposes of invoicing and settlement. And in all three instances the gravitational pull of strong trade ties led to closer exchange-rate relationships and greater use for intervention and reserve purposes as well. China today is more like Japan in the small percentage of its exports denominated in its own money. As world export leader, however, it would seem to be in an excellent position to boost use of the RMB as a medium of exchange.

7. **Do broaden convertibility.** At a minimum, convertibility for current-account transactions would seem to be an absolute requirement to get the process of internationalization going. But what about the capital account? As the cases of both the DM and the yen demonstrate, widespread adoption of a money for cross-border use is possible even in the presence of a substantial array of capital controls. Serious financial liberalization did not begin in either Germany or Japan until well after their currencies had already gained broad acceptance. This would seem to suggest that full convertibility of the RMB is by no means necessary. But it is also clear that the achievements of the DM and yen might have been even greater had full convertibility been introduced earlier. A degree of currency internationalization was sacrificed for the sake of maintaining a grip on domestic financial markets. China today faces the same trade-off. Some broadening of capital-account convertibility would seem called for, to promote interest in the yuan as an investment medium or reserve asset. How much convertibility, however, is a matter of choice. Some range of restrictions could be preserved to
sustain financial control at home, but at the expense of slowing the RMB’s Long March to elevated status abroad.

8. **Do promote financial market development.** Convertibility alone, however, is not enough. Access is just part of the story. The cases of the DM and yen also demonstrate how important it is to promote the development of deep and resilient financial markets capable of meeting the needs of international investors and central banks. Opening the capital account is just the beginning. Equally important is assurance of an adequate degree of exchange convenience and capital certainty.

9. **Don’t ignore domestic political institutions.** Among the qualities that made the DM and yen attractive were domestic political stability and unquestioned respect for the rule of law. Agents could reasonably assume that property rights would be respected and contracts enforced. It would not be unfair to suggest that China still has some way to go in these respects.

10. **Don’t ignore geopolitics.** Foremost among factors that limited adoption of the RMB’s three antecedents was the security dimension – the inability of any of their issuers to match the military prowess of the United States. None could offer the same kind of security guarantees that Washington routinely extends to foreign governments that use its currency. China, by contrast, is rapidly developing an ability to project power beyond its borders, which could in time encourage some states to switch their monetary allegiance. Much depends, however, on how others perceive Beijing’s foreign-policy intentions. Will China use its power defensively, to help promote peace in East Asia or elsewhere; or aggressively, to pursue controversial national goals (such as territorial claims in the East and South China Seas)? The jury is still out on that question.

**CONCLUSION**

This essay began with the question: Will history repeat itself? Or will the RMB prove exceptional, the currency that finally managed to succeed where others failed? The answer, not surprisingly, is uncertain. A look at the past cannot provide an infallible guide to the future.

However, a review of three recent antecedents – the DM, yen, and euro – does help to identify the factors, both economic and political, that seem most likely to determine the RMB’s
prospects. I have summarized the principal lessons to be drawn from these earlier experiences in a decalogue of Ten Commandments. The main message of my analysis is that the challenge of internationalization is formidable, involving some very demanding conditions. Contrary to predictions of the yuan’s “inevitable” rise, success is by no means guaranteed. The Long March may never reach its destination.
REFERENCES


