What Will the Financial Order Be in a Decade?

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Résumé

Cet article porte sur la nécessité de réformer le système financier international à la lumière des récentes crises. L'auteur examine d'abord les problèmes auxquels le système fait face. Dans un deuxième temps, il considère les solutions proposées pour renforcer le système. Enfin, l'auteur se penche sur le rôle que pourrait jouer la Chine dans un nouvel ordre financier international.

Abstract

This article deals with the necessity to reform the international financial system in the light of recent crisis. The author first examines the problems that the system is facing. In the second part, he looks at proposals to enhance the system's efficiency. Finally, the author analyses the role China could play in a new international financial order.

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Since the end of 2008, the US government has continuously adopted a series of quantitative easing policies, including QE 1 and QE 2, which injected a huge number of dollars into the economy and led to an excess supply of dollars and the prospect of rising inflation risk. When developing monetary policies, the Federal Reserve usually prioritizes its domestic interests, and ignores or is indifferent to the economic well-being of other countries. Meanwhile, the unprecedented expansionary financial and monetary policy used by the US government in this round of financial crisis further raised a global concern over the future value of US dollar. Its long-standing and huge trade deficit has eroded the foundation of US dollar as world currency. The recent downgrade of the American sovereign credit rating had a significant impact on the global financial market, which fully demonstrates the substantial defect in the US dollar-dominated international monetary system. A consensus has gradually been achieved, i.e., this round of financial crisis provided the world with a rare historic opportunity for restoring or rebuilding this crippled international monetary framework.

Promoting a diversified international monetary system has become a significant direction in reforming the current system which concerns the whole international community. Various countries are making unremitting efforts to undertake such reform.

There is not only probability but also signs of a diversified international monetary system, or the so-called post-dollar era. In the next decade, we are very likely to see an international monetary system supported by three pillars: US dollar, Euro and Asian currency (or the currency of an Asian economy). It can be expected that a triple-polarized international monetary system will have a positive influence on the whole world by reducing its systemic risk, constraining the irresponsible actions taken by the policy makers of key economies, restoring the balance between the physical economy and monetary economy, and further reducing the transaction cost in cross-border business.

Even though diversification is definitely unable to address the fundamental problems in the current monetary system, it may help maintain a balance to some degree. In the next one or two decades, US dollar will still be the world's dominating currency. The international monetary system will become a more diversified one in which US dollar plays a leading role.

I. Recent Developments in International Financial Law

A. Necessary Reform of the International Monetary System

The financial crisis originated from the United States during the second half of 2007 exposed the major defects of the current international monetary system[1], the Jamaica System[2]. Such system was established after the breakdown of the Bretton Woods System in accordance with the revised edition of Articles of Agreement of the International Monetary Fund, and features two main characteristics, the diversification of reserve currencies and the legitimization of floating rates.

The fundamental problem of the currency system in operation today lies in the imbalance between the rights and duties of the countries issuing international currencies. Theoretically, through diversifying reserve currencies, the Jamaica System seems to have overcome the "Triffin Dilemma"[3], a conflict between the domestic monetary goals of a national currency and other countries' demands for that particular currency. However, the dilemma was scattered rather than perfectly resolved, and conflicts still arise when a sovereign currency acts as a global reserve one. Specifically speaking, as the Japanese and European economies recovered and revived in the post-war era, Japanese yen and Euros are taking increasingly

1 The international monetary system is an arrangement of currency that functions as world currency to meet the needs of international trade and international payments – including the principles, measures and international organizations established for this purpose – and generally consists of international reserve currency system, foreign exchange rate system and balance of payments.

2 Adopted at the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, on July 22, 1944; entered into force on December 27, 1945; amended by the modifications approved by the Board of Governors in Resolution No. 31-4, adopted on April 30, 1976, namely Jamaica System, and becoming effective on April 1, 1978.

3 The Triffin dilemma (or the Triffin paradox) is a theory that when a national currency also serves as an international reserve currency, there could be conflicts of interest between short-term domestic and long-term international economic objectives. This dilemma was first identified by Belgian-American economist Robert Triffin in the 1960s, who pointed out that the country whose currency foreign nations wish to hold (the global reserve currency) must be willing to supply the world with an extra supply of its currency to fulfill world demand for this 'reserve' currency (foreign exchange reserves) and thus cause a trade deficit.

important roles as global reserve currencies. However, due to its failure to distinguish reserve currencies from domestic or regional ones, the multi-currency structure is still unable to get rid of the unsteadiness that goes with a single reserve currency. Moreover, the diverse global reserve system was based on the currencies of those nations and regions which dominate the world economy. Consequently, the stability depends on the economic conditions of such countries and regions[4].

The monetary authorities of reserve currency issuers, including the United States, the United Kingdom, Japan and the European Union, make currency policies according to the needs of domestic economies. Monetary policies, especially those related with the money supply and interest rates rely on the domestic situations, which are inevitably inconsistent with the needs of world economy and finance. This tension will bring about fluctuation in foreign currency exchange rates and turmoil in financial markets. On the global stage, US dollars have been regarded as *de facto* international standard currency, but no international law obligation has been imposed to regularize the actions taken by the issuing country. A lack of restriction will result in the conflict between monetary policies within the territory of United States and the dollars' role as international standard currency which is often suppressed by domestic objectives.

As the former Treasury Secretary John Connelly declared: "It's our currency, and your problem."[5] More often than not, American policy-makers prioritize domestic issues and rarely consider the externalities of their macro-economic policies, an attitude which is especially manifested in the wake of the 2007 financial crisis. In order to stimulate economy and stabilize finance, the US adopts many expansionary measures which exert a significant impact on other countries. Therefore, the dollars' dominant role has to be changed in the international currency system and a multi-currency system needs to be further promoted so as to prevent superfluous US dollars from threatening the normal global currency flow.

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4 Yonghui Wu, "The Reform of the International Monetary System: A Review of the 2008 Financial Crisis", (2009) 6 *Journal of Fujian Administration Institute*.

5 Bob Rice, "Our currency your problem. Fair deal? ", *Huffington Post Politics*, Nov. 16, 2009, available at: <http://www.huffingtonpost.com/bob-rice/our-currency-your-problem_b_359132.html>.

B. Reselection of Financial Governance

Global financial governance is a process in which national financial regulatory institutions and international financial organizations are involved in supervising the global financial regulatory affairs through coordination, cooperation, agreements, etc. so as to establish or maintain an ideal international financial order[6]. Global financial governance is neither national governments nor a simple combination of the international financial institutions but the multilateral cooperation aiming at jointly promoting the stable and orderly development of the global financial system respectively at the regional, national and global level.

This financial crisis is also a great blow to the confidence of the international community in the traditional governance mechanisms – the Group of Seven and its executive body, the International Monetary Fund (IMF). This financial crisis breaking out in the capitalist centers of the world led to international community's profound reflection on and doubt about the existing international financial governance mechanisms. In order to cope with the international financial crisis, the G20 promotes itself from the Council of Ministers to the Summit level, thus becoming a core management platform for addressing and resolving the financial crisis within the preparation time of less than a month, whereas the traditional ones, that is to say IMF and Group of Seven, are basically marginalized in response to the crisis due to their inherent lack of legitimacy and capacity to act.

As a supranational body, IMF makes its major decisions through a weighted voting system in which the voting right of a member state is exercised according to the proportion of its share, even though IMF has relative independence in its daily work. Emerging countries' voting rights in IMF have a slight increase after several reforms. Nevertheless, it is still based on the pattern of financial power after World War II without any renovation adapting to changes of the power structure in a new era. The voting rights of BRICS are as follow: China 3.82%, Brazil 1.72%, India 2.35%, Russia 2.40%, and South Africa 0.77%. It is far less than their respective share in the global GDP. By contrast, the United States alone has 16.8%, which means that it still retains a veto. Mirroring the will of the

6 Guoxin Wang and Jin Cheng, "G20 Mechanization and Global Economic Governance Reform", (2010) 3 *Global Review* 8.

United States and the European Union[7], IMF, whose mechanism is similar to the operation of a joint-venture company, acts as the weapon of Europe and America for ruling the global finance.

Global financial stability nowadays must rely on China and other emerging countries instead of merely depending on the U.S. and its allies. If no action is taken by IMF to get the trust of those members that have been underrepresented in the organization for a long term, these countries will not even use the powers they already have within the system[8].

With the decline of the traditional position, IMF's capacity to act is shrinking while it becomes increasingly difficult to play a constructive role in international economic governance. On the one hand, this stems from the transformation of its functions. In the 1970s, with the collapse of the fixed exchange rate system, IMF lost its regulatory authority of exchange rate altogether. Therefore, the exchange rate issue falls within the sovereignty of each country again. In the era of floating exchange rates, it has become one of the main duties for IMF to provide countries suffering from payments imbalances with short-term loans. On the other hand, the loan provided by IMF is of a harsh and rigid conditionality, which requires a borrower to implement tight fiscal and monetary policies to improve the international balance of payments. This prescription often worsens the economic and financial conditions of a country in crisis, and in turn further deepens the negative effects of crisis. This is also one of the root causes why emerging economies and developing countries are not willing to borrow from IMF. Such phenomenon not only weakens the IMF's influence over these nations, but also reduces the benefits IMF gains by providing

7 Since the 1990s, the IMF has participated in settling many regional financial crises. Political criticism has mounted about the effectiveness of IMF intervention, which in many cases failed to stabilise their currencies or restore their economic well-being. The IMF aid, however, comes with strict conditions. The experience of the world financial crisis over the past year has cast serious doubt on the IMF model, and has left its credibility damaged. The IMF acts as U.S.'s private tool to assist in implementing its foreign policy. For the analysis of these issues, please see: Randall W. Stone, *Lending Credibility: The International Monetary Fund and Post-Communist Transition*, Princeton, Princeton University Press, 2002; Randall W. Stone, "The Scope of IMF Conditionality", (2008) 62-4 *International Organization* 589 Li Wei, "Hegemonic Powers and International Public Performance. The U.S. Selective Aid in Regional Financial Crisis", (2007) 3 *International Politics Quarterly* 164.

8 Ngaire Woods and Qu Bo, "Governing the Global Economy: Strengthening Muhilateral Institutions", (2008) 6 *Foreign Affairs Review*.

loans to these countries. Operating with limited funds, even though IMF can provide necessary financial support to small countries, when the U.S. finds itself in crisis, it proves to be powerless. In addition, changes of the global financial environment make it more difficult for IMF to play a role. Studies have noted that new financial derivatives not only increase the systematic risk but also reduce the IMF's capacity to mitigate risk. Confronted with the international financial crisis, developed countries can no longer cope with it alone; therefore, they have no choice but to enhance cooperation with developing countries, especially emerging economies. In the process of economic globalization, the relative change in each country's strength triggers the demand for a new pattern of global finance.

The UK *Financial Times* commented: "The use of the G20 at this moment of global crisis is a clear indication that the old order has outlived its time"[9].

C. Strengthening of Warning and Supervision of Systematic Risks

The financial crisis shows that fundamental changes have taken place in the business model of financial services. Regulatory authorities must analyze, identify and monitor the risk of financial agencies from a totally new perspective. The business model for financial services has transformed from "buy–hold" strategy into "initiate–decentralize" model. Innovative financial instruments, especially credit derivatives market and asset securitization technologies have together effectively promoted the transformation of financial business model. Facing rapid development of market innovation and increasingly complex product innovation, the system, relying solely on traditional means of supervision, has lagged behind the pace of innovation. At the same time, due to transmission mechanism in the financial system, it is not nearly enough for the regulatory body to only consider the exterior risk of a product. The regulatory body is required to assess financial products prudentially, and understand the risk of the entire financial system, so as to recognize the whole through the observation of a small portion.

9 Quentin Peel, "A Wider Order Comes into View" *Financial Times*, April 6, 2009, available at: <http://www.ft.com/cms/s/0/93e0fc7c-2242-11de-8380-00144feabdc0. html>.

The U.S. Federal Reserve once pursued the principle that non-regulation is the best regulation. However, when drawing lessons from the subprime mortgage crisis in the wake of the financial crisis, it occurred to the Federal Reserve that the ineffectiveness of supervision is the main cause of the financial crisis. Nowadays, strengthening supervision has become an international trend, and the progress in practice includes: "Financial Regulatory Reform: A New Foundation"[10], "Basel ", and "FSB Framework for Strengthening Adherence to International Standards"[11]. Five principles of financial supervision were brought forward in the Washington summit of G20 in November, 2008, i.e., Strengthening Transparency and Accountability; Enhancing Sound Regulation; Promoting Integrity in Financial Markets; Reinforcing International Cooperation; Reforming International Financial Institutions[12].

The British reform plan also emphasizes the supervision of systemically important financial institutions and systemic risks. On February 17, 2011 the UK Treasury published a document entitled "A new approach to financial regulation: building a stronger system". The Government's reforms focus on three key institutional changes: first, a new Financial Policy Committee (FPC) will be established in the Bank of England, with responsibility for "macro-prudential" regulation, or regulation of stability and resilience of the financial system as a whole; second, "micro-prudential" (that is, firm-specific) regulation financial institutions that manage significant risks on their balance sheets will be carried out by an operationally independent subsidiary of the Bank of England, the Prudential Regulation Authority (PRA); and third, responsibility for conduct of business regulation will be transferred to a new specialist regulator, which has had the working title "Consumer Protection and Markets Authority". The Government has finally named this body the Financial Conduct Authority (FCA); the FCA will have responsibility for conduct issues across the entire spectrum of financial services[13.]

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10 "Financial Regulatory Reform: A New Foundation", available at: <http://www.ustress.gov>.

11 See "FSB Framework for Strengthening Adherence to International Standards", available at: <http://www.financialstabilityboard.org/publications/r_091107a.pdf>.

12 "Declaration Summit on Financial Markets and the World Economy", November 15, 2008, available at: <http://www.g20.org/pub_communiques.aspx>.

13 HM Treasury, "A New Approach to Financial Regulation Building a Stronger System", available at: <http://www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf>.

EU financial regulatory reform has three salient features. First, the supervision hierarchy and the supervision objectives of the new system are more comprehensive. In addition to establishing the European Systemic Risk Board, which is specifically set up to perform macro-regulatory functions, the scope of direct supervision permissions at the EU level has also been expanded from the securities market to almost the entire financial service area including banking, insurance, and occupational pensions. Second, the functions and status of the European Central Bank in the financial regulatory system was enhanced. It will support the European Systemic Risk Board in many aspects, including information collection and analysis and administrative management, so as to perform its macro-prudential financial supervision of EU's entire financial system. Third, at the EU level, the status of financial regulators is greatly enhanced, and they are granted some supranational power. In the previous regulatory system, the EU's Financial Supervision Commission, with no regulatory power and actual enforcement power, is nominally responsible for coordinating the financial regulatory policies of different member states and promoting the cooperation of their financial regulatory authorities. The three newly established large financial regulators are endowed with supranational powers in some areas and some special cases, such as supervising rating agencies registered in the EU directly, and in specific crisis situations temporarily prohibiting or restricting activities of a financial transaction.

Major economies have begun to enhance macro-prudential supervision (the majority of which carry it out through strengthening central bank's regulatory functions), to prevent the persistent accumulation of systemic risks.

In the next one or two decades, a more rational financial regulation framework will be set up in global financial regulation from concept to regulation, tool to approach, institution setup to regulation pattern. The future financial regulators will try their best to explore an approach of dynamic balance between "market" and "regulation", and perform more stringent supervision. More financial products, in particular the derivative financial products which have been excluded from the scope of regulation will be included. More financial institutions will be under strict supervision, in particular the large number of hedge funds, sovereign wealth funds and credit rating agencies which are outside of supervision.

II. Future Trends in International Financial Law

A. Diversifying the Reserve Currency and Internationalizing RMB

Given the defects of the current international monetary system and reserve money, reforming the monetary system has become a global trend. Various ideas have been put up by scholars, experts and associations from different countries, representative views of which are as follows. (1) Go back to the gold standard. It is said that the problems originate from the lack of credit reference of US dollar, so it is necessary to re-adopt the gold standard and restrict issuance of currency. However, it is impossible to go back for previous practice of gold standard has failed. (2) Adopt non-national or super-sovereign currency as reserve currency. As Zhou Xiaochuan, Governor of the People's Bank of China puts it:

> "A super-sovereign reserve currency not only eliminates the inherent risks of credit-based sovereign currency, but also makes it possible to manage global liquidity. A super-sovereign reserve currency managed by a global institution could be used to both create and control the global liquidity. And when a country's currency is no longer used as the yardstick for global trade and as the benchmark for other currencies, the exchange rate policy of the country would be far more effective in adjusting economic imbalances. This will significantly reduce the risks of a future crisis and enhance crisis management capability."[14]

However, the thought is too ideal to carry out due to the existence of path dependence and the inadequate support of credit and financial market to the issuance of supranational currency. Besides, the greatest impediment comes from reserve money issuing countries whose vested interest will be affected. (3) Promote regional currency. Euro is a successful case, but other regional currency lacks political will and it is hard to make out within the foreseeable future.

In the foreseeable future, the leading role of US dollar cannot be replaced completely, so the practical way is to diversify reserve money and

[14] Xiaochuan Zhou, "Reform the International Monetary System", March 23, 2009, availableat:<http://www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/20091229104425550619706_.html>.

get rid of dependence on US dollar. Besides traditional international money, there is new currency like RMB, Russian rouble and other currencies of emerging markets. If there is a new international monetary pattern in which US dollar, Euro, pound, yen, RMB and SDR check and balance, the leading role of US dollar will be weaken.

B. Governance of International Finance Requires to Balance Soft and Hard Laws, New and Old Mechanisms

Relatively speaking, the governance of international finance is of a high sensitivity in nature. Financial affairs, as far-reaching issues, involve mostly the overall development of national macro-economy, and are thereby more sensitive than trade or other technical affairs. In this regard, it is second only to security issues. Particularly ever since the 1990s, the financial crises that broke out one after another have caused heavy losses to the states in distress, making the originally sensitive international financial affairs even more of a problem.

The truth is that the promotion of worldwide financial regulation did not pan out as well as expected, even though the financial authorities of different states share common interests on this issue. Of all factors, two have now substantially hindered the progress where uniform standards are formulated and implemented in global financial regulation. For one thing, the international community today is still made up of different nation states, which may vary widely in social and cultural traditions, political and economic systems, level of economic prosperity, and financial regulatory systems and capabilities. For another, when it comes to financial regulation, all financial regulators are loath to give away the liberty and control they once owned. As a result, not only is it difficult to establish a super-sovereign global financial regulator, but universal standards for financial regulation could hardly be substantially binding or effective without strong support or cooperation on the part of the financial authorities across the world.

Since both the afore-mentioned issues shall take long to be settled, global financial regulation can only be based on voluntary compliance by all states, which makes such regulation somehow a “soft law” in effect, instead of the mandatory force of international law. However, the “soft-law” nature does not imply invalidity of a universal standard in global financial regulation. In fact, by promoting regulating rules provided by financial standardizing institutions, Basel process is striving to realize its goals for global financial regulation together with other international financial organizations and national regulatory authorities. The cooperation on international financial regulation advocated by Basel is developed on the voluntary basis of states. It provides minimum standards[15].

The fundamental feature of the current international financial system is that the leading role is played by United States. US dollar's centre position in international key currency field has not been changed despite of the financial crisis, and its economic leading role cannot be replaced temporarily. Therefore, as an absolute authority in respect of rule making, US will not lose its predominance in a short time. In addition, it's impossible for IMF to stop acting on the International Monetary stage.

The G20, which played a growing role in the crisis, is a practical approach to future multilateral coordination. For one thing, it represents 85% of global GDP, 80% of trade volume and 2/3 population, so it is more representative than G7. For another, its work efficiency is highly above some international organizations, so its decision is more operable and binding.

On April 2, 2009, G20 leaders held the second financial summit in London to jointly explore tactics addressing the crisis. Judging from the Summit's outcome, the leaders have not only made practical achievements on strengthening the coordination of macroeconomic policies among the countries concerned and stabilizing the international financial markets, thus boosting the international community's confidence in overcoming the impact of the current financial crisis and promoting the recovery of growth of the world economy, but also reached an initial consensus on reform of the international financial system, which is a positive step towards the future establishment of a just and rational new international economic and financial order. It can be said that the London Summit marks a turning point for the crisis evolution, a new starting point for international cooperation in financial supervision and coordination, and a new opportunity to spur the world economic and financial order to

15 Shiqing Xie and Jiajun Huang, "Basel Process and Global Financial Governance", (2010) 11 *Shanghai Finance*.

develop on the direction toward multi-polarization[16]. To promote G20's greater function in global multilateral governance structure, the London Summit has agreed on an Action Plan, as set out in the attached progress report. The leaders have issued a Declaration: "Strengthening the Financial System". In particular, all members agreed to:

- establish a new Financial Stability Board (FSB), as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission, with a strengthened mandate, according to which the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- reshape their regulatory systems so that their authorities are able to identify and take account of macro-prudential risks;
- extend regulation and oversight to all systemically important financial institutions, instruments and markets[17].
- The G20 was designated to be the premier forum for international economic cooperation, and has established the Financial Stability Board (FSB) to include major emerging economies and welcome its efforts to coordinate and monitor progress in strengthening financial regulation[18].

As an inattentive system, G20 caters to most nations' system preferences in international finance management so it is confronted with less resistance in the process of updating. However, because of the low level of mechanism, it may face the dilemma of weak management in the post-crises era[19]. The future function and development of G20 remains to be seen.

16 Xiaoxia Sun, *London Financial Summit and the International Financial System Reform*, The 92nd Issue, Summer 2009.

17 The London Summit, *Declaration on Strengthening the Financial System*, available at: <http://www.g20ys.org/documents.html>.

18 The Pittsburgh Summit, *Leaders' Statement*, Sept. 24-25, 2009, para. 19, available at: <http://www.g20ys.org/documents.html>.

19 Zhinan Cui and Yue Xing, "From G7Era to G20: The Transition of International Financial Governance Regime", (2011) 1 *World Economics and Politics*.

C. Standards of Financial Supervision: Towards Convergence

This financial crisis tells us that: finance and financial risks have been fully globalized beyond the limits of national boundaries, as well as the financial crisis itself, which results from the simultaneous and intensive outbreak of risks. However, rules and regulations, the most practical defence against the financial crisis, are under each sovereign's control of its own freedom so that the legal system relating to crisis prevention and control cannot keep pace with the development of the banking industry and risks.

After the crisis, The Basel Committee on Banking Regulations and Supervisory Practices proclaimed active innovation, urging profound international cooperation in the field of banking supervision. The Cross-border Bank Resolution Group (CBRG) of the Basel Committee on Banking Supervision developed the following Recommendations as a product of its stocktaking of legal and policy frameworks for cross-border crises resolutions and its follow-up work to identify the lessons learned from the financial crisis. Recommendation 1: Effective national resolution powers. National authorities should have appropriate tools to deal with all types of financial institutions in difficulties so that can be achieved an orderly resolution that helps maintain financial stability, minimize systemic risk, protect consumers, limit moral hazard and promote market efficiency. Recommendation 2: Frameworks for a coordinated resolution of financial groups. Each jurisdiction should establish a national framework to coordinate the resolution of the legal entities of financial groups and financial conglomerates within its jurisdiction. Recommendation 3: Convergence of national resolution measures. National authorities should seek convergence of national resolution tools and measures toward those identified in Recommendations 1 and 2 in order to facilitate the coordinated resolution of financial institutions active in multiple jurisdictions and so on[20].

As previously mentioned, major economies learn lessons from the crisis, beginning to check and make up the defect of banking supervision. Although there are some differences between the financial reform plans provided by each country, the resolution and attitude to tighten the super-

[20] See "Report and recommendations of the Cross-border Bank Resolution Group", available at: <http://www.bis.org/publ/bcbs169.htm>.

vision over the banking industry are manifested and transparent. The common elements indicated in those plans are as follows:

1. Enhancing the Supervision Power from Macroscopic Perspective and Controlling Systematic Risks

The most profound lesson learned from the crisis is the lack and defect of oversight of the banking industry. Facing the complicated systematic risks originating from the interaction of departments across and within, the monetary sector is terribly fragile, and it is necessary to generally assess and control the relevant systematic risks. Especially, the financial innovation brings about new banking systematic risks. Specifically, the creation of financial services and instruments gradually blur the traditional boundaries between different types of financial institutions, and the trans-sector operation may result in new systematic risks if some huge traditional institutions begin to run non-traditional financial business on a large scale. Strengthening coordination between financial supervisory authorities is one of the cardinal ways to intensify macroscopically and prudent supervision.

2. Methodizing Financial Supervision and Coordination Mechanism, and Strengthening the Micro Financial Supervision

Targeted at creating a set of more consistent and convergent rules, promoting regulatory capability and achieving the effective supervision on multinational financial institutions, EU Council has decided to set up European System of Financial Supervisors (ESFS) as the financial supervisory and regulation department in Europe. As a result, the committees of superintendence of the banking, securities and insurance which used to be on the EU level would be upgraded to European Supervision Authorities (ESA). In order to continue performing the advisory functions of its predecessors, ESA would expand its scope of permissions and get a legal personality. The main jobs of ESA are collecting micro prudential regulation information, ensuring the common European supervision culture and the consistency of regulatory operations, and assisting in resolving supervision bifurcations between member states.

The European Council calls for rapid progress to be made in the field of regulation of the financial market, notably on the regulation of alternative investment funds and on improved capital requirements for banks.

EU is planning to establish a steering committee inside European Systematic Risk Committee and a cooperation mechanism with ESA in the field of information exchange and financial supervision. These methods are expected to strengthen the concordance of cooperation and supervision among the European regulators as well as effective control of the financial mixed operation.

The US "Dodd-Frank Wall Street Reform and Consumer Protection Act" has created a new financial supervisory authority, which endows federal financial regulators new power. If large financial institutions got into trouble and threatened to break down the stability of the monetary sector by their insolvency, the federal financial regulators would be able to take them over and spin them off. Besides, the US has set up a financial stability regulatory board consisting of officials from responsibility superintendent department. The committee mainly takes charge of monitoring and handling the systematic risk threatening national financial stability.

The schemes of both EU and US have strengthened the negotiation and cooperation among domestic regulatory bodies. This will be helpful for methodizing the financial supervision and coordination mechanism and strengthening the micro financial supervision.

3. Reducing the Procyclicality of Financial Regulation

There is no doubt that the procyclicality plays an important role in the outbreak and spread of the financial crisis. The London Summit Leaders' Statement published on April 2, 2009 emphasized the importance of strengthening financial supervision and regulation. Strengthened regulation and supervision must promote propriety, integrity and transparency, guard against risk across the financial system, dampen rather than amplify the financial and economic cycle, and reduce reliance on inappropriately risky sources of financing. The Basel Committee on Banking Supervision and the Global Financial System Board have taken actions such as implementing suggestions that help bringing the periodicity down. Nowadays, many regulatory means of banking risk such as capital requirement and accounting standards are key factors which lead to the procyclicality behavior of financial institutions. The lack of measures to buffer countercyclicality and rigid accounting system aggravate the destructiveness of the crisis.

Therefore, Basel Accord[21] brought in the demand of countercyclical capital conservation buffer, which means banks are required to allocate extra countercyclical capital conservation buffer to prevent credit loan from an excessive growth during the economic boom period. During the recession period, such measures will help to absorb the risk of losses. Countercyclical Capital Buffer is based on a macro prudential aim asking banks to prepare for a rainy day in the condition that they hold too abundant credit loan.

III. What Role will China Play in the Financial Area in the Next Decade?

A. Establishing and Maintaining the International Financial Order

Nowadays, China has already become the second largest economy in the world. By the end of March 2011, its foreign exchange reserve balance is 3.04 billion dollars[22]. Such economic strength is no doubt enough to become the supporter of international money. Behind RMB, there is a united political entity, single financial policy, consolidated financial system, uniform capital market and unified military power. As such, RMB has greater advantages than Euro, and it is its strategic object to enable RMB to function as international reserve money.

In the future, at least, China can play its role in the regional and international financial area in two aspects:

1. Promoting the Capability of International Financial Service and Facilitating Trade and Investment

Beginning in 2002, the People's Bank of China actively cooperated with neighbouring countries to use local currency in border trade settle-

21 See "Basel Committee on Banking Supervision, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards", September 12, 2010, available at: <http://www.bis.org/press/p100726.htm>.

22 See "Interview with an Official from the State Administration of Foreign Exchange on Foreign Exchange Reserves", available at the website of the State Administration of Foreign Exchange <http://www.safe.gov.cn/model_safe_en/news_en/new_detail_en.jsp? ID=30100000000000000,302&id=2>.

ment. Since the onset of the world financial crisis in late 2008, China has signed currency swap agreements with 11 countries and regions, including Hong Kong SAR, Korea, Malaysia, Indonesia, Belarus, Argentina and Mongolia, etc., with a total value of 834.2 billion yuan[23]. In addition, the central bank will enter into currency swap deals with more countries. The swap is aimed at promoting bilateral trade, investment and financial cooperation. RMB is being gradually accepted both inside and outside China, which will help to provide effective short-term liquidity support, promote the development of bilateral trade, maintain regional financial stability and establish the international currency status of RMB.

Moreover, China launched the trial scheme of RMB cross-border trade settlement in five cities in April 2009, namely Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan. It expanded the application scope of such scheme to 20 provinces, municipalities and autonomous regions in July of the same year, and then extended it to the whole country on August 22, 2011. Meanwhile, the overseas regions under this project expanded from Hong Kong SAR, Macao SAR and the ASEAN countries to all its trade partners.

In 2010, banks made more than 500 billion yuan of cross-border RMB trade settlement, accounting for 2 percent of China's total foreign trade value that year and about 48 times the amount in 2009. By the end of December 2010, 67,724 enterprises had made trade deals with yuan settlement, compared with only 365 in 2009[24]. China's yuan settlement in cross-border trade surged to 957.57 billion yuan (149.62 billion U.S. dollars) in the first half of 2011, 13.3 times more than that for the same period of last year, according to statistics from the central bank[25].

The new service is bound to help warm up international trade, further push the yuan around the globe and alleviate the world's over reliance on the U.S. dollar.

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23 See news report, "China signs currency swap deal with Mongolia", May 6, 2011, available at: <http://www.gov.cn/english/2011-05/06/content_1858984.htm>.

24 The Annual Report 2011 of the People's Bank of China on International Financial Market, available at: <http://www.pbc.gov.cn/image_public/UserFiles/main/upload/File/2010(1).pdf>.

25 See news report, "China extends cross-border trade settlement in yuan to entire nation", available at:
<http://english.peopledaily.com.cn/90778/90862/7578809.html>.

It is an essential step toward the RMB's internationalization; cross-border settlement is the result of China's rapid growth. It will make it more convenient for exporters and importers to carry out trade and avoid the risk of exchange rate fluctuations.

RMB settlement of cross-border trade will certainly promote its free convertibility. With more enterprises starting to use Renminbi as settlement currency for foreign trade, more Renminbi will circulate overseas. This will in turn benefit trade financing and the development of wealth management products.

On December 15, 2010, Micex, Russia's largest securities exchange began trading in the rouble vs. the RMB. It was largely symbolic given the trading volume was equal to about $700,000. More importantly, authorized by the State Council, the People's Bank of China signed a new bilateral local currency settlement agreement with the Central Bank of the Russian Federation on June 23, 2011 in Russia. Following the execution of the agreement, Chinese and Russian bilateral local currency settlement will cover not only border trade but also general trade, with expanded geographic area. According to the new agreement, economic entities from both countries will be able to conduct settlements and payments for trade in goods and services in any currency at their own discretion, i.e., a freely convertible currency, RMB or the rouble. The agreement is expected to deepen financial cooperation and promote bilateral trade and investment between China and Russia[26].

In August 2010, People's Bank of China allowed foreign central banks or monetary authorities, HK and Macau RMB clearing banks and overseas participating banks to use RMB to make investment in the inter-bank bond market under some amount limit, a decision which enlarged the channel to preserve and increase the value of RMB.

In August, 2011, China sold Renminbi 20 bn (US$3.1bn) of sovereign bonds in Hong Kong. This biggest offshore Renminbi bond issuance to date met huge demand from investors clamoring for assets in the Chinese

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26 See "China and Russia Signed New Bilateral Local Currency Settlement Agreement", available at: <http://www.pbc.gov.cn/publish/english/955/2011/20110630151646500985220/20110630151646500985220_.html>.

currency[27]. The Ministry of Commerce also released draft guidelines on foreign investors' direct investment in China with RMB acquired overseas. Foreign investors will be able to make direct investment in China with yuan legally obtained overseas[28].

Under the shadow of the debt crisis of the United States and Europe, the currency composition of the fund held by international institutional investors is bound to be changed, and the Renminbi government bonds will probably attract more attention from investors. As more international investors are gradually including RMB into their capital pool, the internationalization of yuan will speed up.

2. Decreasing the Dependence on US Dollar in Regional and World Scope

Because of the differences in political, cultural and economic factors in Asia, "Asia Dollar" can hardly come out in a short time. However, with the further financial cooperation between China and ASEAN, East Asia, and Pacific Region, RMB is becoming a key regional currency.

Mundell predicted that US dollar, Euro and Asian currency will become the three main currencies together in 20 years[29.] Especially, with the gradual maturity of Asian customer market and rapid increase of regional trade, the original structure where Europe and America are strong and Asia is weak will be transformed into an equal and diverse one. In a word, the elevation of China's status will lay a foundation for decreasing the heavy dependence on US dollar.

With the future internationalization of RMB, China can build vertical and horizontal alliance with G20 countries to increase the vote share in IMF and World Bank, make RMB become part of the SDR currency basket, counterbalance US dollar hegemony and at last contribute to regional and international financial stability.

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27 See news report, "China in Record Renminbi Bond Sale", available at: <http://www.ftchinese.com/story/001040201/ce>.

28 See news report, "New Policies Help Yuan's Internationalization", available at: <http://english.peopledaily.com.cn/90778/7582491.html>.

29 Yongding Yu, Fan He and Jin Li, "Financial Cooperation in Asia: its background, new development and prospects" (2002) 2 *Studies of International Finance*.

To resolve liquidity shortages, the United Sates Federal Reserve Board has adopted a quantitative easing policy that could trigger a flush of dollars into the market.

Since May 2010, the dollar has been getting weaker, arousing concerns that global trade would suffer from an increasingly unsteady dollar that would lead to increased costs and risks for traders.

The cross-border RMB trade settlement is undoubtedly a piece of good news for traders and will boost trade among China's mainland, Hong Kong, Macao and regional trade partners such as the Association of Southeast Asian Nations (ASEAN).

Since the financial crisis in the late 1990s, Asian governments have been considering strengthening regional monetary and financial cooperation[30]. Proposals have ranged from the Asian Monetary Fund to common currencies. In 2003, the Chinese government proposed the Chiang Mai Initiative Multilateralization (CMIM), and called on the ASEAN+3 countries to develop a multilateral currency swap mechanism. The ASEAN+3 countries signed the CMIM Agreement in 2009 in hopes of establishing a foreign exchange reserves pool to provide short-term financial support to contracting parties hit by financial crises. The reserve pool amounted to 120 billion U.S. dollars. China contributed 38.4 billion U.S. dollars, accounting for 32 percent of the pool. ASEAN+3 is seeking to expand the local currency bond market, a large, underexploited source of investment and finance for the region. New steps under the Asian Bond Markets Initiative will promote and improve the legal framework for these bond-related issues and strengthen the infrastructure for trading on the region's bond markets.

With the completion of China-ASEAN Free Trade Area, the two sides in the cooperation of the financial field will be further expanded, which will lift cooperation to a new high.

B. Influence: Remarkable Rise of China's Financial Status

In the 30 years of Reforming and Opening up, the Chinese economy developed at a high speed and achieved the second highest level. Since

30 The ASEAN+3 countries launched the Chiang Mai Initiative in 2000.

China has made great contribution to stabilize and maintain international financial order in the Asia Financial Crisis ten years ago, it certainly has more advantages nowadays to promote and lead Asia capital market and be the regional or global supplier of international financial public products.

1. Application of Chinese Financial Law

In the international context, China's increasing share in the international financial organization and becoming a member of G20 will consolidate and upgrade the discourse power of emerging economies. And China's future claims, suggestions and standards will be possibly embodied in the rules. China will turn to be a rule maker from a rule follower.

In the national context, on April 29, 2009, the mainland government unveiled a plan to make of Shanghai an international financial and shipping hub which matches the country's economic strength and the international status of its currency by 2020[31]. According to the plan, China will develop a multi-functional and multi-layer financial market in Shanghai with the introduction of more financial products, instruments, derivatives and futures.

On June 22, 2010, a press conference held by the Shanghai Municipal Government announced the substantive results which were obtained through more than one year's efforts in the following areas.

- Construction of a financial system: an inter-bank market clearing house company limited was incorporated with the registered name "Shanghai Clearing House"; screw-thread steel and wire rod were listed at Shanghai Futures Exchange; Hushen 300 stock index future contracts came out; medium-sized collection of medium-term notes appeared in inter-bank market; financial lease companies were about to issue bonds; automobile financing companies would issue corporate bonds; the credit transfer market obtained approval from the competent authorities and are under systematic development; Shanghai Shipping Exchange developed better shipping price index, etc.

31 Opinions on Accelerating the Development of Modern Service Industry and Advanced Manufacturing Industry and the Establishment of International Financial Centre and Shipping Centre in Shanghai issued by the State Council, April 14, 2009.

- Creation of financial institutions: Boc Consumer Finance Co. Ltd was opened on June 12; agricultural financing lease companies have been approved to be established in Shanghai; Shanghai Kingburg Industrial Investment Fund Management Company and Shanghai Re-guarantee Company, etc., were set up one after another; pilot foreign-invested enterprises equity investment management has been launched. Since 2009, four new foreign banks have entered Shanghai: Sumitomo Mitsui Banking, Banque de I'IndoChine, Bangkok Bank and Zhengxin Bank Company Limited.
- Financial services innovation: cross-border RMB settlement expanded gradually (by the end of May 21, 2010, such settlement amount in Shanghai has been RMB 11.5 billion); pilot margin trading in securities companies is launched, and five of the eleven approved companies are in Shanghai; the pilot implementation of domestic and foreign currency exchange business to individuals has been expanded; Shanghai has been granted approval by China's financial authorities to launch a private equity (PE) pilot program involving Qualified Foreign Limited Partners (QFLP); international limited partners can directly invest converted funds in foreign PE and VC institutions operating in the Chinese markets, which could increase funding sources for foreign-owned Renminbi funds[32].
- Financial opening up: five foreign banks were permitted to issue RMB bond; Mitsubishi UFJ (China) Ltd has issued one billion two-year bonds; the Shanghai Administration for Industry and Commerce has issued a business license to Carlyle Fosun (Shanghai), the first foreign-invested equity investment partnership in China; the preparation work for foreign companies to be listed and issue bonds at home are carried out; the Direct Insurance License has been issued to Lloyd's (China) Reinsurance Company; Shanghai-HK and Shanghai-Taipei financial cooperation are under steady progress; Shanghai Financial Services Office and HK Financial Services Authority have signed the memorandum of strengthening Shanghai-HK financial cooperation; two-way exchange business of new Taiwan dollar has been launched[33].

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32 See news report "China Approves Shanghai QFLP Program to Boost PE Participation", available at: <http://en.21cbh.com/HTML/2010-10-12/QFLP-PE.html>.

33 Press Conference from Shanghai Municipal Government on Introduction to Promote the Construction of International Financial Centre, available at: <http://www.scio.gov.cn/xwfbh/gssxwfbh/xwfbh/shanghai/201006/t675898.htm>.

The endeavour to build an international financial center and the availability of various financial products will bring about more opportunities to engage in banking, insurance, trust, fund, and corporation business in China, and to apply the related laws and regulations. In return, the development in practice will also improve the legal framework for the Chinese financial sector.

2. Intensification of Financial Friction with Some Major Countries

China not only is a trade giant but also will become a leading financial power. According to the Balance of Payments Statement of the first half of 2011 released by China Administration of Foreign Exchange, the amount of trade in service for the period is RMB 166.7 billion, representing a 32% increase. Except for several items, trade in service has kept rapid growth on the whole. Especially, the income and expenses amount of insurance and finance have increased by more than 40%.

Though it is still some way behind the world's leading financial centres in terms of market openness, market size and the variety and sophistication of products available, Shanghai has evident advantages over many of its regional competitors in becoming an international financial centre, including the back up of one of the world's most dynamic economies and favorable government policies.

However, in the process of finance internationalization, it is inevitable for China to shake some countries' traditional financial status. Compared with competition in the trade and manufacture sectors, future competition between China and US in the financial sector will matter more because financial rise will jeopardize American fundamental interests more seriously than rise in trade and manufacture, and financial friction will also follow.

In addition, even if the future competitiveness of the Chinese financial industry is enhanced, its domestic foundation is weak and still has a long way to go. To promote financial strength, the construction of a financial system, the completion of a financial legal system and cultivation of financial talents are still needed.

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The international financial crisis has exposed the drawbacks of the global financial system. Facing the post-crisis era, the international community has reached a consensus on reforming the global financial system.

This reform is to be carried out at two levels: at the macroeconomic level, to reform the dollar-dominated international monetary system; at the micro-level, to reform the financial operation and regulatory system. So far, the reform has made significant progress: IMF focused on its reforms to increase the share of emerging market countries; in 2010, the United States passed the bill for reforming financial regulation, and the Basel Committee has also adopted the “Basel ”.

Emerging market countries demand a say, reflecting the change in the world economic map. No international economic organization can function well without the participation of emerging economies.

In addition, the crisis has accelerated the transition of the G20 as the core group for global economic cooperation.

A process of liberalization has started, but it will take quite some time before China and other major emerging economies achieve the financial sophistication of the advanced economies. Progress in this respect would make the international monetary system more balanced.