

Insights From Defect Analysis of the Dollar Standard Currency System for Facilitating RMB Internationalization

ZHU Yanfei^{[a],*}; YAO Songwen^[b]; HAN Mei^[c]; GUO Yinghan^[b]; MA Xinrui^[d]; YAN Xun^[e]; HUANG Zhijian^[a]

^[a] School of Foreign Languages, Sun Yat-sen University (SYSU), Guangzhou, China.

^[b] Lingnan College, Sun Yat-sen University (SYSU), Guangzhou, China.

^[c] College of Literature and Law, Chengdu University of Arts and Sciences, Chengdu, China.

^[d] School of Business and Economics, University of Melbourne (UniMelb), Melbourne.

^[e] School of Sociology and Anthropology, Sun Yat-sen University (SYSU), Guangzhou, China..

*Corresponding author.

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Abstract

With the outbreak of the global epidemic in recent years, the economies of all countries are facing severe challenges. It has another impact on the dollar standard currency system since the financial crisis in 2008. The system is in urgent need of reform and has become a consensus. With the promotion and deepening of the Belt and Road, China's internationalization has brought new opportunities and challenges to the internationalization of RMB. Both the economic problems of the system itself and the behavior of the core countries eventually led to the failure of the gold standard and Bretton Woods. China should learn from the failure of the past systems, clarify the positioning of RMB in the international monetary system, and promote the reform of the current international monetary system. Meanwhile, the internationalization of RMB should closely follow the national development strategy, further deepen it through Greater Bay Area policy, achieve a two-way promotion with the Belt and Road, and steadily advance it to serve the real economy.

Key words: The dollar standard; Currency system; The international monetary system; Internationalization of RMB

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Contribution/ Originality: This article contributes by offering a comprehensive analysis of RMB internationalization within the evolving global monetary landscape. It assesses the unique role of China's dual-track monetary system and explores strategies aligning RMB internationalization with domestic development goals.

1. INTRODUCTION

In recent centuries, with the advancement of globalization and the development of international trade, the frequency of transnational trade and investment has become increasingly high. To ensure the safety and stability of currency exchange and trade countries form international monetary system and exchange orders together. Numbers of different international monetary regimes come and go during this period, but all have been disintegrated and rebuilt due to frequent wars and global events, scholars have already researched the reasons.

Scholars hold different views on the reasons for the collapse of the gold standard system and the failure of gold monetization. Qiu and Han (2013) view from the perspective of the nature of gold, the scarcity of gold and the imbalance of its geographical distribution were deteriorating, which leads to mismatching of the growth rate between gold and trade scale. Gold cannot satisfy the demand for trading any more, the differential directly affected the efficiency of trading. Song held a different

point of view in his work *The Currency War* (2007), the gold standard constrained bankers in Europe and America to raise financial resources, so they ignited wars and unrest that eventually broke the gold standard. It is a conspiracy theory that confuses the logic of war and gold standard, but it leads us to think from the perspective of government economic policy. Under the conditions of the gold standard, governments had limited and weak means of adjustment when facing external economic shock (Li, 2008). It explains why European and American countries could get rid of the depression earlier. They first abandoned the gold standard and gained greater autonomy in monetary expansion, adopting more flexible regulatory measures like devaluation and reduction of interest rate (Peng, 2009).

The US dollar has a central position in the Bretton Woods System or Jamaica system. With the collapse of the gold standard in the two world wars, political power plays an essential role in the new monetary system (Li, 2016). The American central bank became the world central bank after the establishment of the gold-dollar standard because the American central bank plays the role of the world central bank, managing the balance of payments in global currencies. Most scholars explain the failure of the Bretton Woods system through the Triffin dilemma. From the perspective of international politics, as long as the basic unit of the international order remains the nation-state, the Triffin dilemma will occur, which embodies the conflict between economic integration and political pluralism (Liu, 1999). From the perspective of the monetary power of the United States, the US government has no institutional responsibility for the dollar's value (Yao, 2010), which is even worse after the breakup of the Bretton Woods system since the US has been free from its most significant constraint. In short, the United States is now suffering from a decline in overall national strength and the credit crisis, and the standard international monetary system of the dollar is being challenged.

According to the newest data from the IMF, in the first quarter of 2022, US dollar assets accounted for 58.88% of global foreign exchange reserves, though they declined compared to the same period in 2021, they still have more than half of the shares. The RMB accounted for 2.88%, a record high and rising. As the world's second largest economy and the world's largest trading nation, China's status in the international community is rising day by day. Thanks to the stable domestic political and economic environment, the hedging property of RMB has been more and more remarkable. Obviously, China's role in the international monetary system has changed. With respect to foreseeable changes in the monetary system, China is not only an observer of the game, but also a player who can influence the situation. It is unrealistic to completely reconstruct the whole system, reforming and optimization will be a better solution. How should China adapt to and participate in this reform and find the path of currency

internationalization that matches China's national conditions? Based on the experience of the evolution of the international monetary system and China's unique advantages, this paper puts forward some suggestions on the strategy of RMB internationalization through the SWOT model.

2. EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

2.1 Gold standard system

The origin of the gold standard system can be traced back to the double standard system of gold and silver implemented in Britain in the 17th century. However, due to the sudden increase in silver production, the sharp change in the price of gold and silver led to the phenomenon of bad money driving out good. In order to rectify the chaos, the British government issued the Gold Standard Act. After a few adjustments in the following years, finally the gold standard system is officially adopted (Qiu, 2014). In the following decades, the gold standard system spread to the world through trades, cooperation and wars. By the end of the 19th century, the gold standard system had been popularized all over the world, and finally formed the world gold standard system.

The gold standard was an inevitable system that ultimately collapsed. With limited international capital flow and less government intervention in the economy, the gold standard effectively prevented countries from over-issuing money and causing inflation. However, as economies grew and international situations rapidly changed, the gold standard gradually failed. The first reason for its collapse was the production of gold, as mentioned by Qiu (2014), who attributed the failure of the gold standard to a shortage of gold. The growth rate of gold output did not match the growth rate of goods trade, affecting the trade efficiency and leading to its eventual elimination. The second reason was war and the deterioration of the international trading environment, with the Smoot-Hawley Tariff Act in 1930 being the "last straw" that led to the prevalence of beggar-thy-neighbor foreign trade strategies worldwide. As a result, countries could not control domestic monetary quantity and prices, leading to instability in both domestic economies and the international gold standard system. Europe and the United States were the first to abandon the gold standard, gaining more liberal policy space and eventually recovering from the depression.

The gold standard system has its flaws, both internally and externally. Internally, the growth of the physical standard only sometimes aligns with the growth of the global economy and trade, which can result in a lack of liquidity. Externally, while the gold standard can provide stable exchange rates during stable periods, it comes at the cost of sacrificing macro-control over the domestic economy. Without the ability to intervene in domestic

economic affairs and currency issuance, a country's economy can become vulnerable to external shocks.

2.2 The Bretton Woods system and the Jamaica System

After the gold standard system, the Bretton Woods System and the Jamaica System were implemented, which were closely tied to the US dollar. The Bretton Woods System was based on a dollar-gold standard, while the Jamaica System was based on a dollar-credit standard. The reason for the dollar's central role in these systems is that, since the end of the 19th century, the US government seized opportunities and adopted effective strategies during several monetary system changes and global social upheavals. This ultimately led to the formation of US monetary hegemony through a long evolutionary process.

After a century of economic depression and global conflict, there was an urgent need for a new monetary system to revive trade and commerce. The US dollar became the international currency for two reasons: First, during the post-war reconstruction, US dollars flowed into countries worldwide, creating a foundation for the US dollar system. Second, the US could supply a large number of dollars with the help of gold inflows, ultimately establishing the dollar international monetary system. However, frequent economic crises in the US led to "bad currency driving out good," as countries sold their dollars, causing continuous depreciation and a mismatch between US gold reserves and the dollar supply (Wang, 2010). Eventually, the US could no longer maintain the gold peg, and the system collapsed.

The Jamaican system more fully represents American ambitions compared to the former. After the dollar was decoupled from gold, the US government had to rely on geopolitical factors to maintain its value, leading to a foreign policy characterized by militarism and unilateralism (Henry & Liu, 2007). While it is commonly believed that the dollar's status was weakened by its decoupling from gold, it has replaced gold as the most widely recognized symbol of wealth worldwide. As a result, the monetary power of the dollar has not diminished but has dramatically increased in the Jamaican system (Yao, 2010).

From an internal perspective, the system could not avoid the Triffin Dilemma, which states that the US cannot maintain both the stability of the dollar's value and a long-term trade surplus. Externally, the US government could not guarantee sufficient gold reserves in the late Bretton Woods system. A strong US economy and stable domestic political environment were also required under the dollar-centered system; otherwise, US domestic issues would impact the global economy through the monetary system. The US's excessive privilege resulted in irresponsible behavior, as it prioritized its own national interests without considering the risks and losses shared by other countries. This has made the situation unstable.

3. DEFICIENCIES OF THE DOLLAR STANDARD

3.1 Triffin Dilemma

Robert Triffin, an American economist, pointed out the defects of the Bretton Woods system at the very beginning of its establishment, predicted the collapse of the system, and put forward the idea of establishing an ideal system of super-sovereign currency. Triffin dilemma deepens people's understanding of the international monetary system, which is one of the most outstanding intellectual contributions.

Triffin (1997) pointed out in the *Gold and Dollar Crisis - The Future of Free Convertible* that currencies are not directly linked to gold but to the dollar, thus the dollar becomes the core currency status. Among international trades, the dollar settlement can meet the trade demand, and its uniformity and high efficiency are also accepted. The world gradually uses and reserves the dollar passively. As a result, the US dollar is continuously exported and accumulates around the world, which led to a long-term deficit in terms of the US balance of payments. The system requires a stable and strong core currency, which requires the US to be a long-term surplus country. This is the Triffin Dilemma. Wang and Jiang (2021) pointed out that the Triffin dilemma can also be understood as the liquidity and liquidate dilemma, that is, the core currency country cannot take into account the money supply and money liquidity at the same time. Despite Triffin's prescience, Triffin dilemma persisted in the subsequent decades of the international monetary system. In the latest credit standard system, the Triffin problem is manifested as the contradiction between meeting the international solvency and maintaining the confidence of the dollar. The credit of the United States is the core of the current international monetary system.

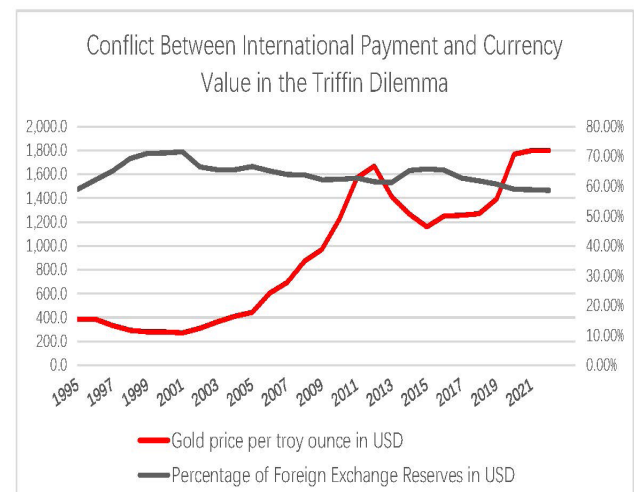


Figure 1
Conflict Between International Payment and Currency Value in the Triffin Dilemma

Source: Gold Price History Chart | Gold Price Trends | Goldhub, Currency Composition of Official Foreign Exchange Reserve - IMF Data

The currency of economy and political powers is the optimal solution for an international currency. In recent decades, the US has led the world in political and economic development, and despite fluctuations and crises, the dollar standard system has operated relatively stable. The accumulation of dollar assets worldwide and US political and economic power growth have not weakened confidence in the dollar, but has it solved the Triffin Dilemma? Liu (1999) answered: No. While there may not currently be a severe crisis of credibility for the dollar, there is no guarantee that the system is not a dormant volcano that could erupt again. No one can be sure that US political and economic power will always remain at the top, and the recent rapid rise of China and its strong performance during the pandemic has further impacted this belief. As the world becomes more interconnected and different currencies gain prominence, countries may alter their international reserve holdings. This could result in the return of the Triffin Dilemma.

3.2 Exorbitant privilege of America

Apart from the internal causes of the system itself, the behavior of the main body of the system, the United States, is also the main reason for the turbulence of the international monetary system and the frequent occurrence of global economic crises. About the mechanism of the US dollar system, Li (2021) concluded that the first is the dollar pricing mechanism of oil transactions. As early as the 1970s, the United States found that any country needed oil for development, so after decoupling from gold, it quickly reached an agreement with the United Kingdom and other countries, so that all countries in the world need to use dollars to settle oil imports. Second one is the commodity dollar return mechanism, while the United States is the final commodity market, the dollars earned by exporting countries from the United States will eventually flow back to the United States through the capital market. Finally, the foreign currency valuation mechanism of the United States. Almost all foreign debts of the United States are denominated in dollars, so creditor countries are more worried about the depreciation of the dollar than the United States, so they will maintain the floating exchange rate against the dollar through the foreign exchange market.

Under such a regime, the dollar system greatly magnifies America's prerogatives. As mentioned, the US central bank acted as the world's central bank from the gold-dollar system. However, there were no institutional constraints on the US government, bringing great uncertainty to the global monetary system. Hegemony led to unilateral and self-interested behavior by the US, considering only its domestic economic cycle when adopting expansion or contraction policies, leading to the creation and collapse of economic bubbles worldwide and inspiring the phenomenon of dollar tide (Liu, 2022). As the largest goods market, the US could print money

or issue bonds to enjoy low-priced goods from other countries without considering dollar depreciation. Creditor countries were more worried and maintained the exchange rate, while the US set up obstacles to limit the return of dollars to its domestic market to avoid depreciation. Yao (2010) also analyzed the causes of US dollar hegemony under the Jamaican system from a monetary power perspective, such as its almost unlimited delay power, lack of issuance constraints, and pass-through solid power.

In international politics, the US uses its hegemony in the dollar and advanced financial market systems to economically and financially regulate hostile countries, a common tactic for suppressing rivals or potential rivals in recent years. He et al. (2022) explained that by the end of 2020, the US had imposed 36 economic and financial sanctions, with 20 explicitly targeting countries and 16 occurring after 2000. The most recent example is the financial sanctions imposed on Russia during the Russia-Ukraine conflict, related to the underlying dollar hegemony. By restricting Russia's use of the international settlement system and blocking its commodity exports, the US aimed at damage its economy.

In general, the US has historically seized opportunities to integrate the dollar into the international monetary system. It uses its muscular economic and financial strength and various political means to establish hegemony in currency, finance, trade, and politics. From the Asian financial crisis at the end of the 20th century to the global financial crisis in 2008, the instability of the current dollar standard system has resulted in global development imbalances. Since the pandemic, the Federal Reserve's continuous quantitative easing policy has led to a surge in dollar reserves worldwide. However, continued implementation of this policy will not only impact the US but also cause countries like China, which hold large amounts of dollar reserve assets, to suffer significant losses (Wang, 2022).

4. SUGGESTIONS ON RMB INTERNATIONALIZATION

4.1 Current status of the reform of the international monetary system

Even before the creation of Bretton Woods, British economist John Maynard Keynes recognized the system's flaws and dangers. Triffin also warned countries about the system's defects and predicted the collapse of Bretton Woods. However, the subsequent Jamaican system had similar roots and origins and shared the same drawbacks. In 1969, following reform proposals from scholars like Keynes and Triffin, the International Monetary Fund (IMF) created a super-sovereign unit of account, the Special Drawing Rights (SDR), also known as "paper gold." While the SDR met the requirement of super-sovereignty, its creation has not had the expected impact and its

role has been insignificant. This is because the dollar's weight in the SDR and the US's share in the IMF are both the highest, and the SDR competes with the dollar, undoubtedly restraining its development. Additionally, SDR issuance has always been insufficient to meet growing global trade demand, and complex international political factors behind the monetary system weaken its role due to its lack of belonging to any sovereign country. Apart from the SDR, the pound and yen have struggled to regain their glory after a century of turmoil due to economic weakness. The euro, an excellent example of currency regionalization, experienced stable development in its early stages but was later impacted by unbalanced development within the European Union and internal constraints leading to the European debt crisis, reducing its competitiveness and credit to some extent (Wang, 2022).

In the foreseeable future, the core currencies of the international monetary system will remain sovereign currencies. Han (2009) summarized the supporting factors for an international currency, stating that it must meet the requirements of convertibility and stability. Stability requires steady internal purchasing power and a steady external exchange rate. For a country to have an international currency, it must have economic strength and sufficient foreign trade scale, as well as a developed and open financial system and wide-ranging cultural and political influence, as confirmed by the historical rise of US and UK currencies. Maintaining system stability and promoting currency development requires not only correct diplomatic strategy but also a firm national position and values.

The Implementation Rules of RMB Cross-border Trade Settlement published by the central bank in 2009 is the sign of the official start of the RMB internationalization process. At the same time, a large-scale RMB offshore market has been initially formed. On October 8, 2015, the RMB cross-border payment system was successfully implemented, and the RMB was officially included in the SDR currency basket.

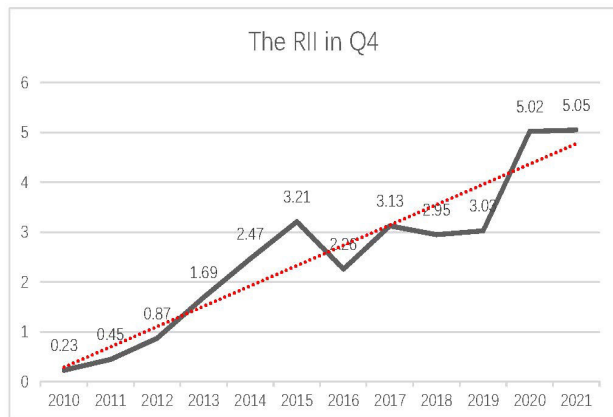


Figure 2
RII (RMB Internationalization Index) in Q4 since 2010
 Source: Report on Renminbi Internationalization from International Monetary Institute of Renmin University of China.

According to the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the share of RMB in international payments surpassed Japanese yen in January 2022 with a share of 3.2%, becoming the world's fourth payment currency, breaking the historical high. The official foreign exchange Reserve Currency composition (COFER) data released by the IMF showed that in the first quarter of 2022, the RMB's global foreign exchange reserves increased by 1.8% compared with the "basket", reaching 2.88%, ranking fifth among significant reserve currencies. In May, the IMF raised the weight of the RMB in the SDR from 10.92 percent to 12.28 percent. Undoubtedly, China has made outstanding achievements in RMB internationalization over the past decade. In the future, the author will make an analysis and suggestions on how to continue prudently promoting RMB internationalization.

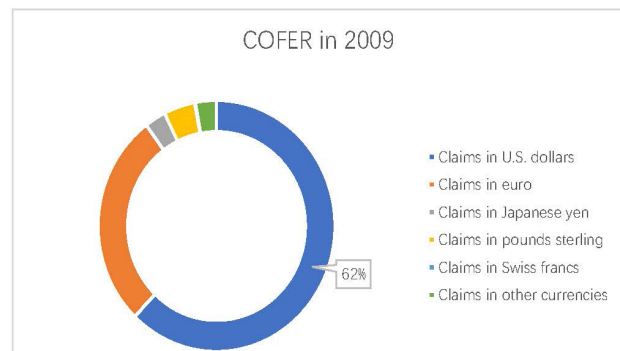


Figure 3
COFER in 2009

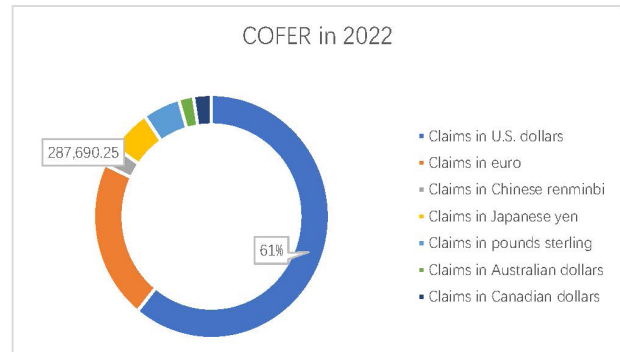


Figure 4
COFER in 2022
 Source: Currency Composition of Official Foreign Exchange Reserve - IMF Data

4.2 SWOT analysis

The author believes that the internationalization of RMB should learn from the lessons of the collapse of the previous monetary systems while not taking the old road of complete internationalization of the dollar and discover the road of currency internationalization with Chinese characteristics, in line with China's national conditions and the needs of the global economy. In the following, we

will use SWOT analysis to construct a matrix from four perspectives and combine different perspectives to make recommendations.

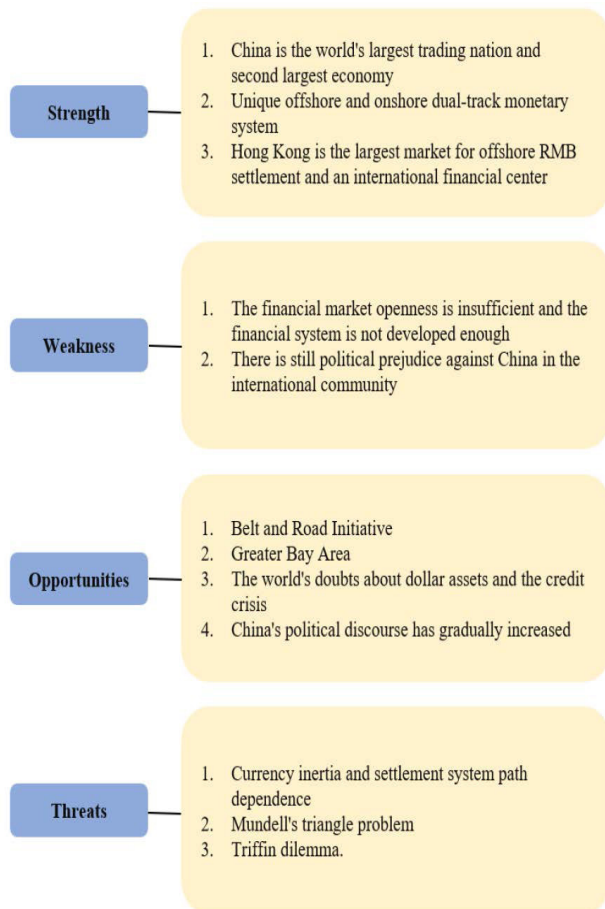


Figure 5
SWOT analysis

4.3 Strategy suggestions

4.3.1 Open up the financial market and improve the investment environment (S3+O3+W1)

In addition to its strong economic and military power, the US has achieved its current hegemonic status due to its efficient and developed financial market. The development and efficiency of a country's financial market greatly affects the liquidity of its currency as an international currency. While China's financial market is large, it still lags behind European and American countries regarding market maturity, operational efficiency, and financial regulatory system. China can seize the opportunity of green investment to establish the world's most mature, largest, and most open green investment market, continuously optimizing its investment environment to attract global investment.

On April 1, 2020, China's financial market officially opened up, which is a milestone in the development of China's financial market. By opening the financial market,

introducing foreign companies, taking the advantage of foreign financial systems and operating under the legal background of China, the competition between domestic and foreign enterprises in the financial market is promoted, the existing financial system is optimized in the competition, and the development of the local financial industry is also promoted at the same time.

In order to slow down the deterioration of global warming, the world is reducing carbon emissions. ESG (environment, society and governance) has become a global investment hotspot, and the rise of global green investment has brought opportunities to RMB internationalization. China's green finance market, represented by Hong Kong, is rising, injecting new impetus into RMB internationalization. According to the goal of a carbon peak by 2030 and carbon neutrality by 2060, China has established the world's largest carbon resource trading market. RMB will be linked to carbon in the future, which is expected to become the mainstream of investment. As the types of green bonds in our country increase and the market scale expands, the investment scale of global investors will also increase steadily. RMB can be used as the valuation and settlement currency of green finance, expand cross-border payment use scenarios, and promote RMB internationalization.

Financial institutions can innovate products, use the relative advantage of our country's current high interest rate, and continuously promote offshore RMB business to improve our financial market's openness. The continuous depreciation of the RMB will directly affect the internationalization level of the RMB. A stable exchange rate can enhance the confidence of global investors in RMB assets and stimulate investment to a certain extent. At the same time, it can stabilize RMB's internationalization level and promote its development. Therefore, the relevant government departments should reasonably adjust the relevant exchange rate policies.

4.3.2 Deepen the development of the offshore RMB market and develop RMB pricing business (S2+S3+O2+T2)

Mundell's triangle problem Is famous in international economics. No country can achieve capital account liberalization and a fixed exchange rate system without monetary policy autonomy, that is, the three cannot be compatible at the same time (Liu,1999). However, while promoting the internationalization of RMB, the offshore market developed by China is unique. The development of both offshore and onshore markets gives China the freedom to intervene in the domestic economy under the condition of capital account liberalization and a stable exchange rate, which overcomes the triangle problem to some extent. Although the cost is to set up barriers to the return of offshore RMB to protect the RMB exchange rate and reduce the willingness of investors to hold RMB, we can deepen market development, strengthen

policy support and pay attention to the risk control while improving the degree of openness, enrich offshore RMB products, and expand the return channel of offshore RMB. Achieve the goal of promoting a positive circulation of the RMB onshore and offshore markets.

4.3.3 Promote RMB settlement along the Belt and Road to promote win-win multilateral cooperation in Asia (S1+W2+O1+T1)

In the context of the development of the Belt and Road, strengthen regional cooperation to establish an RMB settlement circle, learn from establishing an RMB settlement circle in the eurozone, and deepen the regionalization of RMB. On the other hand, export high-quality infrastructure services, and improve China's international recognition and the international status of RMB. Create conditions for international financial cooperation and development, such as signing RMB cooperation agreements with countries along the Belt and Road and setting free trade areas. At the same time, the trade deficit in the foreign trade of the Belt and Road will ensure the supply of RMB to the countries along the Belt and Road and expand the influence of RMB.

In the process of regionalization, it will force the development of the domestic financial market. Also, it can promote RMB's cross-border payment system and speed up digital RMB research and application. Use CIPS to conduct settlement business, reduce the path dependence on the SWIFT system in international trade, and increase RMB application scenarios.

4.3.4 Promote further reform and development of the SDR (O4+T3)

In 2022, the IMF Executive Board completed the review of the valuation of the Special Drawing Rights (SDR) every five years and raised the weight of the RMB from 10.92 percent to 12.28 percent, keeping the RMB in third place. The rise of the RMB and China's international status has brought more discourse power to China, which means that it can speak for more developing countries and change the status quo of dollar hegemony. Krugman once pointed out that international currencies are inert, and the world's recognition and use of international currencies are lagging behind. While the internationalization of RMB is progressing, we can actively promote the reform and development of SDR through initiative and cooperation, play its role, and benefit more countries to weaken the hegemony of the US dollar.

To reduce reliance on the US dollar and tackle currency inertia, it is advisable to increase the distribution of SDR and improve its liquidity. Being a non-sovereign currency, SDR has the potential to overcome the Triffin dilemma. Therefore, issuing more SDR would be a beneficial move. The second is to promote the pricing function of SDR in national trade, to reduce the risks and losses caused by the economic fluctuations of the countries in which the pricing currency belongs. Finally, more countries should

be invited to join the SDR basket. On the one hand, the excessive weight of individual national currencies should be balanced. On the other hand, its super-sovereign nature should be deepened, and it should indeed be the world's currency.

4.3.5 Continue to develop the real economy and strengthen the economy (S2+T1)

The internationalization of the RMB and China's economy are still in development, which cannot be separated from the support of economic power. The financial industry and RMB internationalization should be guided by serving the real economy, the "double cycle" development pattern, and promoting the construction of a large domestic market. Build up manufacturing power to improve the international competitiveness of commodities and industrial hollowing out. We should focus on emerging economic growth areas, be market-driven, foster a sound market environment, attract foreign investment, and increase confidence in the Chinese economy.

5. CONCLUSION

The process of RMB internationalization has reached a new stage, where gradual promotion should shift into an accelerated period. China should take comprehensive yet cautious steps to speed up the development process steadily. It is essential to reflect on past experiences and learn from them regularly, strive for mutually beneficial partnerships in both politics and economics, promote diverse growth in all nations, and support collaborative efforts involving multiple parties. To fully utilize China's distinctive system, we must prioritize catering to the needs of our domestic real economy. It is imperative to exercise prudence in pursuing currency internationalization, as it should come from something other than the cost of our domestic economy or the economies of other nations. In the international community, optimizing and reforming the international monetary system to check and balance hegemony is proposed. Based on the long-term goal, assume the responsibility of a major country.

NOTES ON CONTRIBUTORS

Dr. *Yanfei Zhu* (Corresponding author) is a Special Associate Researcher at Sun Yat-sen University. She obtained Ph.D. degree, visited and studied at the University of Cambridge, UK. Her research interests include second language education and Comparative Education of Chinese as a Foreign Language and Cross Culture. Her publications have been published in magazines such as *Contemporary Education Science* and *Canadian Social Sciences*.

Songwen Yao is currently a student at Lingnan College, Sun Yat-sen University, specializing in International Business. With a strong passion for global economics,

monetary finance, international trade, and international marketing, he is dedicated to exploring various facets of international business. Although he has not yet published any research articles, he actively engages in in-depth research within his chosen field.

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