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Is the U.S. Dollar Losing its Momentum as a Global Leader - Will the Renminbi Change the Future?

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ABSTRACT

Since the financial crisis, a significant decline in the value of the U.S. Dollar (USD) has influenced its international standing as a currency. In order to side-step the volatility, many countries have been taking steps to make themselves less dependent on the USD. Therefore, people doubt whether the position of the USD as the leading currency is still stable. This study discusses the future of the Chinese Renminbi (RMB) and the USD. Although the reign of the USD in the international monetary system will not change in the immediate future but the Euro and the RMB might be bigger challengers of the USD in the future. This study several areas where RMB may become a viable alternative or at least pose some challenge to USD in the long run

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INTRODUCTION

After the First World War, due to the loss from the war and the rise of other countries, the United Kingdom gradually lost its dominance as international reserve currency. In 1931, the United Kingdom abandoned the gold standard and its supremacy was finally replaced by the Dollar. From then onwards, the world began to enter the century of the US Dollar (USD). In the 20 years in between World War I and World War II, the international monetary system split into several currency groups, each of which compete with each other for its own profit. After the World War II, the economic power and military force of the U.S. made them superior and at the same time made the USD a strong currency in the world. In July 1944, the Bretton Woods Conference made an agreement on the convertibility of the USD to gold and to peg currencies of all the member countries to the USD, which established its global primacy.

The dominance of the dollar declined when the economy gradually recovered in the European countries which saw the flaw of the fixed exchange-rate system. In 1971, the U.S. unilaterally terminated convertibility of the USD to gold, ending the Bretton Woods system and leading the world to the era of freely floating currencies.

In the early 1980s, the US had a significant increase of foreign trade deficit. On the other hand, Japan became a strong competitor to the US economy. To ameliorate the US disequilibrium, the Plaza Accord was signed between France, West Germany, Japan, the United Kingdom, and the US to depreciate the USD in relation to the Japanese Yen and German Deutsche Mark. Although the Plaza Accord strengthened the position of the Japanese Yen in the international monetary system to compete with the USD, it triggered a severe recession in Japan in the late 1980s and continued to influence the Japanese economy for several decades forward. In 1987, the Louvre Accord was signed to halt the continuing decline of the USD.

In the 1990s, the rapid development of information technology saw the U.S. achieve ten years of continuous economic growth and expand their advantage over other major economies in the world. At the same time, many emerging economies were experiencing very high growth which encouraged large inflow of funds into these countries. But as these countries started experiencing large current account deficit and other macroeconomic instabilities, these hot money were quickly withdrawn from them, resulting in the significant devaluation in these emerging countries' currencies. The economic crashes, such as the 1995 Mexican Financial Crisis, the 1997 Asian Financial Crisis and the 1998 Russian Debt Crisis, strengthened the power of the USD but at the same time revealed the flaw of the International Monetary System (IMS). However, from 2008, the global financial crisis, which started in the United States, impacted the confidence of the dollar-led international

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Australian Journal of Basic and Applied Sciences, 8(23) Special 2014, Pages: 359-365

monetary system and the status of the USD. The future of the USD again drew public attention. Two questions arose: will the USD still reign? Who will be its potential challenger to change the current currency system?

The main objective of this paper is mapping the changes China made after 2008 and analysing the trend of the RMB and the USD. The paper is divided into four parts. The first part introduces the shift from the dominance of the British pound to the US dollar where the USD has enjoyed the sole global currency status for over sixty years. The second part discusses the factors that support the currency as an international currency and concludes the USD's reign is unbeatable from the point of view of the literature. The third part maps and analyses the internationalization of the RMB, one of the potential challengers of the USD. The last part mentions that although the economy is on a downward trend, if the reform goes successfully, the RMB has a brighter future in the long term. The USD's primacy will not change in the immediate future. However, since the current currency system has brought about the global economic instability, the USD may not keep its reign in the long term.

Literature Review:

Discussions of the reign of the USD as the top international currency must begin with the factors that make the currency international. Helleiner (2008) concluded there are three key economic determinants of international currencies: stable value which is confidence, well-developed and open financial markets which is liquidity, and the extensive transactional networks. He suggested to study currency's future by the view of politics. Brenner (2006) stated monetary mismanagement as the reason of the instability of the USD. He suggested to use the gold price or other forward- looking market price as a stable anchor for the USD.

Kirshner (2008) discussed the reasons for the decline of the dollar. He stated the enormous and dynamic economy, the robust and deep capital markets, the political stability, and the unmatched physical security are good reasons to explain why the USD remains dominant. On the other hand, the massive debt, account imbalances, the emergence of Euro, and the distinct geopolitical setting reduced the power of the USD as a key currency. Parsad (2013) discussed the global economic crisis and how it did not make the prominence of the USD decline but actually increased its value.

Katada (2008) evaluated that Japan will not be a challenger to the USD. He stated that the USD will remain dominant in the near future. Bowles and Wang (2008) analysed the future of the USD based on the economy and policies of US and China and discussed the possible future trends in the three key variables. They also stated that China is unlikely to replace the USD.

Otero-Iglesias and Steinberg (2013) theoretically examined that the Euro could be one of the representative of a multipolar IMS. They stated that the attention should not only narrow to the top currency but to the structure as a whole. Otero-Iglesias and Zhang (2014) explained that the Triffin dilemma is a fundamental flaw in the current international monetary regime and stated that the SDRs currency basket should be expanded to include more currencies of emerging economics such as China's Renminbi. They discussed the reason why the impact of the EU-China collaboration is not much. Komijani and Tavakolian (2011) analysed the data by using the kalman filtering model to show that the share of Euros in foreign reserves has increased and that the Euro has become a challenger for the USD. Quah (2012) studied the potential of Japan or China replacing the US as a monetary anchor country for Hong Kong and Macau by using the optimum currency area theory. He shows evidence of the relative importance that Japan might replace the dollar for Hong Kong, and China, for Macau.

USD, Euro and RMB – Three Pillars in the Future:

All the studies reviewed made a consensus that the USD is unbeatable at least in the near future, since there is still no currency as strong as the USD. But in the long term, the declining of the importance of the USD is unavoidable and there are two alternatives for the future of the dollar. One is to create a super-sovereign currency and the other is a multipolar reserve currency system. (Otero-Iglesias and Zhang, 2014). The former way is hard to realise in the near future, but the multipolar reserve currency system might be created. The Euro and the RMB were considered as potential challengers for the USD and they are good currencies for the potential basket of currencies that some nations are adopting. Although the Euro is the second largest reserve currency, the ECB refused to promote the internationalization. If there is no active political commitment by the authorities, the currency cannot become a top international currency (Otero-Iglesias and Steinberg, 2013). Therefore, the study focuses on the exploration of the RMB.

Chinese Renminbi' s Internationalization – An Experiment:

While the Euro let the market decide the internationalization process, the Chinese Renminbi (RMB) started to push for the internationalization process. On 10 July 2008, the state council of China approved to set up an Exchange Rate Division which is its Monetary Policy Department II. The function of the new division was to develop a RMB offshore market based on the process of RMB's internationalization (People's Bank of China, Public Information). This is a mark to show that the government of China had started to build an international currency.

Australian Journal of Basic and Applied Sciences, 8(23) Special 2014, Pages: 359-365

Bilateral Currency Swap Agreements - Test the Water:

From the end of 2008, the People's Bank of China started to sign bilateral currency swap agreements with other countries. The financial crisis encumbered the economy of the countries which held a large amount of dollars. Using other currency for international trade became a good choice to reduce the impact of relying on the dollar. China grasped the opportunity and stepped to explore the internationalization of the RMB. Currency swap agreements provided a chance for China to estimate the current demand of using RMB as a trade settlement currency and incentive international trade as well as the RMB compositions of those countries' foreign exchange reserves. On the other hand, the agreement can also reduce exchange loss for cross-border transactions.

Bilateral Currency Swap Agreements – Wide Scope, Stable Increase, and Mutual Interest:

Until 2013, the total amount of the bilateral currency swap agreements was 3186.7 billion. There are 23 currency authorities who signed the agreement, in which 11 countries and Hong Kong are in Asia; 6 countries and European Central Bank are from Europe; 2 counties are from Oceania; and 2 countries are in South America. About 66% of the total RMB amount of all agreements are from Asia; 19% are from Europe; 8% are from South America; and 7% are from Oceania (Table 1). Currency authorities whose agreement amounts are over 5% in the total, are Hong Kong Monetary Authority, Bank of Korea, Singapore, European Central Bank, Bank Negara Malaysia, Bank of England, Reserve Bank of Australia, and Central Bank of Brazil. (Chart 1). Based on Chart 2, the trend of the expansion for the currency swap fluctuated upwards. The number of new agreements and the RMB amount in the agreements positively related in the first 5 years. In 2010 and 2012, there were two sharp decreases which cannot simply indicate sluggishness. This could be explained in the following which is about RMB direct trading.

Based on the data collected, during the past six years, the development of currency swap agreements had the following traits geographically, economically and politically: Geographically, the agreements weaved a net to encircle the world by using the related countries as publicity and a springboard. The number of countries in the agreement increased. Among the 6 countries in Europe, one was in Western Europe, one in Northern Europe, one in central Europe, one in Southern Europe, and two in Eastern Europe. The European Central Bank covers members of the European Union. They are like representatives covering the area.

From an economic perspective, some of the related developed countries, who want to have a piece of the pie from China's growing economy, have strong ambitions to capture the chance of being the RMB's offshore trading center while the others who have been impacted by the volatility of the USD are ready to find a harbor in case of another crisis and want to get loans to support their economic construction. As a global financial center, London used to play a vital role during the process of the internationalization of the USD and Yen. George Osborne, UK's Chancellor of the Exchequer, said Britain wanted London to be a leading western hub of offshore RMB trading (China Daily, 18 April 2012). After the financial crisis of 1997, a lot of Korean companies in China had a hard time due to liquidity shortage. This is in part they needed USD to trade. But fast forward to the present time, they can simply RMB to trade directly with China. This in in part because China and South Korea recently agreed to allow direct trading between RMB and Korean Won. This help form a direct foreign-exchange rate between the two currencies, reduce currency conversion costs and promote RMB and Won's use in bilateral trade and investments.

From a political view point, many countries and blocs (e.g. EU) are more willing to have stronger ties with China today as opposed to the past because they see many other benefits (besides increased trade and investments). Increasing political clout of China in the global arena, and the increasing use of RMB in bilateral trade and the potential for rise in RMB and the perceived decline of the USD in the long run are some of the reasons why these countries are announcing these political relationship with China. It will be interesting to see how the changes in the position of the RMB in the global market is slowing changing this new forward by many countries.

Table 1: Bilateral Currency Swap Agreements Signed by People's Bank of China

Date	Authority of the Currency	Swap Agreement Amount (*RMB in billion*)	Note
2008.12.12	Bank of Korea	180	Valid for three years, extended by mutual consent.
2009.01.20	Hong Kong Monetary Authority	200	
2009.02.08	Bank Negara Malaysia	80	
2009.03.11	National Bank of the Republic of Belarus	20	
2009.03.23	Bank Indonesia	100	
2009.04.02	Argentine Central Bank	70	
2010.06.09	The Central Bank of Iceland	3.5	
2010.07.23	Monetary Authority of Singapore	150	
2011.04.18	The Reserve Bank of New Zealand	25	
2011.04.19	The Central Bank of the Republic of Uzbekistan	0.7	
2011.05.06	Bank of Mongolia	5	

Australian Journal of Basic and Applied Sciences, 8(23) Special 2014, Pages: 359-365

2011.06.13	National Bank of Kazakhstan	7	
2011.10.26	Bank of Korea	360	Renewed and expanded to double the size of swap.
2011.11.22	Hong Kong Monetary Authority	400	
2011.12.22	Bank of Thailand	70	Valid for three years, extended by mutual consent.
2011.12.23	State Bank of Pakistan	10	
2012.01.17	Central Bank of the United Arab Emirates	35	
2012.02.08	Bank Negara Malaysia	180	Renewed and expended
2012.02.21	Central Bank of the Republic of Turkey	10	Valid for three years, extended by mutual consent.
2012.03.20	Bank of Mongolia	10	Renewed and expanded to double the size of swap.
2012..03.22	Reserve Bank of Australia	200	Valid for three years, extended by mutual consent.
2012.06.26	National Bank of the Ukraine	15	
2013.03.07	Monetary Authority of Singapore	300	Renewed and expanded to double the size of swap.
2013.03.26	Central Bank of Brazil	190	Valid for three years, extended by mutual consent.
2013.06.22	Bank of England	200	
2013.09.09	National Bank of Hungary	10	
2013.09.12	Bank of Albania	2	
2013.09.30	The Central Bank of Iceland	3.5	Renewed
2013.10.19	European Central Bank	350	Valid for three years, extended by mutual consent.

Source: People's Bank of China, Public Information Compilation

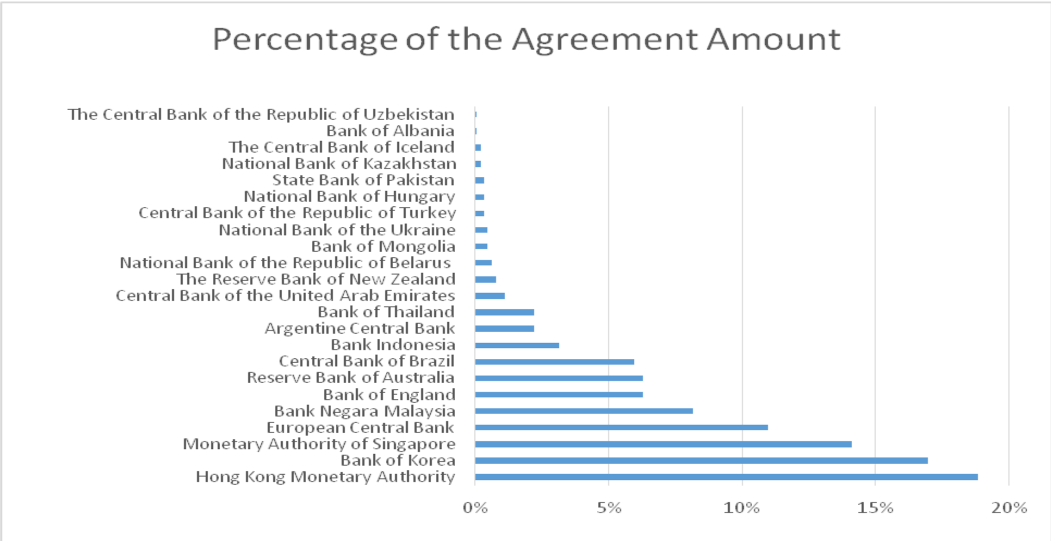

Chart 1: Percentage of the Amount Signed in Bilateral Currency Swap Agreements from 2008-2013.

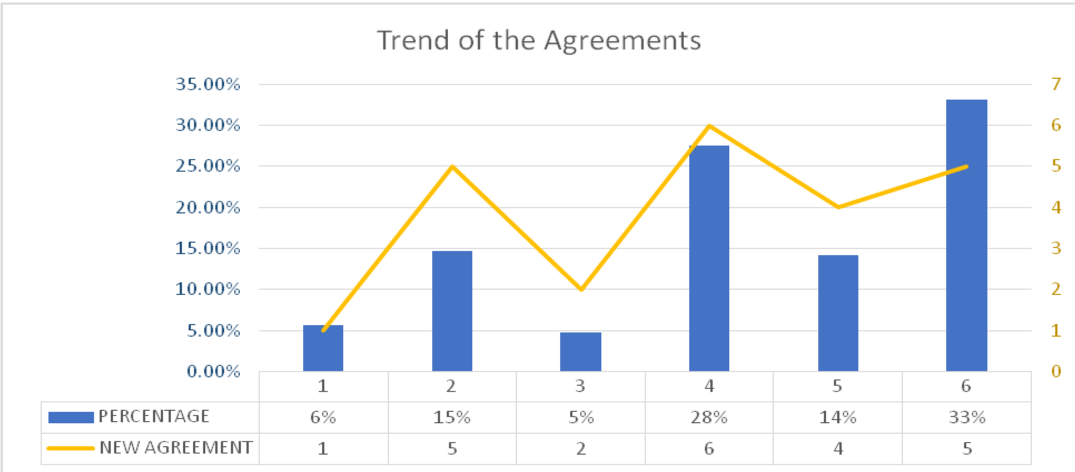

Chart 2: Trend of the RMB amount & the Number of New Agreements Signed in Bilateral Currency Swap Agreements from 2008-2013

Trials of Settling Cross-Border Trade Accounts in RMB – The Start of Becoming the Settlement Currency:

After conducting several feasibility studies in the mid-2000s and pegging the RMB to a basket of currencies rather than USD alone, the State of Council of China decided to move forward with making RMB the settlement currency. In April 8, 2009, they announced the opening of four cities in southern China as the settlement centres of cross-border trade accounts in RMB. These cities are Shanghai, Guangzhou, Shenzhen, Zhuhai, and Dongguan. In the same year on 1 July 2009, the related administration measures came out (The Announcement of PBC 2009, No.10). The reason for choosing those cities is that they are close to Southeast Asia where the transactions happen frequently. In June 2010, the trials expanded to 20 provinces which covered about 60% of China (The Announcement of PBC 2010, No.186). Since then, the process of the RMB internationalization stepped into the first level which is to become a settlement currency. How long will RMB stay at the first level? It depends on whether people want to use RMB after this choice is put in front of their eyes.

Direct Trading with Ringgit, Ruble, Yen, Australian Dollar, and New Zealand Dollar – Connections:

When a store has set up and goods that are to be sold have been decided, the thing left is to find some reliable vendors. With the authorisation of the People's Bank of China since 19 August 2010, the trading between the RMB and the Malaysian Ringgit (CNY/MYR) was to be listed on the interbank foreign exchange market with a 5% plus or minus float per trading day. Since 22 November 2010, the Russia Ruble and the RMB (CNY/RBU) can be traded in the interbank foreign exchange market which were allowed to float 5 % plus or minus the central parity within any trading day. From 1 June 2012 onwards, direct trading between the RMB and the Japanese Yen (CNY/Yen) was launched. At the same time, China continued expanding the bilateral trade by the currency swap agreements. On 10 April 2013, direct trading between the RMB and the Australian Dollar (CNY/AUD) was launched. In the following year, on 19 March, the RMB and the New Zealand Dollar (CNY/NZD) could be traded with a 3% plus or minus the central parity float within any trading day (Public Announcement of China Foreign Exchange Trade System, 2010, 2012, 2013, 2014). Therefore, as of March 2014, there are five direct trading currencies with RMB in the interbank foreign exchange market which are the Malaysian Ringgit, the Russian Ruble, the Japanese Yen, the Australian Dollar and the New Zealand Dollar. Since 2010, China's use of RMB as the direct trading currency doubles each year. This obviously shows China's determination for the internationalization of RMB. Using RMB as the trading currencies has provided some relief to Chinese importers and exporters because the reduce exchange rate risk and exchange loss.

China Pilot Free Trade Zone – The Acceleration of the Internationalization Process:

When we have got some vendors and we are ready to sell, we need to let everybody come and know that we have better goods. China tried to make further efforts to change the market environment in order to attract more trade. On 22 August 2013, China (Shanghai) Pilot Free Trade Zone, an area inside the border but out of the customs, was approved by the state of council of China which allowed free RMB convertibility under the capital account and allowed the market to decide prices of financial institutions' assets. China's Free Trade Zone focused on liberalisation and convenience of trade. This reform is based on the background that the economy of China is facing the decline in external demand and increase in trade protectionism. There is a need for incentive and to change the market. Even though China has already taken more than 5 years to push the process of RMB's internationalization while the US was recovering from their economic crisis, the real feedback of the first level to show that 'RMB is widely used in the normal international transaction' is still not coming .

Further Opening Capital market – A Task for Now and Future:

In the announcement of the People's Bank of China (2011, No.1), to cooperate the trails of settling cross-border trade accounts in RMB, the People's Bank of China issued the regulation about direct RMB investment. In order to improve their effectiveness and their efficiency, in July 2013, the People's Bank of China announced the simplified process of cross-border RMB transactions (PBC Notice 2013-7-5). In April 2014, Li Keqiang, Premier of China, indicated that further opening up the services sector, including the capital market is an important part in the future. He said China will establish a Shanghai-Hong Kong stock exchange connectivity mechanism, and further promote a two-way opening-up and healthy development of the capital markets on the mainland and Hong Kong. The direction of the future reform will be raising the level and quality of opening-up through deeper integration with the international market.

Renminbi' s Position in the Internationalization Process – A Good Start and a Good Future:

As discussed in the first part, an international currency needs three characters, stable value which is confidence, well-developed and open financial markets which is liquidity, and the extensive transactional networks. For the first part, the RMB is appreciating in these years, but the recovery of the US economy and the reform in China will make the value of RMB unstable in short term. For the second part, which is the biggest the problem for RMB, it has a bright future based on the reforms China is going to have. For the third part, China is on her way to achieve it and the reward will be seen in near future.

The Competition between RMB and USD:

Sixty years after the US economy surpassed Britain, the USD replaced the pound. From the historical point of view, even if the economy of China kept growing, there seems to be a long way to go before the RMB can come to replace the USD. However in the last few years alone, what China has done influenced the other countries in the world (especially its' Asian and other key global trading partners) has highlighted the fact that China is very serious in its mission to bring RMB as a global currency and more importantly not to be very dependent on USD. Give the many possible problems that USD may face in the future, especially the problem with the increasing US debt. Some countries are beginning to show sign of supporting the idea of RMB internationalization. Most recently, China's central bank announced that it will allow direct trading between RMB and the euro in the interbank market. This direct trading is the biggest yet because now RMB trades directly with the world's second-most actively traded currency (euro) and it is a significant step in RMB's globalization efforts (The Asian Wall Street, September 30, 2014).

The Threats and Future for Renminbi' s Internationalization:

For China, the power of the currency links firmly with the power of economy and politics. China faced a lot of disharmony in and out of the country with the newly formed fifth generation of leadership. This generation's leadership is firm and resolute, according to the treatment of anti-corruption and sovereignty dispute. The general population seems to have high expectation under this new leadership. For example, the reforms of the economy opens financial market and hastens innovative businesses. The Premier Li, Keqiang indicated that as long as there is fairly sufficient employment and no major fluctuations, the actual GDP growth will be considered to be within the proper range, be it slightly higher or lower than the 7.5% target. The economy has a downward pressure. Also from the lesson learnt from Japan in late the 1980s, China should implement the new currency acts in a moderate manner and concentrate more on the internal economy construction. If the state-owned business remain the same and the financial market system is still not open, the conflict inside will sharpen and also the economy might go backwards. In the short term for about 5-10 years, the effort made in the currency internationalization will not bear fruit easily. In the long term, for about 15-30 years, the RMB might be a reserved currency or a new currency.

The Future of USD:

Although there is a consensus that the USD will not lose its global leadership in the near future, the declining of the USD's power globally is unavoidable unless there is a big war or political movement in Europe or China. Based on the spring meeting of IMF, the economy of the US is recovering and has an upward trend. However, the recovery is built on the sacrifice of other countries and there is no emerging industry like the 1990s to support the US economy. For other countries, they always passively accept any influence the USD brings. It is not possible for them to tolerate the current system until the next crisis. The status's change is from quantitative changes to qualitative changes. This philosophy could be explained in two parts. One is in the long term, the reform and development of Euro or RMB will accumulate a power change. The other is that without any new emerging industry and effective policy, the longtime leading position in the world of the US economy might weaken the competitiveness and make the environment stagnant.

Summary And Conclusion:

Although the USD is unbeatable in the current environment, its power appears weakened by the growing of Euro and RMB. In the future, Euro, RMB, and USD might be the three main currencies in the world. The exploration of RMB's internationalization will accelerate the new situation of IMS. If the reforms in China's capital market are successful, RMB will be the new currency in 15 to 30 years. If not, there is a possibility of a crisis similar to what happened in Japan in 1990. China should moderate the speed of the reform to make the process more stable and concentrate more on the internal economy construction instead of relying on the exporting industry.

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