The Renminbi Goes Global

The Meaning of China's Money

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Gaining Currency: The Rise of the Renminbi
BY ESWAR PRASAD. Oxford University Press, 2016, 344 pp.

The People's Money: How China Is Building a Global Currency
BY PAOLA SUBACCHI. Columbia University Press, 2016, 256 pp.

Last October, the International Monetary Fund officially added China's currency, the renminbi, to the basket that makes up its Special Drawing Rights, the reserve asset in which the IMF denominates its loans to governments. Until then, only the U.S. dollar, the euro, the British pound, and the Japanese yen had enjoyed this exalted status. The addition of the renminbi to the SDR basket occasioned much celebration in China. Lu Jian, vice president of the Guangdong Guangken Rubber Group, hailed the event as a "historic moment." The People's Bank of China (PBOC), the country's central bank, announced that the move was "an affirmation of the success of China's economic development and results of the reform and opening up of the financial sector." As far as many Chinese were concerned, the IMF's move signaled that the renminbi had become a leading global currency, befitting one of the world's leading economies.

But some independent observers suggested that China's official reception greatly exaggerated the significance of the event. After all, SDRs are little more than the accounting units in which the IMF conducts its transactions. There is no private market in SDRs. They are not used by importers and exporters to invoice and settle trade deals. Nor are they used in private financial transactions. The importance of adding the renminbi to the SDR basket, in this view, was more symbolic than real.

Still, symbols matter. In this case, they matter to Chinese policymakers, who in recent years have been making a concerted push to "internationalize" the renminbi by promoting its use as a unit of account, means of payment, and store of value for banks, firms, and governments undertaking international transactions. Since 2009, internationalizing the renminbi has been an explicit goal of Chinese policy. Beijing therefore celebrated the renminbi's addition to the SDR basket as evidence that it was making real progress in this direction.

China's ambitions notwithstanding, the U.S. dollar remains unchallenged as the dominant international currency. The dollar accounts for more than 60 percent of the foreign exchange reserves held by central banks worldwide. Nearly 45 percent of all foreign exchange market transactions involve dollars. Virtually every transaction in the global oil market

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is denominated in dollars. Put simply, the dollar reigns supreme. So why would China attempt to challenge the dollar's dominance, or even try to establish the renminbi as an alternative global currency?

In their recent books, the economists Eswar Prasad and Paola Subacchi set out to answer this question. Both authors take pains to place the attempt to internationalize the renminbi in its historical context. (Prasad reminds readers, for example, that China is no currency neophyte: it was the first country in the world to use paper money.) And both use China's effort as a lens through which to view the bigger picture of the country's ongoing economic and financial reforms.

Both authors also caution against exaggerated claims. Although Beijing has worked hard to encourage the international use of the renminbi, its progress should not be overstated. Renminbi-denominated claims still account for only a tiny fraction—around one percent—of the foreign exchange reserves held by the world's central banks. Although businesses now use the renminbi to pay for about ten percent of all global exports and imports, up from essentially zero a decade ago, most of those payments stem from China's own trade—including trade with Hong Kong, which is not exactly a foreign country. Meanwhile, the renminbi's share of the turnover in the global foreign exchange market stands at only two percent, according to the most recent Bank for International Settlements survey, conducted in April 2016. And according to the Society for Worldwide Interbank Financial Telecommunication (SWIFT), although the renminbi ranks as the fifth most frequently used currency in financial transactions, renminbi-based transactions still account for just 1.86 percent of the value of all global payments.

If China really wants to move the dial and achieve more than symbolic progress on renminbi internationalization, it will have to move much faster on a set of broader economic and regulatory reforms. And it will also need to consider a less centralized approach to economic policymaking—a prospect that seems to hold little appeal for the country's current leadership. All those changes would have to take place during a time when the international environment has become more uncertain, thanks in part to the election of Donald Trump as U.S. president. So although China has managed to upgrade the renminbi's status, the road to further progress looks long and hard.

DOLLAR DEPENDENCE

When asked why Beijing is trying to turn the renminbi into a global currency, many in China have a ready answer: a first-class country should have a first-class currency. But beneath this nationalist sentiment lie other, more practical motives. Chinese officials see internationalizing the renminbi as a way to free themselves from dependence on the dollar. As long as Chinese banks and firms conduct the bulk of their cross-border business in dollars, they face potential losses every time the dollar-renminbi exchange rate changes. Until now, Chinese authorities have heavily managed the exchange rate so as to limit those fluctuations. But this is bound to change in the future, since with financial development and opening come larger capital inflows and outflows—and the need to let the exchange rate adjust as a buffer against their economic and financial effects.

Mao money, more problems: counting notes in Huabei, China, June 2012

STRINGER / REUTERS

Dependence on the dollar also exposes China to strategic risks. The fact that so many trade and financial transactions are settled in dollars gives the U.S. government leverage over the international payment system. After Russia invaded and annexed Crimea in 2014, Chinese officials watched with trepidation as the United States, the EU, and a number of NATO members imposed financial sanctions on Russia that, among other things, made it impossible to use credit cards issued by Russian banks outside Russia. That measure was enforceable only because such cards relied on dollar-based payment networks operated by U.S. firms such as Visa and Mastercard. The United States and its allies were also able to threaten Russia with exclusion from SWIFT, the electronic network that settles the vast majority of cross-border financial transactions, which are mainly conducted in dollars. This gave China pause and stiffened its resolve to develop an alternative international payment system not dependent on dollars or subject to disruption by the United States.

Finally, some in China, including officials at the PBOC, see renminbi internationalization as a means of encouraging wider economic and financial reform. Foreigners will embrace the renminbi only if they can buy and sell it freely. In practice, this means that they must be able to engage in financial transactions in China itself, where the vast majority of renminbi-denominated financial assets reside. Beijing will therefore have to lift the restrictions it has long placed on foreigners (and Chinese citizens) who want to conduct cross-border financial transactions in China.

UNDER PRESSURE

Relaxing controls on financial transactions would allow more capital to flow into and out of China. To cope with that greater volatility, Beijing would need to complete additional financial reforms. The government would have to upgrade its supervisory and regulatory regimes to prevent banks and other financial firms from borrowing excessively and becoming overleveraged. It would have to strengthen corporate governance to prevent Chinese enterprises from incurring too many short-term debts denominated in foreign currencies. Beijing would need to fully liberalize interest rates to eliminate artificial differences between onshore and offshore rates, which might encourage capital flight. And the PBOC would need to adjust its monetary policy more freely in response to changes in the direction of capital flows.

In their efforts to internationalize the renminbi, the PBOC and other authorities have already taken steps that enhance the access of foreign investors to Chinese financial markets. These measures have ratcheted up the pressure to undertake other reforms, such as those on the regulatory and corporate-governance fronts. But history suggests that using capital-account liberalization to force the pace of financial reform is a risky strategy. If other measures do not follow quickly, relaxing capital controls can lead to overborrowing, excessive risk taking, and, in the worst-case scenario, a financial crisis. Chinese leaders need only recall the Asian financial crisis of 1997–98, which reflected precisely that chain of events.

A number of factors explain the uneven pace of reform so far. Although some Communist Party leaders want to move quickly, they face resistance from vested interests, such as state-owned enterprises that benefit from subsidized credit. Prasad and Subacchi emphasize the built-in tension between financial liberalization and China's growth model. The authorities in Beijing have long relied on state-owned banks to direct credit toward more technologically advanced industries and enterprises. That model of economic management would come under strain were the party to reduce its direct role in setting interest rates and step back from its tight control of the banking sector. As Subacchi puts it, policymakers in China will "have to figure out a way to open its financial markets and banking sector while maintaining the unique hybrid, 'socialism with Chinese characteristics,' where economic planning and state control coexist with markets, foreign investments, private property, and individual initiative."

The alternative would be a system of private banks and capital markets capable of more efficiently allocating credit. But such institutions take a long time to develop; Subacchi describes this, appropriately in the Chinese context, as a "long march." China's relatively young stock markets are still subject to violent, unpredictable swings, and officials are understandably reluctant to entrust them with the task of credit allocation. Such volatility also makes foreigners nervous about holding renminbi-denominated securities, since the prices of those securities are apt to change by large amounts when investors in the United States and Europe are asleep.

Subacchi highlights China's distinctive two-pronged approach to overcoming these obstacles to currency internationalization. The first prong involves encouraging domestic and foreign companies to use the renminbi in their trade settlements, hoping that the currency's use in financial transactions will follow organically. For Beijing, this approach represents a logical path of least resistance: trade settlements are less risky than purely financial transactions because the merchandise being traded serves as collateral and the loans are paid off as soon as the goods in transit arrive. Once foreign firms receive payments in the renminbi, they make deposits with local banks, which put that money to work in Chinese financial markets. In this way, encouraging the use of the renminbi in trade settlements leads naturally to its use in financial investment.

In fact, there is ample precedent for this approach. The United States followed a similar strategy when the Federal Reserve sought to internationalize the dollar after 1914. But there is no precedent for the second prong of China's strategy: relying on offshore markets to develop a financial clientele for the renminbi. With prodding from Beijing, financial centers from London to Singapore have begun encouraging the direct trading of their countries' currencies against the renminbi. For each foreign financial hub, China has designated one of its so-called Big Four banks to act as an official clearing bank. Meanwhile, the PBOC has negotiated currency-swap arrangements that effectively give foreign central banks a renminbi credit line. In the absence of this credit line, the Bank of England, for example, couldn't easily provide an emergency loan denominated in the renminbi to a customer in London, since the bank can't print the Chinese currency. But because the Bank of England has a swap agreement with the PBOC, it can act as a renminbi "lender of last resort." Beijing hopes that over time such arrangements will make foreign regulators less apprehensive about allowing their national banks and firms to do business in the renminbi.

It's still unclear, however, whether this limited strategy will generate a significant amount of international business. Ultimately, if it wants to compete in the global financial game, China will have to permit offshore entities to freely invest in the mainland. Before it can safely do that, however, Beijing will need to upgrade its financial supervision, strengthen corporate governance, and, more generally, make significant further progress on economic and structural reform.

SHELTER FROM THE STORM

Progress on economic and structural reform alone, however, would not allow China to mount a real challenge to the dollar's dominance. The dollar is not just the leading international reserve currency: it is also a safe haven, into which foreign investors rush during episodes of financial turmoil—even when the United States is itself the source of the turmoil, as was the case in the crisis of 2008. "Rock-solid faith that the U.S. federal government will honor its debt obligations has made its Treasury securities the instrument of choice for panicky investors," Prasad writes. Other currencies, such as the Swiss franc, also function as safe havens, on a limited scale. But the renminbi does not. The question is why—and whether this will change.

To be a safe haven, a currency has to be traded in deep and liquid markets; during a crisis, investors value nothing more than liquidity. The U.S. Treasury bill and bond market is the single largest and most liquid financial market in the world. This is an advantage that the market in renminbi-denominated securities does not begin to approach.

Moreover, for a currency to act as a safe haven, investors need to feel confident that there won't be unpredictable changes in the rules of the game. In the country that controls that currency, the central bank and financial regulators must be insulated from politics; they should be legally and financially independent. Contract enforcement must be evenhanded, treating residents and foreign investors alike. Finally, the system of government must feature institutional checks and balances on the arbitrary decision-making power of the executive.

These, clearly, are not characteristics of the current Chinese political system. If anything, President Xi Jinping and the Politburo have further centralized power in their own hands, partly in an effort to reverse the recent gradual slowdown in China's economic growth rate. The party's consolidation of authority and its ongoing commitment to maintaining an annual growth rate of more than six percent fundamentally conflict with the goal of renminbi internationalization.

Still, Prasad and Subacchi are cautiously optimistic. Both their optimism and their caution are appropriate. China already boasts one of the world's largest economies and is the largest exporter in the world; over time, it will develop some of the world's largest financial markets. But financial development takes time. And because not only financial reform but also political reform is an essential prerequisite for successful renminbi internationalization, considerable skepticism is indeed in order.

Prasad and Subacchi completed their books before two important recent events. First, in the past several months, Chinese authorities have begun to backtrack on some liberalization measures. For example, they have imposed new restrictions on foreign direct investment by Chinese corporations, and they have begun to require Chinese entities to receive official approval before undertaking other cross-border transactions. These restrictions were imposed in response to weakness in China's exchange rate, which put pressure on the PBOC to raise interest rates and drain liquidity from Chinese financial markets in order to support the currency. But taking those steps would have dampened domestic spending and raised the danger that China would miss its official growth-rate target. So instead, the authorities tightened currency controls. This is more evidence that when push comes to shove, Chinese leaders will continue to prioritize domestic objectives over renminbi internationalization.

Both books were also published prior to the election of Trump as U.S. president. If tensions and trade conflicts develop between Beijing and Washington under a Trump presidency, then financial markets in general, and foreign exchange markets in particular, will grow more volatile. Increased volatility in the renminbi exchange rate would make it less attractive for international investors to use the currency. And in a more uncertain world, the dollar's safe-haven status would further heighten the appeal of the greenback.

Alternatively, investors might look more favorably on the renminbi if the Trump administration makes changes in U.S. policy that undermine faith in the U.S. Treasury's commitment to honor its obligations. During the campaign, Trump suggested that he might seek to "renegotiate" U.S. debts. He has also proposed large, unfunded tax cuts; if those fail to boost productivity and spur economic growth, they could ultimately cast the sustainability of U.S. Treasury obligations into doubt. In that case, the renminbi—and China—would be the obvious beneficiary.