

What Next for Renminbi Internationalization?

Written by Tristram Sainsbury

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TRISTRAM SAINSBURY, JAN 26 2016

On 30 November 2015, the International Monetary Fund (IMF) Executive Board determined that the Chinese renminbi (RMB) was a 'freely usable' currency, based on the advice of IMF staff. As a consequence, it is to be included in the basket of currencies that underpin the IMF's reserve asset, the special drawing right (SDR), alongside the US Dollar, the Euro, the Japanese Yen and Pound Sterling. While the economic consequences of the SDR basket are limited, the IMF's 'tick of approval' for the RMB represents a political milestone for China's currency internationalisation, and signals progress on a reform process that includes gradually opening the capital account, strengthening the domestic financial system, and improving cross-border payments infrastructure and central bank swap lines. All of these are essential to the ongoing rebalancing of the Chinese economy towards a more sustainable growth model.

However, it is inappropriate to make grandiose claims that the SDR decision means China intends to be a 'banker for the world' or that China will use its G20 host year as an opportunity to advocate or substantively advance reforms that lead to the SDR becoming a genuine reserve asset along the lines of Keynes' Bancor. While China has made substantial progress in a short time, it still has to take significant steps in the ongoing process to liberalise its capital account, embark on further financial sector deregulation, and push for international acceptance of the RMB around the world. As the financial sector volatility already viewed in 2016 shows, this will be a bumpy process. With the world increasingly 'on the hook' for outcomes, what matters more than ever is a focus on ensuring that Chinese economic policies are clearly communicated and the rebalancing process does not aggravate global financial instability.

The Global Financial Crisis and Chinese Currency Internationalisation

The story of the Chinese economic miracle is well known. The numbers are staggering: the ongoing process of economic invention and reinvention has seen a 9.8 per cent average growth rate sustained between 1978 and 2010, bringing more than 600 million people out of poverty. The ANU's Peter Drysdale notes that China's "now big enough to matter in markets everywhere". But while China has a successful history of integrating its real economy into global trade networks and building domestic export capacity, the internationalisation of its financial markets has been far less noteworthy (Lombardi and Wang, 2015). A managed exchange rate policy, which includes a peg to US dollar between 1994 and 2005, along with stringent regulation of capital flows, have contributed to the large accumulation of foreign reserves and conspired to keep China's financial market isolated from trading partners.

This has had some unintended consequences. Li Yining argues that China has wasted natural resources, piled up excess capacity (and reserves) and missed opportunities to fix its economic model. The global financial crisis, which in many respects marked a turning point for global economic governance, was also an eye-opener for Chinese policymakers who found that they had a more limited set of monetary policy options to respond to the crisis. Further, the large foreign exchange reserves that have been built up are ploughed in US treasuries which, with the benefit of hindsight, is not turning out to be the best of investments.

In March 2009, an essay by People's Bank of China (PBoC) Governor Zhou Xiaochaun advocated for the need for 'creative reform' of the international monetary system towards an international reserve currency with stable value, rules-based issuance and manageable supply. This would have to be "disconnected from economic conditions and the sovereign interests of any single currency." While this argument has not made noticeable headway in

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international policy circles, particularly the G20, China has been able to embark upon a series of policy measures to promote the international role of its currency – actions that have come to be known as ‘RMB internationalisation’. These policy measures are primarily aimed at enhancing the international appeal of RMB securities and thereby increasing its use as a funding and investment currency. Within the RMB internationalisation strategy, there are three broad policy paths:

- *Gradually opening the capital account.* Capital account transactions in China have been generally subject to restrictions, pre-approvals and quotas. As part of the broader financial reform agenda, Chinese authorities have been gradually easing restrictions, widening channels of access, increasing quotas and importantly looking to reduce the costs to meet regulations, along a path of ‘managed convertibility’ that aims to minimise disruptions and short-term capital flows through a variety of measures including supervision, macro and micro-prudential tools and capital flow tools.
- *Strengthening the domestic financial system* through reforms to achieve more market-based pricing, better align risks and returns, and achieve greater efficiency of credit allocation. The PBoC has, since 2010, liberalised interest rates, established a deposit insurance scheme and taken steps to tighten regulation and supervision of financial activities taken by ‘shadow’ banks.
- *Improving cross-border payments infrastructure and central bank swap lines.* Between 2008 and mid-2015, the PBoC set up 17 offshore clearing banks and signed or renewed bilateral swap agreements worth collectively more than RMB 3.2 trillion (approximately USD 486 billion) with over 30 foreign central banks.

The result has been rapid growth, from a low base.

Enter the SDR Basket: A Political Symbol But Economically Unimportant

These actions also meant that the RMB became a candidate for the SDR basket. The IMF uses two selection criteria when determining whether a currency should be included in the SDR: the size of exports and whether a currency is considered to be ‘freely usable’, a subjective assessment about whether the currency is both widely used for international transactions, and widely traded in the principal foreign exchange markets. China’s extensive international trading relationships meant that it had already met the export criterion during the 2010 Review. The core issue in the 2015 review (currencies and weights are generally reviewed every five years) was whether the RMB could be considered as ‘freely usable’.

An interim assessment by IMF staff in June 2015 recognised the progress that had been made since 2009 and identified some further actions for Chinese authorities. The Chinese authorities responded accordingly. By November, the IMF concluded that the RMB was both widely used for international transactions, and widely traded in the principal foreign exchange markets. This led IMF staff and Managing Director Christine Lagarde to issue statements of support. The IMF Executive Board agreed, and the RMB was included in the basket and received a weight of 10 per cent.

Economically, the decision to include the RMB in the basket actually doesn’t mean much. As my Lowy Institute colleague Leon Berkelmans has pointed out, SDRs are not a currency, they are a bookkeeping entry. When a country borrows from or through the IMF, that loan is recorded as a loan of SDRs, although the country actually receives hard currency. But countries generally don’t do anything with their SDRs, and SDRs play no significant functional role in the economy. The change will not come into effect until 1 October 2016, to allow Central Banks time to diversify their reserve assets into RMB-denominated securities. However, even this effect may not be significant. Only a few central banks benchmark their reserve holdings to the weights of SDR basket currencies, and SDR basket inclusion will not automatically lead to action. Further, the Suez Canal might price its transit fees in SDR but not many corporates do, so few companies were forced to buy yuan-denominated assets to hedge their exposure in response to the IMF’s decision.

Over time, official holdings of RMB-denominated assets are likely to rise and could constitute as much as 5 per cent of global reserve portfolios by 2020 (Standard Chartered, 2015). However, this will more likely be related to ongoing

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reforms to make the RMB more freely usable, rather than its designation as a part of the SDR basket.

So, What Next?

The natural question is what China will do next to pursue its strategy of currency internationalisation. This has led to hype and speculation about supposed geopolitical implications. It has also increased interest in the first Finance Ministers meeting under China's G20 Presidency, in Shanghai in February. China has reprised the G20 International Financial Architecture Working Group and indicated a preference for "expanding the role of the SDR" as part of its ambitious vision for the G20 agenda. China also wants to complete the 15th General Review of IMF quotas, continue to push forward work relating to the World Bank's voting share, strengthen the global financial safety net and promote orderly sovereign debt restructuring.

However, one only has to look at the 2011 French G20 Presidency as a sobering example of the political challenge ahead of China if it wishes to push forward substantive reform to the SDR role. As part of then French President Nicholas Sarkozy's "New Bretton Woods" efforts to reform the monetary system, the French Presidency detailed an ambition for reforms towards the 'diversification of reserve assets', drawing on IMF analysis concluding that the dependence of the monetary system on one country's domestic currency made the world more prone to contagion from shocks affecting that country.

It became clear very early in the French Presidency that no matter how desirable these changes were, and even if they had positive economic consequences for the US (which would be free from the constraints that being a monetary hegemon poses to exchange rate management), the US was unwilling to entertain them. And as a consensus-based gathering without enforcement power, there was little that the G20 could do under such circumstances. It seems highly unlikely that the US position on this matter will have changed markedly since 2011.

In theory, the US dollar could be supplanted or rivalled by the RMB at some point 'over the horizon'. But as Matthew Yglesias notes, a lot of institutional, legal, economic, and political changes need to happen in China for this to make sense. And the last seismic shift in the global balance of power occurred after two world wars.

The focus should instead be on ensuring that the daunting process of Chinese economic reform is well managed. My Lowy Institute colleague Stephen Grenville has put forth a neat summary of the broader adjustment path in the near term for China's financial sector, exchange rate and capital flows. The financial sector is significantly underdeveloped and will continue to expand into unexplored territory with embryonic institutions and inexperienced people, so will continue to be a risk.[1] The exchange rate, which has risen by 50 per cent (in real terms) since 2005 seems to be at either roughly the right level or modestly overvalued. Chinese authorities are likely to continue along the path of 'managed convertibility' to promote RMB internationalisation through market infrastructures and ever-broadening networks of swaps, while still maintaining capital account restrictions. As capital controls continue to soften, Chinese investors will continue to buy more foreign assets in order to diversify their portfolios, leading to capital outflows.

These kinds of transitions are never smooth or riskless. And they are by their nature unpredictable as there is no relevant precedent. As Mike Callaghan has advised, success will crucially depend on policymakers demonstrating that they can manage the Chinese economy. The authorities will need to establish that they are pursuing sound, consistent and measured policies which take into account the impact on other countries, and do not aggravate global financial instability. It will require greater clarity from China on its economic policies.

Notes

[1] Although it is important to remember that the China's stock market is still very underdeveloped, at just a third of GDP, and less than 15 per cent of household financial assets are invested in the stock market – see <http://www.eastasiaforum.org/2016/01/18/get-used-to-living-with-chinese-economic-tremors/>.

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