A Middle Ground

The renminbi is rising, but will not rule

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IN November 2015, the IMF made an announcement that was symbolically momentous in the annals of international finance. It decided to anoint the Chinese renminbi an elite global reserve currency. The renminbi was to join the select basket of currencies (previously comprising the US dollar, euro, Japanese yen, and British pound sterling) that constitute the IMF's artificial currency unit, the special drawing right (SDR). The renminbi appeared to be on its way to taking the world by storm and reshaping global finance.

Since then, much has changed. The renminbi has lost value relative to the dollar, and China is dealing with a spate of capital outflows, partly reflecting loss of confidence in the economy and the currency. The renminbi's inclusion in the SDR basket, which took effect in October 2016, has not stanched this erosion of confidence.

The earlier hype predicting the renminbi's inevitable rise to dominance, perhaps even rivaling the dollar, has proved overblown. But the same is likely to be true for doomsday scenarios now predicting a plunge in the renminbi's value and prominence as financial capital surges out of China. Reality likely lies somewhere between these two extremes.

In the long run, what the renminbi's ascendance means for the global financial system depends, to a large extent, on how China's economy itself changes in the process of elevating its currency. Transforming the domestic economy may in fact have been a hidden agenda behind China's aggressive promotion of its currency.

Size counts but not for all

China's economy is now the second largest in the world (based on market exchange rates). In 2016, its annual GDP was $11 trillion, accounting for 15 percent of world GDP, second only to the United States, whose annual GDP is $19 trillion. China is also an important player in international trade, accounting for 13 percent of global trade in goods. China's impact on the world economy is even greater when measured along other dimensions. The country holds about 30 percent of global foreign exchange reserves and accounts for a third of global GDP growth since the financial crisis.

Despite China's economic might, the international stature of its currency, the renminbi, does not quite match that of its economy. Among the currencies of the world's six largest economies, the renminbi is only now beginning to emerge as a factor in the global economy. The others—the dollar, euro (used by two of the six largest economies—Germany and France), yen, and British pound—all have, to different degrees, well-established roles in global finance.

Unique playbook

In recent years, the Chinese government has taken a number of steps to elevate the renminbi to this group of elite currencies by increasing its international use. The renminbi's adoption in global markets is constrained, however, since the Chinese government seems unwilling to condone a fully market-determined exchange rate and an open capital account that allows for free cross-border capital flows. This may reflect a conservative approach to giving market forces freer rein as well as prudence dictated by the risks of rapid economic liberalization.

China has therefore adopted a unique playbook for promoting the renminbi while trying only gradually to free up capital flows and the exchange rate. Given China's sheer size and its rising shares of global GDP and trade, the government's steps quickly gained traction.

In the mid-2000s, the government started removing restrictions on capital inflows and outflows, but in a controlled and gradual manner. This process continued even after the global financial crisis. For instance, the government has set up a number of systems to allow foreigners to invest in China's stock and bond markets. At the same time, there are now many channels for Chinese households, corporations, and institutions to place some portion of their investments in foreign markets. But the government continues to keep a tight grip on each of these channels.

China has promoted the availability of renminbi outside its borders, including sanctioning 15 offshore trading centers for transactions between renminbi and other currencies. The government also set up the Cross-Border International Payment System to facilitate commercial transactions between domestic and foreign companies using renminbi rather than more widely used currencies such as the dollar and the euro.

These measures led to rising internationalization of the renminbi, its greater use in denominating and settling cross-border trade and financial transactions—that is, as an international medium of exchange. By the latter half of 2014, about a third of China's international trade was denominated and settled in renminbi. Furthermore, the renminbi accounted for about 2 percent of cross-border payments around the world, which—although a low share—already placed the renminbi among the top six payment currencies in the world.

But then the currency's progress stalled, as China grappled with a growth slowdown, a sharp boom and bust cycle in the stock market, and concern about rising debt and financial instability. Over the past year, the renminbi's progress as an international medium of exchange has gone into reverse. The quantitative indicators of its use in international finance all point to signs of a sharp retreat, and the liberalization of capital flows has come to a grinding halt.

Still, it is important to keep both the upswings and downswings in proper perspective. Despite the constraints on capital flowing in and out of China, the renminbi has begun playing a larger, although still modest, role in international finance over a relatively short period. The trajectory of the renminbi's progress in this dimension was impressive initially, but these developments are still at a nascent stage and should not be blown out of proportion. And clearly the path will be bumpy and involve many detours.

Reserve currency

Another aspect of a currency's role in international finance is its status as a reserve currency, one held by foreign central banks as protection against balance of payments crises. This status is often seen as a mixed blessing—a reserve currency economy can borrow more cheaply from foreign investors by issuing debt denominated in its own currency, but higher demand can sometimes make it harder to manage the currency's value. Indeed, in the 1980s and 1990s, Germany and Japan attempted to resist their currencies' gaining this status because they did not want stronger demand, and ensuing currency appreciation, to damage their export sectors.

In any event, this topic may seem premature given that China has neither a flexible exchange rate nor an open capital account—once considered prerequisites for a reserve currency. Even though the IMF has, for all practical purposes, anointed the renminbi a reserve currency, financial market participants' views do more to determine a currency's status. After all, foreign investors must be able to acquire and easily trade financial instruments denominated in that currency without major restrictions on cross-border financial flows. And they must be reasonably confident that the currency's value will not be controlled by a government with scant regard for market forces. As in many other economic matters, here, too, China appears to have broken the traditional mold.

Remarkably, the renminbi has already become a de facto reserve currency even though China does not meet some of the prerequisites once seen as essential. China's sheer economic size and the strength of its trade and financial linkages with economies around the world seem to have overridden the other limitations.

Many central banks around the world are gradually acquiring at least a modest amount of renminbi assets for their foreign exchange reserve portfolios. The list comprises a geographically and economically diverse group of countries, including Australia, Austria, Chile, Japan, Korea, Malaysia, Nigeria, and South Africa. According to IMF estimates, about 2 percent of global foreign exchange reserves are now held in renminbi-denominated financial assets. Some 35 central banks around the world have signed bilateral local currency swap arrangements with China's central bank. These arrangements give them access to renminbi liquidity that they can tap to defend their currencies or maintain stable imports even if foreign capital inflows dry up.

Although the renminbi has managed to attain the status of a reserve currency, its progress along this dimension is likely to be limited by its lack of well-developed financial markets. Foreign official investors, such as central banks and sovereign wealth funds, typically seek to invest in highly liquid and relatively safe fixed-income debt securities, even if such securities have a relatively low rate of return. China's government and corporate debt securities markets are quite large but are still seen as having limited trading volume and weak regulatory frameworks.

Thus, strengthening its financial markets is important both for China's own economic development and for promoting the international role of its currency.

Trojan horse

Indeed, it is possible to make a broader case that China has tried to use elevation of the status of its currency mainly as a cudgel against opposition to domestic reforms. Many of the reforms necessary to enhance the currency's international role will ultimately benefit China, regardless of what happens with the currency. For instance, a more flexible exchange rate will allow for more independent monetary policy that can target domestic policy objectives without the constraint of having to maintain a particular exchange rate. Similarly, a broader and better-regulated financial system can do a better job of allocating China's copious domestic savings to more productive investments that generate more stable output and employment growth.

However, many of these reforms have traditionally run into stiff opposition from powerful interest groups that stand to lose from any changes to the existing system. For instance, Chinese exporters for a long time opposed a market-determined exchange rate, fearing that it would lead to currency appreciation and make their exports less competitive in foreign markets. The large state-owned banks resisted more competitively determined interest rates on deposits (rather than rates fixed by the government), which would allow smaller banks to compete with them for household and corporate deposits by offering better rates. Some government officials have also resisted certain economic reforms that could pose short-term risks, preferring stability and control to the inherent volatility of market forces. By casting these reforms as essential to promoting the status of the currency, reform-minded officials have in effect used a Trojan horse strategy to push economic liberalization measures that would otherwise have floundered.

Gulf between reserve and safe haven

Since the global financial crisis, a new concept has gained traction in international finance: the "safe haven" currency. Such a currency is more than just a plain vanilla reserve currency; it is one that investors turn to for safety in times of global turmoil and not just to diversify their assets or seek higher yields.

China may be gaining economic clout, but whether it will ever gain the trust of foreign investors is an open question. Such trust is crucial for a currency to be seen as a safe haven. A country seeking this status for its currency must have a sound institutional framework—including an independent judiciary, an open and democratic government, and robust public institutions (especially a credible central bank). These elements have traditionally been seen as vital for earning the trust of foreign investors, both private and official, including central banks and sovereign wealth funds.

Foreign investors typically want to know they will be treated fairly according to well-established legal procedures, rather than subject to the whims of the government. They also tend to value independence of institutions such as the central bank from government interference—important for maintaining the credibility and value of the currency.

The renminbi's rise to prominence will change international finance.

Chinese leaders are pursuing, no doubt in a slow and often meandering manner, financial liberalization and limited market-oriented economic reforms. But they have unequivocally repudiated political, legal, and institutional reforms. China's government has, if anything, rolled back freedom of expression, the rule of law, and the independence of key institutions from government interference. In short, while the renminbi has the potential to become a significant reserve currency, it will not attain safe haven status without far-reaching reforms to China's institutional and political structure. Such reforms are apparently not in the cards. Thus, the notion that the renminbi will one day rival the US dollar for dominance as the global reserve currency is far-fetched.

Risks ahead

The renminbi's path to global prominence depends to a significant extent on China's growing economic and financial power. A major growth slowdown or, worse, a collapse of the financial system could alter this trajectory and derail the renminbi's rise. In fact, some of the policies related to enhancing the renminbi's international stature—including capital account opening and allowing the exchange rate to be determined more freely by market forces—could themselves expose China's economic and financial stability to a number of risks if these policy changes are mishandled.

The Trojan horse strategy has indirectly helped to advance at least a limited set of financial sector reforms and capital account liberalization. For instance, to meet the conditions and deadline set by the IMF for the renminbi to be considered for inclusion in the SDR basket, during 2015 China had to liberalize bank deposit interest rates, remove some restrictions on capital flows, and, at least in principle, reduce its intervention in foreign exchange markets.

These changes have not, however, been accompanied by reforms to the real side of the economy. When it comes to state-owned enterprises and much-needed improvements to corporate governance and the urgent need to remove perverse incentives for bankers to lend to government enterprises, there is still a long way to go. Loans to state-owned companies, many of which are unprofitable and inefficient but still undertake large investments, are still implicitly guaranteed by the government, and they have powerful patrons.

China is thus facing complications from haphazard and unbalanced reforms. The limited financial market reforms and capital account opening have not been supported by reforms in other areas, which has generated more volatility rather than yielding the benefits of well-functioning markets.

Concern about the economy's growth prospects and high volatility in domestic stock markets helped fuel a surge in capital outflows over the past couple of years. This put downward pressure on the currency and, as the central bank has tried to continue managing the currency's value relative to the US dollar, resulted in a loss of about $1 trillion in foreign exchange reserves (relative to the peak level of nearly $4 trillion in June 2014). Clearly, the state of China's economy and the status of the renminbi are closely linked.

End game

Despite some fits and starts in the process, the renminbi is on its way to becoming a significant international currency, although this will take many years and will hardly be a linear process. If China plays its cards right, with suitable financial sector and other market-oriented reforms, the renminbi could one day be an important reserve currency and could eventually account for as much as 10 percent of global foreign exchange reserves. (For comparison, the US dollar and the euro now account for 64 percent and 21 percent, respectively, of global foreign exchange reserves.)

While the currency has made remarkable progress in a relatively short period, it is far from assured that it will continue along the same impressive trajectory it has followed for the past few years. And its full potential may remain unrealized unless the Chinese government undertakes a broad range of economic and financial system reforms.

For the renminbi to become a safe haven currency, however, China would have to initiate even more far-reaching reforms of its institutional framework, which would ultimately alter its political, legal, and public institutions. Such changes are currently not in the cards.

Still, the renminbi's rise to international prominence will change international finance, and even China itself, in many ways. Over the next few years, the renminbi's rising importance in international finance could well serve as a catalyst for domestic reforms and perhaps even promote a more stable international financial system.

The renminbi will continue to rise in global finance, but don't expect it to rule. ■

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