A study of the renminbi published by the Brookings Institution this week outlines how the Chinese currency’s international status still pales in comparison to the dollar’s. It also offers something of a blueprint for how Beijing can change that.

There is, of course, much excitement – and concern – globally about the renminbi’s ascendancy. But the study shows that internationalisation of the currency will do far more to change China before it has a chance to change the world.

Eswar Prasad and Lei Ye, the authors, argue that sheer economic clout is not enough to make a currency globally important. China already accounts for 10 per cent of world gross domestic product, 9 per cent of world trade and about a quarter of world growth. Yet the Swiss franc is far more widely used.

What really matters is the openness and the development of China’s financial markets. On both these fronts, it still has far to go.

A country’s capital account must be open to allow a currency to be easily tradable in global markets. According to the Chinn-Ito index, a measure of openness, reserve currency economies scored 2.48 in 2009. China was -1.15, “indicating that China’s capital controls are, on paper, quite stringent” and only a wee bit more open in de facto terms.

As for the level of development of China’s markets, the shortfalls are just as big. This is especially the case in its government debt market – a critical obstacle for the renminbi, since sovereign bonds are precisely the kind of safe asset that investors want in a reserve currency. The turnover ratio on government bonds – a key gauge of liquidity – was 14.3 in the US in 2010 and just 1.0 in China. Even India’s turnover ratio was twice China’s.
Promoting the renminbi via Hong Kong as an international gateway is symbolically important, but the currency’s offshore advances “could soon hit their limits unless China’s capital account becomes more open”.

Prasad and Ye say it all comes down to one big question: will Beijing “use the goal of making the renminbi a global currency to catalyse momentum on a broad agenda of domestic policy reforms that are required to support this goal”?

Their prediction?

“On the basis of the anticipated pace of reforms, we believe that the renminbi will become a competitive reserve currency within the next decade, eroding but not displacing the dollar’s dominance.”

The emphasis should, of course, be on “anticipated pace of reforms”. There is nothing inevitable about the renminbi’s rise – its future will be determined more by Chinese politics than economics.

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- Coming soon: when the renminbi rules the world, FT
- RMB to challenge the USD in a decade, beyondbrics
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