

THE RENMINBI'S PROSPECTS AS A GLOBAL RESERVE CURRENCY

Eswar Prasad and Lei Ye

Popular discussions about the prospects of China's currency, the renminbi, range from the view that it is on the threshold of becoming the dominant global reserve currency to the concern that rapid capital account opening poses serious risks for China. A number of recent academic studies have pointed to the renminbi's rising importance in the international monetary system, although these studies are divided on the renminbi's prospects of becoming a dominant global reserve currency (see Eichengreen 2011a, Subramanian 2011, Frankel 2012, and Yu 2012).

This issue has broader ramifications, as the rise of China's economy and its currency has implications for global macroeconomic and financial stability. Among the currencies of the world's five largest economies, China's renminbi is the only one that is not a reserve currency. Even though the economy has neither a flexible exchange rate nor an open capital account, the Chinese government has recently taken a number of steps to increase the international use of the renminbi. Given China's rising shares of global GDP and trade, these steps are gaining traction and portend a rising role for the renminbi in global trade and finance.

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Eswar Prasad is the Tolani Senior Professor of Trade Policy at Cornell University and a Senior Fellow at the Brookings Institution. Lei Ye is a graduate student in the Department of Economics at Cornell University. This article is based on Prasad and Ye (2012).

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The popular debate often conflates three related but distinct aspects of the renminbi's role in the global monetary system: (1) *internationalization*—its use in denominating and settling cross-border trade and financial transactions (i.e., its use as an international medium of exchange); (2) *capital account convertibility*—the country's level of restrictions on inflows and outflows of financial capital. A fully open capital account has no restrictions; and (3) *reserve currency*—whether the renminbi is held by foreign central banks as protection against balance of payments crises.

A currency's international usage and its convertibility are different concepts, and neither one is a necessary or sufficient condition for the other. Both conditions have to be met, however, for a currency to become a reserve currency. In this article, we consider these aspects in turn.

Internationalization of the Renminbi

China is promoting the international use of its currency by:

- Permitting the settlement of trade transactions with the renminbi.
- Easing restrictions on cross-border remittances of the renminbi for settlement.
- Allowing the issuance of renminbi-denominated bonds (“dim-sum bonds”) in Hong Kong and by foreigners in the Mainland.
- Permitting selected banks to offer offshore renminbi deposit accounts.
- Setting up local currency bilateral swap lines with other central banks.

The trajectory is steep in each of these categories but the amounts are still modest. Trade settlement occurs mostly on the import side; dim-sum bonds remain narrow in scope in terms of industry (primarily banking and financial institutions) and geography of issuance (primarily mainland China); and bilateral swap lines are not always drawn upon. Nevertheless, a big advantage for China is that Hong Kong provides an effective platform for launching these measures in an experimental manner without full capital account opening. However, these developments could soon hit their limits unless China's capital account becomes more open.

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The renminbi is also starting to appear in the reserve portfolios of some emerging market as well as advanced economy central banks. The bilateral currency pact that China and Japan agreed to in December 2011 is an interesting example of how China is attempting to reduce its dependence on the dollar while other countries, especially in the Asian region, appear eager to participate in such agreements because they see advantages to tighter trade and financial links with China. These shifts, which are more symbolic than substantive at present, will develop critical mass over time and have the potential to start transforming the global monetary system (see Prasad 2012).

Financial market development in the home country is one of the crucial determinants of a currency's international status.¹ Historically, each reserve currency has attained that status under unique circumstances and spurred by different motivations. But in all cases foreign investors have been able to buy high-quality assets, typically government and corporate bonds, denominated in the country's currency.

The relevant aspects of financial market development are the following:

- Breadth: the availability of a broad range of financial instruments, including markets for hedging risk;
- Depth: a large volume of financial instruments in specific markets; and
- Liquidity: a high level of turnover (trading volume).

Without a sufficiently large debt market, the renminbi cannot be credibly used in international transactions. If there is insufficient liquidity in markets for renminbi-denominated assets, the currency will not be attractive to foreign investors. Other central banks and large institutional investors will demand renminbi-denominated government and corporate debt as "safe" assets for their portfolios. At the same time, both importers and exporters may be concerned about greater exchange rate volatility resulting from an open capital account if they do not have access to derivatives markets to hedge foreign exchange risk.

¹For example, the strengthening of the U.S. financial market relative to that of the U.K. was a critical factor that contributed to the rise of the U.S. dollar's reserve currency status (Eichengreen 2011b).

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A key determinant of the U.S. dollar's status as the dominant global reserve currency can be traced to its financial markets, which remain unmatched in their breadth, the range of financial instruments available to foreign investors, the amounts of each such instrument, and the volumes of trading in those instruments. Paradoxically, for lack of adequate safe assets provided by other economies, the high and rising level of U.S. government debt is cementing the role of the dollar as the dominant reserve currency. This safety could well be a chimera if the U.S. debt position becomes unsustainable.

Thus far, commercial policies designed to increase the offshore use of the renminbi have been the centerpiece of China's currency internationalization process. Although this has been effective in promoting the renminbi's global role without risking the potential deleterious effects of capital account liberalization, the full potential of the Chinese currency's international use cannot be realized without more active onshore development.

Capital Account Liberalization

Given its size and economic clout, China is adopting a unique approach, which we refer to as "capital account liberalization with Chinese characteristics." As with virtually all other major reforms, China is striking out on its own path to a more open capital account. This is likely to involve removing explicit controls even while attempting to exercise soft control over inflows and outflows through administrative and other measures. The medium-term objective, which we believe will be achieved in the next five years, is an open capital account but with numerous administrative controls and regulations still in place.² This will allow the renminbi to play an increasingly significant role in global trade and finance, but in a manner that allows the government to retain some control over capital flows.

Reserve Currency Status

The renminbi's prospects as a reserve currency will be influenced by the following criteria:

- *Economic size*: A country's size and its shares of global trade and finance are important, but not crucial, determinants of its

²Yam (2011) has referred to such a system as "full capital account convertibility."

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currency's status as a reserve currency. China now accounts for 11 percent of world gross domestic product (15 percent if measured by purchasing power parity rather than market exchange rates) and 10 percent of world trade. In 2012, it is estimated to have accounted for about one quarter of world GDP growth.

- *Open capital account*: The currency must be easily tradable in global financial markets with no restrictions on capital flows. China is gradually and selectively easing restrictions on both inflows and outflows. The capital account has become increasingly open in de facto terms, but extensive capital controls still prevail (Prasad and Wei 2007, Prasad and Ye 2012).
- *Flexible exchange rate*: Reserve currencies generally trade freely at market-determined exchange rates. It is worth emphasizing that an open capital account is not synonymous with a freely floating exchange rate. China still has a tightly managed exchange rate, which will become increasingly hard to manage as the capital account becomes more open.
- *Financial market development*: A country must have broad, deep and liquid financial markets so that international investors will have access to a wide array of financial assets denominated in its currency. China has relatively shallow and underdeveloped government and corporate bond markets. Many other securities and derivatives markets are in their nascent stages.
- *Macroeconomic policies*: Investors in a country's sovereign assets must have faith in its commitment to low inflation and sustainable levels of public debt. China has a lower ratio of explicit public debt to GDP than most major reserve currency economies and has maintained moderate inflation in recent years.

There are no ironclad rules about the relative importance of and tradeoffs among many of the factors listed above. For instance, the Swiss franc is a global reserve currency even though Switzerland's shares of global GDP and trade are quite modest. Moreover, the eurozone, Japan, and the United States have large and rising public debt burdens, which raises questions about their macroeconomic stability but has not (yet) affected their currencies' status as reserve currencies. Some analysts have in fact extrapolated from the U.S. experience to argue that China must run large current account

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deficits if it wants to provide reserve assets to the rest of the world. But this is neither a necessary nor sufficient condition for attaining reserve currency status. Some major reserve currency economies, including the eurozone and Japan, have run current account surpluses or at least a balanced current account for a long time.

In addressing the reserve currency criteria vis-à-vis the renminbi, China faces two major challenges: (1) sequencing of capital account opening with other policies, such as exchange rate flexibility and financial market development, to improve the cost/benefit trade-off; and (2) financial market development—that is, strengthening the banking system and developing deep and liquid government and corporate bond markets, as well as foreign exchange spot and derivative markets.

China's ability to meet these challenges will determine the balance and sustainability of its economic development as well as the renminbi's role in the global monetary system. For example, liberalizing outflows could deliver collateral benefits, such as a broader range of saving instruments for households, and alleviate pressures to further accumulate foreign exchange reserves. Liberalizing inflows could help develop and deepen China's financial markets. Taken together, such measures can help catalyze progress toward China's objective of making Shanghai an international financial center and allow rebalancing of growth. However, a more open capital account can hurt financial stability and constrain monetary policy in the absence of a more flexible exchange rate and financial system reforms (Lardy and Douglass 2011; Prasad, Rumbaugh, and Wang 2005).

Although China's rapidly growing size and dynamism are enormous advantages that will help promote the international use of its currency, its low level of financial market development is a major constraint on the likelihood of the renminbi attaining reserve currency status. Moreover, in the absence of an open capital account and free convertibility of the currency, it is unlikely that the renminbi will become a prominent reserve currency, let alone challenge the dollar's dominance. 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.

Even with only gradual financial market development, we foresee that the renminbi will be included in the basket of currencies that constitute the International Monetary Fund's special drawing rights

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basket within the next five years. The IMF needs China a lot more than China needs the IMF, and the prospect of the renminbi's inclusion in the SDR basket could be seen as a way for the IMF—and the international community that it represents—to exercise leverage over China in internalizing the global repercussions of its domestic policies.

Conclusion

The Chinese government's approach to policies that promote the renminbi's use as an international currency is inherently linked to domestic macroeconomic objectives and financial market development. The impact of the renminbi on the global monetary system and whether it contributes to greater global financial stability depend on the manner and speed with which China opens up its capital account and develops its financial markets, what other policy changes are put in place to support this process, and what the implications are for China's own growth and stability.

The big question now is whether China's government will use the goal of making the renminbi a global currency to catalyze momentum on a broad agenda of domestic policy reforms that are required to support this goal. Ultimately, the path of China's growth and its role in the global economy will depend on those policy choices.

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