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BOOK REVIEW

Domenico Lombardi and Hongying Wang, eds. *Enter the Dragon: China in the International Financial System*

(Waterloo, Ont.: Centre for International Governance Innovation, 2015), 427 p. $28 paperback

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The emergence of the People's Republic of China (PRC) as one of the world's largest economies has produced numerous studies on the country's remarkable economic growth. Less attention, however, has been paid to China's currency, the *Renmin bi* (RMB) or "people's currency" (also known as the *yuan*), and its evolving role in the international financial system. Fortunately, this excellent volume of thirteen individually-authored chapters fills the gap with its primary focus on the "internationalization" of the RMB. Initiated after the 2008–2009 global financial crisis (GFC), internationalization involves transformation of the Chinese currency into a means of exchange, store of value, and unit of account comparable to other international currencies, particularly the U.S. dollar and British pound. Along with such initiatives as the New Development Bank and the Silk Road Infrastructure Fund, RMB internationalization is central to the push by the PRC for a greater role in the international economic order.

Adhering to the view of paramount leader Deng Xiaoping in 1978 that "finance is the core of a modern economy," subsequent Chinese leaders have sought to "deepen reform of the financial system" most recently at the 18th Chinese Communist Party (CCP) Congress in 2012. Led by the People's Bank of China (PBOC), the country's central bank, with support from the Ministry of Finance and the China Banking Regulatory Commission, the Chinese currency is rapidly acquiring the size, stability, confidence, and liquidity required of an international currency. This was apparent in late 2015 when the International Monetary Fund (IMF) included the RMB in its reserve currency basket of special drawing rights (SDR) subordinate only to the U.S. dollar and euro and ahead of the Japanese Yen and British pound.

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The benefits of RMB internationalization are substantial. As the RMB becomes a means of exchange for international trade and financial transactions, Chinese firms will enjoy a reduction in transaction costs and less exposure to exchange-rate risk. The country will also gradually extricate itself from the so-called “dollar trap,” namely the threat of dollar devaluation of the PRC’s huge dollar holdings of over $1 trillion in U.S. treasuries and other dollar-denominated assets that very nearly occurred in 2008–2009. Internationalization of the RMB is seen as the key for reducing China’s dependence on the dollar while at the same time boosting domestic reform—the so-called “reverse pressure mechanism”—in the country by bringing greater market forces to bear on exchange and bank interest rates while also liberalizing its capital account and other deregulation of the domestic market.

The major question posed by the authors is whether China can implement the fundamental domestic and international reforms, and assume the responsibilities that full internationalization entails. Although a strong currency is a prerequisite to the great power status to which China aspires, it also requires assuming substantial adjustment costs that follow from the increasing trade and balance of payments deficits inevitably brought on by the expansion of global liquidity inherent to internationalization along with a stronger domestic property rights regime than currently exists in the PRC.

The overriding consensus of the authors is that while China has made considerable advances toward internationalization, major obstacles remain that will persist for the foreseeable future. Among the most important advances are the promotion led by the PBOC of currency swap arrangements with 28 countries and the establishment of offshore financial trading hubs in Hong Kong, Macau, London, and several other major currency trading cities. Other trade and financial mechanisms include the Qualified Foreign Institutional Investor to soften limits on cross-border capital flows; joining the Chiang Mai Initiative to aid countries with liquidity problems through currency swaps; creation in 2015 of the Shanghai Free Trade and Financial Zone as a fully liberalized financial market; and promotion of an international bond market, so-called “dim sum” bonds, in Hong Kong while making other RMB-denominated securities available to both Hong Kong and Macao residents. With these and other comparable advances the RMB has been turned into a global safe asset currently the world’s fifth largest payment currency having surpassed the Australia dollar.

Yet major obstacles remain as the broad structural reforms needed to achieve full internationalization have been obstructed by a political and institutional rigidity perpetuated by the country’s highly regulated economy. Most important are the powerful state-owned enterprises (SOEs) and especially the five state-run commercial banks that thrive on the current system of exchange and interest rate control (so-called “financial repression”). For these powerful institutions, developing an open capital account and marketization of exchange and interest rates are an anathema such that Chinese financial markets still lack the requisite depth, liquidity, dependability, and openness of internationalization. Inaugurated 30 years ago, financial repression ensures that household wealth is transferred to the government and SOEs, virtually guaranteeing these politically powerful institutions huge profits. Despite recent moves toward a more consumer-based economy, China’s growth model still emphasizes investment and exports that effectively block internationalization. SOE and bank profits derive substantially from arbitrage (exchange and interest rate regulation), which everyone in this

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volume agrees is unsustainable over time but yet constitute the bedrock of the overall economy.

Further internationalization is also constrained by the country's huge holdings of U.S. treasuries making it a virtual prisoner of U.S. policy. Contrary to popular wisdom, these holdings are a burden depriving the PRC of any substantial economic and political influence. The result is insufficient liberalization of capital flow and ancillary reforms including greater protection for creditors' rights that internationalization requires. Until these and other crucial reforms are enacted, including bringing wealth management products and the growing shadow banking system under greater regulation, RMB internationalization will remain incomplete. At best the Chinese currency, like the euro, will be limited to a regional instead of global role that for the foreseeable future will continue to be dominated by the U.S. dollar.

Lawrence R. Sullivan earned a Ph.D. in political science from the University of Michigan and taught at several institutions including Wellesley College and Adelphi University. He is author of several books on China including the forthcoming *Historical Dictionary of the Chinese Economy.*

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