

THE SLOW, UNEVEN RISE OF THE RENMINBI

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The Chinese renminbi (RMB) has come a long way in a short period. It was only in the early 2000s that the Chinese government began the process of gradually opening up the country's capital account, allowing financial capital to flow more freely across its borders. This process was very gradual at first and picked up pace only a decade later. Over the last few years, the RMB's progress as an international currency has been remarkable in some aspects. However, the currency's seemingly inexorable progress stalled in 2014. Starting in mid-2014, the Chinese economy seemed to be losing steam, domestic and foreign investors became less confident about the stability of its financial markets, and, to compound these problems, China's central bank made some missteps as it attempted to make the currency's value more market determined.

Nevertheless, in October 2016, the RMB achieved a major milestone in its ascendance as an international currency. That month, the International Monetary Fund (IMF) officially anointed the RMB as an elite global reserve currency. The RMB joined the select basket of currencies (previously comprising the dollar, the euro, the Japanese yen, and the British pound sterling) that

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constitute the IMF's artificial currency unit, the special drawing right (SDR). However, this does not by itself mean that the RMB is already in a position to significantly reshape global finance, and it still has a long way to go before it can play a major role in international finance.

This article considers three related but distinct aspects of the role of the RMB in the global monetary system and describes the Chinese government's actions in each of these areas. First, I discuss changes in the openness of China's capital account and the degree of progress toward capital account convertibility. Second, I consider the currency's internationalization, which involves its use in denominating and settling cross-border trades and financial transactions—that is, its use as an international medium of exchange. Third, I trace the RMB's evolution as a reserve currency.

The RMB is likely to become a significant player in international financial markets even if its rise to prominence levels off, yet its full potential may remain unrealized unless the Chinese government undertakes a broad range of economic and financial system reforms. In the long run, what the RMB'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.

Capital Account Opening

In recent years, the Chinese government has taken a number of steps to elevate the RMB into this group of elite currencies by increasing its international use. However, the RMB's adoption in global markets has been limited by the Chinese government's unwillingness to free up its exchange rate and fully open the capital account.¹

The government has removed restrictions on capital inflows and outflows, but in a controlled and gradual manner. For instance, the government has set up a number of schemes to allow foreign

¹The literature examining specific aspects of China's exchange rate management and capital account liberalization, along with the RMB's rising role in international finance, includes Frankel (2005, 2011); Lardy and Douglass (2011); Yam (2011); Prasad and Ye (2012); Ito and Chinn (2014); Huang, Wang, and Fan (2014); Eichengreen (2015); Eichengreen and Kawai (2015); Yu (2015); and Subacchi (2016).

investors to invest in China's stock and bond markets. These include the Qualified Foreign Institutional Investor Scheme and the Renminbi Qualified Foreign Institutional Investor Scheme.

At the same time, there are now many channels available for Chinese households, corporations, and institutional investors that wish to invest some portion of their investments in foreign markets. This includes the Qualified Domestic Institutional Investor and Qualified Domestic Individual Investor Schemes.

A few channels for two-way flows, such as the Stock Connect and Bond Connect programs, have also been opened up. But the government continues to maintain a tight grip over each of these channels.

China continues to manage its nominal exchange rate, although it has in principle allowed market forces to play an increasing role in determining the external value of the RMB. In principle, the currency is now managed against a trade-weighted basket of other major currencies, although market participants still see China's central bank as playing a major role in influencing the level of the exchange rate in a manner that does not always hew to such a rule.

International Use of the RMB

China has promoted the availability of RMB outside its borders, including sanctioning 16 offshore trading centers where transactions between RMB and other currencies can be conducted. The government has also set up a payment system, the Cross-Border International Payment System, to facilitate commercial transactions between domestic and foreign companies using RMB rather than more widely used currencies such as the dollar and the euro.

These measures have led to the rising internationalization of the RMB. This term signifies its greater use in denominating and settling cross-border trade and financial transactions—that is, its use as an international medium of exchange. By the latter half of 2014, about one-third of China's international trade was being denominated and settled in RMB. Furthermore, according to data from SWIFT, by 2015 the RMB accounted for over 2 percent of cross-border payments around the world, a low share but one that already ranked the RMB as among the top five 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 concerns about rising debt levels and financial instability.

Since then, the RMB'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.

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 RMB has begun playing a larger, although still modest, role in international finance over a relatively short period. The SWIFT data reveal the rising prominence of the RMB as an international payments currency, although it is still a long way from being a major payments currency that can rival the U.S. dollar. This will be aided by a payments system that China has set up for intermediating transactions. In October 2015, China launched a new cross-border RMB payments system—the China International Payment System (CIPS)—that is organized more in line with internationally accepted standards. This will help facilitate settlement and clearing of cross-border RMB transactions, including trade and investment flows, and bolster the international role of the RMB.

Reserve Currency

A different aspect of a currency's role in international finance is its status as a reserve currency, one that is held by foreign central banks as protection against balance of payments crises. This topic might seem premature given that China has neither a flexible exchange rate nor an open capital account—two features once considered absolute prerequisites for a reserve currency. Even though the IMF has officially anointed the RMB as a reserve currency, financial market participants' views are more important in determining a currency's status.

The RMB's prospects as a reserve currency will ultimately be influenced by progress on these criteria: (1) capital account openness, (2) exchange rate flexibility, (3) economic size, (4) macroeconomic policies, and (5) financial market development.

This section discusses the relative importance of each of these criteria for reserve currency status and summarizes how China measures up against each of these.

Reserves must be acceptable as payments to a country's trade and financial partners, which requires that the currency be easily tradable in global financial markets. 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 remain in place.

Reserve currencies are typically traded freely and their external value is market-determined, although this does not preclude occasional bouts of intervention by the country's central bank in foreign exchange markets. China has in principle increased the flexibility of the exchange rate, but it still remains tightly managed.

China's economy is now the second largest in the world (based on market exchange rates). In 2017, its annual GDP was \$12 trillion, accounting for 15 percent of world GDP, placing it second only to the United States, which has an annual GDP of \$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 has accounted for one-third of global GDP growth since the financial crisis.

Investors in a country's sovereign assets must have faith in its commitment to low inflation and sustainable levels of public debt, so the value of the currency is not in danger of being eroded. 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.

A country must have broad, deep, and liquid financial markets so that international investors can access a wide array of financial assets denominated in its currency. China's financial markets remain limited and underdeveloped, with a number of constraints such as a rigid interest rate structure. The recent growth and opening-up of China's debt markets suggest that the pace of the country's financial market development is consistent with its intention to gradually increase acceptance of its currency as an international currency. Moreover, to satisfy their demand for relatively safe RMB-denominated assets, foreign investors—both official and private—will eventually need to be given greater access to China's debt markets if the RMB is to become a significant reserve currency.

Remarkably, the RMB has already become a de facto reserve currency even though China does not meet some of the traditional prerequisites. 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 RMB assets for their foreign exchange reserve portfolios. The list comprises a geographically and economically diverse group of countries, including Australia, Austria, Chile, Nigeria, South Africa, Korea, Malaysia, and Japan. According to IMF estimates, about 2 percent of global foreign exchange reserves are now held in RMB-denominated financial assets. About 35 central banks around the world have signed bilateral local currency swap arrangements with China's central bank. These arrangements give them access to RMB liquidity that they can draw upon to defend their currencies or maintain stable imports even if foreign capital inflows into their economies were to dry up.

Although the RMB has managed to attain the status of a reserve currency, its progress 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 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.

Safe Haven Status Out of Reach

Since the global financial crisis, a new concept has gained traction in international finance: that of a "safe haven" currency.² Such a currency is one that investors turn to for safety during times of global turmoil, rather than for diversifying their stores of assets denominated in foreign currencies or seeking higher yields on their investments.

China might have rising economic clout, but there is an open question whether it will ever gain the trust of foreign investors. 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

²See Prasad (2014) for more on the criteria for safe haven currencies.

credible central bank). These elements have traditionally been seen as vital for earning the trust of foreign investors, both private as well as official, including central banks and sovereign wealth funds.

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

While the Chinese leadership is pursuing financial liberalization and limited market-oriented economic reforms, it has 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 RMB has the potential to become a significant reserve currency, it will not attain "safe haven" status in the absence of far-reaching reforms to China's institutional and political structure. Such reforms are apparently not in the cards.

Conclusion

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

Still, notwithstanding some fits and starts in the process, the RMB is on its way to becoming a significant international currency, although this will take many years. If China plays its cards right, with suitable financial sector and other market-oriented reforms, the RMB has the potential to one day become an important reserve currency.

For the RMB to become a safe haven currency, however, China will have to undertake even more far-reaching reforms of its institutional framework that would ultimately alter its political, legal, and public institutions. As President Xi Jinping enters his second term with an even stronger lock on power, such changes seem unlikely.

Still, the RMB's rise to international prominence will change international finance, and even China itself, in many ways. Over the next few years, the RMB's rising importance in international finance could well serve as a catalyst for domestic reforms and also help in improving the stability of the international financial system.

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