CHINA'S MONEY

THE HOW, THE WHEN

The economic news from China has lately been dominated by the agonies of the stock market, which has been shuddering through high-speed twists and turns worthy of a Six Flags roller coaster.

GOES GLOBAL

AND THE WHY

BY BARRY EICHENGREEN

However, it's best read in the context of the larger issue of China's evolving integration with global financial markets, and, in particular, of the internationalization of the renminbi.

ANTHONY DEVLIN/PA WIRE

"Renminbi internationalization" is a mouthful – but handy jargon for describing the growing use of China's currency in cross-border transactions. Indeed, you'll be hearing it more often, as financial go-betweens around the world scramble to get a bite of the business. By 2011 (the latest year for which the numbers are readily available), more than 900 financial institutions in over 70 countries were doing business in renminbi (aka RMB), and those numbers are climbing rapidly.

This is happening with active encouragement from Beijing. The big question – well, really, questions – are what the Chinese government is prepared to do to make the RMB a true world currency that could readily serve as a substitute for dollars in international transactions, why the slew of reforms that must precede full internationalization are probably more important to China at home than abroad, and how internationalization will affect global financial markets now largely tied to the dollar (and to its regulators in Washington).

BARRY EICHENGREEN is the George and Helen Pardee professor of economics and political science at the University of California, Berkeley.

WATCH IT GROW

China's central bank, the People's Bank of China – as well as other key regulators, including the State Administration of Foreign Exchange – are taking highly visible steps to broaden the reach of the RMB. Restrictions on Chinese enterprises' discretion to pay for foreign purchases with RMB have been relaxed. And foreigners on the other end of those transactions are increasingly permitted to use their RMB to buy goods from China and to invest in the country's financial markets.

Consider, too, that Beijing, in cooperation with foreign governments, has designated

IMAGINECHINA

one of China's banks as the "official clearing bank" for RMB-denominated transactions for virtually every important Asian and European financial center. In June 2014, for example, it anointed the giant, publicly traded China Construction Bank as the RMB clearing bank for London. The bank is now authorized to buy RMB from customers in Britain (as well as to sell them), providing a low-cost option for firms that use Chinese currency for trade and investment.

In addition, the People's Bank of China has negotiated credit lines with a number of foreign central banks, including the Bank of England. Under these agreements, it stands ready to swap RMB for foreign currencies on demand. Foreign central banks with these lines of credit will thus be able to lend RMB – which they can't print – to customers in need. They will therefore be more inclined to permit local enterprises to engage in RMB-based business.

MOUNTAINS OUT OF MOLEHILLS

All this has the potential to alter the global financial landscape. The dollar and the country issuing it, the United States, currently dominate that terrain. The dollar accounts for nearly two-thirds of all identified foreign-exchange reserves of central banks and governments. It is involved in fully 85 percent of all foreign-exchange transactions. Indeed, more than 35 percent of cross-border payments are in dollars, despite the fact that the United States accounts for barely 10 percent of global trade.

This disproportionate importance of the dollar in international transactions confers a variety of benefits on the United States. Most notably, it gives Washington geopolitical leverage insofar as the Federal Reserve is the ultimate source of the emergency liquidity that everyone needs in times of crisis.

The RMB poses the most serious challenge to the dollar's monopoly since World War II

and the fading of the British pound. China is already the world's largest exporter, and, barring the unlikely scenario in which its GDP growth falls precipitously, it will soon have a larger economy than the United States as measured at current exchange rates (and not just in purchasing power). If China successfully internationalizes its currency, our dollar-centric system will be replaced by a more decentralized arrangement organized around the dollar and the RMB.

The RMB can only take on a dollar-like role if China takes the difficult steps to make its financial markets more liquid.

The existence of rival international currencies would fundamentally change the way the international monetary system operates, or so it is said. Countries would be able to turn to China instead of the United States for emergency liquidity, undermining U.S. financial and geopolitical leverage. But there's a downside for China, too. This transformation would create risks as well as opportunities since internationalization of the RMB can only take place if China opens its financial markets to foreign transactions – something that can have unforeseen, and sometimes unfortunate, consequences.

That said, some financial movers and shakers are inclined to view the current alarm over RMB internationalization as both premature and overwrought. They have a point. The Chinese economy is immense, but China is still a relatively poor country preoccupied with the problems of development at home. For the moment, its financial markets are opaque, volatile and only partially open to the rest of the world. Not surprisingly, then, the RMB is hardly a factor in the machinery of international trade, leagues behind the dollar. Where 95 percent of U.S. imports and exports are invoiced in dollars in its own currency, the same is true for less than 20 percent of China's own trade. China's currency accounts for a scant 2 percent of cross-border payments worldwide. All this could change, but it would have to change dramatically before the RMB began to rival the dollar.

Nor, incidentally, is the dollar's exalted status an unalloyed blessing to the United States that must be guarded at high cost. The country's "exorbitant privilege" as the issuer of the only true global currency may be a source of convenience for U.S. banks and firms able to do cross-border business in their own currency. But that advantage is a wasting asset in a world of ever-cheaper electronic currency trading and FX hedging.

The dollar's standing as a reserve currency does enable the United States to sell government bonds to foreign central banks at bargain-basement interest rates. However, there's a downside: the ongoing demand for dollars as foreign-exchange reserves by those central banks pushes up the dollar's exchange rate, putting U.S. exports at a competitive disadvantage and slowing U.S. growth. All this suggests that the United States may have less to lose from the rise of the RMB than meets the eye.

TWO SIDES OF THE COIN

In fact, RMB internationalization is both more and less important than conventional wisdom would have it. It is less important because it will surely take years, or even decades, before the currency comes to be used in inter-

national transactions on anything approaching the scale of the dollar. And it is less important from the U.S. perspective because there is no reason to imagine the dollar and the RMB as being engaged in a zero-sum battle: the global financial system has room for more than one international currency.

On the other hand, the decision to press for RMB internationalization is likely to have more profound consequences for China than are widely understood. The RMB can only take on a dollar-like role if China takes the difficult steps to make its financial markets more liquid, thereby lowering the cost of trading the currency, limiting volatility and reducing the chance that anyone making large purchases or sales in RMB-denominated securities will move prices to their own disadvantage. This will require not just the construction of more-efficient trading platforms, but also the implementation of more effective regulation, as well as success in attracting a more-diverse investor base. China's recent stock-market gyrations are testament to how much things will have to change.

But this is a slippery slope of sorts. The most direct way to enhance liquidity and increase investor diversity is to allow more foreign financial participation. Thus, for the RMB to rival the dollar, China would have to remove the vast majority of its restrictions on cross-border financial transactions, ultimately moving to what the International Monetary Fund refers to as full capital-account convertibility. An open capital account would, in turn, require China to move toward a more flexible exchange rate: experience has shown that free capital mobility and pegged exchange rates are a toxic mix. Moreover, it is hard to see how China could make this transition without dramatic growth in its service sector – in particular, in financial services.

All this would constitute a revolutionary transformation of the Chinese economy, one that de-emphasizes export-led manufacturing growth in favor of a more balanced mix of drivers. Indeed, the prospect of that transformation is precisely why many Chinese reformers back RMB internationalization. They see it as the edge of the wedge for promoting change that rebalances and liberalizes the economy.

Note that this strategy of using monetary and financial policies to ratchet up the pressure for broader change is not unlike the strategy adopted by European reformers in the 1990s. They saw the adoption of a common currency (the euro) as a way to force banking-sector reform and fiscal cooperation as well as political integration, since everyone would come to understood that monetary union without these reforms simply would not work.

But, as subsequent European experience reveals, sometimes the seemingly irresistible is, in fact, resisted. Putting the monetary/financial cart before the reformist horse can go wrong if the reforms required to make the initiative work do not follow. And Greece's problems suggest how badly wrong the denouement can be.

CHINA'S UPHILL CLIMB

China's financial markets, it is important to recall, were all but totally closed to the rest of the world as recently as a decade ago. Since then, granting access with an eye toward encouraging international use of the RMB has proceeded on two fronts: trade and finance. On the trade side, a handful of Chinese companies were authorized (starting in 2009) to settle their trade-related transactions in RMB with counterparties in Hong Kong and Macau, as well as in member-states of the Association of Southeast Asian Nations. The following year, virtually all companies in a handful of

Chinese provinces were permitted to settle import and export transactions in RMB. And in 2011, this authorization was extended to the entire country.

Since China is an export powerhouse, it made sense that if the RMB was to be used more widely in international transactions, it would be used first and foremost in trade. In effect, China's very extensive trade relations were harnessed to advance this goal, starting six years ago.

On the financial-capital side, foreign companies were authorized, starting in 2007, to issue RMB-denominated bonds in Hong Kong. The RMB funds thereby raised, principally from companies that had accumulated RMB bank deposits in Hong Kong from the proceeds of exports to China, were used mainly to finance foreign direct investments on the mainland. Then in 2010, "qualified" foreign institutional investors (QFII) – mainly Hong Kong-based banks and overseas banks involved in RMB cross-border trade settlement – were authorized to invest RMB in Chinese securities markets. This was known as the QFII program, for self-evident reasons. In 2012, the aggregate ceiling on qualified foreign institutional investors' investment was increased from $30 billion (US) to $80 billion. In 2013, quota shares were extended beyond Hong Kong and Macau to investors in Britain and Singapore.

A growing list of foreign countries that aspire to capture a slice of the rapidly growing RMB-related pie have received what are referred to as "the three gifts": an RMB swap line with the People's Bank of China, designation of a Chinese financial institution as official clearing bank to settle RMB-denominated transactions, and a qualified foreign institutional investors quota to invest in China's local-currency stock market. The list of recipients currently includes, in addition to the countries already cited, Taiwan, Germany, South Korea, France, Luxembourg, Qatar, Canada, Malaysia, Australia and Thailand. The length and geographical dispersion of this list suggest that if the RMB does make serious inroads as a medium of international exchange, the impact will be global and not just regional.

IMAGINECHINA

But for the three gifts to significantly influence international financial practice, China will also have to liberalize access to its domestic financial markets so that foreign investors can use their RMB inside China as well as outside.

This is where loosening of restrictions on the country's international financial transactions comes into play. Chinese officials have repeatedly emphasized that the progressive relaxation of those restrictions is a policy priority. In 2011, Yi Gang, the head of the State Administration of Foreign Exchange, announced that the country was prepared to undertake the transition to full currency con-

Since China is an export powerhouse, it made sense that if the RMB was to be used more widely in international transactions, it would be used first and foremost in trade.

vertibility in a series of "progressive steps" to be completed within five years. While this ambitious deadline could slip, Premier Li Keqiang recently vowed that "China will speed up the basic convertibility of the RMB on the capital account."

Beijing thus seems determined to deliver, if cautiously. To this end, it has unveiled the qualified domestic institutional investor program (which is equivalent to the qualified foreign institutional investors program), through which Chinese residents are allowed to invest abroad. But for the moment, anyway, they must invest through institutional funds, insurance companies and securities brokers approved by the China Securities Regulatory Program.

The government also launched the Hong Kong-Shanghai Stock Connect last November, through which investors in each of the two markets are permitted to trade shares on the other market using local brokers and clearinghouses. But such trades are permitted only up to specified ceilings and only in specified shares. Restrictions on other cross-border financial transactions remain.

Progress is a bit hard to track. But economists have developed summary measures that roughly track the openness of the capital account, among them changes in differences in the prices of identical securities traded both in China and abroad. Their findings vary. There is broad agreement, though, that while China's financial markets are indeed opening,

they have a considerable way to go before they are as open as the markets of most other middle-income countries.

THE FINANCIAL CENTER GAMBIT

The Hong Kong-Shanghai Stock Connect is a special case of a more general strategy for promoting RMB internationalization that relies on offshore financial centers and onshore free-trade and financial zones. For some years, China has used offshore markets, starting with Hong Kong and Macau but now extending to others, as venues for experimenting with financial liberalization and integration. Hong Kong was the first place where foreign institutional investors were permitted to buy and sell exchange-listed securities. It was similarly the first place where residents were permitted to conduct personal business in RMB and open RMB-denominated bank accounts. And, as noted above, it was the first place in which foreign companies were permitted to issue RMB-denominated bonds.

Then in 2010 Hong Kong was designated as an offshore RMB business center, authorizing a wide variety of other transactions in RMB. Taipei and Singapore obtained the same privileges in 2013. Other financial centers, including London, Sydney and Seoul, are angling for parallel access.

These offshore centers can be thought of as financial petri dishes in which foreign enterprises can gain expertise in RMB-related business and Chinese regulators can observe their performance. Offshore market participants can build the requisite clearing and settlement infrastructure. They can cultivate customers. They can offer the entire range of contracts facilitating risk management (for example, futures contracts).

All the while, controls on capital flows into China limit this activity to offshore markets. Capital controls, in turn, help to contain the potential threats to financial stability associated with volatile inflows and outflows. Some observers refer to this strategy of relying on offshore markets as "internationalization within capital controls."

Once domestic markets are suitably reformed and made more liquid, the reasoning goes, China's capital controls can be relaxed and the institutions that developed expertise offshore can migrate onshore. Because development of that expertise and those institutions had a head start in offshore centers, currency internationalization will be able to proceed more rapidly than might otherwise be possible without threatening financial stability in China.

Similarly, the Shanghai Free Trade and Financial Zone can be thought of as an experiment with financial integration in a limited area that insulates the broader Chinese economy from unanticipated effects. The Shanghai zone is essentially an offshore financial center onshore. Once it is fully up and running, trade between it and the rest of the world will be free of customs and licensing formalities. Companies there, both Chinese and foreign, will be permitted to open free-trade accounts for use in local and foreign currency transactions. Holders of such accounts will be permitted to freely transfer funds between offshore accounts and onshore non-resident accounts.

The goal, then, is to use the zone as an onshore testing ground for capital-account convertibility and a magnet for foreign financial intermediaries. But there are risks. For one thing, something could go wrong with the Chinese banks and enterprises operating inside this not-insubstantial zone. There could also be leakages between the Shanghai Free Trade and Financial Zone and the rest of the economy, undermining capital controls and

Offshore centers can be thought of as financial petri dishes in which foreign enterprises can gain expertise in RMB-related business and Chinese regulators can observe their performance.

creating financial vulnerabilities elsewhere. Previous experience suggests that, the longer these walls remain in place, the better financial markets become at scaling them. It is not clear why the Shanghai Free Trade and Financial Zone would be an exception to this rule.

Chinese officials are aware of the risks and have responded by moving deliberately, disappointing the optimists who figured the spigot would be wide open within a year of the plan announcement.

In fact, during the first nine months of 2014, cross-border fund flows in the Shanghai zone totalled just 15 percent of total cross-border flows in and out of Shanghai-based entities. As one observer put it, creation of the zone has done more, it would appear, to facilitate the inward and outward movement of goods than financial services, reflecting the reluctance of the authorities to actually implement their announced financial measures. Another analyst describes the most visible change within the zone as the availability of cheap imported shellfish from Vietnam and Mozambique.

KING OF THE HILL

RMB internationalization will be no walk in the park, and, understandably, Beijing is not prepared to take big risks to get from here to there. By the same token, there's ample reason to believe that displacement of the dollar as the global currency – or, more likely, the sharing of the dollar's status – will be an uphill battle even for a future, better-managed Chinese economy with a much larger global footprint.

The dollar has been the dominant international currency for seven decades. And that

persistence reflects habit formation that is self-reinforcing. Economists refer to this phenomenon as a network effect – in this case, the reality that it pays to use the same currency in international transactions used by one's customers and suppliers. The currency everyone uses is the one with the most liquid market, precisely because everyone uses it. And once these conditions are established, no one has reason to do otherwise. These network effects thus give rise to lock-in, in which a dominant international currency, once established, is difficult to dislodge.

To be sure, the dollar could be displaced if the United States sabotaged its own credibility. In particular, if Washington gave foreigners reason to doubt that it would honor its dollar-denominated debts, they might hesitate to accept and use dollars in other transactions. Searching for alternatives, they might then alight on the RMB.

We have heard such warnings before. In 2007, when the financial crisis erupted, a gaggle of talking heads warned of imminent flight from the dollar. In 2013, when the U.S. Congress temporarily balked at raising the limit on the debt that could be issued by the Treasury, the possibility that the government would default on payments to bondholders again prompted warnings that the dollar's days as the dominant international currency were numbered.

Yet on both occasions, the result was flight toward the dollar, not away from it. The best explanation for this paradox is that in periods of high uncertainty there is nothing investors value more than liquidity, and the market in U.S. Treasury securities is the most liquid financial market in the world. The dollar's status as incumbent – as the prevailing global currency – gives it an advantage in retaining that status even when the country issuing it, the United States, is the source of the shocks to the global system. Note, incidentally, that increasing the liquidity of domestic financial markets will be the hardest nut for Chinese policymakers to crack.

Nearly 40 percent of China's newly issued bonds mature in a year or less, presumably because investors are reluctant to commit to long-term finance.

In any event, it's far from clear that China's (very hard-won) success in elevating its currency to reserve status would be especially problematic for the global system. Some observers warn that a system organized around two international currencies rather than one would be unprecedented, and would likely be unstable. In fact, there are precedents. The British pound, French franc and German mark all played consequential international roles at the beginning of the 20th century. The pound and the dollar then shared first-billing on the international stage in the 1920s.

The second of these two systems, referred to as the interwar gold standard, did prove dangerously unstable. But its early 20th-century predecessor, the classical gold standard, performed better. The appropriate lesson to be drawn is that when the policies of the countries issuing the competing international currencies are themselves unstable, as was the case of the United States and Britain in the 1920s,

the international system organized around their currencies will be unstable. Before World War I, when policy was better, the operation of the international monetary and financial system was more satisfactory.

A SPRINT TO THE FINISH?

The most important consequences of the push to internationalize the RMB will be felt at home because internationalization depends so heavily on the development of deep and liquid financial markets to which non-residents have full access. This in turn will require fundamental changes in the Chinese economy.

Start with the deep and liquid part.

China's bond market is growing rapidly; it is now the third largest in the world, behind only those of the United States and Japan. But the market's weaknesses are all too apparent. Nearly 40 percent of newly issued bonds mature in a year or less, presumably because investors are reluctant to commit to long-term finance. Corporate issuance is the most rapidly growing segment, but it is heavily dominated by state-owned companies that are implicitly backed by Beijing. A substantial fraction of government bonds are issued by the three state-owned policy banks (the China Development Bank, the Export-Import Bank of China, and the Agricultural Development Bank of China) and formally guaranteed by the central government.

Most tellingly, more than two-thirds of government bonds are held by banks – Chinese banks in particular. This is not the diverse investor base to which architects of deep and liquid bond markets aspire. Banks are not active traders. Their dominance may thus account for the relatively low turnover in the secondary market, where turnover in government bonds is barely one-tenth the rate in the United States. Indeed, bid-ask spreads in the government bond market – a good measure of liquidity – compare unfavorably with those not just in the United States but also in the relatively small markets in South Korea and Thailand.

China is moving on multiple fronts to address these weaknesses. The National Association of Financial Market Institutional Investors, China's trade association of bond dealers and investors, has issued guidelines to enhance the transparency of the interbank market and minimize contracting problems. Meanwhile, regulators are seeking to enhance market transparency by requiring additional legal documentation of transfers of ownership.

A key question is whether China should accelerate liberalization of international capital flows at the onset as a way of increasing the diversity of the investor base and fostering market liquidity. Giving foreign investors unfettered access to Chinese financial markets would certainly solve the buy-and-hold problem at a stroke. But prudence suggests that capital-account liberalization must be accompanied by other far-reaching reforms in policy and institutions – notably stronger, smarter regulation that leaves markets less vulnerable to capital-flow volatility and a widening of regulation to bring the so-called shadow banking system into the light.

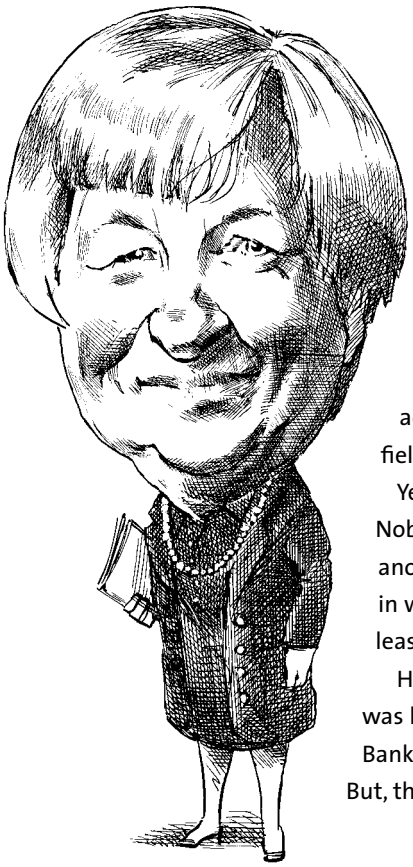
To give foreign investors confidence in the fairness and predictability of regulatory and financial policies, those policies would have to be better insulated from politics and interest-group pressure. The principal regulators would have to be granted statutory independence – a sea change for a hierarchical political system like China's.

With finance free to flow in and out of the country, China would have to move quickly to a more-flexible exchange-rate regime, since greater exchange-rate flexibility would be needed as a buffer against the vicissitudes of capital flows. That would make it impossible for the government to hold the exchange rate

at artificially low levels as a means of promoting exports and enhancing the profitability of export-dependent enterprises. And that, in turn, would force China to rebalance its economy, shifting away from investment in export-oriented industries to consumption, which now accounts for only a third of GDP – barely half the ratio typical of advanced countries.

These changes more or less mesh with the plans of the current government. But they cannot be completed overnight. And for this reason, any strategy for short-circuiting the laborious process of building liquid financial markets carries considerable risks. Corporations, both non-financial and financial, might respond to the appetite of securities-hungry foreigners by recklessly issuing debt. Banks with easier access to foreign funding would be tempted to lever up their balance sheets. At the same time, increased exposure to volatile international capital flows would heighten macroeconomic volatility, especially if it preceded the transition to a significantly more-flexible exchange rate and monetary policies.

The move to the next stage in China's economic development is bound to be perilous in the best of circumstances. But reliance on capital-account liberalization as a means of accelerating that transition would be far riskier. Internationalizing the RMB, one must conclude, will be a marathon, not a sprint.



And our economist on the spine is...

You guessed it (I'm an optimist): the caricature on the spine of the *Review*'s 2015 issues is **Janet Yellen**, the first woman to chair the Federal Reserve Board. Actually Yellen is quite accustomed to cracking glass ceilings. She was the second woman to chair the White House Council of Economic Advisers (Laura Tyson pioneered that one). And she had a long distinguished career in academic economics (Harvard; University of California, Berkeley), a field that until quite recently was virtually a boys club.

Yellen's views on macroeconomics (she wrote her PhD thesis under Nobelist James Tobin at Yale) are fairly conventional. Or, to put it another way, she has remained a pragmatic Keynesian across decades in which macroeconomic theory became ever more faddish. And, at least in this humble editor's opinion, history has proven her right.

Her one significant policy flub, which she is first to acknowledge, was her failure (as the president of the San Francisco Federal Reserve Bank) to sound the alarm over the rapidly inflating housing bubble. But, then, she's in very good company on that score. — *Peter Passell*

DAVID SMITH