

COMMENTARY

The Renminbi's Ascendance in International Finance

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In this wide-ranging review of recent developments involving the progress in renminbi internationalization, Eswar Prasad concludes, “Given China’s sheer size and its rising shares of global GDP and trade, these steps are gaining traction and indicate the growing role of the renminbi in global trade and finance.” This is a difficult proposition to argue with. I would say the renminbi is already an important regional currency. The question is the extent of the prominence and when, if ever, the renminbi will become a *key* international currency.

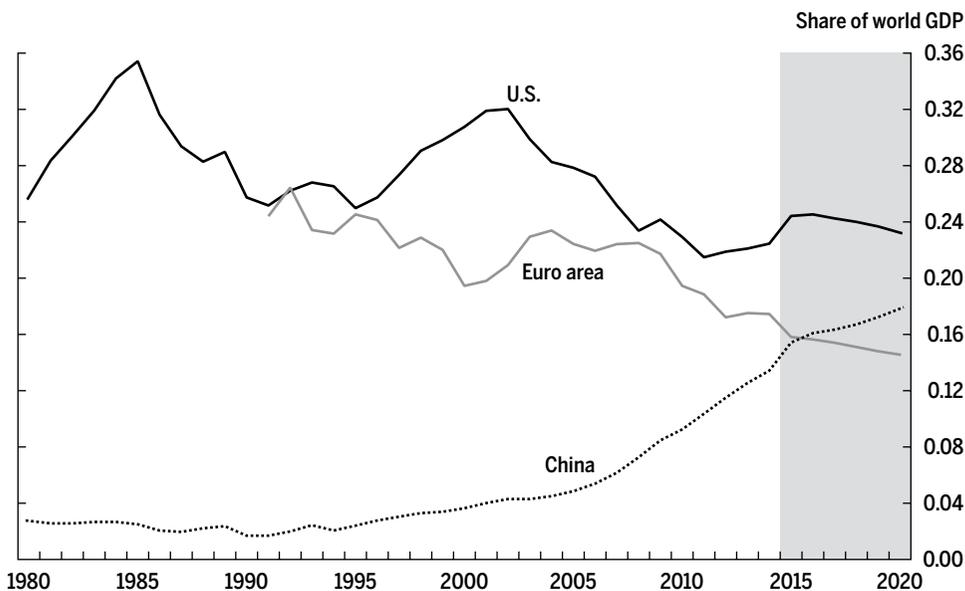
China’s Economic Weight Is Not the Same as the Renminbi’s Financial Weight

To begin with, there is no doubt that China’s economic weight in the world economy has surged over the past two decades, overtaking the euro economy weight, in dollar terms. Figure 1 depicts this process of overtaking. However, we also know that for a currency to become a reserve currency, it needs much more than sheer economic mass. Figure 2, taken from Chinn and Frankel (2007), shows the currency composition of foreign exchange holdings of central banks, before the advent of the euro, plotted against the share of eight-country gross domestic product (GDP). The highly nonlinear relationship between GDP and share in reserve currency holdings is clear and is verified in the post-Bretton Woods sample examined by Chinn and Frankel. This nonlinear relationship between reserve currency status and economic output is also likely to hold for other dimensions of an international currency.

In this extremely informative and comprehensive review, Prasad recounts recent developments in liberalizing domestic, cross-border transactions; examines the pace of internationalization of the renminbi; and discusses the challenges in terms of sequencing opening and financial liberalization. A signal of this rising importance is the inclusion of the renminbi in the special drawing rights (SDR) basket. To that point, I would add that the renminbi has become an anchor for other currencies in the East Asia region.¹

I have one caveat before proceeding. One of the motivations given for the devaluation in August 2015 was the objective of making the renminbi exchange

FIGURE 1
GDP in Trillions of USD, at Market Exchange Rates



Source: International Monetary Fund's *World Economic Outlook* (October 2015).

Note: Shaded area denotes estimates.

rate regime more flexible. I wonder how much of this goal has really been achieved, i.e., how much has really changed. Figure 3 depicts the day-to-day change in the CNY. It is not clear that there has been much of a change.

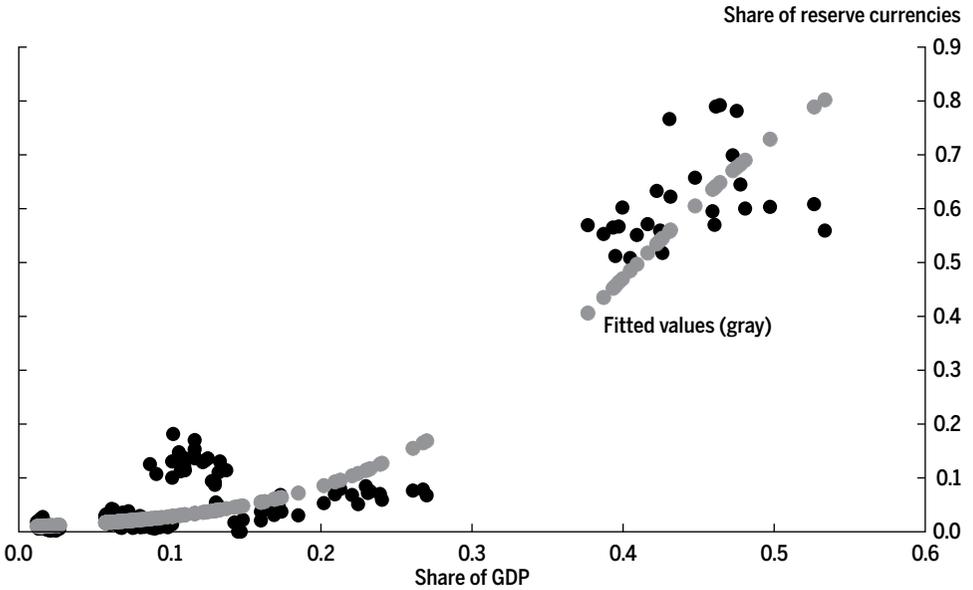
Progress on the Prerequisites for Internationalization

There has been some clear progress along one important dimension: capital controls. While this openness doesn't show up in some standard measures (including the Chinn-Ito 2006 index), it does when looking at measures based on a finer level of disaggregation of categories afforded by the 1997 revision to the *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*. Simple averages and weighted averages of these restrictions are shown in Figure 4, drawn from Chen and Qian (2016).

This process is important, because as shown by Chinn and Ito (2006), financial openness is critical to the process of financial development, and financial development is the critical factor determining a reserve currency. No reserve currency exists without a highly developed financial system.

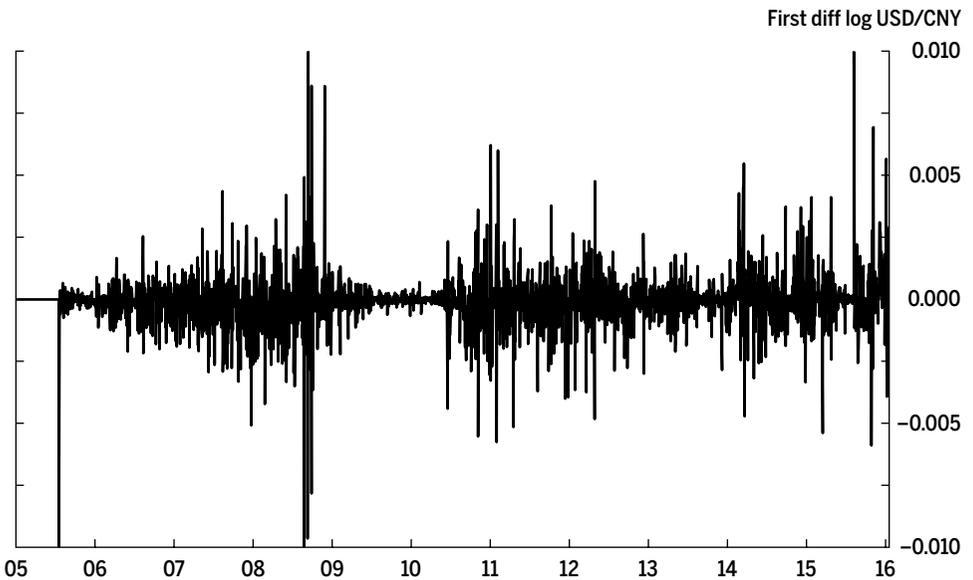
Sheer economic mass and presence in trade partly accounts for the rapid development of the renminbi as an invoicing currency. Figure 5 documents the

FIGURE 2
Share of Reserve Currencies vs. GDP Share



Source: Chinn and Frankel (2007).

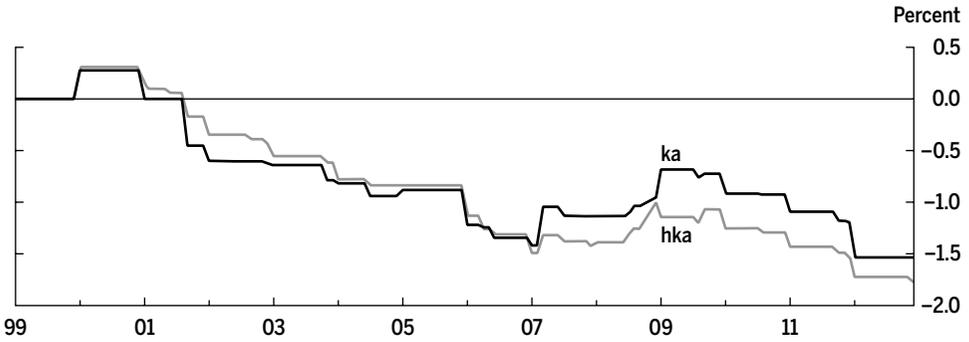
FIGURE 3
Log First Difference of USD/CNY Exchange Rate, Daily



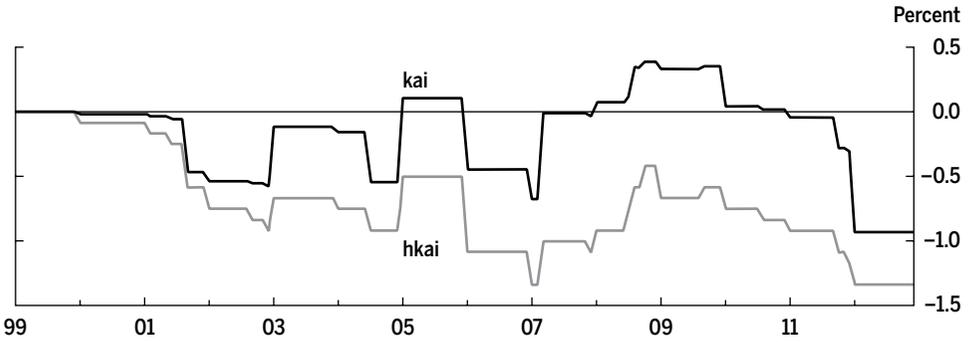
Source: Federal Reserve Board.

FIGURE 4
Capital Account Openness Indices

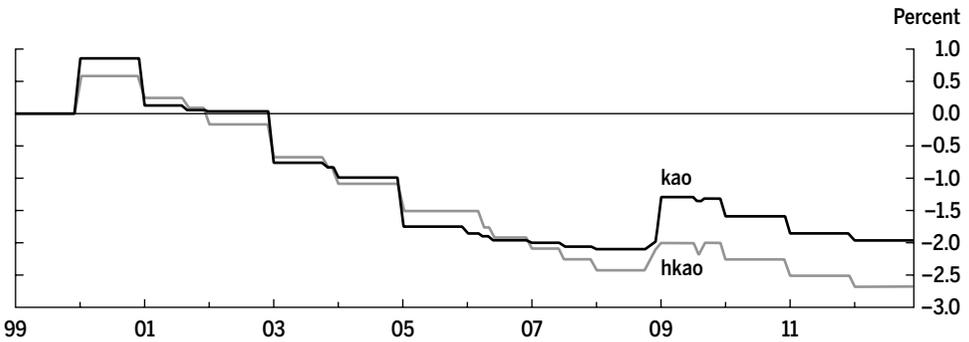
A Gross Flows



B Inflows

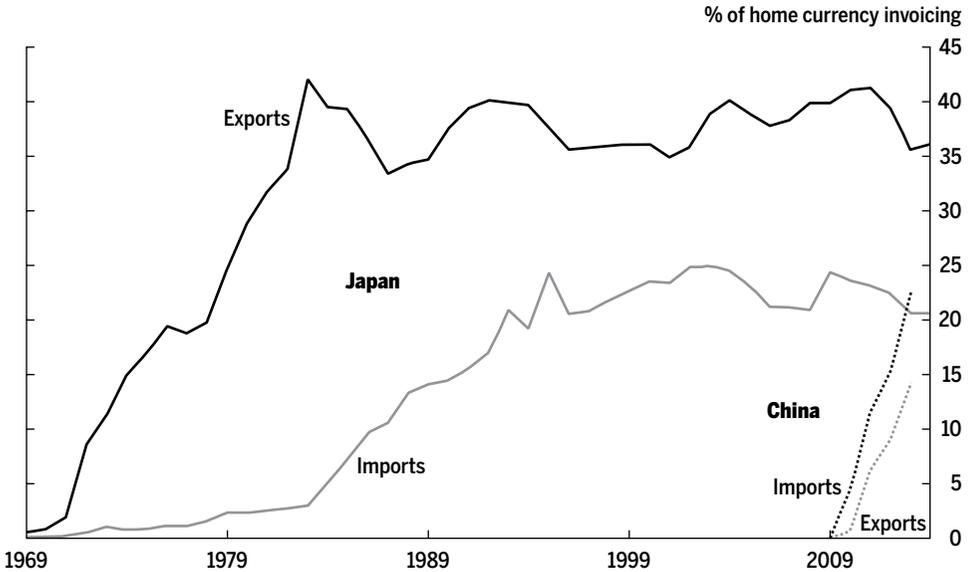


C Outflows



Source: Chen and Qian (2016).

FIGURE 5
Share of Invoicing of Trade in Own Currencies, for Japan and China



Source: Ito and Chinn (2015).

fact that the renminbi has recently taken off as an invoicing currency; however, as of 2013 it remained below predicted levels, according to Ito and Chinn (2015).

How Close?

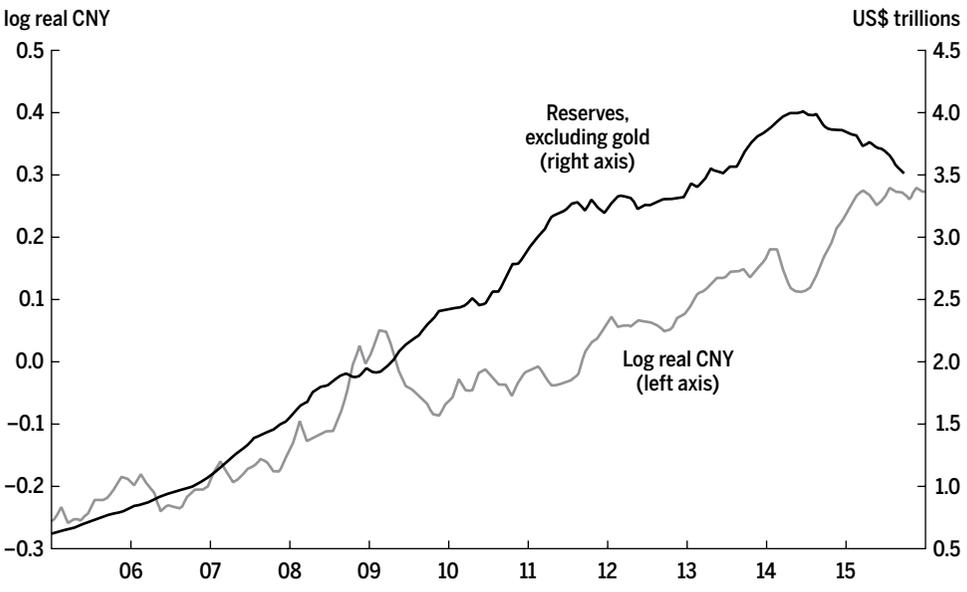
In the end, reserve currency status and extensive use as in invoicing and denominating financial transactions (as opposed to trade) will depend on deep and liquid financial markets, including active stock and bond markets, efficient financial intermediation, and so on.² In Chinn and Frankel (2007), this measure is proxied by foreign exchange turnover. Where does the renminbi stand? China accounts for 0.7 percent, Hong Kong 4.1 percent. When Hong Kong and China are one, then it is in the ballpark of Japan's 5.6 percent share of total forex turnover. And the yen constitutes about 2.2 percent of total central bank foreign exchange holdings. So is the renminbi on the way to becoming a major reserve currency and a currency used in financial transactions?

Perhaps. But in the end, I think it is wrong to focus on the technical constraints to internationalization. Rather, it is probably more fruitful to consider the pace of internationalization as being determined by political choices regarding fuller cross-border/domestic liberalization and the accompanying loss of policy autonomy.

The key question is then, what price in terms of policy autonomy are Chinese policymakers willing to pay in order to achieve renminbi internationalization? This question has been thrown in sharp relief by the faster than anticipated deceleration in growth. Will they be willing to give up the lever of exchange rate management in order to retain monetary policy independence? Will they relinquish control over the financial system (and ability to stem financial outflows) that would occur with capital account convertibility? The heavy-handed nature of intervention in the stock market over the summer of 2015 gives one pause for thought. We may see further backsliding on exchange rate flexibility (and capital account liberalization) if foreign exchange reserves continue to decline, as shown in Figure 6.

These are assessments of political will, and I have no particular expertise in judging the likely outcomes of these policy debates. Personally, I doubt whether full capital convertibility will be achieved in the next five years (and that's not even tackling domestic financial deregulation). Hence, the renminbi will be—and in fact is already—an important regional currency. But graduation to a major international currency is a long way off.

FIGURE 6
**Log Real CNY (Left Axis) and International Reserves, Excluding Gold,
 in Trillions of USD (Right Axis)**



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NOTES

1 Chinn (2014) finds that in recent years, East Asian currencies have become more highly correlated with the CNY.

2 See Chinn (2015) for further discussion of measures of financial development, in relation to emerging reserve currencies.