COMMENTARY

The Renminbi's Role in the Global Monetary System

Shang-Jin Wei

Why May the World Want to Welcome the Internationalization of the Chinese Currency?

Anxiety, Excitement, or Indifference?

China appears to be taking various actions to increase the international role of its currency, the renminbi, through its greater use as a settlement currency in China's exports and imports, and bilateral swap lines with a few central banks in the world that make the renminbi available to them. Some have started to talk about the eventual displacement of the U.S. dollar by the renminbi as the preeminent international reserve currency; others noted (perhaps with an audible sigh of relief) that many of the prerequisites for the renminbi to be a reserve currency are not fulfilled, and therefore the talk of the renminbi as a major international currency is way too premature.

The list of prerequisites is said to include (a) a deep and liquid domestic financial market, including vibrant government and corporate bond markets, (b) capital account convertibility, (c) a flexible nominal exchange rate regime, (d) a stable domestic macroeconomic situation including low inflation and a government debt level within a sustainable threshold. Except for the last one, China is lacking on the other three. There is no strong expectation that China will deliver all of the three any time in the near future.

While these points are discussed as prerequisites for internationalization of the renminbi, it is important to ask ourselves what the goals are and what the means are. For China, internationalization of the renminbi should not be the goal, but improving living standards of its citizens on a sustainable basis should be. Indeed, internationalization has never been articulated as an important national strategic goal. China's twelfth five-year plan, which is supposed to guide the government policies over 2012–16, and is thick with comprehensive targets in various sectors and areas, has only a few somewhat vague sentences on internationalization of the renminbi ("more use of the renminbi in cross-border transactions"). Relative to numerous other goals, this item lacks quantitative targets or a clear timetable. To put it simply, internationalization of the renminbi has yet to be regarded as a priority item of even medium-level importance on the nation's long list of priorities. This is perhaps appropriate from China's standpoint.

In this commentary, I ask a few related questions. First, would a greater international use of the renminbi bring benefits to the world economy? Second, are there things worth doing by international organizations and governments other than that of China that can help promote the greater international use of the renminbi? Third, in which areas are we likely to see a surge of China's outbound capital flows?

Benefits and Costs to the World Economy

When we talk about the implications of the greater internationalization of the renminbi for the world economy, it is useful to distinguish countries whose currencies are major reserve currencies (chiefly the United States, euro-zone member states, Japan, the United Kingdom, and Switzerland) and other countries. For countries whose currencies are not reserve currencies, the effects are mostly beneficial. At this juncture, these countries are between a rock and a hard place in terms of their foreign exchange management. Most of their foreign exchange reserves (about 63 percent as of 2010) are placed in U.S. dollars (or U.S. government securities and agency securities). Not only is the nominal yield in the dollar terms low, the risk of a massive capital loss in the form of dollar deprecation is tangible. In fact, the U.S. government and industrial establishment are actively seeking a weak dollar policy. Sure, the U.S. government has a consistent strong dollar rhetoric; but that consists mostly of an "open-mouth" operation rather than being backed by the Federal Reserve's Open Market operations. More diplomatically, the policy goal could be expressed as having a strong dollar at home but a more competitive dollar abroad. Many prominent economists in international macroeconomics both predict and proscribe a gradually weakening U.S. dollar as a necessary ingredient for the U.S. economic adjustment in the next decade or more.

After the dollar, most countries tend to store their foreign exchange reserves in a combination of the euro, yen, British pound, and Swiss franc government securities (for a collective share of about 25 percent as of 2010). Most of these economies have not been doing great since 2008. This is especially clear in Europe, where a sovereign debt crisis is brewing, and Japan, where a robust recovery from two lost decades has been put on hold by a combination of nuclear power disasters and the spillover from the weak European and U.S. economies.

If the renminbi were to attain a higher international profile, the non-reserve currency countries would have extra flexibility in managing their foreign exchange reserves, potentially reducing the capital loss from being restricted to choose among the existing cast of currencies.

Now I turn to the club of countries whose currencies are already major reserve currencies. Having one's currency as a reserve currency brings a lot of benefits, including prestige, seigniorage revenue, lower borrowing costs for their governments, corporations, and households, and a much lower if not zero probability of a debt crisis. Against this background, it is easy to think that added competition from a new kid on the block would dilute some of these benefits. If you hear that you may be displaced by a newcomer, you can be excused for not feeling like helping to expedite the process.

However, there are benefits even for reserve currency countries from a greater international use of the renminbi. First, many of the measures China would have to take to enhance the international role of the renminbi carry collateral benefits for these countries. The leading existing reserve currency country, the United States, wants China's current account surplus to shrink and the renminbi to be revalued. For example, according to the theories of Caballero, Farhi, and Gourinchas (2008) and Ju and Wei (2010), a more developed domestic financial market would reduce China's exports of its domestic savings abroad. So the United States might wish to encourage more domestic financial development in China. Second, the governments of major reserve currencies want to see more flexibility in China's nominal exchange rate regime. One of China's concerns in the exchange rate reform is the prospect of a massive capital loss in its foreign exchange reserve holdings. If greater renminbi internationalization translates into a rising share of its foreign assets being denominated in renminbi, China will be less hesitant in the exchange rate reforms, other things equal.

While greater capital account convertibility per se may have an ambiguous effect on China's net capital outflows, it could create incentives for China to expedite the schedule on nominal exchange rate reforms, since China will be more keenly aware of the impossible trinity after the renminbi becomes more convertible. If one believes a more flexible nominal exchange rate would reduce China's current account surplus, one should also be inclined to give more consideration to the effects of exchange rate flexibility on the internationalization of the renminbi. Personally I do not regard this as an effective way to address current account imbalances, and my paper with Menzie Chinn (Chinn and Wei, forthcoming) suggests that this is not an empirically valid point. If one assigns a big enough weight to the importance of the renminbi flexibility, one ought to be willing to exert some effort to help with moving the action.

What Can Other Countries and International Organizations Do?

To the extent that measures have been deployed to promote renminbi internationalization, they are largely actions by the Chinese authorities in the areas of trade invoicing, swap agreements with selected central banks, attempts to deepen domestic financial markets, and reviews of capital control regimes with a view to introduce selective liberalization. Do other governments and international organizations have a role to play?

Over the last few years, we already see the birth and modest growth of panda bonds (the issue of renminbi-denominated bonds by a few multinational corporations such as KFC and the Asian Development Bank, to Chinese residents) and of the dim sum bonds (the issuance of renminbi-denominated bonds in Hong Kong by Chinese entities to non-Chinese resident entities). Both have room to grow. But why not introduce more renminbi-denominated products, which I call kung-fu bonds, renminbi-denominated bonds issued by any creditworthy entity to other entities?

Some might ask how this can be done if China does not completely liberalize capital controls. The answer is easy. The key is to separate currency of settlement from currency of denomination. The bond can be denominated in renminbi, so its future payoff is protected from potential depreciation of the dollar or the euro against the renminbi, but the settlement can be done in the dollar, the euro, or any other hard currency at the exchange rate prevailing at the date of maturity.

Now consider two applications of the kung-fu bond idea. One topic in international financial architecture is whether or not the Chinese renminbi should be included in the International Monetary Fund's basket of special drawing rights (or SDRs for short). The SDR is an artificial reserve currency created by the IMF. Its value currently is determined by a basket of four currencies: the dollar, the euro, the yen, and the Swiss franc. SDRs currently account for only 10 percent of worldwide reserves, falling far short of the vision of its creators. The Chinese central bank governor mused over the possibility of adding the renminbi to the SDR basket. The key benefit for the world economy from the renminbi's inclusion is the potential for a more rapid rise in the use of SDRs as a reserve currency. The IMF has always said that it is better for member countries to look to the IMF for collective insurance against global shocks than for individual countries to try to build their own self-sufficient war chests. The

SDR currently consists of a bunch of "losers," not in a derogatory sense, but in the sense that these currencies are expected to lose value vis-à-vis the renminbi over the medium term. Indeed, it is no secret that many governments of the SDR-constituent currencies would like to see a faster renminbi appreciation against their own currencies.

So far, the IMF has ruled out the inclusion of the renminbi in the SDR basket on the ground that the Chinese renminbi is still not convertible. From the previous discussion, it is clear that the exclusion is based more on (arguably misguided) political considerations than technical feasibility. Again, the value of the SDR can very well be pegged to a basket of the five currencies including the renminbi, but the settlement can be made in the U.S. dollar (or any other hard currency.) As long as one is willing to consider this separation of denomination and settlement, capital account convertibility is not needed for a currency's inclusion in the SDR basket.

With the European sovereign debt crisis hanging on a cliff, the world wishes China could be more forthcoming in lending a bigger portion of its foreign exchange reserves to help rescue the euro-zone economies. From China's point of view, it would be imprudent to invest aggressively directly in European debt because the prospect of a capital loss is simply not consistent with the internationally common principle of safety and prudence governing a country's official foreign reserves management. Neither is it wise for China's sovereign wealth fund, the China Investment Corporation (CIC) to aggressively enter this territory. There is in fact a way out (or in). If China can buy a special IMF bond, denominated in the value of an enlarged SDR basket that includes the renminbi, then China would be more willing to lend its vast savings to the purpose of rescuing the European economies. The ensuing credit risk is mitigated by the IMF's more diverse portfolio of lending programs, and the ensuing exchange rate risk is mitigated by having the renminbi as part of the denomination unit.

Let us dial up the audacity level of the out-of-box thinking by one more notch. Perhaps the United States and the European governments (and certainly companies from these countries) could consider letting a portion of their future borrowing be denominated in the renminbi. The benefits to China are obvious—there would be less risk of capital loss triggered by a dollar or euro depreciation. What about the benefits to the United States, Europe, or other countries that choose to do so? First, if this helps convince the Chinese to buy more of their debt, it would help to hold down their cost of borrowing. Second, as China becomes less worried about the capital loss on its foreign exchange holdings from greater renminbi flexibility, China would be more willing to let the nominal exchange rate float To the extent this is important to Western governments (and plenty of politicians proclaim it is very important to them), this should be considered worth facilitating.

Some might doubt whether the United States would ever tolerate the humiliation of denominating its government debt in a foreign currency. If the United States does, it certainly won't be the first country to do so. Most countries denominate their debt in a foreign currency when they need to borrow from the international capital market. Moreover, history shows that the United States is very pragmatic. History, by the way, also reveals that the United States has already denominated some of its government debt in a foreign currency (namely, the deutsche mark in the 1970s). In any case, one has to weigh benefits and costs of doing such a thing rather than dismissing it out of emotion.

The Future of the Renminbi and Chinese Capital in the World Economy

Fundamentally, whether the renminbi will continue to grow in its international profile, and whether capital coming out of China will attract increasing attention are first and foremost determined by two key questions. Can China maintain its growth momentum over the next decade and more? And, can China continue to pile up foreign asset holdings?

On the first question, the optimists think that China will overtake the United States in terms of the absolute size of its economy before the end of this decade, while the pessimists think that the Chinese economy is on the verge of a collapse. My personal view is that the Chinese growth rate will be lower in the next decade than in the last decade, partly because the past success has raised its labor cost sufficiently that it has to switch its growth model from relying mostly on replications and duplications to putting increasing weight on innovation and upgrading. Both textbook models of economic growth and existing experience from other countries suggest that it is entirely normal for the growth rate to slow down after a country enters the middle-income group. However, existing international experience and the textbook growth models provide only an incomplete guide for thinking about the growth prospect of the Chinese economy. The Chinese political institutions and bureaucratic incentive structure have been partly deployed to create an economic environment that is arguably more favorable to capital owners and firm growth than its many democratic counterparts at the comparable stage of development (Du and Wei, 2011). More importantly, an increased competition for (relative) wealth status, motivated by a desire to improve one's (or one's children's) relative status in the marriage market, and triggered by a rise in the sex ratio imbalance, has motivated more people to want to be entrepreneurs. It has also motivated more people to willingly tolerate longer and harder work. Both of these motivations give powerful additional stimulus to economic growth that is not commonly shared by other countries. I have estimated that this factor accounts for about 20 percent of China's recent growth rates (Wei and Zhang 2011a, b). This implies that China will grow a bit stronger and longer than other countries have experienced or than standard theoretical models would have predicted.

On the second question, Chinese foreign asset accumulation will slow but will not die out, let alone reverse, any time soon. Some of the factors that led to the current pace of foreign asset accumulation are temporary. The accession to the World Trade Organization and the phased-in reforms associated with the accession were implemented over 2002–06 but ran out of steam by 2008 (Ju, Shi, and Wei 2011). This produced a temporary boost to China's current account surplus (perhaps by 2 to 3 percent of GDP a year) over 2002–08, but the effect is dying out. Other factors that had also triggered a run-up of the current account surplus are more persistent. Many factors that caused a rise in China's household and corporate savings in the last eight years are in this category. This includes an inadequate social safety net and financial underdevelopment. But an intensified competition in the marriage market, triggered by a rise in the sex ratio in the premarital age cohort since 2002, is also a quantitatively important factor (Du and Wei 2010).

Even if China's total foreign asset accumulation were to be kept at the same pace, there is no reason that its foreign exchange reserves have to grow at the same pace. When China pushes selective relaxation of the controls on capital outflows, maybe because it wishes to facilitate more international use of the renminbi, the world should expect to see a massive rise in China's outbound foreign direct investment and outbound portfolio investment. After all, even though the government finance of many Western countries is on shaky ground, the next Apple, next Google, and the like, are still more likely to emerge in the United States and to a lesser degree in Europe and Japan. Therefore, it is more sensible for China to see a transformation of the composition of its foreign asset holdings towards more productive and innovative assets and less government debt. However, the exact geographic distribution of China's outbound foreign direct investment or portfolio investments will be affected by political as well as economic factors in the potential destination markets.

The increasing internationalization of the renminbi will happen with or without the help of Western governments. It is perhaps better for them if they choose to facilitate and perhaps shape the path of the renminbi internationalization.

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