

GENERAL DISCUSSION

The Renminbi's Role in the Global Monetary System

Chair: Sarah Bloom Raskin

Ms. Raskin: Questions?

Mr. Goodfriend: I find this discussion very interesting in light of a point that's come up that I hadn't thought about before. One of the advantages of the United States having a reserve currency is that it earns a liquidity services yield on Treasury bills and notes, which allows the U.S. to borrow at a lower cost than otherwise. China, being on the opposite side of the transaction, is using the United States as a bank. However, the Chinese can earn liquidity services yields themselves by offering line of credit services from the People's Bank of China (PBOC) to neighboring countries in East Asia. You mentioned that this was beginning to occur through what you call the swaps program. To me the swaps program is nothing but a line of credit program that China is offering to East Asian countries—that in a way competes with the alternative to self-insurance by holding U.S. Treasury securities as reserves. Consequently, countries hold less U.S. Treasury securities, and, if they have good financial relations with the PBOC, they get a line of credit, which is an alternative means of receiving liquidity services. This is a smart move for the Chinese who are trying to get into the business of getting the returns from providing liquidity services to neighborhood trading partners and central banks for whom, if the conditionality was suitable, being able to draw on a line of credit with the PBOC is a good substitute for holding low-yielding U.S. Treasury securities. I'd like you to comment on whether the Chinese see this as a direct way to compete with U.S. liquidity services provision.

Mr. Prasad: That was stated more elegantly than I could have. I should add to what you just pointed out, there is this sense of central banks actually explicitly holding Chinese renminbi in their reserve portfolios. The Bank Negara Malaysia hasn't officially announced this, but apparently they have been accumulating Chinese assets. Chile also has some renminbi assets. There's an interesting question here, whether this makes sense from the point of view of what you hold reserves for. You hold reserves to deal with pressures on your currency and to provide consumption smoothing services. But most importantly, a large

stock of reserves, to use Hank Paulson's analogy, shows that you have a really large bazooka in your pocket so that markets won't attack you. So, if part of this bazooka is tinged with red, does that affect the credibility that markets have in your bazooka? In other words, if you have renminbi reserves, but the International Monetary Fund doesn't count them as reserves, does the market still, so to speak, buy it? The answer seems to be, increasingly, yes, because ultimately the relationships that many of these economies have are very intense trade and financial relationships with China. It makes perfect sense for them to hold reserves in renminbi, even though it's not a convertible currency, because they can pay for imports from China. So in a sense, I think the Chinese are not actively encouraging other central banks to go out and hold renminbi, but I think it's part of the process by which the renminbi gains much more acceptance within the Asian region.

Mr. Goodfriend: I'm interested also in whether China is going to use its swap line more loosely as a liquidity services line of credit, which I find fascinating. Ordinarily swap lines are used for emergency credit, but it is possible to conceive of this as allowing more routine access to liquidity services for trading partners. That is, if you do business with me, I'll give you trade credit.

Ms. Raskin: So are bilateral agreements set up between the central banks? And are they drawn upon?

Mr. Prasad: They are drawn upon, to some extent. The notion with which the bilateral swap started was basically that they would act as credit lines in the event of a crisis. The idea was that you would have access to renminbi, which you could then convert into dollars. But now there is a demand for renminbi. So these are local currency swap lines that the Chinese central bank is providing. These can be used for trade settlement—and to some extent they are being used for that—but the primary purpose, as expressed in the Chiang Mai Initiative, which was intended partly to develop local currency bond markets, was to insure the region as a whole. So the insurance motive is a more important one right now than the trade settlement credit motive. But I suspect this will pick up as we go along.

Ms. Raskin: Thank you. Justin.

Mr. Lin: Well, I have a question for Eswar regarding the consensus of using the renminbi as a global reserve currency and that a necessary condition for that is capital account liberalization and using that as a way to push for further financial reform. However, the major reserve currency countries, including the

U.S., Japan, the U.K., and the euro zone, regulate financial markets as a pool, yet their macro policy management has been worse than China in the past 30 years. Considering this, how can you say this could be a desirable way to push for reform in China? The Chinese people, instead of thinking that you're proposing some desirable reform, might think you are really introducing a Trojan horse into the Chinese economic system.

Mr. Prasad: That's a very legitimate, interesting question. I didn't in any way mean to imply that being a reserve currency country results in you doing good things or being good. But given where China is right now, to accomplish this objective, if there is consensus around it, and to minimize the risks during the transition process, greater exchange rate flexibility and capital account openness would help. One question is whether this is overall a worthy objective for China. Again, I think that this is happening, as the capital account is becoming a lot more open. Of course, the big concern for China is ongoing reserve accumulation; though that came to a halt in the third quarter of 2011, but it's likely to resume, as Shang-Jin suggested. If reserve accumulation continues, you essentially tie yourself more and more to the United States. Building public opinion in favor of the renminbi becoming an important currency in its own right and thereby reducing dependence on the United States is one objective. And the liberalization of the capital account essentially will reduce the dependence on reserve currency assets. Shang-Jin made an important point as well, that capital account liberalization will allow for more effective outflows through the private sector rather than by the government. It all hangs together. So no, being a reserve currency will not guarantee that China will do the right thing. But for China to get where it wants to be, these things would certainly be part of the overall package.

Ms. Raskin: Okay, Mark.

Mr. Spiegel: I wanted to comment on Shang-Jin's idea, which was very interesting, about looking for other entities to issue renminbi-denominated debt as a vehicle for encouraging capital account liberalization in China. There's a bit of a chicken-and-egg problem, in the sense that prior to having those markets liberalized, there's going to be currency risk exposure associated with issuing that type of debt. You would be hard-pressed to find entities that would be willing to undertake that kind of activity, if they couldn't hedge the currency risk.

Mr. Wei: One of the major comparative advantages of the U.S. is the financial services sector. They know how to create hedging policies. There's the example of including renminbi in the special drawing rights basket, even having some

government bonds and even corporate bonds denominated in renminbi. This doesn't present a big problem. There's certainly demand for this, as shown by the examples of both dim sum bonds—renminbi-denominated bonds issued in Hong Kong—and panda bonds—renminbi-denominated bonds issued by non-Chinese entities in China. They are much more limited by regulatory restrictions. Without restrictions, they could potentially grow much faster.

Mr. Prasad: I love the kung fu bonds. I can't wait for other things like that. Tae kwon do bonds and so forth.

Ms. Raskin: Final question.

Mr. McKinnon: Both presentations were very good, but neither presenter mentioned China-bashing, that is, the great pressure the United States is putting on China to appreciate the value of the renminbi. It does appreciate slowly; the exchange rate is not rigid. So besides having zero interest rates in the U.S., you have the expectation the renminbi will be higher in the future. Therefore, there's a flood of hot money into China. And the People's Bank of China doesn't want to see a sharp appreciation of the renminbi, so it intervenes massively to resist this. It creates base money and loses monetary control, so it gets more inflation than it would otherwise like. So a precondition for liberalizing the renminbi and getting rid of capital controls in China is that we need to get rid of China-bashing. Otherwise, more hot money will flood into China.

A second related issue is that China cannot float its exchange rate. It can allow more flexibility and control appreciation a bit, but it can't float. This is because it's an immature creditor, so it has a huge savings surplus which shows up as a trade surplus. But it's not possible for private banks, insurance companies, or pension funds in China to finance that trade surplus. If the People's Bank of China withdrew from the market and tried to float, it would require private banks or insurance companies to build up their dollar assets, and they wouldn't do it—it's too risky. It's too big of a currency mismatch. So floating would mean that the value of the renminbi would just spiral upward indefinitely, and I think the People's Bank of China realizes that, which is why it maintains a gradual peg and keeps control over the currency.

Mr. Prasad: Let me answer that question with an observation. I've been very careful in my writings about referring to exchange rate flexibility rather than appreciation. Many people view these two as the same thing, but it's not obvious to me. Given the productivity differences between China and the United States and other trading partners, the renminbi is likely to appreciate over the long term. But over horizons we care about—the next year or two to three

years—the dynamics from the capital account will be far more important. So what should happen to the renminbi if the exchange rate becomes more flexible and provides more monetary policy independence—which is what I would like to see—is far from obvious. I mentioned the amount of deposits in the banking system that are earning highly negative real rates of return. If 10% of those deposits decide to leave the country for diversification purposes, to get a more decent rate of return, that could swamp other dynamics in the short run. And who knows what would happen to the currency. In fact right now, for technical and other reasons the nondeliverables forwards market in Hong Kong is actually predicting that the renminbi will depreciate over the next year rather than appreciate. So I think focusing on the level of the currency—which a lot of people in the U.S. tend to do—is not the right approach. Instead we need to think about what China needs to do. Circling back to the discussion we had this morning about the U.S. doing the right thing for itself, I think what China should do to benefit itself and the rest of the world is have a better financial system and a more balanced growth path. A flexible exchange rate could help in both respects. It's not going to be the *primary* determinant, but I think it can help. And that is the objective we're really after, rather than a particular level of the exchange rate.

Mr. Wei: What you call China-bashing, Ron, I think is more linked to a combination of China's current account surplus and the inability of authorities in the U.S. and Europe to manage their domestic economies effectively through other instruments. My fear is that more Chinese exchange rate flexibility—which I agree with Eswar would be very good for China and would improve inflation control—is unlikely to fundamentally reduce China's current account surplus. That is not to say the real exchange rate doesn't matter for the current account. I think a more flexible exchange rate would be good for China. But, there's very little evidence that changes in the nominal exchange rate will fundamentally alter the real exchange rate on a sustainable basis. For that reason, it's very unlikely that greater nominal exchange rate flexibility will fundamentally alter the Chinese current account picture or solve the China-bashing problem.

Ms. Raskin: Well, thank you. That concludes our third session. And we look forward to more discussions over lunch.