

## GENERAL DISCUSSION

**The Renminbi's Ascendance in International Finance**

Chair: Zheng Liu

**Mr. Liu:** Let's open to questions.

**Mr. Ostry:** It seems to me that one of the key goals for the domestic financial system in China will be to provide financing for small and medium enterprises, which are key for job creation to serve the huge domestic market. I'm not sure why opening up to foreign finance is an important part of this process.

**Mr. Choi:** I have several questions for Professor Prasad. We recognize that the role of China in the global economy has been increasing and that China's current account surplus, particularly with the United States, has been persistently large. According to Triffin's dilemma, it's important for a reserve currency country to provide sufficient global liquidity to the rest of the world. So if China is to become a provider of global liquidity, reducing its current account surplus might be necessary in the future. So my first question is whether China is better positioned now than the United States to be a provider of global liquidity. A related question is that if global interest rate normalization is beginning now, will there be a shortage of dollar liquidity for some emerging markets and could the renminbi then be a suitable replacement in global financial markets?

**Mr. Gourinchas:** I want to come back to the question of the renminbi as a reserve currency and maybe approach it from a slightly different angle. Stijn mentioned that a task for a reserve currency country is to issue a safe asset, where a safe asset is an asset that is defined as having a negative beta with other global returns, so it provides portfolio protection to the rest of the world. And so if we look at China from that perspective and we ask ourselves "What happened during the financial crisis?" there are some signs that maybe the renminbi did suffer some valuation losses around that time that would support Eswar finding that China is already playing a role as a safe asset provider. But if China is indeed becoming a reserve asset provider, then the flip side of this is it has to be taking long risky asset positions while providing short safe liabilities in global financial markets. In other words, it has to be holding more risky stuff on the asset side of its balance sheet, and I'm not sure we're seeing that yet, given

the amount of foreign reserves it's holding. And you showed some interesting graphs about China's gross capital flows. Maybe we're moving in that direction in the sense that China is exhibiting less accumulation of reserves and more accumulation of private assets. I'm not quite sure whether these private assets are long and risky, as would be consistent with the picture of China emerging as a reserve currency provider. But I think that looking more into whether the structure of China's balance sheet is changing could give a direct indication that it is actually taking on this new role.

**Mr. Liu:** All right. Let's take a couple more questions.

**Mr. Williams:** This paper was so clear and comprehensive that I have no questions about it. So I want to be provocative and pick up on Pierre Olivier's and Stijn's comments and put out a hypothesis that many people like Jeremy Stein and others have made that there is an insatiable demand for safe, money-like assets in the global economy. And one story from the financial crisis was that because of this huge demand for money-like assets, the private sector created these assets through securitization, structured finance, etc. And those assets are all gone now because people have learned that they can be dangerous and bad. But there's still the insatiable demand for money-like assets. So I guess my question is, as the renminbi becomes a more international currency, will investors and others see China as the new place to go for money-like, safe assets when, in fact, as Stijn mentions, there are a lot of reasons why China really isn't yet there?

**Ms. Shirai:** I have first a question and then a comment. I found very interesting the comment by Mr. Claessens about the negative impact of currency internationalization, especially in terms of the demand for safe-haven currencies. I think in the case of Japan, for example, the yen was depreciating before the financial crisis, but after the crisis began, all of a sudden the yen appreciated by 20 to 30 percent. The yen's appreciation further depressed prices and economic growth in Japan during the crisis. And I have a question for Professor Chinn. In your chart, page 8, you compared the use of the yen and renminbi as invoice currencies. You showed that the use of the yen as an invoicing currency is much greater for Japan's exports than for its imports. But in China's case it's the opposite. China's renminbi is used more frequently to invoice imports than exports. I think this is a very interesting finding. The reason that the yen is not used much for import invoicing is because Japan imports a lot of oil which is priced in dollars. The reason that the yen is more frequently used in exports is because a lot these transactions are internal transactions between

Japanese companies and a subsidiary abroad. Now in the case with China, I wonder why so much of its imports are invoiced in renminbi. Maybe this has something to do with the \$4 trillion stimulus package since 2010 that created lots of demand for domestic investment. Maybe that affected the pattern of currency invoicing.

**Mr. Eichengreen:** I have a question for Eswar and the central bankers in the room. One reads that inclusion of the renminbi in the special drawing rights (SDR) is supposed to lead to a significant increase in the demand for renminbi-denominated reserves. I just read online that currency strategists anticipate a \$500 billion increase in renminbi-denominated reserves as a result of the currency's inclusion in the SDR basket. Does that make any sense?

**Mr. Hutchison:** Getting back to the general theme about the rapid internationalization of the renminbi over the last few years, I just want to say that in this same room in the 1980s everyone was saying exactly the same thing about the yen and pretty much making the same arguments. What happened is that use of the yen grew rapidly and then just leveled off, as Menzie Chinn's chart shows. There may be some specific reasons for that based on invoicing of oil and so forth, but at that time there was a massive expansion of Japanese banks around the world and people were thinking that the yen might supplant the dollar as a reserve currency. And that, of course, hasn't happened. Of course, if you go back to Kublai Kai Khan, 800 years ago, as you mentioned, the expansion of currency use is a pretty slow process. Lastly, I want to just mention two papers that Reuven Glick and I wrote on the topic in which we showed that China has had much more of a regional influence through equity markets than through fixed-income markets, and I'm just wondering if this internationalization of finance or at least for equity markets is due to the regional production linkages in which China plays such a huge role as opposed to financial linkages.

**Ms. Goldberg:** Terrific paper, terrific discussion. I want to come back to the safe asset theme and first mention a Vox column of mine where my co-authors and I talked about how the United States basically cemented its role as a safe-haven currency during the financial crisis even though its economy was under stress, by the way that it was able to respond to crisis through the different facilities that were put in place. I'm going to keep that as a backdrop for my other comment. Eswar mentioned some of the risks China faces by providing a safe-haven currency. One of them arises from the terrible returns that China has earned on its external portfolio. Of course, part of that is because a large part of this portfolio is invested in foreign assets with low yields because China

is paying a liquidity premium in the event that these assets need to be liquidated quickly. The other risk that you mentioned is about reserve adequacy and the view that the M2-to-reserves ratio is unfavorable for China, particularly in light of the extent of China's domestic contingent liabilities and the possibility of insufficient policy space for the government during a crisis. So given all of this, is it your view that in a risk-off event or some kind of crisis China can actually play the role that Pierre Olivier was talking about in satisfying the safe-haven need of the rest of the world?

**Mr. Aizenman:** I enjoyed the discussion very much. But I wonder if your de jure measures of a financial openness of China may understate its de facto openness, particularly in light of China's openness to trade and the powerful incentives for trade mis-invoicing to circumvent limits on capital flows. So, one interpretation of the trend in China toward greater financial integration is the desire to internationalize the renminbi. An alternative interpretation is they don't have too many choices because of the pressure of trade mis-invoicing. So, I wonder, what is your view about the capacity of China to fight trade mis-invoicing? Because if the capacity is limited, then China may still move toward greater financial integration, independent of the role of the renminbi in the international financial market.

**Mr. Obstfeld:** A couple of weeks ago the *Wall Street Journal*, somewhat to my surprise, strongly endorsed the yuan's inclusion in the SDR basket. Their rationale was that it's very close to the collateral benefits view that this would create a tsunami of liberalization and market orientation in China. This is related to what Stijn said. So I wonder what China's capacity is in the medium term to really move to a system where markets pick winners and losers subject to fairly transparent rules and whether it's really plausible that China could become a truly major reserve currency unless that criterion is met.

**Mr. Dollar:** My impression is that during the opening up of its capital account China opened up outflows more than inflows, and there are still a lot of restrictions on capital inflows. There's a certain logic to this development, as Chinese policymakers were concerned with the extreme reserve accumulation they experienced several years ago and so letting residents invest more abroad had a certain logic, so they opened the doors to capital outflows. But now it seems like perhaps they miscalculated, because they have awfully large net capital outflows. So my short question is, do you agree there has been asymmetric opening of the capital account in China and is that creating particular risks for China? And by the way, just in the last 48 hours, the government arrested officials

involved in a financial institution that specializes in taking money out. So perhaps they're trying to undo some of the outflow opening.

**Mr. Liu:** Eswar, why don't you take five minutes to respond to the questions.

**Mr. Prasad:** After Kublai Khan, the Mongol Dynasty did not hold together. The Ming Dynasty that followed actually did issue paper money, but there was such hyperinflation that paper money was banned until 1850. So even after paper money was introduced, there were certain bumps in the road in this long process toward where we are today.

The comments that we've heard can be bunched into three groups. First, why is China doing this? Why is it promoting the renminbi's international role? Second, is it doing it the right way? And third, where is this all going to lead? On the first—why is China doing this?—I have a view that's very different from the notion that this is a policy in and of itself. I think there is a much bigger objective here. I've written about this and referred to this in a *Wall Street Journal* piece as a Trojan horse strategy. Once you get the leadership of China to sign on to the notion that it's important to make the renminbi an international reserve currency, it forces the country to do what's necessary for that to happen. You need better financial markets. You need a better regulatory structure. You need a better monetary policy. All of these are very good for China independent of what happens to the renminbi, but it makes it much better to have a framework that helps get around the existing financial structure, especially big reforms like these. The system as it now is structured works wonderfully well for the large state-owned enterprises, the large state-owned banks, and certain provincial governments, and I think this framework has been very important. Including SDR inclusion of the renminbi, the amount of progress that has been made over the last year in terms of financial market reforms in China is remarkable. It's hard to conceive of so much progress having been made in terms of opening up the capital account, liberalizing interest rates, and setting up an explicit deposit insurance system. The SDR inclusion was a microcosm of this bigger picture; it provided a focus but, more importantly, also a timeline.

And I think the collateral benefits view is one where there has been traction. When Shang-Jin Wei, Ken Rogoff, and Ayhan Kose wrote about this, they didn't have a good example. But I think China has proved to be the perfect example of this view. If you think about what it did in 2007 to allow foreign strategic investors into the local banks, that was because it wanted to improve corporate governance and risk management. Perhaps bringing Western banks to improve corporate governance and risk management was not the most spectacular idea, but the concept was exactly right. And then if you think about what

has been accomplished through the Qualified Foreign Institutional Investor (QFII) scheme, the amounts are small. The amount of Asian market capitalization held by the QFIIs amounts to only about 2 percent of Asian market capitalization, but having those players in that market creates new products; it creates a sort of discipline, and I think it has an important catalytic effect. And this catalytic effect is one that the Chinese really take seriously.

But Menzie, Stijn, and others have alluded to the fact that even if the Chinese know where they're going, they're not getting it all right. For example, if you think about the sequencing of reforms that they've undertaken, the classical answer will be get your financial system right first, then get your exchange rate to be flexible, and lastly open up your capital account. China is doing it in exactly the opposite way. If you think about how they've actually gone about capital account opening with all the risks to the financial system, as David (Dollar) pointed out, opening up the capital outflows seems like exactly the wrong thing to do. But here again there is a logic to it. And I think the logic comes from the fact that by setting in place a *fait accompli* in one part of the financial sector, you force the government to undertake a range of other reforms. I think that is exactly the point: so, if you do open up the capital account very significantly, in order to reduce the risks, it forces the government to start thinking about other reforms that are crucial. I spoke about all of the reforms that have been undertaken in the last year or two; however, virtually everything involves the financial markets, and I think if one were to be concerned about China—and there are many reasons to be concerned about China—one reason is not that there have been no reforms, but that these reforms have largely been focused on the financial markets. If you don't have broader real side reforms, if you don't have the institutional reforms to support more liberal markets, you're going to create even more risks than benefits. The stock market is a perfect example. The notion of the stock market working as a market makes sense, but if you don't have good corporate governance, if you don't have good auditing and accounting standards, and if you don't have corporate transparency, then it's no longer a stock market. It's something of a casino. And so I think it's these other reforms that are going to be important and if other reforms don't catch up, that will be a problem.

And finally, where is this all going to lead? I wrote a book last year in which I make a very important distinction between an international currency, a reserve currency, and the safe-haven currency. I don't think there is the slightest prospect that without very broad legal, political, and institutional reforms that the renminbi will ever become a safe-haven currency. People don't go to China for safety. The Chinese don't go to China for safety. They take money out when they

need a safe place to put their money. What you need for a safe-haven currency is a lot more than market size and financial market development. You need institutions that are essential to maintain the trust of foreign investors. Of the amount of debt issued since 2007, if you take away the amount of public debt in the U.S. federal government—debt that is held by the Social Security trust fund and on the Federal Reserve's books—that leaves about \$10.3 trillion, and about 60 percent of that is held by foreign investors. They come here for safety. Why? Because they know that they're going to be treated like other investors. If you think about safety from the point of view of maintaining principal, the dollar is not the best asset. It does have the right sort of beta, but if you look at holding an instrument denominated in renminbi, you would have made much, much better returns over the last 11 years since 2005 given how much the renminbi has appreciated. But people go to China for yield. They go to China for diversification. I don't think they will go to China for safety unless there are much deeper institutional, political, and legal reforms, and I think the current government has made it very clear that that is not going to happen.