COMMENTARY

The Renminbi's Ascendance in International Finance

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This is a very interesting and timely paper, especially since the board of the International Monetary Fund (IMF) endorsed the renminbi for inclusion in the special drawing rights (SDR) basket 10 days after the conference. Let me start by quickly summarizing the paper; then I will provide some comments on the paper and raise some questions that I have that were triggered by the paper.

The paper poses the following very straightforward questions: What is the renminbi's current role in the global monetary system, what is the government's role in driving this international role, and what could the international role of the renminbi be in the future? On the latter it specifically asks, what is the likelihood that the renminbi will become an international and reserve currency? Let me give some corresponding definitions, at least as I see them. Internationalization is what I would call greater use of the renminbi globally in trade and financing. I would define a reserve currency as a currency that provides on a large scale a store of value, as well as a unit and medium of accounts, transactions, and invoicing.

The answers the paper provides to these questions are straightforward: The renminbi is on track to become an important currency. Policies have been put in place over the past decade to support a greater international role for the renminbi. The paper has much evidence of increased use of the renminbi internationally, for both trade invoicing and financing. This increased role is now further enhanced through the likely ramifications of being included in the SDR basket.

At the same time, the paper points out that there are constraints to internationalization and risks along the way. Notably, China still has a financial sector that is not yet fully liberalized. And, while large in size, China's financial sector is limited in other aspects, particularly in the quality of resource allocation and governance, and in the development of its capital markets. And, as many countries have experienced, phasing in capital account and financial liberalization

Author's note: *These comments represent my own views and not necessarily those of the Federal Reserve Board of Governors or its staff.*

policies without triggering a financial crisis is not easy. It is not just about making one's currency freely convertible; one also has to consider the almost inevitable political economy changes that will accompany these steps. Furthermore, regardless of how successful one is in internationalizing a currency, the path toward a reserve currency status is not the same and has to consider the still dominant role of the dollar.

Before giving my comments, let me start by noting the relevance of the paper. This is surely a worthwhile research topic. Internationalization of a currency is of course not just a China-specific issue. Since we actually know little about what drives a currency to be a successful international or global currency, the renminbi internationalization is an interesting but also surely unique case study. The topic is even more important from policy and financial markets perspectives. Many people are focused on the renminbi's internationalization, including international financial markets and policymakers. And renminbi internationalization will have many global repercussions.

I learned a lot from the paper and tend to agree with many of its main findings. The paper provides a very careful historical review of the steps taken by Chinese authorities so far in encouraging the internationalization of the renminbi. Through careful planning and deliberate steps, this program has largely been successful. The paper documents the increased use of the renminbi in trade and finance. And its views expressed on the best strategies for internationalizing the renminbi (or other currencies) are consistent with most other studies.

Overall, the paper makes the case that internationalization of the renminbi is something that is both going to happen and going to be useful for the world as well as for China. Given China's general success with economic reforms and its growth path, it is very hard to question this assessment. This is even truer for this paper, as it is very hard to disagree with the world's expert on this topic. Quotes of Prasad have appeared in many news outlets, including the *Economist*, the *Wall Street Journal*, the *Financial Times*, National Public Radio, and many others.

Let me, in my task as commenter, try to do two things: comment on the stock-taking of the paper, and review why one might want to internationalize a currency and how that can best be done. The paper is mostly an exercise in stock-taking, not a review of goals or paths that China should follow going forward. It informs on where China is with renminbi internationalization in a number of important dimensions, but it does not question the government's stated goals. It concludes that renminbi internationalization appears on path in most respects. I have some quibbles on the stock-taking, on which I will expand next.

But I would also have liked to have seen a review of the goals. This is in part because the analysis relies implicitly heavily on the "collateral benefits" view, espoused earlier by Prasad and colleagues at the IMF (Kose et al. 2009). This view says that pursuing a deliberately gradual path of internationalizing, "stepping the stones across the water," provides many side benefits, among others, as it helps financial markets develop and encourages improvements in the institutional environment. My question though is, are these benefits really as large as we thought they were before the global financial crisis? The experiences of advanced countries over the past decade should make us rethink this paradigm to some degree at least. And, related, are all steps actually being taken in China consistent with maximizing learning? Some would arguably appear to be more for narrow or private interests than for broader collateral benefits.

In terms of the stock-taking, my comments are of the nature "half full versus half empty" in that one can debate progress in some of the dimensions listed. While official reserves are large, for example, they do not necessarily represent a good measure of "internationalization," as they are not the outcomes of market choices but are instead outcomes of public-sector and exchange rate management choices. It is also correct that China's international financial openness is increasing rapidly, but it appears to be happening at asymmetric speeds between inward and outward flows. And which type of investors or financial institution can go in or out China can appear to be selective, up to the point of being intransparent. There is also a difference between openness and control that is not emphasized enough in my opinion. Take debt flows, which do not come with control, and equity flows, which give a majority stake. The latter has been much less relaxed than the former. Also, being open to international capital flows does not equal granting full market access, notably in financial services that are heavily regulated. For example, the limited presence of foreign banks suggests that there are still some serious barriers to the establishment and operation of foreign financial institutions. In addition, the difference between cash flow and control rights—as in the differences between the A, B, and H shares—suggests some hesitations to granting full openness. And while exchange rate management is indeed freer, the regime is still not fully market determined and transparent in its operations (e.g., the difference between the onshore and offshore exchange rate does vary over time for unclear reasons).

In terms of domestic financial development, one can have some quibbles as well. Is financial development high or low? Using the stock figures, financial development is very large, but the quality of financial services is surely less so. Similarly, the fiscal position is strong today, but as we have seen in other situations (countries like Ireland and Spain come to mind), a very large financial system combined with high credit growth can mean that the contingent liabilities could be very large as well. This also applies to the stock of foreign exchange reserves, where both the Greenspan–Guidotti rule, on how much reserves to hold relative to short-term liabilities falling due, and ratios calling for maintaining a high enough ratio of M2 to reserves, would call for some caution. And while the inclusion in the SDR did indeed happen, there can be some questions as to whether it did accelerate reforms in good ways. In this context, some recent policies can make one wonder whether the path was fully worked out. Notably, events over the last half-year, including the stock market gyrations and the somewhat botched exchange rate devaluation, are hard to interpret. Then there are the steps being undertaken in terms of interest rate liberalization, which do not fully fit with overall deliberate strategy of reforms. As such, there can be legitimate differences of opinions on the sequencing and consistency of reforms.

In terms of stepping back (and I am not the first one to do this), let me attempt an analytical framing. Three questions can then be and have been pondered: (1) Can the renminbi internationalize and additionally become an international reserve currency? (2) Should the renminbi internationalize? What are the costs versus the benefits for China? (3) How could the renminbi internationalize? What is the (best) path? This sequence of questions makes it clear that only if one answers yes to questions (1) and (2) does question (3) then become relevant on how to best achieve the goals. For example, what reforms, relative or absolute, matter more? What reforms are needed now? Which can wait? How can one balance any tradeoffs among objectives? What else is important to do? How does one maximize the overall gains?

The paper does some review of the literature to date on whether the renminbi can internationalize and become a reserve currency. Others' lists of what criteria are important in this respect differ somewhat from Prasad's, as others are more cautious and have more preconditions (Table 1). Most agree, however, that both internationalization and reserve currency will take some time and effort, and may not be urgent in the overall sequence of reforms. For example, Frankel (2011) uses phrases such as "a long way to go," "policy defies the logic of political economy," and "sequence appears unorthodox." In a more recent review, Eichengreen (2015) writes, "not in one day" and "not without risk," and stresses the difference between a regional role of the renminbi versus an international or global role. Eichengreen and Kawai (2015) also say that it will take many steps. And Goldberg (2013), in her review of what it takes to become a reserve currency, makes clear that many steps are typically involved as well as overcoming path dependencies, related in part to the persistence of dollar of the

TABLE 1
Can the Renminbi Internationalize and Become a Reserve Currency? Others' Views vs. Prasad's

	ECB (2015), Eichengreen (2015), Eichengreen and Kawai (2015)	Prasad
Size, economic strength, share of world economy, trade, etc.	√√√	√√
Strong financial markets	√√√	√
Reliability of rules	√	
Quality and predictability of fiscal and monetary policies	√√	√
Ability to respond to unexpected shocks	√	√
Political cohesion	√√	
Network externalities persistence, hysteresis	√	
Mountains, island, army, etc.	√	

Note: Checkmarks very roughly correspond to number of times criteria are mentioned in the papers cited.

major reserve currency. Prasad (2014) himself also makes the point that there can be a dollar trap, where its dominance is self-reinforcing.

The views are consistent in that all mention that the key to successful internationalization is policy coherence between domestic financial deregulation; institutional development, including supervisory capacity; and capital account liberalization. And a key requirement consistently mentioned for a reserve currency is stability of domestic markets, especially government bonds. In this context, an important question is whether China's bond market is large and stable enough.

In terms of whether the renminbi should internationalize, the literature points out that there are gains and risks, and that these are not necessarily equally distributed among parties, with more gains for some parties than for others (Table 2). And while some observers believe that the renminbi should become a reserve currency, given costs, others have disagreed. Clearly, the status of a reserve currency comes with some costs. It comes with some volatility

TABLE 2
Gains and Risks of Renminbi Internationalization

Gains	Risks
• Benefits for local financial markets development and monetary policy • More general learning • Better scope for diversification, insulation from shocks, fewer valuation effects • Lower cost of funding (debt) • Seignorage • Global influence	• Challenges managing internal and external balances • Spillovers, importing of global financial cycles • Financial instability ("We are not in Kansas") • Hard to reverse policies (easier to lose than to gain)

in demand due to "safe haven," as the dollar experienced in the global financial crisis and which still affects some other currencies today. There is also the demand, and perhaps need, to adapt its monetary policy, as a reserve currency's monetary policy can have international repercussions. There are also narrower responsibilities. It may be necessary, for example, to maintain swap lines with central banks, ship cash, have more extensive foreign exchange settlement systems, and help countries with their "renminbi-ization." So it is not obvious whether the step from an international to a reserve currency is worth it. As examples, Japan and Germany were reluctant to "reservize," as, in the words of Frankel (2011), "the costs outweigh benefits." Furthermore, as he notes, the optimal timing can be "elusive." For internationalization to be the right choice, the optimal combination of inflation, exchange rate dynamics, and financial stability can make timing difficult.

Lastly, in terms of how to best internationalize the renminbi, evidence suggests caution in quite convincing ways, with the caveat that China is unique. Other capital account liberalization experiences suggest that it can be very complex, perhaps more so than was presented in the paper. One can frame these questions as how to prevent a situation similar to Chile in 1979–82, when financial liberalization was accompanied by large-scale foreign exchange borrowing and buildups of domestic vulnerabilities that ended in a major financial crisis, or, similarly, how to avoid a situation like the 1997 East Asia financial crisis. These cases are not likely to repeat themselves exactly the same way—every crisis is in some sense different—but they do offer some lessons. The literature clearly suggests that one needs to follow an overall consistent approach, starting with domestic financial market development, not just in terms of size but also in terms of institutional development, and that an open capital account can also require economic liberalization *and* political liberalization.

Furthermore, there has been revision of the desirability of an ultimate fully open capital account, notably in the form of the so-called institutional view of the IMF (2012) with its greater emphasis on the use of capital flow management and macroprudential policies. This view stresses the need for an integrated approach, i.e., adopting the right sequencing, and maintaining consistency in various financial reforms. But it also stresses that it is important to have, or at least keep the option open for, the use of macroprudential and capital flow management policies.

Recent experiences and thinking thus suggest some cautionary lessons. It makes one focus on the risks encountered along the path toward full capital account liberalization and how those risks depend on the policies chosen. And it makes one recognize the irreversibilities of some reforms, i.e., those that one cannot easily—or at all—reverse, and therefore suggests the desirability of moving slowly on some reforms. Another related lesson is that international financial integration is not just about cross-border flows. It also needs committed capital, which can mean the local presence of foreign banks and other financial institutions that have set up brick-and-mortar shops and fund themselves locally. By being present, as the experiences of the euro area, Eastern Europe, and other countries show, they can add to financial stability in the face of domestic and foreign shocks. Another lesson is to build in more explicit learning. How can one assure, for example, that the opening up of capital outflows leads Chinese investors to increase their rates of return on their overseas assets, so that they exceed the rates of return on their liabilities?

My last set of comments relate to the theme of the conference, which is "Policy Challenges in a Diverging Global Economy." The paper does not spend much time on the global stability implications of renminbi internationalization, but it is of course an important aspect. Would a rise of the renminbi make the global system more or less stable? On one hand, internationalization could make it more stable, since having more assets and liabilities to choose from means easier and better global risk sharing. On the other hand, in the presence of other, existing reserve currencies, it could also imply, due to market failures and externalities, a greater risk of tipping, meaning large swings in the value of any one currency, with related adverse booms and busts.

There could also be policy implications of a greater renminbi internationalization for the rest of the world. It may be wise, for example, to have greater swaps between central banks to avoid some of the liquidity problems observed during the global financial crisis. And making financial markets work most effectively may require some better infrastructure, such as better settlement systems on currency and derivatives trading. A greater role for the renminbi is also likely to mean more change in Asia and globally. Here there could be lessons from the euro zone on how to best handle regional financial integration. For example, a full banking union may be necessary to avoid the financial trilemma. In the interim, there will be a need for smart macroprudential and capital flow management policies, which is preferable to a policy of ring-fencing.

In summary, my comments on the paper are threefold. First, in terms of the state of play on renminbi internationalization, one can have a half-full or half-empty view. The paper is more of a half-full view, but there are many possible quibbles. Crucial ones in my opinion are on the presence of collateral benefits, the process of learning, and the consistency of reforms. Is the paper too optimistic here? Are reforms following the best processes? Second, the interim and perhaps as well the final goals deserve some more debate. Regarding the interim goals, an important set of questions is whether the balance is right between liberalization of the capital account and that of financial services. Could it be that less capital account openness, but first greater domestic financial development, including market access with more control of foreign investors, is a preferred step? It allows for learning, yet maintains the overall direction of openness. And is the final goal, full openness, worth revisiting in light of recent experiences? Third, in terms of international aspects and repercussions, there are many implications, deserving more thought in the coming years as renminbi internationalization progresses.

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