# Gaining Currency

## *The Rise of the Renminbi*

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OXFORD
UNIVERSITY PRESS

# PREFACE

> I have only to beg that readers, who have been unaccustomed to see Chinese matters treated from a rational point of view, will believe that I am no Mandarin worshipper, and that I am quite alive to the great faults of the Chinese nation and Government. Their civilisation, like our own, has been in great part a failure, though perhaps not such a saddening one as ours, for it has not had such fine material to work upon; but we must at least understand it and treat of it as it really exists, if we would avail ourselves of its experience . . . It is desirable that we should know [the Chinese] system as it really is, and not as it has been fancifully represented—a subject of ridicule to amuse the passing hour, or a subject of abuse to justify dubious aggressions.
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> *The 'Ever-Victorious Army': A History of The Chinese Campaign Under Lt.-Col. C.G. Gordon and of the Suppression of the Tai-Ping Rebellion*, Andrew Wilson, 1868.

China's economy is now the second largest in the world. In 2015, its annual gross domestic product (GDP) was $11 trillion, accounting for 15 percent of world GDP, placing it second only to the United States, which has a GDP of $18 trillion. China is also an important player in international trade, accounting for 12 percent of global trade in goods. China's impact on the world economy is even greater when measured along other dimensions. The country holds about 30 percent of global foreign exchange reserves and has accounted for one-third of global GDP growth since the financial crisis. China is big (Figure P.1).

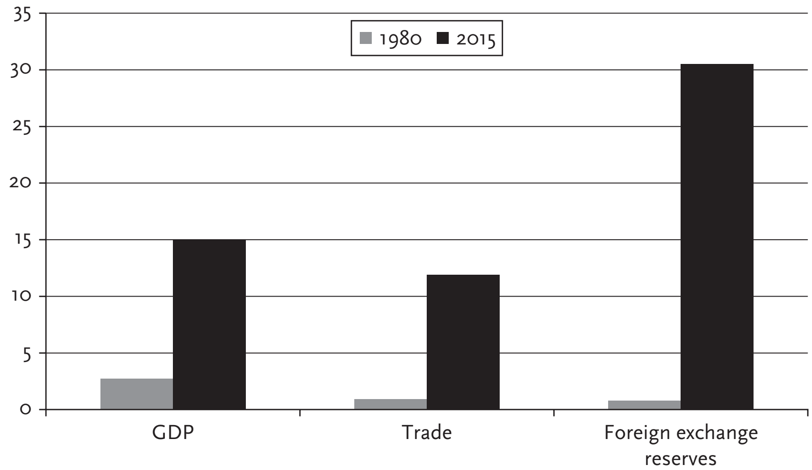


**Figure P.1** China and the world (share of world total, in percent).
All data are for 2015. Gross domestic product is in market prices. Trade refers to merchandise trade (only goods). China's share of world trade in goods and services is 11 percent. Foreign exchange reserves data begin in 1989.
*Sources:* International Monetary Fund, People's Bank of China, and World Trade Organization.

Despite China's economic might, the international stature of its currency, the renminbi (RMB), does not quite match that of its economy. Among the currencies of the world's six largest economies, the RMB is only now beginning to emerge as a factor in the global economy. The others—the U.S. dollar, the euro (which covers two of the six largest economies—Germany and France), the Japanese yen, and the British pound sterling—all have well-established roles in global finance.

In recent years the Chinese government has taken a number of steps to elevate the RMB into this group of elite currencies by increasing its international use. The RMB's adoption in global markets is constrained, however, since the Chinese economy has neither a fully market-determined exchange rate nor an open capital account that allows for free cross-border capital flows. Nevertheless, given China's sheer size and its rising shares of global GDP and trade, the government's steps are rapidly gaining traction.

This book takes stock of China's progress in promoting the RMB as a major currency in international financial markets. While the currency has made remarkable progress in a relatively short period, it is far from assured that it will continue along the same impressive trajectory it has followed for the past few years. To be sure, the RMB will become a significant player even if its rise to prominence levels off, yet its full potential may remain unrealized unless the Chinese government undertakes a broad range of reforms.

## STRUCTURE OF THE BOOK

Although China has used money in some form for more than two thousand years and was actually the first country to use paper money, the RMB came into being only in 1949. Chapter 1 provides a brief history of the evolution of Chinese paper currency, beginning with the Tang dynasty in the seventh century AD and tracing it to the present, following many twists and turns along the way. Even the tale of how present-day RMB notes came to look as they do reveals a colorful history.

There is a great deal of hyperbole surrounding the RMB, with some commentators arguing at the extreme that its displacement of the dollar as the dominant international currency is imminent. Such popular prognostications tend to conflate distinct elements of a currency's role in international finance. Chapter 2 unpacks three related but distinct aspects of the RMB's role in the global monetary system. First, *capital account convertibility* reflects the extent to which China restricts inflows and outflows of financial capital that are intermediated through transactions involving the RMB and foreign currencies. A fully open capital account has no restrictions on cross-border capital flows. The second aspect, *internationalization*, involves the use of the RMB in denominating and settling cross-border trade and financial transactions—that is, its use as an international medium of exchange. The third aspect is whether the RMB serves as a *reserve* currency, which is one that is held by foreign central banks as protection against balance of payments crises.

The remainder of the book evaluates these three elements within a unified conceptual framework and analyzes their implications along two dimensions: first, by reference to the balance and sustainability of China's own economic development; and second, by reference to the associated implications for the international monetary system, including the possible impact on the U.S. dollar and other existing reserve currencies.

Chapter 3 documents the evolution of China's capital account openness in terms of official policy changes to restrictions on capital flows as well as the actual levels of foreign investment in China and the country's own investment abroad. Why and how China has opened up its capital account is a story of some intrigue in itself.

Any mention of the RMB usually brings to mind the value of the currency relative to other currencies—in other words, its exchange rate. The RMB's exchange rate is the subject of considerable fulmination in many national capitals of Western countries. For instance, U.S. politicians and government officials are often incensed by what they see as China's willful attempts to cheapen its currency to boost its exports, thereby unfairly stealing jobs from the U.S. Chapter 4 digs deeper into the facts behind China's currency policy and how it has evolved over time.

Despite the constraints on capital flowing in and out of China, the RMB has begun playing a larger, although still modest, role in international finance over a relatively short period. Chapter 5 documents the areas in which the RMB has made progress, and cautions that the implications of these developments, while noteworthy, should not be blown out of proportion.

Chapter 6 turns to a discussion of the RMB's rise as a reserve currency. This topic might seem premature given that China has neither a flexible exchange rate nor an open capital account—two features once considered absolute prerequisites for a reserve currency. As in many other economic matters, China appears to have broken the traditional mold. The International Monetary Fund, the world's premier multilateral financial institution, has even recently designated the RMB as an official reserve currency.

Therein lies another matter of intrigue, with overt and behind-the-scenes machinations leading to this outcome.

After dispensing with traditional concepts, Chapter 7 turns to a concept that has become important in global finance: that of a "safe haven" currency, a concept transcending that of a plain vanilla reserve currency. Such a currency is one that investors turn to for safety during times of global turmoil, rather than for diversifying their stores of assets denominated in foreign currencies or seeking higher yields on their investments. This chapter advances a provocative argument: that China's economic strength alone is not sufficient for its currency to become a safe haven. A country seeking this status for its currency must have a sound institutional framework—including an independent judiciary, an open and democratic government, and robust public institutions (especially a credible central bank)—to earn the trust of foreign investors. This chapter provides a critical review of the Chinese government's approaches to broader institutional reforms and the implications of these approaches for the RMB's prospects of becoming a safe haven currency.

The RMB's path to global prominence depends to a significant extent on China's growing economic and financial power. A major growth slowdown or, worse, a collapse of the financial system could alter this trajectory. Chapter 8 discusses the potential risks China's economy faces that could derail the RMB's rise. In fact, some of the policies related to enhancing the RMB's international stature—including capital account opening and allowing the exchange rate to be determined more freely by market forces—could themselves expose China's economic and financial stability to a number of risks if these policy changes are mishandled.

Chapter 9 provides a broader geopolitical analysis that links the RMB's rising prominence to China's weight in international finance and its relationships with neighboring countries and other superpowers. China is using its financial clout to pull other countries and international financial institutions into the web of its influence. Eventually, this will allow China to start molding the rules of the game for international finance, which in turn could help level the playing field between the RMB and traditional reserve currencies.

In the U.S., China's rise is generating anxiety and fear, coupled with schadenfreude at China's recent economic troubles. China's exchange rate regime and trade relationship with the U.S. are featuring in the country's presidential politics during 2016 and will no doubt continue to do so in broader political discussions in the future. Chapter 10 reviews the implications of the increasingly prominent RMB for the international monetary system, including the implications for the U.S. dollar and the configuration of reserve currencies.

The main message of this book can be stated simply. The RMB is well on its way to becoming a significant international currency. If China plays its cards right, with suitable financial sector and other market-oriented reforms, the RMB will become an important reserve currency, perhaps eventually accounting for as much as 10 percent of global foreign exchange reserves (for comparison, the U.S. dollar and the euro now account for 64 percent and 21 percent of global foreign exchange reserves, respectively). For the RMB to become a safe haven currency, however, China will have to undertake broader reforms of its institutional framework that would ultimately alter its political, legal, and public institutions. Such changes are currently not in the cards.

The RMB has climbed to prominence on the international economic stage in the space of just a few years—a mere blink of the eye in the historical span of the evolution of China's currency. Indeed, a long time ago, it took a brave traveler from Venice to draw the attention of the Western world to the marvel of paper money, an invention that had its origins in China.