Book Review

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Gaining Currency*: *The Rise of the Renminbi (2016). By Eswar Prasad

Oxford University Press, 344 pages, US$29.95.

Reviewed by Nick Ronalds, CFA

Abstract

This work is effectively two books in one: (1) an account of the rise and internationalization of the renminbi and of its prospects for continued ascendancy over the near term and the medium term and (2) a concise description of the various vehicles for investing in Chinese assets. It also provides an essential guide to the Chinese legal and regulatory environment in which these structures are embedded and that practitioners need to understand.

Full Text

China is the world's largest economy in terms of purchasing power parity, yet Chinese investments have a trivial place in most institutional portfolios. Inevitably, the prominence of Chinese financial assets in portfolios around the world will grow substantially. Investment managers planning to enter the Chinese financial markets will find an excellent guide in Eswar Prasad (http://prasad.aem.cornell.edu/), author of *Gaining Currency: The Rise of the Renminbi*, a clear and even fascinating account of the structures and quirks of China's financial markets. Prasad, a former research economist at the IMF (International Monetary Fund) and now a professor at Cornell University, combines a practitioner's technical grasp of the subject with a nonacademic clarity of style that will enlighten novices as well as professionals experienced in Chinese finance.

Deng Xiaoping's pragmatic, market-based economic policies began transforming China in the late 1970s, with policymakers favoring an incremental approach dependent on pilot programs. Successful ones were expanded and eventually became national policy. Over time, however, a succession of pilot programs led to a profusion of overlapping and confusing programs, each with its own set of rules and often subject to competing regulatory jurisdictions. The challenge of keeping up with all these programs is compounded by the fact that the rules for the programs — including, among many others, QFII (Qualified Foreign Institutional Investor) and RQFII (Renminbi Qualified Foreign Institutional Investor) — are periodically revised. Prasad provides enough history and description of the rules of the game for a financial professional to understand how to invest in China's financial markets and — just as crucially — what some of the risks are.

The first major step in the opening of China's financial markets to the outside world was the introduction in 2002 of the QFII program, which allows large, well-established foreign institutional investors to invest in a range of Chinese financial assets. In 2011 came the RQFII program, similar to QFII but based on offshore renminbi (RMB) only. Another big step came in 2014, when the Shanghai Stock Exchange and the Stock Exchange of Hong Kong jointly launched the Shanghai–Hong Kong Stock Connect, a major new opening to China's equity markets. It was expanded in November 2016 to include the Shenzhen Stock Exchange, home to many small-cap "new economy" stocks. In the spring of 2016, Chinese authorities swept away many of the restrictions on foreign investment in the bond market.

Stylistically, along with concision, Prasad has a knack for storytelling that makes his account highly readable. In the too-short first chapter, which deals with financial history, we learn that Chinese scholars were debating the role of the state in issuing money in 200 BC, predating by two millennia similar debates by David Hume and others in the West. China later became the first country to issue a paper currency and, under Kublai Khan in the 13th century, the first to have a fiat currency. Perhaps predictably, China then became the first to experience hyperinflation. More recently, China's currency war in 1930s Nanjing featured bombs, bullets, and blood in the streets.

There are a few gaps in Prasad's account. He says China has kept its exchange rate low to spur exports. Perhaps so, but has not inflation more than offset the renminbi's nominal weakness, making China's weak-currency policy self-neutralizing in the long run, as theory would predict? A discussion of the connection between currency policy and inflation — and thus between currency policy and the real exchange rate — would have filled in one of the gaps and shed more light on the challenges facing China's central bank.

Prasad provides the crucial context of RMB internationalization. Currently, the proportion of China's trade transactions denominated in RMB stands at about 25%. The RMB has become a reserve currency on the balance sheets of major central banks.

Prasad is neither bullish nor bearish on China. He respectfully credits the great strides China has made in internationalizing the RMB. In October 2016, the Chinese currency was accorded the distinction of becoming the fifth currency in the IMF's SDR (special drawing rights) basket, with a higher weight than either the British pound sterling or the Japanese yen. As China's capital markets continue to be liberalized and its economy continues to grow, so too should the use of the RMB as a reserve currency.

But Prasad sees little chance of the RMB's displacing the US dollar in the foreseeable future. The dollar has something that cannot be duplicated easily: its status as a safe haven. That status rests solidly on US institutions — an independent central bank, the rule of law, and political checks and balances. China's institutions, and even the law itself, are subordinate to the political authorities. The dollar's safe-haven status makes it the first resort in times of political and financial stress. That reality is likely to keep the dollar dominant for years to come.

Reviewer Information

Nick Ronalds, CFA, is managing director at ASIFMA (Asia Securities Industry & Financial Markets Association), Hong Kong.