The Renminbi’s Ascendence in Global Finance

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Two Perspectives

A. Implications for China’s domestic development
B. Implications for global monetary system

Other Issues

1. Sequencing: Capital account liberalization, exchange rate flexibility, financial market development
2. Benefit-risk tradeoffs during transition
Key Concepts

A. **Open capital account** (convertible currency): No controls on capital inflows, outflows

B. **International currency**: Widely used in trade settlement, cross-border financial transactions

C. **Reserve currency**: Held as central banks’ reserves

A not synonymous with freely floating exchange rate

A and B neither necessary nor sufficient for each other

A and B necessary for C
Benefits of CAL

- Collateral (indirect) benefits of financial integration
  - Development of financial markets
  - Regulatory, technical expertise comes with inflows
- Diversification opportunities for domestic investors
- Catalyst for financial sector reforms
External Assets and Liabilities (in trillions of dollars)
External Assets and Liabilities
(in percent of GDP)
Risks of Premature CAL

• Putting the cart before the horse: CAL before greater exchange rate flexibility, reform of financial system risky

• Difficult to control currency value if capital account open

• Risks to financial system if outflows unrestricted

• High ratio of bank deposits to GDP; capital flight?

• Are these major risks? $3.2 trillion of forex reserves buys some protection; low level of foreign-currency external debt
Organizing Framework for Domestic Reforms

- Consensus around objective of making RMB global reserve currency could drive domestic reform agenda
- Achieving objective while mitigating risks requires:
  - Better, deeper, well-regulated financial markets
  - Fx flexibility
  - Better macro policy framework
External Assets and Liabilities

External Assets
- FDI
- Equity
- Debt
- Other
- Reserves 57%

External Liabilities
- FDI
- Equity
- Debt
- Other

$6.3 trillion
$4.7 trillion
Returns on External Assets and Liabilities (in percent)
## Returns on External Investment Positions

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</thead>
<tbody>
<tr>
<td><strong>Net income</strong></td>
<td>-6</td>
<td>-18</td>
<td>-7</td>
<td>4</td>
<td>22</td>
<td>-16</td>
<td>-38</td>
<td>-85</td>
<td>-35</td>
<td>-95</td>
<td>-60</td>
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<tr>
<td><strong>Inward</strong></td>
<td>19</td>
<td>36</td>
<td>50</td>
<td>77</td>
<td>103</td>
<td>99</td>
<td>129</td>
<td>128</td>
<td>150</td>
<td>166</td>
<td>183</td>
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<tr>
<td><strong>Outward</strong></td>
<td>24</td>
<td>54</td>
<td>57</td>
<td>73</td>
<td>80</td>
<td>115</td>
<td>167</td>
<td>213</td>
<td>185</td>
<td>261</td>
<td>243</td>
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<tr>
<td><strong>Net external position</strong></td>
<td><strong>276</strong></td>
<td><strong>408</strong></td>
<td><strong>640</strong></td>
<td><strong>1188</strong></td>
<td><strong>1494</strong></td>
<td><strong>1491</strong></td>
<td><strong>1688</strong></td>
<td><strong>1688</strong></td>
<td><strong>1866</strong></td>
<td><strong>1996</strong></td>
<td><strong>1776</strong></td>
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<tr>
<td>Stock of assets</td>
<td>929</td>
<td>1223</td>
<td>1690</td>
<td>2416</td>
<td>2957</td>
<td>3437</td>
<td>4119</td>
<td>4735</td>
<td>5213</td>
<td>5986</td>
<td>6409</td>
</tr>
<tr>
<td>Stock of liabilities</td>
<td>653</td>
<td>816</td>
<td>1050</td>
<td>1228</td>
<td>1463</td>
<td>1946</td>
<td>2431</td>
<td>3046</td>
<td>3347</td>
<td>3990</td>
<td>4632</td>
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<tr>
<td><strong>Net return (%)</strong></td>
<td><strong>-6.4</strong></td>
<td><strong>-1.7</strong></td>
<td><strong>0.6</strong></td>
<td><strong>1.9</strong></td>
<td><strong>-1.1</strong></td>
<td><strong>-2.6</strong></td>
<td><strong>-5.1</strong></td>
<td><strong>-2.1</strong></td>
<td><strong>-5.1</strong></td>
<td><strong>-3.0</strong></td>
<td></td>
</tr>
<tr>
<td>Return on assets (t/t-1)</td>
<td>3.9</td>
<td>4.1</td>
<td>4.5</td>
<td>4.2</td>
<td>3.3</td>
<td>3.7</td>
<td>3.1</td>
<td>3.2</td>
<td>3.1</td>
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<tr>
<td>Return on liabilities (t/t-1)</td>
<td>8.2</td>
<td>7.0</td>
<td>6.9</td>
<td>6.6</td>
<td>7.8</td>
<td>8.6</td>
<td>8.8</td>
<td>6.1</td>
<td>7.8</td>
<td>6.1</td>
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</table>
Decomposition of Current Account Balance
(in billions of dollars)
Structure of Capital Outflows (in percent)
Internationalization of Renminbi

- Offshore yuan deposits
- Trade settlements in yuan
- Yuan denominated bonds
- Currency swaps with other central banks

*Is renminbi on its way to becoming true global currency?*
Settlement of Foreign Trade in Renminbi

![Graph showing the growth of Trade Settlement in RMB and Share of Trade Settlement in RMB from 2010Q1 to 2015Q1. The graph indicates a steady increase in both categories over the years, with a notable rise in the share of trade settlement in RMB in 2014Q1.]
Dim Sum (Renminbi-Denominated) Bonds

Renminbi bonds outstanding in Hong Kong

RMB billion

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (RMB billion)</th>
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<tbody>
<tr>
<td>2010</td>
<td>50</td>
</tr>
<tr>
<td>2011</td>
<td>100</td>
</tr>
<tr>
<td>2012</td>
<td>150</td>
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<tr>
<td>2013</td>
<td>200</td>
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<tr>
<td>2014</td>
<td>400</td>
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RMB as World Payments Currency by Value (in percent)
The RMB in International Financial Markets

- Share of fx market turnover (2013): 2.2%
- Share of international bonds and notes (2015): 0.5%
- Interest rate derivatives (contracts, volume; 2013): < 1%
RMB’s International Use Requires:

- More financial centers (15), fin. institutions authorized to conduct RMB transactions
- Payment system (CIPS)
- More renminbi liquidity offshore
- Integration of offshore, onshore markets
Key Concepts

A. **International currency**: RMB on its way

B. **Reserve currency**: Held in central bank reserve portfolios. Basic criteria:

- Size
- Open capital account
- Flexible exchange rate
- Well-developed financial markets
- Macroeconomic stability
Trade-Weighted Effective Exchange Rates

[Graph showing nominal and real exchange rates from 2005 to 2016]
## Bond Markets: Stocks and Turnover

<table>
<thead>
<tr>
<th>Country</th>
<th>Government</th>
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<th>Corporate</th>
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<tbody>
<tr>
<td></td>
<td>Amount Outstanding</td>
<td>Turnover</td>
<td>Turnover Ratio</td>
<td>Amount Outstanding</td>
</tr>
<tr>
<td>U.S.</td>
<td>14,495</td>
<td>123,505</td>
<td>8.5</td>
<td>8,047</td>
</tr>
<tr>
<td>Japan</td>
<td>8,341</td>
<td>10,376</td>
<td>1.2</td>
<td>656</td>
</tr>
<tr>
<td>Euro area</td>
<td>8,132</td>
<td>-</td>
<td>-</td>
<td>3,671</td>
</tr>
<tr>
<td>China</td>
<td>3,694</td>
<td>2,339</td>
<td>0.6</td>
<td>1,543</td>
</tr>
<tr>
<td>Germany</td>
<td>1,262</td>
<td>5,919</td>
<td>4.7</td>
<td>282</td>
</tr>
</tbody>
</table>
Financial Markets for a Reserve Currency

■ Financial market characteristics:
  ▸ Breadth: Broad range of financial instruments
  ▸ Depth: Large stock of those instruments
  ▸ Liquidity: High level of turnover

■ High-quality renminbi assets backed by:
  ▸ Technical infrastructure for trading and settlement
  ▸ Regulatory framework—focus on systemic financial stability, adequate capacity, political will
Will China Stumble?

- Financial system risks
- Capital flight
- Policy missteps
- Political, social instability
RMB-dollar exchange rate
Onshore and Offshore Spot Renminbi-Dollar Exchange Rates
Net Errors and Omissions
(in billions of U.S. dollars)
Key Concepts

A. International currency

B. Reserve currency

C. Safe haven currency: Quality of institutions crucial
   • Open, transparent democratic government
   • Trusted, independent central bank
   • Independent judiciary
Prognosis

• Renminbi likely to become widely-used international currency in next 5 years

• RMB could become significant reserve currency if financial market, currency reforms continue + capital account becomes more open

• Will erode but not displace dollar’s dominant role in global finance
China’s Investment Position in the U.S.
(in billions of U.S. dollars)