

The rise of the renminbi

Joseph Mariathan discusses the rise of the renminbi with Prof Eswar Prasad of Cornell University

Currency

What China hopes to accomplish, argues Prof Eswar Prasad, is to use its currency's rise to prominence as a tool for increasing economic and strategic influence in the world. In addition, the notion of making the renminbi an important global currency serves several domestic objectives in terms of financial market liberalisation and reforms and even broader economic liberalisation and reforms.

The notion that a great economic power such as China needs to have a currency that matches its effect on the world economic stage has proved to be a useful framework for economic reformers in China to pursue their agenda. It is a 'Trojan horse' strategy which, by getting China's leaders to buy into the notion that a great economic power must have a great currency, impels certain reforms which ultimately will be good for China, independent of what happens to the currency.

Looking at what China has accomplished since the beginning of 2015, virtually every measure – the financial markets liberalisation, the moves towards allowing market forces a greater role in determining exchange rates, the explicit deposit insurance system, various capital account opening measures – is in some way or another, related to making the renminbi an important currency.

To achieve the establishment of the renminbi as a significant reserve currency there are several

prerequisites: having broad and liquid financial markets so that foreign investors have a lot of renminbi assets they can invest in; a more flexible exchange rate; and a more open capital account together with a robust financial regulatory framework. But while they are all seen as important to China, every one of these reforms faces opposition. Prasad argues that once the country's leadership has embraced the notion that these reforms are necessary to make the renminbi a more global currency, it makes it easier to get around the sources of opposition.

What is likely to be the endgame in the evolution of the renminbi? The notion that the renminbi is an international currency implies that it is used in trade transactions around the world. It has made remarkable progress since 2009-10, essentially starting from a zero base. This can be seen in the fact that about 25-30% of China's international trade is denominated in renminbi and China accounts for about 12% of world trade, so roughly 3% of international trade transactions are now denominated in renminbi.

The magnitude might not be that striking, but the trajectory is, although there has been flatter growth in the past year and a half. But once the Chinese economy stabilises, the upward trajectory will be resumed, assuming that China continues with financial sector reforms.

The renminbi is well on its way to becoming a reserve currency. It formally entered the

International Monetary Fund's Special Drawing Rights (SDR) basket with a status as an elite global currency in 2016 with 10.92% weighting, larger than that of the British pound and the Japanese yen. It has already become a de facto reserve currency with many central banks around the world, including Chile, Austria, UK and a host of economies in Asia, including South Korea and Japan, having the renminbi as some portion of their foreign reserves.

About 34 central banks have also signed bilateral local currency swap arrangements with China's central bank, giving them access to renminbi liquidity. Prasad sees the renminbi becoming a significant reserve currency, possibly rivalling the yen and the pound, each of which account for 4% to 5% of global reserves.

Despite the rapid progress in the internationalisation of the renminbi, what China will not be able to do in a hurry, argues Prasad, is to make the renminbi become a 'safe haven' currency, one which investors turn to during times of turmoil. This is a distinction that did not exist in the past, as other reserve currencies are also safe haven currencies.

To become a significant reserve currency it is necessary to have an open capital account, good financial markets and flexible exchange rates, and China is gradually achieving all of these. But to be a safe haven currency, says Prasad, the trust of foreign investors is also necessary. That requires a few things: an open and transparent system of government with checks and balances; trusted public institutions, particularly an independent central bank; and the rule of law.

China's leadership has made it clear that it is willing to proceed with economic reforms. But it is not willing to make political, legal and institutional reforms. As a result, says Prasad, while the renminbi will challenge sterling and the yen, it will find it difficult to challenge the euro or seriously challenge the dollar.

Gaining Currency: The Rise of the Renminbi, Eswar Prasad, Oxford University Press

