

## **Gaining Currency: The Rise of the Renminbi**

Eswar S. Prasad

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When China began its journey from a centrally planned economy to a socialist market economy in late 1978, it had virtually no footprint in the global economy. Today it is the world's largest trading nation, and its currency, the renminbi (RMB, also known as the yuan), has become an international medium of exchange, albeit on a small scale compared to the dollar, euro, yen, and pound.

In his new book, Eswar Prasad, former head of the IMF's China Division and currently Tolani Senior Professor of Trade Policy in the Dyson School at Cornell University, tells the story of the rise of the RMB and considers its future as a "safe haven" currency (i.e., one investors can turn to during a financial crisis).

Although the RMB has achieved official reserve status and is now included in the IMF's basket of currencies defining the Special Drawing Right (SDR), it still suffers from weak institutions that restrict the RMB's use as a global currency. So, while China has come a long way since 1978, it still has a way to go in becoming a global financial center with a trusted reserve currency.

Prasad begins with an overview of China's long monetary history, noting that paper currency, in the form of certificates of deposit issued by "private deposit shops" and secured by coins or goods as collateral, first appeared in the 7th century during the Tang dynasty, well before the use of paper money in 17th century Europe. However, it was not until the 10th century, during the Song dynasty (960–1279), that paper money became widely used in the form of banknotes, again issued privately and backed by coins or goods. In 1160, the Song ruler established a monopoly over the supply of currency, which was backed by metallic base money. Private currency was outlawed "on the grounds that only the government could ensure a reliable supply of a currency stable enough to support economic activity" (p. 3).

The banning of private currency was controversial and provoked debate over the role of government in supplying a stable currency. That debate was not new; it went back a thousand years to the Han dynasty (206 BC–220 AD), when only metallic money existed and private mints competed with the government. Confucian scholars argued that giving the state monopoly power in minting coins would

lead to debasement without competing private mints, while public officials contended that only they could provide sound money.

Although the debate over private money issuance was lost as the Song government exercised its power to ban private production, the results of that monopoly were as expected: an eventual overissuance of paper money, inflation, and economic instability during the later Song era.

In the 13th century, during the Yuan dynasty (1260–1367), China became the first country to issue an inconvertible paper currency (i.e., fiat money backed by nothing other than the government's promise to accept it as legal tender). It is noteworthy that Song intellectuals, such as Ye Shi, had a rudimentary understanding of the quantity theory of money, as well as the theory of monetary disequilibrium. They recognized that overissuance of paper currency would cause inflation and disrupt economic activity.

When inflation did occur during the Ming dynasty (1368–1644) because of an excess supply of paper money, China turned to the use of metallic money in the form of silver and coins. Paper currency did not appear again until 1853, during the Qing dynasty (1644–1911), and was backed by silver and bronze.

After the 1911 revolution, China experienced a period of competing currencies, as both government and private currencies circulated side by side. Those currencies were convertible into silver. However, the rise in world silver prices during the latter half of 1934 led to a drain of reserves, and in November 1935 China went off the silver standard.

From 1938 to 1941, the Kuomintang government allowed four banks to issue legal tender (*Fa Bi*), nominally convertible into British pound sterling and the U.S. dollar. That currency came into direct competition with paper currency issued by the China Reserve Bank, established by the Japanese in 1938, and later the Central Reserve Bank. The Kuomintang used its printing presses during the war to pay for military expenses, and the resulting hyperinflation made the *Fa Bi* worthless by 1948.

The RMB was introduced in 1949, when the People's Republic of China (PRC) was established. Chairman Mao's picture, however, did not appear on the currency until 1987; and he was not shown alone until 1999.

Many lessons can be learned from this monetary history, and Prasad does an excellent job in summarizing it. He then moves to

chapter 2, where he provides a tutorial on some fundamental concepts in international finance and organizes his book around three themes in the rise of the RMB: (1) the importance of opening the capital account and allowing more flexibility in the exchange rate regime, (2) the steps leading to the acceptance of the RMB as an international medium of exchange, and (3) the use of the RMB as a reserve currency. Those topics are covered in chapters 3–6.

The People's Bank of China (PBC), under Governor Zhou Xiaochuan, has been a strong proponent of financial reform and liberalization, including opening the capital account to impose more market discipline on domestic banks, making the exchange-rate mechanism more flexible and less politicized, and internationalizing the RMB by building confidence in it as a reserve currency. China has made progress on all those fronts, as Prasad explains. However, progress has been hindered by strong special interest groups, notably large state-owned banks and state-owned enterprises (SOEs). Those constraints, and the lack of central bank independence, have encouraged Zhou to advocate “managed convertibility” rather than full convertibility for the RMB.

China's growing debt problem is another key issue affecting the rise of the RMB as a reserve currency. In a system of state-owned banks lending to SOEs that are too big to fail, there is bound to be a debt problem. If the possibility of bankruptcy is absent in such a system, the only thing that can prevent disaster is further state intervention and this boils down to state guarantees of more debt. Moreover, Prasad recognizes that “the RMB's future trajectory as a reserve currency will depend, to a large extent, on China's success in creating large, liquid, and well-regulated debt securities markets” (p. 133). The recent downgrading of China's sovereign debt by Moody's is a sign that things are not moving in the right direction.

The heart of the book is found in chapters 7 and 8 where Prasad explores the shortcomings of China's state-dominated financial system and the reforms necessary to make the RMB a safe haven currency—including instituting a genuine rule of law, allowing capital freedom, and letting market forces be the main drivers of the exchange rate. Prasad notes the advances China has made in opening its capital markets and making macro prices (interest rates and the exchange rate) more market oriented. But he also exposes the cracks in China's institutional infrastructure and makes recommendations for reform. In particular, in chapter 7, he argues that, given current

institutional constraints, the goal of making the RMB a safe haven currency is a “mirage.”

Although the RMB is convertible for current-account transactions, the capital account is still tightly controlled. Chinese investors are strictly limited in moving funds offshore, and foreign investors face very narrow options in moving funds to the Mainland. Those obstacles are being removed little by little. The absence of capital freedom in China and the large role of the state in the financial sector make it difficult for the RMB to become a widely accepted reserve currency. Indeed, the RMB accounts for only 1 percent of global foreign exchange reserves. A telling sign of the limitations of the RMB as an international currency is that Zimbabwe treats it as legal tender!

In contrast to the PRC, Hong Kong is a key destination for foreign investment and a global financial center because the Hong Kong dollar is closely linked to the U.S. dollar via a currency board, backed by a strong institutional infrastructure with limited government, a genuine rule of law, free expression, and the highest degree of economic freedom in the world. All those institutions, notes Prasad (p. 156), are “necessary for building confidence” in a nation’s currency and financial regime. The value of free speech, or what Nobel economist Ronald Coase called “a free market in ideas,” is that it allows people to improve institutions by pointing out weaknesses, which can then lead to improvements. Prasad clearly understands that preventing such an exchange of ideas has been, and will be, detrimental to China’s development as a global financial center.

Deng Xiaoping, China’s paramount leader, who opened China to the outside world and embarked on economic liberalization during the 1980s, abandoned “class struggle” in favor of economic development as the primary goal of “socialism with Chinese characteristics.” Yet, as Prasad points out, there has been a reversal under President Xi Jinping who has written, “Never allow singing to a tune contrary to the party center. Never allow eating the Communist Party’s food and smashing the Communist Party’s cooking pots” (p. 162).

This reversal bodes ill for China’s future. As Liu Xiaobo, one of China’s most famous dissidents, expressed in his Nobel Peace Prize lecture (read by Liv Ullmann in his forced absence on December 23, 2009), “Freedom of expression is the foundation of human rights, the source of humanity, and the mother of truth.

To strangle freedom of speech is to trample on human rights, stifle humanity and suppress truth.” As a key signatory to Charter 08, which defended the rights of all individuals to freedom and democracy, Liu was imprisoned and died earlier this year from liver cancer at the age of 61. His life and the lives of countless others were taken by the state’s refusal to recognize a basic human right.

The Communist Party of China (CPC) pays lip service to the rule of law, and the PRC Constitution holds that “the State respects and protects human rights” (Art. 33, Sec. 3). However, as Prasad argues, the reality is that “the legal system will remain subservient to the CPC and will not in any way provide checks and balances on the government” (p. 168).

China’s “socialist rule of law” should not be confused with Hong Kong’s liberal rule of law that protects persons and property by limiting the power of the state. Beijing could learn from Hong Kong’s mantra, “Big market, small government.”

Prasad raises an important question in chapter 7, namely, “whether financial and other markets can function efficiently without the free flow of information” (p. 164). He calls that “an open question” but goes on to say, “certain reforms remain necessary if a market-oriented system is to work smoothly, especially a legal framework that protects contractual arrangements and property rights.”

There is increasing evidence that a free market in ideas also plays a key role in economic development and that the lack of a free flow of information is detrimental to the smooth operation of capital markets (see, for example, *How China Became Capitalist* by Ning Wang and Ronald Coase). Yet for a person like Liu Xiaobo, the primary consideration is not efficiency but freedom.

In chapter 8, Prasad asks whether China’s financial regime is a “house of cards.” He points to the risk of capital outflows and the accumulation of external debt as the capital account is opened, the instability of the state-dominated banking system, wide swings in the stock market, a growing shadow banking system, an exchange rate regime that fails to reflect market forces, and legal/political barriers to fundamental reform. Solving those problems would help instill confidence in the RBM and facilitate the move from an export- and investment-driven development program to one that is more balanced toward domestic consumption. Adding flexibility to interest rates and the exchange rate would also improve the allocation of capital.

China has taken a gradualist/controlled approach to opening the capital account and freeing up the exchange rate. Prasad reviews the various policies used to accomplish those goals and argues that “trying to maintain a gradual approach . . . can create tensions that show up in large and volatile movements of capital” (p. 178).

Recent capital outflows attest to his observation. However, if China were to adopt the reforms Prasad calls for—in particular, protecting property rights and adhering to a genuine rule of law—capital would be more likely to be attracted to and stay in China. Furthermore, with greater flexibility in the exchange rate, the PBC would not have to accumulate trillions of dollars in foreign exchange reserves and then waste them by trying to prop up the RMB to ward off being labeled a “currency manipulator.”

The pace of reform will depend on politics: so long as the CPC’s main goal is economic development and “stability,” the gradualist approach will continue. That approach has worked well in the nonfinancial sector since 1978, as the nonstate sector grew. However, the pace of reform has been much slower in the financial sector. A statement from the China Securities Regulatory Commission during the turmoil in the stock market in 2015 shows the tension between the leaders’ declared aim of opening markets versus the Party’s desire to maintain control: “The stock market is required to serve the people and the party, and the party alone represents the people. So if the market goes the wrong way or ‘misbehaves’, it is unpatriotic and should be corrected. Anyone who . . . helps the market ‘misbehave’ is a traitor” (p. 211).

Xi Jinping supports the Central Committee’s 2013 “Decision on Major Issues Concerning Comprehensively Deepening Reforms,” which calls for letting “the market play the decisive role in allocating resources,” improving the “property rights system,” and promoting a “market-based Renminbi exchange rate,” as well as “interest-rate liberalization” and “the opening of the capital market.” However, he engages in doublespeak when he pledges: “We in the Communist Party are firm Marxists and our party’s guiding thought is Marxism-Leninism, Mao Zedong Thought and Socialism with Chinese Characteristics.” Thus, while the Central Committee’s roadmap for reform is promising, the reality is, as Weiyang Zhang has pointed out in a recent issue of the *Cato Journal*, “If people are not allowed to freely debate how to reform the political system, then it will be impossible to develop the right ideas to implement this roadmap.”

Chapter 9 provides a snapshot of China's growing power and influence in the global economy. President Xi Jinping's "China Dream" is to have the Middle Kingdom regain its historical prominence and take a key leadership role in global affairs, in addition to achieving all-around development at home. By expanding its influence in multilateral organizations and extending its economic reach through the "Belt and Road Initiative," China hopes to further internationalize the RMB.

In chapter 10, Prasad cautions that, while the RMB has risen as an international currency, there need to be more fundamental reforms rather than mere tinkering with existing institutions. In a nutshell, his view of the rise of the RMB and its future is that,

despite becoming a reserve currency, the RMB has essentially given up its claim of being seen as a safe haven currency, one that investors turn to for safety. In the absence of . . . fundamental reforms, especially the rule of law and a democratic system of government, the rise of the RMB will erode but not seriously challenge the dollar's status as the dominant global reserve currency [p. 247].

By "democratic system," Prasad means "a constitutional democracy" with separation of powers and a just rule of law. That ideal, however, clashes with the reality that the CPC, with its monopoly on power, dictates the range of effective rights so that the individual is subservient to the state.

China's leaders have placed stability above freedom; but without freedom there can be no lasting stability—assuming freedom is bounded by a rule of law that protects persons and property. Prasad is correct in pointing out that what China's leaders want is "collectivist liberalism" not Western liberalism, which places individual rights above state power. Building free-market institutions and making the RMB a safe haven currency mean limiting the power of government and sharply curtailing the reach of the CPC. Paper constitutional provisions for "free speech" and other personal liberties are not enough; those fundamental rights need to be enforced, which the CPC is unwilling to do, lest it lose its "leadership" role and authority.

If China wants to be a major player in global capital markets and ultimately make the RMB a key reserve currency, a fully convertible

RMB must be backed by trust in private property, an independent judiciary, a transparent financial system, and the free flow of information. Yet, instead of moving toward a more open society and privatization, President Xi and his comrades have been cracking down on those who want more competition in the political system and a legal system that protects individual rights. Prasad points to a recent article in *Xinhua*, the CPC's mouthpiece, titled "Why Should China Say No to 'Wrong Western Values?'" (February 13, 2015), to illustrate that, at its core, the Party's soul is still Marxist.

Although China has made significant progress in opening its trade sector, its financial sector remains harnessed by the legacy of central planning, where state-owned banks lend to SOEs, controls on capital flows and interest rates persist, stock markets are subject to sudden changes in government policy, exchange rates are strictly managed, and there is a Great Firewall blocking the free flow of information. China may have a beautiful physical infrastructure, but it lags far behind in creating an institutional infrastructure with secure property rights, broadly defined to include both economic and civil liberties.

In conclusion, Prasad's well-written book will enlighten readers regarding the challenges China faces in liberalizing its capital account, deepening its financial market, internationalizing its currency, and increasing the range of choices open to its people, which is the key criterion of progress. His book will be of great value to all those who want to achieve a better understanding of the interplay of the political and economic forces shaping China's future and the rise of the RMB.

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