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China's Role in the Global Financial System

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This chapter considers China's evolving role in the global financial system, focusing in particular on the role of its currency. China's economy is now the second largest in the world and a key driver of global growth. But the country's role in global finance, and the prominence of its currency, are not commensurate with its weight in the world economy.

The chapter outlines some of the steps taken in recent years by the Chinese government to promote the international use of the renminbi (RMB), which in turn is linked to moves to open up China's capital account. In light of China's rising share of global GDP and trade, these steps are gaining traction and portend a more prominent role for the RMB in global trade and finance. The chapter then reviews the potential implications of these changes for capital flows into and out of China. This is followed by an evaluation of the progress that China has made in various aspects of financial market development and a discussion of the close relationship between those reforms, capital account openness, and the international role of the currency. Finally, the chapter discusses the prospects for the RMB becoming a major reserve currency.[1]

The RMB has come a long way in a short period. It was only in the early 2000s that the Chinese government began the process of gradually opening up the country's capital account, allowing financial capital to flow more

freely across its borders. This process was very gradual at first and picked up pace only a decade later. Over the last few years, the RMB's progress as an international currency has been remarkable in some respects. However, the currency's seemingly inexorable progress stalled in 2014. Starting in mid-2014, the Chinese economy seemed to be losing steam: domestic and foreign investors became less confident about the stability of China's financial markets, and, to compound these problems, China's central bank made some missteps as it attempted to make the currency's value more market-determined.

Nevertheless, in October 2016, the RMB achieved a major milestone in its ascendance as an international currency. That month the International Monetary Fund (IMF) officially anointed the RMB as an elite global reserve currency. The RMB joined the select basket of currencies (previously comprising the dollar, the euro, the Japanese yen, and the British pound sterling) that constitute the IMF's artificial currency unit, the special drawing rights. However, this does not by itself mean that the RMB is already in a position to significantly reshape global finance; it still has a long way to go before it can play a major role in international finance. The Chinese government has taken a number of steps to solidify the RMB's status as an elite global currency by increasing its international use. However, adoption of the RMB in global markets has been limited by the Chinese government's unwillingness to free up its exchange rate and fully open the capital account.

This chapter considers three related but distinct aspects of the role of the RMB in the global monetary system and examines the Chinese government's actions in each of these areas. First, I discuss changes in the openness of China's capital account and the degree of progress toward capital account convertibility. Second, I consider the currency's internationalization, which involves its use in denominating and settling cross-border trades and financial transactions—that is, its use as an international medium of exchange. Third, I trace the RMB's evolution as a reserve currency.

The RMB is likely to become a significant player in international financial markets even if its rise to prominence levels off, yet its full potential may remain unrealized unless the Chinese government undertakes a broad range of economic and financial system reforms. In the long run, what the RMB's ascendance means for the global financial system depends to a large extent on how China's economy itself changes in the process of the country elevating its currency.

CAPITAL ACCOUNT OPENING

In evaluating China's approach to capital account liberalization, one basic question must first be addressed: Why would capital account liberalization be a priority for China given the many domestic challenges the economy faces, including slowing economic growth, a weak financial system, and unbalanced growth that is still heavily dependent on investment? One reason is that such liberalization would generate a number of collateral (indirect) benefits for the domestic economy, particularly in terms of domestic financial market development that, in turn, could facilitate more stable growth (Prasad and Rajan 2008).

Liberalizing outflows provides Chinese households with opportunities to diversify their savings portfolios internationally and stimulates domestic financial reforms by creating competition for domestic banks that currently depend on captive domestic sources of funds (retail deposits of households and corporations). For the RMB to take on a more international role, both portfolio and foreign direct investment (FDI) outflows will need to involve more participation from the private sector.

The liberalization of inflows is also an important part of the overall picture in terms of attaining the collateral benefits of capital account liberalization. This liberalization already has allowed and will continue to allow foreign investors to play a larger role in further developing and deepening China's financial markets. For instance, there is a significant body of evidence that liberalizing portfolio inflows helps improve liquidity in the domestic equity markets of emerging economies. This, along with the entry of foreign banks, would increase competition in the banking sector, which in turn would benefit private savers and borrowers. Other segments of China's financial sector, including the insurance sector, have depended on capital controls and other entry restrictions to stay competitive. These segments will face greater competition with more open inflows. With effective regulation, this could lead to significant efficiency gains.

Capital account liberalization could have broader benefits for China. An open capital account would catalyze progress toward the objective of making Shanghai an international financial center. Capital account opening, especially if accompanied by greater exchange rate flexibility, could also strengthen China's domestic economic structure. It would facilitate financial sector reforms, allowing for a rebalancing of growth away from

a reliance on exports and investment-driven growth to a more balanced model of growth with higher private consumption. Financial sector reforms can play a crucial role in this rebalancing effort by promoting a more efficient allocation of resources toward the most productive uses. A more flexible exchange rate would free up monetary policy to facilitate achieving domestic macroeconomic objectives such as maintaining low and stable inflation (Prasad 2016).

Consistent with all these objectives, the government has in recent years removed restrictions on capital inflows and outflows, but in a controlled and gradual manner. These schemes have been designed to generate many of the collateral benefits of financial openness while creating freer movement of capital. For instance, the government has set up a number of schemes to allow foreign investors to invest in China's stock and bond markets. These include the Qualified Foreign Institutional Investor Scheme and the Renminbi Qualified Foreign Institutional Investor Scheme.

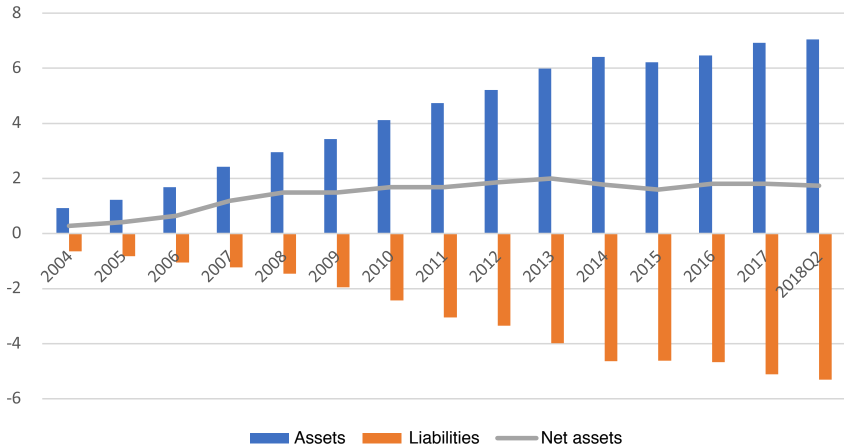
At the same time, there are now many channels available for Chinese households, corporations, and institutional investors that wish to invest some portion of their investments in foreign markets. These include the Qualified Domestic Institutional Investor and Qualified Domestic Individual Investor Schemes.

A few channels for two-way flows, such as the Stock Connect and Bond Connect programs, have also been opened up. But the government continues to maintain a tight grip over each of these channels.

How open is China's capital account? De jure measures of capital account openness typically rely on binary indicators from the International Monetary Fund's *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER). These binary measures reflect the existence of any restrictions on a large number of categories of inflows and outflows. Conventional measures of de jure financial openness drawing on the AREAER data show little, if any, change for China over the past decade.

An alternative and complementary approach to evaluating an economy's financial openness is to analyze de facto measures of integration into global financial markets. Figure 15-1 shows the levels of China's gross external (foreign) assets and liabilities, along with the net asset position, from 2004 through 2018. At the end of 2018, China had US$7 trillion of external assets and about $5 trillion of external liabilities. Both assets and liabilities have risen sharply over the last decade, and the net asset position stood at

FIGURE 15-1. **China's External Assets and Liabilities (in trillions of U.S. dollars)**



$2.1 trillion. Thus the country's capital account is becoming increasingly open in de facto terms, although by this measure China is financially less open than many reserve currency economies.

As China opens up its capital account, there have been important shifts in the structure of its capital outflows over the past decade. The change in the composition of gross outflows, from accumulation of foreign exchange reserves by the central bank to nonofficial outflows, reflects China's controlled approach to capital account liberalization but also increasing seepage around remaining controls. Agarwal, Gu, and Prasad (2019) analyzed the allocation patterns of Chinese institutional investors, who constitute the main channel for foreign portfolio investment outflows. They found that Chinese institutional investors underweight developed countries and high-tech sectors in their international portfolio allocations but overinvest in high-tech stocks in developed countries. These results suggest that the acquisition of technology could be an important motivating factor driving Chinese investors' international portfolio allocations. In such ways, unlocking the enormous pool of domestic savings could have a significant impact on global financial markets as China continues to open up its capital account and as domestic investors look abroad for higher returns and diversification.

While the government is taking a number of steps to promote capital

account liberalization, its final objective in this regard remains unclear. The end game for the government appears to be a capital account that is largely open but still subject to some degree of administrative control. Joseph Yam, the former head of the Hong Kong Monetary Authority, has argued that the long-term objective for China ought to be full capital account convertibility, which he defines as relaxation of capital controls but maintenance of "soft" controls in the form of registration and reporting requirements for regulatory purposes. He draws a careful distinction between this and an entirely unfettered capital-flow regime, referred to as free capital account convertibility. This is a subtle but important distinction that appears to have resonated well with the Chinese leadership, for full convertibility by this definition provides a path to an open capital account without ceding control entirely to market forces.

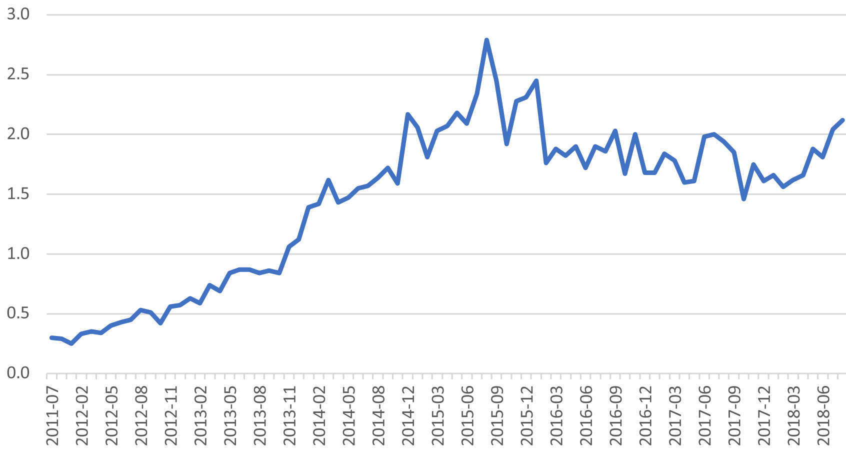
INTERNATIONAL USE OF THE RMB

China has promoted the availability of the RMB outside its borders, including sanctioning more than fifteen offshore trading centers where transactions between the RMB and other currencies can be conducted. The government has also set up a payment system to facilitate commercial transactions between domestic and foreign companies using the RMB rather than more widely used currencies such as the dollar and the euro.

These measures have led to the rising internationalization of the RMB. This term signifies its greater use in denominating and settling cross-border trade and financial transactions—that is, its use as an international medium of exchange. By the latter half of 2014, about one-third of China's international trade was being denominated and settled in RMB. Furthermore, according to data from SWIFT (the Society for Worldwide Interbank Financial Telecommunication), by mid-2015 the RMB accounted for nearly 2.8 percent of cross-border payments around the world, a low share but one that already ranked the RMB as among the top five payment currencies in the world (figure 15-2). Other indicators of China's internationalization also showed substantial progress during this period. Such indicators include settlement of trade transactions with RMB, the issuance of RMB-denominated bonds in Hong Kong and other offshore financial centers, and offshore RMB deposits.

But then the currency's progress stalled, as China grappled with a growth

FIGURE 15-2. **RMB as World Payments Currency by Value (in %)**



slowdown, a sharp boom-and-bust cycle in the stock market, and concerns about rising debt levels and financial instability. Since 2015 the RMB's progress as an international medium of exchange has gone into reverse or, at best, flat-lined. At the end of 2018 the RMB accounted for about 2 percent of cross-border payments (see figure 15-2). Other quantitative indicators of the currency's use in international finance, including trade settlement in RMB and the issuance of RMB-denominated bonds offshore, all point to signs of a stalling of the currency's advance as an international currency.

Still, it is important to keep both the upswings and downswings in proper perspective. Despite the constraints on capital flowing into and out of China, the RMB has begun playing a larger, though still modest, role in international finance over a relatively short period. The SWIFT data reveal the rising prominence of the RMB as an international payments currency, although it is still a long way from being a major payments currency that can rival the U.S. dollar. This will be aided by a payments system that China has set up for intermediating transactions. In October 2015, China launched a new cross-border RMB payments system—the China International Payment System (CIPS)—that is organized more in line with internationally accepted standards. This will help facilitate settlement and clearing of cross-border RMB transactions, including trade and investment flows, and bolster the international role of the RMB.

The pace of the internationalization of China's currency depends on its

use in international financial transactions as well. The choice of currency for denomination and settlement of trade flows is contingent on the extent to which that currency can also be used in international financial transactions. Bank of International Settlements (BIS) data show that, as of 2016 (when the last BIS triennial survey was conducted), the RMB accounted for only about 4 percent of turnover in foreign exchange markets. This is above the share of any other emerging market currency but well below that of the major reserve currencies.

RESERVE CURRENCY

A different aspect of a currency's role in international finance is its status as a reserve currency, one that is held by foreign central banks as protection against balance of payments crises. This topic might seem premature insofar as China has neither a flexible exchange rate nor an open capital account—two features once considered absolute prerequisites for a reserve currency. Even though the IMF has officially anointed the RMB as a reserve currency, financial market participants' views are more important in determining a currency's status.

The RMB's prospects as a reserve currency will ultimately be influenced by progress on these criteria: (1) capital account openness, (2) exchange rate flexibility, (3) economic size, (4) macroeconomic policies, and (5) financial market development. This section discusses the relative importance of each these criteria for reserve currency status and summarizes how China measures up on each.

Reserves must be acceptable as payments to a country's trade and financial partners, which requires that the currency be easily tradable in global financial markets. China is gradually and selectively easing restrictions on both inflows and outflows. As noted above, the capital account has become increasingly open in de facto terms, but extensive capital controls remain in place.

Reserve currencies are typically traded freely and their external value is market-determined, although this does not preclude occasional bouts of intervention by the country's central bank in foreign exchange markets. China continues to manage its nominal exchange rate, although it has in principle allowed market forces to play an increasing role in determining the external value of the RMB. The currency is now managed against a

trade-weighted basket of other major currencies, although market participants still see China's central bank as playing a major role in influencing the level of the exchange rate in a manner that does not always hew to such a rule. The absence of a fully market-determined exchange rate, especially one that is supported using capital controls, could affect the currency's rise in global finance.

China's economy is now the second largest in the world (based on market exchange rates). In 2018, its annual GDP was about two-thirds that of the United States (at market exchange rates). China is also an important player in international trade, accounting for 13 percent of global trade in goods. China's impact on the world economy is even greater when measured along other dimensions. The country is a net global creditor, to the tune of more than US$2 trillion, as noted earlier, and has accounted for about one-third of global GDP growth since the financial crisis.

Investors in a country's sovereign assets must have faith in its commitment to low inflation and sustainable levels of public debt, so that the value of the currency is not in danger of being eroded. China has a lower ratio of explicit public debt to GDP than most major reserve currency economies and has maintained moderate inflation in recent years.

A country must have broad, deep, and liquid financial markets so that international investors can access a wide array of financial assets denominated in its currency. China's financial markets remain limited and underdeveloped, with a number of constraints such as a rigid interest rate structure. The recent growth and opening up of China's debt markets suggests that the pace of the country's financial market development is consistent with its intention to gradually increase acceptance of its currency as an international currency. Moreover, to satisfy their demand for relatively safe RMB-denominated assets, foreign investors—both official and private—will eventually need to be given greater access to China's debt markets if the RMB is to become a significant reserve currency.

Remarkably, the RMB has already become a de facto reserve currency even though China does not meet some of the traditional prerequisites. China's sheer economic size and the strength of its trade and financial linkages with economies around the world seem to have overridden the other limitations.

Many central banks around the world are gradually acquiring at least a modest amount of RMB assets for their foreign exchange reserve portfo-

lios. The list comprises a geographically and economically diverse group of countries, including Australia, Austria, Chile, Nigeria, South Africa, Korea, Malaysia, and Japan. According to IMF estimates, about 2 percent of global foreign exchange reserves are now held in RMB-denominated financial assets. About thirty-five central banks around the world have signed bilateral local currency swap arrangements with China's central bank. These arrangements give them access to RMB liquidity that they can draw on to defend their currencies or maintain stable imports even if foreign capital inflows into their economies were to dry up.

Although the RMB has managed to attain the status of a reserve currency, its progress is likely to be limited by its lack of well-developed financial markets. Foreign official investors, such as central banks and sovereign wealth funds, typically seek to invest in highly liquid and relatively safe fixed income debt securities, even if such securities have a relatively low rate of return. China's government and corporate debt securities markets are quite large but still seen as having limited trading volume and weak regulatory frameworks.

Thus, strengthening its financial markets is important both for China's own economic development and for promoting the international role of its currency.

FINANCIAL SECTOR DEVELOPMENT AND REFORMS

Financial market development in the home country is one of the key determinants of a currency's international status. Historically, each reserve currency has risen on the international stage under unique circumstances, spurred by a range of motivations, but one constant is that this rise has always required financial markets that can cope with the varied and voluminous demands of private and official foreign investors. There are three relevant aspects of financial market development:

- *Breadth:* The availability of a broad range of financial instruments, including markets for hedging risk.
- *Depth:* A large volume of financial instruments in specific markets.
- *Liquidity:* A high level of turnover (trading volume).

Without a sufficiently large and liquid debt market, the RMB cannot be used widely in international transactions. To make the currency attractive to foreign central banks and large institutional investors, they will need access to RMB-denominated government and corporate debt as "safe" assets for their portfolios. At the same time, both importers and exporters may be concerned about greater exchange rate volatility resulting from an open capital account if they do not have access to derivatives markets to hedge foreign exchange risk. Thus, depth, breadth, and liquidity are all relevant considerations in assessing the readiness of a country's financial sector to cope with an open capital account and elevate its currency to reserve currency status.

China's financial system remains bank-dominated, with the state directly controlling most of the banking system. Domestic credit allocation is controlled largely by state-owned banks and is disproportionately directed toward enterprises, especially state-owned enterprises, rather than households.

Chinese stock markets have been prone to concerns about weak corporate governance, limited transparency, weak auditing standards, and shoddy accounting practices. In the absence of the broad institutional and regulatory reforms that are necessary to support effective price discovery and the overall efficient functioning of stock markets, these markets could remain unstable. The recent bouts of volatility in the stock market and the manner in which the government has addressed volatility has heightened many of these concerns. As a consequence, even with more liberalization of portfolio inflows, international investors may shy away from investing heavily in Chinese equities. Therefore, the country's deep equity markets may be of limited help in promoting the international role of the RMB.

Recognizing the importance of a better financial system to an improved allocation of resources within the economy, the Chinese government has instituted a number of reforms in recent years. For instance, bank deposit and lending rates have now been fully liberalized. Commercial banks can now set these rates freely, although the People's Bank of China still sets reference rates to guide banks. An explicit bank deposit insurance program has been in operation since May 2015. This program is intended to expose banks to some degree of market discipline by replacing the implicit full insurance of all deposits by the government. The system also allows for early intervention by the banking regulator and has an improved resolution

mechanism for failing banks. Since the system is relatively new, there have been no test cases as yet.

These reforms are important steps in the right direction. Future reforms and the development of the banking system will have significant implications for the development of China's more nascent financial markets, including the corporate bond market, and also for economic development more broadly. In particular, China's aspirations to make the RMB a global reserve currency rest in large part on the pace of development of its fixed income markets. Reserve currency economies are expected to issue high-quality and creditworthy government debt or government-backed debt instruments that can serve to hedge against foreign investors' domestic currency depreciation during a global downturn.

China's fixed income markets, especially for corporate debt, have developed considerably in the last few years, from both domestic and international perspectives (see table 15-1) The stock of government bonds stood at US$4.9 trillion in September 2018. Nonfinancial corporate debt was practically nonexistent a decade ago, but the outstanding stock has now risen to $2.9 trillion. The size of China's overall fixed income markets, with a capitalization of $12.4 trillion in September 2018, now stands behind only those of the United States, the euro zone, and Japan. However, turnover, a measure of trading volume, remains quite low in China's debt markets. China has recently lifted restrictions on foreign investors' participation in

TABLE 15-1. **Stocks of Government and Corporate Bonds: A Cross-Country Perspective (amounts outstanding at end of September 2018, in trillions of US$)**

		Corporate bonds			
Country	Government bonds	Financial corporations	Nonfinancial corporations	Total corporate bonds	Total debt
United States	18.35	15.91	6.24	22.15	40.50
Eurozone	9.46	8.57	1.50	10.06	19.53
Japan	9.39	2.50	0.73	3.23	12.62
China	4.89	4.61	2.92	7.53	12.42
United Kingdom	2.63	2.65	0.52	3.17	5.79
Germany	1.85	1.56	0.19	1.75	3.60
India	0.81	0.03	0.03	0.05	0.86

its bond markets, which should improve both the depth and liquidity of these markets over time.

Overall, China's financial markets have improved in some respects during the last decade, but there are still significant gaps, especially in terms of achieving sufficiently large and liquid debt markets. More important, the structure and quality of debt markets will also need to be improved to fully prepare for a currency used widely in international financial transactions and reserve holdings. With relatively low external and government debt positions, China's debt markets can in principle expand rapidly without serious threat to inflation credibility or vulnerability to external risks. Effective regulation of corporate debt markets is an important priority so that these markets can expand without generating financial instability.

The main conclusion of this section is that China has made significant progress in many areas but still falls short on some key dimensions of financial market development. The government's efforts to aggressively promote the RMB's international role are likely to be impeded over the medium term by the weaknesses of China's financial system.

SAFE HAVEN STATUS FOR THE CURRENCY WILL REQUIRE INSTITUTIONAL REFORMS

Sine the global financial crisis, a new concept has gained traction in international finance: that of a "safe haven" currency (Prasad 2014). 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.

China might have rising economic clout, but whether it will be able to gain the trust of foreign investors is an open question. Such trust is crucial for a currency to be seen as a safe haven. A country seeking this status for its currency must have a sound institutional framework—including an independent judiciary, an open and transparent government with institutionalized checks and balances, and robust public institutions (especially a credible central bank). These elements have traditionally been seen as vital for earning the trust of foreign investors, both private as well as official, including central banks and sovereign wealth funds.

Foreign investors typically want to know that they will be treated fairly according to well-established legal procedures, rather than being subject to

the whims of the government. They also tend to value the independence of institutions such as the central bank from government interference, as this is important for maintaining the credibility and value of the currency.

While the Chinese leadership is pursuing financial liberalization and limited market-oriented economic reforms, it appears to have repudiated political, legal, and institutional reforms. In short, while the RMB has the potential to become a significant reserve currency, it will not attain safe haven status in the absence of far-reaching reforms to China's institutional and political structures. Such reforms are apparently not in the cards.

CHINA'S IMPACT ON GLOBAL FINANCIAL MARKETS

This section analyzes the potential impact of the RMB's rise on the competitive balance of global reserve currencies and discusses the effects that the internationalization of the RMB could have on the structure of global capital flows.

Promoting the RMB's international role is tied up with many complex domestic and geopolitical considerations. As with all of its policies, China is working toward multiple objectives. For now, it is likely that China will continue promoting the international use of the RMB using Hong Kong as a platform. When the Chinese government determines that its financial markets are finally strong enough to allow for a more open capital account, it is likely that promotion of Shanghai as an international financial center could take precedence, especially as that would fit better with China's domestic financial market development objective.

While using Hong Kong as the main staging ground for the internationalization of the RMB, the Chinese government is also working to promote competition among financial centers eager to engage in RMB business. Regional and international financial centers such as Bangkok, Frankfurt, London, and Singapore are all being given opportunities to engage in RMB transactions. This competition enables Beijing to continue its program of internationalizing the RMB without having to fully open its capital account.

Why are so many countries eager to sign currency swap lines with China and even hold its currency as part of their reserve portfolios? This may be less a sign of the RMB's inevitable march to global dominance than it is a low-cost bet on a likely outcome of a convertible and more widely

accepted global currency. Equally important is the desire on the part of many economies to maintain a good economic relationship with China in anticipation of its rising economic power. Central banks around the world are preparing for a future in which the RMB will start playing an increasingly prominent role in international finance and may ultimately become a reserve currency. A more open capital account will allow the RMB to play an increasingly significant role in Asian as well as global trade and finance, but in a manner that allows the Chinese government to retain some control over capital flows.

There is no clear guidance from economic theory about how many currencies would be best for a world economy that is becoming increasingly closely integrated. Having a system with multiple reserve currencies but with just one principal reserve currency has fueled a number of complications such as persistent global current account imbalances, suggesting that it may not be the optimal situation from the perspective of promoting the stability of the global financial system.

If multiple reserve currencies are indeed desirable, how should one assess the prospects of other currencies that could compete with the dollar? The history of the rise and fall of reserve currencies does offer some useful lessons. The key is for a country to have sound economic policies, well-developed financial markets, and public institutions that are trusted by domestic and foreign investors. These are the relevant criteria that put a country's currency in a position to develop into a reserve currency.

The argument for a world with multiple reserve currencies in a stable competitive equilibrium might be obvious if the world economy was starting with a clean slate. But the argument is far from clear-cut given the present state of financial markets and the level of international financial integration. Events during the financial crisis present a counterargument to the notion that having more reserve currencies is better.

The dollar's dominance has allowed the Fed to act as a credible global lender of last resort, a role that few other central banks are capable of playing. However, there is a risk of confusing cause and effect here. One reason the world was in search of dollar liquidity during the crisis is that many global banks had sought large amounts of cheap dollar funding to finance their worldwide operations. U.S. monetary conditions, which led to an aggressive search for yield through financial innovations, and the fertile ground provided by U.S. financial markets for such sophistry were impor-

tant elements in making many global banks depend so heavily on dollar liquidity.

While the RMB is likely to become a significant reserve currency over the next decade, it is unlikely to challenge the dollar's dominance. There is still a huge gulf between China and the United States in the availability of safe and liquid assets such as government bonds. The depth, breadth, and liquidity of U.S. financial markets will serve as a potent buffer against threats to the dollar's preeminent status. Rather than catching up to the United States by building up debt, the challenge for China is to develop its other financial markets and increase the availability of high-quality RMB-denominated assets.

CONCLUSION

Despite China's economic might, the international stature of its currency, the RMB, does not yet 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.

Given its size and economic clout, China is adopting a unique approach to the RMB's role in the global monetary system. As with virtually all other major reforms, China is striking out on its own path to a more open capital account. This move is likely to involve removing explicit controls even while attempting to exercise "soft" control over inflows and outflows through administrative and other measures.

The selective and calibrated approach to capital account liberalization has been effective at promoting the RMB's international presence, but it has generated some risks, since other reforms have not kept pace. Still, the RMB is beginning to play a significant role in international trade transactions. It is making inroads into the global financial system and starting to appear in the reserve portfolios of a number of central banks around the world. It has also become a constituent of the basket of currencies that constitute the IMF's special drawing rights. These shifts, some of which are more symbolic than substantive at present, will develop critical mass over time and have the potential to start transforming the global monetary system. However,

the full potential of the RMB's international use cannot be realized without more active onshore development. It will be difficult, for instance, to fully develop China's foreign exchange and derivatives markets in the absence of a more open capital account.

The RMB's prospects as a global currency will ultimately be shaped by broader domestic policies, especially those related to financial market development, exchange rate flexibility, and capital account liberalization. As Chinese financial markets become more fully developed and private investors increase the international diversification of their portfolios, these shifts in China's outward investment patterns are likely to become more pronounced. Thus the various policy reforms that are needed to support the international role of the RMB could also create significant changes in China's economy and the patterns of its capital inflows and outflows.

A number of key reforms could increase the RMB's prominence in global finance and also help in China's own economic development. One is the liberalization of financial markets, including further development of fixed income and secondary (derivatives) markets. Another is the further opening up of the capital account by removing restrictions on both inflows and outflows in a calibrated manner. Fixing the banking system so that it operates on more commercial principles and with better governance structures is also important. A more flexible, market-determined exchange rate should accompany capital account opening. This would provide a foundation for a more autonomous monetary policy regime that emphasizes price rather than quantity instruments. Finally, a more comprehensive and robust regulatory framework that enhances rather than attempts to serve as a substitute for market discipline would help build confidence in China's financial markets.

The RMB is on its way to becoming a widely used currency in international trade and finance. So long as China continues to make progress on financial sector and other market-oriented reforms, it is likely that the RMB will become an important reserve currency within the next decade, perhaps eroding but not displacing the dollar's dominance. For the RMB to become a safe haven currency, however, would require not just economic and financial reforms but also significant institutional reforms.

NOTE

1. A sample of the extensive literature on this topic includes Barry Eichengreen and Masahiro Kawai, *Renminbi Internationalization: Achievements, Prospects, and Challenges* (Washington, DC: Brookings Institution Press, 2015); Jeffrey Frankel, "Historical Precedents for the Internationalization of the RMB," paper presented at a workshop organized by the Council on Foreign Relations and the China Development Research Foundation, Beijing, November 1, 2011; Yiping Huang, Daili Wang, and Gang Fan, "Paths to a Reserve Currency: Internationalization of the Renminbi and Its Implications." ABDI Working Paper No. 482 (Tokyo: Asian Development Bank Institute, 2014); Nicholas Lardy and Patrick Douglas, "Capital Account Liberalization and the Role of the Renminbi," Working Paper 11-6 (Washington, DC: Peterson Institute for International Economics, 2011); and Paola Subacchi, *The People's Money: How China Is Building a Global Currency* (New York: Columbia University Press, 2016).

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Prasad, Eswar, and Raghuram Rajan. 2008. "A Pragmatic Approach to Capital Account Liberalization." *Journal of Economic Perspectives* 22 (3): 149–72.

period to 2049. Each has some strong preferences about reform of these institutions. The potential exists for compromise between the two that would modernize the institutions and lay a foundation for a further period of stability and prosperity. It is also easy to imagine a confrontational future in which compromises are not reached and the world economy devolves into blocs and competing institutions. The chapter lays out the key challenges in the trade, development, and finance arenas, and concludes with some thoughts about what practical compromises might look like.

TRADE, FOREIGN DIRECT INVESTMENT, AND THE WTO

In the case of the WTO, China has become an active member since joining in 2001. Between 2006 and 2015, forty-four cases—representing more than a quarter of the WTO caseload—involved China as a complainant or as a respondent. Only the United States and the EU had more active cases over the period. Furthermore, in general, when China has lost cases it has changed the necessary laws and regulations and complied with the ruling. Based on this pattern, one might conclude that China's integration into trade dispute settlement has been quite successful.

Wu, however, makes a compelling case that the situation is not so rosy. China presents a number of unique challenges for the trading regime, and "since the Great Recession WTO litigation has increasingly bifurcated into an 'Established Powers versus China' dynamic." (Wu 2016, 264). Between 2009 and 2015, China-related cases accounted for 90 percent of the cases brought by the four large economies against each other. While cases among the United States, EU, and Japan used to be common, now increasingly these countries line up together against China.

The problem, according to Wu, is that "China, Inc." is sui generis:

> What distinguishes China, Inc.? Contradictions pervade the Chinese economy today. While one might think of the economy as state-dominated, private enterprises drive much of China's dynamic growth. In addition, economic intervention does not always flow through the state. Alongside the state is the Chinese Communist Party ("Party"), a separate political actor that plays an active role in the management of state-owned enterprises ("SOEs"). The economy embraces market-oriented dynamics, yet it is not strictly a free-