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THE PEOPLE'S MONEY

How China Is Building a Global Currency

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INTRODUCTION

IN JANUARY 2016, China sent shockwaves through the international financial community. The Shanghai Composite Index dropped by 18 percent in the first two weeks of the year, the renminbi had been on a downward trend since late 2014, and for the first time in more than ten years, the economy had begun to show clear signs of slowing down. All this came on the heels of the collapse of the Chinese stock market in June 2015 and the reform, and devaluation, of the exchange rate in August 2015. Furthermore, the country's authorities seemed unable to calm the turbulence, acting erratically and ineffectively "like headless chickens." The introduction of the "circuit breaker" mechanism—a kind of backstop that was devised to automatically suspend trading if stocks fell by 7 percent—ended up generating more panic. The abrupt dismissal of Xiao Gang, chairman of the China Securities Regulatory Commission, with no announcement of a replacement, amplified the sense of uncertainty.

After a spectacular, thirty-year ascent, China is now at a pivotal moment. Its leaders are eager to develop the country as a significant financial power and thus to conclude the process of economic transformation from plan to market that Deng Xiaoping launched in 1978. When President Xi Jinping took the helm of the Chinese Communist Party and the country in late 2012, he changed the course of economic policy, emphasizing the role that the private sector is expected to play in the economy and the attendant need to improve the commercial banking system, develop modern financial markets, and write and enforce commercial laws. The challenge is to reduce state interference—in particular, the tangled web of domestic vested interests that continue to link big banks and state-owned enterprises—and to stop the funneling of resources according to social and political control rather than sound investment strategy. All of this will be necessary for China to achieve the title of economic and political superpower. Embedded deeply within every one of these economic goals and challenges is the vexing question of the renminbi.

Indeed, China now faces the paradox, and limits, of having emerged as a major industrial and trading power without a currency that reflects its standing in the world. Paradoxically for a country that has hugely benefited from opening up to and integrating with the rest of the world, the renminbi is a currency of "restricted globalization." It has limited circulation outside the country, and it cannot be easily exchanged with other currencies or be held in deposit accounts in banks overseas. It is hardly used in international transactions, and non-Chinese individuals and institutions—firms, banks, and governments—rarely hold renminbi in their portfolios. As a result, China largely relies on the dollar to price and sell the goods it produces; it needs dollars to pay for imports, to invest abroad, and to implement its economic diplomacy. It has accumulated a large amount of dollars—approximately $3.2 billion in official reserves[1]—to do all this and has considerable capital available to make foreign acquisitions. However, its power in financial and monetary affairs is limited, and this power needs to be "brokered" through the dollar-dominated international monetary system in order to be fully deployed. Above all, its reserves—the nation's wealth—are vulnerable to changes in the value of the dollar.

As a country becomes more economically integrated at the regional or global level and the size of its economy ranks it among the world's largest economies, the argument for using its own currency in trade and finance becomes more compelling. Currencies are nations' blood, their "genetic" imprint, and their identity, and they epitomize those nations' power and standing in the world. The dollar, for example, characterizes the United

States' identity as a nation, and it is a repository of the country's power and a source of its "exorbitant privilege." China needs an international currency to complete its rise to power, expand its influence in monetary affairs, increase its geopolitical weight, and put it on a par with the United States.

China has reasons beyond the political and diplomatic arguments for wanting and needing to develop the renminbi as a currency that can be used overseas and at the same time to cut its financial and monetary dependence on the dollar. Pricing its trade in renminbi will reduce costs and the exchange rate risks for Chinese enterprises when they engage in overseas trade and financial transactions. Thus, expanding the international use of the renminbi will support the country's business and investments abroad. Above all, by developing the renminbi into an international currency, China can reduce the accumulation of dollars in its reserves and instead use its renminbi surplus to invest and lend abroad—and, if necessary, to finance its debt in its own currency.

Developing the renminbi into an international currency is China's long-term plan, one that should stay in place despite the short-term gyration of the stock market. The template is straightforward: exploit China's role in international trade to promote the use of the renminbi while removing existing restrictions on the movement of renminbi into and out of its domestic market in order to increase the currency's usability outside the country—and therefore its demand overseas. Historical experience shows that a currency's use in international trade should be supported and matched by its use in finance and that allowing more open investment and circulation of that currency is critical to developing its international use.

This is where China is breaking from history. It cannot easily follow this traditional route, given the vestiges of a planned economy that continue to characterize its system—vestiges like the management of the interest rate and the exchange rate, which has fueled the country's growth spurt but also stunted its currency. To allow the renminbi more freedom of movement, China must accelerate institutional reforms and economic rebalancing, and this means that the country can not simply and immediately "open up." To create a liquid and trusted currency that meets the world's demand for safe assets in the way the dollar does today, China needs to do several things:

improve the governance of banks, companies, and institutions; curb corruption; and keep vested interests at bay. Above all, its leaders have to figure out a way to open its financial markets and banking sector while maintaining its unique hybrid, "socialism with Chinese characteristics," where economic planning and state control coexist with markets, foreign investments, private property, and individual initiative.

Better governance and transparency are essential not only to promote greater circulation of the renminbi but also to improve the sense, among non-Chinese holders, that it is a trustworthy currency. Currently, foreigners have limited confidence in China's institutions and political system; even if Beijing ends up lifting all restrictions on foreign engagement with the domestic system, they might still be reluctant to entrust the country with their money.

How can China persuade the rest of the world that the renminbi is a currency worth using and holding, like the dollar, the euro, the British pound, and the Japanese yen? In addition to increasing transparency, openness, and accountability, its authorities need to convince the rest of the world that they will not undermine the currency's external value—that is, the exchange rate—even if domestic circumstances, political as well as economic, call for it. Renminbi holders need to have confidence that no matter where they are and in what circumstances they operate, they will always be able to use the renminbi to exchange it for whatever they need, and that the currency will retain its value.

The whole picture is further complicated by the state of the world economy. In the 1990s and up to 2008, China could get traction from the robust and booming global economy, but when the global financial crisis hit in 2008 and ushered in a period of deep uncertainty, the international environment turned less favorable. The country is now facing the challenge of managing the real economy against the headwinds of lower demand, geopolitical tensions, and its own increasingly unmanageable debt.

That said, Chinese leaders are eager to break up the dollar's hegemony—but not to replace the dollar system with the renminbi system. Rather, they envisage the renminbi as a major currency within a new multicurrency international monetary system that reflects the fact that the world economy is no longer dominated by the United States.

These leaders have their hands full. Will they be able to juggle China's overall transition without undermining social cohesion, political balance, and financial stability? And, central to our discussion, can they meet their goals for the renminbi while retaining a measure of state control? What are the options for China?

I argue that one option is to move forward and accelerate the process of financial reforms. But even if accelerated, reforms within the country's uniquely hybrid economy will take time—and China is in a hurry. So the other option is to develop a system based on managed convertibility—in other words, to encourage the international circulation of renminbis while retaining controls on money moving in and out the country. Many Western experts are skeptical that a currency can be internationalized when significant constraints to its circulation remain in place, but the official rhetoric is that the country can achieve some degree of internationalization of the renminbi while maintaining capital controls.

In this book, I lay out the story of China and its currency over ten chapters. I start by setting the background: in chapter 1, I introduce the concept of international money and frame the subsequent discussion. I explore how capital movements have not only driven the transformation of the world economy in the last twenty years but also created more financial instability and made the global economy more vulnerable to financial crises. I then look at what it takes for a currency to become international money—focusing, in particular, on the development of the dollar. Ultimately, in this chapter, I consider the context of China's extraordinary transformation in the last three decades and how the dollar-driven international monetary system has accelerated this transformation.

In chapters 2 and 3, I delve into the transformation of the Chinese economy since the reforms that Deng Xiaoping introduced in the 1980s and show how both exports and investment have been critical to the country's development. In chapter 3, in particular, I discuss China's system of financial repression, in which the cost of borrowing is kept artificially low. High domestic savings rates and financial repression have kept a lid on the structural imbalances within its domestic financial sector. At the same time, however, they have perpetuated inefficiencies, inhibited reform, and thus constrained the development of the renminbi as an international currency. In these chapters, I address the book's key questions: Why doesn't China have its own international currency rather than depending on the U.S. dollar? And why did its extraordinary development not include the renminbi?

Having set the scene, I then explore China's predicament of being the largest trading nation but not having a currency in which to settle a significant share of this trade (chapter 4). Here I discuss the two key features of China's economic policy—capital controls and a managed peg for the exchange rate—that over the years have resulted not only in the extraordinary transformation of the Chinese economy by keeping exports competitive and powering rapid growth and job creation, but also have resulted in the limited development of the renminbi.

In chapter 5, I look at the costs of operating with a dwarf currency—in particular, the constraints of being an immature creditor (i.e., not being able to lend in renminbi)—and the costs of managing the exchange rate. I conclude the chapter by discussing the difficulties of challenging the dollar system when network externalities and inertia create strong disincentives to change.

The question of how to create an international currency is the focus of my discussion in chapter 6, and here I assess lessons that can be learned from the development of other international currencies—notably, the Japanese yen—in the context of China's renminbi strategy. This strategy is a dynamic process that in a relatively short span of time has evolved from a plan devised to encourage regional use of the renminbi to a more complex, policy-driven framework that aims to turn the renminbi (albeit with limitations) into international money and into an international financial asset by supporting the renminbi in cross-border trade settlement and establishing the renminbi offshore market. Here and in chapter 7, I delve into the measures that the Chinese monetary authorities have put together to overcome the limitations of the renminbi and to build a market for the currency.

In chapter 8, I assess progress on the international use of the renminbi since the launch of the renminbi strategy and look at how the strategy has expanded into many policy areas and sectors and supported the use of the renminbi in the main international financial centers around the world—with the exception of the United States. I also chart China's recent attempt to open up the financial sector through managed convertibility—that is, a system of quotas for capital movements.

In chapter 9, I discuss China's financial reforms and argue that its leaders will need a long time to reform the current system—if they are able to do so at all. Otherwise relaxing controls on capital flows—especially on the outflows—may run against the need to maintain plenty of financial resources for domestic banks. For the time being, therefore, managed convertibility will support the circulation and usability of the renminbi outside China.

I conclude by arguing in chapter 10 that the renminbi has become, in approximately five years, Asia's key regional currency. Furthermore, the renminbi strategy has created the conditions to extend the circulation of the Chinese currency beyond Asia. But more needs to be done, and policies can further push the international use of the renminbi. However, unless reforms are accelerated, the renminbi will continue to be a currency of restricted globalization and it will take many years for it to become a leading international currency. Everything being equal, it will eventually become one of the leading currencies in the new multicurrency international monetary system, eroding the dollar's relative weight. But it will be unlikely to replace the dollar as the dominant international currency because, among other reasons, the world may have shifted away from a single-currency system.

What China is doing is critical for its own development but matters for the world as well. If it succeeds in building a global currency, this will usher in the age of Chinese capital, and our monetary system will be radically transformed from the dollar-dominated system we see today. The government has set this as the direction for the renminbi strategy. But whether it can achieve the goal of transforming the people's money into a currency that all people—Chinese and non-Chinese—are happy to use remains to be seen.