

# MEDIUM-TERM PROSPECTS FOR CHINA'S ECONOMY AND THE INTERNATIONALISATION OF THE RENMINBI

ARTICLES

Medium-term prospects for China's economy and the internationalisation of the renminbi

*The impressive growth of China's economy over the past decade has strengthened its global influence. However, although there have been substantial improvements in China's external imbalances since 2008, internal imbalances have become accentuated. Tackling these imbalances will require the implementation of ambitious structural reforms aimed at reducing incentives that have long favoured investment and saving over consumption. Recently announced reform intentions are promising in this respect. The pursuit of the internationalisation of the renminbi by the authorities may also help to overcome these challenges. Reforms aimed at liberalising domestic financial markets, the movement of capital across China's borders and the exchange rate of the renminbi are essential before the currency can be used widely in international trade and finance. As some of the reforms that are vital for the internationalisation of the renminbi coincide with those needed to rebalance China's growth, this may result in a virtuous circle.*

## I INTRODUCTION

As China's emergence on the international scene becomes more established, a question mark hangs over whether its economic performance of the past few decades can continue at the same pace. The persistence of internal imbalances suggests that reforms to the growth model are needed. At the same time, for some years now the authorities have been taking steps to encourage greater international use of the renminbi.

Issuing an international reserve currency brings benefits that facilitate growth, such as reduced financing costs for domestic firms and the sovereign. To achieve international currency status, however, economies must typically be rather large and stable, and feature highly developed domestic financial markets, an open capital account and a floating exchange rate. These features may all stimulate growth independently from their effect on the international use of a currency, and are often conditional on one another. For example, capital account liberalisation enables domestic agents to diversify their portfolio, which helps to improve the allocation of capital, thereby fostering growth. However, in order to ensure orderly capital account liberalisation, domestic financial markets must have achieved a minimum level of development – including sufficiently deep and broad markets, as well as adequate risk management capabilities among financial institutions and supervision by authorities – in order to deal with capital flows that can, at times, be volatile. Similarly, a flexible exchange rate helps to reduce the risk that surges in capital flows may foment currency and banking crises.

Therefore, structural and financial reforms, whether they are geared towards domestic or international goals, are clearly linked. Some even view the policies recently adopted by the authorities which are aimed at supporting the international role of the renminbi as catalysts to accomplishing necessary domestic reforms. From this perspective, there seems to be a mutually reinforcing relationship between the reforms needed in order to sustain China's growth in the medium term and those necessary for fostering the internationalisation of the renminbi.

By analysing the changing nature of the imbalances in the economy and of the pattern of growth in China, this article aims to shed light on which structural reforms are crucial. Moreover, by reviewing recent developments in the international use of the renminbi and its determinants, this article also discusses the role that the internationalisation of the renminbi might play in the implementation of the structural reforms that may ensure a more sustainable growth path.

## 2 MEDIUM-TERM PROSPECTS FOR THE ECONOMY

China's growth performance over the past few decades has propelled it onto the global stage as a major player. However, high levels of growth have been associated with imbalances, such as persistent current account surpluses, high investment ratios and rapid credit growth. Although progress has been made on reducing external imbalances, internal imbalances have continued to grow, despite the slowdown in growth since 2008. The Chinese government has repeatedly expressed its desire to move the economy onto a slower, but more sustainable growth path that is based primarily on private consumption. The authorities have announced guidelines for economic reforms over the next decade to facilitate this transition (see Box 1), but their effects will depend on the way in which and the speed with which they are implemented.

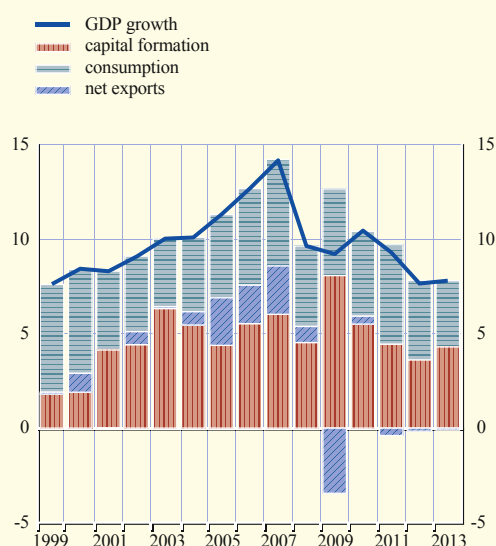
### 2.1 RECENT DEVELOPMENTS IN THE PATTERN OF GROWTH

Growth of the Chinese economy is on a downward path. Since reaching a peak of 14.2% in 2007, real GDP growth has virtually halved, standing at 7.8% in the third quarter of 2013. This decline was temporarily mitigated by a large stimulus package, estimated at CNY 4 trillion (€482 billion, or 12% of GDP in 2009), which was implemented during 2008-09 in reaction to the financial crisis. As the effects of the stimulus have worn off, there has been a decline in the contributions to growth by all major components of GDP (see Chart 1).

The reasons for this slowdown are diverse and are still being debated. Some research<sup>1</sup> suggests that growth is bound to slow down as the economy gradually depletes its extensive sources of growth and transits to a phase of intensive growth. Other research points to the diminishing effects of positive productivity and demand shocks<sup>2</sup> that have given rise to large income windfalls and boosted the savings rate, investment and, ultimately, growth in GDP. More controversially, it has been suggested that countries with high levels of growth experience a significant slowdown in growth of at least 2 percentage points when their per capita income reaches about USD 17,000 (in 2005 constant international prices). Since China is expected to achieve this level in around 2015, it is claimed that the country is poised to experience a slowdown in the decade to 2020.<sup>3</sup>

Chart 1 Decomposition of GDP growth

(year-on-year percentage changes; percentage points)



Sources: CEIC Data and National Bureau of Statistics.  
Note: The data for 2013 are until the third quarter.

- 1 See Dorrucchi, E., Gabor, P. and Santabárbara, D., "China's economic growth and rebalancing", *Occasional Paper Series*, No 142, ECB, Frankfurt am Main, February 2013.
- 2 Favourable demographics, robust restructuring of state-owned enterprises in the 1990s and market liberalisation prior to accession to the World Trade Organization in 2001. See Ma, G., McCauley, R.N. and Lam, L., "The Roles of Saving, Investment and the Renminbi in Rebalancing the Chinese economy", *Review of International Economics*, Vol. 21(1), February 2012, pp. 72-84.
- 3 See Eichengreen, B., Park, D. and Shin, K., "When Fast-Growing Economies Slow Down: International Evidence and Implications for China", *NBER Working Paper*, No 16919, 2011 and Eichengreen, B., Park, D. and Shin, K., "Growth Slowdowns Redux: New Evidence on the Middle-Income Trap", *NBER Working Paper*, No 18673, 2013.

The recent slowdown of growth in China seems to follow historical patterns in a number of Asian countries and other large emerging and advanced economies since 1950, which saw their growth rates drop as their GDP per capita reached USD 6,500-8,000 in purchasing power parity (PPP) terms (see Chart 2), although there is a large degree of variation within that pattern. China's GDP per capita reached USD 8,000 in 2007. Whatever the precise reasons behind the slowdown, the reduction in growth has only gone partially hand in hand with a reduction in the imbalances that have characterised China's economic development, namely its reliance on investment and exports.

### REDUCED EXTERNAL IMBALANCES

China's current account surplus shrank from 10.2% in 2007 to 2.0% in the first three quarters of 2013.

The extent to which the decrease in the current account balance is structural is debatable. Weaker global trade dynamics and slower growth in the euro area and the United States since the international financial crisis are partly at play, suggesting that the external surplus could rise again. However, the real effective exchange rate has risen by 29.6% since 2007, while wages have also risen quickly. Accordingly, the IMF's October 2013 World Economic Outlook foresees a rise in the current account surplus to about 4% by 2018, which is well below previous highs.

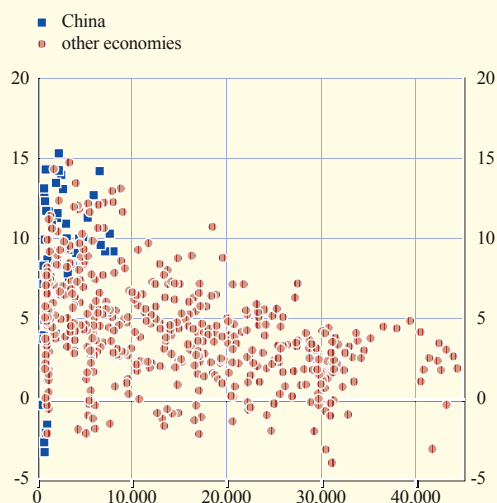
The decline in the current account surplus has greatly reduced the accumulation of foreign exchange reserves. Reserves, which more than tripled from 14% of GDP in 2000 to 48% of GDP in 2009, are hovering around USD 3.7 trillion and have even fallen in terms of GDP, to 41% in September 2013 (see Chart 3).

### REMAINING DOMESTIC CHALLENGES

Despite the reduction in the external imbalance, the composition of domestic demand has become even more skewed towards investment since 2008. In 2012 the investment ratio

**Chart 2 An international comparison of growth rates versus GDP per capita (1951-2011)**

(x-axis: GDP per capita in PPP; y-axis: annual real GDP growth)

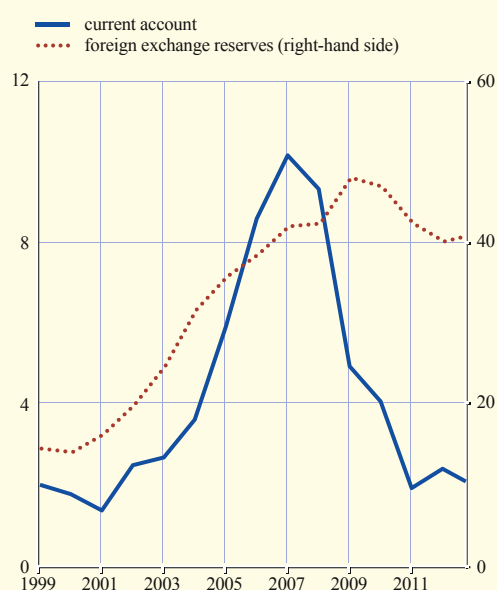


Source: Penn World Tables 8.0.

Note: Other economies include Brazil, France, Germany, India, Japan, Korea, South Africa, the United Kingdom and the United States.

**Chart 3 Current account and foreign exchange reserves**

(percentage of GDP)



Sources: CEIC Data, National Bureau of Statistics.

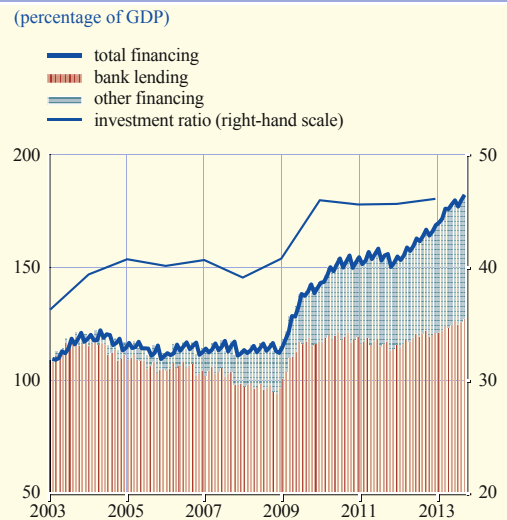
Notes: Current account data are until the third quarter of 2013; foreign exchange reserves data are until September 2013.

reached 46.1% of real GDP, standing at an all-time high. At the same time, growth has become increasingly reliant on credit. Total financing to the economy<sup>4</sup> increased from 113% of GDP at the end of 2007 to 182% of GDP in September 2013. Such financial leverage is much higher than that in other countries with a similar level of development, and is only found in high-income economies such as the United States and United Kingdom. Strong growth has been accompanied by a shift in the composition of financing away from bank lending (see Chart 4).

Local governments have contributed to the above developments. They were instrumental in implementing a large part of the infrastructure investments under the 2008-09 fiscal stimulus package, borrowing heavily by means of so-called local government financing vehicles (LGFVs) to do so. According to the Chinese national audit office, the 2008-09 stimulus package led to a doubling of local government and LGFV debt between 2008 and 2010, to CNY 10.7 trillion (equivalent to 27% of GDP in 2010).<sup>5</sup>

China's investment profile is also deviating increasingly from the historical experience of other economies since 1960, including within Asia. The investment-to-GDP ratio has risen rapidly and substantially beyond that of other major advanced and emerging economies. This could be taken as a sign that the current investment rate might be excessive (see Chart 5). It is debatable whether China's capital stock is too high. Despite the very high investment rate, infrastructure needs are still large, in part because of ongoing urbanisation. Indeed, when comparing the (urban) infrastructure, such as (rail) road density, with that of other economies, there is still scope for expanding public infrastructure investment. Nevertheless, the ratio of China's productive capital stock to GDP as estimated by the OECD, at 2.6 in 2012, is relatively high given its level of development: it has already reached a level that is only matched by economies with a much higher GDP per capita (such as France and Germany) and which is only surpassed by Japan. However, the OECD also estimates that, between 1992 and 2009, profitability outside agriculture and housing remained high by international standards, suggesting that – on an economy-wide basis – investment was still efficient until then.<sup>6</sup> Other measures, such as capital stock per capita, which is only a fraction of that of high-income countries, suggest that capital stock is in line with that of other countries given its level of development. Nonetheless, the rate of growth in capital stock per capita has accelerated since 2000, and since 2008 it has consistently outperformed GDP growth.

Chart 4 Credit and investment ratio



4 This includes financing to the private sector through bank and non-bank lending, as well as corporate bond and equity financing. It does not include outstanding government bonds.

5 The IMF estimates that China's general government debt might be 45% under an augmented definition of government debt that includes local government infrastructure spending (see "People's Republic of China: Staff Report for the 2013 Article IV Consultation", IMF, July 2013).

6 See "Economic Surveys: China", OECD, March 2013.

Signs of overcapacity in a number of manufacturing industries have been apparent for some time and have been recognised explicitly by the Chinese authorities. The five-year plan covering the period 2011-15 has already called for the elimination of backward and excess capacity in manufacturing industries, such as steel, shipbuilding and construction, and for greater focus instead on research and development, as well as rationalising energy and resource utilisation as a source of growth. According to its quarterly monetary policy reports, the People's Bank of China (PBoC) has been using its "credit policy guidance" to banks since at least 2007 to reduce credit flows to industries with excess capacity (see also Section 2.2).

According to the Ministry of Industry and Information Technology, capacity utilisation in manufacturing reached 78.6% in the second quarter of 2013, down from 81.5% at the end of 2009. In 21 of the 39 industries surveyed, including the steel, aluminium and cement industries, capacity utilisation was below 75%.

According to IMF estimates, the downward trend in capacity utilisation since the 1990s has intensified since 2008.<sup>7</sup> Moreover, since 2012 producer price inflation has been negative in year-on-year terms, confirming anecdotal evidence of price drops in response to overproduction, such as of solar panels.

Reacting to the latest signs of overcapacity, the Ministry of Industry and Information Technology published plans in July and August 2013 to reduce capacity by means of closing old production facilities and promoting mergers between firms across a wide range of industries. However, calculations by some industry analysts suggest that the proposed reductions in capacity are relatively modest and may not have a major effect.

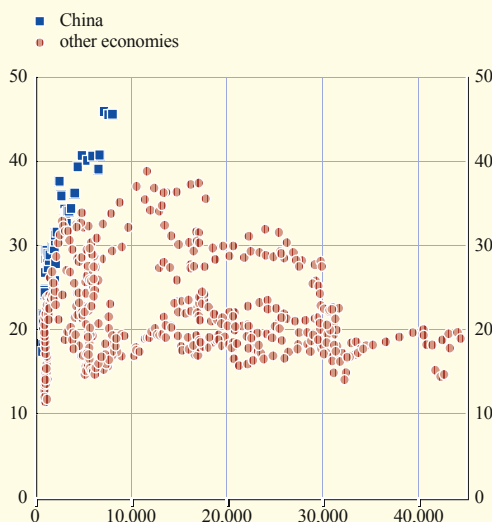
## 2.2 TOWARDS CONSUMPTION-LED GROWTH

The apparent persistence of domestic imbalances suggests that administrative measures to control investment and credit growth have only been partially effective. Structural reforms aimed at tackling incentives that have long favoured investment can also play a role in rebalancing growth. Such reforms are likely to have dislocational effects, as economic agents, authorities and regulators will need to assume new roles. This may have a negative effect on growth in the short term. However, the increased allocational efficiency resulting from structural reforms is expected to lift total factor productivity, thereby limiting the expected slowdown in growth as the catching-up process progresses.

A substantial rebalancing of the economy is likely to require a much slower rate of investment growth, particularly as the overall growth rate moderates. The World Bank has estimated that

**Chart 5 An international comparison of investment relative to GDP (1960-2011)**

(x-axis: GDP per capita in PPP; y-axis: investment as a percentage of GDP in real terms)



Sources: Penn World Tables 8.0, World Bank.  
Note: Other economies include Brazil, France, Germany, India, Japan, Korea, South Africa, the United Kingdom and the United States.

<sup>7</sup> See "People's Republic of China: Staff Report for the 2012 Article IV consultation", IMF, July 2012.

GDP growth will decline to 7% by 2020 and to 5% by 2030. If China's GDP per capita were to grow at a rate of 7% per year, it would reach a level of about USD 30,000 (in PPP terms) by 2030. At that level of development, investment ratios in Japan and Korea stood at about 30%. If China wanted to achieve a similar investment ratio at that level of development, this would imply annual investment growth of about 4-5% (and 3% if growth in GDP per capita were only 5%). Such growth rates stand in stark contrast to the growth rates of around 10% observed until recently. It might, therefore, take longer than expected to significantly rebalance China's demand composition.

The following sections review some of the incentives that favour investment over consumption, before examining the possible elements of a structural reform programme.

### INCENTIVES FAVOURING INVESTMENT

China's growth model contains a number of incentives that favour investment over consumption. Investment has been a central part of its development model since the start of reforms in 1978. Investment in infrastructure is also believed to promote regional growth potential and raise tax revenues for local governments. Although such investments have proved useful, particularly in fast-growing areas of the country that attract migrants looking for employment opportunities, there have been exceptions, notably in more far-flung areas.

Quotas restricting cross-border investment flows and hence the scope of investments available to savers also have a bearing on domestic investment rates. The restricted ability to invest internationally combined with the limited development of the domestic financial markets (see Section 3.2) inevitably leads to a bias in the structure of the economy towards remaining alternatives such as housing. The domestic housing market has seen rapid growth, with new residential floor space doubling from 400 million square metres in 2005 to slightly less than 800 million square metres in the last 12 months to October 2013. Increased housing activity is supported by the ongoing process of urbanisation, which is expected to continue for another few decades.<sup>8</sup> Moreover, it also reflects an upgrading of the existing housing stock and a desire for more modern and larger housing. Nonetheless, authorities have taken measures to avoid speculative investment behaviour, such as imposing high deposit requirements. According to IMF research,<sup>9</sup> full capital account liberalisation may be followed by an increase in Chinese assets abroad in the order of 15-25% of GDP and a (smaller) increase in foreign assets in China in the order of 2-10% of GDP, resulting in an increase of net international assets of 11-18% of GDP. According to these results, the rise in available international investment opportunities would crowd out some domestic investment in net terms, thereby reducing the investment intensity of growth.

The underpricing of the cost of capital has also promoted investment. Benchmark lending and deposit rates have for a long time been set by the PBoC, guaranteeing banks a positive interest rate margin, while keeping real rates low. Since 2000 the benchmark one-year deposit rate has fluctuated at around 0% in real terms and has even been negative for prolonged periods of time. The one-year lending rate has been on average 3.6%. By keeping the return on household savings low, regulated interest rates amounted to a sizeable, forced transfer of households to firms, which was estimated at 4% of GDP in 2008, depressing income and hence consumption.<sup>10</sup> Furthermore, the PBoC influences the lending policies of banks to ensure that these remain in

8 The United Nations expects the percentage of people in China living in cities to rise from 49.2% in 2010 to 68.7% in 2030 and to 77.3% in 2050 (See "World Urbanization Prospects: the 2011 Revision", United Nations, April 2012).

9 See Bayoumi, T. and Ohnsorge, F., "Do Inflows or Outflows Dominate? Global Implications of Capital Account Liberalization in China", Working Paper Series, IMF, No 189, 2013.

10 See Lardy, N., "Financial Repression in China", Peterson Institute for International Economics Working Paper, No PB08-8, September 2008.

line with national priorities. This system, called “window guidance”, uses moral pressure to steer lending decisions. In addition to the window guidance system, there are other channels of political influence over credit flows in China, including government ownership of the largest banks. As a result, China’s state-owned enterprises seem to enjoy easier access to credit than private firms.<sup>11</sup>

### ELEMENTS OF A STRUCTURAL REFORM PROGRAMME

Reducing the incentives that favour investment will require the implementation of an ambitious programme of structural reforms. In order to correctly reflect the cost of capital, market-based interest rates will have to play a larger role, while available capital must be increasingly allowed to flow across borders in search of higher and more diversified returns. It is likely that any steps taken to reduce the level of (precautionary) savings in the economy will further facilitate the transition towards more consumption-based growth. To reduce the high degree of self-financing by enterprises, the financial system will need to become more efficient and competitive, and equally capable of providing financing to small and medium-sized private enterprises as to large state-owned enterprises. Opening up the banking sector for private capital, both domestic and foreign, could provide the necessary competitive pressure. In order to reduce precautionary saving by households, social security coverage will have to become more comprehensive. Increasing the supply of affordable, subsidised housing will also help, while also diminishing speculative pressures.

Such a reform programme is more than ambitious, as it amounts to redefining the relationship between the state and the market, increasingly allowing private enterprises and individuals to take economic decisions. The obstacles to implementing such a reform programme are significant in view of their inherent complexity. Moreover, in the past such reforms have proven to have their pitfalls. For example, in many emerging market economies, these kinds of liberalisation initiatives have entailed banking and currency crises.<sup>12</sup>

11 See Herrala, R. and Yandong, J., “Has the Chinese Growth Model Changed? A View from the Credit Market”, *BOFIT Discussion Paper*, No 5, March 2012.

12 See Ishii, S. and Habermeier, K., “Capital Account Liberalization and Financial Sector Stability”, *Occasional Paper Series*, IMF, No 211, 2002; and Schmukler, S., “Financial Globalisation: Gain and Pain for Developing Countries”, *Economic Review*, Federal Reserve Bank of Atlanta, 2004, pp. 39-66.

#### Box I

### ECONOMIC POLICY PRIORITIES UP TO 2020

From 9 to 12 November 2013, the central committee of the Communist Party of China decided on a comprehensive set of policy and reform priorities, the bulk of which should be implemented by 2020 and will be overseen by a high-level “leading group”. This box briefly describes these priorities and assesses their likely impact on China’s economic development and on the internationalisation of the renminbi.

The following principles underlie the proposed economic reforms: (1) although public ownership will continue to play a dominant role in the economy, markets will play a decisive role in allocating resources; (2) regardless of private or public ownership, all enterprises will be able to

compete in most markets under equal and fair conditions; and (3) the Chinese government will focus on preserving macroeconomic stability and effective regulation, rather than micromanaging decisions by economic actors.

A wide range of reforms is proposed to achieve these aims. To increase the role of market forces, price regulations on water, energy products, transport and telecommunication services will be reduced. Labour mobility will be improved by increasing the possibilities for rural citizens to move to cities and by giving them greater access to urban public services. At the same time, the transfer of property rights will be facilitated. Furthermore, market access restrictions will be abolished for all but a limited number of sensitive industries. Approval procedures and other administrative requirements will be reduced and relegated to the lowest possible level of government. To ensure a level playing field for all market participants, existing preferential treatment and hidden barriers will be eliminated, while the legal system will be strengthened to guarantee equality before the law. To ensure that the financing capacity of local governments remains in line with its responsibilities, the sharing of revenue between the levels of government will be adjusted, and the powers of local governments to raise taxes will be increased, among other things, speeding up the introduction of real estate taxes. It is also proposed to increase the contribution to the budget of state-owned enterprise profits to 30%. With regard to the banking sector, competition will be increased by allowing private small and medium-sized banks to be established. The introduction of a deposit guarantee system as well as a resolution mechanism for financial institutions is also foreseen. The development of domestic financial markets will be promoted by strengthening supervision. Finally, market forces will also be allowed to play a greater role in setting the renminbi exchange rate, while opportunities for cross-border capital transactions will be increased. Further increasing market access for foreign investment is also foreseen. The recently established free trade zone in Shanghai is an important test area in that respect.

Given that the decisions taken are broad policy intentions, rather than fully developed plans, it is difficult to assess their economic impact. Nonetheless, some tentative conclusions can be drawn. The greater role for market forces should increase the efficiency of labour and capital allocation, while uniform market conditions and greater competitive pressures should reduce the opportunities for rent-seeking and increase the scope for productivity gains. A correct pricing of capital should reduce the investment intensity of growth, while broader access to social security services could reduce precautionary savings and boost consumption. The further opening-up of the capital account and development of domestic financial markets should in turn increase the efficiency of credit allocation and promote the greater international use of the renminbi.

The proposed reforms represent a continuation and intensification of the reform and opening-up process initiated in 1978. The systemic nature of the proposed reforms signals a desire to tackle the underlying causes of economic imbalances that have emerged while at the same time strengthening the economy's capacity for growth.

### 3 THE INTERNATIONALISATION OF THE RENMINBI

The growing economic influence of China in the global economy has led to discussions about whether the renminbi might become an important international currency in the years to come. These discussions have also been fuelled by the announcement of reforms that would ultimately lead to the



liberalisation of its capital account, its exchange rate regime and domestic financial markets.<sup>13</sup> It has also been argued that the internationalisation of the renminbi has the potential to act as a catalyst for the reforms that would address China's imbalances (see Section 2.1), and thereby shift the economy onto a more sustainable growth path. This section reviews recent developments in the international use of the renminbi and the economic determinants governing this. It also looks at the prospects going forward and discusses different views on the gradual progress of the internationalisation process.

### 3.1 RECENT DEVELOPMENTS IN THE INTERNATIONAL USE OF THE RENMINBI IN TRADE AND FINANCE

Over the past few years the renminbi has been used increasingly in the settlement of China's international trade and financial transactions. For example, between 2010 and mid-2013 the share of China's trade in goods settled in renminbi increased from essentially 0% to more than 10% (see Chart 6). The growing use of the renminbi as a trade settlement currency has given rise to sizeable renminbi deposits in Hong Kong, reaching more than USD 100 billion in mid-2013, which is equivalent to about 10% of total local deposits (see Chart 7).<sup>14</sup> Moreover, the issuance of renminbi-denominated ("dim-sum") bonds in Hong Kong has risen sharply since 2007 (see Chart 7). While the bulk of renminbi-denominated bonds issued globally have been issued in Hong Kong, international issuance has grown in other financial centres after London, Singapore and Taiwan took steps to become renminbi financial hubs as well. According to data from the BIS, the international issuance of renminbi-denominated bonds rose sharply from almost none in 2007 to USD 60 billion in the first quarter of 2013.

The international use of the renminbi as an official reserve currency has remained limited so far, owing mainly to the fact that it is still largely inconvertible for investment purposes. Only a few central banks (Austria, Hong Kong, Indonesia, Japan, South Africa, South Korea and Thailand) have been given approval to participate in China's Interbank Bond Market Program, which provides investors with access to China's onshore interbank bond market,<sup>15</sup> although the amounts invested under this program are believed to be marginal to date.<sup>16</sup> Nevertheless, there appears to be large potential for an expansion of the investor base, as a recent survey of reserve managers found that 37% of respondents would consider investing in the renminbi within the next five to ten years.<sup>17</sup>

13 See "The timing, path and strategies of renminbi internationalisation", PBoC, 2006; the 12th Five-year Plan of the Chinese State Council in 2011; and "The conditions for accelerating the opening of China's capital account are basically mature", PBoC, 2013.

14 Renminbi deposits in Hong Kong have stabilised since late 2011 owing to greater use of the renminbi to pay for imports from China, thereby creating a more, although not fully, balanced receipt-to-payment ratio. It has been argued that a major reason for the decline in the receipt-to-payment ratio has been the weakening of expectations since 2012 that the renminbi will appreciate vis-à-vis the US dollar, see Yu, Y., "Revisiting the Internationalization of the Yuan", *ADBI Working Paper*, No 366, July 2012. Another reason for the slowdown in the growth of renminbi-denominated deposits in Hong Kong may have been the introduction of the Renminbi Qualified Institutional Investor Scheme, which allows renminbi funds held offshore to be invested in mainland China (see Section 3.2); moreover, the growth in offshore renminbi deposits may also have slowed down as a result of the increase in the issuance of renminbi-denominated certificates of deposits in Hong Kong, which has grown from CNY 6.8 billion in 2010 to CNY 117.3 billion in 2012 according to data from the Hong Kong Monetary Authority (see <http://www.hkma.gov.hk/eng/key-information/insight/20130221.shtml>).

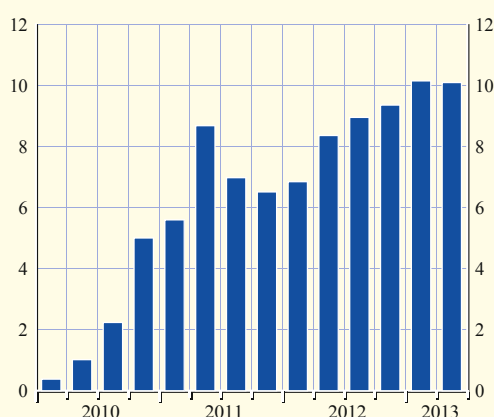
15 See Ballantyne, A. Garner, M. and Wright, M., "Developments in Renminbi Internationalisation", *Bulletin*, Reserve Bank of Australia, June Quarter, 2013.

16 Some evidence suggests that only about 0.17% of global reserves are accounted for by renminbi-denominated securities, see McDowell, D., "Taking on the Dollar: Japanese and Chinese Currency Internationalization in Comparative Perspective", paper prepared for the Workshop on Crisis and Change in the Global Monetary System, Ghent Institute of International Studies, Belgium, 20 March 2013. Recently, Australia announced it would invest 5% of its foreign reserves in Chinese government bonds (see <http://www.ft.com/intl/cms/s/0/f679dad8-aca0-11e2-9454-00144feabdc0.html?siteedition=intl#axzz2iLF76J9s>).

17 See "RBS Reserve Management Trends 2013", Royal Bank of Scotland, 2013.

**Chart 6 Share of renminbi-denominated settlements in China's trade in goods**

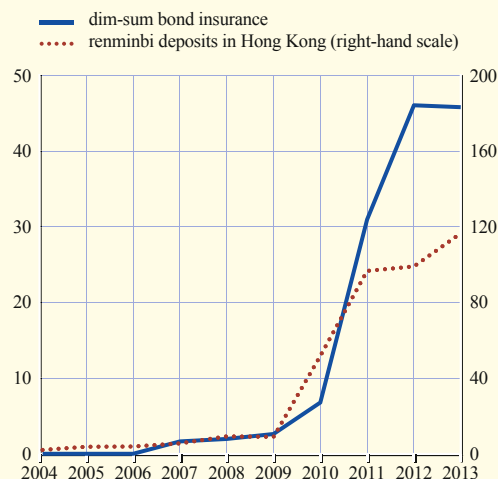
(percentages)



Sources: CEIC and PBoC.

**Chart 7 Renminbi-denominated deposits in Hong Kong and dim-sum bond issuance**

(USD billions)



Sources: CEIC and HKM for deposits and Bloomberg for dim-sum bond issuance.  
Note: Data for 2013 refer to August 31 for deposits and 6 October for dim-sum bonds issuance.

Despite the impressive growth in the use of the renminbi in trade and financial transactions, its use remains limited. For example, trade settlement in renminbi is focused mainly on China's trade with neighbouring Asian economies: in 2012 almost 60% of trade settled in renminbi was with Hong Kong, while together Japan, Macau, Singapore and Taiwan accounted for another 15%, according to data from the PBoC.<sup>18</sup> Similarly, while the amount of renminbi-denominated international bonds and notes outstanding has grown significantly, they only account for about 0.3% of the global amount of bonds and notes outstanding as at the second quarter of 2013.

### 3.2 DETERMINANTS OF THE GROWING INTERNATIONAL USE OF THE RENMINBI

Economies issuing currencies that are used widely in international trade and financial transactions typically account for a large share of global output and trade, feature macroeconomic stability, as well as deep, liquid and broad domestic financial markets. Beyond these classic determinants of an international currency, it has often been argued that an economy needs to have an open capital account and a flexible exchange rate in order for its currency to play an important role in the international monetary system, in particular as a reserve currency.<sup>19, 20</sup> The following sections discuss the extent to which China and the renminbi meet these criteria.

18 See Jin, Z., "The use of RMB in international transactions: Background, development and prospect", keynote speech held at the conference on the "Internationalization of the Renminbi", University of California, San Diego, 7 June 2012.

19 See Ito, T., "The internationalisation of the RMB: Opportunities and pitfalls", Council on Foreign Relations, Washington D.C., 2011; and Prasad, E. and Ye, L., "The Renminbi's Role in the Global Monetary System", Brookings, Washington DC, February 2012.

20 For discussions on whether these are necessary conditions or whether they merely help in the process of currency internationalisation, see Prasad, E., Rumbaugh, T. and Wang, Q., "Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China", *Policy Discussion Paper*, IMF, No 05/1, 2005; and Vallée, S., "The internationalisation path of the renminbi", *Bruegel Working Paper*, 2012/05, Brussels, 2012. It has also been argued that currency convertibility is a necessary condition for a currency to gain international reserve status, see Prasad, E. and Ye, L., *ibid*, 2012.

### ECONOMIC WEIGHT AND MACROECONOMIC STABILITY

In terms of nominal GDP, China is currently the third largest economy in the world, having overtaken Japan in 2010. Moreover, the IMF projects that China will soon overtake the euro area to become the world's second largest economy. Similarly, according to IMF data, while China accounted for 4% of trade in global goods in 2000, this share grew to 11% in 2012, which is comparable to the figure for the United States. However, despite the growing size of China's economy and its increasing share in global trade, the switch from local or vehicle currency pricing to producer currency pricing in export settlement will depend, among other factors, on the strength of incumbency effects (which favour the use of the US dollar or the euro in many of China's export markets) and on the market and bargaining power of China's exporters, which some believe to be limited.<sup>21</sup> As regards macroeconomic stability, over the past decade China's inflation and output growth records have been remarkable. Since 2000 average inflation, at 2.3%, has been low and average output growth has amounted to 10%. However, it is not clear whether China will manage to maintain this performance in terms of output growth and inflation (see Section 2.1).

### DOMESTIC FINANCIAL MARKET DEVELOPMENT

China's domestic financial markets remain less developed compared with those in the United States, for example. In 2011 China set out a programme of reforms up to 2015 to develop its domestic financial markets in the 12th Five-year Plan for the Development and Reform of the Financial Industry. These include more market-based determination of interest rates, financial innovation and coverage, more sophisticated risk management and surveillance. Some of these goals have already been achieved, such as the liberalisation of lending rates.<sup>22</sup> However, despite these efforts, China's financial markets remain insufficiently deep, liquid and broad to generate substantive international demand for renminbi-denominated financial instruments.<sup>23</sup>

### CAPITAL ACCOUNT LIBERALISATION

Except for foreign direct investment, compared with advanced economies, China's capital account remains largely closed and subject to tight regulation. In particular, portfolio investment is significantly more restricted than foreign direct investment and is allowed to enter mainland China's financial market only through special schemes. For example, foreign-currency inward portfolio investment is channelled through the Qualified Foreign Institutional Investor (QFII) scheme. Under the QFII scheme, investments are subject to a lock-in period of up to one year and an aggregate ceiling of USD 150 billion (as of July 2013), the pool of eligible applicants for participation in the scheme is limited and excludes private individuals, and repatriation of invested capital is subject to SAFE approval, which also applies to profits under certain circumstances. The Renminbi Qualified Foreign Institutional Investor scheme (RQFII) is similar to the QFII, but applies to inward portfolio investment undertaken with renminbi held offshore.<sup>24</sup> Outward portfolio investment, in turn, is channelled through the Qualified Domestic Institutional Investor (QDII) scheme. While absolute amounts of cross-border portfolio investment under these schemes have

21 See Jin, Z., *op. cit.*

22 In another attempt to introduce gradual reform, since early 2013 China's authorities have allowed borrowers and lenders to negotiate interest rates freely for cross-border loans in renminbi in the "Special Qianhai Financial Zone", see Sekine, E., "Start of Chinese experimentation in financial deregulation", *Nomura Journal of Capital Markets*, Vol. 5(1), 2013.

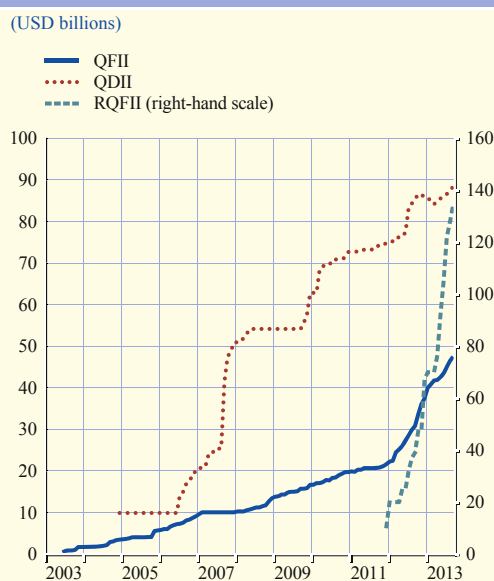
23 See also Eichengreen, B., "Renminbi Internationalization: Tempest in a teapot?", Asian Development Bank Distinguished Lecture, Manila, 11 January 2013, and Yu, Y., *op. cit.*

24 Recently, the RQFII scheme has been expanded to include London and Singapore (see <http://www.ft.com/intl/cms/s/0/9579f608-356e-11e3-b539-00144feab7de.html?siteedition=intl#axzz2iLF76J9s> and <http://www.ft.com/intl/cms/s/0/f3fe0ff00-3ae8-11e3-87fa-00144feab7de.html?siteedition=intl#axzz2iLF76J9s>).

increased continuously since their introduction, reaching around USD 270 billion in September 2013 (see Chart 8), these amount to only about 2% of China's GDP. Beyond these schemes, portfolio investment for the purpose of repatriating renminbi held offshore is also allowed for a small number of financial institutions (namely renminbi clearing banks in Hong Kong and Macau, and overseas banks authorised to settle trade in renminbi) and foreign central banks under China's Interbank Bond Market Program. However, the amount of investment arising through this channel is also small. The limited significance of portfolio investment flowing through the above channels is also reflected in China's international investment position: portfolio investment only accounts for a small share relative to foreign direct investment and other investment (see Chart 9).<sup>25</sup>

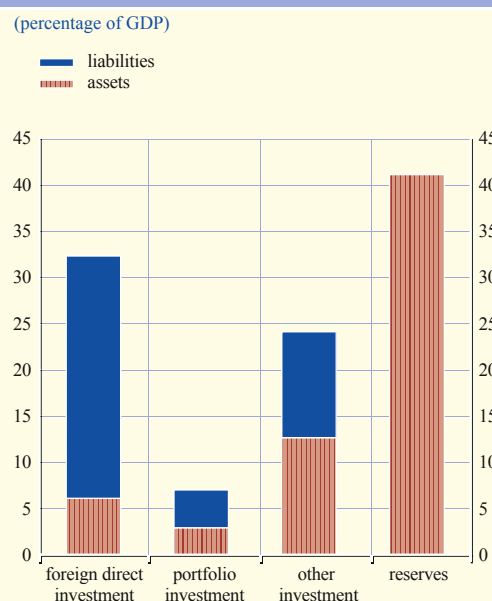
Overall, despite some progress, China's capital account still remains largely closed, in particular for capital flows beyond direct investment. As foreign investors are unlikely to issue large amounts of financial instruments in renminbi as long as they cannot easily enter China's financial markets, the limited degree of capital account convertibility constitutes a major obstacle to a growing international use of the currency.

**Chart 8 Approved investment funds under QFII, QDII and RQFII**



Source: CEIC Data.

**Chart 9 Composition of China's international investment position in 2012**



Sources: IMF Balance of Payments Statistics database and World Economic Outlook.

<sup>25</sup> A noteworthy step taken recently by China's authorities towards gradually liberalising the capital account was the introduction of the "Special Qianhai Financial Zone". In particular, since the beginning of 2013 China's authorities have allowed – subject to regulations – the repatriation of offshore renminbi to Qianhai via cross-border loans in renminbi from Hong Kong; moreover, China's authorities also encourage the issuance by residents of renminbi-denominated bonds in Hong Kong, the creation of funds of funds in Qianhai and foreign equity investment in Qianhai. Similar to the schemes governing cross-border portfolio investment described above, the amount of cross-border loans channelled to Qianhai from Hong Kong have, however, been small so far, amounting to approximately CNY 8 billion by January 2013, Sekine, E., op. cit.

## EXCHANGE RATE FLEXIBILITY

The experience of a number of emerging market economies has shown that limited exchange rate flexibility after opening the capital account may increase an economy's vulnerability to volatile capital flows, for example through currency mismatches between short-term assets and liabilities. By appreciating in times of surges in capital inflows, allowing an independent monetary policy and generating incentives for domestic financial markets to develop, a flexible exchange rate is an important precondition for successful capital account liberalisation.<sup>26</sup> As a consequence, despite the recent widening of the trading band, the limited flexibility of China's exchange rate continues to be viewed as an additional obstacle to the internationalisation of the renminbi.<sup>27, 28</sup>

### 3.3 POLICIES SUPPORTING THE INTERNATIONAL USE OF THE RENMINBI

Another determinant of the international use of a currency beyond economic weight, macroeconomic stability, domestic financial market development, capital account openness and exchange rate flexibility, is the role played by supporting policies. In China, such policies have, for example, aimed at liberalising its current account. For example, in 2009 a pilot project for settling trade in renminbi was launched. It was initially limited to a small number of Chinese cities, firms and trading partners, but was extended in 2012 so that (almost) all of China's trade can now be settled in renminbi. In order to foster the international use of the renminbi in trade, the authorities have also developed a network of bilateral swap agreements between the PBoC and 25 foreign central banks in a total amount of more than USD 400 billion (as of October 2013). So far, however, only marginal amounts have been drawn from these swap lines.<sup>29</sup>

26 See Rajan, R. and Subramanian, A., "Exchange rate flexibility is in Asia's interest", *Financial Times*, 26 September 2004; Prasad, E., Rumbaugh, T. and Wang, Q., op. cit. and Yu, Y., op. cit.

27 See He, D., Cheung, L., Zhang, W.L. and Wu, T., "How would capital account liberalization affect China's capital flows and the renminbi real exchange rate?", *China and the World Economy*, Vol. 20, 2012, pp. 29-54.

28 The renminbi exchange rate has been allowed to float within a narrow band around a central parity determined with reference to a basket of world currencies since 2005. Since April 2012 the band has been expanded to 1% around the central parity.

29 See "*The PBoC Annual Report*", PBoC, 2012.

#### Box 2

#### ESTABLISHMENT OF A BILATERAL CURRENCY SWAP AGREEMENT BETWEEN THE ECB AND THE PBOC

On 8 October 2013 the ECB and the People's Bank of China (PBoC) established a bilateral currency swap arrangement to purchase and subsequently repurchase Chinese renminbi and euro from each other. The swap agreement, which will be valid for three years, has a maximum size of CNY 350 billion when renminbi are provided to the ECB, and of €45 billion when euro are provided to the PBoC. From the ECB's perspective, the swap line serves as a backstop facility to address sudden and temporary disruptions in the renminbi market owing to liquidity shortages. The calibration of the operational parameters with which renminbi will be offered to euro area banks will be consistent with this purpose. The euro/renminbi swap facility is not intended to address any current malfunctioning, but to reassure market participants that a safety net is in place to address possible future market malfunctioning and to reassure euro area banks regarding the continuous provision of renminbi. The latter has become increasingly important given rapidly growing bilateral trade and investment flows between China and the euro area, which have

increased demand for renminbi-denominated financial services within the euro area. The swap arrangement is only intended to be used as a backstop facility to address sudden and temporary disruptions in the renminbi market owing to liquidity shortages. It is not intended for use over an extended period of time, and could therefore not function as an effective policy tool to affect the exchange rate or alleviate pressures related to cross-border transfer restrictions. The establishment of the swap line with the PBoC is consistent with the network of swap lines that the ECB has established with other central banks in systemically important economies, the growing global systemic importance of China, the closer ties between Europe and China, the growing offshore renminbi market in Europe, where many euro area banks are actively engaged, and the actions of the ECB to ensure and preserve the stability of the financial markets. Therefore, the conclusion of the swap agreement with the PBoC reflects the uniqueness of China and its rapidly growing systemic relevance. In this respect, the conclusion of the swap agreement with China is not a precedent and does not pave the way for the conclusion of additional swap lines with other countries.

### 3.4 OUTLOOK FOR INTERNATIONALISATION OF THE RENMINBI

The role of the renminbi in the future international monetary system is difficult to predict. First, it has been argued that the adoption of a gradual approach towards the internationalisation of the renminbi stems from the intention of China's authorities to benefit from capital account and exchange rate liberalisation while limiting possible risks.<sup>30</sup> For example, it is thought that capital account liberalisation is being pursued slowly so as not to expose underdeveloped domestic financial markets to volatile capital flows too quickly. At the same time, it is suggested that China has liberalised selected capital account transactions to allow limited foreign participation in domestic financial markets in order to import technology and know-how, thereby benefiting from so-called collateral benefits.<sup>31</sup> The sequencing of the liberalisation of China's capital account – according to the principle of “inflows before outflows, long-term investment before short-term investment, and institutional investment before private investment” – has also been ascribed to this spirit.<sup>32</sup> Under this view, it is expected that China's capital account and exchange rate will eventually be liberalised to a large extent. As a result of strong fundamentals and helped by supporting policies, it is believed that the renminbi will become an important international currency. It has also been claimed that the policies adopted to support the internationalisation of the renminbi have acted as catalysts for pressing forward with domestic reforms.<sup>33</sup>

30 See Yu, Y., op. cit.; and Prasad, E. and Ye, L., op. cit.

31 See Dell'Ariccia, G., Di Giovanni, J., Faria, A., Kose, A., Mauro, P., Ostry, J., Schindler, M. and Terrones, M., “Reaping the Benefits of Financial Globalization”, *Occasional Paper Series*, IMF, No 264, 2008; and Kose, M.A., Prasad, E.S., Rogoff, K. and Wei, S.J., “Financial Globalization: A Reappraisal”, *IMF Staff Papers*, IMF, Vol. 56, No 1, 2009, pp. 8-62.

32 See “*Financial Statistics Report*”, PBoC, 2011. China's gradual approach to capital account liberalisation and domestic financial market reforms is broadly in line with recent recommendations by the IMF (see “*The Liberalization and Management of Capital Flows: An Institutional View*”, IMF, November 2012). China's gradual approach is also in line with the implications of several empirical studies, which find that the benefits of capital account liberalisation can only be reaped if a minimum level of domestic financial and institutional development has been reached, see Dell'Ariccia, G., Di Giovanni, J., Faria, A., Kose, A., Mauro, P., Ostry, J., Schindler, M. and Terrones, M., op. cit.; Kose, M.A., Prasad, E.S., Rogoff, K. and Wei, S.J., op. cit.; and Kose, A. and Taylor, A., “Thresholds in the process of international financial integration”, *Journal of International Money and Finance*, 30(1), 2011, pp. 147-179; some observers have argued that the necessary preconditions for successful capital account liberalisation have not yet been met in China, see Lardy, N., “Financial Repression in China”, *Peterson Institute for International Economics Working Paper*, No PB08-8, September 2008.

33 See Frankel, J., “*Historical precedents for internationalisation of the RMB*”, Council on Foreign Relations, Washington DC, 2011; Subramanian, A., “Renminbi rules: the conditional imminence of the reserve currency transition”, *Peterson Institute for International Economics Working Paper*, Vol. 11-14, 2012; Thornton, A., “*Anaemic ascent: Why China's currency is far from going global*”, Lowy Institute for International Policy Analysis, 2012; Yu, Y., op. cit.; and Ma, J. and Hui, M., “The impact of financial liberalization on China's financial sector” in Udaibir S.D., Fiechter, J. and Sun, T. (eds.), “*China's Road to Greater Financial Stability: Some Policy Perspectives*”, IMF, Washington, D.C., July 2013, pp. 191-199.

Second, others have argued that the gradual nature of the progress made on the liberalisation of the capital account and the renminbi exchange rate has resulted from diverging views within China's leadership about the desirable extent of reforms.<sup>34</sup> From this perspective, whether the renminbi will become an important international currency will depend on the extent to which market forces rather than state intervention eventually determine China's economic development.

#### 4 CONCLUSION

Although China has made progress on reducing its external imbalances, internal imbalances – in particular a high investment ratio and high leverage – have continued to grow. Tackling these imbalances will require the implementation of ambitious structural reforms aimed at reducing incentives that favour investment and saving over consumption. Such reforms will have an impact on the real and financial sectors, and will redefine the role of the State in economic decision-making. In this context, reforms that promote the internationalisation of the renminbi could act as a catalyst for domestic reforms. In turn, reforms aimed at reducing imbalances also promote domestic stability and the attractiveness of the renminbi as an investment currency.

34 See Cohen, B., "The Yuan tomorrow? Evaluating China's currency internationalization strategy", *New Political Economy*, Vol. 17(3), July 2012; Heep, S., "*China in Global Finance: Domestic Financial Repression and International Financial Power*", Springer, Berlin, forthcoming; and Hess, P., "China's Financial System: Past Reforms, Future Ambitions and Current State" in Rövekamp, F. and Hilpert, H.G. (eds.), "*Currency Cooperation in East Asia*", Springer, Heidelberg, forthcoming.