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The Role of the Renminbi in the International Monetary System

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International Monetary System Purpose

Article IV, International Monetary Fund (IMF):

- "… the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth …"
- "… a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability …"

International Monetary System
IMF Mandate to Achieve Purpose

Article I, International Monetary Fund:

- (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy

International Monetary System IMF Mandate to Achieve Purpose

- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade

International Monetary System
IMF Mandate to Achieve Purpose

- (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members

International Monetary System
Current Structural Characteristics

- Domestic currencies of major economies performing the roles of international money: medium of international transactions; store of international wealth (holding of foreign assets); international unit of accounting
- National authorities (central banks) have responsibility over their domestic currencies, pursuing monetary policy to achieve objectives that are in the national interest; little or no regard is paid to monetary and financial issues that are in the global interest
- No international currency in a meaningful form dedicated to serving the global interest

International Monetary System Current Structural Characteristics

- Voluminous cross-border and cross-currency capital flows through internationalized financial markets that facilitate international transactions, including those relating to the store of international wealth, determining exchange rates between national currencies and the prices of financial products traded in those financial markets
- A group of international financial institutions and standard setting bodies manage a framework of relevant rules and conventions
- The framework appears to be inadequately effective in shaping an international monetary system that the global economy needs; for example, there is no effective influence exercised by international monetary institutions on monetary policy in major economies with currencies performing the roles of international money

International Monetary System Structural Weaknesses

(1) Ineffective Global Adjustment Process

- Absence of an effective mechanism with market based incentives to limit the build-up of large current account imbalances
- Ineffective surveillance by international financial institutions, especially the IMF, to bring about the necessary policy adjustments
- Unsustainable current account imbalances susceptible to disorderly unwinding

International Monetary System Structural Weaknesses

(2) Absence of a Mechanism to Manage the Availability and Price of Global Liquidity

- In the run up to the recent crisis, financial excesses and inadequate supervision over the financial system led to unchecked expansion of global liquidity, compressing risk spreads and generating asset bubbles
- Financial liberalization encouraged capital mobility in search of yield but proved to be volatile and beyond the ability of individual jurisdiction to cope, to the extent of generating monetary and financial stability that are highly contagious
- No global lender of last resort; no international financial institution in a responsible position for the maintenance of global financial stability

International Monetary System
Structural Weaknesses

(3) Excessive volatility in exchange rates unjustified by economic fundamentals

- Experience since generalized floating of exchange rates since 1973 characterized by sharp fluctuations
- Voluminous and volatile speculative capital often caused exchange rate behaviour disconnected from fundamentals
- Exchange rate movements do not always promote the needed adjustments to external imbalances
- Overshooting of exchange rates can be destabilizing and can cause economic distortions

International Monetary System Structural Weaknesses

(4) Excessive Expansion of International Reserves

- Building foreign reserves for possible defense against volatile and predatory capital flows (an outcome of the Asian financial crisis of 1997-98)
- Limiting exchange rate appreciation to safeguard export competitiveness
- Easy external finance for importers of capital, particularly the US, postponing needed fiscal adjustment
- Portfolio shifts of large reserve holders may trigger destabilizing market activity
- No effective mechanism for international coordination

International Monetary System Diagnosis

- A century of US dollar dominance (economic dominance led to monetary dominance with the enactment of the Federal Reserve Act in 1913, the establishment of the Bretton Woods system of fixed exchange rates in 1945 and the subsequent widening gap of economic and financial power between US and other economies) generated "exorbitant privilege" for the US
- Signs of abuse of "exorbitant privilege" in the last 20 years with the running of large and sustained current account deficits, and more recently even bigger budget deficits, taking advantage of financial globalization and the "willingness" of emerging markets to finance them in the absence of better alternative "safe" foreign assets as protection for monetary and financial stability, and as safe haven assets in times of financial crisis, although the euro did, for a while, erode somewhat that dominance

International Monetary System Diagnosis

- A huge dollar trap with many of those caught being unhappy and wanting to get out of that trap, albeit unsuccessfully so far
- There must be a credibility threshold beyond which panic would set in; US macroeconomic numbers bad, although improving, and monetizing budget deficits – normally a recipe for monetary and financial disaster
- The remaining financial market bubble that has not yet burst is the market for US Treasuries
- An unstable equilibrium with huge risks for the global economy waiting for the unknown trigger of collapse
- Is there time to heal and political determination to take remedial action?
- Quantitative easing still adding weight to a system with wobbly legs

International Monetary System Diagnosis

Palais-Royal Initiative (PRI) (2011):

"There is no unified global governance structure to help ensure that major economic and financial policy decisions made nationally, including exchange rate policies, are mutually consistent and contribute to global stability. In a world so deeply inter-connected, economic outcomes in each country depend significantly on developments and policy decisions made in others. In such a world, there is a strong case for rules and processes to be developed to help ensure global stability. The IMF was intended to provide this structure, but has been insufficiently effective …"

International Monetary System
PRI Reform Suggestions

Economic and financial policies:

(1) IMF member countries should undertake to ensure that their policies are conducive to stability of the global economic, monetary and financial system

(2) In support of surveillance over each country’s or groups of countries’ compliance with the obligations under the Articles, the IMF should adopt norms for members’ policies

(3) Persistent breach of a norm would trigger a consultation procedure and, if needed, remedial action

International Monetary System
PRI Reform Suggestions

Economic and financial policies:

(4) For systemically relevant countries whose policies do not appear to meet the norms, compliance with obligations should be explicitly ruled upon by the relevant organ of the IMF

(5) The IMF should develop positive incentives for countries to remain in full compliance with the requirements of the strengthened surveillance system

(6) Strong consideration should be given to including in the surveillance framework the possibility for the IMF to impose appropriate graduated remedial actions if a country has persistently violated one or more obligations

International Monetary System
PRI Reform Suggestions

Exchange rates:

(7) The IMF should develop globally consistent exchange rate "norms" … to help identify significant exchange rate instability and misalignments, at least for the most systemically relevant economies

(8) Under this approach, each country would be expected to refrain from exchange rate policies that push or keep their exchange rate away from its norm

International Monetary System
PRI Reform Suggestions

Global liquidity:

(9) The IMF and the BIS should work together towards a shared analytical approach for a better measurement and surveillance of global liquidity

(10) The central banks and the authorities in charge of macro-prudential policies of systemically relevant economies should conduct their policies taking into account the need for broadly appropriate global liquidity conditions

International Monetary System
PRI Reform Suggestions

Global liquidity:

(11)Use of capital controls, subject to IMF surveillance under an amended Article VI, may be warranted as an option to prevent disorderly exchange rate movements or financial instability

(12)The IMF should work with relevant governments, central banks, and regional pools to put in place, with appropriate safeguards, permanent crisis financing mechanisms akin to a global lender of last resort

International Monetary System PRI Reform Suggestions

The role of the SDR:

(13) The scope for the SDR to play a greater role in the international monetary system should be examined

(14) The composition of the SDR basket should reflect the relative importance of economies in international trade and financial transactions

(15) The scope for the use of the SDR in incentives to improve the workings of the adjustment process could be explored

International Monetary System
PRI Reform Suggestions

Governance:

(16) To ensure both effectiveness and legitimacy, we favor considering a governance of the international monetary system based on a single, three-level architecture (Heads of Government or State, Financial Ministers and Central Bank Governors, Executive Directors overseeing the work of the IMF, and its managing director), ensuring universal representation through a system of constituencies, which has served well the IMF and the World Bank

International Monetary System
PRI Reform Suggestions

Governance:

(17)In order to give a stronger voice to the global interest of the system, consideration should be given to establishing a Global Advisory Committee (GAC) made up of eminent independent personalities

(18)Regional organizations (undertaking a study about the modalities of their representation and relations with the IMF)

International Monetary System Reform Prospects

- A political process; long term global benefits unlikely to attract short term political enthusiasm
- Existing groups (IMF, G-20, etc) suffer from legitimacy deficit; distortions in the distribution of voting rights, representation and influence
- National interest considerations of the major stakeholders override the global interest
- Realistically, minor and gradual changes and no major surgery

International Monetary System
A Chinese View

Governor Zhou, People's Bank of China in March 2009:

- "The desirable goal of reforming the international monetary system … is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies"
- "Though the super-sovereign reserve currency has long been proposed, yet no substantial progress has been achieved to date"

International Monetary System
A Chinese View

- "The role of the SDR has not been put into full play due to limitation on its allocation and the scope of its uses. However it serves as the light in the tunnel for the reform of the international monetary system"
- "Special consideration should be given to giving the SDR a greater role"
- "Set up a settlement system between the SDR and other currencies … Actively promote the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping"

International Monetary System
A Chinese View

- "Create financial assets denominated in the SDR to increase its appeal"
- "Further improve the valuation and allocation of the SDR. The basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and the GDP may also be included as a weight"
- "The reestablishment of a new and widely accepted reserve currency with a stable valuation benchmark may take a long time … a bold initiative that requires extraordinary political vision and courage"

China – Most Affected by the Dollar Trap

- Largest foreign reserve holder: US$3.5 trillion at the end of June 2013
- No alternative but to hold the bulk in USD and euro denominated assets
- Continuing to run substantial albeit reduced current account surpluses (first half 2013 balance of trade surplus: US$108 billion)
- With capital controls, there is continued accumulation of foreign reserves
- Exchange rate under political and economic pressures to appreciate
- Foreign reserves exposed to huge exchange rate and credit risks
- Risk management measure: internationalization of the renminbi, specifically promoting the greater use of the renminbi as a medium of international transactions

Example: Use of RMB in Trade Settlement

- USD used in trade settlement – export receipts in USD sold by exporters to SAFE for RMB, China's foreign reserves increase
- RMB used in trade settlement – banking system directly or indirectly lends RMB to foreign importers to pay for imports from China
- Relative shift of external assets for China as a whole – from foreign reserves assets (e.g. US Treasuries) in USD held by the State to private sector RMB bank loans to foreign importers
- Diversification of credit risk and elimination of exchange rate risk

Internationalization of RMB – Other Benefits

- More offshore holders of RMB increases seigniorage income
- Increases demand for RMB financial assets and therefore promotes development of RMB financial markets
- Deeper RMB financial markets increase financial efficiency and economic growth and development
- Possibility of using RMB in external trade provides additional and convenient choice as medium of transaction and promotes external trade
- Similarly for the use of RMB in overseas investments

Internationalization of the RMB – Possible Costs

- Possibility of greater volatility in capital flows, but this depends on convertibility arrangements for the RMB
- Greater complexity for the People's Bank of China in the conduct of monetary policy – possible structural change in the policy transmission mechanism with an active offshore RMB market (risk of the tail wagging the dog) or, when capital account is fully liberalized, with much greater foreign participation in RMB financial markets
- Generally greater challenge for the maintenance of monetary and financial stability

Pre-conditions for the Internationalization of a Currency

- Size of the economy – country with the economic weight to influence or dictate the choice of currency as medium of international transaction
- International confidence in the currency sustained by prudent macroeconomic policies
- Convenient currency convertibility
- Sophisticated financial markets in the currency to facilitate asset and liability management by domestic and foreign entities and robust financial infrastructure to ensure safety and efficiency in the conduct of transactions denominated in the currency

Size of China's Economy

- Various estimates put China's GDP overtaking that of the US within the next ten years, making China the largest economy in the world.
- China now responsible for 10% of world GDP and 25% of world GDP growth
- China now the largest trading partner in the world
- China the largest foreign reserve holder in the world

China's Macroeconomic Performance

- High and stable growth rate; currently slowing down to more sustainable level (currently around 7.5%), along with necessary economic restructuring
- Current account surplus of reducing magnitude (currently around 2% of GDP)
- Low and stable inflation rate; currently at less than 3%
- Low and stable unemployment rate, currently at around 4%
- Debt to GDP ratio of only around 30%
- Efficiency of the policy transmission mechanism of a socialist, market economy versus a capitalist, free market economy

Convertibility – Current Account

- Current account fully convertible (1966)
- IMF Articles of Agreement 8: “no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions”
- Regulations on Foreign Exchange System of the People’s Bank of China, Article 5: “International payment and transfer in foreign exchange for current account transactions shall not be subject to government restrictions”

Convertibility – Capital Account

- Ongoing capital account liberalization
- Extensive restrictions remain in capital account convertibility
- Financial crisis strengthened caution: repeated emphasis on controllability, gradualism and ability to take initiatives in financial reform
- Recent relaxations in capital controls: QDII. QFII, participation of central banks and banks with offshore RMB funding in onshore inter-bank RMB bond market

Convertibility – Free or Full

- Potency of foreign exchange market – implications for monetary and financial stability; price discovery function of foreign exchange market questionable
- Increasing use of capital controls of different varieties as remedies
- Distinction between free and full convertibility
- PBC Regulation Article 12: "receipts and payments in foreign exchange for current account transactions shall have bona fide and legitimate transaction backgrounds … Financial institutions … shall exercise due diligence in checking authenticity of transaction documents … The foreign exchange administration agencies have the right to supervise and conduct inspections"
- Paradigm shift?

Financial Markets

- Financial markets still lacking in breadth and much dominated by banks; debt market of China only a little over 10% of US debt market and about 25% of that of Japan or the euro area
- Sharp reduction seen in the reliance of "social financing" on bank loans (from 92% in 2002 to 52% in 2012), but deep involvement of banks in the other channels of financial intermediation and in the shadow banking system
- General lack of financial market depth, in terms of the variety of financial instruments available, and liquidity
- Rapid development of equity market; but market is volatile and affected by weak corporate governance; continuing restrictions on foreign participation

The Offshore RMB Market

- Started in 2004 to channel in an orderly and transparent manner the increasing amount of RMB funds accumulated offshore back onshore, hence the introduction of deposit-taking, remittances, credit card and conversion in Hong Kong
- RMB settlement bank in Hong Kong (Bank of China Hong Kong) allowed access to RMB clearing system on the Mainland through a settlement account maintained with PBOC in Shenzhen, but only for these and other approved activities
- Scope of RMB business extended since to offshore RMB bond issues, use of RMB for trade settlement, use of RMB for overseas direct investment, restricted access of offshore RMB to domestic bond and equity markets

The Offshore RMB Market

- Increasing acceptance that the offshore (freer) market exists for the purpose of doing (desirable) things that, for good reasons from the perspective of the Mainland, could not be done onshore; hence “onshore market onshore rules, offshore market offshore rules” in the spirit of “one country, two systems”
- Need to be careful that the tail does not wag the dog – the offshore market does not undermine financial safety and effectiveness of monetary and financial policies onshore
- The two markets need to stay connected for the purposes of effective risk management and the transmission of important market signals (e.g. anomalies between onshore and offshore market conditions) useful for identifying further areas for reform and liberalization

The Role of the RMB in the International Monetary System

- A safe approach to capital account liberalization for China; full rather than free convertibility for the RMB
- Greater use of the RMB as a medium for international transactions, bypassing the USD, facilitated by bilateral swaps of domestic currencies between PBC and other central banks
- RMB as a reserve currency (a store of international wealth) will come slowly as RMB financial markets gain breadth, depth and liquidity, and under the influence of necessary regulation to harness the potency of international capital
- RMB likely to be included in the basket of currencies forming the SDR, if only for political reasons
- Dominance of USD as reserve currency will remain, current concerns hopefully alleviated by a healing US economy
- A multi-polar international monetary system