The internationalization of the RMB, Capital Market Openness and Financial Reforms in China

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China's financial market liberalization

Bank of Finland Auditorium, Helsinki

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USC and the NBER

Agenda

1. Overview of Chinese financial and trade integration in recent decades.
2. On the sequencing of financial reforms: costs and benefits
3. Looking forward

Reflections on the internalization of the CNY

- One expects the rapid accelerating of the commercial internalization of the CNY.
- In contrast, no clear cut reasons to rush with the full CNY financial internalization: the gains from CNY financial internalization are overrated.

1. Overview 2000-

- China has been a prime example of export led growth, benefiting from learning by doing, and by adopting foreign knowhow, supported by a complex industrial policy.

1. Controlled openness.
2. internal financial repression, with preferential treatment of the SOE.
3. Welcoming FDI and join venture inflows, subject to China's rules of the game.
4. A Modern version of mercantilism. Massive hoarding of IR - policy aiming at delaying the on set of real appreciation, with massive sterilization of expending trade surpluses and financial inflows.

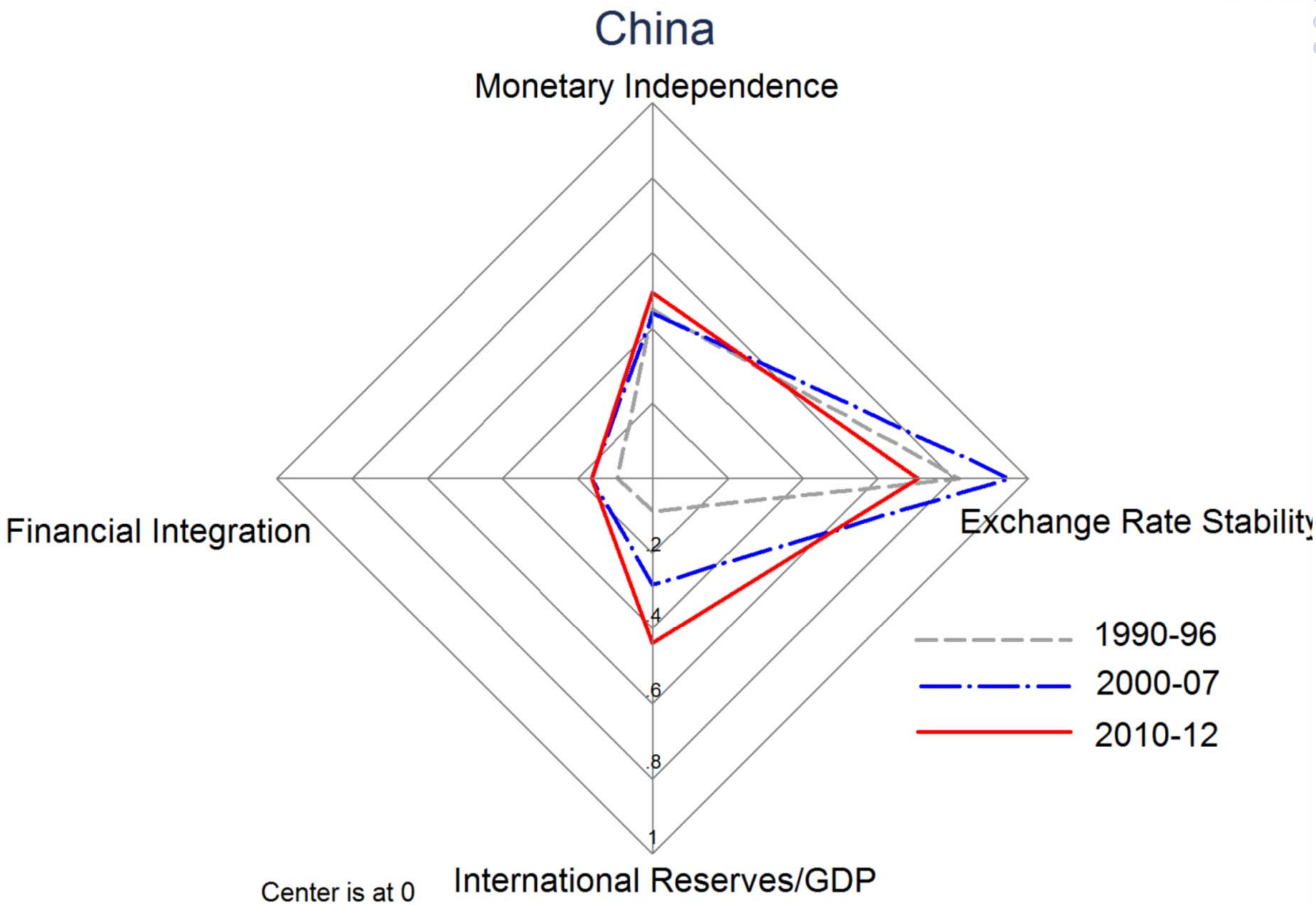
Overview 2000 - cont.

- While the resultant growth has been spectacular, it comes with its hidden but growing costs and distortions.
- Chinese export led growth path has been challenged by its own success.
- The GFC forced rebalancing – a work in progress.
- Post GFC, Chinese authorities put the internalization of the CYN as a top priority.

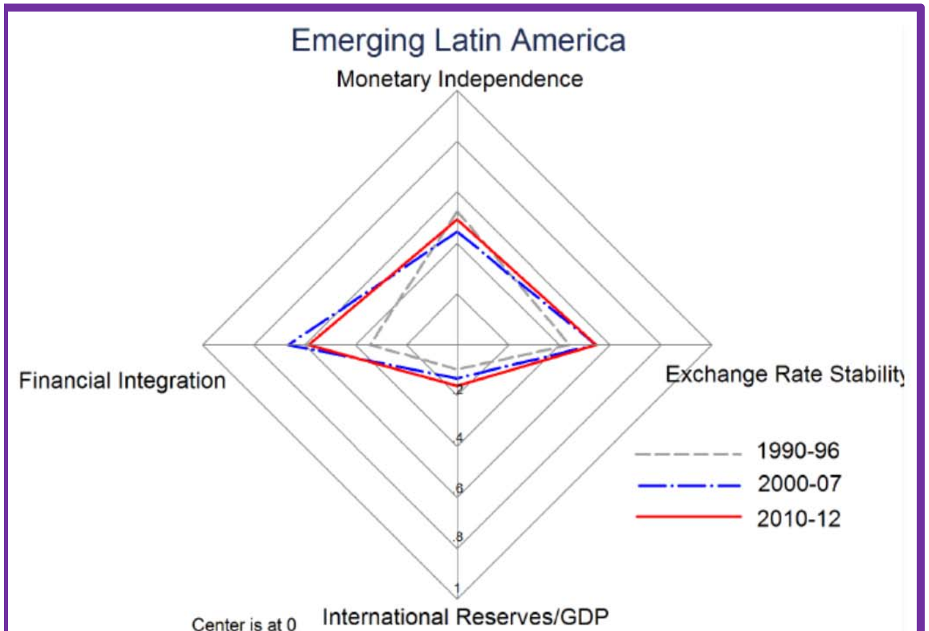
Chinese extended trilemma configuration

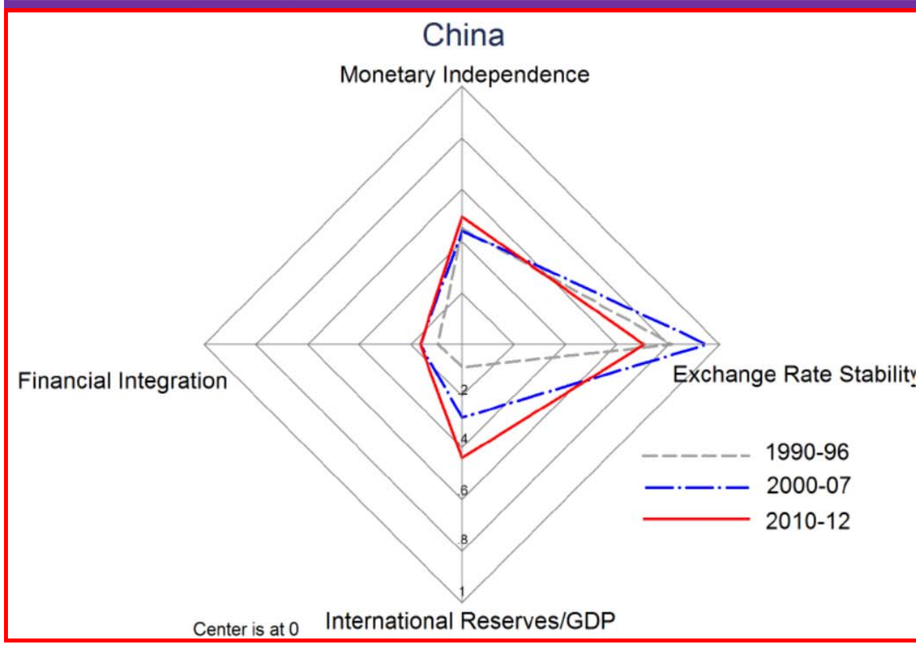
Source: Aizenman, Chinn and Ito

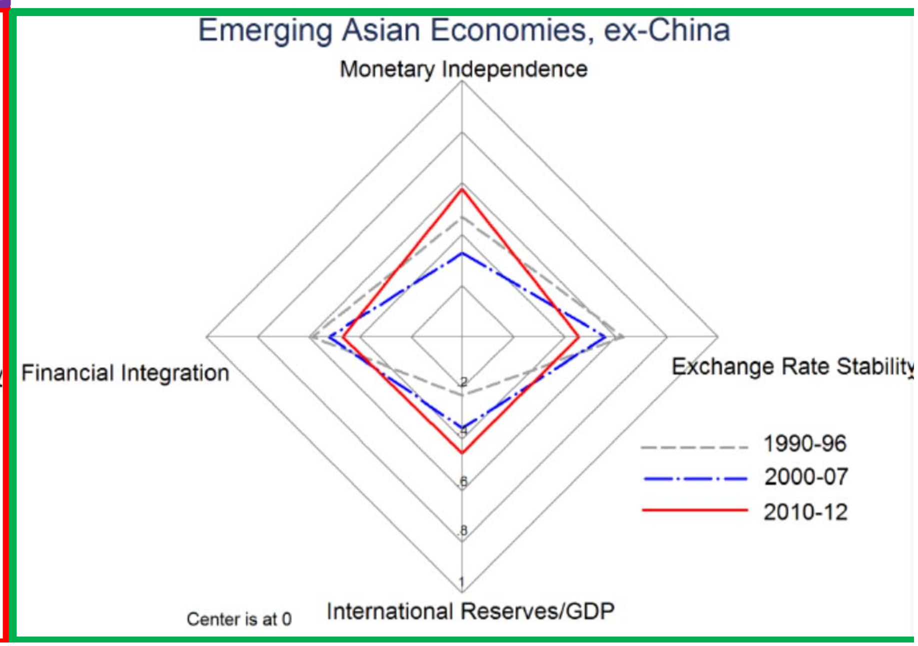
http://web.pdx.edu/~ito/trilemma_indexes.htm



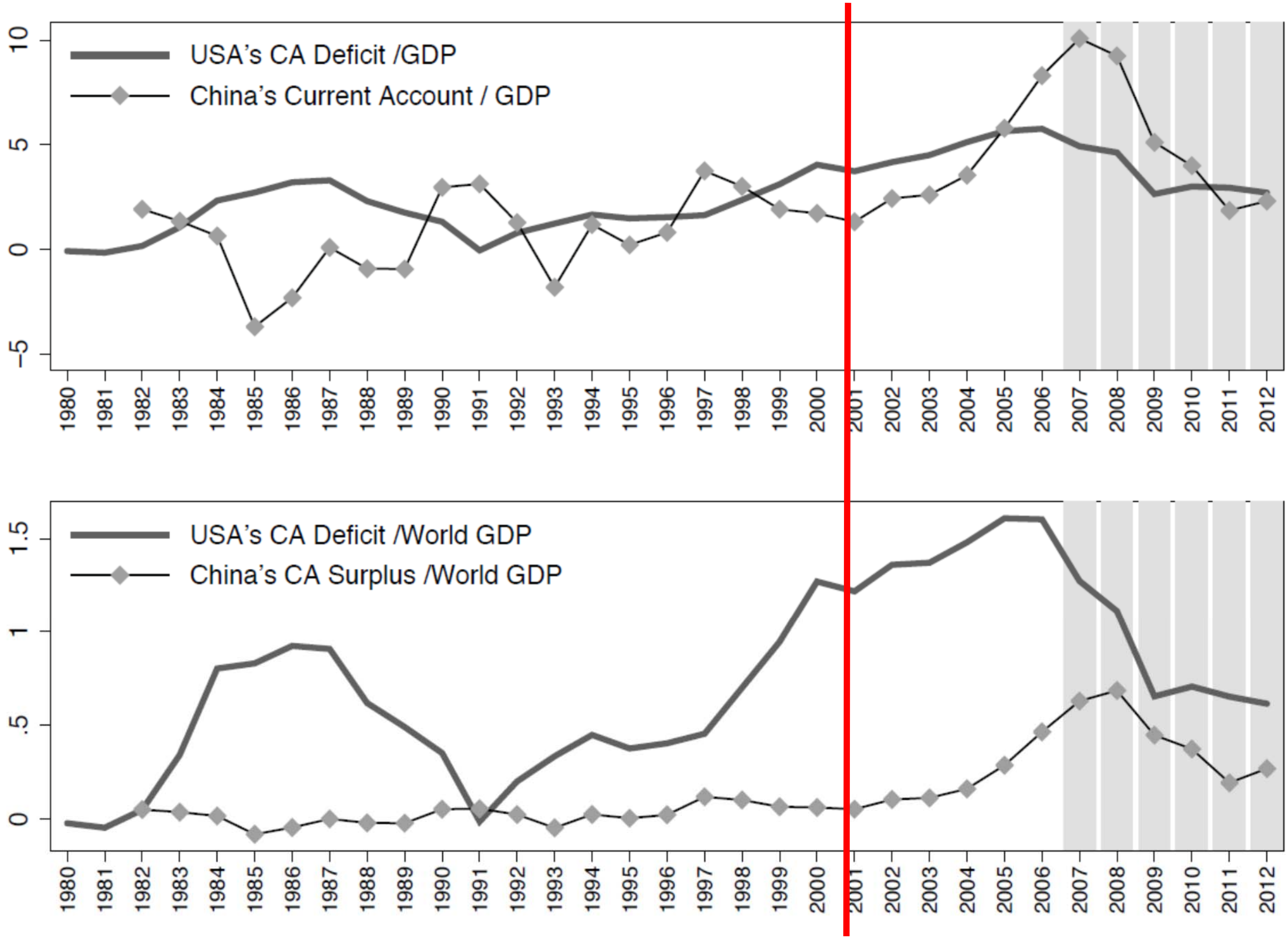
Differs from that of other EMs



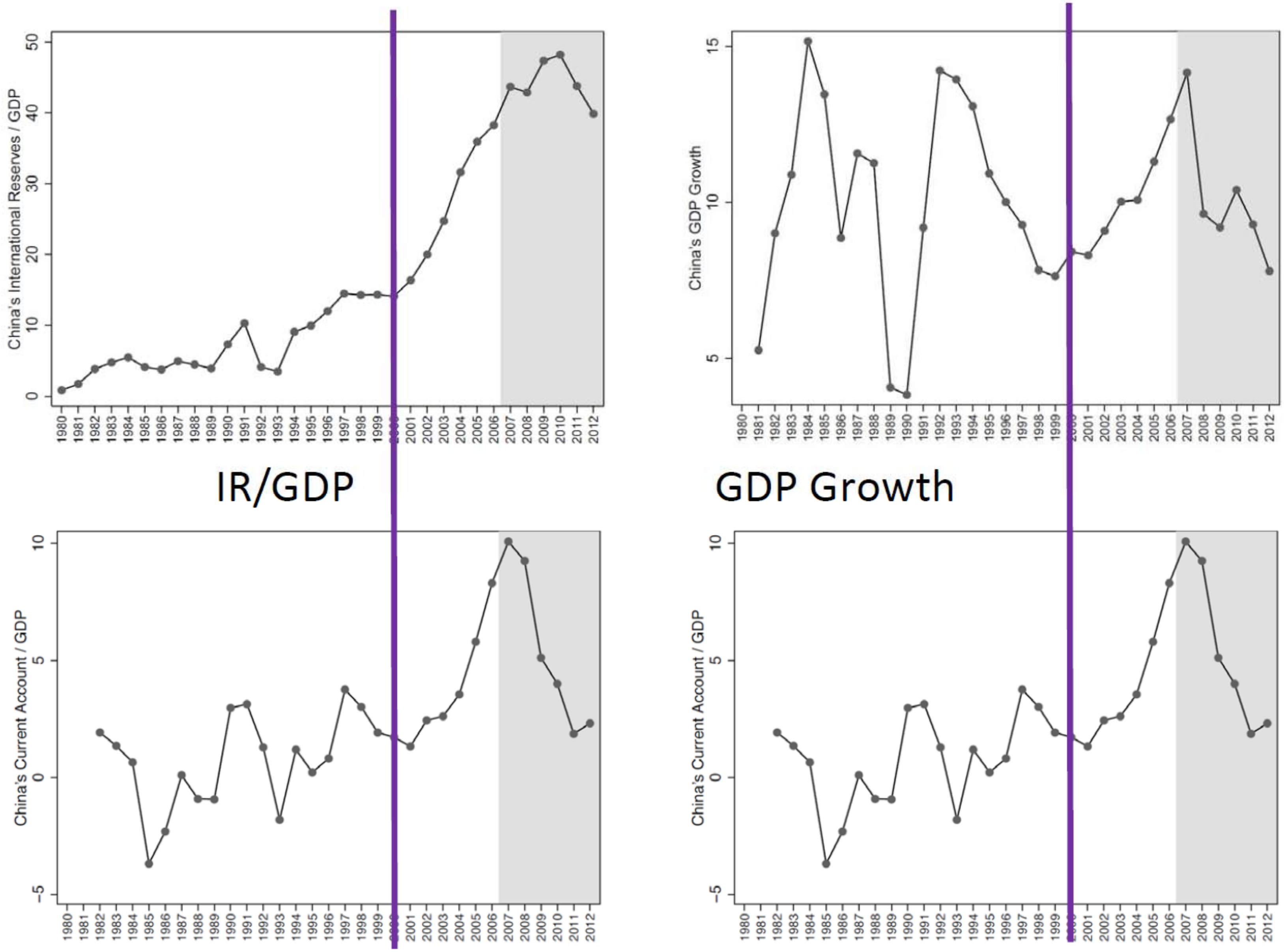




China/US Current act. Patterns

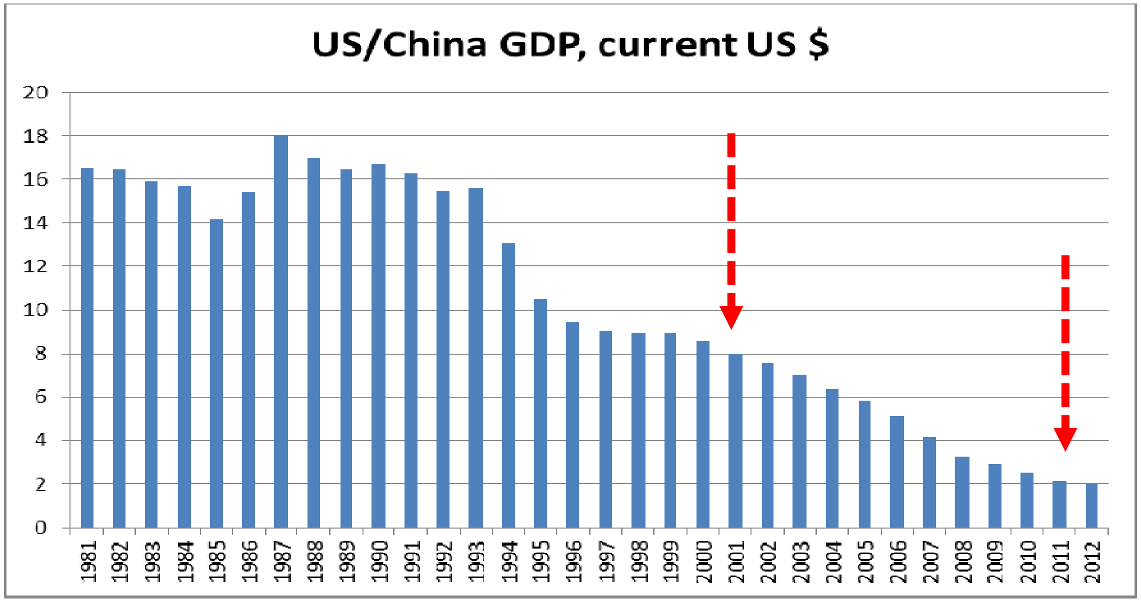


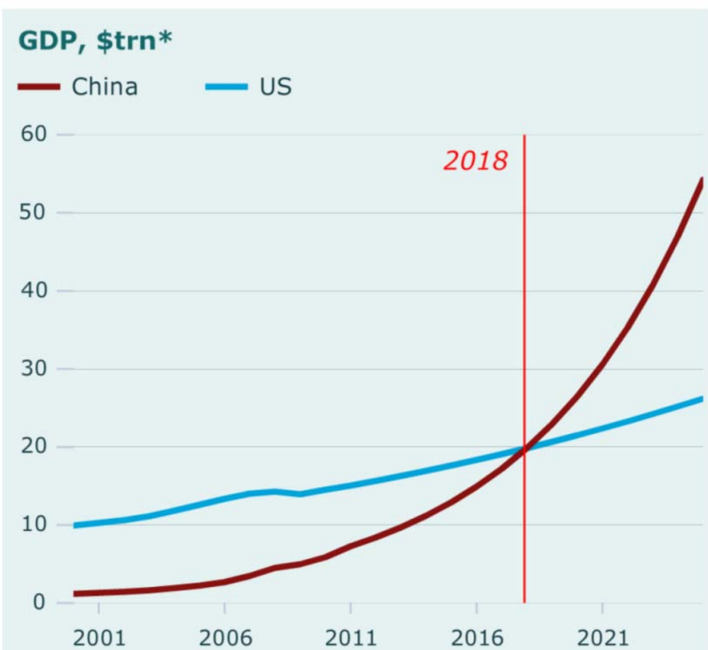
The results: unprecedented



Current account/GDP

China's relative size





Projections of the sizes of China and the US [at current prices and market exchange rates]
The Economist, 2012

Background

- Dooley et al. 2003 argued that an Asian EMs, primarily China, could pursue a development strategy of export-led growth supported by undervalued exchange rates and capital controls for many years.
- Moreover, this strategy was a “win” for the center (the US) -- virtually unlimited demand for its financial assets would allow it to run large current-account deficits, living beyond its means for years.

Modern mercantilism

- The modern mercantilist view [Aizenman and Lee (2007, 8) and others], provided a less sanguine interpretation – after 2000 China accelerated pushing exports to promote growth, racking up current-account surpluses and growing stockpiles of IR/GDP.
- On the eve of the GFC, China's real GDP growth ~ 14%, current-act./GDP ~ 10%, IR/GDP ~ 45%, 48% in 2010.
- Modern mercantilism could lead to unintended adverse consequences such as competitive hoarding, a manifestation of growing trade tensions.

Size matters

The length of current account deficit spells is negatively related to the relative size of the countries' GDP.

- The continuation of the fast growth rate of China, while maintaining its large current account/GPD surpluses, would be constrained by the limited sustainability of the larger current account deficits/GDP of countries that grow at a much slower rate.
- **Short of the emergence of a new "demander of last resort," the Chinese growth path would be challenged by its own success.**

Aizenman and Sun (Journal of Macroeconomics, 2010; NBER WP 13734)

The logic: the global budget constraint

Up to statistical discrepancies, the sum of all current account surpluses [Cu Ac_i] in a common currency adds up to zero. Thus

$$\sum_i Cu.Ac_i = 0 \;;\; \sum_i s_i \frac{Cu.Ac_i}{GDP_i} = 0; \quad s_i = GDP_i / \sum_j GDP_j \,.$$

Suppose that China would keep its high GDP growth rate of 10%, while maintaining a current account surplus of 10% for the next twenty years, while all GDP of AOC grows at 3 % [their rate during 1990-2005].

The global budget constraint implies that OAC would increase overtime their current account deficit as needed, matching the growing global share of China's current account surplus. Specifically, denote the AOC and Chinese GDP at time zero by $GDP_{AOC,0}$ and $GDP_{C,0}$, respectively, and the current account GDP ratio of AOC and China at time t by $cu_{AOC,t}$, $cu_{C,t}$, respectively.

$$cu_{AOC,t} = -0.1\exp(0.07t)\frac{GDP_{C,0}}{GDP_{AOC,0}}$$

Conclusion:

- A small country embarking on an export led growth, like China in 1980, can sustain it without imposing negative ripple effects as long as its relative size remains small.

- The long run success of the Chinese growth strategy put in motion forces that would curtail the sustainability of a high GDP growth rate and a large current account surplus path.
    - By now, China has reached a critical mass of "an elephant running in a China store." The continuation of the fast growth rate of China, while maintaining large current account/GPD surpluses, would be constrained by the sustainability of larger current account deficit/GDP of countries that grow at a much slower rate.

    - Investigating the size distribution and the durability of current account deficits, we found that, with the exception of the US, the duration of spells of current account deficits depend negatively on the relative size of a country, as measured by its GDP/World GDP.

While China's growth has been spectacular, it comes with its hidden but growing costs and distortions

- Financial repression, taxing private saving, transferring them via the state banking system and other means to the SOE.
- Subsidizing to the cost of SOE capital → SOE overinvestment, growing contingent liabilities.
- Limited and costly finance facing private firms → depressing the growth of small and medium private firms.

Outcome: growing distortions – the future growth prospects is brighter for the repressed private sector than the SOE - growing productivity gaps in favor of the private repressed firms.

Song, Storesletten and Zilibotti, 2014, "Growing (with capital controls) like China"

http://www.econ.uzh.ch/faculty/zilibotti/publications/IMF_140606_final.pdf

Then the GFC hit

- In the U.S., the private sector was forced to deleverage and reduced its demand for imports. Other crisis-hit OECD countries also cut back on imports.

As China experienced weaker export demand, it began promoting greater I & C with the help of domestic credit boom.

- China also pursued large fiscal stimulus and allowed its real exchange rate to appreciate.
- It attempted to diversify its holdings of dollar IR by creating a SWF, and encouraging outward foreign direct investment.
- Since the crisis, China's current-account surplus fell from 10 % of GDP (2007) to 2.3% in 2012, 2% in 2013.
- The drop in 2009 alone was the largest ever recorded in the last thirty years.
- U.S. Current-act. Deficit was about 6% of U.S. GDP and 2006, it fell to 2.7% in 2009 and 2.8% in 2012.

Interpretations

Aizenman, Jinjarak, Marion (OER, 2013)

China's smaller current-account surpluses and more moderate IR stance may become a new normal as lower global growth forces China to rely more on domestic demand, while the high cost of holding IR pushes China to place even more emphasis on outward FDI.

- Channeling IR into foreign equity, SWF investment, and outward FDI may be part of Chinese rebalancing.

China joined the trend of other EMs:

EMs eased outflows more in response to higher stock price appreciation, higher appreciation pressures in the exchange market, higher IR/GDP and higher REER volatility.

Aizenman-Pasricha (2013) JIMF

WSJ, December 19, 2013 BEIJING— "Beijing will ease the approval process for all but the largest Chinese investments in overseas companies and projects, a major relaxation of regulatory oversight that analysts say is aimed at encouraging Chinese firms to expand abroad"

State Administration of Foreign Exchange (SAFE)
China's external financial assets at the end of 2013$
Source **SAFE**

- China's external financial assets:

US$ 6 trillion (end 2013).

- IR: US $3.9 trillion,
- IR/GDP (current $) = about 65% of the total assets.
- The outbound direct investment (ODI): 10%, Securities investment: 4%:
- Other investment at 20%.

The country's external liability: US$ 4 trillion, Out of which FDI in China is $2.35 trillion, (60%) of total liability. The investment in securities and other aspects took up 10 % and 30 %, respectively.

- **Net external financial assets: about US$ 2 trillion.**

2. On the sequencing of financial reforms: costs and benefits

- Over the past 5 years, China has strongly intensified its efforts to promote the internationalization of the RMB (CNY).
- This agenda - one of the main aspects of the country's economic policy as expressed in the 12th Five- Year Plan (2011-2015).

The Plan supports the expansion of the cross-border use of RMB + the gradual realization of capital account convertibility.

- The Plan supports the development of HK as a major offshore RMB market.

The internationalization process was put into effect through:

- bilateral currency swap agreements with other countries; after the financial crisis in 2008, China has signed swap agreements with countries such as Argentina, Belarus, Iceland, NZ, Turkey, and United Arab Emirates.

Since 2009, a Pilot program allows RMB settlement of trade with foreign

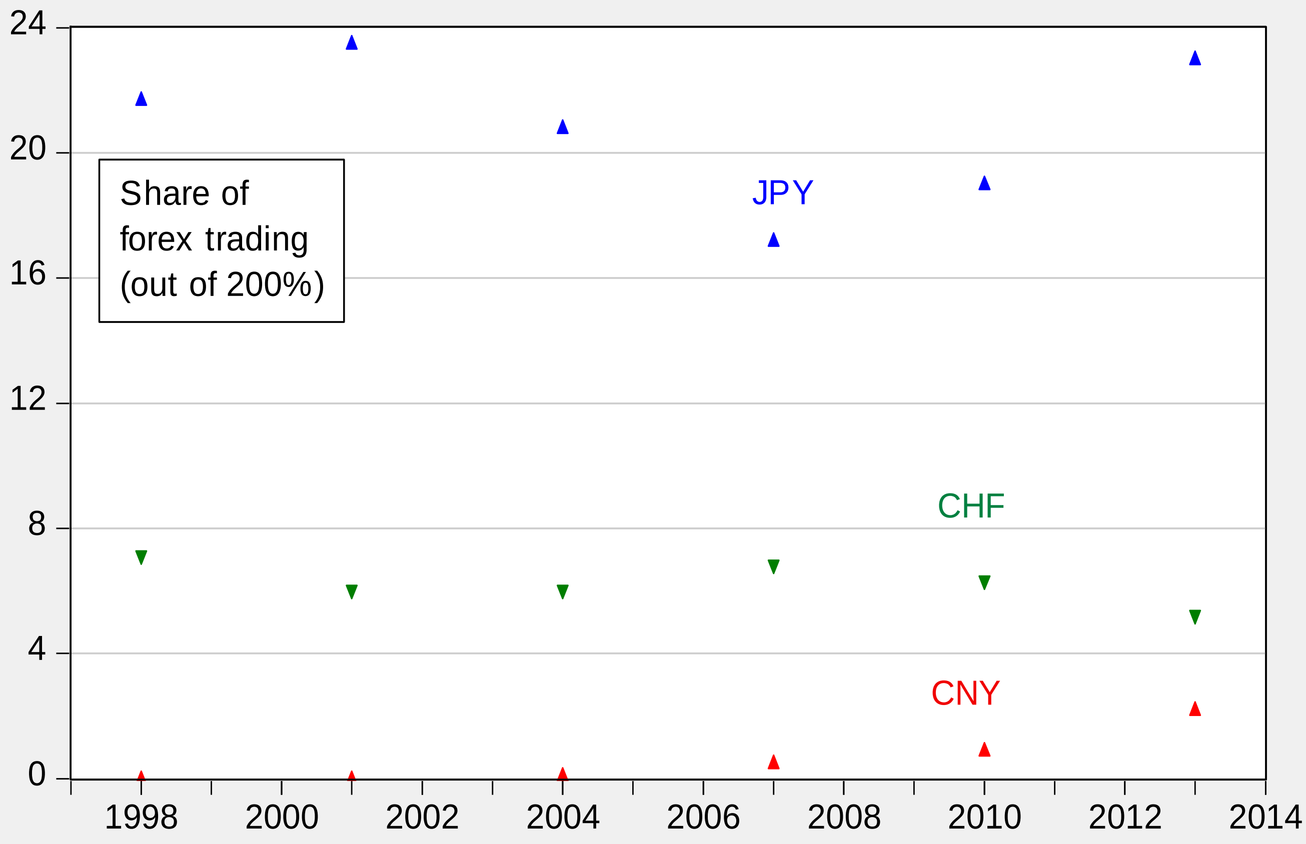
- Limited initially to 5 cities (Sh*anghai, Guangzhou, Shenzhen, Zhuhai, Dongghuan*), and to the trade of Chinese residents with Hong Kong, Macao and ASEAN countries).
- This established the first legal framework for using RMB to settle current account transactions.
- From 6- 2010, it was expanded to 20 provinces and cities in mainland China and geographically extended to the trade with the rest of the world.
- Since 10- 2010 offshore entities were allowed to open Non Resident RMB bank settlement Accounts (NRAs) with onshore banks and use this kind of accounts (NRAs) for lawful cross-border RMB business.

See http://www.lexology.com/library/detail.aspx?g=54bf0e77-82e2-464d-b1a7-736da8a17cfc

Implications

- Rapid increase in the use of CNY in trade and investment settlement, and in trade credit.
- The CNY is used in about 1/3 of China's external trade settlement.
- Presently, CNY SWIFT share is about 1.5% of global volume, with the US $ more than 40%.
- The settlement share of the CNY will keep increasing.

The RMB in Forex Trading

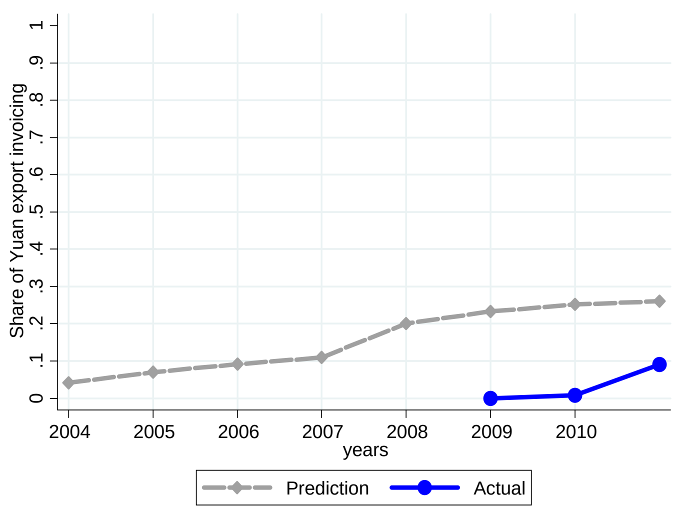


Source: BIS Triennial Survey (2013)

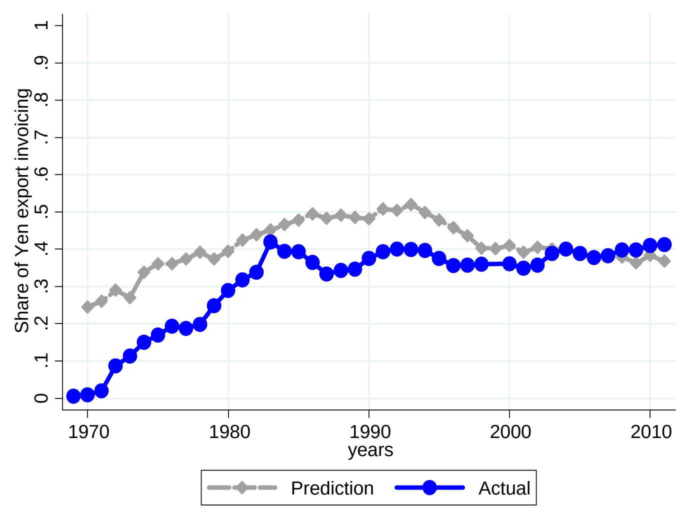
The RMB in Invoicing

Source: Ito and Chinn (2013)

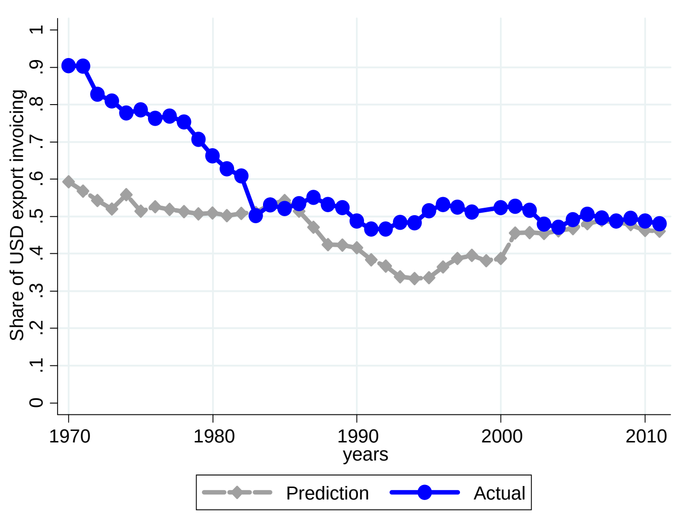
(a) RMB in Chinese Exports



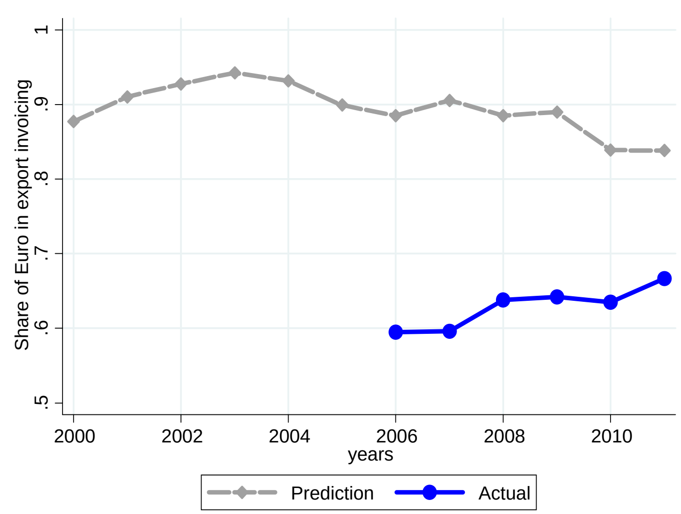
(b) Japanese Yen in Japan's Exports



(c) USD in Japan's Exports



(d) Euro Share in Euro Area's Exports



Ideal global currency, supporting commercial and financial transactions should have the following virtues

I. Liquid, safe, and convertible subject to low transaction costs.

II. Supported by liquid and deep global bond market.

III. Supplied in "sufficient quantity."

Supplying the global currency entails also the provision of a global public good, granting the suppliers the benefit of the 'exorbitant privilege.'

At times of global peril, the public good is manifested by willingness to provide global insurance at a 'reasonable cost.'

Gourinchas and Rey (2005)

As of today, the CNY has not meet yet these conditions. Should China rush the CYN internalization process?

- CNY gains share as major currency in settling trade, and its global share will keep increasing with the maturing of its domestic market.
- CNY offered during the GFC swap lines to its trading and FDI partners.
- Yet, the CNY remains mostly non convertible, lacking a at vibrant and deep global bond market.

No clear reason to rush: the economic gains from CNY internalization maybe over-rated

- Chances are that China's financial integration will keep increasing overtime.
- Trade misinvocing is a commonly used mechanism for overcoming capital control, forcing overtime deeper financial integration.
- Yet, this is not a reason to move much faster towards full convertibility without dealing with domestic sources of financial instability [under funded liabilities, weakening balance sheets of exposed banks, financial repression, etc.].
- Reducing the financial repression would reduce vulnerabilities associated with greater convertibility.

Lessons from past crises

- Past experience suggests that financial internalization before dealing with domestic financial distortions increases the exposure to financial crises.
- Frequently, these crises reduce growth sharply [see Korea 1997 -, Japan 1990s -, Eurozone 2010 -].

On the gains from CNY internalization

The economic gains from upgrading the CNY into a global currency competing with the US $ and the euro are there, by the size of these gains does not worth the risk of moving too fast: the estimates ranges from 1 % GDP [Gourinchas and Rey (2005)] to a much lower fraction [McCauley (2014)].

- US Treasury borrows cheaply because of demand of official reserve managers, but these gains are broadly shared with Australia, Canada and the like through the portfolio balance effect: lower US yields spread across global bond market [McCauley (2014)].

There are also costs

- An international currency also makes a country more susceptible to external monetary shocks. At time of peril, the supplier of the international currency may be induced to provide global insurance.
- Even if other countries merely anchor to RMB, this limits the ability of China to manage its exchange rate.

The gains from capital mobility and capital account convertibility to the real economy are over-rated

- Most EMs take-offs after WWII were more than 95% self funded: higher gdp growth has been associated with higher current account surpluses, with most EMs running surpluses…[capital flows uphill, Lucas].
- The exception: the GIIPS and several Eastern European countries before the Euro crisis. Well, even this exception turned out to be transitory.
- Economic theory does not predict large benefits from external financing, some models predict potential large costs. The empirical evidence failed to show consistent sizable effects [Gourinchas and Jeanne (2006); Gourinchas, Jeanne, Restud (2006)].

Useful future steps

- Reducing the financial repression, reforming the banking system, reducing the preferential treatment of SEO and the improving the funding of the small and medium size private firms would help.
- China remains a net creditor, yet it's return on its global asset position is close to zero. This reflects China's balance sheet: 2/3 of its foreign assets are low yielding IR, most of the foreign liabilities are FDI.
- Allowing the Chinese corporate sector controlled access to external borrowing would be useful.
- Allowing the Chinese corporate sector greater outward FDI would help.
- The odds for smoother transition are higher with gradual sequencing, than with a cold-Turkey financial liberalization.

The calls in China for faster CNY internalization have also internal political economy dimension

“He Fan, a researcher at the Chinese Academy of Social Sciences, said that the interesting question is: Since China's capital account is already undergoing de facto opening-up, "why do the authorities bother to commit to further opening-up?"

His guess is that the central bank is seeking to reform the current regulatory system by deepening capital account liberalization.

He said the way to address the "clumsy" and "inefficient" approval system is to improve exposure to the global monetary system.

Source “Expert: Concerns on capital flows overdone; China Daily,” June 24, 2014.

Putting it in the context of the global financial architecture

- With a lag [network externalities], the global IR system adjusts endogenously to the global patterns of trade, finance and economic might.
- BWI fitted well the 1944-1960s.
- The successful recovery of W. Europe, and the political challenges of the US in the 1960s put growing strains.

The attitude of the U.S. toward the BW system in late 1960s was benign neglect – the administration ‘took no initiative to do anything about the monetary turmoil as long as it did not see its domestic priorities endangered by the market.’ [Zimmermann (2002), page 66].

Arguably, the US overplayed it's exorbitant privilege in the 1960s - ending BWI, and in the 2000s - ending BWII…

- BWII may be a messy transition from a uni-polar world towards a multiplier (possibly a Tri-polar) world.
- Tri-polar?
  - US $ ~ the US sphere of influence [the Americas],
  - € ~ The EU sphere of influence,
  - the Eastern Pacific Rim [China, Japan, Korea, etc…], transiting from a US $ towards a CYU anchored system ?

Multiple reserve currencies, endogenously determined

- The present crisis may hasten the transition to a world where the US$ < 50% [Chinn and Frankel (2008)].
- € share increased from 18% to 28% in about 10 years.
- The transition would be slower if the US deals properly with its fiscal and monetary overhangs…
- **A multi-polar configuration is less stable than a unipolar stable configuration, yet it may be more stable than an unstable unipolar configuration – a multi-polar system may better fit the underlying forces shaping the global redistribution of power.**
- This is a volatility that the world is learning to live with.

The CNY and the Euro are yet to pass the test of a viable strong global currency

- The US$ is a mixed bag:
  - The most liquid global bond market.
  - Yet, the US was the epicenter of the 2008-9 crisis, the source of global instability.
- However, once the crisis took place, the US provided important global insurance services: bailing out Fannie Mae & Freddie Mac, and AIG in ways that shielded global players from the brunt of the crisis.
- Supplying swap lines to 4 EMs and OECD countries helped.

Where is the CNY? Not there yet, it will take time.

the CNY remains mostly non convertible, lacks a at vibrant global bond market.

Looking forward

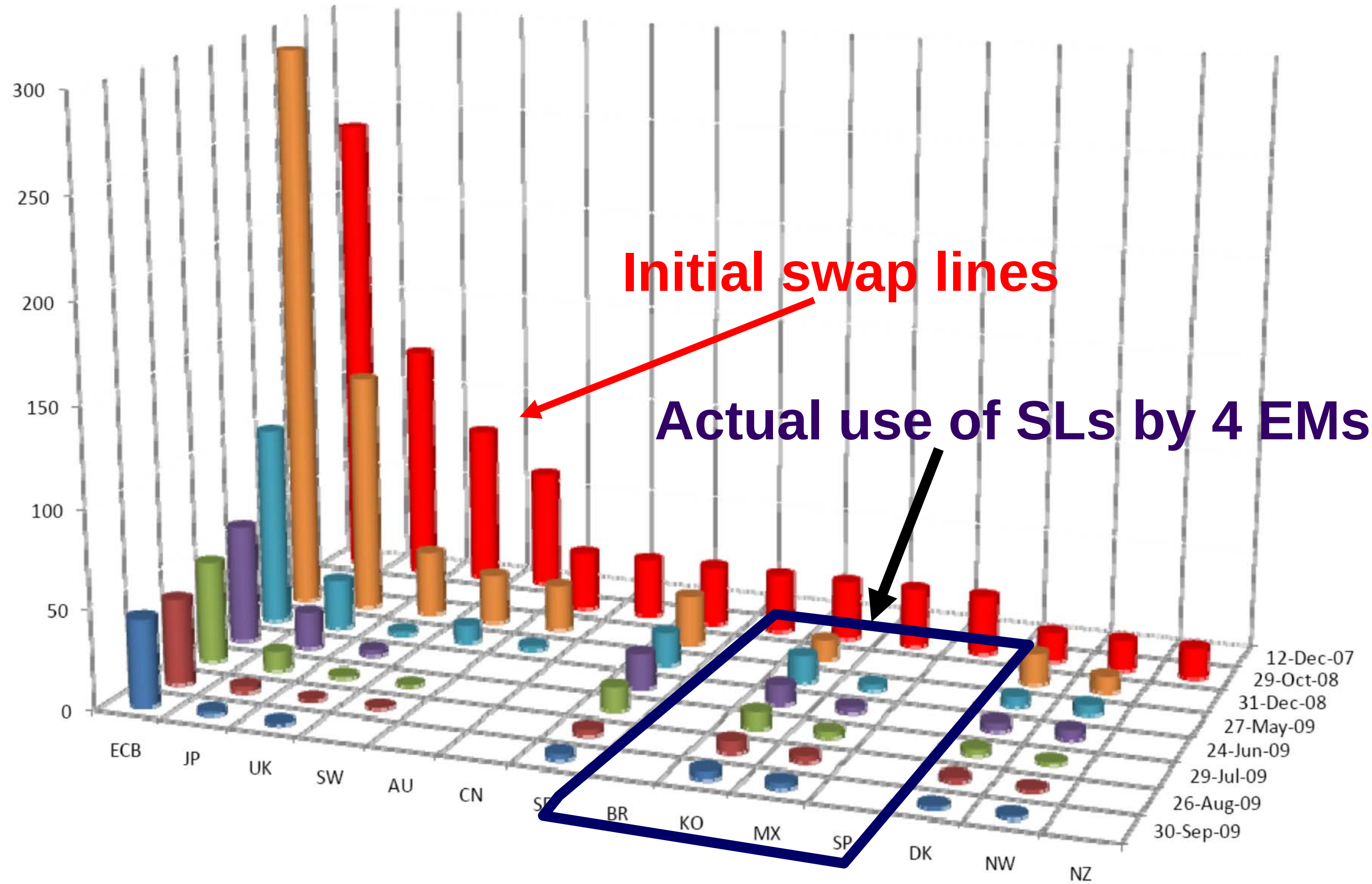
The speed of moving towards the multi-polar configuration will be determined by

- China's ability to navigate its internal balancing, and increasing its financial integration.
- The Euro zone's ability to manage properly an exit from the present crisis, and to move towards a deep Euro bond.
- The transition may be slower if the US deals properly with its fiscal and monetary overhang…

http://memegenerator.net/instance/31669615

Fear of using IR, and fear of using swap lines.

The use of FED's swap lines



Alternatives to self insurance?

- Alternatives to a massive hoarding of reserves include: a deeper use of swap lines and IR pooling arrangements; and channeling IR into potentially higher yielding but riskier assets, probably managed by SWFs.
- While potentially useful, these alternatives are not a panacea.
  - Swap lines are typically for short durations, limited by moral hazard considerations and stigma effects.
  - Diversification by means of SWF -- the value of the fund may collapse precisely at the time that hard currency is needed to fund deleveraging [see the 2008 global liquidity crisis].