The Renmibi Internationalization and Central Banks

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Comments on recent evolutions.

Significant financial turbulences have followed in August the announcement, by China, of a new exchange rate regime. Together with the drop in Shanghai stock exchange, they have generally been seen as a "wake up call", as investors become suddenly aware of growing uncertainties on China's economic growth and internal tensions. Alternatively, and this is my preferred interpretation, market volatility may result from a fundamental - and unexpected - shift in the policy regime towards less predictability.

Over the last two decades, China has been a pillar of stability in global capital markets. Since 2005, the exchange rate has been carefully managed, in a transparent way, to orchestrate a progressive real appreciation of the RMB. Liberalization of the capital account has been announced well in advance, the directions being set and, although, with some recent acceleration, the pace has been regular.

During both the Asian financial crisis in 1997-98, and the Global Financial Crisis of 2008-2009, China refrained from any inflexion in its exchange rate policy. Statements by Chinese Leaders have sought to instill a sense of confidence, thus powerfully contributing to overall stability. The same attitude prevailed during the euro crisis when actions by Chinese policymakers have supported actions by European authorities. They repeatedly expressed confidence in the ability of peripheral economies to overcome their difficulties.

Overall, China's international economic policies have been extremely predictable and stability oriented, providing significant benefits to the world economy. Financial assets' valuations are dependent on the overall economic environment and very sensitive to investors' perceptions. A predictable policy framework is very favorable to financial stability. By contrast, sudden shifts in the policy regime - such as those that have recently occurred - are bound to trigger a general re-pricing of assets through extreme financial volatility.

Reactions to those changes have been somehow contradictory, if not slightly schizophrenic. On the one hand, the IMF and China's trading partners have been arguing, for some time, in favor of more flexible and market oriented exchange rate and capital account regimes. On the other, they seem to regret the predictability that was associated with the previous - more tightly

managed - system. Overall, there is growing awareness, including in China itself, that Chine policies have a significant impact on global capital markets, despite the incomplete openness of its capital account.

A similar contradiction is visible on the Chinese's side. It may reflect internal policy disagreements. Over the last weeks, China has simultaneously (slightly) relaxed its control over the exchange rate and moved to a more accommodative monetary policy. The logical consequence has been an outflow of capital that Chinese authorities are now trying to stem through foreign exchange interventions and more recently, some marginal tightening of capital controls. At some stage, a clarification about the future regime would be warranted. Policymakers would do well remembering and old (and still valid) lesson: internal financial liberalization must precede – not follow – external liberalization of the capital account. Doing it in reverse order creates difficulties: it exposes the economy to external shocks that underdeveloped domestic financial markets may not be able to absorb.

The political case for accelerating RMB internationalization is strong: it strengthens the perception of China as a global leader; it helps the "modernizers" inside the Chinese political system to push for necessary reforms; it pleases foreigners and international institutions. The economic case seems less compelling to day than a few months ago.

Looking into the future,

If and when the RMB becomes a fully convertible and internationalized currency, consequences will be different for Central Banks in emerging and advanced economies.

Emerging economies

Most Central Banks in South East Asia in particular, currently operate under “ soft peg” regimes, where the exchange rate is managed in reference to a basket of currencies. While those baskets are not made public, one can assume that both the USD and RMB have very significant weights. Assuming, further, that baskets are close or similar, there is de facto some stability in bilateral exchange rates between Asian countries.

Those arrangements offer an almost optimal compromise between fixity and flexibility. They allow individual countries to make one – step adjustment to their exchange rates, if they have to absorb shocks that are specific to their economies. At the same time, the risk of significant disruptions arising, for instance, from unexpected exchange rate volatility or competitive depreciation, is minimized. That framework has strongly underpinned regional and financial integration in South East Asia. Obviously, part of its robustness comes from the predictable relationship between Chinese and US currencies, which is effectively acting as an anchor for regional monetary stability (Ma and Mc Cauley, 2010).

Should the RMB and the USD become fully flexible against each other, Central Banks in that part of the world would operate in a totally different environment. They would face difficult dilemmas in choosing and managing their exchange rate regimes. Pegging to a basket would mean, de facto, accepting more volatility towards one or the other major currencies. More importantly, small differences in reference baskets would result in significant bilateral exchange rate movements. Over the medium term, the region could face the same tensions and fundamental questions that have plagued European countries in the last two decades of the XXe century: how to conciliate increased trade and economic integration with bilateral exchange rate flexibility. One lesson from the European experience is that fixed, but adjustable exchange rate systems do not stand, for a very long time, the pressures of free capital movements. The solution adopted in Europe – the creation of a single currency – may not be currently seen in Asia as realistic, or even attractive.

Advanced economies,

Domestic monetary conditions, including in major economies, are not isolated from the global environment. Over the last decade, monetary policies in advanced countries have been influenced, if not constrained, by low interest rates prevailing in international capital markets. To some extent, those rates are a product of (non conventional) monetary policies themselves, that have compressed term premia. But low (real) interest rates are also determined by the global equilibrium between saving and investment.

We can therefore perform a thought experiment. What would happen to the world equilibrium interest rate if the RMB was suddenly to become fully convertible and China's capital account fully open? Several opposite forces would be at work. On the one hand, China's savings would no longer be locally repressed and could freely be invested in the rest of the world, pushing down the equilibrium interest rate. However, this downward shift could (and would, in my view) be more than compensated by other influences. First, the overall saving rate in China would likely drop as a consequence of financial liberalization. And second, there would a decrease in the demand for safe assets (dollar and euro denominated government bonds). At the moment, a significant part of China's external savings is intermediated by the Central Bank, through the accumulation of foreign exchange reserves. There is ample evidence that this "pro safe asset" bias has significant impact on risk free rates. Once foreign asset allocation is freely and privately decided by Chinese private residents, this bias could disappear and the risk free equilibrium interest rate would shift upward. So, everything equal, monetary policy rates in advanced economies would have to be higher as well.

Global financial stability

Should the RMB become an international medium of exchange and store of value, it would have major implications for international financial stability. It would pose new and significant challenges in the cooperation between all Central Banks.

A true international currency is used between non-residents to execute financial operations and investments outside its country of issuance. A good reference, here, is the dollar. Currently, more than one third of cross border credit denominated in dollar involve two non-US counterparties. Non US corporates have massively issued dollar denominated bonds. And non-US banks have engaged into maturity transformation in dollars. In this environment, there is a permanent demand for dollar liquidity provision both in ordinary and crisis time. Liquidity shortages for non- US residents may have great disruptive effects.

As the 2008-2009 crisis has shown, the Central Bank issuing an international currency is confronted with specific dilemmas – some would say specific responsibilities. During the most acute phase of the financial crisis, the Federal Reserve was faced with numerous demands for swaps by other Central Banks that needed dollars to support their domestic banks, corporates and financial markets. Choices had to be made. Consequences were important: at their peak, outstanding swaps amounted to one third of the FED balance sheet (Landau, 2013). There were considerable frictions with countries that were denied the possibility of a swap. To a lesser extent, the ECB was exposed to the same difficulties regarding those regions of the world where the Euro is used as an international financing currency (Central and Eastern Europe).

There are currently more than 60 existing swaps agreements between the PBOC and other Central Banks. However (with the possible exception of the Hong Kong Monetary Authority) those facilities have been designed and structured with the objective of financing RMB denominated bilateral trade. Amounts and modalities have been calibrated accordingly, to temporarily fill mismatches between exports and imports denominated in RMB. If and when the RMB becomes an international vehicle for capital flows and financial transactions, different - and much bigger - arrangements would become necessary. The PBOC would be faced with new dilemmas and choices, with significant global and political economy implications.

China and the SDR

Finally, let me say a few words about the possible inclusion of the RMB in the SDR basket. The recent factsheet published by the IMF is very clear (IMF, 2015). The RMB meets the first criterion for inclusion: the role of China in global exports and imports. The second criterion refers to the concept of “freely usable” currency, which is very specific to the IMF. It should not be confused with full convertibility. A currency can be freely usable and not fully convertible. This is logical, since the Articles of the IMF do not require capital account convertibility and the SDR is, essentially, the currency used by (and inside) the IMF. A “freely usable” currency is one that members of the IMF are prepared or willing to hold and use in their mutual transactions, especially inside the institution itself. It is a currency, for instance, that countries will accept when they draw on the Fund’s facilities. From that perspective, there is no doubt, in my own personal view, that the RMB is freely usable. The willingness to hold RMB is, at least, equal to the willingness to hold the British Pound, which is part of the SDR basket (or, for that matter, the past willingness to hold DM and the French Franc prior the creation of the Euro).

Should the RMB be included in the SDR, immediate consequences would be almost nil. Contrary to some perceptions, it is very unlikely that a change in the SDR basket would trigger massive asset reallocation. The share of private assets denominated in SDR is negligible. Obviously, the evolution of China's capital account and exchange rate regimes will have much greater signification, for investors, than the composition of the SDR basket. In the short run, Central Banks may want to slightly reallocate some reserves to the RMB to better manage their potential exposure (through SDRs). Up to July 2015, Central Banks willing to hold reserves in RMB only had access to the offshore market. That restriction has now been removed and they are allowed to hold and trade onshore bonds.

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