



# China's balancing act

## Why the internationalisation of the renminbi matters for the global economy

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### Key messages

- With an estimated \$4 trillion in foreign exchange reserves, China's liberalisation, and that of its currency, the Renminbi (RMB), matters.
- China's liberalisation will bring further financial market volatility as it manages an economic slowdown and financial sector deepening.
- Foreign capital flows will introduce a 'hard' budget constraint for unprofitable banks and corporations.
- The effects of increases in trade and investment after full RMB internationalisation could offset the global trade slowdown.
- Past liberalisations have, more often than not, heralded currency crises; given this, China's policy-makers will reform at a slow, steady pace.
- China's contribution to world trade and investment could help mitigate emerging and developing economies' 'triple crises' of higher US interest rates, lower oil prices and its own growth transition.

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The author would like to thank DFID for support and Dirk Willem te Velde for comments on the draft.

## Abbreviations

<b>AFP</b>	Agence France Presse	<b>OBOR</b>	One-Belt-One-Road
<b>BIS</b>	Bank for International Settlements	<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>BRICS</b>	Brazil, Russia, India, China, South Africa	<b>OFDI</b>	Outbound FDI
<b>CBOE</b>	Chicago Board Options Exchange	<b>PBOC</b>	People's Bank of China
<b>CRA</b>	Contingency Reserve Arrangement	<b>PPP</b>	Purchasing Power Parity
<b>ECB</b>	European Central Bank	<b>QDII</b>	Qualified Domestic Institutional Investor
<b>FDI</b>	Foreign Direct Investment	<b>QFII</b>	Qualified Foreign Institutional Investor
<b>FEER</b>	Fundamental Equilibrium Exchange Rate	<b>RMB</b>	Renminbi
<b>FOCAC</b>	Forum on China–Africa Cooperation	<b>SDR</b>	Special Drawing Rights
<b>FSB</b>	Financial Stability Board	<b>SSA</b>	Sub-Saharan Africa
<b>GDP</b>	Gross Domestic Product	<b>UK</b>	United Kingdom
<b>IDS</b>	Institute of Development Studies	<b>US</b>	United States
<b>IMF</b>	International Monetary Fund		

## Executive summary

With an estimated \$4 trillion in foreign exchange reserves, the liberalisation of China’s financial system, and its currency, matters. Some of this is already held in US treasuries and foreign direct investment (FDI). China has been setting the stage for the internationalisation<sup>1</sup> of the renminbi (RMB) for several years. Its inclusion in the International Monetary Fund’s basket of special drawing rights is a testament to this. However, recent volatility in China’s stock market underscores the following:

- China’s liberalisation is a risk as the country manages an economic slowdown and financial sector deepening. Foreign capital flows will introduce new competition for unprofitable banks and corporations.
- The effects of increases in trade and investment after full RMB internationalisation could offset the global trade slowdown, a catalyst of sharper growth slowdowns and a G20 concern.
- Both are critical to assess the suitability of whether the RMB should sit alongside the US dollar and the euro as reserve currency and the degree to which it will surpass the US dollar in size.

The internationalisation of the RMB – through increased RMB bond issuance, greater inclusion in trade, greater outbound FDI and its growing status as a reserve currency – will boost global trade and investment at a time when emerging and developing markets are experiencing a slowdown, and recession in some instances. This support

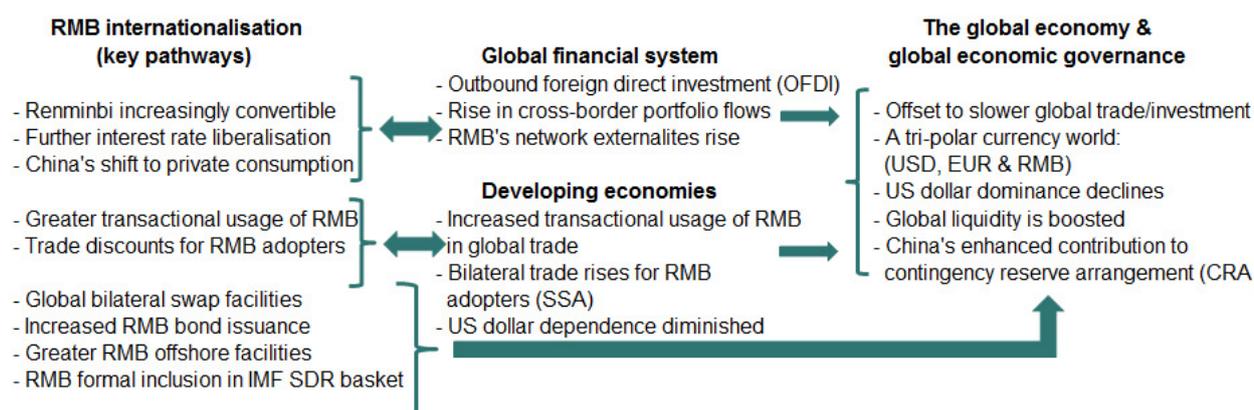
is important at a time when the global economy is facing a downturn in global trade (see figure below).

Past liberalisations have, more often than not, heralded currency crises. After all, moving beyond the ‘impossible trinity’ of a fixed exchange rate, an independent monetary policy and opening an economy is difficult to manage, as witnessed in some of the South-East Asian economies during the Asian financial crisis of 1997. Liberalising a currency regime, from a fixed to a fully floating exchange rate, needs to be managed amid volatility in global capital flows. Given this, China’s policy-makers will reform at a slow, steady pace.<sup>2</sup>

These risks need to be managed when pursuing China’s objective, of taking a full part in a globalised economy. Although, at 10%, its share of world trade is still relatively small, this has increased five-fold since the mid-1990s, according to Organisation for Economic Co-operation and Development (OECD) data. At this pace of growth, China’s contribution to world trade and investment could help mitigate emerging and developing economies’ ‘triple crises’ of higher US interest rates, lower oil and commodity prices and China’s growth transition (Papadavid, 2016).

Section 1 of this report highlights the importance of China balancing its liberalisation with financial sector deepening to protect against a currency crisis. In Section 2, we consider how offshore trading centres<sup>3</sup> and greater RMB transactional usage could spur outbound portfolio and foreign direct investment, offsetting the slowdown in global trade. China’s economic ‘endgame’ and the staying power of the RMB as a reserve currency<sup>4</sup> is addressed in Section 3. Section 4 concludes.

**Figure A. Key pathways and transmission mechanisms for RMB internationalisation**



Source: Overseas Development Institute.

1 Currency internationalisation is distinct from currency convertibility; internationalisation denotes widespread currency usage in international transactions with the removal of restrictions on cross-border transfers of funds, on third-party use in contracts of trade in assets or goods and on assets denominated in the currency in private or official portfolios (Genberg 2010).

2 People’s Bank of China Governor Zhou Xiaochuan has indicated that a slow steady pace in reform is likely (PBOC, 2015b).

3 An offshore currency market specialises in transactions of products not issued by that market and serves a large non-resident population (Cheung, 2015)

4 Reserve currency status is predicated on the depth, breadth and liquidity of a country’s financial market (ECB, 2013). US dollar usage in trade settlement, confidence in it as a stable store of value and its use as an ‘anchor’ currency against which other currencies are pegged have been key (Meissner and Oomes, 2008; Roosa and Hirsch, 1966).

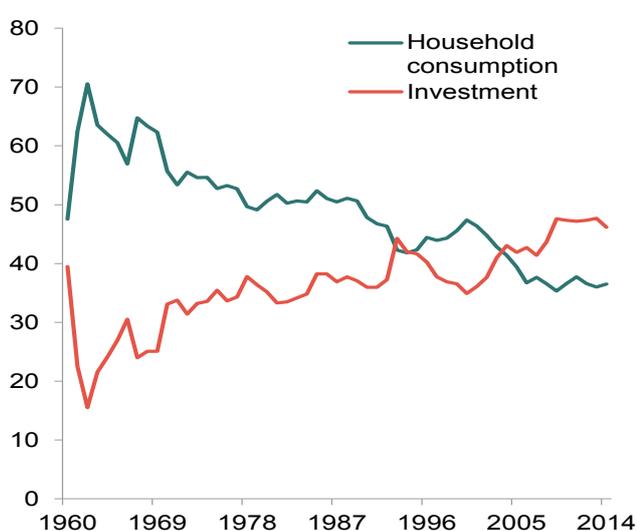
## 1.China could see financial volatility rise further

With an estimated \$4 trillion in foreign exchange reserves<sup>5</sup>, the liberalisation of China’s financial system, and its currency, matters. China has been setting the stage for the internationalisation<sup>6</sup> of the renminbi (RMB) for several years. Its inclusion in the International Monetary Fund’s basket of special drawing rights is a testament to this. Global financial markets are understandably nervous. Their fear comes from the historical experience of liberalizations – more often than not, generating currency crises. Given this, liberalisation accompanied by a liquid, deep and

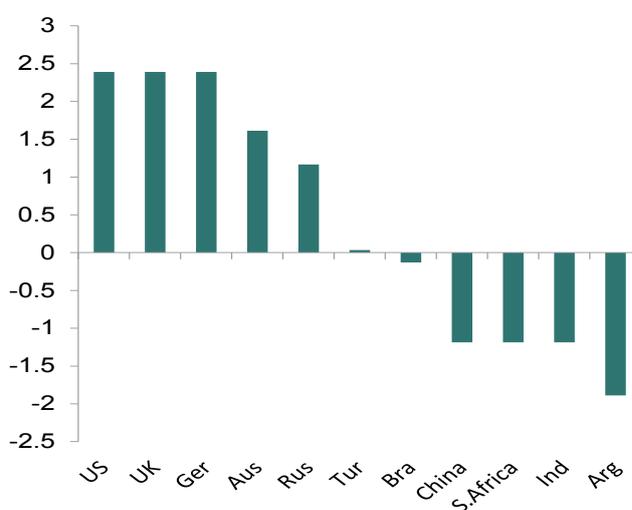
well-regulated financial system is key to China’s balanced growth path.

Financial deepening is important: capital account liberalisations can increase inequality and reduce the labour share of income in countries with underdeveloped financial systems (Furceri and Loungani, 2015). Banking sector reform fuels equity market development, which helps unlock China’s domestic savings too (Chinn and Ito 2005). This is key for China to arrest the downtrend in private consumption as a share of gross domestic product (GDP) (Figure 1). Additionally, foreign entry of global financial institutions will bring knowledge spillover of new financial products (Eichengreen and Kawai, 2015).

**Figure 1. China’s consumption share (% GDP)**



**Figure 2. Index of capital account openness\***



Source: World Bank. \*Data show the Chinn Ito index of capital account openness; Higher readings denote greater openness; see Chinn and Ito (2006)

### 1.1 Further financial volatility

Recent financial volatility has coincided with China becoming increasingly open in de facto terms and selectively dismantling its capital controls; however, the government is far from allowing the extent of free flow of capital that is typical of reserve currencies. China’s financial system is already the fourth largest behind the US, the Eurozone, Japan and the UK. And yet, its capital account is still closed in comparison with its counterparts (Chinn and Ito, 2006). In fact, the Chinn and Ito index of financial openness suggests China is one of the most closed economies in the world (Figure 2).

China’s liberalisation is a risk as the country manages an economic slowdown and financial sector deepening. Foreign capital flows will introduce new competition for unprofitable banks and corporations. This will also bring increased financial volatility, given that open financial systems are also more exposed to the contagion, or spillover effects characteristic of systemic financial crises (Dijkman, 2010; Pang, 2015). In this context, crises are important to consider in the case of China. As it moves to full capital account convertibility, and facilitates both outbound and inbound financial investments through loosening regulations, a key challenge will be to avoid

5 Estimates of China’s foreign exchange reserves are available from the State Administration of Foreign Exchange: <http://www.safe.gov.cn/wps/portal/english/>

6 Currency internationalisation is distinct from its convertibility; it denotes widespread currency usage in global transactions with the removal of restrictions on cross-border transfers of funds, on third-party use in contracts and in assets denominated in the currency in private or official portfolios (Genberg 2010).

the crises its predecessors, such as the South-East Asian economies, have faced when opening up their financial systems (Krugman, 1999; World Bank, 2005).

Past liberalisations have, more often than not, heralded currency crises (World Bank, 2005). After all, moving beyond the ‘impossible trinity’ of a fixed exchange rate, an independent monetary policy and opening an economy is difficult to manage, as witnessed in some of the South-East Asian economies during the Asian financial crisis of 1997. Liberalising a currency regime, from a fixed to a fully floating exchange rate, needs to be managed amid volatility in global capital flows. Given this, China’s policy-makers will reform at a slow, steady pace.<sup>7</sup>

China’s financial system is dominated by bank lending (Cruz Gao and Song, 2015), which can constitute a financial shock to investment. Amity and Weinstein (2013) show that supply-side financial shocks – stemming from bank lending – can have large negative impacts on aggregate loan supply and investment. The volatility in the Shanghai composite index reflected an overvaluation in the actual index, by as much as 23% (Verhage, 2015), and a lack of macro-prudential oversight of publicly listed companies (Wang and Sun, 2013). Although the recent

about of volatility is less pronounced than that in August (Figure 3), China’s ‘shadow’ banking<sup>8</sup> sector, estimated at as high as 43% of GDP (Elliot et al., 2015), heightens risks. Currency weakness and stock market volatility have ensued and authorities have extended the ban on short-selling (Bloomberg, 2015).

Despite the financial volatility that is likely to continue, a financial crisis is not on the cards for China. Its financial soundness indicators, as calculated by the International Monetary Fund (IMF), have not raised any flags. And China plans to steadily implement the reforms necessary for successful liberalisation. These include (1) interest rate liberalisation (in order to introduce a ‘hard’ budget constraint into its banking sector) and (2) the commercialisation of state-owned banks, where default risk is difficult to gauge as a result of implicit guarantees (Law and Roach, 2015). The People’s Bank of China’s (PBOC’s) removal of controls on lending rates has been a step in the direction of interest rate liberalisation. Effectiveness of PBOC monetary policy in terms of successfully filtering through to deposit and lending rates, as has been the case in India (Das, 2015), will be important.

**Figure 3. Comparing China’s financial market volatility with August’s developments**



*Note: The Chicago Board Options Exchange (CBOE) China Exchange Traded Funds are shares of trusts that hold portfolios of stocks designed to closely track the price performance and yield of specific indices.*

*Source: CBOE and Federal Reserve Bank of St Louis.*

<sup>7</sup> People’s Bank of China Governor Zhou Xiaochuan has indicated that a slow steady pace in reform is likely (PBOC, 2015b).

<sup>8</sup> The Financial Stability Board (FSB) defines shadow banking as all entities outside the regulated banking system that perform the core banking function of credit intermediation, taking money from savers and lending it to borrowers (FSB, 2013).

### Box 1. China's QFII and QDII schemes

Promoting inward investment is important. It prompts technological spillover. And inward portfolio investment (in equity and bond investments) promotes competition and prudential health of the banking sector (IMF, 2015a; Prasad, 2015). Over the past decade, policy initiatives including the QFII scheme have facilitated foreign investor purchases of Chinese stocks. The upper limit on portfolio investments has been raised per QFII but remains largely capped at \$1bn; the period in which the investment is locked has also been reduced (Eichengreen, 2015).

More outward investment through the QDII scheme (which includes securities firms, asset management companies and insurance companies) has occurred; this was expanded in 2010 as the government's controlled means to liberalise and to allow institutional investors to invest pooled funds abroad with an improved risk-return tradeoff. Progress thus far in liberalising has included the fact that the government in 2009 dropped review and approval requirements for outward remittances of funds for direct investment abroad by Chinese corporations and financial institutions (Prasad, 2015). The limit on foreign exchange purchases by residents for remittances abroad for personal reasons has also been increased, to \$50,000 a year (ibid.).

Figure 4. 2020 Taylor rules for 2020

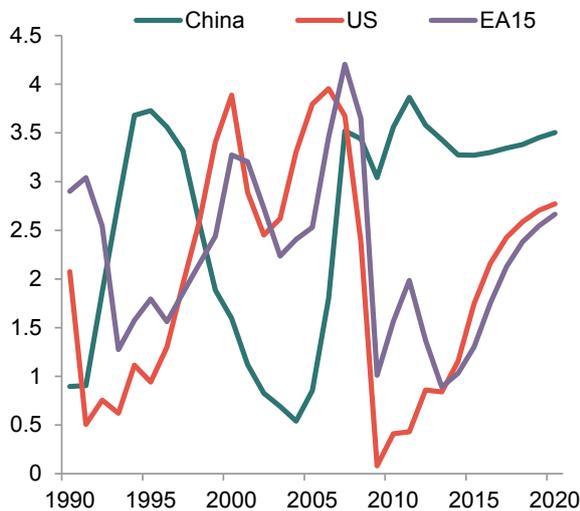
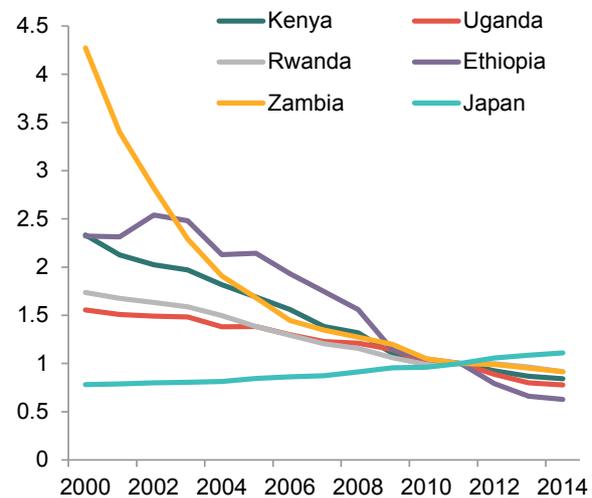


Figure 5. China's relative prices\*



Note: \*Relative prices denotes the ratio of China's Consumer Price Index relative to countries noted.

Source: Taylor rule policy rates are author's calculations based on OECD (2012) estimates of countries' output gaps and inflation rates; there is an implicit assumption of a 2% inflation target adopted by the PBOC in the long term..

## 1.2 China's evolving financial liberalization

Chinese policymakers have employed new strategies to re-invest foreign currency inflows rather than accumulate reserves. The qualified domestic institutional investor (QDII) and qualified foreign institutional investor (QFII) schemes are symptomatic of this (Box 1) and the country's plan to achieve an open capital account and a widely used

renminbi (RMB) . Thus far, reform tools have been aimed at basic, rather than full, capital account convertibility. They have facilitated the purchase and sale of the currency for trade-related purposes as well as a limited range of capital account and financial transactions that promote inward/outbound investment.<sup>9</sup>

<sup>9</sup> The RMB is the official currency of China, and is interchangeably called the yuan. The onshore exchange rate is referred to as the CNY rate and the offshore exchange rate is the CNH rate.

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### 1.3 PBOC currency policy

RMB liberalisation, or market-based currency determination, is a key part of China's overall financial liberalisation. Its inclusion in the IMF's special drawing rights (SDR) basket<sup>10</sup> is partly predicated on its being freely and widely usable – broadly used in international transactions and principal exchange markets. Currently, China maintains a floating exchange rate regime.

China's central bank has intervened on several occasions to support its currency.<sup>11</sup> This is not surprising. Transition to a freely floating currency is tricky, given historical evidence of an 'impossible trinity' – the fact that a fixed exchange rate, free international capital mobility and an independent monetary policy (geared towards domestic goals) are not all mutually consistent (Obstfeld et al., 2004).

The RMB is likely to continue to come under downward pressure amid instability in China's financial markets. The QFII scheme may add to this dynamic as domestic investors seek to diversify their investment portfolios, in both the short and the long term. In theory, China would see a further depreciation of its currency according to equilibrium exchange rate frameworks, such as the Fundamental Equilibrium Exchange Rate (FEER).<sup>12</sup> All other factors constant, a sustained increase in capital outflows suggests a deterioration in its external accounts, requiring a depreciation in the exchange rate to bring China's current account back into equilibrium.

The outlook for the RMB is both uncertain and important. It is uncertain due to the risk of capital outflows. Its long-term rate is important – a low rate will support China's exports. And yet, a strong enough RMB is instrumental for consumers' purchasing power for foreign imports, and for re-balancing to consumption-led growth.

Estimates are split. Persistent RMB undervaluation (Papadavid, 2007; Cline and Williamson, 2007) support

currency strength.<sup>13</sup> Long-run calculations of China's Taylor rule<sup>14</sup> rate, which indicate a rate gap vis-à-vis the US and the Eurozone to 2020 (Figure 4), echo this. However, others see a more recent overvaluation in the RMB (Zhang and Chen 2014). RMB strength has also been reflected broadly in the splits of the newly established RMB trade-weighted index. With the exception of the US\$, the RMB has broadly appreciated.<sup>15</sup>

The currency is an important financial transmission mechanism vis-à-vis its developed and developing trading partners. RMB depreciation risk carries spillover risks for China's trading partners – in the form of both depreciation and devaluations. The Taiwanese dollar, the Korean won and the Japanese yen depreciated in the wake of its weakness. And in August 2015, Vietnam devalued the dong in response to the PBOC devaluation. There is continued risk of this.

As the RMB depreciates, China's major trading partners will see a decline in their relative export competitiveness. SSA economies in particular will see higher real (inflation-adjusted) exchange rates given their persistently high domestic inflation rates. This competitiveness gap is heightened by the fact that China's consumer prices continue to drop dramatically vis-à-vis those in SSA, leading to a lower real effective exchange rate (Figure 5). This will fuel devaluations in SSA, and South-East Asia, to support growth.

External devaluations are particularly problematic for smaller, low-income economies in that the loss of purchasing power (and lower consumption) is not offset by increased investment in the short term, and exchange rate depreciation may lead to unsustainable debt dynamics (Acevedo et al., 2015). SSA countries with high US\$-denominated debt, such as Ghana, Tanzania and South Africa, are likely to see elevated domestic interest rates as investors demand higher protection for holding their debt (Kayizzi-Mugerwa and Birhanu Tessema, 2015).

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10 The IMF SDR basket constitutes its supplementary reserve assets; as of 1 October 2016, the RMB will be included (IMF, 2015b).

11 13 August 2015 was the most recent instance of this (Anderlini, 2015).

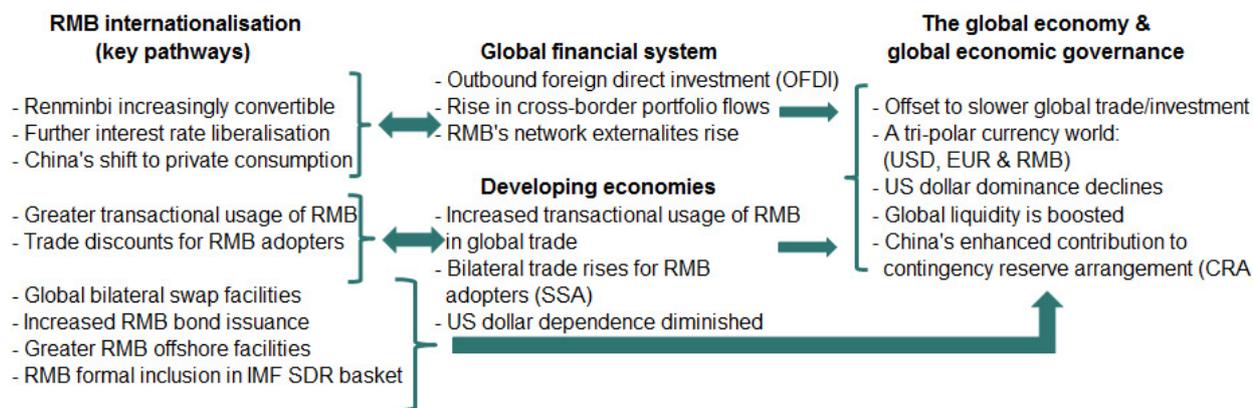
12 The FEER value of a currency when an economy is both at internal and external equilibrium, with internal equilibrium defined as the economy growing at potential and external equilibrium defined as having a sustainable current account (Williamson, 1999).

13 Cheung et al. (2007) found the RMB's persistent undervaluation depended on statistical methods used.

14 The Taylor rule is a rudimentary benchmark of where a policy rate should be based on the deviation of the economy's growth rate from potential and the deviation of inflation from its target. We follow the Taylor (1993) methodology and calculate China's Taylor rule using the following equation:  $r = p + 0.5 * y + 0.5 * (p - 2) + 2$  where  $r$  is the Taylor rule rate,  $p$  is the inflation rate and  $y$  is the deviation of growth from its potential, the output gap. There have been alternatives and proposed variations to this rule (BIS, 2015) to allow for the role of domestic financial imbalances in monetary policy.

15 In December 2015, the PBOC announced a new trade-weighted RMB index against 13 major trading partners, to offer a better gauge of the currency's relative strength beyond the RMB/US\$ rate (PBOC, 2015a).

**Figure 6. Key pathways and transmission mechanisms for RMB internationalisation**



Source: Overseas Development Institute.

## 2. RMB internationalisation, a global growth boon?

The effects of increases in trade and investment, after full RMB internationalization, could offset the global trade slowdown, a catalyst of sharper growth slowdowns, and a G20 concern (Papadavid 2015). China has already deployed its reserves in US treasuries and in foreign direct investment (FDI). The question is the degree to which this will continue, as it opens its financial system in the next years. We look at how the twin dynamic of offshore trading centres and greater RMB transactional usage could spur trade, portfolio investment flows and foreign direct investment, thus offsetting the slowdown witnessed in global trade (Figure 8).

China's FDI will be, in part, directed by its one-belt-one-road (OBOR) policy – where it has promoted economic partnership alongside its geopolitical relationships (Khan, 2015). China's share of world trade is still relatively small, at just under 10 percent. Developed nations, particularly the US, Germany, Hong Kong and Korea will continue to reap the lion's share of China's trade. And yet, RMB transactional usage will spur both trade and tip outward FDI to SSA. This is because of political (and regulatory) opposition to higher profile FDI and mergers and acquisitions: Chinese-US deals are twice as likely to fall through relative to the BRICS economies.<sup>16</sup>

### 2.1 RMB offshore centres a key catalyst

Offshore RMB centres are significant in that they will support global liquidity and financial intermediation,

offsetting the decline in cross-border financial flows (BIS, 2015). The current value of CNH offshore deposits, at CNY698.5 bn, is only a fraction of China's domestic deposit balance of CNY999.3 trillion. The largest 'testing ground' for China has been in Hong Kong since 2004.<sup>17</sup> Institutional and technical arrangements by foreign financial institutions to clear cross-border trade and investment transactions, through local RMB clearing banks, have made offshore business possible and are instrumental for currency internationalisation. Not only do they facilitate currency usage by non-residents, but also, Cheung (2015) highlights, they have exhibited economies of scale in doing so.

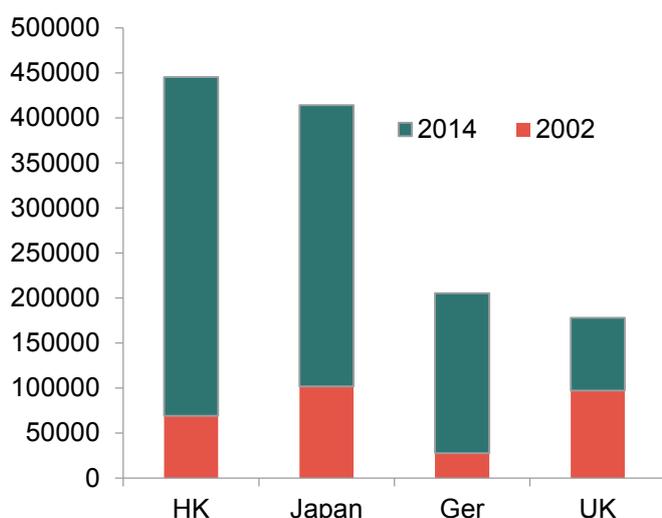
The RMB-denominated bond market is growing in terms of volume, liquidity and breadth (Shu et al., 2013), with the City of London playing a key role. Although London's financial centre already accounts for 46% of global offshore renminbi spot trading (SWIFT, 2011), its RMB offshore centres are a significant institutional development promoting RMB usage, through RMB-denominated bond issuance and trading. Global issuance of dim sum bonds rose sharply during 2007-2011, before leveling out at \$18 billion in 2012 and reaching \$45 bn in 2015 (FTSE Russell, 2015). In October 2014, the UK was the first Western country to successfully issue a RMB 3 billion (£300 million) RMB-denominated sovereign bond with a three-year maturity (HM Treasury, 2014).

Given that the UK holds its reserves only in US dollars, euros, yen and Canadian dollars, the UK's RMB bond issuance signals scope for the RMB's future reserve currency. UK-China bilateral trade is also likely to grow in

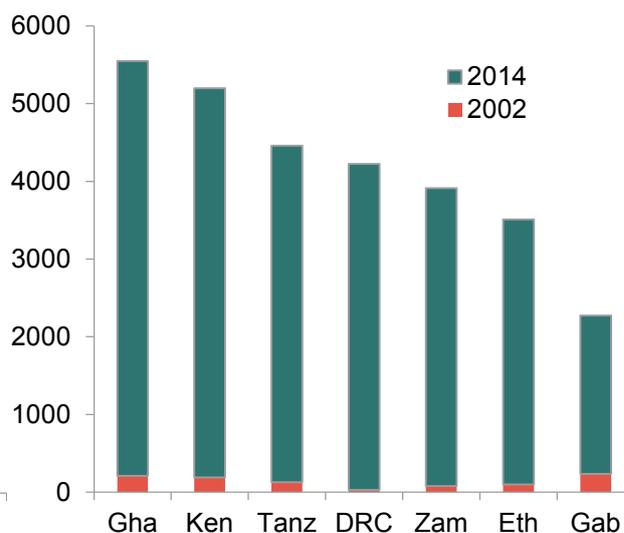
16 Some China-US deals have failed because of national security concerns in the US, which prompted US regulatory opposition to China National Offshore Oil Corporation's attempt to purchase Unocal in 2005 and Huawei's attempt to buy 3Leaf Systems in 2011 (Capron and Mitchell, 2015).

17 Hong Kong was the first offshore centre, given that it is an administrative region of China and it thus has greater flexibility and leverage/bargaining power in regulatory cooperation (Cheung, 2015).

**Figure 7. China–UK trade narrows (US\$ m)**



**Figure 8. China's SSA trade (US\$ m)**



Source: IMF Direction of Trade Statistics

light of Chancellor Osborne making trade a policy priority when announcing the RMB bond issuance: ‘Our long-term plan is working, but the job is not done. We need to export to fast growing economies like China, and attract more investment to our shores.’ These comments are perhaps a reflection of the fact that the UK is the only developed country of a trio including Germany and Japan that has not seen any improvement in its bilateral trade balance with China since 2002 (Figure 7).

Other institutional developments will also be important in supporting the RMB. An expansion of RMB bond issuance in China, by other governments, will increase liquidity significantly. Korea’s announced issuance of a Panda bond is an example of this (Hughes, 2015). Finally, broader acceptance and usage of the RMB is being supported by the PBOC as it expands local currency bilateral swap lines<sup>18</sup> to facilitate usage of RMB-denominated financial instruments. Twenty-five swap facilities have been established thus far, most recently at the Bank of England (Eichengreen and Kawai, 2015).

## 2.2 RMB’s transactional usage is rising

At just under 10%, China’s share of world trade is still relatively small. And yet, it has increased five-fold since the mid-1990s, according to Organisation for Economic Co-operation and Development (OECD) database. Liberalisation in goods trade is important. Among other things, it is a precursor to capital account liberalisation (Chinn and Ito, 2006). China’s continued – and changing

– contribution to world trade and investment could help mitigate emerging and developing economies’ ‘triple crisis’ of higher US interest rates, lower oil and commodity prices and its own growth transition (Papadavid, 2016).

China’s growth re-balancing to its consumer sector will have an impact on its net trade. Already, with private consumption growth having accelerated, it is likely that import demand will follow suit, despite the latter being far more volatile. Detailed splits of China’s growth figures – including the recently weaker 2015 report – suggest that the Chinese consumer is increasingly in the driver’s seat. The likelihood of import demand picking up is high. Areas that were once under state control, when it comes to housing and leisure, are now subject to people’s own control; increasingly people in China are able to shape these areas through the act of spending money (Yu, 2015).

RMB trade settlement has been an explicit trade promotion strategy: China has used its trade network to promote the use of the RMB on the global stage (Cheung, 2015). Offering corporations price concessions to use the RMB in their import, and export, transactions is an example of this, aimed at countering obstacles to RMB usage, such as through new guidelines for cash management, exchange rate risk management, fund transfers and banking facilities and other idiosyncratic factors (ibid.).

China’s strategy is starting to pay off. The value of RMB trade settlement has surged 30-fold: from CNY10 bn to CNY318 bn between 2010 and 2013. And yet, this

<sup>18</sup> A currency swap facility allows central banks to purchase currencies from one another, which facilitates banks’ usage of each currency in each relevant country; swap facilities are frequently used in times of financial crises (Eichengreen and Kawai, 2015).

still constitutes a small dent. as PBOC Governor Zhou Xiaochuan (IFF China Report Staff, 2015) noted, although growth in RMB usage in China's trade transactions has grown, its share in China's trade is still low. At 16.9%, the RMB's share as a percentage of China's trade is much less than the yen's 40% share in Japan's trade transactions and less than the euro's 50%-odd share in Eurozone trade transactions (Eichengreen and Kawai, 2015).

In SSA, the biggest transactional impact is mirrored in the accumulation of RMB reserves in central banks' coffers as a reflection of trade with China. Again, here too, the RMB's share in SSA central bank reserves is still outpaced by the US dollar and the euro. The magnitude of the China-SSA growing trade relationship suggests usage of the RMB will continue to grow, particularly once the RMB overcomes the US dollar's network externality – its incumbent benefit from being regularly used. Zimbabwe has adopted the RMB as legal tender (AFP, 2015), switching fully from the US dollar, in return for Chinese financial support to repay its debt (Hawkins, 2015).

Both the Bank of Ghana and the Central Bank of Nigeria have announced they will shift more foreign reserves into RMB given that their trade with China has grown by several orders of magnitude over the past decade (Figure 8). Additionally, the South African Reserve Bank has signed an agreement with the PBOC to invest in the RMB bond market. The list is growing: Zambia has pledged to increase its use for trade settlements with China; and Kenyan President Uhuru Kenyatta promised to host an RMB clearing house, to settle trading accounts, clear trades, and to regulate and report trading data for its futures market. And, much like their developed country counterparts, SSA central banks are applying to establish bilateral swap facilities to better facilitate RMB usage (Eichengreen and Kawai, 2015; Hawkins, 2015).

Developed country central banks are also accumulating RMB reserves, but for slightly different reasons. Whereas developing central banks' RMB reserves are growing because of their growing trade relationships with China, their developed counterparts are showing interest in RMB-denominated assets, even before full capital account liberalisation, for strategic reasons such as yield advantage and portfolio diversification (Papadavid, 2014). Given this, the RMB could see increased prominence in central bank reserves with only basic capital account convertibility, although this is likely to be the case only in central banks with reserves in excess of requirements for basic functions (Eichengreen and Kawai, 2015). IMF Currency Composition of Official Foreign Exchange Reserves data have suggested a shift to non-traditional reserve currencies.

## 2.3 China's catalytic investments

China's outbound FDI is likely to soon exceed its inbound FDI, with Europe a particular beneficiary, though the treatment of cross-border flows with Hong Kong makes this determination difficult (Garcia-Herrero, 2015). To be sure, policies are in place to increase China's FDI. The privatisation of its state-owned enterprises, regulatory changes promoting further outbound FDI, and implementation of its 'going global' strategy (launched by the Ministry of Commerce in 2015) will be key in boosting overseas FDI.

The US, Europe, India and China see the highest FDI into SSA. Although FDI growth from most countries has remained solid, or in Europe's case, flat-lined (OECD 2015), China has diverged. FDI flows from China to Africa hit an annualized compound growth rate of 47.8%; investment is also shifting out of the traditional extractive industries to Africa's manufacturing sector (Chen et. al. 2015). Recently, China tripled its investments into SSA to \$60 bn, when President Xi Jinping attended the Forum on China–Africa Cooperation (FOCAC) in Johannesburg (Sun, 2015).<sup>19</sup> China has also signed investment deals with India (\$22 bn) and Pakistan (\$46 bn) (Xinhuanet, 2015). Earlier in 2015, UK Prime Minister Cameron, too, heralded a 'golden age' in UK–China relations

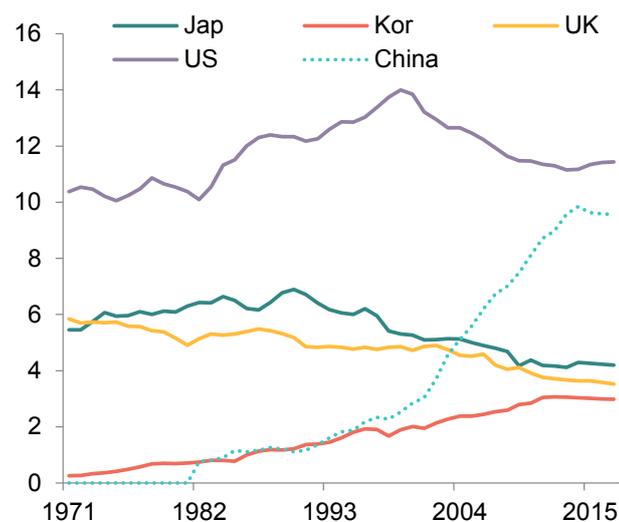
Looking ahead, the quality of outward FDI is set to improve. This is only if China succeeds in rebalancing its growth. If it undertakes reforms to increase its potential output, increased productivity will lead to affordable exports. And, if consumer demand (and wages) are stimulated, cost considerations will both drive manufacturing production to SSA and generate employment in SSA (Anderson et al., 2015).<sup>20</sup> Investment in SSA has continued to grow despite China's growth slowdown, unlike in developed economies; Africa's trade with China is expected to reach \$385 bn by the end of 2015 (Chen et. al. 2015). Increased investment will further spur demand, and a market, for RMB settlements. These are now expensive as transactions have to be first settled in US dollars.

China's SSA investments are becoming more diversified. Recent announcements reflect a broader investment involvement beyond natural resources; at the recent FOCAC meeting, little mention was made of resource-related investments in SSA, which have dominated in the past (Sun, 2015). This suggests Chinese FDI that will become increasingly complementary to local industry rather than extractive (Kaplinsky et al., 2008), although case studies in Rwanda and the Democratic Republic of Congo raise doubts about the degree to which this can occur in certain countries (IDS, 2015).

19 The commitment announced in South Africa is distinct from annual FDI figures in that it is over a multi-year period and includes concessional aid.

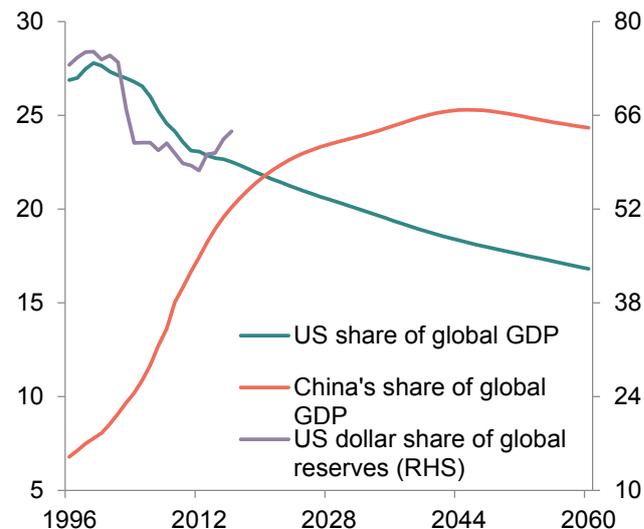
20 A 'relocation' scenario is assumed to fully materialise over 10 years in the model employed by Anderson et. al (2015), with relatively large gains for smaller SSA economies and benefits for the SSA region as a whole.

**Figure 9: Shares of global trade**



Source: OECD

**Figure 10: US and China 2060 outlook**



### 3. China's objective – a tripolar currency world

Steadiness and success in China's liberalization is necessary in assessing the suitability of whether the RMB should sit alongside the US dollar and the euro as reserve currency. And yet, this is not sufficient. Reserve currency status does not simply result from successful liberalisation. China must achieve critical mass in the depth and breadth of its financial instruments so that transactions into and out of RMB-denominated assets are easy and cost effective. And it needs to do so to the degree that it dents the US dollar's advantage as the most used global currency. This takes time. In doing so, the RMB will have established itself as a new reliable store of value, with RMB denominated assets denominated held by both the private and by the public sector (Chinn and Frankel, 2005).

The degree to which the RMB rivals the US dollar and the euro will ultimately be a reflection of China's long-term economic strength. This will then drive the long-term usage and trading of the RMB, beyond simply whether the currency is technically 'freely usable' or convertible. On the basis of its expected economic size, and that of its financial sector, there is scope for the RMB to sit alongside the US dollar and the euro, resulting in a tripolar currency world (ECB, 2013; Papadavid, 2015). This will influence the degree to which other currencies choose to peg to it, making it an 'anchor currency' (Meissner and Oomes, 2008).

China is set to grow in its economic dominance, overtaking the US in size by 2020 (OECD, 2012).<sup>21</sup> Its share of global trade has tripled over the past decade

(Figure 9). The RMB's importance is also likely to grow when considering long-term projections for China's share of global GDP and its share of global trade. Both shares provide good gauges of currency dominance (ECB, 2013). The US share of global GDP, alongside global US dollar reserve holdings, has been on a downtrend; China's share of global GDP is expected to surpass that of the US in 2020 (OECD, 2012), suggesting an important global role for the RMB (Figure 10).

Geopolitical shifts diverting economic clout away from western economies (OECD, 2012) could also bolster the RMB's global status. The US dollar's experience has shown that institutional power is a game changer for reserve currency status. The Bretton Woods institutions proved crucial for the US dollar (Eichengreen, 2013). The new multilateral institutions, such as the New Development Bank (previously known as the BRICS Development Bank) and the Asian Infrastructural Investment Bank could provide the same foundation for the RMB if they catalyse investment and enable emerging powers to divert resources away from the IMF (Hou et al., 2014b).

Ultimately, China's financial strength and openness will be one of the most important barometers of the RMB's staying power as a global currency. China has the institutional machinery in place yet has further work to do. The size of its financial sector is growing: its gross external assets plus its liabilities now greater than 100% of GDP (Prasad, 2015). However, its outbound FDI is still less than 2% of GDP, according to the World Bank, and it has yet to globalize its financial system alongside its developed country counterparts (Chinn and Ito, 2006).

21 Figures are measured in constant purchasing power parity (PPP).

22 An offshore currency market specialises in transactions of products not issued by that market and serves a large non-resident population (Cheung, 2015).

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## 4. Conclusions

China has an opportunity. If the sequencing, steadiness and transparency of its liberalisation are successful, its integration into the global financial system over the next few years will be a boon for the global economy and the global financial system. In this paper, the hope was to highlight the importance of China's balancing act: balancing its liberalization, or opening of its financial sector, with its deepening. Liberalisation alone would introduce continued volatility and instability in China's financial system. So this balance is key in protecting against a currency – or broader financial crisis.

In examining its financial liberalization, there is evidence that China's offshore trading centres<sup>22</sup> and greater RMB transactional usage could spur outbound portfolio and foreign direct investment. This is particularly beneficial for the global economy given the headwinds stemming from a higher US dollar and for, oil exporters, lower oil prices. China's liberalization will be beneficial in this sense. But this will have been a pipe dream if it does not successfully re-balance and support domestic consumption growth.

Ultimately, the culmination of China's success in integrating successfully into the global financial system will be the degree to which the RMB becomes internationalised, rivaling the usage of the US dollar and the euro as a global reserve currency. It is too soon to make this judgment,

given the amount of institutional and economic work that remains to be done. Anecdotal evidence suggests there is significant interest in both the transactional usage of the RMB and its accumulation in central banks' reserves – as a reflection of trade relationships and as a strategic priority in portfolio investments.

Under its current leadership of the G20, it is more likely that China will sequence and communicate its policies in a transparent way, given its stated objective of leading a new type of global economic governance (Greenhill et al., 2015). China should take the lead in promoting both economic transformation and global economic governance through including non-G20 countries in a G20–low-income country hub, as suggested by te Velde (2012).

A speculative policy suggestion is the creation of an enhanced shock facility, drawing in part from its significant reserves – this would be a welcome policy move in light of the current global financial risks. An increased institutional presence through new contingency reserve arrangements (CRAs), or shock facilities, will bolster the regional and global influence of China in particular. The scope for extended CRAs, beyond those established by the Chiang Mai CRA (Hou et al., 2014a), is vast given the scope of China's foreign exchange reserves. A policy move in this direction will be game-changing in consolidating China's lender of last resort power and diminishing global dependence on dollar liquidity in times of crisis.

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22 An offshore currency market specialises in transactions of products not issued by that market and serves a large non-resident population (Cheung, 2015).

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