China’s Growing Financial Muscle

Renminbi Rising: A New Global Monetary System Emerges
By William H. Overholt, Guonan Ma and Cheung Kwok Law
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Reviewed by Hongying Wang

THE RAPID RISE of the Chinese renminbi (RMB) as an international currency has attracted enormous attention from scholars, policy analysts and the global financial community in recent years. In this new book, three leading economic experts affiliated with the Fung Global Institute in Hong Kong take the study of this important topic further, adding new insights into the drivers, progress and future prospects for RMB internationalization. The book covers a wide range of issues in great detail.

As the authors make clear, the internationalization of the Chinese currency has been a consequence of converging trends in the Chinese economy and the international financial system, including domestic reform in China and the growing problems with the Bretton Woods institutions. They argue that the future trajectory of the RMB as an international currency will continue to be shaped by these trends. In particular, they focus on three conditions for China to become the issuer of a global currency — liberalizing its financial system, developing capable and credible institutions, and deepening capital markets.

First, in contrast to many studies that stress the foreign-policy motivations behind Beijing’s push for RMB internationalization — for example, enhancing China’s economic and political influence in the region and reducing the domination of the United States in the international financial system — this book emphasizes the connection between RMB internationalization and the transformation of China’s domestic economy. According to the authors, after three decades of high growth rates, China now faces substantial challenges in changing the engines driving its economy. Instead of relying on investment, exports and state-owned enterprises, it must in the future rely more on domestic consumption, innovation and small- and medium-sized — mostly private — enterprises. This will require a more market-driven financial system and more efficient allocation of financial resources. The Chinese government has accelerated financial reform in order to sustain economic growth, including significant progress in liberalizing interest rates, loosening control of exchange rates, and reducing capital controls. These reforms are exactly what RMB internationalization requires. From this perspective, the needs of the real economy are driving the kinds of financial reforms necessary for internationalizing the Chinese currency. And as the RMB becomes more internationalized, it in turn will facilitate further financial liberalization and economic growth, forming what the authors call a “virtuous circle of reforms.”

This book expresses considerable optimism about the prospects for further financial reforms that will enable the RMB to gain a greater international role. This optimism may be justified, but it may not be. As the authors acknowledge, further financial liberalization is politically difficult because it threatens the vested interest of those sectors and groups benefitting from the old economic growth model. The authors seem quite confident that reforms will forge ahead, pointing to the new leadership’s demonstrated ability to implement major change. The assumption is that the leaders are determined to carry out the necessary reforms. They go so far as to assert that “to impose politically difficult reforms, it has streamlined its top leadership and wielded an anti-corruption campaign.” Such a view of the political priority of the leadership and the logic of the anti-corruption campaign is quite different from the observations of many existing studies and reports. Since it is central to the book’s prognosis of the trajectory of RMB internationalization, it needs to be better substantiated.

Second, the book offers a rich and thoughtiful treatment of the institutional foundations of RMB internationalization. Numerous studies have noted that unlike previous global currency issuers (mainly Britain and the United States), China does not have a democratic political system and a strong system of rule of law. This, they argue, poses a serious obstacle for the Chinese currency to achieve a truly global status. After all, investors hesitate to hold the currency of a country that does not have strong legal protection of property rights and falls short in providing fair and transparent dispute settlement. The authors readily agree with this general observation, but go far beyond it. They offer a detailed analysis of the quality of specific institutions, particularly the People’s Bank of China (PBOC), the country’s central bank.

As the book points out, a central bank issuing a major international currency has to be credible and trusted. It compares the Chinese central bank with the central banks behind other global currencies, especially the US Federal Reserve and the European Central Bank (ECB). It contends that as a relatively new institution, the PBOC does not have the experience of the Fed, nor has it had time to develop the reputation the Fed has. But in the long run, the Chinese central bank has certain advantages over the ECB, because it does not have to deal with the competing sovereign interests faced by the latter. The book examines the record of the PBOC in controlling inflation, maintaining the value of the RMB, preventing financial crises and preserving financial stability. It shows that

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the PBOC has reached a relatively high level of maturity, and compares favorably with the central banks of other emerging economies. Looking ahead, the authors recommend that the Chinese central bank should move to a more market-based monetary policy regime, improve its communications with the investors, and be more transparent with financial data.

The case of the PBOC is quite intriguing. Conventional wisdom stipulates that central bank independence is crucial to its credibility. If a central bank follows the political needs and preferences of the political party in power, its monetary policy is likely to be unpredictable and unsound. As the authors of this book admit, the Chinese central bank lacks independence from the Chinese government (for example, important monetary decisions need to be approved by the State Council, China’s cabinet). However, it has been able to manage monetary policy quite well. This book credits the PBOC with being highly professional and reform-oriented, but does not provide an in-depth analysis of why a politically-controlled central bank has performed so well so far, or if this factor will constrain its future as a credible and trusted issuer of a major global currency. It is an important and interesting question awaiting further studies.

Third, China’s lack of deep and sophisticated capital markets is widely seen as a major obstacle for the country to play a more prominent role in international finance, including having its currency act as a global currency. This book provides a careful and informative analysis of China’s financial markets, with a special focus on the bond market. It shows that although China’s overall leverage of government, corporations and households is quite high, at around 250 percent of gross domestic product (GDP), its bond market is very small. About one-tenth of the size of the US bond market, it ranks the lowest among the world’s top ten bond markets in relation to GDP. Moreover, the Chinese bond market is fragmented, falling under different regulators. Meanwhile, China’s stock market is plagued by fundamental flaws, as shown by the recent turmoil and the government’s poor response. The banking sector, which accounts for the largest share of RMB financial assets globally, is still largely closed to foreign participants, with foreign banks accounting for only 2 percent of bank loans and deposits.

The authors urge China to expand its bond market, especially by increasing the size of the market for Chinese government bonds (CGBs) and making them more accessible to foreign investors. They believe that bold policy initiatives can lift CGBs to the top third of global treasuries markets and make foreign holdings of CGBs twice the projected size of offshore RMB-denominated bonds by 2020. The economic analysis is based on abundant data and insightful comparisons with other financial markets. What is missing is a sophisticated political analysis of the development (or lack thereof) of China’s capital markets. Why has the banking sector been so dominant in China’s financial system? Who stands to lose from a bigger, more integrated and better regulated bond market and stock market? What ideological and strategic considerations have hindered reform in this area? Without a clear answer to these questions, estimates of the size and shape of China’s capital markets in the future can be quite shaky.

Besides the arguments discussed above, the book explores many other fascinating issues, for example, the role of Hong Kong and other offshore RMB centers in the internationalization of the Chinese currency, the impact of the New Development Bank, the Asian Infrastructure Investment Bank and the Silk Road Fund on RMB internationalization, the effect of the RMB’s entry into the IMF’s basket of Special Drawing Rights on its status as a reserve currency, and the utility of the Shanghai Free Trade Zone in internationalizing the Chinese currency. The space limit of this review does not allow me to engage the authors’ often insightful and sometimes controversial views on these issues.

Overall, Renminbi Rising is a timely, comprehensive and nuanced examination of the progress and prospects for the internationalization of China’s currency. It makes a significant contribution to our understanding of China’s changing role in the international financial system.

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