

THE ROLE OF THE RENMINBI IN THE WORLD ECONOMY

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As China's economy has continued its remarkable expansion and gained an increasingly important role in the global economy, China's currency, the renminbi (RMB), has also captured growing attention from investors and policymakers around the world. In this article, I briefly discuss three significant issues concerning the renminbi—namely, the near-term direction of the exchange rate, the renminbi's convertibility in the medium term, and the currency's international role down the road in the future.

Exchange Rate Outlook

On July 21, 2005, China embarked on long-awaited currency reforms toward the goal of greater exchange rate flexibility. Since then the renminbi's annual nominal appreciation has averaged about 5 percent against the U.S. dollar. On a trade-weighted basis, however, the appreciation of the renminbi has been almost negligible.

What will happen next? On the one hand, the Chinese authorities remain cautious toward fast-paced and substantial currency strengthening. On the other hand, it is also clear that pressures are continuing to build—both at home and abroad—for far more pronounced renminbi appreciation. Domestically, China faces rising inflationary pressures and equally worrisome, rapidly developing equity and property bubbles. At the same time, rebalancing requires tighter

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macroeconomic policies and expenditure switching from net exports and fixed investment to private consumption.

First, let us take a quick review of key developments in China's domestic economy. Needless to say, the economy has been extremely buoyant, with real GDP growth averaging more than 11 percent for the last several quarters. Rapid credit expansion, fast growth in fixed investment, torrid pace in net exports, and an overheated property sector all present flash signs about the risk of overheating in China's economy. CPI inflation was zero or even slightly negative just a few years ago, but has since rapidly picked up, approaching high single digit levels, according to the official measures. I suspect the official inflation statistic has probably underestimated the true extent of inflation, because of a variety of measurement problems. For instance, the official CPI index does a rather poor job in capturing price increases in the rapidly expanding service sectors, such as health care, education, transportation, and housing-related services. Furthermore, continued government price controls and subsidies on crucial fuel and energy items distort the official CPI index. Regardless of the precise measure of the rate of inflation, there seems little doubt that there are rising inflationary pressures in the Chinese economy.

Equally worrisome are the sizzling equity and property markets in China. Judging from the price-earnings ratio, the Chinese domestic stock market, mainly consisting of the renminbi denominated shares or the so-called A shares that are listed and traded in Shanghai and Shenzhen exchanges, is now the most richly valued market in the world. And rampant liquidity inflows and speculative frenzies continue to push the stock market to ever higher, unsustainable levels. Any observer who has been following the breathtaking surge in Chinese equity prices and housing prices would see an asset price bubble in full display.

The People's Bank of China has in general done a very good job in managing these difficult issues. In addition to sustained moral pressures on banks to restrain lending through "window guidance," the central bank has hiked interest rates and, far more aggressively, increased reserve management on bank deposits. But the risks of both consumer and asset price inflation remain largely unabated.

At the same time China's external trade and current account surpluses have continued to balloon. The current account surplus

exceeded 9 percent of GDP in 2006, and increased to more than 11 percent in 2007. What is unique about China's current account is neither the surplus nor its persistence, but its magnitude, especially in relation to its GDP. If we look back over the post-World War II period there are a few countries, typically small open economies like Singapore and Malaysia, that have managed to record current account surpluses above 10 percent of GDP in some years. But large economies tend to run much smaller current account balances relative to GDP. Germany has always been known as a very strong exporter and has been running a persistent current account surplus for decades. But the average German current account surplus has amounted to about 3–4 percent of GDP at its peak, and Japan's current account surplus has been more like 2 percent of GDP on average. By contrast, China's current account surplus at more than 10 percent of GDP is unprecedented.

In addition, China has seen large capital inflows on the back of the country's economic fundamentals. Strong capital inflows have further exacerbated the challenge for the PBOC to exercise effective monetary control while trying to maintain the stability of the RMB nominal exchange rate.

China's large trade surpluses have irritated major trading partners, particularly the United States and the European Union, and sparked protectionist backlash against China. And the value of the renminbi has become a lightning rod for many critics of China. The U.S. Congress continues to threaten imposition of punitive tariffs against China if the renminbi should fail to appreciate sharply vis-à-vis the U.S. dollar. Unhappy that the euro seems to have born the brunt for global adjustment, the European Union has also turned heat on the Chinese currency. While the exchange rate is not the root cause for China's current account surplus, which mainly reflects China's domestic savings-investment gap, there is a fair amount of consensus that the exchange rate ought to be a key component of a broad policy package for rebalancing the global economy.

Therefore, the same kind of economic pressures that prompted the Chinese government to widen the trading band for the RMB in July 2005 have persisted, and in fact have intensified. The Chinese authorities are expected to resist such pressures for as long as possible on the grounds of export competitiveness. But worrisome developments on broad fronts, especially rising inflation, may force the

Chinese policymakers to relax their grip on the renminbi. A reasonable baseline case is that the RMB will appreciate by 10 percent or more against the dollar in the coming 12 months on the back of intensifying domestic and external pressures.

Currency Convertibility

China achieved convertibility for the RMB under the current account in December 1996. However, the original policy goal of achieving capital account convertibility by 2000 has been quietly abandoned, in part due to the intellectual backlash against the idea of free capital mobility in the aftermath of the Asian Crisis in 1997–98.

Practically speaking, a major hurdle for lifting capital controls in China has always been its fragile financial system, especially its troubled banking sector. However, since 2003 China has undertaken a sweeping reform program to restructure and rehabilitate its banking sector, with remarkable success. In terms of capital adequacy, asset quality, and profitability, China's banks have shown a dramatic turnaround. As a result, public and investor confidence has soared. And China now boasts three out of the world's 10 largest banks in terms of stock market capitalization, with ICBC overtaking Citigroup as the world's most valuable bank.

As Chinese banks continue to make progress in internal control, IT, and risk management, and the CBRC, the Chinese bank regulator, continues to improve prudential regulation and supervision, the conditions for liberalization of the capital account are gradually in place.

China has introduced QFII and QDII programs as carefully controlled experiments to allow greater two-way cross-border portfolio investment flows. With the rapid development of domestic capital markets, and the growing need for the fast-growing Chinese economy to be more fully integrated with the global economy, it seems that China is increasingly ready to lift the remaining controls over cross-border capital movement. Perhaps in another five years, the renminbi will become a freely convertible currency. Given the increasing size and global impact of the Chinese economy, a freely convertible renminbi will likely rapidly gain prominence in world trade and finance.

The Renminbi as an International Currency

The internationalization of a currency depends on a host of factors—the size of the country's economy and its relative share in the world output, its growth performance, its openness to external trade and investment, the state of developments of its financial markets, the degree of convertibility, and the credibility of macroeconomic policies.

China by now has become a major player in the world economy. In terms of economic size, China's GDP had reached \$2.7 trillion in 2006, compared to \$13.2 trillion in the United States, \$10.5 trillion in the European Union, and \$4.3 trillion in Japan. Just for comparison, the numbers on a purchasing power parity basis are \$7.6 trillion, \$11.6 trillion, \$8.7 trillion, and \$3.7 trillion for China, the United States, the European Union, and Japan, respectively. In 2006, China's foreign trade stood at \$1.8 trillion, versus \$3.0 trillion, \$6.8 trillion, and \$1.2 trillion for the United States, the European Union, and Japan, respectively. It is worth noting that, with a trade/GDP ratio of 66 percent, China is the world's most open major economy, compared to the corresponding ratio of 22 percent, 64 percent, and 28 percent for the United States, the European Union, and Japan, respectively.

China has also made significant progress in developing its financial system in recent years. As an emerging economy, China is already one of the world's largest players in the stock market, government bond market, and the monetary and banking system. However, the lack of a fully convertible currency and the semi-closed domestic financial markets have greatly limited China's importance in global financial flows.

To date the U.S. dollar remains the most popular and dominant currency in global trade and financial markets. It accounts for 64 percent of the world's international reserves. The euro follows with 26 percent of the global reserves. Currently the renminbi has been insignificant as a reserve currency, although a growing number of China's trading partners, especially in neighboring Asian countries and other emerging economies, have become increasingly comfortable holding the RMB as part of their official foreign reserve assets. Clearly, the key-limiting factor for the renminbi's international role is its lack of convertibility under the capital account.

Based on our simulation model, the convertible RMB will likely account for 15–20 percent of international reserves by 2020. As China continues its strong economic expansion, and succeeds in developing and liberalizing its financial system, including achieving the RMB's full convertibility, it can be predicted that the Chinese currency will join the U.S. dollar, the euro, and the Japanese yen as one of the leading global currencies.