Internationalisation of the Renminbi

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The People's Money: How China Is Building a Global Currency by Paola Subacchi, *New York: Columbia University Press, 2016; pp xii+237 ₹1,884.*

This book gives an account of the Chinese government's strategy of internationalisation of the renminbi, which in Chinese literally means "the currency of the people," as echoed in the title of the book. The book is based on the analysis of official documents, formal and informal discussions with government officials and the analysis of secondary literature. It is intended for a general audience, beyond academic economists. The book is extremely readable and provides an informative overview about the topic, including contemporary historical background. At the same time, it poses important theoretical problems for the analysis of foreign exchange policy in general, and of Chinese foreign exchange policy in particular, that it is important to address because they are found elsewhere in this kind of research.

The book helps readers situate the internationalisation of the Chinese currency in the outstanding contemporary history of Chinese GDP (gross domestic product) growth. Chinese GDP is today, the world's second biggest after the United States (US). The country is the leading trading partner for 124 countries and the so-called slowdown in GDP annual growth situates it still above 6%. The book describes how this is the result of policies of "reform and opening up" started after the end of the Cultural Revolution, during the leadership of Deng Xiaoping, in particular, during the 1980s. These reforms have been marked by a gradualism often epitomised by the expression, taken up as a subtitle in Chapter 6, of "crossing the river by feeling the stones," whereby a mid- and long-term strategy of expansion of market mechanisms in economic organisation is carried out by pragmatic implementation. Policies are implemented and, as long as they provide stable growth and profits, they are allowed to develop, whereas they can be reverted otherwise.

Exchange Rate Policy

The book is organised around the fact (which the author finds paradoxical), that the rise of China in global trade and the global institutional recognition of the renminbi is not matched by an important share of the currency in global transactions. The book describes how, in 35 years, the renminbi went from being virtually inconvertible to becoming one of the few institutionally recognised global currencies. Between 1949 and 1981, the Chinese government directly determined the exchange rate, keeping the renminbi high enough to prevent imports from challenging domestic manufacturing. This policy changed in 1981, and since then, although exchange rate is still controlled by the People's Bank of China, it has gone through different forms of managed convertibility. Between 1981 and 1994, several devaluations were carried out, giving more weight to the interests of exporters. Between 1994 and 2005, the renminbi was virtually pegged to the US dollar at a fixed rate. This peg shifted to a basket of currencies until 2008, then back to the US dollar until 2010, and then again to a currency basket since then. In 2014, the band of fluctuation around the exchange rate target set by the central bank was slightly widened, to an intraday 2% upward or downward movement. The book describes the mechanisms whereby the capital account is effectively restricted, as inflows and outflows of money need to obtain licences and be approved by governmental agencies, while the banking system remains under the firm control of the central bank. In the past, the US government in particular, recurrently accused the Chinese government of undervaluing its currency to boost exports, but the weakening of the currency since 2014, when the broader fluctuation band was established, the capital flight of 2015 and the variability of China's current account surplus in the last few years have neutralised that argument. The International Monetary Fund (IMF) has thus recently considered that the currency was not considerably mispriced, and in December 2015, the renminbi entered the small number of currencies that compose the institution's Special Drawing Right basket.

The author describes the fact that the renminbi's share in global transactions is smaller than what this institutional recognition could suggest. China's position as the world's first exporter is based on the US dollar, as the renminbi accounts for only 2% of global payments. The Chinese government does not want to replace the US dollar with the renminbi, but challenges its hegemony by proposing a transformation towards a multi-currency system. With that aim in mind, the internationalisation of the renminbi is being pursued gradually through several policies. Control of the capital account has aimed at easing inflows and outflows of money, in particular as foreign direct investment has been favoured, not so much for need of capital, but because it implied a transfer of technologies and skill. At the same time, two major policies have been directed at contributing to the use of the renminbi in exchanges abroad. One consists in establishing offshore exchange centres, where foreign institutions can exchange the currency with Chinese banks. The other consists in a series of currency swap agreements with trading partners, establishing a mechanism for the payment of imports and exports without using the US dollar.

The author counts 12 offshore centres, mainly in Europe and the Asia–Pacific region, and swap agreements for a nominal 2, 3 trillion renminbi. Yet, the small successes of these policies remain regional. Today, foreign invested joint ventures account for 28% of industrial output. Hong Kong, legally part of Chinese territory but with a different legal and political system, remains the only offshore centre with consistent activity. Swap agreements have barely been used. And if the part of renminbi in global trade is minimal, it accounts for 20% of invoices of Chinese imports and exports (the amount was 0% in 2009), even though this does not mean that actual price setting has not been made in another currency. The creation of new free trade zones in Chinese territory, the One Belt One Road initiative, and the creation of the Asian Infrastructure Investment Bank are potentially future developments of this internationalisation strategy.

The author remarks that the Chinese government's strategy of internationalisation of the renminbi focuses primarily on foreign exchange's effects on domestic economic processes. This part of the analysis is nevertheless given less weight in the book. The author describes how the state-owned banking system orients credit mostly to policy-determined infrastructure projects carried out by state-owned enterprises. Regulatory limitation of financial outflows keeps particularly high middle-class savings captive of the domestic financial system. Bank deposit and lending rates have been fixed by government for decades, with a considerable spread offering the banking system steady profits. Relatively low interest rates indirectly taxed savers with little options on where to put their money, besides real estate and shadow banking schemes that are themselves partly connected to the banking system. The situation has not changed much with the recent elimination of the limits on banking rates, and the system still combines credit orientation by the government, control of the monetary policy for internal aims and a stable exchange rate based on a strongly controlled capital account. Yet, the book does not explore in depth the multiple objectives of this policy, beyond the assertion repeated several times by the author that the aim is keep to exports cheap. The depreciation of the renminbi in recent years and the assertions even by the IMF that it is not undervalued should by themselves imply that other factors than cheap exports and manipulated undervaluation be taken seriously in the analysis of government policy. This is unfortunately not much the case in the book, a limitation that can be in great part attributed to the theoretical frame chosen by the author. This frame presents two major problems that deserve particular attention because they are not unique to this book, and can be encountered in many journalistic and academic analyses of Chinese government policy, even beyond the issue of renminbi internationalisation.

Theoretical Assumptions

The first problematic theoretical assumption, based on neoclassical economics, is that foreign exchange market liberalisation, defined by a fully open capital account, leads to an optimal allocation of resources that can only be damaged by government intervention. The author repeats the classic vocabulary of this frame, considering Chinese foreign exchange policy "inefficient" (p 33), where "vested interests and powerful groups" (p 157), and "social and political control" that prevent "sound investment" (p 2) lead to "misallocation" of capital and resources (pp 27, 51), and "distortions" (p 156), as an "excessive gradualism" (p 186) prevents the reforms that would save it from all these ills. These assertions about inefficiency and misallocation could deserve some qualification, given that Chinese

GDP growth, wealth accumulation, and redistribution and poverty reduction in the last 40 years are totally unprecedented, even taking into account obvious allocation mistakes, extremely high inequality, environmental damage and growing indebtedness. But even more problematic is the assertion that all the policy on foreign exchange must be evaluated positively or negatively depending on whether it approaches or not a fully open capital account. The author here holds a contradictory position. Acknowledging that, quite explicitly, this is not the aim of the Chinese government, and that even the IMF now recognises the benefits of government intervention in foreign exchange (p 169), the author still asserts that less intervention would translate by "economic fundamentals, such as growth, inflation and the country's external balance" (p 164) having a bigger influence on the currency, and that "if the renminbi became a fully floating currency, it would quickly reach its equilibrium level and would achieve two-way flexibility around this central parity, without the need for further intervention and foreign reserve accumulation" (p 166). Yet, it is a well-known feature of foreign exchange that prices are much more related to multiple rationales of financial flows than to trade volumes or macroeconomic aggregate indicators, making it almost impossible to define what "fundamentals" they would ever reflect (Eichengreen 1996).

This point has actually been a recurrent argument of the Chinese government, claiming that exchange rate management actually has kept the renminbi overvalued. This argument asserts that with a fully open capital account the currency, which has very small trading volumes, would have been prone to very high volatility due to speculative movements, which would have translated into a high "risk premium" lowering its average exchange rate. Proving that a currency is undervalued or overvalued is actually very difficult, if not impossible, and is therefore, always the object of controversy. While Chinese GDP growth has, of course, been based on exports, the analysis should also take into account not only that China is also a major importer, but also, that for a country with such an exposure to international trade, foreign exchange stability is paramount, and that it is therefore a crucial policy for the stability of the domestic economy and financial system. Thus, in the book, the neoclassical theoretical frame obscures the analysis of the connection between foreign exchange policy and domestic economic objectives.

Contradictory Hypotheses

A related problem is that, in a loose teleological fashion, the author constantly compares China to what she calls "advanced countries," in particular the US, the United Kingdom (UK) and Japan, from which the author derives models about "how economies develop and modernise" (pp 35–36). This implies two unwarranted and partly contradictory hypotheses (Kirshner 2003). The first one is that there would be a mechanistic evolution of social bundles, defined as "nations" or "countries" (p 11) that would all follow the same path. The second is that the model of development is one in which "maturity" (p 89) and the "normal" (p 167) is reached once the neoclassical frame of free markets is realised. This allows, for instance, mixing a moral and technical appreciation of the renminbi as an "immature" currency because the country does not lend in its own currency (p 89). This of course runs against the fact that the standards of comparison, in particular the UK pound and the US dollar, did not reach their hegemonic position simply through market freedom, however defined, but based on colonial expansion and war. In this case, again, the author takes a contradictory position. After chastising Chinese government policy for not approaching fast enough the idealised "advanced" countries, the author remarks that China "is rewriting history," and that it cannot be assessed by any existing model, because of its unprecedented transformation and its mixture of markets and government planning (p 188).

The theory of money used by the author is marked by the same instability, which both asserts and undermines neoclassic economics. On the one hand, within the neoclassical frame, the author considers that money is a simple tool that can be assessed by how well it performs the canonical three functions of being a means of exchange, a means of valuation and a store of value, within a particular geographical expansion (pp 174–77). On the other, the author recognises that money, as fiat money based on state power within a nationalist frame (p 13), is intimately connected to identity (p 2) and geopolitical relations (pp 2, 177). Yet, the author leaves these latter elements out of the analysis, just like she does with what she designates, without further scrutiny, as the other factors affecting foreign exchange: "habits, network externalities, inertia" (p 19).

More generally, the limitation of the analysis within narratives of neoclassic economics leaves many macroeconomic processes unaddressed, such as, for instance, the importance of state investment in infrastructure whose long-term social rewards make it unviable for short-term profit-oriented companies, and in general the structural aspects of the combination of market mechanisms and state intervention in Chinese government economic policy in the last 40 years (Lin 2012).

As the author acknowledges at the end of the book, its frame of analysis is actually inadequate for the object of study. The theoretical difficulties highlighted above are not unique to this book, but are on the contrary typical of analyses that retain the neoclassic economics model of market efficiency to assess China, and not only China. This does not diminish the quality and clarity of the empirical data presented by the author, which make this a very informative book on the contemporary history and the current orientation of foreign exchange policy in China.

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