



Transcript of IMF podcast with Eswar Prasad: "The Curious Rise of the Renminbi"

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MR. EDWARDS: Hello. I'm Bruce Edwards, and welcome to this podcast produced by the International Monetary Fund. In this program, Eswar Prasad, on the remarkable rise of the renminbi.

MR. PRASAD [Soundbite]: *"China is now the second largest economy in the world, so by all the rights, the renminbi should be an important global currency. But the renminbi is just in the initial stages of making its presence felt on the international stage."*

MR. EDWARDS: As China's economy catches up in size with that of the United States, some predict the renminbi will soon challenge the dollar's dominance in international finance. But in his latest book, *Gaining Currency*, Cornell University's Eswar Prasad says there are limits to how far China's currency can go without undertaking significant domestic reforms. Prasad, a former IMF economist himself, was invited to IMF headquarters in Washington recently to talk about his new book.

MR. PRASAD: Good morning. It's a real pleasure and always an honor to be back at the Fund, where I spent my formative years as an economist. This book has a story which actually starts a long, long time ago. It turns out that China had the first paper currency in the world, and this is not that surprising, because after all, China invented paper.

China invented paper during the Han era, around 200 B.C., but still, it was largely metallic money that was being used at the time. But then, in the 7th century in the Song Dynasty, for the first time ever, there was paper currency. This was a particular type of paper currency. It was essentially something that was backed by commodities of precious metals, so in fact, it was literally a sort of -- deposit notes that were being circulated. What would happen is that...

MR. EDWARDS: What other things can China lay claim to in terms of firsts, you know, in the history of the world economy?

MR. PRASAD: In the monetary world, China has many firsts to its credit. So China issued the first paper currency, and then, under Kublai Kahn, who was the head of the Yuan Dynasty in the 13th century, it turns out that China had also had the first paper currency that became a fiat currency, that it was just issued by the fiat currency, that it was just

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issued by the fiat off the emperor without any precious metals or commodities to back it, and he also made it legal tender, which means it was accepted throughout the land as currency.

So, now this is a little bit more complicated, because you can have currency printed by the monarch, but how do you get people to accept it? Right now, of course, fiat currency is legal tender because there are certain debts, especially debts to the government that can be extinguished using paper currency.

So, how did Kublai Kahn do this? He was slightly less subtle mannered. He said anybody in my land who does not accept my paper currency will lose his life. (Laughter) Turned out to be a very effective way of converting the fiat currency into legal tender.

China has also had among the earliest hyper-inflations in the world, and then there was a competition between the Kuomintang government's currency and the Japanese government's currency. Japan had taken over part of China by the late 1930s, and that devolved into what was a bloody currency war, one where there was literally blood on the streets of Shanghai.

What happened is that the Kuomintang government, when they realized that the Japanese were playing dirty, they went and actually dynamited one of the branches of the Kuomintang led central bank government, and in return, the Wang Jingwei government hauled some of the employees of the Kuomintang led banks onto the streets and shot them. So, there was literally blood on the streets of Shanghai.

So, if you think that currency wars these days are a big deal, there were much, much more vicious back then. So, China...

MR. EDWARDS: And so, I mean today, how relevant is the renminbi in today's global economy?

MR. PRASAD: So, the renminbi came into being in 1949, when the People's Republic of China was formed. It didn't really play much of a big role in international finance until a few years ago. After the global financial crisis the renminbi, partly as a result of the Chinese government's policy, but also partly because the Chinese economy has been growing quite rapidly, is now the second largest economy in the world.

The currency has started playing a bigger role in international finance, so in settling cross-borrowed payments for trade and financial transactions, for instance, the renminbi accounts for about 3 percent. Right now, that number has come down a little bit.

It may not seem like much, but for a currency of an emerging market country rather than advanced country, and for a country that has a relatively close capital account, meaning it doesn't allow free flows of capital across its borders and it doesn't have a market determined exchange rate, that's already saying something.

MR. EDWARDS: And so, what did it mean when the IMF, you know, brought in the renminbi into the basket of currencies almost two years ago now? What did it mean for the renminbi?

MR. PRASAD: So, when the IMF took the decision in November of 2015 that the renminbi will become part of the IMF's elite basket of currencies called the Special Drawing Rights, or SDRs in October of 2016, that was a big deal, because it was the first an emerging market currency was being elevated by the IMF to this pedestal.

Before the renminbi was brought in, there were just four currencies that were part of the SDR basket; the US dollar, the euro, the Japanese yen and the British pound sterling. So, it suggested in some sense, the renminbi has arrived on the international scene.

MR. EDWARDS: And but how easy is it for the private sector to actually trade in renminbi?

MR. PRASAD: That's the interesting thing about the renminbi's journey to becoming an international currency. It's still not very easy to move into or out of China. Although the barriers have been eased over time, there are still significant barriers.

In addition, it's not very easy for foreign investors, whether they be foreign central banks or private investors to acquire assets, financial assets denominated in renminbi or to trade them, because China does not have very well developed financial markets yet.

So, the combination of a relatively close capital account and financial markets that are not very well developed should, in principle, have prevented the RMB from becoming a reserved currency.

But what is interesting, of course, is that although China doesn't meet the prerequisites of a reserved currency, you guys have already basically designated the RMB as an official reserve currency, and more importantly -- I mean, what the IMF says is always very important, but what is even more important is what the market says.

And central banks around the world are signing bilateral local currency swap lines with the People's Bank of China. There are 35 central banks around the world, including many from advanced economies, such as the ECB, the BOJ, the Bank of Canada, and so on. And as you can see from practically every continent, Chile, Brazil, and Latin America, South Africa, Morocco in Africa, a whole host of Asian and European economies, if you sign -- again, I emphasize bilateral local currency swap lines which gives them access to RMB liquidity if needed.

If you put all these swap arrangements together, they add up to about \$500 billion. Once upon a time, a billion used to be a lot of money. Five hundred billion in international finance is not that big anymore, but it's still pretty sizable. But again, the question is why RMB liquidated. This is not an easily tradable currency. This is not a currency of a country with a very open capital account.

So, one could argue, and some have, that the renminbi does not meet the traditional

prerequisites of a reserve currency, and it has already become an official reserve currency and a reserve currency that is playing a big role in international financial markets.

MR. EDWARDS: There seems to be a trend just in the past two or three years where essential banks are really trying to communicate with the general public what their intentions are, what their monetary policy is. Where does China stand in those terms? I mean, is there a strategy well communicated within and outside of China?

MR. PRASAD: Central banks face a major challenge in terms of communicating what it is they're trying to do and how they are trying to do it. Even an independent central bank like the Federal Reserve in the US or the Bank of Japan in Japan has difficulty with its communications.

The People's Bank of China, the Chinese Central Bank often referred to as just the PBC, has a particular challenge, because it's not an independent central bank. The decisions about monetary policy ultimately are taken by a high level political authority rather than by the People's Bank of China.

Still, the PBOC has the duty to execute those monetary policy actions. So, it's a very complicated balancing act, and the PBC has sometimes fallen short. A couple of years ago, the PBC got approval from the government to allow the currency's value to be somehow more determined by market forces and to allow it to be a little bit more volatility.

Unfortunately, they didn't do a good job of preparing the market for that change. So, when that change happened, and particularly because it happened with the Central Bank adjusting the value of the currency, there was a presumption in markets that the Central Bank was doing this out of panic, because the economy was slowing and maybe they were trying to push the value of the currency down so that the economy could benefit from a higher level of exports.

So, communication is certainly not the PBC's forte, but they are working on it.

MR. EDWARDS: So, the rise in -- at least in the prominence of the profile of the renminbi, does it truly reflect the power of the economy, or is it more of a you know, very well executed marketing strategy?

MR. PRASAD: So, if economic size really counts, then the renminbi should in fact, be playing a much more prominent role in international finance. After all, China is now the second largest economy in the world. Since the global financial crisis of 2007–2008, China has added more to global GDP than even the US economy. So, by all rights, the renminbi should be an important global currency.

But China is still just a middle-income country. It's not in the same league as the advanced economies which have per capita incomes that are about five or six times larger than that of China. China does not have well developed financial markets. It does not have a good regulatory structure so that foreign investors are a little bit concerned about coming into China's financial markets.

So, as a consequence, the renminbi is just in the initial stages of making its presence felt on

the international stage. Certainly, the progress it has made is very impressive, given that it's happened in a literally short period, and given all the challenges that China's own economy faces.

But, in order for the currency to really take its place on the international stage the way the Chinese seem to want, it's going to take a lot of heavy lifting in terms of developing domestic financial markets and frankly, domestic institutions, both regulation, but also the rule of law.

MR. EDWARDS: And do you think the drive to sort of establish the renminbi as being a solid reserve currency, that that may well be a catalyst for domestic reforms?

MR. PRASAD: In fact, I think for many pro-reform-minded policy makers in China, the notion of the renminbi becoming a major global currency is not an end in itself, but it serves a very useful purpose in providing a framework for getting around opposition to domestic reforms.

The idea is basically that once the top leadership and also the people of China have signed on to the notion that a major economic power like China should have a currency that matches its stature on the international stage, that forces Chinese policy makers to think about what's necessary for that to happen.

What's necessary is better financial markets, better regulation, better policies overall. Now all of these are going to be very good for China, independent of what happens to the currency. But there are very strong entrenched interests that don't want any reforms in China. So, I think the notion of making the RMB a powerhouse global currency I think has served a very useful purpose for the reformers in pushing forward financial sector reforms and capital market reforms more broadly.

MR. EDWARDS: And do you think that the renminbi will ever challenge the US dollar in terms of you know, a dominant international currency?

MR. PRASAD: So, in my book, I make a distinction between the concept of an international currency that is used for settling international trade and finance transactions. On that part, the renminbi is making progress, although somewhat slowly. The renminbi is now an official reserve currency, because it's part of the IMF's SDR basket.

And many central banks around the world have indicated that they want to hold at least a small portion of their foreign exchange reserves in renminbi assets. But will it ever become a safe haven currency, one that foreign investors, both official and private turn to for safety in terms of financial turmoil?

To that, my answer in my book is no, because in relation to economic and financial strength, you also need good institutions, an institutionalized system of checks and balances of the sort you typically seen in open and democratic forms of government. You need an independent central bank and you need the rule of law, where even the government has to come before the law and cannot change the rules on a whim.

I don't think China is prepared to make much progress on these broader political and

institutional reforms, so if China plays its cards right, it could become a significant international payments currency; perhaps even a significant reserve currency, but it's highly unlikely to be a safe haven currency that challenges the dollar's dominance.

MR. EDWARDS: That was Eswar Prasad, professor of trade policy and economics at Cornell University and senior fellow at the Brookings Institution talking about China's growing economic might. His book, *Gaining Currency*, is published by Oxford University Press.

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