Earthquake Coming

Sooner or later, how the Chinese renminbi is going to shake up the global financial system.

By Chi Lo

Structural changes behind the U.S. dollar, the euro, and the Japanese yen may have started to erode their basic ability to serve as global currencies. This implies that their global influence should fade in the long term. Meanwhile, China is gaining what these G3 currencies are losing by internationalizing the renminbi. President Xi Jinping's "Chinese Dream" is the linchpin of the platform for the rise of the renminbi in the global markets.

The global impact of the renminbi's ascent will be substantial, and even confusing and worrying, because the geopolitical reality behind the future monetary order is that China's global influence is rising at a time when that of the United States and Europe is declining. China's Belt-and-Road initiative is a vision to build trade and investment networks with all roads leading to Beijing.

Arguably, economic and political incentives are aligned for China to transform itself from a large emerging market into an "empire." History has taught us that one of the strongest motives for a country to expand into building an empire is the spectacle of fumbling ineptitude of the existing order. The key economic incentive for building an empire is an attempt by the center to source cheap commodities to produce manufactured goods for sale to the periphery in order to make a profit. The empire-building exercise by China is the political dimension behind the secular rise of the renminbi in the future monetary system.

Chi Lo is a senior economist at BNP Paribas Asset Management and author of Demystifying China's Mega Trends: The Driving Forces That Will Shake Up China and the World *(Emerald Publishing, 2017).*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Does this mean that the Chinese currency will acquire a global reserve currency status soon? Not a chance, because China still lacks many of the economic, political, and cultural attributes that are essential for making the renminbi a global currency. Nevertheless, this does not deter China from building a base for the renminbi's global status. Its biggest challenge is to instill global confidence in the renminbi when it does not have most of the characteristics for serving, on a global basis, as a store of value, a medium of exchange, and a unit of account.

The financial handicap of China's effort to build a global currency is its lack of a deep and liquid capital market.

Before the renminbi acquires a global currency status, it can still sit in the center of a regional financial system in Asia. The rise of the renminbi on the global stage is a secular trend that some of us may not like but cannot ignore. Empirical evidence suggests that Asia has already been increasing its linkages with the renminbi gradually by cutting its linkages with the U.S. dollar and the euro.

THE FAILURE OF THE G3 CURRENCIES

Economic development since the 2007–2008 global financial crisis suggests that the basic functions of money of the G3 currencies might have been eroded. First, while the U.S. dollar has always dominated as a unit of account, this may change over the long term as the global dominance of the United States weakens.

Being a new component currency of the Special Drawing Rights (effective in October 2016) and with Beijing continuing the liberalization of the country's capital account, the renminbi will become a growing part of the global financial infrastructure. Notably, China's creation of the Asian Infrastructure Investment Bank, the Silk Road Fund, the New Development Bank, and the usage of its domestic policy banks for international lending are all instrumental in boosting the role of the renminbi under the Belt-and-Road vision that spans from China through Asia to Europe.

Second, most of the world's major currencies are failing to serve as a store of value because they are unable to deliver a stable positive return both in nominal and real terms. Since the currency war in 2010, global currency market volatility has risen sharply. The Swiss franc and the Japanese yen have become negative-yielding currencies since 2015. The euro, the Swedish krona, and the Danish krone also do not provide any reasonable stable non-zero returns. The Canadian, Australian, and Kiwi dollars, Norwegian krone, Brazilian real, and South African rand have been stuck with volatile downward trends that are influenced by commodity prices.

Although the U.S. dollar and the pound sterling are still providing the store-of-value function (at the time of writing, that is), many are starting to ask whether the renminbi could emerge as an alternative in a world of financial instability. Granted, there are structural problems behind the renminbi and it is not fully convertible on the capital account yet. But who else does not have structural problems?

Finally, on the medium of exchange function, the U.S. dollar's global dominance has been shaken in recent years as more international payments are settled in non-U.S. dollar currencies. A strong challenger to the U.S. dollar seemed once to be the euro. The European integration project in the 1990s and 2000s raised the expectation that Brussels might be able to attract an ever-increasing number of countries into the eurozone system and thus create an ever-increasing demand for the euro as a global medium of exchange.

Unfortunately, the European dream has been disrupted as the expansion path of the euro system now appears to be challenged by the geopolitical conflict in countries in emerging Europe, notably Ukraine, and by the upheavals across the Arab world. Britain's vote on June 23, 2016, to exit from the European Union was the latest blow to global confidence in the European dream.

On the medium of exchange function, the U.S. dollar's global dominance has been shaken in recent years.

Demand for the dollar has also abated since the commodity bust in 2013. The table will turn only when global trade and the commodity cycle re-accelerate markedly again, but that could be a long way away. When global trade accelerates again, where will the biggest momentum come from? Given the difference in growth dynamics between the developed and emerging worlds, long-term global trade growth is likely to come mostly from the emerging markets. With China's rising economic influence, time will tell how much of this trade growth will be denominated in renminbi. What seems likely is that in relative terms, the share of renminbi-denominated trade will rise at the expense of the G3 currencies, especially when one takes into account China's ambitious Belt-and-Road plan.

Just when the European dream is being disrupted, President Xi Jinping is pushing forward earnestly with his Chinese Dream, which plays a central role in fostering the rise of the renminbi amid all these global crosscurrents. The Chinese Dream aims at building a moderately well-off Chinese society by 2020 and a strong and prosperous nation by 2049 so that China can become the dominant power in Asia again with global influence similar to that of the United States by 2050.

The economics of the Chinese Dream are crystallized by the renminbi internationalization program and the Belt-and-Road strategy. The latter aims to create new trade networks, opening up transit routes for Chinese exports and developing China's poor border regions by pushing for the usage of the renminbi as the settlement currency. By financing infrastructure projects in developing Asia, the Belt-and-Road strategy essentially draws China's neighbors closer to its economic embrace.

THE FUTURE CURRENCY DEMAND

It is thus conceivable that global demand for the renminbi as working capital by the private sector and as foreign exchange reserves by the official institution sector will only increase in the future. The eventual inclusion of Chinese assets in the global stock and bond indices will augment the private sector's demand for the renminbi further.

In a world where the prevailing major currencies are failing to serve as a unit of account, a medium of exchange, or a store of value, an opportunity has thus opened up for the renminbi to fill the void in the future global monetary system. The geopolitical conflicts in emerging Europe and upheavals in the Arab World and the ensuing refugee problems are creating political fractures in the euro system that will haunt Europe for a long time to come. This will hurt the incentive for future capital flows to head for Europe.

Over the past two decades, all new roads (in terms of telecommunications infrastructure projects and financial architecture directives, and so on) led to the European capitals of Brussels, Frankfurt, Paris, and Luxemburg. In the next twenty years, however, all new roads of telecommunications infrastructure, railways, ports, airports and similar will likely lead to the Chinese capital of Beijing and major cities such as Shanghai and Hong Kong. Accompanying these new roads will be the rise of the renminbi as a global currency.

IS CHINA READY?

While the incentive may be there and the macroeconomic environment may be conducive for China to build a global currency, the question is whether the renminbi is ready to take up a global role.

In addition to the three basic functions of money, empirical research has established a number of other critical factors that determine a currency's reserve status, including the size of a country's economy, the depth of its financial market, and the global share of its foreign trade. Combining these economic factors with a country's cultural, scientific, and military strengths and sound legal system will give its currency an "exorbitant privilege" in commanding international confidence. It is also clear that even a country with a sizable economy and global trade share that lacks well-developed and deep financial markets, like China at this point, will be handicapped in its effort to acquire reserve currency status.

China's biggest challenge is to instill global confidence in the renminbi when it does not have most of these characteristics that create the necessary and sufficient conditions for its currency to serve as a global currency. Arguably, economic factors are only the necessary conditions for building a global reserve currency. There are other attributes that should go with them to create the sufficient conditions. Notably, the host country should have dominant military power over land, sea, and air to allow it to protect the routes through which its goods and aids can be safely transported during emergency situations, such as a natural disaster or war. For the recipient countries, they will only trust the host country's currency if they have the assurance of receiving shipments safely during crisis times.

Before the renminbi acquires a global currency status, it can still sit in the center of a regional financial system in Asia.

So the host country should also have the most advanced scientific and technological power to allow it to build the most potent weapons to fulfill its role as the currency of last resort. It should also be dominant in cultural and educational aspects so that it can attract the elites of other countries to its educational system. This will be instrumental in fostering its global reserve currency status by creating an influential cadre in foreign countries whose views and thinking are aligned with those of the host country. Last but not least, the host country should have a sound legal system that protects foreign and domestic economic interests by providing the framework of a level playing field.

DOES THE RENMINBI MEASURE UP?

Through currency reform and the internationalization program, Beijing has been working on transforming the renminbi to a proper currency with the three essential functions that any proper currency should have but that the G3 currencies are starting to fail to offer. However, building the financial apparatuses does not automatically build international confidence in the renminbi. At this point, China still does not possess those other attributes that need to go with the economic factors to make it a global currency. Despite its increasingly assertive stance in Asian affairs, notably in the East and South China Seas, it has yet to prove that it has the superior military power to secure control of the land, sea, and air routes that it wants.

The financial handicap of China's effort to build a global currency is its lack of a deep and liquid capital market on which other countries can rely as a source of international liquidity at times of financial stress. There is a lot of catch-up for China to do in establishing global financial dominance. Its capital markets lag way behind those of the developed world. The lack of a full-fledged market mechanism will drag on the pace of its financial liberalization. China's national savings could potentially be deployed for financing growth in other countries by replacing volatile capital flows from the western countries. But it needs a viable private sector to allocate domestic savings efficiently in order to become a major international creditor.

While China has achieved research excellence in some areas, it remains unlikely to gain global scientific dominance in the medium term. Its research and development so far has been focused on applying technology to production to build economic competitiveness. It will also be a long time before it becomes culturally and educationally dominant; many of the best Chinese brains are still heading overseas for education (and many do not return to their motherland after graduation) or to escape cultural suppression.

Meanwhile, the legal credibility and institutional integrity elements that help instill international confidence in the renminbi require a system of reliable and transparent corporate accounts backed by credible auditors and credit rating agencies and an independent/impartial judicial framework. It will take a long time for China to develop such a system.

Finally, a key issue for building international confidence in the renminbi is a legal system and regulatory framework that provide a level playing field for foreign and domestic players. Granted, no countries in the world provide a genuine level playing field. But those that command trust and confidence in their systems have legal frameworks and mechanisms that address the problems when they arise.

China certainly lacks such a system for fostering a level playing field. This is clearly seen in its discriminatory foreign direct investment policy. While most of the major countries that have significant overseas investment are also very open to inward investment, China is not. Despite its status as an important destination for foreign direct investment and its pledge to open up to the world, it has a very discriminatory foreign direct investment policy that shuts off many sectors to foreign investment, including mining, construction, energy, communications, infrastructure, and most services.

Demand for the dollar has also abated since the commodity bust in 2013.

This lack of foreign direct investment reciprocity has not only created problems for China's trading partners but also created an uneven playing field that hurts international confidence in China's policy framework that underlies its currency. For many products, China is the largest or the second-largest market in the world, which is a big attraction to foreign investors. However, many of these sectors are protected so that Chinese firms can grow unfettered by international competition and at the same time expand overseas funded by their domestic financial strength.

BE PREPARED FOR A GLOBAL SHAKE-UP

In a nutshell, despite the fading influence of the G3 currencies in the global monetary system, it is unlikely that the renminbi will gain a global reserve currency status anytime soon. That time will come, but only in the longer term when China has implemented sufficient economic and social reforms to acquire an exorbitant privilege for the renminbi.

Notwithstanding all its faults, the secular trend of the rise of the renminbi will continue to unfold to support it to become a global currency—eventually. You can run, but you cannot hide from it. Like it or not, the renminbi is going to shake up the global financial markets and their underlying economies. ◆