China in a changing global economy

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Where China stands in the world economy
- Economic size catches up quickly, but GDP per capita is low
- Higher saving rate to make China a major global creditor
Outline

• Part one: Economic rebalancing and policy challenges
  - How China rebalances its economy
  - Major risks and challenges
  - Managing financial stability

• Part two: Chinese currency in international monetary system
  - RMB internationalization and IMS reform
  - To what degree the RMB is internationally used
  - Financial openness and reform to support RMB
Part one: 
Economic rebalancing and policy challenges
- A soft landing as a start

- Actual growth: downward trend
- Target rate: revised down; setting floor, mindset shift..
Rebalancing - what is it?

• **The old model**
  - Export and investment driven
  - Domestic market protected
  - State owned sector dominated
  - Factor resource allocation twisted

• **Rethinking of**
  - Quantity vs quality
  - Market vs government
  - External, internal, structural / demand and supply
Rebalancing

- Demand side (% of GDP)

- Consumption - driven
- BS effect and higher income growth
- Better social welfare coverage
- Deleverage walks a fine line/ not depressing consumption- in 2017, ¥100bn fund to support 11.1 million layoffs’ reemployment
Rebalancing
- Supply side (% of GDP)

- Service – led economy
- New service sectors: new technology; less government intervention; fierce competition
- More jobs but lower productivity
- Too early to experience de-industrialization?
Debt issue

- Debt to GDP ratio (BIS data)

- A global phenomenon, but China’s pace one of the fastest
- Corporate debt dominates
- Linked to overcapacity in the sectors where debt to GDP ratios grow faster than their output growth
- Countermeasures: stabilize credit; cut overcapacity in the areas of low profit and high energy cost (steel and coal), encourage new green sectors; deleverage debt by means of debt to bonds/equity swap; ownership reform
Chinese shadow banking has grown very fast. In case of WMPs, it grew from nothing to ¥28.38tn, accounted 26% of Chinese banking assets. In 2016, the size of Chinese shadow banking reached $7 trillion according to FSB shadow banking tracker, 15.5% of $45tn assets of its kind.

Reasons:
Financial repression
Regulation arbitrage
Pressure for interest rate deregulation

Why worrisome:
Banks’ shadow, off balance sheet, maturity mismatched, in various forms: bank-bank; bank-trust; bank-securities…

Regulatory policy response:
Tighten credit
Macro-Prudential Assessment (MPA)
Redefine a broader concept of credit
New financial regulatory structure
Proved by the 13th National People's Congress 2017

State Council

Financial Stability and Development Committee

- China Banking and Insurance Regulatory Commission
- People’s Bank of China

Financial Stability and Development Committee

- China Securities Regulatory Commission
Capital flow

Net capital flow (quarter data in $0.1bn)

- Direct Investment
- Debt Securities
- Others
- Cap and Fin Acc

- Currency appreciation; volatility; financial opening
- Currency depreciation; anticorruption; Fed
- Tighten capital management

Net inflow

Net outflow

Others

Exchange rate: 2015.8.11 removal of intervention

2015.08.11 Removal of RMB middle price intervention

2015.08.11-12 overshooting by -4.7%

2015.12 Reintroducing intervention

Imposing a new 20% reserve requirement on all currency forward positions—aimed at reducing speculation.
Understanding policy mix

Impossible trinity (Mundell-Fleming)
Policy trilemma (Obstfeld and Taylor 1997)
Dilemma (Rey 2013)
Scalene triangle (Sun and Li 2017)

Figure 1 “Impossible Trinity” (Equilateral Triangle)

Figure 2 “Dilemma”
Capital flow management framework based on Ostry 2011

Capital flow
- currency, inflation, boom and bust cycle ..
- Ex rate, MP, FP ..

Macro econ risk
- Fin risk
  - Credit, asset, property, balance sheet risk ..

Macro policy
- Macro prudential
  - FX related measures, reserve requirements, limit to credit growth ..

Macro control

To conclude with long term reform agenda
The 3rd plenum for 2013-2020

• Reflecting past 40 years of reform of opening-up, my view is that the 3rd plenum in 2013 was a demarcating line: 1978-2013 make the cake bigger; 2013-2020 to distribute it fairly.

• The plan covers six areas of reforms: Economic and financial, Social, Political, Cultural, Ecological, and National security.
  E.g. Economic and financial:
  Role of the government
  Financial sector
  Fiscal reform
  State owned enterprise
  Economic Openness and fairness

• Objective: let the market play a decisive role and establish a modern market system in terms of market rules and pricing.
Part two: Chinese currency in international monetary system
• What went wrong with international monetary system?
  • Mismatch between economic /trade weights and financial power distribution
  • Dollar trap
  • Original sin / Conflicted virtue
  • Shortage of reserve/safe assets

• Is Triffin dilemma still with us?
  • Old triffin dilemma: inherent contradiction that exists in the IMS under BWS, where the supply of dollar reserves relied on the US running deficit.
  • Today reserve supply increasingly relies on few countries’ government debt issuances. The more debt issued, the more solvency will be affected.
  • Obstfeld (2011) argued, “on the surface, Triffin’s point seems obvious. But deeper reflection suggests that the classic form of the Triffin dilemma was really a fiscal problem.”
• Gold?
  – Hardly to be qualified as a currency

• A super-sovereign reserve currency?
  – “In theory, the international reserve currency should first have a stable standard for its value and clearly-defined rules governing its issuance in order to guarantee its orderly supply; next, its supply can be timely and flexibly adjusted according to change of demand; third, such adjustment must be independent of any country’s economic conditions and interests.” – Zhou 2009
• SDR - proposals and reforms

  - Proposals
  - RMB’ inclusion in SDR’s basket into effect on October 1, 2016. A new basket of the SDR includes - 41.73% U.S. dollar, 30.93% euro, 10.92% RMB, 8.33% JP yen and 8.09% pound sterling.

  “Expansion of the SDR basket is an important milestone for the SDR, IMF, China & intl. monetary system” - Christine Lagarde
Why RMB – domestic rationales

- Safety of Chinese holdings of US government securities
- Exchange rate risk reduction for the Chinese firms
- Chinese financial sector’s expansion/ Shanghai as a financial center
- Central bank’s ability to create monetary tools
- Seigniorage
- Mixed impact on domestic monetary policy
- Committed device for fin opening and domestic reform
### What is an international currency

<table>
<thead>
<tr>
<th>Functions</th>
<th>Private</th>
<th>Public</th>
</tr>
</thead>
<tbody>
<tr>
<td>Store of value</td>
<td>Bank deposit</td>
<td>FX reserves</td>
</tr>
<tr>
<td></td>
<td>Securities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Currency substitution</td>
<td></td>
</tr>
<tr>
<td>Medium of exchange</td>
<td>Trade and fin settlements</td>
<td>Intervention Swaps</td>
</tr>
<tr>
<td>Unit of account</td>
<td>Invoicing</td>
<td>Anchor (Currency baskets)</td>
</tr>
<tr>
<td></td>
<td>Denomination of fin trans</td>
<td>SDR composition currency</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Denomination of gov bonds</td>
</tr>
</tbody>
</table>
Foreign reserves: share in total allocated currencies
IMF 1999Q1 -2016Q4

- Still dollarized
- Will Trump’s policies jeopardize dollar’s international currency status?
The size of RMB deposit increased very fast from 2004 to the peak time of 2015. But in 2016 it began to decline due to currency depreciation and tightening controls over cross-border capital flows.

Role of offshore RMB market
• A testing ground
• An euro-RMB market
SWIFT’s RMB Tracker monthly (international and domestic payment #)

Payment currency

World share %

- RMB
- USD
- EURO
- Pound Sterling
- Yen

%: 38.00, 34.29, 7.34, 3.29, 1.56
## Top 10 currencies of global foreign exchange market turnover (BIS)

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>USD</td>
<td>89.9</td>
<td>1</td>
<td>88.0</td>
<td>1</td>
<td>85.6</td>
<td>1</td>
</tr>
<tr>
<td>EUR</td>
<td>37.9</td>
<td>2</td>
<td>37.4</td>
<td>2</td>
<td>37.0</td>
<td>2</td>
</tr>
<tr>
<td>JPY</td>
<td>23.5</td>
<td>3</td>
<td>20.8</td>
<td>3</td>
<td>17.2</td>
<td>3</td>
</tr>
<tr>
<td>GBP</td>
<td>13.0</td>
<td>4</td>
<td>16.5</td>
<td>4</td>
<td>14.9</td>
<td>4</td>
</tr>
<tr>
<td>AUD</td>
<td>4.3</td>
<td>7</td>
<td>6.0</td>
<td>6</td>
<td>6.6</td>
<td>6</td>
</tr>
<tr>
<td>CAD</td>
<td>4.5</td>
<td>6</td>
<td>4.2</td>
<td>7</td>
<td>4.3</td>
<td>7</td>
</tr>
<tr>
<td>CHF</td>
<td>6.0</td>
<td>5</td>
<td>6.0</td>
<td>5</td>
<td>6.8</td>
<td>5</td>
</tr>
<tr>
<td>CNY</td>
<td>0.0</td>
<td>35</td>
<td>0.1</td>
<td>29</td>
<td>0.5</td>
<td>20</td>
</tr>
<tr>
<td>SEK</td>
<td>2.5</td>
<td>8</td>
<td>2.2</td>
<td>8</td>
<td>2.7</td>
<td>9</td>
</tr>
<tr>
<td>MXN³</td>
<td>0.8</td>
<td>14</td>
<td>1.1</td>
<td>12</td>
<td>1.3</td>
<td>12</td>
</tr>
</tbody>
</table>

*Note: *The table above shows the share of global foreign exchange market turnover for various currencies from 2001 to 2016, with the rank indicated in each year. The currencies are ranked by their share in descending order for each year. The last row indicates the rank for 2016.
CB RMB bilateral swaps

¥ bn

CB RMB swaps
RMB in China’s trade and investment (¥ bn)
<table>
<thead>
<tr>
<th>Private use</th>
<th>Public use</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Trade settlement</td>
<td>• Reserve currency</td>
</tr>
<tr>
<td>• Direct investment</td>
<td>• Currency swaps</td>
</tr>
<tr>
<td>• Bank deposit/loans</td>
<td>• Anchor for currency baskets (e.g. evidence in Asia) co-movement of exchange rate; monetary policy..</td>
</tr>
<tr>
<td>• Bonds (dim sum; RQFII)</td>
<td></td>
</tr>
<tr>
<td>• Equity (RQFII, SH/SZ-HK connect)</td>
<td></td>
</tr>
<tr>
<td>• Collective market</td>
<td></td>
</tr>
<tr>
<td>• Money market</td>
<td></td>
</tr>
<tr>
<td>• Project financing</td>
<td></td>
</tr>
<tr>
<td>• Commercials (oil future, gold) On March 26, 2018, China launched yuan-denominated oil futures contract, convertible into gold on the Shanghai and Hong Kong</td>
<td></td>
</tr>
</tbody>
</table>
What make currency an international one?

• **Conditions highlighted by literature**
  • The issuing country’s economic size
  • Stable intrinsic value of the currency
  • Credibility of the central bank
  • Financial strength and openness
  • Degree of financial market development
  • Political and military power

• **References of history and other currencies’ experience**
  • US dollar’s network externality/inertia
  • Japanese yen’s “failure” 1984 to 2003
  • Euro at ECB’s neutral stance
Policies to support RMB

Factors for the success of RMB internationalization - Economic size and influence; credible, transparent and independent monetary policy; open, developed and liberalized financial market

Policy options are crucial, as there has been debate on sequencing issue. Capital account liberalization, exchange rate flexibility and domestic financial development are free key policies that will shape the stage and path of the RMB to become a global currency.
Milestones of financial opening

1983
- Open up as a political decision

1988
- Acceptance of IMF Article VIII

2001
- Access to WTO

2002
- QFIs - invest domestic equity
- QDIs - invest abroad equity and bond

2007
- QDIs - residents to invest abroad equity and bond

2009
- RMB trade settlement

2011
- RMB-QFIs; RMB-ODI
- Money market opened

2012
- First stated timetable of RMB full convertibility by 2020

2013
- SFTZ (negative list and FT account)

2014
- Capital market unification (Shanghai-Hong Kong connect)
- Interbank market opened to foreign CBs, IFIs, SWFs (no quotas required)
- Collective securities from Unconvertible to Partial Convertible
- Interest rate liberalization (lift deposit rate control)

2015
- Interest rate liberalization (lift deposit rate control)
- Collective securities from Unconvertible to Partial Convertible
- Macro-prudential measures rolled over to entire market
- Shenzhen-Hong Kong connect

2016
- Further opening interbank market to medium and long term investment
- Macro-prudential measures rolled over to entire market
- Bond Connect

2017
- Mainland-HK Bond Connect
- Opening financial sector to foreign ownership (commercial banks, securities, futures, asset management and insurance - came after the 19th Congress)

2018
- Removal of rules that limit QFIs and RQFIs

2019
- Mainland - HK Bond Connect

2020
- First stated timetable of RMB full convertibility by 2020

2021
- Capital market unification (Shanghai-Hong Kong connect)
- Interbank market opened to foreign CBs, IFIs, SWFs (no quotas required)
- Collective securities from Unconvertible to Partial Convertible
- Interest rate liberalization (lift deposit rate control)

2022
- Further opening interbank market to medium and long term investment
- Macro-prudential measures rolled over to entire market
- Bond Connect

2023
- Mainland-HK Bond Connect
- Opening financial sector to foreign ownership (commercial banks, securities, futures, asset management and insurance - came after the 19th Congress)

2024
- Removal of rules that limit QFIs and RQFIs
Framework of convertibility

Four layers according to the Chinese official classification:

1. Convertible (no restrictions)
2. Few restrictions (subject to registration)
3. More restrictions (subject to approval)
4. Strictly controlled (no permission).

37/40 items are under 1 2 3 (PBoC 2016)
Gateway to China’s domestic fin market

Quotas ($bn)
Non-resident RMB holding (¥ bn)

1. Quotas
2. Shanghai-HK connect
3. Shenzhen-HK connect
4. Mainland-HK bond connect
Exchange rate flexibility

- 2005.7 from hard to soft peg
- 2012.4 managed
- 2014.3 band widened from 1% to 2%
- 2015.8 removal intervention
- 2017.6 adding counter-cyclical factor
- 2018.1 removal of counter-cyclical factor
- Appreciated by 26%

2015.12 introducing CFETS

CFETS, CNH, NDF, CNY
## Financial market development

### Changing financial structure - Aggregate financing (share %)

<table>
<thead>
<tr>
<th>Year</th>
<th>Bank loan</th>
<th>Corporate bonds</th>
<th>Equities</th>
<th>Entrusted loans</th>
<th>Trust loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>78.7</td>
<td>4.6</td>
<td>13.1</td>
<td>2.9</td>
<td>5.7</td>
</tr>
<tr>
<td>2008</td>
<td>82.4</td>
<td>10.1</td>
<td>5.8</td>
<td>4.5</td>
<td>6.1</td>
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<tr>
<td>2009</td>
<td>81.5</td>
<td>9.5</td>
<td>3</td>
<td>3.1</td>
<td>4.9</td>
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<tr>
<td>2010</td>
<td>75.2</td>
<td>10.5</td>
<td>5.5</td>
<td>2.8</td>
<td>6.2</td>
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<tr>
<td>2011</td>
<td>58.2</td>
<td>10.6</td>
<td>3.4</td>
<td>1.6</td>
<td>10.1</td>
</tr>
<tr>
<td>2012</td>
<td>52.1</td>
<td>14.3</td>
<td>1.6</td>
<td>8.1</td>
<td>8.2</td>
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<tr>
<td>2013</td>
<td>51.4</td>
<td>10.5</td>
<td>1.3</td>
<td>14.7</td>
<td>10.6</td>
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<tr>
<td>2014</td>
<td>58.1</td>
<td>13.9</td>
<td>2.1</td>
<td>13.8</td>
<td>3.3</td>
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<td>2015</td>
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<td>2016</td>
<td>67.4</td>
<td>10.6</td>
<td>3.3</td>
<td>7.9</td>
<td>3.9</td>
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<td>2017</td>
<td>68.2</td>
<td>10.5</td>
<td>3.8</td>
<td>8.0</td>
<td>4.9</td>
</tr>
</tbody>
</table>
Conclusion

• International monetary system is moving away from the dollar hegemony to a multi-polar one. How does it work?

• RMB internationalization is work in process. After all, market choice has the final say.

Thank you.