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CHINA ANALYSIS

SPECIAL ISSUE

CHINA, THE YUAN AND THE IMF: DOUBLE OR QUITS?

ABOUT

The Chinese have long been obsessed with strategic culture, power balances and geopolitical shifts. Academic institutions, think-tanks, journals and web-based debates are growing in number and quality, giving China's foreign policy breadth and depth.

China Analysis, which is published in both French and English, introduces European audiences to these debates inside China's expert and think-tank world and helps the European policy community understand how China's leadership thinks about domestic and foreign policy issues. While freedom of expression and information remain restricted in China's media, these published sources and debates provide an important way of understanding emerging trends within China.

Each issue of *China Analysis* focuses on a specific theme and draws mainly on Chinese mainland sources. However, it also monitors content in Chinese-language publications from Hong Kong and Taiwan, which occasionally include news and analysis that is not published in the mainland and reflects the diversity of Chinese thinking.

February 2016

Introduction
by François Godement

In spite of a troubled summer for the Chinese currency, the International Monetary Fund decided on 30 November that the Chinese yuan would join the IMF's reserve currency basket on 1 October 2016, on the grounds that "the renminbi is determined to be a freely usable currency".[1] Inclusion in the Special Drawing Rights (SDR) basket was the Holy Grail of Chinese monetary diplomacy – and, many say, the basic domestic policy argument for Beijing's decision to loosen capital controls and currency trading, if only at the edges. China's ambition is to influence international financial institutions from the inside, and one strand of this is asserting the yuan as a global reserve currency. The other is to create parallel and complementary institutions that will allow for the yuan's internationalisation without convertibility.

For its part, the IMF has made a starkly realist choice. Faced with the risk of becoming irrelevant in a world in which the country with the largest foreign currency reserves was also becoming the largest international public lender, (although mainly in US dollars), the IMF made a political decision: it has taken into the SDR basket a currency that is "freely used" rather than freely tradable.

The implications are profound. Neither China nor the IMF has set a time limit for reaching full convertibility (in the past, Chinese officials and experts have cited varying and

1 "IMF's Executive Board Completes Review of SDR Basket, Includes Chinese Renminbi", International Monetary Fund, 30 November 2015, available at https://www.imf.org/external/np/exr/faq/sdrfaq.htm.

moving dates). In effect, China can choose the date – and in the current trend towards renationalisation of policies, this could mean that other countries may also elect to move away from a floating currency regime or otherwise engage in currency manipulation.

But those implications have been sidelined for now by a more immediate event. China's attempt in early January 2016 to stem a slide in the value of shares by means of an automated trading halt has led to a second stock market crisis, with an attendant capital outflow and a new dip in the value of the yuan. Arbitrage between the offshore and onshore markets for the yuan, which had been curtailed in September, resumed with a vengeance. Net capital outflows in 2015 may have been anywhere between $600 billion and $900 billion. That striking figure is not in itself a cause for panic – China's giant trade surplus has greatly limited the loss in current account terms. But it does mean that a mega-trend is in the process of being reversed. In the past decade, the expectation was that the yuan could only appreciate, with government intervention preventing this from happening; but the focus of government action now is to hold off devaluation, with arguably very large reserves. Individual bank customers have started to hedge the yuan by holding dollar-denominated deposits (a facility that was part of the loosening of capital controls), and firms are paying back their dollar loans in anticipation.

In fairness, this is not solely a Chinese event. The rise of the dollar, coupled with the United States Federal Reserve System's interest rise, has weakened all other currencies. If China were to choose not to implement quantitative easing, it would be the only major economy to abstain from making use of this facility. The monetary policies of other major economies are compounding China's own difficulties.

However, it is clear that on monetary and financial reform, Chinese authorities – which by universal consensus now means the very top of the political pyramid and President Xi Jinping himself – are faced with difficult choices that are familiar to poker players: with losses mounting, they could either double the stakes by speeding up reforms aimed at liberalisation, or they could withdraw from the game by going back on capital market moves and monetary internationalisation. Both choices have deep political implications. Liberalisation would necessitate strong regulatory authorities, which would considerably weaken the hold of the party-state on the economy. Withdrawal would seem a safer choice in the short term, but it would almost guarantee that growth would be arrested, given that future areas for growth are not in basic sectors of the economy but in services, finance, IT, and external investment choices.

This special issue of *China Analysis* should be read against this background. On the eve of China's second stock market and monetary shock, how do Chinese experts view the consequences of SDR basket inclusion for China and for the global system? Liberal economists such as Yu Yongding understandably back the People's Bank of China's (PBoC) continuity in promoting steps towards liberalisation. Others, such as Peng Xingyun, are not so sanguine, emphasising that the future still depends to a great extent on expectations about China's growth and capital markets. The writers acknowledge debate on a key issue: how far to let the market run its course. Accepting "bi-directionality" (rise and fall) for the yuan clearly implies more liberal reforms, and recent events have poured cold water on the expectation that China will take this step. The separate existence of the offshore market was convenient for a time, but now it is an invitation to speculation and might even, according to some, marginalise domestic monetary policy. To have a real, as opposed to a nominal, reserve currency, it would seem necessary to open and deepen domestic capital markets (in bonds and shares).

Our authors make much of the idea of a gradual shift of the international monetary standard from an implicit dollar standard to an explicit SDR standard: this has been a pet project of PBoC governor Zhou Xiaochuan since 2009, and France's support for the idea in 2011 is also noted. But Governor Zhou's lack of communication in the recent crises does not bode well for his continued influence.

Oddly, none of the authors mention what would be the most far-reaching move: accepting the consequences of China moving from a current account surplus economy to one in structural deficit. The US dollar's preeminent role is not ensured by the size of currency reserves, but by the amount of borrowing labelled in dollars, first of all from the US domestic economy. But this is where the transition of the economy from basic sectors to consumption and services would likely take China, and in this scenario, deep market reforms would make the system more manageable.

Only a year ago, the government's problem was how to export capital. Now, the order of the day is keeping capital flows under some degree of control, while sticking for political reasons to the limited capital liberalisation moves adopted to gain the approval of the IMF. The older objective was unequivocal and gave China a great deal of international clout. The new one is much more contradictory and could, in the end, impede Beijing's longer-term strategy.

The yuan's SDR inclusion: More than just a gold star?

Agatha Kratz

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Yang Ping, "After the renminbi's SDR inclusion, strategic meaning and future prospects", *Aisixiang*, 28 August 2015.[7]

China's exchange rate policy had a bumpy year in 2015, with developments and results that were hard to interpret. On 11 August, the People's Bank of China (PBoC) initiated the largest daily depreciation in China's exchange rate since the start of China's foreign exchange reforms in 1994: on the onshore market, a 1.8 percent daily fall on 11 August, and an overall 3 percent drop between 11 and 13 August. Over the entire year, the yuan fell by nearly 5 percent against the dollar. In spite of efforts to limit fluctuations – which cost Beijing hundreds of billions of dollars – late 2015 and early 2016 saw new signs of volatility and downward pressures on China's currency. Between 3 January and 7 January 2016, the government even let the yuan drop by another 1.37 percent. Perhaps most worrying, however, was the lack of official communication on the matter, which has left many wondering what 2016 will look like for China's yuan.

Last year also saw important developments for China's currency, as the International Monetary Fund announced on 30 November that the yuan was to join the Special Drawing Rights (SDR) basket, tye IMF's international reserve asset.[8] After the IMF decision, China's economists and financial press spent a lot of time analysing the significance of the yuan's inclusion in the SDR basket. Was the IMF's decision, as US economist Ben Bernanke says, nothing more than a "gold star" for China?[9] The articles selected here discuss the exchange rate along with the broader financial reforms that China has carried out on its way to SDR inclusion over the past few years. They reflect on the meaning of this summer's events within this process, and on the road ahead, both for the yuan as an international reserve currency and for China in its new role as an integral part of the international monetary system.

Acknowledging China's economic status and financial reform

A number of authors see the SDR inclusion as recognition of China's new international economic status. Economist Peng Xingyun, for example, considers the SDR inclusion to be a natural consequence of China's economic development and of the country's increased importance in global trade and capital flows. By including the yuan in its SDR basket, the IMF is simply acknowledging the new international economic environment. It is also endorsing the yuan's ongoing internationalisation, which is evidenced by the increased use of yuan in trade transactions and the growing global demand for yuan-denominated assets.

Chinese academic Yu Yongding says that by including the yuan, the IMF is also validating the financial reforms taken by Beijing to achieve SDR inclusion. Yu explains that China has been pushing its exchange rate regime towards marketisation since 2005, and that it has accelerated its reform efforts since the 2008 global financial crisis. Furthermore, China has, among other measures over the past decade, promoted yuan internationalisation, interest and exchange rate marketisation, and the partial opening of its capital account.

China has moved towards increased exchange rate liberalisation in a number of ways, as Yang Ping of the PBoC explains. China has developed a more liberalised offshore yuan market for its exchange rate activities, and increased the number of its agreements with international financial centres – for example, it created yuan bond markets in Hong Kong, London, and Singapore. In doing so, it contributed to yuan internationalisation beyond the trade and settlement value of the currency and towards creating a real reserve currency capacity. In 2014, China created the Shanghai-Hong Kong Stock Connect in order to bridge both onshore and offshore markets, which led to a partial onshore market opening, although within quantitative constraints.[10]

China has also progressively opened its domestic bond market to international investors. Peng says that by 2014,

2 Yu Yongding is an academician of the Chinese Academy of Social Sciences. He is a former president of the China Society of World Economics. He also served on the Advisory Committee of National Planning of the Commission of National Development and Reform of the PRC and on the Monetary Policy Committee of the People's Bank of China from 2004 to 2006.

3 Jin Zhongxia is China's executive board member at the IMF.

4 Wang Liwei and Huo Kan are both journalists.

5 Peng Xingyu is chief economist at First Capital, as well as a researcher at the financial research institute of the Chinese Academy of Social Sciences.

6 Shen Minggao is the managing director of *Caixin*'s think tank division, China Insight Group.

7 Yang Ping is a member of the research office of the People's Bank of China.

8 The SDR was created by the IMF in 1969 as a supplementary reserve to go alongside its member countries' official reserves. Up until now, its value has been based on a basket of four major currencies: the dollar, the euro, the British pound, and the Japanese yen. As of 1 October 2016, the basket will be expanded to include the Chinese yuan; the yuan will comprise 10.92 percent of the reserve.

9 See Ben Bernanke, "China's gold star", Brookings, 1 December 2015, available at http://www.brookings.edu/blogs/ben-bernanke/posts/2015/12/01-chinas-gold-star.

10 The Shanghai-Hong Kong Stock Connect is a pilot programme linking the stock markets of Shanghai and Hong Kong. Investors in Hong Kong can trade and settle shares listed on the Shanghai market through the exchange and clearing house in the Hong Kong market, and vice versa, although investors must operate within certain quantitative limits.

211 financial institutions had obtained authorisation to participate in China's domestic bond market.[11] In 2015, China extended the participation of international financial organisations, foreign central banks, and sovereign wealth funds in terms of financial products. Quotas were also scrapped.

Yu sees last summer's events as part of this positive trend. The PBoC's move in August was aimed at increasing the marketisation of China's exchange rate by initiating a long-overdue reform of China's exchange rate formation mechanism. Yu says that the move was badly prepared and that the PBoC's communication about it was poor, which meant the measure caused a shock on international financial markets. Even so, he thinks the move itself should be welcomed. He recognises that China's new exchange rate regime cannot yet be considered a true "market" (市场, *shichang*), because PBoC intervention and control will remain, although now at a higher cost for the PBoC. But even so, he thinks that the exchange rate regime did undergo "marketisation" (市场化, *sichanghua*) last summer.

If the yuan is to become a true international currency, Beijing must learn to tolerate yuan fluctuations.

Further measures have been taken since then, including the PBoC's decision on December 11 to launch a new index for the trade-weighted value of the yuan – to be used, along with the USD-yuan rate, as a gauge for the yuan's value, and the launch of the China International Payments System (CIPS), a new and more efficient cross-border yuan payments system. Others included China's agreement – made in order to join the SDR basket – to participate in the IMF's Special Data Dissemination Standard (SDDS) and Currency Composition of Official Foreign Exchange Reserves (COFER) data projects, as well as China's commitment to publish information on its short-term national debt.[12]

A symbolic event with limited advantages

Peng says that China's inclusion in the SDR validates and rewards this series of reforms, and acknowledges China's growing importance within the global economy and the international financial architecture. However, beyond the symbolic aspect, most of the Chinese authors selected here think that SDR inclusion will likely have few concrete consequences for China. Unlike, for example, China's accession to the World Trade Organization, SDR inclusion will not bring China direct economic advantages. It might solidify long-term demand for yuan-denominated assets, since central banks will keep more yuan as part of their foreign exchange reserves, but in the short term, it is unlikely to have any dramatic effect on asset allocation, according to Shen Minggao. The yuan's attractiveness as an investment still primarily depends on its growth perspectives, on the pace of the opening of capital markets, and on exchange rate expectations. So, decisions about asset allocation will still favour the dollar – and the inclusion will probably not change the current depreciation pressures on the yuan exchange rate.

Peng also warns that SDR inclusion is neither a necessary nor a sufficient condition for the establishment of an international currency. The British pound was international before it joined the SDR, and the euro is still a long way behind the dollar in terms of international influence. China, therefore, should not have any "sense of conquest" (征服感, *zhengfugan*) about the inclusion, because even some countries who have joined the SDR in the past have failed to make their currency truly international: Japan saw its dreams "smashed to pieces" (击碎, *jisui*) because its currency never acquired a real international influence. It would thus be a "delusion" (幻想, *huanxiang*) to think of the SDR as a guarantee of currency internationalisation. China still has a long way to go in promoting the international status of its currency as more than a medium of exchange, but also as a unit of account and a store of value.

Further reforms ahead

Jin Zhongxia of the IMF says that China has a long road ahead. He explains that, in joining the SDR, China fulfilled the IMF requirements only to the minimum degree that it legitimately could. However, China is now the second-largest global economic power; its economy is interdependent with the global economy, and is deeply integrated in the international division of labour. Therefore, China cannot expect to continue to prosper with a controlled capital account. So, SDR inclusion should be considered as a new "starting point for reform" (改革的起点, *gaige de qidian*).

Beijing seems to agree: China has already moved ahead with further financial reform since the SDR inclusion. For example, the PBoC has said that it will continue reform through three types of measures: operational reforms, legal revisions, and improvements to systemic mechanisms. China's State Administration for Foreign Exchange (SAFE) announced on 7 December the establishment of a simplified management mechanism for Qualified Foreign Institutional Investors (QFII), and increased quotas for a number of investment products. On 11 December, the PBoC published proposals for further capital account opening and for the easing of currency convertibility in the Tianjin, Guangdong, and Fujian Free Trade Zones. However, according to Shen, Peng, and Jin, Beijing has a long road of reforms ahead of it.

Accepting bi-directionality and severing dollar-yuan ties

If the yuan is to become a true, attractive international currency, Beijing must learn to tolerate yuan fluctuations.

11 These institutions included central banks, monetary authorities, sovereign wealth funds, yuan clearing banks, yuan cross-border settlements banks, foreign insurance institutions, Renminbi Qualified Foreign Institutional Investors (RQFII), and Qualified Foreign Institutional Investors (QFII).

12 The SDDS, established in 1996, gives information about the economic and financial data of countries that participate in the SDDS. COFER is an IMF database which provides quarterly data from participating countries and jurisdictions about the currency composition of their official foreign exchange reserves.

Shen says that the government needs to recognise that the construction of long-term market equilibrium involves both inflows and outflows, and that outflows are not necessarily a sign of trouble, but can be a useful adjustment mechanism. Moreover, the current situation of "half-opening, half-closure" (半开半关, *bankai banguan*), characterised by capital account control and public intervention, is becoming more and more risky, especially because it tends to bring about costly, policy-driven short-term speculations.[13] Therefore, as Peng and Jin say, Beijing needs instead to become more tolerant of yuan "bi-directionality" (双向, *shuangxiang*). This evolution will require a number of delicate policy moves to ensure that fluctuations are authorised without too much risk being released into the system. China will have to move from a monetary policy based on political and administrative intervention to a policy based on prices, regulation, and supervision. Also, as cross-border flows are liberalised, China will have to rely on economic dynamism driven by structural reforms to ensure its attractiveness to investors, as well as on flexible but relatively "predictable" financial asset prices, governmental "respect" (敬畏, *jingwei*) for market mechanisms, and a policy "bottom line" (底线, *dixian*) of avoiding systemic risk.

Increased bi-directionality will have another positive effect: it will work towards slowly severing yuan-dollar ties. If the yuan continues to have a hard or even a soft link to the dollar, its legitimacy as an SDR currency will be questionable, since yuan inclusion will only serve to increase the dollar's weight within the basket. Therefore, the yuan needs to move away from what Peng calls Beijing's "dollar shadowing" policy (美元影子化, *meiyuan yingzihua*). Shen suggests that this can be achieved by increasing the yuan-dollar trading band, adjusting the structure of China's central bank assets, and increasing the independence of China's monetary policy. By doing so, China will slowly separate yuan expectations from their current dollar referential.

Streamline and deepen China's exchange rate and financial markets

In order to make its currency truly international, China will also need to reconcile its offshore and onshore yuan markets at some point. So far, Beijing has encouraged developments on the offshore market, so as to shelter the onshore market from potential shocks. This has led to the creation of an offshore market that is much deeper and more active than the onshore market.[14] However, according to the *Caixin Weekly* article, the fact of there being two markets has not prevented speculation or arbitrage from having a direct impact on the domestic yuan market. More worryingly, the two-market situation could eventually lead to the overdevelopment of the offshore market and the irreversible marginalisation of the "impenetrable" (进不去, *jinbuqu*) onshore market – which is currently characterised by too much supervision and almost no business opportunities. To prevent this from happening, China will have to progressively merge the two markets, as most other countries with similar dual-track experiences have done.

13 A point made by Huang Yiping, vice-president of Peking University's National School of Development, in an interview with *Caixin Weekly* journalists Wang Liwei and Huo Kan.

14 According to the PBoC's 2015 "Report on the Renminbi internationalisation", transactions on the main yuan offshore markets (Hong Kong, Singapore, London, etc.) amounted to more than $230 billion daily, compared to $55 billion on the onshore market.

Finally, if it is to increase the yuan's international role as a reserve currency, China will need to deepen its bond and capital financial markets. The existing domestic bond market will have to be opened to more actors – particularly private ones – and to more diverse debt products. This will probably involve more short-term actions on the market, but it will improve the volume, liquidity, and diversity of available assets, and thus increasingly satisfy the demand of international investors. It will also work towards building up China's still incomplete yield curve. Chinese companies and institutions with high investment grades should also be allowed to issue bonds accessible to international investors. Gradual stock exchange opening is another crucial step for attracting foreign capital into China's financial market; international investors cited in *Caixin Weekly* seem to believe that inclusion in a Morgan Stanley Capital International (MSCI) index would carry even more meaning than this year's SDR inclusion.[15]

In order to make its currency truly international, China will also need to reconcile its offshore and onshore yuan markets.

A new avenue for China's international ambitions

Much remains to be done if the yuan is to be a truly international currency, but even so, *Caixin Weekly* journalists explain that SDR inclusion does signal that China could potentially take a greater role in the current international monetary system. As an SDR currency in the process of internationalisation, the yuan will increasingly circulate beyond China's borders, and China will have to learn to take more than domestic factors into account in setting its monetary policy. For example, China might have to coordinate its monetary policy with other SDR member countries to ensure that global liquidity flows are not excessive and do not lead to inflation. According to the *Caixin Weekly* journalists, China might also in special cases need to contribute to rationally increasing the supply of global liquidities, particularly by extending the use of yuan to countries in need.[16]

Peng says that, as a new SDR member, China does not intend to "tear down the temple" (拆庙, *chaimiao*) of the current international monetary order. But the author believes that

15 MSCI, an investment research firm best known for its stock market indices, announced in June 2015 that it would continue not to include mainland-listed shares in its emerging-market indices. The firm justified its decision by saying that China-listed companies are still largely inaccessible to foreign investors.

16 Although the yuan is not yet fully convertible, China already provides liquidities to third countries in emergencies. It sets up currency exchange mechanisms (exchanging yuan for dollars) with foreign central banks, thus "dispersing" its excess dollars. So far, China has developed about 30 such agreements with other countries and monetary authorities, for a total amount of around yuan 3,300 billion. The last such operation was with Argentina on 16 December 2015.

China intends to participate more in global economic and financial governance. Indeed, he says that one of the goals of the United States in supporting the yuan's SDR inclusion was to encourage China to further integrate in the current order. With China now "officially" part of the international order, Washington can engage China on global financial issues, while hopefully avoiding Beijing setting up alternate blocs by drawing other countries into newly created, China-led institutions.

In the near future, China intends to take advantage of the joint opportunity presented by SDR inclusion and the 2016 Chinese presidency of the G20 to offer proposals for reforming the international monetary system. China believes, especially since 2008, that the current system has significant defects, and PBoC Governor Zhou Xiaochuan proposed reform as early as 2009. Zhou at the time suggested the expansion of the role of the SDR, the possibility of ad hoc SDR issuance, and greater SDR representativeness.[17] During its 2011 G20 presidency, France picked up on China's push for reform, but no tangible results followed.

This time around, China intends to restart the debate, as indicated by finance minister Lou Jiwei's speech on 8 October at the G20 finance ministers and central bankers working dinner. Lou said that improving global financial governance was one of the six financial and economic items China wanted to promote during its G20 presidency. To this end, China has already reinstated the International Financial Architecture Working Group, which had been stagnant since 2012. Its first meeting was held on 15 December 2015. The groups' future discussions will include issues such as IMF voting shares and government reform, sovereign debt reorganisation, circulation of capital flows, the need for a comprehensive and global financial safety net, and the increased use of the SDR, especially through more frequent issuing. According to *Caixin Weekly*'s journalists, France's reform proposals in 2011, aiming notably at expanding the SDR's role, were met with enthusiasm and there is no reason that China's proposals will not have the same response, especially from developing countries, which continue to suffer from the global overreliance on the dollar.

Conclusion

Overall, it is clear that Chinese observers recognise that the yuan's SDR inclusion has mostly a symbolic significance. Even so, they underline its importance in opening the way for China to play a greater role in the international monetary system – an opportunity that Beijing will no doubt seize with its presidency of the G20 in 2016.

While praising the reforms conducted to date, many of the observers also point to the significant reform efforts that have yet to be made, all of them necessary to turn China's yuan into a truly international currency. However, writing around the time of the SDR inclusion, most of them do not reflect on the government's recent attitude toward China's foreign exchange policy. A statement made by Xi Jinping's aide for economic and financial affairs, Liu He, is quite representative of the situation as a whole. Liu recently said that "financial regulators must have the courage to stand against the market", suggesting that China may still be unwilling to tolerate too much bi-directionality in its financial and foreign exchange markets, and may continue to intervene and seek to control this market for some time to come.[18]

17 In March 2009, Zhou Xiaochuan published the document "Reflections on the reform of the international monetary system", which formed the basis for these proposals.

18 Zhou Xin, "Stand firm against market swing: Xi's aide tells China's financial regulators", *South China Morning Post*, 13 January 2016.

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