

RMB Fantasy & Reality

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RENMINBI RISING

A NEW GLOBAL MONETARY SYSTEM EMERGES



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U.S. manufacturing & China

➤ The myths

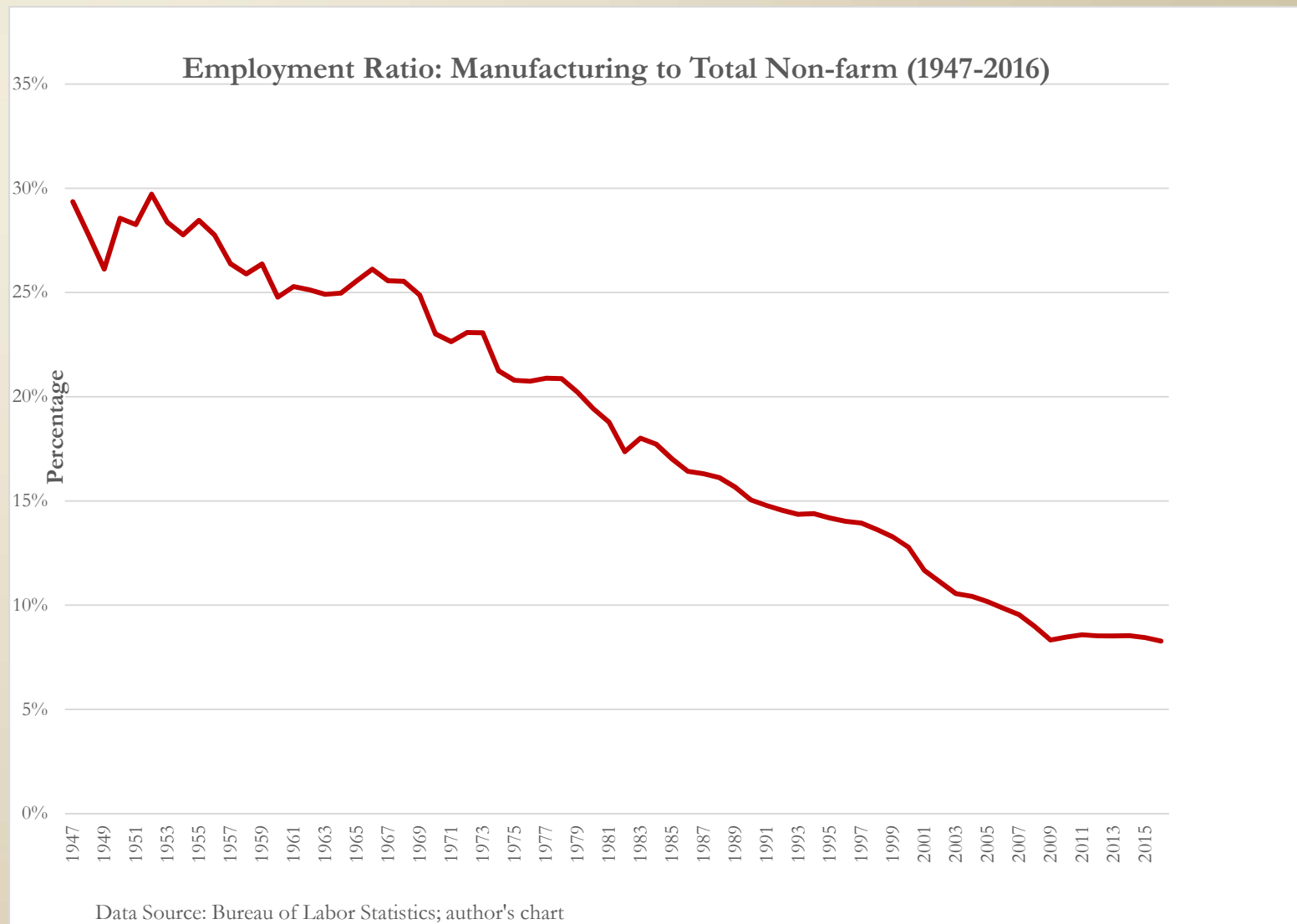
- **U.S. manufacturing is collapsing**
- **The reason is Chinese currency undervaluation**
- **In this way, China continues to steal U.S. jobs**

➤ The reality

- **U.S. manufacturing continues to grow & leads the world**
- **The jobs decline parallels earlier agricultural jobs decline**
Caused by efficiency: five or six out of six or seven jobs lost
- **China's currency has not been undervalued for six years**
Is currently overvalued
- **Both parties have an incentive to divert attention from the real issue**

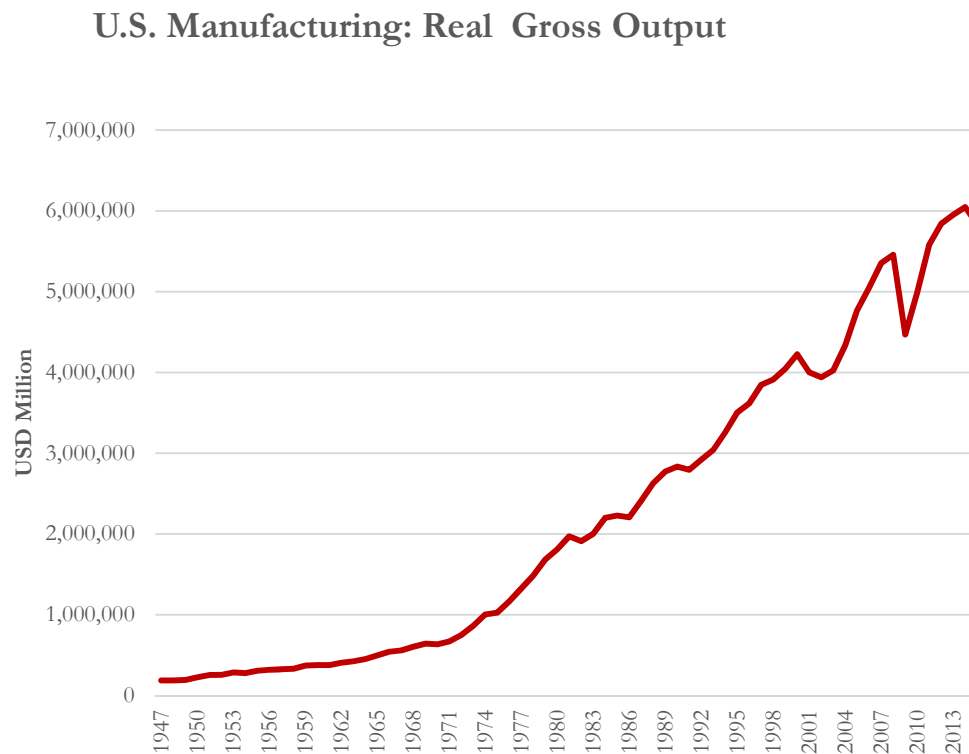


Manufacturing jobs are disappearing





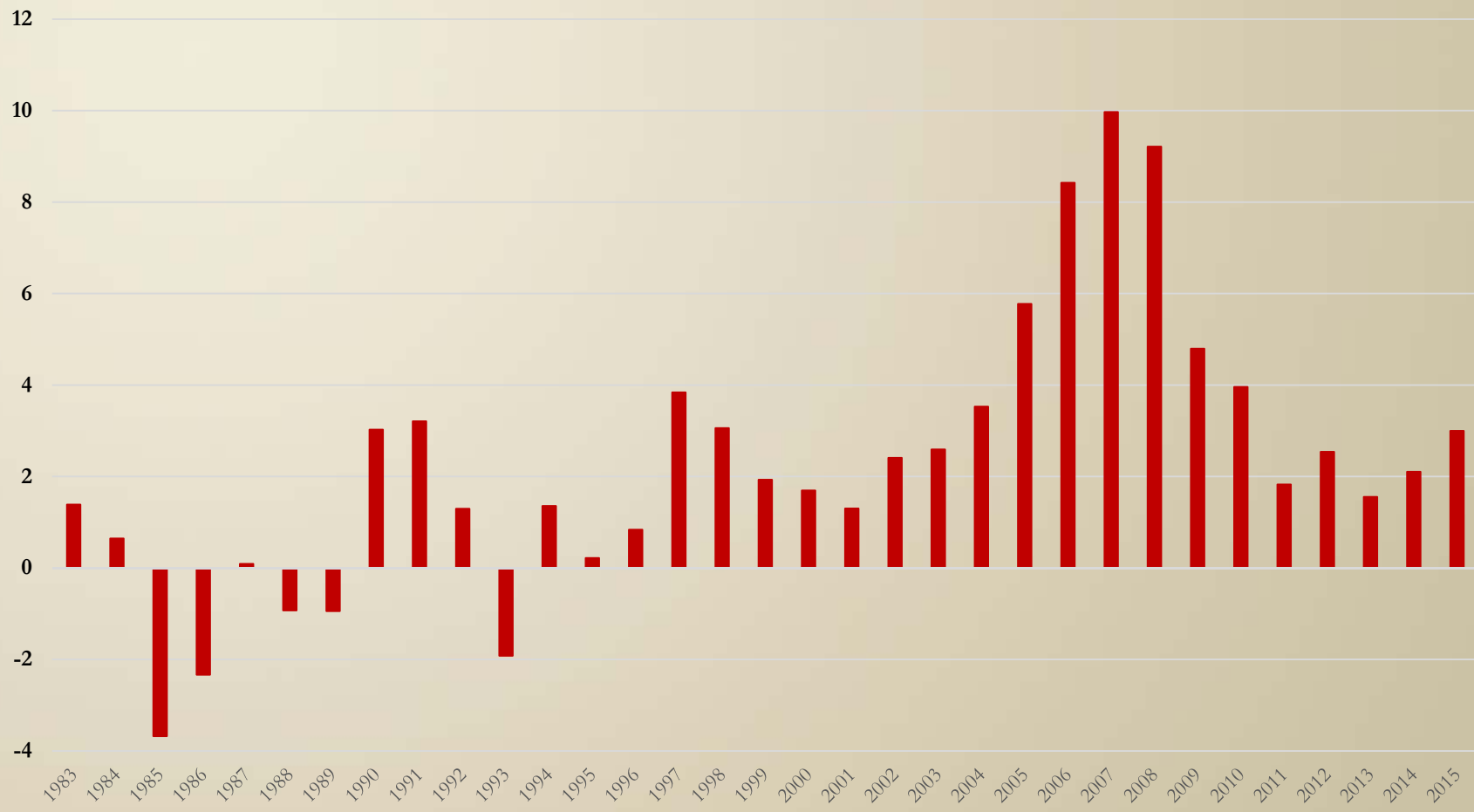
U.S. manufacturing has not collapsed



Source: Commerce Dept. Bureau of Economic Analysis; author's graph

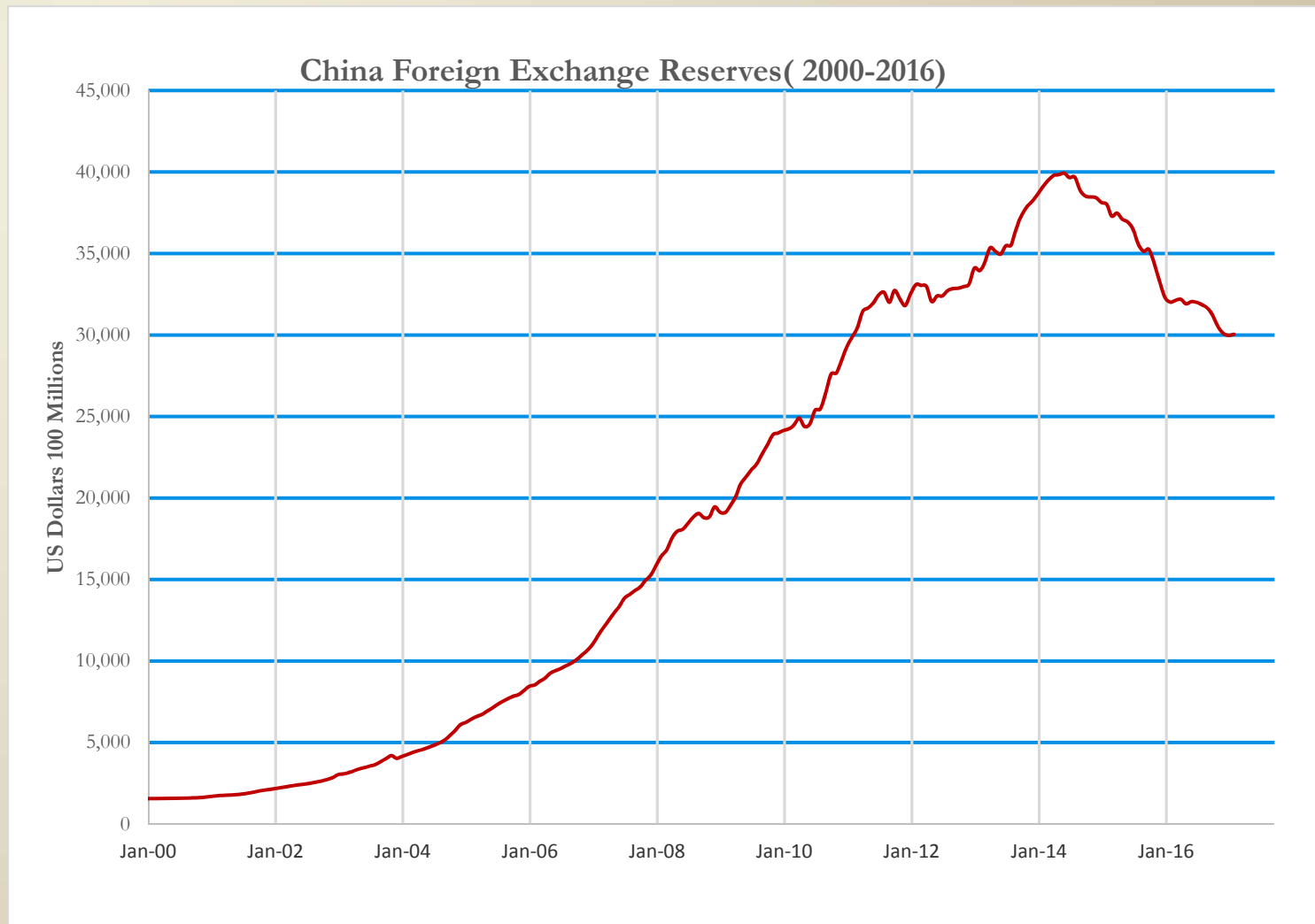


China's current account does not indicate undervaluation after 2010





Current spending to stabilize/overvalue RMB





Motives for RMB internationalization

- **GFC shock led China & others to believe that a USD-based system was too risky**
- **China's international financial position**
 - **Assets (mostly USD) minus liabilities (mostly RMB) equals 50% of GDP, mostly denominated in USD**
 - **Mismatch too risky**
- **Business savings from not having to go in & out of USD**
 - **Shift currency risk from Chinese companies to foreign ones**
- **Use like WTO as lever for domestic reform**
- **Prestige, yes. Ambition to displace USD, evolving.**



Prerequisites of international currency?

- China has turned the Western theory of prerequisites on its head
- Seeks to use RMB internationalization to drive:
 - Liberalization of exchange rate
 - Opening of capital account
 - Freed interest rates
 - Properly regulated banks

Note deposit insurance, move toward acceptance of default risk
- Virtuous circle of incremental reforms from both ends
- Capital flight, weak economy put this approach at risk
 - May create vicious circle; difficult to reverse



Aspects of RMB internationalization

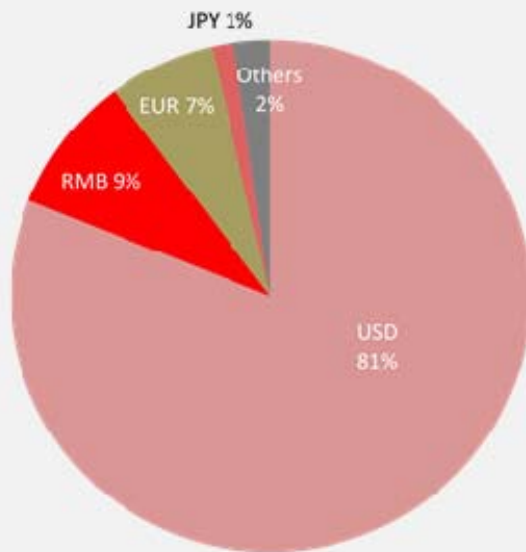
- Trade finance/Trade settlement
- Payments
- Denomination
- Foreign Exchange trading
- Reserves
- Global management structure



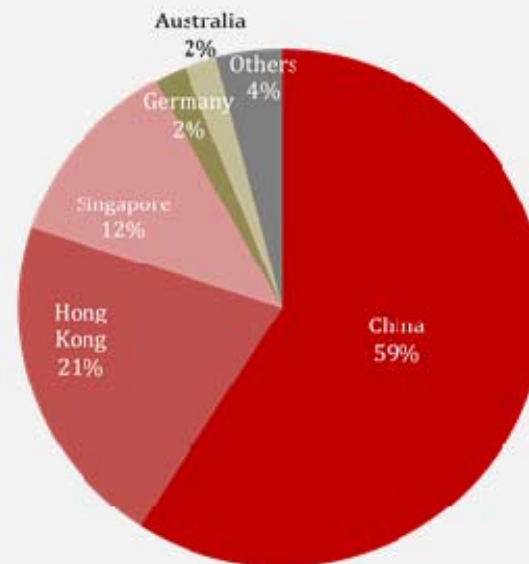
RMB as a trade finance currency

Figure 7.2 | RMB as A Trade Finance Currency (October 2013)

Top Trade Finance Currencies
by Global Share (%)



Top Five Economies using RMB for
Trade Finance (%)



Data source: SWIFT, RMB Tracker Report December 2013.

➤ Post-GFC trade finance collapse, then capital requirements cede market



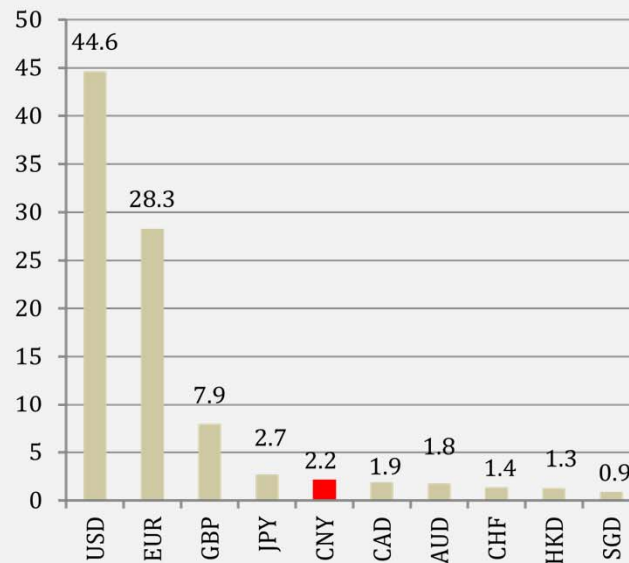
RMB as a payment currency

Figure 7.1 | SWIFT Global Payment Flow by Share: Top Ten Currencies

December 2013 (%)



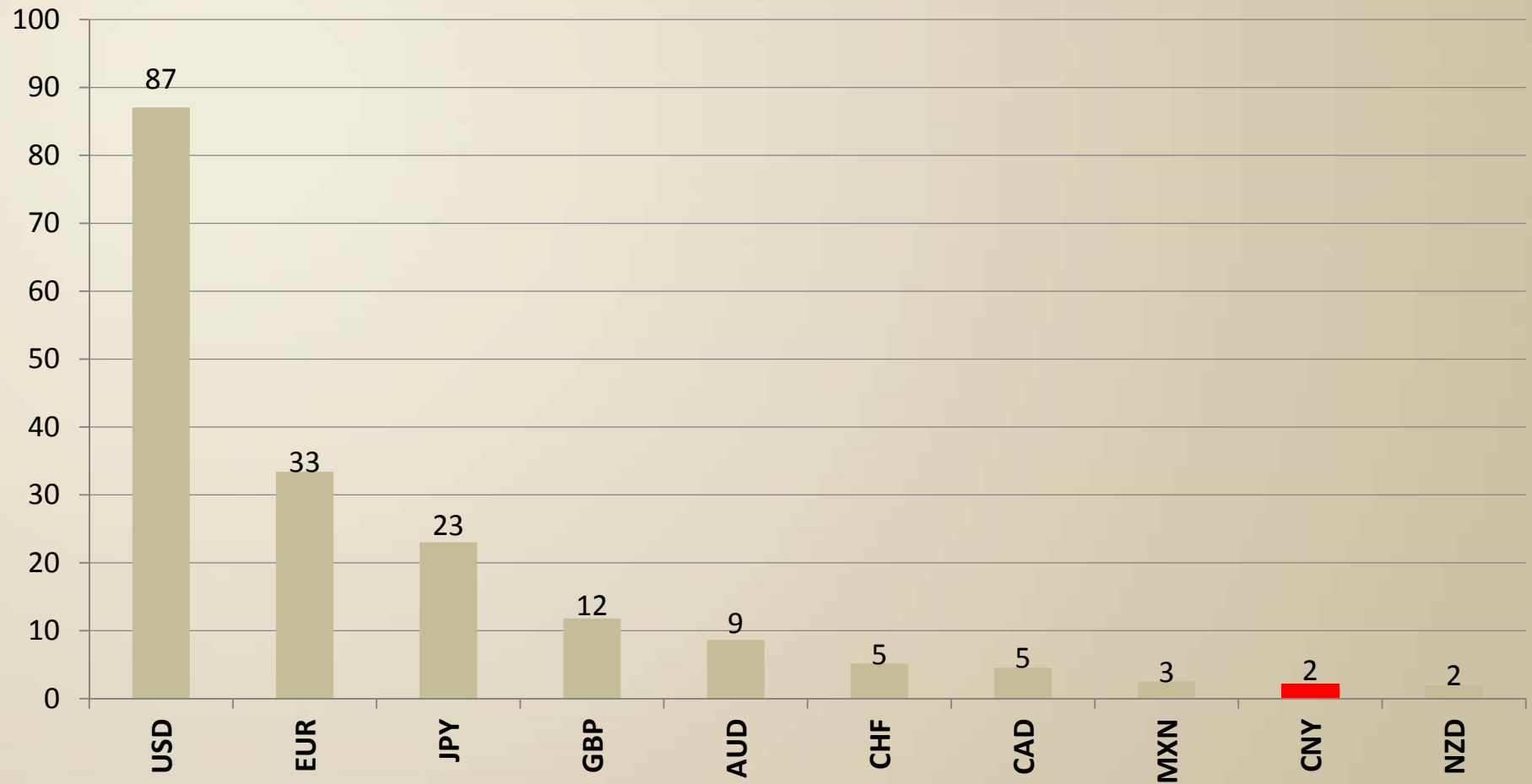
December 2014 (%)



Data sources: SWIFT, RMB Tracker Reports: January 2014 and January 2015.



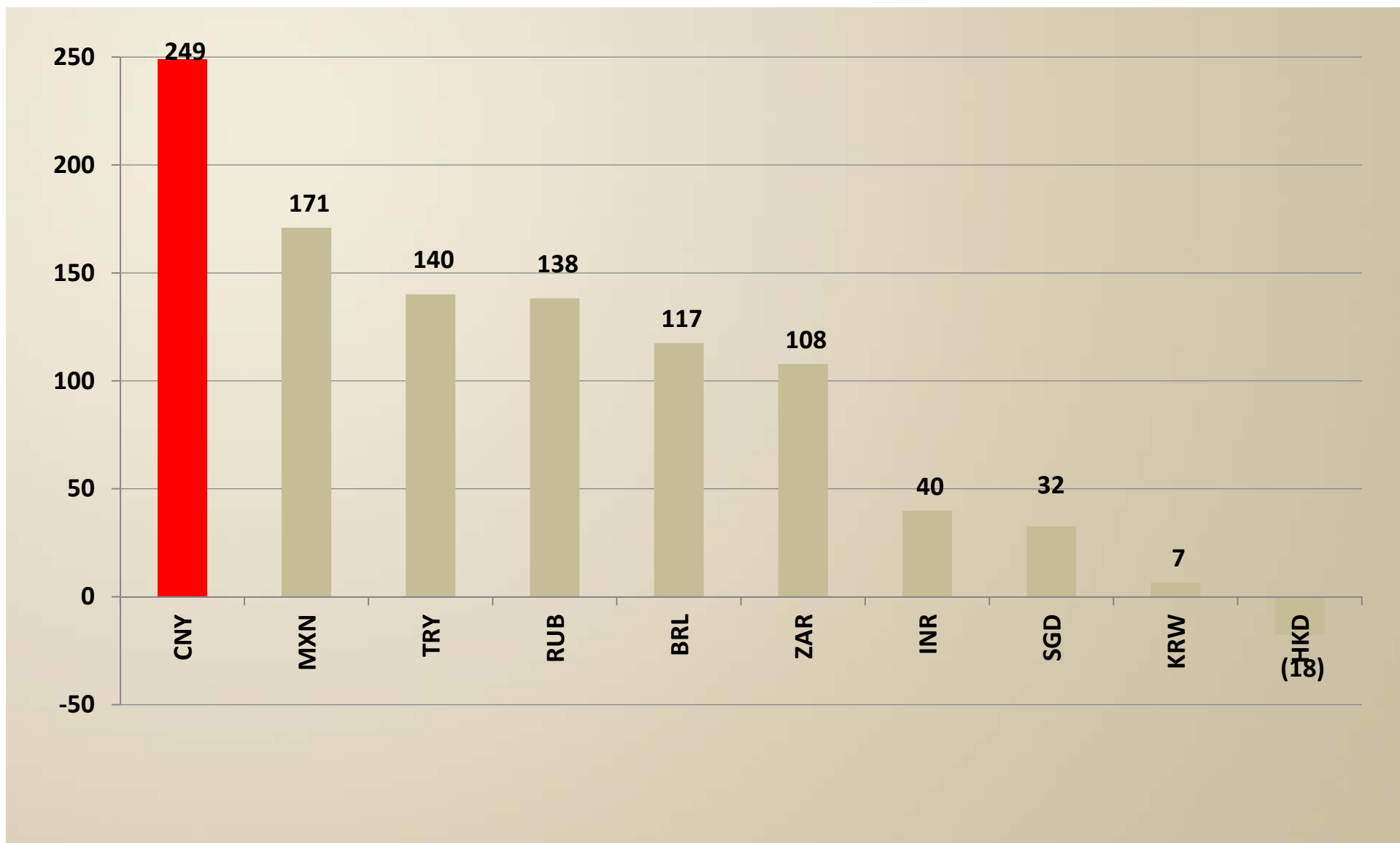
Global foreign exchange trading, %, 2013



Source: BIS. Total is 200% because each trade has two sides

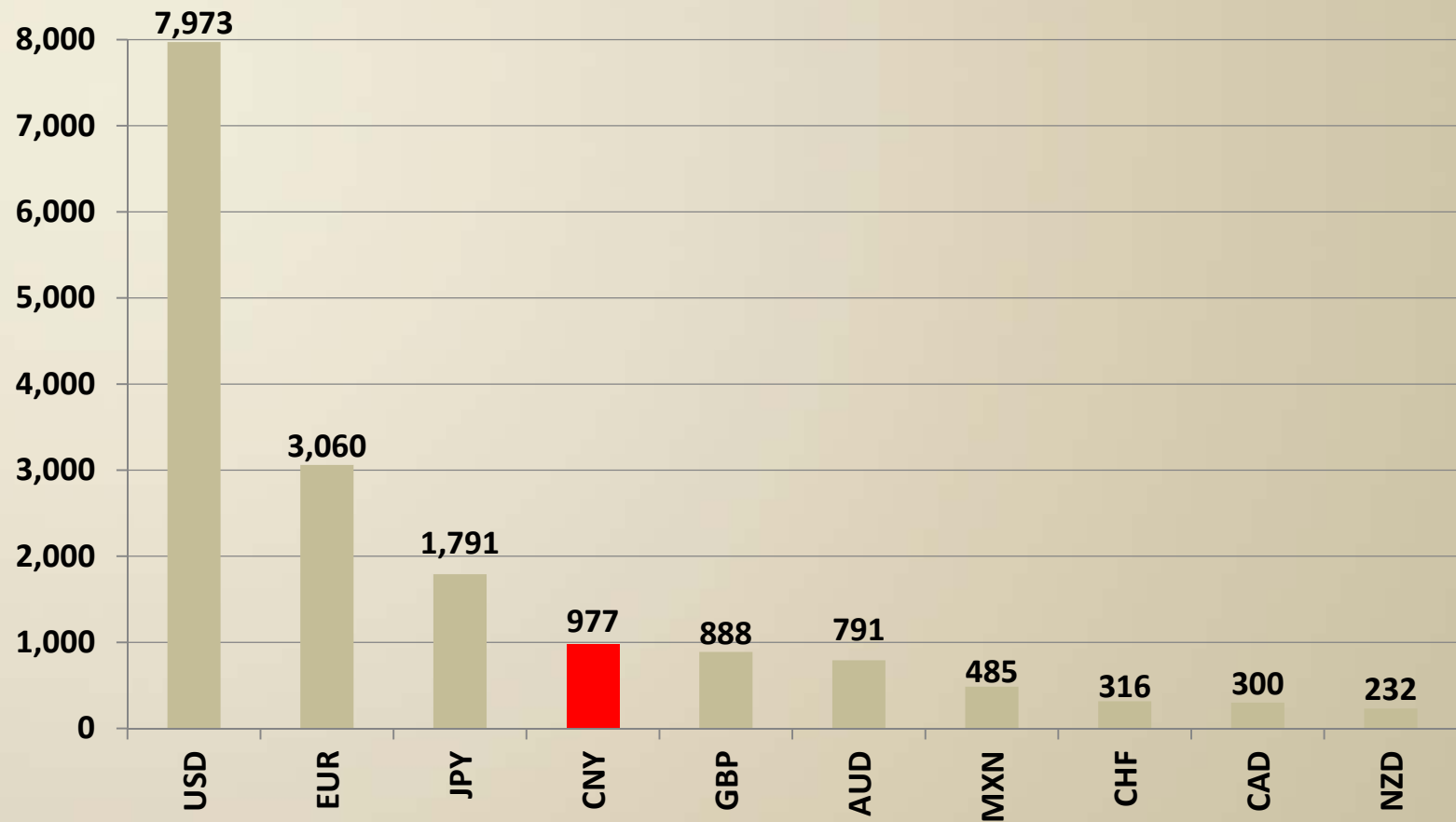


Growth of FX trading, EMs, 2010-13





One 2020 scenario for traded currencies





Institutional infrastructure of RMB promotion

- Big banks moving overseas
- Allowing trading, deposits in Hong Kong, then elsewhere
- Offshore market
- Three free trade zones, starting with Shanghai
 - **Actually national reforms, channeled through trusted institutions**
 - E.g., RMB pooling
- Global network of exchange centers, Hong Kong at core
- New development banks?
- In three years, the number of international banks doing RMB business rose from 900 to 10,000
- Government provides the supply; business provides demand



Reserve currency

- **SDR membership of limited practical significance**
 - **Only USD 294 billion of SDRs in circulation June 2015**
 - **Close decision**
 - **Great symbolic significance**
 - **Intended to facilitate domestic reform**
- **Wide & thin use of RMB reserves**
 - **About 60 countries**
 - **Currently 1% of global reserves, could be 5% by 2020**
- **Role of swaps**
 - **China: USD 498.5 billion with 29 countries**
 - **US: only USD333 billion with 5 countries**



Global management structure I

- Hitherto, global monetary affairs managed by
 - Bretton Woods institutions: IMF, World Bank, ADB...
 - U.S. Fed/Treasury
 - U.S. dollar
- Post-Mexico 1994 Congress restricts swaps
 - From 1997-8 AFC, significant Southeast Asian disillusionment
 - US 5 swaps, China
- Widespread U.S. sanctions create incentive to avoid USD
- From 2008-9 GFC, considerable dissatisfaction with system
 - Interest rate policy, loss of value of USD reserves
 - No swap with China



Global management structure II

- **From 2009 U.S. Congress refused to accept reforms**
 - **U.S. Congress approval of reforms in 2015 too late to prevent emergence of dual structure unless**
 - US & China converge; US joins AIIB
 - Or China seriously falters
- **US refusal to join AIIB**
 - Theory A: U.S. opposed to any Chinese institutional initiative
 - Theory B: U.S. intended to join, but force high standards, sabotaged by UK



Bretton Woods vs. China-initiated institutions

- **New Development Bank (BRICS Bank) \$50/100B**
- **World Bank \$223B**
- **Asia Infrastructure Investment Bank \$100B**
- **Asian Development Bank \$168B**
- **Silk Road Fund \$62B**
- **Restructured China Development Bank \$190B**



Requirements to be a global currency (like USD)

- Internationalization (NZD)
- Deep & open capital markets vs fragmented, partially closed
- Trusted institutions: PBOC, legal system
- Large & growing domestic economy

Economic reforms

Political will



CAN CHINA SATISFY THESE REQUIREMENTS?

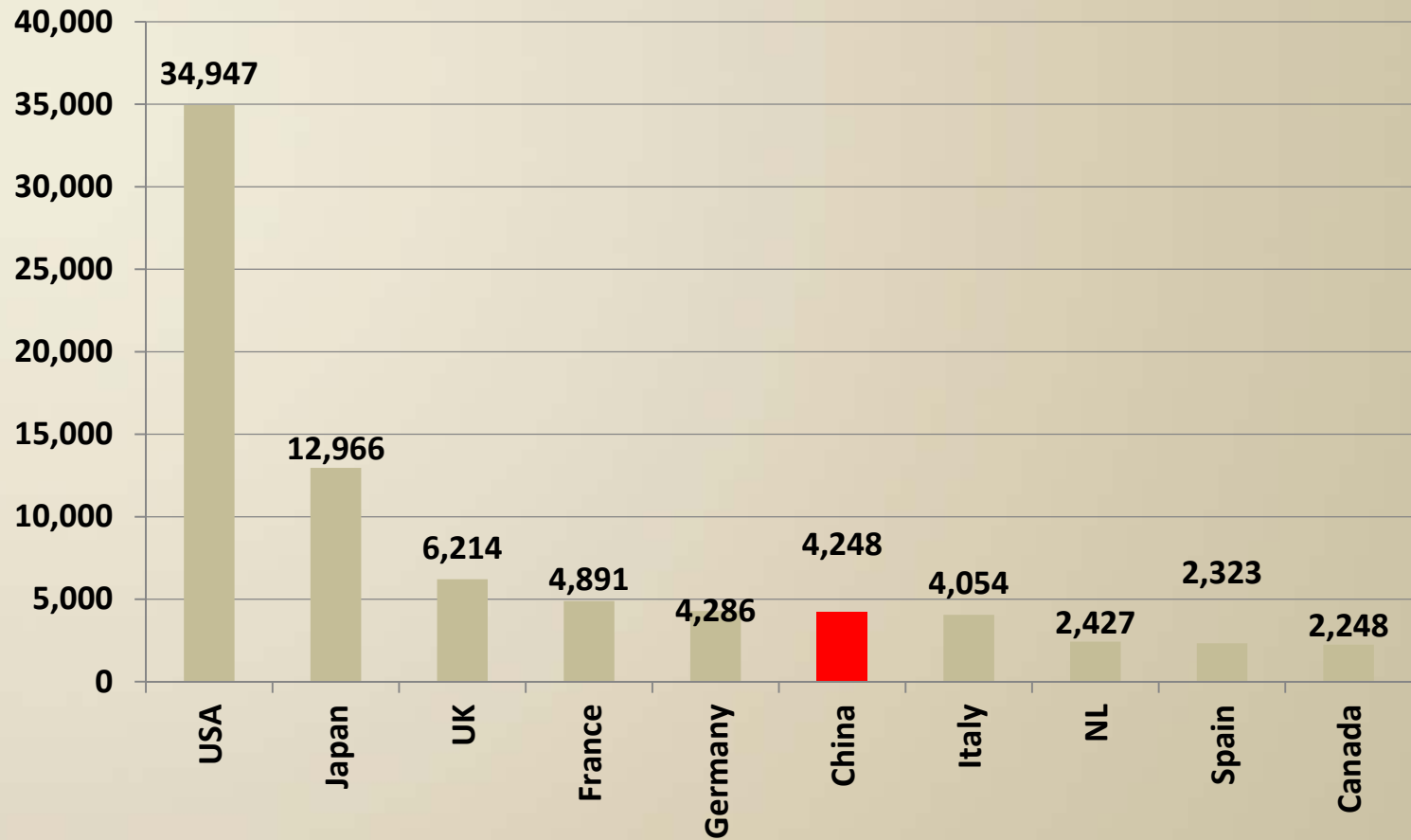


Deep capital markets?

- Compare Euro
- Treasury market (CGB), is 10% of U.S. counterpart
 - **US\$ 4 trillion equivalent**
- Bond market is fragmented under four different regulators
 - **No coherent yield curve**
- If reformed, Chinese bond market will easily surpass Euro
- If local government debt, overbanking are consolidated into treasury bonds, CGB market will be 4X deeper

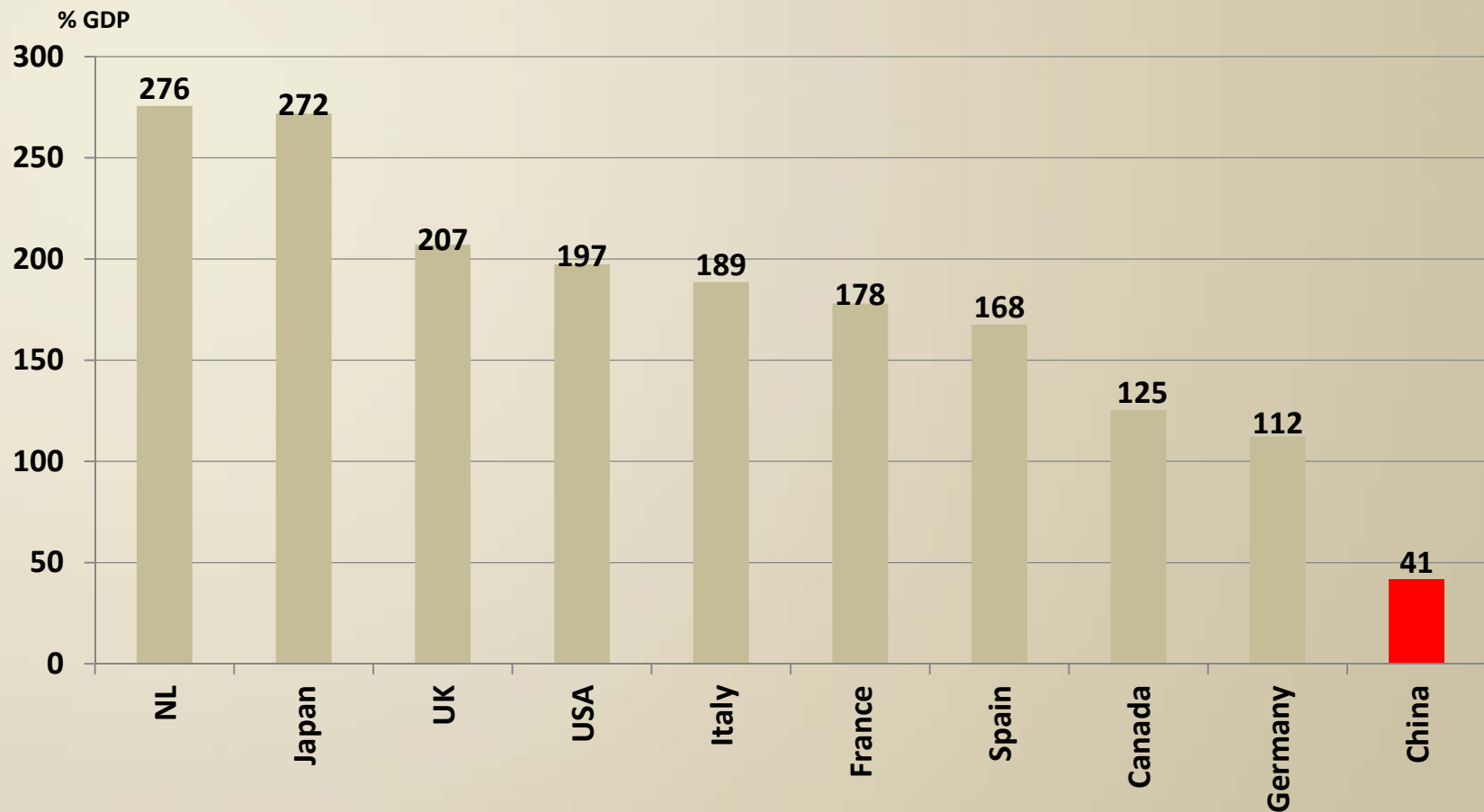


Deep bond market today?



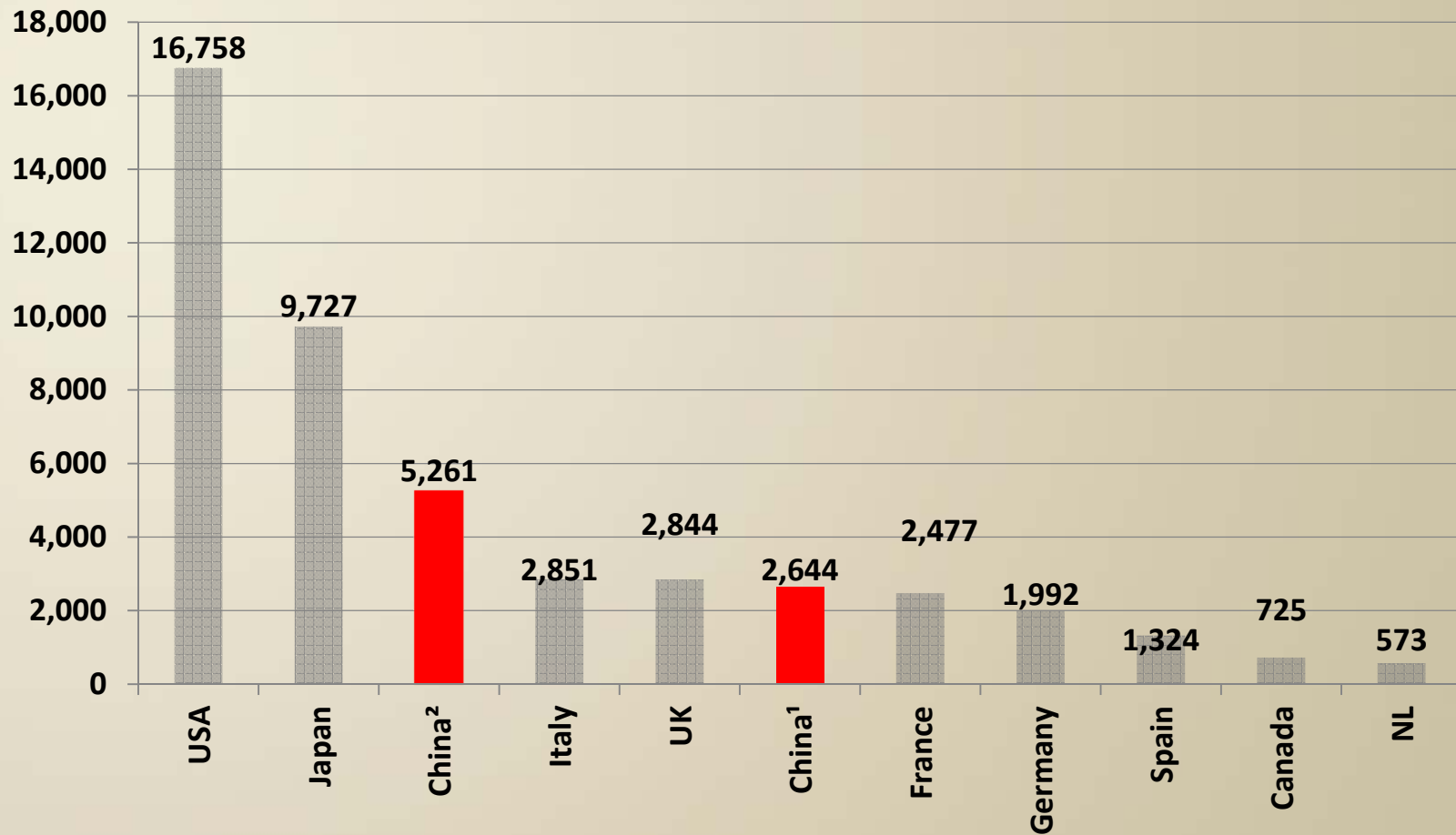


Deep bond market potential: bonds %GDP





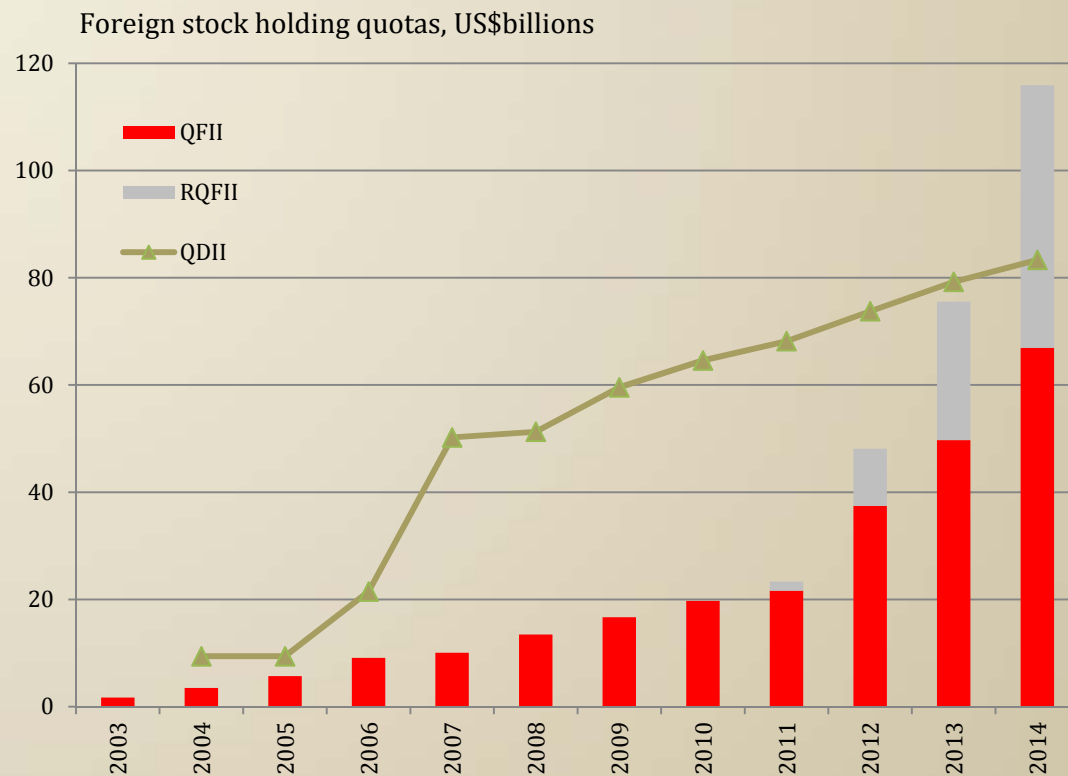
Deep bond market 2020?





Open capital account?

- **Bonds: Only 2.5% of Chinese treasury bonds are foreign held**
- **Stocks:**





Selected capital market openings

1994	Removal of most restrictions on inbound FDI
2003	QFII Qualified foreign institutions get quotas to buy Chinese securities
2004	Hong Kong individuals can have RMB accounts, convert RMB 20,000 per day
2006	QDII – Domestic institutional investor may buy foreign securities
2007	First Dimsum Bond
2008	First Currency swap
2009	Trade settlement in RMB
2012	RQFII Qualified foreign institutions may use offshore RMB to buy Chinese securities
2013	Qianhai Equity Trading Center-raises RMB finance in Hong Kong for Qianhai enterprises
2014	Shanghai-Hong Kong Stock Connect RQDII – Domestic investors may buy offshore RMB products
2015	China-Hong Kong Reciprocal recognition of funds QDII2 – High net worth Chinese may invest overseas



Trusted institutions?

- PBOC
- Record of keeping markets open under pressure
- Record of supporting others with crisis liquidity
 - Fed/Treasury record has weakened, China untested
- Rating agencies
- Legal system
 - Important reforms
 - But decisions ultimately made by a Party commission
 - One option: separate courts



Large & growing economy? Complexity

- Export driven to domestic driven
- Investment driven to consumption driven
 - Retail consumption cannot grow faster
- Manufacturing to services
 - Major cultural & structural shift
 - Services now 50.5% of GDP
- Engineering mentality to market
- Emulation to innovation
- Property-based finance to credit-based
- Overall: market allocation of resources



Large & growing economy? Squeezed

- Local government
- Upgrade status of rural migrants
- SOEs
- Property market
- Shadow banking
- Overcapacity—e.g., 400,000 excess workers in steel
- Excess input inventories
- Environmental amelioration costs
- Military expansion costs
- Graying population (Lewis point reached in 2010)

Total debt/GDP

Typical for China's situation: 117%

2015 China: 255%



Real estate debt/GDP (%)

1999	15.8	2008	33.1
2000	19.1	2009	36.2
2001	19.4	2010	40.9
2002	20.5	2011	44.3
2003	22.5	2012	49.5
2004	22.8	2013	55
2005	22.3	2014	60.4
2006	30.1	2015	62.1
2007	30.8		

Source: Ma & Laurenceson



Large & growing economy? Conflicts

- Stable currency/market currency
- Rapid growth/rapid reform
- SOE reform/enhanced Party control
- Rule of law/enhanced Party control
- Public support for environmental, anti-corruption campaigns/enhanced repression
- FDI to move up-market/squeeze of foreign firms
- Globalization/control of information
- Centralized leadership/rapid, expert decision-making
- Competition/consolidation-national champions



Large & growing economy? Politics

- Possibly most sophisticated economic plan in past century
- Severely damages interests of every important constituency
- Reshaped leadership for greater decisiveness
- Deploy anti-corruption campaign to defeat reform opposition
- Combine economic reform with political repression
- Liberalizing interest rates & exchange rates inadequate without breaking the Party-Government-SOE lock on finance, property, regulation

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APPENDIX



The undervaluation controversy

- China's 1994 currency system kept the currency overvalued through 2001, undervalued until 2009
 - **Not designed for undervaluation, but perhaps maintained deliberately**
- Estimates like Peterson Institute's 40%+ undervaluation were based on ignoring the capital account pressures
- Since 2010, current account surplus has been 2% of GDP or less, compared with IMF criterion of 4% for undervaluation
- In 2015, IMF officially declared RMB not undervalued
- In late 2015-early 2016, massive expenditures to keep the RMB above market levels
- Over last decade, RMB has appreciated more than any other EM currency.