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What is the Future Role  
of the Chinese Currency  
in Global Financial Markets?



## What is the Future Role of the Chinese Currency in Global Financial Markets?

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### **Abstract**

China's economic and diplomatic ascendancy over the past decade has been nothing short of phenomenal in terms of world history. It has seen its influence on the world stage grow from being a bit part player at the start of the 20<sup>th</sup> century, when its territory sovereignty was encroached upon by the European colonial powers and Japan mounted a campaign of conquest, to being seen as the biggest strategic threat to American primacy in the global economy. This view of China as an economic threat has been reiterated recently by various key figures in the United States administration, with calls for a revaluation of China's currency in light of the huge trade deficit the United States has with China. The United States acted on both trade and financial fronts in order to urge Beijing to revalue; in the former, with the implementation of restrictive quotas on certain categories of textiles and garments, and heavy anti-dumping duties on Chinese made TV sets, shoes, furniture and socks, and in the latter with former Treasury Secretary John Snow and former Federal Reserve Chairman Alan Greenspan repeatedly urging Beijing to revalue or move to a flexible exchange rate regime.

Although this paper will focus to an extent on the debate about China's valuation of its currency and its effects on the global economic imbalance, it is the aim of this author to attempt an examination of the role the Chinese currency has played in the recent past, its current effect on the global economy and the potential impacts it will have on financial markets in the future.

### **Keywords**

China, Renminbi, Global Imbalances, Revaluation, Financial Crisis

### **JEL Codes**

D53, E41, E42, E44, F31

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## **Introduction**

China's economic and diplomatic ascendancy over the past decade has been nothing short of phenomenal in terms of world history. It has seen its influence on the world stage grow from being a bit part player at the start of the 20<sup>th</sup> century, when its territory sovereignty was encroached upon by the European colonial powers and Japan mounted a campaign of conquest, to being seen as the biggest strategic threat to American primacy in the global economy. This view of China as an economic threat has been reiterated recently by various key figures in the American administration, with calls for a revaluation of China's currency in light of the huge trade deficit the United States has with China. The United States acted on both trade and financial fronts in order to urge Beijing to revalue<sup>1</sup>; in the former, with the implementation of restrictive quotas on certain categories of textiles and garments, and heavy anti-dumping duties on Chinese made TV sets, shoes, furniture and socks, and in the latter with former Treasury Secretary John Snow and former Federal Reserve Chairman Alan Greenspan repeatedly urging Beijing to revalue or move to a flexible exchange rate regime.

Although this paper will focus to an extent on the debate about China's valuation of its currency and its effects on the global economic imbalance, it is the aim of this author to attempt an examination of the role the Chinese currency has played in the recent past, its current effect on the global economy and the potential impacts it will have on financial markets in the future.

## **The Chinese currency- a primer and a short historical perspective**

The Renminbi (RMB) is the official currency of Mainland China, its title, which translates into '*the people's currency*', reflects China's socialist roots and it has been in circulation in its current form since the 1<sup>st</sup> of March 1955. Politically speaking however, China has three currencies, the RMB<sup>2</sup>, the Hong Kong dollar and the Macau

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<sup>1</sup> China's Role in the Current Global Economic Imbalance, Li-Gang Liu, Research Institute of Economy, Trade and Industry, Tokyo, Japan, March 2005

<sup>2</sup> The RMB is measured in units of Yuan, and both terms will be used interchangeably in this paper

pacata. Today the RMB is valued at 7.86 RMB to the US dollar (USD) and Chinese foreign reserves stand at almost 1 trillion US dollars (USD)<sup>3</sup>.

At the formation of the modern People's Republic of China in 1949, the Chinese currency like many other post-war currencies was virtually unconvertible. China's economic and political isolation from the 1950s to the 1970s also blocked out most world trade, eliminating the need for foreign exchange mechanisms. Only the Bank of China, the Chinese central bank, had the authority to deal in foreign exchange. With the opening up of China's economy in 1978, the need for easier access to foreign exchange led to more than 3800 authorised foreign exchange institutions by the year 2004. However throughout this period and until today China still maintains tight control on capital flows and the exchange rate.

### **The Dual Exchange Rate**

One of the interesting aspects that arose with the Chinese exchange rate during this period of China's re-emergence and re-integration with the global economy was the existence of a dual exchange rate within the country<sup>4</sup>. An internal settlement rate of 2.80 existed for exporters while the official rate was maintained at 1.50. This dual exchange rate system effectively subsidised exports since it increased the profitability of Chinese exports, while actually forcing the government to absorb the foreign exchange losses.

Outcry from China's trading partners, notably from the United States, which filed several cases against the non-competitive disadvantages of the dual exchange rate, and international pressure from the IMF caused a rethink of the system on China's part. At that point anyway the costs of earning a USD in exports were already reaching 3.07 RMB and the Chinese government decided to unify the exchange rate by abolishing the dual system and revaluing at 2.80 RMB in 1985. What is important to note is that during this period of dual exchange rates, the Chinese government took active steps to revalue the official RMB rate so that it would reflect a more 'market realistic' valuation of 2.80 RMB.

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<sup>3</sup> Emerging Market Indicators, The Economist 25<sup>th</sup> November 2006

<sup>4</sup> Is the Chinese Currency Undervalued?, Jiawen Yang & Isabelle Bajoux-Besnainou International Research Journal of Finance and Economics, Issue 2, 2006

### **Unification and Re-emergence of a Dual Exchange Rate**

The Chinese government then liberalised further by allowing local (exporting) firms to retain their foreign exchange earnings and allowing the Bank of China to create local currency swap markets in Shanghai and other major cities in 1980. These swap markets created foreign currency demand from firms previously denied access and with price flexibility in the swaps market, it was an effective way to sound out a market driven exchange rate. Although this in effect led to a second dual currency system, it allowed the Chinese government to effectively gauge market sentiment on exchange rates and it subsequently devalued accordingly. This demonstrated pragmatic and prudential financial management by the Chinese government in an effort to determine the market rate of its currency and this theme of prudential financial management will be an important one when considering the role of the Chinese currency in global financial markets.

With that being said, it should be noted that even in spite of having an effective system to monitor exchange rates, the Bank of China did not revalue fast enough to match the swap rates. Perhaps it was over-cautiousness on its part but it eventually lead to a price mismatch of up to a 50% premium between swap and official rates. With this continued loss of export income, China then chose to reform its foreign exchange system in 1994 by adopting a market based, managed floating exchange rate system. The dual exchange rates were merged at 8.7 RMB, which was more in line with the swap rate. China's first foreign exchange trading centre was opened in Shanghai in April 1994 and this led to its inter-bank foreign exchange market developing. This devaluation in 1994 also coincided with an increased growth in exports during the 1994-1995 period. This observation led to several commentators seeing China's devaluation and subsequent export growth as one of the causes of the Asian financial crisis<sup>5</sup>. If this were true, it could be seen as an indicator of the RMB's clout in financial markets. We shall consider the arguments below.

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<sup>5</sup> The Financial Times (17 September, 1997, p29), The Washington Post (27 November, 1997, pB11), The Economist (22 November 1997, p41), Euromoney (December 1997, p38)

## **The Asian Financial Crisis**

The Asian financial crisis began in 1997 when Thailand was forced to devalue its currency when it exhausted its foreign currency reserves in an effort to defend its currency peg from speculators and investors keen to 'cash out'. The transition from a pegged currency to a free floating one caused the Thai baht to lose half its value<sup>6</sup>. As investor confidence collapsed throughout Asia, Indonesia, South Korea, the Philippines and Malaysia were all affected and their currencies devalued significantly. Many factors were cited as causes to the Asian financial crisis, it is generally accepted that the increase in interest rates in the United States made the USD more attractive to short term investors. This led to an outflow of capital from the affected countries as international investors preferred US investments. This outflow, coupled with slowdown in exports severely affected these economies' current account balance and led to devaluation. With local business and financial sector borrowing heavily denominated in US dollars, devaluation and the lack of short-term capital (which had fled to the United States) led to a credit squeeze in the affected countries, which plunged many of them into recession. Other factors have also been highlighted as causes to the crisis, these include; herd mentality by currency traders and an accusation by Malaysian Prime Minister Mahathir Mohammed accusing George Soros<sup>7</sup>, a currency speculator, of ruining the Malaysian economy with extensive currency speculation.

The underlying reasons for capital outflow and export slowdown merit examination as well. It has been argued by a well-known economist, Joseph Stiglitz<sup>8</sup>, that the capital and financial markets in those countries were not sufficiently developed to deal with the influx of speculative capital that entered these economies in the late 1980s and early 1990s and the subsequent capital flight resembled a bank run after a risk shock. This argument in itself is an interesting one in relation to the Chinese currency as the

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<sup>6</sup> The Thai baht was pegged at 25 Baht to the US dollar and devalued to 56 Baht to the US dollar on 2<sup>nd</sup> July 1997

<sup>7</sup> Soros has also been implicated in Britain's exit from the European Monetary Union, where he was alleged to have made £2 billion pounds overnight speculating against the British pound in 1992

<sup>8</sup> In his book, *Globalisation and Its Discontents*, Stiglitz also blames the IMF for fast tracking financial liberalisation in these countries, leaving them unprepared, and further exacerbating the Asian financial crisis by enforcing 'Structural Adjustment Packages' that contravened conventional Keynesian macro-economic theories. The motives of this were further explored in his next book, *The Roaring Nineties*.

Chinese government has capital controls in place to prevent an event such as this. This issue of convertibility and capital controls will be dealt with later in the paper.

### **China's Role in Causing the Crisis**

The second causal factor, the slowdown in exports, was attributed to a competitive advantage that the Chinese economy had gained due to its devaluation in 1994. This led to an upsurge of Chinese exports from 1994 onwards and a subsequent loss of competitiveness in the East Asian economies. This argument was countered with the contention<sup>9</sup> that although the official rate of depreciation was 20%, with the existence of the dual currency regime, the nominal depreciation was in the region of 7% thus the focus on 1994 got the timing wrong. However this does not essentially mean that the Chinese currency's devaluation did not affect the East Asian crisis, rather the real depreciation of the Chinese currency prior to 1994, when the Bank of China was repeatedly devaluing the RMB from 1989 to 1993, was what gave China its export competitiveness.

Another counter<sup>10</sup> to the argument that the RMB's devaluation was a cause of the Asian financial crisis was a study that showed that China's export growth was strongly positively correlated with the rest of Asia's export growth and thus export competition from China would have minimal effects on other East Asian exports. However it was noted in the study that in the early 1990s exports from China grew 10% faster than the rest of developing Asia and in the first nine months of 1997, exports grew 11% faster. Although it may be hard to precisely define the impact that Chinese export competition had on developing Asia, it would be absurd to say there was no competition. Therefore with that in mind it can be said that China's currency depreciation in the early 1990s, to an extent, could have been an indirect cause of the East Asian crisis. For a nascent economy, the global reverberations that it caused as it devalued its currency would, demonstrate the importance of the role that it might come to play in the global financial markets.

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<sup>9</sup> Was China the First Domino? John Ferland, Hali Edison and Prakash Loungani, Board of Governors of the Federal Reserve System, International Finance Discussion Paper No. 604, March 1998

<sup>10</sup> See footnote 9

## **RMB's role during the Crisis**

Regardless of the various literature and opinions that could be put forth to dispute China's role in causing the Asian financial crisis, what cannot be disputed is the role the Chinese currency (and by extension the Chinese government) played in maintaining financial stability in Asia during the crisis. The subsequent credit crunch arising from a round of devaluations would have further hobbled the affected East Asian economies. Thus it is safe to say that when Vice-Minister Long Yongtu announced,<sup>11</sup> "If China devalues, that would set off a new cycle of devaluations and that would be disastrous. Therefore I have been authorized to tell you: China will not devalue", the financial markets took note of the RMB's new role as one of Asia's most important currencies.

## **Lessons Learnt**

Based on the experiences of the countries involved in the East Asian crisis in 1997, several lessons can be learnt<sup>12</sup>:

1. Interaction between highly global capital markets and poorly supervised financial systems can lead to financial disaster. 'Hot money' flowed in quickly, leading to a lending boom and inflating asset prices. The subsequent speed capital outflow burst the asset bubble.
2. Crony capitalism led to morally hazardous lending by banks
3. A diversified financial market is necessary, as more than 80% of financing in the affected countries were bank lending
4. Interest rate controls are incompatible with a market driven corporate sector
5. Effective and developed insolvency procedures were important
6. Asset management companies were important in restructuring non-performing assets
7. Judicial system has to be developed enough to effectively enforce liquidation
8. Financial sector restructuring had a significant impact on fiscal accounts

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<sup>11</sup> Long Yongtu, China's Vice minister of Trade Development and Economic Cooperation said this at the Asia Pacific Economic and Security Conference held in January 1998 in Honolulu Hawaii

<sup>12</sup> Financial Reforms in Asia since 1997: Lessons and Responses, Ashok K. Lahiri, Ministry of Finance, Government of India, 2004



Based on these lessons, the Chinese government took active steps to prevent such a crisis from happening<sup>13</sup>. Special bonds were issued to increase capitalisation of state banks, and a new banking supervision body, the China Banking Regulatory Commission was set up which focused on both regulatory compliance and risk management. Efforts were made to dispose of state banks non-performing loans, with a new rating system, the CAMEL system, put in place alongside other prudential regulation. Corporate governance supervision was enforced and a risk assessment system and early warning mechanism were set up. Aside from strengthening the financial system, the Chinese government also strengthened the legal framework to ensure there was legal support for the reforms with important financial legislation<sup>14</sup>. One important point to note as well was that China was fairly insulated from the East Asian crisis due to the fact that it maintained capital controls on its economy. This meant that the speculative hot money that inflated asset prices would not affect China's economy as seriously as it affected its neighbours. Although achieving currency convertibility has been a stated aim of the Chinese government, the Asian financial crisis disrupted this process.

### **The Current debate on Revaluation**

In light of the experiences gained from the crisis, we shall now consider the role of the Chinese economy and its currency in the current debate on the revaluation of the RMB. The notion that the RMB was undervalued began in 2002, when at a time of slowing growth in the United States, China's rapid economic growth and increasing trade surplus with the US became more apparent. Calls that an undervalued Chinese currency lead to a trade imbalance and was causing the United States to lose manufacturing jobs from business leaders gained growing support from the American political elite. There was mounting pressure from Washington that China revalues its currency or allow it to float freely. Various arguments were advanced, including testimony to a House of Representatives committee by a US businessman, Jay Bender,

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<sup>13</sup> The Lessons Learnt from the Development and Reform of China's Banking Sector, Liu Shiyu, Wu Yi and Liu Zhengming BIS Papers no 28 part9. 2006

<sup>14</sup> These legislation consist of; the Law of the People's Republic of China on the People's Bank of China, the Law of the People's Republic of China on Commercial Banks, the Securities Law of the People's Republic of China, the Accounting Law of the People's Republic of China, the Guarantee Law of China and the Company Law of the People's Republic of China.

who cited the Big Mac index<sup>15</sup> as evidence that China's currency was undervalued. Burger prices aside, we shall consider the academic arguments about China's currency valuation. The two main arguments for the RMB being undervalued are framed in two approaches<sup>16</sup>, the underlying balance approach and the global payments approach.

### **Underlying Balance Approach**

In the underlying balance approach, the optimal value for a currency is calculated as the rate where there would be equilibrium in a country's balance of payments. By averaging capital account balance from the years 1992 to 2002, 'normal' net capital flows were determined to be around 1.5% of GDP, this would indicate that a corresponding current account deficit of 1.5% of GDP would be needed for equilibrium. In reality however, the overall current account surpluses for the 2003-2004 period were estimated at 4.5 to 5% of GDP, this would mean that China needs a current account deterioration of 6.5 – 8.5% to restore balance of payments equilibrium. Based on this and several other trade assumptions the conclusion was that the RMB was undervalued by about 20 to 40%.

### **Global Payments Approach**

In the global payments approach, global payments imbalances are considered and these are used to determine the role (or rather, the exchange rate) the Chinese currency can adopt to correct these imbalances. Of course this argument focuses more on the US trade deficit, currently at more than 7% GDP and the real, trade weighted depreciation it must experience to correct these imbalances. While the main market determined exchange rates<sup>17</sup> have been appreciating against the US dollar over the past four to five years, Asian currencies, which account for 40% of the US trade weighted dollar index have either appreciated slightly or depreciated against the US dollar. Considering the assertion that a trade weighted depreciation of 15-25% of the dollar is needed to correct the US's external imbalance whilst maintaining sustainable global growth, the Chinese government could actively seek to rectify this. Just as

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<sup>15</sup> The Big Mac index is a global comparison of Big Mac prices in an extremely simple and rough guide to determine currency valuations.

<sup>16</sup> Renminbi Controversies, Morris Goldstein, Dennis Weatherstone Senior Fellow, Institute for International Economics, Nov 2003, revised Dec 2005

<sup>17</sup> Among these are; the Euro, the Canadian dollar, the British Pound and the Australian dollar

China held off a round of currency depreciations during the East Asian crisis by not depreciating, it seems that China could take the lead in correcting the imbalance by appreciating the RMB, which would likely induce appreciation in other Asian currencies as well.

### **Will revaluation make a difference?**

At the beginning of the debate on revaluation in 2003, the International Monetary Fund concluded that “most Directors noted that there is no clear evidence that the RMB is substantially undervalued at this juncture.”<sup>18</sup> Whether or not the RMB was undervalued, it has been suggested that a revaluation of the RMB will not truly restore the trade imbalance anyway<sup>19</sup>. China’s trade with the US is highly dependent on the triangular trading pattern it shares with the US and other East Asian economies. China imports intermediate components from its neighbours, assembles them and exports them to the United States. Its ‘value add’ in the supply chain is assembly due to its comparative advantage of cheap labour. It is important to note that 55% of China’s exports are in the form of processed trade, which are dominated by foreign multinationals and while a RMB appreciation would make Chinese exports expensive, it would also make its import relatively cheaper. Since exporters of processed trade would offset their lower selling prices with lower costs of components, then an appreciation would not make a significant difference in that portion of trade. Global supply chains could also be significantly disrupted in the event of an appreciation, since most of China’s export led growth has been driven by foreign multinationals. In fact nearly two thirds of China’s foreign driven export dynamic since 1994 can be traced to them.

Furthermore Chinese export competitiveness is not just determined by exchange rate alone. China maintains a value added export rebate tax that gives manufacturers further incentive to export. This tax was a response by the Chinese to placate local exporters in 1998 during the Asian financial crisis as compensation for not devaluing and the abolition of this tax would be a better step to addressing the trade imbalance rather than a revaluation. Another element of China’s trade competitiveness lies in its huge reserves of labour. Although technological content in Chinese exports has been

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<sup>18</sup> 2003 Article IV Consultation with the People's Republic of China, International Monetary Fund

<sup>19</sup> See footnote 1

increasing over the past few years, this has not been followed with a corresponding increase in labour costs. In fact wages for export-oriented labour have remained stagnant for the past 10 years, this is somewhat a reflection of the huge reserves of labour China has in its rural agricultural sector. China's FDI regime is also one of the driving factors of its export competitiveness. It is the largest recipient of FDI in the world, with nearly 60% of its inflows coming from Hong Kong and Taiwan. The majority of firms that invest in China are driven by fiscal incentives and the cheap labour available. With income tax rates levied at 15% in Chinese 'economic zones', an income tax exemption for the first 2 years and halved for the next 3 and further concessions involving land, energy, labour and raw materials that favour foreign firms, the fiscal subsidies in place will definitely absorb any effects on competition that an appreciation would have.

### **Negative Effects of Appreciation**

Opponents of a devaluation of the RMB also note the negative global consequences that would be brought about should it be devalued, these views were put forward by Robert Mundell, 'father of the Euro', and Stephen Roach, chief economist at Morgan Stanley, who indicated that an appreciation or floating of the RMB would have important consequences for growth and stability in China and its knock-on effects on the rest of Asia. Due to China's current lack of sound financial and banking systems and the inherent structural problems China faces, a significant appreciation of the RMB by 40 percent, as some suggest it is undervalued by, would lead to economic growth of 5 percent or lower. This would have enormous consequences on China's banking sector, due to its high amount of non-performing loans and would most likely lead to increasing deflationary pressure on an economy just emerging from deflation. The Chinese consumer's tendency to save, due to a lack of a state-supported social structure, would also increase and with investment and consumption now standing at more than 40% of GDP there would be a further economic contraction. Asset bubbles would most likely arise as well; foreign direct investment would drop, as investors flock to lower cost competitors such as Vietnam and the subsequent effect of this would be a weak RMB and depreciation. Furthermore, Alan Greenspan, former Fed Chairman concluded, "a misaligned Chinese currency...could have adverse effects on

the global financial market and hence indirectly on U.S. output and jobs”<sup>20</sup> and his views were echoed by Eisuke Sakakibara, Japan’s former vice-finance minister and once known as “Mr Yen”, who argued that a floating RMB may lead to a disastrous result in Asia and even in the world.<sup>21</sup>

Thus it is easy to see the current debate on China’s currency valuation and its effect on global trade imbalances is a distraction from the root causes of this imbalance. China’s comparative advantage of cheap labour allows it a stronger hand when dealing with its trading partners and the various fiscal policies implemented by its government makes its exports much more competitive than any benefits an undervalued currency would confer. What is more important to note is the impacts of a sharp appreciation in the RMB will have dire consequences on the world economy, this would demonstrate the effect the Chinese currency has on global financial market, it is also relevant to note that there has never been as much focus and debate on the currency of an emerging economy as this, nor have there ever been calls for an emerging economy to appreciate its currency as opposed to devaluing it.

### **Beijing’s Response**

With the continued calls for revaluation however, Beijing responded on 21 July 2005 by appreciating the RMB by 2% against the US dollar and stating that the management of the RMB would be based on a basket of currencies. By widening the trading bands of the RMB as well the Chinese government aimed to bring a market realistic valuation of the RMB. Although the initial response was not a significant appreciation in the value of the RMB, it should be noted that the RMB has moved slowly but surely from 8.20 RMB to the USD, to 7.86 RMB to the USD in the past 15 months. This ‘wait and see’ attitude to appreciation is a reflection of Beijing’s prudential financial management with regards to its own economy. China understands that with its capital controls in place any liberalisation of its exchange rate policies must be in tandem with relaxation of its capital controls. Moving the Chinese currency to total convertibility was a stated aim of the Chinese government on its accession into the WTO and the full political support for achieving this was

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<sup>20</sup> Fuquay, Jim. Fed Chairman Warns Against Forcing China to Boost Value of Its Currency. Knight Ridder Tribune Business News, Washington, D.C., Dec 12, 2003.

<sup>21</sup> See footnote 4

demonstrated in a resolution<sup>22</sup> passed on 21 October 2003 by the powerful Central Committee of the Chinese Communist Party. It stated that “Provided that risks can be effectively guarded off, we should selectively, and in steps, deregulate restrictions on cross-border capital transactions and gradually establish RMB’s convertibility on the capital account.” However, it is important to note that China’s definition of a convertible currency means fundamental convertibility whereby the RMB is fully convertible on the current account and long term capital account transactions are allowed but short term capital flows, which are usually speculative, are not. This would most probably be based on lessons learnt from the Asian financial crisis and again demonstrates Beijing’s attempts at prudential management.

### **Capital controls in China**

The current framework of capital controls in China is based on three pillars<sup>23</sup>; these encompass controls on:

- Foreign debt
- Foreign direct investment
- International portfolio investment

Controls on foreign debt include planning permission and registration for all forms of debt including government liabilities, international loans and project financing.

External collateral and risk management with regard to these loans are also subject to central government restrictions. The next pillar of capital controls, control on foreign direct investment has been one where China has been particularly successful. Even with controls on investment capital, operational expenditure, foreign currency receipts and external borrowings, China has been very successful at attracting inward FDI. In recent years though, the focus has shifted from capital inflows to capital outflows in the form of outward FDI from Chinese companies. Since private Chinese residents are prevented from buying foreign securities, controls on portfolio investment focus exclusively on overseas issuance of Chinese government bonds and shares of Chinese firms listed on overseas exchanges, B shares, which Chinese citizens are prohibited from buying.

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<sup>22</sup> People’s Daily, 22 October 2003.

<sup>23</sup> Capital Controls in China: Recent Developments and Reform Prospects, Zhichao Zhang, Durham Business School, University of Durham, February 2006

In recent years, as China has moved toward increased flexibility in its exchange rate mechanism, it has gradually begun to relax capital controls as well, in an effort to reach its stated aim of fundamental convertibility of the RMB. Specific focus has been given to promoting two way capital flows, not only is foreign capital free to flow across China's borders but the use of the RMB in foreign markets will be actively promoted. This is illustrated in various examples, such as the active promotion of outward FDI, seen in the higher international profiles of Chinese companies and the increasing involvement of Chinese companies in Africa. Private allowances for currency outflows by Chinese residents have been increased as well, with the limit being raised from 6,000 RMB to 30,000 RMB. The biggest step to capital account liberalisation so far was taken on 13 March 2003, with the government formally giving permission for the RMB to be used in foreign trade. With increasing Chinese demand on global energy and commodity markets as well as increased global trading links, this will eventually lead to the RMB being a vehicle currency for international settlement and trade. This would also lead to more multinational corporations holding RMB balances in their accounts.

### **A comparison with Japan**

Perhaps the best way to evaluate China's effects on global financial markets is to draw parallels with Japan's gradual relaxation of capital controls and its subsequent effects on global financial markets. The Japanese economy in the 1960s and 1970s to an extent mirrors China's emergence today<sup>24</sup>. Both have (or had) high economic growth, large amounts of currency reserves, surpluses in the balance of payments and increasing upward pressure on their currencies. In addition both nations adopted similar exchange rate mechanisms and capital controls to manage their currencies. These included prohibition of capital outflows, encouragement of capital inflows and capital management in the economy through banking institutions.

Japan used a policy of gradualism when it came to liberalising its capital account; the entire initial process took 20 years from the implementation of its basic Plan for

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<sup>24</sup> Sequencing of Capital Account Liberalization: Japan's experiences and their implications to China, Kenji Aramaki Professor, School of Arts and Sciences, The University of Tokyo, Public Policy Review, 2006, Vol.2, No.1

Liberalisation of Trade and Foreign Exchange in the 1960s to when a revised and much more liberalised Foreign Exchange Law was implemented in the 1980s. Complete currency liberalisation was achieved in the late 1990s with the liberalisation of the foreign exchange business. During the initial period of capital account liberalisation in the 1960s, Japan started out as a net debtor nation with small net capital inflows. However as capital account liberalisation took effect, Japan became a net creditor and based on its balance of payment data, long term capital account outflows ranged from US\$1 billion to US \$12 billion from the mid 1960s to the 1970s. Although this capital flow was disrupted during the oil crisis in the late 1970s, capital outflow in the 1980s began with renewed vigour as Japanese companies invested overseas to secure energy resources worldwide as well as assets in the United States.<sup>25</sup> China now seems to be experiencing similar patterns of capital outflow as well. The recent debate on CNOOC's<sup>26</sup> bid for Unocal, a US oil firm, as well as China's increased FDI today in Africa in an attempt to secure energy and mineral resources are all indicators that China seeks to gain increased recognition in the global economy and a to facilitate that, convertible currency is required.

All in all, the Japanese experience with capital account liberalisation and the shift to full currency convertibility took nearly 40 years. Assuming this as an appropriate gradual time frame, one could conclude that China will see its foreign exchange mechanism approaching fundamental convertibility during the decade of 2010-2020, considering it only opened its economy to global market forces in the late 1970s/early 1980s period. Several factors also need consideration when drawing similarities between Japan and China's economic expansion and exchange rate liberalisation. Firstly there is a general acceptance of liberalisation worldwide, in contrast, when Japan chose to move toward liberalisation in the 1960s, many developed economies still maintained foreign exchange restrictions and capital controls. Thus pressure on China today to liberalise is considerably more than it was on Japan in the past. However this pressure is balanced by the lessons learnt from the Asian financial crisis, which demonstrated that uncontrolled capital account liberalisation coupled with

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<sup>25</sup> This is reflected in high profile real estate purchases, such as the Rockefeller Centre in New York by Japanese investors and the various attempts by the Japanese to invest in Hollywood movie studios

<sup>26</sup> CNOOC is a Chinese state owned oil company, in August 2003 it bid US\$18.5 billion to buy Unocal an American oil company, this bid was rejected due to political pressure from Washington and is a reflection of tensions over U.S. economic dominance and Chinese ascendancy.



greater international capital flow today could lead to highly volatile capital flows and would severely penalise economies that were not ready.

## **Conclusion**

This paper set out to define the role of the Chinese currency in the global financial markets, having explored the past of the RMB and the implications of various decisions taken by the Chinese government with regard to its currency; we can come to several conclusions on Chinese exchange rate policy

1. The Chinese government favours prudential financial management, it has demonstrated a willingness to succumb to international pressure, but only on its terms, with the Chinese economy as its priority
2. The Asian financial crisis exposed weaknesses in neighbouring economies and lessons learnt from that episode seem to have been implemented, special focus is placed on capital account liberalisation as well as NPL assets of state banks.
3. Currency flexibility and convertibility must be coordinated in tandem with capital account liberalisation. This is a stated aim of the Chinese government and so far Beijing has been moving slowly but surely in this direction.
4. China's economic emergence today has many similarities with Japan in the 1960s and 1970s, thus Japan's experience of liberalisation will serve China well.

With these conclusions in mind, it then left to answer the most important question of all when considering what role will the RMB play in the global financial markets in the future, Will it ever become a reserve currency?

Reserve currency status is the pinnacle in any nation's economic development; it indicates that the nation's economy has reached a state where its currency is considered resilient enough to be held in reserve. It is also a good indicator of trade patterns since major trading partners are more likely to hold reserves of their counterparties. Since the United States ranks as the major trading partner of most nations in the world today, it is no accident that the US dollar is the main reserve

currency of most central banks. To be eligible for reserve status, several prerequisites have to be fulfilled<sup>27</sup>:

- The currency should be fully convertible and widely accepted
- Its financial markets should be broad and liquid
- Its value should be reasonably stable
- Large amounts of trade should be transacted in it

Of course the first stumbling block to this is the fact that the RMB is not fully convertible, but since Beijing has already stated it intends to have a convertible currency and assuming there are no deviations from its exchange rate policy<sup>28</sup>, this is a question worth pondering. Since the Asian crisis, we see that China has taken active steps to reform its banking system and to deal with the high rates of non-performing loans within its banking industry. Strengthened legal frameworks in terms of judicial reforms and improved financial legislation have also helped investors gain confidence in its financial markets and given Beijing's penchant for slow and steady reform and liberalisation, it will be only a matter of time until the Chinese financial markets become fully mature and increasingly liquid. In terms of the value of the RMB, not much evidence has been presented so far on its stability in value. Regardless of the current debate on currency valuation, which is focused more on trade issues, the upward pressure that the RMB faces today is more due to a decline in the value of the US dollar than anything else. Suffice to say China has not undergone any external shocks to its financial system, thus it is hard to empirically gauge its stability of value. However based on qualitative analyses of policy decisions, reform initiatives and financial management by the Bank of China and the Chinese government, we can conclude that the RMB should be able to maintain stability of its value in the long run. Furthermore with formal permission being granted in 13<sup>th</sup> March 2003 for the RMB to be used in foreign trade and China's increasing purchasing power on the international commodities and energy markets, the use of the RMB as a currency of settlement for major trade purchases will only be a matter of time. Other points supporting this

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<sup>27</sup> What makes a reserve currency, Rob Kirby, Financial Sense Online 20/3/2006

<sup>28</sup> After the July 21<sup>st</sup> 2005 appreciation, it has been argued that China will attempt to mimic Singapore's foreign exchange regime, which is based on exchange rate management as a monetary policy instrument. Although China has openly envied Singapore's political model (both have authoritarian one-party rule), the contention that China will copy Singapore's foreign exchange regime was rebutted in 'Is Singapore the Model for China's New Exchange Rate Policy?' Bennett T. McCallum, Carnegie Mellon University, November 2005

argument include the current slide of the US dollar and increasing debate on whether it can maintain its primacy as a petro-currency<sup>29</sup>, China's increasing presence in Africa to secure energy resources as well as increasing diplomatic ties and relations<sup>30</sup>, its increasingly central role in the East Asian- American trade triangle and its continued high rate of economic growth. However it is important to take note of several factors that could adversely affect economic growth and with that the strength of the RMB, among them are the recent debate on human rights vs. economic growth that has gained media attention lately, its rapidly overheating economy, its authoritarian political system, the effective resolution of the NPL problem and the demographic time-bomb planted with Beijing's official one-child policy.

To end, although it is unlikely the RMB will be the primary reserve currency of the world's central banks,<sup>31</sup> we can say that assuming China proceeds along a liberalisation timetable similar to Japan, and based on the above arguments regarding the prerequisites for reserve status, China's role in the global financial markets will be as a major reserve currency, overtaking the Japanese Yen and the British Pound as the third most held currency, due to its potential trade dominance of Asian and Africa, by the early 2020s.

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<sup>29</sup> Petro Euro: A reality or distant nightmare for the U.S.? 30 Apr 2006, [www.aljazeera.com](http://www.aljazeera.com)

<sup>30</sup> Summit shows China's Africa clout 6 Nov 2006, [www.BBC.co.uk](http://www.BBC.co.uk)

<sup>31</sup> Historically, status as the world's primary currency is reserved for not only the world's pre-eminent economy, but also the one with a military system that can protect its economy. This is reflected in Greek and Roman civilisations, and more recently the British Empire and the American 'empire'. Although China has extended the reach of its military capability in the form of bases to protect its energy assets in Africa, it is highly unlikely that it will ever succeed the United States in terms of military strength