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Renminbi Rising?

SHANGHAI – China is increasingly debating whether or not the renminbi should be internationalized, possibly joining the US dollar and the euro as an international vehicle currency (IVC) – that is, a currency that other countries use to denominate the prices of their traded goods and international loans. Related to this is a debate about whether Shanghai can become a first-tier international financial center (1-IFC) like London and New York.

Financial history can help to answer these questions. First, a city can become a 1-IFC only if its national currency is an IVC. But, as London's status shows, a longtime 1-IFC can retain its position in the international financial system even if its currency is no longer an IVC.

Second, the transaction cost of using a foreign currency as a medium of exchange is inversely proportional to the extent to which that currency is used globally. Similar economies of scale characterize foreign investors' use of a particular international financial center. As a result, there cannot be more than three or four IVCs and 1-IFCs.

Third, a country's financial sector must be both open, with no capital-flow restrictions, and sophisticated, with a wide range of instruments and institutions. It must also be safe, with a central bank maintaining economic stability, prudential regulators keeping fraud and speculation in check, macro-prudential authorities displaying adequate financial fire-fighting capabilities, and a legal system that is predictable, transparent, and fair.

Last – and most important – successful convergence to IVC and 1-IFC status requires the national economy to be strong relative to other economies for a substantial period of time. The United Kingdom occupied a position of global economic leadership for more than a century. In 1914, the US/UK GDP ratio was 2.1, but the US dollar was not an IVC, suggesting that America's relative economic strength was inadequate. A decade later, in 1924, the ratio was 3.2 and rising – and the US dollar had eclipsed the British pound as the most important IVC.

Relative economic strength explains why the Japanese yen failed to develop into an IVC, and why Tokyo – whose financial markets satisfied the relevant requirements – failed to become a 1-IFC. With its GDP reaching only about 60% of America's at its peak in 1991, Japan never attained the critical mass required to induce foreigners to use the yen to lower transaction costs.

Determining the future international status of the renminbi and Shanghai must begin with a calculation of China's expected relative economic strength *vis-à-vis* the US under two plausible scenarios.

In the first scenario, China becomes caught in a middle-income trap, with *per capita* GDP stuck at 30% of America's – an outcome that has characterized Latin America's five largest economies since at least 1960, and Malaysia since 1994. This would put China's economic strength relative to the US at 1.1 – well below the necessary ratio.

In the second, more favorable scenario, China's *per capita* GDP would reach 80% of America's – higher than the 70% average rate for the five largest Western European countries since 1960 – and its economic strength relative to the US would amount to roughly 2.8. This would make the renminbi eligible for IVC status and enable Shanghai to choose whether to become a 1-IFC. But China's economy still would not be strong enough relative to the US for natural market forces to ensure the renminbi's international success.

Given this, the Chinese government would have to implement decisive measures to encourage international traders and creditors to price their transactions in renminbi. Specifically, China would have to use its market power to promote pricing in renminbi for relevant manufactured exports and raw-material imports, and encourage renminbi denomination of foreign financial assets that China purchases (which the country's status as a net creditor should facilitate).

But there are serious pitfalls to avoid in this process. As the Asian financial crisis of 1997-1998 demonstrated, capital-account liberalization could lead to financial meltdowns – a danger that opponents of internationalizing the renminbi often cite. But these risks do not outweigh the potential benefits of financial openness, and they can be minimized with effective monitoring and regulation, including requirements for large capital buffers and low leverage ratios, together with strong crisis-response mechanisms, like a resolution trust corporation.

In fact, effective financial-monitoring and prudential-regulation systems do not have to precede opening the capital account. On the contrary, developing and enacting financial regulation must be a gradual process, shaped by both existing knowledge and firsthand experience. After all, no financial market is either completely open or completely closed forever; the degree of openness at a given moment depends on policy choices.

The recent establishment of the Shanghai Free Trade Zone will allow for the emergence of an offshore international financial center that offers real-world training to China's regulators. This will give them the tools they need to recognize the signs of a developing crisis, defuse the threat, and efficiently handle the recapitalization and reorganization of failed financial institutions.

China's pursuit of an IVC and a 1-IFC city would serve not only its own interests. Allowing the renminbi to help meet global demand for international reserves and risk diversification would also strengthen global financial stability.

There is little time to waste in internationalizing the renminbi. Given the limited number of currencies that can serve as IVCs, the failure of the renminbi to achieve IVC status before, say, the Indian rupee, the Russian ruble, or the Brazilian real could mean that the renminbi is denied IVC status – and that Shanghai fails to achieve 1-IFC status – for generations, if not forever.

http://www.project-syndicate.org/commentary/wing-t--woo-lays-out-the-conditions-that-china-must-meet-to-internationalize-its-currency-and-turn-shanghai-into-a-global-financial-center

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