Currency Internationalization and Macro Financial Risk Control

International Monetary Institute

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Preface

The year 2015 was an eventful year. After the Federal Reserve officially started the interest rate increase, the dollar index continued to rise, dollar assets were sought after by many, international capital flow experienced large-scale adjustment, and China faced an increasingly sharp pressure of capital outflow. Refugee crisis slowed down the economic recovery in Europe, the risk of "British Exit" further increased the uncertainty of its prospects, and the European Central Bank announced to implement the negative interest rate policy. Since the EU is China's largest trading partner, a substantial depreciation of the euro hit heavily the export trade of China. Such international circumstances worsened the Chinese economy which was itself in a difficult transformation. For one thing, issues including over-capacity, decline in private investment, and non-performing bank assets have become increasingly prominent. For another, the domestic financial market was in turmoil: the first half of the year witnessed the stock market disaster propelled by high leverage and private funding, ending up with an market value evaporation of over 20 trillion yuan; and the second half experienced a panic exchange rate overshoot in the foreign exchange market, and a cliff-like liquidity crunch of the offshore renminbi market. Domestic and international confidence in China's economic growth and financial stability has been shaken.

RMB internationalization still maintained a good momentum. By the end of 2015, the international use of RMB index marked by the RII reached 3.6, an increase of over ten times over the past five years. The ratio of RMB settlement in China's foreign trade was nearly 30%, and that in global trade was pushed up to 3.38%. RMB foreign direct investment reached 736.2 billion yuan, registering an increase of 294.53% from the previous year. Meanwhile, the share of RMB in international credit, international bonds, and bill business also increased rapidly, pushing the share of RMB in international financial transactions to 5.9%. The currency swap agreement signed by the People's Bank of China registered a balance of 3.31 trillion yuan.

On November 30, 2015, the International Monetary Fund (IMF) announced to include RMB into the SDR basket of currencies, which would enter into force on October 1, 2016, officially with the weight of RMB in the new currency basket reaching 10.92%. This is an important milestone in the integration of the Chinese economy into the global financial system, a win-win for both China and the rest of the world. Although renminbi was officially identified as a "freely usable currency", its "official status" may not necessarily lead to the "market position" as an international currency. Joining the basket does not mean that the RMB internationalization has achieved its goal, because the ultimate goal is to match the currency status with China's economic and trade status in the global stage. That is destined to be a long historical process. Whether the RMB could become one of the major international currencies depends on how much renminbi the international market will use and hold in the actual situation.

In general, the issuer of a major international currency should meet a number of conditions: integrated economic strength, trade status, currency stability, free movement of capital, and macro-management capacity. A review of the past few years show that the first few factors that support the internationalization of the RMB perform soundly in China, but macro-management may present a weakness in the long run. As macro-management capacity affects other factors such as currency stability and free flow of capital, China needs to pay special attention to this aspect through study and making improvement, so as to win the lasting confidence in the RMB from the international community.

RMB Internationalization Report, which is themed at Currency Internationalization and Macro Financial Risk Management, takes a deep look into macro-management issues and explores the macro-financial policy adjustment and the potential macrofinancial risks as the internationalization of RMB has entered a new stage. The report suggests that a macro-prudential policy framework should be built based on the national strategic perspective, which can effectively prevent the systemic financial crisis and provide a fundamental guarantee for the steady growth of the real economy and the ultimate realization of RMB internationalization.

The international financial classic theories hold that the monetary authorities of an open economy can only choose two out of the three macro-financial policy objectives, namely, the independence of monetary policy, the fixed exchange rate system, and the complete free flow of capital. The history of Germany and Japan shows that in the process of the climbing level of currency internationalization, the monetary authority must adjust policy objectives to major changes in cross-border capital flows and exchange rate regimes. Germany and Japan launched internationalization of their currencies from similar starting points, but the different decisions on policy adjustment have had profound but distinct impact on the domestic economy and finance, resulting in the opposite results of currency internationalization of the two countries.

At the initial stage of currency internationalization, Germany regarded exchange rate stabilization as its primary target. It even resorted to the measures including capital controls, the suspension of financial market development, and the use of foreign exchange reserves for market intervention. As a result, it created favorable external conditions for maintaining the advantages in trade, enhancing industrial production competitiveness, and consolidating the domestic development of the real economy, and provided a strong support for the long-term stability of the mark exchange rates. Japan was too radical because it over-estimated the ability of its real economy in coping with the impact of the appreciation of the exchange rate, thus failing to keep the yen exchange rates stable. Coupled with the mistakes made in internal macro-economic policies, Japan has fundamentally undermined its real economy, making the international level of yen temporarily rise before the sharp decline.

The level of RMB internationalization has improved steadily in recent years, and will embark on a new stage of development after joining the currency basket. This marks that China has entered a sensitive period of policy adjustments in the area of macro-management. The difference in the policy adjustment that Germany and Japan made and the distinct impact on the currency internationalization provide us with an important historical lesson. The experience of the two countries reminds us that China should not implement policy adjustment too speedily; rather, the exchange rates and capital account can be liberalized only after the real economy, financial market, and management departments are fully prepared.

Therefore, in the transition of the macro-financial policy mix from the "partial independence of monetary policy + managed floating exchange rate + limited liberalization of capital account" to "independent monetary policy + floating exchange rate + free flow of capital", China must manage the impact of the exchange rate fluctuations on the economic and financial operations, and adapt as soon as possible to the new interaction mechanism between cross-border capital flows and the domestic financial market, financial institutions as well as the real economy, with particular attention to preventing and managing systemic financial risks. Based on study on historical experiences, literature and theoretical research, empirical research, and policy research, especially on the above-mentioned key issues that have great impact on the process of RMB internationalization, this book argues that a macro-prudential policy framework should be put in place as the institutional guarantee, the exchange rate management should be the focus of macro-financial risk management, the capital flow management be the key entry point for macro-financial risk management, with the ultimate goal of preventing and resolving the devastating systemic financial crisis and realizing the internationalization of the RMB. Specifically, we have come to the following core conclusions and recommendations:

First, on the RMB exchange rate system and exchange rate management issues. The defining factors of renminbi exchange rates have clearly shifted as the long-term exchange rates are determined by the fundamentals and the short-term exchange rates are mainly affected by the cross-border capital flows and other countries' policy spillovers, but market arbitrage can lead to a return to long-term equilibrium. With the increasing flexibility of exchange rates, the volatility of it has a significantly greater effect on the stability of economic growth.

China should further promote the market-oriented reform of exchange rates, improve the RMB exchange rate system, and shift gradually from the managed floating to free floating. Exchange rate policy should attain its goals by means of from indirect intervention rather than direct intervention, management of market expectation should be strengthened, and long-term exchange rates should maintain basic stability at the equilibrium level. China needs to pay attention to the effect of policy spillovers, strengthen international policy communication and coordination, and pursue such exchange rate policy objectives as in line with the optimal monetary policy objectives.

Second, on the relationship between cross-border capital flows and the stability of domestic financial market, financial institutions and the real economy. Liberalization of capital account should be coordinated with the reform in the exchange rate system; follow the principle of taking gradual, controllable, coordinated steps; and adapt to the needs of China's economic and financial development and the changes in the international economic situation.

Study shows that since the exchange reform on August 11, 2015, the relationship between the capital market prices, the leverage rate, and the net inflow of cross-border capital has shifted from the previous one-way relation to a cyclical interaction, as the short-term capital flows are sufficient to affect the capital market prices and leverage levels. Asset prices have been more connected between domestic financial subsidiary markets and between financial markets at home and abroad, and financial risk has been more contagious, and the impact on cross-border capital flows has been more sensitive. China should not be aggressive into the capital account liberalization; rather, it should strengthen the overall capital flow monitoring.

Due to the capital account liberalization, Chinese-funded banks can access greater international development space, but they must withstand the dual challenges both domestically and internationally and confront more difficulties in balancing market expansion and risk control. Banks of systematic importance should seize this opportunity to expand cross-border operations while improving risk management mechanisms to avoid becoming an amplifier of external impact or a flashpoint for systemic risks.

Capital flows are having more complex and frequent impacts than ever before, exacerbating the volatility of the real economy. China needs to set the supply-side reform as the starting point, promote technological progress from both the internal and external, provide financial services to the real economy, and watch out for bubbles and virtualization, so as to solve the problems faced by the Chinese economy, such as inappropriate models, backward innovation capacity, wide but weak trade, and reduction in private investment, among other issues, and to reduce the risks of the real economy. RMB internationalization can positively interact with the supply-side reform through direct investment, technological progress, trade upgrades, and so on, and together the two can turn risks into opportunities and promote the restructuring, transformation, and upgrading of China's economy.

Third, on the macro-financial risk management in the process of RMB internationalization. Financial stability is the necessary prerequisite to realize the ultimate goal of the RMB internationalization. Therefore, the core task in macro-financial management of the monetary authorities is to build a more comprehensive, targeted macro-prudential policy framework.

Cross-border capital flows and other external shocks intertwine with and reinforce the risks in domestic financial market, institutions, and the real economy, spreading a single market or local risk into a chain of risks and a likely systemic risk. China needs to plan a systemic risk index which includes assessment and monitoring. A China-specific macro-prudential policy framework should be put in place so as to prevent and manage systemic risk from the institutional level.

In order to solve the problem caused by multi-pronged regulators, such as the overlapping of policies and regulated duties and powers and unified standards, China should draw from the international experience, set clear principles for the current financial regulation reform, and build a China-specific macro-prudential policy framework as an institutional guarantee for managing system risk. Specifically, it is necessary to add the element of "macro-prudential" in the existing financial regulatory framework, and to clarify the enforcers of the macro-prudential policy. In addition to maintaining monetary stability, the central bank should perform the function of securing financial stability and strengthening financial regulation. China should straighten out the relationship between monetary policy, macro-prudence, micro-prudence, and behavioral regulation from the perspective of functions and mechanisms, and enhance coordination between each other. It also needs to improve the availability and accuracy of financial data so as to provide comprehensive and timely information for monitoring, analyzing, and evaluating systemic risks. An effective crisis disposal mechanism should be put in place and financial consumers should be well protected.

The internationalization of RMB, as one of the important plans put forward by China in the twenty-first century as an emerging power, shoulders the dual historical mission of realizing the interests of China and reforming the international monetary system. Therefore, China must stand at the height of the national strategy to implement macro-financial risk management and improve the monetary authorities' macro-management capacity, with the ultimate goal of realizing internationalization of RMB.

International currency diversification is a dynamic process, the structure of which could be adjusted with the changes in international trade patterns and international financial market volatility. The more international economic and financial situation is complex and uncertain, the more China should stand firm, so as to calmly deal with policy adjustment and macro-financial risks and hold the bottom line of avoiding systemic financial crisis. The steady improvement China makes in the internationalization of the RMB is the best response to all the doubts and skepticism.

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