What the IMF's Yuan Decision Will Mean for China – and Global Markets

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This week's decision by the International Monetary Fund (IMF) to include the Chinese renminbi, or RMB, as an international reserve currency beginning in October 2016 may have limited market impact in a world dominated by the U.S. dollar. The move would have a bigger geopolitical impact in providing China a voice in international monetary decisions; in enabling China to create a money transfer system to compete with the widely used "Swift" system; and in limiting the dollar's use in enforcing political sanctions, experts say. It could also encourage China to accelerate its financial sector reforms, in turn depreciating the RMB to levels the U.S. may not relish.

The IMF decision came after its annual meeting on November 30 to review the composition of the basket of five currencies that make up the "special drawing right," or SDR. The IMF allocates SDR quotas to supplement the reserves of its member countries. The other currencies in that basket are the U.S. dollar, the Euro, the pound sterling and the Japanese yen. IMF managing director Christine Lagarde justified the inclusion of the RMB in that elite club saying it recognized the integration of the Chinese economy into the global financial system, and the progress China has made in recent years in reforming its monetary and financial systems.

On balance, the IMF decision appears to be on the right track, according to Marshall W. Meyer, Wharton emeritus professor of management and a long-time China expert. "China's commercial expansion depends on internationalization of the RMB," he said. "The IMF decision is welcome even if it complicates the immediate problem of managing the RMB downward gradually, rather than precipitously, to buoy the domestic economy."

With the RMB as a reserve currency, "[China] will be part of the center of any kind of discussions about monetary reform," said Steve Hanke, professor of applied economics at The Johns Hopkins University in Baltimore and co-director of its Institute for Applied Economics, Global Health, and the Study of Business Enterprise. "The Chinese will be able to get more leverage in the international markets; that is how they see themselves positioned to challenge the U.S. dollar." Hanke is also a senior fellow and director of the Troubled Currencies Project at the Cato Institute in Washington, D.C.

The inclusion of the renminbi as a reserve currency is definitely positive news for China, as other countries may accept it as a trade currency in the future, said Wharton management professor Minyuan Zhao. However, the longer-term impact of that will depend on how China

uses the opportunity, she added. “Whether it is a positive or a negative in the long run depends on how China acts. Will it take it as incentive to bring in transparency and reform the financial system, which is not in good shape now?”

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Hanke and Zhao discussed the implications of the renminbi’s newly elevated status on the Knowledge@Wharton show on Wharton Business Radio on SiriusXM channel 111.

Geopolitical Impact

Hanke explained why the renminbi’s inclusion as a reserve currency is important in the geopolitical realm, and not as it relates to the market. “The dollar is king. It dominates all trading, all pricing, all invoicing, all reserves held by central banks, etc.,” he said. “That is always the case. If you go back 2,000 years, there [has] always [been] one dominant currency that is preferred by the markets. He noted that the British pound sterling dominated the markets before World War I, after which the U.S. dollar took over. Having a dominant currency worldwide for financial transfers and trading brings economies of scale and helps lower transaction costs, he explained.

Hanke did not expect the renminbi to edge out the U.S. dollar in the global financial marketplace. He noted that the dollar controls more than 90% of all global foreign exchange transactions. “In the market, the RMB is not really a challenger. The market test was that it was a big flop; no one was interested in using it, which is still the case.”

However, “it is a different ball game” in the geopolitical sphere, Hanke said. “China is a big, powerful country; it has been the biggest adder to incremental world growth over the last 20 years.”

According to Zhao, countries around the world have amassed $80 billion worth of RMB in their foreign reserves. Putting that in context, China had about $3.5 trillion in foreign reserves at last count, according to a *Wall Street Journal* report.

China’s Economic Station

“We’re at an unusual juncture in China’s economic trajectory,” said Meyer. “Investment-driven growth has reached its limit and China must find a new growth model. In the interim there’s a lot of uncertainty. China’s top economists acknowledge this.”

Meyer outlined the major themes economists agreed on at a Xinhuanet-sponsored conference on the next stage of China’s economy last month, where he was a speaker. “One, China’s economy has been in decline for four to five years. The best indicator of decline is the producer price index or PPI, which has dropped for 44 consecutive months; the CPI (consumer price index), though positive, hasn’t broken 2%, effectively zero, in the same period. Two, the main cause of decline is excess capacity spurred by stimulus measures, and further stimulus will only protract

the decline. Excess capacity is greatest in industries like coal, petro and steel where state-owned enterprises (SOEs) dominate. Three, unless and until the government permits the normal economic cycle to operate and liquidation of excess capacity, the decline will continue. Four, among other effects, some of which are positive, the anti-corruption campaign has delayed the liquidation of excess capacity since sales of state-owned assets are suspect."

Dealing with Surplus Capacity

Meyer put those themes against the backdrop of a broader context. "Not only is China awash in capacity, but it is also awash in currency," he said. He noted that the ratio of M2 (a measure of money supply that includes cash; checking, saving and time deposits; and money market funds) to GDP (gross domestic product) for China is double that of the U.S. "That's a lot of liquidity. You'd expect inflation with this level of liquidity. But capacity has outrun liquidity, hence there's deflation."

China doesn't have easy options to deal with its surplus capacity. "If China tries to liquidate excess capacity, social unrest will erupt," said Meyer. He pointed to the worker riots that followed the shutdown last month of Tangshan Songting Iron & Steel, a private firm in the country's northeastern city of Tangshan. According to a *Reuters* report, Tangshan produces more steel than the entire U.S.

> *"Long-run, the capacity of the U.S. to isolate rogue nations using financial sanctions could be crimped." –Marshall W. Meyer*

Hanke said the key reform China must undertake is "to get rid of the SOEs that are complete back holes; most of them are almost zombie enterprises sucking up all the credit." Private enterprises in China are facing a credit crunch as a result, he added.

Zhao felt the shadow of the anti-corruption crackdown would fall on China's efforts to privatize some of its SOEs as well. "A lot of SOE managers are scared of privatizing because [with] anything you sell, you would be accused of mispricing the assets," she said. "The possibility of being involved in any kind of investigation is scary."

Swift vs. ChIPS

Of all the likely scenarios that could unfold, the one with the greatest possibility appears to be the emergence of a parallel global money transfer system. Most international transfers today use the so-called "Swift" system (Society for Worldwide Interbank Financial Transfers), which is denominated in U.S. dollars.

China is keen on setting up a competing system called ChIPS (China International Payment System) with the renminbi. "That would be good in the sense that now with Swift, the U.S. Treasury has an army of people waiting to impose sanctions and restrictions on countries they don't like," said Hanke. That makes it the RMB's elevation as a reserve currency a geopolitical factor "because sanctions are political."

The case for including the RMB in the SDR basket was actually the opposite, according to Zhao. “One argument for including China in the [SDR] system is to discourage China from creating a parallel system,” she said. By including the renminbi as a reserve currency, the IMF can put pressure on China to shoulder the responsibilities that come along with that status, such as increased transparency in the valuation of its currency.

In that spirit, China would be expected to deliver on its commitment to make the RMB fully convertible by 2020, Zhao explained. “If it acts as an incentive to make the currency more transparent and more tradable, then that is a positive move to prevent another parallel system from being introduced.”

That situation leads to a “paradox the world is facing,” said Zhao. She noted that China has been facing a “capital flight” with many investors taking out their money to safer havens. If, after the renminbi joins the SDR club, it depreciates significantly, “will the U.S. take it as a market outcome?” she asked. “If the U.S. does not like the market outcome, will it muscle in and [try to] influence the system, which the Chinese will not like? So it becomes a geopolitical outcome rather than a market outcome.” If China is able to liberalize more and more of its economy as it has done since 1978, it would attract more capital flows, added Hanke.

Outlook for the RMB

China also cannot easily depreciate the RMB. “If China tries to coax the RMB downward to make their industry more competitive, the rest of the world may remonstrate due to job losses and increased pollution,” Meyer said. The pollution concerns arise because of China’s substitution of coal (which China has in abundance) for oil (Chinese domestic oil fields are past peak production), he explained.

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Meyer expected the impact on the renminbi to be carefully managed. “The RMB will subside gradually and China will manage the subsidence,” he said. He cited comments made by Yi Gang, a deputy governor of the People’s Bank of China, the country’s central bank, that China will maintain a “managed-float” system before it gradually transitions to a “clean float” of the yuan, as *The Wall Street Journal* reported. A clean float is a long-term goal that would mean the central bank stays out of trying to control the currency’s value, the report explained. “In terms of whether the renminbi will depreciate after its inclusion in SDR, there is no need for such a worry,” Gang said.

One could read Yi Gang’s comment in several ways, according to Meyer. “Call this manipulation if you will. Or call it prudence. Your choice,” he said. “If there weren’t some management of outflows, such as limits on foreign exchange transactions, then the hot money would leave China ASAP given prospective if incremental devaluation of the RMB.”

U.S. vs. China

The growing importance of the renminbi could also test U.S. influence on China, said Hanke. He recalled that after the U.S. moved the dollar from a fixed exchange rate system to a freely floating system in 1973, it began pressuring Japan to let the yen appreciate. That was to protect U.S. goods from cheaper imports from Japan, especially the U.S. automotive industry. With "tremendous pressure" from the U.S., the yen appreciated from 360 to the dollar to 80-85 by 1990, he noted. "There was an ever-appreciating yen, because the U.S. was muscling Japan and forcing it to do this, through all kinds of trade conflicts and so on," he said.

On that front, China will be different for the U.S., Hanke said. "China is not going to be muscled around by the U.S., and we won't have an ever-appreciating RMB. The Chinese will do what they think is in the interest of China."

According to Meyer, the IMF move does not erode the dollar's strength immediately. "Long-run, however, the capacity of the U.S. to isolate rogue nations using financial sanctions could be crimped," he said. In any event, such a situation was anticipated, and the U.S. is developing alternatives to financial sanctions.

At the same time, "while China gains international clout, the IMF decision ultimately erodes Chinese government control of the RMB," said Meyer. "The big and unanswered question is what happens if China backslides should the RMB spin out of control. Would, for example, the IMF temporarily suspend China's SDRs?"