Renminbi Internationalization in Light of Recent Turbulence

Barry Eichengreen

Renminbi Internationalization

- Lots of talk
- 76,000 unique Google hits the last time I looked.
- But how are they doing?
  - (Curb your enthusiasm…)

Why not faster progress?

- A number of reasons.
- But one is concern for the stability of the Chinese economy.

So far, I see no cause for alarm

- A slowdown from 9-10% growth in the decade prior to 2010 to 6-7% growth now is precisely what we should expect on the basis of the experience of other countries.
- And given China's characteristics.

As I argued here (5 years ago)

When Fast-Growing Economies Slow Down: International Evidence and Implications for China*

Barry Eichengreen
Department of Economics
University of California
Berkeley, CA 94720, USA
eichengr@econ.berkeley.edu

Donghyun Park
Economics and Research Department
Asian Development Bank
6 ADB Avenue,
Mandaluyong City 1550
Metro Manila, Philippines
dpark@adb.org

Kwanho Shin
Department of Economics
Korea University
5-1 Anam-Dong, Sungbuk-Ku
Seoul, Korea 136-701
khshin@korea.ac.kr

Abstract
Using international data starting in 1957, we construct a sample of cases where fast-growing economies slow down. The evidence suggests that rapidly growing economies slow down significantly, in the sense that the growth rate downshifts by at least 2 percentage points, when their per capita incomes reach around US$ 17,000 in year-2005 constant international prices, a level that China should achieve by or soon after 2015. Among our more provocative findings is that growth slowdowns are more likely in countries that maintain undervalued real exchange rates.

1. Introduction

One of the most important developments affecting humankind in the late 20th and early 21st centuries has been the rapid economic growth of large emerging markets, starting with China, extending now through much of Asia, and experienced increasingly in other parts of the developing world. As Lawrence Summers, former Director of the White House National Economic Council, said, "The dramatic modernization of the Asian economies ranks alongside the Renaissance and the Industrial Revolution as one of the most important developments in economic history." Rapid economic growth, on the order of 10 per-

* This paper, prepared for the March 2011 meeting of the Asian Economic Panel at the Earth Institute in New York, draws on joint work with Dwight Perkins, whose input we acknowledge with thanks. We thank Hiro Ito for help with data, and the ADB for financial support. We also thank Jeffrey Sachs, Wing Thye Woo, Louis Kuijs, Myoung-Jae Lee, and Arvind Subramanian for helpful comments and Gayoung Ko and Ji-Soo Kim for their excellent research assistance.

Asian Economic Papers 11:1

© 2012 The Earth Institute at Columbia University and the Massachusetts Institute of Technology

Soft landing scenario

- Slowdown in 2015 was heavily a real-estate-related phenomenon.
- 25% of economic activity is related to construction and real estate.
- Real estate investment fell from 12% of GDP in 2014 to 2% in 2015.
- Basic arithmetic suggests that this can take 2.5 percentage points off of GDP growth by itself.
- This slowdown reflected admirable efforts by the authorities to eliminate excesses in the property market.
- Now that this has been done, 2016 will be a better year for construction.
- Home sales were up 40% this March over March 2015.

- The Chinese authorities still have policy space.
- Total deficit (on and off budget) shrank in 2015, as authorities clamped down on financing through special vehicles by local governments.
- Now that this has been done, fiscal thrust in 2016 will be broadly neutral.
- On the monetary front, China has room to cut required reserves, and everyone expects it to do so.
- More generally, it can instruct banks to lend. And they will.

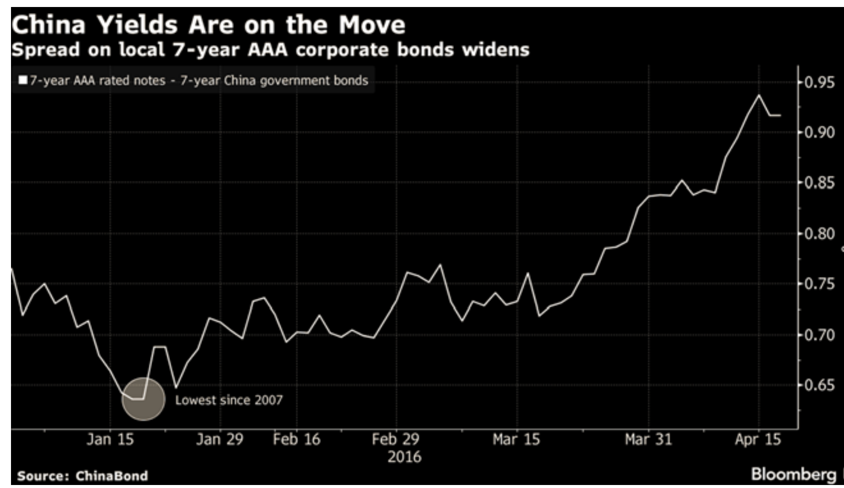
Hard landing scenario

- Corporations are experiencing a profit squeeze.
- You can see how revenue growth in the nonfinancial corporate sector is slower than GDP growth.
- You can also see how this is concentrated in industry.
- So major financial problems linked to slower growth/stagnation in the industrial sector are imminent.

Hard landing scenario

- Then there is the corporate debt problem.
- At more than 150% of GDP, one of the highest ratios of corporate debt to GDP in the world.
- Lots of excess capacity in heavy industry. Eliminating it will force much of this debt to be restructured, causing major financial problems.
- Official estimates classify 5% of loans to corporates as nonperforming.
- But two weeks ago the IMF applied its standard “3 times model,” estimating that that 14% of this corporate debt is “at risk”
(of enterprises whose earnings are insufficient to pay the interest.)

- Until recently, such worries produced only limited fear of defaults among investors.
- Evidently, investors remain confident that the authorities have room to help struggling manufacturers, and that they will use it.
- But this also fans worries that they are only storing up problems for the future.
- And in the last few weeks, corporate bonds yields have moved up by 35 basis points.



So how might this play out?

- With corporate debt = 150% of GDP, bad loans can be conservatively estimated as perhaps a bit more than 25% of GDP.
- In principle, China could use its forex reserves to recapitalize the banks. But its foreign reserves are…

So how might this play out?

- With corporate debt = 150% of GDP, bad loans can be conservatively estimated as perhaps a bit more than 25% of GDP.
- In principle, China could use its forex reserves to recapitalize the banks. But its foreign reserves are only a bit more than 25% of GDP.

So how might this play out?

- I see three options.

First, China could extend and pretend

- That means not acknowledging the bad loans.
- Instead, the banks could be encouraged to evergreen them.
- Leaving the borrowers as zombie firms to undercut the profits of other enterprises.
- Leaving the lenders as zombie banks with inadequate resources to lend to other enterprises.
- This would be the worst of all worlds. Can you say “Japan”?

Second, the government could sell bonds and give them to the banks

- The banks would sell the bad loans to asset management companies or other investors for maybe half their book value.
- The government would then use the bonds to recapitalize the banks.
- But this is effectively transforming the corporate debt problem into a public debt problem. This places the burden on the shoulders of future taxpayers, which will not enhance consumer confidence.
- It will also not be good for confidence in the public finances. China's public debt is still relatively low. But as any citizen of Ireland can tell you, banking problems are times when it can balloon.

Third, the PBOC can be instructed to finance the repair with credit

- This was a tactic on which the authorities relied in 1999, the last time they faced a serious bad-loan problem.
- But running the money printing press is not compatible with the authorities' other stated goal of maintaining a stable exchange rate.
- We saw in August how investors can take fright when the renminbi exchange rate moves unexpectedly.
- Currency depreciation can precipitate capital flight which only accelerates that currency depreciation in a destabilizing spiral.
- This can also destabilize the banks, since the first step for someone seeking to take money out of the country is to withdraw his money from the bank.

Bringing us to the exchange rate issue

- Botched August 11th devaluation/reorganization.
- 3% December/January depreciation against the dollar.
- These exchange rate moves sent tremors through global financial markets.
- The question being why…

Alternative interpretations

1. This was simply a poorly communicated shift from a dollar peg to a basket peg and from a relatively rigid peg to a slightly more flexible peg (somethings euphemistically called a ‘dirty float’), all of which was sensible.
2. Growth was slowing much more rapidly than the authorities let on, rendering them anxious (read ‘desperate’) to boost exports.
3. The policy shift was driven by capital outflows, which made supporting the old regime prohibitively costly (in terms of reserves).

My guess

1. This was simply a poorly communicated shift from a dollar peg to a basket peg and from a relatively rigid peg to a slightly more flexible peg (somethings euphemistically called a ‘dirty float’), all of which was sensible.
2. Growth was slowing much more rapidly than the authorities let on, rendering them anxious (read ‘desperate’) to boost exports.
3. The policy shift was driven by capital outflows, which made supporting the old regime prohibitively costly (in terms of reserves).

- Door #1.
- But by opting for Door #1, the authorities traded for Door #3, creating for themselves a capital outflows problem.

What, then, to do?
China now has three options

1. Use foreign exchange reserves to finance large scale intervention (likely > $100 b. per month), stabilizing the exchange rate.

    Though you can burn thru $3 tr. of reserves pretty quickly.

2. Opt for a mega-devaluation (> 20% against the dollar), moving the RMB back to very competitive levels and creating the expectation that it can only strengthen.

    Though no guarantee of creating that favorable expectation. And this option is not good for the rest of the world.

3. Tighten capital controls.

    And put relevant domestic reforms in place in the meantime. (Though this would be a significant setback for RMB internationalization.)

My guess?

- They will opt for #3 (controls). Indeed, they have already:
  - Imposed a 20% reserve requirement on financial institutions trading foreign exchange forwards.
  - Ordered banks and financial institutions to monitor the practice of over-invoicing imports.
  - Cracked down on individuals using other people's RMB 50,000 quotas for foreign exchange conversions.
  - Restricted purchases of insurance products in Hong Kong using renminbi.
- They may have to tighten those controls further when the bill for the banking crisis comes due.
- Returning us to the question: what does this imply for the progress of renminbi internationalization?

Clearly, it represents a setback

- Additional controls and tighter enforcement will make cross-border transactions in RMB more difficult, and their rate of increase will slow.
- I do not see why this setback should be fatal, assuming that the Chinese authorities avoid the worst.
- After all, these transactions were always subject to a variety of controls.
- A bigger threat to renminbi internationalization is a banking crisis or growth collapse, which the authorities need to avoid at all cost – if they can.

Three Conclusions

1. Renminbi international is good for China and also for the rest of us.
   - For China it has convenience value.
   - For the rest of us, it promises an adequate and better diversified source of international liquidity for the 21st century global economy.
   - It helps to address the intrinsic tension between an increasingly multipolar global economy and a still peculiarly dollar-dominated global monetary system.

Three Conclusions

2. But Rome wasn't built in a day.
   - The U.S. surpassed Britain as the largest economy in the world in 1870.
   - Yet an additional 50 years and more had to pass before the dollar emerged as a consequential international currency and began to rival sterling for that status.
   - The US first had demonstrate the economic stability and financial-market liquidity that were prerequisites for that status.
   - It had to build the institutional infrastructure (an independent central bank, an independent financial regulator) required to achieve that stability and liquidity.
   - This is not to predict that renminbi internationalization will take another 50 years, but it is a reminder to be patient.

Three Conclusions

3. A banking crisis/growth collapse is the one thing that could truly put renminbi internationalization at risk.
   - It is what put dollar internationalization at risk in the 1930s.
   - In China's case, this means addressing the corporate debt problem now.
   - This means restructuring bad corporate debts now rather than using credit creation to put off the day of reckoning.
   - It means relying mainly on bond finance to foot the bill (which is probably tolerable if they move quickly).
   - It means not putting the cart before the horse – liberalizing the capital account with renminbi internationalization in mind only as fast as these other imperatives allow.
   - It means prioritizing rebalancing and financial stability, not arbitrary growth targets.

- Thank you very much, and I am happy to take your questions.