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The Chinese renminbi is ready to take its place on the global stage

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The currency's rise could be a force for change, writes Eswar Prasad



The renminbi is on a seemingly inexorable march towards becoming a global currency. It is already widely used in international trade and finance transactions. Now China wants the International Monetary Fund to label the renminbi an official reserve currency by including it in the exclusive group that make up its unit of account, the Special Drawing Rights. That group comprises the dollar, the euro, the yen and sterling.

There are good reasons to welcome the renminbi's rise. Its trajectory is closely correlated with banking and other reforms that will make China's economy more market friendly. These are necessary to establish a more balanced and less-risky growth path, one that is less dependent on investment, generates more employment and reduces environmental

degradation.

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Economic reformers in China have built public support for the idea that a great economic power should be home to an important international currency. For this to happen, the country must undertake a series of domestic reforms: it needs a better and well-regulated banking system; a broader range of financial markets, including basic currency derivatives; fewer restrictions on the flow of capital in and out of the economy; and a more flexible exchange rate.

These reforms will permit a more efficient allocation of domestic savings to sectors that can generate higher employment and productivity growth. A better financial system will give small and medium-sized enterprises, especially those in the services sector, increased access to credit. Allowing freer capital outflows is already giving households opportunities to diversify their savings and secure better returns.

But there is fierce political opposition to these reforms, which challenge the privileges of powerful vested interests. To overcome the resistance, the government has taken up the rallying cry of making the renminbi a global currency and is now ploughing ahead with its reforms. To take a specific example: the People's Bank of China has made a commitment to eliminate the ceiling on interest rates on bank deposits this year. This will force banks to compete for deposits, giving households a better return on their savings. Large lenders have resisted, wary of competition from smaller rivals. The central bank has fought back, noting that China needs fully market-determined interest rates for the renminbi to become a reserve currency.

The currency's rise could be a force for change in China and the international monetary system

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Reformers in China recognise that the renminbi's prominence in global finance is a mixed blessing. It would become harder to control the currency's value but its official recognition as a reserve currency would be an important validation of reform efforts.

For their part, the US government and others should welcome the renminbi's rise. A more open capital account makes it harder for the central bank to manage or "manipulate" the value of its currency, countering US concerns that Chinese exporters have an unfair advantage from a cheap currency. Stronger demand for the currency will mean a higher exchange rate, making imported goods cheaper for Chinese consumers and giving a leg up to foreign exporters.

Opening up China's financial market could create opportunities for foreign companies, from

banks to insurers. With a more flexible exchange rate, China will no longer accumulate large foreign exchange reserves, reducing its contribution to global current account imbalances.

The IMF's imprimatur is nice to have but ultimately it is market forces that will drive the renminbi's adoption as a reserve currency. If foreign investors, including central banks, see the renminbi as a currency worth holding, they will hold it. Indeed, many countries are already holding small amounts in their foreign exchange portfolios.

There is little prospect, however, that the renminbi will become a dominant global reserve currency. Fundamental political and legal reforms, needed to build trust among foreign investors, are not on the cards. The dollar's position is secure for now.

Official validation of the renminbi's rise is important for the IMF. It would avoid another knock to the institution's legitimacy, which is shaky given the stalling of reforms to give emerging economies their rightful voting share. For China and others, a negative ruling on reserve currency status could symbolise their concerns that the IMF remains an institution run by and for the benefit of advanced economies. A positive outcome will give Beijing a vested interest in maintaining the fund's primacy in international finance.

The renminbi's rise could be a constructive force for change in China and the international monetary system. It should be embraced.

The writer is a professor at Cornell University, a fellow at the Brookings Institution and former head of the IMF's China division

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