China's Effort to Expand the International Use of the Renminbi

By Eswar S. Prasad (Cornell University)

Discussant: Federico Mandelman (Atlanta Fed)

- This report provides a very detailed institutional description of China's effort to enhance the role of the renminbi (RMB) in the global monetary system.

- It shows in great detail the successive changes in the regulatory framework in three areas:

1. Internationalization: Facilitate the use of RMB to settle cross-border trade and financial transactions.
2. Capital account convertibility: Ease restrictions on inflows/outflows of "financial" capital.
3. Reserve Currency: Promote the use of the RMB by other central banks.

Overview

- Very interesting reading for practitioners/academics interested on the institutional details behind the ongoing Chinese financial liberalization.

- Very rich balance of payments (BOP) data for China

My big problem:

Hard to discuss a rich compendium of data and a legal/regulatory framework.

My lame solution:

I will just to focus on one aspect of the data that got my attention.

Trade (and deficits) with China

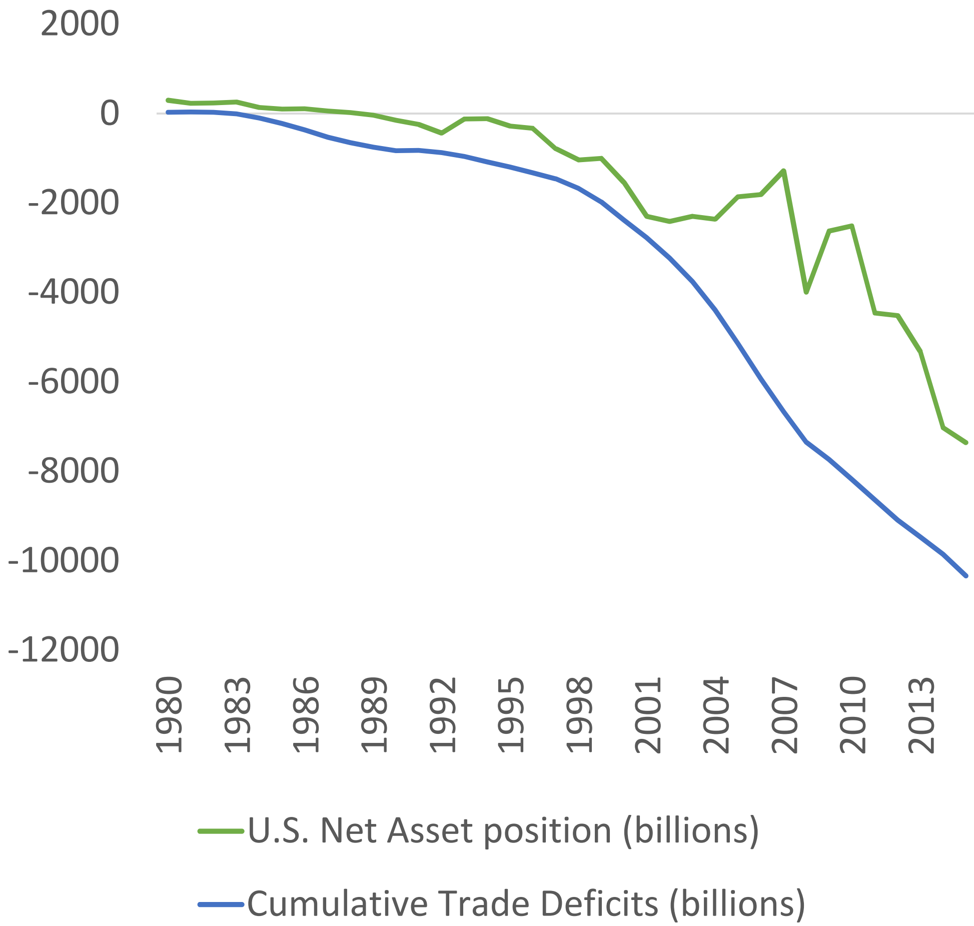
- Trade with China became a key issue in this election cycle.

- Some politicians' quotes in the media:

"China is killing us.. outsmarting us at every turn"

"Currency manipulation…resulted in chronically unsustainable trade deficits and debt…that will eventually bankrupt us."

US Trade Deficits (and Debt)

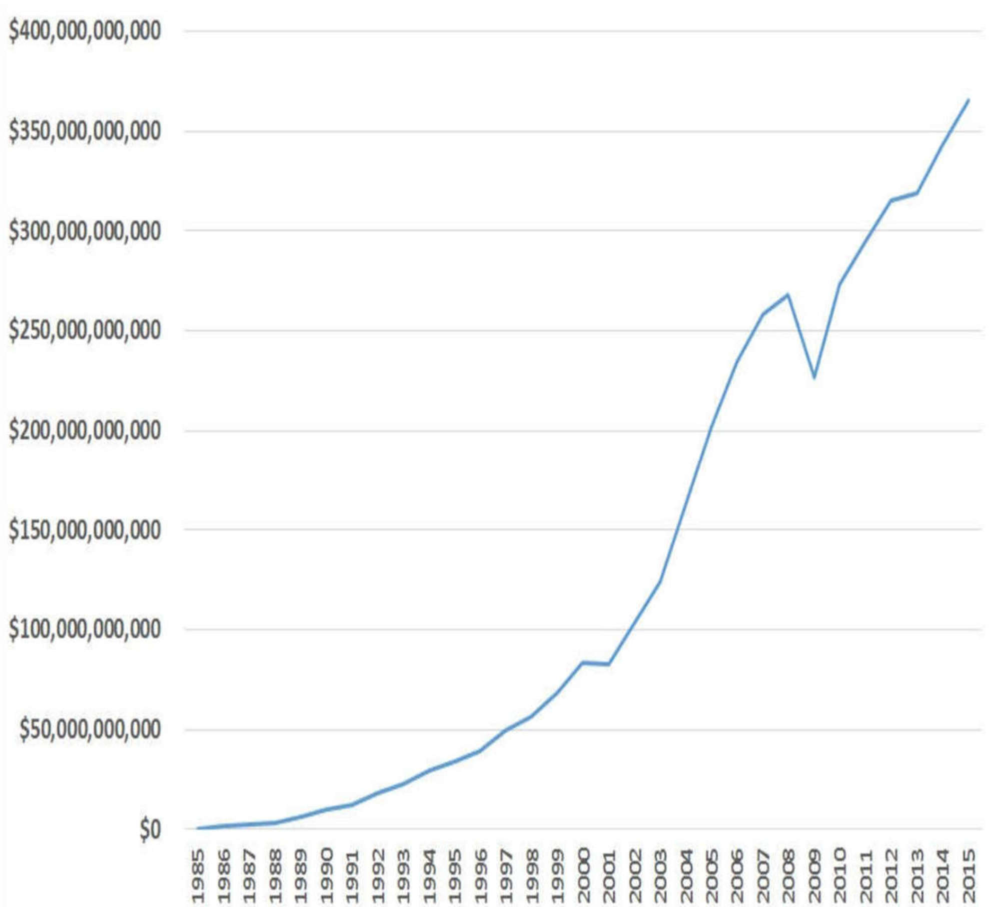


-Since the 80's the US has been accumulating trade deficits.

-These deficits resulted in a deterioration in US Net Asset Position = US ownership of foreign assets – local assets owned by Foreigners.

-US became "largest debtor in the world."

Trade Deficits with China



- Much of those deficits are the by-product of deficits with China.

In 2015:

- Trade deficit with China $315 Bl.
- Total trade deficit: $540 Bl.

Eswar’s paper: Detailed Data on Chinas’ BOP

I was expecting to see this:

-In the last decades, China runs protracted trade surpluses…

-It has accumulated a robust net asset position with the rest of the world (opposite to the US)…

-It is now receiving positive and increasing capital income from these assets (e.g. interest payments, dividends, etc.)…

That did not happen…

Eswar’s paper: Detailed Data on BOP

- The data effectively shows that China has been accumulating foreign assets as a result of the trade surpluses.

- However, it has been increasingly losing money on those increasing assets.

Table 4-2. Returns on China's External Investment Positions

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Net income (USD billions)	**-6**	**-18**	**-7**	**4**	**22**	**-16**	**-38**	**-85**	**-35**	**-95**	**-60**
Inward	19	36	50	77	103	99	129	128	150	166	183
Outward	24	54	57	73	80	115	167	213	185	261	243
Net external position (USD billions)	**276**	**408**	**640**	**1188**	**1494**	**1491**	**1688**	**1688**	**1866**	**1996**	**1776**
Stock of assets	929	1223	1690	2416	2957	3437	4119	4735	5213	5986	6409
Stock of liabilities	653	816	1050	1228	1463	1946	2431	3046	3347	3990	4632
Net return (in percent)		**-6.4**	**-1.7**	**0.6**	**1.9**	**-1.1**	**-2.6**	**-5.1**	**-2.1**	**-5.1**	**-3.0**
Return on assets (t/t-1)		3.9	4.1	4.5	4.2	3.3	3.7	3.1	3.2	3.2	3.1
Return on liabilities (t/t-1)		8.2	7.0	6.9	6.6	7.8	8.6	8.8	6.1	7.8	6.1

-If I save a lot every year to increase my portfolio of stocks,

and …

-I consistently get <u>increasing negative dividends</u> on my portfolio over a decade.

-I would be **very mad** with my Financial Advisor….

So what happened?

Chinese Portfolio

- Assets (Chinese ownership): About 60% are foreign exchange reserves. Safe and liquid but with an ultra low return (e.g. US Gov. Bonds).

- Liabilities (Foreign ownership of Chinese assets): About 60% is FDI and 10% is Equity. This gives foreigners a much higher return (even with shrinking assets).

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015H1
Net position	**276**	**408**	**640**	**1188**	**1494**	**1491**	**1688**	**1688**	**1866**	**1996**	**1776**	**1471**
Assets	**929**	**1223**	**1690**	**2416**	**2957**	**3437**	**4119**	**4735**	**5213**	**5986**	**6409**	**6430**
FDI	53	64	91	116	186	246	317	425	532	660	744	1013
Portfolio	92	117	265	285	253	243	257	204	241	259	263	276
Equity	0	0	1	20	21	55	63	86	130	153	161	178
Debt	92	117	264	265	231	188	194	118	111	105	101	98
Other investments	166	216	254	468	552	495	630	850	1053	1187	1503	1370
Reserve Assets	619	826	1081	1547	1966	2453	2914	3256	3388	3880	3899	3771
FX Reserves	610	819	1066	1528	1946	2399	2847	3181	3312	3821	3843	3694
Liabilities	**653**	**816**	**1050**	**1228**	**1463**	**1946**	**2431**	**3046**	**3347**	**3990**	**4632**	**4959**
FDI	369	472	614	704	916	1315	1570	1907	2068	2331	2678	2827
Portfolio	57	77	121	147	168	190	224	249	336	387	514	900
Equity	43	64	106	129	151	175	206	211	262	298	369	673
Debt	13	13	14	18	17	15	18	37	74	89	145	227
Other investments	227	267	315	378	380	442	637	891	943	1272	1440	1232

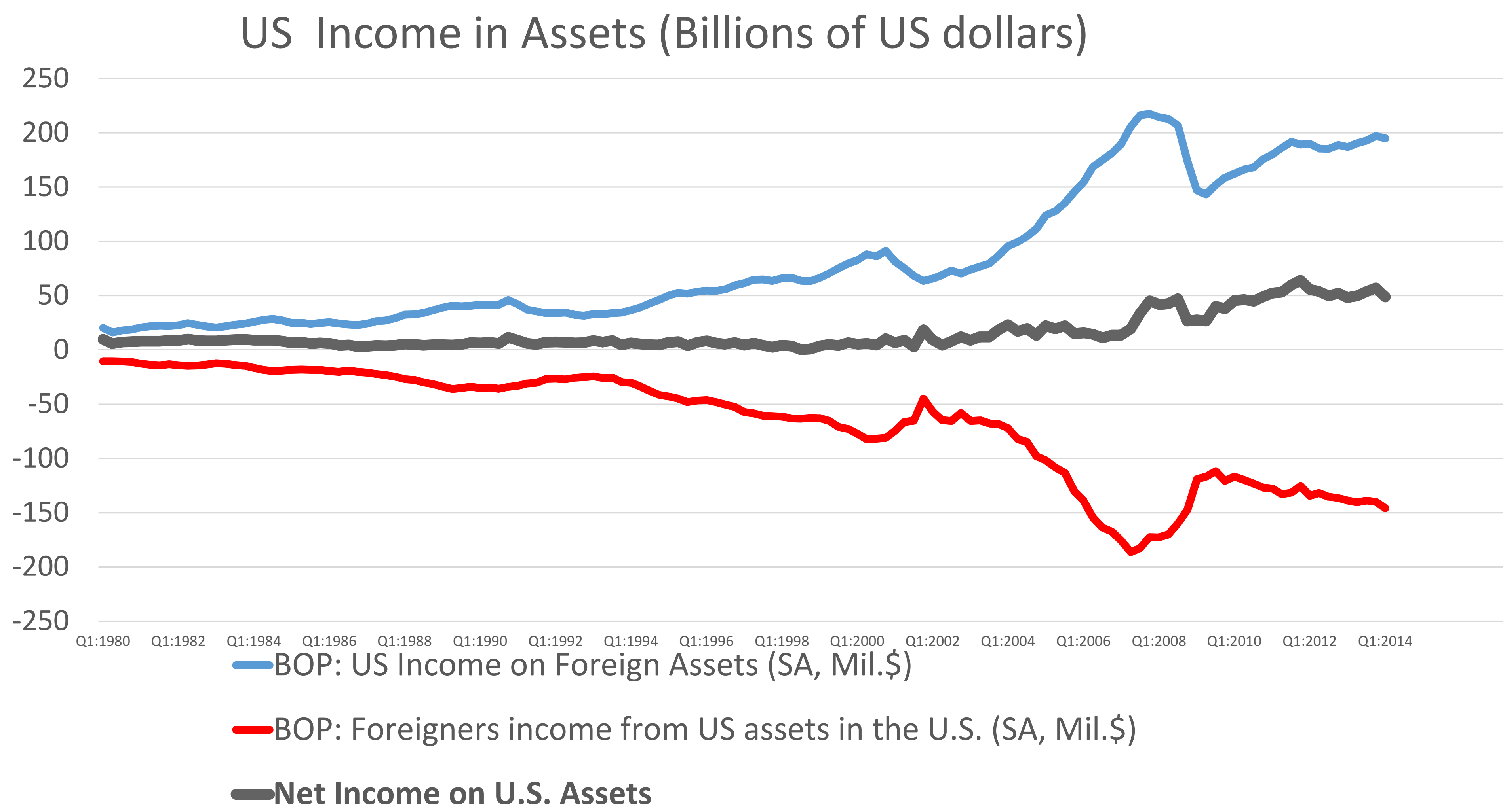
US Portfolio

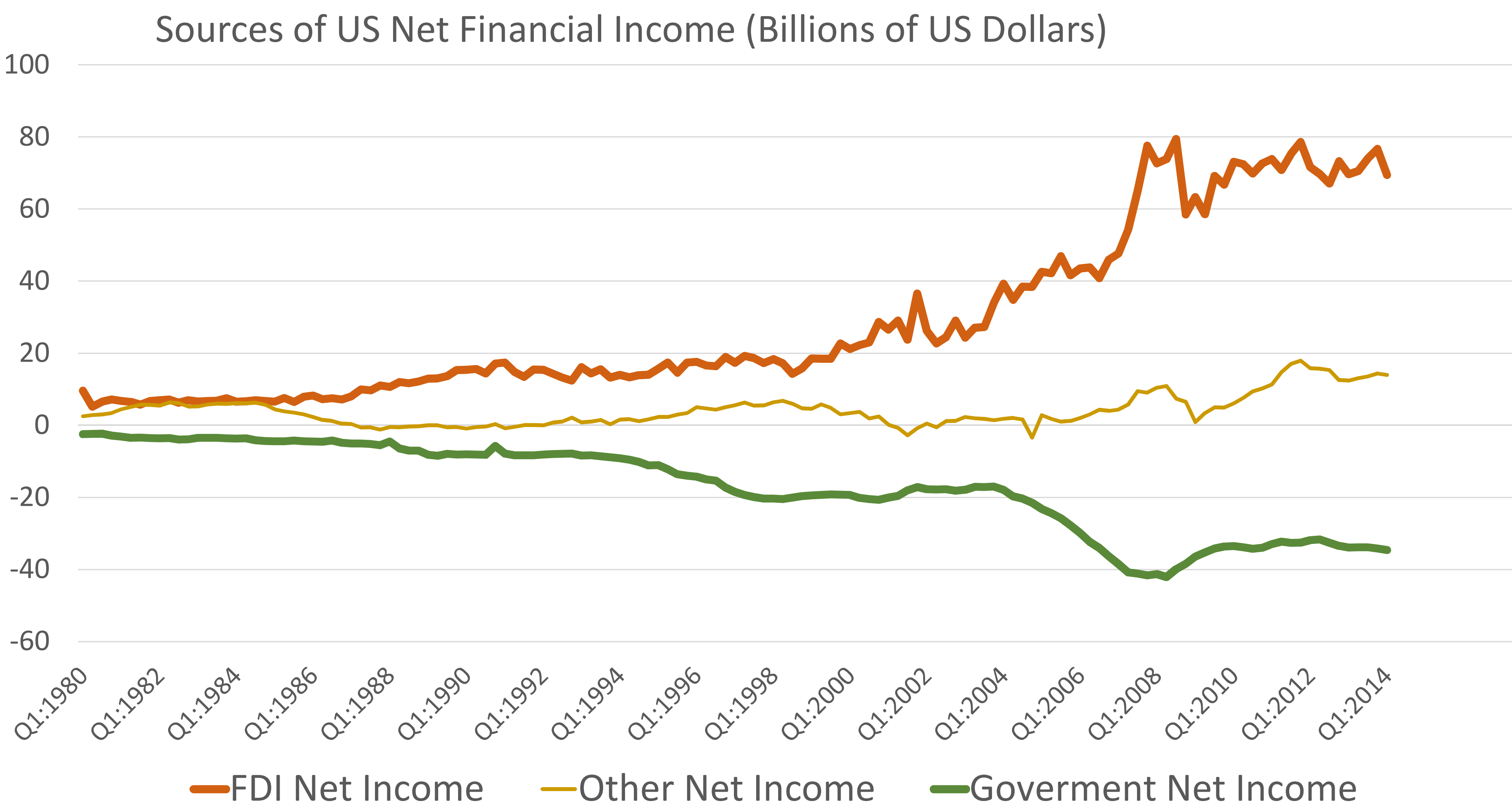
- It is the other side of the coin.

- Despite accumulating more 10 trillion in trade deficits since the 80's and witnessing a collapse in net foreign assets…

- The financial income remained positive (even increasing).

- US accumulated FDI (e.g. Shanghai/Euro Disney with a 20-25% return), while issuing T-bills (paying 1-2%).


US Income in Assets (Billions of US dollars)
250
200
150
100
50
0
-50
-100
-150
-200
-250
Q1:1980
Q1:1982
Q1:1984
Q1:1986
Q1:1988
Q1:1990
Q1:1992
Q1:1994
Q1:1996
Q1:1998
Q1:2000
Q1:2002
Q1:2004
Q1:2006
Q1:2008
Q1:2010
Q1:2012
Q1:2014
BOP: US Income on Foreign Assets (SA, Mil.$)
BOP: Foreigners income from US assets in the U.S. (SA, Mil.$)
Net Income on U.S. Assets


Sources of US Net Financial Income (Billions of US Dollars)
100
80
60
40
20
0
-20
-40
-60
Q1:1980
Q1:1982
Q1:1984
Q1:1986
Q1:1988
Q1:1990
Q1:1992
Q1:1994
Q1:1996
Q1:1998
Q1:2000
Q1:2002
Q1:2004
Q1:2006
Q1:2008
Q1:2010
Q1:2012
Q1:2014
FDI Net Income
Other Net Income
Goverment Net Income

US Gains from trade

(1) Insurance and liquidity: Foreigners (people and central banks) demand liquid assets.

-That pay low (bonds) or zero interest rate (cash).

(USD a reserve currency and an invoice in international transactions helps).

-(2) Globalization: US multinationals get a high return on overseas investments (FDI) and equity portfolio.

Conclusions

If China:

(a) liberalizes its current account and allow its citizens to invest abroad;

(b) enhances the role of RMB as a reserve currency and;

(c) An invoice currency in international trade.

China may be poised to obtain significant gains from globalization.