The Other Side **July 30, 2015**

Capital Account Convertibility and China

Over the last few months, the Chinese stock market, rather than its real economy, has been making headlines. The index rose almost 50% between March and Mid-June before coming back to the March level over the next four weeks, when the authorities took several steps to halt the slump. These moves – like reducing interest rates, restricting margin trading, getting some state controlled organisations to buy equities or provide margin money, suspension of trading in a number of shares, etc. -- are standard measures which all policy makers, including those in the Anglo-Saxon economies, take when a bubble in asset prices bursts.

Market euphoria and gloom are recurring features of all financial, or asset, markets, and exaggerated when leveraged, or margin, trading is preponderant. To recall a few examples from the supposedly deep and "mature" US financial markets: the October 1987 crash of the stock market; the "rescue" of Long Term Capital Management, a hedge fund, by the Fed "persuading" several banks to take it over; the bursting of the .com bubble in 2000; and the 2007-08 crisis in the mortgage securities market. The US Federal Reserve is famous for writing a "Greenspan put" option in favour of markets.

More important in the long term is the way China has been fostering the internationalisation of the yuan. A few years back, Arvind Subramanian, now India's Chief Economic Adviser, wrote a book titled *Eclipse: Living in the Shadow of China's Dominance*: his argument is that, given the size of China's economy (the world's largest in purchasing power parity terms) and trade; and the fact that China is the world's largest creditor nation while the US is a very large debtor; China is likely to become the dominant financial/economic power in the near future. Martin Jacques makes the same point in *When China Rules the World*. More sceptical economists, Eswar Prasad for example, believe that the global economy will remain enmeshed in *The Dollar Trap*; that China needs to liberalise its capital account, and allow the yuan to float before it becomes an international reserve currency. One test will come when the SDR basket of currencies, currently composed of the US dollar, the euro, the yen and the pound, is reviewed later this year. Will the Chinese yuan be added to the basket? This would depend partly on whether the IMF considers it to be “freely usable”.

Its use in trade invoicing has grown rapidly in recent years. Globally, it is now the 5th most used payments currency (and the second largest in trade finance) with a share of 2.17%, and likely to overtake the yen (2.69%) in the current year. A number of offshore centres now clear local currency/yuan trades. There is also a large and rapidly growing market in offshore yuan deposits, currently estimated at CNY 2 trn, the main centres being Hong Kong, Taiwan and Singapore. Many issuers have floated yuan denominated (or “Dim Sum”) bonds in the offshore market.

The capital account is also being gradually liberalised. Foreign investors can access the on-shore equity market, and qualified domestic institutional and individual investors have been permitted to invest abroad. Foreign commercial and central banks have been permitted to trade in the domestic bond market. (However, all such inflows and outflows, have to be within specified limits.) China has entered into domestic currency for yuan swap lines with 28 central banks. All this does suggest deliberate steps towards greater international acceptance and use of the currency, both for transactions and investments.

The exchange rate, however, continues to be managed by the central bank: the daily fluctuation band around the reference rate, which used to be 0.3% was increased first to 1% and recently to 2% on either side. Over the last ten years, the yuan has been appreciated by 30% against the US dollar, partly to reduce the external surpluses (10% of GDP at one time!), and rebalance the economy to increase domestic consumption. The IMF now finds the yuan to be fairly valued. The trade surplus was still $ 250 bn in the first half of 2015, even while reserves fell by $ 150 bn, suggesting capital outflows.

China’s foreign direct investment too has grown rapidly (to yuan 5 trn) and is likely to exceed the inward FDI this year. FDI is going not only to resource rich African and Latin American economies, but increasingly to US and Europe. More ambitious are China’s efforts to promote institutions to rival the World Bank and the Asian Development Bank, for investment in infrastructure. (In one more sign of Dr. Subramanian’s *“Eclipse”*, the US Exim Bank recently stopped lending as the US Congress refused to extend its mandate). The two major institutions are the BRICSpromoted New Development Bank, and the larger Asia Infrastructure Investment Bank (AIIB). While in both China will be the largest shareholder, more than 50 countries including many in Europe, have contributed capital to the AIIB. AIIB will be involved in financing the huge Silk Road project connecting China by land routes (both roads and railways) to central Asia, extending to the Atlantic!

Inclusion of the yuan in the SDR basket may not give much tangible benefit, but will symbolise China's "arrival" on the global financial scene. But if the price is floating the exchange rate, will China accept it? I hope not: it is too important a variable for the real economy to be left to volatile markets to decide.

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