FINANCIAL LIBERALISATION IN CHINA: ECONOMIC POLICY OUTLOOK AND GLOBAL IMPLICATIONS

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Financial liberalisation in China has advanced significantly in the past three years. It has done so both domestically, with market principles weighing more on the functioning of the banking system, and externally, with the adoption of a series of measures culminating in the inclusion of the renminbi in the IMF's Special Drawing Rights (SDR) basket, effective this October. This financial liberalisation process is a fundamental ingredient in the ongoing rebalancing of the Chinese growth model, but it also entails some short-term risks, as highlighted by the bouts of turbulence recorded last year and early in 2016. This article reviews recent headway in liberalisation and the economic policy implications in China.

Introduction

Financial liberalisation in China has advanced significantly in the past three years. It has done so both domestically, with market principles weighing more on the functioning of the banking system, and externally, with the adoption of a series of measures culminating in the inclusion of the renminbi in the IMF's Special Drawing Rights (SDR) basket, effective this October. This decision may be interpreted, for practical purposes, as testimony to the renminbi's new-found status as an international reserve currency.

For China, the liberalisation of its financial system is particularly important for many reasons. First, because it is a key factor in the rebalancing of the economy towards a greater weight of private consumption in GDP, as it provides both for a reduction in precautionary saving and the channelling of financial resources towards productive investment (see Chart 1). The liberalisation of lending and deposit interest rates should be particularly conducive to a more efficient allocation of credit, which has grown substantially in recent years. Further, small firms may see their financing needs better met, with greater access to markets and financial institutions other than public-sector banks which, in China, have routed credit to state-owned enterprises in the main. To date, the financing of small firms has depended almost exclusively on own funds, which raises saving and encourages informal loans. Moreover, external liberalisation and the internationalisation of the renminbi open the way for Chinese issuers to issue debt in their own currency on international markets, providing protection against balance sheet effects that have had such negative consequences for many emerging market issuers.

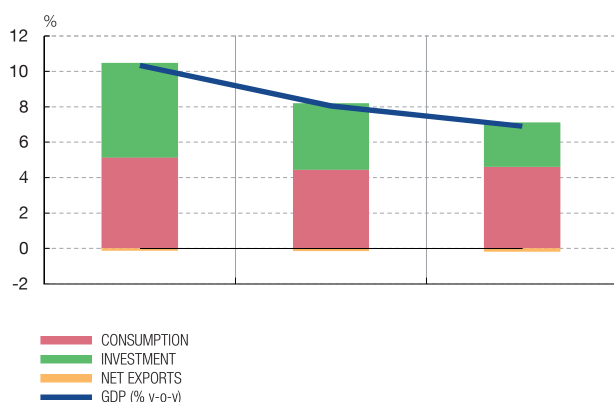
Historically, however, financial liberalisation processes have rarely been free from bouts of acute volatility or crisis [Díaz Alejandro (1985)], which illustrates the difficulty of managing this type of reform. Developments on Chinese financial markets since late 2014 suggest that China is no exception to this rule. From November 2014 – further to the establishment of a channel connecting the Hong Kong and Shanghai stock exchanges – to March 2015 the Chinese stock market increased by more than 110%, this rise being corrected virtually in its entirety over the course of the following year (see Chart 2). Along these same lines, the exchange rate of the renminbi, which had held practically stable against the dollar since late 2013, depreciated by more than 7% from August 2015 to early 2016 (see Chart 2), despite the loss of one-fifth of the international reserves built up over the past 15

1 The authors wish to thank Marina Conesa for her excellent technical support.

ECONOMIC GROWTH AND CREDIT

CHART 1

1 GDP GROWTH BY COMPONENT



2 GDP GROWTH, BANK LENDING AND TOTAL SOCIAL FINANCING

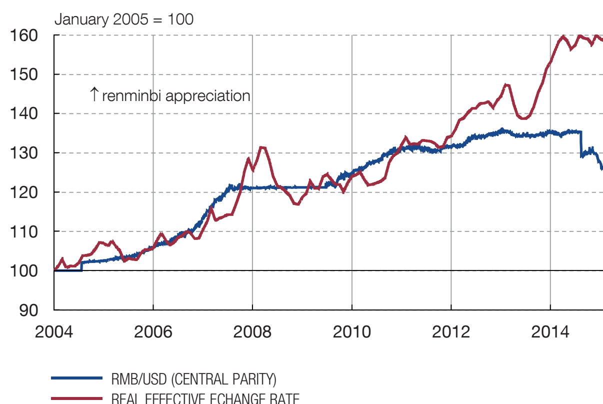
SOURCES: CEIC database, National Bureau of Statistics of China (NBS) and People's Bank of China (PBoC).

STOCK EXCHANGE AND EXCHANGE RATE

CHART 2

1 STOCK MARKET INDICES

2 EXCHANGE RATE AGAINST THE DOLLAR, EFFECTIVE EXCHANGE RATE



SOURCES: CEIC database and Datastream.

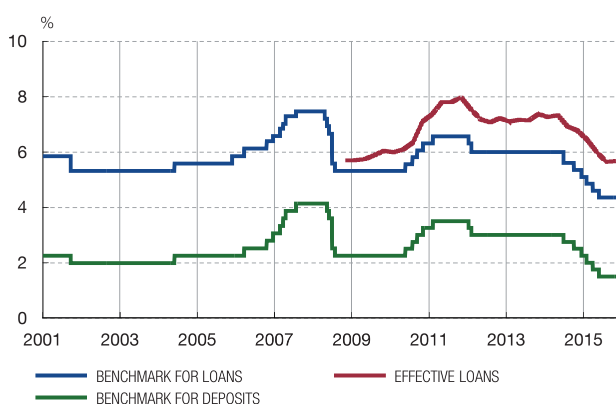
years. The rapid spread of these movements to international financial markets has highlighted the fact that, despite the incomplete liberalisation of its capital account, the shocks originating in China may pass through to other economies by means other than the trade channel, by affecting the degree of international financial markets' risk appetite or aversion.

A useful conceptual framework when evaluating the different economic policy options China has is the so-called "impossible trinity" or "trilemma" that other emerging economies have faced in their external liberalisation processes. Under this framework, as the openness of the capital account increases, it becomes more difficult to maintain simultaneous control of interest rates and the exchange rate, obliging the economic authorities to opt for two of three objectives (control of the exchange rate, monetary autonomy or free capital movements). In China's case, unlike in other, smaller emerging economies, its systemic importance raises the implications for the global economy depending on how this trilemma is resolved.

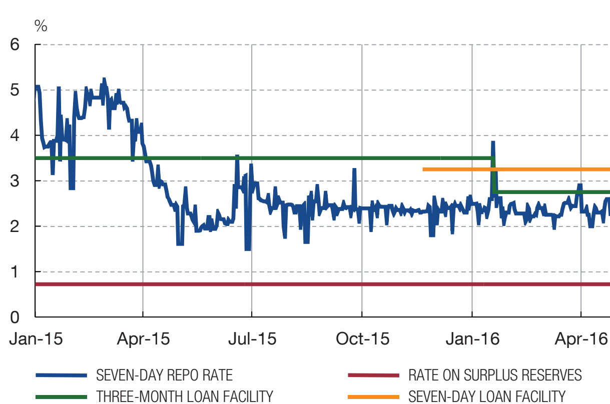
INTEREST RATES

CHART 3

1 ONE-YEAR INTEREST RATES



2 INTEREST RATE CORRIDOR



SOURCES: CEIC database and Bloomberg.

This article reviews the recent headway in China's internal and external liberalisation, and the consequences of both processes for its current economic policy options. The conclusion reached is that the solution to the trilemma in China's case is for now an open question, the specific resolution of which will be greatly influenced by developments in the international environment.

The process of internal financial liberalisation

China's internal financial liberalisation has made enormous advances since the change of government in 2013. The progress has been on three closely interlinked fronts: the liberalisation of interest rates, the development of new monetary policy instruments and, more mutedly, the reform of the banking system's ownership structure.

The most notable aspect of this process has been the liberalisation of the interest rates banks apply to their transactions with customers. Initially, the central bank (People's Bank of China) set benchmark interest rates, both for loans and deposits, that banks had to adopt and that were one of the main instruments for managing monetary policy (see Chart 3). The interest rate on loans was the first to be liberalised, as the room for flexibility given to banks became progressively broader, until they were granted full freedom in July 2013 to set the minimum interest rate at which they lend funds. This has made for lower financing costs for agents and has fomented greater competition among banks.

The key to domestic liberalisation, however, lay in the liberalisation of the interest rates on deposits, the return on which had traditionally been very low (and even negative in real terms). Also, to secure individuals' trust in the system, a deposit guarantee scheme was established in May 2015,[2] replacing the previous system based on the Government's implicit guarantee. The liberalisation procedure was very similar to that for lending rates: from 2012 the room for flexibility in the rates banks could apply was progressively widened until all restrictions were eliminated by October last year.

The liberalisation of interest rates marks an essential change in the functioning of Chinese monetary policy, as lending and deposit benchmark rates have been a key instrument to

2 It guarantees 0.5 million yuan per depositor (approximately €68,000) and covers 99% of deposit accounts in China.

date. Indeed, although the guidelines laid down by the People's Bank of China have ceased to be binding, banks continue to take them into account. This means it is necessary to advance on another of the financial reform fronts, that of defining a new monetary policy implementation framework enabling the central bank to influence bank financing conditions in the markets, so that monetary policy decisions may feed through to the interest rates banks offer to their customers.

In this setting, the People's Bank of China wishes to establish an interest rate corridor system, similar to those used in the euro area or in Japan (see Chart 3), which is still at the development stage. The corridor's upper limit will be given by the central bank's "standing lending facility" and "medium-term lending facility" (created in 2013 and 2014, respectively), while its lower level would be the rate of return on surplus reserves. Although the intermediate monetary policy target is not defined, there is a possibility that the seven-day repo rate, which is less volatile than the Shibor (Shanghai Interbank Offered Rate[3]), is being considered as the alternative rate [Dong and Le (2016)]. The corridor system steers market expectations better, stabilises banks' demand for liquidity and reduces the frequency, scale and costs of the monetary authority's open market operations [Niu *et al*. (2015)], which would help China control the interest rate rises observed on the interbank market in mid-2013 and early 2014.

The area of internal liberalisation in which there have been fewest advances is that relating to the reform of the banking system's ownership structure, where there is a notably high public-sector presence. The major public-sector banks account for approximately 50% of banking assets and the evidence suggests that the public sector exerts some control in most banks, although it does so in many different ways. The highly preliminary progress here has been in pilot programmes, such as that launched in late 2014 to create five purely privately owned banks. The presence of foreign capital is very low and no significant changes are expected in the short run since, although foreign bank assets have not ceased to grow, they have done so more slowly than local bank assets, meaning their share in the banking system's total assets is declining.

The way in which the liberalisation process advanced up to 2013 was a cause, but also a consequence, of certain significant adverse developments. In recent years, the increase in per capita income and the savings surplus generated against a background of extraordinary economic growth and strong financial repression were conducive to the formation of a real estate bubble, given the greater return on investment in this sector compared with traditional saving products. This environment also encouraged the development of high-risk segments within the shadow banking system, which grew at a much higher rate than did GDP (see Chart 2), leading to marked regulatory arbitration. The emergence of these sources of risk was a wake-up call on the urgent need to reform the regulatory and supervisory framework since, although China has virtually completed the adoption of the Basel III regulatory framework [Bank for International Settlements (2015)], it still maintains significant segments that fall outside the scope of the various supervisors, which justifies the high priority given by the government to the regulatory and supervisory framework reform in the economic objectives for 2016. Additionally, international evidence suggests that financial liberalisation processes tend to cause significant credit expansion, which emphasises the importance of strengthening regulatory and supervisory frameworks.

China has completed its internal financial liberalisation with respect to interest rates, but much remains to be done in monetary policy implementation and, especially, in reducing

public-sector involvement in bank management – including the guidelines for granting loans – and in financial regulation, before all the system's segments are covered.

The process of external financial liberalisation

External liberalisation has advanced unevenly. During an initial phase, which lasted until late 2014, progress was relatively modest. According to the schedule managed by the authorities, the opening of the capital account was expected to be completed once internal financial liberalisation was concluded towards 2020. Indeed, since the external liberalisation process started in the 1980s, it has advanced with notable caution through small-scale pilot programmes involving qualified institutional investors for investment both by foreigners in China and Chinese investors abroad.[4] The programme quotas and the number of banks authorised to participate were gradually broadened, albeit in a limited manner. Also as part of the external liberalisation, from 2009 the exchange rate regime was gradually made more flexible and a policy promoting the international use of the renminbi was adopted.

The external liberalisation process gained strong momentum from late 2014, partly associated with the objective of converting the renminbi into a reserve currency. The Chinese authorities have pursued international recognition in the financial sphere more in keeping with China's actual weight in the global economy and trade. In this context and with a view to eliminating restrictions on the international use of its currency, they have introduced greater openness in the capital account.

The channel connecting the Hong Kong and Shanghai stock exchanges, which broadened retail investors' access to the international market, was established in November 2014. This channel allows for a broad group of investors resident in China to purchase equities in the Hong Kong market, subject to Shanghai regulations, and for foreign investors to do so in the Shanghai market through the Hong Kong market. These transactions are subject to much broader quotas than those relating to the prior pilot programmes for investment and take place inside a closed channel which avoids capital inflows towards other kinds of investment – such as real estate or speculative investments – or covert outflows. The marketing of financial products to retail investors by fund managers from China and Hong Kong was liberalised in 2015, albeit with certain limits.

Also, progress was made from late 2014 in the assignment of centres for direct convertibility,[5] which render permanent the currency swap agreements established by the People's Bank of China with other central banks and facilitate the use of the currency abroad.

Since mid-2015, a substantial part of the liberalisation measures have been driven by the specific aim that the renminbi be included in the IMF's SDR basket.[6] In this connection, and in order to meet the "free use" and "free trade" criteria (see Box 1), central banks, sovereign

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3 Benchmark interest rate based on the interest rates at which banks offer funds in the Shanghai interbank market.

4 For example, foreign currency share transactions (QFII) and renminbi share and bond transactions (RQFII), in the first case, or the QDII and the Wenzhou pilot programme, in the second.

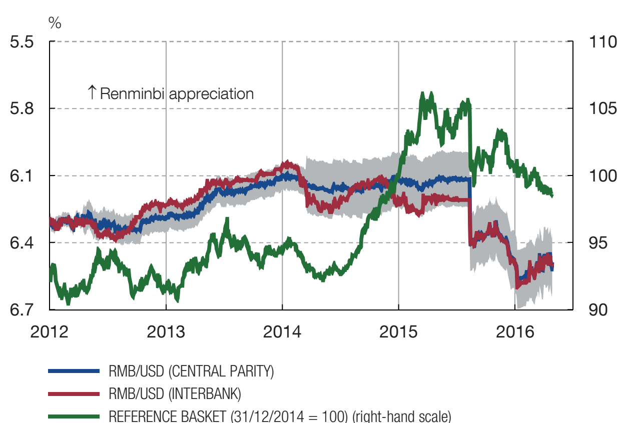
5 These are agreements which the Chinese monetary authority has been entering into since late 2008 in the wake of the global financial crisis. Direct convertibility makes it possible to reduce transaction costs. By mid-2014, 25 countries had agreements for the establishment of direct convertibility centres with the People's Bank of China for a total amount of 2.7 trillion yuan. These agreements are often linked to the existence of free trade agreements and also provide support to direct investment transactions, both to and from China.

6 According to the *IMF Work Progresses on 2015 SDR Basket Review,* in August 2015 the renminbi still did not meet the reserve currency requirements. Although widespread use of the Chinese currency in international transactions in Asia had been achieved, it was hardly used in North America and was not widely used in international debt security denominations.

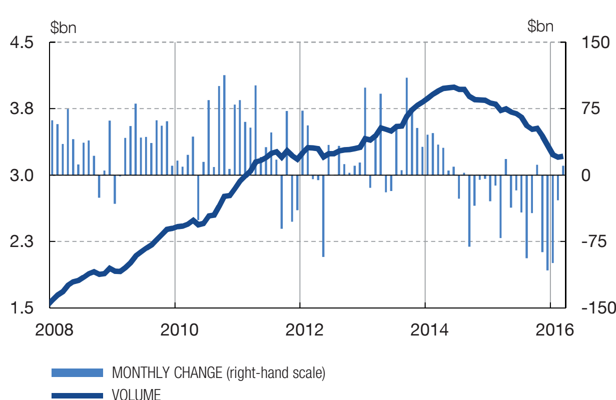
EXCHANGE RATE AND INTERNATIONAL RESERVES

CHART 4

1 EXCHANGE RATE AGAINST THE DOLLAR AND REFERENCE BASKET



2 INTERNATIONAL RESERVES



SOURCES: Datastream and CEIC database.

wealth funds and international financial institutions were granted permission to operate in the interbank foreign exchange market, subject to prior authorisation. The prior authorisation system became a registration system in 2016, thus easing the criteria for investor participation in the bond market. Participation in this market by qualified foreign institutional investors, such as commercial banks, insurance and securities companies, asset and fund managers and pension funds, was finally liberalised, without any quota limits.

Advances in the opening up of the capital account came hand in hand with a renewed boost to exchange rate flexibilisation (see Chart 4). In 2005, China decided to eliminate the fixed exchange rate system it had in place against the US dollar and established a *de facto* managed float regime against the dollar[7] that has persisted through 2015. Under this system, the central bank sets the central parity on a daily basis (enabling the authorities to exert strong control over the exchange rate), with fluctuation bands that progressively expanded, reaching 2% in 2014.

In August 2015,[8] the authorities changed the criteria whereby the central parity is set, moving it closer to its market value, which led to a more than 4.5% depreciation of the renminbi against the dollar during the first few days following the implementation of the new regime. In December 2015, the authorities took a further step, relaxing the renminbi-dollar link and announcing that agents should establish the renminbi exchange rate based on a broader reference basket of currencies more representative of trade and investment flows. For this purpose, they created a new reference basket of 13 currencies, where the US dollar still has the most weight (26.4%), followed by the euro (21.4%). As a result of these changes, the renminbi depreciated against the dollar by 7.3% between August 2015 and January 2016. In more recent months, the correction against the dollar has slowed, in a context where the US currency has begun to experience downward pressures. Therefore, since the changes were introduced in December, the renminbi has depreciated less against the dollar than against its reference basket.[9]

7 Officially, the renminbi was linked to a basket of currencies whose composition was not disclosed. Evidence suggests that the dollar had a very high weight in it.

8 The exchange rate flexibilisation process was held back on two occasions: in 2008, as a result of the global financial crisis; and between June and August 2015, when a stable exchange rate against the dollar was deemed essential to prove its capability as a reserve currency.

9 After two years of appreciation from 2014, the US dollar has depreciated in the last few months. This is associated with less robust growth in the United States, reflecting the expectation of a more gradual and more moderate rise in interest rates.

DIFFERENCES BETWEEN CHINA'S ONSHORE AND OFFSHORE RENMINBI MARKET

TABLE 1

	Onshore market	Offshore market (from 2010)
Exchange rate regime	Dirty float against a basket	Free float
Fluctuation band	+/-2% against the dollar and variable for all other currencies	No
Location	China	Hong Kong, London, Singapore
Traded products	Spot and forward transactions, swaps and options	Spot and forward transactions, swaps and options
Participants	Central Bank, banks resident in China, financial subsidiaries of State-owned enterprises, subsidiaries of foreign banks, other central banks, sovereign wealth funds and international financial institutions	Exporters, importers, banks not resident in China and hedge funds

SOURCES: Funke et al. (2015) and Banco de España.

These decisions have had a significant impact on global financial markets, contributing to bouts of turmoil and feeding strong pressures into the depreciation of the renminbi exchange rate, against the backdrop of the gradual slowdown in activity in China in line with the new economic model sought by the authorities. Accordingly, since the summer of 2015, the authorities have intervened repeatedly to curb exchange rate volatility, even acting in the Hong Kong offshore market (see Table 1) to halt depreciation.[10] This has entailed a substantial cost in terms of international reserves, which have decreased by approximately 20% from a peak of $3.99 trillion in June 2014 to $3.2 trillion in April 2016 (see Chart 4), although this decrease includes valuation effects associated with the dollar appreciation and payment commitments relating to development programmes funded by reserves. The expectations of a depreciation of the renminbi had a marked impact on short-term capital flows in China up to February 2016, with significant capital outflows (see Box 2) being recorded that have decreased in the last few months. In any event, the turmoil in financial markets in early 2016 has tempered the prospects of the opening up of the capital account, which is now expected to be more gradual, in order to preserve stability.

In summary, external financial liberalisation has received a strong boost in the past year, although there is still a long way to go. While it is difficult to quantify the degree of external liberalisation achieved, it should be noted that 35 of the 40 categories included in the IMF's annual report on *Exchange Arrangements and Exchange Restrictions* are fully or partially liberalised.[11]

Economic policy options for China and global implications

Until 2015, with interest rates kept very low in the United States and a relatively closed capital account, China was able simultaneously to maintain control over the exchange rate and its monetary policy. However, the current situation poses greater challenges for China's economic policy. The normalisation of monetary policy in the United States as its macroeconomic recovery stabilises, with the ensuing risk of dollar appreciation, could drag the renminbi in the same direction, precisely when the Chinese economy is converging towards a path of lower growth. A more flexible exchange rate would weaken this bond, enabling the adoption of a monetary policy more attuned to its situation. Indeed, the events of 2015 illustrate how, with a porous capital account, maintaining a fixed exchange rate against the dollar has a high cost in terms of international reserves if it is not wished to increase interest rates and there are widespread expectations of depreciation.

10 They have intervened both directly and through Chinese public institutions.

11 International Monetary Fund (2015).

A useful conceptual framework when assessing China's various economic policy options is the so-called "impossible trinity" or "trilemma" that other emerging economies have faced during their external liberalisation processes [Obstfeld *et al.* (2004)]. Under this framework, based on uncovered interest rate parity, as the openness of the capital account increases, countries find it more difficult to maintain simultaneous control over interest rates and the exchange rate. In the absence of free capital movements, authorities are able to conduct an autonomous monetary policy and to control the exchange rate because the international interest rate differential is not a determining factor for capital movements. However, when the financial account is liberalised, there is less room for manoeuvre. If the aim is a stable exchange rate, monetary policy cannot be independent, since the interest rate must be aligned with the international benchmark interest rate, normally the dollar; if the expectations of depreciation become widespread, reserves will decline. Alternatively, if the preferred economic policy is to pursue an independent monetary policy, the exchange rate will have to be the adjustment variable. In short, only two of the objectives can be achieved at the same time, never three.

China has been facing a situation similar to the trilemma since 2015 and, accordingly, there are several alternatives on the monetary and exchange rate policy front. If China were to opt to advance towards a free-float exchange rate in line with the IMF's recommendations in recent years, by performing exchange rate interventions with the sole aim of mitigating excessive volatility as a first step towards the full liberalisation of the capital account,[12] in exchange it would be able to pursue an independent monetary policy. However, in the current situation, this option entails the significant risk of intense capital outflows arising in the short term, similar to that which occurred in late 2015, fuelling exchange rate depreciation. A strong depreciation of the renminbi would pose problems on different fronts. Globally, given China's high weight in world trade, it would increase the risk of deflation being exported to the rest of the world; additionally, other countries could interpret this as the beginning of a "currency war". Domestically, financial stability problems could arise in certain sectors, as in recent years many Chinese companies have taken on debt in dollars, encouraged by the low interest rates and the expectations of exchange rate appreciation.[13] In these circumstances, depreciation of the renminbi would reduce the capacity of these companies to service their debts in foreign currency, in an environment where the corporate sector's total indebtedness is very high.

In order to assess the intensity and persistence of the pressures on the renminbi exchange rate, it is important to know whether the renminbi is under- or overvalued in fundamental terms. Although China has a substantial current account surplus (above 2% of GDP), several indicators suggest that there has been a reversal of the historic undervaluation of the renminbi in recent years.[14] Since 2005, the renminbi exchange rate has appreciated by 60% in real effective terms (see Chart 2). The currency's recent depreciation has only partially offset the appreciation since 2014 (20% in real effective terms).

Another way of solving the trilemma would be to reverse some of the external financial liberalisation measures adopted in recent years. This would enable China to recover some room for manoeuvre in its monetary and exchange rate policy in the short term. Selective capital controls or "capital flow management measures" could be implemented

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12 See International Monetary Fund (2015) and Prasad *et al.* (2005).

13 At the aggregate level, these financial stability considerations can be confined, as China holds international reserves four times the size of its external debt and part of the reduction in dollar indebtedness of these companies already took place in 2015, as analysed in Box 1.

14 See International Monetary Fund (2015).

to eliminate the most speculative component of capital outflows. Indeed, some of the measures adopted recently – restrictions on the accumulation of short positions in Hong Kong's offshore market in early 2016, the imposition of reserve ratios on offshore renminbi deposits held by Chinese residents, certain restrictions on card payments abroad, and limits on insurance policies arranged in Hong Kong by Chinese residents[15] – can be interpreted in this sense.

However, it is unlikely that China will turn its back on the essential aspects of external financial liberalisation, due to the high cost this would have at both the international and domestic level. Internationally, it would compromise the status of the renminbi as a reserve currency;[16] according to the review conducted by the IMF in late 2015 for its inclusion in the SDR basket, the renminbi qualified as a "freely usable currency". Domestically, a reversal of liberalisation would run counter to rebalancing the growth model sought by the authorities. Indeed, financial repression and maintaining a low return on savings are among the factors that have contributed most to an inefficient allocation of resources in China, with excessively high investment rates in low profitability sectors. External financial openness enhances potential external diversification, reducing the risk of the formation of bubbles in China.[17]

Finally, a third possibility in respect of the trilemma is that the Chinese authorities could continue to opt for a framework of exchange rate stability to encourage development and macroeconomic stability. In this case, if the process of liberalising the capital account is not reversed and capital outflows continue, the trilemma would be solved by means of foreign exchange intervention (selling reserves to support the exchange rate) and, ultimately, by raising interest rates, which seems unlikely in the current situation. The Asian crisis of 1997 showed that this kind of strategy does not work in situations of cyclical weakness and it is unlikely that China will adopt it. Although China's starting position is sound, as it has abundant international reserves, a current account surplus and low inflation, in the medium term the risk of accumulating imbalances with a fixed exchange rate would only postpone the adjustment.

The three alternatives considered offer a reference framework for assessing the trade-offs that the Chinese authorities face. Nevertheless, during the transition towards a more open capital account and greater exchange rate flexibility, the Chinese authorities, in view of the potential risks that each alternative entails, seem to have opted for intermediate solutions: increasing exchange rate flexibility gradually, but without permitting a sharp depreciation of the exchange rate; intervening in the foreign exchange market while trying not to impair reserves excessively, and advancing towards a controlled openness of the capital account. In early 2016 the Chinese authorities again used credit expansion again,[18] together with a more expansive monetary policy, to support short-term growth and thus stabilise the exchange rate, which could adversely affect the rebalancing of the economy.

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15 And possible "moral suasion" measures, such as enquiries to banks on the possible fractioning of dollar purchases by customers to sidestep individual capital controls.

16 The criteria used to include a currency in the SDR basket are, broadly, that the country be a major exporter of goods and services (gateway criterion), and that its currency be freely usable. The latter concept – coined by the IMF in 1977 and applied for the first time in 2000 – is ambiguous and susceptible to differing interpretations by the Board. A currency is freely usable when: 1) it is widely used to make payments in international trade and financial transactions; and 2) it is widely traded in the major currency markets. Free use, however, does not imply full convertibility or having a floating exchange rate regime.

17 See Prasad (2016) and Prasad (2009) for a detailed review of the reasons why financial liberalisation should be a priority for China.

18 See García Herrero (2015).

Against this background, uncertainties regarding the priority assigned to the various objectives and their timing might lead to bouts of greater volatility on the financial markets, which assign changing probabilities to the risks of depreciation, imposition of capital controls and errors in policy design, or a combination of all of these. Also, the international environment may be a key determinant for the Chinese strategy: a speedy normalisation of monetary conditions in the United States – which does not currently appear to be the most likely scenario – or a substantial appreciation of the dollar would strain the situation in China even more, as could more intense quantitative easing in the euro area or in Japan, which would trigger the depreciation of their currencies. Conversely, the stabilisation of growth in China or a decrease in capital outflows could lead to conditions better suited to advancing towards greater exchange rate flexibility and greater monetary policy independence.

Conclusions

China's financial liberalisation has advanced very significantly in recent years, both internally and externally. Internally, interest rates on loans and deposits have finally been fully liberalised and a bank deposit guarantee fund has been set up, both being crucial to reducing the aggregate savings rate and enabling the financial sector to more efficiently allocate credit among different investment opportunities. Externally, the Shanghai and Hong Kong stock market connection was established, which has significantly broadened investment limits for investors not resident in China, and some of the more significant capital controls on capital inflows, particularly regarding the access of institutional investors to Chinese foreign exchange and renminbi bond markets, have been removed. Although there are still numerous de jure restrictions on capital outflows, capital controls are becoming increasingly porous. Against this background, there have been several bouts of turbulence in the financial markets, which have recently prompted the authorities to tighten some of these controls. Additionally, the exchange rate regime has been made more flexible by shifting from a de facto managed float against the dollar to a float that also takes into account a basket of currencies.

The liberalisation process is taking place in a complex international and domestic environment. On the one hand, the deceleration of the Chinese economy and the expectations of depreciation of the renminbi associated therewith have caused unprecedented capital outflows, complicating the transition towards greater exchange rate flexibility that would have been easier to manage in a context of currency appreciation. On the other, it is precisely now, at the beginning of a cycle of rising interest rates in the United States, that China needs to retain greater headroom for monetary policy in order to adapt it to its domestic conditions and dissociate its currency from a potential appreciation of the dollar. Finally, the overriding objective is to obtain international financial recognition more in line with China's actual weight in global trade and in the global economy. China has pursued this objective through a liberalisation of the financial account that has been faster than was expected a few years ago, enabling the renminbi to become part of the IMF's SDR in 2016, thus achieving initial acceptance as a reserve currency. Financial liberalisation will help to rebalance China's economy and to bring about sustainable growth in the medium term, helping to maintain its contribution to world growth. However, any liberalisation process entails risks and, accordingly, new bouts of instability, like those of 2015, cannot be ruled out.

17/5/2016.

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Trade criterion

In terms of five-year averages (2010-2014), China is the world's third largest exporter of goods and services (with a weight of 10.5% in global exports) after the euro area (18.3%) and the United States (13.6%), and well ahead of the other two countries included in the SDR basket (Japan and the United Kingdom, with weights of 5% and 4.8%, respectively).

Freely usable currency criterion

Widely used:

— Weight in official reserves: since the RMB is not one of the seven currencies identified in the COFER, the IMF proposes observing the holdings in Official Foreign Currency Assets, which would make the RMB the seventh most widely used currency, with a weight of 1.1% in the total, behind the four SDR currencies and the Australian and Canadian dollars.

— Weight in international banking liabilities: estimates point to 1.8% in 2015 Q2, positioning the RMB as the fifth most widely used currency after the SDR currencies and slightly ahead of the Swiss franc.

— Weight in the stock of international fixed-income instruments: the RMB has moved from a virtually non-existent weight in 2010, when it ranked 21st, to 0.4% in 2015 Q2, ranking ninth among the most widely used currencies, behind the four SDR currencies, the Swiss franc, the Australian dollar, the Canadian dollar and the Swedish krona. However, in terms of issuance of international debt securities, the RMB would be the sixth most widely used currency, with a weight of 1% (as compared with 22nd position in 2010).

— International payments through SWIFT: the RMB has become the eighth most widely used currency in international payments through the SWIFT payment system, after the four SDR currencies, the Swiss franc, the Canadian dollar and the Australian dollar. The RMB is the third most widely used currency for documentary credit transactions, with a modest weight of 2%, after the euro (7.1%) and the US dollar (86%).

Widely traded:

— Trading volume in foreign exchange markets: the weight of the RMB grew from 0.4% in 2010 (ranking 17th) to 1.1% at end-2013 (ranking 9th) and is expected to be much higher in 2015. RMB trading volumes are very high in Asia, low (although increasing) in Europe and still very low in North America.

1 Prepared by Xavier Serra and Irina Balteanu. Based on the new weighting formula, the weight of the renminbi in the SDR will be the third largest (10.92%) after the US dollar (41.73%) and the euro (30.93%) and ahead of the Japanese yen (8.33%) and pound sterling (8.09%), effective 1 October 2016.

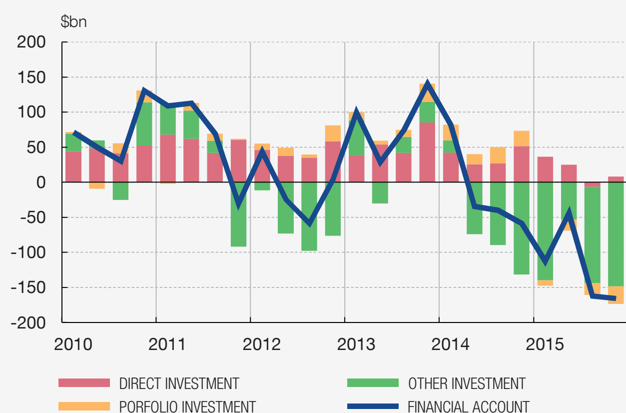
Capital outflows from China have been a major cause for concern over the past year. Outflows began in mid-2014 when there were generalised expectations of renminbi depreciation due to the uncertainty over the scale of China's economic slowdown. In 2015 H2 these two events intensified against the background of the stock market crisis and the uncertainty caused by the two changes to the renminbi exchange rate regime in August and December. To analyse these movements, this box draws on the financial account of the balance of payments, available up to 2015 Q4.

The data for 2015 H2 show that China's financial account became strongly negative (more than $300 billion; see Chart 1). Capital outflows were concentrated in the "Other Investment" item associated with changes in bank loans and deposits and trade credit. However, analysis of the breakdown of the financial account, and of net and gross flows, provides a more qualified valuation.

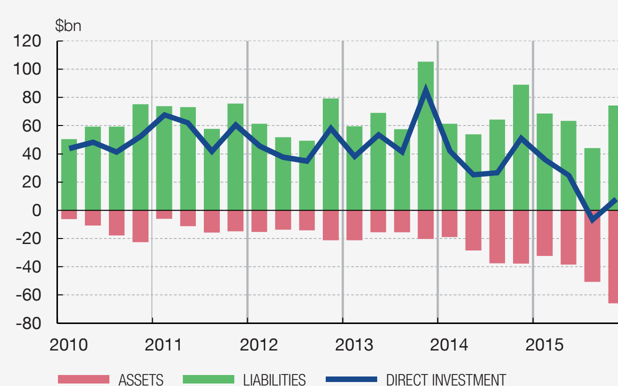
Firstly, the net balance of foreign direct investment in China has eased substantially in recent years. With respect to gross flows, this moderation is due to a greater extent to an increase in China's investment abroad, since higher inflows of FDI into China continue to be observed. The substantial increase in China's direct investment abroad reflects an increasing participation of Chinese investors in the global economy, including the Government's development projects abroad, such as the New Silk Road project. This positive trend is also reflected under "other investment", where assets include bank loans used to finance a fair amount of China's diversification outside its borders.

Chart 1
FINANCIAL ACCOUNT AND DIRECT INVESTMENT

1 FINANCIAL ACCOUNT



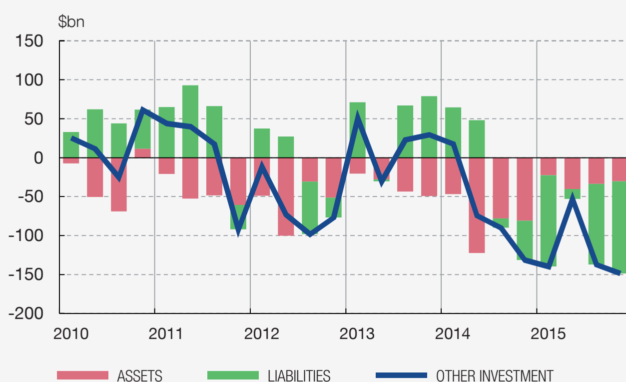
2 DIRECT INVESTMENT



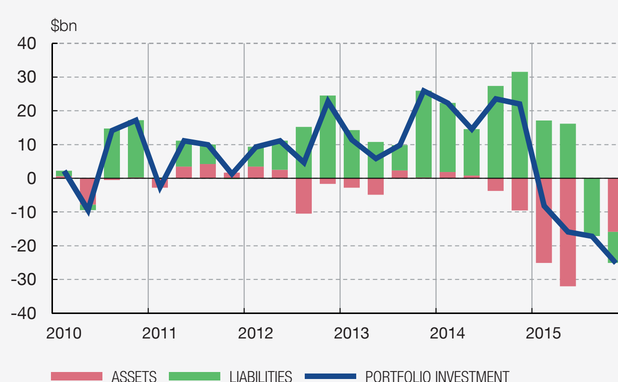
SOURCE: CEIC database.

Chart 2
OTHER INVESTMENT AND PORTFOLIO INVESTMENT

1 OTHER INVESTMENT



2 PORTFOLIO INVESTMENT



SOURCE: CEIC database.

Secondly, strong movements are identified under "other investment", possibly linked to the expectations of renminbi depreciation, which give rise to sizable material net outflows from China. These movements affect both assets and liabilities. On the one hand, resident investors have changed their preferences from holding assets in renminbi and debt in foreign currencies in order to benefit from the appreciation of the Chinese currency until mid-2014 to the opposite position, especially in 2015 H2. The prospect of depreciation explains repayment of debt in dollars and a decline in trade credit, and the increase in foreign currency assets, which has caused resident investors to convert into dollars (mainly US and Hong Kong dollars) a large share of their renminbi deposits held in Hong Kong. On the other, non-resident investors have also reduced their renminbi deposits in China and Hong Kong (see Chart 2).

The stock market crisis also had a significant impact in terms of non-residents' portfolio outflows, although its effect on the financial account is relatively limited, since portfolio investment is much lower than "other investment".

In light of these data, it appears that in 2015 H2 capital outflows were driven primarily by the unwinding of positions held owing to expectations of appreciation of the renminbi, while investment abroad, associated with China's growing role in the global economy, continued to increase. In addition, there is scant evidence of a flight of foreign investment or of capital outflows from households and firms, which would have been reflected in a fall in direct investment in China and in a decrease in bank deposits in the national financial system.