REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, ON "THE RENMINBI AS A GLOBAL RESERVE CURRENCY: A CENTRAL BANK'S PERSPECTIVE", AT THE CENTRAL BANKING PUBLICATIONS' 6TH RENMINBI ROUNDTABLE. Mexico City, May 10, 2017.[1]

I am very glad to have the opportunity to participate in this event. My gratitude to the organizers for their kind invitation.

In recent years, central banks around the world have displayed a growing interest to include assets denominated in currencies from emerging market economies (EMEs) as part of their international reserves. In addition to the continuous search by reserve managers of an adequate balance between risks and returns on their portfolios, this has also been influenced by the improved economic fundamentals and the resilience shown by several of these economies to the difficulties arising from a complicated and, at times, turbulent global environment.

The case of the Chinese renminbi is of particular note. Indeed, its rapid internationalization of recent may well be regarded as a natural development following China's increased significance within the global economic and financial systems. However, there are clearly other explanatory factors. Particularly important among these are the measures implemented by that country's authorities towards this outcome.

[1] The opinions and views expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Board of Governors as a whole.

Although a currency's degree of acceptance beyond its issuer's borders varies across a wide array of dimensions, there are a number of attributes it must possess to achieve a significant international role and, ultimately, global reserve status. At one level, a currency's qualification as an efficient unit of account and medium of exchange allows it to be amply used for the pricing and settlement of cross-border transactions, both commercial and financial. In addition, and perhaps more relevant for its role as a reserve asset, a global currency must be widely regarded as a reliable store of value, meaning that foreign investors, including official reserve managers, are willing to hold assets denominated in that currency.

Of course, the fulfillment of these conditions entails a rather lengthy process and achievement of this goal, as well as the speed at which it takes place, is closely linked to both prevailing and expected conditions in the issuer country. Paramount among these is the strength of the economy's fundamentals, and especially domestic macroeconomic and financial stability. Further to this, the issuer country's economic size and centrality in regional or global production and trade networks is an important driver of demand for its currency at the international level, while capital account openness and the consequent currency's convertibility, as well as the depth of domestic financial markets, provide further assurance to global investors.

Considerable progress has been made in several relevant fronts towards the internationalization of China's renminbi over the last years. Its growing use as a medium of exchange and unit of account is evident. The renminbi's participation in global payments has increased from virtually nil in 2010 to slightly less than 2 percent in early 2017, and a similar pattern is observed in the share of China's total international trade that is settled in its own currency.[2] Also, the most recent BIS triennial survey on foreign exchange turnover,[3] shows that the renminbi was last year the world's eighth most actively traded currency and the first among emerging market economies, after having nearly doubled its share in all foreign exchange transactions over the course of three years.[4]

Significant progress has also been achieved in enhancing the renminbi's use as a store of value by central banks and monetary authorities. The latest release of the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) survey includes specific data for this currency for the first time since records exist. According to this information, albeit low at levels slightly over 1 percent as of the end of 2016, the renminbi's share in the world's total allocated international reserves is not far from other, more established reserve currencies such as the Australian and Canadian dollars (1.9 and 2 percent, respectively), and far above that of the Swiss franc (0.2 percent).[5]

As noted above, these developments respond to a significant extent to China's increased importance in the global economy. In 2014, China overtook the

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[2] Hongbin, Q. et al. (2017): "The Rise of the Redback VI", HSBC Global Research, April.

[3] Bank for International Settlements (2016): "Triennial Central Bank Survey: Foreign Exchange Turnover in April 2016", September.

[4] It should be noted, however, that this development came atop a relatively low base, as the renminbi's participation in all foreign exchange transactions increased from 2.2% in 2013 to 4% in 2016 (note that the sum of shares across currencies adds to 200%, since two are involved in each trade).

[5] International Monetary Fund (2017): Currency Composition of Official Foreign Exchange Reserves (COFER), as of the fourth quarter of 2016, March.

United States as the world's largest economy, as measured by GDP on a purchasing power parity-adjusted basis, representing around one sixth of global output. Since then, the differential between these two economies has continued to widen and, according to the latest projections by the IMF,[6] China's participation in the global economy is expected to increase to over one fifth of total output by 2022, nearly a tenfold increase since 1980. China's participation in global merchandise trade has followed a similar, even more dramatic, pattern, as its share of global imports and exports has climbed from around 1 percent in the early 1980s to over 11 percent currently.

However, there are other factors, beyond China's significance in the global economy, that explain the rise of the renminbi as an international currency. In particular, the Chinese authorities have been implementing a number of measures specifically aimed at this goal.

To promote the use of the renminbi as an investment currency, a first set of efforts included the creation and development of *offshore* markets in which foreign institutional investors were allowed, although on a selective basis and subject to limits, to perform banking operations as well as to trade and even issue financial securities denominated in renminbi. More recently, the removal of important roadblocks to renminbi internationalization has been observed, as a gradual relaxation of restrictions on foreign access to *onshore* markets has begun to take place. In this respect, it is worth to highlight, due to its particular relevance for central banks, measures allowing them to have largely

[6] International Monetary Fund (2017): World Economic Outlook Database, April.

unimpeded access to the domestic fixed-income and foreign exchange markets, further aided by enhanced data transparency and a greater role of market mechanisms in the determination of interest and exchange rates. Recent measures connecting the Stock Exchange of Hong Kong with its counterparts in the mainland, thereby facilitating foreign access to onshore equity markets, are also worth mentioning.

After the accession by China to the World Trade Organization in 2001, strategic trade agreements with other emerging markets, particularly in Asia, have been enacted. In addition, a number of mechanisms facilitating the flows of outward direct investment and either direct or indirect lending from China have encouraged the wider use of the renminbi for the measurement and settlement of cross-border flows and, through this channel, as a reserve currency.[7] The latter includes the so-called "Belt and Road Initiative", the China Development Bank, the Export-Import Bank of China, and recently created multilateral organizations such as the New Development Bank and the Asian Infrastructure Investment Bank, in combination with the growing global network of foreign exchange swap lines between the People's Bank of China and central banks abroad.

Notwithstanding the remarkable advances of recent years, progress towards a deeper and more extended internationalization of the renminbi remains

[7] Once a currency's international use for transactional purposes has been established, incentives for trading partners to stabilize exchange rates against it lead them to accumulate reserves denominated in that currency, as well as to seek contingent liquidity provision from the part of its issuer, thus resulting in its use also as a means to store value.

limited and with important geographical differences in both outcomes and perspectives.[8]

On the one hand, China's greater significance and influence in Asia compared to that at the global scale, certainly add to the renminbi's other advantages in explaining the important role of this currency at the regional level. The latter is explained partly by the numerous official measures and initiatives purposely aiming at greater economic interaction between China and other Asian countries. However, trade is undoubtedly the main force driving the wider cross-border use of the renminbi in the region. Indeed, recent trade figures show that around one half of Chinese imports originate in Asia, a development that is in turn reflected in the renminbi's dominant role as reference for the determination of the value of other currencies in the region, above and beyond those of the dollar or the euro,[9] while also featuring prominently as the currency of choice for payments with China. Going forward, the current prospects of continued growth of the Chinese economy, albeit at lower rates than in the past, in conjunction with likely deeper and more extensive linkages between China and other economies in the region, as well as anticipated reforms in the former allowing a freer use of its currency externally, support the expectation of a further strengthening of these trends over the next several years. The importance of trade in enhancing the international role of the renminbi is also illustrated by the fact that this currency has become the

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[8] See Eichengreen, B. and D. Lombardi (2017): "RMBI or RMBR? Is the Renminbi Destined to Become a Global or Regional Currency?", Asian Economic Papers 16:1.

[9] See Subramanian, A. and M. Kessler (2013): "The Renminbi Bloc Is Here: Asia Down, Rest of the World to Go?", Peterson Institute for International Economics Working Paper No. 12-19, August.

dominant reference in other emerging market economies outside Asia with strong trade ties with China.

On the other hand, it is undeniable that the renminbi's role as a major reserve currency at the global level is still relatively modest. This is clearly illustrated by the fact that China's global economic significance, as measured for instance by its 18 and 11 percent shares in total (PPP-adjusted) output and merchandise trade, respectively, is still far from being matched by the renminbi's 1 percent participation in global international reserves.

To some extent, this may be explained by the significant network-increasing returns (that is, the increased likelihood of a currency being used as either a means of payment, unit of account or store of value deriving from its use for such purposes by other parties) backing the persistence of the US dollar as the main global currency and reserve asset. However, it must be kept in mind that given China's trade and financial linkages worldwide, network effects could in fact rapidly move in favor of underpinning a much wider use of the renminbi globally.

Therefore, the main challenge the Chinese authorities face in allowing the renminbi to achieve a more relevant global currency status, seems to be related to the implementation of additional efforts in a number of areas. In my view, action is particularly important in connection with the following:

1. The further liberalization of the capital account. I fully agree that the best approach here is one emphasizing gradualism and prudence, as a movement in this direction must be accompanied by reforms in a number of other, key areas, to avoid adverse implications for macroeconomic and financial stability. Given China's economic size, this is important not only from a national but from a worldwide perspective. My impression here is that the room of maneuver for the Chinese authorities is not very wide. While a more ambitious pace for the internationalization of the renminbi requires a speedier and more comprehensive liberalization of the capital account, to be successful the latter in turn needs a stronger financial system, as well as further efforts to upgrade governance of the corporate sector and to allow more flexibility of the exchange rate. Furthermore, capital account liberalization efforts have been affected by some actions implemented recently to tackle pressures on the renminbi, particularly those derived from tighter capital flow regulations and enforcement, such as restrictions on the purchase of foreign currency by individuals and more strict limits on outbound foreign direct investment flows.

2. The domestic authorities have taken important steps towards the liberalization of the onshore renminbi's exchange rate over the last few years. However, the overall framework still falls short of a fully supply and demand-driven renminbi market, and failing to effectively fill this void may continue to raise concerns about the possibility of government control over the currency's valuation, particularly vis-à-vis the US dollar, for either stabilization or stimulative purposes. It is also important to consider that the transition to a more market-oriented foreign exchange regime may be difficult and subject to

wide swings. Indeed, the challenges deriving from a complex external environment are accentuated by domestic developments as the Chinese authorities attempt to simultaneously achieve multiple relevant tasks, including a diminished role of the state in the allocation of resources in the economy, a shift in the growth strategy towards consumption and services and away from investment and manufacturing, as well as the tackling of a number of outstanding vulnerabilities. Against such a backdrop, global investors may remain wary of trades in the renminbi.

3. While significantly developed over the last years, the domestic financial markets still need further depth, transparency, and sophistication, while the insufficient degree of connectivity with the global financial system continues to be reflected in low levels of foreign participation. This is observed across virtually all relevant markets. China's stock exchanges figure among the world's largest in terms of market capitalization, but foreign ownership at only slightly above 1 percent pales in comparison to those in other emerging markets such as Brazil (30 percent) and Russia (23 percent). Likewise, China's bond market, the world's third largest, as attractive as it may be in terms of returns and risk, is dominated by domestic participants, as foreign participation remains low at around 2 percent.[10] Of course, this is explained to a large extent by outstanding restrictions to foreign participation in domestic financial markets but, in light of their current features, it is reasonable to assume that demand factors may also be present.

[10] See Zhang, Z. et al. (2017): "China's Bond Market: Deeper, Broader, More Complex", HSBC Global Research, March.

4. As in other areas, important efforts towards greater transparency have been made by the Chinese authorities recently. In this respect, it is worth to note the progress made in monetary, financial and external statistics, as well as the decision to subscribe to the IMF's Special Data Dissemination Standard and Coordinated Portfolio Investment Survey, and to report for the first time the currency composition of a representative portion of China's reserves and international banking liabilities.[11] However, important data gaps remain. According to the IMF, the latter are inconsistent with China's systemic importance, with the most pressing issues relating to national accounts, government finance statistics and bank/shadow bank linkages and foreign exchange exposures.[12] Indeed, enhanced transparency of official statistics would help alleviate potential concerns about the state and prospects of the economy and domestic financial markets, and underpin the renminbi's international role.

5. Although it is true that official reserve managers enjoy special benefits and facilities to trade in renminbi in Chinese domestic financial markets in comparison to their private counterparts, significant operational challenges remain. Among these, a complex legal framework, rigid and frequently non-negotiable rules mandated by the authorities, the potential for misunderstandings arising from language issues, weak channels of communication to overcome these difficulties, and frequent regulatory changes, are limiting factors. The latter may force official investors to rely on

[11] See International Monetary Fund (2015): "Review of the Method of Valuation of the SDR", IMF Policy Paper, November.

[12] See International Monetary Fund (2016): "Article IV Consultation with the People's Republic of China", August.

either private or official intermediaries to participate in onshore trading activities, thus increasing the overall costs associated to holding renminbi-denominated assets. But even some of these institutions find the corresponding procedures challenging, and frequently use disclaimers when providing advice on the interpretation of regulations, leaving responsibility for compliance to the corresponding central bank.

To conclude, I only want to stress that the renminbi's footing in the international monetary system should continue strengthening as a consequence of China's growing economic importance at the global scale, along a path leading to its further use as a reserve currency to levels significantly beyond those observed at present. However, there are a couple of considerations that need to be kept in mind in order to be able to make a realistic assessment in this regard. First, it should be noted that such a process is inherently slow and lengthy, not necessarily linear and subject to important, and perhaps frequent, setbacks. Thus, whatever perspectives there may be, they should be viewed from a long-term standpoint and paying particular attention to the overall trend as separated from specific, often one-off, developments. Second, and closely tied to the previous point, the speed at which this process proceeds will be determined by the commitment and capacity of the authorities to implement the measures required to consolidate the renminbi's role as an international currency commensurate with China's importance in the world economy.