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CHINA'S MONETARY POLICY WITHIN THE CONTEXT OF YUAN INTERNATIONALIZATION

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Abstract

Introduction. *The Renminbi reserve currency gaining process is of vital importance for China's robust economic development. However, the inconsistency in the intentions of the Chinese government regarding both Yuan internationalization and strict control over capital flows, which is contradictory to the former, requires more detailed analysis, since the soaring Chinese economy is about to play the central role in the world economic environment.*

Aim of the article *is to determine the current state of the Yuan internationalization process as the key component of the Chinese current monetary policy and its effects on the China' economic development considering the policy of the strict control of capital flows.*

The method (methodology). *By means of the qualitative methods such as observations and surveys, the motivations and reasons of China's intentions to carry out the Yuan internationalization are found out and analyzed. The quantitative methods have transformed collected statistical and numerical data regarding Renminbi exchange rate fluctuations into comprehensive statistics represented by figures. By applying the logic analysis, the method of absolute and relative values and the system analysis, the current state of Yuan internationalization process in particular and Chinese monetary policy at large is characterized and the effects of reserve currency status gaining on China's long-term economic development strategy are outlined.*

The results of research. *This paper is designated to address the question of China's monetary policy of the last decade, as well as the Yuan internationalization process as a key goal of the modern long-term strategy of China's economic development. The fundamental principles, objectives and possible effects of monetary policy are outlined. The fact of China implementing hybrid policy in regard to the renminbi reserve status gaining is presented. The cause of Yuan exchange rate abrupt drop in the August of 2015 is depicted and analyzed. The improvement to the current growth model of Chinese economy is presented and well-grounded in the paper.*

Keywords: *monetary policy; internationalization; reserve currency gaining; economic development; economic growth; infrastructure spending.*

JEL classification: F300, F400

Introduction

Monetary policy is a way of maintaining price stability, which a healthy economy have. The actions of a central bank or any other regulatory institutions formulate monetary policy determined to regulate the rate of growth and size of money supply, which have effects on interest rates. Inherently, the layouts of monetary policy are solely elaborated and imposed by a regulatory institution, which is a central bank. By affecting money supply and interest rates, monetary policy being “the demand side economic policy” is designated to accomplish positive macroeconomic effects through “harnessing” inflation, as well as reaching objectives such as liquidity, consumption and growth [1]. Additionally, the positive macroeconomic effects may also contain balanced economic growth and full employment. The former requires achieving liquidity, which gives a spur to an economy to grow, whereas the latter is a consistent result of the former. Overall, a central bank establishes a monopoly over money supply, or monetary base. At this point, a central bank is in charge of creating conditions under which commercial banks obtain loans from it.

The regulatory decisions of a central bank in regard to manipulating interest rates and money supply affect developments in prices and output [1]. The process mediating monetary policy impact and relative effects on an economy is transmission mechanism [1]. This mechanism is highly complex for its multidimensional characteristics such as uncertain, variable and long time lags. In other words, it is tremendously hard to accurately predict monetary policy actions on a price level and on an economy as a whole. Manipulation with official interest rates affects money market and bank interest rate, expectation of future changes in interest rates, investment and saving decisions, asset prices, the supply of bank loans, aggregate demand and prices and the supply of credit [1].

Of particular interest to research is the monetary policy of China of the last decade. The matter of the Yuan internationalization process as an inalienable component of China’s monetary policy and its effects on the Chinese economy at large fall within the interests of the economists such as Krugman, Koziuk, Huang, Ashkenas, Richburn and others [2; 3; 4; 7; 8; 9]. The peculiarities of China’s approach to its economy and currency define greater scale and severity of shocks caused by the fluctuations of certain intensity, the effects of which would otherwise mean nothing should they emerge in any other countries [2; 4; 8]. Considering the fact of China being one of the most outstanding developing economies and its pursue to gain the reserve currency status for renminbi, the global monetary environment is indisputably depended of the goals of China’s monetary policy [7]. The scientists aforementioned are of strong opinion that China’s intentions directed at Renminbi reserve currency gaining are inconsistent with the policy of strict control of capital flows [2; 3; 4; 7; 8; 9]. On these grounds, the fact that China may play a central role in the global financial system in the nearest future brings up the necessity of addressing the question of the peculiarities of China’s monetary policy, especially the matter of Yuan internationalization, and their effects on the global monetary strategy.

Purpose

The analysis of the peculiarities of Yuan internationalization process as an inherent and important component of the Chinese monetary policy is the prime purpose of this study. Particularly, the research aims at defining effects the Renminbi recent exchange rate fluctuations may have on the Yuan internationalization process, as well as on China’s economic development as a whole.

Results

China’s economy is on the verge of drastic changes. The preconditions of these shifts contain slowing economic growth and decrease in labor excess [2]. On this ground, China is supposed to shift from mass investing to domestic consumption, for the current agenda in regard to China’s economy is characterized as a slew of gross domestic product invested, but an extremely low share of GDP consumed [2]. For achieving this goal, China supported its economy by mass infrastructure spending, which was mostly sustained by providing state-run enterprises with cheap credit. It is a well-established fact that infrastructure spending is a remedy for economic disasters and it does work. For instance, China launched \$586 billion spending program to avoid recession descending from 2008 financial global crisis [3]. Unlike the U.S. bailout program designated to rescue the U.S. economy through aids to states and tax cuts, China’s one focused on spending on infrastructure extension [3]. A number of construction projects floated China, spreading building boom to deprived and dimly developed areas. By virtue of such stimulus, the 18-month building rush was proven be a frenzy of brand-new subways, downtown centers, airports, highways, high-speed rail lines, which literally sprang up in the middle of nowhere [3]. The loans issued for financing China’s building adventure came from the China’s state-run banks to government entities, namely state-owned enterprises [2; 3]. As a consequence of cheap loaning, these enterprises ran up huge debts, which drove financial concerns last year [3]. To mitigate debt pressure, China’s government embarked on creating market opportunities for these enterprises to repay their debts. There are no doubts that enterprises being at the risk of debt repayment inability, or insolvency, face plummeting capitalization, hence the prices of their shares have downward trend. To prevent more intensive shrinkage in the capitalization of those state-run enterprises, China’s government promoted stock-buying propaganda by

lessening margin requirements, giving a spur to investors to purchase stocks with borrowed capital. Under such encouraging market conditions, enterprises were able to sell a slew of shares to accumulate enough high-liquid capital in order to make debt repayments. As the case stood, the consequence of such intervention was a growing bubble, which began to unleash its wrath at the beginning of this year [3].

The hovering menace to the economy was challenged by the Chinese authorities through applying a set of strict measures including a short-selling ban, the suspension of trading in a host of stocks and the stimulation of prevailing investors to purchase stocks. Moreover, Chinese economic students were involved in public demonstrations to encourage market players to invest more [3]. A positive effect was achieved and stock prices fall was frozen, but such market stabilization was for the time being and more efficient policies and measures were required. In pursue of the betterment of financial stability, China make a decision to adopt the currency devaluation policy, which was proven to be sensible under the current economic agenda. The upshot is that while renminbi was unquestionably undervalued roughly five years ago, it is clearly overvalued to the date [3]. Needless to say that the policy of pegging a currency exchange rate under the conditions of a current account surplus leads to inflationary pressure. Additionally, under fixed exchange rate regime a host of capital inflows a country and the necessity of revaluing China's currency emerged.

On these grounds, renminbi being fixed at 8.28 per 1 USD between the period of Asian crisis and 2005 couldn't keep in line in the face of China running big external surplus. Under the pressure of its foreign partners, especially the USA, Chinese government did conduct 2.1.-percent devaluation in July 2005 under duress, creating opportunities for the currency to slide at a slow rate and controlled manner. In the period of 2005 and 2008, the total devaluation hits the point of 13%, while the U.S. Congress demanded at least 20%. At the peak of 2008 Global financial crisis, China restored its early suspended fixed exchange rate regime by pegging renminbi exchange rate at 6.83 per U.S. dollar [4, p. 651]. The severe response of foreign entities did not make Chinese government have a long wait for the renewal of pressure and China at the beginning of the summer of 2010 applied the "managed float" exchange rate regime [4, p. 652]. However, the policy aforementioned had relatively weak effects on the appreciation pace compared to those expected. The reason of China's government being so reluctant to promote policies demanded by foreign partners was fears to lose both its export competitiveness and domestic income redistribution as a consequence of revaluation. On the other hand, an inflationary pressure hovered over the entire economy, threatening with the likelihood of unemployment intensification and economic slowdown at large. To avoid such undesirable trends, China raised interest rates, which gradually gulped springing inflation down and simultaneously gave an incentive to a rise in absorption [4, p. 652]. Figure 1 demonstrates the dynamics of Yuan/U.S. Dollar exchange rate in historical perspective, starting with the moment of fixed exchange rate regime adaptation and up to early 2010, when interest rate was raised, as well as ameliorative effects on the inflationary pressure. As seen on the figure below, in 2009 inflation ended up in deflation, for China's government launched the two-year \$586 billion program in pursue of retaining 2008 financial crisis effects [3]. The government's efforts resulted in a sharp reduction in unemployment, the continuation of Yuan stable appreciation and keeping China's economic growth. A slew of spending on infrastructure and Yuan appreciation trend both had reductive effects on total prices and promoted people's wealth and prosperity.

By virtue of the policies aforementioned, a fracture of county's total expenditures shifted to import, hence lowered external surplus, prevented a rise in unemployment and balanced China's economy in general.

The fact is that China pulled out all the stops to adjust renminbi exchange rate to the market conditions of 2005-2010 period and it de facto achieved targeted goals. However, the current economic and financial agenda of overvalued renminbi has coerced China's authorities to apply "cheap money" policy, letting its currency value slide down. There were the two key goals China sought to accomplish by devaluing renminbi: first, for its employment rate and economic growth pace to keep at high level; second, for its currency to reach the global dimensions by becoming pre-eminent currency in pursue of accomplishing centrality to the global economy and reinforce diplomatic influence in the world [6]. China's endeavor to promote renminbi to the status of a reserve currency reflects downward trend of developed countries' shares in the world GDP and trade. Developing countries, including China, cause changes regarding global assets allocation, which must inherently be followed by changes in the currency composition of central banks reserves [7, p. 60]. At this point, the shifts in the reserve currency system give birth to a number of issues to be considered with respect to the new way of global monetary reforms [7, p. 60].

The two key goals described aforementioned are proven to be frequently contradictory. High employment rate and permanent economic growth are definitely pursued in order to achieve pervasive stability in the macro level. However, promoting one's currency to globally pre-eminent status is not a unilateral advantage any more, for the country of emission faces a risk of financial volatility on account of fluctuating capital flows and lowered interest rates [7, p. 60]. Taking into account the fact that China is at the stage of the real convergence process, its current state of financial development falls behind with that of a must have, which would let the Chinese economy absorb massive capital inflows. The upshot is that China's economy is thought to have had some issues concerning its internal assets market. Judging by the way the Yuan internationalization process is going on, the

fact is obvious that China's internal asset market seems to be structurally feeble and show the signs of overheat [7, p. 60]. Thus, China promotes the policy of reserve currency status gaining for Yuan in a hybrid manner, which means China's efforts to coerce the global economy to accept renminbi circulation, but totally isolate liquid assets market from outsiders [7, p. 59]. Such a hybrid policy undoubtedly leads to diminishing of the liquidity of global exchange reserves as a consequence of increase in a hybrid reserve currency fraction, inducing the emergence of global monetary instability risks [7, p. 59].

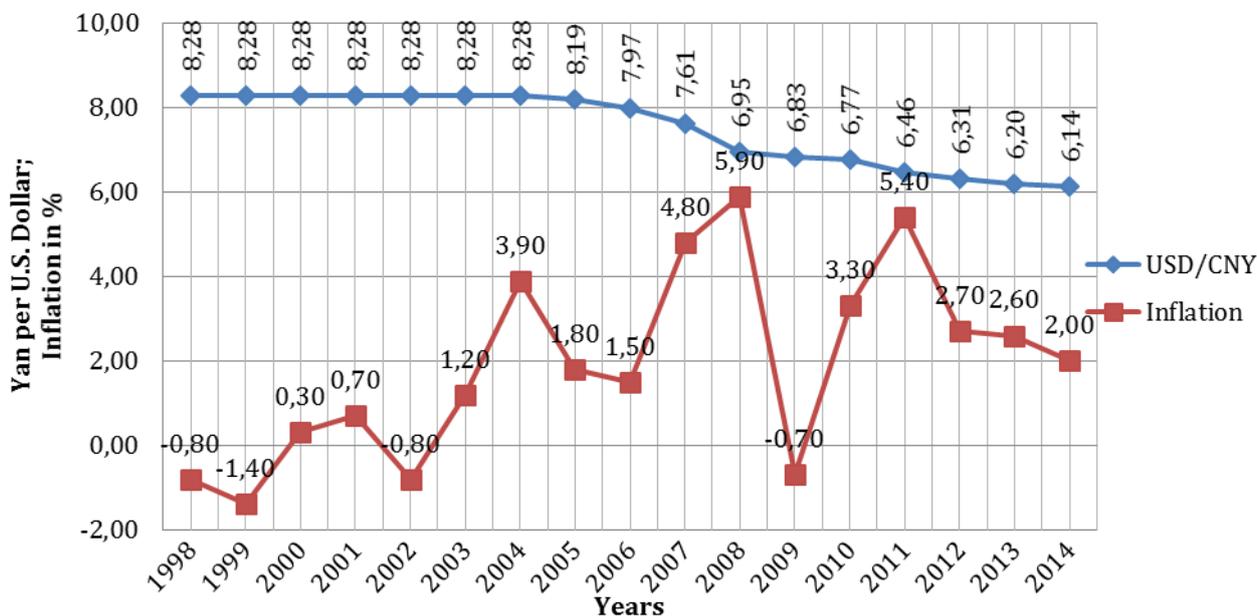


Figure 1. Yuan/U.S. Dollar Exchange Rate and Inflation Dynamics
Source: created by the authors on the basis of the data of the World Bank [5]

Should the renminbi prospects as a reserve currency be analyzed from the perspective of the quantitative measures of the economy, China's currency is highly likely to reach roughly the share of 12 percent in global reserves. However, the qualitative analysis focused on market and institutional variables gives the renminbi a total of 2-percent share in global reserves [8, p. 24].

To gain advantages from Yuan internationalization, China should reach a certain state of economic development characterized by inability of both capital inflows to be a risk for Chinese financial development and stability and flexible exchange rate to enfeeble competitiveness [7, p. 62]. Taking into consideration the fact that China had deliberately undervalued renminbi in order to stay competitive in the world market before U.S. Congress expressed its strong intention to impose pressure in 2005 and the fact that China's authorities embarked on devaluing its currency once again in 2015, China has issues concerning financial system stability to consider should Yuan internationalization be contained in country's long-term strategic goals.

The confrontation of the two economic effects (goals) China is seeking to has turned out to be the key factor of the abrupt 2-percent drop in renminbi value in the August of 2015. This drop is proven to be the largest one since the modernization of exchange rate in 1994 [9]. The precondition for implementing a currency devaluing policy was China's slowing economy, the growth rate of which is now far beyond double-digit rate of the other years as a consequence of the quite exhausted investment-export model. The upshot is that the new generation of Chinese households is a lot wealthier than that of a few years ago. For instance, the largest factory in the world, called EUPA and located in China, offered monthly salary of \$700 on average in 2014, compared to \$150 in 2009 [10]. This upward trend in household prosperity is nationwide, pointing out the increase of purchase power, hence consumption capacity and aggregate demand. Needless to say that the skyrocketing income of households stimulates demand on imported goods. Such trend is inconsistent with the export-oriented strategy of China. Though allowing market forces to affect renminbi with devaluation effect was the case while implementing the currency devaluation policy, the key reason of doing that was a need of bolstering China's economy by intensifying export efficiency [9]. The undelayable effect of the devaluation process launched was renminbi sliding 1.8 percent against U.S. dollar on Tuesday 11, 2015 [6].

However, changes in China's monetary policy are considered to be necessary should country seek to reserve currency status gaining. There is no denying that devalued renminbi puts Chinese economy at a risk of both increase in inflation and less controlled debt burden for domestic enterprises, which have debts in U.S. dollar terms. The prospects of the situation above contain a set of real sector failures, which are inevitable in the short-term. The long-term effects consisting in reserve currency status gaining will not take hold should China keep

sticking to legal restrictions on capital transfers [6]. Truly, the drop of a few percent is not actually that of a big deal, for Japanese yen and the euro dropped dramatically against the U.S. dollar last year compared to the fall of renminbi this year. The reason why China's currency exchange rate move has drawn such vigilant attention and deep concerns was its approach to its economy and currency [6]. The narrow trading band against the U.S. dollar deprived China of one of the key tools for holding economic turnaround back.

The fact was that the U.S. dollar revalued against major world currencies at 8.7 percent in 2014 [6]. Consequently, the renminbi rise against China's partners' currencies and such move was inconsistent with China's intention to push the renminbi exchange rate down. By virtue of this, China's central bank devalued renminbi while sticking to the legal restrictions on capital transfers. By contradicting objective market forces, the legal restrictions caused a shock to the global market [6]. Thus, together with promoting the international use of renminbi in economic transactions China is in urgent need of liberalizing its capital account [8, p. 24]. It is inappropriate for a country chasing the reserve currency status gaining to maintain restrictions on capital flows. The U.S. dollar, for instance, would have failed as a key currency in the global finance had the U.S. government either imposed prohibitions on USD/other currencies exchange transactions or applied explicitly rigorous interventions in order to manipulate the value of the renminbi while simultaneously neglecting market forces [6]. Shortly after the de facto renminbi sudden drop, the International Monetary Fund (IMF) announced that the renminbi is far from being a candidacy for a reserve currency status [6]. It means that China has to improve the ease of the renminbi use worldwide should it be in pursuit of the inclusion of the renminbi in the basket of the reserve currencies. Virtually, China's policy swinging round in the August of 2015 is a step towards the success of the internationalization of Yuan.

Conclusions and recommendations

Therefore, the internationalization of Yuan as one of key goals of China's monetary policy has still had a slew of obstacles on its way. Undoubtedly, both the size of China's economy and its pace of growth indicate the fact of China becoming a major economic powerhouse in the world. However, the success of a country in reserve currency status gaining does not limit itself to the size of an economy only. Though the quantitative measures of the Chinese economy reflect solid future prospects for the renminbi as a reserve currency, the results of qualitative analysis standing for abridged economic freedom and strict capital accounts control signify some frustration. On this ground, the crucial obstacles of China's monetary policy directed at the process of the renminbi reserve status gaining are institutional barriers and restrictions on capital flow. To demolish harmful effects of the Yuan internationalization process, China should foster international economic transactions, use the renminbi for investment settlement and trade, issue renminbi-denominated assets overseas and set offshore markets.

To assure the sustainable process of Yuan internationalization, China's authorities should pay attention to three crucial points: (1) the promotion of China's economic growth, (2) creating efficient and liquid financial market and (3) the improvement of China's political and economic systems credibility. The stumbling pace of China's economic growth signifies the urgent necessity of improving the current growth model. The improvement in fiscal policy, administrative controls, financial system, and household registration, as well as the liberalization of capital account, exchange and interest rates will doubtlessly predispose the success of the growth model transformation. To be a sustainable reserve currency, renminbi should be underpinned by a worldwide accessible financial market. Under no circumstance will the currently sustained restrictions and prohibitions promote the internationalization process, but be the key factors of financial disturbances, just as happened in August 2015. Finally, improving China's economic and political system means gaining the long-term confidence of investors, who are a driving force for sustainable economic growth.

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