# Internationalisation of the Chinese Currency, Act II: Uncharted Waters, Unclear Direction

Jean François Di Meglio



After two waves of important changes in the Chinese system of foreign exchange, one in July 2005, when the Chinese currency was allowed to fluctuate more widely against the US dollar, the other in June 2010, when it was then quoted against an undisclosed basket of currencies, but moreover, was allowed to be partially traded in Hong Kong with the invention of a 'twin', the 'offshore yuan' (CNH), a deep reform could have taken place. The creation of the CNH, allowing debt to be issued internationally in yuan, initially led to the belief that a real set of deep reforms was under way. Yet, like some reforms of the past, which were hesitant or even annulled, the path towards monetary and financial reform is encountering difficulty. The steps taken towards the 'regionalisation' or possibly the 'internationalisation' of the Chinese currency may well be taking the same route. Before the reforms have had time to come to fruition and deliver deep changes, there seems to be some indecisiveness, a sense of relative failure, or at least discovery of the limitations in a process which many, at least at the beginning, believed would be quick and decisive. This article attempts to demonstrate that, like some other Chinese reform processes of the past, the path is not yet very clear and claims of deep changes and unwavering success would be largely premature.

***Keywords:*** regionalisation, internationalisation, renminbi, yuan, Chinese banks, dim sum bonds, monetary reforms

Events, rather than real policymaking, have mostly driven the few noticeable changes in policy in China during the last years of the reactive (more than proactive) Hu-Wen tandem. During this period, monetary aspects have been the focus

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of observers' attention, just as the dialogue on the exchange system between the US and China (or rather its difficulties, not to say its absence) has been, until recently, the hottest topic in bilateral relations.

China is basically debt-free *vis-à-vis* its foreign partners. But after having 'borrowed' its instruments of settlement (the currency China uses to settle its trade since the yuan is not convertible) essentially from the US, it might now 'diversify' its 'borrowings'. Internationalising the yuan is one way to do so: settlements would then be done increasingly in yuan. Chances are Europe would still not be concerned by the diversification: China could increase its settlements in its own currency, keep a portion in USD, also start (as a very recent announcement in early March 2012 mentioned) using currencies from 'BRIC'[1] countries with which China does a lot of trade. The imbalance between the huge volumes of Chinese trade and the small fraction of its own currency used to settle results in foreign currency being 'absorbed' into the system (bought up by the Central Bank) and more yuan being issued as a counterpart in the country's 'balance sheet'. This potentially inflationary situation has to be fixed in some way, but the solutions are still far from being decided. The purpose of this article is precisely to assess the success of the path taken as this does concern global monetary balances, including those of Europe.

Given the importance the monetary issue has taken on in the last few years, the status of the currency and its future has generated internal debates among Chinese stakeholders. The various steps in the process apparently make it similar to the one that eventually led to China's entry into the WTO in 2001 after many debates and turnarounds.[2] However, there seems to be a main difference here: as opposed to the general support eventually garnered within the political class for the WTO, the contrast here is more striking and the outcome – if there will be one at all – more questionable. The volumes of 'offshore yuan' may have increased, but the process of internationalisation of the yuan might already have started to stall, in spite of renewed announcements.

Recent events and official decisions affecting the market of the offshore yuan (CNH for short) shed a new, questioning light on a process that was predicted, advocated and planned at the turn of the century. Based mostly on direct observation of the major trends underlying the steps taken in monetary policy and banking reform, this article will try to define which form (if any) the possible



[1] Brazil, Russia and India, in addition to China, constitute the BRIC group, as originally defined by Goldman Sachs. South Africa is now increasingly associated to this 'conceptual' group.

[2] See Frankel, "On the Yuan" and "The Renminbi since 2005"; and Gao and Yu, "Internationalisation of the Renminbi".

internationalisation (as opposed to 'regionalisation'[3]) of the Chinese currency was supposed to take and to what extent it has succeeded or come up against limitations. An important dimension of this assessment has to be reconnected with the relatively timid pace of reform of the whole financial (and specifically banking) sector. The article will look at the major steps taken since 2005 (and even earlier) to provide a better understanding of what the impact of the most recent, sometimes contradictory, events and decisions may be.[4] To conclude, it will analyse the options remaining for the future path of reforms in China.

## Financial reforms: the existing process

China entered the WTO ten years ago, but its financial system was integrated into the process only five years later, that is in late 2006, in particular with a new banking law defining the main rules of the game for the financial industry. The path towards China's adhesion was finally completed. After protracted negotiations and contradictory public stances, there was finally clarity, direction and positive results. Thereafter, a strong will as well as a driving sense of direction were noticeable when it came to adapting the Chinese economy, its key indicators and the major tools enabling the central powers to influence the trends.[5] Liberalisation was the key word and it led to a successful, apparently seamless accession at the expected time.

Previously, the Chinese financial system long relied on a very basic banking system and an administered redistribution of liquidity by the Central Bank. Interest rates were managed, prospective profits related to any financing action were constrained in regulated margins and the stock market enjoyed very limited opening to diversified pools of investors (at least for so-called 'A' shares[6]). The local currency, the renminbi (yuan, RMB) was exchanged under very strict conditions and its exchange rate highly regulated.

However, the new banking law did little more than pay lip service to the WTO requirements. This law, which still governs the whole system, is highly protectionist

[3] 'Internationalisation' and 'regionalisation' of a currency are not two different versions of the same thing, the former being broader, the latter more restricted. A regional currency (like the Deutsche Mark in Eastern Europe during the late days of the Socialist era) is a stable and trustworthy currency that is widely accepted and circulated outside of its borders, but mostly for practical purposes. Regionalising a currency merely means broadening its area of acceptance and validity, without necessarily changing its global status. Internationalisation is a very different phenomenon. It also derives from stability and wide acceptance, but reflects a much more general trust in the currency. Most importantly, it means that international trade deals with any and all trade partners can be made in this currency and that it is used for central banks' reserves and debt instruments.

[4] See Frankel, "On the Yuan" and "The Renminbi since 2005".

[5] For example, the (still uncompleted) efforts to 'clean' the banking system and the marginal adaptation of the Shanghai stock exchange.

[6] The access to which is limited either to residents or 'QFII' (qualified foreign institutional investors).

even though it ostensibly provides for the liberalisation and opening of the financial market requested by WTO rules.[7] For a long time this was regarded as a way to buy time before curing the numerous imperfections and inefficiencies of the Chinese banking and financial systems. But could a deep reshuffle be possible and an alignment of the Chinese financial system really come to fruition without other steps toward wider reform?

In terms of monetary policy or the liberalisation of the capital account, the debate was always about whether to start with the domestic reform 'at home' (rebuilding the banking system, putting it back on track, applying strict rules while still intending to build strong money and bond markets) and seeing what the consequences might be or to start out by positioning the currency on the international monetary order straight away.

From papers released from the very start of the century and often written by academics but obviously reflecting official views,[8] agendas were set to open markets, diversify access to financing (for corporates at least, through the establishment of a tiny bond market) and make the currency convertible. This abundant literature set 2020 as the earliest date by which the currency would be totally convertible and the domestic market workable within the global monetary system. This was totally consistent with the widespread belief that the liberal model for the monetary system was unquestionable.

With respect to managing relations with other countries, including the use by those countries of the Chinese currency and the diversification of China's own currency reserves, material steps were taken to bring this about: during the last five years, swap agreements were introduced with third countries,[9] allowing China and those countries to trade with each other without using dollars (swap agreements allow China to pay with its own currency and the counterparts to pay China back with money received in the framework of such deals). Gradually it also seemed that China was diversifying its currency reserves and thus shying away more and more from the 'all-dollar' dependency.[10]

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[7] For example, foreign financial institutions have to be assessed in China according to the amount of capital remitted within the country, which is contrary to most 'free market' approaches to finance, where global consolidated capital is taken into account.

[8] See Zhou, "Reform the International Monetary System"; and Chen and Peng, "The Potential of the RMB", 7.

[9] As of the end of 2010, Korea, Hong Kong, Malaysia, Belarus, Indonesia, Argentina, Iceland and Singapore had signed bilateral agreements to use yuan in transactions, with total amounts of potential swaps (deferred exchanges of money) exceeding 20 bn USD-equivalent. Since then, Japan has also joined (see http://www.eurasiareview.com/27012012-china-and-japan-currency-swap) and the total amount of swap agreement with most others has also increased, reaching 842 bn RMB (more than 120 bn USD-equivalent) by the end of 2011.

[10] "Since the Central Bank does not release precise data on the breakdown of its reserves, analysts can only guess. Estimates range from the world average of 62% to as high as 75%. At least USD850 billion (this is the official tally; due to covert buying through offshore accounts, the actual total is probably higher) of its reserves are held in US Treasury securities. It also controls a USD300 billion Investment Fund, which has made very public investments in natural resource companies around the world. The allocation of the other

### The doubts instilled by the 2008 crisis

The steps taken to modernise the monetary system in China, as described above, did not constitute a completed monetary policy. And the 2008 financial crisis seems to have caused a deep disruption in the cautious yet determined way of reforming that China had adopted. Actions were taken that were in contradiction with certain long planned and long announced goals. When looking at monetary policy for example, it seems that, while busy with the preparations for the Olympic games, the Chinese government failed to see the crisis coming and tightened the money supply just when this was least needed: the monetary policy appeared to be a total mismatch with the actual situation. The consequence was a fast reversal of positions.

After that it became unclear whether China would remain on the path of financial reform, and which model (if any) it would adopt. After looking like it was about to adopt a 'quasi-Taiwan' model of liberalising the capital account by gradually widening the number and potential of 'qualified foreign investors', China became much more cautious than Taiwan had been in the late nineties in liberalising those flows. The same happened on the path towards 'depegging' the currency, which had originally seemed to be quite standard, based on the confidence deriving from other examples that depegging would not necessarily harm a currency's status or situation.

It now looks more and more like it was the initial imbalance after the onset of the 2008-09 global financial crisis that made China doubtful of which path to follow, even though the crisis did not deeply affect China (probably even the contrary). Continuing determinedly on the pre-announced path towards liberalisation could expose it to the same problems as its fellow trade partners. Conversely, a slowdown in the liberalisation process could be harmful to both the modernisation of the financial system and the change in models which had started very clearly to be needed to lower the dependency on third parties. As will be seen in the following section, the linear path of monetary reform, which could also be symbolised by the rise of the RMB exchange rate against the USD, was interrupted not only by accidental factors (for example, the narrowing of China's trade surplus), but also by the questioning of the rationale behind liberalisation. Looking at the historical chart of the exchange rate, this 'moment of doubt' is quite conspicuous. But it was probably more than 'doubt', and rather a direct consequence of a (still) managed exchange rate system, adapted to the circumstances. As will be seen later, if repeated in 2012, the same type of sequence could potentially continue to stall internationalisation.

(*footnote continued*)
USD1.5 trillion is a matter of speculation." A. Kritzer, *forexblog*, 10 Dec 2010, http://www.forexblog.org/category/emerging-currencies.

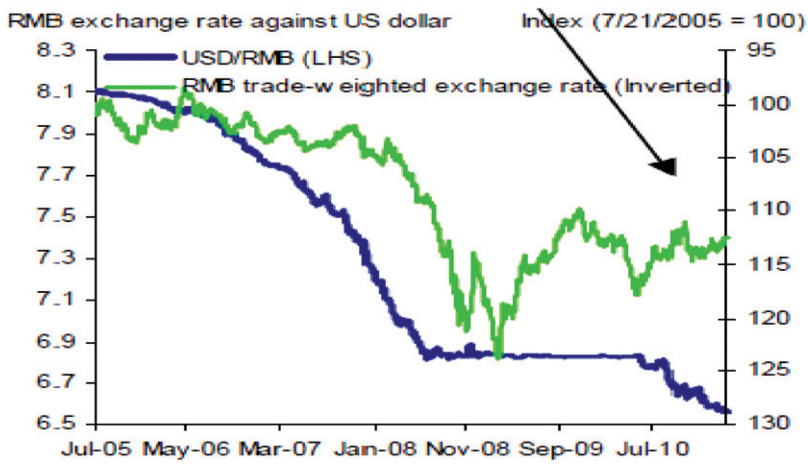


FIGURE 1. RMB exchange rate against the US dollar
*Source:* CEIC, UBS estimates



## Cosmetic changes in monetary and exchange rate policies during the last decades

Modernisations in China started in 1980 with some very well observed changes in the basics of the Chinese economy. Yet it took longer for the financial system to start to be reformed. Given the state of the economy and the need to create new tools, but given also the ideology still pervasive (in spite of the very 'experimental' mood), it made sense that those reforms would start later than the others, as the industrial reforms were closer to the core of the economy. For example, it was not before the mid-eighties that the reform of the People's Bank of China (PBoC, which was the sole financial institution until then) started, that is quite a few years after the four other modernisations started.[11] Equally, the status of the national currency and of the financial markets has always lagged behind the evolution of the country's economy. The impression that financial reform was on an accelerating path essentially came out of the events that followed the 'Asian crisis'. Between 1997 and 2005, a series of unexpected, sometimes 'contradictory' moves by the monetary authorities led observers to believe that China was coming out of its relative conservatism and innovating in the monetary and financial fields. This (all things considered, short) period of acceleration coincided precisely with the run-up to and the early period after entry into the WTO. The Asian financial crisis hit China in 1997 and it joined the WTO in 2001 (except for the financial sector which benefitted from a 5-year exemption/reprieve).

[11] The 'four modernisations' constituting the new policy set up by Deng Xiaoping in 1978 were in agriculture, industry, science and military reform.

Obviously this cannot explain China's position during the crisis, but it eventually helped observers take a different look at how China was approaching financial issues. While the world was expecting China to follow the devaluing stampede of Asian countries, it took the opposite route and posture to erect a 'firewall' against the epidemic spreading across Asia. China had been on an accelerating, integrating path towards 'normalisation' of its financial sector, at least *vis-à-vis* foreign counterparts. The decisive dates for this were summer 1997-98, as just indicated, but also the years following China's entry into WTO from 2002 to 2004: contrary to some expectations, they coincided precisely with the rise of 'foreign exchange reserves' for China's Central Bank. As was standard for the reform process in China, all this was a direct outcome of very pragmatic behaviours. The following years would appear to produce a carefully analysed approach combining theorisation and practical reaction to circumstances.

While scholars in China and Hong Kong were planning the next steps towards internationalisation of the Chinese currency, one important step was taken in July 2005: the 'widening' of the currency's fluctuation band. While this sounded like a purely technical measure, it actually paved the way for attracting more academic and market interest in the Chinese currency. It also opened an initial three-year period of quasi-constant appreciation of the Chinese currency's exchange rate (see Figure 1), which was only stopped by the first tremors of the financial crisis, during the last quarter of 2008, when the upward movement initiated in 2005 was suspended, only to resume in 2010, under very different bases (it is no longer quoted in relation solely to the US dollar but also to an undisclosed 'basket of currencies'). Also, during the same period, the setting-up of swap agreements between China and some of its important trade partners made it possible to stop the disconnect of the Chinese currency from the growing international status of its home country and allowed China to achieve a kind of regionalisation.

Much more important, however, was the launch of a 'proxy international currency' around that time, called CNH (H for Hong Kong added to the CN of CNY, the 'domestic' Chinese yuan).[12] Its founding principle was to create a 'receptacle' for inward remittances, and thus enlarge the influence of a 'renminbi monetary zone' in the region.[13] Hong Kong would act as an offshore financial center, a stepping stone for developing new markets (a comparison with the euro having its financial centre in London could be drawn). What was interesting is that



[12] See Aglietta, *Yuan Convertibility to Non-residents.*

[13] "Japan started a trial internationalization of the yen as early as 1964. However, this process eventually stalled. Currently, there is no dominant currency in East Asia, with the yen the biggest rival of the RMB in reaching such a status. The newly signed currency swap appears to signal an acceptance by the Japanese of the renminbi's dominance." ("China and Japan Sign a Currency Swap Agreement during Christmas", *China Offshore*, 4 January 2012). On this, Barry Eichengreen commented, "What's new here is that (China is) working with and have the support of the Japanese government, which seems to be acknowledging implicitly that there will be a single dominant Asian currency in the future and that it won't be the yen." ("Economists React: China-Japan Currency Pact", *China Real Time Report*, 27 Dec. 2011).

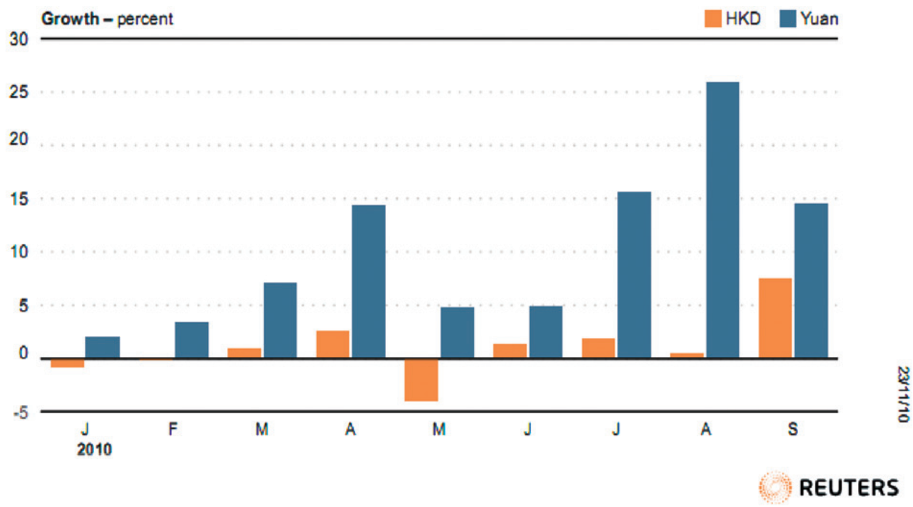


FIGURE 2. Yuan deposit growth in Hong Kong banks
*Source:* Hong Kong Monetary Authority, Reuters graphic/Christine Chan



the experiment sounded like yet another illustration of the Deng Xiaoping famous method ("crossing the river by testing the stones").

All the elements for a promising success were starting to make their appearance and entertain the market players' confidence. However, this new initiative still lacked a few elements that would have propelled it to unquestionable success:

– a clear agenda of what could be expected in the future in terms of development of this new market
– its positioning *vis-à-vis* the 'managed' domestic market: was it supposed to be a totally free market? In that case, thoughts should have been given and communicated as to the connection between the 'onshore' and the 'offshore' market
– a gradual impetus towards new instruments, absolutely critical for opening up a new market. If instruments were left totally to the initiative of private players and investors, there was the risk that development of the new market would be one-sided, since the market's view of the yuan was, at the time, an unwavering trend towards appreciation.

Indeed, the outcome of the initiative was in perfect conformity with what the principles predicted: after a tremendous start and very rapid growth, the market started to stall by the end of the second year (Q3 2011).

Based on the success of the very first months and its acceleration, there were positive hopes for the internationalisation of the currency.[14] A direct consequence

[14] See Subachi, *One Currency, Two Systems.*

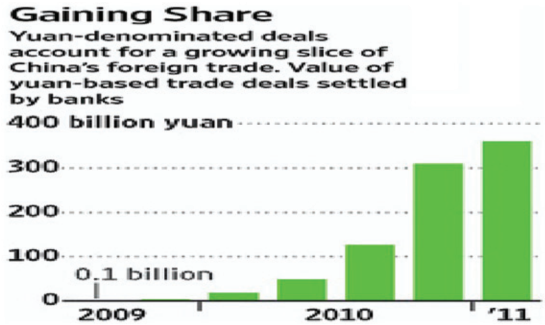


FIGURE 3. Value of yuan-based trade deals settled by banks (billion yuan)
*Note:* 1 billion yuan = $153.1 million at current rate
*Source:* People's Bank of China



could have been the development of the bond market.[15] However, a strange phenomenon started to appear very recently, at the level of rates which, driven by the huge liquidity as they were, should logically have stayed low. Instead, this is what happened:

Figure 4 illustrates the 'jump' in the market rates for so-called 'dim sum' bonds, that is, those bonds issued in offshore yuan in Hong Kong, and expected to help build a 'yield curve' for a future market. Those rates, supposedly low as a function of the appetite for remittances in offshore yuan (supported by the belief that this 'currency' would appreciate and possibly merge with the 'onshore' one) started to climb, as a sign that doubt started filtering through the markets. Two consequences derived from this situation. The first was that the transactions settled in yuan reversed and the trend declined.

A November 2011 PBoC document providing statistics concerning the Chinese current accounts reported a troubling observation:[16] the transactions related to trading of goods declined for the first time in two years over the third quarter of 2011 (less than 580 bn yuan, coming down from 600 during the previous quarter and up of course from 50 bn during the first quarter of 2010). More significantly, the proportion of deals settled in the Chinese currency declined from over 8 percent (still a small number) to just over 7 percent in the same period.

The second consequence, albeit contradictory, shows how complex the exercise of internationalising the yuan is: transactions in Hong Kong in the local currency (Hong Kong dollar) also declined in the same period,[17] in a typical demonstration of a 'chain reaction' related to a gradual loss of trust or at least diminished hopes.

[15] See also J. Anderlini and R. Cookson, "Cross-border Renminbi Trade Flourishes", *Financial Times*, 1 March 2011.
[16] Quoted in J. Anderlini, "China Tames 'Vicious Tiger' of Inflation", *Financial Times*, 9 Dec. 2011.
[17] J. Anderlini, "China Tames 'Vicious Tiger' of Inflation", *Financial Times*, 9 Dec. 2011.


FIGURE 4. Market rates for 'dim sum' bonds (in CNH)

## Act II? What has been (deliberately?) left aside?

While there was an obvious need for a new impetus for financial and monetary reform in China after the very successful entry into WTO in 2001, given the relative weakness of the financial system as compared to other pillars of the 'Chinese story',[18] a window of opportunity for reform opened during the two to three years after WTO entry. In those days, foreign exchange reserves had not yet reached a point (they currently represent three quarters of China's GDP) where any move involving them (true diversification, change in the foreign exchange rules) would make things difficult to adjust. That opportunity was missed. Yet the need and the hopes remain.[19]

Whereas the usual problems facing the Chinese administrations in charge of reforms were of a rather internal nature, financial/monetary issues were a very different matter: domestic problems were very quickly becoming global ones, which called for new types of solutions. And those solutions had to take into account not only the gradual acquisition of a 'market-driven' approach in China, but the fact that 'markets' were ruling the monetary order, at least in a

[18] On the situation of the financial system as a whole, see Garcia-Herrero, "Can Successful Bank Restructuring End in Tears?", http://www.bbvaresearch.com.

[19] See S. Chen, "China Currency Reform may Mark Start of 'Financial Big Bang', Nomura Says", *Bloomberg*, 18 August 2010, http://www.bloomberg.com/news/2010-08-18/china-reforms-may-mark-start-of-financial-big-bang-nomura-s-darby-says.html.

post-Bretton Woods universe. Yet the banking system still had to be addressed, and any reform of the currency regime would have an impact on it.

Conversely, there could be no true reform of the 'protectionist' exchange system ruling China as long as the trade balances (or rather, imbalances) remained, having missed the 2001-06 opening during which the trade surplus was growing but reserves had not yet reached an almost 'unmanageable' peak.

Therefore, it seems that, in spite of the long-term vision of the reform process,[20] the pragmatic, history-informed, research-enriched and gradual approach, if China is to stay within the existing post-Bretton Woods 'consensus', it faces the following dilemmas in tackling monetary reforms:

- The more the domestic economy relies on credit injected or restrained by the decision of the central bank (as opposed to market forces used by domestic banks), the more difficult a conversion of China's economy from an export model to a more balanced model becomes.
- The expectations created by both China's excellent track record in terms of reforming its backwards sectors and the initiative taken with the CNH risk being frustrated so badly that any initiative calling for some form of 'adhesion' by foreign counterparts could fail.
- The strong belief if not unwavering confidence, at least during the first 18 months of existence of this market that the yuan parity (regardless of whether it would be 'domestic yuan' or CNH) only had one way to go, and that was 'up' (appreciation versus most currencies, starting with the USD), made the realisation of real bond and money markets difficult. A market needs instruments, but also relies on the complementarity of 'buyers' and 'sellers': issuers of bonds 'sell', so they run the risk of losing capital if the currency appreciates. Hence, apart from a few foreign issuers and government entities, it would remain difficult to attract more and more issuers if the trend for the yuan is still perceived as 'up'. Conversely, the consensus is that excess of cash should be placed in CNH instead of USD or other currencies. As seen above, if confidence is broken, this could even not remain true. But if the Chinese yuan could be seen as really fluctuating (not to speak of 'freely floating'), the chances of not losing money when selling it would increase and so would the chance to develop this new market.



## Monetary reform: Act III, a more uncertain, reform process in China?

The process of monetary reform has been retraced and analysed here since it belongs to the burning issues that will face the new Chinese administration.

[20] Endorsed by many who see a long-term goal of making RMB "a normal currency", see Z. Ding, "China Leans towards Yuan Float", *Caixin*, 17 March 2010.

In this respect, it will be a key element of China's future evolution, and deserves full attention. Also, the reform process is no longer linear. These changes can easily be explained by several factors, most of them quite new to the history of reform in China.

The various authorities involved in the process are now more mature, but also more numerous. For example, as concerns monetary reform, the decision-making centres are more and more diverse: the Central Bank has its say, as does the China Banking Regulatory Commission, the supreme ruling institution supervising and regulating the banking industry, and the Ministry of Finances. Since currency is related to sovereignty, top levels of power are involved.

Furthermore, in most cases, the reform processes in China affected domestic issues that were of little impact *vis-à-vis* the external positioning of China. Conversely, anything related to money, finance and currency, especially given China's new status, is of global importance. Any decision taken in China has tremendous 'ripple' effects. Finally, the past cycle of reforms was conducted in a global environment which by and large could be considered relatively stable. The collision between the Chinese agenda for reform of monetary issues and the financial crisis has made it much more difficult for China to 'go it alone'.[21]

Nevertheless, the need for reform of the Chinese monetary regime is becoming increasingly urgent: unless a halt is put to the ever present trade surplus generated by China exports, the impact on foreign exchange reserves will continue to grow, with the 'sterilisation'[22] of those reserves merely acting as a partial solution for avoiding inflationary side effects. That said, a liberalisation of the exchange regime would also depend on internal factors, and rationalisation of the banking system is one of them. Failing a deep banking reform, a barrier has to be kept to provide a safety net for non-competitive domestic banks.

At the same time, reform of the financial system, leading to the opening up of the domestic market to outside influences in a period of acute dangers and instability, could allow unsettling factors to spread, as happened (at least according to the Chinese reading of financial history) in Japan prior to the 'lost decade'. Yet, trying to predict the future direction of the markets and the potential solutions to the crisis is far beyond what China can achieve for itself and for the whole system. For example, allowing too much free circulation of the Chinese currency around the world would pose a tremendous risk of uncontrolled internationalisation and rapid appreciation, which would jeopardise China's capacity to keep on exporting and would be seen as a terrible loss of sovereignty in Chinese eyes.

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[21] See Chow and Kim, "A Common Currency Peg in East Asia?"; and Eichengreen and Bayoumi, *Is Asia an Optimum Currency Area*?

[22] Sterilization means 'freezing', that is not allowing to enter into circulation the monetary aggregates created when exporters exchange foreign balances with the Central Bank for domestic yuan.

## Financial reform and beyond

As pointed out earlier in this article, China has gone through a tremendous amount of reforming, from the time, less than 35 years ago, when it emerged from a totally different horizon of public policies. Nevertheless, when compared with the challenges and choices mentioned above, it has never had to consider so many different options and combine so many domestic and international factors and constraints as it now faces. Depending on the path that China chooses (in this specific case, either actively reforming its monetary regime and financial system and thereby impacting the global one, or constraining itself within an established, yet unsatisfactory order), the consequences on the global environment in the sector will be extremely different, given the new space that China is now occupying globally.

The Chinese way of reforming, based on experimentation and allowance for failure and also the very unique rhythm which the reform processes have taken during the first 30 years of the 'new China' succeeding the autocratic old, could run out of steam. Paradoxically, the only chance for the current reform and the creation of the 'offshore yuan' to succeed could well result from a situation in which China, being increasingly exposed to a global slowdown, is less exposed to criticism about the exchange rate of its currency. Under this hypothesis, there could be a real breakthrough of its newly invented currency, the CNH: a market could actually develop, since the play on this currency would stop being 'one-sided', that is, based on constant revaluation. And as a market develops, a long-awaited reform could eventually take shape.

It has to be noted though that such an outcome cannot be determined solely by the monetary authorities. Obviously they have a decisive role to play. But, contrary to the reform process conducted during the early stages of modernisation, success/failure and extension of reform no longer depend solely on the ability of Chinese rulers to design the best possible reforms and to time them perfectly. A new dimension has appeared as China has moved into a more global sphere of interaction.

Finally, a question also arises concerning the process of reforms in China: this process was initiated at a time when shortcomings in Chinese output were obvious. Thirty years later, if China's successes during these years of reform are compared to the potential of the country and its population at the time, it looks as though achievements could have been even more efficient. As clever as it was, the experimentation process sometimes slowed down the whole plan – and the financial sector probably provides the best example. Although China has set itself a goal which still lies some distance ahead, current achievements are already very impressive and have fulfilled many expectations. Yet the jury is still out as to whether the same route should still be followed. In some cases the relative lag in the reform process, or even the absence of reforms has prevented China from being dragged backwards by global crises. This was the case in 1998 when the mere fact that China had shied away from the form of development of the 'newly industrialised countries' (huge use of foreign borrowings, tremendous overcapacities), protected it from a regional crisis that would have wiped out the accumulated wealth.

Once again, as the new decade starts, some of the reforms that have not been carried out have protected China from disaster, the absence of decision-making ability has prevented China from taking wrong paths and some internal constraints have reined in the appetite for change. The example of ill-timed investments during the first wave of the financial crisis is particularly telling: during the 2008-09 crisis, China invested sovereign money in the Royal Bank of Scotland (RBS) in view of getting insight into a Western banking institution, and incurred a double failure since it suffered a capital loss as well as the denial to access to the operational process by the RBS board. By the same token, the relatively cautious, hesitant and irresolute rhythm of investments by the Chinese Investment Corporation (CIC), the Chinese sovereign fund, has also helped avoid trouble and the dispersion of wealth. This way of reasoning is most probably very present in the minds of both active reformers and those involved in assessing the performance of past investments. It does not mean that the reform process will necessarily stall. But, as can be seen from the attempted reform of the current monetary system, it points to the possibility that the reform process has ceased (probably already for some time) to be a secure, undisputable way to ensure development. The current level that China has reached is indubitably the result of reforms very aptly decided and conducted. They have led China to a level of prosperity and success which forces it to question which way to go next.

A form of consensus emerged in the early years of the reform era and lasted for almost twenty years: it was basically based on the principle that trials were allowed, so that the many borrowings from the 'liberal' system could be tested. Obviously there could be divergences about the ex-post assessment of the various tests and trials, and implementation and timing could also become bones of contention, as seen with the experiments done on the opening of the stock markets. However, the general direction was clear because it pointed to a more 'elaborate' form of economy.

In 2008, things changed for two main reasons: the pure 'Western', free-market model was put under strain by the financial crisis, and the major countries in trouble were clearly trying to put China in the 'hot seat', since the degree of development China had reached was viewed as sufficient reason for it to take responsibility and move to contribute and help. While beyond the scope of the present article, internal politics have also played an important role and have to be taken into account in assessing the reasons for the change in the reform process.

## Conclusion

Any conclusion to a review of the current stage of internationalisation of the Chinese currency must adopt caution and a deep sense of nuance: a new path is being invented. Is it *the* way to go for China in terms of changing the terms of its trade and becoming less dependent on a system that is increasingly challenged from the outside? Possibly, yet actions by Chinese authorities may disappoint the main actors and players on the market; hence there is a case for actively revisiting the international yuan, taking more and clearer actions. Otherwise, the CNH could fail the test or simply end up as an example of a hesitant path of reform, at a time when decisions are more difficult to take for domestic reasons (and in relation to internal politics) and because China is increasingly a stakeholder in the global environment.

There is still probably the temptation in China to use the recent innovations as potential exit routes in case the system collapses. In that case, the answers to the questions raised here probably lie outside of China, but for this to happen, a more convincing liberalising action (even if not along the usual routes followed by major currencies) has to be taken.

Still, there is the question of the potential impact of the changeover in the Chinese leadership on decisions regarding the currency and the future paths for internationalisation or even convertibility of the yuan. As important as this may seem, it would be quite imprudent to bet that the new rulers of China after 2012 will have relatively different doctrines.

The new leadership will indeed have to face many issues and the monetary system is part of the list. But China's role and presence in the global community, and its conflicts and challenges will probably pre-empt any acceleration of the pace of monetary reforms. It is legitimate to doubt that on this issue, much more than on others, the very specific path observed in the reform of the monetary system will be changed into an aggressive, hasty one. The stakes are high and the risks for domestic balances and equilibria even more challenging than in many other reform fields.



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