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Qi Ye: Good evening everyone, welcome to this very special event jointly organized by BTC for Public Policy, the School of Public Policy and Management, and the School of Economics and Management. Tonight, we will talk about an interesting and indeed very important subject—the internationalization of RMB, its impact on China's economy and world's finance. I am truly happy and honored that tonight we have some of the best scholars you can find in the world. We invited professor Eswar Prasad from Cornell University, who is also my colleague at Brookings Institution. He is a Tolani Senior Professor of Trade Policy at Cornell University and a senior fellow at Brookings Institution, where he holds the New Century Chair in International Trade and Economics. Before this, he worked for IMF where he was the head of the Financial Studies Division and the China Division. Today we are also very happy to invite Yingyi QIAN, the dean of the School of Economics and Management, who just completed the session in the National People's Congress. I have seen him on TV the last couple of days. I want to mention that Dean Qian is a member of the monetary policy committee of People's Bank of China. As we know, this committee is responsible for making major policies regarding banking and finance. I don't need to give Professor Qian too much introduction since everyone knows him. Tonight, we also have Professor Qiao YU who is my colleague from the School of Public Policy and Management working on finance and other areas. We also have professor Zhiyuan CUI here from the School of Public Policy and Management; professor Barry Naughton from University of California, San Diego. We are not only going to have a great discussion, I want everyone here to prepare your questions and comments. But first, let me just invite professor Eswar Prasad.

Eswar Prasad: Good evening. It is a real privilege and honor to be at Brookings-Tsinghua Center and especially to be part of this distinguished panel, and talking in Beijing about one of my pet topics, which is RMB. When I talk about RMB, especially the internationalization of RMB, there are many aspects and facets to this question. So I will talk about a couple of different angles of RMB, which is trying to think about the RMB's role in international finance. Not just from the point of international monetary system, but also to think about what the implications are for China's domestic development. And then I will talk about the implications are of the RMB's larger role in international monetary system and I think some of the implications will be very profound in the years to come. There are a variety of issues related to this and one can think from analytical perspectives and also policy perspectives. In this talk I will focus largely on conceptual issues. There are many issues about RMB internationalization with facts and figures which are very important, but those are not going to be so much to be focused in my talk today because many experts in the audience have written about these issues, and some of these facts are known. I want to put them into these two specific contexts: China's own development and its implications on the international monetary system.

But even if one thinks from a purely analytical perspective, there are a number of issues that one can think about internationalization: whether it is done in the right way, whether it is going to be productive for China in this dimension. One can think about the issue of Sequencing: capital account liberalization (CAL for short), exchange rate flexibility, and financial market development which is an important part of the story I am going to talk about. I will also talk a little bit of my assessment of financial market reforms. I do this with some degree of trepidation because again I suspect people in this audience will know far more about this than I do. There is also an important issue about the transition of RMB to becoming a major currency and what the risks are in this process. The bottom line I am going to give to you at the front is that it is not likely to become a world order risks, but most of the things are going to be a matter of managing the risks and making benefit-risk tradeoffs on the path to internationalization.

At the beginning, it is useful to be clear about certain concepts, because when talking about RMB internationalization, it means different things to different people. So I think it is helpful to set up very clear conceptual frameworks at the beginning. One very clearly defined concept is the open capital account: it means no restrictions on capital inflows and outflows, so that money can flow relatively easy across national borders. The second concept is international currency which refers to a currency widely used in trade settlement and cross-border financial transactions. And then a distinctive concept is the reserve currency—it is actually one that is held as part of a central bank's portfolios. This typology is important to keep in mind because when you think about this, an open capital account is seen as a synonymous with freely floating exchange rate. And that is not necessarily true. Hong Kong provides a perfect example that an economy with completely open capital account but not flexible exchange rate. It is a very tightly managed exchange rate related to the US dollar. When one thinks about these concepts, neither A (having an open capital account) nor B (being an international currency) sufficient for each other. China does not have an open capital account yet, but we are already talking about RMB as an international currency. There are also countries which have an open capital account but the notion of international currency doesn't work. But both A and B are important for a currency to be a reserve currency. So as we go to the part of RMB internationalization, it is essential to keep these concepts in mind. I will add another concept to it as we go further along this path.

Now, let's start with internationalization where there has been a lot of action and a lot of excitement. Virtually in these dimensions the numbers look very impressive: the deposits of RMB offshore, the amount of trade settlements in yuan, the amount of Yuan denominated bonds being issued in Hong Kong and the currency swaps with other central banks. In the last year or two, in many of these dimensions growth has slowed considerably and one of the reasons for this is that it is no longer the case that some of these channels of acquiring RMB for revenue in the hope that it will appreciate. Because the pressure of RMB seems relatively balanced right now. If anything, there are some pressure for RMB to depreciate. So the incentive of using these channels of RMB internationalization to acquire and hold more RMB has dissipated. But I think since market wants it and government wants it as a policy, we are seeing much development in each of these dimensions. If you think about the currency swap between the central banks, there are now about 28 central banks having signed local currency swap lines with the PBOC and the total amount of these swap lines is about 3 trillion RMB. Again one of my argue, that in the scope of global finance perhaps 3 trillion is not that much, but I think these local currency swap lines being signed with the central bank that does not have a convertible currency is at some level remarkable. It essentially means that the central banks signing these swap lines are willing to take on RMB liquidity, not dollar liquidity as it used to be the case when PBOC signed swap lines with other central banks in the late 90s and even early 2000. So this is a fundamental shift. Why these central banks are doing this is an interesting question. I will come back to this question repeatedly—whether it is a sign that RMB is on its way to become a dominant reserve currency, or simply a low cost, sensible bet that RMB will become an international currency that is quite important. Given China's international finance and international economy overall, everyone wants to be friends with China. This is a very low cost way of doing it. I once had the opportunity to speak to a central banker who had just signed the swap line, for a relatively modest amount with the PBOC. I asked this central banker why he bothered to do such a small number, and he answered was very simple: this is not what I am after in the long run. But when eventually RMB become much more important in the international finance, the base will already be there and we expand our relationship with China. So when we look at the seemingly small magnitude of the swap lines, we should think about what is coming in the future. Which I think is going to be quite significant. If you think about what the RMB's path to internationalization requires, it is going to require far more than what has been done already: more financial centers; financial institutions authorized to conduct RMB transactions, a payment system to mediate RMB business; more RMB liquidity offshore; integration of offshore and onshore markets. Now the government seems to recognize this, and we have seen progress in each of these dimension. One may argue that the progress is relatively slow and somewhat uneven, but again the direction is clear. So my assessment is that RMB is on its way to becoming a fairly important international currency. The numbers are out there. If you look at RMB's role in terms of international settlement, it is said to be the 5th most important currency in the world, many of RMB's indicators are playing a much bigger role in international trade and finance. But the journey from an international currency to a reserve currency will take a lot more. The traditional criteria for a reserve currency are as follows—the country should have an open capital account; a flexible exchange rate; macroeconomic stability; a well-developed financial market, which I think is the most important criteria. So if you think about RMB as a reserve currency, what is necessary? Foreign investors—both foreign private investors and foreign central banks—should have the ability to acquire RMB denominated assets, be able to trade them, and move them in and out easily. And that is essentially the crux of what is needed. So if you think about what this means in terms of financial market development, then this typology may be useful: there are three important characteristics of finance markets: the first one is breadth, which means broad range of financial instruments that foreign investors can have access to. When one thinks about reserve currency, typically this tends to be debt instruments which have less risk and are more liquid. It can take the form of government bonds or corporate bonds. In both dimensions, China certainly has a long way to go largely because disciplinary reasons, at least on the explicit fiscal position China has a relatively low government debt to GDP, and this is not a very liquid market, so perhaps the corporate bonds can take on some of the rule, but that does not happen yet; the second one is depth: large stock of those instruments. Later I will compare what the status of RMB is relative to the dollar and some important lessons to be learned there; the last one is liquidity: High level of turnover so that investors can easily and inexpensively move in and out of those instruments. So we also need a large amount of high quality RMB assets which typically to be debt instruments backed up by technically good infrastructures for trading and settlements, regulatory framework focusing on systemic financial stability, adequate capacity and political will to exercise regulation effectively. If one thinks about the US before the financial crisis, it did not apply the manner that could forestall the crisis. The question at this stage is, when we talk about a reserve currency, is it something worth aspiring to? So let me spend a minute talking about the cost and benefit of a country having a reserve currency.

The big benefit of having a reserve currency is that it is easier to borrow in the domestic currency with low interest rate and if your currency is traded widely abroad, you will get seigniorage revenue that you can collect on issuing the currency. If one looks at the US currency for instance—we don't have precise number but estimates indicate that somewhere between 30-60% of the US currency is outside the US—so the US will get seigniorage revenue by printing money at a very low cost and having the rest of the world using that currency, and a lot of the cost is paid by foreigners. It is a pretty good situation to be in. There are of course costs and I am quite impressed by the way Chinese government is approaching them. Question of whether RMB should become a reserve currency get to Chinese senior officials at various forums. They are much more precautious about this prospect when the rest of the world seems to be agog at the notion of RMB becoming an international currency. The Governor of the PBOC and professor Yi Gang, the deputy governor of PBOC have all made it very clear that they see this as a mixed blessing: if the market wants it to happen, they will facilitate it, but they also recognized the costs. The costs include that if RMB were to become a reserve currency, there is going to be stronger demand both from foreign private investors and foreign central banks that what to hold RMB in their portfolios. That is going to be harder to manage the value of the currency and put an upward pressure on the currency.

I want to address one misconception out there about what is to be a cost of China. The notion of Triffin Dilemma is very often evoked in terms of the reserve currency status of the RMB. The notion of Triffin Dilemma is that a country to provide net liquidity to the rest of the world which is necessary for the reserve currency status. Then the country must run a current account deficit. This is not true for most of the reserve currencies of the world. If you think about Japanese Yen, Euro and Swiss Franc, all of these countries—until recently in the case of Japanese Yen—for a very long period in the last two decades have maintained reserve international currency status while running a current account surplus. So clearly it is not essential for a country to run a current account deficit in order to have its currency be a reserve currency. But what about the dominant currency? Maybe, and based on US experience it seems to be the case, that the dominant reserve currency is going to face a Triffin Dilemma in order to provide net liquidity to the world. I argued in my recent book *The Dollar Trap* that this is a misconception. When Triffin set out his dilemma, it was very true because there was a very different monetary system—the gold standard—and if US want to provide net liquidity to the rest of the world, it did have to run a current account deficit. The world we are living now is a very different one. The US can provide net liquidity to the rest of the world and have that liquidity provision be exactly offset, if not more than offset, by private investors going the other way. So that the US is having a current account balance or even surplus. So in a world without gold standard and with an integrated financial market, even the dominant currency does not need to run a current account deficit. Certainly the US has used its exorbitant privilege. From the view of the US policy makers, they say it is not their fault, it is the fault of the rest of the world. Whatever the reason, the US didn't have to run a current account deficit and if anything, in the last 3 or 4 years since the global financial crisis, the US current account deficit has shrunk very sharply while dollar has become even more important as the dominant reserve currency in the world system. So if the fear is that RMB becoming a reserve currency will require the Chinese current account position to flip dramatically, that is not the case.

At this stage, it is useful to pause a little bit and to think about where China is on its way to reserve currency status. Because the criteria I just laid about—open capital account, flexible exchange rate, well-developed financial markets and macroeconomic stability—China does not meet these criteria yet. Yes, China is making progress in each of these dimensions: the capital account is becoming more open in de facto terms and de jure terms; the exchange rate is becoming more flexible and financial markets are becoming better, although very slowly; and yet, RMB has already become a reserve currency. This is remarkable without historical precedents at least in the recent history that a country can attain reserve currency status without fulfilling the criteria. There are many countries in the world like Chili in Latin America, Nigeria in Africa and Asian economies including Korea Malaysia, Thailand and Japan all indicated that they already held or planned to hold a certain part of the reserve portfolio in RMB. Many people have argued that this means RMB is on its way to becoming dominant reserve currency because even without meeting the criteria, RMB has already served as a reserve currency. So maybe when China meets these prerequisites, it is going to take over. I am going to have a different interpretation for that.

Before that, I will introduce another concept. Bur first I want to talk about one dimension I mentioned earlier about the CAL which I see as a prerequisite for RMB to become a really liberate currency. Capital account liberalization is a very important topic because there are many countries which have opened their capital account and then paid a big price for it. Many of these, including economies in Asia, have faced with disasters because they did not liberalize their capital account the right way or did not sequence the reform the right way. So it is worth stopping to think what the risks are in China's path to a more open current account.

Let's first think about the benefits of opening current account: one traditional benefit of opening up capital account is getting capital. This, according to the neo-classical growth model is supposed to facilitate the welfare improvements of both the sender and the receiver of the capital. Because it is logically and actually true that capital to output ratio is much lower in the developing and emerging market economies, so it makes sense for the rich economies to send capital into the poorer economies, which can then invest more and grow faster. It is true, however, that countries opening up their capital account 100% face troubles and it is in some of my work that I find a very curious pattern. We know that China has a very long period of high growth without running a current account deficit. If anything, China has been exporting capital instead of importing it. We found it consistently to be true that developing and emerging market countries running small current account surpluses grow faster, which is very odd. Because if you send capital out when you have large investment need domestically, what is going on? And one of the reasons for one to argue is that the financial systems are not capable of absorbing or intermediating the domestic savings effectively. So if you try to push foreign savings through that system, you can end up with disaster. Then the question becomes a sequence one: should you get your financial system working well before opening the capital account? So here is some work I did with [inaudible] which took a very different perspective because around the world, there seems to be a notion that if you open up the capital inflows and outflows, you are subject to capital flow volatility and can have crisis, so why bother? Yet if you look at countries like China and India, most of the emerging market are opening their capital account day by day. Why are they doing this? We argued that there is a good framework to think about this. We call this collateral or indirect benefits of financial market opening—it is not the money, but what comes with the money important. China provides a perfect example of it. If you think about China's opening up to foreign direct investment, it is not that China needed the money, but with the foreign direct investment came a lot of other good things. There came technological and management expertise, there came sorts of businesses, all of which have helped in terms of increasing productivity in Chinese manufacturing in foreign-invested firms. And the benefits spread broadly across China's manufacturing. We see this even in the financial sector. If one thinks about what China did in 2006 and 2007—to bring in the foreign strategic investors into the Chinese banks. It is a perfect example. The foreign strategic investors are allowed to have limited stakes up to 25% in the domestic banks, so it is not a controlling stake. The idea is the 25% (or 10% for a single institution) will give foreign institutions a seat aboard and that will generate improvements in corporate governance in those banks, and also give foreign investors incentives to improve risk management capacity. In retrospect, inviting American and European banks to improve risk management in Chinese banks is not such a good idea. But the concept is exactly right: bringing in foreign expertise in order to do things better for you economy. In terms of financial market development both in theory and in practice, the capital account opening can be a very good catalyst for financial sector reforms. In my own country India, opening up the equity market to foreign investors and institutions has been very effective in terms of improving the trading infrastructure in those markets, creating new products, providing liquidity in those markets. Certainly, having more foreign investors playing a bigger role means more volatility in those markets, but it is a relatively sensible price to pay for having a much better financial mediation system, and a broader set of financial market. In addition you get not just technical expertise but also regulatory expertise because many of the banks come in with auditing practices, corporate finance practices that can lead to improvements in these dimensions even domestically. In addition, CAL can provide diversification opportunities, so that domestic investors don't have to rely either on the banking system or a very volatile stock market. And this sort of thing is admittedly very important in terms of catalyzing domestic financial market reform. So opening up the capital account is not the answer to getting financial markets right in China, but creates a momentum. Because if you have domestic investors having the ability to diversify abroad, that will improve the welfare. In addition, it creates competition for the domestic banking system and competition, even in China, is a very powerful force for change. So I think the notion of CAL as a catalyst for domestic reform is actually crucial.

Then the risks. There are definitely risks to CAL and in some of my own work, I argued that the literature and experiences of many countries do point to one particular sequencing that is important: doing CAL while having a tightly managed exchange rate can potentially lead to problems. I think in China these reforms are going hand in hand, so it is less of a concern. But it is certainly true that trying to maintain a tightly managed exchange rate while the capital account becomes more and more open is going to harder, and there are concerns that there could be risks in the financial system if you have capital outflows being relatively [inaudible]. In China's case I think capital account in terms of outflow is already quite open, that individuals can take 50,000 dollars out a year and I understand that if for travel and other reasons the restrictions are even less binding. So could there be a risk of capital flows? In fact, this is a very topical issue right now because there seem to be a notion of capital account outflow and it may suggest concerns, even panic about China's financial system. My interpretation is quite different. I think it is exactly what you expect and want in a maturing economy in terms of capital account opening and financial market development. And if you think about the sheer diversification motive, it makes perfect sense for some money to be flowing out the economy at this time. There are of course other reasons like the corruption crackdown, but the fundamentals I think is still in the right direction. I think arguments about this leading to a cascading panic in the financial system is sort of unlikely, especially given China has a fairly high level of protection through its foreign exchange reserves and a low level of external debt. So as one thinks about RMB internationalization and RMB becoming a reserve currency, the right way to think of it is not an end in itself, but a very important organizing framework for domestic reforms. Having RMB as a major reserve currency whose importance in international finance matches of that of China's economy will provide a lot of political support for doing what needs to be done domestically. And what needs to be done domestically in order for RMB to become an international currency are better, deeper and well-regulated financial markets, foreign exchange flexibility and a better macro policy framework. I am not taking about RMB internationalization, but talking about what China needs to do in order to have balanced development: it will be this list plus a few other things. But I think what is really important to keep in mind of this debate that all of these will benefit China in many important ways in terms of improving its growth model which is "rebalancing" and making growth more sustainable. So when we think about RMB internationalization, rather than just evaluating how much trade settlements are taking place in

RMB and how fast the growth of RMB deposit is, it is also useful to think about how much progress is being made domestically in terms of getting economic [inaudible]

I want to think about 2 aspects in terms of international implications: the first is how important RMB will be as a reserve currency, and the second is what implications other reserve currencies will have. But there is an interesting issue related to the second issue which is this fraught question about whether the RMB will become part of IMF's SDR Basket this year. IMF has a SDR Basket with four major currencies: the US dollar, Euro, Japanese yen and pound sterling and there is a question about whether RMB should be part of it. In order to become part of the SDR basket, the traditional criteria was a convertible currency with completely open capital account—China does not have that yet. It turns out that in 2011 under pressure from Nicolas Sarkozy, the then president of France, there was a move to bring the RMB into the SDR basket earlier, and the SDR basket composition is reviewed once every five years typically, and the review is coming this year, so back then Sarkozy was pushing for this to happen in the 2015 review and in 2011, IMF modified its criteria for the SDR basket. These were the criteria laid down: volume of transactions in fx spot markets; volume of transactions in fx derivatives markets and OTC derivatives; existence of appropriate market-based interest rate instrument; currency held in official reserve portfolios. The interesting is, except for the third one, all the others are criteria with no clear [inaudible] threshold, and China already meets them at some level. China is playing a very important role in international finance: it is accounting for the arising volume of transactions in the spot markets and some less [inaudible] markets. It is already been held—as I mentioned before—as a reserve currency. China does not yet have a market-based interest rate instrument but Governor Zhou has already told us that deposit rate is going to be fully liberalized this year so China will meet that criteria as well. So in replacing the notion of "convertible currency"—a notion put forward by IMF—for "freely usable currency"—one that is widely used in trade and financial transactions. So this is going to become a political decision: does China meet the benchmarks that are required to become part of a SDR Basket? And although I am an academic and shouldn't be making bets, my bet is that it is going to happen. Why? Because—as I put it in my book—it is not that China needs the IMF, but the IMF needs China. To make China feel more vested in the structure of International Monetary Fund. Governance reforms have been blocked largely because the US' congress. I think it is important that China be drown more in to the [inaudible]. So I anticipate that we will see a very significant shift. Then again, this is going to be something unprecedented, for a country that does not have a convertible currency become part of SDR Basket. If it doesn't happen this year, I think IMF will put forward its next review by 2 or 3 years and will happen fairly soon after 2015.

At this stage I would like to introduce another concept which is very important for thinking the landscape of international finance. We have talked about international currency, reserve currency and then there is the notion of safe haven currency. Although China will become a reserve currency before meeting the criteria, I think the safe haven currency is where things will stop. The reason is: for a safe haven currency, you need a lot more than the criteria that are identified in the literature. You need institutions, which mean an open, transparent democratic government, a trusted, independent central bank and an independent judiciary. Why do all of these matter? Here, the question I asked in the book was—actually when I started to write this book, this is not what I intended to write—I planned to write a book summarizing my research about capital flows and all the funny things happening in international capital flows, and expected not many people would read this book. But when I started looking at the data, something remarkable coming out of it and that is what the story of this book turns out to be. As you know, the US was the center of the global financial crisis, and since then the US has issued huge amount of public debt and the Federal Reserve has pumped a lot of dollars into the global financial system. So you have a financial system that is imploding and you have a lot of dollars in the system. What will you expect to happen, that the dollar loses value and becomes less important as a global reserve currency? And what happened was exactly the opposite. If anything, the dollar becomes even more important, and we have seen this repeatedly every time in turmoil in any part of the world—in emerging markets, in Europe—this is a great paradox. If there is turmoil in the US itself, money comes into the US in search of safety. In 2013 there is a concern that the US might actually default its short term debt. This was just a power play between the congress and the administration, nobody believed the US would actually default its debt. But still, when there is a risk of default you will want to move some of the instruments, and interest rate and government debt will rise. What happened to the US interest rates? Oct 15th, 2013 was the D-Day when the US was going to hit the debt ceiling and the US would potentially default its debt for a short period. Between Sep 1st and Oct 15th, 2013 the yield on the 10-year US government bond did not rise but fell by about 20 base points. "Oh my god, bad things are going to happen. The US will default. I'd better go for safety. Where do I go for safety? I go into US bonds. " it points to one very important thing that happened after the financial crisis. The economists like to think about most things as simple as supply and demand, and I think this story just comes down to supply and demand of financial safe assets, which are typically government bonds. After the financial crisis, the demand for financial safe assets has skyrocketed: private investors wanted safety, emerging market central banks want more foreign exchange reserves, and you have many other financial institutions being asked to hold more financial safe assets. But the supply has shrunk. Japan doesn't want money coming into its economy; Europe, as we know, is not what it used to be. So if you put all those together, the demand for safe assets is rising while the supply is shrinking, and who is left to make the difference? The US is obliged to step into the breach. What is remarkable is that when you look at the ownership of the net government debt of the major economies, the US stands up. So this is publicly traded debt which stands about 10.3 trillion dollars for the US. And the publicly traded debt excludes the amount held by the Federal Reserve and other parts of the US government. Nearly 60% of that debt is held by foreign investors. This should make US in principle vulnerable and foreign investors feel very scared. Because if the US decides to generate a burst in inflation, all bond holders in the US are going to get hurt while foreign investors will get doubly hurt—they will lose the capital value of the bonds and they will lose some of the depreciation of the currency relative to the dollar. Yet if you look at the financing, even during the peak crisis years when the US is issuing so much debt, foreign investors are coming in increasing amounts. Since the end of 2007, the amount of privately held debt in the US has increased by 6 trillion dollars. Foreign investors, including foreign central banks, has purchased 3.7 trillion or 60% of this in the country that is issuing in absolute amount the largest increase of public debt. Huge amount of dollars has been printed. What is going on? Here I argue that the institution of the US is very important. When you think about domestic holders of the debt, they are retirees living in Florida and other swing states, they have a lot of political power. So the likelihood that US will default on its debt is very small, because it will be a very big political price for the government to pay. What is the possibility for the US government says: "okay, I will not stiff my investors, but I simply will not pay back China some of its debt." This is where independent judiciary becomes important because there are laws in the US that it cannot discriminate among different classes of its bond holders. So the US cannot treat the Chinese government differently from other classes of bond holders. This is very important in terms of giving the foreign investors the sense that they are going to be treated evenly and fairly because of the independent judiciary and because there is an [inaudible] system of checks and balance in the US government, it will prevent the US government from going crazy with its policies. So all of these are very important when one thinks about the dollar dominance. The four characteristics here were once identified as crucial for the dominant reserve currency: you need size, financial market depth…but many have argued: yes, these were important back in the 1940s or 1950s—depending on which historian you believe—when the US dollar all of a sudden took over the lead position from the British bond. If the RMB is to be a serious challenger of the US dollar's supremacy, it will need not just financial market and economic reforms, but a much broader range of institutional reforms. When one thinks about the global landscape, I sense that the dollar's role as a unit of account in medium of exchange is going to decline over time. China is signing bilateral currency swap lines and also bilateral trade treaties with a number of countries like Korea and Japan where settlements can be undertaken with RMB and local currencies rather than going to the dollar. As China's financial markets develop, the cause of trading in RMB is going to decline as you have more RMB liquidity offshore, trading in RMB will become a lot easier. But without institutional changes in China, my sense is that the dollar will remain as the dominant store of value. So if you think about safe havens around the world, my sense is that these institution characteristics are really important, and the dollar for now is going to remain the ultimate safe haven currency.

So let me conclude with what I believe lies ahead of RMB. Almost certainly RMB is on its way to being a widely-used international currency which is happening with every passing day. My sense is that at the time of the next review of the SDR basket which will happen at the end of this year, it will be hard to resist making RMB part of the SDR basket. Especially if China continues to deliver reforms like interest rate liberalization, and the widening of the band of the RMB around the dollar. The RMB can be a viable reserve currency in the next decade if reforms in financial market continue, and if you have capital account opening and broader economic reforms continuing without too much stumbling. But if one thinks about what this implies to the global monetary system, my sense is that even if RMB becomes a reserve currency, it will to some extend erode but not ultimately displace dollar's dominant role in global finance. This is not a statement about US exceptionalism or saying that the US economy or financial market are the best in the world. But in international finance, everything is relative. Until the rest of the world can get it [inaudible] together, until you have better financial markets in the emerging market economies so that they don't need to cumulate more reserves, until we have a better international monetary system, I think they are pretty much stuck for now in the dollar trap.

Qi Ye: Well thank you very much Professor Prasad and thank you for your insights. Let me invite Professor Qian and Professor Yu come over to here. Before I ask two professor to make their comment, like me just mention that the professor Prasad's book, he has been translated into Chinese and will be laid out here in the summer. I believe and hope we can have some copies to get read and to hold a similar event here for more discussion. I have also mentioned that with us tonight, my colleague professor Gao. He is the professor in this school and while he was doing research in the University of Cambridge, he did very interesting research on RMB internationalization forecasting scenario analysis. So I will reserve the first question for Professor. Gao later on. But first, I want to invite professor Qian. I do want to mention that since we have friends from the media this is a public event and everything we say here is on record. Please make sure do not take the quote out of the context. We recognized professor Qian, and he is a scholar, he is a Dean and at the same time, he is the member of People's Bank of China Monetary Policy Committee, so we do not want to make any confusion here, right? Thank you professor Qian.

Qian Yingyi: Well, I have seen people media in the first row. I am wearing many hats but tonight I only wear one hat: I am an economist and scholar here. I am not being the member of the monetary policy committee in this contact and I want to make sure that I am just a scholar who wants to make some comments from some experts like Eswar Prasad. I want to start saying that this is a very rich presentation, lecture and very up to date. I learn about from this, it laid down a framework to think about the very complex issue of internationalization of RMB, which is an extremely important for China, but also has a huge implication for the rest of the world.

Let's start from the last slide, I think it provided much issue which makes a lot of sense to think about the road map. I think I share very much about the assessment I think the first one: On way to being widely-used international currency is already happening. This is a necessity when an economy as large as the Chinese economy. This is transaction. So it is very natural. I think it is an analysis for the second one. I am not sure that you all get the details of SDR, special drawing rights of IMF. Currently it has four currencies: US dollars, Euro, Pound and Japanese Yen. So, then when and likely Chinese Yuan became an addition to SDR and his analysis is that probably will be this year. This is your assessment. What is interesting is that, it describes the process, but itself is quite interesting because if you look at the original requirements, China seems to be quite far away from that. However, he just told us the story that in 2011, under the push of French president, they pursued an approach that is very pragmatic, that is not look at a book what are the rules, but rather look at the function of the markets or the practical function. So this is full criterion. The transaction foreign exchange market, derivative transactions over the counter. The third is marker-based interest rate and the fourth is the currency official reserve. If you look at that list, as he just mentioned, China actually met all except the third which is market-based interest rate. If that is the case then it is quite possible that the interest rate will liberalize in China. We just learned that last week from Governor Zhou. It is quite possible by the end of this year,. Well, I still remember that a year ago this time in 2014 people's congress, that Governor Zhou said that within two year that China will liberalize the interest rate during the news conference. Not many people believe that actually. In fact he was the only governor official that set the agenda, schedule for the reform, a very specific area in this case is interest liberalization. But by now, we know that on the lending side interest rate was already liberalized, on the deposit side that through several small steps of reforms, that the band of the deposal rate cap, increase from one times the regulated rate to one point one times to one point two times and now to one point three times. It happened without much of the impact for the reason is that it was down at the time of low interest rate. Because when you cut interest rate by 25 base points and then increase the band from 1.2 or 1.3. You do not feel that. You know I also made this argument last week, that if now there is a downward pressure on inflation which is happening worldwide and also happening in China, then that will provide opportunities for reforms. That is for further interest rate liberalization, it is very hard to think in the high inflation environment you could liberalize interest rate without much pay. But in the environment that you do not have pressure on the inflation or you have a downward pressure that is you have to worry about deflation. Of course, China is not in the stage of deflation yet. I have to be very clear because sometimes our reporters often misquote me. We are not in the deflation stage yet, we are in the low inflation about 1% to 2%. You don't have this inflation pressure, but you do have the tendency that inflation is going down, then just want to restore the real interest rate you want to cut interest rate, just for that purpose. You are not changing monetary policy but wanting to keep the neutrality of the real interest rate and at the same time you can relax this band. So interest rate liberalization is very real and possible this year. So if that happens this year, then SDR, the third condition will be met. So we will not be surprised to what Eswar predicts that Chinese currency will be added to SDR.

I think the Eswar utilized a lot of literatures in the economics and lay down a lot of condition. For example, I found the distinction between the notions of reserved currency and safe haven currency. It is very important. I think that for Chinese currency becomes reserved currency is one issue; and he pointed out to become a safe haven currency is a different issue. The safe haven currency goes beyond economic and financial rationale. It has much more content involving trust, even politics, a lot of things inside. So, that's distinction I found is very useful to think about the internationalization of Chinese currency.

Just want to make one last comment, the general comment about his analysis. We have accumulated a lot of examples and cases that were displayed by his analysis: you mentioned many other countries. But there is one thing I think we have not seen before is that China is so large. I think within ten or fifteen years, it's possible, I am not saying it is definite, it's very likely China will overtake the US as the NO.1 economy in the world. It's possible within ten to fifteen years. We believe that (it has already been so) in PPP. IMF and WB have claimed that in the last year. If you do not believe in PPP, let's look at the exchange rate based calculation. It's possible. At the last time a big country emerged, it was Japan. And Japan's population was only one tenth of that of China, so I think small countries you have all those criteria, all theories, all models that mainly based on the previous data. That mostly involves smaller countries. Ok you have settled, for example, when you say A and B are necessary for C, you make a lot of statements. They all think our models are based on observations of the past, but all these cases are small. The largest country was Japan, of course US was a different story. Therefore, in addition I think China has another feature that probably, when we think about all these risks, and you have already pointed out you want to emphasize that Chinese saving rates is so high, China is a net exporting capital country, last year inward foreign direct investment is $120 billion and outward foreign direct investment is already over $100 billion. I won't be surprised that this year the two will be on parallel or even the outward foreign direct investment, I mean direct foreign investment, because this is often a confusion that some people say that last year was the first year of China exporting capital. That's wrong, China has been exporting capital for many years but could be this year that the outward foreign direct investment—investment from China to the rest of the world—could be bigger than inward foreign capital investment. There is a good reason for that because the capital needs global allocation, it doesn't make sense for all the savings that Chinese domestic statement concentrated on the domestic market. And huge savings, the saving rate is so high. China is still a exporting capital country, plus there is near $4 trillion foreign reserves, I agree with Eswar that there are a lot of protections in that. But my point is that understanding of all this international finance based on the past experience and past observation of many countries, most of which are small. We thought there were a lot of data points. But the rise of China's economy is so big and it's possible for China to overtake the US to become the largest economy in the world, in ten to fifteen years. This is fact No.1. No.2, China has a huge saving rate which means a lot of capital can flow in and out. And the third is that Chinese economy is so integrated with the rest of the world. All these fact, I see that in the previous case of Japan to a much less degree. So therefore, a lot of understand of the rules in the past, using the example we just give for SDR, probably could change because of it. We have already seen one example. So, therefore, when we look forward for the next decade, a lot things will happen, and I do believe that will see a whole of the law of economic finance and a lot of institutional details in rules probably will be adjusted for that purpose. So that's the point I want to make. In the end, I think internationalization of RMB is inevitable; however, the distinction between reserved currency and safe haven currency reserves. I think it will prevail for a long time. So, that's my comment.

Qi Ye: Thank you very much for sharing your insights with us, Professor Qian. Let me also next invite Professor Yu Qiao to make his comments. I also want to mention that Professor Yu Qiao not only is a professor here, School of Public Policy and Management, he is also affiliated with us at the Brookings Institution as a nonresident senior fellow and serving at the Academic Advising Committee to the Brookings-Tsinghua Center for Public Policy. Professor Yu, please.

Yu Qiao: Thank you, Professor Qi. Mr. Prasad's speech was quite informative and he also made some feasible suggestions. I would like to make one comment first. What is the incentive for Chinese government to make Renminbi internationalize? What is the attitude of authority power in this government towards the internationalization of Renminbi? I think these are very important, incentives, attitudes, and impact on the rest of the world. We can observe that there are three strategies right now in China, one is "Yi Dai Yi Lu"（一带一路）initiatives of 21st century silk road, the second one is to make Shanghai the international financial center, the third one is internationalization of Renminbi. I don't know which one is the first priority of the three strategies. I assume the first one ranks the first, and the second one, to make Shanghai the international financial center, is number two, and the internationalization of Renminbi is at the bottom in my observation. The second comment I want to make is the currency in terms of the internationalization. There are different divisions of internationalization of one currency. One kind is this, you can call this currency "internationalized currency" if non-residents can use this currency to conduct any kinds of transactions. This is what we can observe in this world, and it is a satisfied category, internationalized currency, for example, Swiss Francs. If you fully open bank account, you are qualified to be internationalized currency. The second category is transacting currency. Transacting currency means this currency is legal to facilitate any kinds of transactions, first of all is trade transactions. So if you are qualified as vehicle currency then you can facilitate any kinds of transactions, trade transactions and financial transactions, you are called vehicle currency or transacting currency. The third one is reserve currency. I think according to the differences of the countries, there must be internationalized currency first, and then to transacting currency. But China's experience is unprecedented. It's not fully convertible currency but right now it's partially performing as transacting currency especially in merchandise transactions. This is an interesting phenomenon that needs further study, because this is totally different from past experiences of other currencies.

And in terms of safe haven currency there are three conditions that must be satisfied. Number one, your economy must be big enough. In terms of economic size, in terms of international trade, it seems that China is roughly qualified. The second one is your financial market as pointed out by Eswar. This is dilemma, we want to do it first, because we know that when Renminbi is internationalized to be transacting currency, this is called irreversible IOUs. That means the foreign holders, the non-resident holders of Renminbi, they can buy any kinds of things available in China's market. This requires China to open the capital market fully but it seems a dilemma. I think the dilemma is not laid down on technical issues, but it is laid down on the trust, domestically and internationally. If Renminbi is used as an international currency, and the foreign owners of Renminbi, that means the non-resident holders of Renminbi, can buy any kinds of products in China, you can imagine what would happen. If Renminbi fully opened, we can imagine there are two possibilities, or two kinds of high risks. Number one is capital fly, and there are lots of reasons for capital fly for residents, many residents like rich people, even government officials, they will immediately ship out their assets to foreign countries. This is very serious. According to Transparency International, in the past decade the illegal out fly of Chinese assets is over trillion U.S. dollars, I don't know whether this number is accurate or not, but it is huge. Among the trust, is due to international trust of state governments, there are also a lot of risks called speculative attack. We can recall the Asian financial crisis; China is averted from speculative attacks. Apparently other currencies, for example, are Thailand Baht, Malaysia Ringgit, and South Korea Won. China was very lucky. But if we think about China's capital account fully opens, what would open? It seems to me, and many researchers, the Chinese government lack ability and capacity to manage speculative attacks. The only way it can do is to close again the capital account. This is the experience by Malaysia. Think about Malaysia in 1998. There was speculative attack and there was nothing the Malaysian government can do but to close the capital account. So this is a very big setback. So this dilemma is very difficult to be solved. The third one is trust, trust relating to the legal system as Eswar pointed out. The legal system should be binding, it's not intervened by administrative body. So it should have a binding protection of property rights, so that people can be free from any fear that their properties be taken away by the government. So this is a serious challenge we meet, it's a significant challenge we're faced for the internationalization of Renminbi.

And also there are some typical challenges. For example as we know that the Chinese government has many initiatives of currency swaps with over 20 countries, so that means there are some arbitrage of Renminbi. Think about the current depreciation of Russian ruble, when Russian ruble depreciate against U.S. dollars by over 100%, some smart guys speculate U.S. dollars could buy, for example some commodities in Russia, and export to China. As an intermediary between Russian ruble and Chinese Renminbi they can easily reap over 100% profit. So how can China manage this kind of risks, speculative risks, by Chinese Renminbi when compared with major currencies? A lot of this is interest rate difference. Think about the U.S. federal reserve, just a couple of years ago, the federal reserve is an issue of statement declared. But upon this year it will exit and their interest rates go up, and there will have a big impact on China's market, as well as the relating markets, how China can manage all this? There is a big difference in interest rates between China and the outside world, so how can China manage this type of issues? I think this is very, very difficult. The third one is, in recent decades, China enjoys a large amount of trade surplus, so when China enjoys a huge amount of trade surplus, how China can provide Renminbi to foreigners? It is very, very difficult for people to resolve this problem.

So this is my general comments. I think this is an unprecedented experience for the internationalization of Renminbi. We cannot simply use other countries' experiences to guide the path of Renminbi's internationalization. This is what would happen next. Thank you.

Qi Ye: Thank you very much. I would like to ask Mr. Prasad to make a quick response.

Eswar Prasad: So let me thank Professor Qian Yingyi and Professor Yu Qiao for their very pertinent and insightful comments, most of which I agree with. It's a very pertinent point that the previous experiences of other countries are somewhat less relevant to China. They cannot escape all the rules of economics in China but China is certainly bending certain rules of economics. I think the size issue is certainly important, and the size itself is not going to be enough for the sheer importance of China, in terms of the world economy, in terms of the world trade and finance. It means that the criteria that Renminbi has to fulfill to become an internationalized currency are very different from what other countries have to fulfill. The second point is I am very encouraged when I wrote a book and I can talk about institutional reform, legal reform, governance reform, I anticipated that I would receive a very strong pushback in China but I am encouraged that when I talked about these issues in China many senior academic experts and policy makers seem to sign on to the notion that this is ultimately going to be important for China's own development. And the only people who complained about the title of my book *The Dollar Trap* happened to be the U.S. officials, they said, "you know, you made it like we set up a trap and the world came into it, but it is the world that came into it, it isn't our fault." But I am glad that in China it is beginning to be this discussion about the broader institutional reforms. And the third issue is again the incentives and why China is doing this, the key issue as Professor Yu Qiao mentioned is that this is an inevitable thing that is going to happen as China plays a bigger role. The question is not that not to prevent it from happening or not to help it from happening, but really how to use the process to most effectively achieve China's own domestic objectives. And this is why I think connecting the internationalization process to the domestic reform process especially in the context of financial market reforms but also broader reforms is really the key issue.