INTERNATIONALIZING LIKE CHINA

CHRISTOPHER CLAYTON, AMANDA DOS SANTOS, MATTEO MAGGIORI, JESSE SCHREGER

BUILDING AN INTERNATIONAL CURRENCY

The Global Capital Allocation Project has released a new paper ***"Internationalizing Like China"*** that empirically characterizes how China is internationalizing the Renminbi by selectively opening up its domestic bond market to foreign investors and propose a dynamic reputation model to explain this internationalization strategy.

With the third largest domestic bond market in the world behind the United States and the European Union, China is often described as a possible future international currency provider (***Fig. 1***). However, unlike the U.S. and E.U. bond markets, the Chinese bond market has been largely closed to foreign investors, severely limiting the use of the Chinese Renminbi as an international currency. Over the last decade, that has begun to change and China has progressively opened its domestic bond market to foreign investment. While the internationalization process is in its early stages, the size of the market and the ongoing opening-up process makes the evolution of China's bond market an important dynamic at the core of the international monetary system.

China is opening-up its domestic bond market to foreign investors. With the third largest bond market in the world, this is potentially a large shock to the supply of investable assets for the rest of the world. Open question whether these assets will turn out to be safe.

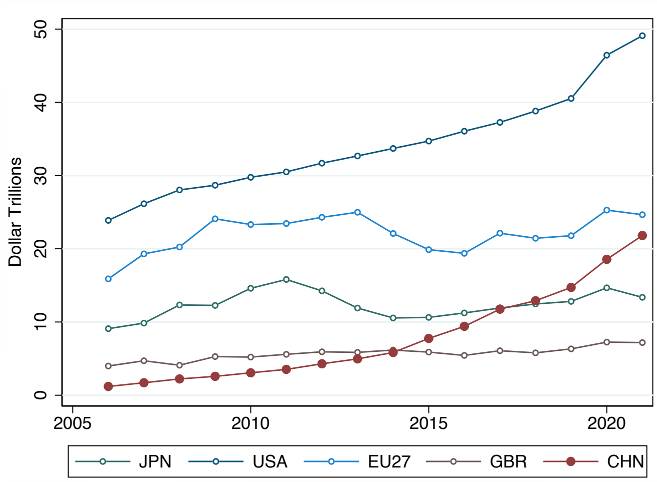


Fig. 1. Size of Domestic Bond Market. Notional Outstanding. Source: BIS

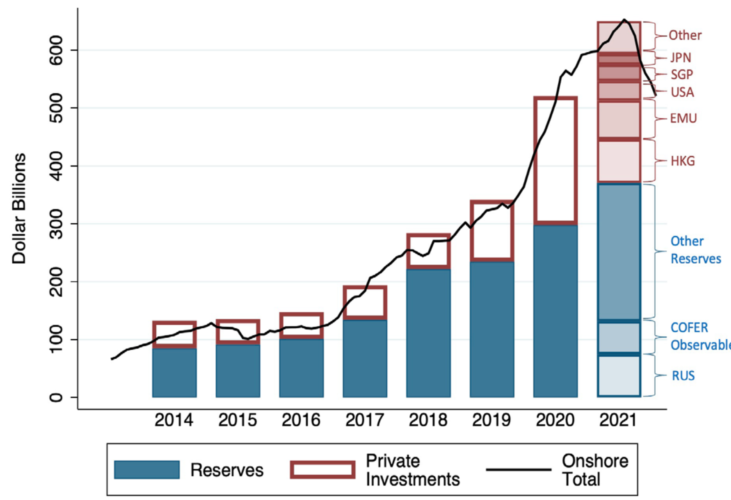
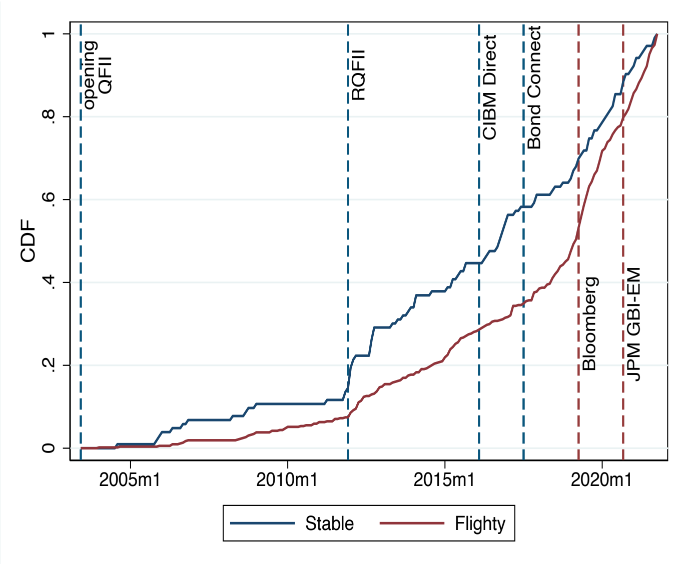


Fig. 2. Foreign Ownership of China-issued RMB Bonds

EXECUTIVE SUMMARY

- **Who Owns China's Renminbi Debt:** early buyers of China RMB debt onshore were mostly official foreign investors. The Central Bank of Russia is the largest known holder. In recent years private investors have entered the market from a broad set of countries, with the US and EMU investors the most prominent.
- **Reputation Building:** the Chinese government has adopted a gradual strategy of building a foreign investor base. Letting in more foreign investors helps build reputation in global markets, but risks a more severe capital flight.
- **Measuring Reputation:** we measure China's reputation in global markets by analyzing the portfolios of global funds. We find China's reputation is in between those of typical developed and emerging markets.
- **Competing to be an International Currency:** competition from existing reserve currency providers, like the US, can discourage new entrats like China from building up reputation. Building reputation is very hard and most countries get stuck at low reputation.

Fig. 3. Tracking Investors Entry into China's Bond Market



Tracking the evolution of investor's entry in the Chinese bond market, *Fig. 3* shows the impact on the investor base of investor-access programs. It shows a striking difference between the entry pattern for the two types of investors, with Stable investors generally entering earlier in the sample period followed by a rapid increase in Flighty investors over the most recent years . The 2017 Bond Connect program targeted flightier private investors and was instrumental in the inclusion of Chinese bonds in major world bond indices.

TRACKING CHINA'S REPUTATION IN MARKETS

Measuring reputation in the data is a notoriously difficult problem. We build a dynamic reputation model and derive a simple sufficient statistic to track countries' reputation over time. It can be estimated in real-time using micro data on foreign investors' portfolios.

Intuitively, we track whether foreign investment funds that own Chinese RMB bonds are specialists in investing in emerging market or developed market bonds. Formally, we estimate at each point in time the correlation among investment funds between the share of the foreign portfolio invested in Chinese RMB bonds and the remaining share invested in a reference set of safe developed countries government bonds. A higher correlation points to a country's reputation closer to the reference set (countries of highest reputation).

In *Fig. 4* we illustrate the estimates for three currencies, the Brazilian Real (BRL) in Panel (a), the RMB in Panel (B), and the Japanese Yen (JPY) in Panel (c). It shows that RMB-denominated Chinese government bonds are held together with developed and emerging market government bonds in global portfolios, while Brazilian government bonds are mostly held by EM focused funds, and Japanese mostly held by DM focused funds.

This implies that, through the lenses of our model, China's reputation is in between emerging markets and developed countries. Analyzing the evolution over time we note that China has drifted upwards in recent years (*Fig. 5*).

SELECTING THE FOREIGN INVESTOR BASE

China built the investor base progressively, trading off letting more investors in to build its reputation in global markets with the risk of capital flight. Letting in foreign investors helps build reputation in global capital markets, but letting in too many foreign investors can be counterproductive by exacerbating crises as the investors pull out in times of stress (as occurred in 2022).

Fig. 2 shows the evolution of investor composition, public or private investors, as well as their geography. Russia is the largest known holder of official reserves in RMB. The private investor base is broad, with both Euro Area and the U.S investors featuring prominently.

We note that the Chinese government deliberately controlled the entry of foreign investors into its market, first allowing in relatively stable long-term investors like central banks before allowing in flightier investors like mutual funds.

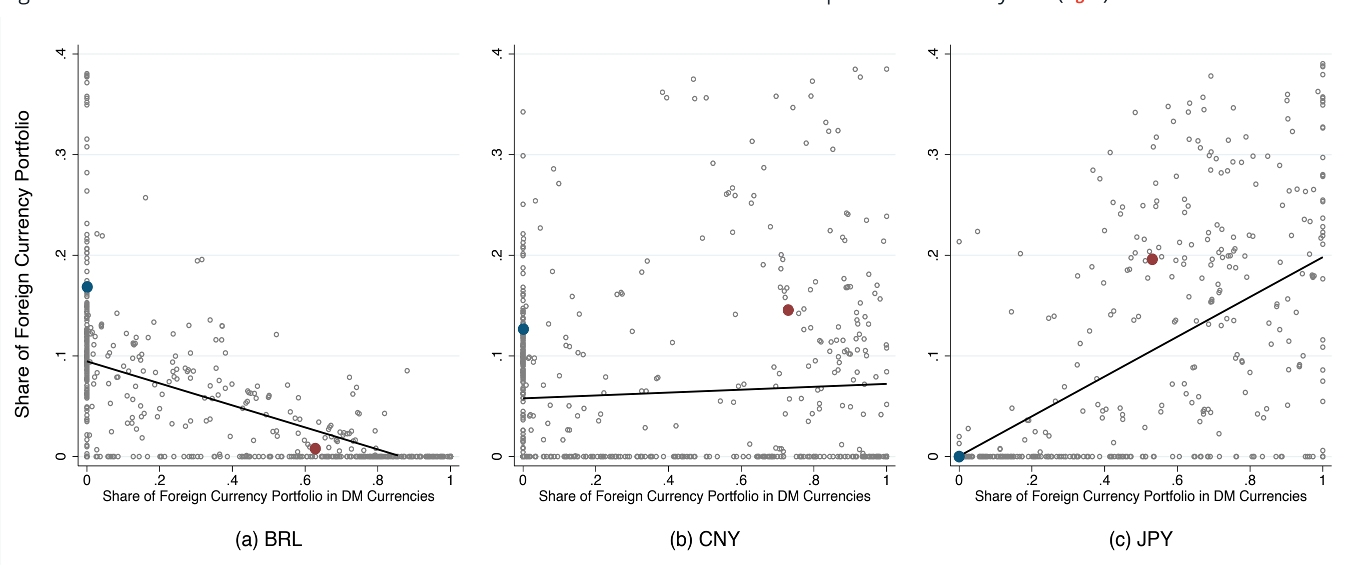
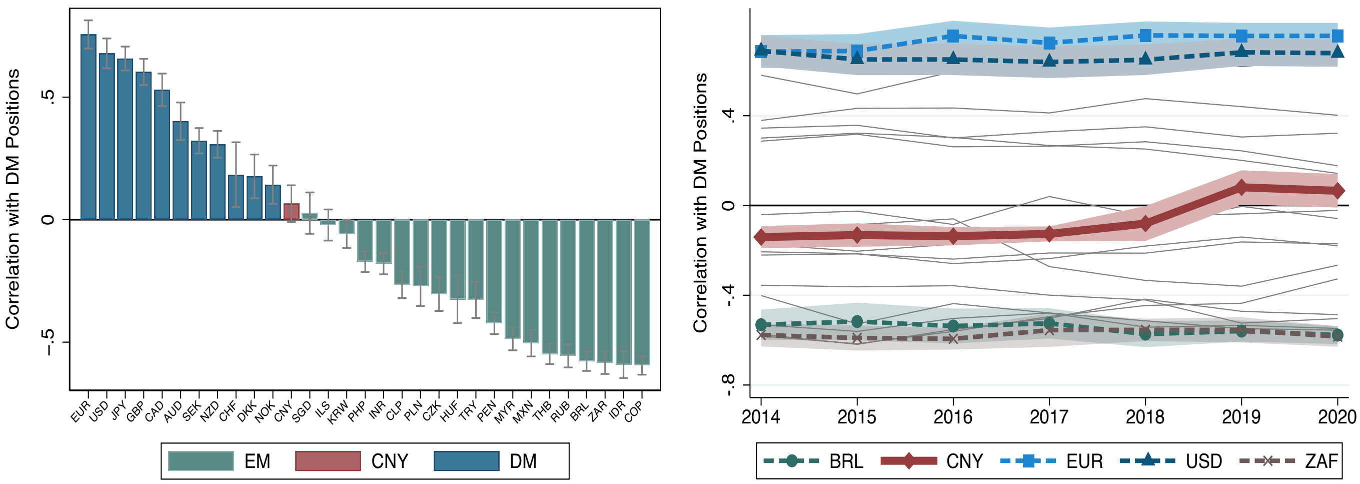


Fig. 4. Portfolio exposures through China

Fig. 5. Measuring Countries Reputation in Bond Markets



(a) Cross–Section of Estimates in 2020 (b) Time Series

COMPETITION WITH THE US

Establishing reputation as an international currency issuer, like the U.S., is a slow and arduous process. Throughout modern history, many would-be contenders, like Japan or the Eurozone, have failed to displace the dominance of the dollar. China's internationalization of it currency will not procced in a straightline.

Our work stresses the difficulty of building reputation as an international currency issuer. Most countries would like to be a reserve currency but in practice succumb to the temptation of short-run gains at the expense of foreign investors. They are endogenously stuck at a low level of reputation (*Fig. 6*).

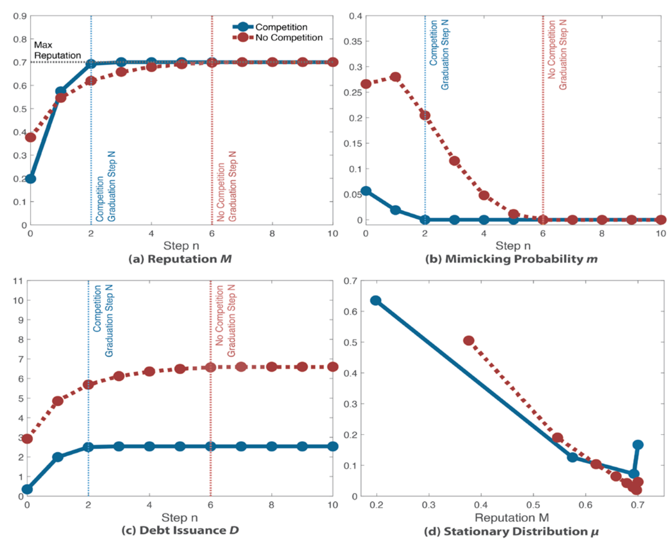
CHINA'S REPUTATION IN BOND MARKETS IS FAR BELOW THAT OF THE U.S. BUT ABOVE TYPICAL EMERGING ECONOMIES

Competition from established reserve currency issuer, like the US, can also deter an up and coming competitor like China by flooding the market with safe assets and satiating investor demand. The rents that accrues by having a very high reputation, its "exorbitant privilege", are what incentivizes new entrants to build reputation. Flooding the market, however, presents its own financial stability risks for the US.

TECHNICAL NOTES

This non-techinical brief summarizes research results in the working paper "Internationalizing Like China", available on our Lab ***website***. We refer interested readers to the paper for further technical details and lists of data sources.

Fig. 6. Competition and the Stationary Distribution



LEARN MORE

- The Global Capital Allocation Project is a research lab based at the Stanford University, Columbia University, and the University of Chicago.
- Our goal is to shed light on global capital flows in order to improve international macroeconomic policy.
- Please visit our website ***globalcapitalallocation.com*** for our research and estimates. Subscribe to our ***mailing list*** to receive updates and be the first to hear about new content. For media inquiries and technical questions, please email us at ***info@globalcapitalallocation.com***.