RENMINBI INTERNATIONALISATION AND THE IMPOSSIBLE TRINITY

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Executive Summary

1. China has had ambitious plans to internationalise the Renminbi (RMB) since the beginning of the 21st century and taken a series of steps over the past two decades and more particularly, since the global financial crisis of 2008.

2. Among the challenges facing China in internationalising the RMB are the constraints dictated by the "Impossible Trinity" that states that a country can only simultaneously achieve two of three policy objectives – an open capital account or free capital flows, a fixed exchange rate and an independent monetary policy. It is impossible to have all three simultaneously.

3. Therefore, China has to choose between the degree to which it liberalises its capital account and exchange rate regimes and the degree of monetary policy autonomy it wishes to maintain.

4. Monetary policy autonomy provides Chinese policymakers with an important lever to conduct effective macroeconomic management. However, this in turn determines the degree to which exchange rate flexibility along with a more open capital account can be maintained. The choice that China makes on all three aspects will impact the degree of RMB internationalisation.

5. China has moved from a closed capital account and fixed exchange rate to a much more open capital account and more flexible exchange rate in the last 20 years. Along with gradually deepening financial markets and its push to have more of its trade settled in RMB, this process has led to a gradual increase in the degree of RMB internationalisation.

6. China's future policies on the three aspects governed by the Impossible Trinity will continue to have important effects on the degree and speed of the further internationalisation of the RMB.

7. International investors' greater access to the Chinese markets and a more market-determined exchange rate are important issues to address before greater acceptance of the RMB as a global currency. China has been moving in this direction. However, its capital account is still not fully open and the authorities still have substantial ability to influence the evolution of the exchange rate.

8. China has learned valuable lessons from the experiences of other developing countries that were subject to economic volatility as a result of their policy choices on exchange rates, capital account openness and monetary policy autonomy.

9. Given the various economic issues facing China, the current policy choice of an "intermediate" policy regime with partial progress on exchange rate flexibility and capital account openness is potentially more attractive than a "corner" solution of a fully flexible exchange rate and/or a fully open capital account.