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Adaptations within the Financial Market in China after Global Financial Crisis

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Abstract: *The purpose of this paper is to present the evolutionary changes occurring in the financial market of China, which were catalysed by the turmoil in the global financial market. These changes were the outcome of anti-crisis measures in macroeconomics policy undertaken at the beginning of the crisis; they were also a response to the quantitative easing policy in the USA and in the Euro Zone (i.e. an increased money supply also reaching the financial market in China). With the currently binding system of currency exchange (managed floating exchange rate), China's policy towards capital movement, on the one hand, is an attempt to maximise the benefits of the inflow of foreign capital, whilst, on the other – to minimise the risk related to the sudden changes in the direction of the flow of capital. The consequence of such an approach is the strategy of gradual liberalisation of capital account, accompanied by the significant involvement of the state in the financial market. Some specific solutions applied to this matter, that are discussed in the paper, point to the specifics of such a strategy. The liberalisation of the national capital market was preceded by the liberalisation of the offshore market (in*

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Hong Kong). Such a strategy allows China to take up measures directed at the internationalisation of their own currency without any significant opening of the capital account. This paper concentrates on a descriptive analysis of the above phenomenon.

Introduction

In the case of China, the global financial crisis revealed the hazardous character of reliance on the growth of the foreign part of aggregated demand. Undoubtedly, the definite reaction of economic policy allowed for the gap in demand, created by the external shock, to be closed, and thus the economic growth could be sustained (lower than before the crisis, yet still impressive). The applied policy of stimulating demand concentrated first of all, on boosting investments. The pace of growth was accelerated mainly due to the system of financing, traditionally based on state management of the movement of credit and most frequently targeted at state corporations. Financial intermediation, which the state was deeply involved with, resulted in the increase of the credit growth rate, which more and more frequently reached the unregulated banking sector. As it is generally known, this sector has almost unlimited possibilities for financing investments, including those of a speculative character. The activity of the unregulated banking sector in China's financial market found favourable conditions for its development. Institutionalised solutions existing within the financial market have a deeply rooted tradition connected with the presence of the state in the economy. This phenomenon concerns both policy with regards to currency exchange as well as opening up the economy to capital movements; the common effect of both is cumulated in the financial market. Since external conditions still have not been sending sufficiently strong stimuli concerning demand, China has to secure its internal demand. The structural changes already taking place in specific sectors of the financial market should not only facilitate this, but also prepare the market for the absorption of potential external shocks.

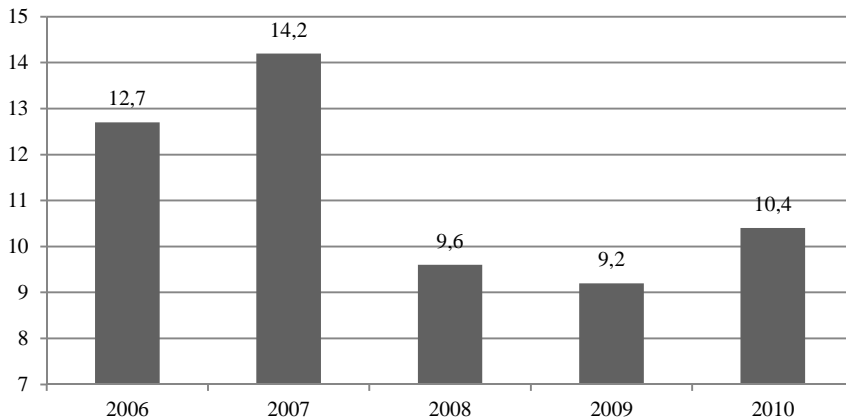
The purpose of the paper is to present the evolutionary changes occurring in the financial market of China, which were catalysed by the instability in the global financial market. The first part of the paper presents the effect of the global financial crisis on the Chinese economy and the anti-crisis measures adopted by the policy. The second part concentrates on the mutual relations between the exchange rate policy and the increased money supply which reaches the markets, also as a result of the quantitative easing policy in the USA and in the Euro Zone. The third part discusses specific solutions in the field of the liberalisation of capital movements,

with special emphasis on the role of the state in this aspect. The fourth part presents the characteristics of the unregulated banking sector, concentrating on the types of activity which pose the greatest threat to the Chinese economy. The fifth part is an attempt at assessing what scope Chinese currency may play in the role of an international currency; this part also presents an overview of the most important undertakings for the internationalisation of Yuan. This paper concentrates on a descriptive analysis of the above phenomenon.

China's Economy after the Turmoil in the Global Financial Market

China was affected relatively later by the financial crisis¹ (which started in the second half of 2007 in the market of mortgage loans in the USA). The turning point for China, as for the majority of countries of the South-Eastern Asia, was 15th September 2008, i.e. the bankruptcy of Lehman Brothers. These events contributed to a significant decrease of the GDP growth rate in 2008 and 2009 (Figure 1).

Figure 1. GDP growth rate in China in 2006–2010 (%)



Source: ADB (2013a, p.9).

¹ In the third stage of the crisis occurring at the end of 2008 and in the second half of 2009. For more extensive discussion of the specific stages of the financial crisis in South-Eastern-Asia – see BIS (2009).

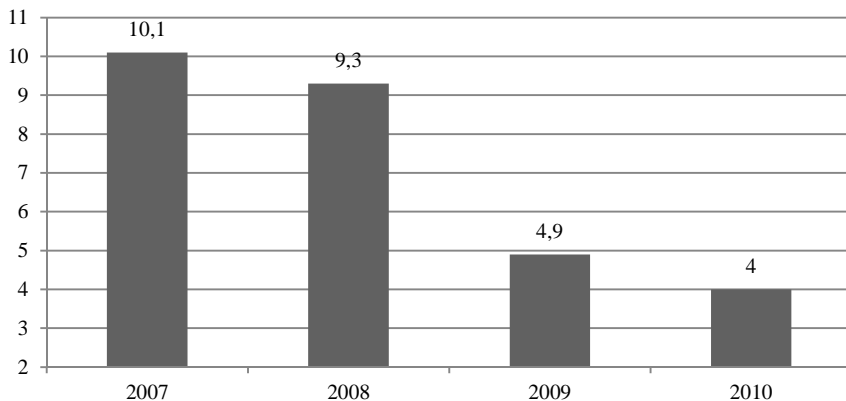
This was a cumulative effect in both changes in the financial area and in the area of the real economy. The relatively poor development of the financial market, and, first and foremost, the small involvement of the banking sector in structured securities (the originate to distribute model), efficiently limited the impact of the financial channel. This does not mean, however, that the financial crisis did not reach China through this channel at all. A few large state-owned Chinese banks were the creditors of American financial institutions connected with Lehman Brothers. After its bankruptcy and the financial panic that ensued, these banks sustained huge losses, yet their balances managed to avoid permanent adverse changes (Yueh, 2010, p. 8). Similarly to other countries in the region, the financial market in China (though to a much smaller degree) was affected by the suspension of the capital inflow (sudden stop), the withdrawal of investors from the market (flight to quality) and the drop in the stock market index (Table 1).

Table 1. China's capital market in reaction to the crisis

	2006	2007	2008	2009	2010
Market capitalisation of securities (%GDP)	89.4	178.2	61.8	100.3	80.3
Average growth rate of the main stock market index (%)	41.4	161.1	-27.7	-10.2	3.4

Source: ADB (2013c, p. 9).

Figure 2. Current account balance in China in 2007–2010 (% GDP)



Source: ADB (2013c, p. 8).

The trade channel was the most active channel through which the financial crisis reached China. China, with an economy strongly dependent on foreign markets (as a result of its export-led strategy), experienced a decrease in demand of imports; this was as a result of the decrease in economic activity in countries affected by the crisis. This phenomenon for the Chinese economy meant a sudden slump in exports and a decrease of the surplus in its current account balance (Figure 2).

It is worth observing that the Chinese economy had never before experienced such an acute and sudden drop in one of the elements of aggregated demand on which the strategy of its economic development was based. Additionally, China had never before been such an important element of the global economy. An economy in which the feedback loop increases the possibility of transmitting instabilities between its participants. Even in the preceding decade when other countries in Southeast Asia experienced one of the largest crises in their history (the Asian crisis in 1997–1998 had its epicentre in this region), the Chinese economy was significantly less affected (Table 2).

Table 2. The impact of the Asian crisis (1997–2000) and the global financial crisis (2007–2009) on the Chinese economy

Change in the currency exchange rate (in %)*		Change in the main stock market index (in %)		Change in the GDP growth rate (in % points)	
Asian crisis	Global financial crisis	Asian crisis	Global financial crisis	Asian crisis	Global financial crisis
0	12	-12	-71	-3,5	-6,5

* (+) maximum appreciation against USD

Source: BIS (2009, p. 17).

The differences in the reaction of the Chinese economy to the two above crises confirms its progressive integration with the global economy.

All the listed symptoms of the worsening economic situation and the fears of the effects of the financial panic justify the reaction of the economic policy at the end of September 2008. The measures, undertaken by China in reaction to the crisis, fit into the general schedule of solutions adopted at the same time by other countries within the region² (Table 3).

² The disputable issues created by the distinction of the anti-crisis measures into standard and non-standard, in particular in reference to emerging countries – are discussed in Wojtyna (2012, pp. 11–21).

Table 3. The measures adopted by China's economic policy in reaction to the crisis (September 2008)

Standard measures	Non-standard measures
Monetary policy	– liquidity assistance in local currency
– a decrease in interest rates	– liquidity assistance in foreign currency
– a decrease in required reserve ratios	– banks recapitalisation
	– support for assets prices
Fiscal policy	
– fiscal stimulus package	

Source: The author's own analysis on the basis of BIS (2009, pp. 50-62).

In comparison with other Asian countries, China can be distinguished by the size of its budgetary expenses within the fiscal package, amounting to 13% of GDP (for a period of 2 years), whereas the average amount of stimulus packages in other Asian countries was about 5% of GDP (Filardo, 2011, p. 14). First of all, this was expenditure on infrastructure, facilitating the employment of workers who had been made redundant in the export sector³. On the other hand, the package had to absorb the continually growing supply of workers (as a result of migration from rural areas to developing Chinese cities). The social part of that package made up less than its 5% and, from the point of view of the high level of savings in the households to be accommodated, was insufficient. In order to use these savings, in 2009 expenditure on healthcare was increased, covering 200 million uninsured citizens (Yueh, 2010, p. 9). Such expansive measures in fiscal policy were definitely facilitated by the budgetary surplus, thanks to which public finances did not deteriorate⁴.

As for standard measures of monetary policy, the central bank of China decreased a required reserve ratios, thereby drawing a dividing line between the large state banks and others. This is a consequence of the state dominance in the banking sector with the so-called Big Four, (made up of four of the largest state banks on the leading position within the sector)⁵. These banks were the beneficiaries of financial assistance from the central bank, provided with non-standard measures, (one of these banks was supported with liquidity amounting to 30 billion USD).

³ This package executes a part of the project connected with the development of transport in China within the 11th Five Year Plan, initiated in 2006 r. (Yueh, 2010, p. 9).

⁴ The costs related to the introduction of the fiscal packages in the countries of Southeast Asia are discussed in Mucha (2012, pp. 176-178).

⁵ Assets amounting to more than 100% of GDP in 2009 made them the most important agent in the Chinese financial market (Fezizoglu, 2009, pp. 20-23).

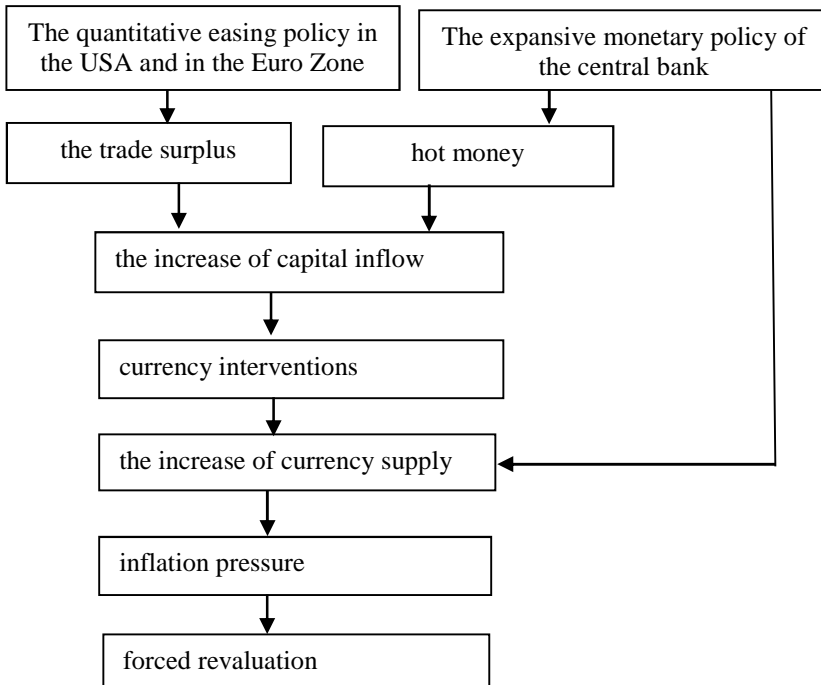
The fiscal package, together with standard and non-standard monetary policy measures, already had an effect by the end of 2009. The GDP growth rate increased in 2010 to more than 10% (Figure 1), and China was then regarded as the economy sustaining growth throughout the entire Asia region (Kose & Prasad, 2010, p. 9) ⁶.

China's Financial Market in Confrontation with Excess Liquidity

A development strategy based on exports, supported with anti-crisis measures undertaken by the government and the central bank facilitating the development of investments, resulted in the expansion of exports even by the end of 2009. China's participation in world exports rose from the level of 3% in 1995 to more than 12% in 2009 (IMF, 2011, p. 4). China became one of the most important links in the supply chain of intermediate capital goods. The demand, supported in the period of crisis, contributed to the growth in world imports of consumption and investment goods. At the same time, the financial market in China was receiving a growing supply of money, with China becoming the largest capital recipient among all the emerging markets (in Europe, Asia and Latin America). In the period between the second half of 2009 and mid- 2010, China was receiving 29% of the total capital inflow, whilst China's GDP made up 31% of the GDP of all emerging markets (IMF, 2011, p. 42). This was not only the result of an expansive monetary policy adopted at the initial stage of the crisis in fear of limitations of loan activity (Figure 3).

Beginning from 2009, the US Central Bank (Fed.) initiated a quantitative easing policy, leading to a sudden increase in money supply. A significant part of the newly issued currency reached China as a trade surplus and hot money, which could find a higher rate of return (with very low interest rates in the USA) in China's financial market. In accordance with the law of supply and demand, which, for the foreign exchange market, means that the increase in the demand for currency is accompanied with its appreciation, the Chinese currency should be strengthened. Yet, according to the IMF classification (*de jure*), China has a managed floating rate. It was even before the crisis in June 2005 that the central bank revaluated the yuan by

⁶ A detailed list of all anti-crisis measures adopted in China – see Glinka (2010, pp. 41-42).

Figure 3. The outcomes of the increase of liquidity in the Chinese financial sector

Source: author's own work.

by 2.1% in relation to the dollar, introducing, at the same time, the currency basket⁷.

The exchange rate could deviate within a very limited band $\pm 0.3\%$ around the central parity announced by the central bank. In 2007 the admissible deviation band was widened to $\pm 0.5\%$. In the period during the largest disturbances in the global financial market (the second half of 2008 till the first half of 2010), the central bank did not permit any deviations practically making interventions in the foreign exchange market. Given the inflow of dollars to the country, the central bank kept purchasing dollars and issuing Yuan, which prevented it from strengthening. As Rickards rightly observes (2012, p. 125), “the more money was printed by Fed, the

⁷ The basket, the contents of which was revealed by the monetary authorities after a few months, contained the dollar, euro, Yuan and Korean won as the main currencies, and amongst the rest there were the pound sterling, Thai baht, Malaysian ringgit and Russian ruble (IMF, 2013a, p. 3).

more money had to be printed by the People's Bank of China in order to maintain the exchange rate of their currency in relation to the dollar". The economy was receiving a larger supply of money, not only as a consequence of the increased loan activity of the banking sector (encouraged by the lower required reserve ratios), but also as a result of the exchange rate policy. When exchange rates in the USA significantly dropped (i.e. the rate of interest of Chinese securities used for market sterilisation increased), neutralising the effects of the capital inflow became very expensive⁸. A growing supply of money had to lead to inflation tensions. Yet both inflation and the strengthening Yuan made Chinese exports lose their competitive advantage, which was of key significance from the point of view of the development strategy adopted by China. The central bank had a much larger chance of controlling the price of currency than controlling the spread of inflation⁹. The consequences of inflation expectations and their impact on the real increase of prices were unknown. Given uncontrolled inflation with its unpredictable effects, on the one hand, and the controlled revaluation of the yuan, on the other, the central bank, in mid-2010 decided to accelerate the pace of the revaluation of their own currency (Rickards, 2012, p. 126). Currently, the currency exchange rate regime in China has not changed practically at all, with the exception of enlarging the admissible band of deviation. Since 17th March 2014 it has been +/-2% from the parity exchange rate¹⁰. A larger flexibility in the exchange rate in China decreased the need for the sterilisation of the purchase of currency reserves, especially that the expectations for appreciation of the currency are not smaller¹¹.

The persisting expectations for Yuan appreciation and the policy of very low interest rates in highly developed countries resulted in the fact that a growing liquidity in the global financial market began to reach China through a very rapid increase in loans in foreign currencies for companies. Between 2009 and 2013 the amount of these loans grew more than three-

⁸ These are direct costs related to the accumulation of foreign currency reserves. For other costs see: Prasad and Sorkin (2009, p. 4).

⁹ It was already then that the signals of an increase of asset prices in financial markets appeared, whilst the most worrisome signals came from the real estate markets. This sector is especially prone to speculative behaviour, which, when accumulated may threaten financial stability (IMF, 2010, p. 39).

¹⁰ The IMF interpreted the growing increase of the band of deviations within the exchange rate (2013a, p. 3) as a crawl-like arrangement.

¹¹ In various estimations of the IMF, the Yuan was in 2012 "moderately" undervalued, by 5%-10% on average. For more extensive discussion of the research methodology see the IMF (2013a, p. 28).

fold: from 270 billion USD to almost 900 billion USD¹². A view of this process from the perspective of the loan to deposit ratio in a foreign currency, clearly shows that 2005 was a turning point, which means that (He & McCauley, 2013, p. 15):

- In the years preceding 2005 the ratio was below 100%;
- In the period after 2005, when, together with the appreciation of the Yuan against the dollar, the increase of foreign currency loans was larger than the foreign currency deposits and the *loan to deposit* ratio was above 160%. After some period of fluctuation, at the beginning of 2013, this ratio increased to about 180%.

The above data points to a significant discrepancy between the loans in a foreign currency and the deposits in a foreign currency. The most probable source of the missing foreign currencies is the cross border capital flows between banks, certainly within the existing limitations¹³.

The Role of the State in the Strategy Towards the Liberalisation of Capital Flows

As far as China's general approach towards the presence of foreign capital in the financial market is concerned, it must be pointed out that cross border capital flows between banks make up one of the areas of the state policy towards capital flows, which has undergone significant changes in the last decade. Generally, with the current system of exchange rates, the policy towards capital flows tries, on the one hand, to use the generally known advantages of the inflow of foreign capital to the emerging markets: whilst on the other, it has to minimise the risks connected with sudden changes in the capital flow. Currently, the poorly developed domestic financial market cannot guarantee the unique possibility of absorbing the shocks connected with the situation. As Kawai observes (2012, p. 13), the choice within the *impossible trinity*, i.e. the liberalisation of the capital flow, the pegged exchange rate or independent monetary policy, works much better in relation

¹² At the same time, the share of foreign currency loans in the total number of loans increased from 5.3% to 8.5%. It is worth pointing out that during the Asian crisis (1997–1998), when the Chinese Yuan was under large depreciation pressure, the monetary authorities allowed for making deposits in a foreign currency in order to avoid the risk connected with making such deposits outside China, i.e. a potential capital outflow. A consequence of permission to make deposits in a foreign currency was permission to grant loans in a foreign currency (in both cases there are strict limitations), (He & McCauley, 2013, p. 14).

¹³ The Bank of International Settlements (BIS) does not preclude that a foreign currency may come from official sources or others, not covered by the BIS studies (He & McCauley, 2013, p. 15).

to economies with completely formed financial markets and appropriate institutional solutions. This does not concern the Chinese economy yet.

Exchange rates make up one of the variables affecting the direction, size and pace of the changes of capital flows. Unfortunately, in China their role is significantly limited, as the central bank administratively controls the level of the interest rates by establishing the ceiling of deposit rates and the floor of loan rates. In this way, the central bank leads to the reinforcement of at least two distortions in the financial markets because (Bae, 2012, p. 18):

- It leads to the inefficient allocation of capital and inefficient use of limited resources, as this does not reflect the market relationship between demand and supply;
- It is not a reliable reference point for the valuation of the market's financial assets which has a negative effect on the process of making investment decisions.

China's central bank is also criticised for the fact that maintaining the ceiling of deposit rates helps many state financial institutions to cope "better" with the problem of bad loans and facilitates saving on lower debt service for state corporations and local authorities (Ran *et al.*, 2013, p. 16). In recent years the central bank of China has been undertaking steps towards liberalisation of the interest rates, by means of introducing some market mechanisms into the monetary transmission. The most significant regulations in this aspect, comprise as follows (IMF, 2012, pp. 7-9):

- Lowering (for the first time since the second half of 2008) benchmark interest rates, concerning both the interest rates for deposits (decreased to 3%) as well as loan interest rates (decreased to 6%),¹⁴
- The introduction of the maximum ceiling of deposit rate to 10% above the rate established by the central bank, i.e. to 3.3%,
- Lowering the floor of loan rates to 70% of the rate established by the central bank, i.e. 4.2%.¹⁵

For banks, this means more freedom in establishing interest rates, certainly within the existing system. Although this is a large step towards increasing competitiveness in the market of financial intermediation, from the point of view of foreign capital it is still inadequate. Administrative regulations on the ceiling of deposit rates and the floor of loan rates effectively reduces the possibilities of precisely assessing the credit rating of potential

¹⁴ The data show the amounts of annual interest rates, but the reduction covered also the interest rates of the loans and deposits with all maturity dates.

¹⁵ On 20th June 2013 the floor of loan rates was removed and further liberalisation of interest rates became a priority among all the reforms of monetary policy (IMF, 2014, pp. 53-55).

borrowers and offering a lower loan interest rate to the best clients; as a consequence, deposits rates higher than those offered by Chinese banks. Foreign banks cannot, therefore, compete for a larger number of deposits which they could use for enlarging their loan activity and, in this way, increase their presence within the Chinese banking market. Immediately after China's admission to WTO (2001), the share of the loans granted by foreign banks to the total number of loans increased from 1% to 4%, and, it has been stable (2%-3%) for the last few years (Ma & McCauley, 2013, p. 15). Also the costs of national currency services provided by foreign banks have increased significantly, since the moment when, in 2006, China began to require that foreign banks on its territory should have the status of a subsidiary; this means that the parent bank must guarantee enough capital so that, if required, it can support the loan activity of the subsidiary and its other banking services¹⁶. What is more, a foreign bank that wants to become active in the Chinese banking market must meet many administrative requirements. Obtaining licenses, the creation of a subsidiary, obligation to have at least three-years of activity before the license could cover providing services in the national currency in the full scope, and the obligation to bring profits over two succeeding years are just some of them (Lardy, 2013, p. 13). He and McCauley (2013, p. 16) also point to the administrative limits concerning incurring debt abroad by foreign banks, as these banks, themselves, have to apply for the permission for such loans every year. The established limits translate into the interest rates of foreign currency loans. In 2010 and in 2011, fearing a growing supply of money, these limits were restricted. Similar limits concern Chinese banks, yet they are less stringent. When, in 2013, an increase in demand for foreign currency loans among Chinese companies was translated into the Yuan's appreciation pressure, monetary authorities imposed additional restrictions on domestic banks, whose loans in foreign currency exceeded 75% of the value of foreign currency deposits.

The entrance of foreign banks into the Chinese financial market most frequently has the form of minority share or co-operation with other banks of the Big Four. The latter form of activity was chosen, among others, by Goldman Sachs and Allianz (Hope & Hu, 2006, p. 40). Today, one of the most significant foreign investors in the Chinese banking sector has been HSBC, with an efficient competitive advantage in retail banking.

The opening of the Chinese banking sector to direct foreign investments contributed to change of the structure of the entire sector from an oligopo-

¹⁶ Before 2006, all foreign banks in China acted as branches of their parent institutions, so there were not any requirements for separate capital for securing the activity in China (Lardy, 2012, p. 3).

listic towards a monopolistic competition (Uchimura-Shiroishi & Wu, 2013, p. 41). The state banks still have a dominant position, yet the share of the Big Four is decreasing. Commercial banks, such as joint stock companies, together with foreign banks and smaller local banks are beginning to compete with each other. The characteristic feature of the state banks having a monopolistic position there is that they did not earn this position in a natural way, i.e. as a result of advanced technologies, innovativeness, an increase in productivity or lowering the costs. This position is, first and foremost, conditioned in an administrative manner, which is a manifestation of the dominant role of the state in the banking sector. The lending possibilities of these banks are by no means related to the profitability of their operating activity. The loans reach the designated subject (most frequently a state company) as a result of an administrative decision. The central bank's preferential policy often comes down to write off the bad loans or capital supply (Uchimura-Shiroishi & Wu, 2013, p. 22).

The increased activity of the state can also be observed on the domestic bond market – both government bonds and corporate bonds (Table 4).

Table 4. Domestic bond market in China (2012–2013)

	Share (%)		Growth rate (%)	
	3 rd quarter of 2012	3 rd quarter of 2013	3 rd quarter of 2012	3 rd quarter of 2013
Total bonds	100	100	11.2	14.4
Government bonds	74.3	68.7	8.4	5.8
Corporate bonds	25.7	31.3	20.2	39.1

Source: ADB (2013b, p. 9).

The dynamically developing market of corporate bonds has been dominated by a relatively small number of issuers. Amongst the 30 largest issuers (making up 49% of the entire corporate bond market), 23 are state corporations¹⁷. In the market of government bonds, three policy banks (state banks) involved in financing strategic investment projects are the most active (ADB, 2013b, p. 76). This increase in bond issuance in domestic currency was, to a large degree, the outcome of the creation of the Asian Bond Fund 2, (ABF2), which, after 2009, was largely involved in the de-

¹⁷ They represent mostly the energy, banking and public services sector. More on the issuers of corporate bonds – see ADB (2013b, p.75).

velopment of the domestic bond markets in all countries of Southeast Asia¹⁸.

An equally evolutionary approach is manifested by China towards cross border portfolio capital flows. Assuming that the main channels of this inflow are the following:

- The investments of non-residents in the Chinese securities market;
- The ratings of Chinese companies in foreign stock exchanges, in the case of China then, the permeability of the first of these channels is significantly limited by Qualified Foreign/Domestic Institutional Investors – (QF/DIIs)¹⁹.

Examples of specific solutions, concerning both the inflow and outflow of portfolio investments, are presented in Table 5.

With regard to the second channel of portfolio investments inflow, among Chinese companies, a pattern of the choice of the location of listing their securities can be observed. Most frequently, the first stock exchange for this is the stock exchange in Hong Kong, then the stock exchange in Shanghai, and in some cases – the New York stock exchange. Permitting some of the Chinese companies to list their own securities outside continental China, and, in particular, in the American market, is another example of the liberalisation of the domestic financial market.

In general, China's strategy in the liberalisation of capital transactions may be characterised as follows (Craig *et al.*, 2013, p. 11):

- The liberalisation of direct investments precedes the liberalisation of portfolio investments;
- The liberalisation concerns the capital inflows more than the outflows;
- Specific measures are tested first within the pilot programmes on smaller samples of entities and then begin to cover more institutions;
- These measures are frequently the transaction limits or require administrative permissions.

¹⁸ ABF2, created already in 2002, contributed to the liberalisation of many limitations in trading bonds denominated in local currencies of Asian economies. More about domestic bond market, not only in China – see Chan *et al.* (2012, pp. 50-58).

¹⁹ The QFIIs Programme comprises foreign financial institutions authorised to invest into the Chinese market of securities, transfer of capital gains or profits of interest. Both the amounts which these institutions may designate for their investments and the number of institutions receiving the QFII status are regularly growing. Their number in 2013 was more than 200. The QDIIs Programme, in turn is addressed at the domestic financial institutions applying for the right to invest in foreign financial markets. Similarly as QFIIs, This programme is dynamically developing, comprising, with its scope more and more subjects in various segments of financial market in China. For more – see IMF (2013a, p. 4).

Table 5. The control of the flow of portfolio investments in China

Capital inflow		Capital outflow		
Money market	Bonds market	Equities market	Domestic investors	Foreign investors
Non-residents cannot invest in money market instruments	QFII may invest in listed bonds subject to quotas (in July 2013 the total quota covering both bond and equity investments for all QFIIs was 150 billion USD)	QFII may invest in A-shares subject to quotas. No single QFII may hold more than 10% shares of a listed company. The quotas are the same as in the case of investments in bonds.	QDII may buy and hold offshore securities subject to certain quotas	Selected QFII investors (investments funds, insurance funds) have a principal lock-up of 3-months (for listed bonds, there is no holding period).
	RQFII* are allowed to fund investments (subject to quotas) using Yuan sourced abroad - from Hong Kong).	RQFII are allowed to fund the purchase of equities (subject to quotas) using Yuan sourced abroad (from Hong Kong)		Other QDIIs are required to keep their investments in China for 1 year
	Eligible financial institutions may invest in the interbank bond market subject to quotas (foreign central banks involved in the cross-border settlements in Yuan or wanting to have Yuan within the diversified portfolio of currency reserves)			Repatriation of foreign exchange requires the approval of SAFE.**

*RQFIIs - Renminbi Qualified Foreign Institutional Investors is an extended (since 2012) program within QFIIs

**SAFE - State Administration for Foreign Exchange, an institution coordinating the exchange rate policy

Source: ADB (2013b, p. 56).

This significantly gradual liberalisation of capital transactions is accompanied by increasing involvement of the state in the financial market. Such a situation does not facilitate any efforts of the state banks towards improving the efficiency of the banking sector. Contrary to that, these efforts are frequently targeted at the unregulated banking sector.

The Shadow Banking Sector in China

It is difficult to provide a clear and precise definition of shadow banking. In the opinion of the Financial Stability Board (ADB, 2013a, p. 10) this is credit intermediation involving entities outside the official banking sector. Another definition (BIS, 2012, p. 67) points to financial activity carried out by non-bank financial institutions which are engaged in the process of leveraging and liquidity transformation²⁰. A general reference to the activity which takes place outside banks might be misleading. To some degree, though, banks might be involved in such activity. By means of the securitisation of securities, a bank takes part in the process of spreading the risk by means of “selling it” through some additional tranches of the next structured securities. They frequently reach financial intermediaries who are affiliated at banks, without being licensed as banks – in this way the scope of shadow banking increases. It is also worth pointing out that institutions involved in such activity frequently do not have capital large enough to absorb the risk which is not completely diversified (systemic risk). This helps to explain why many such undertakings take place in the surrounding of large banks or transfer the risk to large banks. Shadow banking strongly needs such an external support (Claessens & Ratnovski, 2014, p. 5). This type of banking is also supported by all formal and informal guarantees from the state (for example within the institutions *too big to fail*), which legitimises even more such activity²¹. From the point of view of the stability of both the banking sector and the entire economy, the most important thing, however, is that the financial intermediation of the shadow banking system, are neither subject to regulations nor to financial supervision, as opposed to the official banking sector. Even a rough assessment of shadow

²⁰ In other words, the mechanism of leverage (the relation of total assets to capital equity), so the involvement in very risky financial investments with very little contribution of the own capital.

²¹ With regard to the strong connection between the institutions acting in the regulated banking sector and entities outside it, in reaction to the crisis, the entities from the shadow banking system, became the beneficiaries of a significant part of the support funds (Singh, 2012, p. 5).

banking shows that the financial market environment in China creates very favourable conditions for such activity.

Out of many types of financial transactions within the shadow banking system, the following ones are regarded as the most dangerous for China's financial stability (ADB, 2013a, pp. 11-13):

- Informal loans between companies, as the least transparent type of financial activity (evaluated to make up 6.5% of GDP at the end of 2012);
- Loans between companies in which a bank or any other financial institution works as an intermediate party (at the end of 2012, their scope was evaluated to make up 12% of GDP);
- Loans granted by financial institutions other than banks (e.g. trust funds), which are a significant source of financing off-budget local expenditures;
- Loans granted by companies covered by state guarantees;
- Financial products offered by enterprises or banks (outside their official balance), which guarantee a rate of return that is much higher than the rate of return on bank deposits (*wealth management products*). In the period between 2010 and 2012 they grew by a few hundred per cent;
- The loans granted by leasing companies or pawn shops.

At the end of 2012, the size of all the above-listed types of activity forming shadow banking was estimated to make up 40% of China's GDP²². Shadow banking is based on meeting the demand for financial services which are not offered by the official banking sector, for example, because of regulations. In the case of China's economy, a sudden growth in the size of such activity occurred in the period after 2010, which was by no means incidental. It was then that the monetary authorities presented a very stern reaction to the boom for loans in the real estate sector²³. In circumstances of limited access to loans, a significant portion of borrowers turned to shadow banking.

The banking sector, similarly to other segments of the financial market in China, has undergone many changes. Apart from the continuing presence of the state, some private institutions have appeared, and, with them, new types of financial activity, outside the banking sector. A network of formal and informal connections between the state banks, state companies, local and financial institutions blurs the dividing line between the official banking sector and shadow banking. Therefore, it is quite difficult to estimate

²² This made up about 20% of the total assets of the banking sector (ADB, 2013a, p. 10).

²³ The discussion of specific measures, also fiscal restrictions – see IMF (2010, pp. 34-37).

the size of the latter and compare its size with that of other countries²⁴. This difficulty concerns, for example, the diversity of forms of financial activity characteristic of a given financial market. For instance, wealth management products offered by Chinese companies which are affiliated at banks do not have equivalents in the US financial market (Claessens & Ratnovski, 2014, p. 3).

The threats connected with shadow banking are frequently being pointed out by international financial institutions (IMF, 2013c, p. 7). The reaction of the authorities supervising the financial market in China may be indicative of their determination in fighting this type of activity. In May 2013, the China Banking Regulatory Commission introduced restrictions for services such as wealth management products and limits for assets invested into debt instruments outside the bond market. According to the estimations of ADB (2013a, p. 11), the growth rate in some shadow banking activities dropped from more than 100% per year in the first quarter of 2013 to less than 20% in the second. Such detailed measures targeted directly at specific types of financial activity should become a part of the widely understood changes in legislation and supervision of the entire financial sector in China, with special consideration given for the improvement of transparency within all financial transactions.

The Yuan – an International Currency?

The changes which took place in the Chinese financial market are also interpreted in the efforts for making the Yuan a currency with a global scope. In accordance with Kenen's definition (2012, p. 9), an international currency is the currency which is used outside the borders of the issuer's country, not only for transactions with residents, but also for transactions with non-residents. In other words, this is the currency used instead of the national currencies of the participants in international transactions concerning goods, services and financial assets. An international currency should, therefore, play the role of a unit of account, a medium of exchange and a store of value, among both residents and non-residents. On the basis of this definition, Gao and Yu (2009, pp. 2-3) make an attempt at adapting these requirements to the Chinese currency (Table 6).

²⁴ In publications on this subject, this phenomenon is most frequently analysed on the example of the financial market in the USA (with respect to the role played by shadow banking in the global financial crisis).

Table 6. The Yuan as an international currency?

The functions of the Yuan	The Yuan used in the public sector	The Yuan used in the private sector
unit of account	An ingredient of the currency basket in some selected countries of the region	Expression of trade and financial transactions
medium of exchange	A vehicle currency in currency interventions, bilateral swap agreements between central banks	Invoicing trade and financial transactions
store of value	More and more frequently as an element of official foreign exchange reserves	Deposits/off-shore loans (in Hong Kong) Issuance of off-shore corporate and government bonds (in Hong Kong) Investments into equities through QFIIs

Source: Kenen (2012, p. 9), Gao and Yu (2009, pp. 3-7).

The Yuan is not used as a unit of account by public institutions on an international scale. Yet, among the countries of the Southeast Asia region, which stabilise their currencies in relation to the foreign currency basket, the Yuan plays a significant role, being regarded as the regional anchor currency²⁵.

China is very active in various forms of regional financial co-operation, which can be evidenced by bilateral swap agreements within the CMI²⁶ and between the central banks of the region. The objective of the second group of agreements is to enable the importers in other countries to obtain the Yuan for the payment of Chinese exports invoiced in Yuan, and to provide a source of liquidity in national currency for emergency cases. Such agreements were the reaction to the sudden limitation of the role of the banks as intermediaries in settling trade transactions after the beginning of the global financial crisis; a result of this was that global trade movements were limited (Kroeber, 2013, p. 8-9).

²⁵ This is the case for the Singaporean dollar, Malaysian ringgit or Indonesian rupee. Yet this relationship with the Yuan does not concern the currencies of the two most significant economies of the region (apart from China), i.e. Japan and South Korea (Kroeber, 2013, p. 4)

²⁶ The agreement on a bilateral currency swap agreements between members of the ASEAN+3 countries (Chiang Mai Initiative- CMI) signed in 2000 in Chiang Mai (Thailand). More about receiving liquidity support and amounts available within the agreements (see Eichengreen, 2012)

China's dominating role in the trade of the Asian region is reflected by the rapid increase in the use of the Yuan in invoicing and settling cross border trade agreements. In 2013, the share of the goods in which trade was settled in the Chinese currency in comparison with all goods in cross border movement was 14% (Craig *et al.*, 2013, p. 4)

Beginning in 2009, Chinese currency experienced a very significant increase in the daily turnover in the market of OTC currency trading. Although it is still a very small share (2.2%) in global trade, out of the currencies of Emerging Asia, in 2010–2013 this increase was the highest and amounted to as much as 249%²⁷. It must be noted that a significant share of this increase was generated in off-shore markets (outside continental China), with almost two thirds in the region of Emerging Asia (Table 7).

Table 7. Off-shore transactions in Yuan (% in 2013)

Per day trade volume in off-shore trade (billion USD)	The share of off-shore trade in global trade	The share of intraregional trade*	The share of regional financial centres **	The share of UK	The share of USA	The share of the Euro Zone trade
86	72.0	45.5	43.7	18.0	5.8	1.5

* Yuan turnover in the entire region of Emerging Asia

** Hong Kong and Singapore

Source: Ehlers and Packer (2013, p. 60).

Thus, the Chinese currency is clearly dominating in off-shore market transactions. However, this process is limited only to the transactions within the countries of that region. It is in the Hong Kong off-shore market that more and more financial assets denominated in Yuan are present. This concerns, first of all (Craig *et al.*, 2013, pp. 4-5):

- The market of bank loans denominated in Yuan – between 2010 and 2013 they grew from less than 2 billion Yuan to almost 90 billion Yuan;
- The market of bonds denominated in Yuan – their issuance grew from less than 30 billion Yuan in 2009 to almost 270 billion Yuan in 2013;
- The market of deposits dominated in Yuan – their share in total deposits in Hong Kong between 2009 and 2013 grew from 50 billion Yuan to more than 800 billion Yuan.

²⁷ At the same time the growth of daily turnover of all the five currencies of emerging Asian markets (with the Yuan, Singaporean dollar, Korean won, Indian rupee and Hong Kong dollar) was “only” 40.7% (Ehlers & Packer, 2013, p. 61)

It is generally known that from the point of view of the international status of a currency, a financial market with a debt market in particular is of key importance. Increased possibilities of risk management thanks to the issuance of debt denominated in a country's own currency in the financial markets of other countries is one of the advantages of having a currency with an international status.²⁸ Without a debt market which is liquid enough, the currency will not be attractive for foreign agents. Such a market must be the source of safe assets (Prasad & Ye, 2012, p. 27). In China this role has been taken over by the off-shore market in Hong Kong. The beginning of the development of this market can be dated to 2004, when Hong Kong residents gained the right to exchange their own currency (the dollar) into Yuan. Since the onset of the global financial crisis, China has been consistently increasing its involvement in this market. Thanks to the possibility of issuing debt in the domestic currency, China has limited the problem of the foreign currency mismatch of domestic debtors.

Undoubtedly, the global crisis has intensified the efforts towards the internationalisation of the Yuan, which can be manifested by the following undertakings (Maziad & Kang, 2012; Eichengreen, 2013; Kroeber, 2013; Teng, 2013):

- Starting a swap line between the monetary authorities of Hong Kong and the central bank of China in reaction to liquidity needs in Yuan on the off-shore market (2010);
- The first bonds issued by the Ministry of Finance in Hong Kong (2010);
- The first issuance of corporate bonds denominated in Yuan by a Hong Kong company in the off-shore market (2010);
- The first issuance of corporate bonds denominated in Yuan, by an international corporation – McDonalds in the off-shore market (2010);
- The beginning of operations of a branch of the Bank of China in New York (2011);
- The first public offer to sell securities in Yuan in the off-shore market in Hong Kong (2011);

²⁸ The other, frequently enumerated benefits of currency internationalisation are: the decrease of costs of transactions and currency exchange risk, a wide access to financial assets denominated in the country's own currency and the income from the issuance of international currency (*seigniorage*). In the case of China, the Yuan's internationalisation could additionally help in the protection of currency reserves, which, at the end of March 2013 amounted to 3.44 trillion USD (IMF, 2013b, p. 1) and as much as more than 70% of which is denominated in USD. The fears of possible capital losses, as the outcome of the weakening of American currency, could be at least partly eliminated (Gao & Yu, 2009, p. 8). The costs of currency internationalisation are all those pertaining to sudden fluctuations in capital movement.

- Talks with Japan about starting up a programme for cross-border settlements in Yuan (2011);
- The right to cross-border settlements paid in Yuan for all Chinese exporters (2012);
- The creation of a special economic zone in Qianhai with a programme of cross-border loans in Yuan.

Macao, by means of supporting the off-shore market in Hong Kong, has recently been actively involved in the process of the internationalisation of Chinese currency. Macao plays the role of a co-operation platform both for trade and financial co-operation between China and Portuguese-speaking countries²⁹.

This all points to the fact that the creation of off-shore markets preceded the scope and the pace of the liberalisation of the domestic financial market. In order to manage capital movements and control access to the relatively weaker and less developed domestic market, the Chinese authorities decided first on the liberalisation of the off-shore market for transactions in domestic currency (Shim, 2012, p. 11)³⁰. The characteristics of such a solution definitely distinguish China from the majority of countries which concentrate their efforts, first of all, on the development of the domestic financial market.

However, the off-shore market in Hong Kong has not developed without obstacles. Kroeber (2013, pp. 14-15) points out the most important ones:

- Chinese authorities differentiate their own currency into that which comes from the domestic financial market and the off-shore market. As a consequence, the latter is treated as a foreign currency, which means that the transfer of profits from bonds issued in Hong Kong to continental China requires the permission of SAFE. This is a time consuming process and does not always end up in a positive way for the institution applying for such permission; it may effectively discourage the issuance of bonds denominated in Yuan in the off-shore market;
- The persisting expectation for the appreciation of the Yuan does not encourage foreign companies to issue larger debts denominated in Yuan, as this means a continual increase of the real principal;

²⁹ Macao was one of the first participants of the pilot programme in 2004 concerning settlements in Yuan. Since 2009 all the banks in Macao have been able to carry out such settlements (Teng, 2013, p. 4).

³⁰ The reserves of Yuan in bank accounts, Yuan bonds in the extra-continental financial market as well as the possibility of using the national currency off-shore altogether seal the system of capital movement control, facilitating transactional arbitrage (Ma & McCauley, 2013, p. 19).

- Large Chinese state companies do not have to obtain sources of financing in the off-shore market. They take advantage of privileged relationships with state banks and, instead of issuing the debt in Yuan in the off-shore market in Hong Kong, they are financed with bank loans.

Conclusions

The definition of a currency with an international significance suggests that the liberalisation of capital movements should precede the internationalisation of currency. China's case proves that one's own currency can be promoted without any large opening to capital flows. What is interesting is that the internationalisation of the Yuan, as such, does not occupy any special position in the official statements of authorities³¹. The governmental 12th Five Year Plan (covering the period from 2011–2015) only mentions internationalisation within the context of increasing the flexibility of the currency exchange rate and the convertibility of currency within an unspecified deadline. These plans, first of all, emphasise the role of the Yuan in the off-shore market (Teng, 2003, p. 1). Yet, representatives of the central bank of China, frequently suggest that the off-shore market may be used for something more than facilitating cross border transactions thanks to carrying out transactions in Yuan. These messages give reasons to hope that the off-shore market in Hong Kong may also catalyse reforms in China's domestic financial market (Kroeber, 2013, pp. 19-25). This quite optimistic scenario precludes that if the off-shore market is large enough and has enough liquidity, the prices there (and they are determined by the market and not by the state, as it is in China), will have an impact on the cost of loans and debt securities in the domestic market. This mechanism, in turn, will force a greater liberalisation of capital movement with the market "taking over" the determination of interest rates from the state, and, as a consequence, the influence on the exchange rate. This would mean that with the current institutional measures in the Chinese financial market, some of the existing order would be disturbed, First of all, the state banks would lose their privileged position in financing investments and the state would hypothetically lose the possibility of the influence on resources allocation. Secondly, this could mean that the state might also have problems with the cost of incurring debt, which so far, thanks to existing administrative measures, have been kept at a low level. After deregulation, the only chance to maintain a low level of such costs would be reliable fiscal and monetary policies.

³¹ They numerously presented a critical opinion about the role of the dollar in the global financial crisis and the need to reform the international monetary system.

This will be a large challenge for China's economy, requiring many compromises in exchange rate policy, liberalisation of capital account or the development of the domestic financial market. The choices made there will definitely determine the role of the Yuan in the future (Prasad & Ye, 2012, p. 29). As the research shows, today the Yuan plays the role of an international currency to a very limited extent. Usually, international currency is used for invoicing cross border settlements, a vehicle currency for swap agreements or the currency in which off-shore market bonds in Hong Kong and within the ABF2 are issued. Given the fact that such a role for the Yuan is limited to the territory of Asian countries, the notion of the Yuan's internationalisation is increasingly being replaced by that of the Yuan's regionalisation. Similar conclusions can be drawn on the basis of the analysis of the criteria generally applied for international currencies. In the opinion of Eichengreen (2013, pp. 154-161), who analyses the Yuan from the perspective of the size of the economy, the stability and liquidity of financial market, China is close to meeting only the first of the above criteria. Provided that the OECD prognoses that by 2030, 28% of the global GDP will fall onto China (with 18% coming from the USA) are fulfilled, the Yuan will have a potentially larger field to be accommodated. Also the size of the index reflecting the openness to capital movement (Chinn-Ito Index) points to the fact that China belongs to those countries with a minor degree of openness. As a higher index is usually accompanied with a higher degree of currency internalisation, in the case of China, the degree of the Yuan's internationalisation is low (Maziad *et al.*, 2011, p. 12). What is more, currency with an international status should be generally used by non-residents in transactions between them. Unfortunately, in the case of the Yuan, at least one party in the transaction come from China.

The Chinese economy has definitely slowed down. The expected rate of GDP growth in 2014 was 7.4% (as opposed to 7.6% in 2013 and 7.7 % in 2012, ADB, 2013a, p. 9)³². In spite of the decrease in the trade surplus, and thus the decrease in the external imbalance (regarded as a measure of *re-balancing*), the internal imbalance, i.e. the surplus of investments over private consumption is still maintained³³. A natural way to restore this balance would therefore be to increase income and growth of household consump-

³² The drop of the GDP growth in China by 1 percentage point in 2002-2012 slowed down the GDP growth in the entire region of the Emerging Asia by 0.13 percentage point. For the effect of the slow-down of the Chinese economy on specific Asian countries – see ADB (2013a, pp. 12-13).

³³ The main causes of the decrease of the trade surplus to 2.2 % GDP in 2013. (which in 2008 still made up 9.3% GDP and in 2010 was 4% GDP) were: the decrease of the demand from abroad, increase of investments, deterioration of the terms of trade and Yuan's appreciation (IMF, 2013d, p. 21).

tion. Therefore the intermediation of the domestic financial market should be effective enough to become one of the factors guaranteeing the financial stability of the entire economy.

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