

WHY RMB TRADE INVOICING MATTERS TO CHINA'S ECONOMIC FUTURE

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China is keen on internationalizing the RMB. This would make it less costly and less risky for its citizens to buy and sell goods, services and assets, and lend and borrow internationally. If China is to relax its capital controls in the near future, which seems likely, internationalizing the RMB would greatly reduce the chance of China being hit by a currency crisis due to speculative attack on its currency, like what happened to Indonesia and Thailand during the Asian Financial Crisis of 1998. An international currency should be widely used by residents and non-residents to invoice and settle international trade, to lend and borrow, and to denominate financial products. These functions are interrelated. One function reinforces the others. Therefore, one key indicator of the degree of internationalization of a currency is the use of the currency for invoicing trade. In this regard, one finds that there is still some way to go for the RMB to be a major invoicing currency, even in the neighboring Asia-Pacific region, said Professor Edwin Lai.

For most currencies, the settlement currency is almost always the invoicing currency. For RMB, it is quite different. In 2012, for example, less than 12 percent of China's merchandise trade was settled in RMB, out of which 56 per cent was invoiced in the Chinese currency. The rest was invoiced in other currencies such as the US dollar. Hard data on the use of RMB for trade invoicing are hard to find. However, it is not likely that only a very small fraction of China's trade with foreign countries (excluding Hong Kong SAR) was invoiced in RMB even in 2013.

“If only a small fraction of China's trade with foreign countries is invoiced in RMB, the Chinese currency is still far from being an international currency, as trade invoicing, not trade settlement, is the key indicator,” he said. “For foreigners, accepting RMB invoicing is a deeper commitment than accepting RMB settlement, as they have to bear the exchange rate risk.”

“Whether a currency is used for trade invoicing is more determined by economic fundamentals. Whether a currency is used for trade settlement may be determined by short-term considerations, such as expected appreciation. The long term prospect of trade settlement business in HK is not guaranteed once people stop expecting RMB to appreciate.”

This has important implications for Hong Kong, which has been handling about 90 per cent of all China trade settled in RMB (more than RMB 2,600 billion in 2012, up from RMB 369 billion in 2010). The trade settlement businesses, even those arising from trade between Hong Kong SAR and Mainland China, would not be guaranteed, once the expectations of RMB appreciation no longer exist. “The trade settlement businesses will be more guaranteed if people actually accept the RMB as an invoicing currency,” he said. “The trade settlement

businesses in Hong Kong will expand further if a substantial amount of Mainland China's trade with foreign countries, not just trade with Hong Kong, is invoiced in RMB."

How can this be achieved? Two factors impact on which currency a firm chooses for invoicing. One is the coalescing effect – if competitors are using that currency, the firm will be more likely to use it, too. The other is market thickness of the RMB (the size of the RMB market).

"The determinants of RMB invoicing in a country's trade with China are that if China's GDP share of the world gets larger, and if the country's firms trade more with China, they are more likely to use RMB. Those factors enhance the coalescing effect. Furthermore, if their currency is closely pegged to the RMB they are more likely to use it too," Professor Lai said.

The market thickness of the RMB will be enhanced by three factors: the degree of convertibility of the RMB, the degree of capital controls by China and the maturity and stability of China's financial system. Here, China still has some way to go. The Chinese yuan's foreign exchange turnover share of the world rose from 0.048% in 2004 to 1.1% in 2013. This is much lower than that of the US dollar's is 43.5% in 2013. When you look at that share divided by GDP share of the country, RMB's measure drops to 0.096 compared to 2.0 for the US dollar and 1.0 for the euro. "It's just out of line with major currencies in the world. It means the market thickness of the RMB is just not there," he said.

What can China do to address this issue of lack of market thickness of the RMB? "China needs to relax its capital controls, allow full convertibility of the RMB and reform its financial sector much more deeply in order for the offshore RMB market to achieve the required market thickness for it to become a major invoicing currency in the Asia Pacific region and beyond. Relaxing capital controls would allow the free flows of funds between the offshore and onshore markets, which are essential for the development of the offshore RMB market," Professor Lai concluded.

Professor Edwin Lai of the Business School's Department of Economics spoke in the Business Insights luncheon in January 2014.