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THOUGHT LEADERSHIP BRIEF

One Currency, Two Markets: China's Attempt to Internationalize the Renminbi

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KEY POINTS

- The global financial crisis in 2007-2009 caused a shortage of the US dollar all over the world. This sounded an alarm, reminding China that the dollar-based international monetary system (IMS) could be quite unreliable.
- In response, China began to accelerate the pace of RMB internationalization so as to eventually escape from the "dollar trap" i.e. become independent of the US, the USD, and an international monetary system (IMS) dominated by the USD.
- In order for the RMB to be a significant international currency, it has to be largely convertible in the capital account and China's financial market must be sufficiently deep, broad and liquid.

ISSUE

Internationalization of RMB is a long-term strategy of China in creating a stable international monetary environment for its economic development. Its goal is that Chinese citizens (households, firms, government) can use the RMB for invoicing and settling trade in goods and services as well as invoicing and settling trade in financial assets and financial transactions, including borrowing and lending. In the longer run, if the RMB is used as a significant vehicle currency for global trade and finance and reserve currency for foreign central banks, it can increase the political influence of China. Moreover, the use of the RMB for international payments would facilitate them to be handled by a payment system that is under the jurisdiction of China. This is important for national security reasons. This brief investigates the necessary conditions for RMB internationalization to succeed and its prospects.

ASSESSMENT

In my book, *One Currency, Two Markets: China's Attempt to Internationalize the Renminbi* (2021 Cambridge University Press), I explain how the problem with the international monetary system since the demise of the Bretton Woods system and the recent global financial crisis prompted China to seek independence from the dollar standard. One way is to make the RMB a widely accepted currency internationally.

Under the current international monetary system, many well-established currencies choose to adopt a floating exchange rate regime. However, many other countries, especially less developed ones, choose to adopt a pegged exchange rate regime, meaning that they peg their exchange rate to a hard currency or a basket of hard currencies because they want to maintain stable exchange rates with these currencies. In order to maintain a stable exchange rate with the USD, a country's central bank has to accumulate enough USD reserves. As of the end of the second quarter of 2019, the shares of USD, euro, Japanese yen and pound sterling in the total amount of allocated central banks' reserves in the world were 61.6%, 20.3%, 5.4% and 4.4% respectively. Thus, the USD is by far the most important reserve currency. The USD does not have to be pegged to any currency or to any asset such as gold nor keep any substantial amount of foreign exchange reserves. In fact, the US benefits a lot from the advantage that it enjoys as a major reserve currency. Valery Giscard d'Estaing, the finance minister of Charles de Gaulle, called it the "exorbitant privilege" of the US. It has the autonomy to use monetary policy to influence its own national income, unemployment rate and inflation rate, while other countries that peg their currency to the USD do not have the autonomy to use monetary policy to influence their national income, unemployment rate and inflation rate unless they limit capital mobility. This asymmetry is remarkable (Figure 1).

During 1996-2010, the RMB was either firmly pegged to or closely tracked the USD at an undervalued exchange rate. As a result of this policy, China's central bank accumulated a huge amount of USD assets. In its 2018 annual report, the State Administration of Foreign Exchange (SAFE) of China disclosed that China's total value of foreign exchange reserves grew from 1.07 trillion USD at the end of 2006 to 3.84 trillion USD by the end of 2014. The amount then began to fall. Even so, by the end of 2018, China's foreign reserves was equal to an enormous amount of 3.07 trillion USD, compared with 3.14 trillion USD at the end of 2017 (Figure 2). Foreign analysts broadly agreed that as of 2014 about two-thirds of Chinese foreign-exchange reserves are held in USD. The USD assets held by the central bank of China yield very low interest rates compared with the potential average return from investing in domestic real assets. China paid a high price in buying an "insurance policy" to secure a stable exchange rate between the RMB and the USD. Like many other developing countries that pegged their currencies to the USD, China was caught in "the dollar trap".

Figure 1. Shares of currencies in the total amount of allocated foreign exchange reserves across the globe by 2019Q2

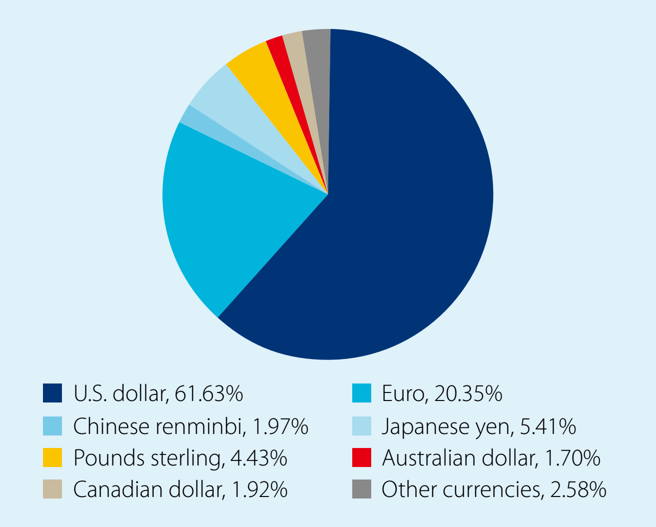
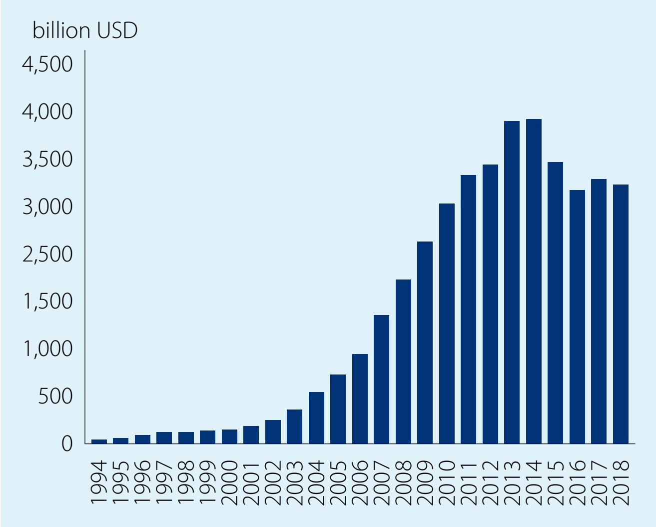


Figure 2. China's foreign exchange reserves 1994-2018



The global financial crisis in 2007-2009 sounded an alarm, reminding China that the dollar-based system could be quite unreliable. For a period after the brokerage house Lehman Brothers went bankrupt in September 2008, there was large-scale credit crunch in the banking system in the US and Europe. They could not provide the necessary trade finance denominated in USD, euro and other hard currencies to Asian countries and regions. This led to the collapse of trade in many Asian countries. Countries and regions such as South Korea, Malaysia, Indonesia, China and Hong Kong began to encourage settling bilateral trade using their own currencies, which was facilitated by bilateral currency swaps agreements among the countries. For China, the natural response to this collapse of the USD-based trade finance was to promote the international use of the RMB for trade settlement. Since 2009, the offshore RMB market in Hong Kong rapidly developed into a platform for facilitating RMB trade settlement. By 2015, the percentage of China trade settled in RMB reached 29.4%, which was a historical high even up till the time of writing. As many as 36 countries entered into bilateral currency swaps with China by March 2018.

Certain quarters within the Chinese government felt that it was a good idea to use capital account liberalization, which is a prerequisite for internationalization of the RMB, to create pressure for domestic financial sector reform. As of the end of 2014, the amount of RMB deposits in banks in Hong Kong reached RMB 1003.6 billion (12% of total deposits). Offshore RMB centers emerged all over the world, including Hong Kong, Taipei, Singapore and London. At the end of 2014, the outstanding amount of offshore RMB-denominated bonds issued in Hong Kong reached RMB 380.5 billion. In December 2015, RMB became the fifth most used payment currency in the world, and second most used trade finance currency, according to SWIFT. In October 2016, RMB officially became one of the five currencies in the basket of the Special Drawing Rights.

However, in order for the RMB to be a significant international currency, it has to be largely convertible in the capital account and China's financial market must be sufficiently deep, broad and liquid. It is not clear whether and when this would happen. The further development of the financial market is hindered by the requirement for the state-owned banks to offer cheap credits to non-profitable state-owned enterprises (SOEs) to keep them afloat for social and political reasons. This leads to misallocation of capital. There are no significant private financial institutions or banks to challenge their large state-owned counterparts. Because of the lack of external competition, the financial sector is quite inefficient.

As for capital account opening, one obstacle is that China does not want to fully integrate its financial system with the rest of the world, partly because of the experience of the global financial crisis in 2007-2009 that the US-based IMS is not always reliable, and partly because of ideology - a mistrust of the West. This is one obstacle to RMB internationalization. To overcome this obstacle, the Chinese government borrows a page from the playbook of Deng Xiaoping's "one country, two systems" idea. They decide to adopt the "one currency, two markets" approach, meaning that they create an offshore RMB market which is not completely integrated with the onshore one. The offshore RMB is called CNH, as distinct from the onshore RMB, which is called CNY. They facilitated the formation of offshore RMB centers in Hong Kong, Singapore, Taipei, London and elsewhere. The CNH is a fully convertible currency in the offshore market. In the offshore centers, the markets for CNH-denominated bonds, loans, bank deposits and financing of projects gradually develop. However, the development of the offshore markets still depends on onshore capital account opening and financial development. Without these, the "one currency, two markets" approach alone cannot catapult the RMB into the league of major currencies in the world.

RECOMMENDATION

RMB internationalization cannot move forward without further reforms. The two major reforms are capital account liberalization and financial sector liberalization. Currently, the country is characterized by capital controls and financial repression, both of which represent distortions to the economy, creating inefficiency. Reforms mean removal of distortions to the economy. According to economic theory, when there is distortion in one part of the economy, distortion in another part of the economy may be justified on the grounds of economic efficiency. This is called The Theory of the Second Best. Thus, when the country is under financial repression, it may be justified to have capital controls so as to maintain economic stability. In order to attain the "first best", however, both distortions need to be removed or relaxed, and this requires reforms in both parts of the economy. In other words, both the capital account and financial sector need to be liberalized. We advocate that both reforms should be carried out in tandem in a gradual and interactive manner so as to exploit the synergy of the two reforms.

It is not clear whether and when China would achieve the sufficient degrees of capital mobility and financial market development to make the RMB a significant international currency on a par with say the euro, not to mention the USD. Moreover, it seems difficult for a country without a mature legal system and a system of checks and balances to secure the confidence of the world on its currency. Based on econometric analysis, I find that financial development and capital account opening are much more important than the GDP of China in making the RMB an international currency. My model predicts that it is possible that, by 2030, the RMB can rank a distant third (behind the USD and the euro) in the global ranking of currencies used in international payments, surpassing the British pound sterling and the Japanese yen. I estimate that RMB's payment share can reach about 6 to 7% by 2030 (it is about 1.5% to 2.0% today, compared with about 55% for the USD and about 20% for the euro[1]). However, this is possible only if China greatly speeds up its financial development and capital account opening in the next decade. In the longer run, because of China's large GDP and continuing reforms and opening, and the world's central banks' demand for safe assets for foreign exchange reserves, the world may become a multi-reserve-currency system, with the USD, Euro and RMB being the three main reserve currencies.

Nonetheless, regardless of how long it takes for the RMB to become a significant international currency, one should not lose sight of the fact that RMB internationalization, in addition to being a long-term goal, is also a tool to stimulate financial markets reforms and opening at the current stage of China's development. The ultimate goal of the initiative is to facilitate economic development. Even if RMB does not become a significant international currency in the near future, if the process of seeking RMB internationalization serves as a catalyst for financial development and opening, the initiative should still be considered a success. RMB internationalization need not be an end in itself.

[1] Intra-eurozone payments and payments to/from global market infrastructure are excluded.

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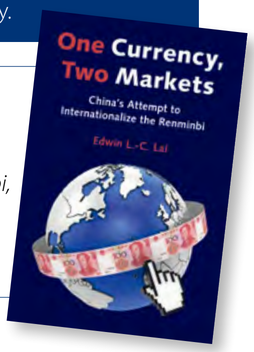
Prof. Lai has been a consultant to the World Bank, visiting scholar/fellow with Boston University, Princeton University, Kobe University, CESifo (University of Munich), Hitotsubashi University and Hong Kong Institute for Monetary Research. He is Associate Editor of Review of International Economics (Wiley Publisher), a Fellow of the CESifo Research Network (U of Munich) and a board member of Asia-Pacific Trade Seminars (APTS) Group. He received his B.Sc. in engineering from University of Hong Kong and A.M. and Ph.D. in economics from Stanford University.

Reference:

Lai, Edwin L.-C. *One Currency, Two Markets: China's Attempt to Internationalize the Renminbi*, Cambridge, United Kingdom: Cambridge University Press (2021).



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