

The Internationalisation of the Renminbi: Prospects and Risks (ARI)¹

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Theme: By looking at how far China has gone in internationalising its currency, the Renminbi (RMB), it is possible to identify the main strategic goals that China wants to achieve through this process, along with the main risks that such an objective embodies.

Summary: It can be said that so far the gradual internationalisation process of the Chinese Renminbi (RMB) has been successful. The Chinese approach of crossing the river by feeling for the stones underwater has proved to be adequate. While it is commonly believed that a currency can only become international when it is fully convertible, Hong Kong and the RMB might prove the contrary. Nonetheless, there are several risks lying ahead. So far the internationalisation process has developed smoothly because the waters of the river have been relatively shallow, but once they deepen proportionally to the amount of RMBs that are in circulation overseas, the journey might not be so easy.

Analysis:

Introduction

In the aftermath of the global financial crisis (2007-08), the Chinese Government has started a policy of promoting the internationalisation of its currency, the Renminbi (RMB), also known popularly as the yuan. The crisis showed policymakers in Beijing how overly dependent their export industry is on the use of the dollar as the currency of settlement in international transactions. The credit crunch initiated in 2007 in the subprime mortgage market in the US had devastating spill-over effects for Chinese exporters. The scarcity of dollars, due to the repatriation and deleveraging flows into the American financial system caused a sudden plunge in the external demand for Chinese goods and triggered the consequent lay-off of millions of Chinese migrant workers. This experience encouraged policymakers in Beijing to use their own currency in trade. Since 2009 they have developed a multi-phase and multi-track strategy to make the RMB a reserve currency *à la par* to the dollar and the euro. To achieve this objective, they have also said that they want to develop Shanghai as an international financial centre that can compete with Wall Street and the City of London by 2020.

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That the second biggest economy in the world wants to promote its currency is understandable. If China wants to play a bigger role in the International Political Economy (IPE), it needs greater autonomy in international monetary affairs, and what better way to achieve this than to use its own currency in international transactions. However, this is easier said than done. Making one's currency global is certainly not an easy task. France had the same aspiration for hundreds of years and was only able to achieve it by merging its monetary sovereignty with that of the German economic powerhouse. The German experience, by contrast, shows the dangers inherent to a currency's internationalisation. Issuing a global currency provides the issuer state with a number of 'exorbitant privileges', but also with responsibilities and risks. Well aware of this, Germany and Japan have always been reluctant to internationalise their currencies until they were convinced (partly erroneously) that they had financial markets sophisticated enough to cope with the risks.

Given these precedents, the aim of this paper is to explore China's RMB internationalisation journey and to identify the strategic aims and potential risks the process entails. The paper is divided into three parts. In the first, it attempts to summarise the achievements of the RMB's internationalisation process to date. Following the well-known Chinese saying of always crossing a river by feeling for the stones underwater, it shows how the Chinese government has successfully started a step-by-little-step campaign to promote its currency as a means of settlement in international trade. The second part of the paper focuses on the strategic objectives that the Chinese government pursues with its internationalisation scheme. This part will try to discern what China's main objectives and goals are with this strategy. Finally, the third part of the paper focuses on the risks that lie ahead. Rivers are shallow by the banks but become deeper in the middle, and sometimes there are currents and stones that make any crossing hazardous.

Crossing the River Starts Successfully

Although in the financial press it is commonly acknowledged that the internationalisation process of the *hongbi* (redback) started in 2009, the first issuance of RMB overseas came in the aftermath of the previous great financial crisis, the Asian crisis of 1997-98. One of the lessons of that crisis was that Asian countries should not overly rely on the financial institutions dominated by the West, such as the International Monetary Fund (IMF), and that they had to develop their own financial institutions. This happened in 2000 with the signing of the Chiang Mai Initiative (CMI) and the setting up of bilateral currency-swap agreements between the ASEAN countries and the three East Asian economic powerhouses: South Korea, China and Japan. What is true is that it was in the midst of the recent global financial crisis, as dollar liquidity was in short supply, that China accelerated its bilateral swap agreements (BSAs). In December 2008 it signed a BSA in RMB with South Korea (Rmb180 billion) which was in need of international currencies. At the beginning of 2009 it did the same with Hong Kong (Rmb 200 billion) and Malaysia (Rmb80 billion). In March of the same year the People's Bank of China (PBoC), the Chinese central bank, took its first step from the mere goal of regionalising the RMB to its internationalisation by signing another BSA with the central bank of Belarus (Rmb20 billion). Shortly afterwards, China signed also BSAs with Indonesia (Rmb100 billion) and Argentina (Rmb70 billion). Finally, in 2010 it helped crisis-strapped Iceland (Rmb3.5 billion) and it signed another BSA with Singapore (Rmb150 billion). These agreements put the total amount of China's BSAs settled in RMB as of the end of 2010 in the order of a little over Rmb800 billion, which is roughly US\$120 billion (See Figure 1). It is important to stress here that apart from the US Federal Reserve and the European Central Bank, the PBoC was the only other central bank that opened swap lines during the global financial

crisis, showing that we are gradually entering a tripolar international monetary system (Bénassy-Quéré & Pisani-Ferry, 2011).

Figure 1. China's Bilateral Currency Swap Agreements since the collapse of Lehman Brothers

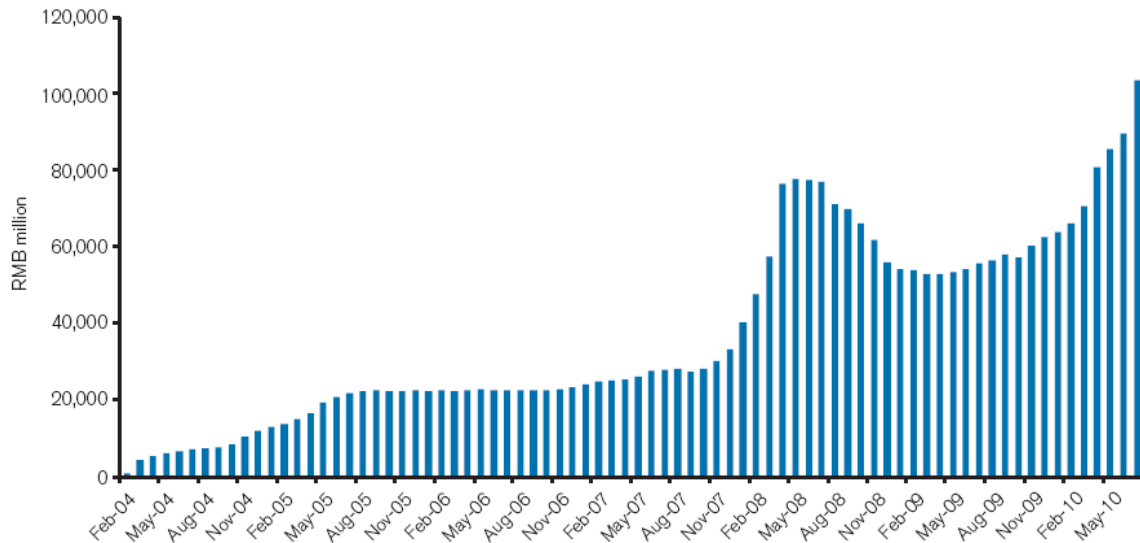
Country	Date	Amount
South Korea	12 December 2008	Rmb180bn
Hong Kong	20 January 2009	Rmb200bn
Malaysia	8 February 2009	Rmb80bn
Belarus	11 March 2009	Rmb20bn
Indonesia	23 March 2009	Rmb100bn
Argentina	29 March 2009	Rmb70bn
Iceland	9 June 2010	Rmb3.5bn
Singapore	23 July 2010	Rmb150bn

Source: author's summary from press reports.

In the private sphere, the availability of RMB-denominated bonds started in 2005 when the Asian Bond Fund, another initiative of the ASEAN+3 group, started to encourage the issuance of bonds in local currencies, including the RMB. Two years later, the PBoC and the National Development and Reform Commission (NDRC) gave the green light to the state-owned public and commercial banks of China to issue RMB-denominated bonds in Hong Kong, which from that moment became the laboratory for the river-crossing strategy. The first so called 'dim sum' bond was issued by the China Development Bank in mid-2007 and since then the issuance of RMB bonds in Hong Kong has increased significantly. This issuance is now not limited only to mainland China's financial institutions. Under the strict regulation of the Hong Kong Monetary Authority (HKMA), international banks and companies have also started gradually to issue this type of bonds. Among foreign banks, the most active in the market are Deutsche Bank, Citigroup, JP Morgan Chase, Standard Chartered and HSBC. Some of the international private companies that have started to issue dim sum bonds through these financial institutions are Caterpillar, McDonalds, Ikea and Nokia, to name just a few.

The issuance of these bonds is the second track in the RMB's internationalisation strategy. The first track is the use of the RMB in international trade. However, the two tracks are intrinsically related. Overseas goods producers and services providers that use the RMB with their Chinese customers need a supply of RMB-denominated products to invest their RMBs. Since China still applies strict capital controls on short-term capital inflows, until very recently there were limited options to use the RMBs and therefore no real incentive to acquire them in the first place. Now, however, the supply is partly provided by the second track and is concentrated in Hong Kong. Before the second track, foreign traders could only store their RMBs in low-interest-yielding bank deposits in Hong Kong, an option available since the beginning of 2004, but now with the gradual issuance of dim sum bonds the options are greater. It is no wonder then that Hong Kong bank deposits in RMB have surged since 2007. Slowly traders and investors are starting to store their *hongbis* in Hong Kong in order to invest in RMB-denominated bonds.

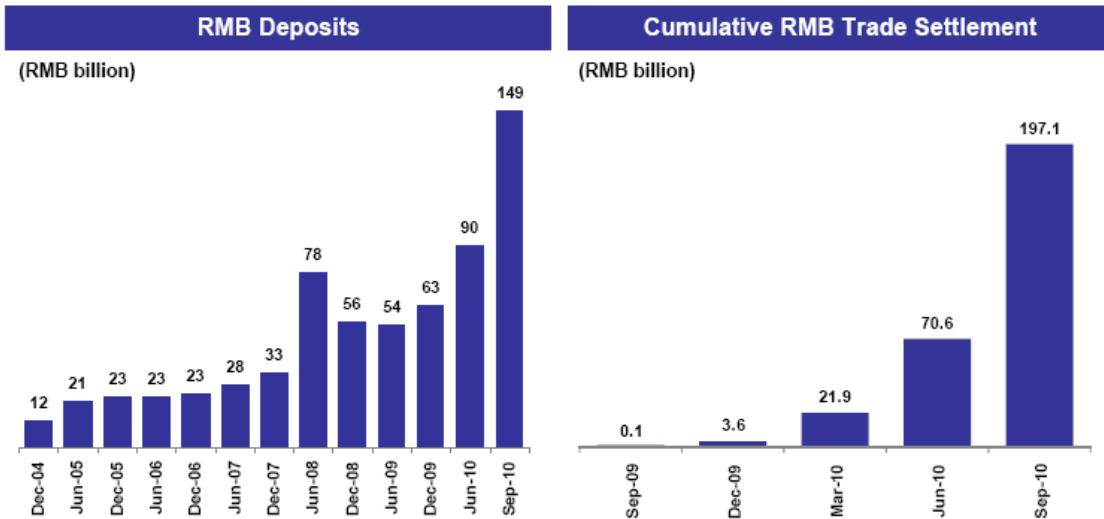
Figure 2. RMB deposits in Hong Kong, in RMB million (taken from Subacchi, 2010)



Source: HKMA

The latest figures at hand show that as of November 2010 total RMB deposits in Hong Kong stood at Rmb217 billion (Cookson & Dyer, 2010). This is double the figure in May 2010 (see Figure 3, left), an exponential increase that is very likely to continue in the foreseeable future. Economists at Goldman Sachs predict, for instance, that RMB deposits in Hong Kong should reach Rmb2 trillion (US\$300 billion) in 2015.

Figure 3. RMB deposits and cumulative RMB trade settlement (taken from Lamba, 2010)



Source: HKMA

Source: PBOC Monetary Policy Execution Reports (2009Q3 - 2010Q3) (non-quarter-end figures are not available)

This surge in RMB deposits is the consequence of the evolution of the first track of the Chinese government's internationalisation strategy, namely to increase the use of the RMB in international trade. This objective started in earnest in mid-2009 with the establishment of a pilot programme designed to encourage Chinese exporters to settle their international trades in *hongbis*. At first, the programme was confined to five major trading cities (Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan) and later, once it was seen to be successful, it was expanded to 20 provinces. Here again the projection is impressive (see Figure 3, right). RMB-denominated trade totalled Rmb440 billion in the second half of 2010, which is six times the Rmb70 billion settled in the first half, making the annual total over Rmb500 billion. June 2010 was a particularly important turning point because until then only 365 exporters nationwide were able to settle trade in RMB; after that watershed, the number has skyrocketed to 67,359. In 2011 the trade settled in RMB is very likely to continue on its upward trend. If the pace continues like this, economists at the China Construction Bank (CCB) believe that by 2015 the total annual settlement in RMB will reach US\$3 trillion, which would mean that more than half of Chinese trade with emerging markets would be priced in the Chinese currency.

The use of RMB is not reduced to trade transactions and to deposits and bonds in Hong Kong. In the neighbouring Republic of Mongolia, 60% of the cash in local circulation is in *hongbi*. In South Korea the RMB is accepted in shops and restaurants and in Vietnam the RMB can be acquired in non-official banking circuits. The RMB has also penetrated the streets of Laos, Myanmar, Cambodia and Nepal. More recently, in another significant step forward, the Chinese state-owned commercial banks, especially the Bank of China (BoC), have also started to provide cash in RMBs in the West. Now it is possible to walk into the Bank of China's branch office in New York and withdraw up to US\$4,000 per day in RMBs with an annual ceiling of US\$20,000. For businesses involved in trade with China there is no ceiling as long as they can prove that they need the RMBs for their trade transactions and not to speculate. Speculation is naturally the biggest fear of the Chinese authorities. Their aim is to promote the RMB for trade and long-term investments but not for short-term speculative gains.

What are China's Strategic Aims?

The Chinese government seeks several objectives with its internationalisation policy. Five stand out as the most important: (1) to reduce its dependence on the US dollar; (2) to generate alternative foreign-demand markets; (3) to increase China's political influence in Asia and the world at large; (4) to establish Shanghai as a financial centre able to compete with Wall Street and London; and (5) to accomplish a smooth transition from a manufacturing and export-led economy to one based on services and driven by domestic demand.

(1) Reducing China's Dollar Dependence

China's unease with the centrality of the dollar in the international monetary system has become increasingly vocal since the Governor of the PBoC, Zhou Xiaochuan, published an article in March 2009 calling for the end of the flexible-dollar system. Chinese policymakers have realised that they are in a 'dollar-trap' and they want to come out of it as soon as possible. One way to do so is to internationalise the RMB. This would reduce the transaction costs for Chinese importers and exporters, would protect them from the volatilities associated with the malfunctioning flexible-dollar-standard and, perhaps more importantly, if the RMB becomes an international currency *à la par* with the dollar and the euro to absorb more liquidity, China will be able to gradually exchange its huge dollar reserves into RMB without having to suffer heavy losses.

(2) Gaining Alternative External Demand

Through the internationalisation of the RMB, China also hopes to increase foreign demand for its products. This is especially the case for less-developed countries that might suffer from dollar shortages. While these markets are still small and will certainly not substitute the demand pull from the US and Europe in the short term, China hopes that it can slowly reduce its export dependence on the developed world and increase its trade with developing and emerging markets, especially with the other BRIC countries: Brazil, Russia and India. It is important to note that Chinese banks are increasingly offering loans in RMB all over the world. China has actually provided more loans in 2010 than the World Bank. The loans will be used to buy Chinese products and services and hence generate foreign demand.

(3) Increasing China's Geopolitical Influence

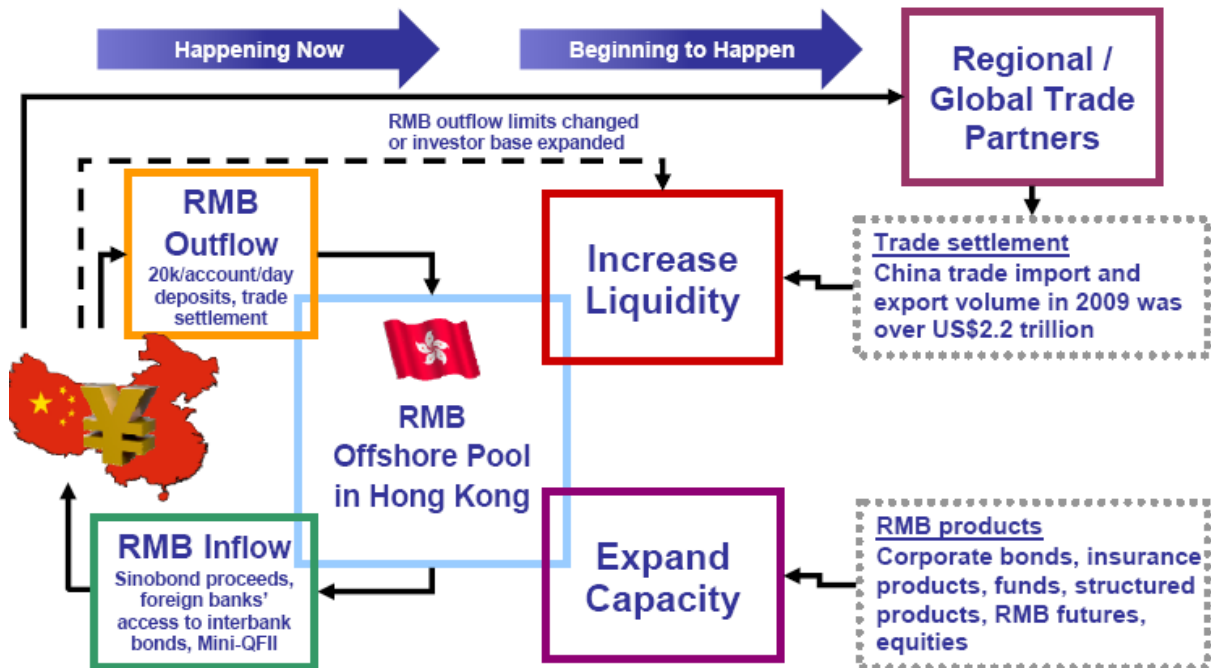
If China wants to leverage on its political power at the global level it needs to promote its currency and gain the necessary reputation of being a good custodian of its currency's value. Its political influence will start with Asia: China aspires to be the leading country in its region and to achieve that the regionalisation of the RMB can be a useful tool. Here Chinese policymakers draw on the lessons of the euro. Similarly to Germany in Europe, China's regional power and strength is seen with suspicion by its neighbours. In this regard, to avoid future confrontations, the ideal would be to establish a regional monetary union. However, an agreement seems unlikely in the foreseeable future. The political differences between Japan and China are too strong for such a thing to happen. Under the circumstances, Chinese policymakers believe that it is better to achieve a monetary union from the bottom up. The idea is to promote the RMB regionally: to increasingly penetrate the streets of neighbouring countries and once the population of these countries accept China's economic might and hegemonic status, the hope is that these same populations might be willing to accept a monetary union dominated by China, as is the case with Germany in Europe.

On the global level, through the RMB's internationalisation China aspires to sit as an equal with the US and the EU at the governance table of the international monetary system. A first step in this direction would be to include the RMB in the next IMF Special Drawing Rights basket composition, which will take place in 2015.

(4) Hong Kong as the Laboratory for Shanghai

The Chinese government is promoting the international use of RMBs in the offshore market of Hong Kong as a laboratory to test how the RMB is received internationally and what this implies for local markets. The use of Hong Kong is significant because it gives China the opportunity to internationalise its currency gradually, by feeling the stones under its feet, without compromising the stability of its own mainland markets. Contrary to common understanding, Hong Kong can make the RMB international without the necessary step of making it first fully convertible. In this regard, Hong Kong can become to China what the London offshore Eurodollar market was to the US dollar in the 1960s. During that period the US had certain capital controls, but this did not stop the greenback from increasing its share in international business transactions. While the Chinese firewalls are in place, the Chinese government wants to use the extra time that it has until 2020 to develop Shanghai's financial centre in order to cope in the future with the full convertibility of the RMB. In this regard, the experience gained from the circuit created through Hong Kong is of great value (see Figure 4).

Figure 4. The RMB's circular loop through Hong Kong (taken from Lamba, 2010)



In general, the Hong Kong experience will quicken the pace of opening up China's mainland capital market and capital account convertibility. Following this logic, in August 2010 the PBoC has opened for the first time the interbank bond market in mainland China to a limited number of foreign investors, in another pilot programme of great significance (see green box in Figure 4).

(5) From Export-led to Service-driven Growth

The sophistication of the debt and credit markets, and the internationalisation and convertibility of the RMB, are part of China's grand strategy to rebalance its economy from an export and investment-led growth model to a more service and consumption based economy. The gradual appreciation of the RMB due to its increased international role is one way to trigger this rebalancing. Right now, China's export industry relies on an undervalued RMB, but as the RMB gains in strength a lot of these companies will have to innovate and climb the value-added chain or perish. The process will be difficult, as acknowledged by the PBoC's Vice-governor Hu Xiaolian (2010), but it is also necessary. In order to rebalance from manufacturing and foreign demand to services provision and domestic consumption, China will have to develop an industry of financial intermediation outside the state-controlled commercial banks that can transform the country's huge private savings into efficient and profitable investment and innovation opportunities. Shanghai is meant to be the main hub where this financial intermediation will be located.

The Risks of Entering Unchartered Waters

Issuing an international currency brings a number of benefits. One's citizens and companies are less exposed to exchange-rate risks. One has greater access to cheaper credit. If one's currency appreciates, one will be able to buy cheaper goods and even companies overseas and also increase one's political influence. However, holding an international currency also brings enormous risks. The best example was seen in the recent financial turmoil in the Eurozone (EZ). In this case, the euro was the victim of its

own success. By having sufficiently developed financial markets to support great amounts of foreign capital inflows, the EZ was able to access cheap credit for an extended period of time (this was especially appealing for the EZ periphery) while coping with a euro that skyrocketed from US\$0.86 in 2002 to US\$1.60 in 2008 (a staggering 85% surge). However, ultimately, the euro's free convertibility led to an unsustainable growth in the EZ periphery that was bound to collapse.

The moral of this story for Chinese policymakers is clear. The opening up of the capital account is desirable because it brings foreign investment and foreign competition and it can develop the financial sector, but sometimes the foreign investment needs to be controlled, especially the speculative one. As the Chinese like to say, financial markets are sometimes like unbridled horses. The question is whether one can have it both ways: a currency that is internationally accepted and able to compete with the dollar and the euro and domestic capital markets that are heavily regulated. But these are uncharted waters. The Chinese authorities seem to be willing to open up very gradually the capital account in mainland China, but the reality is that China has a long way to go before its domestic markets can be opened up to foreign inflows without this course of action being hugely destabilising. The next question, however, is whether they can contain the flow for much longer. The pressure is already piling up. With the deepening of the internationalisation process, Hong Kong is starting to be flooded with *hongbis* ready to jump to the big market, which is mainland China. The desire to penetrate China's mainland market in search of higher yields is increasing. Investors are currently very eager to pile more and more RMB-denominated assets because they believe that the RMB will appreciate in the future, making the whole process a one-way bet. The latest figures also show that hitherto near 90% of RMB invoicing is for mainland China imports, since every trade agent wants to be paid in RMBs but does not want to have any liabilities in the Chinese currency. It needs to be said also that Hong Kong will be able to perform its laboratory role up to a point, but at a certain stage its RMB absorption capacity will be overstretched, provoking destabilising asset-price bubbles and instability.

Chinese policymakers are certainly before a huge test. Will they be able to hold the tide until mainland China develops its financial industry? In recent years, China has speeded up the sophistication of its financial markets. It has increased its market listings, developed its bond and derivatives markets and has even flirted with the idea of establishing a market of credit-default swaps. The training ground has been prepared for increased capital-market opening. As Chinese policymakers like to explain, they do not believe in pushing their children into the water so that they learn to swim by the mere instinct for survival. They prefer a gradual learning process with rubber-rings to make sure the child does not drown.

The other side of the story, however, is that training is not the same as competing. One can train for years, but until one does not enter the real competition it is impossible to assess one's strength. The same might be true for China's financial markets. The Chinese might be right when they say that Japan was wrong to open up its capital account with an underdeveloped financial system in the 1980s, but for a number of financial market experts the solution is not to delay opening up, as China seems to do, but rather to establish as quickly as possible the necessary reforms to be more resilient. As in China's case today, Japan relied in the 1980s on a centralised credit circuit built around its big banks (most of them state controlled or state owned) and the influential export sector. Under this system, credit allocation is biased in favour of the export industry. If China wants to rebalance and reduce its export dependency, it needs to broaden its credit

channels so that credit can flow more to small and medium-sized enterprises (SMEs) and less to the big state-owned enterprises (SOEs). Only in this way will the credit system have enough liquidity and depth to support external shocks. Of course, as many Chinese policymakers point out, promoting higher levels of private investment can bring more risks to the financial system. Naturally, this is also true. In this regard, the most accurate solution is to build an effective regulatory framework for the banking sector, something still missing in China, and certainly something difficult to achieve, as the global financial crisis has clearly shown to financial regulators in the US and Europe. As explained above, issuing an international currency brings several privileges with it but also a high degree of responsibilities and risks.

Conclusion: The main aim of this ARI has been: (1) to provide a summary of how far China has gone in internationalising its currency, the Renminbi (RMB); (2) to identify the main strategic goals that China wants to achieve through this process; and (3) to point out the main risks that such a goal is subject to. One can say that so far the internationalisation process has been successful. The Chinese approach of crossing the river by feeling for the stones underwater has proved to be adequate. By taking small steps China has gradually increased the use of the RMB as an invoice currency in international trade between China and other countries, as a store of value in RMB-denominated bank deposits in Hong Kong and as an investment vehicle through the steady issuance of RMB-denominated financial products (mainly bonds), also in Hong Kong. The former British colony thereby functions as a useful offshore centre, similarly to how the London offshore Eurodollar market served the internationalisation of the dollar. While it is commonly believed that a currency can only become international when it is fully convertible, Hong Kong and the RMB might prove the contrary. It is perfectly feasible, at least for a while, to see the *hongbi* increase its international trade invoicing share without Beijing having to relax its capital controls for mainland China. One can envision a RMB trade and investment circuit in which Hong Kong functions as the clearing and investment centre. The question is how long this circuit will last. One thing is clear, the desires to invest in mainland China are endless, while the absorption capacity of Hong Kong will become at some point limited.

So far the internationalisation process has developed smoothly because the waters of the river were relatively shallow, but once the waters deepen proportionally to the amount of RMBs that are in circulation overseas, the journey might not be so easy. Pressure against the capital-controls dam set up by the Chinese authorities to protect the mainland from financial instabilities is already mounting. Rumours of illegal RMB smuggling into the mainland markets are widespread. While inflation is already a problem in China, the illegal inflows will make the situation even worse. The pressure is likely to continue since most investors believe that the RMB needs to appreciate further. This makes it a one-way bet for currency speculators and also for traders who want to be paid in RMBs but are not as willing to pay Chinese products in a currency that is very likely to be more expensive tomorrow than today.

At some point, the authorities in Beijing might decide to make a leap and open up the capital account further to divert these inflows to the financial circuits. The question is whether the financial markets in mainland China will be able to cope with such a flow of new investments. As of today, the financial markets in China are still considerably underdeveloped. Credit allocation is monopolised by a small amount of state-controlled commercial banks, which normally divert their funds to state-owned enterprises (SOEs) in the export industry, and recently in the real estate sector, which is already overheating.

This model of tight governmental control of credit allocation through the banking system, which mirrors Japan's, has proved to be a great success in China's development drive. It has delivered 30 years of breakneck growth. It remains to be seen whether China will be able to change the model and climb the development chain.

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