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The Internationalization of Emerging Economy Currencies

Some Thoughts on the Internationalization of the Chinese Renminbi, Brazilian Real, and Russian Ruble

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＜Summary＞

1. The Chinese renminbi (RMB) is becoming increasingly internationalized at a steady pace in a number of ways, with more RMB-denominated Chinese trade transactions and increasingly widespread direct exchanges with other currencies. Further, the currencies of other BRIC countries, including the Brazilian real (BRL) and the Russian ruble (RUB), are also gaining a greater presence in international markets, however slowly. The currencies of these three countries, the RMB, the BRL, and the RUB, are expected to become more widely used in the economies of their respective regions, in which economies are highly interdependent.

2. On the other hand, although the Japanese yen (JPY) has been internationalized for years as the sole hard currency used in Asia, the currency has not gained sufficient status as an international currency despite the efforts of the country. Even though Japan is already one of the world's major advanced economies, the JPY's internationalization has not been commensurate with the scale of the country's economy.
3. This has been due to three factors: 1) Japan's economy has struggled since the 1990's, and dependence on and confidence in the Japanese economy has waned as the economies of other Asian countries have grown stronger; 2) international transactions of commodities, which comprise a large portion of Japanese imports, are customarily denominated and settled in USD; and 3) Japanese financial and capital markets are not especially convenient for foreign exchange settlements because of the time difference with Europe and the US. Further, JPY-denominated settlements and JPY-denominated outward capital transactions that supply JPY funds abroad have not been expanded, and sufficient JPY assets have not accumulated overseas, primarily in Asia.
4. As such, Asia-Pacific emerging super-powers China and Russia—both important economic partners for Japan—are trying to internationalize their currencies. Japan must strengthen mutual cooperation in financial and foreign exchange transactions with both countries—with which mutual economic dependency is expected to grow—through currency swap agreements and other means.
5. Furthermore, extending financial mutual cooperation frameworks to other emerging countries in the Asia-Pacific region through the Asia-Pacific Economic Cooperation (APEC) framework would likely contribute to the stability of the region's financial markets and currency systems. Through such actions, Japan must be actively involved with such efforts. Japan's participation could re-ignite the internationalization of the JPY, which had stalled.

Introduction

The Japanese and Chinese governments have agreed to bolster mutual cooperation in the financial markets and promote financial transactions between the two countries. One of those efforts, the introduction of direct trades between the JPY and RMB, began in June on the Tokyo and Shanghai markets. China's currency is steadily internationalizing in a number of ways, including through increased RMB-denominated transactions in Chinese trade and greater issuances of RMB-denominated bonds in Hong Kong. Further, the currencies of other BRIC countries, including the BRL and the RUB, are becoming increasingly visible in international markets, however slowly. Why are the currencies of these three emerging economies internationalizing, and what are their economic linkages? Furthermore, what will future developments bring? On the other hand, Japan has long worked to internationalize the JPY but has not been especially successful. This report will review the case of the JPY and address the outlook for these emerging country currencies based on recent developments.

1. Currency Internationalization: Some Points

1 - 1. Defining Currency Internationalization

When the currency of a given country internationalizes, that currency is generally used more widely around the world. In particular, 1) the use of the country's currency becomes increasingly frequent in outward transactions like foreign transactions including trade, foreign direct investment, and securities investing. Also, 2) the currency comprises a greater share of foreign currency reserves of other countries. According to the definition of currency internationalization in a 1999 paper by Japan's Ministry of Finance, *The Internationalization of the Yen for the 21st Century*, both the use of the currency in cross-border transactions and overseas transactions and the share within asset holdings by non-residents increases.

As such, internationalizing does not necessarily mean expanded usage throughout the entire world, but rather usage spanning borders and among countries and regions with strong economic interdependence. As such, the internationalization of a currency does not mean that a currency becomes a key currency.

1 - 2. The Merits of Becoming an International Currency

The internationalization of a currency offers merits for the home country in terms of private sector economic activity, both during ordinary and extraordinary times. First, during ordinary times, the internationalization of a country's currency: 1) reduces the risk of exchange rate fluctuations in trade; 2) makes financial institutions more competitive internationally; and 3) contributes to the development of financial and capital markets.

In regard to the first merit, 1) reducing the risk of exchange rate fluctuations in trade, companies bear less risk of exchange rate fluctuations particularly when trade and settlements are conducted in the currency of the home country.

Further, 2) the competitiveness of financial institutions strengthens when the home country currency is used more widely in financial transactions, which is significant for the treatment of the country's currency. Under these circumstances business opportunities are likely to increase. Furthermore, liquidity risk related to raising funds in foreign currencies is alleviated for financial institutions as a country's currency internationalizes. As a result, this 3) contributes to the development of the country's financial and capital markets.

On the other hand, internationalized currencies are also advantageous during extraordinary times. The impact of exchange rate fluctuations for key currencies the USD and EUR as well as other major currencies diminishes. The value of the USD and EUR fluctuated wildly during the global financial and debt crises after the collapse of Lehman Brothers in 2008, and shortfalls of liquidity frequently arose. Although the impact from fluctuations in these currencies could not be completely eliminated, the use of a home country currency or more direct transactions in currencies other than the USD and EUR may have reduced impacts in the event of similar crises in the future. Furthermore, alleviated exchange rate fluctuation risk for emerging countries from a currency's internationalization could contribute to the stability of the region's finances and by extension international finance.

On the other hand, there are demerits associated with the internationalization of a currency. As a country's currency is used by economic entities in other countries, speculative funds could flow into the home country through external transactions, and the country's financial markets could become less stable. This was why regulations that constricted capital transactions were introduced by China while RMB trade transactions are liberalized. However, not only is it difficult to distinguish between funds backing actual transactions and speculative funds, as the cases of advanced economies show, in fact some amount of speculative money must flow in and out due to the depth of financial and capital markets. Because of this, the soundness of financial systems must be bolstered as a country's currency becomes increasingly internationalized, as discussed hereafter.

1 - 3. Conditions for Becoming an International Currency～Currency Liberalization and Internationalization

There are two preconditions for a currency to internationalize. One is the development of a country's economic activities, particularly outward trade, to a certain level within the world or a given region. In order for this to happen, economic mutual dependence with the relevant region must increase and cross-border transactions—current transactions and capital transactions (primarily trade)—must expand.

The second precondition is the absence of restrictions or regulations in usage of a country's currency in activities; that is, the liberalization of the currency. Further, there must be an absence or minimum of regulations on the country's currency for cross-border current and capital transactions. If such regulations do exist, they must be either eased or lifted. Furthermore, in order for a currency to be used by the economic entities of other countries, domestic financial and capital markets must be equipped and open in order for economic entities both within and outside the country to make financial and capital transactions. Specifically, 1) interest rates and financial services must be liberalized; 2) interest rate and exchange rate futures markets must be established; and 3) short-term financial markets and bond markets must be nurtured. The establishment and liberalization of such domestic markets improve the competitiveness of financial institutions by promoting open and competitive markets, and this results in the ability of domestic financial and capital markets to handle expanded capital inflows and outflows anticipated after the currency becomes more international. Liberalizing outward transactions while these preconditions were unmet proved to be one of the causes of the Asian currency and financial crisis of 1997-1998 and is one of the most important lessons from recent years.

1－4. Internationalization of the JPY and Developments around the World

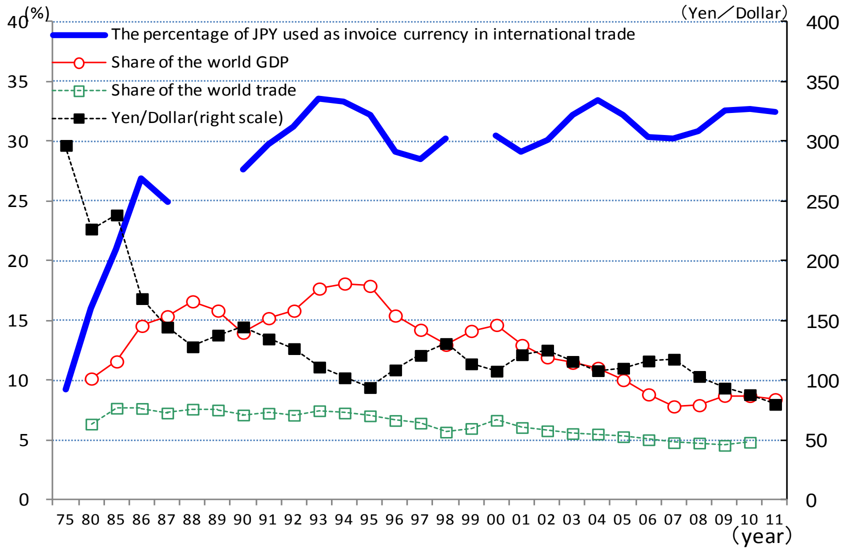
（1） Internationalization of the JPY

This section reviews the efforts and developments in internationalizing the JPY and compares these with emerging economies' current conditions. Following the complete overhaul of the Foreign Exchange and Foreign Trade Control Law of 1980, foreign transactions were liberalized in principle, and greater efforts to internationalize the JPY were made. These efforts further accelerated in the mid-80's, and in May 1984, the US-Japan JPY-USD Committee, which had been established in 1983, released its *Report on JPY-USD Exchange Issues*. The Finance Ministry also released a report on the current conditions and outlook regarding financial liberalization and the internationalization of the JPY. Both projects were intended to internationalize the JPY and liberalize finance at the same time. The internationalization of the JPY and financial liberalization domestically were integrated, and both efforts were promoted at the same time.

The JPY became increasingly internationalized as a result of these efforts, as described below. In short, the JPY internationalized, though not significantly, with 1) trade current transactions, 2) capital transactions and 3) government reserves.

JPY-denominated trade, highly relevant to corporations, especially import- and export-related companies, started to increase in the 1970s. However, expansion moderated in the early 1990s. Figure 1charts the ratio of JPY-denominated transactions in Japanese trade, Japan's share of total world trade and nominal GDP, and the USD/JPY exchange rate. The ratio of JPY-denominated transactions in trade rose from the 1970s through the 1980s as Japan's share of the world economy expanded and the JPY strengthened against the USD. However, this ratio peaked at 33.5% in 1993, then leveled off thereafter.

Figure 1: Japan's JPY-Denominated Trade Settlement Rate and Share of World Trade and Economy



Source: METI, MoF, IMF materials.

Further, Japan lagged behind the US, whose USD was a key currency, and even Germany and France, in own-currency-denominated trade transactions at peak periods (Figure 2).

Figure 2: Share of Trade Settlements Settled in Own-Country Currency

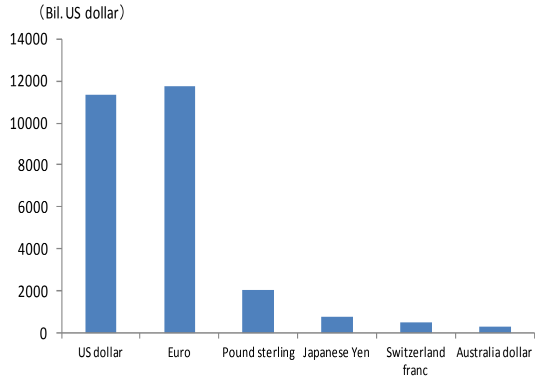
	Japan	U.S.	Germany	France
	1993	1988	1995	1997
Export	43	96	75	49
Import	18	85	52	47

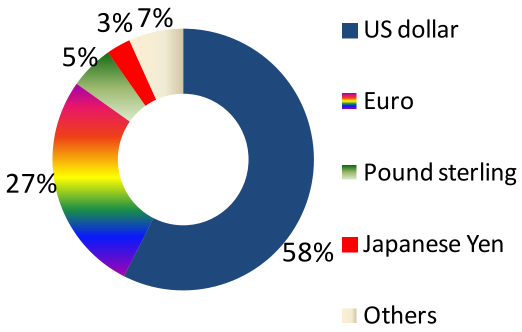
Source: MITI, *Survey of Import Export Settlement Currency*, country data.

Figure 3 shows bond issuances by different types of denominations. The amount of JPY-denominated bonds outstanding lags well behind the amount of USD- and EUR-denominated bonds. JPY-denominated bonds outstanding do not comprise even half the amount of GBP-denominated bonds; rather, the scale is on par with CHF- and AUD-denominated bonds.

Furthermore, the ratio of JPY holdings in the world's foreign currency reserves is extremely small. Figure4 shows the shares of individual currencies in foreign reserves held by central banks around the world. As of end-2011, JPY holdings comprised a mere 3% of central bank foreign reserves. Shares of USD and EUR holdings are large, with the JPY ranking fourth behind the GBP. In the mid-1970s, the JPY holdings ratio was a low 2%, then hit 8% in 1991 as Japan's economic presence expanded. Thereafter, however, JPY holdings have once again sunk to low levels because of the Japanese economy's weakness as well as the launch of a unified currency in Europe.

Figure 3: Global Bond Issuances, by Currency (Dec 2011) Figure 4: World Foreign Currency Reserves by Currency (end-2011)





Source: Bank for International Settlements.

In this way, even though Japan was already one of the world's advanced countries, the reasons the JPY did not internationalize as much as the scale of the country's economy would indicate are summarized in the three points below.

First, Japan's economy was very weak from 1990 onward, and the presence of and confidence in Japan's economy diminished as the economies of other Asian countries emerged. Second, international transactions of commodities, which comprise a large portion of Japan's imports, are customarily denominated and settled in USD. Third, although language restrictions are improving, Japan's financial and capital markets cannot be considered user-friendly because of the impact of time differences with the US and Europe on foreign exchange transaction settlements.

Of course, in fact the JPY did play an important role as the only hard currency in Asia for a long while. But even despite the country's expanding economic presence, JPY-denominated import settlements and JPY-denominated outward capital transactions, both of which supply JPY funds overseas, did not take off, and there were insufficient stockpiles of JPY assets overseas, primarily in Asia. Also, the JPY was not adequately supplied to Asian countries during the Asian currency crisis of 1997-1998 either publicly or privately. This was likely a missed opportunity for the JPY to internationalize further.

University of California-Berkeley professor Barry Eichengreen wrote in *Exorbitant Privilege* (2011) that Japan's financial liberalization policies of the 1980s intended to internationalize the JPY were not as effective as hoped, and rather caused the subsequent bursting of the economic bubble as Tokyo failed in its bid to become a center of international finance. According to Eichengreen, both domestic and foreign financial markets were liberalized as part of Tokyo's efforts to become a center of international finance in the 1980s as the JPY was being internationalized. Financial liberalization eased capital market financing for large companies, but on the other hand, banks lost major customers and aggressively financed the real estate industry. This led to the formation and subsequent bursting of a huge asset bubble. Because of this, Tokyo was unable to rise beyond a second-tier international financial center. Although this view is partially correct, it may be an exaggeration to suggest that the entire reason for the failure of the JPY to internationalize was financial liberalization that caused the economic bubble and subsequent collapse and the plunge of the Tokyo financial markets.

(2) Current Conditions in China, Brazil, and Russia

The following points compare the current economic scales and size of trade and capital transactions of China, Brazil, and Russia to Japan in the 1980s, when the JPY began to internationalize (Figure 5).

Because all are nominal figures, comparisons with figures from thirty years ago are difficult, but China's nominal GDP and shares of global exports and imports are already about the same level or higher than Japan's in 1980. Both inward and outward direct investment flows are similarly difficult to compare, but China and Russia's outward and inward direct investment, and Brazil's inward direct investment, exceed the levels of Japan in 1980. The macro economies of the three countries are already meeting one condition of internationalizing currencies, even more so compared to Japan.

Figure 5: Key Data: Japan, China, and Russia (2011)

(Bil US dollar,%)

	China	Brazil	Russia	Japan (1980)	Japan (2011)
Nominal GDP	7,298	2,475	1,850	1,087	5,869
(shares of global GDP)	10.2	3.4	2.6	10.2	8.2
Exports	1,899	256	516	127	821
(shares of global Exports)	10.6	1.4	2.9	6.5	4.6
Imports	1,743	226	305	125	853
(shares of global Imports)	9.4	1.2	1.6	6.2	4.6
FDI outflows	65	−1	67	2	114
FDI inflows	124	67	53	0	−2
Portfolio invest. outflows	8	5	3	4	57
Portfolio invest. inflows	32	68	2	11	−1

Note: Outward and inward securities investment data from 2010.

Source: IMF IFS.

Restrictions and regulations regarding the use of own-country currency for external transactions as well as the development and liberalization of domestic financial and capital markets vary among the three countries. That said, none of the countries are considered to have established sufficient frameworks. As described below, not only does China strictly manage capital transactions, but the country is only halfway toward liberalizing its domestic financial markets. Further, Russia's current and capital transactions were both liberalized at a relatively early stage, but the central bank has continued aggressive intervention even after the exchange rate system was changed to a floating exchange rate. This is expected control market levels.

1 ‐ 5. Declining Confidence in the USD and Reassessing the International Currency System

China, Brazil and Russia are not only continuing their efforts to internationalize their own currencies, but there is a growing movement among the BRICs as a whole, including India, as well as a number of emerging countries, to break away from the USD. These countries are increasingly vocal as their own economic power grows, and in particular China has starting to actively voice negative views regarding the state of the international currency system since the global financial crisis of 2008. One pivotal event occurred in March 2009, when People's Bank of China Governor Zhou Xiaochuan delivered a speech highlighting the problems with the existing international currency system in which the USD is a key currency. He called for broadening SDR functions to make it a reserve currency. Although his calls themselves are unlikely to be realized anytime soon, economic powerhouse China's pointing out the limitations of the USD, the currency of the United States, and proposing strengthening the functions of the SDR, which is managed by the IMF, came as a shock to the international financial world. Since then, arguments to reform the international currency system have arisen, and IMF staff have released reports on reforming the international currency system. A number of prominent US researchers and economists, including Director of the Peterson Institute for International Economics Fred Bergsten, UC Berkeley professor Barry Eichengreen and Columbia University professor Joseph Stieglitz, have offered proposals regarding the current international currency system.

Even in 2012, the BRICS (including South Africa for a total of five countries) have continued to actively debate international currency and finance. In March, a special meeting to discuss extraordinary currency issues was held at the World Trade Organization meeting at the proposal of Brazil. The BRICS meeting yielded an agreement to consider the creation of a 'BRICS Bank' to support infrastructure and other projects in developing countries and funded by related countries. Events in these countries will continue to bear watching.

Developments for the currencies of China, Brazil, and Russia are described below.

2. China RMB

2 - 1. Recent Developments in the Internationalization of the RMB

(1) RMB Settlements of Cross-Border Trade

In 1996, China accepted Article VIII of the IMF Agreement, and current transactions were liberalized in principle. However, the RMB remained basically unusable in cross border transactions and settlements overseas [1].

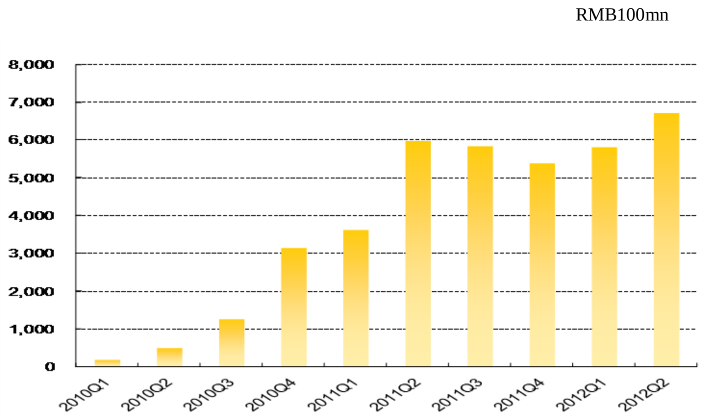
In July 2009, China introduced a pilot program to allow RMB-denominated trade settlements by the People's Bank of China and related institutions. The program allowed pilot companies in Shanghai and four cities in Guangdong Province to settle trades with Hong Kong and ASEAN trading partners in RMB. In June 2010, the framework was broadened to include trade by companies in 20 provinces, autonomous zones, and directly-governed municipalities (exports were limited to the pilot companies) with the entire world. The program was expanded even further thereafter, and now companies in all regions of China with the right to foreign trade are allowed to make cross-border trades denominated in RMB.

Further, when RMB cross-border settlements were first approved in July 2009, transactions that could be settled in RMB were limited to trade transactions. However, from June 2010 the scope of transactions allowed was expanded to include all current transactions including services transactions.

The *China Monetary Policy Report*, released by the People's Bank of China, revealed that cross-border settlements denominated in RMB rose 3.1x on-year to RMB2.8trn in 2011, to one-tenth of all Chinese trade value (Figure 6). However, according to Q3 2011 data, in fact 90% (in terms of value) of RMB-denominated cross-border settlements were made with Hong Kong. RMB-denominated cross-border settlements totaled RMB583.4bn, and of this RMB525.4bn was with Hong Kong as trading partner.

[1] This report uses the term 'overseas' for expediency. Here, the term 'overseas' includes both outside the nation of China, as well as Hong Kong and Macao. Conversely, the term 'domestic' does not include Hong Kong and Macao.

Figure 6: RMB-Denominated Settlements of Cross-Border Trade



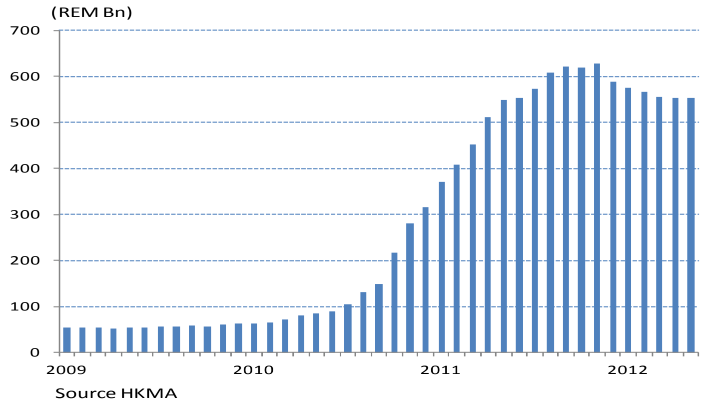
Source: *China Monetary Policy Report* (Q4 2011), People's Bank of China.

(2) Offshore RMB Markets

The RMB is circulating overseas increasingly as the currency internationalizes. Markets are competing around the world to become offshore RMB markets that handle overseas RMB transactions.

Hong Kong enjoys the advantage of being a Chinese territory despite treatment as a foreign country in terms of foreign exchange management, and the bulk of RMB circulating offshore is through the Hong Kong market. Hong Kong was a test market as an offshore RMB market and the prohibition against RMB trading was lifted here first; Hong Kong handles much more RMB transactions than other markets. Hong Kong allowed RMB business dealings for individuals in 2003, and RMB deposits and credit card businesses were introduced. Thereafter, RMB cross-border trade settlements began in 2009, and the Hong Kong Monetary Authority greatly eased regulations covering RMB transactions in July 2010. As long as money flows into Mainland China did not occur, the RMB could now be handled in the same manner as other currencies in principle. The following month, foreign exchange and fund transactions were established for Hong Kong's interbank market, and the offshore RMB market was launched. The Hong Kong market is said to handle approximately RMB15.0bn of USD/RMB transactions, more than 10x the scale of JPY/RMB transactions on the Tokyo market. Further, RMB deposits have surged since mid-2010 in Hong Kong and totaled more than RMB563.2bn (JPY6.9trn) as of July 2012. A variety of RMB-denominated financial instruments are now structured and sold, including Dim Sum Bonds (RMB-denominated bonds) for both Hong Kong companies and non-residents. Dim Sum Bond issuances totaled RMB107.9bn (JPY1.3trn) in 2011.

Figure 7: Hong Kong RMB Deposits



Source: Hong Kong Monetary Authority.

Singapore and London have both launched bids to become the second-biggest offshore RMB market after Hong Kong. The governments of the UK and China agreed in September 2011 to cooperate in the development of an offshore RMB market in London, and HSBC reportedly announced the issuance of RMB-denominated bonds in London, the first RMB-denominated bonds outside the Hong Kong market, in April 2012. The governments of Japan and China reached an agreement at the end of 2011 to strengthen financial cooperation, specifically by developing an RMB offshore market in the Tokyo market, as described below. These efforts are part of strategies to energize their own markets through the internationalization of the RMB.

Figure 8: RMB-Denominated Bond Issuances in Hong Kong (major issuers)

Year	Main Issuers		Amount RMB bn
	Residential	Non-residential	
2007	China Development Bank, The Export-Import Bank of the ROC, Bank of China	—	10
2008	China Development Bank, The Export-Import Bank of the ROC, Bank of China	—	12
2009	Ministry of Finance of PROC, China Development Bank, HSBC China, Bank of East Asia China	—	16
2010	Ministry of Finance of PROC, China Development Bank, The Export-Import Bank of the ROC, Bank of China, SINOTRUK、China Resources Power	ADB, Hopewell, McDonals, Caterpillar Inc, Galaxy Entertainment, SINOTRUK HK, China Resources Power, UBS, ANZ	35.76
2011	Ministry of Finance of PROC, SHOUGANG、Baosteel, LDK Solar Hi-Tech	World Bank, ADB, The Export-Import Bank of Korea,The Korea Development Bank、BMW AUS Finance, BP, Tesco, Caterpilla, Volkswagen, Unilever, ORIX、IDBI、ICBC Asia	100
2012	Ministry of Finance of PROC, China Development Bank, Agricultural Bank of China, Baosteel, Huawei Technologies	Ford Motor Company, Caterpilla, Mitsubishi UFJ Lease & Finance、Mitsui&Co, Lotte Department Store, Hainan Airlines HK	N.A.

Source: Hong Kong Monetary Authority, Reuters.

2－2. The Outlook for the Internationalization of the RMB

(1) Internationalization of the RMB: Developments

China has in the past severely restricted cross-border capital transactions, including foreign currency transactions. China learned from the debt crisis of Central and South America of the 1980s and adopted a strategy of aggressively promoting inflows of non-debt direct investment while severely restricting debt capital, including securities investments and loans from foreign countries. Recent balance of payments crises have been caused more by the sudden repatriation of funds overseas, rather than by difficulties in financing current account deficits. China adopted a strategy to strongly resist pressure to suddenly withdraw funds, and as a result, various periods of economic turmoil abroad have had a relatively limited impact on the domestic economy. China stood out among Asian countries in avoiding a currency and financial crisis during the Asian currency crisis of 1997-98. Furthermore, the global financial crisis touched off by the 2007 subprime crisis in the US did not cause a crisis for China’s domestic financial sector. These were the largely the results of strict financial regulations.

However, the exchange rates of major currencies like the USD and EUR have fluctuated wildly since 2008 because of the global financial crisis. China recognized the risk of excessive dependence on the USD for trade. Promoting RMB settlement of cross-border trade would not only help Chinese companies avert exchange rate risk and reduce foreign exchange losses, but also reduce exchange rate risk factors for foreign currency external assets like foreign currency reserves. Furthermore, Chinese financial institutions would likely benefit from expanding business and improved competitiveness. This would also support the construction of an international financial center in Shanghai, proposed by the Chinese Government and slated for completion in 2020. In sum, as the economy expanded, the severe restrictions on using the RMB abroad were squelching economic activity, and this led to some of the developments noted above.

The Chinese Government has been diversifying from usage of the USD in external transactions and has proposed promoting own country-currency settlements in bilateral trade in a number of arenas. A meeting of heads of state of the BRICS (Brazil, Russia, India, China, and South Africa) was held in April 2011 in Hainan, China. A memorandum on financial cooperation in BRICS government-affiliated bank cooperation mechanisms was drawn up, proposing the gradual expansion of trade settlements in own-country currencies by the BRICS and improved convenience in trade and investing. Furthermore, the joint statement released after the Fourteenth ASEAN + 3 (China, Japan, and South Korea) meeting of financial ministers in Hanoi in May 2011 included an agreement to study the possibility of allowing own-country currency settlements for imports and exports among China, Japan, and South

Korea. In New Delhi this past March, the China Development Bank agreed to provide RMB financing for development banks in the BRICS countries in order to promote the use of the RMB in trade and investments among the BRICS. One financial institution projects that these efforts will result in the ratio of RMB-denominated settlements in Chinese trade with Asia to reach 50% by 2015.

(2) A Master Plan for Internationalizing the RMB

Chinese monetary authorities have indicated that they plan to ease regulations on RMB capital transactions in stages. A February 2012 report by the survey statistics department of the People's Bank of China on the basic conditions for accelerating Chinese capital accounts serves as a reference.

Chinese monetary authorities had not laid out a precise timetable for liberalizing RMB capital transactions, and the report is the first indication of a schedule: 1) Regulations on direct investment will be loosened over the short term (one to three years), and foreign direct investment by Chinese companies will be promoted; 2) Regulations regarding commercial loans, which support the real economy through trade, will be loosened over the medium term (three to five years), promoting the internationalization of the RMB; and 3) the financial markets will be developed over the longer term (five to ten years). Real estate, stock, and bond transactions will first be liberalized at a careful pace. The report notes that short-term external debt, which is speculative in nature, will not be liberalized for some time.

Recently regulations regarding RMB capital transactions have been loosened gradually as a result. More detailed changes are described below.

In August 2010, the People's Bank of China allowed overseas central banks and overseas banks participating in RMB settlements to use RMB to invest in securities that are traded among domestic banks like Chinese government bonds. This allowed the use of RMB for securities investment flowing into China among cross-border capital flows. (But the RMB that could be used was limited to RMB funds sent overseas from within China through currency swap agreements among central banks and RBM cross-border settlements. RMB already in circulation abroad and from new purchases from foreign exchange transactions could not be used.)

In January 2011, the People's Bank of China promulgated a regulation on managing RMB settlements in outward direct investment that allowed RMB-denominated outward direct investment from China. At the same time, RMB-denominated loans to companies in which direct investments are made were allowed within the allowed direct investment amount.

In October 2011, the Chinese Ministry of Commerce announced a regulation on cross-border RMB direct investment issues, and the People's Bank of China issued a regulation on managing RMB settlement for direct investment in foreign businesses. These allowed overseas investors to make inward direct investments into China with RMB. At the same time, loans from abroad (foreign debt) were also allowed.

(3) Internationalization of the RMB: Major Issues

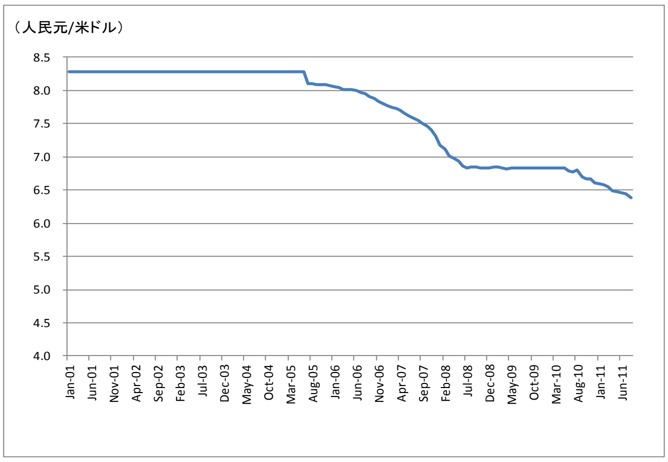
As described above, although the RMB is steadily internationalizing not only with current transactions but also with capital transactions, a number of issues remain. Chinese authorities have stressed three principles in implementing currency policy: ensuring independence (meaning at China's own pace), manageability, and a gradual pace. Because of this, the RMB is expected to internationalize and liberalize in steps and cautiously.

Generally, liberalization of domestic interest rates is considered a prerequisite for loosening capital transactions. Liberalizing capital transactions without first freeing domestic interest rates could cause funds to flow inward from offshore in a manner domestic authorities cannot control, possibly stoking inflation and the formation of bubbles. Conversely, capital flight outward could be encouraged. Sequencing is important in financial liberalization overall, and this must be executed cautiously and in steps while carefully watching the impact on other policies. However, domestic financial reform has not made particular progress because of the stubborn resistance of vested interests. Chinese authorities are also highly sensitive to confusion caused by liberalization.

The foreign exchange rate system must become more flexible in order for RMB usage to expand. RMB markets are slowly becoming more flexible, and there are some views that because it is clear that the other side of trade would suffer losses from using the RMB in settlements (the overseas side for exports from China and the Chinese side for imports into China), a mutual agreement will not be reached and as a result the RMB will not be used more widely as expected. In order to prevent such problems, the RMB exchange rate must be made more flexible to prevent expectations that the RMB will continuously rise. The RMB will not be more widely used if the RMB exchange rate cannot be made more flexible in light of the impact of exports on the Chinese economy.

RMB buying and selling among non-residents of China are basically unrestricted, and RMB procured through trades among foreign banks can be used for capital transactions like direct foreign investment and loans from abroad (foreign debt). Meanwhile, in June 2011 the People's Bank of China released a regulation on issues related to cross-border RMB business, which limited RMB buying and selling between overseas and domestic banks to use for trade settled within three months. Although there are no problems with repatriating RMB outflows through various measures to internationalize the RMB, allowing free access to Mainland Chinese markets and liberalizing cross-border foreign exchange transactions makes it harder to control the RMB exchange rate. Authorities appear to be extremely cautious about such measures.

Figure 9: USD/RMB Since 2001



Source: Bloomberg

2－3. Chinese-Japanese Financial Cooperation

The Chinese and Japanese heads of state agreed at a meeting on December 25, 2011, to strengthen mutual cooperation in developing the financial markets of both countries. As a result of the agreement, direct trades between the JPY and RMB were launched on the Tokyo and Shanghai markets on June 1, 2012. This is one means to promote the internationalization of the RMB for the Chinese side.

Figure 10: Enhanced Cooperation for Financial Markets Development between Japan and China (Fact Sheet)

To support the growing economic and financial ties between Japan and China, the leaders of Japan and China have agreed to enhance mutual cooperation in financial markets of both countries and encourage financial transactions between the two countries, specifically in the following areas, paying attention to the principle that these developments should be market-driven.

I. Promoting the use of JPY and RMB in cross-border transactions between Japan and China.

☐ Facilitating trade settlement in JPY and RMB to reduce foreign exchange risks and transaction costs for exporters/importers in both countries; and

☐ RMB-denominated FDI from Japan to Mainland China, including to subsidiaries of Japanese companies.

II. Supporting the development of direct exchange markets between JPY and RMB;

III. Supporting sound development of JPY and RMB bond markets.

☐ RMB-denominated bonds issued by Japanese companies in Tokyo and other overseas markets; and RMB-denominated bonds issued by Japan Bank for International Cooperation in mainland China markets as a pilot program; and

☐ Application process is underway for the Japanese authority to invest in Chinese government bonds.

IV. Encouraging the private sector to develop JPY-denominated and RMB-denominated financial products and services in the overseas markets; and

V. Establishing "Joint Working Group for Development of Japan-China Financial Markets" to promote mutual cooperation in the above-mentioned areas.

In addition, we agreed to accelerate the ASEAN+3 financial cooperation, including introducing the regional crisis prevention function and further strengthening the crisis resolution mechanism of CMIM.

Source: MoF.

In the past, when companies made JPY-RMB transactions in Japan, banks often covered transactions by breaking down the process into two steps: they exchanged JPY for USD, then exchanged USD for RMB on the foreign exchange markets. Those transaction costs were settled using cross rates combining JPY and RMB rates versus the USD, while funds settlements had to be settled in USD.

With the launch of direct JPY-RMB transactions, the spread between bid and offer rates could shrink without the involvement of the USD in the transaction if the markets are big enough. This could ultimately result in lower transaction costs for companies. Further, fund transactions not involving the USD could be possible and financial institutions would face less risk from time differences. Given these impacts, the start of direct exchange transactions between the JPY and RMB has been a ground-breaking development.

According to market participants, the Tokyo market now has a trading value of approximately RMB800mn (equivalent to approximately JPY10.0bn), and trading has continued to be on that scale. The spread between bid and offer rates appears to have shrunk compared to when the USD was involved in transactions, as direct trading of the JPY and RMB appears to have gotten off to a smooth start.

At the same time a new market maker JPY-RMB transaction system was introduced in the

Shanghai interbank foreign exchange market on June 1. This was the start of increased direct trades between the JPY and RMB. Banks designated as market makers release their buy and sell rates for the JPY and RMB at any given time and must accept deals at those prices. Further, every morning the China Foreign Exchange Trade System (CFETS), the operator of the markets, releases the average JPY/RMB rate offered by multiple market makers as the intermediate value. So far, trades have grown to approximately RMB3.0bn a day, and, as in the Tokyo market, the transaction spreads appear to be shrinking compared to before.

The Shanghai interbank foreign exchange market initially accepted only five currencies for trade with the RMB: the USD, EUR, GBP, JPY, and HKD. The MYR was added in August 2010, with the RUB in November 2010, and AUD and CAD in November 2011 following. However, because of the difficulty in making payments quickly as necessary, trading volume for currencies other than the RMB and USD has been limited, and more than 99% (of value) of transactions involve the USD as an intermediary. Although the RMB had been directly traded only with the MYR and RUB without other currencies as an intermediary, the recent launch has allowed direct trades with the JPY as a non-USD key currency for the first time.

JPY and RMB trading on the Tokyo market is currently primarily conducted using the proprietary accounts of Japan’s three megabanks. Increasing customer order trading of the JPY and RMB will be necessary to further develop the market.

Total imports and exports between Japan and China totaled JPY27.54trn, according to 2011 trade data. Japanese trade with China exceeded trade with the US, and China is Japan’s biggest trading partner. Trade with China is expected to keep growing. On the other hand, the bulk of trade settlements between Japan and China is made using the USD, with JPY settlements comprising approximately 30-40% and settlements in RMB less than 1%. Trade in JPY and RMB by companies has considerable room for growth. With the start of direct JPY-RMB trading, there has been an ‘announcement effect’ regarding the usage of RMB, which has been considered difficult in the past, and the RMB now may feel more familiar. Financial institutions have received a number of inquiries from client companies. There is considerable potential demand for corporate activity between China and Japan, beginning with such trade, and the Tokyo market may be more favorable than other markets.

There are still many regulations concerning RMB cross-border transactions, and this limits the supply of RMB liquidity in overseas markets aside from Hong Kong. In order to ensure adequate liquidity of RMB, Mainland China foreign exchange regulations must be eased. However, Chinese authorities are concerned about the impact on domestic monetary policy and remain cautious about freely recognizing cross-border foreign exchange trading. Even if regulations are loosened, the pace of any changes will most likely be gradual.

Even if the private sector is to engage independently in RMB business in order to develop the Tokyo market, significant progress is unlikely on the efforts of the private sector alone as long as so many regulations covering RMB trading remain. In order to ensure RMB liquidity on the Tokyo market, schemes must be devised to supplement private liquidity. For example, the Bank of Japan and People's Bank of China could conclude a currency swap agreement with the JPY and RMB, and the RMB must be supplied on the Tokyo market.

There are some views that promoting direct trades of the JPY and RMB and the use of the JPY and RMB in cross-border transactions would be a double-edged sword that would expand the use of the RMB in trade between the two countries and also threaten the JPY's status as a global currency. However, merely envying China's hastening internationalization of the RMB means that Japan will face bleak prospects. The RMB's internationalization could be new momentum for both the revitalization of the Tokyo market as well the internationalization of the JPY, which had foundered in the past.

China and Japan are expected to cooperate financially by further promoting the issuance of RMB-denominated bonds by Japanese companies on the Tokyo market. A structure that makes the issuance of RMB-denominated debt on the Tokyo market by Japanese companies active in China could enable SMEs that are not well-known in China to raise funds at relatively low interest rates. As noted above, although company issuance of RMB-denominated bonds overseas to raise RMB, used to invest directly in Mainland China and lending (foreign debt for the Chinese side) are already allowed, just how fast funds can be raised and how smoothly RMB funds can be taken into China calls for the establishment of procedures and infrastructure in the future. The Japanese Government will have to work with the Chinese Government on these points.

Figure 11: Currency Swap Agreements among Central Banks

(Unit: RMB100mio)

Date	The other party	Amount
2008/12/12	Korea	1,800
2009/1/20	Hong Kong	2,000
2009/2/8	Malaysia	800
2009/3/11	Belarus	200
2009/3/23	Indonesia	1,000
2009/3/29	Argentina	700
2010/6/9	Iceland	35
2010/7/23	Singapore	1,500
2011/4/18	New Zealand	250
2011/4/19	Uzbekistan	7
2011/5/6	Mongolia	50
2011/6/13	Kazakhstan	70
2011/10/26	Korea	1,800 (Cumulative total: 3,600)
2011/11/22	Hong Kong	2,000 (Cumulative total: 4,000)
2011/12/22	Thailand	700
2011/12/23	Pakistan	100
2012/1/17	UAE	350
2012/2/8	Malaysia	1,000 (Cumulative total: 1,800)
2012/2/21	Turkey	100
2012/3/20	Mongolia	50 (Cumulative total: 100)
2012/3/22	Australia	2,000
Total amount		16,512

Source: People's Bank of China.

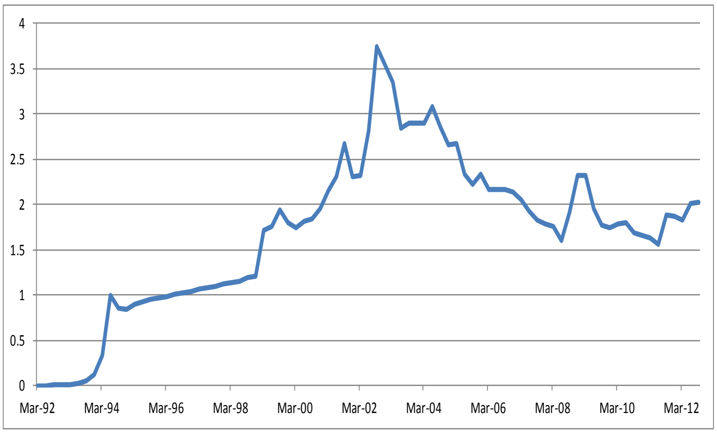
3. The Brazilian Real

As emerging economies—primarily the BRICs—gain more weighting within the world economy, attention has focused increasingly on the internationalization of emerging economy currencies. Much of Japan's concern is with the internationalization of the Chinese RMB, but the BRL is also steadily internationalizing, albeit at a gradual pace.

3 - 1. BRL Currency System and Exchange Rate Developments

Figure 12 tracks the BRL's value against the USD.

Figure 12: USD/BRL

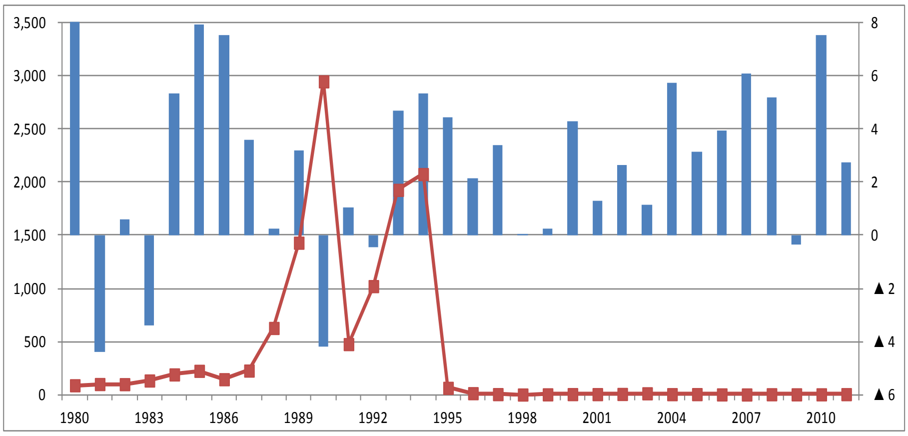


Source: Compiled from Bloomberg data.

In the early 1990's, Brazil struggled with hyperinflation, the aftereffect of its huge debt problem of the 1980's. The government pegged its currency to the USD as an anchor to control hyperinflation in 1994. This was known as the Real Plan, and was in fact a crawling peg system in which the BRL rate against the USD was slowly lowered in response to inflation. The policy was effective and hyperinflation was finally laid to rest (Figure 13). This helped to restore confidence in Brazil after the response to the debt problem ended in the mid-1990's as economic growth recovered with large-scale privatization intended to minimize government.

However, the Asian currency crisis beginning in 1997 impacted Brazil, and huge sums of capital flowed out of the country in 1998. The USD peg system grew difficult to maintain. The USD peg was abandoned and the BRL allowed to be devalued in early 1999, as Brazil shifted to a floating rate system without exchange rate bands and target levels. Even in the early 2000's, ripples from the Argentine debt crisis spread and Brazil's economy was unstable. However, under the Lula Administration that took office in 2003, the central bank introduced a target inflation rate and an inflation targeting policy framework was implemented in which interest rates could move flexibly. Confidence in Brazil's policies surged. Since the late 2000's, Brazil's exchange rate has continued to improve overall amidst steady inflows of capital due to high resource prices and the Brazil boom.

Figure 13: Brazil GDP Growth Rate and Inflation (GDP growth – right axis; Inflation rate – left axis)



Source: Compiled by IIMA from IMF data (WEO).

3 - 2. Current BRL Use in Trade and the Outlook

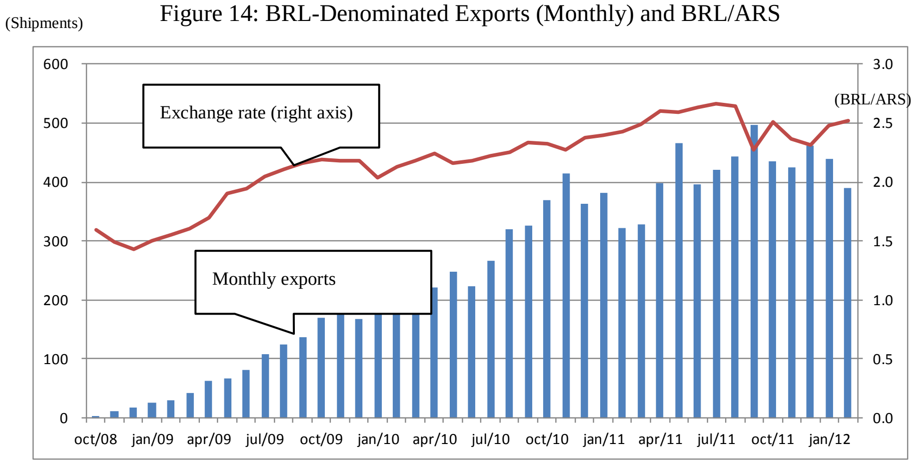
Since the latter half of the 2000's, confidence in Central and South America as a whole has improved considerably as the region's macro economy has stabilized. Autonomous developments have occurred in politics and the economy in the region. For example, from 2005, a joint framework was launched to promote the integration of politics and the economies of South American countries in 2005, and in 2007 an agreement was reached to establish a South American bank to support infrastructure development in the region.

Since the global financial crisis in the fall of 2008, emerging economies, especially the BRICs, have tried to wean themselves off USD dependency amidst efforts to promote own-country currency settlements in trade. In particular, at the BRICs summit held since 2009, a move to promote trade settlements in BRICs currencies was promulgated. Within the Central and South American region, own-country currency settlements began with trade between Brazil and Argentina in October 2008. This was in line with the BRIC efforts.

Data regarding own-country currency trade settlements between Brazil and Argentina are discussed below. BRL-denominated export shipments from Brazil to Argentina have been steadily rising (Figure 14), with aggregate annual shipments totaling approximately 1,200 shipments in 2009, approximately 3,400 in 2010, and approximately 5,000 in 2011. This is thought to be largely because the BRL-ARS exchange rate has been stable in the BRL/ARS2.1 to BRL/ARS2.5 range since 2010.

Conversely, ARS-denominated Brazilian imports (ARS-denominated exports for the Argentine side) have not changed significantly in terms of monthly shipments. This is likely because Argentina has been isolated from the global financial world throughout the 2000's and the ARS has not been used much even in neighboring Brazil.

Figure 14: BRL-Denominated Exports (Monthly) and BRL/ARS



Note: Argentine pesos per Brazilian real.

Source: Compiled from Brazilian central bank website.

Own-country currency trade settlements within Mercosur began between Brazil and Argentina, and are expected to slowly expand to all Mercosur countries. However, own-country currency settlements even between Brazil and Argentina are in fact heavily weighted toward BRL settlements, illustrating the difficulty in increasing own-country currency settlements for both countries.

Further, even if the BRL is used in trade with other Mercosur countries aside from Argentina (Uruguay, Paraguay, and Venezuela), the amount will likely be limited. In particular, Uruguay and Paraguay's shares of trade are small, in line with the scale of their economies. Also, even though Venezuela, which only recently officially joined Mercosur, has about the same amount of exports as Argentina and imports more than Uruguay and Paraguay, it is tightening external trade. Venezuela is unlikely to use the BRL more in trade. In light of this, the BRL's internationalization (in trade) is expected to increase at a gradual pace within Mercosur, particularly in trade with Argentina.

Figure 15: Trade Volume among Mercosur Member Countries, 2010 (USD mn)

		Importer					Total
		Brazil	Argentina	Uruguay	Paraguay	Venezuela	Export
Exporter	Brazil	—	18,523	1,531	2,548	3,854	201,930
	Argentina	14,421	—	1,601	1,154	1,424	68,115
	Uruguay	1,575	553	—	140	336	7,888
	Paraguay	661	538	1,095	—	110	4,533
	Venezuela	455	194	707	—	—	65,782
Total Import		181,595	56,502	12,051	9,400	30,744	

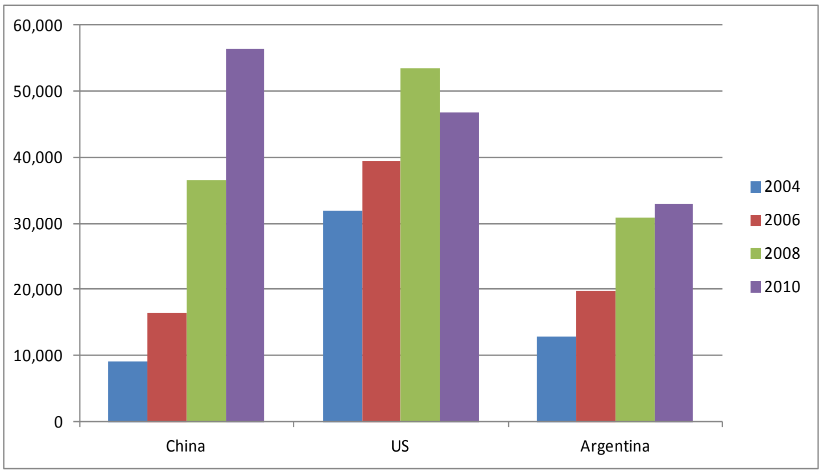
Source: Compiled from IMF data (DOT).

Further, Brazil's linkage to China is of particular note in regard to own-country currency trade settlements. Trade between the two countries ballooned throughout the 2000's as Chinese demanded for foodstuffs and mining resources surged and as China provided a stable supply of cheap goods to Brazil. In 2010, China became Brazil's biggest trading partner, surpassing the US and Argentina (Figure 16). China and Brazil have cooperated to expand trade and investment as relations between the two countries have grown closer.

In June 2012, the heads of both China and Brazil announced the conclusion of a currency swap agreement (up to BRL60.0bn for Brazil) to tap the currency of the other country. With trade expected to continue to expand, measures have been introduced to promote and support settlements with the respective currencies even in trade. But it is unclear just how much the currencies of the two countries will be used for trade settlements. At present, Brazilian trade with China is comprised primarily of exports of foodstuff and mining resources and imports of cheap, labor-intensive manufactured goods.

Natural resource transactions have customarily been denominated in USD. Further, China is not a nearby country like Argentina, and own-country currency trade settlements are unlikely because of the physical distance with Brazil. Given these considerations, BRL-denominated trade settlements with China are unlikely to suddenly surge. But the decision to promote own-country currency trade settlements with China as part of a cooperative relationship is worth watching.

Figure 16: Brazil Major Trading Partners and Trade Volume (total imports and exports)



Source: Compiled by IIMA from IMF data (DOT).

3－3. Outlook for BRL Internationalization and Liberalization

The liberalization of capital transactions is an important condition for the internationalization of a currency, and the inadequate liberalization of China's capital transactions has been highlighted as a limitation for the internationalization of the RMB. On the other hand, the high share of securities investments in Brazil's external debt shows that capital transactions are being liberalized more than in other emerging countries, and overseas investors are pouring investments into Brazil because of the appeal of resource-rich country currencies.

Confidence in the BRL as an investment is gradually building as the country becomes more open to the outside, even among the Central and South American region. The currency can be expected to play a role in global investment portfolios as a resource-producing country currency, like other resource producer currencies the Canadian and Australian dollars.

Further, the use of the BRL in trade has been described above, and the currency's use by international organizations and overseas public institutions in capital transactions is expanding through BRL-denominated bond issuances. Recently, the BRL has been used more frequently by international institutions and public corporations of advanced economies in official prices for capital market fundraising (Figure 17).

Figure 17: Recent BRL-Denominated Bond Issuances in Japan

Date	Issuer	Term
August 2012	Sweden Export Credit Bank	6 years
August 2011	Kommunalbanken Norway	3 years
June 2011	HSBC Bank Plc	2.5 years
December 2010	Africa Development Bank	7 years
November 2010	European Bank for Reconstruction and Development	7 years
June 2010	Inter-American Development Bank	2 years

Source: Compiled from various sources.

As substantial amounts of capital have flowed into Brazil in recent years, the BRL has continued to appear overvalued. Even so, the frequent efforts to open up externally, such as capital transaction tax treatments to limit the BRL's rise, have not necessarily been one-way. Furthermore, the double-edged sword is that a debt-heavy procurement structure—securities investments—increases the risk of the economy being controlled by the direction of capital flows.

Because of this, opening up to the outside must balance the risks and merits of promoting liberalization. On the other hand, Brazil is wholly engaged in the global economy and has been very cognizant of its role as a leader among emerging economies. Because of this, opening up to the world and currency internationalization are both irreversible courses.

Compared to China's incremental internationalization and outward liberalization of the RMB, Brazil's efforts to liberalize its currency to the world appear to be fast-paced overall. On the other hand, monetary authorities have alternated between tightening and loosening regulations in order to manage the BRL's exchange rate. In this way, the risks and appeals are still mixed for investors, but the BRL is clearly steadily confirming its position as a leading emerging economy currency. The internationalization of the BRL will continue to bear watching.

4. The Russian Ruble

4-1. The Internationalization and Liberalization of the RUB and the Foreign Exchange System

(1) The 1998 Fiscal and Financial Crisis

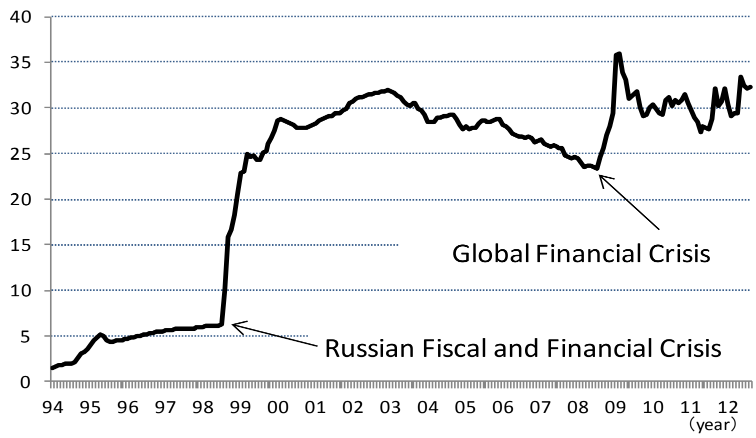
Although Russia unveiled its plans to promote the internationalization of the RUB in 2000 after the inauguration of the Putin Government, the RUB had been gradually expanding its presence in international financial markets since the breakup of the Soviet Union as the country's market economy developed. However, the 1998 fiscal and financial crisis curtailed progress. Russia's 1998 fiscal and financial crisis was the first direct hit on the country's financial and foreign exchange markets since the 1991 collapse of the Soviet Union and birth of Russia and after the economy shifted to a market economy. The cause of the crises was the heavy dependence of Russia's economy on natural resources. The country depended on natural resources for the bulk of its exports, and primary goods prices dropped in the 1990s amidst a worldwide disinflation trend. Tax revenue derived from export revenue shrank, and Russia's fiscal balance continued to deteriorate. Furthermore, the Asian currency crisis from 1997-1998 caused worldwide demand to weaken, and commodities prices, primarily oil prices, plunged, causing the fiscal balance to expand. Thereafter, investment funds from abroad shrunk as investors increasingly sought safety. As a result, in August 1998, Russia was forced to: 1) devalue the RUB, changing the target market range of the RUB against the USD to USD/RUB5.25-USD/RUB7.15 through the end of the year; 2) freeze payments of external debt for commercial capital transactions for 90 days; and 3) halt the redemption of sovereign debt, converting short-term sovereign debt scheduled for redemption through the end of the year to new sovereign bonds. This exacerbated the country's economic chaos. Thereafter, Russia was able to emerge from the crisis relatively quickly. The biggest contributing factor behind the recovery was rising oil prices as the global economy recovered from 1999 to 2000.

In this way, Russia represents a resource-dependent economy, supported by its wealth of commodities. The presence of the RUB on domestic and overseas foreign exchange markets has been controlled by the direction of primary goods prices. Because oil prices have a big impact on the country's trade balance, oil prices and the RUB's exchange rate are very highly correlated. After the 1998 crisis, the RUB plunged in value and the currency's presence on international financial markets diminished. Further, following this development, Russia's government is believed to have recognized the danger of liberalizing capital transfers so quickly to be out of step with the development of domestic financial markets.

(2) Changes in the Foreign Exchange System

On the other hand, the RUB, which had been pegged to the USD, was put under a managed float system in 1998 because of the financial crisis. The managed float exchange rate system has been maintained since then. However, under Russia's managed float system, relatively flexible market movements that usually occur with the system have not been apparent; in fact, a fixed exchange rate policy seems to have been implemented with the intervention of the central bank. Furthermore, in November 2010, the Russian central bank noted in its *2011 Monetary Policy Guidelines* that the currency system was shifting to a completely free float system, announcing the RUB's shift to a floating market system. However, even after the shift to the floating rate, the central bank has an obligation per se to continue to protect the RUB and stabilize exchange rates, and has actively intervened to maintain its policy of maintaining the RUB's rate against a basket of currencies (comprised of rates against the USD and EUR) to within a given level.

Figure18: USD/RUB



Source: Russian central bank website.

4-2. Current Status of the RUB's Internationalization

(1) Use of the RUB in External Transactions

Statistical data shows that the ratio of RUB-denominated transactions in overall trade is less than 4%, extremely small. However, most trade with the CIS countries—with which Russia has had highly interdependent relationships since the collapse of the Soviet Union and which comprise 10% of all Russia's trade—is denominated in RUB. Note that according to Russian financial institutions, a relatively large 30% of services transactions are denominated in RUB. Among CIS countries, the ratio jumps to 50%.

Figure 19: Ratio of RUB-Denominated Trade by Country

(%)

	2006	2007	2008	2009	2010
Russia	3.7	3.9	3.7	3.8	3.9
Belarus	28.0	28.7	27.0	26.2	30.4
Kazakhstan	11.1	12.2	8.5	7.6	8.2
Kyrgys and Tajikistan	11.8	10.3	12.0	12.1	10.8

Source: Compiled by IIMA from VTB Capital Research.

Furthermore, the amount of RUB traded on world foreign exchange markets has tripled in ten years, but the weighting overall remains extremely small compared to major currencies like the USD and EUR. The RUB is used in less than 1% of total foreign exchange transactions, less than the rate of use in trade transactions. This suggests that the ratio of RUB-denominated transactions is small also in capital transactions.

Figure 20: Transactions by Currency on World Foreign Exchange Markets

Currency	1988	2001	2004	2007	2010
US dollar	86.8	89.9	88.0	85.6	84.9
Euro	…	37.9	37.4	37.0	39.1
Japanese yen	21.7	23.5	20.8	17.2	19.0
Pound sterling	11.0	13.0	16.5	14.9	12.9
Australian dollar	3.0	4.3	6.0	6.6	7.6
Swiss franc	7.1	6.0	6.0	6.8	6.4
Canadian dollar	3.5	4.5	4.2	4.3	5.3
Hong Kong dollar	1.0	2.2	1.8	2.7	2.4
Singapore dollar	1.1	1.1	0.9	1.2	1.4
Mexican peso	0.5	0.8	1.1	1.3	1.3
Indian rupee	0.1	0.2	0.3	0.7	0.9
Russian Rouble	0.3	0.3	0.6	0.7	0.9
Chinese renminbi	0.0	0.0	0.1	0.5	0.9
Brazilian real	0.2	0.5	0.3	0.4	0.7
Other currencies	63.7	15.7	15.9	20.0	16.6
All currencies	200.0	200.0	200.0	200.0	200.0

Note: Total is 200% because every transaction is counted for both currencies.

Source: BIS.

(2) Offshore Markets

Issuance of RUB-denominated bonds in offshore markets is low compared to JPY-denominated and RMB-denominated bonds. Although CIS country Belarus issues debt denominated in RUB, Russian companies issue only a very small amount of RUB-denominated corporate debt overseas. Most debt issuances are USD- or EUR-denominated, and local financial institutions report that bond market infrastructure, including custodian, issues persist. At present, the cost of issuing RUB-denominated bonds is much higher than for EUR-denominated bonds, and some feel that the cost is far from fair to issuers. Lowering custodian and settlement costs will be tasks in increasing issuances on the EUR bond market.

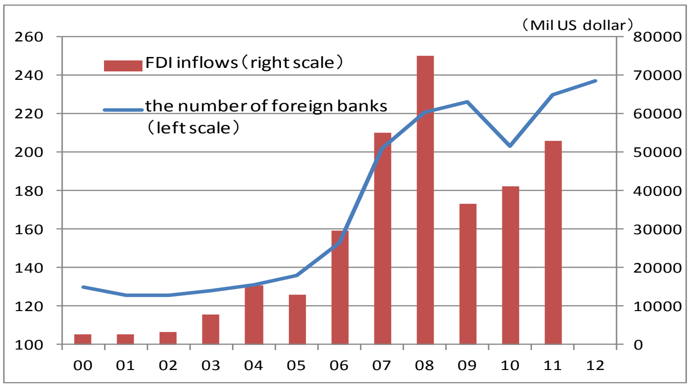
(3) Opening Financial Institutions to Foreign Capital

The presence of foreign financial institutions is increasing in Russia’s banking sector, and this is critical to promoting the use of the RUB among foreign companies and investors. The number of foreign participating banks in Russia stood at approximately 130 from 2000 to 2005, but then started to rise markedly in 2006. Thereafter, the number started falling from 2010 because of the impact of the global financial crisis, then once again began to rise, reaching 237 banks in July 2012. The weight of foreign capital among total capital for banks overall continues to rise.

In this way, the presence of foreign-affiliated financial institutions has expanded primarily because of the increase in foreign manufacturers and services companies penetrating Russia because of the economy's solid growth. Figure 21 shows direct inward investment into Russia and the number of foreign participating banks. Over the past 10 years, because the Russian economy has been fairly strong, more foreign capital has poured into Russia. Because of this, the number of foreign-affiliated banks has increased.

The second reason for the increase in foreign-affiliated banks is limited entry regulations for foreign-affiliated banks. Russia is expected to further ease regulations as the country joins the WTO and the share of foreign-affiliated bank capital in total bank capital is raised to 50% from 12%. Further, foreign-affiliated banks are currently not allowed to open branch offices in Russia, and this is expected to be addressed as Russia negotiates entry into the OECD and in the WTO multilateral trade negotiations.

Figure 21: Russia Inward Direct Investment and Foreign Participating Banks



Source: Russian central bank website, UN UNCTAD *World Investment Report 2012.*

4-3. The RUB's Internationalization and Liberalization: The Outlook

(1) Liberalization of External Transactions toward Internationalizing the RUB

The internationalization of the RUB took on national policy status with the inauguration of the Putin Government in 2000, but the currency had already been liberalized in 1996 for current transactions in terms of easing regulations and liberalizing use of the RUB in external transactions. Also, capital transactions were freed in 2006, at an earlier stage than in other major emerging economies. In particular, the Foreign Currency Management Act was overhauled in July 2006, and various regulations related to capital transactions were abolished. Notably, this was the fastest such move among BRICs countries. Furthermore, with the accession of President Medvedev in 2008, making the RUB an international reserve currency became an official policy objective. However, this has not caused the RUB's presence in international financial markets to expand, such as in more current and capital account transactions. On the other hand, even though the RUB is not a sufficiently convertible currency, transactions did begin in 2010 under a floating exchange system.

Figure 22: Internationalization of the RUB: Developments

Jun. 1996	Current account transaction is liberalized.
Jul. 2006	Capital account transaction is liberalized.
	RUB becomes fully convertible.
Nov. 2010	Free float of the RUB is introduced.
Dec. 2010	Direct conversion of CNY/RUB is introduced.
	Belarus issues sovereign bonds denominated in RUB.

Source: Compiled by IIMA from VTB Capital Research.

(2) The 2008 Global Financial Crisis and the Internationalization of the RUB

The global financial crisis triggered by the collapse of Lehman Brothers in September 2009 spread to Russia, as financial markets were shaken and the economy stalled for some time. The main reason the economy started to deteriorate was, as with the 1998 fiscal crisis, demand for primary goods plummeted throughout the world because of the financial crisis, and prices of commodities like oil plunged. Further, the abolition of capital transaction regulations in July 2006 had a big impact, as it did with the financial markets. Russia's commercial capital transactions became free in principle, and because of a structure that made capital inflows and outflows easy, capital inflows from abroad decreased and capital outflows from inside the country increased. Financial and capital market fluctuations surged, with stock prices and exchange rates plunging. Thereafter, various efforts by the government and central bank—like monetary easing, uncollateralized financing to banks, tax cuts, and industrial fiscal support—took effect, and the economy started to recover.

However, the adverse impacts of the 2008 financial crisis were, ironically, even bigger than the impacts from the 2006 measures to liberalize capital transactions implemented in order to internationalize the RUB. The 2008 impacts once again slowed those movements. Confidence in the USD and EUR declined because the US and the eurozone were the epicenters of the financial crisis, , but the RUB was not able to fill the gap in confidence.

(3) Start of Direct RUB-RMB Exchanges

Amidst such developments, an important step in the internationalization of the RUB was the start of direct trading between the RUB and RMB on December 15, 2010, on the Moscow and Shanghai markets. Direct trading between the RMB and JPY began in Tokyo and Shanghai in June 2012, but the direct RMB and RUB trades had already begun more than a year before. Although the scale of trading is still limited, average trading volume grew by five times through the year, to RUB1.3 million. Trading volume grew to RUB2 million (approximately JPY4.8 million) by mid-2012 as the market surged in size. Russia imports large volumes of manufactured goods from China. In particular, some local companies feel that RUB-RMB trading offers big potential merits for large importing companies that purchase equipment from China in large amounts.

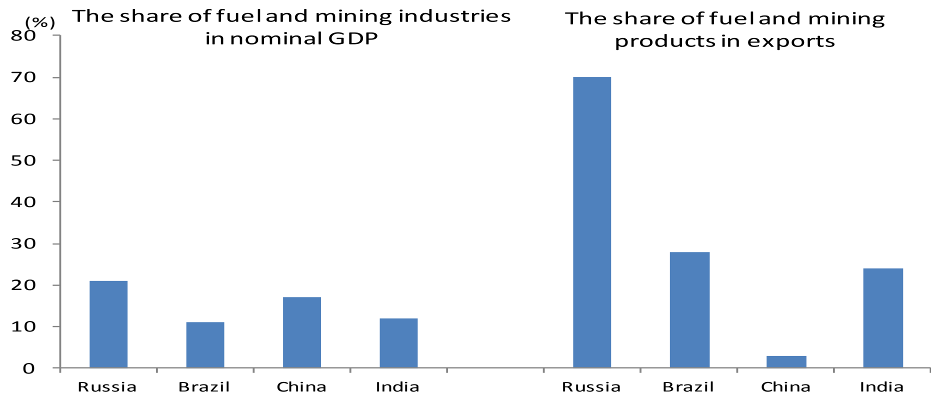
(4) The RUB's Internationalization and Liberalization: The Outlook

① The Natural Resource-Dependent Economy Obstructing the RUB's Internationalization

As noted above, Russia's heavy reliance on natural resources has become an impediment for the two reasons described below as the RUB grows in stature as an international currency.

First, natural resources comprise the bulk of Russia's exports and are commonly denominated in USD. One attribute of Russia's economy is that mining and energy industries comprise a big share of the economy, but compared to the other BRICs, the share of such goods among Russia's exports is an extremely high 70% (Figure 23). If these goods are customarily denominated in USD, it would be difficult to raise the ratio of RUB-denominated exports within exports overall.

Figure 23: The Economy's Dependence on Natural Resources (2010)



Note: Secondary industries minus manufacturing industry, using GDP fuel and mining value-added prices.

Source: World Bank, *World Development Indicators*.

Second, the RUB is prone to fluctuations because of shifts in the commodities market, primarily oil prices, and may not win the confidence of foreign investors. The RUB has repeated a cycle of rising when natural resource prices jump, exports are strong and foreign investors wish to hold the currency, then falling when natural resource prices drop and investors have less desire to hold the RUB. Because of this, it is difficult to maintain confidence in the RUB to expand the use of the currency in trade and investment and as a reserve currency over the long term.

② A Shift in Economic Structure Needed

In internationalizing the RUB, Russian industry must become more advanced and the country's natural resource-dependent economic structure must change in order to increase the use of the currency in trade, raise confidence in the RUB as a currency, and boost usage in overseas direct investing and securities investment as well as in holdings as a reserve currency. In order for this to happen, industrialization is the key, especially manufacturing. Sophisticated production technology must be introduced by aggressively promoting foreign capital, and an industrial society that is competitive internationally must be developed. Russia is adopting this as a national policy.

Russia is expected to increase its ties with the international community, but also to become a society and investment destination more in line with international standards with its accession into WTO in 2012. Moreover, as automobile maker exports (primarily Japanese), the Skolkovo Innovation Center outside Moscow, and the IT park near Kazan have shown, the country is making strides toward developing equipment manufacturing and high-tech industry. Although energy-related exports like oil and natural gas have been strong because of the recent high oil prices and the country has been developing its resources, Russia's economic structure must steadily shift to more sophisticated production and not be overly dependent on these sectors.

On the other hand, as industry becomes more sophisticated, purchasing power is expected to rise at the same time. If the Russian markets grow like the US and Japanese markets in the future, the country will be able to use its bargaining power with overseas sellers and expand RUB-denominated import transactions. This is expected to increase the usage of the RUB both on the export and import sides.

③ The RUB to Gradually Internationalize

That said, although these are the bases of important strategy and issues that should be addressed over the medium- to long terms, they are not problems that can be solved in the short run. Therefore, strategies that will have an immediate effect are the key. For example, bolstering the supply of RUB liquidity with currency swap agreements with countries with which Russia has strong economic relationships would likely be effective. In particular, not only concluding a currency swap agreement with and supplying funds in times of crisis to China—an important trading partner and with which direct currency exchanges have already begun—but also using the RUB as a trade and investment settlement currency during ordinary times would likely facilitate the use of both countries' currencies and increase direct trades.

At the same time, Russia must deepen its dealings not only with major trade and investment partner CIS countries, but also Asia, primarily in the Far East. Relations through trade and investment have already reached a certain level with these regions, primarily China and Japan, but Russia must develop even tighter relations, especially in the Far East.

Dealings with the CIS countries have been thought to be important in the internationalization of the RUB. Although use of the RUB in external transactions has been limited overall, the RUB has been used widely in trade and investment activities with the CIS because of their shared history in the Soviet Union. But considering government aims and the importance of business, expanding the use of the RUB in the Pacific and Far East regions, with which Russia is expected to have even greater economic interdependence, will be an issue.

In this way, assuming that Russia's economic structure changes, however, gradually, the RUB is expected to internationalize at a moderate pace, primarily with the CIS countries and the Far East. Risk factors here may include failing to make a shift in an economic structure that is dependent on natural resources like mining and energy products.

5. Summary and Outlook

As described above, three emerging economy currencies—the RMB, the BRL, and the RUB—are expected to internationalize in their respective neighboring regions with which the home country has a high degree of economic interdependence: the RMB in East Asia, primarily Hong Kong and Japan; the BRL in Argentina; and the RUB in the CIS countries. The linkages among these countries have been strengthening through forums like BRICS summits, and their presence as a core of emerging countries will grow in the world economy, The roles of the RMB, BRL, and RUB will consequently rise in international financial markets. However, it is unlikely that these currencies will supplant the USD in the international currency system, and the USD is expected to retain its role as a key currency even as its status declines. For now, the current structure with multiple international currencies—the USD, the EUR and JPY as well as major emerging economy currencies like the RMB—is expected to persist.

On the other hand, although the JPY has established its status as the sole international currency in Asia, the currency's internationalization has not been commensurate with the size of the economy as an advanced nation. However, Asia Pacific region emerging economy powerhouses—major Japanese economic partners China and Russia—are aiming to internationalize their currencies, and these developments may cause changes. Already, not only have financial cooperation agreements with China been reached and direct settlements between the JPY and RMN started, but Japanese companies are expected to issue RMB-denominated bonds on the Tokyo market. In addition, Russia and China have already begun direct exchanges of their currencies and are expected to seek further mutual cooperation in financial and foreign exchange transactions. As such, Japan is expected to not only conclude more currency swap agreements and supply funds during times of crisis with the two countries, with which Japan is expected to become more interdependent, but to also promote the use of both currencies by encouraging their use as settlement currencies in ordinary trading. Japan can help with the internationalization of the currencies of both countries by supporting China—which still restricts financial and capital markets and external transactions—and Russia—whose domestic financial and capital markets development is inadequate.

Furthermore, increased deposits and bond issuances in the currencies of other countries in offshore markets would likely contribute to the stability of regional financial markets and the currency system. This could result from greater mutual financial cooperation with other Asia-Pacific emerging economies through APEC, while the Asia Bond Market Initiative would also promote bond issuances by developing regional bond markets. In this way, the internationalization of the JPY, which has hit one wall, could once again have room for success.

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