Prospects of the RMB to become an international currency

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The 19th IIMA International Financial Symposium
“Exploring Optimal International Monetary Regimes beyond the Crisis- Perspectives on global currencies and challenges for Asia”

18 March 2010, Tokyo

Background

- What is China's desirable international monetary regime?
  - An ideal format: "super-sovereign reserve currency"
  - A practical one: multi-currency regime
- The world into uncharted waters again:
  - Sovereign debt crisis in Greece
  - Unsustainable budget deficit in the US
- These changes have added uncertainties to the agenda of international financial regime reform:
  - Is a single currency without a single treasury sustainable? Euro's bigger role?
  - A collective form of currency may have inevitable drawbacks, which casts doubts on possible formation of an Asian regional currency.
  - The dollar remains the role of safety haven in times of crisis. This brings out the question: if the dollar's declining may bring an end to the so called "dollar hegemony" in the long term, how long is long enough for us to see it happen?

Will Chinese currency be a candidate?

Outline

- Degree of RMB being used at current stage
- Pros and cons
- Conditions
- Roadmap

Degree

Summary of international / regional use of the RMB

In terms of size and range, the use of the RMB has many limitations, and mostly, they are tied with certain official arrangements.

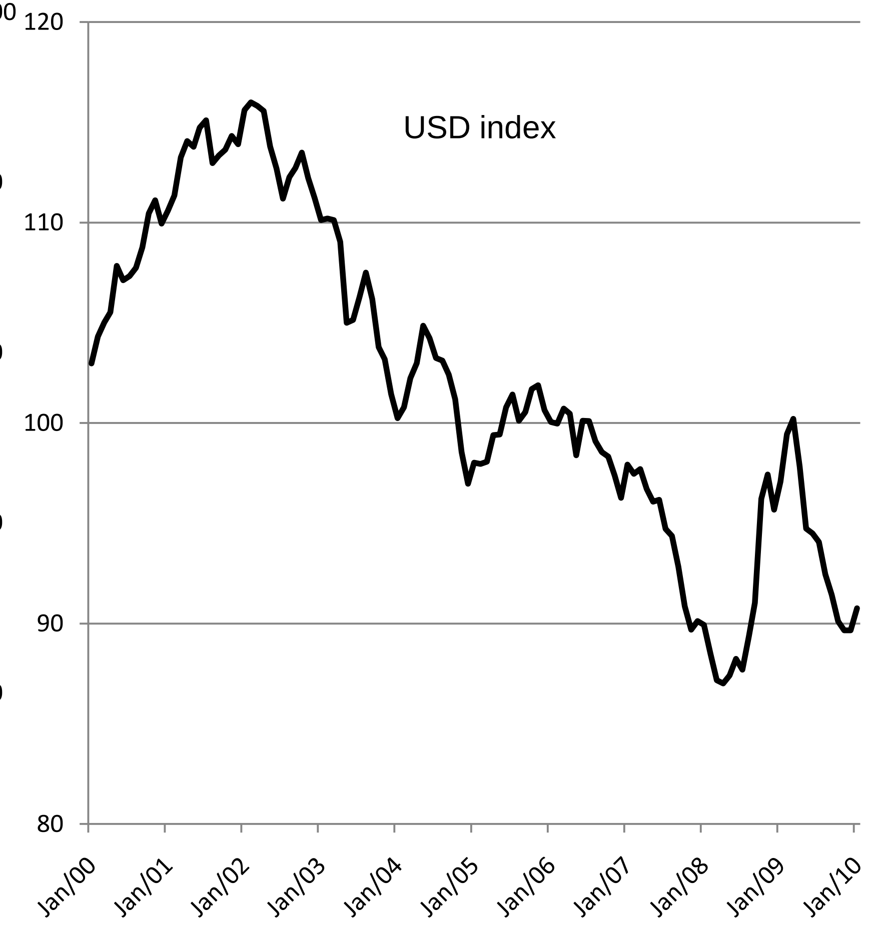
Public purpose	Private purpose
▪ **Payment currency in BSAs under CMI with (in USD billion)** – *Korea: 8* – *Japan: 6* – *Philippines: 2* ▪ **Payment currency in bilateral swap arrangement between central banks, with (in RMB billion)** – *Korea: 180* – *HKMA: 200* – *Malaysia: 80* – *Belarus: 20* – *Indonesia:100* – *Argentina: 70*	▪ **The cross-border clearing and settlement:** *Implement of <Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions>(Jul. 2009)* ▪ **RMB deposits in HK:** – *Initial amount with RMB 895 million (Feb. 2004)* – *Peak with RMB 78 billion (May 2008)* ▪ **RMB bond issuance in HK by state and commercial banks (in RMB billion):** – *China Development Bank: 5 (Jun. 2007).* – *Export-Import Bank of China: 2 (Jun-Jul. 2007)* – *Bank of China: 3 (Sep. 2007)* – *Bank of Communications: no more than 5 (Mar. 2008*) ▪ **RMB government bond issuance under ABF2 (Jun. 2005)** ▪ **ADB: 1 billion yuan Panda bonds (Dec. 2009)**

Pros and cons

- Reducing the risk of exchange rate for Chinese firms
- Extending Chinese financial sector
- Establishing financial centers in China—Shanghai
- Seigniorage
- Mixed impact on domestic monetary policy
  - Stimulate the development of direct finance; quicker adjustment of market interest rates to official rates.
  - Result in currency substitutions in third countries; impact on the central bank's control over money aggregates.
  - Stimulate arbitrage activities when monetary policy changes.
- New impetus for RMB’s internationalization: the safety of Chinese holdings of US government securities

Safety of China's holdings of US government securities

From 2000 to 2009, shares of holdings changed slightly, mostly between 36-41%;
Holding scales increased almost proportional with FX reserves accumulation by 14 times;
Meanwhile, the dollar depreciated by 12%;
What Chinese leaders worry most is how likely the Fed is to inflate public debt away by printing more.



Conditions

- General conditions
  - Economic size
  - Degree of convertibility
  - Financial strength and degree of financial market development
  - Stability of intrinsic value (credibility of low-inflation and austere fiscal framework)
  - Flexibility of exchange rate
  - Non-economic factors: political and military power
  - Inertia
- China's specific focus
  1. **Convertibility**
  2. **Financial market development**
  3. **Float of exchange rate**

1. Degree of convertibility

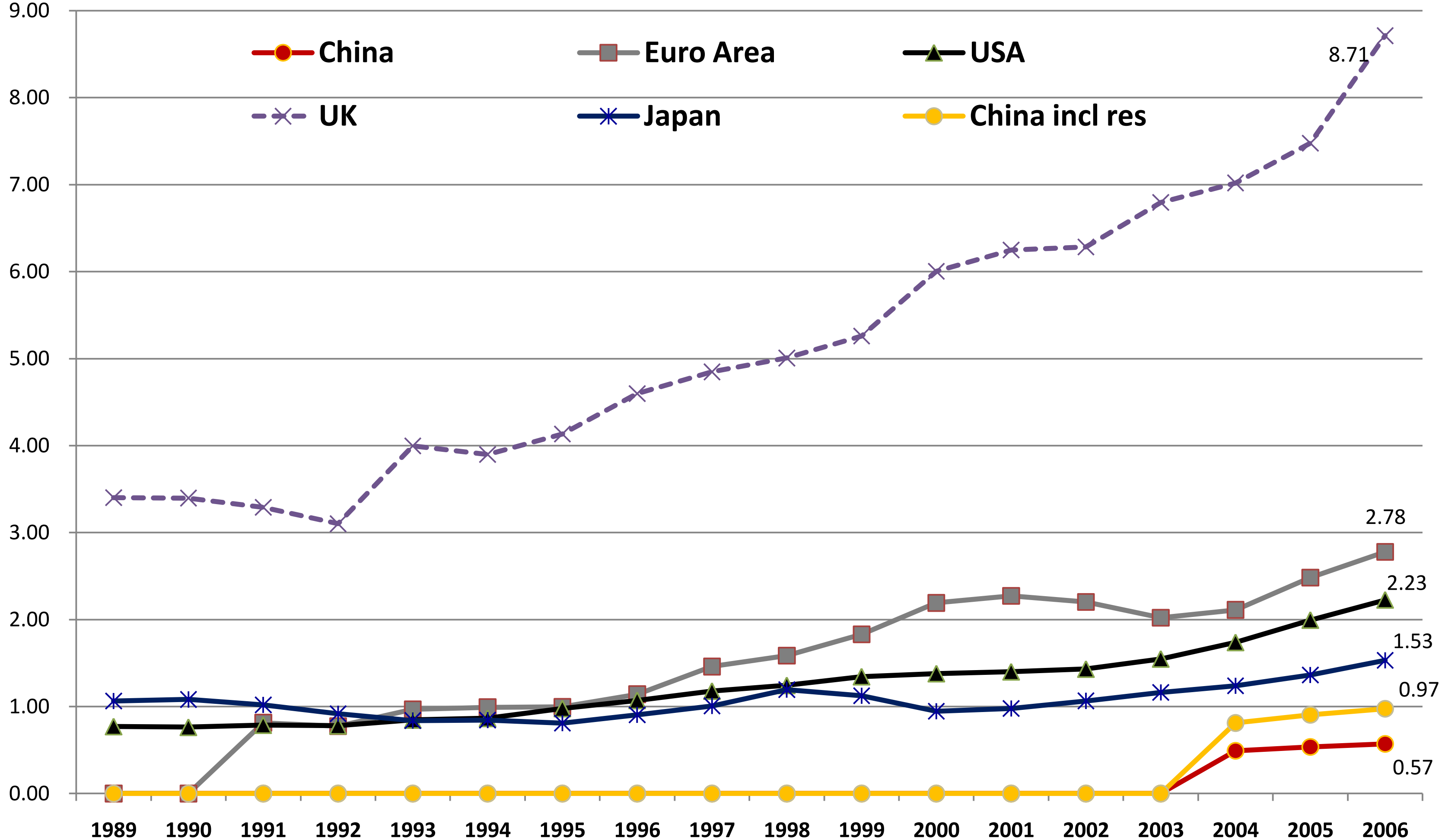
Framework of capital controls

Major items		Inflows	Outflows
Direct investment		Free Inward remittance converted into Renminbi	Free Subject to SAFE reviewing sources of foreign exchange assets investments abroad.
Stock market	nonresidents	Purchase B shares and QFIIs subject to a set of limitations	Sale B shares, repatriate of QFIIs
	residents	Sale B, H, N and S shares abroad	QDIIs
Bonds and other debt securities	nonresidents	QFIIs	International development agencies are permitted to issue RMB denominated bonds locally, with the approval of the MOF, the PBoC, and the National Development and Reform Commission.
	residents	Prior approval by State Council for Examination and SAFE. Earnings should be repatriated.	Authorized entities (insurance companies, securities firms and qualified domestic banks) may purchase foreign bonds that meet rating requirement, subject to approval of the CIRC and the SAFE.
Money market	nonresidents	QFIIs	No permission
	residents	Bonds with less than one year duration and commercial instruments, approval by the SAFE.	Authorized entities (insurance companies, securities firms and qualified domestic banks)
Collective investment securities	nonresidents	QFIIs invest in domestic closed-end and open-end funds.	No permission
	residents	Prior approval by State Council for Examination and SAFE. Earnings should be repatriated.	No permission for residents, except authorized entities
Derivatives and other instruments	nonresidents	No permission	No permission
	residents	Operations in such instruments by financial institutions are subject to prior review of qualifications and to limit on open foreign exchange position.	Banking institutions with approval by CBRC for the purpose of risk hedging, not for speculation. Non-financial institutions through approved business of local financial institutions with no prior permission, but through foreign financial institutions with prior approval by the SAFE.

A relative low level of financial openness

(liability and assets / GDP)

China's ratio was only 97%, lower than that of the UK, Euro area, US and Japan. Excluding official liability and assets, the ratio was even lower.



Is it a barrier?

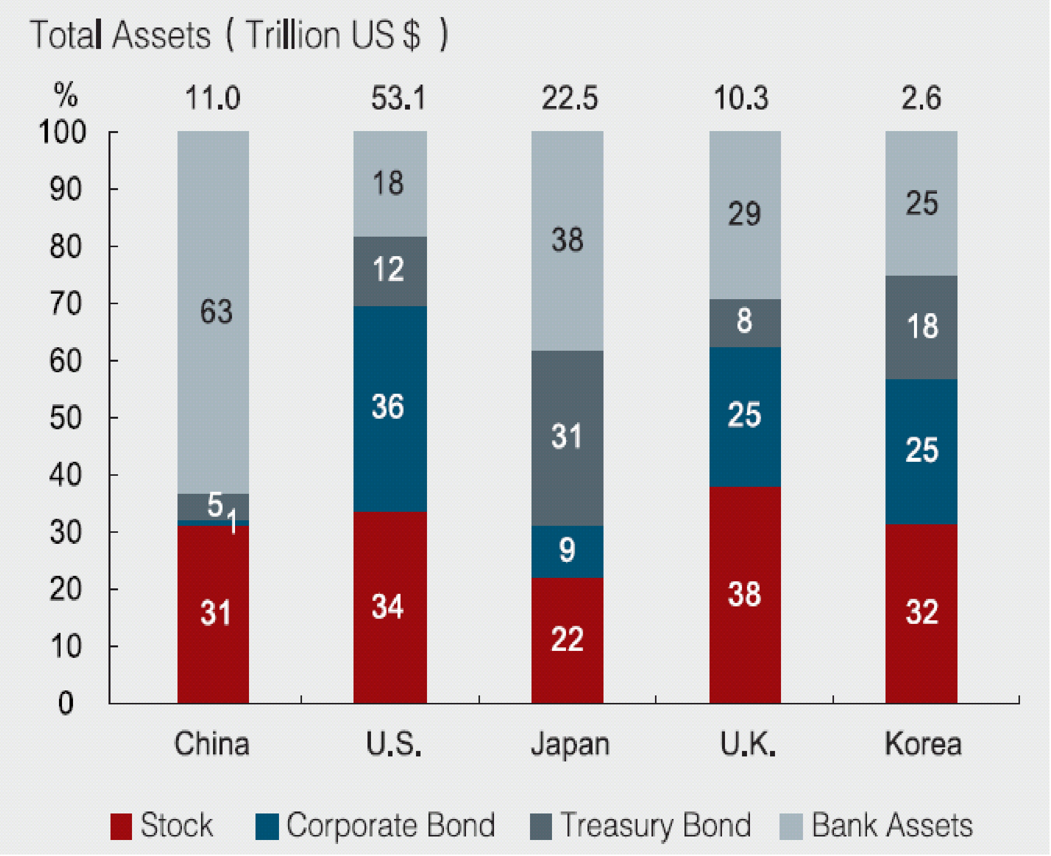
- **Yes.** Structure of capital controls to a large degree determines the channels and the size of the RMB to be used by non-residents domestically and by residents outside the country.
- **However,** in history, there are exceptions.

  Capital controls stimulate off-shore market development (Germany and Japan)

  Convertibility ≠ internationalization (convertible currencies in Asia, HKD and SGD)
- **Implications for China:**
  – First, convertibility can certainly bring with convenience, but convertibility dose not naturally lead to internationalization. International demand for a currency occurs only when the size and influence of the economy becomes large enough.
  – Second, market force can drive the process of currency internationalization despite certain capital controls being in place.
  – Third, currency internationalization should not be a policy objective for China, nor an excuse to accelerate the pace of full convertibility.
  – Personally I think Chinese leaders hope that currency internationalization and convertibility can go hand in hand. It's a process of interaction.

2. Development of domestic financial market

Composition of financial assets, end of 2007



Low percentage of direct financing; small bond markets

- At the end of 2007, the total value of securities assets **including stocks and bonds** constituted only 37% of China's total financial assets, whereas in the US, Japan, UK, and Korea, the ratio was 82%, 62%, 71%, and 75% respectively.
- Bond market is extremely small, which accounted for only 6% of the total financial assets, among which 5% is for government bonds and the proportion of corporate bonds is only 1%.

Is it a problem?

- **Yes**

  The liquid, deep and broad financial market in the US has been a key factor for the dollar to play the role of an international currency.

- **More specific for China**
  - Due to inadequacy of the money markets, there is no benchmark interest rate in China equivalent to the Fed funds rate in the US, the overnight call rate in Japan, or the refinancing rate in Euro area.
  - Interest rates are only partially liberalized, which limits China's monetary authority to fully take advantage of quick response of interest rate resulted from more international use of the RMB.
  - Before having the RMB used internationally, a more comprehensive financial market and a liberalized interest rate mechanism should be in place.

3. Flexibility of RMB exchange rate ?

- Practically, the function of an international currency does not depend on the type of exchange rate regimes.

- Flexibility is a condition for currency internationalization
  - No country wants to anchor its currency to a currency that is pegged to the dollar.
  - The main reason for China to have a more flexible exchange rate is that, free capital flow needs flexible exchange rate in order to have independent monetary policy, which can ensure the credibility of central bank's policy, hence the credibility of the currency.

Concluding remarks: Roadmap

- **In the short term:**
  - Market-driven process starts from cross-border use of the RMB in trade and financial transactions.
  - Policy means are equivalent important at the early stage, such as:
    - Issuing RMB government and corporate bonds
    - Encouraging use of RMB as an invoicing currency in China’s Free Trade Areas (FTAs);
    - Signing up currency swaps (bilateral and multilateral) agreements using RMB as the means of payment;
    - Increasing use of the RMB, along with other key currencies in regional monitoring system.
- **In the medium and long term:**
  - Region-wide use of the RMB shall be the natural outcomes of its covering more areas of China’s neighboring countries, which shall naturally lead to RMB internationalization.
  - Domestic parallel developments are also important for the success of RMB internationalization.
- **Being accepted by other countries** is another key element for China to have its currency internationalized. In doing so, economic importance is certainly a key factor. However, there are other factors beyond the economic sphere, which are subjects that need a broader view.