RMB INTERNATIONALIZATION: HOW FAR HAS IT GONE AND WHAT SHOULD CHINA DO?

by

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Abstract

The objective of this study is to explore how far the internationalization of the RMB has gone so far and what the Chinese government must do to support the internationalization path. This paper analyzes three important aspects of this issue: the dimensions and function of an international currency, the costs and benefits of internationalizing a currency, and China’s economic problems that are likely to influence the outcome of internationalization. If the benefits that the internationalization of the RMB are expected to bring to China may be offset by costs, the government needs to balance the challenges and costs against the benefits. Finally it concludes that China should be cautious about exposing its economy to dramatic shocks or excessive vulnerability to external influences. While the history of currency internationalization provides general guidance that China should not ignore, none of today’s international currencies started the internationalization process from the same point as China. The Chinese government should first clarify its goal, and then proceed gradually with internationalization of the RMB while reforming and opening its financial market.
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<th>Abbreviation</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
</tr>
<tr>
<td>CNH</td>
<td>Chinese Yuan deliverable in Hong Kong</td>
</tr>
<tr>
<td>COFER</td>
<td>Currency Composition of Official Foreign Exchange Reserves</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>FX</td>
<td>Foreign Exchange</td>
</tr>
<tr>
<td>PBC</td>
<td>People’s Republic of China</td>
</tr>
<tr>
<td>PBoC</td>
<td>People’s Bank of China</td>
</tr>
<tr>
<td>RMB</td>
<td>Renminbi</td>
</tr>
<tr>
<td>SDR</td>
<td>Special Drawing Rights</td>
</tr>
<tr>
<td>QDII</td>
<td>Qualified Domestic Institutional Investors</td>
</tr>
<tr>
<td>QFII</td>
<td>Qualified Foreign Institutional Investors</td>
</tr>
</tbody>
</table>
Acknowledgements

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Chapter 1: Introduction

1.1 Research Background and Significance

The national currency of China is predicted by The World Bank to be among the three major reserve currencies by 2025 together with the USD and the Euro (World Bank 2011:7). The Chinese government has initiated several policies that support the internationalization of the RMB.

Contemporary writers in this field emphasize three main factors that contribute to the growing interest in this topic.

The first is China's role in the 1997-98 Asian Financial Crisis, a time when it acted responsibly to maintain the stability of the RMB while many of its Asian neighbours devalued their currencies. China's influence had begun to emerge (Gao and Yu 2009). Thus, the RMB's importance among its neighbours has been increased.

The second reason, given by Park (2010), was the instability of the US financial system after the 2008-2009 global financial crisis, which increased the sense of urgency within and outside China about the reform of the global financial system. China's concerns were particularly acute since China has a large proportion of its foreign reserves in US dollars. In 2009 Zhou Xiaochuan called for reform of the international monetary system, and suggested that SDR\(^1\) should be given a more important role while the US dollar's role should be diminished.\(^2\) Large fluctuations in the US dollar and the Euro increase the cost of hedging for Chinese importers and exporters, leading to uncertainties in China's foreign trade and investment (Zha 2012).

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\(^1\) IMF's Special Drawing Rights


The third factor is related to Mundell’s (1993:10) theory that “great powers have great currencies”. China’s economy has experienced a remarkable expansion, gaining an increasingly prominent role in the global economy. China’s currency, the RMB, has also captured growing attention from investors and policymakers around the world. (Hu 2008) It is understandable that people expect the role of the RMB to increase in proportion to China’s economic weight as the second largest economy in the world.

The references cited above imply that China has reasons – both domestic and international - to move towards internationalizing the RMB.

A review of economic discussion suggests that may be easier said than done. There have been few truly international currencies, and it took decades for them to achieve that status. For example, although the U.S. economy had by 1872 surpassed the UK’s (as measured by national output), according to Chinn and Frankel (2008) who based their work on Triffin, Eichengreen and Flandreau, it was only after World War II that the dollar overtook the sterling. Some researchers are intensely conservative about the prospect of RMB internationalization, with some doubting the RMB’s ability to achieve the status of even the Yen (Kelly 2009), let alone the USD or the Euro. Others predict a more difficult journey, with the RMB achieving only the status of secondary reserve currencies such as the euro, the yen, the Swiss franc, and the British pound (Mallaby and Wethington 2011).

The significance of this research lies in that if China succeeded in the RMB internationalization process it would not only increase China’s monetary and political status but also bring significant changes to the Chinese economy itself and the international monetary system. China aims to avoid the loss in value caused by the accumulation of huge foreign reserves. If the RMB were internationalized, Chinese
traders would be able to avoid the cost of exchange rate hedging since the payments could be arranged in RMB. Further, an internationalized RMB would provide the world with an alternative store of value, medium of exchange and unit of account. This might challenge the dominant role played by the US dollar and change the international monetary pattern.

This paper summarizes a balance of views from within and outside China of the RMB and China's economic situation. It provides insights into what it means to be an international currency. It also reveals important political and economic implications of internationalization by reviewing the history of the main internationalized currencies. It summarizes the RMB performance and the progress to date of RMB internationalization. It points out the main challenges, costs and benefits facing China and makes policy recommendations for the Chinese government in pursuing the path towards RMB internationalization, and suggests further studies regarding the topic.

1.2 Literature Review

The internationalization of the RMB has recently been a hot topic in the fields of economics and political economy. The costs and benefits of internationalizing a currency, the factors that influence this process, and other related theories have been the topic of lively debate within academia and more generally in the business, political and economic media.

1.2.1 Functions and dimensions of an international currency

This section sets out the criteria for an international currency, illustrates the pertinent Chinese government policies for each of these criteria, and evaluates the
extent to which the RMB meets them today.

There is no universally supported framework that defines an international currency. However, there is much common ground among influential writers, and theoretical discussions provide guidelines that will be used to identify the dimensions of an international currency and the functions it performs.

**Definition of an international currency**

An international currency is used beyond its home country, not only for transactions among residents, but also among residents and non-residents (Cohen 1971, Kenen 1983).

Money has three classical domestic functions: it is a store of value, a medium of exchange and a unit of account. Cohen and Kenen applied these criteria to international currencies. Frankel summarized the criteria in Table 1 (Chinn and Frankel 2005).

**Table 1 Dimensions of an international currency**

<table>
<thead>
<tr>
<th>Function of Money</th>
<th>Governments</th>
<th>Private actors</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Store of Value</strong></td>
<td>International reserves</td>
<td>Currency substitution (private dollarization) and investment (portfolio allocation)</td>
</tr>
<tr>
<td><strong>Medium of Exchange</strong></td>
<td>Foreign exchange market intervention</td>
<td>Vehicle currency, invoicing trade and financial transactions, settlement currency</td>
</tr>
<tr>
<td><strong>Unit of account</strong></td>
<td>Anchor for pegging local currency</td>
<td>Denominating trade and financial transactions</td>
</tr>
</tbody>
</table>

Source: Chinn and Frankel 2005 in Yu 2012:4
Ito provided a somewhat different view, summarized in Table 3 below.

Table 2 Dimensions of an international currency

<table>
<thead>
<tr>
<th></th>
<th>Official sector</th>
<th>Private sector</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of Account</strong></td>
<td>Being pegged by other countries</td>
<td>Trade invoicing</td>
</tr>
<tr>
<td></td>
<td>Use in currency baskets of foreign central banks</td>
<td>Denomination of financial products</td>
</tr>
<tr>
<td></td>
<td>SDR composition currency</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Denomination of government bonds</td>
<td></td>
</tr>
<tr>
<td><strong>Medium of Exchange</strong></td>
<td>Currency circulation abroad</td>
<td>Trade and financial transactions</td>
</tr>
<tr>
<td>(Settlement)</td>
<td>Government financial transactions (such as ODA)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Central bank swaps</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Currency intervention</td>
<td></td>
</tr>
<tr>
<td><strong>Store of Value</strong></td>
<td>Foreign reserves (of other countries)</td>
<td>Cross-border deposits</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cross-border securities</td>
</tr>
</tbody>
</table>

Source: Ito 2011 in Yu 2012:4

There are two main differences between Table 1 and Table 2. 1) Ito put “Trade invoicing” and “Denomination of financial products” under the category of “Unit of Account”, while in Table 1, Frankel placed “Trade invoicing” under “Medium of Exchange”. 2) Ito made a clear distinction between the role of settlement and invoicing. Unlike Chinn and Frankel, Ito noted that even when a currency is used for invoicing, it is fairly common that the settlement is made in another currency (Yu 2012).

Table 2 will be used as the main reference for the detailed analysis of dimensions of international currencies in the following pages as it more closely
matches contemporary definitions of currency functions.

In reviewing the RMB’s performance towards an internationalized currency, one line of the research argues that the RMB’s progress towards becoming an international currency has been very limited. The RMB has progressed into functions such as “trade invoicing”, “trade payment/settlements”, and “being included in other’s currency baskets and central bank swaps”. However, there has been limited or no progress of the RMB into other international currency functions (Ito, 2011, Yu 2012). And as Chovanec (2012) reminded, the “swaps” are not a strong indication of internationalization because they serve only as emergency back-ups to prevent financial crises. No global market exists for banks to replenish their RMB balances.

Another group of researchers is more optimistic, Chu (2010), Zhao and Song (2009), believe that widespread use of the RMB in trade settlement would be a breakthrough point for the internationalization of the RMB. The demand for currency as a unit of account and medium of exchange is determined by the structure and breadth of a country’s trade network (closely linked to its economic size) and invoicing practices (Maziad and Kang 2012). Taking advantage of its wide trade networks for using the RMB as a medium of exchange may provide a path for China to enhance the RMB’s progress towards internationalization.

This paper shares Cohen’s view (2012b) that the Chinese government has made much progress along the trade track but limited progress along the financial track—reforming external capital control and domestic financial markets. Although China’s wide trade network is a major advantage, the financial track is more important and essential.
1.2.2 Factors that determine currency internationalization

Researchers have studied the successful internationalization of the Pound, the USD and the Euro to understand which factors determine currency internationalization.

Chinn and Frankel (2005) identified five important variables: 1) Patterns of output and trade 2) Financial markets 3) Political Stability 4) Confidence in the currency’s value 5) Network externalities. Helleiner (2008) added that the economic and political relations between the issuing countries and other countries, policymakers’ decisions, and other states’ attitudes towards the currency’s role, are all political economy factors to be considered.

Cohen (2012b) argued that an issuing country couldn’t control demand for their internationalized currency. Maziad and Kang (2012) found that demand for the RMB is driven by China’s global economic role and wide trade network, and rapid offshore market development.

This paper argues that the above theories are not individually sufficient; it aggregates the major related important theories and argues that both economic and political factors are of core importance. In China’s case, if the government continues to adopt policies to facilitate the internationalization of the RMB, it really helps the internationalization path. China’s large trade network increases the expectation that the RMB will be heavily used as trade transaction and invoicing currency. Since China has the second largest economy in the world, and China’s economic policies and high-sustained economic growth rate drive expectations that the RMB will

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appreciate, to the demand for the RMB depends on whether it is appealing to international investors as an investment currency, and to countries as a reserve currency. However, attention should still be given to the main factors that drive demand for the RMB. This paper argues that demand is largely driven by confidence in the currency's future value and international status, and by short-term speculation of RMB appreciation.

The project will be based on assessing the secondary literature using qualitative dominated multi-methods. This paper adopts a political economy approach to study this issue, focusing on theoretical discussions. Triangulation will be used since it is an important means of validating information gathered using qualitative methodologies. It refers to the principle of neutralizing biases by diversifying perspectives and continuously crosschecking information using different tools and sources.  

1.3 Outline of the Paper

The Second Chapter analyzes the extent to which the RMB has gone so far as an international currency, and compares its performance to existing international currencies and the factors that influence the roles of international currencies. The discussion includes:

1) A brief overview of how a few international currencies made the transition towards internationalization.

2) The extent to which the RMB bears the characteristics of an international currency by comparing pertinent Chinese government policies with international currency

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4 Saprin Guidelines for Research Methodology
theory criteria.

3) A review of what the Chinese government has done so far to promote RMB internationalization, and evaluation of the underlying policies.

4) Challenges for RMB internationalization moving forward.

The Third Chapter analyzes whether this is the right time to internationalize the RMB. This is done by:

1) Analyzing the costs and benefits China would likely experience from internationalization of the RMB;
2) Summarizing the path of RMB internationalization;
3) Suggesting policy guidelines for the Chinese government.

The Fourth Chapter draws conclusions about the main findings of this research, discusses the trend and speed of RMB internationalization in the near future, and suggests avenues for further study of this issue.
2.1 Brief history of currency internationalization

A review of the history of the internationalization of the U.S. dollar, the Euro and the Yen illustrates the complicated process of currency internationalization. It shows that a country’s intentions to internationalize its own currency are not sufficient by themselves. It also illustrates which political and economic factors were interrelated with internationalization of these currencies. This review identifies challenges China will face as it moves towards internationalizing the RMB.

2.2.1 The U.S. Dollar

By the beginning of the 20th Century, the U.S. had become the world’s most powerful country. At the outbreak of World War I in 1914, U.S. economic output was on the verge of overtaking the whole of Europe (Kennedy 1989). The U.S. Dollar played a growing role in the global monetary system.

Although the U.S. economy had surpassed the UK’s economy by 1872 (measured by national output) it wasn’t until after World War II that the dollar overtook the Pound sterling. Eichengreen (2011a) has argued that the dollar overtook the sterling in the mid-1920s. Previously, Krugman (1984) in Frankel (2012), who had introduced the importance of network externalities (choosing to use a currency because everyone else does so), estimated the lag between economic size dominance and currency dominance at half a century (Frankel 2012).

The U.S. Dollar reached its summit in 1944, with the creation of The Bretton Woods Exchange Rate System involving 44 main countries. It established the U.S. Dollar’s leading role in the global economy. The essence of the system was that the
U.S. Dollar was pegged to gold, and the value of other countries' currencies was pegged to the U.S. dollar (Stephey 2008). With the U.S. Dollar reaching the core position of the global currency, other countries had to store dollars as the currency of settlement. As trade expanded, these countries had to store more and more U.S. Dollars. This resulted in the US developing a long-term trade deficit. The premise of a core currency is that its value remains stable and firm. But the need for stability and the broadening trade deficit are in conflict. This inner contradiction is the so-called Triffin Dilemma (Triffin 1960).

By 1971, President Nixon announced that the US would give up the dollar peg to gold. The Bretton Woods System had broken down. The crisis of the Bretton Woods system can be seen as a particular and very dramatic instance of the clash of national economic regulation with the logic of internationalism. (James, 1996) The United States had also exploited its position, whether consciously or unconsciously, as the “international natural lender of last resort”, meaning that the US was using the role of the US dollar to pursue its own interests, causing economic problems and risks for other countries by putting pressure on the exchange rate. The US was using its economic power to its own advantage, just as Europe did in the late 1900’s. (Bowles, 2007)

In spite of the collapse of the Bretton Woods System the US dollar retained its dominant position. The use of the US dollar as a reserve currency is still increasing each year. And the dollar is still the most used currency in trading and financial fields. As can be seen from Table 4 below, the dollar’s contribution in foreign exchange transaction keeps its high range, being always more than double of the Euro’s, with the Japanese Yen ranking third, and the RMB included in other currencies. This continues because of the dominance of the US dollar, the economic strength of the
US, and its currently unbeatable role on the world financial and political stage.

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</tr>
</thead>
<tbody>
<tr>
<td>US dollar</td>
<td>89.9</td>
<td>88.0</td>
<td>85.6</td>
<td>84.9</td>
</tr>
<tr>
<td>Euro</td>
<td>37.9</td>
<td>37.4</td>
<td>37.0</td>
<td>39.1</td>
</tr>
<tr>
<td>Japanese Yen</td>
<td>23.5</td>
<td>20.8</td>
<td>17.2</td>
<td>19.0</td>
</tr>
<tr>
<td>Pound Sterling</td>
<td>13.0</td>
<td>16.5</td>
<td>14.9</td>
<td>12.9</td>
</tr>
<tr>
<td>Australian Dollar</td>
<td>4.3</td>
<td>6.0</td>
<td>6.6</td>
<td>7.6</td>
</tr>
<tr>
<td>Swiss Franc</td>
<td>6.0</td>
<td>6.0</td>
<td>6.8</td>
<td>6.4</td>
</tr>
<tr>
<td>Other currencies</td>
<td>25.4</td>
<td>15.3</td>
<td>31.9</td>
<td>30.1</td>
</tr>
</tbody>
</table>

Source: Bank of International Settlement (BIS), Triennial Bank Survey, and 2010 Notes: Since two currencies are involved in every transaction, the sum of percentage share of individual currencies equals 200% in WTO (2012)

2.2.2 The Euro

The Euro is the currency of the 17 member states of the European economic union comprising the “Eurozone”.

The Euro replaced national currencies on January 1, 2002 (Bowles 2007). Since the Euro came into use, it has been the second most widely held international reserve currency after the US dollar. Its share as a reserve currency increased from 17.9% in 1999 to 26.5% in 2011 (though it dropped to 24.15% in the third quarter of 2010).\(^5\) This growth prompted many economists to debate whether the Euro will replace the US dollar as the dominant reserve currency, in view of the economic and financial market forecast of the EU (Chinn and Frankel 2005). However, since the

\(^5\) See appendix 1. COFER, the percentage regards to allocated reserves
2008 financial crisis, the Euro’s share of the worldwide currency has increased much more slowly. The benefits flowing from the adoption of a single currency in the Euro Zone is increasing intra-zone trading with decreasing transaction costs, and increasing liquidity of the currency, with all Eurozone financial markets benefiting from the growing transaction’s volumes. However, the disadvantage comes that, with the elimination of different exchange rate between the union’s participants, it would no longer be possible to let the exchange rate absorb shocks that asymmetrically affects the monetary union’s various regions (Swoboda 1999).

One of the problems mentioned by Cohen (2012a) was that the Euro Zone allowed all to enjoy the benefits of a supranational currency without asking the member countries to give up many of their national rights and privileges. Though countries share the same monetary policy, they all have different fiscal policies. The PIGS (Portugal, Italy, Greece and Spain) have huge fiscal deficit problems caused by their unsustainable overhang of liabilities. The vulnerability of the Euro Zone is remarkable even if the Union itself is reluctant to admit it. Euro-sceptics such as Barro (2012), Feldstein (2012), Roubini (2011), Rachman (2010) and Munchau (2011) predicted a failure of the Euro and the Eurozone, comparing it to a failed experiment or a broken marriage (all in Cohen 2012a).

2.2.3 The Japanese Yen

After Word War II, Japan’s weight in terms of share of global GDP and in terms of share of global trade showed a rapid increase, which made the Japanese Yen able to meet the first criterion for internationalization. However it was only in 1960-73 that the Japanese government first allowed foreigners to acquire important classes of Japanese assets. Full account convertibility came only in 1964 under the IMF
Articles of Agreement restored. The main driving force that pressured the Yen into internationalization came from the US with the Yen/Dollar Agreement in 1984. During 1987-89 Japan’s stock market and real estate market developed substantial asset bubbles. Afterwards, in 1996 the Japanese government launched a package of financial liberalization policies hoping to recover the country’s economy and to promote the country as a financial center. This failed to reverse Tokyo’s decline as one of the top financial centres in the world (Takagi in Frankel 2012). Today, the Yen is an international currency ranking roughly as high as the Pound sterling and above the Swiss franc (Frankel 2012).

The internationalization of the Japanese Yen was an example of currency internationalization poorly executed.

There are some similarities between China’s current economic situation and Japan’s bubble era before it internationalized its currency. An undervalued exchange rate and exceptionally high savings rate have fuelled export-led growth and the world biggest current account surplus. Vast excess capacity and falling returns on capital have been stimulated by continual overinvestment. Bad loans have risen as the result of excessive bank lending, and bubbles formed in the markets for shares and real estate (The Economist 2010). These factors, together with the side effects observed after Japan’s liberalization of its financial markets, and the failure of Yen internationalization, are thought to have made the Chinese government reluctant to liberalize its financial markets. However, these comparisons overlook important differences. The internationalization of the Japanese Yen was mainly encouraged and driven by the US, while the Chinese government has independently and intentionally taken measured steps to internationalize the RMB. Further, the scale of China’s economy today is far larger than Japan’s was in the 1990s. This paper argues that the
internationalization of the RMB benefits from both a stronger economy and intentional policy support than that of the Yen. It could be argued that whereas Japan was pushed by the US to internationalize its currency, China has embarked on the internationalization path independently and for its own reasons.

2.2 The RMB performance so far

RMB as a Unit of account

The RMB has begun to be used in trade invoicing in the private sector. (Ito 2011) Offshore Renminbi bonds (“dim sum” bonds) have been issued since 2007 (Saidi, Prasad, Salomoni, 2011).

In 2010 McDonald’s⁶ and Caterpillar became the first important multinational companies to issue RMB-denominated notes, exemplifying the trend of increasing foreign demand for RMB-denominated financial products. They were the first RMB-denominated bonds ever issued by non-financial foreign firms in 2011 (Saidi, Prasad, Salomon, 2011). In the same year, the total issuance of Dim Sum bonds reached 108 billion, triple the figure for the previous year. Dim Sum bonds and RMB-denominated notes are now listed on the Luxembourg stock exchange. This is evidence of the growing popularity of these instruments (Herrero, Schwartz, Xia 2012).

Besides the government bonds mentioned in the last paragraph, as a unit of account in the official sector a currency needs also to be pegged against other currencies, used in currency baskets of foreign central banks, and included in the SDR composition currency. Since the RMB is non-convertible, no country uses it as an anchor currency. And even if the Hong Kong dollar might be a possible candidate

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⁶ Original in Financial Times
(currently pegged to the US dollar), Hong Kong’s economic law requires the free flow of capital within the region and the free convertibility of the Hong Kong dollar (Bowles and Wang 2011). According to Ito’s (2011) analysis, (after controlling for the U.S. dollar, the Japanese yen, and the euro), the weight of RMB as a basket currency in Asian economies is as follows: Singapore 49%, Indonesia and Malaysia 40%-46%, Thailand, Taiwan and India 30%-39%. These high percentages illustrate the RMB’s influence on other Asian currencies.

Another recent discussion related to the RMB as a unit of account focuses on the possible inclusion of the RMB in the IMF’s SDR, a basket currency comprising the US dollar, yen, euro and pound sterling, created in 1969 to supplement IMF member countries’ reserves. Every 5 years the IMF reviews the composition of the basket. At the last review in November 2010, the RMB was suggested for inclusion, but due to its lack of full capital account convertibility it was finally excluded. The next review will be in 2015 (Huang Z. in Bowles and Wang 2011).

**RMB as a medium of exchange**

The RMB is increasingly used internationally as a medium of exchange. In the official sector, the People’s Bank of China has started bilateral swap agreements with Argentina⁸ (RMB is acting as a payment currency), Belarus (RMB is acting as a reserve currency), Brazil⁹, Hong Kong (because as the second largest RMB distribution center in the world, HK needs abundant currency supply), Iceland, Indonesia, Malaysia, (bilateral trade settlement need) Singapore, South Korea (to

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⁸ http://www.chinadaily.com.cn/china/2009-03/31/content_7635007.htm

⁹ http://www.ft.com/intl/cms/s/0/015f526a-bc07-11e1-94ff-00144f8abd0c.html
facilitate the financing of China-based Korean companies), Uzbekistan[^10], New Zealand[^11], and Japan[^12] that perform a similar function to central bank liquidity swaps. Its main objective is to solve short-term liquidity problems and to keep the stability of the financial system, but it also helps to expand the RMB's usage and to accelerate its internationalization. ^[13]

Trade and financial transactions are the currency's main roles in the private sector. In countries like Lao PDR, Vietnam, and Myanmar the RMB has been used in border trade for settlement. In Mongolia sixty per cent of the cash in circulation is in RMB. RMB can be used in Hong Kong, Vietnam, Taiwan and South Korea. Cambodia and Nepal also welcome the official circulation of the RMB in their markets. (Ito 2011) With the launch of "RMB Cross Border Trade Settlement Pilot Scheme" in 2009, trade settlement in RMB was allowed for cross-border trade between Hong Kong and other cities in East Asia, as well as five mainland cities in China - Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan (Frankel 2012, J.P. Morgan 2013, Park 2010). In 2010, deregulation was extended to twenty provinces, municipalities, and autonomous regions, including Beijing. Another eleven provinces and autonomous regions were permitted to use RMB in cross-border trade settlement and with trading partners anywhere in the world in 2011 (Ito 2011). And in 2012, the People’s Bank of China (PBoC) announced that all the companies that have import-export certificates in China are allowed RMB-trade settlement of export goods. According to PBoC data, by the end of 2011 RMB cross border settlement had

[^13]: Source: People’s Bank of China
reached 2.08 trillion Yuan.\textsuperscript{14}

**RMB as a store of value**

In the official sector, its being held in the foreign reserves of other countries represents a currency’s status as a store of value. According to the IMF’s COFER (Currency Composition of Official Foreign Exchange Reserves) data (see Appendix 1), the USD is still playing a dominant role as an international reserve currency, with the Euro being stable in second place with less than half the weight of the USD amount. Meanwhile the RMB’s weight as a store of value internationally is so low that it is classified in the “other currencies” category\textsuperscript{15}. The problem causing the RMB’s limited role as an official international reserve currency is its lack of full convertibility. Because of this, central banks have little incentive to hold the RMB as an official reserve currency.

However, a growing number of countries are moving towards the inclusion of RMB in their Foreign Exchange Reserves. Recently Nigeria, Chile, Malaysia, India and other countries announced their intention to include the RMB in their foreign exchange reserves.\textsuperscript{16} In 2006 the central bank of the Philippines accepted the RMB as a reserve currency. And Belarus, Malaysia, Korea, and Cambodia have also begun using RMB as a reserve currency (Financial News, in Bowles and Wang 2011).

In the private sector, when a currency serves as an internationally accepted store of value, foreign investors must be permitted to trade it in denominating deposits and securities (Ito 2011). Chinese debt securities mainly involve RMB denominated bonds. In June 2005 China issued its bonds under the Asian Bond Fund. Following this, governments and corporate borrowers started to issue RMB-denominated bonds

\textsuperscript{14} The People’s Bank of China data, source: http://www.pbc.gov.cn/publish/english/963/index.html
\textsuperscript{15} IMF 2012 data, source: http://www.imf.org/external/index.htm
\textsuperscript{16} People’s Daily Online 2011, source: http://english.peopledaily.com.cn/
in Hong Kong. In July 2010 conditions for bond issuers were liberalized and it was announced that there would be no restrictions on types of issue or volumes for offshore RMB bond issues. In addition, the QFII (Qualified Foreign Institutional Investors) and QDII (Qualified Domestic Institutional Investors) programs allow investors to engage in cross-border capital account transactions. Since August 2011 foreign investors have been permitted to make direct investments in China using RMB obtained from cross-border trade settlement, or from holding RMB bonds and/or stocks (Bowles and Wang 2011).

Chinese equity securities come in three forms. A-shares are domestic equities traded by domestic residents. B-shares are denominated in RMB and traded in USD by foreigners. H-shares are traded in HK dollars in Hong Kong. However, capital control causes differences in A-share and H-share prices. Ito suggests that as long as the capital control holds, Chinese capital assets' volatility and arbitrage will continue to exist and international investment in Chinese equity securities will not rise appreciably (Ito 2011).

The Overall performance of the RMB

Data from HSBC and Hong Kong Monetary Authority shows the significant expansion of the RMB’s offshore use. China’s RMB-denominated trade experienced a growth rate of 464% from 2010 to 2011. China’s RMB deposits have increased from 895 million Yuan in Feb 2004 to a peak of 627,302 million Yuan in Nov. 2011. The issuance of RMB bonds increased by 320% between 2010 and 2011, and China’s RMB borrowing increased by 1,450% in the same period. 17

Despite this impressive growth, there are limitations in the RMB’s development as an international currency. Analyzing the RMB’s performance in

17 Sources: WTO report, HSBC, HKMA, financial media reports
relation to the three functions of an international currency set out previously, it has made substantial progress on “trade invoicing”, “trade payment/settlements”, and “being included in other’s currency baskets and central bank swaps”. However, it has made limited or no progress on the other functions (Ito, 2011, Yu 2012). The main barriers to its progress in other categories evidently lie in the currency’s non-convertibility, and in the strict government control of China’s financial markets, which encourages arbitrage between onshore and offshore markets. The trade track for internationalizing the RMB pursued by the Chinese government is progressing well, but the financial track requires more effort (Cohen 2012). Ultimately, it is the financial track that matters more. Financial factors are likely to be the key determinants of how far the RMB’s internationalization will go.

2.3 What the Chinese government has done so far

The Chinese government has made efforts to internationalize its currency in three areas:

1) Currency swap agreements with other Countries

The Chiang Mai initiative between 2001 and 2004 was the first round of China’s bilateral currency swap agreements with its six members (Thailand, Japan, South Korea, Malaysia, Philippines and Indonesia) worth USD 23.5 billion (Gao and Yu, 2009).

After the 2008 financial crisis the Chinese central bank initiated bilateral currency swap agreements aiming to make it easier for international companies and traders to receive financing in RMB during difficult economic periods (Swiss Metal Assets 2012). Swap agreements were also set up between the Chinese and foreign central banks to mitigate foreign exchange risk (Yau and Fung 2013). The countries
that have local currency swap agreements with China are listed in Table 1.

Table 4: China’s bilateral local currency swap agreements with foreign central banks (in billion Yuan) as of January 14, 2013

<table>
<thead>
<tr>
<th>Partner</th>
<th>Date of initial agreement</th>
<th>Amount RMB billion</th>
<th>Date of initial/Latest Agreement</th>
<th>Amount RMB billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong Monetary Authority</td>
<td>20\textsuperscript{th} Jan 2009</td>
<td>200</td>
<td>22 Nov 2011</td>
<td>400</td>
</tr>
<tr>
<td>Bank Negara Malaysia</td>
<td>8\textsuperscript{th} Feb 2009</td>
<td>80</td>
<td>8 Feb 2012</td>
<td>180</td>
</tr>
<tr>
<td>National Bank of the Republic of Belarus</td>
<td>11\textsuperscript{th} Mar 2009</td>
<td>20</td>
<td>11 Mar 2009</td>
<td>20</td>
</tr>
<tr>
<td>Bank of Indonesia</td>
<td>23 Mar 2009</td>
<td>100</td>
<td>23 Mar 2009</td>
<td>100</td>
</tr>
<tr>
<td>Central bank of Argentina</td>
<td>29 Mar 2009</td>
<td>70</td>
<td>29 Mar 2009</td>
<td>70</td>
</tr>
<tr>
<td>Bank of Korea</td>
<td>20 Apr 2009</td>
<td>180</td>
<td>26 Oct 2011</td>
<td>360</td>
</tr>
<tr>
<td>Central Bank of Iceland</td>
<td>9 Jun 2010</td>
<td>3.5</td>
<td>9 Jun 2010</td>
<td>3.5</td>
</tr>
<tr>
<td>Monetary Authority of Singapore</td>
<td>23 Jul 2010</td>
<td>150</td>
<td>23 Jul 2010</td>
<td>150</td>
</tr>
<tr>
<td>New Zealand Reserve Bank</td>
<td>18 Apr 2011</td>
<td>25</td>
<td>18 Apr 2011</td>
<td>25</td>
</tr>
<tr>
<td>Central Bank of the Republic of</td>
<td>19 Apr 2011</td>
<td>0.7</td>
<td>19 Apr 2011</td>
<td>0.7</td>
</tr>
<tr>
<td>Country</td>
<td>Bank Name</td>
<td>Date</td>
<td>Duration</td>
<td>Expiry Date</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>--------------------------------</td>
<td>---------------</td>
<td>----------</td>
<td>-------------</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>Central Bank of Mongolia</td>
<td>6 May 2011</td>
<td>5</td>
<td>20 Mar 2012</td>
</tr>
<tr>
<td>Mongolia</td>
<td>National Bank of Kazakhstan</td>
<td>13 Jun 2011</td>
<td>7</td>
<td>13 Jun 2010</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>Bank of Thailand</td>
<td></td>
<td></td>
<td>12 Dec 2011</td>
</tr>
<tr>
<td>Pakistan</td>
<td>State Bank of Pakistan</td>
<td></td>
<td></td>
<td>23 Dec 2011</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>Central Bank of United Arab Emirates</td>
<td>17 Jan 2012</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td>Turkey</td>
<td>Central Bank of Republic of Turkey</td>
<td>21 Feb 2012</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>Reserve Bank of Australia</td>
<td>22 Mar 2012</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>Central Bank of Brazil</td>
<td>21 Jun 2012</td>
<td>190</td>
<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>National Bank of Ukraine</td>
<td>26 Jun 2012</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>841.2</td>
<td></td>
<td>1,856.2</td>
</tr>
</tbody>
</table>

Source: *The European Financial Review 2013*

Table 4 shows that the total amount of the bilateral swap agreements between the Chinese and foreign central banks had reached 1,856.2 billion RMB by January 14th 2013. Recent news also reported that the UK and China have discussed establishing a reciprocal 3-year, RMB/sterling currency swap, which would help the direct investment and finance trade between the UK and China and support domestic financial stability (Gov. UK 2013).
2) Establishment of offshore currency centers (London and HK)

Hong Kong is the dominant offshore RMB trading center, with a daily turnover of RMB 1.5 - 2 billion. (Yau and Fung 2013) It has been established as the RMB offshore market since 2004, and since then RMB deposits were allowed in Hong Kong. China has established Hong Kong as a controlled experimental offshore hub for RMB trading, a market denoted as “CNH”. This abbreviation stands for “Chinese Yuan deliverable in Hong Kong”. Beijing has created an onshore and an offshore market for its currency to restrict the flow of the RMB in and out of the mainland. This is considered a step toward letting the RMB trade freely one day. London’s RMB trading center was started to develop its role as the West’s offshore trading center for the RMB in April 2012. At the same time, HSBC launched the first RMB bond market outside China and Hong Kong (Cummings 2012). Offshore trading in RMB has impressively sped up the increase of trading volume (Yau and Fung 2013).

(3) Border trade

Limited RMB-denominated banking services to Hong Kong residents and specified business customers were offered by banks in Hong Kong beginning in February 2004. Under a pilot scheme started in July 2009, participant banks in Hong Kong were permitted to engage in the settlement of RMB trade transactions. This was extended to cover twenty provinces and cities in China in June 2010 as well as making RMB trade and other current account item settlement available in all countries (Yau and Fung 2013). Since March 2012, trading entities all over the world can settle trade in RMB subject to local restrictions (Ni 2012). In 2012, the total RMB trade settlement handled by Hong Kong banks exceeded 2,600 billion Yuan ($413
Policy evaluation

The above measures taken by the Chinese government shows its taking steps towards tackling the dilemma of promoting the internationalization of a currency that is not fully convertible. There is a limited but potential role played by the swap agreements, border trade and offshore market development promoted by the Chinese government and its international counterparts. The swap agreements were initiated for crisis response, but the Chinese government also uses them to challenge the Dollar’s position in those countries and to promote bilateral trade and direct investment between China and each partner in local currencies (Liao and McDowell 2013). The pilot project is established to experiment and quicken capital account liberalization and fully convertibility of the RMB. However, the path that the Chinese government intends to take is not clear. It appears that the government is proceeding towards RMB internationalization through “crossing the river by feeling the stones”. A well-designed long-term plan and short-term policy to coordinate with the long-term plan should be publicized to show a stronger and clearer intention of RMB internationalization.
2.4 Challenges for RMB internationalization moving forward

2.4.1 Strictly controlled financial market

In the history of internationalization of currencies, there is no parallel for a developing country highly dependent on exports and investment, and which has maintained a high rate of economic growth through a combination of authoritarian state capitalism, capital controls, a closed and government-controlled banking sector, and a less than fully convertible currency.

As China’s financial market is still under strict control of the Government and the RMB is not a fully convertible currency, financial liberalization and full convertibility of the currency is the key barrier to RMB internationalization (Frankel 2011, Eichengreen 2011, Cohen 2012, Yu 2012 etc.). All the existing international currencies are fully convertible, the issuing countries of these currencies are all developed countries, and they already had efficient financial markets at the time their currencies were internationalized. Advanced countries are more able to resist external shocks due to their more efficient financial markets. Gong (2010) Kose (2006) offered robust evidence that capital account liberalization creates long-term benefits for developing countries through increases in economic growth, reduced inflation, and higher returns on equity. In the short term, however, volatility in capital flows could cause deflation, inflation and even economic crises (Shih and Shirk 2012). This suggests that the internationalization of China’s currency is both unprecedented and more complicated since it is a developing country with an inefficient financial system.

If China declined to liberalize its financial market, the RMB may not become competitive with international currencies whose issuing countries benefit from liberalized financial markets. History shows that a currency’s attractiveness to investors has an essential impact on the currency’s international status. Usually, to be
an attractive store of value, currency convertibility and a depth and openness of financial markets are required (Maziad and Kang 2012). Currencies with limits on liberalization face higher transaction costs, which inhibit their wide acceptance, particularly when there is competition from alternative currencies (Genberg 2010). If there is no progress towards capital account liberalization and full convertibility, foreign investors are less likely to find the RMB an attractive currency to hold.

However, the liberalization of the capital account will be neither easy nor painless. China’s problem in liberalizing its financial system has four aspects: First, China has a fragile economic system and suffers from over-monetization (Gao and Yu 2009). China’s whole economy is internally unbalanced, with cheap credit for business, negative real interest rates on deposits, subsidised land and subsidised input prices (Pettis 2013) making financial reform even more difficult and complicated. Capital controls removal would likely lead to considerable capital outflows. Secondly, cross-border capital flows could destabilize Chinese asset prices due the lack of depth of China’s capital market. Thirdly, China’s economic structure is inflexible. Fourthly, China’s financial institutions and national firms lack competitiveness and are not able to adjust quickly to exchange rate and interest rate fluctuation (Gao and Yu 2009 and Chavotier 2012). All these show the inappropriateness for China to take the liberalization step without rebalancing its economy, reforming its domestic financial market, and strengthening its financial institutions. But they also reveal that a gradual financial liberalization may be appropriate in view of China’s particular and complicated financial and economic circumstances.
2.4.2 Structure imbalance of RMB cross-border settlement

The RMB cross-border settlement is unbalanced since “Import settlement spending is much larger than export balance sheet income”. Import settlement-spending accounts for 80% of the total RMB cross-border settlement. This reflects the lack of a well-established RMB back flowing channel, and is symptomatic of the limits in domestic financial market openness. Besides that, there are also imbalances in current account and capital account settlement ratios. RMB cross-border settlements under the capital account are taken on a case-by-case basis and gradually opened with limitations, and this may be difficult to change in a short period (Ba 2012).

2.4.3 Offshore market arbitrage

There are two kinds of speculation that exist between onshore and offshore market. 1) Taking advantage of the spot spread between onshore and offshore.\(^{18}\) This will end up in an unbalanced\(^ {19}\) RMB cross-border trade settlement between the Mainland and Hong Kong. When the RMB spot price in Hong Kong is higher than on the Mainland, the stock of RMB in Hong Kong rises. When the RMB spot price in Hong Kong is lower than in Mainland, the stock of RMB in Hong Kong falls. 2) Taking advantage of expectations of RMB appreciation. When the market is expecting the RMB to appreciate, companies or financial institutions borrow US dollars and

\(^{18}\) Which means when the Hong Kong RMB spot price is higher than the RMB spot prices in the Mainland, Mainland exporters will choose to sell the US dollars gained from export in the Mainland. And Mainland importers will choose to purchase the US dollars for import. Vice versa, when the Hong Kong RMB spot price is lower than that one in the Mainland, Mainland exporters will choose to sell the US dollars gained from export in Hong Kong, and Mainland importers will choose to buy the US dollars for import. (He and Zhang 2012:6)

\(^{19}\) When the RMB spot price in Honk Kong is higher than that one in Mainland, the RMB amount paid for import by Mainland companies is larger than the RMB received from export. And when the RMB spot price in Honk Kong is lower than in Mainland, the RMB paid for import decreases and the RMB received for export increases. (He and Zhang 2012:8)
change it into RMB in the Hong Kong market at the same time as they sell the RMB in the forward market and buy US dollars. This results in an increase in US dollar loans and RMB deposits in the Hong Kong market when there is appreciation expectation for the RMB. And when the converse is expected, it drives an increase in US dollar deposits and RMB loans in the Hong Kong market (He and Zhang 2012).

There are also two kinds of interest arbitrage occurring between the onshore and offshore markets. 1) Overseas loans under domestic guarantee: Mainland banks issue letters of guarantee to mainland enterprises that have assets pledged to these banks. The enterprises then use the letters of guarantee as pledges for RMB loans through their offshore companies incorporated in Hong Kong.

Due to the significant spread in loan interest rates between the Mainland and Hong Kong, the overseas loan under domestic guarantee can significantly reduce corporate financing cost. 2) Since interest rates in Hong Kong are lower than in Mainland, enterprises and financial institutions issue RMB bonds offshore. Many mainland companies and financial institutions take this route to get the spread between the cost of issuing the bonds in Hong Kong and in the mainland (He and Zhang 2012).

If arbitrage opportunities between onshore and offshore markets continue to exist, once the expectation of RMB appreciation or the interest rate and exchange rate spread between the two markets disappear, the process of RMB internationalization is likely to be negatively influenced. (He and Zhang 2012) Expansion of feedback and arbitrage channels between onshore and offshore markets would be driven by the strong demand for RMB assets. Effectiveness of credit rationing onshore could be undermined since mainland businesses have more access to credit through offshore subsidiaries of mainland banks or issue RMB bonds.
offshore. Large Chinese firms disintermediate from onshore banking system and borrow directly or forge ties with banks offshore. And with offshore banks directly extending credit to firms onshore it would eventually undermine the onshore credit controls and government management of interest rates. (Maziad and Kang 2012) The establishment of the Hong Kong offshore market has actually allowed importers to purchase US dollars from foreign speculators in Hong Kong rather than from the central bank, and exporters prefer to receive payments in US dollars, later selling them to the central bank. This not only has reversed the RMB’s internationalization initiative of reducing China’s US dollar holdings, but also has helped to artificially prop up the value of the dollar (Mallaby and Wethington 2011).
Chapter 3: Cost, benefits to China and to the world

The internationalization of a currency creates costs and benefits. Analysis of these helps a country to weigh whether the internationalization of its currency is a worthwhile political and economic policy objective.

3.1 Benefits of internationalizing the RMB

A general analysis of the potential benefits and costs for a country to internationalize its currency and the specific challenges that China is faced will be presented in this chapter. This paper uses aggregated theories and observations in the realms of political science and economics.

The benefits a country may realize from internationalizing its currency are set out below.

1) Reduced Transaction Costs: Countries whose currencies are internationalized benefit from reduced transaction costs and lower exchange rate risk. Importers and exporters in China would be expected to reap microeconomic advantages from the elimination of the exchange rate risk if invoiced and settled trade were in RMB (included in the microeconomic level by Cohen 2011, 2012b). This would also make negotiation between trading partners easier (Ito 2011). The internationalization of the RMB would also boost cross-border transactions; enlarge bilateral trade and economic cooperation. This could be particularly attractive to China since it would likely promote the economic development of frontier regions inhabited by minority nationalities (Gao and Yu 2009).

If currency mismatch can be mitigated, the potential benefits of reduced transaction costs would be even more evident (Park and Shin 2009).
2) **Seigniorage**: raised by both Ito (2011) and Cohen (2011) as a benefit to the issuer of an internationalized currency. Cohen describes Seigniorage as a macroeconomic benefit and a real-resource gain for the economy as a whole. Seigniorage is defined as the difference between the lower rate of interest paid on foreign assets acquired by the issuing country and the higher rate of interest paid by foreigners on assets denominated in their own currency. This difference brings gains in international Seigniorage to the issuer of an internationalized currency (Aliber 1964).

However, the benefits of Seigniorage are not risk free. Issuers of internationalized currencies may be hurt by offshore speculation, currency rush flowback, and loss of control of the Central Bank's monetary policy though (Ito 2011).

3) **Macroeconomic flexibility**: Issuers of an internationalized currency benefit from the government’s increased ability to pursue objectives, finance external deficits, and delay adjusted costs. This not only brings economic advantages such as more latitude in managing price behaviour and employment levels, but it also enables issuers to fulfill their military and foreign diplomatic interests, as well (Cohen 2012b). International borrowing ability in the domestic currency helps to offset the currency mismatch problem in which Asian emerging countries were caught during the 1997 Asia financial crisis (Dobson and Masson 2009; Genberg 2010).

4) **Leverage**: Hard power, the autonomy that derives from macroeconomic flexibility, is vital to creating a capacity for leverage over others (Cohen 2012b).

5) **Reputation** is a form of “soft power” which is promoted by the widespread

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international use of the currency. It is also a visible sign of elevated rank in the community of nations, and a source of status and prestige brought by circulation (Cohen 2012).

6) Reduced Cost of Capital: A sixth point is that the international demand for the RMB would increase business for China’s domestic financial institutions, thus creating liquidity (Chen and Peng 2009). The competitiveness of domestic financial institutions would increase by dealing in the countries’ own currency (Chinn and Frankel 2005). Lower costs of capital could be provided to the non-financial sector as the financial sector becomes more profitable (Kenen 2009).

7) Maintain the Value of Reserves: As China holds the largest amount of foreign exchange reserves in the world; the decrease in the value of foreign exchange reserves has lead to China’s huge capital loss. With the internationalization of the RMB, China would be able to preserve the value of its foreign exchange reserves if its United States debts are denominated in the RMB (Gao and Yu (2009) and Ito (2010)).

3.2 Costs

The costs China is likely to experience due to internationalization of the RMB are set out below.

1) Appreciation—the popularity of an internationalized RMB would bring a degree of currency overvaluation. This would damage the benefits of China’s exporters by decreasing their competitiveness (Cohen 2011). This is particularly serious for China since its economy is heavily dependent on exports, and its aggressive exchange rate policy has resulted in the RMB being “moderately
undervalued”. Conversely, Pettis (2013) argues that a seller’s losses due to an undervalued currency are locked in when a transaction is completed in that currency. Accounting for these real losses, however, occurs only when the currency is re-valued correctly. From that perspective, the longer a currency remains undervalued, the more losses will accumulate for future recognition.

2) **External constraint**— Two main risks are involved here: one is the instability of aggregate demand for the currency caused by volatile movements in and out the currency. The other risk is the currency’s future value and usefulness will hold domestic policy increasingly hostage to external factors. Macroeconomic flexibility, domestic monetary autonomy and domestic priorities would be compromised if the RMB becomes an international currency (Cohen 2011). China might not be able to sustain volatile movements since its financial market is still vulnerable, and it is not sure that the Chinese government will be willing to adjust its domestic policy in response to external factors.

3) **Policy responsibility**— The issuing country will find itself responsible for the global monetary structure and broader regional management. To contain a crisis or to provide subsidized loans to rescue some country in distress, the country’s monetary policy may have to be modified (Cohen 2011).

4) **Capital control reduction**— If China were to succeed in internationalizing the RMB, it would have to substantially reduce capital controls (Gao and Yu 2009). The government has to give up its control on both the cost and allocation of capital (Chovanec in Guilford 2013). Which would increase the potential for instability in an over-monetized, inflexible economy with shallow capital markets (Gao and Yu 2009).

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21 Washington Post, June 8, 2012
5) **Vulnerability to speculative currency attacks**—An internationalized RMB would be more vulnerable to speculative currency attacks. Large amounts of capital could flow quickly in and out the country more easily. While this is theoretically feasible, smaller and independent currencies are far more vulnerable to this kind of attack. It is unlikely that this would be a serious strategic issue for China given the size of its economy, but it is possible that short-term mini crises could require active management by China (Gao and Yu 2009).

According to the above analysis, it cannot be quantified whether the potential benefits regarding the internationalization of the RMB outweigh the potential costs or vice versa. However, as long as the Chinese government is willing to absorb the costs, or to shore up its weakness to avoid some of the costs, the internationalization process is likely to bring many political and economic gains to China. Among the above costs, the thorniest ones for China to consider are speculative currency attacks and external constraints, both of which would be likely to reveal weakness in China’s financial and political system. Thus, the success of RMB internationalization depends on the ability and willingness of the government to face the challenges and cede certain controls on capital and financial market.

### 3.3 The path of RMB internationalization

China can follow two different path of RMB internationalization: one is a global strategy, and the other is a regional one (Park, 2010). The former choice is compared with the experience of the US dollar, while the path taken by the euro was regional.
3.3.1 Global approach to RMB internationalization

"China may not have to participate in any regional monetary union to attain the economic financial scale that is a prerequisite for an international or global reserve currency. Instead of trying to emulate the European approach to a regional monetary union, all it has to do is to wait" (Eichengreen in Park, 2010). Following this approach, the RMB could become a global currency over time through economic growth and reform of Chinese financial markets. Chinese policy to date implies that China's decision makers prefer this approach. Waiting would require less overt action, but it would likely take a lot longer, and in the meantime, the global economic environment is continuously changing.

According to the World Economic Forum (in Park 2010), China is at the bottom of the ranking of East Asian economies in terms of the degrees of capital account liberalization and domestic financial market liberalization. This means China would require a considerable time to internationalize the RMB.

Though the global approach would be a slow and challenging path to take, the RMB can take a gradual approach towards this goal. Graph 2 below elaborated by HSBC sets out a three-stage process that the RMB could take if it is in pursuit of a global approach. It describes a path that begins with achieving the status as a top global trading currency; progresses to reaching the status of a top global investment currency; finally culminating in a role as a top global reserve currency.
3.3.2 Regional approach to RMB internationalization

Whether the regional approach would be a viable option depends on the regional role of the RMB. It is reasonable to think that as the neighbouring countries develop deeper trade, investment and financial ties with China, they will be more likely to use the RMB for transactions and as a reserve currency. Park (2010) suggests that China might move in the creation of an RMB bloc among the members of ASEAN+New 3. It would include ASEAN 10, the Chinese Mainland, Taiwan and Hong Kong SAR, using ASEAN+3 as a framework for RMB internationalization (ASEAN+3 approach). The size of the Chinese economy will favour China in forming a RMB bloc and helping China deepen monetary cooperation and financial integration in East Asia and make the RMB the dominant unit of account and store of value in the region (Park 2010).

Some economists, such as Mason and Dobson, (in Park, 2010) believe that the bloc formation might be the most realistic and expedient approach to adopt for Chinese policy-makers. There are, however, 3 problems regarding the regionalization
of the RMB: 1) It hasn’t been evaluated whether ASEAN+New 3 is an optimal currency area, and even it is one, the Euro hasn’t been a good example of regionalization creating advantages since most of the member countries are not performing better than before the forming Euro zone. 2) The traditional criteria for membership in a common currency monetary union can be an endogenous process rather than a contractual one (Frankel and Rose 1998 in Park 2010). 3) Though is it is true that economic and financial interaction between the Asian countries is improved and deepened, so far there does not appear to be a strong interest by either China or neighbouring countries in forming an optimal currency area.

This paper argues that the RMB has a long journey to take towards internalization, and there are many challenges to overcome before realizing that end. However, in the long term, the global approach appears to be more suitable for the RMB. Besides that, the idea of regionalizing the RMB may have originated in China’s bilateral swap agreements with Asian neighbor countries. This idea may have gained support as a result of the more intensely financial and trading interaction between countries within Asian, and with the RMB being increasingly used by neighboring countries. However, none of this necessarily means that RMB internationalization is driving the formation of an Asian version of the “Euro”. It actually refers more to the idea that the RMB’s next stage could be acting as a core currency in Asia, as they see it as an effective way in the post-crisis era to protect Asian countries from potential financial risks (Qu 2010). It may also refer to the fact that the Chinese authorities want to consolidate the regional financial architecture more broadly than the framework provided by the Chang Mai initiative (Yu 2012).

ASEAN members are likely to be reluctant to allow their currencies to
appreciate with the RMB, thus causing their losing of competitiveness compared to the RMB. Using a regional currency would bind the member countries to the same monetary policy, forcing them to manage their economic differences using only their own fiscal policies. Not only does this appear to be more difficult if one takes the Eurozone as an example, but it creates problems in coordinating related economic and political policies within the region. It is also unclear how many ASEAN members are prepared to sacrifice some of their monetary sovereignty by anchoring their currencies to the RMB. The idea of regionalization would require further planning or discussion and evident willingness of cooperation. This would require more trust between Asia’s main countries than has been evident (Zhang 2010).

3.4 Policy implications and suggestions

To expedite progress of the RMB towards internationalization the following policies are recommended.

1) Reform domestic financial markets and institutions in order to improve their transparency and efficiency. Deepen China’s capital market by raising the investment limit for sovereign-wealth funds and central banks investing in domestic stocks and bonds, and by allowing more foreign investment, and deepen and liquidize its bond market in similar ways. This would greatly improve the RMB’s lagging performance along the financial track.

2) Continue with the expansion and development of the RMB offshore markets to improve the RMB’s already substantial progress on the trade track. In the short term, China must be able to control the
inflow and outflow of capital between the two markets to avoid increasing opportunities for arbitrage as reform progresses.

3) Accelerate the transition from controlled exchange and interest rates to market-based rates; which are not only crucial steps in reducing opportunities for arbitrage and currency speculation, but also important factors that determine the openness of financial markets and RMB convertibility.

4) Rebalance China’s economy away from export driven into consumption driven. The government should transfer more benefits and assets to the household sector, while unemployment should be kept low and household income should grow faster than, GDP (Pettis 2013). This would create a more sustainable growth model and economic environment to assist suggestions 1), 2) and 3).

5) Clarify the government’s long-term intentions and publish a roadmap towards full capital liberalization; which also contains the clarification of whether the RMB is going to take the regional or the global path:
Chapter 4: Conclusion

4.1 Summary of this research and main findings

The Chinese government has successfully taken the initiative to promote steps conducive to the internationalization of the RMB through the issuance of bonds in the Hong Kong offshore market and through the establishment of cross border trade settlement in RMB. The success of the RMB internationalization on the trade track has been obvious, but the financial track needs further improvements.

A comparison among major international currencies and the RMB shows the dominant role taken by the US dollar. It also shows the gloomy situation of the Euro as a failing or perhaps failed example of regionalization, the failure of the internationalization of the Yen, and the limited role-played so far by the RMB. However, since the Euro started to circulate in the international market, the role of the US dollar has been challenged. Thus, the RMB has an opportunity to play an increasingly important role as an international currency once it becomes fully convertible.

The comparison reveals the complexity of currency internationalization in terms of history, politics and economics and the unique context for RMB internationalization. Barriers to internationalization of the RMB include its non-convertibility, China’s underdeveloped and closed financial market, the vagueness and uncertainty of the path it might take, and the rapidly changing global economic environment. A critical step before liberalizing its financial market is the reform of China’s domestic institutions. This would help to minimize China’s vulnerability to short term volatility and loss of control.

In order to maximize the success and benefits from RMB internationalization,
the Chinese government must clearly state its willingness to absorb the costs and give up some of the controls on not only capital flows, but across the financial system. At the same time, it should also focus on rebalancing China’s entire economy to create a strong foundation for reform and internationalization. It seems that the ideal time to fully liberalize China’s financial market and complete RMB internationalization process would be after most of these adjustments have been completed.

Furthermore, the offshore market for RMB to be developed further. Interest and exchange rate reform must be coordinated with development so as to minimize opportunities for arbitrage behavior between onshore and offshore markets.

China must clarify its intentions about which approach it has chosen – regional or global – and the path it intends to follow for internationalizing the RMB. Of critical importance is that it must not only describe, but also visibly act on policies supporting this. As to this research, the global approach is a more optimal choice for China to take, and the eventual goal for the Chinese government should be to make the RMB an international currency that can create a tripartite confrontation together with the Euro and the US dollar.

4.2 Trend and speed of RMB Internationalization in the near future

In the near future, the move towards RMB internationalization would be continuous progress on its trade track, aided by China’s large trade output. Meanwhile, since the financial track is far more important and essential than the trade track, it is expected that more policies related to the financial track will be launched to accomplish the gradual process of financial liberalization. It is a good sign that China’s new leaders have spoken energetically about tackling challenges facing RMB internationalization. Their statements suggest the Chinese leadership is aware of how
painful and hard that reform is likely to be – described by Premier Li as “like cutting one’s own wrist”\(^\text{22}\). This talk must be supported by action before many will be convinced of its sincerity.

The Chinese government will continue to experiment with new policies and strategies in the offshore market. This allows the government access to trial and error, learning from experience without taking great risks. To promote the RMB as an international reserve currency, efforts are likely to be made to have the RMB included in the IMF’s SDR basket in its next review in 2015. To increase the likelihood of success, it is expected that the Chinese government will try to deal with the issue of the RMB’s non-fully convertibility.

The speed of the RMB internationalization will be gradual and cautious, not only because of the Chinese government’s unwillingness to suddenly open up its financial market, but also because the government may try to reform the country’s financial system before it takes further big steps like capital account liberalization.

In the short term, the RMB will still play a limited role internationally, which implies that it will still be mainly used in trading fields. Since the internationalization path has not be clarified and related concrete changes have not begun, announcement of intentions and policy studies are not yet taken as real reforms. Until China makes its intentions clear, its policies concrete, and shows real progress on reforms, the RMB’s position and attractiveness will not be powerful enough to challenge the US dollar and the Euro, or perhaps not even the Pound and the Japanese Yen in the short term.

\(^{22}\) The telegraph ‘China’s new premier Li Keqiang ‘to cut state control over economy’
www.telegraph.co.uk/finance/china-business/9936059/Chinas-new-premier-Li-Keqiang-to-cut-state-control-over-economy.html
4.3 What can be further done in studying this issue

Since China has not announced a clear plan and path towards RMB internationalization, studies can be undertaken to find out whether China has implicitly adopted the RMB internationalization path.

Another meaningful study that could be undertaken is a quantitative and qualitative mixed detailed costs benefits analysis to estimate whether the costs to China outweigh the expected benefits, or vice versa. Many researchers have written about the costs and benefits of having an internationalized currency, but since most of this writing is based on only a few examples, their conclusions might not apply to China’s unique situation. Further, the discussion about costs and benefits has not been supported by analysis of whether the benefits outweigh the costs or vice versa.

Further studies can be done on whether currency internationalization can be realized without capital liberalization. There are few examples of currency internationalization. As stated in previous chapters, by the time they internationalized their currency the issuing countries’ financial markets had already been liberalized, but this cannot be taken as proof that the capital account liberalization is a must for internationalizing a currency. As China has used Hong Kong as an experiment to keep both its closed onshore market under control, and an offshore market to initiate activities that promote the internationalization path, this unique model may yield evidence of its feasibility.

An important analysis required is the extent to which Asia makes up an optimal currency zone. This could be conducted by comparing the region to relevant optimal currency theory and models. This may provide important evidence towards a definite and accurate conclusion about whether the regional approach or the global approach is more suitable for China to take.
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## Appendix

<p>| Currency Composition of Official Foreign Exchange Reserves (COFER) (continued) |
|----------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| (In millions of U.S. dollars)          | 2003        | 2004        | 2005        | 2006        | 2007        | 2008        | 2009        | 2010        | 2011        |
| <strong>World</strong>                              |             |             |             |             |             |             |             |             |             |
| Total foreign exchange holdings        | 3,024,664   | 3,747,955   | 4,319,959   | 5,252,907   | 6,704,205   | 7,345,786   | 8,164,052   | 9,364,235   | 10,207,923  |
| Allocated reserves                     | 2,223,206   | 2,655,173   | 2,843,626   | 3,515,544   | 4,119,361   | 4,210,258   | 4,590,412   | 5,161,831   | 5,642,052   |
| Claims in U.S. dollars                 | 1,465,754   | 1,751,012   | 1,902,535   | 2,171,065   | 2,641,657   | 2,695,599   | 2,847,572   | 3,191,655   | 3,502,169   |
| Claims in pounds sterling              | 41,655      | 89,457      | 102,243     | 145,205     | 192,675     | 168,794     | 194,904     | 203,015     | 216,921     |
| Claims in Deutsche mark                |             |             |             |             |             |             |             |             |             |
| Claims in French francs                |             |             |             |             |             |             |             |             |             |
| Claims in Japanese yen                 | 87,608      | 101,769     | 102,051     | 120,480     | 131,901     | 132,994     | 188,770     | 202,629     |             |
| Claims in Swiss francs                 | 5,016       | 4,419       | 4,143       | 5,685       | 6,395       | 5,799       | 5,300       | 6,629       | 16,373      |
| Claims in Netherlands guilder          |             |             |             |             |             |             |             |             |             |
| Claims in ECUs                         |             |             |             |             |             |             |             |             |             |
| Claims in euros                        | 559,340     | 658,634     | 683,893     | 832,018     | 1,082,576   | 1,112,287   | 1,269,590   | 1,342,492   | 1,407,036   |
| Claims in other currencies             | 43,433      | 49,865      | 49,341      | 59,520      | 75,778      | 92,678      | 140,073     | 229,271     | 296,922     |
| Unallocated reserves 2/                 | 801,458     | 1,092,782   | 1,476,334   | 1,937,365   | 2,584,845   | 3,135,528   | 3,733,640   | 4,102,404   | 4,561,871   |
| <strong>Advanced economies</strong>                 |             |             |             |             |             |             |             |             |             |
| Total foreign exchange holdings        | 1,766,733   | 2,070,549   | 2,078,490   | 2,252,532   | 2,432,208   | 2,491,197   | 2,778,625   | 3,092,204   | 3,298,638   |
| Allocated reserves 1/                   | 1,557,148   | 1,825,781   | 1,821,299   | 1,982,264   | 2,157,080   | 2,197,678   | 2,429,109   | 2,708,457   | 3,012,032   |
| Claims in U.S. dollars                 | 1,045,038   | 1,227,839   | 1,261,105   | 1,350,325   | 1,423,433   | 1,475,598   | 1,581,750   | 1,761,725   | 1,989,051   |
| Claims in pounds sterling              | 36,338      | 48,421      | 49,331      | 64,719      | 76,021      | 59,055      | 67,739      | 68,152      | 77,246      |
| Claims in Deutsche mark                |             |             |             |             |             |             |             |             |             |
| Claims in French francs                |             |             |             |             |             |             |             |             |             |
| Claims in Japanese yen                 | 80,512      | 90,764      | 86,263      | 84,197      | 85,215      | 93,545      | 94,922      | 120,656     | 130,842     |
| Claims in Swiss francs                 | 4,158       | 5,247       | 3,428       | 4,579       | 4,721       | 3,955       | 4,511       | 5,198       | 14,633      |
| Claims in Netherlands guilder          |             |             |             |             |             |             |             |             |             |
| Claims in ECUs                         |             |             |             |             |             |             |             |             |             |
| Claims in euros                        | 359,079     | 417,198     | 387,038     | 440,455     | 522,190     | 511,245     | 616,432     | 646,720     | 685,752     |
| Claims in other currencies             | 32,023      | 38,311      | 33,933      | 37,990      | 45,301      | 54,281      | 63,755      | 106,065     | 114,509     |
| Unallocated reserves 2/                 | 209,585     | 244,769     | 256,891     | 270,268     | 275,127     | 293,515     | 349,516     | 333,747     | 386,405     |
| <strong>Emerging and developing economies</strong>   |             |             |             |             |             |             |             |             |             |
| Total foreign exchange holdings        | 1,257,931   | 1,677,466   | 2,241,469   | 3,000,376   | 4,271,998   | 4,854,593   | 5,385,426   | 6,172,030   | 6,805,285   |
| Allocated reserves                     | 666,058     | 829,293     | 1,022,027   | 1,333,280   | 1,962,280   | 2,072,580   | 2,161,303   | 2,453,374   | 2,630,019   |
| Claims in U.S. dollars                 | 420,717     | 523,172     | 641,431     | 820,741     | 1,218,224   | 1,223,061   | 1,265,822   | 1,429,929   | 1,513,118   |
| Claims in pounds sterling              | 25,317      | 41,036      | 52,413      | 80,487      | 116,654     | 109,738     | 127,164     | 134,863     | 135,675     |
| Claims in Deutsche mark                |             |             |             |             |             |             |             |             |             |
| Claims in French francs                |             |             |             |             |             |             |             |             |             |
| Claims in Japanese yen                 | 7,095       | 11,023      | 15,086      | 17,854      | 35,265      | 38,536      | 38,072      | 68,213      | 71,788      |
| Claims in Swiss francs                 | 858         | 1,172       | 715         | 1,106       | 1,675       | 1,845       | 789         | 1,431       | 1,741       |</p>
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<th>Claims in Netherlands guilder</th>
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**Memorandum items**

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