Whither the Renminbi?
人民幣何去何從?

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Introduction

- What do we mean by the “Internationalisation of the Renminbi”? It can mean many different things:
- The Renminbi is used as a “unit of account” and/or a medium of exchange outside of the Mainland.
- The Renminbi is used as a store of value outside of the Mainland.
- The Renminbi is fully convertible, that is, both “current accounts” convertible and “capital accounts” convertible—both inbound and outbound capital controls are lifted.
- The Renminbi and Renminbi assets are held by foreign central banks as a reserve currency.

Introduction

- The U.S. Dollar is the principal currency for the denomination and settlement of international trade and capital transactions in the World. The U.S. Dollar liquidity has been provided by the United States through its trade deficits with the World.
- If, in response to the 2007-2009 global financial crisis, the United States manages to reduce her trade deficit with the World to zero, or even better, to achieve a trade surplus in the future, there will be a reduction at least in the growth of the supply of U.S. Dollars outside of the U.S. for the settlement of international transactions and for official foreign exchange reserve purposes. Unless alternative mechanisms for the settlement of international transactions are developed, the growth of international trade and capital transactions will be constrained by the lack of adequate international liquidity.

Introduction

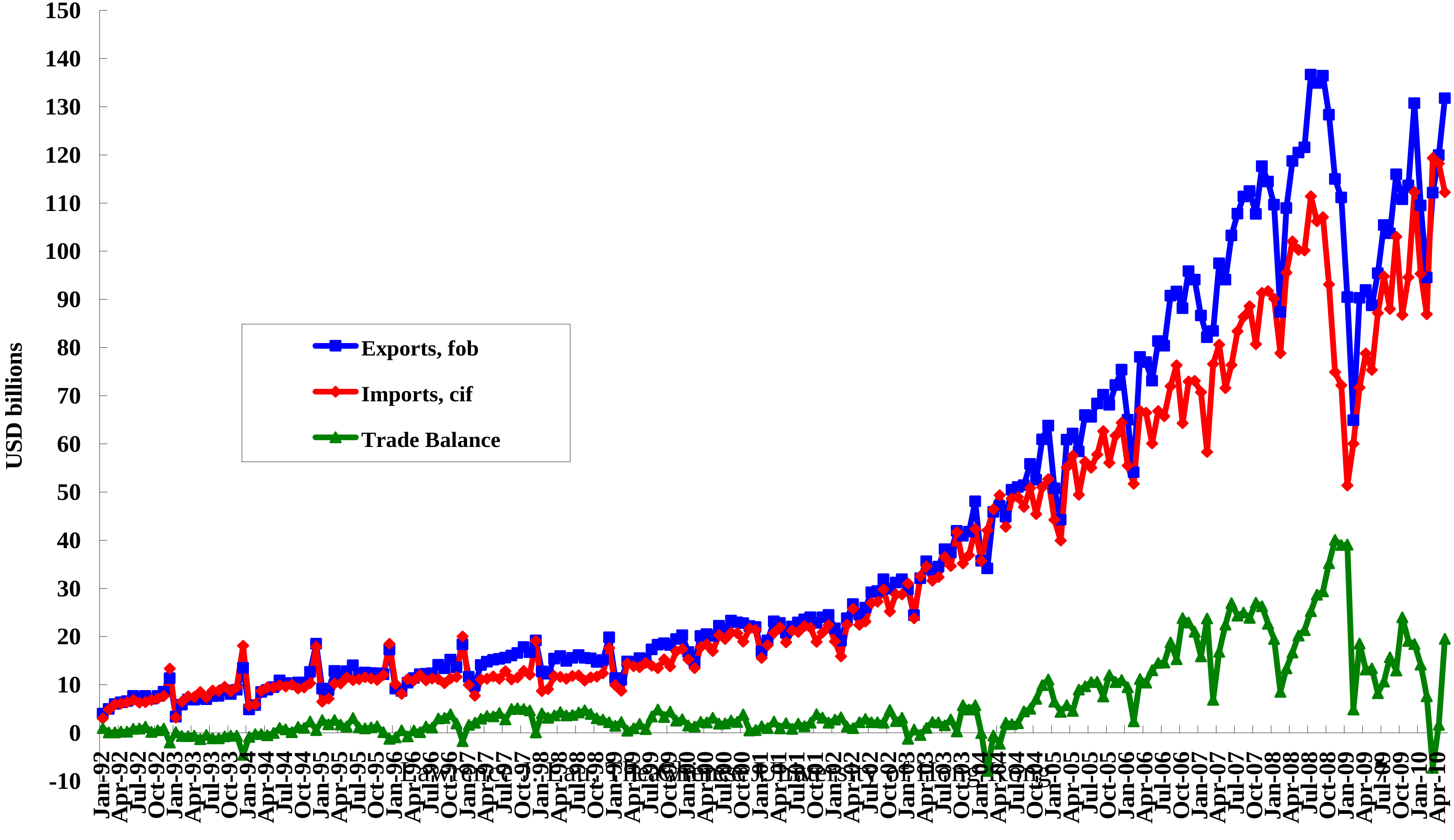
- One alternative is for the world to return to the gold standard, so that countries settle their transactions balances in gold.
- Another alternative is for one or more currencies to assume the role as principal reserve currencies (e.g., the Japanese Yen and the Renminbi). But then these countries must be willing and able to do so.
- Yet another alternative is to develop a new multilateral mechanism for the clearing and settlement of international transactions largely in terms of local currencies.

The Renminbi Exchange Rate

- The statistics on Chinese trade balances over the past three decades indicate that China has had essentially balanced trade in goods and services combined with the World until 2005, when a trade surplus began to emerge (see the following charts).
- The Chinese trade surplus vis-à-vis the World reached a peak in 2008 when it began to decline. For 2009, it declined more than 30 percent. The trend is that it will continue to fall and once again become low and insignificant.

Chinese Monthly Exports, Imports and Trade Balance, US$

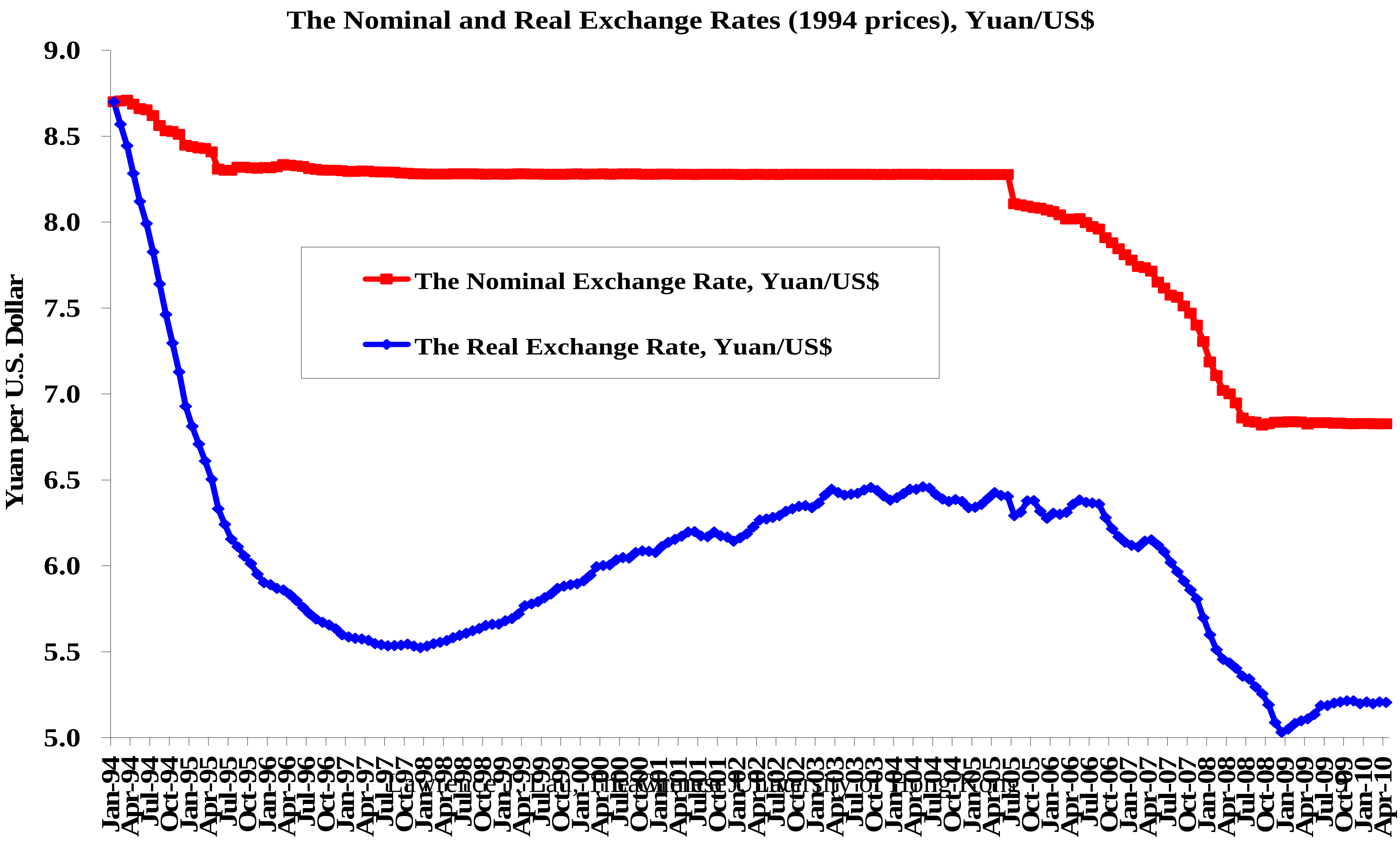
Monthly Chinese Exports, Imports and Trade Balance of Goods, in U.S. Dollars



The Renminbi Exchange Rate

- Because of the trade surpluses vis-à-vis the World since 2005, the Renminbi was allowed to appreciate in July 2005, and actually rose 20 percent in nominal terms and 25 percent in real terms by the end of 2008.
- In response to the global financial crisis triggered by the failure of Lehman Brothers in September 2008, the Yuan was temporarily pegged once again to the U.S. Dollar to assure public confidence and stability. It left the de facto peg up on 19th June 2010 and returned to a "managed floating rate" regime.
- More recently, on a trade-weighted basis, the Renminbi exchange rate has actually gone up significantly with the large devaluation of the Euro vis-a-vis the U.S. Dollar.

The Nominal and Real Yuan/US$ Exchange Rates



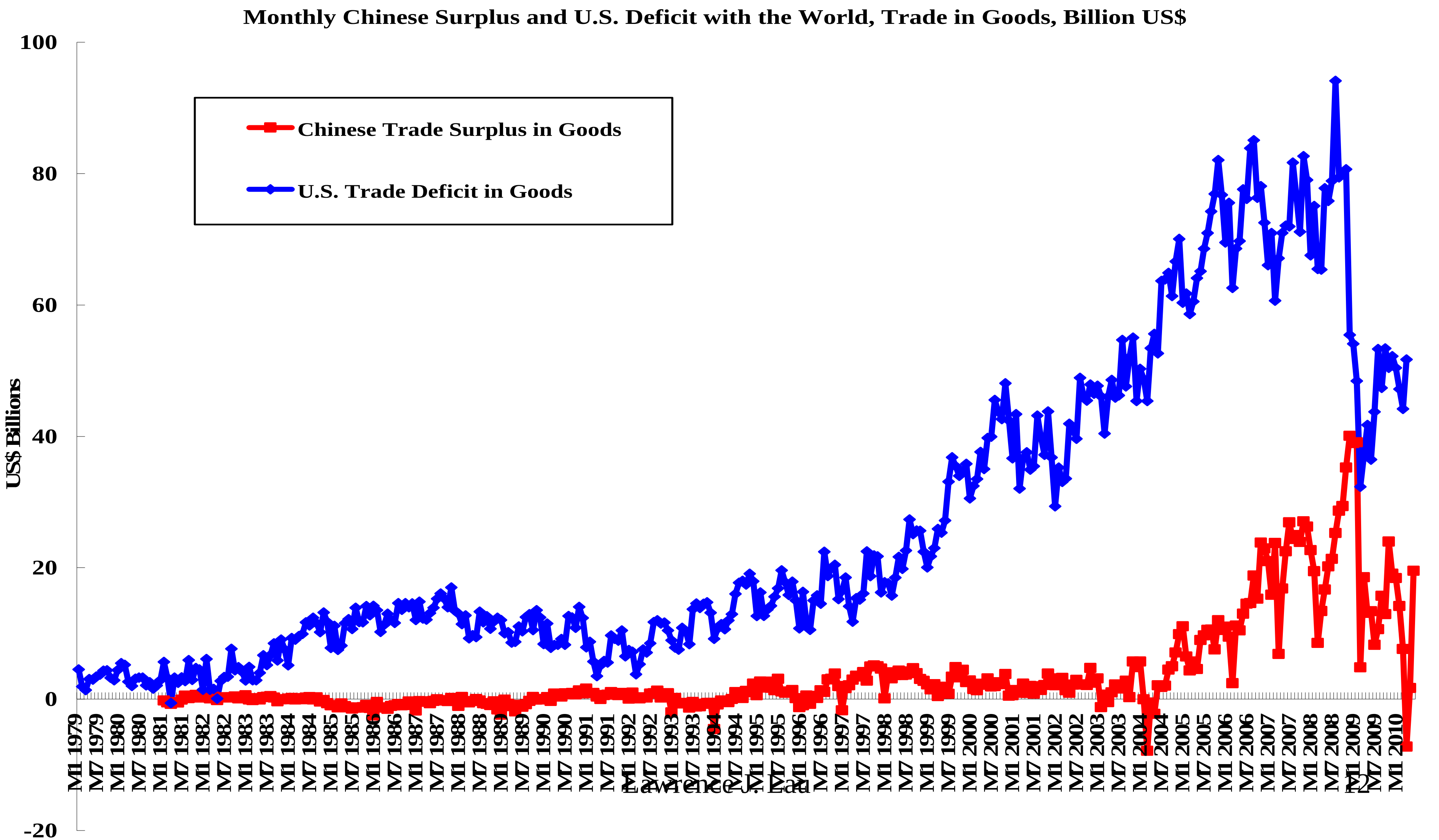
The Renminbi Exchange Rate

- The long-term goal of the Chinese Government is to reduce the Chinese trade surplus vis-à-vis the World to zero.
- If current trends continue, China will once again return to the position of essentially balanced trade with the World in a couple of years, without necessarily any large adjustments in the nominal Yuan/U.S. Dollar exchange rate.
- On an annual basis, the Chinese trade surplus should be within plus or minus 2 percent of Chinese GDP.
- The expectation is that the Renminbi exchange rate will be relatively stable in the near term—defined as the next year or two, but can be expected to appreciate relative to the U.S. Dollar in the medium to long-term as Chinese productivity continues to rise.

The Renminbi Exchange Rate

- In contrast, the large U.S. trade deficit with the World existed since at least 1998, long before China began to have a trade surplus with the World in 2005.
- What this means is that while there is evidence that the U.S. Dollar might have been over-valued, there is no evidence that the Renminbi was under-valued, prior to 2005.
- And the trend is that the Chinese trade surplus vis-a-vis the World will once again become insignificant in a couple of years.

Monthly Chinese Surplus and U.S. Deficit with the World, Trade in Goods, Bill. US$



The Renminbi as a Unit of Account and a Medium of Exchange

- The willingness to accept and to hold a non-local currency depends, but not exclusively, on whether the currency is fully convertible, that is, there are no inbound or outbound capital controls. A person may be quite willing to accept and to hold a non-local currency if he or she knows that the next person he or she comes across is also likely to accept and hold the currency even though the currency may not be fully convertible. There can be wide general acceptance without full convertibility.
- Even though the Renminbi is not de jure fully convertible, it has gradually become de facto convertible in many economies in East Asia because of its wide general acceptance. For example, the Renminbi is widely accepted and used in Hong Kong, Macau, Laos, Myanmar, and other East Asian economies and in border areas on a voluntary basis even though it is not legal tender in these places.

The Renminbi as a Unit of Account and a Medium of Exchange

- The "Renminbi Clearing and Settlement Agreement" just concluded between the People's Bank of China and the Hong Kong Monetary Authority means that the Renminbi can be used in many more types of transactions in Hong Kong, for examples, in the settlement of trade transactions and eventually, for buying and selling shares of Chinese enterprises on the Hong Kong Stock Exchange in Renminbi.
- The global financial crisis of 2007-2009 has paradoxically accelerated the pace of internationalisation of the Renminbi. Neither the U.S. Dollar nor the Euro are perceived as "risk-free" currencies that they once were. The Renminbi has gained in stature relative to the U.S. Dollar and the Euro.

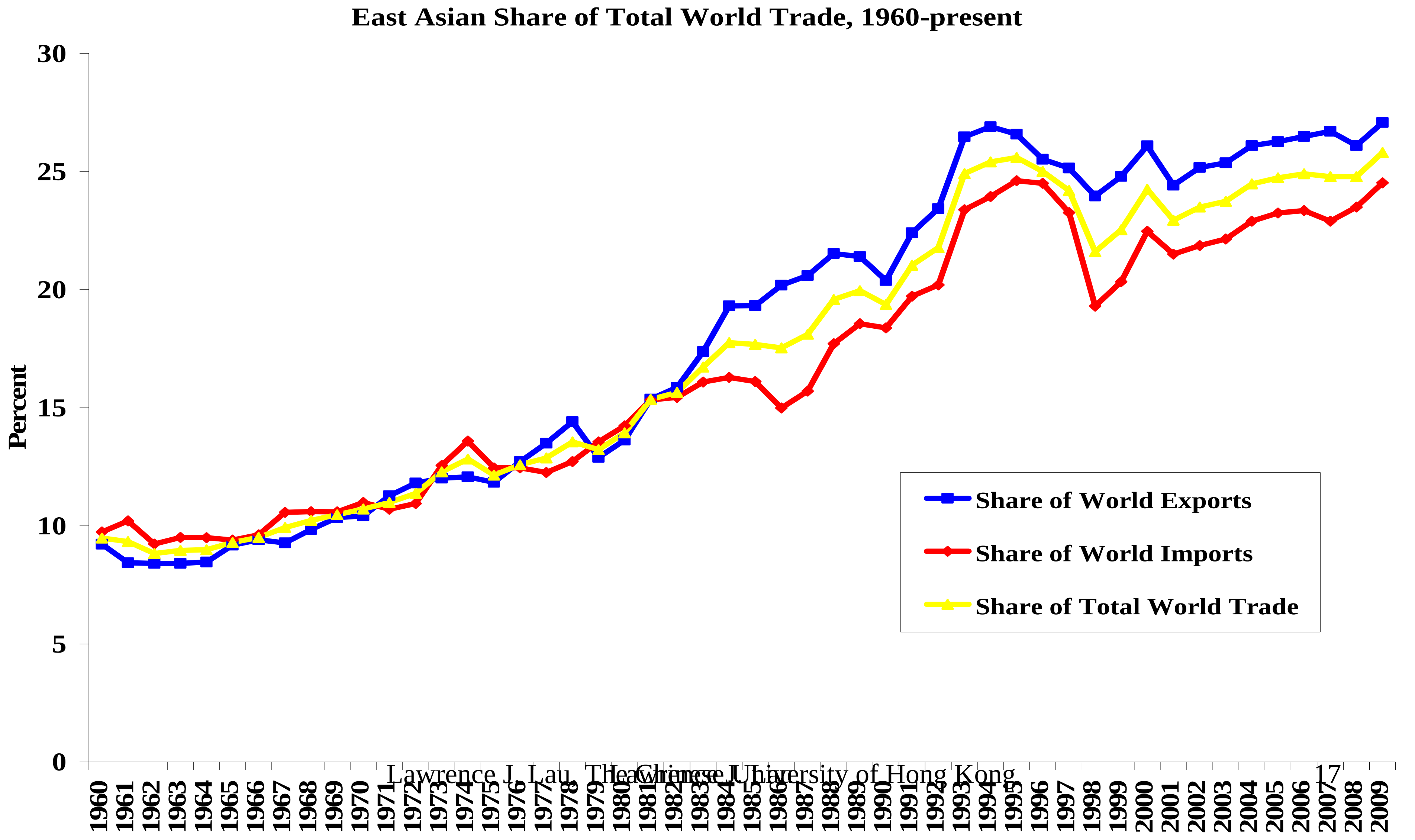
The Renminbi as a Unit of Account and Medium of Exchange

- International trade and other international transactions are normally denominated in a limited number of currencies principally because the citizens of most countries do not wish to accept or to hold the currencies of other countries than the few recognised as "reserve" or "hard" currencies (e.g., US$, Euro, Japanese Yen, Swiss Franc, British Pound). (Gold is possibly an exception.) "Hard" currencies are currencies that are widely accepted and held. Not all fully convertible currencies are hard currencies but almost all hard currencies are fully convertible currencies.
- The major share of World trade is denominated in U.S. Dollars. The U.S. Dollar is used by many countries as the medium of exchange in their international transactions. As world trade and capital flow grow, the demand for U.S. Dollars for transaction balances increases.

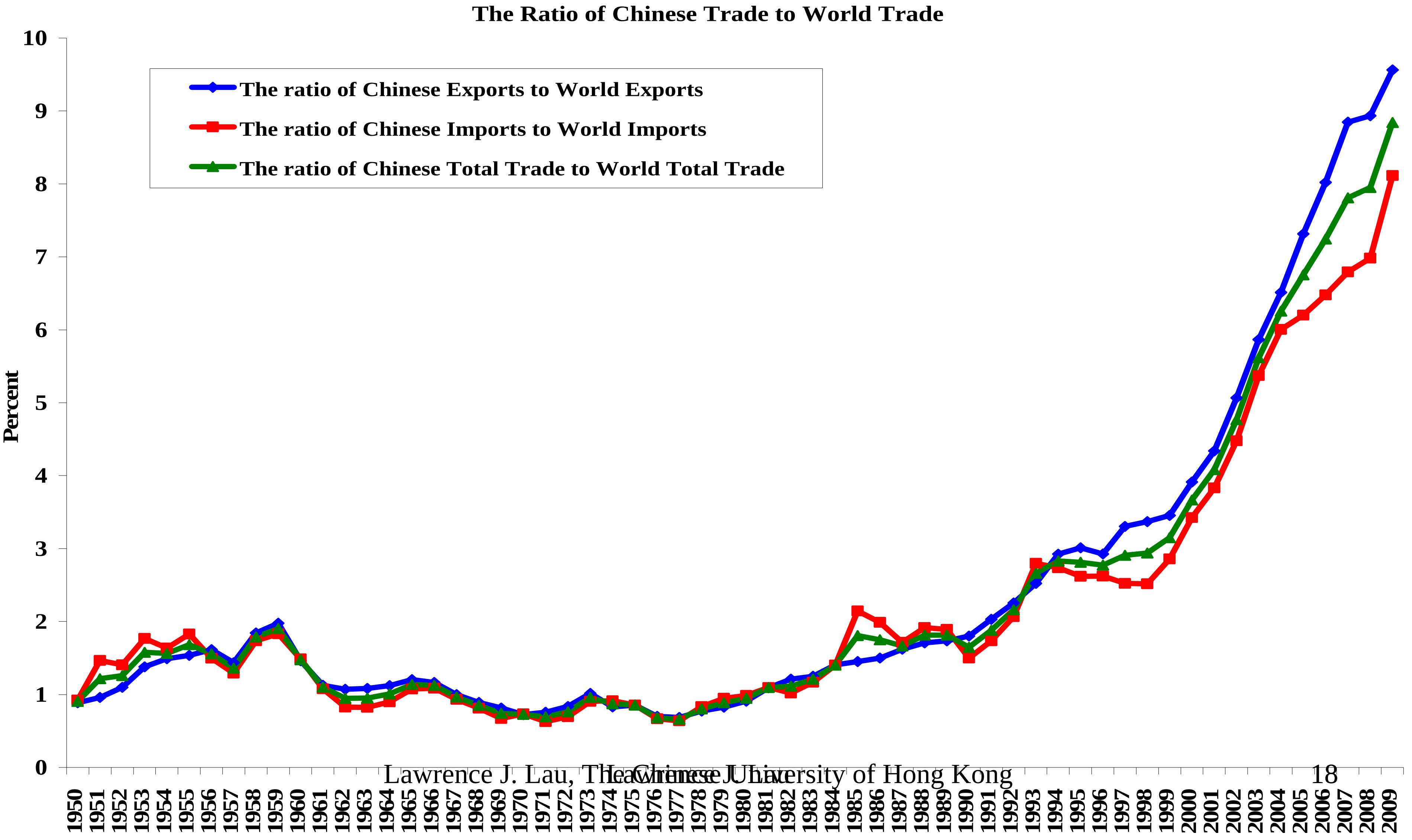
The Renminbi as a Unit of Account and a Medium of Exchange

- Chinese trade with East Asia is approximately 35% of its total international trade. Eventually it is possible that the bulk of the Chinese trade with East Asia may be denominated in Yuan. This trade alone amounts to more than US$1 trillion each year, with most of it currently denominated in U.S. Dollars.

The Rising Ratio of East Asian Trade in Total World Trade, 1960-present



The Ratio of Chinese Trade in Total World Trade, 1950-present



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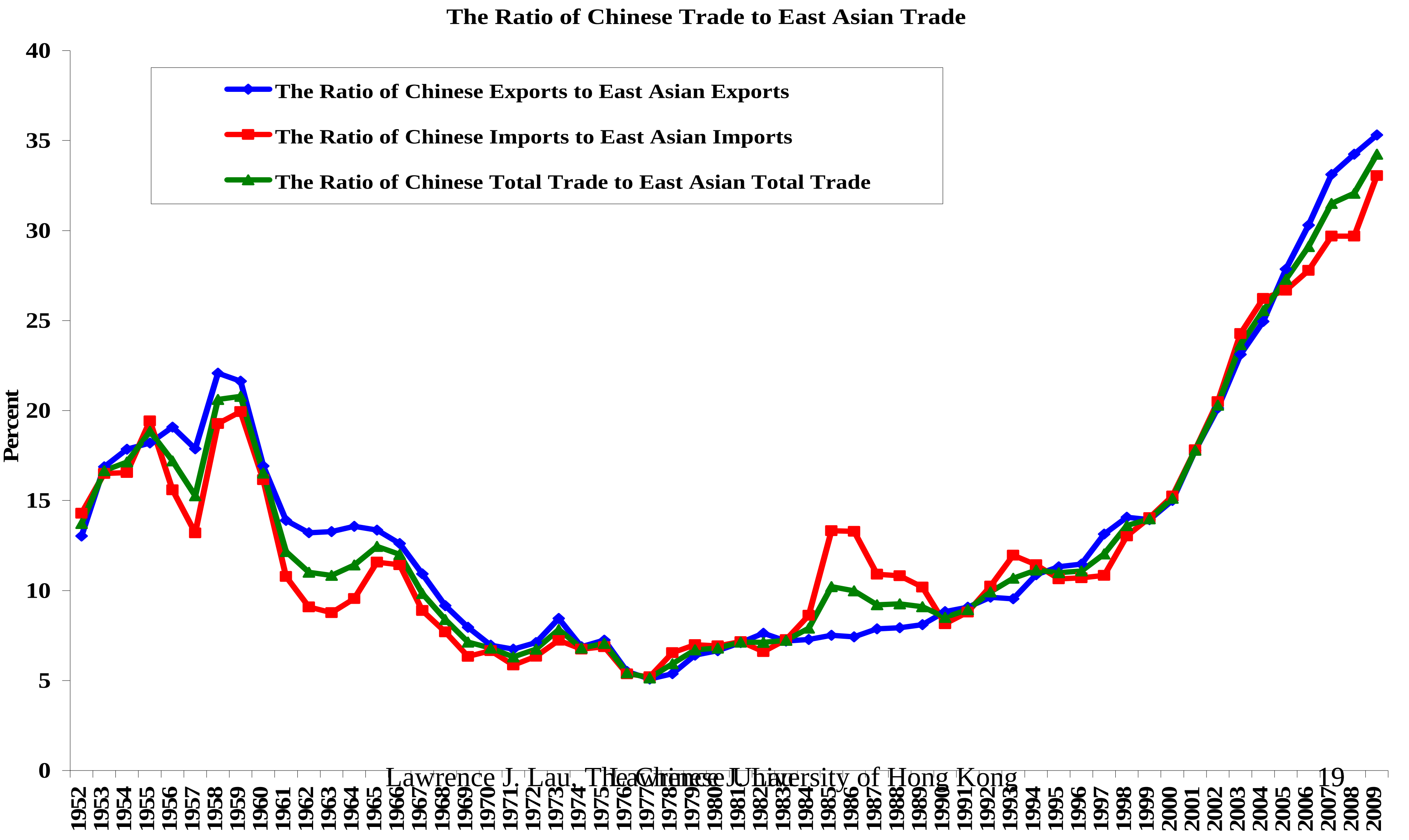
The Ratio of Chinese Trade in Total East Asian Trade, 1952-present



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The Renminbi as a Unit of Account and a Medium of Exchange

- Approximately 20 percent of Japanese imports and 35 percent of Japanese exports are denominated in Japanese Yen. Applying a similar ratio, say 30 percent, to Chinese international trade with East Asia, this would amount to a shift of approximately US$300 billion from U.S.$-denominated trade to Yuan-denominated trade each year.
- The U.S.$ balances that will be needed as working capital by East Asian exporters and importers will be significantly decreased and the Renminbi balances correspondingly increased.
- If the same ratio is applied to all Chinese international trade, the amount of Yuan-denominated Chinese trade can potentially be as high as US$750 billion.

The Renminbi as a Unit of Account and Medium of Exchange

- Reserve currencies such as the U.S. Dollar add value by enabling international transactions, in particular trade transactions, that otherwise may not take place. Without the use of the U.S. Dollar or a similar medium of exchange, many countries will be limited to doing only barter trade with one another. The U.S. has thus contributed to the World economy by being a principal provider of the international liquidity needed to support international trade transactions.
- The United States has been providing this liquidity to the World by running large annual trade deficits and paying for these trade deficits with U.S. Dollars, which are retained as international transaction balances (working capital) by many countries.

The Renminbi as a Unit of Account and Medium of Exchange

- Chinese international trade accounts for one-third of East Asian international trade. Thus, if the settlement of Chinese trade with other East Asian economies can be done in Renminbi and the respective local currencies, the need for the use of other reserve currencies to finance these transactions will be significantly reduced.
- Recent bilateral swap agreements between the People's Bank of China and other East Asian central banks make invoicing and settlement of international trade transactions in local currencies instead of reserve currencies such as the U.S. Dollar and the Euro possible.
- It may become necessary for China and the World to devise alternative mechanisms for the settlement of international trade and capital transactions other than the use of a limited number of reserve currencies.

The Renminbi as a Unit of Account and Medium of Exchange

- Recently, qualified Chinese traders have been allowed to settle their international transactions in Renminbi instead of U.S. Dollars or another convertible currency on a voluntary basis. It is anticipated that eventually all traders will be allowed to settle their international transactions in Renminbi.
- However, the long-term market expectation of the future Renminbi/U.S. Dollar exchange rate is uni-directional, that is, the Yuan will appreciate relative to the U.S. Dollar, and hence also relative to the Hong Kong Dollar. Rightly or wrongly, everyone expects the Renminbi to appreciate with respect to the U.S. Dollar.

The Renminbi as a Unit of Account and Medium of Exchange

- Given this expectation, Mainland importers and service demanders have no incentive to offer to place their orders or settle in Renminbi—they will much prefer to use U.S. Dollars or in Hong Kong Dollars (unless they receive an appropriate discount).
- Also, while a Chinese exporter would like to quote their prices and invoice in Renminbi, a foreign importer of the Chinese goods would not want to place an order in Renminbi and agree to settle in Renminbi for fear that it might cost much more in terms of U.S. Dollars by the time the goods arrive in the U.S. or elsewhere several months later.

The Renminbi as a Unit of Account and Medium of Exchange

- Currently, the cost of hedging is high and can only be done in the non-deliverable-forward market. That is one reason why even though it is now possible for the settlement of Chinese trade transactions in Renminbi, only a very small proportion of Chinese trade is denominated and settled in Renminbi. The most recent estimate is that it amounts to US$5 billion a year, less than 0.2 percent of aggregate Chinese international trade.

The Renminbi as a Unit of Account and Medium of Exchange

- In order to accelerate the transition of Chinese international trade to Renminbi denomination and settlement from U.S. Dollar denomination and settlement, it may be useful for the People's Bank of China to offer a low-cost hedge to bona fide exporters and importers.
- This can be as simple as selling and buying Renminbi forward (say, at 3 months, 6 months and 12 months) to and from bona fide traders engaged in Chinese international trade with established track records and with amounts limited to no more than the full value of the merchandise.
- The purpose of the forward market is to provide "insurance" to those bona fide traders against fluctuations in the Renminbi exchange rate and not to provide an instrument for speculation.

The Renminbi as a Unit of Account and Medium of Exchange

- For example, Hong Kong importers of Mainland goods and services may be permitted to purchase Renminbi forward not exceeding the value of the invoice. Such Renminbi will not be transferrable and can only be paid to the specific Mainland exporters of the goods and services.
- Chinese importers of goods and services will probably insist on settling in U.S. Dollars but they should also be permitted to buy forward foreign currencies from the People's Bank of China to reduce the exchange rate risk.
- The "managed float" regime of the Renminbi does mean that in the short term the Renminbi can go both up and down relative to the U.S. Dollar (even though the long-term direction is clearer).

The Renminbi as a Unit of Account and Medium of Exchange

- It is expected that the use of the Renminbi for settlement of international trade and capital transactions in East Asia will gradually become very common, to the point that it may cover almost all of Chinese international trade within East Asia with the possible exception of Japan.
- Chinese international trade with the United States and Europe, with oil exporting countries in the Middle East, and with Brazil, India and Russia, may continue to be denominated in either the U.S. Dollar or the Euro.
- Chinese international trade with Africa and Latin America may well be denominated in Renminbi, especially Africa if China becomes the major donor of development loans to Africa.

The Renminbi as a Store of Value

- Given the expected long-term appreciation of the Renminbi relative to the U.S. Dollar, the Renminbi can potentially provide a good store of value for households and enterprises outside of China, for example, for retired persons.

The Renminbi as a Possible Reserve Currency

- The central banks of many countries maintain foreign exchange reserves in the form of assets in the major reserve currencies as essentially working capital that may be used to pay for imports from countries unwilling to accept their own currencies, as well as the principal and interest on their foreign-currency denominated loans.
- The future sustainability of the U.S. Dollar as the principal medium of international exchange is in doubt. It is not clear whether U.S. is either able or willing to continue to be the principal supplier of the transactions currency of the world by running large trade deficits.

The Renminbi as a Possible Reserve Currency

- Reserve currencies are characterised by wide, if not universal, general acceptance everywhere and by stability in terms of real purchasing power. Thus, the currency of a country with a high rate of inflation is unlikely to become a reserve currency. Reserve currencies are in general fully convertible.
- The Renminbi has been current accounts convertible since 1994. However, it has not become fully capital accounts convertible. There still exist both inbound and outbound capital controls in China. Some categories of capital movements require prior government approval. But individual Chinese citizens can remit up to US$50,000 per person overseas each year, with few questions asked.

The Renminbi as a Possible Reserve Currency

- The Renminbi is ready to assume a greater role in international transactions, especially in Chinese international trade transactions within East Asia. This is also in part out of necessity, as one can no longer count on a steady growth of U.S. Dollar balances outside of the U.S. Thus the Chinese Government has begun to promote more settlement of Chinese international trade transactions, especially those within East Asia, in Renminbi, so as to reduce reliance on the U.S. Dollar, transactions costs and the risks associated with the U.S. Dollar exchange rates.
- However, increased internationalisation of the Renminbi does not necessarily imply that the Renminbi will become a major international reserve currency. For example, the Japanese Yen is fully convertible but it is not a principal reserve currency. It may not be in China's best interests to have the Renminbi become, over time, a principal reserve currency like the U.S. Dollar.

The Renminbi as a Possible Reserve Currency

- The benefit to the issuing country of a reserve currency is in the seigneurage. The issuing country can pay for its imports by printing money (or what amounts to more or less the same thing, bonds). The country receiving the money and/or bonds puts them into its foreign exchange reserves and does not spend them. So the issuing country is able to acquire real goods of real value with essentially pieces of paper which it can print at will—a great bargain.
- Reserves are normally accumulated and held in the receiving country for a long time, to the benefit of the issuing country. It is only when the receiving country decides to spend the money to buy goods and services from the issuing country that the issuing country has to export real goods and services to the receiving country in exchange.

The Renminbi as a Possible Reserve Currency

- The “cost” to the issuing country is that in order to benefit from seigneurage, it must in general run a trade deficit. (If it has a chronic trade surplus, it does not need to print money (or bonds) to pay for its imports and other countries will have a hard time acquiring its currency.) A country with mercantilist tendencies does not like to run trade deficits and hence may not want its currency to become a major reserve currency.

The Renminbi as a Possible Reserve Currency

- A further potential "cost" is the possibility that the other receiving countries may decide at some point to stop holding this currency and sell the currency and the bonds they hold, potentially creating havoc to the exchange rate of the currency and the financial markets of the issuing country.
- Of course, if the issuing country is "too big to fail," as in the case of the United States, it is another matter altogether.

An Alternative Settlement Mechanism--A "Bank for Intra-Asian Settlements"

- There are also other alternatives, for example, creating a mechanism and framework so that East Asian economies, both developed and developing, can settle their international transactions with one another with their local currencies.
- One model was provided by the European Payments Union (1950-1958). In the aftermath of World War II, when all the major economies in Western Europe were still recovering, West German exporters were reluctant to accept French Francs, French exporters were reluctant to accept the German Mark, and both German and French exporters were reluctant to accept the Italian Lire. They would all accept the U.S. Dollar (the only accepted reserve currency), which was then in short supply in Western Europe. The growth of international trade within Western Europe was thus quite constrained.

An Alternative Settlement Mechanism--A "Bank for Intra-Asian Settlements"

- With the assistance of the United States Marshall Plan, the European Payments Union (EPU) was established by the Organisation for European Economic Cooperation (OEEC) in July 1950, with the Bank for International Settlements acting as its agent, to solve the problem of insufficient international liquidity (U.S. Dollars).

An Alternative Settlement Mechanism--A "Bank for Intra-Asian Settlements"

- The East Asian central banks are now flush with foreign exchange reserves. Continuing accumulation of foreign exchange reserves is no longer necessary for East Asian economies—in fact, the continuing increases in the foreign exchange reserves in the East Asian economies are beginning to present a problem for macroeconomic control.
- For East Asian economies it is now possible to consider creating a similar institution, say, a “Bank for Intra-Asian Settlements,” to facilitate settlement of Intra-East Asian international transactions in their local currencies rather than the U.S. Dollar or the Euro. This makes it unnecessary to continue accumulating foreign exchange reserves in U.S. Dollars or in Euros, and in turn makes it much less important whether these economies have trade surpluses vis-à-vis the United States or the European Union or the rest of the World.

Concluding Remarks

- China will be internationalising the Renminbi gradually and in a planned and orderly manner. It has already made a beginning by allowing the Renminbi to be used on a voluntary basis as a settlement currency in its international trade with selected countries and regions.
- Paradoxically, the global financial crisis of 2007-9 has accelerated the pace of internationalisation of the Renminbi.
- A Renminbi offshore centre will be established in Hong Kong. All normal banking business can be conducted in Renminbi in Hong Kong.

Concluding Remarks

- It is in China's interests to maintain a relatively stable exchange rate. However, it is not in China's long-term interests to have the Renminbi pegged rigidly to the U.S. Dollar.
- For the same reason, it is not in China's long-term interests to have the Renminbi pegged rigidly to a basket of foreign currencies. China must maintain the flexibility to manage its exchange rate—it is too important a price to be left completely to a market full of potential speculators. China should therefore maintain a "managed floating exchange rate."
- Adjustment of the exchange rate can depend on many factors: the long-term trade balance, the rate of inflation relative to those of other major trading partners, public confidence, etc. It is expected that the Chinese international trade with the World will be essentially balanced in the future.
- However, relative stability of the Renminbi exchange rate is beneficial to the continued development of the Chinese economy. It also enhances the potential benefits from using the Renminbi as a store of value.

Concluding Remarks

- It is therefore also in China's best interests to seek other alternatives to the use of the US$ as a principal medium of exchange for the conduct of international transactions. It may not be through making the Yuan an international reserve currency; it is possible to develop a clearing and settlement mechanism within East Asia based on local currencies.
- A Bank for Intra-Asian Settlement can facilitate the settlement in local currencies in the same way the Bank for International Settlement facilitated settlement among Western European countries in their own currencies after World War II.
- If the East Asian economies can settle their trade accounts in their local currencies, it would be a major step towards their further economic and financial cooperation and integration.

Concluding Remarks

- It is clear that the Renminbi will gain increasing acceptance as an unit of account, a medium of exchange and as a store of value, especially in East Asia.
- It is also clear that the Renminbi will gradually play a greater role in the clearing and settlement of international trade and capital transactions, beginning with Chinese international trade, especially in East Asia.
- In time, perhaps within the next five years, the Renminbi will become fully convertible, in the sense that both inbound and outbound capital controls will be effectively lifted.

Concluding Remarks

- It is not so clear whether the Renminbi will be allowed to float completely freely, to have its exchange rate determined completely by the market, without the intervention of the Central Bank. It is too important a price to be left to the speculators. Just recall what happened to the exchange rates of East Asian economies during the East Asian currency crisis of 1997-1998.
- While it is in the interests of China and East Asian economies to reduce their dependence on the U.S. Dollar as a unit of account and medium of exchange for international trade and capital transactions among themselves, given the current state of the World economy, it is also not clear whether it is in Chinese best interests to have the Renminbi become a major reserve currency like the U.S. Dollar and the Euro. To become a major reserve currency that is widely held by central banks elsewhere in the World, China will likely have to run a significant trade deficit. Moreover, there is also the risk of other central banks deciding to dump the currency at inopportune moments.