The Internationalisation of the Renminbi

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The Meaning of Internationalisation

- The internationalisation of the Renminbi can mean different things to different people. It basically implies the use of the Renminbi for various purposes outside of Mainland China.
- (1) The Renminbi as a Unit of Account in cross-border trade transactions. This means that the prices and values are quoted in terms of the Renminbi (however, they do not necessarily imply settlement in Renminbi).
- (2) The Renminbi as a Medium of Exchange. This means the use of the Renminbi for actual settlement of transactions, including cross-border trade transactions between China and its trading partner countries and regions, and eventually between and among its trading partner countries and regions themselves.

The Meaning of Internationalisation

- (3) The Renminbi as a Store of Value. This means the holding of Renminbi as a long-term asset by individuals and institutions. When it is held by central banks and monetary authorities of other countries and regions, it is a foreign exchange reserve asset.
- (4) The Renminbi as an international funding currency. This means money is raised by non-Chinese entities through the issuance of financial instruments such as bonds and stocks denominated in Renminbi.
- (5) The Renminbi as a major international reserve currency like the U.S. Dollar and the Euro.

The Meaning of Internationalisation

- There are also various conditions that are necessary for some of these uses of the Renminbi to be realised, such as the stability of the Renminbi exchange rate, the level of Chinese foreign exchange reserves, and the convertibility of the Renminbi. Each of these uses will be discussed in turn.

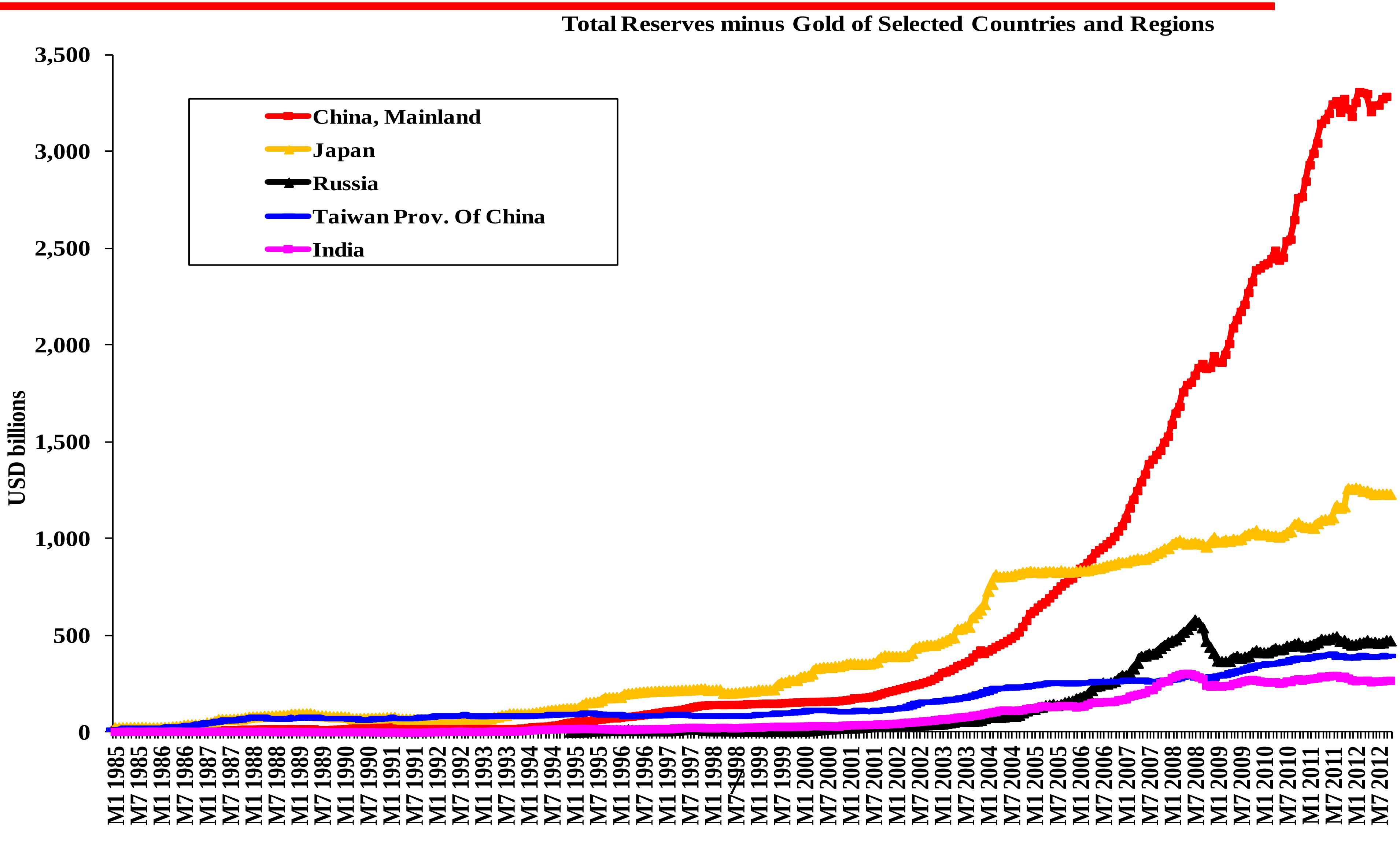
The Convertibility of the Renminbi

- The Renminbi has been current accounts (including trade in both goods and services) convertible since 1994, when China undertook a major foreign exchange policy reform, coupled with a significant devaluation at the time.
- The Renminbi has also over time become essentially long-term capital accounts convertible. Capital movements related to inbound and outbound foreign direct investment, and foreign portfolio investment in the forms of "Qualified Foreign (or Domestic) Institutional Investor (QFII or QDII)" as well as the repatriation of principal and profits are readily approved.
- There is also the soon-to-be-established International Board, on which the shares of foreign corporations can be listed, in Shanghai, which will effectively allow the outflow of long-term portfolio investment.
- However, it has not yet become fully short-term capital accounts convertible. There still exist both inbound and outbound controls on capital movements perceived to be short-term in nature in China.

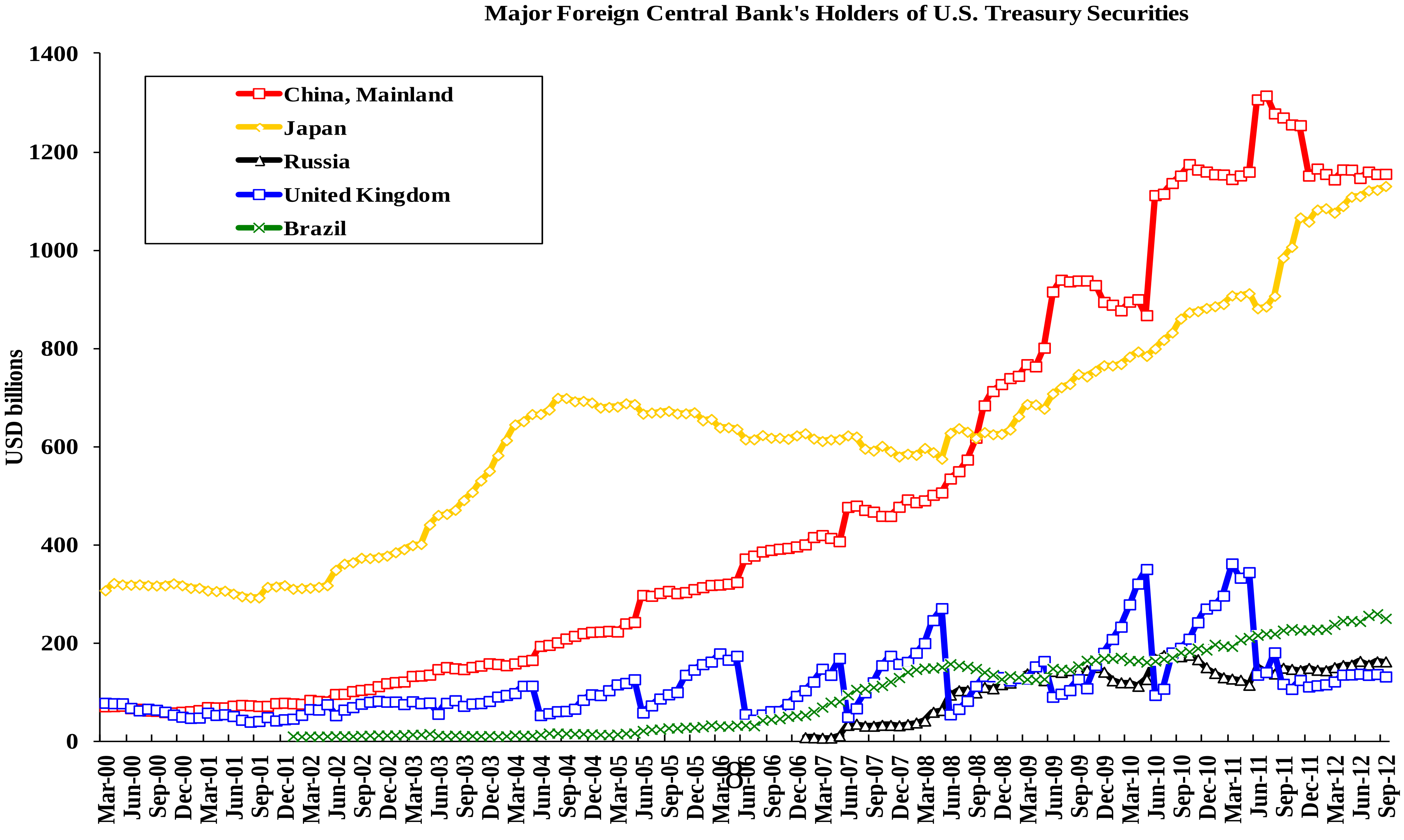
Introduction

- Today, the People's Bank of China, China's central bank, has the World's largest official foreign exchange reserves, in excess of US$3.285 trillion, almost all of which has been acquired during the past decade, followed by Japan with US$1.23 trillion.
- The People's Bank of China is also currently the World's largest holder of U.S. Treasury securities, with not quite US$1.16 trillion, followed by Japan as a very close second.

Total Foreign Exchange Reserves minus Gold, Selected Countries and Regions



Major Foreign Central Banks' Holdings of U.S. Treasury Securities



Nominal Exchange Rate of the Renminbi, Yuan/US$, 1978-present

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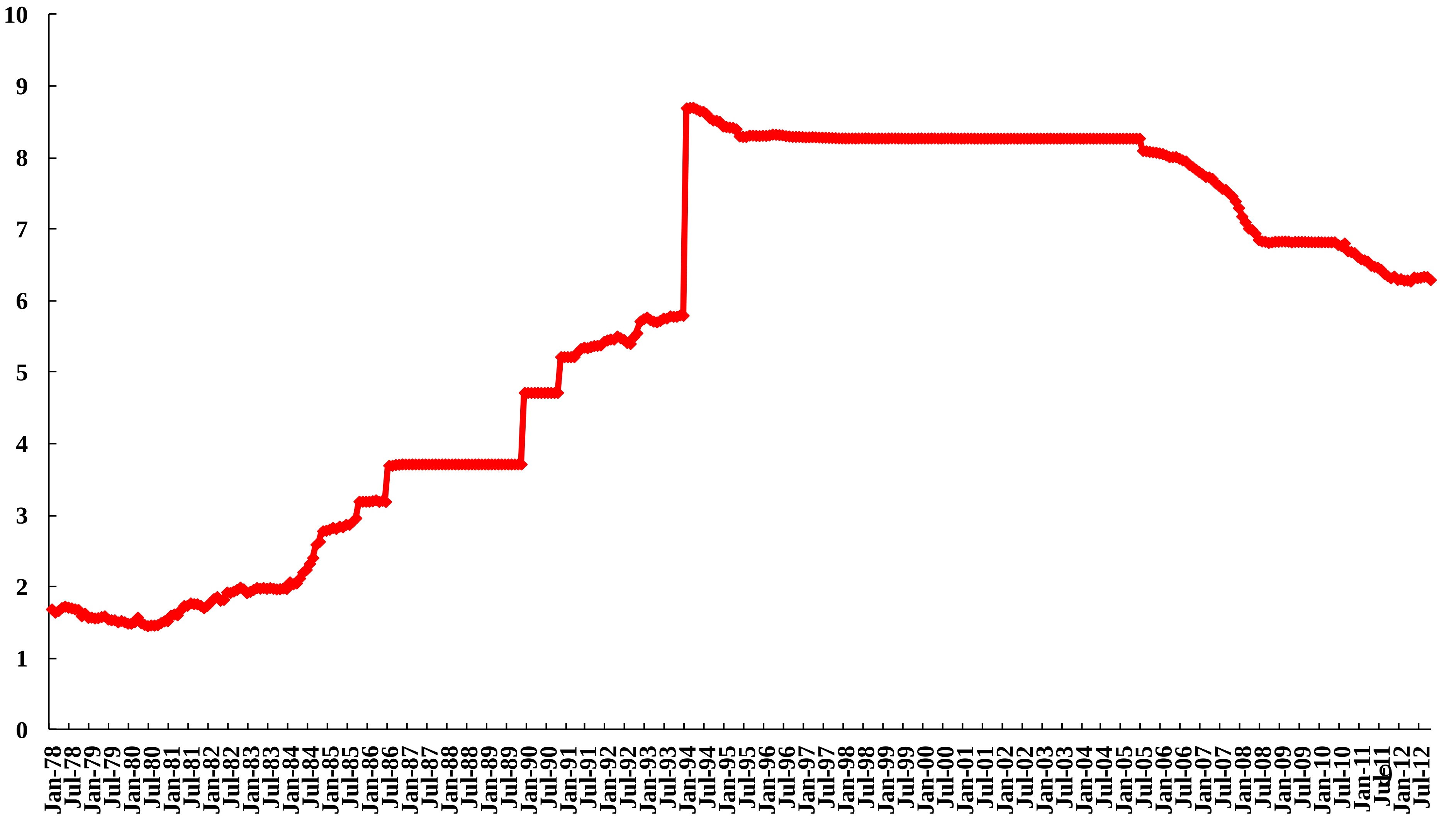
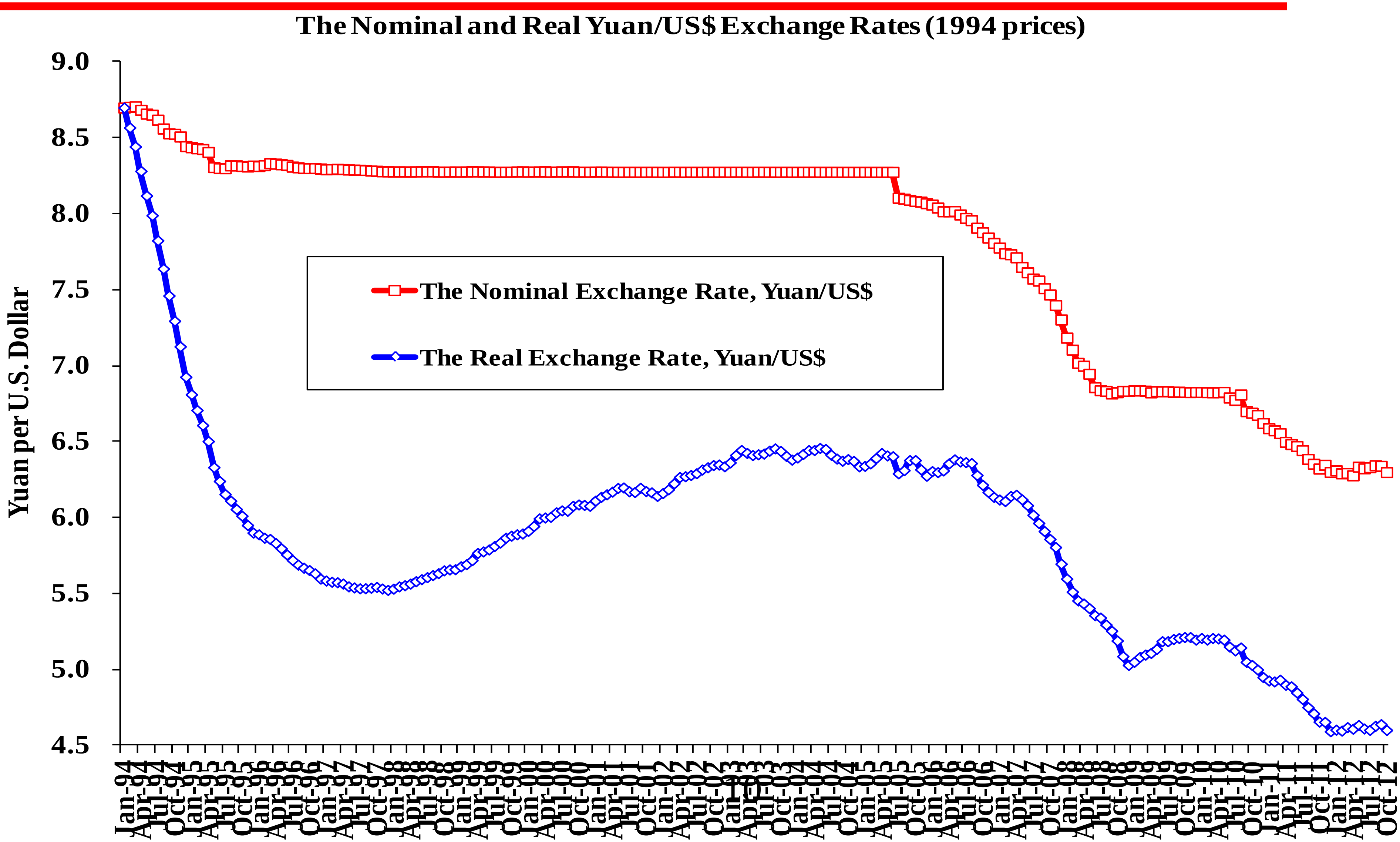


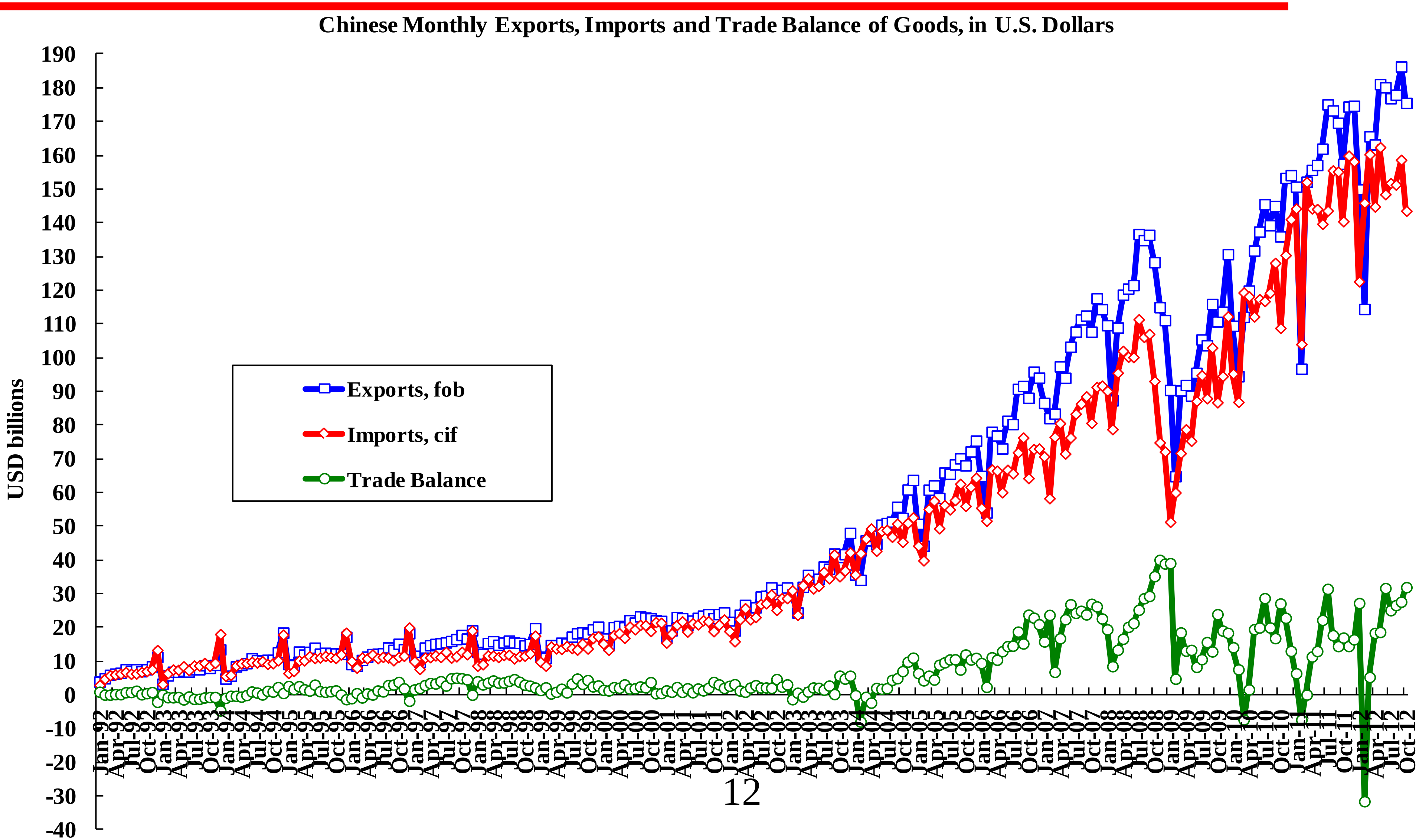
The Nominal and Real Yuan/US$ Exchange Rates, 1994-present



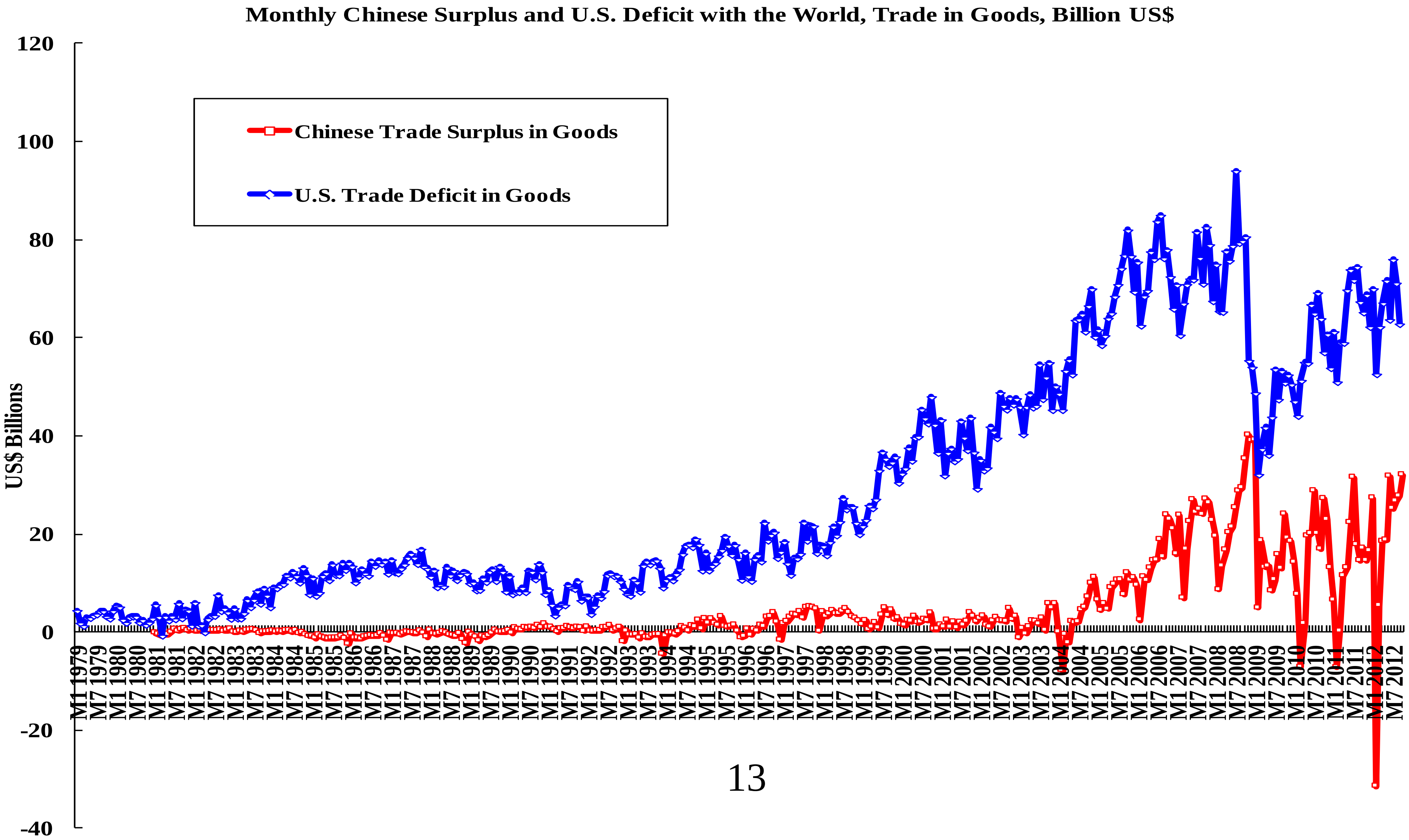
Is the Renminbi (Yuan) Under-Valued?

- The currency of a country is considered under-valued if the country runs persistent surpluses in trade in goods and services combined vis-à-vis the entire World. It is considered over-valued if it runs persistent trade deficits vis-a-vis the World.
- A bilateral trade surplus, even a persistent one, says nothing about whether a country's currency is under-valued because it may still have a near zero or even negative trade balance vis-à-vis the entire World. Most oil-importing countries have persistent bilateral trade deficits with oil-exporting countries. And that does not necessarily mean the currencies of the oil-importing countries are over-valued relative to the respective oil-exporting countries.

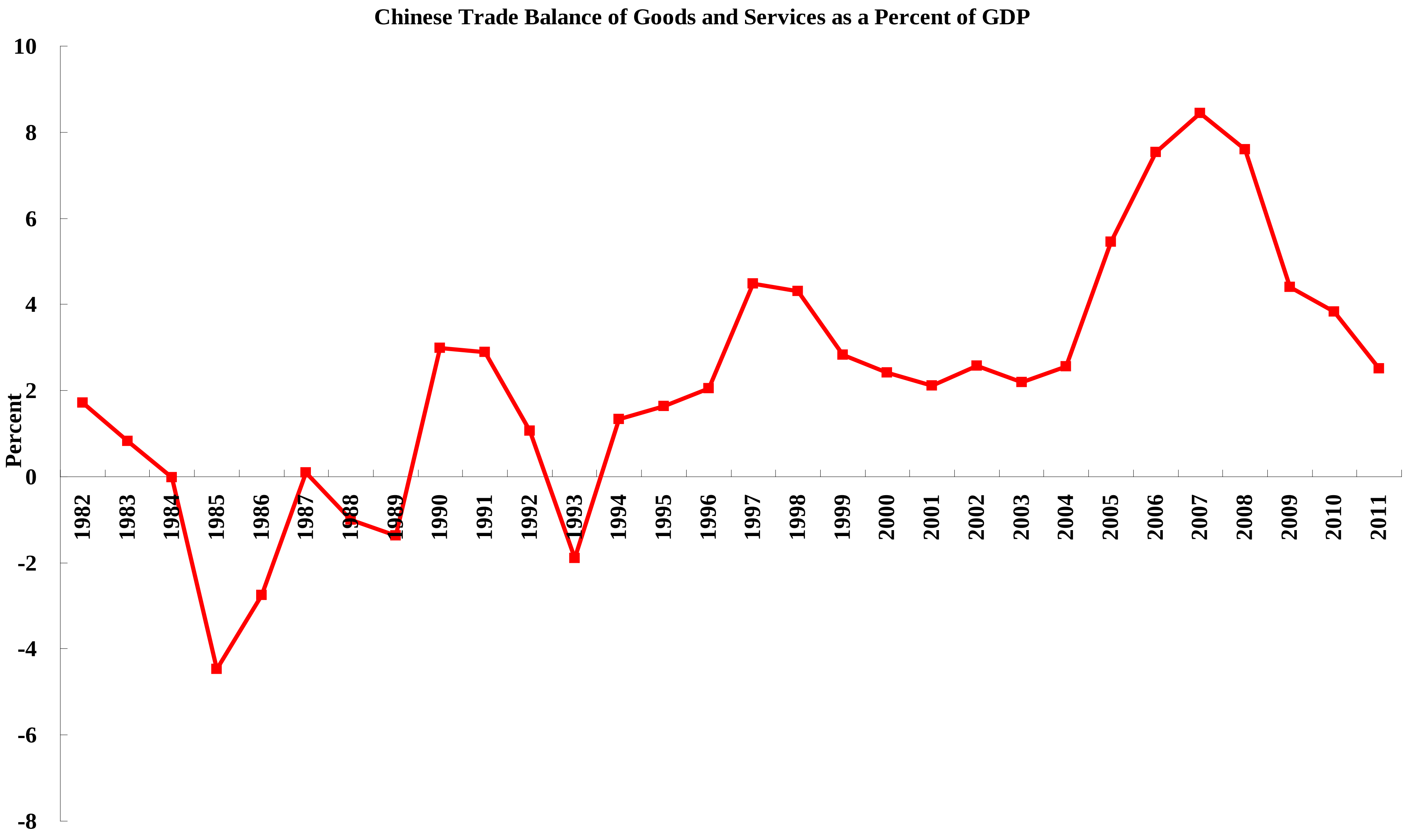
Chinese Monthly Exports, Imports and Trade Balance, US$ Billions



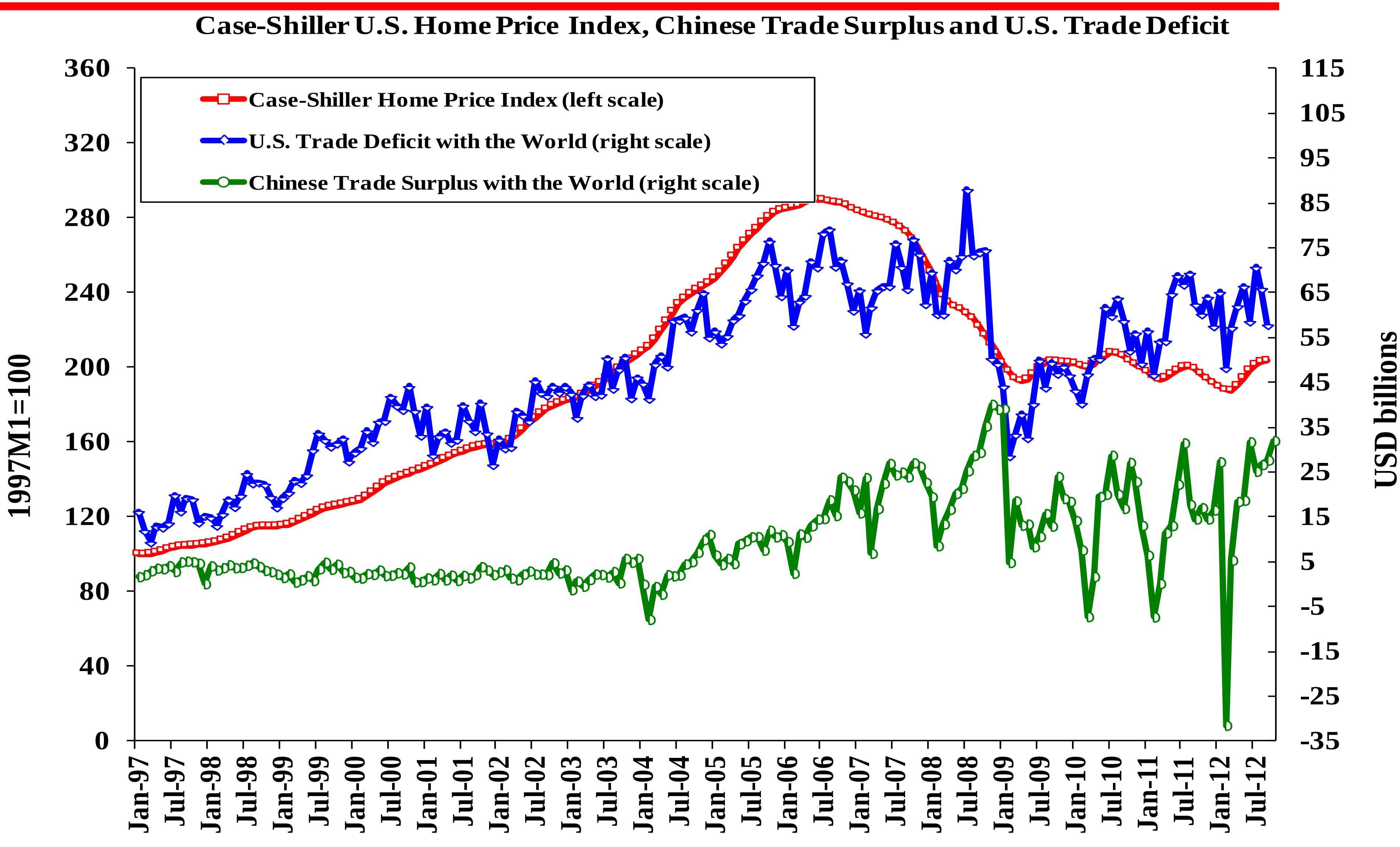
Monthly Chinese Surplus and U.S. Deficit with the World, Trade in Goods, Bill. US$



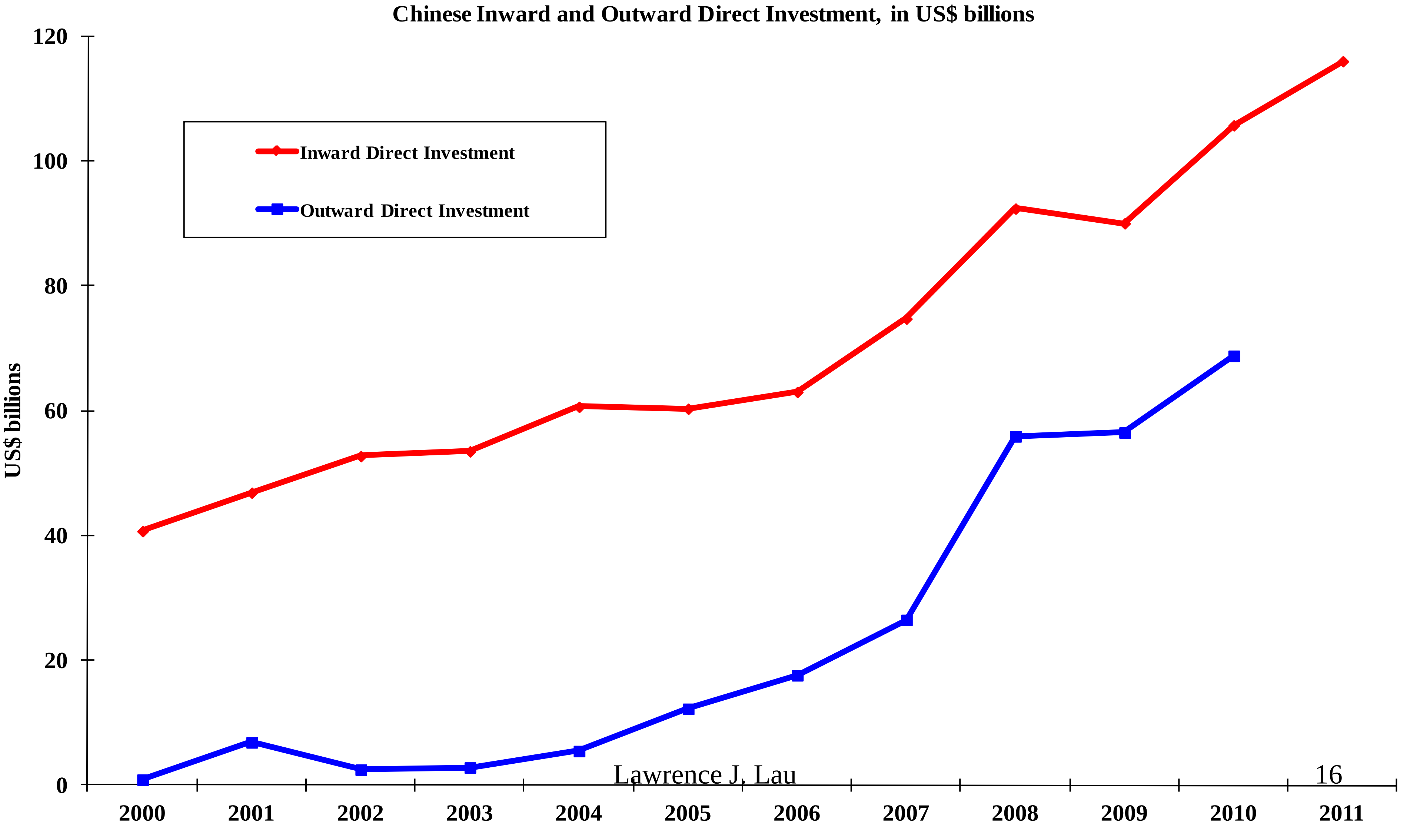
Chinese Trade Balance of Goods & Services as a Percent of GDP, 1982-



Case-Shiller U.S. Home Price Index, Chinese Trade Surplus & U.S. Trade Deficit, Bill. US$



Chinese Inbound and Outbound Foreign Direct Investment, in US$ Billions



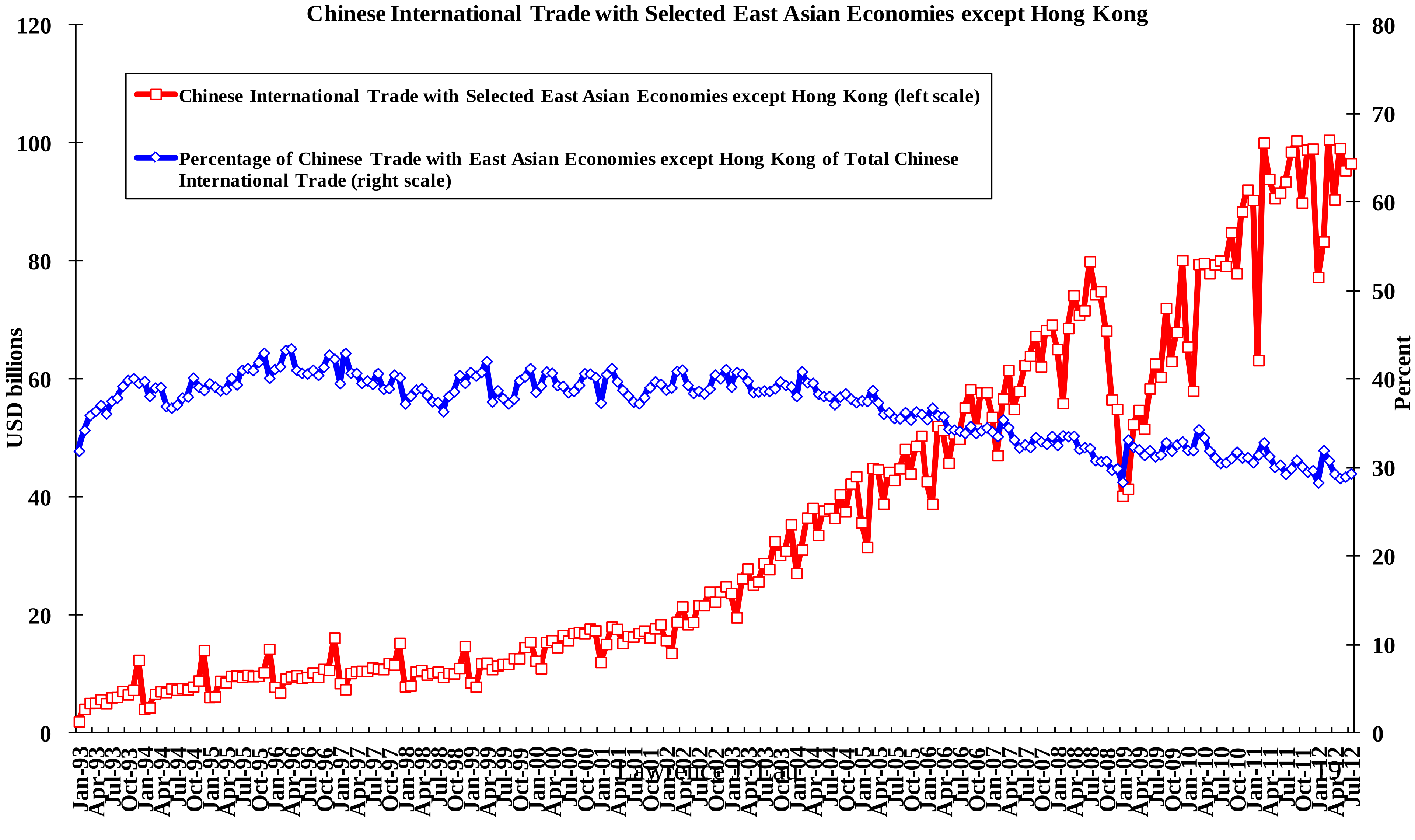
Is the Renminbi (Yuan) Under-Valued?

- In July 2005, partly in response to the then trade surpluses vis-a-vis the World, the Renminbi was allowed to begin to appreciate. This was interrupted briefly by the intensified continuation of the global financial crisis, brought about by the collapse of Lehman Brothers in September, 2008, but then the Renminbi resumed appreciation in 2010. Cumulatively, the Renminbi has appreciated, in real terms, approximately 40% since mid-2005.
- The Chinese trade surplus is expected to continue to decline until it returns to an essentially balanced situation as was the case before 2005.
- The long-term goal of the Chinese Government is to reduce the Chinese trade surplus vis-à-vis the World to zero. If the current trend continues, the goal of zero annual trade balance can probably be achieved by 2015, without necessarily any large adjustment in the nominal Yuan/U.S. Dollar exchange rate.

The RMB as an Invoicing and Settlement Currency for Cross-Border Transactions

- In 2011, approximately US$1.11 trillion, or 30%, of Chinese international trade is conducted with East Asian economies other than Hong Kong. (Hong Kong is a major export destination of Mainland China; however, a large proportion of its imports from China is re-exported from Hong Kong to other destinations, including the U.S. and Europe, around the World.)
- Potentially, the Renminbi can be used as a settlement currency by Chinese exporters and importers with their trading partners in East Asia on a voluntary basis, with the possible exceptions of Japan and South Korea.

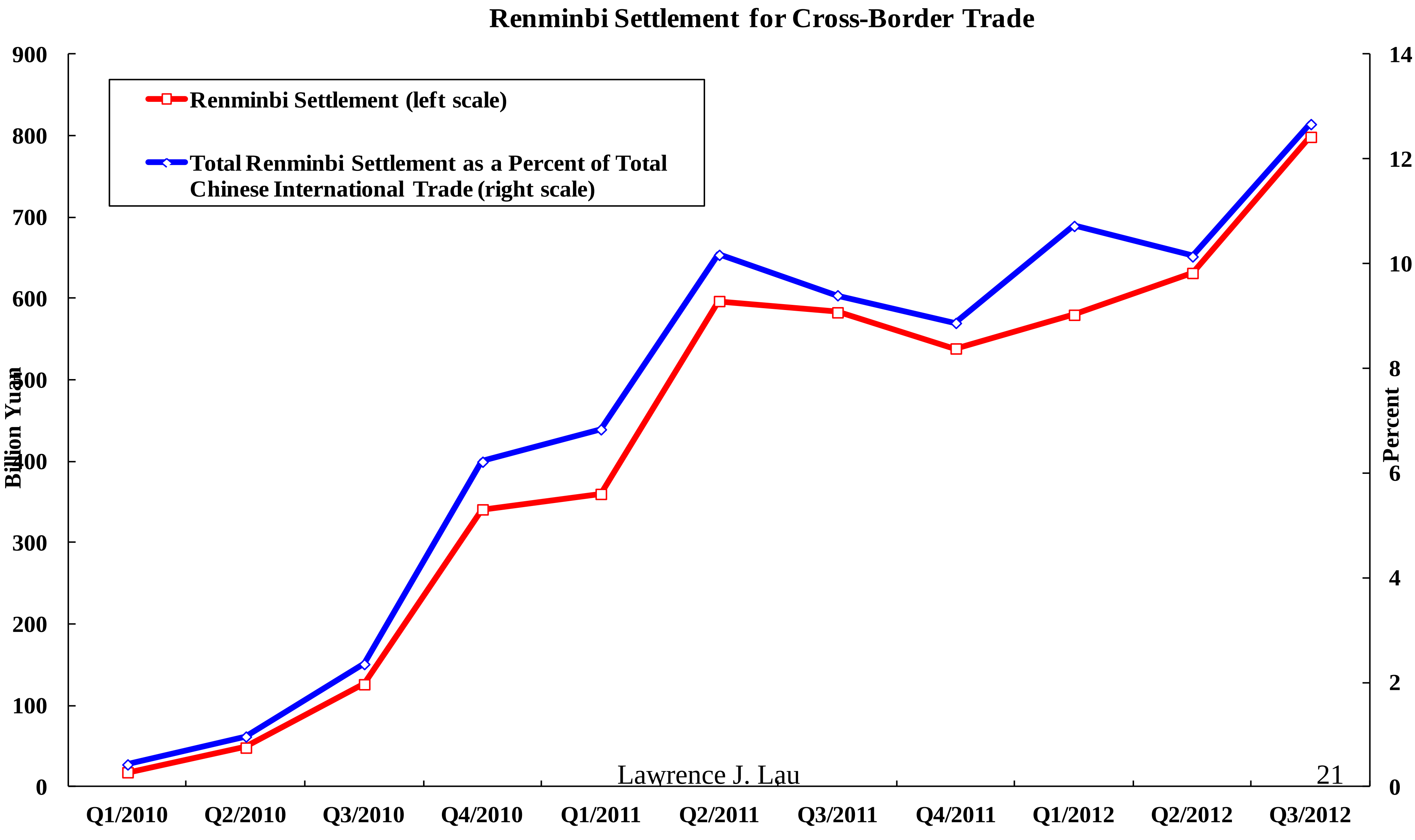
Chinese International Trade with East Asian Economies except Hong Kong



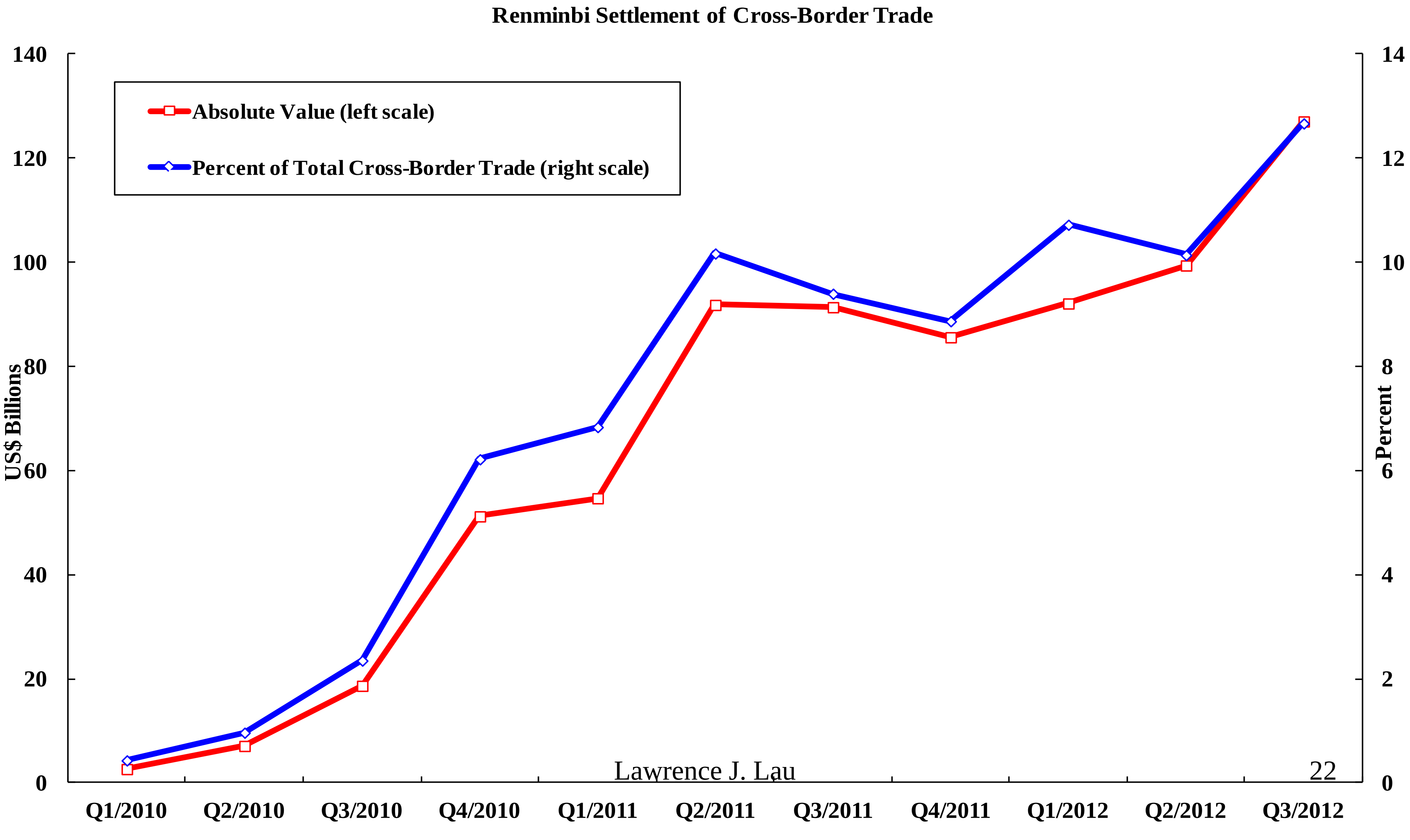
The RMB as an Invoicing and Settlement Currency for Cross-Border Transactions

- The proportion of Mainland Chinese international trade settled in Renminbi has grown rapidly, from almost nothing in 2010Q1 to over 12% by 2012Q3 (see the following Chart). In absolute value, some US$400 billion of Chinese international trade is now settled in Renminbi annually.
- This proportion may be expected to increase further in the future, especially as a bureaucratic problem having to do with VAT tax rebates for Chinese exports that in effect prevented some Chinese exporters from accepting Renminbi for payment has been resolved.

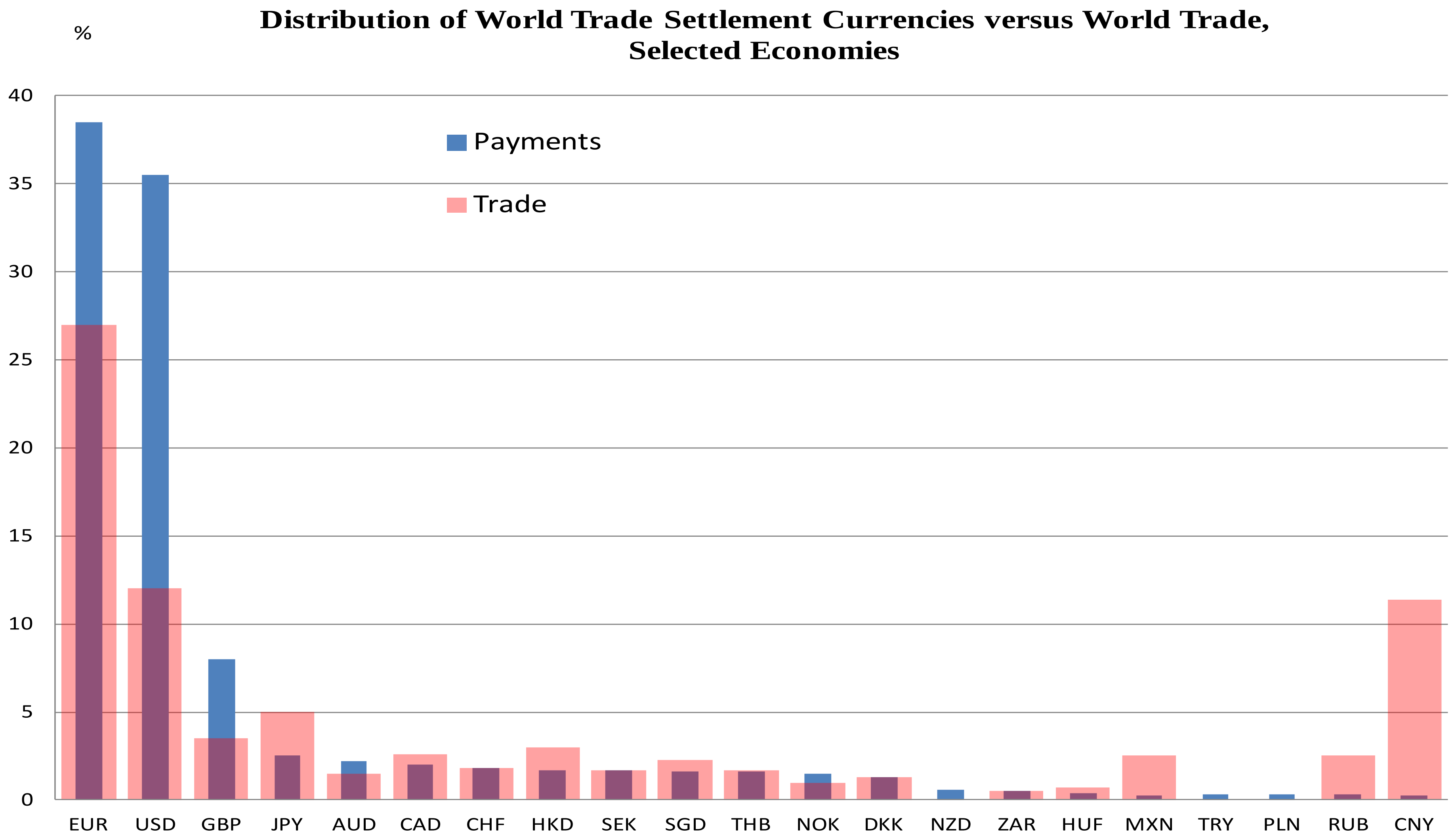
Renminbi Settlement of Cross-Border Trade, Billion Yuan and Percent



Renminbi Settlement of Cross-Border Trade, Billion US$ and Percent



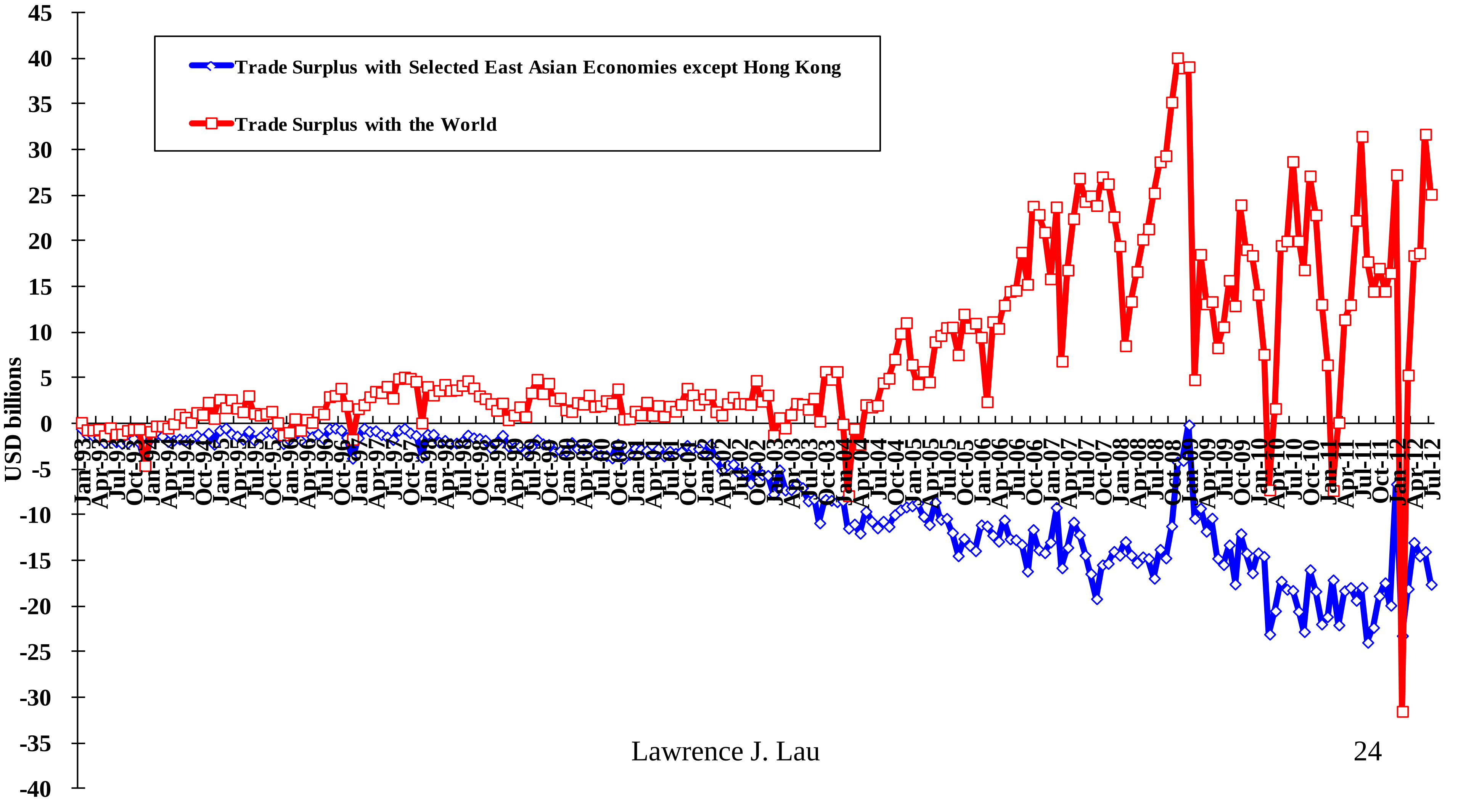
Distribution of World Trade Settlement Currencies versus World Trade



Source: SWIFT Value Analyser. Trade (import/export) 2010, in value., WTO working paper, Daiwa

Chinese Trade Surplus with the World and East Asian Economies except Hong Kong

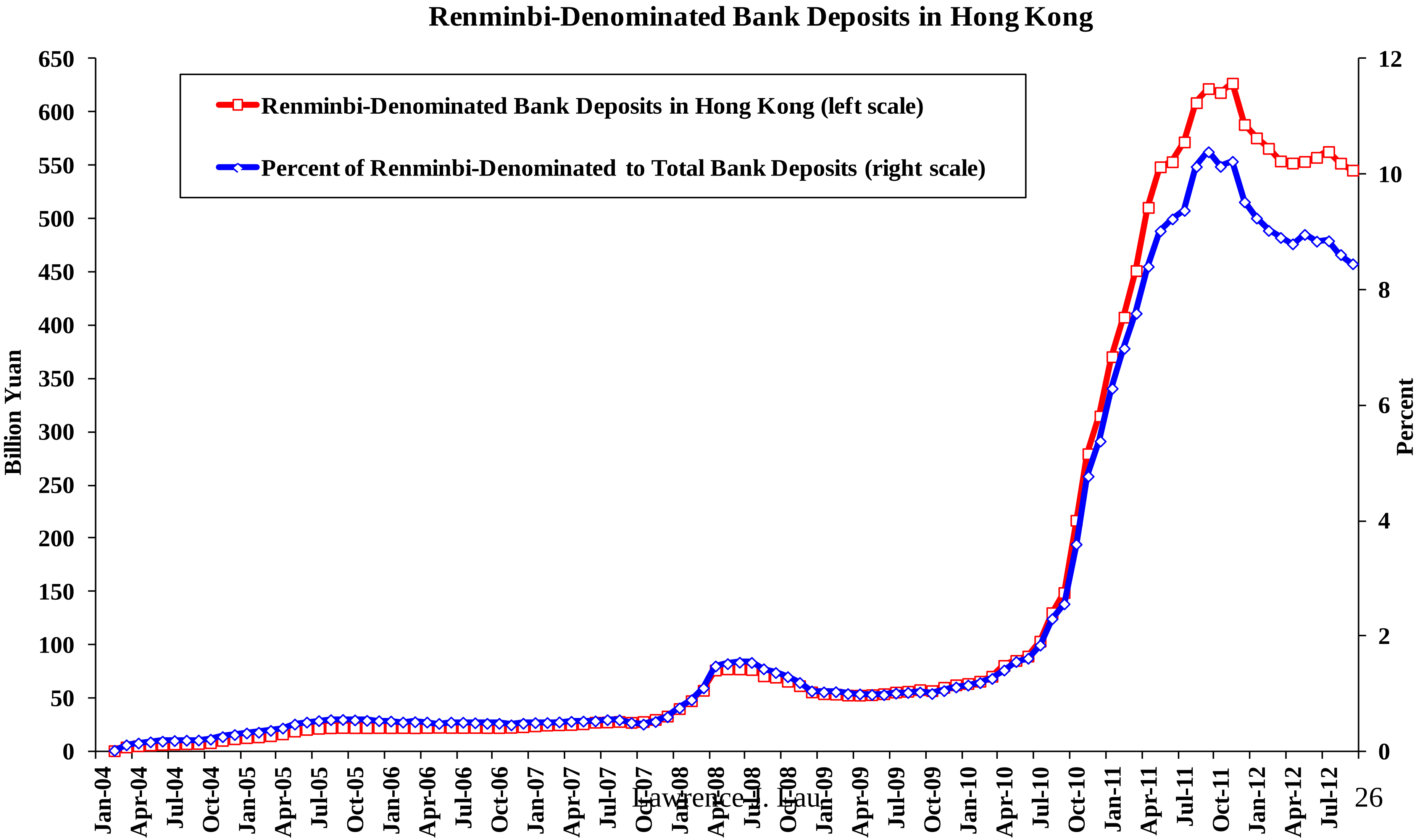
Chinese Trade Surplus vs. Chinese Trade Surplus with Selected East Asian Economies except Hong Kong



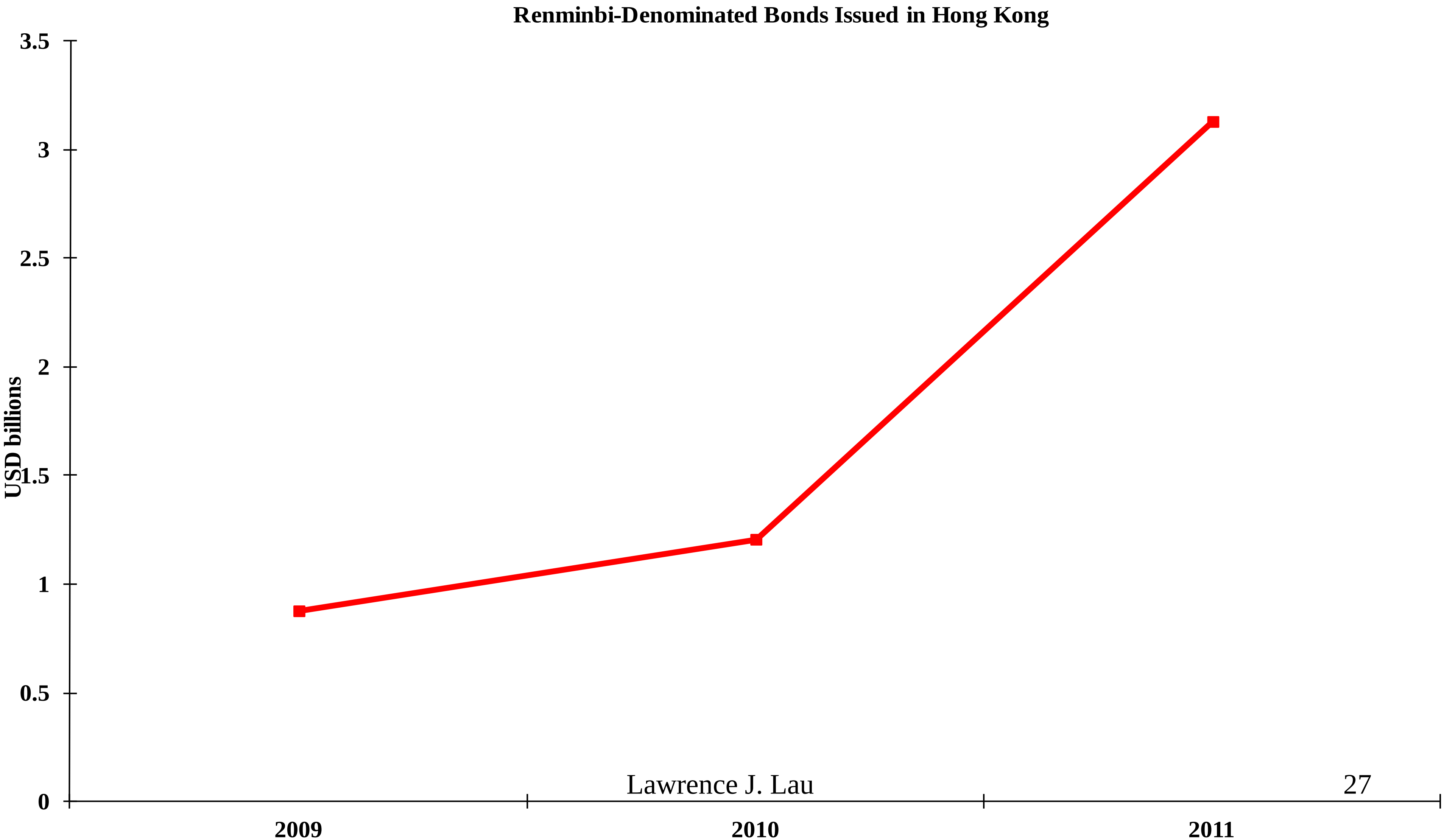
The RMB as an Invoicing and Settlement Currency for Cross-Border Transactions

- The benefits to China and its trading partner countries of using either the Renminbi or the latter's own local currency as an invoicing and settlement currency for cross-border transactions include:
- (1) Reduction of the transactions costs of cross-border transactions (one currency conversion rather than two);
- (2) Reduction of foreign exchange risk for exporters and importers of goods and services (one less currency risk);
- (3) Reduction of foreign exchange reserves held for liquidity and transactions demand purposes.
- The Yen and the Renminbi and some other East Asian currencies have come of age, just as the Western European currencies recovered in the aftermath of World War II—it is no longer necessary to rely on a third currency for invoicing and settlement purposes.

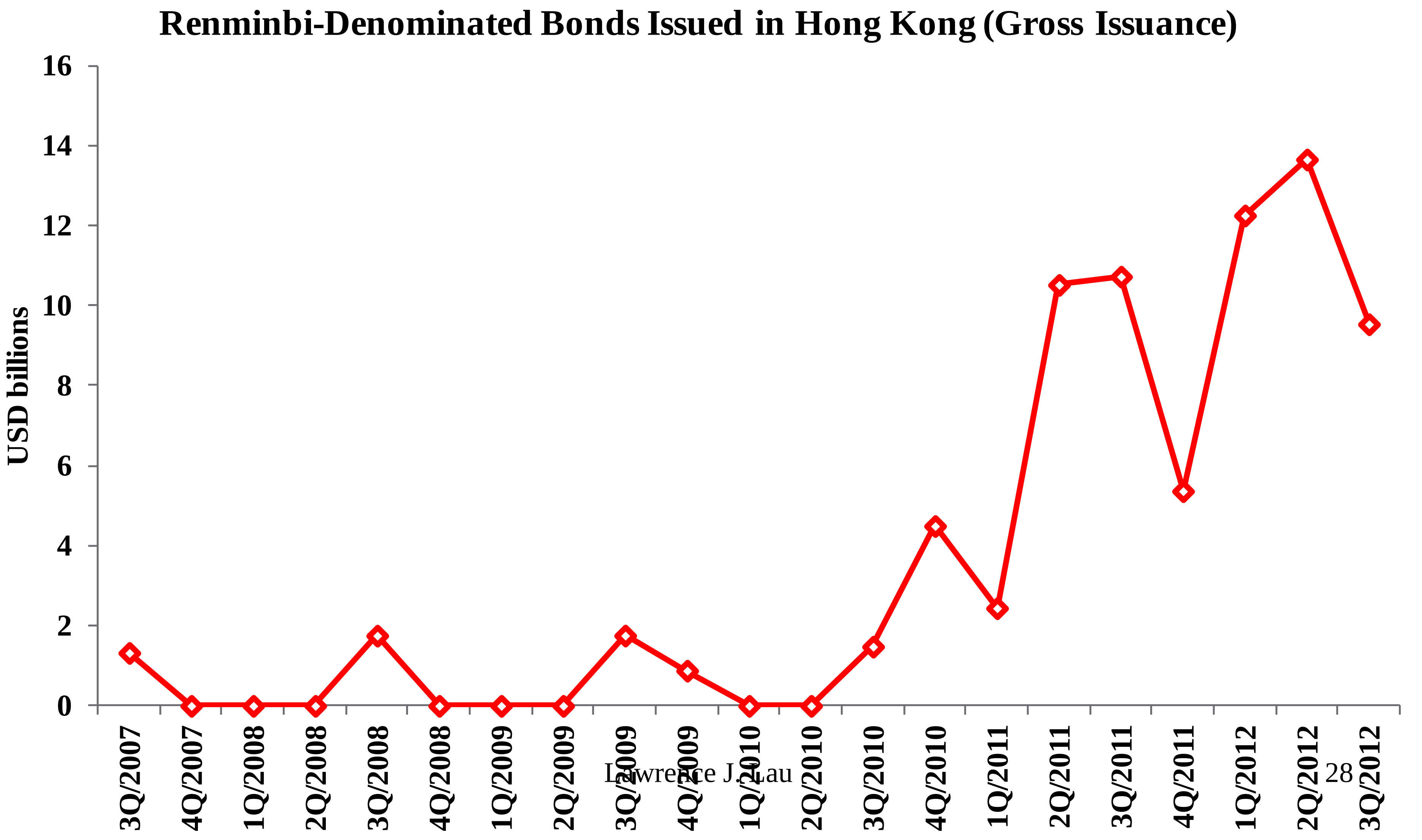
Renminbi-Denominated Bank Deposits in Hong Kong



Renminbi-Denominated Bonds Issued in Hong Kong



Renminbi-Denominated Bonds Issued in Hong Kong (Gross Issuance)



The Renminbi as an International Reserve Currency

- Central banks consider many factors when they decide on the currencies and their relative proportions to hold as their foreign exchange reserves: safety, liquidity, transactions demand for trade and investment, credit worthiness, the relative investment opportunity and rate of return, and diversification.
- In particular, the "network" effect is important—central banks like to hold their foreign exchange reserves in currencies that other central banks also like to hold, thus greatly facilitating settlement among them and enhancing liquidity.
- That is why foreign exchange reserves are typically held in U.S. Dollars, Euros, Japanese Yen, and Swiss Francs.

The Renminbi as an International Reserve Currency

- While the Renminbi is not yet fully convertible in the sense of total absence of inbound as well as outbound capital controls, it may nevertheless be maintained as part of foreign exchange reserves by a central bank of another economy as long as there is a credible commitment by the People's Bank of China to convert any Renminbi balances presented by a foreign central bank into U.S. Dollars or Euros or any other so-called "hard" currencies.
- The huge foreign exchange reserves of the People's Bank underpins such commitments. Foreign central banks can then hold the Renminbi balances for potential transactions purposes with China or other economies willing to accept the Renminbi.

The Renminbi as an International Reserve Currency

- There are both benefits and costs for a country's currency to be used by other countries as a major international reserve currency. One "benefit" is of course the "bragging rights", that the central banks of other countries and regions are willing to hold a country's currency is a positive affirmation of the economic performance of this country.
- The real economic "benefit" to the issuing country of a major international reserve currency is actually seigneurage: The issuing country can pay for its imports by printing money (or what amounts to more or less the same thing, bonds). The citizens of the exporting country can either keep the foreign currency received themselves or sell it to its central bank. The central bank puts the foreign currency it purchases into its foreign exchange reserves and continues to hold it as assets in the form of deposits or bonds. 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 advantage.

The Renminbi as an International Reserve Currency

- This (international) seigneurage is actually no different from the domestic seigneurage enjoyed by every central bank which has the ability to print money or otherwise increase the domestic money supply at will. The government can purchase real goods and services with the money that the government prints.
- Foreign exchange reserves (in the form of bank deposits or bonds of the issuing country) are normally accumulated and held in the central bank of 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 or elsewhere that the issuing country has to export real goods and services to the receiving country or elsewhere in exchange.

The Renminbi as an International Reserve Currency

- The “cost” to the issuing country is that in order to really benefit from the seigneurage, it must in general run a trade deficit or become a long-term net purchaser of foreign assets. (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.) And the larger the trade deficit, the larger is the benefit. However, a country with mercantilist tendencies does not like to run trade deficits and hence may not want its currency to become a major international reserve currency.

The Renminbi as an International Reserve Currency

- A further “cost” is the possibility that as a currency becomes widely held by the central banks of other countries as part of their foreign exchange reserves, it is subject to the risk that the foreign central banks holding its currency and assets denominated in its currency may decide at some point, for economic as well as non-economic reasons, to stop holding this currency and sell all the assets denominated in this currency that they hold, potentially creating havoc to the exchange rate, the interest rate and the financial markets of the country issuing the currency.

The Renminbi as an International Reserve Currency

- Of course, if the issuing country is "too big to fail," as in the case of the United States, it is another matter altogether. The other central banks in the World cannot afford to liquidate their US$-denominated assets without incurring significant losses themselves.
- This is one of the major reasons why the East Asian central banks, which together own the vast majority of the U.S. Treasury securities held by non-U.S. individuals and institutions, have not tried to sell down their holdings. It is in their collective self-interest to continue to hold on to U.S. Treasury securities because any attempt on the part of any central bank to sell a significant amount is likely to lead to a rush to the exit by all, resulting in huge damages and losses to everyone, including the U.S.

The Renminbi as an International Reserve Currency

- Whether the Renminbi will eventually become a major international reserve currency remains to be seen, as there are both benefits and costs for a country’s currency to be used by other countries as a major international reserve currency.
- At the present time, Hong Kong, Singapore, South Korea and Japan have all been considering investing part of their foreign exchange reserves in Yuan-denominated securities to diversify their portfolios, even though the Yuan (Renminbi) is not yet fully convertible.

Towards Fuller Convertibility

- When will the Renminbi become capital accounts convertible?
- The Renminbi is de facto long-term capital accounts convertible. The capital flows for both inbound and outbound direct investment are readily approved (once the projects themselves are approved). So are applications for "Qualified Foreign (or Domestic) Institutional Investors."
- It also seems likely that an international board will be set up soon on the Shanghai Stock Exchange for the shares of firms outside of the Mainland to be listed. Exchange-Traded-Funds (ETFs) for both Mainland and non-Mainland shares are also being contemplated on the Hong Kong and Shanghai Stock Exchanges.

Towards Fuller Convertibility

- However, short-term capital flows, both inbound and outbound, if left unregulated, can greatly increase the volatility of the exchange rate, to the detriment of the Chinese economy, and as a minimum, complicate macroeconomic management and monetary policy. The principal challenge is how the short-term capital flows can be regulated under capital accounts convertibility.
- The Chinese economy has been a victim of speculative short-term capital inflows (hot money) despite the existence of controls on certain categories of capital movements, which have proved to be quite "leaky." The increases in the Chinese foreign exchange reserves have been running much higher than the sum total of Chinese trade surplus, other current income from Chinese investments overseas and net foreign direct and portfolio investment into China in the past several years.

Towards Fuller Convertibility

- A Tobin tax, originally suggested by the late Prof. James Tobin, Nobel Laureate in Economic Sciences, may be defined as a tax of say 0.5% (or 1%) on all spot conversions of a foreign currency into Renminbi or vice versa that are not related to current-account transactions.
- Thus, foreign currency transactions related to the exports or imports of goods and services will be exempted from such a Tobin tax. In practice, even capital account transactions below a certain threshold level, say 2 million Yuan (approximately US$320,000 at current exchange rate), should probably also be exempted. (However, repeated conversions by the same individual or institution to take advantage of the exemption should be taxed.)
- The Tobin tax is intended to impose a penalty on short-term purely financial round-trip excursions from a foreign currency into the Renminbi or vice versa.

The Renminbi Exchange Rate Determination Mechanism

- Full convertibility, however, does not necessarily imply a freely floating exchange rate mechanism. For example, the Hong Kong Dollar is freely and fully convertible, but it has been rigidly pegged to the U.S. Dollar since 1983.
- Thus, even if the Renminbi becomes fully convertible (subject to a tax or other control over short-term capital inflows and outflows), China is likely to maintain a "managed floating exchange rate mechanism." 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 large potential short-term speculators.
- China should remember what happened to the "market-determined" exchange rates of East Asian economies during the East Asian currency crisis of 1997-1998 as well as the volatility of the Euro/US$ rate since September 2008.

The Renminbi Exchange Rate Determination Mechanism

- The total volume of spot Renminbi trading in offshore markets, including Hong Kong, Singapore, London and New York, may be estimated at US$2.7 billion per day. The volume in London alone is approximately a quarter of the global turnover of offshore Renminbi trading.
- For comparison, the total volume of spot Renminbi trading in onshore markets may be estimated at US$15 billion a day.
- As a benchmark, total Chinese annual international trade amounted to US$3.64 trillion, or approximately US$10 billion per calendar day, in 2011.
- In 2010, the annual total value of foreign exchange transactions worldwide was US$1.5 quadrillion, compared to a total value of international trade of US$20 trillion.

Concluding Remarks

- Paradoxically, the global financial crisis of 2007-2009 has accelerated the pace of internationalisation of the Renminbi. 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 an invoicing and settlement currency in its international trade transactions.

Concluding Remarks

- The Renminbi will be used more and more in the denomination and settlement of Chinese international trade with East Asian economies and perhaps even in the settlement of trade among East Asian economies, on a voluntary basis. Chinese trade with the U.S. and Europe will probably continue to be denominated and settled in U.S.$ and the Euro respectively.

Concluding Remarks

- In time, perhaps within the next five years, the Renminbi will become effectively fully convertible, in the sense that both inbound and outbound capital controls will be effectively lifted. However, it is possible that short-term capital flows, which are of little economic benefit to the recipient economies, may continue to be under some form of control, for example, with the imposition of a Tobin tax.
- It is expected that the Chinese international trade with the World will be essentially balanced in the near future.

Concluding Remarks

- However, it is not at all clear whether it is in China's best interests to have the Renminbi become a major international reserve currency like the U.S. Dollar and the Euro. To benefit from being 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 and assets denominated in the currency at inopportune times.

Concluding Remarks

- Relative stability of the Renminbi exchange rate is beneficial to the continued development of the Chinese economy, to the other East Asian economies and to the World, so long as Chinese trade is essentially balanced. It facilitates the development of cross-border trade and investment. It also enhances the potential benefits from using the Renminbi as a store of value.

Concluding Remarks

- However, it is not in China's long-term interests to have the Renminbi pegged rigidly to the U.S. Dollar, or for that matter, to a basket of foreign currencies.
- China must retain the flexibility to manage its exchange rate—China should therefore continue to maintain a "managed floating exchange rate mechanism."