The Internationalisation of the Renminbi

Lawrence J. Lau (刘遵义)
Chairman, CIC International (Hong Kong) Co., Limited
Ralph and Claire Landau Professor of Economics, The Chinese Univ. of Hong Kong
and
Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

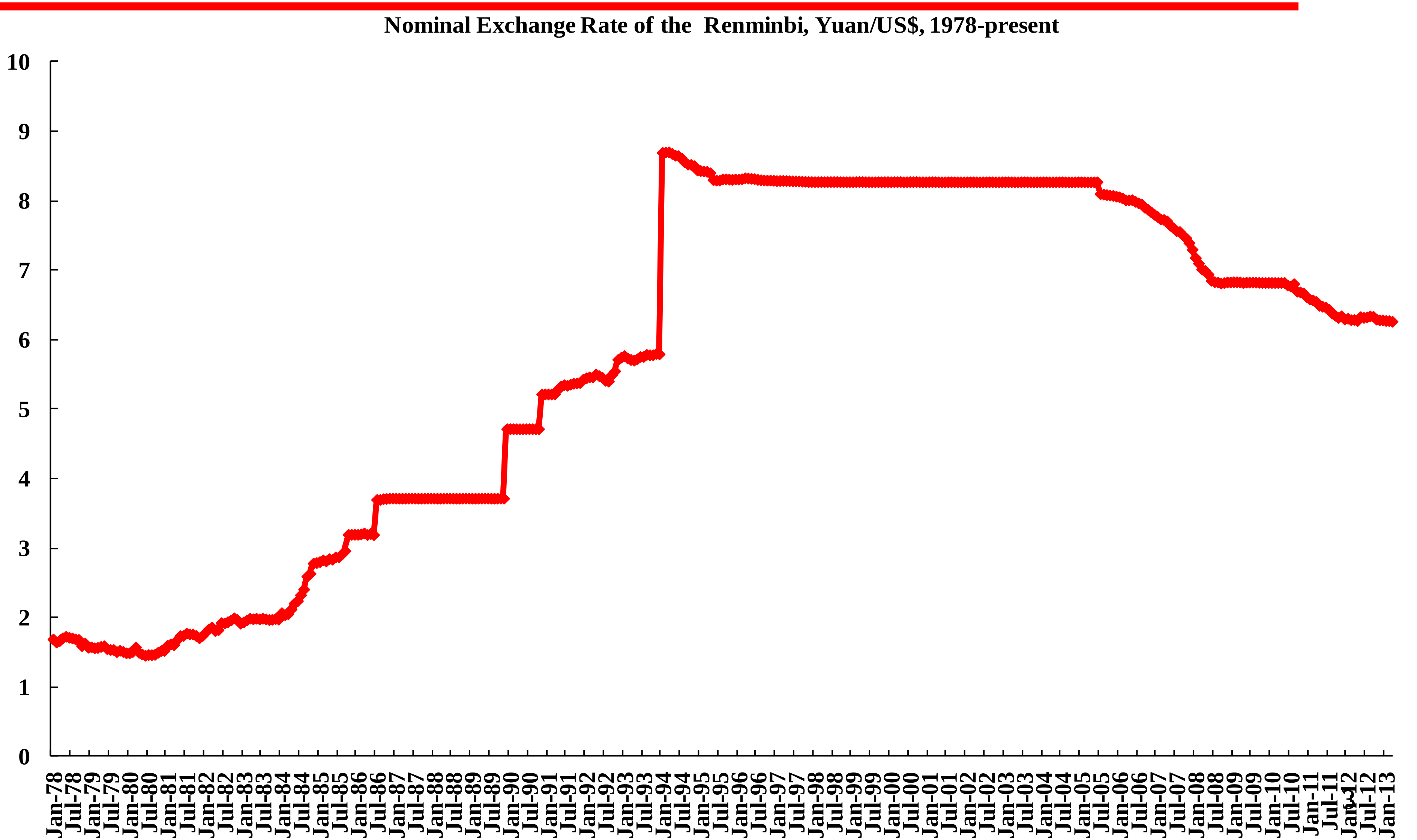
2013 KPMG Asia-Pacific Tax Summit
Shanghai, 25th April 2013

Tel: (852)3550-7070; Fax: (852)2104-6938
Email: lawrence@lawrencejlau.hk; WebPages: www.igef.cuhk.edu.hk/ljl
*All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organisations with which the author is affiliated.

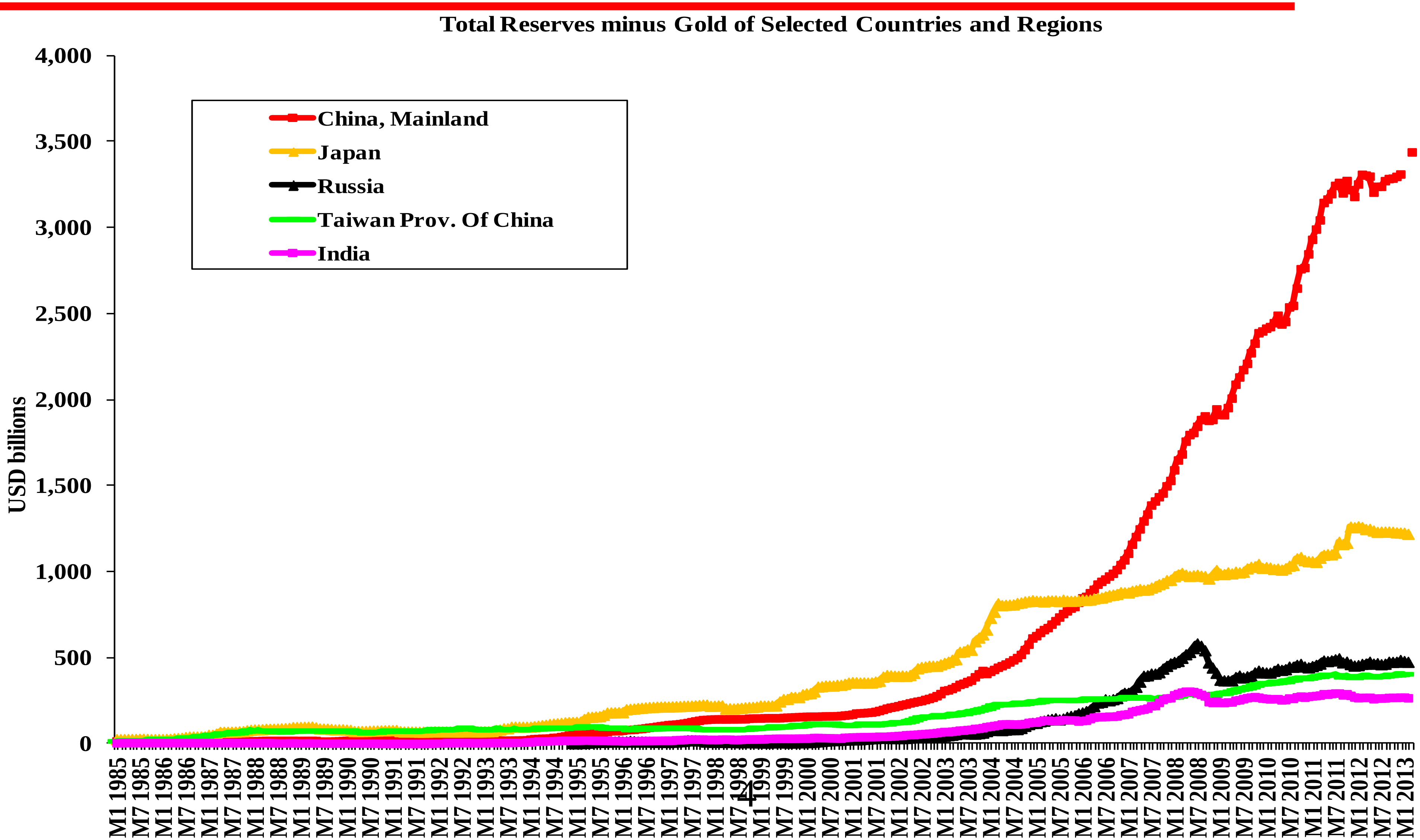
Introduction

- The Renminbi has been current accounts convertible since 1994, when China undertook a major foreign exchange policy reform, coupled with a significant devaluation of the Renminbi at the same time.
- The Renminbi has also over time become essentially long-term capital accounts convertible. Capital flows related to inbound and outbound foreign direct investment, and inbound and outbound foreign portfolio investment in the forms of "Qualified Foreign (or Domestic) Institutional Investor (QFII or QDII)", as well as the repatriation of principals and profits, are readily approved.
- However, it has not yet become fully short-term capital accounts convertible. There still exist both inbound and outbound controls on capital flows.

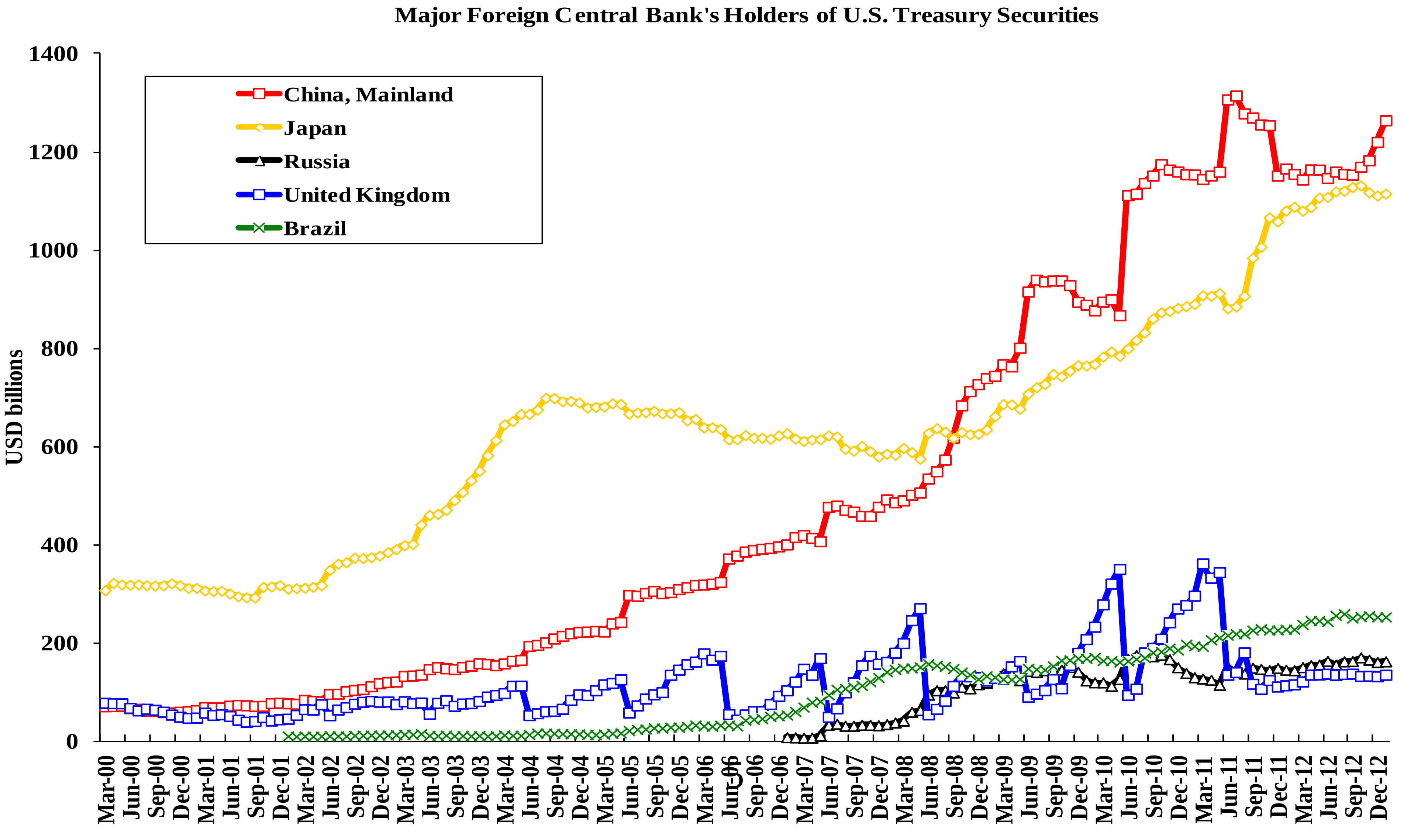
Nominal Exchange Rate of the Renminbi, Yuan/US$, 1978-present



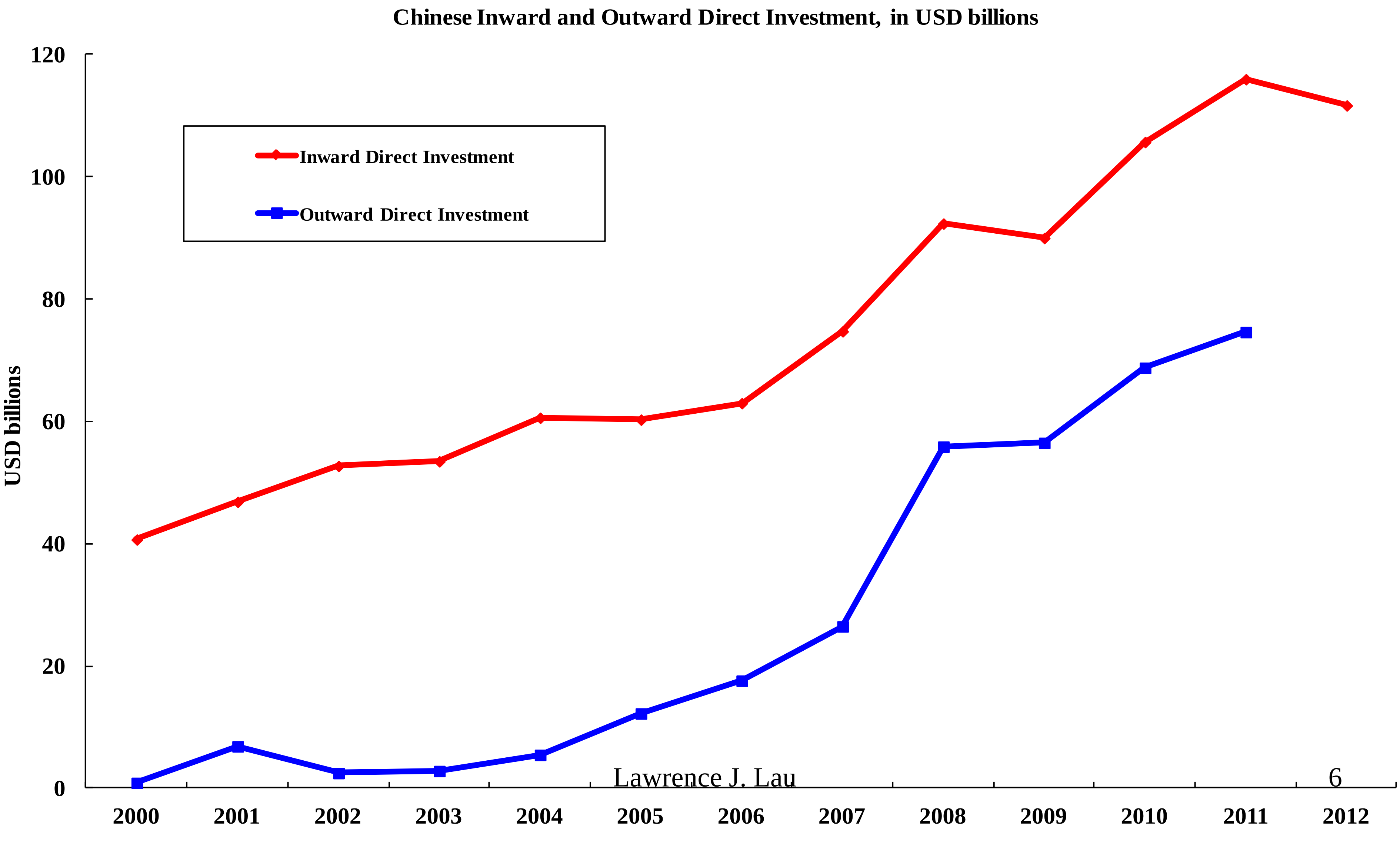
Total Foreign Exchange Reserves minus Gold, Selected Countries and Regions



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

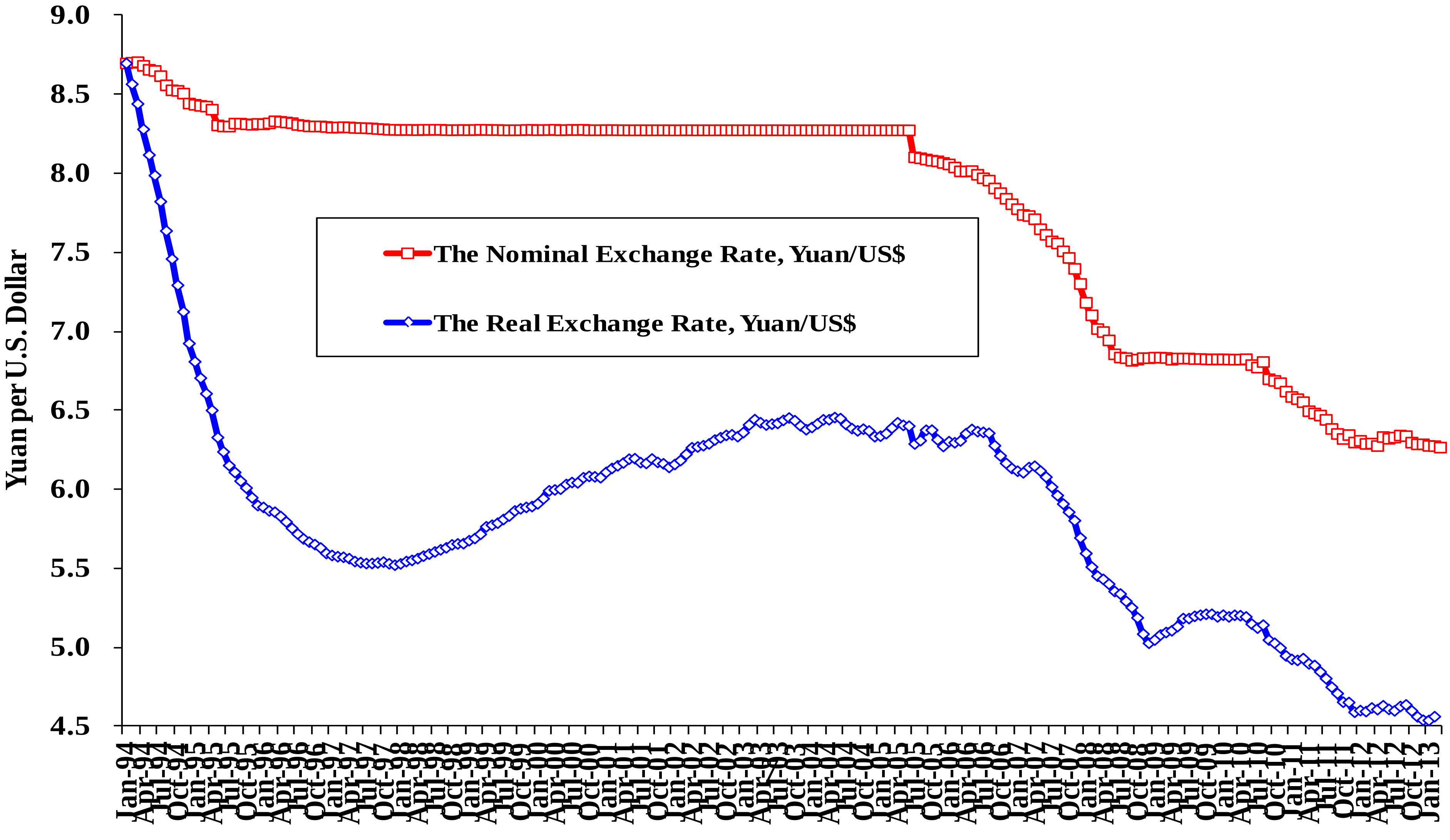


Chinese Inbound and Outbound Foreign Direct Investment, in US$ Billions



The Nominal and Real Yuan/US$ Exchange Rates

The Nominal and Real Yuan/US$ Exchange Rates (1994 prices)



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 possibly between and among its trading partner countries and regions themselves, on a voluntary basis.

The Meaning of Internationalisation

- (3) The Renminbi as a “Store of Value”. This means the holding of Renminbi and Renminbi-denominated assets long term by individuals and institutions. When Renminbi is held by central banks and monetary authorities of other countries and regions, it serves as a foreign exchange reserve currency.
- (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 and if appropriate traded in Renminbi.
- (5) The Renminbi as a “Major International Reserve Currency” like the U.S. Dollar and the Euro, widely held by central banks and monetary authorities of other countries and regions.

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

- The willingness to accept and to hold a non-local currency depends on whether the currency is convertible, but it does not need to be fully or freely convertible, in the sense of a total absence of capital controls on the part of the non-local currency-issuing country.
- A person or a firm may be quite willing to accept and to hold a non-local currency, fully convertible or not, if he (it) knows that the next person (firm) he (it) comes across is also likely to accept the currency.
- And the more people there are who accept a given currency, the more additional people there will be who are also willing to accept the currency. This is known as a "network" effect or externality. The U.S. Dollar benefits from this "network" externality.

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

- Thus, even though the Renminbi is not de jure fully or freely convertible, it has gradually become de facto convertible in some economies in East Asia because of its wide general voluntary acceptance. The Renminbi is today widely accepted and used in Hong Kong, Macau, Laos, Myanmar, and other border areas as a medium of exchange and a store of value even though it is not legal tender in these places.
- Chinese visitors to Hong Kong use the Renminbi freely in the streets to pay for goods and services. The Renminbi can also be exchanged for Hong Kong Dollar freely in the streets and through the Hong Kong Dollar into other "hard" foreign currency such as the US Dollar and the Euro.

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

- Chinese exporters and importers in selected provinces, municipalities and regions have been permitted to settle their cross-border trade transactions in Renminbi in Hong Kong since 2009 on a voluntary basis, by mutual agreement between the exporter and the importer in each case. The practice was extended to the whole of Mainland China at the end of 2011.

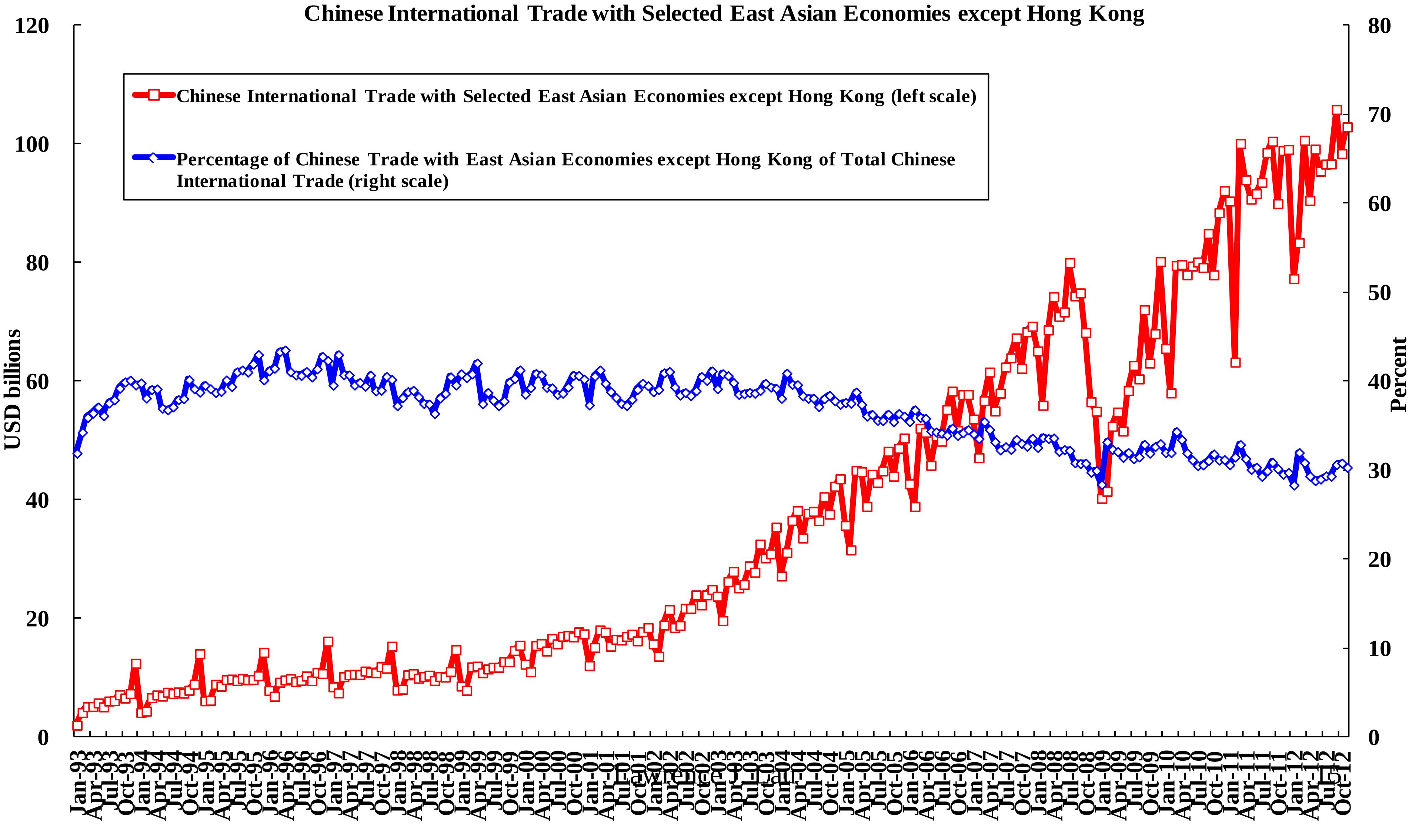
The RMB as an Invoicing and Settlement Currency for Cross-Border Transactions

- Settlement in Renminbi is welcomed by both exporters and importers because it reduces transactions costs and exchange rate risks.
- For example, a Chinese importer pays a Thai exporter directly in Renminbi, without having to convert it into U.S. Dollars first and hence also without having to assume any exchange rate risk. While it is true that a Thai exporter may have to convert the Renminbi into Thai Baht, there is only one currency conversion, from Renminbi to Baht, instead of two currency conversions, first from Renminbi to US$ and then from US$ to Baht. The savings in transactions costs can be shared by both the Chinese importer and the Thai exporter.
- Moreover, the Thai exporter may prefer to denominate its exports to China and settle in Renminbi, because the Renminbi is expected to appreciate relative to the US$ over time.

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

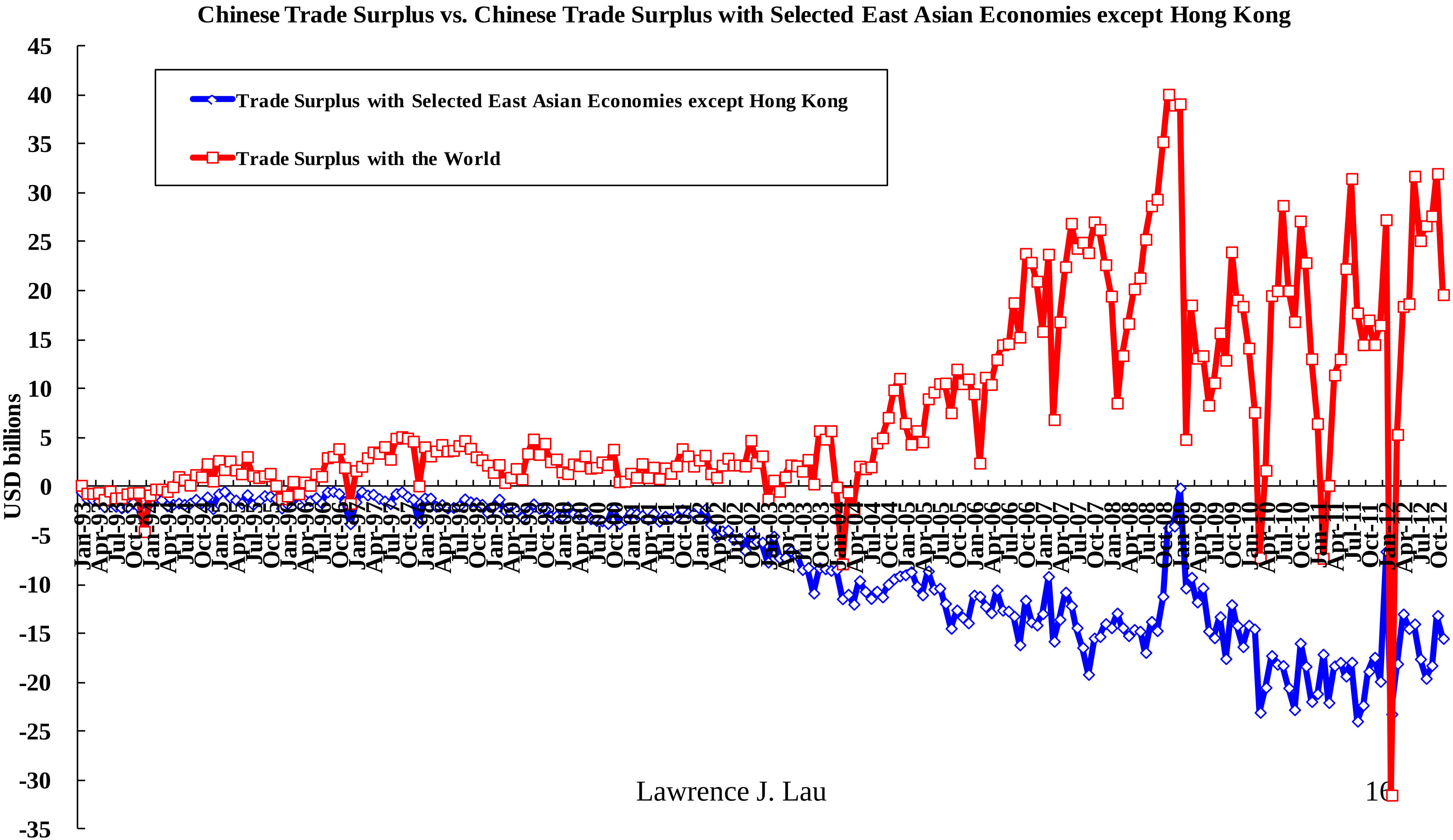
- Alternatively, the Thai exporter may prefer to denominate its exports and settle in Baht. The Chinese importer will need to purchase Baht from the People's Bank of China with Renminbi to pay for the imports. Again, there are savings in transactions costs and reductions in exchange rate risks to be shared by both the exporter and the importer.
- Similarly, a Chinese exporter may prefer to denominate and settle in Renminbi because it reduces both transactions costs and exchange rate risk (most of its costs are in Renminbi).

Chinese International Trade with East Asian Economies except Hong Kong

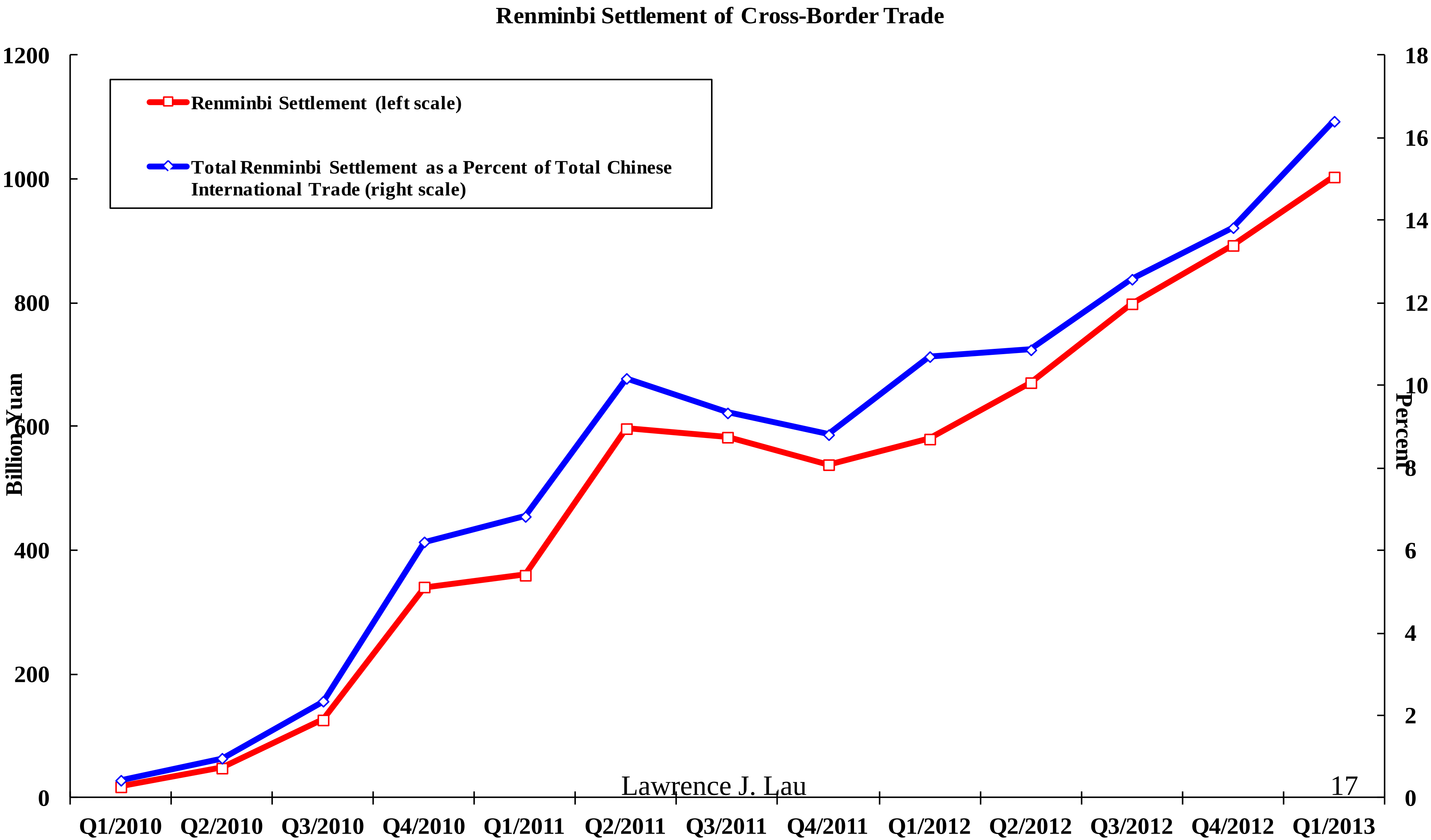


Lawrence J. Lau

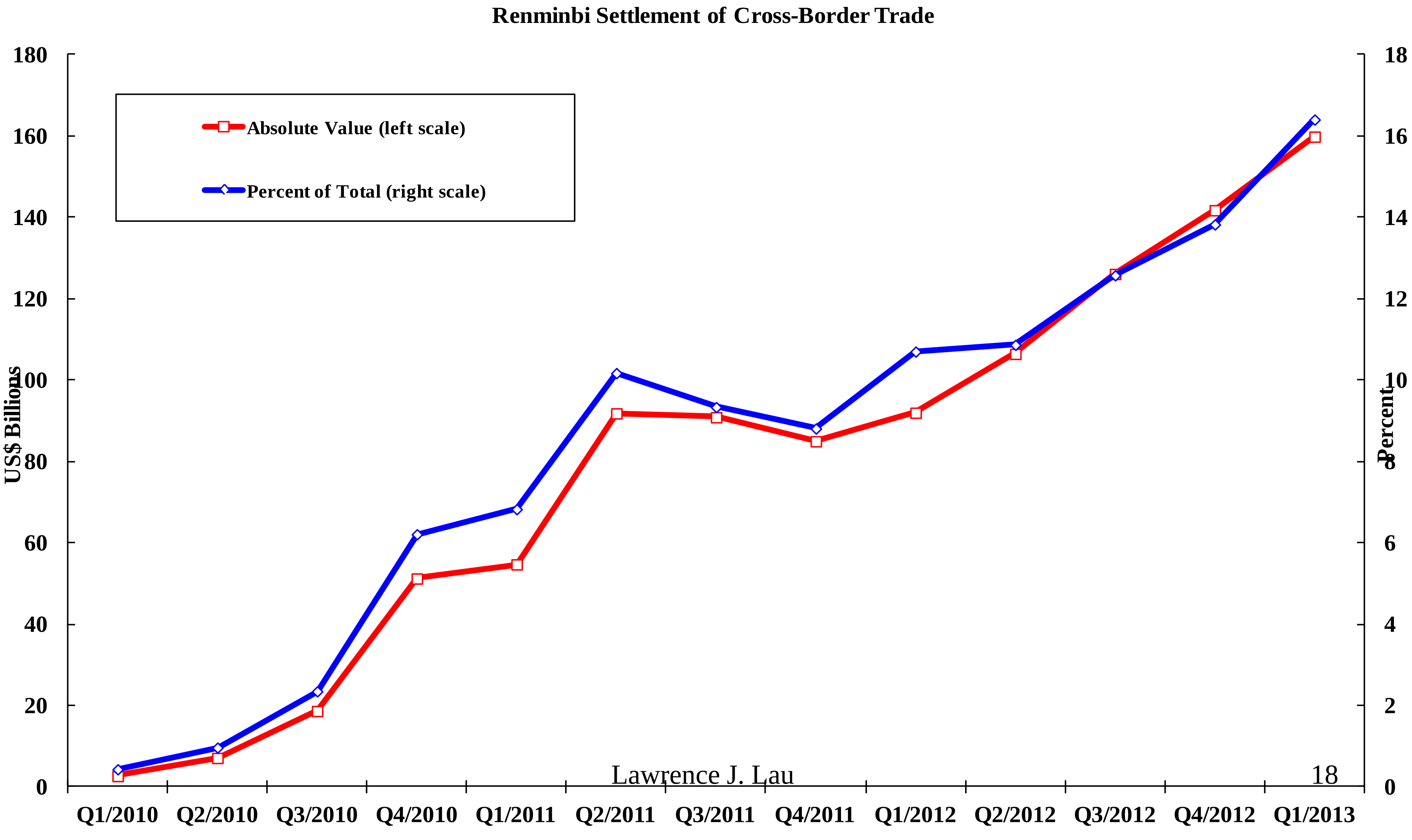
Chinese Trade Surplus with the World and East Asian Economies except Hong Kong



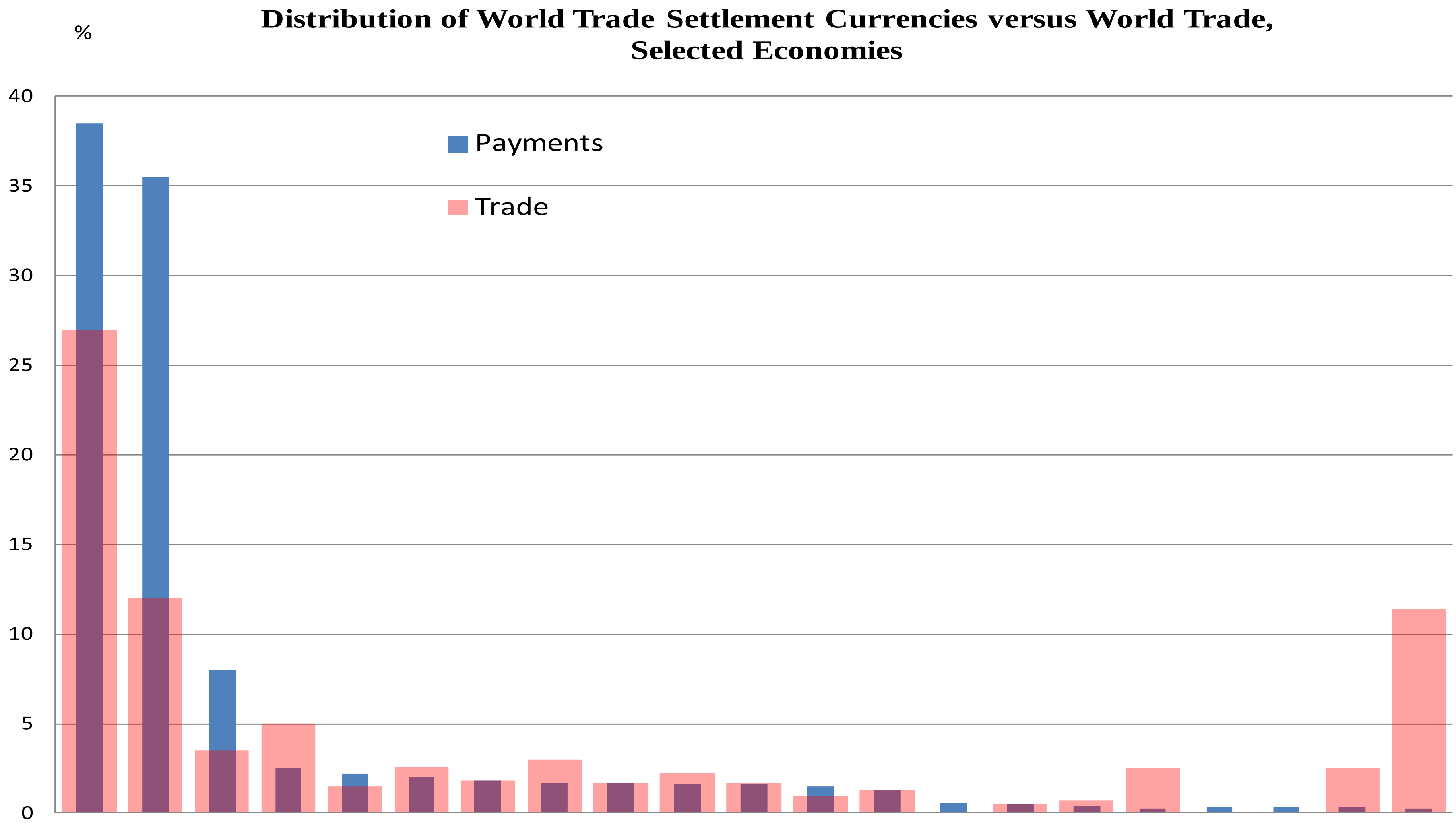
Renminbi Settlement of Cross-Border Trade, Billion Yuan and Percent



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



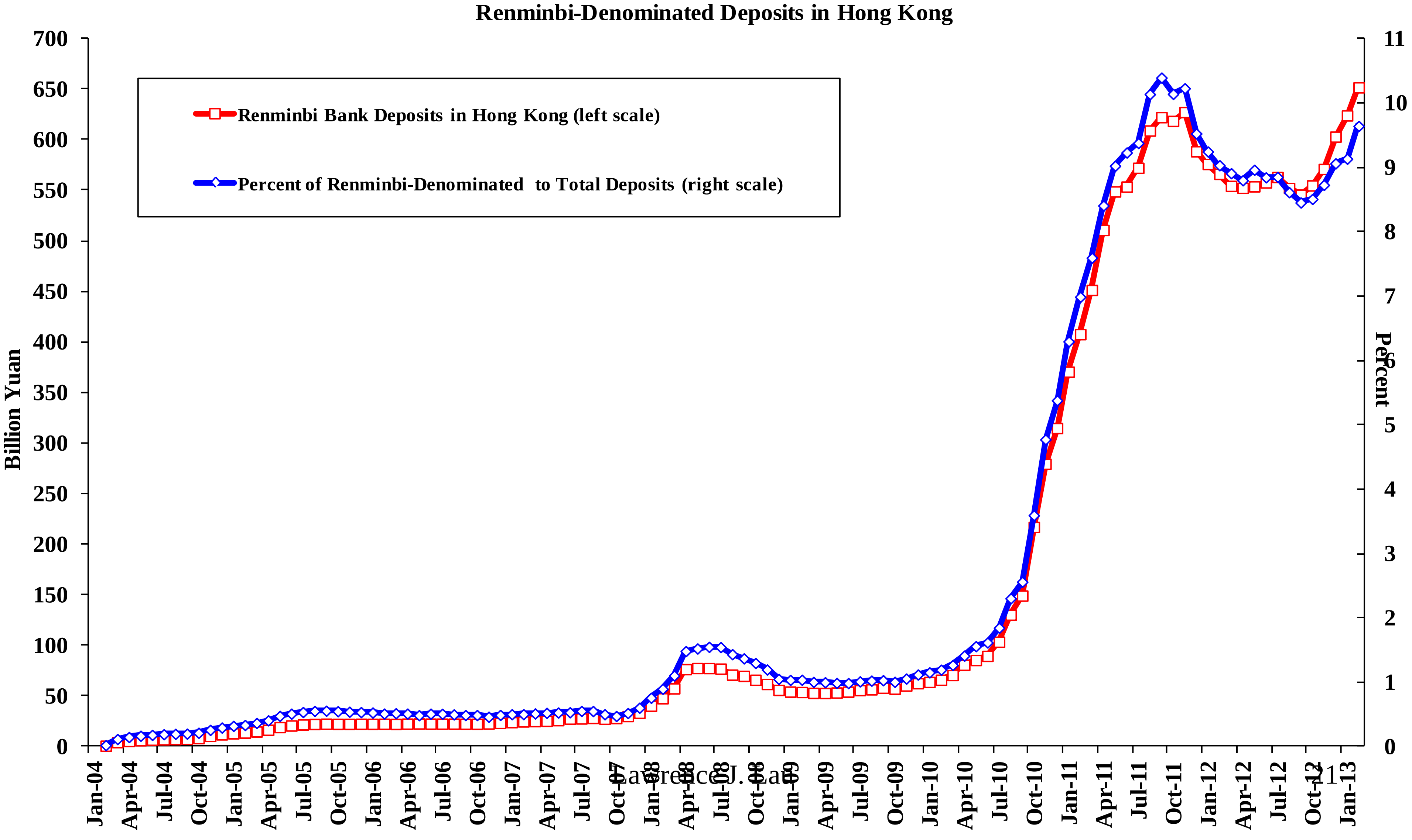
Distribution of World Trade Settlement Currencies versus World Trade



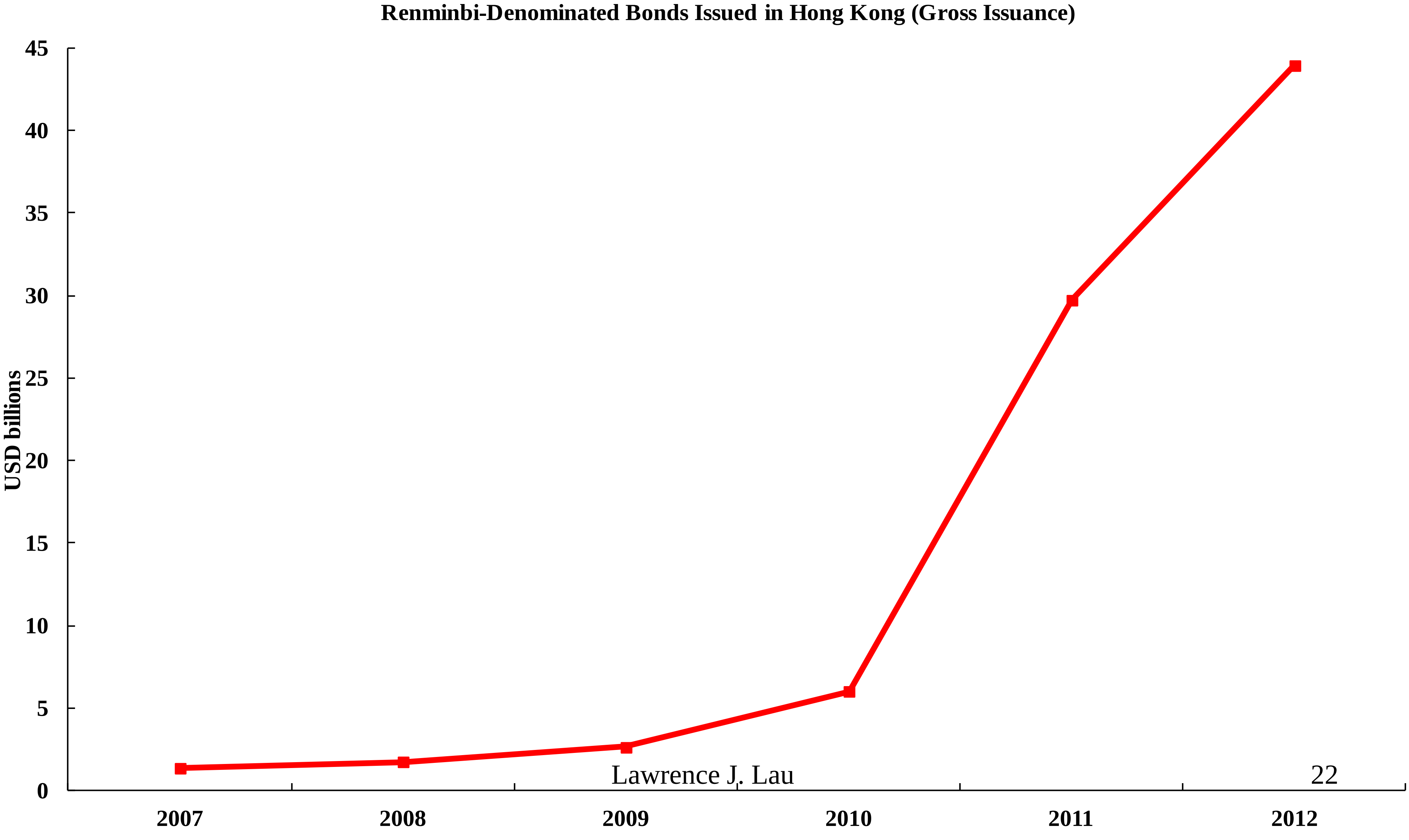
The RMB as an Invoicing and Settlement Currency for Cross-Border Transactions

- The benefits to China and its trading partner countries and regions 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 needed to be 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.

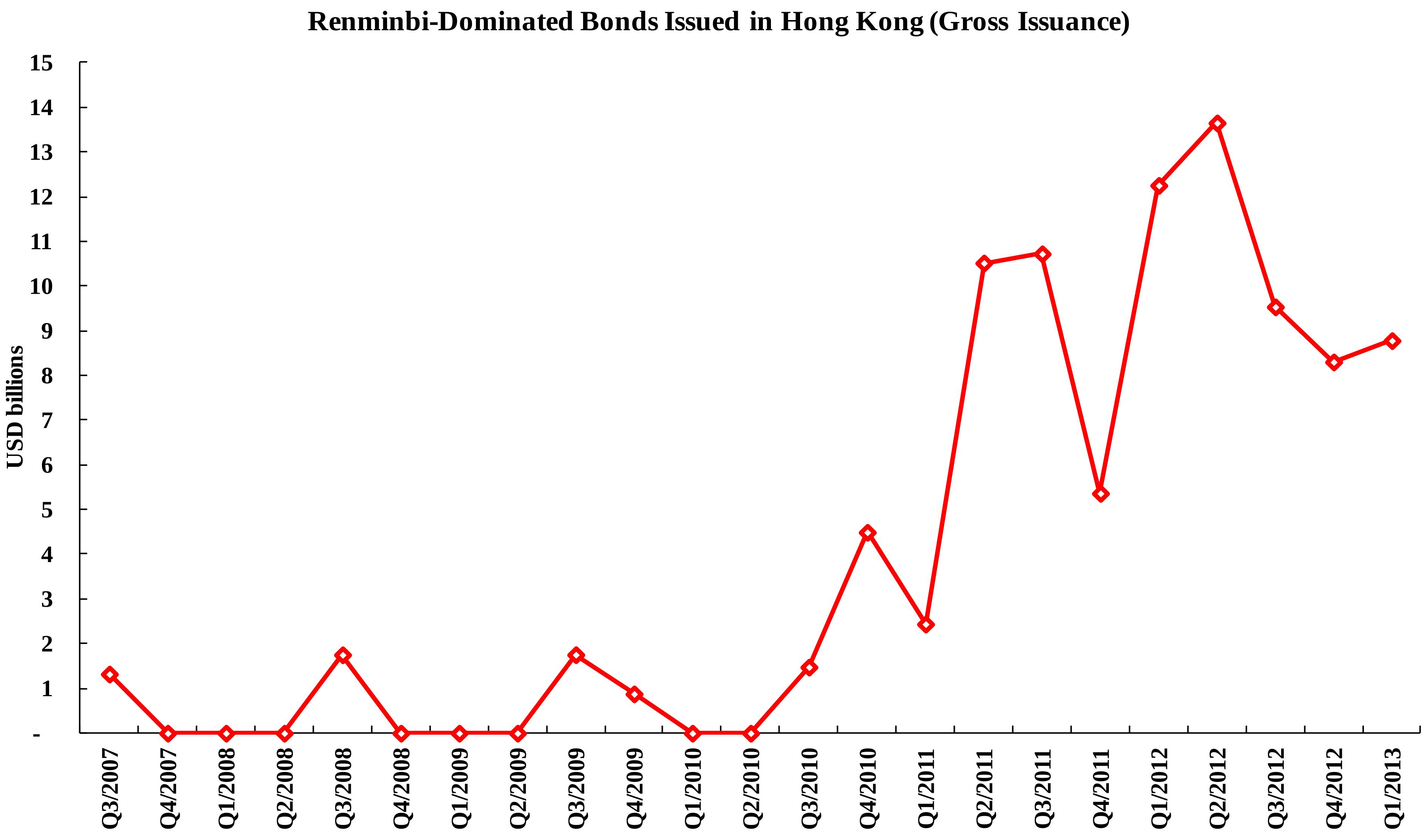
Renminbi-Denominated Bank Deposits in Hong Kong



Renminbi-Denominated Bonds Issued in Hong Kong



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



The Renminbi as an International Reserve Currency

- The People's Bank of China already has bilateral currency swap agreements in place with many central banks and monetary authorities such as those of Argentina, Australia, Belarus, Brazil, Hong Kong, Indonesia, Kazakhstan, Republic of Korea, Malaysia, Mongolia, New Zealand, Pakistan, Russia, Singapore, Thailand, Turkey, Ukraine, The United Arab Emirates, and Uzbekistan, and many more such agreements are expected.

Source: The list of countries is available on the website of People's Bank of China.
(http://www.pbc.gov.cn/publish/huobizhengceersi/3135/index.html)

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 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 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

- 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 and monetary authorities of other countries and regions as part of their foreign exchange reserves, it is subject to the risk that the foreign central banks and monetary authorities 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.

Towards Fuller Convertibility

- Full convertibility implies the removal of all controls on capital flows, inbound and outbound.
- International trade flows are relatively stable. Foreign direct investment flows, both inbound and outbound, are basically long-term in nature and hence also relatively stable on the whole. The same is true of long-term portfolio investment flows.
- However, short-term flows that are susceptible to abrupt changes in magnitude and direction (e.g., hot money) can greatly destabilise the financial markets of a country, including its foreign exchange market, credit market and capital market, impacting the economy negatively.
- But the most compelling argument against short-term cross-currency international capital flows is that, with the exception of short-term trade-related financing, they are not socially productive.

Towards Fuller Convertibility

- A Tobin tax, originally proposed by the late Prof. James Tobin, Nobel Laureate in Economic Sciences, can be an effective means of distinguishing between short- and long-term capital flows. It may be defined as a tax of say 0.5% on all spot conversions of a foreign currency into Renminbi or vice versa that are not related to underlying current-account transactions.
- Thus, foreign currency transactions related to the exports or imports of goods and services will be exempted from such a 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.
- Such a 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, and thereby discourage short-term cross-currency capital flows.

Towards Fuller Convertibility

- If every time a foreign currency is converted into Renminbi or vice versa, a tax of say 0.5% is levied, then a round-trip within a month would amount to an effective cost of more than 12% per annum, whereas for a direct investment with a long time horizon of say 5 years, the tax will amount to only 0.2% per annum, virtually nothing.
- In February, 2013, the European Commission published proposals for a financial transaction tax (FTT), which is also a form of Tobin tax. Only 11 of the 27 member states of the European Union (EU) will participate in the FTT, including France, Germany, Italy and Spain.

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.
- 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. This is because almost all East Asian economies have a trade surplus vis-a-vis China and hence can have a ready supply of Renminbi if they so wish. Chinese trade with the U.S. and Europe will probably continue to be denominated and settled in U.S. Dollar and 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 economy, may continue to be under some form of control, for example, with the imposition of a Tobin tax.
- It is important to note that full convertibility of the Renminbi does not necessarily imply that its exchange rate will be freely determined in the foreign exchange market. The Renminbi will probably continue to be determined under a managed floating rate system. The Hong Kong Dollar is an example of a fully convertible currency that does not have a freely fluctuating exchange rate.

Concluding Remarks

- 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 which it may not be willing to do so. Moreover, there is also the risk of other central banks deciding to dump the currency and assets denominated in the currency at inopportune times.
- An alternative to the denomination and settlement of international transactions in a international reserve currency such as the U.S. Dollar or the Renminbi is the denomination and settlement in the own currencies of the trading partner countries and regions. China can take the lead in promoting such practices among East Asian countries and regions.