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Original Paper

An Analysis of RMB Internationalization

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Abstract

The main objective of this paper is to analyze the internationalization of RMB. A number of charts and statistics were performed to support china's efforts on RMB internationalization. Considering the current financial environment, with presence of global imbalance, shortage of safety assets, and financial integration, China should not rush to allow free flow of capital in the near future.

Keyword

analyze, internationalization, RMB, global imbalance, capital

1. Introduction

China is gaining its international influence as it is now the largest global trader and has the second largest economy in terms of GDP in the world. After the 2008 financial crisis, China has been working to promote RMB as an international currency. In order to supply the reserve currency country, say USA, must run a balance of payment deficit for a long period of time. It is also suggested that (Eichengreen, 2011) multi reserve currencies is a better alternative than having a dominant reserve currency because central banks around the world would like to hold a more diversified reserve currencies portfolio as their foreign reserves. Under reserve currenciessystem, other central banks have the option to reduce the holding of a particular currency if the issuing country increases the money supply too quickly. This may put pressure on countries of reserve currencies to have more monetary discipline.

2. Conditions to Be an International Currency

According to Frankel (Frankel, 2012), the requirements to be an international currency are: adequate economicsize, investors' confidence in the currency, and awell-developed financial market. In most countries, policy decision makers would like to achieve these three goals: free capital flow in and out of the country, able to use monetary policy to stabilize the output, and stable exchange rate. However, a country can only pick two out of these 3 goals. Chinapicks the last two goals and restricts the free flow of capital. It is a logical thinking as China was pretty much sheltered from the shock of 2008 financial crisis, opening up the financial market, especially allow free movement of capital is not as important as avoiding future shock from the global financial system (Huang & Lynch, 2013). RMB has a natural advantage to be an international currency as far as size of trade is concerned.

With respect to the issue of how deep the financial market is, the Chinese financial system in general is still in the early stage of development, and not open to the foreigners. It is the choice of Chinese policy makers to restrict capital flow and is consistent with the Mundell Fleming trilemma.

International currency must be widely accepted.Therefore, evena currency, such as RMB, fulfils all the factors mentioned above, it may not be able to replace the roles of US dollar and or other hard currencies as international currencies within a short period. It takes a long time for a currency to lose the status as a reserve currency, based on the history of sterling (Chinn, 2015). As a medium of exchange, a currency must be accepted by both the seller and the buyer in a transaction. Therefore, if a currency is habitually used in trade, financial transactions, or in foreign exchange, there is a high chance it will be used in trade, financial transaction, and in foreign exchange as well.

3. China's Efforts on RMB Internationalization

Several things China can do to encourage wider use of RMB. China does not want to allow free capital mobility across the border. On the other hand, it would like to promote the internationalization of RMB. As the change in Chinese political and economic institution is rather unlikely within a short period of time, one thing they had already done is setting up off shore centres where RMB transactions can be cleared. The drawback of offshore centres is the size of transaction is limited by the availability of RMB circulating in these centres.

4. B&R and RMB Internalization

China proposed the Silk Road Economic Belt and the 21st—century maritime Silk Road, also known as The Belt and Road Initiative (B&R) in 2013. The purposes of B&R is helps to expand the outside demand for China's economy thus encourage China's growth. This initiative covers more than 69 countries in Asia, Europe, Oceania and East Africa, 65% of the world population and 40% of the global GDP in 2017 (Figure 1). B&R mainly focuses on infrastructure investment, construction materials, railway and highway, automobile, real estate, power grid, iron and steel. Meanwhile, China's FDI to the countries along B&R was 14.4 billion USD and the value of signed contract of construction was 1.443 trillion USD in 2017, which was 14.5% greater than 2016 (Note 1).

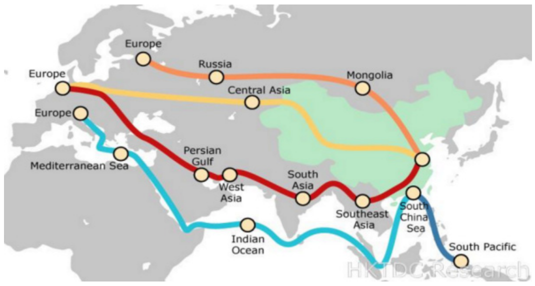

Figure 1. The Map of the Belt and Silk Road and 21st—Century Maritime Silk Road

B&R seems to be a booster to RMB internationalization. China intends to increase trade and investment among all countries in B&R and expects that a large portion of such investment will be in RMB. With the increasing volume of trade and FDI, it is predicted that trade and investment change in B&R countries would increase the usage of RMB off shore.

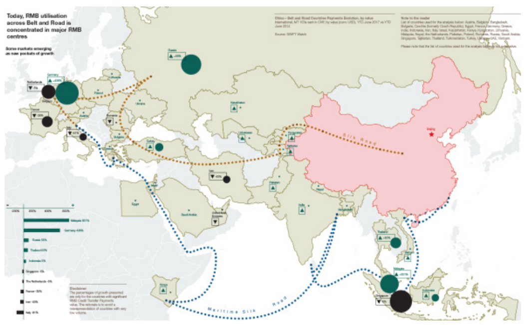

Figure 2. China—B&R Countries Payments Evolution, by Value: 2017 vs. 2014

Figure 2 shows that the changes of RMB usage were very uneven. It increased by 551% and 436% in Malaysia and Germany, respectively, while it decreased by 43% and 81% in Iran and Italy, respectively. They received very low volume of payments made in RMB. The RMB credit transfer payments to German, Poland and Czechia have increases substantially while the ones to Netherlands, France and Italy decreases significantly.

The newest RMB tracker published in January 2018 provides information about RMB internationalisation. It clearly indicates that RMB is not significant as a reserve currency yet. There are several developed countries include RMB in their reserves. For example, the European Central Bank (ECB) converted 500 million Euro into RMB in June 2017 and RMB becomes a portion of ECB's reserve.

However, the evidence is not favourable. China tries to persuade other counties along B&R to increase the usage of RMB while the feedbacks are not all positive. For example, China tries to persuade Pakistan to use more RMB in the Gwadar Free Zone to avoid exchange rate risk while it induces more speculations between the two currencies. Bangladesh, another country benefited from B&R, uses more RMB in its reserve. But now it faces more challenges including risk of macro-economic instability, corruption, policy deficits, a lack of transparency and Sino-Indian rivalry (RMB Tracker, January 2018, p. 12).

Evidence suggests that B&R may help RMB internationalization while it is still very difficult to make RMB an global currency in very short time. The main reason behind is China's monetary policy and its capital control. Because the value of RMB is not determined in the FX market, it would be a little risky to hold RMB as foreign reserve, except the portion needed to deal with the trade and investment exposed to China.

5. SDR and RMB Internationalization

Special Drawing Rights, also abbreviated SDR, are foreign exchange reserve assets maintained by International Monetary Fund (IMF). The initial value of SDR was 1 US dollar. However, after the collapse of Bretton Woods system of fixed exchange rates, SDR adopted a currency basket and the basket is updated every five years, as shown in Figure 3.

Although SDR could be exchanged for other currencies freely, it is mainly hold by the member countries of IMF as part of their foreign reserve. By September 2017, IMF had created 204.2 billion SDRs, which was equivalent to about 291 billion US dollars, and allocated them to its member countries (IMF, 2017). After being a part of SDR, RMB seems to play more important roles in global financial system.

First, let's look at the change of RMB's share in global foreign reserve. The data from IMF shows the change of shares of RMB in the official foreign exchange reserves. It was zero before and appeared to be 90.78 US dollars at the fourth quarter of 2016, which took a share of 1.08%. One year later, the numbers changed to 122.80 US dollar and 1.23% (IMF, 2018) (Note 3). It indicates a positive effect of SDR on RMB internationalism.

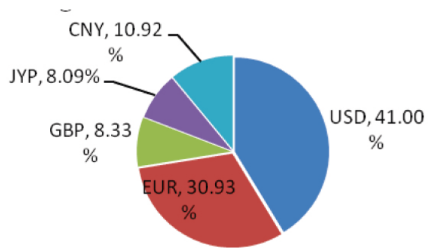

Figure 3. Share of Currencies in SDR

The Data from Wind indicates the monthly data of FDI denominated in RMB, which is summarized in Figure 4. The FDI denominated in RMB increased very fast since 2012, when it was 1.7 billion RMB. It then started to increase and peaked at 2.08 trillion in September 2015, right before RMB joined SDR.

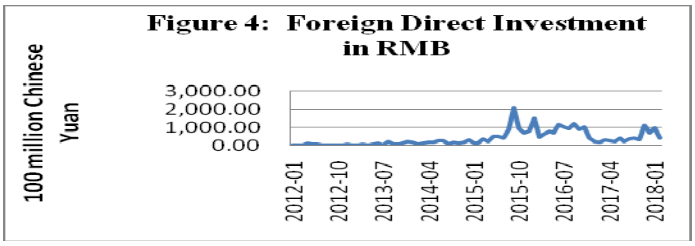

Figure 4. Foreign Direct Investment in RMB

Scource: of data: Wind.

The numbers from SWIFT indicate some changes of the roles of RMB in international payment system but not in a favourable direction. By the end of 2015, right before RMB joined SDR, RMB was the fifth largest currency used in the international payment system. However, after one year joined SDR, RMB overpassed by Canadian dollar. Moreover, 75% of RMB off-shore payment was made in Hongkong, which implies that the usage of RMB in other countries are even less (Note 3).

Therefore, the evidence indicates that the share of RMB in foreign reserve increases while its usage in international trade decreases since RMB joined SDR in 2015. The share of RMB in world reserve is only 1.2%, and there is a large room to improve when compared with its share in SDR.

6. Costs and Benefits of RMB Internationalization

There are several benefits of being an international currency (Frankel, 2012). One is the prestige status that comes when the currency is widely circulated. This may be important especially for an emerging powerhouse like China. Achieving the status is a recognition of its economic success and usually is politically popular.

Some argued that internationalizing of RMB can force the reforms in China in a faster pace. Supporting evidence can be found in the history of development in China (Huang & Lynch, 2013). In 2001, Chinese Premier Zhu capitalized on the opportunity of joining WTO to speed up reforms in China. This included the opening up of certain Chinese service sectors to foreigners, and removable of farm subsidies. There is always a resistance to changes, especially in a planned economy.

The last and probably most important advantage of being an international currency is seigniorage. Foreign countries must buy that currency as part of their reserve. The country can invest in overseas projects that offer return higher than the interest rate on their debts owed denominated in their currency. US needs to finance the long running fiscal deficits by issuing government bonds. As a result, US has accumulated a large quantity of debts.Paying lower interest rate on large quantity of outstanding government debts helps to control the already large US fiscal deficits.

Being an international currency involves several costs (Frankel, 2012). First is the responsibility of the central bank of issuing currency country. Their central bank has to consider what effects of their monetary policies on global financial market when they make the decision. This is crucial because the financial systems around the world are interconnected, through the free flow of capital. This is especially true when some countries have their currencies pegged to this international currency. When some other countries peg their currency to the international currency, the central bank of the international currency country is less flexible to adjust balance of payment when exchange rate is used as tool of stabilization policy (Dobson & Masson, 2009).

7. Conclusion

China has enormous economic influence today because of its leading position in trade and size of its GDP. However, the position of RMB as international currency does not match with its economic influence. RMB is not used in invoicing most of its trade. This is due partially to the fact that Chinese economy is not market economy, poorly developed financial system, and more importantly, Chinese has tight control on the cross-border capital movement. It is the Chinese government policy to promote wider use of RMB. In order to get around the Mundell Fleming trilemma, China set up off shore centres around the world to serve the clearing function. However, the size of RMB deposits in these centres put a limit on how much RMB these centres can clear. China has to do a lot more to develop its financial market in terms of efficiency and depth before RMB can be used more widely. Furthermore, China needs to earn trust from investors on their commitment to make RMB an international currency. Internationalizing RMB brings both costs and benefits to China.Chinese policy makers have to make the difficult decision on the pace of internationalization. However, RMB can play a more important role as a regional reserve currency sooner.

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Notes

Note 1. The numbers are quoted from *Fruits of B&R*, which is published on People's Daily. Retrieved from http://paper.people.com.cn/rmrb/html/2018-01/26/nw.D110000renmrb_20180126_1-01.htm

Note 2. The numbers are quoted from IMF data, which is retrieve from: http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4

Note 3. The numbers are quoted from RMB tracker, published by SWIFT.