# Three Junctures for the Internationalization of the Renminbi (RMB)

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*As China's economy continues to grow, it is agreed worldwide that the Renminbi (RMB) should play a more important role. "Prudence" has always been the policy style of China. To satisfy the condition, this paper foresees that the process of internationalization of the RMB needs to pass through three stages (junctures). The first would be to establish arrangements for cross-border settlement of transactions in the RMB. The second stage would be to diversify the economic growth model. The final stage would be the development of a financial market to protect against any external shocks.*

## THREE JUNCTURES FOR THE INTERNATIONALIZATION OF THE RMB

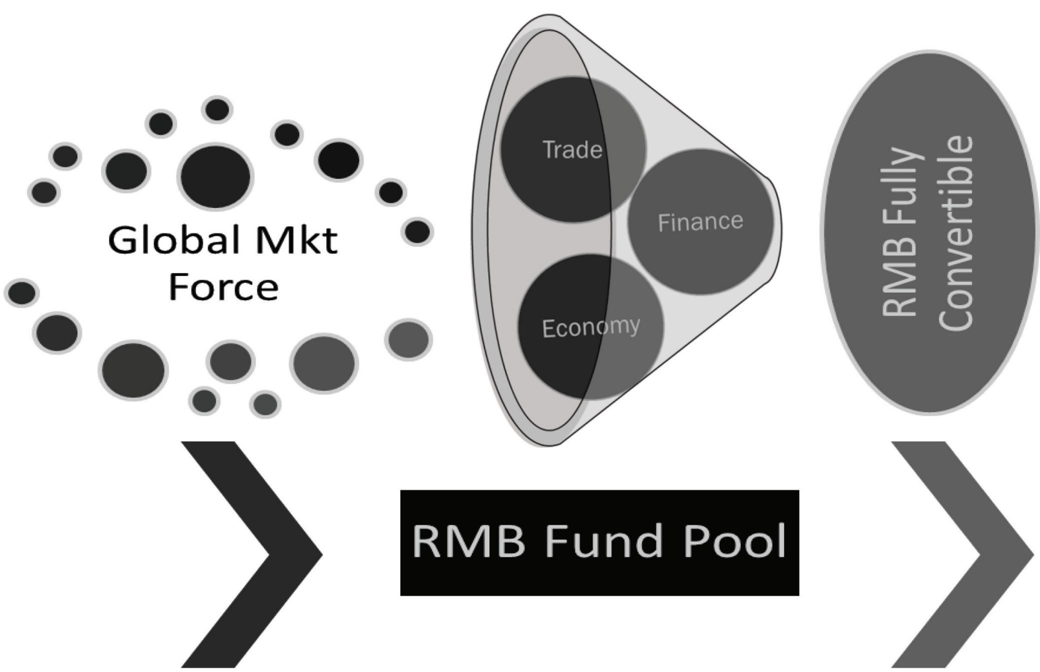
By the end of 2010 China's GDP was worth about $5.7 trillion. In terms of purchasing-power-parity adjustment, this represented about 13% of global GDP (Source: IMF, WEO Database, October 2010). As China's economy continues to grow and would even surpass the western major economies within a decade, it seems only natural that the RMB should be internationalized. As an international currency, the RMB should be widely accepted, globally, in trade invoicing and settlements and in financial markets, and would serve as a store of value (Kene, 1983; Gao and Yu, 2009; Chinn and Frankel, 2005). For example, the US dollar, the major international currency, is widely accepted for quotations and payments in trade, in foreign exchange markets and in commodities markets. Tourists usually use the US dollar across borders to make their payments. In fact, all over the world, public and private institutions are willing and able to hold US dollar denominated financial assets as a store of value. Governments use the US dollar as a reserve currency as well as a tool for foreign exchange rate interventions (Genberg, 2009).

In the IMF's World Economic Outlook it was forecast that China's output, in terms of purchasing-power-parity, would surpass that of the USA in 2016 (Source: IMF, WEO, April 2011). Justin Lin, the World Bank's chief economist, believes that China will overtake the USA and become the world's largest economy within the next two decade (Finance Markets, August 2011). Yet all these predictions ignore the potential risk caused by the imbalance between China's economic activities and the role of the RMB in the world market. As the world's manufacturing centre, China has overtaken Germany as the world's biggest exporter. Moreover, China has the largest foreign reserves and attracts the greatest amount of foreign direct investment. But the RMB still plays only a minor role in trade settlements, in international financial markets and as a reserve currency. This imbalance in the role of the RMB reflects the fact that the participation of China in the global economy is still limited to the manufacturing sector. It is agreed worldwide that, to ensure the recovery of the global economy and the further growth of China, China should be more closely integrated with the global economy through her financial sector. Yet a liberalization of China's financial sector may cause fluctuations in the RMB, and this would hurt foreign investors in China, alter world trade patterns and harm the global economy.

Determining how fast the process of RMB internationalization should be is an art in itself. Different points of view provide different answers. From the market perspective or a Western view point, China should open its capital account, deregulate all unnecessary control over the RMB and let the market handle the process. Kene, 2009 considers that the first condition for a currency to become internationalized is that “the government must remove all restrictions on the freedom of any entity, domestic or foreign, to buy or sell its country’s currency, whether in the spot or forward market” (Kene, 2009, p.3).

However, from the point of view of the Chinese authorities, in order to be a responsible member in the global economy, China needs to avoid any harmful fluctuation of the RMB during the process of its internationalization. It has been reiterated many times by the Chinese authorities that any reform of the RMB should be gradual and controlled. In the third quarterly monetary policy report of the People's Bank of China, 2009), it was stated that the RMB exchange rate formation mechanism should follow the principles of initiative, controllability and gradualism. Yet the call in global society for a reform of the RMB exchange rate is getting louder, as the strength of the Chinese economy continues to grow. “Prudence” has always been the preferred policy style of the Chinese authorities, and one possible future scenario for the reform of the RMB is that they will make use of the market to build a firewall to protect the RMB against harmful speculation. That means it is necessary to ensure that the size of the RMB market pool, in terms of both demand and supply, is large enough to absorb any unexpected shocks. As Zhu (2011), points out, emerging markets need to maintain macroeconomic stability and external buffers if their policies are to work effectively. To satisfy this condition, this paper foresees that the process of internationalization of the RMB needs to pass through three stages (junctures). The following figure 1 outlines the conceptual framework.

**FIGURE 1**
**THREE STAGES FOR INTERNATIONALIZATION OF RMB**

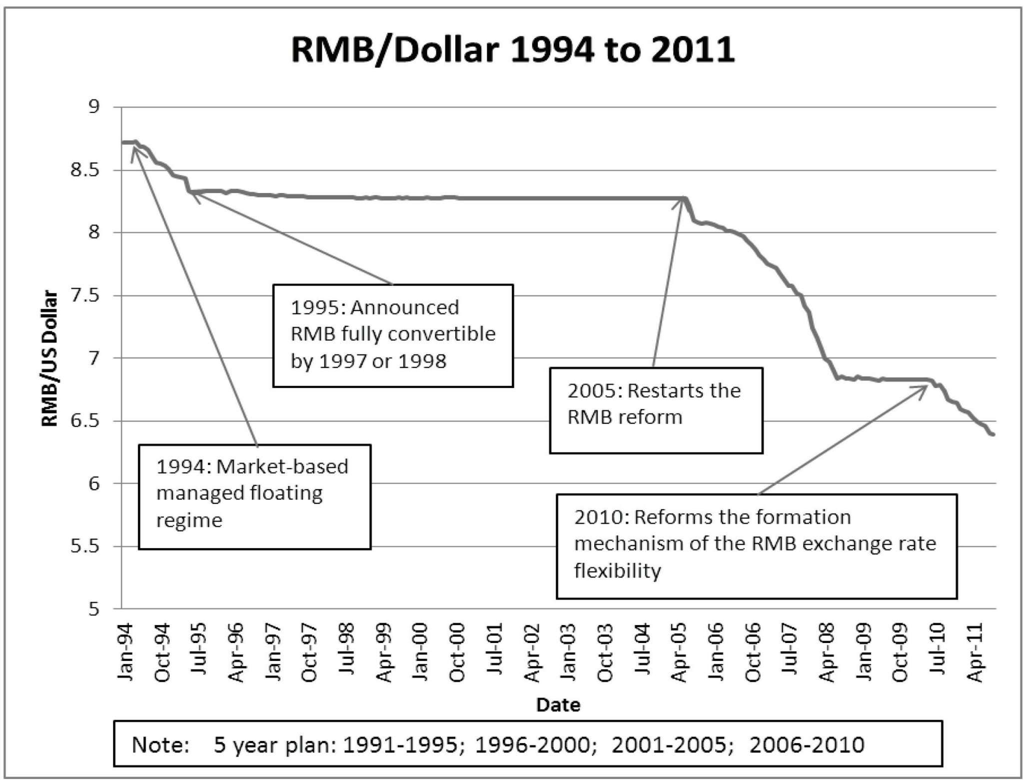



The first would be to establish close trade relationships or free trade agreements and arrangements for cross-border settlement of transactions in the RMB with emerging economies, especially the other countries in the BRICs group. The second stage would be to rebalance the economic growth model from an export-led growth model to an export-consumption-technology led model. The final stage would be the development of a RMB fund pool, including both onshore and offshore RMB centres, that is deep and wide enough to defend against any external shocks.

## RECENT REFORMS IN THE CONVERTIBLE SCHEDULE OF THE RMB

The following figure 2 shows that every reform in the RMB starts with a transformation of China's economy and slows down when there is global financial instability. In China, the transformation of the economy is triggered by the Five-Year Plan. In 1994, China implemented a market-based floating exchange rate regime in which the RMB is allowed to float within a band. To achieve membership of the World Trade Organisation (WTO), in 1995 the Governor of China's central bank announced that the RMB would be fully convertible by 1997 or 1998. China reached its convertibility goal for the current account by the end of 1996 (1996 was the beginning of the Ninth Five-Year Plan). However, due to the 1997 financial crisis in Asia, the schedule for achieving full convertibility was quietly abandoned.

**FIGURE 2**
**REFORM OF RMB 1994-2011**




Sources: Data from UBC's Sauder School of Business

Almost ten years later,, in July 2005, the Chinese authorities announced the restart of the 1995 schedule to make the RMB fully convertible schedule, re-launching the RMB reform leading to a greater exchange rate flexibility (2006 was the beginning of the Eleventh Five-Year Plan). However, the 2008 global financial crisis froze this process for two years. By June 2010 China had further reformed the formation mechanism of the RMB exchange rate flexibility. At the beginning of 2011, the People's Bank of China announced that China would take further steps to improve the RMB formation mechanism (2011 is the beginning of the Twelfth Five-Year Plan). It is therefore to be expected that the next movement towards the internationalization of the RMB will come in 2016, i.e. the beginning of the next Five-year plan. Yet the conditions needed for this next step forward depend on the existence of a stable global financial environment. Previous history shows that internationalization of the RMB is not a standalone issue, and is closely related to the economic development of China and the stability of the global financial markets.

## CROSS-BORDER TRADE SETTLEMENTS

According to the following table 1, China picked up about 10% of world trade. This indicates that trade settlements have a huge potential for contributing to the international use of the RMB.

**TABLE 1**
**CHINA CONTRIBUTION TO THE WORLD TRADE 2010**

| | Value $billion | Rank | Global Share % |
|---|---|---|---|
| Merchandise trade | | | |
| Export | 1578 | 1 | 10.4% |
| Import | 1395 | 2 | 9.1% |
| Service trade | | | |
| Export | 170 | 4 | 4.6% |
| Import | 192 | 3 | 5.5% |
| Source: WTO press release 7 April 2011, PRESS/628 | | | |

In April 2009, the Chinese authorities launched a pilot project to allow exporters and importers in Shanghai, southern Guangzhou, and the cities of Shenzhen, Zhuhai and Dongguan to settle cross-border trade deals in RMBs. By the end of 2010, this project had been extended to a further 20 provinces and cities. At the same time, the overseas areas included in the project were expanded to cover not only Hong Kong and Macao and the ASEAN countries but also all of China's trading partners. Since then the use of the RMB in cross-border trade settlements has continued to grow at an accelerating pace. By February 2011, about RMB725 billion ($114 billion) of trade was settled in RMBs, which was 201 times greater than the amount in 2009 (People's Daily, March 2011). However according to data provided by the People's Bank of China (BOC) in the first quarter of 2011, RMB725 billion still only represents about 7% of the cross-border trade settlements.

One of the major steps taken by the Chinese authorities to promote the use of the RMB in cross-border trade settlements was the establishment of regional trade agreements. The above table shows that regional and emerging economies (ASEAN, BRI and South Korea) represent about 30% of total Chinese trade. Learning the lesson from the 1997 Asian financial crisis, closer links with the Asian region's economies have been created. The ASEAN–China Free Trade Area (ACFTA) became effective on 1 January 2010 and China is also negotiating a regional trade arrangement with India and seeking more trade co-operation with Russia. In March 2006, China and India set up a joint task force to study the feasibility and benefits that could be derived from a regional trading arrangement between the two countries (Bhattacharya and Bhattacharyay, 2006). In November 2010, China and Russia agreed to use their own currencies for their bilateral trade at a meeting in St. Petersburg. Recently, in May 2011, China, Japan and South Korea, meeting on the side-lines of the Asian Development Bank (ADB) annual meeting in Hanoi, announced that they would study the use of their own currencies in trade settlements with one another. It is this co-operation between regional and emerging countries that has enabled emerging countries to safely navigate through the recent global economic instability. However, the intention to use the RMB for cross-border trade settlements is still applied only on a voluntary basis.

**TABLE 2**
**CONTRIBUTION OF CHINA'S MAJOR TRADING PARTNERS TO TOTAL TRADE 2010**

| | Total Trade | Exports to | Imports from |
|---|---|---|---|
| EU | 17% | 20.10% | 13.20% |
| US | 13.60% | 18.30% | 8.00% |
| Japan | 10.50% | 7.40% | 13.80% |
| ASEAN | 10.30% | 8.90% | 12.10% |
| Hong Kong | 8.10% | 14.10% | 0.70% |
| South Korea | 7.30% | 4.40% | 10.80% |
| BRI | 6.40% | 6.10% | 6.60% |

Source: IMF Direction of Trade Statistics
ASEAN: ASEAN members include Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar (Burma), the Philippines, Singapore, Thailand, and Vietnam.
BRI: Brazil, Russia, India

Today, cross-border trade settlements tend to concentrate on imported goods and the transactions tend to be concentrated in Hong Kong. In the first quarter of 2011 about 86% of cross-border trade settlements were handled by Hong Kong (Sources: People's Daily online, June 2011). For companies in China, the use of the RMB in trade settlements can certainly reduce their transaction costs but for their trading partner, especially western customers, this is not the case. The crucial point is that western companies need to have a channel of access to the RMB market. This is the reason why most of the RMB trade settlements take place in one of the major offshore RMB centres, namely Hong Kong. In Hong Kong, with its linked exchange rate system and well-developed financial infrastructure, a company can borrow US dollars at a low interest rate and deposit them in RMBs at a high rate. This creates a huge pool (outside Mainland China) of RMBs which is accessible to western companies. Additionally, it is the strategic plan of the Chinese authorities to turn Hong Kong into an RMB offshore centre. It is obvious that the development of the use of the RMB for cross border trade settlements is closely related to the financial liberation of China.

In a demand driven market, it is easier for a consumer to convince a supplier to settle the transaction in their own currency. As shown in the above table 2, China's regional and emerging trading partners contributed a larger proportion of imports than of exports. Altogether, Japan, ASEAN, South Korea and BRI contributed 43.3% to total imports and 26.8% to total exports. In the reverse case; the western countries, the EU and the USA contributed 38.4% to exports and 21.2% to imports. This is the reason why recent progress in China's bilateral trade arrangements is concentrated in the regional and emerging trading partners.

To increase the incentive for foreign countries to use the RMB in cross border trade settlements, China needs to rebalance her growth model from an export-Capital formation-led growth to an export-consumption-technology-led growth. With the huge size of the consumption market, it is becoming easier to convince other countries to use the RMB for their trade settlements.

Taking the above into consideration, the future development of RMB cross-border trade settlements will start in a nearby area such as Hong Kong and then extend to regions in which the economies are closely linked such as Japan, ASEAN, South Korea and BRI, before ultimately becoming global. Such a development would, of course, be constrained by the development of the Chinese consumption market and the liberalization of China's financial market.

## STRUCTURAL CHANGE OF THE CHINESE ECONOMY

To promote the internationalization of the RMB, the Chinese economy needs to be stable and its growth needs to be sustainable. For the past two decades the Chinese economy has managed to maintain an average GDP growth rate of 10%. The recent western debt crisis will force the western authorities to cut their fiscal budget, thus reducing their aggregate demand. It is expected that the western economies will grow only slowly over the next few years and the demand for China's exports will be reduced. In addition, the appreciation of the RMB, as it goes international, will also contribute to reducing the level of exports. China can no longer depend on exports to maintain her high growth rate. The following figure 3 shows that the appreciation of the RMB (after the reform in 2005) has caused the export to GDP ratio to fall from its peak (39%) in 2006 to 27% in 2009. It is widely agreed that the engine for growth comes from exports and fixed capital formation, but China's growth model is now running into a bottleneck.

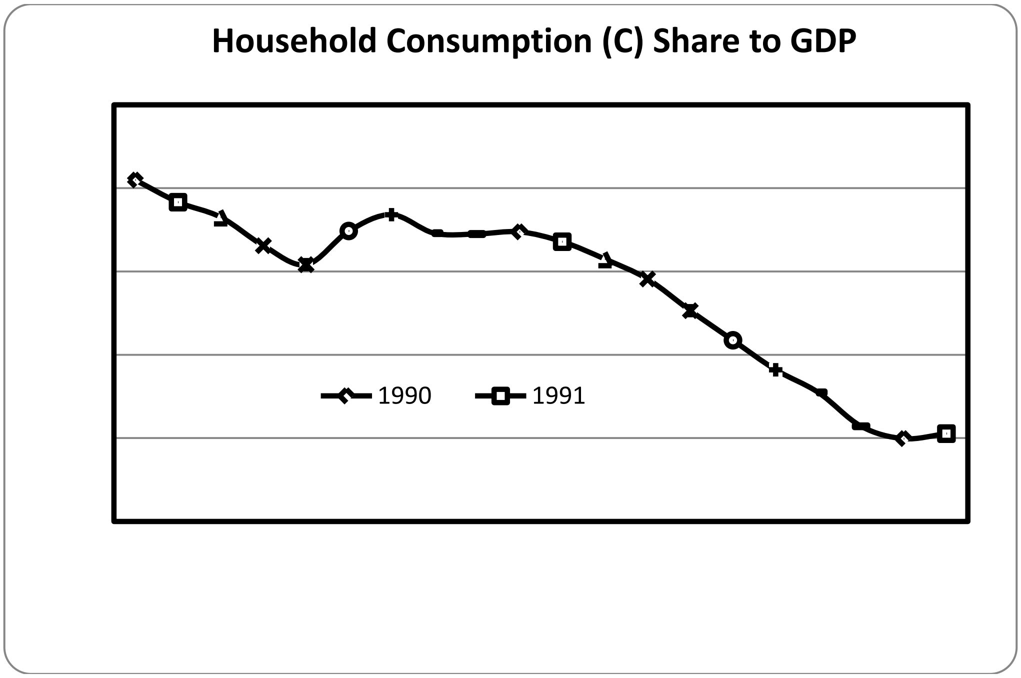
**FIGURE 3**
**CHINA'S EXPORT TO GDP RATIO**


Source: World Bank

Progress towards the internationalization of the RMB depends on the economic power of China, so the expected slowdown of growth in western economies provides China with an opportunity to pick up a larger share of the global economy and this would be favourable for the internationalization of the RMB. But to take advantage of this opportunity, China needs to change its export-led growth model.

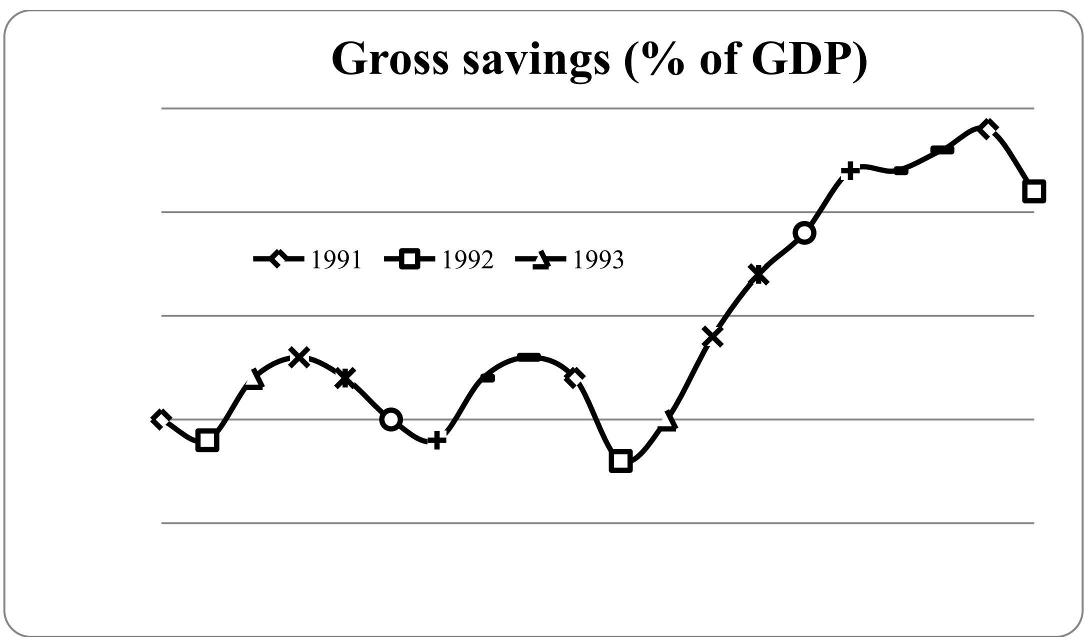
Indeed, in the Eleventh five year plan (2006 to 2010), the Chinese authorities recognized the importance of rebalancing the growth to domestic consumption orientated model. However, not everything went according to plan; the following figure 4 shows that the household consumption to GDP ratio continued to decline, from 50% in 1990 to 35% in 2009. Grossing savings as a percentage of GDP rose from 39% in 1992 to 51.4% in 2008. The literature has reviewed many explanations for the high savings rate in China, such as the weak social security net, the lack of investment tools and the bias towards consumption (Blanchard and Francesco, 2006; Kuijs, 2006).

**FIGURE 4**
**CHINA'S HOUSEHOLD TO GDP RATIO**




Source: National Bureau of Statistics of China

**FIGURE 5**
**CHINA'S GROSS SAVING TO GDP RATIO**




Note: Gross savings are calculated as gross national income less total consumption, plus net transfers.
Source: World Bank national accounts data, and OECD National Accounts data files.
Catalogue Sources: World Development Indicators

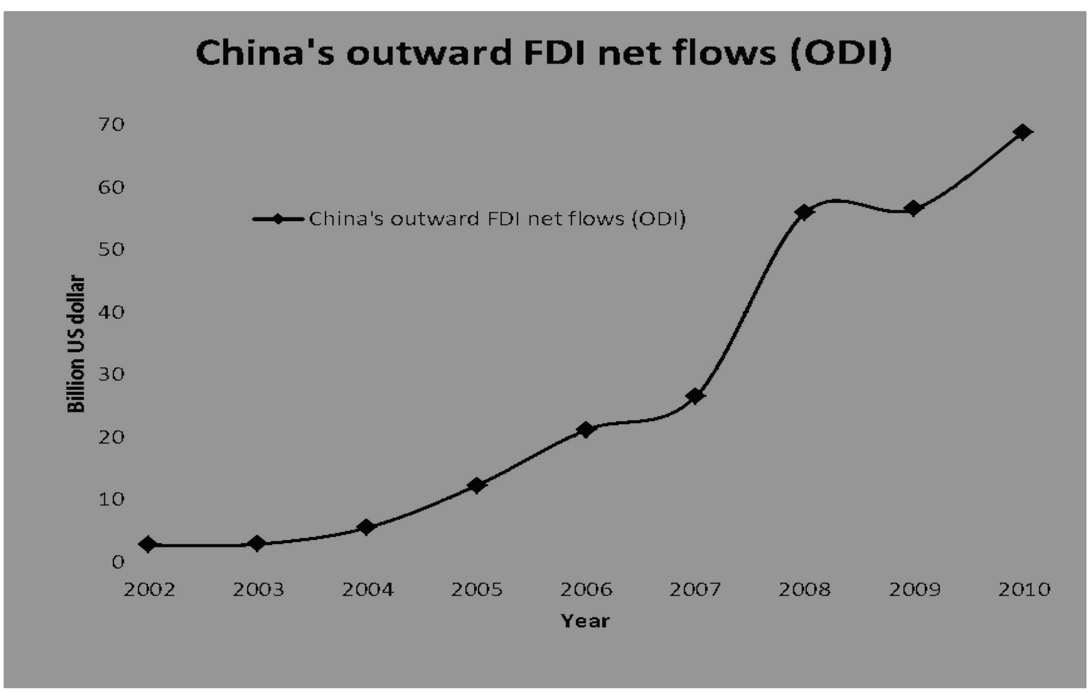
The following figure 5 shows that the waves of increases in savings follow closely the economic crises. The first wave began in 1992, following the 1990-1991 US economic recessions, and the second wave began in 1997, reflecting the Asian financial crisis. After 2001 (in reaction to the IT bubble) the savings continued to increase through the SAR crisis (2003) and the global financial crisis (2008). They began to fall by 2009 in line with the recovery of the world economy. As predicted by the life cycle and permanent income hypothesis, Chinese people tend to save for their future whenever there is an economic downturn.

The financial market in China is still at the development stage, and there are not enough tools available to investors to use to hedge against any potential risk to their wealth. The limited ability of the Chinese household to hedge against any uncertainty about their future living standards causes Chinese people to save more. Channelling these savings into consumption will depend on the liberalization of the Chinese financial market.

## LIBERALIZATION OF THE FINANCIAL MARKET

The new challenge now facing the Chinese economy is to balance growth and inflation, especially food and property inflation. With the inadequacy of the tools available in the financial market to fight against inflation, money tends to float into the property market. Buying real assets, and in particular property, is a traditional way that Chinese people hedge their wealth against inflation. However, too much money washing around the highly inelastic supply of property, especially in the short run, will push property prices up and create a speculative asset bubble. High property prices will also increase the costs for businesses, for example rental costs, thus spreading inflation from one sector into another. The Chinese authorities have tried hard to prevent inflation from spreading to other sectors of the economy by tightening monetary policy and channelling RMBs offshore. But these channels involve outbound direct investment (ODI), currency swaps, using the RMB for trade settlements for imported goods and issuing of RMB denominated bonds offshore.

**FIGURE 6**
**CHINA'S OUTWARD FDI NET FLOWS 2002-2010**




Source: 2010 Statistical Bulletin of China's Outward Foreign Direct Investment

Since 2005 (the most recent phase of RMB internationalization), China's ODI has increased dramatically from $5.5 billion in 2004 to $68.81billion in 2010. China's ODI ranked fifth among all economies in 2010, picking up around 5.62% of world ODI.

**TABLE 3**
**RMB LOCAL CURRENCY SWAP ARRANGEMENTS**

| Effective Date | Country | RMB (Billion) |
|---|---|---|
| Dec 2008 (Renewed in Oct. 2011) | Republic of Korea | 180 |
| Jan 2009 (Renewed in Nov 2011) | Hong Kong | 200 |
| Feb 2009 | Malaysia | 80 |
| March 2009 | Belarus | 20 |
| March 2009 | Indonesia | 100 |
| April 2009 | Argentina | 70 |
| June 2010 | Iceland | 3.5 |
| July 2010 | Singapore | 150 |
| April 2011 | Uzbekistan | 0.7 |
| April 2011 | New Zealand | 25 |
| May 2011 | Mongolia | 5 |
| July 2011 | Kazakhstan | 7 |
| October 2011 | Republic of Korea | 360 |
| November 2011 | Hong Kong | 400 |

Source: People's Bank of China

Before 2008, China's currency swap arrangements were expressed in US dollars. Starting in late 2008, China began to sign a series of bilateral currency swap agreements denominated in RMBs (See the above table). China had signed 12 currency swap agreements with a total swap volume of RMB841.2 billion by 2011. The currency swap agreements provide RMB liquidity offshore that can be used by overseas investors for trade settlements, as a store of value and as investment currency.

Since 2005, the Chinese authorities have approved the issue and trading of Panda bonds, an RMB denominated bond issued by qualified foreign issuers and sold in China. By 2011, Panda bonds to a value of around RMB60 billion had been issued. In July 2007, the Hong Kong financial market was allowed to issue an RMB denominated bond, called the Dim Sum bond. The number of Dim Sum bonds issued jumped from a total value of RMB10 billion in 2007 to RMB36 billion in 2010. In the first five months of 2011, a total of RMB28 billion was issued by 28 issuers including the World Bank, the Asian Development Bank and the International Finance Corporation (reported in The People's Daily online, June 2011). Since 2007, Dim Sum bonds totalling over RMB100 billions of have been issued by 55 issuers.

Opening up the use of the RMB requires the co-operation of both offshore and onshore banking services in order to maintain the clearing balance. The advantage of an offshore RMB centre is that, as the RMB goes international, the offshore centre can serve as a firewall to buffer against potential volatility in the market. Indeed, it is not only Chinese investors who are looking for investment opportunities, but also foreign investors who are seeking out RMB financial assets. Under the one country, two systems policy, Hong Kong, can maintain her own currency and linked exchange rate system. This places Hong Kong in a unique position to serve as the offshore RMB centre for China. As a well-developed international financial centre, the financial infrastructure in Hong Kong can provide services for trade settlements in RMBs, and offer a variety of RMB financial investment and wealth management services. These can include, for example, RMB Bond funds, non-delivery RMB forward, Structured RMB deposits, RMB-denominated IPOs and RMB insurance policies. Indeed Hong Kong was the first place outside Mainland China that was allowed to provide RMB banking services (since 2004) and, since 2007, to run the only

RMB bond market. The building up of an RMB fund pool in Hong Kong has made dramatic progress in recent years. RMB deposits reached RMB609 billion in August 2011, about 10 times the level in 2009 (Source: HKMA, August 2011).

The build-up of RMB deposits in Hong Kong revealed the need for a channel to connect it to the Chinese financial market. Recently, in September 2011, the Chinese authorities approved policies that would allow RMB Qualified Foreign Institutional Investors (RQFII) to invest in the securities markets in Mainland China, and the ETF (Exchange Trade Fund) of Hong Kong to be listed among the stocks in Mainland China. Opening this door for the RMB to "come back" to promote the development of China's financial market, and its integration with the global financial market, is an important step on the road to internationalization of the RMB.

However, the strategies for the "going out" and "coming back" of RMBs still have a long way to go. According to the quarterly review of the Bank for International Settlements (BIS), March 2011, over 60% of the RMB daily turnover is carried out in a strictly off-shore mode, that is, outside the Chinese financial market between two non-residents. Indeed most of the offshore transactions are carried out in Hong Kong. On-shore transactions represent about 39%, and the amount of on-shore/off-shore transactions is very small. (McCauley and Scatigna, 2011, p.72). This may be due to the controls on the RMB that pushes trading offshore into non-deliverable financial instruments, resulting in a high proportion of strictly offshore transactions (Mihaljek and Packer, 2010, p 54). It can be foreseen that achieving financial integration between China and the rest of the world is another stage in the internationalization of the RMB.

## CONCLUSION

This paper shows that the RMB has great potential to be an international currency, but that the internationalization process needs to pass through three interactive stages. The first stage is to build close economic relations with regional and emerging countries through bilateral trade agreements. These agreements can encourage trading partners to use the RMB to settle cross-border trade. In order to convince its trading partners to use the RMB, China needs to transform itself into a consumption-led growth economy and provide channels for the RMB to circulate across borders since the capital account of China is only partially open. In a demand driven market, consumers normally have higher bargaining power concerning the use of the local currency to settle transactions. This paper argues, therefore, that the second stage will be the transformation of China's economy into a consumption-led growth model. With the current debt crisis, it is expected that the growth rate of western economies will be very slow. To maintain the growth of the Chinese economy, therefore, the growth engine needs to shift from being export-led to being consumption-led. However the transformation of the Chinese economy requires the liberalization of China's financial market. The lack of financial tools available to China households to help them to hedge against inflation has caused them to save more during times of economic crisis. However, the development of a financial market will need time to allow both regulators and investors to learn how to manage and survive in a complex financial market. One shortcut perhaps would be to allow the RMB to "go out", making use of Hong Kong as its offshore centre. Chinese investors could take advantage of the well-developed financial infrastructure and tools in Hong Kong to hedge against inflation. On the other side, foreign traders need a channel to get the RMBs back into China, so, as the offshore centre, Hong Kong can co-operate with the onshore banking services and thus help the RMBs to "go back". Alongside the development of this offshore RMB trading centre, there should also be a funding pool of RMBs built up offshore which could serve as a buffer to protect the RMB against harmful fluctuations. Thus the third stage would be the liberation of the financial market.

According to the historical pattern, the next five years should be the critical time for the internationalization of the RMB. Although at present the RMB is only partially open to the world, it is clear that the Chinese authorities would like to take further steps to promote its internationalization. It has to be admitted that at present the internationalization of the RMB is still in its infant stage, but China has always been capable of surprising the world, especially in economic development. It is possible that the

RMB might be able to pass through the three stages and take a big step towards internationalization within the next five years.

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