

Between Globalization and Internal Stability, the Resistible Internationalization of the Renminbi

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Abstract

China's RMB is becoming a major international currency. It has joined major international currencies and intends to continue its growth although it has not yet become a fully convertible currency. Its share in world trade, reserves remains limited. On the one hand, the increase in its international use is increasing, on the other hand the decline in trade, the accumulation of internal problems - decline in GDP growth, growing domestic debt - are leading the Chinese authorities to push back the opening of the capital account, to control interest rates. Social stability has become a priority.

Keywords: RMB; China; convertibility; capital account.

JEL classification: E; F; G.

1. INTRODUCTION

For more than two decades, we have witnessed the rise of China. It now accounts for 15% of global GDP, almost 12% of world trade. By pursuing an international strategy that some people call expansionist, it weaves its web around the world, around it, in Eurasia, in Africa, on the margins of Europe, but also in Latin America. The commercial and financial flows induced by this strategy are still denominated in dollars. China, following its commercial successes, to its overseas operations intends to promote the use of its currency, the Renminbi, both as commercial, investment and reserve currency.

What goals does China pursue by pushing the internationalization of its currency?

Two objectives can be envisaged:

- contribute to the architecture of a new global financial system in which a pool of reserve currencies, including the Chinese Yuan, predominate, or
- develop a Sino-based international financial system that competes with or operates in parallel with the international monetary system with the aim, among other things, of weakening the dollar (and the Euro?)

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Recently the economic context has changed with the return of protectionism that disrupts global trade flows, the "trade war" against China accused of forced transfers of technology, non-compliance with the law, intellectual property theft, dumping practices. US measures (drastic increase in tariffs, control of Chinese investments, prohibition of the sale of sensitive technologies) hinder trade, affect international value chains, impact capital movements.

Another important factor is related to the decline in economic growth in China (Figure no. 1) and the increase in the ratio of indebtedness / GDP to almost 300% today.

Chinese officials are today balancing two conflicting goals: pursue a strategy that promotes trade and investment and international expansion of the RMB and engage in the adoption of economic policies to revive activity, stabilize the economy at the cost of greater debt.

2. RMB, THE COMING CURRENCY

With China's increasing economic weight in recent decades (GDP, trade, capital flows), the role of the Chinese Yuan, the Renminbi (RMB), occupies and is expected to occupy a position in the future. growing in size worldwide. Its place is still limited in comparison with the two dominant currencies (\$, €) and the others (£, Yen) which count in world trade as well as in official foreign exchange reserves (IMF, Central Banks). In 2016, a sign of its growing place, the RMB has been officially integrated into the basket of currencies that make up the IMF's artificial currency Special Drawing Rights. In recent years, the Chinese authorities, along with many national central banks, have established swap centers in different parts of the world. Many Chinese investments outside the country are now denominated in RMB, notably through the *Belt and Road Initiative* project launched by President Xi Jinping in 2013. Previously, Hong Kong became the first financial center to issue bonds denominated in RMB outside China (*Dim sum* bonds) followed by other financial markets, particularly in Asia and Europe.

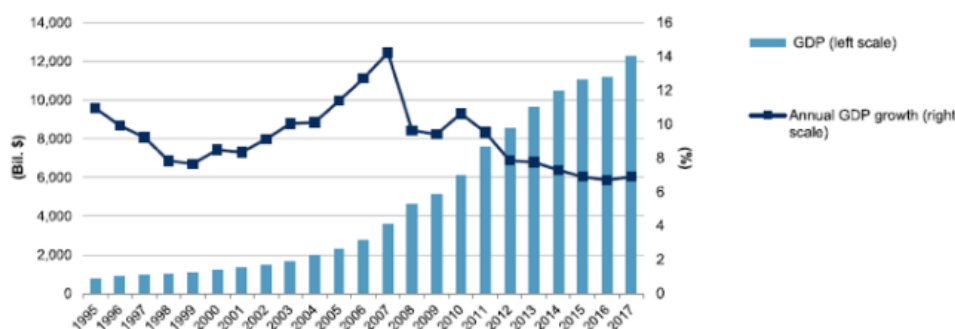


Figure no. 1 – Chinese GDP growth rate (constant prices)

Source: World Bank

However, the Chinese and international domestic financial markets on which Chinese and foreign institutions operate (companies, banks) remain compartmentalized. At the domestic level the capital account is only partially released, interest rates remain administered, and the exchange rate is also heavily regulated despite the adoption and widening of bands of fluctuation. The development of an off-shore RMB market is gradually developing, but its

links with the domestic market are through complicated and highly controlled channels in order to avoid excessive differences between the different markets. The exchange rate remains partly linked to major currencies, particularly the dollar, even if the pegging incorporates, by weighting them, other currencies of countries with which China exchanges.

The internationalization of the RMB, its recognition as an international reserve currency is an objective of the Chinese authorities even if the current environment seems less favorable. First of all, there is a significant gap between the growth in trade volume, capital movements and their settlement, which are still mainly denominated in dollar, including transactions carried out at the domestic level (investment, exports).

Can the internationalization of the RMB continue to grow, its exchange rate become more flexible, evolve into wider bands, or even float? We are not there yet. Several factors are holding back the growth of the internationalization of the RMB and its role as a reserve currency. At the international level, we can cite the hegemony of the dollar and the privileges that are associated with its role, the uncertainties regarding international trade following protectionist measures, the "Trade War" initiated by the United States against of China, the resulting contraction of trade. At the domestic level, the decline in Chinese growth officially stands at 6.2% (it would actually be less than 3 as its level is politically decreed (Pettis, 2019), the growth of debt fueled by central government, provinces, non-financial enterprises, financial institutions, etc. which now stands at more than 300% of GDP (the largest share going to non-financial firms), the very low level current account (0.5% of GDP). China uses policies to support economic activity through the adoption of favorable credit policies, the lowering of reserve requirements for small banks, the issuance of bonds by the provinces, the distribution of subsidies to businesses (favoring the state sector) increases the debt and does not contribute to reduce the opacity of the financial system of the country whose reform is regularly mentioned by the Chinese authorities but which may prove difficult to implement.

3. THE ADVANTAGES OF A RESERVE CURRENCY FOR CHINA¹

Why internationalize the RMB and make it a reserve currency?

It is for China the recognition of the place in the world economy acquired during the last decades. China, in addition, can reap significant benefits in terms of cost of financing. It is also a way to reduce the advantage that the United States derives from the hegemony of the dollar, to participate in a pool of currencies whose transaction costs would be minimized. The use of RMB for Chinese exporters and importers would help reduce the exchange rate risks they face.

Box 1 – What is an international currency?

An international currency is a currency that is held and used outside the currency area where it is issued, including by non-residents. International currencies must fulfill three functions: (i) be a unit of account, (ii) a store of value and (iii) a medium of exchange within and outside the currency area where it is issued. In particular, an international currency must be used both for official purposes (foreign exchange reserves denominated in the currency, use of the currency for foreign exchange interventions and as anchoring for other currencies) and private (invoicing of trade, denomination of financial products, private investment).

There are several factors that promote the international character of a currency:

- the economic size of the country issuing the currency, its role in world trade and the volume of its financial markets;
- the financial, economic and political stability of the currency area where the currency is issued and the ability of the monetary authority to achieve its price stability objectives;
- the liquidity and depth of the financial markets so that the volume of transactions is sufficient for each of them to have a low impact on prices;
- convertibility for current and financial operations, with a removed degree of capital account openness.

Source: Jude and Pierre (2013)

It also reduces the exposure of the Chinese marketable securities sector to changes in the dollar value, especially in the event of a fall in the dollar supply. Finally, the internationalization of the RMB allows Chinese domestic operators to borrow local currency in different markets.

The Chinese currency fulfills the four attributes (Table no. 1), both private and public, of a convertible currency as defined by McKennon, but with different intensities in its different functions. The RMB is still unattractive despite its strong growth in recent years. Most of the world's non-performing economies remain tied to the dollar. In 2015, 62% of countries have their currency indexed to the US \$, 60% of developing countries borrow in this currency; 30% of countries have their currency indexed to the €. Central banks, on the other hand, hold more than 60% of their currency reserves in US \$.

The RMB has quickly become a reference currency (IMF), restrictions on its use in trade, in international investment are gradually lifted. The RMB is now a commercial currency (RMB trade value). RMB-denominated trade rose sharply from 2% in 2010 to more than 15% from 2015, mainly in trade with developing countries. Regarding the investment currency aspect, the launch of the RMB offshore market in Hong Kong in 2010 was an accelerator with the appearance of a variety of products: *dim sum* bonds, investment bonds, equity products, exchange traded-funds, currency derivatives. At the same time, the Chinese monetary authorities have put in place an elaborate mechanism and specific institutions to circumvent unification and confrontation in a real offshore and onshore supply and demand market through the establishment of the Qualified Foreign Institutional Investor program. At the same time, the Chinese authorities have gradually expanded the use of RMB as commercial and investment currency for Chinese exports and non-commodity imports. In the BRICS alliance, the creation of the *New Development Bank*, which has a majority of Chinese capital, is a means of increasing the use of the RMB by granting loans denominated in the Chinese currency. The ambitious *Belt and Road Initiative*, launched in 2013 by the Chinese president, is also an important vehicle for expanding the use of RMB globally.

The most important function, on which the Chinese authorities are very circumspect today, is the RMB's reserve currency dimension. The total convertibility of the RMB, announced several times, is no longer on the agenda even if progress has been achieved. Several central banks have purchased still modest amounts of RMB, but to become a global reserve currency, the RMB should be accepted internationally for investment, financing, payment, and as reserve currency. To date, we are still far from the level of liquidity and depth of the RMB market to reduce transaction costs. We are still far from the opening of the capital account needed to unify the foreign and domestic markets of the Chinese currency.

Specialists (Barry *et al.*, 2017) recall the historical experience of domination, cohabitation and then expansion of the dollar against the British pound. Whereas the United States had become the world's leading economic power since 1870, the pound remained the reference currency for several decades thanks to the network effect of the pound (the international reference currency). It is the opening of the US domestic market that facilitated the international growth of the \$ market. For these specialists, the cohabitation of several convertible currencies is possible, as the cohabitation of the \$ and the € shows today. A system with several dominant currencies would be more stable with several issuers sharing the burden of generating safe and liquid assets in times of crisis (Smart, 2018).

Table no. 1 – The RMB and the 4 key attributes of a convertible currency according to McKinnon

Private	Official
1. Medium of exchange (immediate payment/settlement)	
International payment Trade settlement FDI and ODI	Bilateral currency swap
2. Store and value (Banking and reserve)	
RMB assets held by overseas institutions within China Quotas RMB's turnover in FX market	IMF COFER9
3. Unit of account (Invoice and peg)	
Trade invoice in RMB	Spécial Drawing Rights valuation
4. Standard of deferred payment	
Private bonds	Sovereign bonds

Source: Natixis (2018)

4. THE SLOW INTERNATIONALIZATION OF THE RMB

Following the reforms introduced since the 1980s, the opening of China has led to a strong growth of its foreign trade. The export-led growth model has unfolded in different stages (Box 2) involving different accumulation patterns, on the one hand, and foreign exchange rate, on the other.

China's monetary policy remained unchanged between the years 1991 and 2005. The exchange rate remained pegged to the US \$ at the rate of 8.18 RMB to the dollar; a wider daily fluctuation band was introduced followed by a revaluation of the Chinese currency. At the same time, attempts to open up the capital account were undertaken through the establishment of channels between the Chinese financial centers and the Hong Kong financial center by creating the first offshore RMB market. The Chinese authorities have continued to promote the use of RMB for Chinese merchandise exports and non-commodity imports. China has swap agreements with many financial markets including developed countries. Several European financial centers have become RMB bond issue centers. Finally, several central banks (including those of Great Britain, France, Italy) now include the Chinese currency among their foreign exchange reserves.

Box 2 – China's neo-mercantilist growth model

Basic accumulation model 1980-2001	Upset accumulation model 2002-2008	Towards a more exposed accumulation model? 2008-
Low wages, abundant labor	Rising wages and social expenditures.	Wages up, tension in the labor market, wage growth, robotization Greater social protection. Increase in wages > increase in productivity
Mass production of low value-added goods	Production of higher value-added goods, assembly of imported inputs. Role of incoming IDEs in the upmarket. Transfer (often forced) of technology Relocation of low VA and intensive low-skilled productions (Cambodia, Vietnam)	Production of higher value-added goods incorporating domestic input benefits, integration into international value chains, internationalization of Chinese firms through the acquisition of assets in advanced economies (market research, technology). Securing supplies of raw materials (Asia)
Soft fiscal constraint (political financing),	Soft budget constraint (political financing) but appreciation of the RMB; Expansionary fiscal and monetary policy after 2008	Soft fiscal constraint (political financing), distortions in access to finance between state and non-state firms. Maintaining strong subsidies to state investments
Excess balance of payments	Excess balance of payments	Excess balance of payments but current account close to zero
Numerous barriers to entry (prior to WTO accession)	Reducing barriers to entry, maintaining barriers in strategic sectors (finance) WTO Membership, Inbound FDI inflows	Supply Policy: Modernization of Firms, Regulatory Change, but Support to State Firms Demand policy: stronger competition in mature markets, refocusing on the domestic market. End of growth model driven by exports; increasing role of investment-led growth policies

On November 30, 2015, the IMF granted the Chinese currency the status of reserve currency; On October 1, 2016 the RMB joined the €, ¥, £ and US \$ in the basket of currencies that make up the Special Drawing Rights (SDRs). To date, the RMB's share is still very small by relative to the major reserve currencies ([Figure no. 3](#)) in relation to the dominant currencies, the dollar and the euro.

The creation of new banks with significant Chinese holdings in Asia (Asian Infrastructure Investment Bank) as well as in the context of BRICS (New Development Bank) is an important lever to promote the use of the RMB and to avoid resorting to the US dollar. The ambitious BRI project initiated and driven by China is also a way to promote the international use of the Chinese currency.

5. A DIRTY FLOAT?: FROM PEGGING TO MANAGED FLOATING

The exchange rate of the RMB remains closely monitored. The current system is a BBC (Band, Basket, Crawling) floating type. It is determined by a range of fluctuation (Band) which is widening more and more: it has gone from more at least 0,5% in 2007, to plus or minus 1% in 2012 to establish since 2014 in a range of plus or minus 2%. At the same time the currency is pegged to a basket of currencies (Basket), composed of more than twenty currencies but which is strongly influenced by the main currencies of the countries

with which China trades: \$, € and Japanese Yen (Figure no. 2). Finally, depending on the tension in the currency markets, monetary authorities may resort to incremental adjustments (Crawling).

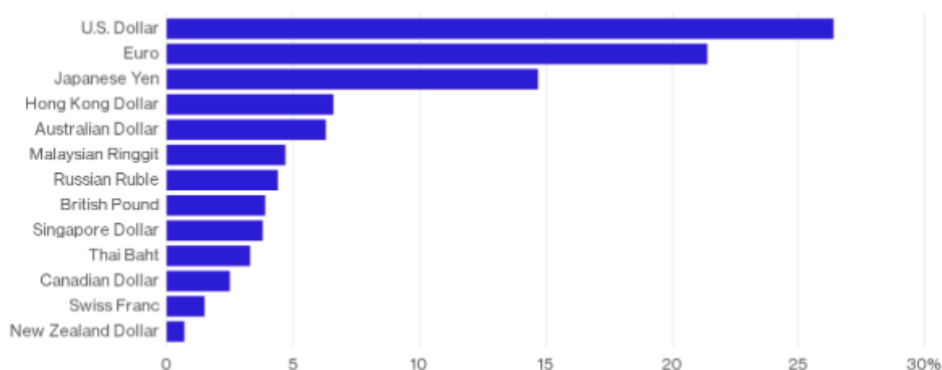


Figure no. 2 – Currency Weightings in China Foreign Exchange Trade System (CFETS) RMB Index
Source: Bloomberg

6. ARBITRATION BETWEEN INTERNATIONALIZATION AND DELEVERAGING: A BRAKE ON THE INTERNATIONALIZATION OF THE RMB

In the early 2010s, the most optimistic analysts announced that the convertibility of the Chinese Yuan would occur during this decade. Despite efforts to both support its internationalization and reduce the control of the capital account, the RMB still remains a relatively small currency at the international level (Figure no. 3) both in trade, reserves, financing of economy.

The change in economic conditions (decline in activity, impact of the trade war) and domestic structural constraints (increasing debt, default risk of financial institutions) have a direct impact on the internationalization of the RMB whose depreciation has recently accelerated.

Several factors are behind this reversal (Benn and Smith, 2017):

- During the period 2005-2013, the RMB appreciated by 36.7% against the \$. Since it has lost more than 11% of its value despite support from the Chinese Central Bank (PBoC) to support the currency, pushing investors to abandon the currency.
- The fall in the RMB reflects the slowdown in Chinese growth driven by debt and the accumulation of default risks despite the policies of stabilizing the level of non-performing loans (NPLs) in the Chinese banking sector. These bad debts reached \$ 220 bn in 2016.

In order to control decline of the RMB exchange rate, the Chinese authorities limited, in 2017, the conversion of the RMB into dollars, in particular by reducing the possibilities of acquiring firms abroad to curb the capital outflows of the companies, making the repatriation of capital more difficult for foreign investors. Short-term economic stability outweighs exchange rate flexibility.

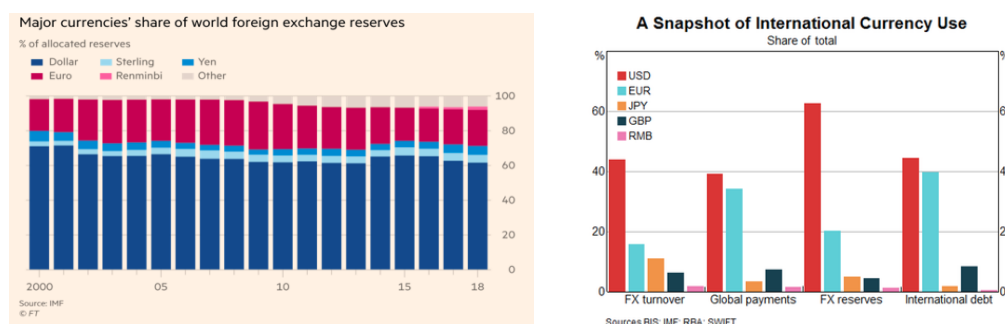


Figure no. 3 – Share of reserve currencies (in%)

Source: FT, UniCredit

A third factor that helps explain the weakness of the RMB is that China has exhausted its export potential. The export volume of more than 15% in 2015 is beginning to decline.

The fourth explanatory factor is the contraction of globalization (Richet and Vercueil, 2019). Capital flows in the form of purchases of shares, bonds, direct investments, loans decreased by 2/3 from 11.9 trillion to 3.3 trillion \$ between 2005 and 2015. Protectionists measures implemented here and there lead to raising customs barriers. Merchandise trade is also declining, shrinking by 10% between 2011 and 2015. China is losing market share in a declining global market.

These factors have a strong impact on the future of the RMB, its international role, especially as a reserve currency that today represents only 1% of the world's reserves.

Today, the priority for the Chinese government is to support economic activity in order to boost growth on the one hand, to tackle deleveraging, the two objectives may be contradictory (Xu, 2018). At the same time, the government must fundamentally restructure the banking system today in great difficulty, and even for some (Pettis, 2019) in bankruptcy. The recovery of the economy in China is generally based on the adoption of Keynesian policies by supporting infrastructure financing providing limited returns, pushing the duplication of businesses without prospects for future profitability, by opening up the credits widely, especially to state-owned firms. This soft budget constraint leads to increased indebtedness and misallocation of resources. Deleveraging itself produces (or should produce) an opposite effect by theoretically making the budget constraint harder (credit squeeze, higher reserve requirements, higher interest rates). However, it is not the case. Financial repression means that the state can continue to finance unprofitable investments by drawing on available savings, including household savings. The risk for China is the possibility of entering a long period of stagnation of its growth.

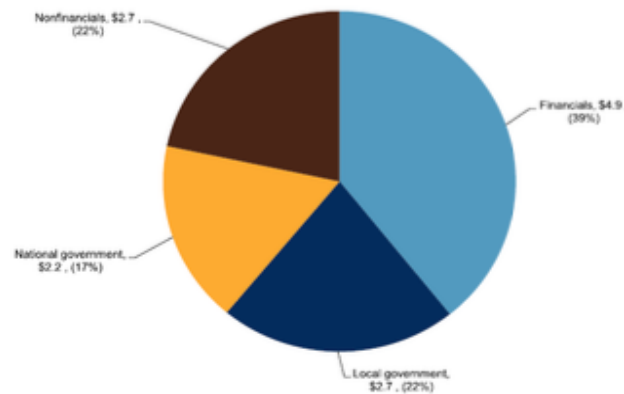


Figure no. 4 – Current Chinese Debt Distribution (in Tril \$)

Source: S&P

The objective of economic stability (in fact social stability) will mobilize the efforts of the Chinese leaders to the detriment of the objectives of internationalization which remains a prerogative. The strategy around the BRI project aims precisely to rely on it to continue to develop the dimension of exchange and investment currency, notably by finding outlets for Chinese companies with overcapacity (Richet, 2019) thanks to loans repayable by borrowing countries, receivers of investments. This strategy is not without risk (see the losses recorded in Venezuela which amount to \$ 23 bns).

The fact remains that the internationalization of the RMB is based on a strong growth of the Chinese economy, the only condition for permanently establishing the Chinese currency as a reserve currency. In China, opinions differ on how to achieve or approach total convertibility (Otero-Iglesias, 2018). A first current suggests the opening of the economy, the end of the monopoly of state enterprises, the profound restructuring of the banking system; the strengthening of the RMB's position in the Asian region (like the € in Europe). Another, more "illiberal" approach is also considered, less market-oriented, as long as the country maintains other key determinants for internationalization such as a large economy and stable macroeconomic framework and enhanced network externalities.

7. CONCLUSION

The internationalization of the RMB is proving harder than expected despite the promising start of the Chinese government's efforts. To date, it represents only 1% of world reserves. Growth as a currency of exchange and investment continues. The measures taken by the Chinese government to protect themselves from speculative capital movements, curbing the capital outflow of Chinese firms have had a negative impact on the appreciation of the RMB. Economic stabilization (revive growth without increasing debt) and financial (restructure the financial system, reduce the risk of default) now outweigh the goal of internationalization of the RMB.

What futures for the Chinese currency?

Abandon the internationalization of the RMB and withdraw from the international money market? This does not seem conceivable because of the importance of China and the project of its leaders to increase its power at the international level.

To develop its financial market, to transform itself into a market economy, to liberalize the exchange system by opening the capital account? This scenario is not on the agenda in the immediate future. It would imply that important structural and institutional measures are taken for restructuring the financial system, end of financial repression, unification of domestic financial and monetary markets with international markets.

It remains the perpetuation of the current status quo, keeping the domestic market in the hands of the State, on the one hand, with the structural imbalances that characterizes it and on the other continuing to expand the RMB as a trade and investment currency. Eventually, the authorities could seek to drive a wedge into the hegemony of the dollar by creating financial instruments (derivative in raw material).

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Notes

¹ The discussion in the following sections is based on Bação *et al.* (2017), Das (2019), Fleming (2019), Gjoza (2018), Kwan Chi (2018), McNally and Gruin (2017), Elcano Royal Institute (2018), Shih (2019), Wildau and Mitchell (2016) and Callan and Halpern (2018).

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