Evaluating Prospects of Internationalization of Chinese RMB

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Abstract

The possibility of RMB becoming an international currency has generated global excitement. In this paper, the author will evaluate the determinants of an international currency, assess the current strategies of RMB internationalization and argue that the Chinese government has a long way to go in liberalizing its capital account before RMB internationalization can occur. The RMB internationalization, despite its great momentum and rapid development, is still in its nascent stage and currency internationalization induced solely by government policies is unlikely to yield ideal results.
I. Introduction

The prospect of Chinese currency Renminbi (RMB) becoming an international currency has globally generated much excitement. Since its launch in early 2009, the internationalization of RMB has progressed rapidly. In contrast to the histories of other major existing international currencies (US Dollar / USD, Euro, Japanese Yen, UK Pound Sterling), the internationalization of RMB has proceeded on a starkly different track. Because the Chinese RMB began as international currency in the off-shore market in Hong Kong, (the Special Administration Region), and not the onshore (Mainland Chinese) market, it has followed a particular path in currency internationalization. This strategy has been pursued because the Chinese government, which adopts a heavy-handed approach in economic policies, has begun to internationalize the RMB before fully liberalizing China’s capital account.

In this paper, the author will argue that it is important, however, that the Chinese liberalize their capital accounts before the RMB can become an international currency. The process of currency internationalization will be ineffective or highly likely to lose its current momentum if it is solely induced by government policies and fiat will. The internationalization of RMB should be the natural outcome of the sustained improvement of economic and financial market fundamentals.

The organization of the paper is detailed below. The author will first assess the determinant of international currency, specifically, in the Chinese context. Second, the author will conduct a brief review of RMB internationalization policies and current status. Last but not least, the author will evaluate the policies and present my aforementioned arguments.
II. Background

In this section, the author will introduce the concept of international currency as well as advantages and disadvantages of having Chinese RMB become internationalized.

2.1 Definition

There is a large amount of literature explaining the nature of an international currency and ways to internationalize a national currency.¹ In essence, a currency is internationalized when market participants - residents and non-residents - conveniently use it to conduct economic and financial activities including trade, investment and offshore invoicing. Theoretical discussions on currency internationalization must begin with an understanding of the functions of having an international currency. Chinn and Frankel² extended the basic theoretical functions of money: as a store of value, a medium of exchange, and a unit of account into an international currency where it takes on certain distinctive functions and features. Their work is summarized in Table 1 below.

Table 1: The Role of an International Currency

<table>
<thead>
<tr>
<th>Function of money</th>
<th>Governments</th>
<th>Private Actors</th>
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<tbody>
<tr>
<td>Store of value</td>
<td>International reserves</td>
<td>Currency substitution (dollarization) and investment (portfolio allocation)</td>
</tr>
<tr>
<td>Medium of exchange</td>
<td>Foreign exchange market intervention</td>
<td>Vehicle currency, invoicing trade and financial transactions, settlement currency</td>
</tr>
<tr>
<td>Unit of account</td>
<td>Anchor for pegging local currency</td>
<td>Denominating trade and financial transactions</td>
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2 Chinn and Frankel (2005)
According to Chinn and Frankel, an international currency not only has three basic functions of money, but also can be further divided into two sub-functions, namely private and public usage. To illustrate, when an international currency is used for private sectors, it is used for currency substitution, trading currency in foreign exchange markets, and invoicing and denominating trade and financial transactions. For public sectors, it functions as a reserve, intervention, and anchor currency. It is reasonable to claim that a currency can play the role of an international currency on different levels. The highest level in this case is the role as an international reserve currency, because it demonstrates a nation’s confidence of that currency as a store of value, medium of exchange, and in some cases, unit of account.

Given the definition of international currency, it is reasonable to question motivation of the Chinese government in promoting its currency on international stage. The author will delineate a cost and benefit analysis below in light of Chinese context.

2.2 Advantages of an International Currency

The first benefit of currency internationalization is minimization of exchange rate risk. If the trade is invoiced and settled in RMB, the exchange rate risk for both importers and exporters would be minimized if not eliminated. For example, Chinese importers purchase goods overseas and sell the goods domestically while exporters purchase raw materials and pay wages for workers domestically and sell the goods overseas. If these transactions can all be cleared in RMB, no difference will arise from exchange rate fluctuations between the time of purchase of goods or raw materials to the time of selling the goods. This minimization of exchange rate risk is particularly
significant for trade contracts which cause payment to become due after goods are initially ordered.

Second, currency internationalization will allow China to benefit from lower transaction costs. In the financial and banking sector, Swoboda characterized this advantage as “denomination rent.”\(^3\) Domestic banks of an international currency enjoy greater access to the resources of the currency issuing country’s central bank. These banks can therefore more easily issue liabilities denominated in the currency. There is potential to generate broader business overseas with lower costs, leading to greater earnings. These earnings include additional earnings arising from commissions for a greater volume of foreign exchange transactions and fees for loans and other banking services. For non-financial enterprises, an international currency will give domestic importers and exporters advantages in trade finance, promoting a further expansion of international trade. Ordinary citizens also benefit because they can use their own money conveniently to travel abroad.

Third, currency internationalization will increase the efficiency of borrowing for financial institutions. For example, a Chinese bank will have a broader investor base after currency internationalization and be able to finance its expansion and operation at a lower cost. In addition, domestic manufacturers will have greater access to funding and can borrow more cheaply by issuing corporate bonds to a more liquid and deeper market. This is particularly relevant in the current Chinese context as many Chinese corporations are struggling to secure funding from the state-controlled banks.

Fourth, the internationalization of RMB means that China will no longer have to hold a large reserve of USD as a medium of exchange and a store of value. This

\(^3\) Swoboda (1968)
reduction in USD denominated asset holdings will significantly reduce the seigniorage\textsuperscript{4} paid to the U.S. In addition, as other countries start to use RMB in trade, China is actually exchanging paper money for real resources. This outflow of RMB will not only result in seigniorage revenue, but also improve China’s status and influence in international affairs. In light of the three rounds of U.S. Quantitative Easing, and the long-term trend of inflation, this reduction of USD holdings will reduce capital losses on China’s foreign reserve which currently stands at over USD 3 trillion.\textsuperscript{5}

Last but not least, an international currency is a symbol of robustness and resilience for an economy and a source of status and prestige. This can be considered as a form of “soft power” in the international community. The Chinese government may want to have this greater power and influence in the world, given that it has already become a significant economy.

2.3 Disadvantages of an International Currency

The costs associated with currency internationalization come from fluctuations in demand for currency, loss of export competitiveness, and greater responsibility as an international currency issuing country.

First, RMB internationalization requires full convertibility in the Chinese capital account; thus, free cross-border capital flow will cause greater fluctuations in demand for RMB and lead to fluctuations in exchange risk, which may hinder the further internationalization of RMB. The Chinese market will be subjected to sudden currency and capital outflows and inflows and changes in the money market. Hence, the open

\textsuperscript{4} Seigniorage refers to the difference between the value of the money and the cost to produce it. In this case, it means the purchasing power of USD held in Chinese foreign reserve decreases over time.

\textsuperscript{5} Data are sourced from the People’s Bank of China (PBoC).
capital account and therefore, free international capital flows, will influence the country’s exchange rates and price levels. I will further explain this point in Section 3.1.2.

Second, free cross-border capital flow also makes it difficult if not impossible to manage the exchange rate under the current “dirty flow” regime, forcing RMB to appreciate.\(^6\) Aside from the past RMB appreciation trend, a greater demand for RMB will cause RMB to experience further undue appreciation because the more money gains in popularity, the greater is the likelihood that some degree of overvaluation will result. This long-run appreciation of RMB will lead to loss of competitiveness for Chinese exporters and manufacturing industries and massive unemployment with its associated social impacts.

Last but not least, an international currency-issuing country will undoubtedly have to assume greater responsibility for managing broader regional and global economic structures. There may be cases where the country’s central bank will have to accommodate systematic fragilities instead of responding to market-driven forces. Monetary policies have to be restrained and modified in order to contain a crisis or discounted loans have to be extended to countries which lack liquidity.

In conclusion, the Chinese government has considerable incentives to implement policies to internationalize its currency: the benefit of the RMB becoming an international currency will outweigh its costs, if the government continuously pushes for technology and capital-intensive manufacturing, and improves export competiveness to offset the cost of RMB internationalization.

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\(^6\) RMB has appreciated over USD for over 30% since 2005, when it entered the managed flow exchange rate regime.
III. Literature Review

There is an ample amount of literature exploring the determinants of international currency. Chinn and Frankel\(^7\) choose share of currency in global international reserve as a metric to gauge whether a currency is international not only because the amount of the Central Bank’s holding of a particular currency in its foreign reserve is the highest level in role of international currency explained above, but also because it is a most easily quantifiable measure of status of an international currency.

They then summarized and proposed four generally accepted determinants of an international currency for their econometric analysis.

3.1.1 Economic Size

The currency of a country with a large share in the international economy, specifically, in trade output, has a natural advantage in internationalizing its currency. The U.S economy, for instance, is the world’s largest in terms of size. It is reasonable to expect, therefore, that most countries conducting trade or financial transactions with the U.S. will invoice their bills in USD.

3.1.2 Confidence in the Currency

To hold a foreign country’s currency in reserve and to use that currency as a unit of account, the home country should have enough confidence that the currency will not erratically fluctuate in value. In addition, the countries that issue this currency will need to adopt responsible monetary policies with inflation targeting in order to encourage internationalization of its currency in light of diminishing seigniorage paid to these countries.

3.1.3 Financial Market

\(^7\) Chinn and Frankel (2005)
The financial markets of the country which issues the currency should be open, deep and liquid. Openness refers to whether the financial markets are free of control, or in other words, that the home country’s government does not adopt a heavy-handed and protectionist attitude towards foreign capital cross-border flows. Depth refers to the volume of trade and financial transactions undertaken in the major financial markets in the home country. Finally, liquidity refers to how quickly and easily assets can be transferred into cash or cash equivalent items.

### 3.1.4 Network Externalities

An international currency derives its value partly because everyone uses it to invoice trade and clear financial transactions. In this way, the intrinsic characteristics of a currency are of less importance than its path-dependent historical equilibrium. That is, there is a strong bias in favor of using the currency that has been used as an international currency before.

Since each of these four factors is suggestion of vague macroeconomic trends or characteristics, for the purpose of their analysis, Chinn and Frankel\(^8\) identify quantifiable proxy measurements for each of the four determinants above. This is summarized in Table 2 below.

<table>
<thead>
<tr>
<th>Proposed Determinants</th>
<th>Proxy Measurements</th>
</tr>
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<tbody>
<tr>
<td>Economic Size</td>
<td>GDP Share</td>
</tr>
<tr>
<td>Confidence in the currency</td>
<td>Exchange rate volatility</td>
</tr>
<tr>
<td></td>
<td>Inflation rate</td>
</tr>
<tr>
<td>Financial Market (openness, liquidity &amp; depth)</td>
<td>Foreign exchange turnover</td>
</tr>
<tr>
<td>Network Externalities</td>
<td>Lagged shares variable</td>
</tr>
</tbody>
</table>

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\(^8\) Chinn and Frankel (2005)
For economic size, they choose the GDP share of the currency-issuing country compared to the world’s total GDP. This is a good gauge of how influential the economic weight of a particular country is with respect to the world.

For confidence in the currency, they use exchange rate volatility and inflation to measure the stability of value of the currency.

For depth, liquidity and openness of financial markets, it is difficult to select a quantifiable metrics to assess this characteristic. They use foreign exchange markets’ daily average turnover as a proxy measurement.

For network externalities, they introduce an endogenous lagged share variable. This helps us gauge how influential the last period status in terms of the share of a particular currency in international reserves around the world affects this period’s performance.

Chinn and Frankel’s results prove that all aforementioned factors are statistically significant factors for currency internationalization. In addition, there are other economists adopting empirical methods to statistically prove the determinants of international currency. Their studies result in similar determinants as those proposed by Chinn and Frankel. The author will therefore evaluate the aforementioned determinants in the Chinese context in order to gauge the potential of the Chinese RMB to become an international currency.

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9 Relevant papers include Subramanian (2011) and Chen, Peng and Shu (2009).
IV. Internationalization of the Chinese RMB

4.1 Potential of RMB to become an international currency

4.1.1 Economic Size

Since the Chinese government implemented the Reform and Opening-up policies in 1983, China has experienced a double-digit growth rate for much of the past three decades. As shown in Figure 1 below, in 2010, China’s GDP reached USD 5.9 trillion and ended Japan’s 42 year reign as the world’s second largest economy. This growth rate continued after the global financial downturn since 2008. China surprised the economists and analysts by maintaining near 8% GDP growth rate in 2012 and reaching USD 7.3 trillion in GDP.\textsuperscript{10}

Figure 1: Recent Years Chinese GDP Annual Growth Rate \textsuperscript{11}

![Figure 1: Recent Years Chinese GDP Annual Growth Rate](source: www.tradingeconomics.com | National Bureau of Statistics of China)

China has a significant trading sector, the GDP component that is most pertinent to internationalization of Chinese RMB as discussed above. To illustrate, in 2012, China’s import and export totaled USD 3.9 trillion with a year-on-year growth of 6.2%. China’s export was USD 2.0 trillion and its import was USD 1.9 trillion, up by 7.9% and

\textsuperscript{10} GDP Data in this paragraph are sourced from the World Bank.

\textsuperscript{11} Data are sourced from National Bureau of Statistics of China.
4.3% respectively.\textsuperscript{12} Despite efforts from the Chinese government to aggressively promote a consumption-driven economy, China is still heavily dependent on its export sector. In fact, China has become the most central economy in global trade, supporting demand for the RMB as currency of settlement for cross-border trade. In addition, China has consistently enjoyed current account surplus, and at its peak in 2007, the surplus amounts to 10% of the GDP.\textsuperscript{13} This is another beneficial factor for RMB internationalization and will be elaborated in Section 4.1.2.

In terms of economic size, let alone China’s influence on world’s trade and commerce, its currency RMB fared well as a potential international currency.

4.1.2 Confidence in the Currency

Prospective rate of return for RMB is another factor that promotes confidence in the currency. As mentioned in Section 4.1.1, China has consistently achieved current account surplus, this surplus offered firm proof that the RMB (Yuan) was undervalued. Since 2005, the Chinese government has slowly appreciated RMB, and the market expects the RMB to continue to appreciate against the USD in the long run.

Figure 2: Chinese RMB Against USD Exchange Rate \textsuperscript{14}

\footnotesize
\begin{itemize}
\item \textsuperscript{12} Trade data are sourced from Ministry of Commerce, China.
\item \textsuperscript{13} “Fair play or foul?” The Economist, April 21 2012 Edition.
\item \textsuperscript{14} Data are sourced from Trading Economics database.
\end{itemize}
In addition, China has a stable inflation comparable to those in advanced economies despite its robust economic growth. As shown in the Figure 3 below, China has stable CPI figures and this strong economic performance and macroeconomic stability is expected to continue over the medium term. This stability therefore ensures the confidence in the business and government sector because the currency does not fluctuate erratically in value and thus acts as a stable unit of account and store of value.

Figure 3: Recent Years Current China CPI (yearly basis)  

4.1.3 Depth, Openness and Liquidity of Financial Market

Despite recent progress in the financial sector, China’s financial market remains less developed and mature than the markets of developed economies. Although it is difficult to quantify depth, openness and liquidity of a financial market, one can adopt the proxy measurement, namely foreign exchange turnover, used by Chinn and Frankel\textsuperscript{16} to assess the current status of the Chinese financial market. According to the Bank of International Settlements (BIS) triennial central bank survey,\textsuperscript{17} the Chinese financial market remains less developed and mature than the markets of developed economies.

\textsuperscript{15} Data are sourced from National Bureau of Statistics of China.

\textsuperscript{16} Chinn and Frankel (2005)

\textsuperscript{17} BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, April 2010
currency is among the emerging market currencies that experienced significant growth in their trading volume. Its share of global foreign exchange trading increased to 0.9% in 2010 from 0.5% in 2007 and 0.1% in 2004.\textsuperscript{18} Despite the sharp growth, the RMB trading turnover is small compared with the size of the Chinese economy. To illustrate, the major international currencies, the US Dollar, the Euro, the Japanese Yen and British Pound accounted for 84.9%, 39.1%, 19.0% and 12.9% of global foreign exchange trading in the BIS triennial survey.

The Chinese government still maintains strict control on capital flows. The financial markets are relatively closed and illiquid compared with other advanced and emerging economies, despite recent progress to partially open its capital account under Qualified Foreign Institutional Investors (QFII) program and Qualified Domestic Institutional Investors (QDII) program. To maintain the capital control and therefore to effectively monitor and implement monetary policies, Chinese government devises a plan to internationalize its currency without capital account convertibility, a unique path that involves setting up Hong Kong SAR as a offshore center to trade RMB and RMB-denominated financial instruments that will be elaborated in Section 4.2.2.

\subsection*{4.1.4 Network Externalities}

Following the analysis in Section 3.1.4, network externalities strongly favor a single international currency. However, this one currency system has an apparent disadvantage; risks are less diversified when associated with holding assets denominated in a single currency. Although the market for other currencies may be less liquid and deep, resulting in higher transaction costs, the emergence of the Euro now

\textsuperscript{18} Because two currencies are involved in each foreign exchange transaction, the sum of the percentage shares amounts to 200%.
offers a viable alternative to the US Dollar as an international currency. The experience of the 2008 global financial crisis also indicates that it is not sound strategy to hold all the assets denominated in USD, but it is wise to diversify holdings into several other international currencies. In this way, RMB as another alternative to the USD and the Euro may experience fewer network externalities and therefore, not a significant potential setback in RMB internationalization.

In conclusion, China has fared well in terms of its economic size, its significant influence on global trade, and its stable macroeconomic performance. However, it conspicuously lacks a liquid, open and deep financial market to internationalize its currency. To overcome the last factor, the Chinese government devised various policies to promote trade settlement in RMB and set up Hong Kong as a center to promote RMB on the international stage. I will delve into this topic and highlight the potential problems with this design and present my arguments mentioned in the Introduction of this paper.

4.2 International Functionalities of RMB and China’s Initiatives

At the time of writing, Chinese RMB is not included in the latest Standard Drawing Right (SDR) basket. The SDR basket selects currencies based on the size of the exports sector and whether the currency is freely usable, meaning whether the currencies are wildly used and traded in the global market. As aforementioned, China is the most central economy in global trade, and the reason its currency RMB is not included in the SDR is the currency usage criterion. In addition, the share of a currency in the SDR depends on the value of the export sector and the amount of the currency held as international reserve by central banks. The international reserve role of RMB is almost non-existent, limiting its potential acting as an SDR component currency.
To promote RMB’s international usage, the Chinese government implemented various policies on trade settlement and convertibility.

4.2.1 Trade Settlement Currency

In April 2009, China announced a pilot RMB (Yuan) trade settlement scheme in five cities: Shanghai and four other Chinese cities in Guangdong Province. In June 2010, the scheme extended as the program eligibility was expanded to cover 20 of the 32 Mainland Chinese provinces and to companies that are headquartered in and outside Hong Kong. In August 2011, cross-border trade settlement was again expanded to the whole nation. By now, all of Mainland China’s external trade and current account transactions can be settled in RMB. At the same time, the type of trade also diversifies from physical goods into services. The expansion of geographic coverage and types of trade was followed by a discernible increase in the volume of RMB cross-border trade settlement. According to data from Hong Kong Monetary Authority (HKMA), the total volume of cross-border RMB trade settlement increased from RMB 506 billion in 2010 to RMB 2.08 trillion in 2011. Nevertheless, the percentage of Mainland’s trade settled in RMB was only 2% and 8% in 2010 and in 2011 respectively. This number is much lower than the numbers of advanced economies with international currency. For example, percentages of trade settled in local currency for the U.S., Europe and Japan were 80+%, 50+% and 30+% respectively.

The RMB trade settlement is complementary to the bilateral currency swap agreements that China arranged with other economies in recent years in order to

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19 “The Pivotal role of Hong Kong in the offshore RMB market,” June 2012, Peter Pang, Deputy Chief Executive, Hong Kong Monetary Authority
20 Data are sourced from International Monetary Fund (IMF), European Central Bank (ECB), and Ministry of Finance Japan.
promote RMB internationalization. These agreements aim to provide liquidity support and extend credit to trade partners and are initially deemed as policy measures to alleviate the trade contraction effect of the dollar shortage during the global financial crisis. They allow the economies in swap agreements to offer RMB trade financing to the local importers to buy Chinese goods. By the end of 2012, PBoC has entered into currency swap agreements with the central banks or monetary authorities of 19 countries and regions. Total transaction amount of these currency swap deals stands at USD 320.3 billion.\(^{21}\) These series of swap agreements with some of China’s key trading partners include Argentina, Australia, Brazil, Indonesia, Japan, Korea, Malaysia, New Zealand, Singapore, and UAE,\(^{22}\) and are seen as part of a push for a more international role of the RMB.

### 4.2.2 The Offshore Market in Hong Kong

Hong Kong is chosen as a testing ground for assessing the impact of RMB convertibility and capital account liberalization, because it has full capital account convertibility. A Special Administrative Region (SAR) of China, Hong Kong SAR has its independent legal and financial systems. This practice aligns with the Chinese government’s philosophy of gradualism approach in implementing its financial market reforms.

The role of Hong Kong in promotion of RMB internationalization includes three major aspects, namely, RMB cross-border trade settlement, RMB offshore deposits and the issuance of RMB denominated bonds.

#### 4.2.2.1 RMB cross-border trade settlement

\(^{21}\)“Value of China’s currency swap deals reaches RMB2 tn,” Wantchinatimes, March 26\(^{\text{th}}\), 2013.

\(^{22}\)Data are sourced from PBoC.
As mentioned in Section 4.2.1, the Chinese government has promoted RMB cross-border trade settlement. Most of these trade settlements are handled by banks in Hong Kong. The percentage of total RMB trade settlement handled in Hong Kong was 72.92% and 92.02% in 2010 and 2011.²³

4.2.2.2 RMB offshore deposits

Hong Kong is allowed to develop an offshore RMB deposit market in 2004. Individuals are allowed to convert up to 20-thousand Yuan daily in Hong Kong, and selected industries are allowed to conduct selected corresponding RMB services. From Figure 4 below, we find that the RMB offshore deposits were steadily increasing to early 2010 and increased dramatically since then. This is one of the most direct and immediate result of the increase in RMB settlement. However, we notice a drop in RMB deposits in October 2011. The reason for this change will be explained under Section V.

Figure 4 RMB Deposits held by Hong Kong Residents (RMB billion) ²⁴

²³ Data are sourced from HKMA.
²⁴ Data are sourced from CEIC database and BBVA Research.
4.2.2.3 The Issuance of RMB Denominated Bonds

Another milestone of the offshore market experiment was the issuance of the “dim-sum” bond, a bond issued in Hong Kong and denominated in RMB. There is clear expansion of offshore issuance of RMB denominated liabilities in Hong Kong. The volume of “dim-sum” bond issuance increased from HKD 34 billion in 2010 to almost HKD 300 billion in 2011. The bond was first issued by the China Development Bank, a Chinese policy bank, in 2007. The bond issuers then diversified into different industries. For example, McDonald’s, Bank of East Asia, HSBC, Bank of Tokyo, Deutsche Bank, Tesco, Caterpillar are some of the later issuers.

Figure 5 “Dim-Sum” Bond Issuance

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25 Data are sourced from HKMA.
26 Data are sourced from CEIC database and BBVA Research.
V. Challenges of RMB Internationalization

On internationalizing RMB, the Chinese government adopted a measured strategy and used Hong Kong as a testing ground as mentioned before. A well-established offshore market helps to accurately assess the impact of cross-border trade settlement and capital account liberalization without loosening capital control of the onshore market in Mainland China. To summarize, the offshore market started with an RMB deposit market in 2004, followed by institutional bond issuance in 2007 and finally expanded to all fronts including RMB trade settlement in 2009 and RMB currency trading. The success of these experiments and potential of RMB as an international currency are difficult to gauge because of the heavy-handed approach of the Chinese government in promoting currency internationalization. For example, the bond issuance is dominated by official and quasi-official Chinese institutions including Bank of China and China Development Bank. The issuances of foreign corporations however are subjected to strict controls in remitting proceeds to Mainland China. RMB trading is still in nascent stage and is heavily regulated by the Chinese regulator.

Despite the major milestones achieved by the offshore Hong Kong market delineated above, there are signs showing that this offshore/onshore model has run into problems and that the RMB internationalization has significant challenges ahead.

First, despite the phenomenal growth of Hong Kong offshore RMB market in recent years, its size remains small compared with that of the Chinese economy. The RMB bonds and deposits in Hong Kong are insignificant fraction of total RMB bonds and deposits. In addition, the future path of the offshore RMB market is crucially dependent on the Chinese government’s policies. It is well-known that China is
promoting Shanghai as an alternative center of RMB internationalization through measures such as establishing Shanghai International Board, in which credible foreign entities will be able to conduct equity financing. The will of the Chinese government on the RMB convertibility in Hong Kong may also change depending on global and Chinese macroeconomic conditions. These factors essentially render the future RMB internationalization process less predictable, therefore, challenging the current offshore / onshore model and lowering the confidence in RMB as an international currency.

Second, offshore RMB deposits reached RMB 580 billion in July 2011 and RMB 622 billion in September 2011, but then it unexpectedly peaked. According to Yu, this is due to the asymmetry between imports and exports in the RMB settlement. The rapid growth in RMB trade settlement was caused solely by imports, since the import settlement is 10 times more than that of exports in fourth quarter of 2010. This asymmetry is due to two chief reasons. First, foreign exporters demand RMB because they expect RMB’s to appreciate. Second, Chinese importers also want to use RMB to conduct exchange-rate arbitrage between onshore CNY market & offshore CNH market. This is evidenced from the premium enjoyed by the offshore CNH market over the onshore CNY market shown below in Figure 6. This is also evidenced from the fact that RMB settlement is larger than RMB invoicing, meaning most cross-border trade is still invoiced in USD because of the confidence in US Dollar as an international currency. As more trade is settled using RMB in Hong Kong, the RMB deposits grow. The trend reversed in October 2011, which brought the asymmetry down and explained the turnaround of RMB deposits in Hong Kong. Because the trade is still invoiced in USD, evidence of RMB internationalization in offshore Hong Kong market may not

Yu (2012)
demonstrate the strength of the RMB. In fact, it is undoubtedly a symptom of the difficulties of internationalizing the RMB if the government restricts capital flows. We can therefore conclude that one of the major forces in development of RMB internationalization and in its slow down in the third quarter of 2011 is the onshore / offshore exchange rate arbitrage. This arbitrage is not the objective of the Chinese government because it exacerbates China’s balance sheet instead of strengthening it, and the development of RMB internationalization can be easily reserved.

Figure 6 Left: RMB / USD Spot Rates; Right: RMB deposits in Hong Kong

Third, the offshore / onshore model is innately contradictory. This model ensures that the Chinese government can internationalize the RMB before fully liberalizing its capital account. On one hand, in the onshore market, lending is subject to quantitative guidance. Cross-border capital flows are subject to heavy control and regulation. Bonds are rationed and credit growth and allocation are supervised. On the other hand, the offshore market has full convertibility. The Chinese government aims to address tension between promoting RMB internationalization, which requires full capital account

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28 Data for RMB / USD spot rates are sourced from Bloomberg and McCauley (2011). Data for RMB deposits in Hong Kong are sourced from CEIC database and BBVA Research.
convertibility, and protecting its export-driven economy, which requires strict control on capital flows by setting up the offshore market. The rationale behind this model is that maintaining macroeconomic stability will become much more challenging as the economy becomes more integrated into the rest of the world and as the Chinese government distances itself from domestic banks and thus, policy lending. This reduced control on banks in turn undermines the political legitimacy of the Chinese government and its ability to allocate capital effectively. In addition, liberalizing capital account requires fundamental changes in the Chinese development model and overhaul of its less mature financial market. To illustrate, the supervision and regulation of financial institutions and market will need to be reinforced. Exchange-rate flexibility will have to be enhanced to reduce shock and volatility to the cross-border capital flow. Most importantly, the export-driven growth model will not be sustainable. China needs to transition from an export-driven economy to a consumption-driven economy and that transition will be especially costly in the short term, again causing political and social instability. However, despite the costs, experiences from previously internationalized currency (UK Pounds, US Dollar, Euro and Japanese Yen) prove that these economic fundamentals are necessary for currency internationalization.\textsuperscript{29} Otherwise, as pointed out in previous two challenges, internationalization of RMB localized in an offshore center and without liberalizing capital account will not be successful.

\textsuperscript{29} Chinn and Frankel (2005)
VI. Conclusions

From analysis presented in this paper, one can safely claim that China is positioned well to internationalize its currency in terms of its economic and trading sector size, its robust and stable growth and the increasing benefit of diversifying asset holdings denominated in a single currency into those denominated in several currencies. However, RMB internationalization solely induced by policies or willingness of the Chinese government will most likely be ineffective and futile. In fact, currency internationalization should be the natural outcome of development of economic and financial market fundamentals. RMB internationalization indeed has a long way to go. As governor of the People's Bank of China Zhou Xiaochuan states, “it is the result of the growing power of the nation and its financial market boom ... though there is still much to do considering the low level of development and openness” and “in general, we should do our homework, and let the market decide which currency should be used”.30

The current offshore / onshore model can only serves a testing ground for RMB internationalization. In order to successfully internationalize RMB, the Chinese government should first liberalize its capital account and ensures full convertibility. One will then ask whether the Chinese government should speed up the opening of its capital account. The author believes that the timing is not right now because the uncertainty in the U.S. and the Europe results in great uncertainty; therefore, potential risks are huge. The far-reaching restructuring in Chinese economic growth and financial market development models are costly yet essential for RMB to become an international currency. One can foresee strong political and social resistance to transition China into

30 China Daily, June 5, 2012
a capital-intensive and consumption-driven economy. However, these changes are in process.

Finally, it seems that the Chinese government is promoting RMB internationalization offshore in order to push for onshore financial market reforms. The author believes however that the Chinese government should first focus on domestic structural reform, devising a best sequence for capital account liberalization, and gradually loosening its capital account. RMB internationalization will naturally follow once the economic and financial fundamentals are in place.
VII. Bibliography


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