The Renminbi Challenge

The future role of the Chinese currency.

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With the rapid economic ascent of China in the new millennium, the explosion of the global crisis in 2008–2009, and the consequent discrediting of the U.S. and European financial models, as well as recent new policy initiatives adopted by Beijing toward its own currency, there have been growing debates on the future role of the renminbi. Will the Chinese unit challenge the primacy of the U.S. dollar in the international monetary system? These unfolding developments have been further fuelled by senior officials of the People's Bank of China who have recently become increasingly vocal in world forums on the need of other economies to rely less on the dollar as a reserve currency and for trade settlement.

THREE FUNCTIONS OF AN INTERNATIONAL CURRENCY

Economists generally agree that for a currency to gain international stature, there must be strong demand by world traders, investors, and central bankers for the currency as a medium of exchange for foreign trade settlement, a unit of account for denominating international financial transactions, and a store of value for central banks' foreign exchange reserves. Hitherto, the dollar, euro, and yen—the so-called "Big Three" currencies—have been fulfilling these three tasks by virtue of the fact that the GDP size, trade volumes, and financial markets of the three note-issuing economies are the world's largest. As such, the dollar, euro, and yen in combination also account for an overwhelming 94 percent of the world's total official foreign exchange reserves.

THREE DETERMINANTS OF CURRENCY INTERNATIONALIZATION

Monetary economists agree that three key economic pillars are required to support the internationalization of a currency: the size of an economy and its trade volume; the breadth,

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Comparison of Reserve Currencies

Currency	COFER	Country	1. Share of World GDP Average (1998–2007)	2. Share of World Trade Average (1998–2007)	3. Share of FDI Inflows Average (1998–2007)	4. Share of FDI Outflows Average (1998–2007)	5. Share of FX Turnover April 2007	6. Stock Market Cap per GDP Average (1998–2007)	7. Inflation Rate Average (1998–2007)	8. Exchange Rate Volatility (1997–2007)
U.S. dollar	64.0%	United States	28.5%	13.0%	17.5%	17.2%	16.1%	140.4%	2.6%	4.5
Euro	26.5%	Euro Area	22.0%	29.7%	25.9%	37.5%	10.3%	66.7%	1.9%	5.4
Yen	3.3%	Japan	11.2%	4.8%	0.7%	3.8%	5.9%	79.1%	-0.2%	8.2
Pound	4.1%	United Kingdom	4.9%	5.1%	9.7%	12.6%	34.7%	148.6%	2.8%	5.0
Renminbi	0.0%	China	4.6%	5.1%	5.6%	0.8%	0.3%	45.6%	1.1%	4.4

Notes: Variables 1,2,3,4, and 5 refer to the specific amount as a share of the world total.
COFER: Currency composition of official foreign exchange reserves (world total).
Sources: 1 and 2, World Bank, World Development Indicators; 3 and 4, UNCTAD; 5, BIS Triennial Central Bank Survey of Foreign Exchange Market Activity; 6, World Bank, Database on Financial Development and Structure; 7 and 8, Chen and Peng (2007). Authors' calculation.

depth, and liquidity of its capital markets; and the stability and convertibility of its currency.

The United States, the euro area, and Japan account for 28.5 percent, 22.0 percent and 11.2 percent of world GDP respectively, compared to China at 4.6 percent (see table). However, with breakneck growth rates since the beginning of the twenty-first century, China has managed to surpass the United Kingdom in 2005 and Germany in 2007 to become the world's third-largest economy after Japan and the United States. Goldman Sachs has projected that China will overtake the United States to become the world's largest economy by 2027, should China continue to grow at its current rate.

However, large GDP is not necessarily equal to a wealthy or healthy economy. Despite its number-three world ranking in absolute economic size, China remains far behind the other leading economies in average per capita income level. In the long run, even though China's GDP per capita is projected to surge exponentially to US$49,650 by 2050, up from US$2,432 in 2007, it will still lag far behind that of the United States (US$91,683) and many other developed and emerging economies, according to Goldman Sachs.

Furthermore, despite optimistic projections of China's future growth potential, its economy is still beset by numerous imbalances and risks in the medium term. These include persistent and even widening regional economic disparity and rural-urban income inequality, rising social unrest and inter-ethnic conflicts, rampant corruption, and serious environmental degradation. An eruption of any or several of these "fault lines" could put a sharp brake on the ascent of the Chinese economy, and at the same time propel the renminbi onto an inordinately volatile trajectory.

In terms of trade volume as a share of the world total, the home countries of the "big three" currencies account for almost half of the world trade, with the United States representing 13 percent, the euro area 29.7 percent and Japan 4.8 percent, compared to China's 5.1 percent. By 2007, however, China's trade volume had surged to US$2,376 billion, having already overtaken Japan and the United Kingdom in 2004. In the first half of 2009, the World Trade Organization reported that China had surpassed Germany to become the second-largest exporting nation in the world.

Accompanying the surging foreign trade is the expanding trade settlement by the renminbi, which has already evolved into a major currency for cross-border trade settlement with neighboring countries such as Vietnam, Cambodia, Russia, and Mongolia. At the end of 2008, the Chinese government announced pilot programs allowing Guangdong province and the Yangtze River delta (including Shanghai) to use the renminbi to settle trade deals with Hong Kong and Macao. A similar arrangement has been proposed to allow Guangxi and Yunnan provinces to use the renminbi to settle trade accounts with selected members of the Association of Southeast Asian Nations. Another recent and significant step is the announcement by the State Council that five trial cities—Shanghai, Guangzhou, Shenzhen, Zhuhai, and Dongguan—are designated to spearhead international trade settlement in the renminbi with overseas counterparties.

Moreover, in order to mitigate exchange-rate risks arising from trade settlement in the dollar, China has entered into bilateral currency-swap agreements with a number of trading partners. Since December 2008, the People's Bank of China has signed a total of RMB¥650 billion worth of currency-swap agreements with Hong Kong, South Korea, Indonesia, Malaysia, Argentina, and Belarus. Moreover, the People's Bank of China is still in talks with other central banks to ink additional swap agreements, and is likely to expand them to cover all of the country's trade with Asia, excluding Japan. Such recent progress signals that the Chinese government is beginning to set the renminbi on a liberalization path, starting with a gentle push of the unit to raise its profile as a medium of exchange in its regional backyard.

Aside from innate economic strength, the home country of an international currency should offer open and sophisticated transaction venues where foreign dealers can trade a range of the currency-denominated financial products, while at the same time put in place regulatory and macroeconomic safeguards to minimize the unit's volatility and exchange rate-related risk. Countries with less restriction on capital account transactions are more likely to promote short-term portfolio inflows and outflows, and hence tend to facilitate high and far-reaching circulation of their currencies offshore.

Despite optimistic projections of China's future growth potential, its economy is still beset by numerous imbalances and risks.

The renminbi lacks the foremost prerequisite to become a global currency: free and full convertibility.

Compared to more developed capital markets elsewhere, it is clear that China's capital markets are still at early stage and it may take China one to two decades to develop capital markets into comparable breadth and depth. First of all, China's capital markets are relatively shallow such that fundraising opportunities by Chinese companies through domestic capital markets are limited. By global standards, China has lower equity and bond market capitalizations to GDP ratios relative to that of issuing countries of major currencies. Furthermore, despite a banking sector as large as 9.1 percent of total global bank assets, China's equity and bond market capitalizations only make up 5.9 percent and 2.4 percent of the world's equity and bond markets respectively, according to Deutsche Bank Research.

Second, due to regulatory barriers on access to China's capital markets, the latter's interaction with foreign markets and openness to the rest of the world is still very restricted. In terms of inward portfolio investments to China, the average amount between 2003 and 2007 represented a mere 0.7 percent of total portfolio investments globally. As of mid-2009, only eighty-seven foreign financial entities were entitled to the qualified foreign institutional investor status, which allows them to trade renminbi-denominated A-shares on secondary markets with an aggregate limit of not more than US$30 billion, or just 1–2 percent of the Shanghai exchange's market capitalization. Furthermore, the purchase of foreign currency-denominated B-shares is also limited to a selected group of foreign institutional investors, and the size of Hong Kong-listed H-shares is but a fraction of the Shanghai and Shenzhen markets.

Third, low efficiency, high transaction costs, and weak supervisory and regulatory frameworks have been major constraints to the integration between China's capital markets and the international financial system. As for equity

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issuance, China still practices a merit-based approval system in comparison to registration-based systems in most overseas mature capital markets. In addition, China's equity and bond transaction costs are also much higher than in more developed markets. According to a comparison of financial transaction costs done by the China Securities Regulatory Commission, the Shanghai and Shenzhen stock exchanges have an average cost of 50 basis points (20 basis points as average commission and 30 as transaction fee), which is much higher than the average of 21 basis points in most mature markets. As for bond transaction costs, China has an average cost of 6.3 basis points, dwarfing the 1.0 cost in the United Kingdom, South Korea, India, and Singapore, 0.4 in the United States, and 0.5 in Japan. In view of the increasing competitiveness among world financial markets, the current bureaucratic supervisory system in China needs to be reformed to a more professional framework by international standards, and transaction costs also need to be reduced substantially.

Nevertheless, some progressive steps have been taken recently to add more breadth and depth to China's capital markets. These include regulators' latest announcements of plans to allow qualified foreign-invested firms to list on the Shanghai exchange in 2010, raise the investment limit per qualified foreign institutional investor from US$800 million to US$1.0 billion, approve foreign banks to issue renminbi-denominated corporate bonds, and build Shanghai into an international financial center by 2020. Likewise, in an unprecedented move, the Ministry of Finance unveiled the news in September that in order to "promote the yuan in neighboring countries and improve the yuan's international status," it would help establish an offshore renminbi bond market by starting to sell RMB¥6 billion (US$879 million) worth of renminbi-denominated sovereign bonds in Hong Kong to foreign institutional and retail investors.

Despite these progressive steps, it will take some years before China's capital markets can successfully transit to a more open and mature stage. According to the development strategies published by the China Securities Regulatory Commission in 2008, it is forecast to take roughly a decade for China to undergo "the drive to maturity stage" and build up well-developed capital markets by the end of 2020. Still, Deutsche Bank Research has predicted that by 2018, China would account for 13 percent of global bond markets, more than 40 percent of global stock markets, and 18 percent of global banking markets. However, even with these optimistic predictions, our rough estimate is that China's capital markets may need another decade to consolidate their "maturity" status, which would render full renminbi internationalization unlikely before 2020.

Apart from the aforementioned "physical" factors fundamental to the internationalization of a currency, other "psychological" factors such as public confidence in the value of the currency also play a supporting role. From an investor's perspective, which is always mindful of exchange rate-related risk, a currency with less volatility over a long period of time will always be more acceptable as an international currency. Empirically, the stability of a currency can be gauged by its home economy's inflation rate, the acceleration of which would undermine the purchasing power of the currency. The average annual inflation rate in the euro area was fairly low at 1.9 percent over 1998–2007, at 2.6 percent in the United States, and at 2.8 percent in the United Kingdom, compared to a lower rate of 1.1 percent in China and even a negative record in Japan. A second measure of currency stability is the unit's exchange rate volatility, which can be calculated as the standard deviation of daily percentage change in the exchange rate against International Monetary Fund's Special Drawing Rights. Our calculation yields an average score of 4.4 for the renminbi during this period—lower than those of the dollar (4.5), euro (5.4) and yen (8.2) (see table).

Currently, the renminbi lacks the foremost prerequisite to become a global currency: free and full convertibility. While the renminbi became convertible for trade transactions and conditionally for foreign direct investment in 1994, it has been largely nonconvertible for all portfolio capital transactions until now. According to the UBS Capital Restrictiveness Index, China has the highest score (8.4) relative to its neighboring economies in Asia in

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terms of legal impediments to capital account transactions as well as the size and variability of actual cross-border capital flows. Even though every country maintains capital restrictions to some degree, in China's case, despite capital account liberalization reforms over the past fifteen years, it still retains a firm grip on capital account transactions. However, recent policy initiatives taken by the government have demonstrated the likelihood of a faster pace. According to Guo Shuqing, former head of the State Administration of Foreign Exchange, the renminbi would be convertible by 2010 for about 70 percent of the 43 capital transaction items under the IMF classification.

Looking ahead, while there seems to be a good chance that the renminbi may evolve into a regional currency in the next few years, it is probably too optimistic to expect that the Chinese unit will become a global currency before 2020, for reasons analyzed earlier. As such, the renminbi is in no position to challenge the preeminent role of the U.S. dollar in the near future. In addition, out of concern for political, economic, and social stability, the adoption of a gradualist approach has made the Chinese government extremely cautious toward financial liberalization. Therefore, it is not a sure bet that the government would have the political will to push forward aggressive reforms in capital markets, even though the government may have shown some interest in using the renminbi for trade settlement. Furthermore, politically it is also not certain whether other countries would have the confidence to accept the renminbi for various international uses, a currency issued by a country controlled by a communist party. ◆