

Renminbi's Potential to Become a Global Currency

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Abstract

This paper is a tentative endeavor to delineate the potential of the renminbi to become a global currency. It first analyzes the critical economic, financial and policy attributes that are required to support a currency to gain an international role. It then examines whether China has the potential to acquire these attributes. The paper concludes by offering some provisional observations on the implications for Asia and the global economy, should the renminbi evolve into a world currency in the coming decades.

Key words: China, global currency, internationalization, renminbi

JEL codes: E42, F31, F33

I. Introduction

Since the internationalization of the yen in the 1980s and the introduction of the euro in 1999, the international monetary system has been dominated by the “Big Three” currencies: the US dollar, the euro and the yen (Cohen, 2000). 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 US and European financial models, as well as recent new policy initiatives adopted by Beijing toward its own currency, there has been growing debate and speculation on the future role of the renminbi (RMB). Among China’s recent policy shifts include bilateral currency-swap agreements worth RMB650bn (US\$95.0bn) signed between the People’s Bank of China (PBOC) and six other central banks from emerging economies,¹ the

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¹ The six economies are Hong Kong, Korea, Indonesia, Malaysia, Argentina and Belarus. See “Toward swapping China’s currency,” *Wall Street Journal* (31 March 2009), online edition.

introduction of a pilot scheme for offshore trade settlement using the RMB in five Chinese cities,² and an ambitious plan to build Shanghai into an international financial center by 2020;³ all of which seem to aim for facilitating wider international use of the RMB. In addition, senior PBOC officials have recently become increasingly vocal in world forums on the need for other economies to rely less on the dollar as a reserve currency and for trade settlement.

Because RMB internationalization is only a recently emerging issue, there is a paucity of scholarly literature on this subject. What has been published hitherto are mostly conjectural and speculative works with little empirical analyses. The US economists are unanimous in their opinions that the RMB, even if successfully internationalized, will not be able to usurp the dollar's hegemony any time soon (Cohen, 2009; Cooper, 2009; Eichengreen, 2009). However, they do concede that the world monetary system will inevitably move toward a multi-currency regime, with the RMB possibly playing a minor role similar to that of the yen and the pound. Dobson and Masson (2009) point out the long list of yet-to-be implemented financial reforms as obstacles to RMB internationalization, and also argue that a note-issuing country that is controlled by a communist government will likely present a confidence problem for other central banks in terms of holding the RMB as a reserve currency. Asia-based economists are, however, more sanguine about the prospect of RMB internationalization. Hu (2008) confidently predicts that a freely convertible RMB could account for as much as 15–20 percent of the world's total official foreign exchange reserves by 2020. Li (2007), however, highlights the possible benefits and costs stemming from RMB internationalization, and cautions that a careful balance-sheet assessment is necessary before rushing to internationalize the RMB.

The present paper differs from the abovementioned studies in that it offers a more rigorous, empirical-based analysis by using a variety of quantitative indicators to delineate the potential of the RMB to become a global currency. It first dissects the critical economic, financial and policy attributes that are required to support a currency to gain an international role. It is then followed by an examination of whether China has the potential to acquire these attributes. The paper concludes by offering some provisional observations on the implications for Asia and the global economy, should the RMB evolve into a world currency in the coming decades.

² "Yuan edges into place as international trade currency," *China Daily* (17 April 2009), online edition.

³ "State Council: Making Shanghai a new global financial center," *People's Daily* (26 March 2009), online edition.

II. Three Determinants of Currency Internationalization

Economists generally agree that for a currency to gain international status, there must be strong demand by world traders, investors and central bankers for the currency as, respectively, a medium of exchange, a unit of account, and a store of value (Cohen, 1971; Kenen, 1983). First, a currency functions as a medium of exchange if it is widely used for invoicing in international trade settlement. A second function of a global currency is its extensive use in denominating international financial transactions. With respect to the role as a store of value, it is reflected by strong demand by central banks worldwide to acquire the currency as a key component of their official foreign exchange reserves. Hitherto, the dollar, the euro and the yen 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, the euro and the yen in combination also account for an overwhelming 94 percent of the world's total official foreign exchange reserves.

Overall, there is broad agreement among monetary economists that the size of an economy and its trade volume; breadth, depth and liquidity of capital markets; as well as the stability and convertibility of its currency are the three key economic pillars that are required to support the internationalization of a currency (Hartmann, 1998; Cohen, 2000). According to regression analysis by Chinn and Frankel (2005) and the extended modeling results by Chen and Peng (2007), the aforementioned variables in an economy are significantly associated with the extensive use of its currency at the global level.

Building on the existing published literature, Table 1 summarizes an analytical framework

Table 1. Basic Model of Currency Internationalization

| Description | Category | | Measurement |
|-----------------------------------------------|-------------------------------------------------|----------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Currency internationalization | Medium of exchange | | Currency's share of world trade settlement |
| | Unit of account | | Currency's share of world foreign exchange turnover Currency's share of international bond markets |
| | Store of value | | Currency's share in the composition of foreign exchange reserves |
| Three functions | | | |
| AAA equals | Ancestry (economic strength of home country) | | Economy size: share of world GDP Trade volume: share of world trade FDI size: share of world FDI inflows and outflows |
| Determinants of currency internationalization | Acceptability | Capital markets (place to trade and earn) | Country's share of world foreign exchange turnover, via financial centre Stock market capitalization Financial market development (deep) and market access (open) |
| Three aspects | | Currency stability (low risk of losses) | Inflation rate Foreign exchange volatility |
| | Availability (currency convertibility) | | No or few restrictions on foreign exchange conversion and cross-border capital movements |

for currency internationalization by introducing a “Triple-A” concept. First and foremost, a currency must have a respectable and affluent “*ancestry*,” meaning that the note-issuing country must have established a long lineage of being politically influential and economically wealthy among the world of nations. Second, “*acceptability*” of a currency denotes two requirements: one, the existence of highly developed and open capital markets in the home economy where foreign investors can freely trade the currency-denominated financial instruments and generate profit; and two, the currency must have a track record of stability (i.e. minimum volatility) such that investors and traders would have confidence that they would not suffer big losses from exchange-rate-related risks. Third, “*availability*” of a currency refers to its convertibility; it’s important that no or few government restrictions will be imposed on foreign exchange conversion and cross-border capital movements.

1. Ancestry: Economic Strength of the Note-issuing Country

“Great powers have great currencies” (Mundell, 1995). Historical evidence demonstrates that large and competitive economies with global influence tend to generate widely accepted currencies outside their borders. Accordingly, it is not unexpected to find that the issuing countries of major international currencies, namely, the USA, Japan, the UK and major countries in the Euro Area, are also the world’s leading economies.

(1) Size of an Economy

Table 2 shows that the USA, the Euro Area and Japan account for 28.5, 22.0 and 11.2 percent of world GDP, respectively, compared to the UK at 4.9 percent and China at 4.6 percent. The three economies that issue the “Big Three” currencies play a pivotal role in the world economy, which in combination account for 61.7 percent of the total world GDP.

(2) Share of World Trade

Another way to measure the economic influence of a country is using its trade volume (the sum of its total exports and imports of all goods and services) as a share of the world total, which is in most cases positively related to its economic size. According to the World Bank, home countries of the “Big Three” currencies account for almost half of the world trade, with the USA representing 13 percent, the Euro Area 29.7 percent and Japan 4.8 percent (Table 2). Whereas the UK and China exhibit comparable levels in terms of global GDP and trade shares (both are approximately 4.7 and 5.1 percent, respectively), the British pound is a far more internationalized currency, owing to its superiority in the other two “acceptability” and “availability” conditions. In short, although “great currencies” tend to associate with “great powers,” strong macroeconomic performance (like that of China) alone is only a

Table 2. A Comparison of Reserve Currencies and Their Determining Factors

| 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 (Apr 2007) (%) | 6. Stk Mkt Cap per GDP average (1998–2007) (%) | 7. Inflation rate average (1998–2007) (%) | 8. Exchange rate volatility (1997–2007) |
|-----------|-----------|-----------|-----------------------------------------------|-------------------------------------------------|-------------------------------------------------|--------------------------------------------------|----------------------------------------|------------------------------------------------|-------------------------------------------|-----------------------------------------|
| US dollar | 64.03 | USA | 28.5 | 13.0 | 17.5 | 17.2 | 16.12 | 140.4 | 2.6 | 4.49 |
| Euro | 26.51 | Euro Area | 22.0 | 29.7 | 25.9 | 37.5 | 10.27 | 66.7 | 1.9 | 5.44 |
| Yen | 3.27 | Japan | 11.2 | 4.8 | 0.7 | 3.8 | 5.93 | 79.1 | –0.2 | 8.15 |
| Pound | 4.08 | UK | 4.9 | 5.1 | 9.7 | 12.6 | 34.68 | 148.6 | 2.8 | 5.02 |
| Renminbi | 0.00 | China | 4.6 | 5.1 | 5.6 | 0.8 | 0.32 | 45.6 | 1.1 | 4.40 |

Sources: 1 and 2, World Bank (2008); 3 and 4, UNCTAD (2008); 5, BIS (2007); 6, World Bank (2009); 7 and 8, Chen and Peng (2007); COFER, IMF (2009). Authors' calculation.

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).

necessary but not sufficient condition in explaining the emergence and sustenance of an international currency.

(3) Share of Inward and Outward Foreign Direct Investments

In addition to economic size and trade volume, the magnitude of long-term foreign direct investment (FDI) flows into an economy is an important indicator for gauging investors' confidence in the profit potential of a market, and the openness and flexibility of its foreign exchange regime. Figures in Table 2 show that the USA and the Euro Area account for nearly half of the world total in terms of FDI inflows and outflows. Japan has much lower global inward and outward FDI shares (inflows at 0.7 percent and outflows at 3.8 percent), compared to its global GDP share (11.2 percent), whereas the opposite is true for the UK's global shares (FDI inflows at 9.7 percent, FDI outflows at 12.6 percent and GDP at 4.9 percent). China attracts a reasonable share of global inward FDI (5.6 percent) in proportion to its world GDP share (4.6 percent), but its global share of outward FDI is as low as 0.8 percent, although more recent evidence suggests that China is rapidly emerging as a significant capital exporter (Wu, 2007).

2. Acceptability: Places to Trade and Earn, and Low Risk of Losses

Aside from a prominent "ancestry," 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.

(1) Breadth and Depth of Capital Markets

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. Historically, the development of major financial centers around the world has helped to facilitate the process. In particular, the global reach of the dollar and pound has benefited enormously from the large and internationalized financial markets in New York and London, compared to the yen and the euro, as well as the latter's predecessor, the deutschemark, in view of less well-developed financial markets in Tokyo and Frankfurt.

A commonly-used proxy for the development level of capital markets is a country's share in world foreign exchange turnover, which captures the daily average turnover of all major currencies traded within that country. According to the Bank for International Settlements (BIS) (2007), a strong positive correlation can be observed between a country's (e.g. USA) share of world foreign exchange turnover (16.1 percent) and its currency's (e.g. US dollar) share of total turnover in the world's major foreign exchange markets (43.2 percent, see Table 3). The Euro Area's share of world foreign exchange turnover in 2007 was 10.3 percent, whereas the euro's share of total turnover in international foreign exchange markets was 18.5 percent. For Japan and the yen, the corresponding ratios were 5.9 and 8.3 percent, respectively (Table 3). The BIS findings support our point in the preceding paragraph that the development level of capital markets in a country, particularly with the existence of a major financial center within its borders, is positively associated with the international use of its home currency. Compared to other countries (regions), the USA, the Euro Area, the UK and Japan have well-developed capital markets, proxied by these countries' (or their financial centers' in the case of the Euro Area) large shares in world foreign exchange turnover, which contribute to their currencies' (the dollar, the euro, the pound and the yen) widespread internationalization. In contrast to the smaller international role of the pound, London ranks the largest financial center in terms of its share of world foreign exchange turnover, at 34.7 percent, far surpassing other major financial centers (Table 3). This might be largely explained by the legacy of London as a world financial hub dating back to the 19th century. Similar to the economic size and trade volume of the UK, however, China has much less developed financial markets, as indicated by its tiny share of 0.32 percent in total world foreign exchange turnover.

An alternative way to gauge the depth and liquidity of capital markets is to measure a

Table 3. Share of World Foreign Exchange Turnover, by Currency and by Country (Region)

| Currency | Country and region | Share of world foreign exchange turnover, by currency, 2007 (%) | Share of world foreign exchange turnover, by country, 2007 (%) |
|--------------------|--------------------|-----------------------------------------------------------------|----------------------------------------------------------------|
| US dollar | USA | 43.17 | 16.12 |
| Euro | Euro Area | 18.49 | 10.27 |
| Japanese yen | Japan | 8.27 | 5.93 |
| Pound sterling | UK | 7.48 | 34.68 |
| Swiss franc | Switzerland | 3.39 | 5.76 |
| Australian dollar | Australia | 3.33 | 4.61 |
| Canadian dollar | Canada | 2.11 | 1.50 |
| Swedish krona | Sweden | 1.39 | 1.02 |
| Hong Kong dollar | Hong Kong SAR | 1.39 | 4.37 |
| Norwegian krone | Norway | 1.09 | 0.73 |
| New Zealand dollar | New Zealand | 0.95 | 0.28 |
| Mexican peso | Mexico | 0.64 | 0.37 |
| Singapore dollar | Singapore | 0.61 | 5.55 |
| Korean won | Korea | 0.55 | 1.08 |
| South African rand | South Africa | 0.46 | 0.37 |
| Danish Krone | Denmark | 0.45 | 2.28 |
| Russian rouble | Russia | 0.40 | 1.39 |
| Polish zloty | Poland | 0.39 | 0.22 |
| Indian rupee | India | 0.34 | 1.04 |
| Chinese renminbi | China | 0.24 | 0.32 |
| New Taiwan dollar | Taiwan, China | 0.19 | 0.37 |
| Brazilian real | Brazil | 0.18 | 0.15 |
| Hungarian forint | Hungary | 0.14 | 0.16 |
| Czech koruna | Czech Republic | 0.11 | 0.12 |
| Thai baht | Thailand | 0.10 | 0.19 |
| Turkish lira | Turkey | 0.08 | 0.08 |
| Philippine peso | Philippines | 0.06 | 0.09 |
| Indonesian rupiah | Indonesia | 0.05 | 0.08 |

Source: BIS (2007) and authors' calculation.

nation's stock market capitalization as a share of its GDP. As shown in Table 2, the UK and the USA have fairly high stock market capitalization to GDP ratios, at 148.6 and 140.4 percent, respectively, compared to 79.1 percent in Japan, 66.7 percent in the Euro Area and 45.6 percent in China. Similar to findings derived from world foreign exchange turnover, the figures indicate that larger stock market capitalization as a share of GDP, which to a certain extent measures the level of capital market development, is positively

correlated with the degree of globalization of a nation's currency.

(2) Stability of the Currency

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 investors' 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. As illustrated in Table 2, 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 USA, and at 2.8 percent in the UK, compared to a lower rate of 1.1 percent in China and a negative record in Japan. A second way of assessing currency stability is to measure the unit's exchange rate volatility, which can be calculated as the standard deviation of daily percentage change in the exchange rate against the IMF's Special Drawing Rights (SDR). Except for the yen, which experienced relative greater volatility, averaging 8.15 percent over 1997–2007, all the currencies in Table 2 exhibit similar low levels of exchange rate volatility, with an average of 4.84 percent during the same period.

3. Availability: Convertibility of the Currency

In addition to prominent “ancestry” and widespread “acceptability,” the convertibility of a currency is essential to its internationalization because nonconvertibility or partial convertibility creates a bottleneck preventing the currency from being broadly used in international financial and trade transactions. In this sense, convertibility of a currency translates directly to its “availability.” Among the five sample currencies in Table 2, the RMB is the least “available” currency due to restrictions on the unit's free convertibility for capital account transactions.

III. Could the Renminbi Catch up with the “Three A's”?

Based on the previous analysis of the three determinants of currency internationalization – “ancestry,” “acceptability” and “availability” – it is obvious that the RMB still has a long way to go in terms of meeting those conditions. However, favorable trends for the RMB are unfolding, which will be delineated in the subsequent sections.

1. Ancestry: Mixed Picture of China's Rise and the RMB

(1) Economic Size: Large but not Affluent

Since the adoption of the “Open Door” policy in 1978, the Chinese economy has experienced one of the fastest long-term growth rates in the world, and at the beginning of the 21st century, has surged to become one of the three largest economies globally. China surpassed the UK and Germany in 2005 and 2007, respectively, to become the third largest economy following the USA and Japan.⁴ The US investment bank Goldman Sachs has projected that China will overtake the USA to become the world's largest economy by 2027 (Wilson and Stupnytska, 2007), should China manage to continue to grow at its current rate.

However, a large GDP size does not necessarily equate 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. By the latter measure, China is still a lower-middle-income country lagging way behind other high-income countries. In 2007, GDP per capita in the USA was as high as US\$45 592, followed by the UK's US\$45 442, Germany's US\$40 324 and Japan's US\$34 313, dwarfing China's US\$2432 (World Bank, 2008). In the long run, even though China's GDP per capita is projected to surge exponentially to US\$49 650 by 2050, it will still lag far behind that of the USA (US\$91 683), the UK (US\$80 234), Germany (US\$68 253), Japan (US\$66 848), as well as other developed and emerging economies (Wilson and Stupnytska, 2007).

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, among others, 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 (Wu, 2006). An eruption of any one of these, or a combination of several “fault lines” could put a sharp brake on the ascent of the Chinese economy, and concomitantly propel the RMB on to an inordinately volatile trajectory.

(2) Trade Volume and Settlement

Mirroring its high economic growth rate, China has also experienced an uninterrupted surge in exports and imports of goods and services during the past two decades. According to the World Bank (2008), the trade volume of China grew from US\$109bn in 1988 to US\$2376bn in 2007, overtaking that of Japan and the UK in 2004. In the first half of 2009, the WTO reported that China had surpassed Germany to become the second largest exporting

⁴ The data is based on the updated statistics announced by the National Bureau of Statistics of China on 14 January 2009. The GDP growth rate for 2007 should be 13 percent rather than the earlier reported 11.9 percent, and the revised GDP should be US\$3.38tn, exceeding the US\$3.32tn of Germany.

nation in the world.⁵ Accompanying the surging foreign trade is the expanding trade settlement by the RMB, which has already evolved into a major currency for cross-border trade settlement with neighboring countries such as Vietnam, Cambodia, Russia and Mongolia.⁶ As the dollar has been losing its appeal since the 2008–2009 global financial crisis, the Chinese Government has recently taken aggressive measures to reduce the risks of exchange rate fluctuations and transaction costs, and at the same time promote the use of the RMB in international trade settlement.

At the end of 2008, the Chinese Government announced pilot programs allowing Guangdong Province and Yangtze River Delta (including Shanghai) to use the RMB to settle trade deals with two special administrative regions, Hong Kong and Macao. A similar arrangement has been proposed to allow Guangxi and Yunnan Provinces to use the RMB to settle trade accounts with selected member-countries of ASEAN. 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 RMB with overseas counterparties.⁷

Moreover, to mitigate exchange-rate risks arising from trade settlement in the dollar, China has entered into bilateral currency-swap agreements with several trading partners. Since December 2008, the PBOC has signed a total of RMB650bn worth of currency-swap agreements with Hong Kong Special Administrative Region, South Korea, Indonesia, Malaysia, Argentina and Belarus.⁸ Moreover, the PBOC 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.⁹ Such recent progress signals that the Chinese Government is beginning to set the RMB 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.

(3) Foreign Direct Investment Flows

Aside from being the world's third largest economy and second largest exporting nation, China is now becoming one of the world's largest recipients of FDI. Indicating the increasing openness of the Chinese economy to foreign capital, the inward FDI stock to GDP ratio rose from 5.1 percent in 1990 to 10.1 percent in 2007. Going forward, China will remain a magnet for multinational investors. The latest survey by the United Nations Conference on

⁵ "China edges ahead of Germany on exports," *Financial Times* (24 August 2009), online edition.

⁶ "Yuan goes global," *Beijing Review* (23 April 2009), online edition.

⁷ "Yuan goes global," *Beijing Review* (23 April 2009), online edition.

⁸ "Toward swapping China's currency," *Wall Street Journal* (31 March 2009), online edition.

⁹ "China plans global role for renminbi," *Financial Times* (14 July 2009), online edition.

Trade and Development (UNCTAD, 2009) ranks China the world's most attractive FDI destination for multinational corporations, while the Economist Intelligence Unit (2007) predicts that China will be the globe's third largest recipient country for inward FDI during 2007–2011. Continuous strong foreign capital inflows will inevitably help to energize China's capital and foreign exchange markets, rendering the RMB a more actively traded currency.

Likewise, since the adoption of the openness policy in the 1990s, Chinese companies have been aggressively expanding their investments abroad through both greenfield investments as well as merger-and-acquisition purchases. According to UNCTAD, outward FDI flows had recorded a dramatic rise from US\$0.8bn in 1990 to US\$22.5bn in 2007, and outward FDI stock as a share of GDP had increased from 1.1 to 3.0 percent during the same period. Despite a ranking of 20th as a source country of FDI in 2007 and a much lower level of outward FDI compared to other leading economies, China has great potential to expand its transnational business operations in the short and medium term (Wu, 2007).

First, projections of continuously fast economic growth, coupled with rapid urbanization, rising car ownership and accelerated infrastructure construction, will raise the nation's appetite for and boost outward FDI to the commodity and resource sector. Second, many years of large current account surpluses and accumulation of huge official foreign exchange reserves will enable the Chinese Government to help finance overseas acquisitions by state-owned enterprises. Third, a forecast trend-appreciation of the RMB in the next few years would make overseas assets targeted by Chinese companies cheaper. Last but not least, the process will be backed by supportive government policies. According to the *Wall Street Journal*, "China's outward direct investment will overtake FDI inflows as early as 2010 ... China will become the fifth largest global foreign investing nation behind the United States, Britain, Germany and Japan."¹⁰ Even though most of China's inward and outward investments are currently made in the dollar, an acceleration of these two-way flows of capital into and out of China will inevitably facilitate the cross-border use of the RMB in the future.

2. Acceptability: Capital Markets and Monetary Policy in China

(1) Developments in Capital Markets

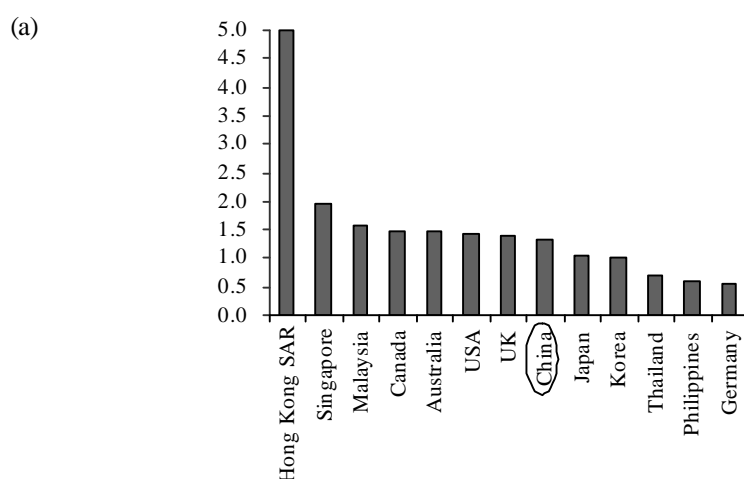
Since 1980 when China assumed seats at the World Bank and the IMF, the government has embarked on capital market reforms, albeit cautiously, resulting in the gradual evolution of "enhanced market infrastructures, a better legal framework, and a unified regulatory system" (Liu, 2007). However, the opening-up of capital markets began to gather pace only after

¹⁰ Brainard L. and J. Fenby, "Chinese takeout," *Wall Street Journal* (20 February 2007), online edition.

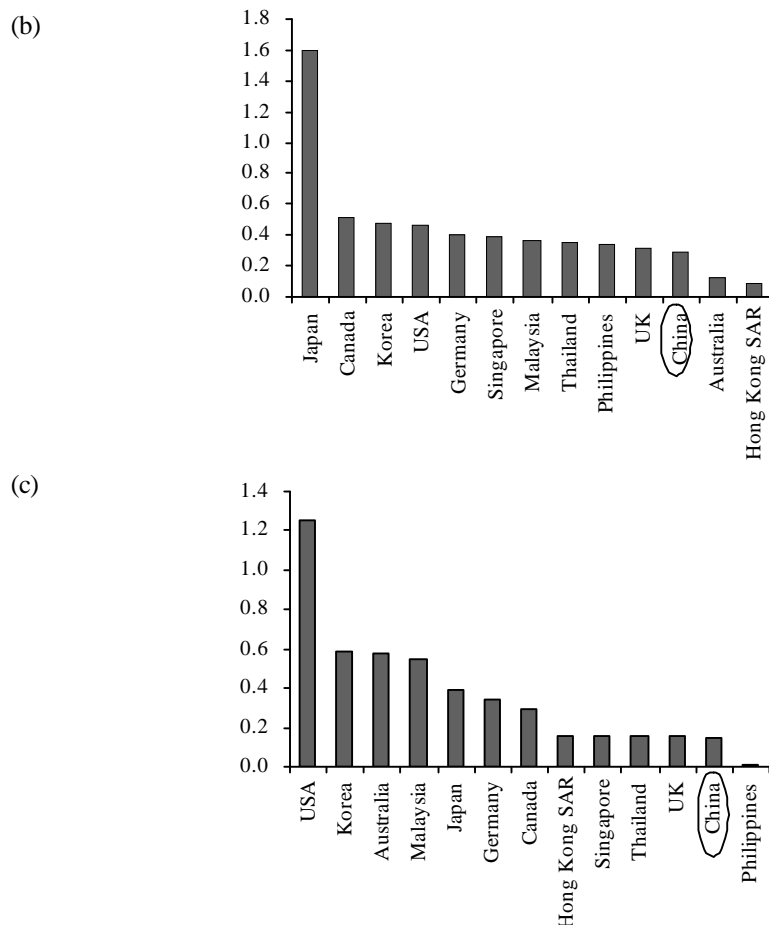
China's accession to the WTO in 2001 and the launch of the Qualified Foreign Institutional Investor (QFII) program in 2002. Nevertheless, China's growing participation in the global financial system and gradual liberalization of capital markets over the past 5 years have resulted in large cross-border portfolio investments. Foreign portfolio investments in China reached a peak of US\$43bn in 2006, and, on average, increased by 51 percent between 2003 and 2007, reflecting strong foreign demand for securities from the country. In addition to ongoing financial reforms, China's State Council declared in March 2009 that it plans to elevate Shanghai to an international financial centre by 2020.¹¹

Despite some modest progress, compared to other more developed capital markets, it is clear that China's capital markets are still in their infancy, 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, the size of China's equity and particularly bond markets remains fairly small despite dramatic increases in the past 5 years. As shown in Figure 1, China has lower equity and bond market capitalizations to GDP ratios compared to those of issuing countries of major currencies. Furthermore, despite having a banking sector holding as much as 9.1 percent of total global

Figure 1. (a) Stock Market Capitalization, (b) Public Bond Market Capitalization and (c) Private Bond Market Capitalization as a Share of GDP



¹¹ "State Council: Making Shanghai a new global financial center," *People's Daily Online* (26 March 2009). <http://english.peopledaily.com.cn/90001/90778/90857/90862/6623230.html> (10 July 2009).



Source: The World Bank (2009).

bank assets, China's equity and bond market capitalizations only make up 5.9 and 2.4 percent of the world's equity and bond markets, respectively (Deutsche Bank Research, 2009).

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 are 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 (Deutsche Bank Research, 2009). As for the structure of China's equity markets, the proportion of domestically listed shares subscribed to by foreign investors (B-shares) and shares listed on the Hong Kong exchange (H-shares: the largest of overseas listings) remain modest

compared to domestically listed shares subscribed to by domestic investors (A-shares), to which foreign investors have very restricted access. As of mid-2009, only 87 foreign institutional investors were entitled to the QFII status,¹² which allows them to trade A-shares on secondary markets with an aggregate limit of not more than US\$30.0bn, or just 1–2 percent of the Shanghai exchange's market capitalization. Furthermore, the purchase of B-shares is also limited to a selected group of foreign institutional investors, and Hong Kong-listed H-shares are but a fraction of the two mainland 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 issuance, China still practices a merit-based approval system in contrast to the registration-based systems observed in most overseas mature capital markets. In addition, China's equity and bond transaction costs are much higher than those in more developed markets. According to a comparison of financial transaction costs done by the China Securities Regulatory Commission (CSRC, 2008), the Shanghai and Shenzhen exchanges have an average cost of 50.0 basis points (with 20.0 basis points as average commission and 30.0 basis points as a transaction fee), which is more than double the average of 21 in most mature markets. As for bond transaction costs, China has an average basis point of 6.3, dwarfing the 1.0 basis point in the UK, South Korea, India and Singapore, 0.4 basis point in the USA and 0.5 basis point 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 initiated 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 from 2010, to raise the investment limit per QFII to US\$1.0bn from US\$800m, and to approve foreign banks to issue RMB-denominated corporate bonds. Likewise, in an unprecedented move, the Ministry of Finance unveiled in September 2009 that in order to "promote the yuan in neighbouring countries and improve the yuan's international status," it would help establish an offshore RMB bond market by starting to sell US\$879m worth of RMB-denominated sovereign bonds in Hong Kong to foreign institutional and retail investors.

Despite these encouraging moves, it will be some years before China's capital markets can successfully transit to a more open and mature stage. According to the development strategies published by CSRC in 2008, it is forecast to take roughly a decade for China to undergo "the drive to maturity stage," and it will build up well developed capital markets by

¹² "Limits up for QFII investors," *China Daily* (7 September 2009), online edition.

the end of 2020. Still, Deutsche Bank Research (2009) has predicted that continuous growth of China's capital markets would significantly raise the country's profile in the international financial system, and by 2018, China could account for 13 percent of global bond markets, more than 40 percent of global stock markets and 18 percent of global banking markets. Even with these optimistic predictions, our rough estimate is that China's capital markets may need another decade to mature. As discussed earlier, only when domestic capital markets in a country are open and deep can its currency become extensively accepted in other capital markets around the world. Therefore, allowing a reasonable time lag, the earliest timeline for the RMB to become a global currency is likely beyond 2025.

(2) Monetary Policy and Currency Stability

Stability and low inflation has been the nominal anchor for China's monetary policy during the past decade. In the wake of a high inflation period (1992–1997), the inflation rate in China has stayed at a fairly low level despite the slight upward surge during the 2008–2009 global financial crisis. According to the IMF's forecast, inflation trends in China will remain at approximately zero, at least until 2014 (IMF, 2009a). At the same time, the RMB has been a stable currency with a record of low volatility (Table 2). From 1994 until 2005, China's central bank pegged the RMB to the US dollar at an undervalued exchange rate of RMB8.28 per dollar. Despite the currency policy reform in 2005, which shifted the RMB from a fixed peg to a regime of managed-float against a basket of currencies, the RMB has remained stable since 2005. This is because the government, although allowing the RMB to appreciate gradually, has intervened heavily to keep the foreign exchange rate at targeted levels. Furthermore, the RMB was only allowed to fluctuate within ± 0.3 percent against the basket on a daily basis, although since then the trading band has been widened to ± 0.5 percent daily against the US dollar.¹³ Therefore, the upward trend of the RMB is estimated to follow a steady, slow and stable track in the foreseeable future. As Hu Xiaolian, Deputy Governor of the PBOC, has argued, China's "gradualist" approach helps safeguard the stability of its financial system and create a favorable environment for advancing and deepening financial sector reform, which is expected to promote the RMB's internationalization (Hu X., 2007).

3. Availability: The Agenda for Renminbi Convertibility

Currently, the RMB lacks the foremost prerequisite to become a global currency: free and

¹³ "Exchange rate could float in a wider band," *RMB Guide* (25 May 2007), http://www.rmbguide.com/Exchange_rate_could_float_in_a_wider_band.htm.

full convertibility. Although the RMB became convertible for trade transactions and conditionally for FDI in 1994, it has been largely nonconvertible for all portfolio capital transactions until now. Even though every country maintains capital restrictions to a certain extent, in China's case, despite capital account liberalization reforms over the past 15 years, it still retains a firm grip on capital account transactions. Always mindful of the risk of widespread financial instability, the Chinese Government is most reluctant to undertake more aggressive relaxation until the reform and recapitalization of the state banking system are completed. However, recent policy initiatives taken by the government have demonstrated the likelihood of a faster pace of relaxation. According to Guo Shuqing, former Head of the State Administration of Foreign Exchange, the RMB would be convertible by 2010 for approximately 70 percent of the 43 capital transaction items under the IMF classification.¹⁴

IV. Implications for Asia and the Rest of the World

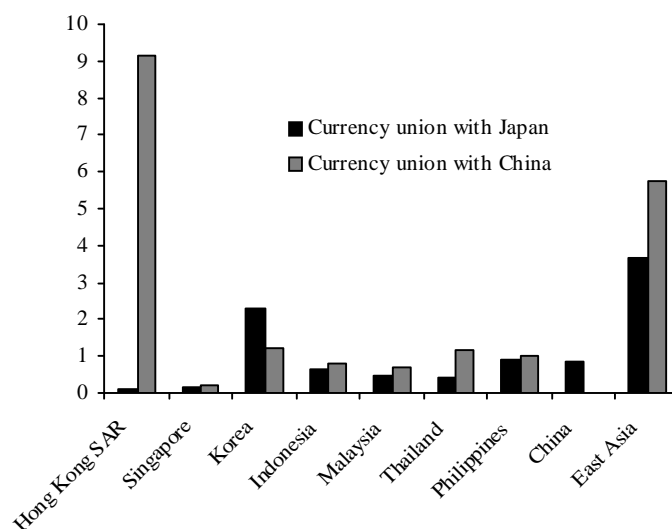
Looking ahead, the replacement of one dominant international currency by another depends not only on the rising status of the new currency-issuing country, but also on erroneous economic policies committed by the existing dominant currency-issuing country (Kawai, 1997). Amidst the current global crisis leading to continuous downward pressure on the US dollar and a deteriorating US economy, the role of the greenback has diminished to some extent. Hence, some influential economists in China have become more optimistic in advocating accelerated internationalization of the RMB. With its massive foreign exchange reserves, China has been able to keep the RMB stable and, consequently, some countries have expressed cautious welcome of the RMB as a settlement or reserve currency.¹⁵

Despite this emerging sentiment, in the medium term, the RMB is only likely to evolve into a regional currency. In light of the important economic linkages between China and the rest of Asia, the internationalization of the RMB is likely to confer some positive impact on the region. This is understandable because it has been empirically demonstrated that establishing a common currency in a region will raise trade volume among regional member-countries (Frankel and Rose, 1998). Furthermore, using a gravity model, IMF economist Kazuko Shirono (2009) estimates that the "welfare gains" yielded by the RMB as a regional

¹⁴ Tian Wei, "Making the RMB convertible," *Beijing Review* (9 December, 2004).

¹⁵ Jane Cai, "Economists hail yuan trade scheme as step to going global," *South China Morning Post* (26 December, 2008).

Figure 2. Welfare Effects of Currency Unions



Source: Shirono (2009).

currency are much higher than those by the yen or the dollar for all East and Southeast Asian countries except South Korea.¹⁶ Specifically, he finds that a currency union with China will deliver higher “welfare gains” than that with Japan, ranging from by 0.1 to 9.1 percent for various regional economies (Figure 2).

It is probably too optimistic, however, to expect the RMB to become a global currency before 2025. It would require fundamental economic, financial, regulatory and political reforms to remake China into a global and responsible stakeholder. On the one hand, it takes time to complete a variety of reforms in China. After all, the prospect of RMB internationalization is closely associated with its convertibility as well as depth and openness of capital markets. These are not expected to be achieved before 2025. 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 conclusion that the government would have the political will to push forward aggressive reforms in capital markets, even though it has recently shown some interest in using the RMB for trade settlement. Furthermore, politically it is also not certain whether other countries would have the confidence to accept the RMB

¹⁶ The “welfare gains” of a currency union refers to a change in welfare generated by a reduction in trade barriers; namely, a reduction in trade costs due to forming a currency union. Other potential welfare gains from a common currency are not captured in his work.

for various international uses, the RMB being a currency issued by a country controlled by a communist party. As such, the RMB is not in a position to challenge the preeminent role of the US dollar in the foreseeable future.

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