



Renminbi Going Global

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Abstract

The present paper evaluates the international status of the Chinese currency, the renminbi (RMB), by examining its use in the global market. Specifically, the discussion focuses on the recent developments of RMB trading in the global foreign exchange market, cross-border trade settlement in RMB, the Hong Kong offshore market and China's policies relating to the RMB. The evidence suggests that the use of the RMB overseas, especially in trade financing and in the off-shore market, has increased rapidly in recent years. However, compared with the size of the Chinese economy, the current scale of the use of the RMB is quite small. Although the RMB has great potential to become an international currency, its acceptance in the global economy is affected by both economic and political factors. Attaining a fully fledged international RMB is still a distant goal.

Key words: cross-border trade settlement, off-shore RMB market, panda bonds, RMB internationalization

JEL codes: F02, F31, F33

I. Introduction

Soon after its accession to the World Trade Organization in December 2001, China established itself as a major hub of the world production chain, as the second largest trading country and as a substantial net external creditor. China is becoming increasingly integrated with the world economy. The integration, however, is mainly taking place via the international trade channel and not in the financial area. China has some strict capital controls and its financial system is quite isolated. Even in the absence of strong financial linkages, the integration of China's trade into the global system has altered the world economic landscape

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significantly. What will be the implications for the global economy when China opens up its financial markets?

China's impressive strides in economic growth make its financial system reform an imminent and critical issue. China has repeatedly affirmed that liberalizing its capital accounts is its ongoing official policy. In practice, China has adopted a gradual approach in implementing its financial market reforms. For instance, although there have been some changes in its exchange rate policy over the past 6 years, China has, in general, adopted a stable foreign exchange policy. China maintains substantial controls on its currency, the renminbi (RMB), and restricts the use of the RMB overseas. For some commentators, it is not that nothing has been done, but that the policy changes are just too insignificant and too slow in their implementation.

In 2004, China started to experiment with convertibility and financial liberalization by establishing an offshore RMB market in Hong Kong. Since then, the offshore market has been growing steadily. The acute US dollar shortage effect on trade experienced in the recent global financial crisis has triggered a response from China. Soon after the governor of the People's Bank of China commented on the super-sovereign reserve currency and implicitly challenged the dominance of the US dollar in the global economy in the midst of the recent global financial crisis (Zhou, 2009), China initiated a scheme to settle cross-border trade in RMB. By June 2010, the RMB could be used to settle trade with all countries.

Undoubtedly, the integration of China's financial markets presents both challenges and opportunities to the rest of the world. China's recent policies supporting the development of the offshore market and promoting the use of RMB in trade settlement have not gone unnoticed. Analysts and commentators are scrambled to assess China's underlying intentions and the implications of a global Chinese currency. Even though most of these Chinese policies have only been introduced in the past few years and academic study on the topic is scant, there is no shortage of discussion within the media, the investment community and policy circles. Most discussions acknowledge the RMB's potential but, at the same time, point out obstacles such as the lack of convertibility and capital controls that deter the RMB's acceptance in the global market. Some are more optimistic than others and predict that the RMB could challenge the US dollar and become an alternative reserve currency in the not so distant future.¹

In the present paper, we focus on the international status of the RMB, which is an

¹ See, for example, Aizenman and Lee (2010), Chen and Peng (2007), Cheung *et al.* (2011), Cui *et al.* (2009), Deloitte China Research and Insight Center (2009), Dobson and Masson (2009), Hu (2008), Huang (2010), Jaeger (2010), Lee (2010), McCauley (2011), Murphy and Yuan (2009), Stier *et al.* (2010), Strategy, Policy and Review Department, IMF (2010) and Wu *et al.* (2010).

important barometer of China's role in the global financial market. To what extent is the RMB an international currency? We will examine the recent efforts made to promote the use of the RMB in trade financing and in the global financial market. A brief overview of international currency and an assessment of the role of the RMB as a global currency are given in the Section II. Section III discusses some policies that China has implemented in recent years. The final section offers some thoughts and comments on the prospect of the RMB becoming an international currency.

II. International Function of the RMB

The basic functions of money are distinguished as: a medium of exchange, a unit of account, and a store of value and purchasing power. These functions are interrelated. The international role of a currency is closely related to the three basic functions of money. For instance, the public and private functions include the uses of the currency to intervene in foreign exchange markets, to peg a local currency, to hold international reserves, to transact in international trade and investment, to invoice international transactions, and to store private wealth (Cohen, 1971; Kenan, 1983; Krugman, 1984; Chinn and Frankel, 2005; Genberg, 2009). Some globally traded commodities, including gold and oil, are conventionally denominated in a prominent international currency, such as the US dollar.

We can assign the degree of internationalization on a continuous scale of 0 to 1, with "0" representing a non-international currency and "1" a full-fledged international currency. For instance, the US dollar is closer to "1" than, say, the Japanese yen, which, in turn, is more international than the RMB. The desirability and acceptability of a currency in the world market depend on the perceived stability of the currency's value and the public's opinion of the issuer's credibility. The US dollar, for example, is commonly used and accepted outside the USA.

The global role of a currency evolves over time. The current international financial system has an informal multipolar arrangement that has the US dollar acting as the dominant international currency, with the euro, the Japanese yen, and the pound sterling the minor international currencies.

Technically speaking, the Special Drawing Rights (SDR) created by the IMF in 1969 act only as a quasi-currency and not as a currency. Although the SDR serves as a reserve asset and a unit of account, its value depends on a basket of currencies and the basket composition is reviewed every 5 years by the IMF Executive Board. The inclusion in the SDR basket is an official recognition of a currency's role in the international economy.

In the latest November 2010 review, the IMF Executive Board determined that the

basket should comprise four currencies: the US dollar, the euro, the pound sterling and the Japanese yen. Their weights are, respectively, 41.9, 37.4, 11.3 and 9.4 percent. These currencies are selected based on the size of the export sector and whether the currency is freely usable, meaning that it is, in fact, widely used and traded in the global market (IMF, 2010).

China is the second largest trading country behind the USA, with US\$2.2tn in imports and exports in 2009 (based on the World Development Indicators database). Therefore, the obvious reason for the RMB not being included in the latest SDR basket is not the trade criterion but the currency usability criterion. Currently, there is only a meager amount of international transactions conducted using the RMB. Until China has achieved substantial progress in making its currency “freely usable,” the RMB has a very small chance of becoming an SDR component currency. Furthermore, the weight in the SDR basket depends on the value of the export sector and the amount of the currency being held as international reserves by other IMF members. At the time of writing, the international reserve role of the RMB is virtually non-existent.

Nevertheless, there have been discussions about the RMB’s potential to be included in the SDR basket. French President Nicolas Sarkozy, for instance, has said that he will ask the IMF to consider the possibility of including the RMB in the SDR basket (Gauthier-Villars, 2011).

1. Global Foreign Exchange Market

Let us consider the global foreign exchange market. According to the Bank for International Settlements (2010) triennial central bank survey, the Chinese currency is among the emerging market currencies that have experienced significant increases in their trading volumes. Its share of global foreign exchange trading increased to 0.9 percent in 2010 from 0.5 percent in 2007 and 0.1 percent in 2004. Note that because two currencies are involved in each foreign exchange transaction, the sum of the percentage shares of individual currencies totals 200 percent instead of 100 percent. The average daily turnover surged from US\$1.7bn in the 2004 survey and US\$14.6bn in the 2007 survey to reach US\$29.2bn in the 2010 survey.

Although its growth has been quite respectable, the RMB trading turnover is quite small compared with the size of the Chinese economy. For instance, the US dollar, the euro, the Japanese yen and the pound sterling accounted for, respectively, 84.9, 39.1, 19.0 and 12.9 percent of the global foreign exchange trading turnover in the 2010 survey. The Hong Kong dollar, the currency of China’s special administrative region, accounted for 2.4 percent of the global turnover.

Furthermore, the RMB turnover volume is relatively small compared with its import and export activities. For instance, when the size of the 2009 trade sector is used to normalize

the currency trading volume, the annualized foreign exchange turnover to international trade (exports plus imports) ratios are 3.0 for the RMB, 30.9 for the Hong Kong dollar and 270.0 for the US dollar.² Taking its huge trade sector into consideration, China still has a long way to go in terms of promoting the use of the RMB in the global economy.

2. Invoicing/Settlement Currency

A common indicator of the international role of a currency is the extent to which it is used as an invoicing currency. Even though detailed information on invoicing behavior is scarce, anecdotal evidence and some recent studies on trade invoicing suggest that the US dollar is the most widely used invoicing currency, followed by the euro and the Japanese yen (Goldberg and Tille, 2008; European Central Bank, 2010; Ito *et al.*, 2010). The widespread use of these currencies in invoicing trade supports their leading transaction roles in the global foreign exchange market.

The RMB has been used in international trade, albeit in a limited manner, for a long time. China's State Administration of Foreign Exchange (2003) formalized the procedure and issued rules and detailed the procedure for domestic institutions using the RMB as an invoicing currency in signing import and export contracts. At that time, the RMB was mainly used in trade taking place near the border areas with neighboring countries such as Cambodia, Mongolia, Russia and Vietnam. Unfortunately, we do not have data on the volume of trade invoiced in RMB. As an alternative, in the present study, we consider China's recent policy on trade settlement.

In April 2009, China's State Council approved a pilot scheme for cross-border trade settlement in RMB. The scheme initially involved Shanghai and four other Chinese cities in Guangdong Province, and Hong Kong. Since the implementation of the scheme in July the same year, RMB trade settlement activity has steadily progressed. The scheme received a substantial boost in June 2010 when the program eligibility was expanded to cover 20 of the 31 mainland Chinese provinces and to companies located in and outside Hong Kong. The expansion of the geographic coverage was followed by a discernable increase in the volume of cross-border trade settled in RMB.

The cumulative volume of trade settled in RMB increased from less than RMB4bn at the end of 2009, to almost RMB45bn by May 2010, and to RMB290bn by November 2010. Nonetheless, the values of RMB trade settlement in November and in the first 11 months of

² The total amounts of goods imports and exports are US\$2158bn (China), US\$670.5bn (Hong Kong) and US\$2649.4bn (USA). A factor of 225 was used to obtain the annualized turnover data. The 2009 data (from the World Development Indicators database) were the latest annual trade data available at the time of writing.

**Table 1. Bilateral Currency Swap Agreements
with the People's Bank of China**

Date of agreement	Counterparty	Size of swap lines	Maturity (year)	Renewable
12 December 2008	Bank of Korea	RMB180bn and KRW38tn	3	Yes
20 January 2009	Hong Kong Monetary Authority	RMB200bn and HKD227bn	3	Yes
8 February 2009	Bank Negara Malaysia	RMB80bn and MYR40bn	3	Yes
11 March 2009	National Bank of the Republic of Belarus	RMB20bn and BYR8000bn	3	Yes
23 March 2009	Bank Indonesia	RMB100bn and IDR175tn	3	Yes
2 April 2009	Central Bank of Argentina	RMB70bn and ARS38bn	3	Yes
9 June 2010	The Central Bank of Iceland	RMB3.5bn	3	Yes
23 July 2010	Monetary Authority of Singapore	RMB150bn and SGD30bn	3	Yes

Note: The bilateral currency swap arrangements concluded as of January 2011 are presented. The information in the table was compiled by the authors.

2010 are less than 2 percent of China's total trade in the two corresponding periods.³ The percentage is far less than the proportion of one-third trade volume predicted by Cui *et al.* (2009). Of course, whether the one-third stipulation is achievable or not depends on economic and political developments in both China and the global economy.

The RMB trade settlement scheme is complementary to the bilateral currency swap agreements China arranged with other economies in the midst of the recent global financial crisis. These swaps were first seen as policy measures introduced to alleviate the trade contraction effect of the US dollar shortage and to help stabilize China's export sector.

So far, China has signed bilateral currency swap agreements with eight economies; namely Argentina, Hong Kong, Iceland, Indonesia, Korea, Malaysia, Russia and Singapore. These agreements have a combined value of more than RMB800bn (Table 1), have a 3-year duration and are renewable. They allow the economies to offer RMB trade financing to the local importers to buy Chinese goods. Indeed, when its quota on RMB trade settlement was exhausted in October 2010, the Hong Kong Monetary Authority activated the swap line facility. In passing, it is noted that under the Chiang Mai Initiative, China has also signed bilateral swap arrangements with some Asian countries.

3. Offshore RMB Market in Hong Kong

Under the stipulation of "The Basic Law of the Hong Kong Special Administrative Region," which, essentially, is a mini-constitution, Hong Kong is allowed to maintain its own legal

³ China's imports and exports totaled US\$283.76bn in November and US\$2677.28bn from January to November of 2010.

and financial systems. Specifically, Hong Kong has its own currency, the Hong Kong dollar, and imposes no capital controls. Given its unique economic and political history, Hong Kong has been chosen as a testing ground for assessing the impact of RMB convertibility and capital account liberalization. Although China has sovereignty over Hong Kong, it considers Hong Kong to be an offshore market in terms of currency trading.⁴ Indeed, China has instituted specific rules and procedures for RMB transactions between China and Hong Kong.

The drastic increase in RMB trade settlement in the second half of 2010 is associated with a change in China's policy relating to the experimental offshore RMB market in Hong Kong. Specifically, on 19 July, China's central bank and the Hong Kong Monetary Authority signed the "Memorandum of Cooperation on Renminbi Business," which substantially expands Hong Kong's capacity to conduct RMB transactions outside China.

Hong Kong's role as a laboratory for offshore RMB transactions commenced in 2004. It began with an arrangement that allows Hong Kong to develop an offshore RMB deposit market. Some specific measures are: (i) individuals are allowed to convert up to RMB20 000 daily in Hong Kong; and (ii) certain industries are allowed to conduct selected corresponding services.

A milestone of the offshore market experiment is the issuance of the so-called "Dim Sum" bonds: bonds denominated in RMB and issued in Hong Kong. The first Dim Sum bond was issued in July 2007 by the China Development Bank, a policy bank under the direct jurisdiction of China's State Council. Hopewell Highway Infrastructure was the first non-financial company to issue Dim Sum bonds. There had been 24 issuances as of January 2011, with a total value of more than RMB60bn (Table 2).

Half of the 24 issues were sold by China's policy banks (China Development Bank and Export-Import Bank of China) and stated-owned banks (Bank of China and China Construction Bank). China's Ministry of Finance offered the 2 largest issuances. The second sovereign RMB-bond issued by the Ministry of Finance in November 2010 is interpreted as an attempt to set up the yield curve for the offshore RMB bond market. The two notable foreign issuers are the US blue chip companies MacDonald's and Caterpillar. The most recent Dim Sum bond sale was offered by the World Bank in January 2011.

The Memorandum signed in July 2010 is another milestone. It literally allows a rich menu of RMB trading activities in Hong Kong, including spot and forward RMB trading. By the end of 2010, the daily trading in spot RMB had grown, from almost nothing, to an estimated average volume of US\$400m. The Memorandum also makes it possible for financial

⁴ Market practitioners coined the RMB traded in Hong Kong as CNH instead of the usual trading symbol CNY.

**Table 2. Renminbi-denominated (Dim Sum)
Bonds Issued in Hong Kong**

Issue date	Issuers	Size (RMBbn)	Rate (%)	Maturity (year)
July 2007	China Development Bank	5.00	3.00	2
August 2007	Export-Import Bank of China	2.00	3.053.2	2, 3
September 2007	Bank of China	3.00	3.15/3.35	2, 3
July 2008	Bank of Communications	3.00	3.25	2
August 2008	Export-Import Bank of China	3.00	3.40	3
September 2008	China Construction Bank	3.00	3.24	2
September 2008	Bank of China	3.00	3.25/3.40	2, 3
June 2009	HSBC (China)	1.00	Floating rate	2
June 2009	Bank of East Asia (China)	4.00	2.80	2
August 2009	China Development Bank	2.00	2.45	2
August 2009	China Development Bank	1.00	Floating rate	2
September 2009	Ministry of Finance of China	6.00	2.25/2.70/3.30	2, 3, 5
July 2010	Hopewell Highway Infrastructure	1.38	2.98	2
August 2010	McDonald's	0.20	3.00	3
September 2010	Bank of China	5.00	2.65/2.90	2, 3
September 2010	Deutsche Bank, Hong Kong	0.20	2.00 (half year)	2
October 2010	China Development Bank	2.00	Floating rate	3
October 2010	Asian Development Bank	1.20	2.85	10
October 2010	China Development Bank	3.00	2.70	3
October 2010	Sinotruk (Hong Kong)	2.70	2.95	2
November 2010	Export-Import Bank of China	5.00	2.65	3
November 2010	Caterpillar	1.00	2.25	2
December 2010	Ministry of Finance, China	8.00	1.60 (retail)	2
January 2011	The World Bank	0.50	0.95	2

Note: The Dim Sum bonds that had been issued as of January 2011 are presented. The information in the table was compiled by the authors.

institutions to offer deliverable forwards, in addition to non-deliverable forwards that are already traded in the market. Banks are planning to develop RMB-linked structural products.

The market consensus is that China will stay the course in experimenting with the offshore RMB market and the nascent RMB market in Hong Kong will gain attraction and grow substantially in the near future. The official stance, however, appears cautious. For

instance, there is concern that market-making, and not trade settlement related activity, is the main driver behind most of the spot trading. Six months after signing the Memorandum, the Hong Kong Monetary Authority (2010) (the de facto central bank in Hong Kong) issued guidelines regulating RMB trading to Hong Kong institutions that are authorized to engage in RMB businesses. These guidelines are meant to rein in RMB trading and to ensure that trading is connected to import and export, rather than speculative, activities.

With these recent developments and growing opportunities in the offshore market, RMB deposits in Hong Kong gained momentum and surged strongly in 2010, especially in the second half of the year. The total amount of RMB deposits in Hong Kong at the end of November 2010 reached RMB279.6bn, which is RMB189.9bn and RMB216.9bn higher than the amount at, respectively, the end of June 2010 and the end of 2009.⁵ The number of authorized institutions engaged in RMB business was 105 as of November 2010, representing an increase of 73 (228 percent) from February 2004.

Although the RMB deposits represented only approximately 5 percent of the total deposits as of November 2010, their growth has been quite stunning. The increase is around 450 percent in a year. If the trend continues, the RMB will soon replace the US dollar (which accounted for 30.8 percent of the total deposits in Hong Kong as of November 2010) to become the most popular foreign currency in the Hong Kong market.

The experiment with the Hong Kong offshore market is expected to evolve in several directions. For instance, it is expected that the Chinese Gold & Silver Exchange in Hong Kong, which is a century-old bullion exchange, will launch the first international gold contract denominated in RMB in 2011. In addition, Hong Kong Exchanges & Clearing is preparing for the issuance of stocks denominated in RMB instead of Hong Kong dollars. The first RMB-denominated initial public offering is expected to be from a real-estate investment trust backed by a major property in Beijing. Of course, the launch of these new RMB-denominated financial products will promote the use of the RMB. However, it is not clear whether and when these offerings will be approved by Chinese regulators.

4. Other Functions

The other functions of an international currency include acting as an international cash currency, a reserve asset, an anchoring currency in a pegged exchange arrangement and a denominating currency for globally traded commodities. Not surprisingly, the RMB plays quite a minor role in these capacities. We are not aware of the use of RMB as an anchoring

⁵ The total RMB deposits in Hong Kong is less than 1 percent of China's (non-corporation) saving deposits, which amounted to RMB29.8tn as of November 2010.

currency or as a denominating currency for commodities in the international market.

China has strict rules in place regarding RMB movements in and out of the country. It is difficult to obtain statistics on the amount of RMB banknotes circulating outside China. Anecdotal evidence suggests that the RMB is used in bordering countries, including Russia, Mongolia, Kazakhstan, Kyrgyzstan, Tajikistan and Vietnam. The growing trade ties with these countries in the first decade of the 21st century are driving the foreign accumulation of RMB banknotes.

Accordingly to a 2007 State Administration of Foreign Exchange study, it is estimated that there are RMB1.4bn and RMB1.8bn circulating in Mongolia and Vietnam, respectively. The official amount of RMB in circulation is RMB4225.2bn as of November 2010. Our estimate is that, even allowing for holdings in other economies, the RMB currency outside China is less than 2 percent of the total circulation.

At the time of writing, we are only aware of the September 2010 news report that Malaysia's central bank bought RMB-denominated bonds for its reserves (Brown *et al.*, 2009). There is unconfirmed speculation that other Asian central banks did the same around that time. Nevertheless, we do not have information on the amount purchased or on the identity of other central banks that added the RMB to their reserve holdings.

Although the current level is low, some studies have conducted analyses and predicted that, in the next 10–15 years, the RMB could account for 3–20 percent of global international reserves (Chen and Peng, 2007; Hu, 2008; Lee, 2010). The wide range of predictions reflects the sensitivity of the analysis to assumptions and methods used in these studies.

III. China's Initiatives

China has launched one of the world's largest, if not the largest, economic experiments since the 1980s. The task of transforming a communist central planning economy into a market-driven one on this scale is quite unprecedented. Reform policies and programs have been contemplated and designed following the so-called "feel the rock, wade across the river" approach. The policies are typically implemented in small and incremental steps to guard against major surprises. The resulting economic achievement is quite admirable. China's GDP was US\$4985.5bn in 2009, compared with US\$189.4bn in 1980 (in current US dollars). An average growth rate of 11.5 percent per annum has been achieved over the past 30 years. The GDP per capita (in current US\$) has increased from US\$193 in 1980 to US\$3744 in 2009.

China's economic accomplishment, however, has been subject to some criticism. For instance, some consider the growth as uneven and too reliant on exports. The country is

rich, with US\$2.847tn in foreign exchange reserves, which accounts for almost 30 percent of the world's total, at the end of 2010, while the Chinese are relatively poor. China's GDP per capita ranks only 95th worldwide according to the IMF. China's trade sector has grown significantly over the past three decades and China is now the second largest trading country in the world. The volume of trade (imports plus exports) in 2009 was US\$2158bn, which is much larger than the US\$38bn traded in 1982. China's growth rate in trade is much faster than the world average. The financial sector, in contrast, is still quite underdeveloped.

Over the past decade, China has stepped up its efforts to reform and upgrade its financial sector. Measures and initiatives have been rolled out to develop its domestic financial markets and to establish offshore RMB markets. These efforts are helping to modernize the economy and complement the solid economic growth experienced over the past three decades. They also steer a path for capital account liberalization and currency convertibility.

In response to the recent financial crisis, in particular to the global liquidity contraction, China has launched a number of initiatives to reduce its reliance on the US dollar and to promote the use of RMB in conducting international transactions. Some commentators have interpreted these initiatives as signs that China is pushing the RMB into the international arena to challenge the US dollar supremacy (e.g. Murphy and Yuan, 2009; Jaeger, 2010). If this is the case, then these initiatives have not yet delivered any substantial material effects. As discussed in the previous section, the international status of the RMB is still quite low.

1. Offshore Markets and Use of the RMB Outside China

In developing the offshore RMB market since 2004, China has followed a measured strategy and used Hong Kong as a testing ground. This strategy has helped to determine the implications of intermediating international transactions in the RMB without giving up capital controls outright (He and McCauley, 2010). Because Hong Kong is a special administrative region of China, China is able to dictate both the growth rate and the evolution of the offshore market via necessary legislation. The push of the RMB abroad is analogous to the 2002 "going global" policy that promoted China's overseas direct investment activity.⁶ Both the RMB and overseas direct investment policies could sustain the domestic economic reform process and promote global champions.

The offshore market experiment was initiated with the introduction of an RMB retail

⁶ The 2002 issue of the *Almanac of China's Foreign Economic Relations and Trade* discusses the effort to vigorously implement the "going global" policy.

deposit market, followed by institutional bond issuance, RMB trade settlement and RMB (spot and forward) trading. The bond issuance so far has been dominated by official or semi-official Chinese institutions, including the Ministry of Finance, the Bank of China and the China Development Bank. The issuance by foreign entities is obviously constrained by rules on the use of the proceeds back in China. The working of the nascent RMB trading is also under considerable scrutiny while the business sector is progressively preparing for RMB-related derivatives and structured products.

The offshore market has great potential and presents substantial implications for the RMB's role in the international market. However, its future path and shape depend crucially on China's policies, including those relating to convertibility and capital controls. It is assumed that China would like to see slow and steady growth rather than fast growth that might get out of control and jeopardize its ability to manage the economy.

Six months after opening the RMB to trading in Hong Kong, China launched RMB trading in the USA in January 2011 (Wei, 2011). The scope of trading is restricted: the purchase of RMB for a US individual customer is limited to the equivalent of US\$4000 a day. However, there is no limit on converting RMB back into dollars. There are also no conversion limits on businesses that are engaged in international trading. Even though currency convertibility might not be in place in the near future, the move is a clear indication that China is preparing for it.

Historically, offshore markets such as the euro-dollar market have sprung from and evolved according to market forces. China's policy driven approach to nurture an offshore market is an experiment in itself.

Besides the offshore market experiment, the RMB trade settlement scheme and the bilateral swap arrangements, there are other means through which China promotes the use of the RMB. For example, in September 2009, China agreed to purchase up to 32 billion SDR-denominated notes from the IMF and to pay for these with RMB (People's Bank of China and the IMF, 2009).

The transaction has the dual effect of denominating its official claims on the rest of the world in RMB and diversifying into the SDR component currencies: the US dollar, the euro, the yen and the pound sterling. Even though it is symbolic, the actual implications on terms of the international use of the RMB could be limited. Cheung *et al.* (2011) label the strategy of denominating China's claims on the rest of the world in RMB as the "renminbisation" of China's foreign assets. These authors also illustrated why the use of the RMB in the SDR bond transaction could be quite ephemeral.

In early January 2011, the news that the city of Wenzhou had launched a trial initiative that allows its residents to invest directly overseas: the initiative represents a pilot program implemented by China to reduce its control on the RMB and to explore the implications of

offshore investment (Wenzhou Foreign Trade and Economic Cooperation Bureau, 2011). In essence, the initiative permits an individual Wenzhou investor to invest up to a maximum of US\$3m in a single project overseas and the initiative's annual total investment limit is US\$200m. Apparently, it maintains a typical Chinese policy feature: the liberalization process is carried out in small and guarded steps. However, within 2 weeks, it was reported that the State Administration of Foreign Exchange had not approved the initiative.

From the perspective of the currency composition of international assets and liabilities, Cheung *et al.* (2011) note that one way for China to promote the use of its currency would be to denominate its official aid programs in Asia, Africa and Latin America in the RMB. Such a policy would offers considerable scope to expand RMB use around the world.

2. Panda Bonds

In the past few years, international organizations have participated in the process of developing the RMB bond market via issuing panda bonds, which are RMB-denominated bonds issued by foreign institutions in China. So far, the two international institutions that have sold Panda bonds are the International Finance Corporation and the Asian Development Bank (Table 3). These institutions simultaneously issued Panda bonds in October 2005 and, then, individually offered further rounds of Panda bonds in 2006 and 2009. In May 2010, the Bank of Tokyo-Mitsubishi UFJ (China) became the first foreign commercial bank to sell Panda bonds through its subsidiary in China. By the end of December 2010, there were five Panda bond issues.

Compared with advanced countries, China's domestic bond market, especially the corporate bond sector, is relatively shallow. Panda bond issuance helps to widen the bond market, to enrich the financing structure and to enhance opportunities for investing in RMB-denominated bonds. In the beginning, proceeds from bond issuance had to be used to finance projects in China and could not be converted into foreign currencies and

Table 3. Panda Bonds Issued in China

Issue date	Issuers	Size (RMBbn)	Rate (%)	Maturity (year)
October 2005	Asian Development Bank	1.00	3.34	10
October 2005	International Finance Corporation	1.13	3.40	10
November 2006	International Finance Corporation	0.87	3.20	7
December 2009	Asian Development Bank	1.00	4.20	10
May 2010	Bank of Tokyo-Mitsubishi UFJ (China)	1.00	Negotiated	2

Note: The Panda bonds that had been issued as of January 2011 are presented. The information in the table was compiled by the authors.

transferred overseas. This rule was changed in September 2010 (People's Bank of China, the Ministry of Finance, the National Development and Reform Commission, and the China Securities Regulatory Commission, 2010). Since then, international institutions, upon the approval of the State Administration of Foreign Exchange, have been able to remit overseas their proceeds from Panda bond sales either in RMB or foreign currencies. This policy change is another step in the experiment on liberalizing the capital account and international use of the RMB.

China has pursued a two-track approach to promote the use of its currency, strengthening its domestic financial markets and developing the offshore RMB market. To enhance acceptance of the RMB abroad, China is focusing its efforts in greater China, especially in Hong Kong. It is conceivable that China will push the RMB schematically to greater China, then to Asia, and then to the rest of the world.

IV. Concluding Remarks

The recurrence of crises has given China a good excuse to maintain its grip on financial markets and capital mobility. However, China's response to the 2008–2009 global financial crisis was different. When the crisis exposed the cataclysmic effect of building the international monetary system around a single national currency, China advocated the adoption of a super-sovereign currency and introduced policy responses to alleviate its dependence on the US dollar. In the process, China has assigned its currency, the RMB, a more active role in the global market. These policy actions have generated discussions on China's intention for the RMB to become an international currency and to challenge the US dollar's international prominence.

The 2008–2009 global financial crisis revealed defects in the current international monetary architecture and triggered reform discussions. An international currency country typically starts with a strong current account position and as a net global creditor. Its international status is eroded with deteriorations in its economic strength. China, as a major economy, in terms of its size, its trading activity and its global creditor status, assumes a relatively minor role in the global financial system.

The potential role of the RMB has become apparent, with the US dollar playing a less prominent role, the EU experiencing a debt crisis and the Japanese economy having been in stagnation for over a decade. An IMF study, for example, names the RMB as one of the three national currency contenders that could challenge the US dollar's status (Strategy, Policy and Review Department, IMF, 2010). The other two currencies are the euro and the Japanese yen.

The obvious question is, then, whether the Chinese policy measures that have rolled out the RMB over the past few years have had any material impact on internationalizing the currency.

Our examination of the international status of the RMB and China's related policies is far from exhaustive. The message, however, is quite clear. Despite the strong momentum displayed over the past few years, the scale of RMB use in the global market is quite small compared with the size of the Chinese economy. It is conceivable that a hastened projection of the RMB into the global economy could carry substantial costs for China. Specifically, with its underdeveloped financial markets, a premature internationalization of the RMB could weaken China's ability to manage its currency and monetary policy, which, in turn, could pose a serious risk to the stability of China's domestic economy. It is reasonable to conjecture that China is willing to pursue a slow and steady path to promote and to enhance the RMB's acceptance overseas.

Our view is not driven by rigorous statistical analyses, not that we underplay the role of statistical analysis. However, for a transitional country like China with its economy in a state of flux, empirical inferences based on experiences of developed countries might not be definitive. The typical empirical determinants of the level of currency internationalization are the country size, the exchange rate variability, the size of the trade sector and the size of the financial (foreign exchange) market. With the exception of a deep and well-functioning financial sector, China fares quite well on three of the four counts.

What is missing in a typical empirical exercise, however, are the political and military considerations. For instance, anecdotal evidence indicates that the ascendant of a national currency's international dominance is closely associated with the nation's global political prowess and military strength, in addition to its economic power. Recent examples include the pound sterling and the US dollar.

Indeed, it is not clear whether the measures introduced in the past few years have been motivated by economic pragmatism in the midst of a dollar shortage, are components of an ongoing modernizing process or have been initiated to develop the international supremacy of the RMB. Perhaps these policies have been implemented to prepare for the use of RMB in the global market rather than to push the RMB to become an international currency.

Even if it is China's intention to compete with the US dollar for supremacy in the international monetary structure, the road for the RMB to be a fully-fledged international currency could be long and winding: it will depend on China's policy initiatives and the responses of other (international currency) countries. Although an offshore market can help to intermediate international (trade and financial) transactions in RMB and, therefore, promote its acceptance, development of a deep and efficient financial sector with prudent governance will be necessary for an internationalized RMB.

It will take time to establish a well-functioning financial sector and the appropriate regulatory framework. The experience of the developed world, especially in light of the weakness of financial markets revealed in the 2008–2009 crisis, might not be that relevant for the Chinese transitional economy. Evidently, China is moving along with its reforms in various financial markets. The modernization of the financial sector, given its close links with other segments of the economy, requires accompanying changes in other sectors and even in politics. Although the task is not insurmountable, China is likely to follow its usual incremental and gradual style in implementing these changes. As such, a fully-fledged international RMB is still a distant goal.

Apart from making some fundamental structural changes in its financial sector, China still has to convince many countries to conduct trade and finance transactions in RMB. The persuasion will go beyond economic reasoning. Political considerations, especially in East Asia, could play a non-negligible role in choosing an international currency. The legacies of war, occupation and communism have induced the antagonism towards regional hegemony.

The ongoing territorial disputes between China and its neighboring countries and China's military buildup, for example, could be sensitive issues that affect the acceptance of the RMB abroad. China has often re-affirmed its commitment to peaceful development, to non-interference foreign policy and to the Five Principles of Peaceful Coexistence. Nevertheless, its neighboring countries might not be completely convincing by such reassurances. All these considerations would require China to make some extra effort to promote the acceptance of the RMB in Asia and in the global market.

However, "a journey of thousand miles begins with one small step." China has indeed taken small first steps in preparation for full convertibility and the internationalization of the RMB. Even though the process could be a fairly long one, China and its currency have great potential to play a more positive role in the global economy.

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