Internationalization of Chinese Currency

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Abstract
China is the largest trading nation but the majority of it is carried out in US dollars. Currently the RMB is not even the top 3 most popular international currencies. The purpose of this paper is to, without prejudice; investigate the costs and benefits for China to internationalize its national currency. The research question is “What is the benefit of international currency?” We draw from the experience of the US dollar and Euros to form the platform for our discussion. The benefits will include seignorage; macroeconomic flexibility and leverage It. would increase business opportunities for domestic financial institutions. Furthermore, allowing the Yuan to be used to settle international transactions would give Chinese residents the opportunity to avoid exchange rate risk. Additional benefits include the overall reduction of transaction costs for exporters because they would be able to trade in RMB. The cost or risk would be China would lose control over the amount of RMB in circulation and also how it is being used. Macroeconomic flexibility is a double edge sword, it cuts both ways. Internationalizing the RMB would bring a certain degree of prestige and convenience to China.

INTRODUCTION

Internationally accepted currency as a medium of exchange (of payment) has been at the core of international trade, and in the past countries had gone to war for this matter. The unchallenged status of the US dollar as the main international currency during several decades has given the US a great advantage in managing its own economy as well as international trade and cross border relations (Kenen, 1983).

Although China’s flourishing economy increases the need for the RMB or Yuan, the official currency of China, to be accepted internationally at present as shown by Table I and Figure I, the RMB is not a major internationally choice of currency of trade currently. The most popular international currency is the US dollars followed by Euros and Japanese Yen. Over the last 60 years US dollar had been dominant. In Asia almost 80% of international trades are carried out using the US dollars and the figure is 25% for Europe (Goldberg & Tille, 2008). China too carried out huge amounts of trade in US dollars. If these trades alone are being carried out in the RMB, China would be able to dominate the international currency usage.

As the world’s second largest economy, largest trading nation, and the largest foreign holder of United States (US) government bonds, the People’s Republic of China (PRC) has the potential to be the number one currency of choice for international trade that can match its economic status in the global economy (Yu, 2012). As China aspires to influence the world, a strong and dominant international currency will elevate China’s status and will provide China with the leverage in international trade and cross border relations.
An international currency is one that is used and held beyond the borders of the issuing country, not merely for transactions with that country’s residents, but also, and importantly for transactions between non-residents (Chinn and Frankel, 2007; ECB, 2007; Kannan, 2007). In other words, an international currency is one that is used instead of the national currencies of the parties directly involved in an international transaction, whether the transaction in question involves a purchase of goods, services or financial assets (Kenen, 2011).

Table I: Currency Distribution in Foreign Exchange Transactions

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>US dollar</td>
<td>89.9</td>
<td>88.0</td>
<td>85.6</td>
<td>84.9</td>
</tr>
<tr>
<td>euro</td>
<td>37.9</td>
<td>37.4</td>
<td>37.0</td>
<td>39.1</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>23.5</td>
<td>20.8</td>
<td>17.2</td>
<td>19.0</td>
</tr>
<tr>
<td>Pound Sterling</td>
<td>13.0</td>
<td>16.5</td>
<td>14.9</td>
<td>12.9</td>
</tr>
<tr>
<td>Australian dollar</td>
<td>4.3</td>
<td>6.0</td>
<td>6.6</td>
<td>7.6</td>
</tr>
<tr>
<td>Swiss Franc</td>
<td>6.0</td>
<td>6.0</td>
<td>6.8</td>
<td>6.4</td>
</tr>
<tr>
<td>Other currencies</td>
<td>25.4</td>
<td>25.3</td>
<td>31.9</td>
<td>30.1</td>
</tr>
</tbody>
</table>

Source: Bank of International Settlement (BIS), Triennial Bank Survey, 2010
Notes: Since two currencies are involved in every transaction, the sum of percentage share of individual currencies equal 200%.

After the financial crisis of 2008, China had begun a campaign to promote the role of its national money, the Yuan or Renminbi (RMB), as an international currency. China began to encourage the use of its currency in international trade, swap arrangements between central banks, and bank deposits and bond issuances in Hong Kong (Yu 2012). “As the world economy becomes more multipolar,” Eichengreen explains, “its monetary
system, logic suggests, should similarly become more multipolar. China has incrementally moved in the direction of currency internationalization for several years and has even begun to allow for the Yuan to be used in the settlement of cross-border trade with Thailand, Burma, Cambodia, Pakistan, North Korea, Mongolia, Russia, Nepal and Vietnam (Hai & Yao, 2010).

In 2004, Hong Kong banks were given permission to provide RMB services such as “deposits, remittance, currency exchange, and debit/credit cards.” Moreover, Hong Kong has recently become the first offshore RMB bond supplier – a product of both increasing integration with mainland China and also of currency internationalization. Furthermore, the Philippines, South Korea, Cambodia, Malaysia and Nepal have accepted the RMB as their foreign exchange reserve. This suggests that, just as in Europe where the composition of most reserves is denominated in Euros, in Asia one may begin to see more reserves of RMB, particularly in countries who trade actively with China. All of these policy choices, however, have one important result: they eliminate the need for exchanges between these two countries to be measured in US dollars, and effectively enable them to make transactions in RMB denominations.

During the first six months of 2011, trade transactions settled in Yuan totaled approximately $146 billion, a 13-fold increase over the same period during the previous year. By mid-2011, Yuan deposits in Hong Kong equaled $85 billion, a roughly tenfold jump since Hu’s 2008 statement. The Yuan is already accepted as a form of payment in Mongolia, Pakistan, Thailand, and Vietnam. Chinese authorities have indicated that as soon as 2015, they want the Yuan to be included in the basket of major currencies that determines the value of Special Drawing Rights (SDRs), the reserve asset issued by the International Monetary Fund.

The purpose of this paper is to, without prejudice; objectively investigate the costs and benefits for China to internationalize its national currency. The research question is “What is the benefit of international currency?” We draw from the experience of the US dollar and Euros to form the platform for our discussion.

WHAT IS MEANT BY INTERNATIONALIZATION OF THE RMB?

A national currency may, in general, be regarded as “internationalized” if it plays a role of money outside the country where it is issued. For example an international currency is used in invoicing exports and imports of goods and services and in denominating financial instruments traded in global financial markets.

The Chinese currency has been used in the settlement of border trade between China and some neighboring countries, and Renminbi banknotes are accepted by shops in many tourist places in the region. Banks in the region started to offer Renminbi banking services such as deposits, remittance, currency exchange and debit/credit cards. Obviously, this is not a workable definition. For an operational definition, it may be useful to identify the qualifications for an international currency (Eichengreen, Park & Shin, 2012).

The use of the Renminbi in international trade and financial transactions is of course limited when compared with the major currencies such as the US Dollar, the Euro, the Pound Sterling and the Japanese Yen. But the current situation reflects the limited capital account convertibility of the Renminbi and a policy of non-

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1 Eichengreen, Barry, Exorbitant Privilege, pg. 121-122
3 Eichengreen, Barry, Exorbitant Privilege, pg. 147
internationalization pursued by the authorities, and the examples cited above are best seen as pointing to the potential of the renminbi as an international currency (Chen, Peng & Shu, 2009).

The fundamental determinants of international currency status are economic size, confidence in the currency, and depth of financial markets (Bochetti & Frankel 2012). Kenen (1983) suggested a framework to define what is meant by the internationalization of a currency while (Chinn and Frankel, 2005) developed a list of the international functions of an international currency, which is summarized in Table II.

An international currency has to be capable of playing the roles of a store of value, a medium of exchange and a unit of account for both residents and non-residents (Chinn and Frankel, 2005). More specifically, it can be used for private purposes as a currency substitution, for invoicing and denoting investments and for trade and financial transactions. It can also be used for public purposes as official reserves, a vehicle currency for foreign exchange intervention and an anchor currency for pegging. This analytical framework can be used as a theoretical guideline for understanding internationalization of the Renminbi (Cohen 2011).

Full convertibility is required for a currency to play any significant role in international trade and financial transactions, but it is not a sufficient condition. The international use of a currency is ultimately determined by market forces (Lim 2006; Yam 2005, 2007; Eichengreen 2005; Mundell 1998; Talvas & Ozeki 1992; Tavlas 1991).

Table II: The International Functions of an International Currency

<table>
<thead>
<tr>
<th>Medium of Exchange</th>
<th>Official Use</th>
<th>Private Use</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Vehicle currency for foreign exchange intervention</td>
<td>Invoicing international trade and financial transactions</td>
</tr>
<tr>
<td>Store of Value</td>
<td>International reserves</td>
<td>International private asset holding</td>
</tr>
<tr>
<td>Unit of Account</td>
<td>Anchor for pegging local currency</td>
<td>Denomining international trade and financial transaction</td>
</tr>
</tbody>
</table>

Source: Chinn and Frankel (2005).

THE COST AND BENEFIT OF INTERNATIONAL CURRENCY

The cost and benefit for having a currency that is accepted internationally such as the US dollar and the Euros is explained by Cohen in Table II. There are several benefits and also risks for making a national currency fully accepted as an international currency.

Transactions Costs

In the past, many of China’s trade with foreign countries were carried out using the US dollar meaning if China were to import raw materials from Brazil, the payment is made after converting China currency, the RMB, into US Dollars. This additional transaction costs as compared to if both Brazil and China were to agree to accept payments in RMB.

Alexander Swoboda (1968) called it denomination rents “the average level of profits of the banking system of an issuing country will tend, other things equal, to be higher [due to the extension of the market] than that of the banking systems of other countries” (Swoboda, 1968).
Since home banks enjoy privileged access to the resources of the issuing country’s central bank, enabling them to more easily create monetary liabilities denominated in the national currency, a distinct competitive advantage is gained relative to banks elsewhere. Business can be expanded abroad at lower costs, generating greater earnings than would otherwise have been possible. Included in these extra earnings may be commissions charged for an increased volume of foreign-exchange transactions as well fees for loans, investment services, or other ancillary activities.

Seigniorage
Seigniorage is the difference between the value of money and the cost to produce it. Seigniorage derived from notes is more indirect, being the difference between interest earned on securities acquired in exchange for bank notes and the costs of producing and distributing those notes (Bank of Canada, 2012). Technically defined as the excess of the nominal value of a currency over its cost of production, seigniorage at the international level is generated whenever foreigners acquire some amount of domestic money in exchange for traded goods and services. Cross-border accumulations represent an implicit economic transfer that constitutes a real-resource gain for the economy as a whole (Cohen, 2011).

Foreign accumulation of RMB is equivalent of an interest-free loan to China since no interest is paid on the cash. More accumulation provides better “liquidity premium” which encourages more transaction to be carried out in RMB. An effectively an interest-rate subsidy (Warnock and Warnock 2009).

Macroeconomic flexibility
The acceptance of the Chinese RMB by international partners gives China the greater ability to finance payments deficits with RMB. This makes it easier for government policy makers to pursue public spending objectives. Cross-border use of a currency can also loosen the constraint of the balance of payments on domestic monetary and fiscal policy. For example, an undervalued Yuan will result in large subsidies for Chinese exporters as well as foreign companies investing in China. Simultaneously, severe RMB undervaluation acts as a tax on China’s imports of foreign products and its companies seeking to invest abroad.

As explained by Corsetti and Pesenti (2005), the currency of invoicing has an influence on the way in which macroeconomic shocks are transmitted, with exporters able to price in their own currencies being less subject to exchange rates fluctuations and in a better position to pass on changes in prices linked to exchange rates changes to consumers.

Importers have also a preference for invoicing in local currency to minimize their exposure to currency changes (Goldberg and Tille, 2008).

Bacchetta and Van Wincoop (2005) found that the currency in which prices are set has significant implications for the optimal pricing strategies of firms (in particular the incentive for exporters to stabilize its price in the importer's currency), exchange rate pass through to import prices, the level of trade and net capital flows, the optimal monetary, and exchange rate policy (to reduce transaction costs).

Leverage
Based on what we have observed with the US Dollar, an internationally dominant currency puts the issuer in a position to exercise leverage through its control of access to vital financial resources. The more others depend on a currency, the greater is the issuer’s potential capacity for pressure or control. For example friendly countries may be granted loans or privileged access to its currency in the midst of a monetary or financial crisis; conversely, adversaries may be deprived of access to essential clearing networks when political tensions are running high (Kirshner, 1995).
The next example is what Kirshner called entrapment. Certainly entrapment seems a good description of the condition that a country like China, with its massive stockpile of dollar reserves, finds itself in today. Since China rely heavily on foreign trade and most are carry out with US dollar as medium of payments, China has to hold large amount of US dollar even when it is not favorable to China. If more international trade is carried out using the RMB, then China could reduce its US dollar reserve and put the money into higher paying venture.

**Reputation**

Finally, at the symbolic level, widespread international use of a currency can promote the issuer’s overall reputation in world affairs. Broad circulation may become a source of status and prestige, a visible sign of elevated rank in the community of nations – a form of what political scientists today call “soft” power. Soft power involves more intangible forms of influence derived from an actor’s culture and values, working through co-option and attraction to shape the preferences of others. “Great powers have great currencies,” Mundell once wrote (1993: 10), acknowledging the role that a money can play as a potent symbol of international primacy. Economists may scoff at the notion of soft power, which is certainly difficult to pin down empirically. But its importance in monetary affairs has by now been well established by historical and contemporary research (Cohen 1998, Helleiner 2003).

**Appreciation**

On the cost side, one frequently mentioned risk of internationalization is the undue exchange-rate appreciation that could result from increased foreign demand for a currency. The more a money gains in popularity, the greater is the likelihood that some degree of overvaluation will result. For consumers appreciation actually represents a benefit, since purchasing power is increased. But for producers the effect is distinctly negative, since the competitiveness of exports and import-competing output will be damaged (Dobbs et al. 2009).

Although this may not be a problem for China initially as RMB is considered undervalued but over the long term as RMB gain popularity this will become a reality.

**External constraint**

Even more serious is the possible constraint that could be imposed on domestic monetary autonomy by an excessive accumulation of liquid foreign liabilities. Macroeconomic flexibility could be compromised by a growing “overhang” of easily movable debt, whether in cash or in the form of claims denominated in the home money. Two dangers are posed for the issuer’s central bank. One is the risk of volatile movements into or out of the currency, which could make the demand for money less stable in aggregate terms. Policy makers, at any given time, may find it more difficult to target interest rates or an appropriate growth rate for money supply. The other is the risk that over time domestic policy may become increasingly hostage to external factors, especially if doubts begin to mount regarding the currency’s future value or usefulness. Ultimately, to persuade investors abroad to hold onto their accumulated balances, priorities at home may have to be compromised or sacrificed. Though neither danger is easy to quantify, both must be regarded as real and could be potentially significant.

**Policy responsibility**

Even more difficult to quantify is one last risk of internationalization – the possibility that in return for the benefits it receives, an issuing country will find itself obliged to assume greater responsibility for management of broader regional or global monetary structures. Quite apart from market-driven pressures on its central bank,
the issuer may find itself called upon to accommodate systemic needs or fragilities should conditions warrant. Monetary policy may have to be modified to contain a crisis, or subsidized loans may have to be provided to rescue some country in distress. A complete catalog of the benefits and costs of an international currency cannot ignore the contingent political claim that goes with monetary leadership – kind of the flip-side of internationalization’s exorbitant privilege.

CONCLUSION
The benefit and cost for China for making RMB an international currency must be weighed by the Chinese authorities. As the size of the economy and financial market increases and the monetary policy framework including exchange rate flexibility becomes more firmly established, the benefits should increasingly surpassed the costs.

The benefits will include seignorage; this enables China to borrow in the international market in its own currency since foreign holdings of RMB would essentially be low interest loans to China. It will provide macroeconomic flexibility and leverage when China deals with foreign partners. It would increase business opportunities for domestic financial institutions. Furthermore, allowing the Yuan to be used to settle international transactions would give Chinese residents the opportunity to avoid exchange rate risk. Additional benefits include the overall reduction of transaction costs for exporters because they would be able to trade in RMB.

The cost or risk would be China would lose control over the amount of RMB in circulation and also how it is being used. Macroeconomic flexibility is a double edge sword, it cuts both ways. Finally, internationalizing the RMB would bring a certain degree of prestige and convenience to China.

Table III: Benefits and Risks of an International Currency

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Risks</th>
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<tbody>
<tr>
<td>Reduced transactions costs</td>
<td>Currency appreciation</td>
</tr>
<tr>
<td>International seignorage</td>
<td>External constraint</td>
</tr>
<tr>
<td>Macroeconomic flexibility</td>
<td>Policy responsibility</td>
</tr>
<tr>
<td>Political leverage (hard power)</td>
<td></td>
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<tr>
<td>Reputation (soft power)</td>
<td></td>
</tr>
</tbody>
</table>

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