RMB Internationalization and its Impact on the International Monetary System[i]

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1. Conclusions

- Will RMB internationalization have a significant impact on the global financial system? My short answer is: it may possible do so in the 22nd century but highly unlikely in this century.

- Why do I think so? First of all, there are too high hurdles for the RMB to become a major international currency in the near future. Secondly, the euro and the Japanese yen are major international currencies next to the US dollar, but they have had much smaller influences over the international monetary scene, to say nothing of the international monetary system. The predominance of the US dollar in the system is far greater than the numerical share of the US economy in terms of GDP or international trade suggests, and this picture has hardly changed over decades.

2. Facts of the international currency markets

- The daily turnover in the global forex market[ii] amounted to $5.3 trillion[iii] in 2013. The BIS shows its currency distribution by percentages, whose total being 200% rather than 100% because it takes a pair for any currency exchange. On that basis, the US dollar captures 87% in the 2013 survey. The dollar's proportion remained virtually unchanged at 90% or a little less since the BIS began this survey in 1989. The second and third currencies actively traded on the global market are the euro and the Japanese yen, each capturing 33% and 23%, respectively. In 1989 the Deutschemark, French franc, and other EMS currencies had a combined share of the same 33% as the euro in 2013. The yen had a share of 27% in 1989, which dropped to 17% by 2007 but recovered to 23% in 2013.

- In short, the international currency market has hardly changed as far as the distribution of major currencies is concerned. Despite a repeated concern over a decline in US dollar status in the international monetary system, the dollar has continued to play the vehicle currency role for the global currency market[iv].

- During the past decade, the RMB's presence increased dramatically. In 2001 the RMB ranked 35 on the currency league table with a negligible percentage share, but moved up to rank 9 with 2.2% share in 2013. However, other emerging economies' currencies also increased percentage shares, e.g., between 2001 and 2013 the Mexican peso from 0.8 to 2.5%, the Russian ruble from 0.3 to 1.6%, the Turkish lira from 0.0 to 1.3%, and the Brazilian real from 0.5 to 1.1%. By the way, the Hong Kong dollar's share declined from 2.2 to 1.4% during the same period, which suggests some substitution effects by the internationalization of the RMB.

- In a nutshell, despite salient increases, the presence of emerging economies' currencies is still pretty small in contrast to the size of their GDP and international trade of goods and services. The underweight of the RMB is particularly conspicuous in this regard.

3. Conditions for the RMB to become a major international currency

- In order for a currency to be used widely in the international markets, Jeff Frankel[v] of Harvard pointed out several conditions: (i) the economic size of the country; (ii) developed financial markets; (iii) confidence in the value of the currency; and (iv) inertia.

- The RMB obviously meets the first condition. However, the economic size does not immediately entail a wide international use of the currency. Take the US dollar for example. In the late 1860s or early 1870s, the US economy overtook the UK economy, but the market remained unconvinced about the international currency role of the US dollar. Around that time the German economy also overtook the UK's, but like the dollar the Reichsmark failed to impress the market, and sterling continued to be the international vehicle currency. It was only after the First World War that the dollar began to glitter and only after the Second World War was its overwhelming status established.

- In recent years the Chinese government has been decontrolling both domestic financial markets and cross-border capital transactions step by step. However, there is skepticism as to the extent to which the liberalization goes. The Chinese government or the Communist Party appears to be reluctant to accept free flows of capital or full liberalization of financial transactions both at home and cross-borders. They seem particularly cagey about outflows of domestic capital.

- In my opinion, market confidence matters a lot for an actively used international currency. It is not only confidence in the value of the currency but confidence in its integrity that matters. The integrity of currency is maintained only when it functions properly as means of exchange, unit of account, and store of value.

- To be a little more specific about the requirements for the integrity of currency, the monetary authorities have to create and maintain a system so as to ensure reliable means of payment and wide, deep financial markets, supported by, e.g., banknote counterfeit deterrence capability, legal stability and transparency as well as law enforcement capability over financial fraud and other wrongdoings. On all accounts, there is a long way to go before the RMB gains confidence in the market.

- I have one footnote to put to this conclusion, not concerning the RMB but the US dollar. In recent years the US government has been actively using its clout over the global financial system as economic sanction against Russia, Iran and others. It was reported a few months ago that the US might even try to limit Russian banks' access to SWIFT, the global message transfer system of inter-bank transactions. If such financial controls were used widely for foreign policy purposes, I am afraid it would damage the market confidence in the US dollar, thereby depreciating its supreme status in the global financial system.

4. <u>Technical issues over RMB internationalization</u>

i. Central bank swap arrangements

- Some central banks have swap arrangements with other central banks. For example, the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank have standing swap arrangements with each other to provide domestic currency against the counterpart's currency. The BOJ also has bilateral currency swap arrangements with several Asian countries.

- At the height of the Global Financial Crisis of 2008, the Fed agreed to have emergency swap arrangements with many foreign central banks to provide the dollar liquidity, and so did the BOJ the yen liquidity with the Bank of Korea.

- Shortly after these episodes, the People's Bank of China also signed swap agreements with the central banks of Korea, Malaysia, Belarus, Indonesia, and a few others. Those countries apparently faced shortage of foreign exchange reserves and the RMB swaps were sought to augment their reserves at a time of a pressing need. Because the RMB was not freely usable for international transactions, however, actual utility of the yuan created by the swap lines was limited to payments to China. In a sense these swap lines were prepared as a safeguard or cosmetics against speculative market attacks on their currencies, and I don't know if these arrangements were actually activated.

- In more recent years the BOE, ECB and other central banks of developed countries have opened up swap arrangements with the PBOC, which are, unlike the swaps aforementioned, intended to enhance the RMB liquidity in its offshore banking markets in those countries so that the RMB clearing can be done smoothly.

ii. RMB offshore clearing centers and the Shanghai FTZ

- In 2009 the PBOC officially launched a RMB clearing bank system in Hong Kong, which was followed by similar arrangements in Singapore, Frankfurt, London, and many cities in Asia, most recently in Sydney.

- Generally speaking, offshore markets are the flipside of the coin of under-developed home markets, and the RMB offshore markets are no exceptions. If the RMB were freely usable inside and outside China, banks would make their clearing of their RMB balances at their accounts held at the PBOC or their corresponding banks' accounts there, which makes the payment final. It is particularly true of banks located in time-zones similar to Beijing's because they could do payment/settlement business within daytime working hours and therefore, there would be no point to do such business in an offshore center, where the finality of payment is not assured. On the other hand, banks in remote time-zones may find some merit of settlement with the designated RMB clearing banks because the RMB is not a globally used currency, hence not a CLS currency.

- In other words, the RMB offshore centers are a means to cover deficiencies in its home markets to some extent. In order to push the internationalization of the RMB more substantially, it is essential for the Chinese authorities to lift virtually all exchange controls in home banking markets. In this regard, the real test concerns the Shanghai FTZ, where RMB exchange transactions are expected to be liberalized considerably, going forward.

iii. AIIB

- AIIB makes sense to me. Asia is ample with both savings and investment opportunities, and there is room for improvement in financial intermediation there. It was this consideration at 11 central banks in Asia-Pacific that led them to embark on a project called the Asian Bond Funds (ABFs) a decade ago to enhance the functions of bond markets in emerging Asian economies so as to channel their rich savings nicely into investment opportunities in Asia. I was the chairman of the committee responsible for supervising ABFs for four years until 2010. By the same token, the AIIB can funnel Asian savings into Asian investment opportunities in infrastructure. There is an additional merit in the AIIB at the present time, when Basel III and other regulatory requirements tend to restrain commercial banks from extending credit to large, riskier projects.

- In order for the AIIB to be successful, there are many technical aspects to examine, e.g., assessment of asset quality, funding capabilities, asset/liability management, which are no different from the conditions for a good commercial bank. In order to become a good bank, the AIIB will need qualified professionals for each important department. Why don't Japanese experts join it?

iv. SDR

- The Aussie dollar captures 9% of the global forex market, four times larger than the RMB in the most recent BIS survey. Each of the Swiss franc and the Canadian dollar has more than twice the share of the RMB. None of these currencies are included in the SDR basket. I think the RMB's inclusion is way too premature although G7 may be making a political decision in its favor prematurely.

- What is the merit of the RMB becoming an SDR composing currency for China? Besides an aspect of national pride, I see no practical benefit. SDR is a unit of account at some international institutions, but practically nothing more than that. There is no scope for private use of SDR as a means of payment because there is no settlement mechanism in kind. You will have to unbundle an SDR into four national currencies before settled. Even for an investment currency, there is no client base among small investors, whose utility function depends on their home currency, or global investors, who can create their own currency-mix tailor-made.

Charles Kindleberger[vi] referred to the SDR in 1985 as something like Esperanto for a language, which I thought to be a very pithy remark then and I continue to do so three decades later.

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i Based on the author's remarks at the Fung Global Institute's Seminar on China's Financial Future at the University of Hong Kong on June 8, 2015.

ii The BIS conducts a survey over the global foreign exchange market every three years. It began that survey in 1989 and did the most recent one in April 2013, in which 53 countries' central banks participated to collect data from about 1,300 banks and other dealers around the world. Cf. BIS, *Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013*

iii On a net-net basis, i.e., net of inter-dealer double counting both inside and cross borders.

iv Horii, A.(1986) illustrates that the US dollar continued to weigh heavy in the global exchange reserves in contrast to the widely held view otherwise. Cf. Horii, Akinari, "The evolution of reserve currency diversification," *BIS Economic Papers no.18* (December 1986)

v Frankel, Jeffrey, "Still the Lingua Franca," *Foreign Affairs* (July/August 1995). See also Kenen, Peter B., "Currency internationalization: an overview," *Currency internationalization: lessons from the global financial crisis and prospects for the future in Asia and the Pacific, BIS Papers No. 61* (December 2011).

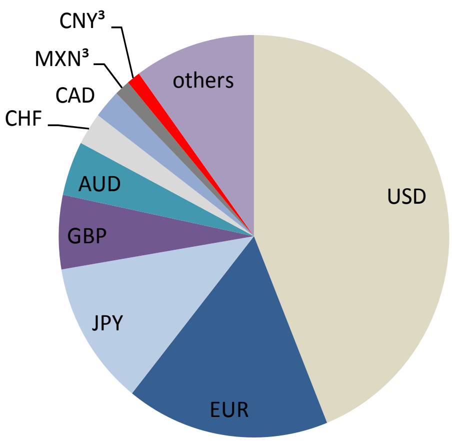
vi Charles P. Kindleberger, "The dollar yesterday, today, tomorrow," *George W. Stocking Memorial Lecture ,* October 17, 1985

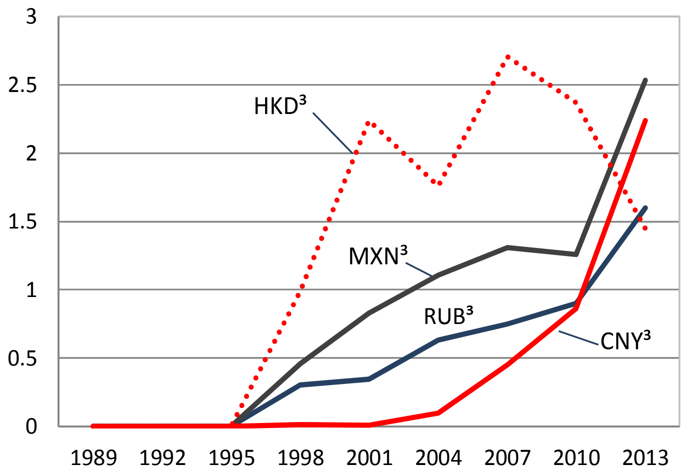
International currencies
(BIS Triennial Central Bank Surveys)

Currency distribution of global foreign exchange market turnover[1]

Percentage shares of average daily turnover in April each year[2]

	1989	1998	2001	2007	2010	2013
US dollar	90	87	90	86	85	87
Euro	33	52	38	37	39	33
JP yen	27	22	24	17	20	23
UK sterling	15	11	13	15	13	12
Aussie dollar	2	3	4	7	8	9
Can. Dollar	1	4	5	4	5	5
Mx peso	-	1	1	1	1	3
Cn yuan	-	0	0	1	1	2
All currencies	**200**	**200**	**200**	**200**	**200**	**200**





[1] Adjusted for local and cross-border inter-dealer double-counting (ie "net-net" basis). [2] Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200% instead of 100%. [3] Turnover for years prior to 2013 may be underestimated owing to incomplete reporting of offshore trading in previous surveys. Methodological changes in the 2013 survey ensured more complete coverage of activity in emerging market and other currencies.

(Source) BIS