B THE EMERGENCE OF THE CHINESE RENMINBI AS AN INTERNATIONAL CURRENCY[34]

In view of China's rapid economic development and the recent measures taken by the Chinese authorities to enable the international use of the Chinese renminbi (RMB), some observers have argued that the latter could become an important international currency over the medium term, alongside the US dollar and the euro, which could possibly lead to the emergence of a tri-polar international monetary system. This special feature takes stock of recent developments in the international use of the renminbi, discussing drivers and challenges, and updates the analysis presented in earlier releases of this review. Overall, the special feature finds that China's growing weight in global output and trade, together with policy measures taken by the Chinese authorities, have led to an increasing use of the Chinese currency in international trade and, to a lesser extent, international financial markets. However, the lack of sufficiently deep and liquid domestic financial markets, financial restrictions and remaining capital controls, as well as constraints regarding exchange rate flexibility, hamper the development of the renminbi as an international currency, and in particular as a reserve currency. However, it is conceivable that the renminbi could play an increasingly prominent international role over the medium term to the extent that the Chinese authorities continue to gradually introduce domestic financial sector reforms, liberalise the capital account and strengthen exchange rate flexibility.

1 INTRODUCTION

In view of China's rapid economic development and the recent measures taken by the Chinese authorities to remove obstacles to the international use of the renminbi, some observers have argued that the latter could become a prominent international currency over the medium term, alongside the US dollar and the euro, which could possibly lead to the emergence of a tri-polar international monetary system.[35] Some observers have argued that the renminbi could play a prominent international role within the next 15 to 20 years (see e.g. Eichengreen, 2012, for a review of the debate). The Chinese authorities have already taken several steps to allow the international use of the renminbi as a trade invoicing and settlement currency, in particular. At the same time, the renminbi's international role has also developed along several other dimensions, including as an international investment and financing currency. This special feature takes stock of recent developments in the international role of the renminbi (Section 2.2), reviews economic and policy-driven determinants of this role (Section 2.3) and assesses the challenges ahead if the renminbi is to play a still more prominent role in the international monetary system (Section 2.4).

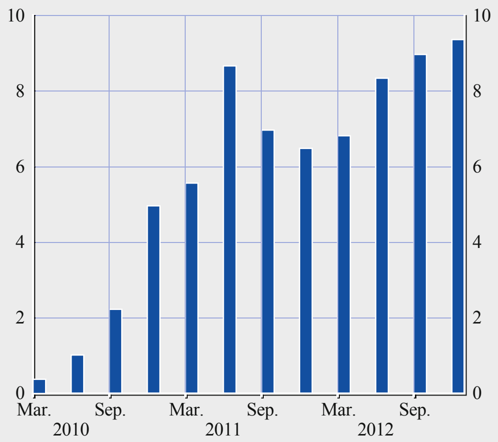
2 RECENT DEVELOPMENTS IN THE INTERNATIONAL USE OF THE CHINESE RENMINBI

The gradual internationalisation of the renminbi is particularly visible in its growing use as an invoicing and settlement currency for China's international trade transactions, in line with China's significant integration into global trade. While the US dollar remains the dominant settlement currency of China's international trade transactions to date, the use of the renminbi has grown significantly in just a few years, inspired by the desire to reduce the foreign exchange exposure of Chinese companies. Between 2010 and the end of 2012, the share of China's trade in goods settled in renminbi increased from essentially nought to almost 10% (see Chart 25).

34 Prepared by Roland Beck, Georgios Georgiadis and Arnaud Mehl with comments by Michel Soudan.
35 See ECB (2012) for a review of this debate.

Chart 25 Share of RMB-denominated settlements in China's trade in goods

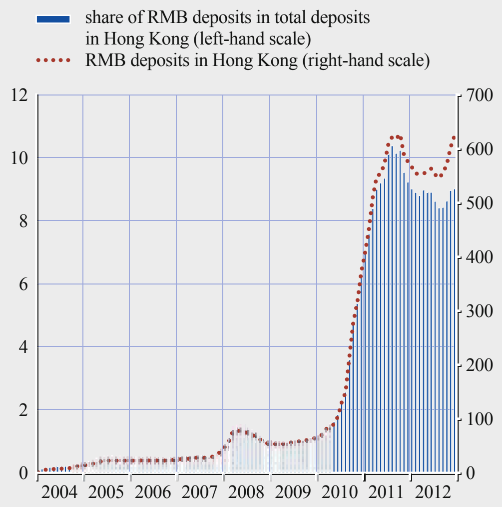
(as a percentage)



Sources: CEIC and People's Bank of China.

Chart 26 RMB-denominated deposits in Hong Kong

(RMB billions; as a percentage of total deposits)



Sources: CEIC and Hong Kong Monetary Authority.

As non-Chinese resident companies started to accumulate renminbi payments in exchange for exports to China, the renminbi's growing use as an international settlement currency also gave impetus to its use as an international deposit currency. Renminbi-denominated deposits in Hong Kong have grown steeply since 2004, reaching roughly USD 100 billion in 2011 (see Chart 26).[36]

In turn, the international issuance of renminbi-denominated bonds has risen strongly since 2007 (see Chart 27). Although the bulk of issuance of such bonds is still accounted for by firms originating from China or Hong Kong (see Chart 28)[37], several non-Chinese multinational companies have also issued so-called "dim sum" bonds in Hong Kong, thereby offering an investment opportunity for non-resident renminbi deposit holders. Furthermore, non-financial firms from mainland China have launched initial public offerings in Hong Kong. In addition, international development organisations have issued renminbi-denominated bonds in mainland China (also known as "panda" bonds), and London, Singapore and Taipei have taken steps to develop their own renminbi financial centres.

The international use of the renminbi as a reserve currency is significantly more limited thus far, mainly reflecting the fact that it is still largely inconvertible for investment purposes. Only a few central banks have started to add renminbi-denominated assets to their reserve holdings, as part of bilateral agreements with China, although the amounts – which remain confidential – are believed to be marginal to date.[38]

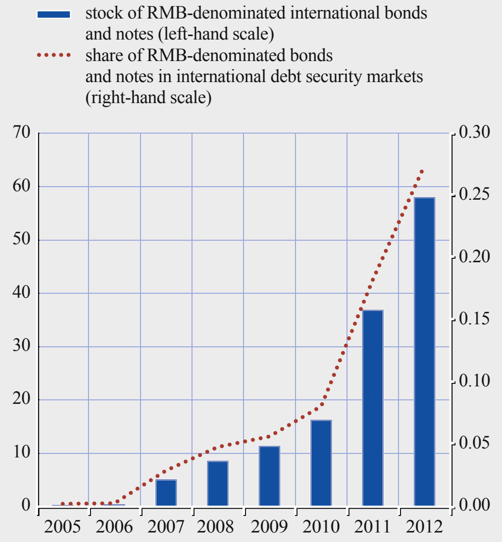
36 Renminbi deposits in Hong Kong have stabilised recently owing to a greater use of the renminbi to pay for imports from China, thereby creating more, although not fully, balanced payment flows. The emergence of expectations of a depreciation of the renminbi vis-à-vis the US dollar during 2012 also played a role.

37 BIS data based on the residence of issuer reveal similar trends, although the assessment of issuer distribution is complicated by the fact that many Chinese firms issue renminbi-denominated bonds via subsidiaries registered in small financial offshore centres, such as the Cayman Islands.

38 According to IMF guidelines, only assets denominated in convertible currencies count as foreign exchange reserves. The central banks of a few countries are reported to have added renminbi assets to their foreign exchange reserve portfolios, while others have said that they would consider adding renminbi-denominated reserves to their reserve portfolios. In a recent survey of reserve managers, 37% of the respondents indicated that they would consider investing in the renminbi within the next five to ten years (RBS, 2013).

Chart 27 Amount of international RMB-denominated bonds and notes outstanding

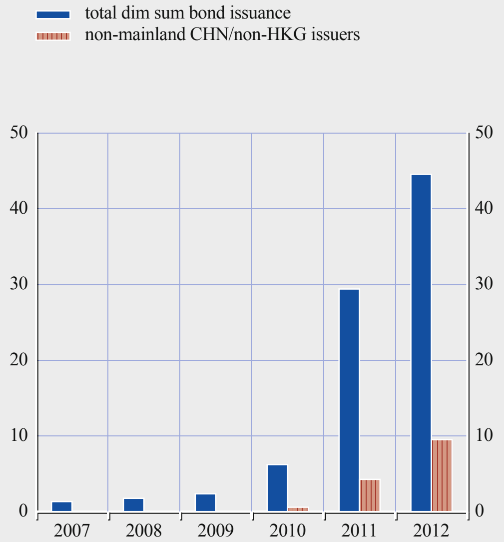
(USD billions; as a percentage)



Source: BIS.

Chart 28 Dim sum bond issuance

(USD billions)



Source: Bloomberg.
Note: Bloomberg's "country risk" indicator is used to determine the economic residence of the issuer.

Despite its rapid development, the use of the renminbi in trade and financial transactions in Asia remains limited compared with the US dollar, which is still the main international currency in the region. For example, 80% of the trade settled in renminbi is between mainland China and Hong Kong, partly reflecting processing trade. Settlement of exports to China denominated in renminbi is also larger than renminbi-denominated settlement of imports from China, which some observers consider to be evidence that the use of China's currency as a settlement unit might be driven by expectations of a future appreciation of the renminbi (see Prasad and Ye, 2012, and Yu, 2012). There is thus still some way to go until the renminbi fulfils the regional role of an international currency in Asia.

3 DETERMINANTS OF THE GROWING INTERNATIONAL USE OF THE RENMINBI

International currency status can largely be explained by persistence, economic size, the stability of the value of the currency (measured against either a basket of currencies or a basket of goods), and the depth and liquidity of financial markets.[39]

With respect to economic size, the growing international use of the renminbi results first and foremost from the increasing importance of China in the global economy. In 2010 China overtook Japan as the second largest economy behind the United States in PPP-adjusted terms. Projections suggest that China could overtake the United States as the largest economy by 2016 (see IMF

39 For a policy-oriented review of international currency status, see BIS (2011). Academic reviews in this context include Chinn (2012) and Chinn and Frankel (2007, 2008).

Table 6 Overview of bilateral swap agreements signed by the People's Bank of China

Partner country	Date	Observation	Amount	
			RMB billions	USD billions
Korea	12/2008	Renewed (10/2011)	360	57
Hong Kong	01/2009	Renewed (11/2011)	400	63
Malaysia	02/2009	Renewed (02/2012)	180	29
Belarus	03/2009		20	3
Indonesia	03/2009		100	15
Argentina	04/2009		70	10
Iceland	06/2010		3.5	1
Singapore	07/2010	Renewed (03/2013)	300	22
New Zealand	04/2011		25	4
Uzbekistan	04/2011		0.7	0
Mongolia	04/2011	Expanded (03/2012)	10	2
Kazakhstan	06/2011		7	1
Thailand	12/2011		70	11
Pakistan	12/2011		10	2
United Arab Emirates	01/2012		35	6
Turkey	02/2012		10	2
Australia	03/2012		200	31
Ukraine	06/2012		15	2
Brazil	03/2013		190	30
United Kingdom		Under discussion (02/2013)		
Total			**2,006.2**	**289**

Source: People's Bank of China.

WEO, 2012).[40] China also accounts for 9% of global trade, closely behind the United States, which accounts for 11%. In terms of price stability, the level of inflation in China and its volatility have been relatively moderate in recent years and this is expected to continue.[41] The development of deep, liquid and broad domestic financial markets, on the other hand, remains a key challenge for the internationalisation of the renminbi (see below).[42]

A particular feature of the growing international use of the renminbi – which is typically not taken directly into account by empirical models of international currency use – is the key role played by supporting policies aimed at liberalising China's current and capital account as well as fostering the international use of the renminbi. For example, in 2009 a pilot project for settling trade in renminbi was initiated. It was initially limited to a small number of Chinese cities, firms and trading partners,

Table 7 Liquidity of Chinese government bond markets

(percentages)

	Stock	Turnover	Ratio
	RMB billions		(percentages)
2000	1,574	13	1
2002	2,716	95	3
2004	4,717	805	17
2006	8,271	2,149	26
2008	13,187	10,373	79
2010	15,906	15,312	96
2012	17,200	12,950	75

Sources: AsianBondsOnline and ECB staff calculations.
Notes: Turnover is defined as the value of bonds traded on the secondary market. The turnover ratio is defined as total turnover divided by the amount of bonds and notes outstanding in the corresponding year.

40 Similarly, OECD projections suggest that China will overtake the US economy in 2018. There are ongoing discussions about the plausibility of the assumptions underlying these projections (see Subramanian, 2011; Eichengreen, 2013).
41 The People's Bank of China does not have a precise medium-term inflation target, but gears its monetary policy towards balancing stable but relatively fast growth and supporting China's reform process while maintaining a stable price level and managing inflation expectations.
42 Financial development and liquidity are also among the criteria considered for currencies to be included in the SDR basket (see e.g. IMF, 2011a).

but was extended in 2012 so that (almost) all of China's trade can now be settled in renminbi. The Chinese authorities have also developed a network of bilateral swap agreements between the People's Bank of China and foreign central banks (see Table 6). These facilities are mainly intended to provide renminbi liquidity for situations in which foreign importers are temporarily unable to obtain renminbi for the settlement of trade transactions with Chinese exporters (see Ito, 2011). So far only marginal amounts have been drawn from these swap lines (Prasad and Ye, 2012).[43]

The Chinese authorities have also adopted measures to support the use of the renminbi in financial markets in mainland China and Hong Kong, as well as to liberalise China's capital account. Policy initiatives undertaken by China's authorities have focused on (i) promoting Hong Kong as an offshore renminbi financial centre (by using its position as a financial hub and as an entry point to mainland China's financial markets; see Vallée, 2012); (ii) increasingly allowing selected Hong Kong-based subsidiaries of Chinese investment firms to invest limited amounts of renminbi raised offshore in specific assets in mainland China; (iii) promoting the use of the renminbi as a reserve currency for foreign central banks. To that end, the authorities have taken a host of measures, ranging from streamlining application procedures to allowing issuance of renminbi-denominated bonds by foreign institutions in mainland China (see Table 8). There have also been important bilateral policy initiatives, such as the agreement announced by China and Japan in December 2011 to liberalise bilateral financial flows.[44] In particular, the agreement involves the development of direct exchange markets in yen and renminbi, allowing Japanese firms to undertake renminbi-denominated foreign direct investment vis-à-vis subsidiaries in mainland China and to issue renminbi-denominated bonds in Tokyo. The agreement also allows the Japanese authorities to invest in Chinese government bonds.

Table 8 Overview of policy measures aimed at fostering the use of the renminbi in international trade and financial transactions

Date	Content
January 2003	Qualified Foreign Institutional Investor (QFII) scheme for foreign investment in listed mainland China bonds and equities
February 2004	Hong Kong banks permitted to offer RMB personal accounts to residents
February 2005	Eligible international development organisations allowed to issue RMB-denominated ("panda") bonds in mainland China
April 2006	Qualified Domestic Institutional Investor (QDII) programme allowing domestic institutions to convert RMB into foreign currency and invest in overseas equities and bonds
January 2007	Mainland China financial institutions allowed to issue RMB-denominated ("dim-sum") bonds in Hong Kong
February 2010	Foreign firms authorised to issue RMB-denominated bonds in Hong Kong
August 2010	Foreign central banks, offshore RMB clearing banks and participating banks allowed to invest RMB raised offshore in mainland China interbank bond market
January 2011	Mainland China firms allowed to apply to take RMB offshore for overseas direct investment in foreign firms
October 2011	Rules formalised to allow approved foreigners to invest RMB raised offshore directly in mainland China firms, including through the provision of RMB cross-border loans
December 2011	RMB Qualified Foreign Institutional Investor (RQGFII) scheme allowing RMB raised offshore to be invested in mainland China bonds and equities
May 2012	Rules formalised for onshore non-financial corporations to issue RMB-denominated bonds offshore
March 2013	RQFII quota applying to offshore RMB that can be re-invested in mainland China financial markets increased; group of eligible investors as well as range of assets broadened significantly

Note: See also Cockerell and Shoory (2012) and Prasad and Ye (2012).

43 In December 2012 the People's Bank of China and the Bank of Korea agreed to use their swap line more actively as a trade financing facility.

44 The agreement also involved measures to facilitate trade settlement in renminbi and yen.

In 2011 the People's Bank of China published a three-stage roadmap which proposes to liberalise remaining unconvertible items according to the general sequencing principle of "inflow first and outflow later; long-term first and short-term later; direct investment first and portfolio later; institutional investors first and individuals later". More recently, in May 2013 the Chinese State Council announced that a detailed plan on renminbi capital account liberalisation, including further measures on currency and interest rate reform, would be put forward in due course. The plan is expected to stipulate mechanisms through which capital could move more freely in and out of China.

Some observers have described the gradual, integrated approach to financial market development and capital account liberalisation pursued by the Chinese authorities as "crossing the river by feeling the stones" (see Yu, 2012; Prasad and Ye, 2012). It has also been argued that the Chinese authorities have been pursuing capital account liberalisation gradually so as not to expose shallow domestic financial markets to volatile capital inflows. At the same time, they have liberalised selected financial account transactions to allow foreign participation in domestic financial markets and import technology and know-how. This careful sequencing of the liberalisation of international transactions and domestic financial reforms is broadly in line with recent recommendations by the IMF and empirical studies, which find that the benefits of full capital account openness can only be reaped if a threshold level of domestic financial and institutional development has been reached.[45]

4 CHALLENGES RELATED TO THE INTERNATIONALISATION OF THE RENMINBI

Challenges remain as regards further developments in the internationalisation of the renminbi.

First, China still lacks to a large extent sufficiently deep, liquid and broad domestic financial markets, which are instrumental in fostering a currency's international role, as suggested, for example, by the experience of the period between the First and the Second World War.[46] Financial market regulations and controls, such as deposit rate ceilings, lending rate floors and directed credit, remain pervasive in China and restrict competition as well as the diversity of financial products (see IMF, 2011b; Ito, 2011; Eichengreen, 2012). The liquidity of international financial assets denominated in renminbi remains low. For instance, daily turnover in renminbi foreign exchange markets accounts for less than 1% of total transactions, according to the latest Triennial Central Bank Survey, conducted by the BIS in 2010. Markets for renminbi-denominated international debt securities remain shallow compared with those in US dollars or euro, accounting for less than 0.3% of total international debt securities. The liquidity of the Chinese government bond market is particularly low (see Table 7). The turnover ratio of Chinese government bonds is in the order of 100%, i.e. 14 times lower than that of US government bonds; the turnover of government bonds in India is about twice that in China, although the absolute size of India's market is smaller (see Prasad and Ye, 2012).

Second, China's financial markets remain largely closed. Foreign investment in mainland China remains subject to quotas and tight regulations to a large extent (Vallée, 2012). It has been argued that international demand for renminbi-denominated financial assets is likely to remain constrained as long as investors do not have greater freedom regarding investment types and amounts undertaken in China (Ito, 2011). The limited convertibility of China's capital account hampers its international financial integration, especially by comparison with other major international currency issuers,

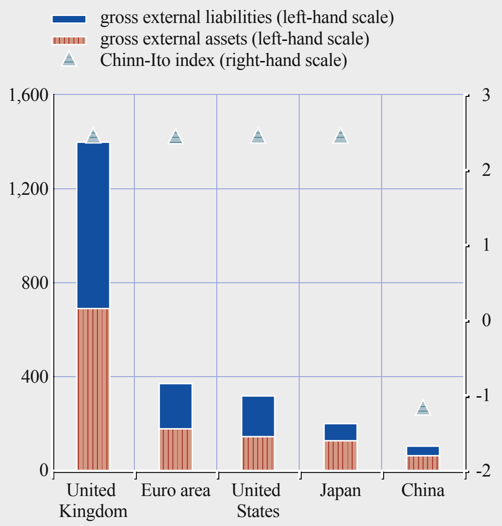
45 See IMF (2012) and, for example, Kose et al. (2009) and Dell'Ariccia et al. (2008).

46 Financial development appears to have been a decisive factor in helping the US dollar overtake the pound sterling as the leading international currency (see e.g. Eichengreen, 2013).

in terms of both de jure and de facto integration measures (see Chart 29).

Chart 29 Measures of international financial integration of selected economies

(percentages; percentage of GDP)



Sources: Chinn and Ito (2003) and IMF.

Considering the use of the renminbi specifically as a trade settlement currency, it is not certain that China will manage to gradually switch from local or vehicle currency pricing to producer currency pricing in export settlement.[47] This will depend, among other factors, on the strength of network effects (which favour the use of the US dollar or the euro in many of China's export markets), on the degree of competition in the export markets concerned, and hence on the market and bargaining power of China's exporters.[48] Japan's experience in the 1980s suggests that supportive policies can be temporarily successful, as indicated by the rising use of the yen as an invoicing currency in Japan's international trade transactions (see ECB, 2012). Nevertheless, Japan's experience also suggests that international currency status has to be continuously underpinned by strong economic and financial fundamentals, given the significant decline in the yen's share in global foreign exchange reserves following the bursting of an asset price bubble in the 1990s and the subsequent period of subdued economic growth.

A final question is whether China will manage to maintain rapid and sustainable growth in the medium to longer term. Recent empirical studies have pointed to the existence of a "middle-income trap", i.e. a slowdown in fast-growing emerging market economies once they reach middle-income status (see Eichengreen et al. 2012, 2013; World Bank, 2012). Sustaining rapid growth in China will require further structural reforms to ensure a smooth transition to a growth model based more on domestic consumption and the development of services industries than on investment, exports and manufacturing. In turn, this is likely to require developing China's domestic financial system, liberalising the capital account and increasing exchange rate flexibility.

5 IMPLICATIONS OF THE RISE OF THE RENMINBI FOR THE INTERNATIONAL MONETARY SYSTEM

The rise of the renminbi to international currency status has stimulated discussions about the implications for the future of the international monetary system (see, for example, Angeloni et al., 2011, for a review of the debate). On the one hand, it has been argued that a move towards a more multipolar international monetary system could increase its stability. According to this line of argument, the existence of alternative reserve currencies would impose discipline on the national economic policies of reserve currency issuers, alleviating the so-called "Triffin dilemma". In particular, the existence of alternative reserve currencies in a multipolar world would enable investors to rebalance their international portfolios more easily should macroeconomic policies

47 For a review of the determinants of currency choice in international trade invoicing, see e.g. Goldberg and Tille (2011).
48 According to Cui et al. (2009), only around 20-30% of China's exports could eventually be settled in renminbi.

pursued by one reserve currency-issuing economy become unsustainable (see Farhi et al., 2011).[49] Moreover, it has been argued that the move to a multipolar system involving the renminbi would mitigate exchange rate volatility by allowing investors to respond to shocks by adjusting their renminbi as well as their US dollar or euro positions (see Bénassy-Quéré and Forouheshfar, 2013). It has also been argued that, to the extent that the move towards a multipolar international monetary system would involve an increase in the flexibility of the renminbi exchange rate, the accumulation of reserves by China would be reduced, contributing to a global rebalancing and a more efficient allocation of capital (see Bénassy-Quéré and Pisany-Ferry, 2011).[50]

On the other hand, it has been postulated that a move towards a multipolar international monetary system could make the international monetary system less stable. This could be the case insofar as a more frequent rebalancing of global investment portfolios in response to changes in perceptions about the sustainability of economic policies in reserve-issuing countries would amplify exchange rate volatility (see United Nations, 2009). In the presence of alternative reserve currencies, rebalancing and precipitous capital flows could be triggered even by minor changes in fundamentals due to asymmetric information and herding behaviour among investors (see Farhi et al., 2011).

It is therefore essential that any transition towards a multipolar international monetary system occurs in an orderly manner so that disruptions and excessive volatility can be avoided (see Bini Smaghi, 2011, and Constâncio, 2011).

6 CONCLUSION

China's increasing weight in global output and trade as well as efforts by the Chinese authorities aimed at facilitating the international use of the renminbi have led to an increasing use of the Chinese currency in international trade and, to a lesser extent, international bond markets. At the same time, the lack of deep and liquid domestic financial markets, tight financial market and capital account restrictions, and limited exchange rate flexibility continue to hamper the development of the international use of the renminbi in several respects, most notably as a reserve currency. A further challenge relates to the question of whether China will manage to sustain rapid and sustainable growth in the medium to longer term, insofar as international currency status is crucially underpinned by economic dynamism, albeit only in tandem with price and financial stability.

There is potential for the renminbi to play a still more prominent international role in the medium term, provided that the Chinese authorities continue to gradually introduce financial sector reforms, liberalise China's capital account and strengthen exchange rate flexibility. Historical experience suggests that a gradual shift to a multipolar international monetary system is not inconceivable and that network externalities, which favour the incumbent currency, are not insurmountable. The evidence of the US dollar overtaking the pound as the leading international currency as early as the period following the First World War, although the British currency still retained a significant role, provides a case in point.[51]

49 An additional stabilising effect of the rise of the renminbi to international currency status would stem from the increase in the global supply of reserve assets that could satisfy more easily the growing demand from emerging market economies that converge to middle and high-income status. The existence of renminbi-denominated reserve assets would also mitigate the tensions in the international monetary system stemming from a possible reduction in the supply of reserve assets due to the limits to fiscal capacity of the United States (see Farhi et al., 2011).

50 Similarly, a liberalised renminbi exchange rate would reduce the potential for persistent misalignments that could distort the allocation of capital.

51 See ECB (2012) and Chițu, Eichengreen and Mehl (2012).

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