The RMB Internationalization and the Reform of the International Monetary System

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Abstract: *The RMB internationalization is one of the major Chinese financial strategies in the aftermath of the global financial crisis. It is driven by an increasing importance of China in the global economy, as well as by its efforts to reform the international monetary system. The paper examines to what extent the RMB is used internationally and outlines the major steps taken from the policy point of view. The Chinese government reaffirms its decision on financial opening and on domestic financial reform, being committed to make the RMB fully convertible by 2020. The author concludes that such forward-looking policy steps, along with the RMB flexible exchange rate, will reshape the Chinese economy and its role within the world economy.*

Keywords: *RMB internationalization, international monetary system, SDR reform, capital account opening, domestic financial market, offshore RMB market*

1. Introduction

The reform of the international monetary system was triggered by the global financial crisis in 2008. However, from a long-term perspective, it was the result of changing economic powers (Gao, 2015). Over the past decades, emerging economies have become engines of growth, massive reserve holders and the largest creditors of developed economies. China has become the second largest economy, but it has struggled with a so called "dollar trap", meaning that it has recycled its savings into dollar-denominated assets while being subject to dollar volatility (Krugman 2009). The global financial crisis certainly has provided a momentum for China to challenge the reality, yet the root motivation for the RMB internationalization was an increasing economic weight of China in the world.

In 2009, the governor of the Chinese central bank, Zhou Xiaochuan, proposed to design a super-sovereign reserve currency. He criticized the predominance of fundamental financial flaws in a single dominant currency system and the existence of Triffin Dilemma (Zhou 2009). The key message of this theoretical proposal was to encourage countries to delink the global financial stability from the balance of payment of one country. Although such an idea is infeasible in practice, it implicitly presents the disagreement of China with the current international monetary system. In fact, China is ready to seek options for increasing its voice within the existing international financial institutions, and to reduce its over-reliance on the US dollar (Gao and Yu, 2012).

Considering this background, the issues of the Chinese currency strategy and the effort of China in reforming the international monetary system have drawn significant attention from policy makers, academic researchers, and market participants worldwide. Particularly, the issue of the RMB internationalization has became the center of the international monetary system's reform. Academic studies have focused on the factors for the RMB to become an international currency, on benefits and costs associated with the RMB internationalization, on Chinese policy choices and the sequence to support the strategy, and on its potential impacts on regional monetary integration and international monetary system (Gao, 2016).

The paper investigates the following issues: how China exerts its influence in order to strengthen its position within international financial institutions, with the focus of Special Drawing Rights (SDR) reform; to what extent the RMB expands its functions as an international currency, and why the Chinese policy sequences and the development of RMB offshore and onshore markets is important for the process of RMB internationalization. The paper concludes with the views on a broader implication of the Chinese currency strategy for the economic reform and the openness in China, and for the future direction of the international monetary system.

2. The increasing role of China within international financial institutions

The IMF is one of the most important Bretton Woods institutions. However, Asian developing countries have had an unhappy experience with the IMF during the financial crisis in 1997-1998 – when the countries in crisis have requested IMF to provide emergent liquidity support, they have had to agree with the IMF conditionality. The conditionality was strict and required the countries to carry out policy adjustments and structure reforms. At that time, the IMF policy recommendations for distressed countries were largely influenced by the prevailing "Washington Consensus", which have turned into wrong solutions for Asian countries to overcome the problems. Such experience has become one of the reasons for Asian countries - ASEAN, China, Japan and Korea (known as 10+3) - to establish their own financial supporting mechanism, namely, Chiang Mai Initiative (CMI). The CMI has been improved and enlarged several times, since its establishment in 2000. Now it has become a multilateral mechanism - Chiang Mai Initiative Multi-lateralization (CMIM), with a capacity of 240 billion of dollars. China and Japan take the lead and are the biggest shareholders. The purpose of CMIM is not only providing the crisis support in Asia, but also is a supplement to the IMF. More importantly, ASEAN+3 Macroeconomic Research Office (AMRO) was established in 2010. It is located in Singapore, performing economic surveillance and policy dialogue among member countries. Although the AMRO has limited capacity, compared with the IMF, it has begun to function as a regional version of the IMF. Being the biggest shareholder in the AMRO, China plays a key role in shaping a regional financial institution in Asia.

At the global level, the IMF is still the principle institution for preserving the global financial stability. After the Asian financial crisis, the IMF has reflected the constraints and the drawbacks and has decided to reform itself in many aspects. For instance, the IMF credit lines are now more flexible and more adaptable for crisis support. The IMF quota resources have doubled since global financial crisis. The IMF has finished the new round of quota reform, giving emerging economies more seats of executive directors. China, as one of the main contributors, has substantially increased its quota share and its voting power.

3. The Special Drawing Rights reform

Another major reform of the IMF refers to its SDR by including the RMB into the SDR basket. The RMB inclusion in the SDR basket is logical, given that China has the largest share in the world trade, and given the Chinese effort concerning the liberalization of its capital account and of the exchange rate regime. Such an insignificant change in the basket composition, actually, raises tremendous potentials for diversification of the international reserve system.

From the SDR view, having one of the most traded currencies on board could certainly improve its presentation. The previous composition of the basket, with USD, Euro, Pound Sterling and Japanese Yen, was apparently irrelevant given world trade shares and reserve accounts diversification. More importantly, the inclusion of China in this basket could bring fresh blood into the SDR, and could make it closer to the purpose of the original design of the SDR: an ideal SDR basket, compared with a single sovereign currency, has weaker link to one country's current account deficit and is less reliant on one country's debt issuance. Unfortunately, such a potential advantage has never been materialized. Instead, the US dollar remains the single important liquid asset worldwide, which becomes a major source of financial instability. As a country with a major current account surplus and an important creditor, China has the potential to become another supplier of a global asset, which can make the current reserve currency system more balanced and diversified.

Recently China has begun to diversify its assets, approaching the SDR as a candidate and tking some steps to boost the use of SDR. For instance, Governor Zhou has reiterated the importance of an enhanced SDR on many occasions. On 6 April, 2016, the People's Bank of China (PBoC) began using the SDR as a reporting currency for China's foreign exchange reserve data, expecting to improve the measurement of the reserve value and to enhance the role of the SDR as a unit of account. In August 2016, the International Bank for Reconstruction and Development issued its first tranche of SDR-denominated bonds on the Chinese Interbank Bond Market. In its statement, the PBoC has agreed to facilitate the trading and the settlement of SDR-denominated bonds, has improved its liquidity and has promoted further openness and development of Chinese bond market. This bond issuance would also help broaden the use of the SDR.

Since its currency is included in the SDR basket, China expectsto use it as a leverage to boost RMB internationalization. The SDR is not a currency. It is only a claim on the freely usable currencies of IMF members for the time being. In other words, the IMF member countries can make a SDR trading arrangement either on voluntarily base or through the IMF as an intermediary. Therefore, the RMB inclusion can certainly be a firm support for performing the RMB function as a reserve currency among member countries. Apart from that, global investors can also take advantage of new issuances of the RMB bonds and other financial instruments, following the confirmation of the RMB membership in the SDR.

There is also another expectation for China. In 2015, when Christine Lagarde, the IMF Managing Director, mentioned about the possibility to transform the RMB into an SDR component, during the time of the IMF review on RMB, the world has turned its attention on China. This has happened because the IMF has not provided a clear definition regarding the condition on a "free usable" currency. Moreover, every move made by China was interpreted as an effort to meet this condition. For instance, the PBoC decided to relax its intervention on the RMB middle price on August 11, 2015. That action was approached as a step for meeting the IMF requirements and for establishing the clearing system before the deadline of the IMF evaluation. China has decided to further open the interbank market and to establish the RMB clearing system (CIPS), which were also viewed as actions for that purpose. Therefore, the RMB inclusion in the SDR has become a "committed device" for further financial opening and liberalization of China, at least untill the approval of the formal status in the IMF Executive Board.

However, such "committed device" is not cost-free. One major concern is that spillovers of financial instability may occur in two ways. The impact on market volatility is getting stronger than before. This impact is a new one for China, while previously it has solved this problem by using the capital control tool. In the current context, China has to learn two things: to adopt macro-prudential policies for curbing excessive capital flows; to manage market expectation in order to stabilize foreign exchange volatility. Chinese monetary policy is no longer domestic, while market expectation across the world can also have an impact on domestic policies.

Joining the SDR basket is not the end of the process of the RMB internationalization. Financial opening and domestic reforms are two parallel paths. A well sequenced domestic policy framework is also crucial. The magical "committed device" has been a success for China. The future of the RMB depends more on the success of the domestic financial reform and liberalization.

4. The rise of RMB and the Chinese supporting polices

Since 2008, when China has signed the first RMB bilateral currency swap with Korea, and since 2009, when China has relaxed its control on the RMB in trade settlement, the international use of the RMB has increased rapidly. As a payment currency, the RMB is ranked fifth in the world, according to SWIFT RMB Tracker. About 28.7% of Chinese trade is settled in the RMB; 10% of Chinese direct investment is denominated in RMB (PBoC 2016). The RMB offshore deposits and bond issuances have rapidly grown , especially during the time of RMB appreciation. Domestically, the RMB market is more open to non-resident investors than before. The Chinese government has reaffirmed the objective of RMB free convertibility by 2020 within the Congress third plenum plan. Moreover, the RMB's influence is increasing, especially in Asia, alongside with the economic importance of China in the region.

The rise of the RMB role is a challenge for the dollar. However, a replacement of the dollar within the international financial system is not feasible. Currently, the dollar is still the most important currency in the world. For instance, the dollar has accounted about 64% of the world foreign reserves, almost half of transactions are carried out in dollars on the global foreign exchange market. The dollar has accounted about 48% of bank loans, Dollar-denominated debt securities has accounted 45%. In other words, the dollar is still the most transacted currency. Considering the fact that the dollar has the most liquid, deep and broad market in the world, the scope for other currencies to compete with the dollar is very limited.

The success of the RMB internationalization is based on many factors. Apart from the economic size, the influence and the openness of China's capital account, the development of the domestic financial market another determinant factor (Gao, 2016). Furthermore, a global currency requires a credible , transparent and independent monetary authority. In conclusion, when putting all these factors together, the RMB has a long way to go.

Especially, for the time being, China is facing more challenges than before. Capital account liberalization, exchange rate flexibility and domestic financial liberalization are three key policies for a better chance of RMB to become an international currency (Gao, 2016). Currently, China faces the difficulty to manage the triangle situation: given that autonomy of monetary policy is China's priority, then the monetary authority has to balance between the exchange rate stability and the capital account opening. Exchange rate flexibility is not a must for currency internationalization. But it gives more rooms for convertibility and openness, which is essential for the accessibility of the currency for non-residents.

Since 2005, China has reformed its exchange rate regime toward a more flexible and market-determined one. The past appreciation of the currency has raised market appetite, making the currency attractive for investors. In August 2015, the PBoC decided to stop its interventions on the currency middle price. However, this movehas led to sharp devaluation of the RMB. There were many factors that have caused this depreciation, such as, the expectation of rate rise by the Fed and the slower growth rate in China. The ongoing capital opening was also a major catalyst. In fact, currency devaluation and capital outflow reinforced each other over the period 2015-2016. In December 2015, the PBoC decided to introduce a currency basket – CFETS (China Foreign Exchange Trade System) to anchor the RMB exchange rates. In the meantime, the PBoC has begun slowing down the pace of capital account opening. In the late 2016, the PBoC tightened the controls of cross-border capital movements, rolling back from the previous commitment of the RMB full convertibility.

In theory, a more flexible exchange rate can be an external shock buffer, providing more freedom for monetary authorities to focus on the domestic objectives. As for capital flows, prudential capital management are a preferable tool to mitigate financial risks, as they are market-oriented measures rather than administrative controls. They are adaptable for individual countries and can be adjusted for different circumstances and for different period of time. For instance, the measures include various treatments of non-resident accounts, reserve requirements, foreign exchange related tools, etc.. However, the recent hesitance of China to speed up capital account opening is, in fact, a reflection that China still regards capital controls as the first and the last defense lines.

5. Implications of the offshore and onshore RMB market

The development of the RMB offshore has multiple implications. First, China aimed to create RMB pool outside mainland China. Due to limited convertibility, the RMB liquidity outside China has been insufficient for market transactions since the beginning. The success of the US dollar actually provides an example for the RMB. US dollar is the most transacted currency in the world. One of the factors that have contributed to this position was the development of the euro-dollar market in 50-60s. There were three pillars supporting the euro-dollar market: Marshall Plan that provided a huge supply of the dollar outside the US; the Bretton Wood System that gave the dollar a unique role as a global currency anchor; and the US domestic financial regulation that created incentives for transactions in offshore market during that period. If the experience of the US dollar is of any guide, the RMB can also create an euro-RMB market while maintaining a limited currency convertibility.

Second, the international use of the RMB has an impact on the domestic monetary policy. Normally, if the offshore is pure, which by definition means that transactions take place between non-residents, its impact on the effectiveness of the domestic monetary policy is limited. However, literature provides no conclusion whether currency internationalization can affect a country’s domestic money aggregates and its credit policy (Gao, 2009). In practice, Germany was hesitant towards the Deutsche-mark offshore market in the 1980s, due to uncontrollable impact on domestic money aggregate; Japan was also worried about the disturbing impact of the yen offshore transactions on its window guidance policy in the early 1980s. The RMB offshore has its own characteristics. For instance, most of the RMB transactions on Hong Kong market have Chinese counterparties. Such involvement of Chinese residents makes the RMB market a hybrid of onshore and offshore. Therefore, there is a need to differentiate various types of offshore markets depending on whether the transactions are between residents and non-residents, or only between non-residents, as different transactions have different implications for domestic market and policy.

Third, domestic market development is important for the RMB international usage.The market liquidity is the result of a large number of players, sufficient choices of products, and narrowed bid-ask spreads. A liquid market, in turn, can attract more players and generate demand for both residents and nonresidents for the transacted currencies. A country’s asset structure can also affect currency internationalization. For instance, a market-based system where direct financing dominates the asset structure is more favorable for international transactions of a currency, compared with a bank-based system. A market-based system is common for the USA; a bank-based system is common for Japan and for the Eurozone. China is also a typical bank-dominating system, where bank loans have accounted over 60% of its total social financing, while bond and equity accounted about 10%. China now is expecting a change of its asset structure by increasing the share of direct financing. However, such a shift is unlikely to materialize in a short period for a country with a long history of bank dominance, the existence of large numbers of State Owned Enterprises (SOEs), and the lack of reliable rating agencies.

The last, an efficient and developed financial infrastructure is also important for currency internationalization, as it can tremendously reduce the transaction cost. China is constructing its own single clearing system, the CIPS. It could give the RMB a big push when it is completed, as virtual financial transactions have no geographic boundaries, and they are much larger in terms of volume than trade transactions. More importantly, this system could also become a catalyst for the RMB used as a vehicle - a third currency used between non-residents, an area where currently the US dollar has no competitors.

6. Conclusion

The accession of China to the WTO was regarded as a successful “committed device” for the domestic reform by facing external pressure and foreign competition. A decade later, China has the goal to repeat its success and to utilize the RMB strategy for breaking domestic financial bottlenecks. This intention was quite subtle at the beginning, but it turned into two parallel processes. In fact, financial openness and liberalization are more meaningful than currency internationalization itself.

Ultimately, whether a currency becomes an international one is the choice of the market. The strengthened role of China within the global economy and world trade, ongoing financial opening, domestic financial reform, exchange rate flexibility, and the ability of the government to manage risks incurred by both external shocks and internal economic instability are crucial for the next step of the RMB strategy. Additionally, apart from economic influence, political factors and the change of international economic environment, such as the rise of de-globalization trends and trade protectionism, are also important elements that determine the future of the RMB on the global financial arena.

The RMB internationalization is the own strategy of China. However, it has global consequences. The international financial system is moving away from the dollar hegemony to a multipolar one, where market instability and short-term volatility are unavoidable. Therefore, international financial cooperation is necessary. In the long-term, the success of the RMB internationalization, domestic reforms and economic opening would be a great contribution of China to reshaping the international financial architecture.

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