

RMB as a Regional International Currency: Cost-benefit Analysis and Roadmap

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Abstract

With the rise of China, following the enhanced economic and trade relationship between China and Asian economies, and China's increasing importance in the world economy, China's national currency, the renminbi (RMB) will be getting global from Asia. As regional internationalization of RMB is double-edged, in order to eliminate the financial risks brought by this process, maximize the benefits, it is necessary for China to consider the trade off between costs and benefits of RMB internationalization. RMB internationalization is a dynamic process, in accordance with the different level of the process, the phased strategy should be implemented, and the corresponding policies should be pursued too.

Key word: RMB internationalization Cost and benefit Roadmap

Introduction

If you travel in the Asian region, you will notice that the Chinese renminbi is appearing more often in shops and restaurants, driven by the rapid growth in mainland tourist volumes. Will Chinese Renminbi be the next world currency? Since 2000, RMB internationalization has attracted great attention from the policymakers and the academics both at home and abroad. There is sizable RMB circulation in China's neighboring countries and economies, even RMB can be fully convertible in some developed countries, some of neighboring countries and economies treated RMB as a reserve currency. This is a new economic phenomenon for both China and the world. Because in economic development history, It has been rarely for a developing country's currency which has attracted so much attention from the international community. This new phenomena raised a big concern for China, How positively can China react to this situation? It is getting more and more important to be aware of the costs and benefits of RMB internationalization process, and then put forward the policies which match China's national interest and comprehensive strategy.

I. The inevitability of RMB Internationalization

RMB internationalization is a dynamic process, it refers to that RMB will both serve the legal tender of China and the vehicle currency in the international economic and trade transactions.

1. Perspective of China

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Currency internationalization is the result of market choice, not the outcome of government's encouragement. Concretely, the internationalization process of national currency will be determined by the economic fundamentals, the larger economic size and sustainable economic growth is the economic foundation for building up confidence of the currency; the country which is more open and influential in world economy will attract the demand from the international dealers. The confidence and demand for the currency determines whether the currency will play more and more important role in the global monetary system, and push the currency to develop into an international currency. The feature of Chinese Economy as a large open economy enhanced the confidence for RMB from the international traders and public, and then it will lead to the increasing demand for RMB. If China's economy is fast and sustainable, the acceptability for RMB will be enhanced as well, RMB will turn into the hard international currency.

2. Perspective of Asia

With the rise of China, the economic and trade ties between China and the World, especially between Asian economies will be further enhanced, the integration of Asian market will speed up. "One market, one money", Within one market, only one currency serving as a common measure of value will eliminate the transaction cost of trade and capital mobility, create more trade opportunities, raise the trade size, efficiency and national welfare. The increased degree of economic integration between China and Asia will expand the size of Asian market, and meanwhile create the demand for the common measure of value. The promotion of RMB reputation is a necessary consequence and RMB will gradually substitute the other currencies in Asia.

3. Perspective of the World

From the perspective of the world, the rise of Chinese economy makes China one of the main players. Its national currency, RMB(the international code id CNY, Chinese Yuan), is going to play more and more important role in the international monetary system. The integration of Asia, and the growth of RMB as a regional key currency will challenge the current imbalanced international monetary system. This will improve the global currency structure, reduce the overdependence on USD, and promote the resource allocation efficiency in developing countries.

In general, RMB circulation in China's neighboring economies is the presence of the new stage of China's economic growth, and the consequence of the economic integration between China and

Asia. In line with the definition of international currency, this is one of the essential features, and it indicates the start of RMB internationalization. With the fast and sustainable Chinese economic growth and the expansion of openness, the degree of RMB internationalization will be promoted gradually. However, the degree will be affected and constrained by many factors.

II. The Main Factors Influencing the Degree of RMB Internationalization

The degree of RMB internationalization is not only constrained by the physical productivity, and also by the internal institutions and international economic environment.

1. The Internal Institutions

RMB convertibility, RMB exchange rate regime reform and the domestic financial system reform will be involved in the process of RMB internationalization. To harmonize the RMB capital account convertibility and RMB internationalization will be conducive to Chinese financial system stability. How to liberalize some foreign exchange controls gradually in line with the new features of Chinese economic growth and the change of external economic environment is the necessary requirement of RMB internationalization, and it is the necessary requirement for the Chinese economy to develop into a large economy as well. Confidence and stability is the core of RMB internationalization. The volatility of RMB in terms of the key currencies holds the close relationship with RMB internationalization. If the degree of RMB internationalization advances to a higher stage, the accommodating measure must be RMB exchange rate regime based on market, stable RMB exchange rate, and essentially secure the stability of RMB assets, push the RMB assets grows to a reliable and safe international assets. The process of RMB internationalization raises a new request for the development of internal financial system and financial market. To a large extent, the development of internal financial system reform determines how far the RMB internationalization can travel. It is thus clear that the process of RMB internationalization require the coordination of the internal overall economic reforms.

2. External Economic Environment

RMB internationalization implicates RMB will be acceptable as the medium of exchange and reserve assets by the international dealers, therefore, the RMB internationalization depends on the opportunities offering by the world economic development. The current situation of RMB circulation, even as a reserve currency in its neighboring economies, which is the presence of the rise of Chinese trade in the world economy, and the natural consequence of the enhanced trade ties

between China and its neighboring countries and economies. It is highly related to China's reform and opening up policy and the world economic growth environment since 1980s. In the future, if the world economic growth slows down, the market demand shrinks, and the shrinkage of international transaction will lead to the decrease of China's foreign trade and investment, the demand for the liquidity from the world market will decrease as well. The RMB internationalization will seriously suffer from the worse economic environment, even some setbacks. Because China's role in Asian economic and trade is the main driver of RMB internationalization, RMB will assume the functions as a common measure of value, a medium of exchange, a store of value in Asian market first. Therefore, RMB internationalization will essentially depend on Asian market, i.e. Asian trade and investment market. Logically China will target Asia as the base of RMB internationalization, the role of supplier for Asian market will help build up the physical foundation for RMB internationalization, the current economic foundations will be unutilized to stabilize and strengthen the role of RMB by Chinese government.

It is no doubt that the process of RMB internationalization is gradual, each step of RMB internationalization process will not be advanced without the support from the internal institutions. Meanwhile, the desirable external economic environment is indispensable for the success of RMB internationalization process. China need to try to improve the environment, fully utilize the world economic growth opportunities. Given both the internal and external environment are desirable for the Chinese fast and sustainable development, the process of RMB internationalization will reach the higher stage, the trade off between the cost and benefit of RMB internationalization will put serious impact on the policy options of Chinese government.

III. Costs and Benefits of RMB Internationalization

National currency internationalization is double edged. With the process of RMB internationalization advanced to a new stage, the costs and benefits issue will take shape. The cost and benefit analysis will determine how positively the Chinese government will react to the internationalization of home currency and what policy choices they will make.

1. The Potential Benefits

- Reducing the exchange rate risks, promote the convenience for regional trade and investment

The wider RMB is acceptable, the more convenient for the Chinese businessman, investors,

tourists dealing international transactions. There will be less risks led by the volatility of exchange rate for home currency is transacted, in addition, the transaction cost will be cut as well. RMB will become the common language of the region, overcoming the communication barrier and cost for using the different languages.

- Financing the BOP Deficit

RMB can be used to finance Chinese BOP deficit. If the Asian trade surplus is settled by acceptance of RMB, the demand for USD from Asian trade partners will be reduced, the capability of financing the BOP deficit will be strengthened.

- Flexibility Advantage

The RMB internationalization will bring China the Flexibility Advantage. If the foreign official institutions prefer to buy RMB denominated asset as a part of home foreign reserves, it would be helpful for China to finance the trade deficit with Asian economies, removing the conflicts between the internal economic goals and external economic goals because of the payment constraint. However, one thing need to be reminded, the government should not overlook the BOP deficit considering holding this advantage, and delay the timing of adjusting the BOP deficit.

- Income Advantage

One of the main advantages of RMB internationalization is income advantage, i.e. China can exchange RMB for the foreign commodities, service and investment, and offer more official aid. The size of this advantage depends on how much foreign commodities, service and investment can be bought by Chinese residents. With the expansion of China - Asia market, the advantage will surely get significant.

- Promoting the Role of RMB in the International Monetary system

With the stronger role of Chinese economy in Asia, the upgrading of the Asian market integration, if RMB can be able to provide the measure of value, the medium of exchange, store of value, which is acceptable by Asian countries, it will therefore help Asian New Emerging Market economies to way out the current difficulty of exchange rate regime choice. With the support of Asia, RMB will become the Asian common language, and significantly promote the current imbalanced international monetary system, raise the role of RMB in the future system. This advantage is very important for promoting China's role in the world economy; China's discourse right will be strengthened in the international economic affairs. The rise of RMB will become the

most important event of international finance in 21 century.

- Enhancing Regional Economic Cooperation

RMB internationalization will benefit economic cooperation in Southeast Asia. It will reduce transaction costs and exchange rate risks, thereby increasing the profitability of the ASEAN 10 + 1 free trade area and quickening economic integration pace. The regionalization of RMB is a spontaneous process that is not the result of systematic and coordinated cooperation. It will give a firm basis for further progress in cooperation, reduce the cost of regional harmonization and increase the speed of integration. Moreover it will bring into full play China's role in the process of economic cooperation in Southeast Asia. Extensive circulation of RMB in Hong Kong, Macao and Taiwan specifically will increase trade within "the Greater China" and bring the same benefits of integration as mentioned above.

2. The costs

However, as with any process of currency integration, RMB internationalization also brings certain risks. Especially as the incomplete internal institutions and the uncertainty of external economic development. At the present the main constraint of RMB internationalization for China can be illustrated as follows.

- Restricting Internal Financial Policy Options.

The role of RMB as a reserve currency will weaken the capability of managing monetary policy independently, especially under the full employment situation at home. If the loose monetary policy is conducted against the background of full employment, the drop of Chinese interest rate and the crease of credit will push the residents and nonresidents switch their assets (convertible assents) from China to the other international financial center, RMB asset will be shifted to the foreign currency assets. Of course, if RMB were not the reserve currency, it is just a convertible currency, the above situation will happen too. However, as the foreign official institutions increase the holding of reserve assets and still prefer to hold RMB, therefore the size of asset switched from private sector to foreign institutions will get smaller. Therefore, if the conflicts between the internal economic targets and external economic targets happens, it would be attributable to RMB as a fully convertible currency, in addition, moreover, the Chinese internal financial market can make the transfer from RMB assets holding by the residents and nonresidents to the foreign assets possible. Without the RMB convertibility under the capital account, this transfer is much more

difficult. Against the background of incomplete internal financial market, the process of RMB internationalization will not run so fast, thus the capital controls become extremely important. The role of government supervision has been momentous.

- Restricting RMB Exchange Rate Policy

As RMB is going global, the idea of changing RMB exchange rate by the government will be restricted, especially the depreciation strategy. The Chinese monetary authority will not like to depreciate RMB for the role of RMB as a reserve currency. Firstly, both Chinese government and foreign official institutions will consider the profit distribution of depreciation. Secondly, the depreciation of RMB as a reserve currency comparing with as a non reserve currency will hurt RMB reputation. Furthermore, if RMB were depreciated, the other currency will be depreciated as well. Meanwhile, the RMB depreciation will hurt the RMB payment system in Asia and result in the shortage of reserve asset. Therefore, the above issues make the less possibility of successful RMB depreciation.

- The traditional “Triffin Dilemma”

As with any other currency, RMB will create problems with providing sufficient international liquidity while maintaining exchange rate stability. China must provide sufficient outflows of RMB in order to maintain liquidity in Southeast Asia. For the most part the outflow of RMB at present is the consequence of China’s trade deficit with Indonesia, Malaysia, Thailand, Mongolia and Taiwan province. However, if the RMB is to become a regional currency, maintaining price stability and balance of payments will be quite important for ensuring its good reputation. Therefore when China experiences a trade deficit, the deficit has to be covered by a capital account surplus so that the equilibrium of balance of payments can be maintained, the external value of RMB remains stable and the status of RMB as an international currency can be consolidated. At present China’s external position features “twin surpluses”, China is a net creditor, conversely, the USA, the producer of USD is a net borrower. In the future as RMB is getting more global, the traditional problems will approach as well.

- RMB will, after its regionalization, assume responsibility for regional financial stability

For the foreseeable future, the RMB internationalization is mainly restricted to Southeast Asia and therefore the most important externalities of China’s macro economic policy decisions will be in Asia. This makes harmonization with the macro- economic policies of other countries in the

region a necessity. In the event that speculation in the region threatens to undermine economic stability, China must assume the role appropriate for a country of great size and act as a lender of last resort.

- RMB, as a regional international currency could precipitate a revival of anti-China cliché

In the context of the slowdown of the world economy, China's rapid economic growth is regarded as exceptional. The large amount of foreign trade and investment that China attracts has caught the attention of other countries. Undeservedly, some countries suggest that China is exporting deflation to Asia and maybe even to the world, China should be responsible the most part of current global economic imbalance. Talk of the RMB internationalization may encourage propagation of anti- China cliché (Haruhiko Kuroda, 2002). International society has put pressure on China's exchange policy. This pressure may influence the overall design and sequence of China's reform and opening up.

Overall, the different stage of RMB internationalization demonstrates the different costs and benefits. The growing use of RMB in China's neighboring regions accords with the needs of China's present economic strategy and is beneficial for the implementation of "China's Greater Economy and Trade" strategy. RMB internationalization should not conflict with the requirements of China's financial stability and successful implementation of its monetary policy regime. China can take appropriate measures according to the sequence of RMB internationalization in order to further stabilize and smoothen the process.

IV. The Roadmap for RMB Internationalization and Policy Options

RMB internationalization is a dynamic process. The phased strategy and policy combinations should be proposed according to the different stages.

1. Initial stage

At this stage, RMB circulates in China's neighboring countries driven by the border trade and tourists expenditure. The main benefits for RMB cross-border circulation is to make the regional trade and travel more convenient and less transaction cost. Because the offshore RMB circulation accounts a small part of the broad money supply of China, then it will not impact the macro economy seriously. In this process, the benefit for China is clear, and the cost constraint is relatively small. However, with the expansive use of RMB in international trade, particularly the

launch of ASEAN + China FTA, the total trade between China and ASEAN countries will increase steadily. The closer trade ties and expansion of trade will definitely result in large rise in RMB holding and demand by the nonresidents. Chinese government needs to do as follows:

- Accommodating the RMB circulation to the official financial service system

To accommodate off shore RMB circulation to the financial service system, and then the risk led by “outside body” circulation of RMB for the traders will be reduced. In details, the outflow and inflow of RMB based on the real transaction can be accommodated to the banking system, weaken the power of the underground economy, to some extent, the surprise sizable outflow and inflow will be prevented.

- Strengthen the comprehensive management of offshore RMB circulation

It is important for the custom, tax administration, economic and trade departments, tourist bureau, foreign exchange administration, foreign affairs office to make a concerted efforts, meanwhile, the corresponding departments need positively sign the cooperation agreement for the RMB circulation with major trade partners. The RMB business for consumption can be started in some regions, which has a wide range of communication with China, the operations of the business can be run with reference of RMB business in Hong Kong.

- Consulting with the neighboring countries, allowing the Chinese enterprises to invest in RMB

RMB as an investment currency is the major channel for supply of RMB. Although RMB has not reach full convertibility, it is still difficult for the Chinese enterprises to invest abroad. Nevertheless, domestic enterprises can take the advantage of RMB reputation in neighboring economies to invest in Southeast Asia. The Chinese government should encourage Chinese companies to be more outward focused and explore the possibility of green-field investments in Southeast Asia by permitting the use of RMB for outbound FDI. In conjunction with the notable rise of Chinese industry, Chinese companies’ investment in Southeast Asia actually increases year on year, but there is still room for Chinese companies to increase investment and cooperation within ASEAN. In order to encourage this the Chinese government will need to offer convenient credit facilities for investment of RMB abroad and allow the use of RMB for financing projects. Furthermore the system of authorization could be adjusted to allow relatively small-scale FDI projects to go ahead with simplified procedures. Bilateral negotiations between Chinese

government and some neighboring economies could also make it easier for Chinese companies to invest outside China.

- Strengthen the statistics and monitoring of offshore RMB circulation, tracking down the money laundering and other illegal activities

This is a long run task after RMB gets global, it would be much helpful for making domestic monetary policy and promote the effectiveness of financial management.

- Stabilizing RMB exchange rate

The volatility of RMB exchange rate is unfavorable for the expansion of trade between China and its neighboring economies. So, at this stage, the stability of RMB is extremely crucial. To be noticed, the stability does not mean non-change with RMB exchange rate, it means the large ups and downs of RMB need to be prevented on the basis of completing RMB exchange rate mechanism.

At this stage, the offshore RMB circulation is driven by the real economy, it does not involve the convertibility of RMB capital account convertibility. China can enjoy the advantages brought by the RMB internationalization, make the neighboring trade convenient, reduce the exchange rate risks, stabilize RMB reputation abroad, and then the policymaking departments will also accumulate the experience in managing the RMB cross-border circulation. This is the essential stage of RMB internationalization. RMB asset will be accumulated abroad, RMB will be held by the nonresidents (individuals, enterprises, and foreign official institutions) as asset, and thus raise the demand for the RMB asset market. Then the RMB internationalization will enter into a new stage.

1. Second stage

RMB becomes the currency of debit and credit abroad. As the size of RMB accumulation is getting large enough, the lending and borrowing of RMB will rise. The offshore lending and borrowing of RMB will raise higher requirement for internal financial market. With the expansion of off shore RMB stock, it will put significant impacts on China's money supply, price level, RMB interest rate and exchange rate. So how to secure the stability of offshore RMB market and domestic RMB supply and demand?

- Requiring significant development of domestic financial market

To develop money market, particularly the public bond market, develop the security market,

enlarge the size of financial market, and then develop the home market which international market can take it for reference. To promote the interest liberalization process, complete the interest system. Then the offshore RMB deposit and credit interest rate can be generated with reference to the domestic interest rate of deposit and lending, and then the internal and external RMB interest rate will be kept at same level.

- Enhancing the financial cooperation between China and its neighboring countries

The borrowing and lending of RMB abroad belongs to European currency business. i.e. offshore RMB business. Then the RMB creation mechanism will be created abroad, which raise higher request for the management of monetary policy. To realize this target successfully, besides the further development of domestic financial market, the construction of offshore financial center needs to be enhanced too. In the process of building up offshore RMB financial center, the cooperation between PBOC and Hong Kong HKMA is getting extremely important. Meanwhile, the financial cooperation between China and Asia will enter into a new stage, where the targets and contents of participants joining the cooperation will be getting clearer.

At the first stage, if the domestic financial market developed slowly, and it could not match the market demand after RMB is used widely, RMB internationalization will slow down as well, the offshore deposit and credit business cannot be conducted rashly. Moreover, the accumulation of offshore RMB will have to get benefits from the underground transaction, which may threaten China's financial stability. It suggests that China will pay high price for the internal financial stability. It is obvious that as RMB internationalization reaches higher stage, the macroeconomic control for China is getting more and more difficult.

1. Third stage

The third stage of RMB internationalization is that RMB turns into Asian investment asset. One of the important experiences of USD internationalization is that the international capital market which is based on USD. This does not only supply the adequate liquidity and desirable investment channels (USD is as good as gold) for the nonresidents holding USD, but also supply the channels to observe the move of demand and supply for USD in the international market, the reference for the internal policymaking. With the formation of offshore RMB market (borrowing and lending of RMB) following the increased scale of RMB circulation, the function of RMB has developed from a mere means of transaction to a type of asset that stores wealth. It is therefore important for the

holders of RMB that the value of this asset is maintained and increased, RMB will absolutely turn into investment asset, a part of portfolio for the companies and individuals. In order to enjoy invest benefits and spread the risks, the investors need to adjust their portfolios. This desire will create the off shore RMB holders' demand for investing China's domestic capital market, exchanging RMB for the other currencies, investing on the other financial assets. Therefore, in order to strengthen the willingness of nonresidents to hold RMB, it is extremely important to establish international (Asian Regional) market with RMB as the key currency. At this stage, the cross-border RMB circulation will develop a closer relationship with RMB transaction and convertibility under capital account, and this trend will definitely speed up the pace of China's capital account liberalization. In order to reduce the risks along with this process, China may allow the offshore RMB to be used by foreigner for FDI in China, some items under capital account can be liberalized (e.g. allowing the double-way convertibility between RMB and HKD). If RMB is convertible, at the regional level, China may consult with the other Asian economies to establish Asian bond market, even take advantage of Hong Kong as the window to issue bonds dominated by RMB. At this stage, the RMB transaction under the current account and capital account will make joint efforts to promote RMB internationalization. However, to be noticed, at this stage, the capital account is not totally liberalized, it requires the monetary authority to manage the capital account more effectively. To strengthen the supervision for the Cross-border RMB circulation will cut the conflicts between the internal economic targets and RMB internationalization, and secure the benefits from RMB internationalization.

2. Fourth stage

The advanced stage of RMB Internationalization, which refers to RMB turns into the key reserve asset for Asian countries and economies, a regional international currency. as RMB serves as the measure of value and medium of exchange in Asian trade and financial transactions, RMB will not only serve as reserve assets for the individuals and companies, but also the intervention asset for the government, i.e. a part of reserve currency. As RMB internationalization reaches this stage, it will take a big jump. Both the payment capability in civil society and inter-government will be enhanced significantly. China's policy options will have more space. However, serving as the Asian reserve currency also means the Chinese government will assume more responsibility for the Asian financial stability. This makes harmonization with the macro- economic policies of other

countries in the region a necessity. In the event that speculation in the region threatens to undermine economic stability, China must assume the role appropriate for a country of great size and act as a lender of last resort. Chinese financial market will be more open, RMB will autonomously turn into the nominal anchor for some countries. In Asian Affairs, China's voice is getting stronger and influential, China will play more important role for the further integration of Asian market, and the position of RMB in Asia will be consolidated.

V. Conclusion

With the rise of Chinese economy and closer trade ties between China and its neighboring countries and economies, RMB is getting more and more acceptable by the local individuals and companies. While RMB internationalization is certainly on the agenda, this presence has been attracting great attention from the world society. In the future, Chinese economy will develop fast and sustainable, then RMB internationalization will be inevitable. How positively China will act to this new issue depends on the trade off between the benefit and cost analysis. The national currency internationalization will face up the similar costs and benefits, however, for RMB is getting global from Asia, meanwhile China is on the transition period, which indicates China will face some particular benefits and costs. As RMB internationalization is a stage-based process, different stage means different costs and benefits and different policy options. The rule of RMB internationalization is to maintain financial stability. The hard constraints for the further RMB internationalization are the incomplete financial market and weak financial supervision. Therefore RMB internationalization process must harmonize the pace of internal economic and financial reforms, it will be another gradualism pilot. In the near future, China should work to strengthen regional economic cooperation, as well as make full use of Hong Kong in the process of realizing convertibility and facilitating regionalization of RMB.

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