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Anaemic Ascent: Why China's Currency is Far from Going Global

Executive summary

China's currency is on the rise. Buoyed by the economy's outperformance and global trade impact, policy steps over the past few years have thrust the renminbi onto the global stage. Is the renminbi going to climb to become a major reserve currency? Not so fast.

Despite impressive progress, obstacles loom. The path to reserve currency status necessitates a near complete retooling of China's economic model: lifting capital controls, floating the exchange rate and liberalising financial markets. This involves facing down powerful vested interests and a willingness to expose the economy to unknown stresses and external volatilities. This is not going to happen quickly.

So why bother? The central bank, it appears, may be pursuing 'reform by Trojan horse'. By pinning strategic value to internationalisation, reformers are able to achieve buy-in from top leaders in pushing their own agenda. The central bank does not want internationalisation per se, but the liberalisation that moving towards internationalisation brings. It allows, for example, authorities to push towards a floating currency, without appearing to cave to US political pressure in doing so.

Nonetheless, given rising domestic pushback and a cacophony of competing voices, strong policy support for the necessary continued reform may be lacking. Combine this with the unpalatable economic consequences of further internationalisation, and it appears that breathless commentary about the rise of the renminbi is misplaced. The renminbi's ascent looks distinctly anaemic.

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> 'What is needed is a roadmap with a stronger and more flexible exchange rate, more effective liquidity and monetary management, with higher quality supervision and regulation, with a more well-developed financial market, with flexible deposit and lending rates, and finally with the opening up of the capital account… If all that happens, there is no reason why the renminbi will not reach the status of a reserve currency occupying a position on par with China's economic status'.
>
> Christine Lagarde, IMF Managing Director, 18 March 2012, Beijing[1]

Change is afoot in the international monetary system. The Chinese renminbi has been set on a path of internationalisation, the eventual destination of which, it has been suggested, could be a place alongside – or, perhaps, even above – the US dollar as a primary reserve currency.

IMF Managing Director Christine Lagarde, for example, has noted that 'there is no reason why the renminbi will not reach'[2] reserve currency status. No reason, that is, should China manage to complete a long list of reforms. Similarly, The Peterson Institute's Arvind Subramanian has extolled the currency's dominance as 'conditionally imminent', predicting the renminbi 'could become the premier reserve currency by the end of the decade'.[3] 'Conditional', that is, on the same long list of reforms. Off the back of such analysis, the City of London has rushed to lay the foundations for an offshore trading hub, whilst Australia is pushing to make its dollar directly convertible with the renminbi.

Both the IMF and Peterson Institute analyses are correct. Should China manage to undertake this veritable laundry-list of necessary reforms, the country's economic size and trade impact mean it stands a strong chance of eventually elevating its currency to primary reserve status. The problem, though, is that these reforms are not going to happen within the next decade. The challenges that China faces in this task are near insurmountable, ensuring that whilst some measure of internationalisation is indeed underway, movement towards a reserve currency status commensurate with China's global economic status will be tortuously slow, relegating the prospect to irrelevance.

Internationally reserved

Much of the confusion in the debate stems from distinguishing between two often-conflated terms: an internationalised currency and a reserve currency.[4] Internationalisation means the use of a currency in 'denominating and settling cross-border trade and financial transactions';[5] that is, the use of a currency as a global medium of exchange, and even as an investment and funding instrument. A reserve currency is one that is held as a store of value and by 'central banks as protection against balance of payments crises'[6] – either a minor reserve currency such as the Japanese yen and Swiss franc, or a primary reserve currency such as the US dollar and the pound sterling of the eighteenth and nineteenth centuries.

The difference between the two is critical. Whilst internationalisation is a necessary condition for reserve currency status, it is by no means sufficient. Indeed, whilst China has accelerated the internationalisation of its currency, in all likelihood it will be unable or unwilling to fulfill the conditions necessary to achieve primary reserve currency status. The very best Beijing can hope for within the next couple of decades is a renminbi similar in position to that of the Japanese yen – an internationalised, but modestly used, reserve currency. Even that will prove a stretch.

The renminbi takes off...

The natural drivers for renminbi internationalisation have been obvious for some time. China has grown from the world's eleventh largest economy in 1990 to the second largest (surpassing Japan in 2010), surging to become the world's second largest trading country and holder of the world's largest pool of foreign exchange reserves. Its outlook, relative to advanced economies, is optimistic. The extensive literature on the history of reserve currencies centres primarily around relative size. As Subramanian notes, 'a country that is large in output, trade, and finance' is a natural contender for reserve currency status. The Dutch guilder accompanied The Netherlands' expansionary trade reaches, whilst the pound sterling rose alongside the British Empire, and the US dollar climbed with the United States' global economic ascension.

Endowed with these natural advantages, internationalisation began in earnest in late 2008, following the onset of the global financial crisis.[7] With trade financing markets frozen, China signed bilateral renminbi currency swap agreements with eight central banks totaling over 800 billion renminbi, in theory allowing central banks access to capital in times of shortage. Currency swap agreements provided a backstop for the June 2009 launch of a pilot scheme for cross-border trade settlement in renminbi. At first, this was restricted to a few mainland cities and Hong Kong, but was subsequently expanded to the whole of China and any trading partner. In February 2010, the Hong Kong Monetary Authority (HKMA) gave permission for non-financial mainland corporations to issue renminbi bonds in Hong Kong, following the Ministry of Finance's raising of its first offshore bond.[8] In July 2010, restrictions were relaxed on the renminbi activities of banks in Hong Kong, allowing financial institutions to open renminbi accounts. In August 2010, the People's Bank of China (PBoC) permitted central banks some access to China's interbank market, subject to quota. Five months later, in January 2011, the PBoC launched a pilot scheme for the settlement of renminbi foreign direct investment (FDI).

Most symbolically, in August 2011, Vice-Premier Li Keqiang visited Hong Kong to announce 36 liberalisation measures. Li's status as Premier-in-Waiting gave strong signaling of continued policy support at the central-government level into the next administration, which takes the reins in late 2012. His message of commitment was delivered at a forum on China's 12th Five-Year Plan, indicating the role that Hong Kong and internationalisation play in Beijing's long-term strategy.

Further measures continue to be announced; a 20 billion renminbi cross-border investment scheme (an expansion of the Qualified Foreign Institutional Investor mechanism), an easing of renminbi foreign direct investment regulations, announcements with London surrounding the City's position as a potential offshore trading hub, and the Shanghai municipal government's plan to establish Shanghai as 'the global centre' for renminbi trading by 2015, feeding into its plans for the city to become an 'international finance centre' by 2020. Qianhai in Shenzhen has been put forward to trial capital account convertibility, whilst Australia is pushing for its dollar to become the third currency to become directly convertible with the renminbi.

Accommodative policy has spurred a dramatic pick-up in renminbi activity in Hong Kong and elsewhere. Whilst only 0.04% of China's total trade was settled in renminbi at the end of 2009, 9% was settled by year-end 2011. As of year-end 2009, renminbi deposits in Hong Kong were 60 billion renminbi. One year on, they totaled over 300 billion renminbi. As of December 2011, they totaled around 600 billion. Daily trading in the foreign exchange market rose similarly, up from nearly zero in mid-2010 to 250 million US dollars by year-end 2010.

This rapid pick-up in activity, it has to be noted, comes from a low base, and there is much distance to cover before the renminbi becomes a global currency with status commensurate to China's economic weight. Even after this growth, the renminbi remains a minor player in global currency markets. According to the Bank for International Settlements, it accounts for less than 1% of average daily turnover, less than the Russian ruble and slightly more than the Turkish new lira. The US dollar, in contrast, accounts for 85% of turnover, and the euro nearly 40%. Swift, the international payments system, reports that the renminbi was used in 0.3% of global payments in 2011, compared to 43% for the euro.[9] In short, despite rapid progress, there is a long road ahead for the renminbi.

Of late, this long road has got longer. With tumultuous global investor sentiment over the past six months, internationalisation has slowed, and in some areas, actually reversed. The volume of renminbi-denominated trade settlement fell to 583 billion renminbi in the third quarter of 2011, down 2% from the second quarter, although a bounce in December saw the full-year figure rise to 2.1 trillion. The slowdown has been compounded by a slowing of transactions between mainland firms and their Hong Kong subsidiaries looking to arbitrage the difference in onshore and offshore renminbi markets. The steady climb in renminbi deposits in Hong Kong also looks to have peaked in November 2011, shrinking from 627 billion down through to 552 billion in April 2012.[10]

…but obstacles loom

The internationalisation that has thus far taken place, though, does not necessarily propel the currency towards reserve status – be it minor or primary reserve status. Indeed, almost insurmountable obstacles loom. The path to reserve status necessitates a near complete retooling of China's economic model – a formidable political and economic challenge.

There are two basic prerequisites to achieving reserve currency status: an open capital account and well-developed financial markets. Without these, foreign central banks and investors will not hold onto the renminbi in any significant quantity. In their own way, however, both pose major policy challenges.

Authorities will need to make the renminbi fully convertible and remove restrictions on the capital account, allowing capital to flow freely in and out of the country. Whilst controls on the current account and some on the capital account (for foreign direct investment) were lifted in the early 1980s, tight restrictions remain on the cross-border flow of capital, particularly portfolio flows. This has enabled the government to insulate domestic financial markets from global markets, allowing authorities to operate a fixed currency whilst maintaining monetary policy independence. Whilst partial removal of controls will allow for partial internationalisation, as the currency is allowed to circulate more freely, a completely open capital account is necessary in order to convince central bankers to hold anything more than merely symbolic amounts of renminbi in their reserves.[11]

A major policy decision is then presented as capital controls are dismantled. Allowing the free flow of capital will force Beijing to either abandon its fixed exchange rate or forfeit its independent monetary policy (as, for example, Hong Kong does). Given it is unfeasible for China to sacrifice its monetary policy on account of its size and sui generis economic dynamics, Beijing would have to float the currency. Whilst moving to a floating currency would go some way to addressing global imbalances (and alleviate much US berating), a flexible currency and open financial system would bring with it vulnerability and volatility. Policymakers have drawn lessons from the impact of both the rapid currency appreciation in Japan following the 1985 Plaza Accord and the unimpeded capital flows on the under-developed financial markets of Thailand as the Asian Financial Crisis struck in 1997. The central bank has also undoubtedly studied the experiences of both South Korea and Mexico, who witnessed financial crises following their rapid capital account liberalisations. Whilst conservatism can likely be overcome in time, policymakers are in no rush to place the economy at greater risk. Moving towards an open capital account and shifting the exchange rate regime constitutes a significant alteration in China's economic model, and as such, is likely to be undertaken gradually, despite almost continuous PBoC commentary to the contrary. Indeed, it is important to remember that most PBoC commentary appears to be designed to shape the domestic debate, rather than outline realistic blueprints for future reform initiatives.

Controls will, therefore, be lifted cautiously, in turn slowing the pace of the renminbi's long voyage towards reserve status. Some influential voices have argued, in fact, that it serves China's interest to maintain the fixed exchange rate and strengthen capital controls whilst focusing efforts on developing domestic financial markets.[12] Only once domestic imbalances are resolved can measures be put in place to open capital controls and progress towards currency internationalisation. Indeed, a precise sequencing in policy liberalisation will need to be such that there is proven confidence in the domestic financial markets' ability to cope with, then thrive from, increasing exposure to global capital flows.

At present, this confidence is desperately lacking and movements towards market maturity are likely to face considerable political and economic constraints. As such, prospects for fulfilling the second prerequisite for reserve currency status – safe, liquid financial markets

– remain weak. The heart of China's financial system, its banking sector, is woefully underdeveloped, yet it dominates at the expense of further development in capital markets.[13] The state banks have little incentive to allocate capital efficiently because of guaranteed 'net interest margins' – profit margins on, and an almost monopoly over, loans.[14] It is because of these margins that capital allocation is skewed towards state firms and heavy industry, starving smaller private sector firms of credit. Bonds function largely as bank loans, given that prices are influenced by the PBoC's lending rates, not a market-driven yield curve, with most buyers not trading in the secondary markets but rather holding to maturity.

The primary impediment to maturing the financial markets is the government's desire to maintain direct control over the economy. Suppressing interest rates and maintaining quantitative controls on the flow of credit – known as 'financial repression' – provides authorities the levers with which to effectively, but crudely, shape macroeconomic performance. Funneling credit through the banking sector to large firms reinforces investment-driven growth and allows banks to build up a strong capital buffer. The cost, however, is that 'to maintain the effectiveness of these levers, they need to hold depositors in China hostage to the state financial system'.[15] [16] This has consequent effects on the property market, the proliferation of shadow banking, and more broadly, the imbalance between consumption and investment. As such, 'so long as the financial system remains a tool of fiscal policy, and the price of capital is determined by the fiat of the party-state to satisfy its budgetary needs, China's capital markets and financial system more generally will remain deformed, and will not be true markets'.[17] Until China has true capital markets, the renminbi does not stand a chance of achieving significant progress towards reserve currency status.

In short, then, the lifting of capital controls, parallel floating of the exchange rate, and liberalisation of the domestic financial markets, require a fundamental retooling of the economic growth model that has driven China for the bulk of the past 30 years. It requires facing down tough political opposition and powerful vested interests, a willingness to expose the economy to new and unknown stresses and external volatilities, and a recognition that China needs to implement one of the largest set of economic and financial reforms in recent history. Against a backdrop of a weak and uncertain outlook in the global economy, it would be unsurprising if leaders in China receded into policy conservatism.

More intangibly, much is dependent on the continuation of China's economic rise, its capacity to create functioning institutions with checks and balances, and ability to instill confidence in reserve managers and investors that the currency is a good store of value. A stable macroeconomic climate and low debt levels are necessary in this regard, and neither is guaranteed, particularly following China's economic performance over the past couple of years. It could also be argued that the most important long-term challenge is the establishment of rule of law, without which there surely cannot be genuine trust in macroeconomic stability. This probably calls into question the whole compatibility of the Communist Party. Indeed, as Subramanian notes, 'when the chips are down, will investors feel that their money is safer in China than in the United States?'.[18] It is unlikely many would choose China, and this stymies progress towards dominant reserve status.

Pushing and pulling on the renminbi

The stark contrast between a rapid burst of internationalisation and a near insurmountable challenge in achieving reserve currency status raises the question as to why authorities are pushing in this direction. What is the motivation for renminbi internationalisation?

China's push for renminbi internationalisation appears to be primarily grounded in a critique of an international monetary system weakened by US dollar dominance. Whilst this has long been a concern for Chinese academics, in the eyes of policymakers the global financial crisis 'laid bare the defects of the existing international monetary system'.[19] Many came to the conclusion 'that the world should look to diversify beyond the dollar system',[20] in large part by internationalising the renminbi.[21] This view was perhaps most famously captured by Zhou Xiaochuan, Governor of the PBoC, who in March 2009 published proposals for reform of the international monetary system, arguing for reduced reliance on the US dollar as the global reserve currency, and for a greater role of the IMF basket of currencies called Special Drawing Rights (SDRs). Importantly, this analysis is not restricted to China. Among others, Joseph Stiglitz, an American Nobel Prize-winning economist, has noted that 'the system in which the dollar is the reserve currency is a system that has long been recognized to be unsustainable in the long run'.[22]

Clearly, China has more narrow interests at work too. The crisis in 2008 'exposed the vulnerability of China's financial position under the existing international monetary system'.[23] The crisis raised concerns over the global inflationary impact of a dollar glut,[24] as the US Federal Reserve pursued 'quantitative easing', aggressively injecting liquidity into financial markets. This vulnerability springs from the 'externalities' of US domestic policy – the mismatch between national policies and their international implications. There is concern about 'the dependence… on a currency subject to national management'.[25] Indeed, as one government think-tanker put it, 'we are afraid of the hegemony of the US dollar… we cannot control [US government] behaviour'.[26]

Undoubtedly, pursuit of an internationalised currency is about more than escape from a US dollar trap. There are immediate benefits to currency internationalisation. At the simplest level, it provides convenience to Chinese importers and exporters, allowing them to invoice and settle in renminbi. This helps to reduce exchange rate risk, decreasing the vulnerability of exporters to shifts in global exchange rates, and lowers transaction costs. An internationalised currency also results in lower borrowing costs for that country,[27] and in significant volumes, in seigniorage income.[28]

As important as economic drivers, there are non-economic factors at play. Many academics and policymakers feel it only right that China has a currency commensurate with its new-found economic weight.[29] As one government think-tanker asks: China's economy is internationalised, so why isn't its currency?[30] Another complains about the 'privilege enjoyed by holding reserve currency position'.[31] For some, it is even 'as important [a symbol] as New China's becoming a nuclear power'.[32]

Most interestingly, though, and perhaps most convincingly, it has been argued that internationalisation is 'reform by Trojan Horse'.[33] As committed reformers, internationalisation is a mechanism for the PBoC (and other progressive actors) to push liberalisation whilst minimising the political debate surrounding the sensitive issues of capital controls and currency, much in the same way that Premier Zhu Rongji used entry into the World Trade Organization as a pretext for implementing necessary but politically difficult reform of the state-owned enterprises (SOEs).[34] In this argument, the PBoC does not want internationalisation per se, but the liberalisation that moving towards internationalisation brings. One think-tanker stressed the importance of 'improving financial competitiveness' as a goal of internationalisation,[35] whilst another noted that, in fact, 'we never had the ambition to over-take the hegemon US dollar'.[36] In this light, the acceleration in internationalisation since 2009 could have been driven by the PBoC as a tool to push on with its reform agenda, as senior leadership had decided to revert to the US dollar peg (2008-2010) in the face of global financial turbulence. By attaching symbolic and strategic value to internationalisation, the PBoC was able to bypass much debate on the controversial but necessary steps to take. It allows authorities to push for measures that lead to a floating currency, for example, without appearing to have caved to US political pressure in doing so. Further, by starting internationalisation at arm's length in Hong Kong, authorities established facts on the ground, acclimatising policymakers to developments, before taking on the tough reforms necessary domestically. Indeed, it is in this context that it makes sense to analyse the recent proposal floated by a PBoC researcher for accelerated capital account liberalisation. Far from being a government-approved plan, this is likely an aggressive reminder from a reform-focused organisation that the reform process needs to be advanced.

Unintended consequences cause pushback…

As some actors push forward, though, others are pushing back. Leading the charge, Yu Yongding of the Chinese Academy of Social Sciences has warned that internationalisation whilst the renminbi remains undervalued creates a dangerous asymmetry. Because exporters to China have been more willing to receive renminbi than have importers, given appreciation expectations, trade settlement has been completely skewed. In 2010, the import/export ratio of trade settlement reached 1:6. As appreciation expectations have calmed, though, more balanced flows have emerged, with the ratio softening to 1:2 in 2011. Total volumes have seen less growth accordingly.

The implication, therefore, is that much of the progress made in internationalisation has been driven by currency speculation, not by a true desire to settle transactions in renminbi. With renminbi growth substantially driven by appreciation expectations, 'internationalisation can be easily reversed and will cause more problems for China's monetary authority to solve in the future'.[37] Indeed, renminbi deposits in Hong Kong peaked in November last year, and continue to decline on account of scaledback appreciation expectations. Moreover, offshore renminbi bond issuance – through so-called ‘dim sum’ bonds – has weakened, peaking out at 22 billion renminbi in September 2011, and since April 2012, has receded into single digits.[38] Part of the reason for this is that yields have had to climb to compensate investors for lack of appreciation (up from around 3% at the beginning of 2011 to over 5.5% in May 2012) ,[39] and issuers are therefore reevaluating whether it makes sense to issue in the offshore market, given higher costs[40] and the fact that approval is still required to repatriate bond proceeds onto the mainland (where the renminbi can actually be put to use). Many are turning back to more traditional US dollar funding markets.

It is not only appreciation expectations that lie behind market asymmetries, but also different market structures onshore and offshore. For instance, although the renminbi has now risen to become the third most popular currency for letters of credit (following the US dollar and euro), the market appears to be dominated by intra-firm trade flows, with large companies arbitraging differences in onshore and offshore interest rates.[41]

This asymmetry also has implications for China’s foreign exchange reserves. If a Chinese importer pays in renminbi rather than requesting US dollars from authorities, dollar reserves are not drawn down, so remain higher than they otherwise would be. In this respect, the pursuit of internationalisation via an offshore market in Hong Kong has the potential to tighten China’s dependence on the US dollar, not loosen it, as reserves continue to build. This could very well lessen appetite for further development of the offshore market in Hong Kong, thus hindering internationalisation. He Fan of the Chinese Academy of Social Sciences has warned extensively about this, noting the potential for added sterilisation costs on the PBoC.[42]

Asymmetry aside, internationalisation has had uncomfortable implications for domestic monetary policy. In early October 2011, for example, as global risk sentiment rose in the face of renewed recession fears, the offshore renminbi exchange rate dropped, as investors fled to safe-haven currencies. This drove the PBoC to further appreciate the onshore rate to demonstrate commitment to continued internationalisation. Indeed, the IMF highlights the risk of feedback loops between offshore and onshore markets, noting that ‘the stability of the onshore market could be negatively impacted by market dislocation offshore’ and that ‘as the offshore market develops, feedback channels are likely to strengthen’.[43] Further, by providing another avenue for mainland firms to raise capital, the authorities appear to be undercutting the effectiveness of domestic monetary policy, given firms’ reduced reliance on the domestic banking sector, the government’s main level of macroeconomic control. By extension, this also has the potential to jeopardise the profitability of state-owned banks, given their dependence on deposit taking and credit issuance for revenue.[44] Lastly, the ability of actors to remit offshore renminbi onshore, all other things equal, expands the money supply and supports inflationary pressures, or alternatively increases sterilisation costs for the central bank.

Despite the pushback and unexpected policy kinks, it is important to note that internationalisation is very much ‘still in trial stage'.[45] Indeed, it is largely for this reason that the experiment was started in relative safety outside China's capital controls in Hong Kong. Authorities allowed rapid progress in 2010, and now appear to be in the process of assessing what has worked and what has not. In this respect, it could be argued that policymakers are moving pragmatically in a similar vein to the creation of Special Economic Zones that marked China's early transition away from central planning in the 1980s.

…and competing voices vie for influence

Continued policy support for internationalisation should not be taken for granted,[46] despite Premier-in-Waiting Li Keqiang's visit to Hong Kong and its place in the 12th Five-Year Plan. Policy formulation in China is increasingly defined by the battle between muscular competing interests.[47] The evolving ability of actors to influence the direction of policy rests on the shifting nature of power within domestic politics and the fast-changing external environment. Three main actors here are the PBoC, the National Development and Reform Commission (NDRC), and the Ministry of Commerce – additional 'quantitative easing' from the US Federal Reserve, for example, supports the case advanced by the PBoC; growing global commercial opportunities may help the National Development and Reform Commission (NDRC) argue its position; whilst a worsening export climate allows the Ministry of Commerce to push their agenda. Indeed, rather than leading, the Politburo Standing Committee – China's supreme ruling body – is often seen as building consensus between competing voices.[48] The top echelons of political China are occupied by Party apparatchiks, not technocrats, and thus grander geo-strategic considerations tend to feature more heavily. A reflexive fear of the 'US dollar trap' and assumed geopolitical power gained from currency internationalisation provide momentum for proactive policy.

The PBoC is arguably the most important actor in this story. They are broadly seen as committed reformers within China, and, as noted above, it has been argued that their push for internationalisation is 'reform by Trojan horse'. They (and others) wish to see the corollary liberalisation that internationalisation entails, and see political efficacy in attaching a symbolic value to the process, in part to help bypass politically sensitive discussions. However, even within the reform-minded PBoC there are voices pushing back. Close contacts of senior PBoC officials note that the PBoC was hesitant in acquiescing to provincial requests for renminbi-denominated FDI into China, perhaps out of fear over the reaction to loosening capital controls. Since the Asian Financial Crisis in 1997-1998, where rapid capital movements saw speculative attacks on Southeast Asian currencies, Party leaders have been extremely suspicious of calls to liberalise the capital account. Given the State Administration for Foreign Exchange are charged with the management of foreign exchange reserves, it is unsurprising they are also concerned about so-called 'hot money' – flows of speculative capital into and out of China.

The blogosphere is also an important actor here, with increasingly nationalist sentiment often arguing that China should not align with Western economic orthodoxy in liberalisation, pointing to the global financial crisis as proof that the Anglo-Saxon model of capitalism is bankrupt. Nationalistic tendencies can run the other way too, with commentators lamenting the fact that China provides the United States with cheap funding through its Treasury holdings, whilst failing to provide sufficient funding for hospitals and schools.

The NDRC, China's old state planning body, has a keen interest in the impact continued internationalisation will have on the SOEs, given their treasured place in China's political economy. The State-owned Assets Supervision and Administration Commission (SASAC), the SOE watchdog, would likely hold similar views, despite their perceived impotence. Further opening, for example, would expose state corporates and 'infant industries' to international competition, and liberalising domestic financial markets would undercut the monopoly that state banks use to generate revenue. The NDRC would perhaps also worry about the increasing reliance on, or exposure to, global markets that follows from internationalisation, whilst the Ministry of Finance would be concerned about the corollary weakening of financial control that comes with internationalisation. But on the other hand, allowing SOEs to settle trade in renminbi when operating abroad has its advantages, and as SOEs are net importers, they have a vested interest in the currency appreciation that is likely to accompany liberalisation in the long term. The Ministry of Commerce, which locates its powerbase in the export sector, may see similar benefits for smaller exporters to trade in renminbi, but nevertheless fiercely guards the status quo of a stable and structurally undervalued exchange rate.[49] It is regularly at odds with the PBoC over the pace of renminbi appreciation. Long-term moves towards internationalisation require a floating currency, which – over the medium term – will likely mean appreciation, squeezing the thin margins of many exporters. The NDRC, though, recognises the need to shift Chinese manufacturing up the value-chain, and may see renminbi appreciation as a critical part of that transition.

Provincial governments also have a strong influence over national policy direction, despite central government efforts to curtail their power. Shanghai is pushing aggressively for internationalisation, given it stands to gain through additional financial sector activity. The same is true for Hong Kong. Although both benefit from internationalisation, they are, in some respects, competitors, as they vie to become the long-term home to renminbi-denominated international finance. Once again, poorer provinces with less international exposure have a different set of interests regarding internationalisation, and may feel central government attention on the issue risks ceding policy focus on more pressing domestic challenges.

A muted internationalisation

Whilst the economic and political obstacles to the renminbi's attaining reserve currency status remain severe, they do not preclude further internationalisation taking place. Despite the recent slowdown in the accumulation of renminbi deposits in Hong Kong, China's continued growth in absolute size and as a trade power ensure that the renminbi has a role to play in trade settlement. In this respect, parallels can be drawn with the internationalisation of the Japanese yen through the 1970s and 1980s.[50] Internationalisation proceeded to the extent that close to half of Japanese exports were denominated in yen, yen-denominated 'samurai bonds' were issued internationally and the yen became actively traded on foreign exchange markets. The global proportion of yen reserve holdings peaked at only 9% in 1991, though, before retreating to around 3% – primarily because of Japanese unwillingness to completely open financial markets to foreign participants and failure to get serious about financial market product development.[51] Given sensitivities domestically, this appears a likely path for China.

At the very least, should the renminbi's rise be restricted to the Japanese experience, there is clearly more potential for renminbi trade settlement. Fortescue Metals Group, for example, made headlines in July 2011 when its Chief Executive announced that the firm had 'started transacting in renminbi', whilst Rio Tinto have openly mulled adopting the renminbi in trade settlement. These moves could prove to be the start of a more modest internationalisation trajectory.

Even muted progress in achieving reserve currency status is possible. Malaysia announced in late 2010 that they bought renminbi-denominated bonds for reserves. Thailand followed suit in November 2011, although adding that renminbi still only accounts for under 1% of total reserves. Likewise with Nigeria, that has 'made a strategic decision to consider adding the renminbi to the basket of reserves', aiming for 5-10%. Importantly, though, this demand appears almost wholly politically motivated, rather than driven by a desire to actually hold renminbi as a store of value and as a guard against balance of payments crises. Most likely, it is merely a symbolic show of support for growing trade relations with China.

An anaemic ascent

The first steps in the untethering of China's currency have coincided with a shift in economic power that emerged through the global financial crisis, provoking breathless commentary about China as an 'inevitable superpower'[52] and the renminbi's imminent 'dominance'.[53] Even the IMF Managing Director has talked up the prospects for the renminbi to rise to reserve currency status, whilst national governments are rushing to position themselves to benefit from the transition. For sure, China's size and relatively optimistic long-term economic trajectory (in comparison to advanced economies) ensure that the renminbi has potential to play a more active role in international trade settlement. However, severe economic challenges and political obstacles look sure to resign the currency to a fate short of major reserve currency status. A status equivalent to that of the Japanese yen appears to be the best-case scenario over the next couple of decades. The renminbi has risen quickly the past couple of years, but its future ascent looks distinctly anaemic.

NOTES

[1] China to reform, grow economy, IMF eyes freer yuan, *Reuters*, 18 March 2012.

[2] Ibid.

[3] Subramanian, Arvind, *Renminbi rules: the conditional imminence of the reserve currency transition*, Peterson Institute for International Economics, Working Paper 11-14, September 2011.

[4] Kroeber, Arthur, *The Chinese yuan grows up – slowly*, New America Foundation, March 2011.

[5] Prasad and Ye, *The renminbi's role in the global monetary system*, Brookings Institution, February 2012.

[6] Ibid.

[7] Cheung, Ma, McCauley, Why does China attempt to internationalise the renminbi?, in Jane Golley and Ligang Song (eds), *Rising China: global challenges and opportunities,* ANU E Press, 2011; Kroeber, Arthur, *The Chinese yuan grows up – slowly*.

[8] Kroeber, Arthur, *The Chinese yuan grows up – slowly*.

[9] Banks institute renminbi safeguards, *Financial Times*, 14 February 2012.

[10] Admittedly, it could be argued that the reversal of CNH deposit growth is a healthy market development, should it reflect continued trade settlement and a more balanced CNH usage.

[11] As detailed later, current reserve holdings of renminbi appear to be entirely politically motivated.

[12] Xiao Geng, Exchange rate policy and macroeconomic adjustment, in Garnaut, Golley and Song (eds), *China: the next twenty years of reform and development*, ANU E Press, 2010.

[13] Walter and Howie, *Red capitalism: the fragile financial foundation of China's extraordinary rise*, John Wiley and Sons, Singapore, 2011.

[14] The 25 basis point interest rate cut on 7 June 2012 was accompanied by a tweak to the way banks are allowed to set rates. Banks are now allowed the float deposit rates up to 10% over the benchmark rate, and float lending rates under the benchmark rates by 20%. Given the current scramble for deposits, most banks took advantage of this float to maintain deposit rates at 3.5%, resulting in a squeeze of bank spreads at shorter tenors. Whilst this is a step towards liberalisation, it is relatively minor, and more likely sprang from the desire to conduct an asymmetric cut, aimed at revitalising growth and stemming the outflow of deposits witnessed through Spring 2012.

[15] Shih, Victor, Goldilocks liberalisation: the uneven path towards interest rate reform in China, *Journal of East Asian Studies*, Vol. 11 2011, pp 435-464.

[16] To a small extent, the emergence of higher-yielding 'wealth management products' has enabled some depositors to escape the worst of financial repression. However, this is concentrated within wealthier households and has significant regulatory implications, meaning that the market faces barriers to expansion.

[17] Walter and Howie, Capital market reform. Market, what market?, *China Economic Quarterly*, June 2010.

[18] Subramanian, Arvind, *Renminbi rules: the conditional imminence of the reserve currency transition*.

[19] Chin and Wang, *China debates: the dollar system and beyond*, Chatham House, 2009.

[20] Ibid.

[21] Author interview, Beijing, November 2011.

[22] Subramanian, Arvind, *Renminbi rules: the conditional imminence of the reserve currency transition*, p 3.

[23] Gao and Yu, *Internationalisation of the renminbi*, Bank for International Settlements, 2009.

[24] Cheung, Ma, McCauley, *Why does China attempt to internationalise the renminbi?*.

[25] Ibid.

[26] Author interview, Beijing, November 2011.

[27] Taylor, Alan, *The future of international liquidity and the role of China*, Council on Foreign Relations, November 2011, p 12.

[28] Defined by the Bank of Canada as 'the revenue earned from the issue of new money' – the difference between the interest earned on government securities and the cost of issuing, distributing and replacing those notes.

[29] Author interview, Beijing, November 2011.

[30] Author interview, Beijing, November 2011.

[31] Author interview, Beijing, November 2011 .

[32] Jiang Yong of CICIR, quoted in Godemont, François, *The renminbi: "Our currency, your problem", China Analysis*, European Council on Foreign Relations, 2011.

[33] Author interviews, Beijing, November 2011.

[34] Author interview, Beijing, November 2011.

[35] Author interview, Beijing, November 2011 .

[36] Author interview, Shanghai, June 2012.

[37] Yu Yongding , The renminbi's journey to the world, *Caijing Magazine*, 31 May 2011.

[38] *BOCI Debt Capital Markets Weekly Update*, BOC International, 8 June 2012.

[39] Dim sum bonds: out of favour, *FT BeyondBrics*, 29 May 2012.

[40] Fundings costs in offshore renminbi have now surpassed that of more traditional US dollar funding markets; Dim sum bonds: out of favour, *FT BeyondBrics*, 29 May 2012.

[41] Renminbi's mysterious rise: trade finance or interest rate arbitrage?, *FT BeyondBrics*, 29 May 2012.

[42] Most recently in comments at the FX China 2012 conference, 7 June 2012, Shanghai.

[43] Maziad and Kang, *RMB internationalisation: onshore/offshore links*, IMF Working Paper, May 2012.

[44] Although, admittedly, whilst banks stand to lose out significantly via net interest margins, there is upside in potential fee income from foreign exchange services.

[45] Author interview, Beijing, November 2011.

[46] Author interviews, Beijing, November 2011.

[47] With regards to foreign policy, see: Jakobson and Knox, *New foreign policy actors in China*, SIPRI, September 2010.

[48] One think-tanker described it as '中庸之道', seeking the middle way in confrontation. Author interview, Beijing, November 2011.

[49] Whilst recent depreciation pressure and more balanced capital flows highlight that the renminbi is nearing equilibrium through the short term, given China's productivity gains, growth and interest rate differentials, the currency should have more to gain against the US dollar through the medium term.

[50] Kroeber, Arthur, The renminbi: the political economy of a currency, *Foreign Policy*, 7 September 2011.

[51] Author interview, Shanghai, June 2012.

[52] Subramanian, Arvind, The inevitable superpower, *Foreign Affairs*, September/October 2011.

[53] Subramanian, Arvind, *Renminbi rules: The conditional imminence of the reserve currency transition.*

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