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THE INTERNATIONALIZATION OF THE RENMINBI AND THE RISE OF A MULTIPOLAR CURRENCY SYSTEM

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ABSTRACT

The dollar's steady depreciation has had little impact on the official reserves of central banks. As scholars of the international monetary system debate whether the dollar can continue to play the dominant role in the international monetary system, actual developments in exchange relations already give reason to expect that the world's currency regime is changing. Recent measures taken by China to internationalize its renminbi, including several bilateral swap agreements signed with other central banks, have reinforced other eastward trends in the world economy.

In this paper, China's acceleration of renminbi internationalization is examined. The growth of renminbi-based trade and settlements has made it Asia's new reference currency, surpassing the US dollar. These developments are mostly due to the effects of the financial crisis and have been supported by the region's economic and financial integration. As a reference currency of necessity or choice, the emergence of the renminbi in Asia is set to weaken the current global dominance of the US dollar. In conclusion, the paper makes the case that the growth of the renminbi as an international currency could generate a multipolar currency system that balances and distributes responsibilities in a better way than the current currency regime.

JEL Code: F02, F33

Keywords: China, Renminbi, international monetary system, capital account liberalizisation, reserve currency.

1. INTRODUCTION[1]

The steady depreciation of the US dollar and the sovereign debt crisis in the Eurozone have had little impact on the weight of currencies in the official reserves of central banks. The dollar–euro duopoly, however, is coming to an end – and the main challenger is the Chinese renminbi (RMB). A number of recent policy initiatives show that Chinese authorities have assumed a proactive strategy to increase the international use of the RMB. China has established currency swap lines with foreign central banks, encouraged Chinese importers and exporters to settle their trade transactions in RMB, and rapidly expanded the ability of corporations to hold RMB deposits and issue bonds denominated in RMB in Hong Kong, the main offshore RMB market.

These developments have combined with public statements of concern by Chinese officials about the long-term value of the central bank's large holdings of US Treasury securities and the role of the US dollar's global dominance in the financial crisis to give rise to widespread speculation that China is ready to position the RMB as an alternative to the dollar. Initially as a trading currency and eventually as a reserve currency, the increasing use of the RMB combined with China's economic weight and large stock of foreign exchange transactions would underpin China's geopolitical ambition. As Melissa Murphy and Wen Jin Yuan (2009) of the CSIS wrote at an early stage of the financial crisis, China would soon be ready to exercise a larger say in the pending reform of the international financial system, and, by means of an international RMB, hit the United States' status as issuer of the de facto global reserve currency. They warned that the United States needed to take steps to maintain the role of the dollar by 'exerting efforts to prolong the [dollar's dominant] status for as long as possible, as [this] is in the best interests of the United States.'

By fast-pedalling the internationalization of the RMB China faces some risks – and China's monetary elite is perfectly aware of them and acts cautiously. The recent debate over whether the RMB is a serious competitor to the dollar has underlined the limits and risks for China. Sylvain Plasschaert predicts the RMB will have to go a long way before it reaches the status of a widely used reserve currency, and he suggests that 'China must first offer a wide and diversified financial market, where central banks can safely lodge their foreign exchange assets' (2013). In the meantime, the US dollar will remain the world's main 'anchor currency', and will continue to maintain this position by virtue of being the dominant reserve currency and the intervention currency in exchange markets, and for invoicing in international trade.

Cohen (2012) is equally sceptical of a rapid RMB internationalization. The process, he writes, 'is unlikely to be as smooth or as swift as many have predicted.' The RMB's prospects as a global currency also remain uncertain when China's repressive financial environment is considered. Eswar Prasad and Lei Ye (2012) hint at a broader range of policy reforms – especially those related to financial market development, exchange rate flexibility, and capital account liberalization – as necessary (but demanding) steps that must be taken before the RMB can be used much more internationally.

Yet we may become blind to actual developments if we approach RMB internationalization in the

1. This paper benefitted from discussions with Fredrik Erixon, Jerry Cohen, Anastasia Nesvetailova and participants at presentations of early draft at ECIPE in February 2013 and the ISA Convention 2013. All errors remain mine.

same way as we discuss basic requisites of other fully fledged reserve currencies. China's policy for internationalizing the RMB has in some way responded to the risks and problems it faces. China has designed an RMB-based trade policy, via bilateral swap agreements, to spread the international use of the RMB. Trade transactions denominated in RMB have jumped from close to zero in 2009 to more than $300 billion in the first 3 quarters of 2012. Trading in the Chinese RMB has surged in the last 3 years with $120 billion now traded each day, up from $34 billion in 2010, according to the Bank of International Settlements (BIS). In the ranking of the world's most traded currencies, the RMB moved from 17th place in 2010 to 9th place in 2013, out-ranking the New Zealand dollar (ranked 10th) and elbowing the Swedish krona out of the top ten (BIS, 2013). On examining the RMB-trade approach, it becomes clear that China's authorities have pursued mostly defensive objectives. For one, by intensifying the use of the RMB in place of the US dollar, China has aimed to distribute the specific currency risks on China's international balance sheet, especially its large and increasing foreign exchange exposure to the US dollar. This exposure, according to Cheung, Ma and McCauley (2011), comes from the combination of China's openness to direct investment from the rest of the world, its current account surpluses, and the RMB's lack of internationalization.

Furthermore, by accelerating the international use of the RMB, China's authorities have indeed reacted to the Federal Reserve's accommodative monetary policy (quantitative easing), which has inflated the country's foreign exchange reserves denominated in the US dollar[2]. Economic theory suggests that there is a risk of accelerated inflation if the large volumes of liquidity injected by the US Federal Reserve to stimulate the economy cannot be managed once the economy picks up speed.[3] China's concerns over the instability of the dollar's value are no doubt reasonable. Nor is China alone in its concerns. With the exception of two brief episodes, the US dollar has performed poorly against major international currencies since 2002.

The proximate motive to internationalize the use of the RMB was the collapse of trade financing during the crisis, which contributed to a 20 percent drop in China's exports. This event, as expressed by Zhou Xiaochuan, the Governor of the PBoC, made Chinese authorities aware of the intrinsic instability of an existing monetary regime based on one national currency that performs the role of global reserve currency[4]. The PBoC's response was to intensify the bilateral currency swap agreements signed with other central banks to insure against a repeat of these events. Swap lines were also extended beyond the Asian region (Zhou Xiaochuan, 2009). Combining the RMB-trade approach with a steady appreciation of the RMB against the US dollar has helped the region's exchange rates to co-move with the RMB, and turned the currency into the region's reference currency. RMB-trade diplomacy has also gone well outside the region. China's central bank has been busy negotiating bilateral swap agreements with major central banks in Europe and Latin America. What was until a few years ago the 'hermit currency' is now coming out of its shell.[5]

The global ascendance of the RMB implies tradeoffs that China cannot ignore. It would make the currency rise, but if it rises too quickly it will also inflate prices, which could force export

2. On October 2 2013, the Boston Fed President, Eric Rosengren, said the central bank should reduce the pace of its bond-buying programme very slowly over the next few years only when the economic data begins to meet Federal Bank expectations.
3. Monetarism, in Milton Friedman's version, focuses on the macroeconomic effects of the supply of money and central banking, and predicts that excessive expansion of the money supply is inherently inflationary. Furthermore, monetary authorities should focus solely on maintaining price stability by controlling money supply growth.
4. John Connally's remark to a delegation of Europeans worried about exchange rate fluctuations in 1971 springs to mind: 'The dollar is our currency, but your problem.'
5. The expression is borrowed from Patrik Young of DV Advisors.

factories to move in search of cheaper labour. In 2012, China's growth slowed and was below the 8 percent benchmark. Since its economy is still dependent on export, giving up full control of the exchange rate in the short-term is risky.

Nevertheless, the expansion of the use of the RMB benefits China's international standing. And it is a highly watched event in the international economy as economic concerns linked to the euro and the US dollar have driven the foreign exchange markets' interest in currency reserve diversification as an alternative to the dollar.6 This paper aims to discuss the speed and substance of internationalizing the RMB. The paper briefly analyses China's first line of defence vis-à-vis a weakening dollar (Chapter 2) and gives an account of efforts to promote the use of RMB in trade and in the global financial market (Chapter 3 and 4). The concluding section offers some views on the consequences of an international RMB, especially on the current dollar-centered monetary regime.

2. THE PBOC AND THE INTERNATIONALIZATION OF THE RMB

The future balance between international currencies is not only a question about economic factors. The rise of the RMB is a complex process involving domestic and international economics and politics. Politics sometimes trump economics. The internationalization of the RMB has seen the involvement of three powerful financial and economic institutions in China: the People's Bank of China (PBoC), the Ministry of Finance, and the Ministry of Commerce. Obviously, the PBoC has been in the driving seat, because of the leadership of Governor Zhou and his familiarity with the political elites rather than for reasons of institutional design.

As Bell and Feng (2013) observe, 'the rise of the PBoC has been based on a relationship of growing mutual dependency with the party leadership.' And the PBoC has acquired an important position among Chinese leaders.[7] Under Governor Zhou's leadership, the central bank has graduated into the global community of central banks. In the wake of the 2008 financial crisis, the bank took direct actions to defend the country's foreign exchange reserves by diversifying reserves[8] and accelerating the international use of the RMB. In 2010, the State Administration of Foreign Exchange (SAFE), a department of the PBoC, changed its investment strategy. Since then, China's overall purchases of US Treasury bonds have steadily been reduced, now (June 2013) representing 35 percent, down from 45 percent, of the reserves (Fidler et Alii 2013). The diversification strategy, which has seen the inclusion of new reserve currencies to balance the dollar, has definitely moved to become a proactive and strategic approach to improve the return on the foreign exchange reserves. The creation of China's Investment Corporation, endowed with $400 billion, and SAFE's policy of 'going global', has increased China's financial power in the global market.

The new policies embedded in these investment vehicles have been designed to create

6. Yaroslav Lissovolik (2013), the chief economist at Deutsche Bank in Moscow, has written: 'There is a global demand for more reserve currencies. The world economy wants to diversify the set of reserve currencies as a way from the volatility and the problems associated with the current reserve currencies, because both the US and Europe are plagued by economic problems. This is natural and clear that the global economy should use more foundations, more columns on which to stand and build a stronger foundation of a more complex global economy.'

7. In the mid-1990s the PBoC was awarded new legislative foundations defining its role as a central bank charged with fighting inflation. Furthermore, the PBoC has developed specialized resources and capacities – information, monetary expertise, and a range of policy instruments – that have substantially boosted its role as an inflation-fighting central bank. On this record, the PBoC has established itself as a reasonably credible inflation fighter.

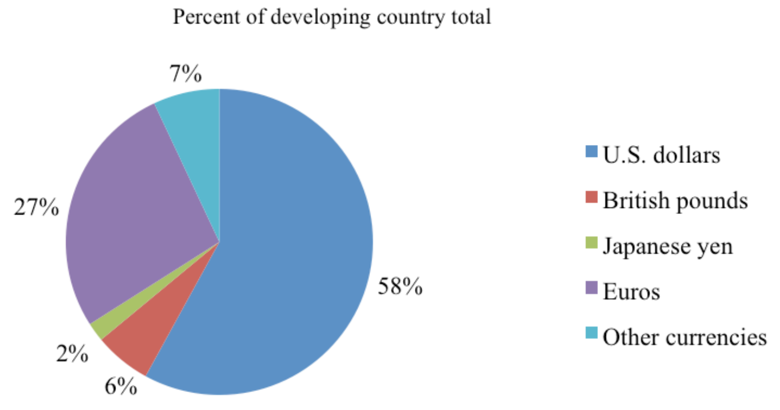
8. This section draws on Campanella (2009).

alternatives to investment in US securities and dry up the flow of cheap capital traveling from Beijing to Washington, DC. Morrison and Labonte (2012) of the US Congressional Research Service delivered a warning on the consequences that were likely to follow if China stopped buying US securities as it 'could cause a possible rise in borrowing costs across the American economy.'

And they continued: 'The United States would need other investors (foreign and domestic) to fill in the gap. Such investors would presumably require higher interest rates than those prevailing today to be enticed to buy them. China's move away from long-term US securities could raise US interest rates by as much as 50 basis points. Higher interest rates would cause a decline in investment spending and other interest-sensitive spending. All else equal, the reduction in Chinese Treasury holdings would cause the overall foreign demand for US assets to fall, and this would cause the dollar to depreciate. If the value of the dollar depreciated, the trade deficit would decline, as the price of US exports fell abroad and the price of imports rose in the United States (…) If China reduced its US investments, the United States would need to obtain investment from other countries, and the overall US current account balance would likely remain relatively unchanged but US interest rates would be expected to rise.'

A comparison with China's own foreign-exchange reserve data suggests a marked reduction in the share of reserves parked in dollars. The purchase of US securities amounted to just 15 percent of the increase in China's foreign-exchange reserves in the 12 months ending June 30, down from 45 percent in 2010 and an average of 63 percent over the past 5 years (Figure 1).

FIGURE 1. CHINA'S FOREIGN EXCHANGE RESERVES, 2011



Sources: IMF COEFER database; authors' calculations
Notes: Data have been adjusted to a constant dollar exchange rate. 2011 is a preliminary calculation.

An alternative to dollar-denominated assets is to invest in euro-denominated bonds. Former Premier Wen Jiabao, speaking at an EU–China summit, said that 'Europe is a main investment destination for China to diversify its foreign-exchange reserves." In the first half of 2011, representatives of the European Financial Stability Facility (EFSF), the Eurozone's initial arm for crisis rescue operations, was in Beijing for talks with the State Administration of Foreign Exchange (SAFE) about investing in EFSF bonds. Regular talks have continued since then and EFSF documents show that, apart from Japan, Asia (essentially China) accounted for between 14 and 24 percent of purchases for 3 EFSF bond sales worth €13 billion.

In a very detailed chronicle, Orlik and Davis (2012) note: 'China has many reasons to try to reduce its exposure to the dollar. They include very low yields paid by the Treasury and a vulnerability to US decisions on managing its debt, which could lead to inflation that would erode the value of those holdings.' Even if it is not always publicly acknowledged, China's resolve to reduce its dollar exposure has intensified after political fights in the United States over the debt ceiling. They have reinforced worries that the United States could unintentionally slip into a situation where it will default on its obligations.

The second channel for diversification is the China Investment Corporation (CIC), the sovereign wealth fund established to manage part of China's foreign exchange reserves. Established in 2007 with approximately $200 billion of assets under management – which makes the CIC one of the largest sovereign wealth funds in the world – its assets had grown to $410 billion at the end of 2010. The CIC generated a 10.65 percent return on overseas investments in 2012. Since its inception, the CIC's total overseas return is above 5 percent. According to the Sovereign Wealth Fund Institute (2013), public equities compose 25 percent of the CIC's portfolio, down from 48 percent at the end of 2010.

A third channel of foreign exchange allocation goes through SAFE, which – as part of the going-out strategy – co-finances State Owned Enterprises (SOEs) in non-financial investments overseas. This support has boosted Chinese foreign direct investment; in the first 11 months of 2012 it increased by 25 percent to $62.5 billion. SAFE has just launched a new credit mechanism that, with access to the government's $3.2 trillion stack of foreign cash, extends the use of foreign exchange reserves for foreign currency loans to enterprises through banks. Like other channels, it now aims to diversify the nation's foreign reserves investment by further supporting Chinese enterprises with overseas ambitions.

3. THE PBOC'S SWAPPING POLICY AND THE INTERNATIONALIZATION OF THE RMB[9]

China's journey of currency internationalization started in 1993 – and ever since then there has been a fits-and-starts process towards greater international use of the RMB. Under Premier Zhu Rongji, the government committed itself to achieving full currency convertibility by the end of the century. In 1994, it began removing capital account restrictions gradually and established current account convertibility by November 1996[10]. However, when the Asian financial crisis erupted the following year, China dropped its full-convertibility target.

As a substitute the PBoC promoted in late 2008 and early 2009 a policy aimed at rapidly concluding currency swap agreements with 6 nations, totaling RMB 650 billion. The aim of these RMB swap provisions was to supply RMB to these nations, a procedure to facilitate trade transactions, especially during recessions or when there is a shortage of US dollars. According to the PBoC, its use of currency swap aims to address short-term liquidity problems in order to cope with crises more efficiently while safeguarding the stability of the financial system. Furthermore, the PBoC puts considerable weight on the 'innovations' it has introduced in the currency swap agreements with other central banks: the extension of the applicable period to three years and

9. This paragraph partially draws on Campanella (2013).

10. Patrice Chovanec (2012) gives a good summary of the character of current account convertibility: 'In practice, convertibility on the current account meant that Chinese companies, or foreign companies operating in China, could exchange renminbi for foreign currencies to purchase imports, as long as they presented a valid invoice. Trade itself, both imports and exports, was conducted almost entirely in foreign currencies, mainly in US dollars.'

an expansion of the swap arrangement to trade finance[11]. According to PBoC (2009):

'In the context of the financial crisis, these new practices will promote bilateral trade and direct investment, and drive economic growth. Currency swap enables a central bank to inject the swapped amount in a foreign currency into its domestic financial system, which will be borrowed by domestic commercial entities to pay for imports from the other country. As such, the exporters in the other country can receive the proceeds denominated in the domestic currency, which will effectively avoid exchange rate risks and reduce the cost of fund transfer. **Against the backdrop of sluggish economic and trade growth, heightening fluctuations on the foreign exchange market and shrinking trade finance, these innovations can play an important role [emphasis added]**.'

In developing bilateral swap agreements, or BSAs, China's central bank has been able to curb the dependence of China and its trade partners on the US dollar for invoicing and settling trade. After the collapse of Lehman Brothers in 2008, Chinese exports plummeted, not only because of a fall in demand but also because credit froze in many importing countries, limiting access to trade finance for importers (Bottelier and Dadush, 2010). The PBoC's innovations make sense as they reduce the risk of shocks and protect Chinese exporters from currency risk. By reducing or eliminating costs for hedging against foreign exchange risks the transaction cost of trade and investment has been lowered.

In part motivated by liquidity concerns during the worst of the financial crisis, China began its efforts with a number of bilateral currency swap agreements in 2008 (with South Korea, Malaysia, Belarus, Indonesia, Argentina, Iceland, and Singapore). More recently it has signed similar agreements with Hong Kong (January 2009), and New Zealand and Uzbekistan (April 2011). These swaps are now valued at RMB 829.2 billion (about $127 billion). China is also reportedly discussing the use of local currencies (RMB, Ruble, and Real) to settle trade with Russia and Brazil.

Similarly, the use of the RMB as an investment currency is likely to help eliminate exchange-rate risk for Chinese firms seeking to borrow money for international investment. Consequently, Liao and McDowell (2013) suggest economic rather than geopolitical motivations behind the internationalization of the RMB. Increased dependence on trade and direct investment and concerns over discontinued liquidity in the credit market have pushed the PBoC to provide BSA liquidity to trade and investment. Liao and McDowell find BSA cooperation occurring 'by way of two mechanisms that benefit participating countries: (1) trade financing insulation from international liquidity shocks and (2) reduced transaction costs of cross-border trade and direct investment.' As they represent a financing channel created by central banks, BSAs allow trade and firms 'independent of international trade financing markets for third-party currencies, like the US dollar.'

Working as an independent sovereign financial mechanism, the BSAs are critical for managing situations when international capital markets break down. At the same time these arrangements have worked pretty well to supply RMB to central banks of trade partners and accelerate the RMB's credentials as a viable reserve currency for central banks.

11. In the wake of the financial crisis a number of emerging markets, such as Argentina, Indonesia, and South Korea, faced short-term liquidity problems; that is, their central banks were short of US dollar reserves to cover demand by traders. Conducting bilateral trade while bypassing the US dollar is an attractive option. According to President Hu Jintao, one of the main purposes of China initiating its currency swap agreements is to 'encourage regional financial cooperation and enhance China's capability of providing liquidity assistance to others' (2010). Another economic rationale for concluding the currency swaps and trade-financing agreements is that it will help to secure China's future supplies of much-needed natural resources.

TABLE 1. BILATERAL SWAP ARRANGEMENTS: CHINA AND OTHER ASEAN+3 COUNTRIES (AS OF JULY 2007)

BSA	One/Two-way	Currency	Total size, USD bn	Status
China–Thailand	One	USD/THB	2	Concluded: Dec 2001
				Expired: Dec 2004
China–Japan	Two	CNY/JPY	6	Concluded: Mar 2002
		JPY/CNY		
China–Korea	Two	RMB/KRW	8	Concluded: Jun 2002
		KRW/CNY		
China–Malaysia	One	USD/MYR	1.5	Concluded: Oct 2002
China–Philippines	One	CNY/PHP	2	Concluded: Aug 2003
				Amended: Apr 2007
China–Indonesia	One	USD/IDR	4	Concluded: Dec 2003
				Amended: Oct 2006

Source: Bank of Japan and Gao, Yongding (2011)

TABLE 2. CHINA'S BILATERAL CURRENCY SWAP AGREEMENTS SINCE THE COLLAPSE OF LEHMAN BROTHERS

Country	Data	Amount
South Korea	12 December 2008	RMB 180 bn
Hong Kong	20 January 2009	RMB 200 bn
Malaysia	8 February 2009	RMB 80 bn
Belarus	11 March 2009	RMB 20 bn
Indonesia	23 March 2009	RMB 100 bn
Argentina	29 March 2009	RMB 70 bn
Iceland	9 June 2010	RMB 3.5 bn
Singapore	23 July 2010	RMB 150 bn

Source: Bank of Japan and Gao, Yongding (2011)

Settlement of trade transactions with the RMB, and issuance of RMB-denominated bonds by banks and companies in Hong Kong, represents the third channel of the internationalization of the RMB. The development of an offshore market for the RMB is part of the PBoC programme to test market views on the international use of the RMB. In July 2009, China piloted an RMB trade-settlement scheme. By the end of 2010, it had licensed more than 67,000 exporters in 20 provinces to invoice in RMB. Though further expansion is likely, concerns about inflation (mainly caused by China's excessive, stimulus-related credit expansion in 2009 and 2010) have put efforts on hold; authorities are concerned that invoicing in RMB could create additional liquidity. In 2011, the PBoC issued 27 administrative rules for the pilot programme of settlement of RMB-denominated outward direct investment. China is now focusing on encouraging importers to pay with RMB via some liberalization measures.

Developing the offshore RMB in Hong Kong is not a risk-free strategy. Cheung, Ma and McCauley (2011) stress the great risk China is taking by internationalizing the RMB before fully liberalizing the country's capital account. China is still at a transitional stage in its financial development; the net interest margin is still regulated, lending is still subject to quantitative guidance, and foreign banks are still playing a small role. On the other hand, building the offshore market is critical to overcoming the RMB's limited convertibility and broaden its use outside mainland China. In this offshore market non-residents have access to the Chinese currency for the purpose of trade and investment and are encouraged to hold RMB funds while China's monetary authorities retain control over the pace of the capital account liberalization (He and McCauley, 2010). Backed by capital controls, restrictions on inward flows provide the authorities with direct leverage over credit growth and its allocation (McCauley, 2011). Measures to keep offshore flows away from the onshore market were clearly conceived to limit capital account convertibility. It appears that China's policy of internationalizing the RMB is an approach with more restrictions on inward than on outward flows. Chinese authorities believe, according to Subacchi and Han (2012), that 'domestic financial stability can be maintained as long as the channel through which offshore RMB get back to the onshore market is restricted.'

Since its inception in 2009, the PBoC's programme of RMB cross-border trade settlement[12] has been successful in raising the profile of the RMB in international transactions. In 2012, cross-border trade transactions settled in RMB amounted to 10.9 percent of China's trade, up from almost zero when the program began. At the same time, the offshore RMB (CNH) market has expanded rapidly across a number of financial products, including spot foreign exchanges deliverable forwards, swaps, deposits and CDs, as well as bonds and other structured products. Issuance of RMB-denominated 'Dim Sum' bonds in particular has grown rapidly.

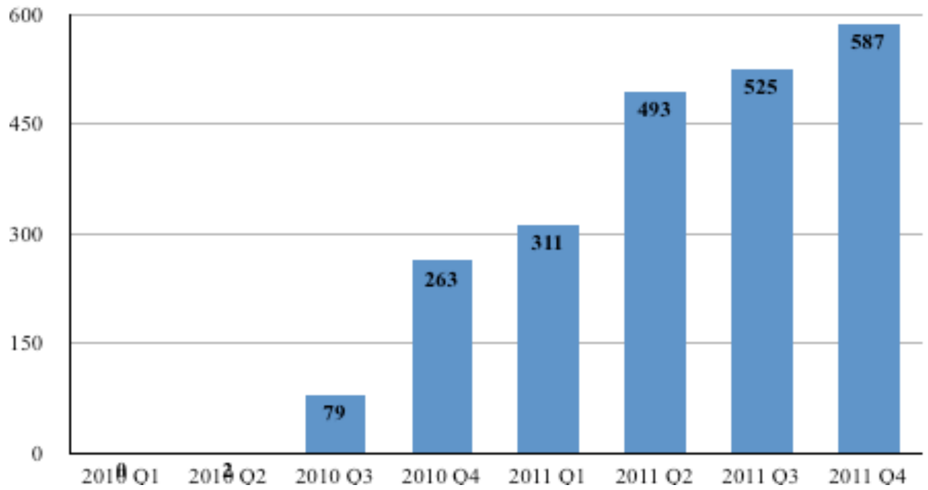
Despite the overall success, RMB internationalization has encountered headwinds. After increasing steadily through mid-2011, the growth of cross-border trade settled in RMB has slowed recently, and RMB deposits in Hong Kong have fallen. Due to the lack of full convertibility, and in contrast to the market-driven development of the world's existing reserve currencies, the internationalization of the RMB is still very much a policy-driven process. The use of Hong Kong for the internationalization of the RMB has raised US concerns, with the US–China Economic and Security Review Commission (2012) calling on political leaders to enact 'Section 301 of the US–Hong Kong Policy Act of 1992, which requires the US Secretary of State to include reporting on interference in Hong Kong's internal political affairs and Chinese efforts to leverage the territory as a platform for the internationalization of the RMB.'

A second trend is the increasing geographical distribution of RMB trade settlements. In particular, the cumulative share of RMB cross-border trade settlements with companies outside Hong Kong increased from around 25 percent at the end of 2010 to around 36 percent at the end of 2011. This suggests that the RMB may be gradually gaining acceptance as an invoicing currency. Despite a slowdown in the growth of RMB trade settlements, offshore RMB business continues to expand given the increasing attractiveness of RMB investment opportunities. As the prime offshore RMB centre, Hong Kong has been a particular beneficiary of this business. The offshore market has expanded in financial centers, too, including Singapore, London and Tokyo, all of which are about to develop their own particular RMB segments and market niches.

12. In June 2009, Chinese officials announced a pilot scheme where business and trade transactions were allowed between limited businesses in Guangdong and Shanghai municipalities and only counterparties in Hong Kong, Macau, and select ASEAN nations. The programme was further extended to 20 Chinese provinces and international counterparties in July 2010, and in September 2011 it was announced that the remaining 11 Chinese provinces would be included. In steps intended to establish the RMB as an international reserve currency, China has signed agreements with Russia, Vietnam, Thailand and Japan allowing trade with those countries to be settled directly in RMB instead of requiring conversion to US dollars. Australia will follow soon.

A growing pool of offshore RMB liquidity has fuelled the growth of the CNH (China–Hong Kong) offshore market alongside the traditional onshore CNY market.[13] Market growth was led by an increase in RMB deposits in Hong Kong, which peaked at RMB 627 billion in November 2011, equivalent to around 10 percent of Hong Kong's total deposit base. In recent months deposits have declined due to lower appreciation expectations. These deposits hold up Hong Kong's primary market for RMB-denominated financial instruments. The market has expanded rapidly since 2009, when China's Ministry of Finance issued a small amount of RMB-denominated bonds to promote the market. Since then several large foreign companies such as HSBC, McDonald's, and Caterpillar have also issued 'Dim sum' bonds.

FIGURE 2. DEPOSITS IN RMB IN HONG KONG



Source: Zhang (2012)

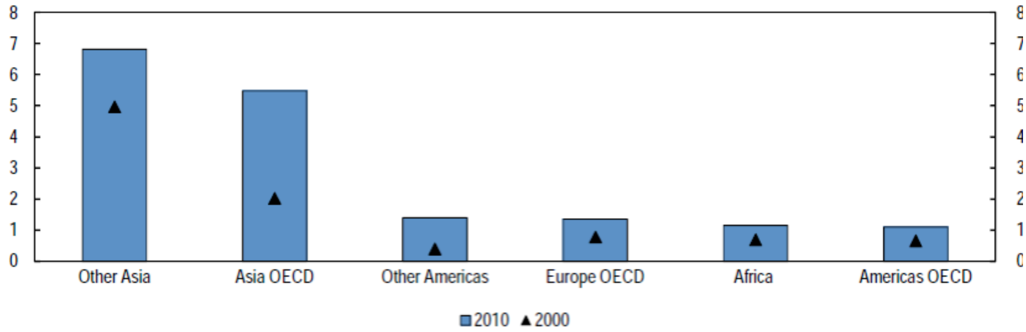
4. RMB – THE NEW ANCHOR CURRENCY IN ASIA

Regardless of whether the growth of RMB is a sign of the currency's inexorable global rise or, as argued by Dailami and Masson (2010), a precautionary measure to manage the region's vulnerability to the US dollar, powerful economic factors are at the roots of the RMB's irresistible ascent. Since 2000, China's trade, investment and aid in Asia have expanded rapidly: China has become the most important export destination for most of the region's economies. The strongest linkages to China's economy are naturally in Asia – average exports to China are equivalent to around 5 percent of GDP (with Korea at 11 percent, Malaysia at 10 percent, and Thailand and Vietnam both at 7 percent).

Despite ongoing territorial disputes, trade between China and the 10 ASEAN countries has accelerated after the ASEAN–China free trade area came into effect in 2010. Trade rose more than 10 percent to $400 billion in 2012; ASEAN is now China's third largest trading partner after the European Union and the United States. The region is expected to become China's main trading partner in a matter of years while China has already become ASEAN's biggest trading partner, overtaking the EU and Japan in recent years.

13. Currently, the onshore CNY and the offshore CNH are two separate markets. Apart from the technical differences, the main feature of CNY is that its exchange rate with the dollar is fixed by the Chinese central bank. Players on the CNY market demand CNY and sell US dollars like other onshore exporters. Onshore importers pay for US dollars with CNY. The PBoC also typically buys US dollars in line with its monetary policy, fixing the USD–CNY exchange rate.

FIGURE 3. CHINESE IMPORTS FROM SELECTED DESTINATIONS AS PERCENTAGE OF PARTNER COUNTRY GDP



Source: OECD 2013

It is not suprising that the use of the RMB is rising. According to recent studies (Subramanian, 2011; Subramanian and Kessler, 2012; Mehl and Fratzscher, 2012), the use of the RMB in trade transactions has consequences for the RMB as a reserve currency. In a very short time span, the RMB has overtaken the US dollar as the exchange-rate anchor currency in East Asia. Mehl and Fratzscher (2011) identify a statistically significant regional foreign exchange factor in emerging Asia's exchange rate dynamics that is stronger than those observed for other regions of the world. They also show that this factor has increased markedly since 2005, when China began its exchange rate reforms. These findings reinforce the view that Asia's policymakers have been more attentive to regional currency developments than to maintaining the peg to the US dollar. In particular, they have followed the RMB movements and China's monetary stance since the Chinese government began to gradually increase the flexibility of its exchange rate. They also find evidence that causality is, to some extent, bidirectional; Asia's regional conditions influence the RMB while Asia's regional exchange-rate factor is driven mainly by the RMB.

On a similar note, Subramanian (2011) argues that fundamental determinants of international currency status are not just about the size of an economy but also the size of its trade and its external financial strength. These factors have been moving strongly in China's favour. Subramanian notes: 'If China were willing to take on the necessary changes of its financial markets and allow greater access for foreigners to the RMB via capital account liberalization, the rise of the RMB to international currency status could be imminent, perhaps within the next 10–15 years.'

A defining moment of a currency's rise to become a reference exchange-rate anchor is when it intensifies its role as a reference currency for other regional currencies. When this moment occurs, a currency bloc tends to develop around the reference currency, whose monetary policy becomes dominant. Europe experienced a similar development when, after the dismissal of the dollar–gold convertibility in the early 1970s, the Deutsche Mark started to act as the region's anchor currency and the Bundesbank took the upper hand in European monetary policy.[14]

The growth to become an exchange rate reference currency is crucial to achieve currency dominance. According to a mainstream definition, an international currency is one that foreigners (official and private) seek for three reasons: as a store of value, a medium of exchange, and a unit of account. This leads to Peter Kenen's famous 3 x 2 taxonomy (3 roles for 2 types of foreign actors).

14. The Deutsche Mark had been the anchor currency of the snake and of the EMS and ERM.

TABLE 3. SIX ROLES OF AN INTERNATIONAL CURRENCY[15]

Six roles of an international currency		
	Private	Official
Medium of exchange	Vehicle	Intervention
Unit of account	Invoice	Peg
Store of value	Banking	Reserve

Source: Following Krugman (1984) and Cohen (1971).

Setting aside the top two functions in Table 3 – store of value and medium of exchange – there are two ways for a currency to become a reference currency once it has become a reference point for other currencies. One way is when foreign governments and/or central banks frequently anchor/peg their currencies to it. Another way is for foreign trade and financial transactions to be denominated/invoiced in the currency. A currency becomes a **reference point when other currencies co-move with it**. As Subramanian and Kessler (2012) observe, 'this datum has many sources. It could be the effect of policy choices by countries to track the reference currency in the context of a fixed or semi-fixed exchange rate regime. Or, its source could reside in market driven factors.' By counting all trade and not just regional manufacturing trade, they see '**the potential for a global RMB bloc beyond Asia with trade as a driving force** [emphasis added]. And the nascent signs of such a development are the earlier findings that the RMB is the dominant reference currency in Chile, India, and Israel (not to mention Macedonia) and is the second-most important reference currency for South Africa and Turkey.'

The reference currency status could signal the RMB's passage to an international currency or that it can stabilize as an anchor currency. For the first case, Subramanian and Kessler (2012) note, 'if more countries track (…) the RMB, that stability in the bilateral exchange rate will be conducive to the private sector using the RMB as a unit of account in trade transactions.' In the case of the RMB, the fact that it has become one of the major global reference currencies, along with the US dollar and the euro, and that the underlying causes of such exchange-rate co-movements could be common trade, financial or other real shocks, does not exclude the ability of policymakers of central banks to increase exchange rate stability with China in order to stabilize the trading environment of their domestic firms. There are also factors of competitiveness that explain why central banks in trading partners with similar income and productivity levels tend to co-move their exchange rates with the RMB. To minimize the cost-competitiveness difference with China, tracking the RMB more closely is an option. So, the choice to track the RMB is rational and imperative. Subramanian and Kessler (2012) note: 'In a context where the RMB appreciates, a flexible peg to the RMB can allow competitor countries to appreciate their currency in order to limit inflation, while retaining competitiveness.'

Since 2010, the RMB has surpassed the dollar and the euro by becoming the top reference currency in East Asia and the Philippines. The dollar's dominance as reference currency in East Asia is now limited to Hong Kong (by virtue of the peg), Vietnam and Mongolia. Yet the RMB as the top exchange-rate reference currency is not restricted to East Asia. For Chile, India and South Africa, the RMB is the dominant reference currency. For Israel and Turkey, the RMB is a more important reference currency than the dollar. With only 9 currencies out of 42 outside East Asia co-moving significantly with the RMB, it is still the case that the dollar and the euro play a greater role than the RMB. But, obviously, actual patterns are changing in favour of the RMB.

15. Following Krugman (1984) and Cohen (1971).

Yet this development is not fully acknowledged. The IMF is graduating more national currencies to the club of reserves status (as the case of the Australian and Canadian dollars) but no Asian currency except the yen meets the IMF qualifications. As David Marsh (2012) argues, this reflects the minor status of the RMB, and its low use in the official portfolios. But are we not overlooking the 'big picture' when dismissing the RMB as a reserve currency? This paper has argued that closer trade and financial integration between China and the Asia region is behind the RMB displacing the US dollar and becoming Asia's new anchor currency. Together with a strong policy push by the PBoC, orchestrating the use of bilateral swap deals with all major central banks, the RMB has been projected itself beyond the region's relevance.

Though these developments are not substitutes for the RMB admission to the 'reserve currencies club', it is worth suggesting the likely implications of current RMB trends. Firstly, as the RMB is shaping a de facto informal currency bloc[16], key structural changes are likely to follow. As the RMB becomes a de facto anchor currency it spurs financial activity in Asia as well as in global capital markets. Cross-border flows in Asia with an active international market in RMB-denominated instruments would reduce Asian dependence on dollar-denominated markets. And as the region's currencies are likely to be more stable against the RMB than against the dollar, the stabilizing effect would provide a 'public good' to the international debt of Asian economies in relations. This development will generate more benefits to economies with the strongest trade links with China. Secondly, along with the stabilizing effect in Asia, an increasing anchor role for the RMB would alter the dynamics of global capital markets. To the extent that emerging Asian countries exit from dollar-tracking currency regimes they will be attracting a large amount of the growth in foreign assets in the region (Lane, 2013).

In anticipation of these developments, the question is: will we move to a global currency regime in which the RMB acts as a stabilizer? Is the RMB set to challenge the US dollar, or will it only become a regional currency? Will we get multipolar currency blocs? And, finally, would a new multipolar currency regime be more stable than the current dollar-centred system?

Gao and Yu (2011) have offered some interesting reponses. China's leadership will have to make a hard choice between two different approaches: the US dollar or the German euro approach. On the weight and strength of the US economy and military power after the Second World War, the US dollar could topple the pound sterling and become a global and dominant currency while pursuing an independent macroeconomic policy. If China followed an 'American approach' it would lead China to pursue a strategy of having the RMB used as an international currency *in parallel to* the US dollar, the euro and, perhaps, the yen. The second option would be the 'German approach': currency regionalization through a series of concrete steps (e.g., a regional currency mechanism like the Exchange Rate Mechanism) in the direction of a single currency replacing all the individual currencies. Say Gao and Yu (2011): 'Given that this approach results in the eventual elimination of individual currencies, if China were to follow this approach, it should involve itself in a fully fledged monetary union in Asia, and, in the final stage, the renminbi would be diminished and replaced by a new Asian single currency.'

16. For Frankel and Rose (1998), the traditional criteria for membership of a common currency area are not as binding as they are often claimed to be, as forming a monetary union can be an endogenous process. This makes the case of the RMB shaping a de facto currency bloc.

5. CONCLUDING REMARKS

China has used unconventional measures to promote the ascendance of the RMB in the international economy. Structural changes in the world economy and the 'rise of the rest', reinforced during the financial crisis, are likely to prompt the rise of new reserve currencies. The RMB's rise will continue even if China's authorities do not implement market-driven reforms of financial and monetary policy (Gallagher, 2013). Indeed, by choosing the third way, China's authorities are in one sense buying time, eschewing the risks by moving towards a fully fledged international RMB in the absence of financial and monetary liberalization, and avoiding an upfront 'war of dominance' with the dollar.

This paper argues that the RMB is on track to significant international relevance and that it has already become an important anchor currency in Asia. This development follows a specific pattern (as suggested by World Bank Report 2009 and Brake and Bunda, 2012): as China has become a new centre for the world economy, other currencies that depend on trade with China have moved closer to the RMB. Like the US dollar and the euro – other 'centres of gravity' – the RMB is likely to intensify its anchor role and shape a regional currency bloc in Asia. Consequently, the future will probably see the emergence of a tripolar or multipolar currency system. But it does not necessarily follow that each currency is endowed with equal qualities in terms of financial depth, store of value and availability. Its merit would rather be a balancing between the different endowments of each currency, which in turn would reduce the inherent instability in the dollar-centred system and the risk of currency-bloc protectionism. Well-managed portfolios, especially by central banks, would likely distribute risks among currencies with different qualities.

In an interview with the Austrian state broadcaster ORF, just after the Lehman default, Ewald Nowotny, the Governor of Austria's central bank, said that a 'tripolar' global currency system is developing between Asia, Europe and the United States and that he was sceptical about the idea that the US dollar's centrality can be revived. Said Nowotny: 'What I see is a system where we have more centers of gravity (...) I see for the future a tri-polar development, and I don't think that there will be fixed exchange rates between these poles.'

The arrival of the dollar's new competitors is a welcome development. A broader multi-currency system will increase the range of choice for market actors, thus making it harder for the global reserve-issuer to act in arbitrary and unilateral fashions. The dollar's 'exorbitant privilege' – a de facto monopoly – has allowed the United States to mismanage its balance of payments and pushed borrowing without concern for systemic instability. In the words of C. Fred Bergsten (2011), a supporter of a wider portfolio of global currencies, 'pressure from abroad can be constructive in promoting needed adjustment' in the United States. Ideally, the new monetary system would curb the US monetary 'independence', imparting more stability to the system.

But that is not the only possible outcome. A disorderly scenario could emerge, in which every issuer of an international money shares the same imperative: the national interest. As Cohen (2012) argues: 'There is no guarantee that in the new multi-currency system, other newly empowered countries might not also seek to enjoy an exorbitant privilege, narrowly prioritizing their own interests to the detriment of the others.' In the absence of global coordination, a new multipolar currency regime could just magnify the present deficiencies of the currency regime.

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