Apart from developing currency markets between RMB and other regional currencies, markets between various major regional currencies also need to be developed. This will facilitate the development of the region’s capital markets. Since the East Asian financial crisis, there have been many discussions about the need to develop East Asian capital markets to keep the region’s saving surplus within the region, rather than recycle the surplus to finance the U.S. deficit and then have hot money flowing back to East Asia with all the problems that it can cause. The development of deep and well-functioning currency markets in the region will reduce the transaction costs of investing and earning in the regions’ local currencies and help to promote the region’s local currency capital markets (see Sussangkarn and Vichyanond 2006).

Reference


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Comments by Jayant Menon, on *The Economics of RMB Internationalization*

Jayant Menon: The paper begins with a useful review of the existing literature on the roles of an international currency and the benefits and costs of being an international currency, both in theory and in practice. The paper presents data to illustrate the rapid increase in the scale of Renminbi (RMB) use and holdings outside of China. Zhang and Tao attribute this increase to a number of market driven factors, namely: (i) increased trade between China and Southeast Asian countries; (ii) the continuous appreciation of the RMB since 2005, which has encouraged foreign exporters to settle their trade in RMB; (iii) the rise in currency swap agreements with China in the wake of the 2008–09 global financial crisis; and (iv) the increasing role of Hong Kong—which conducts business in RMB—as a major financial center in the region.

The paper then discusses the main benefits and costs of RMB internationalization. On the benefits side, the paper argues that RMB internationalization could: (i) reduce the exchange risks of international trade and investment, thereby reducing transaction costs for Chinese firms; (ii) allow Chinese firms and financial institutions to borrow in
RMB; (iii) facilitate the overseas expansion of Chinese firms and financial institutions; (iv) enable Chinese monetary authorities to collect seigniorage from the rest of the world; (v) help China reduce its reliance on the U.S. dollar and reduce the welfare loss caused by the low returns on foreign currency reserves; and (vi) improve China’s political position in the world and thereby strengthen its influence.

The authors utilize an econometric model to examine the effects of currency internationalization on the development of domestic financial markets. The econometric analysis reveals that currency internationalization in terms of trade settlement has a significant and positive effect on the development of a financial market. This is true not just for China but also globally. This is true even when reverse causality and endogeneity issues are considered; RMB internationalization can still have a positive effect on China’s financial development.

On the costs side, the authors identify two main drawbacks: permanent general costs, in the form of reduced effectiveness and independence of China’s monetary policy and exchange rate policy; and temporary transitional risks, such as the probability of asset bubbles and financial instability, exchange rate appreciation and lower trade competitiveness.

Nonetheless, the authors argue that in the long run, the benefits of RMB internationalization should surpass the costs, and that transitional risks can be eliminated if appropriate mitigating measures are taken. These include sustaining economic growth and competitiveness in trade; accelerating domestic financial reforms, but in a cautious manner (particularly in the case of capital account liberalization); reforming the RMB exchange rate market and reducing speculation between onshore and offshore RMB markets; and strengthening global and regional financial cooperation to foster a good environment for RMB internationalization.

One of the key facts worth noting up front is that although there has been a rapid increase in RMB internationalization, current volumes are still small and nowhere near even those associated with the Japanese yen. Furthermore, most of this increase is driven by settlement of trade in RMB. There has also been a rapid growth in the offshore RMB bond market, given restrictions in the domestic financial market and the capital account. These restrictions have led to the creation of distinct offshore and onshore markets, with differences that cannot easily be arbitraged away (see, for instance, ADB 2014).

On the cost–benefit analysis, the authors note that a proper cost–benefit may be premature, but they also conclude that benefits exceed costs. Some of the apparent costs or benefits are themselves in doubt, or should also be subject to cost–benefit analysis. For instance, is the current managed exchange rate a good thing, and will a change to the system, which apparently has started happening recently, be a cost or benefit?
Another issue that needs to be addressed is the question of sustainability, or whether this process of internationalization of the Renminbi has legs (can it continue)? The future of RMB internationalization appears to be constrained at the moment by the fact that there are limited options to invest in RMB-denominated assets. The potential for capital gains through continuous appreciation is not guaranteed and can change, as the depreciation in August 2015 has demonstrated, and therefore yields will indeed matter. As long as the financial system and capital account remain restricted, prospects also remain limited. But opening up the capital account before reforming the financial system can be a highly risky exercise. Strengthening the domestic capital market prior to additional liberalization of the capital account will be critical. It is only through these measures that the internationalization of the RMB is likely to continue to grow in the long run.

Because these domestic reforms are likely to take some time before they are fully implemented, the question in the short to medium term is the extent to which the offshore RMB bond or “dim sum” market can play a role to keep the momentum going? Although the authors do not provide details relating to this market, the information from ADB (2014) suggests relatively good prospects.

Any analysis addressing the prospects for a new global reserve currency must address the issue of current scale, or volume, and its proper measurement. What is the right measure of scale in this case? The econometric evidence presented in the paper highlights the significance of settling trade in RMB. Much is made of trade finance, but this is a relatively small percentage of global capital flows. The medium of exchange function that the RMB currently plays in trade settlement is dependent on China’s bilateral trade flows. In other words, the RMB is not used as a “vehicle” or “invoicing” currency for trade between third parties, or in settling non-China trade. What then happens when the current account surplus and trade as a share of GDP contracts as part of rebalancing? It would appear that the process of internationalization of the RMB will also face a setback, unless its use grows to include third party trade and, eventually, beyond just the medium of exchange function of payments settlement.

On the issue of improving China’s political position in the world, there is perhaps insufficient recognition given to the fact that this also carries a significant responsibility that does not come without cost. China, like most countries, can no longer free-ride and must contribute toward the preservation of global public goods, or the global commons, and share in the cost of their provision.

Finally, it should be noted that in Asia, there are other currencies that are also vying to have a greater presence and play a bigger role in global trade and capital flows. The RMB will face competition from the yen, and maybe the Korean won as well, going forward. If India continues with its reforms that lead to greater engagement in global trade and
finance, will its government also hold out similar ambitions for the rupee? Beyond pure economic interest, who will support China in promoting the internationalization of the RMB, from a geopolitical or strategic perspective? Looking back, did the pound sterling fail partly because of lack of support and/or competition from Germany and France? China will require strong support from strong supporters if it is to succeed in making the RMB a truly international currency.

Reference


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