IN QUEST FOR RIGHTFUL STATUS FOR RENMINBI IN THE INTERNATIONAL MONETARY SYSTEM

M.M.K. Sardana*

*[**Abstract:** In its march to economic development since 1978, China has chosen an approach of experimentation avoiding upheavals. This approach paid off as China has successfully emerged as the biggest economy (on purchasing power parity) and the largest international trader. If on the basis of their sustained success, China wishes to see its currency dominate the International Monetary System at least at par with the US dollar, the aspiration is by no means fanciful. This note discusses the initiatives being taken by China in its quest to gain international recognition for renminbi and concludes that in this endeavour they are pursuing the path of experimentation, steadily moving forward.]*

In 1978, Chairman Xiaoping broke away from Mao's centrally-controlled economy in China to foray into free market economy with the twin objective of (i) achieving significant economic growth and improving the living standards, and (ii) strengthening of the hold of the Communist Party over the people who were becoming disenchanted with the regime over the fall in living standards during the preceding decade. He decided to implement market-oriented reforms, gradually identifying policies which produced favourable economic outcomes (and which did not) so that they could be replicated (avoided) in other parts of the country. Deng Xiaoping reportedly referred to it as "crossing the river by touching the stones". The opening was step by step with controlled experiments in several directions. Since 1979, the central government initiated price ownership incentives for farmers, enabling them to sell a portion of their produce in the free market. Government also established four special economic zones along the coast for attracting foreign investment, boosting exports and importing high technology products into China. Progressively, it decentralised economic policymaking in several sectors such as trade, passing the control of several enterprises to provincial and local governments which were to operate and compete on free market principles rather than being

* The author is a Visiting Fellow at the Institute.

dictated by the State. Citizens were also encouraged to start their businesses. Additional coastal regions and cities were designated as "open cities" and "development zones" with the intent to experiment with free market reforms and offer tax and trade incentives to attract foreign investment. Gradually, State control on prices was eliminated and trade was liberalised encouraging greater FDI inflows.

Since the introduction of reforms and for the most part avoiding major economic disruptions, China's economy has grown substantially faster than during the pre-reform period. From 1979 to 2014, China's annual real GDP growth averaged nearly 10 per cent. During the global meltdown, which began in 2008, its growth did come down from 14.2 per cent in 2007 to 9.6 per cent in 2008 and further slowed down to 9.2 per cent in 2009. Nevertheless, the Chinese government implemented a large stimulus package and checked a sharp decline, maintaining 9.6 per cent average growth from 2009 to 2011—demonstrating China's resilience compared to other economies. In recent years, the growth rate has experienced a decline, from 10.4 per cent in 2010 to 7.8 per cent in 2012 to 7.3 per cent in 2014, and it is being predicted that it will be around 6.8 per cent in 2015 and 6.3 per cent in 2016. Partly, this phenomenon may be attributed to the "middle income trap," which may call for removal of structural inefficiencies that pose as a barrier to further momentum in productivity. If these barriers remain unaddressed and business is done as usual, it will show a falling off of the growth curve in the years ahead. The Chinese, in their characteristic way, are experimenting to meet the challenge by adopting smart growth strategy which seeks to reduce reliance on energy intensive and high polluting industries but increase reliance on high technology and green energy services, thereby seeking to strike a balance between consumption led growth and export dominant and investment based approach[1]. In their characteristic way of "crossing the river by touching the stones," the Chinese seek to address the

[1] Morrsion, W.M. (2015), "China's Economic Rise: History, Trends, Challenges, and Implications for the United States," Congressional Research Service Report, October 21. Available at: https://www.fas.org/sgp/crs/row/RL33534.pdf

challenge in their own way through experimentation, as they have done in respect of rebalancing their economy.[2]

The fact remains that China has rapidly risen as a major economic power within a span of about three decades and has carved out for itself the greatest economic success story in modern times. It is estimated that apart from maintaining an annual average growth rate of 10 per cent from 1979 to 2014, it has been able to pull 679 million people out of extreme poverty. China has emerged as a major global economic power. It is now the world's largest economy (on purchasing power parity basis), largest manufacturer, merchandise exporter and importer and holder of foreign exchange reserves. It is the largest source of imports into the US, the world's largest economy (in dollar terms). It should not appear unusual if China aspires to see its currency dominate the International Monetary System, doing away with the 70 years of hegemony of the US dollar despite the fact that US economy has generated weak growth since 2009 and accumulated a large sovereign debt. It recognizes the advantages and privileges and also the downsizing that occurs during periods of economic prosperity of a country when its currency predominates. Further, it is to recognize that a currency seeking international recognition should possess these attributes[3]. While a predominant currency issuing country can acquire assets at nominal cost, raise debts at easy rates, and do business without the risk of foreign exchange fluctuations, it should take cognizance of the impact of its own monetary policies on other economies and must also be prepared to run deficits in order to provide global liquidity to its currency. Attribute-wise, the currency should be freely convertible both on current account and capital account, and be able to develop deep financial markets where other countries and entities can buy and sell securities, stocks and debts.

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[2] Sardana, M.M.K. (2015), "Rebalancing of the Chinese Economy, Its Slowdown and Devaluation of the Yuan," ISID Discussion Note DN2015/10, November.

[3] Wilson, W.T. (2015), "Washington, China, and the Rise of Renminbi: Are the Dollar's Days as the Global Reserve Currency Numbered?" Special Report #171 on China, August 17. Available at: http://www.heritage.org/research/reports/2015/08/washington-china-and-the-rise-of-the-renminbi-are-the-dollars-days-as-the-global-reserve-currency-numbered

In terms of the preparedness for taking on the mantle of the dominant currency, China has to traverse several lengths. In its own characteristic way of moving ahead slowly and determinedly, China has been seeking the internationalisation of renminbi (RMB) since 2009 when it pitched for its currency to be included in the basket of currencies recognised by IMF as a vehicle for Special Drawing Rights (SDR) along with US dollar, European euro, Japanese yen and the British pound sterling. It did so with the expectation that if RMB is included in the basket, it will encourage other central banks to increase their holdings of the yuan. To win approval from the IMF, Beijing must make a case that the yuan can be easily used in international markets, which will include opening the door wider for central banks and other institutional investors for making investments in China's bond market. Without specifying a timetable, the People's Bank of China (PBOC) has announced that it will give foreign entities greater freedom to sell yuan-denominated debt in China, and other domestic companies more scope to issue such bonds overseas. Further, it will ease limits on Chinese individuals and companies investing in foreign assets. It has been further indicated that China will free up interest rates and the flow of capital across the border by the end of 2015.[4]

Gaining reserve currency status for the yuan from the IMF is not likely to immediately affect how countries manage their foreign exchange reserves. SDRs are really insignificant in the grand scheme of international finance. SDRs are held by IMF member states as a part of their foreign currency reserves and are not freely usable. They only account for less than 3 per cent of the official reserves globally. Adding the yuan to the basket will not change the calculus and the over whelming preference for dollar will continue.[5] Yet China will continue to pursue the goal of yuan's inclusion in the IMF basket of currencies because (i) it will be a step forward in the internationalisation of yuan, and (ii) it will potentially pave the way for yuan internationalisation by encouraging international investors to catch up with the underinvested currency. PBOC is encouraged to note that at the end of April 2015,

[4] Wei, L. (2015), "China Rallies around Yuan as IMF Mulls Reserve-Currency Inclusion," *The Wall Street Journal*, June 15.

[5] Webman, J.A. (2015), "The Yuan as a Reserve Currency? Not so Fast," Oppenheimer Funds, September 04.

foreign central banks held approximately 666.7 billion yuan ($107.41 billion) in their reserve and the total was rising, with the UK and Australia beginning to add the currency to their official reserves; though yuan still represents only a sliver of the total.[6] For economic and other commentators, the inclusion of RMB in the reserve currency basket of IMF may not be significant enough for according it the dominant status of a reserve currency. However, in the Chinese scheme of things, it will be a significant step forward which will sensitize the central banks to earmark part of their currency reserves in yuan.

Because of its increased international trade and its dominance in manufacturing, 30 per cent of the trade transactions were carried out in RMB in the year 2014. RMB, with its new found status of figuring in trade invoices, will encourage trading partner countries to keep their reserves in yuan/RMB for ease of doing business, thus overcoming the costs on conversion and foreign exchange fluctuations.[7] The Chinese currency is already accepted as a form of payment in Mangolia, Pakistan, Thailand and Vietnam.[8]

China's outbound foreign direct investment (FDI) is increasing the use of RMB because it is the predominant settlement currency for Chinese investment abroad. China's outbound investment had increased to $86.3 billion dollar in 2013 compared to $10.1 billion in 2005. China is already the sixth biggest investor abroad and its investments will increase steadily in the years ahead as part of the Chinese strategy of "going out."

In 2009, China signed currency swap agreements with Indonesia, Argentina, Malaysia, Hong Kong, Singapore, South Korea, New Zealand and UAE among others.[9] A transaction clearing bank for Chinese currency was introduced in April 2015 in Toronto, allowing companies, for the first time, to settle accounts with Chinese partners during business hours in the $5.3 trillion-a-day currency market. The

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6 *Ibid*.

7 Johnston, M. (2015), "Will the Yuan become an International Reserve Currency?" Investopedia, August 20.

8 Stuenkel, O. (2015), "The Long Road to Currency Multipolarity," Post-Western World, August 29.

9 *Op. cit.* 3

transaction clearing bank will facilitate access to the yuan and encourage its use beyond the borders as well, specifically to the US where yuan use has been growing faster than in either the UK or Singapore.[10] China's President has been invited to UK to make the city of London the world's renminbi trading centre. Britain has offered China an unprecedented opening. For the first time China will be using renminbi-denominated sovereign bonds outside China.[11] Thus, China is steadfastly moving forward, bypassing the US dollar as the medium of exchange.

Almost non-existent 10 years ago, the Chinese bond market is now the world's third largest at RMB 36 trillion (about $5.8 trillion). Much of this expansion has consisted of the growth of the corporate bond market. Formed in 2014, the Shanghai-Hong Kong Stock Connect allows foreign investors to buy mainland stocks from Hong Kong and mainland investors to buy foreign stocks through the Hong Kong exchange. This initiative is likely to increase global demand for RMB. In 2014, Hong Kong banks handled RMB trade settlements worth 3.8 trillion yuan ten times more than in 2010.[12]

China's steady march to opening up its currency to the present state is to be appreciated, recalling that the Chinese have been discussing Capital Account Convertibility (CAC) since 1993. When China adopted current account convertibility in 1996, it had announced its resolve to achieve CAC. Similarly, in 2003, 2011 and 2013, the resolve was reiterated and had been implemented in phases. Even during April 2015, the Governor of PBOC announced a series of reforms to make renminbi a freely usable currency, though without specifying a time frame.[13] The conduct is truly in tune with the characteristics of China to move ahead by way of experimentation and by touching the stones while crossing the river. Their rationale

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[10] Altstedter, A. and F. Li (2015), "Yuan Enlists Canada to Challenge World Domination of U.S. Dollar," Bloomberg Business, April 02.

[11] Chanda, N. (2105), "Wooing the Renminbi: Why U.K. won't give Modi the Easy Human Rights Pass that it gave Xi," *The Times of India*, New Delhi, October 24.

[12] *Op. cit.* 3

[13] Singh, C. (2015), "As China Devalues, India Must Protect Itself from a Currency War It Cannot Win," The Wire, August 20.

for going steady is also borne out if one were to recall the trajectory of US dollar gaining ascendancy in the International Monetary System.

At the beginning of the 20th century, the British pound was the dominant reserve currency in the world and 60 per cent of world's trade was invoiced in sterling. Foreign exchange holdings as a share of total official holdings were almost two-third in pound sterling. At the outbreak of World War I (WWI) in 1914, the dollar, like the RMB today, played an inconsequential role in international trade settlements despite the fact that the US had emerged as the largest trading nation. The dollar also played a minor role as a currency in which to denominate international bonds, even though US had turned into a net capital exporter in 1890. Prior to 1913, the dollar's lack of status was not due to the size of the US economy, which had surpassed that of Great Britain by 1872. It was because it lacked financial markets that were deep, liquid, dependable and open. Also, the US had lacked a central bank, which could have helped provide stability to its financial market. Yet between 1914 and 1924, the dollar surpassed the sterling as a leading global reserve currency. More trade was invoiced and financed in dollars and floated in the US than in sterling that floated in London. A larger share of global reserve was in dollars than in sterling. The dollar moved from a position of negligible importance to become the leading international and reserve currency in a span of ten years and two decades ahead of its formal recognition, that is, before the end of World War II. This was a triggering factor in favour of the US dollar during WWI, when the US became the world's ordnance factory—extending vast credits to Great Britain and other allies and becoming a net creditor that greatly enhanced the demand for dollar. With UK under debt, the world's financial capital market has shifted to New York. Thus, the internationalisation process of the dollar started during WWI. The US consolidated the position of the dollar by (i) authorizing private financial institutions to branch out, (ii) setting up a Central Bank to act as a market maker, and (iii) provide liquidity to the market in securitized trade credit. From the forgoing it transpires that even by conventional standards spurred by WWI, it took a time lag of 60 to 80 years for the dollar to be formally recognised as the world's reserve currency—and apparently the dominant currency—at the end of WWII. The inertia is rooted in the network of externalities that are interlinked to the choice of currency just as they are in the choice of a language. One chooses the dollar in the belief that the others are using it.[14] Though the size of China's economy is growing—has peaked in fact—and the internationalisation process of the yuan has gained intensity with China going out a big way by launching a la Marshall plan of its own,[15] there is no triggering factor in sight as disruptive as WWI, thus forcing world at large to accept yuan as the preferred currency instead of the dollar which on pure economic logic should have conceded the way. There are political challenges which over power the economic logic and which might make the RMB appear non-competitive in the near future. These are:

1. In the current International Monetary System, China falls short of achieving the status of a global hegemonic power despite its growing economic muscle. It lacks structural power in global finance: power that comes from a high degree of depth and liquidity of the Chinese financial market, which is the key to attracting global financial business. The relative size of the Chinese economy and growing foreign reserves has enabled Beijing to pressurize its trade partners to use RMB to finance their trade with China. The dollar-centered global currency system will continue to constrain the scope and pace of international use of the RMB in the near future.
2. Within China itself, there is a relatively weak influence on Chinese social policymaking of societal or private business groups supportive of financial liberalisation and opening. The native business elites are, however, closely aligned with the single party-state. The latter has managed to resist full RMB internationalisation for fear of their underlying influence getting diluted. This has resulted in an increased yet limited market mechanism combined with state ownership and controls.
3. Recent global financial crisis has dictated China to proceed cautiously with regard to the opening up of the currency.

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[14] *Op. cit.* 3

[15] Greg, I.P. (2015), "China's Yuan as a Rival to the U.S. Dollar? It's Closer than You Think," *The Wall Street Journal*, April 16.

4. A rising China did not have a formal military alliance system during the cold war era, which was responsible for speeding up internationalisation of the dollar among its allies.
5. Chinese government is yet to inspire confidence in markets and international users of the RMB. For this purpose, the arbitrary action by the RMB issuer will have to be restrained and absolute Rule of Law established.[16]

Most of the factors that inhibit the internationalisation of RMB are internal to China, are more political than economic, and are fairly complex in a polity that relies on experimentation to avoid any upheavals, as it has in the past. These constraints will be resolved in due course—at their own time and pace. Meanwhile, China will legitimately and deservedly seek to see its currency settle for its rightful place in the International Monetary System.

[16] Sohn, I. (2015), "Five Political Challenges in China's Monetary Ambition," Brookings, March.