

The Renminbi as an International Currency

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1. Introduction

In this paper I ask how long it will take for the Chinese renminbi to attain international currency status. To place the question in relief, I start with an historical analogy.¹

The dollar in 1914, like the renminbi today, played a negligible role in international trade and payments. Negotiable trade credits denominated in dollars were nonexistent. Manufacturers and wholesalers from other countries seeking to export and import from the United States and, more strikingly, even U.S. exporters and importers themselves, when seeking to obtain credit for a transaction, did so with the intermediation of an investment bank based in London. Those negotiable credit instruments known as bankers acceptances were denominated in sterling, since this was the currency in which London banks were accustomed to dealing. Smaller markets in negotiable trade credits existed in France (in francs) and Germany (in marks) but not in the United States, this despite the fact that by 1914 the United States was the largest trading nation. The dollar similarly played a negligible role as a currency in which to denominate international bonds, even though the U.S. turned from capital importer to capital exporter after 1890. The dollar accounted for just a tiny sliver of the foreign reserves of central banks and governments; only de facto U.S. dependencies like the Philippines held any of their reserves in dollars.

The subsequent change was dramatic. In a span of just ten years, between 1914 and 1924, the dollar surpassed sterling as the leading international and reserve currency.² More trade was invoiced and financed in dollars than in sterling. More international bonds were denominated in dollars and floated in New York than were denominated in sterling and floated in London. A larger share of global foreign exchange reserves was in dollars than in sterling. The dollar thus moved from a position of negligible importance in the international sphere to become the leading international and reserve currency in just ten years.

This historical precedent has several potential implications for the prospective internationalization of the Chinese renminbi. First, it may be possible to complete the internationalization process quickly if the authorities set their minds to it. Second, contrary to the presumption that the existence of an incumbent international currency is a formidable obstacle – contrary to the presumption that, owing to network effects and other sources of increasing returns, there is room for only one true international currency – it is possible for several national currencies to play consequential international roles at a point in time. The

¹ Drawn from Eichengreen (2011).

² I am aware that this is contrary to the textbook wisdom, according to which sterling retained its dominance until after World War II, but that textbook wisdom is not evidence based. For evidence I refer the reader to Eichengreen and Flandreau (2009, 2010).

dollar's rise between 1914 and 1924 did not require sterling's demise.³ Successful internationalization of the renminbi similarly does not presuppose the demise of the dollar.

2. How the Dollar Did It

In thinking about how far to push the analogy, it is useful to recall both the handicaps and advantages confronting the champions of dollar internationalization. London and sterling had a first-mover advantage. While this was not the deciding factor (as emphasized above), neither was its importance negligible. London had a set of specialized investment banks, known as merchant banks in honor of their origins as providers of trade credit to merchants. They had foreign branches and correspondents experienced in the business of originating bankers acceptances. London also had a large reservoir of institutional and individual investors standing ready to buy and sell acceptances on an active secondary market. It had a specialized set of bill brokers to screen and rate trade-related paper. It had a market maker, the Bank of England, that stood ready to discount acceptances and provide liquidity to the market. The sterling bill market then, like the U.S. treasury market today, was the single most liquid market in the world.⁴

To get up and running, New York had to overcome multiple obstacles. In addition to the aforementioned, prior to the coming into force of the Federal Reserve Act of 1913 U.S. banks were prohibited from dealing in bankers acceptances.⁵ U.S. banks were further prohibited from branching abroad, which would in any case have made it difficult to originate acceptance business.⁶ Domestic markets lacked liquidity, the market in commercial paper, the nearest substitute, being notoriously illiquid.⁷

The Federal Reserve Act removed these prohibitions on foreign branching and dealing in acceptances. In a series of rulings, the regulatory authorities liberalized the volume of acceptances that commercial banks could hold on their balance sheets and the kind of acceptances they could hold, from those that arose in connection with the United States' own imports and exports to those arising in connection with trade between other countries, in connection with goods warehoused in other countries, and in connection with transactions in foreign exchange useful for hedging trade-related exposures.

These other reforms aside, the key change bequeathed by the Federal Reserve Act was of course the creation of a central bank to act as market maker and provide liquidity to the market. The Fed worked actively to foster the growth of the acceptance market. It "repoed" acceptances and purchased them outright. All through the period up to 1931, the Fed was the largest investor in this market; in some periods it held the majority of outstanding issues on its balance sheet. It did so both because transactions in acceptances were convenient for managing financial

³ The latter of course took place later, well after World War II.

⁴ World War I did not fundamentally change any of this; if anything, British banks only expanded their reach, seizing space surrendered by their German competitors. It did, however, briefly open a window during which the U.S. market could get up and running.

⁵ As a result of a series of court decisions.

⁶ Trust companies could branch abroad but did so in only very small numbers.

⁷ On this, see James (1995).

conditions, and because the Fed saw as part of its mission attracting international financial business to the United States.

And with a growing share of trade credit and international bond issues being originated in New York and denominated in dollars, it became logical and natural for central banks to hold a growing share of their foreign exchange reserves in that location and form. By 1924, as noted above, a larger share of global foreign exchange reserves was held in dollars than in sterling.

It is also worth recalling why the United States took these concerted steps to internationalize the dollar, authorizing private financial institutions to branch abroad and creating a central bank to act as market maker and provide liquidity to the market in securitized trade credits. In part, there was the argument that requiring U.S. exporters to go to London to obtain trade credit rendered them less competitive; in effect, they had to pay the bankers' commission twice, once to their local bank and a second time to its London correspondent, and still they ended up bearing the exchange risk. In part, there was the argument that internationalizing the dollar would enable New York and U.S. banks to secure a larger share of the available international financial business.⁸ It would not be surprising if Chinese policy makers were similarly motivated today.

3. Then to Now

This experience suggests that the logical sequencing of steps in internationalizing a currency is: first, encouraging its use in invoicing and settling trade; second, encouraging its use in private financial transactions; third, encouraging its use by central banks and governments as a form in which to hold foreign reserves. For a country with limits on capital account convertibility, like China, the first step, additional authorization for onshore and offshore firms to buy and sell its currency for trade-related purposes, implies some de facto increase in the permeability of its capital controls, which can be evaded through leads and lags, misinvoicing, and related expedients. The second step of enhanced access means, at a minimum, still greater permeability of those controls and, in the limit, the removal of capital account restrictions if the authorities are serious about creating a deep and liquid market with the full participation of private and official foreign investors. In the modern (non-gold-standard) context, this implies the need for greater exchange rate flexibility to accompany the transition to capital account convertibility and accommodate the greater volume and volatility of capital flows.

This is more or less the order in which the Chinese policy authorities are moving. As a first step they have begun encouraging the use of the renminbi for trade-related transactions. They started by permitting the currency to be used by select eligible companies in cross-border trade with neighbors like Mongolia, Vietnam, Cambodia, Nepal and North Korea and with the special administrative zones of Hong Kong and Macau.⁹ Initially, those select companies were limited to the municipality of Shanghai and four cities in the province of Guangdong, but in the second half of 2010 the program was expanded to companies in 20 additional municipalities and provinces, to trade with additional countries, and from physical merchandise to services. China

⁸ On these motivations see Broz (1997).

⁹ In addition, there is the fact that Chinese banknotes are widely used in neighboring countries such as the Republic of Mongolia (where they reportedly account for 60 per cent of cash in circulation) and in some provinces of Laos, Myanmar and Vietnam. (Gao and Yu 2009).

also negotiated a series of bilateral agreements with countries further afield, such as Brazil, to allow for use of the two countries' respective currencies in bilateral trade settlements.¹⁰

As companies exporting to and importing from China have begun acquiring balances and making payments in renminbi, they have opened deposit accounts in and linked to the unit, mainly in Hong Kong. Banks in Hong Kong were allowed to accept deposits in renminbi on a pilot basis in 2004. In mid-2010 the Hong Kong Monetary Authority, with the approval of the Mainland, then liberalized the supervisory principles governing renminbi-denominated business in the region, essentially permitting any company in the world to open a renminbi-denominated or linked account. Subsequent months saw a proliferation of accounts resembling time deposits and certificates of deposit.

Holders of renminbi-denominated accounts were then permitted to transfer funds between such accounts in Hong Kong. This created an interbank market in Chinese currency in Hong Kong. It allowed the banks operating the renminbi-based foreign exchange interbank market to put their own renminbi balances to work and to fund their renminbi-based operations.

In addition, companies using renminbi to settle trade-related transactions have sought access to instruments to hedge their currency exposures. Commercial and investment banks have responded by offering deposit-account services and other renminbi-related products including payments and collection, liquidity management, trade services and finance, and foreign exchange in order to attract clients.¹¹ And not just in Hong Kong: in January 2011 the Bank of China, a large state-sponsored bank, was authorized to provide renminbi-denominated deposit accounts in New York (up to a limit) and to engage in dollar-renminbi foreign-exchange transactions, mainly on behalf of firms engaged in bilateral U.S.-China trade.

As a second step in internationalizing their currency, the Chinese authorities have begun permitting other offshore financial transactions by foreign investors in renminbi. This process commenced in 2009 with authorization for HSBC Holdings and then a succession of other foreign banks to sell renminbi-denominated bonds in Hong Kong, thereby tapping the renminbi balances accumulated by other holders in the course of renminbi-based trade settlements. The Chinese government itself followed up with a RMB 6.3 billion renminbi-denominated sovereign issue in Hong Kong, largely in order to create a benchmark for the pricing of bonds placed by other issuers. In 2010 the Asian Development Bank placed RMB 1.2 billion of renminbi-denominated bonds in Hong Kong. Hopewell Highway Infrastructure, a Hong Kong-based construction firm, became the first company other than a bank to receive authorization to issue renminbi-denominated bonds in Hong Kong.¹² McDonald's Corporation then became the first multinational company to do the same by issuing RMB 200 million worth of 3 per cent renminbi-denominated "McBonds" to fund its investments in China. Caterpillar was quick to follow. In December 2010 VTB Bank, based in Moscow, became the first major non-U.S.-

¹⁰ In the first half of 2010, however, only some \$10 billion of China's cross-border trade was settled in renminbi – about 20 times the level recorded in the second half of 2009 but still a very small fraction of the country's total trade (in excess of \$2 trillion in calendar year 2009).

¹¹ See inter alia Ghani (2010). In the summer of 2010, banks like HSBC and Standard Chartered launched roadshows promoting the services they were prepared to offer corporate customers in countries like Korea and Japan interested in transacting in renminbi.

¹² In July 2010.

based entity to do likewise.¹³ And there were also reports of foreign firms responding to the redenomination of their China trade into renminbi by similarly redenominating the balance sheets of their Chinese subsidiaries.¹⁴

Allowing foreign banks, multilaterals and corporates to issue onshore, in Shanghai, would of course be a considerably more consequential step. The People's Bank of China has begun moving cautiously in this direction, in August 2010 authorizing select clearing banks in Hong Kong and Macau and overseas banks participating in renminbi cross-border trade settlement business to invest a portion of their offshore renminbi funds in China's onshore (domestic) interbank bond market. This promises higher returns on the banks' renminbi balances, enabling them to offer higher interest rates on renminbi accounts. In turn, this should make it more attractive for exporters from other countries to accept payment in renminbi. To be sure, allowing select foreign banks to buy fixed-income securities in China is not the same as full capital account liberalization, as required for true international currency status, but it is a step in that direction.

Reliance on renminbi-denominated assets for international reserves will be the caboose on the train. This will require the existence of liquid markets in renminbi-denominated assets, given the value that central banks attach to the liquidity of their investments. But China is already encouraging foreign central banks to contemplate this eventuality through its participation in the Chiang Mai Initiative Multilateralization and by negotiating currency swap arrangements, first with South Korea in December 2008 and subsequently with Argentina, Belarus, Hong Kong, Indonesia, Malaysia, Pakistan, and Russia. It has opened its domestic interbank bond market to foreign central banks with access to renminbi as a result of their participation in these swaps. Malaysia's central bank responded by adding renminbi bonds to its international reserves, and others are likely to follow, at first to a limited extent and eventually more extensively. In addition, governments, central banks and sovereign wealth funds with more foreign assets than they require for balance-of-payments-insurance and smoothing purposes may be predisposed, sooner rather than later, to tie up some of their foreign assets in other less liquid renminbi-denominated investments.

4. China's Challenge

Clearly, Chinese officials are fully committed to internationalization of the renminbi. They have explicitly enunciated a goal of elevating Shanghai to the status of a leading international financial center by 2020, less than ten years from now.¹⁵ Achieving this will imply creating a deep and liquid financial market open to foreign investors, consistent with a role for the renminbi as an international currency.

In seeking to do so, China possesses a number of advantages. As the second largest economy in the world, it has the scale necessary in order to create deep and liquid markets. The

¹³ Meanwhile, to broaden the demand side of the market, Hai Tong Asset Management, a Hong Kong based securities firm, launched a retail fund in Hong Kong designed to invest entirely in renminbi-denominated fixed-income assets (also in August 2010).

¹⁴ As reported in Diola (2010).

¹⁵ In 2009 it announced a policy entitled "the State Council's view on promoting Shanghai to build an international financial center and international shipping center by accelerating the development of a modern service industry and an advanced manufacturing industry."

sheer volume of its foreign trade and inward foreign investment create a large installed base for renminbi-based transactions. It has a central bank and a State Administration of Foreign Exchange, with large balance sheets, both of which actively intervene in on- and offshore markets.

At the same time, the renminbi will have to overcome a number of obstacles in order to achieve international currency status. China's fixed-income market, which provides the kind of instruments that are attractive to foreign reserve holders, is still relatively small, with a capitalization of some \$2.5 trillion. The sum of the bonds issued by corporate, financial and governments in the U.S., by comparison, exceeds \$25 trillion. While Chinese domestic bond market capitalization has been growing by 30 per cent per annum since the turn of the century, whether such a rapid rate of growth can continue indefinitely is questionable. In any case, the market clearly has a long way to go before it rivals that of the United States.

A large literature addresses the determinants of financial deepening and development – and what it takes to develop deep and liquid financial markets attractive to international investors. While not all studies reach the same conclusion, synthetic analyses like Huang (2005) point to the importance of institutional quality and macroeconomic stability. Although Chinese officials can point to the strong regulation of financial markets and the maintenance of macroeconomic and price stability in the face of the global financial crisis of 2008-9, questions can be raised about the prospects going forward. Investors will have to be reassured about rule of law. They will have to see that financial contracts are being reliably enforced, disputes fairly adjudicated.¹⁶ Maintaining macroeconomic stability will become more challenging as the economy becomes more exposed to capital flows and as the Chinese authorities distance themselves from the banks, which until now they could simply direct to ramp up or scale down their lending.

In the limit, internationalizing the renminbi means fully opening Chinese financial markets to foreign investors. It means capital account convertibility. This presupposes fundamental changes in China's development model. The banks would have to be put on a purely commercial footing and distanced from the process of policy lending. More generally, the supervision and regulation of financial institutions and markets will have to be reinforced before it is safe to move to capital account convertibility. The budget constraints of state enterprises and provincial and municipal governments will have to be hardened. To accommodate the volatility of capital flows, exchange rate flexibility will have to be enhanced, which will entail abandoning the strategy of maintaining an undervalued exchange rate in order to stimulate the export of manufactures. The Chinese economy will have to be restructured away from exports in favor of domestic demand, away from manufacturing in favor of services, and away from the coasts in favor of the interior.

This kind of far-reaching restructuring has significant economic costs, and it cannot be completed overnight. There will also be political resistance to moving quickly insofar as policy will become less favorable toward influential export interests. But these kinds of changes are coming. While one can question the timing – whether Shanghai will have become a true

¹⁶ Importing the rules for clearing, settlement and adjudication of disputes pioneered in the offshore market in Hong Kong would be an obvious way for Shanghai to build up the relevant institutional infrastructure.

international financial center by 2020 and whether the renminbi will have become be a first-rank international currency by that date – one cannot question the direction.¹⁷

5. China and the World

Internationalization of the renminbi will be a good thing for China and a good thing for the world. An international monetary system in which the dollar, the euro and the renminbi share the reserve currency role will be an improvement over a system in which countries seeking to accumulate reserves have no alternative to accumulating dollars. No one reserve-currency country will be able to finance its current account deficit as freely as did the United States in the years leading up to the recent financial crisis. No one country will be placed in the position where the yields on its treasury securities are depressed as dramatically as in the U.S. in 2004-6, giving investors such a strong incentive to stretch for yield and setting the stage for the subsequent crisis.¹⁸ Central banks will find it more attractive to accumulate a diversified portfolio of reserves. If they see a reserve-currency country behaving irresponsibly, in the manner of the United States in 2005-7, then they can curtail the rate at which they add its liabilities to their reserves. The discipline on each reserve-currency country will be greater. The danger that the international monetary system will contribute to another crisis like that of 2007-8 will be correspondingly less.

The emergence of the renminbi as an international currency will be a good thing for China in particular. Chinese firms and investors will be able to limit their foreign exchange exposures as a result of being able to transact internationally in their own currency.¹⁹ The People's Bank of China will be able to follow an independent monetary policy, tailoring domestic policy to domestic conditions, because it will be able to allow the exchange rate to adjust without having to worry about currency mismatches on the balance sheets of banks and nonfinancial enterprises which will be able to fund themselves both externally and internally in renminbi. Chinese banks will be able to better compete for international business as a result of their capacity to offer foreign as well as domestic customers services denominated in China's own currency. Shanghai's development into an international financial center will be accelerated.

It was of course these same goals – to free U.S. firms from foreign-currency mismatches and superfluous trade-finance-related costs, to render U.S. monetary policy more independent and effective, to strengthen the international competitive position of U.S. banks, and to make New York an international financial center – that prompted the Fed to aggressively promote the internationalization of the dollar in the decade after 1914. In aggressively promoting the

¹⁷ In addition, foreign investors, and foreign central banks in particular, hold balances in and invest in the securities of only countries with which their governments have friendly geopolitical relations. A China suspected of being inclined to seize the balances of foreign central banks and governments in the event of a geopolitical dispute would not be an attractive place in which to invest. True internationalization of the renminbi therefore presupposes supportive evolution of not just China's foreign as well as domestic policy.

¹⁸ The priority that should be attached to the international monetary system in explaining the crisis is disputed. Many of us would give priority of place to lax supervision and regulation, the perverse incentives associated with flawed compensation practices in the financial services industry, conflicts of interest in the rating-agency industry, and the unusually accommodating monetary policies of the Federal Reserve in the key period 2003-4. That said, a confounding role was almost certainly played by an international system in which countries accumulating reserves as insurance against capital-flow volatility and as a byproduct of policies of export-led growth found themselves disproportionately accumulating dollars.

¹⁹ This point is emphasized by Yam (2010).

internationalization of the renminbi, the People's Bank of China is following in an illustrious tradition.

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