Internationalization of RMB: Its Impact on Asia

Takatoshi Ito
University of Tokyo
For the UCSD conference on Internationalization of RMB
June 8, 2012

Motivating questions

- How much is RMB used as international currency?
  - Compared to JPY, as well as USD and EUR
- Why is China pushing "internationalization"?
  - What benefit?
  - Political economy
- Will China succeed in internationalization?
  - A bit of lesson from JPY internationalization
  - Any pitfall
- Impact on Asia?

Conclusions in advance

- How much is RMB used as international currency?
  - A very small share in transaction and as reserve currency (of other central banks' reserves)
  - Already influential in Asian currencies' basket
- Why is China pushing "internationalization"?
  - RMB internationalization: "hidden" agenda for domestic reform
  - RMB invoicing: Stated economic benefits for exporters, but not necessarily true, contrast to Japanese exporters
  - RMB central bank swaps: trade promo rather than liquidity provision
  - RMB for SDR composition currency: Political prestige
- Will China succeed in internationalization?
  - Sequencing is important—probably no misstep, as China is cautious
- Impact on Asia? (midterm crystal ball)
  - Asian currencies will follow RMB, when RMB becomes more flexible
  - China will have a natural sphere of RMB bloc (exporters will be protected in Asia, but not global protection)
  - Need capital account liberalization before RMB is used widely in transaction and reserve currency.

Outline

- (1) What is "internationalization"?
- (2) Facts
- (3) Intention of the Chinese government
  - Stated benefits
- (4) Will China succeed?
- (5) The challenges
  - Possible Pitfalls?
- (6) Impact on Asia

(1) What is international currency?

Table 1. Dimensions of an International Currency

	Private Sector	Official Sector
Unit of account	**Trade invoicing** Denomination of financial products	**Being pegged by other countries** Use in currency baskets of foreign central banks **SDR composition currency** Denomination of government bonds
Medium of exchange (settlement)	Used in trade and financial **transactions**	Currency circulation abroad; Government financial transactions (such as ODA); **central bank swaps**; **currency intervention**
Store of value	**Cross-border deposits**; cross-border securities holdings	**Foreign reserves** (of other countries)

Source: taken from Ito (2011), originally based on the matrix first proposed by Peter Kenen, "The Role of the Dollar as an International Currency."

What is the "International currency"?

- 1. Unit of Account: Invoicing Currency
  - Trade Invoicing in Trade (private sector)
  - Being pegged by other countries (official sector)
- 2. Settlement: Vehicle Currency
  - Currency Transactions for exports and imports, capital flows (private sector)
  - Location: International financial center (private sector)
  - Intervention currency; central bank swap (official sector)
- 3. Store of Value: Reserve Currency
  - Currency as assets (private-sector portfolio)
  - Foreign reserves (official-sector portfolio)

(2) Fact: Vehicle currency RMB, still very small

- Foreign exchange transactions –USD 4 trillion a day, (total of 200%), of which
  - 80% of global transactions involve USD
  - 40%, EUR
  - 20%, JPY –no trend change in the last 12 years
  - 0.3%, CHY
- Location
  - UK, 36.7%
  - US, 17.9%
  - Japan, 6.2% (down from 10%)
  - Singapore, Switzer land, Hong Kong, --about 5%
  - Australia, 3.8%; China, 0.4%

Forex Transaction ($4 trillion a day!) and Settlement—BIS Triennial survey

Table 1

Global foreign exchange market turnover by instrument[1]

Average daily turnover in April, in billions of US dollars

Instrument	1998	2001	2004	2007	2010
Foreign exchange instruments	**1,527**	**1,239**	**1,934**	**3,324**	**3,981**
Spot transactions[2]	568	386	631	1,005	1,490
Outright forwards[2]	128	130	209	362	475
Foreign exchange swaps[2]	734	656	954	1,714	1,765
Currency swaps	10	7	21	31	43
Options and other products[3]	87	60	119	212	207

Table 3

Currency distribution of global foreign exchange market turnover[1]

Percentage shares of average daily turnover in April, total= 200%

Currency	1998	2001	2004	2007	2010
US dollar	**86.8**	**89.9**	**88.0**	**85.6**	**84.9**
Euro	**...**	**37.9**	**37.4**	**37.0**	**39.1**
Deutsche mark	30.5	...	...	...	...
French franc	5.0	...	...	...	...
ECU and other EMS currencies	16.8	...	...	...	...
Slovak koruna[2]	...	0.0	0.0	0.1	...
Japanese yen	**21.7**	**23.5**	**20.8**	**17.2**	**19.0**
Pound sterling	**11.0**	**13.0**	**16.5**	**14.9**	**12.9**
Australian dollar	3.0	4.3	6.0	6.6	7.6
Swiss franc	7.1	6.0	6.0	6.8	6.4
Canadian dollar	3.5	4.5	4.2	4.3	5.3
Chinese renminbi[4]	**0.0**	**0.0**	**0.1**	**0.5**	**0.3**

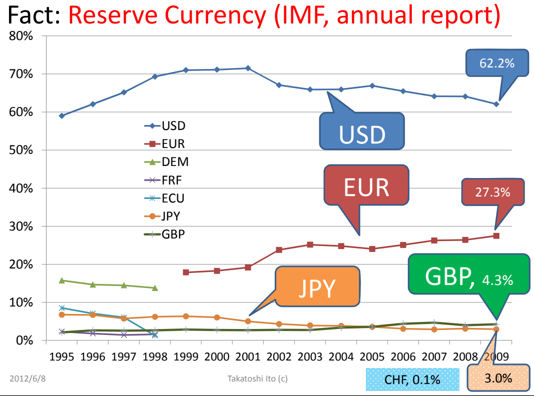
Location: Where are they transacted? –Chinese share still low, but rising quickly

Geographical distribution of global foreign exchange market turnover[1]

Daily averages in April, in billions of US dollars and percentages

Country	1995		1998		2001		2004		2007		2010	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Australia	40.5	2.5	48.3	2.3	54.0	3.2	107.1	4.1	176.3	4.1	192.1	3.8
Canada	30.7	1.9	37.9	1.8	44.2	2.6	59.3	2.3	64.0	1.5	61.9	1.2
China[3]	...	...	0.2	0.0	0.0	0.0	0.6	0.0	9.3	0.2	19.8	0.4
Denmark	31.8	1.9	28.0	1.3	23.8	1.4	42.1	1.6	88.2	2.1	120.5	2.4
France	61.5	3.8	77.2	3.7	49.6	2.9	66.5	2.6	126.8	3.0	151.6	3.0
Germany	79.2	4.8	99.6	4.7	91.5	5.4	120.4	4.6	101.4	2.4	108.6	2.1
Hong Kong SAR	90.9	5.6	79.9	3.8	68.4	4.0	106.0	4.1	181.0	4.2	237.6	4.7
Japan	167.7	10.3	146.3	7.0	152.7	9.0	207.4	8.0	250.2	5.8	312.3	6.2
Korea	...	...	3.6	0.2	9.8	0.6	20.5	0.8	35.2	0.8	43.8	0.9
Luxembourg	19.2	1.2	22.7	1.1	13.1	0.8	14.6	0.6	43.9	1.0	33.4	0.7
New Zealand	7.2	0.4	7.0	0.3	4.0	0.2	7.0	0.3	12.8	0.3	8.8	0.2
Russia	...	...	6.9	0.3	9.6	0.6	29.8	1.1	50.2	1.2	41.7	0.8
Singapore	107.3	6.6	144.9	6.9	103.7	6.1	133.6	5.1	241.8	5.6	266.0	5.3
Spain	18.4	1.1	20.0	1.0	8.1	0.5	13.9	0.5	17.1	0.4	29.3	0.6
Sweden	20.4	1.2	16.1	0.8	24.9	1.5	31.9	1.2	43.9	1.0	44.8	0.9
Switzerland	88.4	5.4	91.6	4.4	76.3	4.5	85.3	3.3	253.6	5.9	262.6	5.2
UK	**478.8**	**29.3**	**685.2**	**32.6**	**541.7**	**32.0**	**835.3**	**32.0**	**1,483.2**	**34.6**	**1,853.6**	**36.7**
US	**265.8**	**16.3**	**383.4**	**18.3**	**272.6**	**16.1**	**498.6**	**19.1**	**745.2**	**17.4**	**904.4**	**17.9**
Total	**1,632.7**	**100.0**	**2,099.4**	**100.0**	**1,691.7**	**100.0**	**2,608.5**	**100.0**	**4,281.1**	**100.0**	**5,056.4**	**100.0**

Fact: Reserve Currency (IMF, annual report)



Basket weight

- Other Asian currencies follow movements of Chinese CHY, that is, the weight of the basket currency is high in the Frankel-Wei regression

RMB weights in the implicit basket of Asian currencies are high

2005/7/4-2008/12/31		USD		EUR		JPY		CHY		Adjusted R^2 / Durbin-Watson
IDR	Coefficient	0.461		0.160		0.005		**0.467**		0.445
	Std. Error	(0.196)	**	(0.080)	**	(0.037)		(0.197)	**	2.122
KRW	Coefficient	0.404		0.994		-0.132		0.303		0.342
	Std. Error	(0.249)		(0.101)	***	(0.047)	***	(0.250)		1.865
MLR	Coefficient	0.435		0.245		-0.005		**0.436**		0.763
	Std. Error	(0.094)	***	(0.038)	***	(0.018)		(0.095)	***	2.457
PHP	Coefficient	0.704		0.351		0.006		0.152		0.650
	Std. Error	(0.127)	***	(0.052)	***	(0.024)		(0.128)		2.323
SGD	Coefficient	0.242		0.349		-0.018		**0.490**		0.800
	Std. Error	(0.074)	***	(0.030)	**	(0.014)		(0.075)	***	2.352
THB	Coefficient	0.490		0.146		0.016		**0.369**		0.466
	Std. Error	(0.176)	***	(0.071)	***	(0.033)		(0.177)	**	2.297
VND	Coefficient	1.038		0.003		-0.002		-0.030		0.947
	Std. Error	(0.044)	***	(0.018)		(0.008)		(0.044)		1.921
TWD	Coefficient	0.549		0.164		0.000		**0.333**		0.854
	Std. Error	(0.069)	***	(0.028)	***	(0.013)		(0.070)	***	1.977

Summary of Facts

- Invoicing of exports exports
  - JPY: Only 40% on average: 50% of exports to Asia
    - Multinational firms have good reason not to invoice in yen
  - RMB: no data, but the government is pushing this
- Transaction (turnover) of the currency,
  - JPY: Reasonably high, 20%, but about half of EUR, ¼ of USD
  - RMB: 0.3%
- Financial Center (where to transact)
  - JPY: 6.2%
  - RMB: 0.4%
- Reserve Currency
  - JPY: Very small and declining, 1/10 of EUR, lower than GBP
  - RMB: Very small, not reported; Will CB swap increase this?
- Peg by others (as a weight in basket)
  - High in Indonesia, Malaysia, Taiwan, Thailand, Singapore

(3) What for?

- Economic benefits from internationalization?
  - Invoicing, stated reason: to lower currency risk of exporters
    - Yes, but invoicing avoids only short-term currency risk (See next slide)
    - Only way to have a protection is the importer has the currency regime, that is pegged to the exporters. Like exports and imports in the Euro zone.
    - RMB bloc in Asia in future?
  - Central Bank swap:
    - It does not make sense that RMB—non convertible currency—is provided as a swap to countries like Argentina, Indonesia, Australia . It must be trade promotion.
- Political benefits
  - Stated reason: to form a part of international reserve currency→ SDR composition currency
    - prestige value?
- Political Economy
  - "Internationalization" as a front banner for liberalization domestic & external

How can exporters avoid currency risk?

- Invoicing in your currency is only a short-term protection
  - In short term, invoicing in exporter's currency will shift currency risk to importers
  - But, if importers have alternative source for products (i.e. competition in the importing countries), then exporters may be asked to cut export prices
- Multinational exporters may want to "manage" currency risks
  - Japanese companies choose to manage currency risks at the HQ when they export to foreign subsidiaries
  - See Ito, Koibuchi, Sato and Shimizu (2012)

(4) Will China succeed?

- Factors for internationalized currencies→ next slide
- Currently, RMB internationalization is more "policy-driven" than "market-driven"
  - Trade denomination
  - Central bank Currency swap
- For market-driven process
  - Capital account liberalization is a must
  - Some hesitation on the part of the government
- Will China liberalize financial sectors in the right sequence at right speed?

Determinants: What factors make a currency an international currency?

- Economic Size and Economic Growth
  - No capital controls (discrimination of nonresidents)
  - Wide-ranged portfolio: safe (government bonds to high-risk, high-return junk bonds)
  - Low transaction costs or tax (withholding tax; bid-ask spread)
  - Deep and efficient financial markets
  - Transparent regulation and property rights
- Free trade
  - Exports and imports (natural markets for exchange rates)
- Free capital mobility
  - FDI; portfolio; bank deposits
- BUT HISTORY MATTERS (advantage of the key currency)

Japanese experiences

- Hesitation to internationalize in the beginning. 1970s – 80s
  - Worry about
  - No Asian country wanted to peg to the Japanese Yen
- Policy of internationalization of JPY in late 1990s
  - By the time, the economy was on the decline
  - Complete liberalization in the midst of serious banking crisis
  - No regulatory push or official incentives for private-sector internationalization
  - In spite of rhetoric, policy push was minimal
- Most of the JPY internationalization is due to market-driven
- Japanese companies developed a global network of production and sales, so that currency risk was managed at Headquarter, keeping HQ-subsidiary trade in the most liquid currency, the USD → See Ito, Koibuchi, Sato and Shimizu(forthcoming)

Experience of yen internationalization

- The Yen Internationalization Committee. Interim report in November 1998; Action in December; Final Report, April 1999
- December deregulation
  - Exemption of withholding tax on TBs and FBs
  - First FB auction held in April 1999
  - Auction of FBs
  - For nonresidents, exemption of withholding tax for JGBs
  - Reform in trading and Settlement of JGBs
- But these measures were too insignificant compared to the large tide against the attractiveness of the yen

Japan	China
1964. CA convertibility	1996. CA convertibility
1970. Allow Samurai bond	2005. Allow Panda bond
1971. Managed float	2005. Exch rate Basket
1972. Abolish central bank's purchase/sales of forex	YYYY. Abolish central bank's purchase/sales of forex
1973 free float	YYYY. Free float
1979 domestic interest rate liberalization	YYYY. Domestic interest rate liberalization
1984 Abolish real demand principle for forward	YYYY. Abolish real demand principle for forward
1984 Allow nonresident euro yen issues	YYYY. Allow nonresident euro yen issues
1997 Completed capital account liberalization	YYYY. Completed capital account liberalization

Summary

- Will China succeed in making the CHY to become an international currency?
  - Positive.
    - Fast growth—it will surpass the US in about 2025
    - Appreciation expectation
    - Strong political will force/induce the market to use CHY
  - Negative.
    - Capital Controls. Foreigners do not have access to domestic markets
    - Domestic market developments are still limited
    - Political risk (in changing regulation suddenly)

(5) Chinese Challenges
Sequencing!

- First, domestic financial liberalization
  - Interest rate liberalization
  - Liberalization on credit provision
  - Equal treatment of residents and nonresidents
  - No dominance of state-controlled financial institutions
  - No withholding tax on short-term government papers
- Second, flexible exchange rate regime (wide band)
- Third, capital account liberalization
  - No capital controls (inflows and outflows)
  - Fewer intervention in the foreign exchange market
- Commitment for future policies
  - Certainty for no reversal in policies
- Pitfalls
  - Wrong sequence? Possibly
  - Too fast a liberalization? So far, not.

(6) Impact on Asia

- Asian basket currencies will put a high weight on RMB, as economies are integrated
  - Chinese exporters will have a natural protection from currency risk, in Asia, but not for US or EU.
  - RMB/JPY exchange rate direct trading,
- RMB in Foreign Reserves of Asian central banks/MOF
  - Japan became first to ask for RMB bonds

References

- Ito, Takatoshi; Satoshi Koibuchi; Kiyotaka Sato; and Junko Shimizu (2012, forthcoming), "The Choice of an Invoicing Currency by Globally Operating Firms: A Firm-Level Analysis of Japanese Exporters" ***International Journal of Finance and Economics***.
- Ito, Takatoshi (2011), **"The Internationalization of the RMB: Opportunities and Pitfalls"** CFR Working Papers, November 2011.
- Ito, Takatoshi (2010), "China as Number One: How about the Renminbi?" ***Asian Economic Policy Review***, vol. 5, No. 2: 249-276.
- Ito, Takatoshi (2008) **"Influence of the Renminbi on Exchange Rate Policies of Other Asian Currencies,"** in Goldstein, Morris and Nicholas R. Lardy (eds.), *Debating China's Exchange Rate Policy*, Washington, DC: Peterson Institute for International Economics, April 2008: 239-258