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 pitfalls?
• 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 fallow 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>
<thead>
<tr>
<th>(1) What is international currency?</th>
<th>Private Sector</th>
<th>Official Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit of account</td>
<td>Trade invoicing</td>
<td>Being pegged by other countries</td>
</tr>
<tr>
<td>Denomination of financial products</td>
<td>Denomination of government bonds</td>
<td>Denomination of government bonds</td>
</tr>
<tr>
<td>Medium of exchange (settlement)</td>
<td>Used in trade and financial transactions</td>
<td>Currency circulation abroad; Government financial transactions (such as ODA); central bank swaps; currency intervention</td>
</tr>
<tr>
<td>Store of value</td>
<td>Cross-border deposits; cross-border securities holdings (of other countries)</td>
<td>Foreign reserves (of other countries)</td>
</tr>
</tbody>
</table>

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%

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**Fact:** Reserve Currency (IMF, annual report)

- 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

<table>
<thead>
<tr>
<th>2005/7/4</th>
<th>2008/12/31</th>
<th>USD</th>
<th>EUR</th>
<th>JPY</th>
<th>CHY</th>
<th>Coefficient</th>
<th>Durbin-Watson</th>
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<tbody>
<tr>
<td>IDR</td>
<td>Coefficient 0.461</td>
<td>0.160</td>
<td>0.005</td>
<td>0.667</td>
<td>0.645</td>
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<tr>
<td>Std. Error</td>
<td>(0.136)***</td>
<td>(0.080)***</td>
<td>(0.07)</td>
<td>(0.107)***</td>
<td>2.122</td>
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<tr>
<td>KRW</td>
<td>Coefficient 0.494</td>
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<td>-0.132</td>
<td>0.160</td>
<td>0.342</td>
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<tr>
<td>Std. Error</td>
<td>(0.245)***</td>
<td>(0.190)***</td>
<td>(0.047)***</td>
<td>(0.250)</td>
<td>1.660</td>
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<td>TWD</td>
<td>Coefficient 0.450</td>
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<td>-0.005</td>
<td>0.636</td>
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<td>Std. Error</td>
<td>(0.094)***</td>
<td>(0.098)***</td>
<td>(0.010)***</td>
<td>(0.09)***</td>
<td>2.957</td>
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<td>PHP</td>
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<td>0.006</td>
<td>0.312</td>
<td>0.630</td>
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<tr>
<td>Std. Error</td>
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<td>(0.052)***</td>
<td>(0.124)</td>
<td>(0.128)</td>
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<td>SGD</td>
<td>Coefficient 0.396</td>
<td>0.396</td>
<td>0.038</td>
<td>0.490</td>
<td>0.000</td>
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<td></td>
</tr>
<tr>
<td>Std. Error</td>
<td>(0.074)***</td>
<td>(0.038)***</td>
<td>(0.014)</td>
<td>(0.075)***</td>
<td>2.352</td>
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<tr>
<td>THB</td>
<td>Coefficient 0.486</td>
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<td>0.016</td>
<td>0.268</td>
<td>0.406</td>
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<tr>
<td>Std. Error</td>
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<td>(0.071)***</td>
<td>(0.093)</td>
<td>(0.177)***</td>
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<td>HED</td>
<td>Coefficient 1.038</td>
<td>0.009</td>
<td>-0.002</td>
<td>0.009</td>
<td>0.947</td>
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<tr>
<td>Std. Error</td>
<td>(0.049)***</td>
<td>(0.01)</td>
<td>(0.009)</td>
<td>(0.049)</td>
<td>1.925</td>
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<tr>
<td>TWD</td>
<td>Coefficient 0.549</td>
<td>0.164</td>
<td>0.000</td>
<td>0.333</td>
<td>0.854</td>
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<tr>
<td>Std. Error</td>
<td>(0.009)***</td>
<td>(0.006)***</td>
<td>(0.015)</td>
<td>(0.070)***</td>
<td>1.977</td>
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</tbody>
</table>

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, % 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 door 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 Yen 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 Yen internationalization is due to market-driven
- Japanese companies developed a global network of production and sales, so that currency risk was managed at Headquarters, 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

Japanese:
- 1970
- 1972
- 2005

Chinese:
- 1996
- 2005

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