
**Report on the Conference**

**"Internationalization of the Renminbi: Its Implications for China's Domestic Reform and the International System"**

*This summary report was submitted by IR/PS MPIA students Nick Sramek, Joseph Miller and Matt Siordia, and edited by 21st Century China Program staff*

**Keynote Address I:**

**Use of RMB in International Transactions: Background, Development and Prospects By JIN Zhongxia,**

Jin Zhongxia, Head of Research Institute, People's Bank of China, addressed the audience on the role of China's central bank in the RMB internationalization process and the prospect for the future.

Mr. Jin began by giving a brief overview of the progression of the RMB as a trading currency beginning in the early 1980s when it was used to settle cross-border trade. In 2003, the People's Bank of China announced the it would provide a clearing service for RMB trade in Hong Kong, and since 2007 it has started issuing RMB-denominated bonds there. During the recent financial crisis, the was more of a push for internationalization of the RMB as the central bank began to allow currency swap with other central banks in the region in an effort to stabilize currencies, support financial institutions, and promote trade.

As more central banks in the region approached the PBC concerning currency swaps, the PBC started a pilot program in 2009 that allowed a small number of enterprises in China to settle trade in RMB. The response from enterprises has been positive, and the list of enterprises with permission to do so has grown to over sixty thousand from all provinces. In the meantime, China's share of world trade has increased from 3.6% to 10% over the past decade. Yet RMB use in trade settlement has not reached a comparable scale, so there is room for the expansion of RMB usage in international trade settlement.

Mr. Jin acknowledged that progress in RMB internationalization has been moderate. The RMB share in the settlement of the goods trade has risen about five percent over the past decade, and now one quarter of the newly invested FDI is settled in RMB. In addition, recent years has seen an emergence of offshore RMB markets in Hong Kong, Singapore, London, Tokyo and Chicago but this has mainly been a regional development, as almost eighty percent of cross-border settlement by RMB took place in Asia. At this point, a major constraint to RMB internationalization is the under-development of China's financial markets, and that liberalization of China's capital account has yet to happen. Looking ahead, Mr. Jin believes that RMB internationalization is dependent on financial development, continuous reform in China, and further integration of China with the world economy. Mr. Jin sees great benefits in increased currency flexibility and the effectiveness of international markets.

After Mr. Jin's remarks, a question and answer period continued the discussion of the role of the PBC in the internationalization of the RMB. Many of the audience voiced their skepticism on the RMB valuation as well as the interest rates. In addition, Mr. Jin addressed questions on the role of arbitrage in the offshore RMB market, as well as the adverse effect of capital flight on RMB internationalization.

**Panel I - China's Domestic Reform and RMB Internationalization**
**By Nicholas LARDY, QIN Xiao, and Michael PETTIS**

This panel focused on domestic reforms in China and how they may affect the RMB internationalization process. The panel consisted of Nicholas Lardy, senior fellow at the Peterson Institute for International Economics, Qin Xiao, Chairman of the Board of the Boyuan Foundation, and Michael Pettis, professor of finance from the Guanghua School of Management, Peking University.

Nicholas Lardy and Qin Xiao agreed that the interest rate in China was too low at present, with the real interest rate being less than zero, and that the negative deposit rate has led to a higher savings rate and lower consumption. This situation would not be sustainable, however. Administered interest rates, according to Mr. Lardy, will negatively affect liberalization of capital account and RMB internationalization.

Mr. Lardy also pointed out the reasons why interest rate reform remains difficult even though it has been on the central government's agenda since 2006. First, raising the interest rate is costly for the central bank, as it will have to pay more on their large sterilization liabilities. Second, the liberalization of interest rates is constrained by the huge volume of bank credit outstanding, close to 175% of GDP at the end of 2011. This large bank credit relative to GDP has made many projects profitable at a very low interest rate; raising interest rates could lead to widespread bankruptcy.

Mr. Qin Xiao's presentation focused on the need for a new round of reform, esp. in the financial sector. Mr. Qin critically reviewed the past economic reform that has emphasized growth at the expense of equity, efficiency and balanced development. He also argued that China needed a market for ideas, and the government needed to change its primary function from running the economy to providing social benefits, and to change its economic structure from its focus on manufacturing and export to service and domestic assumption. He emphasized the need for capital market reform—opening up of the capital market, liberalization of interest rate, and exchange rate marketization, which are all linked to the internationalization of RMB.

The panelists also addressed the issue of how much progress has been made so far in the RMB internationalization. In particular, Michael Pettis expressed skepticism about many claims about rapid pace of RMB internationalization. He claimed that the so-called internationalization of RMB so far represented something else, not really the internationalization of the currency. For example, Pettis argued that redenomination of trade in RMB has occurred not for transactional purposes but for speculative reasons. In other words, the increasing use of RMB did not have much to do with trade, but with speculative demand as a result of capital control. Pettis further argued that the arbitrage between off-shore and on-shore

Pettis believed that financial reform and robust financial institutions are pre-conditions for the internationalization of RMB, but so far meaningful financial reform has not occurred in China. He concluded that the RMB internationalization is still many years away, and that it is dependent on China's success in improving corporate governance, liberalizing interest rate, and lowering government debt.

A heated debate on the progress and prospect of RMB internationalization ensued. Some in the audience pointed out that liberalization would occur as a natural process of reform, as China moves from a planned to a market-based system. Mr. Pettis in particular took aim at this theory, stating that this model does not necessarily work for China, claiming that market-determined rates are still all set by the government. In addition, he looked at the absence of SMEs (Small and Medium Size Enterprises) in the lending process, as most forms of lending are not available to this sector at market rates.

**Keynote Luncheon Address:**

**Implications of Renminbi internationalization for the U.S. and global economy**
**By Richard FISHER**

Mr. Fisher began the talk by stating that the reform of the Renminbi (RMB) is accelerated. He pointed out that the Chinese government had widened the band for RMB exchange rate fluctuation and allowed banks to hold overnight positions, giving them the ability to short. He stated that these are just parts of a lengthy process aimed at transforming the RMB into a fully exchangeable international currency. The leadership is moving cautiously, given the risks of capital account liberalization.

From these opening remarks Mr. Fisher moved on to discussing the general pattern of economic reform and development in China. He pointed to two crucial stages of China's reform, the first being the reform and opening up and the second being China's WTO accession in 2001. He pointed to the growth in the Chinese market and rapid economic growth as signs of success. Much of the economic miracle is due to the remarkable willingness of Chinese leaders to adapt and to their cautious approach that allowed China to remain stable.

Mr. Fisher went on to state that China has now reached an inflection point. As the gains from comparative advantage and economic liberalization are maximized, China risks falling into the middle income trap. Labor costs are increasing, cost savings in China are only 10-15%, and the minimum wage is rising. It is clear that to continue growth China needs to focus on creating efficiency. The difficulty is in fundamentally transforming the growth model.

Mr. Fisher stated that avoiding the middle income trap would require China to promote competition, reform its financial sector, and create the type of transparency lacking in many middle income country. In terms of financial liberalization, he pointed out that China has fallen far behind its five-year plan for opening up its financial sector that it had agreed on during WTO accession negotiations.

Many hurdles remain for financial liberalization in China. RMB trading is only one step; China needs to accelerate reform of financial institution before embarking on capital account reform. The change will be gradual, especially as capital account liberalization can leave a nation with inefficient financial institutions open to financial crises and capital flight. Mr. Fisher stated that China has already made progress, but its bank interest rates are not yet wholly based on the market. The central bank still sets the official rate and the band around that rate at which banks can lend. China has small trading and equity markets, many loans are policy decisions, and SOEs have better access to credit than private competitors. China faces challenges presented by inflationary pressure, an inflating asset bubble, bad local government debt, a shadow banking sector, and Euro crisis uncertainty.

Mr. Fisher stated that Chinese policy shifts would take into account the risks and opportunities outlined above. If China can manage a transition to a fully exchangeable currency, it might challenge the United State's exorbitant privilege, but that is far in the future. Mr. Fisher pointed out how long it took the dollar to achieve preeminence as an example. Mr. Fisher stressed that China will do what is in its best interests, and is unlikely to rush forward with reforms that might risk stability or the governing position of the CCP.

During Q&A, Mr. Fisher stated that his greatest frustration with the Chinese market is the poor accounting standards. He also stated that China should pursue market reforms before Capital account liberalization.

Mr. Fisher's speech seems to put the full internationalization of the RMB out into the future. He believes that it is in China's best interest that it should pursue gradual and purposed reform while maintaining internal stability. He believes that China will eventually complete these reforms, given its past track record. He also believes that financial reforms before capital account liberalization is the best path, and that China is likely to follow it.

**Panel II- Steps Toward RMB Internationalization**
**By SUN Tao, MA Jun, and ZHANG Min**

Sun Tao gave the opening lecture of the panel, with the central tenet of "no haste, no worry." To explain this point he attempted to show the relationship between capital account liberalization and financial institutions.

Mr. Sun pointed out that capital flows are difficult to account for in traditional growth models. Many countries have restricted capital accounts to protect stability, but there has been a general move towards liberalization. However, there have been some moves in the opposite direction, notably in Indonesia and Argentina. Sun did an empirical analysis of the effects of capital account liberalization on relevant economic factors. His results showed that capital account liberalization was correlated with higher GDP per capita growth, lower inflation, higher equity returns, and higher capital inflows and outflows. However, the size of the economy and its stage of development mattered greatly. His model predicted that capital account liberalization would be positive for China, but because China is so large and has many particular institutional issues, the regression may not be apt.

Sun concluded by stating that further liberalization would be difficult given the policy making process and the challenges presented by capital account liberalization. He stated that China should focus on proper sequencing, that is to say they must liberalize institutions before the capital account. But, as he said in the beginning, the process would be gradual; hence, "no haste, no worry".

Ma Jun opened his lecture by stating that the trade account liberalization witnessed in the last three years would end without further capital account reforms. His lecture mainly focused on offshore market formation and its effects on the RMB's internationalization. Ma pointed out the disagreement in Chinese policy making circles between developing offshore markets or opening onshore markets in Shanghai. While the Chinese government seems to favor the Shanghai approach, Ma pointed out that offshore markets are needed to provide for the currency trading on a 24 hours basis, thus allowing the currency to be used for 3rd party transactions, and meeting the demands of non-residents for safe investments. He pointed out that 70% of US dollars held by foreigners are held in offshore markets. Another benefit of offshore markets is that they allow external circulation, reducing the effects of monetary policy.

Ma went on to explain the relevant statistics for the Hong Kong offshore RMB market. Hong Kong already trades in RMB financial products and the price moves in a much more volatile fashion than official government rates. Ma pointed out that China should simplify the documents for RMB trade settlement and that KA liberalization is necessary for gains for currency internationalization. He also pointed out the relationship between cross-border RMB flows and RMB convertibility. He stated that if China lifts restrictions on one of these it would de facto lift restrictions on the other.

Ma stated that the effect of financial liberalization on the financial sector would be a reduction in margins for the banks, greater possibilities for bank growth, higher fee incomes from FX trading (possibly 20x), and positive effect on the provision of global financial products. For the insurance industry, the short run effects would be negative and the long run effects positive.

Zhang Ming focused on RMB internationalization and on-shore offshore arbitrage due to a gap in RMB FX rates. He pointed out that the scale of RMB cross-border trade increased rapidly in 2011, and that these flows only declined with a worsening Euro crisis. He noted that cross-border settlements and Hong Kong settlements were correlated.

Zhang stated that the ratio of RMB paid to receive was large but quickly decreasing. There are currently two different spot exchanges for the RMB, one off shore and the other on-shore. This leaves space for arbitrage. Zhang noted that given the data investors expected RMB appreciation against the dollar in 2010 and 2011, but that trend has reversed depreciation is now expected in both Hong Kong and overseas. Zhang stated that exchange rate arbitrage has meant that Mainland Chinese banks take out loans in Hong Kong (were interest rates are low), which raises FX risk. This has meant that while Hong Kong's liabilities in China have remained steady, its claims have grown rapidly.

Zhang believes that this arbitrage runs contrary to Chinese government policy, and that it could be reversed quickly. China wishes to keep strict control on RMB internationalization and will not allow RMB arbitrage to upset its gradual plans. The approach should follow the sequence of first liberalizing the interest rate, then the exchange rate, then bank reforms, and finally RMB internationalization.

Question focused on if the government has the will and ability to implement a gradual reform process in the face of international pressures for RMB exchange. The panelists agreed with the above stated gradual opening, and voiced confidence in the Chinese government's ability to control the pace of reform.

**Keynote address III:**

**Internationalization of the Renminbi: Politics as well as Economics**
**By Barry EICHENGREEN**

Barry Eichengreen prefaced his presentation with the question of 'why' it may be beneficial for a country to internationalize its currency. He pointed out that a country whose currency holds the prestigious title of "reserve currency" commands economic status and political clout that reflect the global strength of the country. He pointed to four factors at the crux of the RMB internationalization.

The first factor is that the Chinese financial system needs to become a vastly more liquid environment where bond market capitalization must increase by multiple times its current level. To put the Chinese financial system in direct contrast with where the U.S. economy is, Eichengreen pointed out the Chinese bond market is one-tenth the size of the United States. This statistic, coupled with the fact that China is the second largest economy in the world, highlights how illiquid the Chinese financial markets are in contrast to the U.S.

A second factor is China's ability to navigate the turbulent waters of liberalizing their capital account. The liberalization of the capital account allows for increased investment, but it also has the caveat of allowing banks to potentially borrow more excessively offshore under more relaxed regulations. China's ability to navigate capital account liberalization is key to the RMB becoming the next reserve currency.

A third factor is brought up in regards to China's slowing economy. The question was: how will China manage to avoid a hard landing and instead have a series of soft landings as the economy begins to slow from double to single digits? He did not foresee a successful internationalization of the RMB if China cannot avoid a hard landing scenario. Last but not least, Eichengreen pointed to the need for political and institutional reform in China.

This last point was the focus of Eichengreen's presentation. Throughout history all reserve currencies were managed by democratic governments. Although there are few data points to draw a conclusion from, the theory he puts forth is that "credible commitments from democratically elected governments lead to financial deepening and financial deepening leads to international and reserve currency status." The critique of his argument is that autocracies too can make credible commitments due to the elite being insulated from expropriation and therefore able to avoid opportunist rent seeking and make the commitments to domestic and foreign creditors. Although this is not a moot point, Eichengreen asked whether or not autocracies and foreign democracies could align their interests. If they cannot then the currency of an autocratic government cannot be made into a reserve currency.

Eichengreen concludes his presentation on his view of China's path towards RMB internationalization. He sees China as moving slowly on the right path, but it is only beginning the journey to internationalization of its currency. He emphasized once more the importance of political reform and building credible institutions. The political system may appear stable at the time, but in the long run it is uncertain. This long run uncertainty is something that may make creditors uneasy in utilizing the RMB for international trade and as a reserve currency. If China can make credible commitments to long-term political stability, it then has the economic and commercial preeminence to place the RMB among the few reserve currencies in history.

**Panel III. Renminbi Internationalization: The Role of Hong Kong and Shanghai**
**By HE Dong, XIAO Geng, and SUN Lijian**

The focus of this panel was on utilizing the model and case for Hong Kong to be a leading offshore market for RMB transactions. In addition, the panel focused on how China could create an international financial center (IFC) in Shanghai. Finally, the last portion of the panel highlighted how the internationalization of the RMB could stabilize the Chinese economy in the long run.

He Dong from the Hong Kong Monetary Authority argued that the model of Hong Kong as an offshore clearing-house for RMB transactions has been successful due to careful regulations that have been put in place over the last several years. The framework of Hong Kong is that of a plumber, allowing transactions to flow between non-residents and mainland China via Hong Kong. Over the last few years, Hong Kong and China have worked to allow this channel to be slowly opened and regulated. He Dong emphasizes that in order for Hong Kong to continue its rise as an RMB transaction clearing hub and to assist in the internationalization of the RMB, there must be a deliberate pace of financial reforms throughout China and in the mean time, offshore markets such as Hong Kong provide will accelerate the process of internationalization by allowing non-residents a way to use the RMB in international transactions. In a similar thread, Sun Lijian touched upon the importance and ability to develop an onshore IFC.

As the RMB becomes more international, there will be more emphasis on China to take an active role in international financial markets. China must strengthen its financial centers, specifically Shanghai. As of now, Shanghai is a large international financial center but one that is not marked by high quality, nor is it a reputable brand such as New York or London. Shanghai must develop this image of a world-class financial center in order to compete on a global scale. Sun Lijian from Fudan University suggests that in order to do this, Chinese policy should center on strengthening Asian financial cooperation as well as integrating the Asian bond markets. In addition, the government should also try to establish an integrated network of payments and capital cooperation amongst Asian traders and investors. By integrating regional financial markets, the Shanghai IFC will have the opportunity to play a significant role that Chinese leaders hope that it could fulfill.

Building upon He Dong and Sun Jian, Xiao Geng looked at how the internationalization of the RMB would not only increase the economic well-being of China but also how it would stabilize the Chinese economy in the long run. Given the relatively volatile nature of the Chinese economy in regards to inflation, interest rates, and exchange rate appreciation, Xiao Geng saw one way of stabilizing the Chinese economy in the long run is to internationalize the RMB.

There are several dilemmas that China faces in regards to the policies it has at its disposal. First, if it were to adopt a tighter monetary policy, this would lead to slower overall growth and weaken demand in the country. On the other hand, a loosening of monetary policy would allow for an over-capacity of unproductive investments as interest rates are relaxed. In order to stabilize the economy in the long run, the real interest rates must rise. Overall, Xiao Geng argued that an aggressive relaxation of the money supply should be coupled with an increase in interest rates by shifting reserve requirements, raising deposit rates, and providing subsidies on interest payment to certain groups would allow for long term stabilization of the economy.

**Panel IV The International Economic and Geo-Political Consequences of RMB Internationalization**
**By Robert DOHNER, HE Di and Peter GARBER**

This fourth panel focused on the broader impact of RMB internationalization, particularly concerning the regionalization of the RMB and its position as a reserve currency.

One of the main points all speakers agree on is that the market forces must drive the RMB internationalization process. Robert Dohner reiterated the US position that it supports the internationalization process and encourages China to press ahead to make the RMB convertible in capital accounts. Mr. Dohner pointed out that China needed to shift to a model of domestic household consumption. As the labor force begins to decline, China must develop new products and services in order to avoid the middle-income trap.

The financial sector reform is also critical to make transformation possible. Mr. Dohner also noted that that growth of the offshore market must lead to onshore reforms. He looked at the vast sums of RMB build-up in Hong Kong as an example of why reform is needed. In addition, he noted He Dong's comments that the way to transfer to a market system is through the growth of liberalized markets. Mr. Dohner did not agree with this, stating that Hong Kong will not be the tail that would define the Chinese dragon, which in turn would define the financial markets. The real issue is the continued development of the domestic onshore financial markets in China, leading to an economic rebalancing to a sustainable growth model.

He Di continued this theme, stating that the key driver for the RMB to be used out of the country is through border trade. For example, a large part of Vietnam-China trade is denominated in RMB. He Di saw a natural fit between the incremental increase of the use of the RMB in Asia and the need for market infrastructure growth. He believed that the RMB would become more widely used in Asia as a result of increased Chinese spending abroad. Tourism and education exchange, for example, will further increase the importance of RMB in regional economy. He pointed to the fact that as of now, seventeen countries have signed agreements with China to use the RMB as part of their reserve.

All three of the speakers touched on the impact of the RMB becoming a reserve currency for countries around the world. Peter Garber looked at the use of reserve currencies throughout history, stating that the main added power of a reserve currency lies in the international acceptability of actual cash for resources, instantly and in large amount. China must be able to do this with the RMB if it wishes to see its currency rise to this level. Mr. Garber examined how a reserve currency adds to the geopolitical power of a country – the US can punish uncooperative countries by pinching them out of the global financial system, as has been done to Iran recently.

Countries with strong reserve currencies can reward countries that cooperate, for example, the IMF gives dollar-denominated loans to countries that really don't deserve them. In recent times, the best example of exorbitant privilege that Mr. Garber saw is with the US invasion of Afghanistan. First, the US tried to use cash to buy mercenary armies made up of local tribes. Afghanis were willing to take the dollar-denominated money. China would not have been in a position to do so since its currency is not traded on an open market. Even Iraq, in order to engage in international commerce, had to hold a few billion dollars of US currency.

**Panel V. RMB Internationalization and the Global Financial Architecture**
**By Simon FLINT, Takatoshi ITO, and Robert McCauley**

Simon Flint from Nomura Securities was the first to deliver his presentation. He presented an image of the RMB from 2013-2015 and the top ten implications (he did not get to all ten). He started by noting that the Chinese authorities view the RMB as too important to lose control over. They would therefore take a 'leftist' approach. This leftist approach involves tying the RMB to macro-economic factors such as output and inflation instead of market demand.

Simon believes China will continue on this path for a few reasons. First, China has a strong track record of handling this type of rate manipulation in the past. Dollar/RMB inflation rates are correlated, as are the RMB and macro-economic indicators. Second, Simon believes that China sees Japan's Yen globalization and subsequent crash as a cautionary tale. Third, other Asian nations have successfully followed this model to modernity, i.e. Singapore.

For his forecasts, Simon suggested that: 1. If USD/RMB increases, China could lose a good deal of currency reserves. 2. If China does shed reserves, FX markets will see a massive shock. 3. Rising USD/RMB will make the capital account in China more porous. 4. Internationalization of the RMB could lead to an East Asian RMB bloc. 5. Chinese policy makers might use internationalization of the RMB as a Trojan horse to spur domestic reform.

Takatoshi Ito discussed RMB internationalization and its impacts on Asia. He attempted to answer four questions: 1. How much is RMB used internationally? 2. Why is China pursuing RMB internationalization? 3. Will they succeed? 4. What will the impact be?

He pointed out that the RMB's share of international transactions and reserves is quite small, but as a reserve currency it is gaining popularity in Asia. The benefits of RMB internationalization include RMB invoicing, avoiding currency risk in international trade, and possibly forcing domestic reform, Central Bank swaps, and prestige. Ito stated that invoicing might not have real positive effects on anything past three months, as foreigners would demand equivalent pricing. Ito argued that China could succeed if it sequences the reforms properly, and that Asian currencies will follow the RMB when it has more flexibility. The likely result of RMB internationalization is an RMB bloc in East Asia. When this is achieved, exporters will have more FX protection with China but not the US and Europe. A likely time for this would be after 2020.

Ito used Japan's model as an example of the successful internationalization of a currency where he took issue with Simon's view of Japan's reforms. The sequencing in Japan appeared to be domestic financial reform, followed by flexible exchange rate and KA liberalization. At this point, China is where Japan was between 10-20 years before full Yen internationalization.

Robert McCauley was the last panelist to speak. He focused on the possibility that the RMB might become a safe haven currency (SHC) in the future. This would mean China would switch from a nation that demanded safe assets to one that supplied them. Safe assets are defined by their rating, liquidity and accessibility. Safe haven currencies are strong when risky asset prices are low and visa versa. Robert proposed the question of whether China can transform the RMB into a currency like the Yen or if it would stay risky (like Korean currency).

Using empirical analysis of currencies during periods of international distress (e.g. Asian Financial Crisis, Financial Crisis, 2008), McCauley found that the market currently treats the RMB more like the SKW than the Yen. The Yen acted like a true safe haven currency while the SKW and HK RMB lost much of their value during the period of stress (it should be noted that the official RMB exchange rate showed little or no movement during these periods). According to his analysis, the RMB will not be a safe haven currency from either its yields or stress test performance. However, the RMB is still an attractive currency to hold because of China's growing trade share, the yield, and the currency's stability.

Audience raised questions on what the US and Europe should think of a RMB bloc, and what China can learn from Japan in building a safe haven currency. The panelists stated first that a RMB bloc should relieve the US, as it would take pressure off of the US dollar. Ito stated that Japan's strong financial structure is key to its position as a safe have currency while McCauley emphasized the low rates of return in Japan.