Luan Vu Dr. Gang Guo, Dr. Joshua Hendrickson

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Renminbi Internationalization: Analysis of Potential Risks and Benefits

Prospectus for Croft Thesis

Context

Extensive international trade is a defining trait of the modern global economy. Trade involves movements of goods and money, none of which can be missing if trade is to happen as it normally does. The study of international monetary transaction is therefore crucial to understanding how the world economy works.

The implications of monetary transaction also extend to the domestic level. Exporting countries accumulate national wealth with payments from abroad. That is a foreign element in the game that domestic policymakers play. As such, how the domestic economy handles monetary matters will certainly affect its own wellbeing, and vice versa, the wellbeing of any economy that associates with it.

Throughout its modern history, the world economy has witnessed the continuing dominant role of the US dollar. The international use of the US dollar is an important feature of the world economy taken for granted. Together with other factors, the size and influence of the US economy certainly explain why people everywhere opt to use its currency.

Therefore, it is worth asking why, given the size and prospects of the Chinese economy, the Chinese currency is not yet a familiar face to the global citizenry. The limited international use of the renminbi reflects policy deliberations on China’s part and profitability motives on the market’s part. For the year 2013, China’s leaders have revised growth expectation down to 7.5%.

The Chinese economy is going through a crucial period when expectations of reforms abound. Among the most exciting phenomena to come is renminbi internationalization.

Research questions

Talks about renminbi internationalization have taken place both in the academia and the business circles, even though the Chinese government has never put into writing any roadmap to carry out this policy. The literature on renminbi internationalization is abundant, and discussion on risks and benefits has also taken place. The thesis attempts to make a contribution by performing a rigorous analysis on the risks and benefits of renminbi internationalization. Therefore, the question to ask is, to what extent do the risks and benefits identified by the literature apply?

Methodology

First, the thesis will summary the literature on currency internationalization. Issues such as definition and conditions for currency internationalization will be covered. At the same time, I will survey the literature on international economics that pertains to currency internationalization. While a separate topic on its own, currency internationalization is extensively related to other issues of an open economy. I will also describe specifically how China is internationalizing its currency. This step aims to achieve a general understanding of currency internationalization and renminbi internationalization.

Next, I will assess the risks and benefits of renminbi internationalization. I will question the potential costs and gains identified by the literature. Some of these conclusions are not as obvious as they appear. Case studies of different currencies that have experienced internationalization will follow these analyses to illuminate the findings.

To conclude, I will summarize my findings and specify the implications of renminbi internationalization on the Chinese economy.

The proposed thesis outline is as follows:

1. Renminbi internationalization: theory and process
2. Potential benefits of renminbi internationalization
3. Potential costs of renminbi internationalization
4. Conclusions

Preliminary findings

The following points convey features of the contemporary Chinese economy that are relevant to the study of renminbi internationalization:

1. For the past decade China has very consistently achieved a positive balance of payments as a result of surplus in both the current and capital accounts. A peculiar balance of payments position, this means China exports more goods and services than it imports at the same as more capital flows into China than out of China. China has accumulated a huge amount of foreign exchange reserves, 60% of which is denominated in US dollar (Prasad and Sorkin 2009). China's current account has been fully convertible since 1996, while its attitude toward capital controls is still very cautious. Capital inflows mostly take the form of FDI (Prasad and Wei 2007). China's net investment income balance has been in the negative even though it is the world's second largest creditor (Yu 2013). Many scholars make large estimates of capital outflows (Gunter 2003, Naughton 2007).

2. China relies heavily on exports and investment to generate growth. Overtime, productivity has risen together with income (Chen, Jefferson and Zhang 2011). To sustain growth, China is shifting its focus away on to domestic consumption.

3. The Chinese currency is currently under a managed float. In 2005 China abandoned a US dollar peg, and in 2009 China announced the adoption of a currency basket against which the value of renminbi is determined. The renminbi is widely believed to be undervalued, although no consensus exists on estimates of magnitude. The renminbi continues to exhibit appreciation trend, having done so roughly 30% against the US dollar. China allows renminbi trading rate to fluctuate within 1.0% of the official rate.

4. The People's Bank of China maintains a ceiling on bank deposit rates, and only until recently removed the floor on lending rates. As a result, Chinese banks enjoy large profit margin at the expense of depositors (Lardy 2008). Intermediation is inefficient, and people try to channel their savings into alternatives such as the real estate market.

5. Inflation has been low and stable. To keep undesired money out of circulation, the PBOC increases reserves requirement and sterilizes its foreign exchange reserves (Lardy 2008).

6. Huge volumes of capital flow in and out of China's financial markets, but they are underdeveloped. The most important financial institutions are state-owned banks, which provide most of the financing and are inefficient. Bond and stock markets do exist, but are very limited in scope and utilization (Naughton 2007, Elliot and Yan 2013).

7. China's monetary policy targets money growth rate (Burdekin and Siklos 2008).

<u>Currency internationalization</u>

A currency is international when it is used outside of the issuing country. Three functions of money include unit of account, medium of exchange, and storage of value and apply to both domestic and international level. An international currency fulfills some or all of these roles outside of the issuing country. Furthermore, a truly international currency does not choose users, as any entity wishing to use the currency for whatever purpose should be able to do so without any restriction (Kenen 2011).

A currency's international status presents both benefits and costs to the issuing country. Generally, benefits include better control over foreign exchange reserves, reduced risks associated with foreign exchange, and better financing. All costs lead to less independent monetary policy due to the volatility that comes with the increased flows of money in and out of the economy. (Chen and Peng 2009, Hai and Yao 2010, Kenen 2011).

Like any goods, a currency is subject to the law of supply and demand. Some currencies enjoy greater demand worldwide than other currencies, depending on the market's evaluation. Major considerations include the size of the economy, the degree of stability of the currency, the level of domestic financial markets development, and network externalities (Chen and Peng 2009, Frankel 2011). It is obvious that many economic fundamentals underlie the determination of international currency status.

A point of tension develops between the topics of currency internationalization and capital account liberalization. Many scholars believe that capital account liberalization is a necessary but not sufficient condition for currency internationalization, and that each is a topic on its own (Chen and Peng 2009, Genberg 2009, Kenen 2011). In this context, an influential scholar goes so far to assert that renminbi internationalization is China's capital account liberalization “in disguise” (Yu 2012). The issue of capital account liberalization in turn overlaps with other topics such as interest rate and exchange rate policy (Lardy 2011, Yu 2012). An examination of these correlations is essential to the study of renminbi internationalization.

Another related issue is the impossible trinity, according to which a country can only choose two out of three elements between free capital movement, fixed exchange rate, and independent monetary policy. It seems that China has chosen to let go of a fixed exchange rate, although not completely, and the problem facing China is how to manage monetary policy in the context of increasing capital flows (Glick and Hutchinson 2008).

Beside economics, currency internationalization is also political in nature (Chey 2013). The theory of monetary statecraft holds that a country can influence another country with regards to currency use, among three other channels (Andrews 2006). Furthermore, Japan’s experience with internationalization has a lot to do with political pressure from the US (Frankel 1984). China might take into consideration political motivations with regards to renminbi internationalization.

Benefits of renminbi internationalization

The potential benefits of renminbi internationalization include:

1. Reduced exchange rate risks for Chinese exporters and importers
2. Reduced exchange rate risks for Chinese borrowers and lenders
3. Better RMB financing due to reduced transaction costs and diversification options
4. Better management of foreign exchange reserves for the Chinese government

The thesis will answer the following questions. This is by no means an exhaustive list.

1. What is the current invoicing and settling arrangement employed by Chinese exporters and importers? Why is this arrangement chosen? To what extent can Chinese exporters and importers invoice in the RMB?
2. Do Chinese borrowers have a demand for foreign capital? How appealing is RMB nominated bonds to foreigners?

A case study will be performed on the Australian dollar. Australia actively pursued currency internationalization, which has resulted in very positive gains for Australia.

<u>Risks of renminbi internationalization</u>

All risks associated with renminbi internationalization point at the reduction in effectiveness of an independent monetary policy. The questions to ask include:

1. How is China currently carrying out its monetary policy?
2. How much fluctuations in monetary targets can result due to renminbi internationalization?

A case study will be performed on the Japanese yen. Japan pursued currency internationalization under pressure from the US, its achievements very limited.

<u>Conclusions</u>

On the progress of renminbi internationalization, a prominent scholar contends that increasing asymmetry and speculative capital flows are problems facing Chinese policymakers (Yu 2012). To do so, China needs to liberalize interest rates and float the exchange rate. If realized, these changes will not only affect renminbi internationalization but also drastically change the current state of the Chinese economy. Some scholars argue that the liberalization of interest rate and exchange rate will not have too much of an adverse effect on the Chinese economy (Prasad, Rumbaugh and Wang 2005, Feyzioğlu, Porter, and Takáts 2009). Considering its risks and benefits, renminbi internationalization seems to relate to the transforming Chinese economy in many fascinating ways.

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