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The sluggish internationalization of the renminbi

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Abstract

During the last twenty years the Chinese yuan (officially known as renminbi – RMB) has travelled the road from unconvertible currency to international currency accepted in the world trade and finance. This was achieved both under the pressure from foreign trading partners as well as through adjusting China's monetary policy to the changes in major currencies and international capital flows. As China's economy is so heavily dependent on trade, particularly with its largest trading partners, the United States and the European Union, tensions with the US administration over the undervalued renminbi could be very costly for the Chinese economy and might involve the potential loss of its biggest export market. The dilemma between trade expansion and the renminbi exchange rate regime have not, so far, been resolved. China has to allow the market to play a more decisive role in exchange-rate formation and to further enhance the flexibility of the RMB exchange rate.

Keywords: yuan-renminbi (RMB), exchange rate, monetary policy

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1 Introduction

In the last twenty three years the Chinese authorities have been trying, with moderate success, to "internationalize" the renminbi (RMB) by promoting its use as a unit of account, means of payment, and store of value for banks, firms, and governments. Since 2005, the People's Bank of China (PBC) has advanced the market-oriented reform of the RMB exchange rate in a steady and multi-stage manner. It gradually expanded the floating range of the RMB exchange rate against the US dollar from 0.3% to 2% and against euro from 0.2% to 1.4% and lifted the restrictions on the floating range of the RMB exchange rate against the US dollar, the euro, the yen and several other currencies (People's Bank of China 2017). Beginning from 2009, internationalizing the renminbi has been one of the most important goal of Chinese monetary and economic policy. The evolution of the Chinese yuan into a truly international or hard currency has been viewed in Bejing as an affirmation of the success of China's economic development and opening up of the financial sector. Moreover, Chinese authorities have also been trying to internationalize the renminbi in order to free themselves from the dependence on the American dollar. This is a practical motive because as long as Chinese banks and firms conduct the bulk of their cross-border business in dollars, they face potential losses every time the dollar--renminbi exchange rate changes.

Since 2015, the PBC has further strengthened the RMB exchange-rate regime based on supply and demand in the market with reference to a basket of currencies (including the US dollar, the euro, the British pound and the Japanese yen) and has been trying to make the exchange-rate policies more rule-based, transparent and market-oriented. However, in practice, the exchange rate of the yuan (officially known as renminbi) is freely set by the People's Bank of China with no reference to its real purchasing parity as well as to the exchange rates of other currencies. The Chinese government was frequently accused by its trading partners, especially by the US Treasury, of being "a currency manipulator" who wants to secure for himself the "undeserved" advantages from the trade with the rest of the world. In other words, China has been viewed as a country which owes its export success first of all to currency manipulation. This is a rather superficial opinion which does not take into account other factors contributing to China's successes in foreign trade, such as pro-export policies and the philosophy of developmental state. The currency manipulations have been very important but not unique "driving forces" of those successes. The fact is that China's policy directed towards holding down the value of its own currency, the RMB, in order to boost its exports has brought about the huge surplus in the Chinese current account balance and also a huge imbalance of payments in its trading partners. Such a policy also prolonged the process of the internationalization of the RMB, which according to the Chinese authorities' expectations should become a truly international currency by 2020.

2 Controversial yuan

The undervalued yuan was in the 1990's and in the first decade of this century the most controversial issue in the trade between China and the United States as well as other countries. However, in the past China did not always artificially maintain the low exchange rate of its own currency. In the beginning of the 1980's the value of the yuan was high in relation to the US dollar (in 1983 the exchange rate was 1 USD for 2.80 yuans (Zhang 2006). However, at that time exports constituted a small part of the

Chinese GDP and the Chinese government had to secure possibly cheap imports in order to build the appropriate industrial infrastructure. In the following years, with a progressing increase of the share of exports in the GDP, the Chinese government has devalued the yuan six times in the span of 10 years. In 1993, 1 USD was worth 5.32 yuans and in January 1994 already 8.70 yuans. That devaluation of the RMB, which was combined with the reform of the Chinese system of foreign trade, has brought about a sharp protest of America's Treasury Department that is obliged by law to report twice a year which countries fiddle their exchange rates at the world's expense. China was designated in 1994 as currency manipulator, but no sanctions were introduced at that time by the US in its trade with China as, according to the Treasury Department, "they would do more harm than good" (*The Economist* 2010b).

Later, the Chinese government had only slightly revalued its own currency and since 1997 there had been a stable exchange rate of yuan vs. dollar at the level of 1 USD to 8.28 RMB. That exchange rate was maintained without any changes till 2004 (Gwiazda 2013c). However a relatively stable yuan in both a short and longer run did not automatically make this currency hard or truly international. Investopedia defines hard currency as being "widely accepted around the world as a form of payment for goods and services", and as a currency expected to remain relatively stable in the short run. Every hard currency must also be highly liquid in foreign exchange markets. It should be emphasized that the US dollar is one of the best examples of a hard currency. According to the Investopedia, it is both the most traded currency and the world's choice of reserve currency. Seventy percent of the world's international trade is conducted using the US dollar. And the dollar accounts for about 61% of the foreign exchange reserves held by central banks worldwide, down from more than 70% in the 1990s. Still, nearly 45% of all foreign exchange market transactions involve dollars, in which also almost every transaction in the global oil market is denominated. For comparison, renminbi-denominated claims still account for only 1% of the foreign exchange reserves held by the world's central banks. In the foreign trade transactions the position of the renminbi is also very weak despite the fact that businesses now use that currency to pay for about 10% of all global exports and imports (Subacchi 2016). But most of those payments stem from China's own trade, including trade with Hong Kong, which cannot be treated by China as a foreign country. It should also be noted that an increasing part of China's foreign trade is being realized through the bilateral currency swap agreements between the PBC and foreign monetary authorities. Such swap transactions have been playing a positive role in promoting bilateral trade and are reinforcing the position of the RMB. However, that currency is still not, like the US dollar, a safe haven, into which foreign investors save their money during financial crises. Also some other currencies, such as the Swiss franc and the euro perform the role of safe havens, but on a limited scale. The Chinese renminbi does not perform such a role and nobody can foresee whether and when it will function as a safe haven.

Apart from being a number one in terms of global currency, a position which the US dollar has occupied since 1945, there are also seven other most traded currencies, which include (in descending order): the European euro (EUR), the Japanese yen (JPY), the British pound (GBP), the Swiss franc (CHF), the Canadian dollar (CAD), the Australian/New Zealand dollar (AUD/NZD) and the South African rand (ZAR). Conspicuously absent from the list is the Chinese yuan. Although the RMB has been, since October 2016, officially included alongside five currencies (i.e. the US dollar, the euro, the Japanese yen and the British pound) in the prestigious Special Drawing Rights (SDR) currencies of the International Monetary Fund, becoming an IMF-recognized reserve currency, the renminbi still does not qualify as a hard currency. According to the Society for Worldwide Interbank Financial

Telecommunication (SWIFT), the share of the renminbi-based transactions in 2015 accounted for 1.86% and in 2016 for about 2.17% of the value of all global payments (BIS Survey 2016). According to some estimates, the share of the RMB in the global trade in foreign currencies in 2010 amounted to about 2.2% and in 2016 to about 4% (People's Bank of China 2017). However, the position of the RMB as the fifth most frequently used currency in financial transactions should not be overstated.

The above mentioned data are somewhat surprising as the Chinese yuan meets some other requirements of hard currency, e.g. such currency should be issued by a politically stable government and by a country with a large GDP. And the China has been since 2010 the second largest economy of the world (after the United Sates) and since 1949 has been ruled by the Communist Party and has a very stable government as compared to the frequent changes of governments in other countries. In theory almost all preconditions are fulfilled for the yuan to be internationalized. In practice, however, it is very difficult to understand the logic of its internationalization (Zhang 2011). There are various explanations of the current position of the RMB as not fully hard or truly international currency. One of them refers to the rather small usability of the yuan and its acceptance as a reserve currency by central banks. The fact is that in 2015 the RMB was the fifth most used currency globally, but it still accounted for merely about 2.0% of all international payments tracked by SWIFT, as opposed to 43.3% for the dollar or 28.7% for the euro. It should be remembered that about 70% of international transactions involving the RMB were between Hong Kong and mainland China. If Hong Kong is excluded, the RMB only accounts for 0.8% of global SWIFT payments (*The Economist* 2017). On the other hand, the US dollar accounts for 61% of total foreign currency reserves, while the euro is in second place accounting for 25%. One of the many reasons why central banks are not holding significant quantities of RMB in their currency reserves is that central bankers also tend to maintain currency reserves in proportion to their actual use (*The Economist* 2016a, p. 12). Moreover, both banks and foreigners will be more willing to use the renminbi only if they can buy and sell it freely. As the RMB only accounts for about 2.0% of global transactions (including the trade between mainland China and Hong Kong), the percentage of the RMB kept by most central banks is quite low. In 2015 central banks owned RMB currency reserves worth USD 80 billion. If the RMB was so popular and commonly accepted as the Japanese yen currency reserves denominated in yuan would rise to USD 370 billion (Kozieł 2015). And this would result in a substantial strengthening of the yuan *vis-à-vis* other hard currencies.

3 Unresolved Sino-American tension

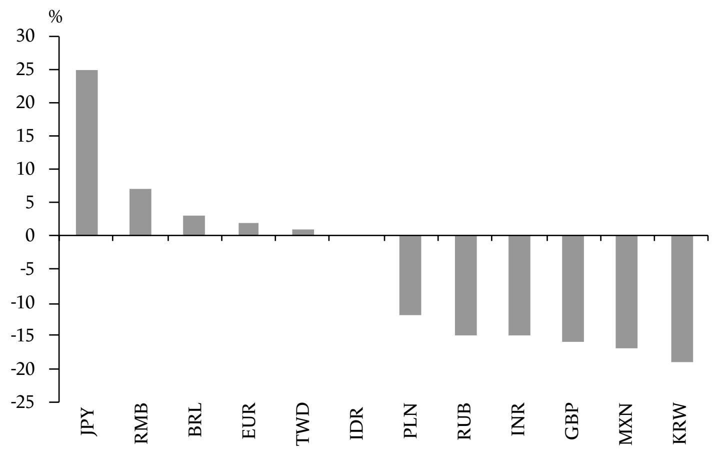
It would be naive to expect that China will finally solve its currency problem according to American demands. The main bone of contention is the value of the yuan, which has been pegged tightly to the dollar since July 2008. Since that time Chinese authorities have been trying to allow the yuan to strengthen regardless of the lack of pressure from the US Department of Treasury, which expects that China will finally allow the yuan to rise. The advocates of such a solution argue that a stronger yuan would not just avoid a trade war between America and China. It would also help China by rebalancing its economy towards domestic consumption and make it easier to control inflation by giving China's central bank a freer hand to raise interest rates. With consumer prices accelerating in China since 2009/2010 that is becoming more urgent. Many Western economists argue that a stronger yuan would not only help reduce global imbalances, such as America's huge trade deficit, but would also benefit China (La Corre, Sepulchre 2016). It would also help China regain control of its monetary policy. By pegging to the dollar, it is, in effect, importing America's monetary policy which is too loose for China's fast-growing economy. A stronger yuan would also help rebalance China's economy, making it less dependent on exports, putting future growth on a more sustainable path based on the growing demand on the domestic market and the evolving middle class (Wu, Ma 2016). However, the Chinese government rejects the accusation that its exchange rate policy has given it an unfair advantage. Chinese authorities admit that the yuan needs to appreciate over the longer term, but not in the situation when the China's current-account surplus has fallen by almost half, to around 6% of GDP from 11% in 2007 (*The Economist* 2009, p. 75). The same holds true of Chinese exports that have been falling since 2007 by the average of 10% *per annum*. Opponents of a stronger yuan argue that the country can ill-afford to harm job-creating exporters, especially since much of the recent credit binge from government stimulus benefited capital-intensive heavy industries, which create relatively few jobs.

It should also be remembered that China's economy is disproportionately skewed to heavy industry in part because of its undervalued exchange rate. A stronger currency would, by reducing the price of imports, increase Chinese households' purchasing power and favour non-traded businesses such as services, which tend to be labour-intensive. That alone will not be enough to rebalance China's economy. All manner of structural reforms, from corporate governance to taxes, are also needed. Some Chinese officials from the banking sector admit that renminbi internationalization would greatly encourage the necessary wider economic and financial reform (Chen, Guo 2017). Moreover, a stronger currency would be a good start and it could also help to "normalize" trade relations with the majority of China's trading partners including the United States and the European Union. Not only the United States are losing in trade with China because of the cheapness of the RMB, but also several EU countries and such countries as India and Brazil, not mention many other both developed and developing countries. The fact is that since the late 1990s trade disputes with China are spreading worldwide. Given the country's growth and economic heft, that is probably inevitable. But allowing the yuan to appreciate would allow China to appease its trading partners at the same time as helping itself.

It should be recalled that China allowed the yuan to rise by 21% against the dollar in the three years prior to July 2008, but since then it has more or less kept the rate fixed. As a result, the yuan's trade-weighted value has been dragged down in 2009 by the sickly dollar while many other currencies have soared and in 2008 China held its currency stable against the dollar throughout the global financial crisis while others tumbled. Since the start of 2008, the yuan has actually risen against every currency except the yen (see Figure 1).

However the Chinese authorities (not only officials of the People's Bank of China) are well aware of the fact that a gradual rise of the value of the yuan encourages investors to bet on further appreciation. Under such expectations hot money inflows swell domestic liquidity. On the other hand, a bigger increase in the value of the yuan, for example in the order of 25%, has been politically unacceptable to China's government because it would put many exporters out of business overnight. Therefore, in 2010–2015 China only slightly changed its policy towards its own currency, which was allowed to rise only at a very moderate rate against other currencies. That rise was, however, strictly correlated with the trends in Chinese exports and with the GDP. Also the outflows of capital and growing China's indebtedness were taken by Chinese authorities into account in the process of shaping the exchange rate of the RMB. They have always been trying, not just for the last few years, to manage the exchange rate of the RMB so as to limit its exchange rate fluctuations.

Figure 1
Exchange rates against the USD, 1 January 2008 – 17 November 2009 (% change)



JPY – Japanese yen, RMB – Chinese yuan, BRL – Brazilian real, EUR – euro, TWD – Taiwanese dollar, IDR – Indonesian rupiah, PLN – Polish zloty, RUB – Russian rouble, INR – Indian rupee, GBP – British pound, MXN – Mexican peso, KRW – Korean won.

4 The falling yuan

Due to lower economic growth, which in recent years has been fuelled by borrowing, nobody could predict the pace at which the yuan has risen and fallen. The experts from Minsheng Securities were sure in early November 2016 that the yuan would "stabilise" at 6.82 per dollar for the rest of the year. But already on 10 November 2016 the yuan fell to an eight-year low and later stood at 6.89 per dollar, to drop to 6.83 per dollar on 18 January 2017 (*The Economist* 2017). Most analysts, investors and companies believed at the beginning of 2017 that the Chinese currency had to fall further against the dollar, but could only guess as to how far and how quickly. It should be recalled that in the beginning of the 2000s, during the boom, Chinese authorities maintained tight capital controls, permitting foreign direct investment while eschewing "hot money". The People's Bank of China intervened in the foreign--exchange markets to keep the yuan cheap, which enabled China to build up USD 4 trillion in reserves. However, due to the three slumps on the Stock Exchange in Shenzhen and Shanghai in July and August 2015 and in January 2016, China's reserves went down by about USD 1 trillion. Those crashes and not capital flight were the main reason for that huge decline in Chinese reserves. In December 2015 alone the reserves fell by more than USD 100 billion. And in the third quarter of 2015 China's outward foreign-direct investment rose from USD 29 billion to USD 32 billion while inward investment fell sharply from USD 71 billion to USD 39 billion (*The Economist* 2016b, p. 78).

Such a situation on the capital market increased the uncertainty as regards the handling of the RMB exchange rate. The Chinese government, long blamed to exercise tremendous control over the yuan, in 2015 started to lose its grip. A new exchange-rate mechanism, introduced in 2015, has made the currency more flexible but also more responsive to global market trends. Dollar strength over October and November 2016 meant that the yuan, just like about every other currency in the world, steadily lost ground against the USD.

There are also other reasons for such a performance of the yuan. One consists in China's relatively quick capital outflows, which in 2016 totalled between USD 650 billion and USD 1 trillion (Lang 2017). For comparison, that outflow in 2015 was also at the annual level of USD 1 trillion. At the same time, China's debt level has continued to rise, as ambitious economic growth targets have been fuelled by borrowing. In the view of Jon Lang this growth model has led to "an unstable market environment with manufacturing overcapacity" (Lang 2017, p. 6). In 2016, China's use of debt reached record proportions (*The Guardian* 2017). Moreover, about USD 1 trillion of China's accumulated debts are denominated in dollars. This may be viewed as a small sum as compared to USD 28 trillion in total Chinese debt. However, because Chinese firms are heavily indebted in dollars, even a small rise in the cost of servicing dollar-denominated debts could force some companies into asset sales or bankruptcy. And that, in turn, would encourage more capital outflows and bring about further fall in yuan's value.

After a 2016 review, the IMF issued a warning regarding China's increasing debt, which they calculated to be 237% of GDP (Financial News 2017). China set a 2017 growth rate of 6.5% which will necessitate incurring more debt and possibly further liquidations of foreign capital reserves. While a growth rate of 6.5% seems ambitious, it still represents a decrease from the previous year's projections. Other signs of a slowing economy include the government's announcement that it will reduce fixed asset investment to 3–4% in 2017, as opposed to 7% in the previous year (Oprita 2017). The recently published data on China's 6.9% GDP increase in the first quarter of 2017 beat consensus estimates of 6.5% year-on-year growth (Sheehan 2017).

The fact is that the economic performance in China was fuelled by a mixture of old-style policy--driven stimuli and increased demand in export and retail sectors, with accelerating investment and industrial upturn. However, there are "old" economic challenges which may be dangerous to China's policy makers as they still continue to direct resources toward inefficient sectors and companies in an effort to artificially boost growth.

That old-style economic policy has also been visible in the field of monetary policy and with respect to maintaining the "appropriate" exchange rate of the yuan against other hard currencies. Since 2015 there was a record fall in China's foreign exchange reserves. As said above, since that year they have been falling despite a record trade surplus of USD 595 billion in 2015. Those reserves began dropping for the first time in a decade in the third quarter of 2014 (Tiezzi 2015). However, China's forex reserves in 2015 were still very high and stood at USD 3.56 trillion, down from a record level of USD 4 trillion in June 2014. In 2015 China still possessed 30% of total central bank holdings around the world (which were valued at USD 11.43 trillion in March 2015). Some western economists tied the decline in forex reserves directly to China's yuan devaluation, pointing out that the devaluation and a general economic slowdown are making the yuan a less attractive investment option (Miller 2016). In the second half of 2015 and also in 2016 the PBC was off-loading dollars and buying the yuan to keep the currency's value from dropping too steeply. On the other hand, Chinese officials pointed to the rising value of the US dollar as a major cause of the fall in China's forex reserves. Therefore not only did the value of non-dollar assets in the reserves drop, but more individuals and enterprises were at that time and still are willing to hold US dollars, which resulted in dropping forex reserves.

The fall in forex reserves was accompanied by the rise in debt levels. Therefore, the value of the yuan continued to drop both in 2015 and in 2016. In that last year the yuan dropped 6.6% against the US dollar and country's forex reserves dropped below USD 3 trillion (Reuters 2017). The weak yuan has been making it more expensive for Chinese companies to service loans in dollars. But a bigger problem was the expectation of depreciation risks becoming a self-fulfilling loss of confidence. Many economists agree that this is a risk even for a country with foreign-exchange reserves of about USD 3 trillion.

It should be emphasized that during the past two years the RMB weakened moderately against the US dollar also due to some international political events such as the Brexit and an uncertain trade and financial policy of president Donald Trump administration. But the depreciation of the RMB has been, in the view of the POB officials, basically well-managed. The fact is that against the backdrop of a stronger dollar, most of the major global currencies also depreciated against the US dollar. For example, from the second half of 2014 to the end of March of 2017, the euro, the Japanese yen, the British pound, and the Australian dollar depreciated against the US dollar by 22.13%, 8.85%, 26.82% and 19.67% respectively, while the Brazilian real, the Russian rouble, the Indian rupee and the South African rand depreciated by 29.48%, 38.99%, 7.36%, and 20.47% respectively against the US dollar. During the same period, the central parity of the RMB exchange rate against the US dollar only depreciated by 10.83% and the depreciation was more modest than that of most currencies in the major advanced and emerging economies (People's Bank of China 2017).

In the beginning of 2017 the Chinese authorities could not decide what kind of exchange-rate policy offers the safe solution to the "yuan's problem". During the 2016 yuan fell by more than 6% and in the beginning of 2017 it was close to a psychologically important level of 7 yuans per 1 dollar. It should be noted that most people and entrepreneurs still focus on the yuan exchange rate against the dollar, the euro and the British pound. As China's economy is still very dependent on trade, especially with its largest trading partners – the United States, and the European Union, so further tensions over the exchange rate of the yuan against the dollar could have an adverse effect on the Chinese economy as well as disrupt the functioning of the world economy.

5 Bleak prospects

The Chinese authorities seem to be aware of the fact that the RMB will not become a reserve currency of choice any time soon. Its position was worsened in 2016, when the RMB fell from fifth to sixth place for SWIFT payments. Even if the Chinese central bank goes on trying to prop up the value of the RMB to stem capital flight and buttress domestic consumption, such efforts can bring more visible results only in a longer term. In addition, stronger capital controls would hurt the economy, closing it off the rest of the world. Another option, namely a faster depreciation of the RMB would only spur greater outflows of capital and would be extremely risky as it would threaten financial stability, not to mention that it would lead to a trade war with the United States and other China's trading partners. Further devaluation of the yuan does not boost exports like in the past since much of the material that goes into Chinese exports is itself imported. It would certainly reduce the purchasing power of Chinese consumers and encourage more capital outflows.

On the other hand, the potential benefits to the United States from yuan revaluation are much exaggerated. In particular, a stronger yuan would not significantly reduce America's trade deficit. There is little overlap between American and Chinese production, so American goods could not simply replace Chinese imports. Moreover, the commitment to a strong yuan could also constrain China's monetary policy and without the profound economic and political reforms would not improve significantly the present status of the renminbi in the long run or the development prospects of the Chinese economy. Those prospects will also depend to a significant extent on the realization of China's project from 2013 called One Belt and One Road (whose name was changed in 2016 to Belt and Road Initiative) encompassing 60 countries mostly from Asia and Europe. Anticipated cumulative investment in that project over an indefinite timescale is put at USD 4 trillion up to USD 8 trillion (Chohan 2017). In 2014, the Chinese government created appropriate institutions for the realization of that project, first of all the Asian Infrastructure Investment Bank, which is viewed as an alternative financial institution to the International Monetary Fund and the World Bank. Not all countries involved in that project are optimistic over the expected results since China may invest, and usually does, in projects solely with its own profits in mind. Therefore, it is hard to foresee how the realization of that project will change the present international status of the RMB. Much will depend on the changes of China's monetary and investment policies as well as on the future directions of the Chinese economic development.

As early as in 2016, Chinese authorities began withdrawing some liberalization measures and imposed new restrictions on foreign direct investment by Chinese corporations. They also tightened currency controls. It seems, however, that it would be better for China to strengthen capital controls temporarily and at the same time to stop stage-managing the yuan's value. At the time this paper is being written, Chinese authorities have been trying to avoid tensions and trade conflicts with president Donald Trump administration. On the other hand president Donald J. Trump confirmed in April 2017 that his administration would not designate China as a currency manipulator (Panda 2017). Such an approach can be explained by heavy interdependence of the Chinese and American economies, which is the main factor preventing both sides, in particular China, from taking such actions that could spoil the mutually beneficial economic cooperation. The fact is that the United States owes China more than USD 1 trillion and the Chinese president Xi Jinping could send America's economy into a tailspin by sanctioning the dumping of US Treasury bonds. It would be, however, a self-damaging operation which could cause enormous damage to the US only at the cost of damaging the Chinese economy itself. China depends on the United States in a way the US does not depend on China. Nearly 4% of China's GDP come directly from exports to the US, while the equivalent figure for the US is less than 1%. Moreover, there are several other countries that could provide the US with the manufactured goods it gets from China, but China would have real trouble finding an alternative to the US as an export market. Therefore it would be unrealistic to expect that China will again artificially depress its currency to benefit its exporters. The exchange rate of the RMB is essentially dependent on the developments in China's economic performance, market expectations, China's cross-border capital flows and external events occurring in individual countries and in the global economy. Despite uncertainties connected with the movements of the US dollar due to the influence of the Fed's normalization of monetary policy, and other international political and economic incidents, the economic fundaments in China and other facts will probably continue to keep the RMB exchange rate relatively stable at an equilibrium level against a basket of currencies.

Concluding the above considerations, it can be stated that in the beginning of 2017 there were no good options for Chinese policy makers responsible for the monetary policy. There was a time for the reform of the Chinese financial system and freeing the exchange rate of the RMB when money (capital) was flowing into the country. Now, the capital is fleeing China and only one thing would improve the position of the yuan in the short run, and it would be a weaker US dollar. However, no one in China and in the whole world, can expect that the US Federal Reserve and Department of Treasury will conduct in the near future a policy aimed at weakening the US dollar. It seems that Chinese authorities will, under the present condition of the world economy, rather prioritize domestic objectives over renminbi internationalization. Therefore, it is unrealistic to expect that the RMB becomes a truly international currency by 2020.

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