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Review Article

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The Renminbi as an Emerging World Currency

Richard C. K. Burdekin*

Claremont McKenna College, Claremont, California, USA

Abstract

Although capital controls ensure that worldwide use of China's currency, the Renminbi, has lagged far behind the nation's influence on world markets, China's currency is seeing greatly increased use in cross-border trade as a vehicle currency. This trend accelerated in the aftermath of the global financial crisis amidst successive agreements with neighbouring countries such as Japan and Russia to move away from the dollar in favour of using their own currencies for bilateral trade. Other key steps include the establishment of a full offshore Renminbi market in Hong Kong in 2010 and the September 2013 establishment of the Shanghai free-trade zone. Meanwhile, offshore Renminbi bond issuance not only reached a cumulative total of nearly RMB 400 billion in Hong Kong by the third quarter of 2013 but also was being joined by such new offshore Renminbi bond centres as Singapore, Taiwan and London. It is no longer so farfetched to imagine the greenback being replaced by a new 'redback' standard in the long run.

Keywords: China; Renminbi; Internationalisation; Shanghai; Hong Kong

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On the condition that the [Renminbi's] convertibility is realized, the Hong Kong dollar may be pegged to the [Renminbi] instead of the dollar in the future.

(Donald Tsang, Chief Executive of the Hong Kong regional government, 2006)[1]

The internationalization of China's currency, the Renminbi, hasn't just taken off – the 'redback' has soared, perhaps becoming the fastest growing currency in the world.

(Qu, 2013)

Introduction

For decades China's economic progress was stifled and hidden from the rest of the world behind Chairman Mao's 'bamboo curtain.' However, the remarkable growth over the post-1978 reform period has launched the country into a major player in the world economy. Although the post-2007 global financial crisis induced recessions in many western economies, Chinese growth remained quite robust despite the damage to many of the nation's main export markets. Exchange rate policy, like financial market development, has admittedly lagged behind, however. The Renminbi did not become fully convertible even for current account transactions until 1996. Nevertheless, the authorities have gradually moved to a somewhat more flexible exchange rate policy [1]. After holding the exchange rate with the U.S. dollar essentially fixed for nearly a decade, the initial 2.1% revaluation from 8.28 RMB/$ to 8.11 RMB/$ on July 21, 2005 has been followed by a gradual strengthening of the Renminbi. This appreciation has been accompanied the growing Renminbi usage in settling international transactions and increased Renminbi circulation not only in Hong Kong but also in other Asian economies [2]. In shifting cross border currency transactions away from the dollar and towards the domestic currency, Renminbi internationalisation can also help reduce ongoing reserve accumulation pressures [3].

A Global Role for the Renminbi?

A global role for the Chinese currency would actually be no more than a return to the position it occupied in past epochs. Traditional Chinese copper coins were a model for the early currencies of Japan and Korea and served as an East Asian and Southeast Asian monetary benchmark for a millennium or so before being displaced by western coinage in the late nineteenth century. Chinese coins even circulated in India and Ceylon between the 7th and 14th centuries. Moreover, rather like today, financial assets long flowed into China from the west in the face of substantial Chinese trade surpluses [4]. The question of how soon, and to what extent, China's currency will regain its former pre-eminence in the region is heavily dependent upon the authorities' willingness to further relax capital controls and, most likely, accept additional Renminbi appreciation. Improved financial markets would almost certainly be a further prerequisite.

Thus far, Chinese policymakers have shied away from any overt challenge to the U.S. dollar's reserve currency role and seem to envisage the Renminbi being just one of many alternatives to the dollar in any potential new global standard. China's ongoing surpluses with the United States have already had the effect of making it a major player in the market for U.S. Treasuries and other dollar assets, however. Thus far, most of the reserves accumulated by China have been kept in U.S. dollars. Should that change, any sudden sale of these holdings could well exert significant new downward pressure on the dollar as well as on the price of U.S. government bonds. Although the Chinese authorities have already incurred significant accounting losses owing to dollar depreciation, large-scale dollar sales would diversify the nation's reserve holdings only at the expense of an additional short-run hit to their value if these actions themselves induced further dollar weakness.

The vulnerability on the U.S. side must be recognised as well, though, given that China is the creditor nation and the United States is the debtor nation. In reality, the bilateral relationship is perhaps best characterised as one of "mutual dependence where it would take considerable provocation for either party to do more than bluff" [5]. Indeed, the announced purpose of China's sovereign wealth fund, created to invest some of the nation's massive reserve holdings in

[1]As quoted by Kwan [30].

***Corresponding author:** Richard C. K. Burdekin, Jonathan B. Lovelace Professor of Economics, Claremont McKenna College, 500 E. Ninth Street, Claremont, California 91711, USA, Tel: (909) 607-2884; Fax (909) 621-8249; E-mail: rburdekin@cmc.edu

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higher-yielding assets, was not to shift away from dollar assets but rather simply move from lower-risk, lower return dollar holdings of Treasuries to higher-risk, potentially higher-return areas – like its early investment in the Blackstone Group IPO. Moves toward accumulating non-dollar assets appear to have had only limited effects on overall composition of China's vast reserves. For example, while the World Gold Council [6] estimates that China doubled its gold reserves between 2007 and 2012 to reach 1,054 tonnes in July 2012, this would still represent only 1.6% of its total reserve holdings.

Renminbi Circulation beyond Mainland China

Although the use of the Renminbi as a 'vehicle' currency for making transactions in cross-border trade was officially permitted as long ago as 1997, a key boost was provided by a 2010 program that expanded cross-border Renminbi trade settlement to 20 provinces and cities (covering over 90% of total Chinese exports) and was open to trade with all countries. This helped lay the groundwork for the Renminbi's growing role in international trade and international currency settlement going forward and the total value of Renminbi cross-border trade settlement quickly increased from less than RMB 25 billion in the first quarter of 2010 to RMB 597.3 billion in the second quarter of 2011 [7]. In the aftermath of the global financial crisis, a series of bilateral currency agreements added to the uptrend in Renminbi usage. This included a November 2010 agreement between China and Russia to switch from the dollar in favour of using their own currencies for bilateral trade, with the subsequent trading of the Renminbi on the Moscow Interbank Currency Exchange in December 2010 representing the first time the Renminbi was officially traded outside mainland China and Hong Kong [8].

An important move towards employing the Renminbi in trade with Japan followed as part of the December 2011 financial cooperation agreement between China and Japan. This agreement also provided for the use of the Renminbi in Japanese direct foreign investment in China, Renminbi bond issuance by Japanese firms, and a direct Renminbi-yen foreign exchange market. Further currency swap arrangements with Turkey and the United Arab Emirates were unveiled in early 2012 [8], with the Bank of England joining the party in June 2013 [23]. Meanwhile, the use of the Renminbi in trade not only with Russia but also with the other BRIC nations has accelerated[2]. A memorandum of understanding signed by China Development Bank in March 2012 actually provided for Renminbi loans to finance trade with Brazil, India, Russia and South Africa. The overall proportion of international transactions settled in Renminbi increased concomitantly. Qu [9] estimates that in the first quarter of 2013 the proportion of exports and imports settled in Renminbi was already approaching 12% – while offshore Renminbi holdings grew from near zero in 2010 to approximately RMB 900 billion.

With currency swap arrangements having been established between the People's Bank of China and a growing list of central banks since 2008 (including those of Indonesia, Malaysia, South Korea and Thailand as well as Hong Kong, Japan and the United Kingdom), there has even been speculation that the Renminbi could have appeal not only as a vehicle currency but also as a potential challenger to the U.S. dollar's role as international reserve currency [10,11]. Although more substantive moves in this direction remained hindered by mainland China's capital controls limiting access to the currency, the Renminbi began to enter the foreign exchange reserve portfolios of central banks as far flung as those of Chile, Malaysia and Nigeria in 2011 [12]. The benchmark share of the Renminbi in the Chilean central bank's investment portfolio reached 2.25% in 2012 [13]. With the euro's scope for challenging the dollar having been severely set back by Europe's protracted sovereign debt crisis, the Renminbi is surely the most viable long-term challenger to dollar hegemony. It is most likely a question of when, not if, the Renminbi grows into this role.

Tung et al. [14] argue that the Renminbi could soon surpass the Japanese yen and the pound sterling, while the World Gold Council [15] points to low volatility, low correlation with traditional reserve assets and appreciation against the U.S. dollar all making the accumulation of Renminbi assets a potential centerpiece of central bank reserve diversification strategies. There have already been dramatic gains in terms of the Renminbi's role in global foreign exchange trading, with the value of total Renminbi turnover accelerating from $34 billion in 2010 to $120 billion in 2013 [16]. This made the Renminbi the ninth most actively traded world currency during 2013 with an overall 2.2% share in worldwide foreign exchange volumes. It actually moved up further into eighth place in December 2013, having altogether overtaken 22 other currencies since 2010 [17]. Although the U.S. dollar remained dominant with an overall 87% market share, the Renminbi did gain ground on the euro as the euro's share of global foreign exchange trading fell from near 39% in 2010 to 33% in 2013 [16]. Moreover, the Renminbi became the second most widely used currency for trade finance, with importers and exporters using the Renminbi for 8.7% of their financing arrangements with their trading counterparties in October 2013 [17].

The first direct penetration of the U.S. market was seen with the establishment of Agricultural Bank of China, Bank of China, and Industrial and Commercial Bank of China branches in New York in 2012, allowing Renminbi customer withdrawals in the United States for the first time[3]. Within mainland China itself three new free currency zones were set up in Guangdong province in 2012. Renminbi convertibility in these zones allows for cross-border investment to be settled in the Chinese currency while removing barriers to entry by foreign firms. Of special note is the free currency market in Qianhai in Shenzhen, which has been established with the objective of making it a global services centre by 2020 [18]. Firms locating there will be able to freely raise Renminbi funds from neighbouring Hong Kong.

Renminbi-denominated bond issues have themselves enjoyed rapid expansion outside mainland China over the last five years. The first offshore Renminbi-based bond issue was China Development Bank's RMB 5 billion bond issue in Hong Kong (yielding 3% a year over a two-year term). This bond issue was almost three times oversubscribed and quickly followed by a RMB 2 billion bond sale by China Export-Import Bank. Renminbi-denominated bond issuance in Hong Kong since expanded to include a growing number of foreign companies, including such large multinational corporations as Caterpillar and McDonalds. In a sign of how deep this market had become, the first offshore Renminbi bond fund was launched by Hai Tong Asset Management in August 2010. Total Renminbi-based bond issuance, while already exceeding RMB 100 billion by year end 2011, accelerated by a further RMB 295 billion between 2011 and the third quarter of 2013 – over which interval 277 separate Renminbi-denominated bonds were issued in Hong Kong [19]. Meanwhile, offshore issuance of Chinese government bonds is attractive for the government itself insofar as the yields in Hong Kong remain below the yields demanded in domestic markets for the same maturities [20].

[2]The 'BRIC' nations comprise Brazil, Russia, India and China.

[3]These banks comprise three of the largest state-owned commercial banks in China, with the only other bank of comparable size being China Construction Bank. All are now publicly traded joint stock companies in which the state retains majority ownership.

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Hong Kong is not the only offshore source of Renminbi-denominated bonds, however. Such bonds are now also issued in such other markets as Singapore, Taiwan and London. In November 2013 the Industrial and Commercial Bank of China's Singapore branch issued RMB 2 billion in bonds in that market and there were plans for initial bond issues by the Agricultural Bank of China and the Bank of Communications in Taiwan [21]. The Industrial and Commercial Bank of China also sold London's first Renminbi bond issue in November 2013 and this came amidst a series of steps designed to make London a major trading centre for Renminbi. Direct Renminbi-sterling trading was established in October 2013 and London-based Renminbi clearing followed in December 2013 [22]. London, in fact, already accounted for more than half of all Renminbi trading outside Hong Kong and mainland China in 2013, with volumes approaching $5 billion per day in value by the fourth quarter of the year [23].

At the same time, actual use of the Renminbi as hand-to-hand currency outside mainland China has become increasingly important not just in Hong Kong and Macau but also further afield in Asia, including the Republic of Mongolia and South Korea. Interest in Renminbi-based commercial transactions has been on the rise as well. China has become particularly important as a destination for Australian commodity exports, led by iron ore, and Fortescue Metal Group Chairman Andrew 'Twiggy' Forrest stated: "We are now exploring the possibilities of being paid in renminbi, [and] purchasing equipment in renminbi from our renminbi bank accounts ..."[4]

The Offshore Renmibi Market in Hong Kong

Although formal arrangements for an offshore Renminbi currency market in Hong Kong were not established until 2010, as early as November 1, 2005 the People's Bank of China reported that 38 banks in Hong Kong – representing almost all banks offering retail services – provided personal Renminbi business to their clients. Renminbi circulation was bolstered by the rising number of visitors traveling to Hong Kong from the mainland after individual visas were permitted in 2004. Many Hong Kong shops post Chinese language signs explicitly welcoming Renminbi and the larger RMB 50 and RMB 100 denominations became widely accepted for settling cash transactions throughout Hong Kong. Renminbi-based transactions in Hong Kong subsequently exploded after the offshore market was formally established in July 2010 and Renminbi deposits exceeded 10% of total Hong Kong deposits in 2011 before settling back. An obvious advantage over Hong Kong holdings of dollars and euros is the scope for investing such offshore Renminbi holdings back into the mainland [24]. The growth in this market encouraged imitation further offshore and Renminbi-clearing banks have been approved in both Singapore and Taiwan. Taiwan first allowed domestic banks to undertake Renminbi transactions in February 2013 and six companies had already issued RMB 3.9 billion in bonds by November 2013 [25].

Increased Renminbi circulation in Hong Kong and Macau could well help to boost regional trade and foster the integration of 'Greater China.' Until July 2005, the Hong Kong dollar and the Renminbi were effectively linked via each currency's fixed exchange rate with the U.S. dollar. With the Hong Kong monetary authorities still committed to exchanging local currency for U.S. dollars at a fixed rate upon demand (under its 'currency board' arrangement), Hong Kong currency issues remain fully backed by U.S. dollar holdings and holders can withdraw their funds as U.S. dollars at any time. The post-2005 appreciation of the Renminbi against the dollar led to accompanying appreciation against the Hong Kong dollar, though. The de-linking of the Hong Kong dollar and the Renminbi only adds to the potential benefits of adopting a common currency by taking the exchange rate fluctuations of the post-2005 period out of the mix.

Although some economists argue that lack of coordination of business cycles between mainland China and Hong Kong could be a potential pitfall, integration seems certain to only increase going forward and this is likely to increase synchronization. Additional impetus stems from the 2004 'Closer Economic Partnership Arrangement' between mainland China and Hong Kong, which offers zero tariffs on goods going in both directions as well as lower entry barriers for banking institutions and other service sectors. Indeed, with the Chinese authorities already having begun the process of expanding Renminbi usage in Hong Kong, continued, albeit gradual, advancement seems inevitable. Based on trade linkages and general economic interdependence between mainland China and Taiwan, a case could even be made on economic grounds for a currency union extending to Taiwan rather than just Hong Kong and mainland China [26].

Renminbi Convertibility and the Shanghai Free-Trade Zone

A potentially major step towards the opening up of China's capital account was the establishment of a free-trade zone in Shanghai in September 2013. This zone covers a total of 28.78 square kilometers and allows foreign investment essentially free access to 18 service industries operating in the region. It is particularly significant that the Chinese authorities see this as a way to explore and establish an administrative system that replaces the rigidities of the old pre-approval process with a more western-type regulatory system free of preset barriers to foreign access [27]. This follows the May 6, 2013 decision by the Standing Committee of the State Council to prepare a concrete plan to advance the liberalization of capital transactions, with the short-term target being to relax regulation on inward direct investment while also encouraging more outward investment [28]. The Shanghai free-trade zone may well prove to be merely the first step towards putting this plan into effect and moving toward more widespread adaptation of such pilot programs.

The first full month of operation of the free-trade zone in October 2013 saw an overall increase in reported cross-border transactions of RMB 89.90 billion, led by China Construction Bank with RMB 13.787 billion that month, closely followed by Industrial and Commercial Bank of China with RMB 13.199 billion and Bank of China with RMB 13.166 billion [29]. Although these three large state-owned Chinese commercial banks conducted the most business overall, the free-trade zone has clearly fostered increased foreign participation in Shanghai cross-border trade. As shown in Table 1, the biggest increases seen after

1. Société Général (France)
2. Hang Seng Bank (Hong Kong)
3. Korea Exchange Bank (Korea)
4. KBC Group (Belgium)
5. First Bank (Taiwan)
6. China Zheshang Bank (China)
7. Rabobank (Netherlands)
8. Unicredit Group (Italy)
9. Shinhan Bank (China)
10. Huaxia Bank (China)

Note: Rankings derived from the first full month of operation of the free-trade zone in October 2013. Source: People's Bank of China, Shanghai [29].

Table 1: Banks with biggest increases in reported cross-border transactions after the opening of the Shanghai free-trade zone.

[4]See Chambers [31].

the free-trade zone's launch applied to banks based outside mainland China. The top gainer was Société Général from France, followed by Hong Kong's Hang Seng Bank and the Korea Exchange Bank. Rounding out the top ten were banks from Belgium, Italy, the Netherlands and Taiwan as well as three smaller mainland Chinese institutions.

Conclusions

Although continued Renminbi penetration in Hong Kong, and its eventual dominance there, seems assured, the future role that the Renminbi will play in Asia as a whole remains much less clear. The Renminbi is certainly not yet ready to be the centrepiece of any broader common currency arrangements in Asia, even assuming other economies were willing to accept it. The absence of any other obvious contender within the region suggests that it would almost have to play an integral part in any future regional monetary standard, however. Meanwhile, rising Renminbi usage as a vehicle currency outside mainland China-Hong Kong, as well as continued slow but steady capital account liberalization, should help pave the way for the much larger future role it seems destined to achieve. It has already broken in to the top ten currencies in terms of its usage in global payments worldwide and overtook 22 other currencies between 2010 and 2013. Meanwhile, more and more offshore markets allow for Renminbi-based bond issuance as well as currency trading. A series of currency swap arrangements have been entered into, beginning with Russia in 2010, but since extending beyond the BRIC nations to such advanced economies as Japan and the United Kingdom. London has, in fact, quickly become second only to Hong Kong as an offshore Renminbi trading centre.

Future Prospects on the World Stage

The accelerating internationalisation of the Renminbi since the outbreak of the global financial crisis has been influenced by policy liberalisation and new steps such as the 2010 establishment of the offshore Renminbi currency market in Hong Kong and the 2013 Shanghai free-trade zone. Greater outside interest in the Renminbi is reflected in the growing number of bilateral arrangements providing for currency exchange and trade settlement in Renminbi as well as the eagerness of foreign multinational corporations to raise funds in Renminbi and transact business in Renminbi. At the same time, the appeal of the dollar has been blunted by the enormous rates of dollar emission since 2008 – while the euro has gone from serious competitor to suddenly facing serious doubts as to its very existence going forward. Indeed, the rapid growth in worldwide Renminbi usage between 2010 and 2013 contrasts sharply with the approximate 6% drop in euro usage over that same time period. While there is no imminent prospect of the greenback being replaced by a new 'redback' standard, eventual Renminbi ascendancy remains a very real possibility even though the pace of the movement remains as unpredictable as ever.

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