

## Why China's Currency Won't Replace The Dollar Anytime Soon

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“How much is that in renminbi?” is a question that could increasingly arise in future international transactions. At least that's what China's recent moves appear to target. Standard & Poor's Ratings Services believes that an increased awareness of foreign exchange risks among China's policymakers is one reason for Beijing's push to internationalize the country's currency. Despite the greater political willingness in China to see it through, major obstacles stand in the way of widespread international use of the currency. Although global economies are adjusting themselves to a “new normal” for trade and money markets, we believe the renminbi is unlikely to feature prominently as a currency for international exchange for a considerable time.

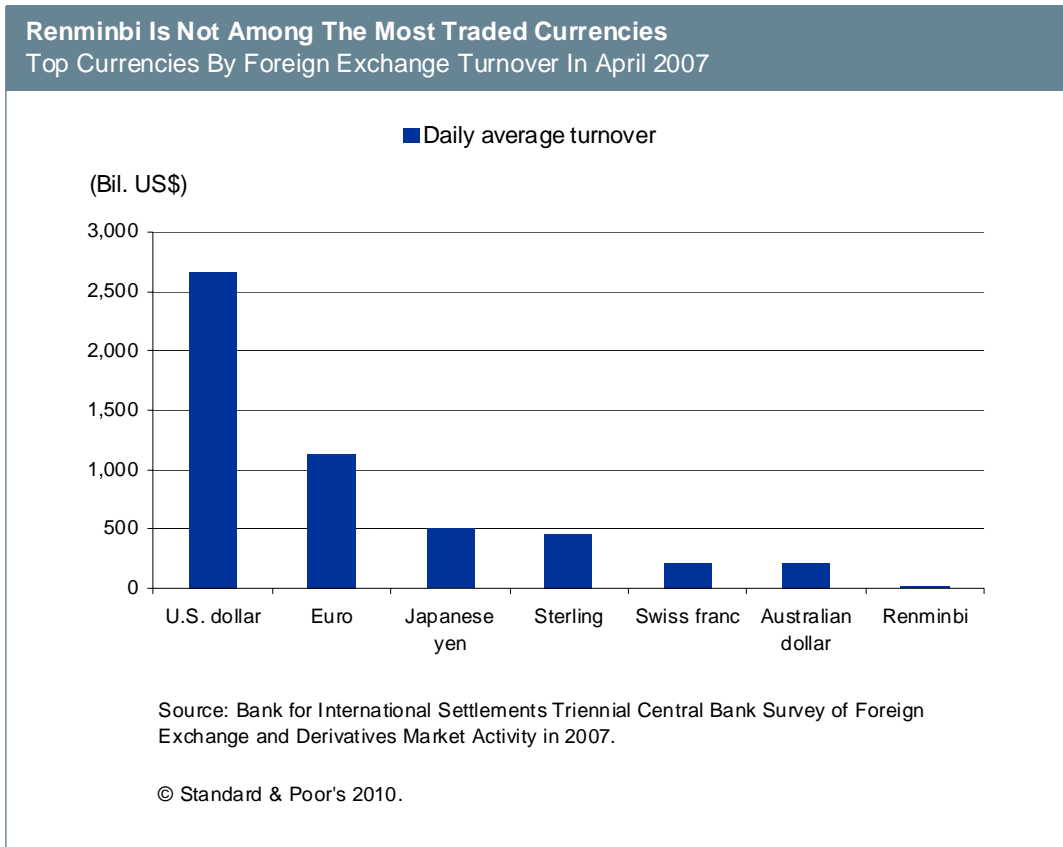
### ***A Conscious Effort To Keep The Renminbi Within China's Borders***

At the moment, the Chinese currency is conspicuously absent in international trade or financial transactions. Yet the International Monetary Fund forecasts that China will overtake Japan to be the world's second-largest economy in 2010. Unlike the currencies of other major economies—the U.S. dollar, the euro, or the yen—the renminbi is rarely used beyond China's borders. In fact, the currencies of several markedly smaller economies, including those of Australia, Switzerland, and the U.K., are more commonly exchanged internationally (see chart 1).

Chart 1

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China's approach to financial and monetary policies partly explains the limited international use of the renminbi. The Asian financial crisis of 1997-1998 shaped the cautious attitude of Chinese policymakers toward liberalizing the financial sector. Although the country has thrown its doors wide open to international trade and direct investment, strict capital controls ensure that its currency is used almost entirely for domestic transactions. Only a small amount of its external trade—mainly with neighbors such as Laos, Myanmar, North Korea, and Vietnam—are denominated in the Chinese currency.

### ***A Change Of Mind***

That said, the volatility in the international financial markets in the past two years has not had the impact that some would have expected. Instead of reining back further financial liberalization, China appears to be forging ahead more confidently. Since 2008, it has announced measures to deepen domestic bond market developments, such as easing restrictions on the sale of papers in the interbank market and possibly allowing foreign companies to sell renminbi bonds, and to ease cross-border financial investments. In our view, these moves are likely to be at least partly related to the push to expand the international role of the Chinese currency.

The Chinese government has recently made serious moves toward internationalizing the renminbi, several years after the idea first came under public discussion. Since late 2008, the People's Bank of China has signed bilateral currency swap agreements with other central banks in countries that include Argentina, Belarus, Indonesia, Malaysia, and South Korea. In some cases, China's counterparties wanted these agreements in order to ease the impact of the international liquidity crunch in 2008-2009.

But the facilities could also provide renminbi for use in bilateral trade in these countries. In April 2009, the Chinese government announced that it would allow renminbi settlement for specific cross-border trading activities in five coastal cities on a pilot basis.

China has also broadened its experiment to build a renminbi financial system in Hong Kong. As part of the pilot trial of cross-border trade settlement, banks in Hong Kong have been allowed to expand their renminbi commercial banking activities to facilitate trade settlement. The Chinese government has also expanded the list of institutions allowed to issue renminbi bonds in Hong Kong to include the mainland subsidiaries of Hong Kong banks. Previously, only mainland banks were allowed this fund-raising option. In September 2009, the Chinese government itself sold renminbi bonds in Hong Kong for the first time.

### ***The Benefits And Costs Of An International Renminbi***

The impetus for China's decision to begin the process of renminbi internationalization despite the severe global financial volatility, in our opinion, was increased concerns over exchange rate risks. A number of governments that issue internationally used currencies are projecting sharply higher debt levels in the next few years. The risk that large currency depreciations or high inflation in these countries could erode Chinese holdings of foreign currency assets has risen as a result. In our view, reducing the foreign exchange exposure of the Chinese economy by increasing the use of the renminbi could limit the risks for Chinese traders, investors, and financial institutions.

Internationalizing the Chinese currency could bring other benefits to the country. Renminbi-denominated financial instruments that non-residents issue would provide Chinese savers with a greater variety of investment options while addressing the risks of currency fluctuations. Chinese bond issuers may also benefit from having access to a more diverse international investor base. The costs of financing the country's foreign exchange reserves could also decline in the long term. As more traders use the renminbi and more investors hold the currency on a long-term basis, an increasing share of the money supply will circulate outside the Chinese economy. The renminbi money supply could grow significantly more than Chinese GDP with less risk of excess liquidity sparking high inflation. This means a lower level of central bank bill issuance (and lower interest costs) for "sterilization" purposes—i.e. excess money market liquidity created by its foreign exchange interventions—at a given level of foreign exchange.

The flip side is a weakening of control over domestic monetary conditions. Internationalizing the renminbi means China would have to significantly ease capital controls, in our opinion. With a large pool of renminbi funds abroad, changes in domestic or international market conditions would likely cause strong capital flows. The result could markedly reduce the effectiveness of Chinese monetary or credit policy actions. China's current interest rate controls, for instance, would weaken to some extent if foreign holders of renminbi are willing to lend at a different rate from the policy rates. Setting macroeconomic policy in the country would become an even more complex task, in our view.

### ***Internationalization Is A long And Difficult Process***

Even if China believes that the benefits of currency internationalization outweigh the costs, major hurdles lie ahead. The most important of these is that the renminbi remains non-convertible and subject to strict capital controls. The Chinese market will always be the largest and most liquid market for renminbi funds. If non-residents cannot easily buy and sell the currency and if non-resident financial

flows are strictly regulated, the costs and liquidity risks of holding the renminbi would likely deter widespread international use.

China's developing financial markets are largely inaccessible to non-residents, a further impediment to internationalizing the currency. An internationalized renminbi requires non-residents to be willing to hold a large amount of the currency. If they are unable to invest these funds in liquid and relatively safe instruments that offer a reasonable rate of return, non-residents are unlikely to hold the currency. Financial derivative markets in China are also insufficiently developed for efficient and cheap hedging against foreign exchange and interest rate risks.

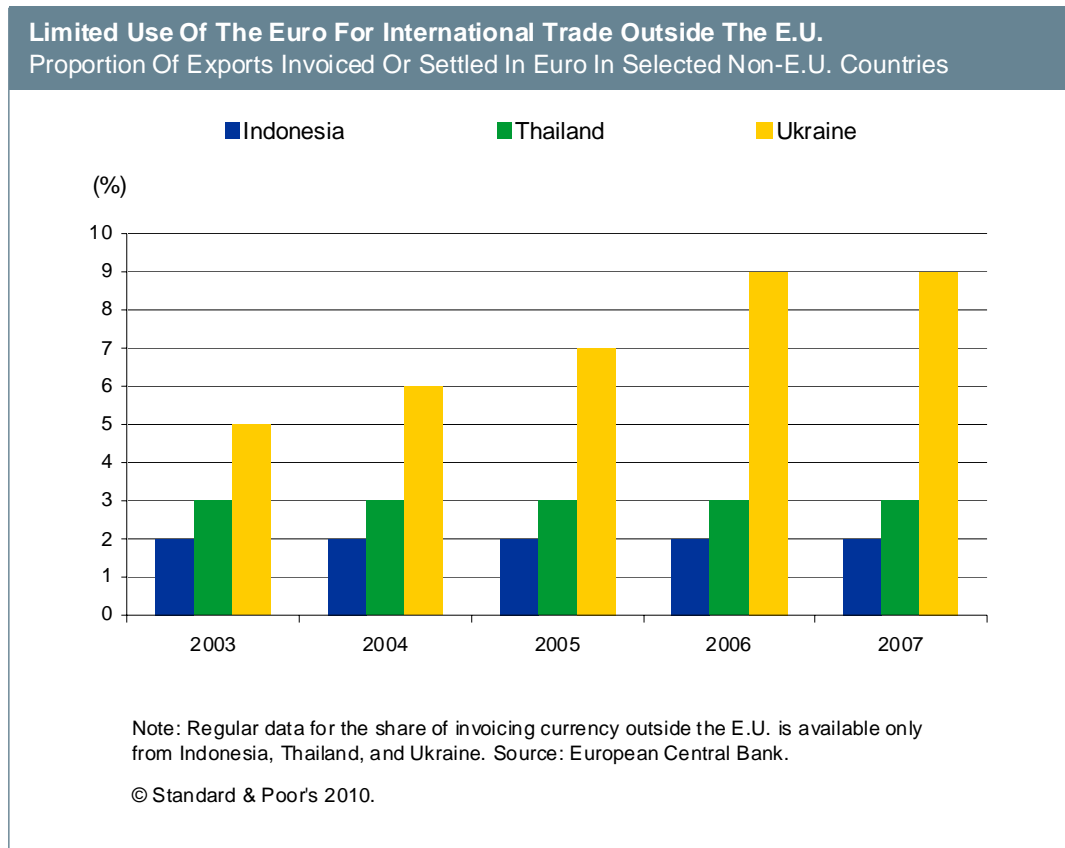
Another issue is that many people consider the policy environment in China to be opaque and difficult to predict. International investors and traders would likely be concerned about abrupt changes that affect their interests for some time to come despite ongoing policy environment improvements. We expect this to be another factor that will deter non-residents from long-term holdings of the currency. Until these conditions improve significantly, in our view, large-scale international use of the Chinese currency won't become a reality.

The experiences of the euro and Japanese yen portend a challenging time for renminbi internationalization. Conditions were in many ways much more favorable at the birth of the euro about a decade ago for that currency to play a big international role:

- The Eurozone's combined economic output was comparable to that of the U.S.
- The predecessor currencies of the euro were in widespread international use.
- Major financial markets in the Eurozone are well developed, relatively deep, and highly accessible to international investors.
- Important policies in the currency union are made within codified frameworks and are, therefore, predictable and transparent.

Yet, while the euro has strengthened its position as a key international currency in the past 10 years, it remains a distant second to the greenback. Within the European Union, the euro has become the currency of choice for cross-border trade and financing. Outside of the European Union, however, the use of the euro has either shown only small gains or even declines in the eight years to the end of 2007. The use of the euro as an invoicing currency for merchandise trade, for instance, accounted for less than 10% of international trade outside Europe (see chart 2).

Chart 2



Similarly, Japan's efforts to internationalize the yen from the 1980s to early 2000s had little lasting impact on the currency's international use. Despite significant liberalization of regulations on the financial sector and capital accounts, the yen's share of cross-border merchandise and financial transactions has remained little changed over the period. Academic studies (1) suggest that factors such as network effects, history, and inertia affect the choice of an international currency much more than government policies. Some also suggest that the prolonged economic weakness in Japan contributed to the lack of progress in internationalizing the yen.

### ***Widespread Usage Will Take Time***

China's strong economic potential and the very limited international use of the renminbi today suggest to us that its internationalization efforts will be more successful than that of the Japanese yen. However, we do not expect international use of the Chinese currency to exceed that of the yen in the coming decade. As with other changes in China, we believe that policymakers will gradually make the requisite changes to facilitate cross-border renminbi use. International confidence in the predictability and transparency of Chinese policies will also take time to build. Thus, the day when traders need to quote renminbi prices for a significant part of their sales and purchases, especially outside East Asia, still appears a long way off.

***Related Research***

Fukuda, Shin-ichi and Masanori Ono, 2006, "On the Determinants of Exporters' Currency Pricing: History vs. Expectations," *Journal of the Japanese and International Economies*, Vol. 20, 548-568.

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