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The puzzling project of RMB internationalization and its consequences for Europe

Li Kechiang's recent visit to Hong Kong gave the city another batch of measures to further internationalizionalize the use of the RMB. Hong Kong was delighted to see its role reinforced as the premier financial center for off-shore RMB business.

So far the internationalization of the RMB can be considered a success when looking at the rapid growth of RMB settlement related deposits, not to talk about the "dim sum" bond market. This success has to be confronted with the difficulty of the project itself. In fact, whatever relates to changing the way the international architecture works can be considered a bold project but the Chinese one is probably bolder. This is because of the uniqueness in the process of RMB going global. In fact, the internationalization of other international currencies such as the US Dollar, British Pound and Japanese Yen, evolved from the on-shore market and not so much on the off-shore one as China. China has had to take an apparently more difficult venue for a very simple reason: the RMB is not yet a convertible currency. One very important thing in China's favor though is that it can count on Hong Kong as a large and liquid financial center, which has a different currency as legal tender, the USD.

Centering on this uniqueness of RMB internationalization, there is a set of interesting questions which merit further analysis including: First, Why does China want to internationalize the RMB now?; second, will it be successful?; and last, what implications should the rest of the world draw from this forthcoming process of RMB internationalization?. Thinking about these questions should not only help understand China's project for RMB internationalization but also shed light on how to overcome the barriers ahead..

Timing of internationalization the RMB

China's economic size has been increasing at a rate unheard of in recent economic history. The most recent steps of that success story have actually coincided with a deep and long economic crisis in the developed world. Such combination, together with the growing lack of confidence in the major currencies in the world, points to a great window of opportunity for a new currency to jump to the global arena. Indeed, the economic influence of China, to a certain degree, has been significantly strengthened recently as the major advanced economies were seriously hit and has yet been inflicted by the sweeping global crisis. Against such a backdrop, the attractiveness of the RMB as an international currency has been increased. After China readopted a more flexible exchange rate regime in June 2010, the expectation of RMB appreciation has been shored up, which has further lured strong capital inflow into China. In view of it, many people argue that China should internationalize its currency to further complement its growing economic influence.

However, looking into the arguments above, the question of timing still remains. With strong capital inflows fueled by the expectations of RMB appreciation, China should take measures to encourage capital outflow rather than inflows but the way in which the project of RMB internationalization is being carried out does exactly the opposite. In fact, most of the off-shore use of RMB is concentrated on Chinese imports and not exports (80% versus 20% of total RMB denominated trade) and on inward FDI instead of outward FDI from China. In other words, RMB internationalization is actually encouraging more capital inflows than outflows. Although China's growth is slowing down, the authorities are still worried about capital inflows and, possibly, a too rapid exchange rate appreciation.

To my mind there are at least two possible reasons which may explain why the authorities have begun to promote RMB internationalization. The first one is that the major advanced economies with international currencies including US, Europe and Japan are as weak as ever due to the long lasting infliction of the global financial crisis. This situation provides a window of opportunity for RMB to enhance its position and gain a foothold in Asia.

The second and more important one is that China has an enormous and ever-growing exposure to foreign currencies, especially for US dollar. China has been registered "twin surpluses" under current account and capital account since 1998. Through the trade surplus, FDI and equity inflow, China has accrued a gigantic stock of foreign reserves of more than USD 3 trillion, equivalent to 50.2% of GDP. Although the gigantic foreign reserves, also the foreign asset held by China, can act as a safety vault in the event of crisis, too much of a good thing also poses serious challenges: reserves are costly to hold, and they need to be managed carefully to avoid losses. In fact, as far as China continues its fast economic growth, RMB will have a tendency to appreciate relative to the currencies it holds in foreign reserve, which will inevitably lead to valuation losses.

Other than eliminating the sources of accumulation of reserves (namely surpluses in the balance of payments), China can reduce such exchange-rate related losses by denominated part of its net foreign assets in RMB. In other words, China can renminbize (using the word coined by Cheung, Ma and McCauley) part of its huge amount of foreign assets. The question, then, is by how much.

Taking Japan as a benchmark (the US would not be a good one since its currency is at a much higher level of internationalization), it is estimated that about 12% of holding s of Japanese debt securities are denominated in Yen. In this sense, China still has a long way to cover since it just begins from scratch.

Will it be successful?

There is no doubt that China has the economic and financial muscles for the RMB to become an international currency or, at least, an important regional currency in Asia. The key question is whether the process of RMB internationalization can proceed smoothly as the authorities desire.

In this regard, the strategy chosen, namely starting with the off-shore market, is very dependent on appreciation expectations of RMB because of inherently speculative motive of participants in off-shore centers. In fact, a sudden change in the expectations of RMB appreciation may bring volatility to this new market. Were the RMB denominated deposits started to be withdrawn (or converted into another currency), Hong Kong institutions could face liquidity issues given the still limited development of the RMB money market and the limited size of the Hong Kong swap line with the PBoC. RMB bond issuance could also slow down substantially as the demand for such bonds would clearly be less without such currency appreciation.

It seems, therefore clear, that the onshore RMB market needs to be developed side by side with the off-shore one. One simple way to do tht would be for non-residents could be allowed to borrow in RMB in China's capital markets. This would be a continuation of the panda bond program but it could also include IPOs of foreign companies in Shanghai stock market.

Such wider use of the RMB for private purposes should also allow to create more liquid derivatives markets in RMB, an important pre-condition for the RMB to have an official use in its internationalization process (i.e., be held in the central bank reserves and pegged to by other countries). In fact, we could have countries such as Singapore officially announcing the inclusion of the RMB in the group of currencies to which it pegs the exchange rate peg (Singapore may be doing this already but announcing that the currency composition of the peg includes the RMB would indeed be an important signaling device for other countries looking for strong currencies to peg in the midst of the worst western crisis in decades. A more futuristic, but still plausible, possibility would be for the Hong Kong Monetary Authority moving to peg a basket which would include the RMB other than the dollar.

Implications for Europe

Europe should carefully follow the RMB internationalization process for at least two reasons. First, having an international currency in a country as important as China could bring back the discussion of whether Asia is close enough to an optimal currency area and, thus, can explore stronger monetary cooperation and eventually a single currency.
Although familiar to the European reality, such idea seems highly unlikely in Asia. This is not only because of the very bad press that the European project has had during the past few years but also because Asia is very far behind from an ideological point of view

Second, and much more relevant, is how RMB internationalization will impact Europe and, in particular the euro. The first possible outcome, positive for Europe, would be the valuation gains that Europe could obtain from diversifying its foreign assets away from the USD into RMB ones. The second one would, however, be much more negative. The same diversification pattern away from Western currencies (not only USD) should reduce the demand for euro assets when the Euro area most need such demand.

In sum, it is still early to know how the process of RMB internationalization will end up but it does look promising. To my mind, the two most urgent issues that the Chinese authorities need to tackle is how to disentangle the internationalization process with the entry of capital inflows and how to make the process more generalized and potentially less volatile by developing the onshore market as well. Finally, Europe should look at the process very attentively to reap all the benefits while limiting the risk o a lack of interest in the euro.

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