The COVID-19 crisis has sharpened the debate between China and the United States over future leadership of the global order that has been dominated by the US since the end of the Second World War. Global Asia looks at China’s vision for a world order that could displace that of the US.

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The Economics and Politics of China’s Currency Internationalization

By Di Dongsheng

Chinese policymakers have long talked of the importance of creating a greater role for the Chinese currency in the US dollar-dominated international financial system.

The government in Beijing has taken steps in that direction, but the obstacles loom large. Di Dongsheng lays out what it will take for China to realize that goal and what it could mean for China’s influence in the world.

THE STARTING POINT for the internationalization of the Chinese currency, the renminbi (RMB), can be traced back to the global financial crisis in 2008, or even earlier, due to what is perceived as the unfairness, irresponsibility and asymmetric distribution of costs among nations showcased in policy responses to the financial crisis. That crisis began with the misconduct of Wall Street, which created the bubble in the US real-estate market. The debacle was also a consequence of failure by the US public sector to supervise the financial markets and contain the formation of bubbles in the first place.

Kidnapped by such factors as political lobbying, personal connections and the idea in the financial sector that some institutions were “too big to fail,” US policymakers bailed out most of the troublemakers through a surge in federal debt and a five-fold expansion in the US Federal Reserve’s balance sheet in the name of quantitative easing (QE). Even more galling, none of the leaders of the financial groups responsible was held accountable. Since the US dollar is a global reserve currency, all savers around the world bore a large portion of the losses in relative purchasing power caused by the overprinting of dollars. In the face of such a drama, Zhou Xiaochuan, former governor of the People’s Bank of China, proposed in an influential article that the RMB should go international. From then on, China’s role began to change from a supporter of US dollar hegemony to a rebel against it.

After 12 years, we are now experiencing another global economic and financial crisis. The origins of the two are different, but the solution is the same. Starting from late September 2019, even before the Covid-19 pandemic broke out, the Fed’s balance sheet rapidly expanded from US$3.72 trillion to US$4.2 trillion. Following the pandemic outbreak, it ballooned further to US$7 trillion within three months. The unique status of the US dollar endows American society with an exorbitant privilege known as “seigniorage,” which means that the US can draw wealth directly from savers across the world. The internationalization of the RMB has grown from almost zero under these circumstances, with progress having been made through a series of steps.

As a weighted average index published by the International Monetary Institute of the Renmin University of China, the currency internationalization index measures the share of major currencies in the international payment market. As shown in Figure 1 above, the US dollar occupies a dominant position, followed by the euro. The pound sterling and the yen belong to the third level. After 10 years of effort, the RMB is finally approaching the share of the pound and the yen. Compared with the US dollar, the share of the RMB still seems insignificant. Interestingly, the increase in the RMB’s share is not at the expense of a decrease in the share of the US dollar. Considering the fact that the other several hundred currencies take only a few percentage in total, however, the achievement the RMB has made in just 10 years should not be regarded as a failure.
INTERNATIONALIZING THE RMB

In order to advance the internationalization of the RMB, the Chinese government, especially its central bank, has implemented a series of reforms that have loosened the artificial restrictions on the cross-border use of the RMB. For instance, exporters are allowed to increasingly use RMB in pricing and settlement; companies are allowed to use the RMB in cross-border direct investment; foreign governments and mainstream international financial institutions are allowed to purchase and hold Chinese government bonds; and the exchange rate of the RMB is allowed to float more widely than before on a daily basis. Increasingly, more capital account funds can enter and exit freely. In addition, interest rates can be determined more by the supply and demand in the market, and foreigners are allowed to invest in China’s stock and bond markets, although with quota restrictions.

The internationalization of the RMB is benefiting directly from initiatives taken by the Chinese government. For example, through successful economic diplomacy, the RMB is included in the International Monetary Fund’s basket of Special Drawing Rights (SDR). Under the Chinese Foreign Exchange Trade System (CFETS) index — part of the central bank — the government aims to provide up-to-date information on the RMB through market infrastructure, such as CIPS I and CIPS II, two phases of the cross-border payment system. The People’s Bank of China is working on the development of its digital currency (DCEP) based on blockchain technology, which can bypass the US-supervised SWIFT system when necessary. Furthermore, China has established the Deposit Insurance System and Macro-Prudential Framework to ensure that the central bank can promptly respond to fluctuations and crises in a more market-oriented manner. The government has also developed several commodity exchanges and futures markets, with the formation of a crude oil-RMB-gold triangle. Since then, natural-resource exporting economies have been able to sell their products on the futures market in Shanghai to get RMB to invest in Chinese domestic financial markets or, if they want, to buy and ship gold from another market in Shanghai to their own country. The US dollar is no longer an indispensable bridge in the transaction process.

In addition, the commercial moves by several domestic and foreign business entities have also had a significant impact on the RMB’s internationalization. For example, when third-party payment systems such as WeChat and Alipay expand to Europe and other regions, overseas Chinese and tourists can more easily use the RMB. What is more, some international institutions, such as Reuters and Morgan Stanley, have included Chinese financial asset prices into their emerging market stock and bond indexes and are gradually raising the weight of such assets. In sum, the market’s profit-seeking behavior of these market players has facilitated the RMB’s internationalization.

WHERE TO NEXT?

There are fierce public debates on the strategy and path of internationalization for the RMB. Officials of the PBOC and scholars from Renmin University generally tend to support the internationalization of the RMB and the progressive liberalization of the capital account. In contrast, scholars from the Chinese Academy of Social Sciences and Peking University tend to oppose or be skeptical of RMB internationalization. A major debate between the two sides took place in 2012-2014, with the controversy centering on the following questions: First, would the benefits of the

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RMB’s internationalization be commensurate with the costs and risks? Second, should traditional capital controls be replaced by a more market-oriented and macro-prudential framework in dealing with potential risks? And third, is the motivation coming from the overall interest of the country, or from lobbying by financial institutions, or even from personal ambition?

Memories of the Latin American debt crisis in the 1980s and the Asian financial crisis in the late 1990s have had a significant influence on the doubters. However, members of the International Monetary Institute (IMI), including myself, and officials from the PBOC, believe that since China has gone through the industrialization period and become the world’s largest exporter, the cases of Mexico and Argentina in the 1980s or Thailand and Indonesia in the 1990s are no longer proper references. While skeptics of RMB internationalization are worried about risks, the promoters believe that the most significant risk lies in not taking any risk. As the world’s second largest economy with a diversified industrial base, if China takes moderate risks, the benefits would cost effective. On the other hand, the doubters maintain that many reforms should be completed prior to the internationalization of the RMB and the opening of the capital account. In response, advocates of internationalization insist that such prioritizing only exists in textbooks and classrooms, because without outside pressure, nobody would like to risk reforms and uncertainties; the strategy “to propel reform by opening up” is always pragmatic and efficient. While the doubters believe that fluctuations in the exchange rate would cause the manufacturing sector to suffer huge losses, the scholars who advocate internationalization maintain that China’s industry is undergoing transformation and upgrading and the sectors with low-profit margins account for only a small proportion of exports. As a result, if fluctuations in exchange rates were artificially eliminated to maintain a climate of fragile survival for certain domestic players, the risks and costs would be finally amassed in the hands of the government, potentially leading to a more significant loss of social welfare. Pessimists are more likely to appear to be correct, while optimists, in fact, become more successful. The simultaneous fall in the Chinese stock market and the RMB exchange rate during 2015-2016 seemed to endorse the correctness of the doubters, because since then, the RMB internationalization index experienced stagnation,
and did not reach a new high until three years later. But 2016 witnessed an apparent change in the path of RMB internationalization. Before 2016, the RMB’s path was similar to that of the yen in the 1980s: to increase the local currency’s share in international trade settlement and to use the Hong Kong financial market as an offshore yen market. In this way, Japan quickly promoted the internationalization of the yen and, by the mid-1990s, the yen’s global share had reached its peak at 10 percent of the global currency market, but also led to the emergence of financial bubbles in Japan’s asset markets, as it encouraged active exchange-rate and interest arbitrage between offshore and onshore markets. After the bubbles burst in 1992, Japan’s economy fell into a prolonged downturn, and the yen’s international share fell to about 4 percent.

In 2015, the dramatic fluctuation of the RMB exchange rate in the Hong Kong offshore market led to a high expectation of RMB depreciation, which attracted many US and European hedge funds to go to Hong Kong to short the RMB. The Chinese government then had to drastically raise the overnight borrowing costs of the RMB to curb the speculative wave, which it barely succeeded in doing. Since then, the scale of RMB deposits in the Hong Kong offshore market has remarkably shrunk. Consequently, China is aware of the lessons and shortcomings of the Japanese model. After 2016, the internationalization model of the RMB was changed into a multi-pronged mixed model, including commodity exchange denomination, RMB foreign direct investment (FDI), the availability of the Chinese debt market to foreign investors, the construction of the Shanghai financial center and the relaxation of access by foreign banks and brokers to Chinese financial markets.

If the process of the RMB’s internationalization before 2016 was a rush and a surge, it has been followed by a stable and steady road.

THE OBSTACLES AHEAD

To become one of the world’s mainstream currencies, the RMB faces a series of difficulties.

First, China will inevitably have to give up its double surplus in both the capital account and the trade account for the balance of payments. If a country wants to become an issuer of an international reserve currency, it must export its currency abroad through some forms of deficits, e.g., through foreign investment and credit (like the Eurozone) or through a continuous rise in the trade deficit (like the US). The former (the Eurozone pattern) means that China’s annual FDI should reach more than US$200 billion, so as to export RMB meaningfully. If so, it would be a big challenge to protect its trillions of dollars of global assets without meddling in other countries’ internal affairs. If the latter approach (the US one) is adopted, China would experience long-term deindustrialization, similar to the road the US took after the Second World War, which seems unacceptable in light of China’s domestic politics.

Second, being an international mainstream reserve currency means a significant appreciation of the RMB and highly volatile exchange rates, both of which could put China’s labor-intensive and low-profit-margin industries out of business. Clearly, it entails time and political will to go through such a big adjustment.

Another obstacle lies in the perception of decision-makers on monetary and financial issues. The internationalization of the RMB requires further (though not complete) liberalization of the capital account. But sudden inflows of capital are likely to result in a substantial decrease in foreign exchange reserves or a dramatic appreciation of the RMB, or vice versa. Compared with the macro- and long-term benefits, are these risks and short-term costs worth bearing? Decision-makers are required to comprehensively and accurately weigh these factors. This is a real challenge, given the economic knowledge demonstrated by the leaders of most countries in the world.

Last but not least, as a newcomer in the field of international currencies, the RMB is subject to headwinds from the international monetary market, given the network characteristics of currencies. The marginal cost of the international monetary system can be zero or even negative. Take a businessman engaged in Sino-Russian trade as an example: he will find that, if the first exchanges rubles into US dollars and then into RMB, the total cost will be significantly lower than directly exchanging rubles into RMB. This counterintuitive phenomenon occurs because the US dollar is the hub of the global monetary market and, therefore, the volume of transactions between rubles and dollars or between the RMB and dollars is much larger than that between rubles and the RMB. Because the transaction activity and the transaction costs are highly interrelated and inversely proportional, more trades with a currency means lower transaction costs. As a result, the status of the currency with the largest share is hard for challengers to dislodge, even if the challengers’ real economy is stronger and larger than that of the existing reserve currency, not to mention weaker challengers. For instance, the size of the US economy surpassed that of the UK at the end of the 19th century; nevertheless, it was not until the 1960s that the global share of the US dollar had exceeded that of the pound sterling.

THE GLOBAL CURRENCY POLITICS OF RMB INTERNATIONALIZATION

Further internationalization of the RMB may lead to more intensified competition and hostility between China and the US. When Chinese policymakers conceived and promoted the reforms related to the internationalization of the RMB in the past, they took a cautious attitude toward the US response. Before 2015, the author of this paper had interviewed think-tank experts and government officials from the US on the issue of the RMB’s internationalization; the feedback was not positive. The main reasons given were that the RMB was issued by a government that lacked the rule of law, freedom and democracy — meaning that the RMB would find it difficult to gain the trust of capital markets and savers. But at the same time, they expressed some interest in seeing China attempt to internationalize its currency. In their opinion, it would be impossible for China to implement its previous mercantilist policies if the RMB went global.

However, since 2016, China-US relations have entered a clear downward trend. China initially held US public- and private-sector debt as reserves. But now China is gradually reducing its holding of US debt and starting to issue Chinese national debt to compete with the US for other international savers. Such a change might not have been made overnight, but the outbreak of the Covid-19 pandemic has dramatically shortened the transition time. In March and April 2020, the Trump administration called on China to take responsibility and pay the US for the costs of the pandemic — some US politicians and media even declared that the US should confiscate China’s foreign-exchange reserves. Moreover, the US government quickly expanded its fiscal deficit by US$2 trillion within a month, while the Fed’s balance sheet expanded from US$4.2 trillion to US$6 trillion over the same period through the purchase of new federal debt. From the perspective of China as a reserve country, the US government and the Fed are abusing the dollar’s privileged status to subsidize US financial institutions, local governments and ordinary families. The printing of dollars can be regarded as a soft default, and the possible confiscation of China’s foreign-exchange reserves as a hard one, both exacerbating the call for “de-dollarization” in China.
LOOK OUT, EURO
There is a possibility of complementarity between the Belt and Road Initiative and the internationalization of the RMB. China has trade deficits with some countries along the Belt and Road, and most countries are not eligible to participate in the US Fed’s currency swap program, meaning they have been deeply hurt by the alternating dollar tides and shortages. The RMB’s internationalization will provide excellent international liquidity support for their financial and monetary stability. A series of new international financial institutions endorsed by China will provide support both for the Belt and Road Initiative and RMB internationalization, such as the Silk Road Fund, the Asian Infrastructure Investment Bank, the New Development Bank and the BRICS forex reserve pool. Compared with their US and European counterparts, Chinese multinational companies are more able to take risks and are willing to enter the underdeveloped regions along the Belt and Road. Besides, the prices of industrial and high-tech products are more affordable for poor countries. With the further opening of the RMB capital account, the RMB digital currency together with electronic payment tools such as WeChat and Alipay will spread into all corners along the Belt and Road and provide financial services to billions of people who still have no bank accounts, while China’s traditional companies and technology giants will restructure the financial and monetary outlook of peripheral regions with RMB instead of euro or US dollar credits.

What will the global monetary system look like in 15 or 20 years if China continues on its path of internationalizing the RMB? Today, the global real economy is basically divided into three parts: the US, the EU and East Asia, each accounting for one-quarter of the global economy, while the rest of the world accounts for the last quarter. Many scholars believe that the global monetary system should present a similar ternary pattern consisting of the US dollar, the euro and the RMB. Nevertheless, considering the winner-takes-all feature of currency markets, such a ternary pattern is neither stable nor reasonable. The rise of the RMB share in the global currency market is likely to take place at the expense of the share lost by the yen, the pound and the euro. This research estimates that the RMB internationalization index will go up to around 15-25 percent by 2035 if the Chinese government makes the RMB’s internationalization a policy priority and the Chinese economy continues its current growth. By then, the partial or even entire euro share will be replaced by the RMB, because the RMB’s advantage over the euro is clear: with a single treasury and bond market behind the RMB, it can provide global investors with a huge pool of assets, second only to the US treasury. Besides, China is now overtaking the eurozone in terms of economic size. Compared with the US dollar, however, the RMB lacks support from either a global military hegemony or a system of political allies. More importantly, China is less willing to accept a continuously widening trade deficit and a more virtualized economy. After all, the financial sector has far less political influence in Communist Party-led China than Wall Street enjoys in American politics.

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