

**RMB's Internationalization: the Origins and the New Round**

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## **RMB's Internationalization: the Origins and the New Round**

The internationalization of the RMB (RMB) was a pivotal event in the contemporary history of the foreign exchange markets on a global level. In 2009, after the global financial crisis, the RMB joined major currencies available for trading on the international markets, initially beginning trading activities between domestic Chinese cities and the likes of Hong Kong and Macau. It was a few years before the RMB become one of the world's most traded international currencies. These events came in the backdrop of an increasingly influential Chinese economy on the global stage, with the RMB maintaining an oasis of financial stability during the Asian financial crisis of 1997-1998, as opposed to China's continental neighbours. Economists Gao and Yu state in their study that a result of the internationalization of the RMB, RMB became available for transactional use as a medium of exchange, a unit of account as well as a store of value for Chinese residents and non-residents in the international markets. It could also be quoted for investments outside China, as well as for reserves and international settlements (Gao & Yu, 2011). Through the first half of the essay, me and my partner will divide the study into three parts: firstly the origins, and then the achievements during the process of the internationalization of RMB, finally the challenges and the setbacks RMB meet along the way. In the second half, we exemplify how the recent pandemic and digital currencies trend affect the internationalization of RMB, so as to conceive the potential future holds for RMB.

### **Origins of the Internationalization of the RMB**

The internationalization of the RMB was a process that had to contest with a number

of factors to ensure its success, namely the size of the Chinese economy, the confidence and sentiment around the national currency, as well as the size and depth of the financial markets. These aspects were significant issues of consideration for the Chinese government, which had proceeded to address them in the early part of the 2000s, in its attempts to emulate the previous successes of major global currencies, namely the US dollar, the Deutsche Mark and the Japanese Yen (Frankel, 2012).

In light of the Asian financial crisis in 1997-98, China sought to contribute to the reform of the global financial system, enhance financial cooperation with its regional neighbours and internationalize its native currency, the RMB. All these initiatives served to mitigate the global dominance held by the US dollar which represents the world's reserve currency within the international financial system. This also threatens Chinese dollar-denominated assets abroad, due to the continuous devaluation of the US dollar. Internationalization of the RMB became a particular goal due to the lack of momentum in terms of regional cooperation and reform of the global monetary system. Yet, China took initiative through the signings of bilateral swap arrangements (BSAs) with neighbouring countries to promote the use of regional currencies in trade and transactions. Due to China's prominent role in reforming the regional financial system, the RMB was used as the primary currency in the BSAs and also as the denominating currency for Asian bonds which were to be issued, and which came in the context of the formation of the regional bond market. China also moved to issue RMB-denominated bonds in Hong Kong, capitalizing on Hong Kong's developed financial system and market, in addition to its global outreach. It was a step towards

the promotion of Chinese bonds outside China and in the global market (Gao & Yu, 2011).

*Progress, Developments and Achievements of the RMB internationalization*

The internationalization of the RMB came about with the regional bilateral swap arrangements with regional countries in Southeast Asia as well as Belarus.

Furthermore, its use in trade settlements with neighbouring countries, in addition to Chinese deposits and bonds in Hong Kong, further underlines the internationalization of the RMB (Gao & Yu, 2011).

Moreover, benefits of the RMB internationalization included the global market presence of the Chinese currency, which became one of the most traded and liquid currencies in the world in the past decade. This was synonymous with the new reality of the RMB being increasingly used as a vehicle to settle international trade and transactions, reducing the exchange rate risk on Chinese firms. Other foreign exchange risks were reduced due to a rise in RMB-denominated assets in financial institutions (Zhang & Tao, 2016). Furthermore, funding of financial institutions was enhanced due to the ease in which these establishments can access and leverage capital for their business operations, in the process becoming more competitive and boosting the Chinese financial services sector. Importantly, the internationalization of the RMB would facilitate the preservation of the value of Chinese foreign exchange reserves, as their denomination in the RMB would protect against the alternative scenario of devaluation of other fiat currencies denominating these reserves, such as the US dollar (Gao & Yu, 2011). The increase in money supply and inflation through

printing money, lowering interest rates and quantitative easing would go a long way towards devaluing currencies and the assets denominated in these currencies.

Furthermore, Chinese monetary authorities also benefited from seigniorage payments by the outside world, which grow with an increasing role played by the RMB in trade settlements, in addition to it becoming a more stable store of value. Also, in addition to the role the RMB played in the signing of BSAs with 28 countries, amounting to a total value of CNY 3.06 trillion, the RMB crucially became a reserve currency for several important emerging market economies in the region and beyond, including the likes of Nigeria, Russia, Malaysia, Belarus, Cambodia and South Korea (Zhang & Tao, 2016).

#### *Costs and Setbacks of the RMB internationalization*

As with any major currency which had undergone internationalization, there have been costs and drawbacks to the process of the internationalization of the RMB. There is an added layer of complication with regards to the Chinese monetary policy, as its autonomy and impact are compromised. This is due to the exchange rate stability coming at the cost of monetary policy and/or free movement of capital and resources. Additionally, with the use of the RMB as a reserve currency and reference point, there is less flexibility in terms of trade due to the resulting inflexibility of the exchange rate. There is also added pressure of the Chinese role in the global economy in maintaining the stability of the financial system worldwide, due to its currency being internationalized and being used in denominations of diverse asset classes. As we have witnessed over the past decade, China has often fulfilled the role of the lender of

vast amounts of capital to struggling developing countries, in the tune of tens of billions of dollars in aid and loans. The liquidity outflows from China into these countries represent a major cost which is evident in the Chinese balance of payments, and have impacted policy-making within its domestic economy (Zhang & Tao, 2016).

### **New Round**

In the early stage of internationalization, RMB was mainly used for international trade settlement between China and neighboring countries. During this period, the RMB continued to appreciate overall. Between 2009 and 2014, the RMB appreciated by nearly 40%. After China joined the WTO in 2001, it has quickly become the world's largest international trading country. The international use of the RMB has increased from only a few billion RMB in 2009 to a breakthrough of 10 trillion RMB in 2015 (Smith, 2018). Along with this process, the international use of the RMB continues to advance.

After 2016, the logic of RMB internationalization has changed. A large number of overseas investors hold RMB assets mainly for investment appreciation. At this time, the logic of RMB internationalization and the motivations of overseas investors to accept, use, invest and hold RMB have undergone very profound changes. More foreign investors hold RMB has gradually changed from an early trade settlement tool to an asset with value-added investment and forming RMB investment and reserve assets. To make the RMB an international reserve currency, the financial market must first be opened, allowing foreign central banks and sovereign wealth funds to enter the Chinese market and purchase RMB-denominated financial assets (Yan, 2020). This is why we

call the internationalization from 2016 to the today as the new round.

### *Arguments and Mistakes*

China is eager to internationalize its RMB. However, long-standing capital controls limit how much of the currency is available to outsiders. So skeptics argue that it is unrealistic for China to be talking about internationalization. They believe that China's financial markets are underdeveloped and that the Chinese authorities prefer cautious reforms rather than encouraging the use of the RMB internationally (Dobson & Masson, 2009). China's exchange rate policy and capital controls also contribute to their pessimism about the RMB becoming a global currency. For example, China's exchange rate policy affects the central bank's ability to adjust asset allocation through interest rates (Dobson & Masson, 2009).

Proponents, on the other hand, suggest that the Chinese authorities have relaxed capital controls to some extent, which has reduced restrictions on the use of the RMB (Dobson & Masson, 2009). In the 2000s, China began to allow Hong Kong residents to open deposit accounts, thereby creating pools of liquidity outside the mainland ("China wants to make the RMB a central-bank favourite", 2020). China also uses Hong Kong for other policies, such as "dim sum" bonds, which are denominated in RMB rather than local currency (Fung, H., Ko, G. C.-W., & Yau, J, 2014). The inadequacy of China's financial markets is the main obstacle for the RMB to become a global currency. However, prudent reforms in China can reduce the risk in the financial markets.

The adjustment of the exchange rate policy started in 2015. The People's Bank of China started using the exchange rate based on the previous day's closing rate in 2015.

China is also gradually relaxing capital controls, which suggests that it is more confident in controlling capital outflows (Smith, 2018).

However, in 2015, the Chinese central bank's reforms did not have the effect they had hoped for. As a result of deregulation and concerns about China's economy, the Chinese central bank dumped \$1 trillion in foreign exchange reserves to counter capital outflows and tighten controls ("China wants to make the RMB a central-bank favourite", 2020). This led, at the time, to a collapse in foreign trade settled in RMB and a sharp contraction in offshore deposits.

But that doesn't mean the skeptics are always right. While deposits took a hit in 2015, they are growing rapidly again, having reached 144 billion US dollars in 2020, 20 times the 2009 total controls ("China wants to make the RMB a central-bank favourite", 2020).

#### *Advantages of a new round of RMB internationalization*

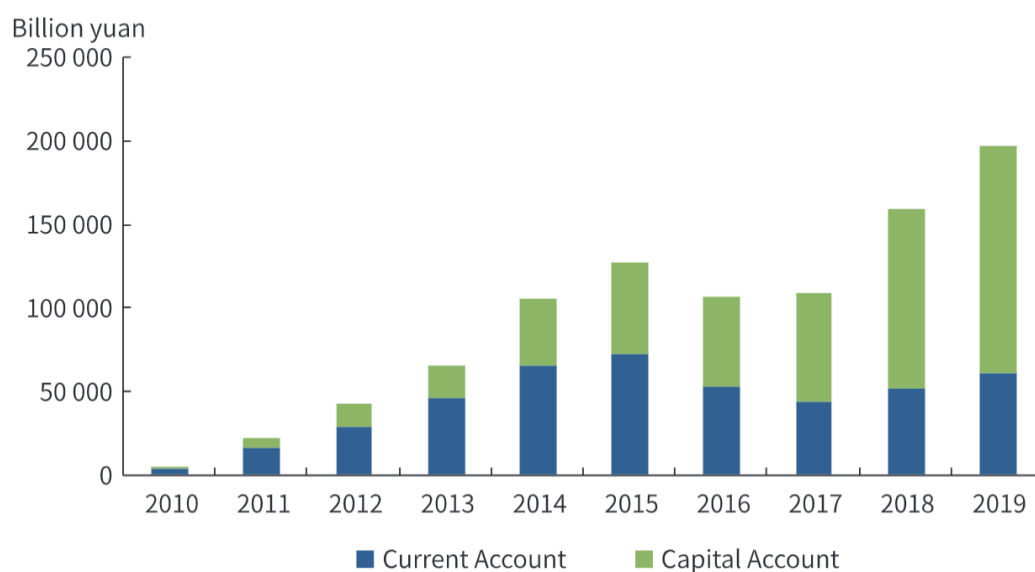
Currently, the International Monetary Fund has added the RMB to its special drawing rights basket and the RMB is now one of the major reserve currencies (Amadeo, 2019). Rapid financial account liberalization will strengthen China's reserve pressure. China chooses to open up the bond market and the stock market because it is easy to control. And it can provide funds for China's foreign loans without having to use their reserves. Despite the current inefficiency of China's financial system, stock and bond markets are playing an increasing role. China's stock and bond markets rank second and third in the world by market capitalization (Huang & Ge, 2019). This puts China in a much better position to move forward with a new round of Internationalization of RMB than it was a decade ago. The advantages of the new



round of Internationalization of RMB are mainly due to the growth of RMB cross-border settlement, the influence of trade and politics, and the improvement of related policies. I provide graphs to show these changes more concretely, where the data sources are all the People's Bank of China.

**Figure 1**

*The RMB Cross-border Receipts and Payments during 2010-2019*



Source: PBC.

While China's economy is no longer growing as fast as it did a decade ago, the country is gradually correcting the omissions and mistakes it made in its original Internationalization of RMB. China has improved its infrastructure for cross-border RMB use, and the RMB cross-border interbank payment system is now the main channel for cross-border RMB clearing and settlement. RMB cross-border payment policies are also being improved, and China has expanded its Internationalization of RMB pilot to facilitate trade and investment.

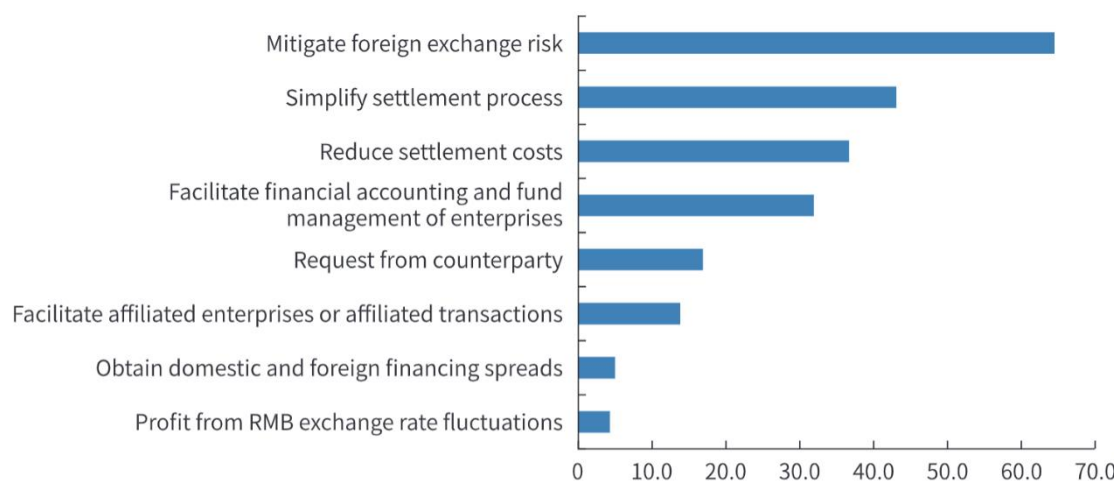
Widespread financial system liberalization remains an open question, but China also has its unique trump card. China's international trade position and investment network are important drivers of the RMB's internationalization. The most direct example of the impact of trade on the internationalization of the RMB is the countries along with the "Belt and Road". In 2019, the resulting RMB cross-border receipts and payments amounted to more than 2.73 trillion RMB, accounting for 13.9% of the total RMB cross-border receipts and payments in the same period. In 2019, China signed local currency swap agreements with 21 countries along the "Belt and Road" and established RMB clearing mechanism arrangements in 8 countries (Internationalization of the RMB, 2020). The rising trade status is also forcing China to accelerate the internationalization of the RMB. Because the Belt and Road Initiative is a global development plan, the trillions of dollars it invests will be used for infrastructure construction, mainly from investment funds and banks funded by the Chinese government. With the narrowing of China's current account surplus and the reduction of foreign exchange reserves, China urgently needs to use the RMB as the main investment tool currency, which will also reduce the need for a large amount of capital account and exchange rate management when investing in US dollars. The internationalization of the RMB also requires more liberalization of the capital account and exchange rate policy (Liang, 2020).

An interesting fact is that the trade war between the US and China has also encouraged the internationalization of the RMB to some extent. As a result of the trade friction between the US and China, the RMB exchange rate has become more

volatile. Many companies have chosen to use RMB cross-border settlement as a means for companies to hedge exchange rate risks. The People's Bank of China conducted a questionnaire survey in which five hundred companies were interviewed across 16 industries (Internationalization of the RMB, 2020). The types of companies also included state-owned, private and foreign investment. Among them, 64.7% said they chose to use cross-border RMB business as a means for enterprises to hedge exchange rate risks. In addition, other reasons are listed in figure 2. The survey also listed that multinational companies want to continue to maintain the stability and continuity of cross-border RMB policies and accelerate the opening of capital markets (Internationalization of the RMB, 2020).

**Figure 2**

*Driving Factors for Companies to Choose the Cross-border RMB settlement*



Source: PBC.

In the new round of internationalization, China has focused its policy improvement on optimizing cross-border RMB settlement policies, continuing to open up financial markets, and exchange rate policies (Internationalization of the RMB, 2020). The

latest settlement policy allows companies to conduct relevant business directly under their creditworthiness, without the need to submit supporting documents beforehand. China has also removed restrictions on QFII/RQFII investment quotas and RQFII pilot countries and regions. China launched Bond Connect in 2017, allowing foreigners to invest in onshore bonds through Hong Kong and canceling investment quotas. In 2019, it also authorized an international credit rating agency ("China wants to make the RMB a central-bank favourite", 2020).

### **Conclusion**

A new round of RMB internationalization is still underway. Last year Until this year, covid-19 made a lot of things uncertain. It also gave a huge blow to globalization. At first, China seemed to be struggling. But Beijing quickly controlled the epidemic and returned to normal production and life. Comparing North America and Europe, which are still affected by the ongoing epidemic, China is now the shining economic outlier in the world. So our attitude is generally optimistic because the success of RMB internationalization is based on the good economic performance of China. China may have a current account deficit in a short time because of the impact of COVID-19 outbreak. China will be more inclined to stimulate the economy and increase consumption to make up for the losses caused by the shutdown and reduced exports. But this is not a structural change. With the epidemic situation under control, the balance of payments will remain stable in the future. China needs to be vigilant about the continued current account surplus because it may affect the sustainability of the Chinese economy. The control of the exchange rate has also exacerbated

inflationary pressures.

Recently, the digital RMB has been placed with high hopes to promote the internationalization of the RMB. Because its cross-border advantages are more obvious. However, while achieving more efficient cross-border payment and settlement, China also needs to think about how to maintain currency and financial stability. The internationalization of the RMB depends on China's overall economy, international trade, currency security and liquidity, the openness of the financial market, and political factors. We believe that the digital RMB is not so much a driver of the internationalization of the RMB, as it is the result of the internationalization of RMB. There is much to look forward to in terms of China's future prospects, in light of the presence of the RMB on the international financial scene amidst China's influential global economic standing. The economic and financial clout which China possesses has been accentuated by the internationalization of the RMB, which has enhanced the domestic and regional financial infrastructure and facilitated large-scale transactions and investments between China and its economic partners across the world. Yet, to maintain China's economic and financial risk, the development of China's capital markets is a necessity. This is to avoid liquidity issues at home, which would otherwise result in asset prices becoming sensitive to sudden cross-border capital flows. If China wants to ensure that this new round of RMB internationalization does not fail as it did before, it still needs to address the issues raised by skeptics. China needs to consider how to continue its reforms, for exchange rate policy, the financial system and the markets.

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