

# The Yuan's Potential as a Medium of Exchange

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JONATHAN COTTINGHAM, NOV 13 2012

With the global economy recovering from the 2008 to 2009 Financial Crisis, the practice of upholding the United States Dollar as a key currency for international transactions has come into question. Many countries are seeking alternative currencies in order to diversify their reserves so that they may insulate themselves from fluctuations in the dollar. Economist Barry Eichengreen summarizes this idea succinctly as he describes that, "It is not obvious why the dollar, the currency of an economy that no longer accounts for a majority of the world's industrial production, should be used to invoice and settle a majority of the world's transactions." [1] With the European Union (E.U.) and United States of America (U.S.A.) still trying to solve their debt problems, one currency that could prove worthy of international use is the Chinese Renminbi (RMB) or Yuan. The attractiveness of the RMB is rooted in China's surge of growth over the past thirty years. Today, it has grown to be the second largest economy in the world and is on the same level as the United States in terms of trade. [2] Merely ten years ago, China accounted for only ten percent of growth in global output. [3] By 2009, at the lowest point of the financial crisis, with the U.S.A. and E.U. mired in economic turmoil, China drove nearly all-global growth accounting for approximately 90 percent. [4]

Despite this economic clout though, the Chinese government maintains a monetary policy which essentially renders its currency useless internationally. Simply, China's financial system does not yet reflect the economic influence that it holds globally. However, China's leaders have indicated their intentions of internationalizing the RMB by 2020 and for it to be used as a medium of exchange. [5] What are then the challenges and plausibility of this intended policy direction? The chances of this occurring may be evaluated, first, by examining the many obstacles that the RMB faces in order to become a medium of exchange, and then, second, by looking at its prospects for success. From these evaluations, one may conclude that it will undoubtedly fulfill its goals of becoming a medium of exchange on a regional level, but will not, however, challenge the predominance of the US dollar internationally – at least not by 2020.

### Obstacles

In order to assess the chances of the RMB becoming an international medium of exchange, one must first identify the obstacles which it faces. There are three basic determinants to the internationalization of a currency: the size of the home economy, the stability of its currency, and finally the development of its financial markets. [6] By examining the RMB in this framework, one will be able to clearly identify the obstacles that it will have to overcome.

To begin, economic size is an important factor in determining whether the RMB may internationalize because key currencies are always associated with competitive economies that partake in extensive trading activities. The Chinese Yuan meets these criteria as it is the second largest economy in the world and its trade is as large as that of the U.S.A's. Between 2009 and 2010, exports in China grew roughly 28% while imports increased by 22%. [7] GDP percentage change over the past three years for China has increased at a steady pace of roughly 10% per year. [8] These are strong indicators of the strength of China's economy and, thus, one may infer that in this sense at least, China meets the requirements for internationalizing the Yuan. Despite this though, China faces obstacles with regards to the stability of the Yuan and a lack of proper development in their financial markets.

A currency's stability may be evaluated based on fluctuations in inflation and exchange rate volatility. [9] Given that the RMB's exchange rate is pegged to the US dollar, its stability is also tied to the dollar. This connection is so deep

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that, according to Eichengreen, "China is estimated to control nearly half of all U.S. treasuries in the hands of foreign owners." [10] This effectively devalues the Yuan in order to make tradeable sector exports globally competitive, to drive employment growth and also to sustain its 10 percent growth model. This causes a paradoxical problem for the Chinese authorities: if they are to internationalize the Yuan, they will enter into competition against the currency that upholds their own. This bears serious implications for the RMB – US dollar relationship. It could diminish the status of the US dollar as a reserve currency as well as imbalance its inflation rate, while at the same time increasing the value of the Yuan. If the dollar were to depreciate, it would make U.S. imports to China more expensive, ultimately hurting Chinese exporters. And since China's economy is oriented around these exporting industries, it would need to adopt a new policy that moves away from its mercantilist system and a pegged exchange rate. In short, the higher the inflation rate is, the bigger the loss in the purchasing power of the currency will be. In contrast, if the exchange rate is highly volatile, then there is a higher risk in holding reserves of that currency.

Above all though, the biggest obstacle is the lack of appropriate development in China's financial markets required for internationalizing its currency. While China's financial market is powerful, it lacks several crucial conditions necessary for currency internationalization. Most importantly, the Yuan needs to be freely convertible and liquid. Doing so could result in two problematic circumstances: currency outflow and inflow. A continuous trade deficit in conjunction with currency outflow would strengthen other currencies' liquidity, and would eventually lead to the depreciation of the Yuan. If the Chinese government were to then balance its trade deficit, a problem of international liquidity could arise. This is a simple case of the Triffin Paradox. Monetary policy in China currently bypasses this dilemma by making the Yuan inaccessible to foreign investors and also giving Chinese leaders the policy autonomy to alter the money supply. Currently, the Yuan is largely inaccessible and unavailable for foreign investors. This is a barrier to its internationalization as it prevents investors and foreign governments from being able to make payments in RMB denominations. [11] By making the Yuan accessible to external investors, the People's Bank of China would no longer be able to have strict control over the money supply. Therefore, the effects of liberalizing the money supply will be the largest obstacle that China will face by making the RMB an international medium of exchange.

## Will They Succeed?

While there are innumerable obstacles to overcome in order for the Yuan to become an international medium of exchange, there are promising signs of its potential for success. "As the world economy becomes more multipolar," Eichengreen explains, "its monetary system, logic suggests, should similarly become more multipolar." [12] China has incrementally moved in the direction of currency internationalization for several years and has even begun to allow for the Yuan to be used in the settlement of cross-border trade with Thailand, Burma, Cambodia, Pakistan, North Korea, Mongolia, Russia, Nepal and Vietnam. [13] Additionally, in 2004, Hong Kong banks were given permission to provide RMB services such as "deposits, remittance, currency exchange, and debit/credit cards." [14] Moreover, Hong Kong has recently become the first offshore RMB bond supplier – a product of both increasing integration with mainland China and also of currency internationalization. Furthermore, the Philippines, South Korea, Cambodia, Malaysia and Nepal have accepted the RMB as their foreign exchange reserve. This suggests that, just as in Europe where the composition of most reserves is denominated in Euros, in Asia one may begin to see more reserves of RMB, particularly in countries who trade actively with China. [15] All of these policy choices, however, have one important result: they eliminate the need for exchanges between these two countries to be measured in US dollars, and effectively enable them to make transactions in RMB denominations. [16]

For China to translate these regional triumphs into the international realm, it must focus on three policy goals. First, it must maintain its high growth rate model from the past thirty years. [17] The RMB can benefit greatly from this as its role in the international system can expand conjointly alongside its economic growth. Second, China must continue to expand its international trade. [18] In doing so, they will assure an increase in the frequency in which its currency is used to settle international transactions, thereby furthering its market proliferation. There is a clear correlation between a currency's importance internationally and the depth of its trading activities. Finally, the inflation rate of the RMB must be kept in check. With the RMB's internationalization also comes an unavoidable susceptibility to market fluctuations. The negative effects of a high inflation rate are that it can result in a depreciation of the exchange rate. This can cause issues in international transactions, as it renders it unstable as a unit of account. A high inflation rate could also reduce the purchasing power of residents, and this is no small matter for a country that sees "70,000 civil

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disturbances a year.”[19]

## Interpreting China's Monetary Policy

One may better understand the logic behind internationalizing the RMB by examining China's policy choices from a realist perspective. There is a lot of power that China can derive from making its currency a medium of exchange. First, they will gain seignorage; this enables China to borrow in the international market in its own currency since foreign holdings of RMB would essentially be low interest loans to China.[20] Another additional benefit that could be gained from promoting the RMB as an international medium of exchange is that it would increase business opportunities for domestic financial institutions. Furthermore, allowing the Yuan to be used to settle international transactions would give Chinese residents the opportunity to avoid exchange rate risk.[21] Additional benefits include the overall reduction of transaction costs for exporters because they would be able to trade in RMB. Finally, internationalizing the RMB would bring a certain degree of prestige and convenience to China.

Despite these advantages that can be gained, there are several drawbacks in moving their currency in this direction. Using the RMB internationally entails the inevitable risk of making the currency defenseless against market fluctuations, which limit domestic monetary policy autonomy. Furthermore, the demand for the RMB that would result from its internationalization could put upward pressure on the exchange rate. Finally, it limits domestic policy autonomy in the region and would force Chinese authorities to maintain financial stability.

## Conclusion

In short, it is clear that China's economic influence has dramatically increased over the past three decades. However, despite their economic clout, their monetary system is weak relatively. Their recent move to internationalize the Yuan brings about many consequences. By examining these, one may conclude that the RMB will likely become the medium of exchange in South-East Asia, but will not however challenge the predominance of the US dollar internationally. It has many obstacles to overcome in this task. Notably, it must maintain stability in its currency, and most significantly, it must manage the unpredictability of a liquid money supply. With these obstacles in mind, Chinese authorities have incrementally taken steps in the direction of currency internationalization, and have begun to promote the role of the RMB in the region. This has resulted in many promising triumphs, but still there is a long way to go.

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[18] Wen Hai and Hongxin Yao, "Pros and Cons of International Use of the RMB for China." pg. 140

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[20] Chen, Hongyi & Peng, Wensheng, "The Potential of the RMB as an International Currency" pg. 129

[21] Chen, Hongyi & Peng, Wensheng, "The Potential of the RMB as an International Currency" pg. 129

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