

A background image of the Great Wall of China winding across a lush green landscape under a clear blue sky. A semi-transparent white box is overlaid on the image, containing the title text.

Chi on China

Mega Trends of China (4): The Future of the Renminbi (part 2) – Becoming a Global Reserve Currency



The way to get started is to quit talking and begin doing.

Walt Disney

SUMMARY

- In addition to the three basic functions of money, empirical research has established a number of other critical factors that determine a currency's reserve status, including the size of a country's economy, the depth of its financial market and the global share of its foreign trade.
- Combining these economic factors with a country's cultural, scientific and military strengths and sound legal system will give its currency an "exorbitant privilege" in commanding international confidence. Brexit or not will not alter these requirements of the renminbi to be a global currency.
- China's biggest challenge is to instill global confidence in the renminbi when it does not have most of these characteristics that create the necessary and sufficient conditions for its currency to serve as a store of value, an international medium of exchange and a unit of account.

Logically, Brexit (which happened on 23 June) looks like the 2007-08 subprime crisis that opened up a window of opportunity for advancing the renminbi's global reserve currency status. But practically, it will not make much difference. This is because in addition to the three essential functions of money as a store of value, a medium of exchange and a unit of account, the renminbi needs to acquire other attributes to become a global currency.



Academic research has established that the currency of a country that has a large share in international output, trade and finance and an open capital account has an immediate advantage over other countries in commanding international confidence in its currency. This will generate network externalities by drawing more and more countries to trust and use this country's currency as a global reserve currency. Once when a currency has acquired a global status, there is a strong inertial bias in keep on using it for a long time despite changes in its fundamentals and in the global environment¹.

Among these criteria, preeminent financial power is probably the most crucial because the reserve-currency host country should operate the biggest and deepest financial markets so that it can have the financial capability to issue debt that establishes the world's risk-free rate. This risk-free rate will then serve as an anchor for other countries to issue debt denominated in the reserve currency, thus enabling them to obtain liquidity at times of financial stress. So it is clear that even a country with a sizable economy but lacks well-developed and deep financial markets, like China at this point, will be handicapped in its effort to acquire a reserve currency status.

The other attributes

Arguably, these economic factors are only necessary conditions for building a global reserve currency. There are other attributes that should go with them to create the necessary and sufficient conditions. Notably, the host country should have dominant military power over land, sea and air to allow it to protect the routes through which its goods and aids can be safely transported during emergency situations, such as a natural disaster or war. For the recipient countries, they will trust the host country's currency if they have the assurance of receiving the shipments safely during crisis times.

So the host country should also have the most advanced scientific and technological power to allow it to build the most potent weapons to fulfill its role as the provider of global reserve currency. It should also be dominant in the cultural and educational aspects so that it can attract the elites of other countries to its educational system. This will be instrumental in fostering its reserve currency status by creating an influential cadre in the foreign countries whose views and thinking are aligned with those of the host country. Last but not least, the host country should have a sound legal system that protects foreign and domestic economic interests by providing a framework of level playing field.

If a country possesses all these conditions, its currency will enjoy an "exorbitant privilege" of having no constraint on its foreign trade and borrowing², since it settles its deficits and debt in its own currency. This

¹ See: Chinn Menzie D. and Jeffrey Frankel (2007), "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?" in R. Clarida (ed.) *G7 Current Account Imbalances: Sustainability and Adjustment*, University of Chicago Press, pp. 285-322 (http://www.ssc.wisc.edu/~mchinn/chinn_frankel_euro.pdf), and

Chinn Menzie D. and Jeffrey Frankel (2008), "Why the Dollar Will Rival the Euro", *International Finance* 11(1): pp. 49-73 (http://www.ssc.wisc.edu/~mchinn/Chinn_Frankel_IntFin2008.pdf), and

Hall, James (2015), "China's Plan to have an International Reserve Currency linked to Gold", *Global Research*, 12 March (<http://www.globalresearch.ca/chinas-plan-to-have-an-international-reserve-currency-linked-to-gold/5436119>)

² For example, see "Dobbs, Richard, David Skilling, Wayne Hu, Susan Lund, James Manyika, Charles Roxburgh (2009), "An Exorbitant Privilege? Implications of Reserve Currencies for Competitiveness", McKinsey & Company, December, and

Bernanke, Ben S. (2016), "The Dollar's International Role: An "Exorbitant Privilege?" Brookings Institute, Ben Bernanke's Blog, 7 January.



implies that the reserve-currency host country will run a current account deficit for most of the time and the rest of the world will run a current account surplus so that global savings and investments are balanced.

Does the renminbi measure up?

The reserve currency status of the G3 currencies, especially of the US dollar, have been eroded gradually, as we argued in part 1 of this report, and Brexit may provide an opportunity for the renminbi to rise in the global stage by weakening the global currencies. But is the renminbi up to the job?

Through currency reform and the internationalisation programme, Beijing has been working on transforming the renminbi to a proper currency with the three essential functions that any proper currency should have but that the G3 currencies are starting to fail to offer³. As an international medium of exchange, the renminbi has moved up from no ranking to the fifth most-used international payments currency in the S.W.I.F.T. system (in April 2016) within a few years. But despite this, the amount of international payments denominated in renminbi remains very small at only 1.9% of the world total.

It has also been admitted to the International Monetary Fund's Special Drawing Rights currency basket, which accounts for about 5% of global foreign reserves. However, this international store of value function of the renminbi is more a symbolic achievement than a real impact on the global system. It is also clear the renminbi has not been used as a unit of account by any major trading nations and for any major commodities and transactions.

Essentially, if the renminbi is to become a global reserve currency it must be priced and managed on its own right but not pegged against the US dollar or any other currencies and be their carbon copy. Beijing does try to break away from the US dollar's dominance by creating a whole apparatus of financial institutions like those built by the US after WWII. They include the Asian Infrastructure and Investment Bank, the Silk Road Fund and the New Development Bank.

However, building these financial apparatuses does not automatically build international confidence in the renminbi. At this point, China still does not possess those other attributes that need to go with the economic factors to make it a global currency. Despite China's increasingly assertive stance in Asian affairs, notably in the East and Southeast China Seas, it has yet to prove that it has the superior military power to secure control of the land, sea and air routes that it wants.

There is a lot of catch up for China to do on establishing global financial dominance. Its capital markets lag way behind that of the developed world. The lack of a fully-fledged market mechanism will drag on the pace of its financial liberalisation. China's savings could potentially be deployed for financing growth in other countries by replacing volatile capital flows from the western countries. But it needs a viable private sector to allocate domestic savings efficiently to become a major international creditor.

While China has achieved research excellence in some areas, it remains unlikely to gain global scientific dominance in the medium-term. Its research and development so far has been focused on applying technology to production to build economic competitiveness. It will also be a long time before it becomes culturally and educationally dominant; many of the best Chinese brains are still heading overseas for education (and many do not return to their motherland after graduation) or escaping cultural suppression.

³ See part 1 of this report: "Chi on China: Mega Trends of China (4): The Future of the Renminbi (part 1) – You May Not Like It, but You Cannot Ignore It", 8 June 2016



Last but not least, the legal credibility and institutional integrity elements that help instill international confidence in the renminbi require a system of reliable and transparent corporate accounts backed by credible auditors and credit-rating agencies and an independent/impartial judicial framework. It will take a long time for China to develop such a system. Hitherto, Hong Kong is the only place in China that can offer these attributes. So it has a crucial role to play in fostering the renminbi as a global currency.

The renminbi's medium-term outlook

In a nutshell, despite the fading influence of the G3 currencies in the global monetary system and Brexit that weakens global confidence in the major currencies, it is unlikely that the renminbi will gain a global reserve currency status anytime soon. That time will come, but only in the longer-term when China has implemented sufficient economic reforms to acquire an exorbitant privilege for the renminbi.

Provided that China keeps up with its reform momentum, the renminbi can still sit in the centre of an Asia regional financial system. Just as the City of London acts as a financial intermediation for Europe's capital flows, Hong Kong can be the financial intermediation for Asia's capital flows. Asia is increasing its linkages with the renminbi gradually by cutting its linkages with the US dollar and the euro⁴. This secular trend will continue to unfold to support the renminbi to become a global currency, eventually that is.

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⁴ See "Renminbi Displacing the US Dollar by Stealth", Chi Lo, BNP Paribas Investment Partners, 3 January 2013.



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