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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

It is not in the stars to hold our destiny but in ourselves.

William Shakespeare

SUMMARY

- Structural changes behind the world's three major (or G3) currencies (the US dollar, the euro and the Japanese yen) are eroding their basic currency functions. This argues that their global influence should fade over the long-term.
- Meanwhile, China is gaining on what the G3 currencies are losing by internationalising the renminbi. President Xi Jinping's "Chinese Dream" is the linchpin of the platform for the rise of the renminbi in the global markets.
- The geopolitical reality behind the future monetary order is that China's global influence is rising at a time when that of the US and Europe is fading. China's Belt-and-Road plan is a strategy to build a trade and investment network with all roads leading to Beijing.

Back in 2013, I argued that some powerful structural shifts were unfolding behind the G3 currencies and the emerging markets, giving rise to some distinctive trends that were conducive to the rise the renminbi. These trends have continued to unfold. They include the weakening of the US dollar's global influence, the uncertainty of the euro and the structural decline of the yen[1]. Meanwhile, even with a largely closed capital account, the global market influence of the renminbi has increased substantially.

The failure of the G3 currencies

Recent economic development suggests that the basic functions of money (as a unit of account, a medium of exchange and a store of value) of the G3 currencies might have been eroded. Firstly, while the US dollar always dominates as a unit of account, the outlook for this dominance is likely to change, underscoring the weakening trend of the US dollar's influence.

Of the five most actively-used international payments currencies in the S.W.I.F.T. system – US dollar, euro, pound sterling, yen and renminbi – only the renminbi stands out as the one that will most likely experience growing international usage in the coming years. Being a new component currency of the Special Drawing Rights (effective in October 2016) and with Beijing continuing the liberalisation of the country's capital account, the renminbi will become a growing part of the global financial infrastructure. Notably, China's creation of the Asian Infrastructure Investment Bank, the Silk Road Fund, the New Development Banks and the usage of its domestic policy banks for international lending are all instrumental in boosting the role of the renminbi under the Belt and Road (BAR)[2] plan that spans from China to Asia and Europe.

Secondly, most of the world's major currencies are failing to serve as a store of value by not being able to deliver stable positive return both in nominal and real terms. Since the currency war in 2010, global currency market volatility has risen sharply. The Swiss franc and the Japanese yen have become negative yielding currencies since 2015. The euro, the Swedish krona and the Danish krone also do not provide any reasonable stable non-zero returns. The Canadian, Australian, Kiwi dollars, Norwegian krone, Brazilian real and South African rand have been stuck with volatile downward trends that are influenced by commodity prices.

Although the US dollar and the pound sterling are still providing the store of value function, could the renminbi emerge as an alternative over time in a world of financial instability? The dollar and the sterling have been more volatile, and providing lower yields, than the Chinese renminbi. Granted, there are structural problems behind the renminbi and it is not fully convertible on the capital account yet. But who else do not have structural problems?

China differs from most other countries in that it has a stronger resolve to reform. It is, arguably, the biggest country in the world implementing the largest amount of structural reforms. Beijing's ambition to make the renminbi a global reserve currency is compatible with its incentive to keep the renminbi strong and stable over time, despite all the short-term noises about devaluation.

Finally, on the medium of exchange function, the US dollar's global dominance has been eroded in recent years as more international payments are settled in non-US dollar currencies. A strong challenger to the US dollar seemed once to be the euro. The European integration project in the 1990s and 2000s raised the expectation that Brussels might be able to attract an ever-increasing number of countries into the euro zone system. That would mean an ever increasing demand for the euro as a medium of exchange in the global markets. Unfortunately, the European dream has been disrupted as the expansion path of the euro system

[1] "*The Renminbi Rises: Myths, Hypes and Realities of the RMB Internationalisation and Reforms in the Post-Crisis World*", Chapter 1, Chi Lo, Palgrave Macmillan 2013.

[2] Formerly, this plan was called One Belt One Road.

now appears to be challenged by the geopolitical conflict in countries in emerging Europe, notably Ukraine, and by the upheavals across the Arab world.

In the 2000s, there was also the commodity boom that increased the demand for US dollar and, hence, further strengthened the dollar's role as a global medium of exchange, as nearly all commodities are priced in US dollars. However, that demand for dollar has abated following the commodity bust in recent years. The table will turn only when global trade and the commodity cycle re-accelerate markedly again, but that could be a long way away.

When global trade accelerates again, where would the biggest momentum come from? Given the difference in growth dynamics between the developed and emerging worlds, long-term global trade growth is likely to take place mostly in the emerging markets. With China's rising economic influence, time will tell how much of this trade growth will be denominated in renminbi. What seems likely is that in relative terms, the share of renminbi-denominated trade will rise at the expense of the G3 currencies, especially when one takes into account China's ambitious BAR plan.

The role of the "Chinese Dream"

Just when the European dream is being disrupted, the "Chinese Dream" is being pushed ahead by President Xi Jinping earnestly. Indeed, the Chinese Dream plays a central role in fostering the rise of the renminbi amid all this global crosscurrents. It aims at building a moderately well-off Chinese society by 2020 and a strong and prosperous nation by 2049 so that China could become the dominant power in Asia again with global influence like the US by 2050.

The economics of the Chinese Dream is crystalised by the BAR plan which creates new trade networks, opens up transit routes for Chinese exports and develops China's poor border regions. By financing infrastructure projects in developing Asia, the BAR strategy aims at drawing China's neighbours closer to its economic embrace[3]. It is also instrumental in boosting renminbi internationalisation by encouraging its usage in trade and financial transactions.

China's geopolitical strategy of integrating its neighbours via the BAR plan to its domestic economy reinforces a strong currency policy. Joining the currency war, as some observers have argued, will only undermine this strategy and the vision of making China the great power in Asia. A stable and strong renminbi will, in turn, reinforce its money functions in the global markets when the major currencies are starting to fail to fulfill these functions.

The future currency demand

It is conceivable that global demand for renminbi as working capital by the private sector and as foreign reserves by the official institution sector will only increase in the future. The eventual inclusion of Chinese assets in the global stock and bond indices will augment the demand for renminbi further.

In a world where the prevailing major currencies are failing to serve as a unit of account, medium of exchange or store of value, an opportunity has opened up for the renminbi to fill the void in the future global monetary system. The geopolitical conflicts in emerging Europe and upheavals in the Arab World and the ensuing refugee problems are creating political fractures in the euro system that will haunt Europe for a long time to come. This will hurt the incentive for future capital flows are unlikely to head for Europe.

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[3] See "*Chi on China: China's One Belt One Road: One Stone Kills Three Birds (Part 1 of 2)*", 24 June2015, and "*Chi on China: China's One Belt One Road: The Land and Sea Strategies (Part 2 of 2)*", 8 July 2015.

Over the past two decades, all new roads (in terms of telecommunications infrastructure projects and financial architecture directives etc.) led to the European capitals of Brussels, Frankfurt, Paris and Luxemburg. In the next twenty years, however, all new roads of telecommunications infrastructure, railways, ports, airports etc. will likely lead to the Chinese capital of Beijing and cities of Shanghai, and Hong Kong etc. Accompanying these new roads will be the rise of the renminbi as a global currency, eventually that is.

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