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## KEY POINTS

- China's growing economic standing suggests a power shift for the twenty-first-century global economy, as exemplified through the internationalization of China's currency, the renminbi (RMB). RMB internationalization can fill China's financial integration gap by promoting faster internal financial reforms, stronger interconnectivity between trade and finance, and greater economic responsibility.
- Since RMB internationalization is still in the infancy stage, the Group of Twenty (G20) should play a globally active role in guiding the process in the years to come. It should view RMB internationalization as an opportunity to benefit both China and the other major economies.
- G20 members should take immediate action to increase the number of currency swap agreements and trading hubs, as well as to encourage greater RMB international usage. They should simultaneously strengthen global financial institutional reforms in order to sustain a stable financial system.
- Greater involvement by the G20 in the RMB internationalization process will help underpin the financial multipolarity present in the world today.

# POWER SHIFT AND RENMINBI INTERNATIONALIZATION: RECOMMENDATIONS FOR THE G20

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## INTRODUCTION

China has gained substantial economic power in recent years, becoming the second-largest trading nation after the United States and the largest goods-trading nation since 2012 (Eichengreen 2014). It is also currently the largest source of savings and the largest potential source of capital for international investment (ibid.). Measured by GDP, China is now the second-largest economy in the world (see Figure 1), and the World Bank surmises it is likely to surpass the United States in 2014 (World Bank 2014). Because of China's growing economic importance, a shift in power is reasonably assumed. As its economic power grows, internationalization of the RMB has become a key policy goal for China, especially after the 2008 financial crisis (Zhang 2009; Park 2010; China Securities Regulatory Commission [CSRC] 2014). This goal demonstrates China's desire for better integration and representation in the international economic community and signals its willingness to perform internal financial reforms and take more responsibility in global economic affairs.

This policy brief underscores the implications of RMB internationalization for the global economic community and provides recommendations on how the G20 can better steer this process. Although the World Bank and the International Monetary Fund (IMF)

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increased China's voting share in 2010,[1] China's economic standing has yet to be recognized in these institutions. In this case, the G20 has done a better job, especially when looking at efforts made to include China as a major contributor in combatting the global economic crisis. Following its agenda of accommodating new power dynamics and reforming current institutions, the G20 should support RMB internationalization efforts to better serve the functioning of the world economy. This process is a vital opportunity for the G20 to help China better integrate into the global economy.

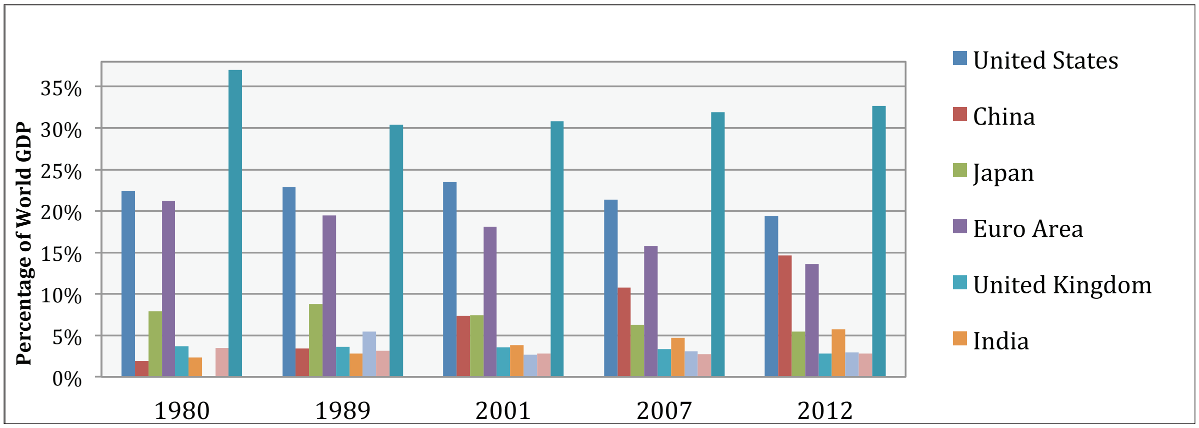
## RMB INTERNATIONALIZATION PROCESS

While there has been exponential growth in China's trade and GDP over the past two decades, its financial system lags significantly behind (see Figure 2). This gap has become a constraint on China's ability to perform a responsible role in global economic governance. RMB internationalization can help bridge this gap by underpinning greater Chinese financial integration, which is critical for G20 economies in the post-2008 financial recovery period. The G20 should keep this opportunity in mind considering the economic interconnectivity of the major economies, and view the process of further internationalizing the RMB as a method of addressing this current gap.

It was not until the outbreak of the global financial crisis that RMB internationalization became publicly vocalized by China. As early as March 2009, Chinese central bank governor Zhou Xiaochuan called for reform of the international reserve system to become less reliant on

1 China's share in the World Bank increased from 2.77 percent to 4.42 percent in 2010 (Reuters 2010). Its votes in the IMF account for 3.81 percent of the total share (IMF 2014). China's voting share is only a quarter of that of the United States, which is slightly above 16 percent.

**FIGURE 1: WORLD GDP (PURCHASING POWER PARITY [PPP]), 1980–2012**




*Source:* World Bank (2013).

*Note:* The histogram outlines the share of world real GDP, PPP adjusted, for the current top eight countries and regions (according to World Bank data).

the US dollar, given that China is currently the largest US Treasury holder, owning more than 1.2 trillion in bills, notes and bonds (US Department of the Treasury 2014). Meanwhile, Chinese leaders have also recognized the importance of expanding domestic demand and utilizing it as a prominent driving force to develop the economy. This is also a useful way for China to address its domestic dual economic imbalance (Wang 2014).

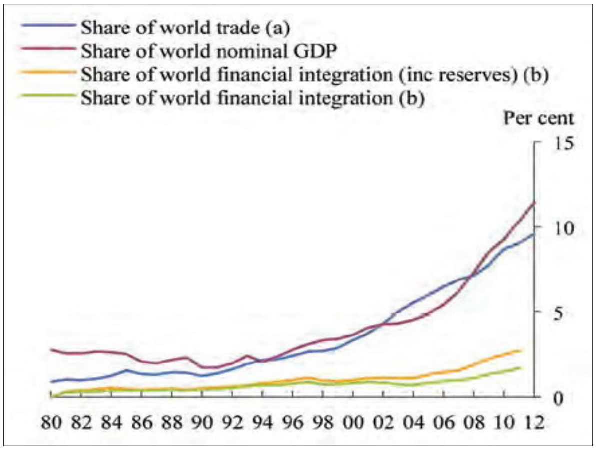
RMB internationalization is also considered an effective way to promote financial liberalization within China, benefiting multiple stakeholders. Chinese firms would enjoy more convenience, lower transaction costs and have less exchange rate risks in doing cross-border business. RMB internationalization will also accelerate the commercialization process and reduce government influence on state-owned banks, hardening budget constraints and increasing their sensitivity to the market (Ma 2014). Further internationalization will help project China's financial leverage in order to better integrate it into the global economy under a regulatory framework.

## RMB INTERNATIONALIZATION PATHWAYS

There are three distinct pathways for China to internationalize its currency, differentiating in regards to the extent China's capital account should be liberalized and how fast domestic financial reforms should be undertaken (Eichengreen 2014). The first pathway prioritizes domestic financial development and reforms. Only when the financial market matures can RMB internationalization feasibly follow. The second pathway recommends opening the capital account substantially and using it as a driving force for domestic financial liberalization and development. The first pathway is considered rather cautious, while the second pathway is criticized as being too risky.

Taking these constraints into account, China has so far leaned toward a third pathway, which lies between the previous two and allows more flexibility and balance (ibid.). This intermediate pathway encourages a testing-ground approach by supporting selective control of capital flows, experimental offshore financial centres

### FIGURE 2: CHINA'S INTERNATIONAL INTEGRATION IN GDP, TRADE AND FINANCE




*Source:* Hooley (2013, 2).

*Key:* (a) Ratio of the sum of exports and imports to world trade
(b) Ratio of the sum of external assets and liabilities

and progressive expansion of swap line agreements with foreign governments. It represents China's desire for a gradual approach and reflects a more realistic and balanced time frame.

Many domestic efforts have already been taken along this pathway. The People's Bank of China (PBoC) has removed the limits and deregulated the interest rates on financial agency loans since July 2013, exemplifying domestic drive toward greater financial liberalization. The Shanghai Free-Trade Zone (SFTZ), established in 2013, is considered a testing ground for greater economic reform including increased cross-border usage of the RMB, along with further liberalizing the capital account and adjusting exchange rate management (Eichengreen 2014). Residents of the SFTZ are currently permitted to open free-trade accounts (FTAs), which can be used both for local and foreign currency transactions and will also be permitted for transferring income generated in the FTA to offshore accounts.

The PBoC has also been active in negotiating bilateral swap agreements (BSAs) with a growing number of partner central banks to promote RMB currency in cross-border trade and direct investment settlement. Since December 2008, the PBoC has signed BSAs with a total of 24 foreign central banks. It now has RMB hubs in London, Luxembourg, Moscow, Paris, Singapore and Tokyo, and is negotiating with another eight countries — including G20 members Australia, Germany, Canada and the United States (Liao and McDowell 2014). RMB international usage has increased greatly from zero percent in 2009 to over 15 percent usage in trade settlements in 2014, reflecting the growing importance of the RMB as an international currency (Eichengreen 2014).

## GLOBAL IMPLICATIONS

RMB internationalization has direct implications for the rest of the world. Globally, it will add to the diversity and complexity of the financial system — the international monetary system in particular. Previous discussions and debates focus on whether RMB internationalization will posit real challenges to the hegemonic status of the US dollar. From a historical perspective, history does suggest that there is the possibility of having multiple international currencies (Eichengreen and Kawai 2014). This provides the RMB with opportunities to perform a global role in a more integrated way in the future alongside other major currencies.

The process of financial diversification is not without risks for the international monetary system, which the G20 should take into account. There is the threat of instability, since adding diversity will provide more space for investors to speculate and arbitrage, rendering increased volatility of exchange rates between major currencies (Eichengreen 2014). However, the euro crisis suggests that even if speculative activities do occur, they will not cause the exchange rate to collapse (Eichengreen and Kawai 2014). Greater currency diversification and a stable international monetary system are not mutually exclusive; however, the G20 should support a precautionary approach to minimize risks in regards to further RMB internationalization.

Particularly for the IMF, internationalization will encourage the inclusion of the RMB into the Special Drawing Rights (SDR) basket (ibid.).. In 2011, the IMF executive board laid down four criteria for inclusion to the SDR basket.[2] The RMB has already met the first two criteria regarding the size of its usage, but market-based reforms concerning stability and liquidity are still needed to meet the remaining criteria. Nevertheless, these efforts are projected to eventually succeed, considering the Chinese government's strong commitment to meeting all requirements. It is expected that in the future, the RMB can be added to the SDR basket to better reflect China's role in the IMF.

Concerning trade, RMB internationalization can be viewed as complementary to the rebalancing of Chinese trade from the production of goods toward the production of services (Eichengreen 2014). Besides Hong Kong, newly created trading hubs, such as Singapore and London, reflect the growing interdependence between finance and trade, helping sustain further liquidity to aid in the liberalization of the Chinese economy (Grant and Strauss 2014). The amount of RMB trade settlement has also increased rapidly, from three percent in 2010 to 11 percent in 2013 (Yongding 2014). This not only confirms the finance-trade nexus, but also the continued growth in the international usage of the RMB. A summary of the primary benefits and costs of RMB internationalization is provided below.

### TABLE 1: PRIMARY BENEFITS AND COSTS OF RMB INTERNATIONALIZATION

| Benefits | Costs |
|---|---|
| greater exchange rate and interest rate flexibility | internal reforms greatly lacking |
| promoting Chinese institutional reform | regional (Asia-Pacific) currency limitations |
| supporting liberalization of the financial system | crisis risk |
| reflecting interconnectivity with trade | - |
| lowering transaction costs with China | - |
| providing a new source of global liquidity and greater financial balance | - |

*Source:* Authors.

## RECOMMENDATIONS FOR THE G20

- **Expand currency swap agreements:** G20 economies who have not signed BSAs with the PBoC[3] should actively seek to negotiate BSAs with China. Those who have signed BSAs should consider expanding their current size. BSAs with the United States and the European Union should be prioritized as they can provide a large market for RMB trading and financial activities.

- **Increase RMB trading hubs:** Some G20 economies have already made headway in becoming RMB trading hubs (for example, Singapore, Luxembourg and London), while more are under negotiation. The G20 economies should actively take this opportunity to further diversify their financial market, strengthen their economic ties with China,, and encourage more financial openness and liberalization through these trading hubs outside of China.

- **Encourage RMB international usage:** In addition to the top-down actions mentioned above, the

2 The four criteria are: active volume of transactions in foreign exchange spot markets; active volume of transactions in foreign exchange derivatives markets and over-the-counter derivatives; existence of an appropriate market-based interest rate instrument; and currency composition of official reserve holdings (IMF 2011).

3 G20 economies that have not yet signed BSAs with China include: the United States, Canada, India, Italy, Mexico, Saudi Arabia and South Africa.

G20 economies should also encourage RMB usage for cross-border business settlements through a bottom-up approach, enlarging the share of RMB internationally while speeding up China's capital account liberalization.

- **Sustain a stable financial system:** The G20 should cooperate with other global economic bodies and institutions, such as the Financial Stability Board, to implement its mandate for financial crisis prevention and risk minimization.

- **Promote financial institutional reforms:** While some reforms have taken place in the IMF and the World Bank, China's rising power has not been correctly represented in global financial institutions. Reforms to accommodate such a power shift will urge both China and the other major economies to take more responsibility as currency internationalization develops in the decades to come.

## CONCLUSION

RMB internationalization will not be achieved overnight. It will remain a gradual process throughout the coming decades. Globally, the G20 should take the opportunity to guide and support RMB internationalization now, while it is still in its infancy stage. The internationalization process remains important for the G20, considering the many benefits both for China and internationally (see Table 1).

Current internationalization efforts signal China's willingness to move toward a more liberal financial system. If opposed by the major economies, China's currency will remain unbalanced in the twenty-first century (compared to its economic growth), causing long-term instability for other major economies, primarily due to today's global interconnectivity in finance and trade. The limitations of the major economies still need to be better addressed post-2008 financial crisis, and Chinese currency internationalization should be given greater importance by the G20 in order to underpin necessary financial reforms. RMB internationalization is recommended to provide more liquidity to the global financial market as a whole, and the G20's support could promote the rebalancing of global finance to better reflect twenty-first-century realities.

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