Currency Internationalization: Global Experiences and Implications for the Renminbi

Edited by Wensheng Peng and Chang Shu

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Currency Internationalization

Foreword

On 15 and 16 October 2007, the Hong Kong Institute for Monetary Research (HKIMR) held an international conference entitled 'Currency Internationalisation: International Experiences and Implications for the Renminbi'. Representatives from the International Monetary Fund, the Bank for International Settlements and a number of central banks, and academics from China and overseas participated in the conference. The presentations given at the conference form the basis of this book.

An international currency is one that is widely used outside its home country. Essentially, the classical domestic functions of money – as unit of account, medium of exchange and store of value – are transferred to the international level in the form of, for example, trade invoicing, reserve holdings and exchange rate anchor for other currencies. What factors contribute to the use of a currency as an international currency? First and foremost, an international currency must be perceived as sound, and market participants must be willing to hold it as a store of value. It should also be convertible so that it may be acquired by non-residents.

Clearly, many currencies meet these criteria, but few emerge as international currencies, so there must be other factors that matter. One such factor has to do with size. A large and competitive economy, which is open to international trade and finance, will naturally generate many foreign exchange transactions with at least one leg in the home currency. Size also matters in terms of the presence of an open and developed financial market which supplies assets denominated in the local currency, for which there is demand among international investors. It is also argued that the international use of a currency involves network externalities. That is, an international currency, like domestic money, derives its value because other economies are using it. As a result, there is inertia in favour of continuing to use the currency that has served as the international currency in the past.

Indeed, historically only a few currencies have acquired international-currency status. In the post-Second World War period, the US dollar has been the dominant reserve currency, despite periodic speculation and discussion about the loss of its international pre-eminence, usually associated with episodes of US-dollar exchange-rate weakness. In recent years, the euro has become the second most widely used international currency, with some predicting that the euro will rival the US dollar, leading to a "bipolar" system in the future. In a way, the emergence of the euro as an international currency can be considered as an extension of the internationalization of the Deutsche Mark, but the introduction of the euro certainly increased the 'habitat' of the currency. It seems to me that the significance of the major currencies in international trade and financial transactions does vary over time, albeit slowly.

In Asia, there are indications of an increasing use of the renminbi outside Mainland China, although this is from a low base and pretty much limited to regions that are closely linked to mainland China. Spending in renminbi by mainland residents outside mainland China has been on the rise, particularly in some Asian countries. In the border trade between residents of China and some of its neighbouring economies, the renminbi is often the preferred currency for settlement. Most notably, since the launch of renminbi banking business there in 2004, Hong Kong has become the first place outside the mainland to have banks providing renminbi deposit taking, exchange, remittance and card services. A further major breakthrough was the issuance of the first renminbi bonds in Hong Kong in July 2007. There have been seven issues so far, all of which have met with very keen investor demand.

It should not come as a surprise to keen observers of the global economy that the international role of the renminbi will gradually increase over time. Already the third largest economy and the third largest trading partner in the world, China continues to rise rapidly as an important force in global trade and production. Meanwhile, the renminbi is gaining flexibility within a framework established in July 2005 and continuously refined since then. Significant steps have also been taken to gradually liberalize the country's capital account transactions. Being the currency of an economy of such growing strength and progressive financial liberalization, the renminbi is surely going to become a major currency in the region and the world, and possibly, in the fullness of time, a reserve currency.

The international use of a currency is ultimately determined by market forces, but in the case of the renminbi, policy restrictions on the capital account convertibility play a role. The pace and form of liberalization of such restrictions are governed by the overall development and reform strategy of the country, not necessarily by a desire to promote the international use of the currency. But liberalization of the restrictions may lead to an increased use of the currency in international transactions, which entails risks as well as benefits to the home country. There are a number of important benefits. First, the economy derives seigniorage, because non-residents' non interest-bearing claims on it are denominated in its own currency. In broader terms, the domestic financial sector will benefit from an expansion of the international trade and financial transactions that are conducted in the domestic currency. Second, it brings convenience for the country's residents, reducing transaction costs and avoiding exchange-rate risks. Third, it increases macroeconomic policy flexibility by allowing borrowing in the international market in the domestic currency at prevailing interest rates. However, internationalization of a currency also brings costs associated with the impact of the international demand for the currency on domestic monetary conditions.

In particular, increasing international demand for a currency coupled with expectations that it will appreciate may add to the pressure on the currency. In the 1960s and 1970s, the Japanese and German authorities were particularly worried about the possibility that if assets were made available to non-residents, an inflow of capital would exacerbate upward pressure on their currencies. In some ways, Mainland China have the same concern today. Thus, for a large economy like China, the international role of the domestic currency, and the concerns associated with it, would inevitably form part of the authorities' consideration when determining the pace and forms of financial liberalization and opening.

An increasing international role of the renminbi would have implications for other economies as well, particularly in Asia. Since the reform of the renminbi exchange rate in July 2005, we have already seen some signs of an increasing impact of renminbi exchange-rate movements on other regional currencies. If the renminbi is increasingly used in regional trade and financial transactions and its exchange rate flexibility rises over time, variations in the exchange rate of the renminbi against other major currencies such as the US dollar will have an increasing impact on the region. This is a challenge for the regional economies, one that we perhaps should start to think about how to address now, when the emerging international role of the renminbi is at an early stage. This calls for increased cooperation by the governments and regulatory authorities in the region to promote financial integration and strengthen the regional arrangements to increase our collective capacity to deal with internal and external shocks.

From Hong Kong's point of view, we see an international role of the renminbi as providing important opportunities for developing our financial market and strengthening our role as an international financial centre. China is in the unique position of having two financial systems within one country. Elsewhere I have argued that these two financial systems should develop a 'complementary, mutually assisting and interactive' relationship to develop in the longer term an integrated, much larger financial market for the country as a whole, and to promote Hong Kong as an international financial centre of global significance. Initiatives have been taken in a number of areas to increase financial integration between Mainland China and Hong Kong. In particular, the development of renminbi business in Hong Kong has provided it with the first renminbi market outside the mainland and built up the capacity of our financial system to conduct renminbi-denominated transactions. Continuing to develop financial intermediation in the renminbi will add to the breadth and depth of Hong Kong's financial markets, and is essential to the maintenance and development of our role as an international financial centre.

The benefits are mutual. As an international financial centre of China and with close cooperation between the mainland and Hong Kong monetary and regulatory authorities, Hong Kong is in an ideal position to provide a reliable testing ground for renminbi convertibility and its increasing international use.

The two-day conference on renminbi internationalization was held at an opportune time, since it is important to discuss a range of relevant policy questions at this early stage. Among the papers presented at the conference, those on the experiences of the euro area, South Africa, Australia and Korea considered the external use of their currencies, shedding light on issues relevant to the international role of the renminbi. Five other papers focused on some key issues in the process of an increasing use of the renminbi in international trade and finance, including the determinants of external use of the renminbi, its interaction with financial market developments and monetary policy, and the potential role of Hong Kong. A final paper presented empirical work suggesting that renminbi exchange rate movements had already started to affect exchange rate dynamics in the region. I am glad that through this conference, we have gathered together these thought-provoking papers on the subject contributed by a group of prominent Chinese and overseas researchers, central bankers and practitioners.

Joseph Yam
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