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| The rise of China's currencyM. Shahidul Islam The Daily Star, Tuesday, August 9, 2011 China's spectacular economic growth has been the hallmark of global economy for the past few decades. While economists debate whether China can maintain its current high growth rates in years to come, the dragon magic is not ending soon. The rise of China's currency, the Renminbi (RMB), seems to be the single most important phenomenon in global finance in this decade. The United States Dollar (USD), also known as greenback, that gained momentum as an international currency after the collapse of Bretton Woods system in 1973 celebrated its 150th birthday in July this year. The RMB was first introduced in 1949 shortly before the communist takeover of the mainland to fight the hyperinflation that plagued the Middle Kingdom under the Kuomintang government. Ever since the opening up of the Chinese economy in late 1970s the RMB has been kept undervalued as part of Beijing's mercantilist policies. Now, owing to a number of factors China has taken several steps to internationalise its currency. What makes an international currency? There are three major variables that will determine Beijing's attempt to globalise its currency: the size of China's GDP, its volume of trade and the convertibility of RMB. Internationalising a currency also has to accord three key functions beyond its territory. It has to be used outside of China as a unit of account, a medium of exchange and a store of value. With over $5 trillion GDP in real exchange rates ($10 trillion in purchasing power parity terms) China is the world's second largest economy -- after the US. It also ranks second after the US in terms of trade volume ($2.8 trillion). Beijing's another notable financial strength is it's gargantuan foreign exchange reserves ($3 trillion). However, in internationalising RMB, there is one deficit -- the Chinese currency is not fully convertible due to a plethora of restrictions placed as far as its capital account is concerned. Then why is a non-convertible currency drawing so much global attention? The short answer is the ongoing debt and other economic malaise in America and Europe do not bode well for their currencies. Whereas China's better economic outlook, including its projected overtaking of America as the world's number one economy within this decade, accelerated RMB's ascendance much earlier than one could anticipate even a couple of years back. Whirling in a "dollar trap," Beijing is worried about the potential long-term (relative) decline of the USD that could depreciate China's holding of huge USD denominated assets, which is somewhere between $1.6 to $2 trillion that include nearly $1,000 billion treasury bonds and approximately $300 billion agency bonds. Internationalisation of RMB will require China to hold less USD denominated assets, thereby minimising risk of capital losses on its foreign-exchange reserves. However, it cannot be done hastily. Beijing intends to diversify its reserves away from the USD without wiping out their value. While it might take some time to make the RMB, also known as "people's money," as the third dominant global currency after the USD and the Euro, China has launched a number of pilot projects to materialise that goal. Beijing wants to internationalise its currency in three stages -- price and settle international trade, as an investment vehicle and as an international reserve. A number of specific projects in this connection have been initiated. They are: settlement of trade through RMB, development of offshore RMB bond markets and currency swap agreements. A pilot cross-border settlement agreement between Hong Kong and five of its large trade cities, including Shanghai and Guangzhou, has been launched. Banks in Hong Kong, Macau and Asean can participate in China's pilot scheme for RMB cross-border settlement. The objective is to facilitate settlement of trade goods and services related transactions. By the first quarter of 2011, 7% of China's total trade was settled in RMB. Indeed, of late the RMB has emerged as a de facto currency of settlement and payment in Russia, Vietnam, Thailand, Myanmar and North Korea. Moreover, to ensure the availability of RMB liquidity, the People's Bank of China (PBOC), the country's central bank, has signed currency swap agreements worth over RMB 800 billion ($130 billion) with a number of countries including South Korea, Malaysia, Belarus, Indonesia, Argentina, Iceland, New Zealand, Singapore and the southern Chinese territory of Hong Kong. This will allow China to receive RMB instead of USD in exchange of its goods. The facilities could be extended to other countries with which China has extensive trade relations. Some analysts foresee that almost $2 trillion worth of cross-border trade can be settled in RMB. A number of recent academic papers argue that the internationalisation of Chain's currency could lead to the creation of a de facto RMB currency bloc in East and Southeast Asia. This is largely due to China's emergence as the largest export and the second largest import market for developing Asia.Hong Kong, which has become a dual currency city of late as its own currency is pegged to the USD, is the epicentre of Beijing's attempt to make RMB an international currency. The mainland is placing much emphasis on its special administrative region to make it an offshore RMB trading hub. Indeed, in many ways -- from political freedom to financial products experiments -- Hong Kong is the mainland's laboratory. Singapore is also in the race to make the city-state an off-shore RMB trading hub.The RMB deposit accounts in Hong Kong are growing exponentially -- amounting to over RMB540 billion by the end of May 2011. The development of RMB bond market is critical for the internationalisation of China's currency, particularly to set the benchmark "risk-free" interest rate for RMB debt. Foreign investors are allowed to invest in RMB- denominated bonds (known as the "dim sum bond") in Hong Kong. The Asian Development Bank sold RMB1.2 billion ($180 million) of RMB-denominated debt. Corporates and banks are issuing similar bonds.The PBoC is allowing the foreign enterprises to raise RMB fund in offshore RMB markets and repatriate them back to the mainland as FDI. The enterprises in China can remit RMB out of the mainland for outward direct investments. There is also a proposal to allow offshore RMB funds to invest in the equity and bond markets on the mainland through qualified foreign institutional investors.While these are all important steps to globalise RMB, no currency has ever been internationalised before its capital account has been fully liberalised. This is also necessary to make RMB a vehicle currency in a third country outside of East Asia.Then why China is pursuing a gradual liberalisation policy regarding its capital account convertibility? The reason is China's financial system is not mature enough to absorb shocks associated with the mobility of foreign capital and exchange rate volatility, inter alia. Moreover, there is a strong export lobby in Beijing that opposes a rapid convertibility of capital account as such a move could appreciate RMB exchange rate -- costing export competitiveness. Nevertheless, Beijing is committed to take the necessary measures with regards to capital account convertibility for the RMB gradually, as stated in its12th Five-Year Plan.There is another concern. In the absence of a market-determined Chinese exchange rate and strong expectation for the RMB appreciation, importers of the mainland's products may not be very comfortable using RMB as a settlement currency, though foreign exporters have much incentive to receive RMB. That said, the RMB's emergence as an international currency offers much food for thought for Bangladesh Bank. The currency is being used for trade settlements in Myanmar and Nepal. Sri Lanka is also allowing the RMB for international transactions. Pakistan is the next in line. With China being the largest trading partner of Bangladesh, the Bangladesh Bank should do the necessary homework to embrace the rise of RMB. The writer is a Research Associate, Institute of South Asian Studies, National University of Singapore. 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