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The Geopolitics of the Renminbi Evolution

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"Great powers have great currencies." (Robert Mundell)

Summary

There is no doubt that the ascension of China, which is at the centre of the global debate, is the most relevant fact of the 21st century. A rising power with many vulnerabilities, yet a clear understanding of what they are and with the willingness to actively reduce them to a minimum, manageable level. China has managed to become, after all, the second largest economy in the world, with outstanding economic performance. Globalisation has brought China from the periphery into the core of the international system.

Since opening up to foreign trade, investment and free-market reforms in 1979, China has been one of the world's fastest growing economies, with the real annual gross domestic product (GDP) averaging 9.5% through 2017. This enabled China to become the world's largest economy (on a Purchasing Power Parity - PPP basis), manufacturer, trader and holder of foreign exchange reserves.

Currently facing yet another fundamental transition period – from the world's global factory to the global marketplace and from hardware to software producer – yet China has seen its real GDP growth slow down significantly, from 14.2% in 2007 to 6.9% in 2017. Such is a concern for the current government since success in economic performance – taught Deng Xiaoping – is essential for the political establishment to remain in power. In order to secure such positive results, Xi Jinping's Belt and Road Initiative and "Made in China 2025 Plan", for instance, play a fundamental role, for instance, in the process of overcoming the economic middle income trap and improving economic results. Steadily, China has pushed both a strategy to become the leading trading partner for a majority of countries and also their most significant investor.

Chinese efforts to expand its economic and political influence around the globe, however, have met the opposition of the United States (U.S.), which, as the current world superpower, has been using all the available instruments of the world liberal order[1] to restrain China. One the areas China has mostly felt the U.S. heavyweight

1. to By adopting liberal economic policies, a State is expected to relinquish direct control over some areas of its national sovereignty and abide by the norms of international regimes, which have been set-up by world powers – France, United Kingdom and United States – to meet their own demands and interests.

and strong hand has been in the global financial system and the challenges resulting from the Dollar as the global reserve currency, instruments that may be weaponised against Chinese growth. With its ever-growing economic size, China has pushed the process to internationalise its currency, the Renminbi (RMB), over the last decades. There is also a sense of unfairness in some of the practices carried out by the U.S. The complaint about the United States and the global financial system is not new, however. The German Minister of Foreign Affairs, Heiko Mass[2], in an article written for the Handelsblatt, where he affirmed:

> "In this situation, it is of strategic importance that we make it clear to Washington that we want to work together. However, also: That we will not allow you to go over our heads, and at our expense. That is why it was right to protect European companies legally from sanctions. It is therefore essential that we strengthen European autonomy by establishing payment channels independent of the U.S., a European monetary fund and an independent SWIFT [payments] system.[3]

This manifestation derived from the U.S. sanctions against Iran and the extraterritorial reach of U.S. actions, which have resulted from its control of the Dollar and the global payment system demonstrates the level of dissatisfaction with the way the U. S. has handled the global financial system. Occasionally, there have been complaints on how the U.S. has manipulated the global system to benefit highly from its interest agenda. The European Union has expressed discontent several times with such course of action. China, too, has manifested grave concerns over this matter as an overreach of U.S. sovereignty power. The purpose of this Policy Brief, therefore, is to analyse China's political efforts to transform its national currency – the RMB – into an international currency and, similarly to the U.S. Dollar or Euros, offer legal security, unrestricted convertibility and easiness to use.

2. Deutsche Welle, 'Germany urges SWIFT end to US payments dominance,' https://www.dw.com/en/germany-urges-swift-end-to-us-payments-dominance/a-45242528, (accessed 19 May 2019)

3. Handelsblatt, 'Making plans for a new world order,' https://www.handelsblatt.com/today/opinion/heiko-maas-making-plans-for-a-new-world-order/23583082.html?ticket=ST-2012977-FD-KOnlmuapjG6E5UGSfJ-ap3 (accessed 23 May 2019)

Chinese integration into the world

Over the past four decades, China's continued integration with the world economy has enhanced its global influence. Since the Asian financial crisis of 1997–98, China's relevance, particularly increased since its holding of a substantial amount of foreign reserves has grown. The Asian financial crisis has pushed China to seek reform of the global financial architecture, including the internationalisation of the Renminbi as an important economic policy goal.

China has thus far achieved some tangible results, trying to avert the domination of the U.S. dollar as the international reserve currency and the consequences related to its holdings of vast U.S. foreign reserves and assets. China has pushed to implement strategies to reduce its high level of exposure. With an internationalised RMB, China will advance significantly in its effort and steps to secure its path to becoming a global superpower.

Functions of Money

Economists have defined that money has three functions: (i) as a medium of exchange; (ii) as a store of value; and (iii) as a unit of account. By medium of exchange, the primary purpose of money is to facilitate transactions and to avoid barter[4]. Money is also a store of value far superior to other types – works of art, jewellery, gold or land – since it is readily accepted and available in a more convenient way. Money also serves as a unit of account, a standard measure of the value of goods and services, allowing smoother decision-making in determining the value of assets.

Trust in the issuing agent, however, is the most crucial element for money to remain valuable. Such confidence results from the capability of the issuer or the guarantor to keep the stability of the currency. Trust builds up and guarantees the capacity of money as a store of value. When a currency becomes internationalised, trust and the ability to perform these three functions are enhanced internationally. International currencies should play internationally the role they have at the local level, particularly considering that the currency will be held and used abroad for transactions by residents and non-residents. The currency may also be used as a currency

4. A barter economy is one in which exchanges occur based on the equal value they have without resorting to currency through a double coincidence of wants between the transacting parties.

substitution for trade and financial transactions or as an anchor currency.

A currency should have a sizable domestic market to provide demand if it runs weak internationally. Confidence in the money, but most importantly in the issuing authorities is quintessential to secure international stability and restrain significant fluctuations with inflationary impact or lead to mistrust by the financial markets. A very well developed financial market is fundamental for capital to move freely. A robust regulatory framework is required to increase confidence. China will thus need to meet some criteria regarding RMB internationalisation, by creating an advanced financial infrastructure, with a stable regulatory framework and, most importantly, constructing trust and confidence on local and international investors.

Power transition between the United States and China

Chinese policymakers have been concerned with the U.S. dominance of the global financial system and have pushed the RMB to expand globally. Measures to achieve such result have included: (i) reduction on the restrictions of its financial system; (ii) a reduction in government interference in the management of the exchange rate; and (iii) the strengthening of economic and financial institutions to reflect a more reliable and trustful holistic stability of the system.

Although China has slowly, yet steadily, been building up against the U.S. Dollar as the global reserve currency, RMB internationalisation should provide China with the means to shield itself and its trading partners from the strangleholds of the U.S. dollar system, as it pursues to shape the global financial system.

Why an international RMB?

The economic crises in the U.S. (2007) and Europe (2008) have significantly impacted trust in the global financial elites and have pushed China to position itself to seek a more autonomous and more significant economic and political role internationally.

Both crises raised concerns about the future of reserve currencies, including a possible replacement of the U.S. Dollar, which has reigned supreme in its position as the international reserve currency since the end of the II World War. In an article published on Deutsche Welle on 16 August 2018, this issue was brought up, as follows:

> "If the stability of a currency is entirely linked to the confidence in the issuer of the currency, then it does not look good for the US dollar."[5]

Despite the U.S. having held its most trusted position, despite its enormous current account deficits, trade imbalance and foreign debt, many countries have since 2007 expressed grave concerns regarding the future of the U.S. Dollar. The U.S. Dollar has even become stronger since there were no alternative currency reserve possibilities at the time to replace the greenback, which remained the only secure harbour in an ocean of economic and financial turmoil.

There are many political and economic advantages for a country whose currency is international. This type of hard power[6] Opens the country up to geopolitical influence, with an increased strategic capability to influence the global agenda. On the soft power side, an international currency adds prestige and status. Such a result would contribute to the improvement of China's global image and perception as a country that has overcome the challenges imposed by its developing country status.

With an ever-increasing role in the international financial and economic system, RMB internationalisation will highly increase expectations regarding China's continued growth and the challenges it still faces, since China is a dual nature country, with highly developed and less developed areas in its vast territory. As China widens its reach internationally, RMB-related strategies will need to be clear, particularly considering its possible role as a significant trading and reserve currency. The graph below demonstrates the dominance of the U.S. Dollar in the global market, as the most crucial foreign reserve currency and for international payment transactions. This indeed constitutes a challenge China needs to overcome in order to steadily replace the U.S. Dollar as the dominant currency in the global financial system.

5. Deutsche Welle, 'US dollar on its way out as world's lead currency?', https://www.dw.com/en/us-dollar-on-its-way-out-as-worlds-lead-currency/a-45111800, (accessed 27 May 2019).

6. Joseph Nye affirmed: "Soft power is the ability to get what you want by attracting and persuading others to adopt your goals. It differs from hard power, the ability to use the carrots and sticks of economic and military might to make others follow your will."

The transition – U.S. Dollar to RMB – will progress at a pace set up by the Chinese authorities, with a clear purpose to avoid any deterrence or turbulence throughout its economic growth process. China has used a long-term approach with cautious roll-outs to reduce volatility and the pressure imposed by the United States, particularly now with the new normal of a long-term trade war perspective between both countries. The RMB – China's foreign currency for more than 50 years – has represented stability to the country, through a streamlined and centralised financial system. Such stability should remain a goal despite all the required reforms that the RMB will need to go through, such as depreciation, more transparency, increased capital outflows and the development of RMB financial products to be traded internationally.

China's ambition to internationalise its currency has brought about a unique set of opportunities, challenges and implications for those investing in the country. As China continues to invest in supporting RMB internationalisation, it is vital for its institutions to articulate what strategic role they want the RMB to play and fine-tune the expectations it has regarding the push the currency will need to move forward into the next phase of internationalisation. The most crucial goal of RMB internationalisation is the reduction of foreign exchange risks Chinese corporations face when doing business internationally. Such a possibility would allow them to execute contracts and make payments in RMB, thus reducing currency fluctuation risk and the need for hedging to reduce foreign exchange exposure, resulting in a reduction of the transaction costs. China would also become stronger when it comes to foreign currency fluctuations and U.S. Dollar depreciation-related vulnerabilities. Finally, the Chinese financial institutions would compete at the same level as their European and U.S. counterparts as to loans, trade financing and bond issuance. Chinese companies will be able to purchase goods and services without falling into deficit since China could use RMB to pay for its international trade and avoid building a negative balance of payments situation.

The internationalisation would also increment cross-border transactions and allow China to reduce exposure in its foreign reserve currencies, by avoiding the possibility of suffering capital losses should the U.S. government debase the U.S. Dollar, for instance. The internationalisation should improve China's global standing, increasing influence in international institutions and its role in global governance. The current global financial infrastructure, heavily dominated by the U.S., allows that country to weaponise such institutions to meet its interests and also create impediments for Chinese corporations and governmental strategies to expand internationally. Unstable situations like sanctions to Iran and Russia or even the Helms-Burton Act against Cuba show abuse by the U.S. of its global financial power extending the reach of the territoriality of its domestic laws. Decoupling from the U.S. Dollar should certainly constitute a goal. China is not alone since many countries have not been quite pleased by the U.S. behaviour. Market-oriented reforms will be needed from China to keep its ascension process and growth and exposure to competition in less-sheltered environments.

Ever since the 2007/8 financial crises, China has increased its pursuit of RMB internationalisation to reduce dependency on the U.S. Dollar and transaction costs involved in international trade. The result is that commodities may become cheaper, and pricing fluctuations more predictable. Finally, China would be able to lend RMB to corporations and financial institutions throughout the world and also it would have an increased capacity to borrow from offshore markets.

On the negative side, an internationalised RMB will bring even more external pressures on China, such as the need to increase the interest rates to sustain RMB value in international markets, a reduction in Chinese policy and political autonomy when regulating the currency to avert flight to other assets and the fear of liquidity and rates of return.

China and the International Monetary Fund (IMF) Special Drawing Rights

One of the most important recent achievements by China in its effort to internationalise the RMB and build trust into it was to have it become a part of the International Monetary Fund (IMF) Special Drawing Rights (SDR)[7] on 1 October 2016, a basket of currencies created in 1969 to supplement IMF member countries' official reserves. Together with the U.S. Dollar, Euro, Japanese Yen and the British Pound, the RMB has ever since seeking to escalate trust, reputation and exchangeability as an international currency.

Such inclusion supports and increases the role Chinese trade has globally and will push for transparency as well as a plethora of reforms that should improve the Chinese own monetary, foreign exchange and financial systems. China's SDR inclusion reaffirmed that the country has met with two critical criteria to be part of the SDR Basket: (i) to be a top exporter in the world and (ii) how widely used the currency is for payments of international transactions and its comprehensive trade in exchange markets. The RMB inclusion in the SDR basket improves the RMB in its role as an international reserve currency, allowing countries to seek a more diversified offer in global reserve assets.

RMB Challenges Ahead

Strategies such as Belt and Road Initiative (BRI), the China International Payment Service Corporation (CIPS)[8] and the Asian Infrastructure Investment Bank (AIIB)[9] have been implemented to facilitate more significant trade flows and to support the Chinese efforts to become a global superpower by bringing countries into its sphere of influence, usage of RMB in financial transactions, in addition to addressing its own domestic needs for growth, employment and income increase.

Such strategies demonstrate a long-term perspective of growing competition against the U.S. Dollar as the international reserve of value. China understands the benefits such a coveted position would bring, allowing it to rely on its own money to finance foreign deficit and improve its geo-economic power. There are – of course – challenges in the road ahead, such as the elimination of restriction of financial flows and the exchange rate regime adopted.

Although the RMB's internationalisation has progressed substantially and is even speeding up, China will need to adapt to meet the challenges deriving from the difficulties associated with the process and the need to increment trust. The element of trust in the RMB may be impacted positively if the United States adopts policies that reduce the reliability of global economic agents in U.S. institutions, a self-erosion process resulting from policies carrying out the perception of too much one-sidedness or ineffective management of government.

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7. The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. So far SDR 204.2 billion (equivalent to about US$ 291 billion) has been allocated to members, including SDR 182.6 billion allocated in 2009 in the wake of the global financial crisis. The value of the SDR is based on a basket of five currencies—the U.S. dollar, the Euro, the Chinese Renminbi, the Japanese yen, and the British pound sterling.

8. With a long-term self-sufficiency goal, the purpose of CIPS is to facilitate the process of RMB internationalisation and create one single system where RMB users can interact. Additionally, CIPS counterbalances the SWIFT capabilities to block the Chinese banking sector or to monitor its financial institutions, with a long term perspective to eventually operate independently of SWIFT.

9. As the unequal share distribution of the World Bank and the IMF does not reflect the current status of the Chinese economy, which creates great concerns about the issue of fairness in global governance, the launching of AIIB, with the mission to promote infrastructure investment in developing countries of Asia, constitutes a critical Chinese bet to push for reform changes in the Bretton-Woods institutions aggressively.

Conclusion

Ever since Reform and Opening-up started in 1979, China has taken significant steps into making the country's economy grow with positive trickle-down impact on its 1.4 billion people. As of late, the country has quite been assertive in the global international system, differently from its low profile initial attitude between the 1980s and 1990s. By becoming the most relevant trade partner to the majority of countries in the world – a truly significant global trader – China's economic overreach has advanced several initiatives, particularly in the last decade. Under the current leadership of President Xi Jinping, China has reasserted itself as a major power and sought greater weight in the global chessboard. As the Chinese government feels challenged by the United States in its pathway, China has promoted several areas to counterbalance the U.S. influence and, where possible, to mitigate its interference.

There is no doubt that one of the most significant advantages the United States has as a global power is the control it exercises over the global payment system. Through it, the United States is capable of monitoring financial transactions and capable of pushing its agenda, even when other countries disagree with its policies or are the target for its sanctions or other retaliation measures. By expediting the internationalisation of the RMB, China addresses a real feeling of discontent towards the policies that the United States has implemented.

There is still a long road to go with many challenges ahead. However, China seems steadfast in its purpose to make the RMB an international currency. There are challenges. There are many more benefits. The greatest challenge remains building trust in the RMB and Chinese monetary agents. China seems convinced that internationalisation is the best policy for the country. A turbulent power and financial transition period, similar to what happened between the two World Wars when the pound sterling was declining, and the U.S. dollar was rising, is likely to happen. Other currencies - like the Euro - might dispute the same position with the RMB as the possible replacement to the U.S. Dollar, but it is highly unlikely that the Eurozone will be able to overcome in number and in-depth the level and web of economic and trade relations China has established throughout the world. China will need to exercise strategic patience in the RMB internationalisation process. Though the United States became the world's largest economy in the mid-1850s, by 1947, the pound sterling still accounted for 87% of the global foreign exchange. How quickly the RMI will emerge as a significant currency is still a matter of time. China, therefore, should carefully weigh in the benefits of RMB internationalisation to avoid the risk of financial reforms that instead of pushing the country up in the development path, could instead force China to slow down its economic development process. Nonetheless, as Robert Mundell, affirmed, China is in the process to make the RMB a great currency.

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