Renminbi's global use growing

Internationalization of China's currency is inevitable and it should prepare for the systematic financial risks that will arise

Just a few years ago, it would have been difficult to imagine that the global use of the renminbi would spread so fast. However, today we can see the situation has changed greatly.

In 2011, China and its trade partners conducted cross-border renminbi trade settlements valued at 2.58 trillion yuan ($410 billion), more than 4 times the 2010 total, and covering nearly 10 percent of the China's total trade.

Meanwhile, renminbi-denominated overseas and foreign direct investment - a pilot program which began in 2011 - reached 110 billion yuan. So far, China's central bank has signed bilateral currency swap agreements valued at 1.6 trillion yuan with 16 of its counterparts around the world.

Although status as a major global reserve currency is closely associated with full capital account convertibility, a flexible currency regime, deep and liquid capital markets and a willingness to let other countries accumulate the currency, through running trade deficits, it should be remembered that the renminbi still has many opportunities to internationalize further before these conditions are met. In fact, the currency's ascendancy and progress toward these conditions can occur simultaneously.

Historically, the internationalization of a sovereign currency is determined by the size of its economy and trade. The United States' economy surpassed the United Kingdom's around the time of the World War I, and the latter lost its status as the world's largest exporter in the 1920s. Finally, the US dollar displaced Sterling as the major global reserve currency around World War II.

As the world's second largest economy, the largest exporter and the second largest importer, China has become increasingly integrated into the world economy, and this has been one of the main driving forces toward the renminbi's global usage. Moreover, China is one of the largest destinations for foreign direct investment, $1.22 trillion from 1978 to 2011.

A fully convertible currency does not equal an international reserve currency. Nowadays, around 100 countries maintain fully convertible currencies, but only a few are used as global reserves. That is to say, the internationalization of a currency can proceed before its capital account is liberalized. It was under such conditions of inconvertibility that the German and Japanese currencies internationalized. A current account surplus should not be a barrier to the path of forging an international currency. The UK, the US, Germany and Japan all internationalized their currencies whilst running trade surpluses. The most important channel for currency outflow was overseas capital investment, in particular, letting credit follow trade outside the countries and have a capital account deficit.

Despite its overall long-term net trade surplus, China runs bilateral deficits with many Asian countries, therefore, there is large potential for wider use of the renminbi. On the other hand, as more and more Chinese enterprises go abroad, China has accelerated its overseas direct investment, totaling $437.3 billion in 178 countries and regions by the end of 2011. The International Monetary Fund forecasts that China's yearly ODI will exceed $280 billion by 2016.

That is a comprehensive way for China to internationalize the renminbi: combining trade settlement, overseas investment and foreign aid.

If the renminbi wants to become a global reserve currency, China's financial markets would need to open further to foreign investors, which would require the removal of restrictions on cross-border capital flows. However, China can make full use of the Hong Kong Special Administrative Region, an international financial center, as a springboard to internationalize its currency while taking gradual steps to reform mainland markets.

Hong Kong's offshore renminbi market has already played and will continue to play an essential role in cross-border renminbi investments and other financial products and services. At present, renminbi deposits amount to 10 percent of total banking deposits in Hong Kong, and the renminbi has become the third largest currency held after the HK dollar and US dollar.

Interestingly, the UK signed a deal with Hong Kong aimed at turning the City of London into an offshore trading center for the renminbi. Singapore has also showed strong interest in this regard. Whether trade in the offshore renminbi has boomed or not, many international banks, such as Deutsche Bank, CitiBank and HSBC already have renminbi traders sitting on their dealing rooms in London.

Fundamentally, status as a global currency must be driven by market forces. The cross-border renminbi business provides enterprises and financial institutions with the right to freely choose settlement and investment currency, so it helps them get rid of the dependence on only one or two currencies, mitigating the exchange rate risks, saving costs and increasing efficiencies. It is estimated that renminbi settlement reduces the transaction cost by about 2 percentage points in contrast to settlement in US dollar.

More importantly, there will be a new choice for enterprises to raise funds from different onshore and offshore renminbi markets, lowering the cost of financing and conversion.

In January, a survey on 200 overseas customers conducted by the Bank of China found that 67 percent of respondents have used or plan to use the renminbi in their business operations, indicating the huge demand of cross-border renminbi markets.

In practical terms, remninbi-denominated assets are becoming attractive products for investors. Japan and the Republic of Korea announced their plans to buy Chinese government bonds. China has been asked to extend renminbi-denominated loans to BRICS group and other countries. That could be a further step to expand the use of the renminbi in international transactions, and would be effective way of gradual internationalization of the renminbi.

It will encourage non-residents to hold renminbi when the currency has potential for appreciation. After years of unilateral appreciation, the renminbi exchange rate is now close to equilibrium, making the currency more likely to experience a two-way fluctuation. But that does not necessarily mean an end to renminbi appreciation. Apparently, it is significant to intensify the currency regime reform and maintain its relative stability at the reasonable level.

Every silver lining has its cloud. With the renminbi's internationalization, China should be well prepared to address new challenges; the systemic financial risks that can be generated hand-in-hand with free cross-border capital flows and financial reforms.

While the renminbi's internationalization has a long way to go, it is inevitable, and will be sooner rather than later. It may not displace the US dollar, but can add a new alternative to the multilateral international monetary system.

(Xiao Gang is chairman of the Board of Directors, Bank of China.)