A Roadmap for RMB Internationalization:

Navigating the Economic and Political Challenges to the Rise of China's Currency

by Professor Jacob Kurien and Bernard Geoxavier

Photo: flickr/Dainis Matisons

In the decades since it began its economic reforms in the early 1980s, China has experienced impressive growth rates—in some years exceeding 10 percent increases in gross domestic product (GDP). Since the reforms of Deng Xiaoping, politician and reformist leader of the Communist Party of China, more than 500 million people have been lifted out of poverty.[1] Today, China is not only the world's largest exporter of manufactured goods, it is also the second-largest economy.[2] Among emerging market economies and their national currencies, China's Renminbi (RMB) holds the greatest prospect for being widely used as a global reserve currency. The size of the economy—coupled with a diversified trade structure and relatively high growth rate—has provided much of the groundwork for internationalizing the RMB.

The Status of the RMB's Internationalization

An essential prerequisite for the RMB to be accepted as an international reserve currency is that residents of other nations must be willing to hold the currency as a financial asset. This will require that the currency be fully convertible and freely traded in international capital markets. The RMB is not a free currency but rather a managed currency. To be recognized as a freely convertible currency, it must perform three major economic functions:

1. Facilitate international transactions as a medium of exchange
2. Be used as an accounting unit for invoicing and international debt servicing
3. Be accepted as a currency reserve asset by Central Banks

At the moment, the extent of internationalization of the RMB is limited because China's financial markets are highly regulated, for example, through capital controls. To further internationalize the RMB, China must adopt an open capital account and liberalize capital markets. When capital is freely mobile it moves from countries with low capital returns to those with higher ones. Understandably, the imminent danger of capital flight constrains China's Central Bank—the People's Bank of China (PBoC)—from liberalizing the domestic capital market.

The internationalization of the RMB is also driven by the degree of China's exports, which require the purchase of Chinese currency.

China has been pursuing internationalization of the RMB as part of its export-driven growth strategy. There are important benefits to internationalization: in addition to developing the export sectors of the economy, a rising RMB has enhanced China's political and economic status across East Asia. This, in turn, has provided a strong impetus to further internationalize the currency.

Switching Strategy: Strong Headwinds after the Financial Crisis

However, the financial crisis has slowed the internationalization of the RMB. The decline in global economic growth has reduced the consumption of Chinese exports and arrested the rise of the RMB. The slowdown has also prompted Chinese policy makers to shift toward greater domestic consumption, which will further delay the internationalization of the RMB.

But a temporary shift toward domestic consumption—whilst slowing the rise of the RMB—makes sense for compelling economic and political reasons. Given the dismal state of world economies and the growing economic challenges and social discontentment confronting China, the state should continue to reset its export-driven growth strategy to one focused on higher domestic wages and consumer spending, even though this slows the rise of the RMB. This strategy will enable the state to pursue social reforms by implementing public welfare programs, pro-growth fiscal policies, and tax incentives.

Domestic political forces also support a shift toward stimulating domestic consumption, rather than export growth, thereby slowing the process of currency internationalization. The Party's support for increased domestic growth is arguably reflected in the eleventh and twelfth five-year plans, where the Party has advocated an agenda for "putting people first" by bridging the gulf between rich

Photo: flickr/Kevin Dooley

and poor and constructing a "harmonious society." China's twelfth five-year plan targets both economic and social development to ensure long-term prosperity for the entire nation. The primary focus of the plan is on the quality of growth structured along with social inclusion to overcome the rural-urban divide and income inequality. The recent rise in social unrest related to land acquisition and the wage disparity among urban and rural migrant workers might compel politicians and policy practitioners to focus on achieving long-term social and economic gains rather than pursue the long-term monetary policy goal of internationalizing RMB.

Aspirations to internationalize the RMB should also be secondary to the need to address inequality and instability in the domestic labor market. If China is going to successfully achieve social, political, and cultural stability over the long-term and continue to balance massive investments in social welfare with economic expansion and currency flexibility, it must reform the labor market and *hukou* system. The *hukou* residence permit and administration system—a holdover from earlier decades—determines a citizen's legal place of residence (rural or urban), which further dictates rights to free education, subsidized medical assistance, unemployment benefits, housing rights, and work authorization. The rise of the migrant worker, *nongmengong*, referred to rural laborers working in Chinese cities with their children but without legal residence and without any insurance, benefits, or education. Granting these citizens local residence *hukou* permits will bring millions of workers and their families into the formal economy, allowing them to better contribute to the greater economy. If little is done, the rift between have's and have-not's—as well as those subsidized by the *hukou* system and those stigmatized by being outside it—will prompt social unrest unlike anything this generation in China has seen. Without internal social and political stability and domestic economic growth, the internationalization of the RMB is a false ideal.

Recent actions suggest that the Party continues to put politics before good public policy.

Managing the Risks to Domestic Growth

Although stimulating domestic demand is important as Western economies deleverage in the wake of the financial crisis, China needs to ensure that the appreciation of the RMB does not lead to higher inflation, which will undermine its ambition to increase real incomes. China's previous export-driven strategy required the PBoC to adopt a policy of monetary sterilization to keep the Yuan deliberately undervalued and consequently keep import costs relatively high. Now, in order to stimulate domestic consumption, import costs need to be lowered by further strengthening the yuan. Although the appreciation of the RMB would facilitate cheaper imports at the cost of lower exports, it could cause price inflation due to increasing money supply and greater global liquidity flows.

Reform Required, But How?

The Chinese government needs to undertake reforms to enhance the autonomy and flexibility of the PBoC so that it can better address the threat of inflation that may follow a renewed focus on domestic growth. In particular, the PBoC must be given the autonomy to target the interest rate. Moreover, there should be state oversight on the distribution and price of essential commodities as well as policies to enhance productivity and growth. But the tragic lessons of the 1997-1998 East Asian financial crisis justifies a more prudent and cautious approach: short-term capital inflows in the form of portfolio investments are subject to speculative attacks when financial markets are weak or illiquid and banks are burdened with excessive loan delinquency and default. This justifies the need for China's current banking and financial sector reforms and re-capitalization of state-owned banking enterprises, prior to opening up China's capital account and deregulating financial markets.

Political Complications

Despite the compelling logic of the domestic growth strategy and associated reforms, China's political context could undermine the success of this plan. The new politburo must be able to utilize all the tools at its disposal to maintain its legitimacy, ensure social stability, and plot the future course for the RMB and the larger Chinese economy. Underlying social and political conditions made China's thirty years of economic progress possible, but they can also unravel the Party's aspiration to lead the global economic order through the RMB.

The strategy to stimulate the domestic economy might be politicized, diminishing its effectiveness. The 2008 experience is illustrative of this danger. The central government's investment in infrastructure, social welfare, and transport projects was, in many cases, funneled into speculative real estate developments and investments.[3] The real estate bubble, coupled with double-digits food price rises, threatened to accelerate inflation. Even worse, it continued the trend of 10-plus percent growth in the money supply, while the RMB had inversely appreciated against the dollar and other major currencies. Whilst good for domestic businesses, the increased money supply reduced average Chinese consumers' real wealth and increased domestic costs for most major exporters. This case study should serve as a warning that RMB internationalization should be pursued slowly to allow the Chinese domestic economy to adjust.

Recent actions suggest that the Party continues to put politics before good public policy. The anti-graft and anticorruption campaign launched under President Xi Jinping's new administration seeks to project a more moral and just party while tackling the excess of the wealthy and a dangerously widening income disparity. Instead, the campaign has ushered in an air of austerity and dented demand of Chinese domestic high-quality goods and services—precisely when those goods and services most need support.

Picking a Path to Internationalization

In the longer term, China has two options for internationalizing the RMB. Neither is mutually exclusive.

"Although stimulating domestic demand is important as Western economies deleverage in the wake of the financial crisis, China needs to ensure that the appreciation of the RMB does not lead to higher inflation, which will undermine its ambition to increase real incomes."

Photo: flickr/Krystal T

If the government decided to promote the RMB toward the status of an international reserve currency, it would need to implement specific reforms. First, it should reform China's financial and banking sector, such as by recapitalizing state-owned enterprises and banks laden with toxic, underperforming assets. Although Chinese GDP expansion has varied, but within a high band, Chinese bad bank loans, underperforming debts, and write-offs for local government lines of credit have risen steadily. In 2012, the Chinese banking industry gradually reduced outstanding debt and wrote off billions of dollars of debt.[4] Secondly, the government should deregulate the financial sector to enable the expansion of liquidity and greater issuing of equities, such as "dim sum" bonds. Importantly, this would require the Party to institutionally distance itself from the PBoC, and formally enhance its independence. Thirdly, the government should undertake reforms to increase labor mobility and widen the social safety net, ensuring that China's economic growth does not regress.

"In 2012, the Chinese banking industry gradually reduced outstanding debt and wrote off billions of dollars of debt."

Above: Shanghai
Photo: flickr/Dainis Matisons

The second option that China could pursue to internationalize the RMB is to first promote the growth of the currency regionally, especially in East Asia. The government should continue to foster intra-regional trade, which China already dominates. If such a trade zone becomes the centerpiece of Chinese trade policy, the RMB could become the major regional currency of choice outside the U.S. dollar—a feat that the yen could not achieve. This would directly benefit Chinese domestic firms because the use of the RMB as a medium of exchange would lower import and export costs within the trade zone. Also, it will encourage foreign investors to reinvest profits into the local economy.

Looking Ahead, with Patience

Irrespective of which option the Party decides to pursue, there is still a long way to go in the process of internationalizing the RMB. But it should not be rushed; convertibility should not be pursued purely for the sake of prestige. Moreover, the Party's position on internationalizing the RMB should not be overtly politicized, either for domestic or foreign policy goals. The lack of transparency of Party functions and the Party's tight control of legal, political, social, and economic institutions will not only continue to erode investor confidence, but also undermine trust that the currency is free from Party interference. News reports that the head of the PBoC, Zhou Xiaochuan, had pulled out of International Monetary Fund talks in Tokyo in October 2012 amidst Chinese-Japanese tensions reinforces the perception that the Central Bank, and macroeconomic policy, is at the whims of state control and party politics. If actions such as this persist under Xi's administration, the path to RMB internationalization will be buffeted not only by the need to address internal structural imbalances but also by political considerations.

Ultimately, China should continue to consolidate its global identity as an economic, political, and military super power, but this will require considerable time and effort. It should not come at the cost of stable, inclusive economic growth.

As Deng Xiaoping said, it is time to "cross the river by feeling stones." ❖

Professor Jacob Kurien is a Resident Professor of International Economics at the Johns Hopkins University - Nanjing University Center for Chinese and American Studies (HNC) and Fulbright Professor, Peradeniya University, Sri Lanka (2009-2010).

Bernard Geoxavier is a graduate of HNC and Middlebury College. He is currently a Chinese instructor at Avenues: The World School.

(Endnotes)

1 The World Bank. 2012. China 2030: Building a modern, harmonious, and creative society.

2 Ibid.

3 Yang, Jia Lynn. 2012. As China's economy slows, real estate bubble looms. Washington Post, 2 October.

4 Luo, Jun. 2012. China's bad loans rise for fourth quarter as economy slows. Bloomberg News, 15 November.