Internationalisation and full convertibility of the Renminbi

Tsang Shu-ki (www.sktsang.com)

17 July 2010

The twins are not exactly the same

In a paper for a conference in Shanghai in December 2007,[1] I emphasized the distinction between the internationalisation and the full convertibility of the Renminbi. The two processes, albeit related, have their own dynamics. While a currency cannot be significantly internationalised without being freely convertible, the reverse is not true.

Clarification of concepts and reform strategies

A currency becomes fully convertible when all controls on current account and capital account transactions are abolished. Renminbi achieved current account convertibility in 1996. However, there are still restrictions on the capital account, especially short-term flows.

For a currency to be "internationalised" outside a country's borders, the prerequisite is that non-residents accept it as: (1) a medium of transaction; (2) a unit of account; and (3) a store of value. They constitute the three basic functions of money, as explained by textbooks.

The traditional path for currency reform in a developing economy is to achieve full convertibility first and then aim at various degrees of internationalisation, if at all. The US dollar was fully convertible and internationalised long time ago. It has since become the most dominant currency in the global economy. A counter example is the Japanese yen which turned fully convertible in 1980. Nevertheless, it is far from being internationalised, in spite of various efforts by the Japanese government in the 1990s, including the Japan Offshore Market (JOM) located in Tokyo. The Hong Kong dollar

---

[1] The paper (in Chinese) is available as www.sktsang.com/ArchiveIII/sktsang_Shanghai_071206.pdf

is fully convertible; but not internationalised to any significant extent because there does not seem to be any need.

The advantages of being an international currency are obviously seignorage as well as the projection of a country's economic might. The main drawback is that the domestic monetary system will be more vulnerable to external shocks. The fact that Japan's cumulative fiscal debt exceeds 200% of its GDP has not caused any particular turbulence, for the simple reason that most of the bonds are held by residents and not by external investors, as in the case of PIIGS in Europe.

Anyhow, there is an alternative to the traditional route of reform: even a currency which is not fully convertible can be internationalised to a certain extent. In my 2007 paper, I argued that one way to achieve that is to establish offshore centre(s) for the currency. It will provide a leeway for non-residents to hold and use the Renminbi (RMB). At the same time, the onshore financial market can be sheltered from external disturbances through suitable firewalls.

China's unconventional path

China was apparently alerted of this possibility. The financial tsunami in 2008 further strengthened its resolve to depart from conventional wisdom, as the international financial architecture dominated by the US dollar came under close scrutiny. The expansion of RMB businesses in Hong Kong, the signing of swap arrangements with various countries, and experiments of using RMB for trade transactions serve as clear evidence that China is keen to internationalise its currency before full convertibility.

Presently, the attractiveness of holding RMB comes from the systematic expectations of its appreciation. So even if it has little practical use, it would still pay for one to hold it as a store of value. That unwittingly limits its function as a medium of transactions for international trade, as only net exporters to China would want the bills to be denominated in RMB. Net importers might lose out as a result of an appreciating Chinese currency unless they can fully hedge the exchange rate risk. The implication is that China probably needs to introduce a higher degree of flexibility into its exchange rate regime and develop hedging facilities for non-residents.

On the other hand, the attractiveness of RMB would be handicapped if there is a comprehensive shut-off between the onshore and offshore markets. In other words, China should open up opportunities for offshore funds to be recycled into the domestic markets. This is a point agreed by many experts in a recent conference held in Shanghai.[2]

Life goes on and on …..

The weakening of onshore-offshore barriers implies that RMB would move further towards full convertibility. Hence, at the end of the day, internationalisation and convertibility are related. China's double-track strategy pushes both processes forward. Even after the abolition of all capital controls, of course, the internationalisation of RMB will still go on and on.

---

[2] See the report in Chinese by Caijing Magazine: http://magazine.caijing.com.cn/templates/inc/chargecontent2.jsp?id=110473181&time=2010-07-05&cl=106&page=all.