

Comments on Haihong Gao and Yongding Yu's paper "Internationalisation of the renminbi" and Hongyi Chen, Wensheng Peng and Chang Shu's paper "The potential of the renminbi as an international currency"

Frank Song¹

In this note, I first outline the key points of the two papers "Internationalisation of the renminbi" and "The potential of the renminbi as an international currency". I then provide my views about the papers.

A. The first paper

The key points of the first paper are as follows. First, currency diversification is inevitable after the world financial crisis. This is because one of the major concerns of the current financial crisis is that the world relies so heavily on US dollars in trade, financial transactions and international reserves. The US monetary policymakers tend to focus on domestic conditions to set the money supply and interest rates, ignoring their potential impact on the rest of the world. The excessive loose monetary policy since the early 2000s created excessive liquidity in the world market, which, combined with lax regulation of financial institutions, led to the current credit crisis. Therefore, the world is searching for other significant international currencies. Second, given the tremendous growth in the Chinese economy and the rising influence of China in the world economy, the renminbi becomes an important candidate for international currency. Third, there are, however, benefits and costs associated with internationalisation of the renminbi. Specifically, the potential benefits of internationalisation of the renminbi are: a reduction in the exchange rate risk for trading partners; a strengthening of the international competitiveness of Chinese financial institutions; a boost to cross-border transactions; seigniorage; and a preservation of the asset value of China's savings. The risks and costs associated with internationalisation of the renminbi are: larger fluctuations in demand for currency; greater difficulty in maintaining the external balance; increased exposure to the shocks from international capital flows; and a burden of responsibility. In particular, internationalisation of the renminbi could also affect monetary policymaking. Finally, in conclusion, the authors of the first paper argue that internationalisation of the renminbi is desirable for China.

My comments on the first paper are mainly that, first, it is rather difficult to quantify the benefits and costs of internationalisation of the renminbi. In addition, even conceptually, some of the claimed benefits are not necessary real. For example, the benefits of reducing the exchange rate risk may not be transferred to Chinese traders. The potential benefits will be shared by the trading parties, depending on the bargaining powers of the two parties, which eventually depend on the competitiveness of Chinese products. Internationalisation of the renminbi could be a consequence of strong domestic financial institutions and an open financial system, rather than the cause of it. Seigniorage is believed to be small for most of the international currencies. Finally, to make the renminbi international in order to preserve the asset value of China's savings is also a questionable argument. When the renminbi

¹ Centre for China Financial Research, University of Hong Kong.

becomes an international currency, there is certainly less need to hold foreign currency as an international reserve, as some developed countries do today. However, China's accumulation of huge foreign exchange reserves results mainly from a policy of export promotion policies and the government's centralised exchange reserve management, and is less to do with whether the renminbi is international. For example, Japan also accumulates a huge amount of foreign exchange reserves even though the Japanese yen is rather international.

Of course, some of the costs associated with internationalisation of the renminbi argued in the paper may also not be real costs either. For example, the argument that a larger fluctuation in the demand for the renminbi leads to a less stable monetary policy may not be true. Germany and Japan in the 1960s and 1970s had similar concerns about their monetary policy when the Deutsche mark and the yen were internationalised. These concerns were later believed to be unnecessary, as monetary policy channels in those countries were mainly through the interest rate rather than through money supply. In addition, it seems that internationalisation of the US dollar does not prevent the Federal Reserve from conducting monetary policy solely on domestic conditions. Another popular argument against internationalisation of the renminbi is the exposure of the financial market to shocks in international capital flows. I argue that this concern is mainly due to capital account liberalisation, which is a precondition of internationalisation of the renminbi, not internationalisation of the renminbi per se. If a country already has full capital account liberalisation and currency convertibility, the added costs/benefits of currency internationalisation may be rather small.

Given these concerns, I think it rather hasty to conclude that internationalisation of the renminbi is desirable for China. We need more rigorous and quantitative research in order to answer the important question of whether policymakers should push for internationalisation of the renminbi.

B. The second paper

The key points of the second paper are as follows: (i) the size of the economy and the inertia feature of currency are the dominant factors affecting the internationalisation of currencies. As China's economy increases its influence on the world economy, a potential of the renminbi as a reserve currency is comparable to the case of the Japanese yen and sterling if it is fully convertible; and (ii) the rising role of the renminbi in regional currency movements since the 2005 exchange rate reform.

The second paper complements the first one in that it provides a quantitative assessment of the importance of internationalisation of the renminbi. It is one of the first papers to have done so. However, my comments on this paper are that: (i) the sample period, 1999 to 2006, is too short, and too little time variation across the panel prevents us from performing a rigorous analysis. For example, Li (2007) finds that significant roles of the inflation differential, exchange rate volatility and a depreciation trend of the exchange rate besides the GDP share also affect currency internationalisation; and (ii) the renminbi's effect on regional currency movements may be the causal result of pegging from the dollar to a basket of currencies since 2005.

References

Li, D, "Prospects and determinants of international use of renminbi", presentation at the Hong Kong Institute of Monetary Research conference on *Currency internationalization: international experiences and implications for the renminbi*, Hong Kong, 15–16 October 2007.