Sukhdave Singh: Global RMB – challenges and implications

Keynote speech by Dr Sukhdave Singh, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the HSBC Forum: China Globalising: RMB Rising (Malaysia) – "Global RMB: Challenges and Implications", Kuala Lumpur, 12 August 2014.

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It is an honour and pleasure to be here with you this morning to talk about what is likely to be the most important development affecting the global monetary system since the introduction of euro. Should the RMB become a global currency, it will transform the global financial landscape. In fact, the RMB could potentially define this century, in the same manner that the US dollar dominated the previous century.

In my remarks today, I would like to share some thoughts on the potential for the RMB to achieve the status of a global currency. Where it to do so, what will the potential impact be on the global monetary system? Finally, I will touch on the implications for Malaysia.

The world is ready, is China ready?

From where we stand today, the world is clearly ready for a global RMB. The question is whether China itself is ready.

There is no question that the RMB would become an international currency. The only question is how big of an international currency. Will the RMB's role in the international trade and finance reflect the status of China as the second largest, and soon to be the largest, economy in the world?

To be an international currency does not take much. You just need to lower the barriers and allow for it to be traded outside your borders. The Malaysian ringgit was an international currency before we de-internationalised it during the Asian Financial Crisis. At its peak, the ringgit accounted for about 18% of Malaysia's trade settlements, which was significant given the high trade orientation of the Malaysian economy. However, what we learnt from the crisis in 1997 was that for our small open economy, the internationalisation of the ringgit was inconsistent with maintaining macroeconomic and financial stability, and the benefits were not commensurate with the risks. China is not a small economy but like Malaysia it is a developing economy. Therefore, it is not immune to the types of vulnerabilities an international currency and the accompanying open capital account can create in its immature economy with its immature financial system.

The rapid momentum of the current RMB internationalisation reflects China's strong position in global trade. However, it also reflects a safe phase of RMB internationalisation. It is comparable to wading in shallow water, where you can see the bottom of the sea, anticipate what hazards may lie on the sea floor, and therefore are able to walk rapidly. The real difficult part is when you get into deeper waters, where the risks are less visible, the waves are higher, the resistance of the water stronger. Progress can then be expected to be slower and more cautious.

As the currency of a developing economy, the road to internationalisation of the RMB will have many potholes, and it would be the skills and resilience of the policymakers in China that will determine whether the RMB manages to navigate these hazards and travels far on the road to internationalisation. After all, we can think of other more developed countries, including another at one time second-largest economy, which upon reaching the threshold on which China stands today, decided that the costs that come with having their currency playing a big international role were something that they did not want to bear. For lack of official support, these currencies consequently never achieved their full global potential.

Would the reality be different for China? Only time will tell. It is the case that the RMB will sail more smoothly and speedily in international waters if its sails are filled by the strong winds of robust Chinese economic fundamentals.

Five key pre-conditions to being a global currency

So allow me to look at some of the key fundamentals that I believe would support a sustainable progress of the RMB towards being a major global currency.

Studying the history of global currencies such as the British pound and the US dollar provides us some indication of the possible path of RMB internationalisation. Let me be clear, this does not mean that I am implying that the RMB must necessarily follow the path of other major global currencies. Nevertheless, such reflection does provide an opportunity for a realistic assessment of the prospects and challenges that lie ahead for the RMB. There are at least 5 key factors. Let me list them without going into the details.

- Currencies that rise to dominance are often of countries that are ***dominant in global trade***.
- Currencies often become internationalised because the country is a ***key global exporter of capital***.
- Every successful currency had ***official support***.
- Currencies can only rise to international prominence when backed by ***liberalised and developed markets***.
- There needs to be ***confidence in the currency and the economy***.

How does China fare against these signposts? I would say that it is three out of five. As far as trade dominance is concerned, China surpassed the US economy as the largest goods trading nation in 2013.

The internationalisation of the currency, despite its cautious nature, is certainly getting a lot of official support – not just from Chinese policymakers but also from policymakers in other countries.

As for confidence in the currency and the economy, there would not be so much enthusiasm for RMB internationalisation were such confidence missing. The fact that countries are queuing up to be able to trade RMB within their borders, or to gain access to China’s domestic financial markets, shows a strong desire on the part of these countries to participate in what they see as an economy with a potential for continued strong growth. There is a deep hunger internationally for Chinese consumers, Chinese exports, Chinese assets and of course, the Chinese currency. While the USD was at one time supported by its gold backing, the RMB today is backed by China’s huge foreign exchange reserves. Confidence in the currency is further enhanced by expectations of conditions in China remaining supportive of a strong currency.

The main precondition on which China does not do well is in the stage of development and readiness of its financial system and policy frameworks.

These challenges are not insurmountable but they are big enough to make Chinese policymakers adopt a gradual and sequenced approach to RMB internationalisation. They are big enough that premature liberalisation could create significant risks to macroeconomic and financial stability. The challenge for Chinese policymakers is to develop the domestic financial system to a level where integration with the global financial system would not lead to significant vulnerabilities. Therefore, the state of the financial system will be a key determinant of the extent to which policymakers are willing to liberalise and open their system, and consequently, will also be a key determinant of the extent and pace of RMB internationalisation. The global status of the RMB is closely linked to the global status of the Chinese financial system. Ambitious reforms could expedite RMB internationalisation.

On the issue of being a global exporter of capital, China is certainly that. However, a large part of these outflows have been official and they have not been in RMB. This in fact touches at the heart of what is known as the Triffin Dilemma. China has been sending USDs abroad because that is what it has been receiving through its current account surpluses and FDI inflows. Sometime in the future, China may develop a structural current account deficit, but I do not see that happening in the foreseeable future. Opening up the capital account and domestic financial system to non-resident investors could lead to even more foreign currency capital inflows. On both accounts, China will not only continue to export USD capital but could find itself confronted by persistent appreciating pressure on its exchange rate due to the high demand for RMB.

Promoting RMB for trade settlement will only go so far in resolving this. If more of China's trade is settled in RMB, less USD will flow in, and China would need to intervene less and would have less USD to send abroad. But the question remains, with more RMB flowing in through the current and capital account, how do you get more RMB out of China in the first place?

There are in fact numerous possibilities for China to create a significant pool of RMB liquidity abroad without necessarily running a current account deficit. This include RMB outflows through official aid, international loans by banks in China, foreign issuance of debt in Chinese markets, direct investment abroad, inter-company loans, repatriation of corporate profits, resident spending abroad and so on. Some of these are already happening. Offshore RMB balances in Hong Kong, Chinese Taipei and Singapore for example rose almost 40% between late 2013 and early 2014 to RMB1.4 trillion.

These numbers are indeed encouraging, except for one thing. When the RMB is abroad, it gets homesick, terribly homesick. It yearns to return home to the land of its birth. When the legal avenues for it to do so are limited, it desperately seeks other ways to do so. And as the size of overseas RMB pool increases, the pressure of the homeward bound flows will also increase. Will the Qualified Investor Schemes, RMB clearing banks and the eventual introduction of the China International Payment System alleviate this situation of the offshore RMB? Yes, it would, but not entirely.

In the current situation, despite the sharp increase in RMB related trade and investment transactions, the data I have seen suggests that the use of RMB remains rather lopsided and favours the flow of RMB into China rather than out of China. A significantly greater proportion of China's exports were paid for in RMB, then its imports. Similarly, while 63% of the FDI into China was in RMB, only 16% of the direct investment out of China was in RMB.

What all these lead us to is that a currency cannot be a true global currency on the basis of current account convertibility alone. It needs to be convertible also on the capital account. However, a significant opening of the capital account is the deep water in China's quest to globalise the RMB. It is like the RMB sailing out of the calm waters of the harbour into the choppy waters of the wide open seas. Having the support of the five fundamental factors I have discussed will ensure that the RMB is better prepared to navigate those choppy waters. To ensure sustainable RMB internationalisation would require patience, persistence and careful thought – both on the part of Chinese policymakers as well as those outside China.

How an internationalised RMB could change the global landscape

Let me now move on to briefly delve on the implications of a global RMB on the global monetary landscape.

In today's global monetary system, nobody can deny that there is a lack of choice when it comes to global currencies. This situation is rather precarious. We saw during the Financial Crisis in the Advanced Economies how financial markets globally seized up and the global monetary system came to the brink of collapse. A more multipolar monetary system should engender greater global financial stability. If global liquidity was represented by more currencies, then the likelihood of any one currency being a determinant of global liquidity would be significantly reduced. The observation of large surpluses of a currency, and that currency nevertheless appreciating, is an anomaly created by a global system where there are too few global currencies. By there not being enough choice, the whole world bears the pain when the domestic policies of the few major currency economies become extreme and inconsistent with the global role of their currencies.

Monetary policy in many major advanced economies is being conducted as if theirs are closed economies with closed financial systems. The implication in terms of how monetary policy is conducted is that it creates a false sense of confidence about the effectiveness of extreme monetary policy with respect to the domestic economy and a failure to fully appreciate the global implications. In an integrated global economy and financial systems, the impact of policies leak out. Investors and savers earning lousy returns on their savings do not simply throw up their hands and say "*since I'm earning lousy returns I might as well consume my savings or save less*." No, they start looking for other means to preserve the value of their savings, including venturing beyond their borders in search for better returns. The outcome is a monetary policy that is less effective than what is envisioned by the policymakers in the major economies and a significant policy headache for countries that are on the receiving end of those capital inflows.

The rise of the RMB will not entirely solve that, but hopefully, it will lead to a world where the global monetary system is less distorted, with less of the friction that we see now, and a greater sharing of the burden and benefits of serving as the world's currency.

Malaysia and the global RMB

Finally, how would the globalisation of RMB affect Malaysia?

For Malaysia, there is no downside to the RMB becoming an international currency. China is one of our largest trading partners and anything that facilitates the growth of trade and investment flows between the two economies is good. We understand some of the policy challenges China faces and is likely to face as it internationalises its currency. We understand the need for it to adopt a gradual approach and providing itself the space to address any vulnerability that may emerge as a consequence of internationalizing the RMB. But, we also know that as China develops its financial markets and its policy frameworks, greater openness would by synergetic in promoting the further development of its financial system and its economy, and of course the international role of the RMB.

Policymakers in Malaysia are fully committed to strengthening our economic and financial ties with China. As far as using RMB for international trade and investment is concerned, we have worked to put the necessary infrastructure in place and continue to improve on it to make it cheaper and more convenient. However, it is the private sector that must decide on the economics of using the RMB for international payments and receipts. Institutions like HSBC can play a very helpful role in educating their clients and the broader business community in Malaysia on the possibilities of the RMB, as well as providing feedback to policymakers on what more we can do to create a more conducive environment to allow RMB trade to grow.

Conclusion

To conclude, ladies and gentlemen, the internationalisation of the RMB has gained significant momentum over the last year or so. That is encouraging and it appropriately reflects the growing role of China in the global economy. As I stated earlier, there is no doubt that the RMB will be an international currency. The only question is how big of an international currency. To answer that question, it is worth reminding ourselves that China is internationalizing the RMB not because it believes that it is good for the world, but because it believes that it is good for China. Therefore, whether the RMB internationalisation will be able to maintain its momentum, or even accelerate, will depend very much on what happens in China in the coming years. If the Chinese policymakers are successful in managing the political, economic and financial trade-offs entailed in moving to a global currency, than the 21st century may indeed very well be the century of the global RMB.