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Can the Renminbi Rise as a Global Currency? The Political Economy of Currency Internationalization

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Abstract: Can the renminbi develop into a global currency? In the near future it seems unlikely. The international political power of the United States remains far greater than that of China at the global level, and is likely to be a significant obstacle to global expansion in use of the renminbi. China's limited economic size—despite its rapid growth over the past decades—and its persistent current account surplus are in addition likely to pose serious economic checks on global use of the renminbi. Thus, although renminbi internationalization will probably develop to some extent, it is at least in the short term likely to be confined to Asia, China's hinterland.

Keywords: Currency internationalization, international monetary order, international monetary system, renminbi internationalization, yuan internationalization

The Chinese government has since the 2008-09 global financial crisis begun pushing enthusiastically ahead with renminbi internationalization, with an emphasis mainly on facilitating use of the renminbi in international trade and developing the offshore renminbi market in Hong Kong.¹ It has for example allowed use of the renminbi in cross-border trade settlements, established bilateral local currency swap arrangements with fourteen foreign countries, and allowed the issuance of renminbi-denominated bonds—so-called “dim sum bonds”—in Hong Kong.² The government has in addition allowed offshore banks to transfer renminbi among themselves, paving the way for creation of renminbi-denominated financial products. It has permitted foreign central banks having currency swaps with China and overseas banks involved in renminbi cross-border trade settlement to invest in the Chinese mainland's interbank bond markets, significantly broadening investment opportunities for foreign renminbi holders. It has also allowed foreign direct investment in the mainland with

¹ The global financial crisis has exposed China's vulnerability to substantial dangers inherent in the current dollar-dominated international monetary system, such as risks related to its holding an enormous amount of dollar reserves, and this appears to partly explain why its government has begun pursuing renminbi internationalization since the crisis. See Sebastian Mallaby and Oline Wethington, “The Future of the Yuan: China's Struggle to Internationalize Its Currency,” *Foreign Affairs* 91:1 (2012), pp. 138-40.

² The fourteen countries that have established bilateral currency swaps with China are South Korea, Hong Kong, Malaysia, Belarus, Argentina, Indonesia, Singapore, Iceland, New Zealand, Uzbekistan, Mongolia, Kazakhstan, Thailand and Pakistan. The swaps provide these countries with renminbi to finance their imports from China, thereby helping to increase use of the renminbi as a trade settlement currency. Meanwhile, the issuance of dim sum bonds expands the incentive for holding renminbi by increasing the volume of assets in which the renminbi can be invested.

renminbi obtained overseas. Finally, it has begun providing foreign aid denominated in renminbi.

Such Chinese government efforts for renminbi internationalization have recently begun to produce meaningful outcomes. The volume of cross-border trade settled in renminbi jumped from 3.6 billion renminbi in the second half of 2009 to 312.6 billion renminbi in the fourth quarter of 2010, for instance, and in Q1 2011 about seven percent of total Chinese foreign trade was settled in the renminbi, a jump from a mere one percent one year earlier. Renminbi deposits and issuance of dim sum bonds in Hong Kong have also surged—from 64 billion to 609 billion renminbi between January 2010 and August 2011, and from 16 billion to 35.7 billion renminbi between 2009 and 2010, respectively. The share of renminbi in global foreign exchange market turnover almost doubled between 2007 and 2010, albeit still accounting for just 0.9 percent.³

Meanwhile, the US dollar's intrinsic economic attractiveness as an international currency has weakened significantly since the global financial crisis, due largely to the extremely loose US fiscal and monetary policies to revitalize the economy, which have damaged long-term foreign confidence in the dollar.⁴ The attractiveness of the euro, the strongest potential rival to the dollar, has also been severely tarnished by the European debt crisis. Under these circumstances renminbi internationalization has been attracting great attention, and given its significant political economy implications for both China and the rest of the world become a central issue related to the future of the global monetary system.

The main potential economic benefits that China is anticipated to gain from renminbi internationalization include: international seigniorage;⁵ the ability to finance balance of payments deficits (if they arise) with its own currency, and ensuing expansion of its macroeconomic flexibility; the decline in currency mismatch risk; domestic financial institution business gains due to their competitive advantage in dealing in the renminbi; the transfer of exchange rate risk from domestic firms to their foreign counterparts; and the growth of domestic consumers' purchasing power with the rise in renminbi value due to its broad acceptability.⁶

³ The sum of the percentage shares of individual currencies in global foreign exchange market turnover totals 200 rather than 100 per cent, since two currencies are involved in each transaction.

⁴ In August 2011, in fact, Standard and Poor's, the world's second largest credit rating agency, downgraded the United States long-term sovereign rating from triple A to double A plus, due largely to its concerns about the US fiscal condition. The dollar has nevertheless still played the role of safe haven currency, as during the global financial crisis even though that originated in the US, since there is at present no strong alternative to it.

⁵ Seigniorage refers to the difference between the face value of a currency and its production costs. It is generated at the international level when foreigners hold the domestic currency, or financial claims denominated in it, in exchange for traded goods and services. See Menzie Chinn and Jeffrey A. Frankel, "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?" in *G7 Current Account Imbalances: Sustainability and Adjustment*, ed. Richard H. Clarida (Chicago: The University of Chicago Press, 2007), pp. 289; and Benjamin J. Cohen, "Currency and State Power," paper presented at conference to honor Stephen D. Krasner, organized by Stanford University, December 4-5, 2009, p. 10.

⁶ A rise in renminbi value can of course impose costs as well to the Chinese economy, if the Chinese development model continues to rely heavily on exports. For a general discussion of the economic benefits and costs of issuing an international currency, see Chinn and Frankel, "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?"; and *The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency* (Cambridge, MA: National Bureau of Economic Research, 2008); Hans Genberg, "The Calculus of International Currency Use," *Central Banking* 20:3 (2010), pp. 63-68; Peter B. Kenen, *Currency Internationalization: An Overview* (Basel: Bank for International Settlements, 2009); and George S. Tavlas, *On the International Use of Currencies: The Case of the Deutsche Mark* (Princeton: Princeton University, 1991). For a discussion focused on renminbi internationalization, see Barry Eichengreen, "The Renminbi as an International Currency," *Journal of Policy Modeling*, 33:5 (2011), pp. 723-30; and Wen Hai and Hongxin Yao, "Pros and Cons of International Use of the RMB for China," in *Currency Internationalization:*

Moreover, renminbi internationalization can enhance China's power as well. It can strengthen China's internal power by boosting its policy autonomy, since it will increase the country's ability to avoid the burdens of adjusting its external imbalances.⁷ International use of the renminbi is also likely to improve China's external power, by augmenting its hard power to coerce other states whose dependence on the renminbi for international economic activities may confer substantial political leverage or advantage on China.⁸ Renminbi internationalization is likely to increase the country's structural power and in turn thereby also strengthen its soft power—its ability to obtain what it wants through co-option and/or attraction—through foreigners' dependence on the renminbi transforming their perceptions of their own interests in favor of China, for instance leading them to develop vested interests in renminbi stability.⁹ International use of the renminbi may furthermore enhance China's soft power symbolically, since currencies have long been regarded as core tangible symbols of sovereignty and their extensive cross-border usage as highly visible signs of the elevated ranks of the issuing countries.¹⁰

Can the renminbi actually emerge as a global currency? A growing number of studies have been addressing this question in recent years.¹¹ A majority of serious academic studies,

Global Experiences and Implications for the Renminbi, ed. Wensheng Peng and Chang Shu (London: Palgrave Macmillan, 2010), pp. 139-66.

⁷ See Benjamin Cohen, "The Macrofoundations of Monetary Power," in *International Monetary Power*, ed. David M. Andrews (Ithaca: Cornell University Press, 2006), pp. 31-50; and Eric Helleiner and Jonathan Kirshner, "The Future of the Dollar: Whither the Key Currency?" in *The Future of the Dollar*, ed. Eric Helleiner and Jonathan Kirshner (Ithaca: Cornell University Press, 2009), pp. 1-23. Given that, unlike the U.S., China has long been running balance of payments surpluses, one might perhaps discount the significance of such a potential gain from renminbi internationalization. It should be noted, however, that for the renminbi to be used internationally to any significant extent China will need to supply sufficient renminbi to the world, and a major channel for doing so may be by running of balance of payments deficits.

⁸ See Benjamin J. Cohen, *The Geography of Money* (Ithaca: Cornell University Press, 1998); and Jonathan Kirshner, *Currency and Coercion: The Political Economy of International Monetary Power* (Princeton, NJ: Princeton University Press, 1995).

⁹ See Jonathan Kirshner, "Dollar Primacy and American Power: What's at Stake?" *Review of International Political Economy* 15:3 (2008), pp. 424-25; and Helleiner and Kirshner, "The Future of the Dollar," p. 6.

¹⁰ See Cohen, *The Geography of Money*, p. 121; and Eric Helleiner, "Below the State: Micro-Level Monetary Power," in *International Monetary Power*, p. 82. Such potential political benefits of renminbi internationalization in fact appear to be a major factor explaining its current active promotion by the Chinese government. Internationalization of the renminbi can along with these benefits also impose substantial economic costs on China, possibly including constraints on domestic monetary policy due to foreign renminbi holdings, other domestic policy limitations stemming from the so-called Triffin Dilemma, loss of ability to use the exchange rate as a macroeconomic policy tool, and adverse export sector impacts due to renminbi appreciation. It is indeed widely indicated that Japan and Germany were in the past reluctant to push internationalization of their currencies due to concerns about such costs. For a state to pursue its currency's internationalization despite the potential costs, it should thus have a strong incentive, and the potential political benefits from renminbi internationalization appear to have provided the Chinese government with this. For Japan and Germany, meanwhile, which have unlike China been close US allies, such effects of currency internationalization may have been considered undesirable political costs rather than benefits, being likely to cause conflict with the United States. There are indications in this regard that European policymakers have also been reluctant to promote euro internationalization due in part to concerns about this causing political tensions with the United States. See Benjamin J. Cohen, "Dollar Dominance, Euro Aspirations: Recipe for Discord?" *Journal of Common Market Studies* 47:4 (2009), p. 759.

¹¹ See, for example, Xiaoli Chen and Yin-Wong Cheung, "Renminbi Going Global," *China & World Economy* 19:2 (2011), pp. 1-18; Wendy Dobson and Paul R. Masson, "Will the Renminbi Become a World Currency?" *China Economic Review* 20:1 (2009), pp. 124-35; Eichengreen, "The Renminbi as an International Currency"; Marcel Fratzscher and Arnaud Mehl, *China's Dominance Hypothesis and the Emergence of A Tri-polar Global Currency System* (Frankfurt: European Central Bank, 2011); Takatoshi Ito, "China as Number One: How about the Renminbi?" *Asian Economic Policy Review* 5:2 (2010), pp. 249-76; Nicholas Lardy and Patrick Douglass,

other than journalistic analyses, have until quite recently tended to express more or less negative prospects for renminbi internationalization. Yet more recently the number of positive views has been increasing. For example, the 2011 annual report of the US-China Economic Commission to the US Congress argued: “It no longer seems inconceivable that the RMB [renminbi] could mount a challenge to the dollar, perhaps within the next *five to ten* years [emphasis added].”¹² Recent research by the European Central Bank meanwhile even sees the international monetary system as a tripolar currency system already, with the renminbi making up one pole alongside the dollar and the euro.¹³

Most of those studies share one serious limitation, however—regardless of whether they hold positive or negative views of renminbi internationalization—in that they examine the matter almost exclusively from an economic perspective only, paying little attention to the political issues involved as well. Such neglect of political issues is odd, given that, as detailed above, the recent progress in renminbi internationalization appears to have been largely a result of active Chinese government policies to promote it. And the internationalization of a currency is in fact fundamentally a political economy issue, with its success or failure affected by not just economic but also political factors. To be more reliable, analysis of the feasibility of renminbi internationalization should thus take into account the political, as well as the economic conditions involved.¹⁴

Especially, this paper calls great attention to the role of one particular systemic political factor: international political power. The international political power of a state can affect international use of its currency by impacting foreigners’ confidence in it, one of the fundamental intrinsic economic properties of an international currency. The issuing state’s international political power can promote international use of its currency more directly, by actively encouraging foreign countries to use it—through provision of military, diplomatic or economic support or even through coercion—and also by increasing their voluntary incentives to strengthen their ties with it through the greater use of its currency. In this regard, given that the international political power of the United States is likely to remain far greater at the global level than that of China in the near future, global expansion of renminbi use appears difficult at least for the time being.

Capital Account Liberalization and the Role of the Renminbi (Washington, D.C.: Peterson Institute for International Economics, 2011); Jong-Wha Lee, “Will the Renminbi Emerge as an International Reserve Currency?” *Asian Development Bank*, 2010 [accessed April 16, 2011], <<http://aric.adb.org/grs/report.php?p=Lee>>; Mallaby and Wethington, “The Future of the Yuan”; Yung Chul Park, “RMB Internationalization and Its Implications for Financial and Monetary Cooperation in East Asia,” *China & World Economy* 18:2 (2010), pp. 1-21; Peng and Shu, eds., *Currency Internationalization*; Arvind Subramanian, *Renminbi Rules: The Conditional Imminence of the Reserve Currency Transition* (Washington, DC: Peterson Institute for International Economics, 2011); U.S.-China Economic and Security Review Commission, *2011 Report to Congress*, 2011 [accessed November 17, 2011], <http://www.uscc.gov/annual_report/2011/annual_report_full_11.pdf>; Friedrich Wu, “The Renminbi Challenge,” *The International Economy*, Fall (2009), pp. 32-35, 53; and Friedrich Wu, Rongfang Pan and Di Wang, “Renminbi’s Potential to Become a Global Currency,” *China & World Economy* 18:1 (2010), pp. 63-81.

¹² U.S.-China Economic and Security Review Commission, *2011 Report to Congress*, p. 37.

¹³ Fratzscher and Mehl, *China’s Dominance Hypothesis and the Emergence of A Tri-polar Global Currency System*. The argument of the study is exaggerated, however, given that it focuses exclusively on just one monetary function of the renminbi as an international currency, that as an anchor currency, without examining the renminbi’s actual international use as a medium of exchange and a store of value, the other main monetary functions of an international currency. Strictly speaking, in fact, the research merely finds some empirical evidence suggesting, with certain qualifications, that the renminbi has exerted a large, though not exclusively dominant, influence on the exchange rate dynamics of emerging economies in Asia since the mid-2000s.

¹⁴ For a comprehensive survey of the literature on international currencies and the future of the international monetary system, encompassing both political science and economics, see Hyoung-kyu Chey, “Theories of International Currencies and the Future of the World Monetary Order,” *International Studies Review* 14:1 (2012).

Renminbi internationalization will of course certainly be influenced by economic factors as well. And in this respect, in contrast to the conventional account this paper does not necessarily regard the current low level of financial liberalization in China, including capital account inconvertibility, as the greatest problem hindering renminbi internationalization. It however indicates that China's limited economic size, despite its considerable growth over the past decades, and its persistent current account surplus vis-à-vis the rest of the world, are likely to be significant economic obstacles to global renminbi use.

Ultimately, this paper anticipates that the renminbi is unlikely to replace the dollar as the leading international currency at the *global* level in the near future. It does however expect the renminbi to nevertheless be able to evolve into a *regional* currency in Asia, given China's strong influence in the region.

The remaining part of this paper is organized as follows. It explores first the economic, and then the political factors that may affect renminbi internationalization, assessing its feasibility at the global level. After that it moves on to consider the likelihood of renminbi internationalization at the regional level, in Asia. The final section concludes.

Economic Conditions for Renminbi Internationalization

Although the Chinese government's striving for renminbi internationalization may be one factor influencing the project's success or failure, it does not of course by itself guarantee success.¹⁵ Internationalization of a currency is a complex process, affected by diverse factors. Economists have long addressed a list of economic factors affecting currency internationalization. These factors can be grouped into two broad categories—confidence and convenience—with those the factors that affecting convenience subject to additional broad division into the two subcategories of liquidity and transactional network.¹⁶ Confidence in the stability of a currency's value is critical to its international use, as instability in a currency's value raises the risk of holding it and thus hurts its attractiveness as a store of value. Confidence in a currency can be affected by factors such as government monetary and fiscal policies and the issuing country's current account and net-debtor positions, all of which affect its solvency risk.¹⁷ Liquidity is another salient economic attribute of an international currency, as users normally hold their international money in the form of liquid, interest-bearing assets rather than currency balances. The existence of well-developed and open financial markets in the issuing country is accordingly important for its international use, as they serve to lower the currency's transaction costs.¹⁸ The international use of a currency is

¹⁵ Note that although the Japanese government did drive for yen internationalization from the late 1990s, this ended in failure. See William W. Grimes, "Internationalization of the Yen and the New Politics of Monetary Insulation," in *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*, ed. Jonathan Kirshner (Ithaca: Cornell University Press, 2003), pp. 172-94; and Saori N. Katada, "From a Supporter to a Challenger? Japan's Currency Leadership in Dollar-dominated East Asia," *Review of International Political Economy* 15:3 (2008), pp. 399-417.

¹⁶ Erich Helleiner provides the trichotomy of the economic determinants of international currency status. See "Political Determinants of International Currencies: What Future for the US Dollar?" *Review of International Political Economy* 15:3 (2008), pp. 354-78. He neglects the property common to liquidity and transactional network of convenience, however, perhaps because the factors that affect liquidity and those that influence transactional networks are quite different from each other.

¹⁷ Ewe-Ghee Lim, *The Euro's Challenge to the Dollar: Different Views from Economists and Evidence from COFER (Currency Composition of Foreign Exchange Reserves) and Other Data* (Washington, D.C.: International Monetary Fund, 2006); and George S. Tavlas and Yuzuru Ozeki, *The Internationalization of Currencies: An Appraisal of the Japanese Yen* (Washington, D.C.: International Monetary Fund, 1992).

¹⁸ Lim, *The Euro's Challenge to the Dollar*.

affected by the scale of the issuing country's transactional networks in the world economy as well, since the benefits of using a particular currency grow with the number of other parties using it, due to network externalities. Factors determining the issuing country's integration into the world economy, such as its economic size, thus influence the currency's international use.¹⁹

It has in addition been widely argued that network externalities give rise to inertia and path dependency in the choice of use of an international currency, and accordingly create incumbency advantages for the dominant international currency. However, some recent studies demonstrate the effect of network externalities on international currency choice to be weak, particularly in connection with the currency's use as a store of value, showing that British sterling, the French franc and the deutschmark shared the reserve currency role in the 1910s, and that sterling, the franc and the dollar did so in the 1920s and 1930s.²⁰

Among these economic conditions related to renminbi internationalization, a majority of studies tend to assess the confidence in it and related transactional networks as largely favorable for renminbi internationalization, while stressing its low liquidity—more specifically, the capital account inconvertibility and underdevelopment of the Chinese financial markets—as the primary obstacle.²¹ Similarly, the tightly regulated financial markets in Japan and Germany have frequently been cited as the principal problems preventing internationalization of the yen and the deutschmark.²² Many studies are moreover skeptical of the likelihood of financial liberalization in China in the near term, as this would require abandonment of the Chinese development model whose main instruments include credit controls and export-led growth.

It is certainly likely that capital account convertibility and development of the Chinese financial markets will help renminbi internationalization. It nonetheless remains debatable whether the current Chinese financial market situations in these regards are, and will persist

¹⁹ Chinn and Frankel, "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?"; and Paul Krugman, "The International Role of the Dollar: Theory and Prospect," in *Exchange Rate Theory and Practice*, ed. John Bilson and Richard Marston (Chicago: University of Chicago Press, 1984), pp. 261-78.

²⁰ See Barry Eichengreen, *Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition* (Cambridge, MA: National Bureau of Economic Research, 2005); Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (Oxford: Oxford University Press, 2011); and Barry Eichengreen and Marc Flandreau, *The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading Reserve Currency?* (London: Center for Economic Policy Research, 2008).

²¹ See, for example, C. Fred Bergsten, "Why the World Needs Three Global Currencies," *Financial Times*, 15 February, 2011; Benjamin J. Cohen, "Toward a Leaderless Currency System," in *The Future of the Dollar*, pp. 142-63; Richard N. Cooper, *The Future of the Dollar* (Washington, D.C.: Peterson Institute for International Economics, 2009); Richard N. Cooper, "Does the SDR Have a Future?" *Journal of Globalization and Development* 1:2 (2010), Article 11; Dobson and Masson, "Will the Renminbi Become a World Currency?"; Barry Eichengreen, "The Dollar Dilemma: The World's Top Currency Faces Competition," *Foreign Affairs* 88:5 (2009), pp. 59-68; International Monetary Fund, *Reserve Accumulation and International Monetary Stability: Supplementary Information* (Washington, D.C., 2010); Lee, "Will the Renminbi Emerge as an International Reserve Currency?"; Mallaby and Wethington, "The Future of the Yuan"; Park, "RMB Internationalization and Its Implications for Financial and Monetary Cooperation in East Asia"; and Wu, Pan and Wang, "Renminbi's Potential to Become a Global Currency."

²² See, for example, Robert Z. Aliber, "The Costs and Benefits of the U.S. Role as a Reserve Currency Country," *Quarterly Journal of Economics* 78:3 (1964), pp. 442-56; Cohen, "Toward a Leaderless Currency System"; Eichengreen, *Exorbitant Privilege*; Katada, "From a Supporter to a Challenger?"; Eric Helleiner, "Enduring Top Currency, Fragile Negotiated Currency: Politics and the Dollar's International Role," in *The Future of the Dollar*, pp. 69-87; Park, "RMB Internationalization and Its Implications for Financial and Monetary Cooperation in East Asia"; and Tavlas, *On the International Use of Currencies*.

as, the most serious obstacles to renminbi internationalization. The Chinese government has recently set up plans for developing Shanghai into a leading international financial center by 2020, and for achieving capital account convertibility by that year as well.²³ And Shanghai's status as an international financial center has indeed been rising rapidly in recent years, to the point where it ranked fifth, even overtaking Tokyo, in the *Global Financial Centres Index* in September 2011.²⁴ The Chinese government's new Five-Year Plan for 2011 to 2015 has also adopted, for the first time, specific measures to increase domestic demand, reflecting thereby a willingness to shift from the traditional Chinese development model.²⁵ Although such a great change is not possible overnight, it may not be impossible given a decade. And there is in this regard a precedent: the evolution of New York into a leading international financial center within ten years after creation of the Federal Reserve in 1913, which was an essential arrangement for the development of US financial markets,²⁶ and the dollar's coincident rise to leading international currency status from a position in which it had lacked any significant international role.²⁷

Meanwhile, even if such substantial change is not realized, development of the offshore renminbi market in Hong Kong may still help to promote renminbi internationalization to a significant extent. In fact, whether financial liberalization is a prerequisite for currency internationalization is a controversial issue. Contrary to the conventional perception, a recent study by the Bank for International Settlements suggests full capital account liberalization to be neither a necessary nor a sufficient condition for currency internationalization, and that promoting the development of offshore markets can help currency internationalization while allowing the issuing state to retain control over its capital account.²⁸ The study emphasizes how the significant US capital controls in the 1960s and early 1970s did not in reality undermine the dollar's international role, but in some ways rather contributed to growth of the eurodollar market, without which the dollar may not have obtained the dominant international currency standing it enjoys today. China's experiment of trying to achieve renminbi internationalization mainly through its offshore market in Hong Kong, with limited liberalization on the mainland, should thus not be judged *ex ante* as doomed to fail merely because of a lack of historical precedents.²⁹ It is in addition noteworthy that British financial institutions have pressed for London to become an offshore renminbi trading center, and that the Chinese government, jointly with that of the UK, has recently expressed formal support for their objective.³⁰

²³ Lardy and Douglass, *Capital Account Liberalization and the Role of the Renminbi*; and *Xinhua News*, "RMB Capital Account Liberalization to Be Achieved in Five Years: Forex Chief," [accessed January 18, 2011], <<http://www.xinhuanet.com/english2010>>.

²⁴ Mark Yeandle, "The Global Financial Centres Index 10," *Long Finance*, 2011 [accessed November 9, 2011], <<http://www.zyen.com/PDF/GFCI%208.pdf>>.

²⁵ China's Five-Year Plans, the first of which was adopted for the period 1953 to 1957, are a series of economic development initiatives of the government.

²⁶ See J. Lawrence Broz, *The International Origins of the Federal Reserve System* (Ithaca: Cornell University Press, 1997).

²⁷ Eichengreen, *Exorbitant Privilege*, p. 146. Contrary to the conventional account that the dollar emerged as the leading international currency after World War II, recent research demonstrates that this first occurred in the 1920s. See *ibid.*; and Eichengreen and Flandreau, "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading Reserve Currency?"

²⁸ Dong He and Robert N. McCauley, *Offshore Markets for the Domestic Currency: Monetary and Financial Stability Issues* (Basel: Bank for International Settlements, 2010).

²⁹ See also Paola Subacchi, *'One Currency, Two Systems': China's Renminbi Strategy* (London: Chatham House, 2010).

³⁰ See James Blitz, "China to Back London as Offshore Renminbi Centre," *Financial Times*, September 7, 2011; and James Blitz, "Britain and China Strengthen Relations," *Financial Times*, September 8, 2011.

Even if the matters of capital account convertibility and financial market development may be put aside, however, there are other significant economic hurdles to renminbi internationalization remaining. One such major problem is China's economic size. Although China did overtake Japan as the world's second largest economy in 2010, its economy is still now just one-third the size that of the United States. And assuming seven percent annual growth in China for the next decade, its gross domestic product (GDP) will likely be only half that of the US by 2020.³¹ Even employing more favorable assumptions China is unlikely to become the world's largest economy until the mid-2020s.³² Given the limits of an economy of this size, the renminbi seems in a difficult position to overcome dollar use inertia and become a consequential international currency globally, considering especially that the dollar's rise as a major international currency in the early 1910s began when the US economy was more than twice the size of the UK.³³

China's consistent huge current account surplus seems to pose an additional notable obstacle to renminbi internationalization, as it constrains other countries' accumulations of renminbi. Foreigners must first accumulate renminbi before they can use them, and a major channel for this would be a Chinese current account deficit. The Chinese government has recently been encouraging foreign lending and investment in renminbi, another channel through which to supply the currency to the world, but the supply through this channel may be limited initially due to the renminbi's low acceptability.

Economic conditions thus do not ultimately appear greatly favorable for renminbi internationalization. Unlike in the conventional account, however, the more substantial problems may be the relatively small size of the Chinese economy and the limited supply of renminbi to foreigners, rather than capital account inconvertibility and underdevelopment of the Chinese financial markets.

Political Conditions for Renminbi Internationalization

The literature on currency internationalization, dominated as it is by economic studies, has a tendency to neglect the significance of political factors as determinants of currency internationalization.³⁴ Politics does affect international currency status, however.³⁵

³¹ Eichengreen, *Exorbitant Privilege*, p. 147. Although the seven percent assumption for annual growth is lower than China's recent rate of about nine to ten percent, it reflects the country's less favorable demographics in the coming years and is still exceptionally high by historical standards.

³² See Ito, "China as Number One."

³³ See Stephen D. Krasner, "State Power and the Structure of International Trade," *World Politics* 28:3 (1976), p. 435.

³⁴ There are of course some significant political economy studies of currency internationalization. Susan Strange pioneered the political economy study of international currencies in the early 1970s, in her majestic *Sterling and British Policy: A Political Study of an International Currency in Decline* (London: Oxford University Press, 1971), which led to the emergence of international political economy as an academic discipline. With some notable exceptions (for example Cohen, *The Geography of Money*; and Kirshner, *Currency and Coercion*), however, the political economy research on international currencies had after that been largely stagnant until recently, when debate on the dollar's future as dominant international currency emerged in the wake of the global financial crisis. For the recent political economy study of international currencies, see for example a 2008 special issue (No. 3) of *Review of International Political Economy*, on the future of the dollar and the international monetary system; Chey, "Theories of International Currencies and the Future of the World Monetary Order"; and Helleiner and Kirshner, eds., *The Future of the Dollar*.

³⁵ Strange categorizes international currencies into four types in accordance with the natures of the factors supporting their international use: "master currencies," "top currencies," "negotiated currencies" and "neutral currencies." A master currency is the currency of a hegemonic or imperial state that coerces its use by other states. It thus always derives its status from the political relationships between the issuing and the subordinate

Especially when a currency's internationalization is either on the rise or in decline, its intrinsic economic properties are unlikely to be strong enough to secure its broad international use, and in such times political factors are likely to have significant influence over its international use as well.

Politics can impact a currency's internationalization through both indirect and direct channels.³⁶ Through the indirect channel, politics affects international use of a currency by influencing the economic determinants of its international status discussed above. During the 1910s and 1920s, for example, when the dollar began its rise as an international currency, the Federal Reserve played a central role in promoting dollar internationalization by actively building a market for dollar-denominated trade acceptances, growth of which was crucial to the success of dollar internationalization.³⁷ Through the direct channel, meanwhile, politics impact a currency's use more directly, without regard to the economic determinants of currency internationalization. For instance, when the dollar was emerging as an international currency in the early twentieth century, US policymakers also actively employed "dollarization diplomacy" in many Latin American countries to encourage their use of the dollar, even calling for creation of a dollar-based monetary union involving all countries in the Americas, as a way of promoting US influence and economic interest in the region.³⁸ Meanwhile, given the recent trends of a considerable rise in state holdings of foreign exchange reserves and the emergence of sovereign wealth funds as new major global investors, the influence of political factors on international currency status may have now become greater than in the past.³⁹

Among the diverse political determinants of international currency standing, this paper calls special attention to one systemic factor: international political power.⁴⁰ International political power can have significant effects on international currency standing through both the indirect and the direct channels. Through the indirect channel, for instance, the

states. Sterling in the sterling area and the French franc in the franc zone in the past were examples. A top currency is in contrast one that is most favored by the world market for various monetary purposes, due to its economic superiority. Its status is therefore determined primarily by economic factors, and it tends to be the currency of the predominant state in the world economy. The dollar in the 1950s was one example. Meanwhile, a negotiated currency occurs when the issuing state bargains or negotiates politically with other states for their use of its currency, offering inducements such as military and diplomatic support or economic benefits. Examples of negotiated currencies include sterling in the postwar period and the dollar in the 1960s. Finally, a neutral currency is a currency whose international use stems primarily from the strong, but not necessarily dominant, economic position of its issuing state, which has no interest in promoting its international use. Examples include the Swiss franc and the deutschmark. This typology of international currencies is not entirely mutually exclusive, and some currencies can belong to more than one international currency types at a time. See Strange, *Sterling and British Policy*, pp. 1-40.

³⁶ Helleiner, "Political Determinants of International Currencies."

³⁷ Eichengreen, *Exorbitant Privilege*, pp. 28-30.

³⁸ Eric Helleiner, "Dollarization Diplomacy: US Policy towards Latin America Coming Full Circle?" *Review of International Political Economy* 10:3 (2003): pp. 406-29.

³⁹ Helleiner, "Enduring Top Currency, Fragile Negotiated Currency," pp. 77-78.

⁴⁰ Nobel laureate economist Robert Mundell also notes: "Great powers have great currencies." See Robert A. Mundell, *EMU and the International Monetary System: A Transatlantic Perspective* (Vienna: Austrian National Bank, 1993). And indeed, the linkage between international political power and currency internationalization has sometimes been noted in the literature, but it is rarely discussed in a systematic way. Meanwhile, together with systemic political factors, domestic political factors may also affect currency internationalization. And given that the Chinese government has been actively pushing ahead with renminbi internationalization, domestic politics in China appear to be largely favorable to this purpose, although the government seems likely to manage its speed and scope carefully in the early stage, particularly as this involves financial liberalization. For the domestic politics of renminbi internationalization in China, see for example Mallaby and Wethington, "The Future of the Yuan," pp. 138-40; and Subramanian, *Renminbi Rules*, pp. 20-22.

international political power of the state issuing an international currency is, as widely recognized, an ultimate source of confidence in its value, especially in the current fiat money system. If the issuing state's security is under serious threat foreign incentives to use its currency, particularly as a store of value, will decline significantly.

The international political power of the issuing state can also directly affect international use of its currency in two different ways. Firstly, an increase in its international political power boosts the issuing state's capacity to actively encourage foreign use of its currency through inducements such as the provision of military, diplomatic or economic support, or even through coercion—as shown in the above-mentioned case of dollarization diplomacy in the early twentieth century when the United States was rapidly expanding its military and economic influence across Latin America.⁴¹ The issuing state's international political power is meanwhile also likely to promote international use of its currency through augmenting its soft power, since foreign countries' economic and military dependence on the state tend to generate voluntary incentives on their parts to strengthen their relationships with it through the greater use of its currency.⁴² Indeed, when the French franc and the deutschmark shared the reserve currency role with sterling in the 1910s, their uses were especially substantial in regions having strong commercial and financial linkages to France and Germany.⁴³ The present-day voluntary “dollarization” in some Latin American countries, and the unilateral “euroization” in some European countries, may also exemplify such soft power.⁴⁴

The significant impact of international political power on the international monetary order is also illustrated by considering the chronology of the dollar's evolution to leading international currency from a broader perspective. As mentioned earlier, the dollar began its take-off toward this role in the 1910s when the US had become a great power, although the United Kingdom did still remain the most powerful country and sterling the leading international currency as well.⁴⁵ After World War I the United States became the world's greatest power, and the dollar then replaced sterling as the top reserve currency in around 1924 and accounted for more than half of total world foreign exchange reserves by 1929. The dollar then temporarily lost its status as leading international currency to sterling in the wake of the Great Depression, which caused US power to decline more than those of other countries through the 1930s.⁴⁶ Yet it regained its supreme status with the consolidation of Pax Americana after World War II.⁴⁷

⁴¹ See Helleiner, “Dollarization Diplomacy.”

⁴² The sources of soft power should not be confused with soft power itself. Although factors such as culture may be important sources of soft power, its sources need not always be soft. Military capacity can also contribute to it.

⁴³ Subramanian, *Renminbi Rules*, p. 8. In 1913, the shares of sterling, the franc and the deutschmark in total world foreign exchange reserves were 38, 24 and 13 percent, respectively.

⁴⁴ The positive effect of a state's international power on its currency's internationalization, and the favorable impact of a currency's internationalization on the issuing state's international power, both discussed earlier, suggest the existence of a circular causation between the two.

⁴⁵ Although the United States overtook the United Kingdom in terms of GDP before World War I, the United States became the dominant economic power in a broader sense encompassing trade and finance only by around the end of the war. The United Kingdom was also more powerful than the United States in military terms before the war. See Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (New York: Random House, 1987), p. 247; and Subramanian, *Renminbi Rules*.

⁴⁶ The US share of world manufacturing output declined considerably, for example, from 43 percent in 1929 to 29 percent in 1938, lower than at any time since the 1910s, while the UK share stayed persistently at 9 to 10 percent during this period. See Kennedy, *The Rise and Fall of the Great Powers*, pp. 329-30.

⁴⁷ This account of the dollar's emergence as leading international currency draws mainly on Eichengreen and Flandreau's study of the matter and Kennedy's and Krasner's work on changes in great powers. See *ibid.*; Eichengreen and Flandreau, “The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the

In this regard, the key issue related to renminbi internationalization at present is the degree to which China has been “gaining” and the United States “losing” international political power. And US power appears still far greater than Chinese, considering the related economic and military underpinnings. As noted above, despite its rapid economic growth over the past decades China has an economy still just one-third the size of the United States’, and it seems likely to take at least fifteen years before the two even become equal.⁴⁸ Yet the US economy was in contrast more than twice the size that of the UK in the early 1910s, when the dollar began emerging as a consequential international currency, and it had grown to more than four times as big by the late 1920s, when the dollar replaced sterling firmly as leading international currency.⁴⁹ The US in addition remains to this day the world’s largest importer, biggest FDI investor and most attractive destination for FDI inflows, greatly surpassing China in all of these areas still, even despite the recent global financial crisis. The US also has unmatched military superiority over China, by which it continues providing security assistance to its allies around the world even after the Cold War’s end. Indeed, US military spending accounted for 43 percent that of the world as a whole in 2010, while that of China accounted for just seven percent. The United States also possesses about 8,500 nuclear weapons, and China only about 240.⁵⁰

Even though the Chinese economy has developed rapidly in recent decades the United States accordingly appears to hold far greater international political power still. A 2011 Pew Research Center survey on the favorability of countries shed some notable light on the international political power of these two rivals,⁵¹ as major Asian powers Japan and India expressed much more favorable attitudes toward the US than toward China, implying substantial United States exercise of soft power even in China’s hinterland.⁵² Meanwhile, major Western powers such as Britain, France, Germany and Spain, as well as major US neighbors like Mexico and Brazil, also showed more positive views of the US than of China,⁵³ suggesting that China’s soft power remains quite weak in regions with traditionally close ties to the US. In these circumstances, the dollar appears much more advantaged on the global scene than the renminbi, as strong centripetal forces ensuring continued dollar use may

Leading Reserve Currency?”; and Krasner, “State Power and the Structure of International Trade.” The traditional account, that sterling did not lose its status as leading international currency until the end of World War II, overlooks the dollar’s replacement of sterling in that role in the 1920s while noticing only sterling’s regained predominance in the 1930s. Meanwhile, Eichengreen emphasizes as the key factor explaining the rise of the dollar as leading international currency the development of US financial markets, which was attributable largely to the establishment of the Federal Reserve in 1913. See Eichengreen, *Exorbitant Privilege*; and Eichengreen, “The Renminbi as an International Currency.” Yet, while it appears certainly true that the development of US financial markets did help the dollar’s internationalization, his account does not appear to fully explain the dollar’s retreat in the 1930s. Indeed, the United Kingdom’s abandonment of the gold standard, which presumably had serious adverse effects on sterling’s international status, occurred two years earlier than that of the United States (in 1931 compared to 1933).

⁴⁸ Eichengreen, *Exorbitant Privilege*, p. 147; and Ito, “China as Number One.”

⁴⁹ Kennedy, *The Rise and Fall of the Great Powers*, p. 243; and Krasner, “State Power and the Structure of International Trade,” p. 345.

⁵⁰ Stockholm International Peace Research Institute, *SIPRI Yearbook 2011: Armaments, Disarmament and International Security* (Oxford: Oxford University Press, 2011).

⁵¹ Pew Research Center, “China Seen Overtaking U.S. as Global Superpower,” 2011 [accessed July 26, 2011], <<http://pewglobal.org/2011/07/13/china-seen-overtaking-us-as-global-superpower>> .

⁵² In Japan, 85 percent of the respondents had a positive view of the United States, while 61 percent showed a negative view of China. In India, 41 percent expressed favorable views toward the United States while only 25 percent did so toward China.

⁵³ The respective shares of the respondents showing favorable views toward the United States and China were 61 and 59 percent in Britain, 75 and 51 percent in France, 62 and 34 percent in Germany, 64 and 55 percent in Spain, 52 and 39 percent in Mexico, and 62 and 49 percent in Brazil.

operate at this level.

Not a Global, but a Regional Currency

Ultimately renminbi replacement of the dollar as the dominant international currency appears unlikely, at least in the near future. The renminbi may however be able to develop into a regional currency in Asia, where China's power is strongest in the world. Indeed, the volume of Asian countries' trade with China has already surpassed that with the United States. Hong Kong, the key offshore financial center for the renminbi, is moreover one of the world's leading international financial centers, ranked third after only London and New York in the *Global Financial Centres Index* in September 2011. And Shanghai, as mentioned earlier, was also ranked fifth in the index, surpassing Tokyo.⁵⁴ Further, while China has been running large trade surpluses against the world as a whole, it has recorded annual trade deficits against its East Asian neighbors on average through the 2000s. If this trend persists in the future, it can boost their renminbi accumulations and thus ultimately help renminbi internationalization.

The Chinese government in fact appears to have set a goal of developing the renminbi into a regional currency in Asia first, and to have been adopting deliberate policies toward this end. China's bilateral local currency swap arrangements with foreign countries for example center on Asia, with ten of the total fourteen partner countries being Asian—South Korea, Hong Kong, Malaysia, Indonesia, Singapore, Uzbekistan, Mongolia, Kazakhstan, Thailand and Pakistan.

China's provision of these swaps exemplifies use of its international political power for renminbi internationalization. For the swaps may give the recipient countries significant incentives to use more renminbi, due to the benefits accruing to them through three channels—through the provision of foreign exchange liquidity to them, which contributes to their financial stability when they face crisis; through the offering to them of renminbi to finance imports from China, which thus encourages their increased use of the renminbi as a trade settlement currency; and through the permission of investment by their central banks in the interbank bond markets on the Chinese mainland (since, as mentioned earlier, China permits only central banks having currency swaps with it to invest in these markets), which will help increase the renminbi compositions of their foreign exchange reserves. Notably, the Malaysian central bank has indeed purchased renminbi-denominated bonds for its foreign exchange reserves, and the South Korean central bank—holder of the world's eighth largest volume of foreign reserves—has drawn up plans to invest part of them in renminbi-denominated assets in mainland China, as a means of reserve diversification away from the dollar.⁵⁵

There is also one noteworthy potential policy relating to renminbi internationalization in Asia, which would be another form of direct exercise of China's international political power: purchase of the sovereign debt of Asian countries. This is a practice that might put upward pressures on the values of these countries' currencies, thus heightening their incentives to buy Chinese debt in response, if allowed, to keep the values of their own currencies from rising and in turn defend their exports. And that would of course ultimately also help renminbi internationalization in Asia.

The Chinese government in fact purchased large amounts of Japanese and South Korean

⁵⁴ Yeandle, "The Global Financial Centres Index 10."

⁵⁵ *Financial Times*, "Malaysian Bond Boost for Renminbi," September 19, 2010; *Financial Times*, "South Korea Seeks to Shift Reserves to China," May 4, 2011.

government bonds briefly in the fall of 2010, causing the yen and the Korean won to rise significantly and leading the Japanese finance minister to complain about how China's closed capital account prevented Japan from reciprocating.⁵⁶ It is also worth noting that diversification of China's foreign exchange reserve portfolio is one of the main goals in its new Five-Year Plan, since such diversification may be realized through growing purchases of Asian government bonds and help facilitate renminbi internationalization in the region. Indeed, a recent study by a senior research fellow at the Chinese Academy of Social Sciences, the premier academic research organization in the field of social sciences in China, proposes that the country substitute Asian government bonds for US Treasuries as its foreign exchange reserves—under the exceptionally politically bold title of “Is it Desirable for Asian Economies to Hold More Asian Assets in Their Foreign Exchange Reserves: The People's Republic of China's Answer.”⁵⁷

The development of the renminbi as a regional currency in Asia will of course not mean complete disappearance of the dollar from the region, but rather a significant decline in its use. Geopolitical factors in fact seem likely to help slow reduction in the dollar's influence in Asia to a degree. Although smaller countries may have stronger incentives to accommodate China more as its power strengthens, rivals of China such as Japan and India, for example, may not wish to depend solely on the renminbi if there is an alternative, which the dollar may continue to be for the foreseeable future. Indeed, as discussed above, Japan and India appear to have more favorable views of the United States than of China, implying weak motivations on their part for using the renminbi in the dollar's stead.

Conclusion

The internationalization of a currency is essentially a political economy issue rather than a mere economic one. The majority of studies of renminbi internationalization have nonetheless approached this subject almost exclusively from an economic perspective only, neglecting its political aspects. In an attempt to fill this important gap in the literature, this paper has provided a political economy analysis of renminbi internationalization, thereby contributing to expansion in the scope of the subject's discussion.

Renminbi internationalization, if actually achieved, is expected to generate considerable political, as well economic, benefits to China, facilitating its power and accordingly accelerating its rise in the world political economy. Given the political, as well as economic, conditions surrounding it, however, renminbi internationalization is likely to be limited primarily to Asia, China's backyard, rather than leading to renminbi replacement of the dollar as the leading international currency globally, at least in the near future.

Although internationalization of the renminbi is likely to be largely restricted to Asia, however, the significance of its impact on the world political economy should not be underestimated. Among other things, development of the renminbi as a regional currency in Asia will mean provision of an alternative reserve currency to the dollar for Asian countries, the largest dollar reserve holders in the world. And the US capacity to finance its current account deficit with its own currency will as a result decline significantly, placing the United States under greater market pressure to behave in a more disciplined manner. This will contribute to a reduction in the risk of global financial crisis recurrence, by mitigating the global imbalances. Meanwhile, the decrease in US policy autonomy may also weaken the US

⁵⁶ *Financial Times*, “Mending Fences in Beijing and Tokyo,” September 14, 2010.

⁵⁷ Bin Zhang, *Is It Desirable for Asian Economies to Hold More Asian Assets in Their Foreign Exchange Reserves: The People's Republic of China's Answer* (Tokyo: Asian Development Bank Institute, 2011).

ability to exercise global influence, given that a state's policy autonomy may be an essential precondition for its exercise of external influence.

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