



outside financial system replacing domestic financial system. In a long term, arbitrage behavior caused by the offshore Renminbi market is not completely useless, saving's cross-border "move" is conducive to the reasonability and stability of the scale of the domestic currency, but the state-owned banking system will lose part of the monetary control capabilities. Therefore, the internationalization of Renminbi must be synchronized with the marketization reforms of the domestic financial system, especially with the package of interest rate marketization and capital market liberalization. Only in this way can it ensure the stability and security of financial system.

### 6.3 Severe external economic environment

The third challenge is the external environment of internationalization of Renminbi. To promote the internationalization of Renminbi, firstly, is based on the fact that the relative strength of China's economy has been growing; secondly, with the increasing speed of the process of economic globalization after the Cold War, if China hopes to continue to promote industrialization and modernization and to become a powerful influence in the world economy, it is necessary to participate and play an important role in the process of economic globalization in the world. The strategy of internationalization of Renminbi needs to be developed according to the new situation and new trends of the world economy. However, China is currently facing a passive external environment, and many problems constitute a considerably obvious challenge to the internationalization of Renminbi.

#### 6.3.1 The "inertia" in the international monetary system

Today's world monetary system, whether national or international, has been completely "nationally credited", which increases the "inertia" of the traditional pattern of the international monetary system. Domestic and international currency, in the Bretton Woods system and after, based on precious metal standard, basically turned into the gold standard after the end of the 19th century. The so-called international currency, in fact, was the gold. Currency of any country determined its official parity by pegging gold. National currency credit depends on the convertibility of this currency to gold. Pound, in the long term, was the center of the international monetary system before the World War I, simply because the United Kingdom, by virtue of its strong economic



and the colonial power, could ensure sufficient domestic supply of gold. In the era of gold-based international monetary system, one country can only ensure the international flow of currency by ensuring its convertibility to gold. Because of this, after the World War I, due to Britain's large sums of debts to the U. S., gold reserves largely flowed out, resulting in the fall of pound from the core of international currency to a regional currency within the Commonwealth countries.

The World War II hit the economic forces of the United Kingdom again, and the UK and Europe were in a gold shortage, whereas the United States, through the opportunity in the war, has held large sums of gold, as well as the debts of the United Kingdom and other European countries. In 1944, when the Allies prepared to establish the post-war monetary system, the United States rejected Keynes's scheme of joint establishment of the international monetary unit, "Bancor", but requested domestic currency of every country be separately and directly linked to gold, completely intact to the pre-war international monetary system. The fact is that only the U. S. dollar had the ability to peg to gold, other countries, in order to maintain parity, were forced to be pegged to the dollar. By using the gold parity of the currency, the U. S once pegged all the European currencies to the dollar, and then, under the situation of European post-war recession, used the Marshall Plan to inject large sums of U. S. dollars into Europe, setting up the dollar-based multilateral settlement relationship within Europe, and the U. S dollar has become the international currency in the western world.

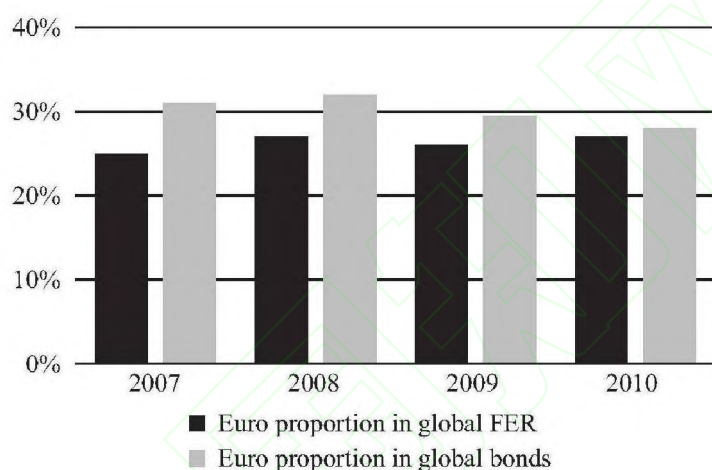
However, in 1971, the U. S. announced disconnection from gold, and the foundation of its status as the international currency was not solid then. Without property right basis, there was no absolute standard on the impact and status of each member in the international monetary system. There is no single standard for Renminbi to get more involved in the international monetary system, but we must realize multiple targets such as to promote the real economic growth, to share and control of international trade, to enhance its status in the international financial markets, and even to actively improve the international political influence and military strength, thus constantly enhance the abstract concept of "national credit".

Because there is no basis of fair property right, the internationalization of Renminbi is basically carried out by signing bilateral currency swap agreements with different countries, and Renminbi cannot circulate freely in the



holder countries. Purely national credit-based international monetary system increases the difficulty of China to expand its currency circulation and reserves network and the difficulty to improve Chinese influence in the international monetary system.

The total size of the EU economy has already surpassed the United States, and has achieved a high degree of integration of the major countries within the economic relations, but the rise of status of the euro in the international monetary system is not significant. In the global currency circulation and reserves, the status of Euro is far behind the U. S dollar (Figure 6-2).



**Figure 6-2 Euro's position in global financial market**

Source: ECB, *The International Role of Euro*, July 2011.

In recent years, the status of Euro in the international monetary system is not in an upward trend, which is not commensurate with the EU countries' relative economic status. However, this trend illustrates a problem, that is, once the world economy has determined the status of a particular currency in circulation, it will have to rely on this money. The United States has always insisted on the policy of low interest rates to stimulate the economy in the 21st century, resulting in the continuous expansion of U. S. dollar supply. Since the financial crisis in 2008, the depreciation trend of the dollar was already evident, but the risk of the U. S. dollar did not reduce its status in the international monetary system. In respect of international monetary system itself, the cost of conversion of the international currency is still higher than adhere to the U. S. dollar as the center in the system. Such concerns will greatly delay the speed of the system's update. Euro has a history more than 10 years, yet cannot rival the U. S. dollar, an important reason of which is that the international



monetary system is inherently sluggish to update.

It should be noted that this inertia is not only from the international monetary system itself, but also from the leading countries in the international monetary system. As we all know, to keep the dollar's high degree of international liquidity is the premise of the United States to grab the world-wide seigniorage. If the dollar's international status and market share is by the entry of Renminbi, it means the United States' ability to grab seigniorage is being squeezed too, resulting in a decline of the ability of the U. S to export economic pressure. If the financial bubble within the U. S. economy cannot be eliminated, the United States is bound to strongly oppose to any changes that may pose a threat to the U. S. dollar international status, and the internationalization of Renminbi will not be an exception. Therefore, in the process of the internationalization of Renminbi, China will inevitably encounter a variety of resistance from the United States.

### 6. 3. 2 Speculative risk of the outflow of Renminbi

China adheres to the export-oriented growth model, and for the past decade, it maintained a long-term current account surplus. Under the settlement system, foreign exchange can only be traded through designated foreign exchange banks, and the vast majority of foreign exchange in the foreign exchange trading is finally bought by the central bank, becoming foreign exchange reserves. As a result, the central bank's foreign exchange reserves swelled with the increase of foreign trade surplus, leading to strong appreciation expectation. However, controls over capital accounts limits the outflow of Renminbi into the overseas market, and the appreciation expectation is not realized. In July 2005, though China ended the fixed exchange rate system pegged to the dollar, China's trade surplus to the United States and the world did not change substantively, and the expansion trend of foreign exchange reserves remains(Figure 6-3).

Internationalization of Renminbi was started when it was facing strong appreciation expectation, which, coupled with the close and tight China's domestic financial system, has promoted a sharp outflow of Renminbi, especially for those overseas investors with speculative purposes. As we mentioned earlier, in July 2009, China liberalized the regular channels of the Renminbi settlement, and the outflow of Renminbi in 2010 was more than 250 billion yuan, equivalent to 40 billion U. S. dollar. Although in the process of internationalization

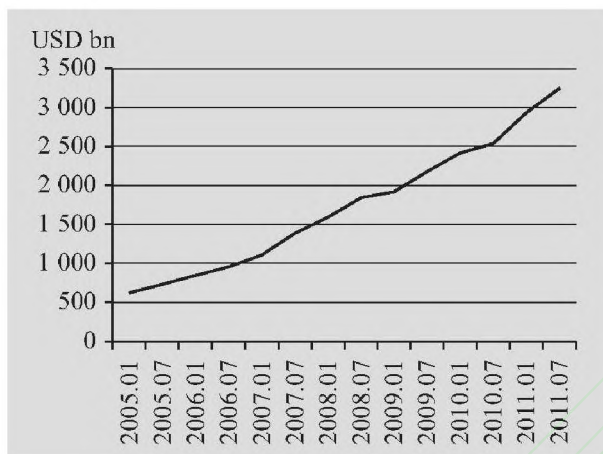


Figure 6-3 FER held by PBOC (2005-2011)

Source: PBOC.

of Renminbi, currency outflow in the early stages of liberalization is a normal situation, China has accumulated so much external appreciation pressure that the speculative foreign investment entities have also stroked a strong impulse, resulting in a bit violent in Renminbi outflow trend.

Currently, the settlement in foreign trade, mainly imports, accounts for 80-90% of the Renminbi settlement, which is actually from the expectation of taking benefit from the appreciation of Renminbi. Corresponding to extensive use of Renminbi in import trade, Renminbi is rarely used in export trade, which is determined by the expectation of appreciation of Renminbi. This is similar to issues with the capital account. What is the difference between direct investment in the foreign country settled in U. S. dollars and Renminbi? If the expected value of these two currencies is stable and equally convenient in use, then these two currencies are the same. However, with the depreciation expectation of the dollar and strong appreciation expectation of Renminbi, people are willing to accept Renminbi, while unwilling to accept U. S. dollars. In this case, the fact that overseas investors prefer to hold Renminbi at early stages cannot be explained as credit of Renminbi in the world market is increased. If the blind outflow of Renminbi leads to excessive speculation, bubble of value of Renminbi is easy to be produced. Once the bubble bursts, it will seriously affect the healthy and stable development of China's economy. Latin American countries, during the neo-liberal reforms from the 1970s to the 1990s, have generally gone through this process. Therefore, as mentioned earlier, the real international currency must have a stable currency value. Though strong appreciation expectation of Renminbi helps it to circulate in the world in the



short term, the Chinese economy may pay a large price in the end. In the long term, we need to change the Chinese economic model of development, balance the international payments and promote the internationalization of Renminbi on the basis of stable currency value.

The Asian financial crisis in 1997 told us that blindly promote the opening of the finance will leave the country easily attacked by foreign speculators, and thus induce the domestic economic crisis. Even for a highly open economy, higher internationalization level is not better. In the Asian financial crisis period, due to the blind financial liberalization in Southeast Asian countries, international speculators were easy to raise the domestic currency in international currency markets, then by the use of financial leverage, hit the Southeast Asian countries financial system one by one. Of course, China's economic scale is far greater than the ASEAN countries with huge foreign exchange reserves, it is difficult to imagine how much Renminbi is needed for the international speculator to bring a catastrophic decline to Renminbi exchange rate. However, China is, so far, also highly dependent on exports, the exchange rate risk in China's economy cannot be ignored. To maintain a stable currency, limitation on the speculation window is needed in order to ensure that the money can be used in the international general settlement, investment and reserve. Therefore, China should pay attention to the outflow trend of Renminbi in the early stage of internationalization, preventing Renminbi from becoming a new object of speculation under the context of excess liquidity in developed countries.