



Monetary Overextension: Why the Chinese Yuan will not become the next Global Currency

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Author Note My name is Wing Wong, and I am a U2 student studying political science and computer science. The paper that you are about to read was written for POLI 445, a fascinating course which delves into the intricacies of international monetary relations. As someone who has roots in Hong Kong, this paper was especially compelling to write as the city plays a critical role in facilitating trade between China and the rest of the world. I would like to thank Professor Mark Brawley for igniting my interest in international political economy, and the field of economics in general. I would also like to thank my parents for providing me the unique experiences which have given me the inspiration to write this paper. Finally, a big thanks to Emma Frattasio and Maëna Raoux for their hard work and encouragement.

Abstract In the first two decades of the twenty-first century, the People's Republic of China has experienced massive growth to become the world's second largest economy. Along with this rise, China has taken steps to expand its economic power and influence overseas. One of the ways it has pursued this is to promote the Chinese Renminbi as an alternative to the US Dollar, which has served as the international currency since the end of the Second World War. By analyzing the features of the Chinese economy through various paradigms, this paper will argue that, despite the best efforts of the Chinese government, the RMB will be unlikely to displace the USD as the premier currency in the near future.

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Introduction

In 2009, the Chinese government launched a campaign to internationalize the Chinese Yuan (RMB) by formally promoting its use outside of Mainland China for the first time. This stood in stark contrast to China's previous monetary policy, which – until 2004 – forbade any amount of RMB from leaving mainland China (Cheung 2014, 3). Since then, China has ensured a steady supply of RMB in the global market by negotiating swap lines with central banks around the world, issuing RMB-denominated bonds, and authorizing global financial centres to engage in the official trading of the currency (Prasad 2017, 106). Consequently, the Yuan has seen a rapid rise in popularity as both a reserve currency and a currency used to record transactions for foreign governments and investors alike, reaching the point where it is now the eighth most traded currency in the world (121). These developments, along with China's massive growth to become the world's second-largest economy, have led scholars to ask an important question: What are the chances that the RMB will replace the US Dollar (USD) as the international medium of exchange?

By adopting an analytical liberal standpoint, this paper will argue that although China publicized its intentions to make the Yuan an international medium of exchange and has aggressively pursued this goal, the chances that it will overtake the US dollar in its role as an international currency remains small. Focusing on the domestic front, there are three main factors preventing the Chinese Yuan from becoming the next global currency: China has yet to 1) develop its economy to its maximum potential, 2) fully liberalize its economy, and 3) resolve the lack of efficiency and transparency of its financial institutions. Thus, it simply lacks many of the same factors that enabled the USD to become a global currency in the first place. Instead, a more likely scenario is that the Yuan will move up the currency hierarchy to become a dominant regional currency.

Premature Ambition

For the Chinese government, the internationalization of the Yuan would bring about numerous advantages. First, the increase in demand associated with an international currency means that domestic banks and other financial institutions will receive more business, as they can gain a competitive edge over foreign banks by receiving security network protection and concessions from the government (Zhang 2011, 210). This enables Chinese banks to provide additional services to their customers, such as deposit insurance and fraud protection, which in turn allows them to recuperate potential losses and increase consumer confidence. Furthermore, through the process of seigniorage, the issuing country can profit by printing currency that is worth more than the cost of producing it (210). Additionally, the issuing country can cut back its debt burden by increasing the money supply, thereby reducing the value of any outstanding debts (211).

Despite the many benefits, currency internationalization also comes with several drawbacks, some of which would be particularly damaging to the Chinese economy. One of the key obstacles preventing the Chinese Yuan from challenging the USD is timing, as the Yuan is undergoing internationalization at a time when the Chinese economy has not yet been fully developed. Although China enjoys growth rates much higher than its Western counterparts – including several years of double-digit growth before 2008 – a significant wealth gap continues to exist (Breznitz and Murphree 2011, 2). As of 2018, the Chinese Gross National Income per capita stood at \$17,841, or slightly more than one-quarter of the US (World Bank 2019). By contrast, the Pound Sterling and the USD were both adopted only after their issuing countries became undisputed leaders in the international economy during the nineteenth and twentieth centuries (Eichengreen and Kawai 2015, 54). This means that the Chinese government has continued to prioritize sustained economic growth as part of its long-term goals. Nevertheless, this also

presents a dilemma for policymakers, as the internationalization of the RMB would run counter to creating growth. Should the Yuan be successfully adopted as an international currency, the increase in foreign demand would inevitably cause its value to rise relative to other currencies. This change in value would make exports look more expensive to potential customers, hurting sales, and slowing economic growth. Moreover, at the time of writing, the growth rate in China has already slowed to 6%, the lowest in 27 years (Tang 2019). Without slowing further plans for internationalization, the Chinese economy could completely stagnate or even begin to experience negative growth, which would prove to be extremely unpopular amongst a population that has enjoyed decades of economic prosperity (Zhang 2011, 140).

Given that China has become much more central in the global economy in recent years and considering the advantages of currency internationalization, some may argue that the RMB will inevitably become a global currency. However, if such an occasion did occur, the disadvantages mentioned above would become amplified, creating an additional incentive for the Chinese government to reverse course. To reduce the appeal of the RMB, the government can simply devalue the currency or implement additional capital controls. The former would reduce the value of foreign holdings of RMB, undermining foreign confidence in the currency as a store of value. Meanwhile, additional capital controls would reduce the supply of RMB overseas, reducing the number of transactions involving the RMB and increasing transaction costs.

Structural Realists would argue that a shift in the international medium of exchange towards the Yuan is inevitable, given China's swift rise as one of the world's largest economies with a growth rate that far outpaces that of the United States (Casetti 2003, 665). They would predict that as China gains economic and political clout, it will be able to influence the international monetary regime to its own liking and impose the Yuan on smaller states. Meanwhile, under analytical liberalism, the unit of analysis begins with the preferences of individuals. As they identify the preferences of others, they begin to form interest groups that compete with one another until a dominant group emerges and can influence government policy. As such, changes can only happen when the breakdown of preferences begins to change. Using this perspective, the government would face growing opposition from several influential groups. First, China's massive manufacturing sector would oppose further attempts to internationalize the currency, as the appreciation of the Yuan would directly impact their profits. Second, internationalization would make it more difficult for the Central Bank of China (PBOC) to manage monetary policy that suits domestic interests. Once growth continues to decline, the central bank would be forced to lower interest rates to encourage borrowing and spending. This can only be done to a limited extent, however, as too much stimulus can lead to high inflation, causing confidence in the Yuan to plummet (Helleiner 2008, 356). To satisfy these groups, the government will most likely be forced to slow or completely stop further efforts to internationalize the Yuan, eliminating any chance the USD would be displaced in the short-term.

Institutional Barriers

A second issue facing the internationalization of the Chinese Yuan is that it continues to be hampered by heavy restrictions on capital flow and monetary exchange, both of which have been long abandoned by the world's advanced economies. In the aftermath of the Asian financial crisis in 1997, the central government severely restricted Chinese banks' ability to borrow from foreign sources and limited the amount that foreigners could purchase from Chinese stock markets (Prasad 2017, 132). These decisions helped reduce stock market volatility and "hot money" which entails short-term investments that are quickly withdrawn by investors (Eichengreen and Kawai 2015, 71). However, the continued use of these policies into the present also prevents more foreign companies and individuals from establishing business ties with mainland China and

circulating RMB around the world. To make matters worse, the Yuan is still not fully convertible at the time of writing. Instead, a separate onshore (CNY) and offshore (CNH) rate provides importers with a source of RMB while still protecting the country's capital account (Cheung 2014, 5). Whereas trading for the CNY is tightly controlled by the PBOC, the CNH can be freely traded on the international market (5). This dual market is a source of worry for businesses and investors alike, as the two rates can differ by up to 10%, significantly increasing transaction costs (16). Moreover, even with the opening of official clearing centres and currency markets outside of mainland China, the Yuan is still largely unavailable in large quantities outside major financial centres such as London or Geneva (Prasad 2017, 111). Although no official statement has been made, the fact that China has not opened any new offshore clearing banks since December 2016 suggests that this is an intentional move by the Chinese government to avoid internationalizing the currency too quickly.

Beyond constraints on the financial and exchange markets, Chinese and foreign investors alike are concerned by the fact that Chinese financial institutions simply lack the transparency that has become the norm in the developed world (Eichengreen 2005, 22). These concerns are symptomatic of the fact that China continues to be ruled by an authoritarian regime, which prevents state-owned financial institutions from being constrained by formal checks and balances or held accountable for their actions. Over time, this has resulted in corporations suffering from weak corporate governance, weak auditing standards, and shoddy accounting practices (Prasad 2017, 132). Therefore, investors' perceived risk of the currency increases as the lack of transparency introduces the possibility of unforeseen fluctuations.

By contrast, not only has the US dollar been free from any capital controls since the closing of the gold window in 1971, but it is also regulated by the Federal Reserve, which acts independently of the US government. These policies mirror international norms that have gradually shifted in favour of a free-market system over the twentieth century. Particularly, investors have an incentive to spend in countries that respect contracts between individuals, as well as between individuals and the government. These incentives are further increased if an independent and impartial judiciary can resolve potential disputes. Furthermore, a free-market system often entails strong property rights, preventing investors' assets from being at risk of government expropriation. As such, unless serious efforts are made to implement institutional reform, there is little incentive for foreign actors to use the RMB in transactions outside of China.

The Fate of the Chinese Yuan

Despite the current challenges facing the Yuan, the currency will almost certainly play a larger role in the international economy. In 2015, the Yuan was added as a basket currency for the International Monetary Fund (IMF), representing 10.92% of the Special Drawing Rights and making it the third reserve currency after the USD and the Euro (Prasad 2017, 121). This was a symbolic acknowledgement from the global community that the RMB has risen to become a major reserve currency. At the same time, the RMB has seen a massive increase as a settlement currency. The volume of RMB used in cross-border mainland trade settlement has increased from 3% in 2010 to 11% in 2013 (Eichengreen and Kawai 2015, 62). Finally, beginning in 2011, China has signed a series of bilateral trading agreements between the RMB and the currencies of major trading partners including Russia, Japan, and Australia (Prasad 2017, 112). This eliminates the need for the USD as an intermediate currency, allowing for a substantial reduction in transaction costs for both sides. Although the pursuance of such an aggressive internationalization policy has many disadvantages as discussed earlier, it is clear that for the time being the Chinese government sees the benefits of influence and prestige to be more valuable than any economic repercussions.

Conclusion

Under the present domestic conditions, it is unlikely that the Chinese Yuan will replace the USD as the international currency. Currently, the Chinese government chooses to pursue internationalization as it seeks to reap its numerous benefits, such as increased business for Chinese banks and influence over countries which use the Yuan for a large proportion of their transactions. Nonetheless, it has failed to recognize how a significant reduction in economic growth would eclipse such benefits. While these benefits may have been sustainable during years of double-digit growth, with growth rates at their lowest level since the 1990s, it has become necessary to re-evaluate the merits of continued internationalization. Moreover, China's financial markets and monetary regime are still under heavy restrictions, undermining investor confidence in the value of the Yuan and preventing it from freely flowing in the international market. Most importantly, the lack of transparency and accountability in Chinese financial institutions makes it difficult for the public to believe that the Yuan will be free from unexpected interventions.

While it is unlikely that the Chinese Yuan will replace the US Dollar anytime soon, it is well on its way to becoming a dominant regional currency. Already, the USD no longer plays a role as a currency of intermediation between China and some of its largest trading partners. Additionally, neighbouring countries have begun issuing RMB-denominated bonds and are holding an increasing amount of RMB in their reserves. Moving forward, if the Chinese government wishes to maximize the chances of internationalization, they must first abandon their overambitious goals. Next, they must work to solidify the Yuan's regional status and to resolve more immediate economic and institutional problems persisting in the domestic sphere. Should they succeed in doing so, the Chinese government will likely find that internationalization will occur in a smooth and orderly fashion.

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