Capital Account Opening is Not a Prerequisite for Enhancing RMB's Role as an International Currency, at Least for Now

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It seems to have become a "common sense" that promoting the internationalization of currencies requires free capital flows and an open capital account. Is that really the case? In a working paper published in November 2022, Barry Eichengreen, a leading scholar on international finance, together with three collaborators from the University of California, Berkeley, the Bank of France, the European Central Bank and the Paris School of Economics, provided some alternative answers (Eichengreen et al 2022 [1]).

In short, Eichengreen et al. (2022) sees that, at the current stage, further enhancing the status of the RMB as an international reserve currency does not necessarily require a fully opened capital account, because, RMB cross-payment infrastructure, the offshore financial markets, and central bank bilateral currency swaps, have been able support for the use of the Renminbi in international trade, thereby enhancing the degree of RMB internationalization.

This article aims to logically present the argument of Eichengreen et al (2022) and add some additional ideas. Ultimately, it tries to break the myth that opening the capital account is a prerequisite for promote the internationalization of RMB.

The Trade Settlement Path of RMB Internationalization

When it comes to currency internationalization, people tend to regard it as a finance problem, because it is closely related to foreign exchange transactions, capital flows, etc. It is true that currency internationalization is inseparable from cross-border financial arrangements. However, for most of our history, settlement mechanism for cross-border trade had been the main usage of international currency and the focus of the international monetary arrangement.

Precious metals such as gold and silver were once major international currencies because they could be exchanged for the local currency of any country. Subsequently, with the rise of the British Empire, Sterling, under the gold standard, became a key clearing medium for international trade. Then, as major portions of the world's gold having flowed to the United States after World War II, the gold-backed US dollar became the preferred settlement currency for international trade. Finally, in the 1979s, the Bretton Woods system of "gold-exchange regime" collapsed, but the US dollar continued to exist as the main international trade settlement currency, supported by the oil-dollar cycle, the deep financial market of the US, and people's habit.

It is based on this basic function of trade settlement that Eichengreen argues that, given China's huge volume of exports and imports, China can promote the internationalization of its currency by increasing the use of the RMB in trade. In other words, RMB will have an international functionality if China pays in RMB when importing goods from other countries, which, in turn, use RMB to import Chinese goods.

China has two important advantages in promoting renminbi trade settlement.

On the one hand, China has a huge trade volume. It is the world's largest trading country, and, according to Eichengreen et al (2022), is already the largest source of imports for about 40% of the world's countries, on par with the Eurozone. The huge volume of trade provides an important basis for exploring local currency payment, and makes it possible to dilute the fixed costs of establishing a RMB payment mechanism.

On the other hand, while China runs a trade surplus with the world as a whole, it actually runs trade deficits with some key emerging market countries (this argument is a supplement to those of Eichengreen et al. 2022). 6 out of China's top 10 deficit-bearing trade partners in 2022 were emerging economies (Brazil, Saudi Arabia, Russia, Oman, Iraq and Chile, total USD 202.1 billion, see IMF Direction of Trade Statistics [2]). Those countries are friendly to China and are willing to try "de-dollarizing" their trade with China. China's trade deficit with them means that they do not have to worry how to get adequate RMB funding to support their trade with China, as the yuan they earns from exporting to China is enough to cover their imports from China.

The settlement of trade in RMB necessarily requires the corresponding RMB cross-border clearing mechanism. Eichengreen et al (2022) pointed out that, over the past decade, China has established corresponding offshore and onshore RMB clearing mechanisms.

The offshore mechanism is the system of overseas RMB clearing banks. According to the People's Bank of China (PBoC)'s "RMB Internationalization Report 2023" (PBoC, 2023 [3]), as of September 2023, the 31 RMB offshore clearing banks have been authorized in 29 countries and regions, with the number of participating banks and institutions reaching 970.

Onshore settlement mechanism refers to the RMB Cross-Border Payment System (CIPS), a clearing system similar to US CHIPS system, able to provide participants with cross-border RMB clearing services. According to the PBoC (2023), as of the end-2022, a total of 1,360 institutions had access to the CIPS.

Eichengreen et al (2022) assesses that, although the number of participants and clearing volume of the above two mechanisms are still far smaller than those of the US dollar, they do set up key market infrastructure using the RMB for trade invoicing and clearance.

Supports from the Offshore RMB Market

Down-playing the role of capital account openness does not mean that enhancing RMB's international role in trade requires not compatible arrangement on finance. On the contrary, trade invoicing and settlement naturally generates demand for financial instruments. Overseas enterprises or banks that hold RMB funds often need to purchase safe RMB financial assets for liquidity management. They may also need to purchase RMB futures, swaps, options and other financial derivatives to manage foreign exchange exposures. Other entities may wish to convert RMB into other hard currencies to import goods from other countries. Those with high risk tolerance may also want to buy RMB-denominated financial assets with long-term growth prospects, such as stocks and bonds.

After decades of development, China's domestic financial market (i.e., the onshore market) has already been able to provide those financial instruments. Thus, if foreign entities are allowed to freely bring their RMB funds to the onshore market, buy and sell corresponding financial instruments, and freely take the funds outside China when needed, the above-mentioned demand will be met. Of course, in such case, China would have fully opened its capital account

However, for financial stability concerns, China sees that it is not possible to immediately open up its capital account. **Then the question turns to be, whether those demand can be met through other mechanisms, namely, are there markets where RMB funds held by overseas entities can be invested in a range of RMB financial instruments, converted into other major international currencies at predictable and reasonable prices, and allocated to other markets when needed without restrictions.**

Eichengreen et al (2022) pointed out that offshore RMB markets in international financial centers such as Hong Kong and London, which are not subject to capital controls, are a key institutional arrangement for meeting these needs. They argue that, as international financial centers allow free flows of capital and are trading centers for major hard currencies, if a deep RMB financial market is cultivated there, overseas entities will be able to purchase safe RMB assets, exchange rate derivatives there, as well as doing foreign exchange transactions, bond issuance, and stock trading without capital control concerns.

Therefore, offshore markets are an important transitional arrangement to promote the internationalization of the RMB, at least up to a certain degree, before China is ready to fully open its capital account.

According to the PBoC (2023), as of end-2022, there were about RMB 1.5 trillion worth of renminbi deposits in offshore markets. At the same time, the RMB financial products that can be traded in offshore markets are becoming increasingly abundant. The Shanghai-Hong Kong Stock Connect established in 2014, the Shenzhen-Hong Kong Stock Connect established in 2016, and the Bond

Connect established in 2017 have made it more convenience for overseas entities to trade stocks and bonds in the onshore market through Hong Kong; in June 2023, "CNY-HK" dual-currency-trading was launched at the Hong Kong Stock Exchange, allowing investors to directly use RMB to buy some of the stocks listed in Hong Kong; in October 2023, the Ministry of Finance issued RMB 16 billion yuan of treasury bonds in Hong Kong, setting a new high in issuance volume, pushing forward the exploration of providing more RMB safe assets for the offshore market participants.

As Eichengreen et al (2023) points out, the internationalization of the dollar in the 1950s was also developed under the "capital controls + offshore markets" model. At that time, only central banks to exchange US dollars for gold with the Federal Reserve. Therefore, private sector dollar holders had to convert their dollars into gold on the unofficial market in London. With abundant market demand, a series of financial products for the "dollar-gold" transaction were created, contributing to the maturing of the "Eurodollar" market.

Although the divergence between the disparity between onshore and offshore gold price of the US dollar eventually led to the breakdown of the Bretton Woods system, it is undeniable that the Eurodollar market provides an indispensable positive incentive for foreign entities to hold US dollar assets under capital controls.

Supports from Central Bank Currency Swaps

Central banks are the lender of last resort to provide liquidity support. Therefore, as Eichengreen et al (2022) points out, with the advancement of the RMB internationalization, for countries who frequently use RMB in trade, central banks would need to assume the responsibility of RMB liquidity provider in case of liquidity shortfall. Therefore, they argue that, **those central banks would need to hold RMB reserves and develop the ability to raise access renminbi liquidity when needed.**

Eichengreen et al (2022) sees that the bilateral currency swaps signed between the PBoC and other central banks will address such concerns as they provide ready access to renminbi liquidity. The essence of bilateral local currency swap agreements is that the two parties agree to swap equivalent currencies at a pre-agreed exchange rate within (sometimes under a time and amount limit), and exchange them back and pay corresponding interest upon maturity. They provide RMB ammos to central banks to meet temporal crisis.

According to the PBoC (2023), as of September 2023, PBoC has signed bilateral currency swap agreements with 40 central banks, and 28 agreements are still in force, with a total value of 4 trillion yuan. Among them, the actual utilized balance was RMB 117.1 billion. Counting in maturity extensions, PBoC’s swaps have a de facto term of about 3.5 years [4], and in July 2022, the People's Bank of China and the Hong Kong Monetary Authority upgraded their fixed-term swap agreement to a "standing" one, marking the first RMB swap without fixed maturity.

Eichengreen et al (2022) also points out that, compared with the Federal Reserve's dollar swaps, the PBoC's RMB swap is over-weighed by emerging economies. According to its tabulation, the

Fed's currency swaps initially covered only four emerging market countries, while PBoC's swaps covered 29 emerging market countries and regions.

A supplement to Eichengreen et al (2022)'s analysis is that, in addition to currency swaps, it has become much easier for foreign central banks to participate in the onshore renminbi market. In July 2015, financial institutions such as foreign central banks (including foreign monetary authorities, official reserve management agencies, international financial organizations, sovereign wealth funds, etc.) were allowed to enter the China Interbank Bond Market for transactions on fixed income securities [5]. Subsequently, in October 2023 they were allowed to enter the China Interbank Foreign Exchange market and engage in foreign exchange transactions on spot, forward, swaps and options [6]. The above two channels are subject to no volume limits and no capital control requirement [7, 8].

RMB already recognized as a "freely usable" currency by the IMF

After more than a decade of efforts, the RMB has made important progress in facilitating trade and has become a key currency traded in international markets. Although still not comparable to the US dollar or the Euro, its growing role as an international currency should be recognized despite not having opened capital account.

When renminbi was included in the Special Drawing Rights (SDR) basket in 2015, the IMF published a series of questions and answers on its website, explaining internationalization of the SDR basket currencies [9]. **The IMF explicitly states that a currency added to the SDR basket must be "freely usable", which means that it is widely used for international transactions and is widely traded in major global foreign exchange markets.**

The IMF also emphasizes that "freely usable" is not an overlapping concept with capital account openness. Namely, a freely usable currency does not necessarily have a fully opened capital account (as did the British pound and the Japanese yen in their early days). Conversely, a currency with a fully opened capital account is not necessarily freely usable. It points out that, the essence is that when receiving a payment by the IMF in a certain currency, IMF's member states (its central bank or other monetary authorities) can use it, directly or indirectly, to solve balance of payments problems without disadvantages.

Since RMB is included into the SDR basket, it is recognized by the IMF to suffice all the above criteria. Unfortunately, this view is rarely mentioned in the discussion of the RMB internationalization, nor was it explicitly discussed in Eichengreen et al (2022).

Multilateral development banks established by developing countries can play a role in further promoting the trade settlement path of RMB

In various policy meetings, China emphasized that it will "steadily and prudentially" promote the internationalization of the RMB in the future. In the current international context, this is a practical choice. On the one hand, **to further buildup its global financial influence and promote the reform of the international financial system, RMB internationalization must not stagnate or even**

regress. On the other hand, the promotion of internationalization must not be at the expense of financial stability. In fact, the temporary decline of RMB's share of international payments around 2016 shows that, without stable exchange rates and a stable domestic financial system, the internationalization of the RMB will lose both foundation and momentum. As is rightly pointed out by Eichengreen et al (2022), at the current stage, promoting RMB internationalization requires China to maintain the basic stability of the RMB against the US dollar. Therefore, aggressively opening up capital accounts for promoting the use of RMB in financial transactions is not unlikely.

Even if efforts are only paid to enhance further use of RMB in trade, RMB's internationalization status can still be greatly enhanced in the coming years. According to the PBoC (2023), "in January-September 2023, China's total cross-border RMB trade transactions were 7.7 trillion yuan (7.9 trillion yuan for the whole year of 2022), accounting for 24.4% of China's total cross-border trade transactions. Despite rapidly increasing, the absolute level of that proportion is still quite low. Given that China's total trade with emerging market and developing economies in 2022 was USD 2.6 trillion (18.7 trillion yuan), even if only considering using RMB for trade with emerging market partners, there is still too much to be done.

Meanwhile, the promotion of RMB trade settlement is also an important driving force to promote RMB outward foreign direct investment. This is because many countries accept RMB direct investment because the financed projects have import demand for Chinese equipment. **According to the calculation in Eichengreen et al (2022), by 2017, only 6% of development financing provided by China are in renminbi. This ration definitely has great potential to rise in the future.**

Many can be done to further support the use of renminbi in trade, such as strengthening the offshore markets, promoting the RMB settlement in commodity trades, improving the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, the Bond Connect and other offshore-onshore linkages.

One rarely mentioned proposal is to enhance the role of multilateral development banks in absorbing overseas RMB fundings and providing RMB trade credits. Multilateral development banks established by developing countries are key multilateral platforms for emerging economies.

On the one hand, they can issue RMB bonds in offshore RMB markets, providing another low-risk RMB assets in additional to Chinese government bonds to overseas entities. In fact, as supranational institutions, they usually have higher credit rating than sovereign countries (for example, the New Development Bank's bond rating is higher than the sovereign rating of China).

On the other, multilateral development banks could try to establish RMB credit lines for trade with export-import banks of member countries. With this, non-Chinese policy banks will have a new source of RMB funding based on multilateralism in addition to direct RMB bond issuance (which could be costly) and bilateral borrowing from Chinese banks.

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