POLICY ANALYSIS EXERCISE

RMB Internationalization

Implications for U.S. Economic Hegemony

Enea Gjoza
Master in Public Policy Candidate, Harvard Kennedy School

HARVARD Kennedy School
BELFER CENTER for Science and International Affairs

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About the Author

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List of Abbreviations

ADB	Asian Development Bank
AIIB	Asian Infrastructure Investment Bank
BRI	Belt and Road Initiative
CCP	Chinese Communist Party
CNAPS	China National Advanced Payment System
IMF	International Monetary Fund
PBOC	People's Bank of China
PRC	People's Republic of China
RMB	Renminbi
SDR	Special Drawing Rights
SWIFT	Society for Worldwide Interbank Financial Telecommunication
WTO	World Trade Organization

1. Executive Summary

China has recently emerged as the second largest economy after the U.S., marking a remarkable turnaround from the undeveloped, largely agrarian society of only 40 years ago.[1] With its growing size has come a desire to translate economic potential into global prestige and influence. A major part of this effort is the initiative to internationalize China's currency, the renminbi (RMB), also known as the yuan.

While China's economy has become a major force on the global stage, its financial system remains underdeveloped, and the RMB is a minor player in global transactions.[2] Despite its economic prowess, China plays a minor role in existing international financial institutions relative to the West, spurring frustration with the current system. Perhaps more importantly, China has seen the danger of allowing the U.S. to own the global financial system and potentially weaponize it against China.

Beginning after 9/11, the U.S. has built an impressive toolkit for leveraging the centrality of the U.S. economy and dollar-denominated transactions to foreign banks, corporations, and nations in order to achieve political objectives.[3] This has taken the form of sanctions and threats of sanctions against individuals, entities, and even whole nations, along with actions such as freezing accounts and expelling undesirable actors from ostensibly commercial institutions like SWIFT, the global payment messaging network. The U.S. has demonstrated a willingness to sanction not only rogue states like North Korea and Iran but also great powers like Russia. More worryingly for the Chinese, the U.S. has threatened to target their financial institutions directly unless they cooperate with its North Korean policy.[4]

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1 " The World Bank In China," World Bank, accessed March 27, 2018, http://www.worldbank.org/en/country/china/overview.

2 "RMB Tracker," SWIFT, accessed March 22, 2018, https://www.swift.com/our-solutions/compliance-and-shared-services/business-intelligence/renminbi/rmb-tracker.

3 Juan Zarate, "Treasury's War: The Unleashing of a New Era of Financial Warfare," PublicAffairs, 2013

4 "Treasury's Mnuchin: China May Face New Sanctions on North Korea," *Reuters*, September 12, 2017, https://www.reuters.com/article/us-northkorea-sanctions-treasury/treasurys-mnuchin-china-may-face-new-sanctions-on-north-korea-idUSKCN1BN1P1.

As a result, Chinese policymakers have called for an end to U.S. dominance and a new global currency controlled by the IMF, while simultaneously working to internationalize their own.[5] To make the RMB more widely used as both a reserve currency and a means of transaction, China has relaxed onerous restrictions on its financial system, reduced government management of the exchange rate, and launched a number of new economic and financial institutions. These include the BRI, which aims to connect Eurasia through infrastructure investment, the AIIB, which is designed to challenge the Japanese-led ADB, and CIPS, which is designed to eventually replace SWIFT.

These measures have generated notable successes, including the recognition of the RMB as an official reserve currency by the IMF (meaning central banks stockpile it in their holdings). However, while the comparative gains have been great, in absolute terms, the RMB remains a minor player compared to the dollar, euro, yen, and pound sterling. The biggest hurdle to faster internationalization has been the inability of Chinese elites to manage the tension between executing the reforms necessary to internationalize the currency and maintaining the Party's control of the economy so as to ensure stability. Although the Chinese government has bought into the idea of internationalization, powerful domestic factions remain opposed, keeping the most significant reforms out of reach. Furthermore, a recent tightening of capital controls after a period of reform has caused the RMB's progress up the currency ladder to temporarily come to a halt.

Although China is likely decades behind replacing the dollar as the global reserve currency, internationalization is possible much faster given sufficient political will. Assuming a viable alternative is possible, there is pent up demand for a non-western dominated global currency, both from states politically at odds with the West and from the many recipients of China's economic and development assistance. Should China succeed in internationalizing the RMB, it would be able to (most likely partially) shield itself and its trading partners from the stranglehold of the U.S. dollar system. If it successfully goes even further and replaces the dollar, it would enjoy many of the same perks the U.S. does today, including the ability to dictate global

5 "China Calls For New Global Currency - ABC News," accessed March 27, 2018, http://abcnews.go.com/International/story?id=7156932&page=1.

financial norms and shape global financial institutions, the ability to coerce other nations, and advantages for its banks and corporations.

To halt the ascendancy of the RMB, the U.S. could either take steps to undermine China or solidify the position of the dollar by taking steps to improve confidence in its economy, currency, and political decision-making. Attempting to undermine China through sanctions, trade restrictions, and exclusion from international institutions is a dangerous path with unpredictable consequences for both countries. Accordingly, the preferred path is to work on making the U.S. model more attractive by (1) Scaling back economic warfare (2) Passing predictable budgets and reducing deficit spending (3) Making international institutions more inclusive. Global reserve currencies, once at the top, have tremendous inertia keeping them in place.[6] With wise policymaking, the U.S. can continue to occupy its dominant position for a long time to come.

6 Jeffrey Frankel, "Internationalization of the RMB and Historical Precedents," *Journal of Economic Integration*, 2012, vol.27, no.3, pp. 329-365.

2. Why Internationalize?

Internationalizing a currency—meaning making it widely used in denominating and settling cross-border trade and financial transactions—is not an easy task, requiring advanced financial infrastructure, a solid regulatory framework, and the trust of investors and other nations among other criteria.[7] Given the cost and complexity of the undertaking, it is important to ask why China is choosing this moment to push for RMB internationalization.

2.1 Political Drivers

Influence and Prestige: Internationalization can help enhance a country's standing in the world as its national currency becomes a de-facto standard in the global system.[8] For a nation with a massive economy such as China, a more prominent currency can help it increase its influence in international institutions where its formal power currently lags its standing in the global economy (such as in the IMF).

Security: The global financial infrastructure is currently dominated by the U.S., and access to the dollar markets is essential for corporations, financial institutions, or countries that want to function in the world economy.[9] The U.S. has already demonstrated a willingness to weaponize this dominance of civilian institutions, most notably in cutting Iran out of the SWIFT system and threatening to do the same to Russia following that nation's annexation of Crimea.[10] It has also threatened Chinese banks with similar sanctions over their dealings with North Korea, blacklisting the relatively

7 Eswar Prasad, "Gaining Currency: The Rise of the Renminbi," Oxford University Press, New York, 2017

8 Yukon Huang and Clare Lynch, "Does Internationalizing the RMB Make Sense for China?," *Cato Journal*, Carnegie Endowment, 2013, http://carnegieendowment.org/files/Internationalizing_the_RMB.pdf

9 AM Lynnley Browning, "The Man Banks Fear Most." Newsweek, June 30, 2014. http://www.newsweek.com/regulator-benjamin-lawsky-man-banks-fear-most-256626.

10 Kenneth Rapoza, "Russia To Retaliate If Bank's Given SWIFT Kick," accessed March 27, 2018, https://www.forbes.com/sites/kenrapoza/2015/01/27/russia-to-retaliate-if-banks-given-swift-kick/#6bee881f652e.

small Bank of Dandong as a warning to larger financial institutions.[11] An international currency that is widely used would allow China to partially mitigate the effects of such measures. On the most optimistic end of the spectrum, it would permit it to operate an alternative financial infrastructure that allows it and its trading partners to gradually decouple themselves from the dollar.

Domestic Reform: Chinese authorities understand that China must undertake further market-oriented reforms in order to become a true economic superpower (and also maintain high growth). However, China's state-directed economy creates numerous powerful special interest groups that benefit by being shielded from economic reality and that resist efforts such as allowing the currency to float and permitting more free movement of capital. In the past, China's domestic reforms have often come as a result of international pressure (such as after its accession to the WTO) and it is hoped that the "reserve pressure" of having to meet the standards for an international currency will compel domestic reform.[12]

Opportunity: The 2008 financial crisis diminished confidence in the West and western economic doctrine, both among China's elite and globally.[13] As a result, the CCP saw an opportunity strengthen China's position on the global stage, doing so both by promoting the RMB and launching a spree of economic and financial institution-building.

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11 Stephen McDonell, "China Banks Fear North Korea Sanctions," *BBC News*, September 12, 2017, sec. Business, http://www.bbc.com/news/business-41242411.

12 Andrew Sheng, "Five Reasons for Renminbi Internationalisation," *South China Morning Post*, March 27, 2015, http://www.scmp.com/comment/insight-opinion/article/1748428/five-reasons-renminbi-internationalisation.

13 Gideon Rachman, "An Assertive China Challenges the West," Financial Times, October 23, 2017, https://www.ft.com/content/d3fb6be8-b7d1-11e7-8c12-5661783e5589.

2.2 **Economic Drivers**

Trade: An international currency makes trade easier for the large national firms that are a major driver of Chinese economic growth by reducing transaction costs and minimizing the need to hedge against currency risk.[14] China accounts for over 10% of global trade, but RMB usage is nowhere near those levels.[15]

Commodities: China is the world's largest importer of commodities, yet crucial raw materials such as iron, coal, and crude oil continue to be priced in dollars.[16] Pricing them in RMB would assist China by making them cheaper, making prices more predictable, and reducing the need to hold dollar reserves.

Borrowing: Internationalization would allow corporations and financial institutions to borrow in RMB, reducing costs due to increased demand for RMB-denominated debt and the ability to borrow from offshore markets (once restrictions have been loosened).[17] The PRC itself would also be able to borrow in RMB, allowing it to maintain higher debt levels than it had previously.

Financial Development: An international RMB would spur growth and increase in sophistication of the financial sector and make domestic banking giants more competitive internationally.[18]

14 David G. Landry and Heiwai Tang, "Rise of the Redback: Internationalizing the Chinese Renminbi," *The Diplomat*, September 16, 2017, https://thediplomat.com/2017/09/rise-of-the-redback-internationalizing-the-chinese-renminbi/.

15 Sheng, "Five Reasons for Renminbi Internationalisation," *South China Morning Post*

16 Sheng, "Five Reasons for Renminbi Internationalisation," *South China Morning Post*

17 Liqing Zhang and Kunyu Tao, "The Benefits and Costs of Renminbi Internationalization," *SSRN Electronic Journal*, 2014, https://doi.org/10.2139/ssrn.2441110.

18 LZhang and Tao, "The Benefits and Costs of Renminbi Internationalization," *SSRN Electronic Journal*

3. What Makes a Currency International?

According to economist Jeffrey Frankel, the determinants of an international currency are:[19]

a. *Size of the domestic market*: Possessing a large domestic market is the most important criterion for internationalization as it provides deep structural demand even when international demand is weak. Strong output and trade also give a nation an advantage when pursuing internationalization.

b. *Network externalities*: Part of what makes a currency valuable as an international currency is that others are already using it. As a result, there are network effects to achieving wide adoption which both make it hard to achieve internationalization but also make it hard to topple a currency that's already international.

c. *Financial markets*: To achieve internationalization, "capital and money markets in the home country must be not only open and free of controls, but also deep and well-developed."

d. *Confidence in the currency*: The currency in question must be stable, not subject to wild fluctuations, and have a low rate of inflation.

[19] Jeffrey Frankel, "Internationalization of the RMB and Historical Precedents," *Journal of Economic Integration*, 2012, vol.27, no.3, pp. 329-365.

Roles of an International Currency (Frankel, 2012, Table 1)

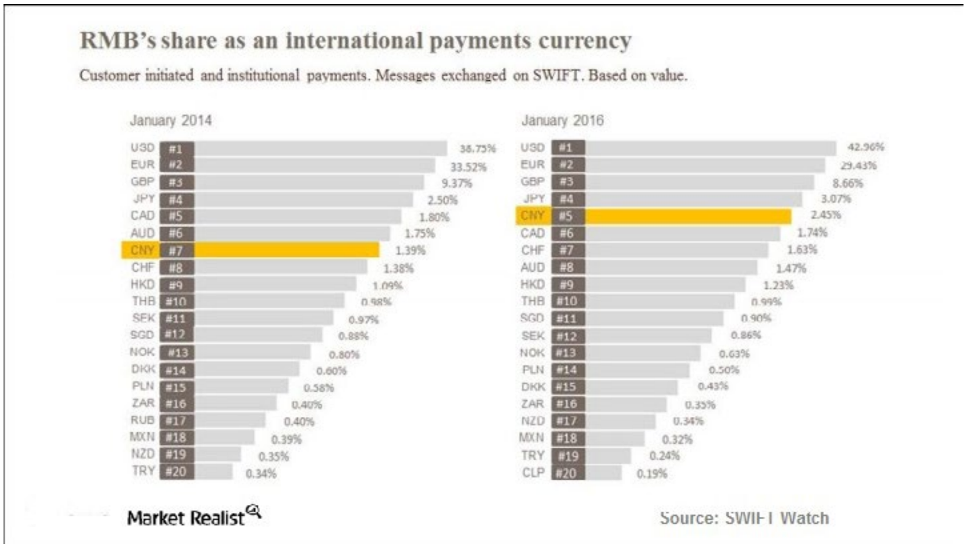
Function of money	Governments	Private Actors
Store of value	International reserves	Currency substitution (private dollarization)
Medium of exchange	Vehicle currency for foreign exchange intervention	Invoicing trade and financial transactions
Unit of account	Anchor for pegging currency	Denominating trade and financial transactions

Of these, China has lacks well-developed financial markets and to some extent, has not yet succeeded in making RMB use widespread. China's financial system is subject to heavy regulation and political control far beyond what is typically the case in advanced market economies.[20] Furthermore, while the RMB peaked at number five among global currencies by usage in international payments, in absolute terms, it never exceeded more than roughly 2% of payments.[21] By contrast, the dollar accounts for over 40% of payments as of 2016.

20 Frankel, "Internationalization of the RMB and Historical Precedents," *Journal of Economic Integration*

21 Gabriel Wildau, "Renminbi Drops to Sixth in International Payment Ranking," *Financial Times*, July 21, 2016, https://www.ft.com/content/bbcaef78-4efd-11e6-8172-e39ecd3b86fc.

Source: SWIFT[22]



It's also important to note that internationalization, and particularly the achievement of global reserve currency status, tends to be a slow process and lag domestic economic achievements. For example, the U.S. economy overtook the British economy 70 years before the dollar overtook the pound as the global reserve currency.[23] There is no guarantee China will face the same slow trajectory however given the state's extensive involvement in the economy and the political mandate driving internationalization.

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[22] "RMB Tracker," SWIFT, accessed March 22, 2018, https://www.swift.com/our-solutions/compliance-and-shared-services/business-intelligence/renminbi/rmb-tracker.

[23] Frankel, "Internationalization of the RMB and Historical Precedents," *Journal of Economic Integration*

4. Timeline of Internationalization

The first steps to relax the tight controls that kept the RMB a parochial currency began in the early 2000s, with internationalization accelerating significantly after 2008. The following developments highlight some of the key progression points in the RMB's path toward greater global prominence.[24, 25, 26]

December 2002: The qualified institutional investor program allowed some foreign institutions to convert foreign currency into RMB and invest in certain RMB-denominated assets.[27]

July 2005: China ends the RMB's peg to the dollar, allowing its currency to float within a narrow range. The PBOC still determines the official "closing rate" from the previous day that the fluctuation was pegged to, giving the central bank considerable control.

May-July 2007: The band in which the RMB is allowed to trade rises from 0.3% to 0.5%, and the first offshore denominated RMB bonds (know as "dim sum bonds") are issued.

July 2009: The yuan has appreciated 21% against the dollar since controls were relaxed, and the PBOC launches a pilot project to settle yuan transactions internationally.

March-December 2010: The Chiang Mai Initiative, a major $120 billion currency swap arrangement is finalized between China and numerous Asian nations. This allows the participating nations to ward off currency speculation and chaos in financial markets. The RBM also begins trading in Russia, its first foreign market.

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24 "Chronology of RMB Going Global," *Xinhua*, accessed March 27, 2018, http://english.gov.cn/news/top_news/2015/12/03/content_281475246990434.htm.

25 "From China to the World: A Timeline of the Yuan's Internationalisation," *South China Morning Post*, September 30, 2016, http://www.scmp.com/business/money/article/2024091/china-world-timeline-yuans-internationalisation.

26 "Key Milestones in RMB Internationalisation—Deutsche Bank," accessed March 27, 2018, https://www.db.com/specials/en/ghp/key-milestones-in-rmb-internationalisation.htm.

27 Prasad, "Gaining Currency," 2017, pg 48

January-December 2011: Domestic Chinese companies are allowed to directly invest in foreign countries in RMB. Foreign investors are allowed to invest in China using RMB in offshore accounts, instead of having to convert foreign currency into RMB domestically.

April-May 2012: The band in which the RMB is allowed to trade daily is increased to 1 percent from the previous day's close. The Chiang Mai Initiative is expanded to $240 billion in swaps.

September 2013: The Shanghai Free Trade Zone is launched, allowing experimentation with developing new financial infrastructure to handle a more international RMB.

2012-2014: Direct trading between the RMB and foreign currencies expands, as do China's currency swaps with other nations.

March 2014: The RMB's trading band rises from 1 to 2 percent.

May-July 2015: The IMF declares the RMB no longer undervalued, and the PBOC grants foreign central banks and financial institutions access to China's domestic interbank bond market. The central parity rate of the RMB set by the PBCO is allowed to more closely reflect market realities. China also launches the first phase of CIPS, its own RMB-based cross-border payment clearing system.

October 2015: The PBOC eliminates ceilings on bank deposit interest rates and fully liberalizes the exchange rate. It also takes steps to promote London as an offshore RMB center.

October 2016: The RMB is accepted into the IMF's SDR basket of currencies, making it officially a global reserve currency.

5. Re-imagining Global Economic Institutions

In addition to attempts to internationalize the RMB itself, China has taken steps to launch several new international economic institutions. These include the Belt and Road Initiative (BRI), the China International Payment Service Corp. (CIPS), and the Asian Infrastructure Investment Bank. These both stimulate greater usage of the RMB and, once the RMB internationalizes, provide a support structure for facilitating its uses.

5.1 Belt and Road Initiative

Since China runs substantial trade surpluses, one of the key problems for facilitating more widespread use of the RMB is that there are few mechanisms for getting large amounts of RMB into circulation internationally.[28] The BRI, China's ambitious $1 trillion infrastructure project, helps partially fill that gap. BRI aims to connect Europe and Asia by providing loans for nations (often with weak credit) to carry out a wide array of infrastructure projects.[29]

Politically and economically, it serves numerous purposes: facilitating greater trade flow from East to West; bringing otherwise weak and marginalized nations into China's orbit; and providing an outlet for huge domestic surpluses of goods like steel and concrete. However, by providing loans that are at least partially denominated in RMB, BRI also creates an outlet for more widespread usage of China's currency in both debt financing and payments. For example, in Indonesia, a recipient of multiple forms of Chinese development aid, 60% of loans are denominated in dollars, while 40% are denominated in RMB.[30] PT Krakatau Steel, Indonesia's largest state-owned steel firm and a major importer of Chinese steel, has begun accepting RMB

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28 Interview with Jeff Williams, former banker

29 Anja Manuel, "The Staggering Impact of China's 'Belt and Road' Initiative - *The Atlantic*," accessed March 26, 2018, https://www.theatlantic.com/international/archive/2017/10/china-belt-and-road/542667/.

30 Sue Zhang and Matthew Miller, "Behind China's Silk Road Vision: Cheap Funds, Heavy Debt, Growing Risk," *Reuters*, May 15, 2017, https://www.reuters.com/article/us-china-silkroad-finance/behind-chinas-silk-road-vision-cheap-funds-heavy-debt-growing-risk-idUSKCN18B0YS.

as payment, signaling its confidence in the currency's future as a major regional medium of exchange.[31]

An analysis of how BRI has contributed to the use of RMB in credit payments by SWIFT determined that:[32]

a. On the land "belt," growth in RMB usage has been substantial in Central Asia.

b. On the maritime "road," RMB usage has increased significantly in Southeast Asia.

c. Other parts of the maritime road have seen negligible increases in RMB usage.

d. In Western Europe, some countries such as Germany, Poland, and the Czech Republic have seen RMB credit payments increase, while others, such as France, Italy, and Holland, have seen notable declines.

5.2 China International Payment Service Corp

Since the RMB is a relatively recent entrant into the world of major currencies and China itself has only entered the global market gradually over the past forty years, clearing and settlement services for cross-border payments in RMB were previously dispersed, inconvenient, and relatively expensive.[33] This is a problem because "the interbank payment system serves as the basic infrastructure…of financial markets."[34] To facilitate the movement of payments, the Chinese government authorized clearing banks in major

[31] Ann Marie Plubell and Siyao Liu, "A Snapshot of Renminbi Internationalization Trends Under One Belt One Road Initiative," EMPEA Regulatory Affairs, https://www.empea.org/app/uploads/2017/10/Snapshot-of-Renminbi-Internationalization-Trends-Under-One-Belt-One-Road-Initiative.pdf

[32] "RMB Internationalisation: Can the Belt and Road Revitalise the RMB?," SWIFT, July 28, 2017, https://www.swift.com/news-events/press-releases/rmb-internationalisation_can-the-belt-and-road-revitalise-the-rmb

[33] Gabriel Wildau, "China Launch of Renminbi Payments System Reflects Swift Spying Concerns," *Financial Times*, October 8, 2015, https://www.ft.com/content/84241292-66a1-11e5-a155-02b6f8af6a62.

[34] Prasad, "Gaining Currency," 2017, pg 114

global financial centers like London and Hong Kong to process RMB transactions. This system was unstandardized and inefficient. Moreover, China's domestic payment system only uses Chinese characters, making it incompatible with SWIFT, the entity facilitating messaging for almost all global interbank transactions.

As a result, in October 2015, the PBOC launched CIPS (previously referred to as the Cross-border Interbank Payment System or China Interbank Payment System). CIPS was explicitly designed to facilitate RMB internationalization by "providing the infrastructure that will connect global RMB users through one single system."[35] It was to be launched in two phases. Phase I, beginning in 2015, provided real time gross settlement, five days a week, 11 hours a day, covering Asia, Europe, Africa but not the US.[36] Phase II, which would prolong operating hours to cover American time zones and implement a hybrid processing model appears to have run into difficulties, and is being implemented only gradually with no expected completion date.

On the political side, by diminishing reliance on SWIFT, CIPS would reduce the ability of the West to damage the Chinese banking sector (and its partners) by cutting them out of the SWIFT network.[37] Additionally, it would make it more difficult for Western spy agencies to use the SWIFT system to monitor the transactions of Chinese financial institutions, as the NSA reportedly had done.[38]

On the business side, "CIPS for the first time will put the renminbi on an even footing with other global currencies in areas such as operating hours, risk reduction and liquidity optimisation."[39] It provides direct access to the onshore and offshore RMB markets, reduces processing times, and saves transacting parties the difficulty of having to navigate different procedures and standards among the clearing houses that previously occupied the

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35 Wildau, "China Launch of Renminbi Payments System Reflects Swift Spying Concerns," *Financial Times*

36 Interview with senior official at CIPS

37 Interview with official at Development Research Center of the State Council of P.R.C

38 Wildau, "China Launch of Renminbi Payments System Reflects Swift Spying Concerns," *Financial Times*

39 Michael Vrontamitis, "CIPS a 'game changer' but needs careful planning," Standard Chartered, March 2013

market.[40] It would also serve as a bridge between the global SWIFT system and China's domestic interbank clearing and settlement platform, CNAPS.

Since its launch, CIPS has grown from 19 direct participating banks and 176 indirect participating financial institutions to 31 direct and 677 indirect participants.[41] While the volume of transactions processed has steadily grown over time, the exact numbers are kept proprietary, suggesting that they might not be particularly impressive. The fact that Phase II has still not been successfully implemented, that mention of CIPS remains sparse in the Chinese media, and that there has been no touting of successes in hitting volume milestones all indicate that the system has had a harder time finding a toehold in international markets than initially anticipated.

CIPS currently works with the existing SWIFT network, but the ultimate objective is self-sufficiency. According to Eswar Prasad, the former head of the IMF's China Division:

> *"The CIPS has been designed as a system that could eventually serve as a conduit for interbank communications concerning international RMB transactions that operates independently of SWIFT. This would make it not only a funds transfer system, but also a communication system, reducing the SWIFT's grip on interbank communications related to cross-border financial flows. China's government is astute enough not to challenge SWIFT until the CIPS has matured, but no doubt one day the challenge will come."*[42]

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40 China Cross-border Interbank Payment System, DBS, http://www.eurofinance.com/sites/default/files/DAY%202%20-%2009.40%20-%20Investing%20in%20RMB%20internationalization%20-%20Tuck%20Wai%20Chan.pdf

41 Interview with senior official at CIPS

42 Prasad, "Gaining Currency," 2017, pg 116

5.3 **Asian Infrastructure Investment Bank**

A major point of frustration for China has been the difficulties it faced in gaining greater influence in existing global economic and financial institutions. The framework and institutions that anchor the global economy arose from the aftermath of the Bretton Woods Conference in 1944 and reflect the balance of power at that time. With the changes to the world economic and political landscape that have taken place over the past 70 years, rising powers have attempted to carve a place for themselves that more accurately reflects the state of the world today.

This is evident in China's attempts to grow its influence at the IMF, where the U.S.' 16.7% share gave it veto power, while China, despite being the second largest economy in the world, was at 3.8%.[43] Although following the 2010 crisis, the nations of the IMF agreed to increase the voting share of rising powers, the agreement required approval by national legislatures, with the U.S. being the key holdout. It was only in 2015 that Congress finally approved an increase in China's voting share to 6%, which although an improvement, still trailed its true economic size and influence.

Meanwhile, the ADB, Asia's key development institution, was dominated by Japan and the U.S. (with voting shares of roughly 12.8% each to China's 5.5%), despite the Chinese economy being much larger than Japan's.[44] China found itself unable to make progress in expanding its influence at the ABD, and as a result, proposed its own competitor, the AIIB, in 2013. The AIIB's stated mission was to help fill the gap in infrastructure investment among developing countries in Asia, and it began with an expected size of $50 billion, later adjusted to $100 billion.

Seeing its potential to undermine existing U.S.-led institutions, the U.S. became the staunchest opponent of the AIIB and carried out an aggressive

[43] "IMF Reforms Clear Last Hurdle," *BBC News*, December 19, 2015, sec. Business, http://www.bbc.com/news/business-35141683.

[44] Prasad, "Gaining Currency," 2017, pg 222

lobbying campaign to dissuade allies from joining the Bank.[45] Despite this diplomatic effort, Great Britain saw the potential to curry favor with China and broke ranks, signing on to the AIIB in 2015.[46] It was quickly followed by France, Germany, Italy, and many other nations (with the notable exception of Japan).[47] The AIIB was launched in January 2016—only 27 months after its proposed creation—with 57 founding members and $100 billion in capital (2/3 of the allocation of the ADB).[48] In fact, China had to double its planned contribution to preserve a controlling stake after many more countries than expected showed an interest in participating.[49] China maintains a 30% share in the AIIB and a 26% voting stake, which grants it veto power, much as the U.S. enjoys in the IMF.[50]

The AIIB is currently lending out only in dollars, both because it reduces transaction costs (since member nations contribute in dollars) and allows China to put its foreign exchange reserves to use.[51] However, that is unlikely to remain the case indefinitely. Soren Elbech, the director general and treasurer of AIIB noted that "U.S. dollar is our functional currency so that points to the initial issue to be in dollars…However, I'm sure we are going to be issuing in renminbi also at some stage and when it makes sense for the bank."[52] While AIIB no doubt serves multiple uses for the Chinese government, such statements point to a desire to eventually use it as a way to institutionalize RMB lending in international development.

45 Thomas Wright, "A Special Argument: The U.S., U.K., and the AIIB," *Brookings* (blog), November 30, 2001, https://www.brookings.edu/blog/order-from-chaos/2015/03/13/a-special-argument-the-u-s-u-k-and-the-aiib/.

46 Jamil Anderlini, "UK Move to Join China-Led Bank a Surprise Even to Beijing," accessed March 26, 2018, https://www.ft.com/content/d33fed8a-d3a1-11e4-a9d3-00144feab7de.

47 Swaminathan S. Anklesaria Aiyar, "Why US Allies Are Happy to Join China's AIIB," *The Diplomat*, accessed March 26, 2018, https://thediplomat.com/2015/07/why-us-allies-are-happy-to-join-chinas-aiib/.

48 Tom Mitchell and Gabriel Wildau, "China's New Asia Development Bank Will Lend in US Dollars," Financial Times, January 17, 2016, https://www.ft.com/content/762ce968-bcee-11e5-a8c6-deeeb63d6d4b.

49 Yuriko Koike, "What Is China's Strategy with the AIIB?," World Economic Forum, accessed March 26, 2018, https://www.weforum.org/agenda/2015/05/what-is-chinas-strategy-with-the-aiib/.

50 "China to Hold 30 per Cent Stake in AIIB and 26 per Cent Voting Rights," *South China Morning Post*, June 29, 2015, https://www.scmp.com/news/china/policies-politics/article/1829095/founding-nations-attend-signing-ceremony-china-led.

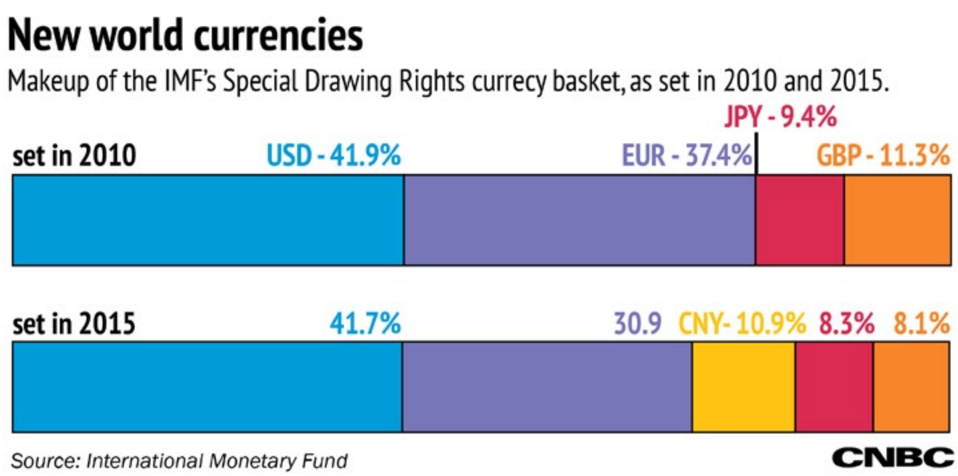
51 Mitchell and Wildau, "China's New Asia Development Bank Will Lend in US Dollars," Financial Timesequitable' global economic governance at launch ceremony","URL":"https://www.ft.com/content/762ce968-bcee-11e5-a8c6-deeeb63d6d4b.

52 "AIIB Hopes to Win International Credit Rating by End of Third Quarter," Nikkei Asian Review, accessed March 26, 2018, https://asia.nikkei.com/Spotlight/ADB-Annual-Meeting-2017/AIIB-hopes-to-win-international-credit-rating-by-end-of-third-quarter.

6. Assessment of Progress

China has made substantial strides in increasing the relevance and usability of the RMB, but still has a way to go towards full internationalization (and an even more substantial hurdle to clear before credibly challenging the dollar).

The PRC's capstone success was the RMB's inclusion in the IMF's SDR, which is used to determine what currencies the IMF lends out in (the IMF loaned over $110 billion in 2015 alone).[53] This made the RMB more accessible and incentivized central banks and large financial institutions to add it to their holdings. It also opened the door to credibly attempt to challenge the dollar's hegemony as the default means of pricing and transacting in crucial markets like commodities. China recently launched its own oil futures priced in RMB, a major move for a nation that has now surpassed the U.S. as the world's largest oil importer.[54]



Source: CNBC[55]

The RMB's role in Chinese trade has grown more prominent, and has outstripped the dollar, yen, and Hong King dollar as the main means of payment between China its Asian trade partners (31% of payments

53 Williamson, Todd, "Too Big to Sanction," Foreign Policy (blog), accessed March 18, 2016, https://foreignpolicy.com/2016/03/18/too-big-to-sanction-rmb-china-imf/.

54 Grant Clark and Sungwoo Park, "China Is About to Shake Up the Oil Futures Market," *Bloomberg*, March 25, 2018, https://www.bloomberg.com/news/articles/2018-03-25/china-s-oil-futures-are-finally-here-what-you-need-to-know.

55 "Who Loses When the Renminbi Joins the IMF Basket?," accessed March 27, 2018, https://www.cnbc.com/2015/12/02/who-loses-when-the-renminbi-joins-the-imf-basket.html.

between China and Asian nations compared to 7% in 2012).[56] In some industries, such as the Australian mining sector, the RMB has already become the currency of choice, giving firms transacting in it an advantage over global competitors.[57]

The use of bilateral currency swap agreements with trading partners has also been a powerful tool to stimulate greater use of the RMB and reduce the need to transact in dollars or euros, thus cutting transaction costs for both parties. Between 2008 and 2015, China entered into over 30 bilateral currency swap agreements covering $468 billion in trade.[58] In addition to their use in facilitating trade, these swaps allow partner countries to borrow against them in times of crisis, as Pakistan and Argentina have, creating a way for China to be politically valuable to its counterparties.

However, it is important to put these achievements in perspective. Despite its relative gains, the RMB comprises less than 2% of international payments, a number that has actually declined since 2015.[59] As a reserve currency, the RMB accounted for 1.12% of global reserves compared to 63.5% for the dollar, 20.04% for the Euro, and 4.52% for the yen according to IMF Q3 2017 data.[60] Policy changes undertaken by the PRC to achieve other economic objectives have actually caused backtracking on some of the RMB's gains. These include an easy money policy to support the economy after the global financial crisis, depreciation of the currency, and capital controls imposed to halt a massive exodus of funds out of the country. As a result, "the ratio of trade accounts settled in yuan has fallen by half from two years ago, and overseas investors have lost interest in the Chinese currency."[61]

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56 Grant, Jeremy, "Battle Is on for Offshore Renminbi Market," *Financial Times*, July 28, 2015, https://www.ft.com/content/4b9725c8-15d3-11e5-be54-00144feabdc0.

57 Williamson, "Too Big to Sanction," Foreign Policy

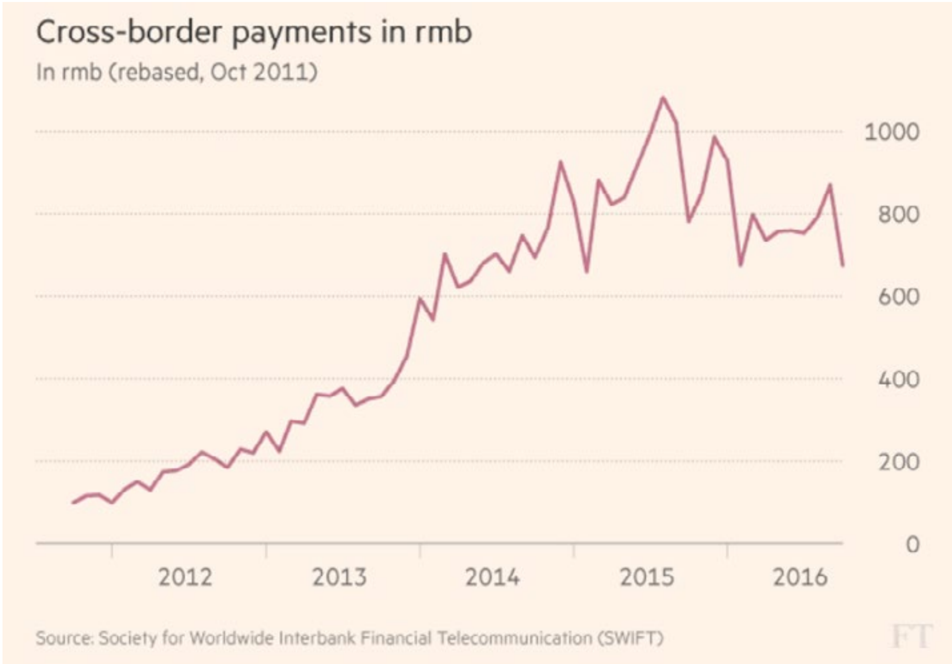
58 Cindy Li, "Banking on China through Currency Swap Agreements," Federal Reserve Bank of San Francisco, accessed October 23, 2015, https://www.frbsf.org/banking/asia-program/pacific-exchange-blog/banking-on-china-renminbi-currency-swap-agreements/.

59 "RMB Tracker," SWIFT, accessed March 22, 2018, https://www.swift.com/our-solutions/compliance-and-shared-services/business-intelligence/renminbi/rmb-tracker.

60 Currency Composition of Official Foreign Exchange Reserves (COFER), IMF Data, Accessed March 4, 2018, http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4

61 Harada, Issaku and Yusho Cho, "Internationalization of Yuan Loses Momentum," Nikkei Asian Review, January 2, 2018, https://asia.nikkei.com/Politics-Economy/Economy/Internationalization-of-yuan-loses-momentum.

Source: *Financial Times*[62]



The fundamental problem faced by the Chinese leadership is a tradeoff between maintaining control of the domestic economy for the sake of political stability and the financial market openness required to make a currency truly global.[63] China has attempted to pursue both of these goals simultaneously, trying to allow freer flow of capital while also intervening to manage the RMB's exchange rate. This policy has forced it to spend nearly $1 trillion of its foreign reserves to combat depreciation, a trajectory that is clearly unsustainable.

[62] Tom Mitchell and Gabriel Wildau, "China: Renminbi Stalls on Road to Being a Global Currency," *Financial Times*, December 11, 2016, https://www.ft.com/content/e480fd92-bc6a-11e6-8b45-b8b81dd5d080.

[63] Mitchell and Wildau, "China: Renminbi Stalls on Road to Being a Global Currency," *Financial Times*

7. Domestic Stakeholders

To complete internationalization, China must undertake substantive economic and financial market reforms. Official government policy suggests internationalization has buy-in at the top, but because there are still powerful interests opposed to it, there has never been a formal government mandate supporting internationalization.[64] This is because internationalization is not without cost: it leads to unpredictable fluctuations in demand for the currency, forces greater discipline on the part of the government (to meet the expectations of foreign users), and can boost the exchange rate, thus hurting exporters.[65]

7.1 Supporters

Nationalists: Given the strong link between major currency status and global influence, prestige, and credibility, senior policymakers in the CCP who support the vision of China as a global power have been pushing RMB internationalization. They view major currency status as China claiming its rightful place in the world, and a way of challenging the "unfair" dominance of the U.S. [66] Their views have been shaped at least partially by the popularity of Hong Songbing's book *Currency Wars*, which describes monetary policy in the context of interstate conflict and has been widely read by China's elite. President Xi Jinping himself is likely in this camp. However, although this group of policy makers support reforms that would strengthen China internationally, they draw the line where potential reforms could undermine domestic economic growth or stability.

Central Bank: The PBOC has been one of the key institutional drivers of internationalization within the PRC and has advocated for

64 Benjamin J Cohen, "Renminbi Internationalization: A Conflict of Statecrafts," Chatham House, March 2017

65 Frankel, "Internationalization of the RMB and Historical Precedents," *Journal of Economic Integration*

66 Daniel McDowell and David A. Steinberg, "Systemic Strengths, Domestic Deficiencies: The Renminbi's Future as a Reserve Currency," *Journal of Contemporary China* 26, no. 108 (November 2, 2017): 801–19, https://doi.org/10.1080/10670564.2017.1337292.

internationalization both internally and through a concerted effort on the policy front.[67] This is not necessarily out of an interest in internationalization itself, but as a way of forcing meaningful domestic financial reforms that would otherwise get bogged down.[68] These reforms would enhance the PBOC's ability to impact monetary conditions and thus fulfill its mandate of controlling inflation. However, the PBOC is not an independent central bank as in other advanced economies, and major changes to monetary or exchange rate policy have to be approved by senior political leaders.

7.2 **Opponents**

Borrowers: Controls on interest rates and capital flows have made borrowing very cheap for politically connected groups in Chinese society, particularly state-owned enterprises.[69] Opening up the system would spike rates higher toward market levels, thus eliminating this unique privilege.

Exporters: Government intervention in the exchange rate has often served to benefit exporters by keeping the currency stable and competitive. An exchange rate that is allowed to move entirely in line with market principles could also swing in an unfavorable direction and damage the export industries which comprise a major part of the Chinese economy.[70]

Domestic Banks: China's large domestic banks stand to gain as the RMB grows in prominence. However, they currently benefit substantially from government policies that keep interest rates on loans substantially higher than those on deposits (up to twice what they would be otherwise).[71] Losing this comfortable source of profit is more alarming to them than the potential long-term gains from internationalization.

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67 Prasad, "Gaining Currency," 2017

68 McDowell and Steinberg, "Systemic Strengths, Domestic Deficiencies," *Journal of Contemporary China*

69 McDowell and Steinberg, "Systemic Strengths, Domestic Deficiencies," *Journal of Contemporary China*

70 Eric Helleiner and Anton Malkin, "Sectoral Interests and Global Money: Renminbi, Dollars and the Domestic Foundations of International Currency Policy," *Open Economies Review* 23, no. 1 (February 1, 2012): 33–55, https://doi.org/10.1007/s11079-011-9225-1.

71 McDowell and Steinberg, "Systemic Strengths, Domestic Deficiencies," *Journal of Contemporary China*

8. Implications

The U.S. currently enjoys some economic benefits by virtue of having the world's pre-eminent currency, including:[72]

- The ability to borrow in its own currency, which does not leave it at the mercy of exchange rate fluctuation.
- Lower interest rates as foreign central banks buy U.S. Treasury bonds to safeguard their assets.

However, the economic benefits are generally overstated and come with non-trivial costs as well.[73] The primary value of dollar dominance is political—namely the ability to dictate the norms and rules of the global financial system, an outsized role in international institutions, and the ability to influence or coerce states and corporations by virtue of the dollar's centrality. As long as the U.S. provided significant value through a stable, universally accepted currency and safe-haven debt, other states were either content to allow this dominance or too weak to resist it. The profligate use of the power to coerce through financial tools has however generated incentives for other great powers to develop alternatives.[74]

If China overcomes its domestic hurdles and succeeds in fully internationalizing the RMB, there are two ways the RMB's role could develop.

1. *The RMB becomes a credible international currency processing a substantial portion of global transactions*. The dollar currently processes over 40% of global transactions and the Euro roughly 30%, so the RMB would likely chip away at their positions and enter double digit territory as well (although the exact figure remains

72 Michael Pettis, "An Exorbitant Burden," Foreign Policy (blog), accessed March 27, 2018, https://foreignpolicy.com/2011/09/07/an-exorbitant-burden/.

73 Robert N. McCauley, "Does the US Dollar Confer an Exorbitant Privilege?," *Journal of International Money and Finance* 57 (October 1, 2015): 1–14, https://doi.org/10.1016/j.jimonfin.2015.06.005.then the difficult measurement of costs can be finessed. The original privilege notion characterised the dollar's systemic role in official foreign exchange reserves before 1973. Five subsequently developed notions refer to the broader, more evolutionary role of the dollar in the international monetary system. (1

74 "Russia's Banking System Has SWIFT Alternative Ready," RT International, accessed March 27, 2018, https://www.rt.com/business/382017-russia-swift-central-bank/.

speculative).[75] The dollar would remain the dominant global reserve currency, but China and its partners would be able to build a sufficient institutional framework around the RMB to facilitate commercial activity even without the dollar. This would reduce the ability of the U.S. to influence other nations through commercial ties, increase China's influence over nations using its system, and potentially compel some U.S. allies with strong economic ties to China to choose sides.

2. *The RMB replaces the dollar as the dominant global reserve currency*. This is far less likely given the strong network effects of the dollar, the sophistication of the U.S. regulatory and financial system, and the strong economic and trade relations the U.S. enjoys. Replacing the dollar with the RMB would require a massive loss of faith in the U.S. and the system it leads either through an economic disaster, political upheaval, or U.S. actions which severely damage the global system. Should China succeed however, it would have considerable latitude to rewrite the rules and norms governing global finance. It would also enjoy a significant increase in its ability to influence and coerce, simultaneously wielding a big market, a huge stockpile of reserves, and a dominant currency.

These scenarios are predicated on the key assumptions that China will continue growing and will not suffer any major political or economic crisis, and that the U.S. will continue on its current path without making an effort to set its economic house in order.

[75] "Worldwide Currency Usage and Trend," SWIFT, December 2015, https://www.swift.com/node/19186

9. Recommendations

The rise of the RMB is made possible by two broad trends: the increasing importance of China as a global economic player, and misguided decision-making in the U.S. that is undermining confidence in the American economy. As such, prospective recommendations will be evaluated by how well they address those two trends and will range from the outward facing (hamper China) to the inward facing (improve domestic factors).

The key criteria used to evaluate potential recommendations will be:

Domestic Feasibility: This assesses whether or not an approach is realistic given domestic political constraints in the U.S. and the capabilities for carrying it out.

International Feasibility: Evaluates whether a proposal is realistic given the constraints imposed through allies or the international system.

Cost: This criterion refers to the cost to the U.S. of executing a specific recommendation in economic terms.

Consequences: Refers specifically to the second and third-order consequences of undertaking a recommendation and attempts to estimate the impact of other actors sequentially responding to U.S. moves.

Given these criteria, several options were considered and rejected because they were overly expensive, infeasible to implement, or risked serious unintended consequences. These were options that tried to undermine the Chinese economy and currency through hostile action, including:

- Damaging China's growth through trade restrictions
- Barring U.S. firms from participating in Chinese institutions or initiatives like CIPS or BRI
- Pushing allies or client states to minimize use of the RMB and RMB-denominated assets

Actions on the confrontational end of the spectrum would inevitably signal overt hostility and likely generate a cycle of retaliation that would have negative second and third-order consequences. The advisable course of action is to strengthen the U.S.' already strong position by undertaking measures that boost confidence in the U.S. economy, the dollar, and U.S.-led institutions.

Recommendation 1: **Scale back the weaponization of the global financial system**

Financial and economic sanctions have become a favored tool of U.S. policy makers, who view them as a relatively low-cost, non-military way of punishing adversarial states. However, using trade and finance as a weapon can have severe unintended consequences, generating distrust among nations outside the Western alliance in the institutions underpinning the international economic order.

While sanctions can be valuable in very specific circumstances, they do have serious drawbacks and should therefore be used sparingly.[76] Research by the Peterson Institute for International Economics suggests that sanctions are more effective when targeted at nations that are "small and weak" and connected by commercial ties to the U.S., when pursuing relatively "modest policy goals," and when applied quickly and decisively.[77]

The sanctions on Iran are a modern success story, but this particular case hit many of the criteria necessary for sanctions success. Iran was a mid-tier power, was effectively isolated from all major trading partners, and the concessions it was called to make were arguably not a core national security interest (Iran has always claimed it was pursuing nuclear energy for civilian uses). In contrast, the U.S has also employed sanctions with no

[76] Steven E. Miller, "The Iraq Experiment and US National Security," *Survival* 48, no. 4 (Winter 2006-07): 38-39; Christopher A. Preble, "What New Sanctions on Iran Would Cost—And What They Would Achieve," *The National Interest*, January 21, 2016, http://nationalinterest.org/blog/the-skeptics/what-new-sanctions-iran-would-cost%E2%80%94-what-they-would-achieve-14982

[77] Gary Clyde Hufbauer, "Trade as a Weapon," *Peterson Institute for International Economics*, April 12, 1999, https://piie.com/commentary/speeches-papers/trade-weapon.

discernible gain against Russia and North Korea. In both cases, the behaviors the sanctions were trying to stop (destabilizing Ukraine and acquiring a nuclear deterrent respectively) are considered core national security interests.[78]

By creating the perception that the dollar's dominance and the U.S.-led global financial architecture can be used to cripple its enemies, the U.S. has created incentives for China to go outside the current system. In essence, the U.S. is trading an unlikely short-term policy gain (possible concessions on North Korea) in exchange for the degradation of its dominant global position over the long term. Given the relatively low effectiveness of sanctions in the most serious cases, this is not wise.

The U.S. should signal through its diplomats a willingness to back away from using the supremacy of the dollar to hold the financial systems of its rivals hostage, particularly to China, whose economy is intertwined with our own. When sanctions are used, they should be used where they are effective—against smaller nations and in pursuit of concrete goals.

Recommendation 2: **Predictable budgets and deficit reduction**

As noted earlier, the success of an international currency depends heavily on the health of the underlying economy, and ultimately, other nations' trust in the underlying government's management. While the U.S. has a vibrant economy, the nation's recent fiscal management does not inspire confidence. The U.S. Congress frequently fails to pass budgets. In 2015, Congress passed the first full budget in six years.[79] Continuing resolutions have become common as a tool to keep government running while

78 John J. Mearsheimer, "Getting Ukraine Wrong," *The International New York Times*, March 13, 2014, http://mearsheimer.uchicago.edu/pdfs/Getting%20Ukraine%20Wrong.pdf.

79 "Congress Passes First Budget in 6 Years," *The Washington Times*, accessed March 27, 2018, https://www.washingtontimes.com/news/2015/may/5/senate-clears-way-final-passage-congress-budget/.

agreements get worked out, with an average of 5 a year since 1999.[80] This creates an inability to plan for the future, both among federal agencies and foreign economic actors that need to be able to predictably read the direction of the U.S. government.

Additionally, U.S. debt has grown substantially as a result of the War on Terror and the 2008 financial crisis, and now amounts to over 100% of GDP. Over the next 6 years, the U.S. is expected to continue running annual deficits of $800 billion to $1 trillion annually.[81] Although the U.S. can sustain large deficits because of its status as the dominant global economy and traditionally reliable credit-worthiness, continuing to run large deficits with no end in sight will eventually weigh on the dollar. The president should take the lead on pushing Congress to make a regular budget a priority, as it is a fundamental function of the legislative branch. By using his bully pulpit to pressure Congress to deliver reliably on this core responsibility, the president is not only safeguarding the dollar but also generating positive externalities for the entire economy.

Recommendation 3: **Make international institutions more inclusive**

The U.S. will have to make a strategic decision about whether it wants to defer China's rise by locking it out of positions of power in existing international institutions or accept reality and instead try to integrate it productively into the current system. Integrating China and other rising powers is ultimately the best play, even if it means diluting U.S. influence in institutions like the IMF and World Bank. Getting China to buy in early and feel accommodated will remove some of the incentives for it to create Chinese alternatives (a venture that is quite expensive and wouldn't make sense absent a pressing strategic need).

80 "Continuing Resolutions Have Become the Norm," FederalNewsRadio.com, September 22, 2017, https://federalnewsradio.com/federal-newscast/2017/09/continuing-resolutions-have-become-the-norm/.

81 "US Federal Deficit by Year - plus Charts and Analysis," accessed March 27, 2018, https://www.usgovernmentspending.com/federal_deficit_chart.html.

Even if China someday becomes “a” or “the” dominant figure within these institutions, it will still be constrained by the history, legal framework, and norms of business that have developed around them. If it is forced to start its own institutions and succeeds in poaching sufficient members to make them viable however, it will be able to brand these institutions with its own norms, characteristics, and legal doctrine. Gradually, as China continues to grow, its influence will make the Bretton Woods institutions less and less relevant. In instances where China decides to start new institutions anyway and opens them to other nations, and the U.S. should join and encourage its allies to do the same. As the case of AIIB demonstrates, the U.S. has been unable to stop even its allies from migrating to a Bretton Woods rival when the economic incentives made sense. As such, there is no reason not to join and try to as much as possible shape their future trajectory.

10. **Conclusion**

As a result of a combination of security concerns and domestic political and economic incentives, China has taken active steps to make the RMB a major international currency. These efforts have borne fruit, as evidenced by the growing prominence of RMB usage for transactions and debt financing in Southeast Asia, Central Asia, and parts of Europe, as well as the RMB's inclusion in the IMF's SDR basket. However, the RMB is not yet a true international currency on par with even the yen or pound. Achieving that milestone will require a greater willingness by the Chinese leadership to undertake painful domestic reforms than they have currently demonstrated.

A truly international RMB, and especially one that becomes a potential dollar competitor, would harm U.S. interests in several ways. These include: allowing China to build an alternative global financial and economic network, run on RMB, that is sheltered from the dollar markets and the reach of the U.S. Treasury; increasing China's ability to influence third-party nations through economic power; and giving China a much-enhanced ability to dictate norms and policies in the global economy.

The U.S. and China are closely bound economically, so given this reality, a confrontational approach to try and curtail China's rise would be destructive for both parties. Instead, the U.S. could anchor its dominant position by scaling down the excessive use of economic tools to coerce other nations, improving its own financial governance, and incentivizing China to slow down its institution-building efforts by giving it a voice in existing institutions proportional to its influence.

Appendix A: Interviews

Aaron Arnold, Belfer Fellow (November 2017)

Anthony Saich, Director of the Ash Center (December 2017)

Dwight Perkins, Economist (December 2017)

James Stent, Banker with decades of experience in Asia (December 2017)

Jeffrey Williams, former president of the Shenzhen Development Bank (December 2017)

Mr. Hong (full name and title confidential), CIPS (January 2017)

Nick Consonery, China Director, Rhodium Group

Zhang Liping, Development Research Center of the State Council of P.R.C

(Name and title confidential), PBOC (January 2017)

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