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Institute of South Asian Studies
National University of Singapore

29 Heng Mui Keng Terrace

#08-06 (Block B)

Singapore 119620

Tel: (65) 6516 4239 Fax: (65) 6776 7505

www.isas.nus.edu.sg

<http://southasiandiaspora.org>



China and South Asia - VII

The RMB's Credentials for Global Currency Status

The reforms that China has announced in September 2015, following the devaluation of its currency a month earlier, may strengthen the case for the inclusion of the Renminbi (RMB) in the basket of currencies that the International Monetary Fund uses for its calculation of Special Drawing Rights or 'virtual currency'.

Shahid Javed Burki¹

The Renminbi, China's people's currency, has a short history which should be of much interest to South Asian economies. (The Renminbi is also called the Yuan or simply RMB). And yet it has been at the centre of some of the recent global financial storms. It is worth

¹ Mr Shahid Javed Burki is Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He can be contacted at sjburki@gmail.com. The author, not the ISAS, is responsible for the facts cited and opinions expressed in this paper. During a professional career spanning over half a century, Mr Burki has held a number of senior positions in Pakistan and at the World Bank. He was the Director of China Operations at the World Bank from 1987 to 1994, and the Vice President of Latin America and the Caribbean Region at the World Bank from 1994 to 1999. On leave of absence from the Bank, he was Pakistan's Finance Minister, 1996-1997.

recalling the currency's brief history to underscore the point that the authorities in China have, over time, acquired the capacity to manage their currency as their economic circumstances changed and as their economy has got better integrated with the global system. Within a decade and half, the country has moved its financial system, backed by its own currency, from total isolation to almost complete international assimilation. It is expected that, within a year or so the International Monetary Fund will give RMB the status of an international reserve currency by including it in the basket that defines the Special Drawing Rights. The SDR is a "virtual currency" used by the IMF for its own transactions. Its value is defined by the weighted value of four reserve currencies – the American dollar, the Euro, the Japanese Yen, and the British pound. Once the Renminbi is included in the basket, it will be the only emerging-country currency to be admitted into the select group.

I will begin the Renminbi story with a personal account. I first visited China in August 1965 with a three-member of delegation from Pakistan invited by Beijing to study its system of communes. Our visit was the result of a request made by the then Chinese Premier Zhou Enlai in a meeting in Beijing with Pakistan's then President General Muhammad Ayub Khan. The Chinese wanted a group of Pakistanis who understood rural economics to write a report on the working of the commune system, which was receiving bad Western media attention. When we arrived at the Beijing airport we were asked to surrender all foreign currencies we had in our possession. When that was done, we received a paper certificate that indicated in RMBs how much the Chinese government owed us. The amount was calculated at the rate of 2.46 Yuan to a US dollar. The paper we carried was called the "foreign exchange certificate", the FEC. When we made a transaction in the very few places where we were allowed to do business – a couple of hotels, a few restaurants, and one large store, the Friendship Store – the amount spent was deducted from the amount left on the FEC. All this was done by hand, and each transaction was recorded and stamped by hand. At the conclusion of our stay, we surrendered the certificate at the airport and received the balance in American dollar converted, once again, at the rate of 2.46.

This system was too cumbersome to work when China began to open its economy to the world in 1979. To deal with this situation, Beijing dispensed with the certificate and introduced a parallel currency that continued to be called the FEC. All foreign transactions were made in the FECs. The rate of exchange for the FEC was pegged at one to the Yuan. The FECs were withdrawn in 2009, as in June of that year, Beijing launched a pilot scheme where a few businesses in Shanghai Municipality and Guangdong City were allowed to use the Yuan for transactions. These transactions could be carried out with designated businesses in Hong Kong, Macau and Singapore.

Deemed successful, the programme was extended to 20 provinces a year later and to the entire country in September 2011. However, the counterparts for trade remained limited to a few geographic entities. At about the same time, the People's Bank of China (PCB), the country's central bank, began to conclude "swap arrangements with some countries that allowed all trade to be conducted in local currencies. The American dollar was used to settle the difference. These arrangements were negotiated initially with Japan, Pakistan, Russia, Sri Lanka, Thailand, and Vietnam. The use of the local currency for international trade, therefore, has a history of only four years. It is extraordinary how far the Chinese have travelled on the road to monetary modernisation.

Beijing maintained a tight control over the value of the Renminbi. Its rate of exchange was determined by the PCB and had little to do with the real value of the currency. Basically, the PCB fixed the exchange rate to give competitive edge to the exporters in the country. Since several enterprises in the export business were foreign companies, the Chinese authorities maintained that they were not pursuing nationalist interests. As the country built up huge trade surpluses with its partners, in particular the United States, this practice called "currency manipulation", became a serious issue in Beijing's relations with Washington, Brussels and Tokyo.

Under pressure, Beijing began to liberalise the use and value of the RMB in July 2010. For most of its history, the Yuan was pegged to the US dollar at the rate of 2.46. It was revalued to 1.50 Yuan in the 1970s, but the value declined rapidly until it reached 8.62 in 1994. It

remained at 8.27 to a dollar for eight years, from 1997 to 2005. However, Beijing began to increase the Yuan value, bringing it down to 6.0395 on 14 January 2014.

In July 2005, the Yuan was allowed to move within a narrow trading band of 0.3 per cent; the band was broadened to 0.5 percent on 18 May 2007 and to 1 per cent on 14 April 2012. The band was broadened to 2 per cent on 17 March 2014. The band remained at that level until 11 August 2015 when the devaluation of the currency shook international markets. Over a period of three days, the Chinese devalued the currency by 4.5 per cent with respect to the United States' dollar while broadening the band within which the currency could move. This was a move to loosen the control of the PCB over determining the value of the RMB; it was misread by the markets.

A number of new reforms were announced by Beijing at the Dalian meeting of the World Economic Forum on 10 September 2015. China will keep the Yuan stable at a reasonable equilibrium level, said Premier Li Keqiang in his address. China will open its domestic foreign exchange market to foreign central banks, making it easier to for other countries to hold Renminbi assets. This move will make the onshore Yuan's exchange more globally recognised. Such direct access gives foreign central banks more flexibility and control over costs as they don't have to do transactions through local banks.

This decision will improve China's prospects of being included in the International Monetary Fund's basket of currencies it uses to determine the value of its virtual currency, the Special Drawing Rights, SDRs. This measure will increase the share of the Chinese currency beyond the current 1.1 per cent. The United States' share is 63.7 per cent. More than 60 global central banks and sovereign wealth funds have invested in RMB-denominated assets with combined holdings of US\$ 120 billion. Also, the first phase of China International Payment System will become operational in Shanghai in the next few months. These developments will bring the Renminbi closer to becoming a global reserve currency, completing the journey it began only three decades ago.

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