

# Can China Internationalize the RMB?

By Saori N. Katada January 1, 2018  
16-20 minutes

---

The jury is still out on whether the [Chinese renminbi \(RMB\)](#) will displace the U.S. dollar in the foreseeable future. What is clear, however, is that challenging a hegemonic currency is not simple. For the RMB to eventually reign supreme, not only would the [Chinese leadership](#), particularly the country's monetary authority, need the political will to prioritize the internationalization of its currency over concerns with domestic stability, it would also have to gain the support of the financial markets and other economic and political players. All that is easier said than done.

The recent history of how the Japanese yen tried and failed to become the dominant international currency provides a good illustration of the challenges. By the late 1980s, the world had started to see Japan's economic power and its currency, the yen, as a major competitor to the U.S. economic order. But Japan was not ready to take on the role of challenger; after the Asian financial crisis (1997-98), the Japanese government made serious efforts to internationalize the yen, but its policies did not help in that regard.

Two decades later, after the Japanese fully liberalized capital account transactions, the yen is largely governed by market forces and is no longer a threat to dollar dominance. Instead, Japan is an effective supporter of dollar-dominated Asia and, given its economic size and its developed financial and monetary capacity, it continues to have great influence in East Asia's economic order. Still, as the region's economic integration deepens and China's currency ambitions increase, Japan also engages in a hedging strategy meant to protect against volatility in the U.S. economy. What Japan does today and the limits of what [Japan found it could do in the past](#) tell us a lot about the dynamics of the international monetary order as a whole—and about what China can expect in the coming decades.

## **Stay informed.**

In-depth analysis delivered weekly.

## JAPAN IN A DOLLAR WORLD

For several decades after the end of World War II, Japan supported dollar dominance in East Asia, partly out of necessity—it relied heavily on exports to the United States and depended on importing natural resources such as petroleum—and partly because of its inefficient domestic financial sector and the government's desire to protect it. Even when the Japanese yen began to capture headlines for its increasing might in the late 1980s and early 1990s, and despite the abolishment in 1980 of a law that restricted foreign exchange and foreign investment, the

Japanese government was neither prepared nor willing to take the necessary steps to make the yen become a rival to the dollar. At that point, the Japanese government saw its control over domestic monetary policy as more important than its ambition for regional currency dominance.

It was only in the aftermath of the 1997 Asian financial crisis that the Japanese government began adopting policies to increase the yen's use in the region as a way of reducing its foreign exchange risk. Policymakers believed that the fundamental cause of the Asian financial crisis was a "double mismatch" in investing in the region. The first mismatch was that short-term investments from external regional actors, particularly the United States, were used to finance long-term projects (a maturity mismatch). The second was that these investments came in the form of U.S. dollars, which were used for local currency funding needs (a currency mismatch).

As the region developed dense production and trade networks with Japan before and after the crisis, balancing dollar dominance by promoting the yen was considered a crucial way to stabilize the region's currency structure. The other motivation was, of course, to use financial stimuli to revive the stagnant Japanese economy after the burst of the economic bubble in the early 1990s. Indeed, the Japanese government revealed its ambition to make Tokyo the region's largest financial center. After 1999, furthermore, the government opted to exempt non-residents from tax withholding on interest and capital gains to facilitate their entry into the market and to improve bond market liquidity and the country's payment settlement system—all to further internationalize the yen.



Tokyo, August 2009.

*Yuriko Nakao / Reuters*

It is now clear that Japan failed in its ambitions; between 2001 and 2016, the use of the Japanese yen as a reserve currency actually declined from 5.5 percent of total official exchange reserves in

the world, according to the IMF, to around three percent. Even in Japan's own trade with the rest of the world, the use of the yen [barely increased in exports](#)—from 36.1 percent in 2000 to 37.1 percent in 2016—and imports—from 23.5 percent to 26.1 percent. On the financial center front, Tokyo could never quite catch up to Hong Kong and Singapore. Although Japan continues to be a major creditor in the world and the yen continues to be an important international currency, its presence in the region has decreased, particularly with the rise of the RMB. Arguably, the only major achievement of Tokyo's policy efforts was financial integration with the rest of the world: Japan saw an increase in foreign financial presence through mergers and acquisitions and through carry trade and inward portfolio investment.

Japan failed to make the yen the dominant currency in the region for many reasons. First, the dollar was already dominant. Many developing Asian economies, which experienced large foreign exchange rate fluctuations after the Asian financial crisis, gradually moved to shadow the U.S. dollar (and later the RMB, which moved closely with the dollar). But none shadowed the yen. Second, Japanese financial institutions themselves [resisted](#) the move away from their traditional business model, in which they earned large profits through currency hedging between the dollar and the yen. Although changes in Japan's regulatory and institutional environment prepared Japan for yen internationalization, in other words, market players did not follow the government's lead.

The third reason was the persistence of an export-promotion model in East Asia ([including Japan](#)) that was largely oriented toward the United States and involved denominating the sales of exports in the currency of the market country. The final sources of failure were Japan's overall economic decline (including a contraction of the Tokyo financial market) and the rise of China, whose rapidly expanding economy made it reluctant to commit to a new regional currency regime dominated by another country.

In the end, the dollar has continued to serve as the regional currency of choice. In the ten years after the Asian financial crisis, the local currency-U.S. dollar hedging market boomed. Meanwhile, despite the establishment of an emergency funding mechanism, called the Chiang Mai Initiative, to fend off currency attacks in Asia, foreign exchange reserves, largely denominated in dollars, have grown—especially in China.

## BETWEEN THE RMB AND THE DOLLAR

In the late 2000s, concerns over dollar dominance in East Asia reemerged, this time in the context of the global financial crisis. A widely cited speech delivered by Peoples' Bank of China Governor Zhou Xiaochuan in March 2009 is revealing. In it, Zhou promoted the use of Special Drawing Rights (SDR), the reserve asset created by the IMF, to launch a new global reserve system to replace the current dollar-based one. His plea showcased a fundamental anxiety on the part of East Asian leaders about their dependence on a currency and economy that was proving more tumultuous than expected. The region withstood the crisis quite well, however, protected by a total of \$3 trillion in foreign exchange reserves in the hands of East Asian central banks. But with a majority of this reserve invested in short-term dollar-denominated assets such as U.S. treasury bills, and with large holdings of other dollar-denominated assets, Asia would have had a lot to lose.

In the end, the dollar has continued to serve as Asia's currency of choice.

This crisis spurred China's efforts to internationalize the RMB, already gradually underway since the early 2000s. How did Japan react to China's acceleration? On balance, Japan has been lukewarm toward RMB internationalization for the last several years. Japanese non-financial corporations, especially small and medium-sized firms, do not typically use the RMB to settle their trade with China despite the high volume of trade between the two countries. That is in part because using the currency is [cumbersome and inconvenient](#), although with some improvements and a push by China, RMB use in Japan's trade rose in 2015.

Yet Japanese financial institutions, especially globalized mega-banks, remain ambivalent. On the one hand, they see that RMB internationalization will expand their business opportunities overseas. Some, including economists from respected think tanks such as the Namura Research Institute and Japan Research Institute, even argue that doing so would revive Tokyo as a financial center and, by directly trading between the RMB and the yen, might also contribute to the internationalization of the yen. On the other hand, the Japanese financial sector continues to see high risk in the RMB business, stemming from Japan's experience with China's highly politicized financial dealings. The collapse of China's Guangdong International Trust and Investment Corporation (GITIC) in 1999 and Dairen International Trust and Investment Corporation (DITIC) in 2000 forced Japanese banks to forgo most of their outstanding debts.

On the government side, enthusiasm about facilitating the use of RMB around Japan and in Asia has been muted since the early days of RMB internationalization, most likely because of the lack of bottom-up demand from Japan's private sector and a wealth of other priorities. In the early days of China's efforts to internationalize its currency, at a summit between the two countries' leaders, the Japanese government did set up a Japanese-Chinese agreement: "Enhanced Cooperation for Financial Markets Development." The [agreement](#) aimed to promote the use of the Japanese yen and RMB in cross-border transactions, including the direct exchange markets, and to support the development of yen- and RMB-based bond markets as well as yen- and RMB-denominated financial products. As a result of this agreement, Japan became the first country besides the United States to engage in direct RMB currency exchange with China. But the overall amount of direct currency trading between the two countries has thus far been limited.



A quarterly branch meeting at the Bank of Japan's headquarters in Tokyo, April 2016.

*Issei Kato / Reuters*

## JAPAN'S ENGAGEMENT WITH THE RMB

Five years after the initial burst of cooperation, on December 22, 2017, the monetary authorities of Japan and China finally approved allowing Japanese corporations to issue RMB-based bonds (so-called “Panda bonds”) in China. Nonetheless, the Japanese government has still not signed on to any of the four important initiatives that the Chinese government has advanced to promote RMB internationalization. The first was the bilateral currency swap arrangement that the Chinese monetary authority extended to more than 30 countries around the world after the global financial crisis. Although the Japanese government was the first to conduct a currency swap with China under the CMI, it has not renewed the arrangement since it expired in September 2013.

Second, Japan has yet to acquire RMB Qualified Foreign Institutional Investor (RQFII) status, which would allow Japanese institutions to invest in RMB-based assets in China. As of January 2017, institutional investors from 16 countries besides Hong Kong and Taiwan are registered, totaling RMB 529.6 billion (US\$77.2 billion) [worth of quota](#).

The third initiative is related to the RMB payment settlement system. In 2014, China's offshore financial centers expanded beyond Hong Kong, Taiwan, and Singapore when China's central bank established deals with banks in several countries, including Australia, Canada, Germany, Malaysia, Thailand, and the United Kingdom. The memoranda of understanding afforded these banks direct access to China's National Advanced Payment System, which functions as an electronic inter-bank clearing and settlement system. Furthermore, to compete against the payment clearing and settlement service offered globally by SWIFT, China launched in October 2015 the Cross-Border Inter-Bank Payment System (also called the China International Payment



System; CIPS), through which foreign banks can access RMB settlement directly. In both cases, no Japanese banks participated, restricting Tokyo's role in the RMB business.

Finally, the Japanese government has thus far stayed out of the Asian Infrastructure Investment Bank (AIIB), which Chinese President Xi Jinping proposed in October 2013 and came into existence in January 2016 with a \$100 billion funding base. Though it is still unclear how much of the AIIB's future projects will be denominated in RMB, many suspect that the establishment of the AIIB and China's concurrent "Belt and Road Initiative" would contribute to RMB internationalization by [expanding RMB-denominated investment](#) in the region.

Japan's refusal to join the AIIB came in spite of heavy courting by the Chinese leadership, as China hoped to increase the institution's legitimacy in Asia. Japanese hesitancy might relate to the fact that China has been dragging its feet on RQFII approval for Japan and the installment of an RMB clearing bank in Tokyo.

Now that the easy part of RMB internationalization—trade settlement—has been achieved, the rest of the process will depend on market forces and the Chinese authority's will and ability to liberalize its domestic financial markets. Of course, China's slowing economic growth adds to such concern. It took Japan more than 20 years to go through this process, and even that was not enough to urge market players to follow. Given the multiple economic and political difficulties Japan has experienced in the process, Japanese experts and officials are not holding their collective breath that China can achieve such feats anytime soon.

Japan, the second-largest economy in Asia with a sophisticated financial sector and experience in financial liberalization, has been slow to ride on the RMB internationalization wave.

#### EASIER SAID THAN DONE

Japan, the second-largest economy in Asia with a sophisticated financial sector and experience in financial liberalization, has been slow to ride on the RMB internationalization wave. In turn, Japan has contributed to the dollar's persistent dominance in Asia. At the same time, the Japanese economy is becoming sensitive to currency competition as the country deepens its financial integration with the rest of the world.

Since December 2012, Abenomics, named after sitting Prime Minister Shinzo Abe, has become Japan's main economic growth strategy. The first of three arrows of this strategy, an aggressive monetary easing policy (conducted by Bank of Japan Governor Haruhiko Kuroda since April 2013), led to a quick depreciation of the yen against the dollar. The result in both economic growth and accusations of currency manipulation. With the U.S. Federal Reserve recently beginning to take steps to raise the country's discount rate under the strengthening dollar, the currency conflict is bound to intensify.

Meanwhile, a cheaper yen and booming stock market have invited further inward foreign investment in Japan, which also includes an increased proportion of foreign ownership in the Japanese government's [short-term debt](#) (Treasury Bills and Financial Bills, whose maturity is less than one year) from 28.6 percent in March 2013 to 50.9 percent in December 2016. Some

report that the bulk of such foreign ownership comes from China, whose monetary authority has worked to diversify the composition of its still-massive foreign exchange reserves.

A stable currency environment is the key component that has underpinned Asia's economic success in the post-1945 period, for Japan between the 1950s and the early 1970s and for China from the 1980s to recently. It was the U.S. dollar that provided such an environment. Because of that, the Japanese government has been an unequivocal supporter of dollar dominance. Now, China faces the dilemma it saw in Japan's yen internationalization experience: prioritize stability in both the regional currency environment and domestic financial conditions and lose the golden opportunity to alter the regional currency hierarchy. The Japanese experience shows that there is not much time left for Chinese leaders to make the final decision.