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On Cross-border RMB Settlement and RMB Internationalization

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Abstract

Constrained by internal and external conditions, the internationalization of RMB can be a long-term process. As an important measure to promote RMB internationalization, cross-border RMB settlement has its own limitations. Cross-border RMB settlement is a conditional policy of capital account liberalization, and its driving force is mainly based on supply rather than demand. Moreover, Outflow and reflux of RMB under cross-border RMB settlement is contrary to the import and export mechanism of typical international currencies, which is unsustainable. Therefore, we cannot expect too much of cross-border RMB settlement in RMB internationalization process.

Keywords: RMB internationalization; cross-border RMB settlement; Capital Account Control

1.Introduction

Since 2009, China has adopted a series of policies while maintaining capital control to promote RMB internationalization, including currency swaps with many countries to start cross-border RMB settlement of trade, direct and indirect investment, and building RMB offshore market. Now RMB cross-border settlement has made remarkable achievements. According to Society for Worldwide Interbank Financial Telecommunications (SWIFT), in February 2021, RMB ranked the fifth largest currency in the global payment. According to the Report on the Internationalization of RMB in 2020 by the People's Bank of China (PBC), the RMB also ranks the fifth among the currencies of reserve assets held by IMF member countries, with a market share of 1.95%. Considering the above achievements, all walks of life are too optimistic and have high expectations for cross-border RMB settlement. So, it is necessary to take an objective view of the present achievements.

Firstly, cross-border RMB settlement is not exactly equivalent to RMB internationalization. When the capital control cannot be eliminated, there will be no substantial breakthrough in RMB internationalization. So, currency mismatch dilemma suffered by China cannot be eliminated for the present. To become an international currency, a national currency must first be widely used as the third-party Currency other than the currencies of both parties to the transactions, namely the so-called *Vehicle Currency*. Take US dollar transaction as an example, half to three quarters of global Dollar transactions are "third-party transactions" (between counter partners except USA residents). From this point of view, RMB cross-border settlement only involves China and its counterparties, which is far different from typical international reserve currencies. And numerous studies have shown that, cross-border RMB settlement indicated by size of RMB outflow and inflow is closely related with depreciation (or expectation) and appreciation (or expectation) of RMB which caused business to switch their transactional currency from RMB to other currency or *vice versa*, and also related with the interest or exchange arbitrage between onshore and offshore RMB market. So, it's hard to say the internationalization of RMB is driven by *non-resident, real transaction demand*.

Secondly, although RMB has been included in SDR currency basket, the official and private institutions of various countries will not transfer assets to RMB on a large scale in the short term. In addition, the main factors that determine the reserve currency allocation of public and private institutions in the financial market are the stability, liquidity (convenience) and

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profitability of the main currencies, but in reality, RMB do not have all these three properties. Whether RMB is the best option for various countries as pricing and settlement currency in their trade and investment activities is not necessarily dependent on the RMB's position as SDR basket currency. Reviewing history of Japanese yen, we find that although JPY has long been included in SDR basket, and Japanese government has also made ambitious efforts to internationalize the yen, but the JPY has not been very successful.

2. Cross-border RMB settlement is a conditional capital account liberalization

Cross-border RMB settlement and offshore RMB are essentially liberalization of the capital account, which is of a currency convertibility measure. It allows money or capital to flow freely across borders, but it must be in the form of RMB, not in the form of other currencies such as US dollar, and it must serve cross-border trade and investment. As a result, the total amount of yuan imported from abroad is controllable, because this amount of RMB originates from previous RMB outflow through currency swap agreement, specifically from previous outflow of RMB in trade and investment activities which is computable and transparent. From this point of view, the shock to the domestic stability of capital flows in the form of RMB, if any, is theoretically manageable.

3. RMB internationalization under capital control cannot go far

The relaxation of capital controls is necessary for the full internationalization of RMB, but completely to lift capital controls is not feasible at present for China. Suffering currency mismatch with so large scale of foreign economic activity, China has no better option except cross-border RMB settlement through currency swap arrangement under capital control. To lift capital control to facilitate RMB internationalization cannot directly stimulate more demand of RMB from trade and investment. The only reason to accelerate capital account liberalization is that the market demand for RMB internationalization (non-resident demand) has already exceeded the space provided by the current RMB cross-border settlement scheme, and capital controls have become the main obstacle to RMB internationalization. Apparently, this is not true for China

today. Among the 40 capital items listed by the International Monetary Fund (IMF), China has liberalized 35 of them, and the other 5 related to short-term capital flows are under control, but none of the 5 items are completely closed. The further opening of the capital account may not have obvious effect on RMB internationalization.

4. Limitations of cross-border RMB settlement as the logically starting point of RMB internationalization

Firstly, cross-border RMB settlement is an institutional arrangement based on supply rather than demand, or initiated by policy but not by market, or aroused by domestic demand but not by external demand. The impetus for cross-border RMB settlement stems from China's strong need to attenuate the overdependency on US dollar to get out of currency mismatch dilemma challenged by Chinese business.

Secondly, in reality, the choice of pricing and settlement currency is a matter of market behavior, but China's position in the global value chain cannot support RMB as vehicle currency in international business, considering China's unique trade structure of large import and large export, low product differentiation and low added value. Chinese enterprises do not have enough say in the choice of pricing and settlement currency. Especially in European and American markets, the willingness to make settlement by RMB is very low.

5. The cross-border circulation of RMB under cross-border settlement is unsustainable

From the perspective of the import and export mechanism of currency (see the table below), the current mode of outflow and reflux of RMB is unsustainable. Although RMB can be exported on a large scale, outflow nearly keeps a balance with inflow (still with high volatility). As a result, it is difficult to achieve stable net outflow of RMB.

Moreover, the current outflow of RMB basically originates from payments for trade settlement, namely imports of goods, while financial and capital account has a net inflow position. Briefly, the current account (CA) is an outflow channel while capital and financial account (FA) acts as inflow channel of RMB. This mode is contrary to the import and export mechanism of typical international currencies and definitely unsustainable.

Table 1: Cross-border Settlement of RMB Unit : Trillion Yuan.

year	CA			FA		
	Inflow	Outflow	Balance	Inflow	Outflow	Balance
2012	1.3	1.57	-	0.25	0.03	+
2013	1.88	2.75	-	0.45	0.08	+
2014	2.73	3.82	-	0.86	0.19	+
2015	3.91	3.32	+	2.27	2.59	-
2016	2.15	3.08	-	1.63	2.98	-
2017	1.77	2.6	-	2.68	2.15	+
2018	2.06	3.05	-	5.94	4.81	+
2019	2.66	3.38	-	7.35	6.27	+

Note: “+” means surplus, “-” means deficit

Data: the monetary policy implementation report of the People's Bank of China

The history shows that in the long run “the mode of currency internationalization is like this way, namely FA has deficit to export currency while CA has surplus to import currency.

This mode corresponds to a BP structure like “+CA-FA (including official reserve) =0”, as has been the case historically for the British pound, the US dollar, the Japanese

yen and the German mark. If an international currency issuing country imports its currency through FA and exports its currency through CA, namely $-CA + KA = 0$ (called second mode), the currency of this country will definitely depreciate and lose its credibility, resulting either in a financial crisis or an economic crisis, and the foundation of currency internationalization will collapse. Even in the era of gold standard, if Britain, as an international currency issuer, has a lasting CA deficit, the convertibility between sterling and gold would be destroyed and the international status of sterling would be eroded.

Of course, second mode has been existing for a long time for USD, but this is just an exception. Only after the bankruptcy of the gold standard and US dollar has become the international core currency with a monopoly position, can US dollar enjoy this privilege while any other country has no way to follow suit. But this situation will not exist forever, and US dollar is still constrained by "Triffin Dilemma". For China, lasting BP like $-Ca + Ka = 0$ indicates that China must be an international debtor, which will surely cause RMB depreciation and even financial crisis. Even if crisis can be avoided, employment and output will be contracted, which is unacceptable for a rising developing country.

6. Conclusion

In history, there has never been a country that regards currency internationalization as prioritized goal of its development. Currency internationalization must be promoted with the maturity of internal and external conditions. The internationalization of the RMB must be based on the overall strategy of China's economic development, and cannot be advanced or given an unrealistic goal. At present, the motivation of RMB internationalization is caused by the over-reliance on export-oriented development strategy with high degree of external dependence, and thereof the dilemma of currency mismatch. This unfavorable situation doubtless is strengthening the strong demand for the reform of international monetary system and RMB internationalization. However, this is taking place just at the time when China still lies at the bottom in global value chain and other domestic economic and institutional conditions were not yet mature. The RMB internationalization is a "premature baby".

The RMB internationalization is not the best solution to China's economic development problems, and cross-border RMB settlement does not guarantee that China Yuan will become a truly international currency. A full range of cross-border settlement to speed up RMB internationalization is of little significance. Especially now we cannot stand any large RMB exchange rate fluctuations and can't completely relax capital controls. To solve China's internal and external imbalances, China should at first deal with domestic income distribution, and gradually raise the level of wages, namely through internal appreciation to balance international payments, and finally make domestic consumption as the leading role in the economic growth. In the long term, China should speed up the domestic industrial adjustment and establish an innovation-driven growth pattern, deepen the reform of marketization and perfect the capital market. Only in this way can we have a sound economic system to survive internal and external shocks. And only in this way can the RMB internationalization continue smoothly.

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