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China’s domestic struggle to internationalise the RMB

Blog post by Senior Associate Jens Presthus, 9 August 2021

Internationalisation of the RMB has again become a hot topic. Not just in western media, which often depicts it as a looming existential threat to the dollar-based global economy, but also within China. However, China is currently not in a position where it can remove capital controls – the minimum requirement for making the RMB an international currency – without undermining its growth model and threatening financial stability. The limited loosening over the last couple of years has already prompted concern in Beijing, meaning a breakthrough for the RMB in the global economy, digital or not, remains unlikely in the near term.

American sanctions aimed at limiting China’s development relative to that of the US have helped spark a new round of debate in Beijing – with concern growing about the slow rate of adoption of the RMB. It has only increased its share of global payments from 0.29% in 2011 to 2.46% in 2021. Many in the foreign affairs and military establishments advocate the political and strategic benefits of the RMB becoming a global reserve currency. Separately, bankers and regulators make the point that opening up the financial system to the outside world would force change and accelerate reforms that policymakers are struggling to implement, including removing implicit government guarantees that lead to poor capital allocation. Zhou Chengjun, director of finance research at the People’s Bank of China, argued for instance in May that the central bank should give up its control of the exchange rate. Others, however, including political and business elites that benefit from the more closed system, worry about risks to the economy, financial stability and ultimately social order.

Indeed, for a developing economy, such “shock-therapy” can be highly risky. Not only would flows of foreign “hot money” put the fragile financial system, which is beset by moral hazard, at risk when favourable growth conditions and inflows suddenly reverse. It would also push up the value of the RMB and undermine China’s manufacturing and export-led growth model. As others have noted before, including Peking University finance professor, Michael Pettis, the PBoC can of course intervene. But this has consequences, including for the country’s state banks, which increasingly are being asked to share the burden by accumulating reserves of depreciating foreign currencies such as the US dollar.

Despite the growing number of voices that argue the use of the digital RMB for cross-border transactions between China and its trading partners will alter global trade and finance, the digitisation of the RMB will unfortunately not be able to sidestep these issues and speed up the currency’s global use. Removing capital controls will still remain a pre-requisite, and making a currency digital does not remove challenges linked to financial stability and the Chinese economic model’s reliance on a weak currency. In fact, if anything, reducing transaction costs and improving

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efficiency by making the currency digital will make it even harder for China to control capital flows and ensure financial stability.

Before China can internationalise the RMB, it will first need to clean up its financial system and rebalance its economy away from a manufacturing sector that relies on a weak domestic currency. While recent savings, investment and consumption figures suggest the leadership has a long way to go on the latter, it is at least allowing more state-owned entities to fail in an attempt to limit moral hazard. Of course, if history is a guide for future events, there is a high risk that attempts at reform will be paused when growth headwinds become too strong and “too big to fail” entities, such as Huarong and Evergrande, come under threat.

The future of the RMB will be decided by domestic economic, financial and political conditions, not by strategic geopolitical interests and the launch of an easy-to-transact digital currency.