

**The Internationalisation of the Renminbi (RMB):
A Strategy of Crossing the River by Feeling the Stones**

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Abstract

The principal aim of this paper is to provide a summary of how far has China gone in internationalising its currency, the Renminbi (RMB), to identify the main strategic goals that China wants to achieve through this process and finally to point to the main risks that this objective entails. One can say that so far the internationalisation process has been quite successful. The Chinese approach of crossing the river by feeling the stones has proven adequate. While it is commonly believed that a currency can only become international when it is fully convertible, Hong Kong and the RMB might prove the contrary. It is perfectly feasible, at least for a while, to see the *hongbi* increase its international trade invoicing share without Beijing having to relax its capital controls for mainland China. Nonetheless, there are several risks that lie ahead. So far the internationalisation process has developed smoothly because the waters of the river were relatively shallow, but once the waters deepen proportionally to the amount of RMBs that are in circulation overseas, the journey might be less tranquil.

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1. Introduction

In the aftermath of the global financial crisis (2007-2008), the Chinese Government has started a policy of promoting the internationalisation of its currency, the Renminbi (RMB), also known popularly as the yuan. The crisis showed policymakers in Beijing how overly dependent their export industry is on the use of the dollar as the currency of settlement in international transactions. The credit crunch initiated in the subprime mortgage market in the United States had devastating spill-over effects for Chinese exporters. The scarcity of dollars, due to the repatriation and deleveraging flows into the American financial system, provoked a sudden plunge in external demand for Chinese goods and the consequent laying off of millions of Chinese migrant workers. This experience encouraged policymakers in Beijing to find their own alternatives to overcome the flaws of the current flexible-dollar-system. By having its monetary policy pegged to the dollar and using the greenback as its main currency for international settlements and store of value, China is tremendously exposed to the volatilities inherent to the system. On the one hand, when the US runs persistent loose monetary policies (as has been the case since the burst of the dot-com bubble in 2000) China has to cope with enormous flows of liquidity that foster inflation and asset price bubbles. On the other hand, when there is a crisis in the US (as was the case after the collapse of Lehman Brothers in 2008), and there is a sudden contraction of liquidity worldwide, China does also suffer because global demand denominated in dollars plunges. To avoid this, policymakers in Beijing have decided to promote the use of the RMB in international trade. Since the global financial crisis they have developed a multi-phase and multi-track strategy to make the RMB a reserve currency *a la par* to the dollar and the euro. To achieve this objective, they have also declared that they want to develop Shanghai as an international financial centre that can compete with Wall Street and the City of London by 2020.

This aim seems only too logical. That the second biggest economy in the world wants to promote its currency is perfectly understandable. If China wants to play a bigger role in the International Political Economy (IPE), it needs greater autonomy in international monetary affairs, and what better way to achieve this than to use its own currency in international transactions. As Charles Kindleberger argued, “a country’s exchange rate is more than a number. It is an emblem of its importance to the world, a

sort of international status symbol". Similarly, Robert Mundell declared that "great powers have great currencies" (Kirshner 2003:15, both quotes). Therefore, if China aspires to become a great power in the foreseeable future, it needs to raise the profile of its currency. However, this is easier said than done. Making ones currency global is certainly not an easy task. France has had this same aspiration for hundreds of years and it was only able to achieve it by merging its monetary sovereignty with that of the German economic powerhouse. The German experience, by contrast, shows the dangers inherent to the internationalisation of a currency. Issuing a global currency provides the issuer state with a number of privileges (the exorbitant privilege of the US is the epitome here), but also with responsibilities and risks. The contraction and expansion of the money supply and its effects on the national economy are curtailed by the presence of large amounts of stocks of this same currency overseas. Well aware of this, Germany and Japan have always been very reluctant to internationalise their currencies until they were convinced (partially erroneously) that they had financial markets sophisticated enough to cope with these risks.

Given this precedents, the aim of this paper is to explore China's RMB internationalisation journey and to identify the strategic aims and potential risks that this process entails. The paper is divided in three parts. In the first part I will try to summarise the achievements of the internationalisation process of the RMB to date. This part is rather descriptive. Its main aim is to identify how far China has gone in crossing the internationalisation river. Following the well known Chinese say of always crossing the river by feeling the stones, it will be shown how the Chinese government has successfully started a step-by-little-step campaign in the promotion of its currency as means of settlement in international trade. In these very edges of the river where water is normally shallow and harmless, China has also (rightly) decided to use a two track approach and not only focus on the use of the RMB in trade, but also in developing investment opportunities for RMB holders by encouraging the issuance of RMB-denominated bonds by banks and companies in Hong Kong, which is China's laboratory in its internationalisation strategy. These two track approach, as identified by Subacchi (2010), is essential if the project wants to be based on solid structures. Following the metaphor of crossing the river, by constructing only one track, one can bridge the river by foot, but if we want something more solid so that cars and trucks can cross the river, we need a second track to stabilise the platform

and make it resilient. In international currencies, the two tracks are essential. You can use RMB exclusively for trade, but the reality is that traders want to use these RMBs for other things such as investment and hedging, therefore they want to have products where they can allocate this cash.

The second part of the paper focuses on the strategic objectives that the Chinese government pursues with its internationalisation process. It is well and fine to want to cross the river, but what is so desirable on the other bank of the river to actually commit so much effort to bridge it? This part will have an analytical component and will try to discern what are China's main objectives and goals in its strategy. Finally, the third part of the paper will focus on the risks that lie ahead. Rivers are shallow on the edges, but they become deeper in the middle, and sometimes there are currents and stones that make the crossing hazardous. As the same Subbachi (2010) points out, by following a strategy of crossing the river by feeling the stones, China is trying to achieve something that no other country has attempted before. It aims to make its currency an international currency through a politically driven process without first developing its financial markets and opening up its capital account in order to make its currency fully convertible. In the case of China, all these aspects are developed at the same time and gradually, making it a fascinating journey. As the saying goes, we are here truly in uncharted waters.

2. The crossing of the river starts with success

Although in the financial press it is commonly acknowledged that the internationalisation process of the *hongbi* (redback) started in 2009, Gao and Yu (2009) set the start of the process in the aftermath of the previous great financial crisis, the Asian crisis of 1997-1998. One of the lessons of that crisis was that Asian countries could not rely so much on the financial institutions dominated by the West, such as the International Monetary Fund (IMF), and that they had to develop their own financial institutions. This happened in 2000 with the signing of the Chiang Mai Initiative (CMI) and the setting up of bilateral currency swaps agreements between the ASEAN countries and the three East Asian economic powerhouses: South Korea, China and Japan. Most of these swaps were effectuated in US dollars, but some of them also in RMB. Table 1 shows China's bilateral swaps as per mid 2007.

Table 1: Bilateral Swap Arrangements: China-ASEAN+3 countries (taken from Gao & Yu 2009)

BSA	One/Two way	Currency	Total Size USD bn	Status
China-Thailand	One	USD/Baht	2	Concluded: Dec. 2001 Expired: Dec. 2004
China-Japan	Two	RMB/Yen Yen/RMB	6	Concluded: Mar. 2002
China-Korea	Two	RMB/Won Won/RMB	8	Concluded Jun. 2002
China-Malaysia	One	USD/Ringgit	1.5	Concluded: Oct. 2002
China-Philippines	One	RMB/ Peso	2	Concluded: Aug. 2003 Amended: Apr. 2007
China-Indonesia	One	USD/Rupiah	4	Concluded: Dec. 2003 Amended: Oct. 2006

Source: Bank of Japan.

In the midst of the recent global financial crisis, when dollar liquidity was in short supply, China accelerated its bilateral swap agreements (BSAs). In December 2008 it signed another BSA in RMB with South Korea (Rmb180bn), who was in need of international currencies. In the beginning of 2009 it did the same with Hong Kong (Rmb 200bn) and Malaysia (Rmb80bn). In March of the same year, the People's Bank of China (PBoC), the Chinese central bank, did its first step from the mere goal to regionalising the RMB to the internationalisation of it by signing another BSA with the central bank of Belarus (Rmb20bn). Shortly afterwards, China signed also BSAs with Indonesia (Rmb100bn) and Argentina (Rmb70bn), and in 2010 with crisis-strapped Iceland (Rmb3.5bn) and Singapore (Rmb150bn). These agreements put the total amount of China's BSAs settled in RMB, as of the time of writing, in the order of a little over Rmb800bn, which is roughly \$120bn (Cookson & Dyer 2010, see table 2).

Table: 2 China's Bilateral Currency Swap Agreements since the collapse of Lehman Brothers

Country	Date	Amount
South Korea	12 December 2008	Rmb180bn
Hong Kong	20 January 2009	Rmb200bn
Malaysia	8 February 2009	Rmb80bn

Belarus	11 March 2009	Rmb20bn
Indonesia	23 March 2009	Rmb100bn
Argentina	29 March 2009	Rmb70bn
Iceland	9 June 2010	Rmb3.5bn
Singapore	23 July 2010	Rmb150bn

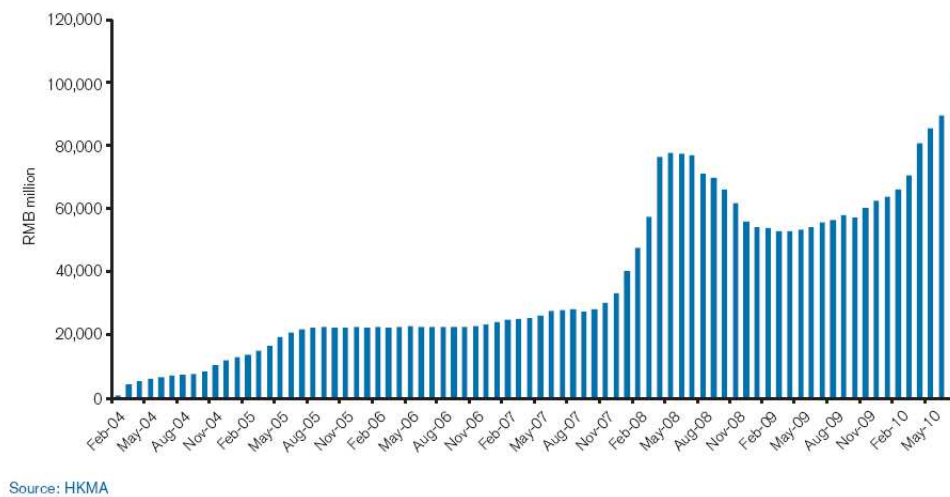
Source: Own summary from press reports

In the private realm the availability of RMB denominated bonds started in 2005 when the Asian Bond Fund, another initiative of the ASEAN+3 group, started to encourage the issuance of bonds in local currencies, including the RMB. Two years later, the PBoC and the National Development and Reform Commission (NDRC) gave their green light to the state-owned public and commercial banks of China to issue RMB-denominated bonds in Hong Kong, which from this moment on starts to be the laboratory, or one can say, the harbinger, in the strategy of crossing the river. The first so called ‘dim sum’ bond was issued by the China Development Bank in mid 2007 and since then the issuance of RMB bonds in Hong Kong has increased significantly. This issuance is now not only limited to mainland China’s financial institutions. Under the guidelines and the strict regulation of the Hong Kong Monetary Authority (HKMA), international banks and companies have also started gradually, but steadily, to issue this type of bonds. Among foreign banks, the most active in this market are Deutsche Bank, Citigroup, JP Morgan Chase, Standard Chartered and HSBC. Some of the international private companies that have started to issue dim sum bonds through these financial institutions are: Caterpillar, McDonalds, Ikea and Nokia, to name just a few.

The issuance of these bonds represents the building of the second track in the internationalisation strategy of the RMB. The first track relates to the use of the RMB in international trade. However, these two tracks are intrinsically related, as explained by Subacchi (2010). Overseas goods producers and services providers that use the RMB with their Chinese customers need a supply of RMB-denominated products to invest their RMBs. Since China still applies strict capital controls on short term capital inflows (Gao & Yu 2009), until very recently there were limited options to use these RMBs, and therefore no real incentive to acquire them in the first place. Now, however, this supply is given by the second track and is concentrated in Hong Kong.

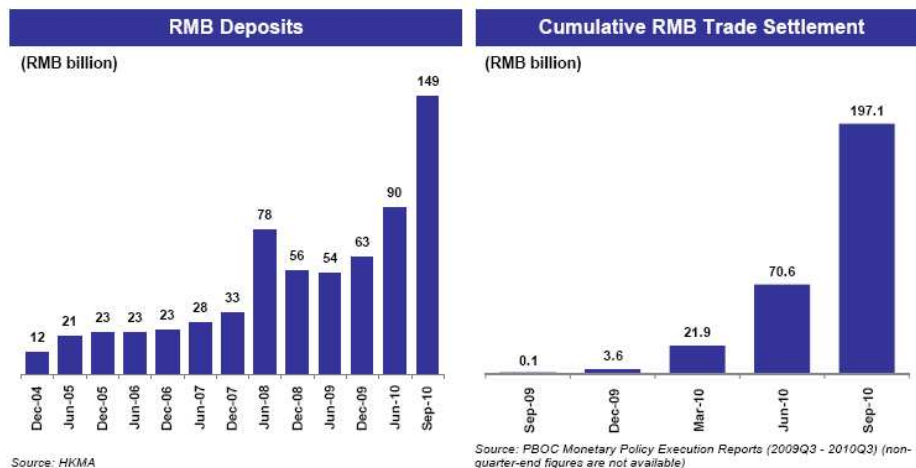
Before the expansion of this second track, foreign traders could only store their RMBs in RMB-denominated bank deposits in Hong Kong, an option available since beginning of 2004, but now with the issuance of dim sum bonds, the options are greater. It is no wonder then that Hong Kong bank deposits in RMB have surged since 2007. Slowly traders and investors are starting to store their *hongbis* in Hong Kong (see figure 1) in order to invest their savings in RMB-denominated bonds.

Figure 1: RMB deposits in Hong Kong, in RMB million (taken from Subacchi 2010)



The latest figures at hand show that as of November 2010 total RMB deposits in Hong Kong stood at Rmb217bn (Cookson & Dyer 2010). This is double the figure in May 2010 (see figure 1 and 2, left side), an exponential increase that is very likely to continue in the foreseeable future. Economists at Goldman Sachs predict for example that RMB deposits in Hong Kong will reach Rmb2 trillion (\$300bn) in 2015.

Figure 2: RMB deposits and cumulative RMB trade settlement (taken from Lamba 2010)



This surge in RMB deposits is consequence of the evolution of the first track of the internationalisation strategy of the Chinese government, namely to increase the use of the RMB in international trade. This aim started in earnest in mid 2009 with the establishment of a pilot programme designed to encourage Chinese exporters to settle their international trades in *hongbis*. At the beginning the programme was confined to five major trade cities (Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan) and later, once it was assessed as successful, it was expanded to 20 provinces. Here again the projection is impressive (see figure 2, right side). RMB denominated trade totalled Rmb440bn in the second half of 2010, which is six times the Rmb70bn settled in the first half, making the annual total over Rmb500bn. June 2010 was a particularly important turning point because until then, under the pilot programme, only 365 exporters nationwide were able to settle trade in RMB, after that watershed, the number has skyrocketed to 67,359 exporters. This year the trade settled in RMB is very likely to continue its upward trend. Just in January, the Industrial and Commercial Bank of China (ICBC), the largest bank in the world by market value, has handled on its own Rmb150bn in RMB trade. If the pace continues like this, economists at HSBC expect that within three to five years around half of China's trade flows with emerging markets will be settled in RMB from today's 3 percent (Anderlini & Cookson 2011), while their Chinese counterparts at China Construction Bank (CCB), another major Chinese bank, believe that by 2015 total annual settlement in RMB will reach \$3 trillion (Gao 2011).

Nonetheless, the use of RMB is not only reduced to trade transactions and to deposits and bonds in Hong Kong. Gao and Yu (2009) highlight that in the neighbouring Republic of Mongolia, 60% of the cash in local circulation is in *hongbi*. In South Korea the RMB is accepted in shops and restaurants and in Vietnam the RMB can be acquired through non-official banking circuits. The RMB has also penetrated the streets of Laos, Myanmar, Cambodia and Nepal. More recently, in another significant step forward, the Chinese state-owned commercial banks, especially Bank of China (BoC), have also started to provide cash in RMBs in the West. Now it is possible as an individual to walk into the Bank of China branch in New York (and presumably in the rest of cities with BoC branches) and withdraw up to \$4,000 per day in RMBs with an annual ceiling of \$20,000. For businesses involved in trade with China there is no ceiling, as long as they can prove that they need the RMBs for their trade

transactions and not to speculate (Gao 2011; Wei 2011). Speculation is naturally the biggest fear for the Chinese authorities. Their aim is to promote the RMB for trade and long term investments but not for short term speculative gains. This is why they maintain literally a Chinese wall between the increased use of the RMB overseas and in the offshore market of Hong Kong and the onshore markets in mainland China. The big question is whether China will be able to maintain this wall watertight.

3. What are the strategic aims of China when crossing the river?

The Chinese government seeks several objectives with its internationalisation policy. Five stand out as the most important ones: 1) To reduce its dependence to the US dollar; 2) to generate alternative foreign demand markets; 3) to increase the political influence of China in Asia and in the world; 4) to establish Shanghai as a financial centre able to compete with Wall Street and London; and 5) to accomplish a smooth transition from a manufacturing and export-led to a service and domestic-demand driven economy. I will now try to cover these five topics one by one.

Reduce China's dollar dependence

China's uneasy with the centrality of the dollar in the international monetary system has become increasingly vocal since the governor of the PBoC, Zhou Xiaochuan (2009), published an article in March 2009 calling for the end of the flexible-dollar system. That this article was published at the same time when China started its RMB internationalisation policy is certainly not a coincidence. Chinese policymakers have realised that they are in a dollar-trap and they want to come out of the trap as soon as possible. One way to do it is to internationalise the RMB (Zhang 2009). This would reduce the transaction costs for Chinese importers and exporters; it would protect them from the volatilities associated to the malfunctioning flexible-dollar-standard (Chin & Wang 2010) and perhaps more importantly, if the RMB becomes an international currency *a la par* to the dollar and the euro able to absorb more liquidity, China will be able to exchange gradually its huge dollar reserves into RMB without having to suffer heavy losses (Gao & Yu 2009). Today this is impossible because the RMB would shoot up in value, destroying the export sector, and trigger high inflation due to the underdeveloped character of the Chinese financial sector.

Gain alternative external demand

Through the internationalisation process of the RMB, China hopes also to increase foreign demand for its products. This is especially the case for countries that might suffer from dollar shortage, which is the case of some of its neighbouring countries, Belarus, Argentina, and more recently Iceland, and also most of Africa. While these markets are still small and will certainly not substitute the demand pull from the US and Europe in the short term, China hopes that it can slowly reduce its dependence on the developed world and increase its trade with developing and emerging markets, especially with the other BRIC countries: Brazil, Russia and India, which have higher growth rates. Significant is here recent agreements to start invoicing bilateral trade with these countries in local currencies (Murphy & Wen 2009). The central banks of China and Brazil have been working on the technicalities of this possibility for some time (Hughes & Vidaillet 2009), and the same could also happen with Russia and India. It is important to note that Chinese banks are increasingly offering loans in RMB all over the world. China has actually provided more loans in 2010 than the World Bank (Dyer et al 2011). These loans will be used to by Chinese products and services and hence generate foreign demand.

Increase China's geopolitical influence

There is no greater symbol of political power than having people in every corner of the world wanting to hold your money. Dollar hegemony is the best example of this. If China wants to leverage political power it needs to promote its currency and gain the necessary reputation of being a good custodian of the value of its currency. This political influence will start with Asia. China aspires to be the leading country in its region, and to achieve that the regionalisation of the RMB can be a useful tool. Here Chinese policymakers draw on the lessons of the euro. Similarly to Germany in Europe, China's regional power and strength is seen with suspicion by its neighbours. In this regard, to avoid future confrontations, the ideal would be to establish a regional monetary union with all ASEAN+3 countries on board, and with China, Japan and Korea playing the leading roles. However, this agreement seems unlikely in the foreseeable future. The political differences between Japan and China are too strong

for this to happen. Given these circumstances, Chinese policymakers believe that it is better to achieve a monetary union bottom-up. The idea is to promote the RMB regionally. To penetrate increasingly the streets of neighbouring countries, and once the population of these countries accepts the economic might and hegemonic status of China, the hope is that these same populations might be forthcoming in accepting a monetary union dominated by China. Following this way of thinking, monetary union will not be imposed by China upon its neighbouring countries, but more demanded by them in order to restraint and embed Chinese power in multilateral institutions, as is the case with Germany in Europe.¹

On the global level, China aspires through the internationalisation of the RMB to sit as an equal to the US and the EU at the governance table of the international monetary system. One first step in this regard would be to include the RMB in the next IMF SDR basket composition which will take place in 2015.

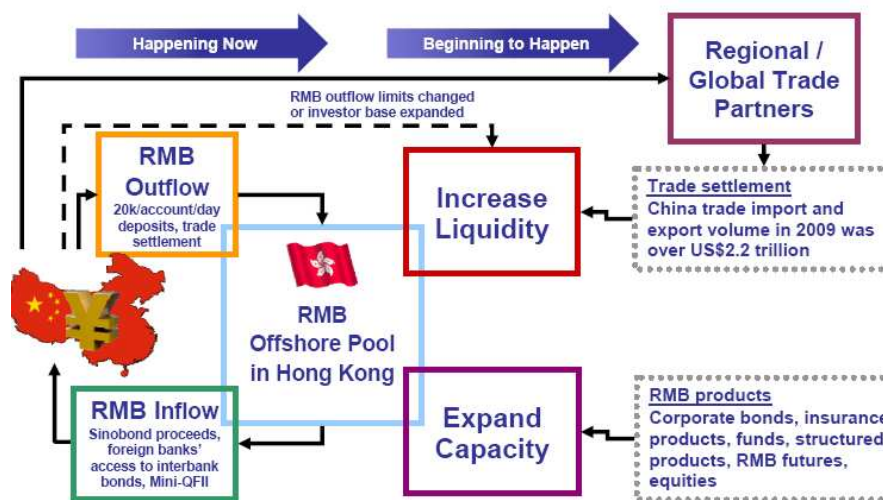
Hong Kong as the laboratory for Shanghai

The Chinese government is promoting the international use of RMBs in the offshore market of Hong Kong as a laboratory to test how the RMB is received internationally and what this implies for local markets. The use of Hong Kong is significant because it gives China the opportunity to internationalise its currency gradually, by feeling the stones under its feet, without compromising the stability of China's mainland markets. Contrary to common understanding, Hong Kong can make the RMB international without the necessary step of making it first fully convertible. As Tsang (2010) argues, "even a currency which is not fully convertible can be internationalised to a certain extent...one way to achieve that is to establish offshore centre(s) for the currency. It will provide a leeway for non-resident to hold and use the Renminbi (RMB). At the same time, the onshore financial market can be sheltered from external disturbances through suitable firewalls". In this regard, Hong Kong can become to China what the London offshore Eurodollar market was to the US dollar in the 1960s. During that period the US had certain capital controls, but this did not stop the greenback to increase its share in international business transactions (He & McCauley

¹ This strategy derives for a series of interviews with Chinese policymakers and financial elites conducted in Beijing in spring 2009.

2010). While the Chinese firewalls are in place and the internationalisation process is restrained to Hong Kong, the Chinese government wants to use effectively the extra time that it has until 2020 to develop the sophistication levels of Shanghai’s financial centre in order to cope in the future with the full convertibility of the RMB, which is the ultimate goal. In this regard, the experience gained through the circuit created through Hong Kong is of great value (see figure 3).

Figure 3: The RMBs circular loop through Hong Kong (taken from Lamba 2010)



As Gao and Yu explain (2009), the evolution of the RMB bond market in Hong Kong helps build up the bond market infrastructure in mainland China and it serves also to specify the transaction rules that will be put in place in the future. In general, the Hong Kong experience will quicken the pace of the opening up of China’s mainland capital market and capital account convertibility. Actually, in another big step forward in crossing the river, in August 2010, the PBoC has opened for the first time the interbank bond market to a limited number of foreign investors, in another pilot programme of great significance (Chen 2010; Pilling 2010, see green box in figure 3).

From export-led to service-driven growth

The sophistication of debt and credit markets, and the internationalisation and convertibility of the RMB, are part of China’s grand strategy to rebalance its economy from an export and investment-led growth model, to a more service and consumption based economy. As the influential Yu Yongding (2010) has warned, China’s “growth

pattern has now almost exhausted its potential. So China has reached a crucial conjuncture: without painful structural adjustments, the momentum of its economic growth could suddenly be lost". The gradual appreciation of the RMB due to its increased international role is one way to trigger this rebalancing. Right now, China's export industry relies on an undervalued RMB, but as the RMB gains in strength a lot of these companies will have to innovate and climb the value-added chain or perish. This process will be difficult, as acknowledged by the PBoC's vice-governor Hu Xiaolian (2010), but it is also necessary. In her words, the "managed floating exchange rate regime is an inevitable choice that will facilitate economic restructuring and comprehensive, balance and sustainable development [...] Improved flexibility of exchange rate also helps make macroeconomic management more proactive and efficient [...] In the long run, the manufacturing industry will evolve from a labor-intensive industry to a capital intensive one, providing fewer jobs. The services industry, in comparison, is by nature a labor-intensive industry and can create more jobs in a sustainable manner". In order to rebalance from manufacturing and foreign demand to services provision and domestic consumption, China will have to develop an industry of financial intermediation, outside the state-controlled commercial banks, that can transform the huge private savings of the country into efficient and profitable investment and innovation opportunities (Yao 2009). Shanghai is meant to be the hub where this financial intermediation will be allocated, with Shenzhen, the other mainland financial centre, having a secondary role.

4. The risks of entering uncharted waters

As mentioned before, issuing an international currency brings a number of benefits. Your citizens and companies are less exposed to exchange rate risks. You have greater access to cheaper credit. If your currency appreciates, you will be able to buy cheaper goods and even companies overseas, and you do also increase your political influence. However, holding an international currency brings also enormous risks. The best example can be seen in the recent turmoil in the eurozone (EZ). In this case the euro has been victim of its own success. By having financial markets developed enough to support great amounts of foreign capital inflows, the EZ was able to access cheap credit for an extended period of time (this was especially appealing for the EZ periphery) while coping with a euro that skyrocketed from \$0.86 in 2002 to \$1.60 in

2008 (a staggering surge of 85%). However, ultimately, the free convertibility of the euro led to an unsustainable path of growth that was bound to collapse. This did finally occur in 2010 with the sovereign debt crises of Greece and Ireland, which were mired in waves of financial speculation.

The moral of this story for Chinese policymakers is clear. The opening up of the capital account is desirable because it brings foreign investment, foreign competition and it can develop the financial sector, but sometimes you need to control this foreign investment, especially the speculative one. As the Chinese like to say, financial markets are sometimes like an unbridled horse. The question is whether you can have it both ways: a currency that is internationally accepted and able to compete with the dollar and the euro and domestic capital markets that are heavily regulated. Here we are literally in uncharted waters when it comes to the river crossing. The Chinese authorities seem to be willing to open up very gradually the capital account in mainland China, step by step, but as John Greenwood, chief economist of Invesco and architect of Hong Kong's exchange rate mechanism, suggests, Chinese policymakers have got to be careful that they don't make a hole in the dam that allows a huge flood in all directions – either inwards or outwards. China has a long way to go before its domestic markets can be opened up to foreign inflows without it being hugely destabilising" (Cookson & Dyer 2010). The next question, however, is whether they can contain the flow for much longer. Already now the pressure is piling up. With the deepening in the internationalisation process, Hong Kong is starting to get flooded with *hongbis* ready to jump to the big market, which is mainland China. The desire to penetrate China's mainland market in search of higher yield is increasing. Investors are currently very eager to pile more and more RMB-denominated assets because they believe that the RMB will appreciate in the future, making the whole process a one way speculative bet. It needs also to be said that Hong Kong will be able to perform its laboratory role for the RMB for some time, but at some point its RMB absorption capacity will be overstretched, provoking destabilising asset price bubbles and instability.

Chinese policymakers are certainly in front of a huge test. Will they be able to hold the tide until mainland China develops its financial markets? In recent years, China has accelerated the sophistication of its financial markets. It has increased its market

listings, it has developed its bond and derivatives markets, it has even flirted with the idea of establishing a market of credit default swaps (Anderlini & Cookson 2010). The training ground has been prepared for increased capital market opening. As Chinese policymakers like to explain, they do not believe in pushing their children into the water so that they learn to swim by mere survival instincts. They prefer a gradual learning process with rubber-rings which make sure that the child does not drown. This, in their opinion, has been the great mistake of their Japanese counterparts. They liberated their financial system too hastily in the 1980s to foreign investment due to Western pressure without preparing the necessary structures to cope with large amounts of speculative flows. This was a huge mistake, in their view.

The other side of the story, however, is that training is not the same than playing. One can train for years, but until one does not enter into the real competition it is impossible to know how strong one is. The same might be true for China's financial markets. Several western analysts are already warning about the slow pace of reforms in light of the enormous pressures that are building up. Gillian Tett (2010), for instance, argues that the Chinese got the Japanese lessons only half right. Japan was wrong in opening up its capital account with an underdeveloped financial centre, but the solution is not to delay the opening up as China seems to do, but rather to establish as quickly as possible the necessary reforms to be more resilient. As in China's case today, Japan relied in the 1980s on a centralised and clientelist credit circuit built around its biggest banks (most of them state controlled or state owned) and the influential export sector. Under this system, credit allocation is biased in favour of these banks and the export industry. If China wants to rebalance and reduce its export dependency, it needs to broaden up its credit channels so that credit can flow more to small and medium-sized enterprises (SMEs) and less to the big state-owned enterprises (SOEs). Only in this way will the credit system have enough liquidity and depth to support external shocks. Of course, as Yao (2009) acknowledges, "promoting higher levels of private investment may bring more risks to the financial system". But as he also specifies, to avoid this "the correct choice is to build an effective regulatory system for monitoring the banking sector", something still missing in China, and certainly something difficult to achieve, as the global financial crisis has clearly shown to financial regulators in the US and Europe. As was explained above, issuing

an international currency brings several privileges but also a high degree of responsibilities and risks.

5. Conclusion

The principal aim of this paper has been to provide a summary of how far has China gone in internationalising its currency, the Renminbi (RMB), to identify the main strategic goals that China wants to achieve through this process and finally to point to the main risks that this objective entails. One can say that so far the internationalisation process has been quite successful. The Chinese approach of crossing the river by feeling the stones has proven adequate. China has through small steps increased gradually, through several pilot programmes, the use of the RMB as invoice currency in international trade between China and other countries; as store of value in RMB denominated bank deposits in Hong Kong; and as investment vehicle through the steady issuance of RMB-denominated financial products (mainly bonds), also in Hong Kong. The former British protectorate, and now special administrative zone of the People's Republic of China, functions thus as a useful offshore centre, similarly to how the London offshore Eurodollar market served the internationalisation of the dollar. While it is commonly believed that a currency can only become international when it is fully convertible, Hong Kong and the RMB might prove the contrary. It is perfectly feasible, at least for a while, to see the *hongbi* increase its international trade invoicing share without Beijing having to relax its capital controls for mainland China. One can envision an RMB trade and investment circuit in which Hong Kong functions as the clearing and investment centre. Exporters to China, who receive RMB from their Chinese customers, can store them in Hong Kong without having to penetrate mainland China. The question is how long this circuit will last. One thing is clear, the desires to invest in mainland China are endless, while the absorption capacity of Hong Kong will become at some point limited. So far, however, this situation is still distant. The waters are still shallow, although uncharted. Hong Kong can certainly increase its issuance of bonds for a considerable amount of time, and the Hong Kong Monetary Authority and the People's Bank of China can certainly be in control of the pace. The good thing is that as Hong Kong deepens its financial services industry it becomes also a perfect laboratory to what is possibly to come in the medium to long term in mainland China,

especially considering that the Chinese government has openly stated its desire to make Shanghai a fully-fledged financial centre able to compete with London and Wall Street by 2020.

Nonetheless, there are several risks that lie ahead. So far the internationalisation process has developed smoothly because the waters of the river were relatively shallow, but once the waters deepen proportionally to the amount of RMBs that are in circulation overseas, the journey might be less tranquil. Pressure against the capital controls dam set up by the Chinese authorities to protect the mainland from financial instabilities is already mounting. Rumours of illegal RMB smuggling into the mainland markets are widespread. While inflation is already a problem in China, these illegal inflows will make the situation even more unstable. This pressure is likely to continue since most investors believe that the RMB needs to appreciate in front of all other major currencies. This makes it a one way bet for currency speculators. At some point, the authorities of Beijing might decide to make a quantum leap and open up the capital account further to divert these inflows to the financial circuits. The question is whether the financial markets in mainland China will be able to cope with such a flow of new investment. As of today, the financial markets in China are still considerably underdeveloped. Credit allocation is monopolized by a small amount of state-controlled commercial banks, which normally divert their funds to state owned enterprises (SOEs) in the export industry, and recently in the real state sector, which is already overheating. This model of tight governmental control of credit allocation through the banking system, which mirrors that of Japan, has shown to be greatly successful in China's development drive. It has delivered 30 years of neck breaking growth. It is to be seen whether China will be able to change this model and climb the development chain. As Eichengreen (2010) coincidentally puts it, the Chinese "have a saying about crossing the river by feeling the stones beneath their feet. In this case, however, if they don't leap between the banks, they risk losing their footing".

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