

Challenges of Internationalisation from the Perspective of the Chinese Currency*

Tamás Gerócs

This paper examines the spread of the international use of the renminbi (yuan), with particular focus on, the multipolarisation of the international monetary system. Additionally, the study addresses the question of how the spread of a new currency in international financial markets influences the external financing opportunities of small open economies (e.g. Hungary). The author sets out two possible scenarios in relation to the spread of the Chinese renminbi (yuan) and, in terms of the development of the entire international financial system, he points out that over the next years it will be of crucial importance which model the Chinese economic policy will move toward, and if there is a road that leads from the one to the other.

Journal of Economic Literature (JEL) codes: G28, G15, H12, H63, N25

Keywords: renminbi (yuan), hegemony, multipolarity, international financial system, convertibility

The quasi-monopoly of the US dollar as an international reserve currency is being eroded as the United States is losing its economic weight, and as *Campanella (2014)* notes, there has been a protracted multi-polarisation process in the international monetary system, whereby in parallel with the relative weakening of the US dollar in international financial flows and financial settlements, alternative currencies are becoming increasingly widespread: in line with the regionalisation of the world economy, a financial regionalisation can also be observed (*Gerócs 2016; Feenstra 1998*). The ongoing changes in the world economy will largely determine the direction for the development of the international monetary system. In this paper, I seek the answer to how the spread of the international use of the Chinese currency, the renminbi (yuan),¹ has repercussions for the development of the international monetary system in the midst of these global economic processes.²

The convertibility of the renminbi, i.e. its free use in international transactions, has been ongoing since 1996, although capital account liberalisation, a part of

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the official view of the Magyar Nemzeti Bank.

Gerócs Tamás an Junior Research Fellow at the Institute of World Economics of the Centre for Economic and Regional Studies of the Hungarian Academy of Sciences. E-mail: gerocs.tamas@rtk.mta.hu.

The manuscript was received on 21 November 2016.

¹ The official name of the Chinese currency is renminbi, and the yuan is its primary unit.

² The economic size of the People's Republic of China caught up with that of the United States by 2015, based on the GDP volume calculated by the IMF at purchasing power parity, and it has been the world's largest exporter of goods since 2009 (*Medeiros da Silva 2016:2*).

the balance of international payments, is still not fully achieved.³ In addition, convertibility and internationalisation are two separate, and only partially overlapping processes. There are different views in the literature as to what extent an only “partially convertible” currency can take over global currency functions, since based on previous experience, international use is a necessary, but not sufficient condition for convertibility (*Ausch 1969:162; Eichengreen – Kawai 2014: 16-18; Subacchi – Driffil 2010; Laurenceson – Ki Tang 2005*).

The renminbi has become one of the most significant settlement currencies in regional transactions, and if this progression moves towards full convertibility, the renminbi could become a global key currency. It is worth taking up this idea, particularly since more and more governments in Central and Eastern Europe, relatively remote from Chinese commercial networks, are also planning to denominate their revolving debt in renminbi.

It is not by chance that China’s central bank (*People’s Bank of China, PBC*) announced the internationalisation of the renminbi (yuan) in 2009, following the outbreak of the global economic and financial crisis spreading from the US mortgage market, and then accelerated the capital account liberalisation, making steps towards convertibility (*Cohen 2012*). In the following, I look at the settlement function of the yuan in international trade, its reserve-currency function in terms of central banks’ foreign currency accounts, and its role in international financial transactions (such as direct equity investments, portfolio investments). The latter affects capital account transactions and thus also the question of convertibility, whereas the first two functions relate to the use of the renminbi in international payments through current account transactions.⁴

1. The yuan in international trade

The share of the renminbi (yuan) in China’s external trade finance has been increasing dynamically since 2010. While the share of transactions denominated in yuan was barely 0.5 per cent of China’s total external trade in the first quarter of 2010, this ratio exceeded 35 per cent by 2014, according to data from SWIFT/ Bloomberg (*Zhang – Tao 2014*). As China’s weight has been steadily increasing in

³ By convertibility, I mean the right of the holder of a country’s currency to freely convert it into another convertible currency at a market rate, at any time. However, convertibility has several degrees: full convertibility covers all components of the balance of payments, including current and capital account items. Convertibility is considered to be limited, if it is restricted to current account transactions. Furthermore, a distinction can be drawn between external and internal convertibility, meaning that limitation refers exclusively to resident or non-resident currency holders. Central bank convertibility occurs when free exchange only applies among central banks in full (*Ausch 1969:144*).

⁴ With regard to the latter, it is worth noting that effective October 2016, the IMF revised the weights of each currency in the SDR basket that serves as the international unit of account, and the renminbi (yuan) became part of the SDR basket. For the funding period until 2020, the renminbi is the third largest member of the SDR basket with a 10.9 per cent weight, following the US dollar (41.7 per cent) and the euro (30.9 per cent).

international trade, this has also had various effects in international settlements. In terms of the pace at which the use of yuan invoices has grown, we can see that the crisis in 2009 was a turning point. The reason for this is that China's foreign trade partners did not have sufficient access to US dollar funds in the global liquidity crisis (*Eichengreen – Kawai 2014:18*). During the months most affected by the crisis, banks suspended their payments, and therefore accessing enough credit to realise trade transactions was not possible. All of this particularly affected China's exports, as the traditional outlets of the country were actually faced with resource constraints, they could not issue foreign invoices in US dollars. As a result of the contraction of export markets, the global crisis had a large impact on the Chinese export-oriented mercantile model. Consequently, as one of the first decisions to respond to the crisis, China's government and central bank provided liquidity for their major commercial partners. At the same time, China did not want to make its own foreign exchange reserves available for partners without restrictions, instead it introduced facilitations in payments in renminbi (yuan) and in the issuance of foreign invoices. In 2009, companies in five designated Chinese provinces⁵ obtained special permission to issue and accept invoices in yuan in trade settlements with ASEAN countries. In 2010, this scheme was expanded to 20 provinces, and today all companies across the whole of China are allowed to use their own currencies for their international trade transactions (*Medeiros da Silva 2016:4*). In order to improve regional trade integration, China and the ASEAN countries concluded a free trade agreement in 2010 (*Campanella 2014:10*).

It was about that time when the role of China's central bank became more significant in regional trade settlements. Although most partner countries of ACFTA (the free trade area including China and the member states of ASEAN) – just like China – still use a currency-peg to the US dollar, most countries are planning to re-peg their currencies to the yuan, when China moves to a floating exchange regime. The aim is to set up a “currency snake” around the renminbi (yuan), that would link the regional trade integration to a monetary cooperation (*Campanella 2014:4-11; Eichengreen – Kawai 2014:18*).

Accordingly, the role of China's central bank is gradually increasing in providing liquidity for regional transactions. However, regional trade integration is characterised by some asymmetry. In China's foreign trade, settlement in yuan essentially materialises on the import side, with 80 per cent of yuan invoices coming from imports, whereas the ratio of exports in invoicing is only 20 per cent. This is primarily because most companies that issue invoices are Chinese firms registered in Hong Kong and they only export their products to Hong Kong on paper with settlements done in US dollars to re-import them back in exchange for renminbi (*McCauley 2011*).

⁵ Guangzhou, Shenzhen, Shanghai, Zhuhai and Dongguan.

2. The yuan among reserve currencies

Attempts by China's central bank to boost the international use of the renminbi are also recognised in the cooperation among other central banks. The PBC has been concluding bilateral agreements on currency swap transactions with other states since 2008, directly providing renminbi funds for peer central banks (*Campanella 2014:7*). The bilateral agreements include currency swap transactions, i.e. participating central banks – within the limit and period specified in the agreement – may exchange their own currencies to renminbi.⁶ So far, there are no official statistics available to show how many states drew money from the facility and to what extent, just as we do not yet know exactly the ratio of the renminbi in central banks' foreign exchange reserves.⁷ However, bilateral agreements on currency swap transactions are open to the public, and according to these, if not the exact financial effects, at least the content of the agreements concluded by the PBC can be monitored.⁸ The geographic scope of the agreements is less concentrated on Southeast Asia: it more facilitates the wide spread of monetary liquidity from Latin America through Europe and Russia to Asia. However, there is no such agreement in place with the United States, which is attributable to the multipolarisation of the monetary system.

The total value of the global swap lines set up by the PBC amounts to roughly USD 500 billion, which allows us to suspect that reserves in renminbi may represent a maximum of 5 per cent in the balance sheet total of the world's central banks. It comes as no surprise that direct trading partners, such as South Korea and Hong Kong, have the largest swap line.⁹

⁶ Countries participating in the bilateral currency swap agreements benefit from the possibility of buying foreign goods in exchange for their own currencies, which is an important alternative to barter transactions, in case there is a shortage of convertible key currencies on financial markets. This was the case during the crisis in 2009, due to the global shortage of US dollar liquidity. For partners with convertible foreign exchange reserves, such as China, it may be worth entering into bilateral agreements for the following reasons: (1) they may expand the international use of their own currencies, (2) they do not have to fear that their exports will decline in countries where convertible currency is not available in sufficient quantity, (3) they can save their own convertible foreign exchange reserves. Similar agreements existed following the global economic crisis in 1931, and between 1945 and 1950 when there were not enough convertible currencies in international payments to sustain international trade (*Ausch 1969:146-147*).

⁷ Following its inclusion into the SDR basket, it is officially considered as a reserve currency in central bank balance sheets. At the same time, estimates are already available on the share of the yuan within the balance sheet and put this share at less than 5 per cent of the global reserves, based on calculations in the field.

⁸ E.g. in September 2013, the Magyar Nemzeti Bank (MNB) and the People's Bank of China concluded an agreement on the establishment of a bilateral foreign exchange swap line with a notional amount of 10 billion yuan (USD 1.6 billion). As the study of the *MNB (2013)* pointed out, the bilateral swap agreement (BSA) is important for Hungary for two reasons: on one hand, it promotes the further development of trade relations between the two countries, and on the other hand it helps to mitigate financial stability risks. With regard to the latter, the MNB draws attention to the point that foreign exchange swap agreements between central banks may considerably improve the risk perception of a country, as central banks can easily access foreign currency resources in the case of market turbulences. Moreover, the mere existence of a swap line agreement represents strong financial commitments from the central bank providing foreign currency. Source: <https://www.mnb.hu/letoltes/kina-swap.pdf>.

⁹ Countries with a line amounting to over USD 20 billion are Russia, Canada, Switzerland, Australia, Brazil, Malaysia, Singapore and the United Kingdom. The European Central Bank established a USD 56 billion swap line, which is not considered to be significant, considering the weight of the community within world trade.

This prompts the question of why the PBC provides renminbi reserves for central banks under bilateral arrangements, and why it does not make a better use of the opportunities provided by multilateral institutions. It is worth examining this question in detail, in the context of international finance.

3. The yuan in international transactions

Since its accession to the WTO in 2001, China has gradually liberalised capital account items, to which the country otherwise made commitments. However, the liberalisation process can be considered to be slow and structurally asymmetric. *Kawai (2014)* uses the expression *basic capital account convertibility* for the complex regulatory mechanism, through which China's central bank – in addition to the current account convertibility – allows limited access to local capital markets through a quota system, and increasingly accepts renminbi-denominated investments. One feature of the quota system is the preference of longer-term (greenfield or brownfield) foreign direct investments (FDI) versus short-term portfolio investments related to equity market transactions. Within the FDI category, the weight of the renminbi-denominated portfolio is increasing.¹⁰ However, authorisation of the latter is more limited by the central bank which seeks to detect hot money. According to *Kawai (2014)*, China does not aim to achieve full convertibility for the time being, because a quick and unilateral changeover could jeopardise the foundations of its current economic model. Over the longer term, the question is more so how long the capital account will only remain partially liberalised (some portfolio and other capital operations are subject to prior authorisation) and whether full convertibility will be achieved with the current account liberalisation (within this, in particular, the capital account), within a reasonable time. As noted, the structure and the development of the opening-up depends on China's economic policy, and within this, in particular, China's central bank.¹¹ One of the ultimate objectives of China's economic policy is to promote convergence to the advanced economies. For that purpose, the regulator seeks to widen the access of Chinese companies to foreign capital and the most advanced technologies by fostering cooperation between foreign and Chinese companies. Due to the large economies of scale made possible in China, the Chinese regulator is able to impose strict requirements on Western capital investments, thereby encouraging the ever-increasing specialisation of its own companies within various global value chains. In most cases, these requirements target the integration of the imported technology into China's economic infrastructure, which accelerates technology transfer between domestic and foreign companies. The most important economic policy

¹⁰ In 2014, the renminbi-dominated portfolio increased to one third of the FDI stock invested in the entire People's Republic of China (*Eichengreen – Kawai 2014*).

¹¹ Private contractors have less considerable influence than was observed in history during the international spread of the US dollar or the British pound.

tools are regulations on sharing ownership, for example joint venture cooperation, as well as market protection in relation to balancing trade (to offset import), and local content requirements (*Liu – Dicken 2006*). Due to its internal potentials, the People's Republic of China is one of the few countries which is able to impose strict conditions on foreign direct investment, since the size of its internal market in addition to the quality of the infrastructure, for example, skill levels and relatively low labour costs valorise Chinese investments on a global scale.

However, embeddedness of foreign companies in China is not without imbalances either. As state regulation has a determining role, which is called *obligated embeddedness* by *Liu – Dicken (2006:1238)*, asymmetries developed in the process of capital account liberalisation. Foreign direct investments into China (*RMB-FDI*) are subject to stricter rules than China's outward direct investment (*RMB-ODI*).¹² However, the "one-leg" liberalisation was disturbed by the sudden outbreak of capital market panic at the end of 2015, and the subsequent sharp increase in capital outflows.¹³ This manifested itself in China's balance of payments turbulences, for example capital flight reduced the level of foreign exchange reserves by USD 500 billion. The sudden effect of the capital flight, which in volume terms, was more significant compared to previous periods, provided useful lessons for China's regulators, indicating the slowdown or the possible suspension of a further reform process related to the outflow side of the capital account, and the synchronisation of rules governing capital outflows (*RMB-ODI*) and inflows (*RMB-FDI*).

For the time being, access to renminbi (yuan)-denominated foreign exchange and bond markets is limited for foreign investors and securities issuers. In the case of both shares and bonds, there is a mainland (onshore) and an overseas (offshore) market. Onshore and offshore markets fall within different jurisdictions, and trading as well as issuance in the two markets are subject to different pricing and exchange rules. Central bank regulation applies to the onshore market, which, in terms of capitalisation, is bigger in both securities segments – also more liquid and deeper – than the offshore market,¹⁴ although operators are typically Chinese state institutions or companies. The central bank may intervene through open market operations in both markets. In the case of the onshore market, it works in a regulated manner with a view to defending the exchange rate band, whereas in the offshore market, intervention is a matter of consideration.

¹² Use of the renminbi was subject to simplified authorisation procedures, in relation to both outflows of foreign direct investment (*Renminbi Outward Direct Investment Scheme in January, 2011*) and FDI inflows (*Renminbi FDI scheme in October, 2011*).

¹³ In the summer of 2015, A shares traded on the Shanghai Stock Exchange lost one third of their capitalisation in the space of one month, and as a result, some domestic owners of capital evacuated their assets outside their home country, mainly to Hong Kong or other surrounding financial market centres.

¹⁴ Compared to the onshore market, there may be less renminbi liquidity in the offshore market, which may be recognised in the offshore renminbi exchange rate (in the level of short-term offshore interest rates and in the difference between the onshore and the offshore exchange rate) (*Ladányi et al. 2016: 6*).

Currently, foreign residents are only present in the offshore market in a larger proportion, although due to the easing measures (RMB-FDI) introduced since 2011, their number is increasing spectacularly in the domestic market as well. Onshore markets remain partially closed, and transactions here are subject to authorisation.¹⁵ Accordingly, convertibility in this segment does not fully apply, as operations related to China's capital account are subject to authorisation. However, convertibility is applicable to the offshore market: market operations here are conducted outside of the direct jurisdiction of the central bank, and private investors are free to trade renminbi-denominated assets on the stock exchange, for example in Hong Kong. At the same time, the PBC provides sufficient liquidity in this context, by ensuring renminbi sources for the clearing bank in the given offshore centre, and this bank then may issue renminbi assets and hold renminbi accounts. To that extent, it has an indirect influence over offshore market liquidity.

Offshore markets play an important role in establishing convertibility, as transactions here impact the onshore markets that are only partially open. The more direct the connection is – either in terms of regulation or investor behaviour – the more exchange rate convergence is achieved between the fragmented markets. For example, according to *Sütő (2016)*, in the case of bond markets a stable coexistence can be observed for some time.

It can be considered that the harmonisation of China's capital market rules, i.e. the gradual liberalisation of transactions towards the mainland is the most advanced in the equity markets. The Stock Exchange of Hong Kong and the Shanghai Stock Exchange are the two biggest and most active platforms for trading renminbi assets; connectivity between them started in 2014, and the Shenzhen Stock Exchange will also join the program by 2017.¹⁶ In terms of capitalisation, the second biggest trading platform in the world will be established with the integration. The Shanghai-Hong Kong Stock Connect can be regarded as a milestone in the opening up of China's capital market, as through this channel, foreign institutional investors may have access to China's internal capital market within certain limits. The stock connect enables foreign residents to trade A shares of China-based companies listed on the Shanghai Stock Exchange directly, through Hong Kong brokers, and vice versa, Chinese investors may trade H securities of international companies registered in Hong Kong more easily, through their mainland brokers. The direct impact of the integration on the financial markets started last year when the prices of A shares and H shares began to converge. Henceforth, financial market developments on one stock exchange affect companies traded on the other one, in an increasingly direct way. It mainly impacts China's internal capital market, which will be more

¹⁵ For example, in the case of a bond issue, the issuer is obliged to assign a credit rating by Chinese credit rating agency to securities.

¹⁶ http://www.portfolio.hu/vallalatok/hamarosan_letrejohet_kina_masodik_legnagyobb_tozsdeje.235888.html.

directly influenced by international financial market developments due to the gradual opening up.

Compared to the foreign exchange market, even closer yield convergence was reached in the two parallel bond markets last year, between the Dim Sum (offshore) bonds issued in Hong Kong and used by foreigners, and the Panda (onshore) bonds which are traded on the internal capital market. For the time being, the onshore market is accessible by a limited circle from both investor's and issuer's side, as that is more closed. In the onshore market, Chinese state-owned companies, credit institutions, even state institutions are predominant among the issuers. By contrast, on the offshore bond market, non-Chinese issuers have been in the majority so far. The first pioneering Western company to issue a Dim Sum bond was McDonald's in August 2010, acquiring renminbi in Hong Kong with the prospect of expanding in mainland China.

The tendency for the two markets to converge is attributable to the opening up of the onshore market beginning in 2011. In the onshore market, more and more foreign investors are issuing bonds. Before 2010, issuers were mainly supranational institutions¹⁷ or central banks, however, since 2011, institutions duly authorised may also use the onshore market for raising capital. Owing to that, the presence of foreign issuers in the Panda bond market has been gradually increasing. In parallel, foreign issuance has been decreasing on the offshore market (by 40 per cent in 2015). Among sovereign issuers, South Korea was the first to issue the Panda bonds at the end of 2015. In the summer of 2016 Poland also announced that it had mandated on a Panda bond issuance, worth USD 450 million. Although, these issuances are few and of low value for the time being, based on the increase in the sovereign issuance of Panda bonds, we can conclude that over the longer term renminbi-denominated financing will have a more important part to play in the management of public debt.¹⁸

4. Crisis management

In this paper, I cannot ignore the question of why integration between onshore and offshore markets has not yet been completed, because such completion could have facilitated full convertibility on all renminbi transactions. I have partially answered this question by presenting the economic policy measures applied in respect of the economic and technological convergence with advanced economies. However, there is another important aspect, and it is not independent from geopolitical interests.

¹⁷ The first international issuers in the 2000s were the International Finance Corporation (IFC), a member of the World Bank Group and the Asian Development Bank (ADB) (*Sütő 2016:2*).

¹⁸ Interestingly, Hungary issued the first sovereign bonds in Hong Kong on 14 April 2016, in a symbolic amount of EUR 140 million (about CNY 1 billion). Following the transaction, the Hungarian government indicated that the low value issuance, which is aimed at testing investors, may be followed by a larger one on the Panda bond market with a view to attracting China's institutional investors.

This measure has slowed down the process of the opening up in the past year, and this process may result in the permanent sustainability of certain rules affecting the capital account.

Although the global economic crisis of 2009 pushed Chinese policy makers toward liberalisation, certain elements of the crisis management at that time had unintended consequences, which encouraged China's new government, taking office in the meantime, to reconsider their priorities for the reform process. Between 2009 and 2013, China's government administrations launched an economic stimulus programme worth USD 586 billion (CNY 4,000 billion). In parallel, the central bank started to ease the monetary stance (lowering interest rates on deposits and loans, and providing the banking sector with extra liquidity). This represented the most vigorous easing of the monetary and fiscal stance ever seen since the four decades of "Reform and Opening" announced by Deng Xiaoping in 1979. Although the net external financial position of the country remained strong enough to cover the financing needs of the monetary stimulus from the reserve fund of USD 3,300 billion, serious financial imbalances emerged in the economy in particular, in the banking sector, and in some cases even across households, local governments and construction firms.

The Chinese economy became overheated as a result of over-investment, which triggered countless economic and social tensions. This was because investments were financed by credit institutions operating under state supervision¹⁹ through the entire state institutional system, and mainly state-owned construction firms carried out infrastructure investments according to the demands of local governments. Although the process took place through strictly controlled channels, there were no institutional feedbacks that could have prevented banks from accumulating toxic assets or rationalised the allocation of local government funds (*Csanádi 2013*). This gave rise to a geographically uneven infrastructure development model, which became subject to political bargaining.

Although, after a while, the central bank started to manage the bad loans accumulating in the banking sector in substantial quantities, the measures taken so far have produced mixed results. For example, the tightening of loan placement steered the focus of capital allocation towards the informal shadow banking sector (*Komlóssy et al. 2015:142; Csanádi and Liu 2012*). The other problem is that although the country's net external financial position can be considered to be stable due to the very high level of foreign exchange reserves, most economic actors – especially households, companies and local governments – have accumulated huge debts in the

¹⁹ Allocation of the funds from the incentive package was carried out through central distribution in smaller proportion and through channels of state banks and bonds issued by the Ministry of Finance in greater proportion. Large and state-owned companies were preferred. Regarding distribution rates, the ratio of funds received from the central budget is smaller, the ratio of bank funds is larger, with the ratio of local bank funds being even larger, and funds granted through the channels of the shadow banking sector were also received (*Csanádi – Liu 2012*).

past years and all of them have become net borrowers.²⁰ Therefore, total internal debt jumped close to 300 per cent of GDP by 2014, which is the second highest in Asia after Japan, and its potential default may bring about tremendous economic damages.²¹

To handle the overheating arising from the crisis management, China is seeking and creating external demand to resolve the overcapacity problem in its construction industry caused by an oversupply of loans. In order to achieve this goal, new infrastructure investments must be initiated for construction firms. Due to the previous spatial unevenness in regional development, China's government is seeking to steer these investments toward internal territories (*Gyuris 2015*), but also outside of the People's Republic of China (*Matura 2015*). With regard to the latter, capital export is moving to centre-stage in economic policy making.

Capital export in general is linked to the operation of the international monetary system, and it is also not unrelated from geopolitical interests, in a broader sense. According to *Matura (2015)*, China began building parallel institutional structures, as most international development funds operate under Anglo-Saxon or European influence. For example, following the positive experiences in relation to ACFTA, Beijing prefers to create a wider free trade area to be wrapped up within the framework of free trade agreements in the Asia-Pacific region (FTAA), from 2013. China is also working on integrating other regionally dominant countries, for example, India into its sphere of influence through a free trade agreement, known as Regional Comprehensive Economic Partnership (RCEP) in order to offset the growing ambitions of the United States in the Pacific region.

China's capital export is typically linked to the extraction of mineral resources, infrastructure development, logistics and long-distance trade, i.e. as a whole, to industries that were once already targeted by the crisis management launched in 2009. One of the most important infrastructure development projects is the "New Silk Road", also known as the "One Belt and One Road" programme (*Nolan 2012*). So far, China has invested USD 40 billion into the Silk Road Fund, 65 per cent of which was allocated to the debit of the foreign exchange reserves, the remaining part was paid by China Investment Corporation, an investment fund created with an initial share capital of USD 400 billion, the Export-Import Bank of China and China Development Bank (*Trebitsch 2015*).

²⁰ In particular, private debt in the corporate sector has increased, and as calculated by *Garcia-Herrero (2015)*, one quarter of the companies fail to cover their interest payment requirements by their operating profit (EBITDA), which portends a wave of bankruptcies (*Garcia-Herrero 2015:11*). Although the debt of the public sector can be considered to be moderate (at 55 per cent of GDP), according to *Garcia-Herrero*, there may be a serious risk to local governments from using short-term debt to finance long-term investments and being compelled to finance their debt at 6-8 per cent lending rates, compared to an average of 4-5 per cent.

²¹ So far, there are only estimates available for the apparent increase in the ratio of non-performing credit portfolio (*Komlóssy et al. 2015:136-139*). At the same time, risk are mitigated when the debt is denominated in local currency instead of foreign currencies, and therefore the central bank has wider room for manoeuvre in facilitating the process of deleveraging. <http://bruegel.org/2016/04/chinese-banks-the-way-forward/>.

Amongst the institutions financing international infrastructure investments, the two most important ones are the Asian Infrastructure Investment Bank (AIIB) with an initial share capital of USD 100 billion and the New Development Bank (BRICS), headquartered in Shanghai and established by the BRICS states in 2014, with a same amount of initial share capital. In addition to these, China has interests in many other financing institutions, for example, the Inter-American Development Bank, which finances developments in Latin America.²² Half of the initial share capital of AIIB based in Beijing is provided by China, in spite of this, the country has no veto rights. Although its share capital is only half of the Bretton Woods institutions in Washington, it may exercise a significant competitive advantage, in regional and even bilateral comparisons. It finances numerous projects related to infrastructure development, generating more than a few conflicts of interests. It also implements rail, road, bridge and even port development projects in Central Eastern Europe and the Balkans.²³

The direction of China's capital flow remains geographically concentrated, 70 per cent of capital export is kept inside Eurasia, with Asia having a share of 50 per cent, the remaining part flows to Europe,²⁴ within which, the role of the Central and Eastern European region is growing.²⁵

The experience of a sudden disinvestment at the end of 2015 showed that an open capital account and a fixed exchange rate system may constitute a dangerous mix, since external financial shocks can be prevented most effectively by a flexible exchange rate system (over the course of a few months, it cost China about USD 500 billion to keep the yuan within the exchange rate band). Therefore, changing over to a floating exchange rate regime has to keep pace with capital account liberalisation. According to the Mundell-trilemma (*Mundell 1963*), it is impossible to meet the cumulative conditions of independent monetary policy, an open capital account and a fixed exchange rate system, at the same time. Two of the three may only be enforced, to the detriment of the third one. For example, the open capital account and the fixed exchange rate sustain monetary mechanisms that reduce the central bank's room for manoeuvre, and thus its ability to support economic convergence, primarily due to the limited use of foreign exchange reserves. If the central bank's room for manoeuvre is an economic priority, convertibility with the

²² http://kitekinto.hu/kelet-azsia/2015/03/17/uj_selyemut_kina_uj_megaprojektet_keszit_el.

²³ See privatisation of Piraeus port in Athens.

²⁴ China's FDI stocks are still low in international comparisons: while global FDI stocks increased from USD 2,100 billion to USD 23,600 billion between 1990 and 2012, 79 per cent of it was accounted for by capital allocations of advanced Western countries. According to 2012 figures, the stock of foreign direct investments was USD 5,200 billion in the United States, whereas it was USD 1,800 billion in United Kingdom, however, in the case of the People's Republic of China, the stock amounted to only USD 509 billion. Moreover, China receives larger FDI inflows than the capital flowing out of the country, and data on FDI net stocks show a negative position of USD 324 billion. In 2009, 68 per cent of China's foreign direct investment outflows went to Hong Kong (or through Hong Kong) (*Nolan 2012*).

²⁵ In 2010, China launched a package of 12 measures, consisting of an investment strategy in relation to the Central Eastern European region. The major steps include the provision of a ten billion investment loan, the establishment of an investment cooperation fund with USD 500 million, as well as the creation of trade and investment promotion missions to the region.

floating exchange rate channel remains the only mechanism capable of tackling the impact of the financial turbulences.

In the case of China, leeway for the PBC constitutes an integral part of the economic model. Taking on an active role, the central bank helps Chinese exporters to adjust to the changing international market competition. Consequently, in order to maintain its independence, sooner or later, the PBC will be compelled to change over to a freely floating exchange rate system. As a first step, the PBC expanded the trading band against the dollar to ± 1 per cent from ± 0.3 per cent in April 2012, then allowed the yuan to float ± 2 per cent in March 2014, and band widening is expected to continue in the coming years.²⁶ However, such a sudden changeover carries risks, which are best identified by the Triffin dilemma (*Triffin 1964; Maziad – Shik Kang 2012:7*). Based on this, a fully open capital account combined with a floating exchange rate system may undermine the stability of the balance of payments, as export competitiveness erodes in a flexible exchange rate system, if extra profits from foreign trade trigger the strengthening of the currency. In line with free international movements of capital, a part of the productive investments increasingly leave the national economy, just as happened in the United States after abolishing the Bretton Woods system in 1971. Capital outflows in addition to changes in export/import ratio enhance the role of external financing in the balance of payments. However, historical experiences suggest that such a shift – in spite of external financial dependencies – is not necessarily harmful. Such an economy, like the US in the past, can be capable of covering almost unlimited financing needs externally.

To sum up, we can conclude that the widening of the exchange rate band in parallel with capital account liberalisation is unavoidable due to the exchange defence mechanism against financial market shocks; however, changing over to a completely open capital account and a flexible exchange rate system, with convertibility entailed, enforces a shift from a mercantile export-led economy model toward domestic consumption, as well as economic restructuring and new concepts on the role of the monetary policy.

5. Conclusions

There is no consensus in the literature about whether the expansion of the international use of the renminbi (yuan) can be made under one or two scenarios. *Gao and Yu (2011)* distinguish two models based on financial experiences following the Second World War. The first one is called “German” type or mercantile model. The core feature of this model is the maintenance of the trading and current

²⁶ The PBC once moved away from fixed dollar peg in 2005, and let the yuan float around a basket of numerous currencies, however, during the crisis in 2008, it reintroduced a fixed exchange rate against the US dollar at USD/RMB 6.83.

account surpluses, and the central bank subordinates currency convertibility to this goal. On the long run, capital account openness only partially remains, because independence of the monetary system is much more important: it aims to prevent surplus capital inflows from strengthening the currency, i.e. to ensure the reserve-currency function only marginally applies. In view of the expansion in trade and production networks, this monetary goal cannot be kept indefinitely and – as in the case of the Bundesbank and hence the German mark, following the 1970s – regional monetary integration comes into the forefront of economic policy. In such cases, the role as an anchor currency is confirmed, rather than the role as a global reserve currency. Also, convertibility will apply within these regional monetary (and trade) blocs, whereas, in global (external) terms, the aforementioned restrictions on capital account operations will be maintained for a longer time. According to Gao and Yu, the advantage of the German model is that the mercantile basis for growth remains, and it can be sustained through an economic policy that extends regional trade integration, while central bank independence is not damaged either.²⁷ To sustain export competitiveness, a state that issues debt is compelled to maintain strict financial policies, which, in turn, entails a shrinking of the fiscal room for manoeuvre. We can partly see the realisation of this scenario in relation to the Chinese renminbi (yuan), as a loose monetary co-operation began to gradually build around the production and trade networks in China's neighbourhood, in which the renminbi already functions as an anchor currency. With the possible development of this model, setting up a currency snake around the renminbi, an Asian Currency Unit could be predicted (similarly to the history of the euro).

In contrast to the German model, the other type is called "American" or hegemon by Gao and Yu. This is much more characterised by a rapid changeover to full convertibility, which is necessary to sustain and continuously ensure global financial market liquidity. Regarding currency use, the reserve currency function becomes dominant, which continuously raises money financial demand for the currency in terms of reserve, as well as trade and financial transactions. This extra demand will obviously cause the currency to appreciate, leading to the erosion of the issuer's export competitiveness, and its central bank will increasingly focus on how to ensure balance in the international monetary system rather than sustaining its own mercantile model. The disadvantage of this model is that instead of the previous mercantile export-led growth model, it requires structural changes in the economy, which makes the engine of growth to shift into new bases. In line with the currency, the role of the central bank also internationalises, e.g. it will become a lender of last resort for the international monetary system. The advantage is that the financial policy of the state, and hence the fiscal room for manoeuvre is

²⁷ Based on the Mundell-trilemma, in such a case, an independent monetary policy and a fixed exchange rate system is enforced, whereas an open capital account cannot be fully applied due to restrictions. This is what defined the European monetary cooperation in the 1970s and 1980s (Benczes 2011).

expanded by offering global funding and exercising the right of issuing safe currency; furthermore it is able to finance rising external debt from global financial markets, relatively unhindered. As a result, it will be able to realise geostrategically important objectives, and that is something a real global hegemon can only afford. In the context of gaining more fiscal room for manoeuvre through the international use of a currency, all of this could mean that the focus would shift from the export-led growth model to domestic consumption, in particular, private and public (for example military) expenditures. The answer to which model China's economic policy will move toward, and if there is a road that leads from one scenario to the other, will be of crucial importance in the coming years, also in terms of the development of the international financial system as a whole.

References

- Ausch, S. (1969): *A KGST-együttműködés helyzete, mechanizmusa, távlatai (CMEA Cooperation, Situation, Mechanism and Perspective)*. Közgazdasági és Jogi Könyvkiadó / Publishing House of Economics and Law, Budapest.
- Benczes, I. (2011): "Az európai gazdasági kormányzás előtt álló kihívások" ("Challenges of European economic governance"). *Közgazdasági Szemle / Journal of Economic Literature*, Vol. LVIII, September.
- Campanella, M. (2014): *The Internationalization of the Renminbi and the Rise of a Multipolar Currency System*, ECIPE Working Paper, No. 01.
- Cohen, J.B. (2012): *The Yuan's Long March*, New Political Economy, May.
- Csanádi, M. (2013): "State Intervention, Local Indebtedness, Investment Overheating and Their Systemic Background During Global Crisis in China". Discussion Papers, MTA KRTK KTI. MT-DP –Nr. 40.
- Csanádi, M. – Liu X. (2012): *Crisis and selective adaptation in a Chinese prefecture between 2008 and 2010: a survey among industrial enterprises*. MT-DP Nr.35. <http://econ.core.hu/file/download/mtdp/MTDP1235.pdf>.
- Eichengreen, B. (2011): *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*. New York, Oxford University Press.
- Eichengreen, B. (2008): *Globalizing Capital: A History of the International Monetary System*. Princeton University Press.
- Eichengreen, B. (2004): Chinese Currency Controversies, Asian Economic Panel, April.
- Eichengreen, B. (2013): *Renminbi Internationalization: Tempest in a Teapot?* Asian Development Review, Vol. 30, No. 1, pp. 148–164.

- Eichengreen, B. – Kawai, M. (2014): *Issues for Renminbi Internationalization: An Overview*, ADBI Working Paper Series, January.
- Feenstra, R. (1998): *Integration of Trade and Disintegration of Production in the Global Economy*. Journal of Economic Perspectives, Vol. 12, No. 4, pp. 31–50. Fall.
- Gao H. – Yu, Y. (2011): “*The Internalisation of the Renminbi*”. Bank for International Settlements Papers, No. 61.
- Garcia-Herrero, A. (2015): *Internationalising the Currency while leveraging massively: The case of China*, Brueghel Working Paper, No. 12.
- Gerőcs, T. (2016): “A polaritással kapcsolatos vita neostrukturista interpretációja” (“The neostructuralist interpretation of the debate in connection with polarity”). *Külügyi Szemle / Foreign Affairs Review*, Vol. XV. No. 1.
- Gyuris, F. (2015): *Területi egyenlőtlenségek és a beruházások földrajzi eloszlása az átmenet Kínájában (Spatial disparities and the geographical distribution of investments in transforming China)*. Book chapter: Kínai álom, kínai valóság (Chinese dream – Chinese reality). Typotex/Pázmány Péter Katolikus Egyetem / Typotex/Pázmány Péter Catholic University, Budapest, Ed: Salát, Gergely, pp. 42–65.
- He, D. – McCauley, R. (2010): *Offshore Markets for the Domestic Currency: Monetary and Financial Stability Issues*. BIS Working Papers. No 320. September.
- Fung, H.G. – Hsu, C.H. – Lee, W. – Yau, J. (2015): *Dim Sum Bonds: Do They Whet your Appetite?* The Journal of Portfolio Management, Special China Issue.
- Komlóssy, L. – Kovalszky, Zs. – Körmendi, Gy. – Land, P. – Stancsics, M. (2015): “*Kína: a tervgazdaságtól a modern bankrendszerig*” (*China: from Command Economy to a Modern Banking System*). Hitelintézet Szemle / Financial and Economic Review, Vol. 14, Special Edition, pp. 133–144. November. <http://www.hitelintezetiszemle.hu/%5Cletoltes%5C10-komlossy-kovalszky-kormendi-lang-stancsics.pdf>
- Ladányi, S. – Sütő, Zs. – Tapaszt, A. (2016): *A kínai devizapiaci nyitás kihívásai (Challenges of the opening up of the Chinese foreign exchange market)*. MNB publication. <http://www.mnb.hu/letoltes/ladanyi-sandor-suto-zsanett-tapaszti-attila-a-kinai-devizapiaci-nyitas-kihivasai.pdf>
- Laurenceson, J. – Ki Tang, K. (2005): *China’s capital account convertibility and financial stability*, East Asia Economic Research Group, Discussion Paper No. 5, October.
- Liu, W. – Dicken, P. (2006): *Transnational Corporations and ‘obligated embeddedness’: foreign direct investment in China’s automobile industry*. Environment and Planning A 2006, volume 38, pp.1229–1247.
- Matura, T. (2015): *Új fejezet a globális hatalmi játszmában - magyar részvétellel (A new chapter in the global power game – with Hungarian participation)*. Kitekinto.hu. 8, April. http://kitekinto.hu/kelet-azsia/2015/04/08/uj-fejezet_a_globalis_hatalmi_jatszmban_-_magyar_reszvetellel

- Medeiros da Silva, R.: *The “Renminbi Swap Lines” and the emergent role of China as an emergency lender: evidence from Argentina* (in publication).
- Gordon, R. (1963): *Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates*. The Canadian Journal of Economics and Political Science / Revue canadienne d’Economie et de Science politique Vol. 29, No. 4, pp. 475–485. Nov.
- McCauley, R. (2011): *Internationalizing the Renminbi and China’s Financial Development Model*, CGS-IIGG, Nov.
- McCauley, R. (2011): *Renminbi internationalisation and China’s financial development*, BIS Quarterly Review, December.
- Murphy, M. – Jin Yuan, W. (2009): *Is China Ready to Challenge the Dollar? Internationalization of the Renminbi and Its Implications for the United States*. Center for Strategic & International Studies, October.
- MNB (2013): *A Magyar Nemzeti Bank és a People’s Bank of China közötti devizaswap keret felállításáról szóló megállapodás (Agreement on the establishment of a foreign currency swap line between the Magyar Nemzeti Bank and the People’s Bank of China)*. <http://mnb.hu/letoltes/kina-swap.pdf>
- Nolan, P. (2012): *“Is China buying the world?”* Polity Press.
- Subacchi, P. – Huang, H. (2012): *The Connecting Dots of China’s Renminbi Strategy*: London and Hong Kong, Chatham House, briefing paper, No. 2.
- Subacchi, P. (2010): *‘One Currency, Two Systems’: China’s Renminbi Strategy*, Chatham House, briefing paper, Nr. 1.
- Subacchi, P. – Driffil, J. (edit) (2010): *Beyond the Dollar, Rethinking the International Monetary System*, Chatham House Report, March.
- Sütő, Zs. (2016): *A panda esete a dim sum-mal (The panda’s affair with the dim sum)*. MNB publication. <http://www.mnb.hu/letoltes/suto-zsanett-a-panda-esete-a-dim-sum-mal.pdf>
- Trebitsch, P. (2015): *Új Selyemút: Kína új megaprojektet készít elő (The new silk road: China is preparing new mega projects)*. Kitekinto.hu. 17, March. http://kitekinto.hu/kelet-azsia/2015/03/17/uj-selyemut_kina_uj-megaprojektet_keszit_el
- Triffin, R. (1964): *The Evolution of the International Monetary System: Historical Reappraisal and Future Perspectives*. Princeton Studies In International Finance. No. 12.
- Zhang, L. – Tao, K. (2014): *The Benefits and Costs of Renminbi Internationalization*, ADBI Working Paper Series, May.