Rise of the Redback

How the renminbi is replacing the greenback as the dominant trade settlement currency in Asia.

BY CHI LO

The renminbi, or yuan, is not going to replace the U.S. dollar as a global reserve currency anytime soon. But it may displace the U.S. dollar as the dominate trade settlement currency in Asia. What's more, a renminbi currency bloc is emerging in Asia, quietly countering the U.S. dollar bloc. The rise of the yuan to challenge the U.S. dollar in Asia is a natural result of changing economic gravity pulling the regional economies towards China. These creeping trends will stealthily erode the U.S. dollar's dominance and reflect the shift of economic clout from the United States to China.

In pushing for renminbi internationalization, Beijing has been introducing new initiatives to broaden the offshore demand base for the renminbi. They include allowing all Chinese firms to settle foreign trade in renminbi with any country in the world, approving the usage of renminbi for foreign direct investment in China, allowing more Chinese entities to issue renminbi bonds in the offshore market (mainly in Hong Kong at this stage), directly trading Australian and Canadian dollars (in addition to U.S. dollars) against the renminbi onshore, and approving the so-called RQFII (Renminbi Qualified Foreign Institutional Investor) scheme, which allows offshore renminbi to be invested in China's capital markets through a quota system. The list will grow over time.

All these measures are meant to create a two-way trading mechanism for the renminbi between onshore and offshore markets, encourage offshore renminbi asset creation, and create an incentive for

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China's trading partners and foreigners to hold and use the renminbi as an investment and reserve currency, although they are not necessarily and directly helpful for increasing the renminbi's circulation overseas. The point is that successful measures to enlarge the offshore renminbi market will greatly increase the ability of the yuan to erode the U.S. dollar's global dominance.

SINO-JAPANESE TIE-UP

Of particular importance is the Sino-Japanese collaboration, announced on Christmas Day in 2011, for using renminbi for trade and non-trade transactions. In this move, China will allow Japan to make foreign direct investment in China using the renminbi as the investment currency, develop a renminbi/yen foreign exchange market to promote trade settlement in renminbi in Japan, and encourage Japanese entities to issue renminbi bonds in Tokyo and other offshore markets. Japan has also pledged to buy up to $10 billion in Chinese sovereign debts in its reserve assets.

The row between China and Japan over the Diaoyu, or Senkaku, Islands may delay this Sino-Japan cooperation, but it does not alter its potential importance for internationalizing the renminbi. This move of Beijing is a major step towards expanding the foreign demand base for the renminbi, as it involves cooperation with Asia's second-largest, and the world's third-largest, economy. When implemented, Japan's buying of Chinese bonds in its reserves will for the first time make renminbi assets part of the reserves of a G-7 economy. This could be the start of a long-term process for accepting the renminbi as a reserve currency.

This Sino-Japanese deal could boost renminbi internationalization significantly through trade settlement. While China's bilateral trade with Japan is smaller in absolute size than with Europe and the United States, the G-2 countries, it imports a significantly larger amount from Japan than from the G-2 (Figure 1). In fact, China runs a trade deficit with Japan, while it runs a trade surplus with the G-2. By paying Japanese exporters with renminbi, assuming that they are willing to accept it, China is trying to replicate its Hong Kong strategy by allowing more renminbi to accumulate in Japan through trade. If Sino-Japanese renminbi trade settlement expands significantly beyond Hong Kong, the dominance of the U.S. dollar in Asia, a least in foreign trade terms, could be eroded.

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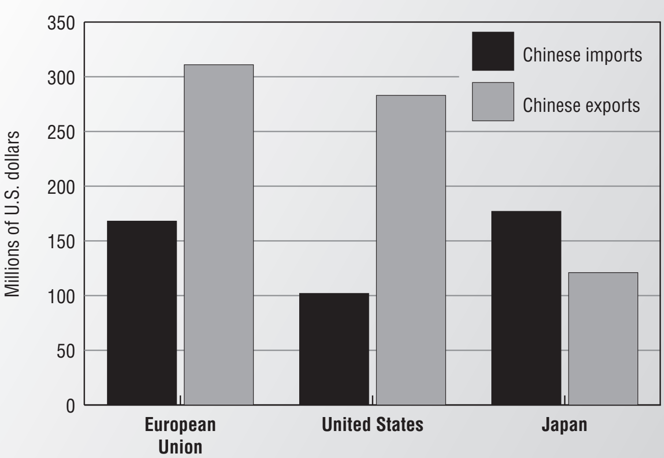
Figure 1 China's Trade Balance with the G-3



Sources: CEIC, BNNP IP Asia.

THE RISE OF A RENMINBI BLOC

Due to the momentum of renminbi accumulation in official reserves by some small central banks recently and the rapid growth rate of foreign exchange reserves in non-China Asia, the actions of reserve managers will be crucial in affecting the development of the renminbi as a reserve currency. The support for including the yuan in official reserves is especially strong in Africa and Latin America, notably in countries with strong economic ties to China. While the U.S. dollar may enjoy a significant inertia as the most important global reserve currency, the renminbi's challenge to its dominance is coming up surely and gradually. In fact, it is already here without drawing much attention.

Empirical research by Arvind Subramanian and Martin Kessler of the Peterson Institute for International Economics shows that there are an increasing number of Asian currencies tracking closely the movement of the renminbi since the Lehman bankruptcy. The subprime crisis and the following European sovereign debt crisis since 2008 have weakened the financial clout of the

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developed world and opened up an opportunity for the renminbi to move up the leadership ranks. Since mid-2008, the yuan has increasingly become an anchor currency in Asia which the movements of the regional currencies have tracked closely. Technically, this is equivalent to saying that a renminbi bloc is developing in Asia, looking set to displace the U.S. dollar bloc in the region.

China ended its U.S. dollar peg policy in mid-2005 by re-pegging the renminbi against a basket of currencies. It re-pegged the yuan against the dollar after the Lehman crisis, ending its three-year "floating" renminbi policy. Then in June 2010, it announced a return of the "floating" policy for the renminbi (floating within the People's Bank of China's tolerance limits, which are defined by the 1 percent trading range above and below the central rate against the U.S. dollar that it sets at the beginning of each trading day).

Hence, China has had two periods of renminbi flexibility, with the first period running from June 2005 to June 2008 and the second period running since June 2010. Since June 2010 when Beijing allowed the renminbi to "float" again, the number of Asian currencies tracking the yuan's movement has increased compared with the earlier period of flexibility between 2005 and 2008. Meanwhile, the number of Asian currencies tracking the movement of the euro and the U.S. dollar has fallen since mid-2010.

Further, the correlations of the renminbi and major Asian currencies' movements have increased in the second period of yuan flexibility compared with the first period, suggesting that the Asian majors have been tracking the renminbi's movement more closely than before. The correlations with the renminbi of eight out of the nine Asian currencies in our sample have increased since June 2010. Meanwhile, the correlations with the U.S. dollar and the euro of four out of the nine Asian majors have fallen (Figure 2), suggesting the Asian units are tracking the G-2 currencies less closely than before.

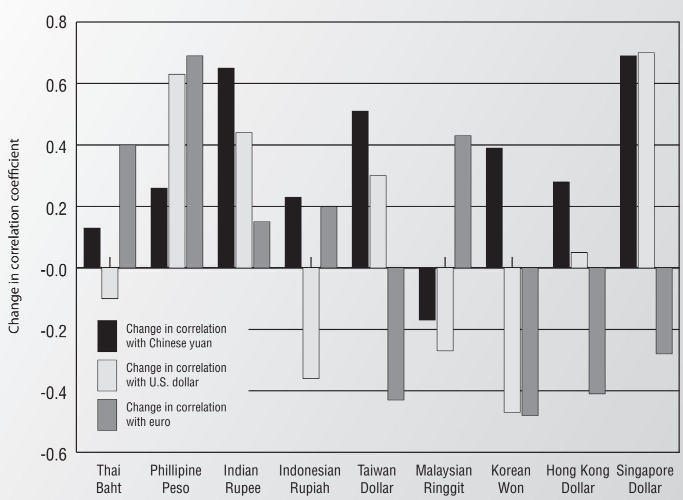
These results echo Subramanian and Kessler's research, which shows that the currencies of seven out of ten Asian major economies have been tracking renminbi movements more closely than those of the dollar since mid-2010. A notable example is the Korean won, which has risen in tandem with the renminbi against the U.S. dollar since mid-2010. From this perspective, Asia has effectively built a yuan bloc with more currencies moving closely together with the renminbi than with the dollar.

The rise of the renminbi bloc in Asia should not come as a surprise, as China's economic ties with the region have increased significantly over the past twenty years. For example, the share of China's manufacturing trade with Asia has now risen from about 2 percent in 1990 to almost a quarter of the regional total trade. Its trade influence outside of the Asian region, for instance on the other three members of the BRIC countries, has also risen sharply. Total trade (imports plus exports) between the BRIC nations has risen to 4.5 percent of total BRIC trade with the world from less than 1 percent in the 1990s. Specifically, Brazil, Russia, and India's trade with China now accounts for 17.5 percent, 10.6 percent, and 9 percent respectively of their total trade values.

The point is that countries that trade with the growing Chinese market, or are part of the supply chains centered on China, have a stronger incentive to minimize exchange rate volatility against the renminbi than against the U.S. dollar. Further, whenever the renminbi tracks the U.S. dollar again, which is on a secular weakening trend despite periodic strengths, in my view, Asian currencies tracking the renminbi will indirectly reap the benefit of a weakening dollar for their exports.

China's push for renminbi settlement for international trade is also boosting the rise of the yuan outside Asia. For example, the currencies of India, Israel, Turkey, and South Africa are now tracking the movement of the renminbi more closely than before; in some cases they are tracking the yuan's movement more closely than the dollar's movement. For those developing nations, they will accept China's request for settling trade in renminbi more easily than the major economies, where the U.S. dollar dominates their payment systems. Settling in renminbi is less a leap

Figure 2 Change in Correlations of Asian Currencies with Renminbi



Sources: Bloomberg, BNNP IP Asia.

The support for including the yuan in official reserves is especially strong in Africa and Latin America.

for the developing nations where the dollar is used as one of the foreign currencies, just like the renminbi.

Here is the link from the increasing usage of the renminbi by the smaller economies to the rise of the renminbi as a reserve currency: If China were to liberalize its financial and currency markets more widely, foreign demand for the renminbi could expand quickly through peer pressure. This in turn would create a feedback loop to deepen renminbi internationalization and quicken its ascent to reserve currency status.

The emergence of the renminbi bloc in Asia is an important pointer in the shift of economic power from the United States towards China. In addition to the fact that China is the world's second-largest economy, the world's largest exporter, and the world's largest net creditor, the renminbi is now rising to build a currency bloc not only to challenge the U.S. dollar, but also to displace it in Asia in terms of the renminbi's influence on the movement of other Asian currencies. This is arguably an historic shift in the economic power balance because Asia, despite its geographical distance, has always been part of the U.S. dollar bloc. Now it is changing into a renminbi bloc.

Some may disagree over this potential renminbi challenge to the dollar's supremacy and argue that China will rise and fall the way Japan did over the past few decades. This is a complacent view because even during the height of the Japanese economic expansion, the Japanese yen never came close to rivalling the dollar as an anchor currency the way the renminbi does today. In other words, there was never a yen bloc in Asia. As the renminbi trend develops, the gravitational force of economics will draw more and more countries towards China. Depending on how China handles its structural reforms and economic liberalization and rebalancing, internationalization will give the redback the potential to displace greenback in the long run. ◆