The Future of the Renminbi and Its Impact on the Hong Kong Dollar

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This article outlines our thoughts on the following three issues. First, will the renminbi become an international currency in the foreseeable future? Second, what does the international use of the renminbi mean for Hong Kong? Third, should the Hong Kong dollar exchange rate be repegged to the renminbi?

Will the Renminbi Become an International Currency?

There is no standard or textbook definition of an "international currency," but a simple and intuitive definition would be that an international currency is one that is widely used outside its home country, for trade invoicing and settlement, reserve holdings, and as an exchange rate anchor for other currencies. To become an international currency, a currency must be perceived as sound, and market participants must be willing to hold it as a store of value. It should also be convertible so that nonresidents can acquire it.

It is nevertheless obvious that only a handful of currencies in the world have enjoyed the status of international currencies. One important determinant of such a status seems to be the size of the home economy. A large trading nation will naturally generate a large quantity of foreign exchange transactions with at least one leg in the home currency. Size also matters in terms of the presence of an open and developed financial market, which supplies assets denominated in the local currency that are demanded by international investors.

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It also seems that the significance of the major currencies in international trade and financial transactions changes only slowly over time. An international currency, like domestic money, derives its value because other economies are using it. As a result, there is inertia in favor of using whatever currency has been the international currency in the past.

In Asia, there are indications of an increasing use of the renminbi outside Mainland China. In the "border trade" between residents of China and some of its neighbouring economies, the renminbi is often the preferred currency for settlement. Most notably, since the launch of renminbi banking business in 2004, Hong Kong is the first place outside the Mainland to have banks providing renminbi deposit taking, exchange, remittance, and card service. A further major breakthrough was the issuance of the first renminbi bonds in July 2007 by the China Development Bank.[1]

There are good reasons to expect that the international role of the renminbi will gradually increase over time. Already the fourth largest economy and the third largest trading nation in the world, China continues to rise rapidly as an important force in global trade and production. Inflation has been low and stable inside China. Meanwhile, the renminbi exchange rate is gaining flexibility within a framework that has been put in place and continuously refined since July 2005. Significant steps have also been taken to gradually liberalize the country's capital account transactions. Being the currency of a fast-growing major trading nation that has low and stable inflation, the renminbi is likely to meet strong demand, both in the Asia region and the rest of the world, as an international currency.

Market forces ultimately determine the international use of a currency. In the case of the renminbi, policy restrictions on the capital account convertibility also play a critical role, because the international use of the currency requires nonresident convertibility. Nonresident convertibility entails benefits as well as risks to the home country. In terms of benefits, the economy derives seigniorage resulting from a larger demand for its currency. In broader terms, the economy will benefit from reduced transaction costs and an expansion of the international trade and financial transactions that are

[1]For more details regarding renminbi banking business in Hong Kong, see Hong Kong Monetary Authority (2006) and Yam (2007).

conducted in the domestic currency. However, nonresident convertibility also bears costs that are associated with the impact of the international demand for the currency on domestic monetary conditions. In particular, a trend of increasing international demand for a currency under expectations of appreciation would add to the pressure on the currency.

Thus, for a large economy like China, the international role of the domestic currency and the associated concerns would inevitably be part of the consideration by the authorities in determining the pace and forms of financial liberalization. It is our observation that while the authorities in Mainland China are keen to reap the benefits that may come from a more open capital account, they are also conscious of the pitfalls associated with a fast pace of liberalization, given that it takes time for the domestic financial system to develop risk management capabilities to withstand large shocks.

The Mainland authorities have articulated a strategy of capital account liberalization that is characterized as "proactive, controllable, and gradualist."[2] Under this approach, the degree of convertibility of the renminbi is best seen as a spectrum, not black or white. For example, for the purpose of portfolio investment either inside China by foreign residents or outside China by Chinese residents, the renminbi is more convertible to collective investment schemes than to individual investors, through the Qualified Foreign Institutional Investors scheme and the Qualified Domestic Institutional Investors scheme.

In addition, the degree of convertibility of the renminbi may also differ geographically; thus the renminbi is more convertible to Hong Kong residents than to residents in other jurisdictions, reflecting the availability of renminbi banking in Hong Kong. In our view, this controlled and gradual path toward capital account convertibility implies that it remains a very long road for the renminbi to become a major international currency, although its role in the Asia region is likely to be more significant than in other regions.

[2]For more details about China's strategy of financial sector reform and capital account liberalization, see Zhou (2006).

What Does the International Use of the Renminbi Mean for Hong Kong?

From Hong Kong's point of view, we see an international role of the renminbi as providing important opportunities for developing our financial market and strengthening our role as an international financial center. China is in a unique situation by having two financial systems within one country. We believe that these two financial systems should develop a "complementary, mutually-assisting and interactive" relationship to create in the longer term an integrated, much larger financial market for the country as a whole, and to promote Hong Kong as an international financial center of global significance. Initiatives have been taken in a number of areas to increase financial integration between the Mainland and Hong Kong. In particular, the development of the renminbi business in Hong Kong has provided Hong Kong with the first renminbi market outside the Mainland and the capacity of our financial system in conducting renminbi denominated transactions. Continuing to develop financial intermediation in the renminbi will add to the breadth and depth of Hong Kong's financial markets, and is essential to the maintenance and development of our role as an international financial center.

The benefits are mutual. As an international financial center of China and with close cooperation between the Mainland and Hong Kong monetary and regulatory authorities, Hong Kong is in an ideal position to provide a reliable testing ground for renminbi convertibility and its increasing international use.

It has been argued that the rapid development of renminbi banking business in Hong Kong will undermine the status and hence the stability of the Hong Kong dollar. The Hong Kong dollar, as prescribed in the Basic Law, is the legal tender of Hong Kong. It is the currency in which the great majority of our daily transactions are denominated. However, Hong Kong residents have traditionally been used to holding foreign currency assets. Half of our banking system deposits are foreign currency deposits, but that has not affected the status and stability of the Hong Kong dollar. The rationale of developing renminbi banking in Hong Kong is no different from that behind the capability that we have already built into the banking system for handling transactions in the major foreign currencies.

Confidence in the Hong Kong dollar is derived from the robustness of the monetary system and we have one of the most robust systems in the world, with the whole of the Hong Kong-dollar monetary base more than fully backed by foreign reserves. If there is a preference on the part of an individual to use the renminbi instead of the Hong Kong dollar in a particular transaction, it is probably because the counterparty to the transaction is from the Mainland. If there is a wish to store wealth in assets denominated in the renminbi, it is because the individual expects a higher rate of return, just as in the case of holding U.S. dollar or euro-denominated assets. One can envisage that with the gradual capital account liberalization on the Mainland, stock issuance and listing by Mainland firms in Hong Kong could in the future be denominated and settled in the renminbi instead of the Hong Kong dollar. Such a development will be convenient to both the issuers and the investors, many of whom may also be from the Mainland. Indeed, it is not illogical for international financial intermediation to be conducted through a foreign currency, which is one reason why we have developed a multi-currency payment system in Hong Kong to ensure that these flows can be cleared and settled in the most efficient manner.

Should the Hong Kong Dollar Exchange Rate Be Repegged to the Renminbi?

Relating to the argument that the use of the renminbi in Hong Kong will marginalize the Hong Kong dollar, there have also been suggestions that the exchange rate of the Hong Kong dollar, which is pegged to the U.S. dollar under a currency board regime, should instead switch to a peg to the renminbi. We would first note that, technically, pegging the Hong Kong dollar, which is a fully convertible currency, to the renminbi, which has yet to become a fully convertible currency, is impractical. Furthermore, it will take a long time for the renminbi to develop into a reserve currency, which requires the presence of deep and liquid capital markets. But even if the renminbi were fully convertible, the economic arguments for changing the anchor currency are not well supported.

Despite the close and growing economic ties between Hong Kong and the Mainland, the two are at very different stages of economic development and are subject to different types of shocks. Although being fairly open to foreign trade and investment, most of the shocks facing the Mainland economy originate from within, whereas the shocks facing the Hong Kong economy, being a free port and an international financial center, originate externally from both the region and the major advanced economies. There is also no free movement of labor between the Mainland and Hong Kong. This implies that the two hardly form an optimal currency area.

Nevertheless, it has been argued that at the present time, the Hong Kong economy is at a cyclical juncture that is out of sync with that of the U.S. economy, and the U.S. monetary policy stance is wrong for the Hong Kong economy. The Hong Kong economy has had four years of above-trend growth and inflation pressures have been rising. Under the Linked Exchange Rate system, because the nominal interest rates in Hong Kong tend to follow the U.S. interest rates, which are not expected by the markets to be rising soon, the real interest rates in Hong Kong will therefore be declining and could even turn negative. Low or negative real interest rates will tend to boost spending and raise property prices. This may further increase inflation.

In responding to such concerns, we would argue that the appropriateness of the Linked Exchange Rate system of the Hong Kong dollar should be judged by its ability to deliver monetary and financial stability in Hong Kong through economic cycles, and we believe that the long-term benefits of the Link outweigh short-term costs associated with cyclical fluctuations in the economy that might result from nominal exchange rate rigidity. In the past 24 years, the Link has become the cornerstone of monetary and financial stability in Hong Kong. It is the anchor of investor and consumer confidence. The Hong Kong economy has also demonstrated its flexibility to adjust to a variety of shocks; the Hong Kong dollar real exchange rate has been flexible even though its nominal exchange rate has been fixed to the U.S. dollar. Such flexibility provides a solid foundation for the viability of the Link in the foreseeable future.

Conclusion

We have argued in this article that the renminbi is likely to become a major international currency in the future, but the process will most likely be a gradual one, reflecting the particular approach that the authorities in the Mainland have taken to capital account liberalization. We have also argued that Hong Kong is well positioned to benefit from the process of the renminbi becoming an international currency. At the Hong Kong Monetary Authority, we have been in the vanguard of developing renminbi banking in Hong Kong and do not worry about the Hong Kong dollar being marginalized. At the same time, we continue to believe in the appropriateness of the link of the Hong Kong dollar exchange rate to the U.S. dollar.

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