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Contents

Część 2. Perspektywy handlu, inwestycji i finansów w regionie Azji i Pacyfiku

Część 3. Wyzwania dla gospodarki Chin w XXI wieku

PRACE NAUKOWE UNIWERSYTETU EKONOMICZNEGO WE WROCŁAWIU
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Redefinition of the Role of Asia-Pacific Region in the Global Economy ISSN 1899-3192

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LEADERSHIP OR PARTNERSHIP – HOW CHINA'S SHANGHAI PILOT FREE TRADE ZONE WILL PROMOTE RMB INTERNATIONALIZATION?

Abstract: In 2009, China initiated steps to promote the internationalization of its renminbi. Today, Beijing's strategy has proven to be effective as the use of the renminbi outside China's borders has been steadily increasing over the last few years. In order to further promote the currency internationalization process, China initiates the pilot liberalization of the financial sector in the Shanghai Pilot Free Trade Zone (SFTZ), established in 2013, to facilitate the use of renminbi in cross-border trade and investment. In SFTZ, the residents of the zone are allowed to undertake cross-border investment, financing and hedging transactions through a new category of dual renminbi and foreign currency bank account, and companies based in SFTZ also are allowed to conduct offshore renminbi borrowing. The liberalization on cross-border renminbi business reflects Beijing's efforts to internationalize its currency while giving a boost to SFTZ as more mainland companies will seek renminbi borrowing.

Keywords: currency internationalization, China Shanghai Free Trade Zone.

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1. Introduction

Nobel Prize laureate Robert Mundell once stated that "great powers have great currencies." In spite of the overall size of the Chinese economy, its position as the world's leading official creditor, its stature as a powerhouse of exporter, and its growing military capacity, Chinese currency renminbi (RMB or yuan) is still on the way climbing up to advance its international status. Beginning in 2009, China initiated steps to promote the internationalization of its renminbi. Today, Beijing's strategy has proven to be effective as the use of the renminbi outside China's borders has been steadily increasing over the last few years.

The Chinese renminbi's growing role in trade and investment is the result of a carefully executed "three-pronged" strategy led by China's central bank, the People's Bank of China (PBOC). The first prong consists of a pilot program that allows banks in mainland China to settle cross border transactions with trading enterprises and investors from the world in renminbi. The second one is to develop the size and scale of the offshore financial markets in several major locations. The third prong involves establishing bilateral currency swap schemes with other countries' central banks. China's central bank has now signed currency swap deals amounting to 2.2 trillion renminbi with 22 countries and regions.

Launched on September 2013, China Shanghai Pilot Free-Trade Zone (SFTZ) is the first free trade zone in mainland. The plan first was announced by the government in July and it was personally endorsed by Premier Li Keqiang who said he wanted to make the zone a snapshot of how China can upgrade its economic structure. The SFTZ first spans 28.78 square kilometers in the Pudong New Area, including the Waigaoqiao duty-free zone and Yangshan port and it is believed it may eventually expand to cover the entire Pudong district which covers 1,210.4 square kilometers of land.

In order to further promote the currency internationalization process, China initiates the pilot liberalization of the financial sector in the Shanghai Pilot Free Trade Zone to facilitate the use of renminbi in cross-border trade and investment. Additionally, the People's Bank of China issued, on 2 December 2013, its guiding framework for the SFTZ in the areas of foreign exchange reform and conversion, interest rate liberalization and the internationalization of the Chinese renminbi.

In SFTZ, the People's Bank of China allows residents of the zone to undertake cross-border investment, financing and hedging transactions through a new category of dual renminbi and foreign currency bank account, and the resident free trade account[1] should be opened by a resident of the zone with a Shanghai based bank.[2] Funds in the free trade account may freely move between other free trade accounts, such as accounts outside mainland China, and non-resident accounts in mainland China. The People's Bank of China also allows companies based in SFTZ to conduct offshore renminbi borrowing. The liberalization on cross-border renminbi business reflects Beijing's efforts to internationalize its currency while giving a boost to SFTZ as more mainland companies will seek renminbi borrowing.

This article is divided into four parts. In two parts after the Introduction there are discussed China's currency internationalization and the liberalization measures introduced in SFTZ associated with this currency internationalization process.

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[1] http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2013/20131202094934794886233/20131202094934794886233.html (retrieved: 25.05.2014).

[2] Two special accounts will be created within the zone, resident free trade accounts (RFTA) and non-resident free trade accounts (NRFTA). These special accounts will provide the PBoC with the ability to segregate and monitor financial flows in the zone from the rest of the financial system. The separation of resident and non-resident accounts allows for another level of differentiation in policies. In general, non-resident accounts will have more constrained channels for moving capital out of the zone and into the mainland. Capital, however, will be more or less freely transferable between RFTA and NRFTAs.

The fourth part contains examination of the impacts which are brought up by this internationalization process alone with the influence upon China's present and future relations with neighbouring countries and other trade partners in global perspective.

2. Chinese renminbi internationalization

2.1. Definition of international currency

An international currency is usually defined as a currency that is used elsewhere beyond its home country. There are two ways of developing this concept. One is to conceptualize an international currency in terms of its functions, and the other is to categorize it under the context of the factors international use.

2.2. Functional conceptualization

International currency research on the basis of its monetary function was first conducted by Cohen (1971) in early 1970s on the British pound sterling and subsequently refined by Kenen (1983), and Krugman (1984).[3] Just like domestic currency, an international currency performs three functions: (1) as a medium of exchange, (2) a unit of account, and (3) a store of value. As a medium of exchange, it is used by private sectors to settle international economic transactions and by governments as a foreign exchange market intervention currency. As a unit of account, at the private level, it denominates international economic transactions while at the public level it plays the role of an anchor to which governments peg their currencies. As a store of value, in private sector it is used as an investment asset and as a reserve currency at the governmental level.

2.3. Political economy conceptualization

Strange, who like Cohen considered sterling in the early 70s, paid attention to the political impact on international currency. Strange classified international currencies into four categories: "master currencies," "top currencies," "negotiated currencies," and "neutral currencies" to highlight how both economic and political factors shape currencies' international uses.[4]

There are very limited currencies that perform all of these international currency roles. The dollar is currently the only one that does so worldwide. Other currencies such as Japanese yen, euro and pound sterling play mainly limited roles within their geographical limits.

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[3] T. Oatley, W.K. Winecoff, *Handbook of the International Political Economy of Monetary Relations*, Edward Elgar Publishing, Cheltenham 2014, p. 40.

[4] S. Strange, *Sterling and British Policy: A Political Study of an International Currency in Decline*, Oxford University Press, London 1971.

Table 1. Susan Strange's classification of international currencies

Master currency	The currency of a hegemonic or imperial state that coerces its use by other states.	British sterling in the sterling area. French franc in the France zone.
Top currency	Favoured by the world market for various monetary purposes due to its economic superiority.	US dollar in the 1950s.
Negotiated currency	Exchange for military and diplomatic support or for economic benefits in bargain or negotiation.	Sterling in the post-war period and the dollar in the 1960s.
Neutral currency	Currency whose international use stems primarily from the strong, but not necessarily dominant, economic position of its issuing state which has no interest in promoting its international use.	Swiss franc and the deutschmark.

Source: S. Strange, The politics of international currencies, *World Politics* 1971, vol. 23, no. 2, pp. 215–231.

2.4. The pursuit of currency internationalization

After the outbreak of 2008 global financial crisis, China has taken a series of steps to promote the renminbi internationalization. Recently it has been discussed that the financial crisis and weak recovery of western economies are the main arguments that renminbi should in the foreseeable future be equal to or eclipse the dollar as the dominant international reserve currency.

The discussion on renminbi internationalization started in March 2009, when People's Bank of China Governor Zhou Xiaochuan called for reform of the international reserve system. Zhou drew attention to the weakness of the current international monetary system, that is, it is too reliant on holding sovereign currency reserves (i.e., the US dollar). Zhou urged expanding the use of the IMF's Special Drawing Rights (SDR) and also proposed a stronger international role for the renminbi in the valuation of Special Drawing Rights.[5] Some argued that internationalized renminbi will increase China's geostrategic influence and international prestige that will allow China to expand its soft power. However, this argument remains unclear for it is difficult to measure such soft power and prestige.

Another concern is that China wants to maintain its stability of economic growth. After the global financial crisis the US Federal Reserve Bank took quantitative easing program which was perceived as to add more instability in global financial markets and accentuating pressures for other countries to appreciate their currencies. However, renminbi internationalization does not necessarily improve the volatility

[5] X. Zhou, Reform the International Monetary System, *BIS Review* 2009, no. 41, 23 March.

in exchange rates for China. In fact, "successful internationalization could actually increase fluctuations and risks as the country relaxes capital controls and moves away from a managed exchange rate regime."[6]

The state issuing an international currency may enjoy significant benefits, but it also may encounter substantial costs. It is crucial to estimate what possibly China can gain from the currency internationalization. There are five possible benefits which can be gained by internationalization renminbi.

(1)This will help to reduce exchange-rate risk and promote convenient regional trade and investment. If Chinese renminbi is widely acceptable, it will be more convenient for Chinese businessmen, investors and tourists to conduct international transactions. Additionally, this will reduce the cost of the exchange rate from the international transactions.

(2) This will generate alternative foreign demand markets. Renminbi internationalization will bring a flexibility advantage for China. If foreign official institutions prefer to purchase assets dominated by renminbi (denominated assets) as a part of their home foreign reserves, China will be able to finance the trade deficit with the Asian economies, reducing conflicts between internal and external economic goals led by payment constraints.

(3) To increase the political and economic influence of China in Asia and in the world. If Chinese renminbi can be considered as a vehicle currency by the Asian economies, China will have a stronger role in this region to realize its desire of balance of powers.

(4) To promote Shanghai Free Trade Zone and this region as the financial centre to compete with other major financial hubs.

(5) To transform from manufacturing and export-oriented economy to service and domestic demand-oriented driven economy.

3. Liberalization practices through SFTZ and impacts

The initiative reforms and liberation in financial sector executed in SFTZ have demonstrated the fact that China actively expands its influence and enhances competition capability on the matter of regional and international trade while other trade entities also actively enhance their relations through multiple tires of free trade agreements and partnerships agreements which some even are beyond geographic impacts. The Trans-Pacific Partnership (TPP), for example, which represents over 40% of global trade and a destination for over 60% of US's exports are strategically significant as it is the economic dimension of a broader US rebalancing towards Asia, however, China has yet to gain such equivalent influence toward the same region.

[6] Y. Huang, C. Lynch, Does internationalization of the RMB make sense for China?, *Cato Journal* 2013, vol. 33, no. 3, p. 573.

The pilot program in financial sector does not only facilitate trade and investment but will also promote a further step of financial reform. Those policy measures amid goals of interest rate and exchange rate liberalization which will create rich opportunities for financial institutions to provide financing, exchange and clearing services for Chinese and foreign enterprises within SFTZ. For example, offshore business will enable banks to transfer funds not only to the domestic interbank market but also to the global market; institutions based in SFTZ who seek outbound direct investment will be allowed to convert foreign currency using bank in the SFTZ and then transfer the funds to other countries directly, while business entities in the SFTZ will be allowed to conduct foreign direct investment and cash pooling in renminbi and in the currency of the destination country.

Furthermore, entities in the SFTZ are allowed to conduct cross-border credit funding in renminbi and foreign currencies, but the funds are only be allowed to use within the SFTZ or abroad. According to the guideline issued by PBOC, banks and financial institutions in the zone may use market pricing systems, but banks within the zone will not be allowed to absorb domestic deposits from outside the zone.

Table 2. Finance and foreign exchange administration liberalization

Main aspects covered by the PBOC Guideline	Highlights of the Guideline
To facilitate investment and financing remittance, and promoting the convertibility of capital account	Allows resident of the zone to set up resident free trade accounts in domestic and foreign currencies; allows RMB to be fully convertible under those accounts.
	Allows non-resident free trade account to enjoy financial services according to the pre-establishment national treatment principles.
	Allows foreign banks and enterprises registered in the zone to invest in Shanghai's securities market.
Promoting the cross-border use of RMB to allow enterprises and individuals in the SFTZ to carry out trade	Allows foreign companies with subsidiaries in the Shanghai FTZ to issue RMB-denominated Bonds.
	Allows qualified individual investors to conduct various foreign investment, including trading overseas securities.
	Allows enterprises in the Shanghai FTZ to borrow RMB funds from overseas lender and directly invest overseas without pre-approval procedures.
Pushing forward the market-oriented reform of interest rate and exchange rate	Removing the interest rate ceiling on small amount of foreign currency deposits at an appropriate time.

Source: Shanghai Free Trade Zone Official Webpage, http://www.china-shftz.gov.cn/Homepage.aspx (retrieved: 24.05.2014).

China proceeds with caution when handling capital flows between the SFTZ and the rest of the country. Authorities would avoid sudden capital flows which may create economy bubbles and further increase risk in banking system.[7] Currently in China, the renminbi is convertible on current accounts but not on capital accounts, individuals can convert renminbi to US dollar for tourism purposes, but cannot do this with the aim of financial investment.

The pilot program of financial innovation in Shanghai Free Trade Zone is regarded as the next level trial to realize renminbi internationalization. "Expanding cross-border use of renminbi is to improve the international circulation scale of currency, and adopting the market-led interest rate mechanism with the foreign exchange management liberalization is to improve the ease of renminbi convertibility. Overall, the financial innovation wants to achieve a comprehensive environment for renminbi internationalization[8]".

4. Conclusions

In recent years, China has been through many significant changes brought by the market-led economy reform policies. Apparently, China clearly understands the necessity of opening up to the world, but also the danger of doing it without proper preparation. The renminbi internationalization is regarded as the sign of China's rising influence.

The renminbi internationalization means the currency has the function of international valuation, settlement, investment as well as reserving. When the capital account liberalization is available, then foreign residents and financial institutions can hold and use renminbi freely, as a means of the pricing and trading of various financial products. Currently, China is using Shanghai Free Trade Zone as its trial base for such financial liberalization.

The renminbi internationalization depends on the condition of China's financial reform and the capital account liberalization. When the renminbi internationalization is gradually established, on the one hand it requires capital account convertibility, and on the other, it requires the capital account continuous liberalization. In another words, capital account convertibility promotes the internationalization and vice versa.

The function and influence of Shanghai Free Trade Zone are still beyond the comment. However, the early result of trial in SFTZ will be the reference for China to establish other free trade zone and even expand the zone to the domestic market. Once China opens the domestic market for free trade, it will enjoy the benefits from

[7] http://www.chinadaily.com.cn/bizchina/shanghaifreetradezone/2013-10/29/content_17065453.htm (retrieved: 24.05.2014).

[8] Jiǎn Dànián, vice director of Shanghai Pilot Free Trade Zone, speech on the occasion of 2014 Shanghai Forum, http://finance.takungpao.com.hk/q/2014/0526/2496803.html (retrieved: 26.05.2014).

free trade and free capital flows, but also will increase the exposure to international finance world.

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PRZYWÓDZTWO CZY PARTNERSTWO – JAK PILOTAŻOWA SZANGHAJSKA STREFA WOLNEGO HANDLU BĘDZIE PROMOWAĆ INTERNACJONALIZACJĘ RMB?

Streszczenie: W 2009 r. Chiny zainicjowały działania mające na celu umiędzynarodowienie swojej waluty. Taktyka Pekinu okazała się skuteczna, gdyż w ciągu ostatnich kilku lat renminbi jest coraz częściej stosowany poza granicami Chin. W celu dalszego wspierania procesu internacjonalizacji waluty, Chiny rozpoczynają proces liberalizacji sektora finansowego w strefie wolnego handlu w Szanghaju (SFTZ). Strefa ta powstała w 2013 r., a celem działania jest wprowadzenie ułatwień w korzystaniu z renminbi w handlu transgranicznym i inwestycjach. W ramach strefy mieszkańcy mogą zawierać transakcje inwestycyjne, finansować i zabezpieczać transakcje transgraniczne poprzez nową kategorię podwójnego rachunku bankowego w walucie renminbi i obcej, a firmy z siedzibą w SFTZ również mają prawo do pożyczania renminbi za granicą. Liberalizacja waluty chińskiej dla biznesu transgranicznego odzwierciedla działania Pekinu zmierzające do umiędzynarodowienia swojej waluty, dając impuls do rozwoju SFTZ jako konsekwencję większej liczby firm korzystających z pożyczania renminbi za granicą.

Słowa kluczowe: umiędzynarodowienie waluty, Strefa Wolnego Handlu Chiny Szanghaj.