Asian Shadow Financial Regulatory Committee
Statement: November 27, 2012
The Internationalization of the RMB: Challenges for East Asia

China is moving steadily to internationalize the RMB. Full convertibility is far off, because China does not wish to destabilize its own financial system, or the international system, from which it has benefitted greatly. But the procession of swap agreements that China has signed with trade partners shows that it sees economic advantages in expanding the use of the RMB for trade. A large volume of RMB is now held outside China. This statement addresses the problems that can result.
The RMB is becoming more important as a currency of trade settlement.[1] There is a natural progression to its use in East Asian finance. Many investors outside China anticipate a rise in the RMB and wish to hold RMB-denominated assets. Hong Kong, Singapore, Taiwan and Japan are competing to become RMB trading centres. So the financial systems of East Asia outside China will hold increasing quantities of RMB-denominated financial instruments. The “base” for these holdings is accumulating from East Asia’s trade surpluses with China[2]. This base will be multiplied up by the usual bank multiplier as banks make RMB loans, and corporations tap RMB deposits by issuing RMB bonds[3]. Moreover, there could be large flows of RMB-denominated capital between regional banking systems[4].
Yet this rising international RMB-denominated financial system has no system-wide regulator, or lender of last resort with the authority and mandate to guarantee system stability. Both the Asian Financial Crisis of 1997-98 and the current Eurozone crisis warn of the dangers that can ensue.

At the heart of the Asian Financial Crisis was the large number of regional loans denominated in the US dollar. Balance of payments problems in Thailand therefore triggered a downward spiral of exchange rates and bank solvency: regional central banks could not create US dollars, so they could not stem the panic by promising unlimited support to their commercial banks. The expansion of RMB-denominated

[1] Standard Chartered Bank estimates that 12.3 percent of China’s trade is settled in RMB.

[2] China has a chronic surplus with the rest of the world, but a deficit with East Asia (US$104 billion in 2011). There is 700 billion yuan in Hong Kong-based financial instruments.

[3] Hong Kong has issued RMB 198 billion of such “dim-sum” bonds so far.

[4] A large proportion of the RMB deposits in Hong Kong originate from Taiwan

loans in East Asia could lead to similar problems if a regional economy were to face a balance of payments crisis.

The European financial crisis has stumbled long past the obvious solution – an unlimited guarantee of Eurozone sovereign debt - because the responsibility and authority for containing contagion is divided amongst many national governments, each accountable to its own electorate, yet exposed to the decisions of the other governments via loans amongst Eurozone economies. So loss of confidence in one economy has precipitated a region-wide crisis as the Eurozone authorities have failed to act decisively, allowing rising default premia to spread threats to fiscal sustainability around the Eurozone periphery.

It is important for regional economies to learn the lessons from these crises and consider what regulation is required to anticipate these problems. We recommend the following:

1. Each economy ought to restrict the volume of RMB loans in its financial system to what can be stabilized by the stocks of RMB that it can be sure of accessing, either through its own reserves or through swap agreements, e.g., the ASEAN+3 Finance Cooperation (the Chiang Mai Initiative).
2. The US contained its financial crisis more effectively than the Eurozone because, far in advance of any crisis, it delegated overwhelming firepower to a group of technocrats in the Federal Reserve who are insulated from short-term political concerns. East Asia should set up a similar system for coordinating regional efforts to contain contagion.