

The Internationalisation of the Renminbi as an Investing and a Funding Currency: Analytics and Prospects

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Summary

While international use of some currencies has been symmetric (such as the US dollar and the euro), that of others has been somewhat asymmetric or “lopsided” (such as the Japanese yen and the Australian dollar). In the first case, non-residents both invest in a currency and borrow in it, but in the asymmetric case, non-residents mostly borrow (a funding currency) or mostly invest in a currency (an investing currency). As the international use of the renminbi has grown rapidly since 2010, in this paper, we ask whether the renminbi will be used mainly as an investing currency or a funding currency, or both, as capital account liberalisation proceeds.

We develop a three-currency model to explore the determinants of an international currency's long and short positions. Our model shows that interest rate differentials would be only one of the factors shaping an international currency's position. We identify two additional factors. These are the correlation between an economy's output growth and the bilateral exchange rate against the international currency, and the correlation between the international currency's exchange rate with those of other international currencies. Our empirical analysis suggests that all these factors affect the positions of international currencies, and that interest rate differentials have not been the most important factor explaining the international use of different currencies.

The findings in this paper shed light on whether the renminbi will become predominantly an investing currency. We note three points. First, China has relatively high interest rates, which makes the renminbi an attractive choice as an investing currency, particularly for investors from the advanced economies. However, since emerging economies typically have even higher interest rates than China, residents in these countries may find the renminbi attractive as a funding currency. Second, judging from the recent correlation between the exchange rates of major international currencies and the renminbi against output growth across different economies, the renminbi may be a desirable choice as a funding currency, because of its role as a hedge vis-à-vis other major currencies. Lastly, the relatively high degree of comovement between the renminbi and the US dollar implies that the international position of the renminbi would be dependent on investors' preference for the US dollar. For the renminbi position to be less affected by the US dollar position, its exchange rate would need to become more independent of the US dollar.