



ВОЗВЫШЕНИЕ КИТАЯ: ВНЕШНЯЯ ПОЛИТИКА И ВНУТРЕННЕЕ РАЗВИТИЕ

THE RISE OF CHINA: FOREIGN POLICY AND DOMESTIC DEVELOPMENT

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Internationalization of Renminbi as a Function of China's Foreign Exchange Policy

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Abstract. This article discusses the prospects of the Chinese renminbi (RMB) to expand its sphere of influence and become a full-scale reserve world currency. The methods used in the article are retrospective analysis and graphic analysis. The work is divided into three sections. The first section provides a broad overview of modern reserve currencies. The second part characterizes RMB's shaping as a reserve currency, as well as inner and outer factors that influence its status. The third section includes information about RMB's current status and its perspectives for being a reserve currency in the future. The article argues that currently RMB has already become a regional reserve currency in Asia-Pacific. Chinese government continues to make steps towards international expansion of RMB, yet these steps cannot make RMB one of the leading world currencies together with USD and EUR in the nearest decade.

Keywords: reserve currencies, Chinese Renminbi, CNY, SDR basket, RMB's status

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Интернационализация юаня как элемент валютной политики Китая

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Аннотация. Рассматриваются перспективы китайского юаня в части расширения его влияния и становления в качестве мировой резервной валюты. Методы, используемые в

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статье, – ретроспективный анализ и графический анализ. Приводится общее описание современных резервных валют. Далее описывается увеличение доли юаня в корзине специальных прав заимствования (СДР), а также внутренние и внешние факторы, влияющие на его статус. Представлена информация о текущем состоянии юаня и его перспективах стать мировой резервной валютой в будущем. Автор приходит к выводу, что в настоящее время юань можно назвать региональной резервной валютой в Азиатско-Тихоокеанском регионе. Китайские власти продолжают делать шаги в направлении международной экспансии, однако этот факт не сделает юань конкурентоспособным по сравнению с долларом США и евро в ближайшее десятилетие.

Ключевые слова: резервные валюты, китайский юань, юань, корзина СДР, статус юаня

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Introduction

In the late 2010s, the Renminbi (RMB) became the third largest currency in the Special Drawing Right (SDR) valuation basket (10,92%) after the euro (EUR) (30,93%) and the United States dollars (USD) (41,73%)¹. However, its further boosting is limited for several reasons, including the absence of floating course and free convertibility as well as the lack of intentions from the international financial system to diversify the structure of reserves. Above all, the Chinese government strictly controls the exchange rate of the national currency and practice financial interventions with the help of the huge currency reserves (a policy that Donald Trump once called “currency manipulation”)². Given these limitations, many experts argue that USD is not going to leave its dominating position among reserve currencies in the nearest decades [Bowles, Wang 2013]. Yet, emerging multilateral projects, such as the Belt and Road Initiative (BRI) and ASEAN+3 (China, Japan, and Korea), intensify trade links between China and other member-countries, increasing the role of RMB [Kurien, Geoxavier 2020].

The history of reserve currencies

In the 1860s, in the era of the gold standard, the British pound sterling was a dominating currency in international trade, because the United Kingdom (UK) was the largest exporter of manufactured goods and services. The UK hegemony came to an end once the confidence in the Pound sterling fell short after the collapse of Austria's and Germany's largest banks and the UK's budgetary and political challenges of 1931.

¹ International Monetary Fund. (2021). Data, Currency Composition of Official Foreign Exchange Reserves (COFER). Retrieved February 08, 2021, from <http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4>.

² Imbert F. (05.08.2019). Trump accuses China of ‘currency manipulation’ as yuan drops to lowest level in more than a decade. *CNBC*. Retrieved January 17, 2021, from <https://www.cnn.com/2019/08/05/trump-accuses-china-of-currency-manipulation-as-yuan-drops-to-new-low.html>.

The Bretton-Woods system, emerged after World War II, has kept the entire international financial architecture tied both to gold and the USD through a fixed exchange course till the mid-1970s. The primary reason of its success was exceptionally high unemployment and inflation rates for the given level of output during the early phase of the cyclical upswing in industrial countries³. The result was the Triffin dilemma that implied a controversy between inflows and outflows in the current account of Balance of Payments (BoP) when it comes to a choice of short-run domestic or a long-run international monetary policy.

The collapse of the Bretton-Woods institutions led to ratification of the Jamaica Accords. Their main principle back then was to change the rules of the International Monetary Fund (IMF) functioning in the way that allowed to create floating currencies. Eventually, an Special Drawing Rights (SDR) basket was established in an attempt to create a “polycentric” currency and “a rather cheap line of credit” for developing countries [McKinnon 2009:7]. However, the accords still privileged position of USD. They also allowed countries to cover their BoP deficit with a national currency (issuing the short-term debt) and manipulate USD interest rate [Narkevich, Trunin 2012].

Moreover, several regional blocks and international funds and organizations tend to use other national currencies for the aims of international accounts. For example, the Asia-Pacific region introduced the Asian Monetary Unit (AMU) basket on the initiative of the Japanese government⁴. It is composed of 13 currencies: Japanese yen, Chinese yuan, South Korean won, and ten currencies of ASEAN. This original set of currencies was later widened by Indian, Australian, and New Zealand’s currencies (the so-called “AMU-wide”) to make the new basket more convenient for the major actors of the region. The Asian Development Bank now uses this basket.

Today’s definition and functions of “reserve currency” varies from one source to another, and none of them provides the actual amounts of “significant quantities”, mentioned in Carbaugh’s et al. version: A reserve currency (or an anchor currency) is “a currency that is held in significant quantities by many governments and institutions as part of their foreign exchange reserves” [Carbaugh, David 2009]. It can be used in international transactions, international investments, and all aspects of the global economy.

Besides, achieving the status of the reserve currency requires fulfilling a list of intrinsic characteristics. The most obvious of them is *currency’s stability*, to minimize losses in case of currency fluctuations. This factor is also connected with the *size of the issuing country’s economy* and its share in international trade. According to Greenspan (2001), what matters is also its *financial institutions’ level of development*: the ability to invest borrowings into financial instruments with appropriate returns

³ International Monetary Fund. (1976). Annual Report. Special Drawing Right (SDR). Retrieved February 08, 2021, from <https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/14/51/Special-Drawing-Right-SDR#:~:text=The%20value%20of%20the%20SDR,and%20the%20British%20pound%20sterling>.

⁴ AMU-wide. *Research Institute of Economy, Trade and Industry*. Retrieved February 17, 2021, from <https://www.rieti.go.jp/users/amu/en/wide.html>.

attracts more and more foreign investors. Due to the sluggishness of business practices the *historical factor* and *network externalities* (the dependency of the utility on the number of users) also play a role in the use of reserve currency.

While economists were debating on a single reserve currency dominating the global economy and network externalities, in 2016 Chinese RMB became yet another world reserve currency (10,92% of the IMF's special drawing rights currency basket) and Bundesbank's (Germany central bank) decision to add Chinese Yuan into its currency reserves⁵.

Currently, there are eight international currencies in the IMF: US dollar, euro, Dutch guilder, Pound sterling, Japanese yen, Swiss franc, Canadian dollar and Renminbi. Only five of them (excluding Swiss franc, Dutch guilder, and Canadian dollar) with different weights are represented in the SDR basket. According to the IMF's Annual report (2019)⁶, the *SDR basket is an international reserve asset that can be exchanged for freely usable currencies*, used for taking loans from the IMF. Though there is no such official status as a dominating currency, USD and partly Euro can still be called dominating currencies, because together they built up to 81%⁷ of world reserve currencies in the third quarter of 2020.

Initially, reserve currencies were created mainly for making international calculations on commodity markets and minimizing transactional costs of foreign trade operations, while nowadays, especially in Asia, they are frequently used as an instrument of accumulating gold reserves for the cases of financial crises and raising the national production's competitiveness via national currency depreciation.

Modern global financial system's characteristics, influencing the status of RMB, include the following trends:

- 1) Deregulation of financial markets and internationalization of RMB, meaning that there are more and more opportunities for FDI and large investors worldwide can choose a country to work in;
- 2) Increased number of cross-border mergers and acquisitions;
- 3) The growth of multinational corporations in developing countries;
- 4) Rebalancing import and export operations, including moving from the Asia-for-the-World to the Asia-for-Asia model of growth.

Shaping RMB as the IMF's new reserve currency

The Internationalization of the Renminbi

The story begins in the 2000s and accelerates in 2009, after the global financial crisis, with the establishment of the dim sum (issued outside mainland,

⁵ Black J., Engle S., Curran E. (15.01.2018). Bundesbank Says It'll Add China's Yuan to the currency Reserves. *Bloomberg News*. Retrieved January 17, 2021, from <https://www.bloomberg.com/news/articles/2018-01-15/bundesbank-to-include-yuan-in-currency-reserves-dombret-says>.

⁶ International Monetary Fund. Press-releases. Retrieved January 17, 2021, from <https://www.imf.org/en/News/Articles/2016/09/30/AM16-PR16440-IMF-Launches-New-SDR-Basket-Including-Chinese-Renminbi>.

⁷ IMF Data, Currency Composition of Official Foreign Exchange Reserves (COFER). Retrieved January 17, 2021, from <http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4>

denominated in RMB) bond market, expanded Cross-Border Trade RMB Settlement Pilot Project (later Cross-Border Inter-Bank Payment System, CIPS) and its further communication with Society for Worldwide Interbank Financial Telecommunication (SWIFT).

It's worth mentioning that the dynamics of RMB's international use are dramatic. According to SWIFT reports (2013–2015), RMB moved from being the 8th most traded currency in the world in 2013 to being 5th in 2014 and the 2nd most used currency for trade and services in 2015. While using the currency outside China was not allowed before 2004, the use of RMB outside China for all current account operations (including commercial trade, dividend payment, payment of services, etc.) and certain approved capital account transactions (ex.: FDI, ODI) was permitted by the government and PBC only in 2008 and followed by establishing bilateral local currency swap arrangements with 19 countries in 2013 [Hyoung-kyu 2013]. It's hard to ignore such a huge progress towards openness, which is significant both for capital allocation in the domestic economy and for the evolution of China's financial relations with the rest of the world [Aglietta 2011].

However, the low liquidity due to government control and underdevelopment of Chinese financial markets are primary obstacles to RMB's internationalization.

RMB's current status

The fact that the IMF executive board decided to include RMB in the SDR basket in 2016⁸, has the air of Chinese symbolic achievement in three directions⁹. First of all, there haven't been any changes in the basket since 2000, when the euro was adopted instead of the French franc and the German mark. Secondly, it was not the first Chinese attempt to “enter the club”: in 2010 RMB was rejected due to the lack of free convertibility. The managing director of the IMF, Christine Lagarde, commented on this event as follows: “*The Renminbi's inclusion reflects the progress made in reforming China's monetary, foreign exchange, and financial systems, and acknowledges the advances made in liberalizing and improving the infrastructure of its financial markets*”¹⁰. Third, RMB's weight among SDR currencies (10,92%) left Japanese yen (8,33%) and British pounds (8,09%) behind.

According to COFER, in the 4th quarter of 2016 (right after the inclusion) RMB's claims amounted up to 84.51 billion. They doubled in less than two years (2nd quarter of 2018) and kept growing steadily since then, summing up to 244.52 billion of the US dollars in the 3rd quarter of 2020. The rates of increase of RMB share in official foreign exchange reserves have been the highest of all major reserve currencies (USD, EUR, JPY) from the 3rd quarter of 2017 to the 2nd quarter of 2018 and returned to the 1st place in the 1st quarter of 2020 (Figure 1), but the numbers are explained purely by the ‘low base’ effect. Since 2017, the USD has increased by 1500, EUR –

⁸ IMF Press-release. Retrieved February 08, 2021, from <https://www.imf.org/en/News/Articles/2016/09/30/AM16-PR16440-IMF-Launches-New-SDR-Basket-Including-Chinese-Renminbi>.

⁹ Ibid.

¹⁰ IMF Press-release. Retrieved February 08, 2021, from <https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr15540>.

by 712, and JPY by 329 thousands USD in absolute terms, which is larger than the overall RMB's claims. But while RMB's presence in foreign exchange reserves and turnover is visible, there are still such functions as cross-border bank claims, external public debt, international securities outstanding and imports invoicing, where RMB is not used and USD takes a leading role.

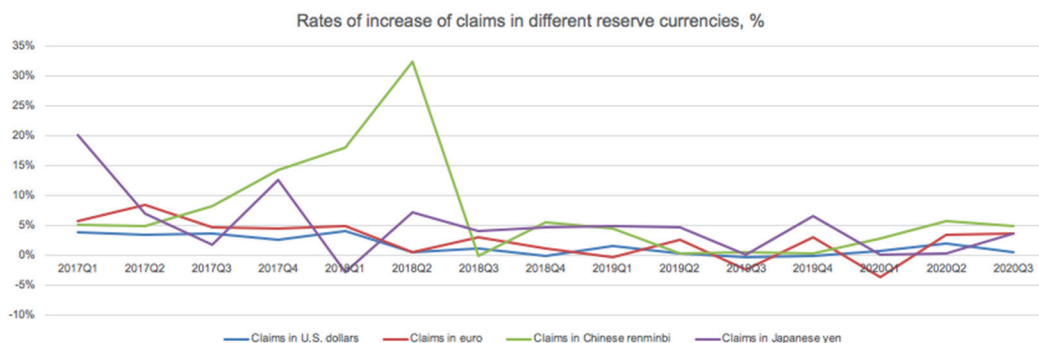


Fig. 1. The rates of increase in claims of the SDR basket in 2018–2019 (billion USD)

Source: Calculated by the author based on the IMF Data, Currency Composition of Official Foreign Exchange Reserves (COFER). Retrieved February 08, 2021, from <http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4>.

However, from the point of the overall amount of IMF's reserve currencies, the share of RMB in world-allocated reserves and official foreign exchange reserves is insignificant even after the inclusion unto the SDR basket.

Theoretically, the gains for different countries anticipated from using RMB as a reserve currency include *lower transactional costs*, because no secondary currency conversion (from USD to the relevant currency) will be needed once RMB becomes free convertible, *international seigniorage* (the revenue or profit derived from creating currency on the international level), *wider space for fiscal and monetary policies* (though in case of China with its governmental interventions this will not have much of an effect), the *transfer of exchange risk* from the domestic firms to their foreign counterparts, the *growth of domestic consumer's purchasing power* owing to renminbi broader acceptability and the *general expansion of Chinese economic and political influence*.

Factors influencing RMB's international status

Economic factors affecting currency's status in the academic research are grouped into two broad categories: confidence and convenience (subcategorized into liquidity and transactional network). The confidence in the stability of RMB is affected by the Chinese government's monetary and fiscal policies, which can be quite harsh. For example, the latest RMB's severe depreciation took place in 2019, 2015, 2008, and every time the reasons differed from the previous one¹¹. Such a situation incurs both solvency and liquidity risks on the currency, which is challenging for international users and harm RMB's international status.

¹¹ China – RMB depreciation: this time is different. (08.09.2019). *FXStreet*. Retrieved January 17, 2021, from <https://www.fxstreet.com/analysis/china-rmb-depreciation-this-time-is-different-201908090838>.

Though there is a cluster of financial institutions, such as QFII/RQFII, SAFE, PBoC, CIC, ABII, ABD, SFI, INE (Shanghai International Energy Exchange), HSBC (Hong Kong Bank), SRB (Silk Road bank), etc. – the path for their development is not clear enough, especially for the foreigners, who raise questions about the well-developed financial market in China. They can also affect the currency's liquidity and work negatively for the status of the currency.

China's share in the world trade (a convenience factor) is growing with the expansion of BRI and diverse integration frames support this process (e.g., Asian Infrastructure Investment Bank, Shanghai Cooperation Organization, Silk Road Fund). Though the estimated level of China's integration in the world trade is not very high¹² due to some aspects of the BRI member's economic development, it is a factor that boosts the use of RMB as a regional means of payment. As BRI is a long-term project of "China-centered economic integration" [Kuteleva, Vasiliev 2020:1], the overall level of Chinese integration can hardly be measured at the moment. Such ambitious SRF's and CIC's actions as taking part in Saudi Aramco IPO (2019)¹³ and the launch of Chinese oil futures contracts in Shanghai INE (2018)¹⁴ tell that there is enormous potential in the Belt and Road and a wish to spread internationally.

The most important external factor is the domination of USD, which has been the world's major reserve currency for over 60 years. Neither the rise of Germany's and Japan's economic power nor the establishment of the European monetary union made USD leave its position. However, according to the US Department of the Treasury, USD will continue to be the major reserve currency "as long as the United States maintain sound macroeconomic policies and deep, liquid and open financial markets"¹⁵. Lately, the sound macroeconomic policies of the U.S. have been questioned all over the world¹⁶, even by such significant actors as JPMorgan: "As economic dominance shifts east, there is less incentive to trade in the USD. Trump's aggressive stance on trade is accelerating this process"¹⁷. Though USD losing

¹² The king of reserves: how Moody's assessed the chance of the dollar losing dominance // RBC. Retrieved February 08, 2021, from <https://www.rbc.ru/economics/13/09/2018/5b993a759a79473ac78ec4f9>.

¹³ China Considers Up to \$10 Billion Stake in Saudi State Oil Giant's IPO. (06.11.2019). *Bloomberg News*. Retrieved January 17, 2021, from: <https://www.bloomberg.com/news/articles/2019-11-06/china-said-to-discuss-at-least-5-billion-aramco-ipo-investment>.

¹⁴ China's petroyuan is going global, and gunning for the USD. (04.12.2018). *SCMP News*. Retrieved February 08, 2021, from <https://www.scmp.com/comment/article/2176256/chinas-petroyuan-going-global-and-gunning-us-dollar>.

¹⁵ Appendix 1: A Historical Perspective on the Reserve Currency Status of the U.S. dollar. Retrieved February 08, 2021, from <https://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/Appendix%201%20Final%20October%2015%202009.pdf>.

¹⁶ Peskov spoke about the shaking of confidence in the US dollar // RBC. Retrieved February 08, 2021, from <https://www.rbc.ru/rbcfreenews/5b9ea5dc9a7947659b664cd0>.

¹⁷ JP Morgan Admits Dollar's Doomed Reserve Status to Unwittingly Cheer Bitcoin. (25.07.2019). *CNN News*. Retrieved December 01, 2020, from <https://www.ccn.com/jp-morgan-admits-dollars-doomed-reserve-status-to-inadvertently-cheer-bitcoin/>.

reserve status is becoming an “*ever-growing mainstream finance meme*”¹⁸, the bifurcation point is coming closer and the US-China Trade War is the first call.

In this regard it’s worth mentioning that HSBC does not believe the RMB will come under pressure, having the Fed raising its rates, although the Fed’s eventual tightening would engineer greater volatility for USD-RMB. First, due to capital account restrictions, China never received much capital inflow that could reverse. Second, China does not need capital inflows to fund a domestic savings gap – the economy has excess savings¹⁹. It is also stated in the 2014’s report that the RMB story is evolving rapidly and “*we expect full convertibility to happen over the next couple of years*”, which makes it clear that HSBC’s expectations do not always come in line with the reality.

There are also international political factors at play, such as creating inducements for encouraging foreign users through a provision of military and diplomatic support and soft power, which were widely used by the USA in the 20th century. China seems to implement soft power through economic cooperation so far.

RMB’s perspectives for being a reserve currency in future

In a Five-Year Plan for 2011–2015, the Chinese government established to develop Shanghai into a leading international financial center by 2020 and to achieve capital-account convertibility by that year as well [Hyoung-kyu 2013]. Nevertheless, RMB is still being closely watched by the Chinese government, and most probably financial liberalization is not going to happen in the nearest future²⁰. The 2 types of exchange rates (onshore yuan (CNY) and offshore yuan (CNH)) is making it even more complicated for broadening RMB’s international usage, but meanwhile, it does not prevent the ECB researchers from seeing the international monetary system “as a tripolar currency system, with the renminbi making up one pole alongside the dollar and the euro”²¹.

Given that Hong Kong and Singapore are the offshore zones trading in RMB, it can already be called the regional reserve currency. Furthermore, if AIIB introduces the Asian Drawing Right (ADR), equaling to 2 USD and driven by both blockchain technology and regional central banks reserves (existing gold reserves + current non-USD FX reserves + GDP size and trade volumes) in 2020, this will lead to “de-dollarizing” the regional trade. While RMB is heavily prominent in the mix, the USD

¹⁸ JP Morgan Admits Dollar’s Doomed Reserve Status to Unwittingly Cheer Bitcoin. (25.07.2019). *CNN News*. Retrieved December 01, 2020, from <https://www.cnn.com/jp-morgan-admits-dollars-doomed-reserve-status-to-inadvertently-cheer-bitcoin/>.

¹⁹ Asian FX focus: RMB Q&A: The Top 10 questions. *HSBC Global Research*. Retrieved February 08, 2021, from <https://www.research.hsbc.com/midas/Res/RDV?p=pdf&key=qaq8Q1dlrV&n=424259.PDF>.

²⁰ The yuan hit an 11-year low this week. Here’s a look at how China controls its currency // *CNBC*. Retrieved February 08, 2021, from <https://www.cnbc.com/2019/08/28/china-economy-how-pboc-controls-the-yuan-rmb-amid-trade-war.html>.

²¹ *Ibid*.

is weighted at below 20%²². The currency's stability will be guaranteed by hi-tech blockchain, further deepening the liquidity and trust in ADR as a reliable asset.

Another goal in the previous Five-Year Plan was the diversification of the Chinese FX reserve portfolio, which can be realized through growing purchases of Asian government bonds and facilitate RMB's internationalization. However, there are some rivals such as Japan and India in the region, and they may not wish to depend solely on the RMB if there is an alternative, which the dollar may continue for the foreseeable future [Hyoung-kyu 2013].

Revoking QFII and RQFII investment quotas (in September 2019) will raise the availability of China's capital and debt markets. *“Foreign investors will find it more convenient to participate in the domestic financial market, and China's bond market and the stock market will be better accepted by the global market, according to the SAFE”*²³. Along with the inclusion of RMB into the main international indexes (MSCI, FTSE Russell, S&P Dow Jones, and Bloomberg Barclays index), such lifting market restrictions and a gesture of financial liberalization surely broadens the channel for overseas RMB use and make the Chinese market more attractive.

Conclusion

For the past decade, China has put a lot of effort into globalizing RMB. It started by including RMB to SDR and now definitely aims at total “de-dollarization” of the Asia-Pacific region, which is quite a logical and natural move for such an economically ambitious power. Today, China's success in this direction is hard to ignore because China's share in the world trade, the growing strength of its financial institutions, as well as new China-led economic initiatives and movement towards openness. The probability of the decline of USD as a major reserve currency, stated by some significant actors (e.g., JP Morgan) is another contributing factor in the expansion of RMB. Though it is hard to predict the future of RMB because of the strict government control over its exchange rates, there is a general internationalization trend that attracts foreign investors to China. The government supports this trend by emphasizing China's commitment to economic openness in Five-Year plans and by revoking QFII quotas. The possible introduction of ADR also increases RMB's chances to go global. Such perspectives look attractive to investors and states searching for alternatives to USD and presents RMB as a decent diversification opportunity. To quote the president and CEO of China's HSBC Bank Liao Yijian, *“the pace of foreign financial institutions and foreign investors entering the Chinese market has never been more active”*²⁴.

²² Outrageous predictions 2020 – Engines of Disruption. (02.12.2019). *Saxo bank*. Retrieved January 17, 2021, from <https://www.home.saxo//media/documents/campaigns/outrageouspredictions/outrageouspredictions2020.pdf>.

²³ China lifts investment quota limit for QFII/RQFII amid financial opening-up. (09.11.2019). *Xinhuanet*. Retrieved January 17, 2021, from http://www.xinhuanet.com/english/2019-09/11/c_138382088.htm.

²⁴ *Ibid*.

Since the 1990s, China has emerged as the world's manufacturing giant and China's "hyperactive and omnipresent" state has been actively stimulating "the process by which the renminbi slowly evolves towards fully convertible status" [Jacques 2009]. As China continues its economic and political rejuvenation, Chinese leaders understand that the internationalization of RMB is their most critical source of power moving forward and push RMB as the currency of choice for its partners in the Asia-Pacific region and BRI members. Overall, the ongoing process of RMB internationalization raises fundamental questions not only about the evolution of the international monetary system and the dominance of USD but, more broadly, about fundamental shifts in the global balance of power.

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