

# *Safe Haven Currency Attribute of RMB*

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**Abstract:** With the continuous progress of RMB internationalization, RMB has shown the attribute of safe haven currency. This paper discusses the exhibition of RMB's attribute of safe haven currency and the causes behind it in some special risk aversion periods recently by comparing RMB with other major currencies. The process of RMB internationalization has an important impact on the exhibition of RMB's attribute of safe haven currency. Although convertibility and high liquidity are necessary conditions for a safe haven currency, we also see that in some special circumstances, proper control is helpful for enhancing the safe haven currency attribute of RMB.

**Keywords:** RMB internationalization, safe haven currency, major currencies.

## **1. Introduction**

Safe haven currency refers to the currency that can rise when global investor behavior becomes more risk averse. Generally speaking, the US dollar, Japanese yen, and Swiss franc are considered as the world's top three haven currencies.

Following the pace of RMB internationalization, RMB has increasingly shown the attribute of safe haven currency in recent years. Some scholars argue that RMB is neither a hedging currency nor a safe haven currency. Cheng et al. (2021) argues that when the market fluctuates or the stock market plummets, RMB is neither a hedging currency nor a safe haven currency as far as the hedging function of safe haven currency is concerned. Some scholars, through historical back testing, agree that RMB shows the attributes of hedging currency compared with other currencies in terms of data, but it cannot be called a safe haven currency. They also put forward different views on how RMB can become a safe haven currency. Fatum et al. (2017) says that although RMB appears relatively safer than Euro and sterling statistically, its hedging attribute is poorer than US dollar and Japanese yen. In addition, they emphasize that RMB is not sufficiently liquid, and RMB could only become a safe haven currency until more extensive economic reform is carried out to enhance its liquidity. There is scant evidence to support that RMB has become or will become a safe haven currency. ZHANG Chong, et al. (2020) also have reached a similar conclusion based on historical data, but they believe that the exchange rate system is a critical reason for RMB to be capable of risk avoiding, and orderly marketization of exchange rates and appropriate capital control contribute to the enhancement of RMB's hedging function.

The impact of capital control or liberalization on the hedging function of RMB depends on how a specific risk affects China. If such risk has low impact on China or does not involve China, RMB will demonstrate the safe haven currency attribute. Open markets and high liquidity of the currency will

strengthen the safe-haven performance of RMB. If such risk has an impact on China, RMB may not demonstrate the safe-haven attribute at this time, and sufficient market liquidity will exacerbate the depreciation of RMB. Proper capital control will avoid the direct impact of such risk on RMB, and allow RMB to show appropriate safe-haven attribute relative to other currencies.

This paper will focus on some specific periods after the “8.11” exchange rate reform, the downturn period of global economy due to the COVID-19 outbreak, the intensification period of the conflict between Russia and Ukraine, and the period of inflation rise in the US and the Federal Reserve’s interest rate hike to discuss the causes behind the demonstration of safe-haven attribute of RMB. Finally, it will explore the impact of the RMB internationalization process on the safe-haven attribute of RMB.

## **2. Preliminary discussion of the safe haven attribute of RMB**

VIX is the volatility of S&P 500, a risk indicator. When global investor behavior becomes more risk averse, the market risk will mount up, the equity volatility will increase, and the VIX will rise. When the VIX is above 30, the market is relatively unstable and the risk is high. In the first half of 2020, due to worldwide spread of the pandemic, the panic intensified and the volatility increased. As the conflict between Russia and Ukraine exacerbated at the end of February and the beginning of March in 2022, the VIX rose. From March 2022, the Federal Reserve resumed its interest rate hike cycle due to the rising inflation in the US, and there was short-term increase in market volatility at the time of several meetings of interest rate hike. It is generally believed that currencies US dollar, Japanese yen and Swiss franc are the world’s top three safe haven currencies. Euro and sterling as two of the world’s three major payment currencies also are in a critical position. This paper will compare the performance of these currencies with the performance of RMB in different risk periods, to provide a preliminary discussion on the hedging function and attribute of RMB.

### **2.1. Period of global COVID-19 pandemic impact**

The COVID-19 spread fast across the globe in the first half of 2020. With the impact of the pandemic on the medical system of all countries, deaths continuously grew, economic and business activities were badly hurt by the pandemic, large companies struggled to survive, sentiment soured and panic spread, and the VIX even hit as high as 80 for a time.

During the period from the end of February to the end of May 2020 when VIX was relatively high, gold, as a primary safe haven asset, rose 8.93%, the US dollar index rose 0.22%, the Japanese yen, Swiss franc, and Euro all climbed against dollar, and RMB fell 2.25% and sterling dropped 3.71% against the dollar. RMB underperformed other safe haven currencies, falling only less than sterling among major currencies. RMB was relatively weak in terms of safe haven attribute during this period mainly because China was seriously hit by the pandemic in the first half of 2020. Especially in the first quarter, the economic growth was -6.8%, the first negative since the reform and opening up. As COVID-19, the specific risk, had a direct and severe impact on China, we can see that RMB’s safe haven attribute in this period was relatively weak.

### **2.2. Period of Intensified conflict between Russia and Ukraine**

On February 24, 2022, Russian President Putin formally announced the military action of Russian army against Ukraine. The intensified Russia-Ukraine conflict, increased market panic, and the flow of global fund to safe haven assets pushed up the prices of safe haven assets such as US Treasury and gold. The dollar index of currencies went up as expected while RMB also unexpectedly strengthened

relative to other safe haven currencies, such as Japanese yen and Swiss franc, exhibiting some attribute of safe haven currency.

Between February 23 and March 8, the dollar index, measuring the greenback against a basket of currencies, rose 3%. RMB was still up 0.2% against the US dollar, very strong. Japanese yen edged down 0.6T against the US dollar, and Swiss franc fell 1.2% against the US dollar. In this period, the trend of RMB was stronger than the traditional safe haven currencies such as US dollar, Japanese yen and Swiss franc, demonstrating a typical attribute of safe haven currency.

China was not directly affected by the conflict between Russia and Ukraine, which helped RMB behave strong to some extent in this period. For the reason of its geographic impact, Europe suffered the most from the conflict, and the Euro's decline contributed to most of the US dollar index's gains. RMB and Japanese yen were not implicated and put up a relatively solid performance. Moreover, during this conflict, Switzerland announced sanctions against Russia in a rare break of its prolonged tradition of political neutrality. Its standing of moving away from neutrality shook the status of Swiss franc as a traditional safe haven currency. In addition, Russia has been diversifying its international reserves for years by reducing the weight of US dollar, and adding the weights of gold and RMB. Against the backdrop of sanctions imposed on Russia by the US and Europe, some market participants may expect the Russia central bank's demand for RMB to rise relative to the US dollar and Euro, which may further boost the demand for RMB, making it show a strong safe haven attribute during this period.

### 2.3. Federal Reserve's interest rate hike cycle

The Federal Reserve resumed the interest rate hike cycle in March 2022 due to high inflation in the US. The Fed raises interest rates at a high speed. Every time it raises rates, there is a spike in the VIX driven by market nervousness. For this interest rate hike by the Federal Reserve, as other major countries in the world were not in the same cycle as the US, when the Fed raised rates, especially sharply, the hike would cause disturbance to the foreign exchange market, and the intervention of other major central banks in the exchange rate or the possibility of intervention would increase the volatility of the foreign exchange market. In this Fed's rate hike cycle, Europe and the UK got bogged down in high inflation and energy crisis as the result of the Russia-Ukraine conflict, their economy grew slowly, and although their monetary policy was tightened, it was hard to keep up with the pace of tightening in the US. Japan's economy was still suffering from the pandemic and in the process of recovery. The Bank of Japan persistently maintained the strong monetary easing policy in order to support the country's economic recovery. China adhered to the dynamic zero COVID policy. For the pandemic control and prevention, economic activities were affected and the economic growth was pressurized. There was no condition for China's central bank to tighten its monetary policy.

After the Federal Reserve embarked on a fast path to rate hike in March 2022, the US dollar's performance stood out. From March 15, 2022 to October 25, 2022, the dollar index rose 11.96%. In the mean time, when the US dollar was strong, demand for gold as an alternative safe haven instrument decreased, with the price falling 13.83%. RMB weakened 14.63% against the US dollar, the Japanese yen weakened 25.05% against the US dollar, the Swiss franc weakened 5.72% against the US dollar, the sterling weakened 12.05% against the US dollar, and the Euro weakened 9.01% against the US dollar.

The central banks of Switzerland, the UK and Europe all raised their countries' interest rates moderately, following the US rate hike. Although the rate increase was not comparable to that of the US, the appropriate rate hike prevented excessive depreciation of their currencies. The Bank of Japan kept its interest rate on hold. As a result, the Japanese yen, as a traditional safe haven asset, slumped 25.05% against the US dollar in just over half a year. The Bank of Japan even intervened directly in the exchange rate of Japanese yen for the first time in 24 years, and used its foreign exchange reserves

to directly intervene twice in just one month in a bid to support its currency. Due to the pandemic, the People's Bank of China was much like the Bank of Japan in terms of monetary policy, and did not have much room for maneuver. However, unlike the Bank of Japan, on one hand, the People's Bank of China launched the counter-cyclical regulatory factor to regulate the middle rate of RMB and mitigate the decline of RMB; on the other hand, China's moderate capital control reduced liquidity and prevented speculative "buying the winner" and panic selling, which could also reduce the decline. In the same period, RMB depreciated 14.63% against the US dollar, far less than the 25.05% fall in the case of Japanese yen. This shows that, when risks or events go against China, China's exchange rate system and moderate capital control can reduce the volatility of RMB, making it relatively stable, perform better than the conventional safe haven currencies, and showing some attribute of safe haven currency.

### 3. Effect of RMB internationalization on the safe haven attribute of RMB

Whether a country's currency is likely to become a safe haven currency or exhibit the safe haven attribute is closely related to the country's international status and exchange rate system. With the development of its economy, China's international status elevates steadily, high international participation and stable macroeconomic situation build a foundation for the robust exchange rate of RMB. In terms of the exchange rate system, the People's Bank of China adopts a managed floating exchange rate system based on market supply and demand and regulated with reference to a basket of currencies. Although many scholars, such as Fatum et al. (2017) believe that convertibility and high liquidity are requisites for a safe haven currency, through the discussion on individual events, we can also find that the current exchange rate system makes it easier to keep the exchange rate of RMB stable in individual risk events, so that RMB shows some attribute of safe haven currency. The People's Bank of China has been always promoting the internationalization of RMB stably and prudently. Such process helps stabilize the exchange rate of RMB, makes it easier for the international community to recognize and accept RMB, steadily improves the degree of internationalization of the currency, and allows it to demonstrate more attributes of safe haven currency.

### 4. Conclusion

With the internationalization of RMB, RMB exhibits some attribute of safe haven currency, but is not a safe haven currency yet. RMB's safe haven attribute varies with the risk environment. When China is not affected by or does not benefit from the risk, RMB will show a strong attribute of safe haven currency. When China was under direct impact of the risk, RMB's attribute of safe haven currency will be weak. However, compared with the currencies of other countries under the impact of the same risk that are fully open, freely circulated, and convertible, RMB demonstrates relative attribute of safe haven currency due to its exchange rate system and moderate capital control in China.

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