ECON4033 Money and Finance in China

Week 13: The Renminbi as an International Currency[1]

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[1] These lecture notes are largely based on the materials prepared by Prof. Siu Kee Wong for the same topic.

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I. Benefits of Internationalization of RMB to China

- Chinese firms and investors will be able to limit their foreign exchange exposures as a result of being able to trade internationally in their own currency.

- The PBOC will be able to follow an independent monetary policy, tailoring domestic policy to domestic conditions, because it will be able to allow the exchange rate to adjust without having to worry about currency mismatches.

- Chinese banks will be more competitive in international business as a result of their capacity to offer foreign as well as domestic customers services denominated in RMB.

- Shanghai's development into an international financial center will be accelerated.

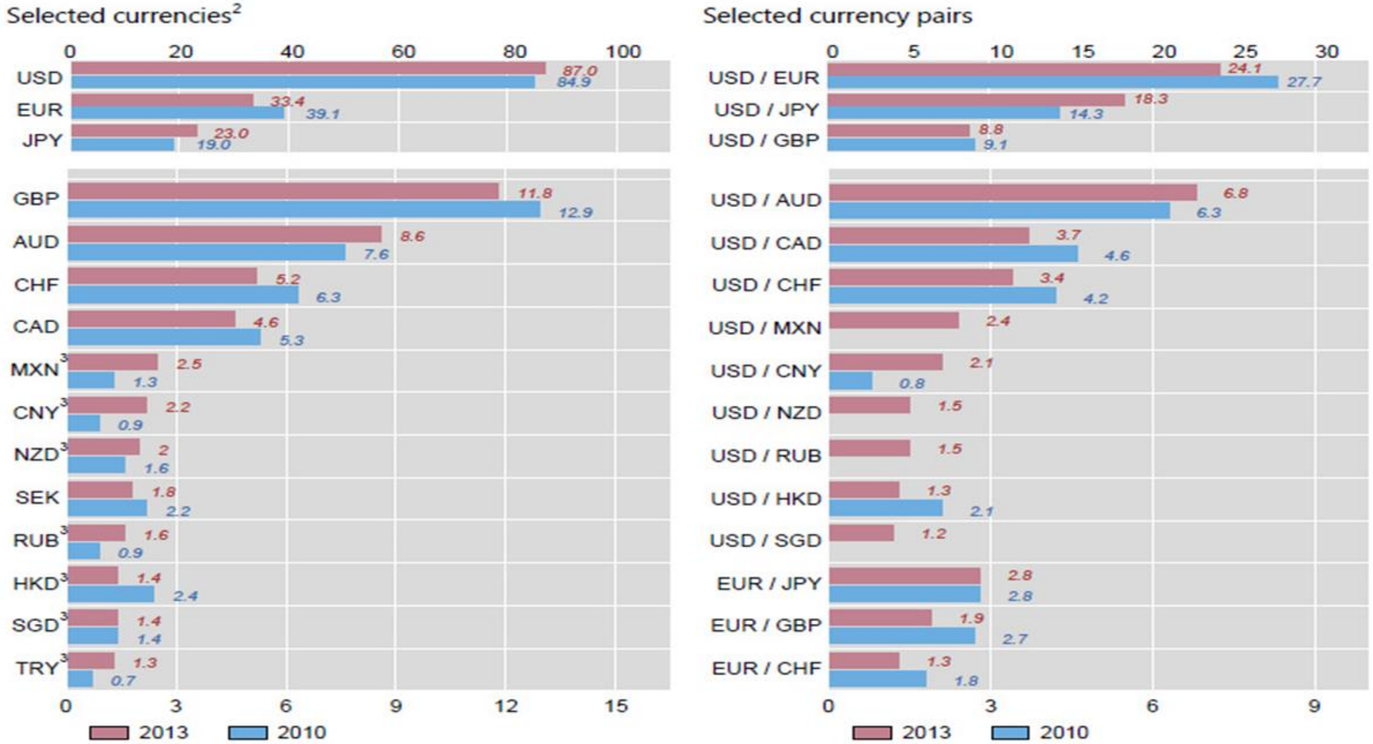
II. RMB Globalization

A. Background Information

- RMB was only the 9th most traded currency in 2013 as per the Bank of International Settlement. It will be a genuine international currency only if RMB assets can be freely traded in deep and liquid markets.

Foreign exchange market turnover by currency and currency pairs[1]

Net-net basis, daily averages in April, in per cent — Graph 1



[1] Adjusted for local and cross-border inter-dealer double-counting, ie "net-net" basis. [2] As two currencies are involved in each transaction, the sum of shares in individual currencies will total 200%. The share of currencies other than the ones listed is 12.2% for 2013 and 13.7% for 2010. [3] Turnover for 2010 may be underestimated owing to incomplete reporting of offshore trading. Methodological changes in the 2013 survey ensured a more complete coverage of the indicated currencies.

Source: BIS Triennial Central Bank Survey. For additional data by currency and currency pairs, see Tables 2 and 3 on pages 10-11.

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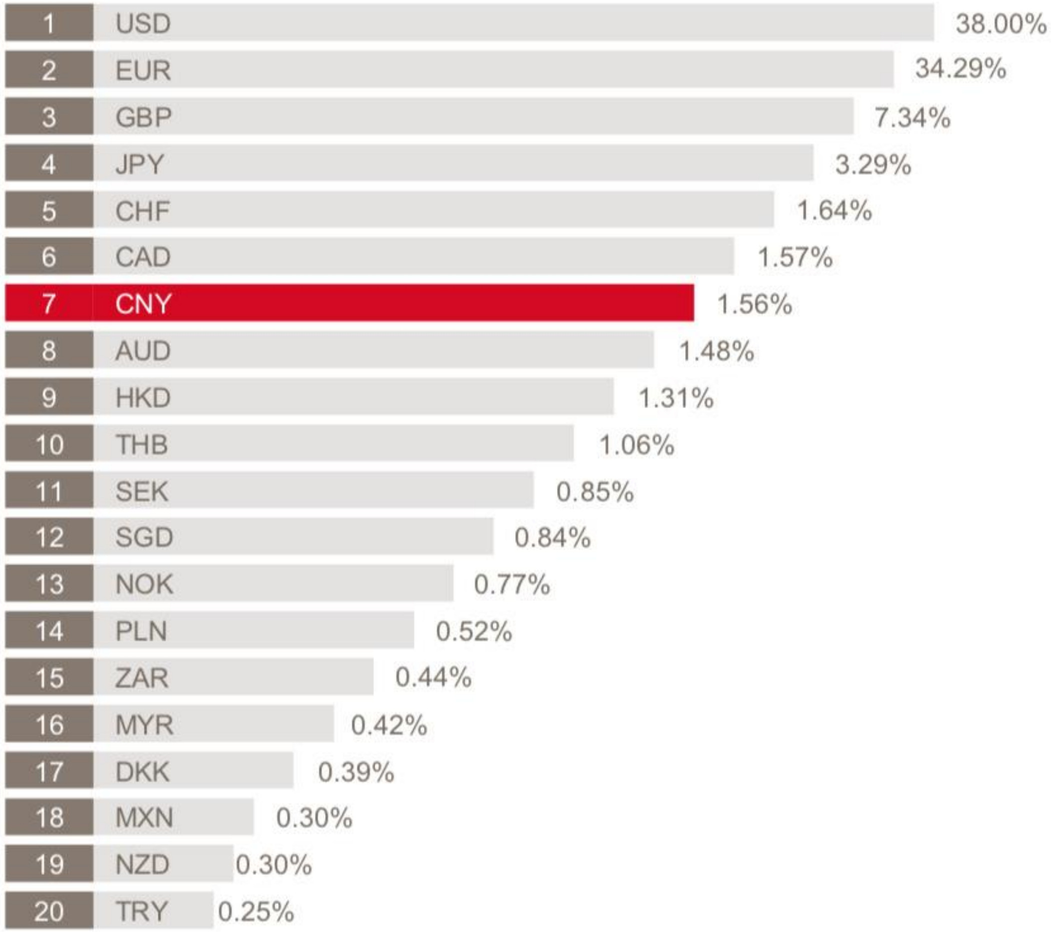

RMB Tracker – source: SWIFT Watch

Source: Society for Worldwide Interbank Financial Telecommunication

- Special Drawing Rights (SDR) are foreign exchange reserve assets maintained by the International Monetary Fund (IMF). The SDR is a unit of account but not a currency. It represents a claim to currency held by IMF member countries. It was created in 1969 to supplement a shortfall of gold and the U.S. dollar as foreign exchange reserve assets. Private parties do not use them.

- The value of the SDR is based on a basket of key international currencies reviewed every five years (currently are U.S. dollar, euro, Chinese yuan, Japanese yen, and pound sterling). The weights assigned to each currency in the basket are adjusted to take into account their prominence in terms of international trade and foreign exchange reserves. RMB was added to the basket effectively on October 1, 2016.

	USD	EUR	CNY	JPY	GBP
2016 – 2020	0.583 (41.73%)	0.387 (30.93%)	1.017 (10.92%)	11.900 (8.33%)	0.086 (8.09%)

- The amount of SDRs in existence was around SDR 21.4 billion in August 2009. During the financial crisis of 2009, an additional SDR 182.6 billion was allocated to "provide liquidity to the global economic system and supplement member countries' official reserves". By October 2014, the amount of SDRs in existence was SDR 204 billion.

B. Sequencing of Reforms

- USD experience suggests that the logical sequencing of steps in internationalizing a currency is:
  - First, encouraging its use in invoicing and settling trade;
  - Second, encouraging its use in private financial transactions;
  - Third, encouraging its use by central banks and governments as a form to hold foreign reserves.
- For countries with capital controls like China, authorization for firms to buy and sell its currency for trade-related purposes implies an increase in the permeability of its capital controls, which can be evaded through mis-invoicing.
- The second step could mean the removal of financial account restrictions, with the full participation of foreign investors in a deep and liquid market.
- This needs greater exchange rate flexibility to accompany the transition to capital account convertibility and accommodate the greater volume and volatility of capital flows.

C. China’s Practices

1) China’s First Step: Invoicing and settlement of Trade-Related Transaction

- China encouraged the use of the RMB for trade-related transactions. They started by permitting RMB to be used by selected eligible companies in cross-border trade with neighbors like Mongolia, Vietnam, Cambodia, Nepal, North Korea, Hong Kong, and Macau.

- China also negotiated bilateral agreements with countries further afield, such as Brazil, to allow for the use of the two countries’ respective currencies in bilateral trade settlements.

2) China’s Second Step: Development of an RMB Financial Market

- Creation of an Offshore RMB Asset Market
  - In mid-2010, the Hong Kong Monetary Authority permitted any company in the world to open an RMB-denominated account. Holders of RMB-denominated accounts were then permitted to transfer funds between such accounts. This created an interbank market in RMB in Hong Kong.
  - It allowed the banks operating the RMB-based foreign exchange interbank market to put their own RMB balances to work and to fund their RMB-based operations.
- Issuance of Offshore RMB Assets by Foreign Entities
  - In 2009, HSBC and other foreign banks began to sell RMB-denominated bonds in Hong Kong. The Chinese government followed up with a 6.3 billion RMB-denominated sovereign issue in Hong Kong to create a benchmark for the pricing of other bonds.
  - In 2010, the Asian Development Bank placed RMB 1.2 billion of RMB-denominated bonds in Hong Kong.
  - Hopewell Highway Infrastructure, a Hong Kong-based construction firm, became the first non-bank company to issue RMB-denominated bonds in Hong Kong.
  - McDonald’s Corporation then became the first multinational company to do the same by issuing RMB 200 million RMB-denominated “McBonds” to fund its investments in China.

- Allowing foreign banks and multinational corporations to issue onshore (domestically) would be a considerably more consequential step.

- In August 2010, the People's Bank of China authorized clearing banks in Hong Kong and Macau and overseas banks participating in RMB cross-border trade settlement business to invest part of their offshore RMB funds in China's onshore interbank bond market.

- The higher returns on the banks' RMB balances enabled them to offer higher interest rates on RMB accounts and attracted foreign exporters to accept payment in RMB.

3) China's Third Step: RMB as a Reserve Currency

- China encourages foreign central banks to consider RMB assets as a reserve through its participation in the Chiang Mai Initiative (CMI) Multilateralization and by negotiating currency swap arrangements. (with South Korea, Argentina, Belarus, Hong Kong, Indonesia, Malaysia, Pakistan, and Russia since 2008).

- China opened its domestic interbank bond market to foreign central banks with access to RMB as a result of their participation in these swaps. Malaysia's central bank has added RMB bonds to its international reserves.

- The Chiang Mai Initiative (CMI) is a multilateral currency swap (also called central bank liquidity swap 中央银行掉期交易) arrangement among the members of the Association of Southeast Asian Nations (ASEAN), China (including Hong Kong), Japan, and South Korea. It drew from a foreign exchange reserve pool worth USD120 billion and was launched on March 24, 2010.[2]

[2] Source: http://en.wikipedia.org/wiki/Chiang_Mai_Initiative.

III. Recent Slowdown

- The internationalization of RMB was stalled in 2016-17. Two connected factors contribute to this:
  - The first was RMB depreciation. The RMB fell 6.6 percent against the U.S. dollar during 2017.
  - Second, government controls on cross-border capital flows became tighter to prevent the decline of the RMB and capital flight. It imposed a tighter cap on offshore lending by Chinese banks and increased scrutiny of overseas investments by Chinese firms. Capital outflows had accelerated in late 2016, owing to the depreciation of RMB and expectations of monetary tightening in the U.S.

IV. China's Challenge

A. Development of the Financial Markets

- The RMB will have to overcome a number of obstacles in order to achieve international currency status.
- China's fixed-income asset market, which provides the instruments for foreign reserve holders, is still small, with a capitalization of $2.5 trillion. The sum of the bonds issued in the U.S., by comparison, exceeds $25 trillion.
- While Chinese domestic bond market capitalization has been growing by 30 % per year since 2000, it is still far behind that of the United States.
- Investors will still need to be assured about the rule of law. They will have to see that financial contracts are being reliably enforced, disputes fairly adjudicated.

B. Financial Account Convertibility and Economic Stability

- Internationalizing the RMB means opening Chinese financial markets to foreign investors. It means financial account convertibility. This presupposes fundamental changes in China's development model.

- The supervision and regulation of financial institutions and markets will have to be reinforced before it is safe to move to capital account convertibility. The banks would have to be put on a purely commercial footing and distanced from the process of policy lending.

- It becomes more difficult to maintain macroeconomic stability as the economy becomes more exposed to capital flows and as the banks gain more autonomy.

- The budget constraints of state enterprises and local governments will have to be hardened.

- To accommodate the volatility of capital flows, exchange rate flexibility will have to be enhanced. It is hard to have an undervalued exchange rate to stimulate export. The Chinese economy will have to be shifted away from exports in favor of domestic demand.

C. Internationalization of the RMB and the World

- Eichengreen (2010) thinks that an international monetary system in which the dollar, the euro, and the RMB share the reserve currency role will be an improvement over the current system.

- No country will be able to finance its current account deficit as freely as the U.S.. No country will be depressing the yields on its treasury securities as the U.S. in 2004-6, setting the stage for the subsequent crisis.

- If a reserve-currency country behaves irresponsibly, then central banks of other countries can stop adding their liabilities to their reserves. This put greater discipline on each reserve-currency country.

Reference:

Ronald M. Schramm (2015), *The Chinese Macroeconomy and Financial System: A U.S. Perspective*, Taylor and Francis, London.

Eichengreen, Barry (2010), "The Renminbi as an International Currency".