European Institute for Asian Studies

Event Report

The Internationalisation of the RMB: Implications for the World Economy

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In 2015, the International Monetary Fund (IMF) declared that the Chinese Renminbi (RMB) became freely usable and thus would be included into its Special Drawing Rights (SDR) basket. With the increasing demand for RMB in international trade and finance, the opening of the first offshore RMB market in Hong Kong in 2009 accelerated the currency's internationalisation. Despite a minimal effect on the global economy in practical terms, RMB's acquisition of a global reserve currency status seems to symbolize the rise of China.

As much as opportunities abound, the internationalisation of the RMB will certainly pose a lot of challenges to the country since it goes hand in hand with reforms. Although China has forged ahead with domestic reforms on finance and banking, there is still a long way to go. Not only does Beijing need to lessen restrictions on its capital market, but it also must work on issues pertinent to the absence of capital account and accountability.

As shown by China's activism in multilateral economic institutions, the country plays an increasingly critical role in global economic affairs. Thus, it is time for Europe to formulate a uniform stance vis-à-vis the rising China and the internationalisation of the RMB. Moreover, Europe should be keenly aware of the opportunities that the RMB's appreciation against the EUR offers to the European economy.

Brief Introduction: The Internationalisation of the RMB

Following opening remarks by Prof Xinning SONG, China Director, Brussels Academy for China and European Studies (BACES), Mr Erik FAMAEY, Senior Associate at the European Institute for Asian Studies (EIAS), gave an overview about RMB internationalisation from a market perspective. Over the last five years, the nominal exchange rate of the RMB has shown a 20 per cent appreciation against most of the major currencies in the IMF's SDR basket. The Euro was no exception in this regard, as RMB was appreciated against it by 24 per cent. The only currency which RMB was depreciated in relation to was the USD, which will serve European interests more than their American counterparts. Though RMB was slightly depreciated last year, such appreciation goes against the popular notion that Beijing actively makes interventions in order to drive down the value of the currency.

Mr FAMAEY stressed that contrary to Europe and Japan having quantitatively eased their currency as a response to ageing societies and declining demand, China at present does not have to do so. In fact, Beijing lacks incentives as a GDP (Gross Domestic Product) growth rate lower than six percent would risk domestic instability. Yet, Beijing might have to consider this option in the foreseeable future to enhance the competitiveness in the global financial market. Despite the decrease of reference rates by two per cent igniting panic in the American market about whether this signifies RMB's drastic devaluation, Beijing actually took measures to make the RMB's exchange rate more market-driven in August 2015, to appeal for the RMB's accession to the SDR basket. Hence, the popular scenario of RMB's devaluation seems unlikely, especially under the circumstances where the Central Bank of China (CBC) saves USD 500 billion to support RMB.[1]

As such, Mr FAMAEY pinpointed misperceptions about the RMB, which Beijing hopes will die down. IMF's declaration of the RMB as a "freely usable" currency in November 2015 and its following inclusion into the basket a month later failed to dampen such biases completely, hardly producing any real effects on the market. Giving the floor to presenters, Mr FAMAEY threw the lingering question of why the latest inclusion of the RMB in the SDR basket is such a momentous event.

RMB's Internationalisation and China's Financial Reform

Prof Feng ZHEN, Associate Professor at the School of Statistics, Renmin University of China, dealt with three main questions in his presentation: first, what motivated China to forge ahead with internationalisation of the RMB; second, how does China promote it; third, what are the future prospects for further internationalisation? In a nutshell, he argued that China ought to remain persistently open to domestic reforms in economic and financial dimensions, while promoting the "China Model" in the common market, all the while pursuing a shift from a bilateral to a multilateral approach.

(i) Origins: Drivers behind RMB's Internationalisation

A currency achieves international status from the fulfillment of three conditions: sizable economy and volume of international trade, opening of the economy, and stable macro-

[1] The current Chinese foreign exchange reserve is estimated to be approximately USD 4 trillion.

economy. Yet, this does not appear to have applied in the case of China. Notwithstanding its status as the second largest economy and the largest exporter, China has been unable to use its own currency to do business internationally. China has, however, taken a careful approach towards instituting the reform as seen from how it has taken nearly three decades for China to promote the internationalization of the RMB. For instance, it was only in 2015 when Beijing finally altered its phrasing from "cross-border trade settlement" to "internationalisation" in official documents, coupled with the introduction of the Cross-Border Inter-Bank Payment System (CIPS).

Both external and internal factors have driven the Chinese reform. In the external dimension, the 1997 Asian Financial Crisis demonstrated how the USD's predominance in short-term investments exacerbated the situation as dollars quickly escaped the Asian market. The crisis made China realise that an element of vulnerability exists in mismatches of currency, term and structure from the exclusive use of USD in international business. Demands arose from within as well, along the line of previous financial reforms on pricing mechanisms and further market liberalisation. Indeed, the RMB's internationalisation in recent times is a significant step for China, expected to be translated into another momentum for Beijing to push ahead with financial reforms.

Following a lesson from the Chinese maxim "crossing the river by touching the stones", China made gradual changes to internationalise the RMB. First, China bid the time until the size of economy and trade volume became sufficiently large. As an organic development of "the stall bank" in Chinese border areas insinuates, cross-border trade with its Southeast Asian neighbours increased considerably. In addition, the Chinese government signed the Comprehensive Economic Partnership Agreement with Hong Kong and Macao, the USD bilateral swap agreement (BSA), and instituted the Chiang Mai Initiative (CMI). As of July 2009, China began taking a more aggressive approach. In recent years, the focus has shifted towards financial reforms, such as introduction of the RMB cross-border trade settlement system, offshore markets in Hong Kong and the RMB BSA.

(ii) Status: Promotion of RMB's Internationalisation and "the China Model"

A dramatic upsurge has been seen in financial transactions in RMB since 2009. According to data released by the Bank of China (BOC), the volume of transactions has burgeoned from RMB 3.58 billion in 2009 to RMB 6.56 trillion in 2014.[2] In terms of RMB FDI (Foreign Direct Investment)/ODI (Outward Direct Investment), there has been a ten-fold growth in volume, from RMB 110.87 billion in 2011 to RMB 1048.60 billion in 2014.[3] Similar changes were detected as to RQFII (Renminbi Qualified Foreign Institutional Investment Scheme), offshore bonds and RMB deposits.

At present, trade settlements are available in Shanghai and Hong Kong. While Shanghai serves as the largest on-shore RMB market and Hong Kong the biggest offshore one, the importance of the latter surpassed that of the former, in that Hong Kong's premium USD-RMB exchange rate and freedom from regulations allow for Shanghai to account for only ten per cent. Consequently, the offshore RMB pool has grown very quickly, despite a

[2] According to another data released by PBoC, the volume of RMB transacted for trade settlement was estimated to reach RMB 7.32 billion.
[3] BOC data was provided by Prof ZHEN during the conference.

sharp decrease in bond and CD (certificate of deposit) issuance in the past two years. On top of this, China's expanding BSA networks, under which RMB can be directly exchanged with seven major currencies, contribute to the international profile of the RMB. Yet, the introduction of China's own clearing system and existing restrictions on capital account remain debatable.

Prof ZHEN mentioned "the China Model" which means liberalisation of RMB followed by that of other currencies. In other words, as part of its gradual and incremental approach to financial reform, China will test the waters by making RMB capital account convertible first, and then liberalise other currencies. In addition, he opined that RMB's accession to the SDR basket boosts Chinese confidence, in that the bar is higher for "freely usable" status than that of "freely convertible". Meanwhile, this will greatly pressurise Beijing to accelerate domestic reform and meet global standards. There are nevertheless challenges such as lack of consensus between policy makers, academia, market analysts and People's Bank of China (PBoC), as well as the need to address negative perceptions on RMB internationalisation.

(iii) Prospects: Route to RMB as the Fully Internationalised Currency

One of the long-term problems China faces is a consistent trade deficit against some particular regions or countries such as Taiwan and Africa. Distinguishing the real demand from market speculation can pose a real threat to China's financial performance. Apart from such general problems, Prof ZHEN identified three key challenges for RMB's further internationalisation.

First and foremost, Prof ZHEN pointed out that the sizable economy as a pre-requisite of RMB's internationalisation requires China to carry out domestic reform, especially on three aspects: financial price such as interest rates and exchange rates; financial market to create a larger and more in-depth pool; and real economy with a special focus on structural reform and improvement of welfare. Next, he urged for China to play a more active participation in international affairs. Amidst inevitable competition with other main currencies, China must bear its responsibility as a global actor to the world development. Lastly, he underscored demands for enhancing cross-border facility including reflux mechanism, offshore market risk control and clearing system.

In the pursuit of trade facilitation, economic structure optimization, and growth and sustainable development, China has catalysed domestic reforms on finance and banking. Stimulated by a series of successes such as those seen with CMI and CEPA, China is working on cross-border settlements, offshore markets, regional cooperation and marketisation. As a result, China aims to achieve full convertibility of the RMB, open capital markets, larger international responsibility and an advanced interest rate pricing system.

Tasks and Conditions for RMB's Internationalisation

As of October 2016, RMB is set to become one of the official international reserve currencies, accounting for 10.92 per cent of the SDR basket.[4] Reminding the audience of

[4] Retrieved from http://www.out-law.com/en/articles/2015/december/chinese-rmb-to-become-a-global-reserve-currency-from-october-2016/ accessed 14 July 2016

this, Prof Em Sylvain PLASSCHAERT, Advisory Board Member, EIAS, succinctly discussed the implication of the internationalisation of the RMB as well as the conditions China should fulfill in the future.

He first clarified that accession of RMB to the SDR system has so far produced minimal effects in practical terms but nonetheless admitted its symbolic value as a marker of the rise of China in the global economy. On top of this, he accentuated the importance of Hong Kong as to the growth of the RMB market in the global arena. In fact, beginning with the launch of the first RMB offshore market in Hong Kong in 2004, Taipei, Singapore and London embarked on the RMB business soon after. Indeed, taking into account that RMB once almost went bankrupt around the year 2000 owing to the legacy of the centrally planned economy, Prof. PLASSCHAERT found today's Chinese enthusiasm on RMB internationalisation impressive.

Next, Prof. PLASSCHAERT made reference to a series of tasks for China's domestic reforms. He summarised the present status of RMB as absence of capital account and accountability. Partial steps have been taken but effect is limited with remaining regulations, such as CPC's modulation of the exchange rate. He proposed two preconditions that need to be fulfilled for the RMB to be a highly appreciated reserve currency. First, strong private forces are necessary for the further internationalisation of RMB. Just as business demands for trade arrangements and settlements have strongly pushed a whole process of internationalisation, a counterpart is desirable in the currency internationalisation. Second, Beijing needs to lessen regulations on the exchange rate. The global reserve currency must be capable of moving in two directions – appreciation and depreciation. Although floating exchange rate does not always come to equilibrium, there is no doubt that the fixed exchange rate system is outdated considering that the rest of the world abandoned it as early as the 1970s.

Prof. PLASSCHAERT expressed appreciation that the Chinese banking system has tremendously improved, while underlining excessive corporate and local government debt as challenges ahead of China. As a concluding remark, he opined that not only is this the perfect time for China to go faster with RMB's internationalisation, but Beijing is not in an urgent need to do so. Rather, China should prioritise domestic reforms on some crucial agendas, such as excessive debt, lending and relationships with the central government.

China's Intensifying Activism in the Global Financial Governance

Mr Balazs UJVARI, Joint Research Fellow at Egmont Institute and the European Policy Centre, focused on China's rise in the context of global financial governance and institutions. Mr UJVARI criticised Europe's limited awareness of, and lack of willingness, to form a uniform stance vis-à-vis China's growing role in global economic governance. Then, he paid special attention to four dimensions: integration and reform, creation, innovation and reinvigoration. The internationalisation of the RMB is highly pertinent to all of these dimensions.

(i) Four Dimensions of Chinese Activism

First off, China is becoming fully integrated into the global economy. As a result of its

successful integration, China's profile in major multilateral economic institutions, such as IMF and the World Bank (WB), has substantially elevated. Today, China is ranked the third largest contributor to the IMF. A few Chinese nationals occupy key positions in these organisations as well. Due to the accession of the RMB to the SDR basket, China is now able to make all contributions in its own currency. At the same time, China attempts to pursue institutional reforms from the inside.

In cases where reforms are tricky, not least because of institutional design, China creates parallel structures, which leads to the presenter's second point. Beijing has recently proposed several eye-catching initiatives such as the Asian Infrastructure Investment Bank (AIIB), New Development Bank (NDB) and Contingent Reserve Arrangement (CRA). China's activism in this regard has ignited heated debate on whether China-led initiatives will complement or rival existing institutions. Mr UJVARI opined that the answer is "both", explaining that though he himself advocates complementarity in one of his reports, major strategic interests behind these initiatives should not be neglected.

Meanwhile, China also launches mechanisms that do not mirror any of the existing ones. These so-called innovative initiatives are exemplified by the One-Belt-One-Road (OBOR) project and the 16+1 framework. Lastly, China reinvigorates existing mechanisms, especially ones which have been neglected thus far. Such reinvigoration is particularly obvious in security affairs, with notable examples of the Conference on Interaction and Confidence-Building Measures in Asia (CICA) and Shangri-La Dialogue.

(ii) Critical Assessment and Prospects for NDB and AIIB

In recent years, China has been making bold moves within the BRICS (Brazil, Russia, India, China, South Africa) framework. For example, one of the key agendas of the upcoming 2016 summit is establishment of its own credit rating agency, as the group seeks to lower borrowing costs that remain excessively high due to the three giants - S&P Global Ratings, Fitch Ratings and Moody's Investor Service. Similarly, NDB, formerly known as BRICS Development Bank, will support public or private projects through various instruments such as equity participation, loans and guarantees. The bank has already clarified its intention to use only BRICS currencies, expected to strongly buttress RMB's internationalization.

Nevertheless, Mr UJVARI critiqued that NDB should work on credibility issues. NDB needs to leverage its capital to draw more resources from the financial market; hence, the highest grade of ratings – AAA – from global creditors is sine qua non for NDB's performance. So far, the NDB has a rating of AA, but some creditors rate NDB as AAA. This seems slightly bizarre as none of the BRICS countries receives a AAA grade from global rating agencies. That these creditors are Chinese adds as a source of doubt on the credibility of this AAA rating. Since the release of the Moody's ratings is expected by the end of this year, NDB expects to enter the international capital market afterwards.

On the other hand, China-led multilateral bank, AIIB, seems able to attain high ratings without difficulty thanks to highly credible members. Alongside OBOR projects, AIIB has succeeded in gathering support from all around the world, and is anticipated to meet the skyrocketing demand for infrastructure in Asia with the Asian Development Bank (ADB). Some experts, including Mr UJVARI himself, strongly argue that China proposed AIIB to

manage its own burgeoning foreign reserves. Rather than dumping this money in US treasury bonds, China has chosen to invest in infrastructure. Yet, unlike NDB, AIIB's major currency is still USD, as all staff and loans will be paid in USD. Last month, the bank approved the first batch of loans to Bangladesh and embarked on projects in conjunction with other multilateral institutions.

Mr UJVARI mentioned that at present, Hong Kong's membership in AIIB is one of China's concerns. China strongly desires it so that the country could play a bigger role in bond issues. Nonetheless, prospects are not so positive at the moment as a result of current regulations that dictate that China's finance minister should apply on behalf of the autonomous region. While working on this issue, China will surely try to shape this financial structure further. As such, Mr UJVARI particularly underlined that it is time for Europe to formulate a common position on China's activism in global financial governance.

Q&A

The first participant among the audience posed related questions. Referring to the consensus in Hong Kong that CNH depreciates by a few percentage points against the USD every year, he asked if the continuing depreciation would motivate Chinese investors to diversify their currency sources. He also wondered if this would cause panic to the point where PBoC becomes incapable of protecting the RMB. As a response, Prof Em PLASSCHAERT raised two points. First, CNH is closely connected with USD in a special arrangement. Second, there is a distinction between onshore CNY and offshore CNH, somewhat below RMB in terms of unit value. Prof Em PLASSCHAERT viewed the scope of arbitrage between the two as limited under the management of both central and autonomous authorities.

The second participant sought panels' opinions on potentials of offshore RMB centres like Luxembourg. Prof ZHEN replied that London and Singapore are rising competitors of Hong Kong, and are greatly helped by larger amount of exchanges between currencies. He articulated that different centres have different roles and all of them are important in promoting RMB internationalisation. Based on market confidence, Prof ZHEN sees Hong Kong and London as the two most important centres. Regarding this issue, Prof Em questioned the relationships between Shanghai and Hong Kong. Prof ZHEN responded that it is unlikely for Shanghai to compete with Hong Kong throughout the reform. Yet, he accentuated that Shanghai will become the most important business centre in the long term, once the reform is done.

The last question concerned how the Chinese clearing system could become compatible with the international clearing system, not least the most widely used SWIFT (Society for Worldwide Interbank Financial Telecommunication) system. Some panels and audience members asked if there was reluctance on the Chinese side vis-à-vis the SWIFT system. Prof ZHEN answered that CIPS will barely pose challenges as they are two different systems.

Concluding Remarks

In conclusion, Mr FAMAEY summarised a few key points from the seminar. Revisiting Prof ZHEN's presentation, he underlined that the reform in China goes hand in hand with the internalization of the RMB, and that the liberalisation of the capital market will become a reality in the future. With respect to Prof Em PLASSCHAERT's speech, Mr FAMAEY noted the symbolic implications of the RMB achieving global reserve currency status, and that China should be aware of the concomitant risks. Last but not least, Mr FAMAEY accentuated China's activism in multilateral financial institutions.

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