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**Article**

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Weekly Report

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# Weekly Report

## Internationalization of the Chinese Renminbi: an opportunity for China

*China has taken first steps hinting at an internationalization of the Renminbi: The country has begun cautious action for opening up its capital account and allowed currency fluctuations within a certain limit between 2005 and 2008. Promoting Hong Kong as a test center for the Renminbi's internationalization is pointing in the right direction because it at least makes an offshore Renminbi market possible. Therefore, the silent re-pegging of the Renminbi to the US Dollar in 2008 was a step back.*

*Instead of binding the Renminbi again to a foreign currency, China should gradually enable more trade with the Renminbi. Independent monetary policy and free foreign currency trading are two key pillars of the modern financial world. Liberalizing the capital account is a gradual process and should go hand in hand with the establishment of a strong Chinese financial sector. As soon as this financial sector can absorb foreign capital in a flexible, independent way, the Renminbi stands a good chance to develop into an appreciated international currency.*

The integration of China into the world economy has added significantly to global growth. A number of countries benefit from this trend by exporting goods to China or importing Chinese capital to their home country. At the same time, China's economic expansion—linked to an export-oriented currency policy—has contributed to massive imbalances in the balance of trade, especially between China and Western countries. China's success as a driving force for the world economy leads to the question about the position of the Renminbi in global trade and capital markets. An international currency should enjoy world wide acceptance as a contractual trading currency, as a freely convertible unit of exchange and as a liquid store of value within a deeply developed financial market. That is currently not the case. Instead the Renminbi is hardly accepted for cross-border trade activities, is pegged to the US Dollar and non convertible. Though both, China and the West, consider the internationalization of the Renminbi as a necessary development, their reasoning is almost diametrical. China voices criticism in view of the current predominance of the US Dollar<sup>1</sup> in global trade and on the capital markets and suggests the Renminbi

<sup>1</sup> "Reform the International Monetary System" Zhou Xiaochuan, Governor, People Bank of China (PBoC), China's central bank, March 2009.

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**Table 1**  
**Hong Kong securities issued in Renminbi**

Date	Issuing institution	In bn of Renminbi
July 07	China Development Bank	5
August 07	China Export-Import Bank	2
September 07	Bank of China	3
July 08	Bank of Communication	3
August 08	China Construction Bank	3
August 08	China Export-Import Bank	3
September 08	Bank of China	3
July 09	Bank of East Asia	1
August 09	China Development Bank	3
August 09	HSBC	2
September 09	Ministry of Finance	6

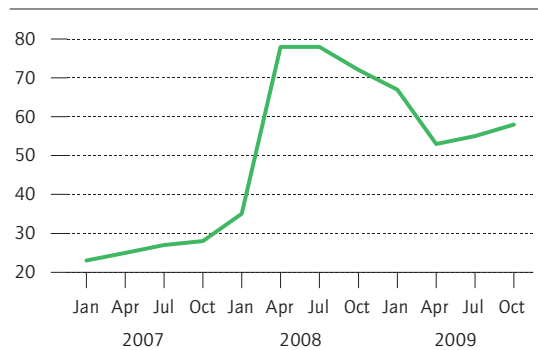
Source: Bloomberg

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**Figure 1**

**Hong Kong deposits in Renminbi**

In billions of Renminbi



Source: HSBC Global Research, October 2009; own calculations.

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as an alternative.<sup>2</sup> It hopes to reduce its dependency on the US Dollar as a means of exchange and store of value. In contrast, the West would welcome the internationalization of the Renminbi because this would entail a more flexible exchange rate system. The latter would, from the point of view of the West, contribute to combating international imbalance<sup>3</sup>.

Success of the Renminbi's internationalization strongly depends on China's strategy regarding its

<sup>2</sup> Statement of Wu Xiaoling, former Vice Director of PBoC, December 2008.

<sup>3</sup> In March 2010, US President Barack Obama declared that a stronger market-oriented Chinese currency system would be beneficial for the whole world.

capital account as well as its monetary policy. In this context, the Mundell-Fleming Trilemma is a quite useful concept: the assumption that a state cannot maintain free capital movement, monetary autonomy and fixed exchange rates all at the same time. According to this concept, only two of the stated goals can be achieved at a given point in time. This means for China: because of its independent monetary policy and the system of fixed exchange rates, China has to control the capital flows. If China opened up its capital account while sticking to fixed exchange rates, Chinese monetary policy would lose its effect. Until now, the Chinese central bank would raise interest rates in times of a strong economy in order to withdraw liquidity from the money market. But increasing interest rates coupled to constant exchange rates attract foreign capital inflow, which would increase domestic liquidity and limit the effects of its monetary policy. If China wants to lessen its dependence on the US Dollar and internationalize the Renminbi, it will need to accept free movement of capital. Foreign investors and exporters will continue to be reluctant to accept the Renminbi if options to use, exchange or invest in this currency remain as limited as has been the case so far. However, capital account liberalization requires a country to move away from a fixed currency regime. Asian countries that kept defending a stable currency while having an open capital account learnt this lesson painfully during the Asian crisis.

**Existing measures of capital account liberalization and internationalization of the Renminbi give the direction**

To date, China has opted for modest and simultaneous measures of capital account- and currency liberalization.

**Bilateral currency swap agreements**

China has signed bilateral swap agreements with countries such as Argentina, South Korea, Indonesia, Malaysia and Belarus allowing them to exchange substantial amounts of their own currency into Renminbi. The idea is to use China as a stabilizing anchor at times when their own currency is under strong selling pressure in the international financial currency markets.

**Cross-border trade financing**

China's state council is allowing more and more exporters and importers from Southern-Chinese prov-

incomes to settle their cross-border transactions with foreign corporates in Renminbi. At the same time, foreign banks can apply to become “participating banks” allowing them to open Renminbi accounts for their corporate customers in locations like Hong Kong or Singapore. The higher the bargaining power of Chinese corporates with their foreign business partners, the more Chinese corporates might press for settlement in Renminbi instead of US Dollar in order to avoid running currency risk. As Chinese companies grow, this could potentially be an important milestone on the way to internationalize the Renminbi.

### Hong Kong as test centre for Renminbi's internationalization

Hong Kong has been positioned by the Chinese government as a test centre for capital market activities in Renminbi. Certain banks in Hong Kong have the official authorization to issue interest-bearing securities in Renminbi, and Hong Kong residents as well as local banks may buy these securities (see Table 1). This act might contribute to creating an offshore capital market which could accelerate the liberalization of interest rates in the rest of China. While the general Chinese interest rates for Renminbi are set by the central bank, they are subject to market forces in Hong Kong and are used as reference by market actors. Hong Kong banks that invest in interest-bearing offshore securities in Renminbi profit from higher earnings of these long-term papers and, thus, are able to offer higher interest rates for Renminbi deposits than banks in the rest of China. This makes deposits in Renminbi more attractive and generates positive interest margins for banks (see Figure 1). So-called “non-deliverable forwards” (NDF) are also offered. These forwards are traded in Dollars and define the forward price of the Renminbi. This way they indirectly enable the calculation of Renminbi money market interest rates on the offshore capital market.

### Renminbi use by the IMF

The Chinese central bank and the International Monetary Fund (IMF) have agreed in 2009 that China may use Renminbi for buying special drawing rights. The main advantage for China is to increase its influence on the IMF. As a second—and in the context of internationalization more important—consequence, the Renminbi is establishing itself with a powerful international organization who can now use its Renminbi reserves for granting loans to developing countries in need. These countries can then buy Chinese products or commodities for

**Table 2**  
**Changes in foreign currency reserves in Q4 2009 in billions of US Dollars**

Position	Bn US Dollars
Changes of foreign currency reserves	128
thereof:	
Exchange rate profit from foreign currency reserves <sup>1</sup>	0
Earnings from foreign currency reserves <sup>2</sup>	11
Trade surplus	61
FDI	26
Potential speculative capital inflow	30

<sup>1</sup> Small change from Renminbi to US Dollar, Euro and Yen.

<sup>2</sup> 1.8% p.a. (Estimation based on 2,399 bn US Dollars of foreign currency reserves); It is assumed that 48 per cent of foreign currency reserves are invested in interest-bearing securities with an average maturity of 5 years and 52 per cent in low-yielding securities with short maturity (currency distribution: 70 per cent US Dollar, 30 per cent other currencies).

Sources: Bloomberg, own calculations.

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Renminbi. These transactions further strengthen the international Renminbi influence.

### Capital inflow

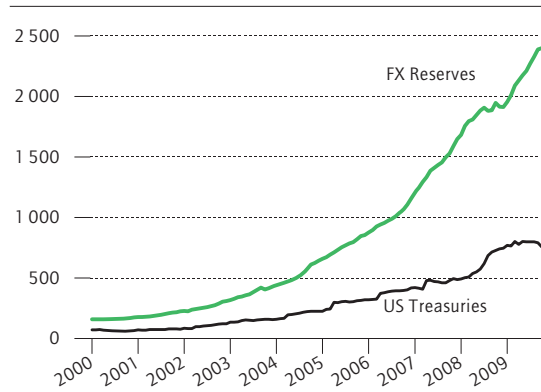
Until now, the Chinese government used to prefer capital inflow against capital drain. It welcomed capital inflow in the framework of foreign direct investment (FDI), cross-border trade settlements in Renminbi, repatriation of foreign earnings from Chinese corporates, “Qualified Foreign Institutional Investor scheme” (QFII)<sup>4</sup> and as money transfers by Chinese expatriates. However, due to the perceived undervaluation of the Renminbi, market participants might use these channels of capital inflows rather to set up currency positions in order to speculate on a future appreciation of the Renminbi than to use these funds for productive investments. This could result in a large sum of accumulated speculative funds. In the fourth quarter of 2009, China's foreign currency reserves rose by 128 billions US Dollars. It can be argued that of this amount 30 billions US Dollars or 20% are speculative inflows (see Table 2). Not included in this number is potentially speculative capital inflow which was brought to the country as part of foreign direct investment.

<sup>4</sup> In the QFII framework authorized foreign investors are allowed to buy A-shares traded in Renminbi in China.

Figure 2

**China's foreign currency reserves and holding of US government bonds in bn US Dollars**

March data



Source: Bloomberg, own calculations.

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Figure 3

**Cost of sterilization of capital inflows**

Calculatory yield difference between US and Chinese government bonds with short-term maturities



Source: Bloomberg, own calculations.

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**China's re-pegging of the Renminbi is a step backwards with regards to internationalization**

For many years, the Renminbi was pegged to the US Dollar at an exchange rate of 8.28 Renminbi to the US Dollar. Even during the Asian crisis in 1997/98, China held the exchange rate stable and did not allow to weaken in an already fragile financial environment. With this decision China avoided that the Asian financial crisis spread to its own economy.

Finally the Chinese government decided in 2005 to replace the connection to the US Dollar by a link to a currency basket.<sup>5</sup> At the same time, the Peoples Bank of China (PBoC) agreed to daily fluctuations of 0.3 per cent (of 0.5 per cent from 2007 onwards) in relation to the US Dollar and introduced currency derivatives in Renminbi.<sup>6</sup> All banks, including foreign banks, are since then permitted to acquire licenses to trade currency derivatives, such as Renminbi currency forwards and swap contracts. However, in July 2008 after the Renminbi appreciated by 21% since 2005 against the US Dollar, the Chinese authorities silently re-introduced the US Dollar-peg, effectively pegging the Rinminbi at 6.828. The decision to move back to a fixed currency was taken after the US property crisis developed into the global financial crisis. The most important reasons for this action were probably the stimulation of Chinese exports and the protection of the Chinese economy from extreme currency fluctuations. Furthermore, China may have wanted to again assume the role of a stabilizing anchor it had already played during the Asian financial crisis. However, re-introducing the US Dollar-peg meant a major step backwards with regards to internationalizing the Renminbi. Besides, risking the reputation of China's efforts to establish the Renminbi internationally, market participants can be attracted to one way bets on one-time re- or devaluations of the Renminbi. In addition, an undervalued Renminbi can give protectionist movements, specifically in the US, renewed political support.

**Cost of sterilization of capital inflow**

Since the Chinese accession to the World Trade Organization in 2001, China has generated significant trade surpluses in US Dollar month after month with its export-oriented growth strategy (see Figure 2).

Chinese exporting companies want to exchange their US Dollars into Renminbi, which puts even more revaluation pressure on the Chinese currency. To alleviate this pressure, the Chinese central bank keeps buying US Dollars for Renminbi at the official exchange rate. But because of these transactions the Renminbi volume circulating in the domestic monetary system is expanding. In order to combat the massive increase of the amount of money in circulation and its inherent danger of inflation, the Chinese central bank contains Renminbi liquidity by issuing governments bonds with short maturity and,

<sup>5</sup> Known as "managed floating" currency regime. This basket includes the currencies of the following countries: USA, EU, Japan, South Korea, Malaysia, Singapore, Russia, Australia, Thailand, Canada and the UK.

<sup>6</sup> 3% against non-US Dollar currencies.

thus, sterilizes capital inflow. In consequence, the Chinese central bank's balance shows comprehensive investment in US government bonds as assets and governments bonds in Renminbi as liabilities. This way the Chinese central bank not only takes on the exchange rate risk for fluctuations between Renminbi and US Dollar, but also the cost amounting to the difference between US and Chinese interest rates (see Figure 3).

At the moment the cost for sterilizing capital inflows is running at around 1.5% of the US government bond holdings of the PBoC. Since the Chinese central bank's balance shows a total portfolio of US government bonds of around 800bn US Dollars, annual costs could potentially reach about 12bn US Dollars. Any interest increase by the PBoC would reinforce this trend even more.

### Loss of control over the monetary policy

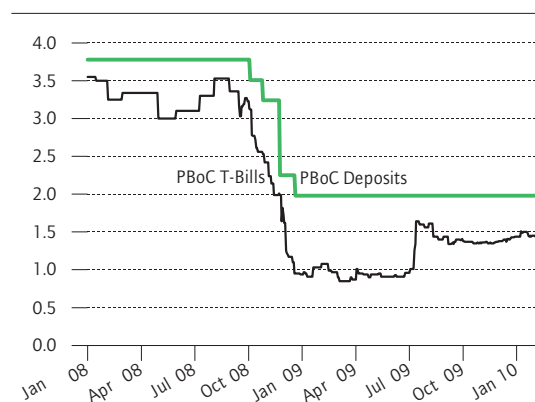
By sterilizing capital inflows, the Chinese central bank has de facto lost control over its own balance sheet and allows its monetary policy to be dominated by the government's currency policy. By absorbing more and more US Dollar inflows, the PBoC is passively enlarging its balance sheet, buying US Dollar assets and generating Renminbi liabilities. At the same time, domestic banks which are the link for the corporate sector to the PBoC are obliged to run deposits for clients at a loss. Interest rates in China are not liberalized but are given within a band by the PBoC (see Figure 4).<sup>7</sup> This applies to interest Chinese banks pay their clients for deposits in Renminbi as well as to interest on deposits at the Chinese central bank and their government bonds. Because deposits with the Chinese central bank—just as its government bonds—generate less profit than deposits at commercial banks, Chinese banks lose money in their funding business, thus having to absorb part of the costs for sterilizing capital inflow. Basic functions of domestic banks and the monetary policy of the PBoC therefore seem to be compromised by being dependent on the government's currency policy. As long as there is no modern Chinese financial sector where interest rates are set freely by commercial banks and where monetary policy is independently controlled by the central bank, foreign investors will not overcome their reservation against the Renminbi as an international currency.

If China moved to a more freely floating Renminbi currency regime, the above mentioned costs could be reduced or even avoided. Protectionist movements would lose their main argument of currency

<sup>7</sup> The maximum interest rate banks are allowed to offer is determined by the Chinese central bank (currently about 2%).

Figure 4

### Interest rates of the PBoC in %



Source: Bloomberg

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manipulation, sterilization costs could be reduced as an appreciating Renminbi would make Chinese exports less attractive. Capital inflows in US Dollar would be held up<sup>8</sup>, and the Chinese central bank could regain control over its monetary policy.

### Timeline and order of steps to internationalization—lessons learned from other Asian countries

Sooner or later, China will have to decide on a specific time and order of measures for liberalizing the capital balance and creating a flexible currency system which may finally lead to the Renminbi's internationalization. Experience from the Asian crisis and the speculative bubble in Japan suggests to keep control over capital flow in the beginning and slowly move towards flexible exchange rates.

#### The Japanese crisis

During the 1960s and 70s, Japan was in a similar position as China today. Just like China, Japan was experiencing a time of strong economic growth. At the time, Japanese financial markets were strictly regulated, and interest rates were centrally set by the Ministry of Finance. During these decades Japan generated an increasing trade surplus, mainly with the US. Because of this surplus and the amount of US Dollar reserves Japan had accumulated during the 80s, the US urged Japan to a revaluation of the

<sup>8</sup> The draft 5-year plan for 2011-2015 mentions as most important goals less dependence on exports and fixed investments and strengthening of domestic consumption, among others (according to a person involved in the drafting process, 19/01/2010).

Yen in relation to the US Dollar. In 1985, the US Dollar was depreciated in a concerted action of the biggest economies worldwide (Plaza Agreement)<sup>9</sup> and the Yen revalued by 50%. However, in contrast to China today, Japan had already liberalized its capital account, allowing free in- and outflow of capital. The result was an enormous capital inflow to Japan because foreign investors wanted to have a share in the Japanese boom and speculated on an appreciation of its currency. This capital flow increased the amount of money in circulation and kept domestic interest rates artificially at a low level. Cheap money caused prices for real estate and other assets to go up until the bubble finally burst at the end of the 1980s. The following credit crunch was so devastating that even today, 20 years later, Japan still has to cope with its effects like low growth, high public debt and a cautious economic climate.

### The Asian financial crisis

Also the South-Eastern Asian States had liberalized their capital account during the 1990s. Their economies were booming and generated high return on investments. Large sums of foreign capital flowed to these countries. National authorities tried to control their currency systems in order to avoid strong revaluations which could have harmed their exports. The capital inflow resulted in speculative bubbles on the stock and real estate market. When the bubble burst in 1997, capital flow went in the opposite direction because the foreign capital was immediately withdrawn from the concerned countries. The sudden capital drain caused a heavy debt crisis and a weakening of the currencies. The central banks fought for a stabilization of their currencies and used their hard-earned foreign currency reserves for interventions on the currency markets. As currency reserves were dwindling at high pace, the central banks began to substantially hike interest rates in order to keep foreign investors. But the high interest rates dragged the Asian economies even deeper into the recession so that these countries finally had to ask the IMF for help.

Both crises were characterized by the fact that significant amounts of foreign capital could flow to the booming states because their capital account was already liberalized. Instead of supplying funds to emerging economies, foreign investors were more interested in speculating for short-term revaluation. This enormous capital inflow increased the amount of money in circulation and reinforced the local

credit boom. The central banks' monetary policy proved inefficient, and the reputation of the currencies concerned was damaged for years.

### Conclusion

China has taken first steps hinting at an internationalization of the Renminbi: The country has begun cautious action for opening up its capital account and allowed currency fluctuations within a certain limit between 2005 and 2008. Promoting Hong Kong as a test center for the Renminbi's internationalization is a step in the right direction because it at least makes an offshore Renminbi market possible. In the current situation, China should prioritize a flexible currency system rather than a liberalized capital account. The continuing control of capital flow prevents the inflow of large sums of speculative capital to China which might have destabilizing effects on the Chinese economy and currency. But steps towards a more flexible currency system would help alleviate the risk of protectionist setbacks, lessen the burden caused by the sterilization of capital inflows and guarantee the PBoC control over its monetary policy. In this sense, the silent re-pegging of the Renminbi to the US Dollar in 2008 was step back. Instead of binding the Renminbi again to a foreign currency, China should gradually widen the trading band. This would give market participants time to get used to flexible exchange rates, and it would support building up a financial infrastructure for foreign exchange trading. Also, Chinese banks and companies would be less inclined to underestimate the foreign currency risk in their balances if they had to deal with exchange rate risks. Independent monetary policy and free foreign currency trading are two key pillars of the modern financial world. Liberalizing the capital account is a gradual process and should go hand in hand with the establishment of a strong Chinese financial sector. As soon as this financial sector can absorb foreign capital in a flexible, independent way, the Renminbi stands a good chance to develop into a respected international currency.

<sup>9</sup> So-called because the agreement was signed in the Plaza Hotel in New York. Signatories were the USA, Japan, West Germany, France and the UK. The Dollar was depreciated in relation to the Yen and the Deutsche Mark.

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