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Understanding China's Renminbi Strategy: The Two-track Road To RMB Internationalization

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<p>The People's Republic of China overtook United States as the world's largest economy the first time in 2014 based on purchasing power parity. It is the largest trading nation and the largest holder of foreign reserves, the bulk of it being United States dollars. The PRC needs a currency with international status to match its economic status in the world economy.</p> <p>What China is trying to do is unprecedented. It is the first time an emerging country seeks to establish a truly international currency where there is no link, even residual, between the reserve currency and gold. This means China's attempt does not follow a clear pre-defined road map. The chosen strategy follows a two-track road: the use of RMB in cross-border trade settlement and the creation of an RMB offshore market. Essentially, this strategy was chosen because it allows China to maintain a closed capital account, although state officials have claimed that eventually the capital account will be opened.</p> <p>China has never published a formal policy document to outline the RMB internationalization program. This means that understanding the motivation behind the internationalization requires further investigation. The most apparent reason why China activated RMB internationalization reforms in 2009 is the response to US dollar overdependence after the Global Financial Crisis. China still remains the number one foreign holder of US Treasury securities, in the long-term, RMB internationalization is believed to help China escape the dollar trap.</p> <p>From a political economy point of view, having an international currency and being added to the International Monetary Fund's Special Drawing Rights, is a symbol of status for China. Now China's relations with the world have entered a new stage, where China is actively trying to participate in the making of international rules.</p>	
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List of abbreviations

ASEAN Association of Southeast Asian Nations
ASIFMA Asia Securities Industry & Financial Markets Association
CNH offshore RMB (market)
CNY onshore RMB (market)
EU European Union
FDI foreign direct investment
FX foreign exchange (market)
GFC global financial crisis
HKMA Hong Kong Monetary Authority
IMF International Monetary Fund
IMS international monetary system
ODI overseas direct investment
OECD Organization for Economic Cooperation and Development
PBoC People's Bank of China
PPP purchasing power parity
PRC People's Republic of China
RMB renminbi
SAR Special Administrative Region
SDR Special Drawing Rights
UK United Kingdom
US United States of America
USD United States dollar

1 Introduction

China has developed into a world economic giant, overtaking US as the world's largest economy (based on purchasing power parity¹) in 2014, first time since starting market reforms in 1978². The economic growth of China has been on average 10% annually since the market reforms up to 2014, making it one of the world's fastest growing economies. (Morrison 2015)

The idea of RMB internationalization was triggered by Chinese leaders' concerns over excessive dependence on the United States dollar (USD), especially after the global financial crisis (GFC) that unfolded in 2008. China wants to be part of reforming the international monetary system (IMS) by integrating its own currency into the global economy to balance the power of the USD. Several other reasons play a role in the goal of an international currency, for example the fact that RMB's status does not match that of China's economy.

Many questions arise from China's efforts to make the RMB an international currency. The first being, what is the motivation behind RMB internationalization and what is the strategy for achieving the goals – is it based on market forces or government strategy? A political economy background is important to understand China's view on US dollar dominance and RMB underutilization despite being the largest economy and trading nation in the world. China's RMB strategy is based on two tracks: the use of RMB in cross-border trade settlement and the creation of an RMB offshore market. What China is trying to do is unprecedented: it is the first time an emerging country which seeks to establish a truly international currency where there is no link, even residual, between reserve currency and gold. (Subacchi 2010) The offshore RMB markets have a special

¹ PPPs are the rates of currency conversion that equalize the purchasing power of different currencies by eliminating the differences in price levels between countries. The major use of PPPs is as a first step in making inter-country comparisons in real terms of gross domestic product (GDP) and its component expenditures. GDP is the aggregate used most frequently to represent the economic size of countries and, on a per capita basis, the economic well-being of their residents. Calculating PPPs is the first step in the process of converting the level of GDP and its major aggregates, expressed in national currencies, into a common currency to enable these comparisons to be made. (OECD 2015)

² China's economic reform process began in December 1978 when the Third Plenum of the Eleventh Central Committee of the Communist Party adopted Deng Xiaoping's economic proposals. Implementation of the reforms began in 1979.

role in China's pursuits, especially focusing on the importance of Hong Kong as a strategic partner. The admittance to the Special Drawing Rights (SDR) basket of reserve currency seems to be an important milestone for China. (The Economist 2015) The International Monetary Fund (IMF) approved RMB as a reserve currency in November 2015.

Although China has set a goal of RMB becoming an international currency, no official timetable has been announced. This means China is taking a gradual approach to achieving its policy goals, utilizing the unique relationship with Hong Kong and other offshore hubs to test the markets before fully liberalizing its own financial market.

1.1 Objectives

China's attempts to internationalize the renminbi (RMB) have significant implications for the international monetary system and economies across the world. This thesis aims to give an overview of China's renminbi strategy, focusing on the two tracks: the use of RMB in cross-border trade settlement and creation of an RMB offshore market. This paper analyses the unique strategy of the Chinese Government and attempts to understand the motivation behind RMB internationalization. The objective of this study is to identify the true intentions behind China's RMB strategy from both historical and political points of view, and to provide an understanding of the macroeconomic and financial implications that arise from it. This study can provide a basis for further research about various topics, for example the competition between Asian financial centres and how the widespread use of RMB can help them develop new business areas. Furthermore, how is the RMB internationalization policy affecting China's goal for Shanghai to become an international financial centre by 2020³.

1.2 Research Question

The aim of the research is to find out how has China's renminbi strategy developed. The first chapters serve as an introduction to the topic. Chapter 2 gives an overview of the renminbi, chapter 3 defines the concept of international currency. The thesis is then

³ In the spring of 2009, China's State Council announced its plans to transform Shanghai into an international financial center by 2020. Currently that role (among Asian countries) is held by Hong Kong.

divided into two parts: The first part (chapters 4, 5, 6) explores *how* China plans to achieve RMB internationalization, given its unprecedented status and lack of a clear road map. The second part (chapter 7) tries to understand *why* RMB internationalization is an important policy goal for China. The research question is: **How does China plan to internationalize the RMB and what is the motivation behind it?** This research will provide a clear understanding of the actions by the Chinese Government, supported by the political economy analysis and the events in the global financial system that led to adopting this strategy. In order to answer the main research question, a series of sub-questions will function as a guideline in the investigation:

- What are the characteristics of an international currency? Does China meet the requirements for becoming an international currency? Why did China want RMB to be admitted to the International Monetary Fund's Special Drawing Rights?
- What is the role of the Global Financial Crisis in China's currency policy development? How has the perception of globalization changed after the GFC? Is China's strategy a signal of national protectionism of its own economy, while executing internationalization on its own terms?
- What political signals is China giving to the rest of the world? Has it started to challenge the United States and is it seeking greater influence on the world economy?

1.3 Methodology

This thesis is an exploratory study based only on secondary research. Exploratory research is a suitable methodology for this type of research that aims to understand and give insight about certain situations or problems. The focus is on gaining familiarity about the subject, to be able to analyse and explain why or how something is happening. In this case: how is the RMB internationalization happening, the reasons for the chosen strategy, and moreover, the motivation to achieve such a policy goal. Conducted in order to determine the nature of the problem, exploratory research is not intended to provide conclusive evidence, but helps us to have a better understanding of the problem. (Saunders et al. 2007:134) The research relies on secondary data from relevant literature.

1.4 Limitations

As the chosen methodology implies, the aim is to explore the research question and does not intend to give a final and conclusive solution to an existing question. This research can be used as a basis for more conclusive research. The topic of the thesis is current and evolving over time, which means new information will be emerging, allowing new discoveries in addition to the existing framework. The findings in this paper are not meant to provide a basis for decision making, but rather a guideline for further investigations in the future. The Chinese Communist Party has announced that by 2020 the country will become a “moderately prosperous society in all respects, and by 2049, when the People’s Republic of China marks its centennial, the country aims to be a modern socialist country that is prosperous, strong, democratic, culturally advanced and harmonious.” (Xi - Xinhua, 2014) What it actually means in economic terms, is still subject to discussion, allowing further predictive research and analysis.

2 The Renminbi

The renminbi - abbreviated RMB - is the official currency of the People's Republic of China. The name literally means "people's currency" in Mandarin. It was first issued in December of 1948 with the establishment of the People's Bank of China (PBoC), who acts also as the monetary authority of China. The ISO code for renminbi is CNY (an abbreviation for "Chinese yuan"), or CNH when traded in offshore markets (Appendix 1). The symbol for renminbi is the same as for the Japanese yen, ¥.

Yuan is the unit of account, which means the currency is denominated in 1 yuan, 2 yuan etc. The paper money also comes in smaller denominations like fen and jiao. One yuan equals 10 jiao, which equals 100 fen.

As of 2013, the renminbi is convertible on current accounts, but not capital accounts. China is concerned that the mainland financial system would be exposed to too much volatility if the capital account was fully opened. As a result, the currency trades with a narrow band specified by the Chinese central government. Until 2005, the renminbi was pegged to US dollar, now it has moved to a managed floating exchange rate based on a basket of currencies, not just the US dollar.

It was a calculated political move to balance external pressures and internal constraints. China has taken an interventionist policy to the currency market, which can be used to favour Chinese producers and exporters. The United States government has argued that RMB is significantly undervalued against the dollar and that has been a major contributor to the large annual US trade deficits with China and a significant decline in US manufacturing jobs in recent years. (Yi, 2005) But the value of the renminbi has steadily risen since the exchange rate was restructured in 2005, it gained 33% against the dollar in a 10-year period (Gu, 2015) The US put China, among Japan, Germany, South Korea and Taiwan, to a new currency watch list, which monitors if their foreign exchange (FX) practices provide an unfair advantage over America. The US dropped its view that China's currency is significantly undervalued, saying the Chinese yuan should continue to experience real appreciation over the medium term. (Mayeda, 2016)

The exchange rate is one of the most important determinants of a country's relative level of economic health. Exchange rates play a vital role in a country's level of trade, which is critical to any country that participates in international trade. The exchange rate of the

renminbi is not only a relative price between domestic and foreign goods and services, it also serves as an indicator of the value of the currency. The renminbi is used as a store of value by the Chinese citizens, so to keep the public confident in the renminbi, it should not appear to lose value against other currencies.

For this reason, China is keeping a tight control over the exchange rate, not allowing it to become a freely floating exchange rate. The goal of Chinese foreign exchange policy in the short and intermediate runs is to help maintain and support Chinese economic growth by promoting international trade and investment while at the same time minimizing the sensitivity and vulnerability of the Chinese economy to external disturbances and preserving autonomy in Chinese macroeconomic policies. In general, fluctuations in the foreign exchange rate discourage long-term cross-border investments as well as trade arrangements. Chinese exchange rate management aims at achieving a stable and sustainable long-term equilibrium in the supply and demand of foreign exchange, driven by the relative rate of inflation as well as changes in relative productivity, so that relative competitiveness may be maintained. (Lau, 2003)

3 The Concept of International Currency

An international currency is one that is commonly used outside of a domestic country's currency. All or part of its function — the classic three functions of money (unit of account, medium of exchange and store of value) — can be transferred to the international level. This concept based on monetary function was defined by Benjamin J. Cohen (1971) and refined by Peter Kenen (1983) into six combinations comprised of three functions of international currency in private and public transactions. These functions are summarized in Table 1 by Alex He (2015).

Table 1. Roles of an international currency

Function of Currency	Governments	Private actors
Unit of account	Anchor for pegging local currency	Denominating trade and financial transactions
Medium of exchange	Vehicle currency for foreign exchange intervention	Invoicing trade and financial transactions
Store of value	Foreign exchange reserves	Investment on financial assets

Data source: Kenen (1983) and Frankel (2011).

Economic and political determinants together define the concept of an international currency. Alex He (2015) in his research found that the fundamental determinants of international currency status are economic size, confidence in the currency and depth⁴ of financial markets. In his study, he points out that the existence of well-developed and open financial markets are a prominent economic attribute of an international currency. For example, full development of the US financial markets after the creation of the Federal Reserve in 1913, as well as London's financial markets in the 19th century, laid the foundation for the rise of the dollar and pound, respectively, as international currencies. In contrast, the tightly regulated financial markets in Japan and Germany were frequently referred to as the principal obstacles of the internationalization of the yen and the Deutschmark. Helleiner (2008) claims that political agencies can play a role in the construction of financial systems that support international currency leadership. An

⁴ A deep market has a large volume of available financial instruments in specific markets

example of this is the creation of the Federal Reserve System which helped boost the USD's international role.

Based on the conditions discussed above, one can argue that the RMB certainly has the potential to evolve into a major international reserve currency. Its capacity to do so is underscored by the size of China's economy, current account surplus and accompanying expectations for RMB appreciation. However, the full development of financial markets (characterized in particular by depth, liquidity⁵, dependability and openness), which China lacks, constitutes an indispensable precursor for an international currency. Furthermore, by the criteria of liquidity, breadth⁶ and openness, Chinese financial markets still have a long way to go before they catch up to those of other major currencies (Frankel, 2011).

In 2011, the RMB was world payments currency number 21, with a 0.24% share of payments value, while China's share in world trade was 11.4% in 2010. These figures show a clear underutilization of the RMB in relation to China's economy. (SWIFT, 2011). In 2015, the RMB entered the top five of world payment currencies, overtaking both the Canadian dollar and the Australian dollar by value, it now takes position behind the Japanese yen, British pound, Euro and US dollar. Overall, global RMB payments increased in value by 20.3% in December 2014, while the growth for payments across all currencies was 14.9%. (SWIFT, 2015)

3.1 Special Drawing Rights

The Special Drawing Rights (SDR) were created by the International Monetary Fund (IMF) in 1969 as a supplementary international reserve asset. The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: first, through the arrangement of voluntary exchanges between members; and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions. In addition to its role as a supplementary reserve asset, the SDR serves as the unit of account of the IMF and some other international organizations. Currently, the SDR basket consists of

⁵ Liquidity of a financial market reflects a high level of trading volume turnover

⁶ Breadth shows the availability of a broad range of financial instruments, including markets for hedging risk

the United States dollar, the European Union's euro, Japanese yen, and pound sterling of the United Kingdom. China was admitted in the basket in November 2015. Effective October 1, 2016, the basket will be expanded to include the Chinese renminbi. The weight of the currency is based on the value of the issuers' exports, the amount of reserves denominated in the respective currencies that were held by other members of the IMF, foreign exchange turnover, and international bank liabilities and international debt securities denominated in the respective currencies. The respective weights of the US dollar, euro, Chinese renminbi, Japanese yen, and pound sterling are 41.73 percent, 30.93 percent, 10.92 percent, 8.33 percent, and 8.09 percent (IMF, 2015).

Previous to the IMF's decision becoming finalized, there was a lot of debate whether the RMB fulfils the two criteria set by the IMF. The issuing country must be a major exporter, and the currency must be freely usable. No one disputes that China meets the first criterion. Over the past five years, its exports averaged 11% of the global total. That places it behind the European Union and America but well ahead of Japan and Britain (Economist 2015). The second criteria is that the currency must be freely usable, which was the source for debates. If freely usable is understood as fully convertible, the yuan would not make the grade. China places caps on how much cash its residents can take out of the country; forces international companies to do extensive paperwork before bringing large sums in; and limits foreigners to strict quotas for investing in its capital markets. (Economist 2015) Many, however, expected the IMF to massage its rules and to make an exception for China. The world's coming economy has already fostered a host of offshore RMB centers, from Hong Kong and Singapore to London and Frankfurt. Foreign corporates have raised debt in the currency, while institutional investors' appetite for assets held onshore in RMB grows by the year. (GlobalCapital, 2015)

The IMF's decision will help pave the way for broader use of the renminbi in trade and finance, securing China's standing as a global economic power. Many central banks follow this benchmark in measuring their reserves, which countries hold to help protect their economies in times of trouble. By adding the renminbi to this group, the IMF effectively says that it considers the currency to be safe, reliable and freely usable. The designation is a point of pride for Beijing, which had made it one of its highest economic policy priorities. The renminbi's new status "will improve the international monetary system and safeguard global financial stability," President Xi Jinping of China said in mid-November of 2015. (Bradsher, 2015)

Chovanec (2015) argues that it doesn't matter if China is included in the SDR, it's not going to be a financial or economic game-changer, but a political gesture. Any country that wants its currency to actually function as an international reserve must supply the rest of the world with claims in that currency, either by running trade deficits or by providing large amounts of aid or investment capital. Until now, at least, China's development model has been based on precisely the opposite: running trade surpluses and attracting foreign investment. In the process, rather than exporting its own currency, it has imported an astonishing \$4 trillion (down to of \$3.23 trillion in January 2016) in other countries' currencies, which it holds as central bank reserves.

China has been recording a consistent trade surplus since 1995, which increased 10 times from 2004-2009. China's trade surplus came in at USD 29.86 billion in March of 2016, up significantly from a USD 3.08 billion surplus reported a year earlier. (Trading Economics, 2016) Figure 1 shows the changes in China's balance of trade in a 10 year period.

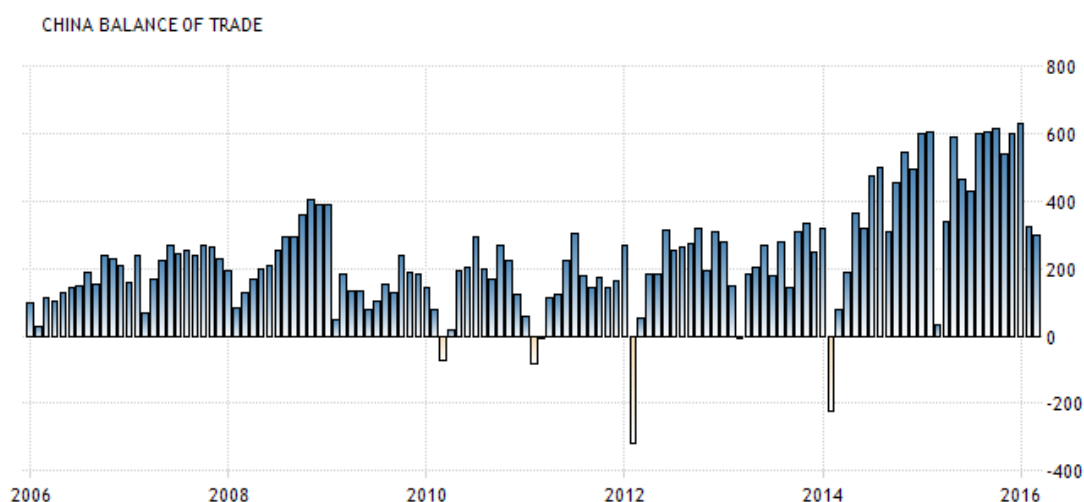


Figure 1. China Balance of Trade (Trading Economics, 2016)

As a non-OECD (Organization for Economic Cooperation and Development) country, China's growing foreign aid has been having a significant impact on the landscape of the global development community. Chinese foreign aid has become a formidable alternative to existing Western aid. Although China has been involved in regional financial cooperation for the last 15 years, its recent minilateral initiatives (explained further in chapter 7.1), such as the New Development Bank, the Contingent Reserve Arrangement and the Asian Infrastructure Investment Bank, are far more China-centred, showing a shift towards a more activist foreign policy. (Wang, 2014) These developments

support the view that China is strengthening its position in Asia, experimenting with regionalization before pushing for a more international strategy (explained further in chapter 5.1). China provided 89.34 billion RMB (about \$14.4 billion) in foreign assistance through grants, interest-free loans, and concessional loans in the three-year period from 2009-2012, making it the world's 10th largest donor. (Taidong, 2014) China's cumulative foreign aid between 1949 and the end of 2009 was 256.29 billion RMB (around US\$43 billion using the exchange rate of 2009). This means that more than a quarter of the aid provided by China from 1949 to 2012 happened during the last three years of that period. (Sun, 2015) Africa and Asia remain the two largest recipient regions of China's foreign assistance. Just over half of the aid, 51.8 percent, went to Africa, a 6-percent increase from 2009, while 30.5 percent of aid went to Asia, a 2-percent drop from 2009. It is also interesting to note that the share of China's aid to Europe has increased from 0.3 percent in 2009 to 1.7 percent for the three-year period. Given the limited number of developing countries in Europe, this is a rather large increase. (Taidong, 2014)

4 China's Ambitions for an International Currency

China has come a long way since initiating economic reforms in the late 1970s, and is now a key player on the international stage. China's economic growth has been on average 10% annually since the market reforms up to 2014, making it one of the world's fastest growing economies. It even overtook US as the world's largest economy (based on PPP) in 2014. China became the world's largest exporter of goods already in 2009, overtaking Germany. China became the world's largest trading nation in 2013, overtaking the United States. (Monaghan, 2014) It is also holds the largest share of foreign exchange reserves of \$3.23 trillion in January 2016 (down from \$4 trillion the year before), more than double Japan's, which has the world's second largest amount. (Bradsher, 2016) Yet, the currency does not reflect such a prominent role.

Key countries in international trade tend to use their currency to invoice and price transactions, as was the case for Great Britain when it controlled 30% of the world exports in the pre-World War I period (Eichengreen, 2005: 4), and is the case for the United States nowadays, as 95% of US exports are invoiced in dollars. (Goldberg and Tille, 2005: 19). The extensive international use of the dollar also supports the development of dollar-denominated banking and financial instruments, both onshore and offshore. China's lack of international currency keeps it from benefiting from gains that are associated with the use of a country's own currency in international trade. It also creates a mismatch on China's international balance sheet, between liabilities that are typically denominated in RMB and claims on foreigners which are typically denominated in major reserve currencies, in particular the dollar. China suffers from over-reliance on the dollar, with the risk of excessive exposure to liquidity shortages within the world economy and the consequent reduction of trade finance. This was the lesson learnt from the 2007–08 financial crisis. (Subacchi, 2010)

The Government of China has not revealed its strategy or even publicly addressed the process of internationalization. In the case of China, internationalization follows the model of gradual and manageable approach, which they have been using since they started the market reforms. What China is doing to develop the RMB into an international currency is unprecedented, it is the first emerging country that seeks to establish a truly international currency. This means China does not have a road map or any previous experience to rely on. From past examples, most countries had fully developed before starting the currency internationalization, they had convertibility and an open capital

account before their currency became internationally used, not the other way round. China is the first country attempting the internationalization of its currency in the era of true fiat money where there is no link, even residual, between the reserve currency and gold. This means that the RMB has to 'go head to head' with the dollar; its credibility cannot be established by comparing the convertibility of both currencies to gold, as had happened when the dollar took over from sterling. The RMB can only be compared to the dollar, i.e. to the incumbent reserve currency itself. Establishing credibility and an international reputation for the RMB, and making it acceptable in those parts of the world economy where the dollar dominates, will take years. The People's Bank of China (PBoC) is well aware of the difficulties inherent in the internationalization of the RMB, and this is why Beijing is cautious in assessing the chances of success and is trying to avoid creating expectations that are too high. (Subacchi, 2010)

China is set to internationalize the renminbi through the liberalization of the current account, without opening the capital account (Appendix 2). Yet China has taken important steps to expand access to its domestic capital markets, indicating that an open capital account is a possibility in the future. According to PBoC governor Zhou Xiaochuan, the capital account convertibility China is seeking to achieve is not based on the traditional concept of being fully or freely convertible. Instead, drawing lessons from the global financial crisis, China will adopt a concept of managed convertibility. (Wildau, 2015) China is tackling an economic phenomenon called the impossible trinity⁷, which means a government can only control two out of the three factors at the same time: a fixed exchange rate, independent monetary policy, and an open capital account. (Figure 2)

⁷ Also called "the unholy trinity" and the "trilemma". Popularized by economists Robert Mundell and Marcus Fleming in the 1960s.



Figure 2. The Impossible Trinity (source: Kinsella, 2009)

No country has managed to have all three, all attempts in the past have ended in disaster⁸. China is trying to adopt a partial variation of the impossible trinity to allow all three conditions to exist at the same time by having a limited independence of monetary policy, strongly managed exchange rate and partially open capital account. Only time will tell if China is able to solve an economic puzzle that no one ever has before.

An open capital account and a deep and liquid capital market are clearly important to the Chinese authorities, but how to achieve it is less clear. The attempt to create an international and eventually fully convertible currency through a policy-driven process is unprecedented – nothing like this has ever been tried before, even partially. Beijing is openly aware of the fact that there is no road map to guide this process. From the economic perspective, the Chinese Government does not follow the ‘normal’ way to achieve currency internationalization, but uses a different approach. In 2009, the people’s Bank of China (PBoC) piloted reforms through cross-border trade settlements and establishing offshore RMB markets, while the domestic financial system was still

⁸ The Mexican peso crisis (1994-95), the 1997 Asian financial crisis and the Argentinean financial collapse (2001-02) are examples of crises caused by violations against the impossible trinity.

strictly regulated by the government. (See Appendix 3 for a timeline of reforms initiated by PBoC). China proceeds with the strategy to internationalize their currency with the two-track road. Past experience (Japanese yen⁹ and the euro in Germany¹⁰) does not seem to support this strategy. Indeed, it suggests the opposite: a fully open capital account and a fully convertible (Appendix 4) currency are necessary step towards currency internationalization. There is no extensive discussion on drawing a road map for currency internationalization, therefore, China cannot have a viable predetermined road map. This does not mean that China's strategy is fundamentally flawed. He and McCauley (2010) draw on the evidence of the Eurodollar¹¹ market in the 1960s and 1970s to argue convincingly that full capital account liberalization is neither necessary nor sufficient for substantial offshore use of a currency. Significant controls on capital by the US authorities from the 1960s to the early 1970s did not undermine the international role of the dollar and in some ways even gave a boost to the Eurodollar market. (Subacchi & Huang, 2012) The Eurodollar markets developed after 1957, when the dollar trade in London increased markedly and the British court had to decide how to deal with it. Surprisingly, the court concluded that the Eurodollar market was not subject to UK's laws and regulations in case that both lenders and borrowers were non-British. This gave a competitive advantage to the London banks, which helped revive London as an international financial centre despite the weak pound. The Soviet Union used London's banks for dollar deposits, because they did not want to risk that their dollar deposits in US banks to be frozen or seized in diplomatic conflicts. The US government tried to protest against the Eurodollar market, but then realised it made the USD even more attractive and decided to start competing with the market by establishing New York's international banking facility system in 1981, hoping to retrieve the dollars deposited offshore. (Ylönen, 2006)

There are other reasons to believe that China's experiment is not doomed to fail. The Chinese economy has shown strong resilience to the economic and financial crisis and has been expanding at an impressive rate since 2009. Whereas the global economy shrank by 0.6% in 2009, China registered growth of 8.7%, and its economy expanded at

⁹ The internationalization of yen was launched under US pressure, but Japan failed to promote yen internationalization as planned

¹⁰ Germany succeeded in making euro an international currency, but on the expense of the Deutsche mark

¹¹ Eurodollars are US currency in the form of deposits and loans handled by commercial banks in Western Europe.

double-digit rates in the first half of 2010. China's international position is stronger than before the crisis and the RMB, in particular, is in a comparatively better position vis-à-vis other currencies. Since January 2008 it has appreciated by 6.5% against the dollar and 18.1% against the euro. (Subacchi 2010) China is taking policy-driven measures to help the market of international currencies to grow. Certain prerequisites are essential to this process, such as no restrictions on third-party use of the currency in contracts or settlements of trade in goods or assets, the existence of a deep and dynamic domestic financial market, a well-respected legal framework for contract enforcement, and stable, predictable micro and macro policies (Genberg, 2009). China's assumption is that once these prerequisites are in place, the process will have enough traction to drive the market. China has accumulated a large and rapidly growing foreign debt. There are concerns that if the capital controls were abolished, there would be large-scale capital outflows and further currency appreciation. This could produce a tightening of financial liquidity, as central banks would have to sell FX reserves in order to protect the currency peg (Chancellor, 2013)

From the market point of view, policies can support the currency internationalization, but cannot drive it. The scope and size of the Chinese economy provides certain incentives to encourage market players to use the RMB, for example companies who seek to enter the Chinese market will be asked to use RMB for trade settlement. (Subacchi, 2010)

China's goal, at least initially, is to achieve currency internationalization under controlled convertibility in order to maintain economic autonomy. To achieve this, China is pursuing a two track strategy. The first track is aimed at increasing the use of the RMB in international trade, the second at turning the RMB into a currency that non-residents are willing to hold. This is a policy-driven strategy, with measures specifically designed for each track (Table 2). The implementation of the scheme has resulted in a strong growth in the use of the renminbi. In the first six months of 2012, almost 11% of China's imports and exports were settled in RMB, a significant increase compared to the whole of 2010, when it was only 2%. (Subacchi & Huang, 2012)

Table 2. Reforms to internationalize the renminbi

Track 1: Increasing the use of the RMB in international trade	Track 2: Making the RMB an attractive currency and developing the RMB offshore market in Hong Kong
<ul style="list-style-type: none"> ● Continuous support to the cross-border RMB trade settlement scheme ● Use of RMB as an invoicing currency in China's Free Trade Agreements ● Promotion of currency swap (bilateral and multilateral) agreements using the RMB as currency of payment ● Increased use of the RMB in regional monitoring system 	<ul style="list-style-type: none"> ● Development of RMB use in areas such as trade finance, project finance, FDI ● Expansion of RMB bond and derivatives markets ● Support for the listing of Mainland companies ● Cooperation between securities markets of Hong Kong and Shanghai

Source: Subacchi, 2010

The next chapter will look into the two-track strategy, assessing the policy goals and steps taken so far.

5 China's two-track strategy

5.1 Trade Settlement in RMB

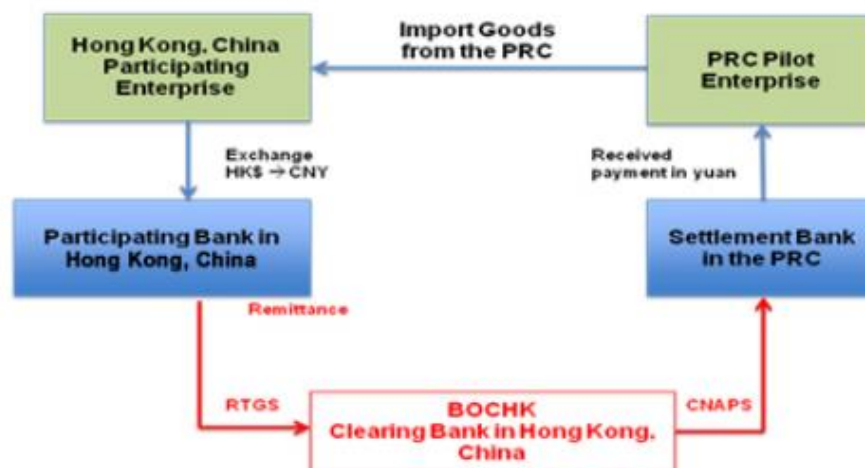
In July 2009, the cross-border RMB trade settlement policy was launched. This is a strategy to develop the RMB as a currency used in international trade. The first track is focused on developing the RMB as a medium of exchange in the form of invoicing for trade and financial transactions for both residents and non-residence. The cross-border RMB trade settlement scheme was originally limited to five pilot cities, but was broadened to include 20 provinces¹² and cities in the mainland in 2010. The scheme began slowly picking up since 2010, as the RMB could be used to invoice 40-50% of China's imports to other Asian countries and about 20-30% of its exports from them. Building on the existing 'Asianalisation' of the RMB (Seade et al., 2010) and its rather limited circulation in China's neighbouring economies (Gao and Yu, 2009: 15), and using policy measures as well as market traction to accelerate the use of the RMB across the region, China's strategy appears, at least for some years, to be regional rather than international. It was an important experiment, both for testing the market and establishing its role as a leader in the region, which allowed a familiar ground to experiment with policies before going global. (Subacchi 2010)

According to the trade settlement scheme, currency conversion between the yuan and other currencies is allowed only under the following circumstances (Yu, 2012):

- Cross-border trade settlement in yuan up to the amount of the relevant transactions;
- Yuan trade finance loans where the customer does not have sufficient yuan for repayment;
- Expenses relating to yuan bond issuance to be settled in Hong Kong, China; and
- transactions allowed by the PRC's authorities to be ultimately squared by the yuan clearing bank—Bank of China, Hong Kong (BOCHK) in the PRC's Foreign Exchange Trading Centre in Shanghai.

To maintain control over the net cross-border flows of yuan between the PRC and Hong Kong, China, all cross-border yuan flows must be settled via the BOCHK (Figure 3)

¹² Beijing, Tianjin, Inner Mongolia, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangdong, Guangxi, Hainan, Chongqing, Xichuan, Yunnan, Jilin, Heilongjiang, Xizang (Tibet) and Xinjiang



Notes: CNAPS = China National Automatic Payment System; PRC = People's Republic of China; RTGS = real time gross settlement systems.

Source: Shum, A. 2012. Renminbi Offshore Market and Future Globalization of Chinese Currency. Presentation at Rotman Master of Finance Speaker Series, University of Toronto, Canada. 15 February.

Figure 3. RMB settlement system

With this reform, China fully opened its current account to all companies in mainland China with import and export qualifications, to make and receive payments in RMB for goods, services and other current account transactions with their counterparts all over the world. China's strategy of internationalization is therefore built on the current account. There has also been progress in capital account liberalization with Overseas Direct Investment¹³ (ODI) and Foreign Direct Investment ¹⁴(FDI) schemes, which can be settled in RMB.

Yu (2012) draws attention to the matter of exchange rate arbitrage¹⁵, due to the distinction of the CNY and CNH (see Appendix 1) markets, which allows Chinese enterprises to benefit from the exchange rate arbitrage. On the surface, the trade settlement scheme merely allows the PRC enterprises to use yuan to settle their trade transactions. In reality it enables enterprises, especially large enterprises with

¹³ The scheme, introduced in January 2011, permits Chinese domestic institutional investors to make RMB-denominated direct investments in select offshore enterprises or projects for greenfield investment, merger and acquisition, equity participation, and other means of acquiring direct ownership or actual control (PBoC, 2011).

¹⁴ The scheme, introduced by the PBoC in October 2011, offers direct investment opportunities in the mainland's real economy for overseas RMB holders. In July 2012, the PBoC restricted investments in the areas of securities, derivatives and property.

¹⁵ Currency arbitrage means taking advantage of exchange rates in different money markets by buying it in one currency market and selling it in another market.

subsidiaries outside borders, to channel funds across the border between the PRC and Hong Kong, China. The starting point of yuan internationalization is supposed to be the use of the yuan for import settlement. But in practice, many PRC importers did not use the yuan to pay for their imports—let alone to use the yuan for invoicing. Instead, they utilize the opportunity provided by the trade settlement scheme, to conduct exchange rate arbitrage.

To promote the international use of RMB, China has signed currency swap agreement with 31 countries since 2008 (Table 3). Beijing has embraced the swap agreements as long term means to expand the use of its currency without significant changes to its capital account. The original purpose of currency swap agreements is to provide countries with liquidity in times of crisis. For example, after the 1997 Asian financial crisis, Asian countries, including China, entered into swap agreements under the framework of the Chiang Mai Initiative¹⁶. In the 2008 financial crisis, the United States conducted currency swaps with several countries, such as Korea, Brazil, Mexico, and Singapore, mainly to provide US dollar liquidity for those countries. Some of the swap agreements are denominated in US dollars while others are in local currencies. But none of the swap agreements under the Chiang Mai Initiative have been activated yet. (Yihong, 2015)

¹⁶ Chiang Mai Agreement, also called Chiang Mai Initiative, set of bilateral currency-swap arrangements established at Chiang Mai, Thailand, in May 2000 by the members of the Association of Southeast Asian Nations (ASEAN) with the addition of Japan, China, and South Korea (collectively referred to as ASEAN+3). The agreement was meant to complement the International Monetary Fund (IMF) by providing emergency infusions of foreign currency to member countries suffering from liquidity crises.

Table 3. China's swap agreements and its counterparties

#	Countries	Signing Date	Swap Amount (RMB billion)	Trade volume (RMB billion)	RMB Clearing Center	RQFII
1	Belarus	May 2015	7	8.94		
2	Malaysia	Apr 2015	180	652.66	√	
3	South Africa	Apr 2015	30	401.25		
4	Australia	Apr 2015	200	839.84	√	√
5	Armenia	Mar 2015	1	1.19		
6	Suriname	Mar 2015	1	1.24		
7	Pakistan	Dec 2014	10	87.46		
8	Thailand	Dec 2014	70	438.29	√	
9	Kazakhstan	Dec 2014	7	175.93		
10	Hong Kong	Nov 2014	400	2,465.25	√	
11	Canada	Nov 2014	200	335.01	√	√
12	Qatar	Nov 2014	35	62.60	√	√
13	Russia	Oct 2014	150	549.15		
14	South Korea	Oct 2014	360	1,687.19		
15	Sri Lanka	Sep 2014	10	22.27		
16	Mongolia	Aug 2014	15	36.66		
17	Switzerland	July 2014	150	367.42	√	√
18	Argentina	July 2014	70	91.28		
19	New Zealand	Apr 2014	25	76.20		
20	EU	Oct 2013	350	N.A.		
21	Iceland	Sep 2013	3.5	1.37		
22	Albania	Sep 2013	2	3.44		
23	Hungary	Sep 2013	10	51.72		
24	UK	Jun 2013	200	430.79	√	
25	Brazil	Jun 2013	190	554.90		
26	Singapore	Mar 2013	300	466.94	√	
27	Ukraine	Jun 2012	15	68.43		
28	Turkey	Feb 2012	10	136.79		
29	UAE	Jan 2012	35	284.45		
30	Uzbekistan	Apr 2011	0.7	28.00		
31	Indonesia	Mar 2009	100	420.54		
Total		—	3,137.2	10,747.2	—	—

Source: Yihong (2015)

This kind of liquidity swap arrangement allows PBoC to provide liquidity support to its counterparts. Foreign banks sell a specified amount of their currency to the PBOC for yuan, at the market exchange rate. Yuan funds obtained by foreign central banks are deposited in accounts held with the PBoC as PBoC liabilities. (Yu, 2012)

The People's Bank of China (PBoC) stated that those swap agreements were intended not only to "stabilize the international financial market," but also to "facilitate bilateral trade and investment." Since these swap agreements are denominated in RMB and the local currencies, without involving the US dollar, it shows the counterparties' willingness to hold RMB. For example, South Korea, one of China's largest trading partners, is willing to have freer access to the RMB mainly to finance bilateral trade. It first signed a swap agreement with China in December 2008, and has renewed and expanded the swap amount several times. (Yihong, 2015) The swap agreements also reflect how China is utilizing its political power instead of market forces to enforce the international use of the RMB.

5.2 The Creation of RMB Offshore Market

China's offshore RMB business hubs are independent of China, which is a positive attribute. This allows them to be under different regulations and have more freedom than if they were within the mainland. China then realized it would be to its benefit to keep currency used inside and outside of its borders separate. There are two notations for their currency, both of which are still the same Chinese Yuan: CNY is RMB for use inside of China and CNH is RMB for use outside of the borders (See Appendix 1). The reasoning behind this is to match the different supply and demand needs inside and outside of mainland China. Keeping the currencies separate also helps China to avoid unwanted transactions of transferring and converting the currencies back into China.

Building the offshore market is essential to overcome the renminbi's limited convertibility and broaden its use outside mainland China. In this market non-residents have access to the Chinese currency for the purpose of trade and investment and are encouraged to hold RMB funds while China's monetary authorities retain control over the pace of the capital account liberalization (He and McCauley, 2010). Building the RMB market is likely to progress in a different way than the Eurodollar market in 1950s and 1960, which expanded outside the jurisdiction and control of the United States. For the time being, it will continue to be driven by China's policy initiative, constrained by the currency's limited

convertibility. By taking this roundabout approach, China is able to protect its domestic financial market, until it has sufficient depth and breadth to be fully liberalized, while securing their currency's international expansion. Given China's rapid economic growth and many trade and investment relationships, there is plenty of demand from the around the world for renminbi transactions.

The liquidity required by the offshore market can either be generated through cross-border operations of banks and other financial institutions or be provided by the monetary authorities (or a combination of the two). Because of the renminbi's lack of convertibility and its limited use in international trade, in the current phase of development the offshore market has to rely on liquidity provided by the PBoC. (Subacchi & Huang, 2012) This means that the development of the offshore market is a policy-led initiative, which is expected to develop in a gradual pace. Essentially, China wants to remain a closed economy, but establish its goal of RMB internationalization through offshore hubs. Using this policy allows the Chinese government to keep control of its own economy and test the market before opening its economy further.

6 Hong Kong's Role in Expanding Offshore RMB Business

Hong Kong plays a very important role in helping China achieve its policy goals. Hong Kong has a unique position in developing the RMB business, it is both an international and an offshore market of China where the Chinese government can experiment with policies and reforms. Hong Kong operates under the “one country, two systems framework”, which means special administrative regions (SAR) such as Hong Kong and Macau can retain their own capitalist economic and political systems, while the rest of China is a socialist republic run by a single communist party. Back in 1978 when the mainland government started economic reforms, Hong Kong was the first to collaborate and assist China in its policies. In the 1990s China needed to raise capital and Hong Kong seized the opportunity. In 1993 the Hong Kong Stock Exchange allowed the listing of state owned enterprises of China and that formally opened the door for mainland Chinese companies to list in Hong Kong. Since the listing of the first mainland company in 1993, mainland enterprises have raised a total of 2,9 trillion HKD from the HK stock market. (Lam, 2014) Hong Kong was also the first to offer RMB Liquidity Facility and provide non-resident investors with additional liquidity, giving the city a competitive advantage over other financial centers. As shown in figure 4, Hong Kong can now provide RMB products and services for cross-border trade settlement, finance and wealth management (Subacchi & Huang, 2012).

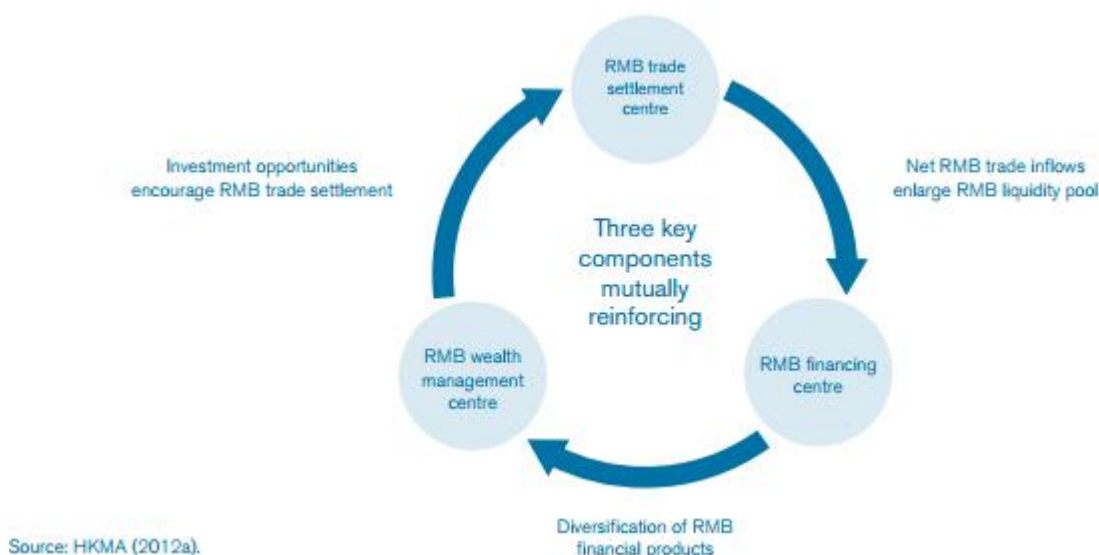


Figure 4. Hong Kong: the most comprehensive renminbi offshore center. Source: HKMA (2012)

Because of the history of a successful partnership, it was a logical step for mainland China to choose Hong Kong as a testing ground to establish the RMB bonds market. The dim sum bond market is the first offshore market for Chinese currency investments. Dim sum bonds are bonds that are denominated in RMB and issued in Hong Kong. Dim Sum bonds are issued mainly by large entities based in China or Hong Kong, but multinational firms are issuing more in the growing market. In the past it was difficult for foreign companies to gain exposure to RMB denominated assets and dim sum bonds now offer a way for these companies. Dim sum bonds offer these companies a way around China's capital controls because all that is required is that the issuers acquire a Hong Kong Monetary Authority (HKMA) settlement account. This makes the dim sum market very attractive to foreign issuers. Usually Dim Sum bonds are short term, with most being less than three years. Companies can choose to issue longer bonds if desired. For example, Asia Development Bank issued a ten-year bond in 2010. Along with varying lengths, companies can also issue dim sum bonds in two different ways. Dim Sum bonds can be issued either as Eurobonds¹⁷ or existing medium term note¹⁸ programs. However, there is one key difference between Eurobonds and Dim Sum bonds and that is the manner in how the payback occurs. Payments for Eurobonds are normally paid in the currency that the bond was dominated. On the contrary, dim sum bond payments can be paid in currencies other than the currency that it is denominated in. Many times these bonds are paid back in US dollars.

There are two types of Dim Sum bonds, retail and synthetic. Retail bonds were the first to be issued in 2007. Retail bonds are settled in RMB. Between 2007 and 2011, retail bonds were only allowed to be issued by locally incorporated subsidiaries of PRC banks and were limited by an annual quota system. These bonds were subject to approval by the PRC Central Bank, PRC National Development, and the Reform Commission. However, many of the regulations on these bonds have been lifted. The first nonfinancial institution to issue retail bonds was Baosteel Group Corp in 2011. The second type of dim sum bond are synthetic bonds. Unlike retail bonds, synthetic bonds are settled in currencies other than RMB. Hopewell Highway Infrastructure was the first company to issue synthetic bonds in 2010. Since then many multinational companies have issued synthetic bonds including McDonald's, Caterpillar, Volkswagen, and British Petroleum. These bonds have growing popularity with more than two dozen Eurobonds issued today

¹⁷ A bond that is denominated in a currency not native to the issuer's home country.

¹⁸ A debt note that has a 5-10 year maturity, but the term can be less than one year or as long as 100 years.

(Norton Rose Fulbright, 2012). The creation of the dim sum market has transformed the core business of Hong Kong as an international financial center, as shown in Figure 5.

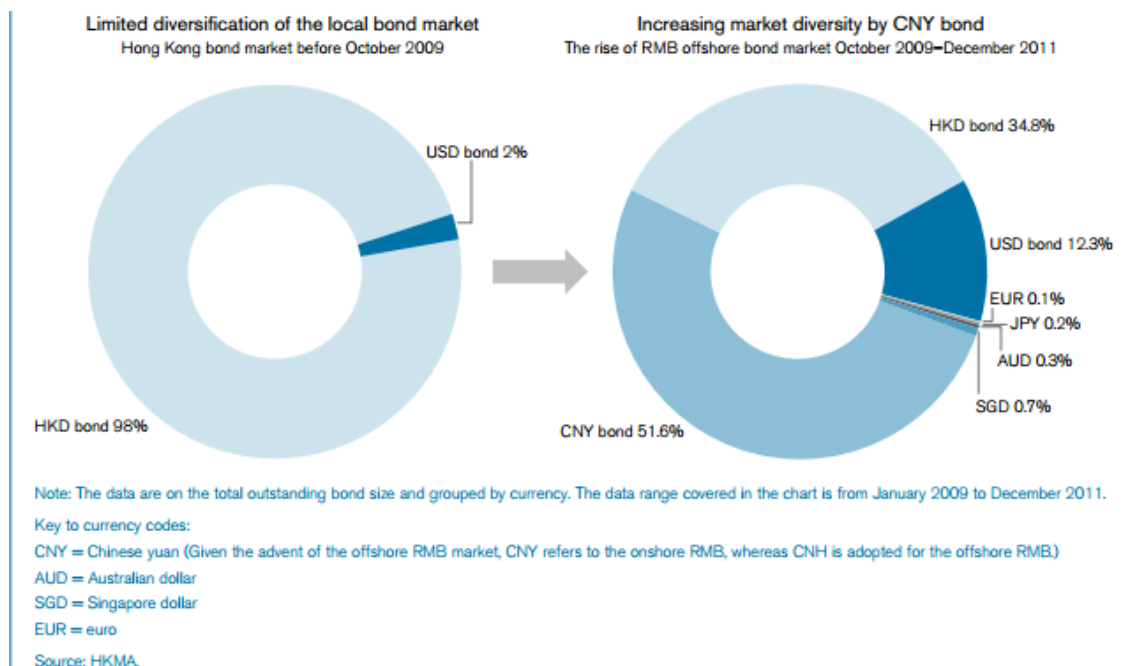


Figure 5. Structural shift in Hong Kong's bond market. Source: HKMA (2016)

Hong Kong is the largest dim sum bond market outside mainland China. (Figure 6) The outstanding bonds amounted to RMB367 billion yuan at end of October 2015. (HKMA, 2016)

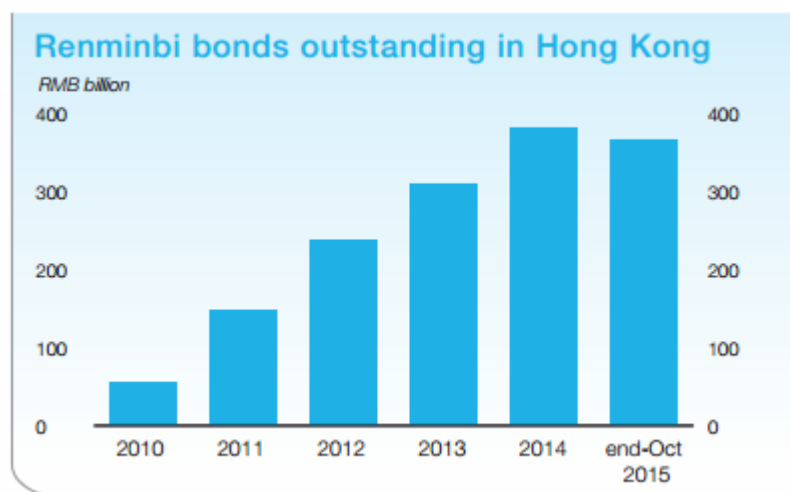


Figure 6. Renminbi bonds outstanding in Hong Kong. Source: HKMA (2016).

Hong Kong has by far the largest offshore liquidity, handling 70% of all renminbi payments globally. (HKMA, 2016) While Hong Kong remains the most important offshore RMB hub, it is now facing competition from Europe and the Americas.

6.1.1 Expanding the Offshore Market in Europe

The first RMB denominated bond was issued in Luxembourg by a European issuer Volkswagen in 2011. In 2014, the first RMB bond by a Chinese mainland company issued inside the Eurozone was listed in Luxembourg. (Luxembourg For Finance 2015) European hubs are fueling RMB internationalization. SWIFT's (2014) RMB Tracker shows that Europe represents 10% of Renminbi payments worldwide in value. In 2014, four European countries have been settling into the top 10, excluding China and Hong Kong. The United Kingdom leads Europe with 123.6% growth between July 2013 and July 2014, followed by France (+43.5%), Germany (+116%) and Luxembourg (+41.9%). Since July 2013, European payments directly exchanged with China and Hong Kong in RMB have increased by 105%, showing a considerable upwards trend in RMB usage. With the appointments of the clearing banks for Frankfurt (Bank of China), London (China Construction Bank), Seoul (Bank of Communications), Paris (Bank of China) and Luxembourg (Industrial and Commercial Bank of China) by PBoC in the second half of 2014, it is becoming increasingly apparent that PBoC is seeking to accelerate the RMB internationalization process through offshore hubs (Heiniger, 2015). This has spurred competition between financial centers to become the main RMB hub in Europe, supporting China's efforts to internationalize its currency.

Establishing a European RMB hub allows China to take advantage over the time zone difference with Asian centers, allowing a 24-hour trading. International financial centers, which are outside the jurisdiction of China, prefer a market driven approach, which may cause problems for the development of the European hubs, because they have to take into account China's unique policy-led strategy of internationalization. While the offshore RMB market has the potential to expand in size and scope, the pace of development will largely depend on Beijing's policy – and politics – on capital account liberalization. Capital liberalization is a critical decision for the Chinese authorities and it is unlikely that the current pace of gradual opening will be accelerated. (Subacchi & Huang, 2012)

6.2 London

London, which already handles 40% of global foreign exchange trading, wants to build a dominant position in offshore renminbi trading in Europe. China and United Kingdom have an agreement since 2013 which allows UK based financial institutions to directly invest in Chinese equity and debt markets. The president of PRC, Xi Jinping, visited the United Kingdom in October 2015. During the four-day state visit, China chose London as the first international financial hub to issue renminbi-denominated Chinese sovereign debt. It is a deal that marks a major milestone in the renminbi's arrival as a major currency on the world stage. This will be the first time that renminbi-denominated Chinese sovereign debt will be available outside of Chinese borders, opening up an international renminbi debt market. (Panda, 2015) Soon after the announcement of opening the new sovereign debt market in London, China was admitted to the IMF's SDR in November 2015.

Offshore hubs are essential to China's renminbi strategy. Currently, the RMB offshore market is organized around Hong Kong. At least at this stage, therefore, the development of London and other financial centres (outside China) that plan to be part of the RMB offshore market will be complementary to that of Hong Kong. While London and other international financial centres such as Singapore will develop as RMB hubs, Hong Kong is likely to be an RMB offshore centre. The offshore hubs worldwide are the connecting dots in the expanding RMB offshore market (Subacchi & Huang, 2012).

London is far from the only city trying to develop closer ties to China. Germany, China's biggest European trade partner, was awarded a quota of 80 billion yuan (\$12.9 billion) that allows European investors to buy securities in China. The allocation is similar to arrangements for France, South Korea and the U.K., which was the first country other than Hong Kong to win a quota. Like London, Frankfurt has agreements with the PBOC to get a share of the offshore renminbi market. (Detrixhe, 2015) A day after China issued the first sovereign bond from London, China and Germany have formally agreed to establish a Frankfurt-based exchange to trade a host of renminbi-denominated products, in a further sign of Europe's aggressive courting of Beijing for financial business. (Jones, 2015)

7 Understanding the Motivation behind RMB Internationalization

China has never published a formal policy document to outline the RMB internationalization program. It is mentioned in the official statement called the 12th Five Year Plan¹⁹, published in 2011, that the general aim is to over time increase exchange rate flexibility and making the renminbi fully convertible, but no specific timeline was given. The government leaders and top officials of PRC have rarely touched the subject in their speeches or interviews. This means that understanding the motivation behind the internationalization requires further investigation.

The main interpretation of what initialized the RMB internationalization is believed to be a response to the Global Financial Crisis (GFC) that unfolded in 2008. The idea of RMB internationalization was triggered by Chinese leaders' concerns over excessive dependence on the US dollar. The crisis affected China's economy greatly, cross-border trade fell, inflows of foreign direct investment (FDI) declined and GDP growth slowed down. In March and April of 2009, the PBoC published on its website a series of papers by PBoC governor Zhou Xiaochuan arguing that the global financial crisis stemmed in large part from the impossible demands placed on the US Federal Reserve, whose monetary policy could never satisfy both the needs of the US economy and the needs of the rest of the world, for which the US dollar was the primary currency. That was the first time China started lobbying for a reduction of the USD's global role and push the renminbi as an alternative major reserve currency (Kroeber, 2013).

Apeldoorn, Graaff & Overbeek (2014) argue that the growth of China's economy is better understood in the context of resistance to Western supremacy. It is pointed out that there have been other challengers in the past, who have been showing promising results in overtaking the West, but somehow never get so far due to the structural constraints of a state-led system. The authors claim that China's current socialist structure is limiting capitalist development, but leaves an open question if China really is ready to sacrifice resurrection of socialism in China to achieve its aspirations to overthrow the Western supremacy. Ian Bremmer states (2010: 5) that the ultimate motive of state capitalism is not economic (maximizing growth) but political (maximizing the state's power and the leadership's chances of survival).

¹⁹ China's Five Year Plans are a series of social and economic development initiatives which serve as roadmaps for the nation's development.

While RMB internationalization is a goal in itself, it is also used as a tool to reform the domestic financial system, specifically liberalizing the capital account, exchange rate and interest rate. (He 2015) The domestic reforms have slowed down since 2005, after shifting from a fixed exchange rate to a managed rate. On the widely-used Chinn-Ito index²⁰, China is one of the least financially open major economies in the world, and is no more open now than it was in 1993 (Prasad and Ye 2012). The reforms piloted in 2009 established cross-border trade settlements and the creation of an offshore RMB markets, while the domestic financial system was still strictly regulated by the government. (See Appendix 2 for a timeline of reforms initiated by PBoC). These reforms acted as catalysts to push the domestic market reforms. For example, the establishment of an offshore market allows China to determine the true price of its currency. Interest rates for renminbi debt securities in Hong Kong are set by market supply and demand, rather than by government fiat. Once the offshore market gets big and liquid enough, its prices can start to affect the prices of loans and debt securities onshore (Kroeber, 2013). McCauley (2011) explains that the offshore renminbi market—if it gets big enough—can be a mechanism by which capital controls are broken down, and the central bank becomes more responsive to market movements when setting interest rates, and by extension the exchange rate.

In an extensive study called RMB Roadmap (2014) conducted by industry experts at ASIFMA²¹ highlights some reasons why RMB internationalization is a major goal for China:

- a) Currency risks for both importers and exporters are reduced if the RMB is internationally accepted as a trade settlement currency. China has the world's second-largest economy, and by some measures, China is the world's largest trading nation – thus, this is a major benefit.
- b) Given China's position as the world's largest holder of FX reserves the bulk of which are in USD (which is the dominant international reserve currency), China's exposure to

²⁰ An index measuring a country's degree of capital account openness

²¹ ASIFMA – Asia Securities Industry & Financial Markets Association is an independent, regional trade association with over 90 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. They promote the development of liquid, deep and broad capital markets in Asia.

USD exchange rate volatility will be considerably reduced if the RMB has a greater international role. China's pace of USD accumulation will likely slow (or even reverse) once the RMB gains prominence as an internationally traded currency.

c) Finally, on the key issue of the RMB becoming a reserve currency as the end objective of IMS rebalancing, there is now evidence that up to 40 of the world's central banks in recent years have chosen to at least hold some of their reserves in RMB. This level of acceptance of the RMB on the part of the world's central banks suggests that the Chinese currency is effectively a "de facto" reserve currency, even before it has become fully convertible – as the IMF has recently pointed out. ASIFMA experts believe that this trend is set to continue, as progressively more central banks consider holding RMB as part of their reserves diversification process

Indeed, as mentioned previously (see Chapter 2.1) the IMF officially accepted RMB as a reserve currency, so China is well on its way to reach some of the goals set out years ago. Other economists, however, point out that RMB internationalization has not reduced China's dependence on the dollar, but instead led the country to accumulate more dollar-denominated assets, and so exchange risk rate has actually increased. (He 2015) China never strategically reduced its US Treasury reserves, but instead continued to increase holdings, reaching a record high US\$1.3 trillion by May 2013, and as of September 2014 still remains the number one foreign holder of US Treasury securities (Department of the Treasury 2014). Krugman (2009) points out, "China now owns so many dollars that it can't sell them off without driving the dollar down and triggering the very capital loss its leaders fear."

One feasible way to eliminate the dependence and the dollar trap is to promote the RMB to an international status. Some economists in China argue that as a long-term strategy, RMB internationalization should be the correct way to eliminate its dollar dependency (He 2009; Xiang 2011; 2013; Cao Yuanzheng 2014). Although the process will take years or even decades, and will bring large economic costs, such as reducing export competitiveness and compromising monetary policy independence, it is still the right solution for stepping out of the dollar trap. In the long run, it can bring vast political and economic advantages. (He, 2015)

7.1 The True Intentions behind RMB Internationalization

There has been debate if China actually wants a fully open capital account and a global currency. An economist at UBS thinks: “China’s goal is eventual full capital account convertibility, which one day will see the full convergence of the onshore and offshore RMB market.” (GlobalCapital 2015) Others are not so sure. Jonathan Anderson from Emerging Group Advisors says: “From a pure macro point of view, China isn’t quite sure that it wants a fully open capital account. The capital account isn’t quite as closed as it used to be but it’s still pretty closed. I don’t think anyone in China is that interested in a full opening while they are trying to deleverage the economy.” Beijing’s true intent, he argues, is to increase foreign investment in the domestic equity market, while triumphantly securing admittance to the SDR basket. (GlobalCapital 2015)

RMB internationalization would bring China political and economic benefits, but most importantly, China needs to focus on domestic reforms. That would explain why China is taking a unique approach to internationalize the RMB through offshore markets. Wu Xiaoling (2014) says that it is clear that the ultimate goal of China’s financial reform is in fact not RMB internationalization itself, but is instead the building of a moderately prosperous society by 2020. He emphasizes that the PBoC is paying more attention to how to promote market-based domestic financial reform, rather than how to push the RMB toward becoming an internationalized currency, and, thus, the era of the RMB is yet to come.

Recently, China has accelerated its engagement in minilateralism, which is the gathering of a sub-group of countries within or outside a multilateral institution to solve a problem when the multilateral institution is unable to reach agreements among its members. (Wang 2014) Financial minilateralism is not new: the G7²² and G20²³ are examples of such cooperation, but within the last years China has accelerated its participation in such activities. The world is still recovering from the GFC, countries are dealing with tensions coming from short-term domestic priorities and long-term international objectives. The perceived benefits of economic globalization have begun to be clouded by an increasing body of research that links the processes of global economic liberalization with increasing income inequality, and long-term unemployment and

²² G7 are the world's seven most industrialized economies: France, Germany, Italy, Japan, the US, UK and Canada.

²³ G20 is a group of finance ministers and central bank governors from 19 of the world's largest economies, and the European Union.

underemployment in developed economies. (Herman 2011) According to Wang (2014) China has three goals in pushing for minilateral financial cooperation schemes: to stimulate reform of global multilateral institutions; to provide under supplied public goods for member countries and other developing countries; and to directly promote China's economic interests and its political standing. China's leadership does not seek to overthrow the existing multilateral framework, but if China and other emerging economies are increasingly compelled to go outside the existing multilateral system to fulfill their needs and aspirations, their actions could weaken the established multilateral institutions of global financial governance. State capitalist countries are not anymore "driven by alliance with superpower or by ambitions to join established power's club" but have desires to make new rules in the global markets. (Bremmer 2012: 55)

For many years the Chinese government sought to "join the world" by learning and selectively following the international rules established by the West (Economy and Oksenberg 1999). Now China's relations with the world have entered a new stage, where China is actively trying to participate in the making of international rules. Its foreign policy strategy is gradually moving away from "keeping a low profile" toward "trying to accomplish something." (Wang 2014) By establishing new minilateral relations China can exercise financial leadership in the Asia-Pacific area, while with the RMB's admittance to the SDR confirmed, China is now becoming more influential in the global level.

8 Conclusion

Despite its prominent role in the world economy, China does not have a currency that can be used as a unit of account, means of exchange and store of value in international transactions. China has taken a policy led initiative to promote the internationalization of RMB, the strategic path chosen by China is unprecedented, lacking a clear road map to guide the process. RMB internationalization is a major challenge for the PRC. However, there is no firm answer about the final goal of the internationalization. Since there is a lack of a clear road map toward internationalization, China is essentially experimenting and taking a unique approach, trying to make the RMB international without it being fully convertible. China is trying to expand the use of its currency through trade settlement, swap agreements and investment facilities without opening up its capital account. The RMB internationalization process will continue with setting up more RMB offshore markets in European cities, but also in the Americas. By creating offshore hubs gradual enlargement of international use of RMB is promoted and China gets closer to the objective of eliminating dollar dependence, while still having a strong grip on the domestic economy.

With the admittance to SDR, RMB has equal status with the dollar in the global monetary system, a symbol which is highly regarded by China. RMB internationalization is a long-term process that will take years and possibly even decades. China is taking a gradual approach to reforms, as it wishes to maintain control over the process, without opening its domestic financial market. So far the PRC has been artificially pushing the use of RMB through favorable policies and political influence. In order for RMB internationalization to take a natural course, the liberalization of capital account is required. For that to happen, China needs to reform its domestic financial market first. China has favorable conditions, such as the growing economy and trade volume to support the RMB internationalization. It lacks, however, deep and liquid financial markets. Until China makes significant reforms to its domestic market, the process of internationalization will not be likely to make a breakthrough and instead will continue in small sequences, such as the two-track road so far.

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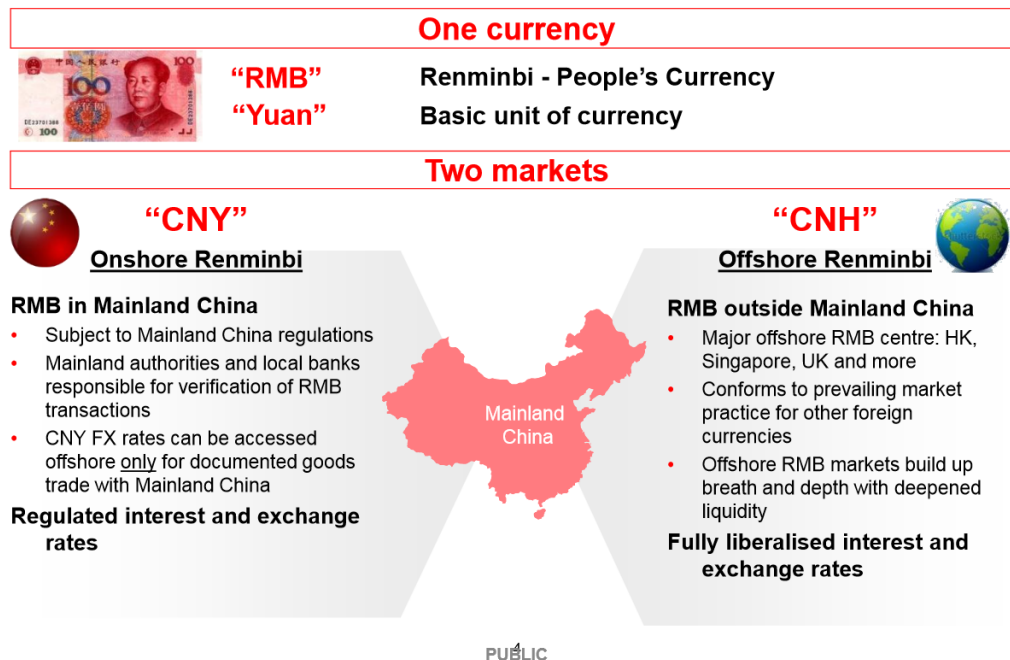
<http://www.adb.org/sites/default/files/publication/156221/adbi-wp366.pdf>

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Appendix 1. One currency, two markets

One currency, two markets

On/offshore connectivity and convergence



Source: Ho 2013

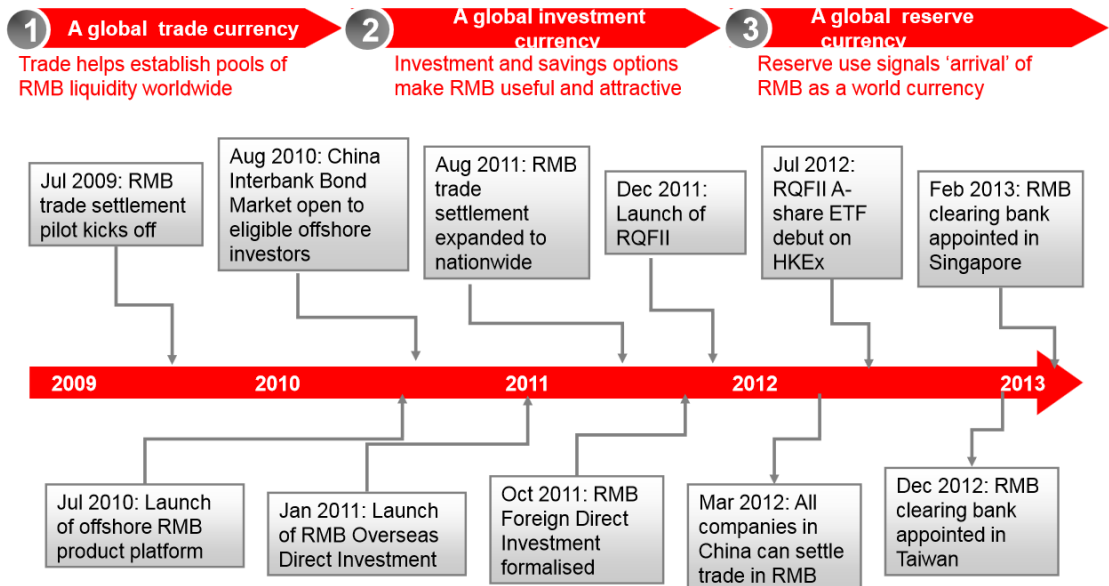
Appendix 2. Balance of payments items

<u>BALANCE OF PAYMENTS ACCOUNT OF A COUNTRY FOR A PARTICULAR YEAR</u>			
<i>Credit Items (Receipts)</i>		<i>Debit Items (Payments)</i>	
<i>(1) Current Account (Rs in Crores)</i>			
1. Merchandise Exports	200	1. a) Merchandise Imports	300
2. Services Exported	100	2. a) Services Imported	200
3. Investment Income (accrued from investment in foreign countries)	100	3. a) Investment Income (accrued by foreigners from their investment)	200
4. Unilateral Receipts	200	4. a) Unilateral payments	100
<i>Sub Total</i>	<i>600</i>	<i>Sub Total</i>	<i>800</i>
<i>(2) Capital Account</i>			
5. Long-term borrowings	200	5. a) Long-term lending's	80
6. Short-term borrowings	100	6. a) Short-term lending's	60
7. Gold shipment (Sale of gold)	100	7. a) Gold shipment (Purchase of Gold)	50
<i>Sub Total</i>	<i>400</i>	<i>Sub Total</i>	<i>190</i>
		8. Errors & Omissions	10
<i>Total Receipts</i>	<i>1000</i>	<i>Total Payments</i>	<i>1000</i>

Appendix 3. Timeline of RMB reforms

Rise of the redback

Timeline unfolding rapidly



Source: HSBC

Source: Ho 2013

Appendix 4. The meaning of convertibility

What Do We Mean by Convertibility?

- ◆ Is the currency accepted by non-residents and foreign nationals? Are these non-residents and foreign nationals willing to hold the currency, for whatever length of time, in their portfolios? Currently residents and nationals of Hong Kong, Myanmar, Singapore, Taiwan, Vietnam and the areas on the Sino-Russian border appear willing to accept and to hold the Renminbi.
- ◆ Are these non-residents and foreign nationals willing to hold the currency long-term? (Then it begins to have the potential of becoming a reserve currency.)
- ◆ Is the central bank legally obligated or committed to repurchase any currency issued by it that is offered for sale by non-residents and foreign nationals with acceptable foreign currencies such as the US\$, the Euro and the Yen? If this were true, it would greatly enhance the willingness of non-residents and foreign nationals to accept and to hold the Renminbi. However, the People's Bank of China, the central bank, is neither legally obligated nor committed to repurchase any Renminbi held by non-residents or foreign nationals, except under certain conditions. (For example, a foreign direct investor in China is permitted to sell the Renminbi that the investor has earned in exchange for foreign currency.) Many non-residents and foreign nationals hold the Renminbi not because it can be exchanged for another foreign currency at the People's Bank on demand but because they believe it will be accepted by others.

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What Do We Mean by Convertibility?

- ◆ Is the central bank legally obligated or committed to sell foreign currency to its own nationals on demand? The People's Bank of China is committed to selling foreign currency to Chinese nationals for all legitimate current account purposes, including payments for services, subject to some quantitative limitations. However, it is not yet possible for Chinese nationals to purchase foreign exchange at the People's Bank of China for the purpose of capital transactions. The exceptions are Chinese enterprises that plan to make direct investments abroad. They will be allowed to purchase the foreign exchange upon the approval of their investment applications by the relevant ministries and commissions.
- ◆ Is the central bank legally obligated or committed to sell the local currency to its own nationals in exchange for acceptable foreign currencies? The People's Bank of China is committed to purchasing all major foreign currencies tendered by Chinese nationals, individuals and enterprises, with Renminbi, provided that the Chinese nationals are the real, rightful owners of the foreign currencies. (For example, they cannot, in principle, be acting as a conduit for foreign nationals.)

Lawrence J. Lau, Stanford University

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