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Prospects for the Internationalisation of Chinese Currency

Artur Gradziuk

The global financial crisis ignited China's move to internationalise the RMB. It signed several bilateral currency swap agreements, expanded settlements of cross-border trade transactions in RMB and allowed new forms of RMB operations in the Hong Kong offshore market. The main obstacles to the further internationalisation of the Chinese currency include the lack of exchange rate flexibility and limited access to capital markets. The implementation of proposals presented in a recent study by China's central bank would be a milestone in the country's integration into the global financial system and would create new opportunities for both foreign and Chinese investors.

In recent years, China has become the second largest economy in the world, the largest exporter and first in terms of currency reserves. But in contrast to other major economies (the U.S., the European Union and Japan), its currency plays a limited role in international trade and financial transactions. After the global financial crisis, the ongoing problems with U.S. indebtedness undermined confidence in the dollar, the main currency held by China in its huge reserves. Since then, the authorities have started to reconsider the role of the dollar in its domestic economy as well as in its foreign economic relations, especially in the context of the declining value of the American currency and potential losses in its foreign assets. Parallel to such proposals as the creation of an "international reserve currency", the internationalisation of the RMB appeared on the agenda of Chinese policymakers. However, these efforts are hampered by a lack of willingness to move to a flexible exchange rate and restrictions in access to China's capital market.

Steps to Internationalise the RMB. China has undertaken over the last several years some gradual measures to internationalise the RMB. Among them, the first was its engagement in various forms of bilateral swap agreements (BSA). After the Asian Financial Crisis of the late 1990s, the main objective of a BSA was to stabilise regional economies. By 2007, it had signed BSA's with Japan, Korea, Thailand, Malaysia, the Philippines and Indonesia, though the primary currency of those agreements was the U.S. dollar. Since late 2008, during the depth of yet another financial crisis, China has signed a series of BSA's denominated in RMB, not only with East Asian countries but also with Belarus, Pakistan, Argentina, New Zealand, Turkey, Kazakhstan and others. Under these BSA's, participating countries can settle trade with China in RMB (rather than the dollar), or in specific cases (e.g., Russia, Turkey) with domestic currencies.

Recently, Chinese authorities have also encouraged the use of the RMB in cross-border trade. Before the launch in July 2009 of the Pilot Program for RMB Settlement of Cross-Border Trade Transactions, almost all cross-border trade transactions were settled in foreign currencies (especially the dollar). Initially, the program covered only designated domestic enterprises from five Chinese cities (Shanghai, Guangzhou, Shenzen, Zhuhai and Dongguan) that were allowed to settle trade transactions in RMB with Hong Kong, Macao and the ASEAN countries. The program was expanded to 20 Chinese provinces in 2010 and to all foreign trading partners internationally, allowing by the end of 2010 all Chinese importers and by March 2012 all exporters to settle cross-border trade transactions in RMB. All the provinces were included in 2011. However, only mainland banks or the Hong Kong branch of the Bank of China were allowed to participate in the settlements. According to data by the People's Bank of China (PBoC), by the end of 2011 the volume of trade settled in RMB had reached about $410 billion.

Apart from its use for public purposes in BSA's and for cross-border trade settlements, the official circulation of RMB outside mainland China was limited to Hong Kong, which was promoted as the main RMB offshore centre. In 2004, banks in Hong Kong were allowed to accept RMB deposits and conduct currency exchange operations and remittance services. Three years later, qualified domestic financial institutions were permitted to issue RMB bonds in Hong Kong (which at that time granted lower interest rates than in mainland China), although the attractiveness of issuing bonds there was hampered by regulations that made the transfer of funds raised offshore subject to approval by authorities. Later on, Hong Kong became a centre for an increasing number of RMB operations, such as clearing cross-border trade transactions, opening accounts for corporations and providing interbank transfer services for RMB funds, and the first IPO (Hui Xin Real Estate Investment Fund) of stock denominated in RMB on the Hong Kong Stock Exchange.

Capital Market Liberalisation. China was very reluctant to open its capital market to foreign investors or relax its control of portfolio capital flows. The main channels for the inflow of such capital was a scheme introduced in 2002 for Qualified Foreign Institutional Investors that allowed trade in equities denominated in RMB (A-shares) on the Shanghai and Shenzhen stock exchanges, but within quotas set by the State Administration of Foreign Exchange (SAFE). However, in 2007 the Qualified Domestic Institutional Investors scheme was implemented, allowing selected Chinese financial institutions to invest in overseas markets, though within quotas set by SAFE. So by any standard, China's capital market is rather closed as foreign investors cannot invest freely in stocks, property and bonds, and capital outflow is subject to strict administrative control.

There are many reasons for capital flow restrictions, among them the most important are having an underdeveloped domestic financial system, the risk of a surge of speculative "hot money" flowing into China then a sudden outflow of capital, and a reluctance to introduce flexible exchange rate mechanisms that that would lead to the appreciation of the RMB, which would negatively affect the competitiveness of China's exports. However, a study released by the PBoC last month proposes further liberalising the financial system and recommends a mid-term plan for reforms. In the first phase (one to three years), the plan assumes rules will be relaxed for overseas FDI by Chinese enterprises and investments directly related to trade encouraged. In the second phase (three to five years), greater cross-border commercial lending would be promoted, including loans in RMB to stimulate the internationalisation of the Chinese currency. In the third phase (five to 10 years), restrictions on foreign investment in Chinese shares, bonds and property would be lifted, with some measure of control on speculative capital flows remaining.

Conclusions. China has been very cautious in the implementation of specific steps related to the circulation of the RMB outside its borders. The increasing use of the RMB in BSA's, cross-border trade and even the offshore market in Hong Kong are rather a reflection of the growing role of the Chinese economy, especially in the East Asia region. So far, the RMB is far from being accepted by foreign entities as an international currency for wider purposes without full convertibility and as long as short-term capital inflows and outflows are controlled and investments in assets in China's market are limited. However, the further internationalisation of the Chinese currency seems inevitable when taking into account the country's recent policy initiatives.

Given the undervaluation of its currency and the broad belief by foreign investors that the RMB would appreciate, the Chinese government was especially reluctant to relax its control over capital flows. The implementation of the recommendations included in the recent study by the PBoC would be not only a necessary step on the way to the internationalisation of the RMB but also would create new opportunities for foreign financial institutions. From the perspective of the EU, the relaxation of control of overseas Chinese investments would add new entities to the list of potential buyers of European assets and bonds, which is especially important with the eurozone crisis. In this context, the greater promotion of cross-border lending, including the prospects for issuing bonds on the Chinese market, could also be an attractive option for EU financial institutions and enterprises. A further opening of the capital market, assuming the lifting of restrictions on the purchase of shares, bonds and property by foreign buyers, would increase access to the Chinese market, including the financial services sector, which for a long time has been one of the main objectives of EU policy on the PRC. However, China still has difficult decisions ahead in order to internationalise the RMB and make it a real competitor not only to the dollar but also to the euro.