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# Renminbi Internationalisation: A Primer

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## Introduction

Since 2009, the internationalisation of the Chinese yuan, or the renminbi, has become an increasingly important subject in the economics of China. On the surface, internationalisation of the renminbi means the currency is used as a unit of account, medium of exchange, and store of value in international trade and financial transactions. Beneath the surface, it means that non-Chinese residents hold renminbi-denominated assets and liabilities, both on-balance sheet and off-balance sheet. Seen from this perspective, the analytical questions in understanding the process of renminbi internationalisation include at least the following: Why do non-Chinese residents have incentives to hold renminbi-denominated assets and liabilities? How do non-Chinese residents acquire renminbi-denominated assets and liabilities? Does this not require convertibility of the renminbi under the capital account of the balance of payments? What are the roles of official policies and market forces in driving the process of renminbi internationalisation?

At the outset, it is useful to dispel the popular notion that China cannot possibly internationalise its currency or become a reserve currency issuing country because it runs current account surpluses. This argument is predicated on the assumption that a country can only supply its currency for international use by running current account deficits. However, a country can also supply its currency for international use through the capital account. In effect, a reserve currency country plays the role of a bank to the rest of the world: it provides a liquidity service by issuing short-term liabilities that non-residents would use for international trade and investment, and it also invests in other countries, perhaps in less liquid forms, such as foreign direct investments. In other words, issuing reserve currency is a process of financial intermediation through the international balance sheet of the reserve currency country. Historically, Great Britain and United States gained reserve currency status while running current account surpluses.

## The context

Renminbi internationalisation was put on the policy agenda by the Chinese authorities in the aftermath of the global financial crisis of 2007-2009. As banks scrambled for liquidity, US dollar funding markets and foreign exchange swap markets seized up in late 2008. The resulting “dollar shortage” threatened to stifle international trade. This experience has highlighted the danger of relying excessively on one reserve currency in international trade and payments, and the possible benefits of using a wider array of currencies, including emerging market currencies, especially in transactions between emerging markets (Zhou, (2012)).

More broadly, the spread of the trans-Atlantic financial crisis globally was seen as an intrinsic defect of the international monetary system, where domestic policy objectives of the major reserve currency country override its obligations to maintain global monetary and financial stability. A more diversified system to supply global liquidity can be seen as an interim solution before the arrival of a truly super-national reserve currency (Zhou, (2009)).

**The role of official policies**

Whether or not a currency is used extensively for international transactions is primarily determined by market forces. Seen in this light, renminbi internationalisation is more a process of dismantling extant restrictions against its international use. Since mid-2009, the Chinese authorities have moved quickly to remove restrictions against the use of renminbi in current account transactions, and have gradually expanded the scope for the use of renminbi in capital account transactions.

The major challenge in managing the process is to delineate the relationship between currency internationalisation and capital account liberalisation. While it is commonly taken for granted that capital account convertibility is a pre-requisite for currency internationalisation, the Chinese authorities have argued that currency internationalisation and capital account liberalisation should be mutually-reinforcing processes (Zhou (2012)). Currency internationalisation is seen as an integral component of the broad financial sector reform and development agenda, and can be made consistent with the "proactive, gradualist, and controllable" approach to capital account liberalisation.

As a bare minimum, international use of the domestic currency requires that offshore banks need to be able to keep and have access to clearing balances with onshore banks. In other words, some degree of non-resident convertibility of the renminbi has to be granted to offshore banks. Before July 2009, offshore banks generally could not maintain and have access to renminbi balances kept with onshore banks. With the launch of pilot scheme of renminbi trade settlement in July 2009, overseas banks could open correspondent accounts with banks inside China. From August 2010 onwards overseas nonbank institutions accepting payments for exports to China in renminbi can deposit the proceeds from such transactions on accounts with banks inside China.

Once cross-border payment flows in renminbi are made possible, non-residents would need the means to acquire renminbi assets and liabilities. The Chinese authorities allowed the settlement of current account balances as the first major source and use of renminbi funds: payment by onshore firms for imports from overseas would be sources of renminbi funds for non-residents, and payment by offshore firms for imports from China would be uses of renminbi funds by non-residents. Before the launch of the pilot scheme of renminbi trade settlement in July 2009, no firm in China could use the renminbi to settle payments with overseas counterparties. Under the pilot scheme, 365 firms were included in the list of firms eligible to choose to the renminbi for trade settlement. A year later, in June 2010, coverage of the pilot scheme was expanded to 20 provinces, allowing all firms in those provinces to settle imports and services trade in renminbi, and more than 60,000 firms to settle exports of goods in renminbi. In August 2011, coverage of the scheme expanded further to all provinces; and finally in June 2012, all current account transactions by all Mainland firms could now be invoiced and settled in renminbi.

The Chinese authorities also expanded gradually the scope of using renminbi to acquire assets and liabilities by non-residents through direct and portfolio investments. In August 2010, the People's Bank of China (PBoC) announced a pilot scheme for eligible offshore financial institutions involved in renminbi trade settlement to make use of their renminbi funds to invest in the onshore interbank bond market. In January 2011 and October 2011, administrative rules for the use of renminbi by Chinese enterprises to conduct overseas direct investments, and administrative rules for conducting foreign direct investments in China by foreign firms in renminbi were promulgated, respectively. A further channel of portfolio flows in renminbi was opened up when the so-called renminbi Qualified Foreign Institutional Investor (R-QFII) scheme was announced in December 2011, under which Hong Kong-based brokerage firms could offer to non-Chinese residents renminbi investment products, subject to an aggregate quota, that are invested in onshore bond and stock markets.

To support the international use of the renminbi and to provide a contingent source of liquidity, the PBoC has also set up bilateral local currency swap facilities with overseas central banks and monetary authorities. By June 2012, 18 agreements for such facilities have been assigned, with the total amount reaching RMB1.6 trillion.

**Incentives**

Market forces have responded quickly to official policies. According to the PBoC statistics, 6.6 percent of China's merchandise trade in 2011 was settled in renminbi, a sharp rise from two percent in 2010. In 2011, foreign investors settled 10.8 percent of their direct investments in China in renminbi, and Chinese investors settled 4.1 percent of their direct investments overseas in renminbi. At the same time, non-Chinese residents' holdings of renminbi deposits and bonds also grew rapidly. Renminbi customer deposits of Hong Kong banks increased from RMB315 billion yuan at end-2010 to RMB588 billion yuan at end-2011. According to BIS international securities data, renminbi offshore bonds outstanding at end-2011 amounted to some RMB320 billion yuan.

Non-Chinese residents have strong incentives to increase their exposure to renminbi assets and liabilities because the starting positions are in all likelihood significantly below their desired or optimal portfolio allocations into the renminbi. And such optimal allocations are likely to grow with the increasing weight of the Chinese economy in global production and trade. Some critics, such as Garber (2011), have taken one-way speculative positioning due to strong renminbi appreciation expectations as the main impetus for international use of the renminbi. However, the underlying incentive to increase exposure to renminbi assets and liabilities by non-Chinese residents is likely to remain strong, not easily reversed by cyclical fluctuations in exchange rate expectations.

From the Chinese residents' point of view, internationalising the renminbi can be expected to help to reduce currency mismatch of China's international balance sheet. Because of both current account surpluses and capital inflows, on the one hand, and the controls and the consequent lack of internationalisation of the renminbi, on the other, Chinese residents bears all the risk of an appreciation. Denominating China's claims on the rest of the world, or allowing non-residents to borrow, in renminbi would reduce this currency exposure (Cheung et al (2011)). Offshore renminbi bond markets would allow governments and firms outside of China to borrow in renminbi and thereby allow Chinese life insurers and pension funds to diversify credit while matching renminbi liabilities.

**The role of offshore markets**

Judging from the experience of the US dollar and other major reserve currencies, currency internationalisation is accompanied by the development of offshore markets of that currency. As He and McCauley (2010) have argued, offshore markets perform essential economic functions, including separation of currency and country risks and the diversification of operational risks.

Hong Kong was the first place outside Mainland China to have renminbi banking, supported by a clearing arrangement provided by the PBoC. Since 2004, Hong Kong has progressively developed into a renminbi offshore centre, with the scope of its renminbi banking business expanding from personal deposits, to bonds, to trade credit and project financing, and to interbank trading. Since July 2010, Hong Kong has produced a second set of spot and forward exchange rates for the renminbi, dubbed the CNH, for delivery of renminbi against dollars outside Mainland China. A second set of renminbi yield curves has also been formed in Hong Kong with the active issuance of bonds by the Chinese Ministry of Finance and firms from both inside and outside China. These offshore renminbi exchange and interest rates have retained a spread over but have tended to move in tandem with onshore rates.

At present, the renminbi balance sheet of banks in Hong Kong serves as a conduit for net renminbi lending from the rest of the world to the mainland. Renminbi bonds issued by non-banks and held outside the banking system tend also to result in a net renminbi claim of the rest of the world on China. However, as the expected path of the renminbi exchange rate shows much less consistent appreciation, non-resident borrowing in the renminbi looks to be less discouraged by one-way expectations on the exchange rate. Indeed, loans and advances in renminbi booked by Hong Kong banks grew rapidly in the first half of 2012. In this case, the renminbi offshore market in Hong Kong (and in other financial centres) can be expected to evolve along the paths of the other types of offshore markets (He and McCauley (2012)). Over time, the renminbi offshore market is likely to play above all the role of intermediary between non-mainland Chinese borrowers and lenders.

**Prospects**

The experience since 2009 shows that facilitating the internationalisation of the renminbi requires a deliberate pace of institutional reforms and policy liberalisation, which in turn would be conducive to a more open and market-based financial system in China. In the long run, the status of the renminbi as an international currency will depend on the size of the Chinese economy and the sophistication of renminbi financial markets. As long as Chinese economy keeps a fast pace of growth and further integrates with the global community, the prospect of the renminbi is bright.

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