The Role of the Renminbi in the International Monetary System

Advanced Programme for Central Bankers and Regulators
17-19 January 2013

Joseph Yam GBM, GBS, CBE, JP

Distinguished Research Fellow, Institute of Global Economics and Finance, The Chinese University of Hong Kong

The Roles of Money – Domestic and International

The Roles of Money

- Medium of exchange
- Store of wealth
- Unit of accounting

Guardian over Money

- National authorities have responsibility over its own money and pursue monetary policy in the national interest – currency stability, etc, so that money performs its roles effectively
- No corresponding international authorities to assume responsibility over international money and pursue policies that are in the global interest
- No dedicated international money exists in a meaningful form

International Monetary System

- Use of national currencies as mediums of international exchange, for the storage of international wealth and as units of international accounting
- Domestic orientation of policies over national money pursued by national authorities and lack of effective international oversight led to structural weaknesses in the international monetary system:
    - Ineffective global adjustment process
    - Financial excesses and destabilizing capital flows
    - Excessive exchange rate fluctuations and deviations from fundamentals
    - Excessive expansion of international reserves

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

International Monetary System

- Ineffectiveness international financial institutions: IMF, G-20, FSB, etc
- The status of the Special Drawing Rights (SDR)
- Two "wobbly legs" of the international monetary system: USD and euro
- Risk of systemic failure:
    - Disorderly unwinding of current account imbalances
    - Unchecked expansion of global liquidity overwhelming global and national financial stability
    - Exchange rate misalignments and crises
    - Encouraging fiscal imbalances in homes of reserve currencies and dangerously postponing needed fiscal adjustment

International Monetary Fund

Article I: Purposes

- (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

International Monetary Fund

Article I: Purposes

- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade

International Monetary Fund

Article I: Purposes

- (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members

International Monetary Fund

Article IV, Section 1. General obligations of members

"...the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth..."

"... a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability..."

Global Governance of the International Monetary System

Palais-Royal Initiative (2011):

"There is no unified global governance structure to help ensure that major economic and financial policy decisions made nationally, including exchange rate policies, are mutually consistent and contribute to global stability. In a world so deeply inter-connected, economic outcomes in each country depend significantly on developments and policy decisions made in others. In such a world, there is a strong case for rules and processes to be developed to help ensure global stability. The IMF was intended to provide this structure, but has been insufficiently effective..."

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

Institutional Reform of the International Monetary System

- A political process; long term global benefits unlikely to attract short term political enthusiasm
- Existing groups (IMF, G-20, etc) suffer from legitimacy deficit; distortions in the distribution of voting rights, representation and influence
- National interest considerations of the major stakeholders override the global interest
- Realistically, minor and gradual changes and no major surgery

A Chinese View on the International Monetary System

Governor Zhou on reforming the international monetary system (March 2009):

> "The desirable goal of reforming the international monetary system … is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies."

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

A Greater Role for the SDR

Governor Zhou (March 2009):

- "Though the super-sovereign reserve currency has long since been proposed, yet no substantial progress has been achieved to date."
- "The role of the SDR has not been put into full play due to limitation on its allocation and the scope of its uses. However it serves as the light in the tunnel for the reform of the international monetary system."
- "Special consideration should be given to giving the SDR a greater role."

Specific Proposals on the SDR

Governor Zhou (March 2009):

- "Set up a settlement system between the SDR and other currencies."
- "Actively promote the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping."
- "Create financial assets denominated in the SDR to increase its appeal."
- "Further improve the valuation and allocation of the SDR. The basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and the GDP may also be included as a weight."

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

A Chinese View on the International Monetary System

Governor Zhou (March 2009):

- "The reestablishment of a new and widely accepted reserve currency with a stable valuation benchmark may take a long time."
- "The creation of an international currency unit … is a bold initiative that requires extraordinary political vision and courage."
- "In the short run, the international community, particularly the IMF, should at least recognize and face up to the risks resulting from the existing system, conduct regular monitoring and assessment and issue timely early warnings."

International Responses to Chinese View

President Obama (March 2009):

"I don't believe that there's a need for a global currency ... As far as confidence in the US economy or the dollar, I would just point out that the dollar is extraordinarily strong right now. The reason why the dollar is strong right now is because investors consider the United States the strongest economy in the world with the most stable political system in the world."

International Responses to Chinese View

IMF MD (May 2010):

- "a more prominent role for the SDR"
- "a gradual move to a more multi-polar reserve system over time"
- "on the near term, there are no clear contenders to match the depth and liquidity of the US dollar market"
- "more widespread use of alternative reserve assets, e.g. euro or yen or renminbi denominated, could be encouraged, as could enhancing EM assets"
- "a multi-polar system may not enjoy the network effects of broad use of a single (sound) money, but the presence of alternatives provides a safety valve from unsound policies of any single reserve issuer"

International Response to Chinese View

G-20 Chair (2011):

- "the world has become multi-polar and could no longer be dominated by a single currency"
- "exchange rate instability poses a major threat to the global economic growth"

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

China's Perspective

- Largest foreign reserve holder: US$3.31 trillion at the end of 2012
- No alternative but to hold the bulk in USD and euro denominated assets
- Running reduced but still substantial balance of payments surplus (2010: 5% of GDP; 2011: 2.8% of GDP)
- With capital controls, foreign reserves are likely to continue to rise
- Exchange rate under political and economic pressures to appreciate
- Sovereign debt crisis in euro area and QE in US – huge exchange rate and credit risks
- Risk management measure: internationalization of the renminbi

Benefits of Internationalization – Example of RMB Trade Settlement

- USD used in trade settlement – export receipts in USD sold by exporter to SAFE for RMB; foreign reserves increase
- RMB used in trade settlement – a bank in China lends to Brazilian importer who pays RMB for imports from China
- Relative shift of external assets for China as a whole – from foreign reserve assets (e.g. US Treasuries) in USD held by the State to a private sector RMB bank loan to Brazilian importer
- Diversification of credit risk and elimination of exchange rate risk

Internationalization of the Renminbi – Benefits

- Reduces exchange rate risks
- Diversifies credit risks arising from the holding of external assets
- Increases seigniorage income
- Promotes development of financial markets
- Increases financial efficiency
- Promotes external trade
- Facilitates overseas investments

Internationalization of the Renminbi – Risks

- Possibility of greater volatility in capital flows, depending on convertibility arrangements
- Greater complexity for the People's Bank of China in the conduct of monetary policy – structural change in the policy transmission mechanism
- Generally greater challenge for the maintenance of monetary, exchange rate and financial stability

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

Five Pre-conditions for Internationalization of a Currency

- Size of the economy – country in a position to influence the choice of currency in international transactions
- International confidence in the currency sustained by prudent macroeconomic policies
- Convenient convertibility
- Sophisticated financial system to facilitate management by domestic and foreign entities of assets and liabilities denominated in the currency
- Robust financial infrastructure to ensure safety and efficiency in the conduct of transactions denominated in the currency

Size and Influence

- China is second largest economy in the world, though still (at around US$8 trillion) only a little over half of US; various projections put it as the largest economy within 10-20 years
- China equals US as largest trading partner in the world; will surpass US quickly
- China is largest foreign reserves holder in the world
- China is largest country in terms of population

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

Prudent Macroeconomic Policies

- Prudent macroeconomic policies support international confidence in currency
- Superb track record in such macroeconomic numbers as growth, inflation, employment, external balance, fiscal balance as % of GDP and debt to GDP ratio
- The policy transmission mechanism of a socialist, market economy versus that of a capitalist, free market economy
- But doubtful efficiency in the allocation of scarce resources

Currency Convertibility – Current Account

- Current account fully convertible (1996)
- IMF Articles of Agreement 8: "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions"
- Regulation of Foreign Exchange System of the People's Bank of China, Article 5: "International payment and transfer in foreign exchange for current transactions shall not be subject to government restrictions"

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

Currency Convertibility – Capital Account

- Ongoing capital account liberalization
- Extensive restrictions remain in capital account convertibility
- Financial crises strengthened caution: repeated emphasis on controllability, gradualism and the ability to take initiatives in financial reform
- Recent relaxations in capital controls: QDII, QFII, participation of central banks and banks with offshore RMB funding to onshore inter-bank RMB bond market

Free or Full Convertibility

- Potency of foreign exchange market – implications for monetary and financial stability
- Increasing use of capital controls as remedies: IMF endorsement; paradigm shift?
- Distinction between free and full convertibility
- PBC regulation Article 12: receipts and payments in foreign exchange for current account transactions shall have bona fide and legitimate transaction backgrounds … Financial institutions … shall exercise due diligence in checking authenticity of transaction documents … The foreign exchange administration agencies have the right to supervise the conduct inspections

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

Financial System

- Relatively less developed
- Financial intermediation becoming more diversified (bank loans as % of aggregate financing of the economy: 52% in 2012 compared with 92% in 2002)
- “Entrusted” and “trust” loans, bonds and equity gaining popularity
- But concerns over robustness of shadow banking
- Inadequate depth and liquidity of financial markets
- Rightly cautious about financial innovation

Financial Infrastructure

- Enjoys the advantage as a late starter with the use of advanced information technology
- Sophisticated trading, payment, clearing, settlement and custodian systems
- Considerable reporting requirement still remain, reflecting continuing controls, inhabiting financial efficiency and convenience
- Hong Kong, as the international financial centre of China, has much to offer

RMB Internationalization – Approach

- No clear strategy articulated, but the benefits (management of exchange rate and credit risks, etc) and the risks (of too hasty capital account liberalization to monetary and financial stability) are clear
- The guiding philosophy for reform and liberalization to build a socialist, market economy – crossing river by feeling the stones (Deng); gradualism, controllability and initiative (Wen)
- Controlled experiments through development of off-shore RMB market in Hong Kong

RMB Internationalization – Approach

- Need to accept that the off-shore (freer) market exists for the purpose of doing (desirable) things that, for good reasons from the perspective of the Mainland, could not be done on-shore
- Need to be careful that the tail does not wag the dog – the off-shore market does not undermine financial safety and effectiveness of monetary and financial policies on-shore
- The two markets need to stay connected for the purposes of effective risk management and the transmission of important market signals (e.g. anomalies between on-shore and off-shore market conditions) useful for identifying further areas for reform and liberalization

RMB Internationalization – Approach

- On-shore market, on-shore rules; off-shore market, off-shore rules, in the spirit of "One Country, Two Systems"
- Linkage of off-shore market to on-shore market through RMB Settlement Bank in Hong Kong (BOCHK) maintaining a clearing account with PBOC in Shenzhen; Mainland banks can also act as correspondence banks for overseas banks conducting approved RMB activities off-shore
- Integrity of continuing Mainland controls safeguarded through provisions in the Settlement Agreement (between PBOC and BOCHK), which are reflected, as necessary, in separate settlement agreements between BOCHK and RMB Participating Banks in Hong Kong

RMB Internationalization – Progress

- Subject first raised in November 2001 visit to Beijing by delegation of Hong Kong Association of Banks
- November 2002 – Qualified Foreign Institutional Investment (QFII) scheme introduced (access of foreign investors to capital markets in China)
- January 2004 – RMB business introduced in Hong Kong covering deposits, remittances, credit cards and conversion by Hong Kong residents
- April 2006 – Qualified Domestic Institutional Investors (QDII) schemes introduced (access of domestic investors to foreign capital markets)
- July 2007 – first issue of RMB bonds in Hong Kong; issuer coverage expanded subsequently but no clear criteria for approval yet

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

RMB Internationalization – Progress

- January 2009 – People's Bank of China and HKMA signed currency swap agreement of RMB200 billion, in effect establishing RMB liquidity facility in Hong Kong; swap agreement enlarged to RMB400 billion in November 2011
- July 2009 – RMB trade settlement pilot scheme (for selected cities and enterprises) introduced and subsequently expanded by stages to cover all entities on the Mainland by March 2012
- August 2010 – selected institutions (including foreign central banks) allowed access to Mainland inter-bank bond market

RMB Internationalization – Progress

- August 2010 – RMB export receipts of overseas non-bank institutions can be put on bank deposits on the Mainland
- January 2011 – use of RMB in overseas direct investment (ODI) by Mainland enterprises allowed
- October 2011 – use of RMB by foreign enterprises for ODI in Mainland of China allowed
- December 2011 – foreign investors allowed access to bond and equity markets on Mainland through RMB QFII schemes
- August 2012 – freedom to conduct RMB business for non-HK residents in off-shore market confirmed; but mobility between CNH and CNY markets restricted

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

RMB Internationalization – Strategy

- Hitherto rather ad hoc moves that do not suggest the existence of an elaborate strategy or sequencing – a reflection of the guiding philosophy of "feeling the stones" and gradualism, etc
- Rather too political at times – complex international politics as well as simply wishing to be seen to be supportive whenever Hong Kong Special Administrative Region is in difficulty
- Could benefit from an analytical framework – for developing strategy and identifying future moves

RMB Internationalization
An Analytical Framework

Analytical Dimensions	Alternatives	
Location	On-shore	Off-shore
Currency	RMB	Forex
Action	Cross Border Mobility	Cross Currency Conversion
Nature	Current Account	Capital Account
Status	Resident	Non-resident
Identity	Individual	Corporation

RMB Internationalization
An Analytical Framework

			On-shore				Off-shore			
			RMB		Forex		RMB		Forex	
			Mobility	Conversion	Mobility	Conversion	Mobility	Conversion	Mobility	Conversion
Current Account	Resident	Individual								
		Corporation								
	Non-Resident	Individual								
		Corporation								
Capital Account	Resident	Individual								
		Corporation								
	Non-Resident	Individual								
		Corporation								

RMB Internationalization
An Analytical Framework

- Anomalies of treatment among the 64 areas provide pointers for further internationalization of RMB and capital account liberalization
- Example (1): mobility of RMB bond proceeds from off-shore to on-shore by resident corporations (allowed) and non-resident corporations (not allowed)
- Example (2): no conversion restrictions by non-residents off-shore but RMB20,000 limit each day for Hong Kong residents
- Example (3): RMB mobility restriction for non-residents from off-shore to on-shore, but RMB80,000 a day limit for Hong Kong residents
- Example (4): mobility of forex from on-shore to off-shore by residents for capital account purposes

香港中文大學
全球經濟及金融研究所
Institute of Global Economics and Finance
The Chinese University of Hong Kong

RMB Internationalization – Implications for the International Monetary System

- RMB internationalization in the national interest of China, particularly in terms of risk management
- China not aiming a RMB takeover of the reserve currency status of the USD or the euro
- Dominance of global reserve currency status of USD will remain, despite increasing concerns arising from uncertain macroeconomic stability
- Break up of euro unlikely and fiscal discipline will be reestablished one way or another, with or without fiscal transfers
- RMB will become the third leg of a multi-polar international monetary system; also likely to be included in the SDR
- New convertibility paradigm may emerge

RMB Internationalization – Implications for the International Monetary System

- Recall structural weaknesses of international monetary system:
  - * Ineffective global adjustment process
  - * Financial excesses and destabilizing capital flows
  - * Excessive exchange rate fluctuations and deviations from fundamentals
  - * Excessive expansion of international reserves
- Improvements likely with RMB internationalization, particularly if new convertibility paradigm emerges, but not panacea
- A larger cultural issue in finance to be, or hopefully being, addressed