



## The 10<sup>th</sup> Anniversary of RMB Internationalization And Future Path ——Constructing A New Ecological Circle Of RMB Internationalization Under Financial Markets Opening

Dr. E Zhihuan, Chief Economist

In the past decade, RMB, as an international settlement and reserve currency, have made progress during its internationalization amid combined efforts of policy-driven development and market traction. Looking ahead, the reversing of economic globalization and the resurgence of trade protectionism will present unprecedented challenges to international economic and financial situation. In response to the changing external environment, China has launched the second round of high-level financial opening since its entry into the WTO, involving banks, securities, funds, insurance, ratings agencies, third-party payment, and financial markets. With improving infrastructure and optimized supporting policies in the capital markets, interconnection between domestic financial markets and overseas markets has been enhanced, which could increase the linkage between domestic and external interest rates, and intensify exchange rate volatility. The dramatic adjustment of internal and external environment will then directly affect the development path of RMB internationalization.

### **The 10<sup>th</sup> anniversary of RMB internationalization: driven by both policies and the market**

After the outbreak of the global financial crisis, the international financial markets generally recognized the institutional flaws of the current US dollar-centric international monetary system, and it is in urgent need of new public goods and solutions. The RMB has kicked off its internationalization process, which was driven by policies as well as the market. With the policy constraints on the offshore RMB business gradually relaxed, endogenous business demands in the offshore RMB market have increased, fulfilling RMB's status as an international reserves currency, and steadily elevating the degree of RMB internationalization.

#### **1. Share of international payments has fluctuated, and the function as settlement currency is base for RMB internationalization**

The cross-border use of RMB under the trade of goods was an important driver of early RMB internationalization. In November 2014, the RMB share as international payments currency reached 2.45%. In 2016, global RMB payments in value fell by 29.5%, with its share slipping from 2.31% in December 2015 to 1.67% at the end of December 2016, while global payments increased by 0.67% during the same period.

According to SWIFT, the RMB share as the fifth largest international payments currency stood at 2.07%, up from 1.60% in the same period last year, along with the US dollar, the euro, the pound and the yen. In April 2019, the Hong Kong RMB RTGS settlement amounted to 20.9 trillion yuan.

At present, cross-border use of RMB in the trade sector is completely liberalized, which indicates that the policy traction has given way to the development of the market itself, and the market adjusts according to changes in the RMB exchange rate and capital flows. Cross-border trade remains a substantial base for the continued promotion of the RMB internationalization.

## **2. RMB began to establish its status as international reserve currency**

With the development of the offshore RMB market, Hong Kong, Singapore, Russia and other regions have taken the lead in allocation into RMB assets. In 2016, the RMB joined the International Monetary Fund Special Drawing Rights (SDR), and overseas central banks become more willing to hold RMB assets. In 2017, the European Central Bank announced to convert 500 million euros worth of its U.S. dollar reserves into the Chinese currency. In early 2018, the Deutsche Bundesbank planned to include the RMB in its foreign exchange reserves, while the French central bank also revealed that foreign exchange reserves are diversified into a limited number of international currencies such as the RMB. Other central banks and related institutions are eager to learn more about the Chinese economy and the RMB exchange rate, to gather market intelligence for their allocation into RMB assets. At present, more than 60 central banks and monetary authorities in the world have included RMB in their foreign exchange reserves, which helped elevated the status of RMB as an international reserve currency.

In March 2017, the International Monetary Fund (IMF) released the currency composition of official foreign exchange reserves (COFER), separately identifying holdings in RMB for the first time. As of the third quarter of the year, the size of RMB foreign exchange reserves was US\$107.94 billion, accounting for 1.12% of the total allocated foreign exchange reserves. As of the fourth quarter of 2018, the size of RMB foreign exchange reserves held by foreign central banks reached US\$202.79 billion, accounting for 1.89% of the world's official foreign exchange reserves, higher than the 1.80% in the third quarter, and the highest since October 2016. The increasing proportion of RMB in global central bank's foreign exchange reserves reflects the continuously rising interests by foreign investors in holding RMB assets, which is conducive to the diversification of foreign exchange reserves.

In July 2017, the launch of Bond Connect successfully linked the domestic bond market with the Hong Kong market, providing a more convenient channel for overseas institutions to increase their holdings of RMB bonds, and encouraging foreign investors to allocate into RMB assets. As of March 2019, the outstanding amount of Chinese inter-bank bonds held by overseas institutions reached 1.76 trillion yuan, up 35.2% from the same period last year. Currently, more than 845 international investors have tapped China's bond market through Bond Connect, and its services have expanded to 27 countries and regions around the world.

## **3. Function as an international pricing currency begins to take root**

Enhancing RMB's function as an international pricing currency is one of the most important goals of RMB internationalization. Over the past few years, RMB was increasingly used for transaction in commodities, and expanded its influence on commodity pricing, such as petroleum, etc. It is hoped that "Petro RMB" could be used to jumpstart the development of RMB internationalization, and explore the possibilities of organic integration between petroleum-related sectors and financial industries, in order to withstand the challenges related to the huge volatilities in international commodity price, secure resource availability and national safety, and expand the use

of RMB in petroleum pricing and transactions. In March 2018, crude oil futures contract was listed in Shanghai International Energy Exchange. These crude oil futures are priced in RMB, with net settlement and tax-free delivery features. Currently, the crude oil futures transactions in Shanghai accounted for around 6% of total crude oil futures transactions in the world, ranked number three, following WTI in New York and Brent in London.

When more and more countries choose to use RMB as the pricing and settlement currency for multilateral trade on crude oil, the demand and usage of RMB will increase notably. Meanwhile, the more active use of currency swap between central banks is also encouraged, which can facilitate the usages of RMB among both governmental and private organizations overseas.

## **The latest round of financial opening has four main characteristics**

The objective of the latest round of financial opening is to create an all-rounded, multi-layered and widely covered high quality opening environment. Overall, it has the following characteristics.

### **1. Pre-entry national treatment and negative list are the main features of the financial opening agenda**

In April 2018, President Xi announced four major opening up initiatives at the Boao Forum. The People's Bank of China (PBOC) then announced 11 financial opening measures. In 2019, the China Banking and Insurance Regulatory Commission (CBIRC) announced Detailed Rules for the Implementation of the Regulation of the People's Republic of China on the Administration of Foreign-funded Banks (Revised Consultation Paper). In May 2019, CBIRC announced 12 opening measures, including removing the shareholding limits in Chinese commercial banks held by a single Chinese bank or a single foreign bank investment, removing the total asset requirement of US\$ 10 billion for foreign bank to set up a Chinese subsidiary bank and the total asset requirement of US\$ 20 billion to set up a Chinese branch; abolishing the approval requirement for foreign banks to carry out RMB businesses and allowing foreign banks to engage in RMB businesses once they are allowed to do business. In the insurance sector, the opening measures allow offshore financial institutions to invest in the equity of foreign insurers in the Mainland or invest in the establishment of insurance institutions, abolish the requirement that foreign insurance brokers engaging in insurance brokerage operations in China should have operation for at least 30 years, and have total assets of no less than US\$ 200 million. Obviously, the financial opening in the Mainland continues to follow the national treatment principle, gradually relaxing the shareholding and licensing requirements, and further shortening of the negative list. The shareholding limits of foreign financial institutions on all financial sectors that require a license have been fully relaxed, hopefully stimulating the interests of foreign financial institutions to actively participate in the financial opening in the Mainland.

Obviously, the national treatment principle and negative list are the main features of financial opening in the Mainland which will gradually lead to a level playing competition between domestic and foreign institutions. The State Administration of Foreign Exchange (SAFE) is now researching on the foreign exchange management framework for foreign investment companies according to the national treatment principle and negative list, which could help solidify the unified macro-prudential and micro-monitoring framework on cross-border capital movement.

## **2. The focus of capital markets opening has shifted from channel management to more connection between onshore and offshore capital markets**

In the past, the Mainland relied on a number of channels to facilitate the opening up of capital markets. The establishment of Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect provides the linkage between onshore and offshore capital markets. In June 2017, MSCI first included Mainland's A share into its emerging markets and world indices, with an initial weighting of 0.73%. It was a milestone of Mainland's equity market development which offers offshore investors the convenience in allocating RMB equity assets. In July 2017, the northbound Bond Connect started its operation, offering offshore investors a new channel to participate in the Mainland's bond market. Since the establishment of Bond Connect, roughly one-third of all new investment into the Mainland's bond market came from the Bond Connect. With the increasing connection between onshore and offshore equity and bond markets, it can better serve the needs of RMB asset allocation of foreign investors.

The increasing capital market connection can bring the benefits of building a rule-based, transparent, open, active and resilient multi-layer capital market system, facilitate more medium to long term foreign capital flows into the Mainland's capital markets, rationalize market structure, foster equity financing, price discovery and risk management role and function of the capital markets, as well as support the supply-side reform for onshore financial sector

## **3. Local currency businesses take priority in the opening up of onshore capital markets**

The opening up of Mainland's capital markets should focus on local currency businesses first. Stability and orderly approach is of the most important for the financial market opening. In the opening up of the few unconvertible items of capital accounts, the Mainland authorities adopt the approach of launching policy initiatives once they are ready. Recently, Bloomberg announced the inclusion of onshore RMB bonds into the Bloomberg Barclays Global Aggregate Bond Index, with a phase-in period of 20 months. Currently, there are around US\$ 5-6 trillion of assets tracking the three major bond indices globally. Some offshore investors tend to create an asset portfolio following a passive investment strategy. Following the incorporation of RMB bonds into these major indices, more foreign investors will adjust their asset portfolio to raise the share of RMB bonds. Assuming overseas investors will include and increase the share of RMB bonds up to 5% to 10% of their asset portfolio, as much as RMB 3-6 trillion of net capital inflows are expected. It is believed that there will be around 390 onshore bonds meeting the eligibility to be included in those global indices. Assuming Chinese bonds could account for around 5.5% of the Bloomberg Barclays Global Aggregate Bond Index (which represents a US\$ 54 trillion global bond market), RMB bonds will become the fourth largest asset group following US dollar, Euro and Japanese yen bonds.

## **4. Free trade zone takes the lead in financial opening**

During the process of financial market opening, the free trade zones in Shanghai and Hainan focus on the pilot scheme of financial opening and strongly supporting the development of international financial center in Shanghai. In addition, the Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area also includes financial market opening and innovative measures, fostering the building of international financial hub, with the focus of specialty finance, including marine financing, technology financing, and aircraft leasing, etc., as well as supporting more cooperation between financial institutions in Guangdong, Hong Kong and Macau

to further develop offshore financial businesses, and gradually increase the scale and scope of cross-border RMB usage in the Greater Bay Area, etc.

## **New environment and challenges to RMB internationalization**

Throughout the history of international currency development, a successful internationalization of a currency is inseparable from a robust economic scale, substantial international trade, as well as stable and dynamic financial markets. After ten years of development, the internationalization of RMB has made some progress, but it still lags behind the development of China's economy, trade, and investment. Therefore, there exists huge room for improvement of the internationalization. However, under the background of dramatic changes in the international financial landscape and China's further opening up in the financial sector, RMB internationalization faces unprecedented opportunities and challenges.

In term of opportunities, to fundamentally change the long-standing trade imbalance and massive trade deficits that plague developed economies, we must adjust the dominant position of the USD in the international monetary system. That provides a possibility for maintaining the stable position of RMB theoretically. The internationalization of RMB can offer a diversified choice for the USD-dominated international monetary system and provide Chinese solutions in promoting a more complete, stable, and fair international monetary system. Judging from the experience of US-Japan trade war, the US supported the appreciation of Yen and proposed that Yen should assume certain international monetary functions at that time. That move was to accelerate structural changes in the Japanese economy and fundamentally reduce Japan-US trade surplus. However, developed economies' trade deficits are inevitable with USD's international reserve currency status. The US has exported USD through trade deficits for a long time, while some of which returned to the US in the form of service surplus, and more returned to the US financial markets through capital investment. This is the global cycle of capital flows.

From the perspective of challenges, trade war embodies the "US first" trade protectionism, which will continue to ferment for a long time with profound economic and social roots. Global trade protectionism is to improve trade deficits ostensibly, but in essence, to curb the development of China's science and technology. It restricts the development of high-tech industries, China's opening-up, and even long-term relationship between China and the US. All those factors are objectively unfavorable to the RMB internationalization because they make Sino-US trade frictions unimaginably complex and serious.

With a closer connection to international markets, China's financial markets face more direct challenges due to the complex and volatile environment. While external risks are rising, the financial uncertainty in China's economic development is more significant. For example, total debt to GDP ratio continued to remain at high level of 277% to 284%; the task of reducing macro leverage is challenging; the risks of shadow banking, real estate finance and internet finance continue to rise. There is an urgent need to prevent and resolve financial risks, effectively control macro leverage, and improve the adaptability of financial structures. Moreover, it's also essential to stress the role of financial sector in serving real economy, comprehensively strengthen the construction of rigid restraint systems, as well as effectively prevent and control financial systemic risks. The ability to control China's internal and external financial risks is related to whether the RMB internationalization can develop steadily. The pace of RMB internationalization will be adjusted if



there is a systemic shock, which will disturb the stability of the RMB exchange rate in the global financial markets.

## **Construct a new ecology of RMB internationalization in the open financial markets**

In the new round of financial openness, the status of the RMB as a reserve currency will be further enhanced. To this end, it is necessary to carry out theoretical innovation and practical exploration in the theoretical and practical subjects of building a modern economic system, establish a conceptual framework of RMB internationalization based on the perspective of opening macroeconomics and finance, and create a new RMB internationalization ecosystem.

Firstly, the RMB internationalization is a long-term strategy. The basic path of RMB internationalization is to adhere to market-based exchange rate reform and stabilize the position of RMB in international monetary system. It provides diversified options and new public goods from emerging markets, which can solve the institutional defects of current USD-centric international monetary system. It also provides China solutions to promote a more stable and fair international monetary system. Chinese authorities should enhance the elasticity of the RMB exchange rate, improve global market's confidence in RMB assets, and create conditions step by step to establish a new function of RMB as a safe-haven currency.

Secondly, under the premise of ensuring economic security, we should meet the long term demands by all global investors for RMB assets. To this end, we will establish a benign interaction between domestic monetary finance and real economy under RMB internationalization framework, open capital markets steadily, improve the operating mechanism of financial markets continuously, and enhance the depth and breadth of RMB financial markets. In that way, new interaction between RMB exchange rate and the main price index of domestic capital markets can be gradually achieved, and the simultaneous decline in stocks and exchange rates can be avoided.

Thirdly, to create a new ecosystem for RMB internationalization, we will realize the combination of policy-driven and market-oriented system under the background of accelerating the opening up of China's financial markets. Increasing the proportion of RMB in global reserves and foreign exchange transactions cannot be done at one go. It needs to be explored from different perspectives such as cross-border trade and investment, assistance for merchants on using RMB, and etc. In this way, it can be realized through coordinating trade, investment, and financial transactions, and forming a productive atmosphere for the international use of RMB.

Fourthly, the scale and structure of capital inflows and outflows will undergo continuous adjustment and optimization, as the demands for global asset allocation by some domestic entities rise continuously. For example, China's private sector holds foreign financial assets equivalent to only 27% of GDP (much lower than US's 129% and Japan's 147%). The factors affecting RMB internationalization are multifaceted, so bottom-line thinking is needed—we should carry out sand table exercise for major initiatives to discuss relevant policies and their possible market impacts in detail for controlling financial risks.

In short, the RMB internationalization means that China needs to undertake more international responsibilities in maintaining global financial stability and play a more active role in global financial governance. Therefore, we should pay attention to coordinate domestic and foreign policies, balance the interests of both domestic and foreign entities, and develop steadily and continuously the process of promoting the RMB internationalization.