The Myth of the Internationalization of the Chinese Yuan

By Chi Lo

Beijing's real behind-the-scenes agenda.

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In August 2010, American hamburger chain McDonald's became the first international non-financial company to issue debt denominated in the Chinese renminbi currency. Despite its small size (US$29 million), the McDonald's renminbi bond has led some, including policymakers and bankers, to believe that Beijing has started a process for internationalizing the renminbi, paving the way for its establishment as a reserve currency to compete with the U.S. dollar. That would be an enormous leap for a currency that is not fully convertible.

The renminbi is nowhere near that stage yet. There may be other shorter-term goals that Beijing aims to achieve by using renminbi internationalization as a conduit. These include jump-starting the domestic bond market in China by shaking up the local financial markets, and rejuvenating Hong Kong's financial sector. Beijing may not want to see the development of a significant offshore renminbi market just yet. Renminbi internationalization is still progressing in small steps, despite the recent seemingly large policy strides, and the Chinese currency is unlikely to replace the U.S. dollar as the world's reserve currency for some years to come.

The McDonald's renminbi bond followed a flurry of offshore renminbi liberalization activity centered on Hong Kong. In mid-2009, Beijing launched a pilot scheme, since expanded, to allow foreign trade to be settled in renminbi. In July this year, it took another step by allowing offshore banks to transfer renminbi among themselves by establishing an inter-bank renminbi

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market among these offshore banks, thus opening the way for the creation of renminbi-denominated financial products such as mutual funds. Then in August, in what was potentially the most crucial change, it allowed offshore banks and central banks to invest in China's inter-bank bond market.

These last two measures are, in fact, a natural development resulting from Beijing's push for the usage of renminbi for trade settlement. This is because successful cross-border trade settlement in renminbi implies a growing accumulation of renminbi holdings by China's trading partners around the world. This will increase the demand for parking these holdings in liquid and safe assets. As a result, pressure on accessing the renminbi bond market should build along with wider adoption of settlement in renminbi.

Even if Beijing is willing to let more foreigners play in the domestic bond market—which is far from certain—there is the other side of the equation to consider. Any significant progress in renminbi internationalization would mean a significant shift away from the U.S. dollar as the world's reserve currency. This would have huge implications for financial markets beyond exchange rates. Foreign investors, including central banks, are estimated to hold 50 percent (US$3.2 trillion) of the U.S. Treasury bond market. China is the largest foreign sovereign holder, accounting for one-quarter of all foreign holdings. The U.S. Treasury market would crash if China and other sovereign holders started to desert it. That would force a sharp rise in U.S. interest rates, strangling America's corporate bond and mortgage markets. All this would crush the U.S. economy and asset markets, sending negative shock waves around the world. It would hurt China, too, both in terms of the negative impact on its economic growth and valuation of its U.S. dollar assets held in its foreign reserves.

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Internationalizing the renminbi may also create a big offshore renminbi market, just like the creation of the offshore U.S. dollar (or euro-dollar, as it is known) market in July 1963 in Europe and subsequently in Asia, following the imposition of the 15 percent interest-equalization tax by the United States to stem capital outflow. Contrary to the optimists' view, Beijing may not want to see such a development because it could negatively impact the local system in unintended ways.

Offshore currency markets operate essentially as a shadow banking system, like that which lay at the heart of the U.S. subprime crisis. Banks offering foreign currency deposits and loans within an offshore currency area (say offshore banks offering renminbi deposits and loans in Hong Kong) do not have to observe reserve requirement ratios

Have It Your Way

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The Drum Tower of Xi'an, erected in 1380 during the early Ming Dynasty, towers above the city center and offers incredible view of the city of Xi'an in Shaanxi province, China. The McDonald's outlet next door is a more recent addition.

that operate in the on-shore currency area (such as China). This gives offshore banks greater latitude to expand their foreign currency offerings. But this also means greater risk in the event of a liquidity shock. Further, banks participating in an offshore market are free from the capital adequacy requirements imposed on them in the currency's home market. Again, this can be a boon to the banks but entails greater risk from the regulator's perspective.

Since regulators generally do not impose liquidity requirements on bank assets held offshore (say in Hong Kong), even though these assets are denominated in the regulator's home currency, there are great risks. Offshore currency markets typically experience faster expansion during business cycle upswings and sharper contractions during economic recessions. This can amplify the boom-bust cyclical forces back in the home system, which the regulators seek to avoid. Hence, there could be potentially unintended negative effects on the world and Chinese economies that Beijing would not want to experience. Even in the medium-term, it is unlikely that China and other central banks can, and would, replace the U.S. dollar in their foreign reserves with other assets and currencies in a significant way.

Fundamentally, for the renminbi to be truly internationalized—a hard currency accepted anywhere in the world as a medium of exchange and a reserve currency—China needs to be a large net importer of goods and a net exporter of capital in order to allow its partner nations to accumulate renminbi assets in significant size. China will also need a strong financial system to withstand significant capital flows, and creditable economic policies to gain international confidence. All this requires considerable changes in the economic structure, which may take decades to achieve. The popularity of the U.S. dollar and British pounds as reserve currencies is associated with at least 20 percent overseas ownership of their respective domestic bonds, which is also a sign of international confidence in their respective economic policies. It could take a long time before offshore entities can hold renminbi bonds of a similar magnitude and before China can acquire complete international policy credibility.

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Finally, how far China wants renminbi internationalization to go remains uncertain. Japan backed out of its Japanese yen internationalization effort after a head start in the 1970s for the fear of negative impact on its domestic financial markets. The Japanese government has since taken a passive role in yen internationalization. The point is that a weak and underdeveloped domestic financial system is an obstacle to currency internationalization. And where does China's financial system stand, and how fast is Beijing willing to modernize it? We do not know for sure. In a nutshell, despite all the hype, Beijing's renminbi internationalization effort so far is at a very initial stage. The renminbi lacks the foremost prerequisite to become a global currency—free and full convertibility—and the move towards this state, in turn, is dependent on the development of a sound, deep, and proper functioning capital market in the country.

PROMPTING CHINESE BOND MARKET REFORM

At the heart of Beijing's concerns about creating a renminbi offshore market as a byproduct of internationalizing the renminbi is its quest for control of the economy, the financial system, and interest rates. That is why the capital account remains largely inconvertible, despite various financial liberalization measures over the years. Freeing up the capital account would mean allowing non-trade-related fund flows in and out of China. This would expose the Chinese economy to sharp currency fluctuations and balance-of-payments shocks which Beijing has been trying hard to avoid. So what to make of the recent seemingly bold moves to allow foreigners participating in the Chinese bond market and offshore banks in Hong Kong to transfer renminbi freely among them?

My guess is that the market reformers at the People's Bank of China are getting an upper hand in the recent policy debates. They are experimenting with shaking up the domestic financial markets with a shock by liberalizing the domestic bond market a little bit (under the guise of internationalizing the renminbi). As it stands, the Chinese bond market is tiny. Financial institutions, which are predominately the holders of bonds, tend to hold onto their bonds till maturity. This deprives the Chinese bond market of liquidity and a price discovery mechanism because there is no secondary trading.

The reformers at the People's Bank of China want market forces to play a bigger role in the process of capital allocation and setting of risk premia. By allowing some foreigners to play in the domestic bond market, the central bank hopes to bring in market forces through the back door. How effective this move will be is uncertain. Experience is not encouraging, because despite Beijing's moves to list shares of the state companies and bring in foreign investors, the A-share market is still distorted.

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BOOSTING HONG KONG'S FINANCIAL SECTOR

The other short-term goal Beijing hopes to achieve in the name of renminbi internationalization, in my view, is to boost Hong Kong's financial sector by giving it an opportunity to expand renminbi business and create value-added for the local economy. The recent new measures will allow greater usage of renminbi under the trade settlement scheme, and provide a more flexible platform for Hong Kong's financial institutions to offer renminbi-denominated investment products.

Most banks in Hong Kong assume that the usage of renminbi in Hong Kong's current account and foreign direct investment flows will grow significantly in the coming years, so there will logically be an increase in the demand for renminbi-denominated investment products to satisfy the desire for holding renminbi. Knowing that there are more renminbi-denominated financial products available, the desire to use renminbi for trade transactions will rise. This will, presumably, create a virtuous cycle of boosting renminbi circulation in Hong Kong, creating more investment products, and increasing the incentive for using renminbi, and so on. The economic value-added coming out of this cycle will be seen in job creation and financial innovation in Hong Kong's financial sector.

THE TRUE COLOR OF RENMINBI INTERNATIONALIZATION

From a policy perspective, Beijing's latest moves to internationalize the renminbi and liberalize the Chinese bond and renminbi interbank markets do not necessarily point to creating a large renminbi offshore market, which many Hong Kong bankers hope would boost offshore renminbi lending capacity. This can be seen in Beijing's latest intention to approve the so-called mini-QFII (or mini-Qualified Foreign Institutional Investor) scheme in Hong Kong and the move to allow offshore banks and central banks to invest in the Chinese interbank bond market. Unlike the QFII scheme, which is an investment quota scheme only open to foreigners who invest in the A-share market by changing foreign currencies into renminbi, the mini-QFII scheme is only open to offshore Chinese corporates in Hong Kong to invest their renminbi cash holdings in the A-share market.

From an investor's perspective, this scheme swaps cash with a renminbi asset. So the net impact on the investor's net worth depends on the changes in the renminbi asset's value. Similarly, when an investor buys a renminbi bond, the investor swaps renminbi cash with the fixed-income asset. But from a macro perspective, the mini-QFII and bond investment schemes are in fact a mechanism for draining renminbi liquidity back to China. All things equal, renminbi liquidity among Hong Kong banks actually falls with the implementation of these schemes so that their lending capacity will also be reduced. Total renminbi deposits in Hong Kong amounted to about ¥100 billion in July 2010. According to market sources, in the first mini-QFII tranche, Beijing would approve a quota of ¥10–20 billion. That means just this scheme would drain 10–20 percent of Hong Kong's renminbi back to China, if other things remain unchanged. With more mini-QFII tranches, more liquidity will be drained back to China. The same argument goes for allowing more foreign investors to invest in the Chinese interbank bond market, as offshore renminbi flow back to China via the bond market.

From this perspective, it is an illusion that Beijing's recent moves will also boost offshore renminbi lending business in Hong Kong. This goes back to my view earlier that Beijing does not want to see the development of a large offshore renminbi market in whatever form it may take, for the fear that it would lose control of the currency. It is unlikely that Beijing would accept a situation like that of the U.S. dollar, which is the world reserve currency but with 50 percent of its stock circulating outside of the United States, and no firm control by the U.S. Federal Reserve. Renminbi internationalization is still a very slow process, and the development of a significant offshore renminbi market is not in the cards yet. The Chinese currency is still a long way from replacing the U.S. dollar as the world's reserve currency. ◆