

Internationalization of the Renminbi

Developments, Problems and Influences



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Ming Zhang



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About the New Thinking and the New G20 Project

The project aims to promote policy and institutional innovation in global economic governance in two key areas: governance of international monetary and financial relations and international collaboration in financial regulation. Sponsored by CIGI and the Institute for New Economic Thinking, the project taps new research and next-generation scholars in the emerging economies, linking them to established networks of researchers in the industrialized world. The objective over the longer run is to create a more permanent and self-sustaining research network that will provide a continuing stream of new ideas, sustain international collaboration and integrate researchers from the emerging economies into global policy discussions.

Miles Kahler and Barry Eichengreen (principals in the original project) recruited C. Randall Henning (new principal, American University) and Andrew Walter (University of Melbourne) to lead two research teams devoted to macroeconomic and financial cooperation and to international financial regulation. Gathering authors from eight countries, the project consists of 11 CIGI papers that add to existing knowledge and offer original recommendations for international policy cooperation and institutional innovation. CIGI will also publish the final papers as an edited volume that addresses the global agenda in these issue-areas.

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Acronyms

BIS	Bank for International Settlements
CASS	Chinese Academy of Social Science
CNH	offshore RMB market
CNY	onshore RMB market
EUR	euro
FDI	foreign direct investment
L/C	letter of credit
ODI	outward direct investment
PBoC	People's Bank of China
QE	quantitative easing
RMB	renminbi
RQFII	RMB Qualified Foreign Institutional Investors
SOE	state-owned enterprise
USD	US dollar

Executive Summary

Due to the 2008-2009 global financial crisis, the Chinese government began to promote renminbi (RMB) internationalization in order to raise its international status, decrease reliance on the US dollar (USD) and advance domestic structural reform. RMB internationalization has achieved progress not only in cross-border trade settlement, but also in the offshore RMB markets. However, the rampant cross-border arbitrage and the relatively slow development of RMB invoicing compared to RMB settlement are becoming increasingly problematic. RMB internationalization has exerted significant influence on not only the Chinese economy but also other emerging market economies. RMB internationalization complicates domestic monetary policy, exacerbates the currency mismatch on China's international balance sheet and increases both the scale and volatility of short-term capital flows. It offers emerging economies another alternative for pricing domestic currency and investing foreign exchange reserves. Its overall impact on the international monetary system's stability will depend on how the capital account is liberalized and the consistency and transparency of Chinese monetary policy. This paper concludes with five recommendations for Chinese policy makers to promote RMB internationalization in a sustainable way that is conducive to international stability.

Introduction

After the collapse of the US subprime mortgage crisis, the Chinese government began to actively promote RMB internationalization. Just like reforms in other issue areas, an experimental policy-making method was adopted to start RMB internationalization under two tracks. On one track, the Chinese government first implemented a pilot scheme of RMB settlement in cross-border trade in Shanghai and several cities of Guangdong province, and then gradually extended RMB trade settlement to all enterprises in China for all transactions under the current account. On the other track, RMB deposit service was allowed in Hong Kong in early 2004, RMB-denominated bonds were first issued in Hong Kong in 2007 and Hong Kong's commercial banks were approved for conducting RMB-related business after July 2010.

Why did the Chinese government begin to initiate the RMB internationalization process in 2009? First, the Chinese government tried to change the fact that the RMB's international status lagged behind China's international status in terms of economic size, especially after China replaced Japan as the second-largest economy in the world (SWIFT 2012; Subacchi and Huang 2013).

Second, the Chinese government attempted to reduce the reliance on the USD for international trade and investment, which could not only help domestic enterprises decrease exchange cost and exchange rate risk, but also slow down the People's Bank of China's (PBoC's) accumulation of foreign exchange reserves (Gao and Yu 2012; Yu 2012; Wang, Hu and Weng 2013).¹ As a consequence of sustained twin surpluses in the balance of payments and, therefore, persistent reserve accumulation, the Chinese government had to bear the severe currency mismatch on its international balance sheet (international investment position), whereby overseas assets were largely denominated in USD while overseas liabilities were denominated in RMB. Since the US Federal Reserve initiated quantitative easing (QE), the Chinese government began to worry more about the potential loss of its USD denominating assets as the result of the USD's depreciation. According to Paul Bowels and Baotai Wang (2013), RMB internationalization is the Chinese government's response to the global financial crisis, thus the true objective is to match the RMB's international status relative to China's share of world GDP, rather than to make the RMB a dominant world currency.

Third, the Chinese government tried to push forward domestic structural reforms by using RMB internationalization as an external commitment device (Yu 2014) or a catalyst (Wang,

1 One of the most important incentives for the PBoC to accumulate foreign exchange rate reserve is to satisfy the potential need to facilitate the payment to import goods or foreign debts. With RMB internationalization, however, if Chinese enterprises could pay the import with the RMB or borrow RMB funds from foreign financial markets, the incentive to accumulate foreign exchange reserves would decline.

Hu and Weng 2013). Because it was difficult for the Chinese government to promote domestic structural reforms due to the resistance of powerful vested-interest groups, some policy makers and scholars argue that RMB internationalization could propel the structural adjustments by introducing external pressures. For example, Arthur Kroeber (2013) argues that the PBoC advocated RMB internationalization as a tool to promote domestic financial liberalization. A positive argument often used by officials in the PBoC is that China's entry into the World Trade Organization in late 2001 had succeeded to push forward the reforms on China's state-owned commercial banks.

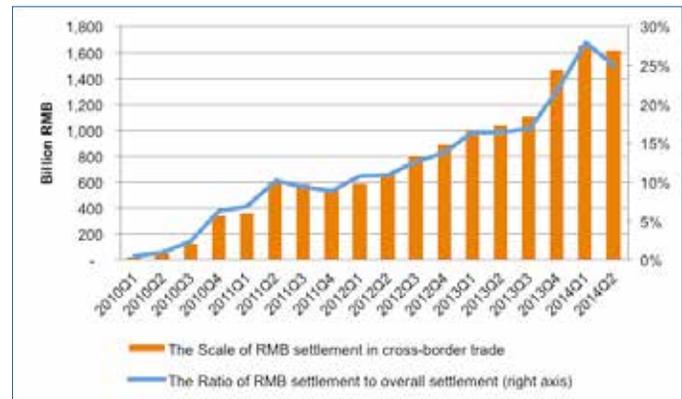
RMB internationalization has achieved significant progresses in the past five years; however, there are some problems rising behind the process that cannot be ignored. Moreover, RMB internationalization has already influenced the Chinese economy and other emerging market economies. This paper summarizes the developments of RMB internationalization in the past five years, analyzes the problems accompanying RMB internationalization, discusses the influence of RMB internationalization on the domestic economy and other emerging market economies and provides some policy suggestions.

The Development of RMB Internationalization in the Past Five Years

The Chinese government promoted RMB internationalization in two tracks: the RMB settlement in cross-border trade and investment, and the construction of offshore RMB markets.² Significant progress has been achieved in both of the tracks since 2009.

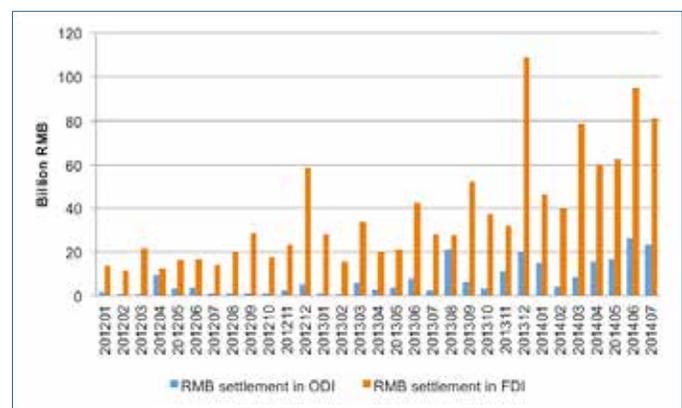
As shown in Figure 1, the scale of RMB settlement in cross-border trade rose from RMB 67 billion in the first half of 2010 to RMB 3.27 trillion in the first half of 2014, and over one-fourth of China's international trade was settled in RMB in the first two quarters of 2014. RMB settlement in both foreign direct investment (FDI) and outward direct investment (ODI) has also developed quickly since early 2012. However, because the scale of RMB settlement in ODI has been persistently and significantly lower than that of RMB settlement in FDI, the RMB settlement in cross-border direct investment has become a major channel for offshore RMB to flow back China, not a channel to export RMB (see Figure 2). SWIFT RMB tracker data show that the RMB became the seventh-most-active currency for global payments and accounted for 1.55 percent of payments worldwide in June 2014, rising from the twentieth-

Figure 1: RMB Settlement in Cross-border Trade



Data source: CEIC and author's calculation.

Figure 2: RMB Settlement in Cross-border Direct Investment



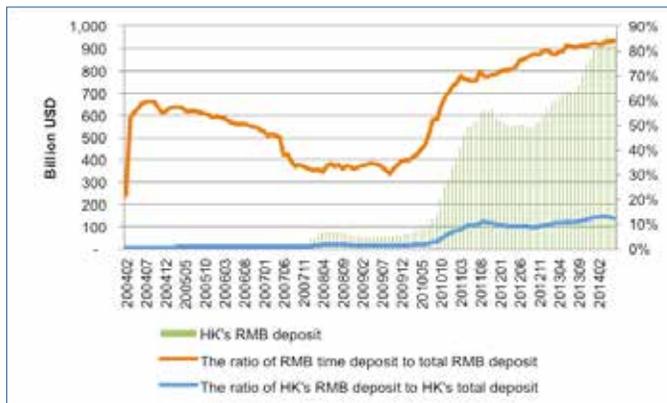
Data source: CEIC.

most-active currency and only 0.25 percent of payments worldwide in January 2012 (SWIFT 2014).

Offshore RMB markets have been growing quickly in the past five years, in particular in Hong Kong. Hong Kong's RMB deposit increased from RMB 90 billion by the end of June 2010 to RMB 926 billion by the end of June 2014, which occupied 12 percent of its total deposit in mid-2014 (see Figure 3). As shown in Figure 4, Hong Kong's RMB-denominating bond market was expanding faster than RMB loan business. By the end of 2013, the outstanding for Hong Kong's RMB-denominating bonds and RMB loans reached RMB 437 billion and RMB 116 billion, respectively. Besides RMB bonds, there was a wide range of other offshore RMB products (such as equity) created in Hong Kong such as real estate investment trust, exchange-traded funds, insurance products, derivatives and commodities (Craig et al. 2013). However, over 80 percent of Hong Kong's RMB deposits in mid-2014 was time deposit rather than demand deposit, reflecting that the overall supply of alternative RMB financial products was still insufficient compared to offshore RMB stock (see Figure 3).

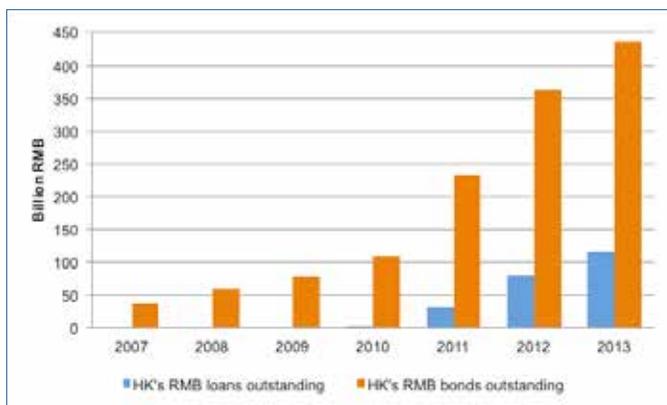
² Cheung (2014) argues that a well-designed offshore market network could promote the international acceptance and solidify the overseas status of the RMB; however, offshore RMB markets could not raise the RMB's status beyond the economic and political capabilities of the Chinese mainland.

Figure 3: Hong Kong's RMB Deposit



Data source: CEIC and author's calculation.

Figure 4: Hong Kong's RMB Loans and the Issuance of RMB Bonds



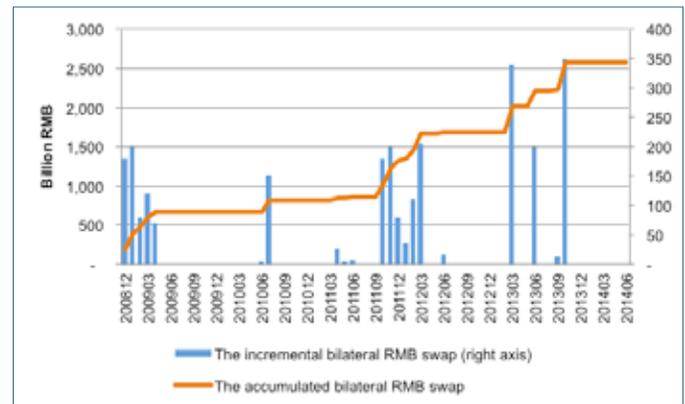
Data source: CEIC, Bank for International Settlements (BIS) and author's calculation.

To facilitate the development of Hong Kong's offshore RMB market, the Chinese government established various RMB flow-back mechanisms to allow offshore RMB to be invested in the mainland's markets. First, qualified foreign central banks and commercial banks were allowed to invest in China's inter-bank bond market under certain quota. Second, foreign companies could use the RMB fund allocated overseas to finance their direct investment into China. Third, the RMB Qualified Foreign Institutional Investors (RQFII) scheme was introduced to allow foreign investors to invest on China's domestic financial markets under some quota, and the overall quota reached RMB 276 billion by the end of July 2014.

Other than Hong Kong, RMB offshore markets also developed in international cities such as Singapore, London, Taipei, Tokyo, Paris, Frankfurt, Luxembourg and New York (Subacchi and Huang, 2012; 2013; Wang, Hu and Weng 2013). To provide extra liquidity support for the demand of RMB from either cross-border settlement or offshore markets, the PBoC signed bilateral local currency swaps with more than 20 foreign central

banks. By the end of June 2014, the accumulated scale of these bilateral swaps reached RMB 2.57 trillion (see Figure 5). However, only the central banks of Hong Kong, Singapore and South Korea ever activated their swaps with the PBoC to satisfy the surge of RMB demand on their domestic markets.

Figure 5: The PBoC's Bilateral Local Currency Swaps with Other Central Banks

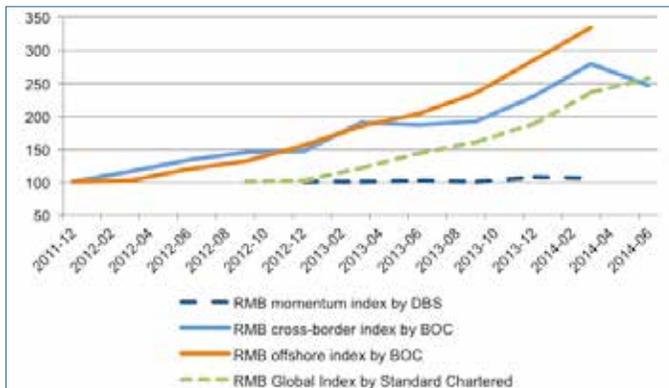


Data source: Wind.

There are several RMB internationalization indexes designed by both Chinese and international institutions. As shown in Figure 6, most indexes demonstrate that RMB internationalization has gained notable progress since 2012. As a consequence, the RMB evolved from the seventeenth-most-traded currency worldwide in 2010 into the ninth in 2013, according to the latest BIS Triennial Survey.³ The average daily turnover of RMB on the mainland market (called the CNY market) surged from US\$0.9 billion in 2010 to US\$20 billion in 2013. More importantly, the average daily turnover in Hong Kong's RMB market (called the CNH market) reached US\$7.3 billion in 2013, although it was established less than three years ago (Shu, He and Cheng 2014).

3 See www.bis.org/publ/rpfx13.htm.

Figure 6: The Various RMB Internationalization Indexes



Data source: CEIC.

Note: DBS means Development Bank of Singapore and BOC is another form of the PBoC.

The Problems behind RMB Internationalization

Despite the promising development of RMB internationalization, there are two important problems that cannot be ignored: the financial arbitraging between onshore and offshore RMB markets, and the slow progress of RMB invoicing compared to the fast progress of RMB settlement.

Cross-border Exchange Rate and Interest Rate Arbitraging

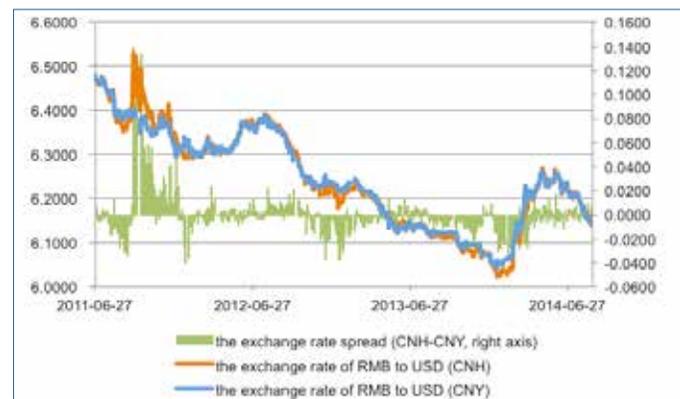
After the establishment of the offshore RMB market, there are actually two different RMB markets that could be utilized by both residents and non-residents. One is the CNY market, in which both the RMB's exchange rate and interest rate are determined, or under heavy management, by the PBoC. The other is the CNH market, in which the RMB's exchange rate and interest rates are determined by market demands and supplies. No wonder there would be some distinct exchange rate or interest rate spreads between CNY and CNH markets. And of course, the market participants would take use of the cross-border spreads to make arbitrage. For example, Craig et al. (2013) tested the integration of CNY and CNH markets through a threshold autoregression model, and they found substantial unexploited cross-border arbitrage opportunities.

Figure 7 displays the spot exchange rate spread of the RMB against the USD between CNY and CNH markets. Under an RMB appreciation expectation, the investors in the offshore market would like to hold more RMB, thus it would be more expensive in the CNH market than the CNY market due to the limited supply in the former. On the contrary, under a RMB depreciation expectation, RMB would become cheaper in the CNH market than the CNY market. The exchange rate spread would induce domestic and foreign enterprises to make arbitrage.

The cross-border exchange rate arbitrage mechanism is as follows: When RMB is more expensive in the CNH market, the enterprises would move RMB from CNY to CNH, using the disguise of RMB settlement for the import (from the mainland's perspective). Oppositely, when RMB is cheaper in the CNH market, the enterprises would move RMB from CNH to CNY, using the disguise of RMB settlement for the export (again from the mainland's perspective).

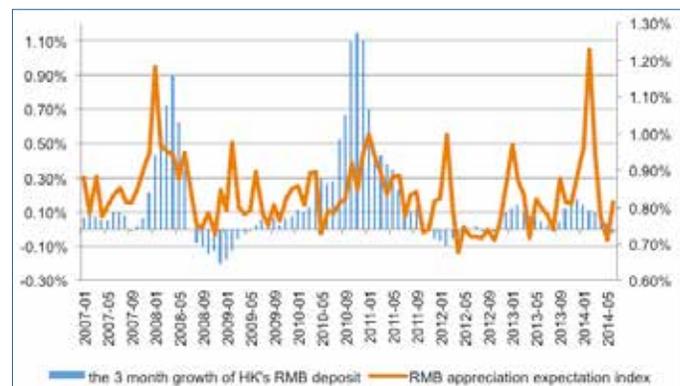
As a result, Hong Kong's RMB stock would increase if there was a RMB appreciation expectation and vice versa. Figure 8 provides evidence of the positive correlation between RMB appreciation expectation and the growth of Hong Kong's RMB deposit.⁴

Figure 7: The Spot Exchange Rate Spread between CNY and CNH Markets



Data source: Wind and author's calculation.

Figure 8: The Growth of Hong Kong's RMB Deposit and the RMB Appreciation Expectation



Data source: CEIC, Wind and author's calculation.

Note: The RMB appreciation expectation is calculated as the ratio of the USD sold by commercial banks' clients to the export revenue. The higher the ratio, the stronger the RMB appreciation expectation would be.

4 More evidence about the onshore-offshore exchange rate arbitraging can be found in Zhang and He (2012) and Zhang and Xu (2012).

Figure 9 shows the interest rate spread of six months of RMB time deposit between CNY and CNH markets. The approximate three percent interest rate spread provides the enterprises a strong incentive to borrow RMB from Hong Kong's commercial banks and move it back to the mainland.

The most typical interest rate arbitraging channel is called "internal guarantee and external borrowing," which includes the following steps:

1. Enterprise A asks a mainland commercial bank to issue a long-term letter of credit (L/C).
2. Enterprise A passes the L/C to its Hong Kong subsidiary, Enterprise B, using the disguise of RMB settlement for the import of A from B. B uses the L/C as collateral to apply for an RMB loan from Hong Kong's commercial bank.
3. B passes the RMB fund to A using the disguise of RMB settlement for the export of A to B. As the result of above interest rate arbitraging, Enterprise A receives the RMB loan provided by Hong Kong's commercial bank, and Hong Kong's commercial bank holds the L/C issued by the mainland commercial bank as collateral.

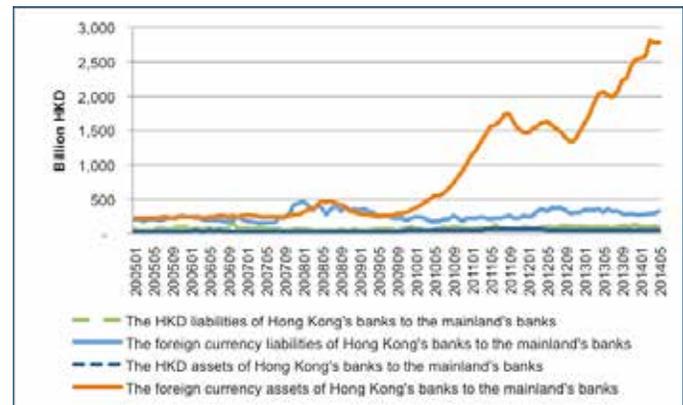
As displayed in Figure 10, the foreign currency (RMB) denominating asset of Hong Kong's commercial banks against mainland commercial banks increased dramatically since mid-2010, which substantiates the rampant cross-border interest rate arbitraging to some extent. Moreover, among the global RMB L/Cs in 2012, over 50 percent were issued from the mainland to Hong Kong and another 20 percent were issued from the mainland to Singapore, which also proved the existence of onshore-offshore interest rate arbitraging (Zhang and He 2012).

Figure 9: The Interest Rate Spread between CNY and CNH Markets



Data source: CEIC.

Figure 10: The Assets and Liabilities between Hong Kong and the Mainland's Commercial Banks



Data source: Hong Kong Monetary Authority.

Note: HKD means Hong Kong dollar.

Arbitrage is unavoidable in market economies. Generally speaking, arbitrage will narrow the price spread; therefore, it cannot last long. However, this regular pattern may not apply for the arbitrage between CNY and CNH markets. This is because the PBoC has the ability to intervene in the RMB exchange and interest rates on the CNY market by maintaining a relatively effective capital account control. As a consequence, the cross-border arbitraging could not reduce the price spreads between CNY and CNH markets and this onshore-offshore arbitraging could last for a long time (Zhang and Xu 2012). Moreover, the establishment of the China (Shanghai) Pilot Free-Trade Zone and other free-trade zones might create more loopholes for domestic and foreign enterprises to make cross-border arbitraging, thus exacerbating the existing problem.

The persistent cross-border arbitrage has brought some unexpected, negative impacts to the PBoC. First, as mentioned above, one of its major incentives for promoting RMB internationalization is to slow down the accumulation of foreign exchange reserve. However, under an RMB appreciation expectation, non-residents would exchange more USD-denominating assets for RMB-denominating assets with the PBoC, therefore the accumulation of foreign exchange reserve would be accelerating instead of slowing down. In other words, the private agents would make significant profit through cross-border arbitraging. As the private agents' final counterparty, the PBoC would unavoidably suffer a loss, often demonstrated as the valuation loss of the PBoC's foreign exchange assets under the environment of the RMB's appreciation. Second, considering that the cross-border arbitraging activities are carried out under the disguise of RMB settlement in international trade, it is no wonder that at least a large proportion of RMB cross-border settlement is based on financial speculations, not on fundamental demands. Therefore, the cross-border arbitraging might significantly exaggerate the real development of RMB trade settlement.

It is very hard to estimate the scale of cross-border arbitraging activities, therefore it is difficult to judge what proportion of the growth of offshore RMB stock has been caused by real demand or arbitraging demand. The next five years could provide a natural experiment to test whether the development of RMB internationalization has until now been driven by real demand or arbitraging demand. With the disappearance of one-way appreciation expectation of RMB against USD, and with the shrinking of onshore-offshore interest rates due to the US Fed's interest rate hikes in the near future, the cross-border arbitraging opportunities would diminish in the next several years. Therefore, if the growth of offshore RMB stock significantly slows down in the next stage, it could be concluded that the RMB internationalization process in the past has, at least to some extent, been driven by arbitraging activities.

Slow Development in RMB Invoicing Compared to RMB Settlement

Another problem behind the current RMB internationalization process is, despite a large proportion of China's cross-border trade being settled in RMB, the proportion of RMB invoicing in China's international trade is still much lower (Wang, Hu and Weng 2013). It is a pity that the Chinese government has not disclosed its data for RMB invoicing; however, from investigations made by the Research Center for International Finance at CASS, it was found that only a very limited proportion of China's international trade was invoiced in RMB during 2011–2013. It is an interesting phenomenon that the RMB's function as an international unit of account is much weaker than its function as an international medium of exchange. As mentioned above, one of China's key objectives to promote RMB internationalization is to reduce the exchange rate risk assumed by Chinese companies.

Nevertheless, if the cross-border trade is only settled in RMB and still invoiced in USD or euro (EUR), the exchange risk facing Chinese companies could not be mitigated yet (Yu 2014). Yongding Yu (2012) argues that as an international currency, the role of invoicing currency is much more fundamental than that of settlement currency in the aspect of minimizing exchange risk. Paola Subacchi and Helena Huang (2013) indicate that the choice of invoicing currency in international trade is influenced by such factors as bargaining power, trade structure and market inertia. Hiro Ito and Menzie Chinn (2014) find that the countries with more developed financial markets and more open capital accounts tend to invoice less in USD and more in their national currencies. Using the above criteria, it can be concluded that the real development of RMB internationalization is not as promising as the trade settlement data show.

The Influences of RMB Internationalization on the Chinese Economy

The RMB's gradual transition from a domestic to an international currency has already exerted some important influences on the Chinese economy: it has increased both the sophistication and the difficulty of domestic monetary policy; it has so far exacerbated the currency mismatch on China's international balance sheet; and it has increased both the scale and the volatility of short-term capital flow by offering new channels, therefore reducing the efficacy of China's capital account control.⁵

Domestic Monetary Policy

Since the launch of RMB internationalization, it has become more difficult for the PBoC to control the RMB's interest and exchange rates. This monetary intervention would offer market participants persistent arbitraging opportunities, and the resulting cross-border arbitraging would result in a "welfare loss" for the PBoC, because arbitraging activity would finally be a zero-sum game. RMB internationalization would therefore accelerate the liberalization of the currency's interest rate and exchange rate on the CNY market, which might bring new challenges to traditional monetary policy management.⁶ Just as the internationalization of the RMB would stimulate the arbitrage activities in responses to monetary policy changes, these arbitrage activities would have an impact on the effectiveness of monetary policy in return (Gao and Yu 2012).

Moreover, RMB internationalization tends to make both money supply and money demand more unstable, which would add difficulty to the traditional quantity-based monetary operation of the PBoC. On the one hand, along with the burgeoning of offshore RMB markets, the development of currency substitution and the change of overseas monetary deposit would bring significant impact to the stability of money demand (ibid.).⁷ The issuance of RMB-denominating bonds in Hong Kong, the borrowing of RMB from overseas commercial banks by domestic enterprises, the investment on the domestic inter-bank market by overseas institutions and RQFII would

5 Ma, Liu and Miao (2012) do not deny the negative impacts of RMB internationalization to Chinese monetary policy, international investment position and financial stability, but they argue that the overall impacts are still small and manageable compared to the potential revenue of RMB internationalization.

6 Maziad and Kang (2012) find that while the changes on the CNY spot market exert influence on the CNH spot market, CNH forward rates have a predictive impact on CNY forward rates. They also find that despite the capital controls between onshore and offshore markets, the developments in the CNH market could influence the CNY market through volatility channels.

7 This is exactly why Germany and Japan were reluctant to internationalize their currencies at an early stage.

all make domestic money supply more unpredictable (Xu and He 2012).

China's monetary policy regime is presently facing a transition. In response to these challenges, and with the gradual liberalization of its interest rate and the burgeoning of the shadow banking system, it is difficult for the PBoC to use money quantity as a monetary policy tool; therefore, the traditional, quantity-based monetary policy framework should be replaced by a modern, price-based framework. The PBoC should also strengthen its reputation by increasing its independence and transparency (Wang, Hu and Weng 2013). With the shrinking twin surplus in China's balance of payments and more volatile international capital flows, purchasing USD in the foreign exchange market (and the subsequent sterilization) is no longer the stable channel to issue base money for the PBoC. Therefore, the PBoC should find another reliable and stable mechanism to supply base money (Zhang and Tan 2014).

This paper argues that the PBoC's monetary policy objectives should be narrowed to sustaining economic growth and maintaining low inflation. Promoting structural reforms should not become its monetary policy objective. To achieve the monetary policy objectives under the new environment, the PBoC should create and utilize the following policy instruments. First, it should choose a short-term benchmark interest rate and use this interest rate as the primary monetary policy instrument. This benchmark interest rate might be the overnight Shanghai Interbank Offered Rate or a one-week, inter-bank bond repo rate. Second, the PBoC should establish a flexible yield curve that could effectively transmit the change of short-term interest rate to various mid-term and long-term interest rates. To achieve this objective, the Chinese government should strengthen the development of corporate and government bond markets. Third, the PBoC should use the open market operation (especially the purchasing and selling of government bonds) as the major tool to adjust domestic liquidity levels, which requires more close cooperation between it and Ministry of Finance. Currently, the PBoC's limited holdings of government bonds significantly restrains its open market operation capacity. Fourth, the PBoC should further liberalize the RMB exchange rate pricing mechanism by decreasing the routine intervention on the foreign exchange market. Finally, to maintain monetary policy independence, the PBoC should keep the right to manage international capital flows. In other words, capital account liberalization should be promoted in a gradual, cautious and controllable way.

In 2014, to balance monetary easing and structural adjustment, the PBoC created some targeted easing tools such as the Pledged Supplementary Loan and Mid-term Loan Facility. However, these new tools are more quantity-based, not price-based, and they are characteristic of credit rationing. It is therefore likely that they are only transitional and supplementary policy tools and will not replace price-based policy tools.

International Investment Position

As shown in Figure 11, the scale of RMB settlement in import has been distinctly higher than that of RMB settlement in export. Both Qiyuan Zhang and Fan He (2012) and Bin Zhang and Qiyuan Xu (2012) demonstrate that the ratio of RMB settlement in import to RMB settlement in export is strongly and positively correlated with RMB appreciation expectation, proving that the asymmetry in RMB trade settlement was largely a result of cross-border exchange rate arbitraging. One of the most adverse results of this asymmetry is that the PBoC ends up with more foreign exchange reserves even under the same trade surplus (Yu 2012).

Figure 11: The “Cripple” RMB Settlement in Export and Import



Data source: Thompson Reuters Datastream Professional.

China is an international creditor with nearly US\$2 trillion in net overseas assets. However, there has been a serious currency mismatch on China's international balance sheet: most of the overseas assets are denominated in foreign currencies, yet most of the overseas liabilities are denominated in RMB. Under the environment of persistent RMB appreciation against major currencies, this mismatch would result in a severe valuation loss for China's international investment position. Even worse, the asymmetry in RMB cross-border settlement would further deteriorate the currency mismatch on China's international balance sheet by accelerating the accumulation of foreign exchange reserve.⁸

Short-term Capital Flow

The RMB trade settlement scheme offered new opportunities for domestic and foreign companies to conduct exchange rate and interest rate arbitrage between CNY and CNH markets, which increased both the scale and volatility of short-term capital flows (Yu 2012). Moreover, a two-track

⁸ Besides the RMB settlement in import, Xu and He (2012) state that the RMB settlement in ODI and overseas financial investment would also result in more foreign exchange reserve accumulation, thus exacerbating the current mismatch on China's international balance sheet.

capital flow management structure has been established since the start of RMB internationalization. For the capital flows denominated by foreign currencies, the regulator is still the State Administration of Foreign Exchange, and the regulation is relatively more rigorous. However, the RMB-denominated capital flows are under the regulation of the local subsidiaries of the PBoC's Monetary Policy Department II, whose regulation is much looser. Therefore, the natural way to circumvent the currency capital account control is to transfer foreign currency-denominating flows into RMB-denominating flows first, then move the RMB flows inward or outward under the disguise of cross-border trade settlement.

Tao Wang, Zhipeng Hu and Jingqing Weng (2013) point out that the volatility of capital flows would increase during the process of RMB internationalization, thus making the domestic economy and financial market more susceptible to global market fluctuations. They further argue that there might be more net capital outflow during RMB internationalization, which would push up the financing cost in China and threaten the stability of the domestic financial system. Barry Eichengreen and Masahiro Kawai (2014) argue that RMB internationalization in the future requires significant capital account liberalization, potentially causing a crisis for Chinese financial markets.

The capital account control in China is asymmetric. The restriction on capital inflow is looser than the restriction on capital outflow. To further promote RMB internationalization, the Chinese government would gradually open its capital account. Therefore, as a result of the capital account liberalization, the potential capital outflow may be larger than capital inflow. The potential net capital outflow might be destabilizing, even causing financial crisis.

RMB internationalization and capital account liberalization are the two sides of the same coin. Indeed, there are some anecdotes in the market that the PBoC's real objective for promoting RMB internationalization is to speed up capital account liberalization, the logic being that PBoC officials are market-oriented and want to promote domestic structural reform. However, due to the resistance of strong vested-interest groups, it is difficult for the Chinese government to push forward structural reforms such as income redistribution and breaking China's state-owned enterprises' (SOEs') monopoly. Therefore, these officials want to introduce external pressures to overcome the resistance of vested-interest groups and to facilitate domestic structural reforms through capital account liberalization under the flag of RMB internationalization.

The PBoC's experiment of using capital account liberalization to promote domestic structural reform may be very tricky and even dangerous. In China, with the declining economic growth and potential financial risks, the confidence of domestic households and enterprises in the domestic financial system would decrease. Outside China, the Fed would begin to raise the benchmark interest rate in the near future, and international capital flows

would be more attracted to the United States. Therefore, if the Chinese government were to fully liberalize its capital account, it is possible that China will face massive and persistent capital outflow, which might make its macroeconomy and financial market more unstable and even trigger financial crisis. There are worries that if a systemic financial crisis break outs, the domestic structural reform would not be accelerated, but would be postponed or even reversed (Zhang 2013).

The Influences of RMB Internationalization on Other Emerging Market Economies

Although the development of RMB internationalization is still in the early stage, it has already imposed some significant influences to other countries, in particular the emerging market economies. On the one hand, RMB internationalization has offered new alternatives for these countries to price their domestic currency and to allocate their foreign exchange reserve. On the other hand, the RMB's rise as a new international reserve currency might enhance the stability of the international monetary system by introducing new competition to the USD.

Exchange Rate Pricing

China is now the second-largest economy and the largest trading economy worldwide. Since the PBoC changed the hard peg to USD and adopted a managed floating exchange rate regime in July 2005, the movement of the RMB's exchange rate has begun to influence the movement of other Asian countries' currencies. Because most of these countries are either important trading partners or competitors with China, they have a strong incentive to stabilize their currencies against the RMB. A common practice is to introduce RMB into the currency basket to which the domestic currency pegs. Since the start of RMB internationalization, the influence of the RMB's exchange rate to other Asian currencies' exchange rate has become more pronounced. Eichengreen and Kawai (2014) argue that the RMB internationalization could hasten Asian financial regionalization because China's trade is disproportionately concentrated in Asia.

C. Randall Henning (2012) argues that Malaysia, Thailand, Singapore, the Philippines and South Korea had already formed a loose but effective RMB bloc with China by testing the weights of key currencies in the implicit baskets targeted by the central banks of the above countries. Chang Shu, Dong He and Xiaoqiang Cheng (2014) find that the changes of RMB and USD rates in both CNY and CNH markets have an economically and statistically significant impact on the changes in Asian currency rates against the USD, even after controlling for the transmission of China's monetary policy to the region and other major currency moves. Masahiro Kawai and Victor Pontines (2014) also find that the RMB had entered into the

currency baskets of many East Asian economies at the expense of the yen, although it had not yet surpassed the USD to be the denominated anchor currency in East Asia.

Reserve Asset Allocation

After the global financial crisis, the central banks of major advanced economies collectively adopted QE. The printing of money through QE would make the currencies issued by the Fed, the European Central Bank and the Bank of Japan depreciate against other currencies in the mid-term. To stabilize the value of their foreign exchange reserve, the emerging market countries have a strong incentive to find other alternative currencies to allocate their foreign exchange reserve. No doubt RMB-denominated assets could become a new choice after the launching of RMB internationalization. First, the RMB has been appreciating against major currencies in the last decade, and there is still some opportunity for further appreciation. Second, the Chinese economy has been enjoying a relatively high growth rate, which might offer many high-yield assets to foreign investors. Third, the Chinese government's new initiatives to open its financial market, such as the Shanghai Free-Trade Zone and the quota-based interconnecting mechanism between Shanghai and Hong Kong's stock market, would offer foreign sovereign investors more channels to invest in China.

According to the *Financial Times*, over 50 central banks are actively investing in RMB assets through onshore or offshore RMB markets.⁹ For example, Malaysia's government announced in December 2006 that the RMB was adopted as one of its major reserve currencies.¹⁰ Even some developed countries' central banks showed interest in investing in RMB assets. For example, Japan published its plan of purchasing Chinese government bonds in March 2012, thus becoming the first developed country to adopt the RMB as a reserve currency.¹¹ In April 2013, Australia declared that just under five percent of its foreign exchange reserve would be invested in Chinese government bonds (Wang, Hu and Weng 2013).

Multipolar International Currency Regime

The collapse of the US subprime mortgage market vividly illustrates the intrinsic problem of the USD's role as the global reserve currency in the international monetary system. The Fed faces the dilemma between providing enough international liquidity and preserving the stability of the USD's exchange rate. Because the Fed formulates monetary policy mainly on domestic economic fundamentals, other countries have to face the negative spillovers from US policies. Establishing a multipolar reserve currency regime — in which the USD, EUR and RMB would all play the role of international reserve

currency — could be a possible solution to this problem. The EUR and RMB could challenge the dominance of the USD as international reserve currency, thus introducing competition between reserve currencies in the form of currency substitution and weakening the exorbitant privilege of the USD. For example, if the Fed pursues a loose monetary policy that might result in the depreciation of the USD against the EUR and the RMB, market participants would sell USD-denominated assets and buy EUR- or RMB-denominated assets.¹² Proponents of a multipolar regime expect that an increasing substitutability between the different reserve currencies would exert new discipline on the domestic monetary policies of each reserve currency country, thus restraining negative externalities of those monetary policies and stabilizing the volatile international capital flows. Moreover, the reserve currency countries have a stronger incentive to coordinate their domestic monetary policies under the multipolar regime, because they need to share both the international seigniorage and the burden of adjusting the international balance of payment.

However, whether a multipolar currency regime is more stable than a unipolar one is highly debatable. On the one side, the hegemonic stability theory argues that the international monetary system operates smoothly only when dominated by a hegemonic economy, such as Britain in the gold standard era and the United States under the Bretton Woods system. On the other side, as Eichengreen (1987) argues, even under the gold standard and Bretton Woods regime, the international monetary system was still fundamentally predicated on international cooperation. Because any hegemony is transitory, it is unwise to build a new international monetary regime on the basis of such dominance.

Some economists argue that under the current circumstances, without close policy coordination, the increasing substitutability between different reserve currencies might cause more volatility, because a small increase of the market participants' perception of risk surrounding one reserve currency may lead to large capital outflow into the alternative currencies. The volatility of capital flows and fluctuation of asset prices would, in other words, become more frequent and extreme in the new multipolar regime (Lin, Fardoust and Rosenblatt 2012).

Eswar Prasad (2014) argues that if domestic financial markets and institutional development allow the RMB to become a credible safe haven currency, then the rise of the RMB could contribute to the stability of Asian and global financial systems. However, the RMB is unlikely to become a major international currency without full capital account convertibility, thus it could only decrease, but not replace, the USD's dominance. Moreover, the successful internationalization of the RMB requires overcoming the market inertia and network externalities of

9 See www.ftchinese.com/story/001057888.

10 Ibid.

11 Ibid.

12 This mechanism only works under the following preconditions: the EUR and RMB authorities do not resist domestic currency appreciations, and the USD authority does not welcome domestic currency depreciation.

the USD or EUR, which is not an easy task. Eichengreen and Kawai (2014) claim that the increasing return to scale and network externalities are less important in the current high-tech world, because everyone could obtain the information on exchange rates in real time and the costs of currency conversion are much lower compared to the past.

It should be noted that most analysis emphasizes the potential benefits of issuing a global reserve currency and ignores the potential burdens that arise from it. A global currency-issuing country should provide enough international liquidity to the global market, open its domestic financial market, deregulate capital account controls and let the exchange rate of domestic currency be determined by market demand and supply. There is an intrinsic conflict between RMB internationalization and the so-called “New Mercantilism.” The core of New Mercantilism is to promote exports by keeping the local currency undervalued. With RMB internationalization, however, it is progressively more difficult for the PBoC to keep the RMB undervalued against other major currencies. In other words, as a global currency issuer, China must have the capacity to absorb global shocks. It is uncertain whether the Chinese government carefully calculated the potential costs and benefits before its promotion of RMB internationalization.

It now promotes RMB internationalization by accelerating capital account liberalization. While this liberalization might be desirable in the long run, accelerating it in the present environment might be very dangerous. From China’s perspective, domestic financial risks are rising as a result of corporate deleveraging and property market adjustment. From the external perspective, the Fed has completed its taper from QE and is likely to increase interest rates in 2015. If the Chinese government were to open the capital account too hastily, China might face huge capital outflows, which would depreciate the RMB or cause a shortage of domestic liquidity or even financial crisis. Considering the importance of China’s economy and the rising status of the RMB, any financial crisis in China would probably spill over to other emerging economies.

Policy Suggestions

To promote RMB internationalization in a steadier and more sustainable way, which is beneficial to China and conducive to international stability, this paper outlines the following five policy suggestions. First, both RMB internationalization and capital account liberalization should be carried forward under appropriate policy sequencing, and the reform of RMB exchange rate and interest rate formation mechanisms should be carried out as soon as possible. The development of RMB internationalization under the PBoC’s regulations on the RMB’s interest rate and exchange rate has induced rampant onshore-offshore arbitraging. Therefore, the liberalization of its interest and exchange rates would base RMB internationalization more on the real demand of the Chinese economy, not on financial

speculation. Wang, Hu and Weng (2013) argue that, considering the capricious external environment and the domestic financial vulnerabilities, the Chinese government should follow a cautious path to promote RMB internationalization, and potential risks might break out without an appropriate sequencing of financial reform measures. The capital account liberalization should still be advanced in a gradual and cautious way (Gallagher et al. 2014).

Second, the Chinese government should accelerate financial reforms and make the domestic financial market more deep, broad and liquid. Jeffrey Frankel (2012) points out that as a potential candidate for an internationalized currency, China lacks deep, liquid and open capital markets. Ito and Chinn (2014) argue that financial development and financial openness are among the key factors to internationalize RMB. Prasad (2014) claims that financial market development is likely to ultimately determine the competitiveness of international reserve currencies. Thomas A. Bernes et al. (2014) argue that to handle the problems arising from current RMB internationalization, the Chinese government should create a robust private-money market with the capacity to absorb foreign exchange risk exposures, which could alleviate the pressure on the PBoC to bear this exposure, and then offer the PBoC more policy space to conduct monetary policy. The Chinese government should issue more government bonds to improve the benchmark yield curve and combine the currently segmented corporate bond markets under multi-regulators into a single regulator; accelerate the development of the direct financing market, which could compete with commercial banks financing; and try to mitigate existing financial vulnerabilities, such as the potential risks in the shadow banking system, the intertwined risks between the health of commercial banks and the situations of the property market. After all, whether China could avoid the burst of a systemic financial crisis in the next decade is one of the key issues determining the future of RMB internationalization.

Third, the PBoC should clarify its monetary policy objectives and streamline its monetary policy tools. Sustaining rational economic growth and maintaining a low-inflation environment should become its top choices; however, promoting structural reforms is not an appropriate monetary policy objective. The PBoC should determine a short-term benchmark interest rate, improve the yield curve and use the open-market operation based on government bonds as the major tool to issue base money in the future. Overall, the traditional quantity-based monetary policy framework should be replaced by the price-based monetary policy framework. The smooth transition of the PBoC’s monetary policy regime could significantly promote the international use of RMB.

Fourth, the Chinese government should put the domestic structural reforms at the top of their policy agenda to ensure the economic growth momentum in the future. The fate of RMB internationalization will ultimately depend on whether the

Chinese economy could maintain relatively high and efficient growth in the next one or two decades, and only the acceleration of domestic structural reforms could secure the mid-term economic growth momentum. The most important structural reforms include increasing the ratio of household income to national income to stimulate domestic consumption; breaking the monopoly of SOEs in many service sectors and opening these sectors to private enterprises; and liberalizing domestic factor prices as soon as possible. The above structural reforms could facilitate the transition of Chinese growth from being investment- and export-driven to being driven by domestic consumption. However, there are various vested-interest groups that would resist these structural reforms. Since using RMB internationalization to promote domestic structural reform is uncertain and even dangerous, the Chinese government should try to overcome the resistance from these groups and promote domestic structural adjustment.

Fifth, other than economic and financial reforms, the Chinese government should also carry forward the reforms on legal, political and administrative systems to boost long-term confidence in the RMB. To summarize international lessons for the RMB from the internationalization experiences of the Deutsche mark, the Japanese yen and the EUR, Benjamin Cohen (2014) emphasizes the importance of maintaining effective policy management and building domestic political institutions. Eichengreen and Kawai (2014) suggest that the Chinese government should promote institutional reforms such as making the PBoC more independent, raising accountability and transparency of policy making, and democratizing the political regime. Yiping Huang, Daili Wang and Gang Fan (2014) also highlight the importance of strengthening confidence in using the RMB by raising the transparency of monetary policy making and promoting further legal and political reforms.

Conclusion

This paper reviews the effects of RMB internationalization on the international monetary system. The RMB's impact on systemic stability is likely to depend on the pace and manner in which Chinese authorities liberalize the capital account, the consistency and transparency of Chinese domestic monetary policy and other domestic economic fundamentals such as banking regulation, financial stability and fiscal policy. If these fundamentals are less consistent than the fundamentals that stand behind the USD and other alternative currencies, RMB internationalization might undermine the stability of international monetary system. Thus, both China and the Group of Twenty have a strong interest in these fundamentals being well managed.

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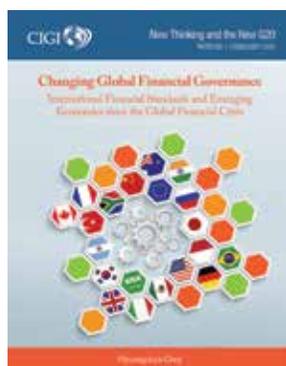
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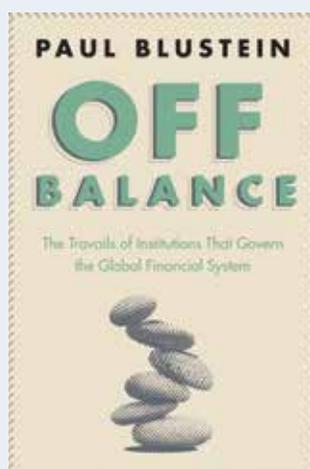
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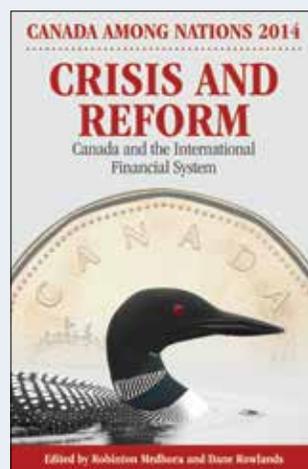
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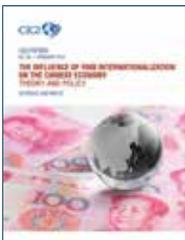
The China (Shanghai) Pilot Free Trade Zone (SPFTZ), founded in September 2013, has promised liberalization on capital account and trade facilitation as its main objectives. This paper discusses reasons why China needs such a pilot zone after three decades of economic development, examines the differences between the SPFTZ and other free trade zones and highlights the developments of the SPFTZ since its inception. The hope is that the success of the SPFTZ will give rise to a more balanced Chinese economy in the following decade.



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Gregory D. Makoff and Robert Kahn

The International Capital Market Association (ICMA) has recently published proposed standard terms for new, aggregated collective action clauses. Concurrently, the ICMA released new model wording for the *pari passu* clause typically included in international sovereign bond contracts. These announcements and the commencement of issuance of bonds with these clauses are an important turning point in the evolution of sovereign bond markets.



The Influence of RMB Internationalization on the Chinese Economy

CIGI Papers No. 58
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Since China's pilot scheme for RMB cross-border settlement was launched in 2009, it has become increasingly important for monetary authorities in terms of macroeconomic policy frameworks. The authors use an analytical model that includes monetary supply and demand to examine the influences of RMB cross-border settlement on China's domestic interest rate, asset price and foreign exchange reserves. They also look at how RMB settlement behaves in different ways with the various items in China's balance of payments.



Completing the G20's Program to Reform Global Financial Regulation

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The measures regulators have largely agreed on for a strengthened and internationally harmonized financial regulatory regime, which were endorsed at the 2014 G20 leaders summit in Brisbane, are a major step toward achieving a robust and less crisis-prone global financial system. There are, however, a number of specific measures that need to receive closer attention in order for the G20 leaders to declare their reform program a success. This paper discusses what policy makers and regulators should focus on in 2015 and why closer international cooperation in implementing regulatory reforms will be essential for success.



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Over-the-counter (OTC) derivatives played an important role in the buildup of systemic risk in financial markets before 2007 and in spreading volatility throughout global financial markets during the crisis. In recognition of the financial and economic benefits of derivatives products, the G20 moved to regulate the use of OTC derivatives. Attention has been drawn to the detrimental effects of the United States and the European Union to coordinate OTC reform, but this overlooks an important aspect of the post-crisis process: the exemption of non-financial operators from OTC derivative regulatory requirements.



The Trade in Services Agreement: Plurilateral Progress or Game-changing Gamble?

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Patricia M. Goff

Trade analysis in the current moment is understandably focused on mega-regional negotiations, but plurilateral talks also deserve our attention. Plurilateral negotiations leading to a Trade in Services Agreement (TiSA) is the focus of this paper. Barriers to trade in services are distinct and their removal consequential; thus inviting careful consideration and, ideally, public debate. This paper seeks to illuminate developments in negotiations toward the plurilateral TiSA. Just as it has become commonplace to ask whether regional agreements advance economic and political agendas, so is it useful to explore the promise and peril of plurilateral agreements such as TiSA.

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