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School of Business,

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**One Currency, Two Markets: China's
Attempt to Internationalize the Renminbi**

by Professor Edwin L.-C. Lai

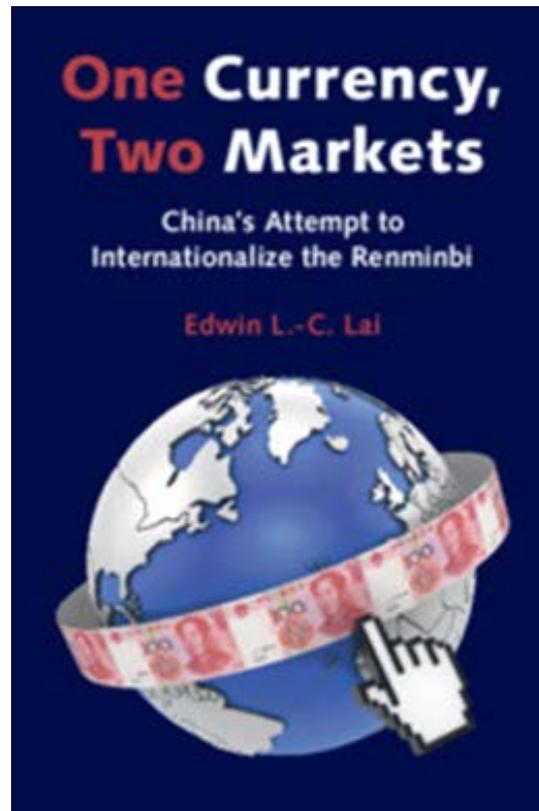
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► Edwin L.-C. Lai, One Currency, Two Markets: China's Attempt to Internationalize the Renminbi, September 2021, Cambridge University Press.



Ch 1 Introduction

- ▶ The Chinese government is trying to internationalize the RMB. **But what are the real reasons for doing it?**
- ▶ One reason: Seeks independence from the USD, its associated payment system, and USD-based International Monetary System (IMS), for financial and national security
- ▶ There are other reasons...

The special case of China

- ▶ Currency internationalization requires the currency to be largely convertible in the capital account
- ▶ China does not want to fully integrate its financial system with the West any time soon.

The special case of China (cont.)

- ▶ Thus, China adopts the “one currency, two markets” approach
- ▶ A firewall between the onshore and offshore markets, allowing full convertibility of RMB in the offshore market but partial convertibility in the onshore market.
- ▶ But RMB Internationalization (RMBI) requires more than the offshore market. It requires capital account opening, financial market development, and other things ...

Outline of this talk

- ▶ Introduction
- ▶ Why Does China Want to Internationalize the RMB?
- ▶ China's strategy of internationalizing the RMB
- ▶ The importance of capital account liberalization
- ▶ The importance of financial sector liberalization
- ▶ The importance of the offshore RMB market
- ▶ The Prospects of RMB Internationalization

Introduction

The background features abstract, overlapping geometric shapes in various shades of green, ranging from light lime to dark forest green. These shapes are primarily located on the right side of the slide, creating a modern, layered effect. The rest of the slide is a plain white background.

Importance of RMB in the international monetary system

	Currency Year reported	USD	EUR	JPY	RMB
FX market turnover share	2019 (April)	44.15	16.14	8.40	2.16
International payments share	2016	55.69	18.72	5.13	1.64
Foreign exchange reserves share	As of 2019Q2	61.6	20.3	5.4	2.0

Table 4-6: The relative importance of the USD, EUR, JPY and RMB in the international monetary system, in percentage.

RMB as an international payment currency

Currency	International payments share in 2016 (%)	GDP share of issuing country in 2016 (%)	Issuing country
USD	55.69	24.53	USA
EUR	18.72	15.72	Eurozone
JPY	5.13	6.52	Japan
GBP	4.91	3.49	UK
CAD	2.79	2.02	Canada
RMB	1.64	14.74	China

Table 8-1: Payment shares and GDP shares in 2016, excluding transactions through global IMI and intra-Eurozone payments.

Denomination of international debt securities

Denomination of outstanding stock of international debt securities in 2020Q1 (out of a total of USD 24.91 trillion)		
rank	currency	share (%)
1	USD	47.4
2	EUR	37.9
3	GBP	7.9
4	JPY	1.80
?	RMB	0.41

The Background

- ▶ **The Dollar Standard** – In the post-Bretton Woods International Monetary System (IMS), the USD is the main reserve currency.
- ▶ **The Dollar Trap** --- Countries that peg to the USD have no better choice but to stay in the peg, and have to accumulate huge quantities of USD-denominated foreign reserves.

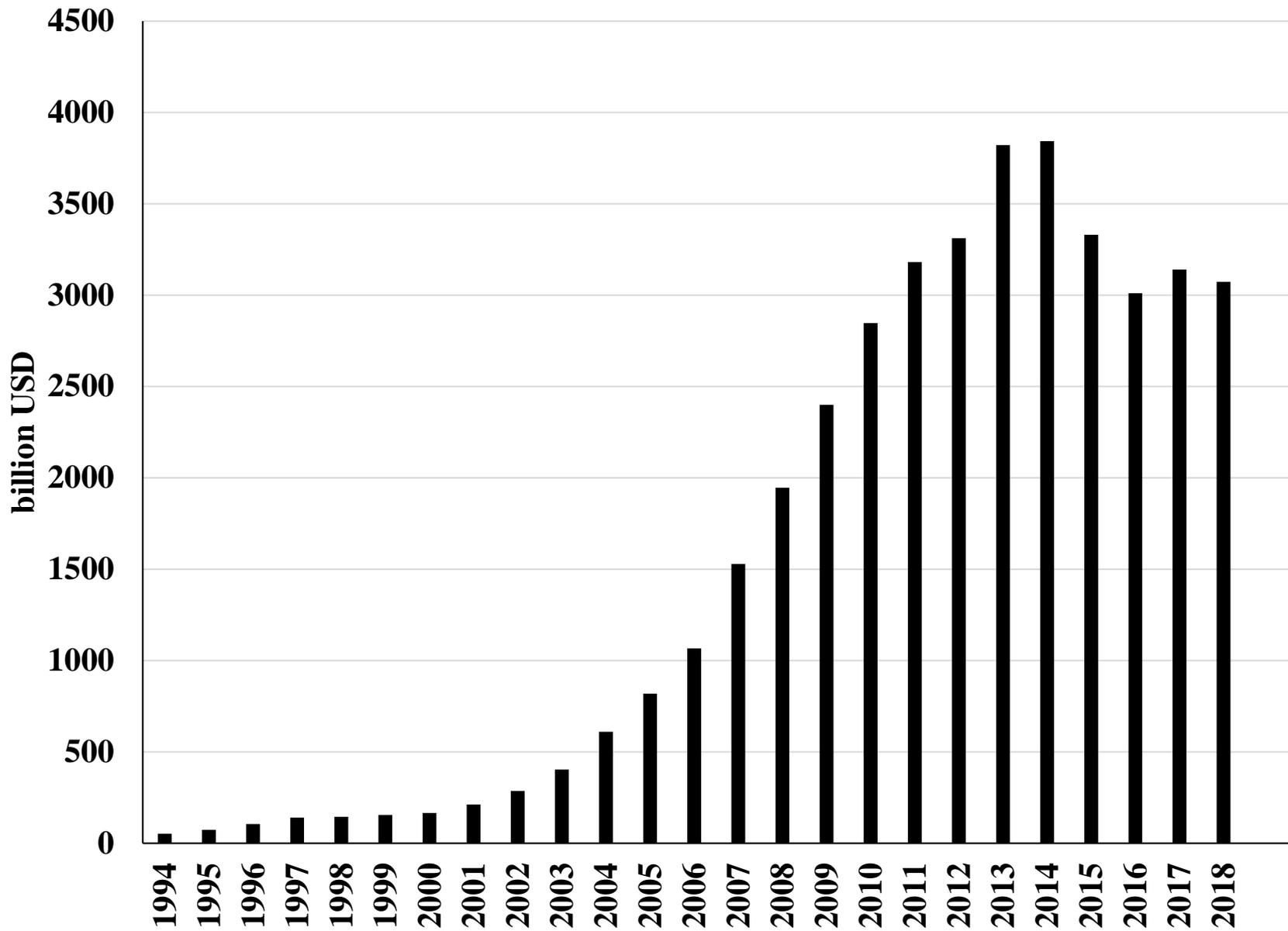
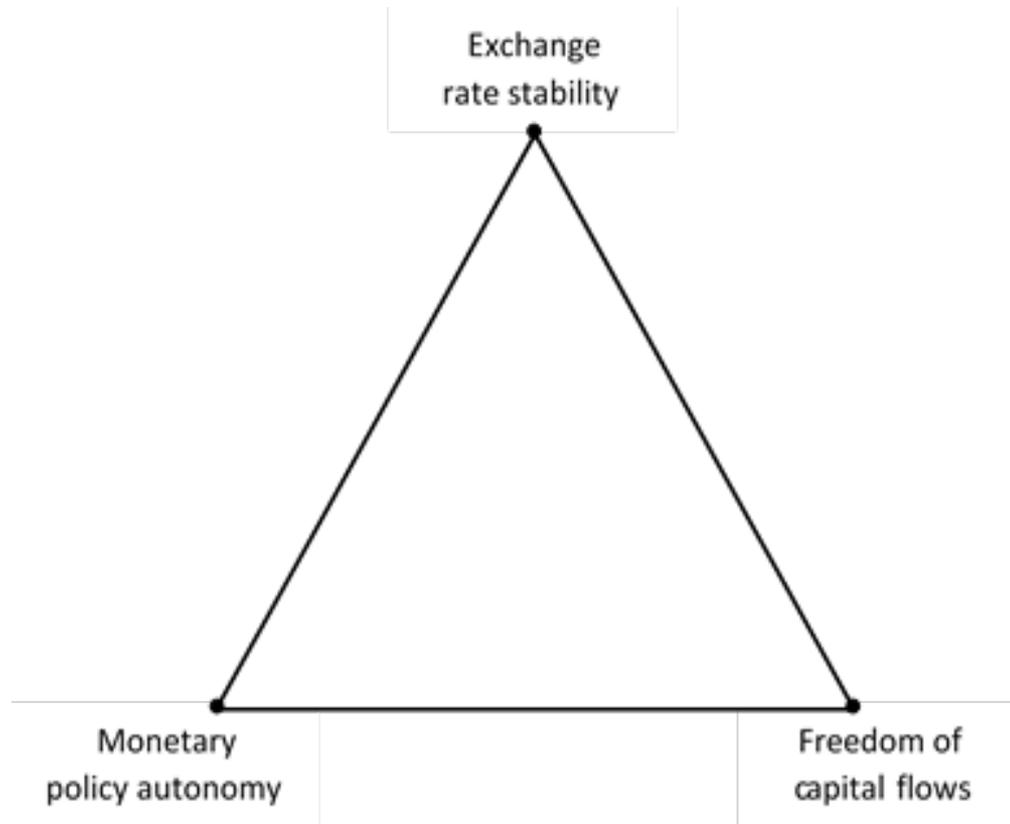


Figure 1-5: China's foreign exchange reserves 1994-2018

The Open Economy Trilemma

- ▶ RMBI requires increase in capital mobility → China may have to give up a considerable degree of exchange rate stability for RMBI



Ch 3 Why Does China Want to Internationalize the RMB?

Benefits of RMBI to China:

- ▶ “Monetary Sovereignty”: Less reliance on foreign currencies such as the USD and the associated payment system.
 - ▶ For example, avoid the legal reach and sanctions of foreign countries (e.g. US through SWIFT)
- ▶ Use the capital account liberalization and financial markets liberalization that come with RMBI to force (“daobi”) (倒逼) domestic financial sector reform and opening.

Benefits of RMBI to China (cont'd)

- ▶ **Being able to borrow and lend internationally in China's own currency** provides more financial security.
- ▶ **Escape from the “dollar trap”** (to peg to the USD and to accumulate a huge amount of foreign reserves)

Benefits to the world:

- ▶ In the long run, supply an alternative global safe assets for central banks reserves and alternative global medium of exchange – fill the gap left by the shrinking importance of USD and euro.

Ch 4 China's strategy of internationalizing the RMB

- ▶ **RMB trade settlement** – pilot scheme started in mid-2009
 - ▶ The large pool of offshore RMB enabled the formation of the offshore RMB market.
 - ▶ It was followed soon after by the formation of the offshore RMB FX market in HK in 2010

Ch 4 China's strategy of internationalizing the RMB (cont'd)

- ▶ **Offshore RMB Centers** (e.g. HK, Singapore, Taipei and London)
 - ▶ Settlement and clearing of offshore RMB payments, e.g. trade settlement
 - ▶ RMB bank deposits
 - ▶ Dim Sum bonds and RMB loans

Ch 4 China's strategy of internationalizing the RMB (cont'd)

- ▶ **Capital account and financial markets opening:**
 - ▶ Liberalization of Capital Flows: QFII, QDII, RQFII, Stock Connects, Bond Connect, Cross-boundary Wealth Management Connect
- ▶ **Bilateral currency swap** agreements between central banks

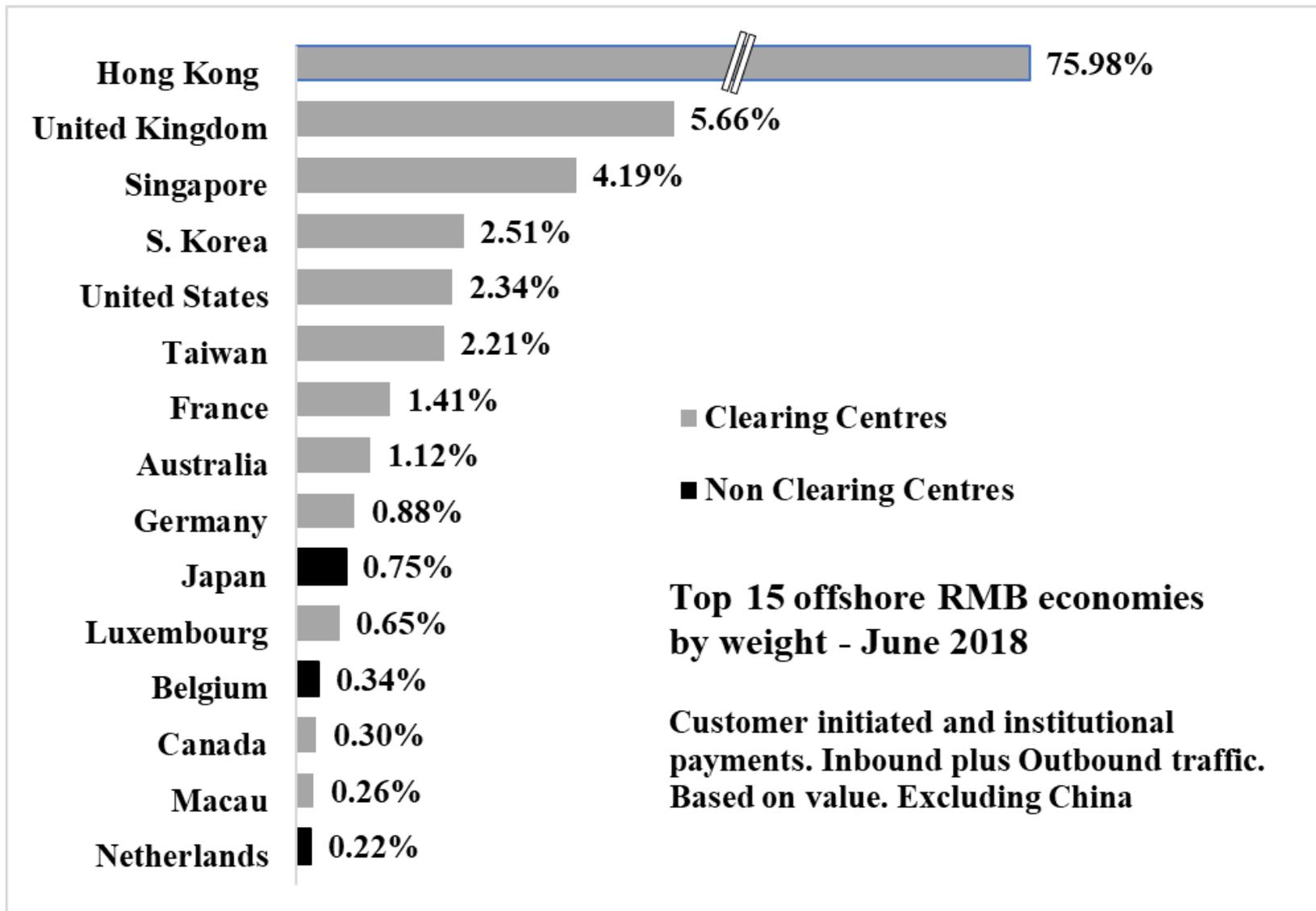


Figure 4-1: Top 15 offshore RMB economies (in terms of payment) by weight as of June 2018

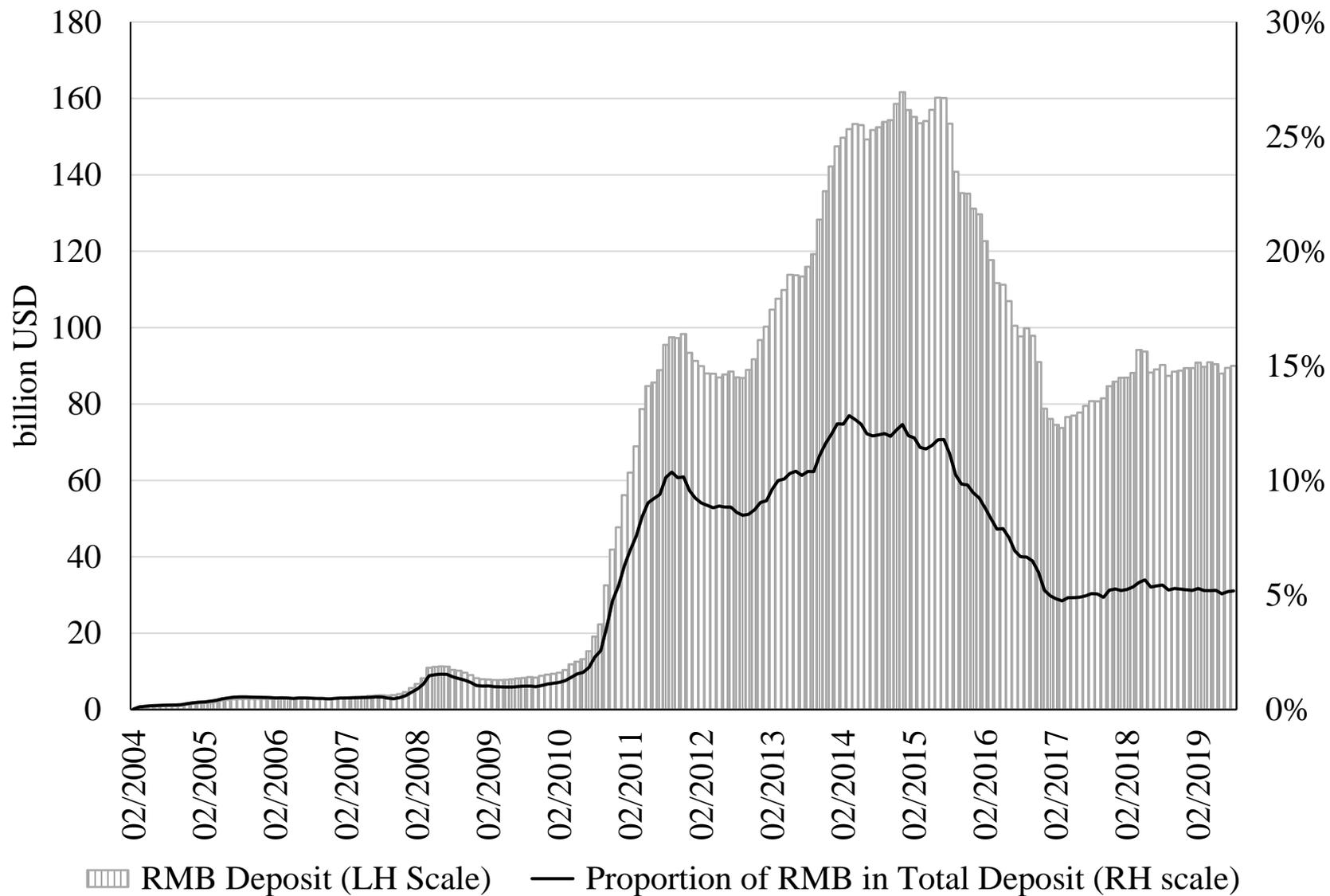


Figure 1-2: Monthly RMB Deposits in Hong Kong in billion USD (excluding certificates of deposit). An indicator of the size of the HK offshore market. There was a great setback in 2015.

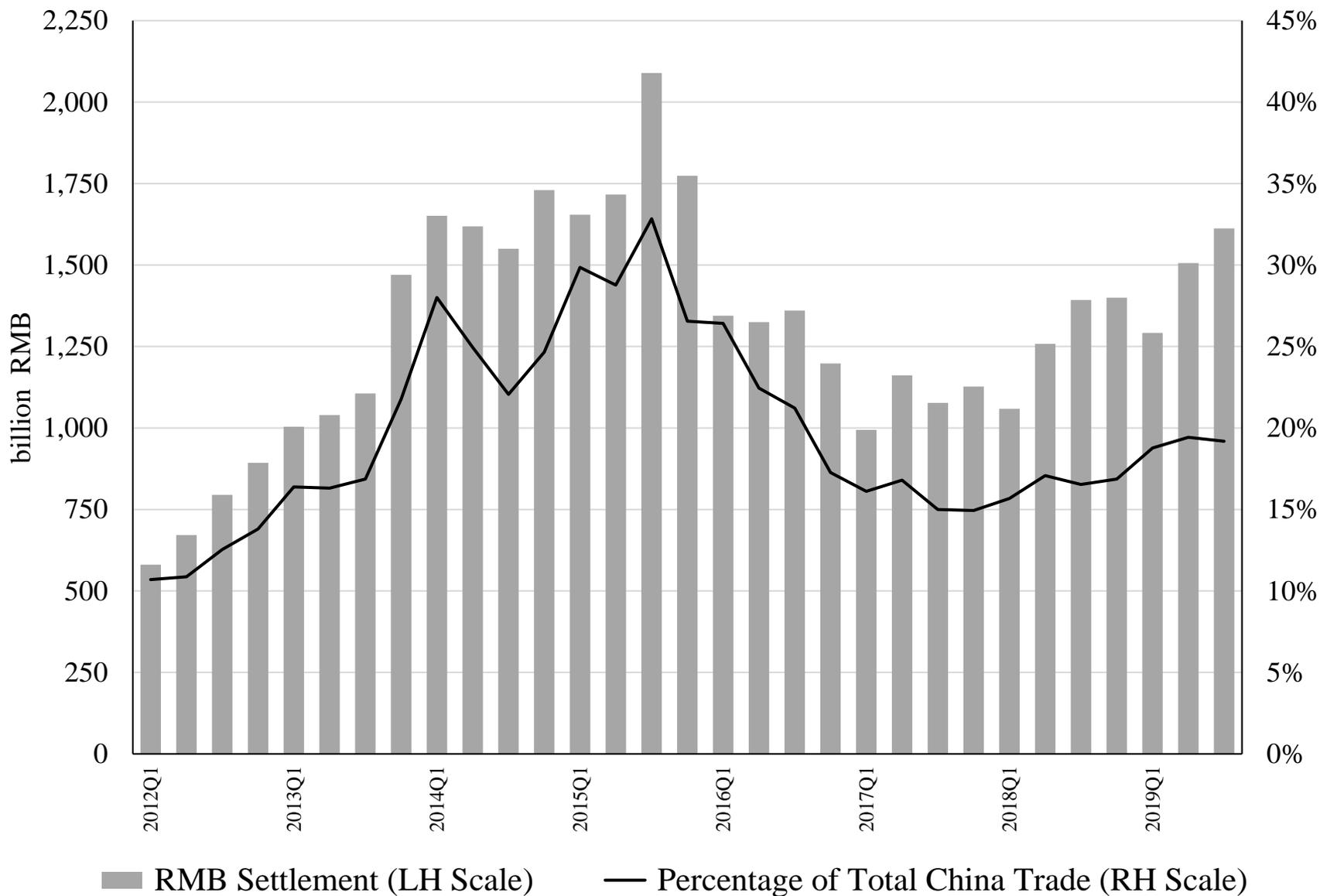


Figure 4-7: Cross-Border RMB Trade Settlement (Quarterly)

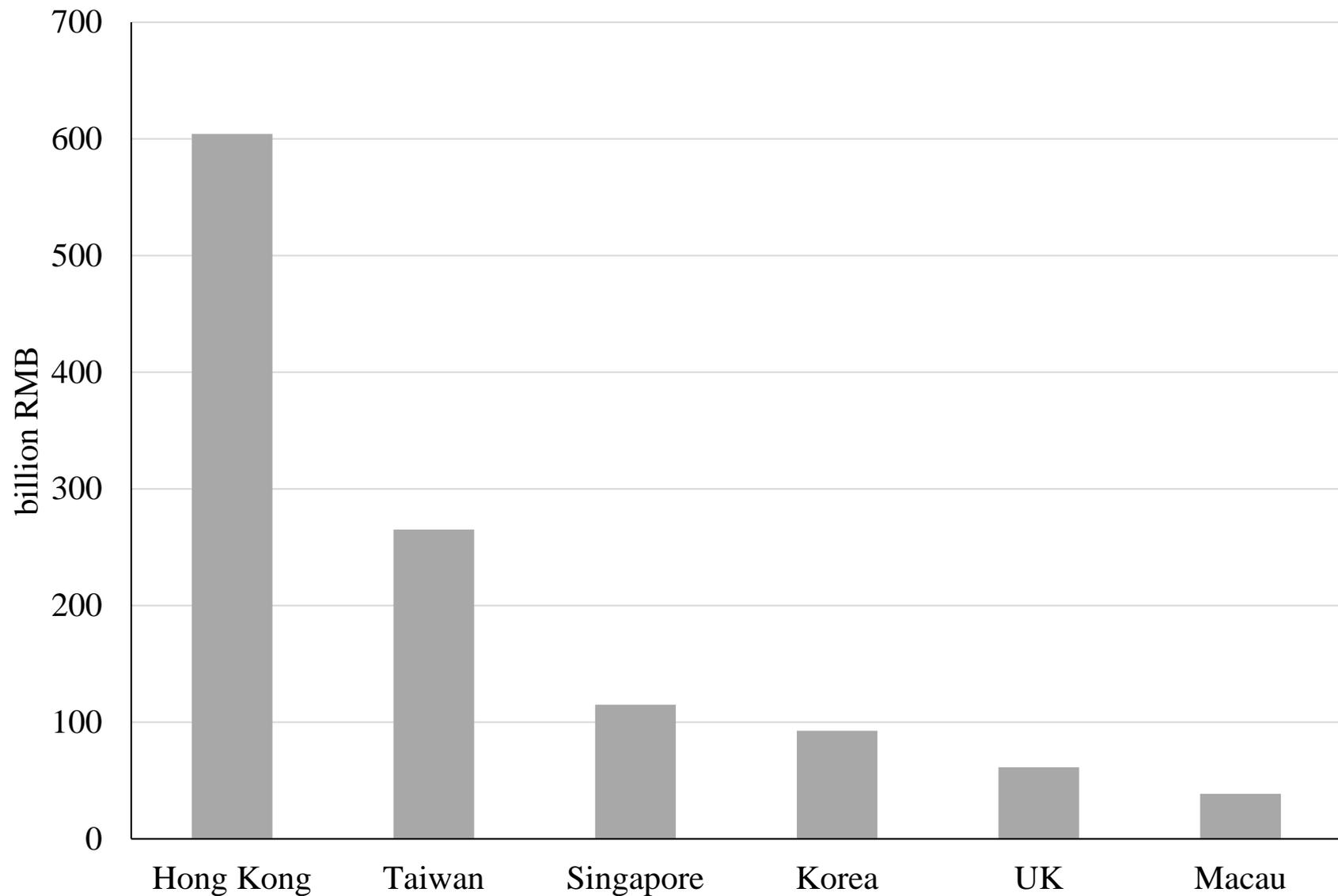


Figure 4-2: Offshore RMB Deposits by Region as of 2019 Q2
(excluding certificates of deposits)

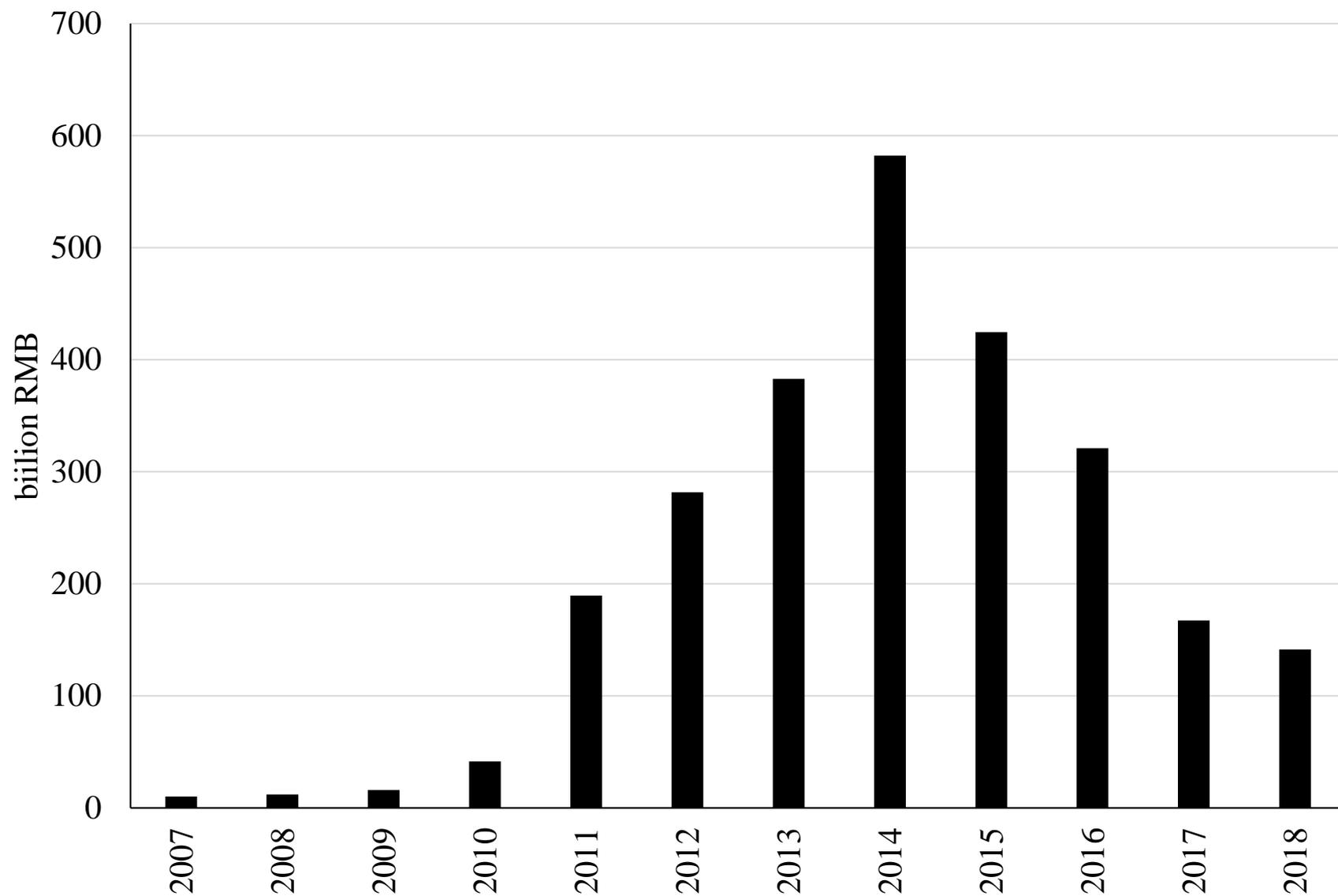


Figure 4-6: Amount of Global CNH Bonds (Dim Sum Bonds) Issued

Ch 5 The importance of capital account liberalization

- ▶ China's capital account openness is low even by developing-country standard
- ▶ There are many capital controls measures, and often through administrative means
- ▶ Foreign ownership of domestic bonds is low

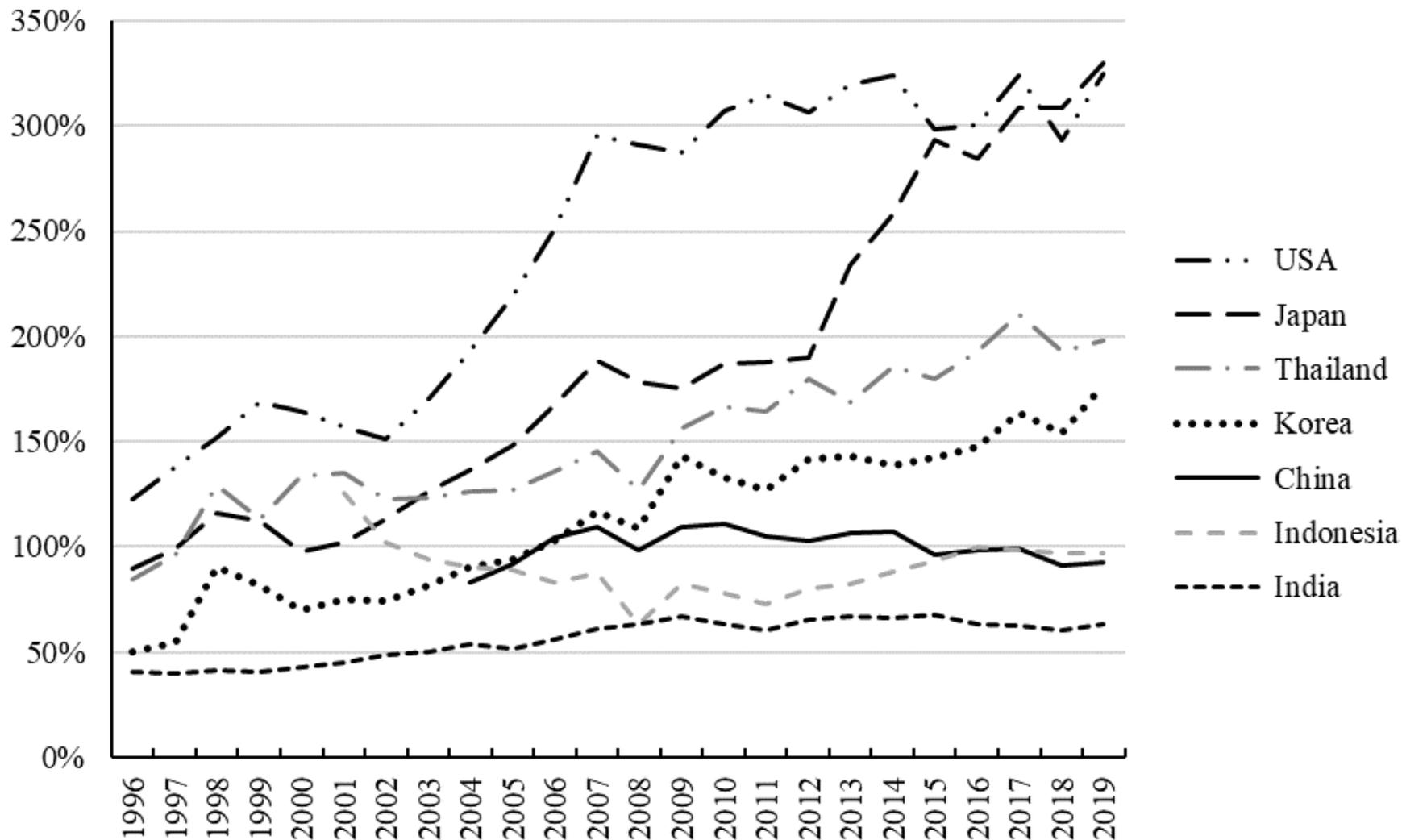


Figure 5-2: Gross international investment position as a percentage of GDP (De facto measure of capital account openness). **China's openness is less than 1/3 of the USA or Japan.**

Why is capital account opening important for RMBI?

- ▶ Freer capital mobility increases inward and outward **investment flows**
- ▶ Freer capital mobility increases the extent to which the currency is used internationally → increases the **market thickness of the currency**
- ▶ Thicker market for the currency lowers transactions costs of currency conversion and increases convenience of using the currency

Ch 6 The importance of financial sector liberalization

- ▶ **Deeper, broader and more liquid financial markets** increase foreign investments in RMB-denominated assets
- ▶ Financial development increases the extent to which the currency is used internationally → increases the **market thickness of the currency**
- ▶ Thicker market for the currency lowers transactions costs of currency conversion and increases convenience of using the currency

China's financial development index is lower than that of Thailand

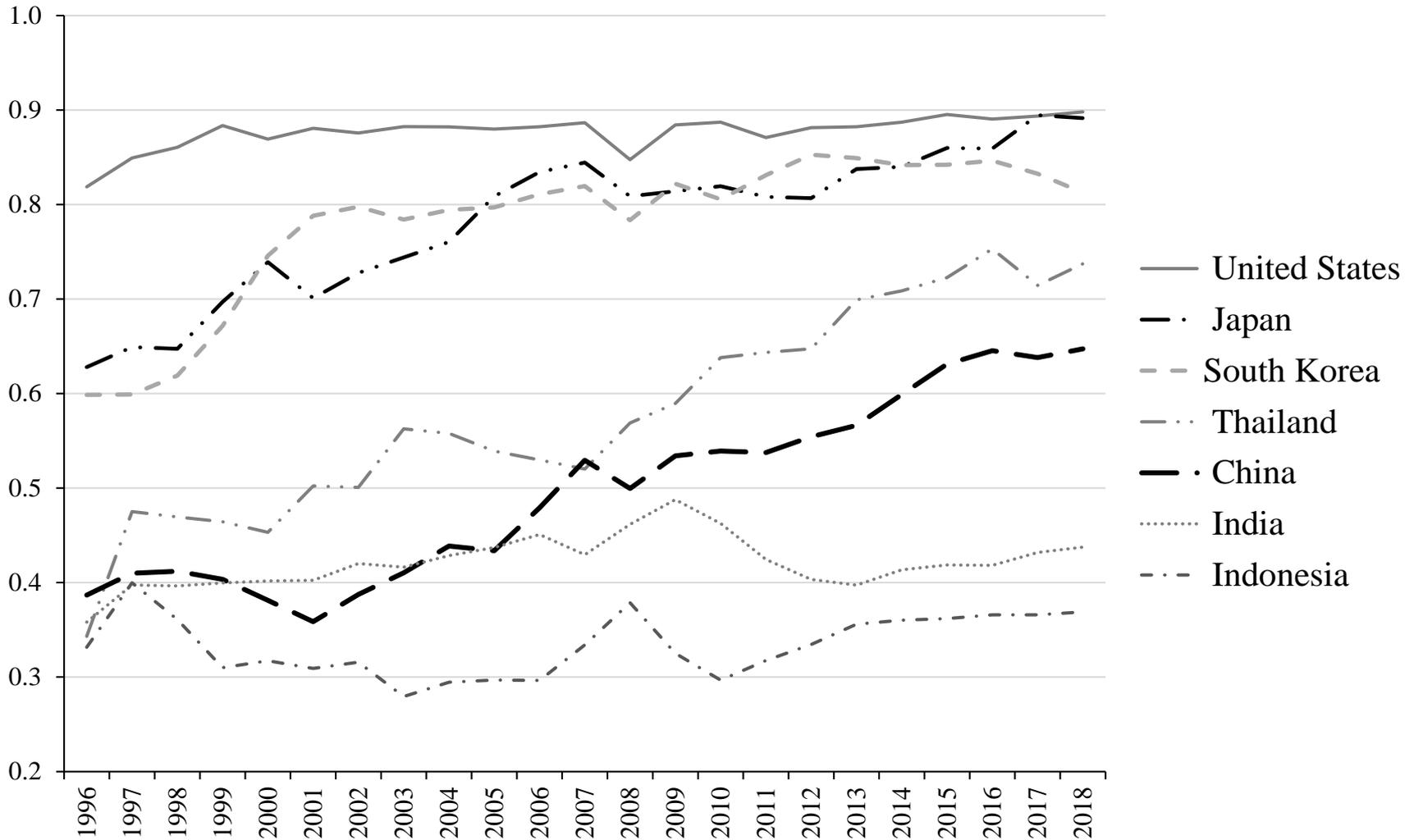


Figure 6-1: IMF Financial Development Index

Structure of China's financial sector

- ▶ **The structure of the financial sector of China is lopsided.** The banking sector is disproportionately large compared with the bond market and the stock market.
- ▶ **An underdeveloped financial market cannot be broad, deep and liquid.** It also cannot be open.

Financial Repression in Chinese banking sector:

- ▶ Interest rates controls
- ▶ Dominance of state-owned banks
- ▶ Controls of credit allocation to favor SOEs, many of which are unprofitable
- ▶ Financial repression → capital misallocation, small firms are disadvantaged

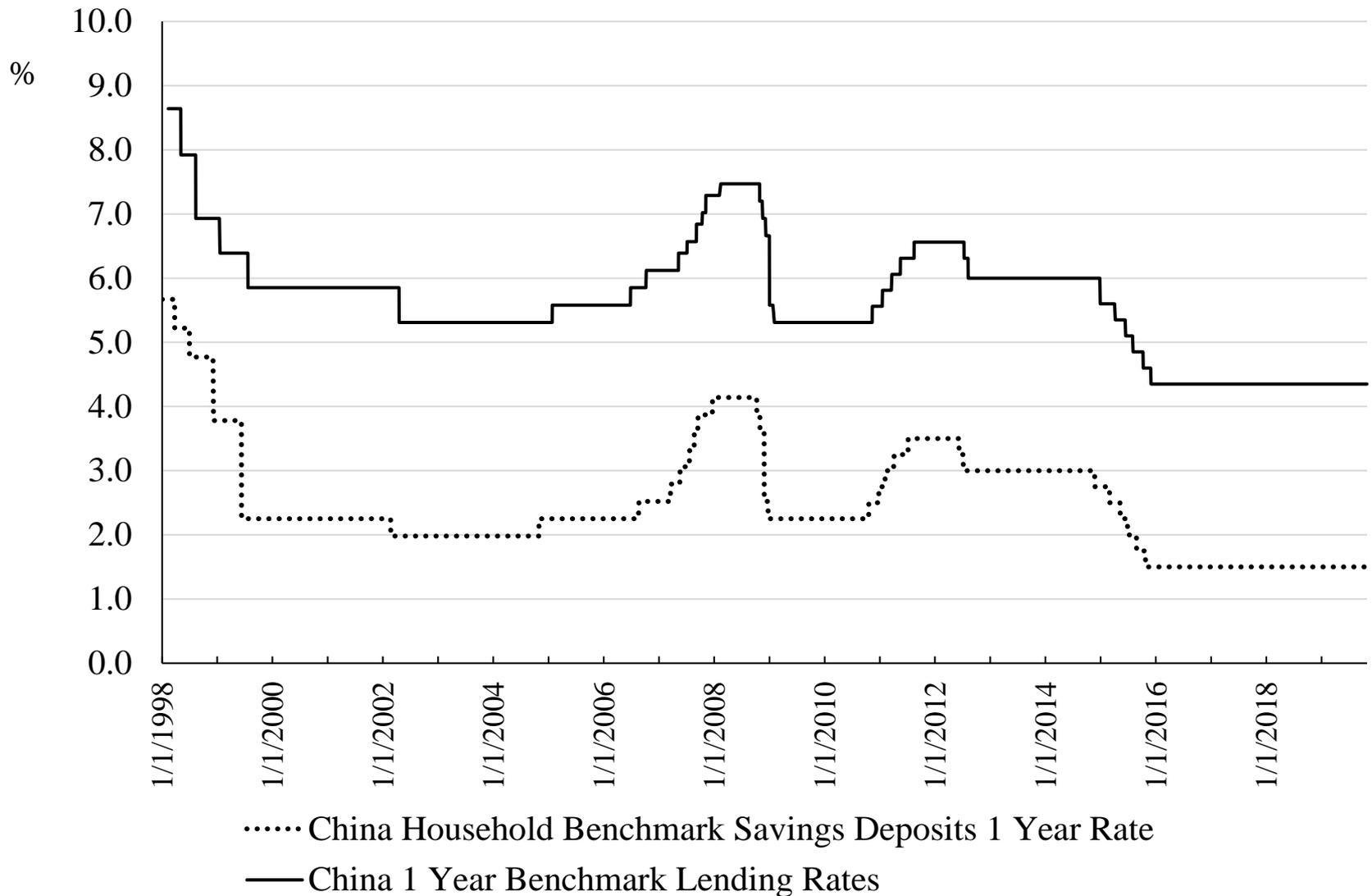


Figure 6-2: PBC Benchmark One-year Deposit and Lending Rates from 1998 to 2020

Financial Repression in Chinese banking sector (cont.)

- ▶ The biggest problem with the financial system is the banking sector and the existence of a large number of unprofitable SOEs.

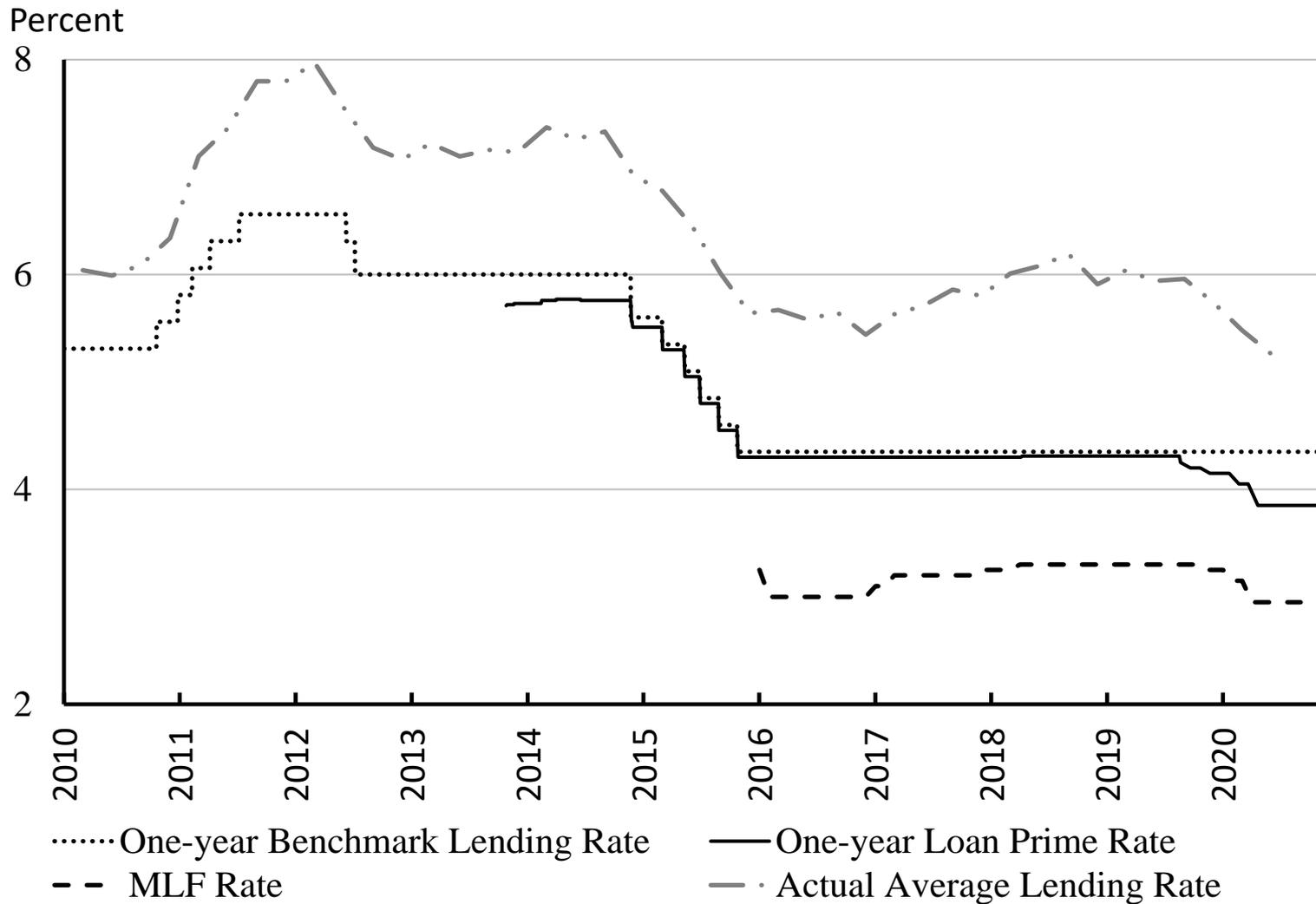


Figure 6-4: One-Year Actual Average Lending Rate, Benchmark Lending Rate, Loan Prime Rate and Medium-term Lending Facility (MLF) Rate. **Actual lending rates are more liberalized over time, but still not market-determined.**

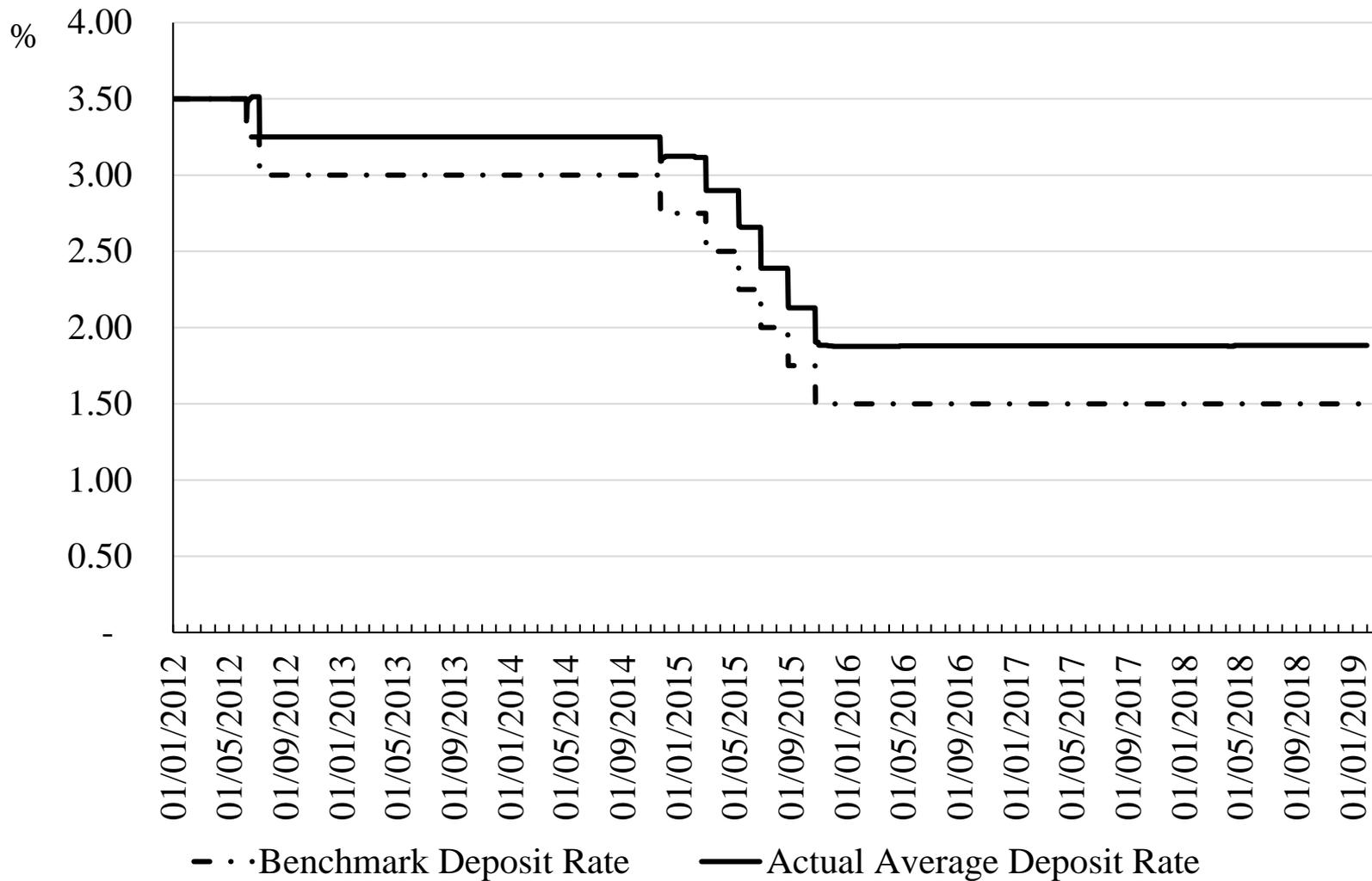


Figure 6-5: Actual Average Deposit Rate and the Benchmark Deposit Rate (1-year). Actual deposit rates almost strictly followed the benchmark rates – far from market-determined. (Dates are of the format dd/mm/yyyy.)

The bond market

- ▶ The development of the bond market, especially the central government bond market, is crucial to making the RMB a truly global currency.
- ▶ However, there are many obstacles, such as its small size, lack of liquidity and the small share of foreign ownership.

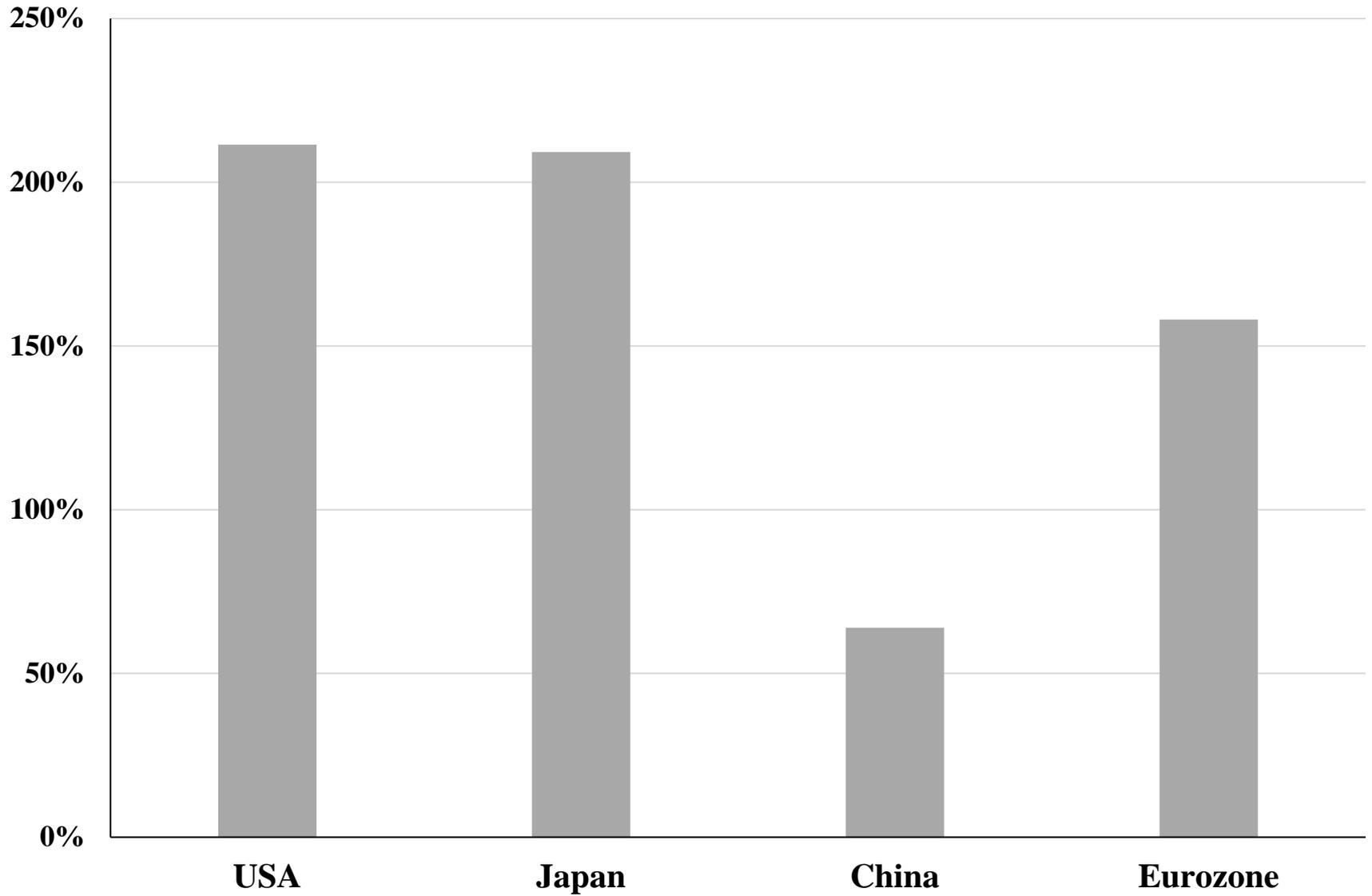


Figure 6-6: Total Bond Outstanding as Percentage of GDP in 2017

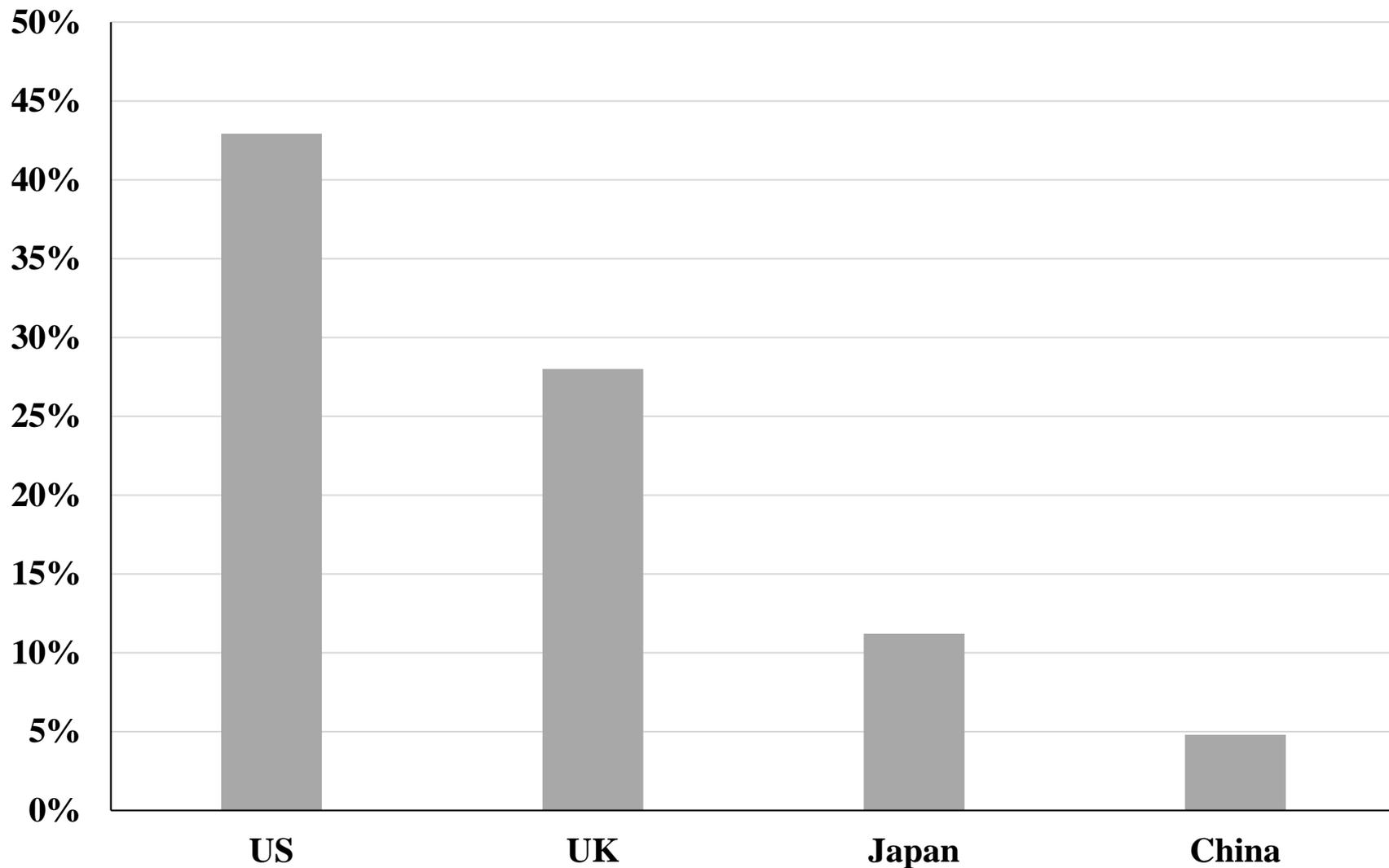


Figure 6-9: Foreign Ownership of Domestic Central Government Bonds as of End of 2017

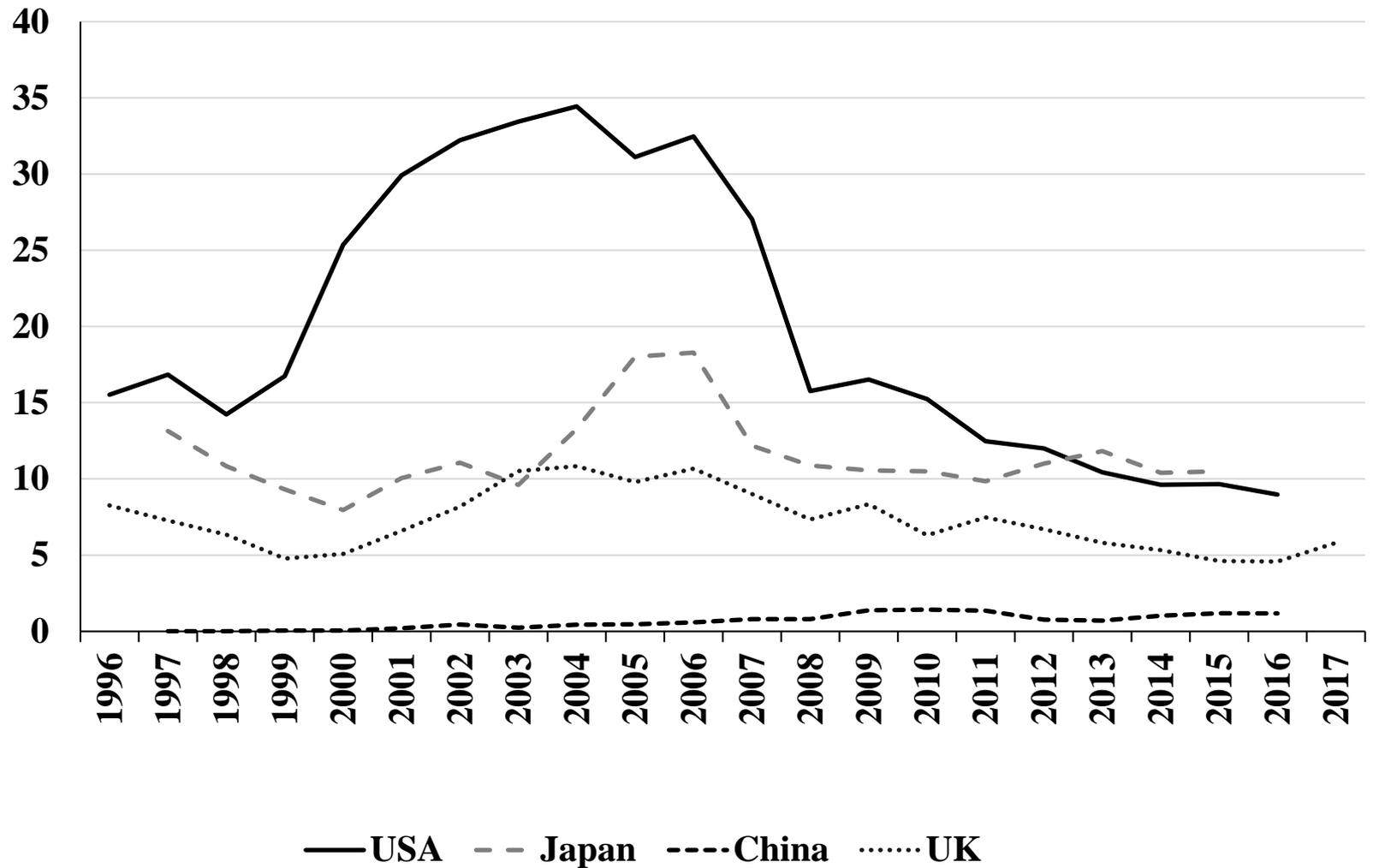


Figure 6-8: Central Government Bond Turnover Ratio

The stock market

- ▶ The track record of government intervention, the lack of transparency, capital controls, corporate governance, and other issues

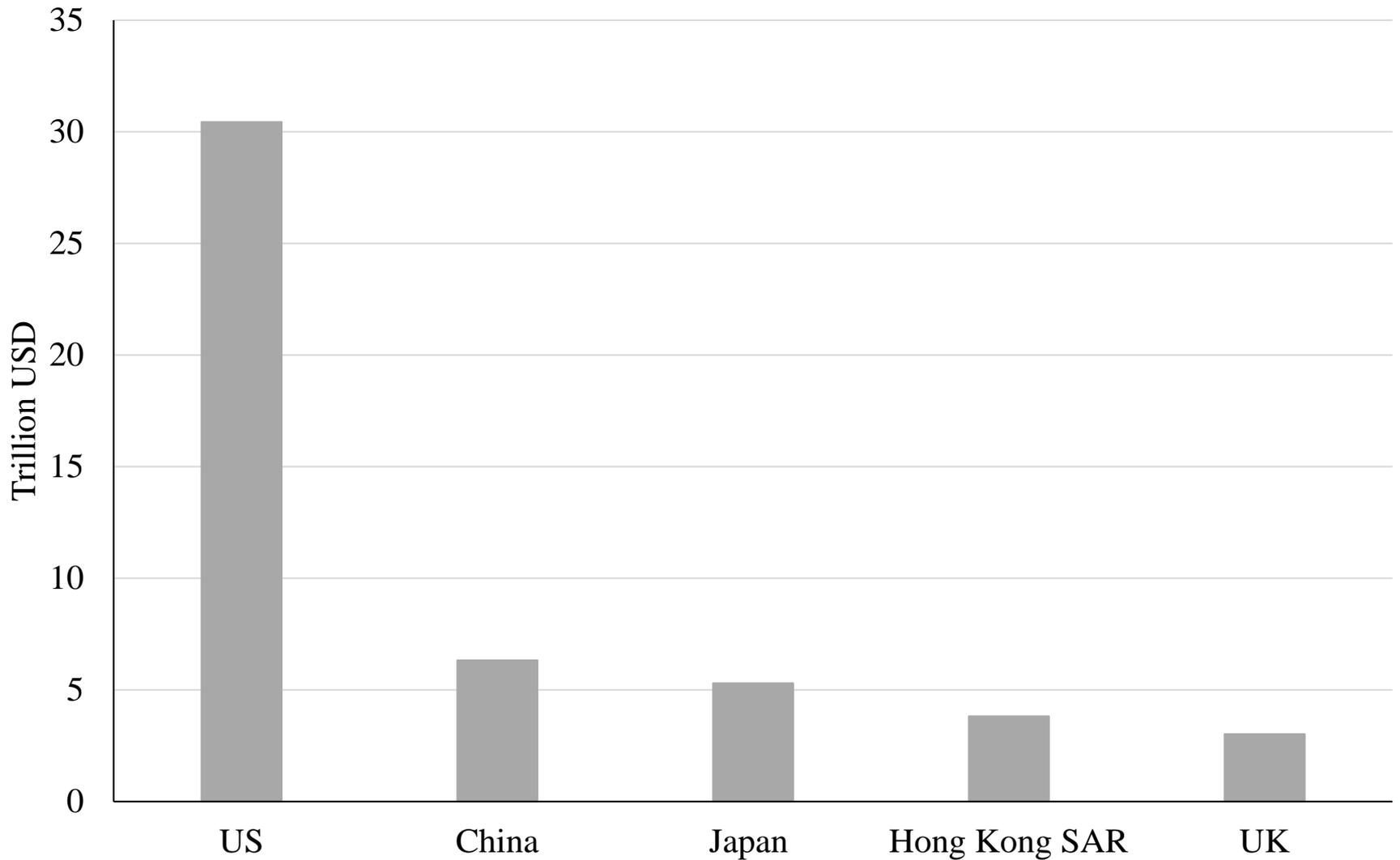


Figure 6-10: Market Capitalization of the Five Largest Stock Markets by Country/Territory as of December 2018

Ch 7 The importance of the offshore RMB market

- ▶ One currency, two markets: **Offshore RMB (CNH) is fully convertible while onshore RMB (CNY) is not**, and there is a firewall for capital flows
- **Internationalizing the currency while opening the onshore capital account at China's own pace.**

Offshore market not main driver

- ▶ The main drivers of RMBI are still onshore financial development and capital account openness.

One currency, two markets - FX markets

- ▶ The onshore RMB (**CNY**) foreign exchange market is subject to **more intervention**
- ▶ The offshore RMB (**CNH**) foreign exchange market is subject to **less intervention**, more volatile

One currency, two markets - the "Connects"

- ▶ SH-HK Stock Connect
- ▶ SZ-HK Stock Connect
- ▶ Bond Connect
- ▶ Cross-boundary Wealth Management Connect (WMC)

The Cross-Border Interbank Payment System (CIPS)

- ▶ Offshore foreign banks can send and receive RMB payments directly to/from China.
- ▶ In the long run, the CIPS can potentially enable Chinese international payment flows to avoid the legal reach of foreign countries, e.g. US.

Ch 9 The Prospects of RMB Internationalization

- ▶ The four key factors for the success of RMB internationalization:
 1. Economic size
 2. Capital mobility
 3. A deep, broad and liquid financial market
 4. Foreigners' confidence on the Chinese system
- ▶ China has economic size on its side, but it needs to work on the other three factors.

The Prospects of RMBI (cont.)

- ▶ By 2030, the RMB can become **a distant third payment currency** (behind the USD and the EUR) if China increases its financial development and capital account openness fast enough.
- ▶ **Economic size alone will not catapult the RMB into the league of major payment currencies.**
- ▶ Hard to become a safe-haven currency.

The Prospects of RMBI (cont.)

- ▶ In the long run, the world may become a **multi-reserve-currency system**, with the USD, Euro and RMB being the three main reserve currencies.
- ▶ However, **the road for the RMB to get there may be quite long and uncertain.**

The Prospects of RMBI (cont.)

- ▶ If RMB internationalization can successfully “daobi” domestic financial development and opening, the initiative should still be considered a success.

THE END
THANK YOU!

One currency, two markets - exchange rate

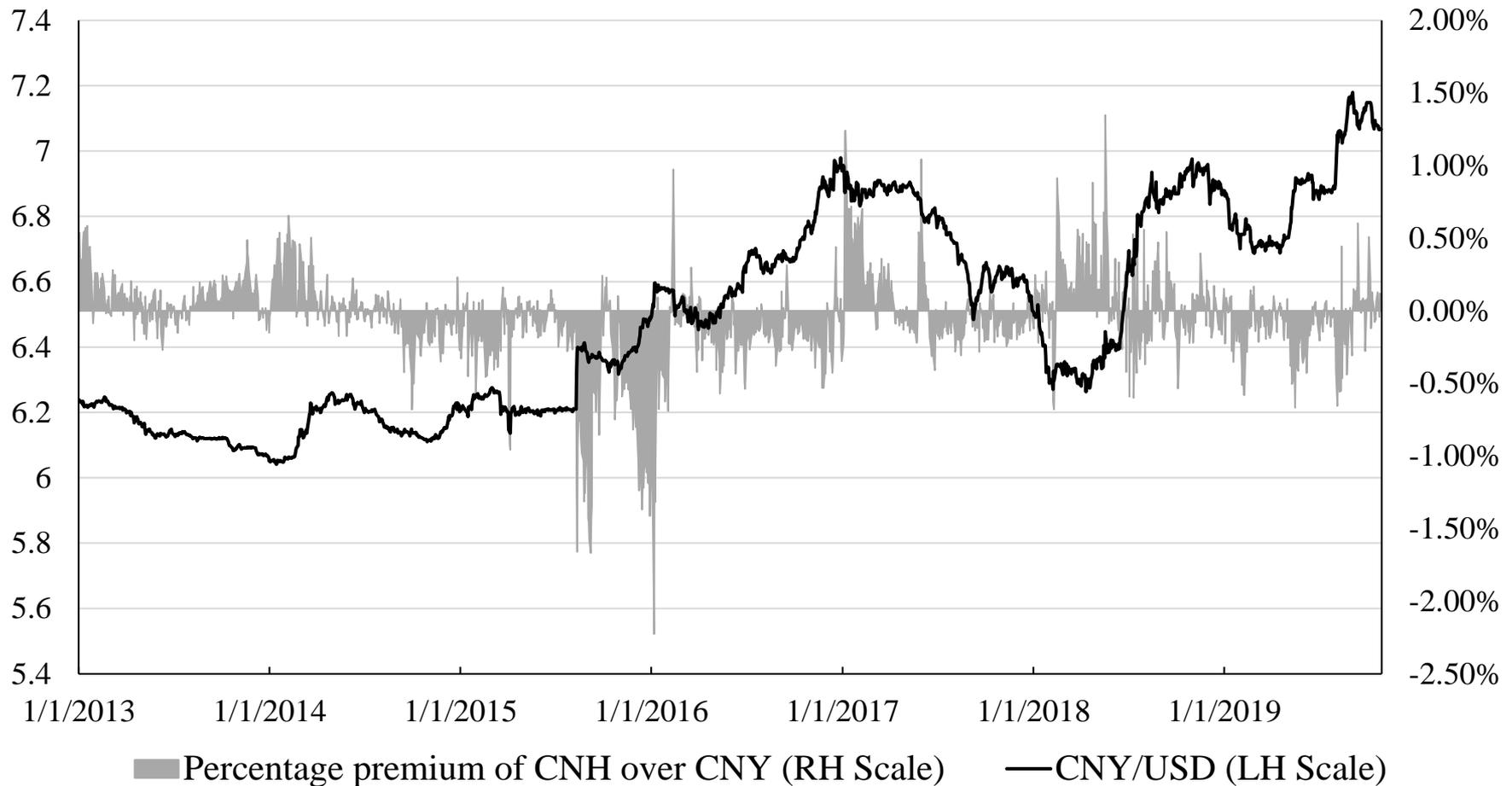
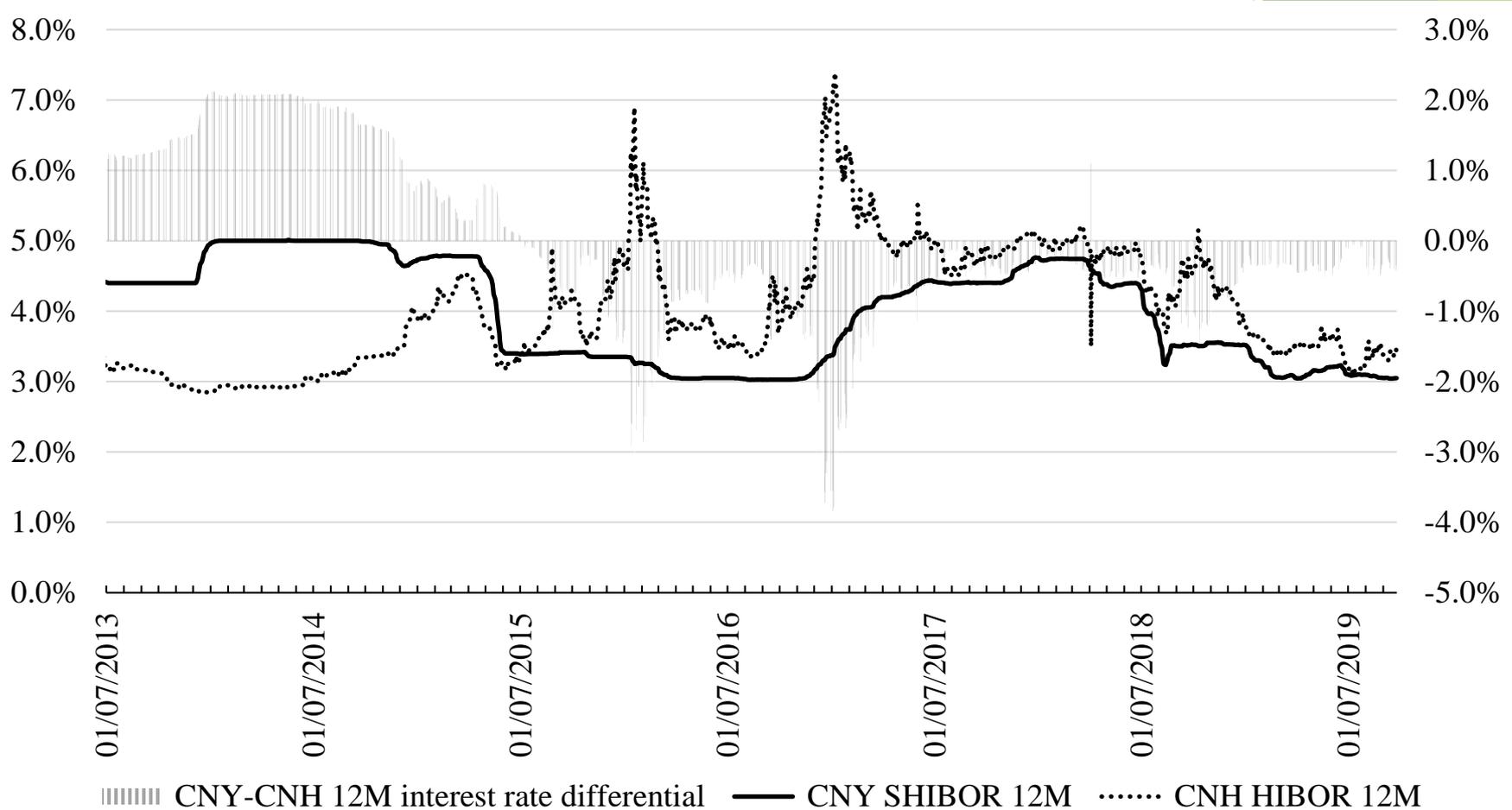


Figure 7-1: CNY/USD exchange rate and percentage premium of CNH over CNY. The CNH exchange rate is more volatile than the CNY exchange rate as the former is subject to less government intervention.

One currency, two markets - interest rate



*Figure 7-2: CNY SHIBOR 12-month interest rate and CNH HIBOR 12-month interest rate are on the LH scale. CNY-CNH 12-month interest rate differential is on the RH scale. **The CNH interest rate is more volatile than the CNY interest rate as the former is subject to less government intervention.***