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# The Role of the Renminbi in the International Monetary System

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# The Roles of Money – Domestic and International

## The Roles of Money

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

## Guardian over Money

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



## International Monetary System

- Use of national currencies as mediums of international exchange, for the storage of international wealth and as units of international accounting
- Domestic orientation of policies over national money pursued by national authorities and lack of effective international oversight led to structural weaknesses in the international monetary system (as articulated in the 2011 Report of the Palais-Royal Initiative):
  - \* Ineffective global adjustment process
  - \* Financial excesses and destabilizing capital flows
  - \* Excessive exchange rate fluctuations and deviations from fundamentals
  - \* Excessive expansion of international reserves



## International Monetary System

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



## International Monetary Fund

### Article I: Purposes

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



# International Monetary Fund

## Article I: Purposes

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



## International Monetary Fund

### Article I: Purposes

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



## International Monetary Fund

### Article IV, Section 1. General obligations of members

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

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





# Global Governance of the International Monetary System

Palais-Royal Initiative (2011):

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



## Institutional Reform of the International Monetary System

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



## A Chinese View on the International Monetary System

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

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



## A Greater Role for the SDR

Governor Zhou (March 2009):

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



## Specific Proposals on the SDR

Governor Zhou (March 2009):

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



# A Chinese View on the International Monetary System

Governor Zhou (March 2009):

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



## International Responses to Chinese View

President Obama (March 2009):

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



## International Responses to Chinese View

IMF MD (May 2010):

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





## International Response to Chinese View

### G-20 Chair (2011):

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



## China's Perspective

- Largest foreign reserve holder: US\$3.24 trillion at the end of June 2012
- No alternative but to hold the bulk in USD and euro denominated assets
- Running reduced but still substantial balance of payments surplus (2010: 5% of GDP; 2011: 2.8% of GDP)
- With capital controls there is continued accumulation of foreign reserves
- Exchange rate under political and economic pressures to appreciate
- Sovereign debt crisis in euro area and QE in US – huge exchange rate and credit risks
- Risk management measure: internationalization of the renminbi



## Internationalization of the Renminbi - Benefits

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



## Benefits of Internationalization – Example of RMB Trade Settlement

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



## Internationalization of the Renminbi - Costs

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



## Pre-conditions for Internationalization of a Currency

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



## Size

Major indicators	Country (world rank)	2011
<b>GDP (Current prices, US\$)</b>	United States (1)	15.09 trillion
	China (2)	7.30 trillion
	Japan (3)	5.87 trillion
<b>GDP (PPP, share of world total)</b>	United States (1)	19.1%
	China (2)	14.3%
	Japan (3)	5.6%
<b>Population*</b>	China (1)	1343 million
	United States (3)	314 million
	Japan (10)	127 million

Sources: IMF, CIA-The World Factbook

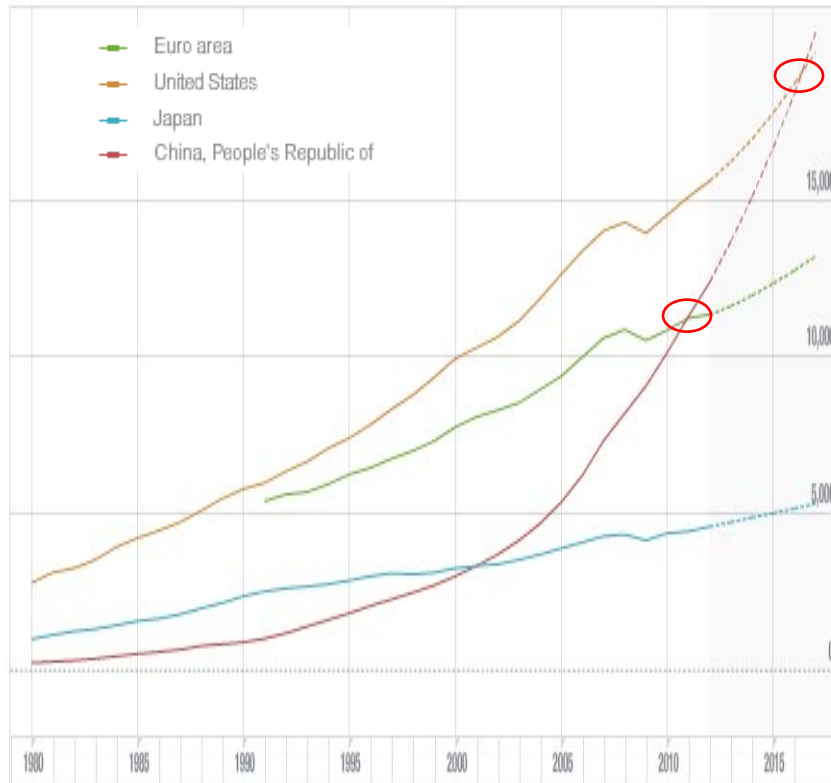
\* Estimated July 2012

Major indicators	Country (world rank)	2011
<b>Stock of Inward FDI (US\$)</b>	United States (1)	2874 billion
	Hong Kong (3)	1141 billion
	China (7)	776 billion
<b>Stock of Outward FDI (US\$)</b>	United States (1)	4051 billion
	United Kingdom (3)	1702 billion
	China (15)	322 billion
<b>Exports (US\$)</b>	China (1)	1.90 trillion
	United States (2)	1.51 trillion
	Germany (3)	1.41 trillion
<b>Imports (US\$)</b>	United States (1)	2.31 trillion
	China (2)	1.74 trillion
	Germany (3)	1.20 trillion



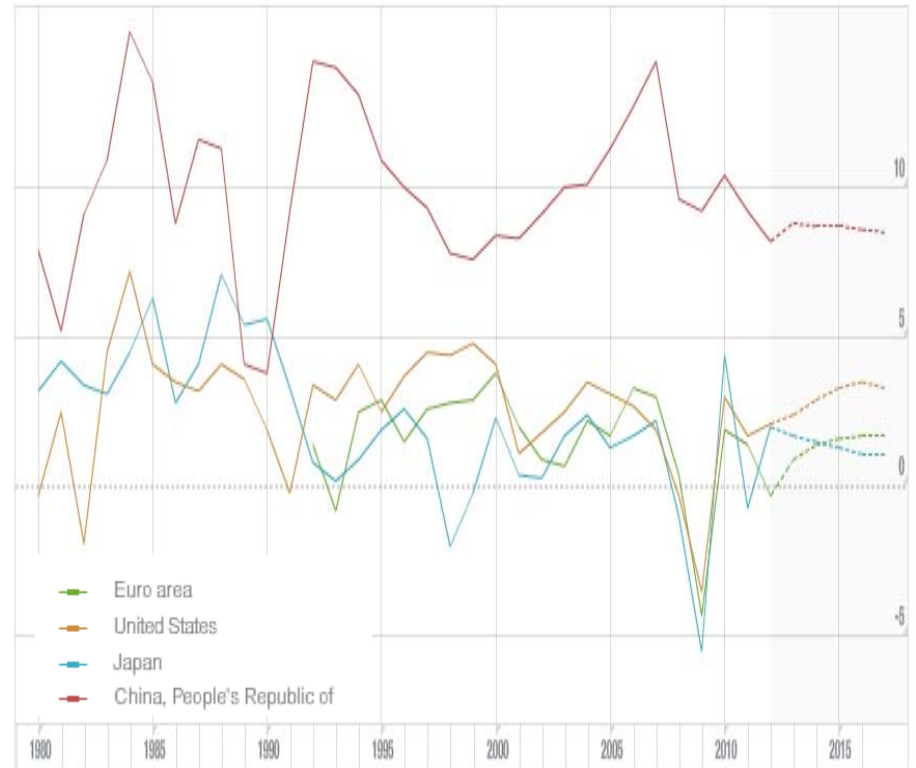
# Projected Size (2017)

### GDP (PPP) (Billions US\$)



Source: IMF forecasts

### Real GDP growth (%)



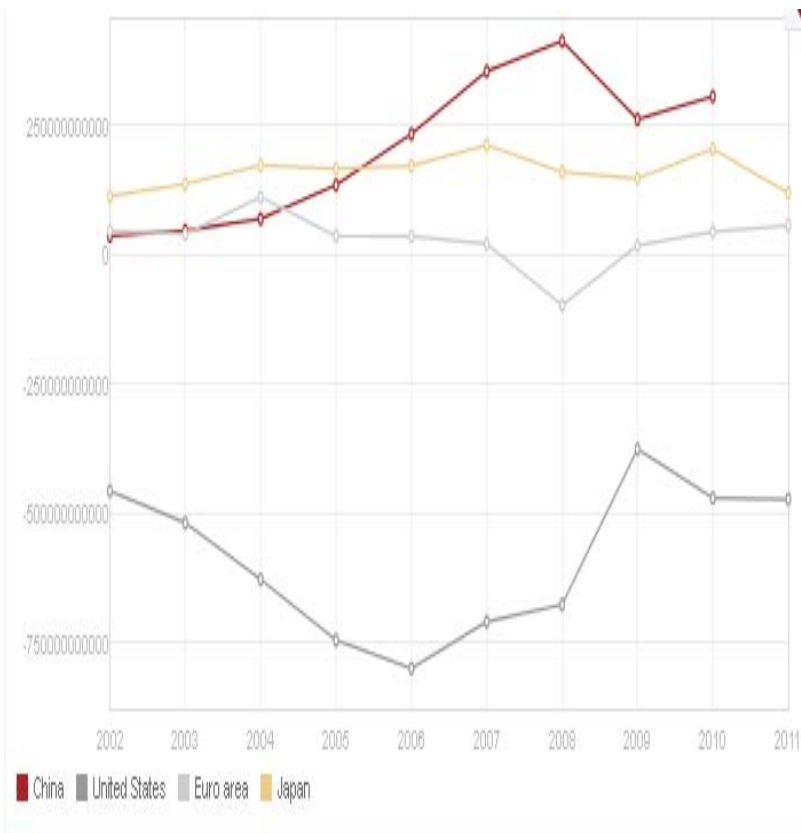
Source: IMF forecasts





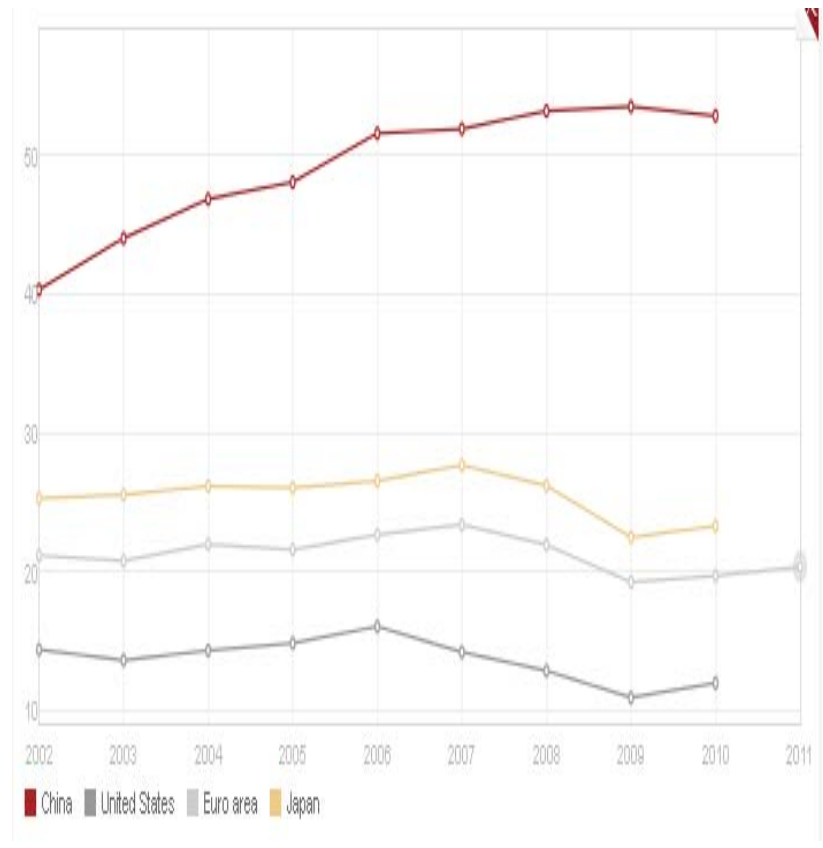
## Prudent Macroeconomic Policies

Current account balance (BoP, current US\$)



Source: The World Bank

Gross savings (% of GDP)

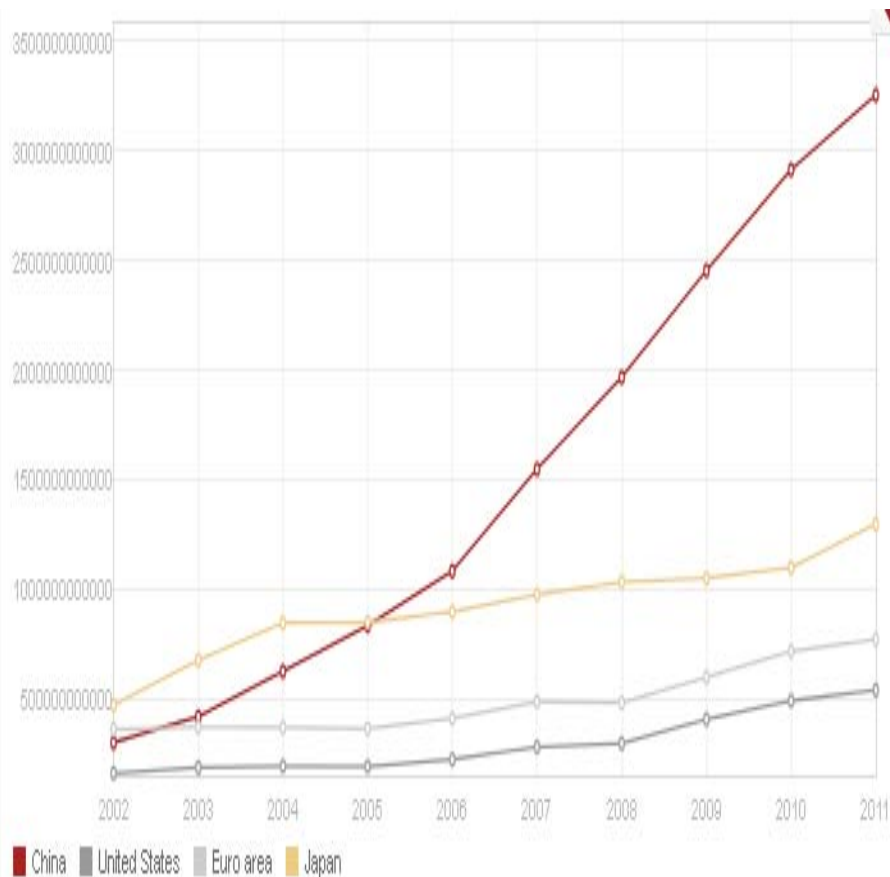


Source: The World Bank



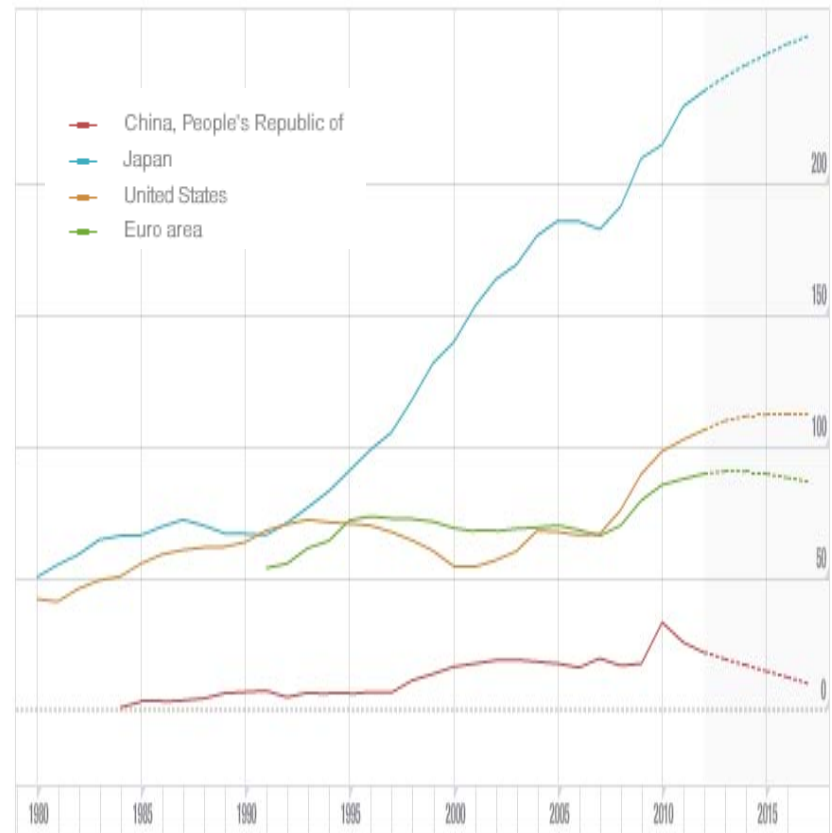
# Prudent Macroeconomic Policies

### Reserve assets (US\$, including gold)



Source: The World Bank

### Central government gross debt (% of GDP)

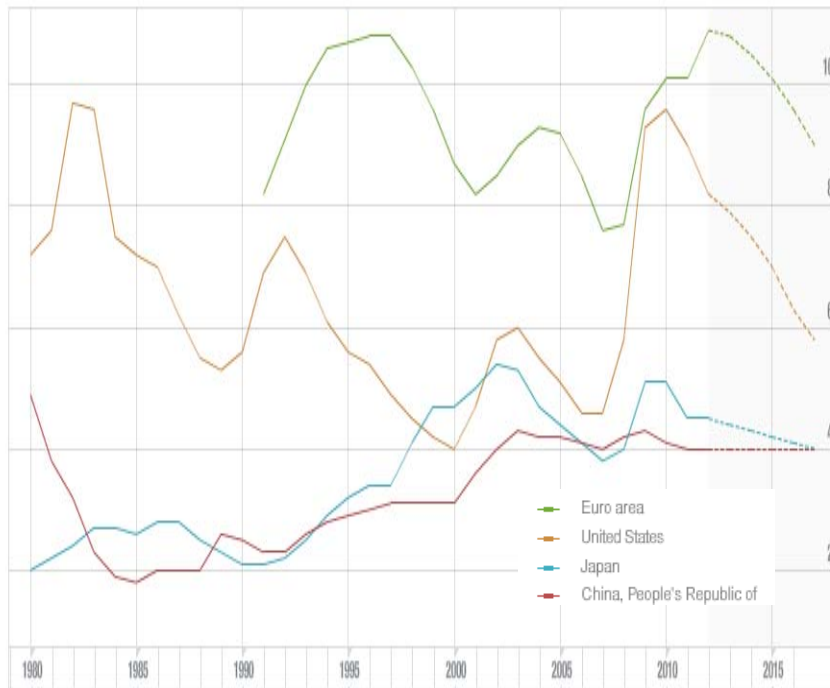


Source: IMF forecasts



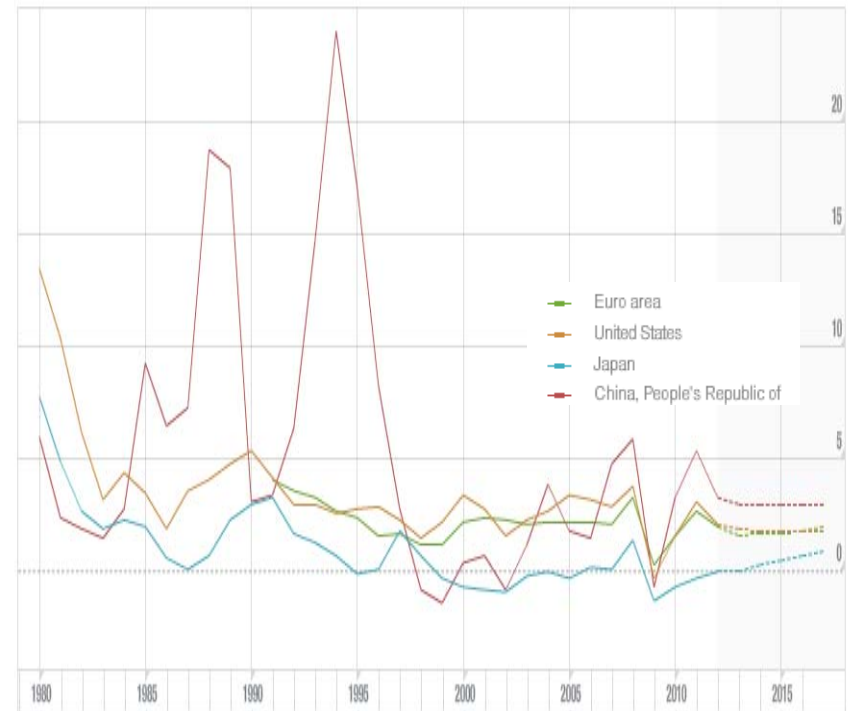
# Prudent Macroeconomic Policies

## Unemployment rate (%)



Source: IMF forecasts

## Inflation rate (%)



Source: IMF forecasts



## Convertibility – Current Account

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



## Convertibility – Capital Account

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



## Convertibility – Capital Account

		Inflow	Outflow
<b>Shares</b>	Residents	- To issue shares abroad (FC denominated) with the approval of SAFE, fund raised to be used in China	- To purchase shares abroad only by SAFE-approved FIs and groups (through QDII in shares limited to 50% of quota, total quota of US\$67 billion to 87 FIs since 2007)
	Non-residents	- To purchase B shares listed on Chinese Securities Exchange only - To purchase A shares through QFII (106 foreign co) with a quota of around US\$19 billion since 2003	- Not permitted to issue shares locally
<b>Bonds</b>	Residents	- To issue bonds abroad (FC) as part of State external debt plan by PBC-approved FIs, fund raised to be used in China	- To purchase bonds abroad only by SAFE-approved FIs and groups (and QDII since 2006)
	Non-residents	- Not permitted to purchase bonds locally (except QFII and interbank bond market available to eligible institutions since 2010)	- Not permitted to issue bonds locally (Mitsubishi Financial Group is the first foreign company to issue RMB bonds in China in May 2010)
<b>Money market instruments</b>	Residents	- To issue MM instruments abroad (PBC and SAFE approval required)	-To purchase MM instruments abroad only by SAFE-approved FIs and groups (and QDII) - SAFE imposed limit on open FX position
	Non-residents	- Not permitted to purchase locally (except QFII)	- Not permitted to issue locally
<b>Mutual funds</b>	Residents	- To issue funds abroad (PBC and SAFE approval required)	-To purchase funds abroad by SAFE-approved FIs and groups (and QDII similar to shares) - SAFE imposed limit on open FX position
	Non-residents	- Not permitted to purchase locally (except QFII)	- Foreigners selling funds require approval from Securities Policy Commission
<b>Derivatives</b>	Residents	- Limited operations by approved FIs and restriction on open FX position	- Limited purchase of foreign derivatives by approved FIs and groups, restriction on open FX position
	Non-residents	- Not permitted to purchase locally (except QFII)	- Not permitted to issue locally



## Convertibility – Free or Full?

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



## Foreign Exchange Administration – Five Transformations (July 2010)

### 外匯管理理念的五個轉變

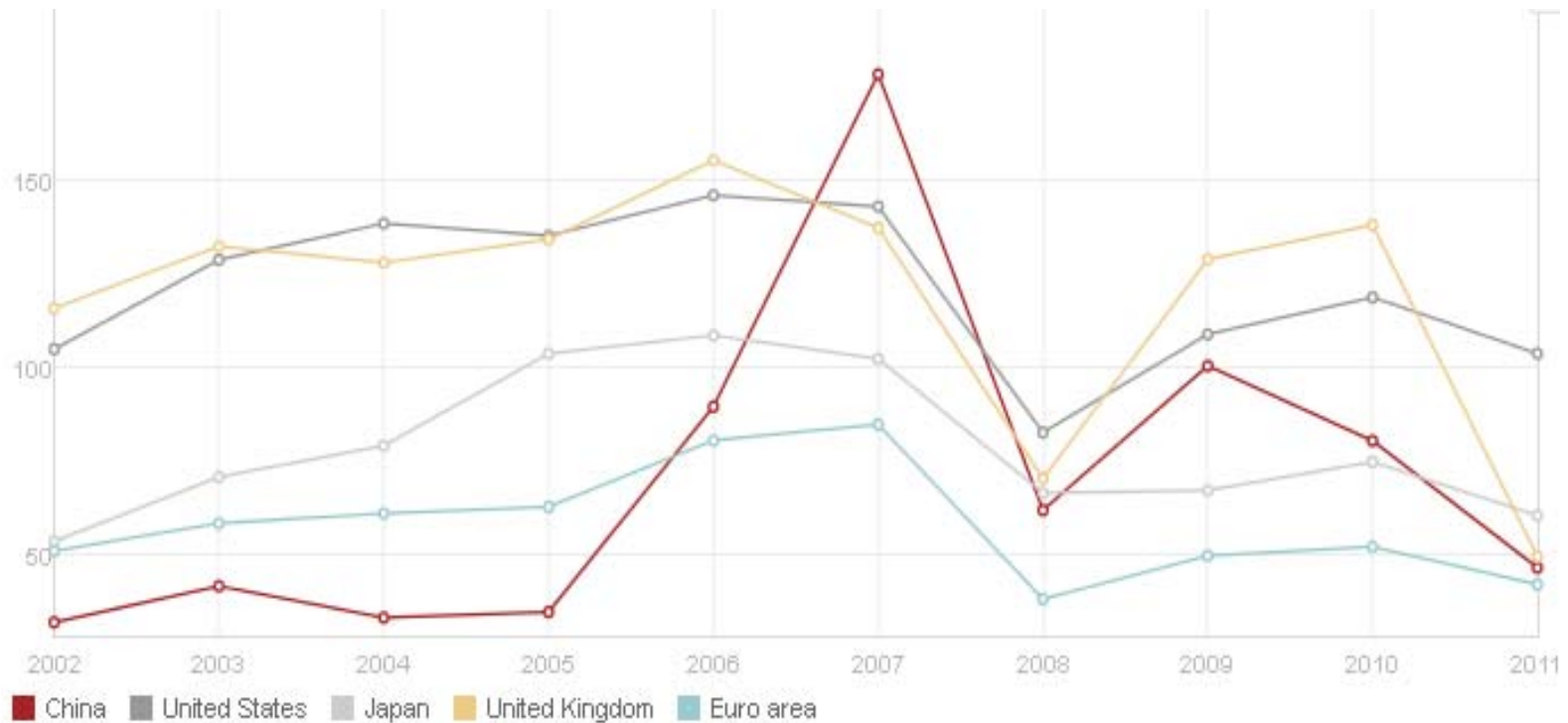
- From prior approval requirements to result analysis 从重審批轉變為重監測分析
- From prior regulatory scrutiny to result management 从重事前監管轉變為強調事後管理
- From transaction management to institutional management 从重行為管理轉變為更加強調主體管理
- From “presumed guilty” to “presumed innocent until proved guilty” 从”有罪假设”轉變到”无罪假设”
- From “prohibited unless stated” to “permitted unless prohibited” 从“正面清單(法无明文授權不可為)”轉為“負面清單(法无明文禁止即可為)”





# Financial System

Market capitalization of listed companies (% of GDP)

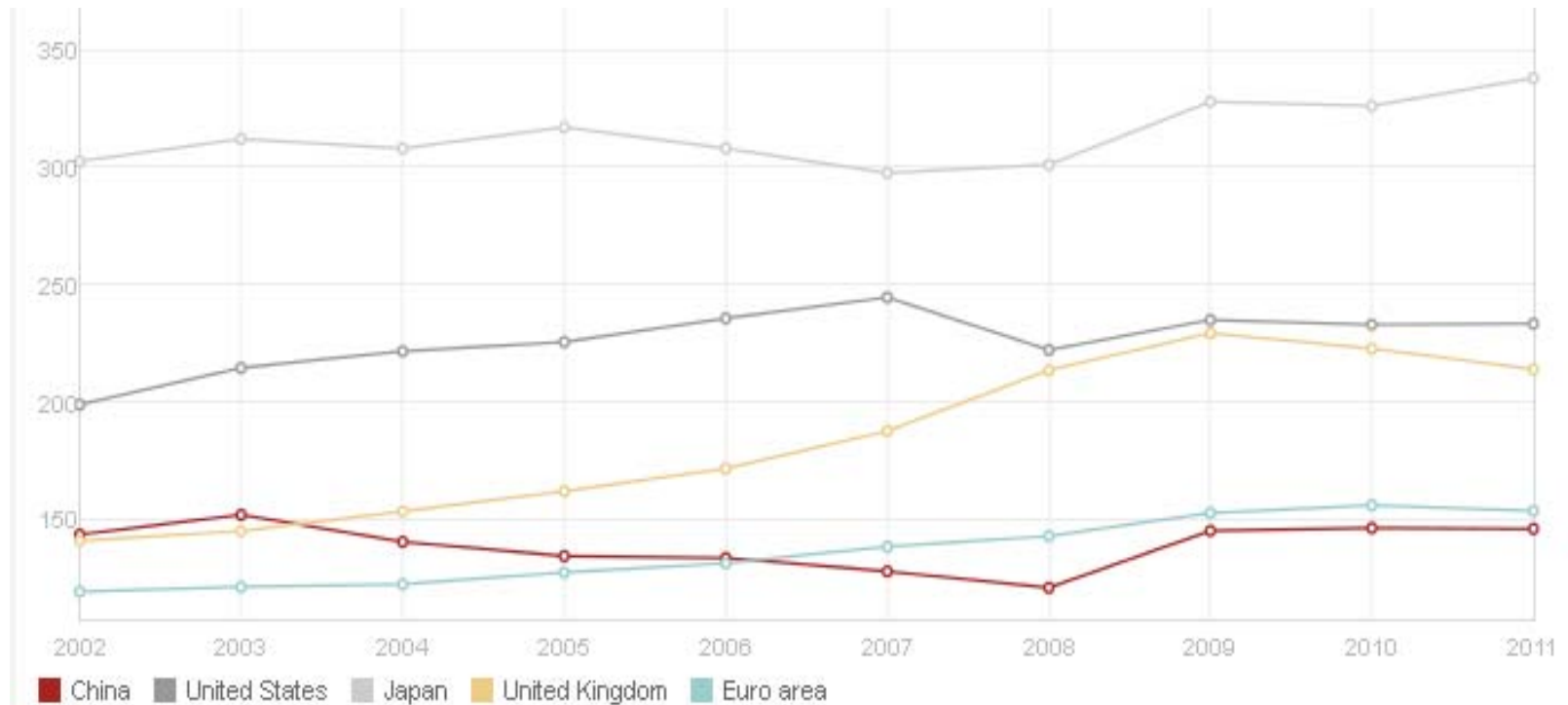


Source: The World Bank



# Financial System

## Domestic credit provided by banking sector (% of GDP)

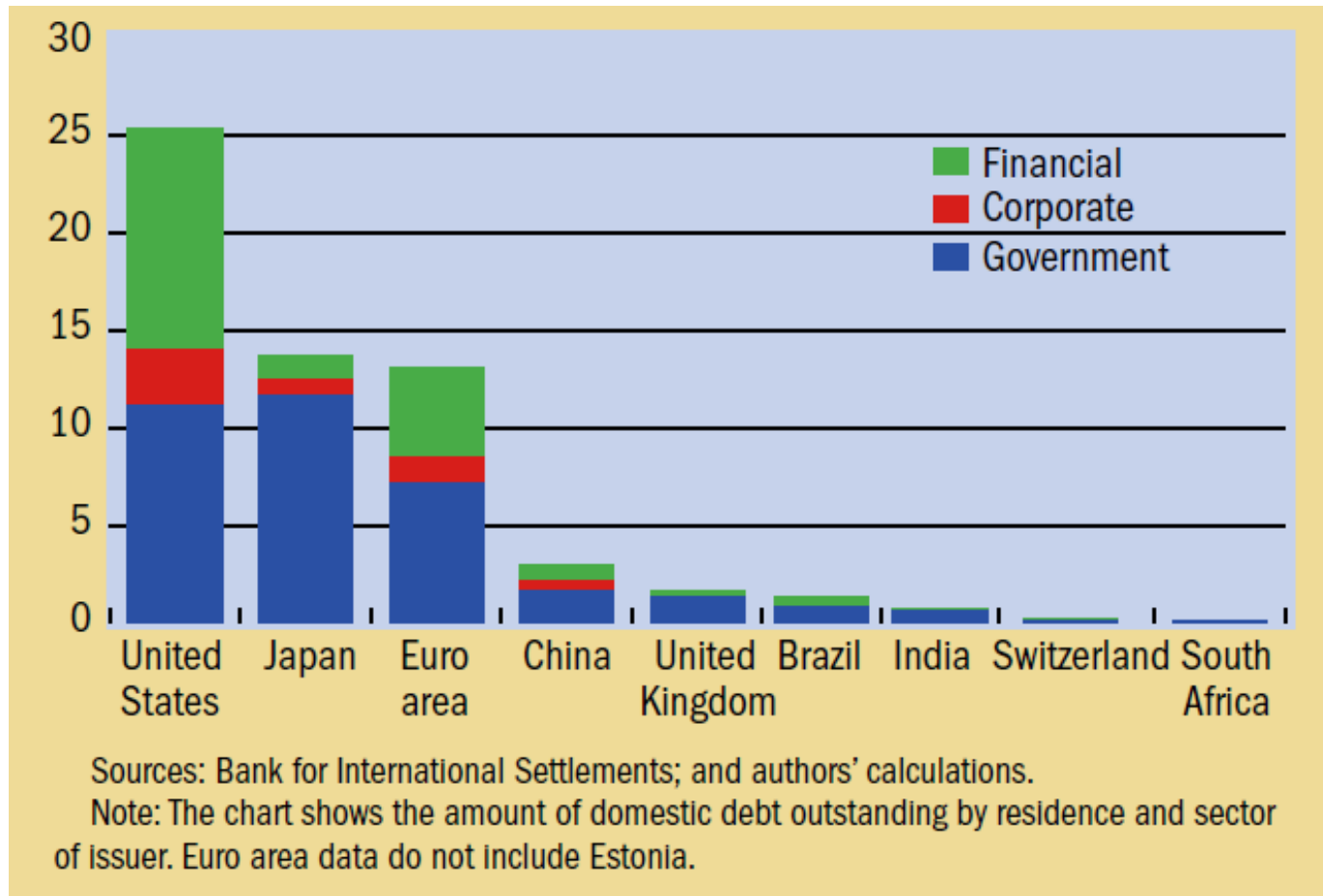


Source: The World Bank



# Financial System

Domestic debt securities outstanding (Billion US\$, 2010)





## Financial Infrastructure

- The plumbing of the financial system – the payment, clearing, settlement and custodian systems
- Advantage of a late starter with advanced information technology
- Hong Kong, as *the* international financial centre of China, has sophisticated and robust financial infrastructure, e.g. RTGS DVP and PVP across four currencies (USD, euro, RMB and HKD)



## RMB Internationalization Approach (1)

- The guiding philosophy for reform and liberalization to build a socialist, market economy – crossing river by feeling the stones (Deng), more recently articulated (by Wen) as gradualism, controllability and the taking of initiative (漸進, 可控, 主動)
- No clear strategy outlined, but benefits of promoting the greater international use of the RMB and the risks of too hasty capital account liberalization are clear
- Controlled experiments through development of off-shore RMB market in Hong Kong



## RMB Internationalization Approach (2)

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



## RMB Internationalization Approach (3)

The emerging guiding principles:

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



## RMB Internationalization Progress (1)

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





## RMB Internationalization Progress (2)

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



## RMB Internationalization Progress (3)

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



## RMB Internationalization Strategy

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



# RMB Internationalization An Analytical Framework

Six important analytical dimensions:

- (A) On-shore or off-shore
- (B) RMB or foreign currencies
- (C) Cross border mobility or cross currency conversion
- (D) Current account or capital account
- (E) Residents or non-residents of the Mainland
- (F) Individuals or corporations

$2 \times 2 \times 2 \times 2 \times 2 \times 2 = 64$  possible areas for consideration



# RMB Internationalization An Analytical Framework

- Need to rationalize anomalies provides pointers for further liberalization
- Example (1): now no restrictions on off-shore (A) conversion (C) between RMB (B) and foreign currency (B) of non-resident (E) individuals (F) for the purpose of investment (D); why should Hong Kong residents still be subject to conversion of RMB20,000 a day?
- Example (2): mobility (C) of off-shore (A) RMB funds (B) on-shore by non-resident (E – Hong Kong residents) individuals (F) for investing on the Mainland (D – capital account) limit is RMB80,000 a day; why should other non-residents or indeed residents not be allowed such mobility?



## RMB Internationalization An Analytical Framework

- Example (3): why should on-shore (A) foreign currency (B) already owned by resident (E) individuals (F) not be given mobility (C) to be invested (D) off-shore?
- Example (4): why should non-resident (E) companies (F) not be allowed greater freedom to issue RMB bonds off-shore (A) through restricting the mobility (C) of RMB bond proceeds (B) for investment (D) on-shore, while resident company could do so rather freely?



# RMB Internationalization – Implications for the International Monetary System

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



# RMB Internationalization – Implications for the International Monetary System

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