Renminbi as a reserve currency

China's renminbi is gaining traction as a global currency, which will pave the way for a multiple global reserve currency system. Discussed here by John Zhu, economist, Greater China, HSBC.

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The US dollar's dominance in the global financial system remains. But, looked at in another way, the dollar is also unusually dominant. According to the International Monetary Fund (IMF), the dollar currently accounts for 61% of total allocated foreign currency reserves compared with 25% for the euro. At its height, prior to the First World War, sterling was only 48% of global reserves.[1] As the renminbi (RMB) becomes more global, the make-up of foreign exchange reserves will change over time. There is plenty of room for the RMB to grow as an international currency – after all, China accounts for around 12% of both global gross domestic product (GDP) and trade, yet the RMB is only used for around 2% of global payments.

There is still a long way to go, but the direction is surely heading towards greater trade flows with China. Already the world's largest trading country, nearly 20% of China's foreign trade is now settled in RMB – up from just 3% in 2010. However, this is still low compared with around 50–60% of the eurozone's external trade settled in euro, and 30–40% in yen for Japanese trade. The Hong Kong Monetary Authority (HKMA) expects RMB settlements to reach 30% by the end of 2015.

While the RMB continues its journey as an international trade and investment currency, some structural shifts in the world reserves market are also under way. Twenty years ago, 65% of reserves were held by developed countries and 35% by emerging markets. Now that position is reversed, with 67% of world reserves held by emerging markets, reflecting the economic rise of Asia in general and China in particular.[2]

The euro was seen as a prime candidate for those seeking alternatives to the dollar, or greater diversification, but it has unfortunately faced its own share of uncertainties arising from the eurozone debt crisis. This has led to increasing interest across the world in holding non-traditional currencies in foreign exchange reserves. Many central banks and global investors are increasingly seeing the RMB as another alternative.

This year, HSBC reaffirmed its view that the RMB will be fully convertible over the next two to three years.[3] An important indicator of the RMB's maturity would be its inclusion in the IMF Special Drawing Right (SDR) basket of reference currencies – currently the euro, yen, sterling and dollar. The SDR will next be reviewed in 2015, and RMB inclusion is sure to be high on the agenda.

A stated policy goal

As economic and financial reforms continue in China, the RMB is likely to play a much more prominent role on the world stage, and should increasingly factor in reserve managers' allocations. China is already actively promoting greater use of the RMB in other parts of the world. The first channel is through trade settlement in the currency, which – as previously mentioned – has expanded. Second, RMB-denominated products have bloomed offshore and policy-makers are opening up the large domestic financial market to foreign investors. Slowly but steadily, the RMB is going global.

Of course, the process is far from complete. History suggests there are a number of key requirements for a true reserve currency. First, the size of the home economy must be large relative to others, which makes it important to its trading partners. In this, China's increasing share of world trade and GDP would clearly justify greater use of the RMB.

Second, economic stability in the form of low inflation, small budget deficits and stable growth is also important. China's record of supportive government policies and macro-economic stability has undoubtedly contributed to the RMB's appeal in recent years. The bursting of Japan's bubble in the early 1990s was arguably one of the main reasons why yen internationalisation stalled, while the stability of the German economy due to the perceived sound monetary policy of the Deutsche Bundesbank was often cited as one of the main attractions of the deutschmark.

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Third, strong official and institutional support. Among other obvious factors, this was an important reason for the dollar's adoption as a global currency after the Second World War, formalised through the Bretton Woods system. Contrast this with the post-war revival of Japan: many also viewed the yen as being on the cusp of becoming an important global reserve currency. However, support for internationalisation of the yen was muted, and eventually came too late as Japan's growth peaked and it subsequently faced its lost decades. By contrast, the internationalisation of the RMB and the opening up of China's capital account is a stated policy goal for the Chinese government, and has already been happening at a faster pace than many commentators had expected. At the China Development Forum in March 2014, the People's Bank of China (PBoC) deputy governor, Yi Gang, stressed the importance of strengthening financial regulations, establishing a deposit insurance scheme and improving market-driven exit mechanisms for financial institutions, while pushing forward reforms. We should expect to see improvement in industry-side infrastructure, including settlement, custody, back-office support and linkages to the over-the-counter market. This will help to ensure the safe and efficient operation of the financial market and systematic stability.

Fourth, deep, open and well-regulated capital markets are necessary so the currency can be used to finance trade as well as provide a large enough market in securities for investors. The opening up of China's onshore capital market will be an important step in the RMB becoming a major investment currency. This is one area where progress has been deliberately slow, as policy-makers are concerned that excess capital could hamper monetary policy operation. For the RMB to go truly global and become a more common and widely held reserve currency there needs to be greater access for foreign investors to local capital markets, even deeper global RMB liquidity and wider cross-border flow channels.

For now, China's onshore and offshore markets remain separate – but there are clear signs of progress towards a single, accessible market.

When monitoring the progress of the reform process towards convertibility – and the convergence of onshore and offshore markets – reserve managers should, in particular, be mindful of two things:

1. The progress of the Shanghai Free Trade Zone (SFTZ), launched in September 2013, is the key to onshore deregulation. Most of the restrictions that apply to onshore currency trading in China have been lifted in the SFTZ. If this continues to be successful, we expect to see further liberalisation within the SFTZ and, eventually, extension of SFTZ principles to other parts of China.
2. The offshore market, dominated by Hong Kong, is expanding quickly. In 2013, the UK and China agreed to establish direct RMB-sterling trading. In February 2014, Singapore and London agreed to work together to boost offshore trading in the Chinese currency in their two markets. And, in 2014, Paris was authorised to establish an offshore market. Other global financial centres are keen to follow suit, such as Germany, Luxembourg, Switzerland and Canada. Cross-border use of the currency should improve the liquidity in the offshore market.

In tandem with deeper and more open markets, a solid and trusted legal and regulatory framework is necessary – and this is steadily evolving. No country has a perfect system, but China's is being tested all the time, with a good example being the recent managed defaults of corporate bonds.

Financial reforms are going to help China open its capital account and internationalise its currency, but it also works the other way around: opening up the markets will also help drive reform. It won't happen overnight, but regulators have already been using the SFTZ to experiment with financial opening and reforms. According to Beijing, the next steps could include measures to improve banking sector stability (for example, deposit insurance), developing the domestic bond market, as well as a more comprehensive credit evaluation system. In addition, it will be necessary to improve transparency, particularly in areas of monetary policy, tax treatment and foreign exchange.

Already more widely held than many expect

Some foreign central banks are already starting to hold RMB in their reserves through channels such as the China Interbank Bond Market (CIBM) scheme and the Qualified Foreign Institutional Investor (QFII) programme. This suggests some investors already see the RMB as a viable reserve currency, although they currently hold only small amounts. It also indicates strong interest in and underlying demand for reserve asset diversification into RMB once the onshore market opens up.

The CIBM was introduced in August 2010 and allows foreign central banks and monetary authorities, RMB clearing banks and participating banks to access China's onshore interbank bond market through a quota. The programme was later extended to other investors, including supranational institutions, sovereign wealth funds and foreign insurance companies. The QFII programme is designed to allow foreign investors to convert their currencies into RMB to invest in China's onshore assets, but access to the bond market was initially limited to the exchange market.

Sovereign interest in RMB assets has come from a wide range of regions, but, unsurprisingly, it seems to be more concentrated in Asia, where both economic links and RMB trade settlements are strongest. Other regions, including Europe and Africa, are showing notable interest, likely a result of growing RMB usage there. This is likely to continue as some central banks have set official targets for RMB in their reserve pools. For example, in January 2014, the Central Bank of Nigeria announced it would increase the RMB holding in the nation's foreign exchange reserves from 2% to 7%.

Swap agreements in place to prevent shortages

One worry for central banks would be whether there is actually enough market depth and liquidity for the RMB. It is true that the RMB is a managed currency and the Chinese central bank's interventions (each morning, the central bank sets a benchmark; the currency is then allowed to move freely within the +/-2% band, while the PBoC can intervene as it deems necessary) make it a less transparent or free market than some reserve managers would like.

However, the PBoC has recently been trying to assuage such fears through a series of swap agreements with other central banks. More than 20 central banks have already signed swap agreements with the PBoC worth around RMB2.5 trillion. These will allow foreign central banks to tap a ready source of RMB liquidity to serve the needs of their local markets. No currency has actually changed hands between the central banks, but this represents an important guarantee of RMB liquidity in the event of a shortage, so trade can continue uninterrupted. The existence of such a facility in itself should help to lower volatility. The HKMA's experience of lower volatility in the offshore RMB market after signing its swap agreement with the PBoC would suggest that markets generally believe these to be credible backstops.

Conclusion

While it will take a long time for the RMB to be considered a meaningful amount of global foreign exchange reserves, there are still a number of reasons why central banks are starting to do so now. The clearest reason is for trade facilitation. The removal of the requirement for both sides to make a conversion into a third currency makes sense, while invoicing in the RMB also improves pricing transparency for customers and reduces currency risk for trading partners.

While China's domestic equity and bond markets are large and growing fast, they punch well below their weight, given the size of the economy. Funding is not a problem – China is the world's biggest saver – and the main obstacles to capital market development are a fragmented regulatory framework, insufficient or inconsistent information disclosure, interest rate controls and the absence of a large pool of institutional investors.

Further financial sector reforms are, therefore, still needed to remove these obstacles. Over time, the currency will be ready to take its place at the top table, with full convertibility being the benchmark. However, that doesn't mean the RMB will replace the dollar as the dominant reserve currency. Instead it will help create a multiple reserve currency system in which the US dollar, the euro and the RMB all play their parts. ❑

The views contained in this research are the independent views of HSBC Global Research

Renminbi milestones

- In December 2013, the renminbi (RMB) overtook the euro to become the second most-used currency in global trade finance after the US dollar, according to SWIFT, which monitors international currency flows.
- The RMB is one of the 10 most-used currencies for payments worldwide. As of February 2014, it ranked seventh, closely followed by the Swiss franc.
- More than 10,000 financial institutions are doing business in RMB, up from 900 in June 2011.
- The offshore RMB bond market – 'dim sum bonds' – has doubled in size each year since 2008.
- From just 3% in 2010, the RMB is now used to settle 18% of China's total trade.
- China has currency swap agreements with at least 20 central banks, including those in Japan, South Korea, Thailand, New Zealand, Argentina and Malaysia, as well as the European Central Bank.
- RMB deposits in Hong Kong totalled RMB860 billion at the end of 2013, an increase from RMB315 billion in 2010.
- RMB deposits account for around 12% of total deposits in the Hong Kong banking system, up from 1% in 2008.
- There are now five offshore RMB centres – Hong Kong, Singapore, London, Taiwan and Paris.

Notes

1. Eichengreen, Barry (May 2005), National Bureau of Economic Research Working Paper no. 11336, *Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition*. http://www.nber.org/papers/w11336
2. HSBC (March 2014), Global Research, *Rise of the Redback III*.
3. Flint, Douglas (18 June 2014), *China's Capital Markets and the Rise of the RMB*, speech given at the UK-China Financial Forum in London. http://www.hsbc.com/news-and-insight/2014/chinas-capital-markets-and-the-rise-of-the-rmb

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