HISTORY

The Rise of the Renminbi: Will China's Yuan Become a Global Reserve Currency?

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In recent months, China has stepped up a longstanding campaign for its currency (officially called the renminbi [RMB] but also referred to as the yuan), to be included as a part of the composition of the International Monetary Fund’s (IMF’s) Special Drawing Rights (SDR). While the media is abuzz with the potential market implications of China’s currency achieving status as an international reserve currency—one which can be held by central banks and other major financial institutions to pay off international debt obligations—at one level, the issue is somewhat arcane. SDRs are a synthetic quasi-currency made up of a basket of widely traded currencies. They are used by the IMF for accounting purposes and as a medium for allocating assets among member countries. They play almost no role in private trade and finance. They do, however, provide the IMF’s approval that a currency has the qualities necessary to be an international reserve currency. Indeed, SDR currencies are automatically regarded as acceptable reserve currencies, whereas other currencies have to meet criteria for full convertibility to have the same status.

Until recently, the Chinese government placed major restrictions on the use of the RMB. The authorities appeared to consider the control that an insulated currency conferred on domestic monetary and fiscal policy to be more important than the potential benefits from full participation in global financial markets. In recent years, however, the government attitude has changed, with market-oriented economic reforms and a more outward-looking foreign policy including measures to encourage wide RMB usage.

The four currencies with SDR status—the US dollar, the euro, the UK pound sterling and the Japanese yen—currently make up the overwhelming majority of global international currency reserves. As a knock-on effect, they dominate international bond markets and global financial transactions. In recent years, the rising share of global trade accounted for by emerging markets, and by China in particular, has left this state of affairs looking somewhat anachronistic. The Chinese government had campaigned for RMB inclusion in SDRs in 2010, at the most recent of the IMF’s reviews of the SDR structure, but at that time, the bid was rejected. In our view, prospects for success at the meeting scheduled for October 2015 appear high.

The Potential Benefits for China

Reserve currency status and RMB internationalization could confer a number of significant benefits on China, including potentially lowering borrowing costs and facilitating overseas expansion by Chinese companies, allowing cross-border contracts in major commodities such as iron ore to be priced in RMB, thereby easing foreign exchange risks arising from pricing in US dollars, and above all, opening the way for a portion of China's enormous foreign exchange reserves to be redeployed in more economically productive directions. The latter measure could conceivably stimulate economic growth at the margin both in China and on a global scale. Other reserve currency countries have much lower reserves relative to their gross domestic product than China does— the United States is able effectively to operate without reserves at present— while overseas investment projects such as China's ambitious "one belt, one road" and "New Silk Road" initiatives to build trading infrastructure with neighboring states, as well as private initiatives, would represent potentially attractive new uses for resources that are at present tied up in currency deposits and Treasury bills.

For a currency to be included in SDRs, the IMF primarily requires that it be important in terms of its share in global trade, but also that it is "freely used," a term further broken down into "widely used" and "widely traded." In 2010, the RMB already featured widely in global trade, but the IMF decided that the currency did not meet the "freely used" criterion. At that time, the RMB was not an internationally convertible currency. Its exchange rate against other currencies was tightly controlled by the Chinese government at a level believed by many commentators to represent a significant undervaluation, while an unsophisticated local banking system lacked the ability to provide many of the instruments required by international companies to manage their currency exposures. A form of the RMB, called "offshore RMB" was available through a few Hong Kong-based banks, but it was cumbersome to trade in compared with other currencies, and its value differed from that of the onshore RMB on foreign exchange markets.

A good deal has changed since 2010, and the process of change has been accelerating. The number of offshore centers where RMB is traded has proliferated, while in the Shanghai Free Trade Zone (FTZ), currency transactions can be executed between mainland and associated offshore companies with few restrictions. Meanwhile, the People's Bank of China (PBOC) has been moving toward reforms in the country's banking system by freeing interest rates and by introducing a deposit insurance system, two important milestones on the road to creating a system fully able to participate in international financial flows. Importantly, many authorities, including the IMF, believe that the RMB is fairly valued. Reserve currency status would imply abandoning the current RMB-dollar peg.

A New Currency Connection

The opening of the Shanghai-Hong Kong Stock Connect in the latter part of 2014, allowing foreign investors to freely invest in eligible Chinese A shares previously restricted to only Chinese citizens or foreigners with special permits, was seen as a major move in internationalizing the RMB through allowing mainland investors to acquire stocks on the internationally traded Hong Kong markets. The initial impact was lower than expected, however, with only small percentages of permitted daily trading quotas being utilized. The situation changed in April 2015 with the announcement of measures to permit mainland mutual fund managers to buy into Hong Kong stocks (that were trading at markedly lower valuations). Restrictions on use of the Stock Connect by individuals were also eased. As details of the move filtered out, use of the Stock Connect rose sharply, such that trading quotas were exceeded on some occasions and remained well above prior levels. In May, we also saw the announcement of a planned "Mutual Recognition" program that would open the way for mainland and Hong Kong mutual fund managers to offer their funds in each other's markets. As mutual recognition comes into operation, we believe Chinese mainland investors would be most impacted, given wider investment choices. These recent developments could also help the Shanghai stock market become much more closely integrated into global financial markets, markedly expanding the effective global use of RMB.

Some remaining areas of uncertainty surrounding direct investment in China—in particular, lingering fears that a "suspended" capital gains tax could be reinstated and the possibility that a "short swing" law could potentially lead to capital gains from larger investor positions in individual companies being expropriated—are tempering our enthusiasm for utilizing the new freedoms at present. In addition, recent government intervention in the stock market and suspension of stocks during a sharp market downturn could have an impact on the reform process and the progress made toward RMB gaining international reserve currency status. However, we do feel there is political will toward economic reform in China, so such issues may not persist.

Going forward, the PBOC is offering a move to full "managed convertibility" over the remainder of 2015, predicting the opening of a stock connect between Hong Kong and China's other major stock exchange at Shenzhen and extending the currency trading freedoms introduced in Shanghai to other FTZs and eventually the whole country. In addition, we think the introduction of the planned China International Payment System (CIPS), setting up a worldwide clearing house for international RMB payments, markedly increases the ease of use of the currency, placing it more on a par with other global currencies. Some controls would be retained in such fields as the monitoring of money laundering and terrorist financing, the avoidance of excessive foreign debt and currency mismatches, the management of short-term speculative flows, and the improvement of balance of payments statistics and monitoring.

Furthermore, the IMF will likely be aware that the prospect of full membership in the world financial system is a significant factor driving the financial reform program in China, and it might be reluctant to risk providing ammunition for domestic opponents of the changes, thus complicating a process that appears very much in the interests of Western investors as well as the Chinese themselves. A strong hint of the direction of IMF thinking came in March with IMF Managing Director Christine Lagarde's comment that the RMB's inclusion in SDRs was a question of "when, not if," but there could be some caution in light of recent market events.

International businesses appear to be "voting with their feet" on the matter of RMB internationalization. In a survey by the Economist Intelligence Unit for the international lawyers Allen & Overy, some 50% of executives who responded anticipated at least a doubling of RMB use, while 45% had used the currency in a cross-border transaction in the past year, as opposed to only 21% in the previous 12 months. Forty-nine percent were planning to use RMB to fund acquisitions. Fewer than 20% had been using the currency for such purposes for more than 12 months.[1] In our view, further movement toward full convertibility could see the process accelerate. Thus, the end of 2015 could see a transformed international financial landscape, with the launch of the Asian Infrastructure Bank, the New Development Bank and CIPS, accompanied by the admission of the RMB to the IMF's SDRs, clearing the way for it to become one of the world's principal reserve currencies. At the same time, China's A share stock market could be well on the way to becoming a component of global indexes, a move likely only delayed rather than blocked by the recent decision by MSCI to exclude Chinese shares at least until 2016. China would thus become far more tied into, and significant in the global financial system than is the case at the moment. We believe that these developments, and the changes that have made them possible, represent a major long-term opportunity for international investors and will greatly raise the status of emerging-market economies as a whole.

However, recent actions by the Chinese government to prop up the market and influence market participants could weigh heavily on the ability of the market to attain international respectability. We believe the index creators will likely be very cautious in regards to putting a heavy weighting on Chinese A shares. So, we can't expect very much in the short term, but in the longer term we believe that the Chinese market will mature and become an important part of global portfolios.

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1. Source: "Generation ¥, RMB The new global currency," an Economist Intelligence Unit report, commissioned by Allen & Overy, 21 April 2015.