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This is the summary of a Chatham House conference on ‘The Renminbi and the Changing Dynamics of the International Monetary System’ that was held in London on 22 October 2015. The conference, preceded by preparatory workshops in Beijing and London, was held under the Chatham House Rule. However, Xia Bin, an economist who is a counsellor of China’s State Council, or cabinet, chose to speak on the record.

The context of the conference

The conference was timed to coincide with the state visit to Britain of Chinese President Xi Jinping, an occasion marked by pomp and pageantry that some portrayed as symbolizing China’s re-emergence as a major power. Certainly, his visit coincided with fresh proof of the country’s economic and financial transformation. At the start of the week, GDP figures showed China’s service sector growing faster than industry for the first time, suggesting efforts to rebalance the economy are slowly paying off. At the end of the week, China abolished the last administrative caps on the interest rates that banks pay depositors. It was a significant step that will inject needed competition into the banking sector but could spark a free-for-all to attract funds. In light of the risks involved, analysts saw the willingness of the authorities to surrender such an important lever of control as a reaffirmation of China’s commitment to reform despite an economic slowdown and stock market volatility.

Continued financial liberalization is one reason why there was universal agreement at the conference that the renminbi would be increasingly used in trade and investment – both direct and portfolio. ‘Natural’ and ‘inevitable’ were among the words used to describe the currency’s ascent. But, in an echo of the preparatory workshops (see the Beijing and London events), speakers cautioned that the renminbi’s rise to reserve currency status was not predetermined. The government officials, central bankers, businessmen, academics and economists who participated in the day-long meeting agreed that the trajectory of the renminbi’s internationalization would depend on a host of factors. These fall under four broad headings: what happens to China’s economy; the pace and extent of further reforms; how market infrastructure and regulations evolve; and the strength of global demand to use and hold the renminbi.

The economy shifts gears

The economy was not the focus of the conference, but Xia Bin and others underlined that a large, flourishing economy is a precondition for reserve currency status. In the past 15 years China’s GDP has increased from about $1.5 trillion to more than $11 trillion, one policymaker noted. So while China’s economic growth is now decelerating, it is doing so from a much higher base. Importantly, the composition of growth is changing for the better, with household spending and services starting to take over from industrial output and investment as the main drivers. One policy-maker described this recalibration as a ‘maturation’ of China’s economy; it was a necessary process in the eyes of Chinese officials, he said, and one that had a long way to go. Unless tackled, overcapacity and excessive debt would undermine the economy in the medium term. Among the many reforms needed to underpin growth and thus the renminbi’s internationalization, he singled out strengthening China’s flimsy welfare system and overhauling inefficient state-owned enterprises. Slower growth made these challenges tougher, but he said China had the wherewithal to make the transition to a better-balanced economy.

1 ‘When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.’
**Sticking to the path of reform**

Alongside sustained growth, the conference highlighted capital account liberalization as indispensable if the renminbi is to fulfil its international potential. Heavy capital outflows this year – estimated by the US Treasury at $500 billion in the first eight months – suggest that China’s capital controls are already very porous. Not so, contended an economist. The simple fact that shares traded in Shanghai are 25 per cent more expensive than shares in the same company listed in Hong Kong was incontrovertible ‘found evidence’ that the controls are still binding. If money could flow freely in and out of China, investors would sell shares in Shanghai and buy them back more cheaply in Hong Kong. He said more outflows could be in store. Hundreds of billions of dollars in carry trades could be unwound as changing market conditions meant it was no longer so favourable to borrow in dollars to buy renminbi.

Capital outflows intensified after the People’s Bank of China (PBoC), the central bank, caught markets off guard on 11 August 2015 by lowering the value of the renminbi by 1.9 per cent. The decision rattled traders and investors. Issuance of ‘dim sum bonds’ – renminbi-denominated debt sold outside China – has slumped 90 per cent since the devaluation, while net outflows from dim sum funds totalled $800 million in August and September combined, the biggest two-month loss on record. A policy-maker played down the market volatility, calling it part of the process of becoming a ‘grown-up currency’. But others said the heavy outflows showed that, as much as capital account liberalization was desirable, the process was fraught with danger. China needed to proceed gradually and calibrate its policy moves carefully, making sure both its intentions and its communications were clear. An economist advised China to be ‘opportunistic’, an approach that other participants subsequently endorsed. For example, he said Beijing should seize the opportunity of a period of dollar strength to switch from managing the renminbi’s exchange rate against the dollar to targeting its trade-weighted exchange rate instead. Making such a policy shift when the US currency is strong would be less disruptive than when it is weak.

For all the progress China has made, it still has a daunting to-do list. One policy-maker welcomed China’s adoption in October of the International Monetary Fund’s advanced set of statistical standards known as SDDS, which the IMF itself has described as a major step forward. China has also begun disclosing sensitive details of the composition of its foreign-exchange reserves to the IMF. But the speaker said that there were still big gaps in China’s data and that its policy-making was not transparent enough. A central bank official raised an issue that is all too seldom aired: if and when China lets its exchange rate float freely, what monetary anchor will it adopt? And are its money and bond markets deep and liquid enough to transmit changes in monetary policy to the real economy? These questions alone underscore the fact that China’s reformers face a long slog. The clumsy handling of the August devaluation was a reminder that policy mistakes will occur. But, as one practitioner reminded the conference, Chinese regulators work very closely with the market, and every time an obstacle arises on the road to internationalizing the renminbi, the government is intent on overcoming it.

**Building a marketplace**

Indeed, China’s authorities have been attentive in cultivating the development of offshore renminbi markets. They have permitted and encouraged trade settlement in the Chinese currency. They have established central bank swap lines to limit the risk of a renminbi liquidity crunch. They have opened channels for renminbi to be reinvested inside China. And they have appointed Chinese banks to clear renminbi transactions in nearly a score of international financial centres. One participant spoke of a ‘golden age of connectivity’.
The results of Beijing’s efforts are visible in the renminbi’s climb up the rankings of currencies most used in international payments, trade finance and foreign-exchange markets. The sum of offshore renminbi traded on one leading foreign-exchange platform had increased sevenfold in two years, one practitioner said. Another said it had become easier for multinational companies to move renminbi around internally, pool cash and convert the currency. But more progress was needed. He said the recent launch of the China International Payments System (CIPS), a clearing house for renminbi transactions, potentially marked a big improvement because it would support automated end-to-end renminbi transfers. ‘We can already do the things that CIPS does, but it’s a relatively clumsy process that takes several days,’ he said.

As an aside, one speaker speculated that the establishment of CIPS would make Beijing more confident about opening the capital account. Policy-makers anxious to keep control of the economy are wary of loosening restrictions, but CIPS would help them better monitor how much money is flowing into and out of China. That in turn would help them fine-tune the macroprudential regulations they intend to retain to dampen destabilizing capital flows, an arrangement PBoC Governor Zhou Xiaochuan has described as ‘managed convertibility’ of the renminbi.

A session of the conference was devoted to the role played by offshore financial centres in promoting the renminbi. Concerns had been expressed at the Beijing workshop that the proliferation of trading hubs was dispersing liquidity. But the consensus in London was that, as internationalization is in its early days, there was room for all of the centres to grow: the more business the better. Europe has several renminbi hubs, but each thrives on its specialization – for instance, Frankfurt because of Germany’s extensive export links with China; and Luxembourg because it is the leading centre for investment fund administration. It is also in China’s interest to have several European centres competing for business. ‘Our Chinese friends are simply far too smart to put all their eggs in one basket,’ one speaker said.

As a special administrative region of China, Hong Kong not surprisingly dominates the market for offshore renminbi – or CNH to use its currency code, to distinguish it from the onshore CNY. Ultimately, once China has perfected managed convertibility and liberalized its domestic financial markets, the CNH will no longer have a reason to exist. (One of the PBoC’s aims when it shifted to a more market-driven exchange rate regime in August was to narrow the gap between the dollar exchange rate of the free-floating CNH and that of the heavily managed CNY.) For now, though, mainland regulations prohibiting payments netting and restricting derivatives are leading a number of Chinese companies to establish treasury operations in Hong Kong, according to a practitioner.

**Driving demand**

The standing of any currency is determined by market demand – the result of competition, not coercion. Seen in that light, an academic suggested, the job of a government is to enhance the appeal of its currency. This is what China has been doing since Beijing, dismayed by the shortcomings of the dollar-centric international monetary system exposed by the global financial crisis, launched its strategy in 2009 to internationalize the renminbi. As mentioned above, it has swiftly established itself as a transaction currency. China now settles close to 30 per cent of its trade in its own currency, making life more convenient and less risky for its exporters and importers. The renminbi is also increasingly used for direct investment, outbound and inbound. But the renminbi, understandably, is still in its infancy as a portfolio investment currency. The Chinese currency accounts for 1.1 per cent of global central bank reserves, compared with 63.7 per cent for the dollar, according to an IMF report released in August.

History shows that the incumbent reserve currency is hard to dethrone. ‘There needs to be an overwhelming need for the world to switch from the dollar. And there isn’t one,’ a speaker said. The global
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The oil market is a good illustration. China accounts for 10 per cent of the market. Even if all its oil were traded in renminbi, the remaining 90 per cent of users would have an incentive to stick to the dollar.

A wider array of investment options would increase the renminbi’s appeal. Western banks have increased their issuance of dim sum bonds this year, and the PBoC made a debut London issue of one-year notes denominated in renminbi to coincide with President Xi’s visit. Two Chinese state-owned commercial banks also issued renminbi debt in the same week. But the primary market remains immature, which was a concern to bankers attending the conference. In this context, it is worth noting that a maiden Chinese government renminbi bond issue, mooted in the press before Xi’s arrival, has not materialized. Nor has any Chinese company listed its shares on the main board of the London Stock Exchange. And while Chinese multinationals stand to be an important catalyst of renminbi business in future, only one, Huawei, has so far established offshore treasury operations outside Hong Kong. The telecommunications and networking equipment maker has chosen London for its treasury centre, the conference heard.

In the short term, a decision to add the renminbi to the basket of currencies that make up the Special Drawing Right (SDR), the IMF’s international reserve asset, could generate considerable demand for the renminbi, more than one speaker argued. The IMF was due to announce its decision in the coming weeks. In the view of some participants, the renminbi’s accession would be largely symbolic – a stamp of approval for China’s reforms to date. But others said that it would be very significant. Once China is officially recognized as a major actor in the international monetary system, it will be hard for Beijing to backtrack on reforms. Indeed, it could spur more reforms, several speakers said. As such, one currency manager said, he would feel more confident about holding renminbi. A second practitioner said joining the SDR could trigger a rapid increase in the renminbi’s share of global reserves. China’s grandiose plans to build a new ‘Silk Road’ of transport and energy infrastructure linking Asia and Europe may also lend itself to renminbi financing. In addition, the China-led Asian Infrastructure Investment Bank can be expected to use the renminbi as a funding and lending currency. Looking farther ahead, China’s eventual inclusion in global equity indexes and the wish of companies to reduce their exposure to the US dollar by denominating more of their liabilities in renminbi were among the reasons to expect the Chinese currency to flourish, this participant said.

But another speaker demurred. Great powers have great currencies, he said, quoting the Nobel prize-winning economist Robert Mundell, and China is becoming a great power in the world. However, he said China fell short on the final three of four criteria that determined the status of a currency – economic size, financial development, foreign policy ties and military reach. ‘There’s only one issuer of a country in the world that has all four of these – the US,’ he said. Of course, China was the world’s second-largest economy and on course to surpass the United States. But, the speaker said, its capital markets still lacked breadth and depth; China was antagonizing its neighbours through its ‘counterproductive’ stance on territorial disputes in the South China Sea, which would deter them from using the renminbi; and China, lacking America’s military alliances and capabilities, could not offer the security guarantees that underpin the dollar’s safe-haven status. Viewed through the military prism, the renminbi shared the shortcomings that have held back the yen, the euro and, before it, the German mark. For the foreseeable future, the speaker concluded, the greatness of the renminbi would be uneven both ‘in scope and domain’. China’s huge transactional network favoured the currency’s use in trade settlement, but its immature financial markets would hold it back as an investment currency.

The outlook

Nevertheless, barring any major accident, the renminbi would become the next major international reserve currency, according to Xia Bin. ‘This is a long, historic process,’ he said more than once through
The trend was irreversible, unstoppable. Yet he also pleaded for patience, saying it would take a long time to achieve this goal. The dollar-based global monetary order would last at least another 20 to 30 years. An academic from a different country agreed that a multipolar system based primarily on the dollar, but supported by the euro and renminbi, would take 20 years to evolve.

In the interim, speakers suggested a number of benchmarks to judge the renminbi’s progress. One said the currency will have come of age when companies start to borrow in renminbi and do not hedge their exposure. For another, the litmus test was for oil and commodities to be traded in renminbi instead of dollars. A third said China – and by inference its currency – will have truly become international when it chooses a foreign financial institution, say Deutsche Bank, to underwrite a government bond issue in Shanghai.

Britain ratcheted up expectations ahead of Xi’s visit, saying it would usher in a golden year, then a golden decade and finally a golden era. Taking his cue, one participant in the conference went further. When it came to the renminbi’s prospects on the international stage, he said, China’s currency would be ‘golden for good’.