Europe and China: Financial Connections Through the Renminbi Markets

9 October 2015
This is the summary of a research workshop organized by the International Economics Department of Chatham House in London on 9 October 2015. An earlier seminar took place in Beijing on 29 July 2015. The purpose of both meetings was to prepare for a Chatham House conference, entitled ‘The Renminbi and the Changing Dynamics of the International Monetary System’, to be held in London on 22 October 2015. The workshop was held under the Chatham House Rule.¹

**The renminbi shakes global markets**

If any doubts remained about the newfound importance of the renminbi in the international monetary system, they were dispelled on 11 August 2015. That morning, the People’s Bank of China (PBoC), the central bank, surprised financial markets by announcing a 1.9 per cent devaluation of the renminbi as part of an operational shift to give market forces more sway in determining the currency’s value. A gradual depreciation of the renminbi had been expected, but not an administered step-change. Jumping to the conclusion that the Chinese economy must be in trouble, investors around the world rushed to sell currencies, commodities and shares dependent on Chinese growth. A second mini-devaluation of 1.1 per cent on 12 August deepened the anxiety. Global markets tumbled; people scrambled to transfer money out of China before the renminbi fell further.

Caught off guard, the PBoC changed gears and intervened heavily in the currency markets to halt the renminbi’s fall. But the damage had been done. Although the cumulative devaluation was too small to be of much macroeconomic significance, the central bank’s abrupt move shook world financial markets, which in the following six weeks suffered their deepest losses since the global financial crisis in 2008. Here was incontrovertible proof of the influence that China, and its currency, now exerted. The renminbi has been growing in stature since China launched a strategy in 2009 to promote the international use of its currency. Discussion of exactly how Beijing has gone about the task, and what it still needs to do, was the focus of the London workshop.

**More of a guiding hand than an invisible hand**

The first stage of the internationalization of the renminbi has been driven largely by policy, not by the market. The authorities in Beijing can be pleased with their work. The renminbi has quickly become the fourth most used currency for global payments (it was fifth at the time of the Chatham House meeting in Beijing in July). But the consensus of the London workshop was that policy-makers must now pass the baton to the markets if the renminbi is to mature from a transaction currency into an investment currency. To date, internationalization has entailed recycling China’s current-account surplus, while maintaining capital controls. Now, several speakers stressed, was the time for China to open its capital account wider and issue more bonds offshore to create a menu of investment options for holders of renminbi. ‘This strategy will fail without genuine market support,’ one participant said. ‘You have to let foreigners own some of your assets.’

To gauge the extent to which renminbi internationalization is policy-driven, it is instructive to look at how the dollar emerged in the 20th century as the pre-eminent reserve currency.

**The dollar versus the renminbi**

Until the outbreak of the First World War, hardly any central banks held dollars as part of their reserves. Yet the dollar swiftly dislodged sterling as the world’s apex currency under the exigencies of war. This was

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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.
no accident. As part of the legislation that created the Federal Reserve in 1913, the US Congress swept away restrictions that had prevented US banks from branching overseas and authorized the fledgling Fed to discount trade bills. This was all US banks needed to challenge the dominance of global trade finance by London lenders. Once unshackled, American banks quickly ended the UK’s quasi-monopoly. When the war forced Britain off the gold standard, the dollar quickly established itself as the principal reserve currency.

Apart from the accelerated timetable, America’s deliberate strategy for internationalizing the dollar a century ago has clear parallels with Beijing’s policy today. Yet history holds another lesson: a currency’s rise is reversible. The Chatham House seminar heard how sterling surged back to become the leading reserve currency between the wars and held the top spot until the mid-1950s, when it was dethroned again by the dollar, this time for good.

The next phase of the dollar’s evolution also provides food for thought for Chinese policy-makers. The emergence in the 1960s of the Eurodollar market, centred in London (and a forerunner of the offshore renminbi market), was a product not of policy but of market innovation. Frustrated by exchange controls and the British government’s ceilings on sterling deposit rates, London banks turned for their funding needs to the offshore dollar market, where the Federal Reserve’s Regulation Q capping deposit rates did not apply. The Eurodollar market quickly took off – the first Eurobond was issued in dollars in 1963 – and many US banks set up or expanded London operations to serve US multinational companies hungry for capital.

One speaker noted that some Chinese officials see the episode as a template for the renminbi’s development, arguing that the dollar flourished overseas even though the Bretton Woods regime restricted capital flows. China would like to follow suit today. But the parallel was not exact, the participant said. First, the Eurodollar market did not spring up as a way around controls in the currency’s home market; it was an organic market response to liquidity shortages in Europe. And second, the Euromarket was not the making of the dollar, which was already established as a major international currency. Another big difference, other speakers added, is that China is a long way from having a comparable roster of multinational firms capable of acting as an engine of growth for the offshore renminbi market.

Preparing for the renminbi

China has taken a different path to stimulate the renminbi’s use. Adopting an approach that could be summed up as ‘build it and they will come’, Beijing has set out to create the basic conditions needed for the offshore market to thrive. It has encouraged Chinese firms to settle trade in renminbi, established central bank swap lines to meet liquidity shortages and set up investment schemes to channel offshore renminbi back into onshore assets. Importantly, it has also created a global network of around 20 offshore clearing banks in key financial centres to make it easier for foreign banks and their corporate customers to conduct transactions in renminbi.

The strategy has worked – up to a point. As noted above, the renminbi is increasingly used in global payments. One practitioner at the seminar said that he expected half of all China’s trade to be invoiced in renminbi by 2020. In the London foreign-exchange market, he added, there was already more liquidity in renminbi options than in some established currencies such as the Australian dollar. In a symbol of the currency’s rise, the London Metal Exchange has started to accept renminbi as cash collateral.
The offshore clearing centres had done an ‘incredible job’ of promoting the renminbi, a second practitioner said. Another speaker agreed that they had served what he saw as their main purpose – giving Chinese banks designated as clearers valuable experience of international markets.

**Linking China to the world**

On the face of it, the launch on 8 October 2015 of the China International Payments System (CIPS) could make the clearing banks redundant. CIPS, another critical part of the infrastructure to internationalize the renminbi, is initially being rolled out only to 19 onshore banks, including the domestic arms of eight foreign lenders. But eventually the system should be available for all overseas banks to make renminbi payments directly, bypassing the clearers.

Nevertheless, the consensus at the workshop was that consolidation of Europe’s renminbi centres was unlikely any time soon. For a start, host-country governments value them as symbols of the political and economic importance they attach to ties with Beijing. What’s more, the centres can argue that they have comparative advantages in aspects of renminbi business – for example, servicing mutual funds in Luxembourg’s case, or the automotive industry in Frankfurt’s case. And of course, the existence of several centres allows China to play one off against another.

London is the leader in Europe for renminbi business and is likely to remain so, several speakers said. London’s success to date was partly due to the personal commitment of the chancellor of the exchequer, George Osborne, to forging close links with China. But it fundamentally reflected the city’s attractiveness to foreign banks for well-documented reasons such as the use of English, a convenient time zone, and a rich ecosystem of lawyers, accountants and support services. A sympathetic recent ruling by the UK’s Prudential Regulation Authority, permitting foreign lenders doing only wholesale business to operate as lightly regulated branches, had further burnished London’s appeal to Chinese lenders (while penalizing others, notably Indian banks, that serve retail customers by requiring them to set up separately capitalized UK subsidiaries). The upshot is that Chinese banks are steadily beefing up their operations in London – especially in areas critical to the Chinese economy, such as commodity trading.

**Ready for take-off?**

The conditions are in place for the offshore renminbi market in Europe to take off, but it has not yet fully done so. Although the renminbi is being used increasingly to pay for imports and exports, deposit growth has been disappointing and investors are showing little enthusiasm for the Chinese currency. One speaker described interest in London in the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme as ‘stale’. (An investment firm with an RQFII quota may channel offshore renminbi back into onshore assets.) Talk of linking the London and Shanghai stock exchanges was unrealistic, more than one speaker said.

The strong consensus at the workshop was that the renminbi was being held back by a dearth of investment opportunities, especially outside Hong Kong. Issuance in Europe of ‘dim sum bonds’ – renminbi-denominated debt sold outside China – was low, not least because companies can fund themselves more cheaply in dollars. And buyers generally held the bonds to maturity, making the

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secondary market very thin. This meant it was hard for investors to exit their positions at short notice, as happened in August when the mini-devaluation of the renminbi caused bond prices to fall sharply.

But the major shortcoming, the meeting heard, was the absence of Chinese government bonds (CGBs) in Europe. Beijing is about to begin tackling this deficiency. The PBoC intends to make a debut issue of short-term renminbi notes in London in the near future, in recognition of the city’s status as a leading offshore renminbi centre, according to a Chinese statement issued during Osborne’s recent visit to China.\(^4\) The planned note issue marks a necessary start. Without a sovereign yield curve, the market cannot properly price other bonds and hedging tools. Without a range of offshore renminbi products to choose from, investors will look elsewhere.

‘Great restaurant, needs more dishes,’ as one speaker put it. The obvious answer was for the Chinese government to extend its overseas bond issuance beyond Hong Kong.

‘We have no CGBs in London to start building an asset class,’ one practitioner said. He said China’s ‘One Belt, One Road’ (OBOR) strategy to build transport and energy infrastructure connecting Asia and Europe was an opportunity for Beijing both to meet overseas demand for its bonds and to raise the vast sums that OBOR will require.

**Implications for the economy**

Even with a full product suite and well-developed infrastructure, the offshore renminbi asset market might never take off if China’s economy were to experience a prolonged downturn, dragging the currency down with it. ‘Dim sum bond’ issuance has slumped since China lowered the value of the renminbi. The devaluation, which ran counter to assurances given by senior officials, has shaken confidence in Chinese policy-making. The policy shift was clumsily managed and poorly communicated. The PBoC’s initial statement announcing the move was published only in Chinese, and the central bank’s governor, Zhou Xiaochuan, did not appear at a news conference two days later to explain the PBoC’s thinking.

The devaluation fuelled speculation that China’s economy must be slowing dramatically as the government seeks to engineer a shift from investment-led to consumption-driven growth. Some commentators interpreted the devaluation as a signal that Beijing was backtracking on market reforms, including plans to open the capital account wider.

President Xi Jinping subsequently provided a reassurance during his state visit to the United States in September that China was still committed to reform. And a senior Chinese economist said the consensus among his peers was that, while growth was indeed slowing under the weight of excess industrial capacity and high corporate debt, the economy’s longer-term prospects remained bright. ‘We can find a way to muddle through,’ he said. Even the change in foreign-exchange regime linked to the devaluation has achieved one of Beijing’s goals, namely to close the gap between onshore and offshore renminbi exchange rates virtually to zero.

Still, the growth scare and devaluation – plus the collapse in the Chinese stock market and the authorities’ heavy-handed attempts to halt it – are a reminder that the continued rise of the Chinese economy and the renminbi are not inexorable. Just because the Chinese Communist Party wants to transform the renminbi into a major international currency does not mean that it will succeed.

To be sure, all the signs are that the International Monetary Fund will admit the renminbi soon to its Special Drawing Rights (SDR) basket of reserve currencies. And the general view among participants in the seminar was that the renminbi would be in wide global use within five to 10 years. But that is not the

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same as saying that the renminbi is shaping up as a serious rival to the dollar. Back in the 1970s, one speaker noted, the dollar’s share of the Euromarket was eroded by the German mark and the Swiss franc. Both remain valued currencies (the mark now absorbed in the euro), as do sterling and the Japanese yen. But, the speaker added, none has challenged the dollar for global currency supremacy. For the foreseeable future, that may be the fate of the renminbi, too.