The A to Z of the RMB
How the yuan is going global

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The A to Z of the RMB
How the yuan is going global
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A quick recap

When Week in China published the first edition of *The A-Z of the RMB* two years ago, we asked when the world was going to start recognising the Chinese ‘redback’ as readily as the greenback, its American equivalent.

It isn’t happening yet: George Washington and the Great Seal of the United States (on the one-dollar bill) remain much better known than the images of Mao Zedong and Mount Tai on the five-yuan note, China’s closest in value to the dollar bill.

Nor is that much of a surprise. Although the renminbi translates as the ‘people’s currency’ in Mandarin, it was virtually unknown outside China until very recently. Instead the Chinese locked it up inside their borders as a means of keeping their goods as cheap as possible and protecting their economy from boom-and-bust capital flows.

Internationally, no one accepted the renminbi as a payment currency and nobody tried to invest with it.

But as China’s economy has started to slow and its ambitions begin to burn brighter on the global stage, that policy is transforming. Accordingly, the renminbi has taken the first steps in a revolutionary journey that promises the biggest shake-up of the global financial markets since the creation of the euro. What began as a cautious debate in Beijing is multiplying into millions of cross-border conversations as shopkeepers and bank clerks, importers and exporters, and bond salesmen and fund managers all start to grapple with the rise of the redback.

The basics

There are six different denominations of renminbi notes with the highest value the Rmb100 (worth about €15 or $16, far less than the largest euro and dollar bills in circulation).

Each features images of Mao Zedong, the founding father of the People’s Republic, who introduced the new currency in 1949.

Although the renminbi is the political term, the Chinese generally refer to their money as ‘yuan’ in everyday usage. This dates back to the local terminology for dollars, or the silver coins minted in the Spanish empire that foreign merchants offered in exchange for consignments of Chinese goods like silk and porcelain.
In shops in China today you will see prices quoted in yuan and rendered typographically as ¥. But internationally ¥ is an identifier widely associated with the Japanese yen. So the renminbi is more usually known in its short form as the RMB.

To make things a little more complicated, investors also use different acronyms for the yuan depending on whether it is being held onshore (at home in China) or offshore (outside the country). The short form for the yuan inside China is CNY; outside China it is known as the CNH.

In the remainder of this book, we’ll be referring to it as the RMB or the yuan.

**Why is the yuan going global?**

Part of the push is policy-driven because the Chinese want to reduce the dollar’s grip on international finance.

But the yuan’s spread is also the inevitable outcome of what HSBC analysts have described as China’s “gravitational pull”.

Simply put, China is the world’s largest exporter and – depending how you calculate it – either the world’s biggest economy (as declared by the IMF in December when it measured it by purchasing power parity) or the second biggest (in absolute terms). So it doesn’t make sense for its currency to stay hidden at home.

The yuan’s champions are pushing for the opposite: they want people around the world to use it much more routinely for payments and investments.

The blueprint is straightforward: first off, the RMB becomes an international currency for paying for goods and services; then it takes on a role as a currency for global investment; and finally it achieves new status as a ‘reserve’ currency with sovereign governments, emerging as more of a rival to the dollar.

In the first baby steps of this journey banks in Hong Kong were allowed to offer RMB deposit accounts in 2003. But the pace didn’t really start to pick up until a few years later when the yuan began to feature as a currency for trade settlement. Initially, this was tested out in a pilot scheme with pre-qualified companies across a few key cities. When the programme was seen to be successful it was expanded nationwide and HSBC then predicted that almost a third of China’s international trade would be paid for with yuan by the end of the decade.

**HSBC raises its prediction on trade flows paid for with yuan**

“Frankly speaking, we haven’t got a lot of things for export apart from some apples, peanuts, pig bristles and soybeans,” Mao Zedong told the Indonesian president Sukarno in the 1950s.

Since then China has emerged as an export powerhouse and it is now conducting much more of its commercial activity in yuan, rather than relying on other currencies like the dollar.

The RMB’s share of China’s trade with key customers like the European Union and the United States still has some distance to grow, while the proportion is even less with economies like Brazil, India and Russia.

But earlier this year a team of HSBC analysts led by Chief China Economist Qu Hongbin made the case for why the RMB is going to become a more important currency.

“Having grown at a rapid pace and shown great resilience amidst market-driven volatility, the next test for RMB trade settlement is whether it can hit critical mass and become a major trade settlement currency for a large number of trade partners,” the research piece suggested.

Traditionally, trade between developing and developed countries tends to be settled in the currency of the developed market. That has been a problem for China because a larger share of its exports has headed to ‘G3’ countries. Chinese exporters have generally been much more willing to take payment in the more recognised G3 currencies too.

HSBC says that will change as the yuan becomes a more important settlement currency with a wider range of China’s trading partners. It also helps that an increasing share of Chinese goods has been sold to non-G3 countries since the global financial crisis. Markets in Southeast Asia are more important than before, for instance, while more trade is expected with countries along China’s ‘New Silk Road’ through Central Asia. All of this will reduce the traditional impulse for trade to be paid for with dollars or the euro, with HSBC now predicting that more than half of China’s cross-border business in goods and services will be settled in yuan by the end of the decade.
Introduction

A  to Z of the RMB

The three-step process

1. A Global Trade Currency
   - Trade settlement in RMB builds pools of liquidity worldwide

2. A Global Investment Currency
   - Investment and savings options make the RMB more attractive

3. A Global Reserve Currency
   - Reserve usage signals 'arrival' of RMB as a world currency

this year. The forecast is on track, with payments ballooning from nothing six years ago to more than a fifth of China’s trade, or Rmb6,550 billion, last year.

The sea change in settlement is significant since how the world pays for its trading activity can have far-reaching repercussions. In the early 1900s sterling was the preferred currency in global commerce and the dominant choice for investments and sovereign reserves. But as the American economy surged in the years after the First World War, the dollar began to challenge the pound as a source of trade finance. This set the stage for a longer term transition, as investors switched into the dollar and central banks adopted it in their own reserves. By the 1930s, the greenback was on its way to overtaking sterling as the world’s preferred currency.

Might history repeat itself, this time with the yuan at the forefront of change? Its prospects in global trade settlement are promising enough for HSBC to make a bold, new prediction that more than half of China’s international commerce will be paid for in yuan by 2020 (see page 7). And a slew of other stats reinforces the story of the RMB’s rise; including its status as the ninth-most traded currency; its fifth position in global payments; and its second place in trade finance (where it overtook the euro two years ago).

In the remainder of this booklet, Week in China talks to a series of HSBC experts about how the yuan is coming of age and what might happen next as its global journey continues.
Turning to trade

The yuan moved into fifth position in global payments for the first time at the end of last year, although its march up the rankings came to a halt in February when it fell back two places behind the Swiss franc and the Canadian dollar. SWIFT, the financial messaging network that captures the data, blamed the drop on a slowdown in business over the Chinese New Year holiday, and the yuan regained fifth place the following month. It has remained there since.

The RMB’s overall progress has been impressive – up from 20th in 2011 – and it now constitutes a little over 2% of the international payments total.

WiC spoke to Vina Cheung – HSBC’s Global Head of RMB Internationalisation, Payments and Cash Management – for a broader update on how the yuan is becoming a more trusted currency, while Jean-Francois Lambert gave his view on the prospects of the RMB becoming a payment option in the world of commodities.

Trade still the catalyst
Despite its growing presence, it will be some time before the RMB catches the yen or the pound in the two places immediately in front of it. The euro and the dollar are even further ahead, with a fraction below 28% and 45% of international payments respectively.

But the pacesetter for the yuan’s rise is its growing usage for buying and selling goods. It has increased its share as a settlement currency for China’s global trade from virtually nothing a few years ago to a high of 23% at the start of 2015. Importantly, it has done so more recently at a time when the yuan has been weakening against some other currencies, suggesting that companies are picking it on the basis of genuine business needs, and not just as a punt on currency appreciation.

Despite these positives, there were mixed messages in the latest findings of HSBC’s RMB Internationalisation Study, an annual survey of more than 1,600 businesses around the world.

Here, yuan usage was reported to have declined in a number of key markets, most notably in France and Germany. Compared to last year’s poll, there was also a slight fall in the share of respondents expecting to derive financial or relationship benefits from conducting business with the RMB.

Vina Cheung is still upbeat about the survey’s insights, especially in conjunction with the data on the yuan’s ascent in global payments.

In part that’s because most of the forward-looking findings in the survey support the story of the RMB’s rise. “The good thing is that 54% of respondents said that they expect to do more business with China in the next 12 months,” she says. “This shows the confidence of our clients: they are anticipating more trading activity despite the relative slowdown in China’s economy and some of its commercial partners.”

Cheung argues too that more of this business will be conducted in RMB, citing the latest forecast that more than half of China’s global trade will be settled in yuan by 2020.

“The trade account is already fully liberalised, so any firm inside or outside the country can use the RMB in cross-border commerce, and that’s going to continue because of China’s position as the world’s leading trading nation.”

What are the benefits of using the RMB?
Although many companies in HSBC’s study have yet to transact in the yuan, more than a fifth of the group has talked at senior level about using it more.
Key report from the IMF says yuan is no longer undervalued

Fair enough?

News in May that the International Monetary Fund had declared the yuan as fairly valued provided a boost for the RMB’s international profile after years of debate about whether it has been kept artificially weak.

“We believe that it is no longer undervalued,” reported the IMF’s first deputy managing director, David Lipton, although he also encouraged Beijing to work towards a floating exchange rate within three years.

“We urge the authorities to make rapid progress toward greater exchange-rate flexibility, a key requirement for a large economy like China’s that strives for market-based pricing and is integrating rapidly in global financial markets,” he said.

Last year, the IMF judged that the yuan was undervalued between 5% and 10%. This year’s reassessment is significant because some of China’s trade rivals have argued that the weaker yuan gives Chinese exports an unfair advantage. Veteran critics of its exchange rate policy like Charles Schumer, a Democrat senator in Washington, have continued to call for tougher legislation to crack down on currency manipulation.

“I think the IMF is wrong in this case and it is still terribly undervalued,” Schumer complained on the eve of the announcement.

In its most recent report to Congress on the currencies of America’s trading partners, the US Treasury also judged that the yuan should be trading at higher levels against the dollar, based on China’s trade surplus, improvements in its productivity and the falling price of oil.

But the IMF’s stance makes it harder for Washington to put pressure on Beijing. “It takes the rug out from under the feet of US critics of Chinese currency policy,” Eswar Prasad, a Cornell University economist and formerly an official at the IMF, explained to the Wall Street Journal. “The US relied to a significant extent on what was seen as the IMF’s objective assessment.”

Customer benefits of RMB cross-border trade settlement

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<th>China Exporter</th>
<th>Overseas Importer</th>
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<td>- Avoid losses due to FX</td>
<td>- Improve supplier relationship by paying in their home currency</td>
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<td>- Eliminate FX costs which can be significant for small exporters</td>
<td>- Greater percentage of Chinese businesses ready to offer discounts for transactions settled in RMB</td>
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<td>- Simplified procedures for export tax rebate</td>
<td>- Overseas importers can buy RMB at a discount in the forward market, a benefit not secured by companies who still purchase goods in USD</td>
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<td>- For open account trade, credit of funds to account is now quicker, as onshore banks may credit the funds first and collect supporting documents later</td>
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<th>Chinese Importer</th>
<th>Overseas Exporter</th>
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<tr>
<td>- Natural hedge if the importer is selling in RMB</td>
<td>- Improve buyer relationship</td>
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<td>- Eliminate FX costs which can be significant for small importers</td>
<td>- Access to an importer base which might otherwise have limited access to FX</td>
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<tr>
<td>- For documentary trade, Chinese importers might be able to get a longer credit period as RMB letter of credit is not governed by the Short Term Foreign Debt Quota for onshore banks</td>
<td>- Help Chinese importers improve their working capital</td>
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<tr>
<td></td>
<td>- Overseas exporters can hedge the FX exposure in the offshore RMB market and invest surplus liquidity in a wide range of investment products offshore</td>
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Some of the reasons for doing so were discussed in the previous edition of The A-Z of the RMB, including the potential for savings of 2-5% in forex and transaction costs by switching into renminbi-denominated contracts.

Pricing goods in yuan may attract new customers for overseas vendors, as well as improving their negotiating stance with their Chinese business partners.

“Of course, getting a better price also depends on the respective bargaining power between buyers and sellers,” Cheung adds.

As a general rule, vendors with a greater proportion of costs in yuan are more likely to be interested in invoicing with it, because of the “natural hedge”
When will the RMB start to feature in commodities trading?

Going for gold

How did the dollar get so dominant in global commodity pricing? The short answer is rather simple, says Jean-Francois Lambert, Global Head of Commodity Structured Finance at HSBC. As the dominant force in global trade for half a century, it was hardly surprising that the greenback has developed an iron grip on the commodity business too. But the influence of the oil business was particularly significant, Lambert says, especially when the Middle Eastern countries asked for the dollar as payment currency, launching the petrodollar era. When commodity producers like Malaysia and Australia then linked their own currencies to the greenback, the trend deepened. Since then the dollar has been the currency of choice for almost every commodity trade except cocoa, where sterling has hung on grimly.

Of course, the RMB is now starting to feature as more of a global settlement currency, fuelled by China’s surging contribution to cross-border commerce. China is also a voracious consumer of most of the world’s commodities. But does that mean that the yuan is about to challenge the dollar, just as the greenback unseated the pound more than two generations ago?

Lambert is careful in his response, emphasising that talk of the dollar’s ‘decline’ can be overstated, with the US still generating the largest share of global GDP.

“But there is no denying that China’s contribution to international trade flows has grown substantially,” he agrees. “The impact is bound to be felt in the commodities business, where the Chinese are already the largest consumers of goods like iron ore, zinc, lead and copper. In my opinion, it’s inevitable that they will want their currency to be used more for settlement, and it is only a matter of time before a larger proportion of the commodity trade is priced in RMB.”

As evidence that the trend is already heading in this direction, Lambert highlights the launch of RMB-denominated contracts on exchanges in Chinese cities including Dalian (iron ore) and Shanghai (steel). The Shanghai Gold Exchange is also trying to increase its pricing power, with the launch of a yuan-denominated gold index by the end of 2015, challenging the ‘London Gold Fix’, the global reference point for the industry for almost a century.

As the world’s largest consumer, producer and importer of gold, the Chinese seem well positioned to play more of a role in determining gold prices. Until now their influence has been limited. It was only earlier this year that Bank of China became the first Asian lender to be invited to join the group of banks that participate in the twice-daily electronic auction in London.

The wider reality is that the commodity world continues to use non-Chinese exchanges for its pricing benchmarks, and settles transactions almost entirely in dollars. Most commentators blame limits to the yuan’s convertibility, which make overseas traders more reluctant to venture further into the Chinese market, while encouraging Chinese trading groups to focus more on the arbitrage opportunities between prices in the onshore market and those available on the global commodity hubs.

Lambert also cites convertibility concerns as a key obstacle. “If I am an international commodity producer selling significant quantities in RMB, what am I going to do with my cash?” he asks. “Unless I have huge expenses in Chinese currency, I am probably going to be hesitant about asking for it as payment. And that’s simply not the case with the dollar.”

Nonetheless, there are signs that the policy push towards RMB-denominated pricing is starting to happen outside China as well, with preparations for a new era in which convertibility isn’t quite such a pressing concern. As an example Lambert highlights the purchase of the London Metals Exchange by Hong Kong Exchanges and Clearing three years ago. “To me that was a very enlightening moment,” he says. “Singapore is the centre for commodity trading in Asia but it was Hong Kong that completed the takeover. The move clearly has the support of the Chinese authorities and it’s hard not to see it as a statement of intent. It makes solid strategic sense, plus it is going to be very valuable in delivering the experience and influence that ownership of the LME confers.”

Of course the key question is when this experience will start to pay dividends, with more commodity prices starting to migrate towards quotation in yuan, and not just in dollars.

Lambert says that it may not happen for a while, especially for flows of energy commodities, where the dollar could rule the roost for the foreseeable future.

But he also envisages a point at which RMB convertibility is no longer a restrictive influence and “the dam breaks” between onshore and offshore markets, with pricing suddenly converging.

When that happens it will become “much more compelling” for a wider range of commodity prices to be quoted in RMB, Lambert says, particularly those for which China is the largest customer.
institutions in other parts of the world also has a deeper, symbolic value in bringing China’s currency directly to the doorsteps of international companies. It also helps to create deeper pools of offshore yuan. This will encourage the creation of more investment and financing products, greater circulation of RMB-denominated payments inside the countries concerned, and more cross-border flow in transactions in which China doesn’t feature directly itself.”

**More work needed at home**

But HSBC’s survey raises another query: why aren’t more Chinese firms choosing to settle more of their international trade in RMB?

Less than a third of the domestic enterprises in the study were using their home currency in cross-border business.

“On roadshows we have heard local bosses saying things like ‘we aren’t registered to do this’ or ‘if we invoice in RMB, we will lose our export incentives’. But these are misunderstandings, so it looks like more promotional effort is needed,” Cheung suggests. “Perhaps it’s because the Chinese banks have been more focused on promoting the yuan as a trade currency outside China than at home. We have seen a similar dynamic with the Chinese multinationals. Often it is their offshore units that are making the case to their head offices that they should be using the yuan more.”

Some of these efforts sound like a case of the tail wagging the dog, also mirroring how it is often the China-based subsidiaries of the global multinationals that lobby their head offices to utilise the yuan more.

More broadly the situation highlights how China’s policymakers need to encourage their own companies to use the RMB more, as the authorities push for its greater uptake as an international currency.

**Clearing the way**

Another prong in the internationalisation effort is the steady stream of approvals for new RMB clearing banks. This year Chinese banks have been appointed to provide offshore clearing in Malaysia, Canada, Thailand, Qatar, Chile and Hungary. One main benefit is direct access to yuan liquidity in China, backstopped by the central bank, the People’s Bank of China (PBoC), which provides a confidence-boosting fallback should the market need access to more Chinese currency than it can find offshore.

“Overseas banks can clear their RMB business via Hong Kong, the leading offshore centre,” Cheung admits. “But the establishment of clearing
The RMB on the road in 2015
A few of the places the yuan has made headlines this year

**London:** In March Britain annoys the United States by joining the AIIB, a Chinese-led bank seen as a potential rival to the International Monetary Fund and the World Bank. Italy, France and Germany then announce they will join too (page 47).

**Santiago:** China establishes the first RMB clearing bank in Latin America in the Chilean capital, facilitating direct transactions between the peso and the yuan. An accompanying three-year currency-swap agreement worth $3.6 billion was agreed, as well as $8.1 billion of RQFII quota.

**Toronto:** More than a tenth of payments between China or Hong Kong and Canada were settled with the RMB in March, three times more than the same month in 2013 (page 36).

**Washington:** Later this year the IMF will decide whether to include the RMB in its Special Drawing Rights currency basket. If that happens, at least $1 trillion of global reserves could start to switch into Chinese assets (page 45).

**Budapest:** Hungary’s central bank announces that it is building a Chinese bond portfolio. As one of the western hubs in China’s new Silk Road plans (see page 21) it also got an RMB clearing bank in June.

**Zurich:** The Swiss National Bank announces that Switzerland has been granted Rmb50 billion in RQFII quota. Fund managers in Luxembourg, the UK, Australia, South Korea and France have all got higher quotas as well.

**Nairobi:** Kenya asks to be the first country to offer yuan currency clearing in Africa, with the Kenyan coast also set to become a stop on the Maritime Silk Road. Nigeria, Tanzania and Angola have also invested in dim sum bonds to diversify their foreign exchange reserves into RMB.

**Gwadar:** Beijing announces $45 billion of new projects in Pakistan, including a 3,000km transport corridor from Xinjiang in western China to Gwadar on the Arabian Sea. The investments will allow a new route for China to import oil from the Middle East, but should also foster the RMB’s international spread.

**Doha:** The first centre for clearing RMB in the Middle East opens in Qatar. The switch could be doubly significant if it means that more of the region’s oil and gas exports start to be priced in yuan (page 14).

**Bangkok:** Thailand gets a clearing bank for the yuan too. “The Chinese economy has become a necessary ingredient for our secret recipe for the past decade,” acknowledged the Bank of Thailand’s governor at the inauguration of the new link.

**Shanghai:** Shanghai’s aspirations to become a global financial centre have been bolstered by the growth of trading volumes through the Shanghai-Hong Kong Stock Connect, and the rollout of the city’s Free Trade Zone reforms (page 24).

**Tokyo:** The Bank of Tokyo-Mitsubishi UFJ issues Japan’s first bond denominated in yuan. Japan and China agreed on the issuance of RMB bonds at a summit in 2011, but the plan was shelved as tensions grew over the sovereignty of disputed islands.
The policy push: silk, steel and Shanghai

For more than a generation China kept to the dictum of its former leader Deng Xiaoping that it should “hide its brightness and cherish obscurity”. The focus was on building an economy at home, not establishing a higher profile overseas.

But to keep its economy growing China now has to look further afield. It has been doing so with a “going out” campaign, seeking a more prominent place on the international stage. Its state-owned enterprises led the first phase of this effort with a buying spree of overseas assets. A similar “going out” spirit has been evident in the millions of new Chinese tourists with the financial means to travel overseas for the first time, as well as the global spread of Chinese brands like Lenovo, Huawei and Alibaba, and the sprinkling of Chinese sports and entertainment stars that are starting to feature in the international news.

Beijing’s diplomats have also been promoting China’s views on international issues ranging from carbon emissions to anti-monopoly laws. Of course, encouraging wider usage of the Chinese currency is another of their policy priorities and WIC talked to Nancy Liang, HSBC’s Senior Vice President for RMB Business Development, and John Zhu, an economist for Greater China for insights on two of the key initiatives.

A new Silk Road

The imagery of the ancient Silk Road is evocative, heralding an era in which China earned its title as the Middle Kingdom by standing at the heart of a sprawling network of trading routes connecting it with South and Central Asia, the Middle East and Europe.

Two years ago Xi Jinping, the Chinese president, drew on this heritage in announcing the reinvention of some of the ancient trading routes.

“Shaanxi, my home province, is right at the starting point of the ancient Silk Road,” he told an audience in Kazakhstan. “Today, as I stand here and look back at that episode of history, I can almost hear the camel bells echoing in the mountains and see the wisp of smoke rising from the desert. It has brought me close to the place I am visiting.”

The plan for a modern-day Silk Road is more usually tagged as the “One Belt, One Road” policy by Chinese commentators, in a shortened form of its two main parts: the Silk Road Economic Belt and the 21st-Century Maritime Silk Road. The “Belt” is a network of overland road and rail, oil and gas pipelines, and other infrastructural projects stretching from Xi’an in central China, through central Asia, and as far as Moscow, Rotterdam and Venice. Rather confusingly, the “Road” is its maritime equivalent: a series of port and coastal projects dotting the map through South and Southeast Asia to East Africa and then on to the Mediterranean.

China’s ambitions for the new Silk Road are best understood as an overarching goal, rather than a highly detailed set of blueprints.

“It is more of a framework through which Beijing will connect its trade and investment policies inside China – especially the less developed western regions – with other parts of the world, primarily by trade and investment linkages through Central and Southeast Asia to Europe,” explains HSBC’s John Zhu.
The first phases of the plan have seen Chinese road, rail and energy loans to its nearest neighbours in Central Asia, like Kazakhstan, Uzbekistan and Kyrgyzstan. In April a huge new package of loans for Pakistan was also announced, with $46 billion in lending for road, rail and pipeline projects in a 3,000km special corridor linking the Pakistani port of Gwadar back into the new Silk Road via the Chinese city of Kashgar in Xinjiang province.

Last month there were signs of Silk Road activity reaching Europe, with Chinese loans for a railway between Budapest in Hungary and Serbia’s capital, Belgrade. Beijing has also said that it has plans to invest in a Europe-wide infrastructure fund being promoted by the European Union. “We are looking for ways to build up synergies between the One Belt, One Road initiative” China’s ambassador to the EU, Yang Yanyi, explained.

“This isn’t aid or charity,” Zhu says, of the fuller ambitions for the One Belt, One Road strategy. “Beijing sees it much more as an investment effort, and as a way in which China can earn better returns on its $4 trillion of sovereign reserves.”

But how does the new Silk Road help to promote yuan usage? The recipients of RMB-denominated financing will soon be spending their loans, and much of the capital is likely to be directed back towards Chinese providers of goods and services. That entails round-trip, cross-border flows as the RMB first moves offshore but then returns home in payments for the construction, engineering and financial support that the Chinese firms will be delivering.

In fact, the Silk Road investment fits into the bigger picture of how Chinese investors are striking more overseas deals in their home currency.

“About 30% of China’s outward investment is already denominated in yuan but the amount is getting bigger in absolute terms every year because total investment is growing too,” Zhu confirms.

He also says that the RMB’s reach is going to lengthen as a result of the commercial activity that will be sparked by the new investment campaign. As greater prosperity starts to spread along Silk Road routes, demand for Chinese exports should pick up, and more of this business is likely to be invoiced in yuan.

“Countries along the Silk Road route already account for about a quarter of..."
Truth be told, some of the early reaction to Shanghai's free trade zone was muted, especially when the authorities rolled out a longer-than-expected "negative list" of sectors in which foreign investment is still banned. Even the Chinese premier Li Keqiang is said to have thumped the table in frustration at some of the bureaucratic foot-dragging. He turned his scorn on red tape again this year, furious at scenarios in which he said that citizens were being asked to prove "your mother is your mother" for getting official permits.

"Why is it so difficult for civilians to get things done with the government?" Li demanded. "Why must the government put up so many barriers for its people?"

That hasn’t stopped thousands of outward-looking enterprises establishing a new presence in the Shanghai zone. “More than 12,000 new entities were set up in the FTZ in the first year,” Liang reports. “In part that was because it was much easier to set up a company in the zone. Outside, firms have to go to a multitude of government offices to get the right licences. But inside, the process has been revamped with the 'one window' system. You submit all your paperwork and all the business licences are issued in 4-10 working days. That is regarded as pretty revolutionary, especially by companies that have been operating in China for a while.”

If they want to do business in the zone, firms have to file their taxes from Shanghai’s global gateway: its free trade area has been open since September 2013

China’s international trade. But some of these markets still aren’t very well connected in transport and trade terms,” Zhu says. “That means that the incremental gains could be very significant once One Belt, One Road investment starts to pay off.”

Shanghai, the pioneer

By design, much of the One Belt, One Road programme is cross-border, reaching out from China into other parts of the world.

Back inside China there is similar focus on promoting the RMB. Shanghai is already making a major contribution to the yuan’s ambitions as a global investment currency, for instance, with the launch of Stock Connect. But another area in which the city has taken the lead is the formation of a free trade area – officially, the China (Shanghai) Pilot Free-Trade Zone – which first opened for business in September two years ago.

This narrow patch of land in Pudong is another of the epicentres in the RMB’s internationalisation story, with an impact that is starting to be felt much further away.

Special zones have a talismanic role in China’s history of economic reform, none more so than Shenzhen, only a few miles from Hong Kong. A small fishing village as recently as the 1970s, it is now one of Asia’s most prosperous and influential cities.

The first generation of special zones was designed to open tiny parts of China to international contact, sparking a new era of export manufacturing as a much-needed engine for economic growth.

But the Shanghai zone has a more proactive mission in bringing China to the world. And rather than spurring a new surge in low-cost exports, it aims to boost local capabilities in service sector industries like logistics, insurance and finance.

“It’s best to see the zone as a testing ground or experimental area,” suggests Nancy Liang from HSBC. “The authorities want to trial new ideas and many of them relate to more of a global role for the RMB. If the proposals work well enough, they can then be extended across the country as a whole.”

That sounds similar to the way that policymakers started out with a small group of companies in a few cities to test the yuan’s usage in cross-border trade settlement, but then extended the scheme nationwide once it was seen to be working well.
registered offices there and meet minimum thresholds that prove they are operating businesses, and not shell companies. So far the majority of the enterprises to register are Chinese, although Liang argues that this is no bad thing as the goal is for all firms to conduct more cross-border business with the RMB, not solely to attract foreign interest.

The proportion of multinationals active in the zone has been increasing as the advantages of operating there become more apparent.

“Any kind of cross-border usage of the RMB is simplified in the zone, from the basics like current accounts and normal trade settlement for goods and services,” Liang confirms. “But another benefit is new financing arrangements which allow companies to borrow in RMB from offshore. Until some more recent changes in market conditions that was helping firms in the zone to get cheaper loans, because borrowing costs inside China were higher than overseas.”

From the perspective of most multinational firms, the pioneering of cross-border cash pooling in the zone has been particularly significant. For years foreign companies have struggled with their surplus capital being trapped inside China. Those with a presence in the zone were given a lifeline last year with a new opportunity to link their cash pools in China with their regional and global treasury centres. The arrangements, which allow for the sweeping of funds from inside China to overseas and vice versa, allow participants to make much more efficient use of their cash balances.

“Many of our multinational clients have multiple operations in China and we have been helping them to pool or concentrate their cash positions via their entity in the free trade zone,” Liang says.

And in a further example of how reforms in the zone are already being extended nationwide, cross-border sweeping is now being permitted outside the zone, provided that participating companies have met eligibility criteria.

In fact, the pilot phase in Pudong has gone well enough to inspire the creation of a further three zones in Guangdong, Fujian and Tianjin, which are now being set up with the experience drawn from the experiments in Shanghai. Liang predicts that each of the new locations is going to speed the yuan’s outward journey in its own way: “In Guangdong, the zone will concentrate on the Pearl River Delta, and cross-border collaboration with Hong Kong; in Fuzhou the focus will be more on business with Taiwan; while Tianjin looks more likely to target a group of domestic industries in the Bohai Bay region.”
Going places

A little over a year ago Britain’s senior diplomat in Hong Kong wanted to highlight how the UK was outpacing its rivals in welcoming the yuan. Picking horse racing as an analogy (a clever choice in a city hooked on the sport), she insisted that London was a leading contender in the currency sweepstakes. But are the British really galloping ahead and where else is the Chinese currency making strides overseas? Candy Ho, HSBC’s Global Head of RMB Business Development, gave WIC her own assessment of how the yuan has progressed offshore, as well as which markets look best positioned to benefit from the internationalisation story.

Then, for an update on how the yuan is faring in the Americas, we talked to Debra Lodge, HSBC’s Head of RMB Business Development for North America.

Swaps and sovereigns
One indicator of how the yuan is spreading globally is bilateral currency swaps—agreements between two countries to guarantee access to each other’s currency if the situation requires it.

The Chinese have been setting up more of these swaps in the wake of the global financial crisis, when dollar credit dried up almost overnight, paralysing many of their exporters. Chastened by the experience the People’s Bank of China started to promote the yuan as an alternative currency for trade finance, and the signing of new swap arrangements since then has been emblematic of the yuan’s new reach.

There are now at least Rmb3 trillion of swaps in working order between China and more than 30 countries (plus Hong Kong). The smallest is with Suriname at Rmb1 billion; the largest with Hong Kong for Rmb400 billion.

In reality, they are rarely activated, although the PBoC sent Rmb20 billion to Hong Kong when a liquidity crunch made it difficult for the territory’s companies to settle trade with the mainland in 2010.

Argentina also drew down on its swap last year, releasing about a third of its commitment from Beijing. Rather than pay for trade, the swap line was converted directly into dollars and used for refinancing purposes, because of Argentina’s difficulties in raising debt from other parts of the international banking system.

A second way of flagging the RMB’s progress is through the sovereign reserves of other nations. Central bankers don’t say too much about their currency choices, but a survey earlier this year of the managers responsible for about 48% of the world’s sovereign holdings supported the view that interest in the RMB is growing.

“The poll results included their prediction that a tenth of sovereign holdings will be denominated in yuan by 2025, and 12.5% of the total by 2030,” Candy Ho says. “At the moment the yuan’s share of reserves is probably low single-digit, so that would be a substantial increase.”

Soon afterwards China’s central bank made its first public estimate of how much yuan is being held at foreign central banks, suggesting about Rmb667 billion ($107 billion) in RMB-denominated assets at the end of April.

Admittedly, this is still a small share of the global total. According to IMF data, central banks reported more than $6 trillion of foreign exchange reserves at the end of last year. More than 60% of that was in dollars, with 23% in euros, and single-digit percentages for the yen and for sterling.

Probably the simplest method for monitoring the RMB’s rise is cash, with yuan bank deposits outside mainland China doubling to about Rmb2 trillion
over the last two years. Hong Kong has the most, with Rmb1 trillion in local bank accounts at the start of this year, followed by Taiwanese deposits of Rmb300 billion and Rmb277 billion in Singapore. Outside Asia, Luxembourg is the leader with about Rmb60 billion.

Despite the increases, the growth rate for deposits has been dropping off, perhaps because fewer account holders think that the yuan is going to gain as much against other currencies as it has done in the past. The RMB rose by more than a quarter against the dollar between 2007 and 2013, for example. But as this trend has slowed (reversing in some cases), the incentive to accumulate yuan has reduced.

**Bonds taking a breather?**

Another reason for the levelling off in cash deposits is that account holders have a wider range of investment options with the yuan.

“Their perspective is broadening,” Ho agrees. “Investors aren’t as limited to parking their cash in deposit accounts because they have more things to do with it.”

The previous edition of *The A-Z of the RMB* focused mostly on investments in yuan-denominated bonds – the so-called *dim sum*, named in tribute to the tasty dumplings of Cantonese cuisine. China Development Bank debuted the first of these offshore bonds in Hong Kong in 2007 and the market has grown steadily, with volumes reaching new highs last year. But the *dim sum* dynamics have been changing as outsiders get more opportunities to own bonds and equities inside China, and as more channels for cross-border capital flows start to open up. This has been pushing up *dim sums* funding costs and the market has been sluggish as companies choose to raise debt on China’s domestic market or through global dollar bonds instead. Issuance in the first four months was Rmb151 billion, down almost half on a year earlier.

Commentators seem split on the prospects for *dim sum* bonds. Some believe that foreign fund managers will shift to onshore debt once they start to get more opportunity to invest inside China (with Rmb35.3 trillion outstanding as of April, domestic bond issuance towers over the Rmb523 billion offshore market). But the contrary view is that *dim sum* bonds won’t disappear in markets like Hong Kong because investors prefer the higher quality of companies issuing debt there, as well as the greater predictability of the legal process in the offshore market.

**New channels for inbound investment**

Apart from offshore bonds two other schemes have been giving international investors greater access to Chinese securities: the Shanghai-Hong Kong Stock Connect and the Renminbi Qualified Foreign Institutional Investor programme.

The Stock Connect scheme – hailed by analysts as a landmark in opening up China’s capital markets – allows Hong Kong and Shanghai investors to trade directly in stocks on each other’s bourses. Both the channels – ‘northbound’ from Hong Kong into Chinese stocks, and ‘southbound’ from China into Hong Kong – are RMB-denominated. After a slow start late last year flows picked up substantially in the early part of 2015, and investors expect the launch of a similar conduit between Shenzhen’s stock market and Hong Kong later this year.

In July another new programme was launched allowing mutual funds domiciled in Hong Kong and mainland China to be marketed and distributed across both territories. The initial quota for this scheme is larger than Stock Connect: Rmb600 billion, split evenly between the two markets.

The Renminbi Qualified Foreign Institutional Investor scheme (RQFII) also allows international asset managers to invest offshore yuan back into Chinese securities. Interest has been growing this year, with China’s State Administration for Foreign Exchange (SAFE) awarding a new batch of
Going places A to Z of the RMB

Outbound flows increasing too
Most of the pool of Chinese currency offshore has accumulated through trade settlement. But greater volatility in exchange rates may make settling trade with the yuan less appealing for foreign counterparties. Other channels need to open up if the yuan is going to feature more outside China.

One of the key contributors is outbound investment. With the Qualified Domestic Institutional Investor programme China already has experience in allowing licensed investors to put capital to work overseas, although the scheme wasn’t an early success with investors, because most funds were launched shortly before the global financial crisis and then dropped alarmingly.

This year there has been speculation that a second iteration of the scheme – unimaginatively titled QDII2 – will be launched in six cities, allowing individuals (and not just institutions) to invest overseas.

The broader context is that direct investment overseas is increasing like never before. Outward flows surged to $116 billion last year, almost the same as the foreign capital flowing in the other direction into China. In fact, if investment by foreign divisions of state-owned firms is included in the calculations, China was a net exporter of capital for the first time in its modern history. Almost a third of the total was denominated in yuan, too, and the outbound push has intensified in the opening four months of this year, reaching Rmb214 billion, or an increase of more than a third on last year.

Who wants to be a hub?
For the yuan to go global it has got to be accepted across all the world’s time zones. But despite the progress of the last five years, its presence outside China is still fairly limited. Even the Rmb2 trillion of overseas bank deposits is a relatively small amount and too much of it is concentrated in Hong Kong.

For comparison purposes, nearly a quarter of worldwide deposits of the
dollar are held outside the United States, according to data from the Bank of International Settlements.

Fortunately there are plenty of candidates who want to serve as standard bearers for the yuan. Unsurprisingly, it has been financial capitals like London and Frankfurt that have been the most active in welcoming it. But flags are now being planted at more spots on the map, including countries that sell commodities to the Chinese, as well as those set to feature as stops along the New Silk Road (see page 21).

Despite the competition to capture a greater share of RMB business, Candy Ho says that the RMB’s rollout isn’t a zero-sum game. Instead the different suitors will promote the yuan in different ways. As examples, she mentions three countries from Europe. “Luxembourg is ahead in fund management and it has larger yuan deposits than other parts of Europe because more Chinese multinationals, including the banks, are setting up their regional headquarters there”, she says. “Germany’s edge is based more on its strengths in trade and manufacturing, so we are seeing growth in intra-company flows at multinationals with large operations in China, who are getting much more active in areas like cash management pooling. And while London doesn’t have the same growth in trade-related financing as Germany, it has been capitalising

Leading riders in the RMB race

Hong Kong
Still the leader in offshore RMB on all fronts, helped by its close ties in trade and investment with mainland China. Hong Kong ticks all the boxes – the biggest swap line, the most deposits, the greatest bond issuance, and the highest volume of trade settlement activity. The advent of the Shanghai-Hong Kong Stock Connect has highlighted the city’s first-mover advantage once again, and it will continue to prosper from its status as a quasi-experimental zone for RMB reforms.

Singapore
Establishing itself as the leading offshore hub for the ASEAN region (which runs a trade surplus with China); as a major commodity-trading centre; and as the largest FX trading hub in Asia. Singapore’s hosting of many multinational corporations, including their regional treasury centres, has supported strong renminbi deposit growth, while its reach has been helped by local banks with strong relationships with ethnic Chinese businesses in Southeast Asia.

Taiwan
Taiwan is one of China’s largest sources of overseas investment and runs a trade surplus with the mainland. Taiwan has sizeable yuan deposits, its own clearing bank arrangements and a market in its own variety of RMB debt called Formosa bonds. But political red tape has slowed progress elsewhere. Negotiators agreed to open a RQFII quota in 2013, for example, but the final decision is still pending as Beijing waits to see whether Taiwan will ratify a controversial pact aimed at liberalising cross-strait trade.

London
London’s time zone advantages and its position as the world’s biggest international financial centre more than offset its relatively shallow pool of RMB deposits. Twice as many dollars are traded on forex market in the UK than in the US, for instance, and more than double the volume of euros than all the Euro-area countries combined. As the RMB becomes more global, London wants to be the place where it is traded too.

Luxembourg
Helped by Chinese banks choosing to headquarter in Luxembourg, the Duchy has a higher-than-average deposit pool than the rest of Europe and has been more active in yuan loans too. It also competes strongly in asset management with over half the European exchange traded funds with Chinese equity domiciled there, as of mid-2013. Five of the six Chinese asset managers to introduce funds in Europe have done so in Luxembourg too, while 38 RMB-denominated bonds amounting to almost Rmb31 billion in issuance had been launched there as of February 2015.
In March Toronto was the first city in the Americas to welcome a clearing house for yuan transactions, backed by a $30 billion swap agreement with the Chinese central bank, and topped off with $50 billion in RQFII quota.

Policymakers hope that an ability to trade directly in yuan will add as much as $32 billion to Canadian exports and also that Canada’s banks and asset managers will grab the opportunity to grow their financial footprint in Asia.

Provinces like British Columbia – with 20% of its exports going to China – are also hoping to cash in on what Michael de Jong, its minister of finance, has described as “a limited time competitive advantage that won’t last forever, but a unique opportunity if we choose to take it”.

“It’s the moment in time when Canada gets to decide to strengthen our relationship with this growing economy that’s re-establishing itself as an economic powerhouse,” de Jong has said.

In May Chile staked its own claim for leadership in Latin America with the signing of a series of similar currency accords during the visit of Li Keqiang, the Chinese premier.

There’s a history of early engagement between the two countries too: Chile was the first in the region to establish diplomatic ties with China and also the first Latin American nation to sign a free trade agreement with the Chinese.

The new clearing bank is also the first of its kind in Latin America and “could serve as a base to finance projects,” says Chilean foreign minister Heraldo Munoz.

Measured against the kind of metrics used to track the yuan’s progress elsewhere, the yuan’s impact in the United States has been more subdued.

Debra Lodge, head of HSBC RMB Business Development in the United States and Canada, acknowledges that most American firms are at least 18 months behind their peers. But she also points out that interest is increasing, with about 10% of the US companies interviewed in HSBC’s survey on RMB readiness this year already using the yuan.

A quarter of respondents from the US said they were talking about doing so too.

“Undoubtedly there has been some inertia, probably because the dollar has been the preferred currency for global trade for so long,” Lodge admits.

This dollar-centric context means American firms won’t see the same

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**The yuan as a trade, financing and investment currency**

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<th>Payments</th>
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<td>■ World’s #5 most used payment currency</td>
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<td>■ 2.07% of world’s total (SWIFT April 2015)</td>
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<td>■ 2nd most used trade finance currency</td>
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<td>■ 9.43% of world’s total</td>
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<td>■ Deepened liquidity in the offshore RMB markets</td>
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<td>■ Volume wise, currency stands at number 9</td>
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<th>Bonds</th>
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<td>■ FY14, offshore gross issuance reached Rmb530 billion, or about 43% more than the full-year issuance in 2013</td>
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<td>■ Offshore RMB bonds issued in multiple locations</td>
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<td>■ Diversified issuers and investors base</td>
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<th>Investments</th>
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<td>■ Developing offshore RMB investment products</td>
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<td>■ Expansion of 2-way RMB investment channel via QFII/RQFII, CIBM, Stock-Connect, QDII/RQDII</td>
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<th>Reserve currency</th>
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<td>■ More than 30 active cross-currency swap agreements in place exceeding Rmb3 trillion</td>
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on a significant surge in forex trading. The widening of the trading band between the dollar and the RMB has been playing a part in stimulating demand for London’s expertise in hedging and risk management.”

**The final frontier: the yuan in the US**

Much of the focus in respect to the RMB’s outward journey has concentrated on developments in Asia and Europe. The Americas have received much less coverage, in part because they seemed to be showing less interest in the new opportunities unleashed by China’s currency reforms.

Few had currency swaps with China, for instance. There were no clearing banks for the yuan. Approvals for RMB-denominated investment into the Shanghai stock market were lacking, and few banks offered yuan deposit accounts.

That picture has started to change, especially in Canada and Chile, which have been making their pitch to become offshore centres for the RMB.
savings in transaction and hedging costs that can accrue to companies in countries more used to switching their own currencies into the dollar when trading with the Chinese.

Indeed, even the experience of transacting in foreign currency can be new for many American companies, Lodge notes.

“Companies in other countries are more likely to have a history of doing business with the US dollar, so they are much more accustomed to executing forex trades and monitoring currency risk,” she explains.

“But historically, many American firms have only ever used the dollar for settlement, which means that they need to get more familiar with the new practice of doing business with other currencies in general. It isn’t simply a question of getting to know China and the yuan better – the changes in mindset are broader than that.”

The flipside of this limited experience in non-dollar settlement is that some of America’s biggest companies are so successful on the global stage that they already have a direct presence in China. That leaves their China-based subsidiaries better positioned to handle the majority of RMB-denominated activity, although some multinationals choose to conduct their business through regional treasury centres in places like Hong Kong and Singapore, and most recently Shanghai too.

In each case the need to develop the same capabilities on American soil is somewhat reduced.

That’s not the case for smaller firms lacking a major presence in Asia and Lodge says that they have been the pioneers in exploring how to use the yuan more. “We find that it is often mid-sized or smaller businesses taking up the RMB at a faster pace,” she explains. “Sometimes that’s because they tend to be more entrepreneurial in looking at how it will help to boost margins or improve their competitive position. Also, their managements are better placed to take the decision to switch more quickly. At some of our bigger clients we’ve got to talk to the treasury team first and then to the procurement department. There may be final sign-off from executive management as well. It can take a year from the first discussions through to implementation.”

The choices about how best to use the RMB depend on the size of the firm and the nature of its China-related activity. Larger companies are usually more focused on the measures that allow them to leverage their cash positions in China through cross-border pooling or secure new financing through intra-group lending and offshore guarantees.

Previously it was common practice to move surplus funds out of the country by declaring dividends, for instance, although this could introduce tax implications and make it harder to reinvest funds back into China once they had been repatriated to the US.

But the newer arrangements made possible by RMB reforms have allowed for quicker, more tax-efficient movement of cash, Lodge says.

Nonetheless, wider demand for the fuller range of yuan services from smaller firms within American borders is yet to materialise, with few companies holding the RMB in US domiciled accounts (only a handful of banks are currently offering deposit facilities).

Instead Lodge says that most treasurers prefer to conduct their currency business through global platforms in hubs like Hong Kong, London and Toronto, with an increasing number of HSBC’s US clients also assisted by its foreign exchange team in New York, or via the bank’s cash management platform online.

In the meantime, the priority is educating American companies about the opportunity to utilise the yuan more for trade and investment purposes. In this respect Lodge thinks that the decision later this year on whether to include the RMB in the IMF’s basket of Special Drawing Rights currencies (see page 45) will be helpful. “It’s not going to change the world overnight but it will generate more media attention as another major step for the RMB outside China, which should prompt more businesses to consider how to incorporate the yuan in their commercial activity with Chinese counterparties,” Lodge suggests. ■
RMB around the world

Rapid expansion in usage outside mainland China

Sources: master source HSBC, from PBoC, HKMA, Swift, MNI, Central Bank of the Republic of China (Taiwan), City of London, CEIC, BIS, WFE, BOK, Bundesbank, Central Bank of Qatar, Central Bank of Australia, Central Bank of Canada,
The duel with dollar

The dollar is our currency, but it’s your problem,” warned American Treasury Secretary John Connally after Richard Nixon’s 1971 ‘new economic policy’ imposed surcharges on imports, closed the ‘gold window’ making the dollar no longer freely convertible, and launched wage and price controls.

Washington’s policy bombshell provides food for thought today, at a time when the Chinese have grown accustomed to lectures on the imperatives of unfettered trade and unrestricted capital markets.

Connally’s rebuke was stirred by European fury at the plummeting dollar. The mood in China was also uneasy after Washington’s more recent foray into quantitative easing, although the greenback has rallied over the last year.

Despite talk of seismic shifts in global trade and finance, the world’s currency landscape has remained remarkably constant over the last generation. The most recent study by the Bank of International Settlements (from 2013) of the foreign exchange markets shows that the shares of the dollar, the yen and the euro (or its precursor currencies in Europe) have been virtually unchanged for 25 years.

That highlights how the greenback has maintained its global clout through the booms and busts of the corresponding period. It indicates too that the

Chinese currency has much further to travel if its impact is going to be genuinely transformative on the international status quo.

Getting more convertible

In this respect it is worth returning to what the RMB internationalisation story really denotes: the purposeful effort of the Chinese government to increase the yuan’s importance internationally. Achieving this objective requires China’s fuller integration into the global financial system, something that Beijing is targeting with its campaign to see the yuan included in the IMF’s basket of Special Drawing Rights (see page 45).

But to take its currency global, the Chinese must respond to two key challenges. The first is to achieve fuller convertibility for the yuan, an issue that featured in most of WIC’s interviews with HSBC’s executives as a crucial step if it is to become an investment currency.

In April Chinese policymakers made the very specific promise that the capital account would be liberalised by the end of this year, and since then further reforms have tightened the linkages between the onshore and offshore markets for the yuan.

Of course, in this particular debate definitions are everything but Paul Mackel, HSBC’s Head of Asian FX Research, believes that “the finishing line is in sight” for a freely convertible RMB. The opening of more cross-border channels like QDII2, broader access for foreign investors to the Shanghai and Shenzhen stock markets, and further loosening of the foreign exchange rules will combine to take the yuan “the last mile” to convertible status, he says.

Mackel also believes that the Chinese authorities have timed this opening up carefully, waiting for a period in which subsequent capital flows aren’t likely to be too wrenching or too one-sided.

Naturally, there are contrary views, particularly from those who question whether the authorities have the stomach for the financial consequences that a fully liberalised capital account could unleash.

The inference is that the political instincts of China’s leaders won’t allow them to leave the market entirely to its own devices, as witnessed in their frenzied efforts to stem the declines in the Shanghai and Shenzhen stock markets this July. The intervention can only lead to questions about Beijing’s commitments to opening its markets to international capital too, especially as the state media appeared to blame unidentified foreign forces for this summer’s market slump.
This debate about market openness is being waged inside China as much as elsewhere. On one side stand those who see currency reform as a way of sweeping aside vested interests and pushing forward with monetary changes that support China’s transition into a more sustainable, consumer-driven economy. On the other side are more conservative forces, including some of the most powerful state-owned enterprises, which are less impressed with the liberalisation process, especially if it destabilises the conditions that have allowed them to prosper from China’s investment-driven, export-led development model.

Friends and foes
The second major theme for the RMB is how the rest of the world is going to respond, recognising that the internationalisation effort can’t just be imposed by the Chinese, but needs support from their global counterparts.

Here the situation is evolving too, with longstanding alliances showing signs of strain. For example, Washington’s cautious stance isn’t shared by its traditional partners, something best seen in the recent row over Britain’s decision to join the Asian Infrastructure Investment Bank (see page 47).

Why SDRs are going to be in the headlines

Bidding for the basket

The International Monetary Fund’s Special Drawing Rights basket was once compared by the historian Charles Kindleberger to Esperanto, the supposedly ‘universal’ language that hardly anyone has ever used.

SDRs are reserve assets used as transaction currency between central banks, but they don’t feature much elsewhere in the international financial system. Held at the IMF, they are currently valued against a basket of four currencies: the dollar, the euro, the pound and the yen.

In May the cash-starved Greeks surprised industry insiders by using a portion of their own SDRs to pay off part of their debt to the IMF. But the more significant question is when the yuan will be included in the basket, which comes up for review every five years.

The Fund is conducting an assessment at the moment and it has said that it will give a decision later in the year. Its managing director Christine Lagarde has already announced that the yuan’s inclusion is only a matter of time, but a formal approval is important because there are two prerequisites for currencies to qualify for the basket: that they come from a major trading country, and that they are ‘freely usable’.

China passes easily on the first parameter, but the second is more problematic because of its capital controls.

A green light for the yuan to go into the basket would bolster its reputation at central banks, which would move towards holding a greater proportion of their reserves in RMB. Most likely it would trigger a wider review by global asset managers, who would also look to increase their RMB-denominated holdings.

The IMF’s critics say that China’s frustration at not getting more of a say at the Fund has already contributed to its efforts to launch its own bank – the AIIB – as an alternative. Some analysts believe that refusals to incorporate the yuan as an SDR could also provoke an adverse response. “If the IMF were to sidestep the explicitly stated desire of China’s government to have the yuan included in the basket, it would create more bad blood in an already contentious relationship regarding currency matters,” Eswar Prasad, a senior fellow at the Brookings Institution in Washington, has warned.

George Soros, the billionaire investor, has also called for the IMF to welcome the yuan so that a “binding connection” is forged with the dollar-led economic order. In the past the basket has included currencies with little capital account convertibility, Soros notes.

The final decision requires a 70% majority vote from the IMF’s board but much depends on the attitude of the US government, which holds veto rights.
How the US reacts to China’s efforts to embed the yuan in global markets is hugely significant, not least because both sides regard the internationalisation effort in political terms as much as economic ones. There’s also the suspicion that both countries see it as a zero-sum exercise. Each time that China’s central bank signs a swap agreement, a little of the dollar’s dominance is dislodged. Each move from other central banks to switch reserves into RMB assets loosens the greenback’s grip a little more.

It is surely no coincidence that the US authorities have made no major policy announcements about the yuan or taken any significant steps towards supporting its participation in global trade and finance.

In the meantime the Chinese are pursuing a dual-pronged approach that demonstrates their readiness to become a fuller participant in the international financial system (lobbying for the yuan’s inclusion in the SDR basket, for instance, or calling for a greater share of Chinese stocks in global equity benchmarks) but which also hints at the possibility of striking out on their own if their ambitions are thwarted.

In some cases the threat has become reality. Washington’s critics say that it miscalculated badly by denying Beijing’s requests for more voting power at the multilateral financial institutions. In response the Chinese set up the AIIB. Despite their protestations to the contrary the Americans are deeply unenthusiastic about a new lender in which China is the largest shareholder and will expect to exert significant influence.

Despite this growing rivalry, signposting the yuan’s future simply as a confrontation with the dollar would be a mistake. The more likely outcome is the dawn of more of a multi-currency world in which the dollar continues to lead, but where other currencies feature, including the yen and the euro (the Eurozone’s current difficulties with Greece notwithstanding). The growing contributions to global growth of countries like India and Brazil may get more recognition in currency terms too.

Naturally, China wants the yuan to be on that list and it will expect it to feature near the top of the rankings. But that kind of future is predicated on Beijing being able to take the final steps – some of which may turn out to be the most difficult ones – in endowing the yuan with the full characteristics of a enduring international currency, like deeper and more open capital markets, a more trusted legal system, and market-determined currency and interest rates.

If that can be achieved, the RMB will be able to rightfully claim that it is a genuinely global currency.
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