2015.10.05 (No.28, 2015)

Newsletter

Institute for International Monetary Affairs
公益財団法人 国際通貨研究所

"Internationalization" of the Renminbi :Xi Government Puts National Prestige on its Inclusion in the SDR Basket

Tetsuji Murase
Professor Emeritus, Kyoto University
Visiting Senior Research Fellow, IIMA

Introduction

This year falls on the review year of the SDR basket when the IMF makes quinquennial review on the composition of the SDR basket, and the Chinese government has actively lobbied other governments and major international institutions to have the Chinese yuan or renminbi (RMB) included in the SDR basket, while making efforts to improve domestic environments to prepare for it. The SDR is a basket currency composed of the US dollar, the euro, the British pound and the Japanese yen and it is internationally used as a reserve currency and as a transaction unit for inter-governmental transactions and those with the IMF.

The inclusion of the RMB in the SDR basket means that the currency has been formally endorsed as an international currency that goes toe and toe with the US dollar and the euro. China is already a big power that is in a political scene a permanent member of the Security Council of the United Nations and in an economic scene a country with the second largest GDP only next to the US, but in the field of international finance, it's currency yuan has not been regarded as equal to other currencies of advanced countries, although China has tried to challenge the existing international order by creating such institutions as the Asian Infrastructure Investment Bank (AIIB).

China may wish to serve as a host country to the G20 Summit meeting scheduled in 2016 by staking its prestige on a successful inclusion of the RMB in the SDR basket. The IMF Executive Board is expected to make a decision by the end of this year.

1. Surging external settlements in the RMB

In 2009, the Chinese government made a big shift in its currency policy by allowing cross-border use of the RMB for external settlements with placing Hong Kong in the center of the RMB's offshore market. Until then, the RMB was a minor local currency, only slightly used in the settlement of border trades, while China relied almost exclusively on the US dollar for the majority of its external settlements of trade and investment. Having realized the strength of the US dollar, a key international currency, and the risks to heavily rely on it through the Asian currency crisis in 1997～98 and the global financial crisis that took place ten years after, China decided to gradually expand external settlement in the RMB while decreasing its dependence on the dollar for its external transactions[1].

China started this process by introducing at first the RMB settlements in the current transactions such as trades in goods and services, then extending them to inward and outward direct investments. In other words, China promoted the RMB settlements in the transactions backed by actual demands while it retained many restrictions including requirements of permission and setting a ceiling or quotas to such transactions as securities transactions and deposits and loans (i.e., capital transactions other than direct investments) that are not always backed by actual demands. This approach reflected the fears on currency speculations that it closely experienced at the time of Asian Currency Crisis as well as the hardship that China suffered from the unmanageable short-term capital flows.

The overseas transactions of the RMB which is paid to foreign countries in such forms as the payment of imports can be made freely and for that reason, China has actively tried to foster Hong Kong, over which it has sovereignty, as an offshore market where deposits and loans can be made in the RMB. The Hong Kong Monetary Authority (HKMA) and People's Bank of China (PBOC) have been cooperating in management of real-time settlement of the RMB, development of spot and forward exchange markets, fostering of the interbank money markets and so on. As a result, bonds denominated in RMB called "dim sum bonds" have grown and channels for recycling the RMB that are retained overseas have gradually been diversified mainly in Hong Kong to include the RMB-denominated securities investment permission system, mutual investment between Shanghai and Hong Kong stock markets, permission of regionally limited RMB loans, etc.

China has established in the overseas 15 countries and regions, headed by Hong Kong, China-affiliated clearing banks to facilitate the circulation and management of the RMB in

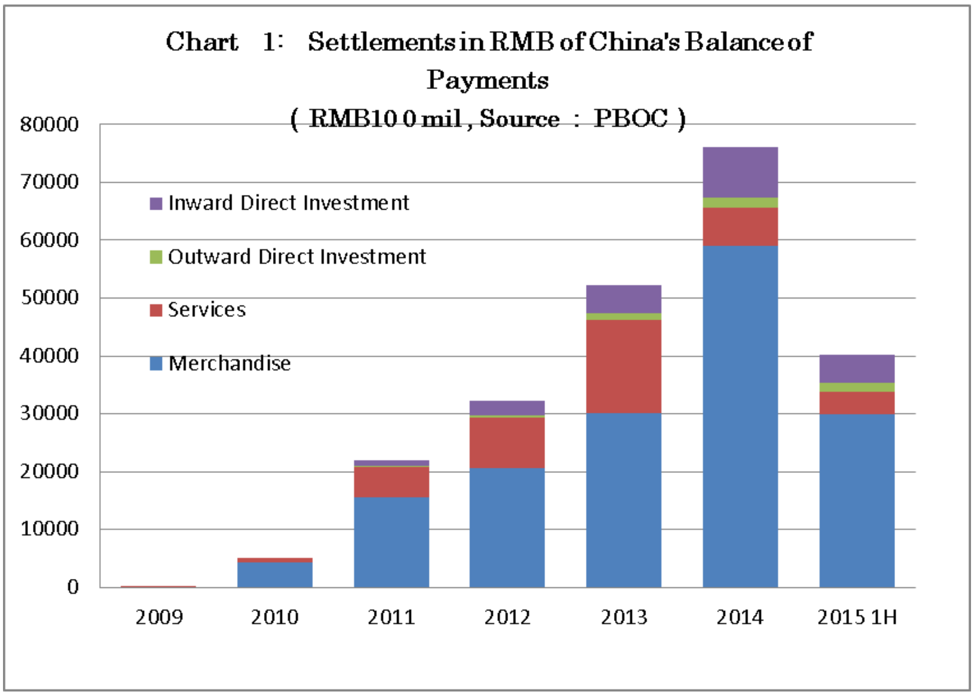
---

1 In 2006, Assistant Governor Mr. Yi Gang of the PBOC (currently Deputy Governor) said like this: "A key to the victory in the current competition of nations lies in the currency war. As the key currency takes the leadership in international economic transactions, the RMB should aim to become a key currency or a quasi-key currency (hard currency), and that is possible." "Make the RMB a top strategy for promoting peaceful development" "Chinese Economic Report," December 24

overseas (as of May 2015, source: PBOC, hereafter the same unless otherwise mentioned). It also has arranged currency swaps with 32 countries totaling RMB3.1 trillion to supply enough RMBs needed for financing trades and direct investment as well as securing the liquidity at a time of currency crises (as of June 2015). Japan and the US have not joined these networks of China, although many Western advanced countries including the UK, Germany, France, Canada, and Australia have been included.

In 2014, the fifth year after it implemented the settlements in the RMB, the RMB settlements amounted to RMB 6.6 trillion (RMB 5.9 trillion for the trade of goods, with RMB settlement ratio reaching 20%). In the first half of 2015, the total amounted RMB 3.4 trillion (RMB 3 trillion for goods), almost the same level as in 2014. Outward direct investment denominated in RMB amounted to RMB186.6 billion in 2014 (RMB147.0 billion in the first half of 2015) while inward direct investment denominated in RMB reached RMB 862 billion (RMB 488.6 in the first half of 2015). Combined amounts of inward and outward direct investment in RMB exceeded RMB 1 trillion level in four years after they were allowed in 2011. More than half of these transactions (52.7% in 2014) were made with the counterparts in Hong Kong, followed by Singapore, Taiwan and Japan.

On the other hand, although the turnovers of the RMB foreign exchange transactions are increasing, it is far behind as compared with the four currencies that consist of the SDR basket. The IMF estimated that the daily average turnover of the RMB in the world market amounted US$250 billion in October 2014, which is less than the turnovers of the Australian dollar, the Swiss franc, and the Canadian dollar (ranking 5th, 6th, 7th respectively in April 2013). Especially its turnover in its mother market in Shanghai still remains only US$55 billion (daily average in 2014, PBOC). The reason of this small volume in Shanghai market can be found in the existence of actual demand principles (transactions should be based on the actual demand, with no speculative transaction permitted) and the restriction on nonresidents’ participation in the market.



2. "Managed Convertibility" of the RMB

Since the external use of the RMB began to be actively promoted, the internationalization of the RMB has been a hot issue in the academic societies in and out of China. However, the Chinese government and monetary authorities for long have carefully avoided the use of the term of "internationalization", by using the expression of "cross-border settlements in RMB" instead. In the world of international finance and politics, internationalization of a currency generally means a realized free convertibility through the liberalization of capital accounts. The Chinese government, which is cautious about the liberalization of capital accounts, seems to have chosen carefully the term so that the internationalization of the RMB may not be regarded as the equivalent to the abolition of capital controls.

However, since the policy objective for "steadily promoting the internationalization of the RMB" was adopted in December 2014 at the Central Committee of the Communist Party of China, the monetary authorities also began to use the word of "internationalization". This change of attitude may reflect their need to advertise the RMB as an international currency when they launched a political attack on other IMF member countries for the inclusion of the RMB in the SDR currency basket. Yet, it seems that China decided not to follow the traditional definition of "internationalization", and to assert instead a new definition somewhat tinted with Chinese characteristics.

Last April, Mr. Zhou Xiaochuan, Governor of the PBOC, addressed at the IMFC meeting and after explaining that the internationalization of the RMB has been rapidly progressing thanks to various measures taken thus far by the government, he advocated the appropriateness of the inclusion of the RMB in the SDR basket, using a new concept of "managed convertibility[2]"

(1) One of the criteria for an SDR currency is that the currency must be "freely usable," which requires a certain degree of capital account convertibility. (Underline is added by the author of this article. Mr. Zhou seems to have intentionally inserted this word.)

(2) Out of the 40 items the IMF identifies as capital account transactions, 35 items are fully or partially convertible in China, and only five items remain inconvertible. Therefore, China is not far from achieving its goal of RMB capital account convertibility.

(3) It should be noted that the concept of capital account convertibility has changed since the global financial crisis. China will adopt a concept of managed convertibility, instead of the traditional one of being fully or freely convertible.

(4) China is intending to retain management of capital account only in the limited cases with special purposes. Therefore, the future capital controls will be either in line with the international practices and those recommended by the Fund, not exclusively of Chinese (which means unconventional).

.

3. The First Release of "Report of RMB Internationalization (2015)"

In June 2015, the PBOC released a report titled "Report of RMB Internationalization (2015)", which gives a detailed explanation on the recent international use of the RMB and at the same time advocates the inclusion of the RMB in the SDR's basket by showing concisely the development of its international usage together with expected reforms and outlook for its internationalization.

(1) Capital Account Convertibility

The RMB is approaching to the target of capital account convertibility. The PBOC will promote further internationalization of the RMB, by such measures as an experimental permission of private outward portfolio investment, improved or new operations of shared investment system in the Shanghai-Hong Kong Stock Exchanges and Shenzhen-Hong Kong Stock Exchanges, improved access to capital market of specified institutional investors that include foreign monetary authorities.

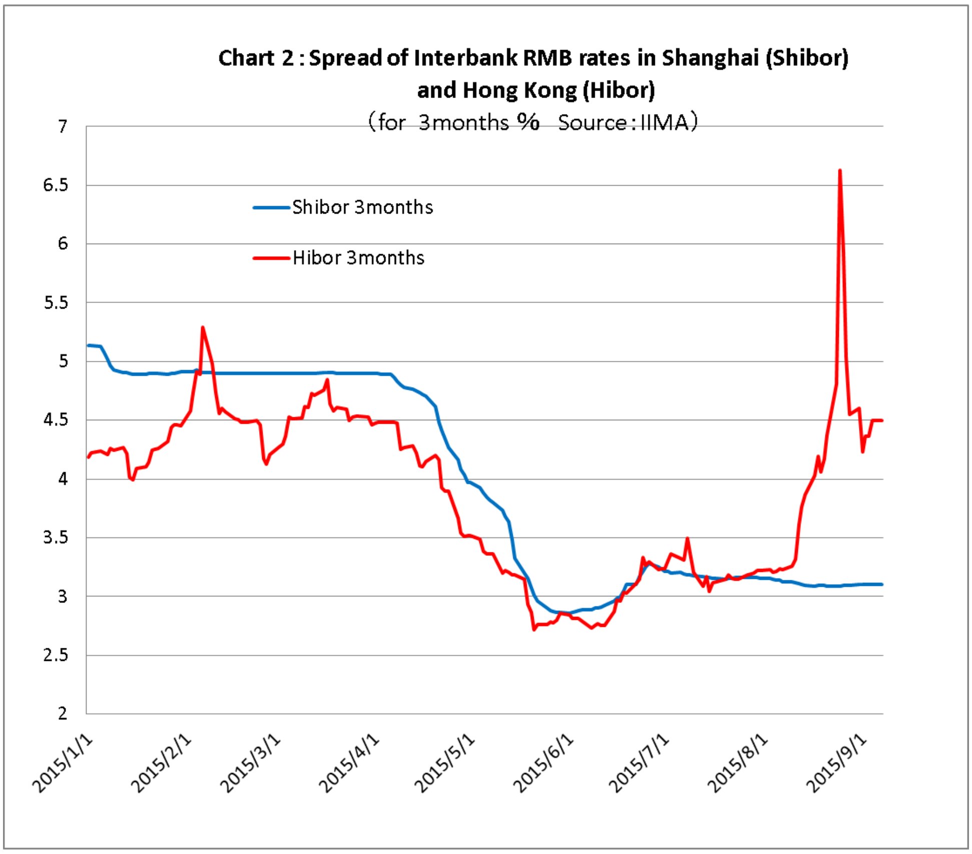
(2) Reforms aimed at liberalization of interest rates

Since 2014, China has been accelerating reforms to liberalize interest rates. They include a lift of the ceiling on the interest rates on small deposits in foreign currency experimented in Shanghai Pilot Free Trade Zone, nationwide liberalization of fluctuation margins of interest rates on small deposits in foreign currency, gradual raise and ultimate abolishment

2 http://www.imf.org/external/spring/2015/imfc/statement/eng/chn.pdf

of the ceiling on interest rates on the RMB deposits, improved valuation method of market interest rates, accelerated issuing and transaction of certificate of deposits, etc.

The report illustrated, as a successful effort of reform of domestic interest rates, a narrowing of the interest rate spreads between Shanghai market (Shibor) and Hong Kong Offshore market (Hibor) from 2.5% in April 2014 to 0.51% a year later, with an increased co-relationship between the two markets. However, this judgment was a bit too premature. Following the depreciation of the RMB on August 11, the interest spread momentarily expanded to more than 3.5% due to market uncertainties, revealing that the problem of international interest spreads is still in place.



（3） Reforms of RMB Foreign Exchange Rates

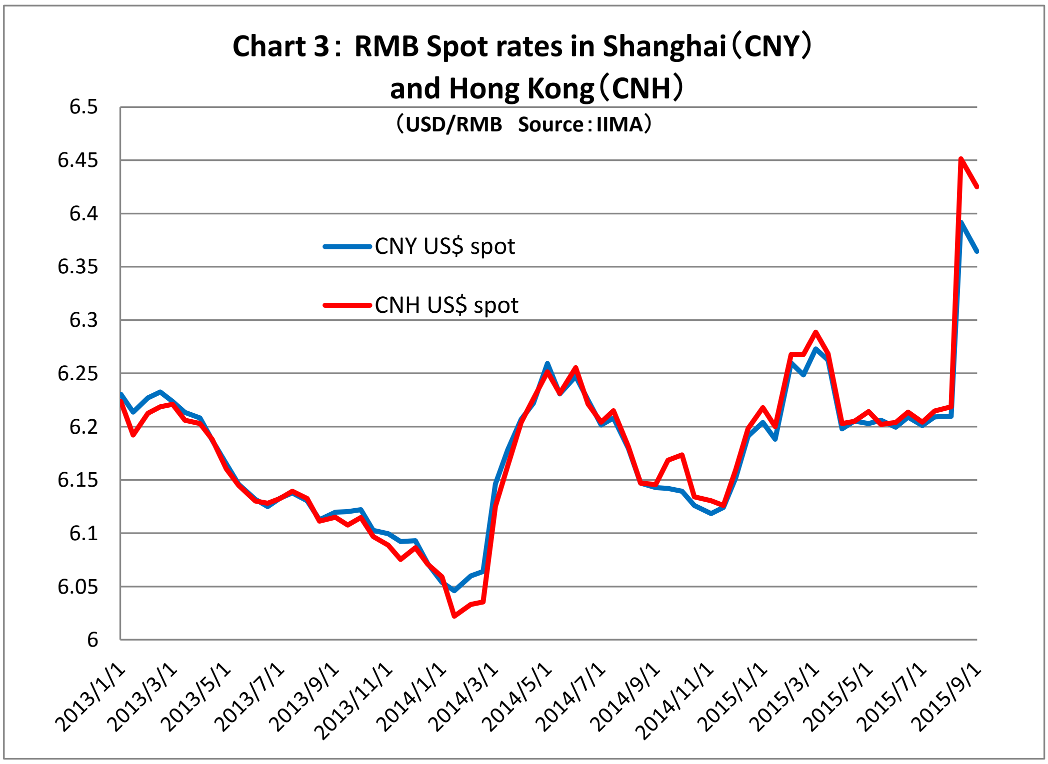
The PBOC has been implementing reforms of its foreign exchange system on the basis of three principles which are “being independent, manageable, and gradual”. In 2014, the bank expanded the margins of the RMB against the dollar from 1% to 2%, abolished the restrictions on the sale-purchase margins for the customer rates of the dollar, and stopped in principle the intervention in the foreign exchange markets at normal times, putting more emphasis on the supply and demand conditions. At the same time it promoted direct transactions in British pound and euro without intermediation of the dollar, and these increased to 4.7% of the total spot exchange transactions in 2014, from 0.5% in ten years ago.

In the ahead, the PBOC is intending to establish a managed floating system based on market conditions of supply and demand, while trying to make reforms toward the market-oriented pricing of the RMB, improve the pricing functions of the market and enhance the flexibility of the margin on the purchase and sale prices.

The report notes that owing to the development of reforms in Shanghai foreign exchange market, there has been an enhanced mutual interaction between domestic markets and offshore markets of the RMB exchange rates against the US dollar, which has reduced the spread between domestic rates (CNY) and offshore rates (CNH) since 2011. Actually at the time of a big turn of exchange rates in September 2011, there was a moment when the spread widened to more than 0.1 yuan between CNY (6.4 yuan to the dollar) and CNH (more than 6.5 yuan), but the spread has been generally within the range of around 0.01 yuan since then.

In August 2015, however, since the PBOC adjusted the official exchange rate cutting by 4% to better reflect market rates, the spread between CNY and CNH began to widely expand again, with the offshore rate of CNH (6.49 yuan) underrunning the CNY (at 6.37 yuan) by 0.12 yuan (about 2%) on September 7 (at the time of this writing)[3]. The PBOC announced that it will restrict the forward arrangements of the RMB, in a backward behavior against the liberalization process.

[3] On September 11, the PBOC intervened to buy the RMB in the offshore markets (possibly Hong Kong) and the spread of the exchange rates between domestic and offshore markets narrowed.



(4) Strengthening the Management System for the RMB "Internationalization"

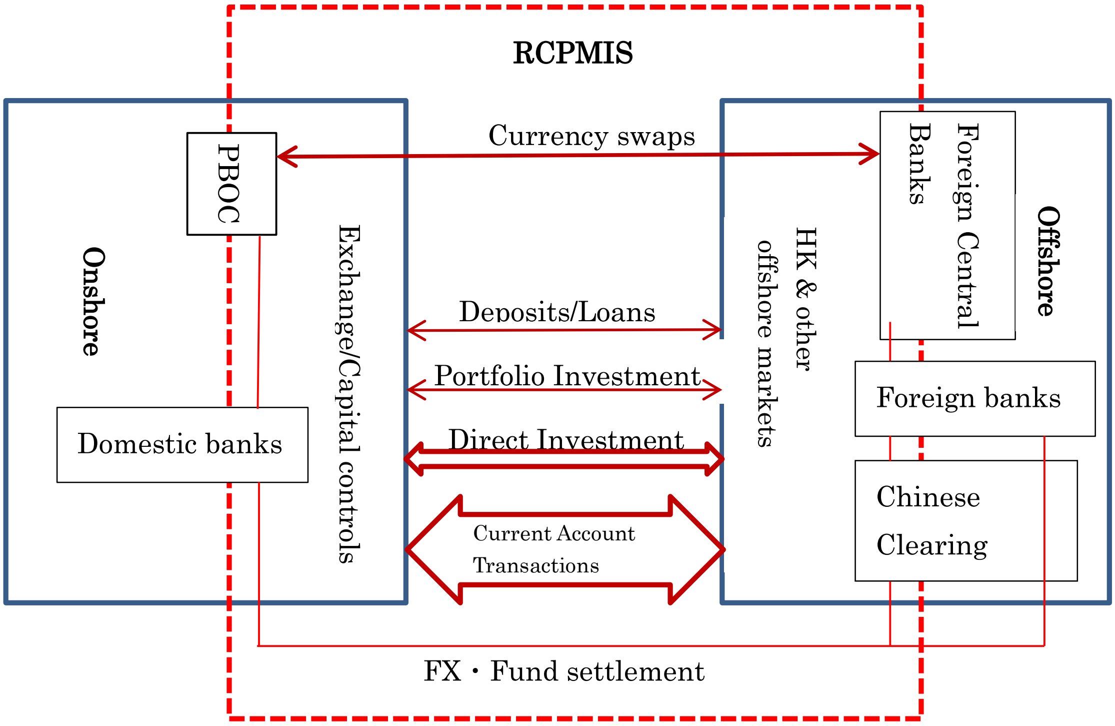
China is strengthening the RMB Cross-border Payment Management Information System (RCPMIS), under which the PBOC collects information for statistical and management purposes through Chinese clearing banks located worldwide. It is rapidly building the China International Payment System (CIPS) to facilitate all the cross-border settlements in RMB (the first stage to be launched in 2015). After the launch of the CIPS, the managed internationalization of the RMB will further proceed as some of foreign banks will be allowed to enter the Shanghai foreign exchange market.

In major countries other than China, it will be hard to conceive of the government to try to capture, almost perfectly and on a nearly real time basis, all the cross-border transactions made in domestic currency. But the Report shows that the internationalization of the RMB has been developing as the author once wrote as follows.

> "The RMB is walking on its way to internationalization under the control of the monetary authorities. The RMB exchange market has been artificially severed into domestic (onshore) and offshore markets, where on the latter market transactions are freely made in principle while access to the former is strictly controlled. This severing policy is monitored and controlled through the RMB Cross-border Payment Management Information System (RCPMIS) and Direct Investment Foreign Exchange Information Management System. In the offshore markets Chinese-affiliated clearing banks play an

important role in management and analysis of the flows of funds. Capital controls will be gradually and selectively reduced but the controls on some transactions including financial derivatives will be retained to the last[4].

Chart 4：Image of Managed Internationalization of the RMB



4. Eligibility of the RMB in the SDR Currency Basket

The SDR is held by the countries worldwide as a reserve currency and used in itself or in exchange for other major currencies like the US dollar for the settlements of inter-governmental transactions. The IMF publishes daily exchange rates of the SDR (for example, US$1=SDR0.712575 on September 8th), and sets its interest rate on holding (equivalent to deposit rate, 0.05% on that day) every week. The exchange rate and interest rate are computed as a weighted average of exchange rates for 4 major currencies and their representative interest rates.

Although not popular among the general public, the SDR is so-to-speak an "ordinary deposit" composed of the dollar, the euro, the pound, and the yen which is put in a "bank" called "the IMF" and into or out of which the governments in the world and international institutions move

[4] "Market Separation Policy for the RMB and Its Managed Internationalization—a Challenge to the International Financial Order" Essay on International Economy and Finance No.2, 2011, Institute for International Monetary Affairs

funds. It is a stable and reliable "money" with less exchange risks and the base for this feeling of safety lies in the currency composition of the SDR and its convenient convertibility to be exchanged into major currencies at any time.

In order to guarantee the value of this world money SDR, the IMF sets out criteria for selecting currencies to compose. The criteria require (i) that the issuing country of the currency has large export values, and (ii) that the currency is freely usable[5]. At the previous review of the SDR in 2010, there was a discussion on the RMB, but its inclusion into the basket was deferred as the RMB meets the first criterion but not the second criterion. At the current process of review, the arguments will focus on whether it is a freely usable currency or not.

The concept of a freely usable currency is based on the practical use of the currency in the international transactions, not on the basis of whether it takes a freely floating regime or whether it has a full convertibility[6]. Therefore, the concept does not necessarily conflict with the managed convertibility that Governor Zhou of the PBOC asserts. The point is (i) whether the RMB is widely used in international transactions, and (ii) whether it is widely traded in major foreign exchange centers and it is important to see whether the exchange rates of the RMB and its interest rates are unambiguously available to and actually accessible by market participants.

As to the use of the RMB in international transactions, there is no room for doubt on its magnitude in the trade settlements. Transactions of general fund remittances, bank deposits and loans and bond issuance are also surely on an increase trend, but there still remains a problem of recognizing these facts that comes from a constraint of international data collection.

A more relevant question here may relate to the status of transactions in the RMB in the major foreign exchange centers, how to determine an exchange rate and interest rate that can be directly linked to the value of the SDR, and the market accessibility. Peterson Institute for International Economics located in the US points out the following problems; that the turnover of the RMB transactions in the markets of London (main), Frankfurt (submain) and New York (submain) on which data the IMF decides the daily exchange rates of the SDR is limited (in two European markets) or nil (in New York); that the levels of exchange rates and interest rates are separated between the domestic market and offshore market; there are problems in the price formation, liquidity and market accessibility of short-term government bonds which should constitute benchmark interest rates[7].

These points are right on target. In the background, as I touched in the previous section, there is an unpredictable process of government-controlled internationalization with foreign exchange,

---

5 Article XXX (f) of the IMF Articles of Agreement defines that "a freely usable currency means a member's currency that the Fund determines (i) is, in fact, widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets."

6 http://www.imf.org/external/np/pp/eng/2010/102610.pdf

7 Peterson Institute for International Economics, RealTime Economic Issues Watch, 'The Chinese Renminbi Is Not a Freely Usable Currency Yet' by Edwin M. Truman, August 7,2015

financial and capital markets separated into domestic and offshore ones, as well as an immature domestic financial market which is under the guidance of the PBOC.

If we adopt the RMB in the SDR basket without facing these problems, the characteristic of SDR itself will be changed. Currently the SDR is composed of the US dollar (41.9%), the euro (37.4%), the British pound (11.3%), and the yen (9.4%). Although the new composition of the currencies with the RMB included is still unknown, it is highly likely that the RMB will take a position after the dollar and the euro. The value of the SDR will become more unstable and its move will become uncertain and unpredictable. With the inclusion of the RMB which has so far taken foreign exchange regime that is close to dollar pegging[8], it is also likely that the weight of the dollar in the SDR will be actually increased.

The access to the money and financial assets in the domestic market of the RMB which will become a core of the SDR will be controlled by the government's discretion, and their prices (exchange rates, interest rates) will differ in the domestic market and the offshore market. Currently there seems to be little need for the holders, creditors and debtors of the SDR to hedge the SDR against the foreign exchange risks, but if and when the need increases, there is a possibility that they cannot secure a sufficient hedging.

8 In the IMF Country Report No. 15/234, August 2015), the IMF recommends China to move to an effectively floating exchange regime within a few years, arguing that the pegging system has had a significant adverse effect on the Chinese economy.

Table 1：Internationalization of the Chinese Yuan[9]

Functions	Private transactions			Official transactions		
		RMB	JPY		RMB	JPY
Unit of account	Trade contract	20 % of merchandise	Ex. 35% Im. 23%	SDR Basket	Requesting the IMF for inclusion	9.4%
Means of payment	Turnovers in FX markets	Share 1.1%	Share 11.5%	Freely usable currency	Under discussion	Acknowledged by the IMF
	Settlement through SWIFT	Share 1.0%	Share 3.3%	Intervention in the third country	Hong Kong	With many records
Means of storage	X-border debts	USD710 bil	USD774.8bil	FX reserves	Share 1%	Share 4.2%
	Internt'l bonds	Share 0.6%	Share 2.0%	Official foreign currency assets	USD 71.9 bil.	USD 225.6 bil

（compiled by the author）

Conclusion

The IMF Executive Board will decide before the yearend, with the majority of more than 70% of voting powers, the composition of the SDR currency basket and their weights to be applied for the next 5 years and to be implemented in September in 2016. The outturn of the discussion remains uncertain but several European countries including Germany and the UK have expressed their support to China and it is reported that voices favorable to the inclusion of the RMB in the SDR basket were dominant at the G20 meeting of finance ministers and central bankers held in Ankara in September[10]. On the other hand, the United States and Japan were reported to have shown cautious stance[11]. It is widely known that Madame Lagarde, Managing

[9] Sources and years of reference for each item are as follows:
Trade contract currency : for the RMB, "RMB Internationalization Report, 2014, and for the yen, Ministry of Finance, 1H of 2015
Foreign Exchange turnover: Source; BIS, Survey of 2013
SWIFT international settlements : Source; IMF, July 2015 "Review of the Method of the Valuation of the SDR" 2014Q2-2015Q1
X-border debts : Source: for the RMB, "RMB Internationalization Report" April 2015; for the yen BIS "LBS", March 2015
International bond outstanding：Source "Review of the Method of the Valuation of the SDR", 2015Q1
Foreign exchange reserves : Source: for the RMB "RMB Internationalization Report" April 2015, for the yen "Review of the Method of the Valuation of the SDR": 2015Q1
Official foreign currency assets：Source "Review of the Method of the Valuation of the SDR", 2014

[10] FAZ electronic version, "G20-Treffen Der Yuan auf dem Weg zur Welt-Reservewährung" , September 5, 2015

[11] Reuters, "Focus: Split between US-Japan and Europe over the inclusion of the RMB to the SDR" April 3, 2015

Director of the IMF, had stated that the inclusion of the RMB "is not a question of if, it's a question of when".

As far as looking at the objective fodders, it is difficult to conclude that the RMB is "a freely usable currency" that is similar to the current component currencies of the SDR. The result will become clear soon on whether the IMF Executive Board will make a compromise with China's assertion and admit the inclusion of the RMB on a political judgment, or it will maintain the rules of law.

References：

People's Bank of China; Report of the RMB Internationalization 2015), June 2015

Miura, Yusuke; "Progress of the RMB Internationalization and challenges; Summary of issues on the Inclusion of the RMB in the SDR Currency Basket", Mizuho Insight, Mizuho Research Institute, July 24, 2015

Murase, Tetsuji; "Market Separation Policy for the RMB and Its Managed Internationalization—a Challenge to the International Financial Order" Essay on International Economy and Finance, No.2, 2011, Institute for International Monetary Affairs

Murase, Tetsuji; Managed Convertibility of the RMB and its Way to the SDR", Newsletter No. 19, 2015, Institute for International Monetary Affairs

International Monetary Fund; "Review of the Method of the Valuation of the SDR --- Initial Considerations", August 3, 2015, http://www.imf.org/external/pp/ppindex.aspx

Address: 3-2, Nihombashi Hongokucho 1-Chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3245-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp　URL: http://www.iima.or.jp