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Internationalisation of Chinese currency

China, a large importer of Iranian oil, is likely to use its petro-yuan to bypass payment in dollars. This may offer India a possible solution

The internationalisation of the Chinese currency, the renminbi (RMB), has been one of the key objectives of Chinese economic reform. Progress was steady up until August 2015 when a cumulative 3 per cent devaluation, as part of exchange rate reform, roiled the financial and the stock markets and triggered capital flight. This led to a reversal, at least temporarily, of current account convertibility, re-imposition of some controls on capital flows, including repatriation of profits and restricting overseas direct investment (ODI) by Chinese conglomerates. These measures also had a dampening impact on the offshore RMB market, both in RMB-denominated bank deposits held abroad and in the issuance of RMB-denominated bonds in offshore financial markets such as Hong Kong and Singapore. For example, foreign holdings of Chinese currencies and deposits declined from a figure of over \$500 billion in 2014 to \$300 billion in 2016. The use of the RMB in settlement of China's foreign trade also declined from a high of 25 per cent of total trade volume to a low of 12.5 per cent in 2016 and has recovered to only 14.6 per cent by April 2018. Exchange rate reform has also been stalled. The August 2015 reform had linked the exchange rate to two variables — one, tracking the value of 13 major currencies on a weighted basis, with the dollar as its largest component(26 per cent), followed by the euro (21 per cent) and the Japanese yen (15 per cent); two, the closing rate of the previous day. Each variable would have a weight of 50 per cent. This limited exchange rate variability was later constrained by the introduction, in May 2017, of a third "counter-cyclical adjustment factor", which means that the central bank will intervene whenever deemed necessary in case of market volatility. The market-determined exchange rate for the RMB is not on the cards. The ongoing trade war with the US may also have a dampening impact.

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However, the other elements of financial reforms are being put in place step by step and their impact on the global economy will be significant. China is opening up its large bond market, currently estimated at \$9.4 trillion, to foreign institutional investors. In November 2017, President Xi Jinping announced significant liberalisation of China's financial sector. Foreign firms can now own up to 51 per cent of domestic securities, insurance and fund management firms and even this cap will be removed in three years. Hedging by private foreign investors up to the amount of funds they are managing would now be permitted for the first time. Recently, China's Asset Management Association has allowed Fidelity International to launch a fund in the country for Chinese institutional investors, but in collaboration with Chinese banks. The Union Bank of Switzerland is another licensee. It is expected that China will finally open up its banking sector to foreign investment. Currently, foreign banks account for only 1.3 per cent of the total banking assets of \$37 trillion, so the potential is huge.

It may be noted that since 2016, China's onshore stock, bond and foreign exchange markets have been opened to foreign official financial institutions, such as central banks and Sovereign Wealth Funds. One could say that capital account convertibility is available for official entities.

In October 2015, the China International Payments System (CIPS) was introduced to facilitate cross-border transactions in Chinese currency. In phase one, 19 domestic and foreign banks in China were included as direct participants, while there were 176 indirect participants, in 147 countries. An MoU was concluded with SWIFT, the bankers' international messaging service, to allow speedy, efficient and secure orders for payments. The second phase of the CIPS has been implemented in May this year, allowing clearing services across time zones and covering the Americas, Europe, Africa and Asia. There are now 31 direct domestic and foreign participants, 695 indirect participants with 148 countries covered. The establishment of the CIPS has been described as putting in place a highway for the RMB's internationalisation.

China has gradually opened up its securities market to foreign investors through the Shanghai-Hong Kong Stock Connect and later the Shenzhen-Hong Kong Stock Connect. These enable investors in China to invest in shares listed on the Hong Kong stock market and foreign investors to invest, through Hong Kong in Chinese shares listed on the stock markets in Shanghai and Shenzhen, respectively. There is an overall quota and trade is only through designated entities but these restrictions will be lifted gradually. In the meantime, the Shanghai-London Stock Connect is likely to be operationalised before the end of the year, but initially, it will only trade in depository receipts issued by designated entities in both financial centres. However, this will be an important development since quite a large proportion of financing related to China's Belt and Road Initiative(BRI) is raised through the London market. Chinese domestic financial institutions are being encouraged to conduct their overseas financing business for the BRI projects in the RMB.

An important avenue for internationalisation of the Chinese currency has opened up with the setting up of the Shanghai International Energy Exchange in March this year. The exchange has become a platform for trading in oil futures denominated by the RMB. The aim is to leverage China's status as the largest importer of oil to create a petro-yuan market to rival the well-established petro-dollar market. An Asian benchmark is likely to emerge, which could eclipse the existing Brent and WTI (West Texas Index) benchmarks which set oil prices worldwide. Within just a few months the Shanghai exchange already has an impressive daily turnover of \$7 billion. China's own crude oil futures trading activity is being progressively shifted from dollar to yuan. This may be further accelerated as a result of US sanctions against Iran's export of oil. China, which is a large importer of Iranian oil, is likely to use its petro-yuan to bypass payment in dollars. Russia, too, may find it convenient to use this channel. The international use of the RMB will, therefore, expand significantly. As India is a large importer of oil and faces sanctions if it continues to import Iranian oil, this development may offer a possible solution.

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