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DEALING WITH A RESURGENT CHINA

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Third time lucky? China's push to internationalise the renminbi

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Abstract

The internationalization of the RMB has long been an objective of China's policy makers but with mixed results until recently. Since 2022, though, coinciding with Russia's invasion of Ukraine and the further weaponization of the US dollar, the cross-border use of the RMB has edged up both for trade settlements and financing of emerging and developing countries. Instead, its use as investment currency remains stagnant, which should not be surprising given the RMB weakness during the last two years. Moving forward, the question is whether the RMB will manage to become a relevant international currency even if it remains a non-convertible currency. The jury is obviously still out but it is surely a very important question for the future of the international monetary system, as we know it, but also the euro as the second most trade international currency in the world.

Key findings

- The ongoing policy debate on whether the RMB stands as the greatest potential rival to the U.S. dollar is important for the global financial architecture, for the US dollar as reserve currency, but also for the euro as the second largest traded currency in the world.
- China's economic authorities have made several efforts to internationalize the RMB since the 2008 global financial crisis with rather underwhelming progress until recently. Since 2022, coinciding with Russia's invasion of Ukraine and the further weaponization of the US dollar, RMB cross-border settlements have increased for trade and financing, especially with emerging countries. This is even more impressive if one considers that the RMB has been depreciating since January 2023 and economic performance has been underwhelming.
- On a less positive note, the international use of the RMB for investment has remained stagnant and even decreased, both in terms of forex reserves but also foreign investors' presence in China's capital markets.
- Whether China will succeed in this renewed attempt to internationalize the RMB by using its heavy weight among trading nations is hard to tell. Still, it is so far going quite well compared to previous attempts to internationalize the currency. On the one hand, obvious constraints for a full internationalization of the currency remain, especially the absence of full capital account convertibility, hardly in the agenda of policy makers in Beijing. On the other, China's somewhat heterodox approach to internationalizing the currency could be successful given the ongoing weaponization of the dollar. How the USD, the euro or the international monetary system may be further affected by the rise of the RMB is an important policy question that needs to be explored further.

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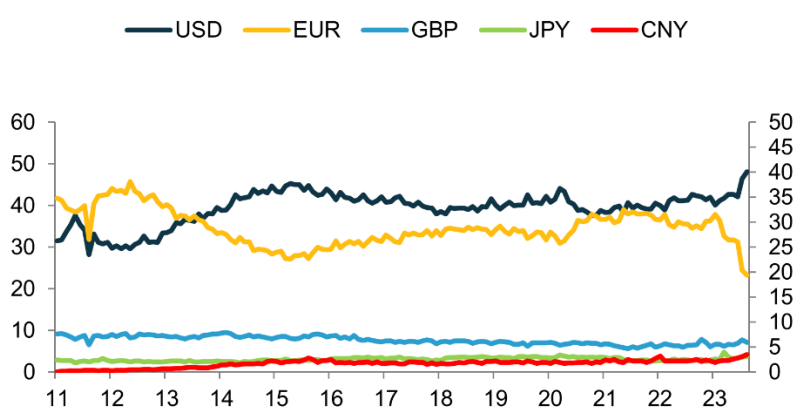
1. Introduction

China is an economic giant not only in terms of manufacturing and exports, but also in terms of the size of its financial sector. China's financial sector is now the largest in the world, with \$60 trillion in assets, equating to 340 percent of China's GDP. Chinese banks also top the list of the largest globally systemic financial institutions, with increasing interrelationships with the rest of the global financial system (García-Herrero, 2021a). However, China's currency, the renminbi is little used internationally, at least when compared with the size of China's economy and financial sector.

There are three main reasons for this. First and foremost, the renminbi is not fully convertible, which means it cannot move freely in and out of China. Second, the legal framework surrounding renminbi payments is uncertain. In particular, investors continue to lack confidence about the rule of law in China. Third, China's financial markets, especially the Treasury market, are less liquid than US markets, and there is no expectation that this will change any time soon (García-Herrero, 2021b).

According to the financial messaging provider Swift, the share of renminbi payments in total cross-border transactions increased somewhat during the first half of 2023, but remains low at 3 percent, compared to 46 percent for the dollar and 24 percent for the euro (Figure 1). The dollar and euro shares have seen the largest movements since the start of 2023, with a significant increase for the former, and a sharp reduction for the latter. It is hard to understand why the euro has suffered the most in terms of international settlements since usage constraints have been placed on the dollar as much as on the euro, if not more. The euro's declining share could, however, be related to the flight to safe assets (essentially, the global reserve currency) at a time of geopolitical uncertainty.

Figure 1: Share in SWIFT Payment by Value

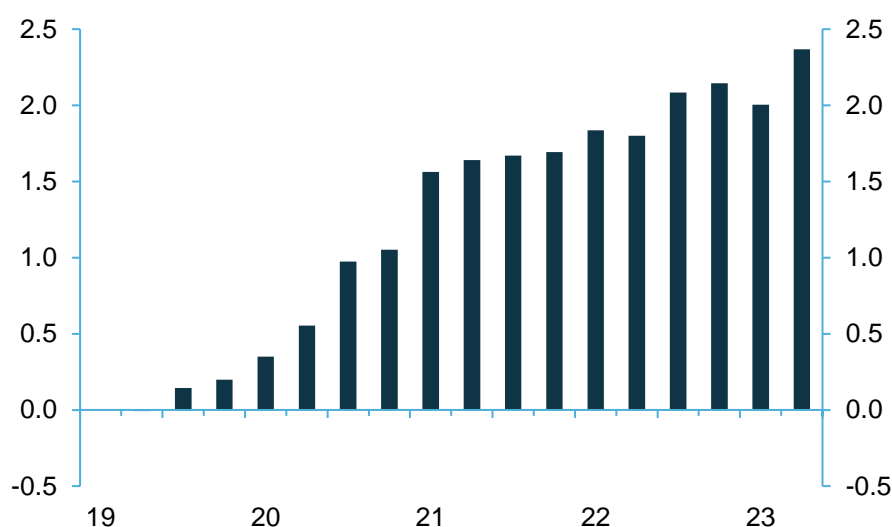


Source: Natixis, SWIFT, Bloomberg. Data as of June 2023

A broader definition of what it takes to become an international currency also includes use of the currency for investment and funding (both public and private). In these respects, the renminbi has become more international since the start of the COVID-19 pandemic (Figure 2, which shows a composite index of internationalisation developed by the People's Bank of

China¹). The process of internationalisation of the renminbi was particularly strong in 2021, as the rest of the world battled with lockdown restrictions while China was relatively free of COVID-19. Even during the much tougher period from early 2022, as the Omicron variant reached China and zero-COVID-19 policies ravaged its economy, renminbi internationalisation continued, though at a much more moderate pace, even receding in the first quarter of 2023 as China opened up after the pandemic. In the second quarter of 2023, though, international use of the renminbi increased rapidly. The increase in the international use of the renminbi was quite balanced across the three functions captured by the index – payments, investment and funding – until recently. Since the end of 2022, investors seem to have lost interest in investing in renminbi, while use in trade and financing remains strong (Figure 3).

Figure 2: RMB Internationalization Index

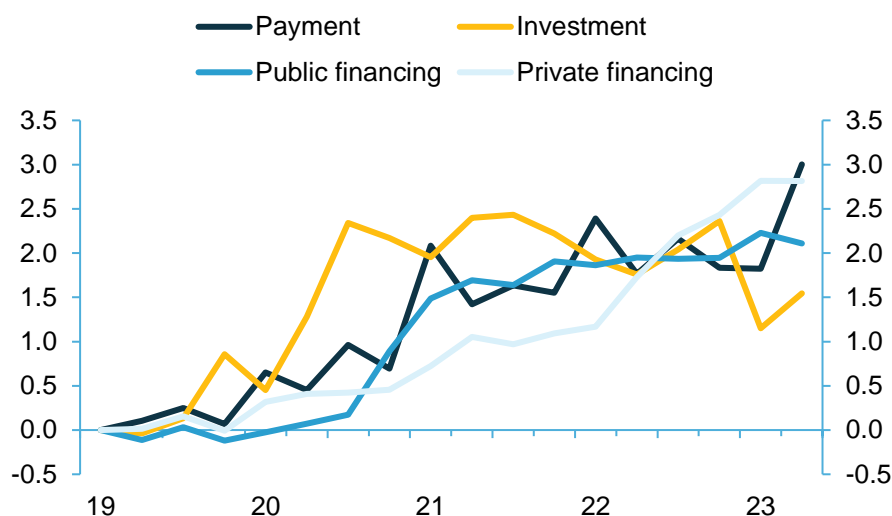


Source: Source: Natixis

Note: Index is composed of different indicators of cross-border use of RMB, such as payments, investment, and funding. Payments focus on trade settlements and investment refers to foreign investors (whether private or public, such as central banks') demand for RMB assets. Financing, from the host perspective, is borrowing in RMB from private markets (loans from Chinese banks or issuing RMB-denominated bonds). Borrowing can also come from the PBoC, though a growing number of swap-lines, which is classified as official borrowing.

¹ <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/5114765/2023102720175126516.pdf>

Figure 3: Natixis RMB Internationalization Sub-Index



Source: Natixis

To gauge the different speeds at which the renminbi is internationalising across the different uses of an international currency, we conducted an empirical analysis of the determinants of the cross-border use of the renminbi (Amighini et al, 2023). The results show that economic factors are certainly relevant in explaining the increasing cross-border use of the renminbi, but these are not alone in driving the international demand for renminbi.

Trade and financial linkages with China are the main drivers of cross-border renminbi payments, but only for countries that participate in China's Belt and Road Initiative (BRI). In particular, alongside trade transactions, receiving loans from China is found to explain to a significant degree bilateral renminbi cross-border transactions. For non-BRI countries, trade relations with China are not significant in explaining bilateral renminbi transactions. Similarly, the extension of renminbi-denominated bilateral swap lines (BSL) by the People's Bank of China and the establishment of RMB clearing houses abroad help explain the increased cross-border use of the renminbi. For non-BRI countries – in the main, developed economies – bilateral swap lines and loans are not significant in fostering the cross-border use of the renminbi. However, QFII schemes and RMB clearing centres do contribute to fostering the use of the renminbi among non-BRI members. In other words, the internationalisation of the RMB does not appear to be a natural process only, but seems steered by economic policy choices.

In the next sections, we analyse China's different attempts to internationalise its currency and how they have fared, with the aim of drawing out some lessons about what has worked best. From this, we highlight some policy considerations on the potential impact of renminbi internationalisation on the international monetary system and Europe.

2. China's attempts to internationalize the RMB

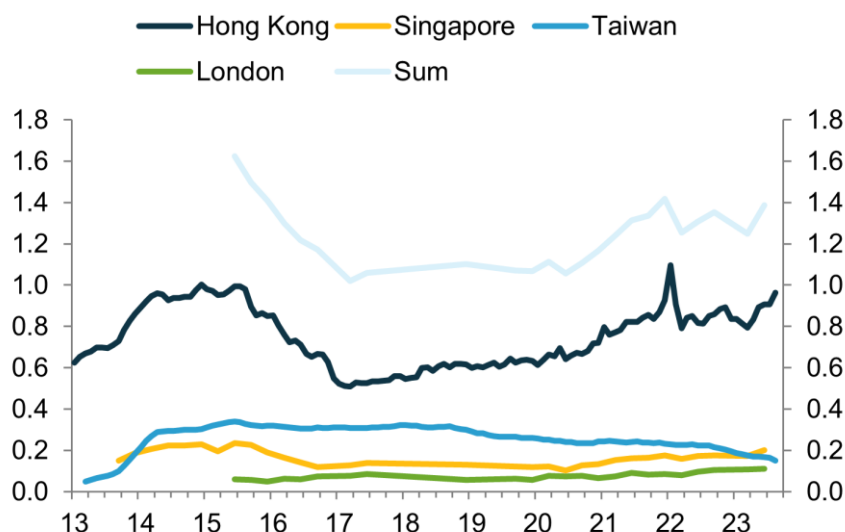
The Chinese government began a wide-ranging process to internationalise the renminbi in the wake of the 2008 global financial crisis. There were two reasons for this response.

- First, there was a sudden loss of confidence in the value of the US dollar, stemming from massive money creation done by the Federal Reserve to mitigate the consequences of the financial crisis on the US financial system and the economy as a whole. Having accumulated significant dollar reserves through large trade surpluses after accession to the World Trade Organisation in 2001, China became wary about the value of its foreign assets, especially since they were mostly concentrated in US Treasuries.
- Second, rapidly vanishing dollar liquidity in global financial markets prompted Chinese policymakers to look for alternatives, not only for China but also for other countries that might run short of foreign currency. None of the swap lines that the Fed extended in 2008 went to China, or even Hong Kong or Southeast Asia, with the exception of Singapore.

The first set of measures to promote the international use of the renminbi were policies allowing cross-border trade settlements in Shanghai and Guangdong in April 2009. Later, offshore renminbi centres were designated, starting with Hong Kong and followed by Singapore and London. Offshore renminbi-denominated deposits (so-called CNH to distinguish it from the onshore renminbi, the CNY) were allowed in these offshore centres. Because of these measures, CNH liabilities, mainly bank deposits, grew rapidly from 2010 to 2015 (Figure 4), especially since those offshore renminbi (CNH) could be used to enter the mainland at a time when there were tight capital controls on the entry of capital and an ever stronger renminbi².

² Offshore renminbi were allowed to enter the mainland through a quota called RQFII (renminbi-denominated qualified foreign institutional investor).

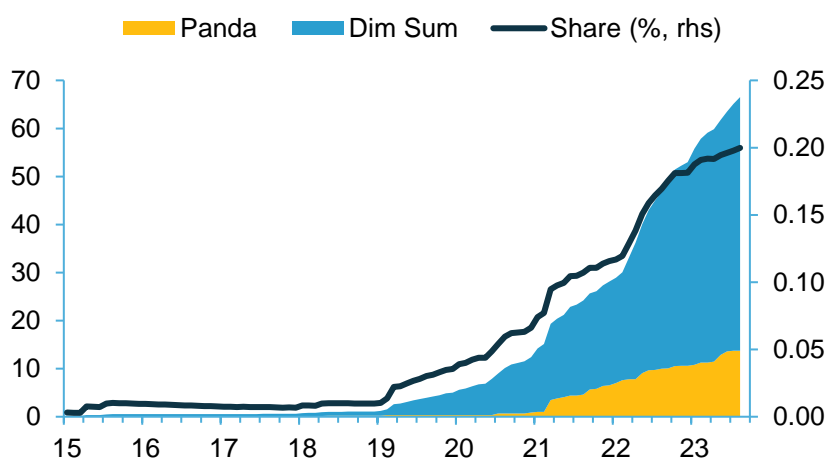
Figure 4: CNH Deposits in Major Offshore Centers (RMB trn)



Source: PBoC, HKMA, CEIC, Natixis. Data as of August 2023.

While CNH deposits kept on growing, peaking at 1 trillion renminbi (\$145 billion) in December 2014, it became clear that it would be much harder to develop a set of CNH assets, whether loans or bonds. For the latter, a new market for renminbi-denominated bonds was created in Hong Kong, on which foreign companies or sovereigns could issue debt. This market, called the dim-sum bond market, has remained underdeveloped until recently (Figure 5). The loan market denominated in renminbi, meanwhile, has never really taken off. The tiny pool of CNH assets was one of the shortcomings of China's first attempt to internationalise the currency, but was not the greatest obstacle. The 2015 stock market crisis and related renminbi devaluation led to the sharp reduction in CNH deposits in Hong Kong and, with it, a setback for the currency internationalisation process that the Chinese authorities had been fostering.

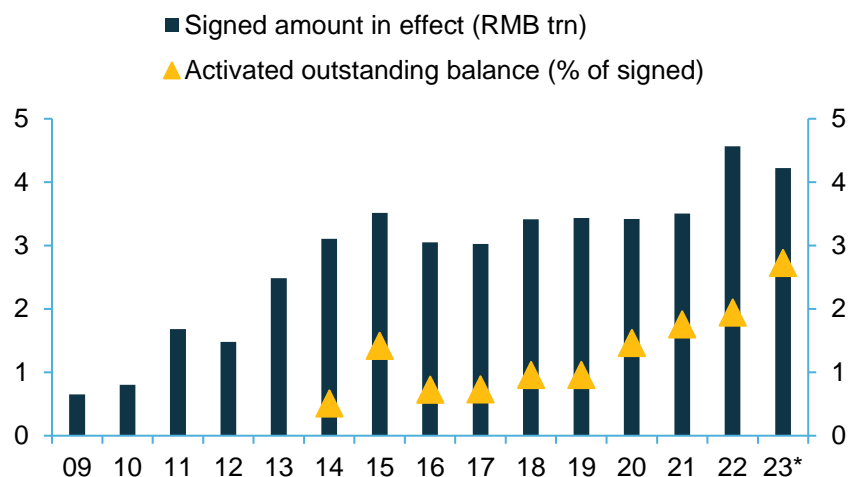
Figure 5: Outstanding RMB Bond Issued by non residents as a share of total bonds issues (USD bn)



Source: Bruegel based on Bloomberg, Natixis. Data as of August 2023. Note: Panda bonds are renminbi-denominated bonds issued in China's mainland by non-residents (sovereign, financial or non-financial institutions). Dim sum bonds are renminbi-denominated bonds issued in Hong Kong by institutions that are not resident on the mainland.

One way to solve the reduction in CNH deposits was for the People's Bank of China to offer a pool of renminbi liquidity to other central banks through swap lines. That pool of liquidity was intended to respond to potential deposit withdrawals in offshore renminbi centres, which is why China signed its first bilateral swap line (BSL) with the Hong Kong Monetary Authority in 2009 (the first official offshore renminbi centre). Since then, the number of countries with BSLs has expanded to 40 (Figure 6).

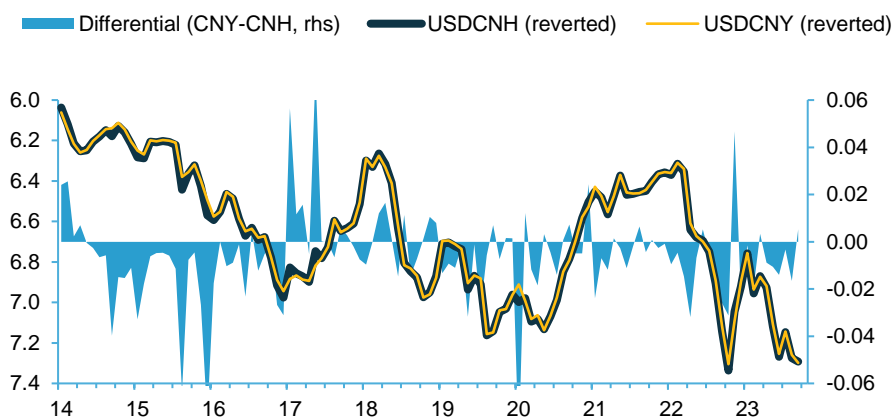
Figure 6: PBoC Bilateral Swap Lines with Foreign Central Banks



Source: PBoC, * Data as of H1 2023.

China's stock market collapse in 2015 and the renminbi devaluation forced China to intervene in the offshore renminbi market to reduce the wedge between the offshore and onshore renminbi exchange at a time when the CNH was considered the best market signal of the future value of the renminbi (Figure 7). After huge capital flows and the loss of as much as \$1 trillion in international reserves, China opted for the introduction of very stringent reserve requirements for CNH deposits (for the lack of a better option as the People's Bank of China could not intervene in the CNH market). All of this meant that offshore renminbi liquidity was frozen. In other words, China decided to give up on the progress made in the cross-border use of the renminbi in favour of domestic financial stability.

Figure 7: RMB Exchange Rate



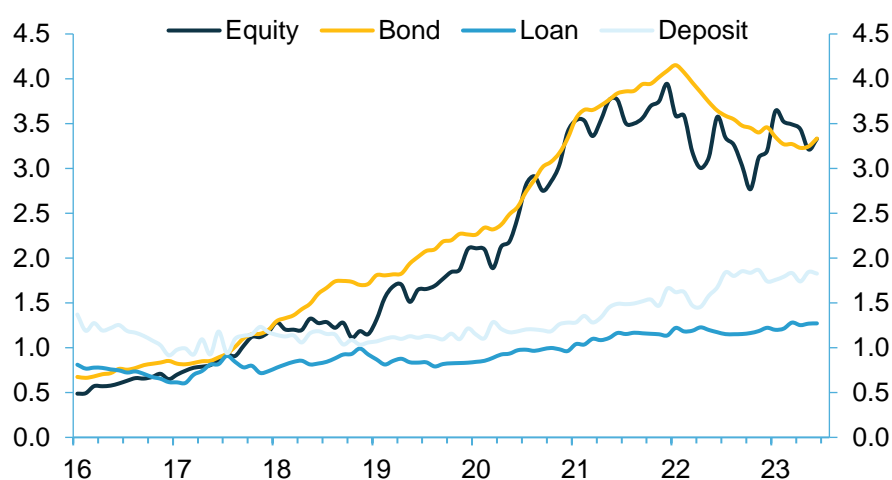
Source: Bloomberg, Data as of September 2023.

Since then, the attempts to promote the international use of the renminbi have changed in nature. The next step was much more official: the entry of the renminbi into the International Monetary Fund's Special Drawing Rights (SDR) basket, where it joined the dollar, the euro, the yen and sterling.

While this move was important symbolically, the SDR share of central banks' foreign exchange reserves is quite small, and even more so the renminbi quota of just 10.9 percent of that basket. Most central banks managed to cover their renminbi needs to comply with the new SDR basket with the renminbi they already had in their reserves. This means that new demand for renminbi has so far has been limited.

Another important step towards increasing the foreign demand for renminbi was to set up additional venues from which to invest in China's financial market. In particular, the Hong Kong-Shanghai Stock Connect³, which started operating in November 2014, aimed to bring foreign investors to China's stock exchanges through the Hong Kong Stock Connect. A similar venue was created for foreign fixed-income investors in 2017, the so-called Stock and Bond Connects. Both are still at very low levels, even compared to Japan (3 percent to 4 percent of domestic renminbi assets for China compared to 9 percent 10 percent for Japan; García-Herrero and Ng, 2020). Furthermore, that share has fallen quite drastically, especially for bonds, since 2022 (Figure 8).

Figure 8: Foreign Holding of Domestic RMB Asset (RMB trn)



Source: CEIC, data as of August 2023.

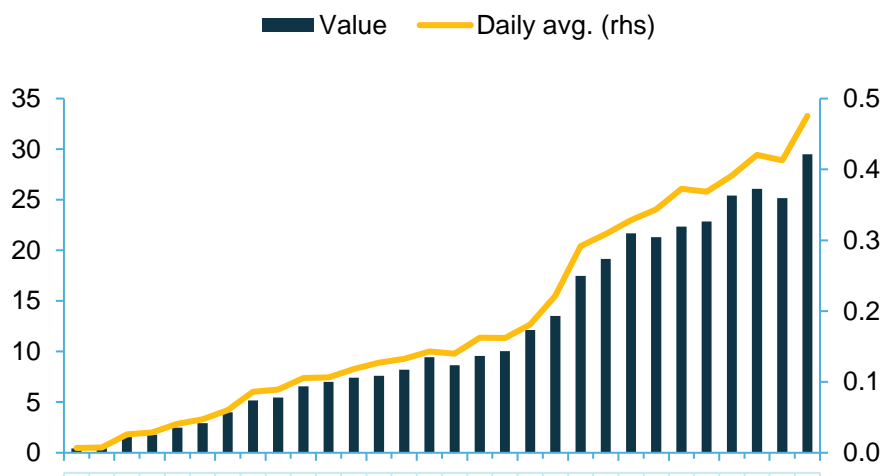
After Donald Trump won the US presidential election in 2016, an additional rationale for expanding the international use of the renminbi arose: diversifying away from dollar assets, and in particular US Treasuries, in light of the measures taken by Trump to contain China, starting with the trade war and followed by export controls on key technologies. Since Trump's election defeat in 2020, the Biden Administration has continued with such containment and has weaponised the dollar by placing restrictions on its use even more than Trump (Eichengreen et al, 2022).

³ See https://www.hkex.com.hk/Mutual-Market/Stock-Connect?sc_lang=en.

Against this backdrop, China's dependence on the dollar, whether for trade or finance, has been identified by China's leaders as a vulnerability. This is why the project of renminbi internationalisation, which had been set aside in favour of more urgent endeavours, has been revived again with a radically different strategy involving the use of China's central bank digital currency (CBDC) beyond its borders. Chinese advancements in the realm of financial technology, together with the rapid adoption of mobile payment applications such as Alipay and WeChat Pay, are expected to facilitate the cross-border acceptance of China's CBDC, thus profiting from a first-mover advantage.

The digital renminbi has been designed, first, to replace the limited physical cash that remains in circulation within the Chinese mainland's borders. But memorandums of understanding have been signed with several central banks, including the Hong Kong Monetary Authority (HKMA), the Bank of Thailand and the Central Bank of the United Arab Emirates, to foster the cross-border use of the digital renminbi in these jurisdictions. In addition, a joint venture has been set up with Swift, which indicates China's aspiration of facilitating the global use of its new digital currency and, possibly, for the renminbi to become a reserve currency one day. Finally, the rapidly increasing use of China's international payment system (Figure 9), especially since Russia's invasion of Ukraine in February 2022, is also helping support the cross-border use of the renminbi.

Figure 9: CIPS Transaction Value (RMB trn)



Source: PBoC, Wind, Data as of Q2 2023.

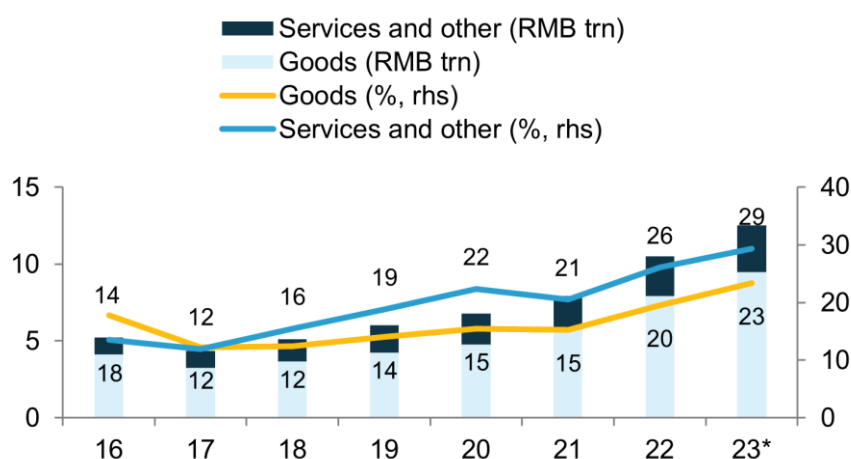
The cross-border use of the digital renminbi suffered a setback from the collapse in movement of people across borders because of the COVID-19 pandemic. In particular, the massive number of Chinese visitors to other parts of the world were expected to have made use of the digital renminbi for international payments, starting with those countries where the People's Bank of China has memorandums of understanding with central banks. The reality has been underwhelming, as the rollout of the digital renminbi has been much more limited than expected, even domestically.

3. The current push for internationalization

A new momentum for the internationalisation of the renminbi has followed on from the Western response to Russia's invasion of Ukraine. The renminbi has offered a route to escape such sanctions, most obviously for Russia, for which a large share of trade – as well as international reserves – is already denominated in renminbi. China has used the opportunity presented by Russia's invasion of Ukraine to step up its efforts to foster the use of renminbi as an alternative currency for international payments, especially trade, and for private and official financing.

Starting with trade, China is pushing the use of renminbi to pay for its imports, on which it is advancing quite fast. Nearly 30 percent of services imports are already denominated in renminbi, while China's trade in goods denominated in renminbi stands at 23 percent, according to China's State Administration of Foreign Reserves (SAFE) (Figure 10).

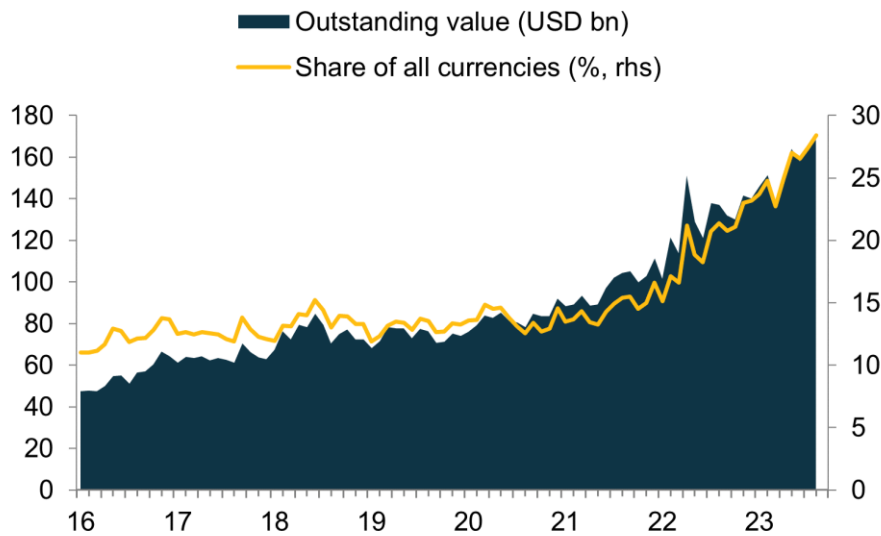
Figure 10: RMB Settlements and Share by Item



Source: Bruegel based on People's Bank of China, SAFE, CEIC. Note: * Trailing 12 months as of June 2023.

The latest phase of renminbi internationalisation has also benefited from elevated US interest rates since 2022. Given the higher costs of borrowing in dollars, many borrowers have turned to the renminbi for financing or refinancing, as shown by the sharp rise in the renminbi's share of Chinese banks' overseas loans and outstanding offshore bonds (Figure 11). Moreover, shocked by the Fed's aggressive hikes and the continued tightening of dollar liquidity, the long-idle renminbi swap lines, which the People's Bank of China had extended to the monetary authorities of 40 countries, have started to be withdrawn by those with dwindling foreign-exchange reserves (Figure 3).

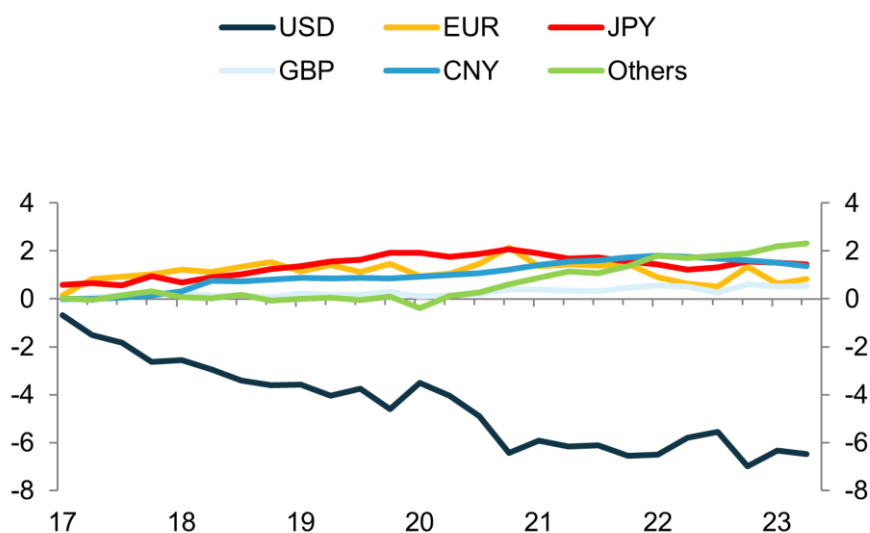
Figure 11: Overseas RMB Loans from Chinese Financial Institutions



Source: Source: People's Bank of China.

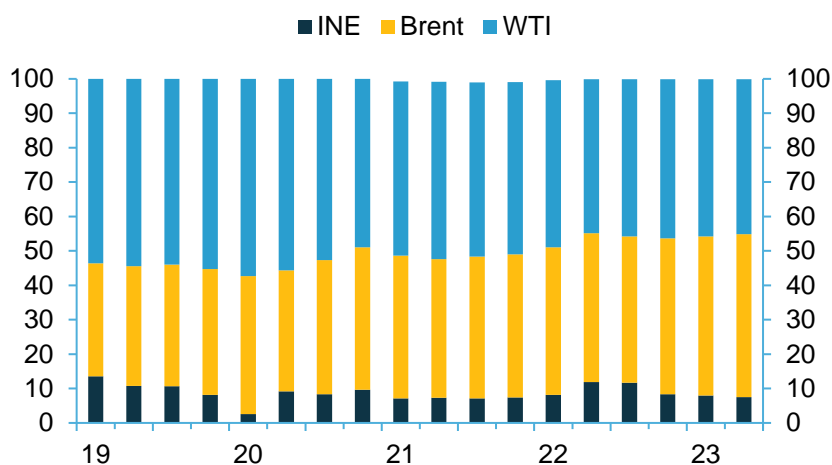
However, there are also areas in which the international use of renminbi remains stagnant or is even decreasing. This is mostly the case for investment, whether private or official (see Figures 12 and 8). However, there does not seem to be a significant increase in the share of oil transactions in renminbi (Figure 13), which is somewhat surprising as China is the world's largest oil importer and has specific arrangements for renminbi settlements with major exporters (from Russia to Saudi Arabia).

Figure 12: Change in Share of Global Allocated Reserves (ppt. vs Q4 2016)



Source: IMF COFER. Data as of June 2023.

Figure 13: Shanghai INE Crude Futures Turnover as a Share of Global Benchmarks (%)



Source: INE, ICE, NYMEX.

Note: Shanghai INE is the Shanghai International Energy Exchange. WTI is West Texas Intermediate, the North American benchmark.

4. Implications for the rest of the world

Notwithstanding China's multiple attempts to achieve renminbi internationalisation since the 2008 global financial crisis, global settlements in renminbi have remained underwhelming until recently. The fast increase in renminbi cross-border transactions started in 2022, after Russia's invasion of Ukraine, for two main reasons. First, China has taken a more pragmatic approach towards renminbi internationalisation which relies on its trade and financing strengths, especially in relation to countries of the Global South. The second reason is the increase in restrictions put on use of the dollar by the US. More generally, a de-dollarisation narrative is now embedded in the new alliances that China has been pursuing, including the BRICS+ and the Belt and Road Initiative.

While the renminbi does not possess all of the key characteristics for a currency to become a global reserve currency, such as an open capital account, China is encouraging countries to create – or use – the necessary infrastructure to facilitate settlement in renminbi, from renminbi regional hubs to swap lines between the People's Bank of China and other central banks. At a time when the renminbi is under severe depreciating pressure, notwithstanding the post-pandemic reopening of the Chinese economy, this strategy should be more effective than promoting the development of offshore renminbi centres, as was the case from 2010 to 2015, or the cross-border use of the digital renminbi at a time when the Chinese are travelling little overseas, at least compared to the pre-pandemic period.

Beyond the potential long-term race between the dollar and the renminbi, it is important to discuss how the renminbi may affect the role of the euro as the second most-traded currency after the dollar. First, it might be easier for China to overtake the euro than the dollar, since euro markets are not as liquid – or as integrated – as dollar markets. Furthermore, the

contribution of the euro area to global growth is shrinking faster than that of the US economy. This is partly because use of the euro has been restricted as much as the dollar, given the coordinated response in terms of sanctions to Russia's invasion of Ukraine. The very rapid fall in euro cross-border settlements based on Swift data (Figure 1) points to this possibility, although it is too early to tell.

Beyond the euro, the use of the renminbi to fund emerging economies, either through official funding such as bilateral swap lines, or renminbi-denominated lending, may have implications for the functioning of the international monetary system. This would be even more the case if China were to push an Asian Monetary Fund, as the Japanese government did after the Asian financial crisis, and Malaysia's prime minister Anwar Ibrahim has proposed⁴. The renminbi could, over time, become the currency of reference for the Asian Monetary Fund, were it to be created.

⁴ Shankaran Nambiar, 'Malaysia's Anwar seeks Asian Monetary Fund and "dedollarisation"', *The Interpreter*, 10 May 2023, <https://www.lowyinstitute.org/the-interpreter/malaysia-s-anwar-seeks-asian-monetary-fund-dedollarisation>.

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Appendix

RMB Internationalization index and its components

Theme	Measure	Function				Coverage	
		Medium of exchange	Unit of account	Store of value	Standard of deferred payment	Cross-border	Offshore
Payments	RMB % of SWIFT international payments	√					√
	RMB % of China's cross-border transaction via bank	√				√	
Investment	Foreign holding % of RMB financial assets			√		√	
	RMB % of global interest rate derivatives transaction				√		√
Public financing	RMB % of global allocated reserves			√			√
	Activated balance % of total BSL				√	√	
Private financing	RMB % of global banks' cross-border claims				√	√	
	RMB % of outstanding foreign-issued bonds				√		√
	RMB % of global trade finance		√		√		√



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