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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 word.

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.

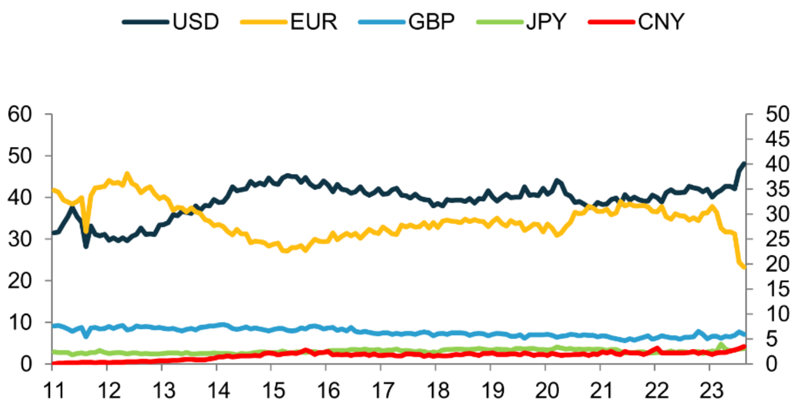
Contents

1. Introduction

China has become an economic giant not only in terms of manufacturing production 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% 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 (Garcia-Herrero, 2021a). At the same time, the Chinese currency, the renminbi (RMB) is hardly used internationally, at least when compared with the size of China's economy and financial sector. There are at least three major reasons for this. First and foremost, the RMB is not fully convertible, which means it cannot move freely in and out of China. Secondly, the legal framework surrounding RMB payments is uncertain. It is true that the US dollar has long been weaponized and increasingly since Ukraine's invasion, but China's rule of law remains a big issue for investors. Thirdly, China's financial markets, especially the Treasury market, are not as liquid as those of the U.S., and there is no expectation that this will be the case any time soon (Garcia-Herrero, 2021b).

As of July 2023, according to Swift, the share of RMB payments has increased somewhat during 2023 but it remains low at 3% of cross-border transactions were settled in RMB, as compared to 46% for the US dollar (USD) and 24% for the euro (Figure 1). The largest movements recently have been in the USD and euro share with a strong increase for the former, and an even sharper reduction for the latter.

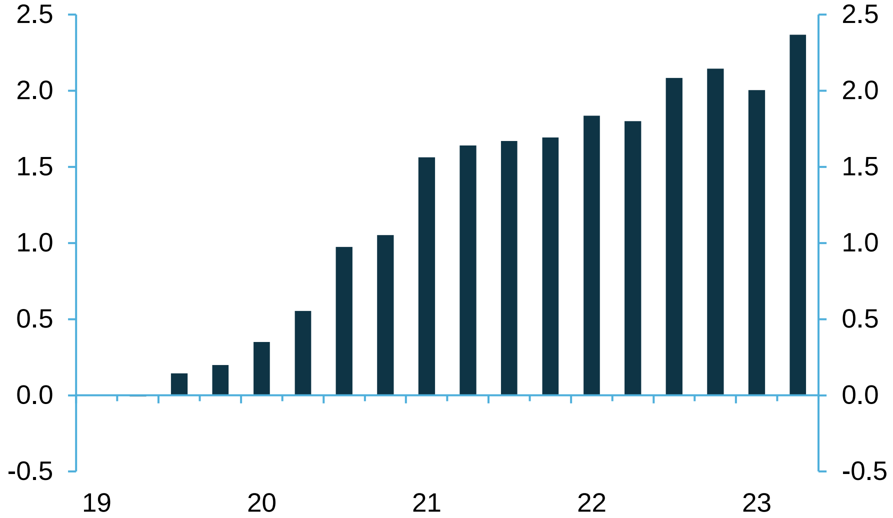
Figure 1: Share in SWIFT Payment by Value



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

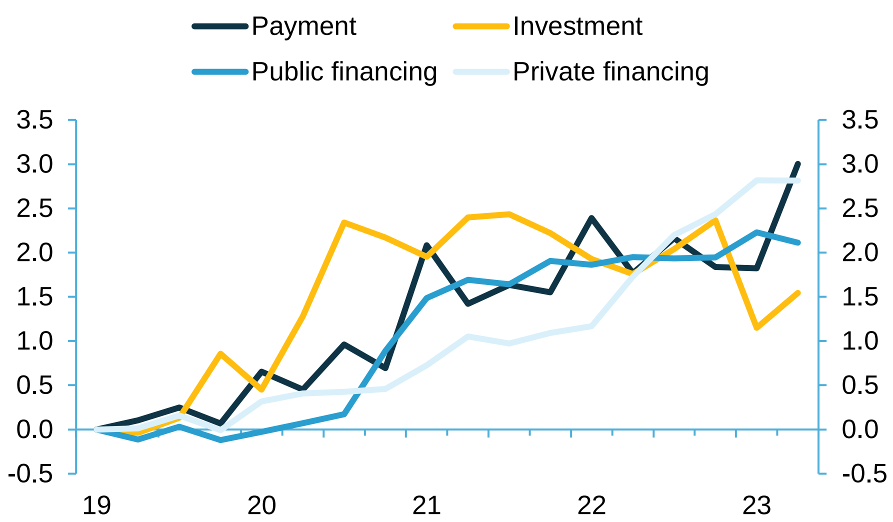
Moving beyond settlements to a much broader definition of what it takes to become an international currency which also includes investment and funding (both public and private), we can see that the RMB has become more international since the pandemic started (Figure 2, which shows a composite index of internationalization and other similar ones developed by the People's Bank of China (PBoC)). The internationalization process was particularly strong in 2021, as the rest of the world was battling with Covid restrictions and China was relatively free from Covid. Even during the much tougher period from early 2022 as Omicron reached China and zero-covid policies ravaged the economy, the process of RMB internationalization did not backtrack although it grew much more moderately, even receding in the first quarter of 2023 as China opened up. The second quarter of 2023, though, has shown a very fast increase in the use of the RMB as shown. The increase in the international use of the RMB has been 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 RMB, while the trade and financing motifs remain 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.

Figure 3: Natixis RMB Internationalization Sub-Index



Source: Natixis

Inspired by the different speeds in which the RMB is internationalizing across the different uses of an international currency, we conducted an empirical analysis of the determinants of the cross-border use of the RMB (Amighini, Garcia-Herrero and Mu, 2023). The results show that economic factors are certainly relevant in explaining the increasing cross-border use of RMB, but they are not alone in driving the international demand for RMB. Among the former, trade and financial linkages with China are key drivers for cross-border RMB payments, but only for members of the Belt ad Road Initiative. In particular, besides trade transactions, receiving loans from China is found to significantly explain bilateral RMB cross-border transactions. For non-BRI countries, trade relations with China are not significant in explaining bilateral RMB transactions. Within the BRI group, institutional factors such as the number, or size, of Qualified Foreign Institutional Investors (QFII) schemes, the Bilateral Swap Lines (BSL) agreements and the presence of Clearing houses abroad help explain use of the RMB. For non-BRI countries, which are largely developed ones, bilateral swap lines and loans are not a significant in fostering the cross-border use of the RMB. However, QFII schemes and RMB clearing centers do contribute to fostering the use of the RMB among non-BRI members as well. In other words, the internationalization of the RMB does not appear to be a natural process only but seems steered by economic policy choices.

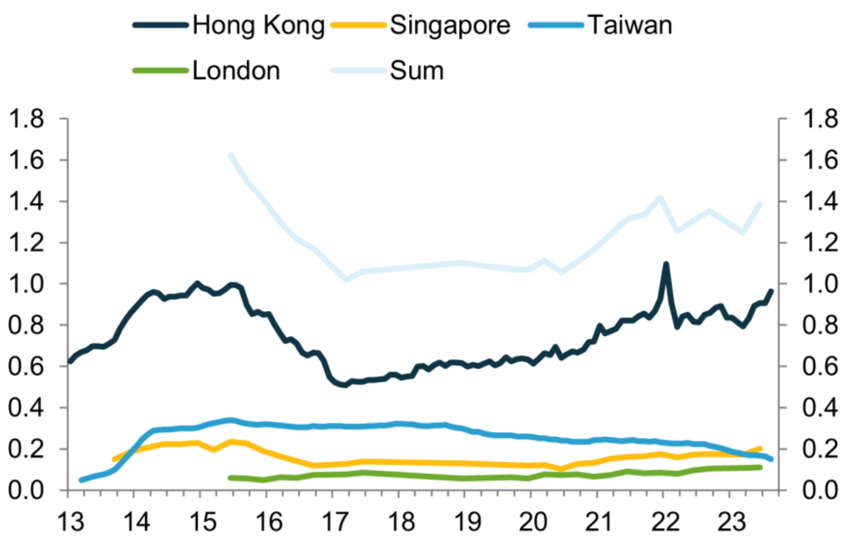
In the next sections, we analyze China's different attempts to internationalize the currency and how they have fared so far, with the aim to draw some lessons on which have worked best. We then zoom into the present situation and draw some policy conclusions on the potential impact on the international monetary system and Europe.

2. China's attempts to internationalize the RMB

The Chinese government began an extensive process to internationalize the RMB in the wake of the 2008 global financial crisis. There were two reasons for such response. Firstly, sudden lack of confidence in the value of the US dollar (USD) stemming from the massive money creation by the Federal Reserve to mitigate the consequences of the financial crisis on the financial system and the economy, as a whole. Having accumulated significant amounts of USD reserves through large trade surpluses after China's accession to the WTO in 2001, China became wary about the value of its foreign assets, especially since they were mostly concentrated in US Treasuries. Secondly, rapidly vanishing USD liquidity in global financial markets prompted Chinese policy makers to look for alternatives, not only for China but also for other countries that might run short of liquidity in foreign currency. None of the swap lines that the Fed extended in 2008 went to China, nor even Hong Kong, or Southeast Asia, except for Singapore.

The first set of measures to promote the international use of the RMB were the policies for cross-border trade settlements in Shanghai and Guangdong in April 2009. Later came the designation of offshore RMB centers (starting with Hong Kong and followed by Singapore and London). Offshore RMB (so-called CNH to distinguish it from the onshore RMB, the CNY)-denominated deposits were allowed in these off-shore centers. Thanks to these measures, CNH liabilities, mainly bank deposits, grew rapidly from 2010 to 2015 (Figure 4), especially since those offshore RMB (CNH) could be used to enter the mainland at a time when there were tight capital controls to the entry of capital and an ever stronger RMB[1].

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

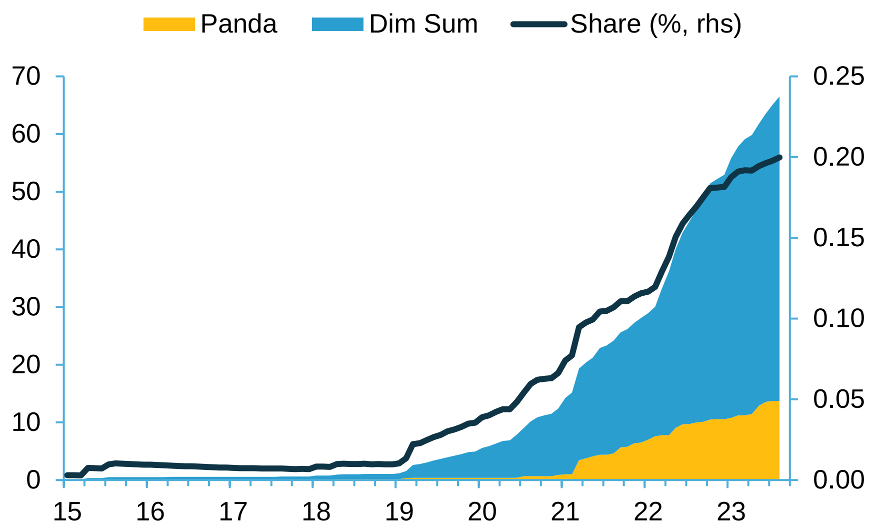


Source: PBoC, HKMA, CEIC, Natixis. Data as of August 2023.

While CNH deposits kept on growing, peaking at RMB 1 trillion (USD 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 RMB-denominated bonds was created in Hong Kong in which foreign companies or sovereign could issue debt. This market, called the dim-sum bond market, has remained underdeveloped until recently (Figure 5) and so was the loan market denominated in RMB, which never really took off. The tiny pool of CNH assets was one of the problems of China's first attempt to internationalize the currency but not the most lethal one. In fact, it was the 2015 stock market crisis, and related RMB devaluation, which led to the sharp reduction of CNH deposits in Hong Kong and, with it, the currency internationalization process that the Chinese authorities had been fostering for years.

[1] Offshore RMB were allowed to enter the Mainland through a quota called RQFII, namely RMB-denominated Qualified Foreign Institutional Investor.

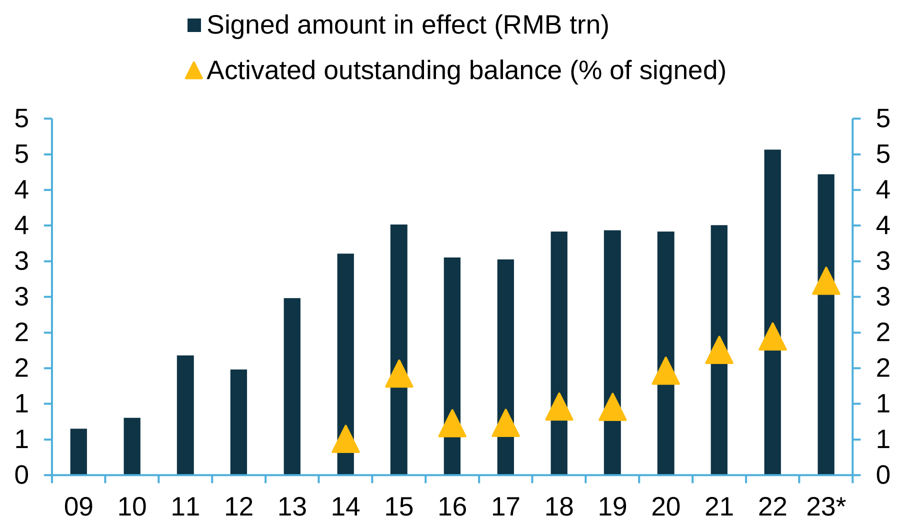
Figure 5: Outstanding RMB Bond Issued by non residents as a share of total bonds issues (USD bn)



Source: Bloomberg, Natixis. Data as of August 2023.

One way to solve that problem was for the PBoC to offer a pool of RMB liquidity to other central banks through swap lines. That pool of liquidity was intended to respond to potential deposit withdrawals in RMB offshore centers, which is why China signed its first bilateral swap line (BSL) with the Hong Kong Monetary Authority in 2009 (the first official offshore RMB center). Since then, BSLs have expanded to 38 as of today (Figure 6).

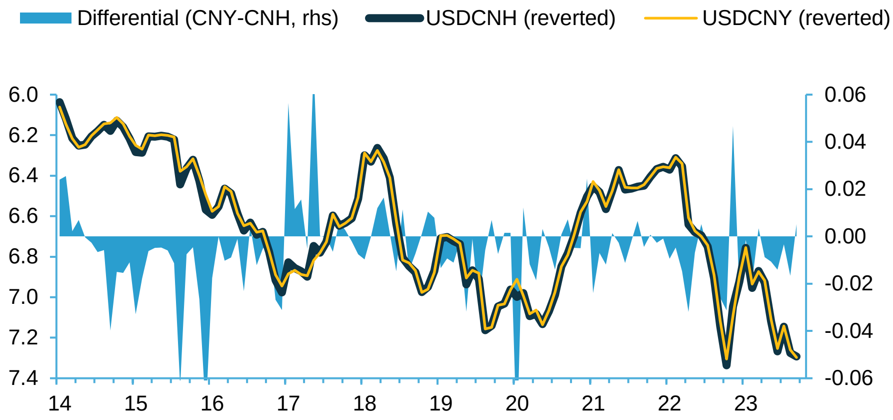
Figure 6: PBoC Bilateral Swap Lines with Foreign Central Banks



Source: PBoC, * Data as of H1 2023.

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

Figure 7: RMB Exchange Rate



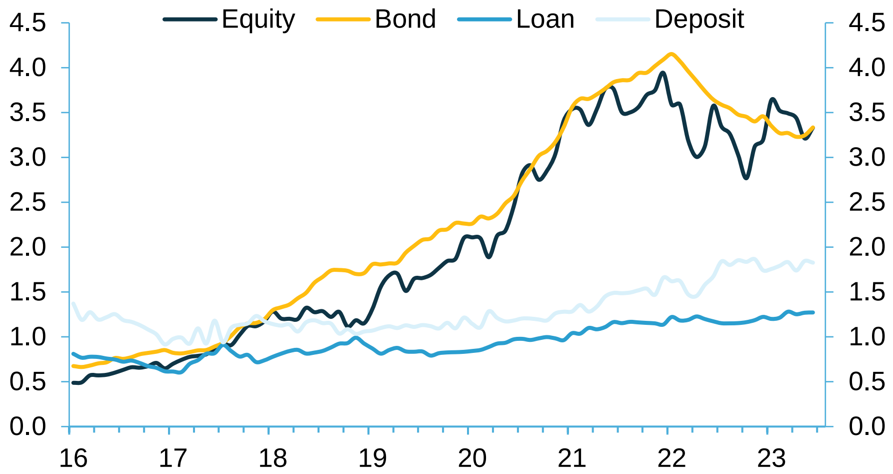
Source: Bloomberg, Data as of September 2023.

Since then, the attempts to promote the international use of the RMB have changed in nature. The next step was much more official, namely the entrance of the RMB in the International Monetary Fund's Special Drawing Rights (SDR)'s basket, together with the US dollar, the euro, the Japanese yen, and the British pound sterling.

While this move had an important symbolism, the SDR share of central banks' forex reserves is quite small, and even more so the RMB quota of just 10.9% of that basket. Most central banks managed to cover their RMB needs to comply with the new SDR basket with the RMB which they had in their reserves. This also meant that the new demand for RMB so far has been limited.

Another important step towards increasing the foreign demand for RMB was to set up additional venues to invest in China's financial market. In particular, the Hong Kong -Shanghai stock connect, which started operating in November 2014, aimed at bringing foreign investors to China's stock exchanges through the Hong Kong stock exchange. A similar venue was created for foreign fixed income investors in 2017, the so-called bond stock connects. Both were still at very low levels even compared with Japan, of the order of 3-4% compared to 9-10% for Japan (Garcia-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)

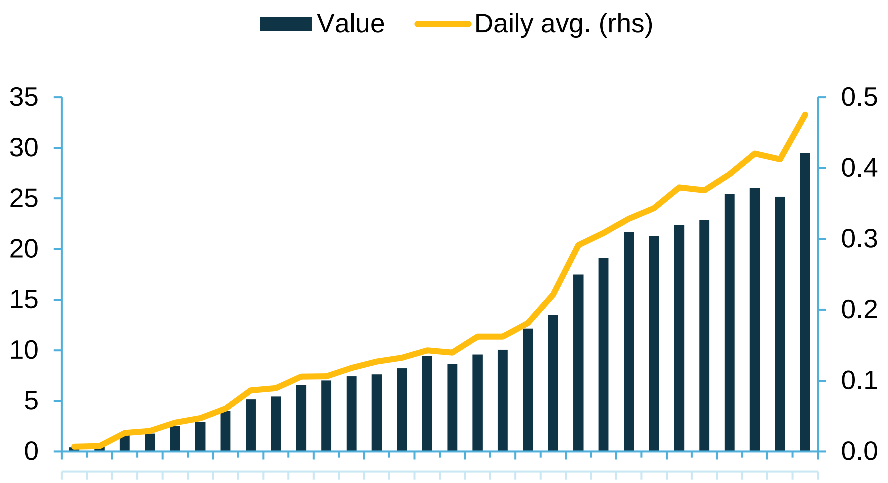


Source: CEIC, Data as of August 2023.

After Trump won the US elections in 2016, an additional rationale for expanding the international use of the RMB arose, namely diversifying away from USD assets, and in particular US Treasuries, in light of the measures taken by Trump to contain China, starting with the trade war, followed by export controls on key technologies. After Trump's election loss in 2020, Biden continued with such containment and weaponized the USD even more than Trump (Eichengreen et al, 2022).

Against this backdrop, China's dependence on the dollar, whether for trade or finance, has been identified as a true Achilles' heel by China's leaders. This is how the project of RMB internationalization, which had been set aside in favor of more urgent endeavors, was revived again with a radically different strategy, namely using China's central bank digital currency (CBDC) beyond its borders. China's achievements in the realm of financial technology, together with the rapid adoption of mobile online transactions such as Alipay and WeChat Pay, were expected to pave the way to the cross-border acceptance of China's CBDC profiting, thereby, from a first mover advantage. At the current stage, the e-CNY is first designed to replace the little physical cash that remains in circulation within the mainland's borders, but it also goes beyond. Memorandums of Understanding (MoU) have been signed with different central banks in the world, starting with the Hong Kong Monetary Authority (HKMA) but also the Bank of Thailand (BOT) and the Central Bank of the United Arab Emirates (CBUAE) to foster the cross-border use of the e-CNY in these jurisdictions. On top of that, a joint venture was set up with SWIFT, which points to China's aspirations to facilitate the global use of its new digital currency and, possibly, have the RMB become a reserve currency one day. Finally, the rapidly increasing use of China's international payment system (CIPS) (Figure 9), especially since Russia's invasion of Ukraine in February 2022, also helps support the cross-border use of the RMB.

Figure 9: CIPS Transaction Value (RMB trn)



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

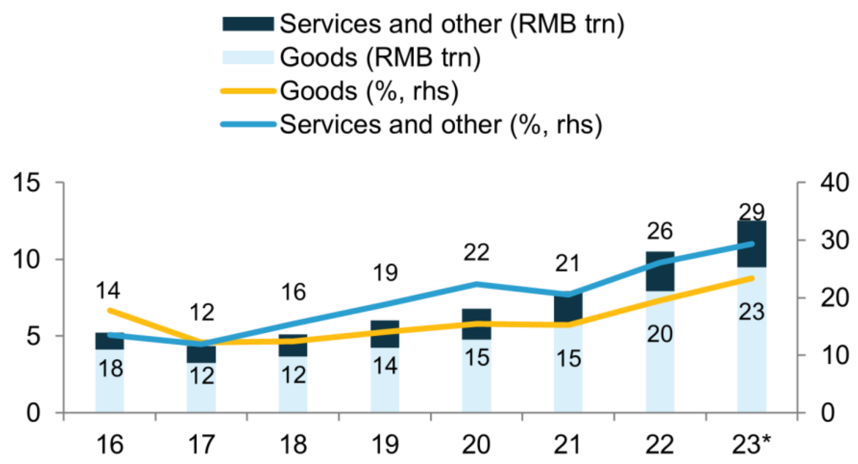
The cross-border use of the E-CNY suffered from the collapse in people-to-people movement across borders due to the Covid 19 pandemics. In particular, the massive number of Chinese visitors to other parts of the world were expected to have made use of E-CNY for international payments, starting with those countries where MoU among the PBoC and their respective central banks had been signed to govern its use. The reality is more underwhelming, as the rollout of the E-CNY is much more limited than expected, even domestically.

3. The current push for internationalization

A new momentum for the internationalization of the RMB has followed the Western response to Russia's invasion of Ukraine. The RMB has offered a venue to escape such sanctions, most obviously for Russia, which has a large share of its trade – as well as international reserves – already denominated in RMB. At the same time, China has used the opportunity to step up its efforts to foster the use of RMB as an alternative currency for international payments, especially trade, but also for private and official financing.

Starting with trade, China is pushing the use of RMB to pay for its imports, which is advancing quite fast. 29% of services imports are already denominated in RMB, while China's trade in goods denominated in RMB stands at 23%, according to China's State Administration of Foreign Reserves (SAFE) (Figure 10).

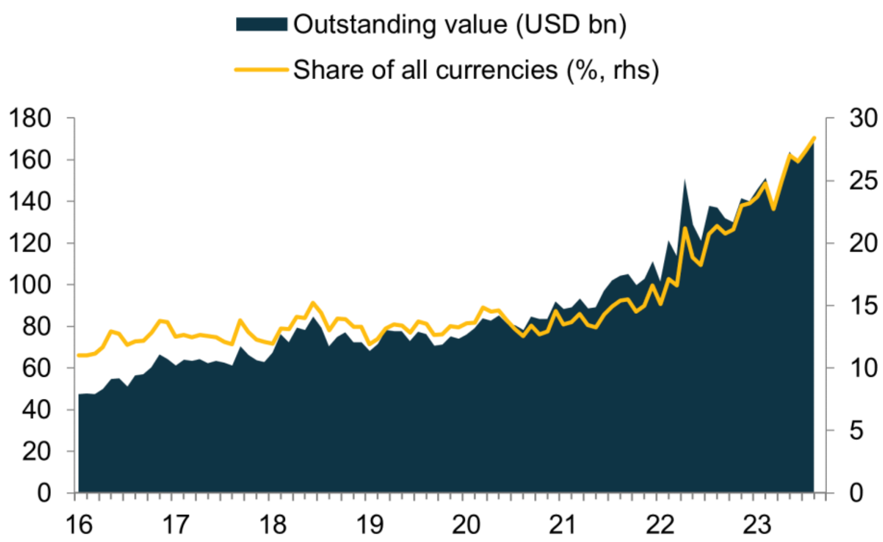
Figure 10: RMB Settlements and Share by Item



Source: PBoC, SAFE, CEIC, * Trailing 12 months as of June 2023.

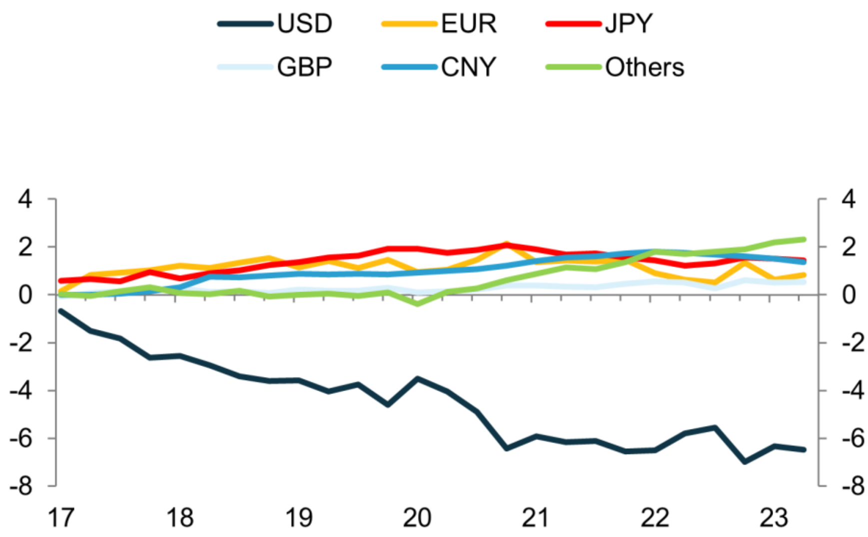
The RMB internationalization has also benefited from elevated US interest rates since 2022. Given the higher borrowing costs of the USD, many debtors have turned to the RMB for financing or refinancing, as shown in the sharp rise of the RMB's share of Chinese banks' overseas loans and the outstanding offshore bonds (Figure 11). Moreover, shocked by the Fed's aggressive hikes and the continued tightening of dollar liquidity, the long-idle RMB swap lines, which the PBoC had extended to the monetary authorities of 25 countries, have started to be withdrawn by those with dwindling forex reserves (Figure 3 above).

Figure 11: Overseas RMB Loans from Chinese Financial Institutions



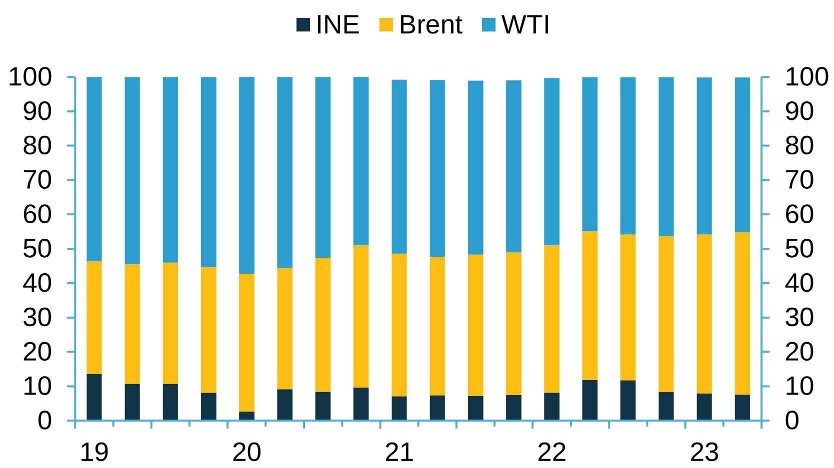
However, there are also areas in which the international use of RMB remains stagnant or is even decreasing. This is mostly the case for investment, whether private or official. As regards private investment of a such as its share in central bank reserves globally (Figure 12) but also the share of foreign investors in China's onshore bond and equity market (Figure 8 above). In the same vein, and somewhat surprisingly, there does not seem to be a relevant increase in the share of oil transactions in RMB (Figure 13).

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.

4. Implications for the rest of the world

Notwithstanding China's multiple attempts to achieve RMB internationalization in the wake of the 2008 global financial crisis, global settlements in RMB has remained rather underwhelming until recently. The fast increase in RMB cross-border transactions started in 2022, after Russia's invasion of Ukraine. There are two main reasons. Firstly, China has introduced a more pragmatic approach towards RMB internationalization which relies on its strengths, namely trade and financing, especially in countries of the Global South. The second is the increasing weaponization of the US dollar. More generally, the anti-dollarization narrative has never been as present as it is now and imbedded in the new alliances that China has been pursuing, such as the BRICS+ but also along the Belt and Road Initiative.

While the RMB does not have some of the key characteristics for a currency to become a global reserve currency, such as an open capital account, China is alluring countries to create – or use- the necessary infrastructure to facilitate RMB settlements, from RMB regional hubs to swap lines between the PBoC and other central banks. At a time in which the RMB is under severe depreciating pressure, both in 2022 but also this year notwithstanding the reopening of the economy, this strategy should be more effective than promoting the development of offshore RMB centers as was the case during the 2010-2015 period or the use of the cross-border use of the E-CNY at a time when Chinese are hardly traveling overseas, at least when compared with the pre-pandemic period.

Beyond the potential long-term race between the USD and the RMB, it seems important to discuss how the RMB may affect the role of the euro as the second most traded currency in the world after the USD. Firstly, it might be easier for China to substitute the euro than the USD since euro markets are not as liquidity – or integrated - as USD ones. Furthermore, the contribution of the euro-zone to global growth is shrinking faster than that of the US economy. This is more so since the euro has been weaponized as much as the USD given the coordinated response, sanctions-wise, to Russia's invasion of Ukraine. The very rapid fall in euro cross-border settlements based on SWIFT data (Figure 1) would point to this possibility, although it is too early to tell.

Beyond the euro, the use of the RMB for funding emerging economies, either through official funding such as bilateral swap lines, or RMB-denominate 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 (AMF), as the Japanese government did after the Asian financial crisis, and Malaysia's prime minister Anwar has proposed this spring. In fact, the RMB could, over time, become the currency of reference for the AMF if it were created.

To conclude, China's renewed push for RMB internationalization since 2021 is proving more successful, at least so far, than previously but there are still major challenges ahead, especially as an investment currency, given the lack of capital account convertibility. Still, the weaponization of the USD and other major reserve currencies, including the euro, is leaving more room for the RMB to grow as international currency in the spheres of trade and financing.

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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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