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HOW CHINA IS BUILDING A GLOBAL CURRENCY

IN CONVERSATION WITH PAOLA SUBACCHI, CHATHAM HOUSE

– THOUGHT LEADERSHIP

APRIL 2017

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In Conversation with Paola Subacchi, Chatham House

Paola Subacchi is director of International Economic Research at the think tank, Chatham House, and is an expert on the functioning and governance of international, financial and monetary systems. She is also the author of 'The People's Money: How China is Building a Global Currency' (Columbia University Press, 2017). In this extract from a talk she gave at Clifford Chance, she discusses the future of the renminbi (RMB).

"In Chinese, renminbi means "the people's money." The policy-driven 'strategy' to internationalise the RMB started in 2009 as a pilot scheme – the RMB cross-border settlement scheme – and only a few details were released at the time. As a result, only a handful of economists and practitioners outside greater China paid much attention. Through this scheme the Chinese authorities tried to encourage companies in the region to use RMB for cross-border trade settlement. It was a very small experiment but with great potential and the timing was important, coming as it did a few months after the global financial crisis.

More than 80 per cent of international trade is invoiced and settled in US dollars, and during the financial crisis there was a shortage of dollars. China, as a major exporter, was at the sharp end. It had moved from a country in deep poverty to become the second largest economy in the world, more or less in the space of a generation. The dollar was the currency that helped China to develop, but by 2009, the government felt that it – and the international monetary system – was too dependent on the dollar. Zhou Xiaochuan, governor of the People's Bank of China, and responsible for the country's monetary policy, said in a speech at the time that what was needed was a supra-national currency. The idea of a supra-national currency was abandoned within a year, but not China's objective to develop the RMB into an international currency.

The internationalisation of the RMB is mainly economic and financial, but is also saddled with political connotations. It reflects China's growing economic importance and its ambition to become a superpower – a great nation with a great currency. It also reveals the constraints and the tension within the Chinese leadership as the country embraces a market economy with "Chinese characteristics" while at the same attempting to keep control. It is incredibly difficult to find a balance between the two because opening up the Chinese domestic market means a series of reforms to ensure financial stability – particularly, that the banking and financial system can withstand capital movements. Because of the constraints on its capital market, and so the RMB's limited convertibility, China's experience of currency internationalisation is in a category of its own, and there is no road map.

The RMB has restricted international circulation and limited convertibility outside designated offshore markets. China is also an "immature creditor" which cannot lend internationally its excess savings in its own currency but has to use another currency. Chinese overseas direct investment is growing, and most of it is in US dollars. Furthermore, due to the policy of managing the exchange rate, over the years the People's Bank of China (PBoC) has accumulated a large amount of foreign exchange reserves – again, mainly dollars. At their peak in September 2014, these were 4.2 trillion

US dollars. It is problematic for a country that still has a significant percentage of its people living in poverty and it is particularly problematic when the dollar falls because China ends up with large reserves that are depreciating. Since late 2014, this trend has reversed and on a number of occasions the PBoC has had to intervene to put a floor to the RMB and so avoid excessive depreciation. As a result, China's foreign exchange reserves have fallen from over 4 trillion US dollars to around 3 trillion US dollars, so one trillion US dollars have been used just to support the value of the currency.

This is suboptimal and China should abandon this system and move to a fully flexible exchange rate. Normal international currencies are fully convertible, which means money can go in and out, of a country. But it is complicated when the domestic market is neither particularly diversified nor particularly liquid, because there can be sudden movements of capital outflows or inflows. Recently, China has restricted outbound foreign investment in a bid to curb outflows, and the government is scrutinising outbound M&A deals worth more than US$10 billion.

The Chinese monetary authorities seem to give priority to stability, and thus control, over flexibility, but this is contradictory, as there is little incentive for traders to keep RMB in their portfolios. Resident investors and savers are not prepared to keep a currency in their portfolios that they can not exchange easily. In order to create a market for the RMB outside mainland China, in 2010 the PBoC started to work very closely with the Hong Kong Monetary Authority to develop the RMB offshore market in Hong Kong. This basically separates the domestic market, maintaining control and then creating a parallel market where residents and foreign investors can hold RMB knowing that there is a liquid market but where capital movements from and to mainland China are controlled.

There is awareness in China about the path followed by Japan to internationalise the yen – a policy-driven process that began in the early 1980s and then stalled during the country's long crisis in the two decades subsequent. In particular, a number of academics and policymakers look at the Plaza accord of 1985, when Japan agreed to strengthen the yen against the dollar, as the turning point for Japan. Parallels can be drawn with the current situation. As tension has risen, with the new US administration accusing China of currency manipulation, (although that is nothing new; currency manipulation has been a bone of contention for the past 12 or 15 years), the Chinese are unlikely to bow to any pressure – even if they will adjust the exchange rate on the margins by introducing more flexibility, as they seem to have done in past years when tension with the US Congress reached boiling point.

This offshore market worked quite well for a while, and between 2010 and 2015 and internationalisation of the RMB moved forward. At the same time, the PBoC introduced a quota system to allow registered foreign investors to access the domestic market. Through this system registered investors can invest in the Chinese domestic market and operate within the limits set by the monetary authorities.

At the end of 2015, the IMF recognised the RMB as a key international currency alongside the US dollar, the euro, sterling and the Japanese yen; and recommended its inclusion in the SDRs basket from October 2016. This was a very symbolic step for China, and completed the first five years of RMB internationalisation.

Where do we go from there? Are we moving into an era of Chinese money? The progress of the RMB has been strong – for example, the share of China's trade being settled in RMB has grown from zero in 2009 to approximately 25 per cent today. The RMB is used and traded regionally, especially in China's neighbouring countries. But there is still a long way to go. I was recently in Zambia and local

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Will the RMB eventually replace the US dollar? I don’t think China wants to create a currency which would replace the dollar. The ambition is to have a much more balanced, more stable, multi-currency international monetary system.

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market traders all wanted to be paid in US dollars or, if dollars were not available, in euros – sterling was accepted grudgingly. There is a great deal of Chinese investment in Zambia and a lot of infrastructure built by Chinese companies, but RMB is not in circulation. As a local market trader told me, "RMB is not serious money."

But there is definitely more Chinese money around. There is an offshore market in London and, in principle, we can buy Chinese RMB-denominated assets on the London market. What we are going to do with that is not clear. China has launched the 'One Belt, One Road' initiative – a 21st century version of the old Silk Road – which aims to boost trade and infrastructure investment between China, Asia, Africa and Europe. It covers 65 countries and six economic corridors accounting for two thirds of the world's population. This could become a good opportunity to channel the RMB in these investments and use the RMB for infrastructure investment. However, there is still the constant political dilemma in China – tension between retaining control and opening up the financial system.

Will the RMB eventually replace the US dollar? I don't think China wants to create a currency which would replace the dollar. The ambition is to have a much more balanced, more stable, multi-currency international monetary system so that people investors and markets can choose what is best for them. Therefore, the objective is for the RMB to become one of the key currencies in the multi-currency international monetary system. However, the internationalisation of the RMB, while an important policy objective, is subordinated to the overall vision for China to move towards a market economy with "Chinese characteristics", where the market is very much tempered and controlled by policy and administrative constraints.

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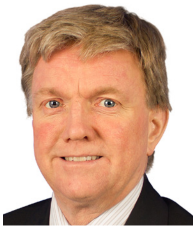

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J20170404171741