RENMINBI - A NEW SETTLEMENT CURRENCY WAS BORN

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While China's weight in international trade and global GDP grew steadily in the past decade as a result of the liberalisation of foreign trade and the rapid economic growth of the country, prior to 2008 the ratio of foreign trade transactions settled in renminbi was negligible due to foreign economic controls. However, encouraging the international use of the Chinese currency, the renminbi[1] or as it often referred to "the renminbi internationalisation" became a priority objective of the Chinese economic policy after the crisis. Foreign economic regulations were gradually eased, and the weight of the renminbi in foreign trade settlements increased rapidly. In parallel with the ongoing liberalisation of the Chinese capital transactions, the exchange rate regime and interest rates, an increasing number of future settlement transactions relating to investments may be carried out in renminbi, and the international role of the renminbi may continue to grow.

This analysis is the first part of a series of articles, presenting a retrospective review of the latest steps in China's trade liberalisation, with special regard to the use of the renminbi in international transactions. Upcoming parts of the series will address the measures taken by international central banks in relation to the renminbi, the exchange rate policy of the People's Bank of China, its currency swap-line agreements with other central banks, and the characteristic features of renminbi centres outside of China.

China carried out several foreign economic policy reforms in the past decades. The liberalisation broadly followed earlier practices of other emerging countries. As a first step, the restrictions on current account settlements were terminated in order to comply with WTO membership requirements in 2001, which was followed by the gradual liberalisation of the capital account. **As a result, China's weight in international trade settlements increased considerably, reaching 10 per cent by 2012, i.e. in less than two decades (Chart 1).**

[1] Renminbi ('the people's money') is the official name of the Chinese currency, whereas the yuan is the unit of the renminbi.

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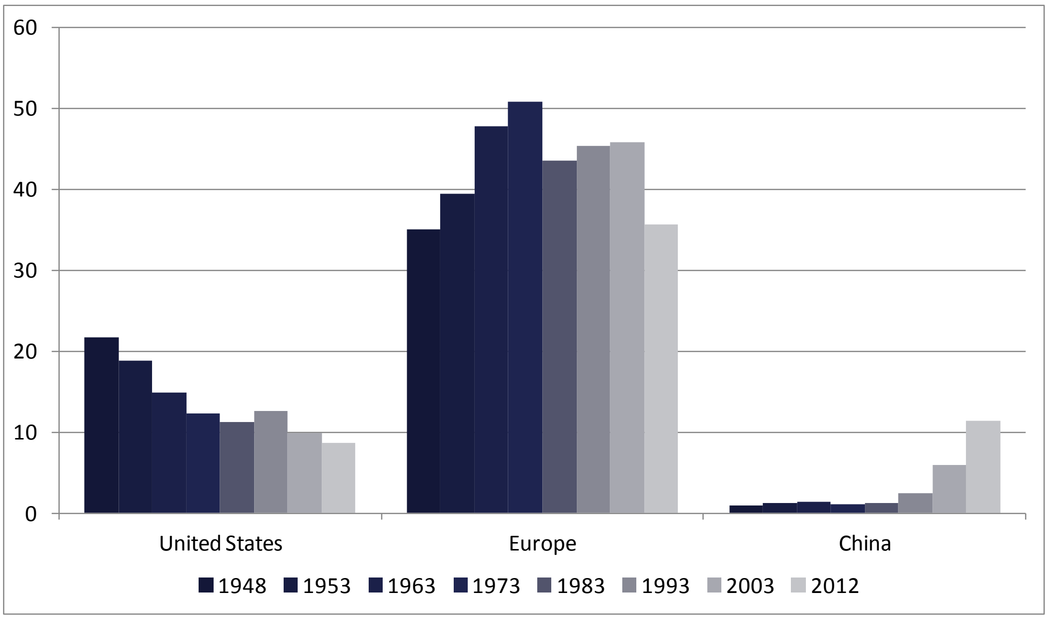
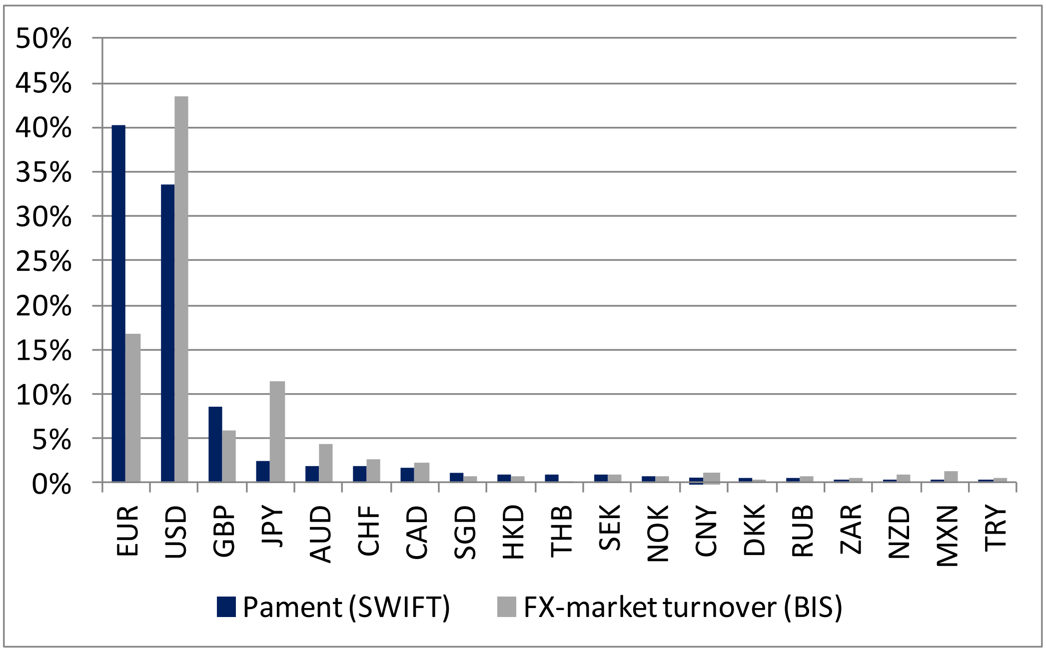
Chart 1: Share in global exports (%)



Source: WTO http://www.wto.org/english/res_e/statis_e/its2013_e/section1_e/i05.xls

In spite of the dynamic expansion in China's foreign trade, the weight of the renminbi in global payment flows and FX market turnover was still only around 1–2 per cent in 2013 (Chart 2), although the increase was very dynamic as a result of the low initial value.

Chart 2: Weight of selected currencies in payment flows and FX market turnover (2013)



Sources: BIS Triennial Central Bank Survey

SWIFT Renminbi Tracker

The liquidity crisis of 2008 was especially damaging Chinese foreign trade settled in USD. Therefore, the Chinese authorities decided to liberalise the use of the renminbi in foreign trade transactions. The extremely high level of renminbi currency reserves was another factor that prompted Chinese policymakers to rethink the international role of the renminbi.

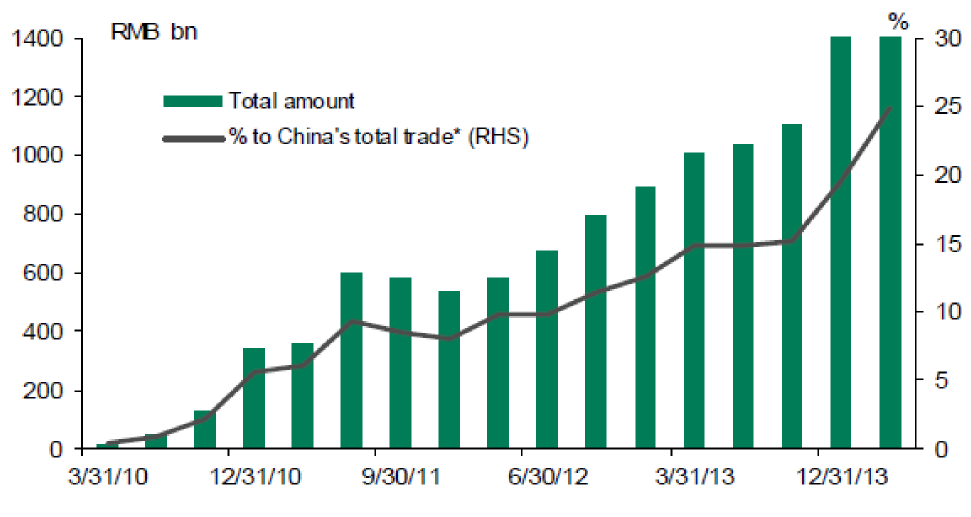
From 2009, restrictions on current account items settled in renminbi were abolished, initially only for transactions between Shanghai and four cities (Guangzhou, Shenzhen, Zhuhai and Dongguan), and between China, Hong Kong, Macau and ASEAN countries. From 2010, the measures were extended to 20 additional Chinese provinces (1: Recent steps in Chinese trade liberalisation). Simultaneously, foreign trade was allowed to be settled directly in renminbi (Cross-border RMB Settlement Scheme), and in 2012 export registration obligations were eliminated.

1: Recent steps in Chinese trade liberalisation

Year	Measures
2009	**Trade Settlement Scheme** (pilot programme: liberalisation of settlement between 5 Mainland Chinese cities and Hong Kong, Macau and ASEAN countries)
2010	**Extension of the Trade Settlement Scheme to 20 Mainland Chinese provinces**
2011	**Cross-border RMB Settlement Scheme** extended to all provinces
2012	**Abolition of export registration obligation**

The volume and weight of Chinese RMB trade settlement expanded significantly inspite of amid unfavourable global business conditions thanks to the liberalisation of cross-border RMB settlement affecting current account items. By the beginning of 2014, the value of trade settled in RMB rose to around 25 per cent within trade settlement. According to data released by the People's Bank of China (PBC Monetary Policy Report Quarter Three, 2014), in the third quarter of 2014 the volume of cross-border renminbi settlements increased by 37 per cent year-on-year, and the value of transactions settled in renminbi reached RMB 1,530 billion (USD 250 billion). 174 countries have executed renminbi payments of all sizes worldwide.

3: Value of Chinese trade and the share of RMB payments*



** The Total value includes all current account items; Chinese trade includes only goods and services*

Source: CEIC, Credit Agricole

According to SWIFT statistics[2], the weight of renminbi payments in the payment flows between France and China, Hong Kong rose to 44 per cent in July 2014 (from 20 per cent two years earlier), followed by the United Kingdom (with a 40 per cent weight in RMB payments value), Luxembourg (23 per cent) and Germany (19 per cent).

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[2] http://www.swift.com/assets/swift_com/documents/products_services/RMB_tracker_Aug2014_SdC.pdf

The increasingly important role of the renminbi is evidenced by the fact that, overtaking the euro, it had become the second most used currency in trade finance by October 2013, claiming a large, 8.66 per cent chunk of world trade finance according to SWIFT's statistics (by comparison, the weight of the renminbi was only 1.89 per cent in 2012).

3. THE LIBERALISATION OF CAPITAL FLOWS WAS GRADUAL AND ASYMMETRIC

Chinese authorities followed the principle of gradualism during the liberalisation of capital flows, from many regards, and they opted for an asymmetric regulatory approach. On the one hand, the liberalisation of inflows preceded the liberalisation of outflows. On the other hand, restrictions on foreign direct investment were lifted earlier than those on portfolio investments. Thirdly, long maturities were preferred to short ones, and institutional investors enjoyed preference over other investors.

Capital account liberalisation, in particular, the growing weight of renminbi settlement in capital account items, may increase the significance of renminbi as a global payment currency even further.

2**:** Recent milestones of capital account liberalisation

Inward flows	
2003	**QFII (Qualified Foreign Institutional Investor) program** allows foreign institutional investors to invest in China (bonds and shares)
2010	**Interbank bond program allows** central banks, offshore clearing banks and Participating Banks to invest RMB raised offshore in Mainland interbank bond market
2010	**Rules formalised to allow approved foreigners to invest RMB raised offshore directly in Mainland firms,** including through the provision of RMB corss-border loans
2011	**RQFII** (RMB – Qualified Foreign Investment Institution) – allows RMB raised offshore to be invested in listed Mainland bonds and equities
2012	**QFII and RQFII quotas expanded** **Rules formalised for onshore non-financial corporations to issue offshore RMB bonds**
2013	**Cross border RMB transactions simplified (cross-border CNY settlements and loans from China)**
Outward flows	
2006	**QDII (Qualified Domestic Institutional Investor)** allows domestic institutions to convert RMB into foreign currency and invest in overseas equities and bonds.
2011	**ODI (Overshore Direct Investment) -** Mainland firms allowed to apply to take RMB offshore for overseas direct investment (ODI) in foreign firms

Sources: Reserve Bank of Australia

3.1. After the inflows of foreign direct investment, outflows were on the rise

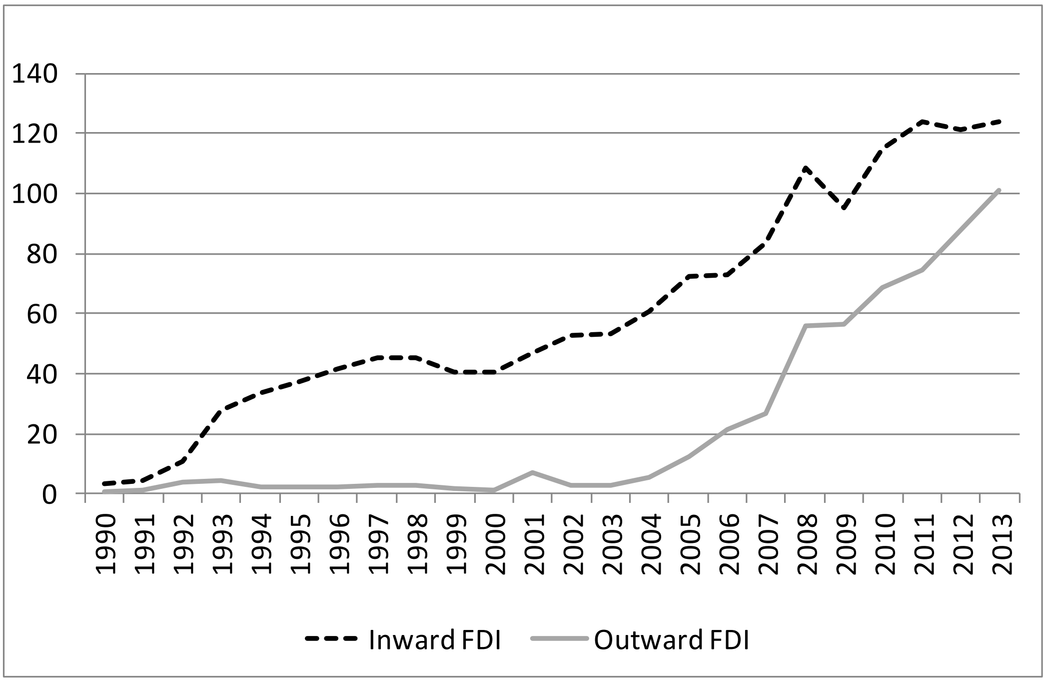
FDI inflows have been one of the drivers of Chinese growth since the 1990s. Economic growth in China benefited both from capital inflows and the technology transfer, management and institutional organisation expertise they entailed. At the same time, due to the deceleration of global and Chinese growth and narrowing profit margins, capital inflows have slowed significantly in recent years (Chart 4).

Within inward FDI, the share of FDI settled in RMB rose to 63 per cent from 12 per cent recorded in 2011 (PWC, 2014)[3]. This can be partly attributed to the fact that the renminbi were channelled to offshore markets via trade settlement, and foreign direct investment meant an opportunity for return flows.

At the same time, outward foreign direct investment (OFDI) also showed dynamic growth after the mid-2000s. Resident firms can use the renminbi for their foreign direct investment, while non-resident investors can also execute their Chinese FDI transactions in renminbi. Chinese FDI was also stimulated by the post-crisis policy shift that attempted to lay new foundations for growth.

Between 2011 and 2013 the share of transactions settled in renminbi in Chinese OFDI flows jumped from 5 per cent to 16 per cent. The most important targets of Chinese FDI comprised (i) brand purchases (e.g.: Volvo, Hummer, MG); (ii) export market acquisition; (iii) relocation of polluting industries; (iv) purchases of strategic resources (mines in Africa, Australia and South-Africa).

4: China's FDI stock (USD billions)



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

3.2. QDII – Qualified Domestic Institutional Investor program

Institutions qualified to participate in the QDII programme have had an opportunity to invest their Chinese resources in foreign capital markets since 2006. The program has gained increasing popularity since its launch. In October 2014 approximately 125 institutional investors had a total quota of USD 90 billion. Participating institutions can be divided into three groups: commercial banks, insurance companies and investment funds. Banks are supervised by the CBRC[4], while the CIRC[5] and the CSRC[6] are responsible for the supervision of insurance companies and funds, respectively. Under the QDII programme institutional investors can invest in the asset classes of bonds,

[3] Where do you Renminbi? A comparative study of cross-border RMB centers, PWC http://www.paris-europlace.net/rmb/PWC_Luxembourg_Where_do_you_RMB.pdf

[4] China Banking Regulatory Commission

[5] China Insurance Regulatory Commission

[6] China Securities Regulatory Commission

shares, bank deposits, investment funds, real estate and derivatives, but different rules are applicable to the three groups of institutions. Commercial banks face the most severe investment restrictions, while the conditions imposed on investment funds are the most lenient. Banks, for instance, are not permitted to invest in bonds or hedge funds below the “BBB” rating.

3.3. QFII (Qualified Foreign Institutional Investor) program (2003–)

The QFII programme was launched jointly by the CSRC and the PBC, allowing foreign institutional investors access to the Chinese bond and equity markets from 2003. The USD 150 billion programme covered only bonds traded on the Shanghai and Shenzen stock exchanges, which accounted for around 2 per cent of the bonds. Interbank market investment may be permitted with an additional license granted by the PBOC. As of July 2012, the CSRC adjusted the quotas, opening up the possibility of investment in the interbank bond market.

3.4. Interbank bond market programme (2010)

Foreign institutions, including central banks and offshore RMB clearing banks have been permitted to invest in the interbank bond market up to a pre-defined limit since August 2010. Several European central banks have been awarded such quotas under the interbank bond market programme in recent years.

3.5. RQFII – Renminbi Qualified Foreign Institutional Investor program (2011)

Qualified foreign institutional investors (RQFII) have been allowed to invest renminbi funds obtained in the offshore market in domestic securities markets since December 2011, at present up to the amount of RMB 740 billion (compared to RMB 20 billion at the launch of the programme in 2011). Investors currently include the Hong Kong subsidiaries of Chinese investment and securities firms and assorted other institutions, subject to pre-defined asset allocation ratios.

Upon awarding the RQFII license, partner central banks are requested to provide a feedback on the financial institution concerned and on supervisory reviews performed in the past 3 years.

Quotas are first granted to countries and institutions can apply for quotas in the next step. As from March 2013, the extension of the programme, companies are also permitted to invest from their Hong Kong based funds, while the asset allocation restrictions were eased, and the investment opportunities were extended to cover listed securities and bonds traded in the interbank market. (Previously, the required ratio of bond market investment was 80 per cent).

In 2013 China granted a quota of RMB 80 billion to the United Kingdom, while Singapore and Hong Kong have quotas of RMB 50 billion and RMB 270 billion, respectively. In 2014 Qatar (RMB 30 billion) and Canada (RMB 50 billion) also obtained RQFII quotas (Chart 5).

5: Distribution of RQFII quotas (October 2014)