BBVA Research

What to expect from RMB internationalization?

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Outline

1. Why should China want to internationalize the RMB NOW?

- The sheer and growing size of the Chinese economy should be a good enough reason to do it at some point
- However, why NOW?
  - Global crisis has actually strengthened China's economic power
  - With change in exchange rate regime in July 2010, expectations of appreciation have stepped up and so capital inflows
  - But China needs to export – not import – capital
  - RMB internationalization may put additional pressure on inflows.

1. Why should China want to internationalize the RMB NOW?

Two possible reasons:

1. Still difficult situation in US and Euro Area –also Japan - so window of opportunity for another currency in Asia (different from yen)
2. China very long in foreign currency and increasingly so
   - Two sources of long position
     1. RMB liabilities: stock of FDI and inward equity flows estimated at 24% of GDP already before crisis (Ma and Zhou, 2009)
     2. Huge accumulation of current account surpluses (Cheung et al (2011) estimate total long forex position at 60% of GDP)
   - *It is about RENMINBISING China's foreign assets!*
   - How much would be enough?
     - Probably more similar to Japan than the US.
       - About 12% of holdings of Japanese debt securities are in yen vs 90% for US ones in USD
       - Still China has a long way to go: starting basically from 0%!

2. Which path has China chosen

- Unprecedented path: develop off-shore internationalization but not on-shore!
  - Still massive controls on capital flows in and out of China
- However, the US experience shows that off-shore internationalization of a currency can be very helpful so why not, specially given that China has control over a large off-shore center: Hong Kong
- So far massive increase in supply of deliverable RMB in HK: CNH market
  - A lot is speculative: HK residents betting on RMB appreciation by increasing their RMB deposits
  - Also growing share of Chinese imports (close to 10% of total imports)
    - Much less exports though (appreciation bias may explain this)
  - And rapid development of RMB denominated bonds in HK: Dim-Sum market
    - At first Chinese official entities and HK banks with subsidiaries in China
    - Later foreign companies: first only investment grade but now junk bonds

3. Will it be successful?

- No doubt that China has the economic and financial muscle for the RMB to become an international currency or, at least, a regional currency
- The question is **whether the process will be smooth**.
- For the market it is currently developing (HK offshore), it very much depends on expectations on RMB
  - If only towards appreciation, accumulation of deposits in HK will continue (RMB assets) but hard to have increasing demand for RMB bond issuance (RMB liabilities): **mismatch**
  - If RMB appreciation pressures stop, RMB deposits may suddenly fall:
    - Possible financial stability issues in HK since RMB money market not well developed and Lender of Last Resort by HKMA still limited

3. Will it be successful?

- To be come a fully fledged international currency **more to do onshore**
  - Hard for central banks to decide to **hold reserves in RMB** based on bond purchases in CNH market!
    - However, some small Asian countries may be induced to do so as was the case with the RMB bilateral swap agreements during crisis
  - Even harder to expect countries **to peg to the RMB** if no liquid forex market exists to intervene
    - Still, first step my come by an Asian country announcing the inclusion of the RMB in their exchange rate basket
      - Singapore in exchange for a share of the ballooning CNH market?
      - Or even HK moving to a basket peg?

4. Implications for Europe

- Need to follow RMB internationalization process carefully
  - Key to understand whether world become more regional (less multilateral)
    - So far China does not seem to have decided for the RMB to become a REGIONAL currency
    - It seems more oriented to follow Japan, i.e., having an INTERNATIONAL currency (held all over the world) but without substituting the hegemony of the USD
    - How will this affect the EURO?
      - Perhaps positively in terms of **diversification gains** by reducing exposure to USD foreign assets and increase RMB ones
      - The risk, however, is that, **it may lead to a reduction in demand for euro assets now that we most need it!**