Cause for optimism on renminbi internationalisation

Inclusion in SDR basket reflects China's growing influence

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The renminbi's inclusion in the International Monetary Fund's Special Drawing Right currency basket, which formally came into effect on 1 October, is a significant landmark in the renminbi's long march to becoming a leading international currency.

Its inclusion is unprecedented in several respects. Not least of these is that it is the first currency issued by a developing country to become one of the basket's five member currencies, though China has yet to realise the full convertibility of its capital account according to the IMF's definition or criteria. With a weighting of 10.93%, it is the third largest currency in the basket, below only the dollar and the euro.

Symbolically at least, this reflects the growing importance of Chinese economic power, financial markets and trade volumes. At the end of 2015, Chinese exports and imports accounted for 14.6% of total world trade. Renminbi settlement of Chinese trade has increased from almost zero a decade ago to around 30% as of the end of this year's second quarter. The renminbi is now the fourth largest currency in international financial transactions, including renminbi-denominated bonds, equities, foreign exchange transactions, and direct investment overseas.

These developments stem from deepening reforms and the opening up of China's economy and financial markets. But the renminbi still has a long way to go to become a key international currency. Compared with the dollar and euro, it lags far behind on almost every indicator of international use, with the pound and the yen much more important. Moreover, renminbi trade settlement occurs almost exclusively between China and its direct trading partners. Key global commodities such as crude oil, precious metals and industrial metals are priced and transacted in US dollars and euros, which still dominate not only foreign exchange markets but also the pricing of and dealing in equities and bonds.

Although the People's Bank of China has signed currency swap agreements with more than 30 counterpart central banks, with total swaps amounting to more than Rmb3.3tn, the renminbi's market share among international reserve currencies stands at just 1.1%. Chinese commercial banks and other financial institutions to a great extent are domestic rather than leading international players. While the renminbi's inclusion in the SDR basket will increase international demand for the currency in the long term, the short-term impact will be less pronounced.

Renminbi internationalisation faces three fundamental challenges. First, how to manage the gradual opening up of China's capital account is a dilemma for the Chinese authorities. On the one hand, renminbi inclusion in the SDR basket requires China to speed up its capital account liberalisation, even though ultimately it will not achieve capital account convertibility in a similar manner to the dollar and euro. On the other, China is sceptical about capital account convertibility and concerned by the potential for out-of-control capital flows and large exchange rate fluctuations.

Zhou Xiaochuan, the PBoC's governor, once said that 'the capital account convertibility China is seeking to achieve is not based on the traditional concept of being fully or freely convertible', defining his goal as 'managed convertibility'. Despite the vagueness of the term, this is consistent with the overall gradualist approach of Chinese reform. However, each time there is significant uncertainty or speculative attacks on the Chinese currency or exchange rate, calls for capital controls or macroprudential surveillance increase, and the pace of opening up the capital account slows. Since August 2015, when the renminbi exchange rate depreciated sharply, the Chinese authorities have become increasingly cautious about the capital account and very alert to capital outflows.

Second, the PBoC will face the challenge of so called 'Mundellian Impossible Trinity' – under which it is impossible to have a fixed foreign exchange rate, free capital movement and an independent monetary policy at the same time. The PBoC has resolved to make the renminbi exchange rate much more flexible and has made significant progress. Following the renminbi's inclusion in the SDR basket and as pressure grows on China to open its financial markets, the PBoC will find it increasingly difficult to choose between a managed exchange rate, capital account convertibility and independent monetary policy. The bank requires a new framework to think about its policy and implications.

Third, for the renminbi to become a key international currency, Chinese commercial banks and financial institutions must become major players in international financial centres. However, almost all Chinese financial institutions are state-owned, and lack real market-oriented corporate governance and incentive structures. This will prove a significant obstacle to Chinese financial institutions becoming real transnational enterprises.

For any currency to become a key global reserve asset, the currency-issuing country must satisfy three conditions. First, it must be a safe haven for global wealth, attracting international investors to invest or deposit their money: ‘safe haven’ in this context means significant protection of private property rights and the rule of law. Second, the country’s economy must be large, as well as sufficiently innovative, to be a major engine of global economic growth. Third, the country must build deep and comprehensive financial markets with international standards of surveillance or regulatory systems.

China has made significant progress in all these fields and resolved to deepen reforms in this direction. There is every reason to optimistic about the prospects for renminbi internationalisation.

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