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The Globalization of the Chinese Yuan (CNY) and Its Rising Role in the International Currency System

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In the past few years, the Chinese government has put the internationalization of CNY on the map. Besides regular reforms such as facilitating CNY trading settlement and relaxing capital accounts, China deployed the Pilot Free Trade Zone and the One Belt One Road policy to significantly expand investment channels for CNY. It was also considered as a response to the criticism of CNY's trade-driven model. CNY was developing from a trade currency to an investment currency and now has the potential to be a global reserve currency. The growth of CNY as an international currency could counterbalance the US dollar-dominated system and contribute to regional and international financial constancy. However, CNY internationalization is a double-edged sword. Inflow surges or disruptive outflows of capitals can give rise to macroeconomic fluctuation. With regard to the potential risks, it is suggested that Chinese authorities adopt more market-based measures and make the best of the international arrangements to protect the domestic financial integrity and stability.

Keywords: CNY/RMB, Currency Internationalization, Capital Account Liberalization, SDRs, Investment-Driven, Financial Risk

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1. Introduction

An international currency may be defined as one widely accepted in the world and used for trade settlements, investments and foreign reserves.[1] In recent years, Chinese authorities have invested a flurry of efforts to encourage cross-border use of the Chinese Yuan ("CNY"). China's 13th Five-Year Plan (2015) indicated:

> China will push forward the marketization of exchange rates, orderly realize convertibility of its currency on capital account and promote the going out of the CNY in the world. A negative list for foreign exchange management will be established, and currency exchange controls over outbound investment will be loosened.[2]

In November 2015, the IMF finally decided to add CNY to the composition of its Special Drawing Rights ("SDRs") basket.[3] Accordingly, there were many reports were discussing CNY's rising important role in the international monetary system.[4] However, rewards are always accompanied with costs. Since mid-2015, the depreciation of CNY has raised questions on whether these strategies are in China's best interests. The main reason for fearing CNY globalization mainly addresses the stabilization of the national financial system. The primary purpose of this research is to evaluate the policy framework by China to accelerate internationalization of CNY; it will further highlight measures to successfully encounter financial risks in line with the market.

This paper is divided into six parts including a short Introduction and Conclusion. Part two will review China's proactive strategy to increase international use of the CNY. Part three will provide background and policy consideration on globalizing CNY, transforming from the trade-driven to the investment-driven model. Given CNY included in SDRs basket, Part four will regard the new status of CNY in the international monetary system. Part five will discuss the risks and countermeasures dealing with the cross-border capital flow.

2. Current Globalizing Progress of CNY

China's recent efforts to globalizing CNY include: (1) creating a more transparent exchange rate formation mechanism; (2) loosening the control of capital account; (3) implementing the Pilot Free Trade Zone ("PFTZ") and the One Belt, One Road ("OBOR") initiative to encourage inward and outward capital flows; and (4) other supporting measures such as offering developed payment infrastructure for CNY clearing.

A. Improving Market-based Managed Floating Exchange Rate Regime

China ended the peg to the US dollar in 2005 and adopted a "regulated, managed floating exchange rate system based on market supply and demand and in reference to a package of currencies."[5] Nevertheless, over a long period of time, the mechanism for forming the exchange rate of CNY was to maintain a general stability of CNY at an adaptive and at an equilibrium level. Spreads between CNY/CNH exchange[6] and interest rates turned out to create substantial speculative opportunities for exporters/importers, financial institutions and arbitragers.[7]

Since March 2014, CNY has been allowed to trade 2 percent up or down on the inter-bank spot foreign exchange market.[8] In July 2015, for the first time, the IMF noted "the staff assessment that the substantial appreciation of the renminbi in real effective terms this year has brought the exchange rate to a level that is no longer undervalued."[9] The IMF's comment potentially admitted the effectiveness of CNY exchange rate formation reform. On August 11, 2015, the People's Bank of China ("PBoC") further adjusted the exchange rate formation mechanism to better reflect fluctuation of the market.[10] Under the new mechanism, daily central parity quotes "should be based on the closing rate of the inter-bank foreign exchange rate market on the previous day, supply and demand in the market, and price movement of major currencies,"[11] while, before them, there was a gap between central parity rate and the closing rate of the inter-bank market. The CNY central parity rate against the US dollar dropped by 1.86 percent on August 11 and 1.6 percent next day.[12]

B. Liberalizing Capital Account

Member States of the IMF Agreement were forbidden to restrict current transfers, while the IMF did not intervene in their power to regulate capital flows.[13] In most cases, however, the IMF tended to support liberalization of capital accounts.[14] In China, the proposal of capital account convertibility was first put forward in the report of Third Plenary Session of the Fourteenth Central Committee in November 1993.[15] As decision was set forth with the effective control of risk, China would selectively loosen the capital account in steps.[16] The process was blocked by the 1997 Asian financial crisis and restarted after China's entry into the WTO in 2001. Thereafter, capital account liberalization was one of China's key economic reform priorities and appeared on most of the Chinese government's important documents.[17] Although China had no clear timetable for achieving CNY capital account liberalization, it was noticed that foreign capital has been allowed in and out in limited ways. Accordingly, long-term investments were welcomed, while short-term flows were subject to severe restrictions.

1. Direct Investment

According to direct investment, Chinese authorities imposed more limitation on CNY than on foreign currencies.[18] In 2011, PBoC began its attempt on relaxing CNY inbound and outbound direct investment.[19] The Bank accelerated CNY, changing from a cross-border trade currency to a cross-border investment currency. As a result, the amount of direct investment in CNY has increased dramatically. By the end of 2014, the total value of inbound CNY non-financial direct investment was 93.5 billion, up by 64 percent over the previous year. Likewise, the outbound CNY non-financial direct investment was 39.3 billion, an increase of 105 percent.[20]

2. Securities Investment

China has gradually relaxed capital controls for securities investments through various channels. Together with the Qualified Foreign Institutional Investor Scheme ("QFII"), CNY qualified foreign institutional investors ("RQFII") were approved for used overseas CNY funds to invest in CNY financial instruments in 2011. As of April 28, 2016, 162 RQFIIs were permitted with a total investment quota of CNY 480.525 billion.[21] Counterparts to these inward investment programs are QDII and RQDII. The programs enable authorized domestic asset managers to offer foreign equities to domestic investors. However, the RQDII program, which was first introduced in November 2014, was reportedly suspended in December 2015.[22]

C. CNY Globalization under Pilot Free Trade Zone and OBOR Initiative

The Pilot Free Trade Zone was an experimental platform in liberalizing China's service economy and serve as a front march towards opening the domestic market.[23] Launched first in Shanghai in September 2013, additional zones at Guangdong, Fujian, and Tianjin were set up in April 2014. In order to stimulate cross-border use of CNY, these zones adopted flexible rules and regulations to achieve capital account liberalization. *E.g.*, residents in Shanghai PFTZ were allowed to set up "Free Trade Accounts" ("FTATs) in domestic and foreign currencies.[24] CNY under these accounts was fully convertible with offshore markets, while fund transfers between FTATs and accounts within mainland China were administered as cross-border transactions.[25] In the other three FTATs in Tianjin, Guangdong and Fujian, onshore institutions registered in the PFTZs have been approved for convertibility on the capital account within USD 10 million annually.[26] There were other capital account loosening measures, such as simplifying cross-border CNY transactions, allowing companies based in the PFTZs to borrow funds from offshore sources, supporting CNY-denominated bonds issued, expanding the channel for offshore CNY to flow back onshore, etc.

China brought forth the OBOR Initiatives in 2013. The routes run through Asia, Europe and Africa, having most countries closely connected in economy and trade with China. The OBOR Initiatives feature five links in the areas of policy, infrastructure, trade, capital and culture, in which financial integration was an important underpinning.[27] The significance of the OBOR Initiatives are obviously related to globalizing CNY. First, export-oriented corporations with highly differentiated products and a dominant share in the market tend to choose their currency invoicing.[28] Compared to many economies along the OBOR, China would have a competitive advantage in industries such as railways, electricity, telecommunication, construction and machinery, in that these transactions were estimated to be invoiced by CNY. Second, the OBOR Initiative supports the corporations and financial institutions with good credit-rating to issue CNY bonds in China. Also, qualified Chinese financial institutions and corporations are allowed to issue CNY bonds outside China.[29] The OBOR Initiative would provide market liquidity and promote development of the offshore market. Today, the Asian Infrastructure Investment Bank ("AIIB"), an important financial institution sponsored by the OBOR Initiative, uses the US dollars for settlement and denomination at its initial stage. As commercial banks are co-financing with the AIIB, some of these projects will finally be quoted in CNY.[30] In general, globalization of a currency needs fluent two-way channels:[31] one is to encourage CNY capital outflow by the OBOR policy; the other, to develop financial market onshore to absorb foreign demand.

D. Other Supporting Measures

In addition, China launched the Cross-border Inter-bank Payment System ("CIPS") as a new CNY clearing system in October 2015.[32] As a major infrastructure for the CNY payments, CIPS adopted internationally recognized standards to enable more efficient payment processing.[33] This system would implement cross-border trade settlement, direct investment, and other CNY-denominated deals. It was expected to improve the ability to conduct CNY liquidity, reduce clearing charges, and make transactions easier.[34]

3. The Optional Mode for Globalization of CNY

Over the last three decades, China has experienced remarkable economic growth, which was achieved by a trade-driven model. Such rapid growth, however, depended heavily on the global demands.[35] Its weaknesses became evident when exports dwindled due to the 2008 global financial crisis. China strived to tackle structural problems and seek a more balanced growth. Besides domestic structural reform, China explored the role of outflow investment in boosting domestic investment and long run economic growth. Up until now, China has entered into 104 bilateral investment treaties[36] and 13 Free Trade Agreements,[37] which removed foreign investment barriers for Chinese companies. Many Chinese companies increasingly realize that overseas investment was an effective means to upgrade, transform and export capacity. Chinese outward direct investment ("ODI") has considerably increased. The ODI was worth of USD 128 billion in 2014 and 123 in 2015, while foreign direct investment ("FDI") was 136 in 2014 and 129 in 2015, respectively.[38] According to the UNCTAD, China was the third largest as a host and home economy in the world. The globalization of China's direct investment capital outflows would stimulate the proportion settled in CNY and promote a considerable increase of CNY-denominated financial products in the burgeoning offshore market.[39]

Another reason was that a trade-driven globalization of CNY had its defects. Traders appeared to have a strong preference for their own currency. They are particularly unwilling to manage foreign currency exposure.[40] Large Chinese exporters are compelled to choose the importer's currency invoicing as the former used to face severe competition in the latter's local market. For the import part, raw materials would constitute a large share of China's imports, much of which are invoiced in US dollars in the global market.[41] Even in trade with Asian countries, the billing of CNY is not significant. Because the US and the EU were by far the most important final destination markets for Asian economies, US dollar, Euro and British pound occupied the choice of currency. As a sudden structural change of China's trade pattern is not substantial, China should make a clear attempt to alter the mode of promoting CNY globalization. Stimulating the cross-border use of CNY by ODI would be a practical and effective option.

4. CNY's New Status in International Financial System

The IMF and the Bretton Woods System reflected the distribution of the postwar financial power. The American influence actually stemmed from its currency (dollar)'s global power.[42] As other economies were recovering, the US as a dominant economic power and the role of its dollar were apparently mismatched.[43] After the Nixon shock, the Bretton Woods system came to an end, but the US dollar still had an exorbitant privilege.[44] There were many complaints about it, particularly when the US employed the quantitative easing policy and triggered a flush of dollars into the market after the 2008 American financial crisis.[45] The depreciation of the US dollar passed on the costs to other countries and caused instabilities resultant of the financial system of other economies.[46] Although the US Federal Reserve gradually ended its economic stimulus campaign in 2014, the instability caused by its adoption and withdraw of the quantitative easing program still exist.[47]

No wonder, any attempt to reform the contemporary international system will certainly be opposed by other nations who delegate more sovereignty to international organizations and rules. During the 2008 G-20 summit, Chinese president Hu Jintao proposed to establish "a new international financial order that is fair, just, inclusive, and orderly."[48] In 2010, with the supporting of emerging economies, the IMF implemented reforms on Quotas and Governance to reflect their voice more adequately.[49] After the IMF empowered the proposed amendment on reallocation of voting rights in 2016, China possessed 6.14 percent of the total votes available to be cast,[50] whereas the GDP in China was worth USD 10354.83 billion; accounting for 16.70 percent of the world economy in 2014.[51]

After completing a regular five-yearly review, in November 2015, the IMF finally admitted CNY for inclusion in the basket of currencies that determines the value of SDRs.[52] The criteria for this decision was: "Whose exports of goods and services had the largest value over a five-year period and have been determined by the Fund to be 'freely usable'?"[53] According to IMF Agreement, a freely usable currency refers to a currency "widely used to make payments for international transactions and is widely traded in the principal exchange markets."[54] Thus, the usage of a currency, its floating and convertibility are different concepts, none of which is a necessary or sufficient condition for others. In fact, when the IMF carried out the previous five-year review in 2010, CNY also met the IMF's hard economic requirement of being a major currency in international trade, but could not meet the 'freely usable' criteria. The IMF's acceptance in 2015 is supposed to recognize China's progress in reforms.

As indicated by the IMF, CNY weighed in at 10.92 percent in the SDR basket, while other currencies are at 41.73 percent (US dollar), 30.93 percent (Euro), 8.33 percent (Japanese yen), and 8.09 percent (British pound).[55] CNY's endeavor with the SDR basket would increase SDR's representation and the growing importance of CNY in the global monetary system. Besides, the IMF will separately list CNY in its official foreign exchange reserves chart from October 2016.[56] It indicated that IMF member countries could record CNY as official reserves of their hold. In the long term, it will lead central banks to diversify their reserve assets into CNY-denominated securities.

5. Potential Risks and Countermeasures in the CNY Globalization

Looking back at history, globalization process of CNY has been inconsistent. Since China's financial market became sensitive when obstruction between domestic and foreign capital markets were gradually removed, China tried to adjust the measures as the effects of reforms became intolerable.

A. Potential Risks

Central banks hold reserves to ensure payment of foreign debts. In June 2014, China's Forex reserves reached the highest value at USD 3.99 trillion.[57] After then, however, China's foreign exchange receipts and payments exhibited an uncertain and highly volatile behavior. In the first quarter of 2016, PBoC registered cumulative foreign-related income of CNY 2.29 trillion (USD 350.0 billion) and made external payments of CNY 3.10 trillion (USD 474.7 billion), with a deficit of CNY 815.2 billion (USD 124.8 billion).[58] By the end of April 2016, China's Forex reserves dropped by USD 7.73 billion to USD 3.22 trillion. The following factors have contributed to the declining reserves. (1) Since October 2015, China has given up its criteria and followed the standards of the IMF in calculating foreign reserves.[59] Compared with the standard China previously adopted, assets that lack in liquidity were not contained.[60] (2) As the CNY exchange rate has been descending, foreign investors choose to sell the Yuan they held due to the exchange rate fluctuation.[61] The sudden decrease of foreign reserves and the high volatility of CNY exchange rate triggered the consideration of financial risk. In general, China's authorities encountered potential risks in the form of:

1. Liquidity and/or currency risk;
2. Interactions between onshore and offshore CNY markets (*e.g.* the issuance of foreign securities to China's residents or the issuance of domestic securities in foreign markets raised the vulnerability when external shocks exist); and
3. Hot money flooded in and out of the market for the purpose of seeking speculative profits.[62]

B. Countermeasures

Domestically, globalization of currency and capital account easing make China's financial regulation reforms more urgent. China's uncertain effort to globalize Yuan indicated the profound struggles behind it. Lately, Chinese authorities have attempted to strengthen the effectiveness of financial supervision.

1. Macro-prudential supervision

Financial questions would not only involve the overall development of domestic macro-economy, but also generate risks from the interaction of departments across and within.[63] As well-known from the 2008 global financial crisis, 'indispensability' is an overarching policy framework to identify systemic financial risks and stability.[64] Over the past two decades, developments in financial markets have expanded transnational financial intermediaries and liquidity-creating instruments in cross-border capital flows.[65] The appropriate financial policies for addressing these risks should combine macroeconomic policies, such as monetary, fiscal, and exchange rate management, with sound financial supervision.[66] Some developed countries have enhanced macro-prudential supervision and have therefore strengthened their central bank's regulatory functions to defuse systemic risks.[67]

In China, the Banking Regulatory Commission ("CBRC"), Securities Regulatory Commission ("CSRC") and Insurance Regulatory Commission ("CIRC") have defined responsibilities on banking, securities and insurance industries. With the development of the financial market, the boundaries of some financial services and products had blurred. Before June 2013, China's financial joint conference mechanism only included CBRC, CSRC, and CIRC whose aim was to consult on major issues and cooperate with each other in complicated cross-sector and cross-border supervision.[68] Then, the State Council introduced a new joint conference mechanism in June 2013. The central bank led this new mechanism in order to: (1) adopt a broader macro-prudential perspective; (2) coordinate monetary policies with financial regulations; (3) maintain financial stability; (4) prevent systemic financial risks, etc.[69] As the central bank issues and controls the circulation of CNY and administers foreign exchange and other related powers, the joint conference mechanism could address the macroeconomic and financial stability risks caused by CNY exchange rate fluctuation and volatile capital flows.

2. Market-based Practical Measures

After the 2008 global financial crisis, the IMF shifted its orientation toward capital control and capital market liberalization.[70] It indicated that: "Rapid capital inflow surges or disruptive outflows can create policy challenges... In certain circumstances, capital flow management measures can be useful."[71] Generally speaking, short-term capital, such as short-term debts may increase the vulnerability of financial markets of emerging economics than long-term flows.[72] Obviously, market-based measures are more effective and transparent to identify and assess the characteristics of capital flow than direct administrative controls. They can also be removed gradually.[73] Emerging economics, such as Brazil, Indonesia, Peru and Argentina adopted Tobin-style taxes or surrender requirements to limit capital inflows and outflows.[74] It was proved that, to some extent, restrictions on at least short-term capital transfers avoid aggravation of the crisis.[75] Thus, China's regulatory authorities were determined to take up market-based methods to identify and eliminate arbitrage possibilities to hot money.

Since October 2015, domestic financial institutions of China have been requested to set aside 20 percent of the previous month's Yuan forwards settlement amount as foreign exchange risk reserve.[76] This requirement expanded to foreign firms from August 2016.[77] The foreign exchange risk reserve could increase capital flow costs and limit speculation against the CNY, as a market-based method. Then, at the Boao Forum of the Asia Financial Cooperation Conference in July 2016, Mingkang Liu, former head of Banking Regulatory Commission hinted that China was likely to implement the Tobin tax to curb capital outflow.[78] He said, when enacting the tax, it should be taken into account that "transparency, sufficient information disclosure and clarified exit mechanism are indispensable."[79]

3. International Cooperation

Currency Swap Agreements ("CSAs") have two functions: (1) encouraging local currencies to be used in bilateral trade and direct investment; and (2) delivering liquidity when facing a liquidity crisis.[80] After the 2008 global financial crisis, central banks around the world signed CSAs to ease the strain of financial tensions.[81] Till now, China has signed CSAs with 33 central banks and monetary authorities, amounting to CNY 3,314.2 billion.[82] On the one hand, CNY sourced through CSAs could be used as a backstop for liquidity facility for qualified financial institutions under the QFII scheme.[83] On the other hand, CSAs could match the currency allocation much easier under liquidity pressure.[84]

6. Conclusion

CNY has rapidly emerged as an international currency with some functions of "a unit of account, a means of exchange, and a store of value."[85] During April-May of 2015, the IMF conducted an ad-hoc survey of countries on their holdings of currencies in Official Foreign Currency Reserves.[86] The CNY was starting to appear in the reserve portfolios of some countries. Total official foreign currency assets of CNY are valued at USD 45,358.87 million at the end of 2013 and USD 74,611.87 million at the end of 2014. The ratios of total holdings in currencies are 0.67 percent and 1.11 percent, respectively.[87] In summation, the globalization of CNY could lead China to hold the position of a supplier of financial public products to regional and global financial markets. With the cross-border use of CNY, however, capitals are permitted freely in and out of a country's system. Accordingly, an autarkic and healthy financial system is absolutely necessary. It is estimated that Chinese authorities will exert themselves to mature their financial supervision system in order to better serve the globalization of CNY.

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