International Finance

RMB Internationalization Status and Its Implications

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China announced the RMB internationalization policy in 2009 and has carried forward many initiatives and strategies to promote the international use of RMB. China's primary strategy is a step-by-step process starting from promoting the use of RMB in international trade transactions. Currently, about 9% of Chinese trade is settled in RMB. Domestic companies in China as well as foreign companies are allowed to use RMB as invoice and settlement currency for their international trade. It is expected that transactions through RMB will account for a third of total trade by 2015. China is also expanding the range of allowable offshore RMB financial transactions as part of its policy efforts for RMB internationalization. Since the Chinese financial markets are not fully open to foreign investors, offshore RMB financial markets are expected to grow further to meet the demands from those who hold RMB deposits offshore. These offshore activities now center in Hong Kong where around 70% of RMB-settled trade transactions occur. London is the second biggest provider of offshore RMB financial services. In order to promote the use of RMB as an international reserve currency, China has expanded its bilateral swap arrangements (BSA) with neighboring countries. With the rapidly growing use of RMB in the Asian region, RMB is forecast to become the regional key currency. Korea is one of China's largest trading partners and its RMB settlement in trade and RMB deposits is likely to grow, which will be followed by the development of offshore RMB-denominated financial products. For a country that has long wanted to become a regional financial center, Korea should make the best of this opportunity.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as the Korea Capital Market Institute's official position.
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I. Introduction

A currency is referred to as an internationalized currency when it is widely used for onshore as well as offshore trade and financial transactions. There is no clear definition about a "widely used currency," but a nation's currency is regarded as so if the nation has open capital markets and there is no serious restriction on access to its domestic foreign exchange and capital markets. In addition, there should be high demand for the currency from abroad. An internationalized currency should meet international standards in major functions, which include the function as the unit of account, storage of value, and settlement. Thus, successful internalization of a currency requires open and free regulatory accessibility, settlement availability, and high demand in international trade settlement and international transactions as reserve currency.

Peter B. Kenen (2003) argues that for currency internationalization, regulatory burdens that impede international usage of the currency should first be removed, thus there is no regulatory barrier for foreigners to access the market. In addition, necessary infrastructures, such as international settlement, a financial services industry that supports international transactions, and etc., should be built to support the internationalization process. Even then, the key to success in internationalization of a currency is how to induce the demand for the currency and related products. It requires more than economic size and trade volume. It requires deep and large financial markets with high-level capacity of international financial services, stable and reliable foreign exchange rate management, liquid foreign exchange markets and so on. According to Kenen, a currency is international if a country can issue foreign debt denominated in the domestic currency. Of course for this to happen, a country needs well developed financial markets and substantial economic size.

The Chinese RMB does not exactly fit the currency internationalization criteria mentioned above. Of course China is the second largest economy in the world, with even greater potential in the near future. However, regarding financial market openness, China still maintains many restrictions on its capital markets as well as the foreign exchange market. These restrictions are likely to stay for some time. Thus,

according to Kenen as well as many other researchers on this field, the Chinese RMB is not a model candidate to be an international currency.

China's approach to currency internationalization, however, is quite different from others due to these limitations of market openness. Since there have been many cases with premature opening of financial markets in the region, China does not seem to be in a rush to liberalize its financial market. Instead, China focuses on utilizing its huge trade volume within the Asian region. If some portions of the trade within the region are settled in RMB, international demand for RMB could be boosted rapidly. This may be the opposite direction of other currency internationalization cases, most of which started from deregulation of financial and foreign exchange markets. The Chinese plan for RMB internationalization is a step-by-step plan starting with expanding RMB usage in trade transactions. Then the financial demand and supply for RMB will follow, and this will boost RMB demand. This paper will examine Chinese strategies of RMB internationalization and find its implications for Korea and Asia.

II. Current Status of RMB Internationalization

1. Government initiatives for RMB internationalization

1) RMB internationalization in trade settlement

In 2003, China allowed RMB settlement in trade transactions in a small number of regions. Those regions include eight border districts. In these districts, Chinese importers and exporters can use RMB as an invoice currency to settle internationally. The central bank of China (People's Bank of China, PBOC) supported RMB settlement in trade in these designated districts. In 2004, the Chinese government exempted tax for small amounts of RMB trade settlement in Yunnan Province in order to promote RMB usage in trade. In September 2007, RMB trade settlement expanded to five major cities in China including Shanghai. These five districts are allowed to use RMB in

international trade with ASEAN countries, Hong Kong, and Macao.

The Chinese government officially announced the national agenda of RMB internationalization in March 2009. For the first step of RMB internationalization, the Chinese government presented its plan to expand the use of RMB transactions in trade settlement. Along with this plan, the Chinese government expanded the RMB trade settlement regions to Yunnan Province, Guangxi, Xinjiang, and 20 major cities in China in 2010. In March 2011, RMB trade settlement was expanded to the whole country. Thus, at the moment there is no restriction on RMB trade settlement, and all Chinese enterprises can use RMB to settle trade transactions. Also, foreign enterprises in China can have RMB transaction bank accounts for RMB trade settlement.

Table 1. RMB trade settlement initiatives

Date	Highlights
2003	Signed on the mutual currency settlement treaty with eight countries near China.
Jan. 2004	Yunnan Province offered tax-benefit for small amounts of RMB trade settlement.
Feb. 2008	Allowed North Korean companies trading with China to open RMB accounts in China.
Jul. 2008	Department of Yuan Internationalization in PBOC was established.
Nov. 2008	Consulted with Taiwan on a mutual currency settlement for cross-border trades.
Dec. 2008	The Government Financial Forum between China and Russia agreed to encourage the use of each currency in cross-border trade.
	Tentatively allowed for RMB trade settlement with Guangdong, the Yangtze River Delta region, Guangxi, Yunnan, Hong Kong, Macao, and ASEAN countries.
Mar. 2009	Allowed for the establishment of a yuan clearing bank in Hong Kong.
Jul 2009	Expanded the use of RMB to cross-border trade in Shanghai and four cities in Guangdong Province with Hong Kong, Macao, and ASEAN countries.
Apr. 2010	Allowed more cities (Yunnan Province, Guangxi, Xinjiang, and Tibet Autonomous Prefecture) to offer tax benefits for small amounts of cross-border trade settlement in yuan.
Jun. 2010	Allowed some cities in mainland (including Beijing) to settle in yuan in cross-border trade.
Oct. 2010	Allowed foreign companies located in China to open trade settlement accounts in yuan.
Dec. 2010	The number of companies using yuan in trade settlement ballooned from 365 to 67,369.
Mar. 2011	RMB trade settlement allowed in the whole mainland.

Source: An (2011)

2) Offshore RMB financial markets

Along with the Chinese government's efforts to promote the use of RMB in its international trade, China is also allowing for more diversified offshore RMB financial transactions. Since Chinese financial markets are not yet fully open to foreign investors, tight restrictions exist in investing in China's financial markets. This may hamper Chinese efforts to promote RMB trade settlement since there are not enough RMB denominated financial instruments. Thus, to complement the Chinese RMB internationalization strategy, China is gradually expanding its allowance of offshore RMB financial transactions to meet the needs of those who hold RMB from trade transactions outside mainland China.

Hong Kong is so far the leading RMB offshore financial center in the world. It first allowed RMB financial services in 2004. At its initial phase of establishing the offshore RMB financial business, four RMB-related services, including deposits, currency exchange, wire transfer, and credit cards were first allowed in Hong Kong. Through "The Close Economic Partnership Arrangements" between China and Hong Kong, the scope of RMB-related financial services available to residents in Hong Kong was broadened.

In 2007, China first allowed offshore bond issuance in Hong Kong. Chinese banks that received permission from the PBOC and National Development and Reform Commission were allowed to issue RMB denominated bonds offshore. In February 2010, foreign (non-Chinese) enterprises residing in HK were allowed to issue RMB denominated bonds, which is currently known as "dim sum" bonds. The issuance volume of both "dim sum" bonds and "panda" bonds (RMB denominated bonds issued by non-Chinese entities within mainland China) increased very rapidly during the last couple of years. In addition, the range of RMB financial services offered offshore has also been expanded along with the volume increase.

With the growth of the offshore RMB financial market, the Chinese government is also expanding foreigner's participation in domestic financial markets. In 2009, China allowed foreign banks incorporated in China to participate in the domestic interbank

bond market. In August 2010, foreign central banks that have bilateral swap contracts with PBOC and the RMB settlement banks in Hong Kong and Macao were also allowed to participate in the interbank bond market in the mainland China.

3) RMB as an international reserve currency

Since the final goal of RMB internationalization is to make the Chinese yuan a major currency used in various forms of international transactions including savings and investing, China is pushing efforts in various uses of RMB. Along with its strategy to facilitate the use of RMB in international trade, the Chinese government is promoting the use of RMB as an international reserve currency. However, as mentioned earlier, it might not be an easy task for China, especially because its capital and foreign exchange markets are still not fully opened. The Chinese government wants to tackle this issue through bilateral currency swap arrangements (BSAs) with neighboring economies.

China has engaged in more than 20 BSAs totaling RMB 1.6 trillion with 20 countries since 2008. Korea and China also have a BSA worth RMB 360 billion. It is observed that China promotes cooperation among regional central banks in its effort to promote the use of RMB. Especially, its recent move to expand BSAs to "middle income" countries such as Korea and Australia (RMB 200 billion) is thought to be an example of Chinese efforts to spur the international use of RMB as a reserve currency.

Table 2. BSA with China

Counter party	Size (RMB billion)	Signed on
Republic of Korea	180	Dec. 12, 2008
Hong Kong	400	Dec. 19, 2008
Malaysia	80	Feb. 8, 2009
Belarus	20	Mar. 11, 2009
Indonesia	100	Mar. 23, 2009
Argentina	70	Mar. 30, 2009
Iceland	3.5	Jun. 10, 2010
Singapore	150	Jul. 24, 2010
New Zealand	25	Apr. 19, 2011
Uzbekistan	0.7	Apr. 19, 2011
Mongolia	5	May. 6, 2011
Kazakhstan	7	Jun. 13, 2011
Republic of Korea (increased)	360	Oct. 26, 2011
Hong Kong (increased)	400	Nov. 22, 2011
Thailand	70	Dec. 22, 2011
Pakistan	10	Dec. 23, 2011
UAE	35	Jan. 17, 2012
Australia	200	Mar. 22, 2012

Source: PBOC

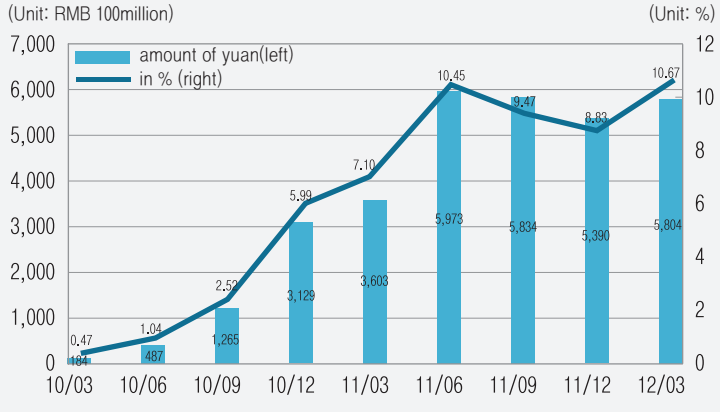
On the other hand, the Chinese government is trying to attain the Special Drawing Rights (SDR, international reserve currency assets maintained by the IMF) status for the RMB. China actively participates in international financial forums, such as G20, as well as the Strategic Economic Dialogue between China and USA to publicize the issue of including RMB in the SDR currency composition. China's concession to many financial issues demanded by the US during the recent dialogues may help China secure a favorable vote from the US in IMF's process to expand SDR composition currencies.

China also promotes this reserve currency issue through cooperation with central banks of advanced economies. In the China-Japan summit meeting in December 2011, both governments agreed upon the direct transaction of the Japanese yen and the Chinese yuan. According to the recent news report, the Japanese central bank decided to purchase Chinese government bonds worth RMB 65 billion for its reserve assets.

2. Current status of offshore RMB usage

RMB trade settlement started to increase rapidly in the third quarter of 2010. Trade transactions settled in RMB in 2011 stood at over RMB 2 trillion in 2011, and as of the first quarter of 2012, RMB trade settlement reached RMB 589 billion, which is a 61% increase relative to the same quarter of the previous year. However, the proportion of RMB-settled trade accounts for only about 9% of total trade as of the last quarter of 2011, although the proportion is increasing. According to HSBC, it is estimated that the 50% of Chinese trade with emerging economies will be settled in RMB by 2015, and also a third of total trade will be settled in RMB by that time.

Table 3. RMB trade settlement status



The offshore RMB financial market is also expanding rapidly recently. Hong Kong is the leading financial center in terms of offshore RMB financial services. As of January 2011, RMB bank deposits in Hong Kong reached RMB 379 billion, which is five times larger than a year earlier. Given the fact that the interest rate applied to RMB deposit is less than 1%, the increase in RMB deposits in Hong Kong is even more remarkable. It is estimated that offshore RMB deposits will exceed RMB 2 trillion in the next couple of years.

Table 4. RMB deposits prospects

Deutsche Bank	sees yuan deposits in Hong Kong reaching RMB 2 trillion by 2013; 1) yuan trade settlement will grow to 10% of China's total imports and exports by 2013 (2.5% for 2010), 2) yuan deposits in Hong Kong will reach RMB 2 trillion if China's trade volume grows 12% every year.
HSBC	expects RMB off-shore deposits to reach RMB 1.2-2.12 trillion by end of 2012 because of the growth in settlement and ODI in yuan.
Daiwa Securities	sees RMB off-shore deposits reaching RMB 2 trillion. Yuan's value against the US dollar increases 5% per year from 2011 to 2013.

3. Offshore RMB financial center

Along with the current trend of increasing usage of RMB in international transactions, offshore RMB financial markets will also expand rapidly to service traders and financial institutions that hold RMB offshore. And perhaps this is the most compelling reason why many countries are trying to become an offshore center for RMB financial services. The term, an offshore RMB financial center, refers to a district or a city, located outside mainland China, where various RMB denominated financial products are traded.

Hong Kong, so far, has been the most exclusive center for RMB financial services. Hong Kong started to offer RMB related business as early as 2004 and kept upgrading its capacity to host RMB financial services continuously. Since the RMB deposits were allowed for Hong Kong residents in Hong Kong domiciled banks in 2004, RMB deposits in Hong Kong have rapidly increased to reach 2.5 millions of accounts with total deposits of RMB 554 billion as of March 2012. Now, RMB deposits account for 15% of total foreign currency denominated deposits in Hong Kong. And, 70% of RMB deposits are held by companies, whereas a half of individual deposits were held by non-residents.

From China' perspective, Hong Kong is considered as "one country with a different set of regulations." This close linkage between Hong Kong and mainland China might

have helped Hong Kong to become the most promising RMB center in the world. In addition, Hong Kong's trade relationship with China is another strong factor that contributes to its role as an offshore RMB center. Roughly 13% of China's trade has gone through Hong Kong and many Chinese companies are listed on the Hong Kong exchange. As of the end of 2011, around RMB 2 trillion or 9% of China's total trade was settled using RMB, which is four times the previous year's level. Hong Kong is also a leading district in trade using RMB where roughly 70% of China's trade settled in RMB takes place. A total of 154 banks in Hong Kong, including the Bank of China (Hong Kong branch), HSBC, etc., provide RMB trade settlement services.

Along with RMB banking services, the RMB-denominated offshore bond, called "dim sum" bonds, is also growing rapidly. In 2007, Chinese financial institutions were first allowed to issue RMB-denominated bonds in Hong Kong, and in 2009, the Chinese government also issued its national bond denominated in RMB in Hong Kong. Since 2010, foreign companies were allowed to issue dim sum bonds in the Hong Kong market. As of the end of 2010, total issuance of RMB-denominated bonds in Hong Kong amounted to RMB 36 billion. It is a quite impressive figure especially when their average yield is merely 2.6%. Investors in dim sum bonds are believed to not only invest in the yields of this financial instrument, but also other benefits such as the possibility of RMB appreciation among others.

Recently, other major cities also joined the race to build a RMB financial center. London is a promising competitor in this regard. RMB deposits in London-based banks reached RMB 109 billion as of the end of 2011. The city of London already provides the relevant environment for RMB retail banking services, foreign exchange services, as well as trade credit services denominated in RMB. Currently, the London Metal Exchange (LME), which is the world's largest mercantile exchange, is preparing to service the RMB settlement for its transactions. London's strong advantage as the most exclusive financial center in the world also makes it even more promising to build the city as a strong center for RMB-denominated financial services.

III. Implications

China set out its goal of completing RMB internationalization by 2020. Accordingly, the Chinese government actively engaged in promoting RMB usage for this end. Considering the Chinese government's strong will and support for its RMB international policy, it is believed that the RMB will become a major international currency, at least in trade settlement, in the region in near future. Also, with the increasing RMB deposits offshore, the range and the depth of offshore RMB financial markets will grow fast to meet the demands from offshore markets.

While it may take more than eight years to accomplish the goal of currency internationalization, we expect a significant increase in the use of RMB in international trade in the Asian region. However, if the goal of RMB internationalization is to make the Chinese yuan a major international vehicle currency such as the euro and the US dollar, that may be possible, but it will take longer than planned. Even though the Chinese economy grows at 7% annually, it will be half of the US economy in 2020. And it is not clear whether Chinese financial markets will be fully open by then. In the meantime, however, the RMB's role in the Asian region will grow fast to become a dominant regional currency if the current pace of development is sustained. Especially, for countries like Korea who have huge trade relationships with China, the RMB will be widely used in trade with China, and thus the RMB exchange rate will become a key variable affecting the economies in the region.

The wide international use of RMB will also increase the demand for RMB financial products. Since Chinese financial markets are not fully open to foreign investors, China is likely to push for expanding offshore markets as the international use of RMB grows. China recognizes the need for offshore RMB financial markets, at least for an intermediate period before RMB internationalization, and therefore allows for offshore financial products in some districts such as Hong Kong. Nowadays, major financial centers are trying hard to promote the function of the offshore RMB center. Those centers include London which has massive advantages as an international finance center.

Korea is one of the largest trading partners of China, and has one of the largest BSAs with China. Thus, it is expected that a significant portion of Korea-China trade will be settled in RMB in the near future. The financial market linkage between the two nations provides Korea with a new opportunity to become a competitive RMB financial center. As RMB deposits grow in the Korean market, efforts to develop new offshore RMB-denominated financial products will follow. For a country that is trying to become a major financial center in the region, Korea should make the best out of this opportunity.

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