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The Impacts of RMB Cross-border Settlement on China's Economy[1]

In Tokyo, I have frequently been asked about two renminbi (RMB) internationalization concerns: the RMB's acceptance as a special drawing rights (SDR) currency and future RMB exchange rate reforms.

The first issue with the RMB receiving SDR status is that the International Monetary Fund (IMF), rather than China, is the biggest winner. Before the RMB received SDR status, it was being gradually forgotten both by policymakers and academics. It's not important at all in the international financial system. China's great interest in SDR in recent years enabled the IMF to very successfully market SDR to China. In China, news about SDR is everywhere.

The second issue is whether "freely usable" is a critical condition for the RMB to be accepted into the SDR basket. I don't think so because "freely useable" only began to appear in IMF documents as a condition for SDR acceptance after 1999 or 2000. When the Deutsche mark and the Japanese yen were accepted in the 1960s and 1970s, the Britain

[1] This presentation was made by Xu Qiyuan at RIETI in Tokyo, on Dec.15, 2015. This summary was compiled by RIETI editorial staff. Readers can also refer to RIETI's website for the summary: http://www.rieti.go.jp/en/events/bbl/15121501.html

system prevailed, so almost none of the international currencies were freely usable; they were controlled by government entities and so on. We need this new condition because SDR currencies are a vehicle for international payments and a store of value.

Liquidity

I would like to mention two types of liquidity in connection with free usability. The first is internal liquidity. For example, when a country such as Thailand wants liquidity, e.g. U.S. dollars, it will take out some SDR quotas and ask the IMF for an exchange. The next step is to put that money into the foreign exchange market for interventions to stabilize the exchange rate, etc. Countries such as the United States are responsible for exchanging their SDR so that Thailand can receive U.S. dollars to manage internal liquidity, for example. It is a duty to which China will now be subject.

External liquidity in the foreign exchange market is the second type. Looking back at the last decade, the RMB has enjoyed an appreciation expectation, so it will not be a problem to find a trade partner. The RMB will be accepted because of the exchange rate appreciation and the interest gap. In the short run, we know that the RMB is now subject to a depreciation expectation, which is a problem. Again, looking at history, when countries such as Thailand experienced difficulties in the foreign exchange market, they demanded that the IMF help them exchange the SDR into another kind of international currency. All of this demand focused on the U.S. dollar and the euro, and almost none on the pound and yen. Therefore, although it is very important from a legal viewpoint, free usability is not a very strict condition in logic for a currency to gain entrance into the SDR. I think free usability is not a key problem for the RMB to gain entrance into the SDR.

SDR and exchange rate reform

The third issue is the meaning of SDR to RMB exchange rate reforms. Since 2005, China has changed the RMB exchange rate regime from hard-pegging to the U.S. dollar to soft-pegging it. Although it is soft-pegged, the RMB remains fairly stable relative to the U.S. dollar. If the RMB attains SDR status while remaining pegged to the U.S. dollar, the U.S. dollar's share in SDR indeed will be indirectly increased. This also means that the SDR will become more volatile from the perspective of non-U.S. dollar countries such as Japan and the European Union (EU).

SDR currencies have a secondary role as a store of value. From this perspective, if RMB keeps pegging to the U.S. dollar to some extent, the SDR will not be very good as a store of value for non-U.S. dollar countries; it will just be favorable to China and the United States. From this view, when the RMB gains entrance into SDR without exchange rate reforms, the new SDR will not be as good a store of value as before. The policy implication is that China will be under pressure to push forward with exchange rate reforms and discontinue pegging the RMB to the U.S. dollar, although it will not necessarily be the main concern in the process of RMB exchange rate reforms.

Cost of SDR entry

The fourth and final issue is the price China will have to pay for the RMB to qualify as an SDR currency. From a long-term view, China should open its capital account and carry out exchange rate reform. But from a short-term view, liberalizing the capital account is risky and not particularly urgent, while exchange rate reform is indeed urgent. An insightful working paper published by CEPII offered two simulations. One assumes the RMB joins the SDR in 2015 and the other in 2020. These two scenarios are very different. The 2015 scenario limits the shock, whereas in 2020, the shock will be much greater. Two factors contribute to the greater shock. First, with regard to RMB interest rates, a big spread exists between the RMB interest rate and the U.S. dollar, Japanese yen, and euro. With this background, if the RMB enters the SDR, the interest rate curve and exchange rate for the SDR will suddenly jump. Second, as the weighting systems in 2015 and 2020 will be different, the later the RMB joins the SDR, the larger ratio of RMB will be in SDR, consequently, a bigger jump of SDR's interest rate and exchange rate will appear. To ensure stability in the interest and exchange rate curves, the sooner the RMB joins the SDR, the better.

The central bank declared an unlimited deposit rate in October 2015. Commercial banking in China is not fully competitive and has been only nominally opened. It is somewhat monopolized by four or five major state-owned commercial banks. They still have some market power over the interest rate system.

The authorities know clearly that the meaning of the SDR is more symbolic than realistic for China. In the process of the IMF reforms, what that is really important for China is the IMF quota, which determines the extent to which the country will be able to influence the IMF. It is more critical for China to increase the IMF quota. Although the SDR ratio for the RMB exceeds 10%, the IMF quota for China is less than 5%. In the future, the quota should be the objective. Therefore, China should not pay too high a price for SDR entry.

Reform sequence

Differing views exist in China regarding financial reforms and the order in which exchange rate reforms, capital account liberalization, and interest rate liberalization should be carried out. Academics believe sequencing is extremely important, while officials, especially those from the financial markets or the central bank, do not.

State-owned enterprises (SOEs) are another strength from the market; the huge state-owned commercial banks. We refer to the Industrial and Commercial Bank of China (ICBC) as the "Bank of the Universe." Other more market-oriented strengths include securities companies, some funds, and foreign investors. The SOEs stand with academics because they are more cautious about opening the capital account. They believe domestic market reforms should take priority. Foreign investors and other market players believe in opening the capital account first. For them, investment opportunity and market access are the most important. Securities companies also prefer first opening the capital account. We conducted a survey using a small sample of about 140 academics unaffiliated with our institute, government officials, commercial banks, foreign investors, securities companies, etc. The results indicate that government officials stand with foreign investors and securities companies, while academics stand with the commercial banks and SOEs. A balance exists between the four sectors. However, SOEs naturally have greater influence with the central government, while foreign investors have relatively little influence.

Compromises are often made between the two sides. In 2012, central bank officials published a famous and influential report. The first half of the report is very aggressive, and takes the position that the opening of the capital account should come first in order to generate international external pressure to promote domestic reforms. The second half contains a rather conservative schedule for the entire financial reform process in China, especially with regard to the timetable for liberalizing the capital account. We agree with the conservative timetable. The report argues that we should open all capital accounts related to international trade and investments within the first three years, with which we agree. It then states that within eight to 10 years, ideally by 2020, most of the capital and financial accounts should be liberalized, except the very risky items.

RMB exchange regime

Turning to the RMB exchange rate regime, 2005 was a turning point in changing the RMB from hard-pegged to soft-pegged to the U.S. dollar. We found an appreciation trend against the U.S. dollar. In addition, in a very important reform, the RMB expanded the daily volatility declared by the deputy director of the People's Bank of China (PBOC) from 0.5% to 1%, and then to 2%. Many financial market reforms have been made this year, including the RMB reforms. The IMF published a preliminary evaluation on the RMB entering the SDR at the beginning of August. RMB exchange rate reforms were announced on August 11 which eliminated the official intervention in central parity. The RMB depreciated by 3% that day and continued to do so for two more days. Officials then told the media that the RMB had reached a reasonable level. The central bank's efforts to promote exchange rate reforms are a very positive sign. Two factors prevent the RMB exchange rate from being fully liberalized. The first is that the center of the parity exchange rate was actually controlled by the central bank before August 11. I believe we have successfully navigated this factor through the reforms on August 11. The second and more important factor is ongoing official intervention in the foreign exchange market. The RMB exchange rate will be fully liberalized when such intervention ceases.

Around September or August 2015, the PBOC introduced new participants into the foreign exchange markets: sovereign funds and another kind of central bank investor. They participate in the foreign exchange market in Shanghai, making it more diversified. This is also a very important step.

I think central bank officials have been given some very valuable advice regarding the domestic market. First, a professor at Peking University proposed an intervention quota. For example, we can set a target quota for a certain period for intervention in the foreign exchange market and if we exhaust it, the central bank will no longer intervene in the market.

Many critics of the August 11 reforms were from the market. We found some resistance to exchange rate reforms in 2008 from import/export companies. The resistance to the reforms this year and last year came from different kinds of companies, because the RMB appreciation had continued for a decade and the interest gap between the onshore and offshore markets led to a great deal of trading of carry trade and arbitrage, especially for the large SOEs. Many SOEs engaged in arbitrage and carry trade without covering their risk to maximize their profits from the interest spread and appreciation expectations. The profits from this speculation are larger for some companies than their main activities. It's very dangerous, but it is a dilemma for the central bank.

RMB depreciation

What would happen if the central bank allowed the RMB to depreciate by 10%? When it depreciated by 3%, companies were holding about $8 billion, so they lost about $800 million with the depreciation. These companies profit in a very limited number of ways, making losses on speculation very serious, and many such companies exist. The exposure to the U.S. dollar is huge. Before the depreciation, the central bank wasn't clear about the whole picture. Crises reveal problems. The PBOC found a very serious situation that it wanted to control, so after three days, it sent a very strong signal to the market that the depreciation would stop and the RMB would stabilize.

The central bank has some conditions to look at in choosing the timing of the RMB depreciation. The first is that the RMB should depreciate but keep the pressure under control. In this way, the central bank can find a time window for losing control of the exchange rate or decreasing its intervention in the foreign exchange market. Another precondition is that the SOEs should stop engaging in speculation and avoid the huge risk from currency mismatch.

If we give up pegging to the U.S. dollar, the central bank should know what the new benchmark will be. It's not necessarily a new anchor, but there should be a reference system to know where we are ex post.

Q&A

Q1. I previously worked for the Bank of Japan and prior to that for the Financial Services Agency (FSA). According to my experience, I feel Japan made a mistake by opening up its current account before establishing a bankruptcy system. In this sense, I felt quite safe when I heard your comment on the schedule for financial reform. A bankruptcy system or reforming the SOEs will be quite difficult. How do you plan to establish a bankruptcy system for SOEs?

Qiyuan XU

I'm not a specialist on this topic, but for China, it also is a great challenge to reform the SOEs, including the commercial banks. Premier Li Keqiang presented a new scheme this year. China wants to learn from Singapore about SOEs. The long-term objective of the central government is to avoid intervening most of the time and allow the SOEs to operate independently. My supervisor and other colleagues believe the fundamental reforms for the financial market are those of the financial institutions, like the banks and insurance companies, especially their relationships with the central government.

Q2. What do you mean by the quota being more important than joining SDR?

Do you mean that China will be able to borrow more or that it will have more power within the IMF?

Qiyuan XU

I meant that it will be more powerful within the IMF.

Q3. I have a related question. If China prioritizes the quota over participation in the SDR basket, does this mean that SDR participation is of lower priority? Or do you just mean to say the biggest priority is the quota, but that participation is also a big priority?

Qiyuan XU

I think China will benefit to a greater degree by increasing the IMF quota. China also benefits from RMB participation in the SDR basket but to a lesser degree. The quota is like the ratio of shares owned in a company. It is about becoming more powerful in the IMF. China has a low quota compared to its economic position in the global economy because its share of the global GDP is 10%-15%, but its quota in the IMF is only 4%.

Q4. I think the SDR will be a success for China and the RMB with its reliance on the international market. What do you think?

Qiyuan XU

I agree SDR will be a success for China, but more from a domestic view. From the perspective of the PBOC, it's extremely important for the RMB to get into the SDR. The entrance will be recorded in history textbooks along with the people that made it possible. At a higher level, though, at the level of the premier, they are more rational. They want to push forward domestic reforms but are feeling resistance from other ministries. With the SDR, they have a type of pressure to apply to institute reforms.

Q5. I can't agree with you about the PBOC's view. I don't think it's that simple. As an example, the United States and Japan are the most indebted countries in the world yet are still very powerful in the world economy. I think part of the reason for this is that they have reserve currencies. The RMB is not a reserve currency. To be a reserve currency, being part of the SDR is very important. As a part of the SDR, risk is avoided, as it is very easy for central banks to decide on the ratio of foreign reserves when diversifying. Being a part of SDR is a really important power for China.

Qiyuan XU

I agree with you. It's a very important point for pushing forward RMB internationalization. In September 2008, after the Lehman Brothers collapse, the two national institutions owed $400 billion to the Chinese government. A financial safety problem exists.

At the operational level we see different effects. The foreign exchange reserve was only about $2 trillion in 2008, but had grown to nearly $4 trillion last year due to excess U.S. dollar supply. RMB trade settlement results in extra U.S. dollar supply, because most of RMB trade settlements are settled in imports, and demand for U.S. dollars then decreased. At the same time, the PBOC wanted to stabilize the exchange rate, so the central bank has to sell RMB and buy U.S. dollars, resulting in a larger dollar reserve. Using the RMB as a settlement currency, the U.S. dollar will accumulate even faster than before.

This happened because the PBOC wanted to keep the exchange rate stable and intervened. If they want to promote RMB settlement, they should make some reforms to the exchange rate regime. Based on this argument, I want to make it clear that exchange rate reforms are more urgent and important than RMB internationalization and RMB's entrance into SDR.

Q6. The onshore Chinese renminbi (CNY) market has an excess supply of U.S. dollars, causing the RMB appreciation trend. Outside of the CNY market, importers pay RMB to world exporters. In the offshore Chinese renminbi (CNH) market, there might be excess RMB. Did these transactions cause the difference between the CNY and the CNH markets?

Qiyuan XU

The interest rate for CNH is much lower than for CNY. The annual rate is around 1% compared with 2%-3% for the onshore market.

Q7. Wider use of the RMB internationally would increase the pressure for RMB appreciation in the medium to long term. History shows that we may also see a decline in external assets and an increase in external debt. How ready do you think China is for these two economic phenomena?

Qiyuan XU

In the long run, capital accounts should be liberalized. The portfolio will change as a result. In 2009, when I visited Tokyo, housing prices were twice that of Beijing. But now Beijing's prices are higher than Tokyo's. One critical reason is that the market is separated from the offshore market and China's domestic market. For China, the GDP growth rate has slowed, and we have felt pressure as a result. Keeping housing prices stable is one of the targets for local and central governments. If housing prices collapse, we are afraid that Japan's history will be repeated in China. If we can invest abroad and buy a house in Japan or in the United States freely, many households in China will invest abroad. If we calculate the ratio of retirement funds, the ratio is very low, but if real estate assets are included, the ratio is actually high. The retirement funds ratio for the United States is almost equal to that of China if the funds and house assets are put together. Chinese cannot invest abroad so they are left to buy more houses. That's the reason in the middle term. It's very hard for China to open the capital account. I think if it opens, things will change in the ways you mentioned.