Joachim Nagel: The internationalisation of the renminbi – opportunities for German industry

Speech by Dr Joachim Nagel, Member of the Executive Board of the Deutsche Bundesbank, at "Bayerischer China-Tag", Ingolstadt, 19 October 2015.

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Ladies and gentlemen

Thank you very much for inviting me to the Bayerischer China-Tag.

Over the past few years, China has become a subject that has grown ever closer to my heart. In saying that, I am not just thinking about the steadily closer ties between our countries. On my trips to China, I have also constantly been noticing many things we have in common. Germany is regarded in China – at least in my experience – as a very reliable partner and as a model in many kinds of issues. In particular, the German economic model with a strong Mittelstand and the financial sector's function of fundamentally serving the real economy are cited as models in China.

Speaking about China at the moment, we often first think of headlines such as "Slump in growth in China" or "Stock market crash in Shanghai". In my speech, I want to put those headlines into perspective and set them in the context of China's ongoing opening – and, saying that, I explicitly do not mean just its financial and economic opening, but rather the overall transformation process in the Chinese economy. I shall give a brief overview of the status quo and present the outlook for the future internationalisation of the renminbi and for what opportunities this will open up not only for large German enterprises, but also – and especially – for the small and medium-sized firms which are so important in Germany and well regarded in China.

Following a long period of strong gains, stock prices fell dramatically in the summer of this year, first in July and then again in August. As I see it, the significant slump in prices on the Chinese stock market represents, first and foremost, a correction of the preceding rapid increase. Between mid-2014 and June 2015, equity indices went up by around 150%. For many market participants, this was a clear indication of an exaggeration. Yet again, it became apparent that financial markets are not a one-way street – not even in China. Since the capital market in China is still comparatively heavily regulated in comparison with other large economies, the direct wealth effects of the slide in prices were limited for foreign investors. That is because roughly only 3% of the equities are held by them.

The contagion effects stem from the far greater worries of investors about a slump in growth in China and its repercussions for the global demand of the People's Republic. Nevertheless, as I see it, the price slump was not driven solely by the poorer outlook for the Chinese economy. Another key factor was speculation about when the United States would adjust its ultra-accommodative monetary policy with the first interest rate hike since 2007. These two topics were the subject of much discussion during the typically less busy trading days in August. The absence of many market participants led to less liquid and more volatile markets. These various factors can explain why the correction on the markets was so violent.

The Chinese government revised its growth forecast downwards compared with previous years to what is now 7%.[1] This is much lower than the larger growth rates of past years. Even so, I would like to put this supposedly bad news into perspective: China is now the second-largest economy in the world. By virtue of its sheer size alone, this means that growth of 7% today will leave a larger footprint on the global economy than, say, growth of 11% did in 2005.

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[1] IMF forecast: 2015 6.8%; 2016 6.3%.

In addition, more moderate rates of growth are a typical consequence of the catching-up process of emerging market economies with rising per capita income. Just to make it absolutely crystal clear what this supposedly small growth of 7% means in terms of size, it should be considered that this is an increase which is roughly equivalent to the annual gross domestic product of Switzerland.

The lower rates on the road to a more balanced path of growth are accompanied by a departure, which was initiated some years ago, from a purely export-oriented economic model to one that is more consumer-oriented. This transformation can also be seen in the sectoral growth rates. The services sector, for example, now contributes a share of roughly 50% to Chinese GDP. The government itself describes the lower overall rates of growth as the "new normal".

The current slowdown in Chinese economic activity has left a clear mark on the international financial markets recently. It is true that China's economy, which takes up some 10% of global goods imports, is very important. But retarding effects on resurgent activity in Germany would be something to be concerned about only if there were to be a dramatic slump in the Chinese economy. According to our estimates, a 4%-points drop in growth in China would lower German gross domestic product by roughly a quarter percentage. Such a slump is not be expected at present, however. All things considered, the neighbouring Asian countries – owing to their geographical proximity and strong economic links – are likely to feel the negative effects more severely than the western industrial nations.

We are seeing a clear correction in the industrial sector, in which excess capacity is being reduced. This is also confirmed by German exporters and producers on site. Growth in trade and services still seems to be good, however. Retail sales are clearly increasing and many "New Economy" firms are rushing towards ever new records in sales and profits. Consumer demand still appears to be intact. Risks exist on account of high levels of debt in local government and state-owned enterprises.

Many observers still rate the data quality of cyclical indicators as a challenge. For example, there are numerous monthly indicators for the industrial sector, but reliable data on the services sector are often available only on a quarterly basis. China is now tackling this problem. At the beginning of September, the National Bureau of Statistics announced that it would calculate gross domestic product in future in accordance with international standards.

The Chinese currency, the renminbi, is playing a key role in the economic and political transformation. In the export-oriented growth model it was an important management tool, but its significance as an actively used instrument is waning given advancing transformation and stronger orientation to services.

The internationalisation of the renminbi has come a long way over the past few years. The renminbi has now becomes established as a trading currency. According to data supplied by the international payment service provider SWIFT, in August the renminbi overtook the Japanese yen among the most traded currencies. Although cross-border payments are currently well below the use of the US dollar or the euro, its share of now 2.8% is remarkable. As recently as 2012, it ranked in twelfth place with a share of merely 0.8%. This constantly increasing use of the renminbi as a transaction currency is also the outcome of the worldwide expansion in clearing houses. One example of this is the launch of the clearing bank in Frankfurt am Main last year.

The renminbi has thus already taken its first step to being a trading currency. The next step to becoming an investment currency is still being hampered by a number of capital controls. But the barriers are constantly being dismantled. So far, the Chinese side has been acting very prudently in these matters and I assume that will remain the case in the future.

The barriers are being dismantled by the constant expansion of existing programmes to promote cross-border renminbi transactions. This is where programmes with investment quotas for institutional investors are playing a key role. Furthermore, the merger of the

Shanghai and Hong Kong stock exchanges allow foreign investors limited access to the capital market of the mainland.

Investors are increasingly using the renminbi as an investment currency. Also establishing the renminbi as a reserve currency has been the declared aim of the Chinese government since as long ago as 2009. China's interest in the renminbi being included in the basket of currencies for the special drawing rights (SDRs) of the IMF is therefore understandable. It is also clear that the currency basket should reflect the world economic balance of power. And, in that respect, China has now undoubtedly become an economic heavyweight.

At present, the currency basket is based on the US dollar, the euro, the Japanese yen and the pound sterling. For a currency to be accepted into the SDR basket, it must be significant for international trade, serve as an internationally widespread medium of payment and be freely usable. Inclusion in the SDR basket is currently reviewed at regular intervals in accordance with the existing criteria. The outcome of the evaluation and the relevant decision are expected before the end of this year.

Many commentators acknowledge the country's liberalisation efforts. The availability of market-based exchange rates and interest rates is essential so that the currency basket can go on fulfilling its intended purpose.

Furthermore, the Chinese central bank announced on 11 August 2015 that the daily fixing of the exchange rate against the US dollar would be more closely geared to the price on the previous evening. The renminbi subsequently depreciated markedly and can now fluctuate more freely. Some voices in the media interpreted this as yet another deliberate attempt to manipulate the exchange rate with the aim of inducing an artificial devaluation. As they see it, China is supporting its own exporters by artificially boosting competitiveness. However, it is also a further liberalising step by the Chinese government. Even the IMF has praised the move, as this reform of the exchange rate fixing procedure gives greater weight to market forces.

The use of the renminbi is forging ahead in other areas of the capital market as well. For example, "Dim Sum bonds" are now being issued across the globe. Named after the tasty dumplings, these are renminbi-denominated bonds issued outside mainland China. Such bonds issued in Germany have been dubbed "Goethe bonds" by market participants. Several Goethe bonds have been issued in the past two years and more such bonds are to be expected to be launched as the renminbi becomes more liquid.

Germany is Europe's largest economy and has the closest trade links with China. Due to these close real economic ties between our enterprises, it is obvious that the settlement of payment flows should be as efficient and thus as direct as possible. To this end, a clearing bank was set up in Frankfurt last year that clears, for instance, payments made by German companies to Chinese suppliers.

Large German enterprises have had a presence in China for quite some time now. However, the ongoing opening of the Chinese market and the simplified clearing of transactions also provides small and medium-sized enterprises a wide range of growth opportunities. It is likely that these enterprises will step up their involvement in China even further in the future. Indeed, a survey by a commercial bank[2] has revealed that 17% of SMEs engaged in business with China already settle their accounts in renminbi. Another 11% are said to be planning to switch their invoices to the Chinese currency. These enterprises are hoping to gain advantages in price negotiations as well as better market access. In addition, it means that enterprises can better hedge exchange rate risks. With a clearing bank in their own country, enterprises can, for example, settle accounts in their own time zone, in German and under German law while

[2] Commerzbank.

still having a direct link to the Chinese payments system. In this way, payments can be settled faster and potentially also at lower cost.

A direct connection is now also possible through the new China International Payments System (CIPS). Participating banks have been able to settle their payments directly with China via this system since 8 October 2015. The stability and efficiency of CIPS will have a decisive impact on the future of the various pre-existing trading platforms. The same is true of the clearing banks.

Legal risks for foreign enterprises are often cited as a problem for those wishing to expand their business in China. The Chinese government, too, is aware of this problem. In February 2015, Prime Minister Li stressed once again that the climate for foreign investors in China needed further improvement. The World Bank's annual Doing Business Report examines business regulations in, at last count, 189 economies on the basis of 36 indicators. China is currently ranked in 90th place. There is therefore still room for improvement. This can be achieved, for instance, by forging ahead with agreements to use common standards and dismantling barriers to market entry.

Achieving a mutual understanding of corporate culture in the various markets can be aided through personal contact. More and more Chinese delegations are coming to Germany every year. One of the objectives of these visits is to examine and gain an understanding of small and medium-sized family businesses and their structures. After all, this organisational structure is often cited as a blueprint in reforming the Chinese growth model – even though it could never be adopted in every single aspect. In China, it is intended that a corps of small and medium-sized private enterprises will provide "new", more qualitative growth and boost the innovative power and competitiveness of Chinese enterprises. Over the past decade, China has been attempting, through various channels, to support the established enterprises by offering fiscal incentives such as tax breaks.

At a meeting between the Chinese President and the Federal Chancellor during the former's visit in March 2014, both countries agreed to establish a high-level financial dialogue. This took place for the first time in the spring of this year in Berlin. The aim of the meeting between the finance ministries and the central banks is to institutionalise cooperation, also in financial matters. This concerns, among other things, not only issues of financial supervision and regulation, but also international cooperation within the G20. An outcome of the meeting is that assistance is to be provided for investment by small and medium-sized enterprises and the cross-border settlement of securities and derivatives is to be made easier.

I expect that these trade relations will become even closer and that financial relations, too, will continue to deepen.