Yves Mersch: China – progressing towards financial market liberalisation and currency internationalisation

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Renminbi Forum Luxembourg, Luxembourg, 26 February 2014.

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Ladies and Gentlemen,

It is a pleasure to be the keynote speaker at the first-ever Luxembourg Renminbi Forum. I would like to thank Luxembourg for Finance for this opportunity to say a few words on the recent, rapid emergence of the renminbi as an international currency. Its new-found status is the result of China's economic performance and part of a wider ongoing reform process in the country. So how will the internationalisation of the renminbi affect China, as well as the rest of the world? These are the issues I will address now.

China's economic rise

The opening-up of China and the reforms pursued by its leaders since 1978 have brought about astonishing economic progress. The Chinese economy has become the third largest in the world, after the US and the euro area. China's GDP per capita in real terms has undergone an 18-fold increase, massively reducing poverty and increasing purchasing power. But economic development has brought its own challenges, such as income inequality and environmental degradation. The authorities are increasingly responding to the concerns stemming from these problems and have made their resolution a policy priority.

China's domestic development has taken place in parallel to its growing economic integration with the rest of the world. Its goods trade has increased about 20-fold over the last 20 years. Cross-border investment is growing again after retreating during the global financial crisis. Flows are also becoming more balanced: the current account surplus last year was slightly over 2% of GDP, a far cry from the surplus of more than 10% recorded in 2007. In addition, since 2012, investment coming from China has caught up with investment flowing into China, accounting for 15% and 17% of GDP respectively.

As its economic importance has grown, China has taken on a larger role in global institutions. Notably, it joined the World Trade Organization in 2001. The IMF has also agreed on an increase in its quota, although this still has to be implemented. Bilateral relations between the EU and China are also intensifying. Following on from the EU-China summit in Beijing on 21 November 2013, the European Commission and the Chinese Ministry of Commerce started talks last month on a comprehensive investment agreement to increase market access and provide better protection for investors.

Renminbi internationalisation as part of China's wider reform process

As China has gained in international stature, some people have asked whether it can maintain its economic dynamism. A decline in growth (from over 10% in 2010 to slightly below 8% at the end of 2013) coupled with the persistence of domestic imbalances suggests that further reforms are needed. In particular, the composition of domestic demand continues to be highly skewed towards investment (now standing at 47% of GDP). At the same time, growth has become increasingly reliant on credit, with total financing to the private sector growing to about 180% of GDP at the end of 2013 from 115% in 2008. Financial leverage on this scale is much higher than in other countries with a similar level of development. Moreover, much of the credit growth has taken place outside the formal banking system, a development which needs to be monitored closely to minimise risks to financial stability.

The Chinese authorities are well aware of these challenges and, in November 2013, presented a comprehensive reform programme aimed at making growth more sustainable. An essential element is the progressive development and liberalisation of domestic financial markets so as to give a greater role to market forces in determining interest rates and allocating credit. Allowing those forces to play a more important role will increase the liquidity of China's financial markets as well as the variety of instruments traded. Over the last few years, we have already seen a rise in the number and variety of financial instruments that are being traded on China's domestic markets, be they bonds, at various maturities and with different ratings, derivative products or different currencies.

As for currencies, China's decision to introduce direct trading between the euro and the renminbi in the Shanghai foreign exchange market could, beyond its symbolic value of signalling stronger relations, bring benefits for the euro area and China. It could do several things – enhance price discovery for the currency pair, encourage a decline in transaction costs, facilitate the access of European banks to the Chinese onshore foreign exchange market, and it could allow the euro area to benefit from the rising importance of the renminbi. However, should trading volumes remain low, some of these advantages, such as lower trading costs, might prove elusive.

An expansion of the country's domestic financial markets should allow for a more efficient allocation of capital, which should benefit China's long-term growth prospects. These measures, together with others aimed, for instance, at increasing competition in product markets, or at making it easier for rural residents to move to China's cities, should help the economy to rebalance away from investment and towards domestic consumption. From a global point of view, that is a welcome step.

Efficient domestic financial markets are also a prerequisite for a further liberalisation of cross-border financial flows, in particular investment flows. Currently, opportunities are limited to a number of quota-based investment schemes. In December 2013, the Governor of the People's Bank of China (PBoC), Mr Zhou Xiaochuan, confirmed that cross-border investment transactions will be gradually liberalised and the quota-based system in use today ultimately abolished.

Nonetheless, market participants should not expect the opening-up process to be absolutely smooth, and neither should they think that periods of increased volatility can be entirely avoided. They should keep a close eye on and adequately provide for the risks inherent in the onshore renminbi asset exposures they take.

Integrating the renminbi in the global financial system

Let me now turn to the internationalisation of the renminbi. The scope for its usage in international trade transactions is significant as China accounts for around 9% of global trade in goods and services, surpassed only by the United States, which accounts for around 12%. According to market participants, a third of China's total trade will be settled in its currency by 2015.

In addition, several other important developments have increased the usage of renminbi for investment purposes: (i) the currency is already available to the corporate sector. Apart from accumulating the currency through trade, companies can also issue renminbi-denominated bonds in Hong Kong (also known as dim sum bonds) and borrow renminbi directly from banks in Hong Kong; (ii) the PBoC has already concluded currency swap agreements with 24 foreign central banks, totalling about CNY 2.6 trillion (around €317 billion). On 8 October 2013 the ECB and the PBoC established a bilateral currency swap agreement with a maximum size of €45 billion; (iii) offshore renminbi centres are progressing quickly; and (iv) domestic financial markets are continuing to develop. The large state banks have all been listed, the number of institutional investors is rising and the market is becoming more diversified and liquid, paving the way for further participation by foreign investors.

Its use in global finance is closely linked to the opening-up of China's domestic financial markets. Foreign investors are unlikely to issue large amounts of renminbi-denominated financial instruments as long as they cannot easily transfer financial assets into and out of China. In addition, Chinese investors who are keen to diversify their assets internationally currently face difficulties in doing so, restricting the availability of renminbi outside of China.

In spite of existing restrictions, the international use of the Chinese currency has already risen very quickly, albeit from a low base. The volume of Chinese goods trade settled in renminbi increased from virtually zero in early 2010 to 15% at the end of 2013. In parallel, the use of renminbi-denominated investment products, such as the issuance of offshore bonds in Hong Kong, has grown. Nonetheless, the outstanding amount of renminbi-denominated bonds only represents a small fraction of the global total. Moreover, in November and December last year, according to data from SWIFT, the renminbi was for the first time among the top ten currencies used for payments in terms of value. Over the past three years it has overtaken 22 other currencies, including the Russian rouble, the Turkish lira and the Mexican peso[1].

Since the inception of the offshore market for renminbi the combined daily turnover in the spot foreign exchange and forward markets in CNH (for offshore trading) has risen sharply to above USD 12 billion. In the fixed income market, the size of CNH debt rose from CNH 69 billion at the end of 2010 to CNH 500 billion in the third quarter of 2013. Additionally, a broad range of instruments has been introduced, including investment funds, equities and structured products.

Liberalising financial flows will allow for a further integration of onshore and offshore markets and should reduce the risks related to market fragmentation. Due to restrictions on financial flows, offshore and onshore renminbi markets are only partially integrated[2]. This results in small but persistent discrepancies in the exchange rate and interest rates in the Shanghai market and offshore markets such as Hong Kong, which are not fully arbitraged away. This is not only economically inefficient but also poses certain exchange and interest rate risks for financial market participants, and in turn complicates the use of the renminbi in international finance.

Market segmentation also creates other risks, such as liquidity risk, when offshore corporates and investors are faced with a sudden and temporary renminbi liquidity shortage which cannot be met by rapidly transferring liquidity from the mainland. The three-year currency swap agreement between the ECB and the People's Bank of China, which I just mentioned, specifically aims to prevent such risks, i.e. to serve as a backstop liquidity facility, reassuring euro area banks of the continuous provision of renminbi in the euro area. Having such a backstop in place makes sense in view of the rapidly growing bilateral trade and investment flows between China and the euro area, and in view of China's major role in the global economy. This rationale is also supported by the rapidly increasing use of the renminbi as a payment currency.

From the perspective of the euro area supervisory authorities, renminbi internationalisation calls for a monitoring from a macro-prudential perspective, including those risks arising from increased exposure to renminbi-denominated assets and liabilities in euro area banks. Furthermore, the increasing presence of Chinese banks within the euro area also brings its own challenges regarding banking supervision, including the need for greater cooperation and exchange of information between home and host authorities.

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1 See "RMB breaks into the top ten most-used currencies for payments", SWIFT Renminbi Tracker (January 2014).

2 See "Development of the Renminbi Market in Hong Kong SAR: Assessing Onshore-Offshore Market Integration", IMF Working Paper No. 13/268.

The integration of the renminbi in the world's financial system will also require the continued development of payment system infrastructures and international payment arrangements – and, ultimately, the integration of onshore and offshore activities, so as to enable cross-border renminbi-denominated payments to be processed quickly, safely and economically. Work is already under way to modernise the domestic Chinese payment system and to ensure its compliance with international technical standards. This is seen as a precondition for establishing arrangements with other payment infrastructures worldwide and for eventually providing banks with efficient and secured payment-versus-payment mechanisms.

Offshore renminbi markets have so far mainly come into being in East Asia. This forum and similar events recently organised in Frankfurt and Paris testify however to the demand for such markets within the euro area. Moreover, the economic size and well-developed financial markets of the euro area inevitably mean that it will play a role in the internationalisation of China's currency. The euro area is also home to global companies with extensive operations in China and an evident interest in conducting operations in renminbi.

The currency's trade settlement scheme is the main link between both markets, on and offshore. This scheme was initially developed to foster the development in offshore markets, offering several benefits to foreign trading partners: (i) the possibility of negotiating better trade terms when invoices are denominated in renminbi rather than the US dollar; (ii) a natural hedge as both trade partners issue invoices in the same currency; (iii) access to small and medium-sized Chinese firms that are unable to contract in foreign currency and (iv) the scheme offers the possibility of benefiting from capital gains, as the renminbi is expected to appreciate in the years ahead.

The main prerequisite for engaging in trade settlement is to involve a bank that can settle transactions in the interbank market in mainland China and convert currency in the onshore foreign exchange market. Typically, there are two channels through which renminbi trade settlement is possible: (i) via a mainland correspondent bank, where the offshore bank of a foreign trade partner settles trade invoices with Chinese firms via an account with that correspondent bank, with the renminbi proceeds subject to Chinese regulations; ii) via clearing banks licensed by the PBoC to operate offshore (BOCHK for Hong Kong), where the offshore bank settles trade invoices via an account with that clearing bank, buying or selling renminbi in the offshore market (at the CNH rate).

Since the expansion of the scheme, renminbi trade settlement has increased sharply, accounting for around 15% of China's total foreign trade in the third quarter of 2013, with prospects for further growth as more offshore centres open across the world.

Conclusion

In conclusion, the internationalisation of the renminbi offers many opportunities, both for Chinese and international investors and corporates, including in the euro area. Nonetheless, to fully reap the benefits of this process, China needs to continue reforming its economy, in particular its financial sector, along a clear, well-sequenced path to minimise risks and enhance confidence. Equally, Chinese and international investors and financial institutions must make a realistic assessment of the risks involved in cross-border investment, and build up commensurate buffers.

In view of these risks, the following considerations should be kept in mind:

First, the significant bilateral commercial relations between euro area and China should support a steady increase in EUR/CNY trade volumes. This is because European counterparties are interested in settling their trade invoices in renminbi to benefit from price discounts and to access different suppliers. Chinese counterparties are also increasingly keen to settle in renminbi to reduce their exchange rate risk and to simplify their cash management.

Second, although they have not committed to a strict timetable, the Chinese authorities have shown their commitment towards a more flexible exchange rate and increasing the convertibility of the renminbi. In 2012, China widened the currency's floating band. In addition, over the last few years, the scope for cross-border investment flows has been enlarged through the setting-up of a number of investment schemes open to institutional investors.

We are still in the early stages of this internationalisation, but it's a process that is rapidly moving forward. Market participants expect trade settlements in renminbi to continue to increase and new offshore markets to emerge, offering a broad range of products to attract foreign investors. They also foresee a progressive liberalisation of the capital account, including an increasing number of institutional investors operating in mainland China and, ultimately, a fully convertible renminbi. Clearly, having become an important trading and payment currency, the renminbi is now taking the first steps towards establishing itself as an international investment currency. If it can do so successfully, it might one day become a leading reserve currency.

Its internationalisation raises questions about the future shape of the world's monetary system. In particular, due to the size of China's economy and its importance in global trade and, potentially, finance, the renminbi might ultimately come to challenge the US dollar. Although it is too early to say what the implications for international financial stability could be, the authorities and investors need to prepare for a world in which the renminbi will play a much more important role.

Thank you for your attention.