Philip Lowe: Some implications of the Internationalisation of the renminbi

Opening remarks by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, to the Centre for International Finance and Regulation Conference on the Internationalisation of the Renminbi, Sydney, 26 March 2014.

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I would like to thank the Centre for International Finance and Regulation (CIFR) for the opportunity to open today's conference on the internationalisation of the renminbi. This topic is an extremely important one and the Reserve Bank is a strong supporter of CIFR's work in this area.

In my own view, the internationalisation of the renminbi (RMB) – and the changes that accompany it – could ultimately prove to be as transformative for global capital markets as was the earlier opening up of China's borders for the global trading system. Even if this turns out to be only half correct, then we need to better understand the process of internationalisation of the RMB, including the pitfalls and the opportunities. This conference is another important step in that journey of understanding.

Internationalisation of the RMB and capital flows

At the outset, I think it is useful to be precise about what we mean when we talk about "internationalisation". In my view, for a country's currency to be viewed as internationalised there are two key conditions that need to be met.

The first is that the country's currency is used for transactions between its residents and non-residents. The progress that China is making in this area is significant, particularly on the trade side. Over the past few years, the share of China's international trade that is denominated in RMB has risen significantly and this trend is expected to continue. On the investment side, there has been an expansion in the schemes that permit approved foreign residents to invest RMB in China. Indeed, over recent times a number of central banks (including the Reserve Bank) have invested some of their foreign currency reserves in RMB. The market for offshore RMB-denominated bonds has also grown strongly, with Chinese residents accounting for the majority of issuance. Further, plans have been announced to allow Chinese residents to invest RMB in approved offshore destinations.

The second condition is that the currency is used in transactions between non-residents. In particular, a truly internationalised currency is one where:

i. non-residents are willing to raise funds in that currency despite ultimately being in need of another currency; and

ii. there are non-residents who are willing to hold an unhedged exposure to that currency.

China has made some progress in this area, but, to date, that progress remains relatively limited. There have, for example, been some reports of non-residents issuing RMB-denominated bonds in the offshore market and swapping the proceeds into their home currencies. But in general, there is still a fair way to go here, including in the development of markets that would support the use of the RMB in this way.

Ultimately, further progress in internationalising the RMB is inextricably linked to China's transition towards capital account liberalisation and a more flexible exchange rate. Experience elsewhere around the world, including here in Australia, suggests that extensive exchange controls and a highly managed exchange rate are unlikely to be consistent with an internationalised currency.

The Chinese authorities understand this and have signalled their intention to further liberalise the capital account and move to a more flexible exchange rate. We saw the latest step in this transition just last week when the daily trading range for the RMB against the US dollar was widened from ±1 per cent to ±2 per cent.

While the journey is clearly a gradual one, I suspect that over the years ahead, the further liberalisation of the Chinese capital account could turn out to be one of the really significant events in global capital markets. To date, much of the capital outflow from China has been intermediated – indirectly – by the People's Bank of China through its intervention in the foreign exchange market and its accumulation of over $US3½ trillion of foreign reserves. At some point, as controls on capital outflows are lifted, this model is likely to change. As it does, the non-official sector will become increasingly responsible for managing the foreign assets of Chinese residents.

As CIFR's report notes, this transition is likely to be associated with an increase in outflows of private capital.[1] This is likely to lead to a change in the type of foreign assets that Chinese entities hold and could have significant implications for some of the asset markets in the countries that receive these inflows. The increase in private capital outflows is also likely to lead to an increase in demand for hedging products by Chinese entities, as at least some of these entities will want to hedge their currency and other risks on their new offshore investments. This growing demand can be expected to support the development of foreign exchange markets in China.

The ability to hedge foreign exchange risk is – alongside the ability to denominate foreign liabilities in local currency – an important ingredient in helping ensure that the benefits associated with a more open capital account and flexible exchange rate are not outweighed by potential financial (in)stability costs.

Indeed, the development of deep and liquid hedging markets is one of the reasons why Australia's experience with capital account liberalisation and exchange rate flexibility has worked out well. When we first moved from a fixed, to a managed, to a floating exchange rate regime in the 1970s and 1980s, these markets were not particularly well developed, but they have since matured significantly. In large part, this occurred organically in response to the increase in demand for hedging products that arose once the exchange rate became more variable. This may well be the case for China too.

This positive feedback loop between liberalisation and market development is also an important lesson from our own experience: if liberalisation does not occur it is hard for markets to develop, and if markets are not developed it is hard to liberalise. But a gradual process of liberalisation can promote market development and stability which makes it easier to liberalise further.

One element of this positive feedback loop is that greater use of RMB for trade invoicing by Chinese firms can allow these firms to reduce currency mismatches on their balance sheets and thus alleviate potential vulnerabilities that could otherwise arise from a more flexible exchange rate regime. Another is that, as capital account liberalisation proceeds, the entry of non-residents to China's domestic financial markets will increase the depth of these markets. And as non-residents become more willing to take on RMB exposures, the pool of potential counterparties for Chinese entities seeking to hedge their foreign currency liabilities will also increase.

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[1] Centre for International Finance and Regulation (2014), "Internationalisation of the Renminbi: Pathways, Implications and Opportunities", Research Report, March. Available at <http://www.cifr.edu.au/site/Research/Targeted_Research_RMB_Internationalisation.aspx>.

Nobody knows precisely how this whole process of RMB internalisation will play out. This is partly because there is no historical precedent for an economy of China's size and relative stage of development integrating itself into a global financial system that is as complex and interconnected as we see today. There are, as Professor Eichengreen highlights in his paper, an array of challenges, risks and uncertainties inherent to China's transition to an open, more market-based economy.

In some ways the task for China is more difficult than it has been for other countries that have made this same journey, including Australia. First, there is much more international scrutiny and the rest of the world has a very strong interest in the outcome. And second, China's financial sector is already very large relative to GDP meaning that setbacks in the reform process could have significant effects on the broader Chinese economy.

That said, if Australia's experience is any guide, the journey can turn out to be a positive one. For us, financial reform and the integration of our capital markets into the global system delivered the basis for sounder macroeconomic policy, more diversified portfolios for Australian investors and the development of tools for hedging risks. But the journey was not without its troubles and there was much learning by doing along the way. At the beginning, the risk management skills of the Australian banks were inadequate to cope with a world in which there was much freer access to foreign capital and credit was no longer rationed. Regulators were also ill-equipped to provide effective supervision. The combination of these institutional weaknesses and intense competition among banks manifested itself most prominently in a bubble, and eventual bust, in commercial property prices in the late 1980s.

Today, China is going through its own adjustment pains. But we should not forget that internationalisation of the RMB holds out the promise of the same benefits that internationalisation of the Australian dollar has delivered for us here in Australia. The effects will not only be felt in China itself, but throughout the world. Amongst other things, the opening up of China's capital account and the process of RMB internationalisation may well elevate the RMB to international reserve currency status. While this still looks to be some way off, it would represent a profound change in the nature of the international monetary and financial system. Some of the potential impacts of all of this are explored for us in Prasanna Gai's paper for this conference.

Some implications for Australia

I would now like to briefly touch on some of the implications of RMB internationalisation for us here in Australia.

It is perhaps stating the obvious to say that we have a strong interest in China's financial reform journey being a successful one. Financial reform can play a significant role in promoting economic and financial stability in our major trading partner. Furthermore, over time, a change in the structure of Chinese capital flows could have significant implications for our own capital and asset markets. And, an increased demand for hedging products and other financial instruments could open up new opportunities for our financial institutions.

In the immediate future, Australia's already strong trade links with China and the growing financial linkages between our two countries mean that there are mutually beneficial opportunities from RMB internationalisation.[2] Some of these are explored in CIFR's research report, and will be discussed by Geoff Weir later today. For example, Australia's funds management industry can benefit from increased investment opportunities within China as inward capital flows to China increase. It can also benefit from sharing its expertise with

[2] I have previously discussed some aspects of this deepening financial relationship in Lowe P (2013), "The Journey of Financial Reform", Address to the Australian Chamber of Commerce in Shanghai, Shanghai, 24 April.

Chinese funds managers and/or providing direct funds management services to Chinese investors as private outward capital flows from China increase. Similarly, the use of RMB for trade settlement in commodity markets may also be mutually advantageous.

In this context, the results of the survey that CIFR has conducted of Australian and Chinese firms' attitudes towards the use of RMB as a trade invoicing currency are particularly relevant. The CIFR survey is an extended version of an earlier RBA survey of Australian firms that was conducted, with the help of local banks, in the lead-up to the inaugural Australia-Hong Kong Renminbi Trade and Investment Dialogue held in Sydney in April last year.[3]

The more recent survey – which Kathy Walsh will present later today – highlights the fact that many Chinese firms still are not aware that RMB can be used as a trade settlement currency. More positively, some of the impediments to RMB trade settlement that were evident in the RBA's initial survey in 2013 – in particular, those related to administrative burden and payment delays – appear to have recently lessened somewhat.

With the second Australia-Hong Kong Renminbi Trade and Investment Dialogue coming up in May, the survey results highlight the importance of efforts to educate firms in both Australia and China about both the RMB trade settlement process and the RMB banking and hedging products that are already available. In this regard, I welcome the Australian financial sector's efforts to support the development of an RMB market here in Sydney, in particular, by ensuring that the current and future RMB product needs of Australian corporates are met, and that clients have ready access to information. Another encouraging sign is the recent announcements by two Chinese banks operating here in Sydney regarding RMB clearing services.

Conclusion

The internationalisation of the RMB – and China's associated move towards a liberalised capital account and more flexible exchange rate regime – has the potential to create a seismic shift in the international monetary and financial landscape. And while China clearly has an interest in getting this process right, the rest of the world – including Australia – also has a strong interest in the outcome. History teaches us that financial deregulation is an inherently risky process, but that there are substantial payoffs if it is done well. Conferences like this are an important part of understanding this whole process and I wish you all the best in exploring the challenges and opportunities that lie ahead.

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3 For an overview of the results of this survey, see Ballantyne A, M Garner and M Wright (2013), "Developments in Renminbi Internationalisation", RBA *Bulletin*, June, pp 65–74.