

# Joachim Nagel: Internationalisation of the renminbi – challenges and opportunities

Speech by Dr Joachim Nagel, Member of the Executive Board of the Deutsche Bundesbank, at the European-Chinese Banking Day at the Euro Finance Week, Frankfurt am Main, 17 November 2014.

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## 1. Introduction

Ladies and gentlemen

I thank you for the invitation and for the opportunity to speak at today's European-Chinese Banking Day.

The 17th of November is a significant date in global trade. One of the world's most important waterways, the Suez Canal, was opened 145 years ago today. At the time it was just 22 metres wide and 8 metres deep, but it shortened shipping routes significantly. European vessels on their way to Asia have been able to bypass the much longer route around the southern tip of Africa ever since. 51 years ago today, another important transport route was inaugurated: the Europe Bridge in the Alps. It is the centrepiece of the Austrian Brenner Autobahn, which is now one of the most important north-south routes in Europe.

But today, on 17 November 2014, the focus isn't primarily on the movement of people or goods, but on payment transactions.

Today we want to celebrate the fact that it is now possible to settle transactions in Chinese renminbi via a local clearing bank here in Frankfurt. From now on, it will no longer be necessary to make use of other trading centres like Hong Kong or other trading hubs for this purpose. I shall talk in more detail about the Frankfurt clearing bank in a moment.

However, I first want to point out where the renminbi currently stands in its process of internationalisation, and what conditions were necessary for the transformation from a trade currency to an investment currency, and what needs to be fulfilled becoming an international reserve currency.

## 2. Status quo: internationalisation of the renminbi

### 2.1 Trade links

The German writer and critic Kurt Tucholsky noted all the way back in the 1930s that the world economy is interwoven.<sup>1</sup> This is true of today's globalised world more than ever before.

Of course, at the time Tucholsky could not have anticipated the rapid pace of development that the People's Republic of China would undergo to become the second largest economy in the world today. As the world's largest exporter, China's foreign trade relations with other countries are highly integrated. This is certainly true of China's economic ties with Germany, which ranks in sixth place in the list of China's ten most important trading partners.

Within Europe, Germany is China's most important trading partner. 12% of all Chinese imports come from Europe, with 43% of these coming from Germany. Put differently, China's trading volume with Germany is the same size as its trading volume with France, the UK and Italy combined. And this is by no means the end of the story. The high level of economic

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<sup>1</sup> "Kurzer Abriss der Nationalökonomie" ("A Brief Outline of Macroeconomics"), in: "Die Weltbühne", 15. September 1931, page 393.

growth expected in China in the coming years represents an opportunity for its trading partners.

As a result of its more extensive trading links, China's strong growth and increasing openness also have an impact on Germany, Europe and the rest of the world. Economists know that for every flow of goods there is a corresponding flow of capital. In other words, money flows into an exporting country in exchange for the goods it sells abroad.

And this is where the internationalisation of the renminbi comes into play.

## **2.2 Payment transactions**

The Chinese currency is increasingly being used as a trade currency, which a brief glance at the payment statistics will confirm. The dollar has traditionally been the main invoicing currency, though the renminbi now already accounts for about 15% of such payments.

There are also signs that the renminbi's significance as a trade currency will continue to grow. According to SWIFT data, the value of all renminbi payments around the world has nearly trebled in the last two years. And, in the same period, the number of financial institutions that use renminbi for payments with China and Hong Kong has risen by 35%.<sup>2</sup>

The majority of renminbi transactions are currently cleared in Hong Kong, but other financial centres are gaining ground. The clearing bank in Frankfurt that I mentioned at the start of my speech is likely to support this trend if not more. German payment transactions in renminbi are growing strongly, up 273% in the first nine months of this year alone. Nearly one-quarter of all German enterprises now use renminbi in their business dealings with China.<sup>3</sup>

For German enterprises, paying in renminbi is certainly an attractive option.

Chinese business partners often provide considerable price advantages to those paying in renminbi. According to a survey by Deutsche Bank, it is possible to negotiate average price reductions of just under 5%.<sup>4</sup>

Many Chinese enterprises prefer to invoice in renminbi in any case, as it is difficult for them to exchange foreign currencies for renminbi. German entrepreneurs that wish to bolster their market position in China now have a way of entering into business dealings with such Chinese enterprises easier.

Despite these advantages, many enterprises still hesitate to use the renminbi. The reasons given are the renminbi's sticky convertibility and restrictions on the movement of capital. Furthermore, until recently it was not possible to directly trade euros and renminbi. Additionally, many SMEs shied away from using offshore markets like Hong Kong, since they want to avoid operating in a different time zone and business language. These caveats are now cleared away by the ongoing liberalisation.

## **2.3 Milestones**

Since the end of September, it has also been possible to trade euros and renminbi directly on the Chinese interbank foreign exchange market at an exchange rate fixed by CFETS

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<sup>2</sup> Time period: August 2012 to August 2014, source: [http://www.swift.com/assets/swift\\_com/documents-products\\_services/RMB\\_tracker\\_Sept2014\\_SdC.pdf](http://www.swift.com/assets/swift_com/documents-products_services/RMB_tracker_Sept2014_SdC.pdf).

<sup>3</sup> SWIFT data  
[http://www.hsbctrinkaus.de/tubweb/pressroom.nsf/0/4CA9D61803F1D8DEC1257D1000264358/\\$File/2014-07-09%20PM%20HSBC%20Internationalisierung%20Renminbi%20Studie%202014.pdf](http://www.hsbctrinkaus.de/tubweb/pressroom.nsf/0/4CA9D61803F1D8DEC1257D1000264358/$File/2014-07-09%20PM%20HSBC%20Internationalisierung%20Renminbi%20Studie%202014.pdf).

<sup>4</sup> [https://www.db.com/medien/de/content/3862\\_4188.htm](https://www.db.com/medien/de/content/3862_4188.htm).

(China Foreign Exchange Trade System) in Shanghai. The euro has thus become the tenth currency to be exchangeable directly for renminbi.<sup>5</sup>

In addition, the Chinese government is currently strengthening the renminbi offshore markets, giving importers outside China a means of paying in renminbi. This year, the Chinese authorities gave the go-ahead for the first clearing banks outside Asia: Germany had the honour of underwriting the first Memorandum of Understanding on Renminbi Clearing in Europe. Subsequently London, Paris, and Luxembourg followed.

In future, German enterprises will also be able to settle payments in Chinese currency without having to reroute them via other financial centres. This will reduce transaction costs and make transactions faster.

The announcement was enough to trigger a significant increase in renminbi trading in those countries in which clearing banks were approved. The expansion of offshore clearing options is therefore strengthening the significance of the renminbi as a trade currency.<sup>6</sup>

#### **2.4 Frankfurt as a centre for renminbi trading**

The Chinese government's decision to appoint a clearing bank for renminbi in Frankfurt – namely the Frankfurt branch of the Bank of China – takes account of the very close economic and financial ties between Germany and the People's Republic of China. The expansion of this clearing solution is likely to further reinforce these relations. Furthermore, Frankfurt is one of the most important financial centres in Europe and hosts two central banks.

German financial institutions and enterprises, in line with officials, were delighted by the announcement of a renminbi clearing bank in Frankfurt. They are hopeful that the choice will provide a boost for the banking metropolis and, above all, for the real economy.

Small and medium-sized enterprises in particular, which form the backbone of the German economy, can tap into the Chinese market more easily or for the first time ever using the option of renminbi clearing from Germany. The clearing bank's expertise and experience will make up for uncertainty or lack of knowledge about renminbi payment transactions with China. Additionally, payments can be cleared within the enterprises own time zone and with client managers speaking their native language.

However, establishing the clearing bank is only the first step. Just as the once very narrow Suez Canal was gradually widened to accommodate enormous container ships – and is now due to be expanded further by building a new canal alongside the existing waterway – the aim here is to expand the clearing bank to form a clearing house in future, too.

This would offer all banks in Germany the opportunity not only to use clearing services but also to shape the design and further development of the clearing house as its co-owners. As a result, the Frankfurt financial centre would be able to position itself as a genuine RMB clearing hub in the European time zone.

### **3. Journey towards as an investment currency**

The renminbi is therefore gaining traction as a trade currency and has in my opinion already reached the level of an investment currency. Expanding use of the renminbi as a global investment currency would mark a further step towards internationalisation.

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<sup>5</sup> Press release issued by the PBoC: <http://www.pbc.gov.cn/publish/english/955/2014-20140929145638977934288/20140929145638977934288.html>.

<sup>6</sup> [http://www.swift.com/assets/swift\\_com/documents/products\\_services/RMB\\_tracker\\_Aug2014\\_SdC.pdf](http://www.swift.com/assets/swift_com/documents/products_services/RMB_tracker_Aug2014_SdC.pdf).

The volumes invested in renminbi will further increase, the more liquid renminbi-denominated financial assets are issued. Important is that the Chinese financial and capital markets are sufficiently deep and receptive to foreign capital.

### **3.1 Milestones**

Due to restrictions on capital movements, the currency is still traded on two different markets: onshore and offshore.

Renminbi-denominated bonds known as “dim sum bonds”, which are issued by both Chinese and non-Chinese issuers, are traded on the offshore renminbi markets – that is to say, outside mainland China. The number of dim sum bonds issued has skyrocketed ever since they were launched in 2007, with a new record level of 451 billion yuan also being achieved in the first nine months of 2014 compared with 376 billion yuan for the whole of 2013.

Dim sum bonds have also been issued in Frankfurt already. Market participants call them “Goethe Bonds”. The trend was started by KfW in April 2014 followed by the Agricultural Bank of China and the China Construction Bank. And I am sure other issues will follow.

In contrast to the comparatively open offshore markets, investors must apply for quotas before they are granted access to the onshore market.

By far the largest onshore market is the interbank bond market, which is currently open to institutional investors only. In July 2014, Germany received a Renminbi Qualified Foreign Institutional Investor (RQFII) quota of 80 billion yuan. Beside the Renminbi Clearing Bank, this was another key milestone for the renminbi hub in Frankfurt. The RQFII quotas enable financial institutions such as asset manager to invest a maximum of just over €10 billion in mainland China. The transactions can be settled via the clearing bank in Frankfurt.

### **3.2 Challenges**

However, surveys among market participants indicate that investors still have some reservations about investing in renminbi. The potential barriers they cite are: operational difficulties, lack of investment products, quota restrictions on investment, concerns about prospects of the currency as a long-term value store and lack of a legal framework.<sup>7</sup>

As I have already mentioned, it is likely that operational issues will soon become less important.

Further reform efforts to make the financial markets more open and receptive are a crucial step towards a flexible and internationally used currency.

To this end, Zhou Xiaochan, the Governor of the People’s Bank of China, assured participants at an IMF committee meeting that major structural reforms in the financial markets would be pushed forward. He explained that the market-based interest rate reform would continue, that the renminbi exchange rate reform would be improved and that the pace of capital account convertibility would be steadily promoted.

With regard to long-term value and potential legal risks, the same applies to Chinese monetary, fiscal and economic policy as to all other currency areas: sound decisions must be made and implemented promptly in order to create and maintain lasting confidence.

## **4. Future of the renminbi as an international reserve currency**

Ladies and gentlemen, I, along with many other economists, believe that it is only a matter of time before the renminbi becomes an international reserve currency. This would be the next

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<sup>7</sup> E.g. Study by Clearstream and Aite Group in May 2014.

step after becoming an investment currency: not only private investors would hold renminbi-denominated assets, but so would central banks.

But how does an investment currency become an international reserve currency?

The IMF has defined a number of criteria that must be met for this to happen.<sup>8</sup>

Allow me to outline the three most important criteria.

1. The currency must be liquid. International reserve currencies are used for interventions in the foreign exchange market, which means that it must be possible to sell or buy the assets quickly and at minimal cost. This is linked to the second condition.
2. The currency must be freely convertible. This means it must be possible to convert it into different currencies in unlimited amounts and at any time.
3. The assets must basically be safe. They must therefore meet the highest standards of credit quality.

The restrictive capital flow regulations and an exchange rate that is steered by central bank intervention mean that the renminbi does not currently meet the IMF's criteria for an international reserve currency. However, over 20 central banks, including a number of European central banks, hold renminbi in their portfolio.

In my opinion, the renminbi has the potential to become a global reserve currency, but still has some way to go.

I see this potential because ...

... thanks to China's economic strength, the renminbi has already become established as a trade currency and its importance will probably continue to increase.

... the renminbi managed its way to an investment currency very smart. And the leap from an investment currency for investors to an investment currency for central banks – in other words, to an international reserve currency – is not so very large.

But I believe the challenge lies in making the transition from a renminbi that is convertible to a limited extent to a renminbi that is freely convertible.

The Chinese government is taking a gradual approach in this regard. This means that it will also decide when the renminbi meets the basic condition for use as a global reserve currency.

## **5. Conclusion**

Ladies and gentlemen, the international role of a currency can be evaluated by looking at how it is used ...

... in payment transactions, or in other words: as a trade currency, ...

... in the asset markets, which is to say as an investment currency, ...

... and potentially even as a reserve currency.

The renminbi has succeeded in becoming a trade currency and its use has increased rapidly over the last few years.

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<sup>8</sup> <https://www.imf.org/external/pubs/ft/bop/2007/pdf/chap6.pdf> (BPM6 paragraph 6.69, BPM6 paragraph 6.72, BPM6 paragraph 6.70).

Nowadays we are witnessing the rise as an investment currency, and ultimately the renminbi has the potential to become an international reserve currency. However, this will not be possible without liberalising capital flows and making the currency fully convertible.

The renminbi's greater international role will benefit both the Chinese economy and its trading partners. This should provide an incentive to explore this path further.

Together with the Federal Ministry of Finance and the state of Hesse, the Bundesbank has laid the foundations for a smoothly functioning renminbi hub in Frankfurt. The infrastructure has been established, and the ball is now in the court of the financial industry, which must make active use of these excellent conditions by creating suitable products and bringing trading volumes to the platform.

In line with the saying that a speaker should exhaust the topic and not the audience, I would now like to draw to a close and thank you for your attention.