Philip Lowe: Renminbi internationalisation

Remarks by Mr Philip Lowe, Governor of the Reserve Bank of Australia, to the RMB Global Cities Dialogue Dinner, Sydney, 27 April 2017.

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It is an honour for me to be able to speak at this Renminbi (RMB) Global Cities Dialogue. I would like to congratulate the Department of Premier and Cabinet in New South Wales and the Sydney for RMB Committee for putting this dialogue together. I would also like to offer a very warm welcome to Sydney to those of you who have travelled from afar, especially those of you from other offshore RMB centres.

We are all here to discuss the internationalisation of the Chinese currency.

This is an important topic. I say this for two reasons. The first is that the internationalisation of the RMB and the associated liberalisation of the Chinese capital account have significant implications for the global financial system. Indeed, it is likely that the internationalisation of the RMB will be one of the biggest forces shaping the global financial system over the next decade or so. The second reason is that as the RMB becomes a truly global currency it is likely to change the way the Chinese economy operates. Australia's experience provides an example here. In our own case, the internationalisation of the Australian dollar played an important role in shaping the development of the Australian economy over the past three decades or so. The internationalisation of our currency was a by-product of the move to a floating exchange rate and the abolition of capital controls. For us, it has been a positive experience. My expectation is that one day China too will be able to make the same claim.

It is easy to appreciate why the Chinese authorities have sought to have an internationalised currency. As one of the world's largest economies – and one that continues to grow in relative importance – it is understandable that China wishes to see the RMB take its place as one of the world's truly global currencies. There are some clear advantages of being in this position. Mainland China's financial markets will be deeper and more liquid, lowering the cost of finance to business. And there's an advantage in being able to use your own currency in international trade and have global prices quoted in your currency. Being a major reserve currency can also help lower the cost of external financing. So China's ambition is readily understandable.

China is clearly making progress towards achieving this ambition. Given this, tonight I would like to talk first about that progress and then about some of the challenges and opportunities that lie ahead.

Progress

When we speak of an internationalised currency, what we typically have in mind is a currency that is used frequently in international trade and investment transactions between residents and non-residents and also in transactions that involve only non-residents.

An internationalised currency can't be achieved overnight. It takes time. It takes time for non-residents to be comfortable using another currency. They need to have the hedging instruments available to manage risk effectively and a degree of familiarity with the foreign currency. It also takes time for the home authorities to be comfortable allowing their currency to be freely bought and sold by non-residents. So internationalisation is not something that occurs quickly.

For the RMB there has been more progress in the use of the currency in transactions between residents and non-residents than there has been in its use for transactions between non-residents only. This is particularly so on the trade side, as the Chinese authorities have been encouraging the use of the RMB for trade invoicing and settlement for quite some time.

The use of the RMB for trade transactions has been facilitated by the establishment of offshore RMB centres, which provide a link between offshore markets and the mainland. As you are aware, these centres are a unique feature of the RMB internationalisation process and are an obvious impetus for this dialogue.[1] Importantly, market participants should have the confidence to use the RMB freely within these centres, as many of these centres have RMB swap facilities with the People's Bank of China (PBC). As such, they play a role in facilitating RMB transactions between non-residents. That said, there has recently been a decline in some measures of offshore RMB activity, which I will touch on in a moment.

Consistent with the experience of other currencies, the increased use of the RMB in trade transactions has led to an increase in RMB-denominated financial transactions between mainland residents and non-residents.[2] Most foreign financial institutions now have access to China's bond markets, including, since last year, in the way previously available only to central banks and sovereign wealth funds. Nevertheless, domestic bonds purchased by foreign investors only account for around 1–1½ per cent of the market, although the market itself has expanded quickly. The authorities also intend to create a link between the bond markets in mainland China and Hong Kong later this year. In addition, as of earlier this year foreign investors are permitted to participate in the domestic foreign exchange derivative market to hedge the currency risk they take on as part of their bond investments.

Foreign investors also have access to China's equity markets through programs such as the Shanghai and Shenzhen Stock Connect schemes with Hong Kong. The stock connect schemes have facilitated capital outflows from China, alongside other schemes allowing institutional investors to invest offshore.

Reflecting the progress that has been made, last year the RMB entered the basket of currencies that determine the value of the IMF's Special Drawing Right. This followed the IMF's decision in late 2015 to designate the RMB as 'freely usable'. Not surprisingly, an increasing number of countries, including Australia, invest a portion of their foreign reserves in RMB. I note, however, that according to the IMF's latest figures, the total value of foreign reserves invested in Australian dollars is still significantly higher than invested in RMB. I expect this to change over time.

Our local RMB market has also been developing, albeit from a low base. Recently published survey data collected by the RBA show that the value of RMB deposits held with Australian-resident banks rose strongly over 2015 and has been broadly unchanged over the past year, at around RMB30–40 billion.[3] Consistent with this, annual data from the Australian Bureau of Statistics show that the share of Australia's trade with China invoiced in RMB has continued to rise in recent years.

In contrast to the experience here in Australia, the share of China's total trade settled in RMB has declined over recent times. After peaking at almost 30 per cent in mid 2015, that share is currently around 15 per cent. The decline in the share of RMB payments for imports has contributed to a decline in the stock of RMB deposits in the offshore centres given that supply of RMB to these centres is largely through RMB trade payments.

As Dr Ma touched on earlier today, part of this rise and subsequent fall in offshore RMB deposits reflects changed expectations about the future path of the RMB. But there has also been some underlying growth in demand for offshore RMB deposits for transactional purposes, with investors actively seeking to manage their exposure to exchange rate fluctuations.

So putting all this together, there has been significant progress on many fronts. Indeed, there has been more progress than many observers expected. There is, though, still some way to go for the RMB to be a truly internationalised currency.

Challenges and Opportunities

An obvious question then is how to build on the progress that has been made.

One lesson from experience elsewhere is that having an internationalised currency requires an open capital account. It requires allowing domestic citizens to buy and sell assets overseas and allowing non-residents to buy and sell domestic assets. The flows associated with these transactions generate depth in financial markets and provide a stimulus to the development of hedging markets. This then encourages more transactions: a form of virtuous circle develops. This was certainly the case here in Australia with the internationalisation of our currency. Interestingly, though, at no point did we have a strategic objective of having an internationalised currency. Instead, it happened rather organically as a result of market forces in an open system.

China has been gradually moving in this direction, but the process of opening up has its challenges.

Two of these are worth pointing out. The first is managing the volatility in capital flows that can be associated with a more open capital account. The second is managing the implications for global markets and investment patterns.

The first of the challenges is one that faces any country moving from a highly constrained system to a more liberal system. As the constraints are lifted, people adjust their portfolios in ways they previously could not. These adjustments can lead to sharp and disruptive movements in market prices, particularly exchange rates, especially when markets are still not fully mature.

To date, the Chinese authorities have largely avoided this volatility in market prices, although changes in expectations for the path of the exchange rate have affected capital flows into and out of China.

For a number of years up until mid 2014, the RMB had been considered a ‘one-way’ bet to appreciate against the US dollar. Foreign capital flowed into China as investors sought to take advantage of the higher returns available, but also the appreciation of the RMB. As this capital flowed into China, the central bank offset some of the upward pressure on the exchange rate by purchasing foreign currency and buying foreign assets.

Over the past couple of years, though, things have changed, with the RMB depreciating against the US dollar, alongside persistent expectations for further depreciation. Chinese residents have taken advantage of some new freedoms to increase foreign investment and the depreciating exchange rate has increased their incentive to do this. Mainland companies also appear to have delayed their export receipts and pre-paid for imports in anticipation of the RMB being weaker in the future. And they have also boosted their foreign currency deposits by holding onto foreign currency trade receipts (rather than converting them to RMB) and using them to repay foreign currency loans.

In response to these changes, the Chinese authorities have sold some of the foreign assets they purchased previously. As a result, China’s foreign currency reserves have declined from a peak of US$4 trillion in mid 2014 to around $US3 trillion now. Fewer foreign assets are now held by the central bank and more are being held by other Chinese entities. As the People’s Bank of China has stated, this is a desirable shift.

The Chinese authorities are understandably concerned that, left unchecked, the turnaround in capital flows could be destabilising. As a result, there has been some tightening up in the ability of Chinese residents to purchase foreign assets. The available data, as well as reports from

China, suggest that these measures have slowed the outflow of capital.

It should not come as a surprise that the Chinese authorities are proceeding cautiously and have sought temporarily to slow outflows or inflows from time to time. While many countries have liberalised their capital account and made their exchange rate more flexible, few, if any, have done so without causing at least some disruption to their domestic financial system.

Short-term controls arguably can have a positive effect on financial stability in China by reducing the risk of a disorderly currency adjustment and pressures in Chinese financial markets. But there is a balance to be struck here, as tightening up controls runs counter to the longer-run goal.

One consideration is the signal that a tightening of controls, after several years of liberalisation, could send to investors about how the government perceives the balance of risks facing the economy. A broad based and persistent tightening of capital controls might also exacerbate domestic vulnerabilities, by causing domestic liquidity to be greater than might be desired from a strict macroeconomic management perspective. Ultimately, balancing these competing risks is a difficult task.

The second challenge for China is dealing with the implications for the global financial system. Unlike the challenge of dealing with volatility, this challenge is not one that most other countries have faced. It is an issue for China because of its size. When Australia opened its capital account the rest of the world hardly paid attention. But this is not the case for China. The rest of the world is watching and it has a strong interest in the outcome.

Chinese gross portfolio flows remain small relative to the size of its economy. As my predecessor, Glenn Stevens, noted, if China's gross portfolio flows were equivalent to 5 per cent of GDP in 2015 – the figure for many other countries in Asia and a bit less than that for Australia – China would account for a little more than one-fifth of global portfolio flows.[4]

Because of China's size, investment by Chinese entities abroad has the potential to affect the prices of many assets significantly. We have already seen some signs of this with, for example, housing prices in some cities being affected by the inflow of Chinese money. The nature of the foreign assets owned by Chinese entities is also changing, as the central bank has a different portfolio composition from that of most other Chinese entities.

In many countries, a related issue is the purchase of domestic assets by Chinese state-owned enterprises. There have been a few high-profile cases where governments have blocked deals by Chinese state-owned enterprises. But, by and large, most countries, including Australia, have welcomed Chinese investors in a wide range of sectors. Chinese capital is helping to build businesses and stronger trade links. So there are a lot of issues to be managed here.

Conclusion

To conclude, China is going through an important transition. It was not that long ago that the Chinese currency could be used only within China's borders. In contrast, today China has the ambition of having a global currency. The effects of this transition – involving the internationalisation of the RMB and the opening up of the capital account – could ultimately be as wideranging as were the effects of China's ascension to the World Trade Organisation. Managed well, this transition can be a win-win for both China and the rest of the world.

Thank you.

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[1] Eichengreen B (2017), 'The Renminbi Goes Global – The Meaning of China's Money', Foreign Affairs, 13 February. Available at www.foreignaffairs.com/reviews/review-essay/2017-02-13/renminbi-goes-global.

[2] See, for example, Frankel (2012), 'Internationalization of the RMB and Historical Precedents', Journal of

Economic Integration, 27(3), pp 329–365, available at www.hks.harvard.edu/fs/jfrankel/RMBintnztnJEI2012pg329~365.pdf.

[3] These data can be found on the Statistical Tables page of the RBA website (Table B20).

[4] Stevens G (2015), ‘Address to the Boao Forum for Asia Financial Cooperation Conference’, Audio address, Reserve Bank of Australia, Sydney, 30 July. Chinese gross portfolio flows were equivalent to a little less than 1 per cent of GDP in 2015.