



SECURITY POLICY BRIEF

Geopolitical Influences on the Future of Renminbi

John Ryan

The Chinese government has made great strides in its ambition to turn the Renminbi into a global reserve currency. The importance of Europe to China's economy is unquestionable, so Brexit is an unwelcomed event. China's resolve to reduce its US Dollar exposure has intensified following the election of Donald Trump as president. This political friction has reinforced concern by China that the US could intentionally slip into a situation in which a trade war occurs. Such a trade war between China and the US could have a detrimental effect on the global economy.

CHINA'S RENMINBI AMBITIONS

The Renminbi is on course to become a major international currency for transaction purposes. It will be increasingly used in international transactions involving Chinese nationals as one or both of the transacting parties. Over time, it may even be used in transactions between third-party countries, especially those that run a trade surplus vis-à-vis China and hence have a ready source for Renminbi balances. What the Renminbi needs to do is hold its exchange rate steady and not to adjust its value abruptly. By reducing its volatility relative to the US Dollar, the Renminbi can become the preferred currency

for international transaction purposes for other countries. Eventually, it may also be used as a unit of account for cross-border credit, debt and loan transaction purposes. For example, some of the loans to be made by the Asian Infrastructural Investment Bank (AIIB) can be denominated in whole or in part in RMB if the borrowers so wish; and some of the long-term projects under the 'One Belt, One Road' initiative can be partially financed through the issuance of Renminbi-denominated bonds.

The People's Bank of China (PBOC) has adopted a policy of bilateral central bank swap arrangements which focuses on three major objectives: strengthening trade following the global financial crisis, shaping an RMB currency zone and encouraging the growth of RMB deposits in foreign central banks.

China has also stepped up purchases of Euro-denominated assets and boosted monetary relations with European central banks through currency-swap agreements and RMB bank clearing. More than 50 central banks have so far added the Chinese currency to their portfolios as growing trade ties and reforms by China are leading reserve managers to view it as a viable reserve currency. Most of Europe's major central banks have added, or are

considering adding, the RMB to their portfolio, often at the expense of the Dollar.

RMB internationalization has increasingly fed offshore centres such as London and Singapore. When it comes to handling global payments in RMB, Hong Kong still takes the lion's share with over 70 percent of the market by value.

In November 2014, the ECB decided to add the RMB to its foreign-currency reserves. China entered into a very large currency swap agreement with the Eurozone which will allow more trade and investment between the regions to be conducted in Euro and RMB, without having to convert into another currency such as the US Dollar. This agreement will result in a reduction of US Dollars being used in trade between China and Europe. China currently owns about US\$1.3 trillion of US debt, and this enormous exposure to US debt has become a major political issue among the country's leadership.

The PBOC has also designated a number of RMB clearing banks as RMB Qualified Foreign Institutional Investors (RQFII). Half of these "RMB hubs" are in Europe, including in London, Frankfurt, Paris, Luxembourg and Prague. On 21 January 2015, China's and Switzerland's central banks signed an RQFII agreement, making Zurich another hub for RMB trading.

China's ultimate goal is to make the RMB one of the main currencies for global trade and to place limits on the role of the US Dollar in the international monetary system. Since 2008, Chinese officials and scholars have maintained that the USA is abusing its position as controller of the main reserve currency by pursuing irresponsible economic policies. An op-ed by Xinhua agency on 22 October 2013 did not hesitate to call for a "de-Americanized" world.¹

RENMINBI AS A FOREIGN POLICY TOOL

China's designs for the RMB are being shaped by foreign policy rather than macroeconomics. In a nutshell, the country wants to create an RMB zone in Asia, together with a larger RMB segment in global finance. The principal instruments include the internationalization of the RMB in currency trading; the settlement and denomination of trade and capital transactions; and backing for a new financial architecture. Yet, success to gain global reserve currency status cannot be taken for granted.

First, even though China will soon be the biggest global economy and already is the biggest exporting nation, it does not follow that the rest of the world will want to accumulate RMB claims on China as their principal reserve assets. To have a reserve currency, a high degree of internationalization is essential. But you also need fundamentals that China will be slow or reluctant to provide: a totally flexible exchange rate, unrestricted inward and outward capital flows, and open, liquid and trusted capital markets that rest on the rule of law.

Second, to groom a reserve currency, foreigners have to be allowed to acquire RMB claims on China in either of two ways: through a current account deficit, which China does not have and may not have for a long time, or through an open capital account, in which capital flows freely in and out of the country. China will run a current account deficit if and when domestic investment exceeds savings, but it still has excess savings, and its current economic rebalancing is designed to lower investment. So its external surplus is unlikely to disappear soon.

Third, capital account liberalization is a central goal of the government, but neither the central bank's 2012 timetable envisaging full RMB

convertibility by 2015-2017, nor the creation in 2013 of a Shanghai free trade zone -- designed as a pilot for convertibility -- have lived up to expectations. The Stock Connect programme is a modest and important step to liberalize capital flows, but like so many others, it is likely to prove incremental, and slow.

China has chosen not to disclose exactly the size of its gold holdings. A gold-backed RMB would need to surpass the Federal Reserve's official, but unaudited, gold holding of 8133.5 tons. This would be a game changer as far as the US Dollar continuing to be the global reserve currency is concerned. The US Dollar will not be replaced overnight, but the incremental policy initiatives by China show that there will be a gradual move over the next ten years to a multipolar currency regime. Meanwhile, the use of the RMB as a reserve currency or as a trading currency will slowly rise, especially with its entry to the IMF Special Drawing Rights basket.

China, along with other countries, continues to raise questions about the dominance of the US Dollar and the need for an alternative monetary system. China's resolve to reduce its US Dollar exposure has intensified following the election of Donald Trump as president. This political friction has reinforced concern by China that the US could intentionally slip into a situation in which a trade war occurs. Such a trade war between China and the US could have a detrimental effect on the global economy.

The US has been concerned that the Asian Infrastructure Investment Bank (AIIB) will act as an instrument of Chinese foreign policy, as has the US-led World Bank since it was founded in the aftermath of the Second World War. The UK's then-Chancellor of the

Exchequer, George Osborne, announced on 12 March 2015 that the UK intended to become a prospective founding member of the AIIB. In doing so, the UK was the first major developed country to seek to join the AIIB. France, Italy and Germany then followed, leaving the US looking isolated. While the US views China as a geopolitical rival, with the two powers now vying for supremacy in the Pacific basin, European nations are more mindful of the importance of China as an existing and future trading partner.²

The Washington-based IMF said it would, despite earlier opposition, be "delighted" to cooperate with the AIIB.³ Japan, the US's staunchest Asian ally, has also indicated that it is now willing to work with the Beijing-based institution. That is irrespective of the fact that Japan at the same time controls the US-backed rival Asian Development Bank.

The US played its diplomatic hand badly. China invested in the IMF in response to the 2007-2008 financial and economic crises, but it received little in return as the US Congress refused to deliver on the agreed deal of Chinese cash for voice and voting reforms.

The decision by the UK, Germany and France to join the AIIB as founding members was a blow to the US, which has been so well in control of the world's financial system since 1944. The full repercussions will be known only in another ten or 20 years, but this development may one day be seen to mark the beginning of the end of the US Dollar supremacy.

The AIIB's establishment would seem a natural development against the background of the lack of progress in the ratification by the US Congress of the reforms which would have

given emerging market countries a greater say in the running of the IMF. Along with the AIIB, there is also the New Development Bank (widely known as the ‘BRICS Bank’) jointly founded with Russia, India, Brazil and South Africa and located in Shanghai. Then there is a planned IMF-style contingent reserve facility, together with a further development bank linked to the Shanghai Co-operation Organization, a six-country Eurasian political, economic and military grouping dominated by China and Russia.

Then there are the Renminbi and capital controls. The International Monetary Fund’s executive board approval to include the Chinese currency in the Special Drawing Right basket seems to be having limited success because of the Renminbi’s and economic weakness. Capital outflows due to concerns about China’s economic performance have led to significant depreciation of the currency.

From June 2014, when Chinese currency reserves were US\$ 4 trillion, reserves have decreased to about US\$ 3 trillion in December 2016, which is a five-year low. By adding to restrictive inbound capital controls, China is imposing increasingly tougher outbound capital controls as well as exchange controls to prevent further depreciation. Managing a currency’s exchange rate while allowing free flow of capital is unsustainable. The obvious answer would be a free float. China fears that could lead to sharp depreciation, and economic—and consequently, political—instability.⁴

The internationalization process is complicated by the weakening of the Renminbi since 2015, which has resulted in a reversal of market dynamics. Previously, expectations that China’s currency would appreciate encouraged international investors to hold Renminbi-

denominated assets. However, as these expectations have faded, the prospect of the Renminbi depreciating against traditional reserve currencies such as the US dollar means that demand for Renminbi-denominated liabilities is set to increase instead.

Chinese foreign direct investment associated with the financing of the ‘Belt and Road’ initiative offers the chance to develop and expand the international use of the Renminbi, but this will require active support from Chinese policymakers. Such a development could also, if managed properly, provide a substantial boost to offshore Renminbi markets – especially London’s. However, it remains unclear whether bond issuance for Belt and Road projects can create sufficient momentum for the offshore Renminbi ecosystem to become self-sustaining.

WILL BREXIT DAMAGE OR ENHANCE UK-CHINA RELATIONS?

The 14 October 2014 was a milestone event, the UK treasury became the first developed nation to issue sovereign bonds denominated in RMB. Oversubscription by investors led to a final issuance of more than RMB 3 billion (US\$490 million) with a tightened yield of 2.7 percent. The majority of investors were from Asia, followed by European investors. This issuance marked another step in the maturation of the modest RMB 500 billion (US\$81.6 billion) offshore RMB bond market, with these bonds also known as “dim sum bonds.”

The UK Treasury’s issuance of RMB-denoted sovereign debt is a substantial move in the global integration of China’s financial markets and a movement toward liberalizing China’s exchange rate. The issuance of sovereign bonds provides a benchmark for risk-free rates in the selected currency denomination which all other bond

issuances in the same currency will refer to. Thus, the nature of this sovereign issuance, particularly by a developed central bank with the approval of the Chinese Government, is critical in building the credibility of the RMB and facilitating the growth of foreign RMB markets.

The UK's decision to leave the EU has created uncertainty not only in the UK and the EU, but throughout the world. China is no exception. If Brexit was to isolate the UK's economy from the EU, China's economic and financial strategy would be affected, at least in relation to the EU. Brexit may, for example, slow down China's free trade agreement negotiation process with the EU. Brexit is also expected to reduce Chinese investment in the UK, which in turn may open up opportunities for other EU countries. In the financial markets, London will still be attractive for China as an offshore Renminbi centre in Europe for the time being, since London is the second largest Renminbi offshore market after Hong Kong, and has the largest Renminbi pool in Europe. But with Brexit on the horizon, China may have to adjust its global Renminbi strategy.⁵

The Brexit process will negatively impact the EU-China Bilateral Comprehensive Agreement on Investment (CAI) and added to that, the Dutch, French and German elections in 2017 will certainly further slow the process. On the other hand, the uncertainty in relations with the new US President Donald Trump may encourage the EU and China to complete the CAI process sooner rather than later.

THE CONSEQUENCES OF PRESIDENT TRUMP'S RESET OF US-CHINA RELATIONS?

The election of Donald Trump as president to the United States will also have an impact on US-China relations. First, the US-led Trans-

Pacific Partnership, from which China was excluded, looks dead. Second, given that a Trump government plans to increase spending while lowering taxes, larger borrowings will be needed. China has been by far the largest foreign owner of US treasuries for several years. The U.S. debt to China is \$1.058 trillion, as of December 2016. China's goodwill is crucial to issuing more debt, although, as usual in these cases, Beijing's ownership of such a large stock of US government bonds ensures the relationship is one of mutual dependence.

The Dollar's status as the primary reserve currency remains. Yet last year over 22% of China's external trade was settled in RMB, well up from zero in 2010, while HSBC estimates it will shoot up to 50% in 2020. President Xi Jinping at the World Economic Forum in Davos in January 2017 defended globalization and Free Trade. But if China is to become a free trade champion—and that is indeed to be wished for—it must deal with several challenges.

The Trump administration could quickly feel the full wrath of Chinese retaliation. If it follows through with its threats of trade actions against China, expect China to reciprocate with sanctions on US companies operating there, and ultimately with tariffs on US imports – hardly trivial considerations for a growth-starved US economy. Also expect China to be far less interested in buying Treasury debt – a potentially serious problem, given the expanded federal budget deficits that are likely under President Trump.⁶

President Trump could declare China a currency manipulator and propose penalties if it does not enter into negotiations to lower its trade surplus with the US. China has been trying to control the rate of its currency's depreciation since 2014, and it has had a harder time keeping it stable in trade-weighted terms since mid-2016.

Policymakers have reversed previous trends of capital account openness and currency internationalization in an attempt to slow the pace of the RMB's depreciation. Additionally, foreign exchange reserves have depreciated as they attempt to support the currency. Notably, there are three criteria that must be met for a country to be labelled a currency manipulator by the Treasury Department. The first is a country must have a significant bilateral trade surplus with the US. Second, a country has a "material" currency account surplus. Third, a country is engaged in persistent one-sided intervention in the foreign exchange market.

In the US Treasury semi-annual April 2017 report, there is a "Monitoring List" of major trading partners that "merit attention based on an analysis of the three criteria. Once a country is added to the list, it is kept on there for at least two consecutive reports. China was among those added to the list. However, the Treasury noted that while it met two out of the three criteria in the April 2016 report (a large bilateral trade surplus and a current account surplus above 3%),⁷ it met only one of the three criteria in the October report (the large bilateral trade surplus.)⁸

In any case, going forward, if Trump does label China a "currency manipulator," the follow-up question becomes: how will China respond? In the trade policy realm, the authorities have signalled that they'll respond with tariffs in proportion to the US move. So a sector-by-sector application of anti-dumping tariffs, for example, will likely be met by a similar response from China. An across-the-board tariff on all imports from China would likely be met by a similar response on the Chinese side.

CONCLUSION

The Chinese government has made great strides in its ambition to turn the Renminbi into a global reserve currency. The slowdown and structural shift in its domestic economy combined with recent financial and political turmoil across Europe and the US has created a complex web of challenges.

The Chinese economy will need to navigate the waters of transitioning from an export-led investment driven economy to a consumption-based services-oriented one. In the short term this can only come about with some loss in output growth momentum. The key challenge will be to keep up the overall momentum through a careful steering of macroeconomic and structural policies. If this is not achieved and policy failures lead to a derailment in the fundamentals of the Chinese economy, the very basis for a successful internationalisation of the Renminbi will be undermined.

The Trump administration is proposing a budget it says will increase defence spending by \$54 billion which will certainly put pressure on China. China's policymakers already have their work cut out tackling a host of problems such as its housing boom, the explosion of household and corporate debt and steep industrial overcapacity remain deeply challenging.

The importance of Europe to China's economy is unquestionable. So Brexit is an unwelcomed event which will weaken the European Union. China will just have to grin and bear any potential downturn from its European trade. But if the Euro's survival looks in doubt, protecting the nation's US\$3 trillion official currency reserves from any subsequent exchange rate fallout is paramount. The People's Bank of China will be keeping an eye on developments

and undertaking measures to protect their reserves denominated in Euros.

All these events will challenge China's reserve currency ambitions and the government will have to adapt its strategies in order to keep its vision for a truly global Renminbi on course.

Professor John Ryan is a Fellow at LSE Ideas (International Strategy and Diplomacy). Professor Ryan was a fellow at the St Edmund's College, University of Cambridge and the European Integration section of the German Institute for International and Security Affairs, Berlin, Germany.

Endnotes

¹ Casarini, N. "The internationalization of Yuan and the role of the Euro," China.org.cn, Beijing, China, 2014.

² Wolf, M. "A rebuff of China's Asian infrastructure investment bank is folly," *Financial Times*, 24 March 2015.

³ BBC News, "Lagarde says IMF to co-operate with China-led AIIB bank", 22 March 2015.

⁴ Bloomberg News, "China Reserves Slumped \$320 Billion Last Year as Yuan Tumbled", 8 January 2017.

⁵ García-Herrero, A. and Xu, J. "Assessing China's post-Brexit globalisation strategy", Bruegel Blog Post, 19 July 2016.

⁶ Financial Review, "Donald Trump will find out how vicious US-China codependency could become", 30 January 2017.

⁷ U.S. Department of Treasury, "Foreign Exchange Policies of Major Trading Partners of the United States", U.S. Department of the Treasury Office of International affairs, 29 April 2016.

⁸ U.S. Department of Treasury, "Foreign Exchange Policies of Major Trading Partners of the United States", U.S. Department of the Treasury Office of International affairs, 14 October 2016.