RENMINBI RISING

A NEW GLOBAL MONETARY SYSTEM EMERGES

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To LIU Ming Kang. His reformist integrity inspires us.

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FOREWORD

At a time when effective management of international monetary affairs is fundamental to global economic recovery, the rapid emergence of a new major currency – China's internationalizing renminbi (RMB) – is a transformative event of global significance.

This book analyzes the drivers, progress and likely trajectory of the RMB internationalization. It also looks at what the dawning of the RMB era potentially means for the global financial system, international business and for supporting financial services and products. Overwhelmingly, we see opportunities more than threats.

In tackling this challenging subject Fung Global Institute has, I believe, gone deeper and wider than previous studies on this subject. We have addressed it objectively with a balanced view of different interests and of the welfare of the global financial system as a whole.

True to Fung Global Institute's mission to provide Asian perspectives on global issues, we have taken as our starting point the inner workings and changing needs of China's economy. As China manages its complex transition to a growth model emphasizing domestic consumption and services over investment and export manufacturing, these needs are necessarily expressing themselves through domestic financial reform, with RMB internationalization as an important focal point. We look deeply into these domestic reasons behind the RMB's arrival on the global stage.

A specific example of domestic reform is the Chinese bond markets. We look in detail at how China needs to integrate its bond markets, expand their use and gradually open them to the world, and then how these domestic imperatives support the internationalization of the currency. We also examine China's expanding global network, with Hong Kong as the cornerstone of offshore settlement centers for RMB trade.

We have gone wider by setting the rise of the RMB in a historical context. A century ago, the US dollar overtook sterling in little over a decade to become the leading international currency. While the dollar looks set to remain the principal reserve currency of the world for years to come, its own historical journey is a reminder of how rapidly currencies rise (and fall). In this report, we foresee the RMB possibly challenging in little more than a decade the euro's role as the world's second most important reserve currency. China has already surpassed the euro as a trade-settlement currency.

For some, the speed of this anticipated reordering is surprising, even unsettling. But global businesses have quickly discovered that they can save costs and raise profits by using the internationalized RMB. Provision by the Chinese government of the necessary hard and soft infrastructure has made internationalization of the RMB possible; business profits are making it successful. We have studies of companies in this book illustrating how the RMB's rise is a major opportunity for business to benefit from dealing in RMB.

Having said that, there are inevitable uncertainties as to how fast China can press ahead with domestic economic transformation and RMB internationalization. With these in mind, we offer alternative policy scenarios outlining different outcomes.

Just as the internationalization of the RMB is a moving target, we present this book as a work in progress. Our hope is that it will stimulate debate from economists and professionals in the financial services and industry generally.

Under the project leadership of William Overholt, the authors of this book have taken on one of the hottest topics in international finance with new depth and freshness. I look forward to seeing more such reports from the Asia Global Institute, which, from July 1, 2015, will carry forward the Fung Global Institute's mission to address major global economic issues from Asian perspectives.

Victor K. Fung
Chairman, Fung Global Institute
June 2015

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This book is the product of a large collective effort. HSBC provided the funding for much of the research, after which we undertook further research and a colloquium with The Fung Global Institute endowment funds. We are profoundly grateful to HSBC for its support. HSBC gave us complete independence and freedom in conducting the research and publishing this book. The content of this book (including our views) has not been endorsed by HSBC and does not necessarily reflect the views of HSBC. Accordingly, we are solely responsible for the content, any of our views and any possible errors.

William Overholt organized the project, wrote much of several chapters (particularly the first three and the last three) and edited the overall book. Guonan Ma wrote much of several chapters and helped edit and reshape the entire book. Many forecasts in the book derive from Cheung Kwok Law's econometric analysis. In the interest of readability, we have not included regression analyses and extensive methodological commentary in the book.

A broader team made important contributions. Dominic Meagher provided much of the analysis of the history of monetary system transitions. Julia Leung provided the principal input, including decisive case studies, on why business finds RMB-based transactions profitable. Chris Jeffery's verbal comments and consulting paper provided much of our understanding of reserve currency issues. Geng Xiao organized panels at conferences that gave us important insights into Chinese thinking. Mingkang Liu's guidance throughout the project provided indispensable insights and wisdom.

Jodie Hu, Warren Lu, Zhu Yan, Sai Yau and especially Wang Yao provided research support throughout the project.

Andrew Keenan's editing helped make the book more readable for a non-specialist audience.

We held two colloquia on renminbi internationalization to appropriate as many ideas from smart people as possible and to get reactions to drafts of our work. Experts at the first colloquium, on December 1, 2014, in Hong Kong, included Vina Cheung, Victor K. Fung, Montgomery Ho, Haizhou Huang, Chris Jeffery, C.K. Law, Ka Chai Leong, Julia Leung, Mingkang Liu, Guonan Ma, Paul Malpass, Pamela Mar, Dominic Meagher, Kumiko Okazaki, William Overholt, Andrew Sheng, Michael Spence, Angus Tsang, Kai Man Wong and Geng Xiao.

Experts at the second colloquium, on June 7, 2015, in Hong Kong, included Robert Aliber, Suman Bery, John Burns, William Chan, Ka Mun Chang, Richard Cooper, Steven Davis, M. Taylor Fravel, Victor K. Fung, Andy Haldane, Akinari Horii, Fred Hu, Takatoshi Ito, C.K. Law, Julia Leung, Mingkang Liu, Patrick Low, Guonan Ma, Chung-In Moon, Benjamin Mok, William Overholt, T.V. Mohandas Pai, Sebastian Paredes, Dwight Perkins, Michael Spence, Angus Tsang, Mark Tucker, Ezra Vogel, Kai Man Wong, Helen Wong, Chenggang Xu and Jianzhang Zhuang.

We are deeply indebted to these thought leaders. With so many illustrious scholars, regulators and executives on tap, we have no excuse for whatever we have missed and for any mistaken conclusions drawn from among the different and sometimes conflicting perspectives. Errors of fact and analysis are solely our own.

ABOUT THE AUTHORS

William Overholt is President of the Fung Global Institute in Hong Kong and Senior Fellow at Harvard University's Asia Center. Dr Overholt is the author of six books, most notably *Asia, America and the Transformation of Geopolitics* (2008) and *The Rise of China* (1993). Previously he was Director, Center for Asia Pacific Policy at RAND Corporation. For 21 years he headed investment bank research teams, serving as Managing Director and Head of Research at Bankers Trust in Hong Kong, Managing Director of Research for BankBoston's regional headquarters in Singapore and Head of Asia Strategy and Economics for Nomura in Hong Kong. He also spent eight years at Hudson Institute, where he managed research projects for the Department of Defense, National Security Council, NASA and others, and was director of a business consulting subsidiary. He received his B.A. from Harvard and his M.Phil. and Ph.D. from Yale.

Guonan Ma is a Senior Fellow at Fung Global Institute and a non-resident Fellow of Bruegel, the Belgian think tank. He was Senior Economist at the Bank for International Settlements from 2001 to 2014. A veteran investment bank economist, with experience at Merrill Lynch Asia, Salomon Smith Barney, Bankers Trust and Peregrine Securities, he is one of the most widely published financial economists in Asia and also a consultant to major central banks. He holds a B.A. from Peking University and a Ph.D. from the University of Pittsburgh, and has served as a Lecturer of Economics at Peking University and as a Lecturer and Senior Fellow in Economics at the Australian National University.

Cheung Kwok Law is a Senior Researcher at Fung Global Institute and co-author of a forthcoming book analyzing the development of a successful Chinese city, Foshan. He has a distinguished career as an economist, including roles as Senior Economist for the Hong Kong government, Senior Economist for HSBC, Director of Regional Research for Bankers Trust Securities, Research Director at South China Brokerage and Research Director of the Hong Kong Policy Research Institute. He has also had a career in public service, including Member of Hong Kong's Legislative Council 1995–1998 and Member of the Chinese People's Political Consultative Conference for two decades, among many others. He has lectured at Hong Kong Baptist University and the Chinese University of Hong Kong and served as Administrative Director of Graduate Programs at the Chinese University's Faculty of Business. He holds a B.A. from the Chinese University, an M.A. from Thammasat University (Thailand) and a Ph.D. from the University of California, Los Angeles.

CHAPTER 1

INTERNATIONALIZING THE RMB

The rapid internationalization of the renminbi (RMB) is driving – and being driven by – a fundamental and historic transformation of the global financial system. The impact, which is only starting to be felt, will eventually ripple across the entire world, affecting every economy, government, business and household.

The ramifications are clearly profound. While some are predictable, others are poorly understood and much is necessarily plain unknown. However, history warns that no substantial realignment of the global monetary system is without risk. Indeed, as we show in Chapter 2, the results have at times been cataclysmic. While conscious of these caveats and the nascent stage of the current changes, we nonetheless see cause for optimism in both the direction and progress of the RMB's internationalization.

In this chapter, we shall describe our findings with a broad brush, leaving the details and most documentation to subsequent chapters.

Even as recently as five years ago, few could have imagined the rapidity of the RMB's rise. This has been both a cause and a consequence of the "perfect storm" of four key converging trends:

- Increasing international use of the currency, driven by a combination of cost savings for business, Beijing's support – backed by domestic reform and opening – and the growing weight and influence of China's economy.
- US resistance not only to modernizing and expanding the Bretton Woods institutions that have guided global monetary affairs since 1944, but also to accepting new alternatives designed to fill the growing gaps.

- Deepening skepticism, especially among emerging nations, of the existing system in the wake of the 2008–2009 global financial crisis (GFC). In particular, they are questioning: whether it truly offers the optimal means to achieve stability and prosperity; the continuing relevance of Bretton Woods institutions; and the role of the US Federal Reserve as the de facto world central bank, given that it is required by law to primarily serve US interests.
- China's promotion – particularly in Central and South Asia, the Middle East and Africa – of the kinds of development that helped OECD (Organisation for Economic Co-operation and Development) countries prosper and integrate, as well as enabling institutions.

The pace and pattern of the RMB's internationalization from here will continue to depend on – and drive – these global and domestic developments.

THE CONDITIONS FOR BECOMING A GLOBAL CURRENCY

Internationalization alone does not guarantee a currency's global importance. The New Zealand dollar, for example, is highly internationalized but of little import beyond its borders. Three connected conditions are required for any currency to become a global heavyweight: a large and growing domestic economy; substantial and open capital markets; and trusted and effective institutions to manage the economy and markets. China faces both improving prowess and serious challenges in each of these areas.

Economic Drivers: Growth and Reform

China certainly appears to meet the first of these three conditions. After little more than three decades of galloping growth, following Deng Xiaoping's "reform and opening," it is now the world's second-largest economy – and the biggest by purchasing power. However, it can no longer continue expanding at the 10% pace of the past 35-odd years. Even to maintain a relatively rapid annual rate of 6–7%, China must overcome four substantial challenges. Combined, they present a formidable hurdle.

First, the most important engines of the economy need to be changed. China has to effect a transition from being driven by investment, exports, catch-up manufacturing and state enterprises and instead look to domestic consumption, services, innovation and small and medium-sized enterprises (SME).

Second, it must manage its way clear of a serious financial squeeze compounded from local-government debt, a housing bubble, unregulated shadow banking and extensive industrial overcapacity.

As if these were not challenge enough, it also faces a rapid decline of its working-age population in proportion to the fast-rising numbers of retirees. To maintain growth and fund social welfare, it needs to use its remaining workforce much more productively.

Finally, it must resolve its current environmental crisis of alarming levels of air, water and soil pollution, with the attendant problems of energy security and food safety.

Beijing's response has been encouraging. Its new leadership has announced plans to pursue a far more market-based economy, has begun judicial and governance reforms, and has begun implementing an ambitious environmental program comprising measures to repair and regulate. To impose politically difficult reforms, it has streamlined its top leadership and wielded an anti-corruption campaign.

Given these aims and China's demonstrated ability to implement major change, we expect it to continue, after overcoming the current financial squeeze, to expand more quickly than most other emerging countries and much faster than the advanced economies. We forecast average annual real GDP growth of 5.0–7.5% over 2016–2020. For the following decade, we expect average growth of about 6.0% if planned reforms are achieved, but only 3.5% otherwise. In Chapter 3, we consider several "surprises" that could push the pace even higher or lower.

The core objective of the economic reforms needed to sustain relatively high growth is more efficient and sustainable allocation of resources by moving to more market-dominated allocation of resources. This is in marked contrast to past practice, whereby bank loans, stock-market listings, land allocations and regulatory permissions have been largely dictated by bureaucrats, with a strong bias toward state-owned enterprises (SOEs). Their preferential access to capital – via both the stock market and bank loans – has been at the expense of smaller, dynamic, private-sector firms, which are now the primary drivers of growth, jobs and innovation. The smaller companies' funding constraints were exacerbated by suppressed interest rates, because, if banks can't charge higher interest rates, they can't cover the risk of lending to SMEs. On top of that, an artificially depressed RMB favored old drivers such as net exports to the detriment of the domestic-market expansion needed to fuel the next phase of growth. Similarly, suppressed exchange rates benefited traditional manufacturing based on cheap labor at the expense of more innovative, high-tech industry and domestic consumers. Meanwhile, controlled capital markets deprived savers of investment opportunities and drove their funds into the unproductive property market.

In a few short years, China has mostly both liberalized interest rates and allowed the RMB to equilibrate to a market level. Consider, for example, that the trade surplus has been running at a small 2% of GDP, capital outflows have been substantial, and the People's Bank of China (PBOC) actually intervened recently to support the currency in the interests of broader stability. As well, the freely convertible offshore and capital-controlled onshore market rates have rapidly converged. In late 2014 and early 2015, senior Chinese officials were indicating privately that the RMB is likely to be basically convertible by 2017 and possibly earlier; whether these optimistic forecasts are realized depends on overcoming the conservative resistance that has been augmented in the wake of the mid-2015 stock-market collapse.

Hence, the fundamental needs of the real economy are driving financial liberalization – and the necessary reforms are proceeding quickly. As it happens, these reforms are also exactly what are required for RMB internationalization.

In turn, RMB liberalization and internationalization are necessary components of further financial liberalization, fueling a virtuous circle of reforms. (They also help drive politically contentious domestic liberalizations.)

More specifically, some key links in this virtuous circle of reforms can be described thus: for the RMB to internationalize, it must be convertible; if it is convertible, capital flows must be open; if they are open, domestic interest rates must be free; if they are free, banks must be sound and soundly regulated so that a rise in interest rates does not risk a banking crisis; if the banking system is to be sound, it must be buttressed against runs by the creation of deposit insurance. We examine these links and the logic behind them in more detail in Chapter 3.

Economists typically describe the links in the preceding paragraph as a set of preconditions. For instance, domestic interest rates must be freed and the banking system fully stabilized before the capital account is opened, because opening capital markets too quickly, for example, can be dangerous. The risk is that money floods in, debt becomes excessive