China: Renminbi stalls on road to being a global currency

New capital controls lead to doubt, especially over hopes of forcing economic reform

DECEMBER 11, 2016
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Back in October 2015, as then prime minister David Cameron welcomed President Xi Jinping to the UK, China's central bank issued one-year bills in London's offshore renminbi debt market. The move was viewed as cementing London's status as the centre of renminbi business outside greater China. Two years earlier George Osborne, then Britain's chancellor of the exchequer, had said that the Chinese currency would "become almost as familiar as the dollar" within his lifetime.

The International Monetary Fund would later add the renminbi to its reserve-currency club, the Special Drawing Right basket, describing it as a "milestone in the integration of the Chinese economy into the global financial system".

But even before the IMF's decision took effect in October, there were signs that SDR recognition might turn out to be the high water mark of the renminbi's internationalisation rather than the dawn of a new, more diversified global monetary system.

Across a range of indicators, the extent of its global push has slowed and in many cases slipped into reverse.

The share of China's foreign trade settled in its own currency has shrunk from 26 per cent to 16 per cent over the past year while renminbi deposits in Hong Kong — the currency's largest offshore centre — are down 30 per cent from a 2014 peak of Rmb1tn. Foreign ownership of Chinese domestic financial assets peaked at Rmb4.6tn in May 2015; it now stands at just Rmb3.3tn. In terms of turnover on global foreign exchange markets, the renminbi is only the world's eighth most-traded currency — squeezed between the Swiss franc and Swedish krona — barely changed from ninth position in 2013.

What appeared to be structural drivers supporting greater international use of the Chinese currency now appear more like opportunism and speculation. Between the renminbi's de-pegging from the US dollar in July 2005 and its all-time high of 6.04 versus the dollar in January 2014, the renminbi gained 37 per cent as it followed a nearly uninterrupted path of appreciation.

An expectation that this would continue drew hundreds of billions of dollars in foreign capital into China, often exploiting loopholes in regulations designed to discourage speculative inflows, as investors hoped to profit from risk-free currency gains.

But the tide has turned. The renminbi hit an eight-year low versus the dollar late last month and is on track for its worst one-year fall on record. Investors are offloading renminbi assets and exploiting those same loopholes to move funds in the opposite direction.

July 2005 – 8.3 Rmb/$ – China ends strict Rmb peg to US$

July 2008 – 6.8 Rmb/$ – China re-institutes US$ peg in response to financial crisis

June 2010 – 6.8 Rmb/$ – Rmb resumes 'dirty float' as crisis recedes

August 2015 – 6.3 Rmb/$ – Rmb weakens sharply after central bank reforms daily guidance mechanism

December 2016 – 6.9 Rmb/$ – Rmb on course for its worst one-year fall on record

"After years of living in a hugely prosperous economy and behind a relatively closed capital account, domestic households and corporates have a strong desire to diversify assets offshore," says Wang Tao, chief China economist at UBS. "This has further swelled on the back of intensifying concerns about a domestic asset bubble."

Trojan horse

An anticipated interest rate rise by the US Federal Reserve — that could come as early as Wednesday — and the election of Donald Trump have recently pushed the dollar to its strongest level in 13 years. For China, that adds to the capital outflow pressure stemming from concerns over its slowing economy and spiralling debt. Interest rate cuts by the People's Bank of China last year further reduced the appeal of renminbi assets for yield-hungry investors.

Against this backdrop, China's recent moves to tighten approvals for foreign acquisitions by Chinese companies, as well as other transactions that require selling renminbi for foreign currency, cast further doubt on China's commitment to currency internationalisation.

"There is a fundamental conflict between preserving stability and allowing the freedom and flexibility required of a global currency," says Brad Setser, senior fellow at the Council on Foreign Relations and a former US Treasury official. "Now that the cost is becoming clear, Chinese policymakers may be realising they are not willing to do what it takes to maintain a global currency.

“Capital controls certainly set back the cause of renminbi internationalisation but they may well be the appropriate step for both China and the world, given the outflow pressure China faces.”

As a topic for banking conferences and think-tank seminars, renminbi internationalisation could not be beaten. It offered a way to express dissatisfaction with the US dollar-dominated monetary system, as laid bare by the 2008 financial crisis, while signalling an eagerness to do business with China’s large, fast-growing economy.

For China’s reform-minded central bank, however, renminbi internationalisation — and the prestige value of SDR membership in particular — offered something else: a Trojan horse that could be used to persuade Communist party leaders in Beijing and financial elites to accept reforms that were, in reality, more important for China’s domestic financial system than for the renminbi’s international status.

Since 2010, when the internationalisation drive began, many of those reforms have been adopted: deregulation of bank deposit and lending rates, a deposit insurance system and a more flexible exchange rate.

The totem of currency internationalisation also served as justification for China’s moves over the past half-decade to open up its domestic financial markets to foreign investment, a process known as capital account liberalisation, that has been crucial to the global push of the renminbi. If foreign investors are to hold large quantities of China’s currency, they must have access to a deep and diverse pool of renminbi assets — and the peace of mind of knowing that they are free to sell those assets and convert proceeds back into their home currency as needed.

Most notable among those measures was the decision to eliminate quotas for foreign institutions to invest in China’s $8tn interbank bond market. “Stock connect” programmes through Hong Kong now allow global investors to buy Chinese domestic shares in both Shanghai and Shenzhen. Until last week, regulators had also steadily loosened approval requirements for foreign direct investment, in to and out of the country.

But those reforms occurred at a time when capital inflows and outflows were roughly balanced, which meant that liberalisation did not create strong pressure on the exchange rate. Now, the situation is very different.

“I think [the government’s] assumption has been that they could open up the capital account to foreigners and suddenly money would flow in,” says Imrad Ahmed, investment director for emerging market fixed income at Standard Life Investments in London. “That certainly hasn’t been the case. Why would institutional investors want to hold renminbi assets when there is this embedded exchange-rate depreciation trend, on top of concerns about growth and financial stability?”

A 'dirty float'

Beijing faces a stark choice. Either row back on freeing up capital flows — as it has already begun to do this year — or relinquish control of the exchange rate and accept a hefty devaluation.

"Trying to manage the renminbi's exchange rate while also allowing for freer cross-border flow of capital is clearly hitting its limits," says Eswar Prasad, economics professor at Cornell University and former IMF director for China.

Many economists believe that a floating exchange rate is the optimal response. But the PBoC remains active in the foreign exchange market as buyer and seller. Over the past 18 months, this has mostly meant selling dollars from foreign exchange reserves to counteract the depreciation pressure weighing on the renminbi.

The Shenzhen stock exchange in Guangdong province, China © EPA
The result has been a hybrid policy that traders call a "dirty float": the exchange rate is responsive to market forces but PBoC intervention limits the extent of its movements.

This strategy has been expensive, contributing to a decline in reserves from $4tn in June 2014 to $3.1tn at the end of November. Defenders of the PBoC believe such aggressive action to curb depreciation has been worth the price because it prevented panic selling by global investors. Critics counter that costly forex intervention has merely delayed an inevitable exchange-rate adjustment.

For years, the IMF, US Treasury and other outside experts have urged China to embrace a floating exchange rate. In theory, such a step should eliminate the need to tighten capital controls or to spend precious foreign reserves on propping up the exchange rate. Instead, the currency would weaken until inflows and outflows balance.

Yu Yongding, a professor at the Chinese Academy of Social Sciences and former PBoC adviser, favours this approach. "Some Chinese economists fear any movement of the exchange rate," he says. "They fear that if it falls 2 per cent, then it will fall 10 per cent — and if it falls 10 per cent, then it will fall 100 per cent. That is too far-fetched."

The fear is that an uncontrolled depreciation of the renminbi would spark turmoil in the broader economy and, in an extreme scenario, even lead to political instability.

Mr Yu argues that the renminbi would remain relatively stable, even under a floating currency regime. He cites China's consistently large trade surplus, low foreign-currency debt, and the substantial capital controls that were in place even before the recent tightening. "If you take the whole balance of payments picture into consideration, the renminbi will stabilise quite easily," he says. "Even if it overshoots initially [on the downside], it would rebound."

But others believe the PBoC is right to be prudent in limiting the outright float of the exchange rate.

"In principle, floating the currency makes sense. It's logical. But you've got to remember, we're now in very unusual circumstances," says Qu Hongbin, chief China economist at HSBC in Hong Kong. "With the dollar strengthening and all the uncertainty over US policy and a possible trade war, do they really want to let the currency go? It's unrealistic."

Mixed messages

China is likely to continue its hybrid approach. The State Administration of Foreign Exchange, the regulator, last week said it would continue to encourage outbound investment deals that support the country's efforts to transform its economy, advance up the global value chain and promote Mr Xi's New Silk Road initiative to invest in infrastructure links with central Asia, the Middle East and Europe. But the agency said it would apply tighter scrutiny to acquisitions of real estate, hotels, Hollywood studios and sport teams.

That will probably mean fewer food-additive tycoons buying second-tier UK football clubs. It also suggests a crackdown on fake trade invoices, Hong Kong insurance purchases and gambling losses in Macau — all channels used to spirit money out of China. But its state-champion companies will still be allowed to acquire advanced technology and consumer brands that appeal to the country's rising middle class.

"They are trying to squeeze out all the low quality or suspicious or fraudulent outbound investment. But they have also made it clear they support genuine high-quality investment," says Mr Qu.

As early as 2012, PBoC governor Zhou Xiaochuan clarified that loosening cross-border capital flows and foreign-exchange conversion did not mean abandoning all control. "We will reserve the right to monitor and restrict capital flows in some sensitive areas," said Mr Zhou, who has repeated this position in the years since.

Economists argue that the fate of renminbi internationalisation ultimately depends on far-reaching economic reforms rather than short-term responses to rising capital outflows. These include measures to tackle rising debt, restructure state-owned "zombie enterprises" that are draining resources from more productive parts of the economy and recapitalise a banking sector where non-performing loans are widely believed to be a larger problem than official data indicate.

Mr Prasad warns that the practical effect of tighter capital controls may be less significant than the message that the tightening sends. Instead, he says the authorities need to focus on reforms to restore the confidence of both domestic and foreign investors.

“When you reimpose capital controls after having rolled them back, it can sometimes have a perverse effect,” says Mr Prasad, author of Gaining Currency: The Rise of the Renminbi. “It creates concern about how the authorities perceive the state of the economy and the risks inherent in it.

“What they need to do is something much harder — actually to get started on the broader reform agenda and show that they are serious about it. Right now the sense is that there is very little happening on other reforms.”