Internationalisation of the Renminbi:

Pathways, Implications and Opportunities
Research Report
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INTERNATIONALISATION OF THE RENMINBI

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Internationalisation of the renminbi is an important event for our age, both practically and symbolically. It marks both the growing prominence of China in global affairs and the vast programme of market reform and institution building that is underway. As China and its institutions and markets continue to grow, we can expect its currency and its capital markets to become as important as its economy and global trade links.

These ongoing developments in China will require adaptation and change around the world: to trade patterns and how they are financed and settled, to portfolio investment flows, and to official and international financial institutions and their practices.

The renminbi internationalisation process has elements of the forces of nature – extremely powerful, but with uncertain timing and consequences. What is very clear is that it will drive important market, regulatory and policy changes, as the financial manifestation of China’s growth works its way through financial systems in the region and beyond.

Australia, with China its most important market and source of imports, is clearly in the tide of these developments, and this Centre for International Finance and Regulation research report is timely. It is forward looking, focused on the important issues and makes sensible and constructive suggestions aimed at facilitating deeper and broader financial relations with China.

The report should go a long way to raising awareness of the strength and significance of the development and reform process underway in China.

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The views expressed in the paper are those of the authors only and are not necessarily shared by members of the Steering Committee or by CIFR.
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EXECUTIVE SUMMARY

- Australia’s trading relations are increasingly focused on Asia in general and China in particular, with China now our largest source of imports and largest destination for our exports.

- By contrast, Australia’s financial relations are still dominated by our traditional trading partners, in particular the US and UK.

- These differences between our trade and financial links with China reflect the fact that, while China is now the largest trading nation in the world and will soon be the largest global economy, its financial markets are underdeveloped, with flows of capital into and out of China still heavily restricted.

- This is changing rapidly for a number of reasons, but perhaps most importantly due to:
  - China’s commitment to internationalising its currency over time and the associated requisite policy changes, which include opening up its capital markets, improving corporate governance and deregulating interest rates and the exchange rate; and
  - distortions resulting from existing capital controls, regulation of bank deposit rates and a managed exchange rate regime, which argue for similar policy changes.

- Paper 1 of this research report looks in detail at the types of reforms that successful internationalisation of the renminbi (RMB) requires; at some of the relationships between these reforms and domestic policy imperatives; and at different pathways to RMB internationalisation, examining the potential benefits and costs of each pathway. It also looks at some of the lessons learnt from other countries that have attempted – successfully or otherwise – to internationalise their currencies.

- As capital controls are removed and China’s financial markets deepen, its financial interconnectedness with other countries will continue to rise and may eventually challenge that of the US. Associated with this, the importance of China not just to world growth prospects but also to the provision of global liquidity and the stability of global financial markets will rise. Paper 1 discusses some of the implications of RMB internationalisation for the international monetary system, concluding that, on balance, a dual reserve currency world is likely to be stabilising rather than destabilising, in part because the availability of alternative reserve currencies is likely to increase the discipline on the supplying countries to adopt sound and stable policy settings.
• Paper 1 also examines whether internationalisation of the RMB will foster monetary regionalism and the emergence of a “renminbi bloc” in Asia, suggesting that there is little evidence that this is likely in the absence of it becoming an important political goal actively pursued by the largest countries in the region.

• Paper 2 uses the framework and reform path outlined in Paper 1 to examine some of the implications for financial markets in general - and Australian financial markets in particular - of the opening up of China’s capital account. It suggests that this is likely to be one of the most important factors influencing the type, volume, currency denomination and location of financial flows and financial market activity over coming decades. Some of the more specific findings are that:

  – the RMB is likely over time to become a major trade invoicing and settlement currency, with significant implications for growth in RMB trade-related foreign exchange turnover, in RMB hedging products and other derivatives, and in RMB trade financing;

  – in the absence of some major setback or change in policy intent, within a decade or so China is likely to have amongst the largest if not the largest equity and bond markets in the world, reflecting both its ongoing growth and capital market deepening;

  – associated with this and with the removal of capital controls and deregulation of interest rates and the exchange rate, capital flows both into and out of China are likely to be extremely large, as on the one hand China becomes a substantial and core component of benchmark indices for international asset managers and on the other Chinese private and official sector financial portfolios are diversified.

• Some countries and financial centres are likely to benefit more than others from these developments. In Australia’s case, its very close trading ties with China, its funds management expertise, its natural endowments in sectors of strategic importance to China and its ongoing need for overseas capital to help fund investment all suggest considerable scope for building much closer and mutually beneficial financial ties between the two countries.

• However, this will not happen as a matter of course. It will require the right “financial architecture” and policy settings in Australia, as well as considerable strategic thinking and investment of time and resources on the part of financial services companies.

• Most of the financial architecture is already in place, in particular the swap facility between the two central banks, direct trading between the two currencies and the presence in Australia of most of the major Chinese banks.

• Paper 2 discusses two areas where significant opportunities are likely to emerge: trade-related banking business and funds management. It examines whether there are any particular policy or market constraints to the emerging opportunities in these sectors being realised. The main conclusions reached are as follows:
Because the cost of hedging exchange rate risk is generally cheaper overseas than in mainland China, there is scope for both parties to benefit from more China/Australia trade being invoiced in RMB.

However, a number of constraints to greater RMB invoicing were identified in the survey conducted of both Chinese and Australian companies and follow-up discussions. Some of these – Chinese banks discouraging customers from invoicing in RMB; concerns from Chinese exporters about identifying RMB payments as being genuinely trade-related and hence not subject to VAT; lack of awareness by many smaller Chinese companies that RMB invoicing is possible – are primarily Chinese issues. More generally, greater corporate awareness in both countries of the potential benefits from RMB invoicing and of the range of hedging and risk management products available with respect to RMB invoicing would be beneficial. This issue is on the agenda of the RMB Working Group which was established in the wake of the Australia-Hong Kong RMB Trade and Investment Dialogue held in Sydney in April 2013.

One important reason why so little China/Australia trade is currently invoiced and settled in RMB is the dominance of commodity exports - which are typically priced and settled in $US – in Australia’s exports to China. While opinions differ considerably on the issue, the assessment in Part 2 of the report is that within the decade we are likely to see considerably more commodity exports being invoiced and settled in RMB.

China has very large and growing pools of domestic savings in both the private and the official sector. As capital controls are removed a significant and growing proportion of these savings are likely to be invested offshore. Some of this will be by way of investment mandates granted to offshore fund managers. While the Australian funds management sector has the skills, platforms and capacity to benefit from these developments, there is still considerable market uncertainty regarding the tax treatment in Australia of offshore investors investing through Australian domiciled investment vehicles. This needs to be addressed, by way of finalising legislation to put in place an effective Investment Manager Regime.

Due to the lack of familiarity and comfort with Australia’s managed investment trust (MIT) regime on the part of many potential investors and investment advisers in Asia, including China, there is a need for a wider range of vehicles that are taxed in the same way as MITs.

There is a growing need for portfolio diversification in Australia given the rapidly expanding funds under management flowing from our superannuation system. In the period leading up to the full removal of China’s capital controls, it will be important to ensure better access for Australian fund managers to China’s capital markets, for example by seeking an RQFII quota allocation to Australia.
- Offshore RMB trade settlement arrangements are changing rapidly, both in Australia and overseas. These developments should be closely monitored to ensure that they are as easy and effective in Australia as in other financial centres. While at present there is not a strong case for seeking to have an “official” RMB settlement bank in Australia, this may change over time.

- There would seem to be a lack of awareness on the part of many funds management executives and trustees of the rapid pace of change in China and the associated need to start thinking strategically about how to position for the opening up of China’s capital markets.

- There is evidence to suggest that some Chinese investors and officials perceive that investment in Australia is not welcome or is discriminated against. While there is no evidence for this in terms of investment approvals, ongoing antipathy in a few quarters in Australia towards Chinese investment does need to be overcome.

- If the above constraints can be dealt with, financial links between the two countries are likely to broaden and deepen substantially over the next decade and beyond, to the mutual benefit of both countries.
PAPER 1

PATHWAYS TO RENMINBI INTERNATIONALIZATION

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1. INTRODUCTION

Renminbi internationalization is a sort of Rorschach test for observers of China’s economy. For some it is a logical corollary of efforts to rebalance away from the production of goods to the production of services, including financial services, and of process of developing the country’s financial markets. For others it is a Trojan horse of policy makers committed to moving China to a fully open capital account. To some it is a logical policy for a country seeking to limit its dependence on the dollar and to confer on Chinese banks and firms the advantages of doing cross-border business in their own currency. To others it is a way for an increasingly powerful China to project its financial leverage internationally and in the Asia-Pacific region in particular.

The reality is that no single motivation, but a combination, lies behind the drive for renminbi internationalization. There is the realization that financial development and currency internationalization go hand in hand: that financial development is necessary for the success of renminbi internationalization, and at the same time that the desire to promote greater international use of the currency can provide a powerful incentive for financial development and reform. There is Chinese dissatisfaction with the prevailing dollar-dominated international monetary and financial system and desire for a more multipolar monetary system to better match the emerging multipolar structure of the world economy. From a narrowly economic point of view, there is the observation that a fully internationalized currency can provide a platform for the global expansion of Chinese banks and finance. From the point of view of symbolism, there is the desire for a global currency to match China’s global economic power. To a greater or lesser extent, all of these motives are at work.

In addition to disagreement about motives, there is disagreement about the best approach to take in advancing the international role of the renminbi. Assume for sake of argument that it is logical and desirable for the renminbi, one day, to play a substantial international role. How then should the country move from the current position, where the renminbi is used internationally to a significantly lesser extent than one would expect of a currency of a country of China’s size that is already the single largest trading economy, to this endpoint where the renminbi is used internationally on a substantial scale?

Pathways

Broadly speaking, there are three approaches, or pathways, to renminbi internationalization. The first pathway prioritizes domestic financial development, liberalization and reform. Domestic reform, including more than just financial reform narrowly defined – one can extend the agenda so that it includes also a considerable range of further economic and political reforms, as discussed below – must come first. Only when that process of domestic reform is well advanced or, in the limit, complete can currency internationalization feasibly follow. Chinese financial markets need to be deepened and developed, while contract enforcement, corporate governance and rule of law need to be strengthened, before renminbi-denominated assets in China will become an attractive unit of account, means of payment and store of value for foreign investors, both private and official. Financial markets need to be substantially reformed by further commercializing the banks, strengthening prudential supervision and regulation, and granting the central bank independence from politics before it will be prudent, from a financial stability standpoint, to adopt the capital account convertibility that is a concomitant of successful currency internationalization.

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1 Rest assured that I fully elaborate the basis for any such assumption below. Similarly I will explore more precisely what might be meant by “one day.”

2 Again, the basis for these assertions – for example, that the renminbi is used internationally to a significantly lesser extent than one would expect of the currency of an economy of China’s size and with its characteristics – is more fully elaborated below. Similarly, the discussion that follows gives more specificity to the phrase “on a substantial scale.”
Since the process of financial development is, by its nature, lengthy, so too will be the process of renminbi internationalization. This approach would seem to be consistent with the Chinese preference for gradual reform – for crossing the stream by feeling the stones beneath the water. But if China opts for this pathway, the process of currency internationalization will take many years to complete.

The second pathway also recognizes the desirability, indeed the necessity, of financial reform but sees renminbi internationalization as a mechanism for accelerating that process. Rapid progress in internationalizing the renminbi will require, as noted, substantially opening the capital account. Capital account liberalization will require the authorities in turn to accept greater exchange rate flexibility. It will require interest rate decontrol to bring domestic rates into line with those prevailing in the rest of the world, insofar as rates at home and abroad are no longer separated by capital controls. It will make bank commercialization and strengthened supervision and regulation imperative if China is to cope with a greater volume of capital inflows and outflows. These are of course the same reforms that the country will have to adopt if it follows the first pathway, but in this second approach rapid currency internationalization forces the process. It is an additional source of pressure for the authorities to reform sooner rather than later. It requires them to move faster in deepening, developing and strengthening financial markets.

If China opts for this second pathway, the process of renminbi internationalization could be relatively quick. But this option comes with risks. If the capital account is liberalized with the goal of internationalizing the currency but domestic reform is not sufficiently quick and comprehensive, financial stability could become a casualty.

The third pathway is an intermediate route in which Chinese financial markets are neither thrown open to the rest of the world as early and completely as in the second approach nor kept closed as long and fully as in the first, and in which the process of currency internationalization is completed more quickly than in the first approach but more slowly than in the second. One version of this pathway concentrates on selective decontrol of capital flows – on liberalizing those components of the capital account most relevant to currency internationalization. Another suggests using offshore financial centers where controls are absent as a platform for launching the process of renminbi internationalization and then progressively deepening the links between those offshore centers and domestic financial markets. A related approach suggests establishing special onshore financial zones, like those recently created in Qianhai and, perhaps more consequentially, in Shanghai, where the currency can be freely accessed and traded while retaining restrictions between the special zone and the rest of the Chinese economy. With time, experience and practices there would then be generalized to the rest of the economy. Yet another variant of this third pathway encourages foreign governments to allow their banks and firms to utilize renminbi credit despite their less than full access to Chinese financial markets by negotiating swap lines between the People’s Bank of China and foreign central banks through which renminbi funds can be obtained.

While this third pathway is designed to lead to an internationalized currency more rapidly than the first, the question is how much more rapidly. In particular, it is not obvious that selective capital account opening will be enough to accommodate the needs of foreign investors for market liquidity and ease of transacting. Similarly, creating an offshore market in an economy as small as Hong Kong or a special financial zone in Qianhai may not be enough to significantly enhance the attractions of the renminbi to foreign firms engaged in import and export trade and private and official foreign investors seeking to diversify their portfolios. Shanghai is a different story, but then Shanghai creates different problems, namely arbitrage between the special economic and financial

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3 In January 2014 the central government announced agreement in principle to create 12 additional free trade zones, including Guangdong, Tianjin and ten to be named later. No timetable was announced, and there was no indication of whether free trade would extend to the financial sector, although given the precedents of Qianhai and Shanghai this would seem likely.
zone and the rest of China and more spontaneous capital account opening than the authorities may have bargained for.

And while this third pathway is designed to lead to currency internationalization more safely than the second, neither is it self-evident that this will be the case. Selective capital controls can be arbitraged. Limited links between offshore and onshore financial markets or between special financial zones and the rest of the economy can be used as conduits for hot money flows. Risks to financial stability will remain.

This paper sets out to analyze these three pathways to renminbi internationalization. It discusses the implications for China, for Asia and for the world of both the three pathways and the terminal state to which they are designed to lead.

It is important to be clear on the destination – on what is meant by currency internationalization. Internationalizing a currency means encouraging its use in cross-border transactions, in general but also specifically by non-residents and in commercial and financial transactions not involving the issuing country itself. Kenen (1983, 2009) distinguishes three functions of an international currency. An international currency serves as a unit of account for cross-border transactions – the private sector can use it for invoicing international trade and denoting international bonds and loans, while a government can use it as the numeraire to which the local currency is pegged. It serves as an international medium of exchange: the private sector can use it for settling import and export transactions, for funding cross-border financial transactions, and as a vehicle for direct foreign investment, while governments can use it as a vehicle for foreign exchange intervention. And it can serve as a store of value for international investors; it can be the currency of denomination for a portion of private investors’ foreign assets and central banks’ and governments’ foreign reserves.

Costs and Benefits

Renminbi internationalization can be seen as desirable for China, Asia and the world, in the abstract in any case. From China’s perspective, the ability of local banks and firms to conduct cross-border business in renminbi is a convenience and an at least modest source of competitive advantage. Banks and firms are freed from incurring currency conversion costs and relieved of having to hedge foreign-currency exposures. Some Chinese firms report that the costs of doing cross-border business in dollars, including both hedging and foreign exchange fees, can be as much as 1.5 per cent of the value of the transaction. The need for the government to hold foreign reserves in order to act as a lender of last resort to private sector entities with foreign-currency exposures is correspondingly less. Renminbi internationalization will facilitate overseas expansion by Chinese financial institutions insofar as they possess an advantage in originating and managing renminbi-denominated credits. An appetite abroad for renminbi-denominated reserves will be an additional source of demand for Chinese government bonds, which will reduce the sovereign’s borrowing costs and potentially also spill over to the corporate sector.

Then there are the advantages to China of the financial deepening and international portfolio diversification that are concomitants of the process of renminbi internationalization. An open capital account that permits borrowing and lending abroad allows households to smooth consumption relative to production. It allows savers to diversify

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4 Cited in Cheng (2013), p.76. Anecdotal evidence suggests that some Chinese firms with market power are able to pass this cost, or at least a portion of it, on to their foreign suppliers and customers by charging a premium in order to bear (or hedge) the exchange risk.

5 McKinsey (2009) estimates that U.S. banks and firms enjoy a 50 to 60 basis point funding cost advantage as a result of the dollar’s international-currency role.
internationally and to insulate their returns from country-specific shocks. Deeper and more efficient financial markets and institutions make for a more efficient allocation of investable resources. They encourage saving where saving is needed (and, in the Chinese case, by providing a higher rate of return are likely to encourage consumption by target savers). They enhance corporate governance by subjecting enterprises to shareholder discipline.

As noted, these advantages come at a cost. There is the loss of monetary autonomy that comes with opening the capital account, given the reluctance of central banks to accept a fully flexible exchange rate. There are the potentially large capital inflows associated with safe-haven motives, which may result in inflation, frothy asset markets, and an overly strong currency that disadvantages exporters. Germany and Switzerland resisted internationalization of their currencies in the 1970s for fear that this would compromise their monetary independence; Germany resorted to capital controls to limit inflows, while Switzerland adopted negative interest rates. Japan similarly resisted yen internationalization until the 1980s for fear that this would interfere with government efforts to direct credit. More recently, Malaysia and Singapore have limited nonresident lending in their respective currencies for fear that this would undermine their central banks’ monetary control.

Moreover, an open capital account, especially if accompanied by a less than fully flexible exchange rate, can fuel an unsustainable credit boom. It can provide a mechanism for big banks subject to moral hazard to assume additional leverage and take on additional risk. A regime that allows governments to fund their deficits more freely, at lower cost, can be a mixed blessing if governments are prone to overspend. Inflows that culminate in sudden stops can pose grave risks to financial stability.

From the standpoint of countries other than China, in Asia and elsewhere, renminbi internationalization promises to lower the cost of transacting with the country that is, in a growing number of cases, their leading trading partner. Access to renminbi reserves and lines of credit will assure other Asian countries of the liquidity needed to complete those transactions. While the same advantages apply to economies in other parts of the world, some of those advantages are likely to be especially pronounced in Asia, where trade with China is greatest and supply chains involving the country are most extensively elaborated.

At the same time, renminbi internationalization may increase the exposure of other Asian countries to economic and financial shocks emanating from China. Whether international liquidity will be provided as predictably and reliably by the People’s Bank of China as it has been by the Federal Reserve System at times of crisis is yet to be seen. Similarly, internationalization of the renminbi will pose new challenges and, potentially, dilemmas for other Asian economies. Whether these will lead to the emergence of a renminbi bloc or to other forms of regional monetary and financial cooperation is, for the time being at least, unclear.

For the world as a whole, a fully internationalized renminbi similarly provides additional opportunity to diversify risks. Renminbi internationalization promises to facilitate global rebalancing to the extent that it is part of the process of rebalancing the Chinese economy from investment to consumption and from manufacturing to services and insofar as it is associated with a more flexible exchange rate. It provides incentives to pursue sustainable policies. Such policies will be needed in China if the effort to internationalize the renminbi is to succeed. Sustainable policies will also become even more important in the United States insofar as the dollar ultimately has a competitor in the international sphere.

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6 See Lardy (2011).
7 Some, like Rey (2013), will argue that monetary autonomy will be limited by an open capital account even when the exchange rate is fully flexible.
8 Section 8 below considers the issue in more detail.
In the longer term, internationalization of the renminbi can also help to meet global liquidity needs. With the continued emergence of emerging markets, it will be increasingly difficult for the United States on its own to provide safe and liquid assets on the scale required by an expanding world economy. The ability of the U.S. government to provide safe assets, in the form of treasury bonds, is limited by its fiscal capacity – that is, by its ability to raise the tax revenues needed to service the debt. With catch-up growth in other countries, the U.S. will come to account for a shrinking share of global GDP, and its ability to provide safe assets on the requisite scale will be cast into doubt. Other sources of safe assets will have to be developed. Other countries with adequate fiscal capacity – other large countries, in other words – will have to step up. China is an obvious candidate.

Again, however, there are risks. Some observers doubt the stability of an international monetary system with multiple reserve currencies, where investors including central banks can shift the composition of their portfolios between several liquid markets, destabilizing exchange rates, and where they may be so inclined at the first sign of trouble. They observe that a country seeking to provide safe assets to the global economy must recognize the public-good nature of their provision and stand ready to provide emergency swaps and loans, as the Federal Reserve did in 2008. They question whether China is prepared to meet these conditions and therefore whether the renminbi can help to meet global liquidity needs.

2. THE END POINT

The end point – the goal of the process – is a situation where the renminbi is used for invoicing and settling a substantial share of global merchandise transactions; where it is the currency of denomination of a substantial share of international bonds (bonds for placement with investors resident in countries other than that of the issuer) and of funds used in direct foreign investment; and where it is held as reserves and used as a vehicle for foreign exchange market intervention by a substantial number of central banks and governments around the world.

This much is agreed. Less widely agreed is the meaning of “substantial.” Traditionally, contributors to the literature assume that the competition for international currency status is a winner-takes-all game. Network effects – the incentive to use the same currency in international transactions that is similarly used by other agents – are so strong that there is room for only one international currency of any consequence. In this view, “substantial” is synonymous with “accounts for close to 100 per cent.” The end-point in this case comes when the system tips from the dollar to the renminbi.

In contrast, according to the “new view” developed in recent years (Frankel 2011) network effects, while present, are not so strong as to cause all transactions to gravitate toward a single currency. Other factors like history or geography may cause different groups of agents to transact across borders using different currencies. Consequently several international and reserve currencies may coexist (a small handful if network effects are relatively strong, a larger number if they are weak). While the experience of the second half of the 20th century when the dollar dominated international transactions is consistent with the traditional interpretation, the situation in other periods is more obviously consistent with the new view. In the 1920s, the pound sterling and the dollar shared this international currency role more or less evenly. In the decades before 1914, sterling dominated, but the French franc and German mark each accounted for a quarter to a fifth of international reserves and international

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9 On the definition of global safe assets, see Gourinchas and Jeanne (2012).
10 See for example Benassy-Quere and Pisani-Ferry (2011).
11 See for example Chinn and Frankel (2005).
transactions generally. In the new view, “substantial” could mean a majority of international transactions, but it could also mean a quarter to a fifth or, for that matter, any number of other fractions. A growing body of evidence is consistent with the new view. This latter, somewhat looser definition of “substantial” is therefore adopted in this paper.

The literature points to three prerequisites for a currency reaching this end-point: scale, stability and liquidity. Scale means that the currency has a large platform. Concretely, it means that the issuing country engages in a large volume of international transactions, creating a natural habitat for the currency and encouraging non-residents to use it in transactions with residents. Scale matters because network effects are present (it is more attractive to use a currency if one’s actual and potential counterparties in commercial and financial transactions also use it), even if – consistent with the new view – network externalities are not the only things that matter.

In addition, foreign use of its currency may be less disruptive for a large country than a small one. Recall the examples of the deutschmark and the yen in the 1970s, foreign use of which was discouraged for fear that large inflows into the unit would have undesirable consequences for inflation, the exchange rate and the allocation of credit. Recall also the case of Switzerland in recent years, where large foreign purchases of Swiss francs by private and official foreign investors led the Swiss National Bank to adopt exceptional policies to discourage the practice. A country like the United States or, potentially, China will find such purchases less disruptive because it is large relative to the rest of the world, meaning that it has a larger supply of local-currency-denominated assets to be made available to investors.

The second prerequisite for attaining international currency status is stability – stability in the economic, financial and political senses of the word. A currency that fails to hold its value, whether through inflation or default on interest or principal payments, will not be attractive to international investors. Even if economic and financial stability prevails for the moment, a country whose political stability is in doubt may not be able to maintain that economic and financial stability in the future. It is relevant in this connection that both Great Britain and the United States had stable, consolidated political systems by the time sterling and the dollar became international currencies.

Stable international alliances similarly encourage use of a currency for cross-border transactions. Allied countries tend to trade disproportionately with one another, encouraging use of their respective currencies. The existence of such alliances reduces the perceived likelihood that the issuing country will expropriate a foreign holder. Before 1914, sterling, the franc and the mark dominated in Britain, France and Germany’s respective spheres of geopolitical influence, and in the 20th century the pound sterling hung on for longest as a reserve currency in the British Commonwealth and Empire.

The third prerequisite for international currency status is liquidity. A national currency will be attractive to non-residents if they can buy and sell it without having prices move significantly as a function of how much they buy or sell. Liquidity in this sense requires the existence of deep markets in standardized claims denominated in the currency in question, where such markets are characterized by low transactions costs.

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12 See inter alia Lindert (1969) and Eichengreen (2011) for evidence and discussion.
13 See Eichengreen and Flandreau (2009, 2012) and Chitu, Eichengreen and Mehl (2012, 2013). The fact that even today the euro accounts for a non-negligible share of international financial transactions (it accounts for 24 per cent of the identified foreign exchange reserves of central banks, for example, according to the IMF’s most recent COFER data at time of writing) is similarly consistent with this view.
14 Here I draw on Eichengreen (2013).
15 To be sure, the nature and extent of that supply will depend not just on an economy’s size but on its financial development, as discussed further below.
16 For further discussion of these linkages see Section 7 below.
A large literature considers the determinants of financial development in this sense.\textsuperscript{17} It shows that the development of deep and liquid financial markets is encouraged by the existence of a competitive environment, and specifically by competition among financial institutions.\textsuperscript{18} It requires the existence of a diverse investor base – the presence of a variety of different institutional and individual investors so that not all investors line up on the same side of the market at a point in time. This diversity tends to be easier to attain in a relative large country; another way of putting the point is that the liquidity provision is subject to economies of scale.\textsuperscript{19} The investor participation on which adequate liquidity depends requires reliable contract enforcement to ensure that debts are serviced and that when they are not the priority of claims is respected. It requires high-quality regulation and effective disclosure requirements to ensure the smooth flow of information to investors. It requires the existence of an efficient clearing and settlement system through which to undertake transactions. It requires a ready source of emergency liquidity to the markets.

Attaining adequate levels of market liquidity is arguably the most challenging task for the issuer of an international currency. Doing so requires coordinating the actions of different agents. It requires putting in place the whole host of preconditions for market liquidity and not just a subset. Indeed, it requires acknowledging that those preconditions cannot simply be “put in place” but are, in fact, themselves outgrowths of deeper institutional reforms. The literature on “legal origins” suggests that contract enforcement tends to be stronger and financial development faster in countries with common-law legal traditions.\textsuperscript{20} Reliable provision of lender-of-last-resort and regulatory functions requires creating an autonomous central bank and an autonomous regulator. The “politics and finance” view stresses the need to develop a stable coalition of elite interests favoring entry and competition in financial markets.\textsuperscript{21} All this suggests that financial development has deep roots that penetrate local soil only over extended periods.

Especially controversial in this connection, as noted in the introduction, is the role of an open capital account in financial deepening and development. Capital account openness is obviously helpful from the standpoint of investor diversity: it adds foreign residents to the domestic investor base. It facilitates the participation of foreign institutions in domestic financial markets, in this way enhancing competition. Rajan and Zingales (2001) argue that it is important from the political standpoint; it limits the ability of entrenched interests to block entry and impose restrictive regulation.

Klein and Oliveira (1999) find a statistically significant and economically important effect of an open capital account on financial depth in a cross-section of countries in the period 1996-1995. Eichengreen and Luengnarumitchai (2004) confirm the result for a more recent period. At the same time, others like Wyplosz (2001) question the importance of capital account liberalization for financial development and economic performance. They suggest that it is equally possible to develop financial markets behind the shelter of controls. Development in this case may be slower, but it is more likely to be sustainable (it is less likely to be interrupted or reversed by crises). If there is an overall conclusion from this literature, it is that capital account liberalization is most likely to promote growth and financial development when institutions are strong and when that financial development has first reached a critical threshold.\textsuperscript{22}

\begin{itemize}
\item \textsuperscript{17} For a representative survey see Voghneuei, Azali and Jamal (2011).
\item \textsuperscript{18} See for example Eichengreen and Luengnarumitchai (2004).
\item \textsuperscript{19} Alternatively, cooperation among smaller separate countries can be a route to building market liquidity; this is one of the insights underlying the Asian Bond Markets Initiative.
\item \textsuperscript{20} See LaPorta, Lopez-de-Silanes, Shleifer and Vishny (1998).
\item \textsuperscript{21} See Rajan and Zingales (2001).
\item \textsuperscript{22} Evidence to this effect is in Eichengreen, Gullapalli and Panizza (2011).
\end{itemize}
Many of these considerations point to the conclusion that the prerequisites for international currency status emerge only over long periods. A country like China is thus unlikely to move from a situation where its currency plays a negligible international role to one where that currency is a consequential international and reserve unit over a relatively short period of time.

The United States in some sense offers “proof by counterexample.” The dollar moved from an initial position where it was not used at all in international transactions in 1914 to coequal with sterling as an invoicing, settlement, investment and reserve currency by 1924. This was rapid transition by historical standards. It is important to note, therefore, that exceptional circumstances allowed it to occur. First, not only was the United States a substantially larger economy than Britain at the outset of the transition, but it had larger and by some measures more liquid financial markets.23 It already had a National Banking System regulated by the Comptroller of the Currency and consolidated democratic political institutions. Second, the U.S. moved decisively in 1914 to put in place the institutional and regulatory preconditions for an international currency, removing restrictions on foreign branching by American financial institutions and creating a fully independent central bank to act as a liquidity provider of last resort.24 Third, World War I intervened to interrupt the provision of international financial services by the leading incumbent, Great Britain, weakening pre-existing network effects and first-mover advantages.25

This history suggests that the equally rapid rise of the renminbi is not inconceivable, but that it would require a confluence of circumstances: rapid financial development in China, wideranging institutional, regulatory and political reform, and finally a shock that undermined confidence in and the attractiveness of the dollar. Absence this exceptional confluence of circumstances, the transition is apt to take longer.26

3. THE STARTING POINT

The starting point – aka the current situation – is one where China maintains significant limits on both the use of renminbi by non-residents in transactions with Chinese residents and on the use of renminbi by Chinese residents abroad. Chinese capital account regulations continue to change almost daily, which guarantees that any detailed review of provisions will quickly become dated. Nonetheless, a broad overview is in order.

From a situation at the turn of the century where China’s capital account was essentially closed, liberalization has proceeded in stages:

- In 2002, “qualified foreign institutional investors” (generally offshore subsidiaries of mainand asset managers with a base in Hong Kong) were permitted to purchase and sell a limited range of renminbi-denominated exchange-traded securities in China.

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23 Experts do not always agree; see Sylla and Smith (1995).
24 As argued in Broz (2005), the desire to internationalize the dollar played an important role in these famous reforms. The Fed’s record as lender and liquidity provider of last resort was far from unblemished, and the dollar as an international currency suffered the (negative) consequences in the 1930s.
25 World War I similarly interrupted the provision of internationalization financial services by the issuers of the two subsidiary international currencies, the franc and the mark.
26 Some might argue that speed of change in an age of electronic payments is likely to be faster than in the early 20th century. Time will tell (as it were).
In 2004, residents of Hong Kong and Macau were permitted to conduct personal business in renminbi (they were permitted to open renminbi-denominated deposit accounts).

2007 then saw authorization for corporations to issue renminbi-denominated “Dim Sum” bonds in Hong Kong, principally for funding their investments in China. There was also an increase in the limit on foreign exchange purchases by Chinese residents for purposes of remittance abroad for personal reasons.

2008 saw the beginning of the process where renminbi funds were made available for official transactions. December saw negotiation of the first renminbi-local currency swap line between the People’s Bank of China and a foreign country, namely South Korea. This was followed by the negotiation of renminbi-local-currency swap arrangements with additional countries (five in 2009, two in 2010, seven in 2011, six in 2012, and three (so far) in 2013. These central bank swap agreements differed from earlier arrangements under the Chiang Mai Initiative of 2000 of the ASEAN+3 countries (ASEAN plus China, Japan and South Korea), in which currency swaps were denominated in U.S. dollars. In addition, where renminbi swaps initially involved only other East Asian economies (Korea, Hong Kong Malaysia), over time they evolved to include countries in other parts of the world (Argentina, Iceland, New Zealand, Pakistan, the United Arab Emirates, Turkey, Brazil, Australia, and most recently the United Kingdom and the Euro Area). The role of these agreements is to permit foreign central banks to provide renminbi liquidity to local banks and firms in need, thereby encouraging those foreign authorities to liberalize restrictions on the use of renminbi by such companies.

In 2009 select Chinese companies were authorized to settle trade-related transactions with Hong Kong, Macau and ASEAN in renminbi. January also saw a pilot scheme for cross-border direct foreign investment in the currency, with the elimination of review and approval requirements for outward remittances of funds for FDI abroad by Chinese corporations and financial institutions.

In 2010, companies in select Chinese provinces were permitted to settle import and export transactions with the rest of the world in renminbi. Qualified foreign institutional investors with renminbi funds (by this time foreign central banks, lenders in Hong Kong and Macau engaged in renminbi clearing, and overseas banks involved in renminbi cross-border trade settlement) were permitted to invest them in the Chinese interbank bond market (previously, qualified foreign institutional investors had been limited to purchasing the small number of exchange-traded Chinese bonds).

In 2011 authorization to settle commercial transactions in renminbi was extended to the entire Chinese economy.

In 2012, the ceiling or quota for investment by qualified foreign institutional investors (QFII) in the Chinese securities market was increased from US$30 billion to US$80 billion. Quotas were extended from investors in Hong Kong and Macau to investors in London and then Singapore in 2013. In July HSBC became the first foreign-owned bank to obtain a license under the QFII scheme; the bank announced the intention of using it to launch a mutual fund that would invest in China’s domestic bond market.

27 In October 2013 China added Indonesia to its list, initially a 100 billion renminbi swap line with the country.
• The ceiling for QFII was then raised from US$80 billion to US$150 billion in July 2013. In addition, RQFII eligibility was expanded to London and Singapore in July 2013.\(^{28}\) Finally, the Chinese authorities announced the intention of allowing essentially full capital account convertibility in the free trade zones of Qianhai and Shanghai.

• Most recently, a the Third Party Plenum in December 2013, the authorities announced the intention of taking further steps in the direction of capital account liberalization. These included launching an internationally-compatible international payments system, allowing for additional individual cross border investments, and establishing “Free Trade Accounts in Shanghai.”

A broad characterization of this process would run as follows. The Chinese authorities have been moving, gradually and progressively, to encourage use of the renminbi for a growing range of commercial and financial transactions. The financial dimension acquired momentum first, with permission for qualified foreign institutional investors to purchase shares on the Chinese stock market and for the issuance of renminbi-denominated bonds in Hong Kong. But the process accelerated significantly with authorization in 2009 for a small but growing range of Chinese and foreign companies to settle cross-border commercial transactions in the currency. This allowed a significant volume of renminbi funds to accumulate in Hong Kong, where they could be tapped to finance foreign direct investment, Dim Sum issuance, and investment in Chinese stock and interbank bond markets, thereby reinforcing the financial dimension of the liberalization process. On the official side, meanwhile, PBOC provision of liquidity to other central banks and governments encouraged foreign authorities to relax their limits on the ability of banks and firms to use the renminbi to settle import and export transactions and to take positions in the currency.\(^{29}\)

Another perspective on the progress of capital account liberalization is to look to the results, as measured by the share of trade settled in renminbi, the share of deposits in major offshore financial centers denominated in renminbi, the share of foreign exchange transactions involving the renminbi, and the share of trade-related letters of credit that are denominated in renminbi. Here the record is promising but again mixed. China has made more progress in promoting international use of its currency for purposes related to trade settlements than purposes related to finance. In addition, certain uses, such as renminbi-denominated letters of credit, are heavily limited to a small set of special economic partners, such as Hong Kong and Singapore. See Box 2 below.

\(^{28}\) Although no quotas have actually been granted to institutions from these regions at the time of writing.

\(^{29}\) And where such limits do not exist, as in Australia, the existence of these swap facilities may give private-sector entities the confidence to transact in renminbi, knowing that the central bank will be able to provide them renminbi liquidity if and when they need it.
BOX 2. PROGRESS IN RENMINBI INTERNATIONALIZATION: MARKET INDICATORS

This box summarizes various market indicators of the use of the renminbi in international transactions related to trade, finance and official reserve holdings.

- The renminbi is now used in more than 15 per cent of China's trade settlements, according to the most recent data available at the time of writing. This is a striking increase from essentially zero in 2009.\textsuperscript{30} At the same time, it contrasts with a country like the United States, the vast majority of whose trade settlements are in its own currency.\textsuperscript{31} Ito and Chinn (2013) find that the renminbi underperforms as an invoicing/settlement currency (relative to the currencies of otherwise comparable countries), even controlling for China's financial openness and development, presumably reflecting the inertial pull of other currencies.

- Some 80 per cent of China's renminbi settlements are of trade between China and Hong Kong. In addition, there have been news reports that the use of the renminbi in extra-Asian settlements is growing.\textsuperscript{32} Whether this tendency reflected expectations of renminbi appreciation and, therefore, whether it will continue if those expectations diminish are yet to be seen. Some observers point to the fact that renminbi settlement is more extensive for Chinese imports than exports and that renminbi settlement is more extensive than renminbi invoicing as suggesting that speculative motives have driven the practice and that its growth will slow if and when expectations of renminbi appreciation become more mixed.

- The renminbi accounts for 4 per cent of global issuance of letters of credit for trade-related purposes, making it the third most important currency of denomination for such credits. But it is still far behind the dollar, which accounts for 84 per cent of the world total (the euro is second with 7 per cent). Use of renminbi-denominated letters of credit is concentrated in China and a small number of nearby economies: some 50 per cent of all letters of credit in transactions value sent by banks in China to Hong Kong are denominated in renminbi, as are nearly 20 per cent of those sent by China to Singapore. It does not appear that any other economy has a comparable share.\textsuperscript{33}

- According to the latest triennial survey of foreign exchange and derivatives market activity by the Bank for International Settlements, the renminbi is involved in 2.2 per cent of global foreign exchange transactions (where currency use in foreign exchange transactions sums to a total of 200 per cent, given that two currencies are involved in each transaction) as of April 2013.\textsuperscript{34} This is up from 0.9 per cent in 2010.\textsuperscript{35} That said, the renminbi's 2.2 per cent share contrasts with a global share of 87 per cent for the United States and 33 per cent for the euro area.\textsuperscript{36} Traders complain of inadequate market transparency and of a lack of reliable real-time data on prices. At the end of 2012, Bloomberg signed an agreement to provide real-time data from the China Foreign Exchange Trade System, a subdivision of the PBOC through which all foreign exchange trades on the Mainland are reported – something that may now help to ameliorate this problem.\textsuperscript{37}

\textsuperscript{30} The initial growth spurt was concentrated in 2010 and the first half of 2011, after which the value of trade settlement in renminbi leveled off. Growth then resumed in the second quarter of 2012.
\textsuperscript{31} See Goldberg and Tille (2011) and the references cited therein.
\textsuperscript{32} For example, there have been news reports that as much as 80 per cent of Germany's bilateral trade with China in May 2013 was settled in renminbi (Wong 2013).
\textsuperscript{33} These are data from SWIFT’s “RMB Tracker” as reported by Holley (2012).
\textsuperscript{34} The according to the preliminary results from the latest BIS triennial survey, released in September 2013.
\textsuperscript{35} Cited in Noble (2013).
\textsuperscript{36} At the same time, this is a substantial increase from 2010, when the renminbi accounted for just 1 per cent. Many of the gains over the intervening years appear to have come at the expense of the Hong Kong dollar, whose share from 5 to 1.4 per cent.
\textsuperscript{37} Details are found in Bloomberg (2013).
• There are now more than US$100 billion of renminbi deposits in Hong Kong.36 This is the equivalent of 10 per cent of all bank deposits in the Special Administrative District. These rose rapidly in 2010–11, after which their growth has slowed noticeably.39

• The issuance of renminbi-denominated bonds in Hong Kong rose impressively from low levels when first authorized in 2007 to nearly $7 billion in 2012. This led to considerable excitement about the growth of the Dim Sum market. However, new issuance then fell off in 2013.40 Initially, issuance tended to be by relatively small Hong Kong-based companies. Subsequently the market was tapped by foreign companies like McDonald’s and Caterpillar seeking to finance foreign direct investment in China and by international financial institutions (the World Bank, the Asian Development Bank) with projects there. Most recently the largest share of Dim Sum issuance has been by China-based financial firms. Even today, however, issuers are mostly in small denominations and lack credit ratings, factors which limit their liquidity. The absence until recently of a market in CNY futures contracts makes it difficult for investors in Dim Sum bonds to hedge foreign exchange risk.41 The share of all international debt securities (securities placed with international investors) denominated in renminbi is a scant 0.3 per cent of the world total.42

• While there has been some growth of renminbi-denominated and related derivative instruments, internationally active firms continue to denominate the vast majority of their offshore treasury operations in dollars. Craig, Hua, Ng and Yuen (2013) attribute this to the illiquidity of the relevant renminbi-denominated hedging markets and instruments. While there is good liquidity in renminbi spot, forward and swap markets, renminbi interest rate swap and repo markets are still absent, leading corporate treasury managers to operate in dollars, markets for which are well developed, deep and liquid.

• More than a quarter of China’s inward and outward FDI flows are denominated and settled in renminbi. This is a considerable fraction, again indicative of the progress of renminbi internationalization. Figures for recent quarters suggest, however, that the share of FDI flows denominated and settled in renminbi has stopped growing.42 Time will tell whether this stabilization is a temporary lull or a permanent slowdown.

• Finally, a number of central banks and sovereign wealth funds have evidently diversified their holdings to include renminbi reserves and investments or have plans for doing so. The central banks include those of Austria, Brazil, Indonesia, Malaysia, Korea, Thailand, Pakistan, South Africa, Thailand, Venezuela, Nigeria, Hong Kong and Macau. In April 2013, the Reserve Bank of Australia announced plans (now in place) to invest around 5 per cent of its foreign currency assets in renminbi securities in China, to be purchased on the China interbank bond over-the-counter market, and the RBA received a quota of CNY6 billion from the People’s Bank of China. In addition, renminbi bonds are reportedly held by the Japanese Finance Ministry, the Kuwait Investment Authority and the World Bank/IBRD.44 In most cases, however, exact amounts are not known. While the share of renminbi-denominated assets in total global reserves is not

36 Along with small deposits denominated in the currency in other offshore financial centers. The figure in the text is for March 2013.
37 Craig, Hua, Ng and Yuen (2013) attribute the stagnation in renminbi deposits starting in 2011 to “an increase in the perceived risk of using the offshore currency, which led offshore investors to reduce renminbi holding.”
38 September saw some indications of the market reviving, with the French energy producer Total issuing a 1 billion renminbi bond at a 3.75 per cent yield, up from the 1 per cent rates typical of 2011. Total announced plans of using the money to finance its operations in China, which may explain the relatively long (5 year) duration of the bond.
39 Futures contracts available from Hong Kong Exchanges and Clearing are limited to one-year tenors and are traded only during local market hours.
41 The most recently available figures at the time of writing are for 2013 Q1. In addition, renminbi finance is much more important for inward FDI than China’s own outward FDI (inward FDI accounts for more than 80 per cent of the total). That said, this regularity that the local currency is more heavily used in inward than outward FDI may be quite common across countries.
42 For an example of such reports see Albanese (2011).
known, that total is, by definition, only a fraction of the total claims in “other currencies” as reported to the IMF. Other currencies account for 1.5 per cent of global reserves, of which renminbi reserves are a fraction.\(^{45}\) (Only reserves in U.S. dollars, euros, pounds, yen, Swiss francs, Canadian dollars and Australian dollars are currently distinguished by the IMF.) Huang, Dalili and Gang (2013) show that the renminbi continues to underperform as a reserve currency: simple regressions using as the dependent value the shares of dollar, sterling, euro and yen reserves suggest that the currency of a country with the GDP, exports, and financial market capitalization of China currently should account for at least 2 per cent of global reserves.

A third metric of the progress of capital account opening is the value of China’s foreign assets and liabilities in comparison with the foreign assets and liabilities of otherwise comparable countries. The most reliable estimates of foreign assets and liabilities are those of the “External Wealth of Nations” data set (Lane and Milesi-Ferretti 2013). This shows that China has a large absolute amount of gross foreign assets, although it ranks behind a number of other emerging markets in terms of the gross-foreign-assets-to-GDP ratio (64 per cent in China compared to 80 per cent in Thailand and 116 per cent in Malaysia, all in 2011). More relevant perhaps is the value of net foreign liabilities, since this measures the ability and willingness of non-residents to accumulate local-currency denominated claims on a country. Again, in absolute value these are large compared to the foreign liabilities of other emerging markets, reflecting China’s size; they are more than three times the foreign liabilities of South Korea, for example. The ratio of gross foreign liabilities to GDP is low relative to other emerging markets (75 per cent for Korea, 91 per cent for Thailand, 113 per cent for Thailand, but only 44 per cent for China), suggesting that the process of financial opening, so measured, has considerably further to go.

Comparison with the leading international and reserve currency countries confirms that the process of financial opening and internationalization remains only partial. U.S. gross foreign liabilities are more than eight times China’s; the ratio of U.S. gross foreign liabilities to GDP is more than 170 per cent (again according to Lane and Milesi-Ferretti and again in 2011). The UK, while a much smaller economy, has gross foreign liabilities more than five times China’s and a gross-foreign-liability to GDP ratio of more than seven.\(^{46}\)

In sum, policy measures and outcomes both indicate considerable movement in the direction of capital account liberalization and renminbi internationalization. At the same time, liberalization of the capital account remains incomplete, along with progress in fostering use of the currency in international transactions by residents and non-residents alike. The renminbi is now used in trade settlements and as a currency of denomination for nonresident bank deposits, letters of credit, bond issuance, and foreign-direct-investment finance. The PBOC has negotiated renminbi swap arrangements with central banks in both the Asia-Pacific region and the rest of the world, encouraging the holding of renminbi reserves by central banks and sovereign wealth funds and the development of offshore markets in renminbi funds.

That said, many of these practices are heavily concentrated in the region. Renminbi reserve holdings remain less than would be expected given China’s size and trade openness, as documented above. In important markets, like that for international debt securities, the renminbi plays a negligible role (Box 1). China still has a considerable

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\(^{45}\) This includes both allocated and unallocated reserves (some countries report the composition of their reserves to the Fund, which allocates them accordingly, while others report only the total, which are listed as unallocated.

\(^{46}\) A high ratio that is largely but not completely offset by the large gross foreign asset position characteristic of an international banking center.
distance to go, in other words, in completing the process of currency internationalization. The question is which of the three pathways to the destination it should pursue. I now consider those three paths in turn.

4. FIRST REFORM DOMESTIC FINANCIAL MARKETS, THEN INTERNATIONALIZE THE CURRENCY

The first approach focuses on completing domestic financial reform before proceeding with further capital account liberalization and currency internationalization. It tends to be favored by academics who read the historical record as indicating that the combination of an open capital account and domestic financial weaknesses can create serious instability. These voices question whether capital account liberalization and currency internationalization have significant economic benefits in and of themselves; they point to empirical work questioning the existence of growth benefits from an open capital account. Finally, they challenge the notion that significant progress toward renminbi internationalization can be successfully completed, capital account convertibility or not, before Chinese financial markets are significantly strengthened and deepened. Thus, domestic financial development and reform should come first because renminbi internationalization without it is both risky and futile.

But this conclusion only raises a series of further questions. What measures specifically should that domestic financial reform entail? How should the reforms in question be sequenced? How many of them, exactly, must be undertaken before it is feasible and desirable to proceed further with renminbi internationalization?

Reforming the Banks

The elements of domestic financial reform are well known. These start by strengthening and reforming the regulation of the banking system. The big four Chinese banks are still majority state owned. While they are ostensibly commercialized – they are supposed to operate at arm’s length from the government – whether they in fact take decisions on the basis of commercial motives is widely questioned. The World Bank, in a study undertaken jointly with the Development Research Center, a leading Chinese government think tank, has reportedly recommended making bank privatization, something that would send an unambiguous signal about commercialization, a priority.

Traditionally, the PBOC has set a ceiling for bank deposit rates and a floor for lending rates, ensuring a spread that makes for healthy profits for state owned banks. Effective privatization and commercialization will require fully deregulating deposit and lending rates so that banks with profitable investment opportunities can compete for both borrowers and funding without having to create unregulated off-balance-sheet financial products. In July 2013 regulators lifted some controls over bank lending rates with the goal of permitting the banks to compete more intensively in extending corporate loans. But other controls, notably the ceiling on deposit rates, remain in place at the time of writing.

In addition, reform of the banking system entails strengthening bank balance sheets where they are weak, whether by securitizing and selling off bad loans, requiring the banks to raise additional capital on the market, or injecting government funds into undercapitalized institutions. It requires strengthening supervision and

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47 A clear statement of the view is Yu (2013).
48 An early review of this literature is Eichengreen (2001).
49 See Davis (2013) for a report.
regulation of not just the banks themselves but also of their off-balance sheet subsidiaries, including the investment companies, wealth management products and on-line accounts that constitute the so-called shadow banking system. Many of China’s trust funds and nonbank investment vehicles are in fact operated by banks which use them to attract funding by offering higher interest rates than permitted on normal bank deposits and to extend loans that would require them to hold costly capital and provisions were they to be held on the banks’ balance sheets. The existence of these off-balance-sheet vehicles is already a concern from the point of view of financial stability. It would be of even more concern were the capital account to be further liberalized, in the interest of currency internationalization, enabling these shadow-banking vehicles to compete for offshore as well as onshore funding. In July 2013 the China Bank Regulatory Commission took a first step in addressing these concerns, requiring commercial banks to register wealth management products prior to selling them to the public.\(^{50}\) Deposit rate regulation, by reducing the incentive to create such products as a way of attracting household savings, would be a further step in the same direction.

Reforming Bond Markets

Financial reform starts with the banks for the simple reason that China’s financial system is disproportionately bank based.\(^{51}\) But it proceeds to securities market reform and development, especially insofar as liquid securities (government bonds in particular) are the preferred habitat of foreign investors.\(^{52}\) China’s bond market is the 7th largest in the world according to BIS data on debt securities outstanding. The value of total bonds outstanding rose to $4.3 trillion as of September 2013.\(^{53}\) But this market is still barely a tenth the size of that in the United States, the leading international and reserve currency country. Compared to the United States, the corporate segment of the market remains particularly underdeveloped.\(^{54}\)

Trading activity has risen rapidly, to some US$35 trillion in 2012. But again turnover (the number of times a bond is bought and sold a year) is only a fraction of that in the United States. Average daily trading volume in the U.S. in 2012 was $843 billion. Correcting for the fact that the U.S. bond market is ten times as large as China’s indicates that U.S. turnover is three times as high.\(^{55}\) The market lacks liquidity insofar as many bonds are held to maturity by banks and investment funds.\(^{56}\) Moreover, relatively few bonds are traded on exchanges: 95 per cent of transactions occur on the interbank over-the-counter market, where bonds are offered and purchased by banks and other qualified institutions “through inquiry and independent negotiations.”\(^{57}\) As with other over-the-counter markets, such transactions lack transparency (transactions prices are not known to third parties), and counterparty risk may deter potential market participants.

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\(^{50}\) Specifically, the rule required commercial banks to provide detailed information on a newly established electronic platform on each new wealth management product at least ten days prior to selling it to the public. In addition, banks were required to submit the same information on all wealth management products issued since January 1, 2011 (Zhu 2013).

\(^{51}\) For up-to-date data see Cruz, Gao and Song (2013).

\(^{52}\) A further motive for the Chinese authorities to speed up development of bond markets is in order to enable local governments to free themselves from borrowing from banks (from funding long term projects with short term credit). At the moment, local governments are not allowed to issue bonds, but they have created special-purpose entities known as Local Government Financing Vehicles (LGFVs) in order to do so. There are also significant issues related to market transparency and corporate governance limiting foreign participation in Chinese equity markets and a corresponding agenda for reform (see again Cruz, Gao and Song 2013). However, it is the bond market that matters for reserve-currency status in particular; hence the bond market and not the equity market is the focus of the present discussion. I do however return to corporate-governance issues in Section 7 below.

\(^{53}\) This according to Asian Bonds Online http://asianbondsonline.adb.org/regional/data/bondmarket.php?code=LCY_Bond_Market_USD.

\(^{54}\) The market is disproportionately dominated by Ministry of Finance bonds, central bank notes, and policy bank bonds. This is not necessarily disadvantageous for currency internationalization insofar as these and not corporate bonds are the preferred vehicles for foreign investors. The undervdevelopment of the corporate bond market is nonetheless an issue for market capitalization and liquidity generally.

\(^{55}\) Questions can be asked about the accuracy of these figures (see below).

\(^{56}\) An article by Governor Zhou of the People’s Bank of China accompanying the public guide to the Third Plenum reforms in November 2013, in which he argued that in order to boost liquidity, banks should reduce the percentage of bonds held to maturity, indicates that officials are aware of the problem.

\(^{57}\) To quote Hongbin, Junwei and Xiaoping (2012), p.16.
The authorities are currently attempted to address these deficiencies and enhance the liquidity of China’s bond markets. In July 2013 the PBOC attempted to enhance liquidity and reduce counterparty risk by strengthening the institutional infrastructure for bond trading. The State Council authorized trading of government debt futures to enable investors to hedge risks, with the goal of encouraging participation and hence market liquidity. It mandated that all transactions in the interbank market be conducted through the National Interbank Funding Center and required additional legal documentation of transfers of ownership. In part this was a crackdown on so-called “proxy holding trades,” where a financial institution transfers a bond from one account to another, both belonging to the same individual or financial institution, as a way for the institution in question to boost its standing in industry league tables for trading volumes. On other occasions, it is alleged, the sale is completed at an inflated price in order to create bookkeeping profits. The result in any case was a sharp drop in daily trading volumes, suggesting that historical turnover figures are inflated and market liquidity, so measured, is even less than previously thought.58

The bond market does not obviously pose the same immediate risks to financial stability as do the banks, but the risks are there. An unexpectedly sharp change in interbank bond markets can catch financial institutions off-guard. Leveraged institutions can incur large losses. Short-term funding may become more costly and, in the limit, impossible to obtain. China had a taste of these problems in June 2013, when overnight interbank interest rates spiked from normal levels of 4-6 per cent to as much as 25 per cent and the PBOC initially declined to provide emergency liquidity to the market (it reversed course subsequently). Insofar as foreign investors are especially prone to run at the first sign of trouble, further opening the bond market to foreigners could aggravate such problems.

Sequencing

Along with strengthened supervision of financial markets and institutions should come adjustments in other economic policies and in the institutional arrangements by which they are determined. Greater exchange rate flexibility is required to encourage banks and corporations to hedge their exposures and to facilitate the conduct of an independent monetary policy. A large literature points to the importance of having a flexible exchange rate before the capital account is opened to provide another mechanism for adjusting to capital inflows and outflows. It also highlights advantages of central bank and regulatory independence; this points – controversially in the Chinese context – to the desirability of strengthening the statutory and budgetary independence of the PBOC and of bank and securities market regulators.

What does this view imply in terms of sequencing? It suggests that the process should start with banking system reform, since banks dominate the Chinese system. It should proceed next to reform of securities markets to enable China to develop a less bank-dominated and better balanced and diversified financial system. All this should be accompanied by the creation of an independent prudential regulatory system. Only when banks and securities markets have been significantly strengthened should China move to a significantly more flexible exchange rate – since only then will investors be able to manage the consequences. Importantly, reform means not just reform of policies but also reform of institutional arrangements so as to make the commitment to improved policies credible. Institutional reform, being the hardest step in the view of many observers, is thus likely to come last.

58 Details are in Wildau (2013). This US$35 trillion figure appears to conclude repos, which were not included in the total bonds outstanding number above. Omitting them and utilizing instead figures from Asian Bonds Online reinforces the picture of low turnover.
In this first view, the entire range of reforms should be completed before it is prudent and, indeed, feasible to proceed significantly further in the direction of capital account liberalization and renminbi internationalization.

What are the major obstacles to proceeding as described above? Obviously, there is resistance from stakeholders benefiting from the status quo. Big banks perceiving themselves as able to fund their investments more cheaply as a result of deposit ceilings resist their removal. Banks able to inflate their profits by creating off-balance-sheet investment funds resist tighter regulation. In the Chinese context this means the big commercial banks.\textsuperscript{59}

A state council that appreciates its ability to influence the decisions of the PBOC and regulators will be slow to acknowledge the advantages of agency independence. The state’s control of the banking sector and its regulation enabled the authorities to instruct the banks to ramp up new lending in order to insulate the Chinese economy from the global financial crisis in 2008-9; they will hesitate to distance themselves from the financial sector until they are confident that they possess other, equally effective policy levers.

Finally, the Chinese authorities have traditionally favored testing the efficacy of reforms by rolling out pilot schemes in certain cities or provinces. They will hesitate to decontrol interest rates because, with widely branched banks and integrated financial markets, such pilot schemes are difficult to implement (insofar as arbitrage undermines their implementation).\textsuperscript{60}

All this suggests that this first pathway to renminbi internationalization, if chosen, is likely to be a long one.

5. USE CURRENCY INTERNATIONALIZATION TO PROMOTE DOMESTIC FINANCIAL REFORM

The attraction of moving quickly – even starting – with currency internationalization is precisely that it promises to be speedier. This approach appears to be favored by the PBOC on these grounds.\textsuperscript{61} It is favored by officials who see the need to break down resistance to domestic financial reform. By making such reform imperative, entrenched interests opposing liberalization will find it harder to carry the day. This rapid route to renminbi internationalization is also favored by those who see China’s dependence on the dollar as exposing the country to potential losses. Since mid-2009, proceeding quickly with renminbi internationalization has been seen in China as the only available option for reforming the international monetary system (for moving away from a dollar-centered system) in the absence of U.S. support for more far-reaching reforms, such as the enhanced role for Special Drawing Rights suggested by PBOC Governor Zhou Xiaochuan earlier in the year (Zhou 2009). This approach is also favored by wealthy residents seeking to shift significant shares of their assets abroad but prevented from doing so by capital account restrictions. Finally, it is favored by financial institutions, both Chinese financial institutions seeking more freedom to do business abroad and financial institutions overseas seeking enhanced access to the market in renminbi-denominated business. Hong Kong-based banks, in particular, appear to be strongly supportive, believing that their first-mover advantage will enable them to dominate this market.

In addition, removing remaining restrictions on capital inflows and outflows in short order is now needed, in this view, to further advance the process of renminbi internationalization. The selective relaxation of controls in

\textsuperscript{59} As discussed in Hongbin, Junwei and Xiaoping (2012).

\textsuperscript{60} See however the discussion of free trade and financial cities and zones, in Section 6 below, where such arbitrage opportunities are exactly the obstacle to progress (or, alternatively, the desired goal).

\textsuperscript{61} Again see the discussion in Yu (2013).
the decade from 2003 and especially starting in 2009 led to increased use of the renminbi for cross-border commercial and financial transactions, but that process may now have run its course. Remaining restrictions render wider use of the currency unattractive. Further internationalization, it follows, requires the wholesale removal of remaining capital account restrictions. Chinese officials favoring this approach have not laid out a blueprint or timetable for the transition, but they have hinted that they would like to achieve “basic” capital account convertibility, where all restrictions on cross-border capital flows other than on select portfolio flows are removed, by 2015, and that they are aiming for full capital account convertibility by 2020.

**Implications for Exchange Rates and Capital Flows**

Basic, much less full, capital account convertibility will require wholesale changes in other Chinese policies, starting with exchange-rate policy. Given the large capital inflows and outflows to which the country will be subject, it will become more difficult – some will say impossibly costly – for the authorities to hold the exchange rate stable. If foreign funds flow in, in large amounts, putting upward pressure on the renminbi exchange rate, the PBOC would have to purchase foreign currency in massive amounts to prevent it from appreciating undesirably. The result would be a massive increase in money and credit with undesirable inflationary consequences.62 The PBOC could attempt to sterilize (mop up) the increase in money and credit by creating and selling special purpose sterilization bonds, but if this was done before the bond market was significantly deepened and developed (recall that the scenario in this section is one in which capital account convertibility comes first and other reforms to financial markets follow later), the result could be uncomfortably sharp movements in bond prices and interest rates. Either way, the PBOC would end up greatly augmenting its foreign currency (dollar) reserves and heightening rather than reducing the foreign currency (dollar) risk to which its portfolio is subject – the opposite of the goal of the internationalization policy.

Alternatively, one can imagine circumstances in which the introduction of capital account convertibility is followed by large capital outflows and strong incipient pressure for the renminbi to depreciate. Capital flows might be dominated by the desire of Chinese residents to diversify their portfolios toward foreign assets. There might be a shock to confidence such as rumors of the insolvency of a large financial institution that causes foreign investors to withdraw their funds. China’s gross foreign liabilities are $3.5 trillion; they will presumably increase further with liberalization of the capital account. Even now, gross foreign liabilities roughly match the central bank’s foreign reserves. Thus, the PBOC’s reserves would be exhausted if foreigners repatriated their funds in their entirety. (China also has foreign assets, but these are relatively illiquid; Wyplosz (2007) argues that gross foreign liabilities are the relevant measure of reserve adequacy for a country seeking to stabilize its exchange rate in the face of an open capital account.) If residents join in the panic and seek to transfer their savings abroad, the authorities will be faced with the Hobson’s choice of whether to stabilize the currency or stabilize the banks. Currency pegs are regularly the casualty under such circumstances.

Which scenario – sharp appreciation which puts China’s export competitiveness at risk, or sharp depreciation which jeopardizes confidence and financial stability – is more likely? This is impossible to say. There could be large inflows and sharp upward pressure on the renminbi if there is overwhelming confidence in Chinese growth and strong unsatisfied foreign demand for Chinese financial assets. Or there could be large outflows and downward pressure on the currency if there is a strong unsatisfied demand by Chinese residents for portfolio

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62 The Swiss National Bank’s policy of capping the appreciation of the Swiss franc in the face of foreign inflows is a case in point, although the inflationary consequences have not (yet) eventuated. See also Section 8 below.
diversification or, worse, a shock to confidence. The one thing we can say with confidence is that there is likely to be a large increase in gross capital flows in both directions (both in and out) following a sudden move to capital account convertibility. We just don’t know which direction will dominate. The one thing that can be said with confidence is that it will become more difficult and costly for the authorities to hold the exchange rate stable. The approach described in this section thus requires them to acknowledge the reality of a more flexible currency.

The experience of other economies with open capital accounts (most recently, members of the Eurozone) suggests that foreign capital is most likely to flow in (and out) via banks. Managers of domestic banks who believe that their institutions are regarded as too big, connected and systemically significant to fail will take advantage of access to foreign funding to lever up their bets. Managers of foreign banks who believe that their Chinese bank counterparties enjoy implicit government guarantees will be disproportionately inclined to loan to them. For all these reasons, bank balance sheets tend to be the most procyclical component of the financial system in economies with open capital accounts.

This means that, along this pathway, Chinese regulators will have to move especially quickly to strengthen regulation of the banking system. This will entail raising capital requirements, limiting the banks’ ability to shift exposures off balance sheet, and creating orderly resolution mechanisms for insolvent banks so as to address the problem of too big to fail. They will have to move quickly to develop their capacities in not just micro-prudential supervision, which is concerned with the condition of individual financial institutions, but also macro-prudential supervision, which is concerned with the condition and stability of the financial system as a whole. The PBOC will have to develop the capacity and the will to act as a proper lender of last resort.

Similarly, the authorities will have to move quickly to establish efficient real-time exchange-based clearing and settlement systems for trading bonds, given the possibility of sudden changes in the volume of trading and in prices when investors are all free to switch between domestic and foreign assets.

The idea, then, is that the capital account liberalization required for effective currency internationalization will ratchet up the pressure for these reforms, cut the ground out from under their opponents, and bring about rapid restructuring of Chinese markets and policies along more market-oriented lines. The corresponding danger is that the requisite reforms will not follow or that they will not follow soon enough, allowing things to go dreadfully wrong. Imagine banning helmets to encourage cyclists to drive more carefully. The problem here, similarly, is that if there is an unexpected bump in the road or if the anticipated change in cyclist behavior does not follow, then the consequences for China, for the region and even the world could, potentially, be grave.

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63 An effort to estimate the net direction of capital flows on the basis of cross-country experience is Bayoumi and Ohnsorge (2013). The authors fit regressions of the bilateral asset position (the share of country i’s total portfolio investment that is invested in country j as a function of country j’s share of global assets, additional country characteristics, and the presence or absence of capital controls. The resulting coefficient estimates are consistent with a wide variety of responses of inward and outward Chinese portfolio investment, although the estimates they choose to emphasize point to larger outflows than inflows: “These estimates suggest that capital account liberalization may be followed by a stock adjustment of Chinese assets abroad on the order of 15-25 percent of GDP and a smaller stock adjustment for foreign assets in China on the order of 2-10 per cent of GDP” (p.14). This exercise of course assumes that Chinese behavior in the future will depend in the same ways as the behavior of investors in other countries in the past. It assumes that the control variables capture all the important determinants of desired bilateral asset positions (the authors’ regressions do not control for exchange rate regimes for example). He et al. (2012) take a very different approach, focusing on the determinants of flows rather than stocks and allowing for feedbacks to the independent variables while ignoring valuation effects, but reach compatible conclusions. Hooley (2013) analyzes the same issue using a small simulation model with assumptions about the Chinese current account balance, Chinese and global growth, portfolio diversification motives and changes in the extent of home bias. He concludes that, circa 2025, capital outflows from China are likely to (slightly) exceed inflows under a fully liberalized capital account, although his methodology similarly points to a large increase in gross (two-way) flows.

64 For evidence see Shin (2012) and Rey (2013).
6. INTERMEDIATE APPROACHES TO CURRENCY INTERNATIONALIZATION

The downsides of both of the preceding pathways to renminbi internationalization point to the desirability of a third approach between these extremes. The question is whether such an intermediate approach is in fact a feasible route to the destination.

Partial Capital Account Liberalization

A first intermediate approach would involve neither keeping the capital account closed until the process of domestic financial reform and development is complete nor throwing it open, but rather liberalizing selectively. This can be thought of as an elaboration of the approach taken by the Chinese authorities to date. All controls and limits on the use of the currency for trade invoicing and settlement might be lifted. Similarly, certain controls on capital flows might be removed. But limits on other cross-border financial flows would remain, perhaps for an extended period. In particular, the ability of individual and corporate investors to buy the A-shares of Chinese companies might be limited so as to insulate China from large capital inflows and the associated asset booms. Limits on the ability of individual and institutional investors to transfer large sums of renminbi funds out of the country (and, conceivably, for qualified foreign institutional investors to transfer their existing holdings out of China all at once) might remain for an extended period. The ability of Chinese banks to fund themselves offshore and to borrow on the overnight market from foreign financial institutions could remain strictly controlled. Over time, these restrictions might be further relaxed. But their broad thrust might remain in place for quite some time.

Meanwhile, the authorities would continue to take steps to further the process of renminbi internationalization. They would negotiate agreements with foreign governments to encourage direct trading, like the renminbi-yen direct interbank market that commenced operations in June 2012 (obviating the need for banks and corporations in other countries seeking to buy and sell renminbi to first go through the dollar), and the similar agreement for direct Australian dollar-renminbi trade introduced in April 2013.65 They would negotiate central bank swap lines that will allow central banks in other countries to supply their markets with renminbi credit, encouraging banks and firms in such countries to take positions in the currency.66

But it is unclear whether these limited measures would be enough to foster significantly faster take-up of the currency for cross-border transactions, by non-residents in particular. Chinese firms are the entities most likely to further increase their use of the currency in trade-related transactions.67 Those transactions would be free of restrictions in this scenario. The convenience value for Chinese firms of invoicing and settling export and import transactions in renminbi would be considerable. Those firms would have a variety of uses for their renminbi receipts. They would have ready access to the Chinese financial system if they needed to temporarily borrow renminbi funds to complete their transactions.

Foreign firms, on the other hand, would find paying for goods imported from China in renminbi attractive only if renminbi could be readily sourced. Such firms could obtain renminbi from their local banks, which could obtain it from banks in Hong Kong or another offshore financial center, but they would pay (perhaps twice) for the privilege.

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65 Similar agreements have been negotiated with Russia and Malaysia. At the time of writing, the UK and Singapore have also announced that their currencies will trade directly against the RMB, although it is not yet clear when this will commence.

66 By now, a significant number of such swap lines between the PBOC and foreign central banks have been negotiated, but with rare exception they have not been activated. But in principle they do not have to be activated to be important. In order to foreign central banks assurance that they can obtain renminbi to on-lend to domestic banks and firms when needed, all that is needed is the firm belief that they can and will be activated on request.

67 Indicative of the fact, it is reported that Chinese corporations regularly offer price concessions to encourage their overseas trading partners to settle their import and export transactions in the currency (Cheung 2013, p.8).
Here initiatives like the creation of a direct market in renminbi-yen trades could potentially make a difference. In practice, however, building markets for trading the renminbi against nondollar currencies is easier said than done. The market in direct trades between the renminbi and yen, for example, has had a small footprint. The initially small volume of renminbi-yen direct transactions has meant that the single bid/ask spread on direct trades is larger than the sum of the two bid/ask spreads on renminbi-dollar and dollar-yen trades. Given this initial condition, the market has failed to grow. And given its failure to grow, the initial condition has remained. Some market participants estimate that daily trading volumes would have to increase to US$20 billion daily from the current average of US$500 million to US$1 million before direct trading became attractive.68

Foreign firms, similarly, would find receiving payment for goods exported to China in renminbi attractive only if there were other potentially attractive uses of the currency (assuming of course that they were not simply betting on renminbi appreciation or did not receive a price discount from the Chinese buyer of their goods for accepting payment in the currency). Such companies might also have a significant presence in mainland China, for example in the forms of marketing and distribution, or they may import from China as well as exporting. Because both sides of their balance sheets are to some extent in renminbi, they may want to run some of their treasury and risk management operations in renminbi, and hence they will seek to acquire short-term renminbi-denominated assets. Here, however, the maintenance of restrictions on financial uses of renminbi funds would be a deterrent. Renminbi settlement would be attractive mainly to foreign firms contemplating direct investment in China and with other already authorized uses for the currency – which in practice would mean only a subset of firms exporting to the country.

Similarly, central banks with reserves far in excess of what they require for intervention in financial markets would presumably find it most attractive to hold a portion of their reserves in renminbi in the absence of full capital account convertibility. But central banks with actual intervention needs, like other investors who value market liquidity, would presumably feel otherwise.

The limited-capital-account liberalization strategy thus implies that we should see the renminbi develop more rapidly as a currency for trade invoicing and settlements, as a vehicle for foreign direct investment, and perhaps also as a currency of denomination for international bonds than as a funding currency for international banks or as a form of international reserves.

A specific proposal along these lines is that of Rhee and Sumulong (2013). They propose that China liberalize use of the renminbi for trade- and bond-related settlements but not for other purposes. The PBOC and foreign banks seeking to promote international use of the renminbi would provide custodial functions and create central securities depositories. Use of the currency for trade settlement by non-residents would be encouraged insofar as there is a ready use in bond purchases for the resulting renminbi receipts. Those bond purchases will be more attractive, in turn, if they are secured by the existence of custodians and central securities depositories. This approach is ambitious, on the one hand, in that it sees the Chinese and foreign governments taking a proactive role by creating the infrastructure needed to make it attractive for non-residents to hold Chinese bonds. It is restrictive, on the other, in that convertibility is limited to the bond market.

68 The $20 billion estimate is cited in Mochizuki (2012). The $500 million – $1 billion figure for daily turnover, as of June 2013, is from Collins (2013). CFETS data yield similar figures for daily turnover. Others will counter that these worries about a low-level equilibrium trap are overdrawn. The volume of direct renminbi-yen trades in fact grew steadily over the year following launch of the market, albeit starting from very low levels.
Can this approach succeed? Prior experience provides no guidance as to the answer. Previous international and reserve currencies, from sterling to the dollar to the euro, have all been the currencies of countries with fully open capital accounts. The so-called subsidiary currencies that have been the subject of much commentary in recent years – the Australian dollar, the Canadian dollar, the Swiss franc and the Norwegian kroner – have similarly been the currencies of countries that long since opened their capital accounts. At a minimum, the absence of a historical precedent points to caution about the prospects for this strategy.

In addition, the approach is not without risks. Partial controls can be arbitraged. Over-invoicing payment for imports and under-invoicing receipts for exports (along with “leads and lags”) are tried and true ways of spiriting financial capital out of a country. Different forms of financial investment can be re- and mis-labeled. Capital flows can be larger than officials intend or than the official statistics indicate. Even if the authorities seek to limit the pace of financial opening, the capital account can grow porous more quickly than they intend. This in turn can have undesirable consequences for financial stability if the pace of domestic financial reform lags.

Rely on Offshore Financial Centers

A second intermediate approach, which may similarly be thought of as an extension of the current Chinese strategy for renminbi internationalization, is to rely on off-shore financial centers to grow the market in remninbi-based transactions. China took a first step down this road in 2004 by authorizing personal renminbi banking in Hong Kong. In 2010 Hong Kong was declared an Offshore RMB Business Center, allowing a wide variety of different transactions (deposits, trade settlements, bond issues) all in renminbi. In 2012 China authorized the Special Administrative Region (SAR) to provide the entire range of offshore renminbi services to non-Hong Kong residents. Taipei, and Singapore both established direct renminbi-local currency clearing in 2013. Other financial centers, led by London, have indicated an interest in following.69

The rationale for this approach is straightforward. Market participants offshore can begin acquiring familiarity with and expertise in renminbi-based transactions now, even while controls limiting their participation in onshore markets remain in place. They can start building the requisite clearing and settlement infrastructure. They can cultivate a market base of customers. They can design and offer the entire range of relevant contracts (not only spot transactions but also futures of all relevant tenors, for example). All the while, the maintenance of controls will limit this activity to offshore markets, which in turn will contain the potential threats to financial stability associated with an open capital account. (McCauley 2011 refers to this strategy of relying on offshore markets as “internationalization within capital controls.”) The limited size and liquidity of those offshore markets will presumably also limit the extent of renminbi internationalization. But once domestic markets are suitably strengthened, capital controls can be relaxed, and the expertise and institutions in question can migrate onshore. Because development of that expertise and those institutions had a head start in the offshore center(s) in question, currency internationalization can proceed more rapidly than otherwise.

69 See for example Treasury Today (2013), or the remarks of Sajid Javid, financial secretary to the UK Treasury, quoted in Cohn (2013).
Box 3. HONG KONG AS AN OFFSHORE FINANCIAL CENTER

Hong Kong illustrates the role that an offshore center can play in accelerating the process of currency internationalization, both in the context of the renminbi and more generally. Hong Kong has built a Real Time Gross Settlement System to facilitate the settlement of foreign exchange transactions on a payment-versus-payment basis. It has a Central Clearing and Settlement System to settle equity transactions on a delivery-versus-payment basis, and a Central Money Markets Unit for clearing bonds and investment fund shares. Its markets are relatively deep and liquid: according to the latest (2013) BIS triennial survey of foreign exchange turnover, Hong Kong is the fifth largest global center for foreign exchange activity.

A wide variety of exchange-rate-related derivatives, including currency forwards and swaps, are actively traded there. There is now a regular CNH HIBOR fixing, overseen by the Hong Kong Treasury Markets Association, covering tenors from overnight to one year to facilitate the pricing of offshore renminbi denominated loans and derivatives for risk-management purposes. Daily net turnover in foreign-exchange instruments denominated in renminbi more than tripled between April 2010 (the time of the previous BIS triennial survey) and April 2013.

Hong Kong has the advantage of a strong business environment. It has a favorable tax regime for business and financial transactions, with no corporation withholding taxes for monies remitted to non-residents. It has a large number of double tax agreements with foreign countries.

In addition, Hong Kong has strong rule of law. It has an independent judiciary. Under the “one country, two systems” policy, the right of final adjudication belongs to the Hong Kong Court of Final Appeal. A pool of non-permanent Hong Kong judges and non-permanent judges from other jurisdictions serve together with a Hong Kong-based chief justice on the Court of Final Appeal. Contract enforcement is reliable. Hong Kong’s common law system inherited from Great Britain is investor friendly. Its Companies Ordinance is similarly based on the familiar UK Company Law. These are all reasons why non-residents (as well as authorized Mainland residents) find it attractive to conduct renminbi business offshore in the SAR.

Box 3 on Hong Kong illustrates a more general point about the role of an offshore center as a petri dish for growing expertise in conducting and managing transactions in renminbi. In practice, Hong Kong is only one of several competing and aspiring offshore centers, including also Singapore, Taipei, London and others. It is worth asking why the authorities are fostering the development of multiple offshore centers. One answer is that different offshore financial markets have expertise in different types of transactions, Hong Kong in commercial transactions with China, London with investment finance, for example. There are different natural constituencies for holding and transacting in renminbi in different places: there is a large natural demand for renminbi deposits among individual account holders in Hong Kong and corporate account holders in Singapore, for example, but a relatively small natural constituency for deposits in London, for example, while there may be a large market for direct renminbi-foreign currency trades in London, given that center’s history as a foreign exchange trading center, compared to Hong Kong. Different offshore centers have different comparative advantages in developing and transferring knowledge, in other words.

70 As argued by La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998).
71 These ideas are developed further elsewhere in the present report, in the chapter where liquidity issues are discussed.
That said, there is again little precedent for the approach. One possible precedent, development of the Eurodollar market starting in London after World War II, in fact post-dates the dollar’s acquisition of international currency status already in the 1920s and its emergence as the dominant international and reserve currency after World War II, which limits the relevance of the case.

To be sure, the impetus for the growth of the Eurodollar market was, first, geopolitical risk, as the Soviet Union sought to shelter its dollar deposits in North American banks from seizure by the U.S. authorities following Soviet invasion of Hungary in 1956, and, second, the imposition of capital-control-like measures by the U.S. in the 1960s.72 Both the geopolitical risk and the role of controls in fostering Hong Kong’s development as an offshore center have parallels in the Chinese case. But the important point is that New York was already the leading international financial center and the dollar was already the leading international and reserve currency by the time transactions began developing offshore. There was no need to first develop expertise in foreign-exchange transactions in London and then transfer it back to New York.

More generally, previous offshore centers took the authorities largely unawares. The Chinese case is different in that the offshore-center approach is being actively managed.73

Analytically, the question about this strategy is who is learning what offshore and how easily that knowledge can be transferred back onshore at the appropriate time. Are Chinese policy makers learning about the advantages of strong rule of law for developing financial markets? This is presumably something they could have observed from international experience even in the absence of the Hong Kong foreign exchange market. Are they learning about how to design and operate a real time gross settlement system? Again, the advantages of such a system and the details of its design could presumably have been learned from observing arrangements in other foreign exchange trading centers where business is conducted in currencies other than the renminbi. One can argue that this knowledge “translates” more easily to the Mainland when the currency in question is the renminbi. But it is hard to know how much weight to attach to the argument. More generally, it is hard to know how easily this knowledge of institutional and product design acquired offshore can be transferred back onshore. Even if Chinese officials better appreciate the advantages of strong rule of law for financial market development as a result of Hong Kong experience, that doesn’t mean that they will necessarily be in a position to emulate Hong Kong’s legal arrangements.

Another way of thinking about what is being learned offshore is that it is the customers who are doing the learning. In other words, the most important dimension may be the role of Hong Kong and other offshore centers in fostering a clientele accustomed to using the renminbi as a unit of account, means of payment and store of value. The clientele in question includes not just international banks and other institutional investors but also Chinese firms who will encounter market pricing when floating bonds and engaging in other similar forms of business offshore. Hopefully the result is a sufficiently large and diverse clientele that, when the business migrates back on shore, bid-ask spreads are narrow and markets are liquid.

These different arguments have different implications for whether reliance on Hong Kong as an offshore financial center is temporary or permanent. At some point in the future Chinese officials will conclude that financial reform and development have reached the point where it is safe to open the capital account. Will the market in cross-


In addition, banks located outside the U.S. were not required to hold non-interest-bearing reserves against their Eurodollar deposits and were free of Regulation Q interest rate ceilings.

73 A partial exception to the generalization is the creation by the Japanese government of a market in offshore banking services in Tokyo in the 1980s (see below).
border renminbi transactions then migrate from Hong Kong to Shanghai, which will presumably have advantages of scale insofar as Chinese residents are already undertaking a significant volume of renminbi-related business there? Will Hong Kong as a renminbi financial center disappear?

If what is being learned about in Hong Kong is the advantage of strong rule of law, the answer is presumably no. Some renminbi business – perhaps very considerable renminbi business – will continue to be conducted in Hong Kong indefinitely because of reliable contract enforcement etc.74 One can draw an analogy with the Eurodollar market: some holders of dollar deposits offshore in Europe declined to bring them back onshore, for reasons of country risk, even after U.S. controls were eliminated. Similarly, if investors have questions about the integrity of trading systems in China, they may wish to avoid excessive concentration of infrastructure or operational risk in one country.75 They will continue to conduct some of their renminbi business offshore. Some observers point to the fact that the first-mover in global exchange trading, London, continues to account for 41 per cent of global forex transactions even today, despite the fact that it has long been surpassed by the United States in terms of exports and GDP.76

On the other hand, if what is important and what is being learned about in Hong Kong is the advantages and design of an efficient trading platform and settlement system, then it will presumably take time for Shanghai to transfer the knowledge. An efficient settlement system, like Rome, is not built in a day. Hong Kong’s head start will, likely, permit it to remain an important renminbi business center for a considerable period, but not indefinitely.

Finally, if it is primarily the customers who are doing the learning, there is no reason why they won’t immediately shift their business to Shanghai once the Chinese capital account is fully open. Hong Kong has no particular time zone advantage relative to Shanghai (unlike, say, London or a number of other aspiring renminbi offshore centers) to differentiate its business. In this case, it is not inconceivable that Hong Kong as a renminbi financial center would wither away.

Again, this approach is not without risks. Controls on financial flows between Hong Kong and other onshore centers are necessarily less than complete. Were they complete, it would be impossible for offshore traders to get their hands on renminbi, and the market would stagnate. As He and McCauley (2010) note, nonresident convertibility of the currency for overseas banks for trade and investment related transactions is the minimal necessary condition.77 In practice, there is considerable arbitrage between the offshore CNH and onshore CNY markets. Maziad and Kang (2012) show that offshore interest rates, in the CNH forward market in particular, have a significant impact on onshore rates. These links work to bring interest rates and the cost of capital on the Mainland closer in line with global financial conditions. As such they can be thought of as part and parcel with the process of rebalancing the Chinese economy. But they also serve as conduits for undocumented capital flows. They are a mechanism for transmitting volatility spillovers, especially during periods of market dislocation.78 In other words, they pose many of the same risks to financial stability as the limited-and-partial-capital-account-opening strategy described above.

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74 A Frank Martin, president of the American Chamber of Commerce in Hong Kong, put it in 1997, Shanghai “will be, I think, the most important city on mainland China, and to some extent the roles will be complementary….We [Hong Kong] have a transparent open legal system, an independent judiciary…and Shanghai, of course, does no…” ANZ (2013), p.3.
75 This is discussed further in He and McCauley (2010), p.4.
76 See ANZ (2013). Indeed, one can imagine an extreme scenario in which confidence in onshore markets is so low and first-mover advantage is so great that with further liberalization of China’s capital account the market migrates entirely to Hong Kong. Not surprisingly this scenario is most enthusiastically advanced by the Hong Kong authorities (e.g. Yue 2013).
77 For example, this minimal condition was met in the case of the Eurodollar market even when the U.S. controlled other cross-border financial flows in the 1960s.
Rely on Onshore Special Economic/Financial Zones

Another variant of this strategy is to rely not on offshore financial centers but instead to build the equivalent onshore. A city or district could be declared a free financial zone (analogous to a free trade zone) exempt from capital controls (analogous to the exemption in free trade zones from tariffs, quotas and export taxes). Financial institutions in the zone would be free to fund themselves by attracting renminbi funds from non-residents and to on-lend such funds, again to non-residents. In this way the relevant learning by doing about cross-border transactions would take place in a domestic as opposed to an overseas venue, much as learning how to produce merchandise for international customers occurs in a free trade zone. Such learning thus might be better tailored to local conditions. If so, the knowledge in question would be more easily generalized (more easily transferred to other cities and districts).

To avoid creating financial stability risks by punching a gaping hole in China’s capital controls, it would be necessary to maintain a strict firewall between lending to non-residents and lending to residents by banks in the special zone. This is something that Japan succeeded in doing, more or less, in the late 1980s and early 1990s. Responding to U.S. pressure to begin internationalizing the yen and in an effort to bring the nascent euro-yen market bank within the purview of domestic regulators, the Japanese government created a Japan Offshore Market (JOM) in 1986. Japanese banks were permitted to accept deposits from foreigners and lend to foreigners, both in yen. The market was segregated from the rest of the Japanese financial system by the country’s still extensive regulatory apparatus. A variety of tax and regulatory preferences were extended to banks operating in the market to encourage repatriation of the business. The JOM then grew rapidly for a decade before succumbing to the Japanese economic and financial crisis, and the yen meanwhile gained ground as an international currency, from approximately 6 per cent of identified global foreign exchange reserves in 1986 to 8 per cent in 1991.

While this experience would appear to establish the viability of the approach, its history is not entirely reassuring. Tetsuji (2000) argues that the Japanese crisis was caused in part by the strict segmentation of the domestic market from the offshore market, which allowed vested interests at home to resist reform, partly by giving reform-minded interests a convenient outlet for their energies. The result was the Japanese economic and financial crisis, as a result of which the yen progressively lost market share as an international currency after 1991.

Be this as it may, this is a precedent that China now proposes to pursue by creating a special financial zone in Qianhai, a commercial district of Shenzhen. The initiative will be a test of the effectiveness of Chinese regulation in maintaining the necessary firewall.

But it is not obvious what advantage Qianhai will have over Hong Kong, assuming strict segmentation of its borrowing and lending to residents and nonresidents. If Qianhai banks with special-financial-zone operations are not allowed to raise renminbi funds from or to lend to residents, it will be competing directly with more efficient and experienced Hong Kong banks for both funding and borrowers.

Cheung (2013) suggests that Qianhai could become a hub connecting Hong Kong to China’s domestic financial markets. But it is not clear, on reflection, what advantage Qianhai would have in this regard. The ability of Qianhai banks to operate as a hub by funneling funds from Hong Kong to borrowers on the Mainland (and, presumably, by also funneling onshore funding to borrowers in Hong Kong) assumes the absence of significant capital controls.
impeding those transactions. In such an environment, it is not clear why Hong Kong banks would have any need for Qianhai counterparties. And in the absence of far-reaching reforms of financial structures and policies on the Mainland, the absence of such controls would pose clear risks to financial stability.

More recently (in July 2013), the Chinese authorities indicated that Shanghai would announce a detailed plan to create a special economic and financial zone in and out of which not just goods but also capital and human resources will be free to flow. The State Council approved the creation of this zone on July 3rd, and it was formally launched on September 27th. In December the PBOC then released a statement explaining in detail how the special Shanghai zone will operate (see Box 4).

This Shanghai zone is likely to be substantially larger than that under construction in Qianhai and therefore to pose a more fundamental challenge to the offshore dominance of Hong Kong. That said, creation of this larger zone in Shanghai also poses many of the same challenges and risks for China as posed by its smaller counterpart in Qianhai. In order to compete successfully, Chinese and international banks doing cross-border business in Shanghai will have to demonstrate that they are as efficient providers of financial services as offshore banks in Hong Kong, since there will be no barriers to business between Hong Kong and the Shanghai special zone. The Shanghai zone being large, any porousness in capital controls between Shanghai and the rest of the Chinese economy will have even more significant implications.

**BOX 4: THE PBOC’S DECEMBER OPINION REGARDING THE SHANGHAI FREE TRADE ZONE**

At the beginning of December the PBoC released a detailed opinion regarding the policies it intended to adopt to support the Shanghai Free Trade Zone.\(^{81}\) As stated, the policy package is designed to promote cross border use of the currency, liberalize the capital account and adjust exchange rate management. This is the clearest statement we have to date of how the Shanghai zone will operate, so it is worth considering in detail.

Residents of the free trade zone will be permitted, according to the PBoC, to open Free-Trade Accounts (FTAs) that can be used for both local and foreign currency transactions. Non-residents will similarly be able to open “Free-Trade Accounts for Non-residents” (FTNs), as soon as national treatment principles with their countries of residence have been established. Holders of FTAs and FTNs will be able to freely transfer funds between offshore accounts and onshore non-resident accounts; funds can similarly be transferred freely between FTAs and FTNs. Commercial banks in the free trade zone will set up a FTA clearing unit which is entirely separate from their onshore clearing systems, which is presumably what will prevent capital controls still applying in the rest of China from being evaded. The effectiveness of this “Chinese wall,” clearly, will be key.

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\(^{81}\) It should be acknowledged that at this point the PBOC’s opinion is just that, an opinion. While the PBOC, as first mover, is sure to shape the discussion, the rules governing the Shanghai Free Trade Zone will ultimately emerge from discussions and negotiations among a wide range of different government agencies.
Capital account transactions such as loan repayments and foreign direct investment can also be funded with these accounts. In addition, corporates with accounts in the free trade zone will be able to invest overseas without having to seek pre-approval. Residents with FTAs will be allowed to invest in foreign securities markets and to freely transfer income generated in the free trade zone to offshore accounts.

Non-residents will be allowed to use funds in their FTNs to invest in onshore securities markets without restriction, as will resident corporations with FTAs. Corporates in the free trade zone, the PBoC opinion states, will be allowed to issue renminbi-denominated bonds on the onshore market. This provision, as stated, is not obviously workable, since it would appear to permit such corporates to borrow in mainland China and freely move the funds offshore, evading the capital controls still prevailing in the rest of China.82

Corporations, nonbank financial institutions and other institutional entities registered in the free trade zone will be allowed to borrow on offshore markets and bring that funding back onshore. Similarly, they will be permitted to access offshore hedging (derivatives) markets to hedge the risks of foreign currency borrowing. Foreign exchange positions should be squared or covered within the free trade zone and offshore markets (positions elsewhere in China cannot be used to square positions in the free trade zone, again reflecting the assumption of binding capital controls between the free trade zone and the rest of China). Renminbi funds borrowed offshore by resident banks and corporations can be invested in securities or derivative markets; this would appear to be one important limit on capital account openness between the Shanghai zone and the rest of the world.

The PBoC says that it will proceed “gradually” with interest rate liberalization in the free trade zone, and its December 2013 statement said nothing about the implications for exchange rate policy.83 How still partially controlled interest and exchange rates will coexist with market-based interest rates offshore and an all-but-fully-open capital account remains to be seen. Probably the best interpretation is that capital account liberalization between the Shanghai zone and offshore markets will proceed gradually, just as interest rate liberalization proceeds gradually, until the two processes of liberalization are complete, say three years from now.

Source: ANZ Research (1 December 2013, 18 February 2014)

The question is to what extent the authorities will tolerate leakage from the “special accounts” covering largely deregulated financial transactions between the Shanghai zone and the rest of the world, on the one hand, to the “general accounts” covering financial transactions between the Shanghai zone and the rest of the Chinese economy, on the other. Such leakages could be a catalyst for updating the internal organization and regulation of financial institutions in the “rest” of China. But, at the same time, they could create scope for massive capital flows, interfere with the conduct of monetary policy, and pose a threat to financial stability. This is the standard dilemma posed by a strategy for currency internationalization making use of the creation of special or offshore financial centers, but in the case of the Shanghai Free Trade Zone writ very large.

82 Most recently, in February 2014, the PBOC announced that SMEs will be able to conduct transactions electronically with their customers in the FTZ, providing 3rd party payment services for e-commerce etc.
83 Discussions suggest that this might entail a wider band for offshore/SFTZ transactions.
This observation about the potential for leakages from the offshore or special financial zones to the domestic financial system points up a larger issue for all intermediate approaches to currency internationalization. Intermediate approaches entail gradually and progressively liberalizing access to renminbi for a variety of foreign economic and financial transactions. At some point, liberalization, having been gradual and progressive to date, may reach a threshold or tipping point where limiting the currency’s use in yet additional economic and financial transactions becomes impossible or at least extremely difficult for the authorities to control. Opportunities for arbitrage between permitted and restricted uses of the currency become too numerous and prevalent for existing restrictions to be effectively enforced.

At this point, leakages and arbitrage create enormous pressure to either turn back the reform process or rapidly speed it up (that is, allow it to reach its logical conclusion), so as to enable the authorities to retain monetary control. How the process then plays out is impossible to say. It may be that the authorities, faced with pervasive arbitrage and loss of monetary control, choose to reverse the reform process. It may be, instead, that faced with growing challenges to the maintenance of remaining controls, they opt instead to go forward to full liberalization, and do so successfully. Or it may be that, in choosing to accelerate the process of liberalization and openness, the economy succumbs to crisis. Which outcome will obtain, under these circumstances, is impossible to predict in the abstract.

7. ARE MORE FUNDAMENTAL REFORMS NEEDED?

The attraction of these intermediate pathways is their compatibility with China’s prevailing economic, financial and political system during the period when steps are being taken to promote nonresident use of the renminbi. But some argue that fundamental changes to that system will, in fact, be needed if the renminbi is ever to rival the dollar as an international currency.

For instance, some market participants point to the need for China to fundamentally reform its system of corporate governance, stressing that they would need to see substantial progress in terms of the corporate governance and transparency of companies in China before they would consider investing in them even in a world of no capital inflow restrictions. Companies would have to be required to appoint independent directors, constitute audit, management, personnel and compensation committees, comply with international accounting standards and be subject to external audits by internationally recognized accountants, and operate under the discipline of hostile takeover bids. In the case of state-owned enterprises, such reforms would require municipal, provincial and central governments to sell off majority stakes to private investors, it being hard to see how majority-state-owned enterprises could be made subject to, say, hostile takeover bids.

But these concerns are only obliquely relevant to currency internationalization insofar as an international currency has unit of account and means of payment and not just store of value functions. In addition, foreign holdings of a currency motivated by store of value considerations have, historically, been holdings mainly of government bonds and bank deposits, not corporate equities. This was true when sterling was the dominant international currency in the 19th century, when sterling and the dollar shared that role in the 1920s and 1930s, and when the dollar dominated in the second half of the 20th century. The story may change insofar as official investment is now undertaken not just by central banks but also by sovereign wealth funds, which hold equities and alternative investments as well as bonds. But to the extent that central banks continue to dominate and attach high value to liquidity, debt claims will still dominate official foreign holdings, and the kind of corporate-governance considerations relevant to equity investors will remain secondary.
Others like Huang, Daili and Gang (2013) suggest that China will have to take steps to significantly enhance economic freedom, for example by removing restrictions on internal migration, in addition to removing limits on cross-border capital flows, before the renminbi can acquire the status of a leading international currency. The 2013 Index of Economic Freedom ranks China only 136th of 177 countries, citing the fact that all land is still state-owned, intellectual property rights receive only weak protection, and price controls continue to be applied to energy, raw materials and a variety of other basic goods. Huang, Daili and Gang estimate regressions of the dollar, euro and yen shares of international reserves as a function of the issuing countries’ economic and financial characteristics including their economic freedom ranking. They find a significant effect of economic freedom on reserve currency shares. Adding economic freedom to their model causes the predicted renminbi share of global reserves to fall from 6.8 to 2.2 per cent.

It is not obvious how these results should be interpreted. Why nonresident investors in China’s bond market should be concerned with limits on internal migration or weak protection of foreign trademarks, brands and technologies is not clear. The presumption may be, as with the argument that China needs stronger corporate governance, that anything limiting the attractiveness of foreign direct investment or the purchase of equities will also limit the attractiveness of Chinese government bonds – that investors prefer the ability to hold diversified portfolios of equities and bonds. But, as with the argument for stronger corporate governance, it is not typical for central banks to hold a significant portion of their reserves in the form of equity as opposed to debt. Recall that it is the demand of central banks that Huang et al. are modeling.84

Others (e.g. Eichengreen 2013) argue that what matters is not just political stability, which China ostensibly possesses, but an adequate system of checks and balances on executive freedom of action, whose existence can be questioned.85 The leading international and reserve currencies of the 19th and 20th centuries, sterling and the dollar, were the currencies of political democracies. Britain and the U.S. had political systems that imposed checks and balances on the executive. The Dutch guilder, the leading international currency prior to sterling, was the currency of a republic that, while not democratic, had a federal structure that limited the prerogatives and scope for opportunistic behavior by top leadership.86

A less extreme version of the argument is that the country will have to strengthen the powers of the National People’s Congress and the responsiveness to public opinion of the Politburo and its Standing Committee. It will have to give statutory and operational independence to the China Banking Regulatory Commission, the Securities Regulatory Commission, and the Insurance Regulatory Commission in order to foster confidence that regulatory decisions are taken with financial stability rather than political objectives in mind. It will have to grant statutory and operational independence to the central bank.87 It will have to allow stronger nongovernmental organizations to monitor government performance. It will have to create an independent media to expose corruption and to encourage “intra-party democracy.” 88

84 It could be that the index of economic freedom is picking up the strength of investor protection. Recall how a series of recent authors, starting with La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998), have shown that countries with legal systems ensuring strong creditor rights tend to have deeper financial markets. Other authors (e.g. Cohen 2013) emphasize not legal tradition but the structure and stability of the political system as the fundamental determinant of the strength of creditor rights. In this view, the key consideration is a stable political system in which investors are able to resist arbitrary action by the executive designed to appropriate their holdings. Gassebner and Meon (2010) analyze the determinants of cross-border merger-and-acquisitions flows, contrasting the impact of creditor-friendly legal rules and political risk/political stability. They find that the role of creditor rights in explaining the magnitude of observed flows is almost entirely limited to politically stable countries. China meets Gassebner and Meon’s political stability criterion at the moment, although whether it will continue to meet it in the future is an open question.

85 The next couple of paragraphs draw on this reference.

86 If one goes back still further, Genoa, whose currency, the denaro, was widely used in international transactions, was first a self-governing commune and then a republic. Venice, whose currency, the ducat, was also widely used in international transactions, was similarly a republic.

87 As noted in Section 4 above. For an earlier discussion along these lines see Goodfriend and Prasad (2006).

88 All this is suggested by Li (2013).
Yet another argument emphasizes not domestic political stability as much as the strength and stability of a country’s foreign relations. A first-class international currency is that of a country able to serve as a safe haven. It must offer security to both private and official investors. And only a country that is safe from external and internal threats will be regarded as a true safe haven by international investors. Cohen (2013) argues that the deutschmark could never be a true international currency because Germany after World War II was divided, on the front lines of the Cold War, and for historical reasons lacked a strong, autonomous military. Japan’s constitution, which similarly limits freedom of action of its military, together with the country’s awkward relations with Korea and China, is yet another explanation for why the yen was never able to achieve first-class international currency status. It is worth observing that the U.S. and Britain, as well as Holland, Genoa and Venice before them, were leading naval powers.

It would be extreme to argue that China cannot succeed in further internationalizing the renminbi until it adopts Western-style democracy and builds a navy capable of controlling two oceans. But there is an argument that the renminbi will not be able to match the dollar’s role in the international economy without reform of both its domestic and foreign political relations.

8. RENMINBI INTERNATIONALIZATION AND MONETARY REGIONALIZATION

As China reforms and strengthens its financial markets and opens them to the rest of the world, capital will flow in and out in growing volumes, and the authorities will have to accept to a more flexible exchange rate. The leading international and reserve currency, the dollar, and the principal subsidiary reserve currencies, the euro, sterling and yen (and arguably also the Australian dollar and the Canadian dollar, which the IMF now distinguishes in its Currency Composition of Foreign Exchange Reserves database), all float freely, reflecting the fact that countries with open capital accounts and internationalized currencies are subject to large capital inflows and outflows.89Large capital movements make pegging a currency more difficult and costly, as described in Section 5. Exchange rate flexibility is desirable to buffer the impact on the domestic economy: capital inflows create a tendency toward credit booms, inflation and overheating; currency appreciation which shifts demand from domestic to foreign markets works to offset these effects.90 Cultivating and preserving international currency status presupposes the maintenance of price, economic and financial stability. A central bank, to preserve such stability, must have the autonomy to adjust policy to domestic conditions, something it sacrifices when it attempts to peg the exchange rate in the presence of an open capital account.91 A country with a fully internationalized currency that is widely accepted and utilized by non-residents is also the currency of a country with deep, liquid and well-regulated financial markets – markets whose stability is sufficient to withstand currency fluctuations.

Does this mean that China will move to a freely floating exchange rate, a la the United States, and that we can look forward to a world of two international and reserve currencies that float freely against one another? That would seem to be the implication at the end of the day – where the end of the day is defined as when the renminbi is as widely utilized as the dollar by non-residents and when the conditions in the last two sentences of the previous paragraph are satisfied, by implication.

89 The Swiss franc (also included in the IMF’s COFER tables) is an exception at the moment; capital inflows leading to undesirably strong appreciation caused the Swiss National Bank to declare a ceiling on the exchange rate and effectively sacrifice its monetary autonomy in order to enforce it. Reserve assets at the SNB rose nearly fourfold between 2011 and mid-2013 as a result of the policy. Whether this problem will persist, and whether the solution will remain feasible indefinitely, only time will tell. The Swiss National Bank has in fact indicated its intention of eventually moving back to a flexible exchange rate.

90 On the other hand, cutting interest rates in an effort to rebuff capital flows and limit appreciation is likely to only accentuate these effects.

91 This is a tradeoff referred to by international economists as the open-economy “trilemma,” that it is possible to have only two of three things: an open capital account, a pegged exchange rate, and monetary autonomy.
But so long as Chinese financial markets remain smaller and shallower than those of the United States, currency fluctuations could be more disruptive, and the PBOC may feel compelled to intervene in the foreign exchange market. So long as the Chinese economy is more export dependent than the U.S., the PBOC may similarly feel compelled to intervene in the interest of maintaining export competitiveness. And so long as limits remain on capital-account transactions or there are other sources of country risk, it will have the ability to do so without sacrificing monetary control entirely, since under these conditions domestic and foreign financial assets will be imperfect substitutes, and sterilized intervention (where the impact on the money supply is neutralized) will retain some effect.92

But limits on capital-account transactions and significant country risk imply limits on renminbi internationalization. In other words, managed floating will be feasible so long as the renminbi acquires only some of the international attributes of the dollar but not others. A world of a managed-floating renminbi would not be one of two co-equal international currencies but, rather, one where one of the rivals, the dollar, was significantly more internationalized and had a larger market share than the other.

In a sense, then, whether and how quickly the renminbi is fully internationalized and whether and how quickly China moves to a fully flexible exchange rate have the same determinants. The two transitions have the same preconditions. This is another way of explaining how and why it is that renminbi internationalization and a more flexible renminbi exchange rate policy are concomitants.

Still other countries that are smaller and/or have shallower financial markets will continue to manage their currencies more heavily. (This is the implication of the “fear of floating” literature pioneered by Calvo and Reinhart 2002.) In a world of a partially internationalized renminbi, where the second leading international currency is subject to a managed float and its movements against the first leading international currency are limited, the dilemma of which currency to utilize in cross-border transactions and which one to adopt as the anchor for exchange rate and monetary policy is not acute. In such a world, there would be only limited changes in the relative value of different reserve assets, by assumption. There would be only limited changes in export competitiveness as a function of which of the two currencies was chosen as the external anchor or reference point.

But in a world where the renminbi is fully internationalized and where it floats freely against the dollar, the choice becomes more consequential for all of the aforementioned reasons. The literature on the choice of currency peg suggests that countries that trade most heavily with China, that compete with it in third markets, and have the greatest tendency to borrow from it (hence incurring renminbi-denominated liabilities) will be most inclined to shadow the renminbi and to hold reserves in the currency so as to facilitate intervention in the renminbi-domestic currency foreign exchange market (see for example Plumper and Neumayer 2008). There may also be an increasing tendency for a country to peg to a currency as a function of how many other countries with which it has significant trade and financial relations also peg to it (Meissner and Oomes 2008). Previous studies are inconclusive on the question of whether geographical proximity to the reserve currency issuing country is important for choice of anchor. Fischer (2011) finds stronger evidence of this for the euro (members of the nascent euro bloc tending to be concentrated in Central and Eastern Europe) than for the dollar (dollar peggers being located a variety of different parts of the world).

Some conclude on the basis of these findings that internationalization of the renminbi will provide further impetus for monetary regionalism. The internationalization process could give rise, in this view, to the emergence of a

92 A primer on sterilized intervention is Rogoff (1984).
renminbi bloc in Asia, where the currency is disproportionately used for cross-border transactions, serves as the exchange rate anchor for its neighbors, and accounts for a disproportionate share of reserves. Some say that these tendencies are already apparent. Subramanian and Kessler (2012) estimate “Frankel and Wei regressions,” where following Frankel and Wei (2007) daily exchange rate changes (against a numeraire currency, typically the Swiss franc) are regressed against daily fluctuations (relative to that same numeraire) of four reference currencies: the dollar, the renminbi, the euro and the yen. They distinguish the period July 2005-August 2008, before there was significant progress in renminbi internationalization, from the subsequent period (July 2010-July 2013). They consider 10 East Asian currencies and find for the more recent period that the weight on the renminbi is 40 per cent higher than the weight on the dollar. In the earlier period, 6 of 10 East Asian currencies followed the dollar more closely than the renminbi, but in the more recent interval 7 of 10 East Asian currencies follow the renminbi more closely (the seven being those of Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand). When the renminbi appreciates by 1 per cent, these 7 East Asian currencies tend to appreciate by half of that amount, whereas when the dollar appreciates by one per cent they move by only a third of a percentage point. Outside East Asia, on the other hand, the renminbi has the largest weight in only 3 of 42 cases.

Huang, Daili and Gang (2013) estimate similar equations for 7 East Asian countries for the longer period from 1991 through mid-2013. They find essentially a zero weight on the renminbi prior to mid-2005 and then a significant effect of renminbi fluctuations in all seven countries thereafter. The weight on the currency rivals that on the dollar for India, Indonesia, Malaysia and Singapore but not for Hong Kong, Korea or Thailand.

The question is what these correlations reflect. It could be that central banks, also elsewhere but especially in East Asia, are paying more attention to the renminbi exchange rate and adjusting their policies to follow it more closely. Or it could be that these economies are simply becoming more subject to common disturbances – such as the credit crisis emanating from the United States or geopolitical disturbances that impact global oil prices – causing their exchange rates and central bank policies to move more closely together (without any conscious shadowing going on). In the latter case the change over time would reflect China’s greater integration into the global economy and hence the greater impact on it, as on its Asian neighbors, of those global shocks, and not the progress of renminbi internationalization per se (although the partial opening of Chinese financial markets could be part of that self-same integration process). Over time, however, that greater co-movement with the renminbi should make the unit more attractive for other international currency functions. To the extent that co-movement is greatest in Asia, this supports the notion of the gradual emergence of a regional renminbi bloc.

There are also compelling reasons for questioning this scenario. Studies considering slightly different subperiods, as discussed earlier in this section, obtain quite different results (compare the findings of Subramanian-Kessler and Huang-Dali-Gang for Korea and Thailand), perhaps indicating that what they are picking up is coincidence more than conscious policy and that efforts to identify a stable renminbi bloc are premature. The PBOC is not obviously seeking to develop a renminbi bloc in Asia; its renminbi swap agreements, which are one of its principal instruments for doing so, have been negotiated with at least 11 economies outside the region. China’s trade is diversified; it trades extensively outside as well as within East Asia. Its foreign investment (in, inter alia, energy and natural resource related industries in Africa and Latin America) is similarly diversified. China may have particularly strong supply-chain linkages and account for a large share of intermediate goods trade in East Asia, but the

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93 The other three Asian countries considered where the dollar still dominates are Hong Kong (with its dollar-based currency board), Vietnam and Mongolia.
94 In the Hong Kong case this of course reflects the SAR’s U.S. dollar based currency board. One would question the methodology if the results were otherwise.
95 If one categorizes Australia and New Zealand, two of the countries in question, as outside.
United States has close supply chain links with Mexico and Canada, and that hasn’t prevented the dollar from functioning as a global rather than a regional currency.96

Similarly, shocks to the Chinese economy affect economies outside East Asia as well as within the region. The IMF in its most recent 2012 “Spillover Report” finds that the peak impact on real GDP of a one standard deviation shock to Chinese investment is larger and more significant for Germany (which specializes in exporting capital goods) than for Indonesia, Korea or India.97 While the impact on Japan is also significant, it is smaller than the impact on Germany.98 Similarly, the impact of one-standard deviation shock to Chinese property investment is larger for Germany than for Japan, India, Indonesia, or Korea.

From a strictly economic standpoint, then, the conclusion that renminbi internationalization will foster monetary regionalism and specifically the emergence of a renminbi bloc in East Asia seems a bit hasty. The leaders of East Asia’s largest economy could one day make this a goal of policy and use a variety of carrots and sticks to advance it, at least hypothetically. But it is far from obvious that this scenario is immediately in the cards.

9. IMPLICATIONS FOR THE INTERNATIONAL MONETARY SYSTEM

The implications for the international monetary system more broadly are equally difficult to assess.

Liquidity

The supply of global liquidity will be better diversified and, to the extent that diversification begets stability, more stable. For its supply of safe and liquid internationally accepted assets, the world has had to rely mainly on the United States in recent decades. As a result, global liquidity has fluctuated along with economic and financial conditions in that country. Federal Reserve interest rates below the levels recommended by the so-called Taylor rule contributed to the large U.S. current account deficits that led to dollar accumulation abroad in the period 2003-5. Other countries then found themselves on the receiving end of a tsunami of dollar liquidity following the U.S. central bank’s adoption of policies of quantitative easing in 2010-12. In the wake of the Lehman Bros. crisis, in contrast, dollar liquidity was scarce, and other countries were forced to rely on the Fed, with which they negotiated swap lines, for its emergency provision. Rey (2013) provides evidence that these fluctuations in dollar liquidity in turn had a dramatic impact on economic and financial conditions in other countries.

Renminbi internationalization holds out some hope of helping to stabilize these cycles. Insofar as economic and financial conditions in the U.S. and China are imperfectly correlated, as will certainly remain the case, so too will be the provision of international liquidity by the two sources. If economic and financial problems arise in the United States, China will be there to step up as an alternative source, and vice versa.

It can be argued further that as sources of global liquidity grow more diverse, the discipline for the suppliers to adopt sound and stable policies will become correspondingly more intense. Some interpretations of global imbalances and of large U.S. current account deficits in the period prior to 2008 point to the country’s monopoly

96 These have not permitted the weight on the U.S. dollar in Frankel-Wei regressions for Canada from declining quite noticeably over time (the break point, according to Frankel and Wei 2008 appears to be around 1998). No analogous estimates for Mexico are reported.
97 In addition, the model used allows for second and third round effects – that is, the hit not just directly via exports to China but also via the hit to partners, which may explain the large impact on Germany.
98 For what it is worth, the estimated impact on Australia is zero.
on the provision of global liquidity. Other growing economies engaged in an expanding volume of international transactions in that period had a growing demand for international liquidity, which they could only obtain from the United States. Concerned as they might have been about the sustainability of the U.S. current account and the country’s debt, they had no choice but to satisfy their need for liquidity by accumulating claims on the U.S. and financing its deficits. But if private and official foreign investors again develop concerns about the sustainability of U.S. policies in the future, they will then be able to accumulate debt claims on China instead. Finance for U.S. deficits will be provided less freely. As a result, upward pressure on U.S. borrowing rates and downward pressure on the dollar will mean more market discipline – more pressure for adjustment by the United States.

Another way of putting the point is that a more multipolar international monetary system where fewer countries are pegging to or shadowing the dollar will leave more room for the dollar exchange rate to adjust, limiting chronic U.S. payments imbalances. This assumes that in this more multipolar system the dollar and the renminbi will float against one another. In fact this is a direct corollary of full renminbi internationalization, as argued above.

**Stability**

One worry expressed in this connection is that the dollar-renminbi exchange rate could become undesirably volatile. In the presence of two true international currencies, both of which are liquid and are increasingly close substitutes for one another, shocks to the U.S. or Chinese economies could lead to large portfolio shifts from one currency to another. The stability properties of the resulting system would hinge on whether the U.S. and China succeed in minimizing such shocks. Historically, we have examples of both stable and unstable multiple reserve-currency systems: a relatively stable configuration before 1913 when sterling, the French franc and the German mark all played consequential international roles, and an unstable interwar system in which sterling and the dollar competed but which suffered from chronic problems. The stability of such a system, this history suggests, hinges on the stability of policy in the issuing countries. The market-discipline argument points to one factor conducive to stability. But interwar experience and the recent global credit crisis both remind us that such stability cannot be taken for granted.

There is also reason to expect that in a world where both the dollar and the renminbi are consequential reserve currencies, other countries will benefit from more stable reserve portfolios. Currently, reserve portfolios concentrated in U.S. treasuries can suffer from a high ratio of volatility to return. In contrast, a reserve portfolio diversified across dollars and renminbi will provide a superior return/volatility tradeoff, whether returns and volatility are measured in dollars or in local currency, for the simple reason that the dollar and renminbi will often move inversely on the foreign exchange market and more generally because dollar and renminbi returns are imperfectly correlated with one another. Estimates of the optimal share of renminbi in reserve portfolios and of the precise improvement in return/volatility tradeoffs for central bank portfolios depend on what one assumes about renminbi returns when the currency is fully internationalized. Under assumptions made by the World Gold Council (2012), the optimal share of the renminbi is 13 per cent, that of the dollar and the euro combined 65 per cent.99

**Emergency Provision of International Liquidity**

Finally there are the implications for the emergency provision of international liquidity. This was provided by the Fed and the PBOC starting in 2008 through bilateral agreements with foreign central banks, as noted above.

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99 The remainder is accounted for by gold and other advanced-country currencies.
But the provision of emergency liquidity bilaterally depends on the maintenance of good relations with the source country and, equally importantly, recognition by the source country that it has global responsibilities. One can imagine an isolationist U.S. Congress that attempts to bar the Fed from providing swap lines to foreign central banks, or a People’s Congress that discourages the provision of emergency renminbi liquidity to a country that is not politically aligned with China.

The other source of emergency liquidity is the International Monetary Fund. By allocating Special Drawing Rights (SDRs), the Fund effectively disburses loans in the currencies that make up the SDR basket. IMF members can buy and sell their SDRs to other IMF members, and if there is insufficient demand the Fund can activate its so-called “designation mechanism,” under which members with strong external positions are designated to buy SDRs with “freely usable currencies” (including their own). This alternative would go some way toward addressing the problems of politicization of emergency liquidity provision described in the preceding paragraph.

Once the renminbi becomes a freely usable currency, it will presumably be included in the SDR basket. In 2011 the IMF’s executive board laid down the criteria that a country should meet in order for its currency to be included in the SDR basket (IMF 2011). First, the currency in question should be actively traded on foreign exchange markets. Second, there should be active markets in exchange-based and over-the-counter foreign exchange derivatives. Third, the country should have market-based interest-rate instruments. Fourth and finally, the currency should be widely held as foreign exchange reserves. The renminbi already meets the first two conditions. The policy reforms needed for currency internationalization will require it to meet the third. The fourth condition, that foreign central banks and governments hold a significant share of their reserves in the currency, is the end-point of that process. But, as earlier sections have argued, that end-point may take considerable time to reach.

One summary description of the three attributes of a well-functioning international monetary system (e.g. Kenen 2000) is that it offers solutions to the problems of liquidity, adjustment and confidence. The analysis here suggests that renminbi internationalization will be a positive for liquidity, for adjustment and, if things go well, for confidence as well.

10. CONCLUSION

China is intent on internationalizing the renminbi, and that intention makes a lot of sense. The ability to do cross-border transactions in their own currency will be an advantage for Chinese banks and firms. The financial reforms and development needed for currency internationalization will move China toward a more robust and efficient domestic financial system. A renminbi that serves as an internationally accepted unit of account, means of payment and store of value will be an attractive vehicle for cross-border transactions for other countries that do business with China, most obviously in Asia but also in other parts of the world. The international monetary system will be strengthened by the more diverse and reliable provision of liquidity and more flexible adjustment process that will result from the renminbi’s emergence as an international complement to the dollar.

100 In practice, it should be noted, the hurdles to new SDR allocations are considerable: agreement of members holding 85 per cent of the votes in the IMF is required. This requirement would presumably have to be loosened – IMF management would have to be granted the powers needed to organize SDR allocations in short order – in order for the Fund to become a consequential provider of global liquidity. Whether the leading members, including the United States and China, would agree to this is unclear. The 85 per cent requirement gives the U.S. effective veto power over new allocations. With future changes in IMF voting weights, China could conceivably acquire a veto as well.
The challenge is getting from here to there. A strategy of rapid currency internationalization has significant risks. Quickly removing all remaining restrictions on access to renminbi by non-residents — an early shift to capital account convertibility, in other words — would be prudent only if accompanied by significant strengthening of the domestic financial system and only if accompanied also by far-reaching changes in China’s monetary and exchange rate policies. These corollary policy changes are widely viewed as desirable in China and abroad, but there are also sources of resistance. There is no guarantee that the requisite adjustments can be completed in short order. Using renminbi internationalization to force them is risky under the circumstances.

The alternative of first putting in place the full panoply of policy adjustments before proceeding with currency internationalization minimizes those risks but requires significant amounts of time. It provides no guarantee that the destination will be reached. Given this, the proponents of renminbi internationalization may be reluctant to wait.

These observations point to the desirability, and relatively high likelihood in practice, of China following a pathway to renminbi internationalization intermediate to these extremes. Several intermediate approaches are suggested by previous commentators and by history and have been considered in these pages. These include opening the capital account gradually as the relevant economic and financial reforms are successively put in place, relying on offshore financial centers to cultivate expertise and an international clientele for the renminbi and then gradually transferring that knowledge back on shore, and relying on onshore special financial zones for developing that clientele and expertise during the transitional phase. These intermediate approaches have the advantage that they avoid or at least limit the risks to financial stability associated with a rapid, across-the-board move in the direction of capital account convertibility, and also the dangers associated with the “comprehensive reform first” approach, namely that momentum for currency internationalization is lost and the destination is never reached.

But neither are these intermediate approaches entirely risk free. For example, gradual and progressive financial and capital account liberalization may, at some point, reach a threshold where arbitrage opportunities become so pervasive that the authorities lose control of the process. The capital account may open spontaneously as agents arbitrage between controlled and uncontrolled transactions, between offshore and onshore centers, or between the special economic and financial zone and the rest of the Chinese economy. At that point, the Chinese authorities will be faced with the choice of rolling back previous liberalization measures in order to reassert their control or acknowledging the tendency for reform to undermine remaining restrictions and move forward more quickly to full openness and liberalization. They will then face all the same dilemmas as posed by the more extreme “reform first” and “liberalize now” approaches.

The bottom line is that there is no guarantee of a safe and successful transition to currency liberalization. Each approach entails risks and uncertainties. But neither is the status quo ante, where the renminbi was a purely national currency, likely to remain viable indefinitely. The conclusion may seem unsatisfactory. But risks and uncertainties are intrinsic features of economic life. They are intrinsic, therefore, to the process of renminbi internationalization.
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PAPER 2

RENMIBI INTERNATIONALISATION: IMPLICATIONS AND OPPORTUNITIES FOR AUSTRALIAN FINANCIAL MARKETS

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OVERVIEW

Professor Eichengreen’s paper commissioned as part of the Centre for International Finance and Regulation’s Renminbi (RMB) internationalisation research project has provided an overview of what currency internationalisation means and outlined different potential pathways to RMB internationalisation, setting out the various reforms that will need to occur if the objective of internationalisation is to be realised. Using his insights as background, this paper examines the financial market implications of RMB internationalisation, in particular for Australia. It focuses on how both China and Australia can use the close trading ties that already exist and the move towards internationalisation of the RMB to also build closer financial ties, to their mutual advantage. It also looks at some of the challenges, from both a market and a public policy perspective, and concludes with a set of policy recommendations.

As has been often stated, financial relationships between countries not only facilitate trade flows but also deepen as trade grows: “finance follows trade”. In the case of China, Eichengreen (2014) noted that the growth in the volume and diversity of its global trade links has been enormous but has significantly exceeded development of its financial links with the rest of the world, due to still pervasive capital controls, lack of exchange rate convertibility and limited development of its capital markets. This imbalance between China’s size and global trading links on the one hand and its global financial links on the other is illustrated in chart 1 below.

**CHART 1: China’s International Integration in GDP, Trade and Finance**

(a) Ratio of the sum of exports and imports to world trade.

(b) Ratio of the sum of external assets and liabilities to world external assets and liabilities.

This situation is set to change dramatically over the coming decade. The sheer size of the Chinese economy and of its trade links with the rest of the world, along with the commitment of the Chinese administration to RMB internationalisation and the importance of financial market reform for sustaining China's economic growth and development, mean in combination that China's financial links with the rest of the world are likely to increase rapidly. Indeed, this process has already begun.

China is already the largest global source of savings and the largest potential source of capital for international investment. Within the decade, its capital markets will also be amongst the largest in the world. In the absence of some major setback or change in policy intent, the "opening up" of China's capital account is likely to be one of the major factors influencing the type, volume, currency denomination and location of financial flows and financial market activity around the world over coming decades. These changes will likely include very large increases over time in trade-related and portfolio investment flows into and out of China and in the associated provision of RMB-denominated financial products and services for trade and other financing, for risk management and for investment purposes. As the RMB grows in importance as an international reserve currency, it is also likely to become increasingly used in offshore-to-offshore financial transactions unrelated to trade or investment flows directly to or from mainland China.

Some countries and financial centres may benefit more than others from these developments. For Australia, the opportunities are substantial. For most of the period since Federation, Australia has been an importer of capital to fund its substantial domestic investment needs. In contrast, since its shift in the late 1970's to an "opening up" policy focussed on export-generated growth, China has generally run current account surpluses and hence been a provider of capital to the rest of the world, albeit primarily via its accumulated foreign exchange reserves.

As China continues to liberalise its capital account and move over time to a floating exchange rate regime, most of the surplus savings will be invested through the private sector and state-owned enterprises rather than via foreign exchange reserve accumulation, providing a substantial potential source of funding for Australian investment on the one hand and attractive opportunities for portfolio diversification and enhanced returns for Chinese investors on the other – including in industries such as energy resources and agriculture that are of such strategic importance to China.

Building deeper and more open financial relations between China and Australia is thus very much in the interests of both countries.

Paper 2 is organised as follows. Chapter 1 outlines briefly the nature of the current trade and financial links between China and Australia, and discusses some relationships between the two.

Chapter 2 looks to a future world where the RMB is a major internationalised currency – with all the policy reforms discussed in Eichengreen (2014) that this implies for China – and examines what this might mean in terms of both the size of China’s capital markets and the size of financial flows between China and the rest of the world.

Chapter 3 examines some of the potential benefits to both Australia and China from China’s opening up, looks at both market and policy constraints that will need to be dealt with if both countries are to realise these opportunities, and makes a number of recommendations.
CHAPTER ONE
CURRENT TRADE AND FINANCIAL FLOWS

1. AUSTRALIA/CHINA TRADE LINKS

The growth in Australia’s trade with China has been well documented. In fiscal year 2012-13, Australia’s total trade with China was valued at $A 129.5 billion, or just under 24% of our total trade in goods and services. China is now Australia’s largest export market and largest source of imports: a dramatic change from just ten years ago (chart 1.1).

CHART 1.1: Australia’s Trading Relationships by Country

Source: Australian Bureau of Statistics
China’s importance to Australia as a trading partner is, moreover, set to rise further as China continues to grow faster than most of our major trading partners. However, the trade composition is likely to change considerably over time – on our export side in particular – as Chinese growth is reoriented more towards domestic consumption and less towards manufactured exports and as the well documented growth in China’s middle class\(^2\) sees increasing demand for a wide range of higher-end products and services including, importantly, financial services.\(^3\)

The growth in Australia’s trade with China has reflected a broader change in our trade patterns: it has been accompanied by strong growth in our trade with a range of other countries in the Asia region, with the main offset being a sharp drop in our trade shares with the US, Europe and Japan. Four out of Australia’s five major trading partners are now in Asia (chart 1.2).

**CHART 1.2: Australia’s Regional Trade Patterns**

<table>
<thead>
<tr>
<th>Australian Exports by Destination</th>
<th>Australian Imports by Origin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of total goods and services</td>
<td>Share of total goods and services</td>
</tr>
</tbody>
</table>

*Goods exports prior to 1999*  
*Goods imports prior to 1999*

Source: Australian Bureau of Statistics

Looking at Australia’s trade with China in more detail, the dominance of commodities in our exports to China – iron ore in particular – can be seen in chart 1.3(a). The extraordinary growth in commodity exports has seen the share of agricultural, manufacturing and services exports all fall, although it is worth noting that in absolute terms these have all risen significantly, including services exports. On the imports side, final manufactured products continue to dominate our trade with China (chart 1.3 (b)).

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\(^2\) See for example Capgemini (2013).

\(^3\) See on this point Kharas & Gertz (2010) and for some more recent analysis specific to Australia, see Deloitte Australia (2014).
CHART 1.3: Australian Trade with China by Category

(a) Exports to China

<table>
<thead>
<tr>
<th>Category</th>
<th>2002-03</th>
<th>2012-13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iron ore</td>
<td>16.0%</td>
<td>49.5%</td>
</tr>
<tr>
<td>Coal</td>
<td>2.0%</td>
<td>8.9%</td>
</tr>
<tr>
<td>Agricultural commodities</td>
<td>17.8%</td>
<td>7.4%</td>
</tr>
<tr>
<td>Education</td>
<td>10.4%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Manufactures (other)</td>
<td>4.0%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Other</td>
<td>2.8%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Commodities (other)</td>
<td>30.8%</td>
<td>21.5%</td>
</tr>
</tbody>
</table>

(b) Imports from China

<table>
<thead>
<tr>
<th>Category</th>
<th>2002-03</th>
<th>2012-13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufactures (final goods)</td>
<td>88.1%</td>
<td>90.9%</td>
</tr>
<tr>
<td>Manufactures (intermediate goods)</td>
<td>5.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Other</td>
<td>6.3%</td>
<td>4.1%</td>
</tr>
</tbody>
</table>

Source: Australian Bureau of Statistics

While China is now the major overseas market for Australia with respect to both our imports and our exports, Australia represents only a small percentage of total Chinese exports and imports (chart 1.4). We are, however, a major source of Chinese imports in some key commodity areas, such as iron ore and coal (chart 1.5).
With China’s current account largely liberalised but its capital account still subject to widespread capital controls, RMB trade invoicing is very important for the development of offshore RMB business, a point discussed in more detail below. Does the fact that Australia is a relatively small trading partner from China’s perspective make us of limited relevance in these earlier stages of RMB internationalisation? Data on trade with China by countries that are already significant offshore RMB centres put these Australian figures into perspective (chart 1.6). While the data are somewhat difficult to interpret with respect to Chinese exports due to the fact that Hong Kong is in many cases just an intermediary port for other ultimate destinations, they do suggest that, on the Chinese imports side - which is the relevant one with respect to building up offshore RMB liquidity – Australia is a larger supplier than, for example, the UK, Singapore or Hong Kong.
2. REGIONAL TRADE LINKS, SUPPLY CHAINS AND RMB INTERNATIONALISATION

While the above data paint a broad picture of Australia’s trade with China, globalisation and the associated development of regional and global supply chains have made interpretation of raw trade data increasingly difficult. Because China’s high level of trade in intermediate goods and associated close integration into regional supply chains have a number of implications for RMB internationalisation, this section looks in some detail at these regional trade patterns.

Many of Australia’s older, developed country trading partners have taken advantage of the much cheaper supply of labour in China and elsewhere in the Asian region and established manufacturing plants and other operations there. Closely associated with this, much of the growth in global trade, particularly in East Asia, has been dominated by intermediate goods used as input into final products, many of which are then exported, in particular to major advanced economies. Kelly and La Cava (2013) have noted that, between 1990 and 2011, East Asia’s share of world intermediate goods trade rose from around 17% to over 50% as the region “became heavily engaged in global supply chains, especially those involving components for computers and other electronic devices.” The authors go on to note the major role played by China in this regional growth in intermediate goods trade following its accession to the World Trade Organisation in 2001, with China now “a core market for intermediate inputs, such as resource commodities from Australia and complex manufactured components from Asian countries.”

Most of China’s intermediate imports originate from East Asian economies. Indeed, despite its very large overall trade surplus, China has been typically running trade deficits or only small surpluses with emerging East Asian economies.

High levels of intermediate imports which are then used in exports boost the level of trade of the country involved. Australia has a relatively low ratio of trade to GDP (chart 1.7) and a much lower level of integration overall (imports plus exports) into the intermediate manufacturing processing stages of global supply chains than does China. Kelly and La Cava attribute this lower trade integration to, amongst other factors, Australia’s geographic isolation and its large endowment of natural resources, which have a low dependence on imported intermediate inputs.

In essence, Australia’s integration into Asian supply chains is primarily on the exports side, via our commodity exports in particular, with more of our imports being final goods and services; whereas for East Asia in general and China in particular the reverse is true, with more of their imports being intermediate goods and more of their exports being final goods and services sold to developed countries in particular. China has thus become a key “transmission mechanism” between the developed and developing economies – both on the trade side and increasingly on the financial side as well (see below).

Kelly and La Cava 2013, p. 30.
Kelly and La Cava 2013, p. 30.
See Xing (2011).
These observations on China’s trade links with Australia and the region, and Australia’s place in the regional picture, are likely to have some important feedback effects on the move to RMB internationalisation and how it impacts on financial markets, not all of them working in the same direction.

Firstly, one of the concerns of the Chinese authorities with respect to RMB internationalisation has been its impact on the exchange rate, and in particular concerns that removal of capital controls would see inflows dominate outflows, putting upward pressure on the exchange rate. However, for as long as intermediate inputs remain a significant proportion of total Chinese imports, the impact of any given appreciation of the RMB on competitiveness and the trade balance will, other things being equal, be dissipated. This is a reflection of the fact that, while there would be a loss of competitiveness on export markets, it would be partially offset by cheaper intermediate inputs used in the production of exports.\(^8\)

Secondly, Errico and Massara (2011), while using 2010 data that are now somewhat out of date, showed that, if one combines measures of the absolute size of trade by country with network analysis measures of cross-border inter-linkages and interconnectedness, China’s global ranking in terms of the overall “systemic importance” of its trade sector increased from thirteenth in 2010 on size alone to first. This is in large part a reflection of the degree of China’s involvement in regional and global supply chains discussed above. Given that a critical dimension of the degree of internationalisation of a currency is the extent to which it is used for trade invoicing, and in turn the importance of the size and geographic dispersion of a country’s trade links with the rest of the world in terms of providing the momentum and incentive for other countries to invoice in that country’s currency,\(^9\) this provides China with a strong starting point in its move towards RMB internationalisation.

Thirdly, and returning to the theme of “finance follows trade”, the study by Errico and Massara (2011) also compared their findings on systemic trade interconnectedness with separate IMF work that looked at systemic financial interconnectedness. The results (chart 1.8 below) show a close overlap between the two.

\(^8\) This point has been made by Xing (2011).

\(^9\) See for example Bacchetta & Wincoop (2005).
China’s overlap, however, is much less than for most countries. It was ranked first in terms of systemic trade interconnectedness but only eleventh in terms of systemic financial interconnectedness – an unusually large difference. Nonetheless, given the pervasive capital controls in China which existed when this study was done and the lack of RMB convertibility on the capital account, this financial interconnectedness ranking – which has almost certainly risen since – is remarkable.

As capital controls are removed and China’s financial markets deepen, its financial interconnectedness ranking will continue to rise and may eventually challenge that of the US. Associated with this, the importance of China not just to world growth prospects but also to the provision of global liquidity and the stability of global financial markets will rise. A separate CIFR funded research project looks at some interesting aspects of this, namely systemic issues that may arise in a world of dual global “safe asset” reserve currencies.10

Turning to some of the regional implications, alongside the growth in regional supply chains in Asia and the central importance of China in these chains has been a rapid rise in what one study refers to as “Asia Financing Asia” (Gruenwald & Conti 2012): that is, in intra-regional financial flows, both direct and portfolio but particularly the latter (see next section). The study attributes this to a number of factors in addition to the increasingly sophisticated regional supply chains, such as infrastructure requirements in south and south east Asia financed by north east Asia; asset and liability diversification away from the US and Europe in the wake of the financial crisis; and capital market deepening in the region. However, trade integration remains a key component of the overall story. The study incorporates some modelling work on these intra-Asian flows and concludes that the portfolio flows could well rise by compound annual rates of around 35-40% over the coming decade and beyond, assuming China continues to liberalise its capital account and develop its domestic capital markets.

In short, as China continues to free up capital controls, a significant proportion of the resultant increase in both portfolio and direct investment flows is likely to be intraregional.

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11 For an analysis of foreign direct investment in China by other countries in the region, see Davies (2012).
From Australia’s perspective, such prospective rapid growth in intraregional lending and associated regional economic development can have important indirect benefits, both on the trade account – given that, as noted earlier, four of our five top trading partners are now in the region – and also for Australian financial institutions with a significant regional presence.

3. CHINA’S FINANCIAL LINKS

a) Global context
As is the case for many other countries, data on Chinese capital flows, both inward and outward, are somewhat sparse and at times inconsistent. One also needs to distinguish carefully between growth rates – in many cases very strong – and levels – generally still low by global standards.

Chart 1.9 examines the broad structure and level of China’s international investment positions, and compares them to those of the U.S. A number of features of China’s external financial position are worth noting. Firstly, both international assets and liabilities remain very low relative to the size of the economy. This is the case not just relative to the US (chart 1.9) but also relative to most other industrialised economies (see chart 1.14 below).

Secondly, if foreign exchange reserves are excluded on the grounds that they are simply a reflection of China’s non-convertible currency and capital controls, China’s external liabilities are substantially larger than its external assets and are dominated by direct investment. This is a reflection of China’s freer regime with respect to direct investment as against portfolio investment. Indeed, as a percentage of GDP, China’s foreign direct investment liabilities are not too dissimilar to those of the U.S. By contrast, and reflecting still pervasive capital controls, the stock of outward portfolio investment is extremely small compared to that of the US. The same is true, and for the same reasons, with respect to inward portfolio investment.

CHART 1.9: International investment Positions, China and the United States, 2012

Source: Hooley 2013, p.3.
Turning from levels to growth rates, the gradual relaxation of capital controls and opening up of China’s capital markets is having an impact, albeit from this low base. A recent analysis of changes in Chinese capital flows by Collyns et al (2014) concluded that:

- both inflows and outflows have surged over the past decade or so, in particular capital outflows which have become “an important factor in the global financial system”12; and
- while China’s banking system – the largest in the world – remains heavily focussed on domestic lending, resident lending abroad has risen very strongly in recent years. While this category includes components other than bank lending, the institute concludes from other data sources that it primarily reflects Chinese banks diversifying their loan portfolios internationally. Once again, however, this increase is from a very low base compared to most advanced economies.

Given the already significant and rapidly growing importance of Chinese direct investment abroad, it is worth looking briefly at its geographic distribution. Heritage Foundation data suggest this has become increasingly focussed on emerging markets, and Asian markets in particular (see chart 1.10), reflecting the “Asia financing Asia” trend referred to earlier. Nonetheless Australia remains a major destination, a point returned to below.

**CHART 1.10: Chinese Offshore Direct Investment by Country (US $bn.)**

Sub-Saharan Africa saw very heavy Chinese construction activity. In investment, Australia holds a narrow lead over the U.S., followed by Canada and Brazil.

Source: The Heritage Foundation: China Global Investment Tracker Dataset.

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Other data also show the extent to which, despite capital controls, RMB cross-border financial transactions are growing rapidly, albeit from a small base. By way of example:

- According to data from the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the volume of RMB cross-border trade transactions conducted with mainland China increased from 0.25% in January 2012 to 1.12% in December 2013, and China’s ranking amongst global payments currencies – which includes for purposes other than just trade-related payments – has risen from fourteenth at the end of 2012 to eighth in December 2013. SWIFT (2013) data suggest that over 47 countries now use RMB for over 10% of their trade transactions with mainland China and Hong Kong, up from 31 countries in July 2012;

- The latest Bank for International Settlements survey of foreign exchange turnover states that, comparing April 2013 to April 2010: “The role of the renminbi in global FX trading has surged, in line with increased efforts to internationalise the Chinese currency. RMB turnover soared from US$ 34 billion to US$ 120 billion. The RMB has thus become the ninth most actively traded currency in 2013, with a share of 2.2% in global FX volumes, mostly driven by a significant expansion of offshore RMB trading”13;

- Dim Sum bond issuance has grown from $US 5.36 billion in 2010 to $US 16.78 billion in 2013, with the bulk of issuance occurring in Hong Kong. In recent years the locations for Dim Sum issuance extend to Taipei, Singapore and London. However the Dim Sum market still represents a very small share of global issuance.

b) Australia/China Financial Links

Turning specifically to capital flows between China and Australia, they – along with our trade links – have been growing rapidly in recent years, in particular Chinese investment in Australia (chart 1.11). However, this has been from a low base and remains a small proportion of our overall financial links with the rest of the world.

**CHART 1.11: Investment Flows between China and Australia**

*FDI flows were undisclosed in 2003 and 2007
**includes portfolio investment, financial derivatives, loans, currency and deposits etc.

*Portfolio flows were undisclosed in 2002
**includes financial derivatives, loans, currency and deposits etc.

**Source: Australian Bureau of Statistics**

13 See Bank for International Settlements 2013, p. 5.
More specifically, Chinese financial assets are less than 2% of Australia’s total foreign assets, while foreign investment in Australia – unlike our trade links – is still dominated by Australia’s traditional trading partners, in particular the US and the UK (chart 1.12). As “finance follows trade” and China’s capital controls are gradually removed, the depth and breadth of financial flows between Australia and China are also likely to increase substantially.

CHART 1.12: Foreign Investment in Australia by Country

![Chart 1.12: Foreign Investment in Australia by Country](chart_url)

*Source: Australian Bureau of Statistics*

Chinese investment in Australia is heavily dominated by direct investment in both equity and debt instruments (Chart 1.13), reflecting the still widespread capital controls in China on the one hand and the much more liberalised controls on offshore direct investment on the other.

CHART 1.13: Level and Composition of Chinese Investment in Australia

![Chart 1.13: Level and Composition of Chinese Investment in Australia](chart_url)

*Estimated for 2007 as data were undisclosed.

**Estimated for 2006 to 2009 as data were undisclosed.

***Includes financial derivatives, which have been estimated for 2006, 2008 and 2009 as data were undisclosed.

*Source: Australian Bureau of Statistics*
Reflecting the policy imperatives driving foreign direct investment out of China, Foreign Investment Review Board data on approved proposed (as against actual) investment suggests most of the direct investment flows into Australia have gone into the mining and resources sector (chart 1.14). However, it is also worth noting that most of the major Chinese commercial banks have a presence in Australia.

**CHART 1.14: Approved Chinese Investment in Australia**

*By industry, financial year*

![Chart showing Chinese investment in Australia by industry, financial year.]

Separate real estate data are unavailable for 2008/9.
Source: Foreign Investment Review Board

As of early February 2014 there were 16 Chinese firms listed on the ASX, with a total market capitalisation of just over A$ 2 billion or around 0.14% of the All Ordinaries index. Three more listings are scheduled in the next month or so, all in the resources sector. APX, a securities exchange in Australia which is fully owned by AIMS Financial Group, is looking to encourage more Chinese companies to list in Australia, both in A$ for Australian investors and also in RMB to attract Chinese investors domiciled in Australia and elsewhere in the region. At the time of writing it had just announced its first such listings.

A private sector survey of Chinese investment in the Australian energy and resources sector between January 2005 and end December 2012 (Li 2013) found that:

- 78% of investments were “for the purpose of securing supply to an underlying commodity”\(^{15}\);
- 65% of investments were about securing a strategic stake in a company, as against acquiring an interest in an asset or a project;
- most corporate investments were for a passive minority stake rather than a controlling interest, reflecting a “preference of Chinese investors to rely on Australian management to operate the assets acquired”\(^{16}\);
- Chinese state owned enterprises were by far the major investors, representing 74% of investments by number and 97% by value;

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\(^{14}\) See Foreign Investment Review Board (2010).
\(^{15}\) Li 2013, p. 6.
\(^{16}\) Li 2013, p. 23.
• the iron ore sector attracted almost half of completed investments by value, with the coal sector attracting an additional 16% by value; and
• towards the end of the survey period, Chinese investment interest in three other key sectors had intensified: oil and gas; gold; and uranium.

Data from the US based Heritage Foundation referred to above suggest that, since they commenced gathering data in 2005, Australia is – outside of Hong Kong – the major recipient of Chinese direct foreign investment, concentrated in areas of strategic importance. Nonetheless, while China’s share of global offshore direct investment has been rising rapidly and may well continue to do so (given the size of China’s economy, its very large stock of foreign assets and the fact that these assets are not well diversified), China’s foreign direct investment assets remain small compared to the size of its economy (chart 1.15).

**CHART 1.15: Foreign Investment Assets by Country**

(Per cent of GDP)

<table>
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* Averaged on a quarterly basis from Q1 2005 to Q4 2012

Source: Australian Bureau of Statistics; Thomson Reuters

As China continues to liberalise outflows of capital from the mainland consistent with its “go global” strategy focused on encouraging overseas investment for strategic and diversification reasons amongst others, Australia is well positioned to become an increasingly important location for Chinese portfolio investment as well as direct investment, so long as it sorts out some ongoing tax issues which are discussed in chapter 3. A 2012 study on Chinese direct investment in Australia suggested that, given some of the sensitivities in Australia over direct investment in strategically important sectors of the economy, in particular by state-owned enterprises, China may over time look increasingly for other ways to achieve their objectives, in particular by way of more portfolio investment.¹⁷

Given Australia’s reliance on imported capital to finance its investment needs, these foreign investment flows from China are very important for Australia. A 2011 survey of Chinese perspectives on investing in Australia found that many Chinese investors and officials perceive that Australia discriminates against Chinese investors. This was seen

¹⁷ See Larum & Qian (2012).
as reflecting a number of factors such as the additional scrutiny applied to investments from government-related entities and “a number of failed high-profile deals …. particularly Chinalco’s 2008 failed bid to take a controlling stake in Rio Tinto”.

Data on foreign investment approvals in Australia show no evidence at all of discrimination against China. But as this survey points out, perceptions matter. Hopefully the perceptions have dissipated somewhat since this survey was conducted. Certainly Chinese perceptions are not helped by examples from time to time of opposition to Chinese foreign investment in Australia.

Given the substantial mutual benefits to Australia and China of such investment, perceptions of discrimination in China and lack of understanding of the benefits in some limited quarters in Australia both need to be overcome. Reflecting, amongst other things, the gradual relaxation of capital controls, in particular in relation to direct investment in China, the level of Australian investment in China has increased strongly in recent years, albeit from a very low base, with most of it being in the form of direct investment (chart 1.16).

**CHART 1.16: Level of Australian Investment in China**

While data on Australian direct investment in China by sector are not available, all of the major Australian banks have an increasing presence in China, as reflected in the rise in Australian banks’ foreign claims on China. These claims, which represent lending to China by Australian owned banks, have risen very strongly in recent years, from just A$ 5.4 billion 5 years ago to A$ 33.6 billion in September 2013. While still heavily constrained by capital controls and other regulations, other parts of Australia's financial services sector, such as insurance and funds management, also have direct investments in China, albeit quite limited overall in size.
CHAPTER TWO
WHAT MIGHT THE FUTURE LOOK LIKE?

1. INTRODUCTION

Chapter 1 focused on existing trade and financial links between Australia and China. This chapter looks ahead to when RMB internationalisation has been well advanced, with all of the concomitant policy changes outlined in Eichengreen (2014) that this requires, and asks the question: what might China’s capital markets look like and what might financial flows between China and the rest of the world look like? More specifically, as Chinese growth continues to outstrip that of developed countries, its already very large pools of domestic savings continue to grow and its capital markets deepen, how large might capital flows into and out of China be?

Undertaking such analysis, it should be stressed, is an art not a science: the objective is simply to provide an “educated guess” for the possible size of China’s capital markets and of financial flows into and out of China in a world where the RMB has been largely internationalised. Furthermore – and as discussed in detail in Eichengreen (2014) – views differ considerably on how long it will take for China to significantly “internationalise” its currency.

Given China’s well-established “step-by-step” approach to reform, the time path towards RMB internationalisation is heavily dependent on whether or not there are any major economic, market or political setbacks to the ongoing reform process. The assumption underlying this chapter is that, in the absence of some major setback, substantial progress will have been made in internationalising the RMB within ten years, with capital controls largely or completely lifted, borrowing and lending rates market-determined, the exchange rate market-determined and the RMB having become a significant international reserve asset.

The widespread discussions that have taken place as background to preparation of this report have seen strong views expressed either side of this ten year central scenario. But as a rough rule of thumb, based on the critical assumption of no major setback to China’s reform process, this ten year scenario would seem consistent with, amongst other factors:

- the observations in Eichengreen (2014) about how the financial market reforms that are required for internationalising the currency are also vital if China is to meet many of its broader economic objectives21, including ongoing reform of state owned enterprises; improving resource allocation and the quality of investment; tackling fiscal issues at the regional and local level; developing a national pension scheme; rebalancing growth more towards domestic demand; and providing a wider array of investment opportunities for its rapidly growing middle class beyond just low interest deposits, real estate and the domestic equity market;

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21 For another interesting analysis of the relationship between RMB internationalisation and structural reforms necessary in order to ensure more sustainable growth in China, see European Central Bank (2014).
• the experience of some other countries, including Australia, that a partially deregulated capital account and exchange rate regime leads over time to an increasing amount of “leakage” and growth in the shadow banking sector, as the private sector finds ways around the remaining controls\(^{22}\). As discussed in Eichengreen (2014), these leakages lead to gradual loss of control of monetary policy and a choice for policy makers between stepping backwards and tightening up on capital controls, or speeding up capital account liberalisation and floating of the exchange rate so as to regain control of monetary policy. In Australia’s case in the early 1980’s, the choice was the latter one; in China’s case, given the extent of commitment to RMB internationalisation and the other considerations listed here, this factor also seems more likely to work in the direction of reforms being sped up rather than reversed;

• the 2012 report from the People’s Bank of China outlining a program of liberalisation which implies that it will be largely completed in ten years’ time\(^{23}\);

• consistent with this timetable, the recent accelerated pace of financial market reform\(^{24}\) – including, importantly, the emerging Shanghai Free Trade Zone experiment, the two to three year timetable attached to it and the history in China of commencing market opening measures on a regional basis and then, if successful, expanding them nationally;

• the historical experience with internationalisation of the US dollar, touched on in Eichengreen (2014), which suggests that, with the right policy framework and market conditions, a currency can move rapidly from a relatively low level of internationalisation to becoming a major global “safe asset”;

• the observation – returned to in Chapter 3 below – that China cannot rely primarily on just increased RMB trade settlement as the key mechanism for expanding offshore use of RMB, due to the fact that, so long as significant capital controls remain in place, the offshore demand for RMB-denominated investment products outside Hong Kong will remain quite limited; and

• the ongoing negotiations with MSCI about China’s inclusion in the MSCI emerging markets equity index\(^{25}\).

One of the above factors is worth elaborating on given its potential importance – namely the Shanghai Free Trade Zone (SFTZ) “experiment” that is currently underway. Widespread discussions with Chinese officials and market participants in the SFTZ suggest that, coming at the same time as the Third Plenum of the Chinese Communist Party’s endorsement of the need to rely more heavily on market forces and market pricing, a successful SFTZ experiment could well see the Chinese Government move even more rapidly than we are assuming to substantially relax capital controls, deregulate bank deposit rates and float the exchange rate.

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\(^{22}\) A current example of this, which is discussed further in Chapter 3, relates to the use of inflated trade invoicing between China and Hong Kong to circumvent capital controls and borrow offshore or lend domestically, spurred by the gap between domestic and mainland interest rates.

\(^{23}\) See People’s Bank of China (2012).

\(^{24}\) Amongst the many recent measures taken are: the establishment of official offshore RMB clearing and settlement banks in Taiwan and Singapore; the expansion of RQFII quotas to London and Singapore; and the inclusion of the Australian dollar, British Pound, Japanese Yen and Singapore dollar in the currencies directly traded with CNY. As at the time of writing direct trading of GBP/CNY and SGD/CNY had not yet commenced.

\(^{25}\) See MSCI (2013). The press release notes at p.4: “It is worth emphasising that a full inclusion of China A-shares in the MSCI Emerging Markets Index is unlikely to be achieved without a complete abolishment of capital flow restrictions...”
A key factor in assessing the importance of the SFTZ experiment in the broader context of RMB internationalisation objectives will be whether the authorities allow financial flows between the “special accounts” covering largely deregulated financial transactions between the SFTZ and the rest of the world on the one hand, and the “general accounts” covering financial transactions between the SFTZ and the rest of China on the other. Discussions with Chinese authorities suggest that such flows will be allowed over time, but within limits so as to ensure there is no loss of control of domestic liquidity or of macro prudential objectives. While full details on the extent of allowable financial transactions between the SFTZ and the rest of mainland China are only likely to emerge over time, these discussions are consistent with the view that the SFTZ experiment is likely to be a very important factor affecting the timing of the move towards RMB internationalisation.

Once capital controls have been removed and interest rates and the exchange rate are market determined, the structure of the RMB market – and indeed of global capital markets – will look quite different:

- the distinction between the onshore (CNY) and offshore (CNH) markets will have disappeared;
- the distinction between the onshore and offshore (Dim Sum) bond markets will have largely gone, with the RMB becoming a significant funding currency – not just for mainland Chinese companies and offshore companies doing business with China, but also offshore companies that are not;
- the mainland Chinese equity and bond markets will be a core and substantial part of both global and emerging market benchmark indices, with significant implications for global portfolio asset allocation and associated portfolio investment flows that are further examined below;
- with China having become both the largest trading nation and the biggest global economy, the RMB’s share of global trade invoicing and trade financing will be substantial, with the RMB becoming one of the most widely traded global currencies, both spot and forward;
- with a floating exchange rate, China’s foreign exchange reserves will become a much smaller proportion of offshore portfolio assets, with the private sector’s share increasing commensurately. This may well have important implications for China’s offshore asset allocation and hence relative asset prices; and
- the RMB is likely to be a significant part of central bank foreign exchange reserves and RMB government securities may well become the main alternative “safe asset” to US Treasuries, with important implications for global capital flows and financial stability.

The following sections focus on the possible future size of direct and portfolio investment flows to and from China, and the potential growth in RMB trade invoicing and associated foreign exchange turnover and trade financing.
2. CAPITAL INFLOW POTENTIAL

a) The Future Size of China’s Capital Markets

At present, there are a number of factors restricting the size of China’s capital markets, including importantly:

• controls on bank deposit rates and the links between state-owned banks and state-owned non-bank enterprises, which mean that the latter have ready access to cheap sources of bank funding and do not need to rely significantly on capital markets for their funding;

• the fact that many private enterprises that would like to list are facing very long delays before they are able to do so, and

• ongoing capital controls, which limit both domestic competition in the development of China’s capital markets and offshore demand for, and access to, those markets.

Despite these constraints, China already has large capital markets, primarily reflecting the absolute size of its economy. Total Chinese equity market capitalisation – including A, B and H-shares and Red Chips27 – is currently around 9% of global market capitalisation28, although its weighting in the MSCI World Index is only around 3%. This difference between China’s market capitalisation weight on the one hand and its index weight in the MSCI on the other reflects a number of factors, including, importantly, the lack of significant offshore access to China A-shares.

A range of approaches can be used to get a “feel” for the likely size of China’s capital markets a decade or so from now. Two main factors will drive it: the ongoing growth in China’s economy, and “capital deepening” resulting from the expected rise in the ratio of market capitalisation to GDP as emerging economies develop.29 Similarly, China’s future benchmark index weights can be projected on the assumption that the market capitalisation of the rest of the world also increases in line with economic growth and capital deepening in the less developed economies. Chart 2.1 shows the current total market capitalisation – defined as domestic bank lending plus equity market capitalisation plus total debt securities outstanding – of a number of countries, along with some of the factors influencing this ratio through the different stages of economic development.

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26 However, it is worth noting the December 2013 announcement by the China Securities Regulatory Commission of a relaxation in regulations designed to “streamline” initial public offerings. It is at the time of writing too early to tell how successful these regulatory changes will be.

27 A-shares are mainland Chinese companies listed in mainland China and only accessible to offshore investors via QFII or RQFII quota schemes. H-shares are mainland Chinese companies listed in Hong Kong. B-shares are mainland Chinese companies listed in mainland China especially for international investors. “Red Chips” are companies that are listed in Hong Kong, not incorporated in mainland China, but effectively controlled by mainland Chinese entities.

28 See World Bank (2012).

29 For an overview of the large body of literature on capital deepening, see Valickova, Havranek & Horvath (2013).
A recent market research report by ANZ\textsuperscript{30} has modelled what they see as the key drivers of capital deepening, focusing in particular on the size of the capital stock and the level of GDP per capita. They then use a range of financial and real variables to break down their estimates of overall financial depth into its components, namely bank loans, the outstanding value of private and public bonds and equity market capitalisation. Using their forecasts of likely capital deepening in China and the rest of the world over the next decade under their “Asian Century” central scenario (in which China continues to grow strongly albeit at a significantly slower pace than in the recent past\textsuperscript{31}), and combining it with an analysis based solely on projected growth in nominal GDP in China versus the rest of the world, their results suggest that, a decade or so from now:

- China’s equity market could be the largest in the world, with a market capitalisation of around US$ 30 trillion or just under 25% of projected world market capitalisation compared to US$ 22 trillion (18%) for the US; and
- China’s bond market could be the second largest in the world after the US, and equal in size to that of the entire Eurozone.

Charts 2.2 and 2.3 below summarise the ANZ projections for China’s equity and bond markets. They paint a picture of enormous changes in the size and geographic distribution of capital markets over the coming decade and beyond.

\textsuperscript{30} ANZ Insight Report (2014).
\textsuperscript{31} The ANZ analysis assumes China’s real growth rate slows from just over 10% in 2001-10 to 7% in 2011-20 and 4.5% in 2021-30. This is reasonably similar to the Australian Treasury long-term growth projections in Au-Yeung et al. (2013).
**CHART 2.2: Total Size of Equity Market Capitalisation as a Percentage of World**

*(market capitalisation in USD trn)*

![Chart 2.2: Total Size of Equity Market Capitalisation as a Percentage of World](chart-2.2.png)

*Data sourced from ANZ Insight Report (2014)*

**CHART 2.3: Total Size of Fixed Income Markets as a Percentage of World**

*(market capitalisation in USD trn)*

![Chart 2.3: Total Size of Fixed Income Markets as a Percentage of World](chart-2.3.png)

*Data sourced from ANZ Insight Report (2014)*
These projections are, of course, partial equilibrium in nature and do not allow for a variety of possible feedback effects or other influences as capital controls are lifted and interest and exchange rates liberalised. However, it is not obvious in which direction these feedback effects bias the results. By way of example:

- the RMB may appreciate on average compared to the rest of the world over the next decade, due to such factors as China’s desire to rebalance its growth towards domestic demand and (more debatably) possible currency undervaluation now.\(^3\) If this occurs, the valuation effect would mean that China’s share of global equity and fixed income markets expressed in a common currency would be higher;

- working in the other direction, unless carefully managed, the liberalisation of China’s capital markets and removal of capital controls could result in something of a speculative bubble in China’s asset markets, leading to a sustained period of underperformance relative to the rest of the world; and

- as controls on bank borrowing and lending rates are removed, an effective subsidy to the corporate sector – in particular to state owned enterprises – will be removed. This could have important feedback effects on corporate savings and hence external financing by companies.

b) How Large Might Future Capital Inflows Be?

While the above rough figuring gives some idea as to how large China’s capital markets may be in ten or so years’ time, they do not tell us how large capital inflows – both direct and portfolio – into those asset markets may be once capital controls have been removed. A crucial missing element in answering that question is offshore investor confidence in China’s asset markets, as against just the size of and access to those markets.

The literature on key factors determining whether portfolio investors are overweight or underweight particular countries relative to their benchmarks generally emphasises some combination of information, governance, liquidity and transaction costs, although some of the more recent literature urges caution in terms of trying to weight these factors and also suggests that other, harder to model factors may be material.\(^3\)

Corporate governance reform in China is not only desirable in its own right but is also crucial to successful RMB internationalisation. If offshore investors are to view the RMB as a medium for investment – an important characteristic of a fully internationalised currency – they will need increasing confidence with respect to investing in China’s capital markets.

A market review of the 2012 expansion of QFII and RQFII quotas and why they were not fully taken up at the time concluded that, while very welcome, the greater challenge for China lay in “structural reforms to increase the integrity and transparency of onshore markets.”\(^3\) Similarly, in our discussions with equity fund managers that are invested in Chinese companies, a common theme was that, despite its limitations in terms of coverage, many of them preferred to access Chinese equities via Hong Kong listed H-shares rather than mainland China listed A-shares because of the much higher standard of corporate governance in Hong Kong.

Discussions with Chinese regulators and some recent reform measures suggest that China is well aware of the importance of this issue. Nonetheless, a great deal remains to be done on this front.

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\(^3\) Note however that the analysis in section 3(c) below suggests that the net effect on the exchange rate of removing capital controls in China is more likely to be depreciation than appreciation.

\(^3\) See Bertaut & Kole (2004).

\(^3\) See Mills 2013, p.22.
If over the coming decade China does successfully undertake the governance and regulatory reforms necessary to increase market confidence in, as well as access to, their capital markets, then the projections in the previous section on the potential future size of China’s capital markets imply very substantial asset reallocations in the portfolios of both active and passive global equity and fixed income fund managers, with China becoming a major and core part of portfolios at the expense of older, more traditional markets, including those of the US, UK, Euro area and Japan.  

This scenario is consistent with a number of academic studies that model both portfolio and direct investment flows or stock adjustments in a world in which China has no capital controls. While there are a range of different methodologies used and different associated strengths and weaknesses in the analyses, a common finding is that these stock adjustments and associated flows are likely to be extremely large. By way of example, one of the more thorough analyses (He et al. 2012) allows for the likely growth in the size of these markets from both GDP growth and capital deepening, along the lines of the analysis above. It then uses some cross-country econometric analysis on the relationship between size (relative to GDP) of inward foreign and portfolio direct investment and a range of factors – including degree of capital account openness, corporate governance proxies, financial market deepening, relative returns vis-à-vis the US equity market, trade openness and the national savings rate – to come up with some “educated guesses” (He et al. 2012) on the possible path of China’s gross and international investment positions over the coming decade. 

A number of scenarios are examined, including one in which, over the course of the decade, the RMB is well on the way to becoming a significant reserve currency. In this scenario (the central scenario in our analysis) and using accumulated capital flow estimates to examine stock adjustments35, on the capital inflow side:  

• inward foreign direct investment would increase over the decade from around US$ 1.5 trillion or 25% of GDP in the base year of the study (2010) to around US$ 7.0 trillion or 36.3% of GDP in a decade; and 

• inward portfolio investment would also increase substantially, from US$ 222 billion or 3.8% of GDP in the base year to US$ 5.9 trillion or 31% of GDP in 10 years. 

These “educated guesses” on adjustments in the stock of direct and portfolio investments in China, based on the assumption of substantial progress in internationalising the currency over the coming decade with all the associated policy changes that requires, are similar to other studies on this issue.36 They imply very large annual capital inflows on average, especially during the stock adjustment phase, although the size of such flows may vary considerably year-to-year due to such factors as where China is in the business cycle; the world business cycle; and the number of years from financial sector reform to capital account liberalization.37 

Chapter 3 below looks at some of the implications of these potential capital inflows into China for the Australian financial sector.

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35 One weakness in this flow-based analysis is that it does not allow for valuation effects. For a stock adjustment approach that nonetheless yields generally similar results, see Bayoumi and Ohnsorge (2013). See also Hooley (2013).
36 See He et al. 2012, p.16.
37 See comments on short-term flows and factors affecting them in Bayoumi & Ohnsorge 2013, pp. 6-9.
3. CAPITAL OUTFLOW POTENTIAL

a) China’s Savings Pool and Portfolio Diversification

One of the key characteristics of the Chinese economy has been its enormous and growing pool of domestic savings. For the best part of 20 years, annual savings flows have exceeded investment flows in China, with – due to the fixed exchange rate regime and the existence of capital controls – much of the excess of savings over investment being reflected in the huge build-up of foreign exchange reserves.

Very high levels of savings in China are held in all three sectors of the economy – corporate, government and household – with the household share being the largest (chart 2.4).

CHART 2.4: Sectoral Savings in China

Looking forward, there are a wide variety of factors that may reduce savings flows, including likely slower average growth in China, the more efficient use of existing savings as capital markets are developed, the development of a more comprehensive social safety net which may reduce precautionary household savings, the ageing of the population and the desire of the Chinese Government to rebalance growth more towards domestic consumption. Nonetheless, most long-term projections of Chinese growth assume that China continues to run current account surpluses (that is, domestic savings flows exceed domestic investment flows), albeit with the current account surplus declining as a percentage of GDP.38

38 OECD long-term projections actually have China’s current account surplus to GDP ratio rising for some time, reflecting their view that the re-orientation of China’s growth more towards domestic consumption will see its investment to GDP ratio fall further than its national savings to GDP ratio. See OECD (2012).
How will RMB internationalisation and associated reforms affect the size and asset allocation of these domestic pools of savings? There are factors operating in both directions. As controls on bank deposit rates in China are abolished, the financial sector liberalised and capital controls removed, the resultant potentially higher returns on savings may result in a higher household saving rate than would otherwise be the case. At the same time, the removal of what is in effect a very substantial subsidy to the corporate sector, in the form of artificially low interest rates on borrowings of state-owned enterprises in particular, may well cause corporate savings to fall.

A third factor relates to the exchange rate regime. Once the exchange rate is floated, China will no longer need to accumulate more and more foreign exchange reserves, and indeed will no longer need to maintain such a large stock of reserves. As capital outflow controls are removed, an increasingly large share of the ongoing net foreign asset accumulation is likely to be in the form of private sector and state-owned enterprise offshore asset holdings – both portfolio and direct – rather than foreign exchange reserves. In short increased private savings are likely to some extent to replace public sector savings (in the form of foreign exchange reserves) rather than add to total national savings.

Looking at China’s savings pools by sector, in the case of the household sector, capital outflow controls have to some extent been liberalised via such measures as QDII quotas and allowing individuals to each invest US$50,000 overseas per year; however, the overall volumes involved relative to the size of the household savings pool are very small. As a consequence, the bulk of household savings are trapped in low interest-bearing bank deposits yielding low or at times negative real returns due to the controls on bank borrowing rates, with the main alternatives being real estate and domestic equities.

As capital controls are removed and restrictions on the sale of offshore managed mutual funds are lifted, Chinese households will have the option of investing in offshore assets, either directly or via collective investment vehicles. This may, at least initially, be most relevant for more sophisticated, high net worth investors. As noted earlier, the dramatic increase in the size of China’s middle class and the number of high net worth individuals has been well documented. To quote just one study, the Capgemini (2013) “Asia Pacific Wealth Report” suggested that:

- Since 2007, Asia Pacific has increased its high net worth individual (HNWI) population by 31%, which is significantly greater than the growth rate in the rest of the world; and
- Asia-Pacific ranked only marginally behind North America in terms of HNWI population, with China’s share over one quarter and rising.

While potentially high returns on domestic financial assets, “home bias” and other factors may limit the extent to which China’s household sector invests offshore – at least in the earlier period following RMB internationalisation – the sheer size of China’s household savings pool, the extent to which this sector has borne the brunt of “financial repression” policies and experience from other countries that have liberalised their capital markets and removed exchange controls all suggest that the scope for capital outflow from the household sector – and associated mandate opportunities for overseas fund managers – is enormous.

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39 In a recent speech (Yi 2013) the Deputy Governor of the PBOC stated that it is not in China’s interest to further increase FX reserves.
40 Another, higher yielding option is the range of trust and wealth management products which, as noted in Eichengreen (2014) p. 16, have grown rapidly in the “shadow banking” sector as a means of circumventing ceilings on bank deposit rates. Some of these products have come under financial stress recently and are under increasing scrutiny from the Chinese regulators.
41 This term has been widely used to describe China’s policy of using capital controls and controls on deposit rates to ensure the availability of large pools of cheap domestic finance to fund its development. See for example Johansson (2012).
Turning to the corporate sector, the very large pool of savings is primarily a reflection of substantial cash balances held on the balance sheets of large State Owned Enterprises (SOE’s) in particular. This is in turn a reflection of a number of factors, including:

- below-market pricing of factor inputs, particularly for SOEs, which has supported high corporate profitability;
- government dividend policy that to date has allowed SOEs to retain most of their earnings rather than distribute them via dividend payments; and
- private enterprises finding it difficult to access competitively priced bank funding, which has encouraged a higher rate of internal saving.

Some of these factors may well change over time as China relies more on market signals to allocate capital, which could encourage lower levels of retained earnings.

At present, the major avenue for offshore corporate investment is in the form of direct investment, which is actively encouraged by the Chinese Government. China’s share of total offshore direct investment has risen rapidly – albeit, as noted earlier, from a small base – and is likely to continue to do so given the size of China’s economy, its very large stock of foreign portfolio assets and the fact that these assets are not well diversified. This would also be consistent with China’s “go global” policy referred to earlier. The ongoing need for greater security of energy and food supplies for China is likely to remain a key driver of higher levels of direct foreign investment by the corporate sector. In the case of investment in Australia, and as noted elsewhere, the continued sensitivity associated with direct investment from China – in particular from state-owned enterprises – may see more investment in the future take the form of portfolio rather than direct investment.

One important source of corporate offshore portfolio investment is the insurance industry, which has grown very strongly in China in recent years. Given the ageing of China’s population, this sector is likely to continue to show rapid growth in assets under management and also face pressures for portfolio diversification overseas. Under revised regulations for Chinese insurance companies’ offshore investment published by the China Insurance Regulatory Commission in Oct 2012, up to 15% of these companies’ assets are permitted to be invested overseas, and Australia is included among the 25 developed markets permitted. In addition, insurance companies are now permitted to invest in real estate investment products offshore – an asset class in which the Australian funds management sector is a world leader.

In the case of the government sector, there are factors operating in different directions that are likely to influence both the size and the asset allocation of savings. One that has already been touched on is foreign exchange reserve accumulation.

China’s foreign currency reserves at the end December 2013 stood at around US$ 3.82 trillion and have continued to increase significantly from US$ 3.2 trillion in July 2012. Over the coming decade, two factors mentioned earlier – the expected floating of the RMB and China’s stated objective of rebalancing its growth more towards consumption – are likely to see a much slower accumulation of foreign exchange reserves and potentially even

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42 See comments on China’s insurance sector in Z-Ben Advisors and Citi OpenInvestor 2013, p.16.
43 This section has benefited from a range of discussions and sources, in particular with Z-Ben Advisors and their publication (Z-Ben Advisors and Citi OpenInvestor 2013).
44 See State Administration of Foreign Exchange (2013).
some reduction in absolute size.\textsuperscript{45} Even allowing for this, however, China is still likely over time to continue to diversify the investment of its stock of exchange reserves away from the very heavy reliance on US Treasuries. While China does not publish data on the composition of its reserves, 2013 analysis by the US Treasury estimated China’s holdings of US Treasuries to be US$ 1.3 trillion or around one-third of total reserves, down significantly from around 65% in 2010.\textsuperscript{46}

Investment of these foreign exchange reserves is the responsibility of both the State Administration of Foreign Exchange (SAFE) – a public sector body overseen by the People’s Bank of China – and China Investment Corporation (CIC) – China’s main sovereign wealth fund. Historically, SAFE has been a conservative investor, with holdings concentrated heavily in US Treasuries. This approach has changed somewhat in recent years, with SAFE taking a more diversified approach to investment of reserves and in the process providing external asset managers with business opportunities across a number of asset classes, although to date such mandates have been limited.

SAFE is also involved in providing financial assistance via the “policy banks” to state-owned enterprises for direct investment offshore, an important factor behind the strong growth in such investment referred to earlier.

Another important channel for portfolio diversification has been the establishment of CIC, a state-owned body charged with making “long-term investments that maximize risk-adjusted financial returns for the benefit of its shareholder.”\textsuperscript{47} CIC was established in 2007 with the issuance of special bonds worth RMB 1.55 trillion by the Ministry of Finance, which were in turn used to acquire approximately USD 200 billion of China’s foreign exchange reserves and formed the foundation of its registered capital.

Since its establishment in 2007, CIC’s assets have grown to US$ 575 billion at the end of 2012.\textsuperscript{48} CIC has both handed out mandates to external managers and developed its own in-house investment capabilities. While the future balance between in-house management and external mandates is unknown, and despite the likely slower pace of reserve accumulation under a floating exchange rate regime and once growth has been re-oriented towards domestic consumption, CIC is likely to remain an important potential source of mandates for external fund managers.

Another critical component of public sector savings pools and one which – unlike exchange reserves – is likely to continue to grow rapidly over the coming decade is the National Social Security Fund (NSSF). China has for some time had the objective of developing a comprehensive national pension scheme, but progress on this front has been mixed. Given the ageing of China’s population, the potential burden on the public purse of a national scheme will be immense and growing over time, which means that investment returns on pension fund assets will be critical.

Against this background, in 2000 the State Council set up the NSSF and its supervisory body, the National Council for State Security Fund (NCSSF), with the explicit mandate of building up its investment expertise and providing strong returns. Chart 2.5 shows the very rapid growth in assets managed by NSSF. These assets may well grow even more strongly going forward, given the decision in late 2013 by the Third Plenary Session of the Central Committee of the Communist Party to have state-owned enterprises pay a 30% annual dividend into the NSSF by 2020.

\textsuperscript{45} See Yi (2013).
\textsuperscript{46} Federal Reserve Board (2014).
\textsuperscript{47} China Investment Corporation (2014).
\textsuperscript{48} Source: Campanella 2014, p. 6; and Z-Ben Advisors and Citi OpenInvestor (2013).
While to date the asset allocation of the NSSF has been fairly conservative – at the end of 2012 it only had 8.6% of its assets under management invested offshore – this would appear to be changing, albeit slowly. NCSSF has handed out some mandates to external managers, mainly for active management of domestic equities and some alternative asset classes: an Australian funds management company currently manages a global real estate mandate for NCSSF.

**CHART 2.5: National Social Security Fund Assets Under Management (RMB bn.)**

One of the difficulties the central Government has faced in establishing a national pension scheme has been the fact that existing schemes are fragmented and many of the assets are held at the provincial level. Some of these provincial pension funds are already running at a deficit. However, it seems likely that, as the central Government steps up its objective of establishing a comprehensive national scheme, the NCSSF may increasingly take responsibility for managing both central and regional pension funds. In 2012, Guangdong province allocated some RMB 100 billion to the NCSSF – a possible harbinger of further changes to come.

**b) How Large Might Future Capital Outflows Be?**

What is the potential size of capital outflows from these pools of domestic savings in China? Again, the most robust framework would appear to be that of He et al. (2012) referred to earlier.

The authors estimate that:

- outward foreign direct investment will increase at a faster pace than inward FDI, with the stock of outward FDI rising from around US$ 300 billion (5% of GDP) in the base year to around US$ 5.1 trillion (27% of GDP) in ten years;

- as part of this, more developed domestic financial markets are seen as facilitating cross-border mergers and acquisitions by Chinese companies; and
• outward portfolio investment will increase very rapidly from around US$ 250 billion or 4% of GDP in the base year to around US$ 5.5 trillion (29% of GDP) in ten years, reflecting amongst other things the incentives and pressures for domestic investors to improve returns and diversify risk. These numbers are qualitatively similar to other studies. They represent massive potential outflows. When combined with the likely decline – at least relative to GDP – of flows into offshore assets from reserve accumulation, the net impact on offshore asset prices could also be very large. A 2011 IMF study that was focused more on reallocations within Chinese reserve assets suggested that a US$ 500 billion shift out of US Treasuries into emerging market government debt could increase US bond yields by 60 basis points and decrease yields on emerging market government debt by 240 basis points. The potential size of asset allocation shifts examined above is considerably larger than those examined in this 2011 study.

c) Will Inflows or Outflows Dominate?
An important issue for China as it gradually liberalises its financial markets, removes capital controls and moves to a floating exchange rate regime is the likely impact on the exchange rate. Concerns have been expressed in both directions – that removal of capital controls could result in a massive shift of “captive funds” out of China that swamps inflows and leads to a sharp depreciation of the RMB; and that capital inflows will dominate and result in a significant loss of competitiveness.

A wide variety of factors can influence the future trajectory of China’s exchange rate. However, concerns about loss of competitiveness resulting specifically from removal of capital controls may be exaggerated. Most empirical work on the potential size of capital flows into and out of China in a deregulated world concludes that outflows are likely to be larger than inflows. He et al, in their scenario in which the RMB becomes a significant reserve asset in 10 years’ time, estimate that China’s net foreign asset position will increase over the decade from 29.2% of GDP to 30.9%. In their scenario in which the RMB does not become a major reserve asset, the increase in net asset position is slightly larger, reflecting amongst other things, the lower level of portfolio inflows from offshore central banks. Bayoumi and Ohnsorge (2013) also estimate an improvement in China’s net foreign asset position, albeit a substantially larger one.

4. TRADE INVOICING, TRADE FINANCING AND FOREIGN EXCHANGE TURNOVER: DRIVERS AND PROSPECTS

The proportion of Chinese trade invoiced in RMB has risen from zero in 2009 to over 20% by the end of 2013, with particularly strong growth in the latter part of 2013 (Chart 2.6).

Associated with this rapid growth in RMB settlement has been a strong rise in RMB foreign exchange turnover: as noted in Eichengreen (2014), the 2013 triennial central bank survey of foreign exchange turnover conducted by the Bank for International Settlements (2013) showed a sharp rise in the CNY’s share of global turnover, from a ranking of seventeenth in 2010 to ninth in 2013. This strong growth has occurred across all instruments – spot, outright forwards and currency swaps.
What is driving this increase in RMB trade invoicing? International trade can be denominated in any currency: the importer’s, the exporter’s, or a third currency (e.g. US$). A fundamental component of the invoicing and settlement choice is the determination of who bears the exchange rate risk. Academic research has investigated the invoicing currency choice and provided theoretical arguments for the selected currency, including such factors as bargaining power, exchange rate volatility, product differentiation, transaction costs and industry structure.51

There needs to be a convincing business case for a company to alter its invoicing currency. Overseas companies can potentially capture a price advantage by settling trade with China in RMB: market estimates suggest that Chinese corporates have typically added between 3 and 5%52 to their quotes in foreign currencies, to hedge against unfavourable exchange rate movements before a trade settles. If trade counterparties are willing and able to trade in RMB then this buffer can be eliminated, but then the exchange risk is borne by the offshore party.

The costs of hedging foreign exchange risks would appear to be significantly higher in China than in many offshore financial centres, reflecting the greater liquidity and interbank connections offshore. This suggests that both parties can potentially benefit from RMB trade invoicing. In a recent Financial Times interview53 Raj Rai, Regional Treasury Manager Asia for Ikea, noted that Ikea switched all invoicing in China to RMB because it was more cost-effective to transfer the foreign exchange exposure to a part of the organisation that has expertise in managing foreign exchange risk.

51 Ito and Chinn (2013) provide a good background to the theory of trade invoicing.
52 Standard Chartered (2014) suggest that companies can shave 2-3% off costs by invoicing in RMB whereas Swift (2012) note that the PBOC have been quoted as saying that importers could save between 2-3% by paying in RMB. Deutsche Bank (2012) reported that for companies paying exports in RMB the savings averaged 4.8%. The HSBC (2013) RMB Cross Border Trade Settlement Survey indicated that 53% of Chinese businesses would offer discounts of up to 5% for transactions settled in RMB.
53 Law (2012).
Looking beyond just potential price advantage, the fact that Hong Kong dominates RMB trade invoicing is also in part a reflection of other historical factors that have encouraged the pick-up in RMB invoicing:

- at least initially, mainland Chinese companies setting up offshore, in particular in Hong Kong, were the main impetus behind the rise in RMB settlement, driven by the interest differential and companies using underlying goods trade and invoicing as a mechanism for accessing cheaper offshore funding. There is a good deal of at least anecdotal evidence to suggest that the most recent surge in RMB trade invoicing has been driven in part by these same factors as the gap between on and offshore RMB interest rates has widened54;

- since then, however, other companies with a presence in mainland China – in particular large multinationals – have also been doing it, and using it to shift their FX hedging from mainland China to their offshore Treasury operations. This started as an intra-company initiative, but has since spread to trading with third parties; and

- this was given a further boost by the decision in June 2013 to allow companies to shift intra-company funds from mainland China to offshore and vice-versa. This has allowed large companies with a significant presence in China to manage their RMB exposure much better through their global or regional Treasury operations.

What are the prospects for RMB trade invoicing looking forward ten years or so? As noted in Chapter 1, the literature on choice of currency for trade invoicing emphasises the importance of the size of a country’s economy and of its trade links with the rest of the world. Australian Treasury long-term growth projections (Au-Yeung et.al (2013)) suggest that China will be the largest global economy by the end of this decade, with a 22% share of global GDP. China’s share of global trade, already the largest at around 10% in 2013, is forecast to rise sharply over coming decades55.

Prima facie56, this suggests that the RMB could become a major trade invoicing currency, with significant implications for growth in trade-related foreign exchange turnover, in RMB hedging products and other derivatives, and in RMB trade financing.

More broadly, the launch in mid-2013 of the offshore RMB (CNH) Hong Kong Interbank Offered Rate (HIBOR) fixing is expected to spur growth in the offshore market for RMB-denominated loans, floating rate bonds and hedging products, such as interest-rate and currency swaps. This fixing provides a credible benchmark to the market for pricing a range of floating-rate instruments and derivatives.

Some recent market projections by Standard Chartered57 suggest that by 2020, with (on their assumption and ours) the RMB largely a freely floating currency and the capital account “more or less” open:

- 28% of China’s trade will be invoiced in RMB, or around US$ 3 trillion a year based on their assumed doubling of China’s trade over the period, making the RMB the fourth largest global payment currency;

- Daily RMB FX turnover will exceed US$ 500 billion, from around US$ 120 billion currently; and

- The offshore RMB (Dim Sum) debt market will also be worth around US$ 500 billion (up from around US$ 87 billion in late 2013).

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54 See for example ANZ Research (2014).
55 See World Bank (2013) which projects China’s share of world trade to increase by two-thirds over the coming 20 years.
56 The volume and degree of “interconnectedness” of a country’s trade is only one factor influencing the extent of invoicing in that country’s currency, but it is an important one.
57 Liu (2013).
Developments since these forecasts were made make some of them – such as the percentage of trade invoiced in RMB, which as noted earlier has already increased to over 20% – appear on the surface to be on the conservative side. However, there are constraints to the continued growth in RMB invoicing. At present, the US dollar remains the dominant currency of choice for trade invoicing. This is particularly true for trade in commodities – a major import category for China - and for much of the broader regional intermediate goods trade in East Asia into which, as discussed earlier, China is so closely integrated.

In the case of East Asia regional trade, the ongoing prominence of the US dollar reflects a number of factors, including:

- historical links to the US dollar for a number of the East Asian currencies, including the RMB;
- the currency turmoil in parts of the region during the Asian financial crisis, which encouraged greater use of the US dollar; and
- the fact that the US has always been a major destination for final exports from East Asia, including China (although its relative importance on this front has been declining). This has meant that many exporting companies in China, both foreign and local, are more willing to pay for processed imports in US dollars, since they have a “natural hedge” on the import and export side. This is particularly relevant to Australia given the dominance of standardised commodities, which are typically priced in US dollars globally, in our exports to China. This point is returned to in Chapter 3.

The importance of the US dollar in intra-regional trade in East Asia may make it harder, at least in the short to medium term, for the RMB to become the dominant currency for trade and investment purposes in the region. However, some of the literature on choice of invoicing currency emphasises the importance of both “inertia effects” – once a currency is well established as a dominant invoicing currency, its critical mass may see its dominance continue beyond the economic dominance of the country – and “tipping points”, whereby once a threshold level of invoicing for the currency of a rising economy is reached, its use can spread rapidly.

While a detailed discussion is beyond the scope of this paper, as China liberalises its exchange rate and removes its capital controls a critical factor with respect to regional trade and currency of invoice may well be China’s willingness to become the “lender of last resort” in the region in the event of a liquidity crisis. Box 1 below examines this issue.

Chapter 3 looks more closely at a range of more specific factors that would appear to be discouraging RMB trade invoicing between Australia and China, as well as factors working in the direction of likely increased invoicing going forward.

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58 See Craig, Elias & Noone 2011, p.6 and graph 6.
China has a series of bilateral swap facilities with other countries in the region, worth a total of over US$400 billion (including Australia and New Zealand). It is also a key member of the Chiang Mai Initiative, or Chiang Mai Initiative Multilateralisation (CMIM) as it has become known. This multi-lateral agreement on swap lines and lines of credit, which was first signed in late 2009, incorporates China, Japan, Korea and the ASEAN countries. The swap lines are worth a total of US$240 billion, of which China contributes just under US$77 billion, as does Japan. Decisions to disburse liquidity are made collectively, with China and Japan each having 30% of the votes, Korea 15% and the ASEAN countries the remainder.

The CMIM was to a significant extent the result of dissatisfaction within the region with the conditionality attached to IMF short-term funding during the 1997/98 Asian financial crisis. Yet – surprisingly given its purpose – the CMIM was not activated during the recent global financial crisis. Eichengreen (2012) attributes this to the conditionality in the CMIM, namely that countries could only draw down more than 10% of their swaps (later raised to 20%) after negotiating a program with the IMF. Given its origin, this conditionality is also more than a little surprising. Eichengreen attributes it to the “difficulty that Asian countries have in conducting critical reviews…of one another’s policies and imposing firm policy conditionality.” Eichengreen argues that this factor “renders governments reluctant to lend to one another, since, without assurance that adjustments will be undertaken, they lack confidence that they will be repaid.”

The countries involved (ASEAN+3) have subsequently established a body with a Chinese founding Director that has regional surveillance responsibilities, which could in principle lead over time to the removal of the IMF’s conditionality on CMIM assistance. But, given its very small number of professional staff and the inherent reluctance of member countries to be seen as criticising each other’s policies and policy framework, Eichengreen remains sceptical as to whether it could develop into an Asian Monetary Fund as originally intended, at least in the near term.

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62 For a similar view see also Beeson (2003).
CHAPTER THREE
OPPORTUNITIES AND CHALLENGES FOR AUSTRALIA

1. INTRODUCTION

As noted earlier, as interest rates and the exchange rate are deregulated and China’s rapidly growing capital markets are opened up to the rest of the world, there will be enormous changes in the type, volume, currency denomination and location of financial flows and financial market activity around the world. Some countries and financial centres are likely to be bigger beneficiaries than others in this process. For example:

- existing locations of offshore RMB expertise and turnover are likely to experience the strongest growth in RMB-related financial flows and activity as the internationalisation process continues, in the process attracting talent and resources from other financial centres as RMB-denominated financial transactions take up an increasing share of the total volume of transactions;

- as capital restrictions are eased, market access increased and Chinese growth continues to outstrip global growth, Chinese financial assets will become major components of global equity and fixed income benchmark indices, at the expense of developed economy markets in particular;

- many multi-national corporations will have more of their resources based in China and the Asian region more generally, and will be raising more capital in the region on average and less in the developed economies; and

- as more Chinese companies grow and expand overseas with much greater financial support to do so from China’s burgeoning capital markets, the centre of merger and acquisition activity will shift.

How will Australia be positioned in this environment of rapidly changing financial flows and financial activity? Substantial use has been made of the Australian dollar and Australian dollar denominated assets, in particular equities, as proxies for exposure to the Asian growth story and the China story in particular. As the RMB becomes fully convertible and capital controls are gradually eased, these “proxy” trades will decline.

More broadly, how can Australia best position itself to ensure that it benefits from the enormous changes and opportunities that are in the pipeline as China’s financial development catches up with its extraordinary economic growth and development?

Chapter 3 looks at those aspects of Australia’s policy framework of most relevance to our financial transactions with China, to see if there are any major policy-related obstacles to developing closer financial ties to the benefit of both countries. It then examines emerging opportunities in what are seen as two key areas: transactional banking business and funds management. It concludes with a number of recommendations.
2. WHAT KIND OF FINANCIAL SERVICES SECTOR?

Australia’s financial sector accounts for around 8% of GDP and directly employs around 420,000 people. Indirectly it employs a significantly larger number of people by way of outsourced services such as legal, accounting, technology and administration.

Increasing the size of the financial sector and the volume of financial services business is not an end in itself. Indeed, the recent global financial crisis raised widespread concerns as to whether, in some countries at least, the financial sector had become too large and whether some of its activities and products had become ends in themselves, rather than directly meeting the financing and investment needs of consumers, businesses and governments efficiently and competitively.

At the same time, from a public policy perspective it is important to ensure that the policy framework is not unintentionally or unnecessarily preventing sectors of the economy or individual companies that have the skills and expertise to do so from growing and contributing to Australia’s living standards – including by way of exporting in areas where we have a comparative advantage. Removing any unnecessary policy obstacles is particularly important in the current environment in which the contribution to Australia’s growth from the mining boom is tapering off.

It is widely accepted that Australia has an efficient, competitive, stable, open and well-regulated financial sector. Typically, such financial centres attract offshore business – that is, transactions involving offshore parties that are directed through the centre. By way of example, these financial services exports may take the form of fees earned by an Australian bank providing trade finance, foreign exchange or other transactional business for an offshore client; fees earned by an Australian company advising an offshore company raising debt or equity capital; or fees earned by an Australian-based fund manager managing offshore-sourced funds.

For financial centres that have built up RMB trade-related client relationships and business, the ongoing growth in Chinese trade and in RMB trade invoicing will provide significant and expanding business opportunities: not just in spot FX, FX hedging products and trade financing but also in a broader array of investment products, as global RMB liquidity increases and the currency becomes more widely used as an investment vehicle as well as an invoicing currency.

There are many financial centres in the Asia Pacific region and beyond competing for new business arising out of financial market liberalisation in China. Some of them offer significant financial incentives to encourage new business to gravitate to them. This is not the approach advocated in this report. Rather, the focus is on ensuring that domestic policy settings are not unnecessarily inhibiting companies with the capacity, skill and comparative advantage from expanding into new activities and opportunities, both domestic and cross-border.

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64 For an assessment of Australia’s financial sector and its areas of comparative advantage, see Australian Financial Centre Forum (2009).
3. THE POLICY FRAMEWORK

There are already a number of features of Australia’s policy framework of direct relevance to its development as an offshore RMB hub. The key ones are discussed below, along with any perceived “gaps”.

a) Swap Facility

Australia has the fifth largest swap facility with China – CNY 200 billion – which was put in place in March 2012. The fact that China encouraged the establishment of this agreement is in itself very positive.

The RBA Deputy Governor, Philip Lowe, last year provided some initial public guidance as to the terms surrounding the use of this facility:

“In the event that this swap were to be activated, it is the RBA’s intention to make RMB available to all authorized deposit-taking institutions (ADIs) in Australia through a standing facility, with ADIs being charged SHIBOR plus 25 basis points. ADIs would, of course, need to provide the RBA with Australian dollar collateral, in the same way that they do in our regular market operations.

We see this swap agreement as another important piece of the financial infrastructure supporting trade and investment between China and Australia. Its existence provides market participants with greater confidence regarding the availability of RMB liquidity in Australia, particularly during times of stressed market conditions. In turn, this greater confidence should help build a solid platform for the growth in the RMB market in Australia.”

Financial market activity gravitates to where the liquidity is. However, the global financial crisis also demonstrated just how rapidly liquidity can disappear once confidence evaporates. Liquidity and confidence go hand in hand: both users and providers of financial products and services need both liquidity today and confidence that it will still be there tomorrow.

The CNY swap facility is important in this context. However, the market needs to understand that, as with other swap agreements which the RBA has with other trading partners, this RMB swap facility is for use in times of market stress, not as a mechanism for underwriting or subsidising trade in normal circumstances. Nonetheless, it is an important factor providing greater confidence for companies engaging in RMB-denominated trade and financial transactions between China and Australia.

b) Direct Trading

Direct trading of AUD/CNY in mainland China commenced in April 2013. At present, the People’s Bank of China (PBOC) each morning announces an official rate for USD/CNY, JPY/CNY and AUD/CNY, with reference to quotes it receives from a group of designated market makers.

There has been a considerable amount of misunderstanding and misinformation in some of the press coverage and market commentary on direct trading in AUD/CNY. Licensed FX traders could always quote AUD/CNY prices to corporate customers seeking CNY for trade purposes, and direct trading does not in any way mean that AUD/CNY can, as a consequence, be bought or sold for purposes that previously it could not be bought or sold for.

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65 See Lowe (2013).
66 See Lowe 2013, p. 2.
Direct trading is an important signal of the desire at an official level for closer financial relations between Australia and China. However, the extent of the impact direct trading will have over time on market pricing and liquidity is difficult to gauge. In theory, direct trading could reduce the bid-ask spread for a given currency pair by increasing trading volumes and reducing transaction costs. Monthly data published by the China Foreign Exchange Trade System (table 3.1) show that spot turnover in the AUD/CNY currency pair has risen noticeably, from a monthly average of around US$ 114 million over the ten months leading up to the introduction of direct trading to a monthly average of around US$ 2.7 billion over the subsequent nine months. The pick-up in turnover occurred around the time of the announcement, and monthly turnover has typically fluctuated within the range of US$ 2.5bn – US$ 3.5bn since then. More generally, turnover in the onshore market remains dominated by USD/CNY transactions, which continue to account for more than 90 per cent of all turnover on the China Foreign Exchange Trading System (CFETS) platform.

What impact has this increased turnover had on spreads? The evidence here is at best mixed. Market makers in AUD/CNY providing an indicative rate to the PBOC and then to the market each day still use the USD/CNY rate, or their expectations of it, as the key element for determining their quoted AUD/CNY rates, and are likely to continue doing so unless and until AUD/CNY trading volumes pick up substantially. Nonetheless, direct trading in AUD/CNY has allowed more banks, including two Australian banks, to participate actively in the mainland China interbank market.

Discussions with market makers in mainland China suggest that, while mainland China trading volumes in AUD/CNY have certainly picked up since the introduction of direct trading, this has been primarily in the interbank market, where most trades are quite small and either speculative or designed to offload risk. For most banks, overnight risk limits on open FX positions are very small. While spreads in this market have fallen, the extent to which this is passed on to corporate customers has to date been limited and dependant on their bargaining power. Hopefully, over time, increased interbank trading and lower spreads will result in further price improvement for corporate customers.

**TABLE 3.1: Interbank Spot Foreign Exchange Turnover**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>284</td>
<td>351</td>
</tr>
<tr>
<td>USD/CNY</td>
<td>262</td>
<td>326</td>
</tr>
<tr>
<td>AUD/CNY</td>
<td>0.11</td>
<td>2.67</td>
</tr>
<tr>
<td>JPY/CNY</td>
<td>17.9</td>
<td>16.3</td>
</tr>
<tr>
<td>AUD/USD</td>
<td>0.72</td>
<td>0.87</td>
</tr>
<tr>
<td>USD/JPY</td>
<td>0.19</td>
<td>0.26</td>
</tr>
</tbody>
</table>

Source: CFETS
c) RMB Clearing and Settlement Arrangements

Australia does not have an “official” locally based RMB clearing and settlement bank chosen by the PBOC, along the lines of Bank of China (Hong Kong) or ICBC (Singapore). As a consequence, RMB trade settlement must be by way of the Australian-based bank either dealing through an official offshore clearing and settlement bank – the main one being Bank of China (Hong Kong); dealing directly via a mainland China correspondent bank that is a participant in CNAPS, the online China clearing system; or dealing through a “participating bank” that is part of an offshore RMB clearing system. In the case of the second option, the correspondent bank in mainland China could be the branch of an Australian bank with a presence in mainland China; or the head office of a Chinese bank branch office in Australia.

From a company’s perspective looking to do RMB transactions with an Australian-domiciled bank, which of these options is used does not make any obvious difference: either way, the company is just dealing with its local bank. Nor is the amount of paperwork involved in proving that the FX transaction is related to a genuine underlying trade transaction much affected by which option is chosen. While some earlier work by the RBA on trade invoicing\(^{67}\) suggested that the administrative burden associated with this was somewhat onerous and to some degree discouraged RMB invoicing, more recent changes in procedures which put the onus on the commercial bank dealing with a corporate client to ensure that the transaction is genuinely trade-related have, according to market feedback, significantly reduced the amount of paperwork.

Despite the above observations, a number of offshore RMB centres have successfully applied for establishment of a local RMB clearing and settlement bank. Bank of China (Taipei) commenced operations as an RMB clearing and settlement bank in February 2013, as did ICBC (Singapore) in April 2013, joining Bank of China (Macau). However, the vast bulk of offshore clearing and settlement still occurs through Bank of China (Hong Kong).

More recently, in December 2013 the Agricultural Bank of China and Standard Chartered announced that they would be working together to provide RMB clearing services in London. This arrangement provides a number of options for clearing and settlement, including directly with mainland China by way of either Standard Chartered’s or Agricultural Bank of China’s mainland banking operations. However, this is an “unofficial” offshore RMB clearing service, in the sense that – unlike Bank of China (Hong Kong), Bank of China (Taipei) or ICBC (Singapore) – it was market led rather than the particular banks being chosen by the PBOC.

Similar clearing services have very recently been put in place in Australia. During February 2014, China Construction Bank launched a new RMB clearing service in Sydney that will facilitate clearing through its head office in mainland China; and Bank of China announced a new clearing arrangement in conjunction with the Australian Securities Exchange’s Austraclear system.

This expansion in the coverage of Austraclear to include settlement of some RMB transactions has enormous potential. Around 800 Australian financial institutions and their customers currently have access to Austraclear. As this paper has emphasised, as China opens up its rapidly growing capital markets and moves toward a freely floating currency, the use of the RMB for both capital account as well as trade account transactions will grow substantially – including for investment purposes and in transactions between offshore counterparties. The expansion of Austraclear facilities to include RMB settlement has the capacity over time to facilitate such

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\(^{67}\) See Ballantyne, Garner & Wright 2013, pp. 65-74.
transactions in Australia, including for RMB denominated bonds and a range of derivative instruments. From both a customer and a bank perspective, it thus provides scope down the track to access/offer an array of RMB denominated products and services, all settled through the same platform.

Any Australian-domiciled bank with a banking presence in mainland China that has an onshore RMB settlement licence and is a participant in the mainland China clearing system (CNAPS), or has a correspondent bank in mainland China that it deals through, can already provide clearing through mainland China rather than through an offshore “official” settlement bank. This is already the case for a number of Australian banks as well as Chinese banks in Australia. The main difference between the “official” and “unofficial” clearing arrangements is that the official clearing banks – at least in the case of Bank of China (Hong Kong) – are directly linked in to CNAPS, whereas the “unofficial” clearing banks are linked in via their correspondent bank or own bank office in mainland China.

Decisions as to whether, and if so where, to set up further “official” offshore RMB clearance and settlement banks going forward are, of course, entirely ones for the Chinese authorities to make. From Australia’s perspective, is this something we should be seeking?

This paper has stressed the potential speed at which capital controls in China may be relaxed and the exchange rate and interest rates may become market determined. In such a world – and depending on exactly what type of cross-border settlement arrangements China puts in place - there may well be no need for offshore official RMB clearing and settlement banks, as RMB is likely to be freely available for trade, investment and other purposes from a wide array of banks and locations. In the interim, China is in the process of developing a new payments settlement system – the China International Payments System or CIPS – which should enable much easier and direct clearance between offshore banks and mainland China participants. Earlier announcements suggest the system is designed to use international reporting standards and be linked to SWIFT. This system, once in place, could make official offshore settlement banks largely redundant. However, the timing of the introduction of CIPS - the development of which was first announced by the PBOC in April 2012 – is unclear, and would appear to have been pushed back from earlier intentions of having it in place before mid-2014.

From an Australian perspective, having an “official” RMB clearing and settlement bank in Australia could provide an added element of market confidence regarding liquidity. However, the current depth of RMB business does not make a compelling case for pursuing this possibility at present. Furthermore, given the likely introduction of CIPS and the move over time to dismantle capital controls, the future role and importance of official offshore clearing and settlement banks is uncertain.

These circumstances may, however, change. The speed with which capital controls will be removed and the CIPS settlement system put in place is not clear: both may take longer than anticipated. In such circumstances – and if as seems likely the volume of trade invoicing by Australian companies continues to grow strongly in the interim, along with the range and depth of RMB-related trade and investment products and services – then a point may be reached where having an official, locally domiciled clearing and settlement bank would be beneficial in terms of market confidence and liquidity. This is an issue which, at an appropriate time, Australia might wish to raise with China. Their encouragement of the establishment of a swap facility and their agreement to the recent introduction of AUD/CNY direct trading suggest that, if at some point a case can be made for having such a locally domiciled official settlement bank, China may be prepared to consider it favourably.
d) Tax Treatment of Cross-Border Financial Flows

One of the unusual characteristics of the Australian financial sector, given its efficiency and competitiveness, is the very low degree to which it exports its skills by way of cross-border financial transactions. This is well illustrated in Chart 3.1 below, which shows financial services exports as a percentage of financial services value added across a number of countries. It is a somewhat surprising feature given that the Australian financial sector is highly regarded internationally as being efficient, competitive, innovative and well regulated – features which would normally be reflected in a high volume of cross-border transactions.

The 2009 Financial Centre Task Force Report on “Australia as a Financial Centre” attributed this inward-looking focus of Australia’s financial sector to a number of factors, but argued – based on widespread market discussions and consultations – that the single most important factor was the tax treatment of cross-border financial flows. More specifically, the report argued that the very considerable uncertainties faced by offshore counterparties as to whether or how cross-border transactions with Australia will be taxed in Australia was acting as a major constraint on financial services exports.

**CHART 3.1: Internationalisation of Financial Services Sectors**

![Chart 3.1: Internationalisation of Financial Services Sectors](image)

*Source: Australian Financial Centre Forum, 2009 p. 22*

This feature of our tax system, if not corrected, will continue to be a major constraint to the efficient development and growth of cross-border financial transactions between Australian and the rest of the world. Section 4 (b) below examines this issue further in relation to potential portfolio flows from China to Australia.

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68 Financial Centre Task Force (November 2009).
69 While the data in this chart are now some five years old, methodological changes in a number of countries have made it very difficult to update. The underlying picture is unlikely to have changed significantly.
4. SOME SPECIFIC MARKET OPPORTUNITIES

a) RMB Banking Products and Services

Given the very substantial trade links between Australia and China, there is a potential need by companies for a wide range of RMB products and capabilities – such as operating accounts, term deposits, payments and collection facilities, RMB-denominated investment options, trade finance (including letters of credit and guarantees), foreign exchange, derivative products for hedging, debt capital markets and online banking – to be provided by their banks.

The extent to which this potential demand for RMB products and services translates into actual demand is a function of a range of factors, including the extent to which trade is invoiced and settled in RMB, liquidity and pricing of products. The most recent official survey on China/Australia trade by currency of invoice was conducted by the Australian Bureau of Statistics (2012). The survey did not separate out invoicing for the smaller invoicing currencies, including RMB. However, the data implied that, in June quarter 2012, RMB invoicing with respect to Australian exports was less than 0.3%; and for imports was less than 2%. Discussions with Australian domiciled banks providing RMB settlement facilities suggest that these numbers have grown at a decent rate since this survey was conducted, but the overall level of invoicing still remains very small.

One obvious reason for this very low level of RMB invoicing on the exports side is the dominance of resources – which are typically priced and settled in $US – in our exports to China. While there are strong views on both sides of the debate as to whether in the future traded commodities such as iron ore and coal might be priced and settled in RMB, the view reached from the authors’ discussions on this issue was that this is likely to happen given China’s dominance on the demand side, the range of measures it is taking to encourage it and the potential price advantage for the commodity exporter, but the timeline is unclear. Box 2 below discusses this issue in more detail.
BOX 2: COMMODITY TRADE INVOICING AND THE RMB

One key reason why such a low volume of Australia’s trade with China is invoiced in RMB is the dominance of commodities priced globally in USD in our exports to China. Is this likely to change over time?

Despite the global financial crisis, the U.S. remains the major global “lender of last resort” in the event of a liquidity crisis, and so long as this is the case it will be an important factor underpinning the pricing of most commodities in $US. However, some studies on choice of currency for commodity invoicing also emphasise the importance of threshold effects or “tipping points”. By way of example, a recent study\(^7\) on oil invoicing uses a network effects model to examine the conditions under which either a complete switch in invoicing currency or parallel invoicing in more than one currency might occur, and conclude that two main conditions would need to be met: oil exporters would need to expect that a certain minimum number of other oil exporters will also begin to use the new invoicing currency; and the information costs associated with quoting prices in two currencies are low.

China is already the most important single player in a wide range of commodity markets. China is also keen to become a central hub for pricing and trading of commodities in Asia, thereby increasing the amount of commodity contracts priced and denominated in RMB. There are already a number of exchanges in China quoting RMB prices on commodities futures contracts, although in most cases – and certainly with respect to iron ore and coal – liquidity is limited and trade is mainly between Chinese based producers and users.

China has had some limited success in pushing for some of its commodity trading partners to invoice in RMB - including Iran, Nigeria and some of the ex-Soviet states. In addition, some Brazilian mining companies appear to be looking actively at the possibility of RMB invoicing and settlement. There has also been some success with Australia, Thailand and Indonesia with respect to some soft commodities. In Australia, RMB invoicing is already occurring in parts of the wool industry.

Some Australian mining companies are actively examining the range and liquidity of RMB banking products as preparation it would seem for the possibility of being asked to invoice and settle in RMB in the not too distant future. In addition, some of them are importing mining-related equipment such as rolling stock from China and are paying for it in RMB, providing them with a further incentive to trial or at least consider invoicing and settling their commodity exports in RMB to create a natural hedge.

If one large commodity exporter “broke ranks”, invoiced in RMB and received a significant price advantage in the process that outweighed their currency hedging costs, this could potentially have a snowballing effect. However, discussions with senior executives at a number of large commodity exporting companies suggest that, at least at this stage, they are not seeing any pressure from Chinese importers to invoice in RMB.

In summary, given the above factors and the potential for both parties to gain, it is easy to envisage a significant increase in RMB commodity invoicing and settlement over the course of the next decade.

\(^7\) Mileva & Siegfried (2012).
Looking beyond the commodities sector, there are also some factors inhibiting RMB invoicing. They are examined below.

**Invoicing survey**

To get a better understanding of both incentives for and impediments to RMB trade settlement, CIFR commissioned a survey\(^71\) in late 2013 of both Chinese and Australian companies that are engaged in China/ Australia trade. The Australian survey was implemented by domestic and foreign banks on behalf of CIFR and the Chinese survey by Redfern Associates (a mainland China advisory firm) and Austrade.\(^72\) There were 93 responses from Australia and 103 from China.\(^73\)

The key results are presented in Table 3.2.

The survey suggested that awareness of the opportunities for RMB invoicing is significantly lower for Chinese firms than for Australian firms. Awareness amongst Chinese companies is greater for larger companies than smaller ones and for State Owned Enterprises than private companies. Many Chinese companies – especially small and medium sized ones (SME’s) – are still not aware that they can invoice and settle in RMB. In the Australian sample, awareness levels were noticeably higher overall and were only slightly lower for smaller firms than larger ones.

These results on levels of awareness by Australian as against Chinese companies are likely to suffer from sample selection bias, given that the Australian interviews were conducted by Australian domiciled banks with their clients. Having said that, an informal survey of its SME customers conducted by a bank in mainland China last year, which they kindly discussed with the authors in confidence and agreed to our referring to in broad terms, also showed very high levels of unawareness of RMB invoicing possibilities.

These results are surprising given the importance which the Chinese authorities have attached to RMB invoicing as part of its broader objective of RMB internationalisation.

Of the firms that undertake RMB settlement, a significant proportion has faced “difficulties”. The main issue faced by the Australian sample was uncertainty regarding the settlement process, with several respondents noting that payment delays and processing issues were experienced early in the piece; however, processing had become more efficient recently. This is consistent with the documentation requirements on companies being substantially reduced in July 2013.\(^74\) The Chinese respondents indicated that concerns over losing potential gains from currency movements were the main “difficulty” in RMB settlement. Respondents who indicated this concern were predominantly importers, probably reflecting an expectation of continued RMB appreciation.

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\(^71\) The survey design was modelled on the Reserve Bank of Australia (RBA) survey completed for the April 2013 RMB dialogue and reported in Ballantyne, Garner & Wright (2013) (hereafter referred to as the RBA survey). The CIFR survey design was augmented with the assistance of the RBA, Treasury and market participants through the RMB Working Group.

\(^72\) The Austrade work was led by their Shanghai office, with support from regional offices.

\(^73\) The Australian respondents included 30% exporters, 55% importers and 15% both. This is a similar breakdown to the Chinese respondents with 25% exporters, 61% importers and 15% both. The surveys captured a wide range of industries: the Australian survey included 21% industrial goods and services, 19% mining and 11% retail; the Chinese survey included 30% food and beverage, 14% mining and 11% industrial goods and services. In both surveys firms were of varying size.

\(^74\) In July 2013 the PBOC released the “Circular Concerning the Simplification of Cross-Border RMB Procedures and Improvement of Relevant Policies”. The revised procedures were aimed at improving the efficiency of settlement and reducing the documentation required.
Respondents were also asked about the benefits of RMB settlement. The Australian respondents indicated benefits that are predominately price and access related. The most significant benefit for the Australian respondents was more favourable pricing, with many also noting the ability to accommodate Chinese companies and improve customer relations. For the Chinese companies, by far the most frequently cited

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75 All respondents were asked about their perceptions of benefits and impediments whether they had settled in RMB or not.
benefit related to removing exchange rate risk. These results are consistent with the earlier observation to the
effect that, because of the higher costs of hedging in China, the transfer of currency risk from China to Australia
can be profitable for both parties.

Chinese respondents also indicated that an advantage from RMB settlement was the appreciation/depreciation
of the RMB. Interpretation of this is unclear. For a Chinese exporter, it likely reflects an expectation that the RMB
will appreciate and that if there is a delay between invoicing and payment the exporter will benefit from this if
paid in RMB. However, companies that referred to this perceived benefit from RMB invoicing were split fairly
evenly between exporters and importers, presumably reflecting opposite expectations with respect to exchange
rate movements.

Both the Chinese and Australian respondents identified several key impediments to greater use of RMB trade
settlement. The Australian respondents indicated that the main disadvantage of RMB settlement was the costs
associated with deviating from the established market practice of denominating contracts in US dollars. This is
particularly relevant for the mining sector in Australia, for whom in most cases both receipts and a substantial
proportion of costs are in $US. The Chinese respondents cited concerns about RMB appreciation/depreciation
as the most significant impediment. Chinese respondents, and to a lesser extent Australian respondents, were
also concerned about the willingness of their trade partners to settle in RMB.

Further discussions with market participants suggest a number of additional reasons why some Chinese firms
may be reluctant to settle in RMB, such as:

• Some Chinese banks being reluctant to forgo their high margin FX business, with some reports that
  mainland China customers are incurring a surcharge or administrative delays if they invoice in RMB;
• VAT rebates on exports being more difficult to substantiate if the exports are invoiced and settled
  in RMB76; and
• Chinese exporters in some cases preferring to be paid in a foreign currency such as $US, in part because
  it is easier to transfer foreign currency receipts offshore.

While it is clear from both surveys that RMB settlement is expected to increase over coming years, there
still remain a number of obstacles. The most important obstacles identified in the survey and follow-up
discussions were:

• the lack of awareness of RMB invoicing, in particular it would seem amongst smaller Chinese companies;
• the feedback concerning VAT rebates and some Chinese banks discouraging RMB invoicing; and
• companies in both countries waiting for their trading counterparts to either initiate or agree to RMB invoicing.

On the first of these points, it would seem that, to the extent that greater RMB invoicing is a policy objective in
China, there is a case for publicising both the ability of companies to do so and the potential benefits from this.
This is also true in Australia, albeit possibly not to the same extent. It is one of the issues being examined by
the RMB Working Group, which incorporates representatives from Australian and Hong Kong banking sectors.

76 This issue was also referred to by 31% of Chinese firms in the survey. Taida Co., a large textile company based in Jiangsu province, had their tax
rebates rejected from exports denominated in RMB from May to December 2013. The 10 million RMB rebate was subsequently granted on appeal.
See Qian (2014).
The Working Group was set up following the Australia-Hong Kong RMB Trade and Investment Dialogue held in Sydney in April 2013. Similarly, on the second dot point, some of the factors discouraging Chinese companies from invoicing in RMB may be worth looking at from a policy perspective.

On the third dot point above, the concept of currency choice “inertia” was referred to earlier, as was the concept of “tipping points”. It may be that, given the rapid growth already in RMB invoicing, this “tipping point” will be reached in coming years. However, greater understanding on the part of companies of the potential benefits from RMB invoicing could again help.

A factor which may encourage more Chinese companies to request invoicing and settlement in RMB relates to exchange rate policy. As China moves further in the direction of capital control liberalisation, it is also likely to widen its exchange rate band further – as it did in 2012 – and allow greater exchange rate volatility, to absorb some of the impact of increased capital flows. This may encourage more Chinese companies to negotiate to pass on the increased exchange rate risk to their offshore counterparties.

**Liquidity and Provision of RMB Trade-Related Products**

Reference was made in Chapter 1 to the fact that, so long as controls continue to severely limit cross-border flows on the capital account, the main source for building up offshore RMB liquidity – at least outside of Hong Kong – is through trade invoicing. More specifically, offshore liquidity can be built up by way of companies that are exporting to China being paid in CNY, and then that CNY (or CNH as it becomes77) remaining in the exporting country.

At present, the potential supply of CNY in Australia via trade settlement is very limited, due to the extremely low proportion of our trade with China that is invoiced in RMB.

On the demand side, there are at present some natural holders of RMB denominated assets in Australia, but they are limited. At the retail level, while there is a large Chinese population in Australia, including a significant student population, the distance and expense of travelling to and from mainland China mean that they are unlikely to be significant holders of RMB deposits in Australia. On the funds management level, there are only three Australian companies that hold QFII quotas.

However, on the corporate side, while the number of companies with both assets and liabilities in RMB is limited it is growing. These could be companies that both export to and import from China; or exporting companies that have a physical presence in China, for example for manufacturing or distribution purposes. Industries where anecdotal evidence suggests this is the case for at least some companies include chemical manufacturing, engineering construction and design services.

As more companies invoice in RMB, this may well encourage greater physical presence in China, if this suits a company’s business model. If that proves to be the case then the number and range of companies that have both sides of their balance sheet in RMB – and hence are “natural holders” of RMB – may well grow.

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77 If the CNY is held offshore, it becomes offshore RMB or CNH as it is generally referred to.
Reflecting these factors, RMB liquidity in Australia as measured for example by total (including interbank) holdings of RMB deposits is still very low. Australia does not publish data on foreign currency deposits broken down by currency, but total foreign currency deposits are only 2-3% of total deposits, and within this RMB deposits are almost certainly a small proportion.\(^78\)

However, Australia does not need a large pool of local RMB liquidity in order to build up more RMB transactional business over time: interbank transactions mean that liquidity can be readily drawn on from other offshore RMB centres as necessary, such as Hong Kong or Singapore (see box 3). This is currently the case not just for AUD/CNY transactions but for other currency pairs as well. For an Australian domiciled bank doing transactional RMB business with an Australian resident client, it does not matter whether the actual execution of that trade occurs in Sydney or via its offices in say Singapore or Hong Kong, where there is more liquidity that makes it easier for the offshore branch to (for example) offset any unwanted FX exposure on the interbank market. All it means is that the Australian head office is a price-taker rather than a price-maker. Nor does it make any difference to the client where the trade is actually executed: the client obtains the same potential benefit from the trade, and the bank gets the fees for the transactional business, whether those fees are booked to its Australian operations or to its offices in Singapore or Hong Kong.

In short, lack of local liquidity is not in itself a constraint to either development of local RMB trade-related products or sale of such products to local customers. This has been the experience of a number of offshore RMB centres including London (see Box 3).

Consistent with these observations, a survey being conducted by the RMB Working Group referred to earlier indicates that the banking sector in Australia already provides a wide range of RMB related products and services to business clients, in particular RMB current account services, deposits and online banking; trade finance loans; commercial loans; and foreign exchange including derivative products. However, few banks provide this full range of services. As RMB trade settlement grows over time and capital account controls in China are liberalised, the breadth and availability of bank products, services and settlement infrastructure are likely to grow significantly, along with transactional volumes.

\(^{78}\) See RBA Statistical Bulletin (2013).
A rough proxy for offshore RMB liquidity is RMB bank deposits, including interbank deposits. Chart 3.2 shows RMB deposits in a range of markets including Hong Kong, Singapore, Taiwan and London.

The generally low level of offshore RMB deposits outside of Hong Kong is a reflection of both the still low level of RMB trade invoicing beyond Hong Kong and the lack of demand for RMB denominated deposits outside of Hong Kong and to some extent Singapore. While the scope for building up offshore liquidity comes via exporters to mainland China invoicing in CNY and receiving CNY as settlement, that is only the supply side of the equation: for such invoicing to lead to actual greater offshore RMB liquidity in the country where the exporter is located, there must also be a counterparty that wants to hold the RMB, such as a company that has both assets and liabilities denominated in RMB on its balance sheet or a bank wanting to maintain CNH balances for transactional purposes with its clients. Otherwise, the exporter will simply ask their bank to convert the CNY into whatever currency it is they wish to hold, typically their home currency, and the CNY will ultimately return to mainland China through the settlement system, unless the bank maintains it as an interbank deposit.

As is clear from Chart 3.2, by far the largest source of offshore RMB liquidity measured in terms of CNH deposits is Hong Kong (which accounts for over 70% of China’s trade that is invoiced in CNY) followed by Singapore. RMB deposits are around 10% of total bank deposits in Hong Kong; around 5% in Singapore, 1% in Taiwan but only 0.4% in London.
The high level of deposits in Hong Kong reflects special factors operating on both the demand and supply side in that jurisdiction:

- on the supply side, the regulations regarding access to CNY are more relaxed in Hong Kong than in any other offshore centre; and
- on the demand side, there is a substantial Chinese population living in Hong Kong; considerable daily population movement across the border with mainland China; and a very large number of mainland Chinese companies with a significant presence in Hong Kong. These are “natural” sources of demand for RMB denominated assets. Indeed, it may well be that, over time, the HK$ is gradually replaced by the RMB as the main currency of choice in Hong Kong.

In the case of Singapore, while there are also significant numbers of Chinese nationals, the main holders of RMB assets are the official sector via their FX reserve assets and the large number of multinational companies with businesses in China that run their global and regional Treasury operations out of Singapore, reflecting amongst other things government incentives designed to encourage such operations to be based there.

London is an interesting case. While it is a major offshore centre for RMB foreign exchange transactions, RMB deposits – both retail, corporate and interbank, which is the largest category – represent a negligible percentage of total interbank deposits. Again, this is a reflection of the fact that, compared to Hong Kong or Singapore, there are few “natural” holders of RMB denominated assets in London.

The 2012 survey of RMB business volumes in London makes the following comments in relation to the low holdings of deposits:

“It is quite clear, when looking at the survey as a whole, that there is no correlation between the level of RMB deposits in London and the volume of RMB services which the London banks are doing. There has been high growth in London in most other business areas irrespective of the level of London deposits. We conclude that the key indicators of the development of offshore RMB market activity are not the level of deposits but the volume of transactional flows such as trade financing, forex trading, bond trading and bond issuance. Transactional volumes rather than physical location of deposits are the measure of market development.”

In short, the London example shows clearly that low levels of RMB liquidity – at least as measured by RMB interbank deposits – and low demand for holding RMB denominated investment products is in no way a constraint on development of RMB transactional business. This is in part simply a reflection of the fact that transactions booked to one financial centre often draw on liquidity in other centres. The City of London survey referred to earlier included information on the extent of deliverable foreign exchange business that London based banks did via other offshore centres – excluding business transacted in their mainland China branches but including trading in Hong Kong, Singapore and other offshore branches. While the results were quite diverse across the banks surveyed, on average the share of spot FX trading transacted offshore was over 40%; for FX forwards 63%; FX swaps 66% and FX options 51%.

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79 Source: Hooley 2013, table 2.
80 Bourse Consult and City of London 2013, p. 28.
81 Bourse Consult and City of London 2013, p. 23.
b) Funds Management

Australia’s funds management business has a strong reputation in the region; our platforms are amongst the most sophisticated in the world; and we have particular expertise in a number of asset classes – notably real estate and infrastructure – into which Chinese institutions such as CIC and NCSSF have been diversifying and providing some external mandates.

A number of Australian funds management companies are already actively involved in China, by way of joint ventures providing products to mainland Chinese investors; investing in mainland China assets via QFII licences; and/or managing mandates on behalf of Chinese institutions. In discussions with a number of longstanding Asian-based funds management executives, the observation has been made that the pace of deregulation in China has accelerated dramatically over the past eighteen months to two years, and that if this pace continues the scope for them to further grow their business links with China will increase rapidly.

However, discussions held with a large number of Australian funds management executives and trustees across most of the capital cities highlighted the fact that, while there was widespread recognition of the importance of China to growth prospects in the region and the world and hence indirectly to portfolio construction, many of them were largely unaware of the pace or significance of recent and prospective financial markets policy changes in China and their implications for investing directly there or for managing mandates sourced in China.

For those companies that have the capacity to invest in China’s financial markets and/or sell financial services products in mainland China, the emerging opportunities are enormous. So too, however, are the difficulties, including market access, distribution and brand recognition. Some of these constraints are market-related and largely beyond the reach of public policy decisions. There are, however, a number of areas where policy changes could make a significant difference. These are examined in the following sections.

Two-way Flows and Regulatory Hurdles

Mention was made earlier of the attraction of Australia to China as a destination for both direct and – increasingly going forward – portfolio investment, in such strategic industries as energy and agriculture but also more broadly as Chinese individuals and institutions seek to diversify their portfolios.

On the other side of the coin, as a result in particular of our compulsory superannuation system, Australia has a very large pool of funds under management – of the order of A$ 2.1 trillion currently and, on Treasury estimates, likely to be over A$ 6 trillion in 25 years’ time. Increasingly, reflecting both the need for diversification and the attractive investment opportunities in the region, Australian funds will be looking to invest in China and other countries in the region. They will become a source of local demand for both RMB and for various RMB products and services, such as hedging instruments. A number of Australian funds management companies are already well down this track in terms of putting in place the platforms, capabilities and know-how.

These two-way portfolio investment flows are likely over time to become an important part of the broadening and deepening of financial links between China, Hong Kong and Australia. However, one of the many constraints that currently exist in this area and inhibit such flows is the very different regulatory environment applying to the

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83 See Parkinson (2012).
funds management industry in different countries in the region. This can make it difficult, time-consuming and expensive for funds management companies to obtain regulatory permission to market their products in another country in the region.

Over the past few years, a number of countries in the region, led by Australia, have been actively involved in negotiations on the establishment of an “Asia Region Funds Passport”. The idea is to develop a common regulatory framework which would enable a mutual fund that is registered in one passport member country to be offered in any other passport country, under a streamlined process. These regional negotiations are being conducted under the auspices of APEC, with the explicit endorsement of APEC Finance Ministers and with very strong support from the Australian Government.

Negotiation of such an agreement is extremely challenging and will take a long time to put fully in place. It may also have to compete with a similar initiative underway under the auspices of ASEAN – of which Australia is not a member – and also the negotiations currently underway between China and Hong Kong for establishing a mutual recognition agreement for sale of funds management products between the two jurisdictions. Nonetheless, the Passport initiative has the potential – in combination with the likely continual easing of Chinese capital controls on both inward and outward portfolio investment – to make it substantially easier for funds domiciled in Hong Kong or mainland China to be sold in Australia, and vice-versa. There are many other obstacles to strong growth in these two-way portfolio flows, but successful negotiation of the Asia Region Funds Passport would go a long way to overcoming at least one such obstacle. The initiative deserves strong support from industry.

Portfolio Outflows from Australia and Market Access

Chapter 2 included an analysis of the potential growth in the size of China’s capital markets and – assuming other requisite policies are put in place, including improved corporate governance – the likely substantial increase in China’s weight in global equity and fixed income benchmark indices. Associated with this will be a sharp increase in China’s weight in the portfolios of both active and passive funds – including Australian domiciled funds – at the expense, at least in relative terms, of other economies.

Some funds management companies will choose to invest offshore by allocating mandates to overseas investment managers. Others will choose to manage the Chinese exposure themselves, from Australia or through their overseas offices.

Once capital controls are removed, Australian fund managers will have open access to China’s burgeoning capital markets. This, however, will take time. In the interim, limited access to mainland China’s markets is available by way of the QFII and RQFII quotas.

At present, and as mentioned earlier, there are only a handful of Australian domiciled funds investing directly in mainland Chinese equities via QFII quota allocations. Discussions we have had with the Australian funds management sector – both fund managers and trustees – suggest this would appear to reflect a number of factors:
• a view by many fund managers that, due to China’s dominance of Australian trade – in particular our Australian commodity exports – investing in Chinese equities entails an element of “doubling up” on investments in Australian equities, in particular in the commodities sector. While there is some truth in this, over time as access to mainland China A-shares increases and more Chinese companies raise equity capital, investors will be better able to express more precise views on different sectors of the Chinese economy and different companies within each sector, rather than expressing broad views by way of “proxy” trades;

• a view by some fund managers – both in Australia and overseas – that, due to the much higher standards of corporate governance and rule of law in Hong Kong at present compared to mainland China, the best way to invest in Chinese equities is via Hong Kong listed H-shares rather than mainland China A-shares. While this view is not surprising, it does emphasise the earlier point about the importance to successful RMB internationalisation of improved corporate governance and rule of law in China – a point the Chinese authorities appear to be very well aware of; and

• in many cases, a lack of understanding of the pace of development in China’s capital markets and the capacity for offshore fund managers to invest in mainland China – a point referred to earlier.

It is of course a commercial decision as to whether to invest in mainland China or via Hong Kong listed shares, and whether to invest in-house or contract out non-$A investments to offshore managers. In many case there are sound reasons for not managing such investments in-house. However, as the Chinese economy and China’s trade links continue to grow and Chinese capital markets expand and open up to foreign investors, China will become not only a major component of global indices but also of increasing importance to the growth and development of other economies, both developing and developed. More Australian funds will be closely following developments in China’s economy and financial markets and will be thinking about opportunities and structures for investing in China. Ensuring Australian fund managers that are looking to invest in China have adequate scope to do so – including during the interim period in which access remains controlled by QFII and RQFII quotas – is thus an important element in broadening and deepening financial ties between the two countries.

The QFII system is designed to encourage longer term (typically around two year plus) investments, with restrictions on the type of assets that can be bought and on the capacity to buy and sell those assets in the short term. By contrast, RQFII rules allow more active trading and are thus much more attractive for many fund managers and investors for whom flexibility in portfolio holdings and liquidity are key aspects of their portfolio management. In addition, RQFII licences are designed for recirculation of offshore RMB funds or CNH, as against QFII licences where the fund manager can use the licence to buy CNY to invest.

While currently dominated by Hong Kong, RQFII quotas have recently been extended to London (RMB 80 billion), Singapore (RMB 50 billion) and Taiwan (RMB 100 billion).

As emphasised earlier, there are no significant holdings of CNH in Australia for investing in mainland China via RQFII funds. Neither is there a widespread “natural demand” – at this stage at least – for investing in RMB denominated funds.

The same is true for London. The 2012 City of London survey on RMB activity referred to earlier make the following observations:
London is a major centre for investment flows and investment management. However, RMB investment activity in London is currently low. In part this is because the regulations at present favour investment services offered from Hong Kong. At some stage in the progress of RMB liberalisation we would expect funds making RMB investment in China to be allowed outside Hong Kong. A way of piloting that situation would be for the Chinese authorities to grant an RQFII quota specifically for London institutions. Overall investment flows could benefit from such a step as the Chinese economy becomes more mature and is able to absorb an additional inflow of foreign investment.84

As noted earlier, London has in fact recently been granted an RMB 80 billion RQFII quota. It will be interesting to observe going forward whether this quota is easily taken up: that is, whether providing an increased opportunity for eligible London-based companies to invest CNH back into mainland China actually increases demand for such investments. Market contacts have told us that the size of the London RQFII quota was based on a survey of fund managers and what they saw as the potential appetite for funds invested in mainland China’s asset markets. However, our understanding at the time of writing is that a number of fund managers in London applying for RQFII quotas will be looking to offer these funds in GBP or in EUR.

To date, it is not clear whether this will be allowed under the RQFII system. If it is allowed, then there will be little difference between RQFII and QFII quota systems. A London based company running a GBP denominated RQFII fund would exchange GBP for CNH through its bank and then invest the CNH in mainland China. This is very similar to the process that would take place if the same unit trust ran a QFII fund, except that in the latter case the company can buy CNY. The RQFII quota system is under such circumstances not really recycling offshore RMB liquidity – or at least not CNH held by the investor – any more than the QFII system is.

However, important differences would remain between a QFII quota and an RQFII quota from the perspective of the fund and its investors – namely, the much less onerous and hence more attractive conditions regarding RQFII as against QFII investments referred to earlier.

It may be that the Chinese authorities will allow this to happen and over time transition quota allocations much more towards RQFII and away from QFII, so long as they are comfortable that this will not lead to highly volatile portfolio investment flows. However, in the shorter term at least the success of RQFII quotas outside of regions like Hong Kong where there is a large natural demand for RMB denominated investments may remain limited if the funds have to be denominated in RMB.

It will be important for Australia to watch these developments in London closely. If the Chinese authorities allow flexibility in terms of the currency of denomination of funds obtaining RQFII licences, Australia should at an appropriate time follow London’s lead and seek to obtain an RQFII quota.

**Portfolio Inflows to Australia and Tax Uncertainty**

As capital controls in China relating to offshore investment are lifted, what are the opportunities for Australian domiciled fund managers to pick up mandates in China?

At present, only 5% of the funds managed by Australian resident fund managers are mandates sourced offshore.85 In part this is simply a reflection of the very large proportion of total funds under management in

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84 Bourse Consult and City of London 2013, p. 29.
85 Source: Australian Bureau of Statistics (2013a)
Australia that are superannuation funds. In addition however – and as stressed in the Financial Centre Forum Report referred to earlier – it is a reflection of the lack of certainty on the part of potential offshore investors and their advisers regarding how such overseas investments might be taxed in Australia.

Australia has a clear comparative advantage in funds management and is a world leader in a number of asset classes, notably real estate and infrastructure. The opening up of China’s capital account provides a unique opportunity for this comparative advantage to feed through into exports of our financial services skills, experience and technology, in the form of fees earned on management of offshore sourced mandates. But as emphasised earlier, unless the right tax structures are put in place – as has been done in other countries with which we are competing – this opportunity will be lost.

The Financial Centre Forum Report made a number of recommendations designed to remove this policy obstacle and to encourage greater exports of financial services in areas where Australia has a comparative advantage. The main recommendations were the introduction of:

- an Investment Manager Regime designed to provide much greater clarity and certainty regarding the tax treatment of cross-border financial transactions; and

- a broader range of tax flow-through collective investment vehicles, given the lack of familiarity of many overseas jurisdictions – including China – with Australia’s unit trust structure.

Both of these recommendations were accepted in principle in 2010 by the then Federal Government and were subsequently sent to the Board of Taxation for review. The Board agreed with the IMR recommendation, but its final report covering some aspects of the IMR as well as alternative “flow-through” vehicles – which was presented to government in December 2011 – has still not been released.

To date, IMR legislation has been only partly implemented, with some further draft legislation pending. There are, however, some significant problems with the current legislation, which are likely to substantially reduce its effectiveness if not addressed.

The second recommendation – introducing a range of tax flow-through collective investment schemes – reflects the fact that some of the tax uncertainty also flows from the observation noted earlier that many potential offshore investors in Australian funds, particularly in the Asia-Pacific region including China, do not come from common law jurisdictions and are not familiar or comfortable with trust structures. For historical reasons, Australia’s tax law largely limits the range of tax effective commercial vehicles that can be used to manage funds to that of a unit trust, because for the most part only unit trusts are taxed on a flow-through basis and meet investor protection needs. While trust structures are used in some instances in China, in particular for professional investors, Australia needs to develop a wider range of investment vehicles that are taxed on a flow-through basis and appeal to a broader range of Chinese and other Asian investors, such as corporate structures.

This recommendation by the Financial Centre Forum has not been implemented at all.

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See Australian Financial Centre Forum 2009, pp 53-64.

A tax flow-through vehicle is one where earnings are only taxed in the hands of the underlying investors and not in the vehicle itself.

Board of Taxation (2011).

On the current state of the legislation and still outstanding problems, see for example: Deloitte International Tax (2014); or PWCTax Insights (2014).
Sensible policy changes which do not involve providing concessions or special treatment to the financial services industry can have an important impact. In 2010, the then Government made a range of changes to Australia’s managed investment trust (MIT) structure designed to make them more workable and accessible by both domestic and offshore investors. A recent study commissioned by the Financial Services Council\(^90\) on flows from offshore investors into Australian domiciled MITs found that, since the introduction of the MIT changes in 2010, funds flowing into them from offshore have increased from A$ 20.3 billion in early January 2010 to A$ 36.2 billion by the end of 2012, or by 78%, in the sample of fund managers they surveyed. Within this total, the Asia Pacific region has remained the largest source of offshore mandates\(^91\), representing around two thirds of the total. While a long enough run of data are not available to fully test the hypothesis, the FSC report suggests the MIT changes were probably an important factor behind this strong growth in financial services exports.

While this growth in offshore sourced funds is encouraging, it needs to be put in context. As noted earlier, ABS data suggest that, of a total of A$ 1.4 trillion under management by Australian resident investment managers in June 2013, only A$ 74 billion, or just over 5%, was sourced from offshore.

From a policy perspective – particularly in the current environment in which mining sector activity is tapering off – it is crucial to ensure that domestic policy settings do not unnecessarily inhibit companies with the skills, capacity and comparative advantage to do so from exporting their financial services – in this particular case by way of Australian funds management companies managing offshore mandates. The rapid growth and development of the Chinese economy and of its global trading links, the opening up of its financial markets and the associated prospect of increasing use of the RMB in cross-border financial transactions makes this general point particularly pertinent: Australia does not want to miss out on these emerging and potentially enormous opportunities.

For these reasons, the above policy changes need to be put in place as soon as possible, in particular introduction of a full and effective Investment Manager Regime along the lines of those that exist already in the UK, US, Singapore and Hong Kong – jurisdictions with which Australia competes for cross-border business. Arguments to the effect that such a scheme would be dangerous to introduce in the current tough fiscal climate due to its potential misuse for tax avoidance purposes ignore the fact that countries such as the UK and US – both of which are in substantially more difficult fiscal circumstances than Australia – have effective and wide-ranging IMR’s in place and have seen no need to amend their schemes.

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\(^{90}\) See Financial Services Council & The Trust Company (2013).

\(^{91}\) Unfortunately separate data for inflows from China are not available.
CHAPTER FOUR
SUMMARY AND CONCLUSIONS

In the space of just 35 years, the Chinese economy has been transformed from a small, centrally planned agrarian one to the largest trading nation and the second largest economy in the world. Before the end of the decade it will be the largest global economy.

To date, much of the public discussion and analysis of China’s economic rise and its implications has focused on the real economy side with, arguably, too little attention to the financial side. This is not surprising: to date China’s extraordinary economic growth and development has not been matched by growth and development on the financial side. However, the central theme of this paper is that this is changing rapidly, as China reforms and opens up its capital markets both for domestic policy reasons and reflecting its desire to internationalise its currency.

This paper has shown how the imbalance in China’s economic development on the one hand and its financial market development on the other is mirrored in Australia’s trade and financial links with China: while China is our largest trading partner on both the imports and exports side, most of Australia’s imported capital still comes from older, traditional trading partners; and similarly most of our overseas financial investments are in those same markets.

This is likely to change significantly over the coming decade and beyond, with mutual benefits to both countries. China is set to become a core part of diversified global investment portfolios; it is already the largest source of global savings, which it will need to diversity into offshore markets; and Australia needs access to global savings pools to fund its ongoing investment needs. But deeper and broader financial links will not happen automatically: they require the right policy settings and a good deal of strategic thinking and planning on the part of the private sector.

This paper has suggested that much of the policy framework is already in place. But for Australia to fully benefit from China’s financial development, there are a number of policy and market issues that need to be addressed or considered. The key ones identified in the discussions, consultations and surveys underlying this paper are as follows:

- There are a range of factors identified in the invoicing survey that are inhibiting greater RMB trade invoicing between Australia and China. Some of these – banks discouraging customers from invoicing in RMB; concerns about identifying transactions as being genuinely trade-related and hence not subject to VAT; lack of awareness by many smaller Chinese companies that RMB invoicing is possible – are more at the Chinese end rather than in Australia. In both cases however, greater corporate awareness of the potential benefits from RMB invoicing and settlement and the range of hedging and risk management products available with respect to RMB settlement would be beneficial.
There is still considerable market uncertainty regarding the tax treatment of cross-border financial transactions, in particular with respect to offshore investors investing through Australian domiciled investment vehicles. This needs to be addressed, by way of finalising legislation to put in place an effective and wide-ranging Investment Manager Regime.

Due to the lack of familiarity and comfort with Australia’s managed investment trust (MIT) regime on the part of many potential investors and investment advisers in Asia, including China, there is a need for a wider range of vehicles that are taxed in the same way as MITs.

It will be important to ensure adequate access for Australian fund managers to China’s capital markets, for example by seeking at an appropriate time an RQFII quota allocation to Australia.

Ongoing developments with respect to offshore RMB settlement arrangements should be watched closely to ensure that they are as easy and effective in Australia as in other financial centres.

There is a lack of awareness on the part of many funds management executives and trustees of the rapid pace of change in China’s financial markets and the associated need to start thinking strategically about how to position for the opening up of China’s capital markets.

Both perceptions in China of Australian discrimination against Chinese investment and also antipathy in some limited quarters towards Chinese investment in Australia need to be overcome, in part perhaps by political and business leaders better explaining the desirability of Chinese investment in Australia.

If these issues are addressed, both Australia and China should benefit substantially from closer and deeper financial relations over time, as they have already done with respect to trade relations.
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APPENDIX
ORGANISATIONS CONSULTED

International
Administrative Commission of China (Shanghai) Pilot Free Trade Zone
AMP Capital Investors Hong Kong
Antai College of Economics and Management Shanghai
ANZ Hong Kong
ANZ Shanghai
Austrade Shanghai
Bank of England
Barclays Bank Hong Kong
BBVA Research Hong Kong
BNP Paribas Hong Kong
Chinese Academy of Social Sciences Institute of Finance and Banking Beijing
China Foreign Exchange Trade System (CFETS) Shanghai
China Institute of Strategy and Management Shanghai
China Investment Corporation (CIC) Beijing
Commonwealth Bank Group Shanghai
Eight Investment Partners Hong Kong
Fung Institute
Hong Kong Institute for Monetary Research (HKIMR)
Hong Kong Monetary Authority (HKMA)
Hong Kong Treasury
HSBC Hong Kong

HSBC Shanghai
International Monetary Fund
J.P.Morgan Hong Kong
Lujiazui Institute of International Finance
Macquarie Funds Management Hong Kong
National Australia Bank Asia
National Social Security Fund (NSSF) Shanghai
Portland State University
Pudong Development Bank Shanghai
Royal Bank of Scotland Hong Kong
State Administration of Foreign Exchange (SAFE) Beijing
Shanghai Municipal Government Financial Services Office
Shanghai Institute of International Finance Center
Shanghai University of Finance and Economics
Standard Chartered Hong Kong
State Street Bank and Trust Company Singapore
State Street Global Advisors Asia Hong Kong
The People's Bank of China Research Institute Beijing
The Peoples Bank of China Shanghai Head Office
The Treasury Beijing
The University of Auckland
Westpac Shanghai
Z-Ben Shanghai
Australia
AIMS Financial Group
Agricultural Bank of China
AMP
ANZ
APIR Systems Limited
Asia Pacific Stock Exchange (APX)
Australian Government Future Fund
Australian Stock Exchange (ASX)
Australian Bankers Association (ABA)
Australian Financial Markets Association (AFMA)
Australian Super
Bank of China
Bank of Communications
BHP Billiton
BT Funds Management
China Construction Bank
Colonial First State
Commonwealth Bank Group
Confucius Institute
Dixon Advisory
Eight Investment Partners
Emerge Capital
ETF Consulting
Financial Services Council (FSC)

Fortescue Metals Group
Franklin Templeton Investments Australia
Fund Executives Association Ltd (FEAL)
HSBC
Industrial and Commercial Bank of China
King & Wood Mallesons
Lowy Institute for International Policy
Macquarie Group
Mercer
Monash University
National Australia Bank
NSW Trade and Investment
Perennial Investment Partners
People’s Bank of China Representative Office
PM Capital
Pottinger
Pricewaterhouse Coopers
Queensland Super
Rio Tinto
Schroder Investment Management Australia
Standard Chartered
State Street Global Advisors
The Association of Superannuation Funds of Australia (ASFA)
The Australian APEC Study Centre
The Australian National University
The University of NSW Australia
The University of Queensland
Think Global Consulting
Towers Watson
UBS
VGI Partners
Westpac
Zen Capital Management