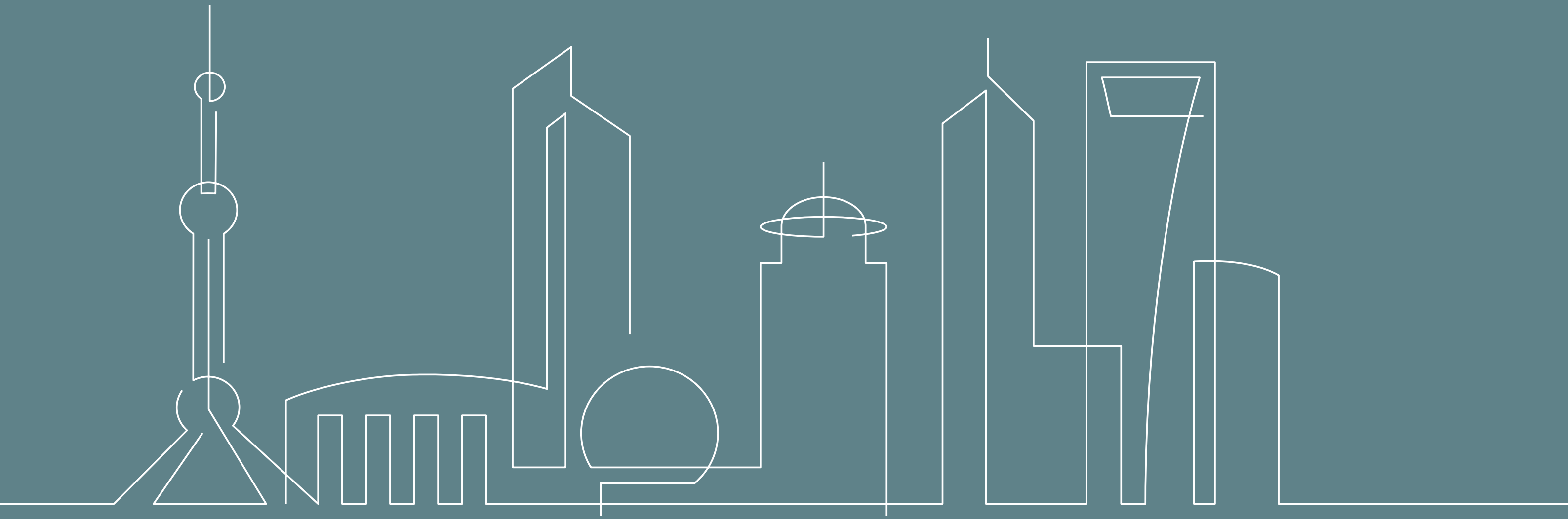

HOW FAR WILL CHINA GO?

Charting the Future of RMB Internationalisation

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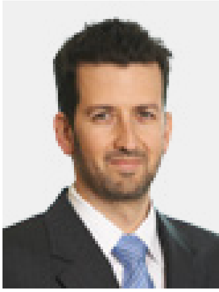

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Key Points

- China's capital account opening and RMB internationalisation has paused
- Sceptics argue that the process has peaked due to risk of capital outflows as well as the Chinese government's reluctance to cede more control to market forces
- However, this underestimates hidden costs and structural forces at play that make the status quo unsustainable
- We believe that further opening is therefore likely to proceed sooner, rather than later

After years of rapid reforms, leading to the International Monetary Fund's (IMF) recognition of the Renminbi (RMB) as a reserve currency,[1] what are the prospects for increased RMB Internationalisation? For now, this process has paused, as China's growth model still precludes further opening of the capital account and loosening of domestic financial repression.

In this regard, ensuring domestic financial stability and reform as well as a lower, more sustainable growth target would need to precede the next phase of currency liberalisation. Nonetheless, this may take place sooner than expected as China bears high costs for the current policy framework and is not enjoying any benefits from reserve currency status yet.

Until 2014–2015, the rise of the RMB was widely considered a one-directional trend. As China grew in international importance, it embarked on a tightly controlled, incremental process of liberalising its capital account and internationalising its currency. This led to increased global usage of the RMB, starting from a very low base. Extrapolating the consistent upward trajectory and year-after-year steps toward liberalisation suggested that the RMB was certain to take its place as one of the major currencies in the coming years. By 2015, it had already breached the top five most used currencies, as per Figure 1.

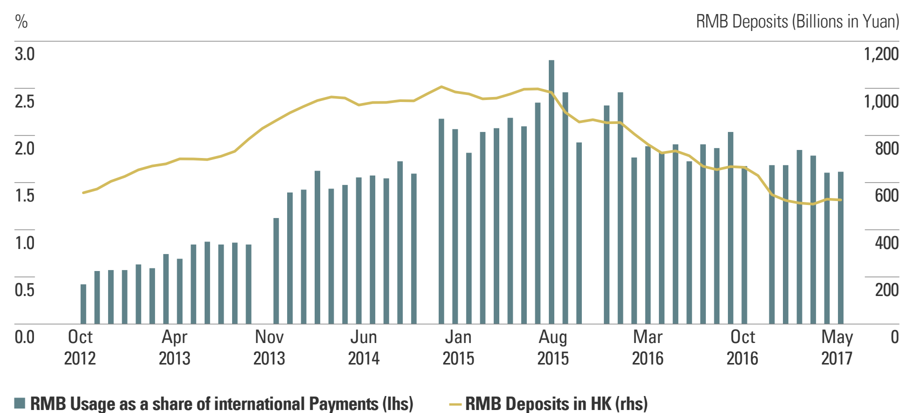
However, as the Figure illustrates, that trend subsequently began to reverse. Could this be a temporary pause or is it a longer-term sign of the contradiction between Chinese state controls over the economy and an open capital account and currency convertibility? Excessive leverage in the financial system as well as macro-economic imbalances makes further capital account opening a risky proposition. Sceptics point to these challenges to argue against expecting further opening, as the central government would not be willing to relinquish that much control to market forces.

> **"The main infrastructure has been created for future capital flows. Further capital account opening is now a question of political will."**

We believe this underestimates structural forces at play which make the question of continued RMB Internationalisation a matter of when, not if. Over the past decade, rapid progress and preparation have been made for an open capital account that would accompany any meaningful RMB Internationalisation. In fact, much of the hard work has been done. As Figure 2 shows, the main infrastructure has been created to allow for future capital flows to move in and out of Chinese financial markets and therefore to accelerate the global usage of RMB .

The timing of further capital account opening is now a question of political will. In order to understand the policy trade-offs, let us examine the challenges that currently impede further progress. We can then contrast those with the gravitational forces that should nonetheless lead to increased convertibility, a more open capital account and by extension, greater RMB usage worldwide.

Figure 1: RMB Usage Abroad and RMB Deposits in Hong Kong



Source: SSGA Research; Swift; Bloomberg. As of 1 August 2017.

Figure 2: Overview of Access Routes to Chinese Capital Markets from 2008–2017

RMB Banking & Clearing

- Offshore CNH Banking System
- Offshore Clearing Bank Infrastructure

Securities Access

Stock Connect programs (HK-Shanghai and Shenzhen-HK)

Market Access

Bond Connect, CIBM, QFII and RQFII enables foreigners access to China's capital markets

Funds Access

Mutual Recognition of Funds (China & HK only, but replicable)

Debt Issuance

CNH (Dim Sum) Bond Issuance

Why RMB Internationalisation Has Slowed — Major Challenges Ahead

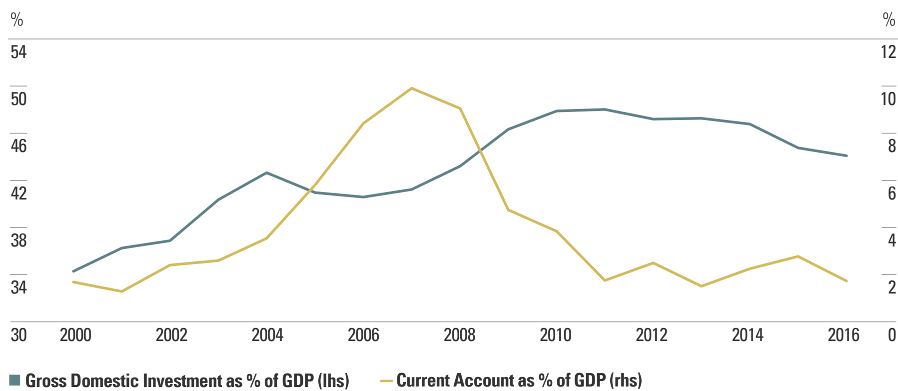
Why is China embarking on the steps listed above? In a simplistic sense, China is following one of the typical trajectories of emerging markets. During early stages of economic development, a fixed exchange rate with a closed capital account regime provides for predictability and transactional ease to help foster export-led growth. As an economy matures, both the exchange rate regime and the capital account evolve. The exchange rate comes under pressure to appreciate, and the country inevitably allows gradual appreciation which balances the need to maintain export competitiveness and import goods for both investment and consumption. Capital account opening usually begins with inward foreign direct investment, facilitated by strong growth as well as limited downside currency risk, and then moves on to opening domestic financial markets to portfolio investment. Finally, when countries reach middle-income stage, the trade-off between the flexibility of a floating exchange rate regime and competitiveness pressures slowly shifts toward the former. As a result, increased market forces promote broader capital flows (not only direct investment but also the variety of portfolio investment in local capital markets) that should boost market efficiency and raise productivity levels. Increased capital flows promote the Internationalisation of the currency, as portfolio investments denominated in that currency occupy an increasing share of global investors' portfolios, which ultimately leads to its increased transactional use.

> "Increased reliance on market forces would raise volatility in asset price movements."

Figure 3: Simplified Illustration of the Evolution of Currency Regimes
Typical Trajectory

While this may be an oversimplification, it broadly characterises the Chinese experience too. However, there are two inter-related challenges that constrain further liberalisation. First is the nature of China's political economy. Any further steps toward opening the capital account and increasing convertibility would come at the expense of state control. By definition, increased reliance on market forces would raise volatility in asset price movements . China's policymakers would also be partly ceding influence on interest rate levels to market forces, not at a policy level but at least with regards to credit spreads. In exchange, markets would presumably impose more discipline on lending and investment decisions in China's economy, thus helping to rebalance the overall economy in line with its current developmental needs. But regardless of the economic rationale, this will always remain largely a political issue around the government's tolerance for the vagaries of markets. It would also require the People's Bank of China to maintain or even expand its areas of independence, something that would run counter to current trends of institutional consolidation.

Figure 4: Current Account Balance and Investment as % of GDP



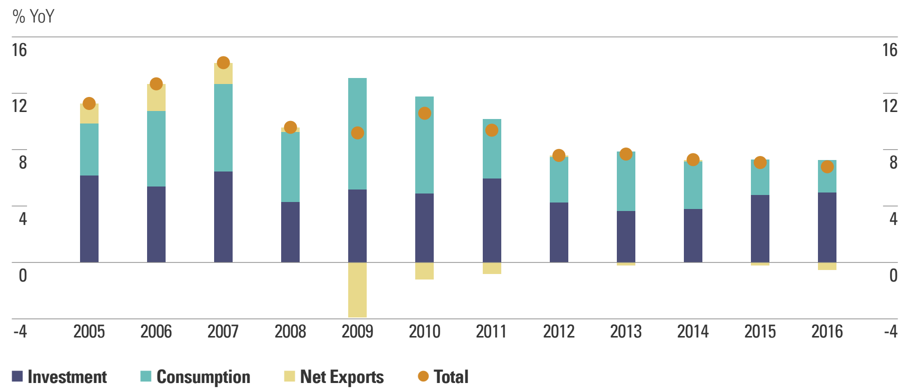
Source: Bloomberg. As of 1 August 2017.

The second overarching challenge is the by-product of previous policy choices, namely the build-up of substantial macro-economic and financial imbalances. These imbalances need to be reduced before resuming the path of capital account opening. China continues to have a very high gross savings rate of close to 50% of GDP. This exceptionally high rate is due to the policy mix in China which has encouraged excessive savings in both the corporate and household sectors,[2] but does not offer enough opportunities for these savings to be reinvested. In addition to heavy state involvement in the financial sector, this element of domestic capture is the most prominent feature of financial repression in China. In plain English, the restricted capital account restricts investment choices for Chinese savers, requiring savings to be reinvested somewhere domestically. This inevitably leads to domestic asset bubbles. Recent examples include the equity market, select commodity items (e.g. iron ore) and regional property markets.

Given a strong sovereign balance sheet, deflating these bubbles has been manageable for the Chinese government. However, the risk is that any mishandling of such bubbles could rapidly undermine confidence. In such a scenario, a more open capital account would enable large, sudden capital outflows so any systemic risks would need to be defused beforehand.

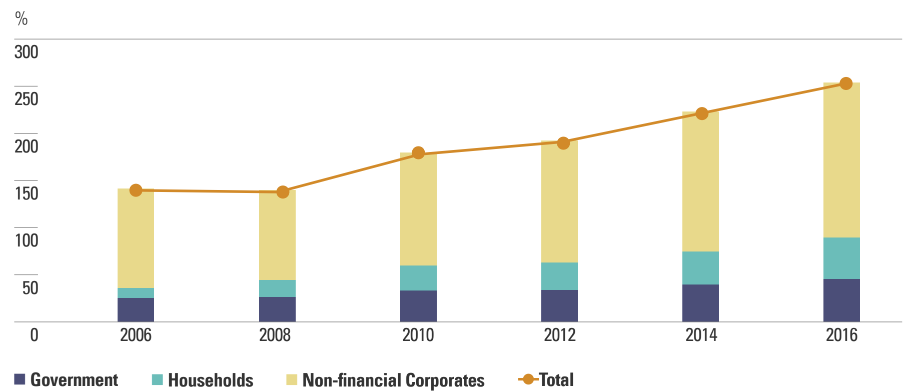
Linked to such financial imbalances is a systemic mispricing of credit.

Figure 5: GDP by Expenditure Growth 2005–2016



Source: Bloomberg. As of 1 August 2017.

Figure 6: Share of Debt to GDP by Sector: Household, Corporate, Government 2006–2016



Source: Bloomberg. As of 1 August 2017.

> "Debt bubbles need to be resolved before further integrating China's capital markets with the rest of the world."

The Chinese government is heavily involved in the running of state-owned enterprises (SOEs), whether for employment or regional development reasons; and such enterprises enjoy favourable financing conditions. (Figure 5 shows that investment (corporate and government) accounts for roughly half of economic growth, much of which is debt-driven.) This in turn leads to uncompetitive and unproductive companies building up excess industrial capacity, leading to increased future default risks. At some point, these will have to be recognised in the system and be resolved through default, restructuring, liquidity injections or bail-outs. In developed economies, similar debt crises have risked the viability of the banking system, but in China's case, the financial links have been mainly intermediated through the shadow banking system. A disorderly resolution of this debt overhang would ultimately hit corporates and households (as the creditors of most of this debt), which would raise political and economic risks. Therefore, the debt bubbles need to be resolved before further integrating China's capital markets with the rest of the world as uncertainty over debt restructurings and legacy issues could lead to sudden capital outflows. An outflow of capital would shrink the credit supply and bring domestic interest rates to higher equilibrium levels, which could result in unmanageable funding stress for SOEs.

In sum, there are major challenges to resolve before advancing a renewed process of RMB Internationalisation. Foremost, the current credit bubble needs to be prudently deleveraged without undermining confidence.

The Chinese government is in the fortunate position of having a variety of tools at its disposal. It can either resolve debts through outright bailouts, i.e., shifting the debt from the corporate to sovereign balance sheet, which is strong enough. It can provide liquidity to struggling debtors over prolonged periods to enable a gradual deleveraging.
It can impose soft restructurings as state entities tend to represent most borrowers as well as lenders, a huge stabiliser in any mounting debt crisis. And lastly, it could allow defaults to occur and let defaulted debt be re-priced. A combination of these measures should enable a smooth overall deleveraging — which is a precondition for further integration with global capital markets.

"The Chinese government has a variety of tools at its disposal to de-leverage."

By implication, lower credit growth means lower overall economic growth. Hence, this process will have to be accompanied by an explicitly lower growth target as set by the Chinese leadership. It also means that those sectors reliant on high credit growth will face pressures to reform. This applies particularly to the SOE sector and more generally to industrial capacity. It would also require local governance to be reframed further to remove the means and incentives for local officials to promote the previous growth model. Many observers find these developments unlikely and therefore remain sceptical about the prospects for China's renewed opening of the capital account, increased currency convertibility and greater Internationalisation of the Renminbi.

China will Restart the Opening of its Capital Account and Promotion of RMB Convertibility

Doubts about the inevitability of China's financial opening ignore long-term forces at play. Broadly, there are five trends that are likely to exert a gravitational influence on China to restart the opening of its capital account. First, the costs of the current system are high and are only gradually being recognised. Second, financial development and inclusion would offer tangible benefits to China's developmental phase. Third, China's sheer economic size makes the existing insulation from global capital unlikely to be sustained indefinitely. Fourth, China's external strengths are real but are not impermeable, so the arguments for liberalisation will return as a tool to boost resilience. Fifth and last, international economic relations will be supportive of China's change.

Regarding the costs, it is important to note that there are substantial opportunity costs even if they may be difficult to quantify. Many governments can sustain distorting their exchange rates and limiting capital account flows because the costs are not visible and not clearly linked to national welfare. For example, China enjoys a very strong position as a net creditor to the rest of the world. In principle, the larger the creditor position, the higher net income should be. For China, this should result in strongly positive net income flows. However, Figure 7 shows what an outlier China is compared to the rest of the world, with net income being negative. Since net income is the difference between income inflows and income outflows, this is largely explained by underperforming income inflows.

> "Doubts about the inevitability of China's financial opening ignore long-term forces at play"

Figure 7: Net International Investment Position versus Net Investment Income, H2 2016 ($bn)

Source: SSGA Research using IMF data for H2 2016 as of 31 December 2016, denominated in USD.[3]

In plain English, China does not earn enough on its investments and loans abroad. The former reflects the disproportionate share of low-yielding foreign reserves as a share of foreign assets, whereas the latter is explained by the cheap lending practices of China's state-owned entities.

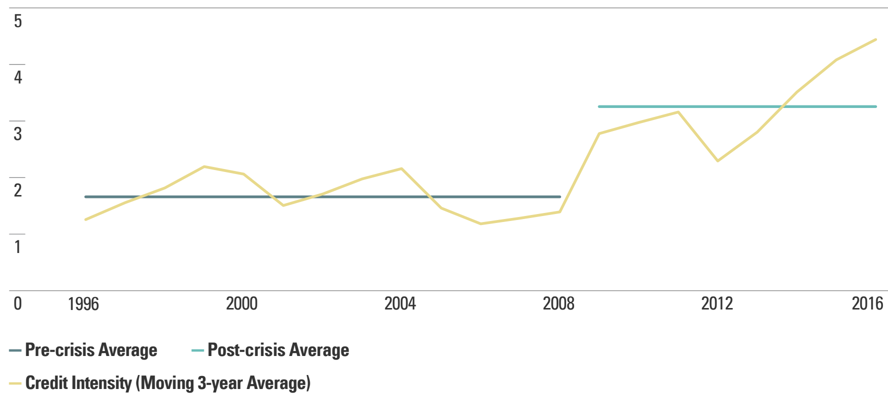
These policy choices show up as national costs, which would be lower if Beijing were to allow partial liberalisation of the capital account and could promote the RMB as an international currency. Over the past year, a chunk of foreign reserves have been converted to foreign assets of Chinese banks and corporations, which should raise investment income in the future. However, this implies structurally lower foreign exchange reserves, which implies less ability to manage the exchange rate. Similarly, if China wishes to project geopolitical power through its lending capacity, the ability to do so in your own currency is far cheaper than subsidising rates in other currencies. Figure 7 also shows how cost-effective the reserve currency status of the US Dollar is for the United States. Inclusion in the IMF's major currency basket provided for the prestige of reserve currency status, but China can enjoy neither the tangible financial nor geopolitical benefits without increased convertibility and Internationalisation of the RMB.

There is a second macro-financial cost to China's capital account policies, namely the domestic effect of financial repression. As most financial products will only offer a zero real rate of return and investment abroad is not permitted on a large scale, Chinese savers pile into domestic growth assets. This invariably spawns financial bubbles (see Figure 8). Parts of China's property markets, the equity market in 2015 and the flourishing of wealth management products (WMPs) in recent years are all examples of the risk of financial imbalances. As a result, the July 2017 National Financial Work Conference endorsed a tighter regulatory and institutional approach to containing financial risks. That is welcome and necessary in the short run. In the longer-term, allowing greater market forces by loosening the capital account would be a complementary step to help remove some of the excess savings from China's financial markets.

“China does not earn enough on its investments and loans abroad.”

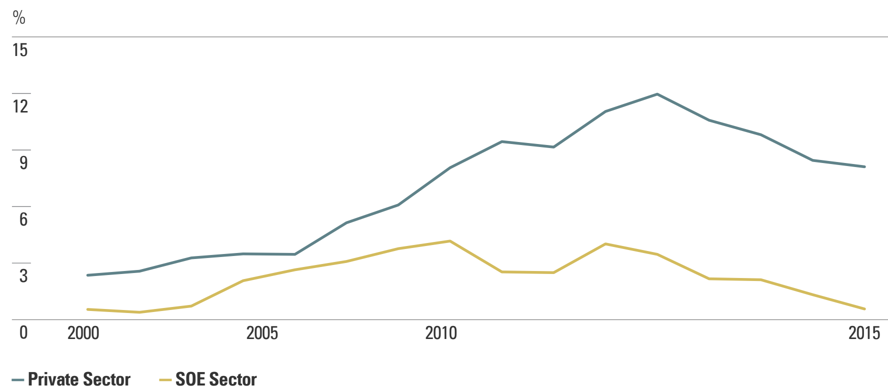
The third, related cost is the distortion of economic growth. The closed capital account is not only a source of financial risk, but the nature of financial intermediation in China adds a secondary problem.

Figure 8: Credit Growth Intensity 1996–2016



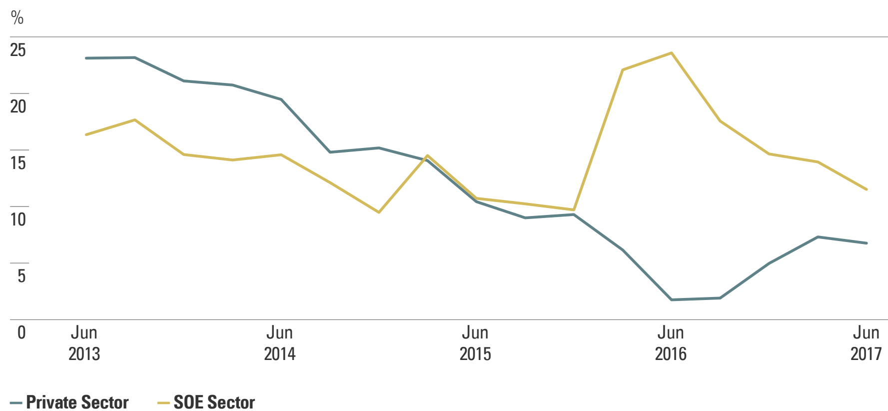
Source: SSGA Research, using Bloomberg data as defined as unit of credit used per unit of GDP generated. As of 1 August 2017.

Figure 9a: RoA of Private versus SOE Sector



Source: SSGA Research; National Bureau of Statistics.[5] As of 1 August 2017.

Figure 9b: Investment Rates of Private versus SOE Sector



Source: Bloomberg. As of 1 August 2017.

The combination of a state-owned banking system and the political economy of local governments mean that there is an institutional bias toward channelling credit toward state-owned enterprises.
The macroeconomic cost is declining productivity as the SOE sector is less productive than the private sector, as illustrated by the differential returns in Figure 9. The inefficiencies of credit allocation are therefore likely to act as a drag on long-term growth. The entry of foreign capital would help impose market discipline and force SOEs to compete more fairly for credit, presumably boosting other sectors at its expense.

All of the above contribute to preventing the needed rebalancing of the economy. Favourable financing conditions directly contributed to higher corporate savings rate, functioning as a hidden subsidy.[4] Moreover, bias toward SOE sector and limited funding opportunities for private enterprises left the latter compelled to maintain higher savings to fund their own capital expenditures. In this regard, we feel a well-timed incremental opening of the capital account would help the rebalancing process. Allowing capital to compete more freely with international opportunities as well as forcing the market to allocate capital more efficiently domestically would have several positive effects:

> **"China can enjoy neither the financial nor geopolitical benefits of a reserve currency without increased RMB Internationalisation."**

1) it would reduce the overhang of industrial capacity; 2) it would likely accelerate the reform of the SOE sector, as subsidies would become more explicit on the government's balance sheet; 3) and it would promote faster growth in the services sector at the expense of manufacturing. All of these trends would help rebalance the economy away from state-directed manufacturing enterprises, and lower the investment rate and the size of export capacity. This in turn would lower the current account surplus over the longer-term.

In addition, foreign capital would greatly improve the workings of China's financial markets. International investors would require advancements in market making, exchange rules, credit ratings, clearing and so forth. The limited opening thus far already shows potential improvements. For example, foreign asset management as well as credit rating firms have been allowed to operate onshore starting in 2017, likely to raise reporting and transparency standards. Another example would be MSCI's decision to partially include A-Shares based on existing Stock Connect platforms in June 2017. The highly limited index inclusion sets out parameters that were previously deemed unacceptable to Chinese regulators, such as the loosening of pre-approval requirements and ensuring no reduction in daily limits.

"The inefficiencies of credit allocation act as a drag on long-term growth."

Figure 10: G-20 Equity and Bond Market Capitalisations and Estimated Shares of Foreign Ownership

	Equity Market Capitalisation ($bn)	Foreign Ownership of Equity Market (%)	Bond Market Outstanding Securities ($bn)	Foreign ownership of Bond Market (%)
United States	27,352	24	38,170	28
China	**7,321**	**3**	**9,409**	**2**
Japan	4,955	31	11,965	10
UK	3,183	46	5,441	42
France	2,157	40	3,957	62
Canada	1,994	23	2,128	48
Germany	1,716	43	3,238	59
India	1,567	9	797	10
Australia	1,268	30	1,806	45
South Korea	1,255	31	1,598	12
South Africa	951	15	235	28
Brazil	759	34	2,204	10
Russia	622	26	423	12
Italy	587	37	2,890	38
Saudi Arabia	449	6	57	37
Indonesia	426	22	257	51
Mexico	351	36	700	46
Turkey	172	21	249	43
Argentina	64	15	178	22

<10% 10–20% >20%

Source: SSGA Research with all data as of 31 December 2016; denominated in USD.[7]

In this regard, the opening of financial markets would deliver similar benefits to other sectors in China that advanced rapidly with the introduction of foreign competition and know-how. Beijing's track record of ensuring national companies can successfully emerge should also limit political reluctance in the longer run to further easing foreign portfolio investments as this would help develop China's financial firms.

In relation to the size of its financial markets, China also represents an aberration in terms of access. As the second-largest economy, its equity and bond markets have reached comparable scale, respectively being the 2nd and 3rd largest in the world. As Figure 10 shows, China's capital account has been the most restrictive to foreign portfolio investment among G-20 economies,[6] with shares of foreign ownership by far the lowest. In terms of participation in local equity markets, only India and Saudi Arabia are comparably low. Those two countries have had similarly restrictive rules governing their local equity markets, but are now gradually loosening those rules to encourage greater international participation.

For bond markets, China's tightly managed access to its interbank bond market has meant that foreign ownership is far below that of the rest at approximately 2%. Interestingly, only the other BRIC (Brazil, Russia, India, China) countries as well as its Korean and Japanese neighbours have very low shares as well. The latter two have shares just above 10%, which perhaps is the long-term level one could expect to characterise the Chinese bond market, once remaining restrictions are lifted. If we assume foreign ownership would approach 10% for both, i.e., China would normalise at the lowest end of the range, then that would still imply nearly $1 trillion of portfolio inflows. This would therefore provide offsetting contributions to foreign reserves and flexibility to allow increased Chinese outflows. This in turn would help improve the intermediation of Chinese savings with global investment opportunities and improve returns on foreign investment. A higher level of RMB convertibility and the resolution of the debt overhang would be a necessary prerequisite.

> **"If the current account ever did turn into deficit, it would be easier to finance with a convertible currency."**

The discussion about capital account liberalisation takes place against the backdrop of China's strong external balances, of which high levels of foreign exchange reserves are one component. As mentioned in the Figure 10, the ideal financial outcome would be fewer reserves for the sake of other external assets, but that would make exchange rate management more difficult. After the rapid depletion of reserves in 2015–2016 in order to prevent a large devaluation of the Renminbi, many observers have been surprised at the stabilisation of reserves around $3 trillion. This remains a substantial level and provides the People's Bank of China (PBOC) with considerable firepower to intervene in foreign exchange markets.

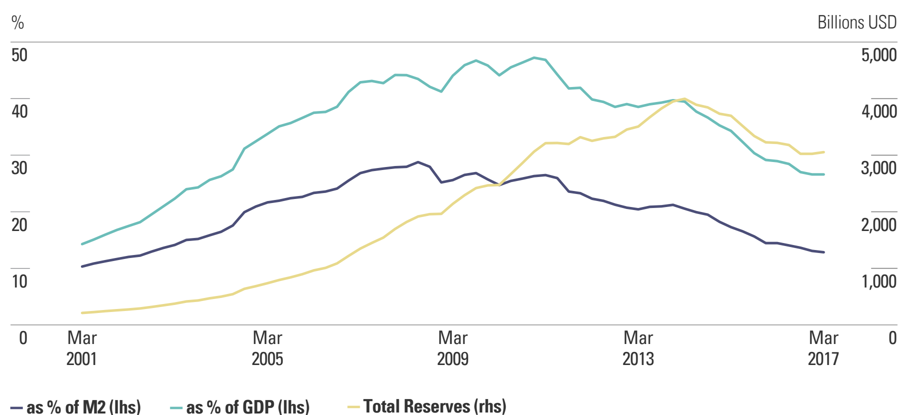
However, Figure 11 reveals that reserves are not infinite and that by relative measures, China's reserves are back to levels at the beginning of the century.

In other words, reserve strength provides a meaningful buffer, but is not invulnerable. China's other external strength, its chronic current account surplus, should also be considered impermanent. The risks of the middle-income trap will become more pronounced for China as its population ages. Demographics alone should raise Chinese consumption and lower the current account surplus. Reforms of the social security system should accelerate that effect. If the current account ever did turn into deficit, it would be easier to finance with a convertible currency. The latter would presumably also imply a more liberal exchange rate regime, allowing any currency appreciation to deliver extra purchasing power. Again, the point here is that any economic rebalancing is likely to engender changes on the capital account as well.

Finally, it is important to note the alternatives. If one imagined that Beijing would pursue its current policy framework, it is unclear whether the global economic system can cope indefinitely. The political convulsions in Western economies are giving urgency to the need for Chinese reforms. In other words, the international environment will continue to be very supportive of any measures that empower market forces in China's foreign economic relations as they are more likely to produce equilibrium. The absence of reforms would suggest domestic financial pressures leading to capital outflow pressures. Even if financial repression and capital controls can maintain stability, such pressures are likely to lead to higher current account surpluses, which in turn will beget higher international pressure for reform.

> "If Beijing pursues its current policy framework, it is unclear whether the global economic system can cope indefinitely."

Figure 11: Foreign Exchange Reserves in USD; as Share of GDP; and as Share of M2



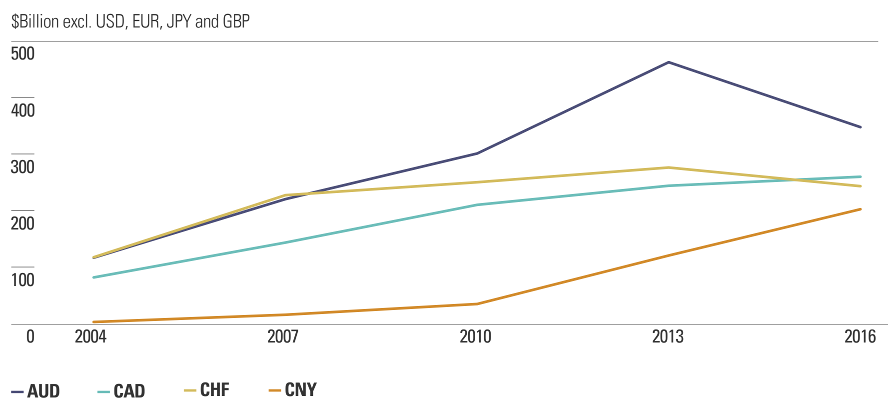
Source: SSGA Research; SAFE; Bloomberg. As of March 2001.[8]

Conclusion

The accumulation of excess savings in China suppressed long-term interest rates in the early years of the century and contributed to the 2008 Financial Crisis. A decade later, China's system has evolved but excess savings still pose systemic risks, currently mainly within China's domestic financial system. In short, the status quo is unsustainable in the long run. And because the imbalance grows year by year, further opening will proceed sooner, rather than later. The Internationalisation of the RMB may have paused in 2016–2017, but as Figure 12 shows, the long-term trajectory is toward taking its rightful place as a major global currency. We therefore expect it to become the 6th most actively traded currency by the time of the next triennial review of the Bank for International Settlements in 2019.

"The status quo is unsustainable in the long run. And because the imbalance grows year by year, further opening will proceed sooner, rather than later."

Figure 12: Most Actively Traded Currencies 2004–2016 (excluding USD, EUR, JPY and GBP)



Source: BIS Triennial Survey. As of 1 August 2017.

[1] The International Monetary Fund (IMF) included the RMB in its "Special Drawing Right" basket of major currencies in October 2016, alongside the US dollar, Japanese yen, euro and sterling.

[2] For details on the Chinese savings puzzle, please see Yang, Zhang, Zhou, "Why are Savings Rates so High in China?", National Bureau of Economic Research, Working Paper 16771, February 2011. In short, corporate savings arose from wage suppression and interest rate subsidies, and was then compounded from the productivity and price gains delivered through increased trade and capital flows. Household savings are a function of an underdeveloped welfare state, while government increases in taxation outpaced spending increases for many years, leading to higher government surpluses and cumulatively high Chinese savings.

[3] *This is modelled on a similar chart from a blog post from 10 January, 2017 by Benn Steil, Council on Foreign Relations, found at https://cfr.org/blog-post/chinas-exorbitant-detriment-mirror-image-americas-exorbitant-privilege-costing-it-dearly*

[4] Yang, Daniel. "Why are Savings Rates so High in China?", NBER Working Paper No. 16771, February 2011, p.11

[5] To calculate RoA, we used operating income and aggregate assets as per National Bureau of Statistics, subtracting interest payments and income tax payable to arrive at net income, which we divided by total assets.

[6] Fernandez, Klein, Rebucci, Schindler and Uribe. "Capital Control Measures: A New Dataset", IMF Working Paper 15/80 (2015), p.15

[7] *For equity market capitalisations, we used World Bank; notional bond market outstanding we used BIS statistics. We then compared it to respective liabilities from the IMF data on international investment positions of respective countries except China, where we used Capital Economics measures (for equities, the estimate of foreign ownership is calculated by summing the approved quotas for foreign investors under the QFII, RQFII and Stock Connect schemes, with the assumption that all of the quota under the QFII and RQFII programmes is fully used. For the Stock Connect, data on the aggregate investment from Hong Kong to the Shanghai via the scheme was available through August 2016 and estimates for flows since then. Assuming that this figure has is now around $300bn, it would mean that the total foreign ownership of Chinese equities is equivalent to around 2.8% of the market capitalisation of Shanghai and Shenzhen. For bonds, the value of bonds held by foreign banks and institutions is divided by the total reported by the country's two major bond clearing houses (China Central Depository & Clearing as well as the Shanghai Clearing House).*

[8] M2 is a measure of the money supply that includes all elements of M1 as well as "near money" e.g. savings accounts and money market funds.

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