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# Grand global ambitions for renminbi sow domestic risks

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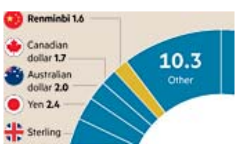
Great wall: a staff member counts renminbi at a bank branch in Suining in southwest China's Sichuan province

Most people from outside China have never used the renminbi for much more than buying trinkets at the Great Wall or steamed buns in a Shanghai eatery.

Despite the country's huge economic clout, its currency remains a minnow in the worlds of trade settlement, cross-border payments and global investing.

**The dollar and the renminbi**




But that is changing fast. Having been almost invisible in much of the world for years, the Chinese currency is now filling more pockets, portfolios and bank accounts across the world.

Last year, 17 per cent of China's trade was settled in renminbi, according to Deutsche Bank, up from almost nothing five years ago. Data from Swift, the international currency clearing system, show it is now the seventh most used currency in the world for payments, while investors are fast adding it to their trading screens. Governments are looking to the renminbi as a new home for their money. Nigeria's central bank already holds some 10 per cent of its foreign exchange reserves in the Chinese currency, while Australia and the UK are among those to state similar intentions.

The UK is to issue a renminbi-denominated bond – the first by a western government – in order to begin the process.

The world of finance is also taking note. Some asset managers have introduced renminbi share classes for their funds, and launched products that invest only in renminbi assets.

This is happening with a nod or a helping hand from Beijing – and progress appears to be speeding up.

The People's Bank of China has set up currency swap agreements – including with the Bank of England and the European Central Bank – to help build a stable global market for trading the renminbi. Commercial lenders have been appointed to act as China's clearing banks in various financial centres.

Tracking China's currency

This interactive graphic shows changes in the value of the renminbi

Beijing has also been dishing out investment licences for those wishing to use their renminbi to buy Chinese assets. By allowing freer access to domestic markets to those who already hold renminbi, China can open up without adding to appreciation pressure on the currency.

There are plenty of other reasons why renminbi internationalisation serves China's long-term goals. By removing the complex and often expensive process of transacting and hedging with the US dollar, renminbi trade settlement should help lower the cost of business for China's exporters. Already, some manufacturers offer discounts on orders to those willing to pay in the local currency.

More renminbi trade should also reduce the burden of holding the world's largest foreign exchange reserves.

Though envied by many in an age of indebtedness, China's $4tn pile of FX reserves – much of it ploughed straight into US Treasuries – has come at a cost. Due to the record low interest rate environment in much of the western world, China has been losing money on its holdings, paying out more to foreign investors in China than it gains from its assets overseas.

"What China would like to do is pull away from this dependency on the low-yielding government bonds in developed markets, and not get sucked deeper and deeper into the dollar trap,“ explains Eswar Prasad, professor of international trade policy at Cornell University.

Extracting itself from the dollar system would give China more clout in global commodity markets, where it is already often the biggest consumer.

That might, in turn, give it wider policy options to help support growth, maintain competitiveness, and help keep a lid on inflation. Lessons have been learnt, too, from the financial crisis in 2008, when a scarcity of dollars in Asia played havoc with cross-border trade.

A more widely held pool of renminbi could also help lower borrowing costs for Chinese companies, as shown by the success of the offshore bond market in Hong Kong, where billions of renminbi have been raised since its launch in 2009. The market is now spreading beyond Hong Kong to Taiwan, Singapore, London and other financial centres.

The renminbi internationalisation project could even be a tool to help force through tricky reforms at home by opening the country's capital account.

The recently announced equity market link-up between Shanghai and Hong Kong is a significant step in that process, allowing investors from all over the world to buy Chinese assets without a licence for the first time. The process of building a new global currency is not without risks. China sees the internationalisation of its currency as a mixed blessing and intends to manage it carefully.

"The Chinese authorities don't like the 'big bang' approach. That's why they test something – and if it works – they do more of it," says Justin Chan, co-head of markets for Asia-Pacific at HSBC.

One of China's fears is losing control of its exchange rate – potentially leading to a stronger renminbi and a loss of competitiveness, something already happening through wage inflation. There has been some progress on this front.

This year, China widened the trading band in which the currency can move on a daily basis against the dollar. But the wider range – it can rise or fall by up to 2 per cent a day – still marks the renminbi out as a highly restricted currency, almost completely subject to the whims of the central bank. With a truly internationalised renminbi, that power would be eroded, if not removed altogether.

For the renminbi to be set free, China's financial markets and interest rates would need to be too. That poses big challenges for the central government, which is plotting a carefully managed course of domestic reform to modernise its domestic economy, and retool it for a future where manufacturing and infrastructure investment are no longer the pillars of growth.

An open economy risks exposing China's companies to global competition before they are ready, or allowing a wave of capital to leave the country.

That the renminbi is becoming more international is patently clear. The bigger questions remain how far and fast the process will go, and whether it is set to challenge the dominance of the US dollar as the world's reserve currency.

A move to make Shanghai home to a new Brics development bank would help lay the foundations of a “renminbi system” to rival that of the dollar.

But, says Prof Prasad, the renminbi’s future will ultimately be dictated by the speed and scope of China’s domestic reforms, not by the rate at which the rest of the world warms to it.

“The renminbi is well on its way to becoming a reserve currency and, if China proceeds with its economic reforms, it could become a significant reserve currency in the next one or two decades,” he says. “But I don’t believe that it will become a safe haven currency . . . My sense is that even the Chinese don’t have trust in China. It is a great place to make money, but not a great place to keep it.”

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