Internationalization of the Renminbi: where have we come from and where do we go next?

May 2018

Hogan Lovells

Introduction

Amidst all the background noise about possible trade wars and retaliatory measures, it seems like a good time to take a step back and reflect on one of the most emblematic representations of Chinese global 'soft power': the internationalization of the Renminbi ("**RMB**"). China's efforts to internationalize the RMB to date have been driven by the desire to ensure that the influence of China and the Chinese currency is commensurate with that of the world's second largest economy.

The internationalization of the RMB refers to the process whereby the RMB progressively assumes the functions of a global currency. The IMF approved RMB as a global reserve currency in November 2015 (alongside the EUR, USD, JPY, and GBP) but that was neither the first nor the last step in the journey of internationalization.

The determinants of international or global currency status are threefold: economic size, market confidence in the currency and depth of financial markets. Successful internationalization of the RMB would manifest itself in many ways, perhaps most obviously when the RMB becomes a major pricing and settlement currency in trade, a preferred financial transaction currency, and an international reserve currency.

But there is an 'elephant in the room', while officially China has long since liberalised current account transactions, which in theory now only require proof/documentation of a genuine and lawful underlying (current account) transaction to be shown to a bank in China to convert RMB and remit out, or convert incoming foreign currency into RMB, China still maintains stricter controls on the capital account (including outbound direct investments ("**ODI**") by Chinese companies).

These controls on the capital account range from approval to record filing or simple registration, with much of the work having been delegated down by the State Administration of Foreign Exchange ("**SAFE**") to the Chinese banks, but with SAFE oversight and reporting very clearly in the background.

SAFE divides foreign currency transactions into two categories: "current account transactions" are typically part of a company's day-to-day operations, such as the import and export of goods and services. On the other hand, "capital account transactions" are transactions of a more incidental or one-off nature, such as ODI, foreign direct investment and foreign loans.

Furthermore, as a policy matter, China reserves the right to turn 'the tap' on and off as it sees fit to ensure that its balance of payments needs are met. The latest set of policy-based currency controls largely targeting ODI imposed towards the end of 2016 were a salutary wake-up call to the markets, that when China sees a potential threat to its foreign exchange reserves (the world's largest) and/or downward pressure on the RMB, it will not hesitate to act. Whilst these actions may not have resulted in the 'taps' being closed off completely, they certainly substantially reduced the 'flow' [see our client note here *China's New Foreign Exchange Controls Create Fresh Concerns for Foreign Investors*]. Since we wrote that publication, China appears to have unofficially increased the threshold at which a 'compliance and genuineness' review kicks in for outbound capital account transactions such as ODI to US$100 million total investment (i.e. purchase price) and published a new list of 'sensitive industries' for ODI. But anecdotally at least, conversion of RMB and payments out in foreign currency are still being processed at a much slower pace than was the case before the controls were introduced.

Barriers to internationalisation of RMB

As China began to open up its economy, there was a desire for its currency to be used in the international markets to settle trades and financial transactions without it fully opening up its capital account, hence the emergence of offshore RMB (CNH) alongside onshore RMB (Yuan or CNY).

The general view is that despite the emergence of offshore RMB (CNH) as a type of quasi-international currency, until the onshore RMB (CNY) becomes freely convertible on the capital account, persuading the world to use RMB (CNH) as a major finance, trading, and reserve currency is likely to be a 'hard sell' to the international markets because:

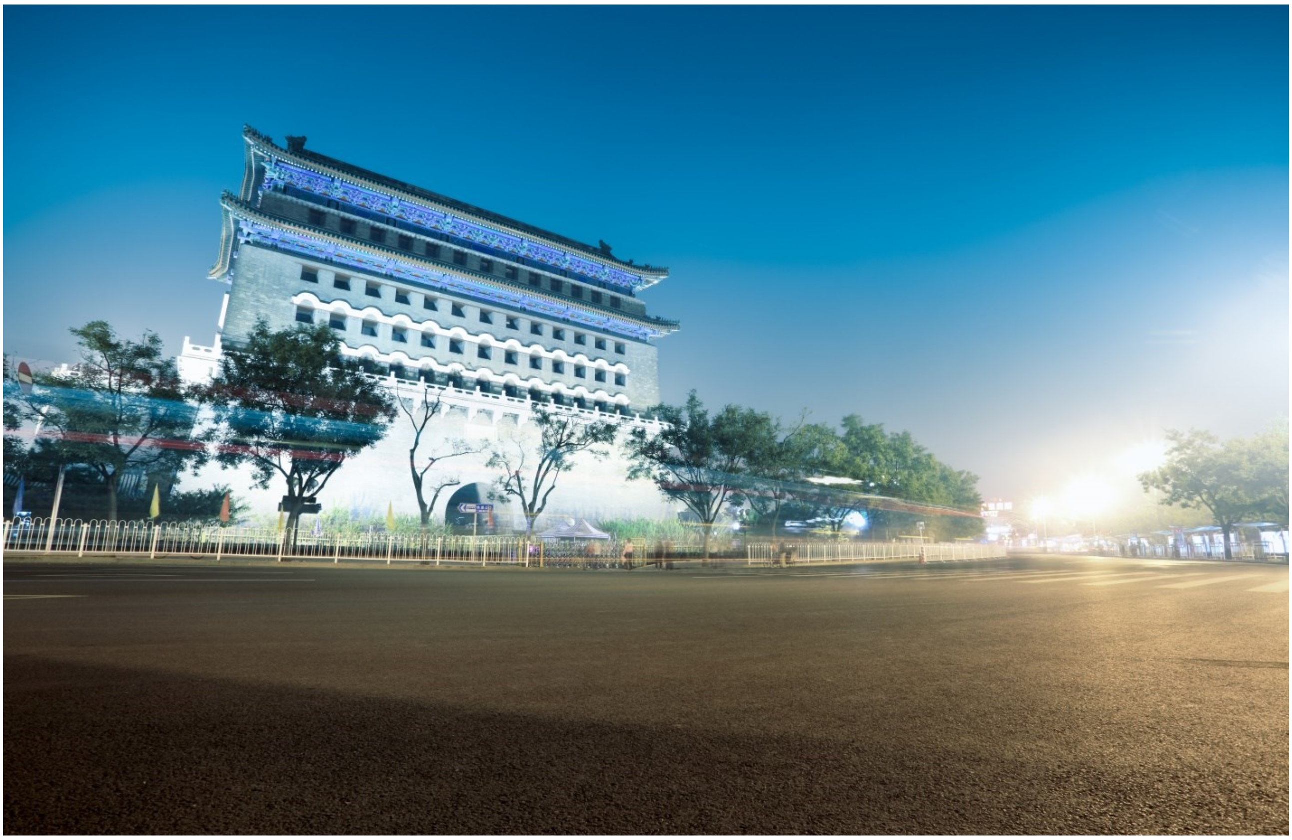
– It is probably likely to substantially increase in value on international markets when allowed to float freely (so could fluctuate materially in the event of a liberalization);

– the taps can be 'turned on and off' at will for opaque policy reasons;

– it remains restricted on the capital account and, due to the imposition of bank monthly quotas covering both capital and current account items as part of the latest currency controls, arguably on the current account as well; and

– it may be in the early stages of a trade dispute with the US.

These barriers may explain why China is effectively 'going it alone' and trying to create the conditions for the RMB to be seen as a global trading and reserve currency itself, with mega-projects like the Belt and Road Initiative ("**BRI**") (about which more below) as a flagship example.



History of internationalization of RMB: playing the long game

To overcome the perception that the RMB is a highly controlled 'soft' currency, over the past 10-15 years China has progressively introduced a series of regulatory-driven reforms to facilitate the internationalization of the RMB. By doing this, China has, in effect, set its own agenda and timetable, adopting a step-by–step approach. We have listed below some of the key milestones.

Year	Description	Main Effect
2004	RMB in Hong Kong	Start of personal RMB banking business in Hong Kong with Bank of China (Hong Kong) as sole offshore RMB clearing bank.
2007	Creation of Dim Sum Bonds and offshore RMB bond market	Chinese and Hong Kong banks were allowed to issue Dim Sum bonds (bonds denominated in RMB) in Hong Kong under an annual quota system.
2008 +	Cross-border RMB settlement: for current account items permitted	Starting from 2008, China allowed RMB settlement of cross-border trading transactions in limited pilot areas. As of 2010, this pilot project was expanded to qualifying enterprises in 20 pilot areas (including Beijing, Tianjin, Chongqing, and Shanghai), allowing cross-border RMB payments for current account items to and from any country in the world.
2011	Cross-border RMB settlement: of capital account items permitted	Developments expanded the use of RMB as a payment currency for capital account items such as inbound foreign direct investment ("**FDI**"), or ODI and inbound loans to foreign invested enterprises ("**FIEs**") (the latter creates a foreign debt from the Chinese regulatory perspective).
2011	RMB Qualified Foreign Institutional Investor ("**RQFII**") scheme set up	In 2002, the Qualified Foreign Institutional Investor ("**QFII**") had allowed investment by foreign institutional investors in 'A' Shares and certain other Chinese financial instruments for the first time by converting a given quota of foreign currency into RMB. The RQFII scheme was styled as a more liberalised version of QFII and RQFII allowed qualifying overseas institutions to make direct onshore RMB investments in the Chinese domestic securities market. Hong Kong's RQFII quota was increased to RMB 500 billion in 2017, meeting RMB investment demand from Hong Kong investors. Reform of the way in which the quota is calculated (rather than leaving this to SAFE discretion) under the QFII scheme has also since increased the quota available to QFIIs.
2013	Shanghai Free Trade Zone ("**FTZ**") formed	The establishment of the Shanghai FTZ liberalized controls over certain capital account transactions, and was designed to act as a pilot zone for further financial deregulation.

Year	Description	Main Effect
		As of 2017, China's FTZ coverage has expanded to 11 locations. FTZs enable the free cross-border transfer of RMB, providing a controlled onshore environment to deal in freely convertible and transferable RMB.
2014	Stock Connect Program	Shanghai-Hong Kong Stock Connect was the first leg of the initiative under the Stock Connect scheme introduced in 2014. This collaboration between the Hong Kong Exchanges ("**HKEX**"), and Shanghai Stock Exchanges ("**SSE**") established mutual order-routing connectivity and related technical infrastructure, creating a channel for mutual market access between Shanghai and Hong Kong by relevant investors. In 2016, Shenzhen-Hong Kong Stock Connect between HKEX and the Shenzhen Stock Exchange ("**SZSE**") was launched as an expansion and extension of Shanghai-Hong Kong Stock Connect. Out of all the various types of SSE-listed or SZSE-listed securities, only China A-shares are included in the Stock Connect Program. Stock Connect has removed a total quota scheme (which was used in QFII and RQFII) and is now operated under a daily quota scheme. The daily quota limits the maximum net buy value of cross-border trades under Stock Connect each day. Hong Kong Securities Clearing Company Limited ("**HKSCC**") and China Securities Depository and Clearing Corporation Limited ("**ChinaClear**") are responsible for the clearing, settlement and the provision of depository, nominee and other related services of the trades executed by their respective market participants and investors. For Northbound Trades, HKSCC will act as a participant in ChinaClear, be recorded as the nominee holder of record of the securities acquired by Northbound trade investors, and exercises shareholder rights with respect to the relevant companies listed on SSE and SZSE.
2015	Cross-Border Interbank Payments System ("**CIPS**")	CIPS provides better infrastructure for facilitating cross-border RMB investment or trade, by increasing the efficiency of cross-border clearing. Its main functions are handling cross-border RMB settlements (for both current account and capital account items) by way of remittances and inter-bank settlements. CIPS operating hours cover the major time zones where there is demand for RMB settlement services (including part of the European and US time zones). Transmissions are available both in English and Chinese. The second phase of the CIPS will be launched in Shanghai to further promote the global use of the RMB.

Year	Description	Main Effect
2015	Qualified Domestic Individual Investor ("**QDII2**")	QDII2 has not been officially implemented as of the date of this article. In 2015, the Shanghai FTZ was selected as a pilot area to further study and working out a detailed plan on QDII2. Currently, converting and remittance out of RMB is prohibited under the capital account for individuals (which means PRC individuals are not allowed to make ODI). Each individual in China – including resident foreigners – has an annual aggregate quota of US$50,000 (which reduces down on both conversion into or out of RMB) which can generally be used on presentation of ID and selecting one of a menu of *current account* uses for the converted funds (e.g. overseas travel, shipping goods overseas, and so forth). The proposed QDII2 scheme will be a significant liberalization in this area, which will offer opportunities for PRC individuals to invest directly in foreign industry markets, real estate markets, and financial markets. Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen, and Wenzhou will possibly be the first batch of pilot cities to implement QDII2 after its official initiation. It is reported broadly that PRC Individuals with at least RMB 1 million in financial assets may apply to join QDII2.
2016	Special Drawing Rights ("**SDR**")	RMB became the fifth currency in the SDR basket (along with USD, Euro, JPY, and GBP) representing 10.92% of the total, which is a significant symbolic milestone for the internationalization of RMB particularly in terms of becoming a reserve currency.
2016	RMB onshore bond market	China Interbank Bond Market ("**CIBM**") Direct allowed a wider range of foreign institutional investors to gain access to the China's onshore bond market for the first time (February 2016).
2017	Full-bore macroprudential administration of overall cross-border financing	This pilot expands the capacity of PRC borrowers to borrow overseas and incur foreign debts. This is clearly an upgrade and a more sophisticated system that will allow Chinese companies (both domestic companies and FIEs) to borrow more freely overseas. Both domestic companies and FIEs are now entitled to incur foreign debts, and are subject to the same formula when calculating the quota and balance of foreign debts. In addition, foreign debts in both RMB and foreign currencies are now regulated in an integrated fashion. Presumably, this reform will increase RMB and foreign currency inflows by bringing more loan principal into China.

Year	Description	Main Effect
2017	Bond Connect	Bond Connect is a mutual market access scheme that allows investors from mainland China and overseas to trade in each other's bond markets through connection between the related mainland and Hong Kong financial infrastructure institutions. July 2017 saw the commencement of 'Northbound Trading', allowing overseas investors from Hong Kong and other regions to invest in the China Interbank Bond Market ("**CIBM"**) through mutual access arrangements in respect of trading, custody and settlement. 'Southbound Trading' (which will allow investors from China to invest) has not been implemented as of the date of this article and will be explored at a later stage.

Recent achievements

While the trajectory of internationalization of the RMB has plateaued recently, some major milestones have still achieved:

Stock Connect: Hong Kong, Shenzhen… London

A unique collaboration between the Hong Kong, Shanghai, and Shenzhen Stock Exchanges, Stock Connect promotes the opening up of the stock exchange market and provides a new channel for international and mainland Chinese investors to invest in securities in each other's markets.

The CSRC has promulgated the provisions to regulate the Stock Connect Program, under which foreign investors must comply with the following shareholding ratio restrictions:

– the shareholding ratio of a foreign investor in a mainland-listed company shall not exceed 10% of the total number of shares of the said listed company; and

– the aggregate of A shares held by all foreign investors in a mainland-listed company shall not exceed 30% of the total number of shares of the said listed company. In practice, if the aggregate foreign shareholding exceeds the 30% threshold, the foreign investors concerned will be requested to sell the shares on a last-in-first-out basis within five trading days.

But despite the restrictions, the numbers involved are huge. In January 2018, HKSE reported that international and Hong Kong based investors now hold RMB600 billion (US$95 billion) of Chinese shares thanks to the connection between the two markets.

And this is part of an on-going process. In April 2018, Yi Gang, governor of the Chinese central bank, the People's Bank of China ("**PBOC**"), confirmed that the London-Shanghai Stock Connect would launch by the end of 2018, creating the first connection outside of greater China and acting as another step in the internationalization of the RMB.

Chinese bond market

The Chinese bond market is the third largest in the world (after Japan and the US) and comprises two main bond markets:

– the exchange markets - Shanghai Stock Exchange and Shenzhen Stock Exchange which are regulated by the securities markets regulator, China Securities Regulatory Commission ("**CSRC**"); and

– CIBM, China's over-the-counter ("**OTC**") market which is regulated by the National Association of Financial Market Institutional Investors ("**NAFMII**") under the supervision of PBOC.

The bonds traded on these markets include (i) Ministry of Finance ("**MOF**")-issued Government Bonds; (ii) bonds issued by PBOC (known as "PBC paper"); (iii) bonds issued by government-backed policy banks and financial institutions; (iv) corporate bonds issued by domestic corporations; (v) commercial paper, issued by securities firms or private corporations; and (vi) medium-term notes ("**MTNs**"). The Interbank bond market accounts for over 80% of China's overall bond market.

Panda Bonds

"**Panda Bonds**" (onshore RMB-denominated bonds issued by foreign entities) are a milestone in the interbank bond market. They are currently regulated under the *Administration of RMB Bonds Issuance by International Development Institutions Interim Measures* ("**IDI Measures**") issued by PBOC, the MOF, the National Development and Reform Commission ("**NDRC**") and CSRC.

In 2010, the amended IDI Measures significantly liberalized the outbound remittance of RMB proceeds from Panda Bonds, meaning the issuer is now allowed to remit the onshore proceeds of Panda Bonds offshore. While remitting the proceeds of Panda Bonds outside China remains difficult and tricky, as

China is currently restricting capital outflows (see above and see our client note [China's New Foreign Exchange Controls Create Fresh Concerns for Foreign Investors]), the proceeds of Panda Bonds which are to be used within China are exempted from being considered as "foreign debt". This is important as it means an overseas issuer of Panda Bonds can on-lend the bond proceeds to its onshore subsidiaries in China without utilizing the subsidiaries' foreign debt quotas.

Bond Connect

Since its launch in 2017, Bond Connect, the purpose of which is to offer China interbank bond market access to a broader group of international investors, has been gathering momentum. Bond Connect has significantly simplified the procedures for foreign investors investing into China ("Northbound trading") who can not only 'click' and enter the Chinese bond market, but also benefit from accelerated admission procedures and simpler onshore account set up procedures. Compared with QFII and RQFII, overseas participants are no longer limited to a given investment quota on gaining market access.

On 21 June 2017, PBOC promulgated the *Interim Measures for the Administration of Mutual Bond Market Access between Hong Kong SAR and Mainland China* to regulate the "northbound" access part of Bond Connect, thereby expanding the scope of the scheme. Southbound trading will be explored at a later stage.

The Q1 2018 Bond Connect Report issued shortly before the date of this article stated that the number of overseas institutional investors on-boarded and the trading volume have been growing steadily since the launch of Bond Connect. By the end of Q1 2018, a total number of 288 overseas institutional investors had entered the China interbank bond market through Bond Connect. Overseas investment products, commercial banks, and securities companies accounted for 50%, 25%, and 9% respectively of the total accounts. Hong Kong SAR had the largest number of registered accounts (around 65%). There were investors from nearly 30 jurisdictions including Taiwan, Singapore, United States, United Kingdom, Ireland, Germany, France, Luxembourg, Australia, Japan, South Korea, and Dubai.

RMB as a payment currency for cross-border settlements

Since January 2008, SAFE, PBOC and the Ministry of Commerce ("**MOFCOM**") have issued a series of administrative circulars to expedite the internationalization of RMB as a currency for making payments under both current account and capital account cross-border transactions.

Most recently, PBOC issued *PBOC Circular on Further Improving the Policies on Cross-border RMB Business to Promote Facilitation of Trade and Investment*[1] on 5 January 2018. The highlights of this include encouraging the use of RMB for cross-border settlement with fewer restrictions, facilitating FDI in RMB, allowing overseas raised-RMB to be transferred into accounts in China and so on and so forth. This sends a positive signal, reflecting China's wish to further open up the capital account. It also gives foreign investors a wider range of payment options.

The Chinese government gave the green light to RMB-denominated FDI by foreign investors in October 2011, when MOFCOM and PBOC released new rules formally permitting FDI utilizing offshore RMB that had been obtained from lawful channels. Any lawful onshore or offshore RMB funds can now be used for FDI without the need to submit documentary proof of the lawful source of the RMB funds.

For RMB-denominated ODI by domestic institutional investors, PBOC issued the *Trial Program for RMB Settlement of Overseas Direct Investment Administrative Measures Circular*[2] to lay the foundation of the current

[1] (Yinfa [2018] No.3)
[2] [2011] No.23 in 2011

regulatory framework. After obtaining the approval of NDRC and MOFCOM and completing the SAFE registration for RMB ODI, PRC non-financial investors registered under the RMB trade settlement pilot project are allowed to use onshore RMB capital to establish enterprises or acquire ownership, control or operation right of enterprises or projects located overseas.

Foreign Debt Developments

There have also been developments relating to overseas loans. Foreign investors or financial institutions may now advance RMB cross-border loans to PRC enterprises, including domestic capital enterprises and FIEs. The foreign loan scheme was reformed in 2017 after PBOC published the *Circular on Matters relating to the Full Bore Macroprudential Administration of Cross-Border Financings* ("**PBOC Circular**") on 11 January 2017, suggesting that China may reform the rules on FIEs incurring foreign debts, notably the statutory debt-equity rations which are very outdated and date back to 1987. Under the PBOC Circular, companies[3] and financial institutions with legal person status incorporated in the PRC (collectively, "**PRC Borrowers**") are permitted to incur foreign debts, provided that the PRC Borrowers cross-border financing risk-weighted balance does not exceed their individually calculated cross-border financing risk-weighted balance ceiling.

In addition, the PBOC Circular changes the cross-border financing leverage ratio of PRC enterprises from 1 to 2, which significantly enlarges the borrowing headroom within which PRC enterprises are entitled to incur foreign debts.

3 This excludes government financing platforms and real estate enterprises.

Future challenges and opportunities for internationalisation of the RMB

Since RMB became the fifth currency in the SDR basket, continued development of the RMB internationally has been relatively slow, as there is still the issue of payments in RMB making up a small portion of the global 'pie'.

Capital controls imposed by the Chinese government (including the Chinese government's recent policies aimed at curbing capital outflows) and on-going concerns over the Chinese currency's depreciation remain the main barriers to further progress in the internationalization of the RMB.

Realistically, these can only be addressed by the Chinese government taking action in the form of further policy liberalisation.

Belt and road initiative

On the other hand, China is not accepting the *status quo*: the Belt & Road Initiative launched by China in 2013 is already becoming a vector for the internationalization of the RMB, as China is self-evidently in the driving seat and most of the countries where projects are being implemented are in dire need of the investment.

Four years from the launch of this initiative, whether you take the view that China is seeking to develop less developed economies by installing infrastructure or that China is using the Belt & Road Initiative to extend its political influence to the target jurisdictions by effectively making them in debt to China (or both), what is clear is that this initiative is already resulting in infrastructure projects where there is a strong push for RMB to be the default currency for settlement, a further significant step in the internationalisation of the RMB.

Conclusion

As we look back to where the RMB has come from in terms of internationalisation and acceptance as a major global currency, it is undoubtedly the case that China has come a long, long way in the space of a decade. Major financial jurisdictions like the City of London have been making huge efforts to establish themselves as offshore RMB centres, something that would have been unthinkable 10 years ago or without the progressive breaking down of the legal and regulatory impediments to the internationalisation of the RMB, to the point where it is now possible to open an RMB account in London through certain designated banks. China has always indicated that full liberalization of the RMB on the capital account remains a medium to long term goal, but the issue for China to take the next big step remains one of confidence and fear: fear that China could experience a meltdown like in the 1997 Asian Financial Crisis or an attack on the RMB by speculators as was the case when the Bank of England was 'broken' by speculative pressures on so-called Black Wednesday that caused it to exit the Exchange Rate Mechanism on 16 September 1992. It would appear that for the moment at least, confidence that China will be able to manage its currency risks without the support of a non-convertible currency and the controls designed to prevent full convertibility on the capital account may still not have reached the required level.

Ultimately, whilst we should acknowledge China's achievements in taking it down the road of internationalization of the RMB, our view is that it is going to be difficult, if not impossible to convince the world to use the RMB as its preferred trading and reserve currency, notwithstanding China's economic miracle, until it becomes free floating on international markets. The fact that the exchange rate with the main rival global trading and reserve currency, the US Dollar (to a lesser extent the Euro), is, to some extent, one element in the on-going trade friction with the US, argues strongly against China making any bold moves at this time, but the reality is that you cannot have your (protected) cake and expect the world to use (eat) it. Making the step to full convertibility of the RMB will inevitably be a trade-off between huge gains along the road towards full internationalization of the RMB and global acceptance, against new threats to China's financial stability and security. Full liberalization on the capital account would, in our view, be the strongest possible affirmation that China has arrived as a leading global economic powerhouse and is confident of its newly-found place in the world economy.

Contacts

Andrew McGinty
Partner, Shanghai
andrew.mcginty@hoganlovells.com

Bronwen May
Partner, Hong Kong
bronwen.may@hoganlovells.com

Jia Zhan
Junior Associate, Shanghai
jia.zhan@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Rio de Janeiro
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar
Warsaw
Washington, D.C.
Zagreb

Our offices
Associated offices

www.hoganlovells.com