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RENMINBI ASCENDING

How China's Currency Impacts Global Markets, Foreign Policy, and Transatlantic Financial Regulation

Report Chair
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Dr. Chris Brummer
C. Boyden Gray Fellow
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A Danger of Divergence Report

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June 2015

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FOREWORD

Few issues confronting the international economy rank as high on the global agenda as the internationalization of the renminbi (RMB). As China asserts its place as the world's biggest economy and its largest trading nation, China's leaders and many of its trading partners are naturally supporting an increased prominence of the currency in international economic affairs. This support is paving the way for a variety of domestic reforms as well as a build-out of infrastructure internationally, all designed to elevate the currency's status.

Nevertheless, the process of internationalization—an admittedly technical and at times political exercise—remains misunderstood and poorly explained. Policy responses in the West often fail to balance, in nonpolitical terms, the tremendous economic opportunities with the sober acknowledgment of the steps needed to ensure maximum economic prosperity and cooperation. This report, prepared by Dr. Chris Brummer, continues our highly respected *Danger of Divergence* series of publications examining transatlantic cooperation and takes us a crucial step closer to understanding the impact RMB internationalization will have on the global financial system. Its chapters spell out how the process is unfolding while identifying key future areas of reform and their ties to much-needed developments in global economic diplomacy. Its analysis uniquely illustrates the important link among macroeconomic, macroprudential, and macropolitical strategies.

On behalf of the Atlantic Council, the City of London Corporation, Standard Chartered, and Thomson Reuters, I hope you enjoy the report.

Jon M. Huntsman, Jr.
Chairman
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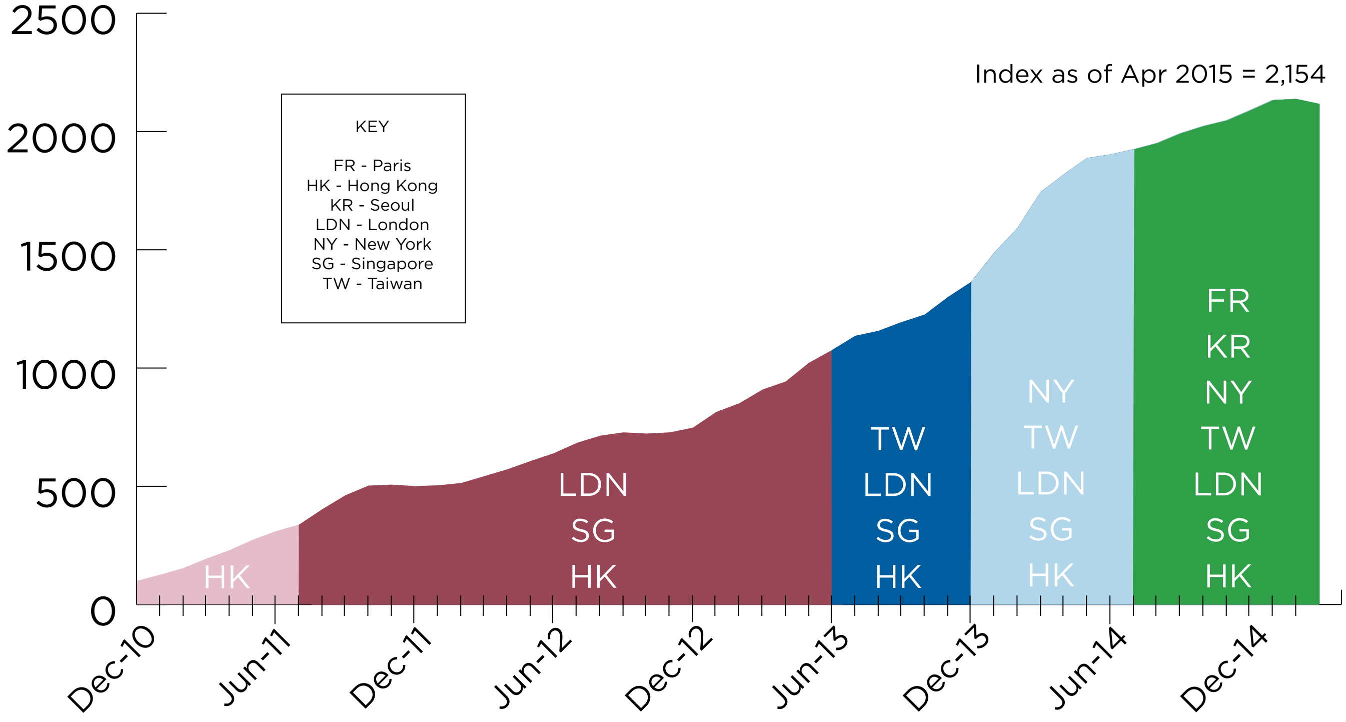
Renminbi Internationalization, 2010-Present



Standard Chartered Renminbi Globalization Index (RGI)

*Singapore and London became eligible markets and were added to the RGI in August 2011;

**Taiwan was included in July 2013; ***New York was included in January 2014;

**** Paris and Seoul were added in August 2014; *Source*: Standard Chartered Research.

EXECUTIVE SUMMARY

China's economic coming of age continues to impact the global monetary and financial systems in unprecedented ways. In the area of currency internationalization, the renminbi (RMB) attained a "G7" status in global payment currencies, and the opportunities for investing internationally and domestically have increased at an exponential pace. In just the last five years, financial authorities and diplomats have faced a series of major developments, including:

- The creation of an offshore market with few capital account restrictions;
- Targeted investment schemes into the country, with specific country and individual quotas;
- Two-way channels allowing companies to sweep money on and offshore between affiliates; and
- A series of mutual recognition programs, including the "Hong Kong-Shanghai Stock Connect" program, allowing investors to invest in one another's on- and offshore markets.

These developments potentially carry a number of welcome advantages for the global economy and even international relations:

- Political frictions involving claims and counter-claims of "currency manipulation" could ease as RMB valuations are subject to greater market influence;
- RMB internationalization, along with a more open capital account, portends a rebalancing of the global economy for more sustainable growth;
- The internationalization process can help facilitate a more competitive, consumer-oriented economy;
- Firms and investors in the United States and Europe will enjoy new means of diversifying their portfolio investments, as will China's savers;
- Earnings made in China and other "trapped cash" will be able to be repatriated abroad, just as RMB profits earned abroad will be able to be put to use in China.

But to achieve these outcomes, stronger transatlantic and transpacific vigilance and coordination is required, along with deeper public and private sector cooperation:

- China will have to continue efforts to not only liberalize its capital account, but also to upgrade its crisis management, bankruptcy regimes, and supervision of key gatekeepers like credit rating agencies, auditors, and accountants. Capital market liberalization will have to account for frothy markets, just as will market supervision.
- The reforms already made by China and the obvious weight of the RMB achieved thus far in cross-border settlement, and increasingly investment, should be recognized by the International Monetary Fund (IMF) in its special drawing rights (SDR) basket of currencies. However, upcoming and future weightings of the RMB in the SDR should reflect both market and continuing regulatory reforms.
- Nondiscrimination policies and private market participation should be embraced by both China and host states of RMB capital markets in order to bolster the market liquidity and depth and to reduce financial risk and the potential for unintended frictions in foreign policy.

All in all, these requirements involve more proactive multilateral engagement with the RMB, stronger regulatory and prudential reforms, and greater private sector involvement in the securing of a robust offshore RMB capital market. With this in mind, the report below outlines the process of RMB internationalization and explains how different parts of the evolving Chinese financial infrastructure interact in a changing geostrategic context.

KEY ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
CMIM	Chiang Mai Initiative Multilateralization
IMF	International Monetary Fund
ISDA	International Swaps and Derivatives Association
FSB	Financial Stability Board
PBOC	People's Bank of China
CFETS	China Foreign Exchange Trade System
CIPS	China International Payment System
CNAPS	China National Advanced Payment Systems
CSRC	China Securities Regulatory Commission
QFII	Qualified Foreign Institutional Investor
RQFII	Renminbi Foreign Institutional Investor
RTGS	Real Time Gross Settlement Systems
SAFE	State Administration of Foreign Exchange
SFC	Hong Kong Securities and Futures Commission
SFTZ	Shanghai Free Trade Zone
SWIFT	Society for Worldwide Interbank Financial Telecommunication

INTRODUCTION

Three decades of double-digit growth, fueled by strong exports and high government investment, have transformed China into the world's leading trading nation and second largest economy—and, by some accounts, it will surpass the United States to become the world's largest economy by as early as 2022. Indeed, even as global growth wanes, the country is still expected to average growth rates at 6.7 percent from 2015 to 2020 and 5.7 percent from 2021 to 2030.[1] By that time, China will have resumed its historical place as the world's largest economy—and its policy choices, along with those of the United States and the European Union (EU), will have the greatest impact on the scope of market opportunities available both domestically and globally.

The foundation of China's economic strategy has until recently been its relentless peg of the country's currency, the yuan (also called the "renminbi" or "RMB"), to the US dollar. Unlike other countries with large economies, China does not allow market forces to determine the value of its currency or the rate at which it should be exchanged with others. Instead, the RMB has been permitted to fluctuate only against a narrow band pertaining to a pre-established value. In this way, China has been able to both keep its exports competitive and achieve monetary objectives. These objectives are not unlike those sought by some developed countries, which have been seeking to jump start their economy since the Great Recession.[2]

Over the last decade, however, China has begun to alter its monetary course, in part out of necessity. As China's development continues, and as the market for its exports softens due to slower global growth, China's economy has reached a tipping point, where it is required to transition from an investment- and export-based economy to a consumer-based economy. Not only do its domestic consumers have to increasingly pick up the slack where the global economy has tapered off in order to sustain growth, but China will also have to make sure that it begins to moderate the stockpiles of debt it holds from foreign governments—and foreign exchange risk[3]—that have accumulated as a result of its persistent trade surpluses.[4] Liberalizing its monetary affairs is viewed as a means of addressing both problems by increasing the wealth of Chinese consumers (via an appreciating currency), thereby supplanting the role of exports.[5]

Though Chinese officials have described the resulting change in policy as a rethinking of the "cross-border use of the RMB," market participants have overwhelmingly called the process "RMB internationalization," largely in acknowledgment of both the immediate impact of the policy change as well as its market trajectory. However one chooses to describe it, purposely increasing a currency's international role in the way many authorities ultimately envision has never been attempted for a country the size of China.[6] Monetary liberalization is by definition hazardous for any economy. It permits investors to move capital in and out of a country at will and removes controls over interest and exchange rates. Furthermore, where currency values have been kept low, as arguably in the case of the RMB, internationalization potentially opens the way for currency appreciation and, by extension, a decrease in the competitiveness of exports.

Indeed, for these reasons, most developing countries that have internationalized their currencies and opened their current and capital accounts have subsequently faced recession or a financial crisis. With this in mind, China has taken careful, risk-averse steps to internationalizing the currency. For the most part, the internationalization process has been one largely channeled via the liberalization of the current account. By internationalizing the RMB through trade channels, China has been able to minimize

1 Standard Chartered, "Global Focus: Hawks Doves and Parrots," March 25, 2015, https://www.sc.com/en/news-and-media/news/global/2015-03-25-global-focus-hawks-doves-and-parrots.html.

2 Recent monetary policies by Mario Draghi, for example, have been designed to weaken the euro in order to boost the flagging competitiveness of weak eurozone countries. See "Draghi's Dangerous Bet: The Perils of a Weaker Euro," *Spiegel*, January 28, 2015. Similarly, after its earlier efforts to cut interest rates hadn't done enough to dampen interest in the franc during the initial years of the eurozone crisis, the Swiss Central bank had announced allow the franc to appreciate such that one franc bought fewer than 1.2 euros (which in 2015) it had to reverse course on. See Neil Irwin, "Skyrocketing of the Franc in One Day Holds Lesson," *International New York Times*, January 17, 2015. Even the United States, according to Alan Greenspan, adopted a tacit "weak dollar" policy to help shore up the global financial system. See Alan Beattie, "Greenspan Criticises China but Warns US over Weaker Dollar," *Financial Times*, November 11, 2010. The article notes Greenspan's view that the United States is pursuing a policy of weakening its currency which is driving up exchange rates in the rest of the world.

3 In 2007, just before the financial crisis, China's current account surplus stood at nearly 10 percent of its GDP, and the country's foreign reserves topped $1.5 trillion. Hongying Wang, "China's Long March toward Economic Rebalancing," Policy Brief no. 38, Center for International Governance Innovation, April 2014, p. 11, https://www.cigionline.org/sites/default/files/cigi_pb_38.pdf. With such massive foreign exchange exposures, the 2008 crisis galvanized Chinese authorities to rethink the wisdom of relying so heavily on exports (and the accumulation of dollar denominated reserves) as a growth strategy. Today reserves amount to over $4 trillion.

4 Though the future of such surpluses remain in doubt, the IMF predicted as late as 2012 that once US growth accelerates, China's trade surplus—which has abated somewhat since the crisis—would rise and reach 4.3 percent of its GDP by 2017 under current trends. Ibid., p. 3.

5 Allowing the RMB to trade on the open market, and on a global basis, would provide space for the currency to appreciate—and in the process increase wages that have, like exports, been artificially cheapened (suggest sharing the fact comparing the trade-weighted appreciation/depreciation rates) due to the RMB's peg to the dollar. As the Chinese people enjoyed more wealth, their consumption patterns would change (and increase), and shift the structure of the economy. Less debt, meanwhile, would have to be loaned out to creditor countries in foreign currencies to help them purchase (often Chinese) goods. Meanwhile, internationalizing the currency could help to allocate capital in ways that better supported both a consumer-based economy and competitive exports. Because of strict capital controls, Chinese savers have been forced either to invest in banks with capped interest rates on deposits or put their money in occasionally dodgy "wealth management products" and privately placed debt instruments called trusts (and more derisively called "shadow banks") that now sport over RMB 13 trillion in assets. Freeing the capital account would unlock competition and give them more choices as to how to deploy their capital at home and abroad. Domestic borrowers would have to improve rates of return—and increase opportunities in services sectors sidelined in export driven economies. This would in turn lead to more money flowing from underperforming fixed assets to more productive services, health and technology sectors—and in the process boost productivity and long-term growth.

6 Although the United States did take steps to internationalize the dollar between World War I and World War II, its policy approach did not evolve along the same state-sponsored pathway as the RMB.

some of the disruption that could upend the safety and soundness of its domestic banking system. Meanwhile, liberalization of the capital account—which is also necessary for internationalization, since users of a currency need avenues for not only storing capital, but also for putting it to its most productive uses—has been more incremental. The ability of investors to commit capital to the purchase and issuance of securities has depended on targeted but rapidly expanding tactical programs and schemes that are based on a variety of factors, including:

- The creation of an offshore market with few capital account restrictions (called the "CNH market" and anchored in Hong Kong by the "dim sum market");
- Targeted investment schemes into the country with specific country and individual quotas (under initiatives termed "Qualified Foreign Institutional Investors (QFII)" and "Renminbi QFII (RQFII) programs");
- Two way channels allowing companies to sweep money on- and offshore between affiliates (including programs establishing zones of deregulated trade and finance such as the "Shanghai Free Trade Zone"); and
- A series of mutual recognition programs, including the "Hong Kong-Shanghai Stock Connect" (HK-SH Stock Connect) program, allowing investors to invest in one another's on- and offshore markets.[7]

Even with its limited approach to capital account liberalization, this two-pronged strategy to currency internationalization is already transforming cross-border trade and services:

- Transactions settled in RMB have increased thirteen-fold from the first six months of 2011 to the first six months of 2012.[8] The RMB is now used in more than 22 percent of China's trade settlement;[9]
- RMB climbed to fifth place in the ranking of global payment currencies at the beginning of 2015, up from thirty-fifth in 2011,[10] before falling to a still impressive seventh place in the spring;
- RMB-denominated bonds have now been listed in the United Kingdom (UK), Luxembourg, Germany, and France and throughout Southeast Asia, as well as traded on the over-the-counter market. This is occurring just as firms in the United States and Europe are now directly investing in China's onshore capital markets for the first time;[11]
- More currencies in East Asia now co-move with the RMB than with the dollar or the euro, a point most recently demonstrated by economist Arvind Subramanian. South Korea, Indonesia, Malaysia, the Philippines, Taiwan, Singapore, and Thailand all track the RMB more closely than the dollar. The dollar only dominates in Hong Kong, Vietnam, and Mongolia. Even beyond Asia, the RMB is the dominant reference currency for Chile, India, Israel, South Africa, and Turkey.

The degree of change in some ways reflects the small base from which internationalization started, given the historically strict controls in place for the currency. But it also reflects the extent to which even modest internationalization will reshape global capital markets. Because of the closed capital account, global allocations to China (estimated at less than 0.01 percent of global portfolios) are, regardless of decelerating growth, severely underweight. This discrepancy means that even modest changes in investment behavior will have an outsized impact. China's representation in global equity benchmarks stands at about 2 percent, even though China represents approximately 13 percent of global gross domestic product (GDP) and 11 percent of global market capitalization. As a result, even if (or, more accurately, when) global portfolios are reweighed in light of the unfolding regulatory changes to place China at just 5 percent, this would imply a shift of $1.5 trillion worth of assets into QFII, RQFII, and HK-SH Stock Connect or offshore bond markets, which today stand at only an estimated $77 billion in total allocated assets combined. Similarly, but over the longer term, once China's GDP per capita reaches $40,000, which by some accounts is expected by 2050, the Investment Company Institute's statistical analysis suggests that China's long-term mutual fund assets could reach $11.8 trillion (or 21 percent of GDP) to upwards of $15 trillion.[12] The question, as a result, is just how to accommodate these changes in a way that is efficient and safe for the global financial system.

A Blueprint for (Transatlantic *and* Transpacific) Coordination

In principle, the internationalization of the RMB, in both its current, "partially" liberalized form and in a more robust, "fully" internationalized status, holds a range of potential benefits for transatlantic investors and the global financial system:

- RMB internationalization, along with an eased capital account, portends a rebalancing of the global economy for more sustainable growth;
- Political frictions involving claims of "currency manipulation" will be eased as the RMB is subject to greater market influence;
- At its best, the internationalization process will promote market reforms in China, leading to a more competitive, consumer-oriented economy;
- Firms and investors in the United States and Europe will enjoy new means of diversifying their portfolio

7 Descriptions of each of these programs are provided in the balance of this report.

8 Sebastian Mallaby and Olin Wethington, "The Future of the Yuan: China's Struggle to Internationalize Its Currency," *Foreign Affairs*, January/February 2012, http://www.foreignaffairs.com/articles/136778/sebastian-mallaby-and-olin-wethington/the-future-of-the-yuan.

9 Yves Mersch, Member of the Executive Board of the ECB, speech at Renminbi Forum Luxembourg, "China: Progressing towards Financial Market Liberalisation and Currency Internationalisation," February 26, 2014, http://www.ecb.europa.eu/press/key/date/2014/html/sp140226.en.html.

10 J.P. Morgan Treasury Services Market Update, "China's Economic and Political Trends and Their Impact on the U.S.," December 10, 2012, https://www.jpmorgan.com/cm/BlobServer/China_s_Economic_and_Political_Trends.pdf?blobkey=id&blobwhere=1320602031429&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs.

11 Kenneth Rapoza, "In China, European Companies Investing More Than Americans," *Forbes*, May 16, 2013, 2:49 p.m., http://www.forbes.com/sites/kenrapoza/2013/05/16/in-china-european-companies-investing-more-than-americans/.

12 L. Christopher Plantier, "Globalisation and the Global Growth of Long-Term Mutual Funds," *ICI Global Research Perspective*, vol. 1, no. 1. March 2014.

investments in domestic securities markets, China's onshore markets, and other RMB financial centers;

- China's savers, likewise, will have more opportunities to invest their savings globally; and
- Earnings made in China and other "trapped cash" will be able to be repatriated abroad, just as RMB profits earned abroad will be able to be put to use in China.

Still, internationalization creates a number of challenges from the standpoint of global governance and international economic cooperation. At a minimum, the rise of the RMB will create or exacerbate conflicts along the transmission of three very different policy dimensions:

- *Monetary Policy*. Even the partial internationalization of the currency will impact China's transmission of monetary policy. Capital account liberalization will reduce the government's ability to control interest rates and steer savings to preferred borrowers. Similarly, liberalization undermines exchange rate controls. The RMB will thus be able to appreciate, as well as potentially depreciate, depending on China's economic fundamentals and competitiveness, as well as possible outflows of "hot money" insofar as the stock market falters and the United States raises interest rates. Still, Chinese monetary authorities, if successful in achieving moderate levels of internationalization, will begin to enjoy new powers of monetary seigniorage, just as the US dollar could see its dominance gradually erode as the global financial system develops along "multipolar" lines.
- *Regulatory Policy*. Internationalizing the RMB will place new pressures on the Chinese government to reform its market supervision and bolster the credibility of RMB denominated/Chinese investments and infrastructure. China's interest rate policies will also have to continue to be liberalized in order to prevent household deposits from exiting the domestic banking system and undermining domestic financial stability. At the same time, as China's domestic infrastructure grows and develops, and as foreign market participants operate in on- and offshore RMB markets, regulatory authorities will be increasingly well-positioned to export their own domestic policy preferences to the international community. US and EU regulatory authorities, as a result, will increasingly be not only "makers" of financial regulatory policy, but "takers" as well, creating new frictions in cross-border policymaking.
- *Foreign Policy*. The lucrative nature of RMB internationalization will provide the Chinese government with more tools to reward and strengthen ties with trade partners and potential allies, as well as promote the competitiveness of its onshore financial system and offshore financial institutions. US and European countries have departed on how to engage these developments. Europe has actively engaged China to construct offshore centers—and EU member states competing with one another for RMB infrastructure—while the United States has been conspicuously absent, and Toronto has aspired to become the leading RMB center in the Americas. Furthermore, over the long term, internationalization will enable the Chinese government, if it so chooses, to leverage its financial system in ways that punish actors for not only prudential, but also undesired political policy postures, in much the same way that the United States and the EU now are capable of doing. Likewise, the development of alternative channels of finance has the potential to undermine the effectiveness of US and EU use of the financial system to influence behavior.

How these fissures are handled will impact not only the speed at which the internationalization process unfolds, but also the extent to which cross-border risks and fissures are addressed and market opportunities grasped for authorities on both sides of the Pacific and Atlantic Oceans. In short, depending on the economic statecraft and strategy employed by policymakers, RMB internationalization can result in "currency wars" or turf battles, fragmented market structures enabling systemic risk, and diminished opportunities for firms and financial institutions to manage their foreign exchange risks.[13] To that end, the paper announces a range of principles—touching on legal reform, capacity building, changes in the IMF's SDR, and, critically, nondiscrimination—and advocates a number of policy measures:

- China's legal infrastructure should be enhanced to meet the demand and growing use of the RMB. RMB internationalization has relied on the sheer weight of the Chinese economy and expected appreciation of the currency. But as the Chinese economy slows, and the issue of internationalization reaches more skeptical policy audiences and investors, **capital account liberalization will increasingly require reliable and predictable rules to support the ownership, transfer, pledging, and investment of the currency.** Furthermore, Chinese authorities will have to be able to credibly demonstrate to market participants that they will have the information needed to assess the rewards, risks, and opportunities of market activities relating to the currency and RMB-denominated financial products. We thus suggest that China:
    - continue to upgrade transparency concerning RMB infrastructure and RMB-denominated products, and along with current reforms in clearing and settlement, adhere to best international standards in accounting, market supervision, credit rating agencies, and derivatives contracts; and
    - move swiftly to entrench bankruptcy, debtor-in-possession (DIP) financing credit stress protocols and other crisis management devices where, especially in the Shanghai Free Trade Zone, capital account liberalization is accelerating.

13 To see how China's influence is being transmitted through financial linkages including its controlled exchange rate movements and monetary policy, see Chang Shu, Dong He, and Xiaoqiang Cheng, "One Currency, Two Markets: The Renminbi's Growing Influence in Asia-Pacific, *China Economic Review*, vol. 33, April 2015, pp. 163-178, http://dx.doi.org/10.1016/j.chieco.2015.01.013.

- Trans-Pacific capacity building is required among regulators. RMB internationalization, if successfully executed, will help establish healthier and better balanced global growth. But deeper levels of cross-border coordination will also be required.[14] Up to this point, collaboration, even at the bilateral level, has been targeted, with select regulatory authorities (especially in Hong Kong). In the future, however, RMB internationalization will need to be subject to specifically tailored working groups at the Bank for International Settlements (BIS), Committee on Payments and Market Infrastructures (CPMI), International Organization of Securities Commissions (IOSCO), Financial Stability Board (FSB), and other relevant international standard setting bodies. Furthermore, even national agencies (e.g., European Securities and Markets Authority (ESMA), US Securities and Exchange Commission (SEC), European Banking Authority (EBA), US Federal Deposit Insurance Corporation (FDIC), and others) will need to bolster staff with Chinese regulatory and market specialists or improve (and in most instances create) secondment programs with Chinese regulatory officials and vice versa in order to raise awareness and avoid needless misinterpretations and conflict as RMB denominated products and Chinese investments become more popular.
- The IMF should include the RMB as a reference currency for IMF Special Drawing Rights. The RMB is not yet included in the IMF's basket of reference currencies. Recent reforms strongly suggest, however, that this longstanding policy stance should be reversed. The IMF itself has found the currency to be fairly valued. Moreover, China has liberalized its current account, significantly opened its onshore capital markets, and is accelerating an already unprecedented process of building offshore RMB financial centers. **The IMF's Executive Committee**, led by the United States and EU, **should** thus **devise in 2015 appropriate measures for including the RMB in the SDR**. This step should, however, be operationalized thoughtfully. **We propose that the RMB's weight in the updated system should not only reflect the degree to which the currency is "freely usable" but also the extent to which sufficient macroprudential reforms have been introduced by banking and securities authorities to support capital account liberalization in a possibly volatile exchange market.**
- Prudential concerns and nondiscrimination principles should trump politics—and Western institutions should participate in the internationalization process. Although currency internationalization is at times inherently a political process to the extent to which it affects levers of foreign policy, **authorities supervising market participants should make regulatory decisions on economic and prudential grounds**. In both jurisdictions, rules and regulations relating to the authorization of one another's institutions to transact, trade, and operate should be clarified in advance and applied consistently regardless of national origin. Furthermore, just as the RMB should be integrated into a multilateral monetary system, Western financial institutions should be actively involved in (both market and official) clearing bank programs, data processing, and infrastructure services provision for the increasingly global RMB, both on- and offshore. In their absence, internationalization will not only be slower, but face questions of credibility in many financial centers.

14 Indeed, the Third Plenary Session of the 18th CPC Central Committee concluded in 2013 to, among other things, "speed up the building of new competitive advantage in participating in and leading international economic cooperation." See Daniel H. Rosen, *Avoiding the Blind Alley: China's Economic Overhaul and Its Global Implications* (New York: Asia Society Policy Institute and Rhodium Group, 2014), p. 55, http://asiasociety.org/files/pdf/AvoidingtheBlindAlley_FullReport.pdf.

THE CURRENCY INTERNATIONALIZATION PROCESS—AND WHAT MAKES CHINA DIFFERENT

The internationalization of major currencies tends to follow an evolutionary process in which a currency evolves from being merely an instrument for invoicing and trade to a means of investment and eventually a staple of central bank reserves. This continuum reflects the fact that a currency achieving internationalization has to be supported by a country with the size and weight necessary to generate and support transactions around the world denominated in its currency. It also recognizes that internationalization, though requiring a willingness of the issuing government to allow an offshore market to provide a global transmission system for the distribution and deployment of the currency, ultimately relies on the faith of market participants and foreign governments in the currency as a reliable instrument of commerce and holder of value.

This pattern identified above is one associated with the rise in dominance of the US dollar in the twentieth century. Although the dollar was adopted as the monetary unit of the United States in the late 1780s, the desirability of dollar-denominated instruments was limited due to the youth and economic fragility of the country and the absence of a national central bank. With the creation of the Federal Reserve in 1913 and the post-World War I emergence of the United States as the world's largest economy, the dollar was poised for international dominance. However, it was not until after World War II—with the launch of the Marshall Plan to rebuild Europe and the creation of the Bretton Woods system (in which the US government effectively provided the world with US dollar liquidity)—that the dollar was formally recognized as the world's international currency. And even then, global liquidity for the dollar did not fully take root until an offshore financial system based in London emerged to provide a critical distribution system for processing and recycling US dollar transactions.

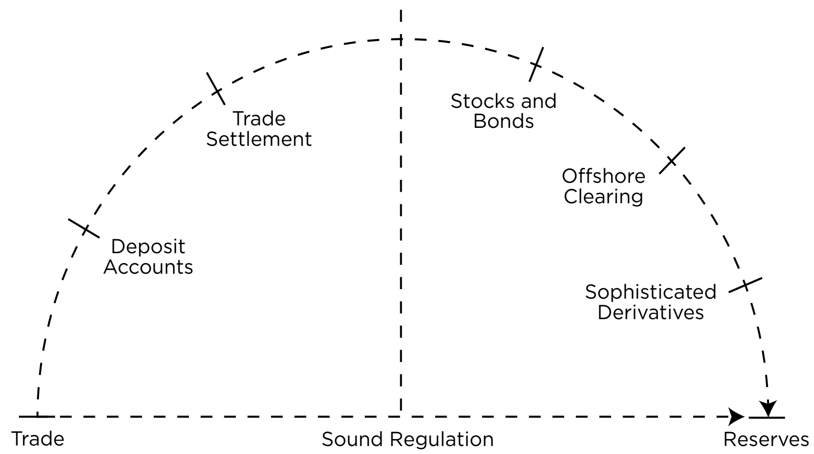
China's liberalization process hews to some of these historical patterns, while taking its own unique path. Its starting point is very different from that of the United States. In contrast to the mid-twentieth century dollar, the RMB has been largely nonconvertible and subject to capital controls and a currency peg. Its financial markets are also young and untested and have been relatively closed to the world. As a result, there is little widespread market or regulatory familiarity with the currency or with the policy of the People's Bank of China (PBOC). Indeed, Chinese authorities have not explicitly or implicitly suggested a willingness to provide the world with the RMB liquidity via official or market channels to support unfettered internationalization, or to accept the kind of volatility in its financial markets that a floating, globally-circulating and -traded currency would entail.

As a result, the internationalization of the RMB has been primarily operationalized via China's status as a leading trading nation. Capital account liberalization has meanwhile been more incremental, with targeted channels of liberalization relating to, among other things:

- Who can move RMB on- and offshore;
- How much RMB can be moved and how often;
- Where the RMB can be moved;
- Who can invest in onshore and offshore RMB capital markets; and
- How much (and what kind of) permission is required to do any of the above.

This approach to currency internationalization has both market and strategic relevance. Partial liberalization gives policy space for regulating the flow of money in and out of the country and can meaningfully assist in curbing macroprudential risks in the absence of mature financial market supervision. It can also allow officials to ease the blow of deep structural reform. But many critics have argued that selective liberalization provides additional opportunities for discrimination against foreign enterprises and market participants, for both political and economic purposes, and can slow the implementation of changes needed to secure the long-term success of China's economy.

Evolutionary Process of Currency Internationalization



Source: Chris Brummer

THE LAUNCH OF RMB INTERNATIONALIZATION: OFFSHORE DEPOSITS AND TRADE SETTLEMENT

The internationalization of the RMB has its origins in 2004, when the Chinese government permitted the creation of offshore RMB bank accounts. For the first time, people could hold and manage RMB savings outside the mainland that are subject to local rules and protections.[15] Then in 2010, following a breakthrough clearing agreement signed between Hong Kong and Chinese monetary authorities, the RMB became transferable between accounts[16] and virtually "all restrictions on [offshore] foreign exchange transactions, borrowing, and lending in CNH by Hong Kong and foreign institutions" were eliminated.[17] From there, global deposits surged, as they could be used to hold the currency as a store of (presumably appreciating) value, fund purchases of RMB-denominated goods and services, and contain the proceeds of increasingly efficient offshore RMB fundraising.

Yet even this growth would not have been possible without China's 2009 decision to open its current account. Up to that point, commercial (trade) transactions had to be settled in a major foreign currency, usually US dollars or, to a lesser extent, Japanese yen. But in the wake of the 2008 crisis and the subsequent heightened concerns regarding foreign exchange exposures, the PBOC—China's central bank—initiated a pilot program whereby companies approved by mainland authorities would be permitted to use RMB to settle trade payments with customers or producers outside of China.[18] Two years later, the program was extended to exporters and importers throughout China, effectively liberalizing the country's current account.[19]

The importance of these reforms for the internationalization of the RMB is hard to overstate. By the mid-2000s, China had become the largest trading nation in the world by dint of not only its trading relationship with the United States, but also its deep economic ties to Greater Asia and, as a commodities importing country, to Africa and South America. It was, in short, a leading exporter of goods, a regional trading hegemon, and an importer of natural resources. Opening the current account thus created a major channel for internationalization. Domestic exporters could avoid hedging and foreign exchange transaction costs by selling goods in RMB. Foreign companies, meanwhile, could gain a competitive advantage by selling goods to customers in their local currency—or receive discounts on purchases—as well as access a currency likely to appreciate.

Today, over 20 percent of China's foreign trade is settled in RMB—up from just 3 percent in 2010,[20] and the Society for Worldwide Interbank Financial Telecommunication (SWIFT) estimates that the RMB is the second most commonly used currency in the world for trade finance and documentary credit transactions.[21] Notably, it would also create a powerful market mechanism for building up offshore RMB account liquidity as proceeds from commercial and trade transactions could be deposited and saved in deposit accounts in Hong Kong and eventually offshore financial centers in London, Singapore, and elsewhere. Energized by trade settlement and other official mechanisms, more than 900 billion in RMB deposits have accumulated in Hong Kong alone and over 1.6 trillion globally.[22]

15 There were, however, limits that until recently restricted how much individuals could buy in the foreign exchange market, and stood at 20k CNH from 2005 to 2014. See Becky Liu, "CNH CGB Auction: Yield Curve to Flatten Further," Standard Chartered, November 12, 2014, p. 4, https://research.standardchartered.com/configuration/ROW%20Documents/CNH_CGB_auction__Yield_curve_to_flatten_further_12_11_14_10_03.pdf.

16 Paola Subacchi and Helena Huang, "The Connecting Dots of China's Renminbi Strategy: London and Hong Kong," Chatham House, September 2012, http://www.chathamhouse.org/sites/files/chathamhouse/public/Research/International%20Economics/0912bp_subacchi_huang.pdf.

17 Joseph E. Gagnon and Kent Troutman, "Internationalization of the Renminbi: The Role of Trade Settlement," Peterson Institute for International Economics, May 2014, p. 2, http://www.iie.com/publications/pb/pb14-15.pdf.

18 ASIFMA, Standard Chartered, and Thomson Reuters, *RMB Roadmap* (May 2014), http://www.asifma.org/uploadedfiles/resources/rmb%20roadmap.pdf.

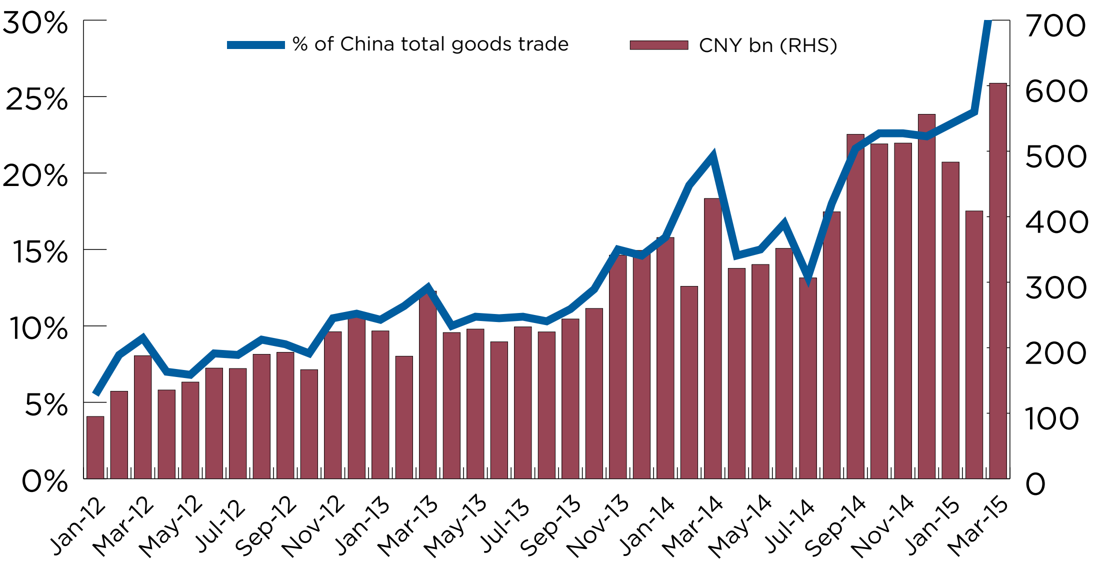
19 Barry Eichengreen, Kathleen Walsh, and Geoff Weir, Internalisation of the Renminbi: Pathways, Implications and Opportunities (Sydney: Center for International Finance and Regulation, March 2014), http://www.cifr.edu.au/assets/document/CIFR%20Internationalisation%20of%20the%20RMB%20Report%20Final%20web.pdf.

20 Kathleen Walsh, *RMB Trade Invoicing: Benefits, Impediments and Tipping Points* (Canberra: Australian National University, 2014), p. 3, chart 1, http://www.treasury.gov.au/PublicationsAndMedia/Events/2014/~/media/Treasury/Publications%20and%20Media/Events/2014/RMB%20Dialogue/RMB_trade_invoicing_report.ashx. However, this is still low compared with around 50–60 percent of the eurozone's external trade settled in euro, and 30–40 percent in yen for Japanese trade. The Hong Kong Monetary Authority (HKMA) expects RMB settlements to reach 30 percent by the end of 2015.

21 Sreeja VN, "Yuan Overtakes Euro as Second-Most Used Currency in International Trade Settlement: SWIFT," *International Business Times*, December 3, 2013, http://www.ibtimes.com/yuan-overtakes-euro-second-most-used-currency-international-trade-settlement-swift-1492476.

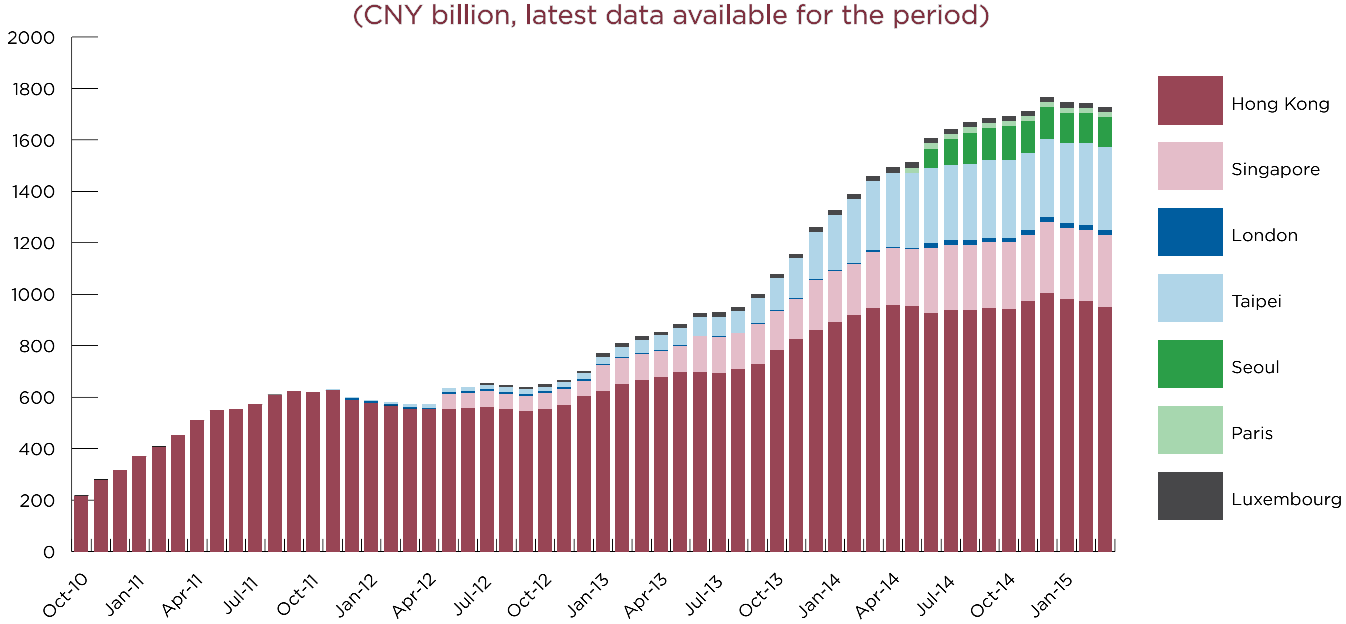
22 Barry Eichengreen, et. al., *Internalisation of the Renminbi: Pathways, Implications and Opportunities*, op. cit., p. 17.

China Total Goods Trade Settled in Renminbi



Source: CEIC, Standard Chartered Research

Renminbi Deposits among Selected Offshore Centers
(CNY billion, latest data available for the period)



Source: CEIC, Standard Chartered Research

Determinants of Offshore RMB Account Liquidity

1. Trade. Perhaps most commonly, an entity may be able to access the currency through simple current-account transactions. That is, a company may sell widgets to a firm in Beijing and receive RMB in exchange for the widgets.

2. Foreign Exchange (FX). People, companies, and governments can also convert their euros and dollars, and other major currencies into RMB through FX transactions and deposit the proceeds in their accounts.

3. On- and Offshore Capital Markets. Firms routinely access RMB via the sale of securities. For example, a company may do a bond offering (in the dim sum market or other offshore market) denominated in RMB and deposit the proceeds in an offshore bank account. These deposits may also be used to purchase securities.

4. Cross-border Cash Pooling Structures. Increasingly, companies have the ability to move cash on- and offshore between affiliates and their accounts.

But note: As channels to move RMB onshore increase, they may draw on offshore deposit bases as companies put capital to work in China (see QFII, RQFII, and the two-way channels, discussed below).

ONSHORE INVESTMENT CHANNELS: QFII, RQFII, AND THE INTERBANK INVESTMENT PROGRAM

China has also worked to liberalize its capital account domestically by offering foreign investors more access to its domestic capital markets—a process that when finished will rank as the most significant change in global capital markets in the last half century.

China's domestic stock markets are younger than their Western counterparts, with both the two primary exchanges, the Shanghai and Shenzhen exchanges, having opened in 1990. Since then, the country's stock markets have developed rapidly, with the Shanghai exchange hosting larger, more developed corporate mainstays in ways analogous to the New York Stock Exchange (NYSE), and Shenzhen serving small, medium, and emerging growth (often technology) companies similar to NASDAQ. With roughly 2,500 companies between them, China boasts a stock market capitalization second only to the United States, though the liquidity and participation are well below those seen in the West. Both exchanges are regulated by the China Securities Regulatory Commission (CSRC).

Considerably more imposing than the equities market is China's domestic bond market, which, according to some reports, is already the world's third-largest, after the United States and Japan. Bonds trade on limited, overlapping markets. The interbank bond market (an over-the-counter market) accounts for 95 percent of volume and trades on a system called the China Foreign Exchange Trade System (CFETS). CFETS, which operates alongside ICAP, is regulated by the PBOC and the exchange markets by the CSRC.[23] Fixed income securities like Chinese government bonds and bonds called enterprise bonds that are issued by central and local state owned enterprises can trade on exchanges. Recently, foreign issuers have been permitted to issue RMB denominated bonds onshore (called "Panda Bonds"), with the first being Daimler's 500 million renminbi offering in March 2014. Foreign ownership accounted for 2.4 percent of Chinese government bonds, and 1.9 percent of the overall China's bond market in 2014.

QFII and RQFII

Investors primarily rely on three channels to invest in the stocks and bonds listed on the Shanghai and Shenzhen exchanges, as well as over-the-counter bonds, investment funds, and other instruments. The first is the Qualified Foreign Institutional Investors (QFII), which was established in 2002 and enables foreign investors to invest in China's domestic capital markets using foreign currency obtained outside of China (usually US dollars).[24] For investments to be legal, the CSRC is required to first approve an investment license for the prospective investor, after which the State Administration of Foreign Exchange (SAFE) approves the quota limit. Non-sovereign sector investors are permitted a maximum quota of $1 billion under QFII, with a minimum application amount of $50 million. Since December 2012, the Chinese government has allowed sovereign investors to exceed a previously-set $1 billion investment quota limit. Sovereign QFIIs are also able to repatriate their principal and investment returns after a lock-up period of just three months, as long as the monthly remittances do not exceed 20 percent of the total onshore assets in the previous year.[25]

The foreign investment scheme was supplemented in December 2011 with the launch of RQFII. Under this program, foreign investors enjoy access to the domestic markets using RMB funding obtained from outside mainland China. Between these two formal programs, RQFII demand is by most accounts growing faster, with more than CNY 329 billion in RQFII quota allocated in just under four years. China is looking to increase connectivity with offshore markets by making it easier to obtain investment quotas and allowing wider investment scope to encourage two-way flows. Certain changes—including the introduction of a registration system for QFII and RQFII that may shorten the approval process for quotas, greater flexibility for QFII (i.e., becoming similar to RQFII), and the possible expansion of investment scope to include repos and derivatives such as interest rate swaps—are expected later in 2015.

The RQFII is also generally a more flexible scheme.[26] Under QFII, the CSRC requires investors to devote at least 50 percent of their capital to equities and no more than 20 percent to cash, whereas the RQFII program currently imposes no such restrictions. Furthermore, QFII investors must repatriate their money in the form of the currency that they used to invest it, whereas RQFII can choose to repatriate in either RMB or foreign currencies. Both funds are, however, usually subject to a yearlong lock-up period. Where 70 percent of capital is invested in shares, however, no lock-up period is imposed under RQFII, and under QFII, lock-up periods are reduced to only three months.[27]

Interbank Investment Program

The final initiative of note is the interbank investment program, overseen by the PBOC, which gives foreign investors direct access to China's onshore interbank bond market within a quota assigned by the central bank. It offers the greatest flexibility of the three programs, but is limited to six types of foreign investors: foreign central banks, sovereign wealth funds, RMB clearing banks, RMB settlement banks, supranationals, and insurance companies.[28] Part of its breadth is due to the fact that the pro-

23 Becky Liu, "China Onshore Bond Compendium 2014," Standard Chartered, April 29, 2014, p. 1, https://research.standard-chartered.com/configuration/ROW%20Documents/China_onshore_bond_compendium_2014_29_04_14_07_34.pdf.

24 Ibid.

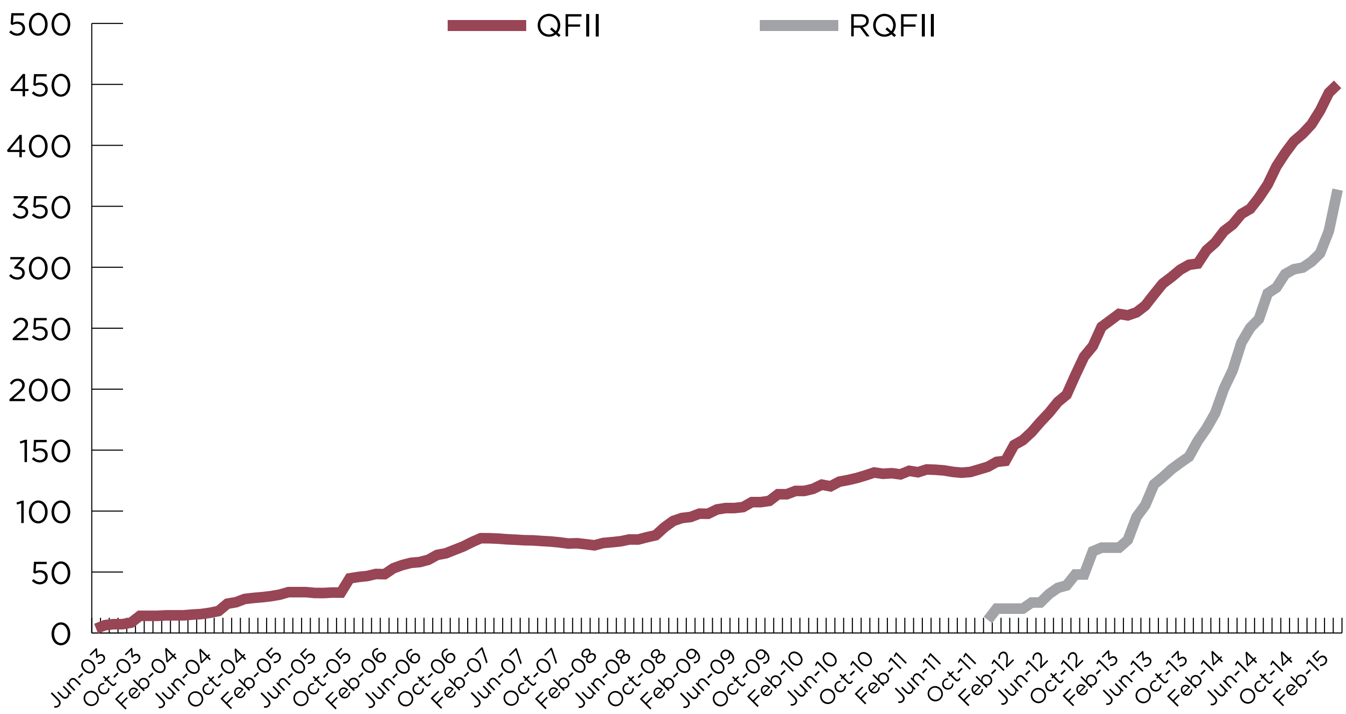
25 As of end of 2014, twenty-seven sovereign entities have received quotas and are accessing the Chinese stock and bond market, including eight central banks, with over half having recently been approved for investing. And three sovereigns—the Hong Kong Monetary Authority, Norges Bank, and Temasek—have now exceeded this limit. On the private side, BlackRock is one of the most aggressive players in the QFII space, and has received a quota allocation of US$600 million. Nearly US$72,149 million has been approved under the program.

26 For an in depth comparison, see Becky Liu, "China Onshore Bond Compendium 2014," op. cit., p. 25.

27 Lock-up periods are also only three months long under QFII where pension funds, insurance funds, charity and endowment funds, governments, and sovereign wealth funds (SWFs) make investments. Ibid.

28 Ibid., p. 19.

Approved Investment Fund Quota Allocations (cumulative, CNY billion)



Source: CEIC. Standard Chartered Research

gram aims, above all else, to support internationalization and is not a first order scheme for channeling foreign direct investment, even though November 2013 statistics show that a total of CNY 600 billion of the quota had been assigned to 138 investors. The program's primary criticism is, however, that it lacks transparency.[29] Requirements relating to applicants' financial profiles and regulations concerning the repatriation of funding—along with approved investment quotas—are not publicly disclosed.

Note: Reforms for Asset Managers

Though still viewed as largely symbolic given the relatively limited liberalization offered, other less well known alternatives modeled in part after RQFII and QFII, including the Qualified Domestic Limited Partnership (QDLP) program, may gain more prominence. The program, launched in April 2015, enables overseas asset managers to establish qualified domestic private RMB funds, domiciled in Shanghai, to invest into offshore securities markets. In the first iteration of the program, however, only six hedge fund managers received quotas of $50 million each. A similar pilot program, dubbed the Qualified Domestic Investment Enterprise (QDIE), was introduced for Shenzhen in 2014.

29 Ibid., p. 20.

OFFSHORE RMB INVESTMENT VIA THE OFFSHORE RMB BOND MARKET

Alongside a domestic bond market, an offshore RMB market has been launched to support the internationalization process. As with many currencies in the past, offshore markets are useful and, in some instances, necessary conduits for recycling currency through the global financial system. For China in particular, offshore markets allow holders of the currency to put their money to use as an investment. Opening deposit accounts and the current account creates a channel for pushing liquidity abroad. But for it to stay there, there must be a counterparty willing to hold it.[30] Otherwise, the exporter will simply convert RMB into another international currency or its home currency, especially where, as has been the case, restrictions have been placed on investing money onshore due to the volatility and risk that cross-border capital flows can create.

The most important channel outside of China for RMB-denominated investment has traditionally been the "dim sum market." Though the term can have varying connotations, dim sum bonds are largely understood to be commercial and government bonds issued outside China in the international market (thus in Hong Kong and elsewhere) but denominated in offshore RMB. As a result, there are no restrictions on the use of proceeds unless companies seek to repatriate the funds onshore.[31] Bond covenants are also notably subject to the global standard, and Hong Kong boasts an internationally recognized legal framework for resolving contractual disputes and running insolvency proceedings.[32]

RMB bonds began to trickle cross border in 2003, as reforms in deposit taking and personal banking services were introduced. The offshore RMB-denominated bond market was, however, officially inaugurated in July 2007, when China-based firms, led by the China Development Bank, were permitted to issue bonds in Hong Kong. Then, in July 2010, the Chinese government gave foreign, non-financial companies the right to issue RMB-denominated bonds outside of China's otherwise closed capital markets.[33] The first foreign multi-national company to successfully secure permission from the government and take advantage of the program was McDonald's, which raised CNY 200 million one month later. Today, the dim sum market is mostly dominated by small, denominated, and short-term issuances; however, a number of major market participants have issued offshore securities—from the Chinese Construction Bank and state-owned enterprises like Shanghai Baosteel to foreign financial institutions and corporations like Standard Chartered Bank and Caterpillar Financial, respectively. The Ministry of Finance has also issued longer term bonds of thirty years to set up an offshore market yield curve.[34]

In just five years, the dim sum market has emerged as a viable funding option for corporations, regardless of their size. And the market's growth has been, in many ways, explosive.

The expansion of the offshore bond market can be attributed to several factors. First, increasingly large pools of RMB liquidity were located offshore since the mid-2000s—made possible by reforms relating to trade settlement, discussed above, and related growth in offshore deposits. Second, investors had few channels through which to invest in either Chinese companies or the RMB itself. Government programs (like the QFII program, discussed below) permitting foreign investors to directly invest onshore or repatriate profits or cash onshore were limited or not yet in existence, leaving offshore bond markets to be the only practical outlet for RMB-denominated investments in many instances. Many issuers did not complain, since offshore interest rates were often lower than onshore rates, just as the RMB traded at a premium vis a vis the US dollar. So as offshore RMB grew, banks quickly began redeploying their proceeds in the dim sum market.

Still, recent data indicate that many of the structural tailwinds in place at the inception of the dim sum market are now reversing course. Intervention by the Chinese government to hold down the yuan, along with a steady appreciation of the US dollar, have curbed the RMB's appeal. This has in turn contributed to a shortage of yuan offshore, which drove up general borrowing costs as well as the costs for borrowing RMB in the cross-currency swap (CCS) market.[35] Meanwhile, the onshore bond market is becoming more attractive to issuers and more available to foreign investors. Chinese regulators have, among other things, reduced reserve ratio requirements, allowing banks to make more investments at less cost for borrowers. Moreover, the PBOC has lowered interest rates to stimulate the sagging Chinese economy, moving onshore and offshore rates closer together.

At the same time, and critically, an increasing array of channels became available for the onshore repatriation of offshore funds after existing quotas allocated to foreign investors increased (see RQFII, QFII, and Interbank programs discussed below). A series of new programs is also in development, aimed at increasing the ability of investors to put their capital to work onshore (see HK-SH Stock Connect and two-way cash pooling, discussed below). Though these factors all help to promote the RMB, they have at least partially muted the short-term effect of reducing the luster of the offshore bond market and the offshore deposit system.

30 Barry Eichengreen, et. al., *Internalisation of the Renminbi: Pathways, Implications and Opportunities*, op. cit., p. 100.

31 Though even here, rules have weakened dramatically. New FDI rules introduced in March 2012 have made it easier to issue CNH bonds and bring the proceeds onshore, as have new innovations like the cash pooling made available in the SHFTZ.

32 Yin Wong Cheung, "The Role of Offshore Financial Centers in the Process of Renminbi Internationalization," in Barry Eichengreen and Masahiro Kawai eds., *Renminbi Internationalization, Achievements, Prospects and Challenges* (Tokyo and Washington, DC: Asia Development Bank Institute and Brookings Institution Press, 2015), p. 216.

33 John Maxfield, "How Dim Sum Bonds Will Change the World," Motley Fool, February 10, 2012, http://www.fool.com/investing/general/2012/02/10/how-dim-sum-bonds-will-change-the-world.aspx.

34 Yin Wong Cheung, "The Role of Offshore Financial Centers in the Process of Renminbi Internationalization," op. cit., p. 216.

35 One particular challenge is that, as liquidity has dried up, the yields on cross currency swaps have increased and with them the cost. This in turn may have a negative impact on the dim sum market, since foreign investors heavily rely on CCSs to borrow RMB-denominated money for use in purchasing dim sum bonds.

Evolution between 2007 and 2015 of the Gross Issuance of Dim Sum Bonds (CNY 100 million)

Type	*Initial Balance*	*Issues*	*Issues (%)*	*Issue Amount*	*Issue Amount(%)*
Eurobond	22.34	7,868	75.81	8,377.96	45.78
Korea	0.00	20	0.19	18.68	0.10
France	0.00	27	0.26	84.37	0.46
United States	0.00	1	0.01	0.00	0.00
Germany	0.00	8	0.08	331.60	1.81
Taiwan	5.58	75	0.72	490.86	2.68
Thailand	0.00	1	0.01	1.26	0.01
Switzerland	0.00	5	0.05	3.08	0.02
Singapore	0.00	2	0.02	7.40	0.04
Hong Kong	0.00	2,372	22.85	8,987.05	49.10
TOTAL	27.92	10,379	100.00	18,302.27	100.00

Source: Thomson Reuters

Nevertheless, even as interest rates and currency valuations have in some instances converged, the dim sum market offers a number of important advantages over the onshore market for foreign investors. Perhaps most importantly, offshore RMB investments are not subject to lock-up periods (and thus are distinguishable from RQFII and QFII) and can be repatriated anywhere without government intervention as long as they are not channeled back into China; moreover, investments escape many of the capital gains taxes applied onshore. Thus, investors enjoy more flexible cash management and more favorable tax treatment. The dim sum market is also adapting to make itself more attractive to foreign investors over the longer term. The dim sum market has been criticized since its inception for a relative absence of rated products. Consequently, participants have worked assiduously to increase the number of rated, fixed-income products as a more mature market has emerged that is as concerned with credit risk as currency appreciation. More ratings have in turn opened a pathway for more foreign institutional investors and funds to participate in China's economic growth.

ADDITIONAL (TWO-WAY) INVESTMENT CHANNELS: THE HONG KONG-SHANGHAI STOCK CONNECT, CASH SWEEPING, AND FREE TRADE ACCOUNTS

In addition to programs offering targeted paths for investors to channel RMB investment money into targeted offshore programs (like the dim sum market) or specifically into the mainland (via QFII and RQFII), other programs offer flexibility for bilateral flows of RMB and investment *both on- and offshore.*

The Hong Kong-Shanghai Stock Connect

The first is the Hong Kong-Shanghai Stock Connect program, which allows global investors to buy Shanghai-listed shares through Hong Kong and investors on the mainland to trade Hong Kong-listed shares through Shanghai. Under the terms of the program, investors can trade eligible shares listed in Shanghai by routing orders through Hong Kong brokers and a securities trading service established by the Hong Kong Stock Exchange. Meanwhile, eligible investors in China will be able to place orders with the help of local brokers and a firm established by the Shanghai Stock Exchange to trade shares listed on the Hong Kong Stock Exchange. The China Securities Depository and Clearing Corporation and the Hong Kong Securities Clearing Company will clear the transactions.[36]

The program presents an unprecedented opportunity for retail investors outside China to trade Chinese stocks alongside their more sophisticated institutional counterparts.[37] However, trading has been slow by many measures, in part due to regulatory controls on the capital account, which have undermined the program's short-term effectiveness.[38] Shanghai's settlement system for stocks differs from that of many international counterparts. Investors selling A-shares have had to initially "pre-deliver" their shares to brokers on the day prior to the trade, generating settlement risks because investors have two days between the delivery of their shares and receipt of payment. Furthermore, once the quotas under the program are reached (CNY 13 billion for northbound investors and CNY 10.5 billion for southbound investors), buy orders are prohibited, and investors are only permitted to sell.[39] Similarly, once a government-imposed limit of 10 percent foreign ownership of any one stock is breached, a forced sale procedure is undertaken at the end of the day. With such risks, hedge funds, as opposed to longer-term, risk-averse investors (who have largely continued to rely on QFII and RQFII) have been the first to enter the market.[40]

The lack of cross-border coordination also stymied the launch. Although an unprecedented degree of cooperation between the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities and Futures Commission (SFC) was necessary to get the program off the ground, there was limited coordination with other offshore financial authorities in London and Luxembourg.[41] As a result, concerns about the ownership rights of shares subject to pre-delivery caused authorities to temporarily delay permitting funds from investing in the link.[42] Furthermore, European fund managers were only given one week's notice concerning the start date of the program, delaying their participation since many needed client approval before proceeding. This delay slowed the impact of the capital account reforms.

That said, the program is still widely hailed by market participants and commentators as a breakthrough. Already capital flows have increased dramatically with more buoyant stock markets, especially on the mainland. And over time, it will serve as a major conduit for two-way portfolio investment. With investment portfolios underweight in China-related investments, most experts expect the existing quotas to be quickly surpassed once initial regulatory hurdles are addressed. Furthermore, additional programs like the Stock Connect are under consideration—not only with Shenzhen's exchange for early stage companies, but also with exchanges in Europe and Asia. Similarly, SFC and the CSRC have initiated a potentially pathbreaking mutual recognition program between Hong Kong and China investment funds. Still, concern is growing as China's historic equities bull market run continues at least in part on the back of accommodative Chinese monetary policy. If the market was, in short, to suddenly falter or crash, not only could foreign investors become more tepid in their approach to investing in China, but Chinese regulators too could slow the pace of liberalization and reform.

Two-Way Cash Pooling and RMB Sweeping

Another key program involves so-called "two-way cash sweeping" for multinational corporations to enable more efficient cash management. In 2013, the PBOC allowed companies registered in the Shanghai Free Trade Zone (SFTZ) to remit working funds across the border and thus extend RMB intercompany loans to their offshore parent

36 ASIFMA, Standard Chartered, and Thomson Reuters, *RMB Roadmap*, op. cit., p. 24.

37 ASIFMA and Thomson Reuters, *The Through Train: Stock Connect's Impact and Future* (December 2014), p. 9, http://share.thomsonreuters.com/assets/forms/shanghai-hk-stock-connect-1008885.pdf.

38 Under the program, CNY 13 billion flow north into mainland equities each day and CNY 10.5 billion head south. The opening days of the program saw, however, a net departure of capital from Hong Kong to Shanghai and a draw of funds from offshore deposits and the dim sum market. As a result, HKMA is setting up a CNY 10 billion intraday repurchase facility and seeking to relax a cap on RMB purchases by the city's residents before local investors gain access to Shanghai's stock market to help smooth intraday money-market volatility. See Saikat Chatterjee, "CNH Tracker-Stock Connect Scheme Reduces Dim Sum Issuers' Costs," Reuters, November 20, 2014, 2:34 a.m., http://www.reuters.com/article/2014/11/20/markets-offshore-yuan-idUSL3N0T937X20141120.

39 ASIFMA and Thomson Reuters, *The Through Train: Stock Connect's Impact and Future*, op. cit., p. 9.

40 Ibid., p. 7.

41 Among the necessary measures was an unprecedented memorandum of understanding (MOU) concluded between the CSRC and the SFC, establishing a basis for cooperation on issues including market surveillance enforcement coordination and information sharing. Ibid., p. 6.

42 Michelle Price and Saikat Chatterjee, "Exclusive: EU Regulatory Concerns Curb China Stock Link Volumes, Reuters, November 28, 2014, 4:40 a.m., http://www.reuters.com/article/2014/11/26/us-hong-kong-china-stocks-exclusive-idUSKCN0JA0WY20141126.

companies, subsidiaries, or affiliates.[43] Since then, the program has evolved into a two-way cash sweeping tool, allowing funds to be reallocated in and out of the country.

The RMB sweeping program is widely hailed as one of the most important reforms under the SFTZ. Prior to the reforms, China-based companies required regulatory approval to borrow funds from overseas, and a foreign investment enterprise could exhaust quotas imposed by the government on the amount of debt it could borrow abroad (called a "foreign debt quota"), at which point they would be forced to borrow from onshore banks, where liquidity was not always stable, especially as the economic growth slowed. Today, companies can effectively compare offshore and onshore rates and remit excess liquidity via intercompany loans and transfers for operating use where needed. Moreover, firms can bring money in and out of the country while circumventing many restrictions of the RQFII and QFII programs, such as lock-up periods.[44]

Notably, the Chinese government has also introduced a pan-China program with similar aims. Under the new scheme, participating corporations in the same group will have access to many of the same benefits afforded under the SFTZ. To be eligible, each onshore affiliate company needs to have operated for at least three years in China, and the same amount of time applies to each offshore firm operating overseas. Furthermore, the sales turnover of the previous year needs to be at least CNY 5 billion for onshore participating companies and CNY 1 billion for offshore affiliates.[45]

Free Trade Accounts

A third imminent reform, also tied with the SFTZ, is the availability of so-called "free trade" accounts for Chinese residents and foreign companies. Under the pending reforms, the accounts will be treated like bank accounts outside of China. Thus, holders of the free trade accounts will be able to move funds offshore and, "when the time is ripe," use them for unrestricted foreign exchange transactions.[46] Holders will also be able to move funds to nonresident bank accounts in China but outside of the free trade zone.[47] Prior to the reforms, individuals or companies outside the free trade zone were required to seek approval from SAFE or show documented evidence for large payments, demonstrating that they are lawful (usually current account) transactions. As such, the reforms are viewed as particularly significant.[48] According to recent reports, five mainland banks have already received a permit, including three of the Big Four state lenders—Bank of China, Industrial and Commercial Bank of China, and China Construction Bank—as well as Shanghai Pudong Development Bank and Bank of Shanghai.[49] Ten foreign banks have opened subsidiaries in the zone and are expected to receive accounts by mid-2015.

What's the Shanghai Free Trade Zone?

The SFTZ was launched September 29, 2013 by Premier Li Keqiang as both a mechanism and symbol of the country's commitment to economic reform. In the SFTZ, Chinese officials plan to administer a range of liberalization efforts—in areas as diverse as trade, intellectual property, interest rates, and the cross-border flow of capital—and, where successful, gradually export the reforms to rest of the country.

43 Deutsche Bank, *At the Centre of RMB Internationalisation: A Brief Guide to Offshore RMB* (2014), p. 24, https://www.db.com/en/media/At-the-centre-of-Renminbi-internationalisation--A-brief-guide-to-offshore-RMB.pdf.

44 Note there is also a leasing model, like the sweeping system, with no use-up of the quota and thereby enabling registered leasing companies to firms to access up to ten times their capital. This has been a popular route of bringing capital into the company.

45 Kevin Lau et. al., "Offshore RMB–Slowly Emerging from a Soft Patch" Standard Chartered, November 7, 2014, p. 10, https://research.standardchartered.com/configuration/ROW%20Documents/Offshore_RMB_%E2%80%93_Slowly_emerging_from_a_soft_patch_07_11_14_05_39.pdf.

46 Jeanny Yu, "Proposals Announced to Boost Shanghai Free Trade Zone," *South China Morning Post*, December 2, 2013, 11:37 p.m., http://www.scmp.com/business/economy/article/1371388/proposals-announced-boost-shanghai-free-trade-zone.

47 Barry Eichengreen, et. al., *Internalisation of the Renminbi: Pathways, Implications and Opportunities*, op. cit., p. 32.

48 Hogan Lovells, "China Streamlines Foreign Exchange Administrative Procedures to Facilitate Cross-Border Investments," March 2013, p. 4, http://www.hoganlovells.com/files/Publication/a8424594-eb7a-41da-a907-003617097867/Presentation/PublicationAttachment/2596e344-6d67-4ac2-8c8b-6dc339366d8b/Hogan_Lovells_Client_Alert_-_China_Streamlines_Foreign_Exchange_Administrative_Pro.pdf.

49 George Chen and Jeanny Yu, "Foreign Banks in Shanghai Free-Trade Zone Lack Permits to Transfer Funds Freely," *South China Morning Post*, July 8, 2014, 11:58 a.m., http://www.scmp.com/business/banking-finance/article/1549490/lack-permit-stalls-ability-foreign-banks-ftz-branches.

OFFICIAL SUPPORT FOR THE RMB

Although often compared to the eurodollar market, the offshore RMB market is a qualitatively different project in many ways given the deep levels of proactive Chinese government involvement and control over the process. The eurodollar market, for its part, was an initiative largely privately run by banks seeking to escape tax equalization charges. As discussed above, the offshore RMB market, by contrast, has involved targeted state-run efforts to gradually open the capital account alongside a comparatively more concerted effort to pen the current account. Offshore liberalization has also included a series of novel applications of existing statecraft to promote the internationalization of RMB and development of offshore pools of RMB liquidity.

Bilateral Swap Agreements

Among the most important and publicized channels of "exporting" the RMB have been bilateral swap agreements with other central banks. Under a program launched in 2009, the PBOC has agreed to extend three-year lines of liquidity support for selected central banks. The lines can be drawn on and deployed to increase market stability or downstreamed to domestic banks. In the former case, creating a line of liquidity allows central banks to supply banks participating in RMB markets with emergency or intraday liquidity should the need arise; in that way, central banks can provide a bulwark against potential runs. In the latter case, a foreign central bank establishes facilities for trade or investment financing by offering long-term RMB denominated loans for qualifying domestic financial institutions so that offshore funding demands can be met locally. China has also, notably, joined neighboring countries in launching what is today known as the Chiang Mai Initiative Multilateralization (CMIM)—a series of swap lines backed by foreign reserve pools of $240 billion for countries facing balance of payments crises. Part of the initiative's agenda includes diversifying swap lines to include the RMB.

Development Loans

Another important channel has been through international development and assistance programs. As early as 2011, the China Ex-Im Bank began to work alongside the Inter-American Development Bank to establish an RMB-based fund to support investments in Latin America and the Caribbean.[50] And more recently, in 2014, China established the New Development Bank (NDB) alongside Brazil, Russia, India, and South Africa (initially styled the BRICS Development Bank).[51] According to commentators, the $50 billion of subscribed capital for the new bank aims to mobilize resources to invest in infrastructure and sustainable development projects in member countries. It also aims to do so through local currencies.[52] In this way, the NDB not only works to incrementally decrease countries' reliance on traditional multilateral sources of assistance like the IMF, but also to promote alternative cur-

50 Paola Subacchi and Helena Huang, "The Connecting Dots of China's Renminbi Strategy: London and Hong Kong," op. cit., p. 6.
51 Hongying Wang, *From "Taoguang Yanghui" to "Yousuo Zuowei": China's Engagement in Financial Minilateralism*, Cigi, December 2014, No. 52, p. 1, https://www.cigionline.org/sites/default/files/cigi_paper_no52.pdf.
52 Ibid., p. 3.

Summary of Bilateral Swap Agreements between PBOC and Other Monetary Authorities

Country	*Amount (CNY billion)*	*Entry Date*
Albania	2	Sep 2013
Argentina	70	Jul 2014
Australia	200	Mar 2012
Belarus	20	Mar 2009
Brazil	190	Mar 2013
Canada	200	Aug 2013
ECB	350	Oct 2013
England	200	Jun 2013
Hong Kong	400	Nov 2014
Hungary	10	Sep 2013
Iceland	3.5	Sep 2013
Indonesia	100	Jan 2013
Kazakhstan	7	Dec 2014
Korea	360	Oct 2014
Malaysia	180	Feb 2012
Mongolia	10	Mar 2012
New Zealand	25	Apr 2014
Pakistan	10	Dec 2014
Qatar	35	Mar 2014
Russia	150	Oct 2014
Singapore	300	Mar 2013
Sri Lanka	10	Sep 2014
South Africa	30	Apr 2015
Switzerland	150	Jul 2014
Suriname	1	Mar 2015
Thailand	70	Dec 2014
Turkey	10	Feb 2012
UAE	35	Jan 2012
Ukraine	15	Jun 2012
Uzbekistan	0.7	Apr 2011
TOTAL	3,144	

Source: PBOC, Standard Chartered Research rencies—and most importantly the RMB. Similarly, China has signed a memorandum of understanding (MOU) establishing a $100 billion Asian Infrastructure Investment Bank (AIIB), which likewise supports Asian infrastructure projects. AIIB is intended to not only promote closer relations in the region, but also the internationalization of the currency.[53] Though still in the early stages, the bank has won plaudits from some governments, including the United Kingdom, which announced plans to join the bank despite US skepticism and charges of "constant accommodation" of Chinese political interests. Since then, other European countries including Germany, France, and Italy have announced their intentions to join the bank.

Clearing Banks

The Chinese government has also played an important role in supporting the RMB by publicly nominating specially designated, offshore "RMB clearing banks," and by implicitly standing by the liquidity they provide. China has furthermore granted agent bank licenses for banks in China as an alternative to clear RMB payments overseas. Clearing generally refers to the activities involved in confirming, monitoring, and ensuring that sufficient collateral or margin is provided where required, until a trade is actually settled (i.e., monies exchanged between transacting parties).

A list of offshore RMB clearing banks nominated by the PBOC is provided below:

City	Bank
Hong Kong	BOC - Hong Kong branch
Macau	BOC - Macau branch
Taiwan	BOC - Taipei branch
Singapore	ICBC - Singapore branch
Seoul	BoCom - Seoul branch
Frankfurt	BOC - Frankfurt branch
London	CCB - London branch
Paris	BOC - Paris branch
Luxembourg	ICBC - Luxembourg
Doha	ICBC - Doha
Toronto	ICBC - Toronto
Sydney	BOC - Sydney
Kuala Lumpur	BOC - Malaysia
Bangkok	ICBC - Bangkok

53 Ibid., pp. 1-2.

Apart from directly routing RMB payments to an official offshore clearing bank or a PBOC-licensed onshore agent bank for clearing, offshore RMB payments initiated from any offshore commercial bank can also be routed to a correspondent bank that transacts with an RMB agent or clearing bank for clearing via the Chinese RMB payment system.

Various RMB Payment Clearing Paths
(1) Direct clearing through offshore RMB clearing banks
(2) Direct clearing through onshore RMB agent banks
(3) Clearing through an offshore correspondent bank which in turn clear payments with offshore RMB clearing banks or onshore RMB agent banks

However, onshore liquidity can be a constraint for banks mediating the transaction, since cash from the PBOC can often only be withdrawn at 9:00 a.m. the following day.[54] Thus, routing through correspondent banks instead of using direct clearing may take extra link without the implicit promise of enjoying direct liquidity support from the PBOC.

The offshore clearing bank model was introduced in 2003, when the Bank of China (Hong Kong) Ltd was appointed by the PBOC as the first clearing bank for offshore RMB.[55] This model was then given a boost (see discussion below) when the Bank of China Hong Kong engaged Hong Kong Interbank Clearing Limited to develop a settlement system that operated in real time for offshore transactions. Since then, clearing banks have been established throughout Asia and Europe, and some financial centers are developing world-class RMB settlement systems on their own.

It is worth noting, however, that the advantages of official support for clearing banks may be, above all, political. In many ways, designated clearing banks do not necessarily perform any functions beyond those of correspondent banks. Like Western banks, they can facilitate RMB payment to beneficiaries of payments and participate in FX deliverable markets to access the currency where needed. Most clearing banks even had to connect with China National Advanced Payment Systems (CNAPs) through an affiliate in China. But they do provide an opportunity to provide a bricks and mortar face for RMB internationalization to clients and customers who may be unfamiliar with the currency. This in turn increases overall awareness of the RMB, heightens foreign interest in the currency for trade and investment purposes, and raises the profile of the country hosting the bank as an international financial center.

54 Swift, "RMB Internationalisation: Perspectives on the Future of RMB Clearing," p. 4, http://www.swift.com/resources/documents/SWIFT_White_paper_RMB_internationalisation_EN.pdf.
55 Ibid.

THE GLOBAL GROWTH OF RMB FINANCIAL CENTERS

Hong Kong was a natural first stop for the internationalization process. Besides being part of China (albeit with a separate legal and financial system), its geographic location, and its international expertise and connections, Hong Kong hosts a multi-currency settlement infrastructure underpinning its role as one of the world's leading international financial centers. As a result, Hong Kong as a special administrative region (SAR) still receives the majority of investment quotas and is often the locale of choice for pilot programs that, when successful, are exported to the rest of the world.

Hong Kong boasts a real time gross settlement system (RTGS) to facilitate settlement of foreign exchange transactions on a payment-versus-payment basis, a Central Clearing and Settlement System (CCASS) to settle equity transactions on a delivery-versus-payment basis, and a Central Moneymarkets Unit (CMU) to clear bonds and investment fund shares. There is now a regular CNH Hong Kong Inter-Bank Offered Rate (HIBOR), overseen by the Hong Kong Treasury Markets Association and covering tenors from overnight to one year to facilitate the pricing of offshore RMB-denominated loans and derivatives for risk-management purposes. Also, Hong Kong's favorable tax rates for business transactions with no corporation withholding taxes for monies remitted to nonresidents and the presence of a large number of double taxation treaties with foreign governments make it a preferred place of business. Not to mention its strong rule of law, contract enforcement, and the presence of a common law system inherited from Great Britain make Hong Kong a top-rated location for economic and business freedom. Finally, Hong Kong hosts a native Chinese population, a large number of mainland companies, and considerable daily population movement across the border with mainland China.[56]

Other financial centers are, however, gaining ground and offer services as diverse as securities trading services, clearing, FX trading, and banking. In Asia, Singapore and Taiwan have developed liquid RMB markets based on their close trade and financial ties with mainland China and Hong Kong. In Singapore, the major RMB asset holders hail from the official sector or are multinational companies with businesses in China that run their global and regional treasury operations out of Singapore. Singapore was one of the first locations outside China, apart from Hong Kong and Taiwan, that secured bilateral financial arrangements with Chinese authorities to boost the use of RMB for trade and investment.[57] The PBOC has also launched specific pilot initiatives in China such as the Suzhou Industrial Park (SIP) and Tianjin Eco-City (TEC) to encourage the use of RMB liquidity in Singapore, which in turn supports corporations in SIP/TEC and enables direct investment in the Association of Southeast Asian Nations (ASEAN) region.[58]

Taiwan, meanwhile, has in the last year in some respects surpassed Singapore in RMB financial metrics, and is second only to Hong Kong in terms of offshore RMB liquidity, with CNY 215 billion in deposits.[59] Prospects remain bright insofar as Taiwan has enjoyed a large trade surplus with China, which contributes to RMB liquidity. Additionally, according to industry surveys, some 40 percent of Taiwan's residents intend to open RMB deposit accounts.[60] To promote its potential as an RMB market, Taiwan is working assiduously to develop its market infrastructure and has placed a high priority on expanding its RMB-denominated Formosa bond market. The PBOC has also permitted two-way intercompany lending for Taiwanese corporates through a program called the Kunshan cross-border initiative.

London, meanwhile, has arguably positioned itself as the most liquid international center in the world and the largest RMB financial center outside of Asia (albeit a still modest one). As such, it has a reservoir of international institutional investors who are ready to buy and sell RMB and its related financial products. Not surprisingly, London was the first G7 country to receive an RQFII quota.[61] Additionally, its trading day overlaps that of China and North America, giving the city an important geographical advantage for global trading and 26 percent of all daily offshore RMB spot FX transactions.[62]

Luxembourg has also developed a highly competitive position. It serves as the European headquarters of ICBC, Bank of China, and the China Construction Bank—the three largest banks in China—and boasts the largest pools of RMB in Europe in terms of deposits, loans, listed bonds, and assets in mutual funds. The country also serves as the main hub and entry point for Chinese investors into the eurozone,[63] and as the home of most Undertakings for Collective Investment in Transferable Securities (UCITS) funds, it mediates most investment funds into China. Like London, Luxembourg has extensive experience with RMB products, and its stock exchange listed the first dim sum bond issued by a European corporation.[64]

Meanwhile, Germany and France are among China's most important trading partners in Europe. In terms of trading volume with China, Germany bests all others, and France, which also serves as a financial focal point with Fran-

56 Barry Eichengreen, et. al., *Internalisation of the Renminbi: Pathways, Implications and Opportunities*, op. cit.
57 Monetary Authority of Singapore, "Regional Gateway for RMB," May 11, 2015, 3:33 p.m., http://www.mas.gov.sg/singapore-financial-centre/overview/regional-gateway-for-rmb.aspx.
58 Ibid.
59 PriceWaterhouseCoopers, *Where Do You Renminbi? A Comparative Study of Cross-Border RMB Centres* (2014), p. 5, http://www.pwc.lu/en/china/docs/pwc-where-do-you-renminbi.pdf.
60 Michelle Chen, "CNH Tracker-Favourable Policies Bode Well for Taiwan's Yuan Business," Reuters, January 31, 2013, http://www.reuters.com/article/2013/01/31/markets-offshore-yuan-idUSL4N0AX11620130131.
61 PriceWaterhouseCoopers, *Where Do You Renminbi? A Comparative Study of Cross-Border RMB Centres,* op. cit., p. 4.
62 Thomson Reuters, "London's Infrastructure Needs as an Offshore RMB Centre," September 12, 2012, p. 4, http://www.chinalux.eu/wp-content/uploads/2012/11/RMB_offshore_centre_infrastructure_london.pdf.
63 PriceWaterhouseCoopers, *Where Do You Renminbi? A Comparative Study of Cross-Border RMB Centres*, op. cit., p. 22.
64 Ibid.

cophone Africa, is the fourth largest partner.[65] Despite having embraced RMB internationalization later than London and Luxembourg, both Germany and France have articulated an interest in supporting RMB financial centers and have signed agreements with Chinese authorities for the establishment of clearing banks. German companies, in particular, have also accessed the onshore and offshore RMB bond market, and in 2014, Daimler became the first European company to issue bonds in China's interbank market.[66]

Notably missing from the list is North America. Neither the United States nor Mexico currently boasts any operational offshore RMB centers. US authorities have yet to make a public announcement regarding the facilitation of RMB internationalization, much less one regarding US participation in an RMB network. Perhaps not surprisingly, the United States has thus accounted for less than 13 percent of offshore RMB FX transactions outside of Hong Kong and mainland China.[67] Mexico's existing financial centers, meanwhile, are arguably too small to attract sufficient liquidity and investors for growing a large-scale RMB financial center, though its trade relationship with China is impressive. This relative dearth of a significant RMB presence, however, may soon come to an end: Canada has created an RMB center in Toronto with an RMB clearing bank also appointed by the PBOC (see above) and is diversifying its financial and trade relations with China—its second largest trade partner. As one expression, British Columbia was the first sovereign RMB issuer in the Americas.

65 Ibid., p. 26.
66 Weihao Cao and Gabriel Wildau, "Daimler AG to Launch First-Ever Bond Sale in China by Foreign Non-Financial Company—Sources," Reuters, January 22, 2014, http://www.reuters.com/article/2014/01/22/china-bond-daimler-idUSL3N0KW1NY20140122.
67 Yin Wong Cheung, "The Role of Offshore Financial Centers in the Process of Renminbi Internationalization," p. 221.

Competitive Advantages of Major Financial Centers

Hong Kong	Largest and first offshore RMB center Hong Kong's offshore markets enjoy a unique political and economic relationship with the mainland The island has played the traditional testing center for new RMB liberalization measures
Singapore	Key trading and investment partner of China and strategically located as the ASEAN trading hub Leverages advantages with regional headquarters and treasury centers of multinational corporations and Chinese enterprises. Leading Fx, Commodities, Global private banking and wealth management center
London	Most international and diverse capital market in the world One of the two largest and most prestigious global financial centers Strategically important geographic location and timezone Extensive expertise and experience with RMB transactions
Luxembourg	European headquarters of major Chinese banks; headquarters for offshore mutual fund investments
Germany	Europe's largest economy; Europe's most successful exporter to China
France	Francophone world's financial center; funding center for half of Africa's governments
Canada	Large Chinese diaspora; would be first and only RMB financial center in North America

Note: The larger the center, the more RMB global liquidity—leading to network externalities and advantages for all.

HOW RMB BANK TRANSACTIONS ARE CLEARED AND SETTLED

The RMB clearing and settlement infrastructure is divided by an onshore and offshore component. On the mainland, domestic payments are cleared via the CNAPS, which is run by the PBOC and offers RTGS services. In order to access CNAPS, a bank must have a settlement account at a PBOC branch.

There are, however, a number of caveats that generate complexity for banks seeking to settle transactions. First, CNAPS, the traditional payment system, has been criticized due to its inefficiency, limited interoperability, and potential lack of financial stability, even with its RTGS capabilities. A number of factors contribute to these difficulties:

- CNAPS's hours of operation are only 8 a.m.-5 p.m., which means it can take up to a day to settle transactions, creating Herstatt risk;
- CNAPS is not SWIFT-based, which means offshore banks may not be able to send proper instructions for settlement to onshore processing systems;
- Use of Roman characters for the system is limited, even though there are dual language capabilities; and
- Banks are required to add specific codes noting the purpose of each payment cleared through CNAPS, introducing greater delays in processing payments.[68]

Meanwhile, as briefly mentioned above, an offshore clearing and settlement system primarily based in Hong Kong has also developed. As mentioned above in the clearing banks section, the first important steps were taken in 2004, when the PBOC designated the Bank of China (Hong Kong) Ltd as an authorized RMB clearing bank. The primary driver behind the demand for clearing services came in 2007, however, when Hong Kong launched what is still the only fully operational offshore RMB RTGS system on a payment-versus-payment basis.[69] With the inauguration of this system, transactions could be settled irrevocably and in real time, reducing Herstatt risk for far-flung financial institutions. Because of the certainty, Hong Kong's platform is currently used for 80 percent of offshore RMB transaction settlements, though other RTGS systems are in development in Singapore and Taiwan.[70] Granted, even in Hong Kong, offshore payments are subject to the mainland's capital control systems, and when payments are made onshore, the CNAPS platform must be used.

With these limitations in mind, a second system, inspired by CHIPS in the United States and dubbed the China International Payment System (CIPS), is under construction in the mainland. This platform will put the RMB on even footing with other global currencies in areas such as operating hours, risk reduction, and liquidity optimization. This new system will support both Chinese and English characters, though the burdens of translation and comprehension still remain with the commercial banks. It is expected to operate twenty-three hours a day, which would help to accommodate Asian and European markets. Though the new system will remain onshore, it will specifically cater to international transactions. It is expected that the new system will enable cross-border clearing among both onshore and offshore participants. It will also run on SWIFT ISO20022 standards, thus optimizing mapping between SWIFT and CNAPS messaging formats, potentially serving as a competitor to SWIFT.[71]

Until then, complications persist in the processing of financial transactions. Correspondent banking offers an efficient means of processing small denominated transactions, but can still generate Herstatt risks in the chain of affiliate transactions leading to ultimate settlement. The risk is then elevated to the extent that smaller banks have to rely on non-affiliates to clear and settle transactions. Hong Kong's RTGS helps to address this problem, but only partially. As an offshore real-time payment platform, it allows institutions to settle transactions where the delivery of RMB is required and can do so far beyond the operational hours of CNAPS. However, as mentioned above, when banks need to make payments into China, they still have to go through the limited CNAPS platform. When CIPS is operational, however, experts believe that it will not only streamline the clearing and settlement process, but it may also challenge offshore financial centers to diversify and innovate new lines of business that are less reliant on basic correspondent banking services.[72]

68 J. P. Morgan, *RMB Clearing: Navigating On and Offshore*, https://www.jpmorgan.com/tss/General/RMB_Clearing_Navigating_On_and_Offshore/1320510545695.

69 Paola Subacchi and Helena Huang, "The Connecting Dots of China's Renminbi Strategy: London and Hong Kong," op. cit., p. 8.

70 Ibid., p. 9.

71 Michael Vrontamitis, "CIPS a 'Game Changer' but Needs Careful Planning," Standard Chartered, https://www.sc.com/en/resources/global-en/pdf/Research/CIPS_game_changer_needs_careful_planning.pdf.

72 But cf. "Global Renminbi Trade Platform Not a Substitute for Capital Account Liberalisation," *Euromoney*, April 13, 2012, http://www.euromoney.com/Article/3011110/Global-renminbi-trade-platform-not-a-substitute-for-capital-account-liberalisation.html.

CENTRAL BANK RESERVES

One of the most interesting aspects of the internationalization process has been the speed with which foreign monetary authorities have acted to begin accumulating RMB or redenominating a portion of their reserves into the currency. Instead of waiting for the full opening of the country's capital account, central bankers, sovereign wealth funds, and governments have begun to actively make official sector investments intended to increase their exposure to RMB. In this way, the emergence of the currency as a store of value in the official sector is, in many ways, an accompaniment to its increasing usage as a means of payment and invoicing.

There are several drivers behind this development. As mentioned above, the PBOC has given foreign central banks special direct access to invest in the RMB interbank bond market and special treatment under QFII quota schemes and the offshore dim sum market. Eased access has in some instances helped facilitate entry of governments that were first in the market, raising the profile of and comfort levels with the currency for officials.

A number of macroeconomic trends and realities have also contributed to growing interest in the RMB. Growth in Asia has been fueled by many of the same export and current account surplus dynamics that have driven China's success.[73] But as the region develops, monetary authorities, like their Chinese counterparts, have increasingly sought to diversify their foreign exchange holdings given the low returns associated with European and American currencies over the last decade. Part of this diversification process has involved rethinking and even embracing greater RMB-denominated transactions. Meanwhile, central banks have recognized the trend toward an increasingly multicurrency system and have consequently worked to diversify their sovereign balance sheet to ensure the necessary liquidity to support an RMB-denominated capital market. Accordingly, a range of developments have underscored considerable interest in the RMB as a reserve asset among governments, even as the total reserve allocations in RMB remain extremely small compared to those in US dollar (USD):

- Regional central banks and sovereign wealth funds from Australia, Indonesia, Malaysia, Korea, and Thailand have all announced plans to diversify reserve balance sheets and increase RMB reserves and RMB-denominated investments.[74]
- Nigeria's central bank is moving $43 billion of reserves into RMB from USD, and the RMB will increase from 2 to as high as 7 percent.[75]
- Following British Columbia, the UK became the first sovereign issuer of RMB denominated debt and will use the proceeds to fund its reserves.[76]
- In October 2014, the European Central Bank (ECB) launched discussions concerning whether or not to include the RMB in its reserves.[77]

Yet, despite this growth in the popularity of the RMB, one policy posture has not changed—the exclusion of the RMB from IMF's "Special Drawing Rights." SDRs are credit accounts at the IMF that countries can draw on for financial assistance. They are also the basis of voting at the IMF.[78] To qualify for inclusion in SDRs, currencies must be declared "freely usable." This in turn means that a currency is traded on active exchange and derivatives markets, market-based interest-rate instruments support the currency, and the currency is held as a reserve by many governments.[79] Currently, only the dollar, euro, sterling, and yen are included in the basket of currencies that determine the value of SDRs.

SDRs are relevant for central banks because they are essentially counted as part of their reserves, since they can be exchanged for marketable currencies. Furthermore, currencies that count toward the SDR enjoy extra legitimacy, bolstering demand for them among central banks. For this reason, China, as well as other emerging market countries, have argued that the composition of the SDR and the way it is calculated should be updated to reflect changes in the global economy and the ascent of new economic powers like China. However, because the RMB is not freely convertible, it was not considered eligible for SDR status in 2011, the last time the IMF considered RMB inclusion in SDR. This decision has consequently undermined the attractiveness of the RMB as not only an asset class for market participants but also for governments and governmental bodies.

73 "Twenty years ago, 65 percent of reserves were held by developed countries and 35 percent by emerging markets. Now that position is reversed, with 67 percent of world reserves held by emerging markets, reflecting the economic rise of Asia in general and China in particular." John Zhu, "Renminbi as a Reserve Currency," *Central Banking Journal*, August 11, 2014, http://www.centralbanking.com/central-banking-journal/advertisement/2357296/renminbi-as-a-reserve-currency.

74 Barry Eichengreen, et. al., *Internalisation of the Renminbi: Pathways, Implications and Opportunities*, op. cit., p. 17.

75 John Zhu, "Renminbi as a Reserve Currency," op. cit.

76 Elaine Moore and Josh Noble, "UK Takes Orders for Debut Renminbi Bond," *Financial Times*, October 14, 2014, http://www.ft.com/cms/s/0/8d157620-5388-11e4-929b-00144feab7de.html#axzz3NxxZQHHF.

77 Saikat Chatterjee and Rachel Armstrong, "China Currency Claims a Bigger Share of Reserve Manager Portfolios," Reuters, October 24, 2014, http://www.reuters.com/article/2014/10/29/us-china-summit-reserves-reuters-summit-idUSKBN0II0VX20141029 (noting "media reports that indicate that the "European Central Bank plans to add the renminbi to its foreign exchange reserves").

78 In short, member countries are required to provide a certain baseline of capital to the organization's pool of resources based roughly on their economic size, and then that pool of capital is made available to the general membership of the organization. The amount that a country can draw on unilaterally corresponds to the funding commitment made by the country (and is also tied to the voting power of the IMF member state).

79 IMF, IMF Executive Board Discusses Criteria for Broadening the SDR Currency Basket, Public Information Notice No. 11/137, November 11, 2011. See also Article XXX(f) of the IMF's Articles of Agreement.

THE CHALLENGES AHEAD

Where these developments go from here has been the subject of considerable speculation. In principle, the internationalization of the RMB holds the prospect of a range of potential benefits for transatlantic investors and the global financial system. If well orchestrated, it portends market reforms in China and a rebalancing of the global economy for more sustainable growth. Meanwhile, firms and investors in the United States and Europe will enjoy new means of diversifying their portfolio investments, as will China's burgeoning investor class.

Still, internationalization creates a number of challenges from the standpoint of global governance and international economic cooperation. Even given the speed of regulatory reforms in China, more channels have to be opened for onshore and offshore investment; prudential oversight must be strengthened; and the exchange rate controls further relaxed. These are not, however, only economic issues, but also policy reforms that hold deep regulatory and political significance. That is, not only does RMB liberalization impact the transmission of economic and monetary policy, a point we elaborate on below, but it also holds implications for the transmission of regulatory and even foreign policy—a point often overlooked by commentators.

Challenge #1: RMB Internationalization Will Impact the Transmission of Economic and Monetary Policy

A large economic literature points to the difficulty and costs of capital account liberalization for China, even given the necessity of economic reform. Traditionally, the PBOC has capped bank deposit rates and established minimum lending rates, which has worked well to support, where necessary, state-owned banks and enterprises.[80] The official interest rate policy has thus comprised an essential component of state-supported capitalism in the country and is the means by which government has steered and controlled economic growth. Opening up the capital account would have the opposite effect, reducing the ability of the Chinese government to move capital to its preferred borrowers. With less access to subsidized capital, state-owned enterprises would be forced to modernize and potentially accept more private capital and ownership. For some experts, exchange rate controls would have to be loosened in advance to allow investors to manage shifts in cross-border capital flows and bolster risk management capacities.[81] The RMB would then be able to appreciate or depreciate more rapidly, depending on the fundamentals and competitiveness of the Chinese economy and the outflows of "hot money" as the United States raises interest rates in the years ahead.

The PBOC would also face more external pressure to demonstrate its competence and explain its decision-making. In contrast to most Western central banks, which are structurally designed as independent agencies (though they may nonetheless act in highly political ways), the PBOC operates under the explicit guidance of the State Council. In the absence of full structural independence, the bank could face more difficulty in making credible commitments about the value of the currency to investors. This is all the more important since internationalization would generate expectations about market reform. Domestic bank balance sheets would, for example, have to be strengthened and robust, internationally recognized forms of supervision extended to banks and off-balance sheet subsidiaries.[82] Meanwhile, the PBOC would have to accept an erosion in the effectiveness of its own monetary policy, as the development of an offshore RMB (CNH) market would provide an escape route for onshore economic agents otherwise subject to domestic monetary tightening and liquidity controls.[83]

How these political costs will net out for China impacts both the speed and forms of internationalization. By most accounts, China has continued its reform process, which some commentators have attributed to the fact that small- and medium-sized enterprises are generating the lion's share of jobs in China. But as state-owned enterprises (or, for that matter, local governments) come to need capital and as powerful domestic interests resist reforms, one could imagine the pace of capital account liberalization slowing. Moreover, if China's GDP growth weakens substantially, so could incentives to appreciate the RMB by loosening the band within currency trades.

By extension, the internationalization of the RMB will also likely impact the transmission of EU and US economic and monetary policy, though in different ways. For the EU, the emergence of the RMB as a new currency introduces a potential competitor on the global stage. Central banks and global investors will, in short, have yet another option for investments and savings. That said, because the euro is less widely used than the US dollar (alongside the sterling and yen) and does not enjoy safe-haven status, the consequences of introducing another major currency could be, at least over the longer term, comparatively less profound.

The position of the euro diverges considerably from that of the US dollar, which is the traditional anchor currency for international financial and trade transactions. The demand for US debt has been relatively inelastic due to the utility of the dollar and the long-standing hegemonic status of the United States. Indeed, in times of crisis, the US dollar has enjoyed safe-haven status, even where the health of the US economy is in question. But if the RMB comes to offer a credible alternative to the US dollar, these privileges would moderate, and the US government would increasingly internalize the costs of its fiscal and monetary policies, since savers would be able to choose what currency to use as a store of value and for investments. Consequently, many experts interpret the degree of support for a range of Chinese priorities—including a reconfiguration of SDRs—as a reflection of the government's view of how fast internationalization will proceed and its impact on

80 Barry Eichengreen, et. al., *Internalisation of the Renminbi: Pathways, Implications and Opportunities*, op. cit., p. 19.
81 Ibid., p. 21.
82 Ibid., pp. 19-20.
83 Chi Lo, *The Renminbi Rises: Hypes and Realities of RMB Internationalisation and Reforms* (Basingstoke: Palgrave Macmillan, 2013), p. 20.

the country's long-term financial interests. US officials are, however, adamant that such concerns play no role in current monetary diplomacy.

Challenge #2: RMB Internationalization Will Impact the Transmission of Regulatory Policy

The internationalization of the RMB will also impact what can be considered the transmission of regulatory policy in both China and the United States in different ways. For China, RMB internationalization requires the building of infrastructure to support transactions in the currency. The supervision of local banks and non-banks will have to be upgraded, along with the oversight of securities issuers and the promotion of a less bank-dominated capital market (points we will discuss in greater depth below). Furthermore, the onshore payments system capable of processing increasingly complex financial transactions will have to be adapted to international standards.

Reinforcing (and in some instances, creating from scratch) an international market for RMB financial products and services is a difficult process and will be operationalized incrementally. However, once the number of participants reaches critical mass, Chinese regulators and market authorities will enjoy a new means of influencing global regulatory policy. Domestic rules will have increasingly extraterritorial implications as the number of foreign participants in the domestic interbank market and on mainland exchanges increase. Furthermore, prudential expectations and requirements associated with RMB infrastructure will be exported abroad, where foreign market participants can utilize it. Thus, as markets for the RMB grow and develop, officials will be increasingly well-positioned to export their own domestic policy preferences to the international community.

Meanwhile, internationalizing the RMB will necessarily generate occasions where Chinese regulators will clash with EU and US counterparts on key aspects of regulatory policy. Besides having a different market structure than its Western counterparts, with different relationships between the government and market entities, China will have different areas of emphasis and regulatory priorities. Moreover, differences in regulatory and economic risk tolerance across the Pacific will inform regulatory approaches. Nevertheless, international policy will have to be increasingly negotiated among regulatory equals as the capital account liberalizes and China's mainland capital markets grow. In contrast to the past where the United States (and to a lesser extent, the EU) wrote the world's financial rules, Western authorities will increasingly be not only "makers" of global financial regulatory policy, but also "takers." Not only will agencies like the FDIC, Federal Reserve, and SEC have to preserve domestic market stability and vigorously protect their local investors, but they will also, in pursuit of their mandates, have to engage and in some instances mediate China's policy prerogatives. Their inability to do so effectively could not only exacerbate market fragmentation, but also undermine the balanced economic growth RMB internationalization potentially facilitates—and exacerbate the risks of volatility and financial instability.

Challenge #3: RMB Internationalization Will Impact the Transmission of Foreign Policy

Internationalization of the RMB will also impact how China promotes its broader strategic interests as part of "the country's overall foreign policy strategy."[84] Already, the internationalization of the RMB is improving China's relations with neighbors and trade partners. For example, China's embrace of bilateral RMB swap lines under the CMIM and elsewhere, along with the New Development Bank and related initiatives, has not been established for China's own sake. These organizations respond to short-term liquidity crises in member economies. Given the more than $3 trillion in reserves, the likelihood of a current account crisis in China is slim. Instead, an accelerating pace of official assistance has allowed China to enhance its reputation as a benevolent player in Asia and around the world and to push multilateral institutions like the IMF and the World Bank to become more inclusive of emerging economies and their currencies. This in turn is forcing institutions to rethink not only the reference currencies for facilities (like SDRs for the IMF), but also the governance of those institutions, since rebalancing economic weight will ultimately require changes in the voting requirements that govern them.

Similarly, the lucrative nature of RMB internationalization provides the Chinese government with more tools to reward and strengthen economic ties with existing or potential partners. Trade talks that have traditionally centered on the sale of goods now routinely involve discussions regarding clearing banks, QFII, RQFII, and interbank quota allocations. And, agreements relating to the establishment of RMB infrastructure are almost always used by host countries (and China) to tout their domestic financial centers and the closer political and economic cooperation driving RMB internationalization. Thus, by leveraging RMB internationalization in its traditional economic dialogue, China is able to raise the profile of the currency, facilitate China's trade relations, and even support Chinese companies' "going out" strategy.[85]

Over the longer term, a more popular RMB infrastructure will enable the exertion of "harder" forms of influence. China will, for example, have the ability to more effectively impose economic sanctions via monetary and banking channels. It also will be able to exclude firms from rival countries from the instrumentalities of RMB-denominated finance. At the same time, countries otherwise subject to transatlantic sanctions or constraints may be able to circumvent or mitigate the effects of those sanctions by participating in Chinese capital markets.

How leading transatlantic governments respond to these developments in foreign policy diverges across capitals. European countries, for their part, have actively engaged China to construct offshore centers—and EU member states have competed with one another to attract RMB infrastructure, from clearing banks to quota allocations for RQFII and QFII investments. Indeed, it is likely that Europe will be more inclined to support the RMB's inclusion in SDRs and the de facto recognition of the currency as an official reserve. On the other hand, the United States has been conspicuously absent in engaging RMB internation-

84 Hongying Wang, *From "Taoguang Yanghui" to "Yousuo Zuowei": China's Engagement in Financial Minilateralism*, op. cit., p. 5.
85 Ibid.

alization as a foreign policy issue (or as a market opportunity for local capital markets)—even as China's efforts to internationalize the currency have partially assuaged longstanding US accusations of currency manipulation. Instead, US authorities tend to emphasize prudential priorities and concerns as to the extent to which Chinese companies raise capital locally. Furthermore, authorities have increasingly chastised traditional allies—and in particular the United Kingdom—that have embraced the RMB as a major transactional and reserve currency. That said, as discussed above, Canada has, like most other major economies, viewed RMB internationalization as an opportunity to deepen its bilateral economic relationship with China, as well as to position itself as North America's premier RMB financial hub.

PRINCIPLES FOR AN EFFECTIVE INTERNATIONALIZATION PROCESS

How divergent interests, policy postures, and approaches are addressed by domestic and global regulators will impact not only the speed of the internationalization process, but also the extent to which cross-border risks are addressed and opportunities realized. If successful, RMB internationalization could facilitate a healthier global economy; if unsuccessful, RMB internationalization could result in "currency wars" or turf battles, fragmented market structures enabling systemic risk, and diminished opportunities for firms and financial institutions to manage their foreign exchange risks. To that end, the regulatory (and deregulatory) process accompanying internationalization should follow clear cut principles, with relatively straightforward policy applications.

Agenda Setting Should Be Pragmatic, Not Aspirational

One of the constant challenges involving the internationalization of the RMB concerns the lack of certainty regarding the speed and nature of reforms. On one hand, this uncertainty is a product of internationalization itself; in order to be prudently operationalized, the opening of the capital account depends on the facts on the ground. On the other hand, it is also the result of increasing mismatches between policy pronouncements and the professed expectations of market participants. To this end, Beijing needs to sustainably incentivize the using and holding of RMB deposits by China's trade partners—encompassing both speculative and precautionary money demand.

This is not a unique challenge. It is one that Western governments have also had to grapple with in matters of financial reform, especially in the wake of the recent crisis.[86] In order to avoid similar problems and the inevitable questioning of China's commitment to capital account liberalization, the policy-transmission process needs tweaking: for one, policy announcements should be crafted in modest terms (ideally in English) palatable to and understood by not only Chinese stakeholders, but also foreign stakeholders; timetables should be transparent and pragmatic—and not aspirational; and foreign investors must exhibit market and political constraint. While meeting critical benchmarks is necessary to developing faith and credibility in the internationalization process, pushing for premature liberalization without the proper infrastructure will introduce long-term costs that will only undermine the safety and soundness of the Chinese and global financial systems. Indeed, even in the short term, changes in US interest rate policy could dramatically undermine the Chinese and the global economy if it coincides with poorly conceived capital account liberalization in China and promotes a precipitous drop, as opposed to appreciation, of the currency.

86 Atlantic Council, Thomson Reuters, and TheCityUK, *Danger of Divergence, Transatlantic Financial Reform & the G20 Agenda* (Washington, DC: December 10, 2013), http://www.atlanticcouncil.org/publications/reports/the-danger-of-divergence-transatlantic-financial-reform-the-g20-agenda. Facing a crisis of confidence in financial markets, G20 leaders announced ambitious, though in some ways unrealistic commitments about the timeline for implementing in their home jurisdictions wholesale reforms of banking, derivatives, and securities markets. Delays in many ways exacerbated uncertainty as timelines were not met, and, by extension, undermined investment decisions by firms and companies.

Reforms in Legal Infrastructure Must Accompany Market Liberalization to Meet Growing RMB Demand and Usage

The sheer size of China's economy and expectations of further RMB appreciation have helped fuel interest in the currency and liquidity in offshore and onshore markets. In the long term, however, as China's spectacular growth rate moderates and as the internationalization process requires the support of at times skeptical foreign audiences (especially in the United States), rule of law will become increasingly important. Market demand must be sustained by not only a stable of safe and investable products, but also reliable and predictable rules to support the ownership (including equity minority ownership), transfer, pledging, and investment of the currency and RMB-denominated products. Furthermore, financial authorities must be able to credibly demonstrate that stakeholders will have the information needed to assess the rewards, risks, and opportunities of market activities relating to the currency and RMB-denominated financial products (e.g., exchange traded funds (ETFs), mutual funds, and funds with RMB share classes) and/or the ability to hedge the currency risk.

Transparency in Market Structure. For all of the dynamism in Asian markets, the Chinese financial system lacks the transparency needed to maximize robust, long-term foreign investment. The government's involvement in the market is often unclear; the fact that capital markets are considered strategic sectors of state planning complicates outsider perceptions of investment risk. Thus, as an initial matter, infrastructure providers should disclose to stakeholders the governing policies, rules, ownership, and other relevant matters concerning their relationship with home-state authorities. Accountability frameworks should be clearly defined in relevant legislation, charter, constitutive documents, and management agreements. Finally, clearing banks, payment systems, and asset managers should fully disclose any legal relationships they enjoy with state bodies, including channels of official funding and liquidity support, in order for clients and users to deepen their understanding of the responsibilities and risks that are tied to their operation.[87]

Better Accounting and Auditing Supervision. Chinese accounting and auditing services have come under increasing scrutiny as RMB internationalization accelerates and as price discovery and transparency have become critical goals of burgeoning RMB markets. This attention is partly a byproduct of the fact that the profession's primary regulatory body, the Chinese Institute of Certified Public Accountants, is controlled by the government, as are many of the country's leading businesses, which cre-

87 This approach would notably bring the process in line with other similar ventures including the Santiago Principles for Sovereign Wealth Funds.

A Regulatory To-Do List

Market Structure	Create clear lines of accountability and support for key RMB payment mechanisms
Accounting	Demonstrate the credibility of accounting and auditing service providers as enablers of price discovery, quality control, and value preservation
Rating Agency	Bolster credibility of rating agency practices with international investors; provide evidence of supervision of domestic credit rating agencies (CRAs), including national champions
Bankruptcy	Entrench bankruptcy courts in the legal system; develop rules for DIP financing, articulate credit stress protocols for investment funds; articulate equal treatment of foreign creditors in bankruptcy
Derivatives	Ensure interoperability of a master agreement with International Swaps and Derivatives Association (ISDA); provide certainty on netting to encourage faith and liquidity in onshore forward, swaps markets, especially in SFTZ

ates potential conflicts of interest. There have also been some concerns about the capacity of existing accounting systems to address the non-bank (or "shadow banking") system and the willingness of the government to tighten accounting practices.[88]

But arguably the most public shortcomings have been a spate of highly conspicuous fraud cases involving Chinese reverse mergers on the NASDAQ, which have fueled longstanding speculation that the gatekeeping role of accountants and auditors in mainland China is not being performed as rigorously as in the United States and Europe.[89] Affiliates of outside consultants of principal audit firms have been accused of inept oversight and misunderstanding financial statements of Chinese firms seeking capital abroad.[90] The degree of supervision in China has also been viewed as lax, leading to questions about the quality of oversight in dim sum markets where US and EU oversight is absent.[91] These concerns have only heightened in the wake of less than fulsome cooperation between Chinese and US authorities.

As growth inevitably moderates in China, interest in accounting surveillance and controls will increase, especially with regards to the implementation of international financial reporting standards (IFRS). Foreign investors who may seek to invest in RMB-denominated products issued by Chinese companies will (and to some extent already do) demand a risk premium for their capital in the absence of sufficient controls, ultimately reducing the market liquidity supporting the currency.[92] Furthermore, funds and investments may face attacks by short sellers when accounting mishaps or fraud is discovered, eviscerating shareholder value for long-term retail investors.[93] Strides have been taken to speak to these challenges at least indirectly through an accelerated adoption of largely IFRS-compatible standards in 2006 and an an-

88 Recent commentary from the *Economist* has, for example, argued that funds funneled from banks to trusts, which used to appear as "assets for resale" on their balance sheet have, in the face of criticism, only mildly upgraded their practices and book the assets as "investment receivables," only a slightly more burdensome category. "China's Shadow Banks: A Moving Target," *Economist*, September 6, 2014.

89 Masako Darrough et. al., "The Spillover Effect of Fraud Allegations against Chinese Reverse Mergers," Social Science Research Network, December 30, 2013, p. 3, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2144483 (arguing, among other things, a major shift in investor sentiment after 2010 regarding Chinese listings); Kun-Chih Chen et. al., "Financial Reporting Quality of Chinese Reverse Merger Firms: The Reverse Merger Effect or the China Effect," Social Science Research Network, December 10, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2043899.

90 Nevertheless, US firms, including the Big 4, are required to utilize the joint venture model when doing business in China since foreign ownership of private firms in not permitted. Benjamin A. Templin, "Chinese Reverse Mergers, Accounting Regimes, and the Rule of Law in China," Social Science Research Network, March 20, 2012, p. 134, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2024135. As a result, the firms often depend to a large degree on Chinese counterparts over whom they have limited control.

91 Recent frauds have, for example, arisen from auditors' failure to understand worksheets written in Chinese and an inability to validate basic legal documents like deposit certifications. As a result, the PCAOB has argued that auditors, including the Big 4, may lack resources or rely too much on other people's work. See Chen et. al., op. cit., p. 35; PCAOB, "Auditor Considerations regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm," Staff Audit Practice Alert no. 6. July 12, 2010.

92 Templin, op. cit. p. 143 (noting that in the face of the delisting of Chinese reverse merger companies, "one market response has been widespread discounting of Chinese [firms] based on perceived risk"). This risk, quite notably, applies to issuances in other currencies as well by Chinese companies, including the US dollar.

93 Ibid., p.146 (noting the impact short sellers have on investments where financial fraud may be present, months ahead of official news being leaked).

ti-corruption campaign initiated in 2012. But in order to reassure the foreign investors necessary for deep RMB bond and equity markets—as well as mainland investors increasingly capable of putting their capital abroad via the SHFTZ and loosening capital controls throughout the economy—China must strengthen efforts to demonstrate stronger surveillance and enforcement.

Credible Ratings Processes. CRAs play a critical role in financial markets by providing opinions on the credit risks of products denominated in relevant currencies and by standardizing credit information for investors. This creates the informational conditions necessary for a liquid secondary bond market—a must-have for an international currency. CRAs are also important because many investment funds in the United States and Europe restrict their investments to products that receive a certain rating from a governmentally-recognized CRA. Thus, CRA ratings are either official or unofficial factors impacting the demand for credit-related financial products. Nevertheless, Hong Kong Monetary Authority (HKMA) data has indicated as recently as 2012 that only around 40 percent of the locally-issued dim sum bonds had any credit rating whatsoever.[94] As a result, many investments receive heavy risk premiums, are ineligible for the portfolios of institutional funds, and lack the credibility necessary to generate deep market demand.

In order to bolster the liquidity for issuances and to expand the investor base of onshore and offshore RMB markets, more products should be rated, and the agencies delivering ratings should meet minimum international standards such as those embodied in the *IOSCO Code of Conduct*. At this point, applications by Chinese CRAs to register as service providers have been unsuccessful in the United States for failure to maintain records in line with production and examination requirements[95]—and they are only beginning to make way in Europe.[96] Moreover, difficulties in attaining acceptance have spurred unwelcome polemics between Chinese and transatlantic authorities that have criticized one another's biases in analytics and methodologies. These stumbling blocks must be overcome in order to sustain the functionality and liquidity of the market, even where the capital account is liberalized.

Crisis Management. Finally, and perhaps most importantly, the consequences of financial stress in RMB-denominated markets need to be more predictable. In June 2007, China's new Enterprise Bankruptcy Law came into force; however, like many other commercial Chinese government statutes, was cast at a high level and in broad principles. As a result, a number of issues remain unresolved, such as debtor-in-possession financing.[97] Furthermore, the country lacks specialized bankruptcy courts and judges and professionals familiar with bankruptcy proceedings.[98] As a result, enormous uncertainty underpins commercial transactions onshore. How foreign investors should be treated and what priority their investments should take in the event of bankruptcy are often matters of considerable academic and commercial debate. As a result, the bankruptcy process is rarely used to wind down company operations or seek protection from creditors.[99]

Where financial institutions and funds are particularly subject to stress, such as when hot money flows abruptly exit the banking system, even more ambiguity exists. China has traditionally lacked a deposit insurance system, and though a new system is being introduced, support will be capped at CNY 500,000 and will not cover branches of foreign banks and overseas branches of China-incorporated banks. Moreover, bailouts of distressed financial institutions have been orchestrated according to unclear metrics. Governmental support for some banks and trusts (and their investment products, which are often referred to as part of the country's "shadow banking" system) has been forthcoming in some situations yet absent in other, nearly identical situations.[100] Because of such ambiguity, trading and investment operations with Chinese banks are often subject to risk premiums, and international firms are especially cognizant of enterprise risk exposures. Thus to facilitate a more robust RMB market, more clarity is needed on the conditions and framework for state support and resolution and bankruptcy mechanisms.

Along similar lines, regulatory officials will have to develop close-out and netting arrangements and procedures for reiterative, high volume onshore derivatives transactions. Close-out netting refers to a process available in the United States and Europe involving the termination of obligations under a contract with a defaulting party and then netting out outstanding obligations into a single net payable or receivable by one party. It allows, as a result, a non-defaulting party to effectively set off payments that it owes the defaulting party if the defaulting party goes bankrupt or enters the zone of insolvency. However, close-out netting is not a legal concept expressly recognized under the Chinese law, nor is it a concept addressed under the country's bankruptcy law.[101] Although ISDA has made strides this year to narrow the degree of ambiguity in the area, market participants have expressed skepticism as to the level of certainty in conducting large scale transactions.

94 Oswald Chen, "Mainland Credit Rating to Lift HK's Dim Sum Bond Market," *China Daily*, October 22, 2012, http://usa.chinadaily.com.cn/business/2012-10/22/content_15835630.htm.

95 Dian L. Chu, "SEC Denies China's Dagong of Market Entry after U.S. Debt Downgrade," Zero Hedge, September 26, 2010, http://www.zerohedge.com/article/sec-denies-chinas-dagong-market-entry-after-us-debt-downgrade.

96 "China Credit Ratings Issuer Dagong Europe Begin Operations in Milan," *Standard*, June 2013, http://www.thestandard.com.hk/breaking_news_detail.asp?id=37520.

97 Richard C. Pedone and Henry H. Liu, "The Evolution of Chinese Bankruptcy Law: Challenges of a Growing Practice Area," Aspatore, September 20, 2010, p. 2, http://law.okcu.edu/wp-content/uploads/2014/06/I.China_Bankruptcy_Law_Pedone.pdf.

98 Ibid.

99 US Department of State, "Investment Climate Statement," June 2014, p. 16, http://www.state.gov/documents/organization/228504.pdf.

100 In the early fall of 2014, for example, China's regulators helped organize a bailout of "Credit Equals Gold #1," an alternative investment trust product, as panic in the market arose about the viability of non-bank investments. However, officials permitted "Credit Equals Gold #2" to effectively fail, illustrating a lack of consistency—similar to the United States in the Lehman Brothers case—as to when and under what circumstances governmental intervention and assistance will arise.

101 "ISDA Published the New Legal Memorandum on Enforceability of Close-out Netting of Privately Negotiated Derivatives Transactions under ISDA Master Agreements in the PRC," King and Wood Mallesons, February 2014, http://www.kingandwood.com/bulletin.aspx?id=banking-newsletter-2014-02-25&language=en.

Transpacific Capacity Building Is Required

To achieve many of these goals, deeper levels of cross-border coordination will be required. This necessity has been recognized by the Chinese government.[102] As was the case with the Hong Kong-Shanghai Stock Connect—where the details concerning the coordination of the program failed to materialize between China and Luxembourg, stymying initial European investment participation—cooperation with foreign authorities tasked with protecting their own investors will be necessary to successfully operationalize even unilateral liberalization efforts. Differences in interest rates would be only one of the factors shaping the RMB's position. Other factors, including the correlation between foreign countries' economic growth, their bilateral exchange rates with the RMB, and the correlation between exchange rates of the RMB with those of other international currencies, would also be important. Therefore, the RMB will likely be very attractive to investors from high-income economies and fundraisers from emerging market economies.[103]

However, capital account liberalization, though it assuages many macroeconomic concerns, will by its nature catalyze occasional frictions with EU and US regulatory approaches and infrastructure. The potential list of irritants is extensive, but as we have already discussed, some of the most obvious regulatory issues may include:

- Differing philosophical and prudential concerns as macroprudential concerns push product development in China and product simplification in the United States and the EU
- Varying US and EU accounting standards and auditing and supervision
- Conflicting cultural and philosophical operations of credit rating agencies
- Divergent expectations of clearing banks, clearinghouses, and their members
- The differences between ISDA standards and Chinese master agreements

Moreover, these divergences may be more difficult to assuage. Not only will China have its own timetable for implementing reforms, but it will also have an increased stake in policy stances, at least as compared to the past, since the cross-border capital restrictions that buffered its markets from the effects of lapses in supervision abroad will no longer be in place.

Whether or not the global regulatory system has the institutional capacity to accommodate, examine, and bridge these differences is questionable. On the one hand, the FSB, IOSCO, and Basel Committee on Banking Supervision (BCBS) all have important responsibilities in bridging regulatory differences. Furthermore, their membership includes the United States, the EU, and China (as well as Hong Kong, Singapore, and major financial centers in Europe). However, no work streams are currently designated to tie regulatory reforms to capital account liberalization. As a result, little work has been done to predict and foresee the kinds of clashes likely to materialize as capital account liberalization progresses. RMB Working Groups should be created at institutions such as ISDA, the International Accounting Standards Board (IASB), the Investment Company Institute (ICI), the Financial Accounting Standards Board (FASB), BCBS, IOSCO, CPMI, and FSB to manage new developments in RMB infrastructure and Chinese monetary policy.

Similarly, although a robust regulatory dialogue has emerged between China and Hong Kong, major regulatory agencies in both the United States and the EU have not built the capacity to engage Chinese regulatory designs from their respective standpoints of national (or regional) strategy. Neither the SEC nor ESMA, for example, has a full-time China specialist; similarly, the Federal Reserve, though working through international counterparts, does not have a public work stream or educational programs relating to the regulatory issues generated by RMB internationalization. As a result, gaps will be inevitable, as will poorly designed responses to changes in Chinese market reforms—already, from credit rating agency regulation and reverse mergers to accounting to clearinghouses, conflicts have increasingly arisen between transatlantic and transpacific regulators at the bilateral level. To minimize such gaps, targeted staffing should be allocated to China's growing capital markets or, alternatively, to ensuring secondment programs for Chinese officials, offshore RMB financial authorities, and their EU and US counterparts to share information with their transatlantic counterparts.

Prudential Concerns, Nondiscrimination Principles Should Trump Politics

Although currency internationalization is at times inherently a political process in that it affects levers of foreign policy, authorities supervising market participants should make regulatory decisions above all on economic and prudential grounds—as should market participants themselves. In short, the ultimate success of RMB internationalization will depend on whether market participants have faith in China's economy—and in the laws governing price discovery, exchange and interest rate formation, and regulatory supervision supporting the currency. Politicized markets invite distrust and higher risk premiums, since official policy actions unrelated to economic or prudential concerns can with little notice undermine an investor's returns. When, on the other hand, decisions are based on credible economic rationale, markets can incentivize the foreign investment necessary for achieving deep levels of liquidity.

Similarly, just as economic principles should predominate, so should longstanding principles of nondiscrimination. This is not to say that governmental involvement should be prohibited outright. Although the RMB process is a state-driven process—and as such diverges considerably from the historical internationalization process of the US dollar and the British pound—one can and should

102 Indeed, the Third Plenary Session of the 18th CPC Central Committee concluded in 2013 to, among other things, "to adapt to the new situation of economic globalization, [we] must accelerate the cultivation of new competitive advantages in participating in and leading international economic cooperation." *Communique of the Third Plenary Session of the 18th Central Committee of the Communist Party of China*, January 15, 2014, http://www.china.org.cn/china/third_plenary_session/2014-01/15/content_31203056.htm.

103 Dong He, Paul Luk, and Wenlang Zhang, "The Internationalisation of the Renminbi as an Investing and a Funding Currency: Analytics and Prospects," HKIMR Working Paper no. 01/2015, January 16, 2015, http://ssrn.com/abstract=2550713.

expect, especially given the incremental nature of reforms, that Chinese officials may mandate that Chinese companies play particular roles as channels of RMB finance. For example, the Chinese government may demand or expect Chinese institutions to serve key intermediary roles such as clearing banks in early stages of capital account liberalization. But given these possibilities, it should be practiced with nondiscrimination as an overarching principle. In the case of clearing banks, for example, Chinese authorities should ensure that clearing services are well regulated, conform with international best practices, and treat customers uniformly—from margin and collateral requirements for investments and clearing member obligations and standards to short-term lending. Similarly, host states should impose rules on foreign CRAs that are no better or worse than what is expected in the operations of their own institutions and that espouses and reflects international best practices. Only then can regulators ensure that customers, borrowers, and clients have access to the service providers that either service them most efficiently or most directly speak to their financing and investment needs.

The IMF Should Include the RMB in Its Basket of Reserve Currencies—and Incorporate Regulatory Reform in Its Weighting Metrics

Nondiscrimination principles should also apply to the RMB and its treatment globally. SDRs are, as mentioned above, credit lines for distressed economies encountering balance of payments crises. Currencies included should be those that can help countries in the midst of such challenges—which have roots in poor capital or current accounts. From this perspective, the appropriate metric for the suitability of a currency should indeed be based on the prevailing standard as to whether a currency is "freely usable," which in turn requires that it be widely used and widely traded. These standards interrogate whether the currency in question has met minimal international market expectations as instruments for invoicing, payment, and storing value.

Although China is still far away from classically conceived full RMB convertibility and has yet to develop a market-based interest rate instrument, the IMF has recently declared that the currency is no longer undervalued—and most commentators appear to believe that the RMB meets the minimum standards necessary for inclusion in the SDR. Besides being supported by the world's biggest trading nation and the second largest economy, the RMB is, as seen above, relied on heavily: it is used for trade settlement purposes through China's fully liberalized current account; foreign investors have access to RMB denominated investments onshore via expanding quota allocations; and the currency is becoming exponentially more available in multiplying offshore RMB financial centers. For these and other reasons, PBOC Governor Zhou Xiaochuan has noted to IMF Managing Director Christine Lagarde that the RMB is ready to take its place as an international reserve currency alongside other major currencies.

That said, attaining more visibility and credibility in the SDR's basket should come with explicit attendant responsibilities. Clearly, China should continue to support the international financial system through its ramped up efforts to inject RMB-denominated liquidity to support commerce and investment. But it is in the world's interest that redenominations of the SDR track not only the availability and convertibility of a currency, but also the maturation and robustness of the regulatory ecosystem supporting it. Only in this way will the currency's heightened use benefit the international monetary system over the long run. Thus, the extent to which the RMB in particular is included in the SDR's currency basket should be regularly revisited, and its weight should reflect not only the depth and liquidity of its capital markets, but also the robustness and governance supporting those markets and their ability to withstand the volatility that accompanies capital account liberalization. Perhaps surprisingly, this is not the IMF approach, which instead emphasizes market metrics like transaction volume in foreign exchange and derivatives markets. But in light of the interconnected nature of the global financial system, a more nuanced approach is used. In this way, proper incentives can be generated to continue both market and regulatory reforms, while also integrating the RMB into the global financial system and solidifying its reputation, credibility, and utility.

CONCLUSION

The suggestions highlighted above articulate a measured approach for constructively engaging the rising prominence and popularity of the RMB that integrates developments in capital and currency account liberalization, financial regulation, and economic growth both in China and globally. As the report underlines, the increasing role of the currency is in many ways a salutary development—and one to be expected as China's growth story matures. At the same time, however, even as China blazes its own independent and unique path of currency internationalization, several core universal norms should and must be maintained. In particular, steady and credible institutional reform, nondiscrimination, and robust market supervision are the keys to promoting the currency's acceptability for market participants as the country's growth moderates. Moreover, these principles will lay the foundation for a healthy RMB financial system, enabling governments and official institutions to come to embrace it. Yet, internationalization is not only a matter of Chinese governance and policy. The same commitments of institutional reform, nondiscrimination, and cross-border cooperation will be necessary with China's transatlantic partners as well in order to support these goals, foster cross-border efficiency and collaboration, and lend greater stability to the global financial system.

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