CITY OF LONDON

Aberdeen Standard Investments

RMB Internationalisation: The Start of A Long and Winding Road

Jeremy Lawson – Chief Economist at Aberdeen Standard Investments

China has made extraordinary economic progress over the past four decades. In 1980 the Chinese economy was only 10% of the size of the United States economy in nominal US dollar terms. By 2008, on the eve of the global financial crisis, that ratio had reached a little over 31%, while today it is closer to 65%. With a population more than 4 times that of the US it seems inevitable that the Chinese economy will one day be the largest in the world.

When it comes to international goods exports, China is already the dominant global player. In 2016 it accounted for 17% of the global total, above that of the European Union (16%) and the US (12%), though China's gross export figures are somewhat inflated by the high foreign value-added content of its foreign sales. Moreover, as a source of global demand, China is still a smaller market for imports than both the US and the EU.

Yet despite this growing economic might, China's currency – the renminbi (RMB) is still a relatively small player. According to the most recent data, a little under 14% of China's current account transactions are in its own currency, down from more than 25% in the middle of 2015, and RMB-denominated assets comprise less than 2% of global allocated reserves. Meanwhile, overseas entities own less than 3.5% of the stock of domestic RMB-denominated bonds and only a little over 1% of domestically listed equities.

The enormous gap between China's role in the global economy and the use of its currency in foreign trade and financial transactions largely comes down to its domestic policy and regulatory regime. Becoming a major global trading power was a core component of the country's post-Mao drive to accelerate the development of its economy.

But the authorities have traditionally been far more reluctant to liberalise its financial system; foreign access to domestic financial markets was heavily restricted, the currency was carefully managed, and the capital account kept relatively closed. This was all part of a strategy to maximise domestic policy control and limit the ability of foreigners to dictate local financial conditions.

Recent years have seen the Chinese authorities take a more divergent approach to financial liberalisation. In particular, there has been a conscious decision to open domestic financial markets to more foreign participation.

As an example, foreign investors are now able to take majority stakes in non-state owned banking and insurance companies, while access to the domestic bond market has been relaxed even more quickly. The upshot is that the overseas ownership share of domestic RMB-denominated assets is likely to grow significantly over time.

However, the outlook for the currency and the RMB's reserve status is much cloudier. Until the middle of 2015, cross-border settlement of Chinese trade and current account transactions was rising rapidly. But the subsequent decision to devalue the currency and tighten capital account restrictions to stem destabilising capital outflows and increase domestic policy flexibility in the face of US monetary policy normalisation, dealt a blow to the confidence of domestic and foreign asset holders alike.

As a result, the share of transactions settled in RMB fell precipitously, only stabilising very recently. Through this period RMB's share of global reserve allocation has continued to increase, but it remains an order of magnitude lower than the shares of the US dollar and the Euro, and even the Japanese yen and UK pounds sterling.

China's closed capital account will continue to be structural weight on the internationalisation of the RMB. There are also a variety of other factors that cloud the outlook. One is the opacity of the country's monetary and currency framework. After a long period of real and nominal appreciation against the US dollar, the RMB trend has reversed over the past three years as the authorities have continued to prioritise monetary policy decoupling from the Fed.

This has been necessary as a means to rebalance the economy from its excess reliance on credit and investment to drive growth, as well as offset the negative effects of the trade war with the US. But until policymakers objectives are clearer and the economy stabilises, progress on internationalisation is likely to be constrained.

Moreover, despite the temporary truce agreed at the recent G-20 agreement, trade tensions are likely to escalate again through 2019. At the same time, although the rhetoric of Jerome Powell and other senior officials has become more dovish of late, the Fed is likely to deliver more rate hikes in 2019, extending policy divergence. Both are likely to put further downward pressure on the RMB. Indeed, even if China does forestall tariffs by importing more goods from the US, this will strengthen the relative demand for dollars.