Natural Process or Deliberate Strategy? Yuan Globalization

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China's approach towards yuan globalization is very prudently considered by China's authorities.

> To deal with money is generally a very complex issue and when it comes to governance - internationalization brings as much opportunities as threats. It refers not only to particular types of transactions but also to geographical (sometimes for China even political) locations and chosen institutions.

China has always chosen experiments to try new reforms. In case of currency they were; first – particular places (Hong Kong being very handy place for various trials), and institutions (local and international financial institutions nominated as temporary performers).

Whilestudying different aspects of currency internationalization one has to start with simple overview of roles that money plays in economy. Then how to transform basic functions of local money into its international variation.

The functions are:

- Intermediary in transactions (invoices denominated in particular currency)
- Stock of savings (currency reserves)
- Value measurement (prices set in particular currency)
- Means of financial accounting (international credit and capital market transactions)

To perform all these functions particular currency has to be relatively free to use by all actors in international transactions. Chinese currency is not yet as the US dollar, considered as the most freely used.

Theoretical background

In most nations, economic policy makers would like to achieve three goals , sometimes known as trilemma in international finance :

1. ***Make the country's economy open to international flows of capital.*** **Capital mobility lets a nation's citizens diversify their holdings by investing abroad**. It also encourages foreign investors to bring their resources and expertise into the country.

2. ***Use monetary policy as a tool to help stabilize the economy***. The central bank can then increase the money supply and reduce interest rates when the economy is depressed, and reduce money growth and raise interest rates when it is overheated.

3. ***Maintain stability in the currency exchange rate.*** A volatile exchange rate, at times driven by speculation, can be a source of broader economic volatility. Moreover, a stable rate makes it easier for households and businesses to engage in the world economy and plan for the future.

The thing is you may not achieve three simultaneously.

In the United States, they have picked the first two. Any American can easily invest abroad, simply by sending cash to an international mutual fund, and foreigners are free to buy stocks and bonds on domestic exchanges. Moreover, the Federal Reserve sets monetary policy to try to maintain full employment and price stability. But a result of this decision is volatility in the value of the dollar in foreign exchange markets.

By contrast, China has chosen a different response to the trilemma. Its central bank conducts monetary policy and maintains tight control over the exchange value of its currency. But to accomplish these two goals, it has to restrict the international flow of capital, including the ability of Chinese citizens to move their wealth abroad. Without such restrictions, money would flow into and out of the country, forcing the domestic interest rate to match those set by foreign central banks.

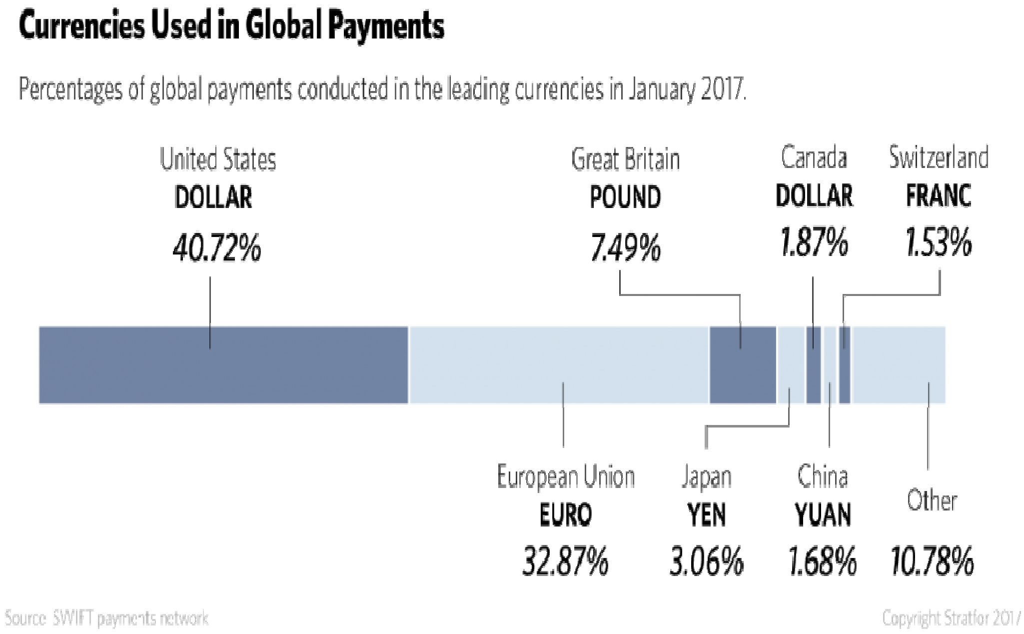
Any attempts to loose China policy in this fields leads to troubles.

Chinese main measures to globalize yuan.

Until 2003 yuan was purely internally used currency.

Growing importance of Chinese international trade, development of inbound/outbound international investment, rising role of banking sector and internal capital market creation and rapid growth required thoughtful actions and cautious steps. Not until, November 2003 the State Council of China gave the permission for banks in Hong Kong to provide yuan deposit, remittance, exchange and credit card services. Hong Kong Monetary Authority (HKMA) and People’s Bank of China (PBOC) sign a regulatory agreement limiting the amount Hong Kong residents can exchange and remit at 20,000 yuan and 80,000 yuan per day, respectively.

INTERMEDIARY -With growing role in international trade China attempts to use yuan in transactions with some biggest of its trading partners (limited amount of yuan permitted to use on yearly basis (so called swaps)

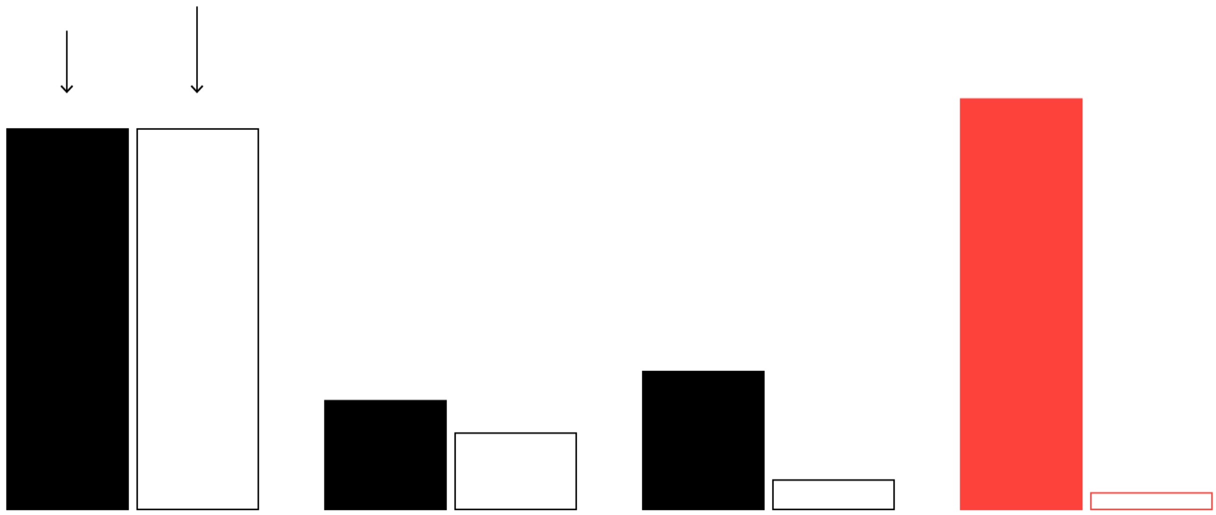


Quite recently there is a pressure to use yuan in oil transactions with OPEC countries (petroyuan instead of petrodollar). One obvious reason China wants oil to be traded in yuan is to increase global demand for yuan-denominated assets. This would increase capital inflows and may eventually lead to the yuan being a plausible global alternative to the American dollar. Saudi Arabia is OPEC's historic swing producer and price arbiter — if it agreed to conduct transactions in currencies other than the dollar, other OPEC producers would be forced to follow suit.

To what an extent it is also the aim to cut transaction costs and increase capital inflows rather than increase prestigious importance of yuan remains to be discussed. And still US$ remains, so far, the mostly used currency (80 to 65% according to different sources) .

Comparison of international trade and currency use

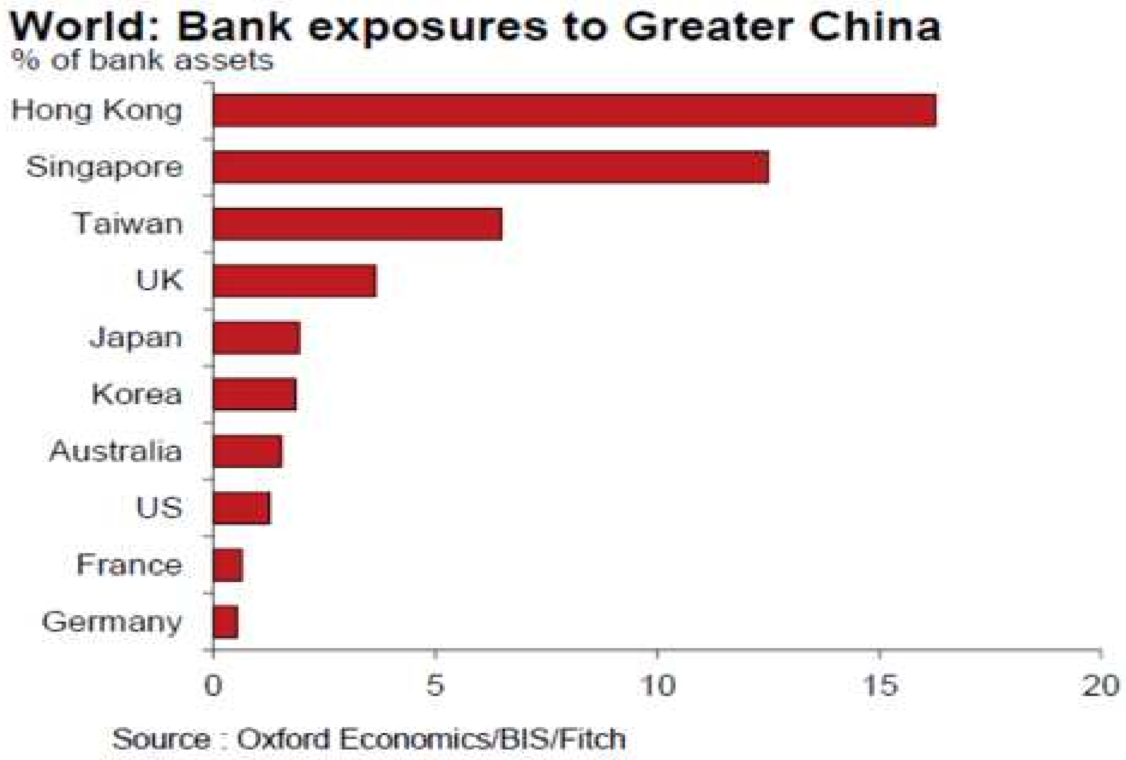
Tade value   Share of global payments



US US$ UK GBP JAPAN JPY CHINA
CNY
2,7tr$ 41,9% 1,1tr$ 8,4% 1,3tr$ 3,2% 4,0tr$
1,8%

In China only in June 2009, HKMA and PBOC sign agreement to allow trade between Hong Kong and the mainland to be settled in yuan from July in 5 cities. In June 2010 cross-border yuan trade settlement scheme was expanded to 20 provinces and cities.

CURRENCY RESERVES IMF data and BIS show that majority of international reserves are still kept in US$, and global banking system exposure to China is quite mediocre. (see below)



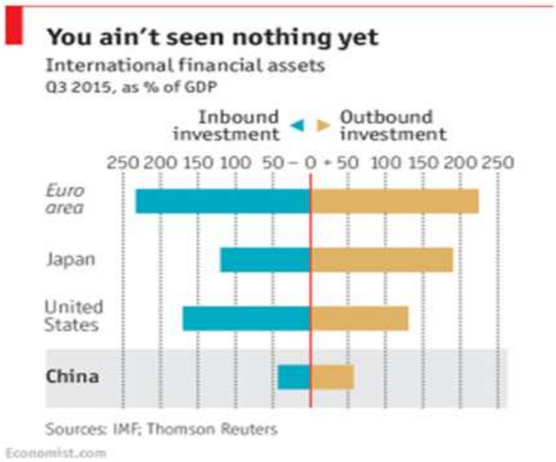
PRICING -Prices in international markets are published in US$ and EUR accordingly.

CREDIT AND CAPITAL MARKETS TRANSACTIONS –it always was the most complex and sensitive part of currency internationalization and many countries still do not cope with the issue entirely. Only in July 2010, Beijing allows yuan transfers among financial firms and individuals to enable them to offer funds, insurance and other investment products denominated in yuan still only in Hong Kong. First yuan-denominated corporate bonds were issued in Hong Kong by Hopewell Highway Infrastructure, raising 1 billion yuan.Still only around one fifth of capital flows in form of FDI or ODI refers to China (see below)

Foreign direct investments as very desirable source of capital at first started to flow from Hong Kong Taiwan (via Virgin Islands).

Thus in August2010 The PBOC allowed yuan clearing banks and other overseas eligible financial institutions to trade directly in the mainland interbank market. As reciprocal movement in January 2011 A pilot scheme for mainland companies to settle overseas direct investments in yuan was announced. A month later Beijing allowed overseas firms to use yuan to settle foreign direct investments (FDI) in China, instead of the US dollar.

WORLD INTERNATIONAL ASSETS



Chinese banks are ranking among ten biggest in the world but China capital markets measured as market capitalization and major financial instruments (shares and bonds) are stil much below greaters.(See below)

In December 2011, There was a launch of renminbi qualified foreign institutional investor scheme (RQFII). That means chosen indicated by Chinese international financial institutions have a right to trade in yuan on internal financial markets.

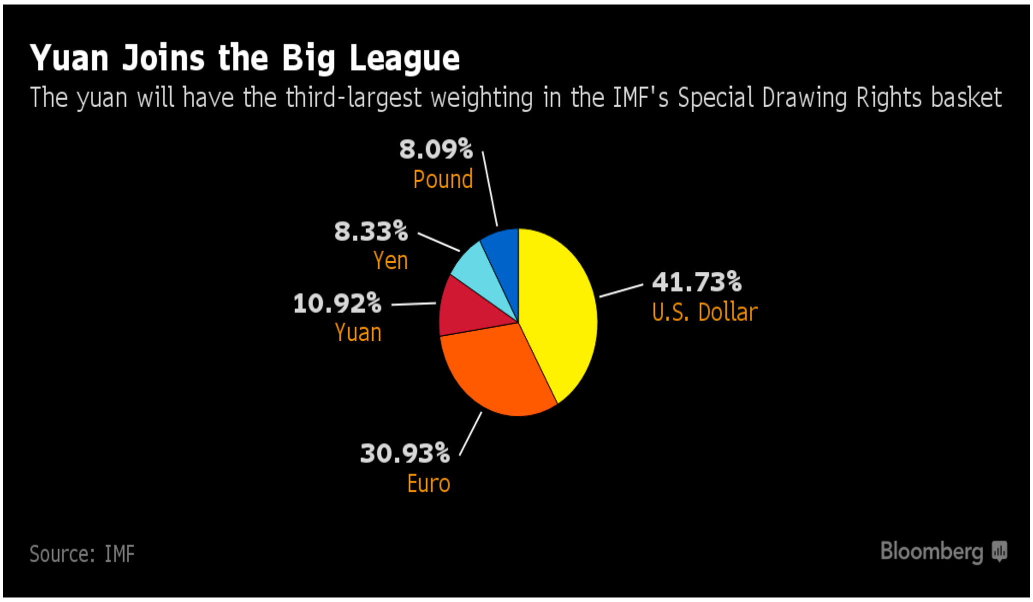
WORLD FINANCIAL SYSTEM

From January 2012 till 2013 UK-London, Tokio, Taipei and Sydney got agreements to trade yuan within special swap lines(First Hong Kong banks, then Bank of China, Bank of England)

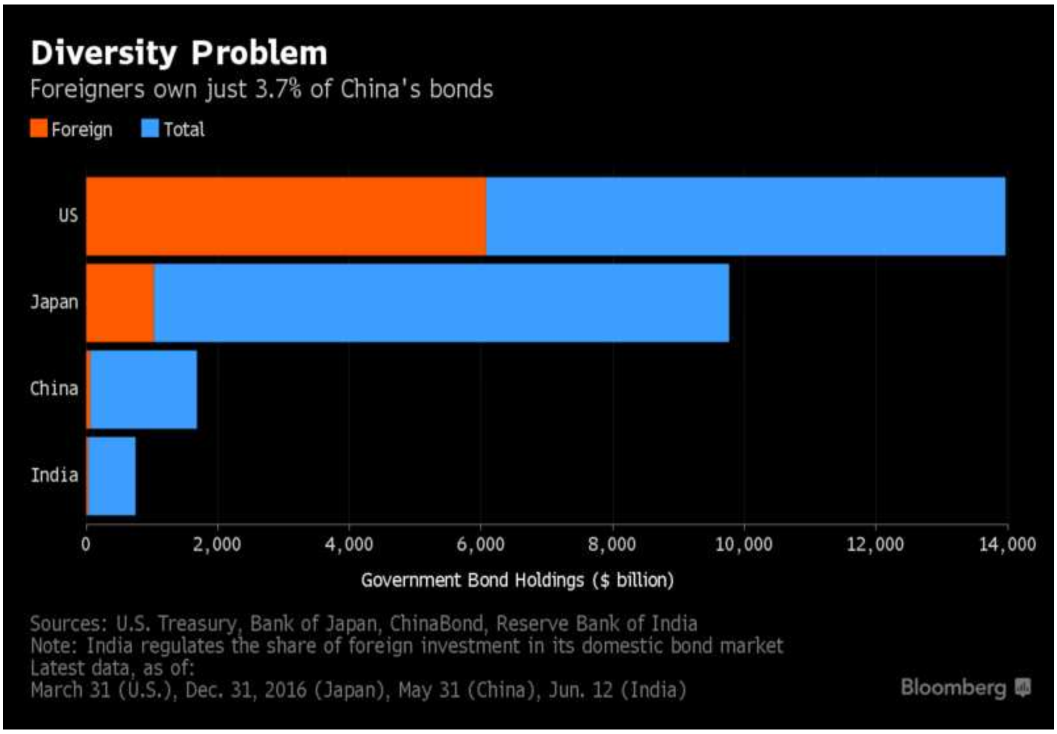
In 2014 the daily RMB exchange cap of 20,000 yuan was removed ahead of the launch of the stock connect scheme to link the stock markets of Hong Kong and Shanghai and allow retail investors to conduct cross-border trading in yuan.

In 2015 Foreign banks started trade in mainland bonds. PBOC launches the first phase of the China International Payment System (CIPS) and allows certain foreign banks to trade in the mainland bond

And November 2015 yuan gains reserve currency status. China states its goal of making the onshore yuan a freely tradeable currency by 2020**. In December the IMF includes the yuan in its Special Drawing Rights, giving it the status of a reserve currency like the US dollar, euro, pound and yen. Formally Yuan share extends Pound and Yen share** (see below)



Still according to some sources foreigners own just 3,7% of Chinese bonds, it proves the very limited demand for Chinese financial products. (see below)



YUAN INTERNATIONALIZATIONPROCESS

The yuan journey to becoming a global currency lasts for long and it is very cautious and multidimensional process. It covers actions in institutional, geographical and business scopeareas. Starting from 2003 China authorities start to ease control in use of yuan internationally.

2003, November: State Council gives the green light for banks in Hong Kong to provide yuan deposit, remittance, exchange and credit card services. Hong Kong Monetary Authority (HKMA) and People's Bank of China (PBOC) sign a regulatory agreement capping the amount Hong Kong residents can exchange and remit at 20,000 yuan and 80,000 yuan per day, respectively.

2004, February: Banks launch their personal yuan business.

2009, June: HKMA and PBOC sign agreement to allow trade between Hong Kong and the mainland to be settled in yuan from July in five cities.

2010, June: Cross-border yuan trade settlement scheme is expanded to 20 provinces and cities.

2010, July: Beijing allows yuan transfers among financial firms and individuals to enable them to offer funds, insurance and other investment products denominated in yuan. First yuan-denominated corporate bond is issued in Hong Kong by Hopewell Highway Infrastructure, raising 1 billion yuan.

2010, August: PBOC allows yuan clearing banks and other overseas eligible financial institutions to trade directly in the mainland interbank market.

2010, December: Beijing expands the list of eligible mainland firms to conduct cross-border yuan trade settlement.

2011, January: PBOC announces pilot scheme for mainland companies to settle overseas direct investments in yuan.

2011, April: First yuan-denominated IPO in Hong Kong with the listing of Hui Xian Real Estate Investment Trust, a spin-off of Li Ka-shing's Beijing Oriental Plaza.

2011, June: HKEX introduces guideline for dual-currency IPO model for candidates to sell shares denominated in both yuan and HK dollars – but no such IPO is launched yet.

2011, August: Beijing allows overseas firms to use yuan to settle foreign direct investments (FDI) in China, instead of the US dollar.

2011, December: Launch of renminbi qualified foreign institutional investor scheme (RQFII).

2012, January: Hong Kong signs agreement with City of London to help the English capital develop as the next offshore yuan trading centre. HKMA extends yuan trading hours, including yuan sovereign bonds and mainland interbank bonds as banks' yuan risk management limits positions.

2012, June: China starts direct trading between the yuan and the Japanese yen in Tokyo and Shanghai. The National Development and Reform Commission identifies Qianhai as a testing ground for freer convertibility of the yuan. HKMA launches facility to provide yuan liquidity to banks engaged in yuan business in Hong Kong.

2012, July: Hong Kong banks are allowed to offer yuan services to non-residents.

2012, October: SFC approves the first dual-currency exchange-traded fund, Harvest MSCI China A Index ETF. Hopewell Highway Infrastructure announces the first yuan shares placement in the city, becoming the first listed company to offer both yuan and Hong Kong dollar-denominated stock.

2013, January: PBOC appoints Bank of China's Taipei branch as yuan clearing bank for Taiwan. First cross-border yuan loans authorised with 15 banks in Hong Kong permitted to offer a combined 2 billion yuan in loans to companies in Qianhai.

2013, February: Beijing names Industrial and Commercial Bank of China (ICBC) as clearing bank for offshore yuan business in Singapore.

2013, April: Australia starts direct trading between the yuan and the Australian dollar. HKMA removes the yuan net open position limit for Hong Kong banks and lifts the 25 per cent minimum liquidity ratio for yuan.

2013, June: PBOC and Bank of England agree to a three-year currency swap line of up to 200 billion yuan. Hong Kong launches the world's first offshore yuan interbank rate fixing.

2013, September: Shanghai becomes a free-trade zone, enjoying freer convertibility of yuan.

2014, November: Removal of the daily RMB exchange cap of 20,000 yuan a day ahead of the launch of the stock connect scheme to link the stock markets of Hong Kong and Shanghai and allow retail investors to conduct cross-border trading in yuan.

2015, July: Launch of the mutual recognition scheme to allow certain mutual funds in Hong Kong and mutual funds in China to cross-sell in each other's market up to a total of 600 billion yuan.

2015, August: PBOC makes a one-off devaluation of the yuan by 2 per cent and changes the method for setting the mid-price range according to the previous market price at close of trading.

2015, October: PBOC launches the first phase of the China International Payment System (CIPS) and allows certain foreign banks to trade in the mainland bond market.

2015, November: State Council states goal of making the onshore yuan a freely tradeable currency by 2020.

2015, December: IMF decides to include the yuan in its Special Drawing Rights, giving it the status of a reserve currency like the US, euro, pound and yen.

2016, December: Launch of Hong Kong and Shenzhen stock connect scheme to allow cross-border trading.

2017, July: Launch of north-bound trading bond connect scheme.

2017, Pressure to denominate oil international transactions in yuan- "petroyuan" -currency accomplished -beginning 2018

2018: New reforms announced by PBOC.

A number of commercial banks from the United Kingdom, Japan and Singapore, and a few French and German insurers, have said they want to build or boost their presence in China, **the China Banking and Insurance Regulatory Commission (CBIRC) -** said last month, without naming any of the institutions.

UBS Group confirmed to the *South China Morning Post* that it applied to increase its stake in Beijing-based venture UBS Securities from 24 per cent to 51 per cent because "China is a key market".

The company has been trying to boost its presence in the market for a long time.

It was the first to sign up for the qualified foreign institutional investor (QFII) scheme when China launched it in 2002, allowing overseas firms limited access to the mainland stock exchanges.

UBS has remained the largest QFII since then, with a combined investment quota of about US$3 billion, although that is a tiny quota for China's US$9 trillion stock market.

15 years after China entered the World Trade Organisation in 2001, despite repeated promises from Beijing to open up, foreign institutions still have a limited presence in the financial market and in most cases rely on local partners.

There were signs of progress in the middle of last year, when Beijing allowed foreign credit rating agencies to enter its domestic market as trade frictions were escalating with Washington. Some restrictions on foreign ownership of Chinese financial companies and their business operations were then relaxed – a move announced straight after US President Donald Trump visited Beijing in November.

Iris Pang, chief economist for Greater China at ING, said many of the big financial institutions may be hesitant about investing too much in China at the moment, and that the companies showing the most interest were the smaller ones.

“They are active because even a small slice of the China market would be a big boost to their business turnover and they can survive by developing a niche market such as Sino-European cross-border payments,” Pang said.

The asset management business was, for the smaller firms, the best opportunity because they would have an advantage in designing mature product lines that can meet the demands of China’s growing middle class.

“It’s very attractive, but not easy. You have to be very familiar with the local conditions before you take that first step,” she said.

Several US asset managers, such as Vanguard and Bridgewater, set up subsidiaries in Shanghai a year ago, but they have yet to release further details.

Huang Zhilong, a senior researcher with Suning Institute of Finance, said opening the financial market to foreign firms would improve due diligence and help to bring the local companies into line with international practice.

But he said the authorities were unlikely to relinquish their control over the institutions at the heart of the financial industry – banks.

“For a country as vast as China, the government needs to make financial stability the priority,” Huang said. “And there’s no better way to do that than with state-controlled banks.”

Is China really planning to open its financial sector?

In a keynote speech delivered at the Boao Forum for Asia on April 10th, China's president, Xi Jinping, pledged that the country would further open its financial sector to foreign investment. Shortly after the governor of the People's Bank of China (PBC, the central bank), Yi Gang, announced that liberalisations would be imminent in areas including asset management, securities and insurance. The overall impact of the proposals, however, is likely to be muted by a lengthy implementation timeline and other onerous regulatory requirements, suggesting that China's financial services will not see a surge in foreign investment.

The measures echoed previous commitments made in November 2017 following a visit by the US president, Donald Trump, to the Chinese capital, Beijing. As part of that pledge, China indicated that it would liberalise its banking, securities and insurance sectors over a three- to five-year period. The announcement by Mr Yi was the first time that China indicated a detailed timetable for when these measures would come into effect. Mr Yi's timeline was also much more ambitious than that indicated in 2017, with many of the changes planned for implementation in 2018.

China's proposed financial-sector liberalisations

Industry	**Policy steps**	**Expected date**
Equity market	Enhance the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect frameworks. This is to be done by raising the quotas for Shanghai-bound and Shenzhen-bound investment to Rmb52bn (US$8.1bn), and Hong Kong-bound investment to Rmb42bn.	May 2018
Banking and asset management	Cancel equity restrictions for foreign investors with the goal of allowing equal treatment between foreign and domestic institutions, while also allowing foreign banks to set up branches and subsidiaries in China at the same time.	June 2018
Fund management, securities, futures industry and life insurance	Raise foreign-ownership restrictions from 49% at present to 51%, with the goal of eliminating all restrictions after three years.	June 2018; full ownership (in theory) by June 2021
Securities	No longer require foreign securities joint ventures (JVs) to include one local securities company as a shareholder.	June 2018
Insurance	Allow qualified foreign investors to provide insurance agents and loss-adjustment services in China.	June 2018
Brokerages	Lift the business scope restrictions on foreign brokerage companies, with the goal of equal treatment between foreign and local players.	June 2018
Trust, financial leasing, automotive finance, currency brokerage and consumer finance	Encourage foreign ownership in these areas.	End-2018
Financial asset investment and wealth	Remove foreign-ownership caps on companies operating in areas that have been newly established	End-2018

management	by commercial banks	
Banking	Allow for the expansion of business scope for foreign banks	End-2018
Securities	Remove restrictions on business scopes of foreign JV securities companies, with the goal of equal treatment between foreign and local players.	End-2018
Insurance	Remove the requirement that foreign insurance companies have a local representative office for two years before establishing a formal presence in China.	End-2018
Equities	Aim to launch the Shanghai-London Stock Connect this year.	End-2018

Note. The above liberalisations reflect statements given by Mr Yi at a press conference in April, although the only concrete policy measures released to date cover liberalisations in the securities industry.

Sources: People's Bank of China; The Economist Intelligence Unit.

The timeline of many of the financial-sector liberalisations coincide with proposed openings of market access in portions of China's automotive manufacturing sector, as well as the unveiling of a new foreign direct investment "negative list", which is expected in June.

Still a lots of limits

Although state media have proclaimed the financial liberalisation measures as being of "landmark importance" for foreign investors, a number of important caveats are included in the policy documents, and they may ultimately blunt the impact of the liberalisations. Importantly, the only measures released so far to embed the proposed foreign-investment liberalisations into law have been administrative measures finalised by the China Securities Regulatory Commission (CSRC) in late April 2018, which target only foreign investment in the securities industry. Released for public comment in March 2018, the measures build on a pilot involving a UK-based financial services firm, HSBC, operating a majority-owned securities firm (which received regulatory approval in June 2017) in the Qianhai Shenzhen-Hong Kong Modern Service Industry Co-operation Zone. However, other than statements given by Chinese officials, specific measures related to foreign investment in banking and asset management, as well as in futures, fund management and insurance, have not yet been published by the authorities.

The CSRC measures will have only a limited impact on the overall composition of foreign investment in China's financial services sector. Moreover, the finalised measures suggest that foreign companies will still face a number of operating challenges. For example, the document does not explicitly call for raising the ownership cap of foreign securities companies in joint ventures (JVs) with local firms from the current 49% level. Although this does not necessarily mean that foreign-ownership caps will not be adjusted, the absence of a specific pledge in the sole authoritative document behind these liberalisations suggests that Mr Yi's comments ought to be treated with some caution.

The measures also preserve stipulations in the original draft that companies that have undergone investigations for rule-breaking in any part of the world within the past three years will also be disqualified from potentially raising their ownership stakes. The measures do not clarify whether this includes routine inspections, such as regulatory inquiries, or are limited only to investigations which have resulted in a conviction. For many major foreign financial firms, which face constant regulatory scrutiny in almost all major financial markets, such provisions could, in effect, limit them from benefiting from these changes. The measures also restrict the number of foreign senior management personnel allowed to hold positions in foreign majority-controlled JVs, in accordance with China's Company Law, Securities Law and other relevant measures from the CSRC.

Foreign industry associations have also identified a number of other proposed challenges in separate draft measures published by the CSRC in late March. These draft regulations also govern equity ownership in securities companies, but are applicable to both domestic and foreign companies, and set high revenue and asset requirements—at Rmb50bn (US$7.8bn) and Rmb100bn respectively—necessary to raise ownership caps in an existing securities JV. There are concerns that if these provisions were applied to only the Chinese-based subsidiaries of foreign securities institutions, as opposed to their global entities, they would prevent even large foreign securities firms from taking advantage of the changes. This could negate some of the positive liberalisations in the final April CSRC measures.

What this means for foreign companies

Even if China does release and finalise measures in other financial sectors before the June timeline outlined by Mr Yi, we do not expect the structure of China's financial services sector to shift significantly. Currently, foreign financial companies play a very small role in the country's financial markets; for example, foreign banks held only 1.3% of total banking assets at end-2017.

In addition, even if foreign financial companies are permitted majority ownership of JVs, their role in the market may be still marginal. One of the main reasons is the now-entrenched position of their Chinese rivals. Chinese financial services have a better grasp of regulatory movements, stronger government connections and more established reputations among corporate and retail clients. Although foreign financial firms might have an advantage in positioning themselves to help Chinese companies and households to access global capital markets, this remains a relatively niche area given the closed nature of China's capital account.

The proposed reforms to the foreign-ownership structure will also be complicated by the overall policy environment, which has increased scrutiny over the financial sector as part of a campaign aimed at tackling "financial risk", one of Mr Xi's main priorities. Throughout 2017 the PBC expanded its regulatory oversight over a number of previously lightly regulated segments of the financial industry. The segments include wealth-management products, with news reports indicating that this supervision has been extended to cover negotiable certificates of deposits, starting from the first quarter of 2018. Stronger efforts centred on improving transparency and risk management have also underpinned this policy push. Although the whole industry would benefit from the high standards of risk management that are employed by foreign financial firms, a tighter regulatory environment would increase the licensing and approval scrutiny of foreign-investment activity in the financial services sector. In turn, that could, in practice, delay any attempts to raise ownership caps on the basis of avoiding systemic risk.

Foreign firms will also be subject to laws and regulations outside the financial industry. One of the most important of these will be China's cyber-security law (CSL), which came into effect on June 1st 2017. It applies to operators of "critical information infrastructure", a vaguely defined term which nonetheless expressly includes companies in the nation's financial services sector, and includes related measures comprising data and product security. Policy efforts are ongoing to replace foreign-built information technology products in Chinese-based financial firms with domestic alternatives. To date, these have been largely concentrated in the banking and insurance industries; however, they are expected to affect all financial firms as part of the CSL's broad scope of authority. These policies may also disrupt internal corporate information networks, creating vulnerabilities and disruptions for the Chinese-based operations of major foreign companies.

Notably, the CSL mandates that all data generated in China must remain in China—a concept known as data localisation. It also requires that any data sent abroad for processing, analysis or other purposes first undergo a data security audit, the details of which have not yet been finalised but are expected to come into force by end-2018. The provisions on data flows will complicate regulatory requirements for US financial firms, in particular, as they are required to provide information regularly to the Federal Reserve (the US central bank) on their worldwide operations as part of standard risk assessments.

Although the proposed liberalisations have been welcomed by several foreign financial services providers, we expect that in practice they will do little to change the landscape of China's financial services industry radically, and that Chinese state-owned firms will continue to dominate the sector. In addition, although state media have termed the measures as a tool to defuse US-China trade tensions, their limited scope—and the existence of so many other inter-connected non-tariff barriers—is unlikely to placate the US administration—around the same time China's proposed financial liberalisations are likely to come into effect.

From this perspective it may look like US is forcing China to liberalize its financial markets thus making yuan more internationally used- meaning globalize?