

REGIONAL  
MALAYSIA  
SINGAPORE  
INDONESIA  
THAILAND  
PHILIPPINES  
CHINA, HONG KONG



## MACRO PULSE

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*“China should avoid any excessive adjustment of the yuan exchange rate that may damage the domestic economy.”*

— Yi Gang,  
Head of China’s State  
Administration of Foreign  
Exchange (SAFE)

## Rmb – Is China ready to pull the trigger?

*The process of internationalization of China’s yuan has gone quite smoothly so far, but that could change if the amount of Rmb in circulation offshore increases. The widening of the yuan’s trading band and its inclusion in the IMF’s basket of currencies are steps towards a more market-based floating exchange rate regime. We believe that at some point, the authorities will take the huge step of opening up the capital account further and making the Rmb fully convertible.*

### China steps up Rmb internationalisation ▶

China has taken small yet quite successful steps in its quest for internationalisation of the renminbi (Rmb) since the US subprime crisis. To promote the use of the Rmb in international trade, it has adopted a multi-phase and multi-track strategy which includes easing restrictions on cross-border remittances, allowing the issuance of Rmb-denominated bonds and accelerating bilateral currency swap agreements with regional central banks. The move to widen the Rmb’s daily trading band from +/-0.5% to +/-1% in Apr and its inclusion in the IMF basket of currencies are steps towards a more flexible exchange rate regime.

### Is China ready to pull the plug? ▶

We view full-fledged internationalisation of the yuan as a distant goal. To make it as the world’s reserves and trade currency, the Rmb needs to show stability and ability to fulfil that role in the global monetary system. To achieve this, the Beijing authorities need to find the right policy balance as internationalisation presents China with a dilemma. While the policymakers would relish a global role for the Rmb for status reasons and a way to check the US dollar’s dominance of the world’s financial system, they also fear a loss of trade competitiveness from a stronger and more volatile Rmb.

### Rmb dominance and its impact on Asia ▶

We believe that the internationalisation of Rmb will ultimately erode the US dollar’s dominance in foreign trade and financial transactions in Asia. Given the deepening intra-regional trade anchored by China in Asia, this compels regional economies to maintain their competitiveness relative to China in the export markets and the stability of their currencies against the Rmb. If the Rmb becomes an international currency rivalling the US dollar, the upward rerating of the Rmb will spill over to regional currencies.

**Figure 1: Performance of Rmb against major and regional currencies (% change)**

	1997-2000	2001-2005	2006-latest 2012
US\$	-0.1	2.6	23.0
EUR	6.6	-23.0	29.1
JPY	-12.4	-8.3	-17.6
MYR	-2.1	2.0	9.8
THB	-7.8	-4.8	9.2
IDR	79.8	-3.4	28.1
SGD	3.3	-7.6	1.6

SOURCES: BLOOMBERG, CIMB RESEARCH

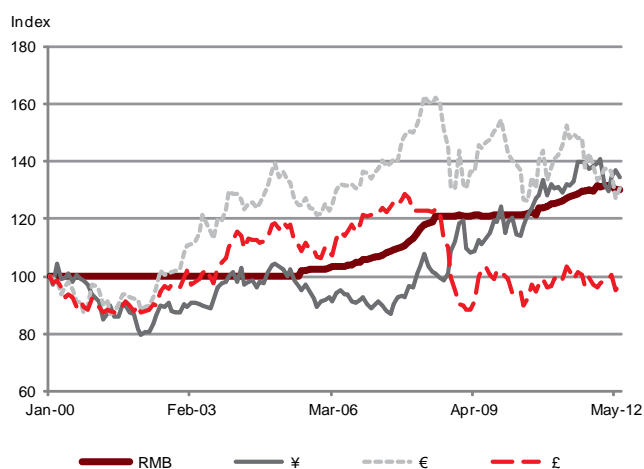
## 1. On a slow boat to China

### Stability reigns over the Rmb ▶

The People's Bank of China (PBOC) announced the widening of the trading band from +/-0.5% to +/-1% for the renminbi (Rmb) relative to the dollar in Apr, reaffirming its policy stance of further exchange rate flexibility. In our view, this is a positive move as the widening of the Rmb's trading band would better reflect market supply and demand of the currency. But given that it is a two-way fluctuation, we should not expect too much from the widening of the trading band as it could be a mere technical adjustment. Since Jul 2005 when the yuan was depegged from the US dollar, it has appreciated more than 30%. It remains unclear how wide the yuan's fluctuations will be as, judging by the daily fluctuations of major world currencies, it is extremely rare for daily changes to reach or exceed 1%.

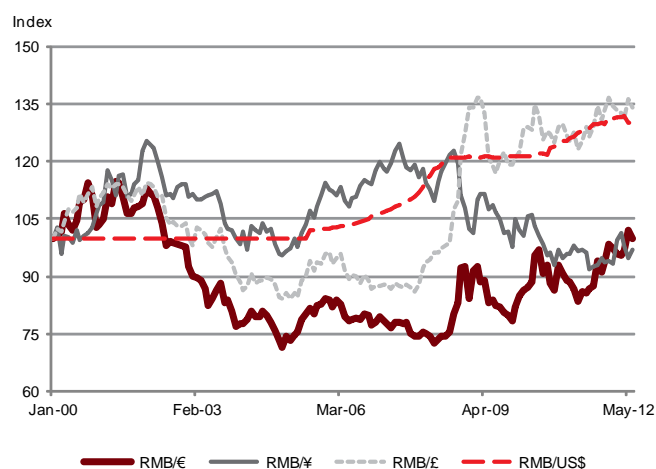
Since China's entry into the World Trade Organization (WTO) in 2001, the Rmb has strengthened by over 30% against the US\$. In terms of real effective exchange rate (REER), which is a composite measure that weights bilateral real exchange rates against China's major trading partners' share of total trade, the Rmb has risen almost 15%. The gradual and consistent Rmb appreciation (+2.3% p.a. against US\$ and +0.9% in REER terms since 2001) can be considered a stabilising factor for the economy, particularly its export-oriented sector.

**Figure 2: Rmb gains traction relative to other major currencies, against the US\$**



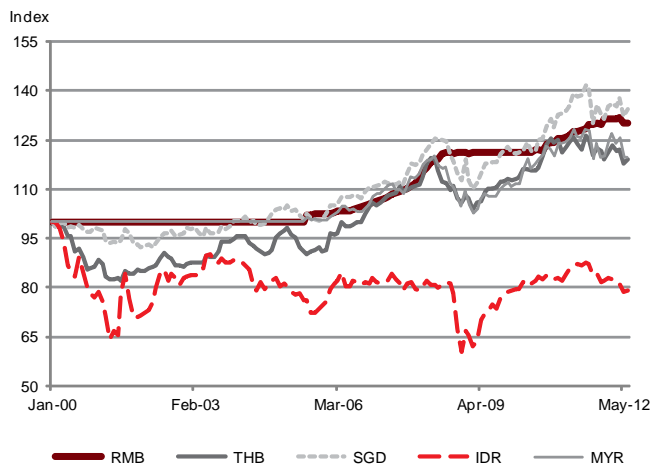
SOURCES: BLOOMBERG, CIMB RESEARCH

**Figure 3: Since the crisis, the Rmb has gained ground against the Euro and Pound but weakened against the Yen**



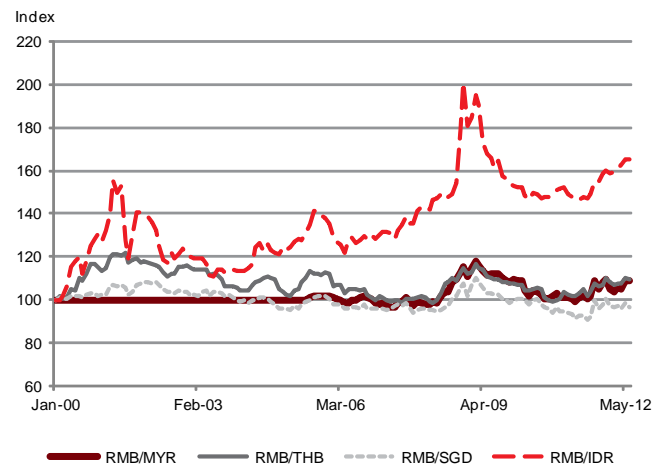
SOURCES: BLOOMBERG, CIMB RESEARCH

**Figure 4: Asian currencies (except for Rupiah) move in tandem with rising Rmb, against the US\$**



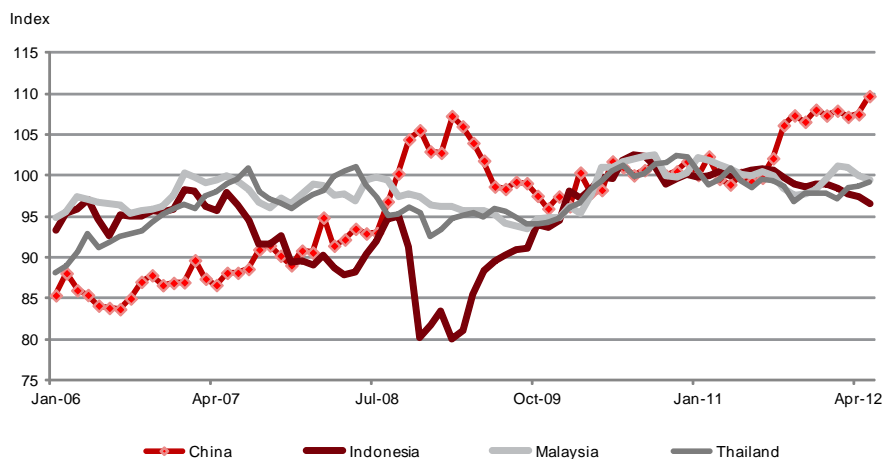
SOURCES: BLOOMBERG, CIMB RESEARCH

**Figure 5: ... but cross rates show mild gains of Rmb against Ringgit, Baht and Singapore dollar**



SOURCES: BLOOMBERG, CIMB RESEARCH

**Figure 6: Trade-weighted effective exchange rate (EER) suggest the Rmb has risen in the last few months amid increasing government efforts to promote Rmb usage**



SOURCES: BIS, CIMB RESEARCH

**Figure 7: Summary of international/regional use of the RMB**

Function of Rmb	Public purpose	Private purpose
Store of value	International reserves	Currency substitution and investment Rmb deposits in Hong Kong Rmb loans in Hong Kong Rmb bonds in Hong Kong, by policy and commercial banks RMB bonds in London by foreign bank (HSBC) Rmb government bonds under ABF2 Rmb equities via QFII, RQFII
	Medium of exchange	Vehicle currency Bilateral swap arrangements under the Chiang Mai Initiative Bilateral swap arrangements between central banks

SOURCES: CHINN, M AND J FRANKEL (2005) NBER WORKING PAPERS, CIMB RESEARCH

## Stepping up Rmb internationalisation ▶

There are obvious benefits from the internalisation of the Rmb but the first hurdle to becoming a global currency is to make it convertible. A deep and liquid currency and capital market is necessary and liberalisation of its currency regime is needed en route to liberalisation of the capital account. China's efforts to internationalise the Rmb and gradually liberalise the capital account have gained traction since 2010. Although it faces pressure from the west to speed up the currency liberalisation, the liberalisation process has been gradual to avoid disrupting economic development.

The Beijing authorities have adopted a multi-phase and multi-track strategy to make the Rmb a reserve currency on par with the US dollar and euro, preceded by the promotion of Rmb in international trade. There were policy changes to ease restrictions on capital flows in and out of the country. In 2004, China started its experiment with convertibility and financial liberalisation by establishing an offshore Rmb market in Hong Kong. Since then, the offshore market has been growing steadily. The acute US dollar shortage that disrupted world trade during the global financial crisis in 2008 prompted the Chinese authorities to respond to prevent future trade shocks arising from the shortage of dollar liquidity. In Apr 2009, China initiated the scheme to settle cross-border trade in Rmb. By June 2010, the yuan was used to settle trade with all countries.

The Rmb trade settlement scheme is complementary to the bilateral currency swap agreements that China arranged with other economies in the midst of the 2008-09 global financial crisis. Since the collapse of Lehman Brothers, China has negotiated 18 bilateral swap agreements with foreign central banks of countries including South Korea, Iceland, Pakistan, the United Arab Emirates and Turkey. It is reported that UK and Japan may be next in line. These swaps offer a buffer against the trade contraction effect in the event of a dollar shortage. The combined value of the signed bilateral swap arrangements to date are worth almost Rmb1.6tr. These arrangements have a three-year duration and are renewable before expiration. The bilateral swap arrangements with a few ASEAN countries were first signed under the Chiang Mai Initiative and effectuated in US dollars. The new swap arrangements are now in Rmb and respective local currencies. The obvious question is whether the policy measures promoting the use of Rmb in the past few years had any material impact on internationalising the currency.

The Rmb accounted for less than 1% of all turnover in foreign exchange markets in 2010. But this understates reality as China uses Hong Kong SAR as an important financial centre for settling foreign exchange transactions. In 2010, Hong Kong accounted for 5% of global foreign exchange market turnover. It is a useful platform that puts the yuan on a competitive footing with other emerging market currencies in reaching international currency status. However, given that the government still intervenes heavily to control the value of the Rmb, whether the Rmb will achieve the global stature of the Chinese economy (10-15% of global GDP) remains a million-dollar question.

Rmb-denominated assets have also made a footprint in a few central banks' foreign exchange reserve portfolios. Malaysia and Nigeria first reported Rmb reserves in 2011. Chile holds 0.3% of its assets in Rmb-denominated instruments. Other central banks are considering adding Rmb to their reserve portfolios. Though still small and modest in size, these moves are symbolically important in signalling the shift in perception of the Rmb's stability and its future role in the global monetary system.

**Figure 8: Bilateral swap agreements: China and other ASEAN+3 countries before 2008 Lehman crisis**

	One-/two-way	Currency	Total size, US\$ bn	Status
China-Japan	Two	Rmb/¥, ¥/Rmb	6	Concluded Mar 2002
China-Korea	Two	Rmb/KRW, KRW/Rmb	8	Concluded Jun 2002
China-Thailand	One	USD/THB	2	Concluded Dec 2001
China-Malaysia	One	USD/MYR	1.5	Concluded Oct 2002
China-Philippines	One	USD/PHP	2	Concluded Aug 2003
China-Indonesia	One	USD/IDR	4	Concluded Dec 2003

SOURCES: BANK OF JAPAN, CIMB RESEARCH

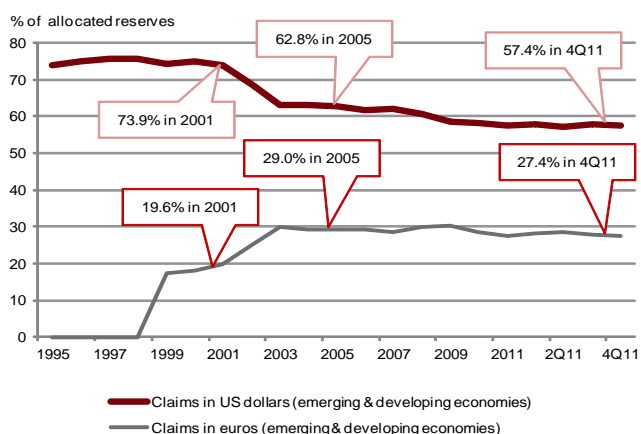
**Figure 9: China's bilateral swap agreements after Lehman crisis, 2008-12 (RMB bn)**

	Dec-08	Jan-09	Mar-09	Apr-09	Jun-10	Jul-10	Apr-11	May-11	Jun-11	Oct-11	Nov-11	Dec-11	Jan-12	Feb-12	Mar-12	Jun-12
South Korea	180					360										
Hong Kong	-	200								400						
Argentina	-	-	70													
Indonesia	-	-	100													
Belarus	-	-	20													
Malaysia	-	-	-	80							180					
Iceland	-	-	-	-	3.5											
Singapore	-	-	-	-	-	150										
New Zealand	-	-	-	-	-	-	25									
Uzbekistan	-	-	-	-	-	-	0.7									
Mongolia	-	-	-	-	-	-	5									
Kazakhstan	-	-	-	-	-	-	7									
Russia	-	-	-	-	-	-	n.a.									
Thailand	-	-	-	-	-	-	-	-	-	-	-	70				
Pakistan	-	-	-	-	-	-	-	-	-	-	-	10				
UAE	-	-	-	-	-	-	-	-	-	-	-	35				
Turkey	-	-	-	-	-	-	-	-	-	-	-	-	1.6			
Australia														200		
Ukraine																15
<b>TOTAL</b>	<b>180.0</b>	<b>380.0</b>	<b>570.0</b>	<b>650.0</b>	<b>653.5</b>	<b>803.5</b>	<b>829.2</b>	<b>834.2</b>	<b>841.2</b>	<b>1,021.2</b>	<b>1,221.2</b>	<b>1,301.2</b>	<b>1,336.2</b>	<b>1,337.8</b>	<b>1,537.8</b>	<b>1,552.8</b>

SOURCES: CIMB RESEARCH

Note: While the PBC reported reaching a swap agreement with Russia on 23 Jun 2011, the announcement did not specify the size of the arrangement. This is the only BSA where the PBC did not make such information public.

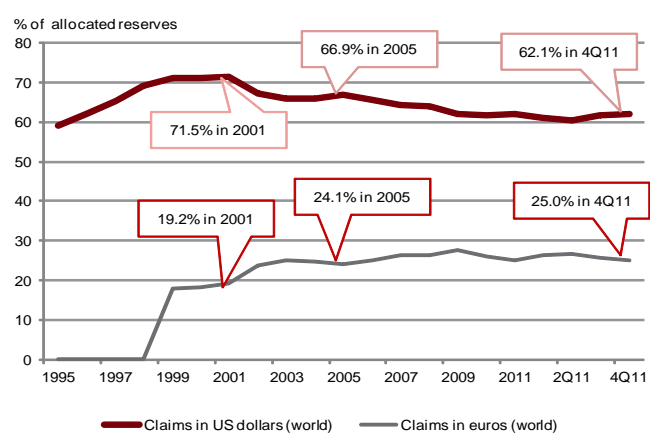
**Figure 10: Foreign reserves held in US dollars vs. euros by emerging & developing economies**



SOURCES: IMF, CIMB RESEARCH

Note: the euro was launched to world monetary markets as an official currency on 1 Jan 1999

**Figure 11: Global foreign reserves held in US dollars vs. euros**



SOURCES: IMF, CIMB RESEARCH

Note: the euro was launched to world monetary markets as an official currency on 1 Jan 1999

## Prospects for Rmb going global ▶

Both international use and an open capital account are necessary for a currency to become an international reserve currency. Since its accession to the WTO in Dec 2001, China has established itself as a major hub in the production chain, the second largest trading country and a substantial net external creditor. As of 2011, it is the world's second-largest economy by both nominal GDP and purchasing power parity (PPP), and is also the world's largest exporter and second largest importer of goods. China is increasingly integrated with the world economy though mainly via the international trade channel and not in the financial channel. Small steps have been taken to experiment with Rmb convertibility in the offshore Rmb market in Hong Kong in 2004. Some strict capital controls are still in place and its financial system is quite isolated. In late 2011, Beijing took action to enable two-way trading between onshore and offshore markets and encourage Rmb asset creation offshore. Japan's decision to buy Chinese bonds means that for the first time Rmb assets will form part of a G7 economy's reserves, albeit small. It could mark the start of a long-term process of accepting the Rmb as a reserve currency.

The Rmb's prospects as a reserve currency will be influenced by 1) China's economic size, 2) capital account openness – the currency must be easily tradable in global financial markets with no restrictions on capital flows, 3) flexible exchange rate, 4) financial and capital markets development – strengthen the banking system, develop broader and deeper financial markets denominated in Rmb, and 5) credible macro policies – a commitment to maintaining low inflation, sound fiscal position and sustainable debt levels. China's ability to meet these challenges will determine the balance and sustainability of its economic development as well as its currency's role in the global monetary system.

What is interesting is that the current Rmb phenomenon differs from the historical circumstances of the rise of the US dollar, the Yen and Deutschemark, in that the Chinese government is actively promoting the international use of its currency. Germany, Japan and the US were less active in promoting the international use of their currencies for fear that their exporters stood to lose competitiveness if international demand for the currency were to rise. In this regard, China faces a dilemma in its quest for the internationalisation of the Rmb – fears of a stronger currency and its effects on manufacturing exports and enterprises' cost competitiveness. We view full-fledged internationalisation of the yuan as a distant goal. China is clearly more influential than in the past and the internationalisation of the Rmb has sped up. But it will take many more years, perhaps another 5-10, for the Rmb to be fully global and convertible. Some soft capital controls will remain for some time until domestic banks are equipped to cope with the financial volatility associated with capital account openness. Talks are already underway to include the Rmb in the basket of currencies that make up the IMF's Special Drawing Rights basket within the next five years.



### Notes from the Field

*“The Chinese currency is on track to become more important globally, but is unlikely to challenge the dollar anytime soon.”*

– IMF

## How would capital account openness affect the Rmb? ▶

Some quarters have expressed concerns that the Rmb will weaken considerably if China liberalises its capital account. We beg to differ as a fully convertible Rmb would mean that there is a two-way bet on the Rmb's trajectory. Inevitably, there are risks of instability associated with a move towards capital liberalisation. The rapid growth of the Rmb offshore markets could erode China's control over its money supply and invite external volatility into the domestic financial system. This would pose to the PBOC the challenge to strengthen its financial and monetary management.

So, when considering the Rmb as a global currency, the following are prerequisites: a deep and liquid capital market including more Rmb products and hedging tools, transparent markets, simplified trading rules and complex rules on the use of Rmb, strengthening of banking supervision and regulation, and sound and stable monetary and fiscal policies. More importantly, the Rmb must be flexible enough to accommodate larger flows of capital.

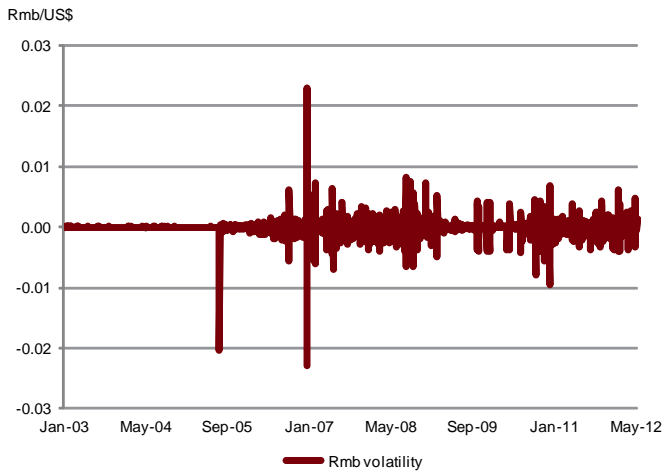
Once the capital account becomes fully liberalised and China's economy reaches a more balanced economic structure and optimal growth model, the outward FDI will increase at a faster pace than inward FDI, reflecting a deepening of domestic financial market integration with the international financial markets. A more open financial market also facilitates domestic corporations in cross-border mergers and acquisitions. Outward portfolio investments will also increase as domestic investors diversify their portfolio risks. On a net basis, there will be two-way capital flows, which will balance out the effect on the Rmb.

## **2. Rmb dominance and its impact on Asia**

Just as China exerts a large influence on its regional neighbours through the Asian supply chain, the Rmb also exerts an equal, if not larger, influence on regional exchange rates and monetary policies in the region. The strong trade and financial linkages in the region compel regional economies to maintain their competitiveness relative to China in external markets and the stability of their currencies against the Rmb. This suggests that China's increasing reforms to increase foreign exchange flexibility since mid-2005 are likely to have a significant influence on exchange rates and monetary policies in emerging Asia.

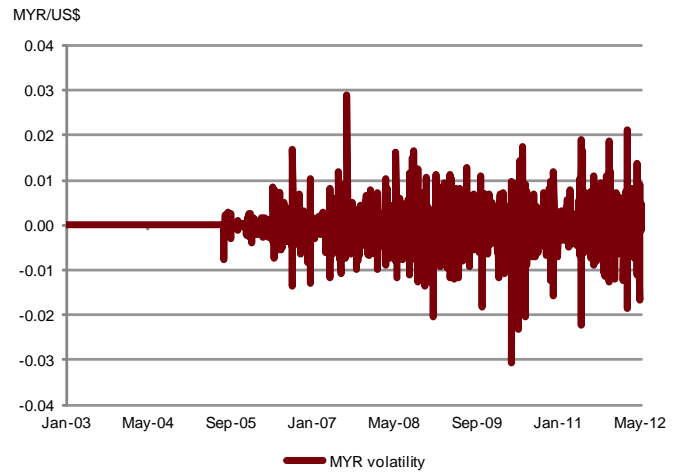
A study of the US dollar, euro and regional currencies found evidence in line with the hypothesis of China's dominance. The results identified a strong regional orientation of exchange rate policies in the area. Regional foreign exchange currencies are mainly driven by the Rmb, though we also found evidence that movements in Asia's currencies partly steer the Rmb. The analysis also showed that the responses of Asian currencies are more similar to that of the Rmb than to the greenback, euro, yen or other emerging market currencies. The question is: as China continues to reform its exchange rate regime, how will Asia manage its foreign exchange configurations against a currency from outside the region such as the US dollar or coordinate exchange rate policy at the regional level? This depends very much on the extent of the Rmb's flexibility and China's pace of economic reform. Since the US subprime crisis, the internationalisation of the Rmb seems to have gained impetus. Against the backdrop of rising fiscal and debt problems in the advanced economies, reform of the international monetary and financial system as well as regional financial cooperation are moving up on the policy agenda.

Figure 12: Managed intraday Rmb volatility after de-peg



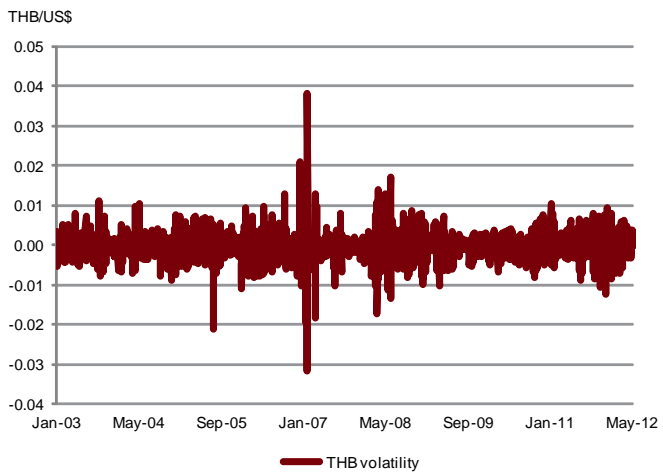
SOURCES: BLOOMBERG, CIMB RESEARCH

Figure 13: The Rmb de-peg prompted the MYR depeg, intraday MYR volatility ...



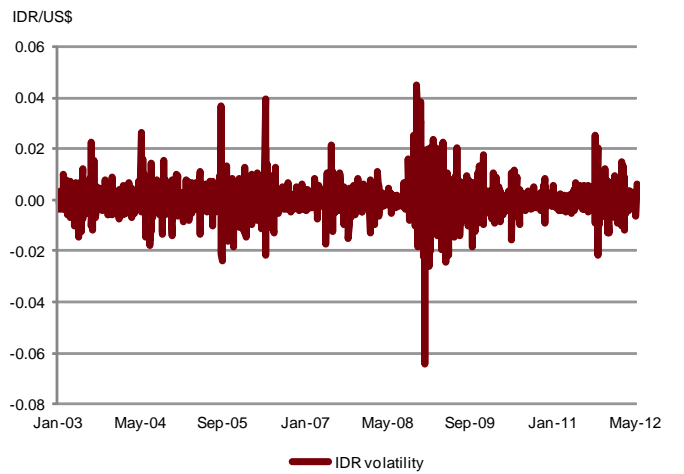
SOURCES: BLOOMBERG, CIMB RESEARCH

Figure 14: ...intraday THB volatility



SOURCES: BLOOMBERG, CIMB RESEARCH

Figure 15: ...and intraday IDR volatility are managed within similar tight ranges



SOURCES: BLOOMBERG, CIMB RESEARCH



Figure 16: Appendix

Period	Key milestones
Jan-94	Dual exchange rates unified; an effective 33% devaluation of Rmb to 8.7/US\$1
Apr-94	Interbank FX market, China Foreign Exchange Trade System, set up in Shanghai
Dec-96	Rmb to be convertible on current account
1997-1999	USD/Rmb held steady at around 8.277-8.280 throughout the Asian Financial Crisis
Dec-01	China joins the World Trade Organisation
2002	Launch of Qualified Foreign Institutional Investor (QFII) allowing licensed foreign investors to buy and sell yuan-denominated "A" shares in China exchanges (i.e. Shanghai and Shenzhen)
Feb-04	Rmb personal businesses (deposit, exchange, remittance and card services) allowed
Jul-05	China revalues Rmb by 2.1% to 8.11/US\$; moves to manage Rmb against a basket of currencies
May-07	Widening of USD/Rmb trading band from $\pm 0.3\%$ to $\pm 0.5\%$ ; trading bands for other currencies unchanged at 3% against Rmb
Jul-07	First Rmb bond (CDB) launched
Jul-08	USD/Rmb effectively pegged at 6.83 as the US subprime crisis worsens
Jul-09	First tentative step to internationalise the Rmb with the launch of the pilot program for external trade settlement in Rmb
Jul-09	Pilot scheme for Rmb cross-border settlement announced
Sep-09	First Rmb sovereign bond (MOF) launched
Jun-10	Announces further reform and increased flexibility of currency, effectively unshackling the USD/Rmb from the two-year-old peg
Jun-10	Rmb cross-border settlement scheme extended to 20 provinces and cities
Aug-10	Three types of overseas institutions* permitted to participate in the interbank bond market in China First Rmb bond issued by MNC (i.e. McDonald's)
Sep-10	Offshore institutions permitted to open Rmb settlement accounts
Jan-11	Rmb overseas direct investment (ODI) by Chinese enterprises allowed
Jun-11	Rmb foreign direct investment (FDI) allowed on a case-by-case basis
Jun-11	PBOC and Central Bank of the Russian Federation signed a new bilateral local-currency settlement agreement. This bilateral local-currency settlement covers not only border trade, but also general trade, with an expanded geographical area. According to the new agreement, economic entities from both countries can conduct settlements and payments for trade of goods and services with a currency of their choice, i.e. either a freely convertible currency, Rmb or the Russian ruble.
Aug-11	Geographical coverage of use of Rmb in cross-border trade settlement extended
Oct-11	Commercial banks to provide Rmb fund settlement services for Rmb-denominated FDI
Oct-11	PBOC signed agreements with the Bank of Korea to renew the bilateral local currency swap arrangement and to increase its size from Rmb180bn to Rmb360bn or WN64tr. The two central banks have also agreed to explore the possibility of converting some swap currencies into reserve currencies.
Nov-11	PBOC and the Austrian central bank (OeNB) signed an agreement to enable the OeNB to invest via the PBOC in China's interbank bond market
Nov-11	Launch of Renminbi Qualified Foreign Institutional Investor (RQFII) to allow qualified investors to invest yuan-based funds raised in HK in the mainland market within a permitted quota
Dec-11	Promotion of use of Rmb and JPY in cross-border transactions in trade and FDI between China and Japan, support development of direct exchange of Rmb and JPY, support development of Rmb and JPY bond markets, Japan to invest in Chinese government bonds
Dec-11	PBOC signed with the State Bank of Pakistan a bilateral local-currency swap agreement. The amount of the agreement is Rmb10bn or 140bn PKR
Dec-11	PBOC signed with the Bank of Thailand a bilateral local-currency swap agreement. The amount of the agreement is Rmb70bn or THB320bn
Jan-12	PBOC signed with the Central Bank of the UAE a bilateral local-currency swap agreement. The amount of the agreement is Rmb35bn or 20bn AED
Jan-12	PBOC and the Qatar Central Bank signed a Memorandum of Understanding to further promote bilateral exchange and cooperation
Feb-12	PBOC renewed bilateral local-currency swap arrangement with Bank Negara Malaysia and to increase its size from Rmb80bn or RM40bn to Rmb100bn or RM50bn
Feb-12	PBOC signed bilateral local-currency swap agreement with the Central Bank of the Republic of Turkey. The amount of the agreement is Rmb100bn or TRY400bn
Mar-12	PBOC signed bilateral local-currency swap agreement with the Reserve Bank of Australia. The amount of the agreement is Rmb200bn or A\$30bn
Mar-12	Trade settlement in Rmb expanded to all firms in China
Apr-12	PBOC signed agreements with the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) to invest in China's interbank bond market on behalf of the two agencies
Apr-12	First issuance of Rmb-denominated bond valued at Rmb1bn in London by HSBC
Apr-12	Widening of USD/Rmb trading band from $\pm 0.5\%$ to $\pm 1\%$ ; presumably trading bands against EUR, JPY, HKD and GBP are unchanged at 3%, MYR
Apr-12	Expansion of QFII and RQFII investment quotas
May-12	Launch of direct trading between Rmb and JPY (CNY/JPY) on the interbank foreign exchange market
Jun-12	PBOC signed a bilateral local-currency swap agreement with the National Bank of Ukraine. The amount of the agreement is Rmb15bn or 19bn UAH
Jun-12	China participates in IMF Resource Boost by pledging US\$43bn as a line of credit to the IMF
Jun-12	China allows sales of yuan-denominated bonds directly to foreign central banks. HK authorities would allow banks involved in offshore yuan business to sell term funds from an existing swap line with PBOC

\* Include foreign central banks and monetary authorities, Rmb business clearing banks in HK and Macau, and offshore authorised participating banks for cross-border Rmb settlement

SOURCES: PBOC, VARIOUS NEWS, CIMB RESEARCH

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