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RMB internationalisation: the new commanding heights

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In the early stage of RMB internationalisation, RMB transactions occurred mostly in trade settlement between China and neighbouring economies. As China liberalises its capital account and rolls out the Belt & Road scheme, RMB's investment & financing functions have soared. To thrive in the next stage of Internationalisation, we believe there are three areas (the new commanding heights) in which Beijing has genuine interests to drive ahead: 1) Pursue a higher level of opening of financial markets, 2) Promote the anchor role of the RMB for Belt & Road and Asian economies, 3)Build next-generation infrastructure.

How far has the RMB gone?

A look at SWIFT transaction data often leaves a false impression that RMB internationalisation progress has stalled, since RMB's share in the global payments market has stayed below 3% for six years (Chart 1) and its popularity rank appears to be stuck in fifth place after USD, EUR, GBP and JPY. This, however, understates RMB settlement that happens outside of the SWIFT platform, as China launched its own payment system CIPS in October 2015. In five and half years, transactions through CIPS have risen to RMB 45.2tn ($6.5tn) in 2020 from none, driving cross-border RMB settlement in trade and investments to triple in 2020 from 2016-17, a much faster rate than SWIFT transactions would otherwise suggest.

Nevertheless, **the underlying driver for using RMB shifted when investment and financing demand started to outpace trade flows in late 2016.** The integration of China's onshore market with the rest of the world has witnessed an increase of global asset allocation into RMB assets. The share of RMB in global FX reserves more than doubled, from 0.8% in Q4 2016 to 2.1% in Q4 2020 (Chart 2). Non-residential investors held a total of RMB3.4tn in Chinese A shares as of the end of March 2021, 5x more than end-2016; positions in China's domestic bond market increased to RMB 3.7tn, 4x more than at end-2016 (Chart 3).

The next stage of internationalisation

Following the initial boom, there are greater barriers in raising RMB's status even further. Besides, the ball is not always in China's court. Shifting geopolitical tides, for instance, will complicate the picture. In the 14th Five Year Plan, China vows to steadily and prudently promote RMB internalisation within a market-driven approach, and to build mutually beneficial partnerships based on the free use of RMB. This is an approach that lays more stress on the free choice of using RMB.

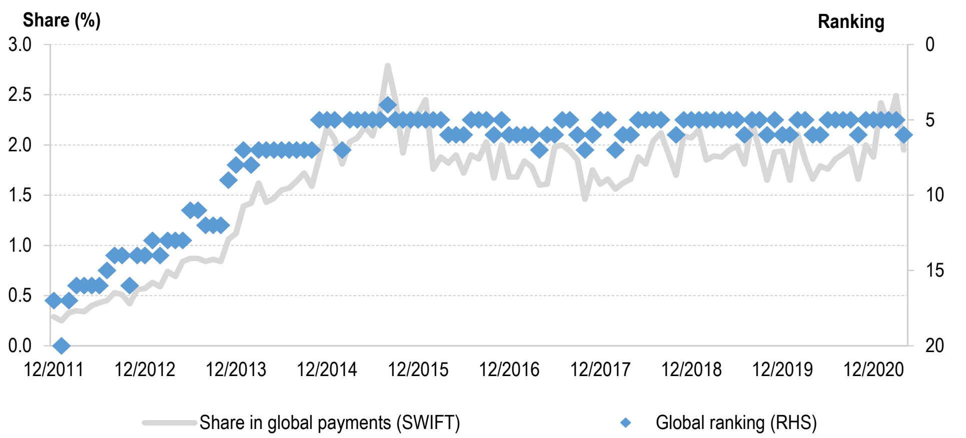
To thrive in the next stage of internationalisation, RMB's prospects may well depend on China's progress in following areas.

1. A higher level of financial sector opening-up

A more open, transparent and sophisticated market that delivers returns will help retain foreign investments in the long term, a main driver for RMB flows. From the policy point of view, this involves providing a wider range of products, equal access to all, and an increase in types of participants. In 2020, financial liberalisation promises were delivered without delay (e.g., removal of foreign ownership limits), showing it remains a policy consensus to pursue a higher level of opening-up of the financial sector.

The underlying driver for using RMB shifted since late 2016

1/ **RMB's share and ranking in SWIFT payments**



Source: SWIFT, Amundi Research. Data as of 20/05/2021

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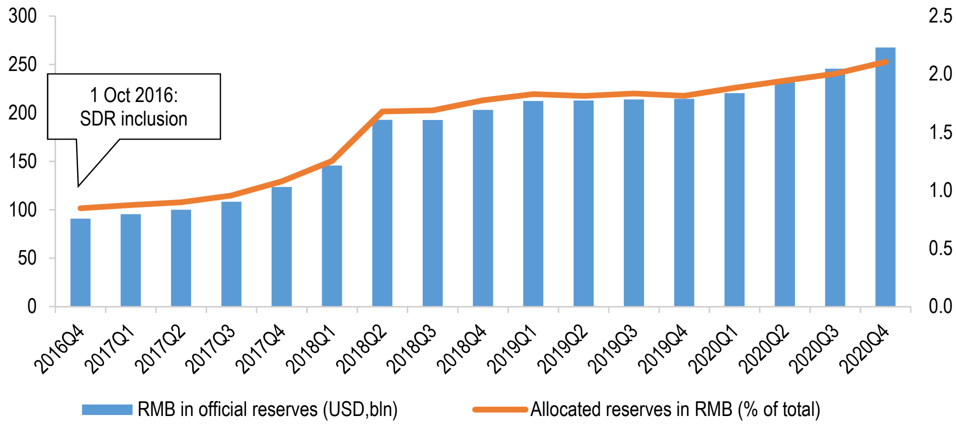
2/ Global FX reserves allocated to RMB



Source: IMF, Amundi Research. Data as of 31/03/2021

It remains a policy consensus to pursue a higher level of opening-up of the financial sector

That said, China has progressed more quickly on relaxing barriers for foreign investors, but not the other way around. Hence, overseas investments from domestic institutions have been effectively capped by existing quotas, mainly QDII ones. Given that this policy preference is here to stay, portfolio inflows are likely to continue outpacing outflows, adding upward pressures on the RMB in the medium term until inflows peak.

2. The anchor role of the RMB

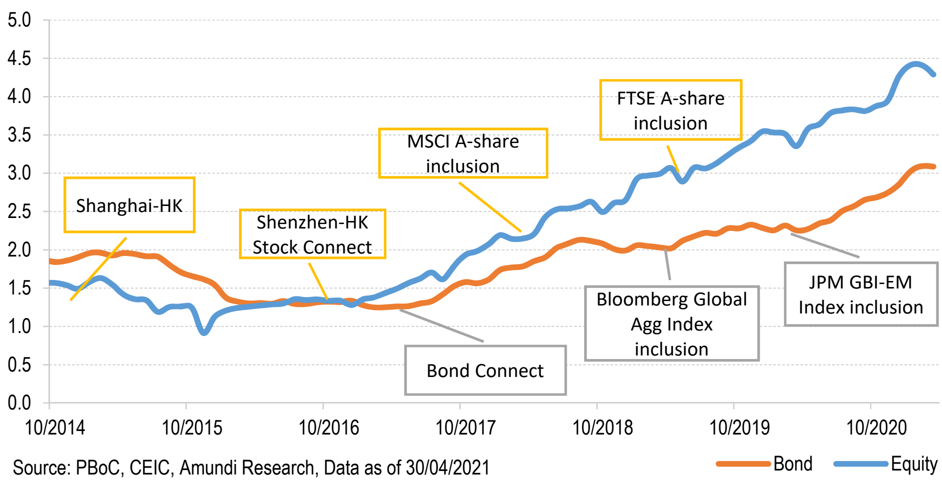
In Q1 2021, cross-border RMB receipts and payments accounted for nearly 50% of BoP flows, up from less than 20% in 2016. The PBoC revealed that transactions with Asian economies and the Belt & Road economies grew quickly. The trend was facilitated by the string of RMB offshore clearing banks in the related countries, and set-ups of bilateral currency swap agreements between the PBoC and peer central banks. Multilateral cooperation among the Asian central banks have gained pace, the amendment to Chiang Mai agreement (CMIM) now allows the use of members local currencies in addition to USD for financing within the total capacity of $240billion[1].

While RMB is branded as an alternative choice to the dollar for Belt & Road countries and neighbouring Asia economies, **exchange rate stability is desirable with non-dollar currencies.** This resembles the early integration effort of European economies in creating the "snake in the tunnel" mechanism, under which member states' currencies could fluctuate within narrow limits against each other and the dollar[2]. That said, instead

[1] *The amended Chiang Mai Initiative Multilateralisation (CMIM) Agreement, which is a regional financing arrangement by ASEAN member states, China, Japan and Korea (ASEAN+3) and the HKMA, came into effect on 31 March 2021. The amendment allows the use of members' local currencies, in addition to the USD, for financing on a voluntary basis within the standing financing capacity of USD 240 billion.*

[2] *On 24 April 1972, EEC central-bank governors concluded the 'Basel Agreement', creating a mechanism called the 'Snake in the tunnel'. Under this mechanism, Member States' currencies could fluctuate (like a snake) within narrow limits against the dollar (the tunnel) and central banks could buy and sell European currencies, provided that they remained within the fluctuation margin of 2.25%. Source: EPRS - A history of European monetary integration.*

3/ Foreign investments in Chinese markets



Source: PBoC, CEIC, Amundi Research, Data as of 30/04/2021

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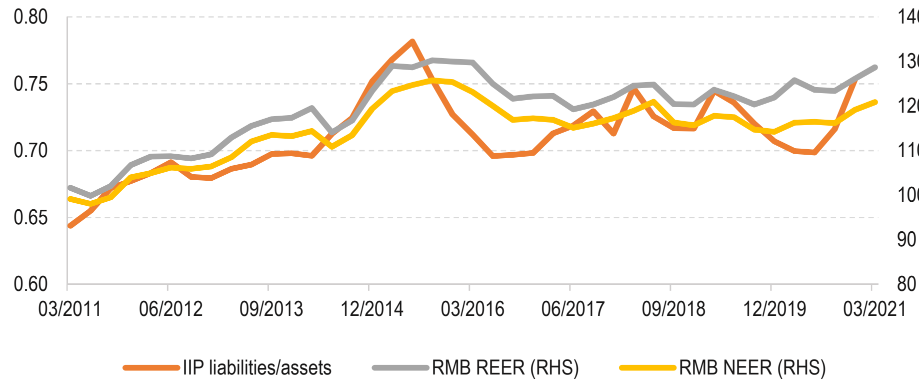
4/ China's international investment position and currency



Source: SAFE, BIS, CEIC, Amundi Research. Data as of 19/05/2021
IIP=International Investment Position. Liabilities = Non-residential investments in China.
Assets = Residential investments to other countries. REER= Real Effective Exchange Rate. NEER= Nominal Effective Exchange Rate

The digital CNY can play a role in internationalisation through multi-CBDC arrangements

of limiting its movement against the USD, the PBoC has chosen to tolerate higher volatility in the USD/CNY pair, in exchange for lower volatility of the RMB against other currencies (Chart 5). Essentially, the central bank releases the USD/CNY fixing rate on a daily basis, which in a large part reflects the overnight movement of a basket of currencies against the dollar. By matching the reference basket's movement against the dollar in daily pricing, RMB is able to anchor itself with the reference basket, without an actual Asian currency bloc.

3.Next generation of infrastructure

At the time of this writing, China's digital CNY pilot has expanded to cover 10 cities, plus the Beijing 2022 Winter Olympics, to replace part of the currency in circulation (M0). While the digital CNY is still in its infancy, a multilateral project sheds light on what role the digital CNY could play in RMB internationalisation.

In February, PBoC and the Central Bank of the UAE announced they were joining the second phase of the Inthanon-LionRock project, which was initiated by the HKMA and the BoT. The project, targeted to support real-time cross-border transactions 24/7, shows **the possibility of a future multi-CBDC arrangement among the central banks.** Through compatible standards agreed by CBDC-issuing countries, central banks are able to reduce the costs and improve the transparency of cross-border flows. Former PBoC governor Zhou suggests retail use should be the focus of digital currency in cross-border payments.

The roll-out of PBoC's digital CNY and its leading role in designing the multi-CBDC arrangement show China is paving the high way for future RMB payments across the borders, in particular Belt & Road and Asian economies.

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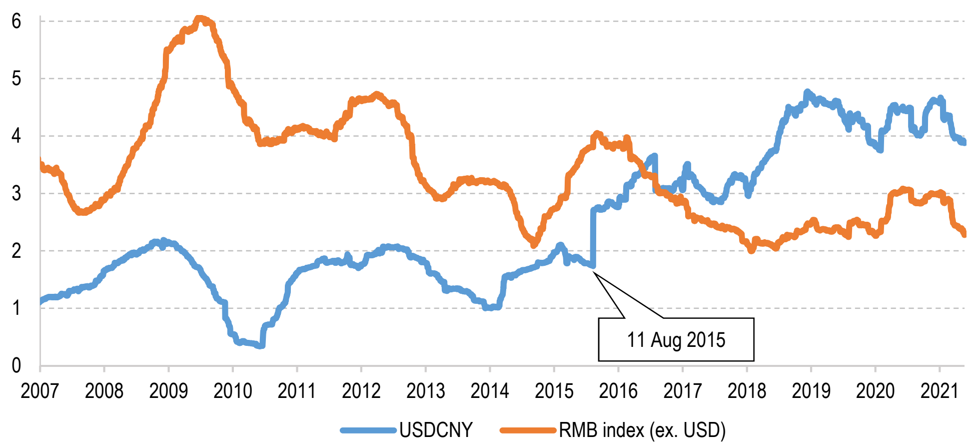
5/ Foreign exchange rate volatility (annualised, %)



Source: Bloomberg, Amundi Research. Data as of 21/05/2021

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