Long march to renminbi convertibility

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Published: August 25 2010 22:11 | Last updated: August 25 2010 22:11

If you've been paying attention you'll know that RMB now stands for Ronald McDonald Bonds. This month, the American hamburger chain became the first non-financial foreign company to issue debt denominated in the Chinese currency. The exercise raised a tiny RMB200m, or $29m if you still think in passé American-dollar terms. But it follows a flurry (should that be a McFlurry?) of offshore renminbi activity centred on Hong Kong. That has led some to believe that Beijing has started an experiment whose eventual aim is internationalisation of the renminbi and its establishment as a reserve currency to compete with the dollar.

That would be an enormous leap for a currency that is not yet convertible. We are nowhere near there yet. But something is stirring. In mid-2009, Beijing launched a pilot scheme, since expanded, to allow trade to be settled in renminbi. Last month, it took another step by allowing offshore banks to transfer renminbi among themselves, opening the way for the creation of **renminbi-denominated financial products** such as mutual funds. A few days ago, in potentially the most important change, it allowed offshore banks and central banks **to invest in China's interbank bond market**.

EDITOR'S CHOICE

The last two measures give companies a decent reason to accept payment in renminbi. Before, there was really nothing they could do with the Chinese currency save stick it in the bank at paltry interest rates and hope to gain through appreciation. Now they can invest it, more companies may take the plunge. Julia Leung, Hong Kong's undersecretary for financial services, predicts a "dramatic expansion" in the amount of renminbi circulating outside China. If the offshore renminbi market takes off, Hong Kong stands to play a similar role to that of London in the Eurodollar market for dollars circulating outside the US.

At the moment the volumes are tiny. But, in theory, more companies operating within the "bamboo economy" of China-centred Asian trade in components and finished goods could start settling in renminbi. That could help eliminate transaction costs. More important, it could remove the risk of another dollar trade-credit shock of the kind that followed the collapse of Lehman. China has offered several of its trading partners renminbi currency swap lines in the hope that, should dollar credit markets freeze again, trade might keep flowing in a parallel renminbi universe.

In truth, even people who watch China very closely can only guess at what is going on. At one extreme, we could be witnessing the first tentative steps towards the eventual opening of China's capital account, with an accompanying freeing up of its exchange-rate regime and birth of the renminbi as a reserve currency. Certainly, there has been much Chinese carping about the perceived vulnerability of Beijing's dollar holdings, issued by a US government seemingly addicted to deficits.

Last year, Zhou Xiaochuan, China's central bank governor, created a stir by proposing the **replacement of the dollar as a reserve currency** with the special drawing rights used by the International Monetary Fund. As Ben Simpfendorfer at Royal Bank of Scotland points out, China would gain certain benefits if the renminbi ever won acceptance as a reserve currency, including the ability to issue debt cheaply in its own currency. But Fraser Howie, co-author of *Privatizing China*, is extremely doubtful that moves to open the capital account are afoot. "It strikes at the heart of their control of the economy, the banking sector, interest rates etc," he says. "Why would they now throw open the doors with gay abandon?"

Freeing up the capital account would mean allowing non-trade-related flows in and out of China. That could expose the economy to the sort of currency fluctuations and balance-of-payments shocks that Chinese policymakers have been at such pains to avoid. For the moment, regulations limit offshore renminbi to currency with its origin in trade, in other words current account transactions. If rules are not further loosened, the experiment might simply stall.

Arthur Kroeber at GaveKal-Dragonomics, a research consultancy, wonders whether something else might be going on. He speculates that market reformers at the central bank may be trying to shake up the domestic financial markets. The bond market, as it stands, is about as lively as a graveyard. On some days, there is no trade at all. Banks tend to hold bonds to maturity, depriving the market of liquidity or a price-discovery mechanism through secondary trading. The central bank, says Mr Kroeber, is filled with people who want market forces to play a bigger role in the allocation of capital and the setting of risk premiums. By allowing foreigners to invest, he says, the hope may be to allow those forces in through the back door.

Similar expectations of foreign influence on China’s equity markets have so far not materialised. James Liu, vice-president of the Shanghai Stock Exchange, concedes that Beijing remains wary of capital markets that act like “an unbridled horse”. But if Mr Kroeber is right, that horse may now have been quietly released. The latest renminbi measures could conceivably have a bigger impact inside China than outside.