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Research Report



# RMB Internationalization Report 2017 • Press Release

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# **RMB Internationalization Report 2017**

## **Strengthen the Financial Transaction Function of RMB**

Press Release

International Monetary Institute, Renmin University of China

July 15th, 2017

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\*This is an excerpt from the *RMB Internationalization Report 2017*.

# 1. Introduction

RMB internationalization means that the RMB plays the role of an international currency in foreign economic activities, and after a number of years becomes a major settlement and global reserve currency in international trade and investment. Statically, it is the state and the results of using RMB as an international currency; dynamically, it involves the whole process of how the RMB becomes a major international currency. With the US dollar's dominant position in global reserves and other major currencies catching up, RMB internationalization is destined to undergo a long and tortuous process. Its ultimate goal is to become one of the major international currencies, and to achieve the currency status that matches with China's economy.

The International Monetary Institute of Renmin University of China issues the "RMB Internationalization Report" annually from 2012, faithfully recording the process of RMB internationalization, and conducting in-depth research of the major theoretical issues and policies of different stages. Our research team put forward the RMB Internationalization Index (RII) to objectively describe the acceptability of RMB in international economic activities. This comprehensive quantitative indicator enables people to understand the new developments of RMB as an international currency in trade settlement, financial transactions and official reserves, and to make comparisons with other major international currencies, thus laying a solid technical foundation for analyzing RMB internationalization from both home and abroad.

In early 2010, RII was only 0.02%. The acceptability of RMB in the international market was almost zero. At the end of 2016, RII reached 2.26%. After just a few years it has emerged from the horizon. At present, the proportion of RMB settlement in international trade is 2.11%. The share of RMB in direct investment, global credit, bond and note transactions, etc., accounts for 3.59%. The International Monetary Fund (IMF) announced to include RMB into the SDR basket (RMB's share being set at 10.92%) and the decision came into force in October, 2016. Although RII began to fall after mid-2015, it has maintained its overall level since 2014 against the backdrop of international political and financial turmoil, domestic economic restructuring and the continued financial reform. In the early stage, RMB internationalization was driven by cross border trade. Now it is driven by two wheels: trade and finance. RMB will play a more important role in the international financial markets and global official foreign reserves. It can be seen that the driving forces behind RMB internationalization are moving in the right direction and are in line with China's goal of turning RMB into an international currency.

The theme of the report in 2013 is "Changing Global Trade Landscape and RMB Internationalization". Through the analysis of the changing global trade landscape, the monetary substitution and the evolution of the international monetary system, the report summarizes the theoretical connection between and the general regularities of currency internationalization and the internationalization of the real economy. We have found that throughout history currency powers are generally trade powers. RMB internationalization shoulders a major historical

mission to challenge or even break the dollar dominance that inhibits the multivariate competition in global trade. The 2013 report concludes that China should seize the opportunities of the changing global trade landscape, make full use of the favorable conditions of regional trade and bilateral trade offered by platforms such as the ASEAN 10 +3, SCO, BRICS countries, Latin America, AU and other emerging economies, strengthen the trade pricing function of RMB, and increase RII by promoting RMB direct investment, RMB-denominated loans and other forms of capital outflows.

The 2014 report theme is on "RMB offshore market construction and development". Based on the historical experience and related literature, this report discusses the inherent logic of how the offshore financial market promotes currency internationalization, and analyzes the significance and influence of the rapid development of the global offshore RMB markets on RMB internationalization. The report points out that the rapid development of offshore markets removes the technical barriers for RMB internationalization, wins the necessary time and creates favorable conditions for the liberalization of the capital account; in the long run, the scale of offshore financial business and the proportion of transactions conducted in RMB in London, Frankfurt and other major international financial centers will be an important indicator of whether the RMB has become one of the major international currencies. The report also explores the development of RMB offshore markets in Hong Kong, London and other cities, conducts a preliminary discussion on the global layout of RMB offshore financial markets through empirical research, and elaborates on the challenges and ways out from the two angles of how to build a RMB offshore market and how to deal with the negative impact of the offshore market.

The 2015 report theme is on monetization strategy in the execution of "One Belt One Road" strategy. The report points out that the "One Belt One Road" strategy and the RMB internationalization are China's two major national development strategies proposed in the new century, and they are in line with China's national interests, providing an indispensable support for China as an emerging power; and at the same time, they are also in line with global interests, standing as a further improvement to the current international monetary system and reflecting the responsibility of China to provide public goods for the world. The report systematically combs the logic of how the two strategies promote each other from the perspectives of theoretical discussion, historical experience and empirical tests, emphasizing that the two should develop in synergy. We believe that commodity pricing and settlement, infrastructure financing, industrial park construction, cross-border e-commerce should be the effective breakthrough points that further improve RMB internationalization; and China must adhere to the policy of "reform and opening up" when promoting RMB internationalization in the construction of "One Belt One Road" strategy. Successful transformation of the domestic economy, technological progress and institutional innovation are the fundamental guarantees of the "One Belt One Road" strategy and RMB internationalization. China can create favorable conditions for the ultimate success of the "One Belt One Road" strategy and RMB internationalization if it achieves a higher standard of

opening up, adheres to inclusive development, mobilizes global resources, and benefits the countries along the route.

The 2016 report themes on "Currency Internationalization and Macro Risk Management". We believe that with the RMB joining the SDR currency basket, RMB internationalization is about to start a new stage of development. This indicates that China has entered the sensitive period of macroeconomic management, and macro management capacity should not be a drawback that restricts the internationalization of RMB. China needs to pay special attention to improving macro management capacity in order to boost the long-term confidence of the international community in RMB. The report stresses that in the process of policy adjustments China must deal with the impact of exchange rate fluctuations on the domestic economic and financial operation, and also must adapt to the impact of cross-border capital flows on the domestic financial markets, financial institutions and the real economy. Special attention must be paid to guarding against and managing systemic financial risks. Drawing from historical experience, relevant literature, theories, practices and policies, the report puts forward these following suggestions: macro-prudential policy framework should be constructed based on the national strategy; with the macro-prudential policy framework as a systemic guarantee, China should see exchange rate management as a critical tool and capital flow management as a key to curb macro-financial risks. In this way China can prevent and resolve the devastating systemic financial crisis, and ensure the smooth realization of RMB internationalization.

The 2017 report themes on "Strengthening the financial transaction function of the RMB". On one hand, the dynamic evolution of the driving forces behind RII in recent years shows that the share of RMB in direct investment, global credit, bond and note transactions is increasing remarkably, making RMB settlement in cross border trade another important contributor to RMB internationalization. On the other hand, historical analysis and empirical research suggest that every successful international currency is widely accepted in international investment and finance. Strengthening the financial transaction function of RMB in the international market is a highly relevant problem that we must solve in order to usher in a new stage for RMB internationalization. After the formal inclusion of the RMB into the SDR currency basket, the international financial market will open a favorable window period for the multinational banks, transnational corporations and even monetary authorities to allocate their RMB assets. Based on historical experience, theoretical analysis and empirical research, this report aims to answer the questions of "why the financial transaction function of RMB should be strengthened", "how to strengthen it" and other issues. The report not only demonstrates the necessity of strengthening the financial transaction function of RMB in the international market, but also provides theories, empirical evidence and historical experience. It also discusses the main way to strengthen the financial transaction function of RMB, analyzes the existing problems and solutions, and provides suggestions for clearing the systemic and technical barriers.

Specifically, we have come to the following conclusions and put forward some recommendations.

First, the realistic urgency of strengthening the financial transaction function of RMB. Empirical study shows that the international credit market plays a fundamentally supportive role in the internationalization of a country's currency, while the international bond market a positive role. History shows that foreign trade and capital export provide the impetus for currency internationalization. Without a sound financial market, currency internationalization will probably slide into the abyss of a financial crisis. China must seize the opportunity of international financial market adjustments, make full use of the dividends of RMB joining the SDR, deepen domestic financial reform, and strive to improve the international financial pricing and transaction functions of RMB. Financial market is the logistic support for the foreign trade and capital export. RMB internationalization needs a mature international financial center. A complete international financial market for pricing and trading RMB can take shape in the order of short-term money market, medium-term bond market, and long-term multi-level equity market. In the process of currency internationalization, government support is necessary, but some degree of freedom for development should be granted to the market. The development of financial markets should be stable. China should pay attention to the connections between the financial markets, establish the "government - market - business" transmission mechanism, and let these three players jointly promote RMB internationalization.

Second, direct investment has made a positive contribution to China's economic development and trade growth. The contribution of ODI on economic growth is much greater than that of FDI. Direct investment can expand the use of RMB in many ways and play an efficient leveraging role. It can become an important facilitator of RMB internationalization. In the new situation where the multinational corporations dominate international trade, expanding direct investment can consolidate China's trade position and provide markets and impetuses for domestically funded financial institutions to go global and develop offshore RMB business.

Top-level design and international coordination of related laws and policies create favorable conditions for direct investment to play a leveraging role in trade and offshore market. China should establish and improve the national risk management mechanism, improve the proportion of ODI in finance and manufacturing industries, enhance the trade dominance and pricing power of China's multinational corporations, and clear the barriers to RMB trade and settlement. China should also promote the coordination between economic entities and departments, and establish a mechanism under which direct investment drives RMB settlement and financial services support each other. Vigorously developing financial technology and Internet finance is a must. Let technology change the way people use currency. Make use of China's sound electronic payment and mobile payment systems to build a new platform for RMB payment. In this way China can go beyond the traditional international monetary formation mechanism and develop the network effect of RMB use.

Thirdly, actively promoting the development of the international RMB bond market is an important way to build a smooth RMB circulation mechanism and further deepen the process of RMB internationalization. Bond market is the main channel of international capital flows.

Regarded as safe assets, sovereign bond, high-level financial bonds are the first choice for non-resident investors. Therefore, China should vigorously build and develop the RMB bond market in order to improve the proportion of RMB in the international bond market which is one of the important indicators and stage tasks of comprehensively evaluating RMB internationalization. The RMB bond market will become China's main channel to provide safe assets for the world.

China should improve its domestic RMB bond market, establish the market maker rule, increase short-term T-bond issuance, enhance the structure of interest rates, and promote bond market liquidity to attract more non-residents to participate in China's bond market. Also, China needs to establish a unified bond market regulatory framework, and gradually remove the policy barriers for the domestic enterprises and institutions to issue and trade RMB bonds in the international market. Innovation is the key to developing the international RMB bond market. Our future focus should be on the development of asset-backed bonds, panda bonds, Magnolia bonds and other financial instruments.

Fourth, credit market is one of the three pillars to strengthen the financial transaction function of RMB. The dependence of the global economy on China's trade has increased, the problem of currency mismatch in developing countries has made the development of international RMB credit market an inevitable trend, and the appreciation of the US dollar provides a window of opportunity. History shows that the main international currency promotes the development of international credit market through the international financial center and trade. Based on China's national conditions, at this stage we should consider using trade to promote the development of international RMB credit market.

We must give full play to China's unique advantages of a financial system dominated by the banks to provide financing for the real economy, and use trade as the main strategic choice to expand RMB credit. Encourage enterprises and financial institutions to operate in countries along the Belt and Road and emerging economies, strengthen mutual cooperation in overseas mergers and acquisitions, market expansion, technological upgrading, energy acquisition and other key projects. Attach great importance to the construction of overseas capital pool, improve the RMB offshore market pricing mechanism, and make RMB credit more attractive for global investors.

Fifth, the realization of the financial transaction function of RMB ultimately depends on whether there is a powerful foreign exchange market. The key is to build a multi-level RMB foreign exchange market, provide the basic conditions for the RMB settlement of trade, support the RMB in pricing commodities, and provide an important channel for the RMB to act as an international reserve currency.

We should deepen the level of foreign exchange market transactions, timely relax some pre-transaction management requirements, and create greater room for the electronic transactions of RMB foreign exchanges. Encourage financial institutions to develop their own OTC systems to cater to the needs of different transaction parties.



Sixth, after RMB internationalization enters a new stage of development, China need to enhance its financial infrastructure to promote the transaction function of RMB, increase the acceptability of RMB and enhance the safety of RMB assets. Establish an efficient and safe RMB cross-border payment and settlement system, improve relevant legal system, develop a scientific and impartial credit rating system. These are the three important ways to enhance current financial infrastructure.

We need to further improve the RMB cross-border payment and settlement system, so that the world could access this system despite time differences. Systemic services will range from foreign exchange to securities transactions and other financial transactions. To adapt to the needs of developing direct investment, the RMB bond market, the international RMB credit market, China should speed up filling legal loopholes, and gradually improve the legal framework for settlement that matches the RMB internationalization. China should also encourage the development of both public and market credit, formulate rating standards according to China's market features, respect international practice, strive to increase international credibility, and give a new impetus to expand the financial transactions of RMB.

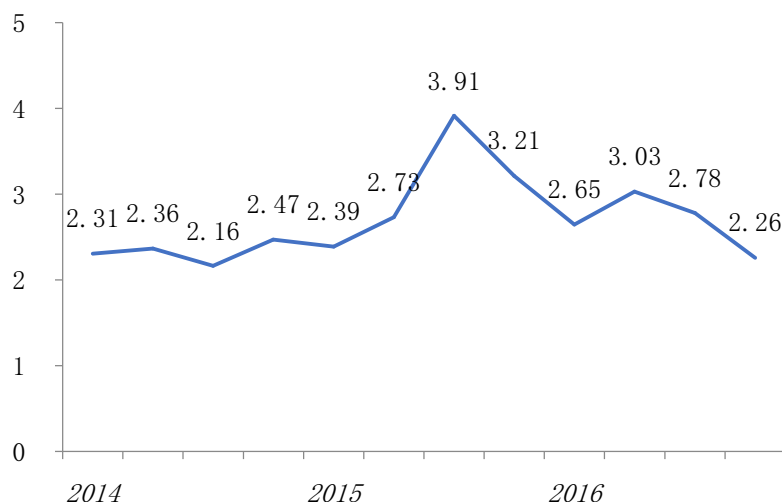
Almost a decade has passed since the global financial crisis broke out. There are obvious differences between the major countries in terms of macroeconomic operation, financial market adjustments and monetary policy trends. Against this backdrop, the impetuses behind RMB internationalization are more rational. While consolidating trade settlement, we constantly strengthen the financial transaction function of RMB to provide safe assets and inject liquidity into the international community. By seizing the historical opportunity of "Belt and Road" initiative, China can participate more actively in international economic and financial governance, and strive to obtain the status of international reserve currency that matches China's economic and trade volume, thus injecting new vitality into the stable operation of the international monetary system.

## 2. RMB internationalization index

### 2.1 RMB internationalization index

#### 1. RMB internationalization index fluctuates downward, but the long-term development trend remains unchanged.

In 2016, the global economy was still sluggish, trade and investment withered, geopolitical risks increased, black swan incidents occurred frequently, anti-globalization and populism was on the rise, and the global landscape was undergoing major changes. China pressed ahead with its supply side reform, but the downward pressure still existed, and RMB internationalization encountered some short-term setbacks because of currency devaluation and capital outflow. The use of RMB has declined in areas such as trade settlement, offshore capital pool and dim sum bonds. However, in direct investment, Panda bonds, international credit, foreign exchange transactions and reserves there have been some highlights. In October, RMB officially joined the SDR currency basket, and RMB-related infrastructure, market mechanism and standards gradually harmonized with international standards, which became a major milestone in RMB internationalization. In general, in 2016, RMB internationalization has gone from the triumphant stage into the adjustment and consolidation period. At the end of the fourth quarter of 2016, the RMB internationalization index (RII) was 2.26, a drop of 29.8% year on year. The long-term upward trend remained unchanged (see Figure 1).



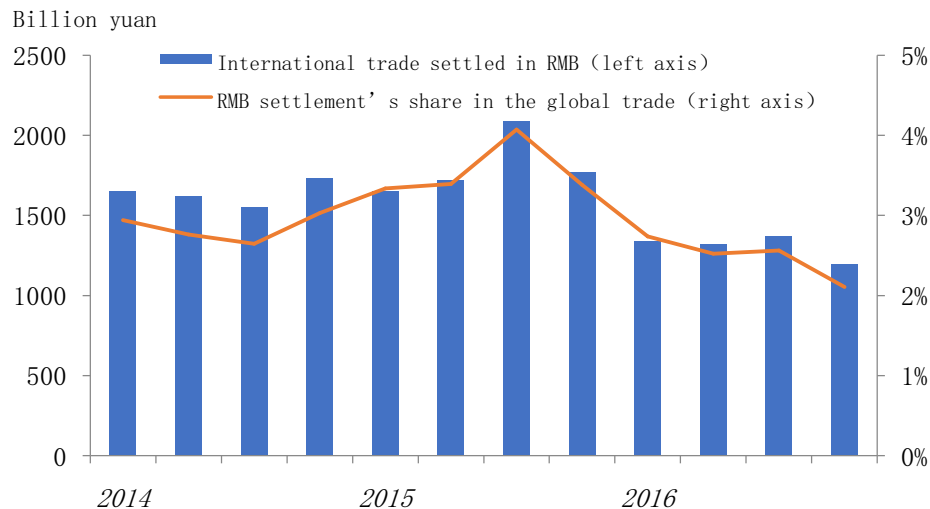
**Figure 1. RMB Internationalization Index**

**Note:** With the development of the market and statistics, RII is adjusted in the following way: first, RII international trade index is compiled based on both the original data of trade in goods and data of trade in services; second, RII international credit index not only includes the statistics of mainland China and Hong Kong, but also those of Macau, Taiwan, Singapore, South Korea, the United Kingdom and other countries and regions; third, due to statistical adjustments of the Bank for International Settlement, RII indicators of

international bonds is changed from a combined indicator of volume of issuance and balance, to a proportion of balance to total volume; forth, the statistic of international reserve of RMB follows IMF standard.

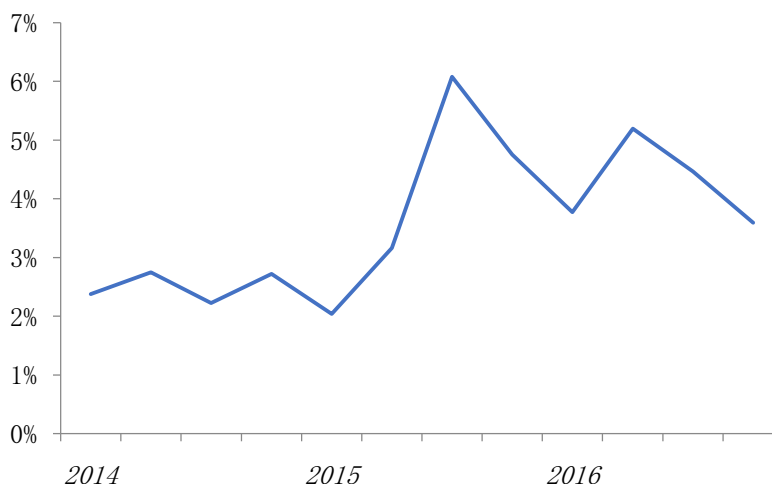
## 2. The driving force of trade settlement was weakened and the driving force of financial transaction enhanced.

According to SWIFT, the global RMB payment in 2016 fell by 29.5% year on year and dropped to sixth place in the international payment rankings. From the structural point of view, the driving force for RMB internationalization in terms of tradewasslightly weakened, and cross-border trade settled in RMB was 9.85 trillion Yuan, a year-on-year decline of 18.6%. The global share of RMB in international trade settlement dropped from 4.07% in 2015to 2.11%, a decline of 48.27% (see Figure 2).



**Figure 2. The pricing and settlement function of RMB in international trade**

Due to the Fed rate hike, the market was expecting the RMB to depreciate. Coupled with tightening capital management policies, the trade volume in RMB international bonds and international credit transactions significantly decreased. The share of RMB in international financial trade was 3.59%, registering a year-on-year decline of 24.4%. However, after joining the SDR, the reserve function of the RMB has been enhanced, and countries along the Belt and Road expanded the use of RMB. In the field of foreign direct investment, Panda bonds, overseas credit there was a significant growth of RMB acceptability. All these highlights expanded the financial transaction function of RMB.



**Figure 3. Comprehensive index of RMB international financial valuation**

## **2.2 Impetuses for RMB Internationalization**

### **1. Progress has been made in international financial structure reform, and the RMB officially joined the SDR.**

In 2016, under the framework of G20, China took the initiative to restart the working group of international financial structure to promote the reform of the international monetary system. Such a move not only enhanced China's voice in financial affairs, but also maintained the global economic and financial stability, and injected positive energy into RMB internationalization. In October, the RMB officially joined the SDR currency basket, signifying that the RMB has become an international currency and one of the reserve currencies for central banks around the world. At the same time, China actively promoted the expansion of RMB currency swap system to 36 countries and regions, strengthened cooperation with international multilateral organizations such as the IMF, World Bank, ADB and European Bank for Reconstruction and Development, and achieved substantial progress with BRICS New Development Bank and the AIIB and other platforms to create an enabling international environment for RMB internationalization.

### **2. China's economy was generally stable, and the process of reform and opening up was deepening.**

The economic strength of a country has a fundamental effect on the internationalization of the country's currency. In 2016, China's economy was growing in a stable and sound manner, contributing more than 30% to the global economic growth. Supply side structural reform was pressing ahead, and initial results have been achieved in capacity reduction, de-stocking, deleveraging, cost reduction and improving underdeveloped areas. China has comprehensively deepened reform, and focused on streamlining government, delegating authorities and optimizing

services. China has fully implemented the "Made in China 2025" strategy, nurturing new driving forces. Urban and rural areas developed in synergy, environmental protection was advocated, and China was committed to improving people's livelihood and ensuring social harmony and stability. In the special period of rising global political and economic risks and prominent domestic structural problems, China's economy was still showing its resilience and potential. Development quality and efficiency have been improved, providing solid support for RMB internationalization.

### **3. "Belt and Road" initiative and various types of pilot zones together built open platforms, and enterprises picked up pace going global.**

In the new era, China continuously raises the level of opening up, builds a new pattern of opening to the outside world, and provides a solid carrier for the international use of RMB. On one hand, with the orderly implementation of the Belt and Road initiative, China has strengthened bilateral and multilateral cooperation, and a large number of key construction projects have been launched, and regional economic and trade exchanges have been deepened, creating favorable conditions for the regional use of RMB. More than half of RMB settlement occurred in the areas along the Belt and Road. On the other hand, China improves the foreign trade and investment environment, and use pilot projects to promote innovation. In 2016, the construction of Free Trade Zones went into a stage. Shanghai and other free trade zones further promoted the achievements in financial liberalization and the cross border use of RMB. Seven new Free Trade Zones and 12 cross-border e-commerce pilot zones have been set up, actively exploring the ways to internationalize RMB. China-Myanmar Currency Exchange Center in Ruili, Yunnan Province, Guangxi regional cross-border RMB business platform, Horgos offshore RMB financial business pilot area, have opened a window for the regional use of RMB along the borders. Chinese enterprises have also accelerated their pace of "going global", engaged in the mergers and acquisitions wave, and actively participate in the global value chain integration, promoting the rapid growth of RMB foreign direct investment.

### **4. Cross-border channels of RMB use were set up in an orderly manner, and the RMB clearing system was accessible worldwide.**

In 2016, China's policy regarding the cross border use of RMB focused on function expansion and risk prevention, followed the principle of controlling risks and serving the real economy to support RMB internationalization. The interbank depository market is further opened to foreign institutions, and the foreign institutions such as the International Monetary Fund and the Asian Development Bank have been allowed to become members of China's interbank FX market. Although RMB bonds were not chased after as expected outside China, but the rapid development of the panda bond market, RMB central bank bills, RMB green bonds, SDR-denominated bonds have also made a breakthrough. RMB foreign exchange direct transactions added 11 currency pairs, including international mainstream currencies. RMB has become the No.1 traded emerging market currency. RMB stock market connectivity mechanism was further improved, the Shanghai-Hong Kong Stock Connect is well afoot while the Shenzhen-Hong Kong Stock Connect was to be launched at the end of 2016 as scheduled. China has attached great

importance to the legal system, regulatory framework, and supporting facilities, and strived to raise accounting rules, regulatory rules, laws and regulations to international standards. The RMB clearing system basically covered the whole world, especially the United States and Russia in 2016, which was a milestone in RMB internationalization. The cross-border RMB payment system CIPS was running well and its direct participants have expanded from 19 to 27. Its 480 indirect participants covered 78 countries and regions from 6 continents, accumulating long-term energy for RMB internationalization.

## **2.3 Main obstacles facing RMB Internationalization**

### **1. The global landscape is in turmoil and the currency competition is becoming increasingly white-hot.**

In the process of rebalancing the international economic and financial situation, the recent political risks have risen sharply. In some major countries, protectionism is gathering steam, which has a negative impact on China's foreign trade, "Belt and Road" initiative and cross-border RMB settlement. It's hard for RMB to break through the inherent currency inertia. The Fed rate hike causes volatilities in exchange rate and large-scale capital reflux. The Brexit referendum, the tense European political situation, the underperformance of Brazil and other emerging economies are to a certain extent making the US dollar stronger. Increasingly white-hot competition inhibits the internationalization of RMB.

### **2. The domestic economy is still faced with downward pressure, sapping people's confidence in RMB internationalization.**

China's smooth economic transition is the key to RMB internationalization. At present, China's economy has entered a new normal, with the traditional driving forces being weakened. New impetuses are unlikely to power significant economic growth in the short term. Structural problems still exist. There is rising doubt about China's economic prospects. At the same time, the domestic financial market is limited in both breadth and depth. Financial risks continue to accumulate. The banking sector has more NPAs. The stock market is underperforming. The bond market sees more defaults. The rise of the new financial formats promotes the cross-market and cross-border transmission of risks. Market volatility increases remarkably, casting a gloomy shadow over the economic prospects, further sapping the international confidence of the RMB, restricting the trade settlement and financial pricing functions of the RMB. According to SWIFT statistics, in 2016 the global share of RMB payment and settlement in transactions fell by 29.5% compared with the previous year. RMB ranked fifth in the rankings of payment currencies.

### **3. Exchange rate is expected to decrease, and non-residents hold fewer RMB assets**

After the exchange rate reform on August 11<sup>th</sup>, 2015, the RMB is no longer pegged to the US dollar, increasing the flexibility of the exchange rate. In 2016 the market expected the RMB to depreciate, and the RMB did depreciate by 6.22% against the US dollar. Non-residents began to sell their RMB assets. At the end of 2016, the scale of RMB financial assets held by foreign

institutions and individuals was 3.03 trillion Yuan, a decline of 34.08% from May 2015, while in Hong Kong RMB deposits were worth 546.07 billion Yuan, a decline of 45.01% from July 2015. With the offshore RMB capital pool shrinking significantly, the cost of overseas RMB financing rises, further inhibiting the use of RMB outside China.

#### **4. Capital outflow pressure is mounting, and capital management policies are tightening.**

2016 saw divergences in the monetary policies of major economies, rising expectation of RMB depreciation. China's capital outflow pressure was mounting, with deficits in non-reserve capital and financial accounts. The balance of net errors and missing items, bank settlement and foreign exchange payments continues to be negative. According to IIF statistics, in 2016 China's net outflow of private capital reached 275.1 billion US dollars. In particular, RMB has become the main currency that flows out of China's border. The annual balance of RMB payment has a deficit of \$ 30,944.6 million. In order to prevent excessive capital outflow, China's capital account management tends to restrict capital outflow, to guard against the irrational foreign investment and the potential risks of RMB NRA accounts, strengthen the authenticity review and suppress speculative factors. This is of great significance to China's macroeconomic and financial stability, but it is not conducive to the expansion of the international use of RMB in the short term.

## **2.4 Comparison of Major Currencies**

In order to objectively assess the development of the international monetary landscape and dynamically reflect the gap between the RMB and the major international currencies, this report also compiles the internationalization indexes of USD, EUR, GBP and JPY with the same compilation methods of RII (See Table 1). Global political and economic landscape is in turmoil. Recovery is uneven among economies. "Black Swan" events frequently occur. The positions of major currencies fluctuate violently. The US economy is recovering, with improvements in inflation and employment. The Fed rate hike and Trump effect push up the value of US dollar, influencing global financial trends and capital flows, pushing up the dollar index from 53.55 last year to 54.02. Dollar dominance is further consolidated. Europe's economic and political risks have risen markedly. The structural problems within the Euro zone have been prominent, and the Brexit still has many uncertainties. Populism, terrorist threats, the refugee crises and political turmoil have cast a shadow over the process of European integration. However, since the fourth quarter in 2016, the European economy has shown signs of recovery, pushing the internationalization indexes of the Euro and the GBP to 24.57 and 5.50 respectively. Japan's economic recovery is slow, but in the context of global financial market turmoil, its characteristic of hedging against risks becomes more prominent. The Yen international index rose from 4.04 last year to 4.26. The yen's position in the world has been greatly elevated.

**Table 1.Major world currency internationalization indexes**

	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
USD	55.33	54.47	53.46	53.55	53.94	56.38	55.34	54.02
EUR	22.13	21.50	24.38	23.70	23.93	20.53	22.78	24.57
GPB	2.76	3.96	4.10	4.57	4.55	4.04	4.10	5.50
JPY	4.05	4.04	3.94	4.04	4.02	4.14	4.64	4.26
Total	84.27	83.97	85.88	85.86	86.43	85.10	86.86	88.36

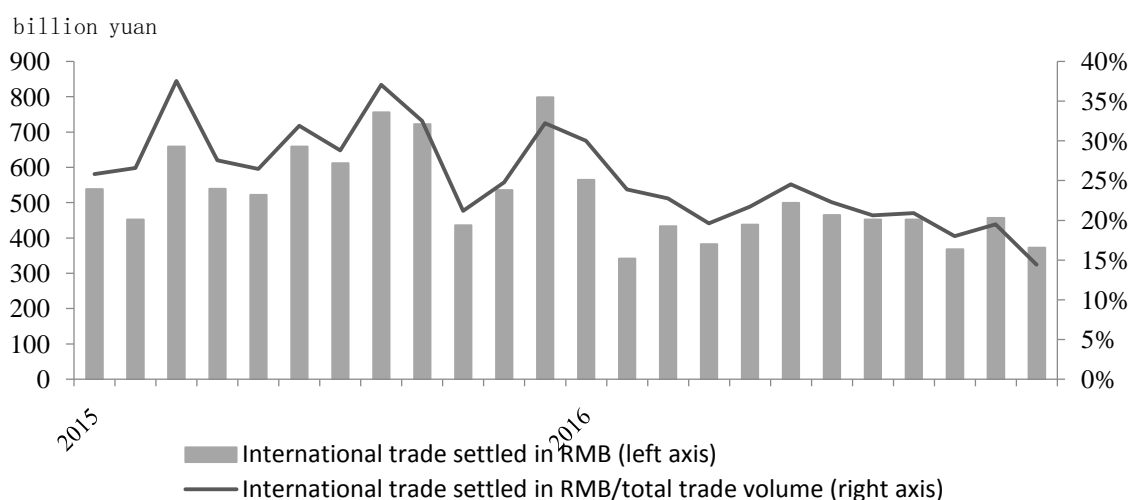


### 3. The current situation of RMB internationalization

#### 3.1 RMB Settlement of Cross Border Trade

##### 1. Scale has significantly declined, but settlement fluctuates downward.

In 2016, the scale of cross-border trade RMB settlement decreased significantly. The annual cross-border trade RMB settlement was 5.23 trillion Yuan, registering a decline of 2 trillion Yuan compared with that in 2015, a year-on-year drop of 27.66%. This is the first time that the scale has decreased since the start of the pilot project of the RMB cross-border trade settlement in 2009. The share of cross-border trade settled in RMB accounted for 18.08% of China's total trade in goods and services (balance of payments), a decline of 8.4% from that in 2015.

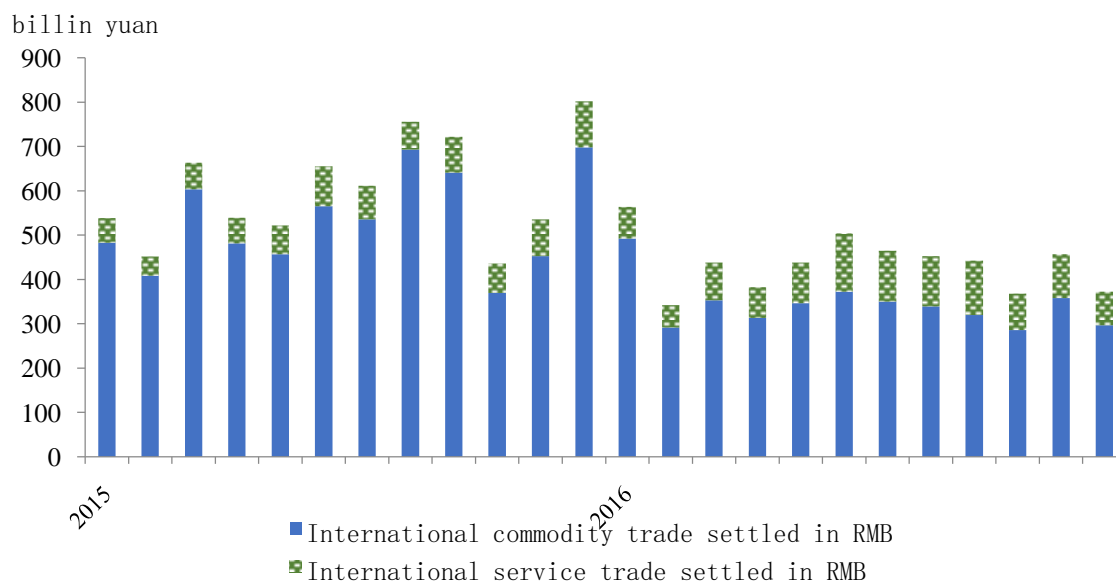


**Figure 4. Cross-border trade settled in RMB**

Source: People's Bank of China, State Administration of Foreign Exchange

##### 2. Settlement of trade in goods is the main part, and service trade settlement growth continues to accelerate

In 2016, cross-border trade of goods settled in RMB totaled 4.12 trillion Yuan, a decline of 35.5% year on year, accounting for 79.58% of cross-border trade settled in RMB. Cross-border trade in services settled in RMB totaled 1.11 trillion Yuan, up by 31.2 percent year on year, accounting for 20.42 percent of cross-border trade settled in RMB. The share of trade in services in the current account rose from 8.66% in 2010 to the 18.61% in 2016.

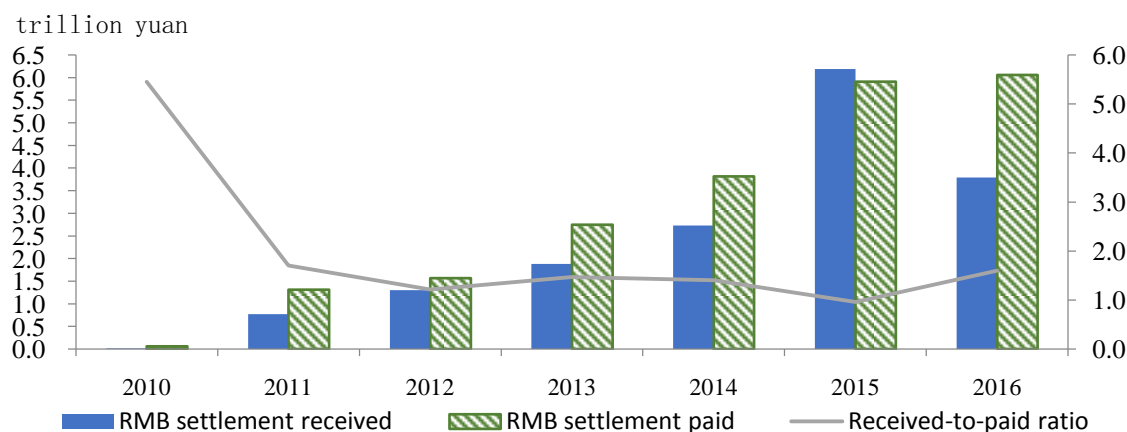


**Figure 5. Trade of goods and services settled in RMB**

Source: People's Bank of China

### 3. The gap of cross-border RMB payment balance has widened.

In 2016, the total amount of cross-border RMB flow was 9.85 trillion Yuan, a year-on-year decline of 18.6%. Actual receipt was 3.79 trillion Yuan, down by 38.8%. Actual payment was 6.06 trillion Yuan, a year-on-year growth of 2.5%. Cross-border RMB flow was in deficit, with the payment ratio rising from 1: 0.95 in 2015 to 1: 1.6. The expansion of the RMB payment deficit means that the RMB flowed overseas through the trade channel, which is conducive to expanding the offshore capital market and the offshore RMB business.



**Figure 6. Cross-border trade settled in RMB**

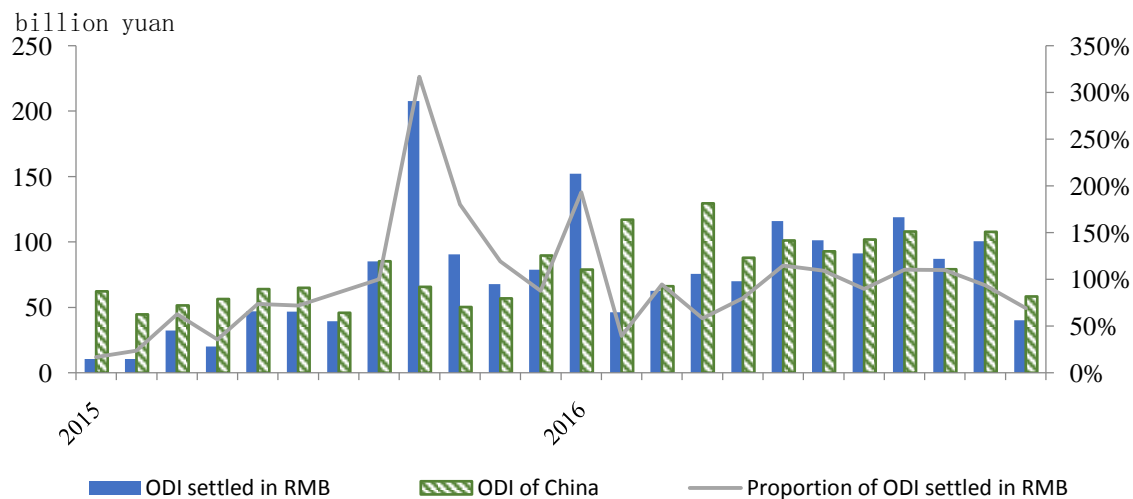
Source: People's Bank of China

## 3.2 RMB-denominated Financial Transactions 20

### (A) RMB direct investment

#### 1. The scale of foreign investment continued to increase, and the RMB ODI growth slowed down.

According to the statistics of the Ministry of Commerce, in 2016, Chinese investors invested a total of 1,191.92 billion Yuan (US \$ 170.11 billion) in 7961 foreign enterprises in 164 countries worldwide, registering an increase of 44.1% over that in 2015. Among them, ODI settled in RMB was 1061.9 billion Yuan, a year-on-year increase of 44.24%. Such an increase is insignificant compared with the 294.5% increase in 2015.

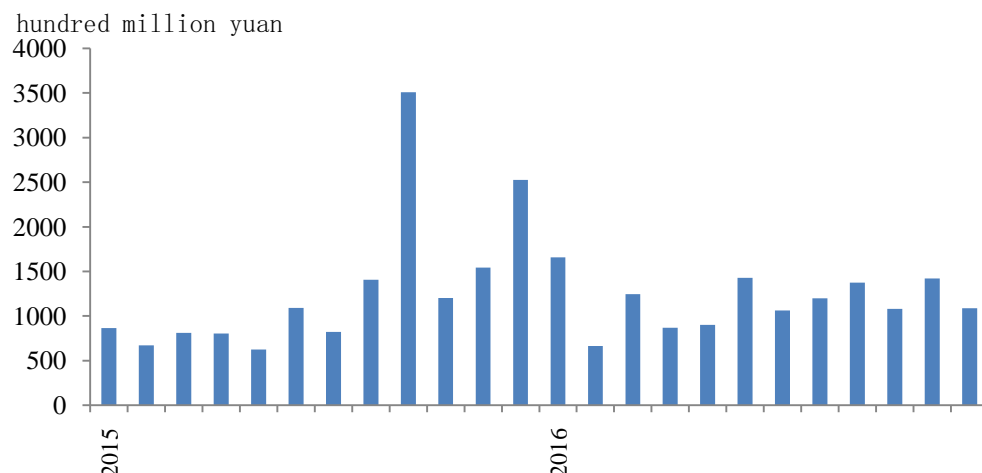


**Figure 7. Proportion of ODI settled in RMB in China's total ODI**

Source: People's Bank of China, Ministry of Commerce

#### 2. RMB FDI has slowed down

In 2016, China's actual use of foreign capital amounts to 813.22 billion Yuan, an increase of 4.1%. The sources of foreign direct investment were diversified. The United States, the European Union, Macao SAR, South Korea maintained a high growth rate, and Japan's investment in China stabilized. Foreign direct investment settled in RMB declined, with a total value of 1.4 trillion Yuan, a decline of 11.86% year on year.



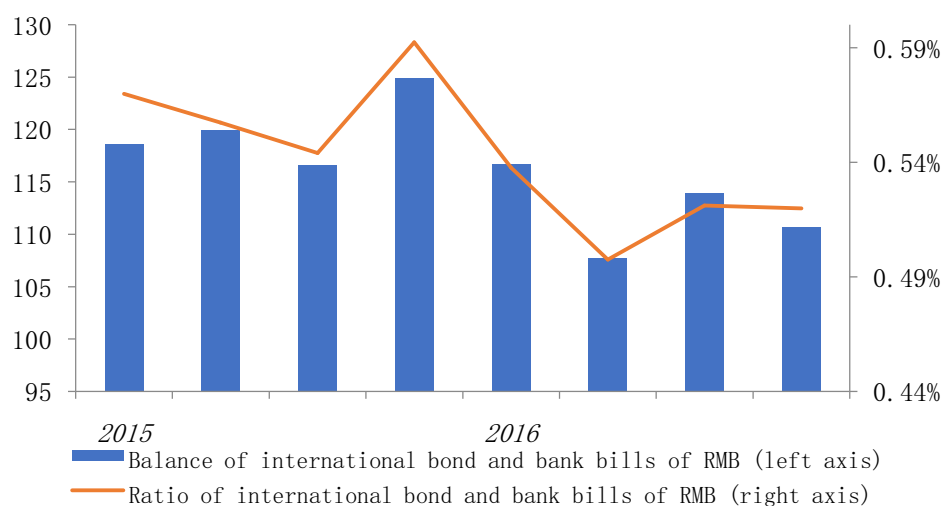
**Figure 8. FDI of RMB**

Source: People's Bank of China

## **(B) RMB securities investment**

### **1. The decline in the stock of international bonds and bank notes**

In 2016 the stock of RMB international bonds and notes has been reduced, with considerable fluctuations between the quarters. The year-end stock was \$ 110.655 billion, a decline of 11.4% year on year. The devaluation of RMB has blunted the international motivation to invest in RMB bonds to a certain extent. At the end of 2016, the share of RMB in the international bond market was only 0.52%, and this was a considerable gap compared with the share of the RMB in SDR.

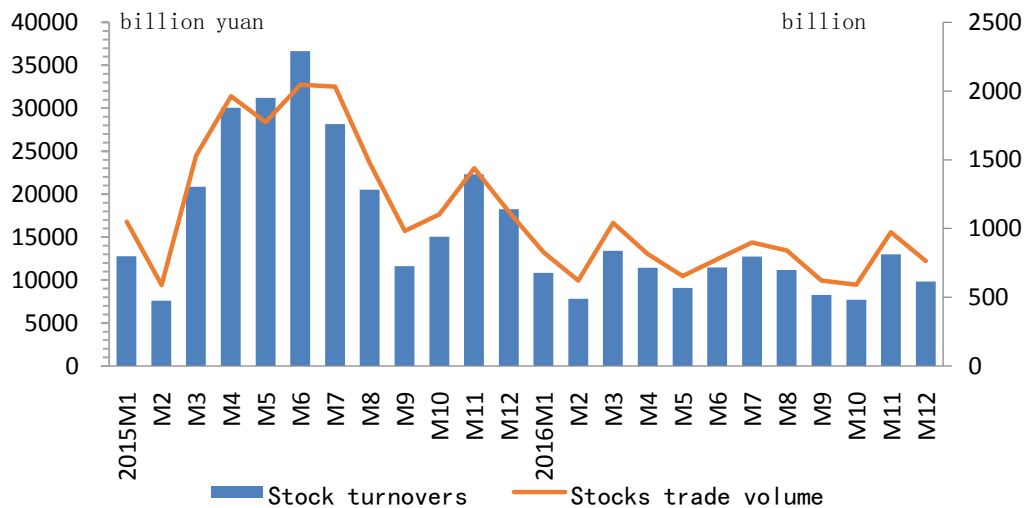


**Figure 9. RMB international bond and bill stock and its share**

Source: Bank for International Settlements

## 2. The size of the stock market has declined slightly, but the financing function has been enhanced.

At the end of 2016, the total market value of stock (A, B shares) totaled 50.8 trillion Yuan, registering a decline of 4.34% year on year. Stock prices fluctuations have blunted transaction activities, with the cumulative turnover in Shanghai and Shenzhen Stock Exchanges reaching 126.8 trillion Yuan, registering a year-on-year decline of 50.3%.



**Figure 10. China stock market transactions**

Source: China Securities Regulatory Commission

However, the financing function of China's stock market in 2016 has been enhanced. A total of 227 new companies are listed, including 103 companies on the main board, 46 on the Shenzhen SME board, and 78 on the GEM board. Newly listed companies raised a total of 163.356 billion Yuan on the stock market. The amount of private placement of listed companies also increased significantly compared with that in 2015. The total value reached 169.7828 billion Yuan, an increase of 1026.88 billion Yuan, which is a growth rate of 153%.

**Table 2. financing of China's stock market**

Year	IPO			Refinancing					
	A Share	BShare	H Share	AShare (Bn ¥)				BShare	HShare
	(Bn ¥)	(Bn \$)	(Bn \$)	Public Offering	Private Placement	Allotment	warrants exercise	(Bn \$)	(Bn \$)
2014	66.89	0	12.87	1.83	403.13	13.80	0	0	21.29
2015	176.69	0	23.62	0	670.95	4.23	0	0	22.71
2016	163.36	0	107.88	0	1697.83	29.85	0	0	52.90

Source: China Securities Regulatory Commission

### 3. Derivative market is underdeveloped, with a small scale

Compared with that in developed countries, China's derivative market still lags far behind, and RMB derivatives have not been counted by the Bank for International Settlements separately. In 2016, the RMB interest rate swap market saw 87800 transactions, a year-on-year increase of 35.5%. Total nominal capital was 9 trillion Yuan, registering a year-on-year increase of 19.9%. The RMB swap interest rate mainly refers to the 7-day repo fixed rate and Shibor, with 85.9% and 13.9% nominal principles respectively pegged to the former and latter.

**Table 3. inter-bank interest rate swap transactions(unit: billion)**

	2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
interest rate swap	1659.78	1931.94	2251.95	2372.20	2006.67	2361.77	2577.82	2971.44

Against the backdrop of limiting positions, increasing margins and commission fees, the liquidity of stocks and futures continued to shrink, with the volume and turnover of transactions in stock and futures dwindling significantly. CSI 300 stock index saw total turnover of 4.10 trillion Yuan, a sharp decline of 98.8% year on year. Treasury futures saw turnover of 2.77 trillion Yuan, a year-on-year decrease of 36.5%.

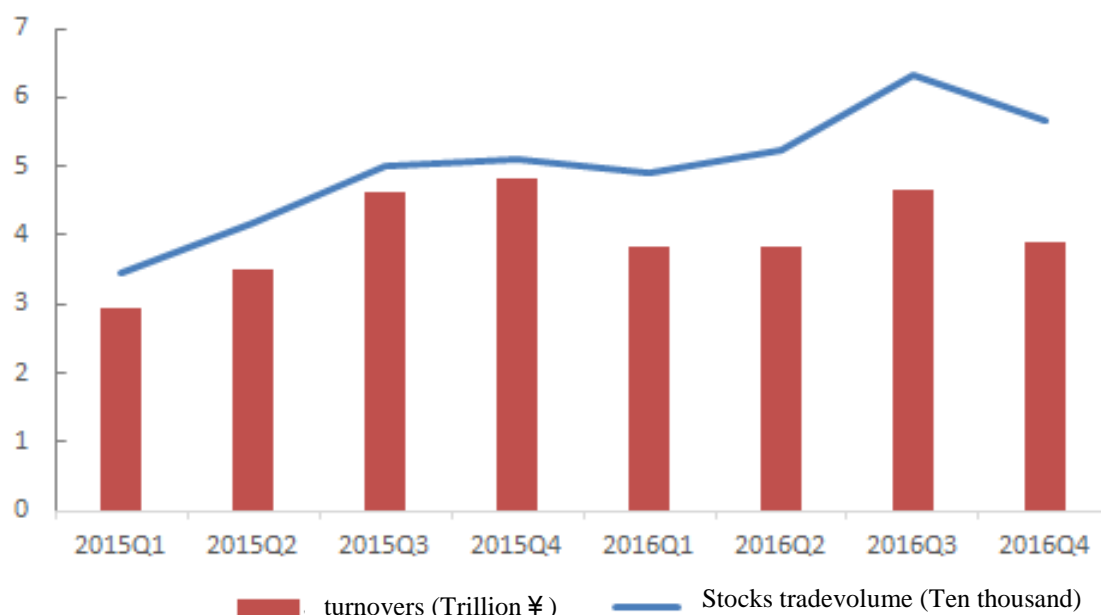
**Table 4. Transactions in stock index and Treasury bonds (unit: billion Yuan)**

	2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
CSI 300	88277	154658	97762	1210	12441	10627	933	775
Treasury bonds	677.90	716.76	433.43	2531.42	1013.28	561.67	554.39	644.89

Source: China Financial Futures Trading

### 4. More foreign institutional investors invest in domestic RMB financial assets

By the end of 2016, 278 new QFIIs were registered, with a total investment value of \$87.309 billion, an increase of \$6.241 billion over 2015. 177 new RQFIIs were registered, with 22 foreign institutional investors being approved for the first time. The total investment is expected to reach 528.475 billion Yuan, an increase of 84.15 billion Yuan compared with that in 2015. 407 foreign institutional investors participated in the inter-bank bond market in China, an increase of 105 over the previous year. Non-residents hold all kinds of RMB financial assets worth 3.03 trillion Yuan in China.



**Figure 11. Foreign institutional investors get involved in inter-bank bond market spot trading**

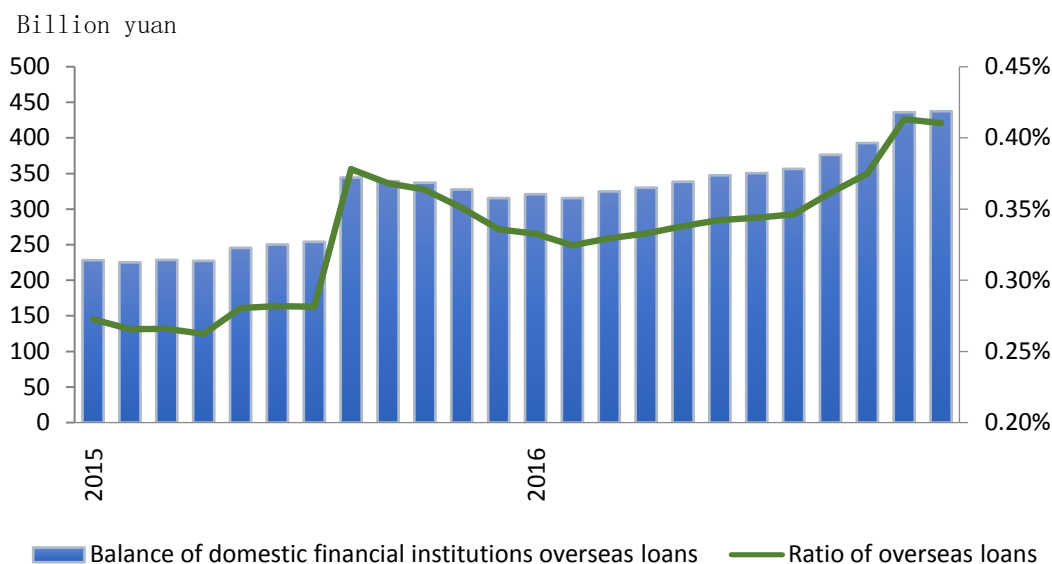
Source: China Foreign Exchange Trading Center

**Table 5. RMB assets held by overseas institutions and individuals (unit: billion yuan)**

Project	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Stock	738.41	784.40	528.52	598.67	570.95	601.21	656.23	649.19
Bond	712.80	764.08	764.68	751.71	679.95	763.98	805.96	852.62
Loan	876.92	924.21	935.71	851.56	778.27	747.42	708.19	616.44
Deposit	2024.80	2120.35	1664.18	1538.07	1274.45	1252.94	1130.72	915.47

### (C) RMB Overseas Credit Market

At the end of 2016, the balance of RMB overseas loans for domestic financial institutions reached 437.326 billion Yuan, a year-on-year growth of 38.7%. New loans reached 121.5 billion Yuan, a year-on-year increase of 24.3 billion Yuan. The share of RMB overseas loans in financial institutions' total loans reached 0.41%, representing a faster growth than that in 2015.



**Figure 12. Balance and share of overseas RMB loans for foreign financial institutions**

Source: People's Bank of china.

#### (D) RMB Foreign Exchange Market

In 2016, the turnover of interbank FX market reached 124.2 trillion Yuan, a year-on-year increase of 44%. The turnover of RMB foreign exchange market reached 112.4 trillion Yuan. The trading volume of foreign currencies against RMB reached 80 million Yuan. The trading volume in the interbank market for foreign currencies reached 11 trillion Yuan. USD, EUR, JPY are the currencies with the largest trade volumes. MYR, CAD and USD trade volumes saw significant increase.

**Table 6. 2016 trading volume of RMB against various currencies in the interbank spot FX market (Unit: USD 100 million)**

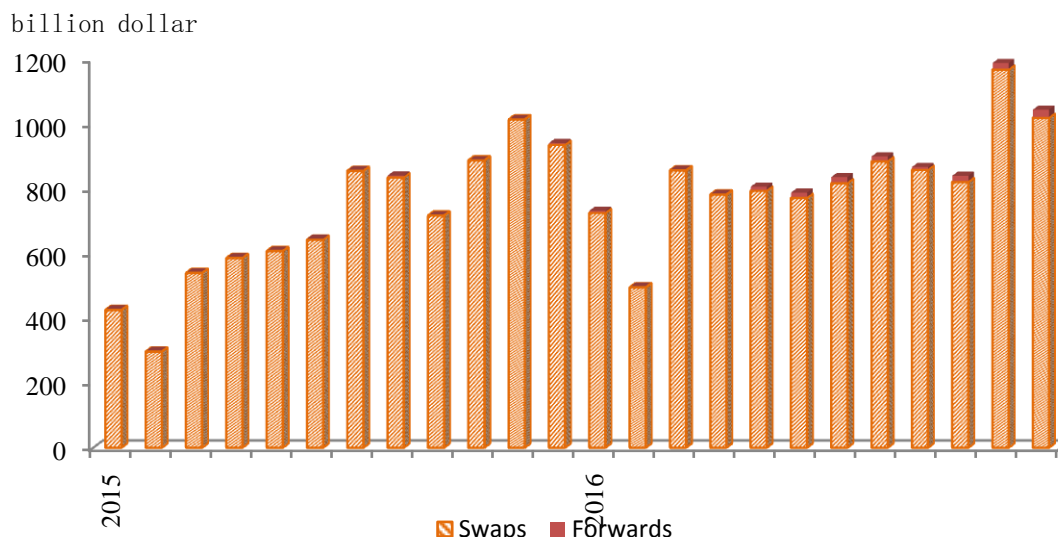
Currency	USD	EUR	100 JPY	HKD	GBP	AUD	NZD	SGD	CHF	CAD	MYR	RUB
Turnover	5734.66	69.09	49.29	22.44	7.35	11.91	2.06	16.54	2.69	3.77	0.51	1.76
y-o-y growth %	24.31	1.93	-8.14	-19.57	-40.95	-25.72	-24.24	-72.67	15.44	87.22	115.13	-50.17

Source: China Foreign Exchange Trading Center

In 2016, the turnover of inter-bank FX derivatives reached 11 trillion US dollars, up by 25.5% year on year; FX spot transactions reached 6 trillion US dollars, an increase of 21.8%. Since 2009, FX derivatives enjoyed faster growth than the spot transactions, increasing the share of FX derivatives in the market. In 2016, the share of FX derivatives transactions in the inter-bank FX market (foreign currency inter-bank borrowing excluded) increased from the 63.9% in the



previous year to 64.6%, which is very close to the 33:67 ratio between international FX spot market and derivative market released by the Bank for International Settlements.



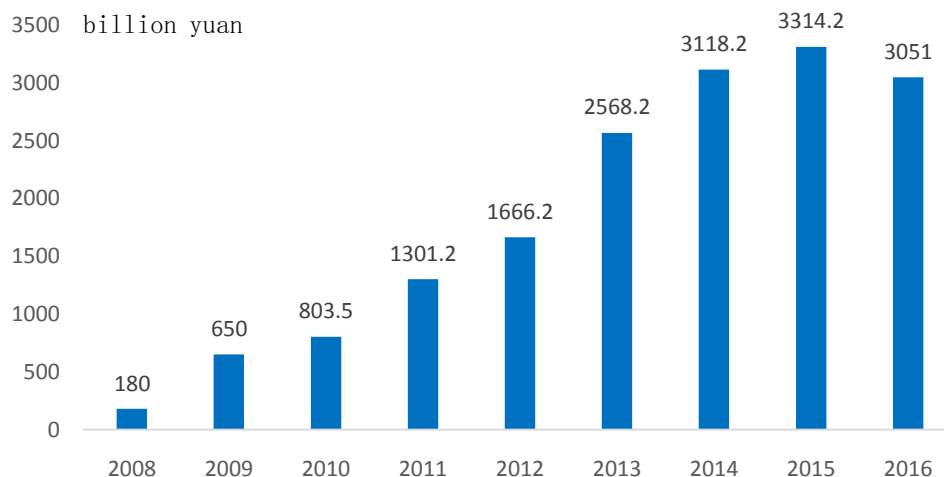
**Figure 13. 2015-2016 RMB FX derivative market**

Source: China Foreign Exchange Trading Center.

### 3.3 RMB in Global Foreign Reserves

The International Monetary Fund (IMF) released as of December 2016 "official foreign exchange reserve currency composition" (COFER) quarterly data. According to COFER, IMF member states held RMB worth a total of 845.1 billion USD, accounting for 1.1% of the total amount of foreign reserves. The first separate list of the holdings of the RMB indicates that the RMB reserve currency function has been enhanced.

In 2016, the People's Bank of China signed a new bilateral currency swap agreement with the Central Bank of Morocco, the National Bank of Serbia and the Egyptian central bank, with the total volume reaching RMB29.5 billion. The PBoC renewed bilateral currency swap agreements with the Singapore Monetary Authority, the Hungarian Central Bank, the European Central Bank and the Central Bank of Iceland, with the total volume reaching 663.5 billion Yuan. At the end of 2016, the People's Bank of China has signed currency swap agreements with the monetary authorities of 36 countries or regions to ensure the international liquidity of the RMB.



**Figure 14. People's Bank of China's balance of currency swap with monetary authorities from other countries**

Source: People's Bank of China.

### **3.4 RMB Exchange Rate and the Liberalization of China's Capital Account**

#### **(A) RMB exchange rate**

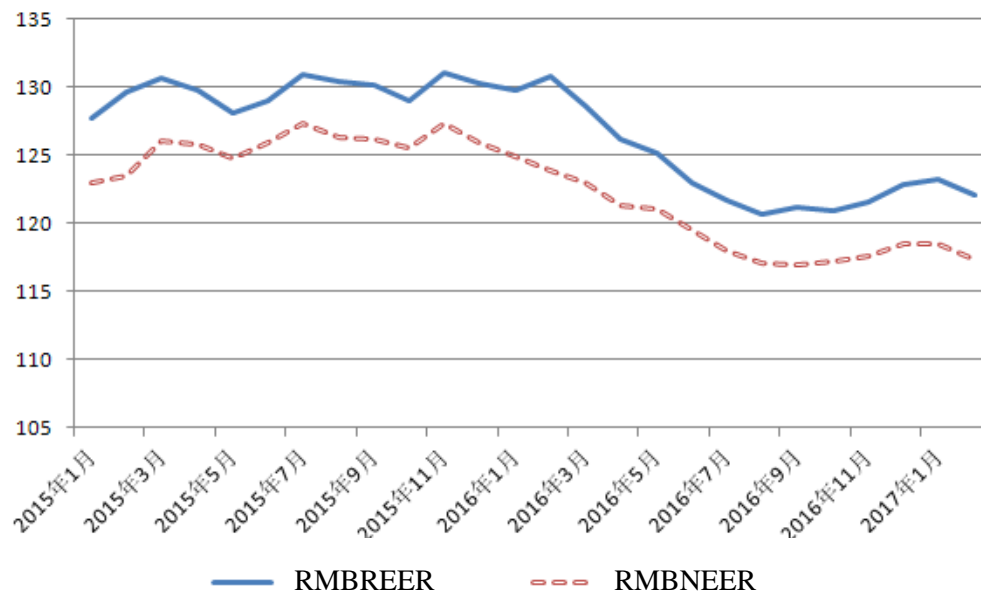
In 2016, the central parity rate of RMB against the US dollar was valued to the closing rate and the exchange rate against a basket of currencies. After a period of adjustment, the effect of the policy is gradually materializing. The central parity rate became more rule-based and transparent, playing an important role in enhancing the credibility of the central bank's exchange rate policy and stabilizing the market expectations.

#### **1. Depreciation against the currencies of developed countries.**

In 2016, against the backdrop of US economic recovery, the Fed rate hike and the Brexit, the financial market was relatively turbulent, and there were divergences. RMB depreciated against the US dollar by 6.39%, the Euro by 3.54%, the Japanese yen by 9.39%, the Australian dollar by 5.64%, Swiss franc by 4.49%, Canadian dollar by 8.77%, the NZD by 8.36% and SGD by 4.68%. The Brexit was a blow against the pound in 2016, and the Yuan appreciated by 12.50% against the pound.

#### **2. Effective exchange rate declined.**

The effective exchange rate index for RMB in December 2016 was 118.55, a decrease of 5.85% from the 125.91 a year earlier, according to the Bank for International Settlements. The real exchange rate index of the RMB was 122.86, a decline of 5.69% compared with 130.27 at the end of 2015. Both fell for the first time in seven years with the biggest decline since 2003.

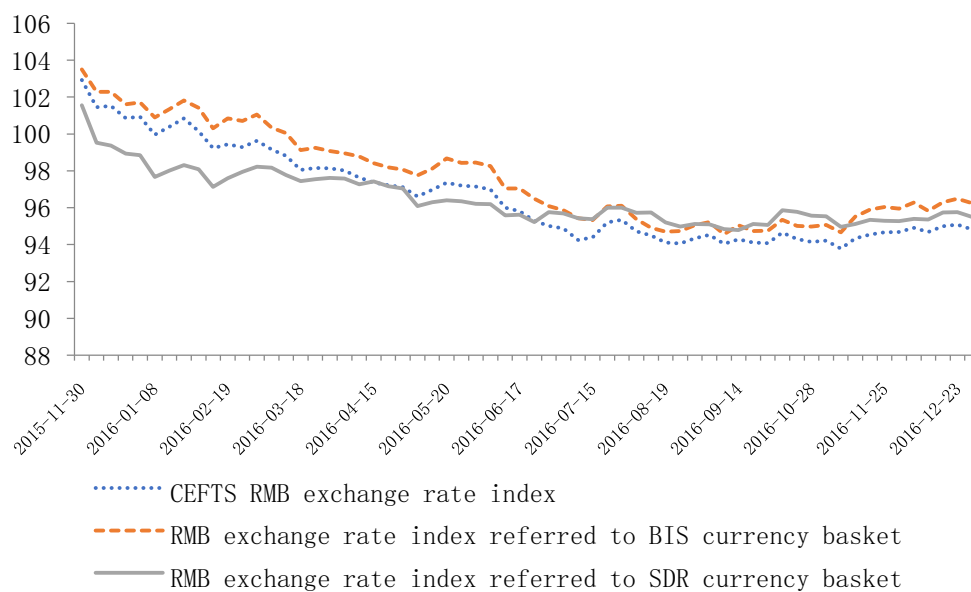


**Figure 15. RMB effective exchange rate**

Source: Bank for International Settlements

### 3. RMB exchange rate index drops.

On December 30, 2016, the CFETS RMB exchange rate index closed at 94.83, with the annual depreciation rate of 6.05%. The RMB exchange rate index based on the BIS basket and the RMB exchange rate index based on the SDR basket closed at 96.24 and 95.50 respectively, with the depreciation rate of 5.38% and 3.38% respectively. In general, the depreciation of the RMB exchange rate index is slightly smaller than the bilateral exchange rate of the RMB against the US dollar.

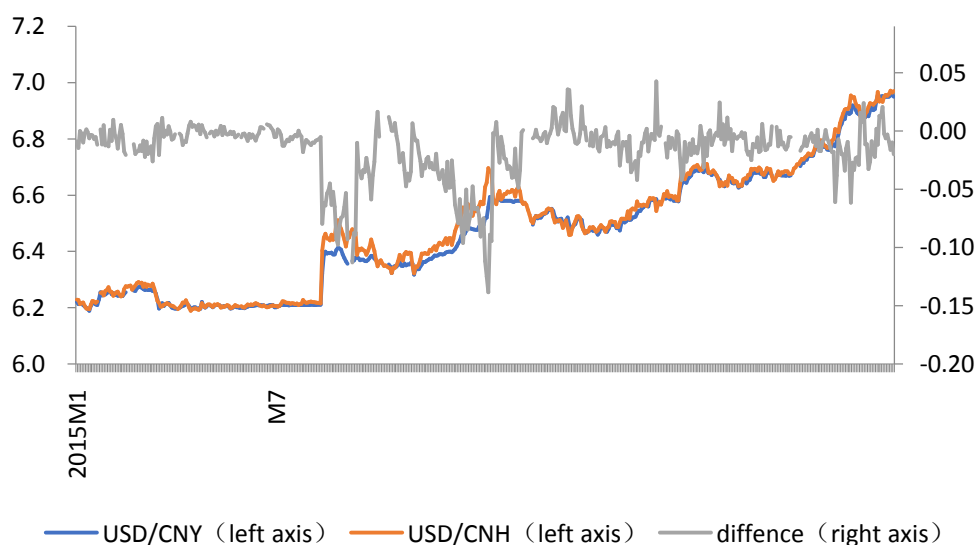


**Figure 16. RMB exchange rate index**

Source: China Foreign Exchange Trading Center

#### 4. CNH depreciated.

In 2016, USD to CNH Exchange Rate fell. In December 2016, CNH closed at 6.9726, a monthly decline of 0.8% and an annual decline of 6.16%. The spot FX price difference between domestic and overseas RMB narrowed, with an average spread of 134 basis points, down from the 209 basis points in 2015.

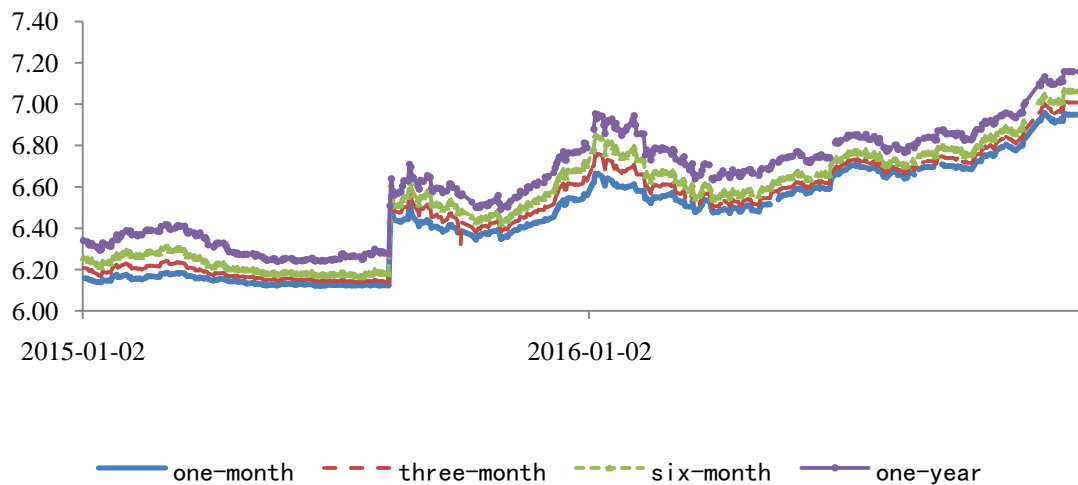


**Figure 17. 2015 - 2016 CNY, CNH exchange rate and spreads**

Source: Wind.

## 5. Devaluation of RMB NDF

By the end of December 2016, 1-month, 3-month, 6-month and 1-year RMB NDF closed at 6.949, 7.008, 7.065 and 7.158 respectively. Compared with the same period in 2015, in terms of the four types of NDF transaction, the RMB exchange rate against the dollar depreciated by 5.60%, 5.39%, 5.10%, and 5.14% respectively.



**Figure 18. 2015 - 2016 RMB NDF daily closing price**

Source: wind.

### (B) Measurement of the openness of China's capital account

This report uses the current mainstream method, namely, the four ranges of capital account restrictions to measure the openness of China's nominal capital account. According to the description in the "2016 Annual Report on Exchange Arrangements and Exchange Restrictions", there are three major non-convertible items in China's capital account in 2015, mainly focusing on non-residents participating in the domestic money market, the sales and distribution of collective investment securities and derivatives. Part of the convertible items are mainly concentrated in the bond market transactions, stock market transactions, real estate transactions and personal capital transactions and so on. Using four ranges of capital account restrictions, taking into account the subtle changes, comprehensively quantify the description in "2016 Annual Report on Exchange Arrangements and Exchange Restrictions", we calculated China's capital openness degree at 0.6716.

### (D) More liberalized items under capital account

Compared with those in 2014, the seven items of "regulation of capital market securities transactions", "control of collective investment securities", "control of financial credit", "control

of guarantees and reserve financing", " Direct investment control "and" control of real estate transactions, " are further liberalized. Specifically, in the 40 sub-items under the capital account, 11 items have seen obvious changes, showing that China's capital account is further liberalized.

The IMF's "2016 Annual Report on Exchange Arrangements and Exchange Restrictions" describes the situation of capital account control in 2015. There is a one-year time lag, so the capital account openness that we measured is relatively conservative compared to the level of 2015. China's capital account are further liberalized, and the People's Bank of China and other relevant institutions have made a great adjustment in the description of capital account openness. Next year capital account openness is expected to see a big change.

## **4. The logic and Strategy of Strengthening the Financial Transaction Function of RMB**

### **4.1 Theoretical Logic of the Financial Transaction Function of RMB**

#### **(1) RMB internationalization needs to be propelled by trade and finance**

In 2016, RMB internationalization has slowed down, from the stage of high growth to the period of market adjustment. On one hand, the US election led to an increase in uncertainties. The Fed rate hike stirred the international market, causing a large number of capital flow back to the United States. RMB internationalization was faced with complicated external environment. On the other hand, the domestic economic slowdown, structural transformation, especially the exchange rate pressure after August 11th, and tighter capital policy to some extent affected the international use of the RMB. The end of the golden era of global trade, the rise of protectionism, the limited space for China to boost trade share make it hard for China to elevate its status in the global value chain and bargaining capacity in the short term. The impetus for RMB internationalization in terms of trade has weakened. RMB global payment fell by 29.5%. RMB's international payment currency ranking dropped from fifth place to sixth.

Based on historical experience, trade pricing and settlement is the cornerstone to internalize a country's currency. But the current RMB liquidity fluctuations, depreciation expectations and poor backflow mechanism and other issues restrict the RMB settlement of cross-border trade. In view of the weakening impetus of RMB internationalization in terms of trade and the greater scale of financial transactions than the scale of trade settlement in international trading activities, it is urgent to develop and improve the RMB financial market, tap the potential of RMB use in terms of capital finance, strengthen the financial transaction function of RMB, and enhance the position of RMB in the international financial transactions. In this way we can let trade and finance together drive RMB internationalization.

#### **(2) The development of financial market is the key to strengthening the financial transaction function of RMB**

With the RMB becoming more internationalized, China's capital control will be further relaxed, the scale of capital flows will continue to expand, and the interaction between domestic and international financial markets will be strengthened. In the context of increasing flexibility of the RMB exchange rate, we are faced with the challenge of "ternary paradox". Our theoretical analysis and empirical research show that building a developed financial market is conducive to enhancing the effectiveness of monetary policy, slowing down speculative capital flows and maintaining the stability of the foreign exchange market. It also helps strengthen the RMB financial transaction function and resolve the ternary paradox of the issuer of an international currency.

A mature international financial center is an important support for RMB internationalization. We should learn from the experience of other major currencies. At the beginning we should pay attention to the development of international credit market and the improvement of the financial market system, enhance the inherent stability of the whole financial market and lay the market foundation for RMB internationalization. A mature financial market, a sound international financial center, rational market participants, a sound financial regulatory system don't come by easily. We need to follow the laws of market development. A complete financial market for pricing and trading RMB can take shape in the order of short-term money market, medium-term bond market, and long-term multi-level equity market. In particular, we need to build a solid market base for RMB internationalization and provide safe, efficient and convenient foreign exchange transactions and clearing services. The financial market is a whole, and we should pay attention to the interaction between different markets, establish the "government - market - business" transmission mechanism to strengthen the ability of the financial sector to serve the real economy.

## **4.2 Direct Investment as a Leverage to Promote RMB Internationalization**

Direct investment promotes the sustainable development of China's economy, and consolidate the economic basis of RMB internationalization. Our empirical research shows that both FDI and ODI can promote China's economic growth, but the effect of the two is obviously different. ODI promotes greater economic growth than FDI does. We should further encourage ODI.

Foreign investment can play a bigger role in promoting RMB internationalization. First, outbound investment significantly promotes the growth of bilateral trade volume, which helps Chinese multinational companies have greater pricing power and seize the initiative in trade negotiations. Second, outbound investment promotes the internationalization of financial institutions. Outbound investment of enterprises will inevitably increase the demand for cross-border payment and settlement, investment and financing, and cash management. This will provide a market for China's financial institutions to develop cross-border RMB business and inject a steady stream of investment into RMB offshore market.

Of course, the development of outbound investment to promote RMB internationalization is facing enormous challenges. (1) Geopolitical conflict, legal constraints, cultural differences in Asia make it hard to localize, and higher national risks may inhibit the further expansion of China's outbound investment. (2) Most of the industries are in the low-end of international industrial chain, and it's difficult for China to grasp the financial and trade pricing power, which is not conducive to promoting the use of RMB in international direct investment. (3) The interaction mechanism between outbound investment and RMB internationalization has not yet established. (4) The basis for RMB internationalization is weak. The inertia of the international community and the "network effect" will curb the international use of RMB in the long run.

At the macro level, we propose to strengthen the supervision of national risks, enhance legislation and coordination of international laws and policy, and establish a national risk compensation



mechanism. We should continue to expand direct investment, and optimize investment structure. We should intensify our efforts to learn advanced technology and advanced management experience from developed countries, and vigorously boost outbound investment, combine it with the "One Belt One Road" strategy and the supply side structural reform, making the manufacturing industry as the main focus for outbound investment in the next three years.

We also need to promote the coordination between economic entities and departments, and establish a mechanism under which direct investment promotes the RMB trade settlement with sound financial services. For the direct investment to promote RMB internationalization, we should not only encourage Chinese enterprises to use RMB in investment and trade. Financial institutions should strive to build a large financial trading platform, and government departments should further improve the financial infrastructure and policies to facilitate the use of RMB.

At the micro level, we advise enterprises to develop financial technology, changing people's way of using money through technologies such as the block chain, the Internet, big data to promote the application of e-commerce, electronic settlement and digital currency. Leverage China's advantages in e-commerce, third-party payment, and mobile payment to construct a new platform of RMB-denominated settlement. In this way we can go beyond the traditional international monetary formation mechanism and develop the network effect of the use of RMB.

#### **4.3 Bond Market as a Breakthrough Point for Strengthening the Financial Transaction Function of RMB**

The bond market is the main channel for international capital flows, but the international bond market is usually monopolized by a small number of internationalized currencies. RMB internationalization is bound to face this challenge. China should open the bond market as a breakthrough point to lay a solid foundation for the final success of RMB internationalization.

At present, the RMB bond market has been a great attraction to overseas investors. First, the Chinese economy maintains a rapid pace of sustainable development, so overseas investors are motivated to hold RMB bonds, whether for risk diversification or for higher returns. Second, the global economy enters the new normal, and RMB bonds in terms promise higher returns over those of advanced economies. Finally, after joining the SDR, the RMB as the international reserve currency further attracts more overseas central banks and sovereign funds. RMB bonds can play an important role in providing "safe assets" and liquidity to the whole world, therefore RMB bond market should be given a unique position in the process of RMB internationalization, making it an important breakthrough point to enhance the financial transaction function of RMB.

How to develop the RMB bond market? We recommend the following measures: (1) optimizing the implementation of monetary policies to enhance the liquidity of the bond market. Build a monetary policy implementation system that is compatible with the marketization of interest rates, reduce the volatility of market interest rates, improve the interest rate structure curve, and boost bond market transactions. (2) The fiscal departments should play their role, and we should pay attention to the financial function of treasury bonds. We should consciously increase short-term

bond issuance, vitalize short-term bond market transactions. The fiscal departments should also consider setting up a special mechanism to provide liquidity support for treasury market makers. (3) Establishing a unified regulatory framework to increase connectivity between markets, improving the efficiency of regulation. (4) Enriching the risk management tools, and developing bond derivatives market. Eliminate the unreasonable rigid payment of the bond market, and use the market to find credit risk premium. (5) Boosting the RMB bond market innovation, enriching the categories of onshore market investment products, focusing on the development of asset-backed bonds, panda bonds and Magnolia bonds, strengthening the financing function of the RMB worldwide.

#### **4.4 Credit Market as an Important Pillar for Strengthening the Financial Transaction Function of RMB**

The RMB overseas credit market is the basis for the RMB to become the currency of the international financial market. The development of the market will help to expand the international use of the RMB, enhance the non-residents' confidence to hold RMB, increase the RMB settlement of trade between overseas enterprises as well as overseas and domestic enterprises. In this way, better conditions can be provided for the RMB internationalization. The global economy is increasingly dependent on the Chinese economy, and the currency mismatch is a prominent problem in developing countries. In light of this, developing the RMB international credit market is an inevitable historic trend. The substantial appreciation of the US dollar has reduced the financing cost of the RMB and provided a rare opportunity for the RMB credit market. We propose to adopt the following strategies to build the RMB credit market into the main pillar of strengthen the RMB financial transaction function:

First, trade should be chosen as the main path to the RMB credit expansion and funds should be guided "from virtual to real" so that the international competitiveness of enterprises can be enhanced. We should expand the RMB credit market focusing on countries which have close trade relationship with China. The most effective way is to, by means of trade credit, encourage foreign importers to pay Chinese exporters in RMB. What is crucial is to enhance Chinese business' bargaining power in international trade.

Second, we should encourage enterprises and financial institutions to focus on countries along the "Belt and Road" route and emerging economies. Most of the developing countries along the route need considerable and long-term financial support from the international community. It is suggested that the China Development Bank, the Silk Road Fund and the financial institutions should expand the use of RMB in the countries along the route. The large-scale use of RMB will compensate the shortage of the US dollar liquidity and enhance the RMB internationalization while meeting the demands of those countries' national economic development. In addition, at the national level, we should strengthen financial cooperation with emerging economies by improving cooperation and mutual investment in overseas mergers and acquisitions, market expansion, technological upgrading, energy acquisition and other key projects. By doing so, we

can change the status quo that reserve assets solely flow to developed economies, and also alleviate the risk of currency mismatch in countries along the “Belt and Road” route and emerging economies.

Third, we should promote the RMB offshore market development: whether it is the foreign exchange market or the RMB international credit market, the carrier is the offshore market. In order to better the RMB international credit market, we must attach great importance to the construction and development of the RMB offshore centers around the world to establish foreign capital pools and improve the RMB offshore market pricing mechanism. Only by doing so can we increase the appeal of the RMB credit to global investors.

#### **4.5 A Sound Foreign Exchange Market to Help Achieve RMB financial transaction function 39**

Developing and improving the multilevel RMB foreign exchange market is important for the RMB internationalization: (1) It provides the basic conditions for the RMB to serve trade settlement functions. In recent years, China's foreign trade has seen a substantial increase in the scale and proportion of the RMB pricing and settlement. In addition to the flourishing RMB internationalization driven by trade, the improved multilevel RMB foreign exchange market can provide the participants in foreign trade with transparent and effective price information, and a variety of derivative instruments to hedge against exchange rate risks, which can make market players choosing RMB as trade settlement currency more appealing. (2) It supports the RMB to serve as a currency for pricing commodity. Although China is a major importer of commodity, its voice and market influence is relatively weak in the pricing of international commodity. At present, promoting the RMB-denominated commodity trade is an important part of the RMB internationalization strategy. The multilevel RMB foreign exchange market can provide the RMB-denominated commodity trade with the pricing basis and risk-hedging means to help the RMB gain increasing influence on the commodity pricing. (3) It provides an important channel for RMB to serve as an international reserve currency. At present, the US dollar is still the dominant reserve currency in the world. This is closely related to the fact that the US dollar has a flexible and efficient foreign exchange market in the world and the international investors can easily buy and sell dollars to adjust asset and liability. Establishing a multilevel RMB foreign exchange market can provide the overseas central banks with a convenient and reliable access to RMB and promote RMB to become an international reserve currency.

In order to help the RMB realize the international financial transaction function, we believe that the following targeted measures must be taken to accelerate the construction of the multilevel foreign exchange market and enhance the international competitiveness of the RMB foreign exchange market comprehensively.

First, we should strengthen the foreign exchange market construction and diversify the types of market players. At present, there is only several types of domestic participants in the retail market, which are mainly businesses engaged in import and export trade. This structure increases the

volatility of the market, because China usually has surplus in its current account, it is easy for the RMB to appreciate excessively in the short term; however, when the RMB is expected to depreciate, the convergence between the transaction direction and expectation can easily lead to an excessive depreciation of the RMB as well. Therefore, diversifying the market participants is an important approach to rendering the market price fair and effective. The introduction of more types of market participants can fully reflect different expectations of the RMB foreign exchange market, help the RMB exchange rate more comprehensively and accurately reflect the market supply and demand, and also reduce the pressure on regulators.

Second, we should deepen the level of foreign exchange market transactions and give due relaxation to the pre-transaction management. According to the degree of freedom in access to foreign exchange markets, the current development of the RMB foreign exchange market can be divided into three levels. First, we should establish a retail foreign exchange market based on the principle of “real needs”. Second, in the inter-bank market restricted by indicators such as synthetic positions, banks have certain autonomy in deciding transactions and can offer the prices of the RMB foreign exchange products in the same industry. Third, an internationalized RMB offshore foreign market allows the participation of speculators and is not restricted by the “real needs” principle. For the first level, the domestic RMB foreign exchange market has accumulated rich experience and has made significant contributions to the preservation of value in corporate exchange rates. The next step is to pursue deepened reforms to help the domestic RMB foreign exchange market improve at the second level and move forward to the third level. This requires regulators to properly relax the pre-transaction management requirements to create large space for deepening the RMB foreign exchange transactions.

Third, we should speed up the construction of electronic trading platforms to promote the electronic development of China's foreign exchange market. The RMB internationalization requires the foreign exchange electronic platform to meet the international standards and provide a favorable market for the RMB financial transactions. We should fully learn from experience from developed countries and practices in building the offshore RMB electronic trading platform. By doing so, we can create a comprehensive electronic trading platform for the Chinese foreign exchange market that suits our national conditions. We should promote the domestic and foreign exchange market transactions to go from exchanges to counters, and encourage financial institutions to develop their distinctive foreign exchange trading systems at the counter based on their own conditions. The electronic trading platform must integrate demands of various transactions widely to form a powerful, secure and efficient trading network, which can help facilitate the development of domestic and overseas RMB foreign exchange transactions.

Sixth, we should strengthen the financial infrastructure development and build a RMB financial transaction "highway".

From the perspective of strengthening the function of the RMB financial transaction, the establishment of the efficient and secure RMB cross-border payment and settlement system, the improvement of the finance-related legal system, and the development of scientific and fair credit

investigation and credit rating systems are the "three pillars" for improving the financial infrastructure.

The RMB cross-border trading volume continues to increase, imposing higher requirements on cross-border RMB settlement. Although CIPS excels at improving efficiency, saving costs, reducing liquidity and credit risk, and ensuring the security of the domestic financial system, the current CIPS, with its focus on cross-border payments under trade accounts, fails to meet the needs of using RMB on a large scale under capital accounts in terms of saving funds, attracting participants and others. We should learn from the mature international currency payment and settlement system—the United States CHIPS and the European TARGET2, drawing on their design concepts and management experience to improve the RMB cross-border payment and settlement system. The CIPS system should be operated around the world with services covering foreign exchange, securities transactions, etc., and settlements should adopt a mixed model combining full and net settlement. In this way, we can further enhance efficiency and reduce costs, providing competitive technology support and market base to promote the RMB internationalization.

After the RMB joins SDR, China needs to assume more responsibility in the governance of the international monetary system. As the RMB international demand and supply have changed significantly, China's capital flows, the RMB exchange rates and the balance of payments management will face a series of new problems and challenges. China needs to accelerate the legal system development and provide legal protection for expanding the RMB international financial transactions. First, we should build a macro-prudential regulation system to prevent the RMB internationalization risks, and monitor volatility in exchange rates and interest rates, as well as the offshore market and cross-border funds, so as to deal with the impact of huge cross-border capital flows. Second, in macroeconomic management, we should reduce the dependence on administrative means, and rely more on market and legal means. This means that we should make good use of exchange rates, interest rates, tax rates and other price tools to regulate economic activities, so as to improve the macroeconomic regulation's prospective guidance, targeted resolution, transparency and credibility. Finally, we should build and improve the legal system which adapts to the RMB internationalization. For problems that may arise in different stages of the RMB internationalization development, we should improve policies and legal regulations. At present, the urgent task is to build a legal system for the cross-border settlement system, improve the emergency plans for handling the excessive cross-border inflow or outflow, improve the domestic tax laws and regulations for cross-border transactions, specify cross-border transaction tax incentives, revise the current bilateral taxation agreements, so as to clarify such definitions as dividends and interests that are earned in cross-border investment, rules on affirming places of origin, and taxation methods, and also to reduce the tax rates in source countries.

Credit is the basis for financial transactions and financial market development. The current sovereign credit rating business is dominated by the three major international rating agencies. The sovereign credit rating results released by China's Dagong Global Credit Rating Group have not

been internationally recognized. Although China's credit investigation and rating system has made some achievements, there is still much room to be desired before it meets the needs of promoting the opening-up of the bond market and giving full play to RMB financial transaction functions. The prominent problems are as follows: the credit market is fragmented; the customer coverage is not wide enough; information channels are blocked; an internationally recognized credit rating agency has not been established; the rating methods are immature; the reputation capital accumulation is small. To address the problems above, we propose to adjust the mindset and take the following measures to build a fair and scientific credit investigation and rating system. (1) We encourage the synchronized development between the public and market credit investigation to realize connectivity in information exchange, strengthen supervision, highlight information protection, and enhance the credit culture. (2) We should speed up the legal system development to change the bond market rigid payment and specify the regulators in credit rating. (3) Credit rating agencies should make self-improvement, formulate credit rating standards based on Chinese market's characteristics, and reflect the credit status of the RMB bonds accurately. (4) We should integrate the credit rating market, avoid homogeneous vicious competition, prevent interest conflicts, and improve information disclosure.

## 5. Timeline of RMB Internationalization (2016)

Time	Event
January 4th, 2016	The trading hours of China's interbank forex market was extended.
January 13th, 2016	China began publish data on its external portfolio investment after formally joining a global survey conducted by the International Monetary Fund (IMF)
January 14th, 2016	The first RMB clearing bank in Switzerland was established.
January 16th, 2016	The AIIB was declared open for business.
January 20th, 2016	The People's Bank of China released <i>Notice of Issues on the Adjustment of the Use of Funds in RMB Settlement Account for Foreign Institutions</i> .
January 22nd, 2016	The pilot programs on full-caliber cross-border financing macro-prudential management were expanded.
January 27th, 2016	China officially became the third largest shareholder of the IMF.
January 29th, 2016	Overseas participating banks of RMB purchases and sales business could enter China's interbank FX market.
February 4th, 2016	The State Administration of Foreign Exchange reformed the management system for qualified foreign institutional investors (QFII).
March 3rd, 2016	The PBoC and Russia's Central Bank completed a number of bilateral currency swaps.
March 7th, 2016	Macao's RMB real time gross settlements system was formally in operation.
March 7th, 2016	The PBoC and the Monetary Authority of Singapore renewed a bilateral currency swap arrangement.
March 23rd, 2016	The first corporate panda bonds was issued.
March 25th, 2016	Zhongxin Chongqing launched a pilot program to provide multiple cross-border RMB innovative businesses.
April 7th, 2016	The PBoC released foreign reserves data in US dollars and SDR.
April 14th, 2016	Guangdong Free Trade Area expanded the cross-border use of RMB.
April 14th, 2016	Fujian Free Trade Area expanded the cross-border use of RMB.
April 15th, 2016	Suzhou launched a city-wide pilot program of the cross-border use of

	RMB.
April 15th, 2016	The Hungarian government issued offshore RMB bonds.
April 19th, 2016	The first Yuan-denominated gold benchmark price was launched.
April 28th, 2016	The pilot cross-border RMB innovative business in Tianjin was launched.
April 29th, 2016	Trade and investment facilitation were promoted and authenticity was strengthened.
May 3rd, 2016	China launched standardized RMB foreign exchange forward trading.
May 3rd, 2016	The PBoC launched the Macro-prudential Management Framework of Overall Cross-border Financing.
May 9th, 2016	CFETS Transaction Confirmation Interface Services was officially put into use.
May 11th, 2016	The PBoC signed a currency swap agreement with the Central Bank of Morocco.
May 17th, 2016	Chinese financial institutions issued the first RMB bonds in the United States.
May 20th, 2016	The first financial product approved by the US Securities Depository and Clearing Corporation (DTCC) was issued.
May 25th, 2016	Shanghai FTA's first RMB FX swap business was launched.
May 26th, 2016	The Chinese Ministry of Finance successfully issued the first RMB bond in London.
May 27th, 2016	New regulations on the investment in the Interbank Bond Market by foreign institutional investors were released.
May 30th, 2016	May 30, 2016 Hong Kong Stock Exchange launched a new batch of RMB futures.
June 1st, 2016	Hong Kong Monetary Authority announced that the list of eligible collateral for the RMB Liquidity Facility.
June 7th, 2016	The PBoC and the Federal Reserve signed a memorandum of cooperation in the establishment of RMB settlement arrangements in the United States.
June 15th, 2016	China's Treasury and other bond yields curves were released.
June 15th, 2016	The SAFE fully implemented the policies for managing settlement of foreign exchange under external debt.



June 17th, 2016	China launched direct trading between the Yuan and South Africa's Rand on its interbank foreign exchange market.
June 17th, 2016	The PBoC signed a bilateral currency swap agreement with the Central Bank of Serbia.
June 21st, 2016	China Fund Manager Listed its First Sovereign Bond ETF in London.
June 21st, 2016	Foreign institutional investors could invest in CDs issued in inter-bank market.
June 21st, 2016	The SAFE revised the statistics system of foreign financial assets and liabilities.
June 22nd, 2016	The Monetary Authority of Singapore (MAS) announced that RMB investments will be a part of its official foreign reserves.
June 22nd, 2016	Chile's RMB clearing center came into use.
June 23rd, 2016	HKEx and Thomson Reuters launched a series of RMB indices.
June 24th, 2016	Won-Yuan direct trading market in China was launched.
June 24th, 2016	The national foreign exchange market self-regulatory mechanism was set up in Shanghai.
June 25th, 2016	The PBoC and the Russian Central Bank signed a memorandum of cooperation in the establishment of RMB settlement arrangements in Russia.
June 27th, 2016	The first U.S. dollar-Yuan futures options were launched.
June 29th, 2016	The Ministry of Finance successfully issued RMB national debt in Hong Kong.
July 4th, 2016	RMB FX option portfolio was launched.
July 6th, 2016	Overseas financial institutions should pay foreign exchange risk reserves after netting out position in forward selling.
July 9th, 2016	In the new Chongqing project the first offshore RMB bond was issued.
July 11th, 2016	Bank of China (Hong Kong) became the first overseas direct participant in CIPS.
July 13th, 2016	South African Standard Bank became Kenya's first RMB cash-free convertible bank.
July 15th, 2016	The first round of foreign exchange swap write-off business successfully organized.

July 18th, 2016	NDB Successfully Issued First RMB-Denominated Green Financial Bond.
July 28th, 2016	In Cambodia RMB can be used directly.
August 15th, 2016	The HKEx launched a cross-currency swap (CCS) clearing service.
August 25th, 2016	The first sovereign country in Europe issued the Panda bond.
August 25th, 2016	RMB's reference exchange rate against the Euro, the Yen and the Pound was released.
August 31st, 2016	The World Bank issued in China's interbank market SDR-denominated Magnolia bonds settled in RMB.
September 1st, 2016	RMB became the most actively traded emerging market currency.
September 5th, 2016	The SAFE announced management over investment quota of RQFII through filing on record or approval.
September 10th, 2016	The Australian Stock Exchange began to provide RMB custody services.
September 12th, 2016	The PBoC and the Hungarian Central Bank renewed the bilateral currency swap agreement.
September 19th, 2016	ICBC signed a memorandum of understanding with the Singapore Exchange to support offshore RMB bonds.
September 20th, 2016	The PBoC designated the BOC (New York) as the RMB clearing center in the US.
September 23rd, 2016	The PBoC designated ICBC (Moscow) Co., Ltd. as the RMB clearing center in Russia.
September 26th, 2016	Direct trading between RMB and UAE Dirham and Saudi Riyal.
September 27th, 2016	The PBoC signed a supplementary agreement with the European Central Bank to extend the validity of the bilateral currency swap agreement.
September 30th, 2016	Treasury bond market support mechanism was established.
October 1st, 2016	The International Monetary Fund announced that the new SDR currency basket was officially in force.
October 18th, 2016	Kazakhstan National Stock Exchange opened RMB clearing accounts.
October 18th, 2016	The first foreign banks became members of China's Foreign Exchange Trading Center.

October 20th, 2016	International Center for Securitization (ICSD) officially entered the China Interbank Bond Market.
October 24th, 2016	The Philippine central bank included the Chinese Yuan in its official international reserves.
October 25th, 2016	Standard Chartered successfully priced its first SDR bonds in China.
October 27th, 2016	HKMA Designates Nine CNH Primary Liquidity Providers.
October 28th, 2016	Shanghai Gold Exchange and Dubai Gold and Commodity Exchange signed the Shanghai gold benchmark price license agreement.
October 28th, 2016	The Ministry of Finance announced the 30-year bond yield curve for the first time.
November 2nd, 2016	The first Panda Bonds were issued by foreign financial institutions.
November 7th, 2016	The first inter-bank lending of US dollars by oversea institutions in China
November 14th, 2016	China launched Yuan direct trading pair with Canadian dollar.
November 18th, 2016	The world's largest hedge fund, Bridgewater, was approved to enter China's inter-bank bond market.
November 18th, 2016	China's ICBC became Dubai's clearing and settlement bank.
November 22nd, 2016	Bank of China signed a RMB futures trading market maker agreement with the Korea Stock Exchange.
November 23rd, 2016	Two-way Cross-border RMB Cash Pooling Business was launched.
November 25th, 2016	The first ultra-short-term panda bond was issued in inter-bank market.
December 5th, 2016	Shenzhen-Hong Kong Stock Connect officially commenced.
December 6th, 2016	The PBoC signed a bilateral currency swap agreement with the Egyptian Central Bank.
December 8th, 2016	The Ministry of Finance successfully issued RMB sovereign bonds in Hong Kong.
December 8th, 2016	Shanghai Commercial Paper Exchange was established.
December 9th, 2016	China's central bank chose Agricultural Bank of China Ltd to clear Yuan transactions in Dubai for the United Arab Emirates.
December 11th, 2016	China officially joined the BIS locational banking statistics.
December 12th, 2016	Yuan's direct trading with Swedish krona, Hungarian forint, Danish krone, Polish zloty, Mexican peso, Turkish lira and Norwegian

	kronewas launched.
December 13th, 2016	In Shanghai Free Trade Zone, the first batch of bond transactions weresettled successfully.
December 20th, 2016	RQFII pilot area was expanded to Ireland.
December 21st, 2016	The PBoC and the Central Bank of Iceland renewed the bilateral currency swap agreement.
December 21st, 2016	CFETS RMB exchange rate index adjusted its currency basket.



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