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Research Report



# Internationalization Progress and Outlook of RMB

International Monetary Institute, Renmin University of China



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## Focus on the Internationalization of RMB

In 2016, the internationalization of RMB changed from a phase of big strides into a phase of market adjustment and RII experienced minor shock. The combination of twinge from the structural reform of supply side in China and the downward economic pressure has added to the misgivings in the market; RMB exchange rate has become more flexible under the new exchange rate formation mechanism; and the market still needs some time to adjust and adapt. Frequent occurrence of Black Swan incidents such as US general election and Brexit etc., fermenting refugee crisis in Europe, and coincidence of multiple uncertain factors in the international society have reinforced the role of US dollar in avoiding risks. With adoption of new policies by US President Trump in the first quarter of 2017, the international economic and financial environment becomes clear; in China, the stable economic growth has boosted confidence in the market and the benefits of RMB joining SDR have become noticeable. It is estimated that in the first quarter RII will have smaller decline to 3.04, an increase of 14.1% compared to the same period last year. As dual drive from trade and direct investment intensify in the future, and in particular, as the financial transaction function of RMB improves, RMB can potentially sustain its role as an international currency. It is predicted that by the end of 2017, RII will rise to 3.08.

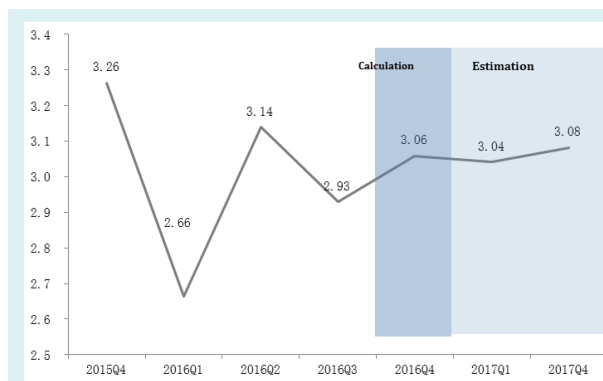


Figure 1  
RMB  
Internationalization  
Index (RII)

## ●RII Drive

China continues to be an important driving force for global economic growth. Against the backdrop of complex and changeable domestic and international situation, China managed to realize 6.7% of GDP growth in 2016. IMF has thus upgraded the expected GDP growth rate of China in 2017. In the first quarter of 2017, China's import and export trade have registered a double-digit growth, the structural reform of supply side has been enhanced, and the new motive power after development has been gathering force, which have laid solid economic foundation for the internationalization of RMB.

Outward Direct Investment has reached a new high and countries along “the Belt and Road” have become popular investment destinations. With infrastructure interconnectivity and international capacity cooperation as priorities, China's investment in countries along “the Belt and Road” has exceeded 50 billion USD and in 2017, investment abroad will keep the good momentum. The Outward Direct Investment has markedly boosted the bilateral trade ties and has promoted the cross-border business of Chinese-funded financial institutions and thus expanded the RMB business. EPC (Engineering-Procurement-Construction) has become a new impetus behind RMB internationalization.

RMB's international influence is on the rise. RMB has, for the first time ever, been listed separately in IMF's Currency Composition of Official Foreign Exchange Reserves (COFER). This shows that the institutional benefits of RMB joining SDR are becoming noticeable. More countries have officially recognized RMB assets, RMB's range of use has expanded from private sectors to public sectors, and like USD and Euro, RMB can now comprehensively display its function as international currency.

With stable market expectation for RMB exchange rate, the short-term capital outflow **decreases**. With the exchange rate formation mechanism of “closing rate on the preceding day + currency basket-based adjustment”, RMB has maintained stability towards the basket of currencies in 2017 and enhanced the flexibility of two-way fluctuation towards USD. The expectation of RMB devaluation goes short, short-term capital outflow reduces, and the official foreign exchange reserve remains to be over 3 trillion USD. At the same time, the dwindling exchange rate difference and cost of carry narrowing in the onshore and offshore markets can help wipe off the speculative bubbles and ensure that the cross-border RMB business of financial institutions serve economic entities again.

Further opening of the bond market has raised the international appeal of RMB assets. To provide international safe assets, China has not only lifted investment restrictions over many capital markets, but also opened up foreign exchange, interest rate, and credit derivative markets to the overseas institutional inves-

tors for their convenience of hedge management. Internationalization of pricing and clearing mechanisms as well as high yields have attracted the main international institutional investors to purchase bonds issued in RMB. While minor RMB depreciation as well as declining interest rate have led to fast growth in Panda Bonds issuance. Bloomberg and HSBC launched one after another indices with Chinese bonds included. China's bond market will be a new bright spot in RMB internationalization.

## ●Challenges in the Future

Overseas investment and purchase of foreign currencies are growing unreasonably. Standardizing and strictly enforcing the capital management measures, as well as the expectation of RMB depreciation, have prompted some people into panics in currency exchange. They either try to exchange currency by breaking up the total sum into small portions or exchange through illegal means such as illegal private banks etc.; or overinvest in real estate, buy foreign companies or financial assets without any knowledge of the local laws or market risks. These led to the excessively fast outward investment and the fast outflow of capital, exerting big pressure on the stability of RMB exchange rate.

The global competitiveness of bond market is yet to be improved. The bond market is insufficient in depth and scope, bond products are not diversified enough, and structure of bond issuers is not reasonable. The yield curve, as the pricing benchmark in the market, cannot yet meet the demand of investors; and the derivative market, which can avoid risks of interest rate and exchange rate, is still not developed. Rating agencies with sufficient credibility are still lacking, and legal and taxation system as well as market infrastructure are yet to be improved.

Difficulties in coordinating international policies have increased and trade war risks are lurking. The major developed countries are inconsistent in their pace of economic recovery and different in the elasticity of macro-economic policy mix. USD has entered a period of interest rate hikes, Euro and Yen maintain the negative interest rates, and as Britain started the Brexit process, the rate-hike expectation for Pound has increased. China needs to cope with spillover effects of different monetary policies. Trump Administration has shown conservative tendency and EU has started the anti-dumping and anti-subsidy investigation over trade with China, which are all challenges to expansion of RMB use.

## ●Policy Advices

Improve the system and realize the refined and accurate management for capital flow.

White List and Black List for overseas investment should be created to ensure flexibility, and real and eligible overseas investment and currency exchange should be supported. Companies should be encouraged to participate in “the Belt and Road” initiative and the international capacity cooperation. With Big Data technology, monitoring over the capital flow and regulation for compliance should be strengthened and flow of speculative capital should be restricted.

**Accelerate the infrastructure development of bond market and strive to turn bonds issued in RMB into competitive international safe assets.** Bond market diversification should be enhanced, cooperation with overseas bond markets should be strengthened, and the two-way opening up should be furthered. We should promote asset securitization, diversify the types of national bonds and extend the maturity, enrich the types of bond derivatives, perfect the yield curve, improve the pricing mechanism in bond market, raise the international credibility of rating agencies, and thus meet the investment demand in international safe assets. We should increase the number of foreign currencies with direct trading with RMB for greater convenience in RMB usage. The interaction mechanism between onshore and offshore markets should be built to lower the trade costs and boost the international competitiveness of RMB assets.

**Uphold the principle of win-win cooperation, properly handle the disagreements with major countries, and strengthen cooperation at policy level.** China and US should communicate with each other to enhance mutual trust and avoid trade war or interest rate war. Also, we should seize the opportunities in the new dimension of European integration process, strengthen cooperation with Britain and EU countries in “the Belt and Road” Initiative, fully display the advantages of European countries in technology and factor market, accelerate the financial cooperation with Britain, and promote the development of RMB offshore market in London.

## Other Major Monetary Events and Outlook

2017 world economy will as a whole be in a rosy picture. The US economy has been on an upward trend, FED’s rate hikes policy has attracted the backflow of global capital, and US Dollar has staged a strong comeback. The Euro Zone, still under the loom of refugee crisis, will be faced with sluggish economic recovery and a declining Euro. With official start of the Brexit process, uncertainties for British economy will be rising and the Pound’s position in global monetary market will decline. Affected by economic growth in Japan and the inflow of global hedge capital, demand for Yen has increased and Yen’s position in global monetary market has stabilized.

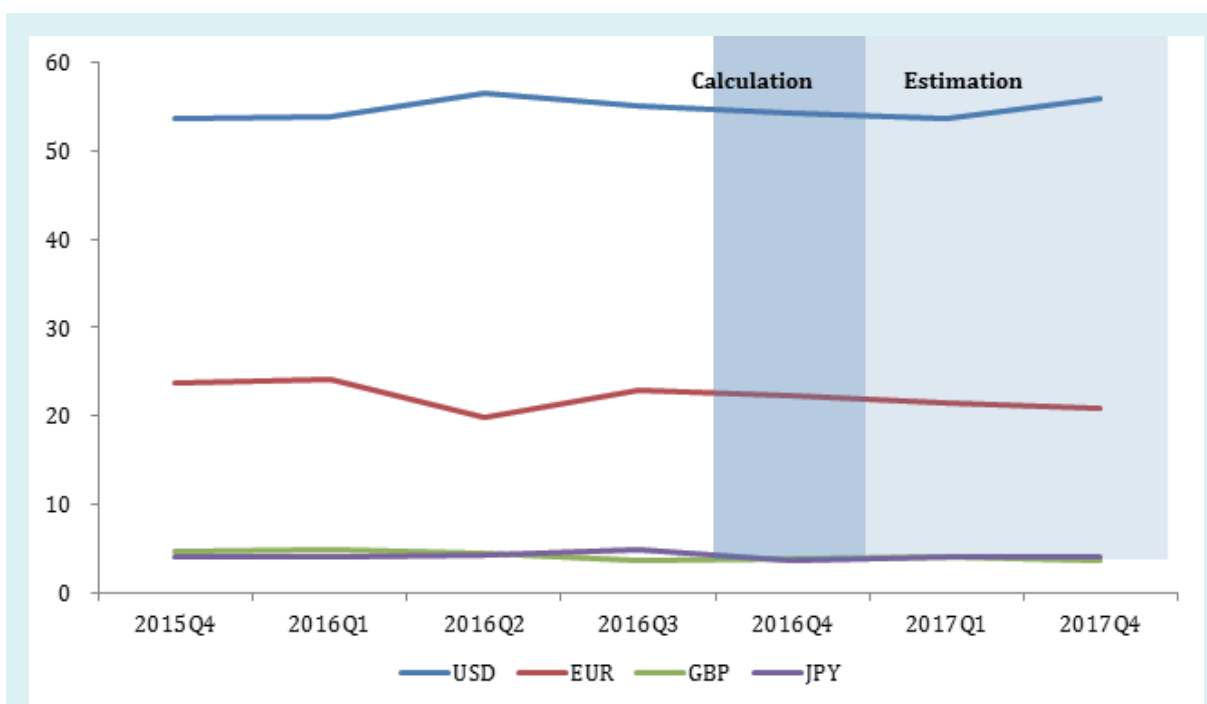


Figure 2 Internationalization Indices of Major Currencies

Time	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q4
USD	53.63	53.92	56.62	55.06	54.35	53.66	55.84
EUR	23.66	24.05	19.87	22.84	22.30	21.36	20.80
GBP	4.58	4.74	4.42	3.66	3.79	4.01	3.60
JPY	4.05	4.01	4.20	4.75	3.51	4.07	4.06

Table 1 Rough Estimates and Forecasts for Internationalization Indices of Major Currencies

## •USD

In the first quarter of 2017, the US economy has maintained stable growth, PMI of manufacturing industry has registered a new high, and employment and inflation statistics have been approaching the target range. Since the Trump Administration came to office, the policies of emphasizing and promoting growth have become clear and the recovery momentum has become prominent. In March, the Federal Funds Target Rate grew by another 25 base points and USD Index fluctuates around 101. Despite the uncertainties in Trump's policies and the effects, the United States still stands out among the developed economies. US economy is expected to grow at over 2% in 2017, attracting the global capital and demand and also consolidating the global position of USD.

The Internationalization Index of USD for the first quarter of 2017 was 53.66 and the estimate for the end of 2017 is 55.84.

## ● EUR

In 2017, the EUR Zone is expected to realize mild recovery. In March, PMI increased to 56.4, a record high in six years. The economic development is off to a good start. However, the EUR Zone is still confronted with striking internal structural issues, uncertainties and downward pressure. Brexit, rise of right-wing forces, refugee crisis, banking industry predicament etc. will severely affect the economic prospect of EUR Zone and add to the fragility of financial industry. Given such situation, EUR is still on the sustained downward path in the wake of the financial crisis, the market confidence has plummeted to the bottom, and the position of EUR in the global monetary system has been greatly affected. The Internationalization Index of EUR for the first quarter of 2017 was 21.36 and the estimate for the end of 2017 is 20.80.

## ● GBP

UK is, on the whole, having a sound economic recovery. Inflation and employment situation have improved, the general situation is stable and better than the market expectation. At the end of the first quarter in 2017, Britain officially started the Brexit process. Despite the tough stance in Brexit, Britain still faces mounting pressure in dealing with EU. The Scottish Independence Referendum has also added to the uncertainties in the negotiation. In the middle and short term, Britain's development prospect is not upbeat, GBP will still fluctuate at a low rank, and market confidence will shake. The Internationalization Index of GBP for the first quarter of 2017 was 4.01 and the estimate for the end of 2017 is 3.60.

## ● JPY

In 2017, Japan's growth will remain sluggish. Inflation pressure is increasing, effects of monetary policies are fading out, and Abenomics will face a turning point, which will all have negative impact on JPY holding. However, against the backdrop of turmoil in financial market and upsurge of global risk aversion, the global demand for JPY will have sharp increase, the JPY exchange rate will be markedly stronger, and JPY's position in the global monetary system will be stable and will even have minor rise. The Internationalization Index of JPY for the first quarter of 2017 was 4.07 and the estimate for the end of 2017 is 4.06.



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