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Renminbi in central banking 2022

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On May 14, 2022, the International Monetary Fund (IMF) announced it was increasing the weighting of the dollar and renminbi in the special drawing rights (SDR) – an international asset created by the IMF in 1969 to supplement its member countries' reserve assets.

The dollar's weighting rose to 43.38% and the renminbi's to 12.28%. The formula for SDR weight looks at each currency's share in exports, official reserves, foreign exchange turnover, international bank liabilities and international debt securities. In the IMF's most recently available data covering the second quarter of 2022, the dollar made up around 55% of FX reserves and the renminbi around 2.7%.

Last year, *Central Banking* looked at the impact the addition of the renminbi to the SDR basket has had on internationalising the Chinese currency. This year's report looks more closely at some of the economic forces at play affecting parts of the SDR formula, with a focus on the renminbi's share of central bank reserves.

Central bank reserve managers convened in June and discussed geopolitical developments and China's macroeconomic outlook, as global inflation rises (pages 52–55). Subsequently, reserve managers from Africa, the Americas, Europe and the Middle East discuss the benefits and challenges of investing in renminbi, how they think China's economy will develop in the short to long term, as well as details about their own allocations (pages 40–43).

A potentially important development is the Regional Comprehensive Economic Partnership (RCEP), a free trade agreement between 15 Asia-Pacific countries, which took effect for most members earlier this year. The RCEP will reduce tariffs and establish common investment, e-commerce, intellectual property, competition and government procurement rules.

At the centre of the RCEP sits China, the world's largest exporter and second-largest economy. Jimmy Choi asks if the deal will support the use of renminbi in settlement and as a reserve currency (pages 56–59).

Triffin's dilemma represents the conflict of economic interests that arises when a national currency plays a role as an international public good, for countries whose currencies serve as global reserve currencies. However, the SDR has "the characteristics and potential of a supra-sovereign reserve currency," a People's Bank of China spokesperson tells *Central Banking*, "which is helpful to alleviate the Triffin problem".

Central Banking investigates the impact the renminbi's increased weight and the $650 billion increase in SDR have for the role of the Chinese currency in reserve management (pages 60–64). At this point in the story, the currency's share of FX reserves is increasing, incrementally. ❑

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Adopting renminbi in reserve portfolios

Central Banking speaks to four reserve managers about investing in renminbi.

On May 14, 2022, the International Monetary Fund (IMF) announced it was increasing the weighting of the US dollar and renminbi in its special drawing rights (SDR), the international reserve assets designed to supplement central banks' reserves. The dollar increased to 43.38% and the renminbi to 12.28%. The renminbi's prominence in reserves has increased to 2.7% since 2016, when it was included in the SDR basket and made up 0.8% at the time. The dollar comprised 55% of official foreign exchange reserves, as of the second quarter of 2022, according to anonymised IMF data from 149 reporters. Here, reserve managers discuss with *Central Banking* the benefits and challenges of investing in renminbi, how they think China's economy will develop in the short to long term, and offer details about their own allocations.

How are inflation and interest rate hikes affecting your reserve management strategy?

Alexander Ng'winamila, Bank of Tanzania: In response to rising inflation and the resulting rate hikes by some key central banks, it has been necessary to shorten durations for most of our portfolios. Also, although the People's Bank of China continues to hold a policy easing stance, rising yields elsewhere have exerted upward pressure on renminbi bond yields, limiting the extent to which we could position the portfolio to benefit from People's Bank of China policy easing measures.

In response to interest rate hikes, it has been necessary to shorten durations for most portfolios to limit the impact of rising yields on portfolio performance.

Michał Zajac, National Bank of Slovakia: As central banks are traditional fixed-income investors, the inflation prospects and possible interest rate changes represent an important factor they need to include in their allocation models. However, as our bank is running an asset-liability investment strategy, the impact of expected rate changes needs to be evaluated from a more holistic perspective.

Malick Dioume, Bank of the Republic of Haiti (BRH): Reserve management at the BRH is almost exclusively confined to the US dollar-denominated fixed-income universe, with exposure to treasuries, agencies, sovereign, supranational and agencies (SSAs), and corporates. Our strategy could be best described as 'wait and see'. Unfavourable market conditions – especially since the beginning of 2022 – coupled with the portfolio's maturity profile have caused the bank to suffer important unrealised losses. The higher level of interest rates and spreads compared with less than a year ago has also precluded BRH reserve managers from rebalancing (thus materialising losses) to try and profit from more attractive reinvestment options.

The Panel

Alexander Ng'winamila, Director of financial markets, Bank of Tanzania
Michał Zajac, Head of risk management, National Bank of Slovakia
Malick Dioume, Director, risk management, Bank of the Republic of Haiti
Hatem Ibrahim, Chief financial officer, Central Bank of Egypt

Michał Zajac, National Bank of Slovakia

Hatem Ibrahim, Central Bank of Egypt: Foreign reserve portfolios consist of a basket of different foreign currencies in addition to gold. Inflation has a direct impact on FX rates. With inflation rising dramatically in the US, the US Federal Reserve is accordingly aggressively raising interest rates to face the negative inflationary effects. This led to the rise of the dollar against all other currencies, and fluctuations in gold prices worldwide – as gold prices are currently unstable because of the high return on the dollar.

What are the pros and cons of investing in renminbi assets?

Michał Zajac: The principal goal when initial steps were taken toward the renminbi market was to learn how to transact in renminbi spot transactions to manage the FX risk that arises when involved in SDR operations. As IMF operations are denominated in SDR, renminbi inclusion into the SDR basket was a logical trigger to incorporate renminbi conversions into our instrument list. Other instruments followed.

The level of market regulation was and still is higher compared to standards of other developed markets. Trading opportunities are limited location-wise as well as time-wise, which represents an obstacle in the process of active portfolio management – especially for investors in other time zones.

The dual currency market (onshore and offshore renminbi) is unique and entails additional challenges for investors. For investors interested in derivative instruments, local legal schemes coupled with the language barrier represent another obstruction.

On the other hand, there are distinct pros to renminbi exposure – diversification and different yield environments. The yields prevailing in the world's second-largest world bond market differ significantly from the yields in other major markets and offer an opportunity to return seekers. As the People's Bank of China has been facing unique challenges – partly dissimilar to the rest of the developed world – appropriate exposure to onshore renminbi and the local yield curve was and still is considered beneficial from a risk/return standpoint.

Malick Dioume: In terms of pros, these are primarily the benefits of diversification. A lack of correlation with the global market could reduce overall portfolio volatility. Another positive aspect is the higher yielding securities offered on the renminbi bond market. Given the very tight range within which the renminbi is evolving, currency risk does not seem to be a major issue and would not detract

Malick Dioume,
Bank of the
Republic of Haiti

too greatly from performance. the China Aggregate Index (I08271CN) year-to-date performance is 2.32%, compared with global indexes that have double digit negative returns.

The cons of investing in renminbi assets could be summarised as the lack of information and/or opacity within the Chinese markets. Recent events (talks of a major real estate bubble and bank runs in small provinces) make us question ourselves about the potential of a systemic disruption in the Chinese economy and how that would affect its bond market. Also, creditworthiness of renminbi bonds is based on China's onshore credit rating system, which might differ from international rating conventions.

Alexander Ng'winamila: I would summarise the main pros as, first, the diversification benefits away from US and other developed market bonds, historically higher yields, and then low currency and bond price volatility.

The main cons I see as being limited liquidity, the limited number of active brokers and the limited choice of adequate benchmarks.

Hatem Ibrahim: The pros of investing in renminbi assets, as the Chinese economy is expected to become the largest in the world in the long term – which will give strength and stability investing in renminbi assets – include the renminbi becoming a reserve for some emerging market economies and developing countries.

These countries include Belarus, Cambodia, Malaysia, Nigeria, the Philippines, the Republic of Korea and Russia. Although the scale is very small – often below 5% of the total holding in these countries – it is somewhat symbolic that the renminbi has, to some degree, emerged as a reserve currency. One con is that, in the short and medium terms, it is preferable not to invest in renminbi assets, as it is expected to decline amid the rise and strength of the US dollar.

What renminbi-denominated assets are included in your central bank's investment portfolio?

Michał Zajac: Our bank is investing in Chinese government bonds only, while carefully looking for other opportunities suitable for our risk profile.

Alexander Ng'winamila: SSA bonds and money market/term deposits.

Hatem Ibrahim: Deposits and investments.

Has your central bank's portfolio position on renminbi investments changed over the past year?

Alexander Ng'winamila: Over the past year our portfolio position on renminbi investments has been slightly increased.

Michał Zajac: Our position has not changed in volume. The only recent change was that the entire portfolio is currently managed by the internal investment team (it was previously partially managed externally).

Hatem Ibrahim: Our portfolio position is almost the same.

With so much uncertainty in the global financial market, what is your opinion on the development of China's economy in the short, medium and long terms?

Alexander Ng'winamila: We expect China's economy to remain weak in the short run, as long as the Chinese government maintains its 'zero-Covid' policy. However, in the medium term, the economy is expected to fully recover and maintain this strength in the long term.

Hatem Ibrahim,
Central Bank of Egypt

Michał Zajac: The Chinese bond market is facing significant headwinds due (but not limited) to recent development in the construction sector and real estate market. In the medium term, however, the momentum of the Chinese economy and rising geopolitical power should help to stabilise the situation.

Malick Dioume: In the short and medium terms, we expect some disruptions caused by the central government's zero-Covid policy. That would translate into lockdowns affecting economic activity to a certain extent. We also believe the real estate market could cause some systemic problems, but it is hard to know the extent of this. Central government's involvement in economic issues in China has advantages and disadvantages, but should keep the country on a fairly prosperous path over the long term, given its strong track record over the past two decades.

Hatem Ibrahim: Generally, China's economy is anticipated to moderate in 2022. After a solid beginning in early 2022, Covid-19 disturbed the normalisation of China's development. GDP growth is expected to moderate strongly to 4.3% in 2022. The slower growth generally reflects the financial harm caused by Omicron flare-ups and the delayed lockdowns in parts of China from March to May. The development driver is expected to bounce back within the second half of 2022.

In the short term, China faces the dual challenge of balancing Covid-19 mitigation with supporting economic growth. The government has stepped up macroeconomic policy easing with high public spending, tax rebates, policy rate cuts and a more dovish stance on the property sector, while China has the macroeconomic space to counter the growth slowdown.

Over the medium term, China's economy is confronting basic headwinds given unfavourable socioeconomics and high borrowing. To confront these challenges, macroeconomic policies must use caution so as not to worsen monetary dangers. Auxiliary changes are required to reinvigorate the move to more adjusted high-quality development.

Over the long term, China will move away from its previous economic downturn, which began in 2021, and this is what has happened. Over the period covered by China's 14th Five Year Plan, it has built a moderately prosperous society and achieved its first goal of "entering a new stage of GDP growth rate". ❑

This is a summary of a forum convened by Central Banking. *The commentary and responses to this forum are personal and do not necessarily reflect the views and opinions of the panellists' respective organisations.*

Renminbi in focus: diversification and internationalisation

Bank of China (Hong Kong) comments on the case study interviews conducted by *Central Banking* and discusses China's GDP growth and renminbi internationalisation, the renminbi as a financing currency and its role in cross-border settlement.

All the central bank representatives in this report's case study interviews about investment in renminbi (pages 40–43) are optimistic about the medium- to long-term potential of China's economy and its increasingly important currency, renminbi. Even in the recent complicated and fast-changing economic environment, interviewees said they did not reduce their renminbi investments – some even increased their renminbi asset allocation. It is encouraging to know that some interviewees are willing to carry on increasing this asset allocation in the future. Some said they will remain conservative in allocating renminbi assets because of concerns over renminbi liquidity and US interest hikes. Considering these factors, this commentary discusses China's economy and renminbi internationalisation, new opportunities for the renminbi to become a financing currency and increasing demand for renminbi cross-border settlement.

Growth and international positioning

China's economy is steadily progressing, with further enhancements in renminbi internationalisation.

China reported annualised GDP growth of 3.9% in the third quarter of 2022 – higher than market expectations of 3.3% and 0.4% of GDP growth in Q2. It shows that the economy continues to recover, production demand continues to improve and the overall operation is within a reasonable range. Meanwhile, according to September data from China's General Administration of Customs, China exports and imports rose 10.7% and 5.2% year-on-year. The total trade volume of imports and exports accounted for CNY3.81 trillion, up 8.3%, with a trade surplus of CNY573.6 billion. With China's policy of 'steady growth', consumer demand continues to recover and foreign trade and investment grow steadily, indicating that the Chinese economy is still resilient.

The People's Bank of China's *2022 RMB internationalisation report* shows that China's financial market continues to open up, and renminbi assets remain attractive to global investors.[1] By the end of 2021, the total amount of foreign holdings in renminbi stocks, bonds, loans, deposits and other financial assets accounted for CNY10.83 trillion – up 20.5% year-on-year.

The report also reveals that, in 2021, the total amount of cross-border renminbi payment on commission reached CNY36.6 trillion – up 29.0% year-on-year, reaching a record high. According to Swift, the renminbi international payment share increased to 2.7% in December 2021, surpassing the Japanese yen to become the fourth-largest payment currency in the world. Renminbi's international payment share further increased to 3.2% in January 2022 – a new record high.

According to the International Monetary Fund (IMF), the renminbi accounted for 2.88% of global foreign exchange reserves in Q1 2022, up 1.8 percentage points from 2016, when the renminbi was first included in the special drawing rights (SDR) basket, ranking fifth among major reserve currencies. In May 2022, the IMF increased the weighting of renminbi in the SDR from 10.92% to 12.28%. According to data released by the Bank for International Settlements in October, trading volume in the global FX market rose to a record high, with the renminbi growing the most, accounting for 7% of the total, making it the fifth most-traded currency. This data reflects the growing acceptance of renminbi.

The People's Bank of China states in its report that, in the next stage of internationalisation, China will continue to open up its financial market and improve the liquidity of renminbi assets. China will also provide a more convenient way for foreign investors to invest in China markets by diversifying investable assets and encouraging foreign investors – especially central banks – to allocate more renminbi assets. Further strengthening cross-border renminbi usage arrangements, fulfilling the real sectors' renminbi usage demand, promoting two-way opening up of the financial market and promoting the interconnection of onshore and offshore renminbi markets will also be key future developments. It is therefore believed that more foreign investors – including individuals, financial institutions and central banks – will be willing to hold renminbi assets.

Renminbi as a financing currency

During the interviews, central bank representatives said that their renminbi asset allocations are mainly in deposits and bonds, adding that their expectations that renminbi bonds will become the main asset allocation in the future. At present, the US is entering an interest rate hike cycle, making the dollar index continuously rise, driving non-US dollar currency traded lower against the US dollar, with emerging market currencies falling by about 30%. For example, the Japanese yen, South Korean won and Australian dollar are down about 20%. Yet, renminbi is relatively stable against the US dollar compared with other emerging market currencies, with lower volatility compared with some major currencies, such as the euro, yen and sterling. As renminbi has demonstrated resilience in global financial market volatility, it is believed the global acceptance of the renminbi will further increase.

The US yield curve has flattened recently, and short- and long-term yields have inverted. US and China interest rates also inverted. For example, in the past few years, two-year Chinese government bond yields were higher than US government bond yields by 100–200 basis points. However, in November 2022, US government bond yields were higher than China's – about 4.61% versus 2.12%, respectively – meaning the US dollar is no longer a cheap financing currency.

We have also noticed that more financial institutions such as the World Bank, KfW – the world's largest national development bank – and the European Investment Bank have successfully issued dim sum bonds. The issuance of these bonds in the first half of this year has exceeded that of 2021 and reached a record high, surpassing the peak of issuance in 2014. As the US Federal Reserve continues to raise interest rates sharply and the US-China interest rate spread continues to widen, it is believed that more international organisations, multinational corporates, international banks and even some foreign governments will use offshore renminbi bonds as financing instruments.

Globally, renminbi financing costs are low, with rising renminbi acceptance and a relatively stable exchange rate compared with other currencies. Also, the People's Bank of China maintains reasonable liquidity and China's inflation is under control. These factors provide a favourable environment for renminbi to become a global financing currency.

Moreover, most foreign investors look for long-term investment return rather than short-term speculation. Foreign holdings in China markets are still generally at a low level. Renminbi assets have a lower correlation with developed and emerging economies, which is favourable for international investors and central banks to diversify their asset allocation and decrease portfolio volatility. As China's long-term economic growth remains positive and renminbi assets are secured, profitable and highly liquid, it is believed foreign holding in renminbi assets will steadily increase and it is expected that renminbi assets will attract more foreign capital inflow in the future.

Demand for renminbi cross-border settlement

Data from China's General Administration of Customs shows that China's foreign trade growth remains strong, driving overseas demand for using renminbi for cross-border settlement, especially in countries participating in the Belt and Road Initiative (BRI) and the Regional Comprehensive Economic Partnership (RCEP).

Renminbi has been widely used in trade and investment in BRI countries, as using renminbi can reduce FX risk, avoid FX rate fluctuations and lower FX cost. By the end of July 2022, to support local renminbi settlement, China has established bilateral currency swap arrangements with more than 20 BRI countries, and has established the renminbi clearing arrangement in more than 10 countries. Countries in the BRI area generally support renminbi internationalisation and accept renminbi as the currency for trade and investment settlement. Chinese corporates use renminbi more frequently in infrastructure contracting, manufacturing investment and trade with the mainland. An increasing number of local corporates, individuals and financial institutions are also willing to hold renminbi, which has become an important driving force for the internationalisation of renminbi. With the Fed raising interest rates and shrinking its balance sheet, there are signs of capital flow returning to the US. Meanwhile, financing costs are also rising. Decreased US dollar usage by BRI countries will benefit renminbi trade settlement.

There is obvious demand for renminbi cross-border payment in the RCEP region. The RCEP is the world's largest free-trade zone, accounting for about 30% of the world's population, trade volume and GDP. Trade between China and the Association of Southeast Asian Nations (Asean) stood at US$544.88 billion between January and July, up 13.1% year-on-year, according to official data. China has been Asean's largest trading partner for 13 consecutive years. Therefore, renminbi has the conditions to become a major trading currency in the region. In promoting regional monetary co-operation, local currency settlements (LCSs) are a good example. In September 2021, China and Indonesia started an LCS and established regional markets in Zhejiang province, which allow renminbi to be traded directly with the Indonesian rupiah. The current average monthly trading volume recorded an obvious increase. The LCS mechanism has gained market confidence and popularity, and it has effectively promoted the status of renminbi as a regional settlement currency. Therefore, as companies worldwide conduct more trade with China, central banks are gradually increasing the renminbi proportion of their FX reserves to meet their settlement needs.

Renminbi in reserves

To conclude, in the complicated international environment and in light of the ongoing situation regarding the Covid-19 pandemic, China maintains stable improvement in renminbi internationalisation and market-driven characteristics, and allows corporates free selection in renminbi usage. With the deepening of China's open policy and renminbi currency supply channels remaining open, it is believed the renminbi cross-border payment will continue to grow, and the attractiveness of renminbi as a reserve currency will gradually improve. The willingness of central banks and monetary authorities worldwide to hold renminbi reserve assets is sure to increase further. ❑

Notes

1. People's Bank of China (September 2022), *2022 RMB internationalisation report*, https://bit.ly/3X3fWmU

The investment outlook for renminbi-denominated assets

Bank of China (Hong Kong) assesses the prospects for renminbi-denominated assets as GDP growth slows worldwide.

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Despite changes in the international economic environment, China has shown it can still achieve high-quality economic growth and maintain stability in its financial system while preventing the spread of Covid-19. Driven by market demand, renminbi internationalisation has been further consolidated and the scale of renminbi current account settlement has reached a record high. The renminbi is now China's second-largest cross-border payment currency, the world's third-largest special drawing rights (SDR) basket currency, the fourth-largest global payment currency and the fifth-largest international reserve currency. This emphasises the resilience of China's economy. This article analyses the potential of investing in renminbi assets from three aspects:

1. China's economic situation
2. The characteristics of renminbi assets
3. The future development of renminbi internationalisation.

China's economy

China's economy grew 8.1% in 2021, reaching its fastest growth rate in a decade. Since the beginning of 2022, as the global economy encounters a number of uncertainties, China has adopted a steady strategy to progress its economic development.

China has demonstrated its economic resilience over the years – maintaining stable economic growth relatively well during the economic turmoil of the Covid-19 pandemic. According to the latest data from the National Bureau of Statistics of China, the nation's economy continued to recover, with a stable start to 2022. The world's second-largest economy's GDP increased by 3.9% in the third quarter of 2022, compared with the same period last year, exceeding the 3.4% pace predicted by some previous analyses and picking up speed from the 0.4% growth recorded in Q2 2022. The data shows China's economic resilience in three different areas. First, industrial production rose 6.3% between January and September. This strong growth rate indicates a solid development of the real economy. Second, in terms of consumption, China's retail sales grew 2.5%.

This also reflects China's proficient handling of economic turmoil, with stable consumption growth. Third, fixed-asset investment has experienced a good recovery growth trend, expanding by 5.9% year-on-year in the first nine months of 2022, signifying China's potential economic growth.

However, with China's zero-Covid policy and monetary policy shift among major economies, it is believed it will encounter pressure on its economic recovery. Yet, with current market environment changes, China has been actively supporting the economy and stabilising market expectations by providing policy support to the market. Its government has emphasised steady economic growth repeatedly in various high-level meetings. It also provided policy support to stabilise market expectations and promote development, investment and consumption to drive economic growth. For example, by:

1. Promoting tax reduction policies to reduce financial burdens on corporations
2. Reducing financial institutions' reserve requirement ratio to increase market liquidity
3. Local governments issuing consumption vouchers to stimulate the real economy.

Regarding renminbi internationalisation, the International Monetary Fund's (IMF's) decision to increase the currency's weighting in SDR – from 10.92% to 12.28% – is encouraging. It recognises China's economic development and renminbi internationalisation efforts. There is believed to be an increasing trend of foreign holding in renminbi assets. Since the IMF included renminbi in the SDR basket in 2015, global foreign exchange reserves in renminbi increased from $90.3 billion in Q4 2016 to $336.1 billion in Q4 2021 – up 3.7 times in five years. Meanwhile, the latest Currency Composition of Foreign Exchange Reserves data showed that the renminbi remained the world's fifth-largest reserve currency, with a rise in its share to 2.88% – the highest since the report was first published in Q4 of 2016. According to Swift's latest data, although the renminbi exchange rate fell in April, the renminbi accounted for 2.44% of global payments in September – up from 2.3% from a month earlier. The renminbi also maintained its status as the fifth-most active payment currency worldwide.

Indicating the rising market share of China's exports, 2021 saw cumulative year-on-year growth in exports of chemical products (41%), labour-intensive products and non-ferrous metals (16.5%), and mechanical, electrical and high-tech products (24.5%), emphasising China's international status, supply chain resilience and economic strength in global industry during the pandemic era.

Renminbi asset characteristics

Renminbi assets have attracted global investors, mainly because of the currency's low correlation with other risky assets. Investing in renminbi assets can achieve risk diversification while capturing stable returns. Take renminbi bonds for example: when global economic growth was weak and the financial market was experiencing high volatility – particularly in recent years when the global economy has been affected by the pandemic – more foreign institutional investors increased holdings in renminbi bonds. According to the People's Bank of China, the nation's bond market balance reached CNY138.2 trillion in April this year. China has been the second-largest bond market worldwide since 2016.

Meanwhile, 1,035 foreign institutional investors have entered China's bond market, with a total holding of CNY3.9 trillion worth of bonds – up 225% from the end of 2017. Long-term investors don't seek to speculate on short-term yield

spread or arbitrage opportunities, but look for relatively stable investments and mid- to long-term returns in different markets. This can be achieved by entering China’s government bonds market and investing in renminbi bonds.

Compared with the volatile state of the international financial markets and the uncertain international environment, China’s economy’s relatively steady growth has endowed renminbi assets with better risk resilience than other assets. Multiple uncertain economic factors have caused some foreign nations to encounter high inflation rates, while China’s newly released consumer price index was only 2.1% in October – a relatively lower inflation rate compared with other major economies. Amid high inflation worldwide, China has a relatively stable environment in energy and food prices. As a global manufacturing country, its strong global industrial position in supply chain and production contributed to China’s economic stability. China’s economic growth is one of the highest among major economies but, at the same time, its inflation is low. These positive factors all contribute to the currency’s safe-haven characteristics, increasing renminbi assets’ attractiveness.

Future international development of renminbi

After years of renminbi internationalisation and more offshore institutions – such as central banks, financial institutions and corporations – increasing their holdings in renminbi, the currency's usage experienced a significant change. The renminbi's function has diversified from a settlement currency to an investment and hedging currency. The renminbi has also steadily developed as an investment and reserve currency. For example, Brazil increased the renminbi share of its FX reserves from 1.21% in 2020 to 4.99% in 2021. According to Goldman Sachs, renminbi holdings in four Latin American countries – Brazil, Chile, Mexico and Peru – are close to $30 billion, up about 10 times from the end of 2018. Israel, meanwhile, is expected to invest 2% of its FX reserves in renminbi from 2022. With the gradual internationalisation progress, the renminbi's exchange rate is expected to trade with a healthy two-way fluctuation, with more market-driven characteristics.

Recently, the renminbi's exchange rate has experienced considerable fluctuation. From late April to early November, it depreciated from 6.37 against the US dollar to 7.32. Reasons for this rapid depreciation include the effects on China's economy of a regional Covid-19 outbreak and the US Federal Reserve's decision to raise interest rates in early May and shrink its balance sheet in June. The US-China government bond yield spread narrowed and even inverted, causing foreign capital outflow. Because of that, risk-off sentiment was developed in the FX market. After market adjustment and priced-in negative factors, the depreciation of the renminbi subsided and the market stabilised. The renminbi market correction also came to an end and started to rally, returning back to 7.10 against the dollar, which highlights the fundamental strength of the renminbi and indicates that it will not depreciate over the long term.

The Fed has been increasing the pace at which it is raising interest rates and reducing its balance sheet. At the same time, most nations have begun tightening their monetary policies, which contrasted with China's monetary policy stance, causing a central bank policy divergence. However, to some extent, monetary policy tightening in western countries was driven by previous monetary easing policy. In contrast, the People's Bank of China maintained a supportive monetary policy stance as a result of previously maintaining prudent monetary policy. In recent years, through the development of China's real economy, it has accumulated a balance of payments surplus, which has become an important support for the renminbi exchange rate, ensuring steadiness.

The narrowing – and even inversion – of government bond yield spread may continue due to divergence in economic cycles and monetary policies between China and the US. Uncertainties – such as those resulting from current geopolitical situations – still exist, and the renminbi's exchange rate is expected to fluctuate in the short term. However, in the long term, with the steady opening-up of China's financial market, renminbi assets remain attractive to foreign investors. The fundamentals of China's economy remain unchanged, and with sufficient policy tools, the renminbi's exchange rate is expected to remain stable at an appropriate level.

Renminbi reserve assets

To conclude, after the increase of renminbi weighting in SDR, it is possible more and more central banks will increase renminbi in their FX reserves, which will help promote renminbi internationalisation. Meanwhile, as the pandemic slowly continues to come under control and China's economy steadily grows, its assets will become more attractive. It is hoped that more central banks, financial institutions, corporates and even individuals will increase their investment in renminbi assets in the future for satisfactory returns. ❑

Inflation, geopolitics and the renminbi

At a Bank of China (Hong Kong)-sponsored forum, policy-makers discussed geopolitical developments and China's macroeconomic outlook as global inflation rises.

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Central banks are working in "the most challenging environment that I have known", reported the industry veteran chairing *Central Banking*'s panel on renminbi in reserves. Financial markets have been hit by sharply increasing interest rates and the end of central bank bond purchases for monetary policy purposes. Cryptocurrency looks more like a highly speculative commodity than an investment, and gold – currently nearing 10-year highs – has resumed its traditional role as a safe haven.

Foreign currency reserves have made global headlines because of the impact of foreign sanctions on reserves. First with the freezing of Afghanistan's reserves early in the year, and then Russia's following its invasion of Ukraine.

In the first case, the Taliban had violently seized power and was not recognised as a legitimate government of Afghanistan by many advanced nations. There are precedents for this, such as in Libya, where foreign central banks withheld the delivery of reserves because it was unclear who was acting as the central bank and government. In the case of Russia, however, reserves were frozen not because the legitimacy of the Russian government was in question, but rather as a tool of resistance by a number of reserve currency nations against the invasion. It was unexpected and unprecedented, and is ultimately likely to raise fundamental questions regarding the safety and liquidity of financial assets held abroad – two of the three principal criteria for the selection of foreign exchange assets.

As a result, there will be more interest in reserve currency diversification, the chair predicted. There will be more interest in gold, with geographic diversification of vaulting, and there also may be more interest in alternative payment systems, whether from crypto or from Swift.

Both local currency bonds and the Chinese settlement system have been touted as alternatives to US dollar assets and the US dollar-centric financial system because of the size of the market, and the importance of China in global trade.

A European perspective

On the webinar panel were speakers from a bank and from central banks in Europe and Asia, invited to offer their perspectives on the renminbi. The central banker at a European institution said it started investing in renminbi almost 10 years ago. In its asset allocation, the central bank has four aims. The first is to support monetary policy: "We have to maintain some intervention capacity." The second is to support financial stability: "We should be able to provide foreign currency facilities to our banking system." Supporting the government through its transactions in foreign currency and its debt management operation is the third.

The fourth "is an interesting one", the central banker said. The central bank has an international collateral role over foreign currency reserves. "We hold reserves, because it makes investors more calm and satisfied with our financial position."

The central bank needs a benchmark currency numeraire, which is the euro. This is the currency in which the central bank maintains many of its foreign reserves, and in which it measures the adequacy of its reserves. The euro is the numeraire because the country has close economic ties to the EU area and the country is a member of the EU. As a result, the euro influences monetary policy and the banking system has strong ties with the EU banking system.

The central bank uses quantitative models to drive its asset allocations, but makes exceptions for some currency positions. To provide an example, "if we have a model that tells us to short the US dollar, or US dollar assets", the central bank may nonetheless reject this "because the US dollar is still the world-leading reserve currency". The central bank ensures it has a defined minimum amount of US dollars.

The renminbi also features in the central bank's quantitative considerations. "In our model we don't have any weight towards renminbi," they said. "In the past, when we started to think about renminbi, we felt that, due to the economic power – and rising economic power – of China, at some point we should consider renminbi as an asset class." At the central bank, officials felt it would be "interesting" to invest from a diversification standpoint. It has not been easy to balance the losses they have had in recent months in other asset classes, they said.

The size of the reserves invested in China is small. In this central bank's case it is between 1% and 2% of reserves. The reason for this is that it is "still an experimental experience" for the central bank to invest in China. "We want to learn about the market," they said. This incremental approach is also a risk management tool.

"We started by investing in government bonds," the official said. They added that the central bank wants to improve its operations, and it has broadened the asset classes it invests in. "Last year, we introduced policy bank bonds as a new asset class," the central banker added. The central bank may consider increasing its renminbi exposure in the future.

With China's steady opening up of financial markets, renminbi assets remain attractive to foreign investors

The view from Asia

The Asia-based central bank's economy is more integrated with China than the economy of the central bank based in Europe. It is also a small, open economy that is highly dollarised. Its clearing house uses US dollars. The entire banking system pays loans in US dollars. "Only around 7% of banking deposits are in the local currency."

For its reserves, the central bank reviews strategic asset allocation every two years, when it decides on asset classes and currencies. Renminbi has the largest share of its total reserves because China is its biggest trade partner and it receives development assistance from China. Tourism is also a factor.

"We started to get into the renminbi, even before the special drawing rights inclusion," the official said.

The central bank tried to get into renminbi using a quota, but its economy and the transaction amount were too small for the requirements of the Chinese central bank. It gained access to the renminbi by using its external asset manager, which allowed it to invest in the onshore China market.

At the time, in terms of the central bank's reserve calculation, the International Monetary Fund did not include renminbi. So, whenever the central bank bought renminbi, its 'official' total reserves decreased.

Now, both the central bank's total reserves and the proportion of renminbi are increasing. The central bank has among the largest total renminbi reserve proportions in the world, they said.

Liquidity has also improved. In the past, even focusing on the short end of the curve, it could not execute trades. Moving forward, the panel made the point that Chinese banks should consider supporting the Chinese government market further with bigger trading books and extended trading hours. This would help towards achieving 24-hour liquidity, as is the case in US treasuries.

More recently, the introduction of the Chinese market benchmark has been very important for the central bank to calculate its performance and risk management report, they said.

The central bank also invests in the policy bank bond market in China. This has been a bittersweet experience because, through the private sector, it had to pay tax.

Compared with the other central bank on the panel, "we are not in the learning space", the official said, but in a "very strategic and tactical management" phase in terms of the renminbi portfolio. It's easier for the central bank's team to trade because of the shared time zone with China for settlement.

Macroeconomic situation

China has demonstrated economic resilience over the past years, the economist from the private bank on the panel said. According to the National Bureau of Statistics of China, China's economy continues to recover with a stable start to 2022. The Chinese economy grew by 1.3% quarter-on-quarter (Q4 2021–Q1 2022) – higher than the first three quarters last year. GDP reached RMB27 trillion ($4.2 trillion) in the first quarter, which means it remained the world's second-largest economy.

Per capita disposable personal income grew by 5.1% in real terms, outperforming GDP growth. The fixed income market recovered well, with more investment in the secondary market. However, with China's Covid-19 outbreak and developed countries' monetary policy shifts, China will encounter some pressure on economic recovery.

Nonetheless, in the economist's view, renminbi assets have attracted global investors – mainly because of their low correlation with other assets, achieving risk diversification while providing stable returns.

The economist said that long-term investors don't seek to speculate on short-term interest rates, but seek a relatively stable mid- to long-term return. While global economic growth is turning weak. China's economic growth is one of highest among major economies, and inflation is at a lower level, potentially making the renminbi a safe haven asset.

Multiple factors have contributed to some developed countries encountering high inflation, but China's April consumer price index was only 2.1%. China has a relatively stable environment in energy and food prices. As a global manufacturing country, China's strong global industrial position in supply chains and production have contributed to its economic stability.

The exchange rate will remain another important factor when investing in renminbi assets alongside the renminbi's gradual internationalisation, the economist said. The exchange rate experienced considerable fluctuations from late April to early May. The main reasons for this were that China's economy was affected by regional Covid-19 outbreaks, as well as the US Federal Reserve's decision to raise interest rates in early May and shrink its balance sheet in June. The US decision to tighten monetary policy contrasts with China's monetary policy stance, causing central bank policy divergence.

The US–China government bond yield spread narrowed and even inverted sometimes, causing foreign capital to change its position, due to sentiment risks in the foreign exchange market. But the renminbi market correction came to an end and the Chinese currency, which has outperformed the euro, yen and sterling, has started to rally.

In recent years, through the development of China's real economy, China's balance of payment surplus has become an important source of support for the steady renminbi exchange rate, the economist said. Because of the geopolitical situation, the exchange rate is expected to fluctuate in the short term. Looking forward, the narrowing and even inverted government bond yield spread may continue for a while, because of divergence in monetary policy between China and the other major economies.

However, in the long term, with China's steady opening up of financial markets, in the economist's view, renminbi assets remain attractive to foreign investors. The fundamentals of China's economy remain unchanged and, with sufficient policy tools, the exchange rate is expected to remain stable, at an appropriate level.

Risk

The central banker from the Asian institution said their first priority is capital preservation. China's credit rating is good, they said, and the recent currency depreciation is not viewed as a problem because the central bank does not trade it mark-to-market or make money from FX. "We hold the currency to maturity," they said.

Though the return on renminbi assets is now a little lower compared with the US dollar due to interest rate hikes, for the Asian central bank "there isn't huge market risk from a government bond investor perspective". Liquidity, the bank's second priority, is also there. They see appropriate reactions from the authorities and necessary central banking policy. Chinese government bond yields decreased in the global market, they pointed out, with one panellist reporting a risk that China may reverse its policy to open up markets. ❑

RCEP and renminbi's role as a reserve currency

Will the new Asia-Pacific economic partnership support the use of renminbi in settlement and as a reserve currency? asks Jimmy Choi.

The Regional Comprehensive Economic Partnership (RCEP), a free-trade agreement between 15 Asia-Pacific (Apac) countries, took effect for most members at the beginning of this year. At the centre of the deal sits China, the world's largest exporter and second-largest economy. Aside from forging closer trade ties with its neighbours, RCEP will give China new opportunities to promote its long-term goal of internationalising the renminbi, some analysts say.

RCEP spans 10 Association of Southeast Asian Nation (Asean) countries, Australia, China, Japan, the Republic of Korea and New Zealand. The 15 members collectively account for around 30% of the world's population (2.2 billion) and 30% of global GDP (US$26 trillion). Before RCEP, Asean had already signed free-trade agreements with individual countries, including China, Japan and the Republic of Korea, the three largest economies in Asia. However, RCEP is the first free-trade agreement integrating the three leading powers into a single trading bloc. The deal aims to reduce or eliminate around 90% of the tariffs on imports between member states within 20 years. It will also establish common rules in areas such as investment, e-commerce, intellectual property, competition and government procurement.

Renminbi as a payment currency

While RCEP members do not envisage a monetary union such as the eurozone, Chinese policymakers clearly see opportunities ahead for renminbi. In a 2021 report, the People's Bank of China said RCEP will extend the scope for the use of renminbi in trade and investment activities.[1] "The use of the renminbi in commodities trading already had a good start and is expected to be a growth pillar for the cross-border use of the renminbi," it states. The central bank also noted that new trade modes under the pact, such as cross-border e-commerce, would help promote the use of the currency in foreign trade.

The People's Bank of China reiterated its commitment to internationalising the renminbi in a September report, saying it would push forward the project "steadily and prudently".[2]

China has been pushing to build the renminbi's status as an international currency for trade settlement, investment and foreign currency reserves since 2007. Over the years, the country has helped develop offshore renminbi centres and gradually liberalised its capital accounts through various schemes. By the end of 2021, the People's Bank of China had set up bilateral currency swap lines with

40 central banks, totalling more than CNY4 trillion ($562 billion), data from the central bank shows.[3] China also launched its cross-border interbank payment system in 2015, which clears and settles renminbi-denominated payments, as an alternative to the internationally dominant Swift network.

Edwin Lai, professor of economics at the Hong Kong University of Science and Technology, says RCEP will help bolster the region's use of the renminbi via increased renminbi trade settlement. "How big would such positive impact be?" he asks. "A stronger trading relationship with China would mean that firms in these countries will need more renminbi in order to trade with China." Furthermore, he adds that South-east Asian countries are beginning to accumulate more renminbi to trade with China.

The renminbi is now the world's fifth-largest currency for global payments, according to September data from Swift. It accounted for 2.44% of global payments, up from 1.97% in September 2020 and closely trailed the yen (2.88%). But the currency is still far behind sterling (6.54%), the euro (35.15%) and the US dollar (42.31%) as a payment currency. Between September 2020 and September 2022, global payment shares of the US dollar and renminbi rose while those of the yen, sterling and euro fell.

In his book *One currency, two markets: China's attempt to internationalize the renminbi*, Lai predicted the renminbi would likely become the world's third payment currency by 2030. He said it would take up approximately 6–7% of global payments, surpassing yen and sterling.

Chris Leung, chief China economist at Singapore's DBS Bank, argues that China is using RCEP as one its three key pillars to internationalise the renminbi.[4] Other pillars include boosting yuan-denominated oil trades, for example with Saudi Arabia, and increasing renminbi trade settlements with Latin America by investing in local renewable energy projects. "As trade volume grows between China and fellow members, especially when they start building up trade surplus, it would then be easier for Beijing to lobby renminbi settlement in a gradual manner," he says.

Some analysts are less sure whether RCEP would significantly increase trade settlement in renminbi.

David Dollar, senior fellow at the Brookings Institution, says the deal should increase the renminbi as a settlement currency, as it will increase trade between China and its east Asian partners. "Still, the renminbi share of settlement is low and will probably only grow gradually over time," he adds.

Kathy Walsh, professor of finance at the University of Technology Sydney, says there has not been "a great appetite" for settling trade in renminbi from either China or its trade partners. "From an Australian perspective, much of the trade with China is one-directional: companies either export to or import from China, so there is no need to recycle the renminbi," she says. "From China's perspective, there is added flexibility to transact in US dollars."

Renminbi as a reserve currency

There is clear evidence that central banks worldwide have been diversifying away from the US dollar in recent years and some have increased their holdings in renminbi.

In a working paper published by the International Monetary Fund (IMF) in March, economists Serkan Arslanalp, Barry Eichengreen and Chima Simpson-Bell argued there had been a "stealth erosion" of the US dollar's share of international reserves over the past 20 years.[5] They said the decline reflects "active portfolio diversification" by central bank reserve managers and is not a by-product of changes in exchange rates and interest rates. One-quarter of the shift has gone into the renminbi and three-quarters into the currencies of smaller countries. The change signals an ongoing movement away from the dollar and a "recent, if still modest, rise" in the role of the renminbi, the economists said.

The renminbi's share of the world's foreign exchange reserves was 2.88% by the second quarter of 2022, up from 1.08% when it was first included in the IMF's special drawing rights basket in Q4 2016. The renminbi is now the fifth most held currency in global FX reserves, IMF data shows, behind sterling (4.88%), the yen (5.18%), the euro (19.77%) and the US dollar (59.53%). Around 80 central banks have included the renminbi in their foreign reserves, according to the People's Bank of China's estimations.

Experts interviewed by *Central Banking* generally agree that RCEP should have a positive impact on the renminbi's status as a trade settlement currency. But some believe that structural factors, including the openness of China's capital account, are more important when it comes to determining the renminbi's reserve currency status.

Walsh says the implementation of RCEP is a strong signal of China's importance in the region, and this may be reflected in an increase in central banks' reserve allocations.

Lai, meanwhile, says central banks will have a stronger incentive to hold more renminbi in their foreign reserves when their countries trade more with China. "If a country trades more with China, they want their exchange rate to the renminbi to be stable," he says. This requires the central bank to hold more reserves of the renminbi, Lai adds, so it can intervene in the FX market if needed and provide renminbi funds to firms as a last resort for a lender.

However, Lai believes boosting trade settlement in renminbi will not have a "first-order" impact on its reserve currency status. A much more important factor is the size of the settlement of trade in financial assets, such as bonds, stocks and derivatives in renminbi, he adds. This is because global financial transactions are much larger than trade transactions, and financial asset trade settlement in renminbi is still small today.

Unlike the US, China's financial markets are still not "thick, broad and liquid" enough for the renminbi to become a major reserve currency, Lai continues. Central banks worldwide are holding US Treasury bills because they are considered a safe asset. The US Treasury bills market is also the largest in the world and very liquid, which allows central banks to buy and sell their assets more easily to manage their exchange rates without adversely affecting their prices. By contrast, foreign ownership of Chinese government bonds issued by the Chinese Ministry of Finance is much smaller.

Dollar agrees: "Reserve holdings of renminbi are not large because it is difficult to use. Moving money in and out of China is still bureaucratic and subject to capital controls. China's capital markets are not deep and transparent."

Countries hold reserves in order to move quickly in times of emergency and central banks cannot count on quick access to renminbi in this situation, Dollar says. "China would have to become much more open and transparent in order to make its currency attractive as a reserve asset."

Le Xia, chief economist for Apac at BBVA Research, argues that RCEP may not have a major direct impact on the renminbi's reserve currency status. But the deal, coupled with US sanctions against Russia, may help strengthen trade and supply chains in the region.

He notes that past studies showed that international use of the renminbi is closely linked to people's expectations of China's economy and the financing cost of the US dollar. "When the US dollar's financing cost rises, leading to a shortage of the US dollar, more people will shift to using the renminbi," Xia says.

The renminbi's road to internationalisation and its future as a reserve currency also depends on China's economic performance, Xia says, adding that China's zero-Covid strategy has affected its economic development. But, he says renminbi internationalisation is deepening: "If there aren't any major shocks to China's economy, I remain optimistic." ❑

Notes

1. The People's Bank of China (2021), *2021 RMB Internationalization Report*, https://bit.ly/3gdagGj
2. The People's Bank of China (2022), *Recent developments*, https://bit.ly/3O9CH4u
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4. C Leung (May 2022), China: contours of RMB internationalisation, *DBS Treasures*, https://bit.ly/3UFgspJ
5. S Arslanalp, BJ Eichengreen and C Simpson-Bell (March 2022), *The stealth erosion of dollar dominance: active diversifiers and the rise of nontraditional reserve currencies*, IMF Working Paper, https://bit.ly/3UJabJB

Renminbi and the special drawing rights

What impact does the renminbi's increased weight and the $650 billion increase in the International Monetary Fund special drawing rights have for the role of the Chinese currency in reserve management?

By Joasia E. Popowicz.

Belgian-Australian economist Robert Triffin's dilemma represents the conflict of economic interests that arises when a national currency plays a role as an international public good – for countries whose currencies serve as global reserve currencies. In the modern era, the US dollar replaced sterling as the world's main reserve currency following World War I, after European countries abandoned the gold standard.

Speaking before the US Congress in 1960, Triffin testified to the inherent instability of having more dollars in circulation than the amount of gold backing them. Triffin's prediction that the system would break came true and US president Richard Nixon abolished the gold standard in 1973.

One modern extension of Triffin's view – countered by Michael Bordo and Robert McCauley in their 2017 Bank for International Settlements working paper, *Triffin: dilemma or myth?*[1] – is that the dollar's reserve role requires US current account deficits. This current account extension of Triffin is "popular" but "flawed", Bordo and McCauley argued.

They hold that the hypothesis that the dollar's role has led to wider US current account deficits is not easily tested. Outside of the US, borrowers widely use the dollar to denominate debts that are, in turn, largely held by non-resident creditors. For example, "the Chinese central bank can hold a dollar bond of a German agency that, in turn, has a dollar claim on an emerging market government."

The People's Bank of China appears to hold the opposite view: "Global economic growth often requires reserve currency-issuing countries to increase the supply of reserve currency through balance of payments deficits," a spokesperson tells *Central Banking*. But this "endangers" their credibility as a reserve currency and "impairs" their role in the global monetary system. Conversely, if reserve currency issuers want to maintain a balance of international payments, other countries may have insufficient international liquidity, which would have a detrimental effect, the People's Bank of China spokesperson says.

The International Monetary Fund (IMF) created the special drawing rights (SDR) in 1969 within the context of the Bretton Woods fixed exchange-rate system. After the gold standard was abandoned, and floating exchange rates for major fiat currencies became the norm, the IMF notes "this lessened the reliance on the SDR as a global reserve asset".

However, the SDR has “the characteristics and potential of a supra-sovereign reserve currency,” the People’s Bank of China spokesperson says, “which is helpful to alleviate the Triffin problem.”

Renminbi in SDR

Economists John Maynard Keynes and Ernst Friedrich Schumacher first proposed a supranational currency to be introduced after World War II. SDR are the nearest thing to their ‘bancor’. Keynes and Schumacher envisaged that the bancor would be used in international trade as a unit of account within a multilateral clearing system.

SDRs act as supplementary foreign exchange assets. In 2016, the IMF added the renminbi to the basket of currencies in the SDR for the first time, following one of its regular five-year reviews.

The basket of currencies is currently made up of the world’s five leading currencies: the US dollar, the euro, the renminbi, the Japanese yen and sterling. Entry to the basket is conditional on a currency being freely usable. In 2015, “the renminbi was clearly less freely usable in cross-border transactions than the four incumbent members of the basket,” Barry Eichengreen and Guangtao Xia note.[2] However, the IMF, when making the decision, also acknowledged that, when sterling and the yen were first deemed freely usable, both the UK and Japan had some capital account restrictions in place.

In 2021, the renminbi extended its place as the third-largest currency in the basket when the IMF increased the currency’s SDR weighting to 12.28% from 10.92%. It also raised the weight of the US dollar to 43.38% from 41.73%. The weightings for the euro, yen and sterling declined to 29.31%, 7.59% and 7.44%, respectively.

The formula for SDR weighting looks at each currency's share in exports, official reserves, FX turnover, international bank liabilities and international debt securities. Asked about the decision-making process, the People's Bank of China spokesperson says IMF staff based their calculations on "public data" and did not hold discussions with Chinese officials or ask them to provide supporting materials.

IMF directors attributed the decision to increase the renminbi weighting to "developments in trade and financial markets". More specifically, the increase of 136 basis points is because of China's share of global exports increasing over the past five years, Qiao Yide, vice-chairman of the Shanghai Development Research Foundation tells *Central Banking*. Other indicators, such as renminbi transactions on foreign exchanges, did not increase dramatically, Qiao adds.

Looking more deeply at the factors that led to the increased weighting, Qiao points out that Chinese exports to the US – its largest single country trading partner – are still growing. Data from Comtrade shows Chinese exports to the US reached a record high of $577 billion during 2021 (US exports to China were $151 billion – also a record high). As well as the strength of China's manufacturing sector, another reason the share of China's exports increased is because the Covid-19 pandemic damaged the exporting capacity of many other developing countries. A key question, Qiao says, is whether China's share of exports will continue to rise.

The Chinese government faces a dilemma, however. Cautious after capital flight caused market instability in 2015, officials are concerned about the potential effect of opening up the capital account too far, too quickly, according to Qiao.

As part of the SDR review, IMF directors acknowledged the progress made on financial market reforms in China, but they called for additional efforts to further open and deepen the onshore renminbi market. SDR users noted "a higher burden in terms of transaction costs and operational procedures in the onshore market, inconvenient or less flexible trading hours, and lower liquidity compared to more mature markets".

The People's Bank of China spokesperson reiterated commitments to simplify the procedures for foreign investors to invest in the Chinese market. The central bank says China "will enlarge the universe of investable assets, improve data disclosures and the business environment, and extend the trading hours of the interbank FX market".

As one example, Swap Connect – which will provide trading and clearing services for Hong Kong and international investors to access mainland China's financial derivatives market, and for investors in mainland China to access Hong Kong's financial derivatives market – is preparing to launch. Initially available for 'northbound' transactions (via Hong Kong into mainland China), the service will facilitate the trading of interest rate swaps, which should assist international investors in better managing their risks associated with mainland bond investments.

Emerging market potential

The funding strains associated with responses to the pandemic also gave rise to the largest allocation of SDRs in history: $650 billion, which came into effect August 2021. "As the global economy is still facing large uncertainty, newly allocated SDR should play a bigger role," the People's Bank of China spokesperson tells *Central Banking*.

Having noted that emerging market economies are struggling with exports, Qiao appeared to echo the People's Bank of China's view in a speech he gave in September when he noted that the present monetary system "has a basic flaw that is the use of a sovereign currency as a global reserve currency".

The IMF's managing director, Kristalina Georgieva, said at the time that the new SDR allocation "will provide additional liquidity to the global economic system – supplementing countries' FX reserves and reducing their reliance on more expensive domestic or external debt".

SDRs can provide an injection of liquidity, without adding to debt burdens. Countries may use SDRs in different ways. Some may convert them to other currencies and hold on to the foreign reserves. Others may use SDRs to service debt. SDRs can also be converted to other currencies and spent.

However, jurisdictions with more expensive debt to service received the least in SDR. Low-income countries received just $21 billion of the $650 billion allocation. Observers warn of a "looming emerging-market debt crisis". Meanwhile, many emerging market economies' currencies continue to fall against the dollar.

IMF members have the option of giving their shares to other nations, with China among the countries that have pledged to do so. "China supports countries with abundant resources to voluntarily channel SDRs to countries in need," the People's Bank of China spokesperson says.

China committed to channelling more than 10 billion SDRs through mechanisms such as the Poverty Reduction and Growth Trust (PRGT) and Resilience and Sustainability Trust (RST). The IMF calls the PRGT its "main vehicle" for providing concessional loans to low-income countries.[3] The RST was established this year.

In 2021, the Group of 20 said it would recycle $100 billion worth of SDRs from members to vulnerable countries. To date, around $60 billion has been pledged, not including around $20 billion from the US that failed to gain congressional approval. *Central Banking* reached out to the IMF for comment on progress regarding SDR reallocation but the IMF said it would not be able to provide a response in time for the publication of this article.

Renminbi in reserves

Over the past 20 years, traditional reserve currencies, dominated by the 'big four' – the US dollar, euro, yen and British pound – have seen their share of reserves decrease slightly from around 98% to 90%. Non-traditional reserve currencies have seen theirs increase from around 2% to 10%.

IMF data shows that claims in US dollars rose to $7.09 trillion at the end of the fourth quarter of 2021, up from $6.99 trillion in Q4 2020. The euro decreased slightly from $2.53 trillion to $2.48 trillion and the Japanese yen from $715 billion to $665 billion in the same period. In contrast, sterling increased from $561 billion to $579 billion. The renminbi's share increased from $272 billion to $337 billion.

Shares of allocated reserves remained fairly level, with the US accounting for just under 60% and the euro just over 20%. The yen, sterling and renminbi account for around 6%, 5% and 3%, respectively.

But China has become the world's largest trading partner. Before 2000, the US was at the helm of global trade. More than 80% of countries traded with the US more than they did with China. By 2018, that number had dropped sharply to 30%. China took top position in 128 of 190 countries.[4]

This change in trade dynamics was a key reason Nigeria became "the first

African central bank to take renminbi as part of reserves", Lamido Sanusi, former governor of the Central Bank of Nigeria, tells *Central Banking*.

Sanusi's thinking at the time was to look at China's share of world exports and reserves: it had become the world's greatest manufacturing nation and there was ongoing structural transformation with the growth of the services sector. Wages had risen and consumer spending followed – safety nets and insurance would be next.

Given the huge population and rising purchasing power, Sanusi's belief was that, more and more, China would rely on consumer spending and private investment and de-emphasise export-led growth. Low-value industries would be scrapped as China could afford imports of those products. All of this would mean that the artificial manipulation of the renminbi would no longer be necessary and, in all likelihood, it would rise in value over the medium term and be a good investment.

China had already started opening up by allowing its exporters to receive payment in renminbi and also allowing payments for imports in renminbi. Sanusi had proposed to the government that Nigeria accept renminbi as currency for payment for oil exports to China, but this was not adopted. His plan was that the cashflow would provide a hedge and Nigeria could then issue long-term bonds on the dim sum market in Hong Kong to finance infrastructure.

With projects undertaken by Chinese companies, Nigeria would then be able to raise money in Hong Kong to pay and use renminbi export proceeds to service debt. This was all part of comprehensive strategic thinking aimed at diversifying funding sources for external debt in a set of recommendations that, at that time, included issuing *sukuk* – shariah-compliant bonds. It was part of a strategic framework that looked at the external balance sheet, composition of fiscal debt and China as a source of not just goods but capital and infrastructure, as well as an importer of Nigeria's oil.

Other 'south' nations share similar perspectives. Chile is the world's leading copper exporter and China the main destination of the country's total exports. *Central Banking* asked the Central Bank of Chile's governor, Rosanna Costa, whether China's key role in global trade will boost the international adoption of the renminbi as a reserve currency. She said that Chile's main FX reserves currency continues to be the dollar "by far", but that the renminbi represents 8% of Chile's reserve assets. This is higher than the 3% average found among respondents to a Bank for International Settlements survey, she added, because the renminbi is a "powerful source of diversification". "China government bond rates have little correlation with developed markets," Costa said.

"I am just pleased that our forecast about the inevitability of internationalisation is coming true. We knew the IMF would have to accept the renminbi as part of the SDR," Sanusi tells *Central Banking*. ❑

Notes

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