IIEL ISSUE BRIEF 02/2017

Institute of International Economic Law
Georgetown University Law Center
600 New Jersey Avenue, NW
Washington, DC 20001

lawiiel@georgetown.edu; http://iielaw.org/

RENMINBI INTERNATIONALIZATION AND SYSTEMIC RISK

Chris Brummer[*]

(Note: This *Brief* and its accompanying arguments are excerpted from, and explained in more depth, in my working paper *The Renminbi and Systemic Risk*.)

The internationalization of China's currency, the renminbi ("RMB"), is arising in ways with few historical precedents. Instead of waiting for international markets for its currency to evolve organically, the Chinese government has undertaken a quasi-mercantilist strategy designed to promote the currency and its own national RMB-based infrastructure. This strategy has emphasized tightly managed capital account deregulation over both prudential reforms and robust market supervision, and incentivizes foreign jurisdictions to compete for RMB-based transactions.

China's approach, which is envisioned in part to accelerate needed structural reforms and competitiveness in the Mainland, has largely been hailed as

[*] Chris Brummer is the Williams Research Professor and the Faculty Director of Georgetown's Institute of International Economic Law.

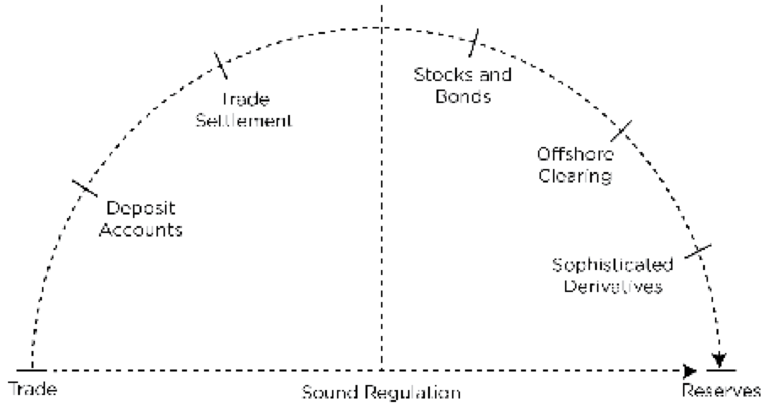
a positive market liberalizing development since the yuan should become more tightly tethered to market forces. But as I explain below, the renminbi's internationalization is a complex phenomenon, and introduces novel systemic risks to cross-border finance. First, the strategy adopted by China to limit the availability of the renminbi to market actors—which is itself premised on the currency's appreciation—fragments the renminbi's global liquidity and generates a number of potential payment and credit risks for institutions transacting in the currency abroad. Furthermore, the country's financial system is riddled with weaknesses in accounting, auditing, credit rating agencies and even derivatives regulation that could expose its capital markets to intermittent crises as liberalization progresses. And instead of proverbial accounts of the past where developed host markets provided incentives for emerging markets to improve their domestic rules and regulation, the country's rationing of renminbi and auctioning of renminbi infrastructure potentially enables the very opposite outcome.

These drawbacks ultimately highlight how some of the same mechanisms facilitating the export of the renminbi—and its control and manipulation by the Chinese government—are increasingly enabling poorly regulated instruments and institutions to endanger foreign investors and infrastructures, including those in the United States. In doing so, they complicate the prospect of more balanced global growth espoused by China's financial authorities.

The Typical Path of Currency Internationalization

The way China has internationalized the renminbi is without historical precedent. But to properly understand just how unusual the country's policy decisions have been, it helps to outline how currencies have typically come to gain cross-border prominence. Though national currencies are all very different, and their paths to global significance are rarely linear, currencies usually begin to acquire some measure of internationalization after they have achieved a monopoly or near-universal use in their home countries, and they begin to be used cross border as a means of exchanging value between merchants. Commonly, this would arise quite literally on national borders, as sellers or private individuals who work in varying jurisdictions use currencies to facilitate and settle simple commerce and trade in goods. The net balance of such trade on a national level constitutes what economists call the *current account*.[1]

[1] The current account is defined as the sum of the balance of trade (goods and services exports less imports), net income from abroad and net current transfers. *Current Account*, INVESTOPEDIA, http://www.investopedia.com/terms/c/currentaccount.asp (last visited Jan 11, 2017). Trade in goods usually is the largest factor in this calculation.



Source: Chris Brummer

Over time, and with the permission of the state, currencies then become more popular in larger scale transactions, and as a means of invoicing. The price of goods, in short, becomes denominated for sale in the currency, even where sold abroad. Eventually, merchants in far flung parts of the world might come to use the currency as a means of exchanging value, even where neither the buyer or seller may be a national of the country issuing the currency, and denominate the price of some goods in terms of the currency.

Once a currency is used for cross border trade, holders of the currency seek to do something with it, especially when they are not immediately deploying the currency to purchase goods. In the breach, financial markets begin to open and coalesce in order to allow those who have exchanged goods or services for the currency to put it to use between transactions and for investment. There is in effect a gradual liberalization, either de jure or de facto, of what economists call the *capital account* as foreign currency holders begin to participate in the capital markets of the currency's issuing country, and hold financial (and real) assets.[2] This in turn spurs the creation of a variety of products denominated in the currency, from stocks and bonds to complex derivatives.

Finally, as trade progresses and capital markets deepen and become more liquid, central banks begin to use the currency as a store of value.[3] Just as individuals and corporates come to use the currency as a means of saving and later investment, governments, too, start to rely on a currency as a reserve asset for sovereign balance sheets. When markets freeze, or balance of payments problems arise, an international currency can then be used as a critical source of liquidity

---

[2] The capital account is generally defined as a metric gauging the net change in physical or financial asset ownership for a nation. Along with the current account, it comprises a country's balance of payments. *Capital Account*, INVESTOPEDIA, http://www.investopedia.com/terms/c/capitalaccount.asp (last visited Jan 11, 2017).

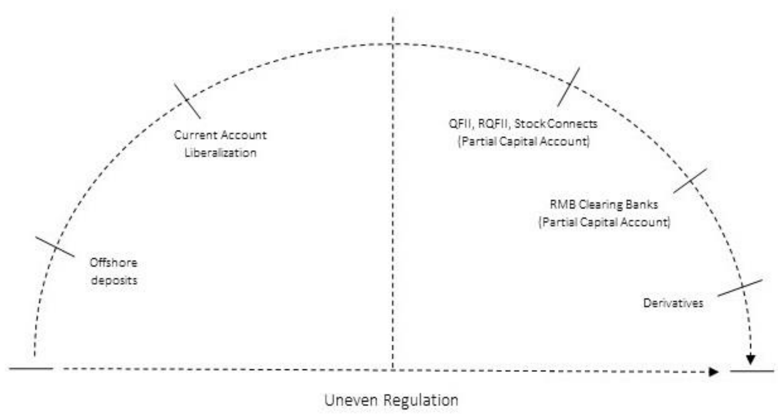
[3] Liqing Zhang & Kunyu Tao, *The Benefits and Costs of Renminbi Internationalization* 3(Asia Dev. Bank Institute, Working Paper No. 481, 2014), https://www.adb.org/sites/default/files/publication/156336/adbi-wp481.pdf (noting that a country must forgo its domestically oriented monetary policy when its capital account is liberalized).

and help grease the wheels of commerce with other countries should the government's own currency lose its luster.

How China "Exports" its Currency

The renminbi's internationalization departs considerably from the historical pattern outlined above. Generally speaking, the larger the economy of a country, the more its currency is used for cross-border transactions. That said, the use of the renminbi has lagged significantly behind the growth of China as both an economic power and a trading nation.[45] This is because China has until recently imposed, alongside a currency peg, capital controls restricting the currency's use outside of China, and intervened in currency and bond markets in ways that are intended to keep the renminbi cheap. In this way, local manufacturers have been able to enjoy trade advantages over competitors.

Recently, China has reversed its strategy in part, and adopted a so-called dual track strategy designed to help promote the renminbi's cross border use. The first track comprises efforts to enhance the renminbi's presence in international trade and direct investment. The second track focuses on promoting the cross-border use of the renminbi in financial markets.[6]



Source: Chris Brummer

[4] Steven Liao & Daniel McDowell, *Redback Rising: China's Bilateral Swap Agreements and Renminbi Internationalization*, 58 INT'L STUDIES Q. 1, 3 (2014), http://faculty.maxwell.syr.edu/dmcdowel/ISQ_liao_mcdowell.pdf.
[5] *Id.*
[6] *Id.* at 3.

Step 1: A Rapid Opening of the Current Account

The first track has leveraged China's position as a trading nation. Instead of going for a "big bang" deregulatory approach in which both the capital and current account are liberalized, authorities have focused on the more modest route of liberalizing the current account rapidly, and more gradually opening the capital account via a highly micromanaged and strategic process.[7] In 2008, the PBOC initiated a pilot program whereby companies approved by Mainland authorities would be permitted to use RMB to settle trade payments with customers or producers outside of China.[8] Two years later, the program was extended to exporters and importers throughout China, effectively liberalizing the country's current account.[9]

Although technically comprising only a partial liberalization of the currency, China's current account strategy had important implications for global currency markets. Because China was by the second decade of the century the largest trading nation in the world by dint of its commerce with the United States and deep ties to commodity exporting countries,[10] even modest steps tied to the current account would impact its popularity. Domestic exporters could avoid hedging and foreign exchange transaction costs that usually accompanied transacting in a foreign currency by selling goods in RMB. Foreign companies, meanwhile, could sell and buy goods to customers in their local currency—as well as access a currency likely to appreciate.[11] All the while, by focusing on trade and not finance, minimal risks to the financial system would presumably be created even as the currency's export was accelerated.

These reforms helped galvanize interest in the currency. In little more than five years, China's foreign trade settled in renminbi would grow from just three percent in 2010 to over 20 percent,[12] and the RMB would climb to become second most commonly used currency in the world for trade finance and documentary

---

[7] Capital account liberalization had taken some tepid steps prior to the opening of the trade account, however. Most notably, in 2004 individuals were permitted to hold and manage limited RMB savings outside the Mainland in bank accounts subject to local rules and protections.

[8] *See* ASIFMA, STANDARD CHARTERED & THOMSON REUTERS, RMB ROADMAP 8 (2014), http://www.asifma.org/uploadedfiles/resources/rmb%20roadmap.pdf.

[9] BARRY EICHENGREEN ET AL., INTERNATIONALIZATION OF THE RENMINBI, PATHWAYS, IMPLICATIONS AND OPPORTUNITIES 14, http://www.cifr.edu.au/assets/document/CIFR%20Internationalisation%20of%20the%20RMB%20Report%20Final%20web.pdf.

[10] China by 2013 would be officially recognized as the world's top trading nation. *China Eclipses U.S. as Biggest Trading Nation*, BLOOMBERG NEWS (Feb. 10, 2013, 11:01 AM), https://www.bloomberg.com/news/articles/2013-02-09/china-passes-u-s-to-become-the-world-s-biggest-trading-nation.

[11] They can also conceivably receive discounts on purchases made in the local currency.

[12] *See* KATHLEEN WALSH, RMB TRADE INVOICING: BENEFITS, IMPEDIMENTS AND TIPPING POINTS 3 (2014), http://www.treasury.gov.au/PublicationsAndMedia/Events/2014/~/media/Treasury/Publications%20and%20Media/Events/2014/RMB%20Dialogue/RMB_trade_invoicing_report.ashx (Chart 1 on Growth in RMB Trade Invoicing). However, this is still low compared with around 50–60 percent of the Eurozone's external trade settled in euro, and 30–40 percent in yen for Japanese trade. The Hong Kong Monetary Authority (HKMA) expects RMB settlements to reach 30 percent by the end of 2015.

credit transactions.[13] And perhaps most impressive, the renminbi would become one of the top ten currencies used in global payments, where it remains today.[14]

Step 2: Piecemeal Capital Account Liberalization

The second track has involved China opening up its stock, bond and derivatives markets. But instead of adopting an untrammeled free flow of capital across borders, China has chosen to largely ration the availability and access foreign investors have to the currency for financial transactions and activities. According to varying quota systems and regulations, which are commonly applied *both* to foreign investors seeking to invest in China and national jurisdictions hosting renminbi transactions, parties interested in participating in or facilitating RMB-capital markets must apply to one or more regulatory authorities in the Mainland for permission.

Additionally, China has developed a number of offshore financial infrastructure and trading hubs to facilitate trading and investing in RMB-denominated instruments. The earliest was the establishment of the dim sum market, a bond market hosting RMB-issuances by state owned and even U.S. and international firms. Furthermore, China has introduced a number of "stock connects" operating as conduits between the Mainland and Hong Kong. Through them, foreign investors can access Shanghai and Shenzhen stock exchanges through brokers based in Hong Kong.

The linchpin of offshore finance lies in the aptly named clearing banks. Clearing is an essential aspect of internationalizing a currency insofar as payments in the banking sector need to be supported by institutions that can assist in confirming and settling transactions as well as ensure sufficient RMB-denominated collateral is available or provided when trades are made. The offshore clearing bank model was introduced in 2003, when the Bank of China Hong Kong was appointed by the PBOC as the first Clearing Bank for offshore RMB.[15] Clearing was then supercharged when the Bank of China Hong Kong engaged Hong Kong Interbank Clearing Limited to develop a settlement system that operated in real time for offshore transactions. Since then, most of the country's largest banks have come to participate in cross-border clearing, and act offshore as leading conduits of RMB liquidity (often cash or government-issued

---

[13] *See* Sreeja VN, *Yuan Overtakes Euro As Second-Most Used Currency In International Trade Settlement: SWIFT*, INT'L BUS. TIMES (Dec. 3, 2013, 6:11 AM), http://www.ibtimes.com/yuan-overtakes-euro-second-most-used-currency-international-trade-settlement-swift-1492476.

[14] See Gabriel Wildau, *Renminbi drops to sixth in international payment ranking*, FIN. TIMES (JULY 21, 2016) (noting expectations that despite challenges the long-term trend of increased use of the renminbi for payments continues even today).

[15] *See id.*

debt) provided by the People's Bank of China.

Five Key Risks

The internationalization of the renminbi holds the prospect of a range of potential benefits for global commercial actors, investors, and nations around the world. Among them, the internationalization of the currency portends a rebalancing of the global economy for more sustainable growth and helps ensure that the Chinese currency is increasingly subject to market forces and less susceptible to currency manipulation. Yet the manner in which internationalization has been executed presents a number of significant risks.

1. *The "Inter-Hub Liquidity" Risk*

First, offshore hubs are tied to one another in partial and often complicated ways. Hubs also may enjoy very different quota allocations, which means that they are provided varying levels of room with which to inject renminbi into their financial systems and develop renminbi business. Financial centers and institutions have borrowing facilities of varying duration, accessible to divergent market participants and backed by differing pools of money. If quota is exhausted in one locale, you have to go elsewhere to transact (unless a central bank swap line is available and accessed), or at least to complete a transaction. Payments then have to be cleared in both the country of origin and also the country of receipt, requiring transacting parties to potentially navigate varying administrative regulations and exhaustion rates in the currency.[16]

The clearing banks that buttress offshore hubs also have their own potential credit risks and logistical operations, and thus route payments in ways clients and corporate end users may not always expect.[17] Indeed, every stop along a payment route can travel paths unknown to customers as banks direct payments in ways that conform with their own renminbi holdings and the protocols of facilities that process RMB transactions.

Extenuated clearing potentially generates time-consuming practices that increase the chance of renminbi payments being delayed, just as transaction linkages

[16] *RMB Hubs are the Best Choice for Now*, TREASURY TODAY (July 2015), http://treasurytoday.com/2015/07/rmb-hubs-the-best-choice-for-now-ttti.

[17] Deborah Mur, *Offshore Renminbi Hubs: Challengers to Hong Kong* 2, CITIBANK http://www.citibank.com/tts/sa/renminbi/docs/offshore_renminbi_hubs.pdf (indicating that discussions between bank and payor necessary before payments can be effectuated).

spanning different time zones heighten risks of delayed payments. These delays in turn generate potential payment risks, insofar as a party could conceivably go bankrupt before a transaction is settled. The default of a major counterparty in turn could introduce wider risks to not only renmibi-based markets, but any markets where firms are counterparties to the institution awaiting payment. Compromised payment channels also create lesser operational costs like overdraft charges where corporates are fined for not having the renminbi in their accounts when they expect it.[18] Renminbi-based transactions thus often involve more planning, as well as strategic execution services that comply with the network of varied on and offshore operational rules.

These bottlenecks raise a number of important operational questions. As one commentator has summarized: "When can a party default on a transaction based on a lack of liquidity in the RMB market? When will a market be considered not liquid enough?"[19] Moreover, should, and if so, when can other international currencies be used as a backup settlement currency?[20] Ironically, these questions possibly become *more*, not less, pressing as the internationalization of the currency moves apace. Because of the structure of RMB markets and the particular strategy officials have adopted, the currency's export could conceivably stretch existing offshore liquidity, instead of add to it, since the addition of a hub does not necessarily contribute to a unitary offshore pool of liquidity, even as pools of liquidity multiply.

2. The "Onshore-Offshore Liquidity" Risk

Challenges lie not just between offshore hubs; payment channels with the Mainland, too, are not always integrated, and may not be fully interoperable. Transactions that go onshore, where a counterparty is a Chinese person or entity, have to be cleared via domestic clearing facilities. Historically, this has meant going through the legacy China National Advanced Payment System ("CNAPS"), which was not integrated into messaging systems that relied solely on Western (non-Chinese) characters and had only limited hours of operation.[21]

To reduce payment problems, China in October 2015 launched the China International Payment System (CIPS), which aims to operate as a payment platform akin to the dollar-based CHIPS in the United States.[22] Specifically, it offers a means whereby offshore market participants can directly clear RMB-denominated transactions in China, unlike the prior system where cross-border

---

[18] *RMB Hubs are the Best Choice for Now*, *supra* note 16.
[19] Terry Chang, *The International Use of Currencies: The U.S. Dollar and the Euro*, 25 COLUM. J. ASIAN L. 79 (2012).
[20] *Id.*
[21] For an overview of CNAPS, see *Chinese Renminbi, Payment From and to China – Convenient and Secure,* DEUTSCHE BANK (Sept. 2014), https://www.db.com/specials/en/docs/Chinese-Renminbi-Payments.pdf.
[22] Michelle Chen, *China's International Yuan Payment System Pursues World Finance*, REUTERS (Oct. 8, 2015, 4:23 AM), http://www.reuters.com/article/china-yuan-cips-idUSL3N1281VL20151008.

renminbi clearing could only be conducted through one of the clearing banks in the offshore hubs or through a correspondent bank in Mainland China.

There are, however, persistent challenges facing inter-hub transactions and offshore liquidity more generally. Although the renminbi is considered one currency, it at least historically has functioned more similarly to two currencies that trade at different rates.[23] There has on the one hand been the onshore yuan (traded under the symbol "CNY"), and on the other the offshore renminbi (alternatively, under the designation "CNH") based in Hong Kong.[24] Between the two, a difference in value has arisen, due in part to varying yields and capital account restrictions. For many years, their separation has meant that different market equilibriums have impacted their prices.[25]

This is important because for some foreign exchange conversion purposes, payments destined for China may still route through some offshore centers before sending payments to the Mainland.[26] Extra links to the routing process, as we saw above, increase the time for clearing and settlement and in the process potentially contribute to the Herstatt risk that CIPS itself aims to reduce.

Monetary decisions devised on the Mainland can also enhance some payment risks, which is especially relevant given the renminbi's status as a partially managed currency. Whether onshore or off, the PBOC has sought to make the yuan a stable store of value and prevent undue volatility. To achieve this end, authorities have encouraged investors and stakeholders to trade, save and invest the currency, and increasingly intervened to discourage perceptions of one-sided appreciation or depreciation. As downward pressures on the currency's value have increased, one of the PBOC's more significant approaches is to engineer (or permit) liquidity crunches in order to drive up the currency's value.[27] By in effect informally instructing Chinese banks to raise their interest rates for borrowers, officials can increase the cost of borrowing, making it more expensive for short sellers to borrow the funds they need to bet against the yuan in currency markets. In that way, the currency can better maintain its value. However, higher interest rates lower RMB liquidity in the aggregate,[28] which has in turn led commercial borrowers to depend on more formal sources of funding than was the case in the past.[29]

Collectively, these observations suggest that even with the operationalization of CIPS, the integration of offshore and onshore monetary

[23] Chang, *supra* note 19, at 79. I do not include Non Deliverable Forwards as Chang does since they are derivatives instruments and not primary currencies, or for that matter, an international "money."
[24] *Id.*
[25] *Id.*
[26] From private, off the record interviews with renminbi bankers.
[27] The total amount of CNH liquidity that can potentially be injected by all facilities in Hong Kong, Singapore, and Korea now stands at CNY 1tn. STANDARD CHARTERED, GLOBAL RESEARCH, CNH – LIQUIDITY DRIVERS AND FACILITIES 1 (2017).
[28] Larger CNH liquidity facilities are typically backed by offshore central banks' bilateral swap agreements with the PBOC. However, settlement times are longer—and the activation of swap lines may require the PBOC's consent. *Id.*
[29] *Id.*

ecosystems remains incomplete. Routing of payments will even today be at times ad hoc, and payment times and processes could be extensive enough to generate various dimensions of Herstatt risk tied to counterparty credit. Clearing banks remain potentially significant conduits for renminbi payments, but also comprise potential sources of risk for not only the counterparties that rely on them, but the renminbi financial system as a whole.[30] All the while, although CIPS provides significant opportunities for enhancing the efficiency of payments, liquidity management remain challenging for some market participants—due in part to the very transmission of monetary policy effected by the PBOC.

3. A Problematic Regulatory Ecosystem

Liquidity is not the only problem facing renminbi internationalization. The regulatory system supporting the renminbi is also weak. Perhaps most important, the Chinese financial system lacks the disclosure system and transparency needed to maximize robust, long-term foreign investment. China's auditors and accountants are viewed skeptically by foreign regulators due to long-held reputations of lax monitoring and a failure to adopt international accounting standards.[31] Moreover supervision is at best "light touch": litigation against key gatekeepers is extremely rare, and is brought only after the governmental authorities have launched cases of its own. As a result, investors willing to take on direct exposure to the Mainland have tended to apply, at the very least, a risk premium to Chinese issuances, and have continued to rely on foreign legal systems, where possible, to enforce informational rights and investor protection.[32]

The country's bond markets are hampered by similar defects in opacity and gatekeeping. Since the 1980s, China has increasingly relied on bond markets to enable state-owned, and now corporate firms, to issue debt to investors. In this way, banks could diversify their balance sheets while accessing a greater pool of capital for expansion. Some of the tools commonplace in Western markets, however, have not always been available. Perhaps the most obvious of these have been credit ratings. In theory, credit ratings of issuers provide valuable guidance for investors in corporate and government debt since they classify the relative riskiness of borrowers and their likelihood of default.[33] But ratings have historically been altogether absent from some markets. Meanwhile, where ratings

---

[30] *RMB Hubs are the Best Choice for Now*, *supra* note 16.

[31] Part of the attention is a by product of the fact that the profession's primary regulatory body, the Chinese Institute of Certified Public Accountants, is government controlled, just as are many of the country's leading businesses, creating potential conflicts of interest.

[32] *See* Yimiao Chen et al., *GAAP Difference or Accounting Fraud? Evidence from Chinese Reverse Mergers Delisted from U.S. Markets*, 7 J. FORENSIC & INVESTIGATIVE ACCOUNTING 122, 122 (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2567141 (noting that in 2012, one in four federal securities class-action lawsuits filed in the U.S. involved Chinese Reverse Merge companies).

[33] Chris Brummer & Rachel Loko, *The New Politics of Transatlantic Credit Rating Agency Regulation, in* THE FATE OF TRANSNATIONAL FINANCIAL REGULATION 155 (Routledge, Tony Porter ed. 2013).

have been available, they have been of modest utility, at best. For one, ratings are homogenous, and range from AAA to AA, with just four ratings available, a significant departure from international agencies like Standard & Poor's and Moody's that utilize a scale with 22 ratings.[34] They also do not provide a forward-looking view for investors[35] and often lack standardized criteria and procedures for giving ratings.[36]

China's underdeveloped derivatives markets offer another sobering example. Usually, investors in Western capital markets can rely on derivatives to help protect them from a counterparty's credit risk and poor transparency. By entering into contracts with other parties to make them whole in the case of a default, the risk posed by bad debt, fraud and other challenges can in some ways be minimized. Limited avenues for such self-help are available in Chinese derivatives markets, however. While China has tools for hedging interest rates, no mature infrastructure exists for credit risks. Only belatedly have authorities announced plans to introduce a credit default swap market—largely to enhance the attractiveness of the interbank bond market—and yet key terms common in contracts enjoy only minimal standardization, limiting their usefulness to foreign investors.[37]

These challenges are exacerbated by a relative lack of formal crisis response mechanisms in China. Bankruptcy, for example, offers little predictability for foreign investors, and the process of recovery and debt restructuring lacks transparency.[38] A relatively recent Enterprise Bankruptcy Law has been in force since 2007, but like many other commercial PRC statutes, was cast at a high level, in broad principles.[39] Furthermore, the country lacks specialized bankruptcy courts, judges and professionals familiar with bankruptcy proceedings.[40] Indeed, significant uncertainty underpins commercial transactions onshore, including how foreign investors should be treated, and what priority their investments should take should bankruptcy be triggered.[41] There is, for example, no scale of seniority in terms of debt repayment. Moreover, recoveries are often settled through a negotiation between issuers, local governments, banks and bond holders, and not

---

[34] Toby Yiu, *Time to Rate China's Riskiness*, INT'L FIN. L. REV., May 2016, at 45.
[35] *Id.* The reasons stem, apparently, from longstanding assumptions of government assistance if issuers were to encounter financial stress.
[36] *Id.*
[37] Brian Yap, *Why China Needs More Hedging Tools for Foreign Investors*, INT'L FIN. L. REV. (June 16, 2016), http://www.iflr.com/Article/3562843/Why-China-needs-more-hedging-tools-for-foreign-investors.html.
[37] *Id.* Indeed, even in the United States, with its largely implemented reforms for clearinghouses, still faces the hazards of clearing risks. *See* Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 GEO L.J. 387, (arguing that clearinghouses may generate systemic risks).
[38] Yiu, *supra* note 34, at 45.
[39] Ricahard C. Pedone & Henry H. Liu, *The Evolution of Chinese Bankruptcy Law: Challenges of a Growing Practice Area* 2 (Aspatore Books, 2010), http://law.okcu.edu/wp-content/uploads/2014/06/I.China_Bankruptcy_Law_Pedone.pdf.
[40] *See id*.
[41] U.S. DEPT. OF STATE, INVESTMENT CLIMATE STATEMENT 16 (2014), http://www.state.gov/documents/organization/228504.pdf.

through a transparent legal process. [42]

4. Suboptimal Offshore Regulatory Competition

The means by which China is exporting the renminbi makes it unlikely that offshore hubs will be able to incentivize significant improvements in China's domestic regulatory architecture. Indeed, although scholars routinely assert that developed offshore markets can create incentives for emerging markets to improve their domestic rules and regulation, the renminbi's internationalization creates incentives to do the opposite.

The problem lies in the likely regulatory competition sparked by multiple countries' desire to host a finite volume of renmibi transactions. Because China's capital account liberalization is limited, and quotas effectively ration countries' access to the currency, Chinese authorities have some discretion in deciding how, where, when and to what degree quotas should be given to foreign jurisdictions. This in turn allows them to either explicitly or implicitly expect conditions for hosting renminbi transactions that are favorable for Chinese market participants.

Most financial centers want the business. Active financial centers tend to elevate demand for local services, as well as goods and merchandise produced domestically. Moreover, financial centers generally attract wealthy bankers, traders, and economic infrastructure providers who help provide revenues to host countries in the form of corporate and personal taxes.[43] With China's economy poised even in a challenging global environment to grow more than 6 percent a year, and the country's financial development still in its early stages, renminbi banking and financial services comprise a potentially enormous growth industry with considerable upside for centers that can establish themselves early on as go-to places for doing business. [44]

As a result, competition for the facilities, quotas, and infrastructure necessary to launch competitive financial centers has been high. Germany, France, and the United Kingdom have all issued a range of high profile study groups and research streams aimed at attracting more China-related deals and renminbi-denominated transactions and infrastructure. [45] Similarly, Hong Kong and

---

[42] Yiu, *supra* note 34, at 45.

[43] CITY OF LONDON CORPORATION, AN INDISPENSABLE INDUSTRY: FINANCIAL SERVICES IN THE UK 4 (2013), https://www.cityoflondon.gov.uk/business/economic-research-and-information/statistics/Documents/an-indispensable-idustry.pdf, (indicating that financial services in London contribute over 11% of tax revenue for the country).

[44] Much of the presumed upside is additionally tied to the fact that the renminbi still assumes but a fractional share of global financial transactions, even as the economy stands as the second largest in the world.

[45] *See, e.g.*, *Renminbi Clearing in Frankfurt*, DEUTSCHE BUNDESBANK, https://www.bundesbank.de/Redaktion/EN/Standardartikel/Tasks/Payment_systems/rmb_clearing_frankfurt.html (last visited Jan 11, 2017); *Competitiveness of Hong Kong in Offshore Renminbi Business*, Legislative Counsel

Singapore have embarked upon robust multisector governmental and private initiatives aimed at maintaining their dominance in renminbi finance, and pushing consistently for expanded quota allocations.[46]

The means by which jurisdictions have competed are diverse—from light touch regulation of Chinese bank branches to MOUs and mutual recognition schemes with Mainland financial authorities. Whether or not these developments fare well for foreign investors in the absence of a credible glide path for future Mainland regulatory reforms is uncertain. Certainly, the mere possibility of official or market-driven pressures to dilute standards—whether in the UK or in other hubs seeking to increase allocations or renminbi business more generally—carries a number of risks. More obviously, it portends a potential "race to the bottom" in the quality of supervision among jurisdictions seeking to attract renminbi business. If offshore financial centers create loopholes for Chinese firms, not only might they no longer provide strict oversight, but they may themselves provide transmission belts of risk to foreign markets. Failures in regulatory governance in China could have, as a consequence, implications for not only Chinese markets, but also investors in far-flung locales.

5. Volatile Currency Fundamentals

A final major risk is tied to the volatile fundamentals supporting the currency. In short, internationalization has been premised on the appreciation of the currency given its longstanding undervaluation. Its structure, process and offshore incentives and infrastructure are based on demand for the currency which in turn is based on the likelihood that holders of the currency could gain outsized profits from appreciation as governmental interventions diminished. Today, however, the economics driving the currency have gone into reverse, creating new questions about the appropriateness of the PBOC's capital account liberalization program.

For nearly twenty years, experts have surmised that the yuan was undervalued as much as 40% in the early 2000s due to significant intervention and sterilization efforts of the PBOC.[47] This made the renminbi an extremely attractive

---

of the Special Administrative Region of China, http://www.legco.gov.hk/research-publications/english/essentials-1516ise08-competitiveness-of-hong-kong-in-offshore-renminbi-business.htm(last visited Jan. 11, 2017).

[46] LIGANG SONG, ET AL. CHINA'S DOMESTIC TRANSFORMATION IN A GLOBAL CONTEXT 271 (ANU Press 2015); YAN-LEUNG CHEUNG ET AL., HONG KONG'S GLOBAL FINANCIAL CENTRE AND CHINA'S DEVELOPMENT: CHANGING ROLES AND FUTURE PROSPECTS (Routledge 2016); Shen Wei, *Competing for Renminbi: Financial Centers in the Context of Renminbi Globalisation*, *in* RECONCEPTUALISING GLOBAL FINANCE AND ITS REGULATION 193, (Cambridge University Press, 2016); Paola Subacchi & Helena Huang, *The Connecting Dots of China's Renminbi Strategy, London and Hong Kong* (Chatham House Briefing Paper, 2012/02, 2012).

[47] WAYNE M. MORRISON & MARC LABONTE, CONGRESSIONAL RES. SERV., RL32165, CHINA'S CURRENCY: ECONOMIC ISSUES AND OPTIONS FOR U.S. TRADE POLICY 3 n. 5 (2008), https://fas.org/sgp/crs/row/RL32165.pdf.

payment instrument, as noted above, since it would presumably appreciate significantly as capital controls loosened and the country's monetary policies modernized. By 2015, however, China's economy slowed as wages increased and as demand for its exports (and trade) dropped 45% in the wake of the Great Recession.[48] After spending nearly 14 trillion in stimulus, which has largely been devoted to infrastructure and housing, China's GDP growth moderated to approximately 7%, the lowest in a quarter century.[49] And just as deflationary pressures began to rise, the Federal Reserve began to plan to raise its interest rates, which would boost the dollar—and by extension, reduce the value of the yuan if traded on normal markets.

In what was at the time a highly unexpected (and subsequently criticized) development, the PBOC ultimately responded to the economic slowdown by cutting its daily-managed reference rate by just under 2 percent—in effect devaluating the currency—and triggering the yuan's biggest one-day drop since 1994. The unexpected shift in policy unleashed historic levels of volatility in China's (underregulated) capital markets, where the country's stock market endured its biggest one day fall since 2007 and state media bemoaned the day as "Black Monday."[50]

The cut was understood in part as a PBOC decision allowing market forces more directly impact the value of the currency, with the convenient upside of making Chinese exports more competitive.[51] However, China's policy responses to

---

48 Yi Wen & Jing Wu, *Withstanding Great Recession Like China* 1, (Fed. Res. Bank of St. Louis, Working Paper 007A, 2014), https://research.stlouisfed.org/wp/2014/2014-007.pdf.

49 *The Great Fall of China*, THE ECONOMIST (Aug. 29, 2015, 1:00 AM), http://www.economist.com/news/leaders/21662544-fear-about-chinas-economy-can-be-overdone-investors-are-right-be-nervous-great-fall.

50 *Id.*

51 Enda Curran, *Why China Devalued the Yuan*, BLOOMBERG NEWS (AUG. 13, 2015, 8:00 AM), https://www.bloomberg.com/news/articles/2015-08-13/why-china-devalued-the-yuan.

the stock market plunge following the devaluation, as well as widespread perceptions that Chinese authorities were commandeering market participants to staunch the flow and effectively manipulate markets, fueled further liquidations of renminbi positions and investments. The head of the country's securities regulator, criticized for his poor oversight of the market, was fired.[52]

By early 2017, the PBOC's policy responses had evolved and settled on three interwoven monetary, as opposed to regulatory, strategies: large interventions in foreign exchange markets aimed at purchasing yuan with dollar denominated savings, limiting capital conversions out of the currency, and making it more expensive to short the currency in the foreign exchange markets. Despite these responses—which collectively comprise an "*upward manipulation*" of the renminbi designed to bolster its market value—capital outflows continue, the country has lost nearly $1 trillion in foreign reserves, and efforts to back the currency offshore have created liquidity squeezes that could exacerbate liquidity flashpoints already embedded in China's complex internationalization-by-quota strategy.[53] In short, not only is the renminbi less attractive than at nearly any recent point in history, but economists increasingly question the health and sustainability of the country's overall balance of payments.

Mitigation Strategies

None of these problems will be solved quickly. Some regulatory issues—like building a capable infrastructure for credit derivatives, or reforming rating agencies and getting sufficient data on issuers for effective opinions—could take years of work by China's domestic authorities. Additionally, the immediate direction of the Chinese economy is unclear, and will likely remain so for the medium term as international political and economic uncertainty persists.

There are, however, several steps, all outlined in my working paper, that both China and the international community should advance to mitigate the excesses and policy blowbacks of the current internationalization approach. First, macroprudential and market oversight should be elevated in importance alongside macroeconomic reforms. Bank and stock supervision, credit rating agency oversight, derivatives and much more should attract as much energy from policymakers as the amount of renminbi flowing across national borders. To help accomplish this, China should ensure that macroeconomic and macroprudential rulemaking be administratively synched such that deregulation of the capital

---

[52] *China Removes Xiao as CSRC Head After Stock Market Meltdown*, BLOOMBERG (Feb. 19, 2016, 7:47 AM), https://www.bloomberg.com/news/articles/2016-02-19/head-of-china-s-securities-regulator-to-step-down-wsj-reports.

[53] *Goldman Warns China Outflows Rising in Both Yuan Payments, Forex*, BLOOMBERG NEWS (Dec. 19, 2016, 12:59 AM), https://www.bloomberg.com/news/articles/2016-12-19/goldman-warns-china-outflows-rising-in-both-yuan-payments-forex.

account *always* be taken in conjunction with upgrades in the oversight of the institutions on which internationalization's success ultimately depends.

Second, as China improves the quality of its financial markets, it should advance a policy of countercyclical implementation of capital account reforms. Monetary liberalization, in short, should accommodate economic cycles. Where, as is currently the case, China faces prospects of prolonged and significant capital outflows, dramatically increasing offshore conduits may not necessarily promote financial stability. Instead, a countercyclical approach is warranted, where more high-quality, well regulated onshore investment opportunities are made available through transparent, efficient and macroeconomically rational quota regimes. In this way, improvements in financial openness could accommodate balance of payments problems. And even as a partial step, investment reforms could help promote familiarity with the currency and RMB-denominated products, and in the process render the renminbi more relevant to the capital management and treasury operations of both multinationals and the financial institutions that service them.

Finally, new monetary commitments may be warranted to allay fears of future competitive devaluations, and serve as a basis for enhanced and stable trade beyond Asia. Notably, trade helps mitigate some, though not all, of the financial risks that arise where countries experience capital outflows. Countries with an open current account are less likely to experience sudden stops or reversals in capital flows when concerns intensify about a country's economy or fiscal condition. This is because countries with an open account are generally viewed as more capable of withstanding balance of payments pressures since they will be, all else being equal, in a better position to service its external obligations through export revenues.[54] For China to significantly deepen its trade relationships, however, credible commitments relinquishing currency manipulation and competitive devaluations in the future would likely be necessary, especially for skeptical potential trading partners beyond Asia. Such commitments could conceivably be operationalized through new weighting metrics for currencies included in the International Monetary Fund's Special Drawing Rights that take into account the strength and quality of its financial market oversight. In this way, not only would the renminbi's international significance be more directly tethered to capital and foreign exchange markets, but also China would face enhanced obligations to execute its monetary policies via a safe, nondiscriminatory and well-supervised institutional environment.

[54] Eswar S. Prasad & Raghuram G. Rajan, *A Pragmatic Approach to Capital Account Liberalization*, 22 J. ECON. PERSPECTIVES 149, 152 (2008).