SLOW AVALANCHE: INTERNATIONALIZING THE RENMINBI AND LIBERALIZING CHINA'S CAPITAL ACCOUNT

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Abstract

China finds itself in the unprecedented situation of internationalizing its currency while liberalizing its partially-closed capital account. This article discusses the steps, the risks and the predictions of such an unusual process.

Steps: In its quest for capital account liberalization, China has adopted a four-pronged approach: (1) relaxing restrictions on inbound and outbound foreign direct investment, (2) expanding RMB trade settlement, (3) allowing the proliferation of RMB-denominated offshore financial products in Hong Kong (such as "dim sum" bonds), and (4) permitting new methods of repatriating offshore RMB for onshore investment (such as the RQFII scheme).

Risks: Certain hazards still lie ahead in the liberalization process, including issues related to: liquidity and currency risk, concentration of credit risk, "hot money" and illegal funds, the complexity of interactions for multiple offshore RMB hubs, and asymmetry in currency demand accelerating the accumulation of foreign exchange reserves.

Predictions: The Mainland government will likely seek to expand the use of the RMB specifically within the Asian region, among its fellow BRICS countries, as well as to the financial capitals in the West. Yuan appreciation will occur hand in hand with a slow metamorphosis from an export-driven economy to a consumer-driven model. Gradually, foreign countries will be encouraged to hold more yuan in their foreign reserves as their confidence in China's financial and banking systems is improved through the development of a deposit insurance system and greater transparency as to legal protections available to them, and as more long term fixed-income financial products denominated in RMB for foreign investors are introduced.

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INTRODUCTION

"For a currency to be a reserve currency, you have to have capital markets in which you can sell it and buy it very easily. New reserve currencies don't emerge by fiat. They emerge as countries change."—Bank of Israel Governor Stanley Fischer, in an interview on June 18, 2010.[1]

China is performing an epic balancing act: slowly liberalizing its capital account while increasing the international use of the renminbi ("RMB," a currency whose base units are also referred to as "yuan"). This article will trace the steps (Part II), risks (Part III) and predictions (Part IV) involved in the Chinese government's efforts to achieve currency internationalization and capital account liberalization.

China's most recent Five-Year Plan provides a helpful insight into the country's key economic priorities, which include the following:

> Improve the market-based managed floating exchange rate regime. Press ahead with the reform of the foreign exchange management system. Expand the scope of cross-border yuan trade. Push forward RMB capital account convertibility. Improve the management of foreign exchange reserves, expand the scale and increase the yields.[2]

Six months before the Plan was released, Yi Gang, the Director of the State Administration of Foreign Exchange ("SAFE") and Deputy Governor of the People's Bank of China ("PBoC"), confirmed that "our ultimate goal is to make the RMB a convertible currency . . . but we don't have an official timetable for RMB convertibility in China."[3] Yi further cited an International Monetary Fund ("IMF") study which found that countries normally require seven to ten years

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[1] Paul Abelsky, *Medvedev Promotes Ruble as World Reserve Currency to Cut Dollar Dominance*, BLOOMBERG NEWS (June 19 2010, 9:07 AM), http://www.bloomberg.com/news/2010-06-18/medvedev-talks-up-russia-s-ruble-as-global-reserve-currency-of-the-future.html.

[2] Guomin Jingji he Shehui Fazhan Di Shier Ge Wunian Guihua Ganyao (国民经济和社会发展第十二个五年规划纲要) [The Twelfth Five-Year Plan for National Economic and Social Development] (promulgated by the Nat'l People's Cong., Mar. 14, 2011, effective Mar. 14, 2011) STANDING COMM., NAT'L PEOPLE'S CONG. GAZETTE, Apr. 15, 2011, at 190 [hereinafter Twelfth Five-Year Plan], *available at* http://www.gov.cn/2011lh/content_1825838.htm, *translated in Full Translation of China's Twelfth Five-Year Plan*, CONFEDERATION OF BRITISH INDUS. (CBI), http://www.cbichina.org.cn/cbichina/upload/fckeditor/Full%20Translation%20of%20the%2012th%20Five-Year%20Plan.pdf (last visited Mar. 12, 2012).

[3] Interview by the Executive Editor-in-Chief of China Reform with Yi Gang, Deputy Governor of the People's Bank of China (PBOC) and Adm'r of the State Admin. of Foreign Exch. (SAFE) (July 10, 2010) [hereinafter Interview with Yi Gang], *available at* http://www.safe.gov.cn/model_safe_en/news_en/new_detail_en.jsp?ID=30100000000000000,261&type=&id=2.

to transition into full capital account convertibility after achieving current account convertibility.[4] He noted that China achieved current account convertibility in 1996, but fifteen years later, capital account convertibility had not occurred,[5] and pointed to China's size and unevenness in development as the reasons why it has been "difficult to achieve a consensus."[6]

Although Chinese officials have not publicly committed to a formal timetable for achieving RMB convertibility, industry insiders believe that RMB convertibility will occur in the foreseeable future.[7] Why do investors, traders and analysts have such optimism in regards to RMB convertibility and its eventual status as a major global reserve currency? In just the past year, industry insiders have witnessed the dramatic rise in the use of RMB in cross-border trade settlement and in a panoply of new RMB-denominated investment products.

This trend is no fluke, but rather a measured and multi-pronged policy that has been gaining momentum for some time.[8] The liberalization of capital accounts still faces potential pitfalls, such as liquidity or currency risk, concentration of credit risk, hot money and illegal funds, complexity of interactions for offshore RMB hubs, and asymmetry in currency demand leading to accelerated accumulation of foreign exchange reserves. But the Mainland government is carefully laying the groundwork for the proliferation of RMB throughout Asia, among its fellow BRICS countries and among Western financial capitals, possibly promoting its future inclusion as a currency in the IMF's Special Drawing Rights basket.[9]

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[4] *Id.*

[5] *Id.* Capital account convertibility, defined as the freedom to convert local financial assets into foreign financial assets and vice versa at market-determined rates of exchange, forms but one part of capital account liberalization, defined as easing restrictions on capital inflows and outflows across a country's borders. Current account convertibility is defined as the freedom to make transfers or payments with respect to current transactions, such as exports of goods, services, and income. *See* RESERVE BANK OF INDIA, *Report of the Committee on Fuller Capital Account Convertibility*, 5 (1997), *available at* http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/72250.pdf.

[6] *Id.*

[7] In a customer survey conducted by Bloomberg and published on Bloomberg News, fifty seven percent of investors, traders and analysts polled (including fifty eight percent of Asian respondents to the survey) said they believed the RMB would be convertible within five years. Nineteen percent predicted that the yuan would become a reserve currency within those five years, and thirty one percent predicted that it would become a reserve currency within ten years. See Michael Forsythe & Andrea Wong, *China's Yuan Convertible by 2016 in Global Poll Marking Big Investor Shift*, BLOOMBERG NEWS (May 11, 2011, 11:43 PM), http://www.bloomberg.com/news/2011-05-12/china-s-yuan-convertible-by-2016-in-poll.html.

[8] *See infra* Table 1.

[9] Special Drawing Rights ("SDRs") is an international reserve asset created to supplement member countries' currency reserves. Its value is based on a basket of

Does the currency have the potential to become a world reserve currency, in a similar league with the U.S. dollar and the Euro, and what would be the benefits to China if this were to occur? What are the Mainland government's aspirations for its own currency? How will the government encourage foreign countries to hold the RMB as a reserve currency? There is tension between the two processes: it is difficult to internationalize one's currency while one's capital account is not open. Such a currency cannot have widespread use in trade if it is not freely exchangeable and transferable. And in the process of loosening its capital controls to promote the use of its currency internationally, it is unclear whether China will be willing to revalue its currency, even at the price of hurting its exports. As Dr. Ilan Goldfajn, chief economist at Brazil's Itau Inibanco, commented during a panel regarding the internationalization of the RMB: "I don't think you can cook an omelet without breaking the eggs."[10] Chinese state planners will be able to make the RMB into a world reserve currency only if they loosen the capital controls and float their currency, i.e., allow the RMB to appreciate against the U.S. dollar.[11] Such a process will doubtless require gradual and delicate maneuvering.

I. STEPS: A FOUR-PRONG APPROACH TO CAPITAL ACCOUNT LIBERALIZATION

In comparison with the average number of years countries spent between opening up current account and capital account, capital account liberalization in China has been inching along.[12] However, the snail-like pace of liberalization in China belies a rather well-coordinated, multi-faceted approach involving four distinct yet complementary prongs that the government has been employing since current account convertibility was first achieved in 1996. These prongs are: (1) relaxing restrictions on inbound and outbound foreign direct investment; (2) expanding the RMB trade settlement; (3) encouraging the proliferation of RMB-denominated offshore financial products in Hong Kong; and (4) permitting new methods of repatriating offshore RMB for onshore investment.

important international currencies. *Special Drawing Rights (SDRS)*, INT'L MONETARY FUND (IMF) (Sept. 13, 2011), http://www.imf.org/external/np/exr/facts/sdr.htm.

[10] Goldfajn made this remark at a panel hosted by the Americas Society and Council of the Americas. Joe Leahy, *Redback Vies for Share of Latam Trade*, BEYONDBRICS (June 7, 2011, 3:58 AM), http://blogs.ft.com/beyond-brics/2011/06/07/redback-vies-for-share-of-latam-trade/#axzz1TKwQabpM.

[11] *Id.*

[12] Twelfth Five-Year Plan, *supra* note 2.

A. First Prong: Relaxing Restrictions on Inbound and Outbound Foreign Direct Investment

First allowed in China in 1986, Wholly Foreign-Owned Enterprises ("WFOEs")[13] permitted greater inflows of foreign direct investment. Unlike some of the joint venture entities that were their predecessors, WFOEs were not required to have a Mainland Chinese investor or partner but rather were fully funded by foreign funds and run by foreign nationals.[14] Whereas previously foreign institutions were restricted to the foreign-only "B" share market, the Qualified Foreign Institutional Investor scheme ("QFII"), debuted in 2002, allotted quotas to qualified foreign financial institutions such as large foreign investment banks to buy and sell RMB-denominated domestic "A" shares on the Shanghai and Shenzhen stock exchanges.[15] Despite allowing select foreign institutions to foray into the domestic stock exchange, the QFII was tightly regulated due to the Chinese government's fear of volatility from hot money inflows from abroad.[16]

Furthermore, capital outflows were relaxed in 2006 with the Qualified Domestic Institutional Investor program ("QDII"), which allowed qualified Mainland financial institutions to invest in foreign securities markets via asset managers, or via securities or insurance companies approved by the Chinese Securities Regulatory Commission ("CSRC").[17] The purpose of the QDII is two-fold: to allow domestic Chinese investors to cut a wider swath with their investing and to relieve pressure from China's ballooning foreign exchange reserves.[18] Domestic Chinese investors may now also transfer RMB offshore for

[13] WFOEs, a popular type of investment vehicle, are limited liability companies formed by foreign nations and capitalized with foreign funds. *See* Dan Harris, *How to Start a Business in China—WFOE*, CHINA L. BLOG (Dec. 4, 2009), http://www.chinalawblog.com/2009/12/how_to_start_a_business_in_chi.html.

[14] Terry E. Chang, Note, *The Gold Rush in the East: Recent Developments in Foreign Participation within China's Securities Market as Prepared to the Taiwanese Model*, 44 COLUM. J. TRANSNAT'L. L. 279, 284-97 (2005).

[15] *Id.*

[16] *Id.* "Hot money" refers to the flow of a currency into a country because investors see an opportunity to profit from the currency's appreciation. Interview by Century Weekly with Liu Wei, Dir.-Gen., State Admin. of Foreign Exch. (SAFE) Gen. Affairs Dep't (Jan. 10, 2011) [hereinafter Interview with Liu Wei], *available at* http://www.safe.gov.cn/model_safe_en/news_en/new_detail_en.jsp?ID=30100000000000000,267&type=&id=2.

[17] *PRC Issues in the QDII Context—Opportunities and Challenges*, CLIFFORD CHANCE CLIENT BRIEFING (Clifford Chance LLP, London, U.K.), Nov. 2008, *available at* http://www.cliffordchance.com/publicationviews/publications/2009/02/prc_legal_issuesintheqdiicontext.html.

[18] *Id.*

M&A and greenfield investments abroad,[19] and profits from such investments may be repatriated in RMB.

In January 2011, the Mainland government launched the Qualified Foreign Limited Partner ("QFLP") program, which allowed foreign-invested private equity investment funds and fund management companies to convert their foreign currency capital into RMB for capital contributions into RMB funds.[20] The foreign currency can be converted (in an amount up until its licensed quota limit) without prior approval of SAFE, and under the QFLP, foreign private equity firms can launch their own RMB denominated funds using overseas capital.[21]

B. Second Prong: Expanding RMB Trade Settlement

In April 2009, a pilot RMB trade-settlement program was introduced so that cross-border trade could be for the first time settled in RMB instead of U.S. dollars.[22] By June 2010, the trade settlement program had quickly expanded from five Mainland cities (Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan) to twenty cities, with their complementary overseas partners growing from just the Hong Kong Special Administrative Region (HKSAR,) Macao Special Administrative Region (Macao SAR), and ASEAN trading partners to encompass all overseas countries as trading partners.[23] By February 2011, 724.9 billion RMB worth of trade had been settled in RMB, which is 201 times the amount settled in 2009; by the end of the 2010 financial year, 67,724 enterprises had used the RMB to settle trade deals, as opposed to 365 enterprises in 2009.[24]

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[19] "Greenfield" investments refer to previously undeveloped early stage investments. *See* Press Release, United Nations Conference on Trade and Dev., Survival in Global Business Arena Is Key Driver of Cross-Border Merger and Acquisition Boom, U.N. Press Release TAD/INF/PR/055 (Mar. 10, 2000), *available at* http://www.unctad.org/templates/webflyer.asp?docid=2928&intItemID=2023&lang=1.

[20] Helen H. Chan, *Foreign Private Equity Braces for Rough Ride to China—ANALYSIS*, REUTERS FIN. REG. FORUM (May 20, 2011, 3:40 PM), http://blogs.reuters.com/financial-regulatory-forum/2011/05/20/foreign-private-equity-braces-for-rough-ride-to-china-analysis/.

[21] *Id.*

[22] Paola Subacchi, *'One Currency, Two Systems': China's Renminbi Strategy*, CHATHAM HOUSE BRIEFING PAPERS (Chatham House: The Royal Inst. for Int'l Affairs, London, U.K.), Oct. 2010, *available at* http://www.chathamhouse.org/sites/default/files/public/Research/International%20Economics/bp1010renminbi.pdf.

[23] *Id.*

[24] Li Jia, *Cross-border Yuan Trade Settlement May Expand Nationwide*, PEOPLE'S DAILY ONLINE (Mar. 29, 2011, 3:06 PM), http://english.peopledaily.com.cn/90001/90778/90859/7334278.html. *See also infra* Table 2.

C. Third Prong: Encouraging the Proliferation of RMB-denominated Offshore Financial Products in Hong Kong

The HKSAR is being used by the Mainland Government as an offshore "financial laboratory" or testing ground, i.e., the first place where RMB-denominated financial products have been allowed to proliferate outside of the Mainland. This financial experimentation began in 2003, when offshore RMB-denominated personal bank deposits and RMB credit and debit card issuances were first permitted in Hong Kong. RMB-denominated bank deposits followed, becoming available for businesses in 2005.[25] RMB non-deliverable forward contracts.[26] were also launched in Hong Kong in 2005. With the amount of RMB that began to accumulate outside of the Mainland in Hong Kong, holders of RMB needed opportunities to invest their holdings.[27]

So called "dim sum" (RMB-denominated) bonds are bonds issued in Hong Kong but that are denominated and settled in RMB.[28] Introduced in 2007, dim sum bonds were at first solely limited to entities incorporated in the Mainland.[29] By 2010, Hong-Kong incorporated, foreign-incorporated and supranational entities were allowed to issue these offshore RMB-denominated bonds in Hong Kong.[30] A new permutation, called "synthetic" dim-sum bonds, which are denominated in RMB but settled in U.S. dollars, has also emerged.[31] If dim sum bonds are not satisfactory for long term investing, Hong Kong citizens now also have the option of parking their offshore RMB in Hong

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[25] ASIA SOC'Y, TRADING WITH CHINA: THE RISE OF THE OFFSHORE RENMINBI BUSINESS (Mar. 2011), *available at* http://www.anz.com/resources/0/d/0d80268045e31613a152e348799f dafa/AsiaSocietyRMBHandbook.pdf.

[26] A non-deliverable foreign contract is a foreign exchange derivatives product traded over the counter, with an agreement to exchange two currencies at pre-determined rate at a specified date in the future, with no physical delivery of the currencies. the spread between the spot rate and the pre-determined rate may be settled in either currency. *See* INDUS. & COMMERCIAL BANK OF CHINA (ASIA) LTD., *Renminbi Non-Deliverable Foreign Contract*, http://www.icbcasia.com/eng/retail/invest/rmbndf.shtml (last visited Mar. 12, 2012).

[27] *See infra* Table 3.

[28] Dominique Gribot-Carroz & Ivan Chung, *Special Comment: The Current Menu for Renminbi Bonds in Hong Kong: Dim Sum or Synthetic?*, INSTITUTIONAL INVESTOR (Jan. 19, 2011), *available at* http://www.institutionalinvestorchina.com/arfy/uploads/soft/110209/1_0843072771.pdf. *See also infra* Table 4.

[29] *Id.*

[30] *Id.*

[31] *Id.*

Kong's RMB-denominated insurance plans, RMB-denominated mutual funds, and RMB-denominated real estate investment trusts.[32]

In April 2011, the first RMB-denominated IPO (by Hui Xian Real Estate Investment Fund, a spin-off of Hong Kong real estate tycoon Li Ka-shing's Cheung Kong Holdings) launched on the Hong Kong Stock Exchange. The *Financial Times* quoted the Hong Kong Secretary for Financial Services and Treasury's prediction that challenges for RMB-denominated Hong Kong IPOs such as the Hui Xian offering would follow, due to lack of liquidity in offshore RMB currency; the Secretary pointed out that a "renminbi-denominated IPO has to compete with a Hong Kong dollar-denominated IPO."[33] Indeed, the Hui Xian offering has proven to be disappointing so far; although the IPO raised 10.5 billion in offshore yuan at CNH 5.24, Hui Xian shares fell nearly ten percent on its April 29, 2011 secondary market debut and fell further later the week.[34]

D. Fourth Prong: Permitting New Methods of Repatriating Offshore RMB for Onshore Investment

The last prong in the gradual liberalization of yuan involves allowing it to come full circle, permitting RMB funds raised offshore to be reinvested onshore in the domestic Chinese markets. The rules for the new RQFII (Renminbi Qualified Foreign Institutional Investor) program (previously known by its nickname "mini-QFII") were announced on December 16, 2011.[35] The RQFII program allows retail offshore investors (e.g. Hong Kong subsidiaries of Mainland fund management companies or securities firms) to invest into RMB-denominated funds directly using their offshore RMB.[36] The initial quota for the RQFII program is capped at RMB 20 billion (approximately $3 billion USD),[37] with RMB 10.7 billion granted to the first tranche of 10 companies in December 2011[38] and RMB 8.2 billion granted to the

[32] Peter Pang, Deputy Chief Exec., H.K. Monetary Auth., Speech at the Hong Kong Institute of Bankers Third Annual Banking Conference, Hong Kong: The Premier Offshore Renminbi Business Centre (Sept. 27, 2011).

[33] Glori Ye, *Renminbi Opportunities to Expand*, FIN. TIMES (Jan. 23, 2011, 9:48 AM), http://www.ft.com/intl/cms/s/0/7a6ba938-26c6-11e0-80d7-00144feab49a.html.

[34] *Debut Renminbi IPO on HKEx Strikes Muted Note*, THE TRADE (May 5, 2011), http://www.thetradenews.com/trading-venues/exchanges/6133. "CNH" is the currency code for offshore RMB in Hong Kong. *Id.*

[35] Jeckle Chiu et al., *New RQFII Rules Announced: New Ways to Use Offshore RMB—Part II*, MAYER BROWN LLP (Jan. 4, 2012), http://www.mayerbrown.com/publications/article.asp?id=12028&nid=6.

[36] *Id.*

[37] Lingling Wei, *China Grants Licenses for New Yuan Program*, WALL ST. J. (Dec. 22, 2011, 12:54 PM), http://online.wsj.com/article/SB10001424052970204464404577114333764137066.html?KEYWORDS=%22China+Grants+Licenses+for+New+Yuan+Program%22.

second tranche of funds in January 2012.[39] As part of risk control,[40] the guidelines state that at least eighty percent of the RQFII funds must be allocated to investments in fixed income products and no more than twenty percent can be used for investment in equities[41] (*e.g.* A-shares and equity funds in the Mainland[42]).

E. Review of the Progress of the Four Prongs

Regarding the first prong ("relax restrictions on inbound and outbound foreign direct investment"), the Mainland government has initiated a number of programs relaxing inbound and outbound foreign direct investment (FDI), including WFOE, QFII, QFLP on the inbound side, and QDII and M&A and greenfield projects on the outbound transfers.[43] However, the scale of these programs is still stunted. As of March 2011, only 109 entities had been approved for QFII licenses since the program's inception in 2003.[44] As of April 26, 2011, only thirty six entities had been given QDII licenses.[45]

In evaluating the second prong ("expand RMB trade settlement"), the number of Chinese enterprises subscribing to RMB trade settlement has expanded over 200 times since its recent advent in 2009. And yet, while 500 billion RMB of global trade was settled in 2010 alone, that figure amounted to only a tiny slice—two percent—of all trade worldwide.[46] So, while RMB trade settlement has accelerated rapidly given its short history, the scheme has a long way to go.

As for the third prong ("encourage the proliferation of RMB-denominated offshore financial products in Hong Kong"), while there has been a myriad of these products and the rapid escalation in use of those products has been

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[38] Chiu et al., *supra* note 35.

[39] Melanie Lee, *China Has Approved Second Tranche of RQFII Quotas*, REUTERS (Jan. 5, 2012, 9:25 PM), *available at* http://www.reuters.com/article/2012/01/06/china-yuan-rqfii-idUSL3E8C60CH20120106.

[40] Chiu et al., *supra* note 35.

[41] *See* Wei, *China Grants Licenses for New Yuan Program*, *supra* note 37.

[42] Chiu et al., *supra* note 35.

[43] ASIA SOC'Y, *supra* note 25.

[44] *China QFII Member List, March 2011*, CHINASTOCKVENTURE.COM (Apr. 26, 2011), http://chinastockventure.com/2011/04/china-qfii-member-list-march-2011.

[45] *List of China QDII Funds, April 2011*, CHINASTOCKVENTURE.COM (Apr. 26, 2011), http://chinastockventure.com/2011/04/china-qdii-fund-list-april-2011.

[46] Angela Koll, *Making the Most of the Renminbi Opportunity*, TREASURY MGMT. INT'L, http://www.treasury-management.com/article/1/219/1875/making-the-most-of-the-renminbi-opportunity.html (last visited Mar. 22, 2012).

admirable, significant explanation of their usages is required. For instance, the volume of dim sum bonds has doubled in 2011 to 85.3 billion RMB.[47] Thirty-two banks have arranged dim sum bond deals in 2011 (as of July 2011) compared with fifteen in 2010.[48] Monthly trading volumes of dim sum bonds are up to three billion RMB in July, compared to January's 200 million RMB.[49] Deutsche Bank has even initiated an index tracking the dim sum bonds as trading volumes have "surged," according to Bloomberg.[50] However, the volume of the worldwide bond market is estimated at $95 trillion U.S. dollars,[51] which makes the volume of the dim sum market appear as an infinitesimal droplet in a deluge—a mere one-thousandth of all bonds worldwide. On the IPO side, one can be also reminded that there has been only one RMB IPO so far, as of January 2012.[52]

As for the final prong ("permitting new methods of repatriating offshore RMB for onshore investment"), as of January 2012, the RQFII scheme has just been launched and its success or failure has yet to be determined.

To conclude, while the steps taken toward the opening of China's capital account are auspicious and the acceleration of its programs commendable, China must increase the scale of all four prongs of the capital account liberalization program before China's capital account can be fully open.

II. RISKS: POTENTIAL PITFALLS IN RMB LIBERALIZATION

The tentative approach the Chinese government has taken toward liberalization, with multiple prongs and stages, indicates its keen awareness that certain perils may lurk on the path to reform. Section III of this article will address five potential pitfalls in the use of Hong Kong as an experimental offshore RMB center and how the government is guarding against these dangers. Such possible perils include: (1) liquidity and/or currency risk; (2) concentration of credit risk; (3) hot money and illegal funds; (4) complexity of interactions for offshore RMB hubs; and (5) asymmetry in currency demand resulting in accumulation of more foreign exchange reserves.

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[47] Flon Li, *Deutsche Bank Starts Dim Sum Bond Index as Volumes Rise*, BLOOMBERG NEWS (July 18, 2011, 4:56 AM), http://www.bloomberg.com/news/2011-07-18/deutsche-bank-starts-dim-sum-bond-index-as-trading-volumes-rise.html.

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Financial Markets Series: Bond Markets, July 2011*, THECITYUK, http://www.thecityuk.com/assets/Uploads/BondMarkets2011.pdf (last visited Apr. 11, 2012)

[52] *UPDATE: CCRC Vice Chair: To Encourage Yuan-IPOs in HK, Streamline Overseas Listing Rules*, WALL ST. J. (Jan. 16, 2012, 3:05 AM), http://online.wsj.com/article/BT-CO-20120116-701462.html.

A. Liquidity and/or Currency Risk

In order for the burgeoning offshore RMB markets to function smoothly, for contracts involving RMB payment to be reliably enforced, and for public offerings or bond issues denominated in RMB to successfully sell, a large and liquid pool of RMB must be available offshore. Otherwise, transactions performed in RMB are subject to additional currency risk and nebulous practical and legal concerns. 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? And when can the U.S. dollar be used as a backup settlement currency? In reality, as of April 2011, Hong Kong has a significant reservoir of RMB deposits (estimated at RMB 408 billion or USD 62 billion).[53] But even the fear that its shares would be difficult to liquidate in a secondary market may have a chilling effect and keep investors gun-shy about investing in RMB products.[54]

More than one commentator has noted that the lackluster performance of the much-anticipated Hui Xian IPO in Hong Kong—the first offshore RMB IPO—was likely related to the fact that investors did not feel that there was enough RMB to support equity trading of the stock.[55] Not to mention the fact that a RMB product in an offshore market such as Hong Kong is competing for cash from the same investors that could be investing in Hong Kong dollar-denominated products, which could potentially produce a comparable or higher return without the currency risk. On the other hand, some market analysts have noted that the improvement in the size of offshore RMB bond issuances by both government and corporate issuers in Hong Kong should relieve concerns about both liquidity and the existence of a willing offshore investor base: as of December 2010, there have been RMB 73.8 billion in bond issuances in the aggregate, and the first two months of 2011 saw RMB 7.8 billion bond issuances.[56] In 2011, the Bank of China and the Bank of Communications issued RMB 20 billion bonds offshore in Hong Kong, and reports indicate that the Agricultural Bank of China is planning to sell up to RMB 10 billion in the next two years.[57]

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[53] Robert Cookson, *HK's First Renminbi IPO: Overhyped?*, BEYONDBRICS (Apr. 20, 2011, 11:49 AM), http://blogs.ft.com/beyond-brics/2011/04/20/hks-first-renminbi-ipo-overhyped.

[54] *Id.*

[55] *Id.*

[56] Jarvis Smith, *Spotlight: China's RMB*, CITIBANK, http://www.citibank.com/transactionservices/home/region/fiacademy/docs/rmb_internationalization_preso.pdf (last visited Apr. 11, 2012).

[57] *Id.*

Solutions that would ameliorate the concern regarding RMB liquidity may include currency fallback clauses synthetic products in the short term, and the proposed new RMB Equity Trading Support Facility in the long term.

Currency fallback clauses allow issuers to pay back investors in U.S. dollars in the case of a RMB shortage.[58] In the past, there was fear that the regulators either in Hong Kong or the Mainland would strike such clauses down, but they have since become commonplace.[59] A synthetic "dim sum" bond is another quick-fix solution to liquidity or currency risk concerns. Since the synthetic bond is denominated and paid for in RMB but settled in U.S. dollars, it may reduce liquidity and currency risk related fears.

As a longer term solution, a new scheme, called the RMB Equity Trading Support Facility ("TSF") was launched by the Hong Kong Exchanges and Clearing Limited in October 2011.[60] The facility helps investors to exchange their Hong Kong dollars for RMB to purchase secondary market RMB-denominated shares, with the TSF partner banks determining the exchange rate between the RMB and HKD on a commercial basis.[61] After selling the shares, investors under the scheme may return the RMB to the facility for an equal amount of Hong Kong dollars under the TSF's exchange rate at the relevant time.[62]

B. Concentration of Credit Risk

Since December 2003, the Bank of China (Hong Kong) ("BoCHK") has been the sole Hong Kong offshore clearing bank in an arrangement with the PBoC on the Mainland.[63] Investors and Hong Kong banks have feared that the credit and concentration risk on their deposits with BoCHK and the bottleneck created by this clearing system would prove unacceptable.[64]

As a solution, on March 31, 2011, the Hong Kong Monetary Authority ("HKMA") announced the "Renminbi (RMB) Fiduciary Account" program.[65]

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58 LINKLATERS LLP, *Offshore RMB—A One-Way Bet*, FIN. ASIA MAG. (May 19, 2011), http://www.financeasia.com/News/257829,offshore-rmb-8212-a-one-way-bet.aspx.

59 *Id.*

60 Jeckle Chiu, *The New RMB Equity Trading Support Facility: Update No. 2*, MAYER BROWN LLP (Nov. 22, 2011), http://www.mayerbrown.com/publications/article.asp?id=11868&nid=6.

61 Jeckle Chiu & Juliana Lee, *The New RMB Equity Trading Support Facility*, MAYER BROWN LLP (May 12, 2011), http://www.mayerbrown.com/publications/article.asp?id=10960&nid=6.

62 *Id.*

63 LINKLATERS LLP, *supra* note 58.

64 *Id.*

65 ARTHUR YUEN, H.K. MONETARY AUTH., RENMINBI (RMB) FIDUCIARY ACCOUNT (Mar. 31, 2011), *available at* http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines

Authorized institutions may opt to place RMB funds in excess of their daily business and settlement needs in a segregated fiduciary account. Participating authorized institutions are required to maintain a total amount of RMB cash and settlement account balance with BoCHK equal to no less than twenty five percent of their RMB customer deposits.[66] The rest is swept into the fiduciary account until the cash is required again for transactions.[67] The purpose of this system is to have the majority of credit exposure of the banks borne by PBoC and not by the BoCHK, whose risk is limited to the twenty five percent maintained with the BoCHK.

C. Hot Money and Illegal Funds

Through the nineties and early 2000s, capital flight from China during the capital account liberalization process was a concern.[68] However, with the expectation of RMB appreciation in the new millennium, speculation had driven fund flow inwards until September 2011, a phenomenon commonly known as "hot money."

Liu Wei, director-general of the General Affairs Department of the SAFE, defined the phenomenon in an interview with Century Weekly, as follows:

> In economies with free flows of capital, hot money generally refers to capital moving rapidly in and out of the country for the purpose of short-term speculative profits. Due to China's capital account management, short-term capital is not allowed free entry or exit; therefore, the key to determining whether some capital is hot money is to find out whether the capital flows are for real and legitimate trade or investment purposes.[69]

It is sometimes difficult to "draw the line between investment and speculation," admitted Liu.[70]

Those entities and individuals sending flows of hot money into the Mainland were attempting to "game the system" by utilizing the differences between foreign and domestic exchange rates and interest rates for short term

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-and-circular/2011/20110331e2.pdf.

[66] *Id.*

[67] *Id.*

[68] Yin-Wong Cheung & XingWang Qian, Capital Flight: China's Experience 34, Figure 1 (Sept. 2009) (unpublished paper), *available at* http://faculty.buffalostate.edu/joth/pk2009/Site/program_files/Qian.pdf.

[69] Interview with Liu Wei, *supra* note 16.

[70] *Id.*

gain from expected rises in either asset prices or RMB appreciation.[71] Pathways for hot money that Liu cited in his speech included using open and unpatrolled channels such as cargo trade, service trade and direct investment.[72] For example, a person might disguise speculative investment as legitimate foreign direct investment and instead use the funds to play the stock or property markets after faking a capital settlement. Hot money can also make its way through illegal routes such as underground money shops and online entities engaging in foreign exchange speculation without a license.

SAFE had vowed to curb hot money flows and illegal funds vigorously, and to announce publicly the penalties imposed on illegal money shops and online foreign exchange speculative entities located in Shenzhen, Zhuhai, Dongguan, and Enping of Guangdong province, Yunnan province, and Zhangzhou city of Fujian province.[73] The sentences for various crimes committed between 2007 and 2010 have been described in detail in the Circular.[74] Penalties included, for most, fixed prison terms, a fine for the crime of illegal operations or cross-border transactions, confiscation of on-site illegal income, and freezing of bank accounts.[75]

However, Liu acknowledged that in the pursuit of profits, violators may turn a blind eye to the severe penalties instituted by China.[76] While SAFE had been levying and publicizing penalties incurred by hot money and illegal funds violations, it was also trying to fortify the system of regulation, by "strengthen[ing] the management of banks' positions in foreign exchange settlement and sales, and short-term external debts and to reinforce the banks' obligation to verify the authenticity [of the investor] when dealing with foreign exchange businesses.[77]

Liu also stated that SAFE would attempt to further four simultaneous goals: (1) maintaining vigorous enforcement efforts against hot money flows by stepping up their examinations and inspections of banks; (2) improving methods for regulation of foreign exchange and cross-border capital inflows, with follow-up examinations following exchange settlement and reinforcing the regulation of off-balance-sheet financing; (3) promoting the liberalization of China's capital markets; and (4) using foreign exchange and interest rates to

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[71] *Id.*

[72] *Id.*

[73] *Circular of the SAFE on Penalties Imposed on Underground Money Shops, Online Foreign Exchange Speculation, and Other Kinds of Illegal Foreign Exchange Transactions*, STATE ADMIN. OF FOREIGN EXCH. (Nov. 5, 2010), http://www.safe.gov.cn/model_safe_en/news_en/new_detail_en.jsp?ID=30100000000000000,263.

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] Interview with Liu Wei, *supra* note 16.

provide guidance and eliminate arbitrage opportunities attractive to hot money.[78]

In addition to SAFE's vigorous enforcement on the Mainland, the HKMA had also taken concrete steps to reduce the threat of cross-border hot money flows and to manage foreign exchange rate risk, including limiting net open positions, so that authorized institutions cannot maintain RMB net open positions (either net long or net short) in excess of ten percent of their RMB assets or liabilities.[79]

Hot money has flowed out of the country, however, beginning in September 2011 and continuing through January 2012. Some market analysts have ascribed the hot money outflows to "diminished expectations of yuan appreciation, falling property prices and a deepening crisis in Europe pushing investors away from risky positions.[80]

In dealing with the risk of quick hot money inflows and outflows, steps that I would suggest include: (1) implementing lock-ups, so that capital invested in entities on the Mainland must remain there for significant fixed terms, (2) limiting leverage, and (3) issuing longer term bonds such as sovereign issuances with longer maturities.

D. Complexity of Interactions for Offshore RMB Hubs

Although there had been some speculation that Singapore would be named a second offshore yuan hub in addition to Hong Kong,[81] it was announced in early 2012 that London would instead be given the honor. In January 2012, the British government signed an agreement with the Hong Kong Monetary Authority with the intention of making London the primary global center for offshore trading of the renminbi.[82]

As for what city would serve as a third hub city outside of Hong Kong and London (or if in fact there would be another RMB trading hub), the question remains open. One economist and Asia scholar predicts that Kuala Lumpur, Jakarta, Manila, Seoul, and perhaps one day Taipei will be the runners-up in

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[78] *Id.*

[79] ARTHUR YUEN, H.K. MONETARY AUTH., RENMINBI (RMB) CROSS-BORDER TRADE SETTLEMENT AND NET OPEN POSITION (Dec. 23, 2010), *available at* http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2010/20111223e1.pdf.

[80] Tom Orlik, *Hot Money's Hurried Exit from China*, CHINA REAL TIME REPORT (Nov. 21, 2011, 8:30 PM), http://blogs.wsj.com/chinarealtime/2011/11/21/hot-money%E2%80%99s-hurried-exit-from-china/.

[81] Lingling Wei, *Singapore Has a Leg Up in Trading Hub Race*, WALL ST. J., June 2, 2011, at R6.

[82] William Kemble-Diaz, *UK Government Jumps on the Bandwagon as Yuan Market Blooms*, WALL ST. J. (Jan. 20, 2012, 9:16 AM) http://online.wsj.com/article/BT-CO-20120120-707136.html.

this beauty pageant.[83] The *Wall Street Journal* listed the following cities as potential candidates for future offshore RMB-trading centers: Singapore for Southeast Asia; Dubai for Middle East and North Africa; Johannesburg for sub-Saharan Africa; Moscow for Commonwealth of Independent States; New York for North America; and Sao Paulo for South America.[84]

With multiple hubs, the question of how all of these hubs will interact necessarily arises. A difference in value and yield already has arisen between onshore RMB and offshore RMB in Hong Kong.[85] Interest and exchange rates for offshore RMB in Hong Kong and onshore RMB also differ, because the Mainland government determines the rates onshore.[86]

Although RMB is considered one currency, it is functionally more similar to three currencies that trade at different rates.[87] There is the onshore RMB (known by the currency code "CNY"), offshore RMB in Hong Kong (known by the currency code "CNH"), and the traditional dollar-settled non-deliverable forward ("NDF"s), which trades independently of CNY and CNH.[88] The difference in values, appreciation expectations, and yields between CNH and CNY relates to the relative difficulty in making cross-border transfers for each.[89] Because the onshore and offshore pools have been kept separate, they result in different market equilibriums. However, as channels flowing between the two gradually enlarge, they eventually will converge.[90] The NDF market existed prior to the establishment of the CNH market, but the NDF market is fixed by reference to the onshore CNY market rates and the NDF is priced with reference to expectations for actual future onshore CNY spot rates.[91] The divergence between CNY and CNH was set intentionally—the government's idea was to purposely segregate onshore and offshore liquidity.[92]

Once London formalizes its status as an offshore RMB trading hub, how will the differences in the values and yields of offshore RMB in London and those of offshore RMB in Hong Kong be reconciled with each other?

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[83] Pieter Bottelier, *The Future of the Renminbi as an International Currency*, CHINA US FOCUS (Apr. 29, 2011), http://www.chinausfocus.com/finance-economy/future-of-the-renminbi-as-an-international-currency.

[84] Wei, *Singapore Has a Leg Up in Trading Hub Race*, *supra* note 81.

[85] DANIEL HUI & DOMINIC BUNNING, HSBC, THE OFFSHORE RENMINBI: A PRACTICAL PRIMER ON THE CNH MARKET (Dec. 1, 2010), *available at*, http://www.research.hsbc.com/midas/Res/RDV?p=pdf&key=UHa14N6Tu3&n=282753.PDF.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.* at 4.

[91] *Id.*

[92] *Id.* at 5.

Separately, how will they be reconciled with RMB values and yields in Mainland? With a greater number of hubs, the number of such logistical problems could multiply. Since each hub may have its own separate clearing bank, logistical questions may also arise as to how these banks will interact and how the potentially differing credit risk of each may need to be addressed.

E. Asymmetry in Currency Demand

Yu Yongding, President of the China Society of World Economics and a former member of the monetary policy committee of the PBoC, published an essay in May 2011 in *Caijing* magazine arguing that China's promotion of the renminbi in international transactions may backfire and result in China accumulating even larger foreign exchange reserves.[93] The article postulated that since, at the time, the renminbi was expected to appreciate, those importing Chinese goods would likely refuse to use the renminbi to settle transactions, whereas foreign exporters would be eager to accept the renminbi.[94] Similarly, while RMB-denominated bonds were popular, non-Chinese entities would not have the motivation to issue them when they could hold on to an appreciating currency instead.[95] And while foreign lenders would be thrilled to offer RMB loans, foreign borrowers would have no real appetite to incur loans and pay back interest utilizing an appreciating currency.[96] China's attempts to increase the global use of the renminbi in such a way could create a paradox: although the Chinese government wishes to internationalize renminbi and escape the "dollar trap,"[97] China would potentially instead accumulate even greater foreign exchange reserves due to this currency demand mismatch.

One possible solution to this dilemma may arise if a super-sovereign currency, such as Special Drawing Rights ("SDRs"), becomes the standard for settling international trade. SDRs, which were originally created by the IMF in 1969 after the Bretton Woods conference,[98] are based on a basket of currencies

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93 Yu Yongding, *The Renminbi's Journey to the World*, CAIJING (May 31, 2011, 3:21 PM), http://english.caijing.com.cn/2011-05-31/110734053.html.

94 *Id.*

95 *Id.*

96 *Id.*

97 The "dollar trap" is a term which has been used to describe China's current situation: in order to keep its currency more or less fixed to the dollar, China had to buy up U.S. treasuries as it ran large trade surpluses. Now the lion's share of its foreign exchange reserves are denominated in U.S. dollars and so any fall in value of the dollar would result in a large capital loss for China. *See* Paul Krugman, Editorial, *China's Dollar Trap*, N.Y. TIMES, Apr. 2, 2009, at A29, *available at* http://www.nytimes.com/2009/04/03/opinion/03krugman.html.

98 IMF, *Special Drawing Rights*, *supra* note 9.

currently composed of the U.S. dollar, the Euro, the yen and the British pound. Zhou Xiaochuan, Governor of the PBoC, released a published statement on the Central Bank's website on March 23, 2009, in which he called for the dollar to be replaced by SDRs. Of course, since the current SDR basket is heavily weighted towards the dollar, China might also press for the inclusion of a greater array of currencies in the basket—including, perhaps, some emerging markets currencies such as the renminbi.

Another option to escape the dollar trap is for China, which is currently allowing its currency to gradually appreciate relative to the dollar, to diversify away from U.S. dollar reserves and to begin purchasing the currencies of other nations to change the composition of its foreign exchange reserves, as it began doing in the early months of 2011.[99]

In the last quarter of 2011, however, a reversal has occurred in the accumulation of foreign exchange reserves. For the first time in 14 years, Chinese foreign exchange reserves have dropped (to $3.18 trillion at the end of the year from a high of $3.274 trillion in October).[100] Since foreign direct investment and trade surplus data are still positive, market analysts suggest that the reversal of hot money flows are to blame.[101]

III. PREDICTIONS: FUTURE POLICIES TOWARD INTERNATIONALIZATION

Chinese government officials have been rather coy when asked about their aspirations for the yuan. When an interviewer asked, "Is it possible for the RMB to become a reserve currency? Does the world need it?," Yi Gang, the Deputy Governor of the PBoC, responded:

> This compliment is half flattery, half prediction. We should be modest and prudent and keep a low profile. If the RMB is chosen by other countries to be a reserve currency, we will let it happen because it is a market demand. But we are not going to push it. I think the best way is to let things run their own course. We must not take the flattery too seriously; in fact, the RMB is still far from being a reserve currency.[102]

Yi continued:

[99] Tracy Alloway, *China Is Finally Buying Fewer U.S. Treasuries, StanChart Says*, ALPHAVILLE (June 20, 2011, 12:06 PM), http://ftalphaville.ft.com/blog/2011/06/20/599391/china-is-finally-buying-fewer-us-treasuries-stanchart-says.

[100] *China's Forex Reserves Fall for First Time Since Asian Crisis*, THE TELEGRAPH (London) (Jan. 13, 2012, 7:20 AM), http://www.telegraph.co.uk/finance/financialcrisis/9012053/Chinas-forex-reserves-fall-for-first-time-since-Asian-crisis.html.

[101] Craig Stephen, *Eyeing China's Response to Drop in Forex Reserves*, MARKETWATCH (Jan. 15, 2012, 9:26 PM), http://www.marketwatch.com/story/chinas-foreign-reserves-fall-2012-01-15.

[102] Interview with Yi Gang, *supra* note 3.

> For a currency to become a reserve currency, the first[,] most important factor is the economic strength of that country or confederation; the second is its cultural cohesion and influence; and the third is political and military power. Economic strength is the deciding factor. . . . A reserve currency must be backed by a powerful culture and influential value system. Do not underestimate the resilience of the U.S. and Europe.[103]

The PBoC Governor's published statement calling for the dollar to be replaced by SDRs was a bit more direct; while Zhou Xiaochuan did not call for the RMB to replace the U.S. dollar as a world currency, the statement clearly implied that there should be *some* alternative to the U.S. dollar as the world's primary reserve currency.[104]

Since no government official has openly declared that the yuan merits a spot on the stage of world reserve currencies, one can only read between the lines of official statements and surmise based on historical analogues. Dr. Barry Eichengreen, a professor at the University of California-Berkeley, compares the U.S. dollar in 1914 with the RMB today.[105] Eichengreen points out that the U.S. dollar overtook the pound sterling as the world's premiere international currency in the ten years between 1914 and 1924.[106] To accomplish this, Eichengreen identifies three "concerted steps"[107] that United States government took in those years; in that time, the U.S. promoted the currency's use in settling and invoicing trade, its use in private financial transactions, and its use by central banks and governments as a form in which to hold foreign reserves.[108] Of course, it can be argued that in that same era, England bankrupted itself during World War I, and that the distress of its pound sterling was just as large a contributing factor to the dollar's rise as any attempt by the U.S. government to promote its own currency. One might also argue, analogously, that, taking into account the recent credit crisis and its current budget deficits, the United States economy is in a weakened state, and that the U.S.'s current vulnerability might be just as large a cause of the renminbi's incipient rise to reserve currency status as any concerted effort of the Chinese government to promote its own currency.

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[103] *Id.*

[104] Zhou Xiaochuan, *Reform the International Monetary System* (Mar. 23, 2009), http://www.bis.org/review/r090402c.pdf?frames=0.

[105] Barry Eichengreen, The Renminbi as an International Currency (2010) (unpublished paper), *available at* http://www.econ.berkeley.edu/~eichengr/renminbi_international_1-2011.pdf.

[106] *Id.*

[107] *Id.* at 3.

[108] *Id.* at 1–3.

As described earlier in this article, the Chinese government has begun encouraging the use of the renminbi in international trade settlement, which Eichengreen identifies as step one,[109] through its pilot trade settlement program, which has expanded rapidly from five to twenty Mainland cities and from including HKSAR, Macao SAR, and ASEAN as trading partners to including all overseas countries as trading partners.[110] Step two, promoting the currency's use in private financial transactions,[111] is currently being promoted and is continuing to evolve as the government permits a proliferation of offshore RMB financial tools to emerge in Hong Kong. As for step three (encouraging its use by central banks and governments as a form in which to hold reserves),[112] the next section will describe the Chinese government's progress.

A. International Expansion, Four Ways

I predict that the use of the renminbi will be allowed to expand globally in the following four ways: (1) the RMB will grow in influence in the Asian region (including in Kuala Lumpur, Manila, Jakarta, Seoul, and Taipei, among others.); (2) the rest of the BRICS countries (Brazil, Russia, India and South Africa) will increase their use of the RMB; (3) the RMB will achieve greater relevance in the financial capitals of the West (including in New York and London); and (4) the Mainland government will press for the yuan's inclusion in the currency basket of which the SDR is composed when it comes up for IMF review in 2015.

1. Asian Region

The Chinese government has been promoting the use of RMB in other Asian countries for over a decade now.[113] This push began with the Chiang Mai Initiative, launched on March 24, 2010, which put into place bilateral currency swaps between Korea, China and Japan and the ASEAN countries (Indonesia, Malaysia, Singapore, Philippines and Thailand). While China's multi-billion dollar swaps with Thailand, Malaysia and Indonesia were performed using U.S. dollars, the swaps with Japan, Korea and the Philippines were performed using

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[109] *Id.* at 3.

[110] Subacchi, *supra* note 22.

[111] Eichengreen, *supra* note 105, at 3.

[112] *Id.*

[113] Miguel Otero-Iglesias, The Internationalisation of the Renminbi (RMB): A Strategy of Crossing the River by Feeling the Stones (2010) (unpublished symposium article), *available at* http://www.igadi.org/china/2011/pdf/moi_the_internationalisation_of_the_renminbi.pdf.

RMB.[114] China then signed additional bilateral currency swap agreements during the midst of the recent global financial crisis with the following countries: Korea (in December 2008), Hong Kong (in January 2009), Malaysia (in February 2009), Belarus (in March 2009), Indonesia (in March 2009), Argentina (also in March 2009), Iceland (in June 2010) and Singapore (in July 2010).[115]

The possibility that a brand new Asian regional currency other than the RMB might rise to unify all of the many currencies of Asia in a fashion akin to the unifying Euro in Europe seems doubtful. As one example of the acknowledgement of the importance of the yuan in the Asian region, South Korea's $35 billion sovereign wealth fund, the Korea Investment Corporation, applied for a QFII license in October 2010 to allow it to invest directly in China's stock market in yuan-denominated assets.[116] As a second example, Taiwanese authorities made a call to foreign banks to apply for a license to offer RMB services in Taiwan; starting September 19, 2011, HSBC became the first bank to offer such RMB services (including deposits, remittances, FX, trade, investments, loans and receivables finance).[117] As a third and perhaps the most dramatic example, Japan and China signed a currency agreement in December 2011 to allow for direct trading of their currencies, and Japan will apply to buy Chinese bonds beginning in 2012 to accumulate more yuan for its foreign exchange reserves.[118]

Yi Gang identified a country or confederation's "cultural cohesion" as the second factor necessary for a currency to become a reserve.[119] This may be the reason that, in terms of offshore hubs, China has looked first to Hong Kong, which is a special administrative region of China and also shares its language and culture. The next logical expansion may be to other countries in the Greater China region with large numbers of overseas Chinese residents and where the Chinese culture has been influential (for example, Malaysia, Taiwan, or Indonesia) and then to the wider South East Asian and East Asian regions, which may have a shared regional understanding (for example, the Philippines, Thailand, South Korea, or Japan, among others).

[114] *Id.*

[115] *Id.*

[116] Ju-Min Park, *S.Korea KIC Applies for China QFII License*, REUTERS (May 5, 2011, 12:42 AM), *available at* http://www.reuters.com/article/2011/05/05/kic-china-idUSL3E7G50EN20110505.

[117] *HSBC to offer RMB services in Taiwan*, CHINA DAILY (Sept. 15, 2011, 9:29 AM), http://www.chinadaily.com.cn/bizchina/2011-09/15/content_13691184.htm.

[118] Edward Wong & Natasha Singer, *Currency Agreement for Japan and China*, N.Y. TIMES, Dec. 26, 2011, at B1.

[119] Interview with Yi Gang, *supra* note 3.

2. Other BRICS Countries

The BRICS countries have been regarded as "all-stars" in terms of new economic development; these nations have led the global recovery from the recent credit crisis, and have been predicted to become powerhouses in the world economy by 2050.[120]

In June 2009, the governors of the Central Banks of China and Brazil (PBoC Governor Zhou Xiaochuan and Banco Central do Brazil President Henrique Meirelles) agreed that their respective governments would begin exploring how bilateral trade between their two countries should be settled in their respective currencies, without the use of the U.S. dollar as an intermediary.[121] In November 2010, following meetings in St. Petersburg, the Premier of China, Wen Jiabao, and Russian President Vladimir Putin announced that they would cease using the U.S. dollar for their bilateral trade settlements, opting instead to use the ruble or the yuan.[122] On June 23, 2011, China and Russia signed a revised bilateral trade settlement agreement, under which both individuals and corporations from either country can conduct settlements and payments using the ruble, the yuan and other freely convertible currencies; according to the revised agreement, not only can cross-border trade be conducted in either the ruble or the yuan, but ordinary trade also may be conducted in either currency.[123]

There have been three BRICS summits to enhance mutual cooperation.[124] At Sanya in April 2011, the five BRICS countries agreed to a currency alliance, signed by the designated banks of the five representative countries, and affirmed that they would provide credit to each other in their local currencies and further collaborate with one another in financial services and capital markets.[125]

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[120] DOMINIC WILSON & ROOPA PURUSHOTHAMAN, GOLDMAN SACHS, DREAMING WITH BRICS: THE PATH TO 2050 (Oct. 1, 2003), *available at* http://www2.goldmansachs.com/our-thinking/brics/brics-reports-pdfs/brics-dream.pdf.

[121] *China, Brazil Reported Planning Trade Deal*, MARKET WATCH (June 28, 2009, 10:54 PM), http://www.marketwatch.com/story/china-brazil-plan-currency-trade-deal-reports.

[122] Chris Oliver, *China, Russia to Drop Dollar in Bilateral Trade*, MARKET WATCH (Nov. 23, 2010, 11:38 PM), http://www.marketwatch.com/story/china-russia-to-drop-dollar-in-bilateral-trade-2010-11-23.

[123] *China, Russia Sign Currency Settlement Deal*, CHINA DAILY (June 24, 2011, 10:35 AM), http://www.chinadaily.com.cn/bizchina/2011-06/24/content_12767947.htm.

[124] These include the 2009 summit in Yekaterinburg, Russia, the 2010 summit in Brasilia, Brazil, and the 2011 summit in Sanya, China. *See 2011 BRICS Summit in Sanya, China*, GOV'T OF SANYA, http://english.sanya.gov.cn/publicfiles/business/htmlfiles/englishsite/brics/index.html (last visited Mar. 12, 2012).

[125] *Fab Five Forge Currency Alliance*, TELEGRAPH INDIA (Calcutta), Apr. 14, 2011, at 1, *available at* http://www.telegraphindia.com/1110415/jsp/business/story_13856760.jsp.

Chen Yuan, the head of the China Development Bank ("CDB"), stated that he was willing to lend up to ten billion RMB to his fellow BRICS participants,[126] and the chairman of Vnesheconombank, Russia's state development bank, Vladmir Dmitriev, stated that he was interested in borrowing the RMB equivalent of at least 500 million U.S. dollars from the CDB to "broaden the opportunities for Russian companies to diversify their loans."[127] The CDB's statement that it would willingly lend its other conference participants up to ten billion RMB signals China's desire to cooperate with its fellow BRICS in providing an alternative to the U.S. dollar.

3. World Financial Capitals

At the same time that the Chinese government may be looking to expand the use of the RMB both within the Asian region and to the other BRICS countries, it is unlikely the government would overlook Western financial capitals when promoting the international use of the RMB. London has been announced as a global RMB trading hub, following Hong Kong.[128] In the U.S., the Bank of China Ltd. offers corporate service in yuan in New York City and Los Angeles, with personal customers in New York able to convert as much as four thousand U.S. dollars per day into RMB, with a maximum of twenty thousand U.S. dollars per annum.[129] The deposits in New York, though not those in Los Angeles, are FDIC insured against bank failure, and the accounts must be opened in person in both locations.[130] However, according to the *BeyondBrics* blog of the *Financial Times*, customers have not yet been able to deposit or withdraw RMB in cash from those accounts; the RMB can only be remitted from China by either the account holders themselves or by their relatives.[131] Alternatively, the customer can purchase yuan from the bank with U.S. dollars.[132] Bank of China clients in London and Canada have also been able to open up RMB savings and deposits accounts, with limitations.[133] HSBC

[126] *Id.*

[127] *Id.*

[128] *See* Kemble-Diaz, *supra* note 82.

[129] *Bank of China Begins Offering Yuan Deposits*, BLOOMBERG NEWS (Jan. 12, 2011), http://www.bloomberg.com/news/2011-01-11/bank-of-china-begins-offering-yuan-service-to-customers-of-u-s-branches.html.

[130] Brett Arends, *Do You Need a Chinese Bank Account?*, WALL ST. J. (Jan. 14, 2011, 7:07 PM), http://online.wsj.com/article/SB10001424052748704307404576080222812076888.html.

[131] Jamil Anderlini & Robert Cookson, *China Makes it Easier to Save Renminbi*, BEYONDBRICS (Jan. 12, 2011, 12:15 PM), http://blogs.ft.com/beyond-brics/2011/01/12/china-gets-more-flexible-about-its-currency/.

[132] *Id.*

[133] BOTTELIER, *supra* note 83.

clients can open UK-based RMB accounts to conduct and settle yuan trade deals directly with China, in transactions both onshore and offshore.[134]

4. Inclusion in the SDR Basket

Lastly, the Mainland government is likely to press for the yuan's inclusion in the SDR basket when it comes up for review by the IMF in 2015. The Joint Declaration agreed to by the five participating countries of the BRICS Summit 2011 included the following language:

> Recognizing that the international financial crisis has exposed the inadequacies and deficiencies of the existing international monetary and financial system, we support the reform and improvement of the international monetary system, with a broad-based international reserve currency system providing stability and certainty. We welcome the current discussion about the role of the SDR in the existing international monetary system *including the composition of SDR's basket of currencies.*[135]

Not only does this announcement underscore the desire of the BRICS participants to become less reliant on the U.S. dollar and the shared belief by the BRICS countries that the SDR should have a greater role internationally, but it also opens up the discussion of *which* currencies should be included in the composition of the SDR's basket of currencies. The renminbi may be a top contender for a slot in a revised basket. Certainly, the renminbi possesses many of the attributes that a recent policy paper prepared by the IMF's Strategy, Policy and Review Department identifies as attractive:

> Including emerging market currencies in the basket as their shares in global trade and finance increase could enhance the attractiveness of the SDR by increasing its diversity and representativeness. Moreover, such [a] process could facilitate a greater role for emerging markets in the [international monetary system] as well as support financial deepening in those markets. However going beyond a few additional currencies could mean adding currencies with low weight, increasing complexity and transaction costs for those tracking the SDR basket or needing to hedge their exposure. . . . On balance, adding a large number of emerging market currencies thus seems undesirable, *but*

[134] *Chinese Renminbi (RMB) Account*, HSBC UK, http://www.business.hsbc.co.uk/1/2/international-business/chinese-renminbi-rmb-account (last visited Mar. 12, 2012).

[135] Joint Declaration of the BRICS Summit Leaders' Meeting 2011, Apr. 14, 2011, (emphasis added), *available at* http://english.sanya.gov.cn/publicfiles/business/htmlfiles/englishsite/sanya%20brics/201109/2398.html.

> *there may be a case for the ones with the largest weights in global trade and economic growth.*[136]

Is there any doubt that the renminbi is indeed an emerging market currency whose country is taking proactive steps to ensure that it will bear one of the largest weights in global trade and economic growth? However, one roadblock to the renminbi's inclusion in the SDR basket is the fact that it is not freely convertible. The IMF's Executive Board assessment during the previous review, in 2010, noted,

> [A]lthough China has become the third-largest exporter of goods and services on a five-year average basis and has taken steps to facilitate international use of its currency, the Chinese renminbi does not currently meet the criteria to be a freely usable currency and it [will] therefore not be included in the SDR basket at this time. [Board] Directors urged that this issue be kept under review in light of developments.[137]

The more recent January policy paper seemed to indicate that the IMF was open to reconsidering the renminbi question in light of recent reforms that allow foreign investment using RMB and the offshore RMB products now being developed in Hong Kong. The paper stated:

> The recent review of the SDR valuation concluded that in spite of China's prominent share of global exports, the RMB should not be included in the SDR basket, as it did not meet the criteria to be determined a freely usable currency. . . . It is an open question however whether this criterion should be retained as part of the SDR valuation method. *Recent reforms that allow non-residents, including central banks, to hold RMB denominated deposits and the gradual development of RMB derivatives in Hong Kong could contribute, overtime* [sic], *to resolving some of the technical difficulties in hedging RMB exposure.* These could perhaps be supplemented by additional convertibility agreements between the PBC and other SDR designated holders. Such steps might be sufficient to preserve the SDR's attractiveness with traditional reserve managers, particularly if explicitly part of a broader plan to include a credible public commitment to internationalize use of the RMB and to liberalize capital flows."[138]

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136 IMF Strategy, Policy, & Review Dep't, *Enhancing International Monetary Stability—A Role for the SDR?*, at 18 (Jan. 7, 2011), http://www.imf.org/external/np/pp/eng/2011/010711.pdf (emphasis added).

137 Press Release, IMF, IMF Executive Board Completes the 2010 Review of SDR Valuation, IMF Public Info. Notice No. 10/149 (Nov. 17, 2010).

138 IMF Strategy, Policy, & Review Dep't, *supra* note 136, at 20 (emphasis added).

The IMF noted, however, that the fact that the yuan is pegged to the U.S. dollar still poses a hurdle to the yuan's inclusion in the SDR basket, since it would overstate the weight of the U.S. dollar in the SDR's calculations.[139] Therefore, it is still unresolved whether the RMB will successfully be included in the SDR basket in 2015.

Goldman Sachs Group, Inc. Chief Global Economist Jim O'Neill (who coined the term "BRIC" in 2001[140]) says that he believes both the Russian ruble and the Chinese yuan may be added to the SDR basket in 2015; however, O'Neill says that allowing the ruble to trade freely is vital.[141] Chairman Sergei Ignatiev, the head of Bank Rossii, Russia's central bank, predicted that Russia may come close to floating the ruble at some point between April 2012 and October 2012.[142] President Dmitry Medvedev stated, "[We] really live at a unique time, and we should use it to build a modern prosperous strong Russia, a Russia that will be a co-founder of the new world economic order."[143] Bloomberg News reported that Medvedev visualizes a "new economic hierarchy allowing emerging-market giants such as Russia and China to drive the global agenda as the world emerges from the first global recession since the 1930s."[144] The article notes that inclusion of both the Russian and the Chinese currencies in the SDR basket may form a key initial step in this new world economic order.[145]

B. RMB Appreciation and the Move from an Export-driven to a Consumption-driven Economy

Aside from whether the Mainland government plans to promote its currency as a world reserve currency, the other elephant in the room is the question of whether the government plans to re-value the yuan, even at the price of hurting China's exports. I believe that the RMB will appreciate as China moves from an export-driven to a consumption-driven economy.

After keeping the yuan rate fixed for almost two years during the financial crisis, PBoC has allowed the yuan to float, plus or minus one half percent the daily parity rate, since June 2010.[146] Between June 2010 and June 2011, the RMB

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139 *Id.*

140 *See* Abelsky, *supra* note 1.

141 *Id.*

142 *Id.*

143 *Id.*

144 *Id.*

145 *Id.*

146 *See infra* Table 5.

slowly appreciated against the dollar, moving from 6.82 RMB to the dollar during the fixed rate era to 6.47 RMB to the U.S. dollar,[147] nominally a 5.4 percent rate of appreciation over a year. Since China has been dealing with inflation, the real appreciation for the yuan is somewhat higher; some estimate the consumer price index-deflated rate of real appreciation to be closer to 7 to 7.5%.[148]

Beijing has begun to let the RMB appreciate steadily in an effort to tame inflation.[149] According to *MarketWatch*, figures due to be released would indicate that the Chinese consumer price index rose 5.4%, following a 5.3% rise in April.[150] In the first quarter of 2011, China's foreign exchange reserves gained two hundred billion U.S. dollars to reach a total of three trillion dollars cumulatively,[151] or a twenty three percent increase in sixteen months. To offset capital inflows, China must print more yuan, which would amount to an estimated RMB 1.8 trillion each quarter, or RMB 7.2 trillion annually if the reserves continue to balloon at a rate consistent with recent trends.[152] According to analysts at Société Générale, currency appreciation is necessary to cool the accumulation of this burgeoning money supply.[153] Alternatives to allowing the currency to appreciate include quantitative tightening (increasing the ratio of funds that banks need to keep as reserves) or increasing interest rates to cool inflation. However, Société Générale analysts say that the Chinese banking system will erode if the reserve ratio increases above twenty three percent (as of June 2011, the reserve ratio was already at twenty one percent).[154] Further, raising interest rates will likely have little effect, since investors can simply look to Hong Kong for less costly financing.[155]

The SAFE stated in its annual report: "We will improve the foreign exchange rate system based on market supply and demand, and steadily increase the flexibility of the yuan exchange rate."[156] I agree that the Chinese

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[147] Ed Dolan, *How China's Yuan Has Appreciated: A Scorecard*, SEEKINGALPHA (June 14, 2011), http://seekingalpha.com/article/274778-how-china-s-yuan-has-appreciated-a-scorecard.

[148] *Id.*

[149] Chris Oliver, *China Likely to Opt for Faster Yuan Appreciation*, MARKETWATCH (June 3, 2011, 7:57 AM), http://www.marketwatch.com/story/china-likely-to-opt-for-faster-rise-in-yuan-2011-06-03.

[150] *Id.*

[151] *Id.*

[152] *Id.*

[153] *Id.*

[154] *Id.*

[155] *Id.*

[156] Annual Report (2010), STATE ADMIN. OF FOREIGN EXCH., http://www.safe.gov.cn/model_safe_en/glnb_en/pic/20110823151741426.pdf (last visited Feb. 22, 2012).

government will allow the RMB to appreciate and will also widen the managed float. Some critics, notably U.S. Treasury Secretary Timothy Geithner, have stated that China will not let its currency appreciate since an undervalued yuan is what is fueling cheap exports to foreign countries, and these exports are driving the growth in the Chinese economy.[157] Revaluing the yuan would increase export prices, which in turn would reduce demand for Chinese exports and potentially result in factory closings and lay-offs for Chinese workers. Some may claim that the Mainland government will never revalue the yuan because it would threaten the country's economic stability and dampen its stellar economic growth rate, which has averaged ten percent per year for the past two decades.[158] There may be some truth to this in the short term, but the critics fail to see that Beijing is also playing a long range game, one in which an export-driven manufacturing economy will gradually transition into a domestic consumption and financial investment-driven one.

1. Transitioning from Exports to Consumption

A growing class consisting of those individuals who have left the countryside for jobs in urban centers and who are enjoying the perks of rising incomes will eventually help the Chinese economy ease away from an export-driven model to a consumer-driven economy. The *Harvard Business Review* reports that the number of Chinese cities with a middle class population of 250,000 people or more will grow from ninety cities in 2011 to approximately four hundred cities by 2020.[159] It further reports that in the top ten consumer durable goods categories, China ranks as either the first or second market for sales in the world.[160] The majority of Chinese-produced air conditioners, motorcycles, trucks and steel products are purchased by Chinese domestic

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[157] Jennifer Liberto, *Geithner Criticizes China's Currency Policy*, CNN MONEY (Sept. 16, 2010, 1:45 PM), http://money.cnn.com/2010/09/16/news/economy/Geithner_China/ index.htm

[158] *GDP Growth (Annual %)*, WORLD BANK, http://data.worldbank.org/indicator/ NY.GDP.MKTP.KD.ZG (last visited Feb. 12, 2012). Note that China's growth rate softened to 8.9% in the last quarter of 2011 (China's slowest quarter in the last 2.5 years) and China's central government authorities predict an eight percent growth rate in 2012, which some market analysts have interpreted as a cooling-off of the Chinese economy. *See* Keith B. Richburg, *China's December Growth Slowest in 2 ½ Years*, WASH. POST, Jan. 18, 2012, at A12, *available at* http://www.washingtonpost.com/world/asia _pacific/chinas-december-growth-slowest-in-2-years/2012/01/17/gIQAC9W64P_story. html.

[159] George Stalk & David Michael, *What the West Doesn't Get About China*, HARV. BUS. REV., June 2011, at 25, *available at* http://hbr.org/2011/06/what-the-west-doesnt-get-about-china/ar/1.

[160] China ranks first in sales of bikes and motorcycles, shoes, automobiles, mobile phones and luxury goods, and second for home appliances, consumer electronics, jewelry and internet use. *Id.*

consumers.[161] As for China's import-export balance, the *Harvard Business Review* estimates that the "combined flow of shipping containers between Asia and North America and Asia and Europe is already less than the flow between Asian nations—with much of the latter consisting of goods imported to China."[162]

Thus, while the Chinese government relies heavily on exports as well as infrastructure development (for example, building roads and railways), there are indications that its consumption will grow at a rapid clip. Hence, an appreciated yuan may mean that Chinese exports will grow costlier for foreign consumers and thereby lead to a reduction in sales by Chinese companies, and an appreciated yuan also means that Chinese consumers will benefit from the increased purchasing power of the yuan they do hold. As Chinese domestic consumption and financial markets expand, China should emerge beyond the industrializing stage of development. *New York Times* economics columnist David Leonhardt summarizes China's development transition:

> To continue growing rapidly, China needs to make the next transition, from sweatshop economy to innovation economy . . . . Once a country has turned itself into an export factory, it cannot keep growing by repeating the exercise. It can't move a worker from an inefficient farm to a modern factory more than once. It cannot even retain its industrial might forever. As a country industrializes, workers will demand their share of the bounty, as has been happening in China, and some factories will start moving to poorer countries. Eventually, a rising economy needs to take two crucial steps: manufacture goods that aren't just cheaper than the competition, but better; and create a thriving domestic market, so that its own consumers can pick up the slack when exports are inevitably slow. These steps go hand in hand. Big consumer markets become laboratories where companies know that innovations will be tested and the successful ones richly rewarded. Those products can then expand into countries with less mature consumer markets.[163]

While RMB appreciation and the widening of the trading band may potentially hurt exports in the short term, in the long term China needs to move away from an export-driven model to a consumer-driven model as the next necessary step in its development. The RMB has shown constant and consistent progress in that direction since June 2010,[164] and it is possible in the not too distant future that the trading band around the dollar peg may widen

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[161] *Id.*

[162] *Id.*

[163] David Leonhardt, *In China, Cultivating the Urge to Splurge*, N.Y. TIMES, Nov. 24, 2010, at M56.

[164] *See infra*, Table 5.

from one half percent in either direction to one percent.[165] Such appreciation needs to be gradual given the risk of destabilizing the economy and loosening the floodgates of hot money.

2. U.S.-China Relations

Potential hiccups in the slow but gradual process of China's currency appreciation may include legislative and policy actions recently proposed by the U.S. government, which could invite Chinese retaliation in the form of stalling the currency exchange reform process or, in an extreme instance, igniting a trade war.

The first proposed action is a Senate bill (the Currency Exchange Rate Oversight Reform Act of 2011, S.1619),[166] which passed in the U.S. Senate by a 79-19 vote in October 2011.[167] The bill proposes to levy tariffs as countervailing measures against those countries whose currencies are deemed undervalued.[168] Official Chinese reactions to the Senate passage have been sharp. The People's Bank of China warned in a statement that the bill's passage could "seriously affect" China's exchange rate reform process and result in a trade war.[169] China's Foreign Ministry declared that the bill violated World Trade Organization rules, and the Ministry of Commerce labeled the bill "unfair."[170] The Chinese Xinhua news agency compared the U.S. legislation to the Smoot-Hawley tariff act in 1930, which has been blamed for deepening the Great Depression.[171]

He Ning, Director-General of the Department of American and Oceanian Affairs of the Ministry of Commerce, was quoted saying, "The currency legislation proposed by the U.S. would hurt the interests of both China and the U.S. We are strongly against it. If it eventually passes and becomes law, we

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[165] Kevin Yao, *Analysis: Window May Be Opening For China To Widen Yuan Band*, REUTERS (Jan. 9, 2012, 11:06 PM), *available at* http://www.reuters.com/article/2012/01/10/us-china-economy-yuan-idUSTRE80909320120110.

[166] SENATE DEMOCRATIC POLICY & COMMNC'NS COMM., 112TH CONG., CURRENCY EXCHANGE RATE OVERSIGHT REFORM ACT—S. 1619: LEGISLATIVE BULLETIN (October 3, 2011), http://dpc.senate.gov/docs/lb-112-1-27.pdf.

[167] Shen Hong, *China Rips U.S. Senate Vote on Yuan*, WALL ST. J. ASIA, Oct. 5, 2011, at 3, *available at* http://online.wsj.com/article/SB10001424052970204524604576610033445928562.html.

[168] Currency Exchange Rate Oversight Reform Act of 2011, S. 1619, 112th Cong. (2011).

[169] Hong, *supra* note 167.

[170] *Id.*

[171] Alan Beattie & Simon Rabinovitch, *US Currency Bill Passes Senate Vote*, FIN. TIMES (Oct. 11, 2011, 11:58 PM), http://www.ft.com/intl/cms/s/0/5a6bd3ca-f3fc-11e0-b221-00144feab49a.html#axzz1kJu40oIe.

cannot ignore it and will definitely reciprocate in kind. We have readied ourselves with measures to deal with the possible outcome from the U.S."[172] Indeed, market analysts have noted that the PBoC has in the past "engineered declines in the yuan to coincide with U.S. pressure for it to strengthen its currency," as a symbolic gesture that it will re-value the RMB at the pace it wishes and will not succumb to perceived U.S. political coercion.[173]

In all actuality, the currency bill is unlikely to pass the Republican-controlled House of Representatives. John Boehner, a Republican Representative for the state of Ohio and the current Speaker of the House, said, "[I]'m concerned about the Chinese currency situation . . . . But I think it's pretty dangerous to be moving legislation through the United States Congress forcing someone to deal with the value of their currency."[174] Through January 2012, the bill has continued to stall in the House.[175]

As 2012 is a U.S. election year, China continues to be a popular rhetorical target for politicians. For instance, in his State of the Union address, January 24, 2012, Obama announced the creation of a Trade Enforcement Unit to be "charged with investigating unfair trading practices in countries like China."[176] It remains to be seen whether the currency bill and more stringent trade enforcement will come to pass or whether these proposals are merely election-year posturing. The Chinese National People's Congress, too, is poised to elect China's new president and vice premier after President Hu Jintao and Vice Premier Wen JiaBao finish respective their terms in 2012. How election year drama will play out against the international political arena is yet unknown, except that escalating retaliatory measures or a trade war between these two trading partners would threaten to halt China's slow but steady currency reform progress.

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[172] Kenneth Rapoza, *If Senate's Anti-Yuan Bill Becomes Law, China Will Retaliate*, FORBES (Nov. 1, 2011, 12:08 AM), http://www.forbes.com/sites/kenrapoza/2011/11/01/if-senates-anti-yuan-bill-becomes-law-china-will-retaliate/.

[173] Lu Jianxin & Jason Subler, *Yuan Falls on Currency Retaliation Worry, But Off Daily Limit Low*, REUTERS (Oct. 12, 2011, 2:04 AM), *available at* http://www.reuters.com/article/2011/10/12/markets-china-yuan-midday-idUSL3E7LC0MR20111012.

[174] Felicia Sonmez, *China Currency Bill 'Pretty Dangerous,' Boehner Says*, WASH. POST (October 4, 2011, 12:43 PM), http://www.washingtonpost.com/blogs/2chambers/post/china-currency-bill-pretty-dangerous-boehner-says/2011/10/04/gIQADmE8KL_blog.html.

[175] *Currency Exchange Rate Oversight Reform Act of 2011 Bill Summary & Status*, LIBRARY OF CONGRESS, http://thomas.loc.gov/cgi-bin/bdquery/z?d112:SN01619:@@@X (last visited Mar. 22, 2012).

[176] President Barack Obama, State of the Union Address (January 24, 2012) (transcript available at http://www.nytimes.com/interactive/2012/01/24/us/politics/state-of-the-union-2012-video-transcript.html).

3. Diversification from U.S. Dollar Reserves into Other Foreign Assets

If the yuan appreciates against the dollar, another potential dilemma will arise: what will happen to the U.S. dollar reserves currently held by the Chinese government? In May 2009, the *Washington Post* published an article indicating that China had accumulated $1.5 trillion U.S. dollars in currency assets.[177] The article cited economist Brad Setser's estimation that a thirty percent move in the yuan-dollar rate would cost China $450 billion, or one tenth of its economy at the time.[178]

From November 2010 through March 2011, the Chinese government reduced its holdings of U.S. Treasury securities from $1.1753 trillion to $1.1449 trillion.[179] Specifically, the Chinese government's buying of short-term U.S. Treasury bills of one-year maturity was down by ninety seven percent, from $210 billion in May 2009 to $5.69 billion in March 2011.[180] A report issued by the analysts of Standard Chartered Bank in June 2011 noted a gap "over the last few months . . . between China's new FX reserve accumulations . . . and total net purchases of U.S. Treasuries and T-bills by buyers in China, London and Hong Kong."[181] The gap had increased to $150 billion in 2011, meaning that seventy six percent of China's recent purchases of FX reserves were in a currency *other than* U.S. dollars.[182] The analysts hypothesized that, unless China had found a new way to disguise its purchase of U.S. debt, China was buying "something else—something non-American."[183] As to what that new foreign asset was, Standard Chartered analysts hypothesized that it might be distressed European debt.[184] It is possible that China sensed an opportunity to kill two birds with one stone—to diversify away from U.S. dollars while providing support to European countries during the Eurozone crisis.[185]

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177 Sebastian Mallaby, Editorial, *China's Dollar Problem*, WASH. POST (May 26, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502110.html.

178 *Id.*

179 Terrence P. Jeffrey, *Fed Passes China as Top Owner of U.S. Debt*, CNS NEWS (June 8, 2011), http://www.cnsnews.com/news/article/fed-eclipses-china-top-owner-us-debt.

180 *Id.*

181 Tracy Alloway, *China is Finally Buying Fewer U.S. Treasuries, StanChart Says*, ALPHAVILLE (June 20, 2011, 12:06 PM), http://ftalphaville.ft.com/blog/2011/06/20/599391/china-is-finally-buying-fewer-us-treasuries-stanchart-says. The estimates used in the article are based on official FX reserve numbers, adjusted for the effects of portfolio valuation. *Id.*

182 *Id.*

183 *Id.*

184 *Id.*

185 Kathleen Brooks, *Why China's Support for Europe Comes with a Caveat*, THE GREAT DEBATE UK (June 17, 2011, 4:12 PM), http://blogs.reuters.com/great-debate-

C. Encouraging Other Countries to Hold RMB in Their Foreign Reserves by Strengthening Confidence in China's Financial and Banking Systems

The Chinese government is doing its part to internationalize the RMB by opening up other offshore hubs outside of Hong Kong where RMB investment products are being offered.[186] Ultimately, however, in order for other central banks and governments to look to the RMB as a "form in which to hold foreign reserves,"[187] China needs to change the way its financial and banking systems are perceived by foreign central banks and governments.

Foreign investors currently lack certainty in a number of important areas. They may fear that their RMB deposits will not be honored, and that they will lack recourse to litigate within the Chinese legal system if they are not. For instance, with the advent of the fiduciary account system in Hong Kong, only a small percentage of the deposits sits offshore, while the rest of the deposits are swept under the PBoC's aegis.[188] It is likewise unclear what legal protections the PBoC would give to foreign holders of RMB, and the question of whether China will establish a deposit insurance corporation, like the Federal Deposit Insurance Corporation in the U.S., to assuage concerns is unsettled. *China Daily* reported in January 2011 that the PBoC was "on track to establish a deposit insurance system to strengthen risk management" and that such an insurance system would pave the way to future interest rate liberalization.[189] On the other hand, the PBoC had previously announced plans to institute a deposit insurance system in August 2007, almost four years prior to the most recent announcement, so the timing of the system's implementation is not entirely clear.[190] Nevertheless, Deutsche Bank predicts that offshore RMB

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uk/2011/06/17/why-china%E2%80%99s-support-for-europe-comes-with-a-caveat%E2%80%A6/.

[186] London is the first of these hubs. *See* Kemble-Diaz, *supra* note 82.

[187] Eichengreen, *supra* note 105. In the currency talks between Japan and China in December 2011, Japan has stated its interest in applying in 2012 to purchase Chinese government bonds to accumulate more yuan for its foreign exchange reserves. *See* Wong & Singer, *supra* note 118.

[188] YUEN, RENMINBI (RMB) FIDUCIARY ACCOUNT, *supra* note 66.

[189] Xiaotian Wang, *Deposit Insurance System to be Introduced*, CHINA DAILY (Jan. 8, 2011, 10:15 AM), http://www.chinadaily.com.cn/business/2011-01/08/content_11812713.htm. For example, the government could, within the next five years, allow banks to determine their own market-oriented interest rates so that institutions could price their own financial products.

[190] *China's Central Bank Drafts Plan for Deposit Insurance*, N.Y. TIMES (Aug. 2, 2007), http://www.nytimes.com/2007/08/02/business/worldbusiness/02iht-yuan.1.6953861.html.

deposits will double to RMB 1.5 trillion in 2012 from RMB 700 billion as of January 2012.

In the meantime, the international perception of China's business environment (specifically, of Shanghai's evolving financial market) appears to have improved within the past few years. According to the Global Financial Centre Index, a list which is published twice yearly by the City of London Corporation and ranks cities based on the competitiveness of their financial centers, in March 2009, Shanghai ranked thirty-fifth out of sixty-two major financial capitals.[191] By March 2010, Shanghai had risen in the rankings to eleventh, out of seventy-five.[192] By March 2011, Shanghai had tied with Tokyo as fifth out of seventy-five.[193] The Global Financial Centre Index ranking is an aggregate of indices encompassing the areas of people, business environment, market access, infrastructure and general competitiveness.[194] Notably, the business environment factor takes into account regulation, tax rates, levels of corruption and economic freedom and ease of doing business.[195]

Along with increasing investor confidence and the improving reputation of China's business environment, foreign central banks and governments will need sufficient fixed-income financial products denominated in RMB available to invest. Although the RMB bond market is still in its relative infancy, the market has promising prospects. In 2012, Deutsche Bank estimates that the issuance of offshore RMB bonds should reach RMB 280 billion, an increase of fifty percent from the previous year.[196] Three U.S.-listed RMB bond exchange traded funds ("ETF"s)[197] debuted in the last quarter of 2011: Guggenheim Investment's China Yuan Bond Fund, Invesco PowerShares, and Market

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[191] *See infra* Table 6.

[192] *See infra* Table 6.

[193] London was ranked first, New York second, Hong Kong third, and Singapore fourth. *See* CITY OF LONDON CORP., GLOBAL FINANCIAL CENTRE INDEX NO. 9, at 4 (Mar. 2011), *available at* http://www.zyen.com/GFCI/GFCI%209.pdf.

[194] *Id.* at 2.

[195] *Id.* at 37.

[196] Simon Rabinovitch, *Renminbi: Proof You Can Be Half Pregnant*, BEYONDBRICS (Jan. 13, 2012, 4:30 AM), http://blogs.ft.com/beyond-brics/2012/01/13/renminbi-proof-you-can-be-half-pregnant/.

[197] An exchange traded fund is an investment fund which is listed and traded on the stock market. ETFs issue shares in large blocks known as creation units, which are purchased by investors utilizing baskets of securities that mirror the ETFs portfolio. Investors can split up the creation units and sell individual shares back to other investors in the secondary market or sell creation units back to the ETF. ETFs generally pay out redemptions with securities comprising the portfolio instead of cash. *See Exchange Traded Funds*, SEC. & EXCH. COMM'N, http://www.sec.gov/answers/etf.htm (last modified Mar. 18, 2010).

Vectors Renminbi Bond Fund ETF, giving offshore investors another vehicle for investing in RMB-denominated products in the Chinese market.[198]

CONCLUSION

With all the carefully measured reforms that the Mainland government has been implementing to shepherd the liberalization of China's capital account, one might ask what is motivating China to move away from the status quo and open its capital account. The benefits to China in the event of capital account liberalization and internationalization of the RMB are fivefold: first, capital account liberalization would provide the opportunity to unlock Chinese domestic savings for investment offshore. Bloomberg News, as of May 11, 2011, estimates that these domestic savings are valued at 75.6 trillion RMB (U.S. $11.6 trillion), or approximately eighty percent of U.S. GDP.[199] Second, capital account liberalization would allow Chinese banks to become more competitive by allowing them to service both foreign and domestic customers in their country's own currency. According to an IIFL Institutional Equities research report, by utilizing RMB settlement instead of U.S. dollar settlement, the Chinese banks would benefit from higher net interest margins, fee income, and loan demand while corporations would have lower costs, risks, and transaction times.[200] Third, when trade can be settled in RMB, foreign exchange risk can be reduced without incurring additional hedging costs.[201] Fourth, RMB internationalization would serve as an assertion of political and economic power within Asia and around the world. In a plan unveiled on April 29, 2009, the Chinese government openly stated its ambition to make Shanghai a global financial capital by 2020.[202] A world economic leader should, at the very least, have the ability to conduct trade and encourage investment in its own currency. Fifth, RMB internationalization would reduce China's dependence on the fate of the U.S. dollar. Like its fellow BRICS countries, China has observed and seemingly lost faith in Washington's handling of the United States's financial affairs, given its mounting deficits and the U.S.'s recent role in the global financial crisis of 2008-2009.

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[198] Tom Lydon, *Dim Sum: Three New Yuan Bond ETFs*, ETFTRENDS (Oct. 14, 2011, 12:57 PM), http://www.etftrends.com/2011/10/dim-sum-three-new-yuan-bond-etfs/.

[199] Michael Forsythe & Andrea Wong, *China's Yuan Convertible by 2016 in Global Poll Marking Big Investor Shift*, BLOOMBERG NEWS (May 11, 2011, 11:43 PM), http://www.bloomberg.com/news/2011-05-12/china-s-yuan-convertible-by-2016-in-poll.html.

[200] Sachin Nikhare & Prabodh Agrawal, Renminbi Internationalization—Hurry Slowly, IIFL Institutional Equities, Singapore Banks (May 27, 2011) (unpublished manuscript) (on file with author).

[201] *Id.*

[202] Bill Leung & Joanne Yim, *Shanghai's Future as an International Financial Centre*, HANG SENG BANK (June 24, 2009), http://www.hangseng.com/ermt/eng/fxmv/pdf/ecof_e_2009jun.pdf.

In sum, China has taken a four-pronged approach to capital account liberalization by (1) relaxing restrictions on inbound and outbound foreign direct investment, (2) expanding RMB trade settlement, (3) allowing the proliferation of RMB-denominated offshore financial products in Hong Kong, and (4) permitting new methods of repatriating offshore RMB for onshore investment (such as the RQFII scheme). Certain pitfalls still lie ahead in the liberalization process, including issues related to liquidity and currency risk, concentration of credit risk, hot money and illegal funds, complexity of interactions for multiple offshore RMB hubs, and asymmetry in currency demand accelerating accumulation of foreign exchange reserves. The Mainland government will likely seek to expand the use of the RMB specifically within the Asian region, among its fellow BRICS countries, and to the financial capitals in the West. If all goes well, yuan appreciation will occur hand in hand with a slow restructuring of China's economy from an export-driven economy to a consumer-driven model. Gradually, foreign countries will be encouraged to hold more yuan in their foreign reserves as their confidence in China's financial and banking systems is improved through the development of a deposit insurance system and greater transparency as to legal protections available to them, and as more long term fixed-income financial products denominated in RMB for foreign investors are introduced.

China finds itself in an unprecedented situation of internationalizing its currency while liberalizing its partially-closed capital account. While most countries take seven to ten years from current account liberalization to capital account liberalization,[203] it has been fifteen years since China liberalized its current account, and the opening-up of its capital account is still a work in progress. Despite its measured pace, China has taken proactive steps. At the very least, there is a high likelihood that China will push for RMB inclusion in the SDR basket when its composition comes up for review in 2015 before the IMF. Tensions in U.S.-China political and economic relations may add an additional wrinkle in the currency reform process but how these complications will play out in the 2012 election year and beyond remains to be seen. While it may be years before the renminbi may be considered a world reserve currency with the same prevalence and caliber as the U.S. dollar or the Euro, China is laying the groundwork for such a day. As the Chinese proverb states, "Be not afraid of going slowly, be afraid only of standing still."

ADDENDUM

On February 23, 2012, the People's Bank of China released a policy recommendation report proposing a ten-year timeline to renminbi liberalization.[204] The initiative consists of four stages: (1) in the near term, to encourage Chinese companies to invest overseas; (2) in three to five years, to

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[203] Interview with Yi Gang, *supra* note 3.

[204] J.M., *China and the World Bank: 2030 Vision*, ANALECTS CHINA (Feb. 28, 2012, 3:46 PM), http://www.economist.com/blogs/analects/2012/02/china-and-world-bank.

further liberalize renminbi trading; (3) in five to ten years, to grant wider access to Mainland stock, bonds and properties by foreign investors; and finally, (4) to have a fully convertible currency.[205] It is unclear whether or not these are aspirational suggestions or concrete policy deadlines;[206] exactly how and when the landslide of currency reform will come to pass remains yet to be seen.

[205] Wang Xiaotian, *'Chance' to Open Capital Account*, PEOPLE'S DAILY ONLINE (Feb. 24, 2012, 9:35 AM), http://english.peopledaily.com.cn/102774/7739049.html.

[206] J.M., *supra* note 204.

APPENDIX

Table 1
A Timeline of RMB Internationalization Reforms

1986	Wholly Foreign-Owned Enterprises (WFOE) introduced.
2002	Qualified Foreign Institutional Investor (QFII) introduced.
2003	Trial personal bank deposits in RMB allowed in Hong Kong.
2005	Trial business bank deposits in RMB allowed in Hong Kong and RMB non-deliverable forward contracts launched in Hong Kong.
2006	Qualified Domestic Institutional Investor (QDIIs) introduced.
2007	"Dim Sum" bonds introduced, issued in Hong Kong but denominated and settled in RMB (but only for entities incorporated in the mainland).
April 2009	Pilot cross-border RMB trade settlement scheme for five mainland cities (Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan) with overseas areas including HKSAR and Macao SAR and ASEAN trading partners.
2010	HK-incorporated, foreign-incorporated and supranational entities allowed to issue offshore RMB-denominated bonds in Hong Kong.
June 2010	Cross-border RMB trade settlement program expanded to 20 cities with overseas areas including all overseas trading partners.
January 2011	Qualified Foreign Limited Partner Program introduced.
April 2011	First RMB-denominated IPO outside mainland China, by Hui Xian Real Estate Investment Fund. RMB vs. foreign exchange options trading introduced to China's inter-bank foreign exchange market.
September 2011	First Yuan bond ETF (by Guggenheim Funds) launches on NYSE.
October 2011	RMB Equity Trading Support Facility (TSF) launches.
December 2011	First RQFII (also known as Mini-Qualified Foreign Institutional Investor (Mini-QFII) licenses granted.

Table 2
Value of RMB Cross-border Settlement, 4th Quarter 2009 Through 4th Quarter 2010[207]

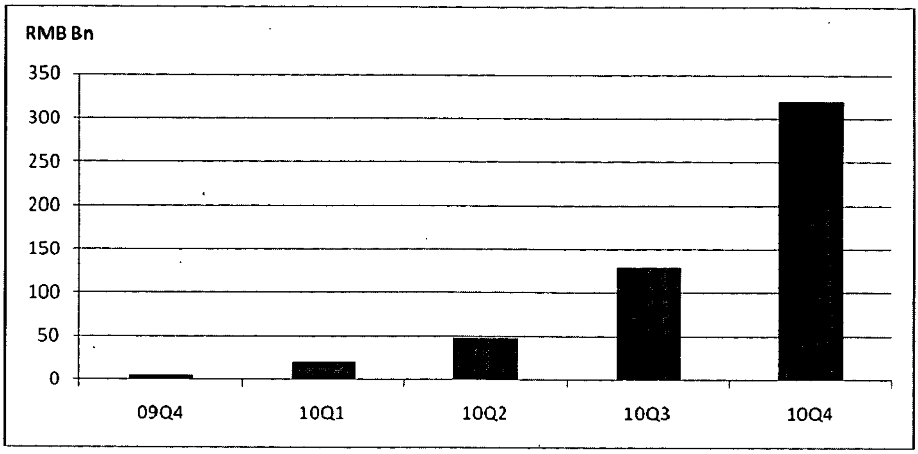
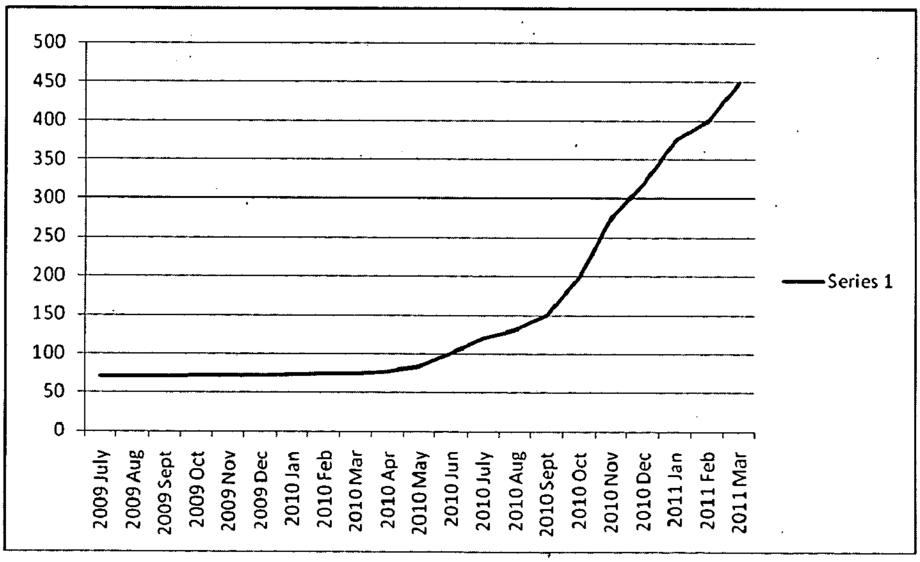


Table 3
Hong Kong Banks RMB Deposits, June 2009 to March 2011[208]
(amount in billions of RMB)



[207] *RMB Cross-Border Settlement: Origins, Mechanics and Opportunities*, BBVA RESEARCH, HONG KONG (Mar. 9, 2011), *available at* http://www.bbvaresearch.com/KETD/fbin/mult/110309_China_RMB_settlement_EN_tcm348-249217.pdf?ts=2842011.

[208] MORGAN STANLEY, GREATER CHINA ECONOMICS: ISSUES IN FOCUS 36, Ex. 11 (May 18, 2011).

Table 4
Dim Sum Bond Issuance in Hong Kong[209]
(size in billions of RMB)

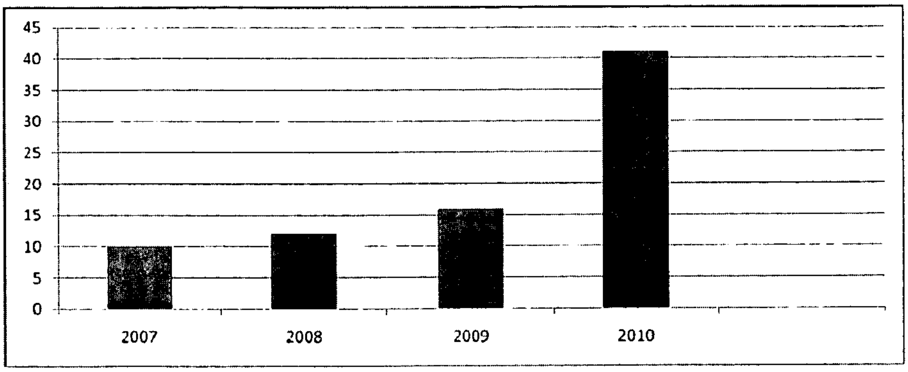
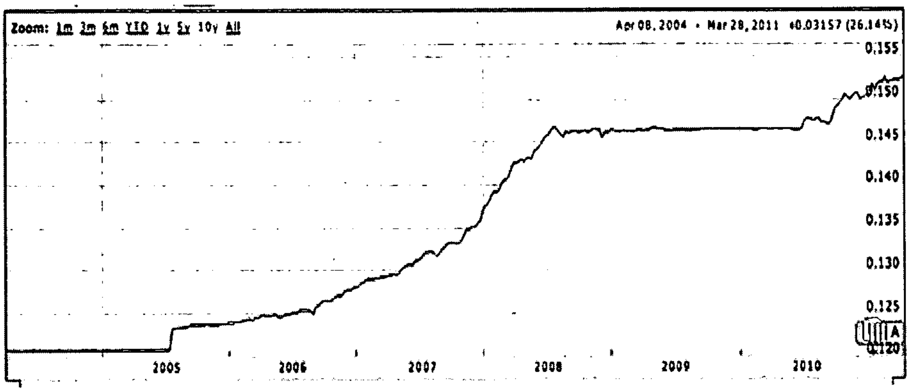


Table 5
RMB Against U.S. Dollar Nominal Exchange Rate[210]



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[209] Gribot-Carroz & Chung, *supra* note 28.

[210] Derek Thompson, *Infographic: How China Manipulates Its Currency*, THE ATLANTIC (Mar. 29, 2011, 6:00 PM), http://www.theatlantic.com/business/archive/2011/03/infographic-how-china-manipulates-its-currency/73201/.

Table 6
Global Financial Center Index
(Published by the City of London Rankings)

City Name	**Ranking Mar 2009**[211]	**Ranking Mar 2010**[212]	**Ranking Mar 2011**[213]
Shanghai	35	11	5 (tie)
Hong Kong	4	3	3
Singapore	3	4	4
Shenzhen	N/A	9 (tie)	15
London	1	1 (tie)	1
New York	2	1 (tie)	2
Tokyo	15	5	5 (tie)
Chicago	7	6	7
Zurich	5	7	8
Geneva	6	8	9
Total Number of Ranked Cities	62	75	75

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[211] CITY OF LONDON CORP., GLOBAL FINANCIAL CENTRE INDEX NO. 5, at 12 (Mar. 2009), *available at* http://217.154.230.218/NR/rdonlyres/8D37DAE2-5937-4FC5-A004-C2FC4BED7742/0/BC_RS_GFCI5.pdf.

[212] CITY OF LONDON CORP., GLOBAL FINANCIAL CENTRE INDEX NO. 7, at 29 (Mar. 2010), *available at* http://217.154.230.218/NR/rdonlyres/661216D8-AD60-486B-A96F-EE75BB61B28A/0/BC_RS_GFC7full.pdf

[213] CITY OF LONDON CORP., GLOBAL FINANCIAL CENTRE INDEX NO. 9, *supra* note 193.