What's the Deal?

China’s currency and its global impact: One currency, two systems

In previous editions of What’s the Deal, we have explored the many issues in China’s domestic economy and overseas borrowing that suggest a Forex squeeze and consequent policy adjustments for capital flows in both directions across China’s borders. Access to hard currencies, primarily the USD and Euro, have been essential for China to pursue long-established “going out” goals, including M&A plays to acquire natural resources, technology, and real estate abroad. In this edition of “What’s the Deal,” we look at one of the core initiatives to strengthening China’s financial capacity abroad, the decade-long project to internationalize the yuan itself as an invoicing, trade settlement, and reserve currency. If successful at scale, this could enable acquisitions abroad with yuan and thus reduce the dependence on other currencies, primarily the USD and Euro, for “going out.”

China’s reported foreign exchange reserves have hovered around US$3.1 trillion for all of 2019, with a brief peak in June. Notwithstanding the absence of a clear trend, some analysts predict China will have a current account deficit in 2019,
which would bring to hand less liquid foreign currency assets than previous decades of export surpluses and high levels of inbound direct foreign investment provided. But as noted in previous “What’s the Deal” editions, China faces a rapidly growing demand for capital in globally acceptable trade, investment, and reserve currencies that can be used to support imports, overseas acquisitions, and a range of Belt & Road Initiative encumbrances and plans. Among the many facets of China’s fiscal and monetary policy moving ahead, the international role of the yuan will be important.

The origins of the yuan abroad

The project to internationalize the yuan was part of the broad financialization of the Chinese economy after the Global Financial Crisis (GFC). In the wake of the crisis, China took the lead in advocating for a substitute for the USD as the premier global currency. The first idea promoted was a special drawing rights issue (SDR) from the IMF, but this did not get traction with other major trading countries. That was followed by a campaign to promote the yuan itself as a regional and eventually as a global invoicing and trading currency. If that could be accomplished, China could be able to acquire targets like mineral and energy resources, tech companies, agricultural resources, and real estate with currency of its own issue, something the US and to a lesser extent the EU enjoyed.

What was unique about this initiative is the process by which China had managed the exchange rate since reforms began, avoiding formal exposure to market forces and showing a propensity to maintain control by issuing multiple currencies and maintaining multiple regimens for exchange and use. That has been the case with the internationalization of the yuan, a “one currency, two systems” approach to the CNY, the Mainland yuan, which is not “freely usable,” to use the IMF term, and CNH, the yuan used abroad, which is freely usable. Early advocates for internationalizing the yuan sought a larger role as a trade settlement currency and as a reserve currency. But the yuan itself was exposed to market forces only through marginal interfaces like black market exchange rates. Full convertibility with genuine market-based exchange rates has always been on the table for discussion but with the caveat at the appropriate time. Even now, officially the initiative is referred to as the “internationalization of the yuan,” avoiding an explicit commitment to full convertibility and submission to market pricing mechanisms.

China has a history of monetary control tactics that used multiple currencies. For fifteen years, from 1980 to 1994, officially China required hard currencies to be converted into Foreign Exchange Certificates (FEC) for use by foreigners in the Mainland in currency transactions. That complicated approach to currency management led to informal and illegal markets in USD to FEC and FEC to yuan conversion. Subsequently, central management of the yuan exchange rate by the Ministry of Finance (MoF) and People’s Bank of China (PBoC) became the process by which the yuan was valued in foreign exchange terms.
The effort to internationalize the yuan officially required relinquishing some measure of control of the exchange rates and accordingly required a new accommodation. In 2007, China initiated the dim sum bond market in Hong Kong. Dim sums were bonds available to foreign investors denominated in yuan. As local issuers were permitted to join SOE banks in issuing dim sum bonds, the dual currency system emerged, where essentially the same yuan operated under two regimes, the CNY domestic regimen and the CNH international one. By June 2009, several designated cities in China were permitted to settle offshore obligations in yuan. The latter was tradeable in special swap markets established first in Hong Kong, then in a swap agreement with South Korea (December 2008), and then elsewhere in Asia and Europe. China undertook negotiations with major trading partners, including suppliers of critical resources like iron ore, to accept yuan in payment for imports, but success was limited because of the limited appeal of the yuan as a reserve.\(^6\)

China’s hard currency pressures and risks could be significantly mitigated if the yuan had become a significant global reserve currency, but it has not. Although a major step was taken in late September 2016, when the IMF added the yuan to the basket of special drawing rights currencies, it was noted at the time that China still had to make more progress in marketizing its currency and its economy overall for the yuan to become a viable global reserve currency.\(^7\) In fact, the inclusion of the yuan in the SDR significantly altered the concept of “freely usable” that had historically been a criterium for inclusion in the basket. Far less than one percent of the total yuan in circulation met the criteria.\(^8\)

**Where do things stand now?**

Trends and measures over the last decade confirm that the yuan internationalization project remains a work in progress. We can look at three measures to assess both the state, trends, and prospects for the yuan to become an impactful global currency.

Progress in being adopted as a reserve currency has been slow. The IMF reports that reserve holdings of the yuan totaled less than US$213 billion in 2019 Q1, or 1.95 percent of world totals, compared to the US$6.739 trillion, or nearly 62 percent or world totals. The Euro was next, with US$2.2 trillion, or a bit over 20 percent or world totals.\(^9\)

How large are bank holdings in yuan abroad? Since the Hong Kong SAR was originally and continues to be the center pillar of the yuan internationalization project, another useful measure is the yuan CNH holdings in Hong Kong banks, reported monthly by the Hong Kong Monetary Authority. Hong Kong account holders held deposits that peaked at slightly over one trillion yuan at the end of 2015, but that number has shrunk over the years since. In the first seven months of 2019, yuan held in Hong Kong banks ranged from 599 billion to 624 billion, with no clear month-to-month trend.\(^10\) In comparison, total Hong Kong deposits ranged from 13.3 to 13.7 trillion HK$, so yuan deposits represented less than five percent of deposits in HK$ and other foreign currencies. Data is not yet available...
for the trends since the yuan has depreciated below the long-held symbolic level of yuan seven: USD one, but the trends are not likely to be positive for yuan deposit numbers.

Finally, there are cross-border trade and investment settlement figures. China has been supportive of expanding the use of yuan for such purposes, and as recently as last year liberalized regulations to make it easier for domestic and foreign parties to open appropriate bank accounts and settle cross-border obligations in yuan. CEIC data, based on officially reported statistics, show growth in cross-border settlement for goods and services, accumulating to almost 9 trillion yuan from Dec 2009 to June 2019.

However, in reality, off-shore counterparties should be willing to accept yuan for this process to grow, and it is not clear how many are willing to do so. The statistics for cross-border trade settlement are difficult to assess because substantial transactions can occur between the Mainland and Hong Kong, and between the Mainland operations and off-shore operations of Chinese companies, private and state-owned. Settlements between related parties can be structured for all sorts of reasons, many related to currency management and exchange advantages, rather than a straightforward preference for transacting in one currency or another.

**Looking ahead**

When the IMF accepted the yuan into the basket of SDR currencies, many analysts argued that this would accelerate liberalization and even marketization of the yuan. Along with that, the expectation was that the yuan’s usage as a settlement and reserve currency would accelerate dramatically.

China’s official state media currently reports substantial progress in the yuan’s global presence. Reports note that swap agreements have been signed with 30 countries and that several of China’s crude oil suppliers “have shown interest for oil trade in yuan.” A swap agreement with Pakistan was concluded in 2012, and in 2018 the size of the currency swap between the two central banks was expanded. In late 2018, an agreement was made between China and Pakistan to use their two local currencies for trade settlement as a substitute for the USD.

These remain small if not aspirational achievements. As China’s global role expands, the benefits of a widely usable yuan expand as well. But the signals are mixed, and notwithstanding the importance of the IMF accepting the yuan for inclusion in the SDR basket, the most basis usability criterion remain unmet under what we are calling the “one currency two systems regimen.” For central banks around the world to take on serious levels of yuan reserves and for major traders with China to accept yuan in exchange for goods and services there should be substantial additional steps toward a more transparent, stable, and marketized exchange arrangement than what has emerged in the ten years of the internationalization program.
Still the trends are of critical importance and worth watching. If and when the Chinese yuan achieves the scale of global use its promoters envision—when it becomes one currency one system—it will likely be transformational in terms of China’s impact on trade and investment in every corner of the world. And it can vastly expand the complexity and the opportunities for financial and treasury managers in every sector of international business and finance.

Disclaimer: This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

Endnotes

1 https://tradingeconomics.com/china/foreign-exchange-reserves
4 https://www.chathamhouse.org/about/structure/international-economics-department/china-yuan-internationalization-strategy-and-capital-account-liberalization-project
5 http://global.chinadaily.com.cn/a/201901/02/WS5c2c2a45a310d912140520d8.html
8 Deloitte analysis
10 http://www.chinadaily.com.cn/a/201801/07/WS5a51c69ea31008cf16da58cb.html
12 http://global.chinadaily.com.cn/a/201901/02/WS5c2c2a45a310d912140520d8.html

Trends to watch
China's economy is getting worse. That makes a trade deal more likely, CNN Business, 9/16/2019
China’s overseas investment fell 10% last year, as government crackdown on capital flight continues, SCMP, 9/13/2019
China scraps foreign investment limit in stocks and bonds, Bloomberg, 9/10/2019

### Outbound M&A from China

**Consumer**
- Chinese engineering company in talks to buy Wrightbus, The Irish News, 8/22/2019
- China Merchants Industry Investment to make pre-conditional offer for AVIC International Maritime shares, The Business Times, 8/27/2019

**Energy, Resources & Industrials**
- Brother enterprises to buy SA's LANXESS CISA for $93 mln, Yicai, 8/13/2019
- China’s CATL buys into Australian lithium miner Pilbara, Reuters, 9/4/2019

**Life science & health care**
- HiFiBiO Therapeutics closes $67 mln series C financing to build on recent success and advance pipeline of novel antibody drugs for cancer and autoimmune disorders, BusinessWire, 8/28/2019

**Technology, media & telecommunications**
- Chinese steel maker picks additional 24% stake in Global Switch ahead of IPO, Reuters, 8/27/2019
- Fosun will take a majority stake in The Naga Group AG alongside significant planned co-investment, Markets Insider, 8/29/2019

### Inbound M&A into China

**Financial Services**
- OUE announces increase in shareholding in Gemdale Properties and Investment Corp, Yahoo News, 8/28/2019
Energy, Resources & Industrials
Marelli forms strategic partnerships with Highly Group, MarketScreener, 9/2/2019

China Domestic M&A and Industry Consolidation

Consumer
Chinese NEV startup Lixiang raises $530 mln led by Meituan founder, 8/19/2019

Life Science & Health Care
Shanghai Fosun Pharma to sell Healthy Harmony for about $523 mln, Yahoo News, 7/30/2019

Real Estate
This Beijing skyscraper, seized by Chinese authorities, just sold for $734 mln online, Yahoo Finance, 8/22/2019

Technology, Media & Telecommunications
Alibaba buys NetEase online mall for $2 bln in rare pact, Bloomberg, 9/6/2019
Tencent-backed Kuaishou, Baidu invest $434 mln in Zhihu, Bloomberg, 8/12/2019
TKK Symphony Acquisition Corporation and Glory Star New Media Group Ltd announce execution of definitive share exchange agreement with a potential value up to approximately $525 mln, Global Newswire, 9/6/2019

Dbriefs China Issues Webcasts

China's new retail: Implications for China and the world
October 3 | 11 a.m. ET
In one generation, Chinese consumers have grown to assume an important role in retail innovation by participating in a huge mobile online population, engaging in immersive and innovative customer experiences, and driving significant gross merchandise value growth for e-commerce giants, brand owners, and fast-moving unicorns.
REGISTER

Multinational companies in China: A look at the road ahead
November 14 | 11 a.m. ET
Potential agreements and disagreements in the ongoing negotiations between the United States and China continue to create uncertainty in many areas, including taxes and tariffs, technology deployment, supply chain migration, equity and strategic partnering, and market development. What should multinational company executives know?

Related report

**Launching innovative biopharma in China**
China has swiftly become one of the largest biopharmaceuticals and medical products markets in the world. Quicker regulatory approval and widening market access are among the profound changes that have made China a significant market to launch innovative medical products.

Related links

- Subscribe to China M&A Round-Up
- China M&A Round-Up archive
- Asia Pacific Dbriefs webcast series
- US Chinese Services Group
- Global Chinese Services Group

Included are summaries of, and links to, reports of M&A transactions and related news appearing in the media. Neither the Chinese Services Group of Deloitte LLP, nor any of its affiliates or their related entities, has an opinion on the transactions listed. No guarantees are made as to the accuracy of what is reported in the media. No information herein, implied or explicit, should be perceived as an endorsement, assessment or judgment as to the propriety of the transactions by the Chinese Services Group of Deloitte LLP or any of its affiliates or related entities.