The recent opening of the offshore market for China’s currency, the renminbi (RMB), in Hong Kong, London and elsewhere is undoubtedly an important step in China’s economic development. However, as a step in the internationalization of the RMB, its importance should not be exaggerated. There are far more important steps that China needs to take that — on current policies — the Chinese authorities show no signs of taking any time soon. It therefore follows that these recent moves toward creating an offshore market in RMB or denominating certain bilateral trade transactions in RMB don’t amount to any significant threat to the position of the US dollar as the world’s premier international reserve currency.

The US dollar has been the dominant international reserve currency, widely used for denominating trade and capital transactions around the world, effectively since the 1920s. More formally, it became the central currency for intervention and reserve accumulation by countries that pegged their currencies to the US dollar after the Bretton Woods Agreement of 1944, which established a landmark system for monetary and exchange-rate management. The emergence of the Japanese yen in the 1980s and the euro in 1999 didn’t topple the US dollar.

The offshore market for US dollars started in the 1960s as a result of the imposition in July 1963 of the 15% US interest equalization tax — effectively a tax on capital outflows from the US — and the desire of non-US residents, such as Russians or other governments that were not particularly friendly to the US in those Cold War days of the ‘60s, to hold US dollars in locations that were safe from confiscation by the US authorities. Increasingly, US corporations found it more profitable to hold US dollar deposits in London (and later in Asia) than to hold those deposits in the US.

A key point was that there were no restrictions on the types of US dollar loans that offshore banks could make when using the currency offshore. So once funds were transferred into the offshore arena, the amount of US dollars lent could be multiplied up to virtually unlimited amounts (subject to supply and demand at prevailing interest rates), contributing to the widespread availability of US dollars.

By contrast, the offshore market for the RMB promises to be much more limited. In the US case, funds could be freely transferred abroad without restriction by individuals, domestic US corporations, foreign corporations or other entities — whether for trade, investment, financial or other purposes.

The result of the present restrictions is that offshore RMB cannot be loaned for financial investment, hedging or other nontrade-related purposes. For example, offshore RMB cannot be loaned for personal mortgages and cannot be lent to individuals for other purposes (such as for car purchases). An offshore currency that is subject to such a widespread range of controls is no threat to the status of the US dollar.

It is sometimes said that China has an agenda to ensure the RMB becomes an international currency and replaces the US dollar. Such statements show a serious ignorance of what is required for a currency to become a vehicle for international transactions.

The restrictions on the development of the offshore RMB market stem from two broad sets of controls that apply to onshore RMB in terms of foreign exchange and capital markets. In my view, the RMB cannot expect to become a full international currency — let alone a reserve currency — until these two problems are addressed.

First, China will have to lift its foreign-exchange controls on outbound and inbound capital transactions. China’s “Great Wall” of foreign-exchange controls seems likely to persist for an extended period of time — years, if not decades. Abolishing foreign-exchange control means, for example, allowing Chinese companies and individuals to hold accounts abroad or freely remit funds abroad. Equally, it requires nonresident foreigners to be able to hold accounts in China or to remit funds to China without prior approval from Chinese bureaucrats. It’s interesting to note in this context that no communist country has ever permitted free inflows and outflows of capital.

Nobody should be under the illusion that these changes can be implemented quickly. Remember that Britain only lifted its foreign-exchange controls after World War II in 1979, while Japan didn’t lift its exchange controls until 1982. The net result of China’s capital controls today is that the onshore and offshore markets for the RMB remain separate, creating a significant barrier to arbitrage between the onshore and offshore markets for the RMB.

However, to open up China’s external capital accounts and abolish foreign-exchange controls, a second change will be necessary — and that is to liberalize China’s domestic money and credit markets and other capital markets. Currently China’s domestic credit markets operate largely on the basis of credit quotas and administrative guidance to the banks. Interest rates are not much used for deciding on the allocation of credit, and the range of credit instruments available to Chinese savers remains very limited. Powerful domestic pressure groups, such as the banks and state-owned enterprises, are lined up against liberalization, in their own self-interest. Not surprisingly then, China’s progress in this area has been slow in recent years. As with freeing up foreign-exchange control, it’s likely to be years or even decades before China moves to a fully liberalized domestic financial system.

Therefore, the conclusion I draw is that although the offshore RMB market has grown rapidly in the past two years from a very small base, it’s not likely to continue growing at the same pace. Indeed, the rate of growth has already slowed down abruptly. From a peak of 765 billion Hong Kong dollars (HKD) (627 billion RMB) in November 2011, offshore RMB deposits had declined to 675 billion HKD (544 billion RMB) in August 2012.

The future prospects for the offshore RMB market or the RMB as an international currency should not be exaggerated. Unless and until the Chinese authorities change their attitude toward foreign-exchange controls and domestic financial liberalization, the role of the RMB as an international currency will remain severely constrained. Meantime, the RMB will be no threat to the US dollar.

Important information
Where John Greenwood has expressed opinions, they are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.