FOR PROFESSIONAL INVESTORS – 12 April 2023

Chi on China

THE RENMINBI'S CREEPING INTERNATIONALISATION (III): THE SALAMI-SLICING TACTICS

Know thy self, know thy enemy. A thousand battles, a thousand victories.

Sun Tzu

SUMMARY

- Developments in late March 2023 showed that renminbi internationalisation moved a significant step forward, with Brazil, Saudi Arabia, France and ASEAN countries joining the game. This could boost China's effort to build a financial infrastructure for the renminbi to become a global currency.
- China's 'salami-slicing tactics' for internationalising its currency will slowly erode, not replace, the US dollar's global dominance in the medium-term. Countries may increasingly trade with China using renminbi but they will still use the dollar in trade with most of the rest of the world.
- When there is enough penetration of the renminbi in a separate jurisdiction, a payments system parallel to the US dollar system could gain critical mass, re-orientating the world's payments systems and the underlying technical, regulatory and institutional frameworks to accommodate the renminbi over time.

WHAT HAPPENED IN MARCH 2023?

Further to China's renewed discussion with Saudi Arabia to trade oil in renminbi early this year[1], several developments in the last week of March boosted the pace of renminbi internationalisation:

- 27 March – Saudi Arabia announced that Aramco would build oil refineries with China for RMB 83.7 billion (here).
- 28 March – China and France completed their first LNG trade using renminbi (here), involving 65,000 tonnes of LNG from the UAE.
- 29 March – Saudi Arabia joined the China-led regional security and trade club, the Shanghai Cooperation Organisation (here), improving diplomatic relationship and advancing talks on trading oil in renminbi.

[1] See "*Chi on China: The Renminbi's Creeping Internationalisation (II): The Petro-Yuan and the Role of Gold*", 4 January 2023 (here).

- 29 March – China and Brazil struck a deal to ditch the US dollar and use the renminbi in cross-border transactions (here).
- 30 March – ASEAN leaders considered reducing the usage of the US dollar, euro, pound sterling and Japanese yen in financial transactions and move to settlements in local currencies (here, or here).
- 31 March – At the Boao Forum in Hainan in China, Malaysia revived a former proposal to create an 'Asian Monetary Fund' to reduce dependence on the US dollar (here, or here).

INCENTIVE TO DIVERSIFY OUT OF THE US DOLLAR

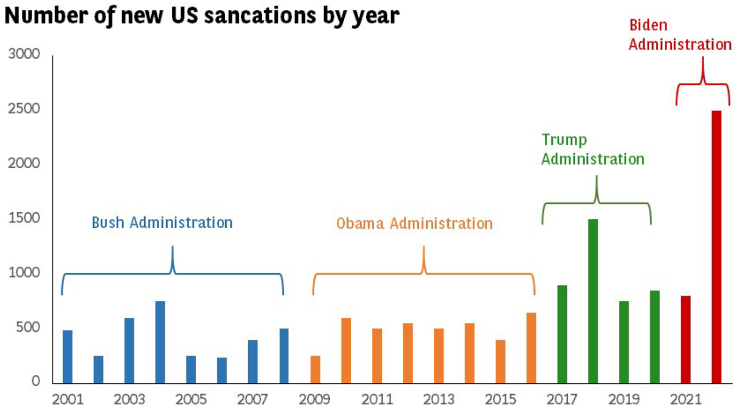
These developments underscore the efforts of many countries to diversify out of the US dollar risk exposure by shifting away from the dollar-based payments system, SWIFT. Notably,

- in 2014, Russia introduced its System for Transfer of Financial Messages (SPFS)
- in 2015, China set up its Cross-Border Inter-Bank Payments System (CIPS)
- in 2020, the EU developed the European Payments Initiative (EPI)
- and in early 2021, China's Digital Currency Institute, an affiliate of the People's Bank of China, launched the Multiple Central Bank Digital Currency Bridge Project (or m-CBDC Bridge) together with the Hong Kong Monetary Authority, the Bank of Thailand and the Central Bank of the United Arab Emirates, to explore cross-border payments using the digital renminbi. The Bank for International Settlements Innovation Hub Centre in Hong Kong endorses the project.

The incentive for diversifying out of the US dollar system has grown over time due to fears about US sanctions. The US has imposed more than 10,000 unilateral sanctions on foreign entities over the past 20 years. The sanction efforts have intensified under the Biden Administration (Exhibit 1). Arguably, the effect is a 'de-dollarisation' of trade, with China picking up the slack through internationalisation.

Exhibit 1

Number of new US sancations by year



Sources: Compiled from US Treasury, BNP Paribas Asset Management 26 Mar23

THE SALAMI-SLICING TACTICS

Individually, the latest developments do not dent the dollar's global supremacy. Take the China-Brazil agreement, which received much international attention, to replace the US dollar in most of their bilateral trade settlement by the renminbi. Sino-Brazil total trade totals about USD150 bn a year. China's cumulative investment in Brazil since the 1990s is about USD100 bn.

Now consider SWIFT. It processes about USD150 trillion worth of payment messages worldwide a year (here), or USD12.5 trillion a month. If we assume all the China-Brazil trade and investment payments were made in renminbi, that would cut USD250 billion worth of payments from SWIFT, or only about 0.17% of its annual total.

However, China is using a 'salami-slicing' tactics by taking small steps to encourage countries, not just Brazil, to use renminbi for cross-border payments. It is already trading with Russia in renminbi (due to the Western sanctions on Russia) and doing some oil trades with countries like Indonesia, Iran and Venezuela in renminbi. Among the BRICS countries, the three largest ones – China, Russia and Brazil – are now working together on using renminbi for cross-border payments. They are the world's largest commodity exporters and importers, and their cooperation could draw many other countries to the renminbi payments mechanism over time.

The point is that while each small individual agreement or alliance does not have much impact on the US dollar-dominated global payments system, cumulatively they could produce a large impact on eroding the US dollar influence and favouring the renminbi global influence. To see this, consider the following.

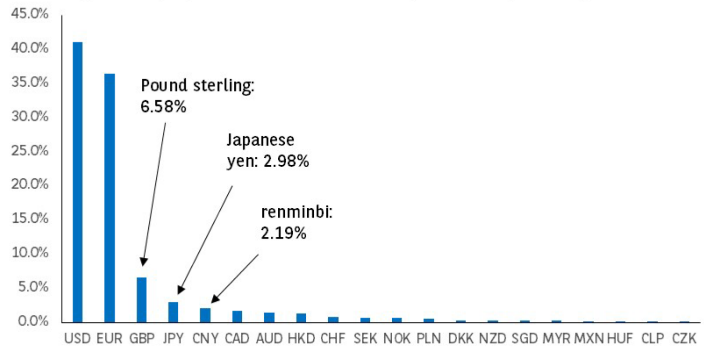
Some oil market players estimated that switching the oil trade from the dollar to the renminbi, say if Saudi Arabia agreed to the Chinese proposal, would initially move about USD800 billion worth of transactions out of the dollar a month[2], or USD9,600 billion a year. Meanwhile, Sino-Russian trade totals about USD190 billion a year (here), and rising.

Adding these amounts to the Sino-Brazilian trade and investment data would suggest that about USD10 trillion (USD250 billion + 9,600 billion + 190 billion) worth of cross-border payments could move from US dollar (SWIFT) to renminbi (CIPS), or 6.7% of SWIFT's annual payments processing total.

Furthermore, SWIFT data shows that the renminbi was the fifth most-widely-used global payments currency, accounting for 2.19% of the total, in February 2023 (the latest data available at the time of writing, Exhibit 2).

Exhibit 2

Share of global payments currencies (February 2023)



Sources: SWIFT, BNP Paribas Asset Management 7 April 23

With about USD12.5 trillion worth of monthly payment messages moving through SWIFT, the renminbi's 2.19% amounted to about USD0.27 trillion a month. Add to that the estimated monthly amount of USD0.83 trillion (= USD10 trillion ÷ 12, from Brazil, Russia and oil) that could be settled in renminbi, the yuan's monthly share of global payments (USD 0.83 trillion + 0.27 trillion = USD1.1 trillion) would rise to 8.8%% (= USD1.1 trillion ÷ 12.5 trillion) in the SWIFT system. That would easily replace the pound sterling as the third most-widely-used global currency, *ceteris paribus*.

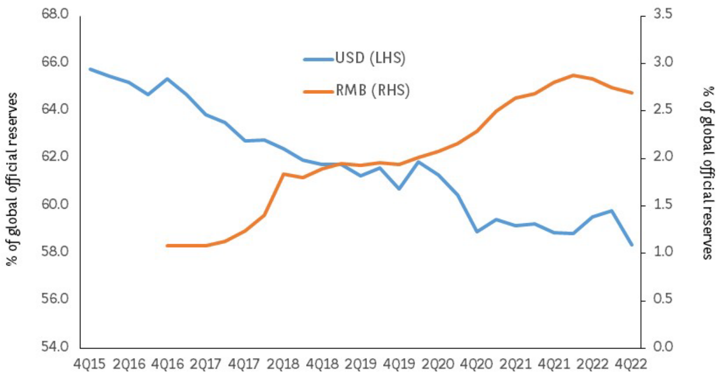
[2] See reference in footnote 1.

THE SHORT-, MEDIUM- AND LONG-TERM

Of course, the renminbi will not displace the US dollar and the dollar-based payments system anytime soon. China's inconvertible capital account is the biggest obstacle for the renminbi to become a global currency. Crucially, China needs to build global credibility and gain international trust for the world to accept its currency as a global reserve currency. All this will take a long time to accomplish.

However, its tactics for internationalising the renminbi could erode the US dollar dominance over time, as the volume and the scope of using renminbi for international payments could grow when more countries diversify out of US dollar risk. This could further erode the declining share of the US dollar in global reserves and boost the share of the renminbi in the coming years (Exhibit 3).

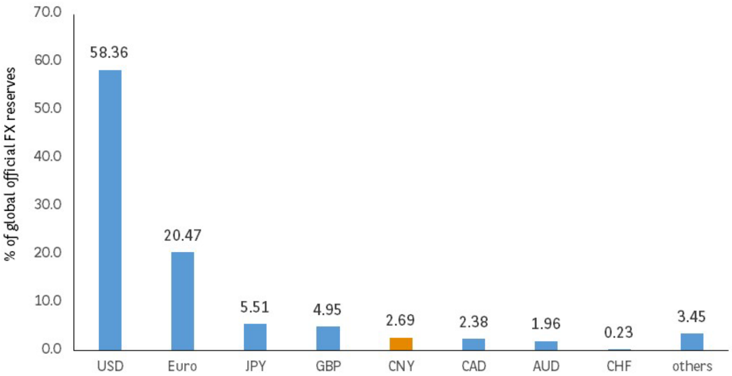
Exhibit 3
Shares of USD & RMB in global reserves



Sources: IMF, BNP Paribas Asset Management 7 April 23

If China gets its economic and reform policies right, that could sustain or even speed up the momentum of internationalisation. The renminbi's share in global reserves could possibly double from the current 2.7%, making it the world's third largest reserve currency ahead of sterling and the yen much quicker than many players expect (Exhibit 4).

Exhibit 4
World currency composition of official FX reserves (4Q 2022)



sources: IMF, BNP Paribas Asset Management 7 Apr 23

In the medium-term, countries might seek to balance their interests between China and the US by trading with China (and probably also with Asia) in renminbi using China's CIPS system and with the rest of the world in US dollar via SWIFT.

In the long-term, when there is enough penetration of the renminbi, in both physical and digital forms, in a separate jurisdiction or region, a trade and finance system parallel to the US dollar system could form and gain critical mass. This will force the world to adapt the cross-border transaction mechanisms and their underlying technical, regulatory and institutional frameworks to accommodate the renminbi framework.

One can run but not hide, and in this case from the Chinese renminbi.

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DISCLAIMER