

# *Research on the Construction of Shanghai International Financial Center from the Perspective of RMB Internationalization*

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**Abstract:** By reviewing the history of RMB internationalization, this paper analyzes the new circumstance of RMB internationalization, consequently the necessity of a financial center for China's onshore financial market, and Shanghai's superiority being the financial center. Then three suggestions are proposed for Shanghai to build an RMB onshore financial center, including the further opening of the financial market, establishment of market rules, and strengthening risk prevention.

## 1. Introduction

The internationalization of RMB (Renminbi-China's currency), which began in 2010, has been a decade. In the past decade, the most iconic achievement of RMB internationalization has been to become a special drawing right (SDR) currency of the IMF. As RMB is accepted and used by more international traders and investors, there is an increasing demand for RMB foreign exchange trading services, RMB-denominated asset management services, and RMB cross-border investment and finance services. Concerning the development of other international currencies, these services are often provided centrally by an international financial center.

Although Hong Kong has played an essential role in the process of RMB internationalization as an offshore financial center for RMB, considering the transformation of China's current economic development mode and changes in the international economic and financial environment, if RMB internationalization needs further development, it is urgent to develop onshore financial markets. Previous studies have paid insufficient attention to the construction of onshore financial centers in the process of RMB internationalization. Hence, the purpose of this paper is to explore what kind of onshore financial center needs to be built for the further development of RMB internationalization.

## 2. RMB Internationalization

### 2.1. Currency Internationalization

Currency internationalization refers to the process in which a sovereign currency transcends national

boundaries and is widely used by other countries in international trade, international capital flows, and foreign exchange reserves. Currency internationalization is essentially the product of economic internationalization. In general, currency internationalization can create an array of benefits for the economic agents and the monetary authority of a country. Particularly, economic agents evade exchange rate risks with the assistance of using the domestic currency in cross-border trade settlement; approaches of both public and private finance extend to international markets; the costs of both public and private finance may diminish to a lower level, due to lower interest rates of the offshore currency in international markets.

RMB internationalization refers to that RMB plays the role of an international currency in foreign economic exchanges and develops into primary pricing and settlement currency for international trade, international investments and financing, and also a valuable international reserve currency after a few years[1]. Statically, it is a state and result of the use of RMB as an international currency. Dynamically, it involves the whole process of RMB's development into a major international currency.

## **2.2. Why Promote RMB Internationalization**

For China promoting RMB internationalization has many benefits:

- (1) reduce trade costs and foreign exchange risks;
- (2) deepen China's financial sector and improve the efficiency of the financial system;
- (3) promote the international competitiveness of China's financial institutions;
- (4) gain international seigniorage revenue and currency privilege;
- (5) enhance China's political influence;

In addition, there is a growing call for the international monetary system to gradually move from a single currency to a pluralistic one, as this will reduce the deficit pressure on the sole reserve currency provider and provide more options for other countries' foreign exchange reserves.

In short, RMB internationalization not only benefits China but also allows other countries to benefit from a diversified international currency system.

## **3. The Development Process of RMB Internationalization**

### **3.1. The Development History of RMB Internationalization**

The internationalization of RMB started in 2009. The initial driving force was the drastic fluctuation of the exchange rate of major reserve currencies after the outbreak of the international financial crisis. Many Chinese enterprises hoped to use RMB in international transactions to reduce the risk of the exchange rate. After about ten years of development, in 2018, the share of RMB settlement in international trade was 2.05% globally. In international financial transactions, including direct investment, international credit, international bonds, and bills, RMB accounts for 4.90% of the total. The RMB accounts for 1.89% of official foreign exchange reserve assets globally. The international monetary institute of the Renmin University of China compiled the RMB internationalization index RII to measure the degree of RMB internationalization. At the end of 2009, the RII was only 0.02. By the end of 2018, RII reached 2.95, which means the degree of RMB internationalization, as measured by the index, has increased 147.5 times in about ten years. To sum up, using the same measurement method as RII, the top five critical international currencies in the world in 2018 are the US dollar (51.95), the European dollar (25.75), the Japanese yen (4.38), the British pound (3.98) and RMB (2.95)[2].

### **3.2. New Changes and Requirements of RMB Internationalization**

As mentioned above, the essence of a country's currency internationalization has always been this country's economic internationalization. The degree of China's economy internationalization today is quite different from that of the beginning of the internationalization of RMB. Namely, the use of RMB for cross-border trade settlement to reduce exchange rate fluctuation losses is no longer the most urgent and crucial need, though this demand is still an essential requirement. Now, the internationalization of China's economy has reached a new stage, and its new features are high-quality development and high-level opening.

High-quality development requires industrial structural upgrading, which is inseparable from the transformation of investment structure. For one thing, the structure of China's Foreign Direct Investment (FDI) is changing. As China is a big country in the utilization of foreign capital, foreign investment is significant in the investment structure. In the past, most of the foreign investment in China was based on China's resource endowment as a low-cost export processing base, while industrial structural upgrading requires more foreign investment in high-end manufacturing and high-end service industries. For another, the scale of China's Outward Direct Investment (ODI) has increased rapidly. In 2010, China's FDI was far higher than its ODI (105.74 billion US dollars vs. 68.81 billion US dollars). However, in 2019, the two are almost flat (138.14 billion USD vs. 117.12 billion USD). The above two changes caused by high-quality development mode require more comprehensive, convenient, and efficient financial services. There is no doubt that those financial services are effectively and efficiently provided by numerous and varied financial institutions. At present, only a prosperous international financial center can gather so many financial institutions with different functions.

A higher-level opening means openness in both the current account and capital account in the balance of payments. China has made remarkable achievements in current account liberalization. In contrast, the opening of the capital account is lagged compared with the current account due to lessons from the Southeast Asian financial crisis at the end of the 20th century. However, as the world's second-largest economy with more than \$3 trillion in foreign exchange reserves, China now needs to expand the opening of the financial sector further to achieve the enhancement of the competitiveness of its financial sector and to meet international investment and financing needs. Consequently, higher-level opening means providing a wide range of financial services for businesses and individuals, which needs an international financial center as a carrier to gather financial institutions and expand the breadth and depth of the financial market.

Therefore, based on the new internationalization features of China's economy, a prosperous onshore financial center would better promote the development of RMB internationalization.

## **4. Establishing Onshore International Financial Centers in the Process of RMB Internationalization**

### **4.1. Onshore and Offshore Financial Centers**

Historically, the US dollar, as the most successful international currency, was realized gradually with the development of the Eurodollar market and the expansion of US banking overseas business. In this process, London, as an offshore financial center, is an essential carrier of the Euro market, providing the market with necessary infrastructure, institutional arrangements, human resources, and various business opportunities.

As the latest international currency, RMB draws on the experience of existing international currencies. To no small extent, today's Hong Kong had become an RMB offshore financial center, which is very close to the currency internationalization process when London became a US dollar

offshore financial center. Judging from the development of the RMB offshore financial center in Hong Kong for more than a decade, it has played an irreplaceable role in the RMB internationalization. It not only promotes the development of financial infrastructures such as RMB clearing banks and RMB cross-border payment systems, but also enriches RMB's overseas investment products, and also bolsters the further opening of China's financial system.

However, compared with Hong Kong's RMB offshore market, the development of the RMB onshore market has lagged. If the onshore market of a country's local currency is less developed than the offshore market for an extended period time, it will inevitably lead to an imbalance between the two markets. The imbalance will form an impact on the onshore market by the offshore market interest rates and exchange rates and erode the pricing capacity of domestic funds. It will also cause a fragmentation of the domestic market, which may easily lead to the arbitrage of speculative capital. Therefore, China needs a well-developed RMB onshore financial market and a prosperous offshore financial market to drive the development of RMB internationalization jointly.

Comprehensively analyzing the development environment of China's onshore financial market, Shanghai is the best financial center. At present, Shanghai has gathered various national financial factor markets such as stocks, bonds, currencies, foreign exchange, futures, gold, bills, insurance, and trusts[3]. The second phase of the RMB cross-border payment system (CIPS) was fully commissioned in May 2018. The financial infrastructure has been continuously improved, and a complete financial industry chain has been gradually formed, which includes transactions, clearing, settlement, and payment. The RMB pricing system has been initially established, which provides a reliable guarantee for the international use and investment of RMB. In addition, the Chinese government's policy support also gives Shanghai a unique advantage in competing with other cities. As early as 2009, the Central Government of China issued an opinion supporting Shanghai's construction of "two centers" (international financial center and international shipping center), clearly requesting that "the basic development of Shanghai by 2020 is compatible with China's economic strength and RMB's international status international financial center".

#### **4.2. Building Shanghai RMB Onshore International Financial Center from Three Aspects**

The external macroeconomic environment, the micro mechanism of the realization of global investors' interests, and the changes in the international financial structure have given Shanghai a new opportunity to develop an RMB onshore financial center[4].

First, the external macroeconomic environment is tightening (China-US economic and trade friction), and it may become the new normal in the foreseeable future. Under such circumstances, accelerating the cross-border use of RMB and the construction of an international financial center can enhance monetary and exchange rate policy autonomy, reduce the spillover effect of foreign currency authorities and decrease the risk of long-arm jurisdiction and financial sanctions.

Only a stable and prosperous foreign exchange trading market can achieve the above objectives, so the Shanghai international financial center should include the RMB foreign exchange trading center. The reality is that Shanghai has many Chinese and foreign financial institutions, completed and developed financial infrastructure supported by the vast scale of the Chinese market. Therefore, the government can focus on RMB foreign exchange transactions and build Shanghai into a world-leading foreign exchange trading center.

Second, in recent years, China's bond market and stock market have been opening up rapidly, and related indexes have been included in international indexes, attracting more foreign capital inflows. At the same time, China's domestic RMB direct foreign investment has steadily increased. While promoting the optimization and upgrading of its domestic industrial structure, it has also enhanced

the participation and recognition of international investors in China's economic development.

Because Shanghai has advantages in the bond and stock market and infrastructure, Shanghai can focus on the construction of an RMB financial asset allocation center to facilitate foreign investors to increase their holdings of RMB assets, smooth the circulation channel of currency supply and demand, and allow foreign investors to share dividends from financial market development. Such a financial center for RMB cross-border users and global investors can achieve interest bundling, then meeting a win-win situation in the micro mechanism.

Third, in the context of changes in the international financial landscape, many countries need other currency and asset options than the current mainstream currency.

Furthermore, the "Belt and Road" strategy is an important direction for RMB's internationalization in the future.

Therefore, Shanghai can focus on building a cross-border investment and financing service center. Because the total volume of imports and exports from Shanghai to the "Belt and Road" countries accounted for about 1/7 of China in 2019. As the most developed and dynamic city in China's economy, Shanghai has great potential in promoting cross-border investment and financing services and driving RMB out.

## **5. The Path Choice of Building Shanghai International Financial Center**

### **5.1. Further Opening of Shanghai's Financial Market**

First, it is about time that the government fully opened the secondary markets for bonds and stocks. The government should focus on promoting QFII and RQFII access policies, and integrate various open channels for direct market access to form a consistent policy. At the same time, China's domestic financial products should be more integrated into the international mainstream index.

Second, a steady promotion of the primary bond and stock markets will be indispensable. In terms of the opening of the bond market, it is vital that further enhancement of the cross-border fund management of panda bonds and issuance of panda bonds regularly. In terms of the stock market, it is essential to study and implement the domestic stock issuance by overseas institutions.

Third, the government should prudently promote the opening up of derivatives to the foreign investors, and support them to use derivatives to hedge the risk of domestic operating assets. However, the government should adhere to the principle of the actual demand of the market in the process.

### **5.2. Establish Universal Rules in Line with Market Construction**

The construction of any international financial center must have both abundant products and universal international rules. The following three global rules are the premise and basis for the development of an international financial center:

First, the monetary authority should advance interest rates and exchange rates more market-based. From the perspective of the whole country, the monetary authority should further develop the loan market quotation rate and improve the efficiency of monetary policy transmission. Moreover, the capital account deregulation should be taken into consideration as well. The deregulation of non-convertible items should be in an orderly manner, and convertible items should be more convenient by introducing more facilitation measures. Shanghai should try to take the lead in these areas.

Second, the government should give priority to RMB in the course of development, but adhere to the principle of currency neutrality in transactions and management. Furthermore, the problem of arbitrage across currencies should be solved at the policy level and the transaction level.

Third, the government needs to focus on infrastructure. Infrastructure is the implicit safeguard rule

of the universal platform, which will take effect in the aspects of delivery, registration, clearing, and settlement. Therefore, Shanghai and the whole country should jointly consider this issue. Shanghai should explore to accelerate the formation of a financial infrastructure system with reasonable layout, effective governance, and flexibility, while taking into account the cross-border use of RMB, and continue to enhance the service functions of the CIPS system. Besides, taxes, accounting, and ratings must be consistent with international standards to jointly promote the cross-border use of RMB and the construction of an international financial center.

### 5.3. Strengthen Risk Prevention

The government demands to inaugurate a risk management and control framework that combines macro-prudential and micro-regulatory approaches. Macro-prudential regulation should aim at maintaining the stability of the foreign exchange market and avoiding abnormal fluctuations. This object also needs to be propped up by a counter-cyclical market regulatory mechanism for cross-border capital. The critical point of micro-regulation is to strengthen the examination of transaction authenticity. Three prerequisites need to be accomplished to lay the foundation for establishing a relatively complete risk management and control framework: first, the principle of retention of cross-border transactions; second, the principle of rational application of information and digital technology; third, the timely correction mechanism when the international financial market is seriously out of balance.

## 6. Conclusion

This paper reviewed the history of RMB internationalization. Then it analyzes the new demands for China's onshore financial market under the conditions of high-quality economic development and high-level opening up in China. According to the status quo of RMB internationalization and the new demands, the construction of an onshore RMB international financial center in Shanghai will promote the development of RMB internationalization. The construction of Shanghai international financial center should focus on three aspects: market opening, market construction, and market supervision.

The internationalization of RMB and the construction of the Shanghai international financial center are both a long-term process. In this process, market development, implementation of government plans, and changes in the international environment will have a complex impact on both. Therefore, researchers need to continue to pay attention to the status of the two in order to analyze new problems.

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