



Atlantic Council

ADRIENNE ARSHT
LATIN AMERICA CENTER

HSBC 

A Globalized Renminbi

**WILL IT RESHAPE
LATIN AMERICA?**

By Douglas W. Arner and Andre Soares



Atlantic Council

ADRIENNE ARSHT
LATIN AMERICA CENTER

The Atlantic Council's Adrienne Arsht Latin America Center is dedicated to broadening awareness of the transformational political, economic, and social changes throughout Latin America. It is focused on bringing in new political, corporate, civil society, and academic leaders to change the fundamental nature of discussions on Latin America and to develop new ideas and innovative policy recommendations that highlight the region's potential as a strategic and economic partner for Europe, the United States, and beyond. The nonpartisan Arsht Center began operations in October 2013.

The Atlantic Council promotes constructive leadership and engagement in international affairs based on the central role of the Atlantic Community in meeting global challenges. For more information, please visit www.AtlanticCouncil.org.

This report is written and published in accordance with the Atlantic Council Policy on Intellectual Independence. The authors are solely responsible for its analysis and recommendations. The Atlantic Council and its donors do not determine, nor do they necessarily endorse or advocate for, any of this report's conclusions.

ACKNOWLEDGMENTS

We extend a special thanks to HSBC for the generous support for this initiative, without which this report would not have been possible.

We would like to thank the many people who contributed to this report. Foremost among them are the many participants at our May 2016 roundtable in New York City whose insight is reflected in the pages that follow. Luis Miguel Castilla, our senior fellow and the former minister of finance of Peru and Peruvian ambassador to the United States, provided valuable feedback on the draft of this report. Beth Adelman, external editor, and Sarah DeLucia, Atlantic Council editor, provided excellent copy editing. We would also like to thank Romain Warnault, associate director of publications, for his hard work and good-spirited flexibility. Donald Partyka continues to design excellent, captivating reports for the Arsht Center.

© 2016 The Atlantic Council of the United States. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means without permission in writing from the Atlantic Council, except in the case of brief quotations in news articles, critical articles, or reviews. Please direct inquiries to:

Atlantic Council
1030 15th Street NW, 12th Floor
Washington, DC 20005

ISBN: 978-1-61977-467-4

October 2016

A Globalized Renminbi

WILL IT RESHAPE
LATIN AMERICA?

By Douglas W. Arner and Andre Soares

Douglas W. Arner is professor of law at the University of Hong Kong and Co-Director of the Duke-HKU Asia America Institute in Transnational Law.

Andre Soares is counselor at the Inter-American Development Bank and former research director at the China-Brazil Business Council.

Foreword

Jason Marczak

Director, Latin America Economic Growth Initiative
Adrienne Arsht Latin America Center
Atlantic Council

María Fernanda Pérez Argüello

Assistant director
Adrienne Arsht Latin America Center
Atlantic Council

For the past several months, China has been making headlines across the world. And not for the usual reasons.

In September 2016, China hosted the G20 for the first time. Argentine President Mauricio Macri, Brazilian President Michel Temer, and Mexican President Enrique Peña Nieto joined world leaders in Hangzhou for this historic gathering. Peruvian President Pedro Pablo Kuczynski followed up with a trip to Beijing as his first official foreign destination. China seeks to celebrate its economic muscle again in October 2016. The renminbi (RMB) becomes the fifth global currency—joining the US, European Union, Japanese, and United Kingdom banknotes—to be accepted by the International Monetary Fund as an international reserve asset.

The renminbi is clearly on the rise. But why is a Latin America center devoting its intellectual firepower to what at first appears to be an issue for the world's financial centers? The answer is simple: Internationalization of the renminbi may fundamentally reshape trade and finance with emerging markets around the world, with a particular impact in Latin America.

Although there is a temptation to set aside the discussion as too technical or even too political, opening up investment and trade to take place in China's own currency may push even more commerce to the East.

China is already one of Latin America's top three trading partners and the number one export destination for Brazil, Chile, Peru, and Argentina. In the past five years, China's investment in the region has reached almost \$11 billion annually. With the renminbi as a global currency, this reality may eclipse previous trends. More businesses are likely to trade directly in the renminbi and Chinese-originated investment could open up to new players who prefer RMB-denominated transactions.

This could be a unique opportunity for Latin America to further diversify its trade and investment partners. But policymakers should

recognize the pitfalls that come with a currency around which many questions swirl in global financial markets.

Is Latin America ready? This report focuses on the regional ramifications of a globalized renminbi, but there are implications for the United States as well. The potential of a further boost in China-focused investment and commerce, with transactions in the renminbi rather than the dollar, has the potential to come at the expense of US commerce. More easily accessible Chinese money must be weighed against the certainty and strong historical fundamentals of the US currency. Clearly, even those outside Latin America should pay close attention.

This report is important for those seeking an accessible primer on China's motivation for internationalizing the renminbi and how Latin America fits into the equation. It lays out the path for how this new reality can become an asset for the region, and also the bumps that may exist along the way.

The China–Latin America relationship has already proven to be highly complex. Our first two reports on this topic—*China's Evolving Role in Latin America* (September 2015) and *Industrial Development in Latin America* (August 2016)—point out the benefits and drawbacks of closer engagement. This publication tackles a topic that is often left to the back pages of financial sections, but should really be front-page news. We are grateful to the many US, Latin American, and Chinese institutions that participated in a May 2016 New York City roundtable, whose comments and insights on the topic helped inform our work.

This report could not come at a more timely moment. Though there is limited insight on the regional implications of an internationalized renminbi, the time to lay out a way forward is now. These are uncharted waters, making it even more critical to ensure that this new reality further fosters Latin America's economic ascent.

Internationalization of the renminbi may fundamentally reshape trade and finance with Latin America.

Contents

- 1 **The Rise of China's Currency**
- 2 **Why Internationalize: China's Perspective**
 - The Pillars of RMB Policy
 - Is the Policy Working?
- 6 **Why Does This Matter for Latin America?**
 - A Bumpy Relationship
 - The Road Ahead
- 9 **Policy Proposals: How Should Latin America Access the RMB Market?**
- 11 **Looking Forward**
- 12 **Endnotes**

The Rise of China's Currency

In the past four decades, beginning with Deng Xiaoping's gradual economic opening in 1978, China has reemerged as one of the world's most important economies. Its economic, geopolitical, and financial rise is underscored by key milestones: joining the World Trade Organization (WTO) in 2001; surpassing the United States, Germany, and Japan to become the world's most significant exporting nation;¹ and becoming one of the world's top three global sources of outward foreign direct investment (FDI).² In 2015, China became a net foreign investor, sending more FDI out than it took in.³ China is well on its way to overtaking the United States as the world's largest economy in absolute gross domestic product terms, and has already done so on purchasing power parity measures.⁴

Its economic and financial importance in Latin America echoes trends on the global stage. China is now among the three most significant trading partners for the region, eclipsing the European Union (EU) in 2012. Brazil, Chile, Peru, and Argentina count China as their top export destination, as well as a major source of imports. Chinese investment has also surged, with Brazil topping the list as the region's leading destination for Chinese FDI.

China's rise in the global economy is reflected by changes in the international significance of its currency, the renminbi (RMB). This is not surprising. Currency internationalization is a natural step in the evolution of a leading economy. The international use of the dollar, for example, grew out of the United States's rapid economic emergence at the beginning of the twentieth century, although it became the world's leading currency only in the aftermath of World War II. Likewise, the international significance of the Japanese yen grew out of the country's rapid economic ascent in the 1970s and 1980s.⁵

With the October 2016 inclusion of the RMB in the International Monetary Fund's Special Drawing Right (SDR) basket of major international currencies, joining the US dollar, the euro, the Japanese yen, and the British pound sterling, China is now among a select group of countries whose currency is recognized as an international reserve asset. It adds credibility to a currency still observed with some skepticism in many parts of the world.

While China is now firmly established as a leading driver in the global economy, the ramifications of the renminbi's internationalization are still evolving, especially

If history repeats itself, it will be just a matter of time until China's currency is used internationally.

for emerging markets such as those of Latin America. To the extent that Chinese authorities undertake additional domestic reforms—in areas including the capital account, financial market, and exchange rate policies—this may give other economies, including Latin American countries, more confidence to use the RMB for trade and financial transactions.⁶

If history repeats itself, it will just be a matter of time until China's currency is widely used internationally. But the story is not that simple. The Chinese economy continues to be characterized by a high

degree of government involvement, including with its exchange rate. This gives pause to the many governments and private businesses that question the possible implications for market behavior.

How relevant are these policies to Latin American countries? With major economic relationships with China, most of the region's largest economies are likely to see both more businesses trading directly in the RMB and more Chinese-originated FDI using the RMB. To encourage this and manage possible liquidity issues, China has already signed currency swap agreements with countries such as Brazil, Argentina, and Chile. What do these agreements actually mean and what are the risks for businesses that traditionally have depended on trading and investing in dollars? What measures could Latin American countries and businesses take—individually and collectively—to adapt to China's changing economic landscape and the opportunities and risks that come with greater use of the RMB?

RMB: THE 101

- In October 2016, the renminbi joins the ranks of major international currencies as a reserve asset.
- Most of the region's economies are likely to see more businesses trading in RMB.
- An increase in RMB-denominated FDI in Latin America is expected in the next few years.

Why Internationalize China's Perspective

From an economic standpoint, China's process of RMB internationalization is intended to support the diversification of its trade and investment relationships, and encourage continued domestic economic restructuring. Enhanced competitiveness and a more innovation-friendly financial ecosystem are major objectives in China's economic reform strategy. Top international goals under this framework include trade with and investment in emerging markets

worldwide, as well as achieving greater economic and financial balance between its developed and emerging market relationships.

The process of restructuring addresses both changing demographics in China as well as concerns about the middle-income trap. Both of these are important changes from China's pre-2008 economic model, which was based largely on exports, particularly to the United States and the EU, and was underpinned by WTO accession in 2001.

RMB internationalization is intended to both reduce risks associated with an overreliance on the dollar and provide outlets for China's domestic savings and investments. The combination of these twin objectives is intended to support economic restructuring and competitiveness, in addition to reducing currency risks. It aims to serve as a bulwark against the many potential financial crisis indicators that have characterized China's economic and financial system over the last several years: rapid credit growth, dramatic changes in property prices, and currency and financial market volatility.

Major challenges lie ahead for China, and thus for the rest of the world. In particular, the financial and currency market volatility that began in spring 2015 highlights the risks of China's ongoing process of financial liberalization and currency internationalization. New doubts have been cast around China's resulting interventions in its stock markets, its expenditures and outflows of foreign exchange reserves, and uncertainties over its exchange rate.

In the wake of the United Kingdom's June 2016 decision to leave the EU, the value of the

The market volatility that began in spring 2015 highlights the risks of China's financial liberalization and currency internationalization.

RMB declined, a stark contrast to the yen and the dollar. This reversal marks a different trajectory for the RMB from what happened during the 1997 Asian financial crisis and the 2008 global financial crisis—both periods in which the currency strengthened as a safe haven.

Beyond the important economic and financial factors underpinning RMB internationalization, there is also a major political component. Widespread global use of a currency is symbolic of a country's

growing power. China seeks both greater recognition of its economic significance and a more active role in international economic affairs. SDR inclusion was a major step. China also has its eye on the United States and what will come of its pivot to Asia. In some ways, Chinese involvement in Latin America is an attempt to counter-balance growing US ties with many countries in Asia.

The Pillars of RMB Policy

In the aftermath of the 2008 global financial crisis, the Chinese government initiated a series of policies that would later define RMB internationalization. These policies aimed at developing three main markets for

FIGURE 1. The Path for the RMB to Become a Global Currency

TRADE	INVESTMENT	FINANCIAL
Import in RMB Export in RMB Pay for services in RMB Thirty-three currency swap agreements with different countries and regions. The agreements total \$500 billion Sixteen agreements to establish clearing-houses	Foreign direct investment in RMB Outward direct investment in RMB RMB Qualified Foreign Institutional Investor quotas. RMB 1.5 trillion (\$225 billion) in such quotas over the last decade to twelve different countries	Panda Bonds (Foreign companies issue bonds in the Chinese market) Dim Sum Bonds (Chinese and foreign companies issue RMB-denominated bonds abroad) Opening up A-shares markets in China Shanghai-Hong Kong stock exchange connection

Source: André Soares, with data from the Chinese Ministry of Finance.

FIGURE 2. China's Financial Footprint in Latin America



Source: André Soares, with data from the Chinese Ministry of Finance.

RMB international use: trade settlement; crossborder investment; and crossborder financial transactions (see figure 1, page 2). The goal is for countries around the world to be able to trade, receive FDI, and invest in RMB-denominated products (including bonds and stocks).

The first step in RMB internationalization occurred in mid-2009 when the People's Bank of China (China's central bank) launched a pilot program for crossborder trade transactions. For the first time, companies inside and outside of China could engage in commercial transactions (imports and exports) using the RMB rather than the dollar.

But this also posed a challenge. China sought to promote the international use of its currency but without an established market. Unlike the dollar, which is underpinned by the world's deepest and most liquid capital markets and has a dominant status in a variety of international transactions, RMB markets were neither large nor liquid and the currency was not widely held outside of China. This created a problem. How could companies trade in RMB without either an offshore market beyond

China or access to a developed domestic RMB market?

China's solution: develop a series of global currency swap agreements—an idea loosely based on its experience in the wake of the 1997 Asian financial crisis.⁷ These agreements between central banks, which exchange local currencies for direct access to RMB liquidity, helped increase confidence in and access to RMB in international markets. Another result is that the RMB can then be offered as an alternative to the dollar, making China an alternative to the International Monetary Fund for countries facing liquidity constraints.

Since 2009, China has signed thirty-three currency swap agreements with different countries and regions, totaling \$500 billion; the latest is a May 2015 agreement with Chile.⁸ Together with the bilateral swap agreements with Brazil and Argentina, the total for those signed with Latin America reaches \$49 billion (see figure 2).

But a mechanism was also needed to carry out RMB transactions among a wider pool of participants. For this purpose, China agreed to a series of clearinghouse agreements, which allow a designated bank (a Chinese bank

on the RMB side, with a local or international bank as counterparty) to act as a financial intermediary—a middleman between two parties—in local currency operations involving RMB. Chile is home to one of the sixteen global clearinghouses that China established. Through these agreements, middleman banks facilitate a company's imports and exports by helping to save in transaction costs, translate all operation-related documents, and assist in operations with intermediary banks in another country.⁹ The China International Payment System (CIPS) also was launched—a mechanism to draw these various clearing arrangements into a global network, similar to the way SWIFT (Society for Worldwide Interbank Financial Telecommunication) works for the dollar.

China also began to liberalize its capital account, launching a series of programs allowing foreign investors to conduct operations in RMB-denominated products. Of particular importance was the creation of the RMB Qualified Foreign Institutional Investor (RQFII) scheme, which gives investors from select countries and jurisdictions access to China's domestic markets. Through it, a quota system determines how much each investor—a public or private-sector financial institution—is allowed to invest in the Chinese financial market. As of June 2016, China had provided program licenses to eighteen countries, plus Hong Kong, with a total quota ceiling of almost RMB1.5 trillion (\$225 billion). The most recent RMB250

billion (\$37 billion) agreement, with the United States, is the second largest after Hong Kong. In Latin America, so far only Chile has received such a license, with a quota of RMB50 billion (\$7.5 billion).

Still, lingering obstacles to currency internationalization efforts, as well as allegations of currency manipulation, are continuing to create concerns around China's foreign exchange rate controls. Before 2005, China's exchange rate was tied closely to the dollar. It was generally viewed as undervalued, providing an exchange rate advantage for Chinese exports.

In reaction to US concerns, for several years prior to the 2008 global financial crisis, China steadily allowed its currency to appreciate against the dollar and its exchange rate to more closely reflect a basket of currencies. But as China's economy slowed, its currency once again became more closely tied to the dollar. This time it depreciated as the dollar appreciated.

▼ **Mexico's Central Bank (pictured)—like its regional counterparts—will be tasked with developing a strategy that adjusts to RMB internationalization.**

In an effort to allow greater market determination of the exchange rate, China substantially altered the pre-existing system in August 2015. This brought an extremely volatile market reaction, with global implications. Since then, exchange rate policy has been inconsistent, raising significant concerns around the world. In



JORGE MARTINEZ/FICKR

particular, China has come under pressure for its failure to communicate exchange rate policy directions and for a lack of clarity in the mechanism itself.

Is the Policy Working?

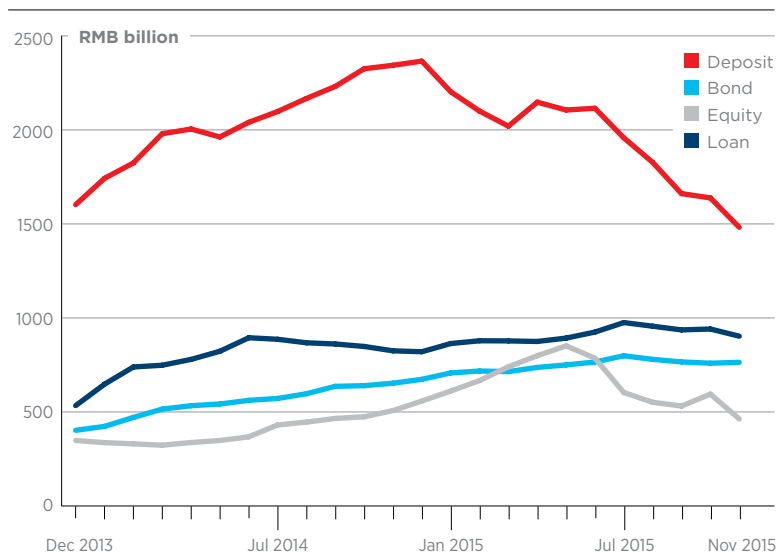
Over the past decade, use of RMB as a trade currency has increased dramatically. Trade in RMB already represents 26 percent of China's trade with the world; it grew an average of 46 percent per year over the last five years.¹⁰ But when Hong Kong's share of China's total trade is eliminated, global trade denominated in RMB falls to just 12 percent.¹¹ Service trade in RMB—an area of particular importance to Latin American countries—has experienced only a modest boost, perhaps reflecting the fact that China is not a major service exporter. Overall, although the RMB is the fifth most important payment currency in the world, it only accounts for less than 3 percent of global payments for cross-border trade and financial transactions.¹²

However, the use of the RMB as an investment currency has grown rapidly. Outward direct investment (ODI) increased dramatically over the past two years. In 2014, RMB as an investment currency accounted for 25 percent of China's ODI, up from only 5 percent in 2012.¹³ Still, there is not much evidence that China is using RMB for its investments across Latin America. Chinese FDI in the region tends to be directed to cost-intensive natural resource projects, such as mining activities in Peru or constructing a hydropower plant in Ecuador. Given these projects' importance to the local economies, countries tend to rely on the more stable and liquid dollar as the currency of choice.

Financial operations is an area where China has yet to develop policies attractive to both domestic and foreign interests. Foreign institutions actually decreased their RMB assets over the past couple of years (see figure 3). This decision can be explained by a shift in market sentiment, questioning the future possibilities of RMB appreciation. Latin American countries are not isolated from the impacts of changes in RMB value; a relative RMB appreciation makes it more expensive for Chinese importers to buy commodities from the region.

At the same time, loans and bond markets experienced disappointing growth over the past two years. This is likely due to the regulatory constraints that worry foreign institutions. There is still a lack of regulatory understanding about whether a company is able to bring the RMB to the offshore market. A knowledge gap is also common among Chinese investors about the issuers and their businesses.

FIGURE 3. Foreign Holdings of RMB Assets



Source: André Soares, with data from the Chinese Ministry of Finance.

WHY INTERNATIONALIZE?: THE 101

- The internationalization of China's currency has major economic, financial, and political underpinnings.
- A globalized RMB allows countries around the world to trade, receive FDI, and invest in RMB-denominated products.
- China has pursued a global push for swap agreements and establishment of currency clearinghouses.
- Still, the RMB has yet to fully take hold among commercial partners.

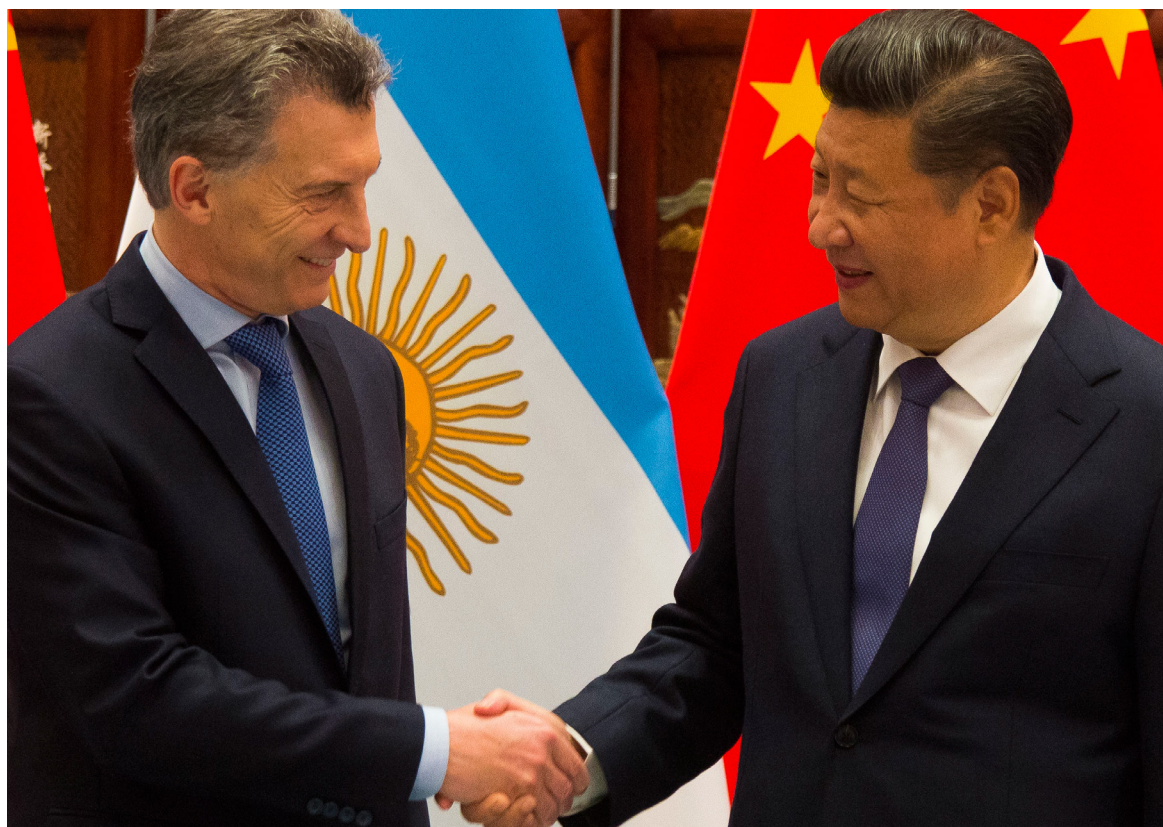
Why Does This Matter to Latin America?

An internationalized RMB can be a new opportunity for Latin American countries to diversify their sources of finance—perhaps in the same way that trading relationships have expanded with the rise of China. For example, countries and companies can issue RMB-denominated debt, which—depending on prevailing interest rates—may lower their financing costs. This is particularly true for countries with constrained access to the G3 (dollar, euro, yen) markets, with Venezuela serving as the leading current example.

A central aspect of China's RMB internationalization strategy is increasing RMB use for trade and trade finance. Trade in a local currency offers significant cost savings: It avoids the transaction costs that result from using a third currency, such as the dollar. Although China-Latin America trade has decelerated in the past two years, the outlook points to robust commerce, becoming a new normal. RMB-denominated trade could provide huge cost savings and a competitive advantage going forward,¹⁴ since China offers a discount to all foreign companies that settle in RMB.¹⁵

At the same time, in 2015 China and Latin America announced their intention to increase trade to \$500 billion per year within the next ten years, slightly less than double current volumes. RMB use may facilitate that growth. Given strong trading links to China, three of the top six economies in the region—Brazil, Argentina, and Chile—will likely lead the charge to put mechanisms in place that allow for greater RMB-denominated operations.

RMB use also helps companies tap into the massive Chinese market and a consumer class greater than the United States and EU combined. A 2015 poll conducted among 150 companies found that lowering transaction costs and accessing new business opportunities are the



▲ Argentine President Mauricio Macri meets with Chinese President Xi Jinping during the G20 meeting in Hangzhou, China, in September 2016.

top reasons why a foreign company engages in RMB operations.¹⁶

However, one potential outcome is an increase in the risk of Chinese investments in Latin America, since less trusted companies without access to international credit in dollars can start to invest. This adds extra layers of opacity when a Latin American company is considering an investment offer from a Chinese partner. A separate concern is the political tensions that come with a greater Chinese presence. These sorts of tensions have already arisen in Africa, where China is the preeminent foreign force today.

Still, RMB internationalization was seen initially as an attractive proposition with few drawbacks. Given China's continued growth, the RMB was anticipated to appreciate against the dollar. Likewise, investments in China's stock markets were regarded as an opportunity to participate in the fortunes of rapidly developing enterprises. Financially distressed Latin American countries, such as Argentina and Venezuela, saw China as not only a major new trading partner but as a new source of investment and finance, often with less demanding conditions



attached—in terms of transparency, labor rights, etc.—than those from developed countries. This may yet prove to be the case.

But major concerns lie ahead. An increase in RMB use in China-Latin America economic and financial relations also creates risks. If Chinese companies invest in the region using RMB, what implications will arise from having assets valued in RMB? This could bring more Chinese investment but it also could lead to greater fears of over-dependence on Chinese trade, investment, and finance.

A Bumpy Relationship

A number of important challenges exist. So far, the numbers do not match China's efforts to promote the RMB in Latin America. Today, less than 1 percent of the region's trade with China is RMB-denominated, a sharp contrast to the previously mentioned 26 percent of China's trade with the world that is RMB-denominated.¹⁷ The reason is simple: China's imports from Latin America consist mainly of commodities, where prices are determined by international markets and are already negotiated in dollars. Switching to RMB would require rewriting contracts already denominated in dollars.

At the same time, a lack of RMB liquidity is seen throughout the region. This is despite the visible increase in the number of Chinese banks present in Latin America to promote RMB products. Today, Chinese state-controlled banks have subsidiaries in eight of the largest countries.¹⁸

▲ The RMB is now an IMF-accepted reserve asset. Here, Managing Director Christine Lagarde (center) headlines a June 2016 press conference.

Still, Chinese banks that operate in Latin America do not have significant capitalization. For example, in Brazil, Bank of China and the Industrial and Commercial Bank of China have, respectively, \$100 million and \$200 million in capital allocated to their domestic subsidiaries.¹⁹ These are trivial amounts for two of the world's largest banks, particularly in comparison to the scale of China-Brazil bilateral trade, which is uniquely composed of high volumes of commodity exports (traditionally priced in dollars).

Likewise, the potential under existing swap and clearinghouse agreements is limited. Only Chile has a clearinghouse for RMB operations. The swap agreement with Argentina only became operational under emergency circumstances: a lack of international liquidity for the country's currency in 2015. Without any other option, the Argentine government was able to swap pesos for RMB to access international markets and then swap RMB for dollars, boosting its domestic reserves. While this is the intended scope of the China-Argentina swap agreement (i.e., to alleviate an international liquidity crisis), this is clearly not the best use. The purpose should be to provide liquidity to ensure confidence in RMB transactions, thus engendering real economic activity, not prolonging calamitous policies.

After exhausting the \$11 billion in funds in the agreement, the Cristina Fernández de Kirchner government sought to renew the agreement with the same face value. Negotiations have yet to conclude, but the new terms are likely to amount to less than half the previous agreement (\$5 billion). This highlights the risk for China in using such swap agreements for political rather than economic purposes.

Private-sector financial operations also remain limited. Latin American asset management firms tend to have a position in Chinese companies in the offshore Hong Kong market. Despite an investment made by China Investment Corporation in Brazil's BTG Pactual investment bank in 2010, a deal that was supposed to pave the way for financial cooperation between the countries, little has been done in this field.²⁰

Latin American firms also have yet to actively trade in the Chinese stock market. Much of this is attributed to the prevailing lack of trust in the fundamentals behind the Chinese stock market and the underlying institutional economic framework of the Chinese economy. After the Shanghai Stock Exchange's 2015 boom and

subsequent collapse, the Chinese government imposed a series of market control measures. Among them were the imposition of strict limits on asset sales and repatriation, which severely affected the confidence of foreign investors, including those from Latin America. Similar to many other foreign investors in Chinese equity markets, Hong Kong now looks to be a more reliable venue than direct investment in mainland markets.

Nevertheless, Panda bonds (bonds issued by foreign companies in the Chinese market) could be seen as an opportunity for Latin American firms to issue debt in the vast Chinese bond market with attractive current yields. This is due to interest rate differentials between the ten-year yields in China (around 3 percent) and those in Latin American countries (on average, above 5 percent). This interest rate differential could be positive for Latin American firms wanting to leverage operations, but with the caveat that China imposes capital controls on taking money out of the country. This makes Panda bonds useful for companies that plan to expand operations in China. It is also attractive for countries seeking to diversify their foreign exchange reserves, particularly as trade flows in RMB increase.

As much as Latin American countries tend not to engage in RMB-denominated operations, they cannot be isolated from the international spillovers of China's monetary policies. Intense RMB volatility and devaluation from August 2015 to February 2016 caused global market turmoil, particularly given uncertainties regarding Chinese exchange rate policy direction and setting mechanisms. Contagion spread to the region's financial markets, as well as other emerging markets around the world.

Latin American markets are seen internationally as highly dependent on Chinese demand, particularly for commodities. A period of decline in the value of the RMB has made commodities generally traded in dollars more expensive to Chinese local buyers, at the same time that Chinese consumers are dealing with a significant slowdown in their domestic economy. The result has been increased market and economic volatility in Latin America as uncertainties about the direction of China's policy and the extent of its slowdown persist.

Perhaps most importantly, a profound cultural and informational gap also exists. A survey of over 150 executives from companies in the US, Europe, and the Asia-Pacific region shows that over 80 percent of business executives see a lack of understanding in how to conduct business in RMB as the greatest obstacle to RMB use in international transactions.²¹ Not all exporters know how to operate in RMB or how doing so benefits these operations.

Today, Chinese state-controlled banks have subsidiaries in eight of the largest countries in Latin America.

The Road Ahead

Both China and Latin America need to come to terms with how to improve the partnership. Latin American exporters need to consider assuming more risk and engaging in operations to access China's vast domestic market. Regional banks could also increase their activities in China, which would boost the confidence of Latin American exporters and mitigate cultural gaps. Currently, only Bank of Brazil has a subsidiary in the Chinese market. Hong Kong would be an ideal starting point for entering the Chinese market; it brings deep links to mainland China and has a central position in global RMB markets.

For their part, Chinese banks could do a better job of committing more resources to and understanding the Latin American business culture. For example, most Chinese banks in the region have no locals on their boards and avoid participation in local associations and media.

All in all, despite China's massive investments in Latin America over the past decade, there is little evidence of substantial RMB use. A general reliance on the dollar still pervades. But recent reports suggest an increase in use in the past year, which could be a sign of things to come.²²

Greater RMB use will require providing answers to the lingering regional concerns that swirl around working with Chinese companies that invest in RMB. Those who receive payment in RMB do not have a clear idea of what to do with the currency and lack confidence in investing in Chinese assets. More risk-averse Latin American companies will not consider selling assets to risky Chinese firms. Still, with the recent opening of the domestic interbank bond market and increases in international liquidity, RMB use is likely to increase across the region.

WHY DOES THIS MATTER?: THE 101

- RMB-denominated debt could lower financing costs for many Latin American countries.
- Challenges exist, however. Chinese banks operating in Latin America do not have significant capitalization or liquidity.
- The use of RMB to alleviate international liquidity problems—instead of creating real economic activity—could help to perpetuate unsound fiscal and monetary policies.

Policy Proposals

How Should Latin America Access the RMB Market?

RMB internationalization is clearly a central Chinese policy objective. However, before the RMB becomes widely used for trade, investment, finance, or reserves management in Latin America, it must win the confidence of financial market participants and policymakers. By taking the following three steps, the **Chinese government** could encourage greater RMB use in the region.



Advance capital account reforms.

If the Chinese government does this, particularly with capital outflow controls, foreign investors would have more freedom to access both bond and stock markets in China. In addition, China could simplify the process of bond issuance to make it easier for foreign issuers to access its domestic markets. However, a more fundamental challenge is sequencing the capital account opening with other policies, such as exchange rate flexibility and financial market development. Strengthening the banking system and developing better regulated equity and bond markets are crucial for better resource allocation within China.²³



Better communicate policy intentions.

An information gap exists in the financial markets. Poor communication from policymakers over the past eighteen months caused a series of misinterpretations among market players. This led to stress in the markets, with ripple effects on Latin American economies.



Clarify the government's role.

An important step would be to clearly signal how the government will involve itself in its domestic stock markets. Last summer, the Chinese government intervened dramatically in markets and imposed a series of restrictions on their operations. This caused foreign investors to lose confidence in China's market and brought contagion effects to regional markets.

If the Chinese government does not address these concerns, the level of confidence of market participants from Latin America is likely to remain low. Nevertheless, China's efforts to internationalize the RMB—if its underlying fundamentals are strong—can better diversify Latin American countries' sources of finance and trade.

The region should step away from the idea of using China as the lender of last resort.

For example, companies could issue RMB-denominated debt, which could potentially reduce financing costs. In addition, denominating trade in RMB decreases transaction costs, a boost for large trading companies that frequently import from and export to China.

To ensure that **Latin American countries and firms** benefit from RMB internationalization, governments and businesses from the region should consider taking the following steps.



Expand the number and scope of swap agreements.

Latin American countries and China could negotiate and expand the number of swap agreements signed; only eight of thirty-three countries in the region have agreements with China. These agreements should focus on creating market liquidity for RMB operations. For this to happen, the swap agreements should be activated under regular circumstances and not only when there is a liquidity emergency. Such swap agreements, if properly structured, have the potential to diversify countries' sources of liquidity as well as support expansion of RMB operations.



Set up more clearinghouses to efficiently boost RMB transactions.

Today only Chile has a clearinghouse for RMB operations. More clearinghouses would enable a larger number of banks to act as financial intermediaries in local currency operations involving RMB, thus reducing transaction costs with China. Clearinghouses increase efficiency, decrease transaction costs, and enhance confidence in the ability to settle RMB transactions. In tandem with the development of the China International Payment System, they provide the fundamental infrastructure for well-functioning global markets. Certainly, Chile envisages a regional hub role for itself in regional RMB transactions. However, clear benefits exist for other major markets to develop their own arrangements to support RMB operations.



Double down on Latin American companies entering the Chinese market.

The private sector should better explore the opportunities the Chinese market offers. Latin American banks should start



committing resources to China and learn more about how to navigate China's complex financial system. More importantly, Latin American exporters outside of commodities should focus on the commercial potential of China's domestic markets. This is an important opportunity for Latin America to diversify away from its reliance on commodities; if steps are not taken expeditiously, the moment may be missed.



Guard against RMB volatility. The coming years are likely to see an uptick in rapid changes to the prevailing exchange rates between the dollar, euro, and renminbi. This will make it imperative that markets and instruments are developed in the region to hedge against currency risks. Such instruments are generally underdeveloped, but particularly so in Latin America, which is likely to be among the more exposed to risk. Going forward, financial institutions and policy-makers should support greater development of derivatives markets to manage the risks of increased RMB use in the region.



Resort to Chinese loans when there are technical and economic grounds for it. The region should step away from the idea of using China as the

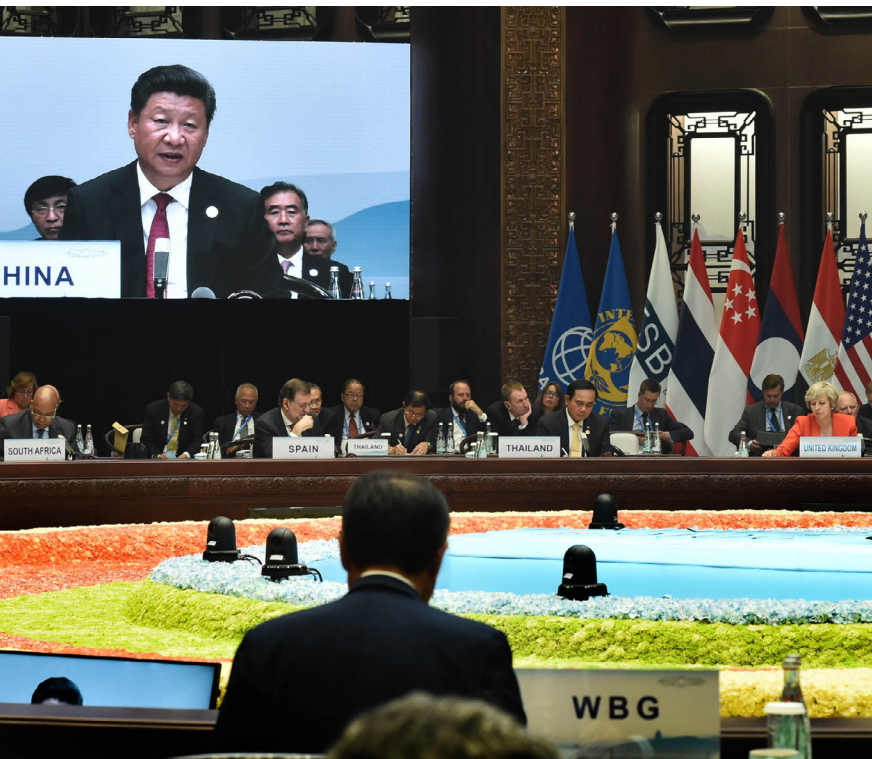
▲ **The Chinese flag flies next to the Bank of England to mark the landmark bilateral currency swap agreement in June 2014.**

lender of last resort. Chinese funding—whether in RMB or dollars—should be used only when there is a clear purpose for it. The use of RMB funds for countries in difficult financial conditions is risky and negative to all sides of the equation. For Latin America, it creates an opportunity to postpone needed economic reforms, while on the Chinese side, it increases the risk of default, contributing to a misallocation of resources.

PROPOSALS: THE 101

- China should advance capital account reforms and grant foreign investors more freedom to access domestic bond and stock markets.
- China should work with Latin American economies to expand the number of swap agreements and clearinghouses. But the region should prepare for RMB volatility.
- Latin American companies should double down on the potential of the Chinese market.

Looking Forward



◀ **A new frontier?**
China hosted its first-ever G20 Summit in September.

the United States has already lost its trade primacy in some of the largest economies, such as Brazil and Argentina. This trend will continue if countries in the region decide to adopt the Chinese cur-

rency more widely in their trade operations. Importing from China using RMB decreases transaction costs and grants Latin American countries access to a wider range of Chinese exporters that may not have access to international markets. This means more competition for US exporters to the region.

The United States therefore should focus on strengthening financial ties with Latin American countries. US banks, for example, could extend more credit lines to their Latin American subsidiaries. In addition, multilaterals such as the World Bank and the Inter-American Development Bank should place greater emphasis on trade finance.

Clearly, China's currency will play a bigger role in international markets. The first step in that direction came with RMB inclusion in the SDR basket on October 1, 2016. But this does not seem to be enough to convince governments and companies across Latin America to engage in more operations using the Chinese currency. That is largely to be expected. China has just started building the infrastructure for RMB operations and promoting the currency's use.

But governments and companies should keep in mind that now is the moment to start engaging in these operations; if not, they may miss this window of opportunity. As China's currency continues to play a bigger role in international markets, there is no other option. Nonetheless, the pace of RMB internationalization and its impact on financial markets, and on Latin American economies in particular, hinges on further domestic reforms in China to further boost confidence.

Given the current level of bilateral trade flows and the increasing focus on using RMB both for denomination of transactions as well as for trade finance, it is highly likely that RMB use will continue to increase in China-Latin America deals, especially with the currency's inclusion in the Fund's SDR. In addition, more of China's increasing external investment in the region is likely to be denominated in RMB, although at a gradual pace.

The combination of payments, trade finance, and investment in RMB means China's currency will occupy a more significant percentage of flows with Latin America. Still, the share denominated in dollars will remain high, particularly in the context of dollar-priced commodities.

Likewise, China's shrinking labor force, plus a determination to restructure its domestic economy toward higher levels of productivity, value-added products, and innovation, raise opportunities for Chinese investment in the region in lower-cost manufacturing. This is a new frontier that expands beyond the commodities and infrastructure focus. More real RMB flows are also likely to result in an increase in the amount of foreign exchange reserves held in RMB.

For the United States, it is undeniable that the increasing influence of the RMB in Latin America will affect US economic presence in the region. Over the past decade,

LOOKING FORWARD: THE 101

- With the inclusion of the RMB as an IMF reserve asset, it is likely that the currency will be used more freely in China-Latin American deals.
- The United States should boost financial ties to offset the potential of greater Latin American trade and investment going to China.
- The window for countries to engage in more RMB-denominated operations is now; however, China must stay on track with its domestic reforms.

Endnotes

- 1 Bloomberg News, "China Eclipses U.S. as Biggest Trading Nation," February 10, 2013, <http://www.bloomberg.com/news/articles/2013-02-09/china-passes-u-s-to-become-the-world-s-biggest-trading-nation>.
- 2 Jamil Anderlini, "China to become one of world's biggest overseas investors by 2020," *Financial Times*, June 25, 2015, <http://www.ft.com/cms/s/0/5136953a-1b3d-11e5-8201-cbdb03d71480.html#axzz4IOLiMG>.
- 3 Ministry of Commerce, People's Republic of China, "Official of the Department of Outward Investment and Economic Cooperation of the Ministry of Commerce Comments on China's Outward Investment and Economic Cooperation in 2015," January 18, 2016, <http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201602/20160201251488.shtml>.
- 4 Mike Bird, "China Just Overtook the US as the World's Largest Economy," *Business Insider*, October 8, 2014, <http://www.businessinsider.com/china-overtakes-us-as-worlds-largest-economy-2014-10>.
- 5 Jeffrey Frankel, *Historical Precedents for Internationalization of the RMB*, Council on Foreign Relations, November 2011.
- 6 Today, the four major currencies in the SDR are the US dollar, the euro, the yen, and the pound sterling. For the purpose of comparison, the Japanese yen is the third most used and traded currency in the world—after the US dollar and the euro—and was consolidated shortly after Japan became one of the most important and powerful world economies. Much uncertainty surrounds the pound sterling and the euro today, given the recent Brexit vote. In addition, over the past five years the RMB has gained more than 30 percent against the dollar. In recent months, when currencies from around the globe have been losing against the dollar, given fears of a potential US Federal Reserve rate hike, the RMB's value dropped less than other currencies on average (6 percent for the RMB; 10 percent for the world average).
- 7 As a consequence of the 1997 Asian financial crisis, finance ministers of the Association of Southeast Asian Nations (ASEAN), China, Japan, and South Korea, met in Chiang Mai to discuss creating bilateral currency swap agreements, with the goal that the network would complement the IMF's capacities.
- 8 Keith Bradsher, "China's Renminbi Is Approved by I.M.F. as a Main World Currency," *New York Times*, November 30, 2015, http://www.nytimes.com/2015/12/01/business/international/china-renminbi-reserve-currency.html?_r=0.html.
- 9 Other clearinghouses are in the United Kingdom, Germany, South Korea, France, Luxembourg, Qatar, Canada, Australia, Malaysia, and Thailand.
- 10 Pete Sweeney and Lu Jianxin, "China doubles yuan trading band, seen as sign of confidence," Reuters, March 15, 2014.
- 11 Ministry of Commerce, People's Republic of China, "Official of the Department of Outward Investment and Economic Cooperation of the Ministry of Commerce Comments on China's Outward Investment and Economic Cooperation in 2015," August 18, 2016.
- 12 Eswar S. Prasad, "China's Efforts to Expand the International Use of the Renminbi," The Brookings Institution, February 4, 2016.
- 13 Ministry of Commerce, People's Republic of China, op. cit.
- 14 HSBC, "Settlement of trade flows in RMB," 2015, <https://www.hsbc.fr/1/2/en/entreprises-institutionnels/international/settlement-trade-flows-rmb>.
- 15 Ibid.
- 16 Allen & Overy LLP, "Generation ¥ - RMB: the new global currency," 2015, <http://www.allenoverly.com/SiteCollectionDocuments/RMB%20the%20new%20global%20currency.pdf>.
- 17 Ministry of Commerce, People's Republic of China, op. cit.
- 18 Ibid.
- 19 Ibid.
- 20 Patrick Jenkins and Jonathan Wheatley, "BTG Pactual gets \$1.8bn capital investment," *Financial Times*, December 6, 2010.
- 21 Allen & Overy LLP, "Generation ¥ — RMB: the new global currency," op. cit.
- 22 Society for Worldwide Interbank Financial Telecommunication, "Worldwide Currency Usage and Trends," July 2016, <https://www.swift.com/our-solutions/compliance-and-shared-services/business-intelligence/renminbi/rmb-tracker>.
- 23 Eswar S. Prasad, "China's Efforts to Expand the International Use of the Renminbi," op. cit.

Atlantic Council Board of Directors

CHAIRMAN

*Jon M. Huntsman, Jr.

CHAIRMAN EMERITUS, INTERNATIONAL ADVISORY BOARD

Brent Scowcroft

PRESIDENT AND CEO

*Frederick Kempe

EXECUTIVE VICE CHAIRS

*Adrienne Arsht

*Stephen J. Hadley

VICE CHAIRS

*Robert J. Abernethy

*Richard Edelman

*C. Boyden Gray

*George Lund

*Virginia A. Mulberger

*W. DeVier Pierson

*John Studzinski

TREASURER

*Brian C. McK. Henderson

SECRETARY

*Walter B. Slocombe

DIRECTORS

Stéphane Abrial

Odeh Aburdene

*Peter Ackerman

Timothy D. Adams

Bertrand-Marc Allen

John R. Allen

Michael Andersson

Michael S. Ansari

Richard L. Armitage

David D. Aufhauser

Elizabeth F. Bagley

Peter Bass

*Rafic A. Bizri

Dennis C. Blair

*Thomas L. Blair

Philip M. Breedlove

Myron Brilliant

Esther Brimmer

*R. Nicholas Burns

William J. Burns

*Richard R. Burt

Michael Calvey

James E. Cartwright

John E. Chapoton

Ahmed Charai

Sandra Charles

Melanie Chen

George Chopivsky

Wesley K. Clark

David W. Craig

*Ralph D. Crosby, Jr.

Nelson W. Cunningham

Ivo H. Daalder

*Paula J. Dobriansky

Christopher J. Dodd

Conrado Dornier

Thomas J. Egan, Jr.

*Stuart E. Eizenstat

Thomas R. Eldridge

Julie Finley

Lawrence P. Fisher, II

*Alan H. Fleischmann

*Ronald M. Freeman

Laurie S. Fulton

Courtney Geduldig

*Robert S. Gelbard

Thomas H. Glocer

*Sherri W. Goodman

Mikael Hagström

Ian Hague

Amir A. Handjani

John D. Harris, II

Frank Haun

Michael V. Hayden

Annette Heuser

Ed Holland

*Karl V. Hopkins

Robert D. Hormats

Miroslav Hornak

*Mary L. Howell

Wolfgang F. Ischinger

Reuben Jeffery, III

*James L. Jones, Jr.

George A. Joulwan

Lawrence S. Kanarek

Stephen R. Kappes

Maria Pica Karp

Sean Kevelighan

*Zalmay M. Khalilzad

Robert M. Kimmitt

Henry A. Kissinger

Franklin D. Kramer

Philip Lader

*Richard L. Lawson

*Jan M. Lodal

Jane Holl Lute

William J. Lynn

Izzat Majeed

Wendy W. Makins

Zaza Mamulaishvili

Mian M. Mansha

Gerardo Mato

William E. Mayer

T. Allan McArtor

John M. McHugh

Eric D.K. Melby

Franklin C. Miller

James N. Miller

*Judith A. Miller

*Alexander V. Mirtchev

Susan Molinari

Michael J. Morell

Georgette Mosbacher

Thomas R. Nides

Franco Nuschese

Joseph S. Nye

Hilda Ochoa-Brillem-
bourg

Sean C. O'Keefe

Ahmet M. Oren

*Ana I. Palacio

Carlos Pascual

Alan Pellegrini

David H. Petraeus

Thomas R. Pickering

Daniel B. Poneman

Daniel M. Price

Arnold L. Punaro

Robert Rangel

Thomas J. Ridge

Charles O. Rossotti

Robert O. Rowland

Harry Sachinis

John P. Schmitz

Brent Scowcroft

Rajiv Shah

James G. Stavridis

Richard J.A. Steele

*Paula Stern

Robert J. Stevens

John S. Tanner

*Ellen O. Tauscher

Frances M. Townsend

Karen Tramontano

Clyde C. Tuggle

Paul Twomey

Melanne Verveer

Enzo Viscusi

Charles F. Wald

Michael F. Walsh

Mark R. Warner

Maciej Witucki

Neal S. Wolin

Mary C. Yates

Dov S. Zakheim

HONORARY DIRECTORS

David C. Acheson

Madeleine K. Albright

James A. Baker, III

Harold Brown

Frank C. Carlucci, III

Robert M. Gates

Michael G. Mullen

Leon E. Panetta

William J. Perry

Colin L. Powell

Condoleezza Rice

Edward L. Rowny

George P. Shultz

John W. Warner

William H. Webster

*Executive Committee Members
List as of September 22, 2016

The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

1030 15th Street, NW, 12th Floor, Washington, DC 20005

(202) 778-4952, www.AtlanticCouncil.org