

# A Revolutionary Idea: A Renminbi In Your Wallet

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JANUARY 2018

If the seismic events that shaped the 20th Century took place around the Atlantic, in the 21st Century it is surely the Pacific that will become the centre of the world. The single most important bilateral relationship in the world today must be that of the United States and China. In 1972, when Nixon went to meet Mao, China, economically, was on its knees. Today, it is the second largest economy in the world, the second largest holder of US government debt and now, willingly or not, it holds the balance of economic power. If Russia went bankrupt tomorrow economically, the world could wear it. The same cannot be said for China. As a manufacturer, a consumer, a source of capital and yes, as a debtor China wields huge influence as a marketplace for some of the world's largest companies and as a holder of government, especially US government debt. It is extraordinary that for a country that wields such economic clout that its currency, though closely watched, is barely used. We believe that inevitably this state of affairs will change.

## IMPORTANCE OF THE RENMINBI

China ranks second in the world by output and ranks first for trade in goods and in foreign exchange reserves. The country's economic output in 2016 was \$11.4 trillion, accounting for 15% of the world's total; its trade in merchandise goods during 2016 was \$3.7 trillion, 11.7% of the world's total and placing it ahead of the United States, which it has been since 2012.<sup>1</sup> At the end of 2016 foreign exchange reserves held by the world's central banks totalled \$10.79 trillion of which 28% (\$3 trillion) were held by China. Individual central banks tend not to publish a breakdown of their holdings but on average, according to IMF data, 63% of allocated central bank reserves are held in US dollars and China's allocation is believed to be in line.

Unsurprisingly, central banks' holdings in renminbi assets is low but in October 2016 the IMF included the renminbi in its basket of reserve currencies for Special Drawing Rights

<sup>1</sup> China trade figures from China Customs data. US and world comparison data from the World Trade Organization

(SDR) with a weight of 10.9%, well above the current actual level of central bank holdings which the IMF disclosed for the first time in March 2017, stood at \$84.5 billion (0.8% of total reserves).<sup>2</sup>

Policymakers, bankers, companies and investors should all care about the renminbi. It is not tenable, practical or even likely that a country with China's massive economic clout would persist with an arrangement that effectively outsources financial transactions through a currency that is not their own.

*"The expansion of the SDR basket is an important and historic milestone for the SDR, the Fund, China and the international monetary system...The Renminbi's inclusion reflects the progress made in reforming China's monetary, foreign exchange, and financial systems, and acknowledges the advances made in liberalizing and improving the infrastructure of its financial markets...This milestone also reflects the ongoing evolution of the global economy."*

**Ms. Christine Lagarde, Managing Director of the IMF, Press release September 30 2016**

China has taken the first big step toward currency convertibility using its \$3.7 trillion of trade-related flows. Since 2010 Chinese companies engaged in the purchase and sale of goods overseas have been permitted to settle their bills in renminbi. The result has been a growing renminbi deposit pool outside mainland China. There has also been a surge in renminbi foreign exchange transactions. According to SWIFT,<sup>3</sup> over the last 5 years to the end of 2016 the number of transactions

has increased from 1.8 million to 13 million, 36.9% done in London, 29.3% in Hong Kong and 7.3% in the United States. Over 97% of renminbi trades were against the US dollar (88% of ALL currency trades are against the dollar).

Renminbi, raised offshore is being brought back into China either in the course of trade or to fund business expansion or for the purposes of financial investment into bonds and equities in China. Today, the renminbi has risen to 6th as a world payments currency by value (behind the USD, EUR, GBP, JPY and CAD) from 17th five years ago and there are more than 1,300 financial institutions around the world using the renminbi for payments with China and Hong Kong, 220 more than last year.<sup>4</sup>

The development of the offshore renminbi market and currency convertibility is important to China for a variety of reasons, not the least of which is to untie itself from the US dollar and allow scope to pursue a fully independent monetary policy. The notion that underpins China's concern was succinctly put by John Connally, Nixon's Treasury secretary in 1971 when he told a worried group of European finance ministers that the dollar "is our currency, but your problem". Zhou Xiaochuan, Governor at the People's Bank of China put it more elegantly in 2013, "[US monetary policy] may be optimal for the US alone...it is not necessarily optimal for the world. There is a conflict between the US dollar's domestic role and its international settlement role."<sup>5</sup>

China still sees a world where the dollar re-

2 International Monetary Fund (IMF) COFER data

3 SWIFT (Society for Worldwide Interbank Financial Telecommunication) RMB Tracker, April 2017

4 SWIFT ibid

5 Wall Street Journal February 27, 2013

mains the pre-eminent world currency. The head of the Chinese central bank's Research Institute wrote in 2013:

*“For the foreseeable future, we can speak of the global currency system as a framework of ‘1+4’. The dollar will continue to be the superior reserve currency, supplemented by four smaller reserve currencies: the euro and the British pound in Europe and the Japanese yen and the Chinese renminbi in Asia.”*

the US with flexibility that no other country enjoys. In particular, despite the record levels of US bond purchases in recent years the dollar has remained strong against many major world currencies. But in the long run, country fundamentals matter; should the US continue to create unprecedented amounts of fiat dollars, run large and growing trade and budget deficits and in general live well beyond its means, the position as sole world reserve currency may be challenged.

## THE TALE OF TWO CURRENCIES

US dollar-based investors should consider the relative merits of the renminbi and the US dollar. A country's currency is often likened to “stock” of a country. While an imperfect analogy, countries, like companies, have growth rates, debt levels, deficits, and wealth creating and wealth destroying attributes. If we were to compare China to the US we might look at the following:

	China	US
Personal Savings rate	37.4%	5.4%
Budget Surplus/(Deficit)	(3.4%)	(3.1%)
GDP growth rate	6.7%	1.6%
Trade Surplus/(Deficit)	\$511bn	(\$502bn)
Foreign Reserves	\$3.010bn	

*Sources: IMF; US Department of Commerce, Bureau of Analysis; China National Bureau of Statistics*

Naturally, this simple comparison doesn't tell the whole story. With the US enjoying status as the world's largest economy and with its currency being the world's reserve currency, the US dollar has built in support that provides

## THE OFFSHORE RENMINBI INVESTMENT MARKET

Direct access to renminbi cash and bank accounts for non-Chinese residents is available to corporations and investment funds, and increasingly to individuals. While the onshore renminbi (CNY) and the offshore renminbi (CNH) are the same currency, the rates of exchange against the dollar are different.

- The CNY trades within a permitted range of 2% above and below a central parity rate (CNY fixing) that is published each day. The CNY is underpinned by China's monetary base.
- The central parity rate is calculated with reference to:
  - The onshore interbank closing price of USD-CNY spot at 4.30pm in Beijing; and,
  - The move in the RMB basket of 24 currencies, reflecting China's trade partners, between 4.30pm the prior day and 7.30am on the day of the fixing.
- The CNH can trade wherever the market takes it according to prevailing supply and demand conditions. The CNH is underpinned by the amount of renminbi held offshore.

Buyers and sellers of renminbi outside China who use renminbi for trade settlement purposes may trade at either the CNY rate of exchange or the CNH rate. Those trading renminbi for any other purpose including investment must use the CNH exchange rate. Changes to domestic Chinese fund flows and sentiment can move the CNY rate above or below the central parity rate; changes in foreign flows and sentiment can move the CNH above or below the CNY rate. In practice, the ability of Chinese importers and exporters to use either exchange rate keeps the two very close.

For renminbi investors, the investment options are primarily cash deposits and fixed income instruments such as certificates of deposit, notes and bonds.

### CERTIFICATES OF DEPOSIT (CD)

Banks issue certificates of deposit to secure the funding required for carrying on commercial lending. In 2016, they raised RMB 191.6 billion (\$28.8 billion) of which 93% were for maturities of less than one year. The most active issuers have been the overseas branches of Chinese banks (such as in London, Paris, Luxemburg, Sydney) and overseas non-Chinese banks with Hong Kong branches.

This level of issuance indicates significant growth in renminbi lending, especially when we consider that in 2010, when the offshore renminbi market opened up, issuance was only RMB 5.69 billion (\$0.85 billion). In recent months, the interest rate offered on one year deposits has reached 4.5%.

### BONDS AND MEDIUM TERM NOTES

The offshore bond market has renminbi denominated bonds outstanding worth almost RMB 458 billion (\$67 billion) as at the end of April 2017 compared to \$5.8 billion at the end of 2010 and \$23 billion at the end of 2011. The market is characterized by short maturity, with 79% of issues with less than 3 years' maturity. Chinese issuers account for 62% of the market with overseas issuers from over 25 countries accounting for 38%. 75% of the market carries a credit rating and 69% of issues are above investment grade (rated BBB or higher by S&P).

As of May 31, 2017 the average yield to maturity for the Offshore CNY bond market was 4.62% and the duration was 2.76 years (based on Citi Dim Sum (Offshore CNY) Bond Index).

## FROM RARE TO MAINSTREAM

Over the last six years, offshore renminbi activities have expanded from Hong Kong to Singapore, Taiwan, London and New York. There are now 22 renminbi clearing centres around using the renminbi for payments with China and Hong Kong. The range of activities has expanded from simple trade settlement to:

- Foreign exchange trading
- Currency swaps
- Trade settlement
- Commercial lending
- Bond issuance
- Portfolio investment

In the Bank for International Settlements' (BIS) triennial survey the renminbi's average daily trading volume rose from \$120 billion in April 2013 to \$202 billion in April 2016.<sup>6</sup> This was made up of \$68 billion per day in the spot market and the rest in the form of forward foreign exchange contracts or swaps. The US dollar – Renminbi (USD-CNY) is now the sixth-most traded currency pair against the dollar, up from ninth place in 2013.

The renminbi's growing presence in foreign exchange markets and its increasing usage in payments for goods and services (ranked 6th by SWIFT) means that the currency is no longer a rarity. The decision by the IMF in 2015 to include the renminbi as the fifth reserve currency alongside the dollar, euro, yen and British pound is a formal acknowledge-

ment of its growing role in the global financial system. China's role in the global production supply chain, its provision of capital and its holdings of US Treasuries already put its economy into the mainstream; the renminbi cannot be far behind.

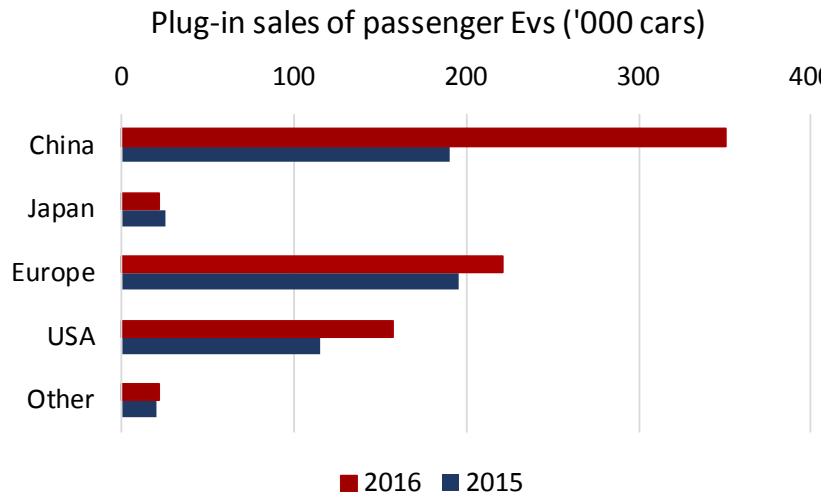
The focus of the debate in the short term is on a market derived exchange rate, liberalization of the capital account, 24-hour trading, opening up clearing and payments systems and access to the domestic bond markets. While certainly important, this misses the bigger picture. There is something that China does well for which it is given little credit: it has vision. They may not know every step of the journey and the course may not be the most direct, but they have a clearer idea than many countries of where they want to be.

Today, this has brought them to number two in the world economic rankings and number one in worldwide merchandise trade. China has the world's largest car market and accounts for the bulk of car sales for companies including General Motors from the US, Volkswagen from Germany and Hyundai from South Korea. Tomorrow, they want to be dominant in specific industries, among them alternative energy. China seeks to have the largest solar energy sector and it seeks to dominate in electric vehicles. Tesla may be gaining the press coverage but it is in China where there is and will be increasing take-up of pure electric vehicles. The chart below shows sales of just passenger vehicles and does not include the 160,000 commercial vehicles, mostly buses also sold in 2016. China is serious about its goals and is, once again mobilizing.

<sup>6</sup> Bank for International Settlements (BIS) Triennial Bank Survey, Foreign exchange turnover in April 2016

## WHY HOLD THE RENMINBI

For the renminbi to have a future as an international currency and a reserve currency, it needs to be seen not only as a usable medium of exchange but also as a store of value. To be that there needs to be sufficient engage-



ment externally for there to be sufficient supply and demand for the currency around the world and domestically there has to be sufficient robustness in both economic and institutional structures for renminbi denominated assets to be a store of wealth.

The external engagement that matters for the renminbi is China's substantial trade and trade surplus. China's economy may not be growing as fast as it was but at over \$11 trillion, 6.5% growth makes a difference. Overall merchandise trade is running at \$3.8 trillion. While China's trade surplus may now be around 3% of GDP rather than 7%, at more than \$500 billion this represents significant demand for the currency. If China's trade competitiveness was based only on low cost

land, labor and capital there might be an argument that this position would be eroded. However, there are other forces at work.

## China's Economic Complexity

A measure of China's economic complexity shows how China's export manufacturing industrial base has been transformed over the last 20 years. Economic Complexity as described by the Observatory of Economic Complexity describes the concept:

*"The complexity of an economy is related to the multiplicity of useful knowledge embedded in it. Because individuals*

*are limited in what they know, the only way societies can expand their knowledge base is by facilitating the interaction of individuals in increasingly complex networks in order to make products. We can measure economic complexity by the mix of these products that countries are able to make.*

*Some products, like medical imaging devices or jet engines, embed large amounts of knowledge and are the results of very large networks of people and organizations. These products cannot be made in simpler economies that are missing parts of this network's capability set. Economic complexity, therefore, is expressed in the composition of a country's productive output and reflects the structures that emerge to hold and combine knowledge."*

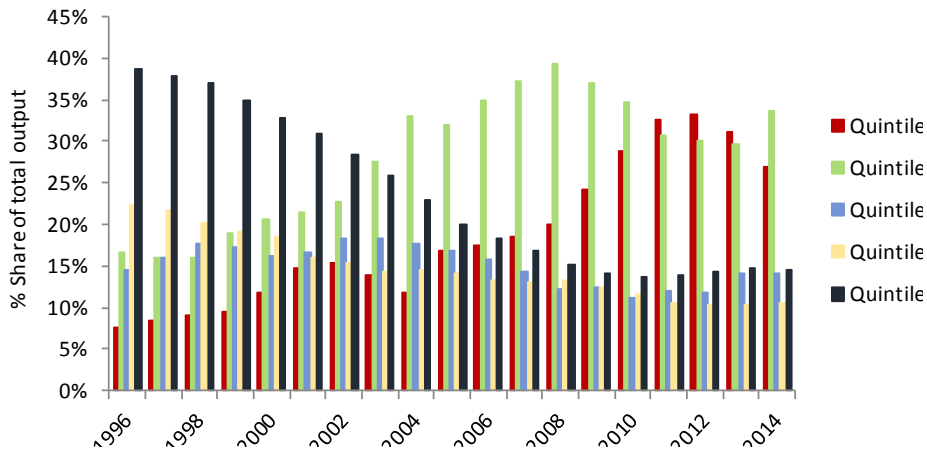
7 [www.federalreserve.gov/boarddocs/speeches/2004/20041119/](http://www.federalreserve.gov/boarddocs/speeches/2004/20041119/)

We look at China's economic complexity by grouping all the products it produces into quintiles, the top quintile being the most complex and the fifth quintile the least complex and looking at how the shares of each have changed over time:

standard of living.

- Increasing industrial complexity and know-how combined with China's domestic resources is likely to sustain it as major trading partner with the rest of the world.

### China Economic Complexity



- Increasing economic complexity is likely to be accompanied by increasing financial developments. China's bond market at over \$9 trillion is already second only to the US and is likely to become deeper and more liquid.

Increasingly complex output indicates competitive advantages extend beyond cost into technology, know-how, skilled labor as well as industrial clustering and logistics. These spill-over into the real economy through high-wages, job creation and higher value-added growth. This is what supports a middle-class consumer society with long-term aspirations including home-ownership and children which moves people from being economic inputs to being active economic participants.

- At the same time China is likely to receive more inbound investment over time, both capital and portfolio, to take advantage of this next phase of China's development.

### Growth Transformation

The economic transformation this implies is what we believe supports our long-term argument for the renminbi to appreciate significantly against the dollar and other currencies.

Economic growth is likely to be slower over the next ten years than over the past twenty; this is still expected to be in the 5%-7% range but potentially much more profitable and therefore sustainable than it was when the economy was growing in the 9%-11% range. Such a slow-down has to be expected as China's infrastructure, industrial and housing base has already expanded so the incremental gains must subside. China's future now lies in higher value-added production, reflecting the higher cost-base and its comparative advantages, and also in services (provided by both state and private sectors) to meet the needs of an increasingly affluent population.

- Higher domestic consumption of goods and services in China is likely to raise the

## VALUING THE RENMINBI

Our core argument is that China's currency in terms of both usage and valuation fails to reflect the progress and evolution of China's economy. Furthermore, we argue that long term assumptions made today about the future value of renminbi fail to take into account the economic platform that underpins China's long-term trajectory.

### Fairly valued or Under valued

In the short term, the valuation of a currency is determined by factors including interest rate differentials and supply/demand factors that are linked to portfolio and trade flows. However, as Alan Greenspan pointed out in 2004, *"The inability to anticipate changes in supply and demand...[means] that forecasting exchange rates has a success rate no better than that of forecasting the outcome of a coin toss."*<sup>8</sup>

Today, most econometric models put the value of the renminbi versus the dollar at around 'fair' value (or within 5% of equilibrium). As noted above short term pressures which are exceedingly hard to model can push the currency away from fair value and well away from where underlying economy appears to be taking it.

A more fundamental approach to currency valuation use models such as those used by the International Monetary Fund including effective Real Exchange Rate, External Sustainability and Macro-Economic Balance models. These incorporate factors such as those driving the trade surplus, balance of payments,

national savings and investment rates all of which change as the economic character of the country changes. For example, as a country grows richer it consumes more, not only of manufactured goods but also financial services, education and health services resulting in a decline in overall savings. Demand for the currency as a result of this greater prosperity both from inside the country (expressing a preference for their own currency as opposed to say, the dollar) and from outside including central banks, portfolio investors and direct investment can structurally push the currency higher.

## WHAT'S IN YOUR WALLET?

While a currency revolution is not necessarily at hand, it is not a radical idea to think that the renminbi's small stature could, at some point in the near future, rise to match China's giant economic position as the number two... and perhaps soon to be the number one... global economy. At that point, owning the renminbi will be a less revolutionary thought.

<sup>8</sup> [www.federalreserve.gov/boarddocs/speeches/2004/20041119/](http://www.federalreserve.gov/boarddocs/speeches/2004/20041119/)





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Joined Guinness Atkinson Asset Management in 2003 and also serves as investment

director and board member.

Edmund spent time living in Hong Kong while managing the Guinness Atkinson China & Hong Kong Fund giving him first hand experience of investing in the region.

Edmund graduated from Christ Church, University of Oxford, with a Master's degree in Management Studies and has a Bachelor's degree in History from the University of York.

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Co-founder of Guinness Flight Global Asset Management and, after its acquisition by Investec, chairman of Investec Asset Management until March 2003.

Graduated from Cambridge University in 1968 with a degree in Engineering. After obtaining an MBA at MIT, worked for 10 years as a corporate financier

## Guinness Atkinson Renminbi Yuan & Bond Fund (GARBX)

This Fund is designed to offer a simple solution and easy access to the renminbi cash and bond markets. The Fund buys renminbi in the offshore spot market which is held in a bank account. The renminbi cash is then invested into a range of bonds and certificates of deposit with an emphasis on keeping credit risk low.

The aims of the Fund are:

- To provide US investors with exposure to the renminbi
- To provide some diversification from the dollar
- To provide an attractive yield combined with the possibility of currency appreciation and
- To minimize risk.

To this end we keep our investment strategy as simple as we can. We buy renminbi cash directly, we do not use synthetic products such as non-deliverable forward contracts. We prefer to invest in investment grade instruments primarily, although as China specialists we are willing to invest in unrated names where we know the business and consider it to be of equivalent of investment grade.

### IMPORTANT INFORMATION

*Investors should consider the investment objectives, risks, charges and expenses carefully before investing. For a prospectus with this and other information about the Fund, please call 899 915-6565 or visit our website at [www.gafunds.com](http://www.gafunds.com). Read the prospectus carefully before investing.*

The Fund invests in foreign securities which will involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets countries. The Fund is non-diversified meaning its assets may be concentrated in fewer individual holdings than diversified funds. Therefore, the Fund is more exposed to individual securities volatility than diversified funds. Investments in debt securities typically decrease in value when interest rates rise, which can be greater for longer term debt securities.

The Fund may invest in derivatives which involves risks different from, and in certain cases, greater than the risks presented by traditional investments.

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

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