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Topics *China aims to accelerate internationalization of the yuan*

Under the US-China conflict, the Chinese government attaches importance to internationalization of the yuan, and is willing to promote liberalization of capital transactions and increase the flexibility of the yuan's exchange rate in order to increase the use rate of the yuan in cross-border transactions.

■ Emphasis has been placed on internationalization of the yuan

On April 28, U.S. President Joe Biden made it clear in his address to a joint session of Congress to mark his 100th day in office that he would do his best to compete with China. On the other hand, China has taken measures to increase its self-sufficiency ratio for semiconductors and food in response to intensification of the U.S.-China conflict, and there are growing calls for accelerating internationalization of the yuan.

In June 2020, for example, China Securities Regulatory Commission (CSRC) Vice Chairman Fang Xinghai said, "Foreign operations of Chinese financial institutions and companies depend mainly on dollar payments, and there should be great doubt as to whether such payments are safe. We must accelerate internationalization of the yuan over the next 10 years."

In October 2019, Huang Qifan, vice chairman of the China Center for International Economic Exchanges (CCIEE), said, "It is risky for Chinese companies to use SWIFT, an international payment network essential for dollar trade, and CHIPS, a U.S. payment system." He added by saying, "This risk can be avoided by promoting internationalization of the yuan through the practical application of digital yuan."

The People's Bank of China also intends to focus on accelerating internationalization of the yuan. In October 2020, Zhu Jun, Director General, International Department of the Bank, said the People's Bank of China was reviewing its strategy for internationalization of the yuan in light of the complex international situation, and planned to provide more policy support. He cited steady progress in liberalizing capital transactions, increasing the flexibility of the yuan's exchange rate and increasing liquidity in the bond market as examples.

Amid this situation, the People's Bank of China changed the method of setting the reference value of the yuan in October 2020 and stopped using the countercyclical factor, which had been established to stabilize the exchange rate.

On May 6, 2021, the Chinese government lifted the ban on the cross-trading of financial instruments in the Greater Bay Area, which includes Hong Kong, Macao and some parts of Guangdong Province, and announced the "Wealth Management Connect" scheme, which allows individual investors from Hong Kong and Macao to invest in financial instruments in mainland China. This policy aims at liberalizing capital transactions, and is positioned as a policy aimed at internationalizing the yuan.

The internationalization of a currency generally refers to an increase in the role of the currency in the international monetary system and an increase in the weight of the currency in current transactions, capital transactions, and foreign exchange reserves, etc. Current transactions consist mainly of trade transactions and service transactions such as overseas travel. Capital transactions are mainly direct investments and securities investments such as bonds and stocks. "Internationalization of the yuan" often refers to the lowering of China's use of the dollar in its transactions with other countries and increasing its use of yuan instead.

■ The Chinese government has placed restrictions on use of the yuan

The Chinese government has regulated use of the yuan in cross-border transactions. Yuan-denominated transactions had been banned up until 2009, and yuan-denominated direct investment in China and foreign direct investment had been prohibited up until 2011. Although restrictions on yuan-denominated direct investment have gradually been eased, restrictions on foreign capital investment and on the purchase of real estate by foreign investors have not, which has been a deterrent to yuan-denominated direct investment in China. As for yuan-denominated securities investment, while the high yield of Chinese government bonds boosts foreign investor demand, the Chinese government is continuing to restrict investment. There is still room for reform in China's capital transaction regulations and relevant financial systems.

From the perspective of a "trilemma of international finance (failure to meet all of the requirements of independent monetary policy, stable currencies, and free capital flows)," the Chinese government has restricted use of the yuan in cross-border transactions in order to ensure freedom of monetary policy and exchange rate stability, while restricting free capital flows.

Since the collapse of Lehman Brothers, which suffered enormous losses due to depreciation of the dollar, the Chinese government has taken steps to internationalize the yuan. However, due to the sudden depreciation of the yuan (China shock) that occurred between 2015 and 2016, regulations on capital transactions were once again strengthened. Thereafter, China's policy regarding internationalization of the yuan has been sluggish.

■ Yuan-denominated capital transactions are expanding

Looking at the current situation surrounding internationalization of the yuan, the total amount of receipts and payments of yuan-denominated cross-border transactions in 2019 was 19.7 trillion yuan in total. The share of yuan receipts and payments in trade transactions and service transactions/other current transactions was 22% and 9%, respectively. The share of yuan-denominated foreign direct investment, inward direct investment, and securities and other investments was 4%, 10% and 55%, respectively.

In particular, it is noteworthy that the receipts and payments of yuan-denominated securities and other investments increased significantly from 2.2 trillion yuan in 2016 to 10.9 trillion yuan in 2019. Investment in Chinese government bonds by overseas institutional investors, including Japanese and U.S. investors, rapidly expanded following the introduction in 2017 of Bond Connect, a system that allows overseas investors to trade in mainland China's interbank bond market via Hong Kong.

Due to the lifting of the ban on trading in yuan and continued appreciation of the yuan, the total amount of yuan receipts and payments in trade transactions increased greatly from 2 billion yuan in 2009 to 6.4 trillion yuan in 2015. However, between 2015 and 2016 the yuan plunged, with the total amount of receipts and payments dropping to 4.1 trillion yuan in 2016. Since then, the value has been hovering at a low level, remaining at 4.2 trillion yuan in 2019, due to weakening of the yuan.

Looking at the currencies used in receipts and payments in various cross-border transactions, the use of yuan in trade transactions amounted to only 13%. The use of yuan in service transactions and direct investment was 24% and 20%, respectively. On the other hand, the use of yuan in securities and other investments accounted for 70%, which was higher than other transactions. When current transactions and capital transactions are combined, the use of yuan was 38%, which indicates that China is highly dependent on the dollar for its trade with other countries and investment activities.

The main purpose of past measures aimed at internationalization of the yuan had been to avoid exchange rate risk for Chinese companies by promoting yuan-denominated trade settlements with neighboring countries and regions. On the other hand, China's recent emphasis on internationalization of the yuan seems to be aimed at strengthening its voice in the global economy and international finance, and increasing its geopolitical influence and presence. Because of these differences, it is possible that the Chinese government will allow liberalization of capital transactions and fluctuation of exchange rates against the yuan in the future at a rate exceeding most expectations.

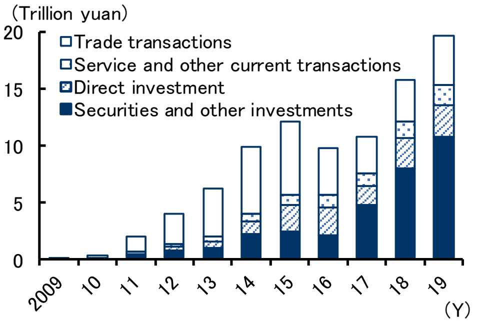
(Shinichi Seki)

＜Major Initiatives Toward Internationalization of the Yuan＞

・Gradual lifting of the ban on trading in yuan (since 2009)
・Establishment of clearing banks overseas for settlement in yuan (since 2012)
・Launch of the Cross-border Interbank Payment System (CIPS) using yuan (2015)
・Lifting of the ban on yuan-denominated foreign direct investment (2011)
・Lifting of the ban on yuan-denominated direct investment in China by foreign investors (2011)
・Relaxation of inward securities investment (since 2011), including establishment of the Renminbi Qualified Foreign Institutional Investor (RQFII) program
・Launch of Shanghai-Hong Kong Stock Connect (2014)
・Launch of Shenzhen-Hong Kong Stock Connect (2016)
・Launch of Bond Connect (2017)
・Relaxation of outward investment in securities, including establishment of the Renminbi Qualified Domestic Institutional Investor (RQDII) program (since 2014)
・Elimination of the minimum lending rate regulation (2013)
・Elimination of the maximum deposit rate regulation (2015)
・Conclusion of currency swap agreements with other countries (since 2008)

Source: Prepared by The Japan Research Institute, Limited based on the People's Bank of China "2020 RMB Internationalization Report"

＜Total Amount of Yuan Receipts and Payments in Cross-border Transactions＞



Source: People's Bank of China "2019 Annual Report"

Topics India aims to raise CO_2 reduction targets

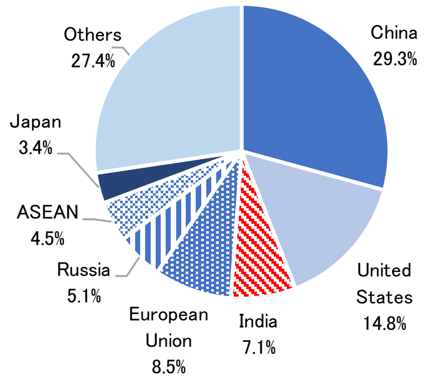
India, the world's third-largest emitter of greenhouse gases, is also considering raising its emissions reduction target amid moves by many countries to set a long-term goal of becoming carbon-neutral by achieving net zero greenhouse gas emissions.

■ There is a growing trend in countries around the world to set carbon-neutral targets

With the increasing importance of responding to climate change, there is a growing trend in countries around the world to set a long-term goal of "carbon neutrality," which means to achieve net zero emissions after subtracting the amount absorbed by forests, while significantly raising the medium-term targets of greenhouse gas emissions reduction, mainly CO_2.

Looking at policy trends among major greenhouse gas emitters, China, which accounts for about 30% of global CO_2 emissions, announced at the United Nations General Assembly in September 2020 that it would be carbon neutral by 2060, in addition to its conventional goal of having CO_2 emissions peak by 2030. The United States, which is the second largest emitter of greenhouse gases after China, announced in conjunction with the Climate Change Summit held online in April 2021 that it would nearly double its target for its reduction in greenhouse gas emissions by 2030 from its previous target of 26-28%, to 50-52% of the 2005 level, and also set a target for achieving net zero emissions by 2050. When the Suga administration was inaugurated in October 2020, Japan also set a goal of achieving carbon neutrality by 2050, and in line with the Summit, the fiscal 2030 emissions reduction target was raised to 46% of the fiscal 2013 level, up significantly from the previous target of 26%. In the EU, which aims to achieve carbon neutrality by 2050 in the same way as Japan and the United States, moves have been made to legislate the achievement as a binding target, and in April 2021, a draft of the European Climate Law was tentatively agreed upon.

<CO_2 Emission by Countries and Regions (2016)>



Source: World Bank

As countries and regions accelerate their efforts to improve the environment, India, the world's third largest greenhouse gas emitter, is also considering raising its emissions reduction target. In its Nationally Determined Contributions (NDCs) submitted to the United Nations Framework Convention on Climate Change (UNFCCC) based on the Paris Agreement, which was ratified in 2016 and which established a new framework for international cooperation to combat global warming, India indicated a policy of reducing greenhouse gas emissions per unit GDP by 33-35% from the 2005 level by 2030. While a target for total emissions was not included in its NDCs, it was reported in March 2021 that the Indian government was working with a foreign advisor to set a carbon neutrality target by 2050 (or 2047, the 100th anniversary of India's independence). Following in the footsteps of other countries, India is likely to significantly raise its emissions reduction target by 2030 and set a long-term target of achieving carbon neutrality.

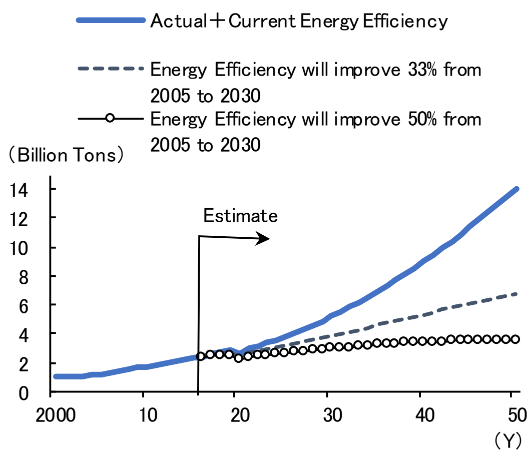
However, since there is a great deal of room for expansion in the consumption of fossil fuels due to economic growth in emerging countries, the target for reducing total emissions is often set at a reduction rate relative to business-as-usual (BAU) emissions rather than a reduction rate from the base point. BAU emissions are emissions that would be expected if no additional measures were taken to control them. If the Indian government finds it difficult to achieve the goal of carbon neutrality, it may choose to present only new targets based on BAU emissions.

■ What is the outlook for CO_2 emissions in India?

In fact, looking at the outlook for India's CO_2 emissions based on two factors, economic growth and energy efficiency, as economic growth will likely continue to exceed the pace of improvement in energy efficiency, emissions are expected to continue to increase, and there is little chance for India to achieve carbon neutrality.

First, in terms of economic growth, India's real GDP growth rate through the 2010s was about +6%, which was the main cause of the increase in energy consumption and CO_2 emissions. Due to its lockdown amid the COVID-19 pandemic, India recorded its first negative growth in about 40 years for fiscal 2020 (April 2020 to March 2021), and the future of the economy remains unpredictable against the backdrop of a resurgence of infections, the fiscal deficit problem, and issues of nonperforming loans at commercial banks. However, the growth potential associated with population growth and urbanization has not been lost, and the economy will gradually regain its firmness once the COVID-19 pandemic is brought under control as a result of rolling-out vaccine programs. In its revised global economic outlook as of April 2021, the IMF forecast that India's real GDP growth would recover to the mid-6% range by the mid-2020s. Since India's nominal GDP per capita is now just under 2,000 dollars and it is necessary to solve social problems such as poverty, hunger, and unemployment through economic growth, it is unlikely that the country will adopt policies that intentionally slow down economic growth by making environmental improvement its top priority. If the current energy consumption structure continues, annual CO_2 emissions are expected to increase by approximately six times through 2050, even if the growth rate slows gradually after the 2030s as the economy matures.

＜India's CO_2 Emission＞



Source; JRI EStimate Based on World Bank and IMF

On the other hand, energy efficiency, the key to controlling CO_2 emissions, will likely not improve enough to offset the increase in emissions associated with economic growth. The current target of reducing greenhouse gas emissions per unit GDP by 33-35% from the 2005 level by 2030 means that energy efficiency must be improved at an annual rate of 1.7-1.8%, which is lower than real GDP growth. Therefore, even if the target is achieved by 2030 and energy efficiency continues to improve at the same pace, emissions will inevitably increase by about three times over the period through 2050. And even if the pace of improvement in energy efficiency is accelerated so that emissions per unit GDP in 2030 are halved compared to the 2005 level, total emissions will continue to increase.

These findings provide some implications for India's efforts to combat global warming. First of all, it is necessary to steadily implement measures to improve the environment, such as boosting power generation efficiency by renewing facilities at existing thermal power plants, promoting renewable energy and electric vehicles (EVs), and encouraging the scrapping of old vehicles and their replacement with new ones, for which preparation toward the introduction of a new policy is already underway. Given that it is difficult to reduce total emissions using existing measures alone, it will also be necessary to actively incorporate new low-carbon and decarbonizing technologies that are being demonstrated in various countries. Furthermore, it is important to increase CO_2 recovery capacity. In addition to the government's plan to increase its CO_2 absorption capacity by 2.5 billion to 3.0 billion tons by 2030 through tree planting and other means, large-scale introduction of technologies such as carbon capture, utilization and storage (CCUS) will be necessary.

(Shotaro Kumagai)