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Topics *Tail/head-winds for recent moves of RMB internationalization*

Use of RMB is expanding in transactions for trading, where China has global influence. However, against the backdrop of antagonism between Western countries and China/Russia, its use in capital transactions has not progressed to the extent that it threatens the status of USD.

■ Factors such as sanctions against Russia and de-dollarization due to Fed's rate hikes are driving increased use of RMB

The proportion of Chinese trade transactions settled in RMB is rising rapidly. China had suffered a sharp capital outflow since 2015, and use of RMB even in transactions for trading, where China has significant influence, had stalled. Recently, however, RMB has been regaining momentum. Although China's market openness with respect to financial and capital transactions remains insufficient, as described below, 1) the exclusion of Russia from SWIFT, 2) de-dollarization due to rapid U.S. interest rate hikes, and 3) China's proactive diplomacy aimed at expanding "petroyuan" (i.e., use of RMB in crude oil trade) are serving as tailwinds for the RMB internationalization.

First, in March 2022, Western countries locked Russian banks out of SWIFT as part of sanctions in response to Russia's invasion of Ukraine. This makes it difficult for Russian companies to settle trade in USD, and in September 2022, Russian state-owned energy corporation Gazprom changed the currency it receives as payment for supplying gas from the U.S. dollar to RMB or Russian ruble. Also, in April 2023, Bangladesh, which could no longer make USD-denominated payments to Russia for the construction of nuclear power plants, switched to paying in RMB.

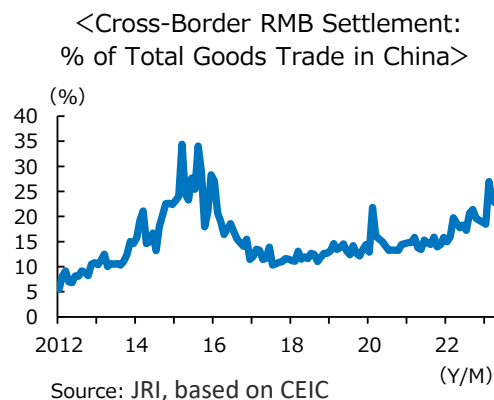
Second, the cost of raising USD funds has risen sharply as a result of interest rate hikes by the U.S. Fed, and countries other than Russia are also increasingly using RMB instead of USD for trade settlement. In March 2023, Brazil made an agreement with China to create a mechanism for the direct use of both their countries' currencies in trade and financial transactions. In April, Argentina announced that it would switch payments for imports from China from USD to RMB. In addition, Iraq allowed RMB-denominated import settlements in February, and Thailand has announced plans to relax its restrictions on RMB-denominated trade settlement the year.

Third, since 2018, China, which became the world's largest importer of crude oil in 2017, has moved to promote the use of RMB and to break the "petrodollar" (i.e., use of USD in crude oil trade), or the monopoly of USD in oil trading, by listing crude oil futures denominated in RMB. In December 2022, in a speech at the China-Gulf Cooperation Council (GCC) Summit, President Xi called for promoting RMB-denominated settlement in oil and gas trade, and in March 2023 it was reported that Saudi Arabia is considering invoicing some of its oil sales to China in RMB. And in the same month, France traded LNG with China in RMB for the first time.

■ Capital transactions face headwinds, and progress in RMB internationalization is confronted with difficult situations

Therefore, use of RMB in international transactions is expanding, but the bulk of this growth is in trade transactions, mainly with emerging economies. In the past, it was capital transactions such as investments that significantly boosted the value of RMB settlements in international transactions. These were predominantly transactions with developed countries, and were considerably larger than trade and other current transactions.

Among international capital transactions, China used to be successful in expanding portfolio investment, which led to greater use of RMB. Yet at the same time, the Chinese government did not make notable progress in opening up its financial and capital markets. Through clever strategies such as successfully lobbying index providers such as MSCI to include RMB-denominated securities in their investment



benchmark indices and the IMF to add RMB to the SDR (Special Drawing Right) basket, China has increased demand for RMB transactions among global investment institutions and central banks.

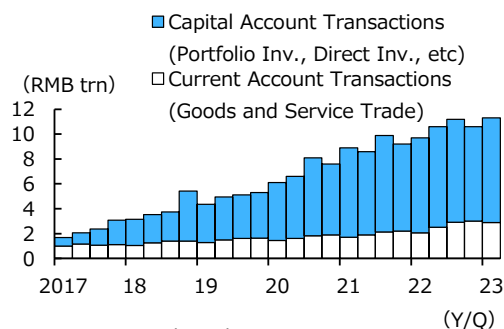
However, the amount of investment by foreign investors in mainland China RMB securities has reversed course from a rapid rise to an ongoing downward trend in both equities and bonds since 2022, showing signs of change. Heightened geopolitical risks have played a part in this. The U.S.-China confrontation shows no signs of subsiding, and foreign investors are cautious about investing in China because the U.S. government's restrictions on dealings with China may be extended to investment as well. In addition, Western countries may impose secondary sanctions on foreign individuals and companies that do business with Russia to prevent the opening of "backdoors" for evading sanctions against Russia, and this risk also continues to loom over investment in China. It has been reported that certain foreign investors have sold bonds issued by China's policy banks, because they have extended loans in connection with Russian energy development projects. Most of the entities that originally expanded their portfolio investments in China were investors from Western countries, and this is a factor that has increased the headwind for capital transactions with China against the backdrop of these heightened geopolitical risks.

In addition, among the foreign exchange reserves held by central banks and governments around the globe, assets denominated in RMB have been declining since the beginning of 2022. Assets in foreign exchange reserves not only provide for the settlement of import payments by each country, but also for foreign debt service and foreign exchange intervention. The share of USD in the asset composition of foreign exchange reserves has declined markedly in recent years, and there is a clear pivot away from USD. Attention is focused on the currencies being chosen to replace USD, but it is not RMB that is being picked recently, but rather currencies of emerging countries other than China.

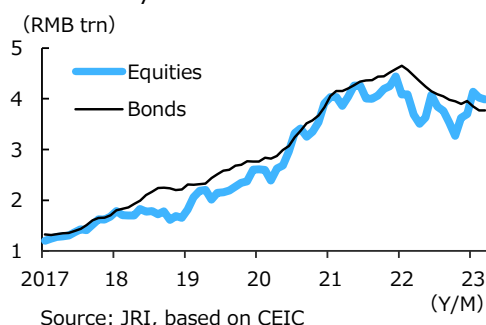
RMB boasts strength in transactions for trading, where China has global influence, and the tailwind for increased trade in RMB is expected to continue to blow. However, when it comes to capital transactions, which are larger in scale than current transactions such as trade, the use of RMB has been stagnant against the backdrop of deepening antagonism between Western countries and China/Russia, and the headwinds have recently become stronger than the tailwinds for the internationalization of RMB. Given this situation, it will likely remain difficult for RMB to gain enough ground to usurp USD's position.

(Minoru Nogimori)

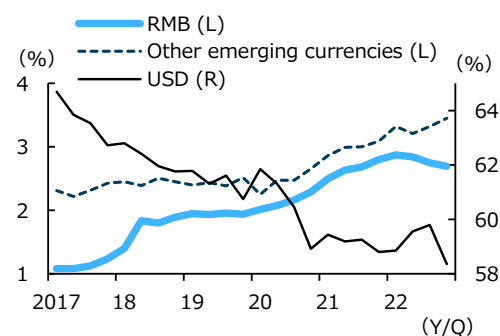
<China's Cross-Border RMB Settlement>



<Mainland China RMB Securities Held by Oversea Investors>



<Currency Composition of Official Foreign Exchange Reserve>



Topics *El Niño and Emerging Asian Economies*

It appears increasingly likely that the El Niño phenomenon will occur during the summer and fall of 2023. Extreme weather conditions could put downward pressure on the economies of drought-prone emerging countries in Asia.

■ The probability of an El Niño event occurring is growing

It appears increasingly likely that the “El Niño phenomenon” will occur during the summer and fall of 2023. El Niño is a phenomenon in which sea surface temperatures in the equatorial Pacific Ocean from near the date line to the coast of South America are higher than normal (in contrast, a phenomenon in which sea surface temperatures are lower than normal is called the “La Niña phenomenon”). The Japan Meteorological Agency (JMA) defines an El Niño as a situation where the five-month moving average of the difference between the sea surface temperature in the monitored area and the reference value (the average temperature over the past 30 years) is $+0.5^{\circ}\text{C}$ or higher for six consecutive months. If the figure is -0.5°C or lower, the situation is defined as La Niña.

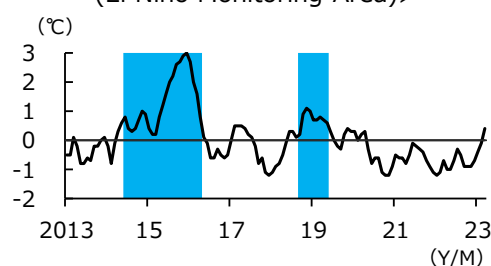
The last La Niña finished at the end of 2022, and neither El Niño nor La Niña has occurred since then, but in May 2023, the JMA predicted that there was an 80% chance of El Niño occurring during the summer and fall. The frequency of extreme weather events is expected to increase in the event of a lengthy “Strong El Niño,” where the difference from the reference value exceeds $+1.5^{\circ}\text{C}$, or a “Super El Niño,” where the difference from the reference value exceeds $+2.0^{\circ}\text{C}$. Such events occurred in the late 1990s and mid-2010s.

■ El Niño could impact Asian economies

It is difficult to say exactly how an El Niño event would affect economies because temperature and rainfall changes accompanying El Niño vary from region to region. In Asian countries, El Niño often causes droughts, and if droughts occur, the following economic impacts will be seen:

First, agricultural production will decrease. In countries with high income levels, such as Singapore, Japan, and South Korea, agriculture, forestry, and fisheries account for only around 1% of GDP, so the downward pressure on the macroeconomy of lower farm output would be limited. In the emerging economies of South and Southeast Asia, however, the figures are 10-20% of GDP, and in many countries, farmworkers make up over 30% of all workers, so any decline in agricultural production tends to have a negative impact on the overall economy. In addition, shortages in the supply of agricultural products exert inflationary pressure. Food price indices tend to move in tandem with the El Niño monitoring index (the difference between the sea surface temperature in the El Niño monitoring area and the reference value), so El Niño could push up global food prices by causing extreme weather. Inflation reduces the purchasing power of households, and because it triggers tighter monetary policy, e.g., interest rate hikes, it also puts downward pressure on durable goods consumption and capital investment. With their lower income levels, emerging countries are regarded as being especially susceptible to downward pressure on their economies from food-price inflation because food accounts for a higher percentage of consumption.

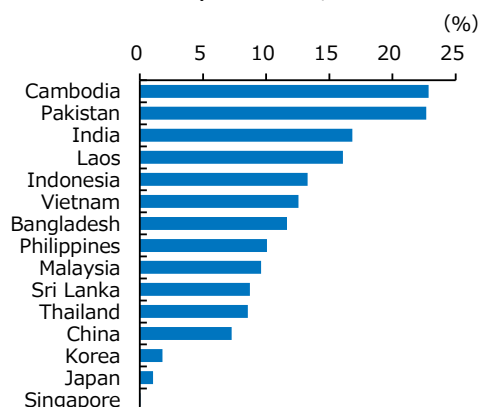
<Sea Surface Temperature Deviations from Standard Temperature (El Niño Monitoring Area)>



Source: JRI, based on Japan Meteorological Agency

Note: The shaded area indicates the periods in El Niño phenomenon.

<Agriculture, Forestry, and Fishing, Value Added (% of GDP, 2021) >



Source: JRI, based on World Bank

Second, countries that are highly dependent on hydropower are likely to face electricity shortages. Laos, Cambodia, and Myanmar get more than 40% of their electricity from hydropower, and Sri Lanka and Pakistan also rely on hydropower for 20-30% of their electricity. Therefore, if the El Niño phenomenon causes a significant drop in the water levels of major rivers, countries surrounding them will face severe power shortages. These electricity shortages will interfere with activity in the manufacturing and service sectors in such nations, so inflationary pressures driven by supply shortages can be expected to intensify in non-food sectors as well.

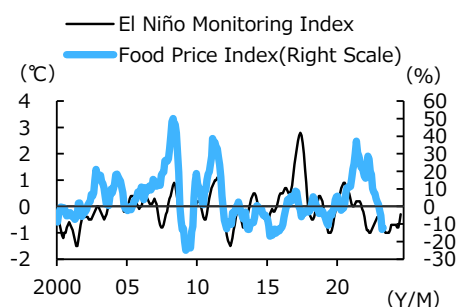
Incidentally, during the El Niño phase of the mid-2010s, growth in real value added in agriculture, forestry, and fisheries slowed in many Asian countries, and electricity generation from hydropower temporarily declined as dam and river levels fell. Although the extreme weather conditions brought inflationary pressures, at the same time, oil prices fell sharply from around \$100 per barrel in the first half of 2014 to the range of \$30 per barrel in the first half of 2016, so inflation actually slowed in many of the affected countries. This time, though, resource prices are high against the backdrop of geopolitical risks and other factors, and the economies of these countries are viewed as being vulnerable to additional inflationary pressures from this upcoming El Niño phase.

■ Responding to the risk of an economic downturn associated with El Niño

Although there is no magic pill that Asian countries can take to dodge the risk of an economic downturn caused by El Niño, over the medium term they should take the following steps to mitigate their risk:

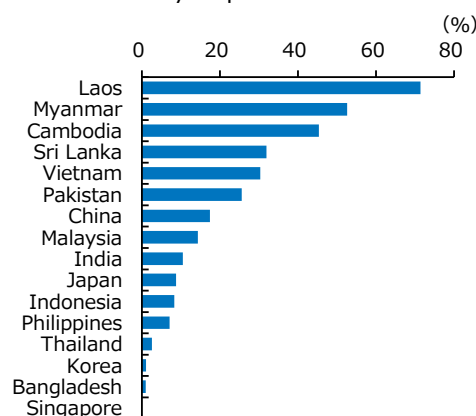
First, they ought to work to stabilize their agricultural production and food supply: Specifically, they should 1) be flexible in altering planting seasons to reflect weather conditions, 2) pivot to crops and varieties that are less susceptible to the effects of higher temperatures and lower precipitation, 3) construct the farm water infrastructure necessary for irrigated agriculture, 4) construct the water treatment infrastructure necessary for recycling domestic and industrial wastewater into farm water, 5) proactively stockpile food, and 6) expand agricultural imports from regions unaffected by El Niño. In addition, expanding agricultural insurance schemes and increasing the proportion of farmers covered by them would also be worthwhile, as such measures would prevent drops in farmers' incomes due to lower agricultural output. And to address the risk of electricity deficits caused by water shortages, they should encourage households to conserve water, urge companies to use water more efficiently, and diversify energy sources to reduce the weight of hydropower in the energy mix.

<El Niño Monitoring Index (18-months Lag) and Food Price Index (YoY) >



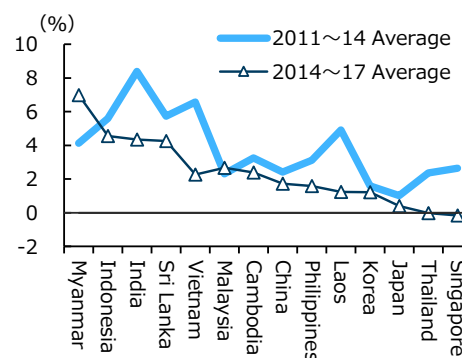
Source: JRI, based on Japan Meteorological Agency and World Bank

<Share of Electricity Production from Hydropower (2020) >



Source: JRI, based on IEA

<Consumer Price Index (YoY) >



Source: JRI, based on IMF

(Shotaro Kumagai)