RMB internationalization and capital account liberalization in China

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RMB internationalization marks a new stage of capital account liberalization

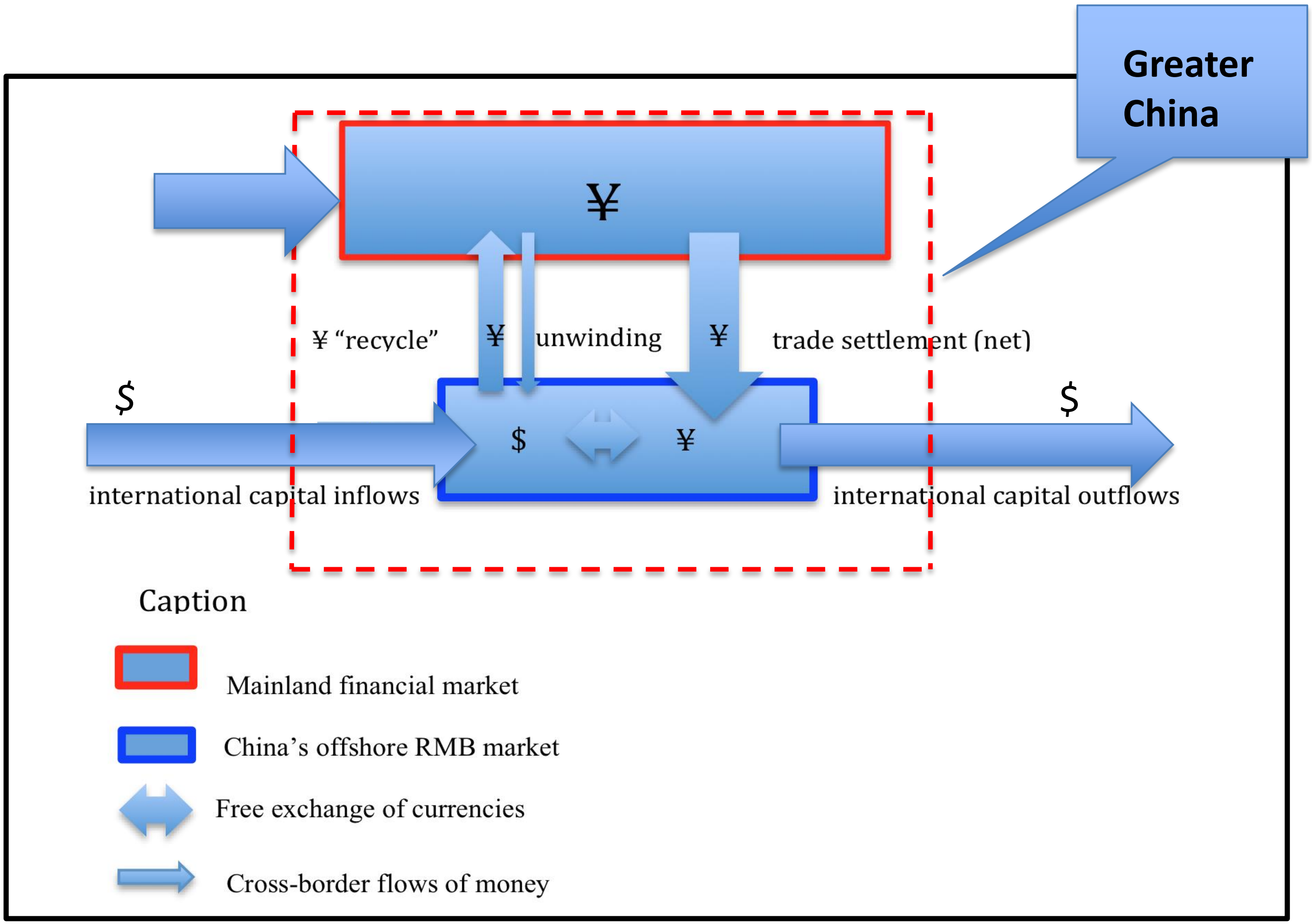
- The purposes of RMB internationalization
  1. Reduce exchange rate risks
  2. Reduce the increase in Foreign exchange reserves
  3. Increase competitiveness of financial institutions
  4. Reduce transaction cost of trade
  5. **To promote capital account liberaliztion**

How cross-border capital flows are facilitated by RMB internationalization

1. **The RMB import settlement** enables the RMB flows into Hong Kong and create an offshore RMB market—the CNH market, side by side with an onshore market (in Shanghai) – the CNY market.
2. **Foreign investors**, who wish to purchase renminbi assets due to RMB appreciation expectations and higher returns on RMB assets, can **purchase renminbis in CNH market** and
3. then invest in renminbi assets via **recycling mechanisms**.
4. If they wish to unwind their RMB positions and take profits, they can **convert their renminbis proceeds back into dollars in the CNH market and leave Hong Kong**

- Thus, international capital can move across the borders via **RMB trade settlement and recycling mechanisms**. Renminbi internationalization **opened a big hole** in the Chinese wall of capital controls.

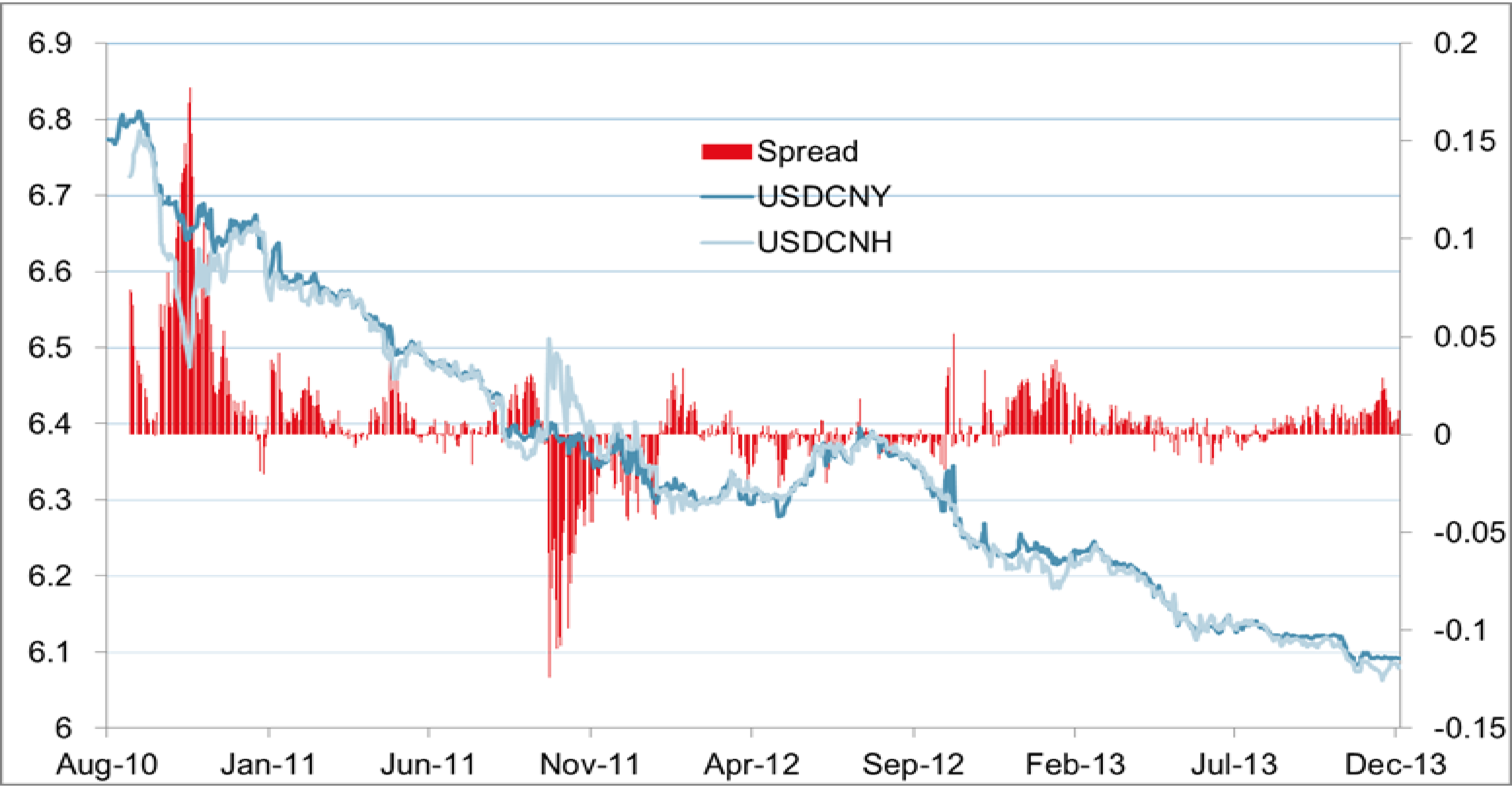
Capital flows through offshore market



One currency two exchange rates

- The CNH market is a free market, while the CNY market is under the People's Bank of China (PBOC) tight regulation.
- Two RMB exchange rates co-exist and a material CNH–CNY spread exists for most of the time

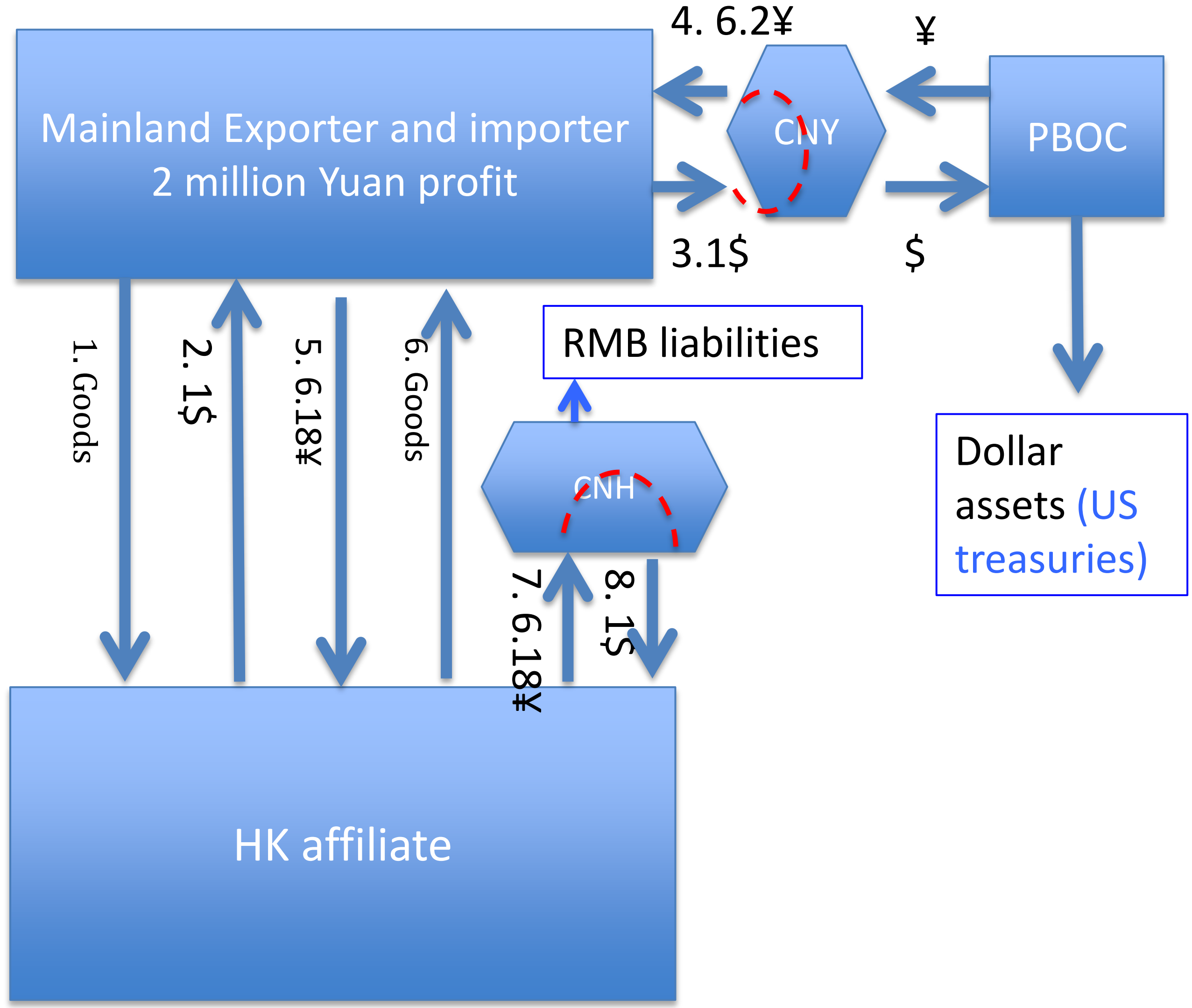
CNH-CNY spread



Exchange rate arbitrage has become less fashionable in 2012

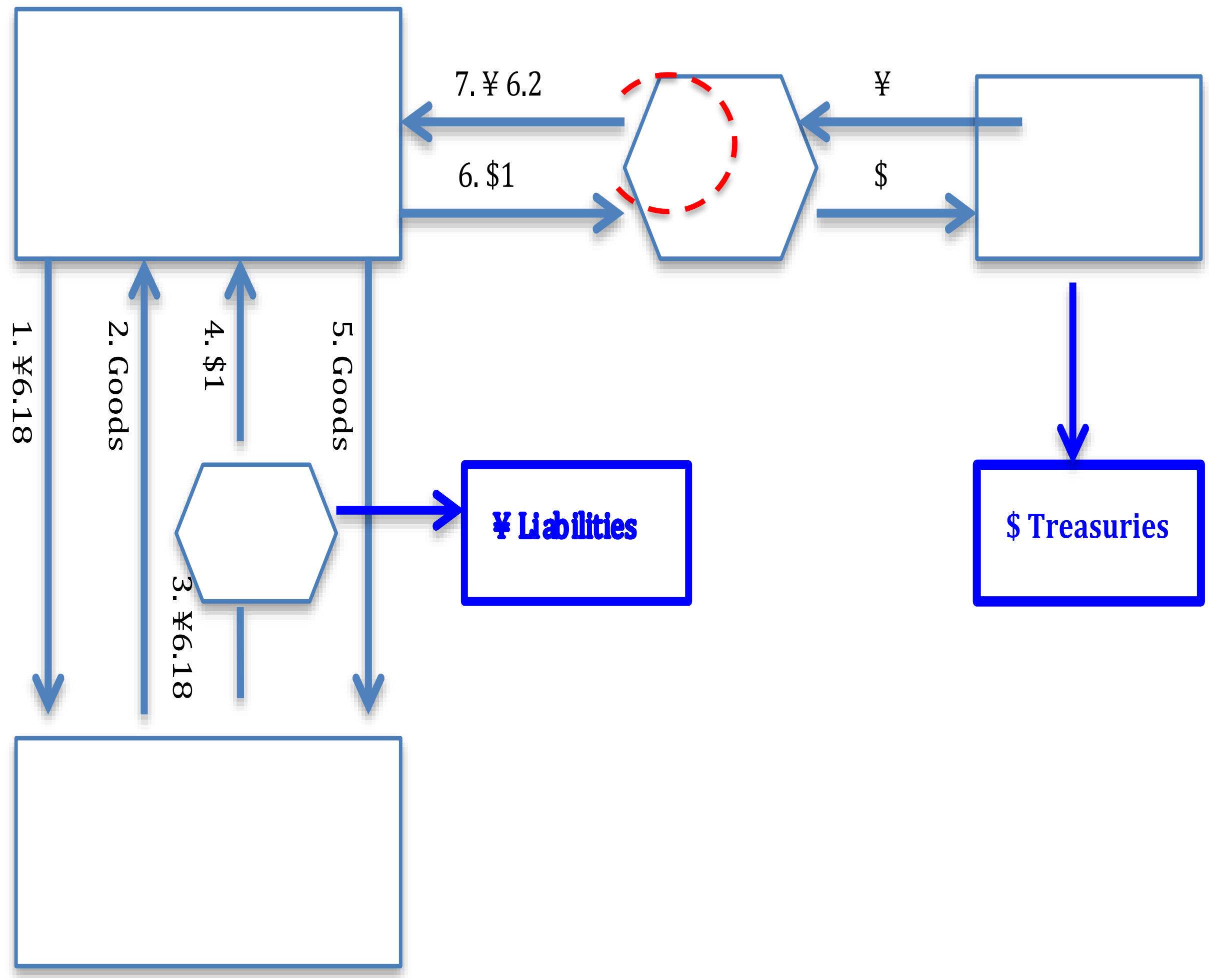
"A day trip to bonded area"

To begin with export

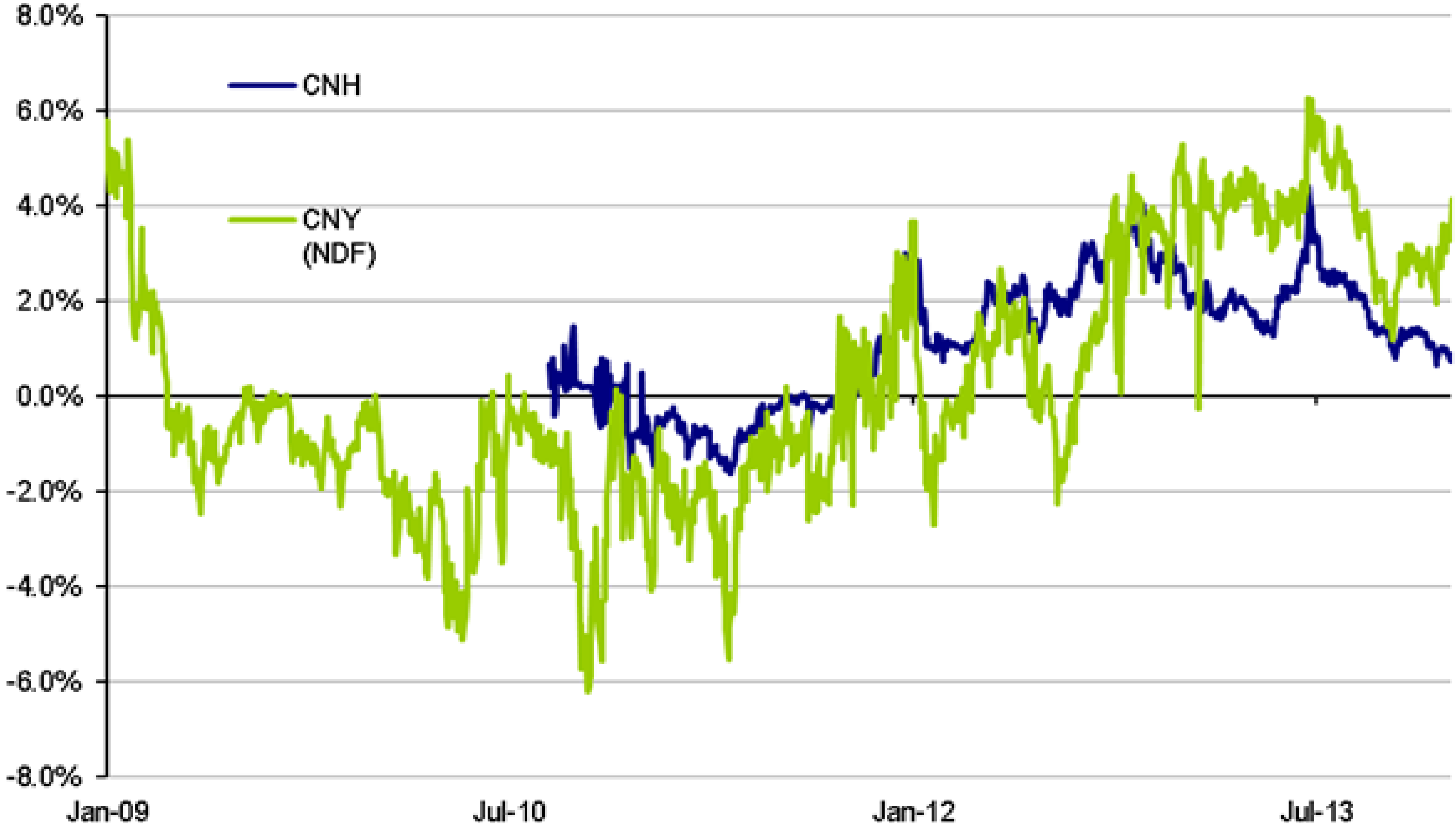


To begin with import

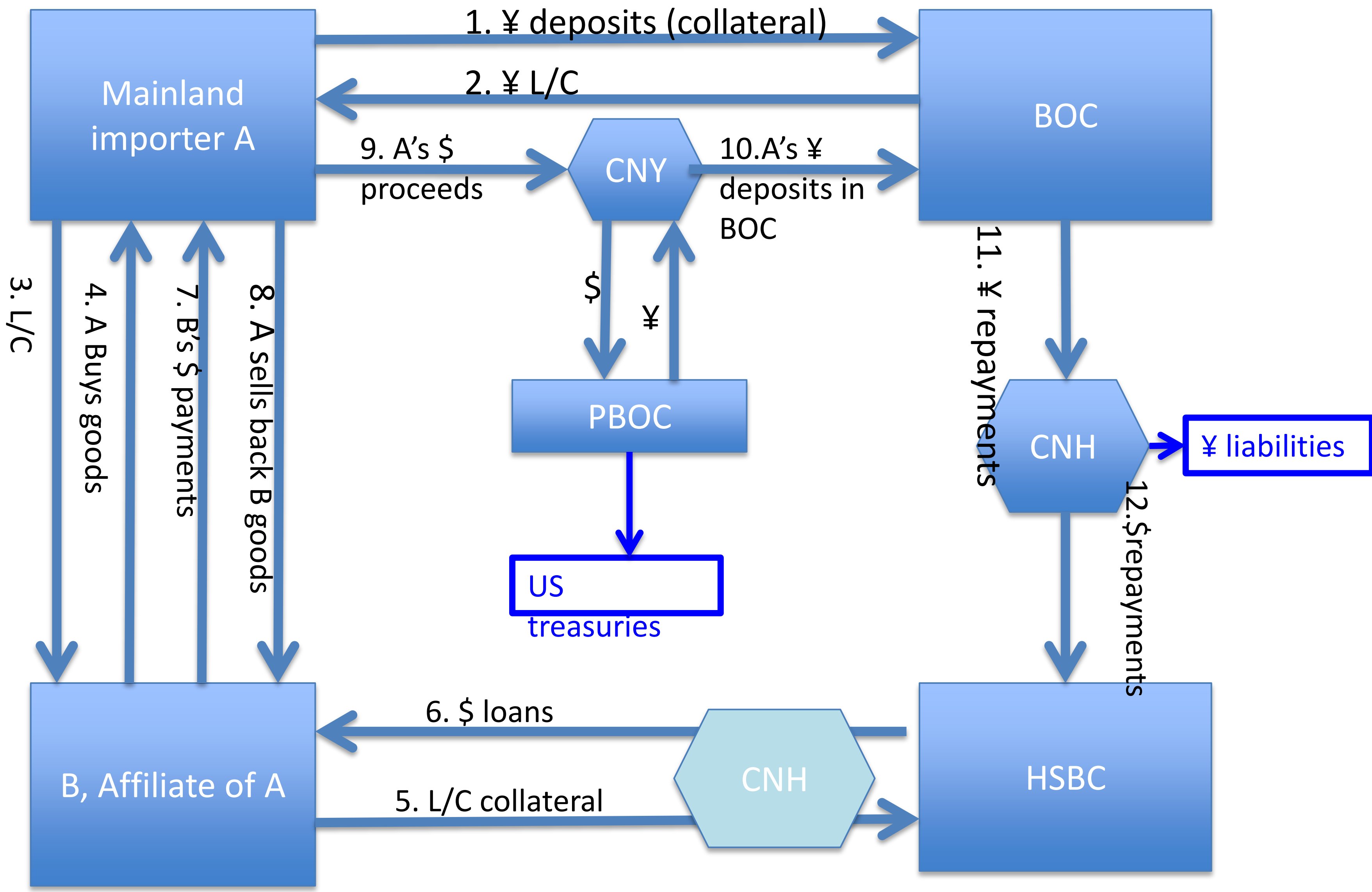
the resulting currency structure of assets and liabilities are the same.



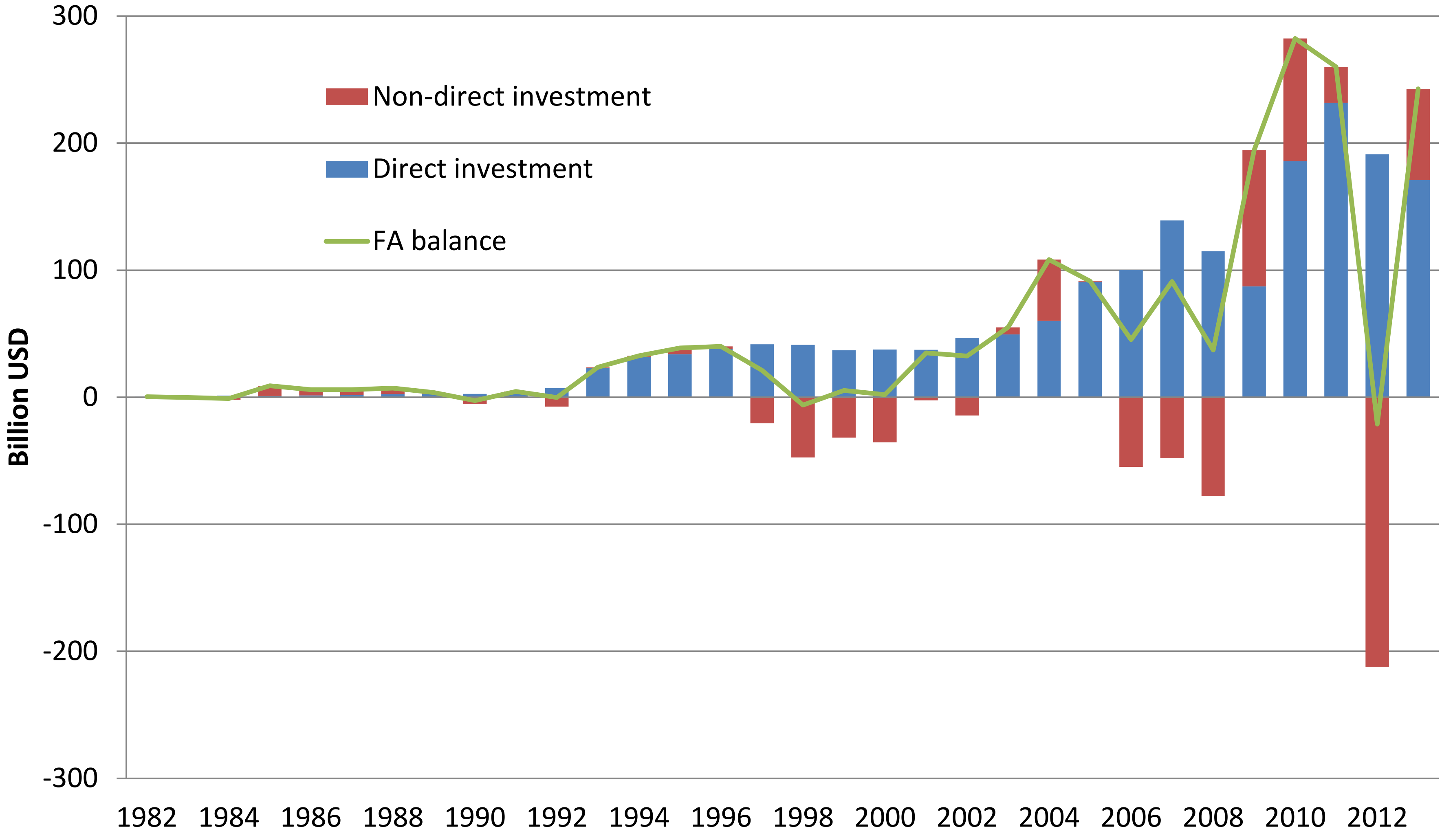
Interest rate spread between RMB (CNH or CNY) and US dollar (3 month rate annualized)



This explains why interest rate arbitrage through trade credit has become fashionable since 2012

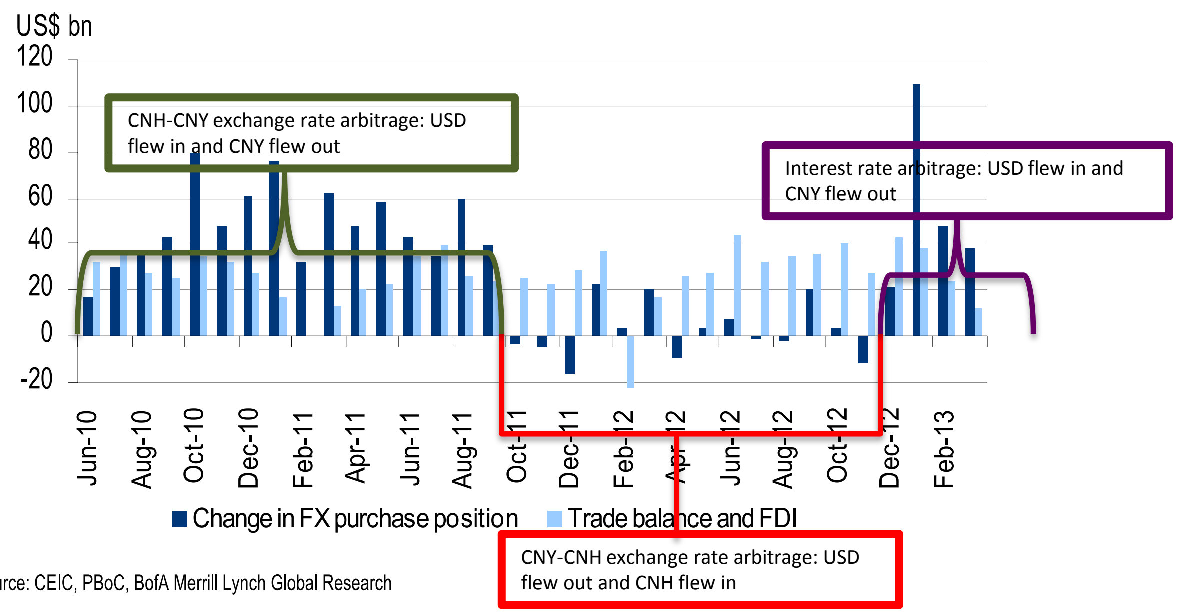

Mainland importer A
BOC
1. ¥ deposits (collateral)
2. ¥ L/C
9. A's $ proceeds
CNY
10.A's ¥ deposits in BOC
$
¥
PBOC
US treasuries
11. ¥ repayments
CNH
¥ liabilities
12.$repayments
3. L/C
4. A Buys goods
7. B's $ payments
8. A sells back B goods
B, Affiliate of A
6. $ loans
5. L/C collateral
CNH
HSBC

China’s capital account



Capital flows and arbitrage

Chart 31: Change in FX purchase position vs. Trade balance and FDI



Source: CEIC, PBoC, BofA Merrill Lynch Global Research

Capital flows through current account

The macroeconomic implications

- In the first 4 months of 2013, PBOC's trade-related net purchase of FX was $ 208 billion vis-à-vis trade surplus of $ 62 billion
- The gap was attributable to trade credit and trade finance (75%), and RMB import settlement. Both increased the foreign exchanges that the PBOC has to buy
- In fact, since 2010, capital flows classified as **"other investment"** has increased significantly. Basically, this category of capital flows consist of short-term cross-border capital flows
- Hot money is destabilizing the economy and causing serious misallocation resources
- To minimize arbitrage, one solution is to fully liberalize capital account, another is to liberalize exchange rate. In the first case, arbitrage will eliminate exchange rate and interest rate spread(currency board system). In the second, exchange rate risks will deter the arbitrage.

capital account liberalization and its implications for RMB internationalization

To liberalize capital account, China should first put its own house in order.

1. macroeconomic stability has to be achieved
2. <u>the high leverage ratio should be reduced</u>
3. a rational and flexible interest rate structure must be created
4. risk management capacity across industries should be established
5. Most importantly, China must make the RMB exchange rate flexible to reflect demand for and supply of foreign exchanges in the FX market so that intervention in the foreign exchange market can be minimized

Without fall capital account liberalization, the progress in RMB internationalization will be unsustainable. Hence, RMB's impacts on the reform of the international monetary system will be limited.