

RMB Internationalization and China's Financial Liberalization*

ZHAI Fan

Managing Director

Dept. of Asset Allocation and Strategic Research

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* The views expressed in the presentation are those of the author and should not be attributed to China Investment Corporation.

Outline

- What progress have been made?
- Which path has China chosen?
- Prospects for the internationalization of RMB
- Implications for China's macro policy and financial reform

RMB as a currency for pricing & settlement of trade

- July 2009: Pilot program of using RMB for cross-border settlement launched, covering only 5 domestic cities and their trade with HK, Macro and ASEAN.
- June 2010: The pilot program was expanded to 20 provinces/municipalities and all countries.
- Complemented with bilateral currency swap between central banks
 - *China has signed bilateral currency swap with 15 economies, amounted to RMB1.3 tn.*

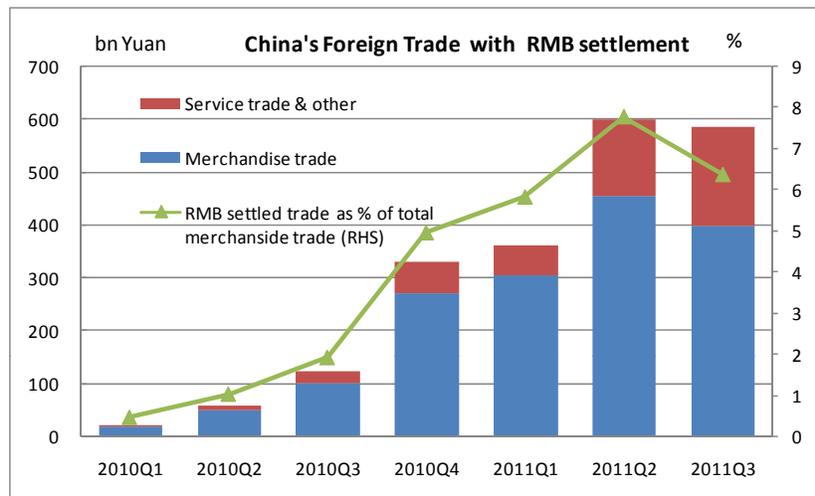
RMB as a currency for international investment

- Dim Sum Bond
 - *Began in 2007 with mainland banks issuing RMB bonds in HK*
 - *MoF issued sovereign RMB-bond twice in 2009/10, helping to set up the yield curve of the offshore RMB bond market*
 - *Grown rapidly since July 2010, and total issuance amounted to 200bn.*
- Aug 2010: Pilot scheme for eligible offshore financial institutions to invest in domestic inter-bank bond market.
- Jan 2011: Pilot RMB settlement of ODI launched.
- April 2011: First RMB IPO raising RMB 100bn
- Aug 2011: RQFII trail launched with initial quota of RMB 20bn.
- Oct 2011: RMB FDI was introduced by MofCom and PBoC.

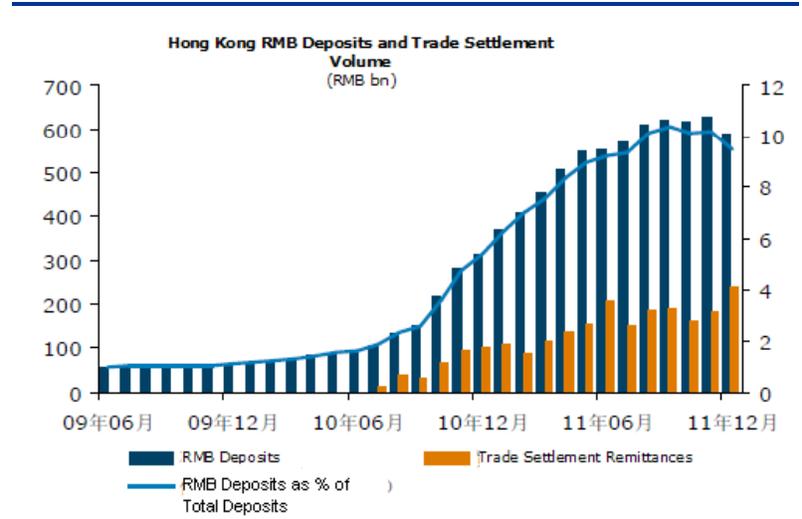
RMB as a reserve currency

- It was reported that Malaysia and Nigeria hold RMB bonds as a part of its foreign reserves.
- There is speculation that some other Asian central banks did the same.
- PBoC announced on 25 Dec 2011 that China and Japan will collaborate to promote the role of the RMB and yen in trade and financial transactions, and the Japanese government will invest US\$10bn in China's sovereign debt.

RMB trade settlement has sharply increased...



... RMB deposits in HK increased sharply as well



Will the momentum continue?

What do the policy makers want?

- They may not plan for a full-fledged RMB internationalization
 - *Note that the term “RMB internationalization” has never appeared in official governmental documents.*
- PBoC has been eager to prompt the use of RMB in trade settlement, given:
 - *China’s large trade presence*
 - *Demand from Asian trade neighbors*
 - *The potential benefits from more RMB invoicing and settlement*
- ... but no concrete plan for opening of China’s capital account and domestic financial market.
- The usage of a currency for trade hinges on the usage of it for financial activities.
 - *Inter-bank clearing and settlement system, trade financing, financial products for investment and hedging exchange rate risks, ...*

A unique approach

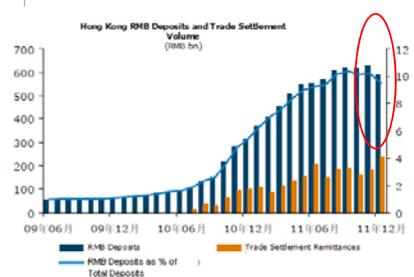
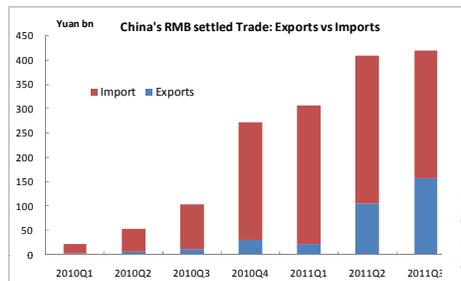
- Developing offshore internationalization, ...
 - *Boosting cross-border usage of RMB in trade settlement*
 - *Building HK RMB offshore market*
- ...aiming at:
 - *Promoting international use of RMB, but walling it off from the domestic financial system*
- Will it be sustainable and successful?

Tensions may arise from closed capital account

- Under the constrained capital account, how to ensure the flow of RMB from mainland to HK to develop offshore RMB liquidity?
 - RMB trade settlement plus bilateral currency swap
 - But the switch from US\$ to RMB for trade settlement depends on the development of offshore market.
 - A typical chicken-and-egg problem: some special institutional arrangements to breach current capital control are necessary to ignite the market.
- Dilemma to be faced in the longer term
 - If the offshore market is too small, it may have no sufficient depth and liquidity to develop financial derivatives and attract investors;
 - But if it is big enough, it can hardly be isolated from onshore market.

HK RMB offshore market: a looming setback?

- The very sharp growth of HK RMB offshore market has been driven by its low basis, the expectation of RMB appreciation and a series of small steps in the deregulation of capital accounts transactions.



Three possible scenarios

- **Liberalization:** the current progress in RMB internationalization initiates a broad reform towards opening-up of domestic financial system and capital account, leading to side-by-side development in both onshore and offshore markets, and rising role of RMB in the world economy .
- **Stagnation:** Stagnation in the development of offshore RMB market and RMB trade settlement, due to the slow progress in RMB convertibility.
- **Disorderly liberalization and crisis:** Desires for RMB internalization, as well as pressures from offshore RMB market, lead to premature and ill-prepared financial liberalization, increasing the vulnerability of financial system and possibility of financial crisis.

What is the right sequence?

- A genuine RMB internationalization can not be achieved without RMB convertibility.
- Two key impediments for China's capital account liberalization
 - Underdeveloped bond market
 - Regulated exchange rate and interest rates
- Proposed sequence of reforms
 - Increase the flexibility of RMB exchange rate
 - Liberalize interest rates on bank deposits and loans
 - Prompt the development of domestic bond markets with the purpose of increasing their size, liquidity and depth and diversifying their investors.