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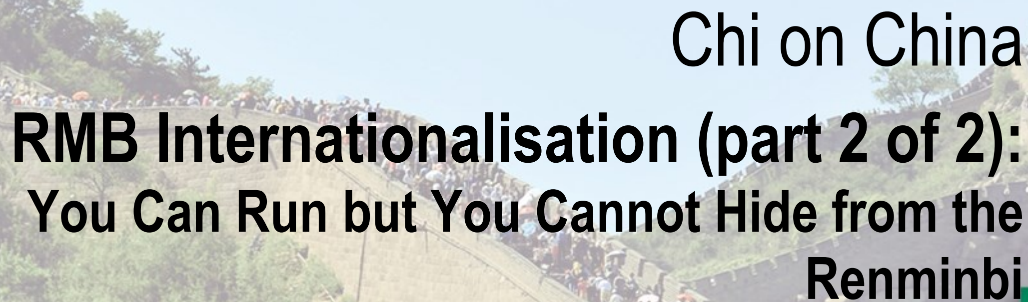

Chi on China

RMB Internationalisation (part 2 of 2):

You Can Run but You Cannot Hide from the Renminbi

Life is like riding a bicycle. To keep your balance, you must keep moving.

Albert Einstein

SUMMARY

- When investing in renminbi-denominated dim sum bonds, many investors have been pursuing a simple buy-on-dip strategy. It hinges upon a strong renminbi internationalisation initiative by Beijing, which also embeds an implicit guarantee on FX-risk-adjusted returns on renminbi-denominated assets.
- But if the People's Bank of China is shifting away from renminbi internationalisation, as we argued in part 1 of this report, will this investment strategy still work? The answer is yes as long as Beijing still wants to internationalise the renminbi, even at a sharply slower pace.
- This begs other questions though: to continue internationalising the renminbi, is Beijing willing to continue loosening control of the currency and to incur more FX volatility? How will foreign investors view renminbi-denominated assets in light of Beijing's policy challenges?

Since the creation of the offshore dim sum bond market in 2010, investors have been following a simple buy-on-dip strategy which has been successful in generating decent returns on their investment. This is because dim sum bond prices and the renminbi exchange rate tend to move together so that investors would buy on the dips when Beijing would step in to support the renminbi.

Before the latest policy shift away from pushing for more renminbi internationalisation[1], Beijing had strong incentives to support the renminbi whenever it weakened. The aim was to promote the renminbi as a credible global currency to be used for international trade and financial transactions, and eventually for central banks' foreign exchange reserves.

Does it still make sense to buy on weakness?

While Beijing wants to liberalise the exchange rate as part of financial reform, its renminbi policy also reflects an unwillingness to let go of its control on the exchange rate. From the perspective of the buy-on-dip strategy, it is precisely this reluctance to free the exchange rate that makes the strategy profitable. Why?

Embedded in the strong renminbi policy is an implicit guarantee by Beijing to uphold the renminbi's external value and to limit its volatility against the US dollar within a narrow trading band. At this stage of development, a strong and stable currency is the key reason for foreign investors (including central banks) to hold renminbi-denominated assets despite the distortions behind them.

However, if Beijing is down-grading the priority of renminbi internationalisation in the short-term, as we argued in part 1 of this report, its willingness to keep a strong and stable renminbi is becoming questionable. So buying on weakness is also becoming a questionable strategy.

It all depends on Beijing

Regarding the renminbi, *ceteris paribus*, Beijing has the choice of either discarding its internationalisation programme or paying the price of freeing the exchange rate and facing more market volatility by continue deepening internationalisation.

Things may not be that clear-cut though. In my view, Beijing still does not see this as a binary choice. It still wants to continue internationalising the renminbi but at its controlled pace of progress which, in turn, is contingent upon domestic conditions. Foreign influences cannot force Beijing's hand to any great extent.

In other words, despite all the threats by hedge funds to break the renminbi, speculative attacks cannot push the inconvertible renminbi on the capital account over the edge like they did, for example, to the pound sterling in 1992 when hedge funds short-sold the pound sterling and forced it out of the Exchange Rate Mechanism. All the speculators can do is short-sell China proxies or the offshore renminbi. These segments are too small and illiquid to overwhelm the gigantic onshore system, which is still relatively shielded from external forces by the closed capital account.

If this is the case, the buy-on-dip strategy for renminbi investment will continue to work as long as Beijing stops short of allowing the renminbi to free-float in the medium-term, even if the volatility of the underlying assets rises.

Foreign ownership

This view rests on the assumption that foreign demand for renminbi-denominated assets, which are still one of the most under-owned asset classes in the world, will continue to rise steadily over the coming years.

A signpost for this is the potential inclusion of China A-shares in the MSCI Emerging Market Index. When that happens, fund managers will have to include onshore Chinese assets in their portfolios (which currently

[1] See part 1 of this report, "*Chi on China: Renminbi Internationalisation (part 1 of 2): Short-term Policy Tactics May Have Changed*", 24 February 2016.

have a negligible weighting) according to the global benchmark weighting. As and when more central banks start to hold renminbi in their foreign reserves, institutional demand for renminbi-denominated assets will also rise.

However, there is still no guarantee that there will be an increase in foreign demand for Chinese assets. For this to happen, Beijing will have to earn international confidence by continuing to reform its financial policy framework and economic structure to attract more foreign capital inflows towards renminbi-denominated assets.

Renminbi internationalisation and the corresponding structural and policy reforms are powerful trends unfolding in the longer-term. The odds are rising on a greater usage of the renminbi in international trade and finance, central bank reserves and capital market issuance in the coming years.

To conclude bluntly, you can run but you cannot hide from the renminbi.

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