

A photograph of the Great Wall of China winding across a lush green hillside under a clear blue sky. A large crowd of people is visible along the wall.

Chi on China

RMB Internationalisation (part 1 of 2): Short-term Tactics May have Changed



Change will not come if we wait for some other person or some other time. We are the ones we've been waiting for. We are the change that we seek.

Barack Obama

SUMMARY

- Changes in economic conditions since 2014 both in China and globally may have prompted Beijing to sharply slow the process of renminbi internationalisation in the short-term. This implies that Beijing may have also downgraded the policy priority of capital account liberalisation.
- An indicator of this, in my view, is the heavy intervention by the People's Bank of China in the offshore FX market this January, which pushed up the overnight offshore renminbi inter-bank lending rate to over 60%. Beijing seems to be willing to “sacrifice” the offshore market in favour of domestic priorities.
- Beijing reckons that renminbi internationalisation may carry more risks than benefits at this stage of the economic transition. This underscores our long-held view that renminbi internationalisation based on currency movement speculation would not be sustainable.

What has changed?

Renminbi internationalisation, in conjunction with a strong FX policy bias, was once a high policy priority in facilitating China's financial liberalisation. However, several developments since late 2014 may have caused Beijing to stall the internationalisation strategy.



Firstly, changing global growth and interest rate dynamics have dented Beijing's strong renminbi policy stance. When China's economic growth was strong and US's growth was weak before 2014, it was easy for China to defend a strong currency bias. But between late 2014 and 2015, US growth continued to recover, the US dollar rose by 20% against all major currencies and the US raised interest rate (in December 2015) for the first time since the Great Financial Crisis. Meanwhile, China's growth remained weak and the PBoC cut interest rates six times.

Secondly, from Beijing's perspectives, the role of renminbi internationalisation as a force to push through financial deregulation has largely been completed¹. Hence, its official importance has diminished. To gain the renminbi's entry to the Special Drawing Rights (SDR) basket, Beijing scrapped the deposit interest rate cap (in July 2015), and shifted its exchange-rate mechanism from a *de facto* US dollar peg to a more flexible one (in August 2015) allowing more market forces to drive the renminbi-US dollar cross rate with two-way volatility. It also implemented a series of other opening-up measures to increase access to China's onshore markets (see Table 1). The admission of the renminbi to the SDR basket in December 2015 was seen as an international recognition of China's achievement in financial liberalisation.

Thirdly, renminbi internationalisation seems to have turned from a political boon to a bane for Beijing. The success of the CNH market in making the renminbi more widely used has also allowed offshore players to sell short the Chinese currency. This has created unwelcome volatility in the internationalisation process just when the pressure of structural rebalancing on China's domestic economy is also intensifying.

China signed swap lines with more than 30 foreign central banks, but they seem to have backfired on renminbi internationalisation. In late December 2015, the central bank of Argentina unexpectedly activated its renminbi swap line with the PBoC, acquiring renminbi and swapping it for US dollars to replenish its depleted reserves. While the swapped amount was small (USD3 billion), its implication was significant.

If other central banks start following Argentina's lead and use their renminbi swap lines to acquire US dollars, they would put significant selling pressure on the renminbi. Rather than encouraging the international use of the renminbi to stabilise international FX markets, the renminbi swap lines might ironically end up strengthening the US dollar and causing more FX volatility at the expense of the renminbi.

Signs of a slowdown in renminbi internationalisation

Beijing seems to be retreating from using the "Belt and Road" strategic project as a tool to deepen renminbi internationalisation. The Asian Infrastructure and Investment Bank will lend in US dollars. Two of the Chinese policy banks that have international lending directives from Beijing, the China Development bank and the China EXIM Bank, were recently capitalised by transferring US dollars from the FX reserves, likely setting them up for lending in US dollars to external borrowers.

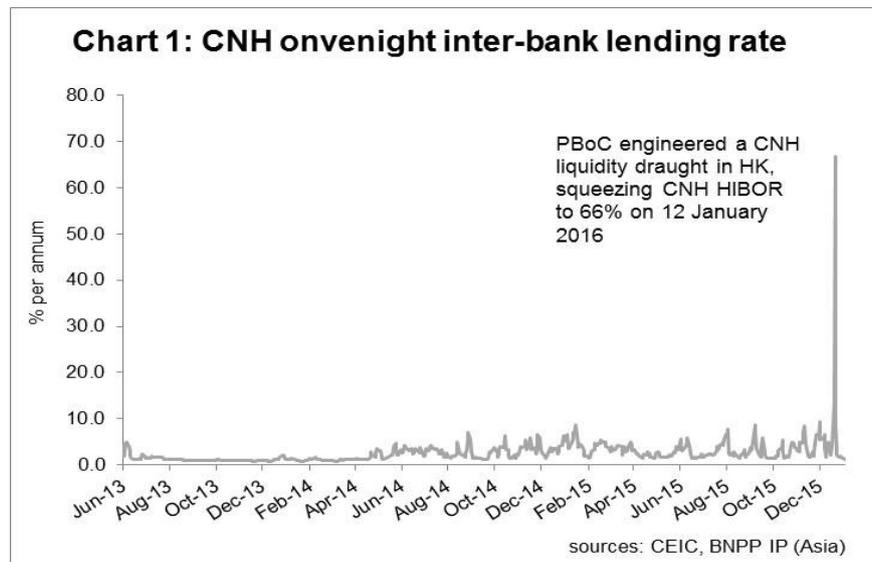
Crucially, the PBoC's heavy intervention in the offshore market suggests it might be considering sacrificing the offshore market (i.e. renminbi internationalisation) for domestic policy priorities. In mid-January, the PBoC drained CNH liquidity in Hong Kong, causing a sharp contraction in the offshore renminbi pool, pushing up overnight CNH lending rates to over 60% (Chart 1) and forcing up the CNH-USD cross rate by 1.5% in a single day. This resulted in an artificial convergence between the onshore CNY and the offshore CNH FX rates.

¹ But we have argued that genuine deregulation has yet to be done. See "*Chi Time: China Moving Towards A New Monetary Policy Era*", 4 November 2015.


Table 1: Financial liberalisation under President Xi Jinping

Banking	<p>Mar-14 China Banking Regulatory Commission (CBRC) approved a pilot scheme to set up five private banks.</p> <p>Feb-15 State Council issued Deposit Insurance Scheme Ordinance to insure bank deposit with the cap of RMB 500k for each depositor in one bank, effective 1 May 2015.</p> <p>Jun-15 State Council revised in a bill draft to remove loan-to-deposit ratio (LDR) from banking regulatory indicators.</p> <p>Oct-15 Implemented the first stage of Cross-border Interbank Payment System (CIPS) for current a/c settlements</p> <p>Oct-15 The 75% loan-to-deposit was scrapped</p>
Interest rate liberalisation	<p>Dec-13 The PBoC issued interim management measures for interbank CDs.</p> <p>Nov-14 Raised the cap of deposit rate from 1.1x to 1.2x</p> <p>Mar-15 Raised the cap of deposit rate from 1.2x to 1.3x</p> <p>May-15 Raised the cap of deposit rate from 1.3x to 1.5x</p> <p>Jun-15 Introduced the negotiable CDs to individuals and corporate</p> <p>Oct-15 Deposit interest rate cap scrapped.</p>
Exchange rate flexibility	<p>Mar-14 Expanded the daily trading band for CNY against USD to 2% from 1%.</p> <p>Aug-15 Reformed the daily fixing mechanism by basing the fixing rate on the previous day's market closing rate from the CFETS, instead of basing it on the moving average of the closing rates of the past 10 trading days</p> <p>Sep-15 PBoC relaxed regulations to encourage CNY-CNH convergence by lowering the requirements for MNCs to participate in the cash-pooling scheme and by raising the quota of net cash flows under the scheme by 5 times</p> <p>Sep-15 Opened the onshore interbank FX market to free-trading by foreign central banks</p> <p>Oct-15 Extension of onshore RMB trading hours to 2330hrs Beijing (1530 GMT) to overlap with London's trading hours</p>
Stock market	<p>Nov-13 China Securities Regulatory Commission (CSRC) issued opinions on further IPO reforms, preparing for IPO registration system reform.</p> <p>Apr-14 The CSRC announced inter-connectivity between the HK Stock Exchange and the Shanghai Stock Exchange to be launched in six months or so.</p> <p>Nov-14 Shanghai - Hong Kong stock connection started</p> <p>Feb-15 Introduced the first index option, SSE50 ETF option</p> <p>Apr-15 Introduced the IC500 index future</p>
Bond market	<p>Oct-14 MoF issued document 43 to impose restrictions over LGFV borrowing and bond issuances.</p> <p>Mar-15 MoF launched Local Government Debt Swap Programme and offer RMB1 trn quota for local government bond issuance this year to replace the existing local government debt.</p> <p>Jun-15 MoF approved another RMB 1trn quota for local government bond issuance this year.</p> <p>Jul-15 PBoC announced CBs/SWFs/selected global financial organisations could participate in the interbank bond market in trading cash bonds, repos and interest rate swaps w/o the need for approval and quotas.</p>
Capital account liberalisation	<p>Mar-15 Relaxed restrictions on Chinese mutual funds and insurance companies to invest in HK stock market.</p> <p>May-15 CSRC and Hong Kong SFC signed a memorandum on mutual recognition of funds between the mainland and Hong Kong</p> <p>Jun-15 PBoC issued a circular to allow offshore RMB clearing and settlement participant banks to conduct repo business in the onshore interbank bond market, with funds borrowed via repo being allowed to be used offshore</p> <p>Jul-15 Launched China-HK Mutual Recognition of Funds scheme</p> <p>Sep-15 Allowed foreign central banks to trade directly in the onshore interbank FX market</p> <p>Sep-15 Scrapped quotas for Chinese firms to raise funds in overseas bond and loan markets</p>

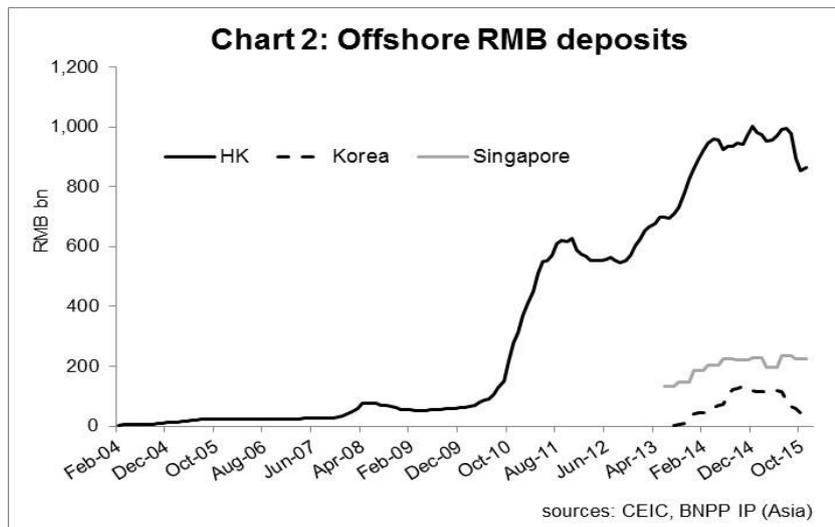
sources: Xinhua News, govvt websites, Bloomberg, Reuters, BNPP IP (Asia)



The PBoC's most recent intervention was an abrupt change from its previous moves. When offshore rates surged in 2014, it asked Chinese banks to divert funds to the CNH market from their onshore parents and injected liquidity into the CNH market directly via the Hong Kong Monetary Authority. This time, however, it did the opposite by barring Chinese banks from sending renminbi to Hong Kong.

While such a move stamped out speculative short positions in CNH and, arguably, helped cut offshore investor losses on CNH assets, it might also have conveyed a subtle policy message from Beijing about its stance on the offshore renminbi market. In order to focus on managing China's domestic economic woes, which in Beijing's eyes have been aggravated by market volatility, it is willing to sacrifice the offshore market (even by shutting it down, if needed) to minimise complications in the domestic economy which is struggling to transit to a new growth model.

If this understanding is correct, it marks a significant shift in Beijing's view on using renminbi internationalisation as an external force to push domestic financial deregulation. When internationalisation was a high policy priority, China had to accept the complementary policy of a strong renminbi (as no foreigners would want to hold a depreciating renminbi). And thanks to this strong currency bias and rapid creation of offshore renminbi assets (which is part of the internationalisation process), renminbi bonds were accepted as a new asset class and offshore renminbi deposits soared, notably in Hong Kong.



We predicted a while ago that internationalisation based on the speculative motive of a rising renminbi would not be sustainable². The recent sharp drop in offshore renminbi deposits (Chart 2) has vindicated our long-held view. And now Beijing is even shifting to a slow renminbi internationalisation policy.

All this is not to say that the internationalisation initiatives have failed. They are just being slowed down. Going forward, China should focus its currency internationalisation efforts on strengthening the role of the renminbi as a medium of exchange (i.e. for trade settlement) and keep the pace of financial liberalisation up with the progress in the trade sector development so as to create demand for renminbi for non-trade purposes³.

What will be the market implications of all this? Stay tuned for the second part of this report series.

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² See "The Renminbi Rises: Myths, Hypes and Realities of RMB Internationalisation and Reforms in the Post-Crisis World", chapter 4, Chi Lo, Palgrave Macmillan 2013

³ See reference in footnote 2.



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