RMB internationalization and China’s economic transformation

Jianguang Shen

Summary

RMB internationalization involves two core steps: to achieve convertibility and status as a global reserve currency. Hence, convertibility is a first step towards RMB’s internationalisation, which requires four key changes, including capital account liberalization, circulation of RMB abroad, interest rate liberalization and a more flexible exchange rate mechanism. From a longer-term perspective, RMB internationalization will lead to four key transformations of the Chinese economy: from an export-oriented economy to an economy focused on domestic demand; from low-end manufacturing to moving upwards on the value-added chain and establishing a strong service sector; from being reliant on FDI to the “go abroad” strategy of Chinese enterprises; from policy-oriented towards a more market-based financial market.

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Table of Contents

1.0 Two future trends impacts China’s future 3
1.1 The long and winding road towards global rebalancing 3
1.2 Lewis Turning Point (LTP) leads to economic restructuring 3
1.3 Implications of RMB internationalization 4

2.0 RMB internationalization’s influence on China economy’s four key transformations 7
2.1 Transformation 1: Export-led to domestic-demand-oriented economy 7
2.2 Transformation 2: Manufacturing towards a strong service sector 11
2.3 Transformation 3: From FDI to "go abroad" strategy 16
2.4 Transformation 4: From policy-oriented towards market-based financial market 18

3.0 Two potential risks of RMB internationalization 22
3.1 Risk 1: Increasing difficulty of macro control 22
3.2 Risk 2: Short-term capital movement impacts on RMB exchange rate 22

4.0 Reference 24
1.0
New foreign and domestic developments accelerate RMB internationalization

1.1 The treacherous road towards global rebalancing
Since the global financial crisis in 2008, the advanced economies have been shifting the debt burden from the private sector towards the public sector. As a result, US faces aggravating “twin deficit” like it once did in 1980s. Meanwhile, despite Federal Reserve’s two rounds of quantitative easing in 2009 and 2010, the overall effect on US economic recovery was limited. Meanwhile, a sovereign debt crisis emerges in the Eurozone. Different from its American counterpart, Euro debt crisis also suffered from the difficult task of maintaining a monetary union without a fiscal union.

Fig 1 US faces a twin deficit as it did once before during the 1980s

The deteriorating global economic condition has brought about three major impacts on the Chinese economy: first, slowing foreign demand cut the overall Chinese export growth. Despite recent highs in China’s overall export growth, export to US has dropped for several months, merely maintaining a single-digit growth. With wage increase and RMB appreciation against the US dollars, export firms’ competitiveness was compromised. Meanwhile, despite that the economic slowdown might lead to a fall in oil prices, alleviating the short-term inflationary pressure, the possibility of US proposing a further round of quantitative easing will still lead to surges in commodity prices in the medium term, further deteriorating the inflationary pressures. Moreover, China was the largest debt holder of US; US dollar-denominated asset accounted for around 70% of China’s 3.2 trillion worth of foreign exchange reserves, the depreciation of US dollar casts huge doubts on the asset security of China’s foreign exchange reserves.

1.2 Lewis Turning Point (LTP) leads to economic restructuring

Lewis Turning Point – The market force to raise wages and reduce income gap
The emergence of Lewis Turning Point reveals the market power to reduce the income gap. Current labour shortage indicates that the shift of excess labour from China’s rural area has ended. Future wage increases, especially among manufacturing-based migrant workers, will serve as the major source to push income increases among low-income residents. Currently,
a structural imbalance has already emerged, as wages of college graduate and rural workers are converging. Structural elements of wage increases became apparent.

**Fig 2** Migrant workers’ wages approaching the same level as college graduates

![Chart showing wage trends](chart.png)

Source: CEIC, MOA, Mizuho Research

**Inadequate surplus rural labour force in China**

According to estimates of Mr. Cai Fang, Head of the Institute of Population and Labour Economics of Chinese Academy of Social Sciences (CASS), the surplus labour force in rural areas would decrease to only 5% at 24.81 million. There is a serious shortage of surplus rural labour, especially those under 30 years old, while the amount of surplus labour over 30 years old accounts for 80%. Hence, the rural areas have no more ‘young labour’ to provide.

**Fig 3** Labour shortage has been pronounced among under 30 years-olds

<table>
<thead>
<tr>
<th>Type</th>
<th>Labour transferred</th>
<th>Rural labour force</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>million people</td>
<td>%</td>
</tr>
<tr>
<td>16-20</td>
<td>36.60</td>
<td>18.3</td>
</tr>
<tr>
<td>21-25</td>
<td>54.20</td>
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<td>26-30</td>
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<tr>
<td>Over 40</td>
<td>31.00</td>
<td>15.5</td>
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<tr>
<td>All</td>
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<td>100</td>
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</table>

Source: CASS, Mizuho Research

### 1.3 Implications of RMB internationalization

RMB internationalization’s core implications are to achieve convertibility and status as global reserve currency. In order to reach RMB convertibility, capital account liberalization and RMB circulation offshore – supported by RMB exchange rate reform and interest rate liberalization – are the four pillars of further reforms. Meanwhile, as China’s economic influence enhances, RMB will transition from a local currency towards a more global one. Along with more currency swap agreements signed between PBOC and other countries’ monetary authorities, as well as the increasing exposure of RMB as an investment currency, RMB may become one of the world’s major reserve currencies in probably one decade.

China’s initial conditions for capital account opening are excellent: high growth rate and savings rate, surplus current account and huge foreign exchange reserves, sound fiscal condition and low non-performing loans in the banking system, strong long-term FDI inflows, minimum external indebtedness, and rapidly expanding domestic capital markets. International Monetary Funds (IMF) research shows that China is not lagging behind and has
progressed in many aspects in recent years, especially in portfolio investment. Now we believe the conditions are ripe for a breakthrough. RMB’s offshore circulation and repatriation will inevitably lead to capital account liberalization.

RMB’s offshore circulation holds the key to the whole story: the RMB will first establish itself as a common currency for trade settlements, avoiding overreliance on US dollars and spread its influence worldwide. Meanwhile, Hong Kong’s unique status as RMB offshore centre will provide adequate investment channels for offshore liquidity, including a return mechanism that will facilitate cross-border investment flows.

China has also made significant progress on exchange rate flexibility and the abolishment of interest rate restrictions. In the 11th five year plan (FYP), PBOC’s regulatory framework on the currency market improved, and the tools for monetary policy enforcement became more effective. RMB internationalization will also facilitate faster currency reform, because the ultimate goal is to establish a market-based exchange rate.
### RMB’s roadmap towards a global currency

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
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<tbody>
<tr>
<td>2011</td>
<td>ODI RMB settlement; Expansion of QDII, QFII and R-QFII; Open HK-linked ETF</td>
</tr>
<tr>
<td>2012</td>
<td>ODI surges; Further expansion of QDII, QFII and R-QFII; Shanghai Intl. Board</td>
</tr>
<tr>
<td>2013</td>
<td>ODI and overseas portfolio liberalized; Shanghai opens up as onshore centre</td>
</tr>
<tr>
<td>2014</td>
<td>Inward investment mostly liberalized; Foreign debt market partially opens</td>
</tr>
<tr>
<td>2015</td>
<td>Capital account liberalized with some remaining restriction on short-term debt</td>
</tr>
<tr>
<td>2020</td>
<td>Wider circulation of RMB abroad</td>
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</table>

#### Capital account liberalization
- ODI RMB settlement; Expansion of QDII, QFII and R-QFII; Open HK-linked ETF
- ODI surges; Further expansion of QDII, QFII and R-QFII; Shanghai Intl. Board
- ODI and overseas portfolio liberalized; Shanghai opens up as onshore centre
- Inward investment mostly liberalized; Foreign debt market partially opens
- Capital account liberalized with some remaining restriction on short-term debt

#### Offshore RMB market
- HK RMB deposits to 700bn. Establishing a new offshore centre in London.
- More HK shares issued in RMB; London RMB deposits initiated
- Hong Kong with wide diversity of RMB products; A Euro-yuan market in London
- More offshore financial centers created, as Singapore, NYC, Taipei.
- Wider circulation of RMB abroad

#### RMB exchange rate flexibility
- Appreciate against USD by 5-6%
- Further appreciation against USD by 5-6%
- Wider fluctuation in RMB exchange rate under a shifting band.
- RMB around CNY5-6 per dollar, more foreign participants in RMB forex market
- RMB to become free floating currency

#### Interest rate liberalization
- Off-balance sheet lending and more structural wealth products
- Trials for deposit rate liberalization; SHIBOR market depth deepens
- PBOC to widen the scope in deposit and lending rate formation, and lending rate will be liberalized
- Deposit rate to become completely liberalized

Source: Mizuho research

**Basic convertibility**

**RMB to become a global reserve currency, around 10% of SDR basket**
2.0 RMB internationalization facilitates China’s four key transformations

Recent literature [IMF (2011), Kenen (2009), Park and Shin (2009)] points out that the internationalization of emerging market countries’ currency will effectively curb the uneven distribution of currency risks among different economies and reduce the distortive effect of reserve currency countries’ monetary expansion on other economies. It will also help enhance the diversity of globally traded assets, improve capital allocation and risk sharing, reduce global imbalances and make domestic banks acquire competitive advantage over foreign banks. Moreover, previous IMF research showed that capital account liberalization could lead to better smoothing of consumption cycle and resource allocation efficiency. More available sources of foreign financing also stabilize domestic consumption when facing country-specific risks. In the meantime, however, it also imposes a higher requirement on curbing financial market risks and monetary policy adjustments.

China pledges in its 12th Five Year Plan to further enhance domestic demand, accelerate economic reforms and increase development efficiency. In order to achieve these goals, supply-side reforms, via four key transformations, are urgently required to clear the obstacles ahead for further development, including reforms on exchange rate mechanism to stimulate domestic demand, further development in service industry, enhancing ODI to achieve industry upgrade, as well as loosening up regulatory control on interest rates.

### 2.1 Transformation 1: From export-led to a domestic-demand-oriented economy

#### 2.1.1 Domestic consumption ratio still trails behind

Despite the remarkable economic growth in China since the economic reform began in 1978, the share of consumption in overall GDP has been remarkably low. A quick comparison between the consumption ratio in China and other economies show that the phenomenon is unique.
The potential for China’s consumption is immense, and the government’s revision of the existing policies, including high tax burden, retained SOE dividend payment, and PBOCs restriction on interest rate, along with income increase following the emergence of Lewis Turning Point, will unleash the potential for higher income and consumption growth. It will have significant benefit to China’s service sector and discretionary spending.

2.1.2 Export-oriented pattern could not sustain

During the 11th five-year plan, the surplus of China’s balance of payments has widened further, as the current account surplus in terms of GDP exceeded 10% in 2007, and capital account surplus also rose rapidly.
But from a longer term perspective, export-led growth has become unsustainable under weak foreign demand. Facing recurrent debt crises of western countries, China cannot find the right cure to solve all problems. But as China’s consistent economic growth increased its overall voice in global economic and political arena, proposing RMB internationalization would not only adjust China’s position of passively accumulating US dollar-denominated assets, but also would facilitate active participation in international trade and regional investments.

Meanwhile, China will adopt a more balanced foreign trade policy, in order to reduce overall foreign trade surplus while increasing exports. In five years, China is expected to import 8 trillion USD worth of products and the retail sales will reach 31 trillion RMB. With expectations of RMB appreciation, RMB internationalization would increase China’s purchasing power of energy and raw materials, raising China’s overall competitiveness.

2.1.3 Contribution of domestic demand to the economy will significantly increase

China has long been a country with a high savings rate and a low consumption rate. The emergence of the LTP should boost incomes, and provide an opportunity for China to shift its economy from investment-led to consumption-led. In the next five years, we believe China’s household consumption should increase rapidly, and that China is very likely to become the second largest country globally, in consumption terms.
Income growth generates power for economic growth and structural shifts
From the experiences of Japan and Korea, the emergence of the LTP is a necessary step for development. Japan and Korea reached their own LTP at the end of the 1960s or 1970s. After the LTP, both economies faced labour shortages, wage hikes as well as rapid economic growth and radical structural adjustments. Wage increases generally lead to stronger consumption. From Japan’s experience, residential consumption picked up and the share of consumption in GDP surged after the emergence of the LTP. Korea saw a similar scenario.

Fig 10  Consumption rates in Japan and Korea

RMB internationalization facilitates increase in domestic demand
The lack of significant increase in China’s domestic demand results from a variety of reasons: primarily, the lack of purchasing power is the root cause, as both rural and urban residents’ real income growth has been slow. Meanwhile, China’s traditional consumption and saving pattern restricts China’s internal consumption growth, also impeded by high precautionary saving need. Moreover, China’s domestic savers have limited channels of investing overseas. Together with strict capital control, domestic FAI level remains high.

Earlier IMF research showed that capital account liberalization will more effectively smooth consumption over life cycle and achieve better resource allocation. Foreign financing also has a stabilizing effect towards residents’ consumption rate. RMB internationalization could facilitate policies in stimulating domestic demand from three main aspects:

- RMB internationalization will lead to cost saving within trade-related firms or firms that are dependent on foreign raw material imports. These firms’ profitability will increase and employees’ income level will be enhanced.

- RMB internationalization stretches domestic demand outwards, namely the increase in demand of foreign exports and overseas consumption. Meanwhile, price level of certain domestic products will be adjusted, as lots of them are significantly higher than their counterparts overseas, effectively increasing domestic residents’ purchasing power.

- Because of RMB internationalization, domestic residents’ will have more channels in investing overseas, thus having more ways of generating income apart from passively saving in banks or possessing limited investment channels.
2.2 Transformation 2: From manufacturing towards service sector

2.2.1 Slow growth in service sector

During the 11th five-year plan period, the service sector’s contribution to GDP stopped rising, while heavy industry sectors as a share of GDP rose very rapidly. Since 1985’s 7th FYP, “promoting a strong service sector for production and welfare” has been proposed. Yet service as of GDP ratio remain stagnant and even fall for some years. Meanwhile, China’s service sector as of GDP’s gap with other countries is increasing. For instance, in 2009, China’s service sector is only 42.6% of GDP, while other developing and developed countries’ service sector weights are increasing, normally between 50% -80%.

Fig 11 BRIC countries’ major sector contributions towards GDP

Source: WDI, Mizuho research

Domestic manufacturing stretching westward, great potential for service sector in the coastal region

As of now, the wage increase in south-eastern coastal region leads to significant cost increase in setting up factories. Many companies have decided to move their factories westward. This is helpful in balancing the economic development level of Eastern and Western China, also improving regional development pattern. China is still far from development phase of moving manufacturing base overseas as Japan and Korea did previously in 1980s and 1990s.

Fig 12 Coastal region’s service sector growth has huge growth potential (as of GDP)

Source: CEIC, Mizuho research
RMB internationalization facilitates export upgrade
Despite the fact that China is a major world exporter, China is still far from being a product giant. As majority of Chinese exports focused on lower value-added products, most Chinese companies remain passive price takers on the international market. RMB internationalization will facilitate purchasing of high-end equipments, technology and intellectual property rights, a positive sign for exports moving up the value-added chain.

Increasing proportion of service trade, RMB internationalization will help obtain full potential
China’s service trade achieved rapid growth in the past 30 years. Service trade contains both labour-intensive services, such as travel and transportation, as well as capital-intensive ones, such as airlines, communication, architecture, finance and information services. China’s overall service trade as of world proportion was still low, mainly due to two reasons: service as of GDP ratio was even lower than other three BRIC countries; capital control and low circulation of overseas RMB create obstacles for faster development of service trade. After RMB internationalization proceeds further, China’s potential for service trade, including advantages of human resources and further expansion of service industry, will be fully exploited.

Fig 13 RMB internationalization will help China service trade reach its full potential

Source: MOFCOM, Mizuho research

2.2.2 RMB internationalization boosts development in financial services industry
RMB internationalization’s direct impact on China’s service industry is to further develop financial services in China. Specifically, establishing Hong Kong as RMB offshore centre and ameliorating domestic capital markets will help boost growth in China’s finance industry, while the increase in investment products becomes the key to sustainable growth.

2.2.2.1 Market infrastructure: interactions between onshore and offshore financial markets
Before capital account liberalization, Hong Kong offshore RMB centre has become the touchstone for RMB internationalization. Because of a well-established financial service industry in Hong Kong, Hong Kong will act as a role model for later development in coastal areas.

On July 19th, 2010, the PBOC and HKMA refined the RMB settlement pact, enabling basic RMB convertibility in Hong Kong. Later on Aug 16th, the opening up of domestic interbank bond market towards foreign institutional investors provided more channels for firms to allocate their RMB liquidity. As of August, Hong Kong’s RMB deposits totalled more than 600 billion RMB, and is likely to reach 2 trillion in a couple of years.
On 17 August, Vice Premier Li Keqiang pledged in his official visit to Hong Kong, a series of new measures to reaffirm the city’s status as the RMB’s offshore hub. Some of the measures signal a breakthrough on capital account liberalisation and RMB’s offshore circulations, and is a major step towards RMB convertibility. New measures include:

- Launching the mini-QFII scheme which would allow HK investors to invest in mainland securities with an initial quota size of CNY20bn
- Expanding an RMB trade settlement scheme nationwide
- Allowing Hong Kong enterprises to invest directly in the mainland using RMB
- Introducing an ETF linked to Hong Kong stocks in the mainland
- Broadening the RMB bond market in Hong Kong, including increasing issuance of offshore sovereign bond

Successful interactions between onshore and offshore financial market is crucial towards the success of RMB internationalization. Without a repatriation channel, potential offshore liquidity will decrease investors’ willingness of holding RMB, leading to a lack of overall offshore demand. On the other hand, changes in ODI and patterns of trade finance will lead to overall outflow of onshore RMB, boosting overall overseas investment.
Diversified financial products strengthens RMB internationalization

Following the promotion of more varied RMB-denominated financial products, China’s finance industry would likely increase its product depth, which demands the government to devote more energy on building a stable institutional framework, attracting more financial experts, risk management as well as macro-planning.

QFII & QDII

As a prudent measure to avoid short-term capital volatility, the restriction on foreigners’ portfolio investment still existed. When inbound investment was finally allowed in 2003, it was achieved by the use of a “pre-commitment” vehicle, the Qualified Foreign Institutional Investor (QFII) scheme. As of now, a total of 116 foreign institutional investors have been approved under the QFII program, at an overall volume of 20.7 billion USD.

The Qualified Domestic Institutional Investor (QDII) scheme was also introduced in 2006, allowing domestic financial institutions to invest in overseas markets. Similar to QFII investors, QDII participants are not affected by capital control. It is designed to be a
transitional arrangement which provides domestic investors the opportunity to access foreign markets via certain fund management institutions, insurance companies, securities companies and other assets management institutions. Starting from 2006, China’s QDII has developed steadily, despite the 2008 global financial crisis which slowed down the overall QDII expansion. As of now, China permitted QDII of a total volume of CNY 72.6bn. QDII provide more options for domestic residents.

Fig 15  Approved QDII and QFII volumes are constantly expanding

Source: Mizuho research

R-QFII and HK-linked ETF
The long-awaited green light on the “mini-QFII” scheme, which has an initial quota at CNY20bn, facilitates the return of offshore RMB liquidity towards the mainland capital market. Also, the mini-QFII scheme will not use up the quota from the current QFII. The unveiling of an ETF linked to Hong Kong stocks in China will enable mainland China investors to access stocks listed in Hong Kong, such as the Hang Seng Index (HSI) constituents. Via this arrangement, Chinese investors can gain exposure to Hong Kong market directly, not via the mini-QDII scheme.

Mainland Interbank Bond Market
Opening up of the onshore interbank bond market is a rational choice for initiating return mechanism of offshore RMB liquidity based on several important reasons: First, interbank bond market consists of a variety of bond products, including government bonds, policy bank bonds, corporate bonds, etc. The trading volume within the interbank market was also huge. For instance, the interbank bond market contributed to 99.38% of non-financial enterprises’ bond issuance, with a total volume of CNY 569.1bn. Second, the interbank bond market has a more attractive yield than the offshore RMB bond market, which mostly has an annual yield of 2-3%. Also, investment risks are relatively smaller in the interbank bond market, which currently has low level of speculation and volatility.

On 16 August 2010, the PBOC published a notice which permits three types of offshore entities to invest RMB into China’s domestic interbank bond market, including foreign central banks or monetary authorities, RMB clearing banks in Hong Kong and Macau, as well as participating banks for RMB cross-border trade settlement. The whole scheme is regulated by PBOC on a case-by-case basis, and funds will be channelled through currency swap agreements and cross-border trade or investments.

Offshore RMB products
2010 - A watershed year for RMB offshore bonds
The year 2010 marked a watershed year for RMB offshore bonds, as international firms, supranational entity and domestic banking corporations all took advantage of the revised settlement agreement, which lifted restrictions on establishing RMB accounts and conducting RMB transfers in Hong Kong. As of now, RMB bonds issuance totaled 138 billion RMB and is likely to reach 500 billion RMB in 5 years.
Entities that issue Dim Sum bonds have already achieved significant diversification (2010-2011)

RMB-denominated shares and other products
The Hong Kong Securities and Futures Commission (SFC), Hong Kong Exchanges and Clearing Ltd (HKEx) and HKMA are testing Hong Kong’s system preparedness for RMB listing and settlement, to boost their readiness to conduct listed RMB securities business. Apart from that, HKEx is considering to build up a liquidity pool to promote RMB-denominated investment.

Apart from that, more offshore products, such as offshore RMB derivatives (RMB-denominated interest rate swap), as well as offshore RMB fund mostly situated in Hong Kong, Europe, Japan and Cayman Islands, will diversify offshore RMB products, enhancing its overall depth.

Dim Sum Bond-linked funds have significantly increased at major financial centers (Initial NAV=10)

2.3 Transformation 3: From FDI to “go abroad” strategy
An important part of the economic reform process in China has been the promotion of FDI inflows, and capital account convertibility has been achieved in this area. Since 1993, China has boosted the largest amount of FDI inflow among all developing countries, thanks to the favorable policies, such as tax incentives and the Guiding Directory on Industries Open to Foreign Investment. In fact, foreign enterprises have until recently enjoyed preferential treatment compared to domestic enterprises.
In comparison, Outward Direct Investment (ODI) did not flourish until the recent decade, when the government relaxed the restrictions on overseas investments and created government funds to support enterprises investing overseas. It is in line with the country’s “Go Global” policy. The investments are primarily focused on the nearby economies, particularly in SE Asia, and developing economies. As China’s economic growth expands, as does its appetite for natural resources. Much of the ODI quest abroad is related to acquisition of resources from resource abundant countries, and is usually spearheaded by State Owned Enterprises (SOEs).

Recent China’s ODI statistics revealed that China’s overall FDI outflow as of world has reached 5.2%, higher than traditional FDI outflow giants as Japan and UK. Moreover, China’s ODI stock reached 317.2 billion USD, 17th overall in the world. More importantly, China’s overseas M&A volume expanded to 29.7 billion USD, increasing 5.5 billion yoy.

As ODI volume increased further, Chinese government has already proposed RMB settlement of ODI. This will facilitate the “go abroad” strategy of Chinese enterprises and also provide opportunities to strengthen RMB internationalization. South Africa’s Standard Bank Group recently revealed that eventually 40% of Sino-African trade will be denominated in RMB, namely 100 billion USD, 2010’s overall Sino-African trade volume.

RMB internationalization will have a huge impact on China’s overseas investment: First, RMB internationalization will promote more private enterprises going abroad. Despite various obstacles, RMB internationalization will clear away controls on capital movement and foreign exchange management. Meanwhile, RMB internationalization will increase Chinese enterprises’ competitiveness overseas, as pricing power and settlement procedures were mainly controlled by foreign enterprises and governments. Foreign currency control also imposed limits on Chinese enterprises’ M&A activities overseas, while RMB internationalization could solve this problem. Moreover, RMB internationalization will increase overall RMB ODI stock overseas. As of end 2010, China re-invest 34.9% of its current profits of ODI, RMB internationalization will further increase the re-investment ratio.
ODI promotes industry upgrade

Developed countries’ experience showed that ODI reflected the transition from low-productivity, high volume growth towards an upgrade on the value-added chain and a more efficient growth. ODI pattern will also follow a transition from resource-seeking to companies' grasping market share, and eventually seeking for more efficient business model and acquisition of strategic assets.

2.4 Transformation 4: From policy-oriented towards market-based financial market

The biggest current issue for China’s financial market to interact globally was the lack of market-based mechanism, as policy measures were still the major power in adjusting local financial market. Among them interest rate liberalization and a more flexible exchange rate mechanism are the most crucial ones. We have already witnessed progresses in the past few years, but RMB internationalization will accelerate the reform progress, enhancing the market depth of the overall market.

2.4.1 Interest rate liberalization will progress

A market-based interest rate formation mechanism has to go hand-in-hand with RMB’s internationalization, because of four main reasons: First, a market based interest rate determination system that better facilitates the allocation of resources in the economy. Second, as China’s money rates were not completely market-based, yield structure of financial products were not available for accurate pricing. The RMB internationalization required adequate channels with diversified products at a market-based pricing system. Third, a non-market based interest rate regime combined with a gradually opening capital account
might lead to increasing arbitrage opportunities and volatility in capital transactions. It will also affect policy decisions negatively, reversing the efforts made in previous reforms. Forth, it facilitates competition within the banking system, preparing domestic banks for potential risks of a gradually opening capital account.

2.4.1 Lack of interest rate liberalization leads to off-balance sheet risks

In order to circumvent the regulated deposit interest rates amid tight supervision of the loan-deposit ratio (LDR) and high pressure on funding, many banks increased their sales of financial products in 1H11, and subsequently started a price war on these products. Compared with a year ago, the number of short-term financial products (3-21 days) sold in September 2011 has increased by more than 120%, while the number of products sold with a one-year maturity has decreased. Banks have also been competing on yields offered. Although these financial products have catered to the capital needs for off-balance sheet, they nevertheless constitute a potential risk for the overall banking system.

In addition, these financial products have diluted the effectiveness of monetary policy on the market. The growth of money supply (M2) and new loan were at 13% and CNY470bn respectively in August, both significantly below market expectation. The expansion of off-balance sheet financing products have compromised the effectiveness of the traditional policy tools.

The financial products, and the off-balance sheet risk that ensued are both results of the overly low deposit interest rates regulated by the authority. Competition for deposits between banks, and it is a preview of what is to come when deposit rate becomes liberalized. To avoid the off-balance sheet risks from getting out of control, we believe the policymakers should move towards using interest rate as the primary policy tool, and move the assets back to the balance sheet. In the long run, we believe deposit rate liberalisation need to speed up to eradicate the problem at its roots.

2.4.2 Interest rate liberalization process

Progress along the way

Until now, China has already proactively progressed in interest rate liberalization. Zhang Xiaohui, head of the monetary policy department at the PBOC pointed out that since 1996, interest rate liberalization has been ongoing at China’s economy. The PBOC has taken steps to relax its control on interest rates, and gradually set up the rate setting mechanism in the market. The priority of the liberalization process has been on the currency and bond market first, and followed by eliminating the control with the following principle: lending rate before deposit rate, foreign currency before RMB, long term deposit before near term ones, and large size account before small size ones.

Against the general direction, PBOC has so far eliminated the control on 199 interest rate related products, accomplished the interest rate marketization in the currency and bond market, and removed the cap for lending and floor for deposit rate. The process strengthened the central bank’s ability to monitor the market using interest rates, and set the ground for further reforms to come. We have compiled a short list of what China has already achieved towards interest rate liberalization.
### Progress in China’s Interest rate liberalization

<table>
<thead>
<tr>
<th>Category</th>
<th>Interest Rate Liberalization Moves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Currency interest rate</td>
<td>Completely liberalized in 2003, covering 29 different currencies.</td>
</tr>
<tr>
<td>Shanghai interbank offer rate</td>
<td>Market determined SHIBOR rates in 2007</td>
</tr>
<tr>
<td>Corporate bonds/ Commercial Papers</td>
<td>Market-based pricing with no restrictions (interest rate restrictions removed in 2009).</td>
</tr>
<tr>
<td>Mortgage rate</td>
<td>Expansion of mortgage rate’s float width after Wenchuan Earthquake in 2008 (not widely accepted by firms)</td>
</tr>
<tr>
<td>Loans/Deposits rate</td>
<td>“Impose limits on only lower bound for loans and upper bound for deposit rates”. From expansion of rate’s float width towards removal of loan rate’s upper bound and deposit rate’s lower bound.</td>
</tr>
</tbody>
</table>

Source: PBOC, Mizuho research

So far, liberalization of commercial banks’ deposit and lending rates was basically stagnant. Banking risk is the main concern in the interest rate liberalization process ahead. A comprehensive reform of the banking system, including the imposition of hard-budget constraint, exit mechanism and deposit insurance system, as well as a better transformation mechanism from policy rates to commercial bank deposit and lending rates would have to be in place.

The deposit rate will increase after the cap is abolished, and it will erode the interest rate spread, a main source of profit for commercial banks. It is therefore a significant challenge to the health of the banking system, and the major banks that are operational under the traditional mandate will be put under stress. A major hurdle for lifting capital controls in China has always been its fragile financial system, especially its troubled banking sector. The spread between the ceiling on deposit rates and the floor on lending rates, at roughly 3%, continues to over 80% of their profit. Scrapping a ceiling on deposit rates may promote more efficient pricing, allocation of capital and boost returns for savers, but it would have to be a gradual and orchestrated process, as it tests on the adoptability of the current banking system to open competition.

However, the good news is that China’s commercial banks have come a long way since the early 1990s, with significant improvement in their balance sheets and management structure. As late as 2002, BIS called China’s banking system “daunting”, based on the scale of the non-performing loans problem. In 2002, the share of non-performing loans amounted to 23.6% of total loans outstanding.

In the past decade, China has undertaken a sweeping reform program to restructure and rehabilitate its banking sector, with remarkable success. To begin to address this “stock” problem and to restore bank balance sheets, the Chinese government set up four state-owned asset management corporations (AMCs) in 1999. Their purpose was to buy bad debts of the four major state-owned commercial banks (the big four banks) and to dispose of them over 10 years. BIS stipulated that PBOC credit was the principal source of cash financing for the AMCs. Banks were also encouraged to using sizable amounts of provisioning funds to write off bad loans under the supervision of China Banking Regulatory Commission (CBRC), to prevent loans from deteriorating, and appearing on balance sheets. By 2010, China’s NPL has fallen to a healthy 1.15%.

We believe the government will likely continue with noticeable progress, and the cap for deposit rate may be one of the restrictions to be removed in five years. The reform will facilitate transition of monetary policy to relying more on “price-based mechanisms” rather than “quantitative mechanisms” such as lending quotas, a key to China’s financial system reform. The price-based mechanism will likely be supplemented with more open market intervention in the future.

#### Currency rate regime towards more flexibility

In order to achieve full convertibility, a more flexible RMB exchange rate mechanism is required to end the current slow-paced, one-way appreciation and a virtual peg with the US dollar. Since the beginning of 1994, China’s exchange rate has been determined in the China Foreign Exchange Trading Centre (CFETC), an inter-bank foreign exchange market. The
actual exchange policy itself, however, is supported by an elaborate system of direct capital controls implemented through administrative measures. While encouraging foreign direct investment (FDI), foreign portfolio investment and short-term foreign borrowing was restricted. At the end of 1996, China reached an important milestone by permitting RMB convertibility under current accounts. But the Asian financial crisis crushed this hope and the central bank made currency stability its primary goal of exchange rate policy.

China initially modified its exchange rate regime on 21 July 2005, abandoning the fixed dollar peg. The PBOC has also widened the RMB’s daily trading band to 0.5% since 18 May 2007. However, the one-sided appreciation process was once halted since late 2008 because of the global financial crisis, when export firms in China had already suffered from decline in foreign demand and was afraid of more downward pressure caused by RMB appreciation. A de facto dollar peg was thus resumed. In June 2010, the PBOC decided to proceed further with the reform of the RMB exchange rate regime to enhance the RMB exchange rate flexibility.

Other preparations for RMB’s full convertibility are also on the way. The market infrastructure precursory to full convertibility is required, such as the trading and market maker system to improve the RMB mid-price formation process, and the development of various kinds of RMB related financial products, to provide hedging tools. In 2010, the size of RMB spot, forward, and swap markets were USD3.05tn, USD32.7bn, and USD1.27tn respectively. They were respectively around 4 times, 2 times and 25 times larger than the size in 2006.
3.0
Two risks of RMB internationalization

3.1 Risk 1: Increasing difficulty in macro control

The greatest challenge that RMB internationalization will bring for the Chinese government is the increasing difficulty of macro control and curtailed effectiveness of policy measures. Specifically, due to increase of offshore RMB circulation, RMB cash and liquidity management will become harder to monitor, and PBoC’s open market operations might be less effective than before. As RMB internationalization was not completed, we find the high interest rate gap between onshore and offshore staggering. The fact that couple of domestic enterprises could use low cost to raise debt in Hong Kong offshore markets (dim sum bonds) has already created pressures for effective macro control.

![Fig 22 Gap between Hong Kong and the mainland deposit rates widening](image)

In order to prevent the foreign exchange reserves from further increases, China’s foreign exchange control has shifted from “restricting outflow” to “restricting inflow”. However, SAFE has loosened up the policy of extending credit certificates for domestic enterprises seeking for foreign loans. The mechanism enabled domestic enterprises to deposit in domestic banks in exchange of a credit certificate for the company to seek overseas financing for its offshore subsidiary. HKMA’s Norman Chan pointed out that 60% of the 444 billion HKD increase in loans towards Chinese non-financial clients are guaranteed by domestic banks. These clients normally transferred their funds borrowed back into Chinese domestic banks, in order to profit from the interest rate gap and the RMB appreciation.

Meanwhile, PBOC will have a harder time choosing an appropriate monetary policy for the time being, as it not only needs to consider domestic inflation, but also has to look at increasing offshore RMB demand, which is likely to expand to around 5-10% of overall RMB liquidity in 5-10 years.

3.2 Risk 2: short-term capital flow and RMB exchange rate volatility

RMB exchange rate regime will be based on market supply and demand after RMB internationalization is completed. Together with the parallel development in capital account liberalization and hence the increasing offshore RMB demand, RMB exchange rate will be unable to maintain at the current pace of gradual appreciation.
With increasing exposure to offshore RMB, volatility in the offshore markets is likely to lead to fluctuations in offshore RMB exchange rates, and this may subsequently have a knock-on effect on onshore exchange rates. Currently, however, we don’t expect volatility in the offshore markets to significantly impact the performance of the onshore market, as offshore liquidity is relatively thin. Nevertheless, with increasing offshore RMB deposits and investment channels, such insulation will not last forever, and onshore rates will inevitably be influenced by offshore volatility.

**Fig 23** CNH-CNY rate differentiation not an unseen story

![Graph showing CNH-CNY rate differentiation from August 2010 to August 2011]

Source: Bloomberg, Mizuho research
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