RMB Internationalization
GBSN Webinar
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Ron Schramm
CEIBS
Columbia University

Interviewed by Russell Flannery
Forbes
RMB/USD The official rate
The History of China’s Foreign Exchange System

• Up to 1978, the exchange rate was meaningless since trade and capital flows barely existed. A Price is Meaningless if there is No Market in the Underlying.

• Segregation from Foreign Involvement – Housing, Equity Markets and of course the Foreign Exchange System
Current Account Convertibility vs. Capital Account Convertibility

• December 1996 Article VIII.

• Absence of Capital Account Convertibility at the Company Level Implies:
  – Different Types of Forex Accounts.
  – Continued Surrender Requirements.
  – Access to Foreign Exchange and Forex Borrowing Traditionally Very Regulated.
A Staged Process

I. Only FDI Welcomed

II. Only Current Account Convertibility (Article VIII)

III. Only Large Institutional Investors Welcomed (QFIIIs)

IV. Only Large Outward Bound Investors Welcomed (QDIIIs)
On the Individual Level

• A History of Restrictions on Forex Access
  but now:
  – $2,000 can be taken out of the country no questions asked.
  – For > USD 2000 and less than < USD 20000 removal, burden of proof rises.
  – Hong Kong has become an important portal for moving forex into and out of China.
The Old FEC

BANK OF CHINA
FOREIGN EXCHANGE CERTIFICATE

The yuan expressed in this certificate is equivalent in value to the Renminbi yuan. This certificate can only be used within China at designated places. No request to register its loss will be accepted by the Bank.

TEN
FEN

0.10
Table 1  
Key dates and events in the reform of China’s foreign exchange system

<table>
<thead>
<tr>
<th>Date</th>
<th>Event or development</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>ISR established for the RMB at ¥2.8 per US$ (January); official rate at the time is ¥1.53 per US$.</td>
</tr>
<tr>
<td>1985</td>
<td>ISR is abolished (January). A series of official rate devaluations begins (eventually moving the exchange rate to ¥3.71 per US$ in the following year).</td>
</tr>
<tr>
<td></td>
<td>System of surrender requirements and foreign exchange retention scheme rationalized. Domestic residents allowed to hold foreign exchange accounts at the BOC (March).</td>
</tr>
<tr>
<td>1986</td>
<td>Foreign currency swap centers established in Shenzen and other SEZs.</td>
</tr>
<tr>
<td>1990</td>
<td>Major devaluation of the official exchange rate to ¥5.22 per US$ (November 17).</td>
</tr>
<tr>
<td>1991</td>
<td>All restrictions on domestic entities and residents’ sale of foreign exchange into the swap market are removed (December).</td>
</tr>
<tr>
<td>1994</td>
<td>Major reforms initiated: Unification of the official and swap market rate to ¥8.7 per US$. Swap market participation by domestic entities and individuals no longer permitted. Interbank market established as the CFETS based in Shanghai (April 4). Domestic firms commence purchase/sale of current account foreign exchange balances at designated foreign exchange banks. Trading in U.S. dollars and HK dollars commences.</td>
</tr>
<tr>
<td>1995</td>
<td>Interbank trading in the Japanese yen commences (March).</td>
</tr>
<tr>
<td>1996</td>
<td>China accepts obligations IMF’s Article VIII obligations for current account convertibility (December 1). Liberalization of foreign exchange restrictions on residents.</td>
</tr>
<tr>
<td>1998</td>
<td>Swap centers permanently closed (FFEs had been the only remaining participants).</td>
</tr>
<tr>
<td>1999</td>
<td>IMF classifies RMB exchange rate as a conventional peg (to the U.S. dollar).</td>
</tr>
<tr>
<td>2001</td>
<td>China accedes to the WTO (November 10).</td>
</tr>
<tr>
<td>2002</td>
<td>Trading in euro commences in interbank market (April).</td>
</tr>
</tbody>
</table>

Source: Table 6 in Appendix A.
Recent Developments

- July, 2008: Precautionary Return to a Fixed Exchange Rate.
- June 19, 2010: a Return (after 23 months of fixity) to a crawling float (5% appreciation since).
## Global Trade Shares and Trade in USD Billions

<table>
<thead>
<tr>
<th>Rank</th>
<th>Exporters</th>
<th>Value</th>
<th>Share</th>
<th>Annual % change</th>
<th>Rank</th>
<th>Importers</th>
<th>Value</th>
<th>Share</th>
<th>Annual % change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>China</td>
<td>1202</td>
<td>9.6</td>
<td>-16</td>
<td>1</td>
<td>United States</td>
<td>1604</td>
<td>12.7</td>
<td>-26</td>
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<tr>
<td>2</td>
<td>Germany</td>
<td>1121</td>
<td>9.0</td>
<td>-22</td>
<td>2</td>
<td>China</td>
<td>1006</td>
<td>8.0</td>
<td>-11</td>
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<tr>
<td>3</td>
<td>United States</td>
<td>1057</td>
<td>8.5</td>
<td>-18</td>
<td>3</td>
<td>Germany</td>
<td>931</td>
<td>7.4</td>
<td>-21</td>
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<tr>
<td>4</td>
<td>Japan</td>
<td>581</td>
<td>4.7</td>
<td>-26</td>
<td>4</td>
<td>France</td>
<td>551</td>
<td>4.4</td>
<td>-22</td>
</tr>
<tr>
<td>5</td>
<td>Netherlands</td>
<td>499</td>
<td>4.0</td>
<td>-22</td>
<td>5</td>
<td>Japan</td>
<td>551</td>
<td>4.4</td>
<td>-28</td>
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<tr>
<td>6</td>
<td>France</td>
<td>475</td>
<td>3.8</td>
<td>-21</td>
<td>6</td>
<td>United Kingdom</td>
<td>480</td>
<td>3.8</td>
<td>-24</td>
</tr>
<tr>
<td>7</td>
<td>Italy</td>
<td>405</td>
<td>3.2</td>
<td>-25</td>
<td>7</td>
<td>Netherlands</td>
<td>446</td>
<td>3.5</td>
<td>-23</td>
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<tr>
<td>8</td>
<td>Belgium</td>
<td>370</td>
<td>3.0</td>
<td>-22</td>
<td>8</td>
<td>Italy</td>
<td>410</td>
<td>3.2</td>
<td>-26</td>
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<tr>
<td>9</td>
<td>Korea, Republic of</td>
<td>364</td>
<td>2.9</td>
<td>-14</td>
<td>9</td>
<td>Hong Kong, China</td>
<td>353</td>
<td>2.8</td>
<td>-10</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>- retained imports a</td>
<td>91</td>
<td>0.7</td>
<td>-8</td>
</tr>
<tr>
<td>10</td>
<td>United Kingdom</td>
<td>351</td>
<td>2.8</td>
<td>-24</td>
<td>10</td>
<td>Belgium</td>
<td>351</td>
<td>2.8</td>
<td>-25</td>
</tr>
</tbody>
</table>

As a Share of World GDP

% of world total, 2010*

- Dollar reserves
- US GDP
- US Trade

*Or latest
BIS 2010 Survey

• RMB only .15 % of Global Trading.
• USD 42 %
• Euro 20 %
But by 2011

• Cumulative USD half a trillion in trade settlement in RMB.

• 10% of China’s trade invoiced in RMB from less than a percent a few years ago.
Move to Greater Internationalization Starting in 2008

• Exporters to China allowed to Price in RMB and Deposit offshore.
Companies Allowed to Issue RMB Bonds
“Dim Sums”
More Developments

- Swap arrangements with 14 Central Banks including Argentina, South Korea, Hong Kong, New Zealand, Singapore, Belarus. Arrangements valued at RMB 1.3 trillion.
- Japan agrees to hold RMB bonds as part of its reserves.
- Hints of Capital Mobility as foreigners are allowed to invest overseas holdings of RMB
Settlement Business for RMB-Denominated Foreign Direct Investment Started to Expand Cross-Border Use of RMB

The PBOC released the Administrative Rules on Settlement Business of Foreign Direct Investment Denominated in RMB in order to realize the plan of expanding the RMB’s use abroad as contained in the 12th Five-Year Program, to implement the central government policies designed to support the economic and social developments in Hong Kong, and to regulate banks’ handling of settlement business of foreign direct investment denominated in RMB. Banks can now provide settlement services to overseas investors who have made RMB denominated direct investment.

The Administrative Rules are compatible with the current FDI management practices in China, and released in accordance with the principle of market-based regulation to facilitate investment. The Administrative Rules make it clear that overseas enterprises, economic entities and individuals can apply directly to commercial banks for settlement of their RMB denominated direct investment as long as such investment comply with the relevant laws in China that governs FDI activities, and the commercial banks shall provide RMB fund settlement services to enterprises established with FDI. The procedures have become more convenient.

PBOC and the concerned departments will establish an information sharing mechanism, step up ex post supervision, facilitate follow-on check of the use of FDI fund, and enhance bank awareness of risk prevention.

It is expected that the launch of settlement business for RMB-denominated FDI will encourage overseas use of RMB, support the RMB market development in Hong Kong and facilitate trade and investment.
What Makes Your Currency an International Medium of Exchange – a Reserve or Vehicle Currency?

• Acceptability as a Medium of Exchange.
  – Unit of Account.
  – Store of Value
  – Medium of Exchange.

• Motives
  – Inventory Motive.
  – Precautionary Motive.
  – Portfolio Motive.
Some Considerations

• No Matter What Instrument You Create or Present to the World (Including the RMB)
• You need Investors to Want to Hold it.
• Market Depth and Become Acceptable as a Medium of Exchange.
• In the end you want return and diversification opportunities: assets you can invest in.
• This is what China is attempting.
You also need

• A Yield Curve

• But that needs an active and deep treasury market.
The Policy Trilemma
(notice how things come in 3s?)

• Control of Your Money Supply
• Fixed Exchange Rates
• International Capital Mobility

• So Where is China Heading???? (we know the trajectory and we know the theory).
Why Does China Want to Have the RMB as a Vehicle Currency?

• Seignorage?
• Shift the Hedging Costs to Outsiders?
• Give Trading Partners a Chance to Hedge?
• Greater Regional Influence?
• Prestige?
Or

• Reduce RMB inflation at home (just like having an RMB capital outflow).

• Reduce holdings of US dollar denominated assets since they have so many already (e.g., they receive payments for exports in RMB rather than USD).
Or

- ‘Whatever is inevitable becomes necessary.’
Bottlenecks

• Control of the Exchange Rate
• The Banking System
• Exporters and Employment in China. Even Consumption still has a bad name (消費, disappear and waste)
• Skill Set and Experience of Currency Hedgers and Trading
• Capital Mobility that Could Move Either Dramatically in or out of the Country.
• Creating a Foreign Vested Interest in Seeing the RMB Strengthen
• These bottlenecks will slow the process of capital mobility and currency flexibility since capital mobility and currency flexibility are “identical twins”

• In turn, those bottlenecks will slow the internationalization of the RMB.
A Key Driver: China’s Savings
Major Lessons

• There is a Difference Between the Trade Regime and Currency Regime (Be Wary of tinkering with the latter to achieve a policy goal).
• The Government experiments a lot with the exchange system (test pilots).
• Most countries that tinker with their exchange rate system on an ongoing basis get into a lot of trouble – there are too many smart people out there.
Hedging Instruments

• Local Banks offer Forwards up to 1 Year.

• March, 2011 Forex Swaps Permitted.

• An Active NDF Market Exists.

• An Active HK RMB Market exists on a Daily Basis (USD 1 billion per day).
THE NDF MARKET, 1 Year Forwards

Forex Market Alerts

Forex - China Flows: USD/CNY 1Y NDF firmer; govt to be allowed to issue bonds independently

Fri, Oct 21 2011, 02:16 GMT
by FXMarketAlerts Team - FXMarketAlerts | View company's profile

Vote: 0 0

Published at 02:16 (GMT) 21 Oct

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* 21 Oct 11: 01:03 GMT (SGA) - EMGA CNY FX FLOWS: USD/CNY 1Y NDF firmer; govt to be allowed to issue bonds independently

Source:
FXStreet.com
Violation of Arbitrage Condition

- RMB should be at about a 4-5% discount in the 1 Year forward market.
- It’s at a .2% Premium offshore.
- 5% Differential is Implicit Minimum Cost of Moving Funds across the border.
How would I arbitrage

• Borrow $
• Sell $ Spot for RMB
• Lend/Deposit in China at 4-5%
• Sell offshore at the Overvalued NDF rate.

Implied Pressures:

Above would more or less be risk-free.
• This type of thing is what makes the macro controls so difficult to implement.

• Short-run outlook (given inflation): Capital Control Enforcement. This will maintain control of the money supply and the fixity of the exchange rate.

• Note: Speculation in the Asian1997 crisis worked through the forward markets.
Internationalization is Part of a Package

• Will China have Dual Exchange Rates – in the Spot and Forward. Onshore vs. Offshore?

• Will China allow unfettered capital mobility?
• Pearl River Piano and Hedging Strategy: The Social Unrest Question.
# Some Large Exporters

<table>
<thead>
<tr>
<th>Company</th>
<th>Export (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of work Shanghai Computer Co., Ltd.</td>
<td>95237043</td>
</tr>
<tr>
<td>Huawei Technologies Co., Ltd.</td>
<td>$ 14,342,526,163</td>
</tr>
<tr>
<td>Nokia Communication Co., Ltd.</td>
<td>67446675</td>
</tr>
<tr>
<td>60800931</td>
<td>$ 13,159,664,910</td>
</tr>
<tr>
<td>Tech-Front Shanghai Computer Co., Ltd.</td>
<td>47903620</td>
</tr>
<tr>
<td>Hong Futai Precision Electronics (Yantai) Co., Ltd.</td>
<td>44405410</td>
</tr>
<tr>
<td>British Shunda Technology Co., Ltd.</td>
<td>41332075</td>
</tr>
<tr>
<td>Wei new Information and Communication (Kunshan) Co., Ltd.</td>
<td>37166850</td>
</tr>
<tr>
<td>35266879</td>
<td>$ 6,224,710,090</td>
</tr>
<tr>
<td>Group Health Technology (Shenzhen) Co., Ltd.</td>
<td>33451680</td>
</tr>
<tr>
<td>Compal Information (Kunshan) Co., Ltd.</td>
<td>32665560</td>
</tr>
<tr>
<td>Strapdown Electronics Co., Ltd. Fujian</td>
<td>31643984</td>
</tr>
<tr>
<td>Fuxitronics Manufacturing (Zhuhai) Co., Ltd.</td>
<td>31441041</td>
</tr>
<tr>
<td>LG Display (Nanjing) Co., Ltd.</td>
<td>30846227</td>
</tr>
<tr>
<td>Ningbo Chi Mei Electronics Co., Ltd.</td>
<td>29206133</td>
</tr>
<tr>
<td>Lenovo Information Products (Shenzhen) Co., Ltd.</td>
<td>26320006</td>
</tr>
<tr>
<td>Midea Group Co., Ltd.</td>
<td>26069964</td>
</tr>
<tr>
<td>Beijing Mobile Communications Co., Ltd. Suzhou Pu</td>
<td>25879452</td>
</tr>
<tr>
<td>Wei Chi Information and Communication (Kunshan) Co., Ltd.</td>
<td>25115687</td>
</tr>
<tr>
<td>English Source Technology Co., Ltd.</td>
<td>111,839,714,006</td>
</tr>
</tbody>
</table>

Source: China Macro Finance
Tools of PBOC still crude:
Interest rate mandates; reserve requirements; forced open market operations - sterilization.
Sterilization

- Mundell Critique: Can only work in the short-run - the Chinese Government can only buy up so much.
- China’s large pool of savings with nowhere to go has delayed the process somewhat. But can that last forever.
- If China stopped sterilizing what would happen.