RMB Internationalization GBSN Webinar January 25, 2012

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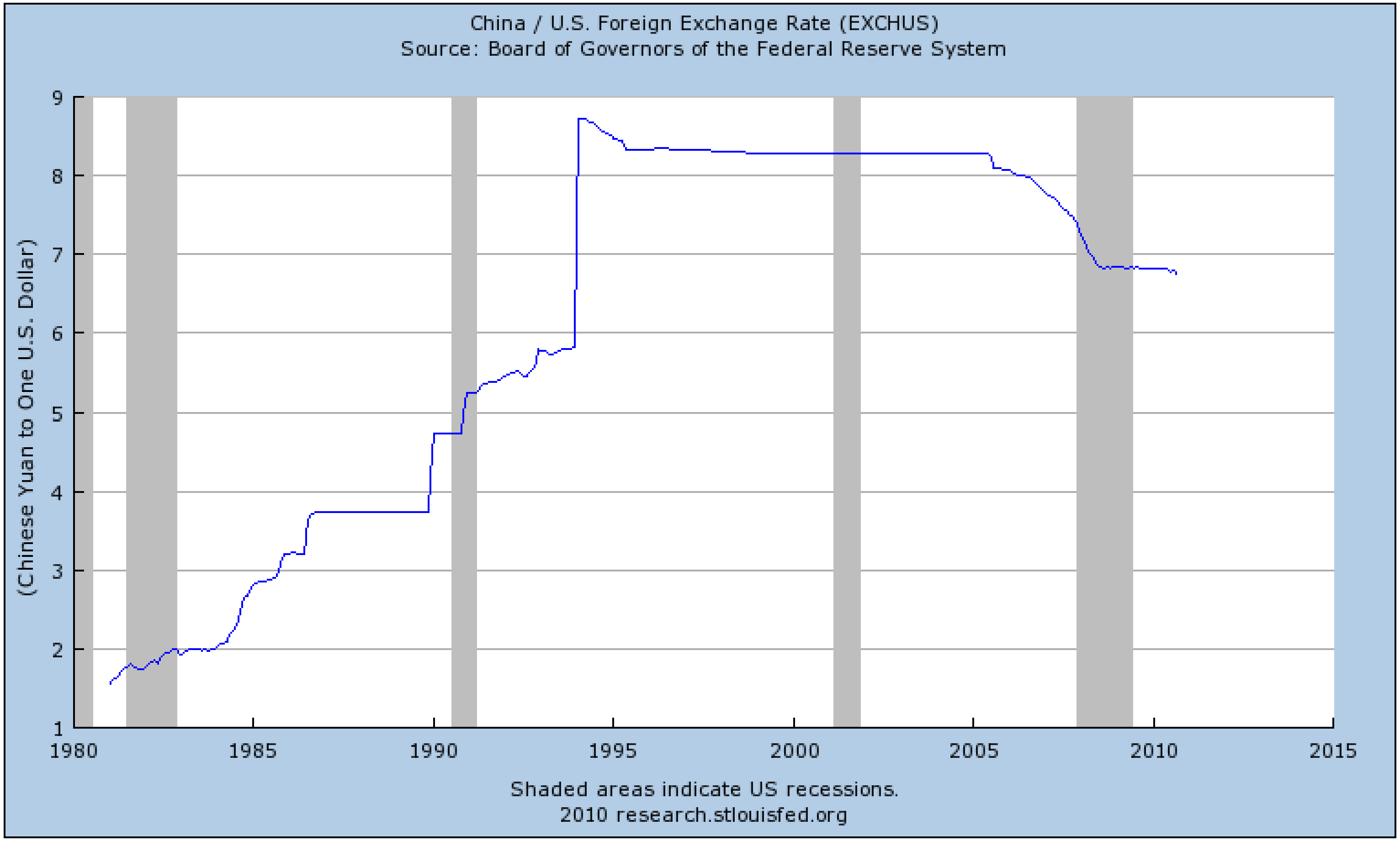
Forbes

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 Involvment – 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 (QFIIs)
IV. Only Large Outward Bound Investors Welcomed (QDIIs)

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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The yuan expressed in this certificate is equivalent in value to the Renminbi yuan.
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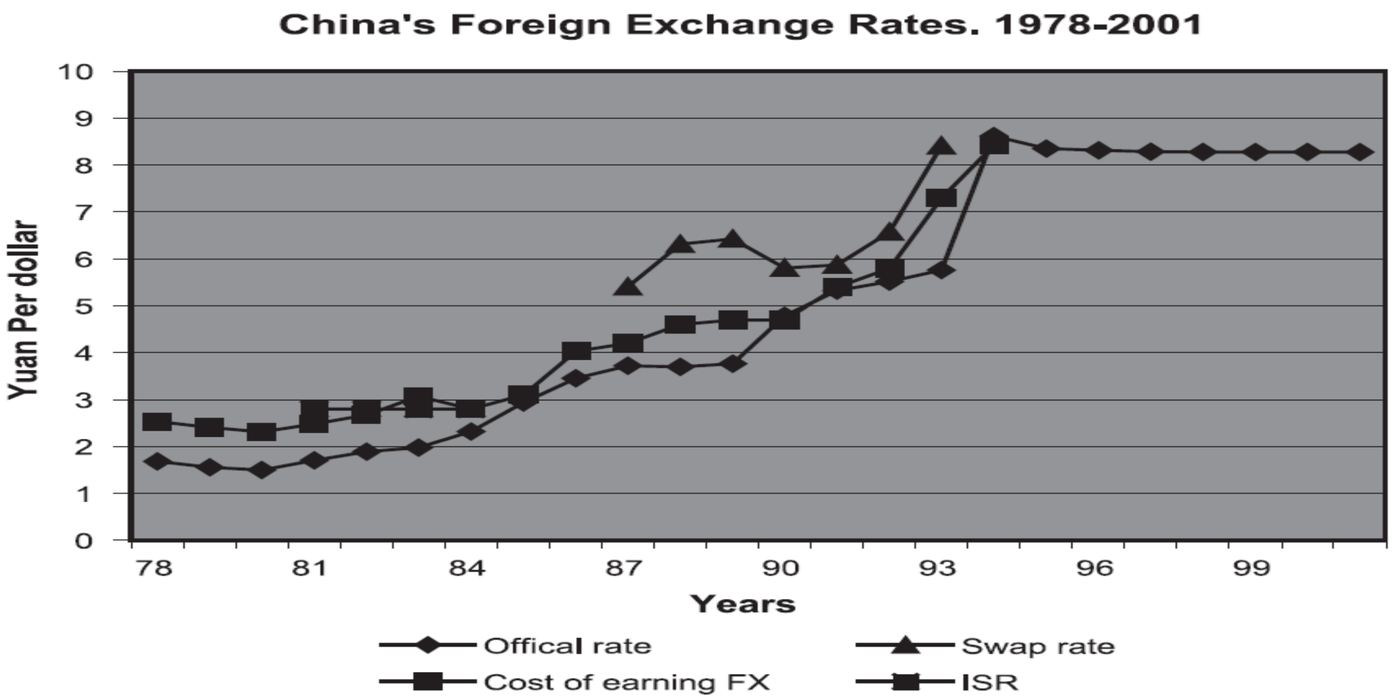


Fig. 1. Source: *International financial Statistics*, IMF, and SAFE.

Lin, G., and Ronald M. Schramm. "China's Foreign Exchange Policies since 1979: A Review of Developments and an Assessment." *China Economic Review* 14.3 (2003): 246-80. Print.

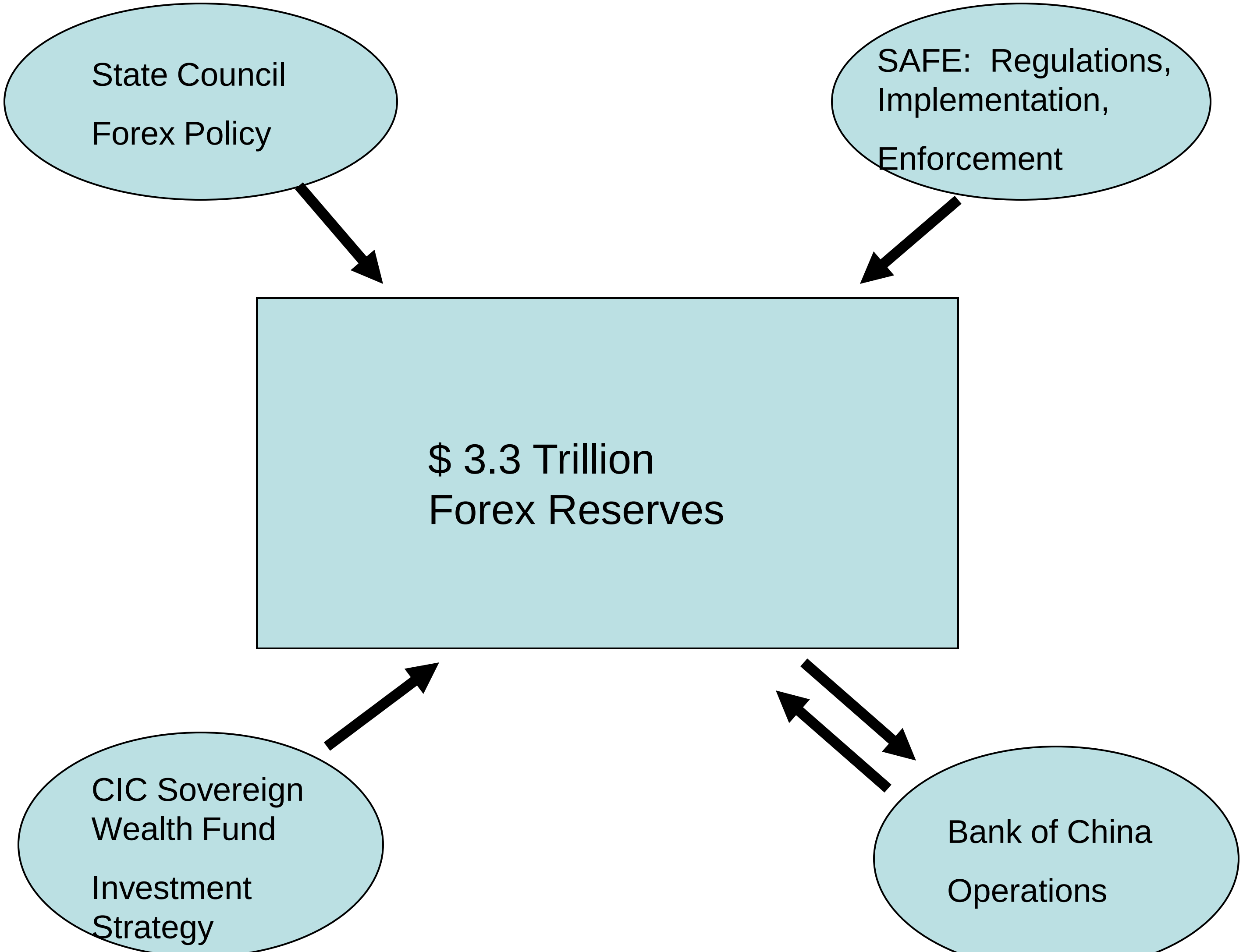
Table 1
Key dates and events in the reform of China's foreign exchange system

Date	Event or development
1979	Fundamental reform commences. Decentralization of international export/import activities. Establishment of SAFE (March). Introduction of foreign exchange retention scheme.
1981	ISR established for the RMB at ¥2.8 per US$ (January); official rate at the time is ¥1.53 per US$.
1985	ISR is abolished (January). A series of official rate devaluations begins (eventually moving the exchange rate to ¥3.71 per US$ in the following year). System of surrender requirements and foreign exchange retention scheme rationalized. Domestic residents allowed to hold foreign exchange accounts at the BOC (March).
1986	Foreign currency swap centers established in Shenzen and other SEZs.
1990	Major devaluation of the official exchange rate to ¥5.22 per US$ (November 17).
1991	All restrictions on domestic entities and residents' sale of foreign exchange into the swap market are removed (December).
1994	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.
1995	Interbank trading in the Japanese yen commences (March).
1996	China accepts obligations IMF's Article VIII obligations for current account convertibility (December 1). Liberalization of foreign exchange restrictions on residents.
1998	Swap centers permanently closed (FFEs had been the only remaining participants).
1999	IMF classifies RMB exchange rate as a conventional peg (to the U.S. dollar).
2001	China accedes to the WTO (November 10).
2002	Trading in euro commences in interbank market (April).

Source: Table 6 in Appendix A.

Recent Developments

- July 21, 2005: Revalution and Crawling Float against a Basket of Currencies.
- 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).

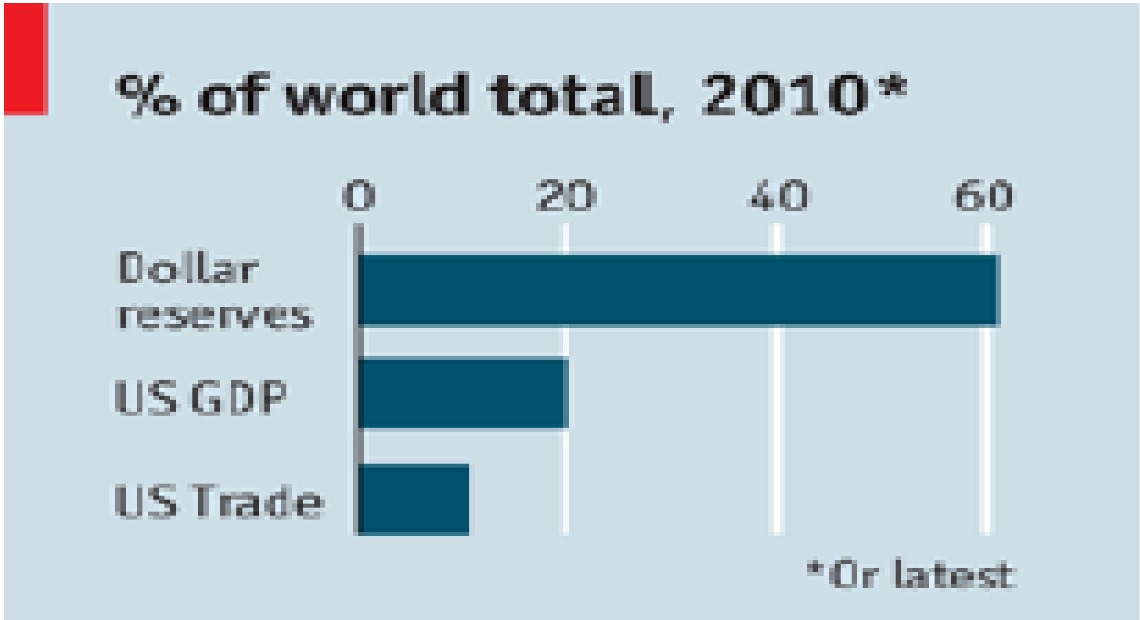

State Council
Forex Policy
SAFE: Regulations, Implementation,
Enforcement
$ 3.3 Trillion
Forex Reserves
CIC Sovereign Wealth Fund
Investment Strategy
Bank of China
Operations

Global Trade Shares and Trade in USD Billions

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

Source: World Trade Organization. 2009

As a Share of World GDP



BIS 2010 Survey

- RMB only .15 % of Global Trading.
- USD 42 %
- Euro 20 %

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But by 2011

- Cumulative USD half a trillion in trade settlment 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"

McDonald's

CAT

HHI Hopewell Highway Infrastructure Limited


人民銀行
100

More Developments

- Swap arrangements with 14 Central Banks including Argentina, South Korea, Hong Kong, New Zealand, Singapore, Belarus. Arrangments 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

RMB PE Funds and now RMB FDI

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Settlement Business for RMB-Denominated Foreign Direct Investment Started to Expand Cross-Border Use of RMB

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The PBC 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.

PBC 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

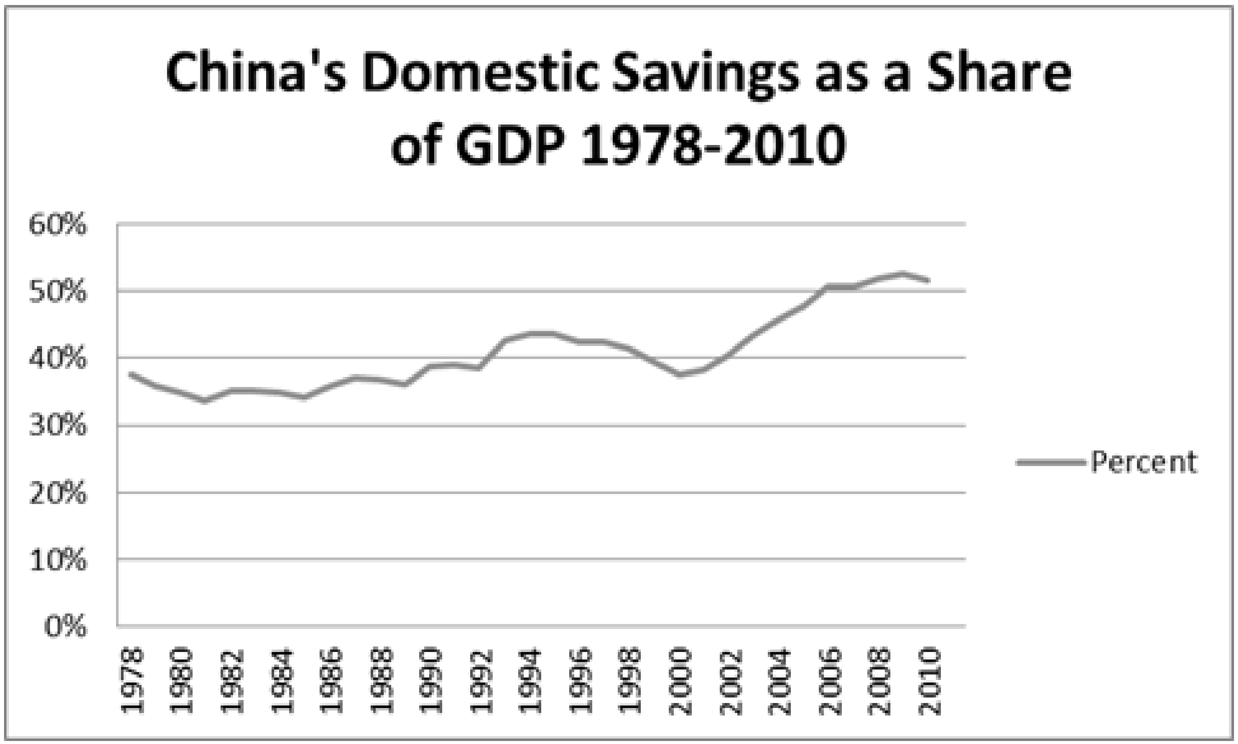
- Control of the Exchange Rate
- The Banking System
- Exporters and Employment in China. Even Consumption still has a bad name

  (消费, 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; govts to be allowed to issue bonds independently

fx market alerts

Fri, Oct 21 2011, 02:16 GMT
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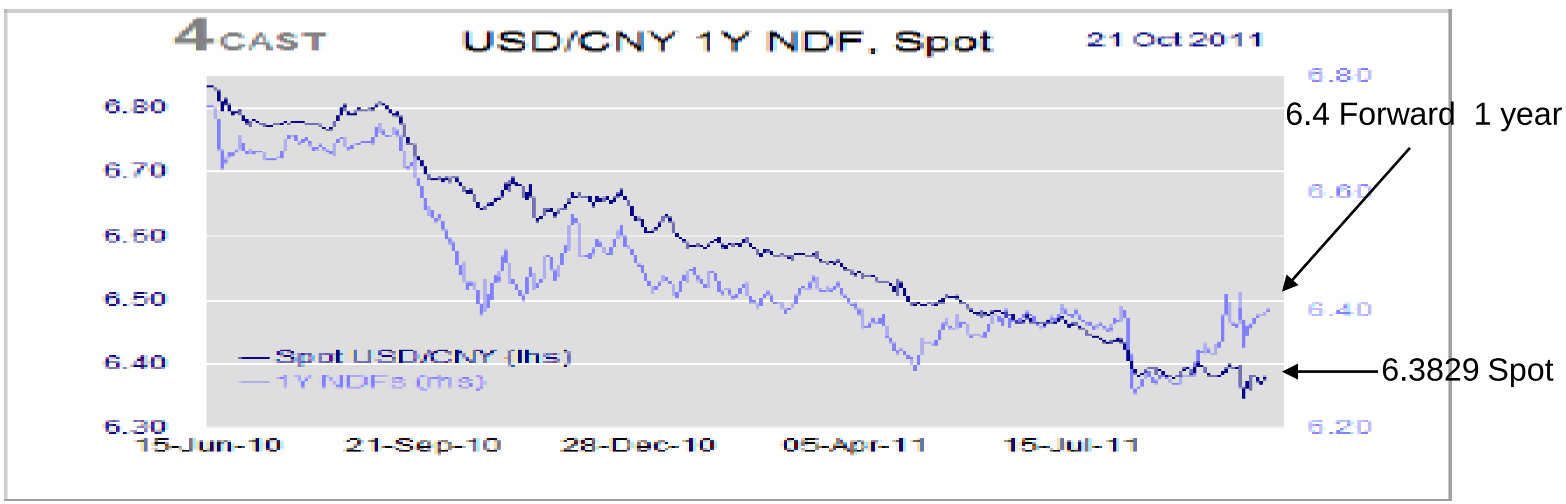


* 21 Oct 11: 01:03 GMT (SGA) - EMGA CNY FX FLOWS: USD/CNY 1Y NDF firmer; govts to be allowed to issue bonds independently

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:

Stronger RMB, More Chinese Inflation, Weaker RMB in the Forward Market.

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?

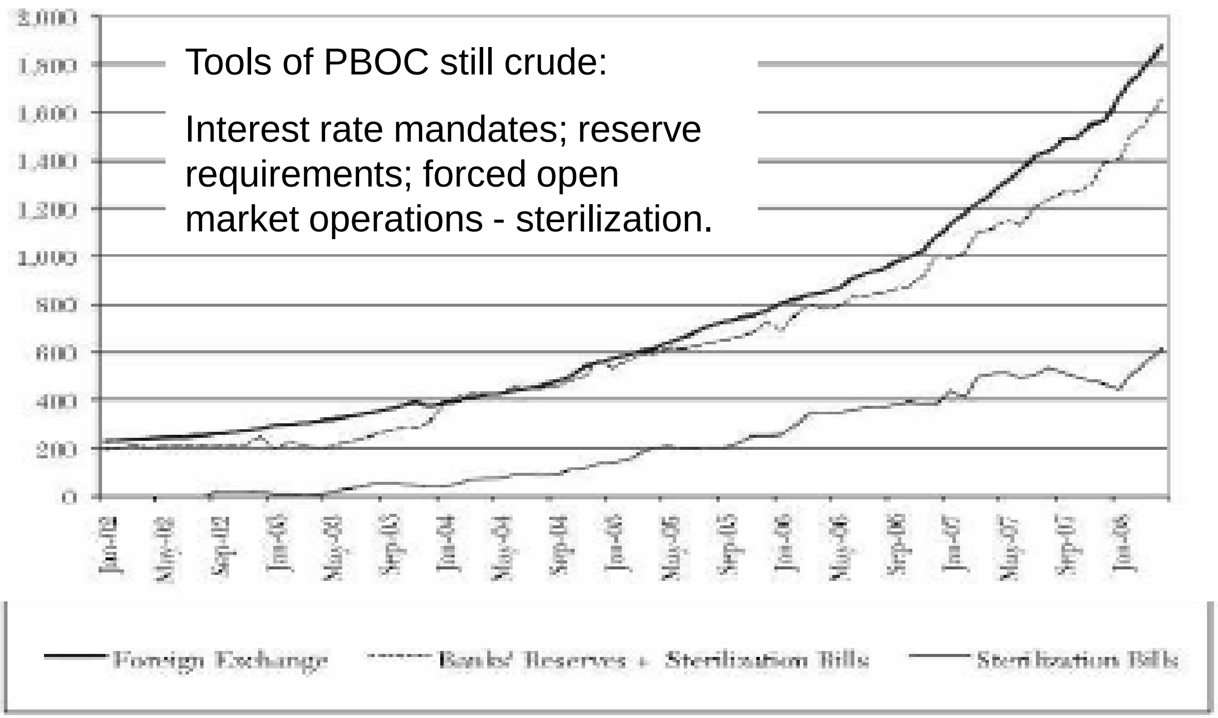
- Pearl River Piano and Hedging Strategy: The Social Unrest Question.

Some Large Exporters

Of work (Shanghai) Computer Co., Ltd.	95237043	$ 14,342,928,163
Huawei Technologies Co., Ltd.	87446575	$ 13,169,664,910
Nokia Communication Co., Ltd.	60600931	$ 9,126,646,235
Tech-Front (Shanghai) Computer Co., Ltd.	47983920	$ 7,226,493,976
Hong Futai Precision Electronics (Yantai) Co., Ltd.	44605410	$ 6,717,682,229
British Shunda Technology Co., Ltd.	41332075	$ 6,224,710,090
Wei new information and communication (Kunshan) Co., Ltd.	37165850	$ 5,597,266,566
Group Health Technology (Shenzhen) Co., Ltd.	35288879	$ 5,314,590,211
Compal Information (Kunshan) Co., Ltd.	33451680	$ 5,037,903,614
Strapdown Electronics Co., Ltd. Fujian	32689350	$ 4,923,094,880
Flextronics Manufacturing (Zhuhai) Co., Ltd.	31843984	$ 4,795,780,723
LG Display (Nanjing) Co., Ltd.	31441041	$ 4,735,096,536
Ningbo Chi Mei Electronics Co., Ltd.	30848227	$ 4,645,817,319
Lenovo Information Products (Shenzhen) Co., Ltd.	29266133	$ 4,407,550,151
Midea Group Co., Ltd.	26320000	$ 3,963,855,422
Beijing Mobile Communications Co., Ltd. Suoai Pu	26099564	$ 3,930,657,229
Wei Chi Information and Communication (Kunshan) Co., Ltd.	25879452	$ 3,897,507,831
English Source Technology Co., Ltd.	25115587	$ 3,782,467,922
TOTAL		$ 111,839,714,006

Source: China Macro Finance

FIGURE 2
PBC FOREIGN RESERVES AND STERILIZATION INSTRUMENTS
(US$ Billions)



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.