

# RMB internationalization marks a new stage of capital account liberalization

- The purposes of RMB internationalization
  1. Reduce exchange rate risks
  2. Reduce the increase in Foreign exchange reserves
  3. Increase competitiveness of financial institutions
  4. Reduce transaction cost of trade
  - 5. To promote capital account liberalization**

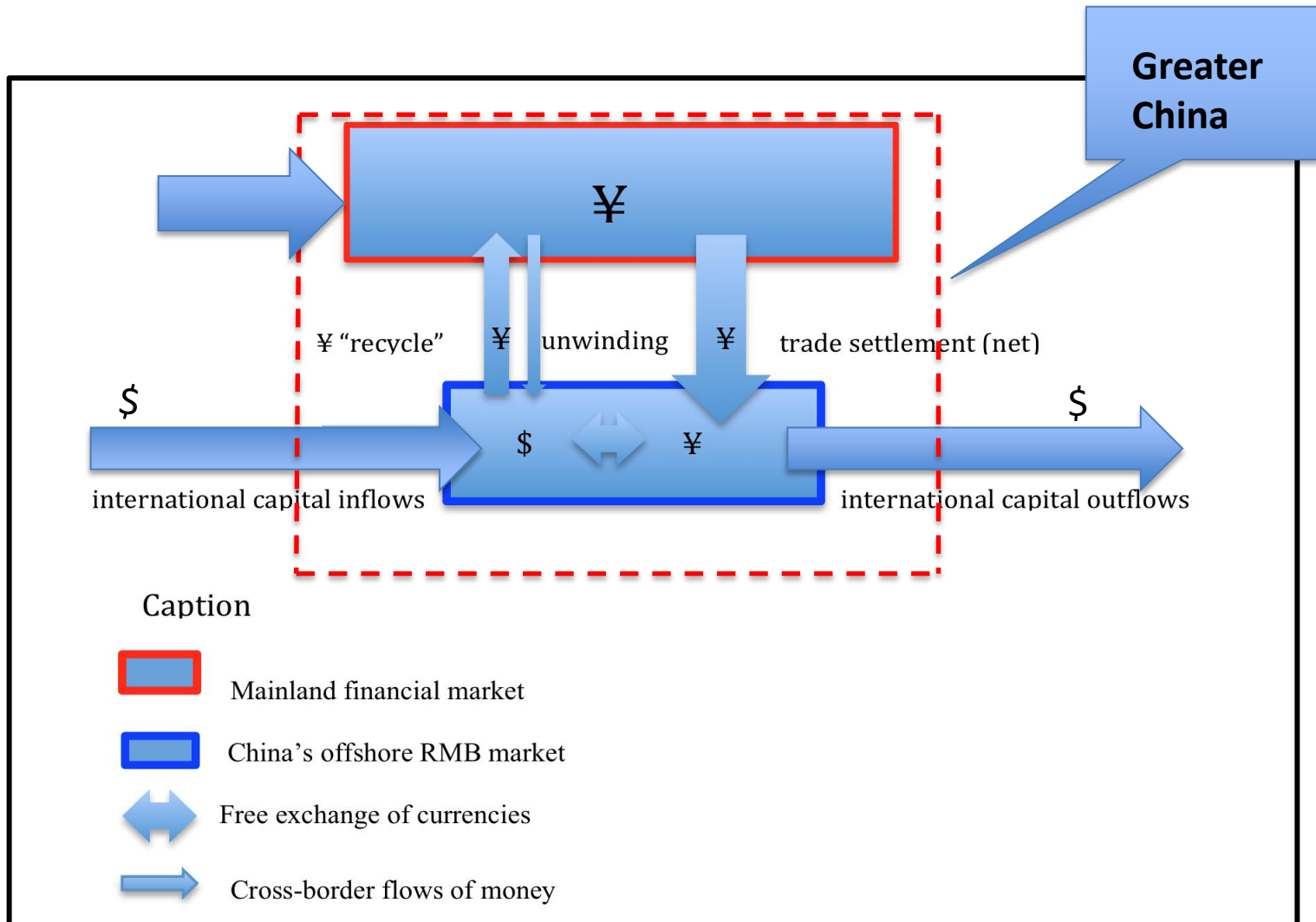
# Answer provided by a senior central banker

- “it is too difficult to reach consensus among all parties concerned on how to reform the exchanger rate (regime). Hence, the PBOC looks one way and rows another to promote the use of the renminbi for international trade settlement... Thus it will **force us** to speed up capital account liberalization with a ‘fight or die’ attitude. Because so many renminbis have flown out of China (when the renminbi has been internationalized—added by the author) you have to create channels to allow these renminbis to flow back. Without channels for recycling, no one will be interested in using renminbis for trade settlement. Thus, pressures will be created **to force open China’s capital account.**”
- **We force us! China forces China!**

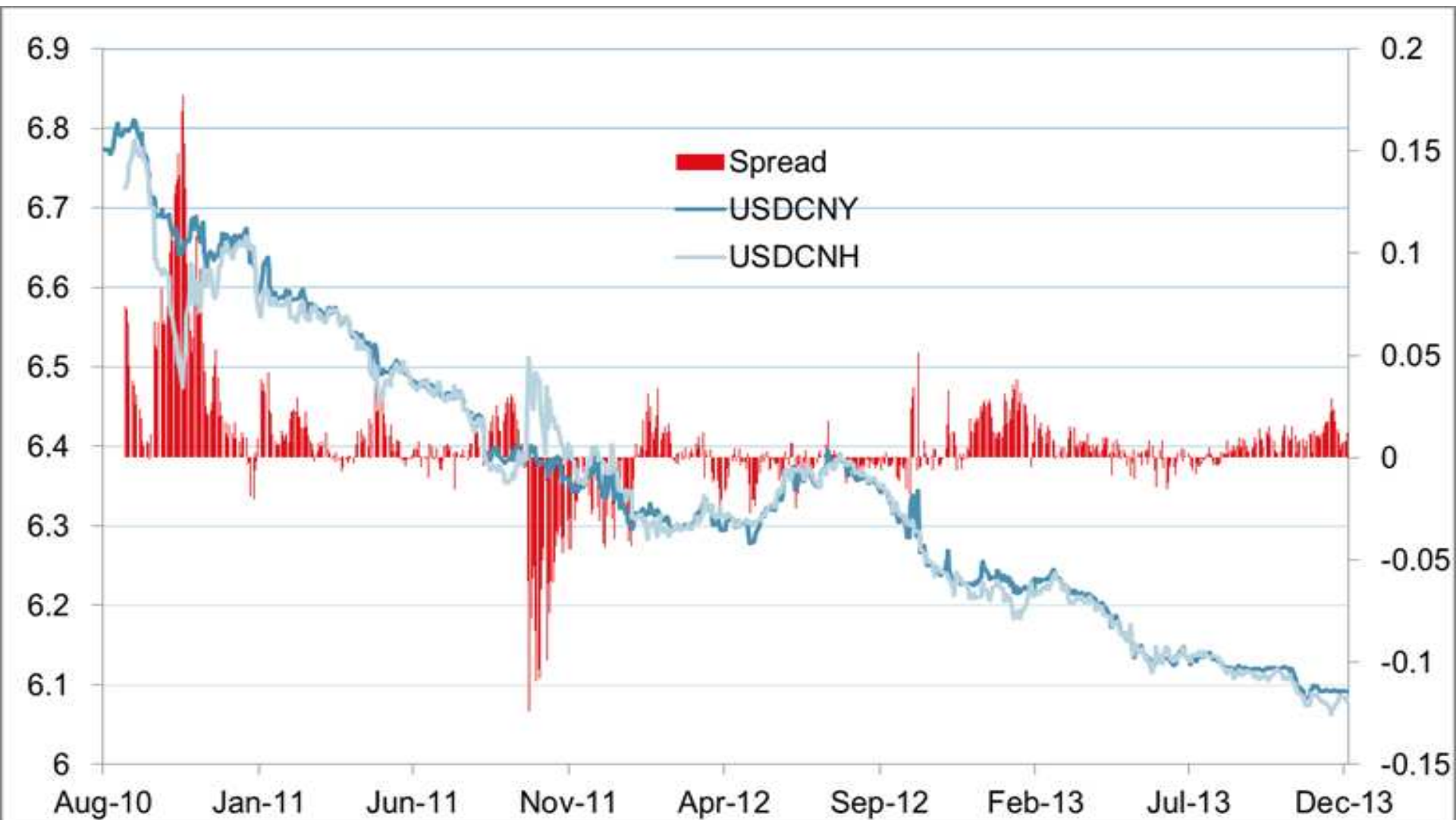
# How RMB internationalization facilitates cross-border capital flows

- As a result of the introduction of RMB trade settlement scheme, RMB flows into Hong Kong. An offshore RMB market, known as the CNH market, was created in Hong Kong, side by side with an onshore market (in Shanghai) dubbed the CNY market.
- Foreign investors who wish to purchase renminbi assets can purchase renminbis in CNH market and then invest in renminbi assets via eligible banks in Hong Kong.
- When they unwind their RMB positions and take profits, they can convert their renminbis proceeds back into dollars in the CNH market. Thus, international capital can move across the borders of the Mainland.
- Renminbi internationalization opened a big hole in the Chinese wall of capital controls.

# Cross-border flows via offshore markets



# CNH-CNY spread



# A simple way to do exchange rate arbitrage

- The CNH market is a free market and renminbis can convert into the US dollar and visa versa freely, while the CNY market is under the People's Bank of China (PBOC) tight regulation.
- Hence, two RMB exchange rates for the renminbi co-exist and a material CNH–CNY spread exists for most of the time, which provides investors opportunity for exchange rate arbitrage.
- **“a day trip to free trade area”**: assume that  $CNY=6.2$   $CNH=6.18$ ,
  1. A mainland enterprise ships its products to a free trade area (or bonded area) first
  2. From the area , products are sold to its affiliate in Hong Kong for 1 hundred million dollar
  3. the mainland enterprise covert 1 hundred million dollar into **6.2** hundred million yuan in the CNY market. 中国出口商卖产品得美元，美元在chy贵，故用美元在chy换人民币
  4. At the same time it use **6.18** hundred million yuan to buy **1 hundred million dollar in the CNH market** and buy back the products it sold to its affiliate in Hong Kong (RMB import settlement) 在香港cnh,人民币贵，用较少的人民币买美元，再买回所出口的产品
  5. As a result, while the real export=0, the mainland enterprise earned 20 million yuan.

# More complicated exchange rate arbitrage between CNH and CNY

- In case of CNH is dearer than CNY. The importer sells the RMB for the dollar in the CNH market, and sells the dollar for the RMB in the CNY market.
- The common procedure for exchange rate arbitrage
  - **A mainland importer** pays its affiliate in Hong Kong 6.05 hundred million yuan to import goods worth 1 hundred million US dollar 中国进口商付人民币（过去不行，必须先在外汇市场买美元，以便进口）给关联公司进口商品，使之能够在香港买美元
  - The Hong Kong affiliate **sells** the 6.05 hundred million **yuan** for 1 hundred million dollars **in the CNH market** at the exchange rate of **6.05 yuan per dollar** 关联公司在香港cnh用所得人民币买美元
  - The mainland importer sells the same goods back to the affiliate and obtains 1 hundred million US dollar 中国进口商将产品卖回给关联企业，得美元，使自己能在cny把美元换成人民币
  - Finally, **the mainland importer sells** the 1 hundred million US **dollar** for 6.1 hundred million yuan **in the CNY market** at the exchange rate of **6.1 yuan per dollar**
- As a result, the mainland importer obtains profit of 5 million yuan
- In case CNH is cheaper than CNY. **The mainland exporter sells the dollar in the CNH market** for the RMB, and spends the RMB in the mainland or **sells the dollar for the RMB in the CNY market.**

# Interest rate arbitrage via trade credit

1. Enterprise A, a mainland enterprise, can deposit a certain amount of RMB in a mainland bank for one year.
  2. Under the RMB import settlement scheme, it can use the RMB deposit as collateral to obtain a RMB-denominated L/C from the mainland bank, and **use the L/C to purchase goods from its affiliate — Enterprise B in Hong Kong.**
  3. **Enterprise B** in turn can use the L/C as collateral **to borrow US dollars from a bank in Hong Kong** and use the dollars to **buy back the goods** it has sold to Enterprise A.
  4. Enterprise A then converts the USD into RMB in the spot market and **deposits it in its bank in the mainland.**
  5. When the L/C is settled one year later, Enterprise A pays Enterprise B in RMB via the mainland bank.
  6. Finally, Enterprise B converts the RMB into the dollar at the exchange rate, which has already been locked in the NDF (non-deliverable forward) market, and repays the dollar loans extended by the Hong Kong bank.
- Because the interest rate on RMB deposits is significantly higher than that on dollar loans, Enterprise A and its affiliate Enterprise B obtain material profits from this process.

# Why China should be in a hurry to open its capital account

- China does not need net capital inflows. China is a high saving country with too much capital failing to be utilized domestically
- China has already opened its capital account for long term capital
- Short-term cross-border capital flows makes not positive contribution to China's economic growth
- Speculation, interest rate arbitrage and exchange rate arbitrage distort resource allocation and are harmful to economic development, which should be eliminated rather facilitated. **Real activities become instruments for financial activities aimed at speculation and arbitrage.**

# Sequencing and preconditions for full capital account liberalization

- before making the capital account fully open and the RMB freely convertible, China should first put its own house in order. For example, macroeconomic stability has to be achieved; the high leverage ratio should be reduced, a rational and flexible interest rate structure must be created; risk management capacity across industries should be established and intervention in the foreign exchange market minimized. Most importantly, China must make the RMB exchange rate flexible to reflect demand for and supply of foreign exchanges in the FX market. The litany can be much longer. All of this takes time. Without completing these tasks first, hasty capital account liberalization could lead to dire consequences.