

Capital account management in China

Yu Yongding

CAFRAL Conference, New Delhi,

Jan 12, 2014

China now is more sympathetic with capital account liberalization, but why?

- since 2003, and especially since 2009
 1. To encourage capital outflows
 - to reduce RMB appreciation pressure
 - to reduce the increase in foreign exchange reserves, if PBOC has to maintain the stability of the exchange rate
 2. To promote RMB internationalization (but why the internationalization is needed is another issue)
 3. To facilitate ODI (changes in comparative advantage, overcapacity etc.)
 4. To use liberalization to push domestic financial reforms just like what China's entry the WTO have achieved

What are your advice?

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** (I just said that one objective of capital account liberalization is RMB internationalization. Is there any logic fallacy? There is a long story, I do not have time to tell.)

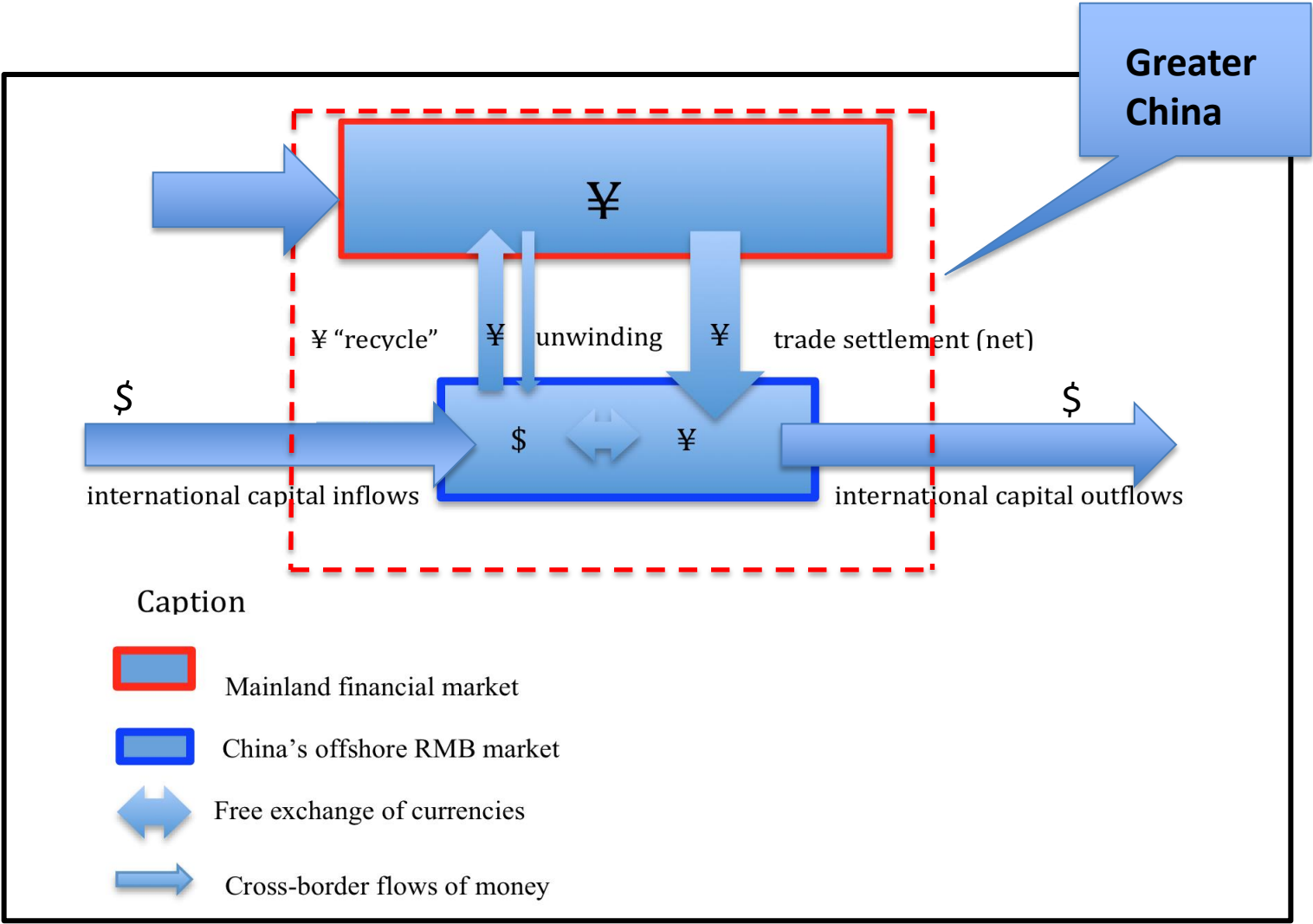
The purpose of RMB internationalization: a answer provided by a highly respected central banker

- “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. If a large amount of renminbis has flown out of China, 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 building up **to force open China’s capital account.**”

How cross-border capital flows are facilitated by RMB internationalization

- 1. The RMB import settlement** enables the RMB flows into Hong Kong and create an offshore RMB market—the CNH market, side by side with an onshore market (in Shanghai) – the CNY market.
 - 2. Foreign investors**, who wish to purchase renminbi assets due to RMB appreciation expectations and higher returns on RMB assets, can **purchase renminbis in CNH market** and
 3. then invest in renminbi assets via **recycling mechanisms**.
 4. If they wish to unwind their RMB positions and take profits, they can **convert their renminbis proceeds back into dollars in the CNH market and leave Hong Kong**
- Thus, international capital can move across the borders via **RMB trade settlement and recycling mechanisms**. Renminbi internationalization **opened a big hole** in the Chinese wall of capital controls.

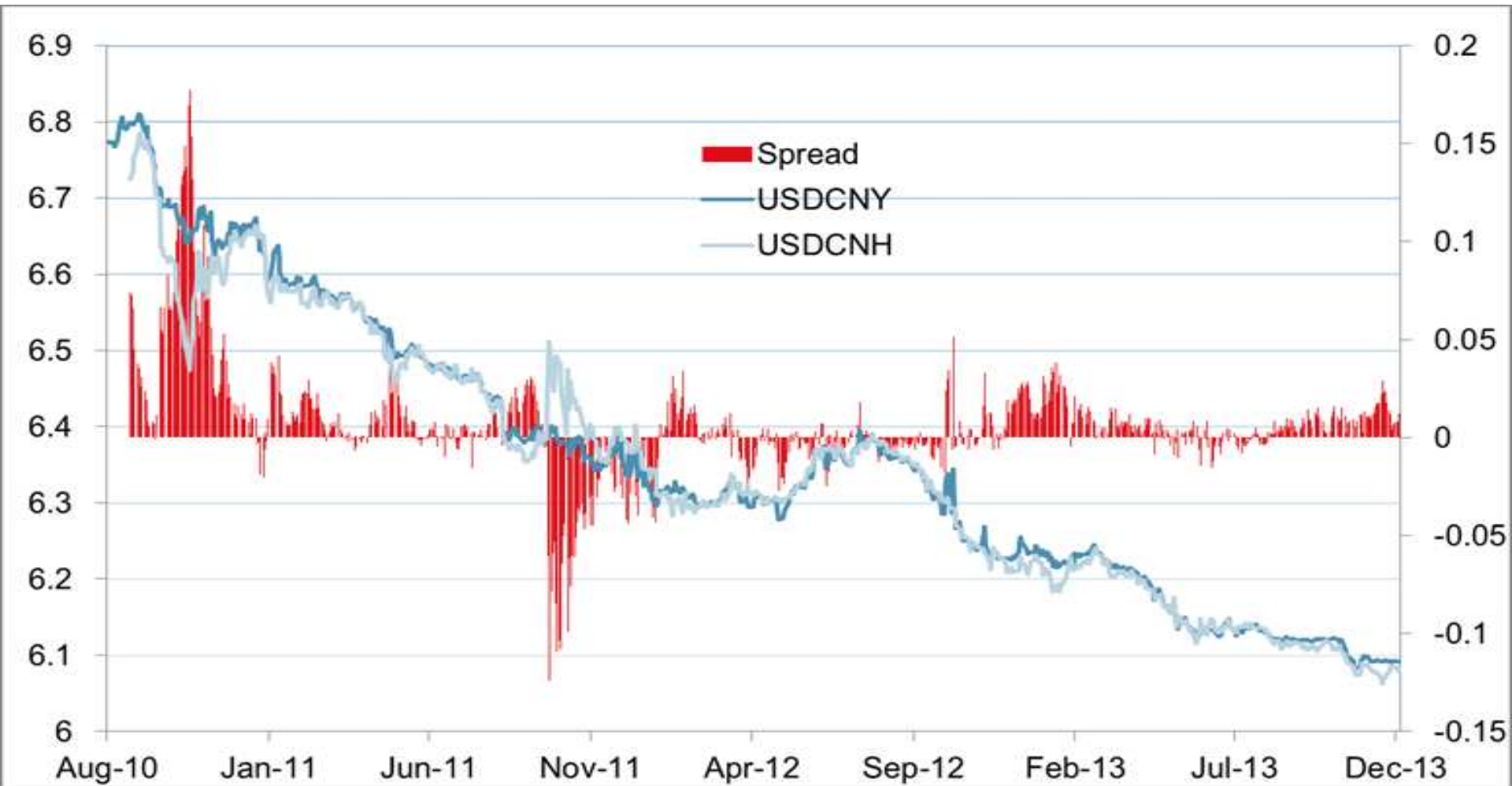
Capital flows through offshore market



One currency two exchange rates

- The CNH market is a free market, while the CNY market is under the People's Bank of China (PBOC) tight regulation.
- Two RMB exchange rates co-exist and a material CNH–CNY spread exists for most of the time
- If CNH is more expensive than CNY
 - **Importers sell RMB for dollar in the CNH market**, and sell dollar for RMB in the CNY market.
 - **Exporters** sell dollar for RMB in CNY market and use their affiliates to sell RMB in CNH market
- If CNH is cheaper than CNY
 - **exporters sell dollar for RMB in the CNH market**, and sell RMB for dollar in the CNY market (or spend the RMB in the mainland).
 - **Importers** sell RMB for dollar in the CNY market and sell dollar for RMB in CNH.

CNH-CNY spread



Exchange rate arbitrage has become less fashionable in 2012

exchange rate arbitrage by importers

1. **A mainland importer** pays its affiliate in Hong Kong 6.05 hundred million yuan to import goods worth 1 hundred million US dollar (让人民币流出)

2. Affiliate SELLS RMB FOR DOLLAR IN HONG KONG

- The 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**

3. The importer SELLS DOLLAR FOR RMB IN MAINLAND

- The Affiliate buys back the goods with 1 hundred million US dollar from the mainland importer
 - **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, while the real trade=0, the mainland importer obtains profit of 5 million yuan. The cycle will repeat.**

exchange rate arbitrage by exporters

- ***“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) and sells products to its affiliate in Hong Kong for 1 hundred million dollar
 - 2. SELL DOLLAR FOR RMB IN MAINLAND**
 - the mainland enterprise converts 1 hundred million dollar into **6.2** hundred million yuan in the CNY market. (结汇)
 - 3. SELL RMB FOR DOLLAR IN HONG KONG**
 - Then it use only **6.18** hundred million yuan to buy back the products that it sold to its affiliate (the mainland enterprise regain its products)
 - The affiliate can sell 6.18 hundred million to buy 1 hundred million dollar in the CNH market in Hong Kong (the affiliate regain its dollars)
- **As a result, while the real trade=0, the mainland exporter earned profit of 20 million yuan. Cycle will repeat**

Interest rate spread between renminbi and US dollar (3 month rate annualized)



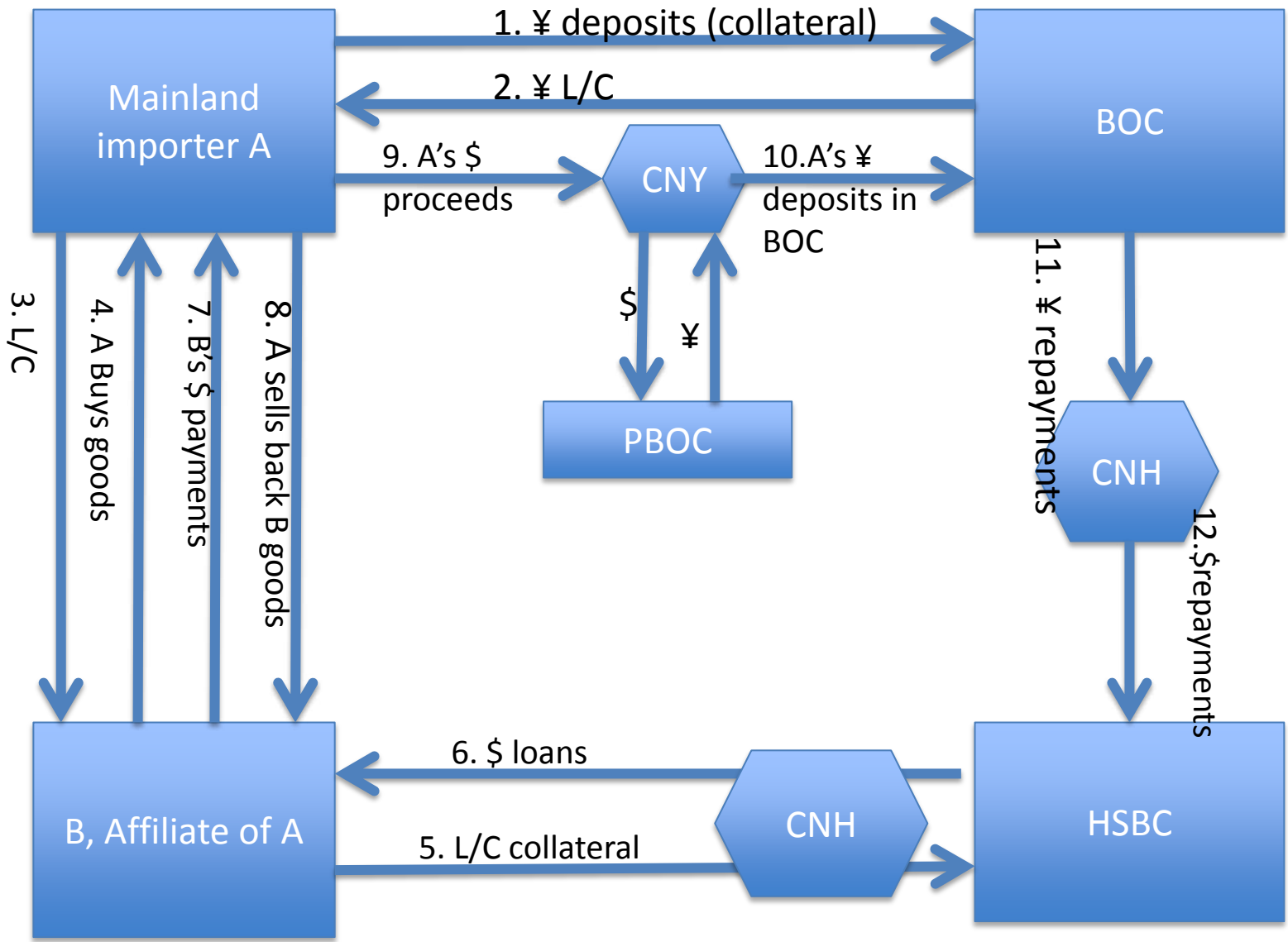
This explains why interest rate arbitrage through trade credit has become fashionable since 2012

The simplest interest rate arbitrage: HK residents' carry trade

- HK residents borrow dollars from HK banks with low interest rates
- Convert dollar into RMBs in CNH market
- Deposits RMBs with banks
- Hong Kong banks deposit the deposits with PBOC's Shenzhen branch with higher interest rates
- If the RMB is expected to continue to appreciate
- The risk for the carry trade is minimum.

Interest rate arbitrage via trade finance

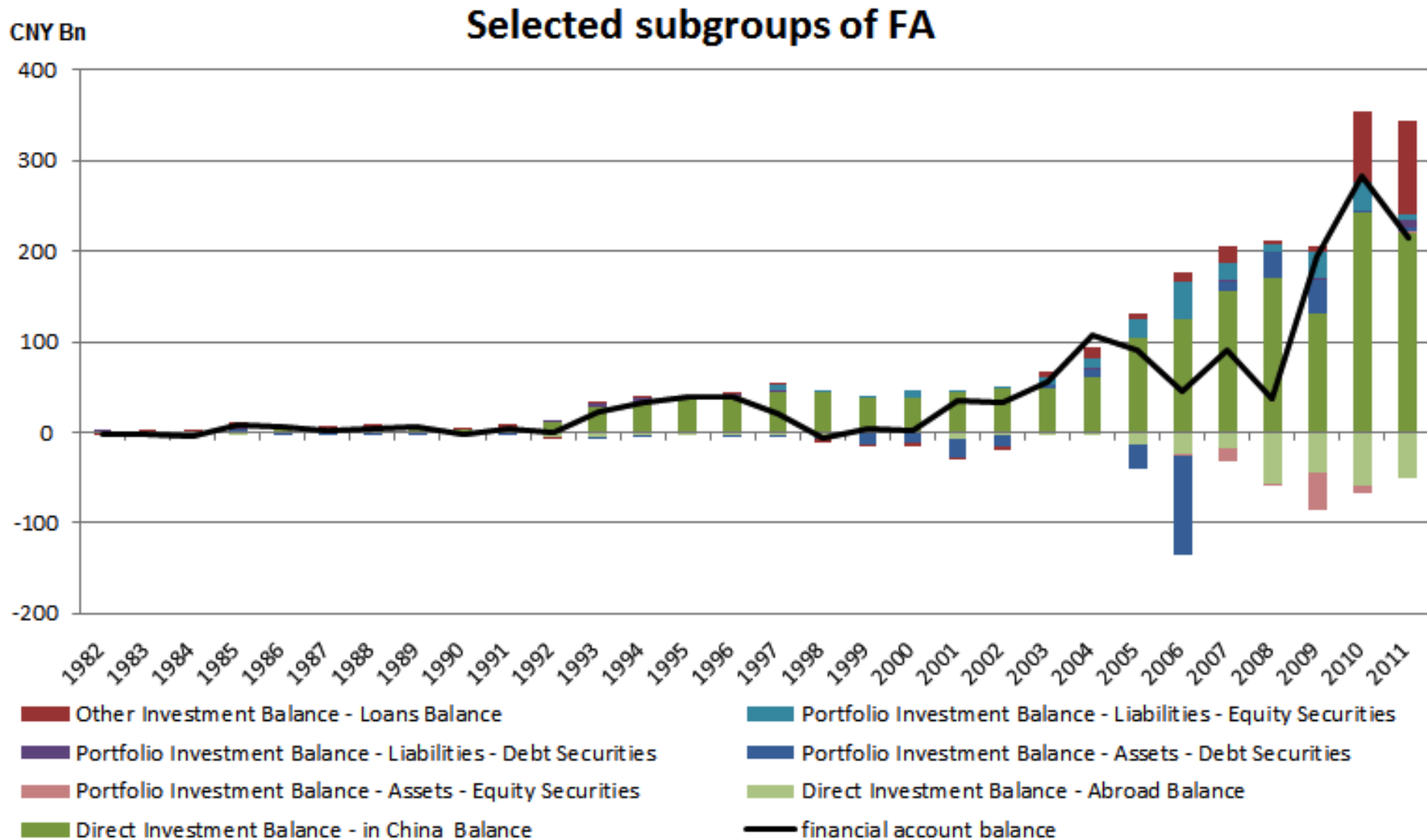
1. Enterprise **A**, a mainland enterprise, can deposit a certain amount of RMB in a mainland bank for one year.
2. With the RMB deposit as collateral, it obtains RMB L/C from the bank, and use the L/C to buy goods from its **affiliate** in Hong Kong.
3. The **affiliate** uses the L/C as collateral **to borrow US dollars from a bank in Hong Kong** and use the dollars to buy back the goods it has sold to **A**
4. **A converts the USD into RMB in CNY market and deposits them in the mainland bank**
5. When the L/C is settled one year later, **the mainland bank converts** the RMB into the dollar in the CNH market and repays the dollar loans extended by the Hong Kong bank.
6. Because the interest rate on RMB deposits is significantly higher than that on dollar loans, Enterprise A and its affiliate together obtain material profits from this process. Cycle will repeat. The same goods can move out and in the borders **6-7 times** a day.



The macroeconomic implications

- In the first 4 months of 2013, PBOC's trade-related net purchase of FX was \$ 208 billion vis-à-vis trade surplus of \$ 62 billion
- The gap was attributable to trade credit and finance (75%), and RMB import settlement. Both increased the foreign exchanges that the PBOC has to buy
- In fact, since 2010, capital flows classified as **“other investment”** has increased significantly. Basically, this category of capital flows consist of short-term cross-border capital flows.

The components of China's cross-border capital flows



The short-term cross-border capital flows is harmful for the economy

- Destabilize the macro-economy
- Speculation, interest rate arbitrage and exchange rate arbitrage distort resource allocation: huge resources are wasted in unproductive activities
- Increase the financial costs of real economic activities
- Demoralize the participants of economic activities: If legal cheating brings income and wealth, who should care about honest hard work?

China's official position: decision on capital account liberalization made in the third plenum of the 18th party congress

- “Perfect mechanisms for the formation of Renminbi exchange marketization, accelerate with moving interest rate marketization forward, complete national debt yield curves that reflect the relation between market supply and demand. Promote bidirectional openness for capital markets, raise the extent of convertibility of cross-border capital and financial trading, establish and complete foreign debt and capital flow management systems under prudential macro-level management frameworks, accelerate the realization of the convertibility of Renminbi capital accounts.”

Sequencing and preconditions for full capital account liberalization

Even if capital account eventually should be fully open, China should first put its own house in order.

1. macroeconomic stability has to be achieved
2. the high leverage ratio should be reduced
3. a rational and flexible interest rate structure must be created
4. risk management capacity across industries should be established
5. Most importantly, China must make the RMB exchange rate flexible to reflect demand for and supply of foreign exchanges in the FX market so that intervention in the foreign exchange market can be minimized

The litany can be much longer. All of these takes time.

Without completing these tasks first, a hasty capital account liberalization could lead to dire consequences.

My worry 7 years ago

Think about the unthinkable

- **China's household saving deposits** amount to 17 trillion Yuan (= \$ 2.3 trillion) and account for 85 percent of GDP in 2006.
 - supposing that households suddenly decided that they should hold 20 percent of their savings in the foreign assets, the total amount capital outflows will amount to **\$ 400 billion**.
- **China's FDI stock** 500 billion and the corresponding investment income outflows can be as high as **\$50 billion--\$100 billion**
- China's balance of **foreign borrowing** is \$305 billion
 - **\$169 billion short-term**
- If capital flows reverse, due to failure in macroeconomic management. The Fragility of the banking system and the convertibility of RMB means balance of payments crisis, currency crisis, financial crisis and economic crisis
- **If China will make a fatal mistake in the next 5 years, the mistake will be the premature abandon of capital controls aimed at reducing RMB appreciation pressure, before it has completed its economic reform.**

China's household saving deposits now have surpassed **42 trillion yuan (7 trillion dollar)** Diversification alone will lead huge outflow



My bet

- Despite the decision made in the third plenum, which is subject to different explanations, I believe that
- due to the high risks involved, the Chinese government eventually will maintain the gradualist approach with regard to capital account liberalization.
- China will not make the RMB fully convertible in foreseeable future