

“Capital Flows Management Measures and Systemic Risk”

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Thank you very much. My topic is about capital account management in China. Its monetary authority declared since 2012 that China was about to accelerate capital account liberation. However, this is a position I am hesitating to endorse. Over the past 2 years capital account liberalization has become one of the most controversial issues in China.

On the one hand, until today, China has maintained relatively strict capital controls. On the other hand, capital account liberalization has been a much-talked topic in China since 1994. Since 2003, especially since 2009, there are four main reasons why Chinese monetary authority is interested in liberalizing capital account. Number one, probably the most important one, is to encourage capital outflows. China has been running both current account surplus and capital account surplus for more than two decades. As a result, the RMB is constantly under appreciation pressure. So the government assumes that by liberalization, capital will flow out of China. As a result, the pressure on RMB appreciation will be reduced, and there will less need for the People’s Bank of China (PBoC) to intervene and it will stop accumulating foreign exchange reserves endlessly. The second one, a more recent one, is to promote RMB internationalization. The third one is to facilitate ODI (outbound direct investment). China’s ODI has been increasing rapidly in recent years, which of course is a very good news for developing countries. Chinese monetary and regulatory authorities are trying to make procedure simpler so that private entrepreneurs and also state-owned enterprise can invest abroad more freely. The fourth one is to use liberalization as an instrument to push domestic financial reforms just like what China’s entry to the WTO has achieved. I think perhaps this is the most important objective among the four objectives.

What is your advice? I hope you can provide your advice, and I also hope you can go to China and talk to government officials and economists about your experience on the pros and cons of capital account liberalization.

Here, I want to discuss mainly the impact of RMB internationalization on capital account controls or capital account liberalization. The purposes of RMB internationalization are supposed to be five: (i) to reduce exchange rate risks; (ii) to reduce the increase in foreign exchange reserves; (iii) to increase competitiveness of financial institutions of China; (iv) to reduce transaction cost of trade; (v) to promote capital account liberalization.

However, the most important purpose, or the true purpose of RMB internationalization, is to promote capital account liberalization.

According to a very senior and highly respected central banker, “It is too difficult to reach consensus among all parties concerned on how to reform the exchange rate regime. Hence the PBoC looks one way and rows another to promote the use of the RMB for international trade settlement... Thus it will force us ourselves to speed up capital account liberalization with a ‘fight or die’ attitude. If a large amount of RMB has flown out of China, you have to create the channels to allow these RMB to flow back. Without the channels for recycling, no one will be interested in using RMB for trade settlement. Thus, pressure will be building up to force open China’s capital account”.

Whatever the purposes of RMB internationalization, the fact is that RMB internationalization has led to a further liberalization of capital account. How are cross-border capital flows facilitated by RMB internationalization? I will give you a very simple explanation by means of this chart here. We have a red wall of capital control over Mainland China. (see the red line.) If foreign capital intends to enter into China, it will hit immediately this red wall of capital controls. Then, we try to use the RMB trade settlement to create an offshore market in Hong Kong. This small part of rectangle area is Hong Kong. In Hong Kong, of course, there is a free market for foreign exchanges, you can exchange RMB into US \$ or US \$ into RMB.

So firstly, via RMB import settlement, Mainland importer buys things from an exporter in Hong Kong and pays the Hong Kong exporter with the RMB. So RMB flows from Mainland to Hong Kong. Because Hong Kong is a free market, the exporter can use the RMB to buy the US dollar, that is, foreign investors can use the US dollar to buy the RMB, if the foreign investor wants to invest in China. Previously this was impossible because there was no way for foreign investors to get hold of the RMB in offshore markets. Now the foreign investors can invest in RMB denominated assets in Mainland China via the so-called recycle scheme/mechanism, which allowed non-residents who have the RMB up to a certain limit to buy RMB assets, such as RMB deposits, RMB bonds, and RMB shares. So via this recycle channel, RMB flows back to mainland China. After earning profits, if you want to unwind, you can take the RMB out of China legally. This RMB can be converted back to US dollar in Hong Kong, and then you go. So this offshore market, actually, has opened a very big hole on the wall of capital controls.

But China has not entirely open up its capital account, the net amount of RMB moving cross-border is still capped. Here comes the new argument recently that in order to promote RMB internationalization China should dismantle those controls to allow capital to flow in/out of China freely. My Hong Kong friends are adamant on this, but my advice is that please don’t argue for total liberalization. It is not in your own interest. If capital control is totally dismantled, then capital

flows will not move via this Hong Kong market, they will go to China directly, and you will lose your business. So you should call for the Mainland government to maintain some controls over cross border capital flows. Only then will offshore markets maintain their value of existence.

China is in a transitional stage. On the one hand, because of RMB internationalization, RMB can move cross-border, and hence there are two exchange rates for the RMB. One is in Mainland, which is dubbed CNY, and another is in Hong Kong, which is dubbed CNH. The coexistence of two exchange rates for one currency creates opportunities for exchange rate arbitrage. On the other hand, capital controls have not been entirely dismantled and the PBOC intervenes constantly in the CNY exchange market mostly to prevent the RMB from appreciation. As a result, the spread between CNH and CNY is maintained despite the arbitrage. In the early stages of RMB internationalization, until the middle of 2010, the spread was quite big. In other words, the price of RMB in terms of the US dollar in Hong Kong was significantly higher than in Mainland China. Attracted by arbitrage profits, Chinese importers sold RMB in Hong Kong. On the other hand, attracted by potential gains from RMB appreciation and higher returns in holding RMB assets, Hong Kong residents were happy to buy and hold the RMB. As a result, the spread between CNH and CNY was maintained. But in later 2011, because of the worsening of the European financial crisis, capital flew out of Hong Kong, the RMB in Hong Kong suddenly became cheaper than in Mainland China. In other words, the spread between CNH and CNY became negative. The direction of the exchange rate arbitrage reversed. Mainland exporters sold the dollar they earned from their exports in the CNH market in Hong Kong in exchange for the RMB. Among the Chinese exporters, there were many foreign multinationals, by selling the dollar in Hong Kong for the RMB, they were able to use the profits gained from the arbitrage to pay off their RMB expenditures in Mainland China.

But how specifically is the exchange rate arbitrage being conducted? There are many different ways. Here is one example. Suppose I have a company, father and son. My son is in Hong Kong. As importer, I pay say 618 million yuan to import a certain amount of products from my affiliate in Hong Kong managed by my son. This is entirely legal under the RMB settlement scheme. Then my son uses this 618 million yuan (it is called CNH, because the RMB now is in Hong Kong) to buy, according to the exchange rate in Hong Kong, USD 100 million. My son uses this USD 100 million to buy back what I have bought from him. So goods return to the warehouse of my son in Hong Kong and I get USD 100 million. I sell this USD 100 million for the RMB in the foreign exchange market in Mainland. According to the RMB exchange rate in Mainland, I will get 620 million yuan, a profit of 2 million. Despite the fact that there is no real trading that has ever happened. The products are still in

the warehouse in Hong Kong, and I earn 2 million yuan profits by conducting exchange rate arbitrage. In order to consolidate your understanding, I can give you another slightly different example.

As an exporter, I sell products worth USD 100 million to my son. So my son gets the products. This time, products move from Beijing warehouse to Hong Kong warehouse. My son pays me USD100 million. I sell USD 100 million in Mainland for 620 million yuan. Then I buy back the goods from my son by only 618 million yuan. So the products travel back to Mainland China. According to the RMB exchange rate in Hong Kong, my son can use 618 million yuan to buy USD 100 million. So at the end of the transaction, this father and son company has the same products in the same warehouse in Mainland and the same amount of money— USD 100 million in the son's possession. But the father and son company obtains 2 million yuan profits.

This kind of “day trip to Hong Kong” can be done very frequently. You can do this day trip hundred times a year. So you got huge profits. In both cases, the essence is subsidy by the central bank. The profits of individual entities are obtained at the expense of national welfare.

Since 2012, RMB appreciation expectations weakened, and the CNH and CNY spread narrowed significantly. As a result, the exchange rate arbitrage became less attractive. However, Chinese exporters and importers and financial institutions found that to engage in interest rate arbitrage was more profitable. This is because the market believes that the RMB will continue to appreciate. Hence, to use the US dollar as funding currency to engage in interest rate arbitrage (carry trade) is risk-free. Then, how are Chinese enterprises engaged in interest rate arbitrage?

I use this chart to explain. The first step, consider still a father and son company. I have a quite good reputation, so I can apply for letter of credit (L/C) from my bank with certain amount of collateral. Suppose I get a L/C of, say, 618 million yuan. I can use this L/C to buy products from my son. Then my son can use this L/C as collateral to borrow USD 100 million from HSBC, according to the spot rate of the RMB in Hong Kong. Then my son uses this USD 100 million to buy back the product he had sold to me. In return, I get USD 100 million, and then I sell this USD 100 million in the Mainland foreign exchange market and obtain 618 million yuan. I deposit 618 million yuan with my bank— Bank of China for one year. Via this process, the company deposits the RMB with Mainland bank and borrows US dollar from Hong Kong bank. One year later the L/C will be settled between Bank of China and HSBC. Because the interest rate in Mainland is much higher than in Hong Kong, the father and son company will obtain significant profits.

I was talking about arbitrage as a micro activity. But what is the macroeconomic implication? According to the PBoC, in the first four months of 2013, its trade-related net purchases of foreign exchange reserve was USD 208 billion while at the same time China's trade surplus was just USD 62 billion. Why is there such a big gap? This is attributable to the interest arbitrage activities through trade finance, which, according to the PBoC, account for 75 per cent of the gap.

Previously all capital inflows consisted of FDI. Now this is no longer the case. The situation has been changing. My view is that such short term cross-border capital flows are harmful to the economy. Why? First, they destabilize the macroeconomy. Second, the existence of a large scale of arbitrage activities means that huge resources are wasted in unproductive activities. Third, the financial costs of real economic activities have increased. Lastly, the profitability of the arbitrage and speculation demoralize the participants of economic activities. If easy money can be earned legally and without bearing risks, who should care about honest and hard work?

What will China do about its capital account in the future? In the Decision of the Third Plenum of the 18th Party congress there is a section from the party congress:

“Perfect mechanisms for formation of RMB 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 RMB capital accounts.”

Anyway, even if the English translation is awful, the message is very clear: China will accelerate capital account liberalization. But I think the situation is not that simple.

Several years ago Stephany chaired a discussion in Bangkok. In that discussion, I raised the concern about capital flight. Even though capital had been flowing in China continuously, I pointed out, China should try to think about unthinkable. China has huge household savings in deposits. At the time, the total amount of household saving deposits had reached 17 trillion yuan. If households try to diversify, say 10%, of their portfolios into USD, capital outflows could be huge. And if you take into consideration other shocks, such as political shocks, external shocks, and so on, the situation could be graver. If capital starts to flow out in a significant way, the RMB would devalue, which in turn would lead to more diversification away from the RMB assets into USD assets, and more capital outflows. If a vicious circle has established, a financial crisis could occur despite China's

huge foreign exchange reserves. So at that time I said, if China would make a fatal mistake in the next 5 years, the mistake would be the premature abandoning of capital controls before it has completed its economic reform. I said this seven years ago. I still hold that view. The danger of a premature dismantle of capital controls is even bigger than 7 years ago, owing to the fact that China's M2-to-GDP ratio has surpassed 200 per cent and QEs has created a highly uncertain international financial environment.

To conclude, if China really abandons capital controls, the consequences will be very serious. Regardless what China's monetary authorities have said so far, due to the high risk involved, the Chinese government eventually will maintain a gradualist approach with regard to capital account liberalization. My bet is that China will not fully liberalize capital account and make RMB fully convertible in foreseeable future. Thank you very much.