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China's double act: how the financial reform and the RMB strategy are linked together

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Outline

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- Part 1: China's RMB Strategy
- Part 2: China's financial reform and the RMB strategy
- Part 3: China's financial centres, domestic financial stability and the opening of the capital account
- Conclusion

Introduction

- China's rise as the world's second largest economy is extraordinary and largely unexpected.
- Thanks to the economic reform policy initiated by Deng Xiaoping, its income per capita has increased twenty times from \$ 205 in 1980 to \$ 4422 in 2010.
- While China achieved rapid trade integration with the rest of the world, it does not have a financial sector nor a currency that reflects country's size and economic significance in the world. Its renminbi (RMB) remains largely unconvertible due to various restrictions on the capital account.
- Now, China has embarked on a cautious journey to open up its financial system and to integrate further with the international financial system.
- Beijing's strategy of the RMB internationalization sits on the spot light jointly with the nation's plan to reform its domestic financial sector.

Introduction

- In this paper, we argue that the financial and monetary reform is the next round of structural transformation and a critical part of China's reform agenda for the next decade.

- The internationalization of the RMB is an intermediary step towards greater financial integration between China and the rest of the world, but also a part of a broader set of reforms.

- A deep and efficient capital market is critical to support China's economic development and to rebalancing the relationship between the banking sector and capital markets.

- Yet how far could the RMB internationalization proceed forward is largely determined by the reform progress of China financial sector in the domestic market.

Part 1. China's RMB Strategy

- 1.1. China 'Go Global'
- 1.2. A two-track strategy
- 1.3. Recent policies and the way forward

Part 1.1 China ‘Go Global’

- China’s ‘Go Global’ strategy was officially launched in 1999 with the aim of supporting Chinese enterprises going outside China.

- Three motivations of the ‘Go Global’ strategy:
  1) The authorities realized that domestic market was not large enough to sustain China’s growth and thus urged enterprises to search new markets and resources abroad.
  2) The government wanted to encourage large SOEs to become multinational companies and expand their influence in the international community.
  3) The government aimed to help large SOEs to move upwards within the global value chain.

Part 1.1 China 'Go Global'

- China's 'Go Global' strategy has progressively exposed the Chinese financial sector to international markets as banks expanded aboard to support Chinese companies overseas.

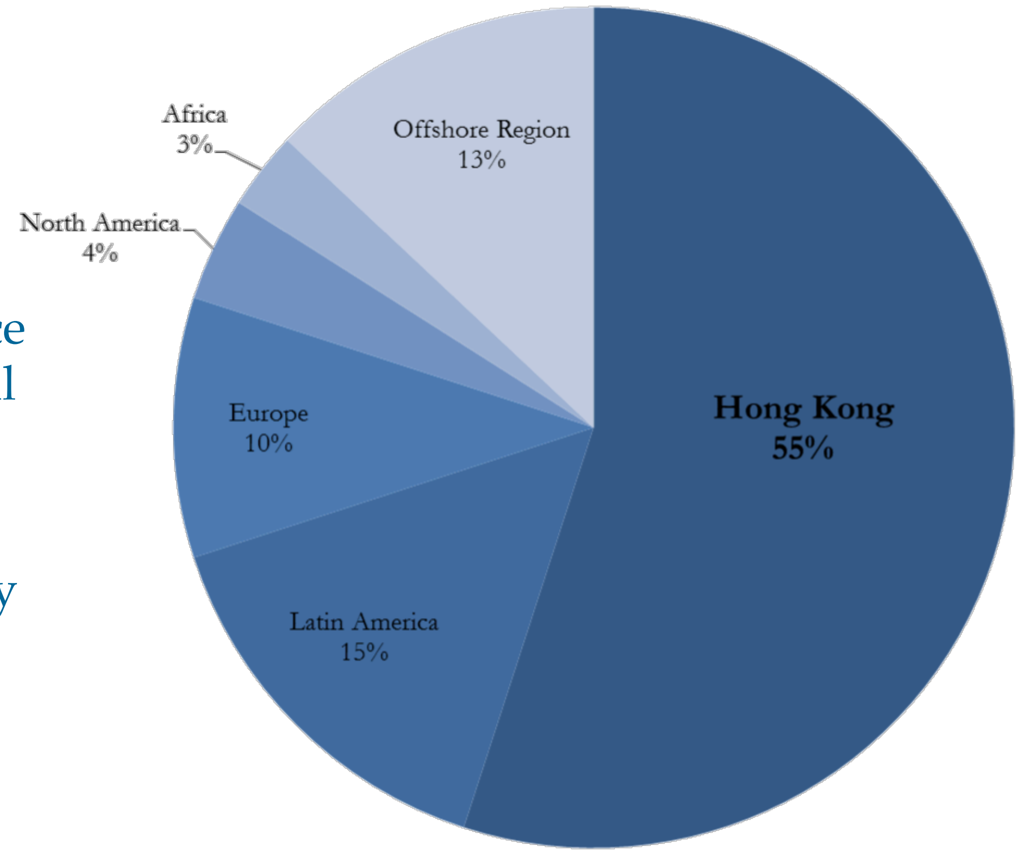
- Financial institutions were encouraged to seek greater exposure to international financial markets in mid 2000's.

  - For example, PBoC urged the 'Big Fours' to become more competitive in the international market and to prepare fore direct competition from international banks in 2002.

  - By 2010, the 'Big Fours' have all completed their public listing on both the onshore market (A-share board in Shanghai Stock Exchange) as well as the offshore market (namely, H-share board in Hong Kong Stock Exchange).

Figure 1. Destination of China's Outward Foreign Direct Investment in 2011 (OFDI)

- Asia is the main recipient of China's OFDI.
- Hong Kong is the most popular destination, for market preference as well as mainland's preferential policies.
- Hong Kong becomes the gateway for Chinese companies to reach the rest of the world as well as a place where they can seek access to global capital markets.



Source: Ministry of Commerce, PRC

Figure 2. Growth of China's OFDI is primarily led by investment in non-financial sectors

	OFDI Volume (USD Billion)			Growth Rate
Year	Non-Financial Sector	Financial Sector	Total	
2002	2.70	0.00	2.70	
2003	2.85	0.00	2.85	5.6%
2004	5.50	0.00	5.50	93.0%
2005	12.26	0.00	12.26	122.9%
2006	17.56	3.60	21.16	72.6%
2007	24.80	1.71	26.51	25.3%
2008	41.90	14.01	55.91	110.9%
2009	47.80	8.73	56.53	1.1%
2010	60.21	8.60	68.81	21.7%
2011	68.58	6.07	74.65	8.5%
2012.08	47.60	4.92	52.52	-29.6%

Source: Ministry of Commerce, 2012 August

Part 1.2. A two-track strategy

- China's 'Go Global' strategy for the RMB is a two-track strategy that relying on the cross-border trade transactions and the creation of an RMB offshore market in Hong Kong.

- The goal is to increase the usage of the RMB in international transitions and investments without, however, allowing full-scale capital account openness nor complete convertibility.

- During the RMB internationalization process, the swap agreements have a unique role to promote the use of RMB in countries that have commercial and investment relations with China and encourage central banks to hold the RMB in their reserves.

Table 1. The RMB bilateral swap agreements

Country/Region	Date	Amount(RMB Billion)
Bank of Indonesia	2009.03.23	100.0
Central Bank of Argentina	2009.03.23	70.0
National Bank of the Republic of Belarus	2010.03.24	Agreement on Bilateral Settlement in Local Currencies
	2009.03.11	20.0
Central Bank of Iceland	2010.06.09	3.5
Monetary Authority of Singapore	2010.07.23	150.0
New Zealand Reserve Bank	2011.04.18	25.0
Central Bank of the Republic of Uzbekistan	2011.04.19	0.7
Central Bank of Mongolia	2011.05.06	5.0
National Bank of Kazakhstan	2011.06.13	7.0
Central Bank of Russia Federation	2011.06.23	No Limitation
	2010.11.22	Bilateral Trading
Bank of Korean	2011.10.26	360.0
	2009.04.20 (Expired)	180.0
Hong Kong Monetary Authority	2011.11.22	400.0
	2009.01.20 (Expired)	200.0
Bank of Thailand	2011.12.22	70.0
State Bank of Pakistan	2011.12.23	10.0
Central Bank of the United Arab Emirates	2012.01.17	35.0
Bank Negara Malaysia	2012.02.08	180.0
	2009.02.08 (Expired)	80.0
Turkish Central Bank	2012.02.21	10.0
Central Bank of Mongolia	2012.03.21	10.0
	2011.05.06 (Expired)	5.0
Reserve Bank of Australia	2012.03.22	200.0
Central Bank of Ukraine	2012.06.26	15.0

Source: PBoC, Chatham House

Part 1.3. Recent policies and the way forward

- How far could China's RMB international strategy go forward rests on the progress of the convertibility of the RMB and liberalization of the capital account.

- It therefore ultimately is determined by the reform of the financial and banking sector in China's onshore market.

- Many experts and market participants predict 2015 as the year for the RMB to be fully convertible, yet the Chinese authorities have been very careful not to fuel expectations in order to retain full control of the the reform process in a gradual way.

- Based on the lessons from international community and on China's traditional gradualism approach on reform, the progress of capital account liberalization and currency convertibility may be happened later than expected.

Part 2. China's financial reform and the RMB strategy

- **2.1. The process of reforming the financial sector**
- **2.2. The financial system in mainland China: work in progress**
- **2.3. Reforming the interest rate regime and the exchange rate regime**

Part 2.1. The process of reforming the financial sector

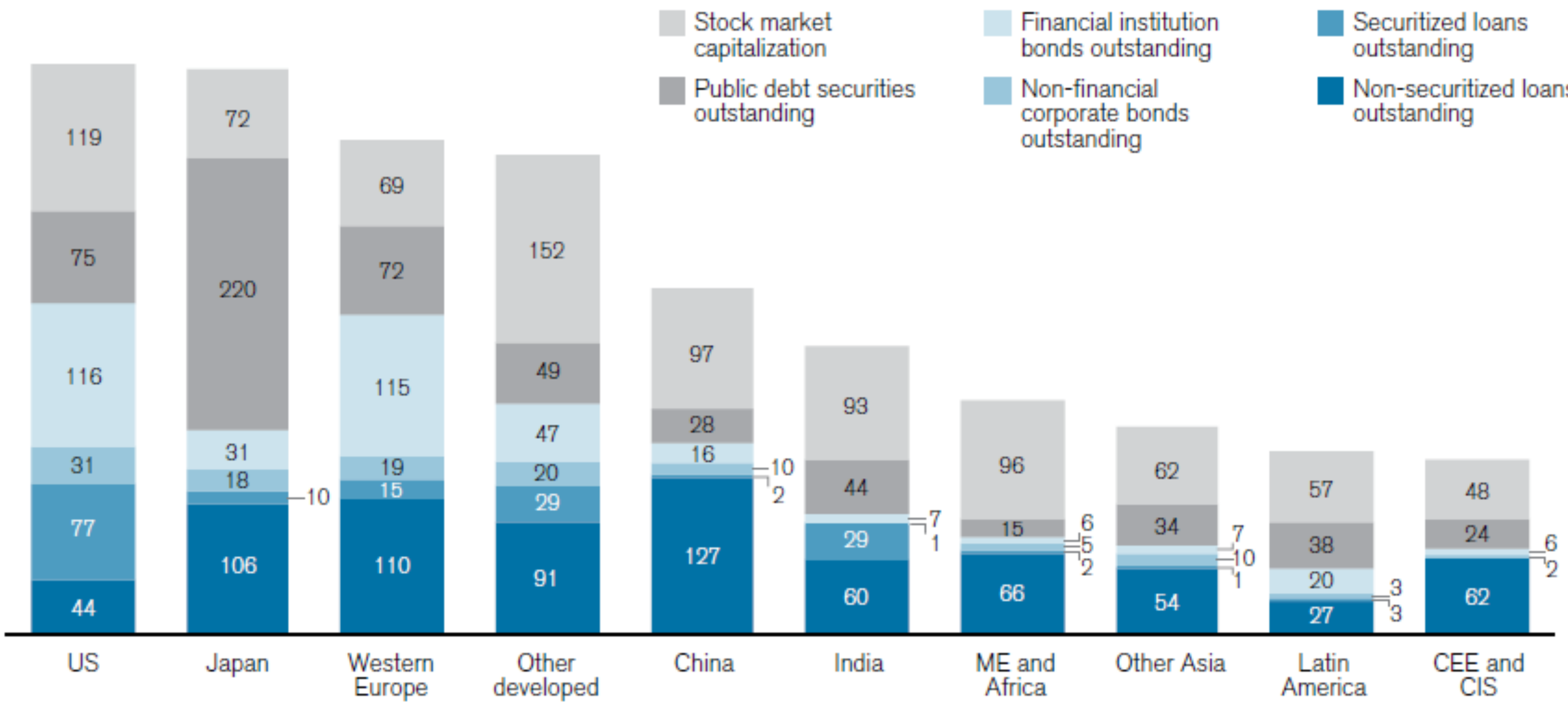
- China's challenge:
  1) Reconciling the need for an efficient market-driven financial sector with its policy-driven growth model.
  2) Reconciling political considerations with market preferences.

- China lacks financial depth. The dominant banking sector in China is the major financing source and channels to support its domestic market.

- The corporate bond and securitization markets need to be further developed. Financial services need to reach the rural sector. Private capital needs to be encouraged to feed into financial services*.

*Note: Above are key are of financial sector reform in China's 12th five-year plan as stated in the Fourth National Financial Work Conference in 2012 January.

Figure 3. Financial depth, year-end 2010 (% of regional/ country GDP)



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Source: McKinsey Global Institute (2011)

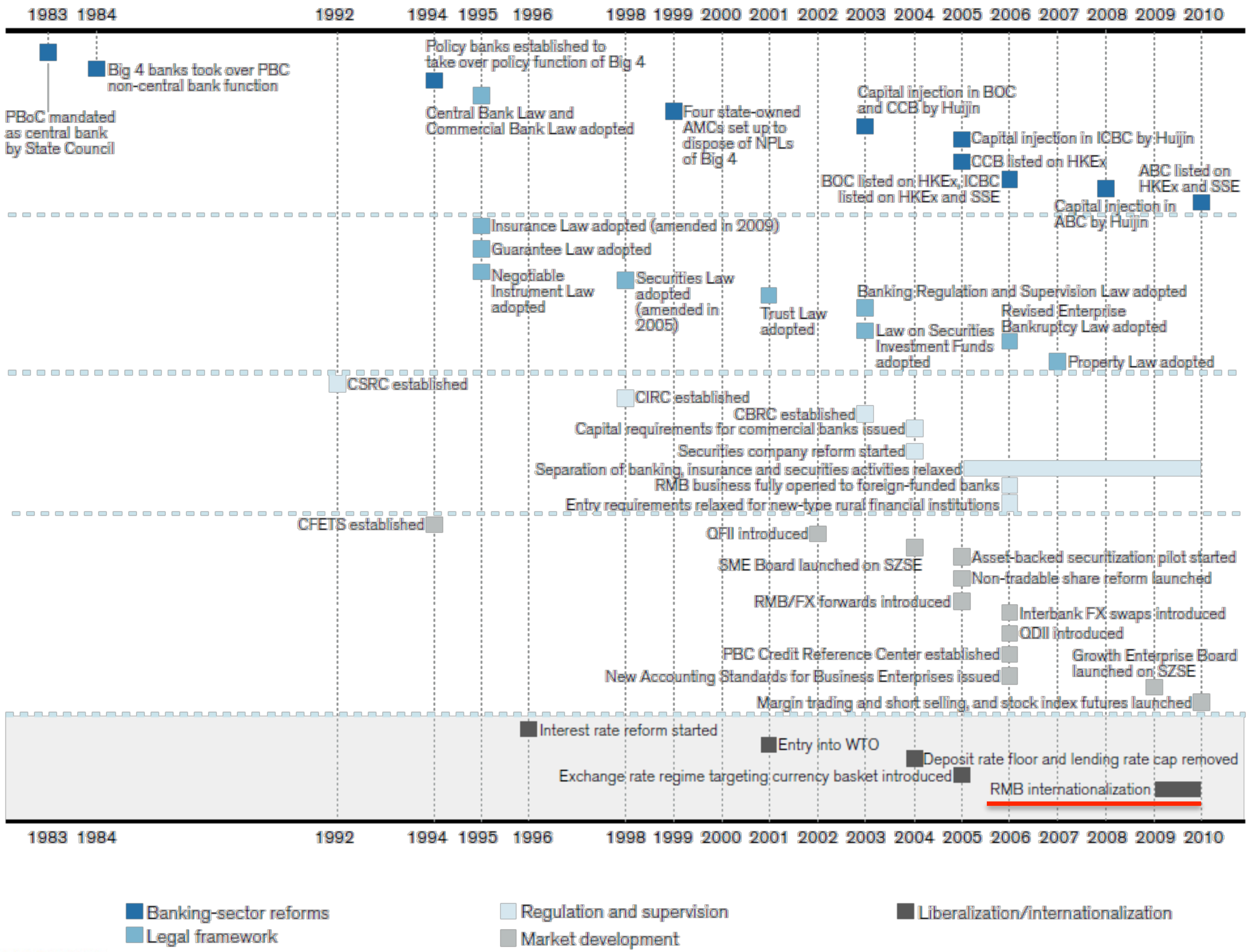
Part 2.1. The process of reforming the financial sector

- China's financial reform started in earnest in the 1980's and accelerated in late 1990's when Premiere Zhu step on board.

- The entire reform process began with the liberalization of China's banking sector and then gradually evolve towards the establishment of a capital market, mainly the equity market, and the legal and regulatory framework.
  - The commercialization of the 'Big Four' in 2000's
  - The establishment of the three commissions, the CBRC, CSRC and CIRC

- At present, China's financial regulatory framework is based on the 'One-Bank, Three-Commissions' model

Figure 4. Financial-sector reforms in mainland China – selected benchmarks



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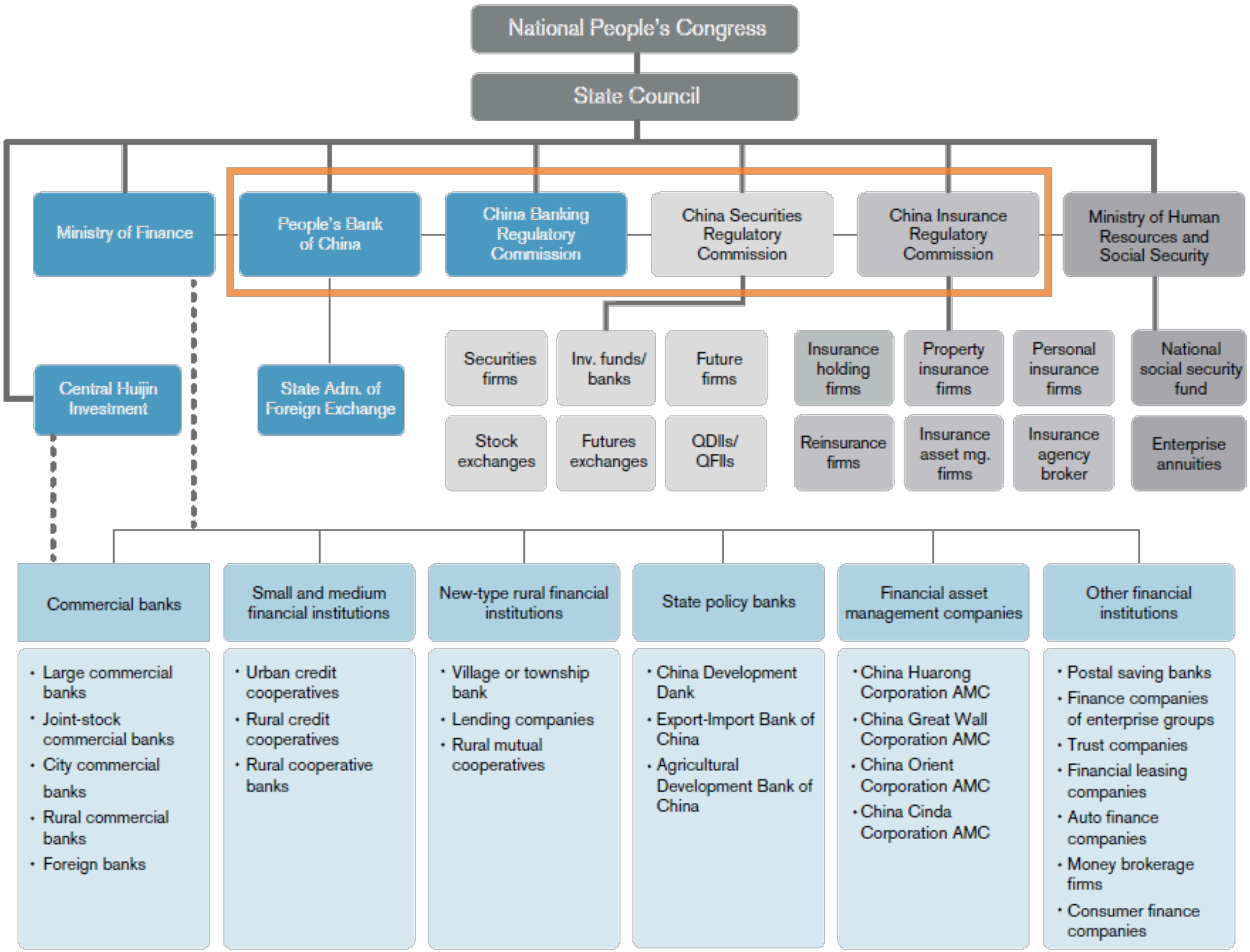
Source: IMF (2011b)

Figure 5. Financial system architecture in mainland China



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Source: IMF (2011b)

Part 2.2. The financial system in mainland China: work in progress

- Several Key issues:
  - **The mighty Chinese banks still need further effort to adjust their business model from a policy-driven one so as to improve the significant capital misallocation situation in China.**

    i.e. dominant market power of the large commercial banks in the financial sector. SOEs hold excessive capital resources whereas SMEs suffer from limited credit lines.

  - **Shadow banking activities need to be regulated and formalized.**

    i.e. In China, shadow banking primarily includes wealth management products, underground finance and off-balance sheet lending(Xiao Gang, 2012).

  - **Absence of an effective price-signaling mechanism**

    i.e. interest rate and exchange rate

Part 2.3. Reforming the interest rate regime and the exchange rate regime

- The revision of China's interest rate and exchange rate regimes is the key aspect of the financial reform.

- For the interest rate reform, however, this is a process needs considerable political maneuvering among different interest groups.

  i.e. Large commercial banks and SOEs v.s. SMEs and private sector

- The politics behind the reform of the interest rate is complex and epitomizes the dilemma between the role of polities and that of the market for China to manage its domestic economy.

  i.e. Greater political power hold by large banks and SOEs v.s. less importance of SMEs and private sector in China's political system

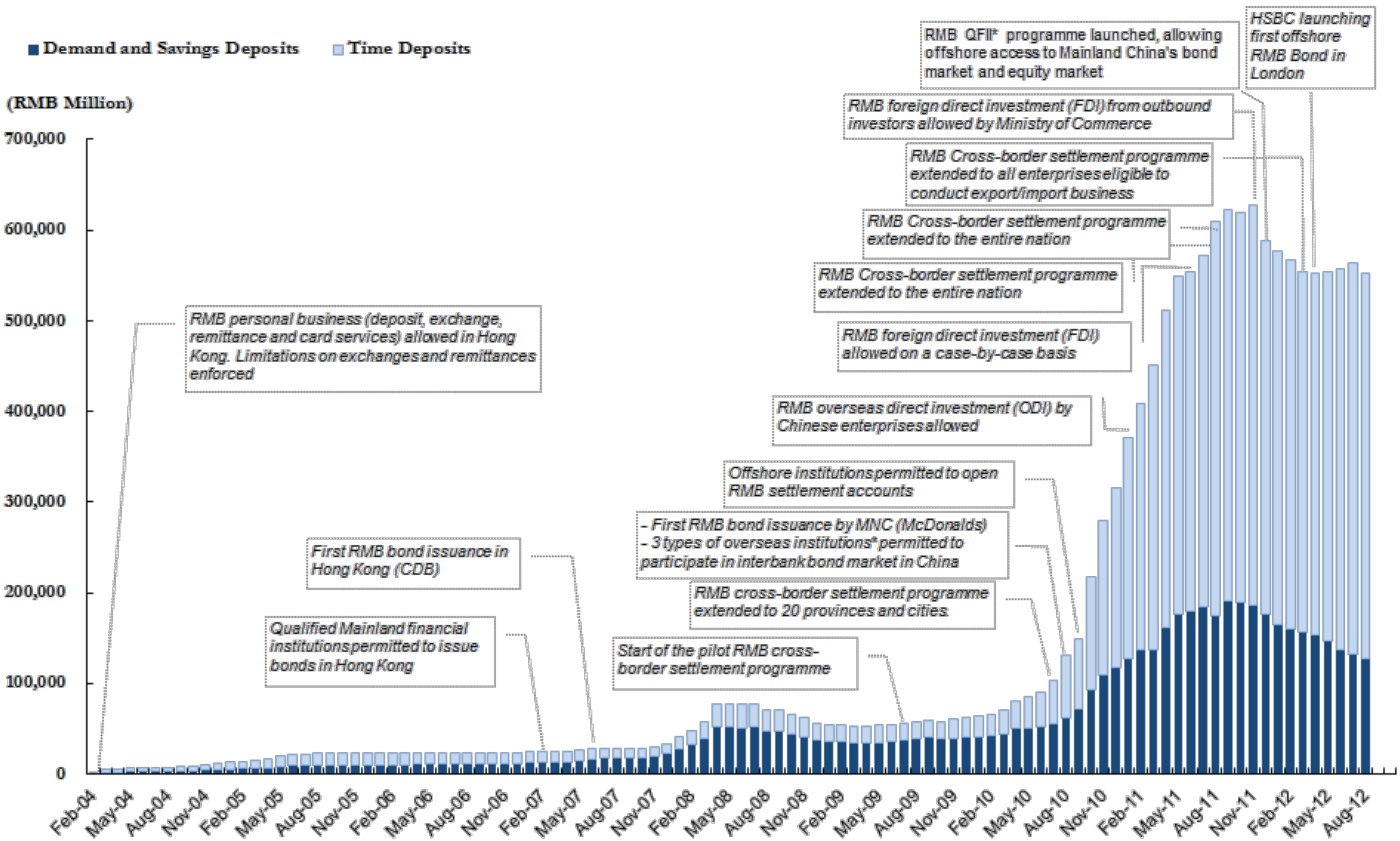
Part 2.3. Reforming the interest rate regime and the exchange rate regime

- China's exchange rate reform is with a more prominent international relevance.
- China's decision to fix its official foreign exchange rate of the RMB at 8.7 CNY per USD in January 1994 came jointly with abolishment of its exports subsidiary policies. The massive devaluation of the RMB in 1994 indirectly created additional competitive advantage for China's exporters until 2005.
- However, the cost of having such a fixed exchange rate regime is also costly. Most evidently is China's huge foreign exchange reserves and the restricted impact of PBoC's monetary policy.
- A more flexible exchange rate regime jointly with greater convertibility of the RMB under capital account are essential to increase China's financial integration with the world and to improve its IIP performance.

Part 3. China's financial centres, domestic financial stability and the opening of the capital account

- **3.1. Building the offshore market to support the RMB strategy**
- **3.2. Bridging financial and monetary reforms: Hong Kong and Shanghai**
- **3.3. Shanghai: a centre for RMB trade by 2015?**

Figure 6. RMB deposits in Hong Kong



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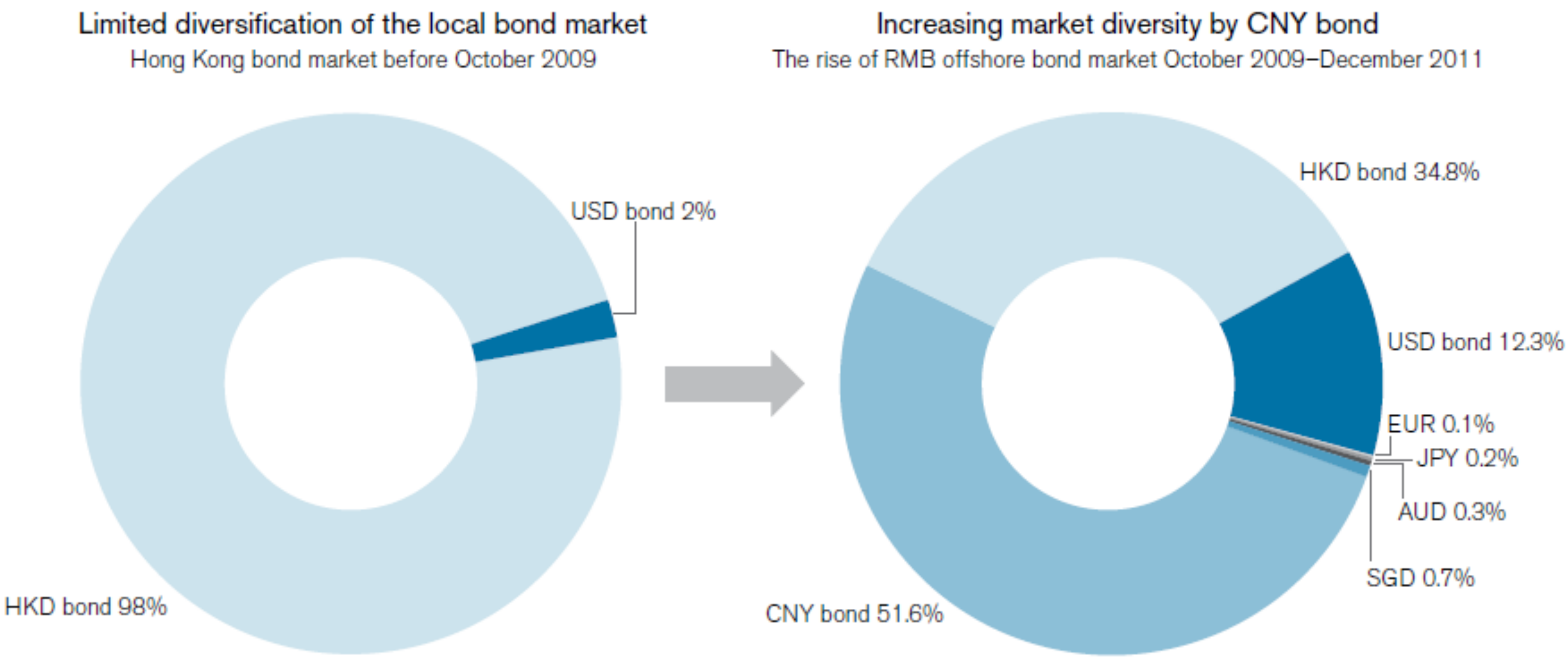
Source: HKMA

Figure 7. Growing RMB offshore bond market



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Source: HKMA

Table 2. Goals for Shanghai's financial sector during the 12th Five-Year Plan period (2011 – 15)

	Item	2010	2015
Size of the Financial Markets	Total Transaction Volume of Shanghai's Financial Markets (excluding foreign exchange market)	386.2 Trillion RMB	1000 Trillion RMB
	Total Volume of the Balance of Securities Deposit	Global No. 5	Global Top 3
	Total Transaction Volume of Gold Spot Trading	Global No. 1	Global No.1
	Total Transaction Volume of Financial Derivatives	NA	Global Top 5
	Total Insurance Premium	69.5 Billion RMB	140 Billion RMB
	Total Interbank Card Transaction	10 Trillion RMB	25 Trillion RMB
Market Connectivity and Diversity	Overseas Investor	Limited market participation	Significant market participation
	Global Influence	Limited overseas market influence	Promote international market influence through listing major indices in Shanghai Stock Exchange and developing RMB denominated commodity future prices
Market Depth	Direct Financing as % of Total Financial Markets	16.70%	22%
	Financial Assets Under Management (AUM)	15 Trillion RMB	30 Trillion RMB
Financial Environment	Professional Financier	245,000	320,000
	Global Competitiveness	National No.1	Adopt international standards for stable legal and regulatory financial environment

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Source: NDRC(2012), Subacchi et al. (2012)

Conclusion

- Whether the Chinese authorities will be prepared to carry out *de facto* reforms that are necessary to liberalise the domestic financial market remains an un-answered question.

- Concerns about domestic financial stability as a cover to ensure social stability can be used as an excuse to slow down the entire reform process and eventually erode the effectiveness of the whole reform agenda.

- There is strong opposition in China towards the government's intention to further open the nation's financial market to the external side. This coincides with the political maneuverings around the current change of leadership in 2012.

Conclusion

- China is evidently at the crossroad.

- The RMB internationalization strategy is a goal that China is keen to realize in the long term. Yet beneath the surface, this strategy in fact triggered the progress of China's financial reform in the domestic market, which in turn determines the success or failure of this strategy.

- The future development trajectory of Shanghai and Hong Kong can provide the best snapshot of how closely China's financial reform and the RMB strategy are linked together.

Thanks!

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