

China Focus

RMB Internationalization: Forging Ahead

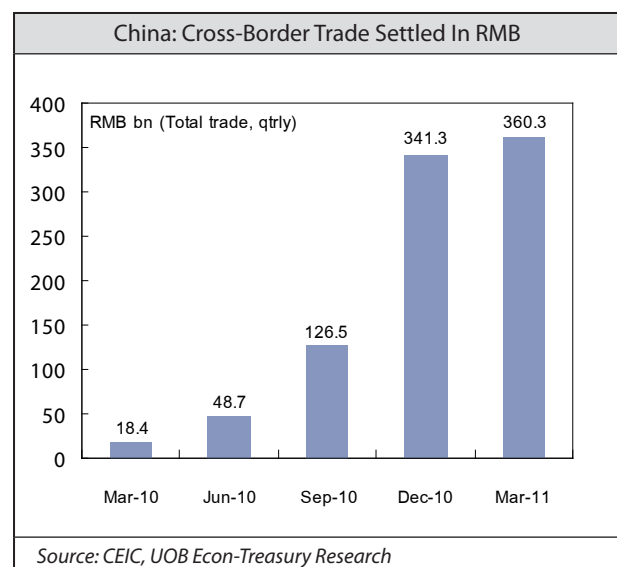
- *RMB internationalization is progressing gradually and steadily, and this process is unlikely to be reversed unless there are some significant event or systemic shocks. This is because over time, the RMB would become convertible and freely traded just like the currency of any major economy.*
- *The internationalization progress can be seen through the extent of China's external trade that is settled in RMB in 1Q11, which was up sharply against the amount in 2010. With trade settlement as the beginning of the process, the next step should see investment flows being denominated in RMB, and the ultimate step would be one of global reserve currencies.*
- *However, for RMB to become a reserve currency would require free capital movements in and out of China, which we reckon would likely take another 5-10 years, if not longer, as the evolution of the Eurodollar deposit market shows.*
- *The next development is when a second RMB clearing bank would be set up, which would be a symbolic step towards a more "international" RMB. For now, we still see the USD/RMB pair to continue on its gradual decline, and maintain our forecast at 6.35 by end-2011 and 6.10 for end-2012.*

RMB Internationalization: Update

Offshore RMB (also called "CNH") is a key part of the internationalisation of the RMB. This process started in second half of 2010 and is unlikely to be reversed, unless there are some significant event or systemic shocks that cause a rethink. This is because over time, the RMB would become convertible and freely traded just like the currency of any major economy. There is also a possibility of it becoming one of the reserve currencies in the global system, but that is a secondary consideration for Chinese policymakers.

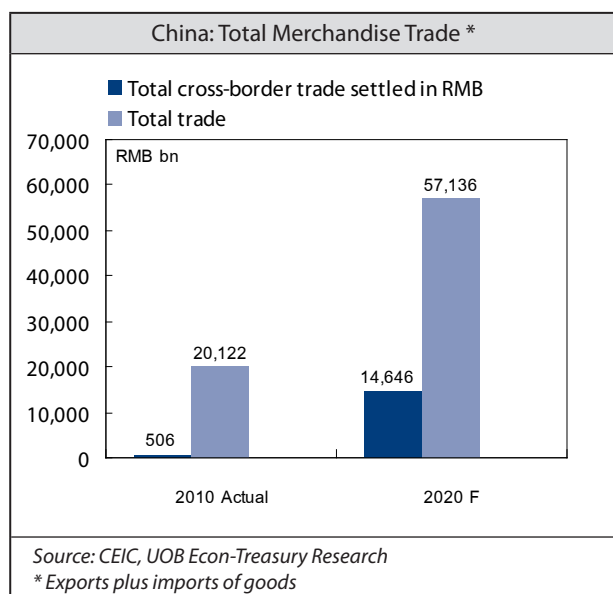
For currency convertibility to happen while still retaining an independent monetary policy, China's capital account must be fully open -- i.e. allowing free movements of capital -- under the Mundell-Fleming's framework of "Impossible Trinity". However, this process could take another 5-10 years to complete, if not longer, for the financial system and trade sector to be ready to withstand such capital flows. In the meantime, the flow of RMB out of the mainland continues to take shape through trade of goods and services in this initial phase. Subsequent phases should see RMB as a currency of capital investment, and then eventually in the final phase, as a reserve currency for central banks to hold.

In 2010, cross border trade settled in RMB only accounts for about 2.5% (or RMB500bn) of China's total trade. This figure has jumped up sharply in 1Q11, to account for 7% of total China's import and export trade during that quarter.



There is much room for this activity to expand. Even under our conservative assumptions, total RMB-settled cross-border import and export trade could account for 25%, or about RMB15tn, of China's total trade by 2020 (see chart below). Gradually such cross border trade would also expand through other countries in the region and to the rest of the world. The fact is that under the current closed capital account regime and non-convertibility of RMB, more clearing banks -- modeled after the one in Hong Kong (BOC HK) -- would need to be set up in key regional centers as the Chinese currency becomes more "internationalized" and its use rises. These clearing banks are crucial in the equation, as they serve as a conduit or bridge (i.e. a middleman) between the onshore central bank (PBoC) and domestic commercial banks offshore in settling payments and receipts of RMB.

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Offshore RMB Vs Eurodollar Deposits: Still A Long Way

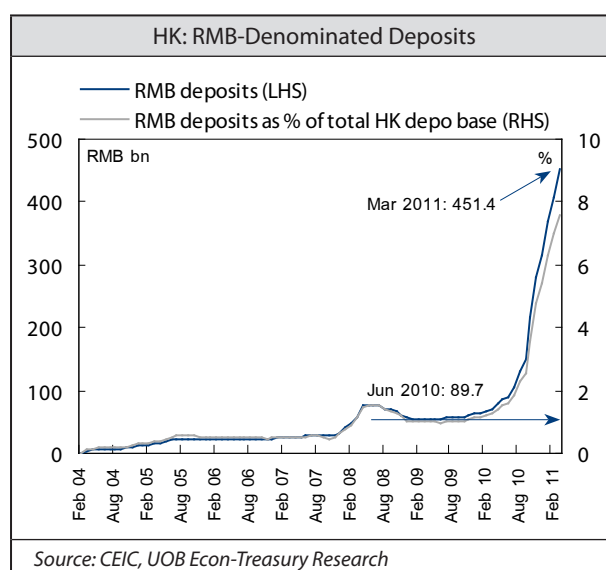
There have been comparisons of internationalization of RMB to the development of the Eurodollar market. There are some similarities and differences and both are not strictly comparable.

Eurodollar is said to have grown partly out of the Cold War period in the 1950s, with the then Soviet Union keeping its US dollar holdings outside of the US, out of reach of US authorities. At the same time, US government restrictions on lending and saving interest rates also encouraged the development of the Eurodollar deposit market, mainly in Europe (hence the name), where these restrictions (such as interest rate controls, reserve requirements, and deposit insurance, among others) did not apply. Eurodollar deposits grew from about US\$1bn in the 1950s, to US\$20bn by 1964, as a result of tight regulation in the US (onshore) and generally unregulated markets for the Eurodollar outside of US (offshore). There are no reliable statistics on the size of the Eurodollar market. According to a Richmond Federal Reserve Bank study in 1998¹, the market was estimated to be US\$3-5 trillions, compared to onshore US M2 money supply of US\$9 trillions recently. This suggests that the Eurodollar deposits account for a staggering 33% to 55% of onshore US M2 money supply.

In contrast to the very much liberal nature of the US dollar counterpart, China's internationalization of RMB is very much a controlled process, with restrictions placed in almost every step of the way. The closed capital account ensures

that there are limited opportunities to arbitrage between the onshore and offshore RMB markets.

If the Eurodollar deposit took 20-30 years to become a full fledged, mature market, then one could similarly expect such multi-decade schedule for the RMB market. Even with advance technology and much globalized international trade and finance, it is difficult to see the offshore RMB market maturing within the next 3-5 years, as some people have claimed. Currently, offshore RMB deposits amount to about RMB451bn, accounting for nearly 8% of Hong Kong's total deposits (see chart below). While it is not insignificant, these offshore RMB deposits account for less than 0.6% of total onshore deposits of RMB76.73tn (at end-May), a tiny portion of the whole picture. Compared to the Eurodollar share to onshore US money, there is indeed a long way to go for the RMB, which also means there is much significant room for CNH to grow.



What Is Next?

One thing is for certain, offshore RMB and the overall liberalization of the RMB/capital account is a structural and long-term development. Some reports have said that RMB will become fully convertible over the next 3-5 years, but we think it would take longer than that for the reasons above. The process will be slow and deliberate. Social implication, the broader impact on China's 1.3bn population, will be top priority for Chinese policy makers, especially with a new slate of top leaders taking over the helm of central government in 2012.

¹ Marvin Goodfriend "Chapter 5: Eurodollar", Federal Reserve Bank of Richmond, 1998, http://www.richmondfed.org/publications/research/special_reports/instruments_of_the_money_market/pdf/chapter_05.pdf

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It should be noted that China's policy process, especially in major FX initiatives, has never deviated significantly from the principles of '谨慎, 主动, 渐进, 有序, 可控' (loosely translated to: cautious, proactive, gradual, orderly, manageable). For instance, these principles are reflected in the FX policy reform in 2005, where the RMB was revalued by "only" and a surprisingly small 2% against the USD on the first day, lack of subsequent revaluation, and the second FX reform in Jun 2010, among others.

The next milestone in this process of internationalization is

when a second RMB clearing bank would be set up, which would be a symbolic and also a significant step towards a more "international" RMB, and not just confined to Hong Kong. Based on press reports, Singapore appears to be in the running as another center for offshore RMB although other centres e.g. London, etc may also be possible. Timing is again the issue.

For now, we still see the USD/RMB pair to continue on its gradual decline over the next 1-2 years, and maintain our forecast at 6.35 by end-2011 and 6.10 for end-2012.