Global Counsel

What is the People's Bank of China's offshore strategy?

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Summary

- Last week's leaked report by the People's Bank of China on the future liberalisation of China's capital account and the internationalisation of the renminbi managed the difficult job of suggesting both ambition and caution. It said little that the Bank has not been saying in public and private for some time.

- It was, however, intended as a marker in an internal debate ahead of the 2012 leadership change and reflected the fact that the People's Bank of China is increasingly confident in speaking over the head of the rest of the Chinese system to Chinese business on the question of capital markets and currency strategy.

- The People's Bank of China's strategy is more ambitious than this report suggests, not necessarily in terms of moving quickly to full convertibility, but certainly in terms of 'investability': widening the scope for foreigners to settle trade in renminbi and to use it to invest in China.

- This strategy of using 'offshore' to apply targeted policy pressure 'onshore' reflects the People's Bank of China's concerns about weaknesses in the Chinese banking and financial system, especially the need for more diversity in China's funding markets.

Last week's leaked report by the People's Bank of China (PBoC) on the future liberalisation of China's capital account and the internationalisation of the renminbi created a stir in the western financial press. The paper was drafted by the Bank's statistics division and neither posted on the Bank's website nor released in English, which suggests that it was intended as a contribution to an internal debate. It clearly had one eye firmly on shaping the national argument ahead of the change of Chinese leadership at the end of 2012.

At least among western commentators, the report managed to pull off the impressive trick of simultaneously being praised for its ambition and its caution. It was ambitious for liberal observers who have long wanted to see China set a clear course towards capital account liberalisation. It was cautious for those who think that this process will and probably should take years if not decades.

Squaring this odd circle helps us understand the political strategy of the PBoC on the growth of the offshore market for renminbi, its priorities for domestic reform, and how they interact. This Global Counsel Insight note speculates on what that strategy may be, and looks at what it implies for inward investors in China and those with an interest in the internationalisation of the redback.

A redback red-herring?

At one level the report is a red herring. There was nothing in it that senior leadership and officials of the PBoC have not been saying in private and increasingly in public for a long time. In short: that the long term prospectus for the renminbi should be reserve currency status; and that the route there would be widening the use of the renminbi for trade settlement, followed by a widening of access for foreigners to mainland equity and bond markets. But the emphasis has always been, and remains, long-term.

Yet, in this context, the paper is actually a lot more conservative than insiders at the Bank and their bosses have been in the last couple of years. As one obvious example, the five to ten year time frames envisaged in the paper for liberalising even basic forms of cross-border movement of renminbi such as foreign investment in RMB-denominated equities and debt in China would almost certainly imply a failure to meet stated targets for dramatically expanding Shanghai's role as a global financial centre by 2015.

This conservatism is partly genuine pragmatism, but it is also political. The report is a trial balloon, and officials at the PBoC are to some degree deliberately fudging the timescales to help secure wide political agreement on the principles and the strategic direction. With the publication of a major World Bank report last week in coordination with the Chinese NRDC on China's economy in 2030 (and with the implicit support of likely future Premier, Li Keqiang), the PBoC seems to have judged the moment right for reinforcing the basic strategy of liberalisation, especially ahead of the leadership transition towards the end of the year. With Governor Zhou Xiaochuan's tenure at the Bank coming to an end this year, it may also be an attempt to secure some form of legacy and continuation beyond his departure.

Expanding offshore to drive change onshore

Is the PBoC more ambitious than this paper suggests? Almost certainly. The PBoC is widely regarded in other parts of Chinese officialdom as wanting to use capital account liberalisation to force reform in other parts of the system. This charge probably sticks. The PBoC has long been concerned that limited outlets for Chinese capital have helped fuel a property bubble and unproductive local government spending, and in doing so have lumbered the Chinese banking system with a large amount of bad debt.

It also worries that China's capital markets are still too shallow to fund the investment that Chinese firms will ultimately require to move up value chains: a bottleneck that has already led to many Chinese companies raising capital abroad. In 2011, eleven Chinese companies raised a total of over $2 billion in IPOs on US exchanges. Indeed, for parts of the system – notably private enterprises rather than State-owned – developed capital markets with international access will be critical for continued growth and development up the value chain. The flip-side is, however, that domestic pressures and constraints – such as a more developed financial services sector capable of servicing such growth, and a legal system able to deal with complexity in commercial law such as bankruptcy – remain significant challenges that need to be addressed at the same time as capital market reform.

The PBoC calculates that the growing stock of renminbi offshore must eventually drive further onshore reform. The PBoC has now signed currency swap agreements with 14 of its largest emerging economy trading partners totalling around RMB1.5 trillion. In the last two weeks, it opened a new line with Turkey and doubled its existing line with Malaysia. The report also advocates a spurt of outward Chinese direct investment to take advantage of weakened asset values in the west, and rules on doing this with domestic currency were relaxed at the end of 2010. This will also have the effect of deepening the supply of renminbi outside China.

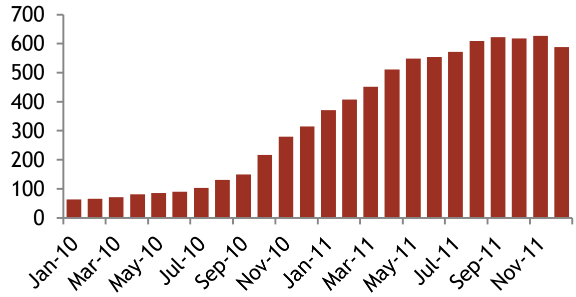

Chart 1: RMB deposit base in Hong Kong (RMB 000)

Source: Hong Kong Monetary Authority 2012

The clearest sign of this has been the dramatic expansion of offshore deposits in Hong Kong since 2009 (Chart 1). This market, which accounts for almost all offshore holdings of the currency, is both increasingly large and increasingly liquid, trading some $2bn in currency and currency derivatives a day. This growing pool of renminbi abroad has helped drive a rapid acceleration in the level of trade settled in the Chinese currency which is now probably close to 10% - up from 1% two years ago.

Foreign holders of renminbi will increasingly demand places to park it. While some of this demand will be met in the short term by deposits in Hong Kong – at least while expectations of RMB appreciation remain strong – investors are already looking for RMB-denominated assets. European and US investors have a substantial appetite for Chinese exposure and purchased significant chunks of bonds issues offered in Hong Kong in the first two months of this year – including China Development Bank and America Movil.

For now, bonds sold in Hong Kong will fill part of this appetite but ultimately the pressure to open wider channels to mainland debt and equity markets will be hard to resist if the Chinese government wants to maintain the incentive to hold RMB outside China. In the last half of 2011 quotas for inward investment from Hong Kong were raised, and general rules for RMB-denominated inward investment streamlined. Rules on the scope of RMB-denominated assets held in licensed institutions in Hong Kong have also been relaxed.

On one hand, last week's paper might be read as an attempt by the PBoC to show its hand a bit more transparently. With strong backing from the export lobby for its policy of expanding the use of the renminbi for trade settlement, it appears increasingly confident in talking over the head of the rest of the government to the business community.

On the other hand, the PBoC still clearly feels the need to talk up its caution, even while its implicit strategy is to use market-based changes to create irresistible momentum for further reform. The PBoC surely calculates that the Hong Kong experiment will demonstrate to more conservative elements in Beijing that Chinese banks and companies can manage exchange and interest rate volatility in a way that will pave the way for greater liberalisation on the mainland.

Investability over convertibility?

It is, however, important to be clear what reform means. Aims like turning the renminbi into a global reserve currency, which would require full and free convertibility and very substantial holdings of Chinese debt outside of China are probably decades away. This of course implies a serious mismatch between China's global economic weight and the traditional marks of that status. But this is still unlikely to trump a pragmatic and incremental approach.

Although it is the most ambitious part of the system, the PBoC is comfortable with pushing the political timetable for issues like full convertibility years into the future because, for the purposes of driving change in the Chinese economy, convertibility matters less than 'investability' – a currency that can be used with growing freedom by foreign investors into China and by those seeking to finance trade with China.

In just two years policy has given serious momentum to both of these. However, it should be borne in mind that widening the scope for RMB-denominated foreign investment into China does not imply a relaxing of political and regulatory scrutiny of that investment. Foreign investment will remain constrained by a wide range of restrictions on foreign ownership.

For those outside China with a commercial interest in the growing scope for using the renminbi this is good news. Chinese trade counterparties can increasingly be expected to want to settle in renminbi and banks will increasingly be able to facilitate this. Given the current gap between China's trading weight and the international use of its currency, the potential for financial intermediaries is obviously huge. China accounts for around 11% of global trade. The renminbi accounts for less than 0.3% of all global payments.

London has been quick to position itself as a possible hub for the offshore renminbi market. In the medium term, the most likely development in London is tentative growth in the use of RMB-denominated bonds by European corporates active in China. European companies like Tesco, Volkswagen and BP have accounted for around 5% of bonds issued Hong Kong since the creation of the 'dim sum' market and would like to be able to do the same with their home investor base.

However, the development of this market will depend on a very deep pool of RMB deposits in London and a swap line between the Bank of England and the PBoC. To this point, China has focussed on its emerging economy trading partners in building an offshore renminbi market. For now, Hong Kong's first-mover advantage, buttressed by its hybrid onshore/offshore status and mainland political patronage, will be formidable.

London's development as a currency trading centre for the renminbi will hang to a much greater extent on the speed with which China moves to full convertibility. Given the level of political anxiety in the Chinese system about surrendering control of its onshore currency market, and given that reformers in the PBoC calculate they can probably drive change in the short term without it, this still looks a long way off.

38 Wigmore Street
London
SW1U 2HA
info@global-counsel.co.uk
+44 (0)207 656 7600