RMB Internationalisation: Topping China's Next List of Reforms

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1.0 Why Pursue RMB Internationalization?

The timing has never been better for China to complete capital account liberalization and achieve full convertibility of the RMB. The article by People's Bank of China (PBOC) governor Zhou in 2009 heralds the start of a new push by the authority to further financial market liberalization, and the official 12th Five-year Plan made it clear: "Steadily promote market-oriented interest rate reform and improve market-based, managed and floating exchange rate system; improve management of foreign exchange reserves and gradually achieve RMB convertibility under capital account." (see "RMB Internationalization and China's Economic Transformation," November 21, 2011).

1.1 Reasons for Pursuing Full Convertibility

Indeed, there have been a number of compelling reasons for China to move ahead towards full convertibility:

- First, China has become the second largest economy in the world since 2010, and is the largest exporter and holder of foreign exchange reserves, predominantly in U.S. dollars. However, the international circulation of the RMB is still

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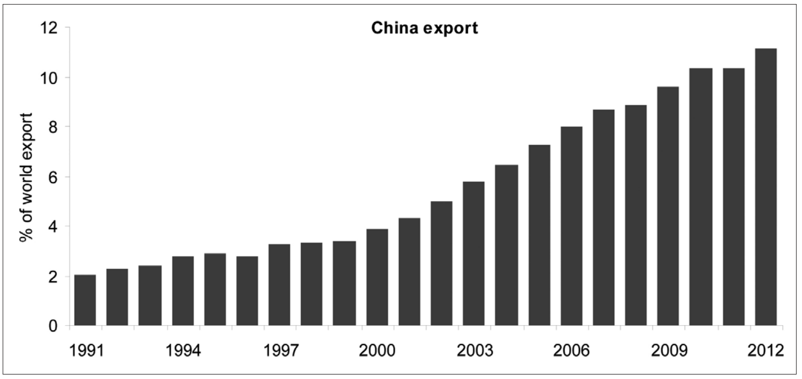
relatively limited. The currency's status is not compatible to economic fundamentals and international demand.

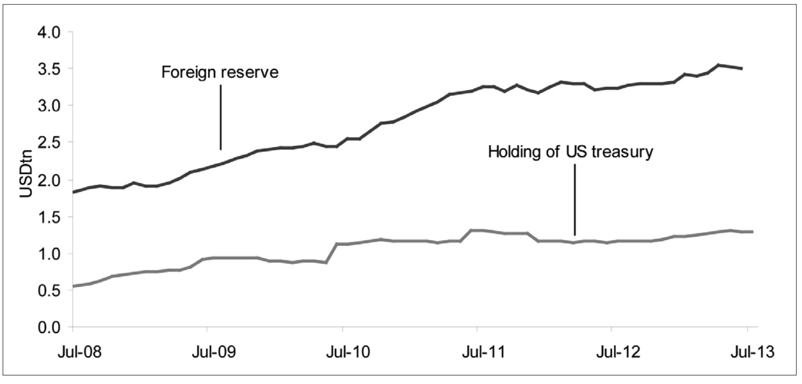
Fig 1 The share of China in world export is rising



Source: CEIC, Mizuho research

- Second, China is facing a huge foreign exchange reserve, most of which is denominated in USD. Rather than creating undue appreciation for the RMB and creating both political pressure and instability in the international monetary system in the future, the Chinese should be able to acquire foreign asset and explore foreign investment opportunities. Establishing RMB as an international currency also reduces the risk of diminishing foreign exchange (FX) reserve value due to USD depreciation in the long term.

Fig 2 China's rising foreign exchange reserve is a challenge to manage



Source: CEIC, Mizuho research

- Third, China's economy needs to go through a fundamental transformation to become more efficient, market-driven and domestic demand oriented, as Premier Li Keqiang is determined to push structural reform forward. The restriction on exchange rate, interest rate, and capital account remain totems of market distortion and it has been put at the forefront of Premier Li's reform agenda, according to the government work report released during the National People's Congress in March 2013.

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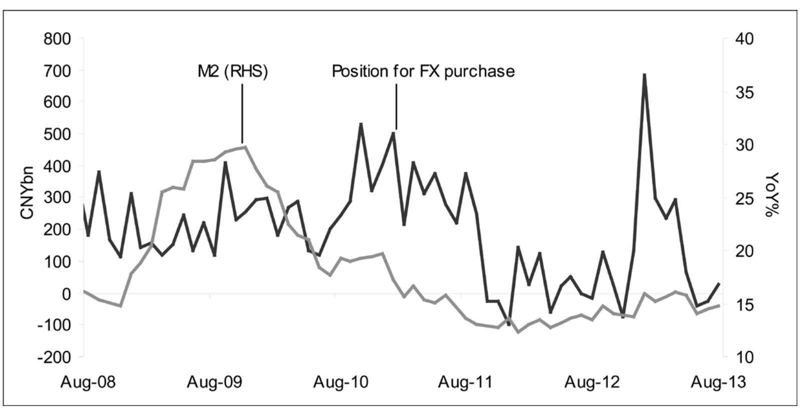
- Fourth, capital inflows that contributed to rapid monetary expansion in China and created a huge pool of foreign exchange reserves that are hard to control from PBOC's sterilization process.

Fig 3 Capital inflow contributed to strong money supply growth



Source: CEIC, Mizuho research

- Fifth, being a reserve currency that is floating brings considerable benefits, including seignior age.

Capital account liberalization and RMB circulation offshore — supported by RMB exchange rate and interest rate liberalization — are forming two pillars to achieve a global reserve currency. These two pillars are mutually supporting and reinforcing. We have already witnessed the accelerated steps of RMB's internationalization since 2010.

1.2 Gradual Progress towards Becoming a Reserve Currency

RMB's offshore circulation holds the key to the whole story through an unprecedented three step roadmap: The RMB is beginning to establish itself as a common currency for trade settlements, avoiding overreliance on U.S. dollars and spread its influence worldwide. Meanwhile, Hong Kong's unique status as RMB offshore center is providing expanding investment channels for offshore liquidity, including a return mechanism that will facilitate cross-border investment flows. The other offshore centers, including London, Taipei, and Singapore, not only expanded the franchise but also provided healthy competition.

Eventually, RMB becomes a popular currency for portfolio investments, enhancing the competitiveness of onshore financial institutions and the market itself. In the long run, along with more currency swap agreements signed between PBOC and other countries' monetary authorities, as well as the increasing exposure of RMB as an investment currency, RMB may become one of the world's major reserve currencies.

1.3 Lessons from Other Countries

Thanks to the broad similarities, China could draw a number of important lessons from Japan's experience towards capital account liberalization: First, during the 1970s, Japan faced the exact same problem that China is currently experiencing — high economic growth with capital controls, facing external pressures of opening up and letting the Japanese yen appreciate. Second, Japan adopted a "stop and go" policy in terms of liberalization and convertibility reform, very much similar to the "pilot schemes" by China. Third, it took Japan 20 years from its current account convertibility (1964) to yen's convertibility (1984). The duration was much longer than other countries, similar to China's case. However, due to the rapidly changing economic environment, we do not suggest that Japan's experience will be replicated, but rather that the experience can provide some good lessons.

In addition to Japan, we have studied four more economies: India, Chile, Mexico and Korea for their experience in attaining capital account convertibility. Korea and Mexico suffered from massive short-term capital inflows which resulted in financial crisis. But on the other hand, Chile's experience of levying short-term capital inflow tax in the form of reserve requirements could provide China with some useful lessons. These experiences have four major implications:

- First, gradualism is the key: RMB should not go towards floating immediately. Instead, a period of gradual widening of the floating range should be tested before full floating.
- Second, interest rate liberalization should not lag behind capital account liberalization, as it would cause distortion in local markets and create asset bubbles.
- Third, parallel development of onshore and offshore market at the same time will reduce the risks of opening up the capital account.
- Fourth, as certain capital account restrictions are allowed by the IMF when an economy is termed fully convertible, restrictions or levies on short-term debt flow could be used in China even when the RMB is fully convertible.

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2.0
Foreign and Domestic Trends Accelerate RMB Internationalization

2.1 The Treacherous Road towards Global Rebalancing

Since the global financial crisis in 2008, the advanced economies have been shifting the debt burden from the private sector to the public sector. As a result, the U.S. faces an aggravated "twin deficit" similar to its predicament in the 1980s. Meanwhile, despite the Federal Reserve's three rounds of quantitative easing in 2009, 2010 and 2012, the overall effect on recovery has yet to be fully reflected in the U.S. economy.

Meanwhile, a sovereign debt crisis has emerged in the Eurozone. Different from its American counterpart, the Eurozone debt crisis suffers from the difficult task of maintaining a monetary union without a fiscal one. Despite the rescue efforts on Iceland, Greece, Portugal, Ireland, Spain and Cyprus so far, a full recovery is not yet in sight. Eventually, a major structural reform is required, including establishing a financial supra-infrastructure to mend the governance disparities between member countries.

Deteriorating global economic conditions have led to three main impacts to the Chinese economy: First, slowing foreign demand cut the overall growth in Chinese exports. Exports to the EU and the U.S. have slowed significantly since 2007, and the demand from the rest of the world has been affected as part of the global production chain.

Second, the easing commodity price, as a result of downbeat global economic condition, contributed to China's PPI deflation; Third, China is the largest debt holder of the U.S.; USD-denominated asset accounted for around 70% of China's USD3.5 trillion worth of foreign exchange reserves, uncertainty in the future of USD therefore casts substantial doubt on the asset security of China's foreign exchange reserves.

2.2 Lewis Turning Point Leads to Economic Restructuring

Lewis Turning Point — the market force to raise wages and reduce income gap

The emergence of a Lewis Turning Point (LTP) indicates a market's power to reduce the income gap. Current labor shortages in China indicate that the shift of excess labor from rural areas has ended, and future wage increases, especially among manufacturing-based migrant workers, will serve as the major driver pushing income increases among low-income residents. At present, a structural imbalance has already emerged, as wages of college graduates and rural workers converge and the structural wage increases become apparent.

According to the estimates by Mr. Cai Fang, the surplus labor force in rural areas would decrease to just 5% at 24.81mn. There is, therefore, a serious shortage of surplus rural labor, especially of individuals under 30 years of age, those over 30 years of age accounting for 80% of the total surplus labor force and indicating that the rural areas have no more "young labor" to contribute.

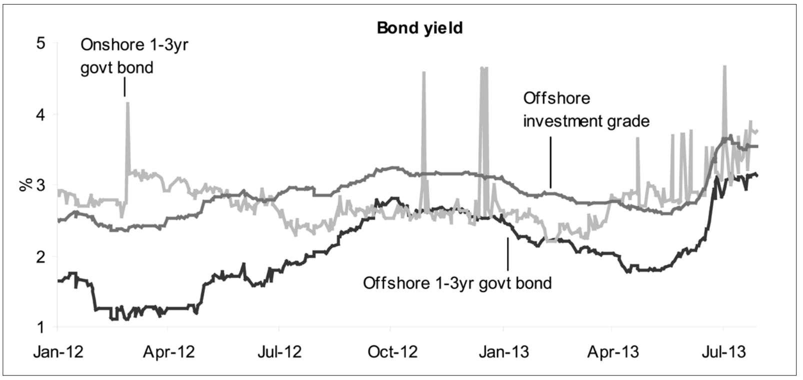
Consequences of the Lewis Turning Point (LTP) for the Chinese economy

As we argued in our report "Welcome to a new era of higher wages and flexible RMB" (June 2010), the emergence of an LTP will result in three main consequences: 1) China's current model of a significant manufacturing growth may slow down and an industrial upgrade would become crucial if Chinese industries are to be competitive. We believe a more rapid development towards high-skill and high value-added manufacturing could be a result if supply-side reforms are carried out successfully. 2) China is likely to face a "middle-income" trap, meaning that the rapid and dynamic growth would cease once cheap labor is depleted, as the labor shortage may cause a decline in the savings ratio and a reduction in the current account surplus, necessitating a transformation in China's development model. 3) There are demographic implications, in that China would likely use up its "population dividend" soon, i.e., chronic population imbalances will be pronounced between urban and rural areas, as well as between the agricultural and services sectors.

2.3 Potential Risk: Increasing Difficulty in Macro Control

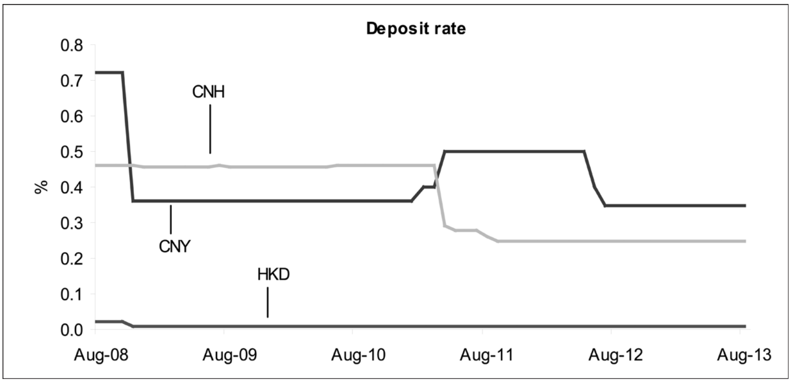
The greatest challenge that RMB internationalization poses for the Chinese government is the increasing difficulty of macro controls and the curtailed effectiveness of policy measures. Specifically, due to the increase of offshore RMB circulation and the channels for capital repatriation, RMB onshore liquidity management will become harder to monitor. As the RMB internationalization process was not completed, we find the high interest rate gap between onshore and offshore staggering. The fact that a couple of domestic enterprises could, at low cost, raise debt in Hong Kong offshore markets (in the form of dim sum bonds) created pressure on effective macro controls.

Fig 4 Gap between dim sum bond yield (BOCHK index) and onshore government bond yield



Source: Bloomberg, Mizuho research

Fig 5 Gap between Hong Kong and mainland deposit rates widening



Source: CEIC, Mizuho research

Shadow banking consolidation has begun since 1Q, creating a tightened credit environment in China. The shortage of liquidity reached its height in late June when the cost of borrowing in the interbank market spiked during a credit crunch engineered by the PBOC. That saw the difference, or spread, between some onshore and offshore lending rates rise to levels not seen since the middle of 2011.

Meanwhile, the rate of offshore borrowing by Chinese companies in Hong Kong is believed to have picked up dramatically in recent months. Total monthly lending volumes in Hong Kong — all corporate and retail loans, onshore and offshore — surged in May with 40% growth over April, and a further 20% in June. It has raised the concern from Hong Kong's authority about Hong Kong's risk tolerance.

According to the Hong Kong Monetary Authority (HKMA), the loan-to-deposit ratio in all currencies had spurted to its highest level at nearly 70% in May since early 2006, with large corporations likely leading the list of borrowers tapping funds in Hong Kong. The U.S. dollar loan-to-deposit ratio, in particular, rose by 5 ppt to 85%. The HKMA has not revealed how much of that lending was going to Chinese companies, but it has since issued a warning about U.S. dollar lending to mainland groups.

As such, as capital account opens further, the PBOC will have a harder time choosing an appropriate monetary policy at present, as it not only needs to consider domestic inflation, but also has to look at increasing offshore RMB demand.

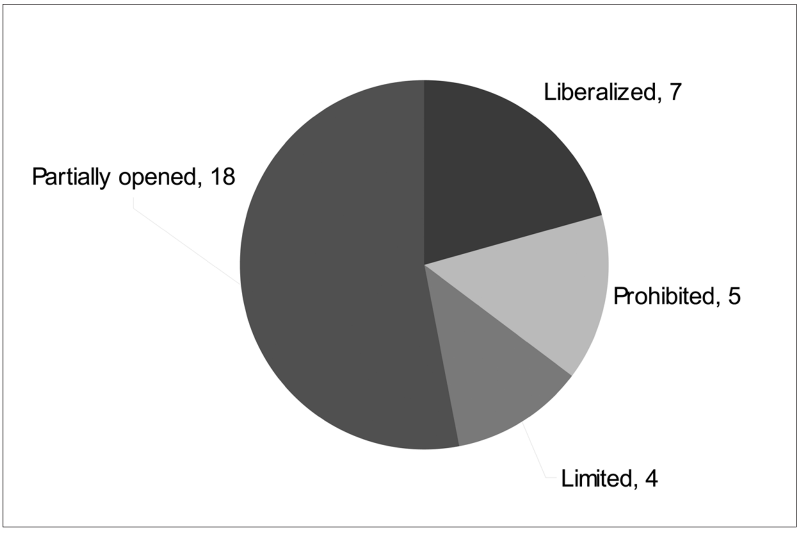
3.0
Capital Account Is Steadily Opening Up

Until the Asia financial crisis in 1997-1998, the long championed position of IMF was for countries to liberalize their capital account, to facilitate free flow of capital as a corollary to the free flow of trade. The orthodoxy was that capital controls are costly because they induce distortions to resource allocation and that they are not effective because they are easily evaded.

Despite these loopholes, however, China has weathered both the Asian financial crisis and the global financial crisis well, and it was partly attributable to the capital account's barrier to hot money flows. Moreover, the weight of the evidence seems to point to the conclusion that it is difficult to find a strong and robust causal link between capital account liberalization and economic growth. In April 2011, the IMF proposed its first guidelines for controlling flows of speculative capital, officially endorsing the prudent approach of using capital account restrictions as an appropriate management tool for short-term capital surges.

Actually, China's capital account has already become relatively convertible. Only four out of 40 items under the capital account are still non-convertible, according to the IMF. It includes derivatives and outflow of money market instruments, as well as collective investment securities. Meanwhile, 22 categories have become partially convertible, including transactions in the bond market, stock market, real estate market and personal transactions; 14 categories have become basically convertible, including credit operations, and direct investment. In comparison, over 70% of IMF members still report to have restrictions on direct investment, real estate transactions and portfolio transactions.

Fig 6 Capital account restrictions have been partially liberalized



Source: IMF, Mizuho research

3.1 Direct Investment Liberalization Almost Complete

In November 2012, China's State Administration of Foreign Exchange (SAFE) simplified the foreign exchange administration procedures for inbound and outbound direct investment, including foreign exchange registration and settlements, account opening and usage, and fund remittances. Then on 11 May 2013, further steps to streamline the process were announced, which expressly provided that foreign exchange matters of FDI activities are only subject to registration regime. After these SAFE announcements, direct investment restrictions have been essentially removed.

The foundation of the current regulatory framework for RMB-denominated outbound direct investment (ODI) by domestic institutional investors was established in January 2011, when PBOC issued the Administrative Measures for Trial Program of RMB Settlement of Overseas Direct Investment. For inbound investment, the government gave the green light to RMB-denominated direct investment by foreign investors in October 2011, when the Ministry of Commerce and the PBOC released new rules formally permitting foreign direct investment utilizing offshore RMB that had been obtained using legitimate channels. According to PBOC data, in 2012 RMB ODI totaled Chinese Yuan (onshore) CNY30.4 billion while FDI settled in RMB onshore reached CNY253.6 billion, both representing remarkable increases from CNY20.2 billion and CNY90.7billion respectively in 2011.

Then again, in July 2013 PBOC released another circular to simplify cross-border RMB procedures. It further encourages domestic banks to offer cross-border RMB trade financing services. The circular also allows domestic Chinese non-financial institutions to now apply for loans from domestic banks to be distributed to their foreign affiliates through a RMB cash pool with the stipulation that the loans are repaid in RMB.

3.2 Portfolio Investment Liberalization

While portfolio investment remains relatively restricted, three schemes controlled by quotas, Qualified Domestic Institutional Investors (QDII), Qualified Foreign Institutional Investors (QFII), and RMB Qualified Foreign Institutional Investors (RQFII) have made significant headway in recent years, and will remain at the forefront of the reform.

QDII

QDII started in April 2006, and it allows China's asset to be pooled by its professional financial institutions and converted into foreign currency, which will then be invested overseas. Its response, however, has initially been limited due to the 2008-09 global financial crisis. Since then, it has prospered with notable growth. As of June 2013, there are 112 QDII licensees that can invest up to USD85.9 billion.

QFII

In comparison, the market reception for both QFII and RQFII has been much better, on the back of China's resilient growth compared to the rest of the world. For QFII, investment is now allowed in A-shares, government treasury, convertible bonds and corporate bonds listed on stock exchanges. As of June 2013, there are 207 QFII licensees that can invest up to USD43.5 billion.

In July 2013, 229 foreign institutions had been approved by the China Securities Regulatory Commission (CSRC) to participate in the market, with total quota at USD150b, up from USD80b. The number of product issuer has also increased from around two to three new issuers per month to 22 in July 2013. CSRC is also considering relaxing the QFII approval rules, which will allow institutions to receive more than one license and provide wide selection of QFII products by asset class, thus expanding the depth of the QFII market.

RQFII

The RMB version of QFII was launched in December 2011. The initial quota, at CNY20bn, has since been expanded to CNY270 billion, underlying its popularity as the bridge that connects the offshore RMB pool with the onshore market. In Hong Kong, its licenses have been granted to 30 companies as of June 2013, with approved investment of CNY104.9 billion. Following the launch of RMB business in other offshore centers, the CSRC has also granted RQFII quota for Taipei in January 2013, and for London and Singapore in July 2013.

In March 2013, CSRC issued new rules on RQFII, significantly broadening the type of managers who qualify as RQFII and allow more variety of fund products under the scheme. Before March 2013, the only fund products permitted are RQFII ETFs which invest in China A shares with reference to an index, or RQFII funds which invest not less than 80% of the assets in fixed-income securities. Under the new rules, these restrictions have been removed so that RQFII funds are permitted to have a variety of strategies such as investing equities only. Further, RQFII funds may invest in stock index futures.

RQFLP

In October 2012, Shanghai has been authorized to become the first pilot city for a new RMB cross-border program — Qualified Foreign Limited Partner (RQFLP). It means offshore RMB can be raised and used for private equity investments in the mainland, thus creating another channel for offshore RMB to be repatriated back to China.

Unlike the RQFII program, which is only allowed to invest in the stock and debt markets, RMB raised through RQFLP can invest in unlisted companies, private equity of listed companies, convertible bonds, and sector funds which further broadens the channels for offshore RMB investments. This is also the first time for offshore RMB to be brought back for "real economy" investments.

3.3 The Next Stage in Capital Account Convertibility

Despite the substantial growth in these schemes in the past few years, QFII and RQFII only account for around 5% of the A-share market in China, according to CSRC. It provides huge potential for expanding the scale and depth of these existing schemes.

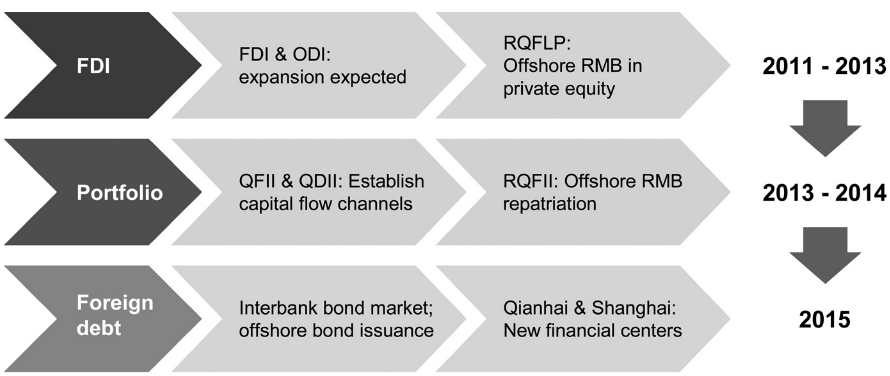
On 11 January 2013, PBOC said in its annual work conference that it will soon allow Chinese individuals to invest abroad as part of its efforts to further open up capital accounts. The trial program, termed QDII 2, will be different from the QDII as investors will be able to make direct portfolio investment rather than via qualified funds.

Similar to the through-train scheme that was abandoned in 2007, QDII 2 will likely have limits for individual investors and overall quota. The trial scheme will likely be launched first in financial reform areas such as Wenzhou in Zhejiang Province and Qianhai in Shenzhen. As global growth gradually begins to recover and investors' appetite returns to the developed market, the demand from Chinese investors is immense.

Another important step will be for foreign companies to raise RMB directly through the equity and bond markets in China. While no schedule been announced on the long expected international board, when the State Council announced on 4 July that Shanghai would become the first free-trade zone in China, it moves in line with the goal of establishing Shanghai as a financial center by 2020, and more progress will likely follow soon.

Financial deregulation that allow more porous flow of RMB across border will continue to be tested in the existing pilot zones. The first batch of RMB cross border loan for enterprises registered in Qianhai were made in January 2013. The central government has pledged to allow Qianhai companies to issue dim sum bonds directly in Hong Kong, and allow foreign companies to set up private equity funds there. If the pilot schemes are successful, further expansion in coastal cities such as Shenzhen and Tianjin will follow suit.

Fig 7 Framework and timeline for China's capital account liberalization



Source: Mizuho research

Fig 8 China's capital account status under IMF classification

Categories	Notes	Status
I. Portfolio		
i. Shares		
1.Non-resident local purchase	QFII and RQFII may enter the market under conditions such as purchase limit and holding period.	Partially opened
2.Non-resident local issuance	There are no restrictions on the issuance by a nonresident, but no nonresident has yet issued any A or B shares in China.	Partially opened
3.Resident purchase abroad	QDII may invest in overseas securities markets within certain quotas and approval from SAFE.	Partially opened
4.Resident issuance abroad	CSRC approval required.	Partially opened
ii. Bonds		
1.Non-resident local purchase	QFIIs may invest in interbank bond market, exchange-listed bonds and securities and apply to participate in new share issues, convertible bond issues, add-on equity offerings, and script issues.	Partially opened
2.Non-resident local issuance	RMB-denominated bonds may be issued by international development agencies with approval.	Partially opened
3.Resident purchase abroad	Insurance companies, securities firms, banks, and QDII were allowed, with applicable quotas and regulations applicable.	Partially opened
4.Resident issuance abroad	Application to file to NDRC with maturities in excess of one year.	Partially opened
iii. Money Market Instruments		
1.Non-resident local purchase	QFII allowed to purchase securities funds with a lock-up period.	Partially opened
2.Non-resident local issuance	Offshore RMB bond fund flourished.	Limited
3.Resident purchase abroad	Insurance companies, securities firms, banks, and QDII were allowed, with applicable quotas and regulations applicable.	Partially opened

4.Resident issuance abroad	May issue abroad money market instruments with maturities of less than one year with SAFE approval.	Partially opened
iv. Derivatives		
1.Non-resident local purchase	Prohibited.	Prohibited
2.Non-resident local issuance	Prohibited.	Prohibited
3.Resident purchase abroad	Financial institutions may purchase and sell derivative instruments with CBRC approval for: 1) to hedge inherent balance sheet risk; 2) for profit; and 3) to provide customers (including financial institutions) derivatives trading services.	Limited
4.Resident issuance abroad		Limited

II. Foreign Debt

i. Credit Operations	Under supervision of SAFE	Liberalized
ii. Commercial Credits		
1. Resident to non-resident	With SAFE approval, corporations may lend directly to associated companies.	Liberalized
2. Non-resident to resident	Financial institutions may engage in foreign borrowing for one-year or less with prior approval from SAFE. Borrowing for maturities in excess of one year is approved by NDRC.	Partially opened
iii. Financial Credits	Same as commercial credits (see above).	Partially opened
iv. Guarantees & Sureties		
1.Resident to non-resident	Subject to prior authorization by SAFE. Non-finance guarantees more relaxed.	Partially opened
2.Non-resident to resident	Enterprises that have been approved by MOC in accordance with the Foreign Investment Law may accept guarantees from foreign institutions.	Limited

III. Direct Investment		
i. Outward (ODI)	SAFE notification for both RMB-denominated and regular ODI.	Liberalized
ii. Inward (FDI)	Nonresidents may invest in China, if they are in compliance with the requirements of laws and regulations.	Liberalized
iii. Liquidation	The regulations governing direct investment apply.	Liberalized
iv. Real Estate	The regulations governing direct investment apply.	Liberalized
IV. Personal Capital Transaction		
i. Loans	Prohibited.	Prohibited
ii. Gifts & inheritances		
1.Resident to non-resident	Allowed with maximum quota imposed.	Partially opened
2.Non-resident to resident	Same as above.	Partially opened
iii. Settlement of debts abroad	Prohibited.	Prohibited
iv. Transfer of Assets		
1.Transfer abroad by emigrants	Funds allowed to emigrate in stages.	Limited
2.Transfer into the country	Prohibited.	Prohibited

Source: IMF AREAER (2011), Mizuho research

4.0
Notable Progress in Establishing RMB Offshore Markets

The most dramatic progress in RMB internationalization could be seen in the rapid development of the offshore RMB market since the CNH [Chinese Yuan (offshore in Hong Kong)] was introduced in July 2010. Due to remaining capital account restrictions, the CNY and CNH markets were essentially separated, but the CNH market has been attractive to global investors first due to its potential for appreciation then for the potential for capital gain in China, as the channels for investment improves.

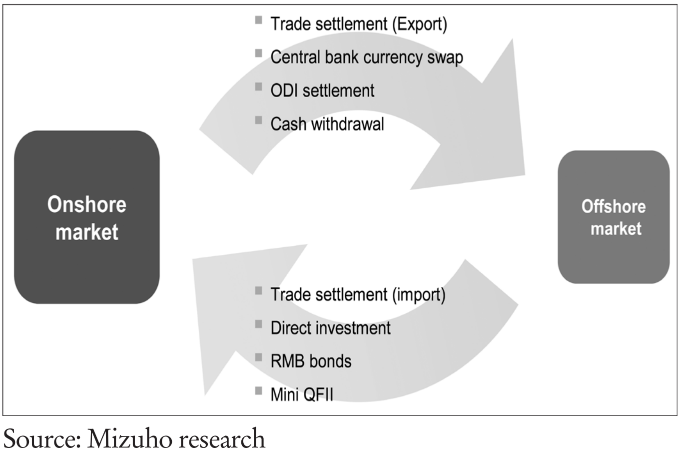
4.1 Rapid Expansion in the Offshore Market

The growing size of the offshore market is a reflection of the increase in the number of offshore RMB centers and the broadening of liquidity in these centers. As of May 2013, there are nearly CNY1 trillion of offshore RMB in circulation. Hong Kong, the largest center, accounts for around 70% of it at CNY698.5 billion, compared to CNY63 billion at the beginning of 2010. Meanwhile, Singapore and Taiwan respectively holds CNY100 billion and CNY66 billion in RMB deposits. London and Macau also witnessed a rapid build up in RMB deposits.

In fact, daily trading volume of offshore RMB in Hong Kong exceeded the volume of HK dollar for the first time in May. At CNY390 billion per day, the HKMA expects RMB trading volume to rise further, as the size of it exceeds 10% of Hong Kong's total deposit in 2013, from less than 1% in mid-2010.

According to Society for Worldwide Interbank Financial Telecommunication (SWIFT), RMB climbed to No.11 for transaction in the global payment system with 0.87% market share in June. Moving up from No. 20 in January 2012, RMB's market share has increased more than three folds in the past two years while other Asian currencies have stayed flat, according to SWIFT.

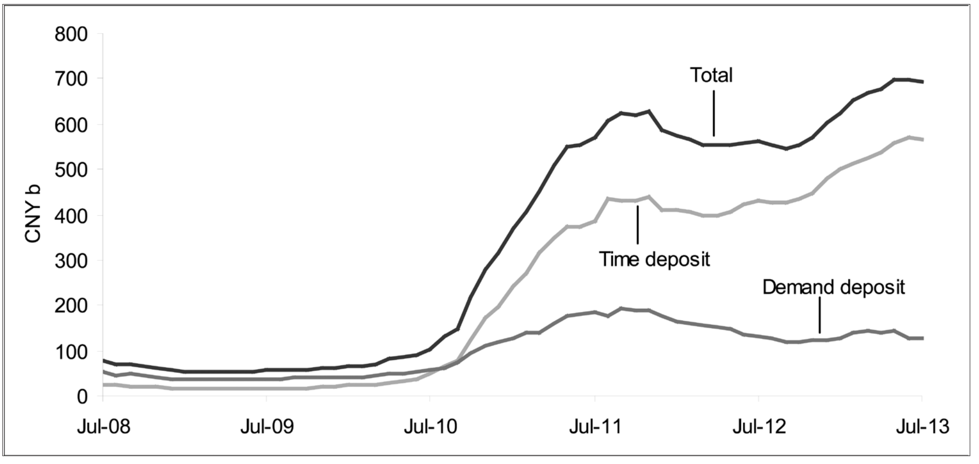
Fig 9 Interaction between RMB onshore and offshore market



Source: Mizuho research

In addition, as of the fourth quarter for 2012, more than 12 per cent of China's total trade in goods and services was settled in RMB, up from less than 8 per cent a year before. According to a survey conducted by the Bank of China in May, 61% of foreign companies said they plan to either start using RMB or broaden usage of the currency in settling cross-border trade, up from 54% in 2012. The survey also found that more than half the respondents expect the proportion of RMB settlement in China's external trade to rise to 20-30% in five years, up from 11% at the end of May 2013. As such, the size of offshore RMB in circulation can be expected to expand significantly.

Fig 10 Hong Kong RMB deposits surged since 2010



Source: HKMA, Mizuho research

4.2 Expanding Range of CNH Products

The expansion of the market also came with a wider range of products: The CNH bond market has grown substantially in line with a more diversified investor and issuer base. The size of outstanding CNH debt (including bonds and CDs) rose from CNY69 billion in 2011 to more than CNY450 billion by the end of first quarter of 2013. Also, the secondary trading of CNH credit has also picked up thanks to the steady growth in new issues. More international issuers have raised funds in this market due to strong interest.

Besides the sharp increase in spot and forwards traded on CNH, there have also been significant developments in the options market. Since the first over-the-counter CNH option was traded in November 2010, the daily turnover has reached USD3 billion. This is three times the volume of the NDF option markets, which was non-deliverable offshore option of RMB before CNH was established. In addition, the CNH market also offers a wide range of other products, including investment funds, equity and equity related products, in addition to other structured products.

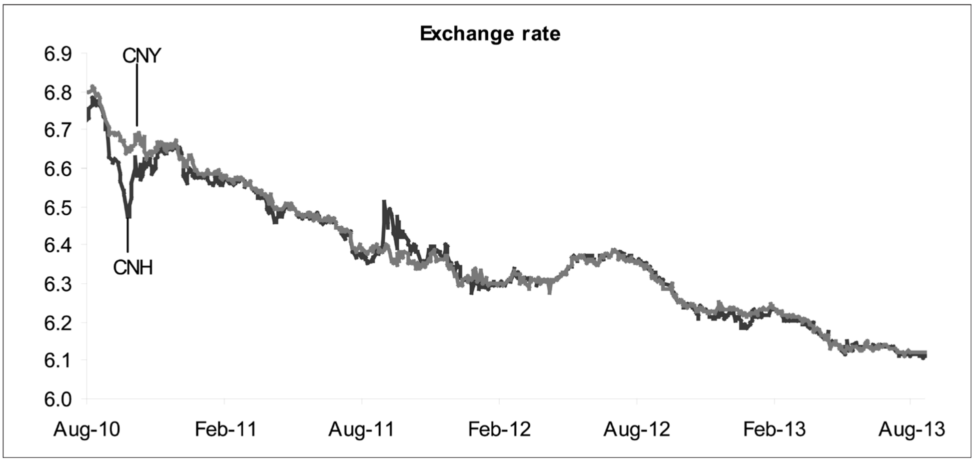
In order to facilitate the development of CNH financial products, and expand its lead as the main offshore RMB center, Hong Kong announced in June 2013 the launch of an interbank reference rate for the CNH market. According to the Hong Kong Monetary Authority, the move is expected to help address a lack of hedging options that have restrained enthusiasm for holding the CNH. So far, market players have resorted to using imperfect derivatives to hedge their interest rate risk such as currency swaps.

4.3 Efficiency in the CNH Market Improved

As the depth of the CNH market increased, the efficiency of the market also improved. It is seen from the convergence between the onshore and offshore RMB curves. When it was first launched, the CNH market was visibly more volatile than CNY and large gaps existed. While there is no official intervention in the CNH market, it has a separate set of demand and supply condition from the onshore CNY.

Nevertheless, as the channels between onshore and offshore market, such as RQFII and RQFLP, widened, the gap between CNH and CNY has shrunk considerably in the past year. The HKMA's gradual deregulation of financial institutions' net open position and its RMB liquidity facilities were also important drivers to alleviate CNH volatility.

Fig 11 Disparities between CNH and CNY have narrowed



Source: Bloomberg, Mizuho research

4.4 The List of Offshore RMB Center Expands

While most offshore RMB transactions are settled in Hong Kong, the government has extended the scope of China's offshore market by broadening its geographic base well beyond it. Since July 2012, around 4% of RMB trade has been conducted in London and in Singapore. Both Singapore and Taipei now have a Chinese commercial bank acting as a clearer for RMB transactions.

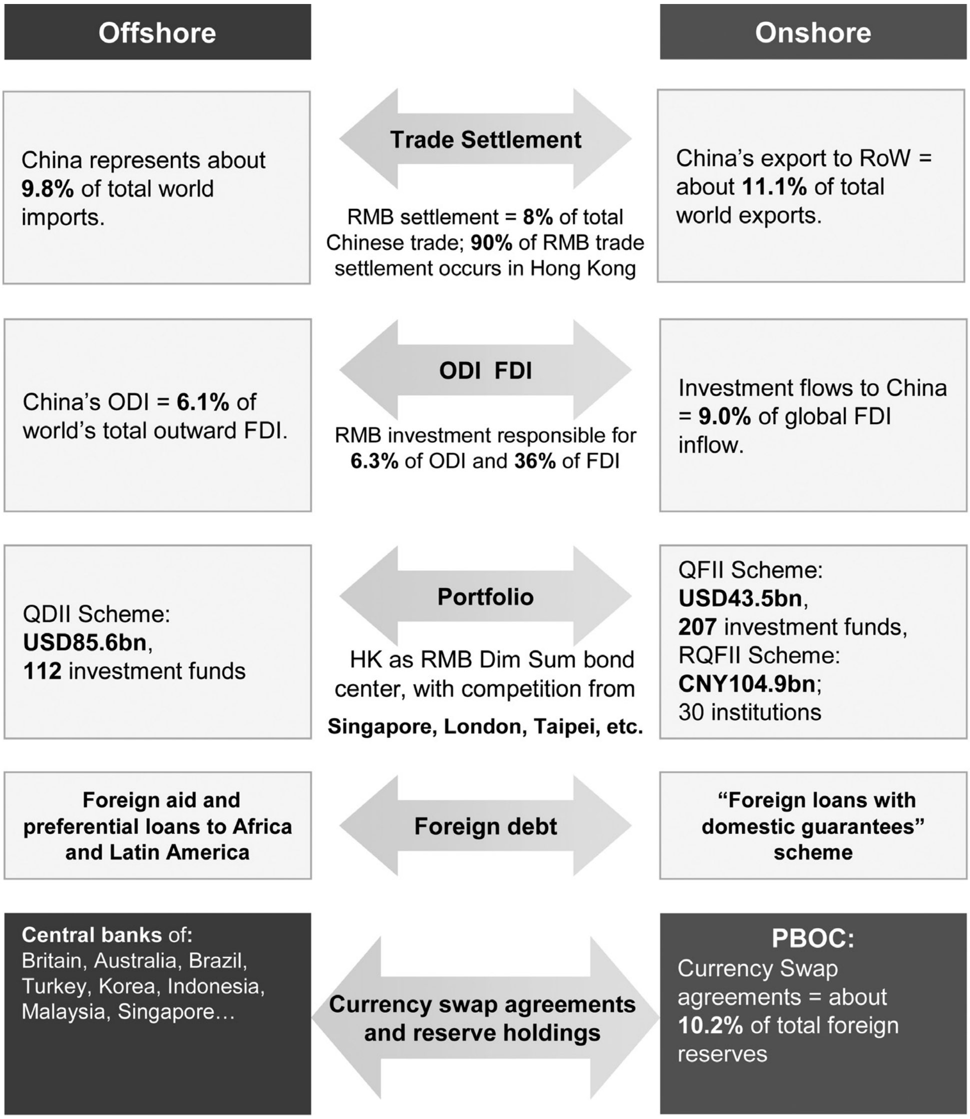
Over the medium term, we expect other locations with strong trade and investment relationship with China to become offshore RMB centers. The central banks in many countries have already signed bilateral FX swap agreements with the PBOC. While Hong Kong will likely remain the dominant center for the time being, given its head start and the concentration of offshore entities of mainland companies, other centers will gradually form a worldwide network of offshore RMB trading.

Fig 12 Currency swap agreements signed with other monetary authorities

Country	Size (CNY b)	Date
Britain	200	22 Jun 2013
Brazil	190	26 Mar 2013
Singapore	300	07 Mar 2013
Ukraine	15	26 Jun 2012
Australia	200	22 Mar 2012
Mongolia	10	20 Mar 2012
Turkey	10	21 Feb 2012
Malaysia	180	08 Feb 2012
UAE	35	17 Jan 2012
Pakistan	10	23 Dec 2011
Thailand	70	22 Dec 2011
Hong Kong	400	22 Nov 2011
Korea	360	26 Oct 2011
Kazakstan	7	13 Jun 2011
Uzbekistan	0.7	19 Apr 2011
New Zealand	25	18 Apr 2011
Iceland	3.5	09 Jun 2010
Argentina	70	02 Apr 2009
Indonesia	100	23 Mar 2009
Belarus	20	11 Mar 2009

Source: PBOC, Mizuho research

Fig 13 Interaction between RMB onshore and offshore market



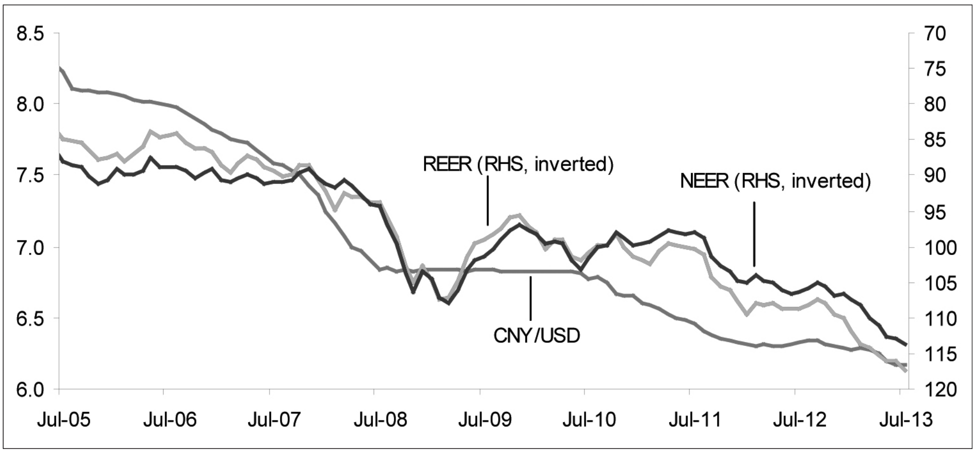
Source: Mizuho research

5.0
Moving Towards a Floating Exchange Rate

5.1 Increased Two Ways Fluctuation

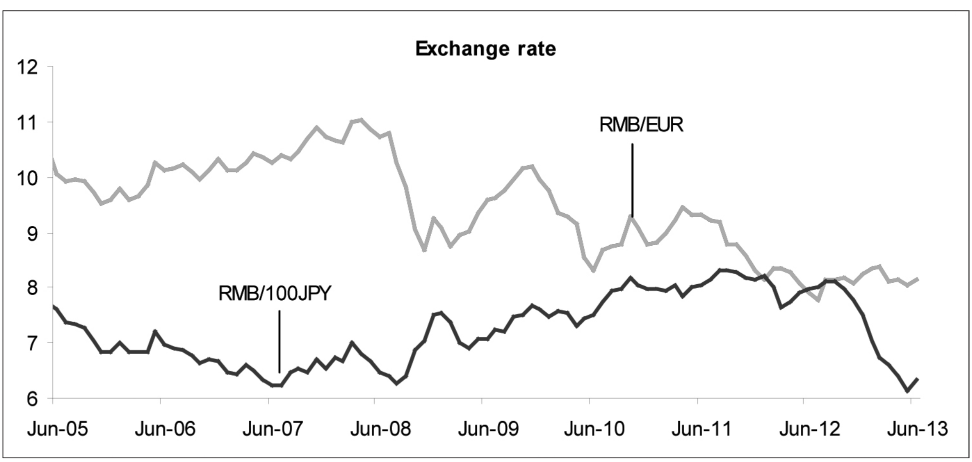
Before July 2005, China's exchange rate was determined by the China Foreign Exchange Trading Center, and it was pegged to the U.S. dollar at CNY8.28 per USD. Thereafter, it was under mostly one-sided appreciation, except the period between July 2008 and June 2010 when CNY was re-pegged temporarily to the USD during the most volatile period of the global financial crisis. As of June 2013, the RMB has cumulatively appreciated by 25.9% against the USD. In terms of real effective exchange rate（REER）and Nominal effective exchange rate (NEER） the CNY appreciated by 36.9% and 28.1% respectively. Against the EUR and JPY, the RMB also appreciated by 13.8% and 17.9%.

Fig 14 RMB has appreciated by 25.9% against the USD cumulatively



Source: CEIC, Mizuho research

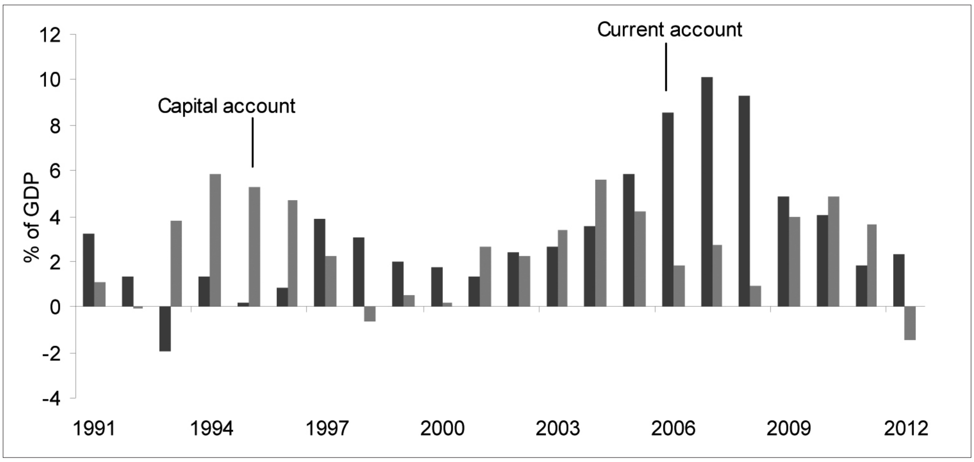
Fig 15 RMB has also appreciated notably against EUR and JPY



Source: CEIC, Mizuho research

After the end of the peg in 2010, the flexibility of the RMB has significantly increased. Since January 2012, the one-sided appreciation of the CNY has given way to two-sided fluctuation, suggesting that the CNY is no longer perceived as over-valued by the market. As a proof to the change, China's current account surplus has narrowed to 2.3% of GDP in 2012 from 10.1% of GDP at its peak in 2007. Capital account deficit in 2012, at 1.4% of GDP, has become the largest on record.

Fig 16 Both current and capital account surplus have declined



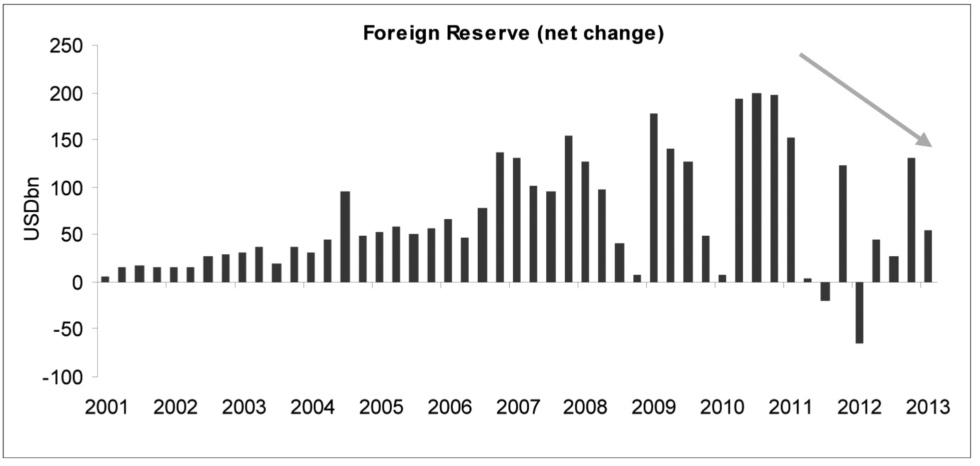
Source: CEIC, Mizuho research

Meanwhile, the trading band of the CNY expanded to 1% from the previous 0.5% in April 2012, confirming that the authorities are confident that the RMB equilibrium has been reached, and it is time to push for more flexible exchange rate. Also, since 2012 banks are allowed to hold negative positions in settlement and sales of foreign exchange, in order to promote price discovery of the RMB exchange rate. In April 2013, Yi Gang, deputy governor of the PBOC, remarked that China is ready to widen RMB's trading band further, thus allowing the market to fully determine the exchange rate.

5.2 Government Taking a More Backstage Role

China's FX reserve data showed that PBOC has intervened less in the FX market, allowing exchange rate to become more market-driven. Before the global financial crisis, the PBOC used to purchase large amounts of U.S. dollars to stabilise the RMB exchange rate. In 2012, foreign exchange reserve increased by USD130.4 billion, the least since 2003. Instead, the PBOC now only intervenes during periods of excessive uncertainty. The way the PBOC manages the market now is to set the mid-price daily, which the market takes as its starting point for that day's trading. The PBOC's new strategy helps to free up the bank and increase the autonomy of China's monetary policy. As a result, the onshore CNY forward curve is now more accurately reflecting interest rate differentials.

Fig 17 Government has taken a more backstage role in RMB intervention



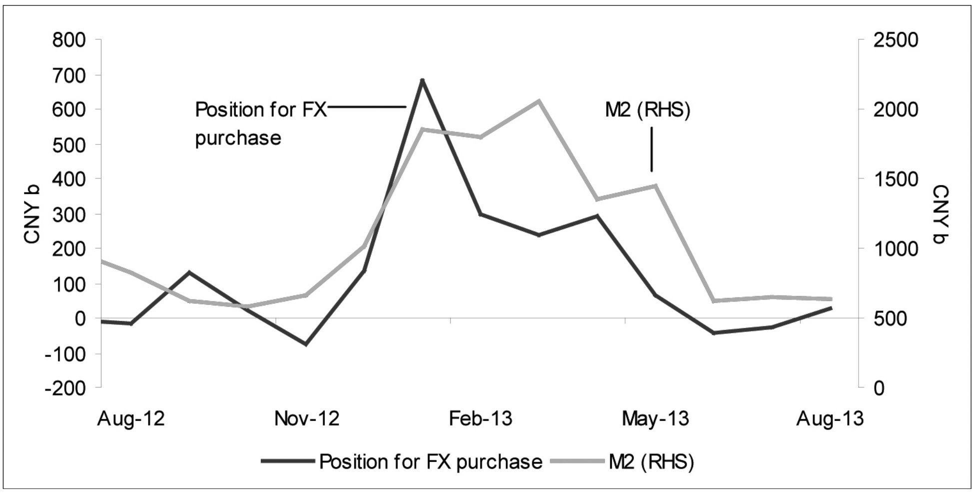
Source: CEIC, Mizuho research

In fact, we maintain that while other economies have manipulated their currencies to boost exports, China's policymakers should also keep its exchange rate from appreciating further to defend its competitiveness. The low cost advantage of Chinese exports has been declining due to rising production cost, deteriorating terms of trade, increasing awareness in environment protection and endless trade disputes (see "China's exports at a crossroad" 10 May 2012). As such, we maintain that the RMB will likely stay at 6.15/USD by the end of 2013.

5.3 Facing the Challenge When QE Tapering Begins

As the market expects Quantitative Easing in the U.S. to taper off towards the end of 2013, it has caused investors to withdraw money from emerging markets, stoking volatility in currency market. As a result, FX purchase position fell by a net CNY41.2 billion in June. It was also accompanied by reduced pressure for RMB appreciation since May, and a sharp drop in money supply growth to 14.0% year-on-year change (YoY) in June. The repatriation of capital from emerging markets back to the U.S. has sparked off the market's concern for global slowdown, at which China is no exception.

Fig 18 QE tapering could potentially lead to financial instability in China, but the risk is low



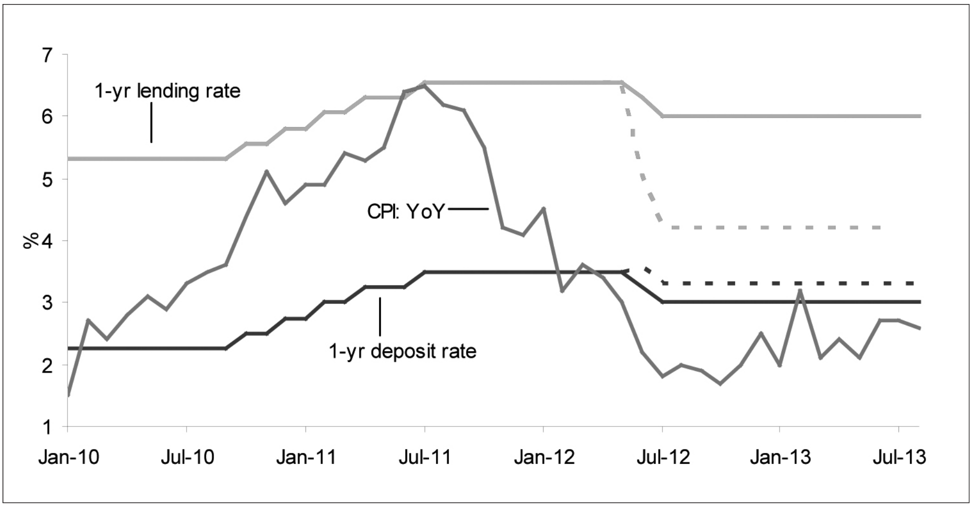
Source: CEIC, Mizuho research

In our view, the main factor remains in China's domestic condition: First, the recovery in U.S. remains gradual, and the situation in EU is still less than optimistic. As such, the pace of capital repatriation will be controllable in the coming months; Second, as Yi Gang, deputy governor of the PBOC remarked in 11 July, China is fully prepared to take on the challenge with its abundant liquidity and high reserve requirements; Third, the main trigger for capital outflow is still China's domestic condition. The turning point in policy has already emerged, as the government has announced an expanding list of targeted easing measures (see "Timely policy easing to meet 7.5% growth target," 26 July 2013). We expect the government will be able to fight hard-landing risk, and keep full-year growth on target at 7.5% YoY in 2013.

6.0
Deposit Rate Is the Last Step Before Total Interest Rate Liberalization

The PBOC announced the removal of lending rate floor on 19 July. It is a significant progress towards RMB internationalization. By removing the lower bound, borrowers have more incentive to improve their credit profile in order to obtain lower cost of capital. It will also be conducive to further development of the credit rating system in China. The lending rate liberalization also applies to interest rate charged for discounting bills, a form of short-term collateralized borrowing, allowing banks full control in evaluating and assessing the appropriate level of risk premium.

Fig 19 Lending rate floor restriction has been removed



Source: CEIC, Mizuho research

6.1 Removing Deposit Rate Ceiling Completes China's Interest Rate Liberalization

After the lending rate, removing the ceiling of deposit rates would be the next and final step towards China's interest rate liberalization, according to Wu Xiaoling, former PBOC vice-governor who was in charge of the issue. The removal of lending rate floor, as the window below benchmark was never fully exploited before, is expected to produce relatively little impact on the actual cost of lending. In comparison, the removal of the deposit ceiling is expected to lead to significantly higher deposit rates as smaller lenders compete for deposit. The profit squeeze could potentially threaten the survival of smaller lenders.

The liberalization of deposit rate, therefore, calls for the protection of a deposit insurance system to protect depositors. According to PBOC's 2013 financial stability report, the system is ready to be launched before the end of 2013. The liberalization will likely be broken down into small steps: Interest rate for large and long-term deposit, such as large certificates of deposit, may be relaxed first. We also expect the ceiling of the deposit rate will be upped to 20% above the benchmark from the current 10% first, before complete restriction removals become a reality.

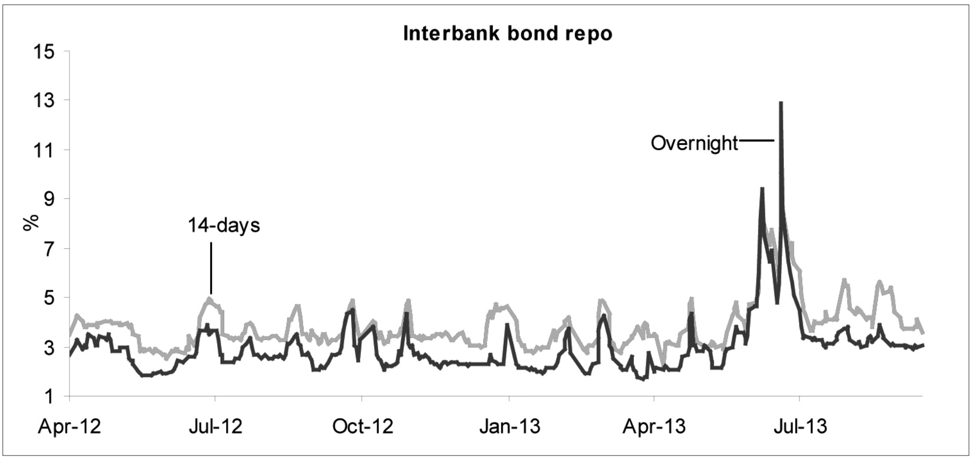
6.2 Shadow Banking Is a Response to Interest Rate Distortion

There is a view in the market that the government should not remove the ceiling on bank deposit rates in the next two years, as banks will need more self-restraint to prevent risks to the financial system. However, we maintain that the market distortion created by interest rate restrictions is a main cause for the shadow banking in China. Complete liberalization should come as soon as the deposit insurance system is ready.

Fundamentally, shadow banking exists as deposit rate, fixed by the government and below the equilibrium rate, kept depositors away from the banking system. As a result, depositors and borrowers who are willing to pay high interest rate are connected by off-balance sheet instruments that help eliminate the shortage of loans. As such, shadow banking is actually financial innovations to bypass the market's inefficiency (see "Urbanization to lead growth in the medium term — Takeaways from Mizuho macro day," 18 March 2013), but the lack of transparency and regulation has led to significant risk in China's outlook.

The interbank market's liquidity squeeze in June was engineered by the PBOC, in order to temporarily tighten the screw on the shadow banking system, and teach the banking sector a lesson against their mismatch between short-term liabilities and long-term assets in wealth management products. It shows that policymakers are no longer willing to tolerate the expansion of shadow banking risk.

Fig 20 Share of non-bank loan financing declined in 2Q amid consolidation

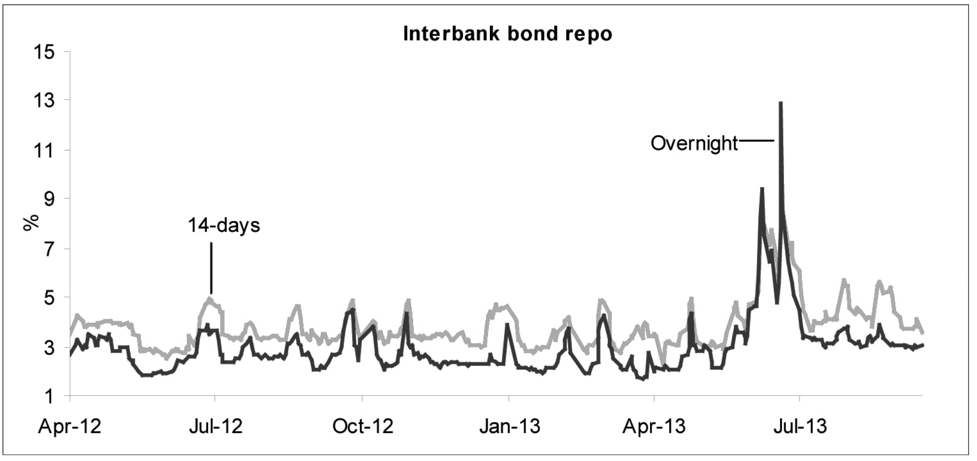


Source: CEIC, Mizuho research

6.3 Identifying a New Market-driven Benchmark Rate

Following the liberalization of interest rate from a controlled to a market-driven system, a new benchmark interest rate is needed: A liberalized and market-based interest rate system means the current policy deposit and lending rates will broaden to cover wide variations. Instead, the government should shift to focus on using a market-driven interest rate as its new benchmark, a practice prescribed by the IMF in it's 2013 Article IV consultation (see "IMF projection on Chinese growth still too optimistic," 19 July 2013).

Fig 21 The government will need to identify a market-based policy target



Source: CEIC, Mizuho research

Specifically, we believe the PBOC's repo and reverse repo rates are likely candidates. The market-based policy rate needs to be able to guide banks' funding costs in the interbank market, and the rate changes can have a broad-based impact on the overall interest rate level in the economy.

In order to achieve a market-based interest rate system, the central bank's policy rate needs to be able to guide banks' funding costs via interbank rates, so that the impact of rate changes filters through more broadly and eventually affects overall interest rate levels in the economy. Since June 2012, the PBOC has conducted regular repo and reversed repo auction on Tuesday and Thursday.

Since January 2013, the PBOC has started the Short-term Liquidity Operations (SLO) program to allow daily bids by 12 primary dealers for its reverse repo. In our view, these are steps to establishing a steady operational regime, as part of gradual process to establish these as the new benchmarks.

7.0 En route to RMB Convertibility and Internationalisation

The removal of lending rate floor on 19 July marked a significant progress towards interest rate liberalization. We maintain it is a precursor to the removal of deposit rate ceiling, which will take place after the deposit insurance system is launched before the end of 2013. At that point, interest rate liberalization will be completed.

> The Chinese economy will go through structural reforms in the coming years to become more market-driven.

Since Premier Li took office in March, he has remarked in March that the Chinese economy will go through structural reforms in the coming years to become more market-driven. His approach to reform, termed "Likonomics" (in Chinese: "李克强经济学") by the media, is essentially 1) liberalising key prices, including interest and exchange rates; 2) eliminating red tape and entry barriers; and 3) deepening reforms. In particular, he mentioned that financial reform will be pushed forward in the near future. We maintain that China's financial reform, including RMB internationalization, is at the forefront of China's structural reforms.

In fact, RMB internationalization has made outstanding progress since 2010. I was among the first in the market to outline the RMB's roadmap towards full convertibility, and identify the four pillars for CNY internationalization: interest rate liberalization, exchange rate flexibility, off-shore RMB development and capital account liberalization. So far, the achievements are broadly in line with our expectations.

In the next two-three years, I expect the internationalization process to tread into deep water zone, and it will be a test on policymakers' determination. Nevertheless, the 12th Five-Year Plan has emphasized making RMB a regional or global settlement currency as one of its stated goals. As such, we are confident that basic RMB convertibility will be achieved by 2015, paving the way for it to become one of the global reserve currency in 2020.

In conclusion, we believe the time for RMB to become an international currency has come. In fact, the notable achievements have drawn the goal of RMB convertibility much closer since we first explored the topic in 2011. Going forward, the main frontier for liberalization will be on increasing portfolio investment flows across border, further development of off-shore RMB markets and products, and deposit rate liberalization. We maintain that by 2015, RMB will have achieved basic convertibility. It will be the foundation for RMB to become a global reserve currency by 2020.

Interest rate liberalization can not delay any longer. We argued in "RMB's roadmap towards full convertibility" (7 April 2011) that the four pillars of internationalization: CNY exchange rate flexibility, interest rate liberalization, capital account convertibility and offshore RMB market development must go hand in hand. As evident from shadow banking problem, financial market innovation has taken advantage of the inefficiencies caused by interest rate distortion. It is important therefore to remove the restrictions as soon as possible to deflate the economy's bubbles, and return China to sustainable growth path.

The process is not without risks: QE tapers may lead to capital outflow in the emerging market. It will be a test for the authority's determination and ability to stabilize the economy as external environment deteriorates. Nevertheless, we maintain that the risk of dramatic sell-off in China is low, because 1) the pace of capital repatriation will be controllable; 2) China is fully prepared with abundant liquidity and high reserve requirements; and 3) We maintain that the government will be able to fight hard-landing risk, and keep full-year growth on target at 7.5%YoY in 2013.

Lastly, as we argued in "Will China fall into a liquidity trap?" (11 June 2013), structural reforms are critical for the sustainable development in the medium term and RMB internationalization has a key role in it. More so than other reforms, such as urbanization and fiscal reform that may face significant upheaval from vested interest, China's financial reform is ready to proceed. It will lay the foundation for sustainable growth in China at around 7% over the next five-to-ten years.