Global Research

RMB mid-year performance check

The currency has undergone dramatic change this year, reflecting China’s growth outlook and reform agenda

We answer key questions on FX flows, valuation, policy and reforms

Much has changed for the RMB this year. It started off strong, but then policy-induced volatility saw some depreciation pressure. However, the RMB internationalisation process has stayed intact. If anything, less speculative pressure surrounding the RMB has led to a greater willingness by policymakers to introduce reforms.

In H2 and into 2015, the RMB will remain influenced, sometimes in different directions, by China’s growth outlook, measures to make the currency more market determined, and ongoing interest rate liberalisation. The RMB story will continue to evolve rapidly.

Here, we update our RMB Q&A report – designed to keep readers up to speed with the RMB’s changing story – answering key questions regarding the currency, including:

- What is the outlook for the RMB in H2? Why has spot RMB stabilised and why have the forward points been elevated?
- Why have CNH funding rates followed onshore rates higher? Have onshore-offshore linkages increased?
- What are the flows driving the RMB, and is there a seasonal pattern in these flows?
- Does RMB weakness conflict with internationalisation?
- Is the RMB still undervalued?
- How will the shift in the Fed’s policies impact the RMB?
- What RMB reforms have been announced lately, and what should we expect to see next?

Links to a number of our key related research notes can be found at the back of this report.
In this report, we use RMB (renminbi) to refer to the Chinese currency, CNY for the RMB exchange rate in onshore markets and CNH for the deliverable RMB exchange rate offshore.

Q1. What is the H2 outlook for the RMB after its weakness earlier this year?

The RMB started recovering in June but remains an underperformer year-to-date. The onshore CNY and offshore CNH ranked 138nd and 109th out of 176 currencies in their performance versus the USD y-t-d, as tracked by Bloomberg (Chart 1). We believe the RMB will strengthen moderately versus the USD in H2 (to 6.14 by year-end), due to stabilizing growth and supportive trade flows. However, the recovery could be initially tempered by capital account outflows that started in Q2. We also expect the currency to trade with greater volatility amid capital account liberalisation, and an upcoming shift in the US interest rate outlook (as we discuss in Question 7).

Growth has stabilised and interest rates have bottomed out

Spot RMB has steadied since mid-June, in line with China’s stabilising growth and inflation conditions (Chart 2). This confirms our thinking that the change in FX policy earlier this year was not specifically aimed at trying to weaken the CNY to support growth. China still has many other policy tools and CNY depreciation is only going to be the last resort.

Meanwhile, the RMB’s interest rate differential versus the USD, EUR, GBP and JPY remains supportive. Credit and M2 growth have rebounded from March’s low, which reduced expectations of an immediate cut to China’s RRR.

Current account surplus narrowing but still supportive

Exports and imports have also rebounded since May (Chart 3). China’s Ministry of Commerce is
cautiously optimistic about H2 exports and it expects imports to lag due to weak commodity prices. The trade surplus in H1 was USD103bn, only slightly lower than last year’s USD108bn. Considering that China’s trade surplus tends to be back-loaded, the trade balance should be more supportive of the RMB in H2.

But the broader trend is for a narrower current account surplus. Indeed, China’s current account surplus has thinned to 1.5% of GDP in Q1, the lowest since 2002. This is because the non-goods trade accounts have registered bigger deficits (Chart 4). China’s services’ deficit continues to widen on increased tourism spending overseas. It rose to USD59bn in first H1, the widest H1 number historically. The income account is in deficit as China pays more dividends on FDI than the income received from investing its FX reserves.

Capital account outflows have started
China’s Q2 FX reserves rose by USD40bn, significantly less than the USD130bn increase in Q1. This happened even though the trade balance has rebounded, and the direct investment surplus was stable, and thus suggests that a sizeable amount of hot money inflows seen in Q1 has now reversed (Chart 5).

Hot money outflows will likely continue for now, given the size of such inflows registered in previous quarters. The heavy hot money inflows seen earlier largely reflected exporters front-loading their FX selling needs, while importers have been under-hedged. Importers will now have to cover their short USD positions.

We come to this conclusion from observing the large divergence between the State Administration of Foreign Exchange’s (SAFE) monthly banks’ FX settlement for clients and the underlying trade balance data (Chart 6). While some of the difference could be caused by a statistical difference between FX flows and customs trade, the degree of the divergence nevertheless suggests there are still sizeable short FX positions that may need to be covered. This should temper the RMB’s recovery and keep the forward curve...
We should also be able to see these corporate hedging activities in the "other investment" account in China’s BoP. The Q2 BoP data has yet to be released but we can already obtain an indication from the FX deposits and loans in the onshore banking statistics. Indeed, in Q2, FX deposits in the banking system increased by USD86bn, whereas FX loans only grew by USD6bn, suggesting the private sector has reduced their net FX liabilities by USD80bn (Chart 7).

Q2. Spot has stabilised, but why are RMB forward points still elevated?

Although spot RMB has stabilised, USD-RMB forward points have stayed elevated. As we mentioned in our answer to Q1, we expect this situation to persist in the near term while importers cover their short FX positions by buying USD-RMB forwards. Indeed, the correlation between forward points and hot money flows is strong in China (Chart 8).

The fact that forward points no longer track spot and FX expectations as closely as before should not be surprising – RMB FX forward curves are reflecting interest rate parity conditions better as China’s capital account is gradually opening up.

What drives the RMB forward curves?

As we explained in a previous RMB Q&A, the RMB forward curves (especially the NDF curve) used to be driven largely by FX appreciation expectations. But as China’s capital account gradually opens up, stronger links have emerged between onshore interest rates and onshore FX curves, and increasing cross-border FX flows have also led the offshore FX curves to better track onshore curves (see Question 3 for more detail).

Indeed, the seasonal pattern of onshore interest rates is transmitting to RMB FX forward points. RMB liquidity conditions can be volatile, affected by seasonality in FX inflows and fiscal deposits, and due to banking regulations. The Lunar New Year and June periods tend to see...
tighter funding conditions and hence higher FX forward points (Chart 9).

But these linkages are still developing. The relationship between interest rates and FX still, on occasions, breaks down. For instance, in H2 2013 China’s interest rates rose sharply (stronger growth and interest rate liberalisation), yet onshore FX forwards kept declining. Without a fully open capital account, banks are the only financial institutions active in the FX swap market, and their ability to arbitrage the interest rate and FX forward markets is limited.

The periodical breakdown of covered interest rate parity can also be seen in the significant deviation between onshore and offshore USD funding rates. When RMB appreciation expectations are strong, the onshore private sector tends to borrow more in foreign currencies to finance their trade but hold fewer USD deposits to avoid the exchange losses. This will drive up onshore FX loan-to-deposit ratio and hence onshore USD funding costs. FX policy that tends to be more interventionist (on the buy USD side) aggravates the situation. The reverse occurs when RMB appreciation expectations ease, as we have seen recently (Chart 10). The current easing of USD funding conditions has helped FX forwards to normalise from depressed levels.

Q3. Why have CNH funding rates risen?

The offshore RMB liquidity pool has risen rapidly, to more than RMB1.5 trillion, as measured by global CNH deposits. RMB trade settlement is the biggest generator for offshore RMB liquidity, as imports settled in RMB exceed exports. In Q1, there were RMB315bn of trade-settlement outflows from China. RMB-denominated FDI and RMB QFII repatriated some of this offshore liquidity, but the size of these offsetting flows remains small (Chart 11).

Despite this increase in liquidity pool, offshore RMB funding rates have risen, mirroring the situation onshore (Chart 12). We offer a few explanations for higher rates:
Stronger onshore-offshore linkages

1) As more Chinese corporates go abroad, their larger presence in the offshore market has resulted in a stronger capability to close the onshore-offshore price differential, in both the spot and forward markets. Easing RMB appreciation expectations have led to these corporates adopting similar buy FX forward and/or pay CCS activities in both the onshore and offshore markets.

2) Rising participation of banks (especially the Chinese banks) in the offshore RMB market has resulted in a greater volume of funding activities that can better link onshore and offshore interest rates. Issuance of banks’ CDs totalled RMB236bn in H1 (Chart 13). The proceeds can be used for lending, trade financing and investments. Some banks can even repatriate the funds onshore under related cross-border schemes. Most of the CDs are offered at rates around 2.8% in recent years, which serve as a floor for offshore RMB interest rates.

3) The recent relaxation of inter-company loans and the cross-border guarantee programme, as well as developments in the free-trade zones on the mainland (see Question 9) are likely to lead to stronger demand for offshore borrowing and result in a smaller onshore-offshore interest rate differential.

4) Offshore financial institutions were recently allowed to deploy funds more efficiently onshore and offshore. Under the PBoC’s new regulation (notice 168) introduced in July 2013, offshore financial institutions can now transfer RMB funds between their onshore and offshore RMB nostro accounts or between two onshore RMB nostro accounts for settlement purposes, including transactions for the need of funding arrangements. Previously, offshore financial institutions could only transfer funds between their onshore and offshore RMB nostro accounts for trade settlement purposes.

Q4. Is there any seasonality in China’s FX flows?

There is a degree of seasonality behind the underlying FX flows that move the RMB. SAFE’s reported monthly banks’ FX settlement for clients offer insight into such seasonal patterns. Monthly FX inflows tend to be strong in Q1, and to a lesser extent Q4; inflows are at their weakest in Q2 (Chart 14).

In the past, when the RMB delivered steady appreciation through the year, corporates (mainly exporters) naturally chose Q1 to sell FX forwards
in order to minimise the loss from potential RMB appreciation. Q4 also tends to see greater FX supply from exporters as their proceeds increase ahead of the western holiday period.

Meanwhile, weak Q2 inflows are driven by China’s income and service accounts (Chart 15). This reflects corporates’ dividend pay-outs (in June and December in China) as well as locals buying USD before travelling overseas during school holidays (July and August). The change in FX flows (strong in Q1/weak in Q2) was more obvious this year, due to the change in RMB appreciation expectations.

Q5. Does RMB weakness conflict with RMB internationalisation?

Rather than steady appreciation, we believe two key features of a reserve currency are actually macroeconomic stability – a low risk of hyper-inflation or deflation – and a certain degree of FX flexibility – symptomatic of a deep and liquid currency market.

The Chinese economy is remarkably stable, due to vigilant policy fine-tuning. However, RMB volatility is too low. The currency’s carry to volatility ratio is still very high (Chart 16).

Such low FX volatility could attract too much speculative inflow that puts persistent upward pressure on the RMB. Within reason, greater RMB flexibility would also help to develop the respective offshore loan market, which is much smaller than the pool of liquidity (Chart 17).

RMB weakness seen earlier this year did not
derail internationalisation efforts when considering:

1) **Dim sum bond issuance was robust;** a record RMB366bn of bonds and CDs were issued in H1 (Chart 13)

2) **Offshore RMB turnover continued to grow** (Chart 18)

3) **The spot basis between the onshore CNY and CNH has re-converged** and stayed tight

4) **Offshore RMB deposits kept rising**

5) **RMB trade settlement increased** – average monthly RMB trade settlement rose from RMB320bn in 2013 to RMB480bn in 2014.

As at end of Q1 2014, 18% of China trade was settled in RMB (Chart 19).

Q6. **Is the RMB under or over-valued?**

A number of currency valuation metrics – by the IMF’s external balance assessment (EBA), Peterson Institute for International Economics (FEER), and The Economist (Big Mac index) – suggest the RMB is now only moderately undervalued (i.e. 0 to 5% away from “fair value”). We summarise these assessments, which are either based on some measure of equilibrium current account balances, or PPP and the Balassa-Samuelson relationship, in Table 1.

It may be argued that absolute valuation matters...
less than relative valuation, and ranking most currencies in our coverage universe by various metrics – REER deviation from a 5-year moving average, OECD PPP valuation, the adjusted Big Mac index and PIIE’s FEER – suggest the RMB is not particularly undervalued from a relative perspective either (Chart 20).

Any currency valuation model has a degree of uncertainty. Instead of another attempt at fair value modelling, we offer some simple observations of China’s economic data that could be indicative of either under or over-valuation.

**FX reserves – RMB undervaluation?**
The large increase in FX reserves is frequently pointed to as indicative of an undervalued exchange rate. We note that after growing at a rapid pace of about USD450bn per year in 2007-2010, reserves growth slowed in 2011 (USD330bn) and 2012 (USD130bn) – in line with the generally smaller trade balances and suggesting a less interventionist approach by the PBoC and SAFE. However, FX reserves surged last year by USD510bn, leading to criticism that China had reverted to its earlier ways. Reserves rose USD170bn in H1 this year, mostly in Q1.

**Table 1. Literature on RMB valuation**

<table>
<thead>
<tr>
<th>Organisation</th>
<th>IMF</th>
<th>Peterson Institute for International Economics (William R Cline)</th>
<th>The Economist</th>
<th>PIIE researchers (Martin Kessler and Arvind Subramanian)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Framework</td>
<td>External Balance Assessment</td>
<td>Fundamental Equilibrium Exchange Rates (FEER)</td>
<td>The Big Mac Index</td>
<td>Worldbank PPP</td>
</tr>
<tr>
<td>Theory</td>
<td>Focuses on the equilibrium current account balance of an economy (which is in turn based on medium-term fundamentals such as projected trend growth, productivity, net foreign assets position, demographics and institutional and political risks).</td>
<td>Also focuses on the exchange rate adjustment needed to curb &quot;prospectively excessive&quot; current account imbalances (subject to the limits of +1-3% of GDP, consistent with sustainability for deficit countries and global adding-up for surplus countries)</td>
<td>The theory of purchasing-power parity (PPP) states that in the long run, exchange rates should move towards the rate that would equalise the prices of an identical basket of goods and services. The Economist simplifies that basket to one product – the Big Mac.</td>
<td>Uses the latest 2011 PPP estimates by the World Bank and the Balassa-Samuelson relationship. Examines both linear and quadratic functions. Valuation is the average of the two different models with two different samples (excluding oil exporters or excluding small countries). The authors made simple extrapolations to get a 2014 estimate.</td>
</tr>
<tr>
<td>Assessment of RMB valuation</td>
<td>&quot;moderately undervalued&quot; (2013 Article IV)</td>
<td>-2.8% undervalued vs USD (May 2014)</td>
<td>41% undervalued vs USD (unadjusted); -1.4% undervalued vs USD (adjusted for GDP per capita) - updated January 2014</td>
<td>&quot;fairly valued” in 2014 (2% overvalued vs USD); -1.7% undervalued vs USD in 2011 - analysis published in May 2014</td>
</tr>
</tbody>
</table>

Source: IMF, PIIE, The Economist, HSBC estimates
Capital account liberalisation is progressing but is doing so unevenly – onshore market access to foreigners (through CIMB, QFII and RQFII) is improving faster than offshore market access to locals (QDII).

Some researchers believe China will likely see net capital outflows when it liberalises its capital account (see this IMF August 2013 working paper), which would suggest that the currency is not particularly undervalued.

Is the RMB overvalued?
On the opposite side of the valuation argument, we note three symptoms of overvaluation in China’s data, including:

1) Persistent PPI, import and export price deflation, as well as a switch in CPI inflation drivers from goods to services over the past 2-3 years (Chart 21).
2) Weak industrial profit growth since 2012 – averaging less than 10% y-o-y vs >25% y-o-y in the past decade.
3) The gains in China’s exports market share in the US and Eurozone have slowed in recent years (Chart 22).

These observations, on their own, are arguably circumstantial, but together, they paint a more cohesive picture of possible RMB overvaluation. Indeed, if the RMB was undervalued, companies would not have needed to reduce prices of their goods or posted weaker profits. There would also have been more import price inflation and CPI goods inflation. And China’s exports would have been able to continue grabbing global market share.

Q7. What will happen to the RMB when the Fed raises rates?
Much has been said about how EM currencies will come under pressure when the Fed raises interest rates. High global funding rates and a slowdown in capital inflows (or even capital outflows) could reveal the structural vulnerabilities of these currencies, such as current account deficits, fiscal deficits, and highly leveraged household and/or corporate sectors.

We do not believe the RMB will come under that kind of pressure, although the Fed’s eventual tightening would engineer greater volatility for USD-RMB. First, due to capital account restrictions, China never received much capital inflow that could reverse.

Foreign access to onshore assets remains very limited and has significant room to grow as China opens up its capital account (more on this in Question 10). China’s largest source of external liabilities comes from foreign direct investment,
which tends to be sticky even during times of reversal of global FX flows.

Second, China does not need capital inflows to fund a domestic savings gap – the economy actually has excess savings.

But the shrinking current account surplus (as detailed in Q1) suggests that the RMB may not receive as much support as it did in the past. At the same time, the US current account deficit has narrowed from a record of almost 6% of GDP in 2006 to 2.4% as of Q1 2014 (Chart 23).

Another angle is the interest rate differential between China and the US. The median forecasts among FOMC members is for the Fed funds rate to rise to 1.25% by the end of 2015 and 2.5% by the end of 2016. But this does not necessarily mean an erosion of China’s interest rate advantage. Over the next two years at least, China’s monetary policy would remain relatively restrictive, as the new government tries to balance downside risks to growth and rising debt.

For the FX forward curves, should the RMB’s interest rate advantage start to decline, the forward points would start to come down, which would reduce corporates’ forward hedging costs.

Q8. Are there risks to the RMB from China’s external debt and commodity trade financing?

According to SAFE data, China’s external debt as a share of GDP has actually moderated slightly over the past decade from 13.4% in 2003 to 9.4% today. Even if we were to modify SAFE’s statistics by adding the outstanding amount of CNH bonds issued by Chinese entities (around USD80bn as of Q1 2014), China’s external claims would still amount to around 10.5% of China’s GDP (USD955bn or RMB5.9trn), far lower than in most other Asian economies (20-30%; Chart 24).

Most of China’s reported external debt is short-term in nature (78%), and of this, more than half is related to trade financing, be it from banks (22% of short-term external debt) or in the form of cross-border inter-company trade credit (46%). Concerns over the unwinding of commodity trade financing (and consequent capital outflows) have risen lately after reports of loan fraud in Qingdao (Bloomberg, 10 June 2014).

Commodity trade finance deals were seen as profitable due to the high credit premium in China, the high interest rate differential between CNY and USD and the relatively low perceived risk of CNY depreciation versus the USD. However, these factors are changing due to
tightening controls on LCs and shadow banking, and rising currency volatility. Some Chinese commodity financing deals were likely unwound in Q2 when the RMB weakened and onshore interest rates fell.

There is no official data on the amount of commodity trade finance used for collateral loans. The total annual flow of commodity trade finance may be large but most of that is probably used to finance actual consumption and would not be unwound. In Q1 2014, China’s total trade financing-related external debt reached USD470bn. If we assume 20% of this is commodity-related (20% of China’s trade is in commodities), it suggests around USD120bn of the hot money coming into China is related to commodity financing. This is not insignificant but still manageable compared to a current account surplus of USD180bn in 2013.

External claims are also manageable compared to China’s FX reserves (USD4trn) and the domestic credit system, which carries around RMB77.6trn of loans and RMB30-40trn in off-balance sheet assets. The items that are directly (letters of credit) linked to the private sector’s external activities only count for a minor part of domestic banks’ overall balance sheet (Chart 25). As China allows more corporates to access the offshore market, especially the offshore RMB market, its external debt is likely to increase rather than decrease over time. However, as long as its external debt is not built up beyond its external surplus, as reflected in the stable net international investment position, we believe there is not a lot to worry about.

Q9. What are the recent RMB reforms?

We highlight a few key RMB reforms announced over the past year in Tables 2 and 3. There have been a number of notable onshore CNY market developments, such as widening of the onshore USD-CNY trading band this March. The Shanghai Free Trade Zone (SFTZ) was launched last September and key implementation details on free trade accounts were announced in May this year (more below). The authorities also introduced more deregulation of cross-border flows, for specific geographies – such as Shanghai-Hong Kong (Stock Connect) – and more generally, simplifying procedures.

Regarding offshore RMB developments, we noted key currency swap agreements with the ECB and Swiss National Bank (SNB) in October 2013 and in July 2014, five countries – the UK, Germany, France, Luxembourg and Korea – were either assigned RMB clearing banks or signed MOUs. RQFII quotas were also extended to five countries – the UK, Singapore, France, Korea and Germany.
What is the significance of the Shanghai Free Trade Zone?

The SFTZ was launched on 29 September 2013. The zone is being used as a testing ground for investment, trade and financial reforms, before nationwide roll-out. For FX, the most important development in the SFTZ, thus far, is the implementation of Free Trade Accounts (FTAs; see Asian FX: Shanghai FTZ: Implementation details announced, 26 May 2014).

The RMB can flow freely between the FTAs, non-resident onshore accounts (outside the SFTZ) and offshore accounts. Transactions between resident onshore accounts (outside the SFTZ) and FTAs are also allowed, provided they are held by the same entity and do not involve capital account transactions that are not yet approved by the PBoC and SAFE — such as portfolio investments.

The major implication of the FTA system, as it stands now, is that companies within the SFTZ will have better access to the offshore markets. Given the lower offshore RMB borrowing costs, we expect strong demand for offshore borrowing, which would tighten liquidity offshore and support USD-CNH forward points.

Demand for the offshore RMB will be further supported by the recent relaxation of cross-border guarantee rules. More cross-border channels for fund movements would lead to greater convergence between the onshore and offshore FX curves and stronger visibility of interest rate parity.

The authorities intend for greater deregulation of cross-border FX flows, although implementation details have not been released. As per the PBoC’s opinions on financial measures to support the SFTZ published on 2 December 2013, we can eventually expect companies and individuals within the zone to be able to make portfolio investments overseas (independent of the QDII programme), and to invest in onshore capital markets (independent of QFII and RQFII programmes). Issuance of "panda bonds" (RMB-denominated bonds from a foreign issuer) will also be deregulated for companies in the SFTZ.

### Table 2. Recent developments in offshore RMB

<table>
<thead>
<tr>
<th>Market</th>
<th>Regulatory update</th>
<th>Date</th>
<th>Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency swap</td>
<td>PBoC and ECB signed a bilateral RMB350bn/EUR45bn local currency swap arrangement.</td>
<td>9 October 2013</td>
<td>PBoC Link</td>
</tr>
<tr>
<td>Currency swap</td>
<td>PBoC and Swiss National Bank signed a RMB150bn/CHF21bn local currency swap agreement.</td>
<td>21 July 2014</td>
<td>SNB Link</td>
</tr>
<tr>
<td>Offshore RMB</td>
<td>PBoC appointed China Construction Bank’s London branch as the RMB clearing bank</td>
<td>18 June 2014</td>
<td>BOE Link</td>
</tr>
<tr>
<td>Offshore RMB</td>
<td>PBoC nominated Bank of China as the RMB clearing bank for Frankfurt</td>
<td>19 June 2014</td>
<td>Bundesbank Link</td>
</tr>
<tr>
<td>Offshore RMB</td>
<td>PBoC and Banque de France signed a MOU on establishing RMB clearing arrangements in Paris</td>
<td>28 June 2014</td>
<td>PBoC Link</td>
</tr>
<tr>
<td>Offshore RMB</td>
<td>PBoC and Banque Centrale du Luxembourg signed a MOU on establishing RMB clearing arrangements in Luxembourg</td>
<td>28 June 2014</td>
<td>PBoC Link</td>
</tr>
<tr>
<td>Offshore RMB</td>
<td>PBoC and the Bank of Korea signed a MOU on establishing RMB clearing arrangements in Seoul, PBoC appointed the Bank of Communications to be the RMB clearing bank in Seoul</td>
<td>3 July 2014</td>
<td>PBoC Link</td>
</tr>
<tr>
<td>RQFII quota</td>
<td>China agreed to grant London RMB80bn of RQFII quota</td>
<td>15 October 2013</td>
<td>UK Gov Link</td>
</tr>
<tr>
<td>RQFII quota</td>
<td>China granted Singapore RMB50bn of RQFII quota</td>
<td>22 October 2013</td>
<td>MAS Link</td>
</tr>
<tr>
<td>RQFII quota</td>
<td>CSRC granted RMB80bn of RQFII quota to France</td>
<td>20 June 2014</td>
<td>CSRC Link</td>
</tr>
<tr>
<td>RQFII quota</td>
<td>CSRC granted RMB80bn of RQFII quota to Korea</td>
<td>18 July 2014</td>
<td>CSRC Link</td>
</tr>
<tr>
<td>RQFII quota</td>
<td>CSRC granted RMB80bn of RQFII quota to Germany</td>
<td>18 July 2014</td>
<td>CSRC Link</td>
</tr>
<tr>
<td>Direct trading</td>
<td>CFETS announced the direct trading between RMB and NZD on the inter-bank FX market</td>
<td>18 March 2014</td>
<td>PBoC Link</td>
</tr>
<tr>
<td>Direct trading</td>
<td>CFETS announced the direct trading between RMB and GBP on the inter-bank FX market</td>
<td>18 June 2014</td>
<td>PBoC Link</td>
</tr>
</tbody>
</table>

Source: CSRC, PBoC, SNB, BOE, Bundesbank, UK Gov, MAS, HSBC
Once these are implemented, there will be a de facto opening of the capital account in the SFTZ, and full convertibility of the RMB within it. The next step from there will be a nationwide roll-out of these measures. We expect the RMB to achieve full convertibility within the next two to three years.

Q10. RMB reforms – what is next?

There have been many RMB reforms announced in recent months (Question 9). And there is no reason to believe that this process will slow anytime soon, especially when there is a better balance of flows surrounding the currency, as has been the case in recent months.

Macro measures – what to expect?

We expect future macro measures to be designed in such that they would help to achieve a better balanced BoP.

A few conclusions can be drawn by a simple comparison between China’s international investment position with the G3 – US, EU and Japan – as well as the other BRICS – Brazil, Russia, India and South Africa (Chart 26).

1) The Chinese financial system needs to be more integrated globally – the sum of China’s external assets and liabilities comprise 104% of GDP as at end-2013, compared to an average of 284% in the G3. Even within BRICS, financial and investment openness in China needs to catch up with South Africa and Russia.

---

**Table 3. Recent developments in onshore RMB**

<table>
<thead>
<tr>
<th>Market/Flow</th>
<th>Regulatory Update</th>
<th>Date</th>
<th>Link</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNY trading band</td>
<td>PBoC widened the USD-CNY daily trading band to +/-2% from +/-1%</td>
<td>15 March 2014</td>
<td>PBoC Link</td>
</tr>
<tr>
<td>FX deposits</td>
<td>PBoC Shanghai extended the earlier liberalisation of the interest rate cap for small-sized FX deposits in the FTZ to all of Shanghai</td>
<td>26 June 2014</td>
<td>Shanghai PBoC Link</td>
</tr>
<tr>
<td>FX options</td>
<td>SAFE to allow corporates to sell FX options from 1 August 2014 (previously they could only buy FX options onshore)</td>
<td>2 July 2014</td>
<td>SAFE Link</td>
</tr>
<tr>
<td>CNY bid-ask spreads</td>
<td>SAFE removed restrictions on banks’ bid-offer spreads to clients for USD-CNY transactions - banks can make independent pricing decisions</td>
<td>29 September 2013</td>
<td>CSRC Link</td>
</tr>
<tr>
<td>Shanghai FTZ - launched</td>
<td>Shanghai Free Trade Zone launched on 29 September 2013. CSRC published policy measures for capital market reform in the FTZ, including to allow parent companies of enterprises in the FTZ to issue panda bonds</td>
<td>Shanghai PBoC Link</td>
<td></td>
</tr>
<tr>
<td>Shanghai FTZ - cross-border flows via FTAs</td>
<td>PBoC Shanghai announced implementation details on Free Trade Accounts: RMB transactions via the FTAs are permitted for current account business, foreign direct investment and cross-border lending, but not yet for portfolio investment.</td>
<td>22 May 2014</td>
<td>SFC Link</td>
</tr>
<tr>
<td>Cross-border flows (Shanghai-HK)</td>
<td>China’s CSRC and Hong Kong’s SFC approved the development of a pilot programme to establish mutual stock market access. Investors will be able to trade eligible shares listed on the other’s market through local securities firms or brokers. Trading will, initially, be subject to a maximum cross-boundary investment quota (Northbound: RMB 300bn; Southbound RMB250bn), and a daily quota (northbound: RMB13bn; southbound: 10.5bn). Trading will also, initially, be limited to institutional investors, and selected individual investors.</td>
<td>10 April 2014</td>
<td>SFC Link</td>
</tr>
<tr>
<td>Cross-border guarantors</td>
<td>SAFE greatly simplified the approval of cross-border guarantees, and removed the previous limit on the outstanding amount for such guarantees.</td>
<td>19 May 2014</td>
<td>SAFE Link</td>
</tr>
<tr>
<td>Cross-border flows (Suzhou-Singapore)</td>
<td>PBoC Nanjing branch allowed eligible corporates and individuals in the Suzhou Industrial Park to conduct cross-border RMB transactions with Singapore - including cross-border loans, RMB bond issuance in Singapore and individual RMB remittances.</td>
<td>13 June 2014</td>
<td>MAS Link</td>
</tr>
<tr>
<td>Cross-border flows (Tianjin-Singapore)</td>
<td>PBoC Tianjin branch allowed eligible corporates and individuals in the Sino-Singapore Tianjin Eco-city (SSTEC) to conduct cross-border RMB transactions with financial institutions and corporates in Singapore. The activities allowed will be similar to what was proposed for the Suzhou Industrial Park</td>
<td>9 July 2014</td>
<td>MAS Link</td>
</tr>
</tbody>
</table>

Source: CSRC, PBoC, SAFE, MAS, HSBC
2) **China’s external assets are heavily skewed towards official reserves, whereas external assets in the G3 are more evenly distributed** across direct investment, portfolio investment and banking sector assets. While such a pattern is not uncommon amongst emerging economies, China’s outward direct investment and external portfolio assets are very low and its reserve accumulation excessive even compared to the other BRICS (Chart 27).

Given that China runs a current account surplus (i.e. has excess savings), the low accumulation of external portfolio assets can be indicative of “trapped” savings in the economy.

3) China’s liabilities are skewed towards direct investment, far more so than its BRICS counterparts (Chart 28). Correspondingly, its portfolio investment liabilities are very small compared to the other BRICS and certainly the G3. While this has shielded China from portfolio outflow risks, it also reduced international exposure in the areas of accounting standards, risk management and financial product development, and stymied the development of the financial market.

To alleviate these imbalances, we expect a higher degree of investment abroad by both Chinese corporates and individuals. The former has been accelerating for some time but still needs
greater flexibility for onshore corporates to borrow more abroad before the amount of outbound direct investment (ODI) could catch up to the amount of FDI that China receives.

We have seen specific rules to support ODI recently. For instance, SAFE lifted a ban on loans made by domestic firms to their overseas SPVs – entities created for a specific, limited and normally temporary purpose – and simplified rules on the establishment of such entities (see its July 14 rule).

In terms of individual portfolio outflow channels or so-called QDII2 (Qualified Domestic Individual Investors programme), little concrete details have been implemented. But individual level portfolio investment will receive a great boost from the upcoming Shanghai-Hong Kong Stock Connect.

**Connecting Shanghai to Hong Kong**

Shanghai-Hong Kong Stock Connect (SHKSC), which allows investors to trade on each equity market exchange, should lead to convergence between the two markets. This scheme is seen as being a broader form of QDII2 and QFII2 but is expected to grow much faster in the coming years than the current portfolio investment channels and is seen as an important step in liberalising China’s capital account. By extension, it will help promote RMB internationalisation.

Steven Sun, our Head of China Equity Strategy, expects SHKSC to be launched in October and over time, it could be expanded to cover Shenzhen’s A-share market or beyond.

We believe RMB liquidity (more than RMB1.5tn as measured by offshore RMB deposits) and RMB turnover (close to USD10bn in spot and USD20bn in forwards in Hong Kong) in the offshore market are large enough to support the new scheme, in particular considering there will be initial limits for both northbound and southbound schemes (northbound daily limit RMB13bn; total limit RMB300bn; southbound daily limit RMB10.5bn; total limit RMB250bn).

**There is a potential risk for one-sided inflows initially, especially considering the large price discrepancies between Shanghai and Hong Kong market for the dual-listed stocks. One-sided preference for the northbound scheme, if it happens, could result in one-off repatriation of CNH liquidity to the onshore market.**

Accordingly, CNH funding could tighten, USD-CNHN spot could trade lower, and onshore offshore USD-RMB basis could widen.

However, we expect that cross-border trade settlement and investment flows would quickly take advantage of any significant divergence in the FX curves, which would then drive RMB liquidity to flow back to the offshore market. After all, these trade and investments flows are still significantly larger than the existing portfolio flow channels (even including the SHKSC).

In addition, we believe the HKMA could upgrade its RMB liquidity facility to help the market to handle the potential challenges. In July 2013, the authority started to provide one day RMB funds on a T+1 basis, based on its swap agreement with the PBoC. It also made overnight funds on the same day available based on its own source of RMB funds with a cap of RMB10bn in total in a single day. These facilities could be expanded on agreement between HKMA and PBoC.

**Also, it would be of interest to see if the daily RMB20,000 individual conversion limit in Hong Kong and Taiwan gets removed in light of the SHKSC as the scheme raises individual FX conversion needs.**

The HKMA’s Norman Chan said late last year that it had requested that the PBoC remove the daily conversion limit and “The People’s Bank of China said this is feasible and it will pro-actively
consider it.” (Bloomberg, 18 October 2013). Should Hong Kong’s RMB conversion limit be increased or removed altogether, it is seen as a precursor to helping develop more RMB-denominated investment products but also help build the offshore market.

RMB – micro FX reforms

We expect greater efforts to make the RMB more volatile on a day-to-day basis. The volatility of both the USD-CNY spot rate and the daily USD-CNY fix remains low (Chart 29 and 30) and highlights the challenge for the authorities to make the onshore exchange more flexible. But the reason for lower USD-CNY volatility now is more likely a reflection of a benign market conditions globally than last year when hot money inflows were matched off by strong USD buying by the PBoC.

While the USD-CNY daily trading band is wider, we note how it has not been an effective precursor to higher FX volatility. Additional USD-CNY band widening cannot be ruled out but we would not see this being materially significant, especially given the current capacity for USD-CNY to move +/- 2 percent around its daily midpoint has not been fully utilised.

Instead, we still wait for the USD-CNY fix to become more market-driven. Recently, there has been a small step in this direction. On 2 July 2014, SAFE announced the removal of bid-ask spread of +/-1.5 percent for clients from the daily fix. The removal of the prior regulation would mean that the +/-2% band is now also being applicable to clients as well as in the interbank market. This could create a little more room for intraday FX volatility.

The SAFE notice also suggested that the USD-CNY fixing mechanism and intraday movements in USD-CNY will be made more transparent, although no details are provided as to how this will work in practice.

The RMB story is evolving rapidly and we expect full convertibility to happen over the next couple of years. RMB internationalization and FX reforms are moving into the fast lane. This document therefore provides essential reading for anyone looking to trade the world’s fastest growing currency.

Conclusion

The RMB story is evolving rapidly and we expect full convertibility to happen over the next couple of years. RMB internationalization and FX reforms are moving into the fast lane. This document therefore provides essential reading for anyone looking to trade the world’s fastest growing currency.
In this edition of RMB Q&A, we address the key client questions we have recently received on the RMB. There has been a fresh focus on new developments such as the unprecedented RMB weakness seen in H1, commodity debt financing irregularities, and the RMB’s reaction eventual to Fed policy rate hikes. Meanwhile, we continue to update clients regarding RMB valuation, changes in onshore regulations, offshore RMB market developments and the RMB internationalization roadmap.

We have also noted greater interest in understanding the impact of corporate hedging behavior on FX forward points, the seasonality behind underlying FX flows, and the growing linkages between onshore and offshore interest rates and FX forward points. This demand for more technical market knowledge shows that the RMB is becoming increasingly utilized by a wider range of market participants for a range of purposes, aided by the rapid acceleration of RMB FX reforms.

We expect the RMB to appreciate to 6.14 against the USD by year-end, as growth stabilizes and underlying FX flows turn more supportive. Forward points may stay elevated for longer due to importer hedging. But appreciation should be increasingly volatile, due to ongoing reforms to make the currency more market-driven, the upcoming shift in the Fed’s policy, and the fact that the RMB is no longer undervalued. The acceleration in FX reforms alongside the ongoing and rapid development of offshore RMB markets suggest that currency appreciation is not a necessary condition for internationalization. We expect the opening of more cross-border fund flow channels to lead to further onshore-offshore price convergence.
Recent key RMB and China research publications:

FX

Asian FX: RMB: More options to hedge, 26 June 2014
Asian FX: SAFE and PBoC committed to two-way volatility, 12 June 2014
Asian FX: Shanghai Free Trade Zone - Implementation Details Announced, 26 May 2014
Asian FX & Credit: SAFE reforms cross-border guarantee rule, 23 May 2014
HSBC: The rise of the redback III: The world's next reserve currency, 19 March 2014
Asian FX and Economics comment: Quick thoughts on CNY band widening, 15 March 2014
Asian FX: RMB: Where do we stand?, 26 February 2014
Asian FX Focus: RMB: One direction?, 20 November 2013
Asia FX Focus: China: RMB Q&A: The top 10 questions investors are asking, 25 July 2013

Economics

China's challenges: Daunting but not unprecedented, 16 May 2014
China Inside Out: Time to ease a little, 5 May 2014
China Economics & Credit: Balancing the books: Debt, assets and fiscal reform, 7 January 2014
China's Big Bang, November 2012

Rates

China rates: Why China's money market matters: The essential guide to liquidity operations, March 2014
Notes
Notes
Disclosure appendix

Analyst Certification
The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Paul Mackel, Ju Wang, Dominic Bunning and Joey Chew

Important Disclosures
This document has been prepared and is being distributed by the Research Department of HSBC and is intended solely for the clients of HSBC and is not for publication to other persons, whether through the press or by other means.

This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy the securities or other investment products mentioned in it and/or to participate in any trading strategy. Advice in this document is general and should not be construed as personal advice, given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs. If necessary, seek professional investment and tax advice.

Certain investment products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. Investors should consult with their HSBC representative regarding the suitability of the investment products mentioned in this document and take into account their specific investment objectives, financial situation or particular needs before making a commitment to purchase investment products.

The value of and the income produced by the investment products mentioned in this document may fluctuate, so that an investor may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Value and income from investment products may be adversely affected by exchange rates, interest rates, or other factors. Past performance of a particular investment product is not indicative of future results.

HSBC and its affiliates will from time to time sell to and buy from customers the securities/instruments (including derivatives) of companies covered in HSBC Research on a principal or agency basis.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at www.hsbcnet.com/research.

Additional disclosures
1. This report is dated as at 28 July 2014.
2. All market data included in this report are dated as at close 25 July 2014, unless otherwise indicated in the report.
3. HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC’s analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC’s Investment Banking business. Information Barrier procedures are in place between the Investment Banking and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.
Global Currency Strategy Research Team

Global
David Bloom
Global Head of FX Research
+44 20 7991 5969  david.bloom@hsbcib.com

Asia
Paul Mackel
Head of FX Research, Asia-Pacific
+852 2996 6565  paulmackel@hsbc.com.hk
Dominic Bunning
+852 2822 1672  dominic.bunning@hsbc.com
Ju Wang
+852 2822 4340  juwang@hsbc.com.hk
Joey Chew
+852 2996 6568  joey.s.chew@hsbc.com.hk

United Kingdom
Daragh Maher
+44 20 7991 5968  daragh.maher@hsbcib.com
Stacy Williams
+44 20 7991 5967  stacy.williams@hsbcgroup.com
Mark McDonald
+44 20 7991 5966  mark.mcdonald@hsbcib.com
Murat Toprak
+44 20 7991 5415  murat.toprak@hsbcib.com
Mark Austin
Consultant
United States
Robert Lynch
+1 212 525 3159  robert.lynch@us.hsbc.com
Clyde Wardle
+1 212 525 3345  clyde.wardle@us.hsbc.com
Marjorie Hernandez
+1 212 525 4109  marjorie.hernandez@us.hsbc.com

Technical Analysis
Murray Gunn
+44 20 7991 6797  murray.gunn@hsbcib.com

Precious Metals
James Steel
+1 212 525 3117  james.steel@us.hsbc.com
Howard Wen
+1 212 525 3726  howard.x.wen@us.hsbc.com