LIBERALISATION OF THE RENMINBI EXCHANGE RATE REGIME AND FOREIGN CURRENCY REGULATIONS

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Following the example of other large, closed economies, China has chosen a more flexible exchange rate arrangement in recent years, and concluded FX swap agreements with foreign central banks with a view to supporting the internationalisation of the renminbi. At present, the Chinese exchange rate regime is a so-called "crawling- like" exchange rate arrangement, where the band was gradually widened to +/– 2 per cent, allowing for a 20 per cent appreciation of the exchange rate since October 2008. Besides the conversion to a more flexible exchange rate regime, regulations on foreign exchange management have been also eased, which improved the liquidity of renminbi markets outside of China ("offshore" markets) significantly. China established swap-line agreements with several central banks to stimulate international trade and support financial stability goals. The number of counterparties participating in Chinese swap-line agreements has increased to nearly 30 in recent years. Besides the Central Bank of Hungary (MNB), China's European partners include, among others, the Bank of England, the European Central Bank and the Swiss National Bank.

This analysis presents a review of the latest steps in China's foreing economic policy liberalisation as a second part of a series of articles. Upcoming parts of the series will address the measures taken by international central banks in relation to the renminbi, the future of Chinese capital account liberalisation, and the characteristic features of renminbi centres outside of China.

1. THE CHINESE EXCHANGE RATE ARRANGEMENT IS BECOMING MORE FLEXIBLE

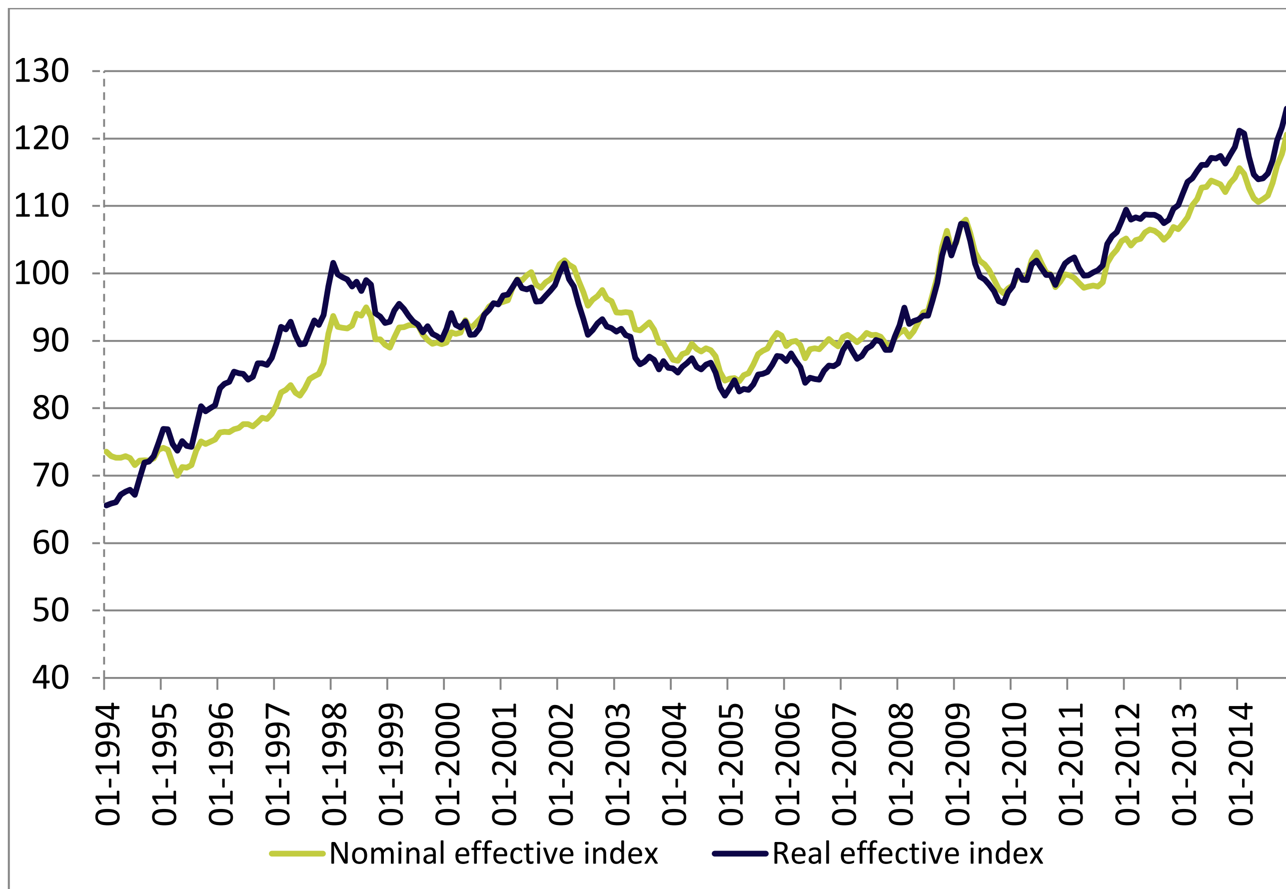
In recent years, China has moved to a crawl-like exchange rate regime. The central bank allowed the exchange rate of the renminbi to float within a gradually widening band around the central parity. Until April 2012, the exchange rate band against the dollar was +/– 0.5 per cent, which was subsequently raised to +/– 1 per cent before the band was extended to +/– 2 per cent in March 2014. Moreover, the foreign exchange rates quoted by banks for their clients have been allowed to change in line with supply and demand since July 2014 (previously, the difference between buy and sell rates could be no more than 4 per cent).

The central parity for spot transactions is determined through the China Foreign Exchange Trade System (CFETS) based on the quotes between interbank market participants, **with the approval of the central bank.**

The appreciation pressure stemming from China's convergence and the so-called Balassa-Samuelson effect influenced the exchange rate of the renminbi as well. Although the Chinese central bank attempted to restrict the nominal appreciation of the renminbi during the 2000s, in response to the global imbalances evidenced by the financial crisis, it has recently given more room to the appreciation of the currency. Between October 2008 and

November 2014 the CPI-based real exchange rate appreciated by 21 per cent[1]. Exchange rate developments were somewhat more balanced in 2014, partly as a result of the measures taken by Chinese authorities to prevent speculation on the anticipated strengthening of the exchange rate, including required reserve ratio cuts and liquidity-providing operations.

1: Nominal effective and real effective exchange rate indices of the renminbi (%, 2010=100)



Source: BIS effective exchange rate indices

According to market expectations and central bank communication, the flexibility of the exchange rate may be increased further in the future: gradually, the fluctuation band may be widened even more, the central parity may be abolished, finally, as a last step China may adopt a flexible exchange rate regime. From an economic perspective, a more flexible exchange rate regime is warranted by China's position as a large, closed economy; indeed, such countries tend to opt for a flexible, typically floating exchange rate regime. Inspite of the high Chinese export and import turnover the value added contents of net exports were relatively low. Hence further flexiblility of the exchange rate regime may not be a challenge for China taking into account also its closed capital account.

[1] PBC (People's Bank of China): Monetary Policy Report Quarter Two, 2014:

http://www.pbc.gov.cn:8080/image_public/UserFiles/english/upload/File/2014MPRQ2(after%20Nancy).pdf

2. ONSHORE AND OFFSHORE RENMINBI FOREIGN EXCHANGE MARKET

In case of the renminbi, a distinction should be made between the onshore (mainland China) and offshore (outside of China) foreign exchange markets. While parallel to the liberalisation of the exchange rate regime and the balance of payments the exchange rate was increasingly shaped by market forces in offshore markets, the onshore market remained strictly regulated. As of 2010, trade settlements introduced traffic between the onshore and offshore markets as payments were gradually permitted to be settled in renminbi as well; in addition, the Chinese authorities slowly allowed renminbi settlements for capital flows – up to a certain limit – in the case of selected institutions (primarily institutional investors and central banks). (Budapest Renminbi Initiative Paper No 1 gives a more detailed overview of renminbi settlements).

2.1. Onshore renminbi market: the fixed exchange rate regime is preserved

In China the domestic foreign exchange market was launched in 1994, and it still has a relatively low turnover for a country of this size. Transactions are permitted only in relation to real economy transactions, primarily export and import activities (speculative trading is banned). Since 1997, derivative transactions have been also allowed.

Market participants are domestic players, foreign subsidiary banks and financial firms (a total of 375 institutions). They execute their transactions in China Foreign Exchange Trading System (CFETS). Around 80 authorised institutions can execute forward, FX swap and cross-currency swap transactions, while around 30 institutions have a license for option trading.

Certain currencies can be traded directly against the RMB in all provinces: NZD (since 2014), USD, JPY (since 2012), AUD (since 2013), MYR, GBP (since June 2014), EUR (since September 2014), SGD (since October 2014). The trading of certain currencies (LAK, KZT, VND, KRW, THB)[2] is limited to selected provinces, and two other currencies **(HKD and CAD) can only be traded indirectly through the USD.** The bulk (95%) of the turnover comprises transactions against the dollar (Table 4).

According to the People's Bank of China (PBOC) data disclosure, in 2014 Q1 the onshore foreign exchange turnover of the renminbi amounted to RMB 12,700 billion, translating into a daily turnover of USD 16–17 billion, which is broadly consistent with BIS statistics for April 2013 (Table 2).

1: Onshore (CNY) foreign exchange turnover in 2014 H1

Currency	USD	EUR	JPY	HKD	GBP	AUD	NZD	CAD	MYR	RUB	THB	Total
Turnover (bn RMB)	12202	110	252	82	26	81	12	0.2	0.4	6	0.1	12771
Relative turnover	96%	1%	2%	1%	0%	1%	0%	0%	0%	0%	0%	100%

3. OFFSHORE RENMINBI MARKET

The offshore market was launched in August 2010 concurrently with cross-border renminbi settlements and has been available, without restrictions, for all participants since then (hedging and speculative transactions are also permitted). Since corporations, banks and investment institutions, which typically did not use the spot market shifted increasingly to offshore markets in the recent past, spot market bid-ask spreads fell to 20–40 basis points compared to 30–300 basis points in 2010.

[2] The Laos kip (LAK), the Kazakh tenge (KZT), the Vietnamese dong (VND), the Korean won (KRW) and the Thai baht (THB)

RMB liquidity in the offshore market increased rapidly. Based on BIS statistics, the average daily turnover of the offshore spot market reached USD 5.1 billion in April 2013, and the onshore turnover was roughly triple this value. The average daily turnover of the offshore spot market outside of Hong Kong was USD 7.7 billion (BIS). BIS estimated daily turnover in the global offshore renminbi market at USD 12.8 billion for spot transactions and USD 7.1 billion for forward transactions. Data released in London indicate that 26 per cent of total offshore FX renminbi transactions are executed in London, and 56.6 per cent in Hong Kong.

2: Main characteristic features of the onshore and offshore renminbi markets

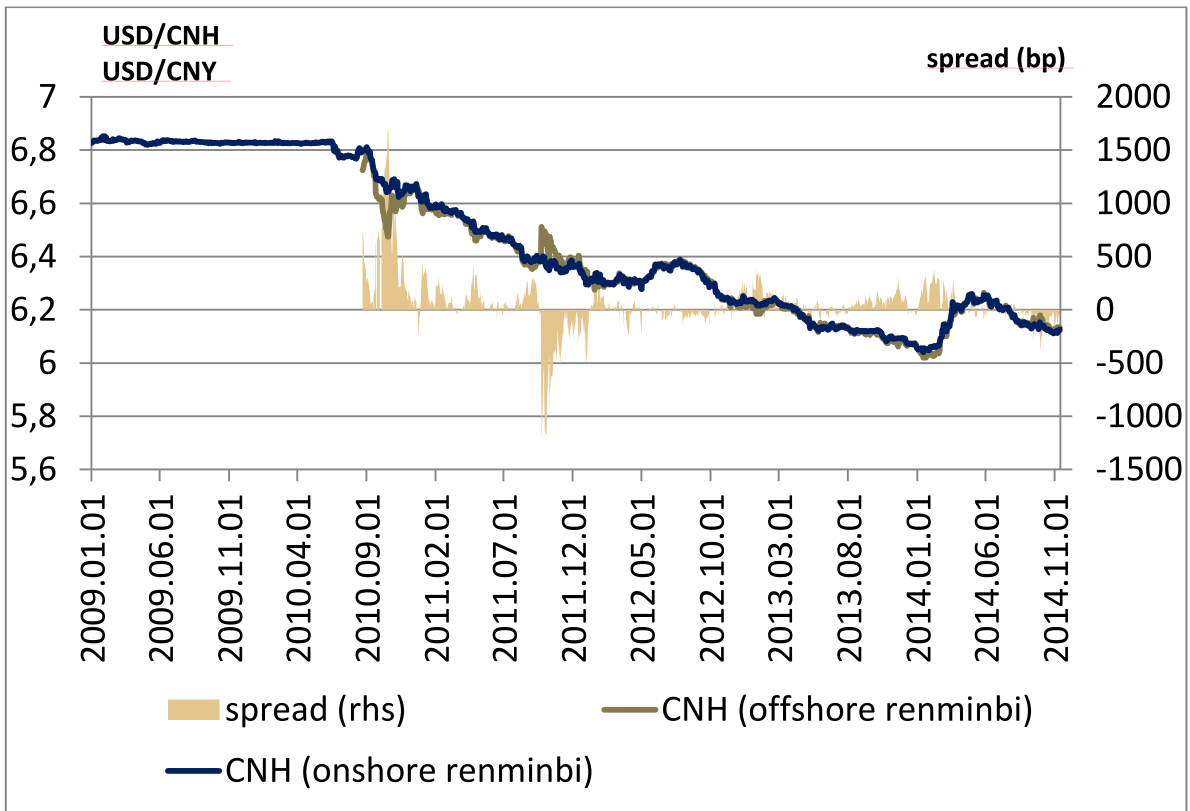
	average daily turnover (bn USD)	average daily turnover (bn USD)
	Merrill Lynch Bank of America 2012	**BIS** Apr 2013
CNY onshore market		
deliverable		
spot	20	17.6
forward	5-10	2.4
non-deliverable		
forwards	4-5	
options	0,5-0,8	
bid ask spread (spot)	5-20 bp	17 bp
CNH offhsore piac		
spot	1.5-2	5.1
forwards	1.5-3	2.2
bid ask spread (spot)	20-30 bp	33 bp
Reuters reference	CNY=CFXS	CNH=D2
average spot transaction	5-20 m USD	

Values in the second column of the table refer to the Hong Kong centre.

Source: BIS, BofA Merrill Research Global Research

Thanks to the trade liberalisation and the surge of renminbi foreign exchange turnover, the spread between offshore and onshore exchange rates fell sharply: while in 2010 the spread was at times as high as 1,000 basis points, by 2014 it shrank below 100 basis points; thus the differential between the exchange rates against the dollar is measurable in thousandth at the most. Moreover, in recent years the spread between offshore spot market buy and sell quotes has also declined to a level of 20–30 basis points, which is consistent with the onshore market spread.

2: Onshore (CNY) and offshore (CNH) RMB/USD exchange rates and their differentials



Source: Bloomberg

4. THE PBOC'S SWAPLINE AGREEMENTS WITH CENTRAL BANKS

The Chinese swap line agreements constituted the newest and most dynamically growing segment of the global central bank swap line network set up in the 2008–2009 crisis. The People's Bank of China (PBOC) concluded 6 swap line agreements until the end of 2009, with a total value of USD 181 billion. However, by November 2014, the value of the agreements reached USD 475 billion, and the number of swap partners grew to 29.

Chart 3: The PBOC's swapline network since 2011*

***Black colour indicate the PBoC's swapline network in 2011 and green colour shows the enlargement of the net-work** since 2011. t

FX swap agreements

The FX swap is one of the most common products in foreign exchange markets, where the parties agree to exchange two currencies and re-exchange them at a future date. The FX swap may be interpreted as borrowing in one currency and simultaneously depositing in another, where the claims denominated in one currency serve as collateral for the liability outstanding in the other currency. That is, under the FX swap transaction parties agree to exchange the currency in their possession (on day T0) at spot rate for the other currency, and to re-exchange it at a later date (on day T1) at a forward exchange rate, which represents the interest rate difference, stipulated on the deal date. Thus the FX swap consists of a spot foreign exchange sale/purchase transaction (spot leg) and a forward transaction (forward or termin leg). **Source and details:** Mák–Páles (2009): http://www.mnb.hu/Root/Dokumentumtar/MNB/Kiadvanyok/mnbhu_mnbszemle/mnbhu_msz_200905/mak-pales.pdf

Central bank swap-line agreements

For the purposes of our analysis, under central bank swap-line agreements we refer to central bank contracts pertaining to the conclusion of FX-swap deals between central banks. These contracts typically entail a mutual commitment to conclude FX swap deals. In some cases, the commitment is subject to conditions; the assessment of the partner country's solvency and the decision on its macroeconomic situation may influence the possibility and the financial details of the drawdown.

The purpose of China's central bank swap line agreements is to strengthen economic relations, encourage bilateral trade and investment activity and maintain financial stability. All these also contribute to a decline in the weight of the dollar in China's trade settlements, and thus potential future liquidity troubles in the dollar interbank markets will be less harmful for those involved in foreign trade transactions with China.

Table 3: Details of the swap agreements of the People's Bank of China

No	Partner country	value (RMB)	value (USD)	Announcement
1	South Korea	360	57.6	2008
2	Argentina	70	11.2	2009
3	Belarus	20	3.2	2009
4	Hong Kong	400	64.0	2009
5	Indonesia	100	16.0	2009
6	Malaysia	180	28.8	2009
7	Iceland	3.5	0.6	2010
8	Singapore	150	24.0	2010
9	Kazakhstan	7	1.1	2011
10	Mongolia	5	0.8	2011
11	Russia	150	24.0	2011
12	Pakistan	10	1.6	2011
13	Thailand	70	11.2	2011
14	New Zealand	25	4.0	2011
15	Uzbekistan	0.7	0.1	2011
16	Australia	200	32.0	2012
17	Brazil	190	30.4	2012
18	U.A.E	35	5.6	2012
19	Japan	20	3.2	2012
20	Turkey	1.6	0.3	2012
21	Ukraine	15	2.4	2012
22	Albania	2	0.3	2013
23	United Kingdom	200	32.0	2013
24	Euro Area	350	56.0	2013
25	Hungary	10	1.6	2013
26	Switzerland	150	24.0	2014
27	Sri Lanka	10	1.6	2014
28	Qatar	35	5.6	2014
29	Canada	200	32.0	2014
	Total	**2725**	**436**	

Source: Liao-McDowell (2013), The People's Bank of China

In the case of the PBOC, in addition to the intention to mitigate the liquidity disturbances, emphasis was put on the objective of the development of foreign trade relations when the swap agreements were formulated. Namely, the FX liquidity provided through the central bank swap agreements can also be used for financing and stimulating foreign trade. The convertibility of the renminbi is limited; therefore, central bank intermediation is especially important to provide the liquidity necessary for foreign trade. Furthermore, trade settlement can become faster and cheaper with the development of central bank facilities and settlement and clearing infrastructure.

- transaction and invoicing costs may be reduced and settlements can be conducted faster when the intermediary currency is eliminated

  Eichengreen et al (2014) cites several surveys in this regard. Standard Chartered found that companies can receive a 2–3 per cent discount by invoicing in RMB. According to the PBOC, importers could save 2–3 per cent by paying in RMB. Deutsche Bank reported that for companies paying exports in RMB the savings averaged 4.8 per cent.

- settlement in the partners' currency may imply a competitive advantage

- trade partners can shield themselves from the liquidity turbulences of any third currencies used for the trade (for example, a large part of Chinese trade was settled in USD before the crisis; consequently, Chinese trade was hit especially hard by the liquidity troubles in the USD market)

- the exchange rate risk of the partners may be mitigated, which can support the precision of price setting and corporate planning

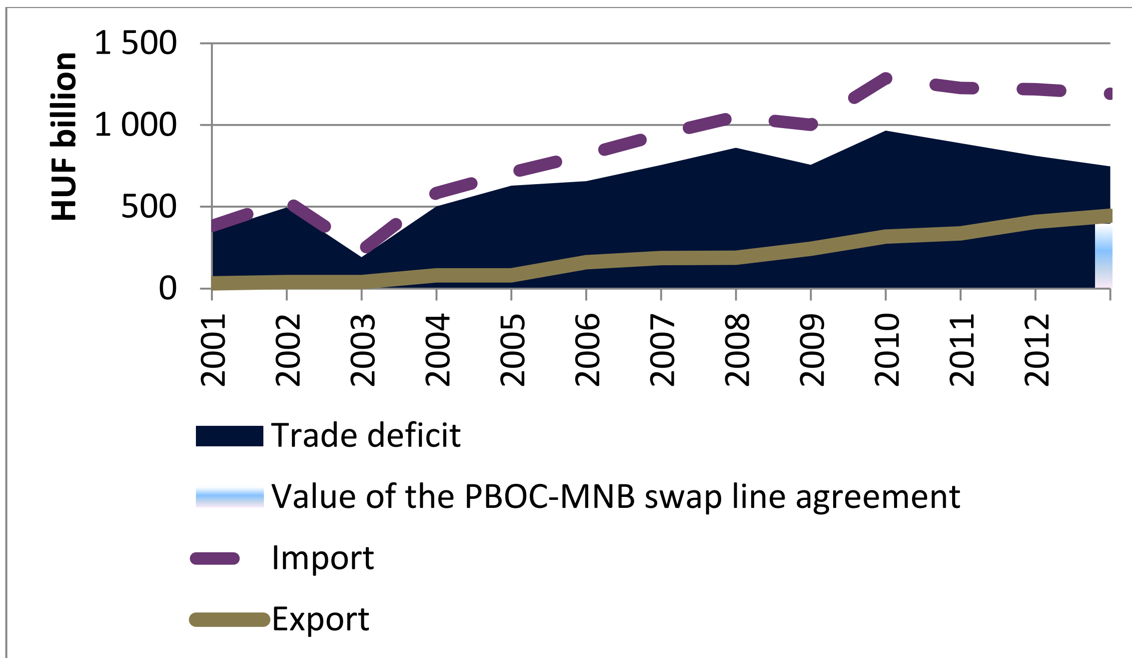
- swap agreements reinforce market participants' confidence in the currency, which has a positive effect on market liquidity

- similar to the positive effects on foreign trade, swap agreements may benefit the settlement costs and risks of foreign direct investment, portfolio investments, etc.

- trade relations may be strengthened; external relationships become more diversified

The MNB's swap-line agreement with China (Palotai, 2013) allows for the provision of foreign currency liquidity up to HUF 375 billion, which may also help to provide the market liquidity necessary for foreign trade settlement in the future. Owing to stagnating imports and growing exports, Hungary's trade deficit vis-à-vis China has declined gradually since the crisis; at current prices, the deficit amounted to around HUF 750 billion in 2013. Considering that the share of RMB settlement will gradually increase in foreign trade settlement and that Hungarian companies and financial service providers will have access to the European offshore renminbi market, the MNB swap-line should provide a sufficient buffer to support the safe execution of renminbi payments.

Chart 4: Hungary–China trade balance at current price and the value of the Chinese swap-line agreement



Source: KSH