

Letting go: How internationalization is freeing the RMB from PBoC control

Beijing has prioritized RMB internationalization over its control of the currency. As a result, the central bank's (PBoC) ability to influence the RMB has greatly diminished – and is set to diminish further.

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hq@triviumchina.com

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Key takeaways

- Its influence has weakened because the majority of foreign exchange transactions involving the RMB no longer occur in the onshore RMB market where the CNY is traded. The weight of activity has migrated to the offshore RMB market which trades the CNH and over which China's central bank (PBoC) can't exercise direct control.
- According to the Bank of International Settlements, in April 2022 more than 80% of average daily foreign exchange transactions involving the RMB took place offshore.
- We expect the offshore market to grow further in 2023. The Swap Connect program – which allows foreigners to invest in RMB-denominated mainland Chinese derivatives – is due to launch in January and requires foreigners use RMB sourced offshore. We also anticipate other opening measures that will boost the volume of offshore RMB transactions.
- As the CNH market expands so will its influence, further diminishing the PBoC's ability to guide the RMB's exchange rate.
- We expect that the PBoC's current foreign exchange management regime – a "managed float" – will become increasingly unsustainable and that a new regime will emerge within two years, one that leans heavily on the use of interest rates to influence the currency's value.

The speed and size of the RMB's decline against the US dollar in 2022 was unprecedented. Between mid-April and the first week of November, the RMB fell 12.5% against the dollar, taking the Chinese currency to its lowest point since January 2008.

Only a few years ago it would have been inconceivable for such a sharp decline to be tolerated. However, the lesson of the past year is not that Beijing has become more willing to allow the market to guide the RMB's value – although that is certainly the case. Rather, it is that the People's Bank of China (PBoC) can no longer control the RMB's value, even if it wanted to, and its waning influence is part of a deliberate trade-off to promote the currency's internationalization.

Today, the majority of foreign exchange transactions involving the RMB no longer occur in mainland China's onshore currency market which trades the CNY. According to the Bank for International Settlements (BIS) (which publishes a snapshot of currency trading volumes every three years) average daily RMB trading in foreign exchange markets – adjusted for exchange rate movements – during April 2022 was more than 70% higher than during April 2019. In April 2022, just over 80% of transactions by volume were offshore.¹ We expect offshore RMB transactions both absolutely and as a percentage of total transactions will increase further in 2023 with the scheduled launch in January of the Swap Connect program which – like the Stock Connect and Bond Connect programs – requires foreign investors to invest in China using yuan acquired offshore.

The RMB's value in the CNH market has become the price used for the bulk of foreign exchange transactions and CNY is set to become increasingly irrelevant. This trend will affect the PBoC's ability to directly control the currency because the CNH market is beyond its direct regulatory reach. Direct intervention will become increasingly expensive as the market grows. And while the PBoC can influence the CNH market indirectly – through its control of CNY and by instructing state banks to act on its behalf offshore – as the size of the CNH market grows, the PBoC's ability to exert influence will wane.

Consequently, the tools the PBoC used in 2022 to smooth the yuan's decline and limit daily volatility [Fig. 1], will become increasingly ineffective and it would be a mistake to assume that the central bank's efforts to influence the RMB's value represent a new normal.

Fig. 1 – PBoC regulatory measures used in 2022 to slow yuan depreciation

Date	Measure	
Apr 25	PBoC announces a cut to the reserve requirement ratio on banks' foreign currency deposits to 8% from 9%	The change requires banks to hold less foreign currency as reserves, freeing up dollars for banks to use as they see fit

1 "BIS Quarterly Review: International Banking and Financial Market Developments," Bank for International Settlements, December 2022, https://www.bis.org/publ/qtrpdf/r_qt2212.pdf

Date	Measure	
Aug	PBoC repeatedly sets the USD/CNY central parity rate weaker than the level its formula for the daily fixing would dictate	Given that the trading band is based on the central parity, the move signaled that the PBoC would tolerate a smaller maximum decline in the RMB's value than it had tolerated in the past
Sep 5	PBoC announces a further cut in the reserve requirement ratios on banks' foreign currency deposits to 6%	See above
Sep 27	Reuters reports that the PBoC has instructed market maker banks to use the "counter cyclical factor" when calculating daily central parity submissions	The counter cyclical factor is a way to weaken the central parity during times of RMB strength, and strengthen it during periods of RMB weakness
Oct 25	PBoC and SAFE raise the macroprudential adjustment parameter (MAP) to 1.25 from 1	The MAP is a multiplier that determines how much a company can borrow offshore. Raising the MAP allows banks to meet customer demand for foreign currency by borrowing dollars rather than buying dollars with RMB, which puts downward pressure on the Chinese currency

Source: PBoC, Trivium

We expect that it will become increasingly difficult for the PBoC to maintain the RMB's "managed float," which is how the current foreign exchange regime is described. Given the urgency with which the central bank is pursuing both RMB internationalization and interest rate reform, we expect the managed float will be abandoned and replaced by a new, more flexible foreign exchange management regime within the next couple of years.

This new regime will be one that relies heavily on the use of interest rates to influence the RMB's value, as is the case in most major economies. A foreign exchange management regime based on interest rates will allow the PBoC to exert direct influence over the value of CNH. The PBoC needs to be able to combat currency weakness – both CNH and CNY alike – by raising interest rates, thereby increasing global demand for RMB-denominated investment assets. If the currency strengthens too much, it can do the reverse. The central bank has spent the last few years actively working toward building a market-based interest rate system that does just that (see our July 26 report, [Getting interest rates to work: Will the latest overhaul of deposit rates drive more effective monetary policy?](#).)

The PBoC is not yet ready to make such a transition. But with market forces increasingly taking the lead in determining the RMB's value – both onshore and offshore – the change will need to happen soon.

CNH vs CNY

Since 2018, the PBoC has maintained a managed float, which involves allowing the onshore CNY to move freely over the long term while limiting its daily volatility against the dollar. Each morning 14 major banks submit to the PBoC a level at which they think the CNY should start trading against the dollar when the market opens. Their

submissions are based on the CNY's closing price the previous day, adjusted to take into account its value against a trade-weighted basket of currencies.

The PBoC then publishes what it calls the central parity rate – a reference level for the day's trading. The RMB can trade as much as 2% above or below the reference level, also known as the daily fixing. That gives the CNY a lot of scope of move over time, albeit within daily limits.

This regime applies only to the onshore CNY. The offshore CNH trades freely around the world. Its value is mainly determined by the market.

CNH and CNY exist as two separate markets because RMB can't flow in and out of mainland China except under certain conditions, primarily the settlement of cross-border trade, foreign and outward direct investment, inward investment in Chinese securities, and outward investment into overseas securities.

As a result, CNH and CNY consistently trade at different levels against the dollar [Fig. 2].

Fig. 2 – CNH typically trades at a discount to CNY

30-day moving average of the daily spread between USD/CNY central parity and USD/CNH spot rate



Note: The USD/CNH spot rate is published daily by the Hong Kong Treasury Markets Association. It is a benchmark rate calculated based on "transactions executed in a window of 30 minutes centered at 11am." (TMA)

Source: CEIC, Trivium

The PBoC has, for the majority of the time, been able to keep the spread to a minimum by allowing some institutions to transfer RMB cross-border to take advantage of the difference in price. Offshore banks that do RMB business can apply to become "participating banks" in the China Foreign Exchange Trade System (CFETS), which allows them to trade in the onshore interbank foreign exchange market. There are currently more than 60 participating banks, most of which are the Hong Kong branches of major Chinese and global banks.

These banks help narrow the price gap between CNH and CNY by selling CNH onshore for foreign currency and using it to buy CNY. There are limits to what the banks can do with the CNY – they are only allowed to transfer it back to Hong Kong into special accounts and use it to invest in mainland capital markets, recycling it back into the mainland.

These participating banks are thus a key tool for the PBoC to narrow the CNY/CNH price gap. If the PBoC sets the CNY's central parity at a strong level relative to the CNH's trading level, then participating banks will sell their CNH for dollars onshore. By reducing the supply of CNH offshore, the value of the CNH should strengthen, thereby bringing it into closer alignment with the CNY.

Offshore overtakes onshore

For years after the launch of the CNH in 2010, the cross-border use of RMB was marginal. Consequently, by controlling the value of the CNY, the PBoC controlled the price at which the vast majority of RMB transactions were settled. Because the RMB was mostly traded inside mainland China's borders, the PBoC could impose rules to ensure that the currency moved in ways it approved of. Failing that, the central bank stood ready to intervene directly, buying and selling dollars to alter the CNY's level.

However, in recent years CNH has become the bigger of the two markets which means that today, the price at which most RMB transactions are settled is primarily determined by market forces, and only indirectly influenced by the PBoC.

According to the BIS's triennial survey, offshore trading accounted for almost 83% of global trading in April 2022. That's up from 72% in April 2019. That said, there's reason to think the CNH's ascendance hasn't moved in a straight line. According to an April 2021 speech by Zhou Chengjun, director of the PBoC's Institute of Finance, only about 60% of daily global foreign exchange transactions the RMB occurred offshore at that time. Still, even at a lower percentage, Zhou said that:

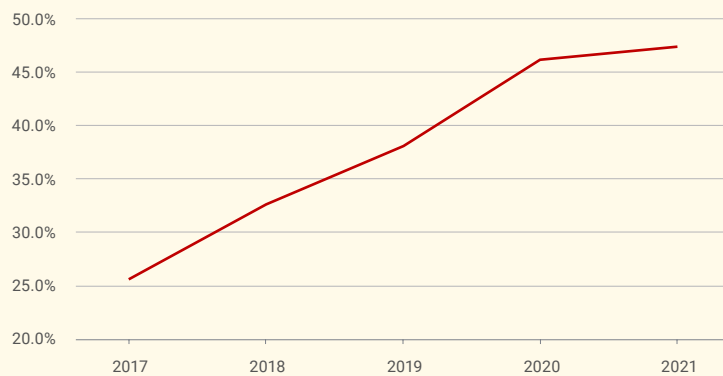
“It is difficult for the PBoC to intervene and determine the offshore RMB's price formation.”

The rising importance of the offshore market has in large part been due to the increasing use of RMB for cross-border transactions. In 2021, 47.4% of all cross-border transactions in and out of mainland China (including for trade, investment in financial securities, direct investment, lending, and remittances) were denominated in RMB, according to the PBoC's 2022 RMB internationalization report, up from only 25.6% in 2017 [Fig. 3]. Such transactions involve the RMB being exchanged for foreign currency outside of mainland China.

The growth has been driven almost entirely by foreigners investing in mainland China's stock and bond markets, although investment by Chinese funds in Hong Kong stocks and bonds has played some part. The volume of foreign capital invested in mainland financial markets has surged since mid-2017 and almost all of it has entered and left China as RMB [Fig. 4]. In 2021, 74.1% of cross-border capital account transactions in RMB involved investing in securities, according to the PBoC.

Fig. 3 – RMB share of China's fund inflows and outflows

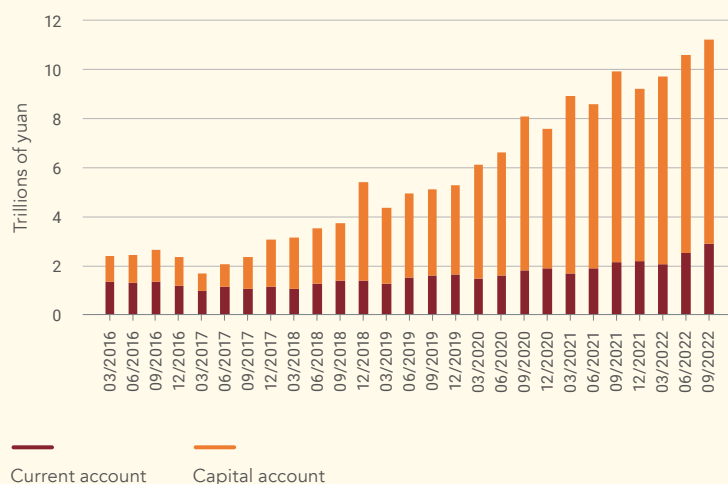
Annual cross-border payments and receipts made by banks for their customers in RMB as a percentage of the total



Source: PBoC, Trivium

Fig. 4 – Cross-border RMB transactions are dominated by capital account investments

Quarterly RMB payments and receipts by banks for customers, by use of funds



Source: CEIC, PBoC, Trivium

Capital entering or leaving the mainland for the purpose of investing in financial markets is tightly controlled by the Chinese authorities. Funds can only enter via a handful of specific programs, which each have their own rules governing who can invest, what markets they can invest in, and how much money can flow in and out. The programs also have rules prescribing which currency is allowed to enter. Almost all – RQFII, Stock Connect, Bond Connect, Wealth Management Connect, and Swap Connect (which formally launches in January 2023) – require foreigners to use RMB sourced offshore (CNH) to invest in onshore

markets. Similarly, funds flowing the other way under comparable programs must leave China as RMB.

There are exceptions. Under the China Interbank Bond Market (CIBM) Direct program, foreign institutions can bring in RMB or foreign currency. Only QFII, the earliest investment program that started in 2002, allows investors to bring in foreign currency.

The cross-border flow of RMB is only part of the picture. Forcing foreign investors to obtain RMB offshore has a multiplier effect on demand. It generates offshore demand for the hedging tools – namely currency futures and interest rate swaps – that investors rely on to manage their risks. Consequently, the volume of offshore RMB transactions has increased well beyond simple spot transactions.

According to the BIS data, more than 90% of all RMB options, currency swaps, and outright forwards were conducted offshore in April 2022. Total volume of all three are still relatively low compared with spot and FX swap transactions, but they've grown quickly. RMB options transactions were up almost 300% from April 2019, currency swaps were up 64%, and forwards were up 74%.

This is how Zhou explained it in a speech in April 2021:

When an overseas entity invests in RMB assets, it must “conduct exchange rate risk management, avoid currency mismatch risks caused by holding these non-local-currency financial assets, and conduct hedging transactions and hedging on these non-local-currency positions and assets.”

Hence, even though only about half of cross-border transactions in and out of China are denominated in RMB, the preponderance of capital account transactions is a source of demand for RMB derivatives unique to the offshore market.

According to the BIS, the global surge in RMB foreign exchange transactions between April 2019 and April 2022:

“...was led by trading in options and with institutional investors, hedge funds and other non-bank financial customers. The shares of options in total turnover about doubled between 2019 and 2022, to 10%, as did the share of non-bank financial customers, to 18%.”

The volume of offshore RMB transactions will continue to increase. The new Swap Connect program is due to launch in January, and Beijing is slowly opening the onshore commodities futures markets to more foreign investment. Both should generate greater offshore demand for yuan, as well as demand for related hedging tools.

With the vast majority of RMB foreign exchange transactions now occurring offshore, the onshore market has become peripheral to RMB price discovery. As such, tweaks by the PBoC to the onshore CNY are registering less and less on the CNH.

RMB internationalization trumps control

Relinquishing control over the RMB is a precondition for internationalizing the RMB, and Beijing is now increasingly prepared to give up that power. Foreigners will never willingly use the RMB for cross-border trade, lending, and investment, or as an anchor currency unless the RMB's value reflects market demand. The value of a currency needs to be determined wherever trading is most active – and increasingly that's outside of China's borders.

In a May 2021 presentation, Zhou Chengjun put it like this:

“In South Korea, the average daily trading volume of the RMB against the Korean won...is about 150 times the average daily trading volume of the Korean won against the RMB in the Shanghai Foreign Exchange Trading Center; in Kazakhstan, the average daily trading volume of the tenge against RMB is nearly 60 times the average daily trading volume [in China].

“Under the conditions of RMB internationalization, where is the foreign exchange market for the RMB? I think eventually it will not be in Shanghai...but overseas, in our neighboring countries...We have to acknowledge that under the conditions of RMB internationalization, we cannot control the RMB exchange rate.”

Beijing is increasingly disinclined to intervene in offshore markets because its ability to control or even influence the currency's value is diminishing given the dominance of offshore markets in RMB trading. In theory, the PBoC could deploy its foreign exchange reserves to prop up the RMB by buying CNH offshore. In fact, in October Reuters reported that the PBoC told Chinese banks to use dollars to buy CNH. The RMB declined – both onshore and offshore – until early November when the dollar's global strength petered out.

However, we don't think the PBoC will regularly resort to such measures. To maintain the CNH at an artificially higher level, it would have to be willing to provide dollars for as long as the market kept trying to push it lower. That's a potentially expensive intervention with an uncertain outcome. China's foreign exchange reserves declined by almost USD 1 trillion in 2015-16 as the PBoC battled to stem the currency's decline, unsettling global financial markets. Since then, the PBoC has been less willing to deploy its shrinking reserves to defend the RMB. According to Zhou, since 2018 the PBoC no longer “routinely” intervenes even in the onshore market.

The endgame

Beijing has long wanted the RMB to become an international currency, and developing deep and liquid offshore markets to trade RMB – and RMB derivatives – is an essential part of the process. Requiring foreigners to source RMB offshore as a precondition for investing in China's onshore financial markets is an important building block.

But achieving internationalization comes at the cost of relinquishing control over the currency's value. The PBoC appears increasingly

prepared to make that trade-off – indeed it has little, if any, choice. The central bank gave up absolute control years ago and is now giving up its ability to even influence the RMB given the diminished relevance of the onshore CNY market. As the offshore market grows in both absolute and relative size, the PBoC will have no option but to start to experiment with interest rates as a way to influence the yuan's value.