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Hong Kong Renminbi Offshore Market and Risks to Chinese Economy[1]

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1. Hong Kong offshore market and RMB dual exchange rates

The RMB offshore market is booming in HK. The balance of the RMB deposits and bonds exceeded RMB170 billion as of September, more than double as half a year before. The interbank RMB business, especially, is developing rapidly. The RMB foreign exchange market, where RMB fund can be delivered in HK, started in July, and the daily turnover of spot and forward exchanges has grown to US$300-500 million.

It should be noted that since the start of the HK RMB foreign exchange market, the RMB is de facto under the dual exchange rate system. One is the exchange rate fixed in Shanghai (CNY) under the management of the Peoples Bank of China, which I call "Shanghai (or official) rate" here. The Shanghai rate is applicable to all legal external transactions of China. The other is the freely quoted exchange rate in HK (CNH), which I call "HK (or offshore) rate." The HK rate is applied to all transactions (except trade-related) among non-residents, whose access to the Shanghai market is not permitted. The HK rate of the RMB vs. US dollar has so far remained higher than the Shanghai rate, and in mid-October the divergence of CNH6.47 against CNY6.64 reached 2.5%.

[1] This article in Chinese is in Oriental Morning Post (An economic newspaper in Shanghai, China) on December 7th, 2010. The views expressed in the article are those of the author and do not necessarily present those of IIMA.

2. Background of dual exchange rates

As a background why the RMB has now dual exchange rates of the Shanghai official and HK offshore rates, one can point out technical and policy factors.

The technical factor is the availability of the "China Foreign Exchange Trade System" (CFETS) to financial institutions. When domestic banks deal foreign exchange transactions, they have an obligation to use CFETS, a computer platform run by PBoC. Overseas banks may access CFETS indirectly via e.g. the Clearing Bank in HK only for transactions related to trade and other legal business with China. For RMB deals originated otherwise they must use the HK offshore market.

The policy factor is related to policies of opening domestic markets and the internationalization of the RMB. In December 2008 the State Council publicized the so-called "30 Articles of Financial Policy," in which it clarified its support of developing the RMB business in HK. By defining HK as a RMB offshore center, where financial transactions are allowed freely, it intends to promote Asianization or regionalization of the RMB. In July this year Chinese monetary authorities and Hong Kong Monetary Authority revised the RMB Clearing Agreement, by which the policy of separating the offshore RMB market from the domestic has been implemented.

3. The roles and risks of Hong Kong offshore market

The HK RMB offshore market has two important roles for the Chinese economy. One is to gain time before opening domestic markets and financial reforms by offering a variety of financial products for the internationalization of the RMB. The other is to induce hot money anticipating the RMB appreciation into HK, easing the pressure for such short-term capital to flow into China. The premium of CNH over CNY may be interpreted as a kind of "Tobin tax" (taxation to the cross-border short-term capital movement).

On the other hand, risks to the Chinese economy are not small. The dual exchange rate system distorts China's export-import prices. By switching imports to the RMB settlement, importing companies can enjoy legally the benefits of the higher RMB rate vs. US dollar than the official rate. The accumulated balance of RMB settlements rose from RMB 70.6 billion as of June to RMB 197.1 billion as of September, of which export and import accounted for RMB 17.7 and 157.1 billion respectively, showing the overwhelming share of import. The reason why the RMB settlement of export (the main target of the scheme) is stagnant, while that of import rises sharply, lies, in addition to the issues of competitiveness/bargaining power of general trading firms, undoubtedly in the existence of dual exchange rates.

The greater risk is the possible delay in domestic financial reforms. By dividing RMB markets into domestic and offshore ones, the reform pressure to domestic market participants and monetary authorities will decline. Regulations on interest rates and market entry become hindrance to competition, preserving vested interest groups that enjoy extra rent-seeking. The HK offshore market may be used as an excuse for delaying the domestic financial reform.

4. Experiences in Japan and Europe

During 1980s, in order to avoid negative effects of short-term capital upon trade and domestic economy, Belgium maintained the dual exchange rate system, by categorizing commercial transactions into those, on which the official rate (fixed rate) should be applied, and those for the financial rate (floating rate). The dual system was abolished when the European Community (EC) decided to fully liberalize capital account controls.

When Japan implemented financial reforms/liberalization in the 1980s and 90s, the monetary authority divided markets into the domestic and overseas, liberalizing overseas yen financial transactions first. The domestic reform was delayed by the conflict of interests among heavily protected banking, securities and insurance industries, which resulted in the outflow of financial businesses to London and other financial centers. The full-fledged financial overhaul had to await the so-called “Financial Big Bang” in 1998. This delay in the domestic financial reforms is one of the causes why the internationalization of the yen is stagnant and the ranking of Tokyo as an international financial center is declining today.

5. Hong Kong offshore market as a transitional step

There are two ways in resolving the present dual exchange rates of the RMB. One is to admit the direct or indirect access to CFETS by overseas banks for any kind of RMB deals. The RMB exchange rate will converge to the Shanghai rate. The other is to abolish CFETS, and to introduce the same modus (use of the private information network) of foreign exchange trading in the mainland as in HK and other international financial centers. Led by the Shanghai market, the RMB will be traded in major financial centers globally.

The HK offshore market should be positioned as a temporary, transitional step in the process of the RMB internationalization. China should be engaged actively in financial reforms and open domestic markets in an orderly sequence. By the rise of Shanghai to an international financial center, HK will lose its monopolistic status as a RMB offshore center, but with its longstanding, unparalleled financial record its relative advantage will be kept.

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