



Direct Exchange Transactions between Japanese Yen and Renminbi

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On June 1, 2012, direct exchange transactions between the Japanese Yen (JPY) and the Chinese Yuan (Renminbi, RMB) started in both the Tokyo and Shanghai markets. This is one of the results of an agreement reached at the meeting of both countries' leaders on December 25, 2011, aiming to "strengthen mutual cooperation toward the development of financial markets both in Japan and China." It is quite welcome that the actual transaction is going to start after the relatively short period of preparation of just half a year.

Transactions of RMB have been quite rare so far in the Tokyo market despite growing trade volume with China, so it is a landmark moment that RMB exchange rates are going to be quoted against JPY in the Tokyo market. Yet, the transaction of the RMB in Tokyo is to be made in the offshore market (among nonresidents) as is the case in Hong Kong, and it is not possible to have free access to the Chinese mainland markets. For the time being, market-making in Tokyo will be conducted mainly by the 3 Japanese megabanks (Bank of Tokyo-Mitsubishi UFJ, Mizuho Corporate Bank, and Sumitomo-Mitsui Banking Corporation) within the limited liquidity available.

The merits of the direct exchange market between JPY and RMB in Tokyo include a reduction of exchange costs and risks to customers (exporters/importers), but for the moment, not much can be expected from this since the liquidity of the market currently remains limited. Rather, it should be considered a declaration that the transaction of RMB has become much

easier in the Tokyo market. For the moment, the lack of market thickness in Tokyo will require the banks to concurrently use the USD-RMB markets in Hong Kong to cover their positions resulting from customer transactions. However, the start of direct exchange transactions between the Yen and RMB in the Tokyo market will encourage and promote the development of the market by bringing in the potential need for RMB transactions, which will increase against the backdrop of rapidly growing trade and capital transactions between Japan and China.

On the other hand, the introduction of the new market-making system for JPY in China can be understood as a measure to encourage the internationalization of RMB as well as a way to lower dependence on the USD. Both countries share mutual interest in the development of the onshore market in Shanghai that will result from the promoted direct exchange between JPY and RMB, since the development of the onshore market in Shanghai will help promote Tokyo's offshore markets of JPY/RMB, thus encouraging further deepening of financial markets in Tokyo. Currently, the settlements in RMB of trade between Japan and China account for less than 1% of the total, but support by both governments is expected to facilitate the shift of the settlements from the USD to RMB or JPY in the foreseeable future.

The most important challenge for the Japanese banks is to figure out how to secure the liquidity of RMB in the Tokyo market. At present, there are many restrictions in the cross-border transactions of RMB, constraining the provision of liquidity in overseas markets other than Hong Kong. In order to secure adequate liquidity for RMB in the Tokyo market, it is important to push the Chinese government to deregulate its foreign exchange controls. The Chinese government, however, is still reluctant and cautious to liberalize the cross-border transactions of RMB, due to concerns over its impact on domestic monetary and financial policies. The future deregulations/liberalizations of the exchange controls, therefore, will be a rather slow and modest process, if they are implemented at all.

In these circumstances, one possible measure to increase the liquidity of RMB in the Tokyo market will be for the Bank of Japan and the People's Bank of China to conclude a swap agreement to mutually provide their currencies, thus supplementing the liquidity in the private sector with the provision of RMB via Bank of Japan. During the press release meeting for the start of the direct exchange of Yen and Chinese Yuan on May 29, Finance Minister Azumi told reporters that both authorities will continue to discuss possible solutions every time disturbances or difficulties should be observed. Further solid progress with specific measures created is necessary for strengthened financial cooperation between Japan and China.

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