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The Capital Liberalization and Financial Reform are the Key to the Renminbi Internationalization

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Abstract:

1. The internationalization of renminbi (RMB) progresses steadily, the currency swap network is expanded and the RMB offshore centers diversified.
2. In liberalizing capital accounts, China's intention seems that capital transactions using RMB are given priority in easing before restrictions are lifted generally in steps.
3. The financial reform is indispensable for capital liberalization, and is an urgent task in face of the recent rapidly changing domestic financial structure. The government formulated a reform program to be realized by 2015, but may face tough resistance from vested interests.
4. It will not be surprising if the delay of the financial reform and capital liberalization causes the internationalization of RMB to slow down, or even be shelved temporarily.

Introduction

In the Report on the Work of the Government at the National People's Congress last March former Premier Wen Jiabao emphasized the importance of financial reform, saying "We will steadily promote the reform to make interest rates and the RMB exchange rate more market-based, and extend the use of RMB in cross-border trade settlement, and re*alize step by* *step the RMB convertibility of capital accounts*[1]. He mentioned three important policy agenda of the internationalization of RMB, capital liberalization and financial reform in this sentence. The paper tries to clarify how three policy agenda are related each other, and how the Chinese government intends to realize them, and concludes with a possible perspective.

1. Steady progress of the RMB internationalization

(1) Recent development

For three years since nonresidents obtained access to RMB, various indices of the RMB internationalization showed a remarkable growth with a heated demand for RMB in expectation of its exchange rate appreciation. The one-sided growth changed last year, and the Japan Economic Journal once reported “The government guided internationalization halts.”

In 2012 the China’s trade volume of goods increased by 6.2% to US$3.87 trillion, close at the heels of the United States. As the RMB settlement of traded goods increased from CNY1.56 trillion (RMB denominated trade ratio 8.6%) in 2011 to CNY2.06 trillion, the RMB denominated trade ratio is estimated to have grown to ca. 10%. The RMB denominated direct investments (in-, outward) increased substantially from CNY110.9 billion to CNY284.0 billion.

In Hong Kong the balance of the RMB deposit was CNY603.0 billion at the end of 2012, and remained stagnant throughout the year. It was due to the receding expectation of the RMB appreciation in the first half of the year. However, when the balances of the CD (Certificates of Deposit) and Dim Sum bond are combined with the deposit, the total balance increased by 22.1% from CNY812.1 billion (2011) to CNY991.2 billion at the end of 2012. The temporary stagnation of the RMB deposit balance in HK reflects, in addition to the exchange rate factor, the diversification of RMB financial products, the wider channels of investment in the mainland and the expansion of RMB off-shore markets. In 2013 the RMB deposit balance recorded CNY668.1 billion in March, the highest in history, as the RMB exchange rate climbed against US dollar.

The currency swap agreements of total CNY16.6 trillion were concluded with 18 countries/area as of end of 2012. In March 2013 People’s Bank of China (PBoC) concluded an agreement amounting to CNY190.0 billion (Real60.0 billion) with the central bank of Brazil. At

[1] In the full text of the Report distributed by the Xinhua News Agency, the sentence in italic is included in the Chinese and Japanese versions, but omitted in the English version.

least eight countries so far announced to hold RMB in their foreign reserves[2].

(2) Expansion of off-shore markets with HK as a core market

Since 2012 multiple RMB off-shore markets are growing. In order to make London a center for RMB business in Europe, Britain, having agreed to cooperate with China and HK on the governmental basis, holds a private forum with HK twice a year. While the RMB deposit balance in London dropped sharply from ca. CNY100 billion end of 2011 to CNY14.3 billion June 2012, the daily turnover of RMB spot exchange increased by 150% of the previous year to US$1.7 billion, equivalent to that in HK. Two RMB denominated off-shore bonds were issued. The decrease of the RMB deposit is attributed to the speculative nature of funds, which is not based on the real demand such as trade finance (City of London (2013)).

In Taiwan, Bank of China started its activity as a RMB clearing bank in February 2013, and in Singapore, Industrial and Commercial Bank of China was nominated as a RMB clearing bank soon after. In Taiwan, where the RMB business was allowed newly in the Domestic Banking Unit (DBU) in addition to the Off-shore Banking Unit (OBU), the RMB deposit balance reached CNY48.3 billion in March 2013 (CNY11.5 billion March 2012). The RMB deposit balance in Singapore is estimated to have increased to ca. CNY100 billion recently from CNY60 billion mid-2012[3].

In June 2012 the Yen/RMB direct dealing started. While the share of the yen in Shanghai exchange market increased to 7.4% in the 4th quarter of 2012 (0.1% in previous 4th Q) with the average daily turnover US$900 million, in Tokyo the RMB daily turnover increased to US$300 million in October 2012 (US$30 million in April 2011). In April 2013 governments of Australia and China agreed to the A$/RMB direct dealing.

2. RMB internationalization, capital liberalization and financial reform

(1) China's trilemma

As economic policy targets, the objectives of an autonomous monetary policy, stable (fixed) exchange rate and free cross-border movements of capital cannot be realized simultaneously,

[2] A report of the Reserve Bank of Australia writes "until RMB is fully convertible, these holdings will not be recognized as part of a country's official reserve assets under the International Monetary Fund's definition." (RBA (2012)) The author's understanding is that there is an exception to the IMF definition, and that when an 'inconvertible' currency can be practically used for trade purpose, it may be counted in official reserve.

[3] (Source) homepage of Taiwan Central Bank and WSJ Net dated 8. Feb. 2013 "ICBC Picked as Yuan-Clearing Bank in Singapore"

and therefore, at least one of them needs to be abandoned to achieve the rest. This is well-known as a theory of irreconcilable triangle in a textbook of international finance.

For decades China adopted a fixed exchange rate regime under strict capital controls. Due to the chronic depreciation trend of RMB, the Chinese government had to be alert on capital flights. After China's accession to the World Trade Organization (WTO), with the increasing trade surplus and foreign reserves, RMB was placed under the constant pressure for revaluation, and the hot money (international short-term capital) flowed into China despite tight capital regulations.

In 2005 the RMB exchange rate regime was switched from the fixed to the managed floating rate, and the aim of capital control from "encourage inflow, discourage outflow" to the balanced management of in- and outflows, and in 2007 further to "discourage inflow, encourage outflow." As is the case of in- and outward direct investments, which were de facto liberalized, capital account restrictions related to the "real demand" have been eased gradually. The excessive liquidity caused by the rapid increase of reserve assets and inflow of hot money limited the maneuvering room of the monetary authority, who had to rely as policy adjustment instruments more on quantitative ones such as deposit minimum reserves and the window (administrative) guidance to banks than on qualitative ones (interest rate adjustment).

Table 1. Irreconcilable triangle and China

		Autonomous monetary policy	Stable exchange rate	Free capital movement	Description
Japan, US, UK		○	×	○	
HK(currency board) Euro area (single ccy)		×	○	○	Euro floats externally. Independent ECB
Vietnam, Myanmar		○	△	×	V: semi fixed, M: managed float
China	Before Jul 2005 (Jul 08-Jul10)	△ Quantiv. means	○ US$ peg	×	Despite strict capital control, hot money flowed in and out.
	Today	△ Quantiv. means	△ Managed float	△ RMB capital a/c	RMB offshore market becomes buffer for hot money.
	Future	△→○ Qualitiv. means	△→× Wider band	△→○△	Floating rate, capital liberalization under authority supervision

(Source) Author's composition

China's trilemma appears to have entered a new phase since 2012. Seeing the RMB rate to be close to the equilibrium level, the government reduced the intervention in the foreign exchange market, and expanded the daily fluctuation band of RMB from ±0.5% to ±1.0%. In February the Research and Statistics Bureau of PBoC publicized a report entitled "Conditions are almost fulfilled for China to accelerate the capital liberalization," and indicated its sequence and time-table. According to the report, in the short term (1-3 years) direct investments should be mostly liberalized, in the middle term (3-5 years) trade related finances are to be freed in support of the RMB internationalization, and in the long term (5-10 years) the inflow, and then outflow, of capital should be liberalized, and the real estate and securities markets be opened stepwise. The management modus of financial markets will change from the management of volume to that of price.

In September the State Council announced a financial reform program up to 2015 (to be described in the Section 3).

In November 2012 the 18th National Congress of the Communist Party of China (CPC) expressed its determination to deepen economic structural reform, saying "We should deepen reform of the financial system and improve the modern financial system…..We should accelerate development of a multilevel capital market, take steady steps to make interest rates and the RMB exchange rate more market-based, and promote the RMB's convertibility under capital accounts in due course[4]."

(2) RMB internationalization and capital liberalization

No country is known, except Japan and China, which made the internationalization of its own currency a policy objective. Industrial countries in general let it a matter of market preference, and West Germany and Switzerland were reluctant to the international holding of their currencies. In May 1998 Japan's finance minister H. Matsunaga announced at an APEC forum the government's intention to internationalize the yen. Ironically the yen internationalization had peaked by then, and up to today, due to the long-lasting stagnant Japanese economy, the yen denominated trade ratio remained unchanged and the yen holding in the international portfolio and reserves declined substantially.

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[4] The importance of market-based interest and exchange rates and the promotion of RMB convertibility under capital accounts was reconfirmed at a meeting of the State Council, headed by Premier Li Keqiang, on the 6th May 2013 (Source: Xinhuanet) .
PBoC described them as this year's major policy in the 1st Quarterly Report of Monetary Policy publicized on the 9th May 2013.

The Chinese authorities avoid carefully the term "internationalization" of RMB, but what their policies imply is nothing but RMB internationalization, such as establishing RMB offshore markets, providing foreign central banks with RMB liquidity through a currency swap network, or promoting the RMB convertibility under certain capital accounts.

Mr. Yu Yonding of the Chinese Academy of Social Sciences pointed out rightly that for the internationalization of a currency capital liberalization is a necessary, but not sufficient, condition. It is indispensable for the RMB internationalization that China eases its capital account restrictions. It may be obvious that it itself is not a sufficient condition, if one reviews Japan's experience of the yen.

Prerequisites of capital liberalization are such conditions as a stable financial system, availability of macroeconomic policy instruments, a well-functioning market economy (including the market-based interest rate and exchange rate), and an adequate level of foreign reserves. Lacking some of the conditions, a number of developing economies impose capital controls to safeguard themselves from volatile movements of international capital, and China has been no exception so far.

The experience of Germany shows that it set interest rates free and moved to the floating rate regime in the 1970s before it abolished capital controls totally. In the mid-1980s it switched the policy stance towards the internationalization of the deutschemark (DM) from negative to neutral one. The DM and its de facto successor euro has evolved to the second important international currency next to the US dollar.

In the case of Japan the timing of capital liberalization and interest rate liberalization is reversed, which leaves a lasting aftereffect to the yen internationalization and development of Tokyo as an international financial center. The Ministry of Finance and the banking industry those days, cautious or reluctant to deregulate interest rates even after the capital liberalization in principle in 1980, let the liberalization of offshore yen (the so-called euro yen) deals go ahead of the reform of the domestic market, where vested interests of various financial groups were intertwined. As a consequence, the development of the domestic financial market into an open and competitive one was delayed, as exemplified by the once "hollowing out" of the domestic debt market due to the exodus of yen denominated bond issues overseas.

Table 2. Sequence of currency internationalization, capital liberalization and financial reform: Germany, Japan and China

Germany	Free floating rate (1972) Free int. rate (60-70's)	→	Free capital movement (1981)	→			DM (euro) 2nd key currency next to US$
Japan	Free floating rate (1972)	→	Free capital movement (80's)	→	Gradual interest rate deregulation (80-90's)	→	¥ international use less than Japan's weight
China	RMB internationalization starts (2009) ・Of 40 capital a/c (IMF) more than 2/3 items partially/effectively free ・Managed floating rate ・Int. rate regulated	→	RMB offshore markets and cross border deals promoted (10～) ・ RMB use preferred in capital a/c deregulation ・Wider floating band (2012) ・ Ceiling/floor of regulated int. rate widened (2012)			→	When will RMB become a full-fledged international currency?

(Source) Author's composition

In the midst of the world financial crisis China made a political decision to hasten with the internationalization of RMB. While the dollar and euro swung wildly in markets, the aim was to reduce, and eventually free itself from, the dollar dependency of the Chinese economy. The exchange risk of the mostly dollar denominated China's trade had to be curtailed, and the value of foreign reserves worth more than US$ 3 trillion maintained.

At that time (2008-09) RMB was repegged to the US dollar, and the domestic financial reform was put on ice. Although capital accounts related closely to the real economic activities like direct investments had been deregulated in practice, capital transactions which are indispensable for the RMB internationalization such as cross-border fund lending, portfolio and foreign exchange dealings, remained strictly restricted. In other words, conditions necessary for a currency internationalization were not fulfilled.

The Chinese government made a surprise move by installing a RMB offshore market in Hong Kong which is under the "one country, two systems" rule. RMB transactions were liberalized in HK, while capital controls remained tight on the mainland for the sake of economic and social stability.

The government encouraged the use of RMB in China's trade and other current accounts, and in financial and capital accounts, regulations were eased in such a way that RMB should be used in preference to foreign currencies[5]. As all cross-border transactions in RMB are registered in the computerized management information system of China's monetary authorities, authorities seem to judge that the total picture of RMB fund movements can be easily grasped, and, therefore, possible irregularities can be coped with relatively easily. In addition, there seems to prevail a popular thought in China, i.e. "The use of Renminbi in the payment of main items of current account and financial account balance will possibly decrease the inflow of foreign currency and thus reduce the purchasing pressure faced by the PBoC." (Gao and Coffman (2013)).

For the portfolio investment in China the system of Qualified Foreign Institutional Investors (QFII) started in 2002, and its total ceiling was raised to US$80 billion ten years later by the end 2012. On the other hand, the ceiling of the RMB denominated QFII (RQFII), which started in 2011, was expanded rapidly to CNY270 billion (ca. US$43 billion) as of March 2013[6]. This is an example how the use of RMB in capital transactions is encouraged.

The Chinese government made it public that Shanghai shall grow to an international financial center by 2020, and simultaneously promised to support the prosperity of Hong Kong as an international financial center. To my question how these two issues should be interpreted, Dr. Lu Zhengwei, Chief Economist at the Industrial Bank, whom I interviewed in Shanghai, analyzed that the key is the limited capital account liberalization that prioritizes the use of RMB to foreign currencies until 2015 at least. The scenario runs as follows; "When RMB is used in capital accounts, the pressure to widen the floating band of RMB, eventually to a free floating rate regime, will lessen[7]. Meanwhile, Shanghai endeavors to increase its competitiveness as money, capital and commodity markets in the course of domestic financial reform. During the next five year plan (2016-20), the overall capital liberalization and the transition to the free floating regime of RMB are likely realized, opening China's domestic market to the world.

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5 The original Chinese version of "Convertibility of RMB capital accounts is realized step by step" is「逐步实现人民币资本项目可兑换」. This expression is identical in official papers such as the report on the foreign exchange control by PBoC Vice Governor Yi Gang, Head of SAFE, dated 18. January 2011, and the Report on the Work of Government by Premier Wen Jiabao dated 5. March 2013.

6 (Source) "BTMU (China) Jitsumu/Seido (Business/Institution) Newsletter" dated 11. April 2013 When the Taiwan$/RMB direct deal started in February 2013, the RQFII ceiling of CNY100 billion was granted to Taiwanese investors, but it is unclear whether this amount is included in the aforementioned ceiling of CNY270 billion.

7 This logic may sound strange to those who analyze exchange dealings in global terms. But for many Chinese intellectuals, for whom the closed, government controlled Shanghai exchange market is the norm, such logic appears to be natural and persuasive. In practice, however, the free trading of RMB at the HK offshore market is already exerting strong impact upon the exchange rate formation in Shanghai, and the logic will prove invalid sooner or later.

Shanghai will gain the status of an international financial center, and with a vast domestic market as its hinterland, Shanghai will prevail over Hong Kong."

The limited liberalization of capital accounts that encourages the use of RMB may be an interim measure until 2015, the last year of the current five year plan. For RMB to become an international currency it is inevitable, sooner or later, to liberalize capital controls more fully regardless of currencies. As a prerequisite, the reform of domestic financial markets must be accelerated, accompanied by gradual easing of capital account regulations in a proper sequence.

3. Market-based interest and exchange rates, and challenges ahead

(1) Official reform program announced

In September 2012 the State Council announced "the 12th Five Year Program for the Development and Reform of Financial Industries" (the Program). It is a financial reform program based on discussions by the PBoC and four other financial authorities over the past two years. It stipulates, besides quantitative objectives of raising the share of financial industries in the GDP to 5%, and the share of direct finance in the aggregate social financing to 15%, strategically important fields, basic policies and roadmaps of China's financial reform.

One needs to know the recent development of China's domestic financial structure, in addition to the argument from the viewpoint of capital liberalization, to understand why the financial reform is an imminent issue. PBoC announces regularly the aggregate social financing that explains the total volume of funds (flow of funds) the real economy procured from the financial system within a period of time. The major items of aggregate social financing include loans in local and foreign currencies, entrusted loans, trust loans, undiscounted bank acceptance bills, corporate bonds and equity financing.

The aggregate social financing increased sharply during 2008-09 in the course of CNY4 trillion stimulus package after the collapse of Lehman Brothers. Its composition has changed drastically due to the tight bank lending policy to fight inflation, and a subsequent low level of regulated interest rates. While the share of loans dropped to 44.8% in the 1st quarter of 2013, entrusted loans, trust loans and undiscounted bank acceptance bills, which are not subject to PBoC monetary policy directly, increased to 32.3%.

Table 3. Composition of aggregate social funding

	Aggregate social funding								
	Total (billion Yuan)	Compo-sition (%)	RMB loans	Foreign Currency loans	Entrusted loans	Trust loans	Bankers acceptance	Corporate bonds	Equity issue
2002	2011.2	100	91.9	3.6	0.9	——	-3.5	1.8	3.1
2003	3411.3	100	81.1	6.7	1.8	——	5.9	1.5	1.6
2004	2862.9	100	79.2	4.8	10.9	——	-1.0	1.6	2.4
2005	3000.8	100	78.5	4.7	6.5	——	0.1	6.7	1.1
2006	4269.6	100	73.8	3.4	6.3	1.9	3.5	5.4	3.6
2007	5966.3	100	60.9	6.5	5.7	2.9	11.2	3.8	7.3
2008	6980.2	100	70.3	2.8	6.1	4.5	1.5	7.9	4.8
2009	13910.4	100	69.0	6.7	4.9	3.1	3.3	8.9	2.4
2010	14019.1	100	56.7	3.5	6.2	2.8	16.7	7.9	4.1
2011	12828.6	100	58.2	4.5	10.1	1.6	8.0	10.6	3.4
2012	15763.1	100	52.0	4.9	8.1	8.1	6.7	14.3	1.6
2013 1st Q.	6152.2	100	44.8	7.2	8.7	13.4	10.2	12.2	1.0

(Source) Original data from Peoples Bank of China

The change in the weights of aggregate social financing imply that the modus of traditional monetary policy, which is dependent on volume adjustment such as the window guidance of bank lending and the management of reserve requirements, is losing its effectiveness. It is imperative to switch the modus to a more price-oriented one of interest rate adjustment. Financial reform must be undertaken to make interest rates market-based and to establish a transmission mechanism of policy interest rate adjustments.

Entrusted loans, trust loans and undiscounted bank acceptance bills make up the shadow banking in the narrower sense of term, and their balance was CNY13.7 trillion or 26% of the nominal GDP in the 3rd quarter 2012. The shadow banking in the wider sense consists of, in addition to the above three finance routes, informal finance (lending among private entities), other trust assets and corporate bond in possession of the private sector, and its balance is estimated to be CNY24.4 trillion or roughly half of GDP (Li Lirong (2012)).

"The 12th Five Year Program for Development and Reform of Financial Industries" designates the followings as strategically important reform areas;

(a) Gradual promotion of market-based interest rates (liberalization)

(b) Improvement of mechanism for RMB exchange rate formation

(c) Step by step realization of RMB convertibility of capital accounts

(d) Improvement of foreign reserve management

(e) Continued reform of financial institutions

(f) Encouragement of private sector entry into financial services

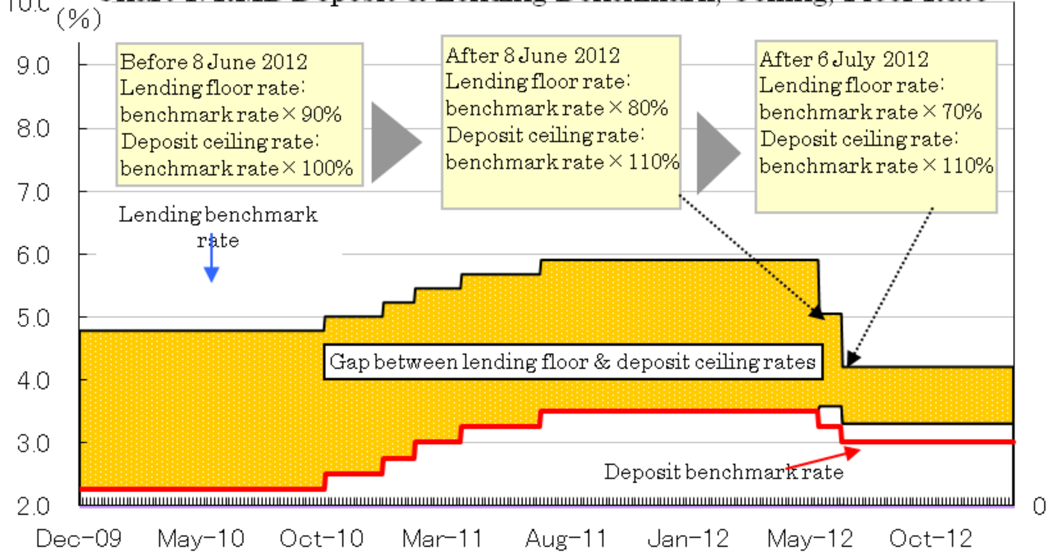
These are all financial reform areas, which might not be completed by 2015, but require continuous efforts beyond the target year. The program addresses further such topics exhaustively as making the macro-financial control more effective, establishing modern financial organization systems, accelerating the development of multi-layered financial markets (e.g. equity, bond, money, foreign exchange, gold, insurance, futures, financial derivatives), deepening the external opening of financial industries, enhancing the financial supervision, and maintaining the financial stability and safety.

(2) Market-based interest rate and challenges

In June and July 2012 PBoC lowered benchmark interest rates successively, and lowered the minimum lending rate limit from 90% to 70% of the benchmark rate, while raising for the first time the maximum limit of deposit rate to 110% of the benchmark rate. As a consequence, the interest gap of marginal one year lending/deposit rates narrowed from 2.5% to 0.9%. Although the interest rate of large amount deposits of CNY30 million or above had been already liberalized, and the ceiling of lending rate and the floor of deposit rate had been abolished, the newly established deposit ceiling rate forced commercial banks a surge of price competition and renewed efforts for more efficient management. Big banks such as four state owned banks raised deposit interest rates of only up to one year above the benchmark, leaving the rest of deposit rates at the benchmark level as before. On the other hand, many of smaller banks lifted all range of deposit interest rates full to the ceiling to survive the competition (C.H. Kwan (2012)).

The reform program formulates its guideline in carrying out the reform process of realizing step by step the interest rate liberalization; (ⅰ) relaxation of upper- and lower limit deviation from the benchmark, (ⅱ) development of benchmark rates in the market, and (ⅲ) transmission mechanism of effects of market operations by PBoC. As to (ⅰ) the first big step was taken last year, and the complete abolition of limits will be the next issue. Instead of the government regulated benchmark, (ⅱ) the role of SHIBOR and its reliability will become important as a benchmark determined in the market. As the weight of bank lending in the aggregate social financing drops, PBoC's monetary policy must shift from the volume-oriented one to the one that uses interest rate functions more fully. (iii)To secure the transmission effect of market operations, money as well as debt markets need to become more liquid.

Chart 1. RMB Deposit & Lending Benchmark, Ceiling, Floor Rate



(Source) Bank of Tokyo Mitsubishi UFJ (China)

In January 2013 Hong Kong-based banks were allowed to extend RMB loan at an interest rate of their discretion to companies registered in Qianhai district, Shenzhen. Hongkong Shanghai Banking Corporation and 14 other banks arranged loans amounting to CNY2 billion for 26 projects, and the interest rates were reported 4.3-4.5%, close to the lower limit 70% (4.2%) of the then benchmark rate 6.0%. Governor Zhou Xiaochuan of PBoC stated at a press conference to the effect that the pilot reform of offshore RMB business in Qianhai would promote the external opening of financial markets in China[8].

Deposits, loans and other banking products are more or less identical. Banks tend to be trapped in price competition (higher deposit, lower lending interest rates) rather than differentiate their products. Consequently, as the market-based interest rate will mean a smaller profit margin, banks must enhance risk management of e.g. counterparty credit and liquidity risk by asset & liability management (ALM).

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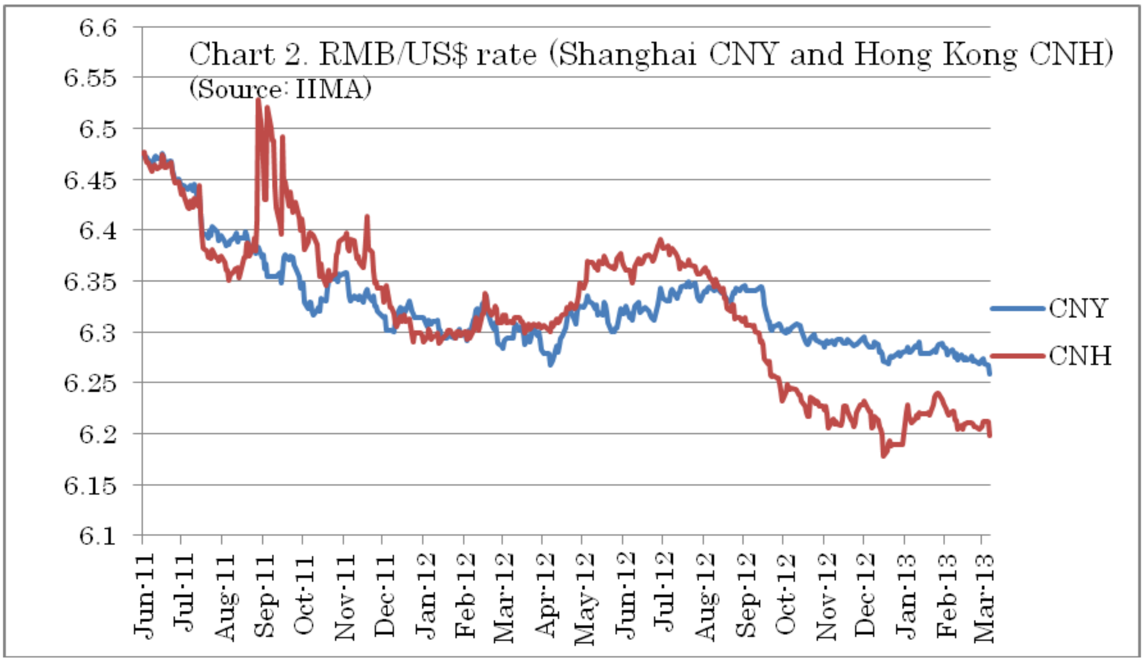
8 (Source) "China: RMB Q & A" 5 February 2013, HSBC Global Research, "China Weekly" March 21st 2013, Bank of Tokyo-Mitsubishi UFJ

Some banks may fail in competitive business circumstances, and it will be imperative to make rules, in case of bank failures, that enable financial bankruptcy resolution expediently. The deposit insurance scheme must be established to protect small depositor's interests. In 2007 the National Financial Work Conference decided to enact a deposit insurance ordinance, but the plan was frozen due to the world financial crisis. The recent reform program reconfirmed the introduction of a deposit insurance scheme. It may take some time before such rules and scheme are put into effect, as differences of interests need to be settled between large and smaller/regional financial institutions, and between the central and local governments that represent their interests respectively. For the four state owned commercial banks, which are unlikely to go bust, the plan means nothing but cost increase. Especially if the deposit insurance premium were to be levied flat across the board, large banks, which have a majority share of private depositors nationwide, would bear most of the cost of smaller bank's failure. If the level of premium were differentiated in accordance with credit risks of banks, insurance expenses might soar for small- and medium sized banks beyond their limit. This issue must be settled first before the full liberalization of interest rates takes effect.

(3) Market-based exchange rate and challenges

As the RMB exchange rate affects profitability of not only trading firms, but also a numerous number of domestic economic players, it is understandable that the Chinese government wishes to maintain the current "managed" floating exchange rate regime. Following the development of the HK offshore RMB market, the impact of CNH rate (RMB exchange rate freely priced in HK) on the CNY rate in Shanghai market has become non-negligible. Of course, CNY influences CNH and vice versa, and the market-based CNH tends to represent market participants' expectation in advance, and then the regulated CNY follows suit. In the Shanghai market the monetary authority fixes the RMB middle rate daily, and CNY is traded within the ±1% band thereof. When the CNH rate quotes outside the regulated band, in Shanghai exchange dealings either stop virtually, or are kept going through the market intervention by monetary authorities. Indeed, from October to December 2013, the Shanghai exchange market was forced almost to a stand still. So far as the RMB exchange rate moves freely in HK, there should be no other choice than the RMB floating band be widened in Shanghai.

The reform program stipulates about the RMB exchange rate that, with the principle of independent initiative, controllability and gradualism, the government will, "based on market supply and demand, improve the managed floating exchange rate system with reference to a currency basket, expand the upward-, downward flexibility of the exchange rate, and maintain the RMB exchange rate basically stable at an adaptive and equilibrium level."



The managed floating rate system, when its floating band is broad enough, can function practically the same way as a free floating rate system, and will not hamper the capital account liberalization. As the expansion of the floating band, however, increases the exchange risk of financial institutions and enterprises engaged in exchange business, they must enhance risk management system, and diverse risk hedge instruments must be made available.

Another challenge is the process how to make Shanghai an international financial center with an exchange market of the scale equivalent to HK or Tokyo. It will be necessary to redesign fundamentally the current management system of the Shanghai exchange market. At present in China, all exchange deals must originate from real economic needs, and speculative deals are not admitted. Deals are concluded only among domestic financial institutions in principle on the computerized dealing platform (CFETS: China Foreign Exchange Trading System) run by the monetary authority. Therefore, the access to the Shanghai market from overseas nonresidents is not possible but for some Chinese banks overseas.

Should Shanghai grow to one of leading exchange markets in the world, it must develop to a large, deep and liquid market open to both domestic and overseas participants. The government reform program, in which such a perspective seems totally lacking, might have put off the subject as a future challenge for the next five year plan.

Table 4. China's financial reform in the past decade

Year	Field*	Description
2004	IntR	Loan rate ceiling, deposit rate floor abolished
2005	ExR	RMB shifts from fixed to floating rate regime after revaluation
	FinI	China Construction Bank listed, receives foreign stake 14%
	Mart	CP issued by enterprises
2006	FinI	Bank of China, ICBC listed, receives foreign stake 15% & 8%
2007	IntR	SHIBOR introduced
	ExR	RMB intra-day fluctuation band widened from ±0.3% to ±0.5%
	FinI	Trust company supervisory system starts, trust company newly licensed
	Mart	Corporate bond tested
	Pol	National Financial Work Conference decision on deposit insurance
2008	Mart	MTN issued by enterprises
	YInt	RMB currency swap agreement concluded with Bank of Korea
	ExR	RMB repegged against US$ in summer (de facto fixed rate)
2009	YInt	RMB trade settlement starts
	Mart	Local governments issue bond
2010	ExR	RMB returns from fixed to managed floating rate in summer
	YInt	RMB offshore market in HK debuts (sharp rise of RMB deposit balance, RMB foreign exchange deals started)
	YInt	Foreign central banks etc. invest in domestic RMB bond market
	FinI	Agricultural Bank of China listed
	Pol	"Aggregate social funding" introduced (sharp rise of off B/S deals)
2011	Pol	Chinese version of Basel III announced
	Pol	Items of off B/S included in calculating minimum reserves
	YInt	RMB in/outward direct investment and lending permitted
	YInt	In HK RQFII tested
2012	ExR	Market intervention by PBoC refrained
	ExR	RMB intra-day fluctuation band widened from ±0.5% to ±1.0%
	IntR	Loan rate floor widened to 70%, Deposit rate ceiling to 110%
	Pol	PBoC introduces repo & reverse repo as policy instruments

2013	Pol	PM Li Keqiang confirms market-based interest & exchange rates
	YInt & IntR	RMB loan with free interest rate to Qianhai firms from HK banks

*Fields IntR: Interest rate, ExR: Exchange rate, FinI: Financial institution, Mart: Money & bond markets, YInt: RMB internationalization, Pol: Policy

(Source) Author's composition from newspapers, magazines and internet pages

Conclusion

After the completion of financial reforms and capital liberalization, Germany and most of industrial countries stayed neutral towards the internationalization of their currencies. Unlike precedent cases, China promotes the RMB internationalization as a state policy, and in parallel, tries through financial reforms to make interest and exchange rates more market-based, and to relax capital account regulations with preference to RMB transactions than transactions in foreign currencies.

The crisis awareness that the Chinese economy is too much dependent on the US dollar triggered the move to the RMB internationalization. The capital liberalization to a certain level is a necessary condition thereof, but the domestic finance system was not yet mature enough to make it possible. The government chose, therefore, the policy of "managed" internationalization of the RMB, installing RMB offshore markets in HK and others, and are pushing ahead simultaneously with the capital liberalization (of RMB transactions), and the financial reform program with the target year 2015. The difficult challenge will be the financial reform, which is likely to confront with the resistance by vested interest groups.

The financial reform and capital liberalization need to proceed in tandem. Should the deregulation of interest rates, or the capital account liberalization be delayed on the ground of e.g. domestic economic or social instability, the RMB internationalization would slow down, or under circumstances could be shelved temporarily. China follows a policy of narrow path with high difficulty level.

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