more give, less take

China Economic Update

by NAB Group Economics

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Opening the capital account will further internationalise the Yuan and monetary policy

This report is the second of two looking into capital account liberalisation in China. This report looks at the international implications of this reform. Part one is here.

In mid-June, Pan Gongsheng, vice-governor of the People's Bank of China (PBoC), suggested that China is 'not too far away' from full Yuan convertibility, while announcing the opening of a new channel for capital flows. Although we argue that the capital account is still some way from full convertibility, the liberalisation process has gone hand in hand with the internationalisation of the Yuan – with China's government seeking a greater role for its currency in the global economy.

The gradual opening up of the capital account

As we noted last month, the People's Republic has maintained a closed capital account across its history, although policy changes over the past two decades have allowed a gradual opening. The first change was the introduction of the Qualified Foreign Institutional Investor (QFII) program in 2002 – which allowed foreign residents to invest in Chinese equity and bond markets through closely regulated collective investment schemes – increasing the level of foreign investment within China, while retaining significant control (some of which has lessened since).

This was followed in 2006 by the Qualified Domestic Institutional Investor (QDII) program – which allowed Chinese financial institutions (on behalf of domestic investors) to invest in foreign markets (initially restricted to fixed income and money market products but subsequently widened to equity markets). That said, some observers have suggested that this scheme has been unpopular, with little marketing from institutions and little interest from retail investors (Reuters).

Following on from the Shanghai-Hong Kong stock connect in November 2014, the next opening will be the new Qualified Domestic Institutional Investor (QDII2) program. This scheme will remove restrictions on overseas investments by Chinese residents (meeting qualifying criteria), including the RMB 50,000 limit on exchanging Yuan for foreign currency. It is expected to launch later this year in six cities (Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen and Wenzhou) for residents with at least 1 million Yuan in financial assets.

While this continues the gradual opening of the capital account, it still falls short of full convertibility. As discussed last month, China is likely to implement a system of managed convertibility – with a goal of limiting the risks from cross-border capital flows and maintaining a stable currency and 'safe' financial environment – having observed the impact of capital flows during the Asian and Global Financial Crises.

One area of control may be a Tobin tax – a levy on financial flows that would increase foreign exchange costs, providing a disincentive for the short term currency conversion associated with hot money. This may help to retain investment funds within China. The potential for a Tobin tax was flagged in early 2014 by PBoC vice-governor Yi Gang.

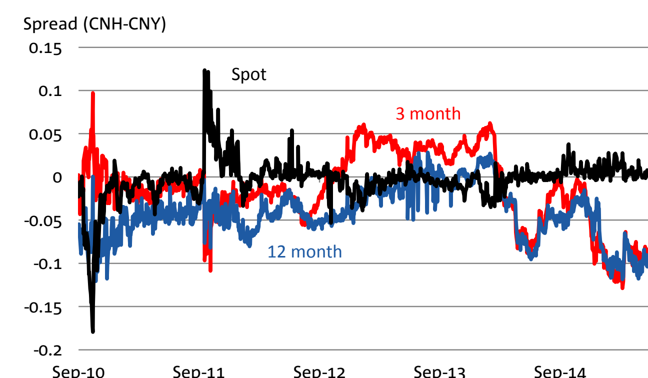
Internationalising the Yuan

The Yuan has gradually become more convertible over the past two decades. Multiple exchange rates for the currency were unified in 1994 and it became fully convertible under the current account in 1996. In 2005, the PBoC announced the end of the US dollar peg and commenced a managed floating exchange rate referenced to a basket of currencies. The permitted daily trading band has gradually widened over time (currently 2%) – with the PBoC suggesting in late 2013 that it would eventually end regular intervention in the market.

Capital account convertibility goes hand in hand with the process of internationalising the Yuan – a process that has been accelerating in recent times. While it is possible to have limited international use of the Yuan without full capital account convertibility, growing demand for the currency requires a greater level of convertibility to ensure sufficient Yuan liquidity in global markets.

China's partial solution over the past decade has been a separate onshore Yuan (typically denoted CNY) and a freely trading offshore Yuan (CNH), predominantly based in Hong Kong. This allowed greater international use of the currency, while shielding the domestic economy from excessive volatility. The freely floating nature of the CNH means that it often trades at either a premium or discount to the onshore Yuan – providing an arbitrage opportunity to the few firms able to convert between the two.

Limited convertibility contributes to sizeable spreads between CNY and CNH (particularly in forwards)



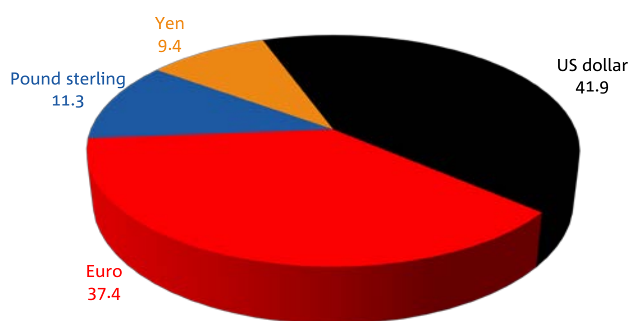
Source: Bloomberg, NAB Economics

IMF review driving the urgency of capital account reform

Later this year, the International Monetary Fund (IMF) will conclude its five yearly review of the composition of the Special Drawing Rights (SDR) basket. The SDR is an international reserve asset, designed to supplement the official reserves of IMF member countries. At present, the SDR basket comprises of four currencies – the US dollar, the Euro, the Japanese Yen and the British Pound. As a part of this year's review, the IMF is considering whether to include the Chinese Yuan in the SDR basket from January 2016 – a decision that is contributing to the Chinese government's current urgency to liberalised its capital account.

Current SDR basket is dominated by the US dollar and Euro, but this could change late this year

% of Special Drawing Rights basket

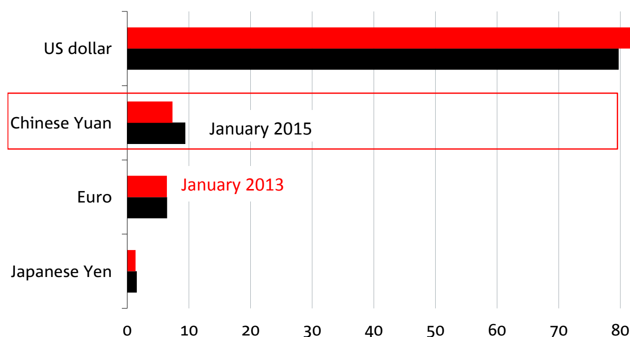


Source: IMF

It is generally thought that the Yuan must satisfy two key requirements: that it is freely useable (perhaps meaning convertible to an acceptable level) and that it is widely used in trade and financial transactions. The Yuan would seem to satisfy the second requirement easily – the growing internationalisation of the currency has increased its global usage significantly. In early 2015, the Yuan was the second largest global trade financing currency (after the dominant US dollar) and the fifth largest global payment currency (SWIFT).

Yuan now the second largest trade finance currency (albeit well behind the US dollar)…

Share of trade finance (%)

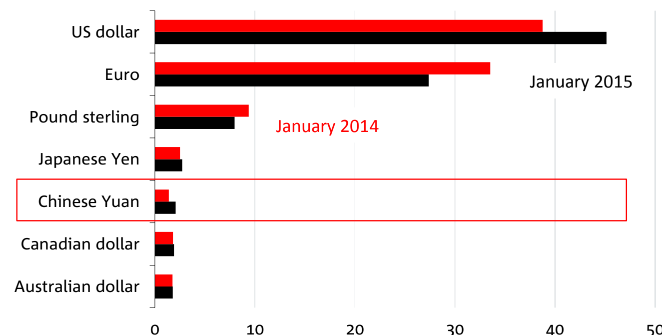


Source: SWIFT, NAB Economics

Less clear is whether the Yuan can satisfy the freely useable requirement, having failed to meet it during the IMF's 2010 SDR review. According to the IMF's 2014 Annual report on Exchange Arrangements and Exchange Restrictions, the Yuan is either 'fully' or 'partly' convertible on 35 out of 40 capital account transactions. There is speculation that China may accelerate reform on the remaining five (which involve cross border investment by individuals and the sale of bonds and stocks by foreign companies) to at least 'partial' convertibility, hoping to meet IMF SDR requirements.

…and fifth overall in terms of share of global payments

Share of global payments (%)



Source: SWIFT, NAB Economics

There are no guarantees that such measures will be considered sufficient. In early June, MSCI – a compiler of global equity indices – deferred including Yuan-denominated stocks in its emerging market index, noting concerns from investors around accessibility and capital mobility in China's markets. However, public statements from the IMF indicate that the Yuan's inclusion in the SDR basket is a matter of when, not if. Officials have highlighted that the five year review is a requirement, but more frequent reviews are permitted – leaving the possibility that a rejection in 2015 does not mean waiting until 2020 for the Yuan to be included.

Conclusions: a more open capital account and convertible Yuan to internationalise monetary policy

The immediate impact of a more open capital account is not clear – it would depend on a range of factors, including the differing rates of return available in China and overseas markets, as well as the comparative risk profiles at the point in time. Over the medium term, there is a general consensus that opening the capital account would lead to a net outflow – as Chinese investors diversify their portfolios.

An open capital account would pose significant challenges for China's financial regulators. In economic theory, the 'Mundell–Fleming trilemma' suggests that it is only possible to maintain two of the three of: a stable exchange rate; free flow of capital; and, independent monetary policy. It is the latter which is most likely to come under pressure, with the PBoC's monetary policy decisions likely to be more globally influenced under such a scenario.

While capital outflow would imply lower demand for the Yuan – as investors convert domestic financial assets into foreign currency denominated ones – the direction for the Yuan is less clear. Admission into the SDR basket (whether this year or in the immediate future) would increase demand for Yuan, particularly as this would likely be accompanied by increased demand for Yuan denominated assets in global central bank reserves, taking share from other currencies.

Further reading

For a more detailed look at the impact of China's currency liberalisation on the Australian dollar, please see the recent report produced by Emma Lawson, Senior Currency Strategist – FX Strategy: AUD & RMB Internationalisation.

For more on the outlook for Asian currencies (including China's), please see the latest Essential Asia publication, produced by Christy Tan, Head of Markets Strategy/Research, Asia.

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