

Georgia State University

## ScholarWorks @ Georgia State University

---

International Business Faculty Publications

Institute of International Business

---

2014

### China's Current Reforms from a Banker's Perspective

Penelope B. Prime

*Georgia State University*, pprime@gsu.edu

Follow this and additional works at: [https://scholarworks.gsu.edu/intlbus\\_facpub](https://scholarworks.gsu.edu/intlbus_facpub)



Part of the [International Business Commons](#)

---

#### Recommended Citation

"China's Currency Reforms from a Banker's Perspective," *China Currents* 13.1 (2014).

This Article is brought to you for free and open access by the Institute of International Business at ScholarWorks @ Georgia State University. It has been accepted for inclusion in International Business Faculty Publications by an authorized administrator of ScholarWorks @ Georgia State University. For more information, please contact [scholarworks@gsu.edu](mailto:scholarworks@gsu.edu).

# China's Currency Reforms from a Banker's Perspective

2014: Volume 13, Number 1

Penelope Prime

China's Currency Reforms from a Banker's Perspective: A Conversation with Henry Yu, Managing Director of Fifth Third Bank, Atlanta, Georgia.

As China's economy moves ever closer to surpassing the U.S. in terms of purchasing power GDP, China's currency system seems incompatible with its global economic status. China's new leadership led by President Xi Jinping is pushing to modernize and marketize the currency system along with necessary concurrent reforms. The 2008 financial crisis was a wake-up call for many countries, demonstrating the heavy dependence of the global economy on the U.S. dollar. The vulnerability of the U.S. economy became everyone's challenge. Reform of the Renminbi (RMB) became a priority in order to establish the Chinese currency as a global player and lessen China's reliance on the U.S. dollar. Aside from the fallout from the financial crisis, the sheer size of China's cross-border trade is creating demand for far more depth and flexibility in the currency markets.

On April 28, 2014, China Research Center Director Penelope Prime talked with Henry Yu, Managing Director of Fifth Third Bank in Atlanta, Georgia, via telephone about China's current currency reforms. This commentary is based largely on that conversation.

Based on his observations of China's most recent moves towards currency reform and from talking with bank officials and other experts in China about the on-going policy discussions, Henry Yu expects major changes to occur within three to five years, with the lifting of all capital restrictions a few years later.

Yu believes that the process of establishing the RMB as an international currency will involve merging offshore and onshore currency markets. This merger will require deepening the sophistication and depth of China's financial institutions in order to integrate China's system with global markets. If China's currency is to become a major player, whether as a managed or a free floating currency, many steps need to be taken throughout the economy. Multinational corporations today manage cash on a global basis, and the RMB is acting as a constraint in this process. As has been the norm in China during the reform era, China's leaders are taking measured steps, one baby step at a time, to achieve these goals, but Yu sees definite movement forward.

## *Historical Context*

In the early days of economic reform and opening, China established Foreign Exchange Certificates as a parallel currency to the domestic Renminbi, or "people's currency." Yu remembers this as an awkward system, especially as cross-border trade increased, but it served

the purpose of controlling access to foreign currency by domestic business and consumers to shield the economy from global markets. This was a political imperative at the time.

By the early 1990s, the Chinese National Yuan (CNY) was introduced as part of comprehensive banking and financial reform, and Foreign Exchange Certificates were retired. Soon after this the Asian financial crisis revealed that freeing capital flows without a sophisticated financial system could lead to serious trouble. One could surmise that China's leaders took this lesson to heart and decided to delay more currency reform until after successful banking reform. The next decade saw measures to lower China's banks' bad debt, to create and strengthen the supervision of the banking, securities and insurance sectors, and to prepare for and successfully carry out initial public offerings of the four major state banks in the global market place.

Yu emphasizes the importance of Hong Kong in China's currency reform process. From the beginning of China's reforms, Hong Kong played a major role in both the shift of manufacturing from the territory to southern China and the financial logistics and support behind it. By the early 2000s, Beijing tapped Hong Kong to play a key role in the next steps of currency reform. Hong Kong was designated as a test location where banks could facilitate individuals' retail conversion of Hong Kong Dollars to RMB with a small daily conversion limit imposed, but companies were not yet allowed to do so. This was the first offshore currency trading in RMB, and was distinguished from onshore RMB (or CNY) as CNH.

As Yu put it, "The way I look at it, the leadership is creating a new currency outside of China using Hong Kong as a window."

### *The Yuan Offshore Market*

The movement of onshore and offshore RMB became possible as part of China's cross-border trade transactions rules. Over the last decade the yuan offshore currency market has steadily developed, propelled by China's entry into the World Trade Organization in 2001. The currency has been freely convertible for trading purposes since 2009, and growing offshore access facilitates these transactions. The currency is not deliverable outside of China except in offshore centers, which now include Singapore, London, and Taipei. At this time the offshore circulation is quite small, estimated at less than 1 percent of the onshore circulation. However, about 15 percent of China's cross-border trade is settled in domestic currency, which means that many traders have access to RMB either onshore or off. As a result, then, there is a rising demand to hold RMB outside of China, creating an even greater need for offshore markets.

China's Vice Premier Li Keqiang visited Hong Kong on August 19, 2011 to reaffirm China's Central Government's commitment to develop the territory as *the* offshore RMB Center. The People's Bank of China designated the Bank of China as the clearing institution for CNH in Hong Kong. An offshore link to China's domestic national advance payments system (CNAPS) is needed for the free flow of fund, Yu says. Ideally there would be a one-to-one correspondence between the value of the CNH and CNY. This is evolving, with CNH commanding a premium for now.

With an estimated \$140 billion worth of RMB now in Hong Kong, a balance of RMB assets and liabilities and broader investment options are needed for offshore RMB to expand its reach, value, liquidity, and acceptance to investors and traders, Yu says. Right now, RMB can be held in Bank of China accounts, with some options to buy bonds (known as Dim Sum bonds) or derivatives offered by Hong Kong banks tied to the stock exchange. The latest option is lending offshore CNH back to onshore Chinese or foreign companies. This is being tried on a very limited basis with large companies in special zones such as the Qianhai zone in the West Shenzhen (announced in 2012) district and the new Shanghai Free Trade Zone (announced in September of 2013). Both the Qianhai Free Trade Area and Shanghai Pilot FTZ broadened the usage of RMB and for the first time allowed companies within the zone to borrow offshore RMB for operating needs on a limited basis, as well as pooling of onshore and offshore RMB. One of the major benefits is that companies can borrow at lower costs offshore, which will also eventually lower the onshore interest rates. In addition, the new practices create a limited testing ground for free movements of onshore and offshore RMB.

According to Yu, on the official level, China has negotiated bilateral currency swaps worth over \$400 billion with 20-plus countries, with approximately half of these countries in the Asia-Pacific region. These have two purposes. One is that in the case of distress, the two countries can have access to each others' currency. Second, it opens a currency channel between the two central banks, allowing liquidity to be shared.

### *The Capital Account Opens*

A key aspect of moving the RMB toward serving as an international currency is the continued loosening of restrictions on inward and outward flows of capital. New moves are expected with respect to allowing Chinese tourists to convert more RMB into foreign currency, allowing some investors to begin buying foreign equities and eventually increasing the amount of capital that can be used outside of China for investment purposes (Davies 2014). Ultimately private outflows of capital would lessen the need for official purchases of government bonds, assuming China continues to experience trade surpluses. Outward flows would also serve as a counter-balance to the inward flows aimed at capturing an ever rising value of the RMB.

### *What to Expect Next*

The strategy of “taking baby and calculated steps” is expected to continue, Yu says. Chinese policymakers will not want to introduce currency value volatility or encourage “hot money” flows, especially when they still need time to create currency instruments, extend banking sector experience, and improve the debt and equity markets to handle the new stage of financial deepening. But eventually, according to Yu, there will be few if any restrictions on offshore RMB flowing back into China. The ultimate goal is to increase the circulation of offshore RMB and eventually merge the offshore and onshore markets into one currency system with one value. Yu feels strongly that the new leadership team of President Xi and Premier Li is serious about increased market reforms, and financial reform in particular, to allow the market to be the force in driving the economy and to further reduce government intervention. Yu cites as one example an official at the People's Bank of China indicated that if a transaction can be done in dollars it should also be able to be done in RMB.

As China's economy grows and with cross-border trade expected to surpass \$10 trillion by 2020, the sheer quantity of currency transactions will require more options and flexibility. All indications are that China's policy makers are responding to this growing global demand for RMB.

References:

Davies, Gavyn (2014). "China's changing exchange rate policy," *The Wall Street Journal*, May 4<sup>th</sup>. <http://blogs.ft.com/gavyndavies>. Accessed May 6, 2014.