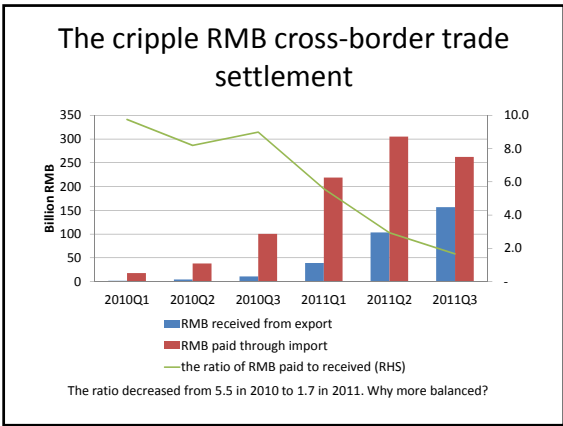
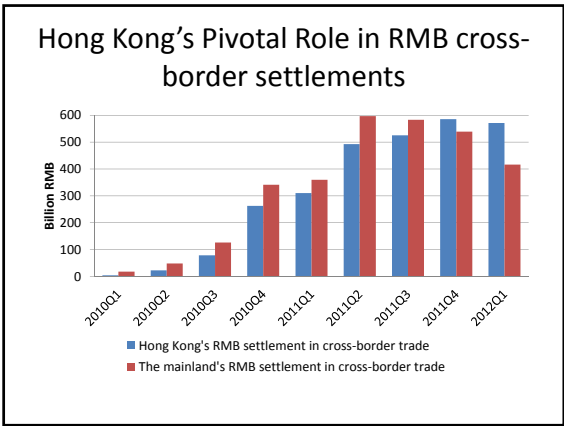
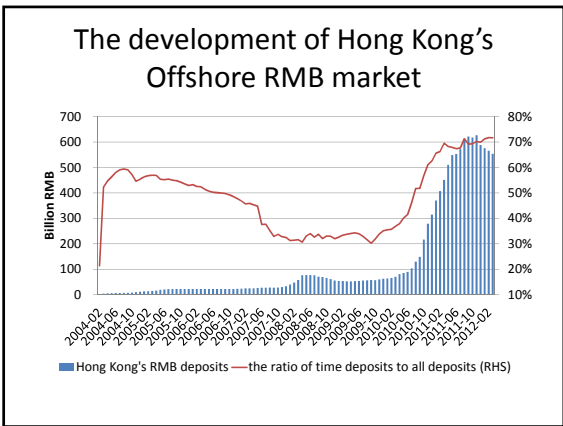
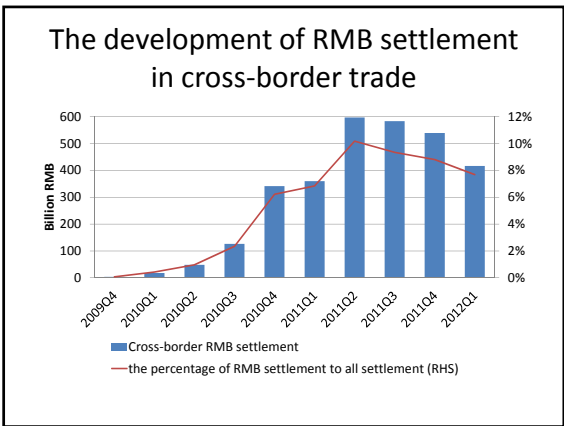


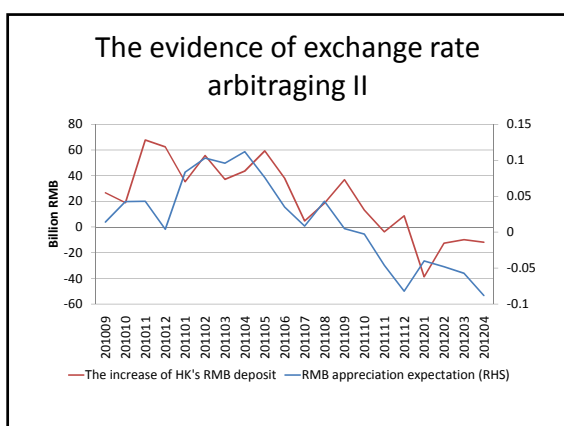
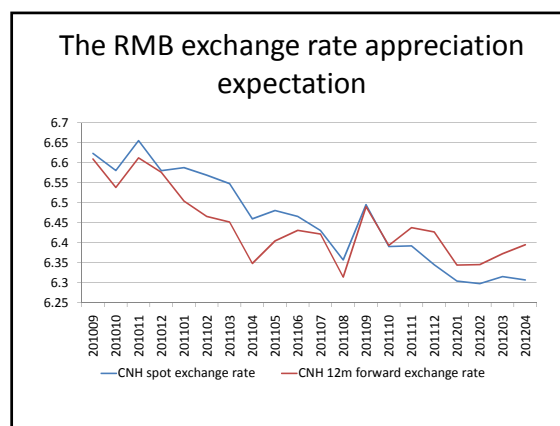
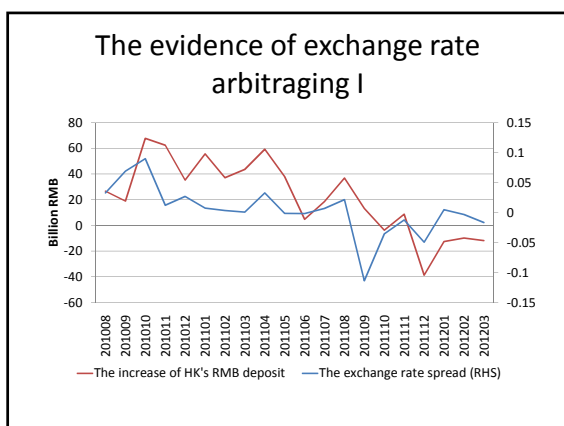
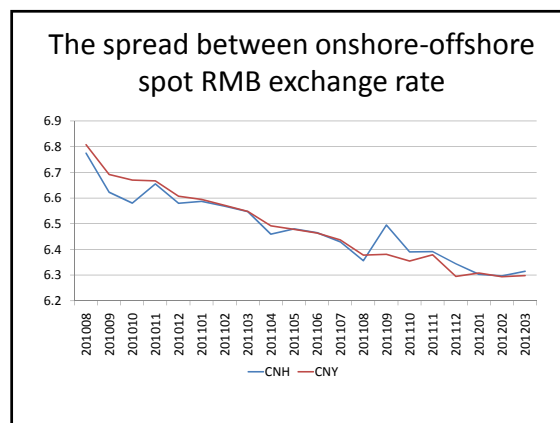
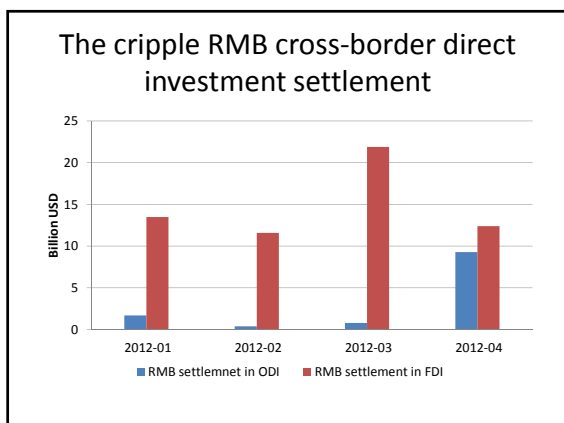
RMB Internationalization or Onshore-Offshore Arbitraging

Ming Zhang
 Institute of World Economics and Politics
 Chinese Academy of Social Science
 June 2012, UC San Diego

Outline

- The development of RMB internationalization;
- Onshore-offshore arbitraging;
 - Exchange rate arbitraging;
 - Interest rate arbitraging;
- Conclusions and policy implications;

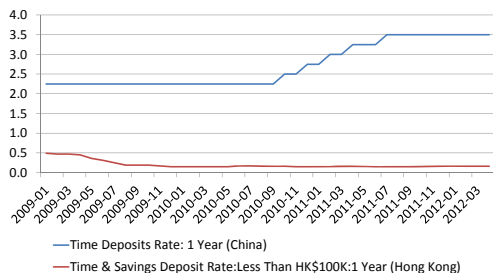




Channels for exchange rate arbitraging

- Exchange rate arbitraging I:
 - Before the development of HK's offshore RMB market, Chinese firms have to purchase USD from onshore market to pay import, and sell USD on onshore market for export;
 - When RMB is more expensive offshore than onshore, Chinese firms will choose to purchase USD through its offshore subsidiaries and sell USD for export on onshore market, which will result in the cripple RMB settlement;
 - When RMB is more expensive onshore than offshore, Chinese firms will choose to purchase USD onshore for import, and to sell USD offshore for export. As a result, the cripple RMB settlement tend to be more balanced;
- Exchange rate arbitraging II:
 - When there is a strong RMB appreciation expectation, the foreign trade partners would like to receive RMB, but no to pay in RMB.

The spread between onshore-offshore interest rate



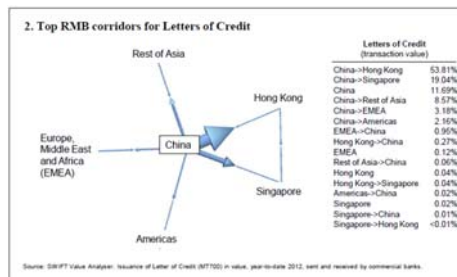
The evidence of interest rate arbitrage

- According to SWIFT, “While the renminbi accounts for just **0.34 per cent** of all international payments (the 16th of the world), this year it has accounted for **4 per cent** of global issuance of letters of credit (LCs) (the 3rd of the world).”

Channels for interest rate arbitrage

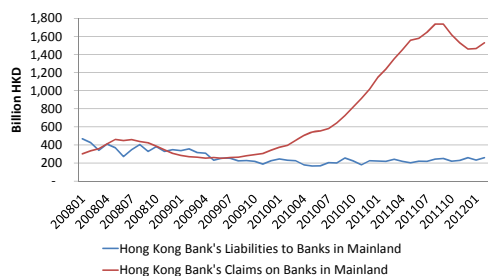
- A Chinese company places RMB on deposit with a mainland bank. The company then obtains a long-dated, RMB-denominated letter of credit from the bank, ostensibly to pay for a shipment of goods from its own subsidiary in Hong Kong.
- The HK subsidiary takes the letter of credit to a local bank and uses it as collateral to obtain a US dollar loan at a lower interest rate than those available on the mainland.
- The company would also use a currency derivative to eliminate the foreign exchange risk.
- The result: the company has captured the difference between onshore and offshore interest rates, less banker’s fees.

The flow of RMB L/C



Almost all the L/Cs are going out of China, and half of them go to Hong Kong.

HK bank’s claims and liabilities against mainland banks



Conclusions

- One of the major forces behind the development of RMB internationalization is the onshore-offshore exchange rate and interest rate arbitrage.
- The slow down of RMB internationalization process since the 3rd quarter of 2011 proved that cross-border arbitrage played a critical role.
- The development of RMB internationalization based on cross-border arbitrage is not Chinese government’s objective (exacerbating China’s balance sheet), and could reverse quickly and significantly.

Policy Implications

- Should RMB internationalization become one priority on Chinese government's agenda?
 - Market selection or policy driven?
 - The domestic structural reform is still the top of priority.
- Should Chinese government speed up the opening of capital account?
 - The timing is not right.
 - The global trend is changing.
 - Potential risks are huge.
 - Could opening up promote domestic reform, just as before?
 - What is the best sequence for capital account liberalization?