

The Internationalization of the Yuan or the Sino-ification of Hong Kong?

One of the fundamental characteristics of the global financial architecture is that the world's second largest economy maintains a rigidly controlled currency. The concept of currency wars, as initially articulated last year, seemed to have been a criticism of the easy monetary policy of the Federal Reserve, but is being appropriated and used as a criticism of the lack of flexibility of the Chinese yuan.

The reluctance of Chinese officials to allow its currency to be another shock absorber in the circuit of capital means that other liquid flexible or floating currencies have to shoulder a greater burden of the adjustment. Some, like a well respected analyst at a recent industry conference in New York, suggest that as long as Asian currencies remain under-valued that the European currencies will remain over-valued, and by implication other currencies as well.

Given the tightly controlled yuan market, the extent of its use offshore is a development that is capturing the imagination of many observers and participants. Entities like the World Bank's International Financial Corp, the Asian Development Bank, McDonalds, Caterpillar and some of the largest banks in the world have issued yuan denominated bonds in recent months. Billions of dollars in trade is being settled in yuan. China has also arranged swap lines with a number of countries, mostly in the region, but as far reaching as Argentina. To date, only Hong Kong appears to have utilized them. As such, the amount of yuan on deposit outside China is growing rapidly. Some observers suggest that this is the beginning of the Chinese yuan becoming a truly global currency and a rival to the privileged place of the US dollar.

Hong Kong

There is both less and more than meets the eye in terms of the internationalization of the yuan. The internationalization of the yuan is less than it may seem because it has been largely confined to Hong Kong -- a special administrative region of China. Yet, at the same time, it reveals the savvy financial prowess of the Chinese government and is pregnant with vast potential. At the very least, China has found a way to profit from the speculative interest in the yuan, betting as it were, on its appreciation.

China has allowed an interbank market for the yuan to flourish in Hong Kong since last July. If there is a consensus among hedge funds and other speculators, it is that the yuan is going to appreciate in the short and long-term. On the other side are businesses, often Chinese companies owned or backed by the government, who want to borrow yuan to fund onshore operations. Owing to the strong demand for yuan denominated financial products, the cost of (yuan) capital is less than half of what it is onshore.

The yuan raised in Hong Kong is regarded by Chinese officials as a foreign currency (the common mnemonic is CNH to distinguish it from the onshore yuan CNY). The process by which CNH can be brought onshore—transformed into CNY—is not yet transparent and has not been standardized as are the procedures for dollars, for which there is a clear channel and necessary steps. The yuan raised in Hong Kong is brought into China on a case-by-case basis. It appears to be guided by Chinese officials to help achieve policy objectives. The location of the borrowing company's mainland operation seems to be important as the provincial governments are ultimately behind the process. In addition, the sector the borrowing company operates is also important. If it is for a sector that officials worry about overheating or excess investment, it is reportedly more difficult to get authority to bring the funds onshore.

Domestic Offshore Market

The number of institutions in Hong Kong authorized to do yuan banking business has increased from around 65 at the start of 2010 to more than 100 by the end of the year. Yuan deposits in Hong Kong (CNH) was near 300 bln (~\$43 bln) at the end of 2010, more than quadrupling over the course the year. To put that in perspective, the deposits in the mainland (CNY) are on the magnitude of 60 trillion. CNH accounts for roughly 4.5% of Hong Kong's M2 money supply and about 10% of the foreign currency component of M2.

China has also been encouraging the use of the yuan to settle trades. In October 2010, the most recently available data suggests that trade worth some \$10 bln was settled in yuan in October doubling from the month before. Overall, imports plus exports were near \$70 bln, but a more appropriate metric may be imports from the mainland. In that respect, more than half of Hong Kong's imports from China were settled in yuan. Note, too, that nearly half of Hong Kong's imports get re-exported.

Arbitrate opportunities have made the gap between the CNH and CNY nearly disappear. The mid-October 2010 the CNH was as much as 2.6% richer than CNY. In recent days the gap was 0.07%, while the wide spread drew Chinese companies' interest.

Consider a chip maker who was build a new fabrication plant in the province of Fujian. It would need to import capital equipment. The supplier was unwilling to accept yuan as it is not convertible. The company could send yuan to its Hong Kong subsidiary who can swap it for dollars at the better offshore rate.

The Future of Two Currencies One Country

The Hong Kong dollar has been pegged to the US dollar since 1983. The peg has come under attack in the past, most notably during the 1997-98 Asian financial crises. Officials creatively defended the band and remain committed to it. Some observers suggest that over time, the yuan will supplement and then supplant the Hong Kong dollar.

Hong Kong banks are allowed to issue yuan raised in bond sales. Hong Kong depositors can increase yuan savings by converting up to a fixed amount of Hong Kong dollars a day to yuan. That cap is currently around \$2500 a day. Hong Kong registered companies can convert foreign currencies into yuan in lieu of US dollars. Indeed, some recent pressure on the Hong Kong dollar, well above the floor permissible by the peg, may have been stemmed from moving into yuan.

Yet we should not believe for a moment that it is a free market. Chinese officials still retain control of the process; regulating the speed and quantity that CNH can become CNY. Hong Kong Monetary Authority maintains strong local control and requires that banks document trades and discourages speculation.

The HKMA Chief Executive Norman Chan has outlined four conditions that would need to be met to peg the Hong Kong dollar to the Chinese yuan instead of the dollar:

- China has an open capital account
 - China has a freely convertible currency
 - China has a mature financial system
- China and Hong Kong economies are closely aligned

In late 2010, Chan said that none of the criteria had been met.

Evolving Market

China wants to control the pace and draw advantage from the seemingly insatiable demand for yuan exposure. Dim Sum bonds exploded on the scene in 2010. Thirty-three deals raised a cumulative sum of about CNY42.5 bln.

The pace picked up a bit in early 2011, but the bigger story may be synthetic yuan bonds. Investors buy the bonds with US dollars and are paid back in yuan. In January, there have been more issues than all last year and they have raised five times more. Nearly four times more money was raised in January in synthetic yuan bonds than in the Dim Sum market. This market is dominated by Chinese property developers.

In mid-January, China announced that mainland fund managers could raise money in Hong Kong for investment in the domestic market, but 80% of the funds raised must be invested in the Chinese bonds market. Around the same time, China indicated it would allow its companies to make foreign acquisitions using yuan. Also starting in January, the Bank of China, the country's fourth largest bank began offering yuan deposits at its US branches.

These are still early days of the internationalization of the yuan and the Sino-ification of Hong Kong. The yuan accounted for 0.3% of the turnover in the foreign exchange market according to the BIS 2010 triennial survey (actually slightly less than in the prior 2007 survey), which is 1/8 the turnover of the Hong Kong dollar. The internationalization of the use of the yuan is largely a function thus far of converting the special administrative region into an "offshore" center.

More steps toward the internationalization of the China's capital markets are likely. There is talk that in the coming months, China may allow foreign companies to list their shares on the Shanghai stock exchange. There may be efforts to encourage the Panda bond market (foreign companies issuing yuan bonds on the mainland). The development will take place under the guiding hand of China, for whom stability remains a guiding principle. This evolution will build institutional capacity, but a fully open capital account and full convertibility of the yuan still appears to be at least several years away. It is far premature to speak of a challenge to the greenback by the redback (yuan), though it continues to catch the fancy of many observers.

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