Financial Market Reform in China & the Strategic Currency Policy of ASEAN Countries


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Direct trading between the Japanese yen and the Chinese renminbi in interbank foreign exchange markets began simultaneously in Japan and China on June 1, 2012. This currency trading is closely related to the beginning of the internationalization of the renminbi and financial market reform in China. Similar projects are also planned for adoption in ASEAN countries.

Japan-China Financial Cooperation Agreement

The December 2011 summit meeting in Beijing between then Japanese Prime Minister Noda Yoshihiko and then Chinese Premier Wen Jiabao produced an agreement on enhanced cooperation for financial market development between Japan and China. The agreement covers the following five points:

1. Promoting the use of the yen and renminbi in cross-border transactions between Japan and China
2. Supporting the development of markets for direct exchange of the yen and renminbi
3. Supporting sound development of yen and renminbi bond markets
4. Encouraging the private sector to develop yen- and renminbi-denominated financial products and services in overseas markets
5. Establishing the Joint Working Group for Development of Japan-China Financial Markets to promote cooperation in these areas.

The direct currency conversion that began in June 2012 was related to points 1 and 2 of the agreement and signified the realization of point 2. With respect to point 1, figures on how much of the trade between Japan and China is settled in yen, renminbi, or US dollars are not officially available, but it is thought that the yen is used for 30–40% of the transactions and that the renminbi is used for 1-2%. Almost all of the other deals are denominated in dollars.

In July 2009 China began to internationalize the renminbi and opened the door to its use in settling external transactions. When the People's Bank of China started the pilot program of cross-border use of the renminbi, it announced the reason for this policy on its website. The announcement said that "as a result of the global financial crisis, the exchange rates of major international settlement currencies, including the dollar and the euro, fluctuate drastically, posing substantial exchange risks for Chinese enterprises and enterprises in neighboring countries and regions when they settle trade transactions in a third currency." This "third currency" apparently means the dollar.

In the case of trade between Japan and China, around 30-40% of trade is settled in yen and 1-2% is settled in renminbi. Almost all the remaining 60-70% is settled in dollars. The beginning of cross-border use of the renminbi is aimed at eliminating excessive dependence on the dollar and achieving a better balance in settlements by diversifying the currencies available. In the case of trade between Japan and China, for instance, there is no inherent necessity to use the dollar, a third-country currency. Deals can instead be denominated in either of the two countries' currencies. This is the substance of point 1.

For the time being, the renminbi is not a very convenient means of settling external transactions. This is because the Chinese government, which is concerned about the effectiveness of its monetary policy and needs to control the renminbi's exchange rate, still places numerous restrictions on capital transactions and currency trading. In this light, the significance of point 1 is that it signalled China's willingness to accept the yen's use in transactions. If the yen-denominated share of bilateral trade can be expanded, smaller Japanese companies in particular will be able to reduce their foreign exchange risks, which they have few means of hedging against.

Turning now to point 2, let us consider the case of a Chinese business wishing to import products from Japan denominated in yen. To pay for the deal, the Chinese importer will ask a bank to convert renminbi into yen and send the yen to the Japanese exporter. In order to avoid foreign exchange risks, the bank will convert the renminbi into yen on the interbank market. Until now the bank did not have the option of exchanging renminbi for yen directly. It would have first sold renminbi and bought dollars, and then sold the dollars to buy yen, thus using a two-step process. This was normal because, in the past, banks had no great need to buy and sell the renminbi for currencies other than the dollar. A bank hoping to convert renminbi into yen directly would have had to go in search of a transaction partner looking to buy renminbi and sell yen in the same amount at the same time: a costly and complicated process. Under the circumstances, almost 100% of the renminbi trading on the interbank market involved dollars.

Because of the low level of need for yen-renminbi conversion, this two-step process mediated by the dollar was the least expensive way of handling the conversion. Over recent years, however, trade between Japan and China has expanded, and the need for direct yen-renminbi trading has greatly increased. Now that the option of direct conversion has become available, its cost may be low enough already to warrant using it in place of dollar-mediated conversion.

Time zones are another factor banks will take into account when selecting a conversion method. There is a large time differential between operating hours in Asia and New York, and it creates a risk because banks must make yen and renminbi payments before they can confirm that the corresponding payment of dollars has been completed. This risk was actually realized when Herstatt Bank in West Germany collapsed in 1974. After that, this risk was named the Herstatt risk. With direct yen-renminbi exchange, the Herstatt risk almost disappeared.

These two factors — the low-cost issue and the time-zone risk — are the main substance of point 2.

Start of Direct Yen-Renminbi Trading

Interbank currency trading in China must utilize the China Foreign Exchange Trading System (CFETS) in Shanghai. Trading of the renminbi is limited to 10 currencies, including the yen, the dollar, and the euro. There are currently 31 banks that have been approved to act as market makers for foreign exchange trading. They announce the prices they are using for buying and selling currencies and are obligated to conclude deals with these prices. On June 1, 2012 the Chinese authorities newly approved 10 banks, including three major Japanese banks, to act as market makers specialized in yen-renminbi trading, and these banks also must constantly quote their buying and selling rates and agree to accept deals at these prices. A bank hoping to convert between renminbi and yen directly can easily find a transaction partner in all cases now.

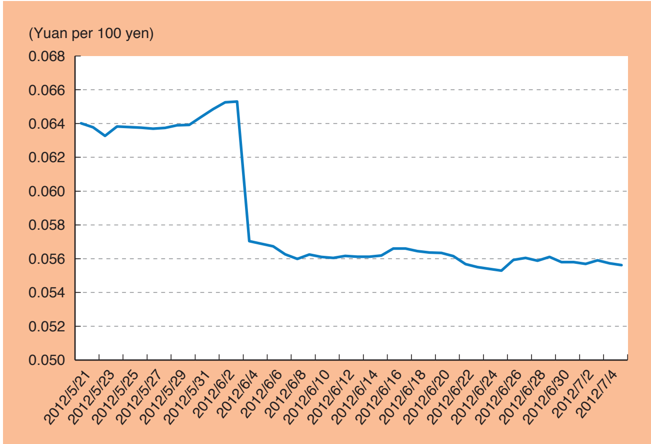
In Japan, meanwhile, direct conversion began on June 1, 2012 by means of a system in which major banks provide yen-renminbi rates to voice brokers, who orally announce the rates for the use of market participants. The Chinese currency in this case is the "offshore renminbi". The renminbi has onshore and offshore markets, with the currency in the onshore market termed CNY and that in the offshore market, where most trading takes place in Hong Kong, termed CNH. Once the system was in place, the interbank market for offshore renminbi effectively started in Tokyo.

The press reported that on the first day of trading, deals amounting to 800 million yuan (about 10 billion yen) were concluded in Tokyo. Thus far, substantial amounts seem to have been traded in Tokyo. Apparently in Shanghai, the volume of trading has amounted to several tens of billions of yen per day so far. According to the People's Bank of China, before the beginning of direct yen-renminbi trade, in the first quarter of 2012, 99.18% of counterparty currency in renminbi trade in CFETS was the dollar. After direct trade started, this ratio was reduced to 92.14% in the first quarter of 2013. The yen ratio has rapidly increased from 0.14% to 6.65% during the same period. Since the ratio of the currency in third place, the euro, remained at 0.72% in the first quarter of 2013, the effectiveness of direct yen-renminbi trade is very substantial. With respect to the size of the spreads for interbank trading, it appears that those for direct conversion have become smaller than those for dollar-mediated conversion in both Tokyo and Shanghai.

It is not entirely clear how this trading has affected the commissions

CHART 1

Average yen-renminbi buy-sell spreads for customer trades quoted by 3 major Chinese banks



Source: Compiled from data on websites of the Industrial & Commercial Bank of China, the Bank of China and the Bank of Communications

that banks collect from companies and other customers. Still, some information has been made public in China on the buy-sell spreads major banks use when carrying out yen-renminbi conversion for customers. As shown in *Chart 1*, the average spreads fell suddenly at the start of June 2012. These are reference figures, so there is no guarantee that they were applied in actual trading for all institutional customers.

In China, major banks determine buy-sell spreads for renminbi and foreign currencies for their customers by setting the difference in the buying rate and selling rate from a middle rate by using a ratio to the middle rate. In the case of renminbi-dollar conversion, the difference in buying rate from middle rate is set at 0.2% of the middle rate. The difference in selling rate from middle rate is also 0.2%. These ratios were 0.4% for conversion between renminbi and all other foreign currencies including the euro and the British pound before the beginning of direct yen-renminbi trade. After the beginning of this direct trade, this ratio for yen-renminbi conversion reduced to 0.35% at major Chinese banks. We can read from the figure that those on the Chinese side hope to encourage direct yen-renminbi conversion in China.

In cases where trades between China and Japan are settled in yen, the conversions between yen and renminbi are transacted in China. So the aim of making such conversions in China more convenient means that China is accepting the increasing use of yen in bilateral trades.

In Japan, almost the same thing has occurred. Some major banks announced a spread of 0.4 or 0.5 yen between the buying rate and middle rate as a reference for yen-renminbi conversion before the beginning of direct trade. Now these banks are one by one announcing 0.3 yen as the spread for conversion since the beginning of direct trade. This will make the renminbi a more convenient currency in Japan and will encourage its use in bilateral trades.

Epochal Development for Yen's Future

The start of direct currency conversion will of course be beneficial for the Japanese and Chinese economies, but beyond that it is an epochal development for the future of the Tokyo market and the yen. For direct conversion to be further developed, rewarding those involved in it, the transactions underlying it need to be expanded. These are cross-border deals denominated in yen or renminbi involving trade, investment, and other activities. Thus there are intimate relations between the first two points of the Japan-China agreement, namely promoting the use of the yen and the renminbi in cross-border transactions and developing markets for direct exchange of the two currencies. An increase in yen- and renminbi-denominated deals will result in even smaller buy-sell spreads on both interbank and customer markets. Henceforth, accordingly, hopes will be pinned on further growth in these transactions, and this will increase the demand for direct yen-renminbi trade in the interbank market, which will complete this virtuous circle.

One precondition for growth is additional action on the Chinese side to relax the controls on external trading of the renminbi. This loosening of regulations will facilitate the agreement's point 3, assisting sound development of yen and renminbi bond markets, and point 4, encouraging the private sector to develop yen- and renminbi-denominated financial products and services in overseas markets. With respect to point 3, the Japanese government is at the stage of preparing procedures for the purchase of Chinese government bonds, and the Japan Bank for International Cooperation is planning to issue renminbi-denominated bonds in China. To this end, both sides need to work out practical procedures, and China needs to move forward on deregulation. Beyond that, when renminbi-denominated bonds are sold on the Tokyo market, the issue of these bonds will be energized if bond issuers gain greater freedom to use the renminbi they acquire within China. Yen-renminbi trading will then be boosted by the desire to acquire renminbi for investments in renminbi-denominated bonds, promoting progress on point 4.

Designating a clearing bank for renminbi in Tokyo through agreement between Chinese and Japanese authorities is also one possible measure for promoting renminbi transactions in Tokyo. Clearing banks are currently established in Hong Kong, Macau, Singapore,Taipei, Frankfurt and London. Offshore renminbi must be remitted to and from mainland China through clearing banks. Having a clearing bank is an effective measure to increase renminbi transactions in any given area. (I have already proposed setting up a clearing bank in Tokyo in "Internationalization of RMB & JPY-RMB Direct Trade", *Chinese Economy*, August 2013, JETRO.)

Cooperation between the two central banks is also important. To improve the existing yen-renminbi currency swap agreement both qualitatively and quantitatively will lessen the anxiety over shortages of renminbi and activate renminbi transactions in Tokyo. From the standpoint of reducing the settlement risk, to link the payment and settlement systems of the two central banks and realize payment versus payment (PvP) will be another possible measure.

On the Japanese side, one of the tasks to be addressed is increasing the share of yen-denominated trades. To this end, Japanese and Chinese banks both need to improve the transparency of the spreads on the interbank and customer markets and the volume of trading involved. The shift from dollar cross-border settlement to yen or renminbi settlement will gain momentum if it is clearly shown that spreads on the customer market have become smaller. In that event, it is to be expected that yen-denominated deals in particular will be boosted, since renminbi-denominated external transactions are still less convenient.

Financial Market Reform in China

Examples of the inconvenience of cross-border use of the renminbi are as follows. Cross-border capital account transactions are still firmly restricted regardless of whether they are settled by foreign currencies or renminbi. Cross-border buying and selling of renminbi by banks in mainland China is limited to cases where underlying trade of goods can be settled within three months. Position-taking activity by banks between the renminbi and foreign currencies is strictly regulated. Foreign exchange forward transactions in renminbi must have an underlying trade.

The reasons for these restrictions are the Chinese authorities' anxiety over the effectiveness of monetary policy and the controllability of renminbi exchange rates. In China, monetary policy is conducted mainly by using direct control over the amount of bank loans. This measure is called "window guidance". Interest rates for bank deposits are discretionally decided by the People's Bank of China. Yield curbs are also decided by the central bank, not by market forces. Under such circumstances, it is impossible to use interbank short-term interest rates as a monetary policy tool. Chinese authorities are compelled to use a quantitative measure — controlling the amount of bank loans — as a monetary policy tool.

In order to make the renminbi a more convenient currency for overseas use, lifting the restrictions on capital account transactions is necessary. However, if cross-border inflows and outflows of money become free, the present monetary policy which depends on direct control over bank loans will lose its effectiveness. China could lose the ability to stablize the macro economy. If renminbi transactions with foreign currencies in markets abroad, for example in New York, London, or Tokyo, become free, the renminbi's exchange rate will be also decided in these markets and it will be more difficult for Chinese authorities to control.

According to the Impossible Trinity theory in international finance, China now has restricted capital account transactions, a stable foreign exchange rate and independence of monetary policy from foreign countries. But the parts of regulations on capital account transactions have already been lifted. In spite of the regulations, absolute amounts of capital account transactions have increased quickly with the rapid growth of the Chinese economy. To maintain the effectiveness of monetary policy, the People's Bank of China should change its way of executing monetary policy from controlling the amounts of bank loans to controlling interest rates. To utilize interest rates as a monetary policy tool, regulations on interest rates must be lifted, and they should be decided by market forces. Then the Chinese authorities will be able to lift the restrictions on capital account transactions to promote overseas use of the renminbi. Under this situation, the foreign exchange rates of the renminbi will have to be decided by the market in order to maintain the independence of monetary policy from foreign countries.

Japan's past experiences show that after lifting regulations on interest rates, the interest rate margin between bank deposits and loans shrinks drastically. Bank profits are reduced. The same thing will happen in China. On the other hand, banks will suffer from greater foreign exchange rate risks and interest rate risks. The possibility of bank collapses will be higher, so it will be necessary to establish a deposit insurance company. At the National People's Congress in March 2014, the government reported that a deposit insurance company would be set up in this year. Zhou Xiaochuan, governor of the People's Bank of China, told a press conference that regulations on interest rates for bank deposits will be lifted in one or two years. Financial market reforms, including lifting regulations on interest rates and capital account transactions, changing monetary policy measures and realizing flexible foreign exchange rates, are being pushed forward step by step.

Strategic Currency Policies of ASEAN Countries

As already mentioned, China aims to eliminate excessive dependence on the dollar and achieve a better balance in settlements by diversifying the currencies available. This strategy of eliminating excessive dependence on the dollar is commonly held among ASEAN countries. When the global financial crisis occurred in 2008, dollar liquidity dried up all over the world. Through this experience, ASEAN countries recognized the huge risk of such dependence.

Hong Kong introduced a dollar settlement system in 2000 and a euro settlement system in 2003. The Hong Kong dollar settlement system was linked with the US dollar settlement system and euro settlement system. Using these linkages, transactions between the HK dollar and US dollar, and between the HK dollar and the euro are settled by PvP. In the PvP mode, HK dollar payments are made at the same time as payment of the counter party currency.

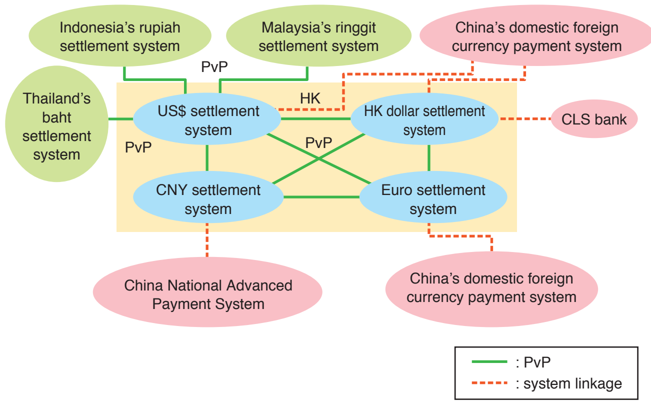
After these linkages were set up, major parts of Hong Kong transactions related to US dollar settlements and euro settlements shifted from New York and European time zones to the HK time zone, and the Herstatt risk was largely eliminated. Subsequently, Malaysia linked its ringgit settlement system to Hong Kong's US dollar settlement system in November 2006 and started PvP between the ringgit and US dollar. Indonesia then linked its rupiah settlement system to Hong Kong's US dollar settlement system in January 2010, and Thailand did the same with its baht settlement system in July 2013 *(Chart 2)*. These countries aim to avoid US dollar settlements in New York and to reduce the Herstatt risk.

ATM Linkage in Asia

Another project is ATM linkage among Asian and Oceania countries.

CHART 2

Linkage with settlement systems in Hong Kong



Source: Hong Kong Monetary Authority

This project is called the Asian Payment Network (APN). ASEAN countries are enhancing regional cooperation and harmonization in the area of payments in support of their vision of achieving an ASEAN Economic Community by 2015. The APN is originally part of this initiative. Malaysia, Singapore, Thailand and Indonesia started to link their ATM systems bilaterally in 2006. Central banks in ASEAN countries established the ASEAN Working Committee on Payment and Settlement Systems (WC-PSS) in April 2010 to support the APN. The Philippines joined the APN in 2008, South Korea and Vietnam joined in 2010, and China, Australia and New Zealand joined in 2011. By the end of 2011, 12 switch operators in 10 countries had joined the APN and 19 bilateral linkages were established. A switch operator is the institution which exchanges the information between the ATM systems of different banks.

Thai travelers in Malaysia can use their ATM cards to withdraw ringgit from the ATMs of Malaysian banks, with the equivalent sum in baht being withdrawn from their bank accounts in Thailand. The same procedure is available using major international credit cards, in which case remittances between the banks in the two countries are done using dollars. According to the principles of the APN, remittances from Thai banks to Malaysian banks should be done in baht or ringgit without using dollars. This is another measure for eliminating excessive dependence on the dollar. Generally speaking, Asian countries settle most of their cross-border transactions in dollars. In the case of trade between Japan and Asian countries, 54% of Japanese exports and 73% of Japanese imports are settled in dollars *(Table 1)*. In the case of trade among Asian countries, the dollar ratio seems to be much higher.

In the interbank foreign exchange market, transactions between one Asian currency and other currencies, except the dollar, are divided into two transactions using the dollar as an intermediate currency. As a consequence, in the interbank market, almost 100% of Asian currencies' counterparty currencies are dollars. According to statistics published by the Bank for International Settlements (BIS) triennially, in the case of transactions among reporting dealers, the ratios of the

TABLE 1

Currency composition of Japanese trade (2nd half of 2013)

(Exports from Japan) (%)

World	US$	Yen	Euro	AU$	Renminbi	Others
	53.4	35.6	6.1	1.2	0.6	3.1
Asia	US$	Yen	Renminbi	Baht	Korean won	Others
	53.6	42.7	1.1	1.0	0.4	1.3

(Imports to Japan) (%)

World	US$	Yen	Euro	Swiss Franc	Renminbi	Others
	74.1	20.6	3.5	0.4	0.3	1.0
Asia	US$	Yen	Renminbi	Baht	Euro	Others
	73.2	24.5	0.7	0.5	0.4	0.9

Source: Ministry of Finance, Japan

TABLE 2

Reporting dealers' transactions against US$ by counterparties in April 2013

(%)

	Euro	Yen	HK$	SG$	Renminbi	Korean won	Rupee	TW$
with reporting dealers	76.4	82.5	92.6	90.2	97.1	97.5	98.0	98.3
with financial customers	72.6	77.1	88.9	88.2	94.3	90.2	90.5	81.8
with non-financial customers	56.9	64.0	72.9	72.9	87.6	89.6	93.7	90.2
total	72.6	77.8	88.8	87.9	94.3	94.8	94.7	88.7

Source: Triennial Central Bank Survey, BIS, February 2014

dollar as a counter party currency of Asian currencies are higher than 90% *(Table 2)*. Reporting dealers for the BIS are major interbank players. So "transactions among reporting dealers" means approximately the same as interbank transactions.

Strategic Currency Policy of Japan

In response to this strategy of ASEAN countries, the Japanese government agreed with five of the member states (Indonesia, Malaysia, the Philippines, Singapore and Thailand) bilaterally on financial market cooperation in a meeting of finance ministers and central bank governors in Delhi in May 2013, when the Asian Development Bank held its annual meeting there. The contents of the agreements differed with each of the five countries. An article in the agreement with Singapore proposed studying "ways to enhance the use of the Singapore dollar and the yen in cross-border transactions, including direct exchange between the Singapore dollar and yen" as medium- and long-term issues. The agreement with Thailand has a similar proposal.

But trading volume between Japan and each ASEAN country is not as great as the trading volume between Japan and China, so it is rather difficult to start direct trade between the yen and each currency in these countries in the interbank market. The first step should be to enhance the cross-border trade between Japan and each of these countries settled by the currencies of both sides. To this end, joining the APN is under consideration by Japan.

The Panel for Vitalizing Financial and Capital Markets, whose secretariats were the Japanese Financial Services Agency and Ministry of Finance, was held in 2013, and the panel published its "Recommendations for Vitalizing Financial and Capital Markets" on Dec. 13, 2013. It proposed that "consideration will be given to the feasibility of direct trading between Asian currencies and the Japanese yen, in lieu of the current cross-trading through the US dollar. As part of such efforts, it is important to support private entities participating *in the Asian-wide ATM inter-linkage network*" (emphasis in original). This reflects the notion that the APN can introduce direct trade between Asian currencies in the interbank market. As a consequence, Japanese switch operator NTT Data Corp. announced on Jan. 8, 2014 that it had joined the APN, and its press release referred to expressions in the "recommendations" of the panel.

Next Steps

Japan's joining the APN is one possible measure to realize the proposals for financial market cooperation between Japan and ASEAN. It will provide for the yen instead of the dollar to meet the needs of ASEAN members, and at the same time promote the internationalization of the yen.

A further possible next step in promoting direct trade between the yen and ASEAN currencies will be setting up yen settlement banks in each ASEAN country. Yen settlements in each country will be concentrated at this yen settlement bank, and other banks in each country will have yen settlement accounts with this bank. When the system of settlement banks is linked with the settlement system of the central bank in each country and PvP is realized by this linkage, direct trade between the yen and each country's currency will be much more efficient and safe.

Yet another step will be possible by linking the settlement system of the Bank of Japan with the settlement systems of the central banks in each ASEAN country. Then PvP between the yen and each ASEAN currency will be even more efficient and safe. Joining the APN is an important step for Japan to take in supporting the strategic currency policy of ASEAN countries and will benefit both Japan and ASEAN.

Note: The contents of this article reflect the personal viewpoint of the author and not necessarily the official viewpoint of Shinkin Central Bank. JS

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