

Experts discussed about the RMB and foreign exchange market

On September 13th, a joint forum was organized by the National Institution for Finance and Development (NIFD) of the Chinese Academy of Social Sciences (CASS) and CLS (Continuous Linked Settlement) in Beijing. The forum was held on *RMB and Foreign Exchange (FX) Market* and covered the following topics: *challenges to China's financial development from a China perspective; further steps in the global integration of China's financial market; and FX's role in support of cross-border investment and importance of risk mitigation to China's financial system*. This summary transcript provides the key messages from keynote speakers and panellists at the event.

Opening Speech: Li Yang, Chairman of the NIFD and former Vice President of the CASS

"The pace of RMB internationalization has slowed down in the past two years, mainly due to the impact of global trade protectionism." Li Yang said in his opening remarks. He pointed out that in the past, as China was the largest trade nation, RMB internationalization was primarily facilitated through commodities trading and labour. However, in recent years, with the rise of global trade protectionism, the pace of world trade expansion has shown signs of slowing down, which has contributed to the slowdown of RMB internationalization.

In addition, the imperfection of RMB payment and settlement infrastructure has become a technical factor that hindered RMB internationalization. To promote the internationalization of the RMB, Li Yang believed that China's focus should not be limited to trade but to consider capital finance, which has even greater potential. "The RMB has already been 'going out', but the payment and settlement of the RMB is still inconvenient for [both foreign and domestic] investors. A PvP system can effectively mitigate risks and improve the efficiency of settlement transactions; while PvP is accepted and applied globally, China has yet to adopt it. Moving forward, China should pay more attention to the issue of payment and settlement." Li Yang said.

Opening Speech: Lu Lei, the Deputy Administrator, the State Administration of Foreign Exchange (SAFE)

For the future development trends of RMB and FX markets, Lu Lei's keynote covered 3 points: 1. [we should] adhere to the financial markets role to serve the real economy; 2. from the perspective of market participants, if there are more Chinese entities entering the international markets and more foreign investors entering China's currency, bond and capital markets, the "retail investors and herding effect" situation may change; 3. from the perspective of currency rate, the RMB exchange rate will become more flexible in the future; China will continue perfecting the RMB exchange rate formation regime based on market supply and demand.

Academic research presentations: Sammie Chan (Corporate Strategic Development Department, CLS) and Cheng Lian (Secretary General of the Academic Committee, NIFD)

Sammie Chan analysed the challenges in FX risk management during periods of market volatility and the implications to trading. He acknowledged that China had made progress to support the RMB internationalization (i.e. the development of CIPS and the arrangement of the global network of RMB clearing banks). However further infrastructure development was required to mitigate settlement risk in cross-border payments and support the internationalisation of the RMB.

As the Chinese financial system grows, reflective of growth in Chinese trade, foreign and overseas direct investment as well as portfolio investment activities, it is expected that the demand in the scope and scale of hedging and FX activities will also increase. The exposures of financial market participants to their counterparties, including Chinese institutions, to principal risk will also increase and can exceed the entire capital of the bank on a peak day.

A cross-border payment-versus-payment (PvP) settlement solution would mitigate the principal risk in cross-border settlements. In the absence of a PvP settlement mechanism, financial institutions would manage their settlement risk by means of counterparty credit limits, which becomes a binding constraint to further growth and internationalisation of the

RMB. For RMB to assume a greater role and influence it must become an international medium for exchange, therefore safe and efficient settlement of RMB should be explored.

Based on the FX survey data from CLS settlement members for the RMB and CLS settlement data for currencies settled by CLS, Cheng Lian evaluated and analysed the internationalization of RMB from the perspective of market trading patterns between trading institutions. Initial analysis of the data showed that the RMB's characteristics are similar to other recognised internationalized currencies, but at the same time, compared to other international currencies, RMB's trading pattern is quite unique. This seemingly contradictory phenomenon may be because of two reasons: 1. RMB is not a CLS settled currency; 2. Sparseness of RMB trading data. "It is expected that with the development of RMB internationalization and RMB offshore market, the need for participating in the international financial infrastructure, especially the cooperation of payment mechanisms, will also increase." Cheng said.

Panel 1: Challenges to China's financial development from a China perspective

Panel 1 was moderated by Zhang Jie (Director and Council Member, IMI); panellists were: Cao Yuanzheng (Chairman, BOCI Research Limited), Ding Zhijie (Professor, University of International Business and Economics), Wen Bin (Chief Researcher, Minsheng Bank), and Wu Ge (Chief Economist, Huarong Securities).

Cao Yuanzheng delivered a keynote speech in panel 1. He discussed the patterns of RMB internationalization; the inevitability of the development of the offshore market and its challenges, and future prospects of the RMB internationalization. He pointed out that it was the uniqueness of the RMB internationalization that caused the rapid growth of the offshore market and the formation of "offshore market + clearing banks" pattern; the capital account opening up in turn facilitated the development of the onshore market; once RMB realises full convertibility, the route of RMB internationalization will return to normal – RMB will be transacted multilaterally, instead of bilaterally.

Through analysing the new Triffin problem, Ding Zhijie put forward policy suggestions for China's capital account liberalization and RMB internationalization: 1. the capital flows of

the emerging markets, including the process of capital account opening, need to be managed; 2. the international monetary system should provide effective mechanisms to implement the international liquidity supplement, and SDR can play an important role in it; 3. China should strengthen the management (but not control) of capital inflows; 4. Instead of holding back, China should further improve the international acceptance of the RMB.

Wen Bin presented five main reasons for the recent appreciation of RMB exchange rate, namely: 1. China's economic fundamentals was picking up; 2. the dollar index was growing; 3. China's strengthening of capital account management and overseas investment compliance; 4. the improvement of the RMB exchange rate formation mechanism; and 5. the widening spread of the US-China risk-free rate of return (10-year treasury bonds). He believed that in the near future, the uncertainty of the RMB exchange rate will depend on the recovery of the US economy, the trend of the dollar index and the Fed's action of shrinking its balance sheet.

Wu Ge analysed the fundamentals of China's economy, market expectations, the balance of payments, and drew the conclusion that in the medium to long term, the possibility of RMB's continuous appreciation is limited. He believed that the current appreciation of the RMB is mainly due to China's relatively high growth rate compared with other economies, the performance of the Chinese economy was above expectation in 2017H1, which drove the recent appreciation of RMB. However, since the US's macroeconomic indicators are still positive and the Fed is likely to shrink its balance sheet, the weak trend of the dollar index may not continue; also, he believed that with the gradual weakening of the real estate and export's roles in promoting the economy, China's economic growth is likely to slowdown in 2017H2. Therefore, it is unlikely that RMB will continue appreciating.

Panel 2: Further steps in the global integration of China's financial market

Panel 2 was moderated by Mark Austen (CEO, Asia Securities Industry & Financial Markets Association (ASIFMA)); panellists were David Cruikshank (Chairman, Asia Pacific, BNY Mellon), Winnie Pun (Head of Public Policy for the Asia Pacific, BlackRock) and Ryan Song (Executive Vice President and Head of Global Markets, HSBC).

Mark Austen delivered a keynote speech outlining the significant progress of China's capital market, and advised considerations from the perspective of foreign institutions. Since China is a very large and complex economy, the reform will not be achieved through a particular order (sequence) or by one institution itself- it requires close cooperation between China and other international institutions. He believed that the internationalization of the RMB should continue, and the convertibility of the RMB should be further promoted. The considerations of overseas investors for different asset classes, including: establishing standards and apply international standards in stock market; diversifying the investors for secondary bond market; introducing financial products and hedging tools in the derivatives market; applying netting in the fixed income market; establishing sound financial infrastructures and applying clear and transparent mechanisms.

Ryan Song pointed out that whilst the speed of RMB internationalization slowed recently, China's capital markets, especially the inter-bank bond market, have been developing rapidly. The driving factors include: 1. the decision makers' willingness to attract offshore investors; 2. the investors' interest in the Chinese market. From the asset managers' point of view, he said the major considerations would be the risk of RMB devaluation and the potential currency control. He pointed out that China should consider connecting with the institutions that apply globally accepted standards like BlackRock.

As Asia's chairman of the world's largest custodian BNY Mellon, David Cruikshank said that China's reform and market opening has been gaining momentum in recent years, with increased investment channels and investment opportunities. From the perspective of international institutions, the major considerations when investing in China included the predictability, consistency, transparency, liquidity and efficiency of markets and policies. David suggested that China should strengthen international dialogue, facilitate financial reforms and capital market opening, and improve the consistency of market access policy, thereby fostering the international investors' confidence in the Chinese market.

As a senior executive of the world's largest asset management company, BlackRock's Winnie Pun briefly introduced the four important components regarding the opening of China's capital markets: foreign capital into China, China's capital going abroad, foreign financial institutions entering China, and overseas expansion of Chinese financial institutions. Winnie

analysed the major considerations of foreign investors when investing in China, including compliance and transparency of access channels, hedging tools availability, market liquidity, and the convergence of currency markets, transaction/trading efficiency. Currently, there are increasing types of access channels for foreign investors (including QFII, RQFII, Bond Connect, Stock Connects). However, since the channels are changeable and are too many, the operational risks and potential costs are increasing –Winnie called for more transparent, consolidated and stable access channels. She also suggested that China should actively participate in the establishment of a global financial ecosystem, and adopt international industry standards.

Panel 3: FX's role in support of cross-border investment and importance of risk mitigation to China's financial system

Panel 3 was moderated by Zhang Xiaojing (Deputy Director, NIFD); the panellists were Dino Kos (Chief Regulatory Officer, CLS), Zhang Xin (General Manager, Cross-Border Interbank Payment System (CIPS)), Wang Ren (Deputy General Manager, China National Clearing Center (CNCC)), Jack Yang (Division Head of RMB Business, Economics & Strategic Planning Department, BOCHK), Jim Hughes (Head of Credit Risk, CLS).

Dino Kos delivered a keynote speech focusing on the supporting role of FX markets in international finance and trade, the risk inherent to the FX markets, and approaches and solutions to mitigate these risks. Dino believed market participants can mitigate some of the FX settlement-related risks (i.e. market, operational and pre-settlement risks) on their own; but due to the interconnected nature of the FX markets, the mitigation of principal risk and legal risk requires multilateral solutions supported by cooperation mechanisms through international coordination. He analysed China's recent development in internationalization and risk mitigation solutions. "To assume a greater global role and influence, RMB must become an international medium of exchange where FX market participants have comfort and security in the settlement of RMB transactions through systems that comply with international practices and standards that build on multilateral international cooperation and regulatory coordination ". He said.

Zhang Xin reviewed the development of RMB cross-border payment system, the development and achievements of the CIPS system, especially its supportive role in the “One Belt, One Road” initiative. In terms of the future prospects of CIPS, three points were pointed out: full time zones/ areas coverage; additional settlement mechanisms such as netting; and direct overseas participants onboarding.

Wang Ren outlined the overview of China's payment systems, analysed the external payment and settlement services provided by the PBoC, and the outlook of CNCC's focus on the future development, including the technical implementation of simultaneous multi-site service, development and strengthening of the capabilities on innovation, Strategic research on financial technology and practical application.

From a technical prospective, Jack Yang analysed the challenges that BOCHK, the largest offshore clearing bank for RMB, faces in cross-border transactions. He proposed 5 key considerations of China's developing international financial infrastructures: 1. to extend operation hours of China's payment and settlement systems to cover all time zones; 2. to achieve DvP and PVP infrastructures; 3. to achieve linkages among payment systems in different countries, 4. to apply FinTech & RegTech to monitor and manage the risks, and 5. PBoC to establish liquidity support mechanism for the offshore RMB market in order to further develop the market

Jim Hughes mainly focused on the risk mitigation methods for settlement of FX. He analysed the main features of financial market infrastructures (including RTGS systems, global settlement standard, PVP legal finality), the drivers and the mitigants of settlement risk, including the global connectivity and operation of RTGS systems, the creation of global standards, and the application of PVP. Jim also introduced the international best practice for FX settlement, which should provide a reference for the development of China's payment and settlement system infrastructure.