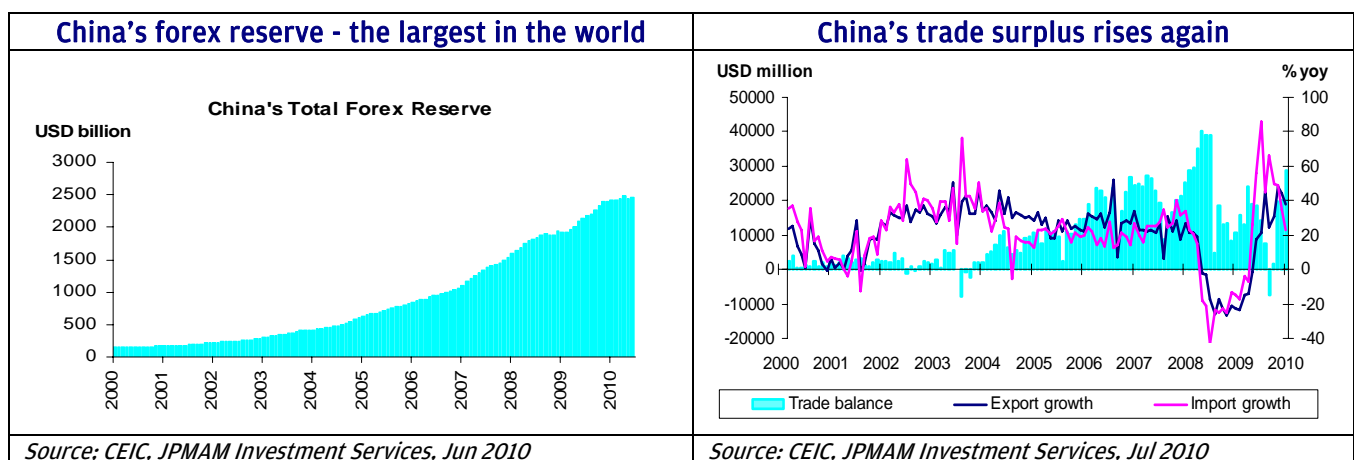


Market Focus – China eases currency control

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Beijing allows exporters to keep earnings offshore

- ◆ The State Administration of Foreign Exchange (SAFE), China's foreign exchange regulator, recently introduced a one-year pilot scheme to allow up to 10 exporters in each of four trial zones (Beijing, Guangdong, Shandong and Jiangsu) to park their foreign earnings offshore, effective from 1 October 2010. The move is believed to aim at slowing the growth of the country's forex reserves and thereby ease pressures on the RMB for appreciation.
- ◆ Chinese exporters are currently required to repatriate their forex income to the Mainland and convert most if not all of their overseas earnings back into local currency. The People's Bank of China (PBoC), the Chinese central bank, then buys up the foreign currencies and adds them to the official reserve stockpile.
- ◆ Hence, the new scheme helps cost cutting for exporters as charges on conversion into RMB are avoided. However, the amount that exporters can keep offshore is subject to a fixed portion of the company's annual export income.
- ◆ The stronger-than-expected rebound in exports in 1H'10 has led to a surge in China's trade surplus from USD 14.5 billion in 1Q to USD 41 billion in 2Q, which has led to renewed pressure on RMB appreciation besides increased attention from the US Congress. A massive trade surplus has been one of the main contributors to China's forex reserves - the world's largest - which in USD stood at 2.45 trillion as at June 2010.
- ◆ The SAFE disclosed that it accumulated USD 81 billion of new forex reserves in 2Q'10. While a large amount of them are still in US Treasuries, the PBoC has also been increasing its purchases of Japanese and Korean sovereign bonds lately in order to diversify its forex holdings.
- ◆ Given the small scale of the pilot program, we believe the impact in the short term should be limited. Nevertheless, if the program is extended to all exporters in the Mainland over the next few years, the impact will be more significant as a substantial amount of China's foreign earnings would then be kept overseas. This would be a step forward towards global rebalancing, alleviating the constant pressure for the RMB to appreciate.



Recent measures to accelerate RMB internationalisation

- ◆ The RMB needs to satisfy three major criteria to become a truly international currency: (1) a global trade settlement currency; (2) a viable investment currency; and (3) an international reserve currency. The recent measures announced by the PBoC indicate that the pace towards RMB internationalisation is accelerating.
- ◆ With the aim of eventually becoming a global trade settlement currency and thereby improving the yuan's candidacy as a reserve currency, the RMB Trade Settlement Scheme, first introduced in July 2009, expanded from Hong Kong, Macau and ASEAN countries to all countries in the world in June 2010. Within the Mainland, the coverage expanded from 5 to 20 provinces and cities.
- ◆ Also, Beijing recently added the Malaysian ringgit (MYR) to a small group of currencies (USD, GBP, JPY, EUR and HKD) that it allows to be traded directly against the RMB, another small step but a crucial part of its plan to increase the use of RMB to settle trades throughout the region. The government plans to further increase the number of currencies that trade against the RMB in the interbank market.
- ◆ To be a future global investment currency, opening the door to foreign investors is naturally a key step. The PBoC announced in mid-August that it will widen foreign access to its domestic bond market. The trial program will allow overseas financial institutions that hold RMB-denominated assets to invest in China's interbank bond market, which is currently largely off-limits to foreign investors.

Conclusion - Despite their small scale, these latest series of moves by the Chinese authorities put across the message that China is paving the way for currency internationalisation and capital account opening, which are also natural and critical steps to the country's future economic success.

