

Analysis on the Channels of China's Cross-border Speculative Capital Flows Based on the Hong Kong RMB Offshore Market

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Abstract: Since the pilot of the RMB settlement for cross-border trade in July 2009, the Hong Kong offshore market has formed an offshore RMB interest rate and the exchange rate, which are different from the onshore in the mainland market, and the market has a strong expectation of appreciation of the RMB, which constitutes the basis of arbitrage on cross-border speculative funds. The speculative and volatile nature of speculative funds will not only affect the effectiveness of the implementation of macroeconomic policies in China, but also seriously threaten the security of the national economic operation. Based on the Hong Kong offshore market, this paper discusses the mechanism of its influence on cross-border speculative funds, and analyzes the flow of cross-border speculative funds in China in order to provide direction for state to strengthen the supervision of cross-border capital flow from Hong Kong.

1. Introduction

In recent years, capital outflow in China has been under great pressure. On the one hand, it reflects the return of speculative funds in the preceding period. On the other hand, it reflects the increasing demand for domestic funds to seek asset allocation worldwide. The scale of China's foreign exchange reserves has decreased from nearly \$4 trillion in 2015 to \$3.19 trillion at the end of May 2016. The renminbi depreciated from close to 6 in early 2014 to around 6.5 in June 2016, all of which suggest that in the current international market the demand for outbound investment is very strong.

2. Influence mechanism

Since the 1950s, the offshore financial market has grown globally, and the impact on cross-border capital flows has become increasingly significant. In the context of economic globalization, cross-border capital flows have been greatly accelerated worldwide. However, because of its speculative and unstable nature, it not only brings development opportunities to recipient countries, but also intensifies the financial risks of recipient countries. Cross-border RMB trade settlement as the main content of the internationalization of the RMB is essentially loosened the cross-border flows to capital controls, plus offshore RMB foreign exchange market in Hong Kong and mainland coexist under the pattern of the onshore foreign exchange market, these are for cross-border speculative arbitrage activities provides a great convenience[1].

2.1 The interest rate difference is an opportunity for arbitrage activities of speculative funds

As shown in figure 1, there has been a significant difference in one-year deposit rates between the offshore market in Hong Kong and the onshore market in the mainland. Through the theory of interest rate parity, we can see that if there is a spread between the two markets, and the forward

discount rate of its currency exchange rate is contrary to the difference of interest rate, where it will appear arbitrage operations, so as to realize the cross-border flows of speculative capital.

At the same time, speculators will swap foreign exchange operations for the sake of reducing the risk of exchange rate. Generally speaking, under the action of large-scale foreign exchange swaps, the spot exchange rate in the market with lower interest rates will fall and the forward exchange rate will rise[2].

The difference between the above spot exchange rate and forward exchange rate is part of the forward price difference. Speculators continue to operate arbitrage behavior, which will increase the forward price difference until the forward difference is equal to the two-market interest rate, arbitrage activities end. And the significant spread between the offshore market and the onshore market provides an opportunity for speculative funds to carry out arbitrage activities, thus causing cross-border capital to flow between the offshore market in Hong Kong and the onshore market in the mainland. It can be seen from this that the difference in RMB interest rate between the offshore market and the onshore market constitutes the basis for arbitrage activities of cross-border speculative funds.

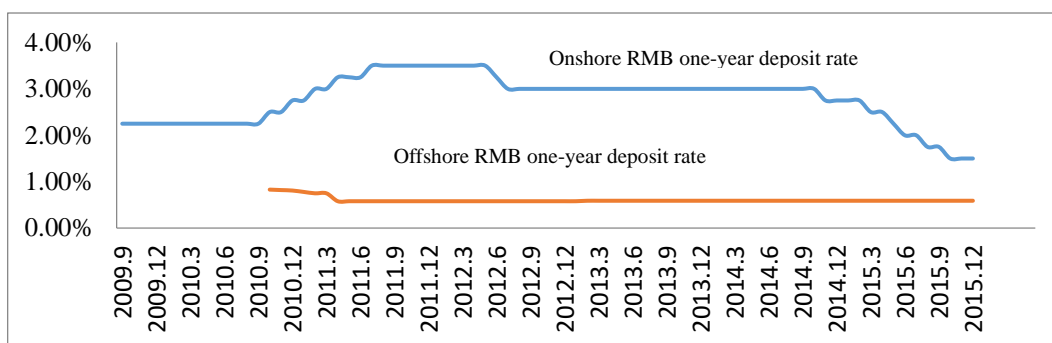


Figure 1. From Sept. 2009 to Dec. 2015, one-year deposit rates in onshore and offshore markets

2.2 The exchange rate difference is an opportunity for arbitrage activities of speculative funds

There is an obvious difference between the onshore and offshore markets in RMB exchange rate determination mechanism: CNY is a managed floating exchange rate, while the CNH is mainly determined by the supply and demand relationship in the offshore market, which determines the difference between the onshore and offshore markets in RMB exchange rate[3].

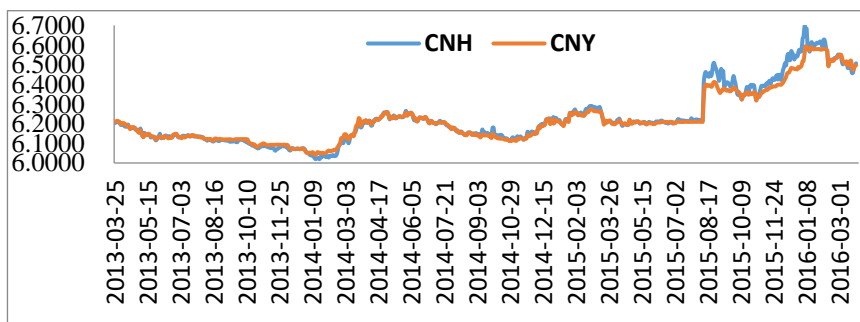


Figure 2. From Mar. 2013 to Mar. 2016, RMB exchange rate in onshore and offshore markets

As shown in figure 2, there are significant differences in RMB exchange rates between the mainland onshore market and the offshore market, which provides favorable conditions for speculators to arbitrage. Speculators can take advantage of the exchange rate differences to earn. At the same time, speculators can also use the expectation of the RMB to arbitrage.

2.3 RMB settlement of cross-border trade provides an opportunity for arbitrage of speculative funds

The RMB settlement of cross-border trade facilitates arbitrage and makes the cross-border flow

of speculative funds easier. At the end of 2009, the balance of RMB deposits in Hong Kong was only 62.7 billion yuan, but by the end of December 2015, the scale had reached 851.1 billion yuan, up 13.5 times since the end of 2009. Zhang Bin et al. (2015)[4] based on the disclosed import and export proportion of RMB settlement in Hong Kong, the proportion of cross-border trade RMB settlement increased by about 80 percent over the same period in the increase in RMB deposits in Hong Kong.

3. Analysis of the channels

3.1 Cross-border trade channel

Through RMB settlement channels for cross-border trade, speculative funds flowing between the onshore and offshore markets can be realized by means of projects with real trade backgrounds, or through false trade, import and export false declaration in reality is difficult to strictly distinguish the project to implement arbitrage. The mechanism is based on the fact that the different RMB exchange prices in onshore and offshore markets. The operation is that if CNH is higher than CNY, mainland exporters will choose to sell US dollar income from exports in onshore markets. While mainland importers will choose to buy the dollars, they need for imports in the Hong Kong offshore market.

The main results of this arbitrage behavior are two: first, if Hong Kong is higher than the onshore and offshore RMB remittance arbitrage behavior of the mainland importers and exporters in mainland and Hong Kong cross-border yuan trade settlement between the "lame", namely mainland enterprises import payment of RMB yuan high than export received;

If Hong Kong's offshore renminbi spot prices are lower than onshore, the "lame" phenomenon will be improved, with imports paying less and exports more renminbi.

The main results of this arbitrage behavior are as follows: first, if Hong Kong's offshore RMB spot price is higher than onshore, the arbitrage behavior of mainland importers and exporters shows that the RMB settlement of cross-border trade between the mainland and Hong Kong is "crippled", that is, the RMB paid by mainland enterprises is higher than that received by exports; If Hong Kong's offshore RMB spot price is lower than onshore, the "crippling" phenomenon will improve, with fewer RMB for imports and more for exports.

3.2 Direct investment channel

Funds from the offshore market in Hong Kong can flow into the onshore market through direct investment in RMB and qualified overseas limited partners. Relatively speaking, mainland onshore funds can flow to offshore through RMB outbound investment(RMB-ODI)[5]. The scale of foreign direct investment (FDI) in China has been the first in the developing countries for many years, and the huge amount of FDI provides a hidden space for the cross-border flow of speculative funds. There are two specific methods of operation: first, in the name of FDI capital (such as virtual capital increase) flows to get RMB funds, through the design of controlling complex ownership structure to realize cross-border flows, with the aid of the associated enterprises realize the value of money transfers and transportation. The second is to make use of foreign exchange retention and foreign exchange mortgage to realize the flow of cross-border speculative funds.

3.3 Financial market channel

The return of RMB bonds issued by mainland companies in Hong Kong is an important way for offshore market capital to flow into mainland onshore market. On January 14, 2007, China allowed domestic financial institutions to issue RMB bonds in Hong Kong after approval. There are two modes of bond issuance: one is that domestic parent companies directly raise funds abroad, that is the domestic parent companies bear the pressure of liabilities directly. Under this model, the management of offshore bond issuance is the responsibility of both the State Development and Reform Commission and the Administration of Foreign Exchange. The second is financing through offshore subsidiaries: the domestic parent companies have been approved to establish offshore subsidiaries,

and the parent company issues a guarantee for the subsidiary to issue bonds directly overseas. Because the interest rate on basic deposits and loans in Hong Kong is linked to the US dollar, mainland enterprises and financial institutions issue RMB bonds in Hong Kong at a significantly lower rate than the interest rate on the issuance of RMB bonds in the mainland, which has attracted a large number of mainland enterprises and financial institutions to issue RMB bonds in Hong Kong in order to take the interest rate difference in the cost of issuing bonds between the onshore and offshore markets, then return the gains to the onshore market in a certain way. Such speculation will lead to an increase in offshore bond issuance by companies and financial institutions while a decline in onshore bond issuance.

In addition, financial innovation also broadens the flow of cross-border speculative funds between the onshore and offshore markets [6]. For example, offshore speculative funds can enter the onshore market through QFII, RQFII and "three institutions" to invest in the RMB bond market. Financial institutions in the onshore market can enter the Hong Kong offshore market through the QDII system but can only leave in the form of RMB foreign exchange purchase. In 2011, the Securities and Futures Commission launched ETF, an open-end fund with a portfolio of Hong Kong stocks, giving onshore investors the opportunity to participate in offshore securities. On November 17, 2014, the Stock Connect of Shanghai and Hong Kong was formally launched, which realized the two-way opening of the stock market between the onshore and offshore markets. On July 1, 2015, the mutual recognition of funds between the two markets was officially implemented, which increased the number of investors in the onshore public offering funds. Offshore funds have also become a new option for onshore investors to diversify their exposure. On December 5, 2016, Shenzhen-Hong Kong Link officially opened, which is another major move to connect the onshore market with the offshore market in Hong Kong.

3.4 Personal channel

On the one hand, individuals can carry out cross-border transfers of funds by means of money smuggling and ants move in pieces. Individuals bring foreign currency from the Hong Kong offshore market and settle it into RMB. The funds flow either to the real estate market, or to the stock market, the bond market, and other capital markets or depository banks. Funds that should have been used for current account payments are converted into capital account expenditures, resulting in capital transfers. In addition to carrying foreign currency banknotes, carrying international credit cards became a shortcut to personal currency smuggling. International credit card memory exceeds the amount of foreign exchange deposit stipulated in the state foreign exchange management, and the cardholder overdrafts or withdrawals after the offshore market in Hong Kong. There are foreign exchange deposits in the memory of the international credit card that exceed the limits of the State's foreign exchange control regulations. The card holder can overdraft or withdrawal illegally in the Hong Kong offshore market. This approach has greatly contributed to the unhealthy tendency of some people to travel abroad for real estate, gambling, lotteries or other financial investments.

On the other hand, individuals can achieve cross-border flows through foreign exchange accounts. Since 2010, foreign institutions can open RMB non-resident Account in domestic banks to purchase and remit foreign exchange. Overseas institutions use RMB NRA accounts to purchase foreign exchange in China, and then transfer the foreign exchange to the RMB offshore market in Hong Kong for settlement. After foreign exchange settlement and arbitrage, the RMB can be transferred back to China by means of legal income, such as the construction of trade arrangements, and the transfer of the NRA account of the same name. These measures have increased the scale of foreign exchange outflows and increased the selling pressure of the RMB in the onshore market.

4. Conclusion

Driven by the construction process of the Hong Kong RMB offshore market, the settlement of RMB cross-border trade has been continuously expanding, and the scale of cross-border speculative capital flow is bound to increase gradually. The instability of speculative capital flow has a great destructive effect on the development of China's macro economy and has seriously affected the

macro-control effect of the central bank. In this background, this paper discusses the large-scale arbitrage activities of speculative funds between the onshore and offshore markets since the introduction of RMB settlement of cross-border trade. It also summarizes the channels of cross-border flow based on the Hong Kong RMB offshore market, which provides the direction for the state to strengthen the supervision of cross-border liquidity in Hong Kong.

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