

China: How opening up the financial sector could affect the yuan

China's Central Bank Governor Yi Gang says there's further room to open up the country's financial sector. But we don't think that includes the capital account, at least not yet. And that has implications for the yuan



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Opening up the financial sector during an economic downturn is rare

At the China Development Forum on Sunday, the governor of the central bank commented that [China's financial sector has room to open further.](#)

The content of the speech is rare because China is currently facing a weakening economy. And the central bank or regulators as a whole in China usually adopt a more cautious approach on opening or liberalisation reforms when there is an economic downturn.

Which area of the financial sector does China want to open up?

In fact, areas of the financial sector such as payment platforms and private equity

funds have been increasingly open for foreign investments since the 2018 Boao Forum, and we think there will be continuous progress.

Removing red-tape and equalising licensing requirements for domestic and foreign investments in the financial sector are good practices. But as domestic players have dominated the market, it is difficult for foreign companies as a whole to get a meaningful share of the market.

This makes us believe that opening up the financial industry to foreign investment is not really what Yi Gang was referring to.

Reform on the yuan mechanism

The governor touched on the yuan exchange rate mechanism and claimed that the currency has been more flexible.

We agree that the USD/CNY has followed the movements of the dollar index in general, and has sometimes been more volatile than the dollar index.

""The People's Bank has largely phased out regular interventions in the foreign exchange market, and the RMB has become more flexible. Market participants are able to adapt to this increased flexibility.""

Yi Gang, PBoC governor

Capital account in focus

Our view is that allowing the USD/CNY to follow the dollar index is the first stage of exchange rate reform.

The second stage will be opening up the capital account, which will allow capital to flow in and out of China with few restrictions so that the yuan exchange rate can be a genuine free floating currency.

To prepare for the second stage, and with a more liberalised interest rate policy, the governor rightly pointed out that China needs to have more hedging tools to mitigate market risks.

We believe we will indeed see more hedging products for interest rates, exchange rates, equities and bonds, but not necessarily this year. Markets take time to develop meaningful trading depth.

China won't open up capital account while economy is weakening

It is rare for Chinese regulators to talk about market liberalisation during an economic downturn. As such, we believe that the opening up of the capital account, in terms of outflow channels, will not happen this year.

We may see more capital inflows into China via passive funds that follow the MSCI and Bloomberg bond indices but we doubt there will be a further opening up of capital outflows channels, as this would create extra risk to the weakening economy. So the yuan will likely continue to follow the dollar index but won't be a truly free floating currency until China really opens up its capital account.

This means we may see the yuan appreciate more frequently in 2019, rather than depreciate.

As such, we maintain our forecast of USD/CNY and USD/CNH at 6.75 by end of 2019 from 6.88 at the end of 2018.