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Flash Notes

China: Daily Conversion Limit Removed In HK Ahead Of "Through Train"

- The just-announced removal of the RMB conversion limit in HK paves the way for the Shanghai-Hong Kong Stock Connect, which is slated to begin on 17 Nov, after much uncertainty.
- The initiatives reflect China's determination in market reforms and towards the opening of the capital account, and the speed of which is astonishing given that an equivalent program, QFII, has existed more than a decade.
- The excitement at the official launch could see some RMB liquidity tightness initially but we do not expect persistent disruption given the availability of offshore liquidity. Over the medium to long term, we are still positive on the RMB, though more two-way moves for the currency should be expected as RMB internationalization broadens.

Background

In a widely anticipated move, Hong Kong government announced today (Wed, 12 Nov) the removal of the RMB20,000 daily currency-conversion cap for Hong Kong's permanent residents, effective Mon 17 Nov, which is also the start of the much-delayed Shanghai-Hong Kong Stock Connect trading. The change will allow locals to buy an unlimited amount of RMB at offshore rates, instead of having to get it via the Shanghai market, with all the restrictions associated with the onshore market. Hong Kong has allowed non-residents to purchase an unlimited amount of offshore RMB since August 2012. In addition to the above, the HKMA has on 10 Nov set up a RMB10bn intraday repurchase facility and has appointed seven banks as "primary liquidity providers" for the RMB. These moves are in preparation for the beginning of the link up between Shanghai and the Hong Kong stock markets, under the Shanghai-Hong Kong Stock Connect program, as China paves its way to open up further its capital market.

The Shanghai-Hong Kong Stock Connect (also known as "through-train"; 沪港股市互联互通机制 ("沪港通")) will allow investors in Mainland China to trade Hong Kong stocks, and Hong Kong (and overseas, in general) investors to participate in Shanghai-listed stocks. The key aims of the "through train" are more than just "product innovation" or increasing market liquidity, but to deepen China's integration and connectivity with international markets and expand the global role of the RMB. It should be noted that QFII schemes account for just 2% of mainland's capital market, compared to the typical foreign share of about 30% for emerging markets, and China is certainly aware of the severe lag in foreign participation.

The initiative was announced on 10 Apr 2014 by China Premier Li Keqiang and an opening date stated to be end-October. Various connectivity tests have been completed between both sides and after much delayed and uncertainty, possibly due to the "Occupy Central" protests in HK that started late-Sep, the "through train" program will begin on Mon, 17 Nov. A final testing run will be conducted between both sides on Sat (15 Nov). With much symbolism, regulators from both China and HK announced the opening date for the Stock Connect, just as the APEC meeting was underway in Beijing (7-12 Nov).

Mechanism Of The Shanghai-HK Stock Connect

To understand how this Stock Connect program will impact on the offshore RMB market and RMB internationalization process, it is important to have some understanding of the mechanism.

The Stock Connect is an additional capital-account channel for cross-border capital flows. The existing channels include the QFII/RQFII schemes for foreign institutional investors ("Qualified Foreign Institutional Investors"/"Renminbi Qualified Foreign Institutional Investors") to invest in mainland securities and QDII for mainland investors ("Qualified Domestic Institutional

Investor") to invest in overseas stocks and bonds, all of which are limited to institutional investors and required to be licensed, and subject to restrictions in terms of injection and repatriation of capital, among other limitations.

One key differentiating feature of the Shanghai-HK Stock Connect compared to existing QFII/QDII schemes is that it is open to both institutional and retail investors, thus broadening the investor base which is expected to lift trading liquidity significantly in both Shanghai and HK stock markets, subject to daily and cumulative trading limits, which are explained in detail below.

Northbound Trading Link (Hong Kong ➡ Shanghai)

Allows HK and overseas investors to purchase stocks traded on the Shanghai Stock Exchange (SSE)
569 Shanghai-listed stocks
Daily net quota = RMB 13bn (~13.3% of SSE's daily turnover)
Aggregate net quota = RMB 300bn (~3.1x of SSE's average daily turnover)

Southbound Trading Link (Shanghai ➡ Hong Kong)

Allows China investors to purchase stocks traded on the Hong Kong Stock Exchange (HKSE)
268 HK-listed stocks
Daily net quota = RMB 10.5bn (~21% of HKSE daily turnover)
Aggregate net quota = RMB 250bn (~7.1x of HKSE daily turnover)

It is important to note that the daily quotas under the Shanghai-HK Stock Connect scheme are on a NET BUY basis, rather than gross amount, i.e. investors will always be allowed to SELL their cross-boundary securities regardless of the quota balance. This means that theoretically the daily limits would not be hit if buy and sell orders offset each other.

The calculation is: Daily Quota Balance = Daily Quota – Buy Orders + Sell Trades + Adjustments. Note that the Daily Quota will be refreshed and remain the same every day, subject to the balance of the Aggregate Quota. Unused Daily Quota will NOT be carried over to next day's Daily Quota.

Based on this mechanism, it is our view that the cumulative quotas (for both northbound and southbound) will not be exhausted anytime soon, given the design of the daily limits.

Assuming the net daily quota is maxed out continuously, it would take 23 sessions for Northbound (RMB300bn ÷ RMB13bn), and 24 sessions for Southbound (RMB250bn ÷ RMB10.5bn), to exhaust the cumulative quotas.

This means that on a daily basis, even in the extreme situation of one-sided net purchases (no sale) of Shanghai stocks by HK investors, the maximum liquidity that will be absorbed offshore is RMB13bn. Will it cause distress to the offshore RMB liquidity condition?

Considering the availability of RMB liquidity in HK, we believe it is unlikely to cause severe stress to the system persistently: RMB deposits in HK reached RMB944.47bn as of Sep 2014, with global RMB deposit pool (including HK) exceeding RMB1.5tn. RMB loans outstanding in HK was RMB123bn as of end-February, meaning a loan-deposit ratio of 13%. In addition, HKMA has a bilateral swap line of RMB400bn on standby should the system run short of RMB liquidity, as well as the RMB10bn intraday repo facility as mentioned earlier. IMF estimates that average daily trading volume of RMB in HK at close to US$50bn (~RMB300bn equivalent). These figures suggest that offshore liquidity should be sufficient to handle quotas being maxed out temporarily, though it should be conceivable that the regulators would step in should financial conditions are being disrupted.

For comparison, the current size of the QDII/QFII/RQFII schemes are (as of 30 Oct 2014): Approved QDII quota US$87.373bn; Approved QFII quota US$64.061bn; and Approved RQFII quota RMB294.4bn.

Implications For The RMB

The latest initiative highlights China's determination to move along the market reform path, with greater sense of urgency, and the shift towards less cumbersome regulation.

Consider that the QFII program started in 2003 (QDII in 2007 and RQFII in 2011), it has taken more than a decade to arrive at today's scale. In contrast, the Shanghai-Hong Kong Stock Connect project was first announced in April 2014 and is slated to commence operation in about 6 months' time. This is truly an astonishing pace considering the operational complications that need to be overcome and coordinated: different sets of regulatory, taxation, and legal frameworks, operating environments, clearing and settlement cycles, down to different trading hours and holiday schedules and potential weather interruptions. In addition, unlike the QFII/RQFII/QDII schemes where Mainland China regulators have the sole discretion to dictate the conditions that investors must abide by, the "through train" project requires coordination and cooperation of regulators from both sides of the border.

As for the RMB currency itself, the opening of the Shanghai market to foreign investors will allow another alternative and more flexible means to deploy offshore RMB liquidity, in addition to the usual loans, insurance, bond, and other investment vehicles. This will increase the attractiveness to offshore RMB holders with an alternative avenue to generate yields and returns. The program is also another step towards opening up of the capital account and further RMB internationalization, as it allows an opening for backflow of the RMB to the mainland.

Notwithstanding the daily limits set, as the Northbound (i.e. into Shanghai market) trade is required to be funded by RMB, it is conceivable that there would be upward pressure on the offshore RMB FX rate and interest rates, and tightened liquidity in the initial stages of the program, though the situation is likely to normalize once the initial excitement and adjustment is over.

Nevertheless, it may still be prudent to keep sufficient RMB liquidity at hand, rather than short, ahead of and into the launch. The extent of offshore RMB tightness should be short lived and may not be as large as some expect, as explained earlier on the amount of liquidity available in the system.

Over the medium term, we remain positive on RMB, with our end-2014 target of 6.10/USD is still within sight, and our preference is for a firmer RMB exchange rate for end-2014 but should be capped inside 6.10/USD. Into 2015, we expect the RMB to rise to just 6.03-6.05/USD given our wariness of the impact of US Federal Reserve's moves ahead as its interest rate policy normalization is expected by mid-2015, which would see USD supported and possibly further volatility for the RMB and other Asian currencies ahead.

Near term there is some scope for weaker RMB on technical basis (see below), which just highlights the movements for the currency will remain volatile especially after the widening of the daily trading bands from 1% to 2% on 17 March early this year. This is one important point to keep in mind after the currency enjoyed a period of almost uninterrupted appreciation against the USD from 2005 to 2013. While we still think there is much mid-to-long term appreciation potential for the RMB, the USD strength into 2015 (please see our report "The Dollar Bull Looks Set To Charge Into 2015" dated 12 Nov 2014) and a modest growth environment in China may curb much of the RMB upside and instead could bring with it risks of short bouts of depreciation similar to the episode that we saw in March-April 2014 as RMB internationalization pace broadens.

Technical View **(From "Daily Technical Insights", dated 11 Nov 2014)**

In the last Chart of the Day update on 4/11/14 (Spot: 6.1225), we held the view that USD/CNH is in a recovery phase with a target of 6.1440. The target was almost met with a high of 6.1430 last Friday but the subsequent sharp drop has resulted in a mixed outlook from here. That said, with Daily MACD still holding clearly above 0, a sustained break below the recent low at 6.1100 is not expected. Allow for a deeper pull-back towards 6.1110/20 but as long as 6.1000 is not taken out, expect this pair to stage another attempt towards the major resistant just above 6.1400.

For more information on "Through Train":

Shanghai-Hong Kong Stock Connect: Information Book for Investors, HKEx
http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Documents/14051596_HKEx_Shanghai-Hong%20Kong%20Stock%20Connect(e)full.pdf

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