

DEVELOPMENTS IN OFFSHORE RMB

TOWARDS INCREASED TRANSPARENCY AND FURTHER INTERNATIONALIZATION OF THE RENMINBI



In January 2013, Bloomberg held a series of events in Singapore, Hong Kong and London on the topic of the internationalization of the renminbi and its implications for further reform of China's economy.

On January 28, Hong Kong banks agreed to loan RMB 2 billion to businesses across the border in China's Qianhai economic zone. What might appear on the surface to be an everyday banking transaction was anything but. The loans, by 15 banks to 26 projects, marked a significant step forward in China's ambitious plan to internationalize the renminbi—a strategy that could see the yuan rival the US dollar as a reserve currency and which has cities from Taipei to London vying to play a role.

Since establishing an offshore market for the yuan in 2004, with the launch of personal RMB banking in Hong Kong, China has taken increasingly rapid steps toward internationalizing its currency. In 2010 the SAR was declared the first Offshore RMB Business Centre, creating a deliverable, offshore form of the renminbi for the first time. Dubbed CNH by the markets, to distinguish it from the onshore CNY, its advent sparked exponential growth in RMB denominated deposits, trade settlements and so-called "dim sum" bonds in Hong Kong—with deposits alone now topping RMB 600 billion and rising.

"The pace of reform is much faster than expected," says Shantanu Basu, a Market Specialist with Bloomberg. "Nobody expected it to be done so fast." In 2012 alone China authorized the launch of diversified offshore RMB services to non-Hong Kong residents, allowed onshore non-financial institutions to issue dim sum bonds for the

first time, and completed the launch of its RQFII scheme, which allows qualified foreign institutional investors to invest offshore RMB in onshore securities markets—expanding the quota from RMB 70 billion to RMB 270 billion in the process. Situated within the Shenzhen special economic zone, Qianhai is a testing ground not only for freer use of renminbi but also capital account convertibility, with two banks in Shenzhen also lending to corporates in Hong Kong.

NEW TERRITORIES

There's little sign of a slow up. Following the success of CNH, China is now eyeing new offshore markets to further internationalize its currency. Taiwan appears poised to become the second offshore center following several announcements from Beijing designed to fast track the island's yuan business—including the appointment of the Bank of China's Taipei Branch as the designated RMB clearing bank in December 2012, a role Bank of China (Hong Kong) and Bank of China Macau Branch already hold in Hong Kong and Macau respectively.

Like Hong Kong, Taiwan has a natural demand for the yuan. Some 40 percent of Taiwan residents intend to open RMB deposit accounts, according to a Deutsche Banks survey, and Taiwan runs a large trade surplus with China. The start of personal banking and an increase in RMB settlement would release that pent up demand, giving the territory the potential to amass a large pool of renminbi

liquidity in a short period of time. BNP Paribas predicts Taiwan's yuan deposits will hit RMB 100 billion by the end of 2013—a fivefold increase on the funds currently held in the offshore banking units of Taiwan's banks.

Singapore is expected to become the third offshore center following the appointment of ICBC as the Lion City's yuan clearing bank in February 2013. Singapore is second only to Hong Kong in terms of offshore yuan liquidity, with some RMB 60 billion in deposits, and accounts for around 11 percent of the total offshore market according to the Standard Chartered Renminbi Globalisation Index (RGI). As the financial hub of ASEAN, Singapore has benefited from a massive influx of Chinese investment in the region, which reached \$18.8 billion in the first six months of 2012, up from \$7 billion in the same period the year before. Over 4,000 Chinese companies have set up business in Singapore, with 140 quoted on the local stock exchange.

While China has recently focused on bilateral tie-ups with strategically important partners, such as Taiwan, Australia and Japan, it is expected that Singapore will be granted offshore business center status sooner rather than later. The city state's diversity as a global trading partner means it could play a useful role in promoting the use of the renminbi more widely in the region, leading some commentators to predict an offshore market will be established within the year.

LONDON CALLING

Beyond the Asian region, London is lobbying to be given the same status. Backed by the UK government and the Bank of England, which has given in principal approval to a swap line with the People's Bank of China, the capital's financial district is proactively positioning itself as a European hub for renminbi transactions.

With less natural demand for the yuan and a smaller deposit base of around RMB 35 billion, London is playing to its geographical location and strength in the foreign exchange market, where it commands 40 per cent of global turnover—the equivalent of New York and Tokyo combined. "London is absolutely critical," says Derek Sammann, Senior Managing Director and Global Head of Interest Rate & FX Products with CME Group. "The infrastructure is second to none and the crossover between Asia and the US markets during the European time zone means London is wonderfully positioned."

In the first half of 2012, deliverable renminbi forex activity in London increased 150 percent year on year, with spot RMB also increasing by the same amount to an average daily volume of \$1.7 billion. Deliverable RMB FX swaps are up 240 percent to \$3.1 billion. London's increasingly prominent role is recognized in Standard Chartered's RGI, where London now matches Singapore with 11 percent of the market, but however rapid the growth only 0.56 percent

of the \$4 trillion in daily forex trades involve the renminbi.

"As much as it's about China, it's really about the currency," says Paul Gooding Managing Director and Head of European Renminbi Business Development with HSBC in London. "We know that China is already the world's second largest economy, it's already the world's largest exporter, but it's the currency that's so underrepresented. And that's the internationalization process, getting the currency out there." The challenge for London will be to increase the amount of yuan it has in circulation to match its Asian counterparts. "It's up to us now to build those liquidity pools through trade," says Gooding.

In the home of the CNH, the expansion of offshore renminbi markets to other cities is seen as a positive development. While it is still unclear whether there will be restrictions on fund movements between the different offshore centers, the consensus is that a larger pie will mean bigger slices for all. "We're glad to see more financial centers coming to join the party. We're moving clearly in the direction of increasing global use of RMB in a speedy manner," says Tony Wang, Deputy General Manager, Global Markets at Bank of China (Hong Kong).

A GLOBAL PLAYER

The accelerating pace of internationalization should be understood in the context of China's wider aim of making the renminbi a reserve currency. In 2015, the International Monetary Fund is set to review the composition of the basket of currencies it uses to define Special Drawing Rights (SDR). China hopes the renminbi will be added alongside the dollar, euro, pound sterling and yen. "Being part of SDR is very important from a political and status point of view. Being a reserve currency brings a lot of clout," says KC Lam, Executive Director, Head of FX Products, Asia for CME Group. "The argument for the inclusion of RMB is that it's already traded heavily in the Asian currency basket, so they are already a key part of the emerging market economy."

China's role at the core of emerging markets is without question. The majority of China's outward investment from 2005 to 2010 was in emerging markets, according to the Heritage Foundation, while China had over 40 percent share of trade among developing countries in 2009, according to the Asian Development Bank. With emerging markets heavily dependent on China for trade, and China's exports similarly reliant on demand from Europe, the US and Japan, Bloomberg economist Michael McDonough describes China as the "transmission mechanism" between the developed and developing worlds, giving it unique importance in the global economy.

Indeed, the renminbi is increasingly being seen as a trade currency, rather than a speculative one, on international markets. While some investors are still attracted by

the prospect of renminbi appreciation, trade flows are increasingly making the currency a natural part of many portfolios. "Eventually we expect that the interest in holding RMB assets will not be a function of whether the exchange rate will appreciate or depreciate, because that's the case with the dollar and other currencies," says Louis Kuijs Chief Economist with RBS in Hong Kong.

Both trading partners and central banks are showing increased appetite for the renminbi—an increasing number of central banks adding the yuan to their reserve portfolios. Deutsche Bank forecasts RMB trade settlement will more than double to over RMB 8 trillion in 2015, with more and more countries willing to settle in renminbi given the opportunity. In Australia, RMB payments increased 24 percent from October to November 2012, according to SWIFT, putting the resources exporter fourth in the list of renminbi settlements—up from 12th in 2010.

As China internationalizes the currency, trade settlement in renminbi—already up from two percent in 2010 to around one tenth of China's total trade—is likely to increase. While Letter of Credit issuance in yuan is one of the largest in the world, less than one percent of global trade is actually settled in the currency, while Hong Kong still accounts for 90 percent of all cross-border settlement. As bilateral agreements and offshore centers multiply, those numbers should change markedly—further strengthening the renminbi's claims on reserve currency status even while reducing business costs and foreign exchange risk for Chinese businesses.

"The days of only one reserve currency are over. We're in for a multipolar world," says Sammann, who sees the speed at which it will happen as the only debatable—the timetable influenced by the pace of reform in Beijing. "There are some folks going for 2015, some folks by 2055, but the way you get there is open, transparent markets, stability of infrastructure, rule of law. These are all critical components that underlie any reserve currency."

TOWARD TRANSPARENT MARKETS

By internationalizing the renminbi through offshore centers, China is able to introduce a measure of that openness and transparency without fully liberalizing its onshore market or opening its capital account. Already there are signs of increasing maturity in the CNH market as the growing supply of renminbi leads to demand for a broader, higher quality range of financial products.

The trend is most obvious in the dim sum bond market, which is becoming increasingly diversified through international and corporate issuances and boasts an increasingly discriminating investor base. "As the market matures, people are demanding bonds that have got ratings," says Don Tang, Regional Market Specialist with Bloomberg. "In the past dim sum bond issuers could get away with murder—and they did.

No one cared about the credit rating of the issuer, people would still buy them. Last year almost half of the bond issues were rated, which is a good sign."

In February 2013, CME Group began offering CNH futures contracts to meet demand from offshore dim sum bond investors looking to hedge their forex risk. Available to be traded 23 hours a day and with tenors of up to three years, the contracts should offer increased choice to international investors—existing futures from Hong Kong Exchanges and Clearing (HKEx) limited to one year tenors and traded only during local market hours. "The increase in issuance of dim sum bonds is clearly driving an increased demand for settleable, deliverable renminbi," says Sammann. "Markets in China are changing. We're seeing significant growth in demand for Chinese assets, particularly from customers that have historically not been able to access them."

Hong Kong's pioneering should benefit the next offshore centers, which—liquidity permitting—will be able to mature and deepen more rapidly. Developments that took several years to introduce in the CNH market, such as dim sum bonds and RQFII scheme, are expected to be available in other offshore markets from launch. There are signs, too, that China is increasing transparency in its onshore market. In late 2012, Bloomberg became the first, and so far only, global provider of real time data from the China Foreign Exchange Trade System (CFETS). All FX trades on the mainland are reported through this onshore exchange, a sub-division of the PBOC, meaning the data feed can help investors analyze the now highly correlated onshore and offshore markets in real time, rather than at one minute intervals.

SMALL LEAPS FORWARD

The challenge for China's leaders over the next five years will be how to balance rapid internationalization of the renminbi with its desire for a controlled, step-by-step liberalization of its currency and interest rates. The process of liberalizing interest rates began in 2006, but has proceeded much more slowly than the opening up of the currency—economic stability taking priority over any opening of the capital markets. However, China's economic interests and the process of liberalization are becoming increasingly aligned.

"The single most important reform now is liberalizing interest rates," says McDonough. China's transition from an export to consumption driven economy has been a stuttering one, despite high savings rates. Deposits are double those held by US banks and total over 50 percent of China's GDP. If that proportion fell to 40 percent, as in Singapore, it would increase consumption by \$500 billion—the size of the Swiss economy. "The potential is there, it just needs to be unlocked," says McDonough.

To stoke consumption China needs to raise incomes, which at an average of \$4,940 per annum are still low by

international standards. One way to do that is by liberalizing interest rates to help productive, private sector businesses get the funding they need to grow. McDonough sees positive signs that interest rate reform is now being treated as a priority in Beijing, including two asymmetric rate cuts in mid 2012 and the PBOCs adoption of open market operations aimed at lowering interbank rate volatility—a prerequisite for interest rate liberalization. Rate liberalization is also occurring through the expansion of trust lending and shadow banking, the effects of which are already feeding through into the private sector.

Freer interest rates will support further liberalization of the renminbi. "You can't really have exchange rate reform without interest rate reform," says Miranda Carr, Head of China Research for North Square Blue Oak. "We've seen that in Qianhai: they only started doing loans once the on and offshore rates had narrowed. If interest rates and exchange rates are both liberalized, then this will enable much more aggressive RMB internationalization."

While interest rate and currency reforms form a potentially virtuous circle, expect Beijing to remain cautious. "The internationalization of the RMB gives added motivation to open up the capital account in order to create the deeper markets that are necessary for foreigners to want to hold RMB assets," says Kuijs. "But financial policy making is influenced by real economic situations. I would continue to think in terms of very steady progress, but not a very quick, full blown opening of the capital account."

A FREE FLOATING FUTURE

Despite the challenges, many observers predict a freely floating renminbi within five to seven years—the timeframe influenced not only by the IMF's 2015 review of SDR

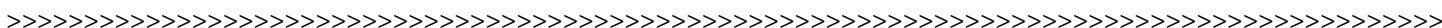
but also the Chinese government's stated aim of making Shanghai an international finance center by 2020. That may mean a limited lifespan for the renminbi's offshore business centers. Once the yuan becomes fully convertible there will be no need for CNH or any other offshore equivalents of CNY. The dim sum bond markets—which represent less than two percent of all RMB denominated bonds—are likely to be absorbed into an onshore market that is already the third largest in the world.

But while the world may be ready add the renminbi to the reserve currency club before the decade is out—which point China may overtake the US as the number one economy—the yuan could still face a long march to topple the dollar as the global economy's default method of payment. "Sterling was still the world currency for some 50 years after the US became the largest economy in the world," says Alison Fletcher, FX and Economic Market Specialist with Bloomberg.

Modern China has made a habit of compressing time, however. As a symbol for the renminbi's rapid expansion into new lands, Qianhai could hardly be more appropriate. The first loans to companies registered in Shenzhen's new services hub have been agreed, but at this stage the zone is "just a construction site," says Justin Chan Deputy Head of Global Markets, Asia-Pacific, and Head of Hong Kong Trading with HSBC Hong Kong, who visited the area in January 2013. Don't expect it to stay that way for long. "China is China. If they're determined to do something it can be completed pretty fast," says Chan, who expects the new financial district to take concrete form within three to five years. Qinghai's glass and steel towers may open for business in a world where the renminbi is growing beyond offshore centers and taking its place as a true global currency.

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