30 October 2014

RMB Internationalization

Highlight

- As China continues to play a prominent role on the world stage, the Chinese government has sought to internationalize its official currency, the Renminbi (RMB). RMB internationalization is to be achieved in three phases: 1) through international trade; 2) through international capital markets, including financing and investment; and 3) adoption as a reserve currency.
- The use of RMB is considered underrepresented when compared to the size of China's economy and international trade volumes but it is increasing rapidly. Thai entrepreneurs that invest and trade with China should closely monitor to relevant information on RMB and market updates in order to maximize their benefits.

RMB Evolution: From a fixed exchange rate system to a managed floating rate system. In the past, the Chinese Yuan or Renminbi (RMB) was pegged to the US dollar through a fixed exchange rate system; the RMB exchange rate during 1998-2005 was 8.28 Yuan per USD. In July 2005, the Chinese government switched its exchange rate regime to a managed floating rate system linked to a basket of currencies based on China's trade partner currencies such as the US dollar, Euro, Japanese yen, and Korean won. The People's Bank of China (PBoC) controlled the RMB by setting the daily mid-value and allowing the currency to fluctuate within the trading band of +/- 0.3%.

The latest widening of the trading band signals that China will allow more free capital flows, which can provide more RMB fluctuation, and we may no longer see the currency's typical trend of one-way appreciation. Since switching to a managed floating rate system, China's trade surplus has increased as exports continued to rise, while the US experienced a significant deficit that exacerbated global imbalances. As a result, China trade partners, especially US started to pressure China to allow the RMB to appreciate, and the Chinese government responsively deployed a gradual appreciation trend. During 2005-2013, RMB appreciation was seen as a steady one-way trend (Figure 1), appreciating as high as 6.03 yuan per USD on January 15, 2014.

Because the RMB's one-way appreciation trend brought about significant amounts of money from foreign speculators, the Chinese government decided to widen its trading band from +/- 0.3% to +/- 0.5% in 2007 and to +/- 1% in 2012.

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On March 15, 2014, China widened its trading band to +/- 2%, which has been perceived as a signal that the PBoC aims to promote free movement of capital in and out of the country. Currently, China has a current account surplus of around 2% of the country's GDP, down from a 2007 surplus of 10% of the country's GDP (Figure 2). This simply means that RMB will not be only one-way appreciation trend. As a result of China's further widening of the trading band in March, the RMB weakened to 6.25 yuan per USD and the exchange rate as of October 28, 2014 was 6.12 yuan per USD.

China's capital control policy designated two different trade markets for RMB currency – the onshore RMB market and the offshore RMB market. The two markets have different exchange rates with a foreseeable narrowing gap. The RMB is legal tender in mainland China and is abbreviated as CNY, whereas it is abbreviated CNH for trades outside the mainland. Consequently, the exchange rates in the two markets can differ at any given time (Figure 3). The CNY exchange rate is set by the PBoC and controlled by its trading band. Main players in the CNY market are Chinese importers who convert RMB to USD as a means of payment and Chinese exporters who convert their USD income to RMB. Other players are institutional investors who receive quota to invest in the mainland and there are not many investors at the moment. On the other hand, the CNH market is free of China's control, foreign players are allowed to trade freely, and therefore, CNH exchange rate is based on demand and supply in reference to the offshore market.

The reason why CNH exchange rate is different from CNY exchange rate is because during the rapid pace of China's economic expansion (Between 2010 and 2011, China's economic growth rate was 10% per year), investors demanded to open RMB deposit accounts in order to do their business transactions, and for investment in equity investment, mutual funds, and debentures which investors need not to receive quota like those in CNY market. Because of the limit supply and great demand from investors, the CNH exchange rate tends to be stronger than that of CNY. However, the Chinese government has established CNH liquidity pools through four channels (Figure 4): 1) RMB-settled import; 2) RMB retail conversion; 3) Bilateral currency swap arrangements between the PBoC and foreign central banks; and 4) RMB overseas direct investment received quota from Qualified Domestic Institutional Investors (QDII). These channels help narrow the gap between CNH and CNY. Consequently, these exchange rates will be a single currency in a foreseeable future.

As China continues to play a significant role in the global economy, the Chinese government has been seeking to internationalize its official currency, the Renminbi. In 2013, China became the world's largest goods trading nation, with total exports accounting for 12% of global exports, and the size of China's economy is the world's second largest after the US (Figure 5). Seeing that trade and investment were pouring into the country, China started to accelerate RMB internationalization, aiming for the RMB to be the main currency traded in the world like the US dollar and the Euro. In doing so, the path of RMB internationalization can be divided into the following three phases:

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1) Promoting the use of RMB for international trade

2) Promoting the use of RMB in international capital markets, including financing and investment

3) Promoting the use of RMB as an international reserve currency

1) In an attempt to promote the use of RMB for international trade, China wanted to reduce the transaction costs for its importers and exporters in order to raise international trade volume.

China is an important trade partner with many countries, not only for the US but also for emerging markets. In the past, the US dollar was the main medium of exchange in international trade. Therefore, China sought to internationalize its official currency to address challenges from the US dollar. China saw the benefits for its importers and exporters as it will help reduce cost of foreign exchange transaction, exchange rate risk, the cost of currency hedge, and shorten settlement times.

The first step of RMB internationalization kicked off in 2009 under the pilot scheme for RMB cross-border trade settlement in the 5 pilot cities, namely Shanghai, Guangzhou, Shenzhen, Zhuhai, and Dongguan with overseas enterprises from Hong Kong, Macau and ASEAN countries, including Thailand. In 2010, the RMB cross-border trade settlement expanded to the rest of the world and locally from 5 cities to 20 cities. In order to boost confidence in the RMB for trade settlement and to increase pools of offshore RMB liquidity, the PBoC signed a bilateral currency swap arrangement with the central banks of numerous countries. Moreover, the PBoC also issued a policy allowing the foreign central banks, RMB clearing banks, and offshore participating banks to apply for quota to trade in their mainland RMB interbank market.

China pioneered Hong Kong as an RMB offshore center and continues increasing in many countries. In order to facilitate RMB flow outside the mainland, China designated Hong Kong as an RMB offshore center. Currently, Hong Kong handles around 70% of all trade settlements in RMB. According to the Hong Kong Monetary Authority, 220 participating banks have joined the RMB RTGS system for interbank RMB settlement[1]. In addition, RMB offshore centers have expanded beyond Hong Kong, and there are RMB clearing banks in many locations, including Taiwan, Singapore, Macau, London, Paris, Frankfurt, Luxembourg, and Seoul. According to a report from the Industrial and Commercial Bank of China (ICBC), it plans to give services to banks and entrepreneurs in Thailand as RMB Clearing Banks within the next 1-2 years [2]

RMB international trade is on a positive trend. Since the 2009 pilot scheme for RMB cross-border trade settlement, the use of RMB in international trade has risen accordingly. Currently, average monthly RMB trade

[1] RMB RTGS (Real-time Gross Settlement) is a system enabling inter-bank payment with the RMB Clearing bank in Hong Kong, which is the Bank of China (Hong Kong). As of September 2014, list of Thai Participating banks in Hong Kong RMB RTGS includes the Siam Commercial Bank Hong Kong branch, Bangkok Bank Hong Kong branch, and CIMB Thai.

[2] "ICBC eyes yuan clearing bank - Allows for greater trade and investment", Bangkok Post, Jul 19, 2014

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settlement is valued at approximately 500 billion yuan (Figure 6), accounting for 18% of China's total trade. This is a significant increase when compared with the previous record of 3% in 2010. In addition, the RMB overtook the euro to become the second most-used currency in global trade finance after the US dollar (Figure 7). However, the use of RMB is considered underrepresented when compared to the size of China's economy and international trade volumes but it has the potential to increase.

2) China has opened up opportunities for promoting financing and investment in RMB in order to facilitate the use of RMB in international capital markets. The evolution of the RMB offshore market began in 2004 when China allowed RMB deposits in Hong Kong. By H1/2014, RMB deposits totalled 900 billion yuan and grew rapidly in other countries such as Singapore and Taiwan (Figure 8). Offshore RMB-denominated bonds, or "Dim Sum bonds", were issued for the first time in 2007 by the China Development Bank, and in 2009 China's Ministry of Finance issued Dim Sum sovereign bonds for the first time. McDonald's was the first foreign corporate to issue Dim Sum bonds in 2010, followed by the Asian Development Bank (ADB), the first supranational agency to do so. In 2011, the first offshore RMB REIT, Hui Xian was listed on the Hong Kong Exchange. Until now, RMB assets in offshore markets are growing significantly, and the Dim Sum bond market has doubled in size each year from 2008 to 2013 (Figure 9). The reason RMB assets in offshore markets, especially Dim Sum bonds, grew in popularity among Hong Kong and international investors is because they offer high yields in a relatively short maturity and investors can also benefit from RMB appreciation. EIC believes RMB assets in offshore markets will continue to expand greatly as large Chinese and foreign corporations will continue to raise more capital in RMB.

In regard to onshore markets, China announced the 2003 Qualified Foreign Institutional Investor (QFII) regulation, which allowed foreign investors access to mainland stock markets (A-shares[3]). In 2011, China announced the RMB Qualified Foreign Institutional Investors (RQFII) policy, which allowed RMB investment funds to be set up in Hong Kong and invest in mainland China's securities markets. As yet, China continues to relax its regulations to increase quota granting and expand investment quotas. The QFII program grew from USD 80 billion in 2012 to USD 150 billion, while the RQFII program grew from 70 billion yuan in 2012 to 270 billion yuan (Figure 10). The increased QFII and RQFII quotas help facilitate access for overseas institutions to mainland China, especially A-shares on the Shanghai and Shenzhen Stock Exchanges, in which the scale of foreign participation is still limited.

3) The path to establishing the RMB as a reserve currency is still at an early stage. Reports from HSBC have revealed that several central banks hold RMB assets as a reserve currency. The practice is accomplished by offshore RMB investment into the China bond market through the China Inter-bank Bond Market (CIMB) quota, QFII quota, and investment into offshore RMB bond markets. In addition, China has signed bilateral currency swap

[3] A-shares are shares in mainland China-based companies that trade on Shanghai and Shenzhen Stock Exchanges. A-shares are traded in RMB and limited to institution investors through the investment quota. B-shares are Chinese companies listed primarily for international investors in the Shanghai exchange (trade in USD), and the Shenzhen exchange (trade in HKD). H-shares represent Chinese companies listed in Hong Kong Exchange and are quoted in HKD, freely tradable by anyone.

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agreements with 23 central banks in a total amount of 2.5 trillion yuan. This indicates that foreign central banks are keen on employing the RMB as a viable reserve currency before China makes it fully convertible. EIC believes that the major driver behind this trend is to diversify away from the US dollar (Figure 11), while the euro and yen are set to depreciate in line with weakening economies.

However, the RMB still has a long way to go to become a major reserve currency because, 1) The RMB is the managed floating rate system, which is not driven by the market supply and demand like the US dollar or the euro; 2) The RMB is subject to regulated quota in trade and investment; and, 3) Access for foreign investors to onshore market investment is limited. Currently, foreign ownership in the onshore RMB bond market accounts is only 1-2%. Therefore, in order to achieve the RMB's adoption as a reserve currency it is essential to boost confidence in the RMB by promoting greater use of the currency and to issue government policies supporting full convertibility for the RMB.

EIC views that the RMB will be fully convertible over the next 3-5 years. Currently, the Chinese government has not implemented full RMB convertibility due to its precautionary outlook on foreign exchange reserves. As far as it is concerned, excessive foreign currency inflow could cause PBoC to hold a great amount of US dollars which will become the burden of the PBoC, whereas excessive outflow of the RMB could pinch its value and its depreciation would induce attacks by speculators. Therefore, China aims for gradual convertibility through financial reforms. These include improving banking sector stability; developing a regulatory framework for capital markets through QFII and RQFII quota expansion to offer greater access for foreign financial institutions to invest in capital and onshore RMB bond markets; expanding the Qualified Domestic Institutional Investor (QDII) scheme quota to allow Chinese institutions to invest in financial products overseas; and finally removing the quota system in the capital control policy.

The evidence of China's financial reforms can be seen through the implementation of the Shanghai integrated Free Trade Zone, or SFTZ, as part of the Capital Account Liberalization Pilot Schemes. The Zone permits RMB convertibility between resident and non-resident onshore and offshore accounts and facilitates the management of capital account transactions. For example, foreign corporates are allowed to raise funds through the issuance of Panda bonds (RMB-dominated bonds issued by non-Chinese) and to invest in stock markets in excess of QFII quotas. Meanwhile, domestic corporates are also allowed to invest in stock markets overseas in excess of QDII quotas.

Implication

- **Thai entrepreneurs who trade and invest with China will gain benefits from RMB trade settlement.** EIC expects the RMB to play a more significant role in international trade. The use of RMB for trade settlement will enable Thai entrepreneurs who trade with Chinese partners to gain more benefits as it helps minimize exchange rate risk and reduce transaction cost. Importers and exporters can convert their payments/incomes directly into RMB without having to first convert into the US dollar. Thai entrepreneurs who

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are interested in RMB trade settlement should pay attention to the development path of RMB trade settlement, especially the increasing trend of financial products or services from financial institutions that service RMB transactions.[4]

- **Investors should be cautious of exchange rate fluctuations.** In the past, RMB assets, especially Dim Sum bonds, were popular with foreign investors due to high yields in a relatively short horizon, as well as benefits from RMB appreciation. EIC believes that RMB financing and RMB assets will continue to grow rapidly and still attract investors. In addition, RQFII quota expansion contributes to the more appealing A-shares for foreign investors. However, RMB full convertibility and the latest attempt in widening the trading band will result in an increasingly fluctuating exchange rate. RMB will no longer move on the expectations of one-way appreciation but will move in line with China's trade and economy. According to these factors, investors who are exposed to RMB assets should closely monitor exchange rate risk besides credit risk and price risk.

[4] More information about Thailand's financial institutions that operate RMB trade settlement service can be found in "RMB Settlement Guideline", http://www.bot.or.th/Thai/FinancialMarkets/LocalCurrency/Yuan/DocLib_text/คู่มือการทำธุรกรรมเงินหยวน.pdf

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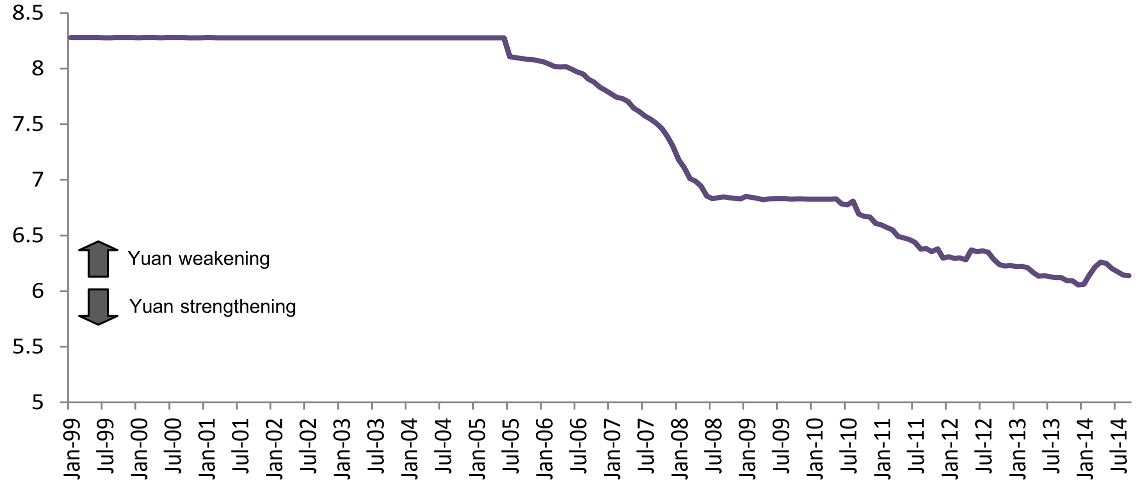
Figure 1: CNY currency

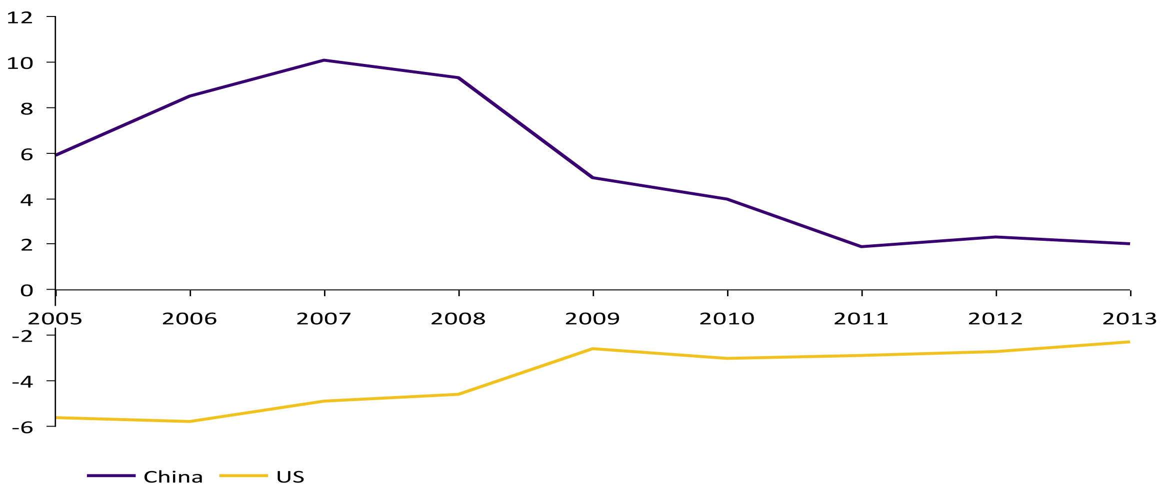
Unit: yuan per USD



Source: EIC analysis based on data from Bloomberg

Figure 2: China and US Current Account to GDP

Unit: %



Source: EIC analysis based on data from World Bank

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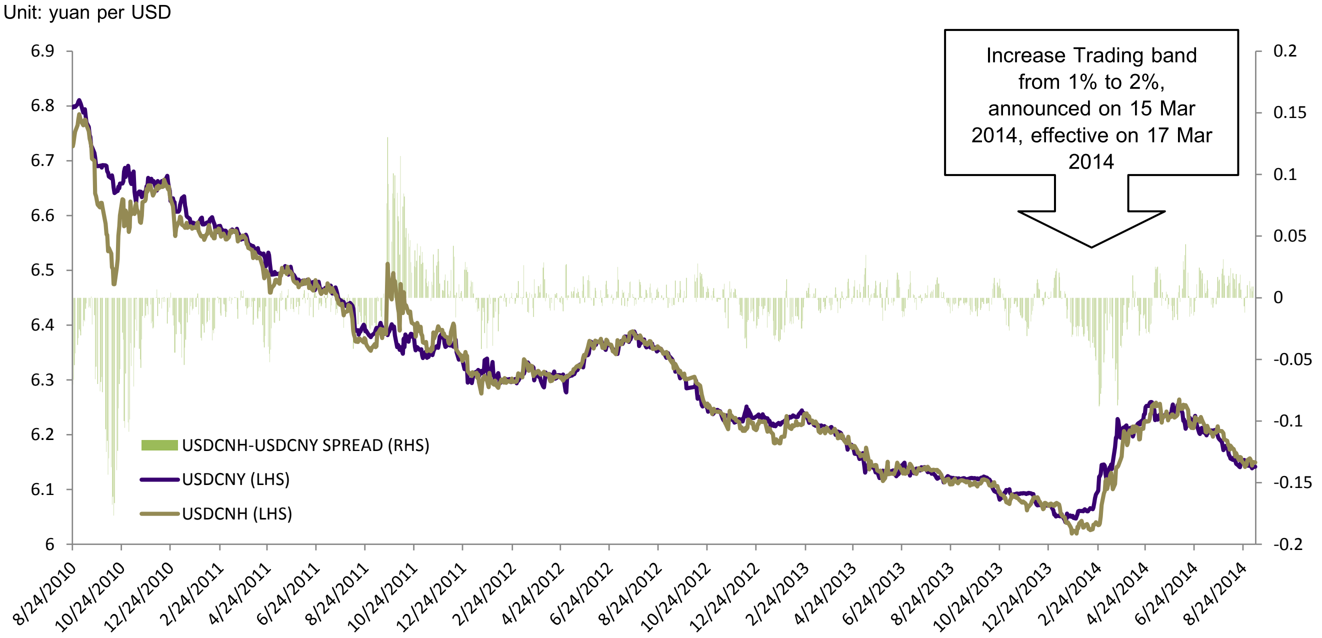
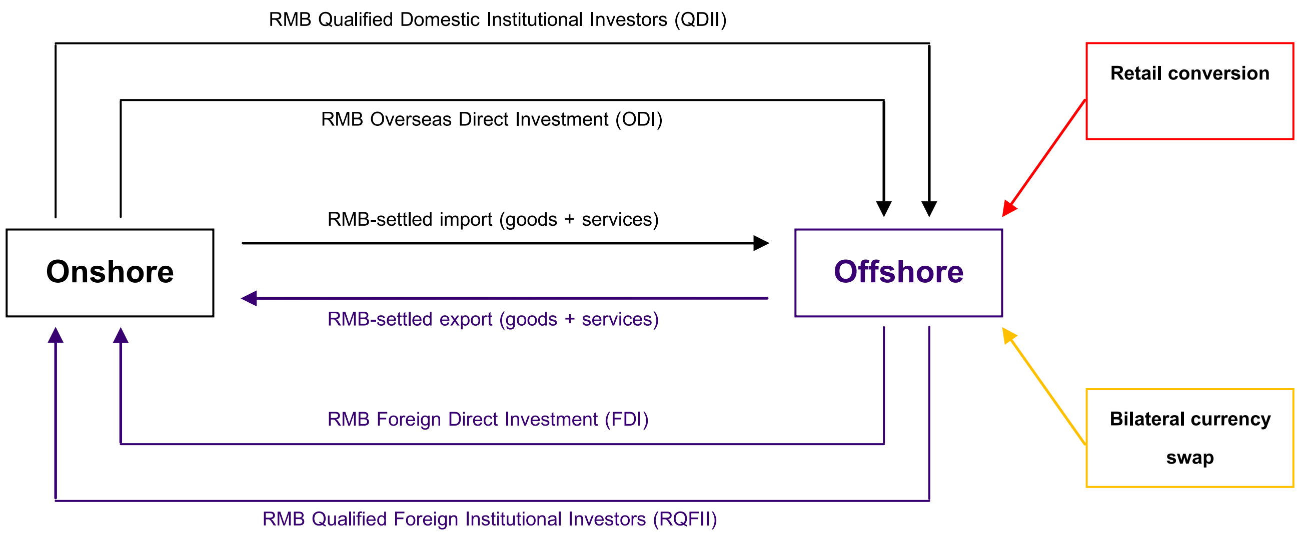
Figure 3: USD-CNH, USD-CNY and spread between USD-CNH and USD-CNY



Source: EIC analysis based on data from Bloomberg

Figure 4: Main sources for CNH liquidity



Source: EIC analysis based on data from HSBC

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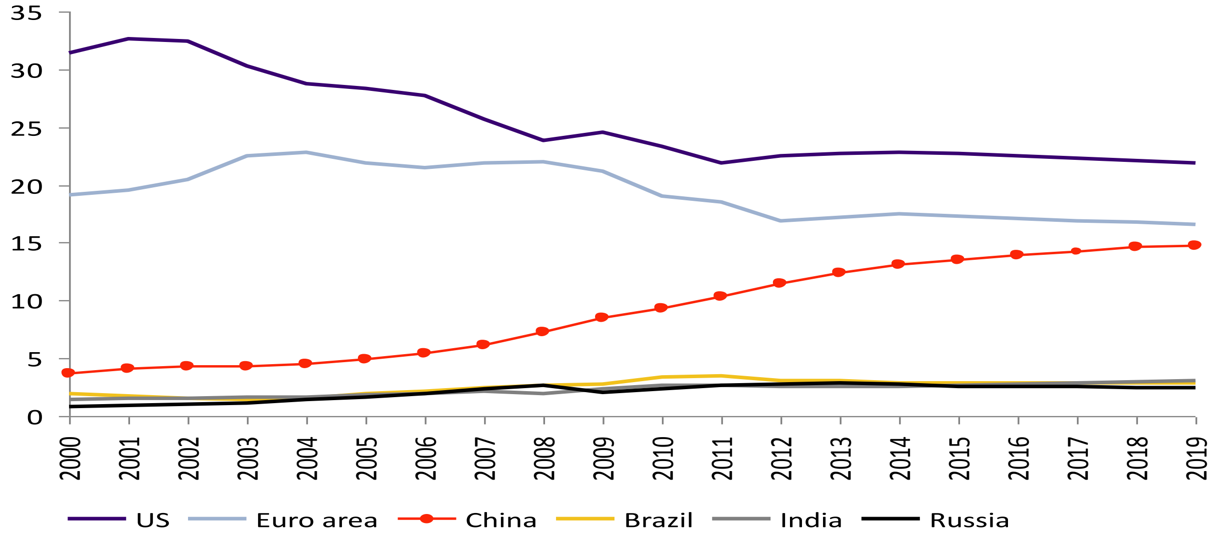
Figure 5: China's economy is the world's second largest, accounting for 12% of global GDP (GDP in USD)

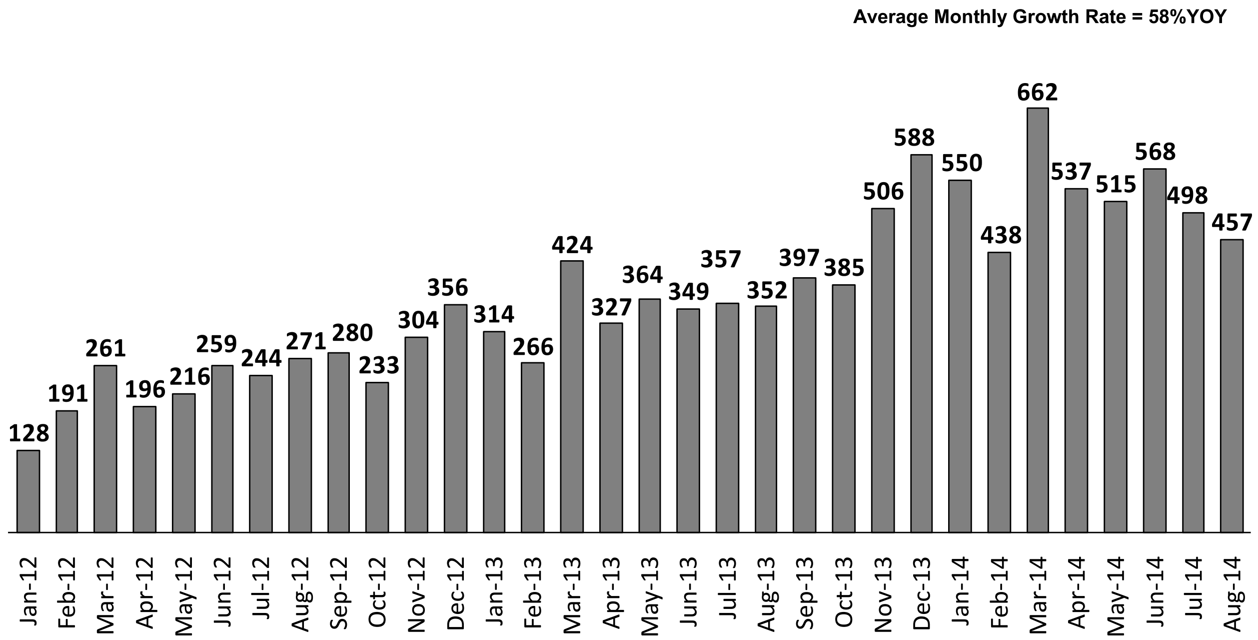
Unit: % of world GDP



Source: EIC analysis based on data from IMF and WEO

Figure 6: Value of RMB Trade Settlement (Monthly)

Unit: RMB billion



Source: EIC analysis based on data from Bloomberg

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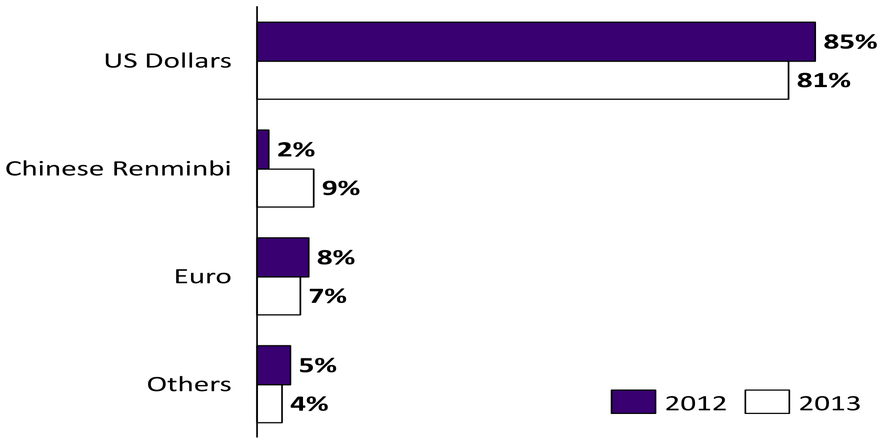
Figure 7: Value of Global Trade Finance by Currency

Unit: %



Source: EIC analysis based on data from SWIFT

Figure 8: Value of RMB Deposits in Hong Kong, Singapore, and Taiwan

Unit: RMB billion

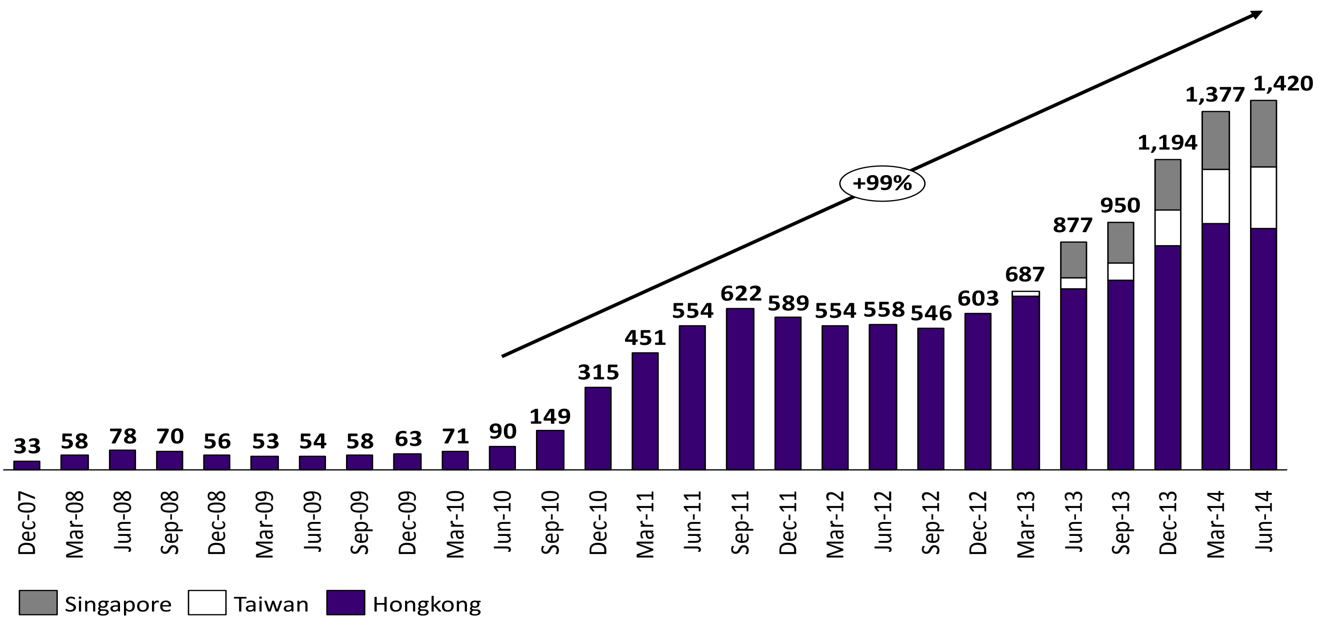


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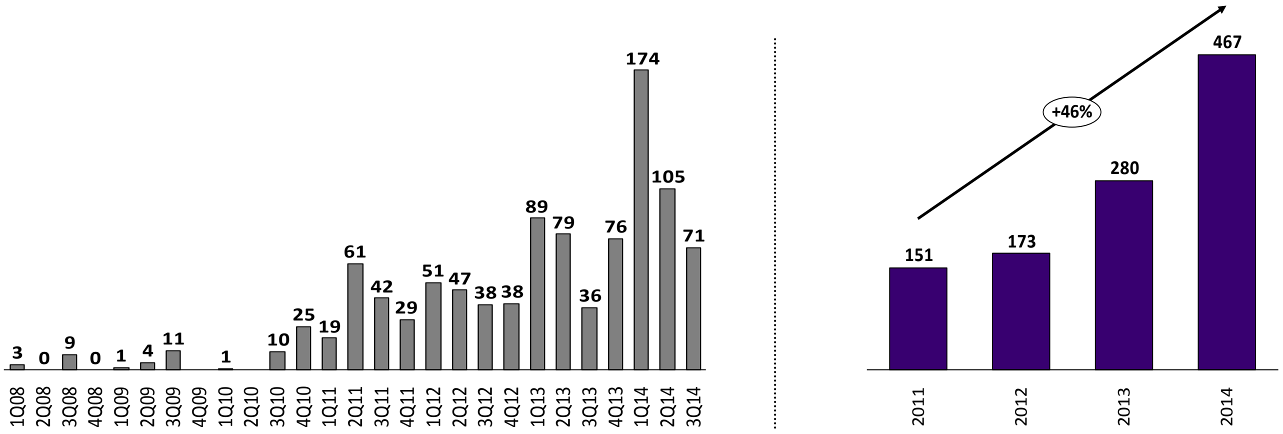
Figure 9: Value of Issued Dim Sim Bonds

Unit: RMB billion



Source: EIC analysis based on data from Bloomberg

Figure 10: QFII and RQFII Comparison

		QFII	RQFII
1)	Regulator	CSRC,SAFE	CSRC, SAFE, PBOC, Hong Kong SFC
2)	Applicable institution	Asset management companies, Securities houses, Insurance companies, Commercial banks, and other institutions. There are 251 licenses listed currently.	Hong Kong subsidiaries of qualified China mainland financial institutions registered and mainly operating in Hong Kong, Securities houses, Insurance companies, Commercial banks and Financial institutions in Hong Kong, London, and Singapore. There are 43 licenses listed currently.
3)	Source of funding	Foreign currency	Offshore RMB
4)	Available instrument	Exchange-listed or transferred A-shares, bonds and warrants, Fixed income products traded in inter-bank bond market, Securities investment funds, Stock index futures and Subscription to IPO, additional issuance, rights issues, and convertible bond issuance.	
5)	Asset allocation	No less than 50% in equity and no more than 20% in cash	Restrictions removed
6)	Foreign ownership	30% for all foreign investors	
7)	Total quota approved (as of February 2014)	USD 150 billion	Yuan 270 billion

Source: EIC analysis based on data from HSBC

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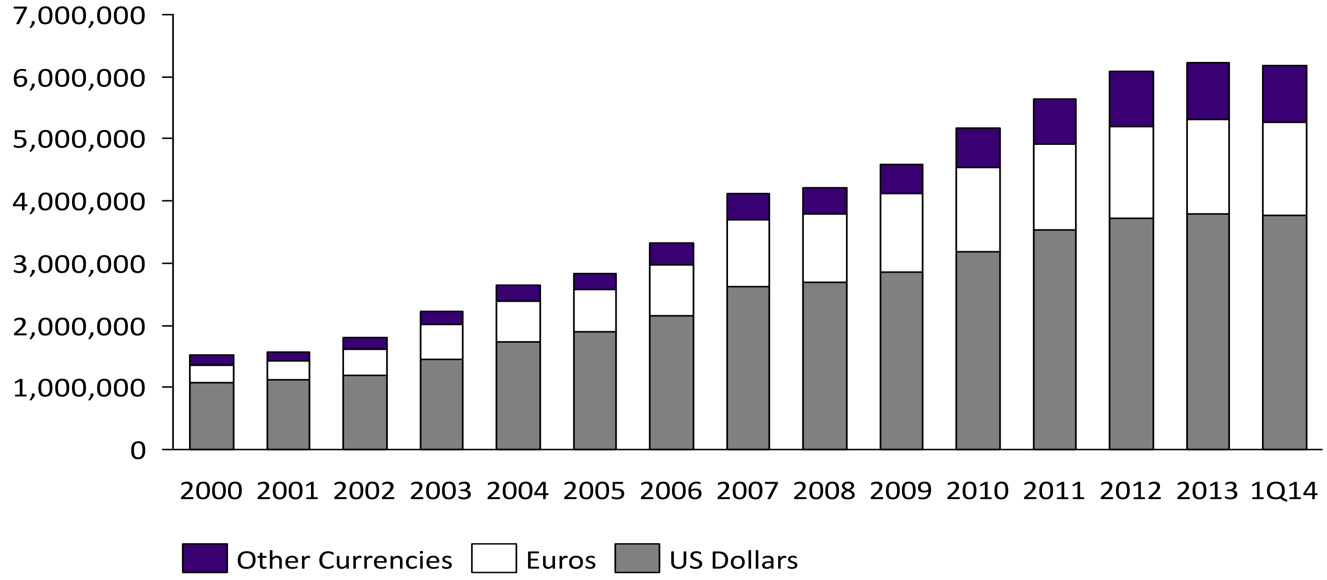
Figure 11: Foreign Central Banks Reserve Assets by currency

Unit: USD million



Source: EIC analysis based on data from IMF

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Figure 12: RMB Internationalization Milestones

Preliminary stage

2003	- The PBoc and the HKMA agreed that Hong Kong banks could conduct personal RMB business on a trial basis and BOCHK was designated as the RMB clearing bank. Personal RMB business includes deposit-taking, exchange RMB into HKD or vice versa and remittance service.
2004	- Banks in Hong Kong were allowed RMB deposits.
2005	- Designated Business Customers (DBCs) were allowed RMB deposits. - The Asian Development Bank (ADB) was the first supranational agency to issue Panda bonds (a RMB-dominated bond issued from a non-Chinese issuer) but unable to transfer RMB outside the mainland.
2006	- The QDII was announced as a pilot scheme, allowing Chinese institutions approved by the Chinese Securities Regulatory Commission (CRSC) to invest in financial products overseas through a signed MOU with China. Initially, the investment was established only on the Hong Kong Stock Exchange.
2007	- China Development Bank (CDB) was the first Chinese institution approved by the PBoC to issue the RMB-dominated bonds.
2008	- The PBoC signed the first Bilateral Currency Swap Agreement with the bank of Korea, and later expanded to several countries.
2009	- China's Ministry of Finance issued first offshore RMB sovereign bond ("Dim Sum" sovereign bonds) in Hong Kong. - China announced pilot scheme for RMB cross-border trade settlement in the 5 pilot cities with overseas enterprises from Hong Kong, Macau and ASEAN countries. There were 365 eligible Mainland Designated Enterprises (MDE).
2010	- The PBoC announced the expansion of RMB cross-border trade settlement to the rest of the world and locally from 5 cities to 20 cities as well as expanded RMB settlement trial for trade to 67,359 exporters (MDE). - The PBoC issued policy allowing the foreign central bank, RMB clearing banks, and offshore participating banks to apply for quota to invest their RMB funds in the mainland interbank bond market. - McDonald's was the first corporate and the ADB was the first supranational agency to issue Dim Sum bonds listed on the Hong Kong Stock Exchange.

Acceleration stage

2011	- RMB Overseas Direct investment (ODI) was announced. - RMB Foreign Direct Investment (FDI) was announced. - The first offshore RMB IPO, Hui Xian REIT, was listed on the Hong Kong stock exchange. - RMB Qualified Foreign Institutional Investors (RQFII) was announced.

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2012

- The PBoC expanded the USD-RMB daily trading band from 0.5% to 1%.
- The Hong Kong Monetary Authority (HKMA) revised the RMB net open position (NOP) limit requirement.
- China announced the Qianhai pilot zone.
- The HKMA loosened liquidity risk management rule. Institutions can issue loans for customers with urgent need, including policy to adjust liquidity-ratio requirement.
- The HKMA issued a policy allowing RMB deposits for non-HK residents, investors, and tourists in Hong Kong institutions. RMB can move freely in Hong Kong but cannot transfer back to the mainland.
- CSRC expanded QFII and RQFII quotas significantly. The QFII quota increased to USD 2.8 billion while the RQFII quota increased to 270 billion yuan.
- The PBoc appointed Bank of China Taipei branch as the RMB business clearing bank in Taiwan.

Latest development

2013 – Present

- RMB bonds were issued in Taiwan for the first time.
- The PBoC expands the USD-RMB daily trading band from 1% to 2%.
- QFII and RQFII investors can invest in inter-bank bond market. In addition, CSRC expanded the QFII quota to USD 15 billion and continued to relax QFII and RQFII regulations. It also expanded RQFII to London and Singapore.
- HKMA issued CNH Hong Kong Rate Fixing (CNH HIBOR Fixing).
- The Shanghai Integrated Free Trade Zone (Shanghai FTZ) was launched.
- China implemented a Qualified Domestic Limited Partnership (QDLP) program, allowing foreign asset managers to set up wholly owned subsidiaries in China and establish financing through hedge funds from the general public and corporates, in order to invest in offshore securities markets in line with quotas granted from the CSRC.
- The PBoC appointed the Industrial and Commercial Bank of China (ICBC) Singapore as a RMB Clearing Bank for banks and entrepreneurs in Singapore and plans to expand the clearing system to Singapore, London, France, and Germany.

Source: EIC analysis based on data from HSBC

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