Origination and Development of RMB Internationalization

Chief Economist, BOC
Cao Yuanzheng
June 12, 2012
Content

- Origination of RMB Internationalization
- RMB Cross-boarder Trade Settlement
- Hong Kong RMB Offshore Market
- Debate and Prospect
Origination of RMB Internationalization
Special Condition for RMB Internationalization

- **Fully Convertibility of Sovereign Currency.** Convertible currency may not be the internationalized currency, but reverse must be true.

- **Deficit of International Trade.** Deficit must be have in at least one item of balance of payment.

- **Incomplete Independence of Monetary Policy.** Monetary policy of an internationalized currency is the international monetary policy---international liquidity must be satisfied. Thus a sound financial infrastructure is required.

Obviously, these basic conditions are not satisfied while RMB is on the internationalizing process. This process is a special arrangement and differs RMB internationalization from traditional process.
International Demands of RMB

- Enhancement of regional currency cooperation is desired by emerging economies, so as to maintain local economic stability and growth, and to promote regional economic convergence.

- Problems occurred during 2008-2009 crisis reduce the dependence of Dollar on international trade and FDI. Risks, especially liquidity risk, are reduced.
  - Local currency settlement on regional trade to lower the influence by the volatility of third-party currency.
  - Local trade financing will be increased.

- Based on the increasing of inter-trade and financing, local currency in the region will be used in foreign reserves, pricing and settlement.

- Development of regional bond market to improve the structure of investment and savings.
RMB Demands Orientated in Asia

- China has a long history of trade deficit with east Asia, although US dollar remains the trading currency.
  - China-ASEAN free trade area: established in Jan 1\textsuperscript{st} 2010. with 1.9bn population, $6tn GDP and $4.5tn international trade. Zero tariff in 2015.
  - Negotiation of China-Japan-Korea free trade area is on going.
  - Shanghai Cooperation Organization (SCO) declaration: closer arrangement on trade and economy between members.

- Enhancement of regional financial and monetary cooperation: in 2009 China improved financial infrastructure with ASEAN; SCO and BRICS mentioned to increase the use of local currencies and regional financial and monetary cooperation.
RMB Cross-boarder Trade Settlement
RMB Internationalization Originated from Trade

- To cope with the financial crisis and rapid growth of Asian Economy, RMB settlement was adopted on cross-border trades between Hong Kong/Macau and the Pearl River Delta/Yangtze River Delta, and ASEAN and Guangxi/Yunnan in November 2008. The Detailed Rules for the Implement of the Measures for the Administration of Pilot RMB Settlement in Cross-border Trade was implemented in July 2009. Since then, RMB cross-border settlement was started officially.

- Two models for cross-border RMB settlement:
  - the correspondent agent model (Shanghai model): overseas banks settle with the Shanghai Branch of the Bank of China and Bank of Communications.
  - the clearing bank model (Hong Kong/Macau model): RMB liquidation through BOCHK.
Amount of Cross-boarder RMB Settlement

Unite: CHY 100mn

Statistics: the clearing bank model predominates with CHY1.6tn settlement amount, taking 80% of total settlement amount.
RMB global use “not only on trade”

- The models facilitate RMB outflow under current items so as to access to RMB on international trade. This supports the development of international trade to some extend.

- Over long-run, use of RMB should not been limited on trade. There will not be more motivation of using RMB if there are no facilitative RMB investment channels----this is the reason of little use of Shanghai model.

- No deepening use of RMB internationally, no clear prospection of expanding RMB use, no improvement of international trade and trading-investment liberalization.
Hong Kong RMB Offshore Market
HK Offshore RMB Centers--- A Non-Traditional Process

Future of Hong Kong Model: RMB outflow through existing channels and inflow via current account. Capital account inflows must be via HK.

- Nonresidential RMB holdings should be pooled and mainly by adjustment---Multiple channels but only one gate.

- BoP capital account regulation is like the dam of the reservoir. Due to this dam, HK capital markets becomes the RMB reservoir while PBOC and HKMA become the gate guardians.
Unique Advantages of Hong Kong Offshore Market (1)

- After the Asian financial crisis, the mainland China and Hong Kong started “Closer Economic Partnership Arrangement (CEPA). In Nov 2003, RMB is officially used in Hong Kong for the first time. After these year’s development, Hong Kong see RMB business scope much wider, amount larger and in accountancy with the regulations. The RMB established decent reputation and foundation.

- Unlike other RMB cross-border usage arrangement, HK RMB business is for both individuals and institutions, involving both trade financing and capital markets. To some extent, it indicates the opening up of both current account and capital account. Hong Kong is now a viable channel for RMB flow back mechanism. this not only lay the foundation for Hong Kong as the RMB offshore center but also offers new landscape for Asian trade financing and capital market financing.
Hong Kong is equipped with sound financial infrastructure and functioning RMB instant payment system. Clearing arrangement is very efficient and is linked to all instant payment system of major currencies. Clearing payment risk is appropriately management. Meanwhile, as one of the major global financial centers, Hong Kong sees free flow of information, easy capital deployment. All these provide a good environment for further deepening of RMB internationalization.

During the evolvement of the HK RMB market, the mainland and HK monetary authority have obtains valuable management experience and have established standard procedures. The two also have a great communication and coordination, beneficial to a stable development of HK RMB market and gradual opening up of RMB capital account.
Supervisory Principles of RMB Business in Hong Kong

- HKMA(2010.02): Elucidation of Supervisory Principles and Operational Arrangements Regarding Renminbi Business in Hong Kong

RMB inflows/outflow Mainland China:
1. Under mainland China regulations
2. The Mainland Authorities and banks are in charge of

Hong Kong RMB Business:
Under local regulatory requirements and market conditions, applicable to the businesses conducted in other foreign currencies
## RMB Financial Products in Hong Kong

<table>
<thead>
<tr>
<th>RMB Products</th>
<th>Status of Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposit</td>
<td>Over CHY 600bn</td>
</tr>
<tr>
<td>Spot</td>
<td>Daily turnover USD1-1.5bn, narrower bid-ask spread</td>
</tr>
<tr>
<td>Forward</td>
<td>Offshore RMB forward rate curve is complete, good liquidity of 1-year products</td>
</tr>
<tr>
<td>Currency swap</td>
<td>Quoted for 1-5 years securities, but low transaction</td>
</tr>
<tr>
<td>Foreign exchange Options</td>
<td>Term to maturity: no longer than 1 year</td>
</tr>
<tr>
<td>Deposit Certificates</td>
<td>Can be issued by many banks</td>
</tr>
<tr>
<td>Structure Products</td>
<td>Issued by many banks such as BOCHK</td>
</tr>
<tr>
<td>Bonds</td>
<td>Issuing value over CHY 230bn</td>
</tr>
<tr>
<td>Funds</td>
<td>RMB bond fund is issued by BOCHK asset management ltd.</td>
</tr>
<tr>
<td>Insurances</td>
<td>By 2010, RMB insurance income CHY 2.54bn</td>
</tr>
<tr>
<td>RMB REIT</td>
<td>First RMB-denominated REIT (Hui Xian REIT) listed in Hong Kong</td>
</tr>
</tbody>
</table>
RMB Deposits in Hong Kong

Data from: HKMA

- By Feb 2012, Hong Kong RMB deposits is about CHY566.2bn, lowering recently

2007.06: first RMB-denominated bond issued in HK, increasing RMB deposits

2010.07: Agreement on RMB Clearing by PBOC and BOCHK, widening offshore RMB business and further booming RMB deposits
Build Stable Mechanism of RMB Inflow

- Offshore RMB capital markets have become a component of RMB inflow mechanism: besides the normal inflow channel under current account, inflows under capital account are via Hong Kong.

- Expanding uses of RMB under current account lead to RMB outflow excess to inflows---an inflow mechanism is desired. The inflow mechanism depends on capital account openness and HK market provide the approach.

- IMF defines 43 items under capital account and China has opened most of them. Only 3 items are restricted: FDI, China residence foreign debt and foreign investment on china’s capital markets. HK experiences show that the three items can be partly opened---opening in terms of RMB while remaining foreign exchanges under restriction. The development of HK offshore RMB markets is a step of the RMB internationalization.
Main Participants of RMB spot markets:
BOC, DBS, Standard Chartered, Deutche Bank, CITI group, Bank of America, HSBC and BNP paribas

- CNH fluctuates around CNY
- In 2010, CNH >> CNY, larger spread---demand-supple gap and pressure of RMB appreciation.
- Sep.-Nov. 2011, CNH << CNY --- pressure of RMB depreciation.
New Position of Shanghai and Hong Kong

Shanghai: the largest onshore financial market, will be international financial centre if RMB become fully convertible.

Function of Shanghai: establishes and expands RMB outflows under current account.

Hong Kong: the largest offshore market: benefitted by RMB not convertible.

Function of Hong Kong: stabilizes and maintain RMB inflows under capital account.

Common Function of Shanghai and Hong Kong: expanding the global use of RMB, meanwhile creating foundations for RMB capital account openness.
Debate and Prospect
New Debates

- There are long debates about the policy design and implementation since the cross-boarder use of RMB, especially after Sep. 2011 as RMB exchange rate began to fluctuate:

  - Are there real international demands of RMB cross-boarder use? Or simply for cross-boarder arbitrage?
  - Which is the main point of financial reform, capital account openness or RMB cross-boarder use?
  - The cross-boarder use of RMB is a strategic purpose or just a makeshift?
Global Demand for RMB Internationalization

- The current US Dollar-dominated International Monetary System showed severe deficiency.
  
  - Fluctuations of the US dollar exchange rate has posed difficulty on international trade pricing and settlement
  - Depreciation of the intrinsic value of the US dollar has led to a diverging international reserve currency

Diversification is shown both international reserve currencies and on trade pricing and settlement. Relative equilibrium regime of RMB exchange rate that has achieved and stable economic growth of China both indicate the increasing international demand for RMB. The demand firstly emerges on trade demands.
Capital account openness is inevitable for developing countries. Capital account openness implies full convertibility of local currency, while the fully convertible invite the impulsion of international capital flows, especially hot money. The frequent capital flows arouse instability of the developing countries’ economies. 15 year ago, the Asia financial crisis is the example. Consequently, developing countries are apt to capital account restriction.

The cross-boarder use of RMB provide condition of separate capital account openness from full convertibility. It is conductible to open RMB under capital account before considering convertible under capital account. The separation reduce the operative difficulty, which in turn, provide a clear schedule of RMB fully convertible.
Responsible for Global Economic Rebalance

- Heavily rely on US Dollar increases the systematic risk of global economy, not only because the conflict between US domestic monetary policy and stability requirement of international currency. The efforts of expanding trade surplus for increasing foreign exchange reserves also result in unbalance of world economy.

- RMB internationalization is the representation of international currency diversification, while international currency diversification helps to reduce the dependence of world economy upon US dollar, which, in turn, enhances global economic rebalance.