ROBERT MINIKIN
KELVIN LAU

THE OFFSHORE RENMINBI

THE RISE OF THE CHINESE CURRENCY AND ITS GLOBAL FUTURE

Contents

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WILEY
John Wiley & Sons Singapore Pte. Ltd.

Excerpts from “Special Report—The CNH FX, Rates and Dim Sum Bond Markets,” first published October, 2010; “Special Report—The Super-Cycle Report,” first published 15 November 2010; “Special Report—CNH Supports CNY Reserve-ification,” first published 10 January 2011; “The Renminbi Insider—Growing Up,” first published 15 February 2012; “The Renminbi Insider—On the Move,” first published 3 May, 2012; © Standard Chartered Bank (Hong Kong) Limited, 2010, 2011 2012. Reprinted with permission.

Published by John Wiley & Sons Singapore Pte. Ltd.

1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628

Other Wiley Editorial Offices

John Wiley & Sons, 111 River Street, Hoboken, NJ 07030, USA

John Wiley & Sons, The Atrium, Southern Gate, Chichester, West Sussex, P019 8SQ, United Kingdom

John Wiley & Sons (Canada) Ltd., 5353 Dundas Street West, Suite 400, Toronto, Ontario, M9B 6HB Canada

John Wiley & Sons Australia Ltd., 42 McDougall Street, Milton, Queensland 4064, Australia

Wiley-VCH, Boschstrasse 12, D-69469 Weinheim, Germany

ISBN 978-1-118-33925-1 (Cloth)

ISBN 978-1-118-33926-8 (ePDF)

ISBN 978-1-118-33927-5 (Mobi)

ISBN 978-1-118-33928-2 (ePub)

Foreword

Talk about being in the right place at the right time. Right at the eye of a building storm; the epicent of a currency's ascension. And to be a ripple maker.

Having been in the financial industry for over 25 years spanning different continents, watching fro close range the renminbi's internationalisation foray—and Hong Kong's transformation into a offshore renminbi financial centre—has to be one of the most exciting watershed developments. M colleagues and I have had the privilege to be at the heart of all these actions, not only as witnesses b also as contributors, each playing an active role in facilitating and shaping the global ascent of th Chinese currency. It could be as small as ensuring that a customer gets the needed renminbi to settle cross-border payment; educating a local exporter on the benefits of invoicing in the Chinese currenc or advising a multinational corporate on ways to raise Dim Sum funds and repatriating them into th mainland. It may also entail working with on- and offshore authorities on broadening and deepenin the offshore renminbi market, designing and integrating settlement platforms, and developing ne products.

The whole experience of helping the offshore renminbi market develop is both fascinating an humbling. It has been fascinating seeing how smoothly the renminbi, through successive polic liberalisations and its seamless fusion with offshore market forces, has gradually eased into its ne but certainly more natural form—a currency with a status that better matches China's growin economic importance. And then there is the eye-popping pace of growth in the various markets, be the rise in renminbi trade settlement volume to more than 10 percent of total China trade in Q1–201 or the CNY 190 billion worth of total issuance of Dim Sum bonds in Hong Kong in 2011.

One can also be easily humbled by the renminbi's transformative power on the global business an market landscape. Longstanding market practices are being challenged—for example, multination corporates are starting to move away from USD-invoicing, while more and more central banks arou the world are beginning to allocate a small part of their reserve holdings to the renminbi. Th redenomination of commodities into renminbi could well be the next big wave transforming th international trade and financial ecosystem. On a more local scale, Hong Kong is finding its moneta conditions increasingly influenced by onshore lending cycles, and its deposit base steadily shiftin toward a greater mix of renminbi.

Reading this book on the rise of offshore renminbi authored by my colleagues Kelvin and Robe one could get a strong sense that the powerful forces allowing renminbi internationalisation to flouris are converging. An assortment of economic, financial, and policy tailwinds are set to carry th renminbi to further places beyond Hong Kong, into the hands of corporate treasurers, sovereign institutional investors, and households. These forces, as they gather pace, will help the offsho renminbi market ride through any inevitable bumps uncovered along the way.

The timing of Beijing pursuing renminbi internationalisation, in particular, seems impeccable. Wi the world still reeling from the financial crisis in the West, the search is on for the next maj currency that is international, influential, and dependable. The prevailing crisis is set to bring abo structural changes that could be game-changing. For many, this presents a once-in-a-lifetim opportunity. Acting as a catalyst, the crisis has accelerated the shift of economic power from the We to the East, with the latter being led by China, placing it under the spotlight as an increasing important growth engine of the world economy for years if not decades to come. To duly perform th role, China must transform to a more sustainable and domestic-oriented growth model. The continu

orderly opening up of its capital account and the internationalisation of its currency are, in the eyes Beijing, crucial parts to this grand scheme.

Hong Kong has been the right place for renminbi to gain an initial footing offshore. For decade Hong Kong has been a conduit connecting the mainland with the rest of the world—via trad investment flows, and effective financial solutions. Not only is Hong Kong already equipped with full package of financial hardware and software, but it is also designated by Beijing as *the* offsho renminbi center. It acts as both a testing ground and a firewall. Hong Kong has a unique role to play- to support China as it liberalises its currency in an orderly but well-paced manner, and to help shap such development through free-market forces. Hong Kong, in turn, stands to benefit from th enormous opportunities brought about by the process.

I am very delighted that Robert and Kelvin have taken on this initiative to author a book dedicate to the offshore renminbi. They are among the best in town on this research area, and are certainly mo qualified to write about this new chapter of global currency development. Their hands-on experienc spanning both the early and rampant years of offshore market development, together with the complementary areas of expertise in macroeconomics, currency, and market-oriented dynamics, mak this one of the most comprehensive and authoritative books you will find out there. And the ripple have just begun.

Benjamin Hur

Chief Executive Offic

Standard Chartered Bank (Hong Kong) Lt

Preface

The Hong Kong trams are a longstanding and much-loved part of the territory's street-scene. For ov a hundred years they have made stately progress across Hong Kong Island even as the shacks arou them have been torn down, replaced by low-rise buildings and finally gleaming towers. The tran themselves are not much changed since their introduction, although today they often sport viv advertising livery. As we draw together the contents of this book in July 2012, a bright blue and gree tram wends its way through the Hong Kong streets, not advertising high-end luxury brands or financi services (which is typical) but touting an unusual message. It congratulates China's Ministry Finance on the latest successful sale of its renminbi government bonds in Hong Kong. The regula annual sales of Chinese government bonds are fast developing into a familiar feature of the landsca of the new "offshore renminbi" financial markets—those that use the Chinese currency outside mainland China itself.

The enthusiasm of Hong Kong for the development of this new market should not be seen surprising. It cements the city's status as a major global financial centre and gives it a key role as conduit between the mainland and the rest of the global financial system. However, in writing th book we want to give an overview of the issue that explains the importance of the development n just for Greater China and Asia but also the global economy. The tram's advertising highlights a important step in the development of the renminbi bond market in the Hong Kong market—what h become known as the *Dim Sum* bond market. But in this book we outline how the new "offsho renminbi" is the basis for a much broader range of flourishing new financial markets that are of valu to corporate treasurers, asset managers and individual investors. Finally, we briefly assess the publ policy implications of the renminbi's new global role as the global financial architecture is redrawn response to profound shifts in the global economic balance of power. Will all of the trams in Sa Francisco soon be congratulating China's Ministry of Finance on the sale of its renminbi bonds on th West Coast of the United States?

This book is, to a large extent, a response to the vast diversity of questions we have been asked sin the acceleration of the pace of renminbi reforms in July 2010. We have travelled globally and spoke to a wide range of audiences as we outlined the developments in renminbi internationalisatio Working within research at the oldest note-issuing bank in Hong Kong, we have been well-placed track the institutional reforms (not all of which have been announced to the media), to track th resulting shifts in transaction flows and analyse relative value opportunities in the new markets. It h been particularly exciting to watch entirely new financial markets spring into life. When we[1] foreca the level that a major foreign exchange crosses (such as USD-CNY) in the future, then often our fir reference point is simply where it closed yesterday. We assess how the incoming news will driv changes in the exchange rate. When new offshore renminbi markets opened (such as USD-CNH sp and forwards) there was simply no "yesterday" as a point of comparison. This proved a particular challenging environment for analysts—and market makers at their trading desks.

Also exciting has been the opportunity to name the entirely new markets. Although economic da releases and market pricing are often transitory developments, this has given us the opportunity make a more permanent mark on the financial markets. Here we[2] have had an important initi success, dubbing the renminbi bond market in Hong Kong the Dim Sum bond market.

The name was, in fact, voted by a committee of sorts—on September 14, 2010—at a half-da

seminar hosted by Standard Chartered where 170-odd corporate clients were asked to help name th new offshore renminbi bond market. They were given two choices: Dim Sum and Kung Fu. Th former won, as we all know by now, but it was also a lopsided win. The name was first used in publication on September 22, 2010, by Standard Chartered Global Research, a report appropriate titled “Adding Dim Sum to the Menu.” With additional help from some timely media reporting, th name went viral and global. The rest, as they say, is history.

But why “Dim Sum” to begin with? It came from a brainstorming session in preparation for th aforementioned seminar. Among the dozen of names long-listed, research-nominated Dim Sum wa an instant favourite, as it encompasses all the key qualities of this new offshore renminbi bon market, then exclusively available in Hong Kong. Dim Sum’s Cantonese root in southern China is th perfect representation of the “renminbi in Hong Kong” concept. It is a unique culinary art form th comes with a great variety of shapes and sizes. Because of its usually bite-sized portion, we have ov the years come across other interpretations of the namesake that have to do with its perceptive sma issuance sizes (at its initial stage of development).

Issuance of Dim Sum bonds has since extended beyond Hong Kong, and the name has followe much as one often finds dim sum on Chinatown menus globally. The name CNH—which originate from “CNY deliverable in Hong Kong”—is now similarly due for a timely redefinition. First propose by the Bank’s transaction banking colleagues, we at research have pioneered a change in what the stands for in “CNH,” from “Hong Kong” to *Haiwai* (meaning “overseas” in Chinese), to better refle the true nature of the market that is becoming more and more international. Hopefully, this book wi play some role in educating a broader, global audience on the new offshore renminbi market accelerating CNH’s transformation in becoming truly *Haiwai*.

We would like to thank those who have helped us think about this topic and prepare the boo Within Global Research at Standard Chartered Bank, we extend our thanks to Callum Henderso Eddie Cheung, Li Wei, Nicolas Kwan, Sandeep Tharian, Shen Lan, Stephen Green, Thomas Harr, an Will Oswald. More widely within the bank, we extend our thanks to Ben Hung, Bethy Tam, Boe Wong, Charles Feng, Frankie Au, Joe Ng, Michael Vrontamitis, Rita Liu, Tee Choon Hong, Ton Yang, and Yan Chan. We would also like to thank Standard Chartered Bank for permission t reproduce copyrighted material. All royalties from the book will go to Seeing Is Believing, the chari devoted to tackling avoidable blindness.

Kelvin Lau and Robert Minik

21 July 201

[1]More specifically, Robert Minikin.

[2]More specifically, Kelvin Lau.

List of Acronyms and Key Terms

A

ASEAN Association of Southeast Asian Nations—regional co-operation organisation

ASEAN plus Three ASEAN plus China, Japan, and South Korea

B

The Basic Law Outlines key elements of the Hong Kong SAR administration and its way of life ov the first fifty years following the colonial handover

Basis swap Cost of accessing funding over and above pure interest rate differentials (reflects balan sheet constraints)

BSAs Bilateral swap arrangements—agreement between overseas central banks and PBoC th provides backstop offshore renminbi liquidity

BOCHK Bank of China (Hong Kong)—"The Clearing Bank" in Hong Kong

C

CBRC China Banking Regulatory Commission—supervisor and regulator for China's banks

CCS Cross Currency Swap—cost of swapping funding in one currency for that of another, over ar above the pure interest rate differentials between the two currencies

CEPA Closer Economic Partnership Arrangement—agreement to promote mainland China and Hor Kong economic linkages

CGB China government bonds

Chiang Mai Initiative Network of bilateral swap arrangements providing finance for ASEAN plu Three economies

CFETS China Foreign Exchange Trading System

"The Clearing Bank" in Hong Kong Offers general offshore renminbi settlement and clearin services in Hong Kong alongside facilities for netting out of FX positions

CNH Chinese yuan deliverable in Hong Kong

The CNH Premium Richness of CNH in Hong Kong relative to CNY in the onshore FX market

CIPS China International Payments System—planned for renminbi cross-border transactions

CMU Central Moneymarkets Unit—computerised clearing and settlement for debt securities in Hor Kong

CNAPS China National Advanced Payment System—the large-value renminbi payment system Mainland China

CNT Chinese yuan traded in Hong Kong in the context of trade documentation

CNY *Haiwai* Chinese yuan outside mainland China

D

DFEC China's Department of Outward Investment and Economic Co-operation—part of MOFCo implementing the "going global" strategy

Dim Sum Bonds denominated in renminbi and issued in Hong Kong

DXY Simple measure of the dollar's value against other major currencies

E

Eurodollar market US dollar-denominated financial markets outside the United States

F

FDI Foreign direct investment—cross-border investment flows into an economy from overseas

H

HKEx Securities and futures exchange in Hong Kong

HKMA Hong Kong Monetary Authority—regulatory authority and local central bank in Hong Kong

HKSAR Hong Kong Special Administrative Region—Hong Kong's status within the People Republic of China following the handover of the Colony in 1997

HKTMA Hong Kong Treasury Market Association

Hong Kong "Exchange Fund" Funds managed by the HKMA that underpin the value of the Hon Kong dollar

I

Interbank bond market Non–exchange-traded, and by far the largest, bond market in mainland Chin

L

LC Letters of credit—form of trade finance issued by banks

M

MDE Mainland Designated Enterprises—list of onshore companies originally able to access to trad settlement scheme (restriction has been abandoned)

MOFCom Ministry of Commerce—powerful planning and regulatory body in mainland China

MoU Memorandum of Understanding—typically an international agreement between official bodies

N

NDF Nondeliverable forward—form of FX forward transaction that is cash-settled (typically in U dollars) rather than with actual exchange of the underlying currency amounts

NDRC National Development and Reform Commission—overarching economic planning body mainland China

NRA Nonresident account—renminbi account onshore held by overseas enterprise

P

PBoC People's Bank of China—China's central bank

PBoC fix Start-day daily fix that sets centre of trading band for on-shore FX trading (mo importantly, of USD-CNY)

PRD Pearl River Delta—low-lying area around the Pearl River estuary in Guanddong Provinc economically very dynamic and embracing major cities such as Guangzhou (broader definition als

includes Hong Kong and Macau)

Q

QDII Qualified Domestic Institutional Investor—mainland investor who has been given (qualifie approval to invest in overseas financial markets

QFII Qualified Foreign Institutional Investor—overseas investor who has been given access exchange-traded equities and bonds on the mainland

Qianhai Shenzhen economic zone with a regulatory environment promoting close economic ties wi Hong Kong and its renminbi financial markets

R

R-QFII Renminbi-denominated QFII scheme in Hong Kong

ROB Russian rouble

RTGS Real-time gross settlement system—method of making domestic bank transfers, typical overseen by a country's central bank

S

SAFE State Administration of Foreign Exchange—supervises cross-border payments and manag China's FX reserves

SCB Standard Chartered Bank—leading international banking group operating primarily across Asi Africa and the Middle East

SDR Special drawing right—accounting unit for the International Monetary Fund (and oth international transactions)

SWIFT Society for Worldwide Interbank Financial Telecommunications—global financial messag network

T

Trade settlement scheme Mechanism for trade-related payments in yuan to and from mainland Chi (initially launched in Hong Kong in early 2009)

TWD Taiwanese dollar

TWI Trade-weighted index—measure of a currency's external value that is calculated with referenc to the issuing country's trading patterns

W

WTO World Trade Organization—global international organization dealing with the rules of trad between nations

Y

YRD Yangtze River Delta—embraces Shnaghai, Jiangsu and Zhejiand Provinces around the poi where the Yangtze flows into the East China Sea. Highly urbanized, densely populated an economically dynamic.

Chapter 1

The New Global Role for the Renminbi

Gradualism has been the key hallmark of Chinese financial reforms. But when Chinese Vice Premi Li Keqiang launched the sale of Chinese government bonds (CGBs) in the offshore renminbi centre Hong Kong in August 2011 it capped just fourteen incident-packed months of profound change th propelled the Chinese renminbi from a purely national currency onto the international stage.

The beginning and the end of the fourteen months were marked in quite different ways. The Ju 2010 agreement between the People's Bank of China (PBoC) and the Hong Kong Monetary Authorit (HKMA), known as the Supplementary Memorandum, was launched in a relatively low-key way. Th agreement was simply signed by top officials from the twin official bodies and new banking rul circulated in Hong Kong. Given the official emphasis on the memorandum, it would have been easy overlook its significance. At a stroke, it transformed the regulations surrounding the use of th renminbi outside mainland China, stripping away all the prohibitions to allow the renminbi to be use as freely in the international financial markets as it is on the mainland.

The launch of the sale of the CGBs in August 2011, in contrast, tapped into a long-standing Chines tradition of elaborate formal starting-points for policy initiatives. At the "Forum on the Nation Twelfth Five-Year Plan," Li Keqiang stepped forward before a row of smiling dignitaries and presse a button, which launched the mainland authorities' third sale of CGBs in Hong Kong (following muc smaller sales of CGBs back in October 2009 and December 2010). The prominence of the event an the widespread applause that greeted Li Keqiang's step suggests that the sale's importance for Hon Kong was widely understood by the local audience. Unlike the launch of a US initial public offerin there was no market ticker to signal whether fortunes had been made (or lost) in investing in th CGBs. Li Keqiang's signal that the mainland authorities were keen to reinforce Hong Kong's status a a global financial, and offshore renminbi, centre meant that the significance of the sale went f beyond the fortunes of a single IPO.

The July 2010 memorandum was not the first development in the internationalisation of th renminbi—the baby steps for the project go all the way back to December 2003 with the introductio of limited retail conversion into renminbi by personal depositors in Hong Kong. Certainly, the launc of the CGB bond sale in August 2011 is far from being the final step to boost the renminbi international role. However, the fourteen months spanning these two developments saw a powerf acceleration of measures to promote renminbi internationalisation. The PBoC opened up access to th domestic (interbank) bond market for overseas central banks; the USD-CNH spot, forward and optio markets sprang into life; the Dim Sum bond market (comprising renminbi-denominated bonds so outside mainland China) was tapped by multinational and supranational issuers alike; the reach of th renminbi trade settlement scheme was expanded to cover the whole of China . . . the list goes on. Th was truly the equivalent of a "Big Bang" by the standards of the recent history of Chinese financi reform.

From the perspective of an international observer, the early steps toward a global role for th renminbi sound very Hong Kong–specific. But this is best viewed as simply the transitional featur

of a completely new market for the Chinese renminbi, rather than a guide to the future. All currenci ~~typically have a "home" geographical centre—just as international transactions in the US~~ doll typically settle in New York—and Hong Kong is playing this role in the offshore renminbi's earl stages. The year 2012 has seen the sale of certificates of deposit, Euro-Commercial Paper, *and* Di Sum bonds in London as banks seek to tap funding in the new international currency. This is just single specific geographic breakthrough in the much broader global renminbi rollout.

These new international markets taken together are referred to as the "offshore renminbi markets In the next chapters we will look at why we talk about the offshore renminbi in a way that isn common for other currencies (we rarely see references to the "offshore dollar"). We trac developments in the international use of the renminbi so far and the likely trajectory over comin years. We examine investment and hedging opportunities in the new markets created by th internationalisation project. And, finally, we ask what it means for policy makers—does the launch o the renminbi, for example, even threaten the existence the Hong Kong dollar?

But before we examine these broader issues, an assessment of the foundations on which all of th rests is required. What prompted the Chinese authorities to embark on a project that unleashe powerful free-market forces (outside mainland China) and stood at odds with the typical pattern of F management for fast-industrializing Asian economies?

A Longstanding—but Failing—Path

There are many well-recognised advantages for the authorities in an economy that establishes itself a the issuer of a major international currency. At a very prosaic level, the central bankers can prin currency, which can then be used to purchase goods and services (or assets) overseas. To the exten that the Chinese renminbi is held overseas and never repatriated to mainland China, then the People Bank of China earns what economists term as *seignorage*. If the renminbi can achieve the status of major reserve currency, then the Chinese government may be able to issue debt to overseas holders o renminbi without any requirement to repay it any time soon. When the China government bond launched by Li Keqiang in Hong Kong are in hot demand from overseas central banks for use a official reserves, then China will share some of the advantages of the United States as an issuer government debt. This is what Europeans have called the United States' *exorbitant privilege*.

Although these aspirations play some role in driving the renminbi internationalisation project, th experience of developing countries over the course of the global financial crisis has been equal important in boosting the appetite for change. It vividly demonstrated the shortfalls of the curre global monetary system and helped spark the acceleration of China's steps to promote the mo widespread use of the renminbi.

The global financial crisis over the years 2007 to 2009 in some ways vindicated China's choice t remain only semi-attached (or semi-detached) from the global financial system. Chinese banks ha not participated in the sub-prime lending boom in the United States or drawn on cheap internation credit to fund huge securities portfolios. It was this that left the Chinese authorities—and the Chine banks—well-placed to embark on the 2009 stimulus (sometimes put at RMB 4 trillion, USD 585 billion) that played a big role in driving the global economic recovery of 2009 and 2010. However, th global financial crisis also vividly illustrated the dangers for developing economies of a global tradin system overdependent on the US dollar. Historically developing countries may have typically use their national currency domestically and relied on a developed currency (such as the US dollar) f

international transactions but the whole crisis raised a big question mark over this model. The Unite ~~States and the US dollar were no longer necessarily the secure basis on which developing countri~~ could rely for international transactions. The global financial crisis saw global monetary shift originating in the United States, that threatened to both overwhelm emerging economies with to many US dollars—and strangle it with too few.

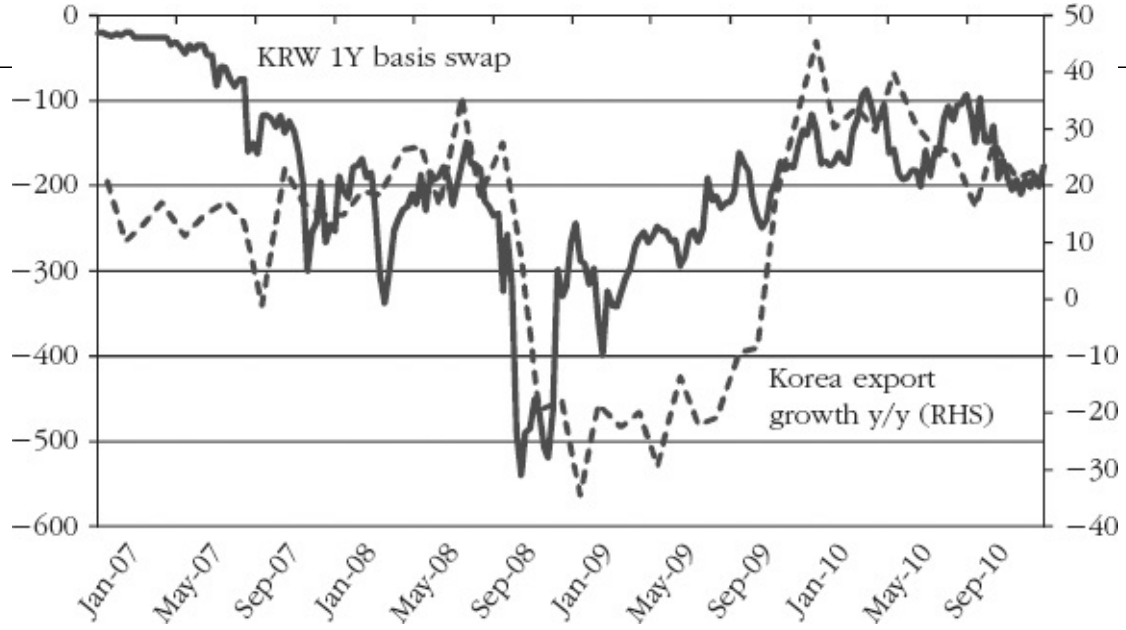
In August 2007, the Federal Reserve embarked on a series of policy rate cuts to tackle the mark turmoil sparked by the subprime crisis. The first half point cut in the discount rate in the middle that month heralded a series of easing steps that saw the federal funds target slide from 5.25 percent 2 percent in May of 2008. Over much of this period, growth in the emerging economies was sti robust and the central banks (and governments) were typically tackling the problems of overheatin rather than market deleveraging. The boost to global liquidity conditions triggered by the Fed actions helped propel a sustained upswing in commodity prices. As China's inflation steadily climbe to a peak of 8.7 percent year over year in February 2008, the People's Bank of China used the polic flexibility it had in the context of its adjustable peg against the US dollar—lifting policy rates an boosting the pace of the Chinese yuan appreciation. Indeed, over the twelve months to the middle 2008, the Chinese yuan's trade-weighted value rose by 3.7 percent—not too far off the FX adjustme of freely floating currencies such as the Australian dollar (up 4.3 percent).

The Chinese authorities, amongst other central banks in the region, battled to contain importe inflationary pressures until the severity of the global financial crisis finally put global econom output, and with it, commodity prices, on a downward path in the second half of 2008. It was th second phase of the crisis that underlined even more powerfully the dangers of overreliance on the U dollar in international trade. As the financial market failures became ever more intense, the scalin back of balance sheets (led by US institutions) triggered a global US dollar credit crunch. A companies searched desperately for USD short-term funding, interest rate costs surged—and son forms of finance simply became impossible to find.

Figure 1.1 shows what market analysts refer to as the "one-year Korean basis swap," a measure the additional cost of accessing US dollar liquidity from a Korean base (expressed as a negative) ov and above the simple interest rate differential between US dollars and the Korean won in th international capital markets. At its peak, this measure climbed above 500 basis points, signalling a extreme local US dollar credit crunch. As corporations scrabbled to find replacement USD fundin and trade finance markets jammed, the developed financial market stresses had a powerful impact o Korean exports performance. Indeed, it is notable that the spike in Korean USD funding costs can not long before the deepest plunge in Korean exports.

FIGURE 1.1 One-year Korean basis swap and export growth

Source: Bloomberg



In Chapter 6 of this book, we argue that the outlook for Chinese yuan appreciation is lil Goldilocks' porridge—neither too hot nor too cold. But during the global financial crisis, Asia appea to have suffered from both extremes of US dollar liquidity—too hot in the early stages of the cris and then too cold in the later stages of the crisis. It is not clear whether a monetary policy "made Asia" or "made in China" would have led to more stable economic outturns over the course of tl global financial crisis but we can readily guess at the feeling of impotence of the Beijing authorities the average Korean exporter as they waited for news on the latest twists and turns in the glob financial crisis.

The experience of the global financial crisis suggests that China may need a more flexible curren in order to shield itself from shocks originated in the major developed countries. Indeed, tl arguments in favour of more FX flexibility are much broader. China should tolerate more renmin flexibility as the FX adjustments will play a role in helping to rebalance Chinese growth (away fro an export-led to a domestic consumption-led dynamic) and preventing the development of abnorm external imbalances (either surpluses or deficits). But why does China need to issue an *internation* currency?

A more flexible currency can play some role in shielding China from the imported inflation seen the early stages of the global financial crisis. To the extent that this flexibility means an increase FX risk for Chinese companies, then by itself this is a good reason for greater renminbi use international transactions. A Chinese exporter invoicing in renminbi will be protecting itself again FX volatility (albeit at the expense of passing on the FX risk to its overseas customer). But tl additional flexibility provides no answer to the late-global financial crisis dynamics, where at a tin of market turbulence, global trade became suddenly hostage to the overall supply and internation distribution of US dollar liquidity. That can only be solved by the use of alternative currencies international payments and trade settlement.

The use of the renminbi in international transactions can dilute the overdependence on the US doll in international trade. That by itself is a concrete policy objective for the Chinese authoritie However, for fast-growing, emerging market economies generally, the international renminbi ma have an additional value. It offers not only a potential alternative to the US dollar but also one that h its roots firmly in the developed world. Using a little dated terminology, we might describe this as vehicle for South–South trade that doesn't rely on the currencies of the developed West. This is potential exit route from the economic stresses in developing countries sparked by far-distant mark

dislocations in the developed world.

The United States and the USD might not have been a particularly appropriate anchor of stabili over the course of the global financial crisis. However, we can step back and see that there are muc broader economic dynamics—a reshaping of the global economy—that also undermine the relevan of developed currencies, and the US dollar in particular, as a basis for the international trade of b developing economies such as China. To illustrate this, we can contrast where Japan and the Unite State stood when Japan embarked on its powerful growth phase of the 1960s and 1970s (whilst relyin on the US dollar as its external transaction currency), with where China and the United States star today. In the early 1960s, the United States accounted for just over a third of global output and was th market for 28 percent of Japan's exports. The US export market was so buoyant over the next decad that while Japan's overall exports grew by 5.8 times, exports to the United States grew by *6.3 times* (value terms). Ahead of the first oil crisis, the US share of Japan's exports peaked at 31 percen Against this backdrop, it was perhaps natural that Japan chose to keep the yen as primarily a nation currency and simply used USD in international trade. The economic drivers for China's choice of F regime today, however, are very, very different from those of Japan in the 1960s and 1970s.

Given the relative economic buoyancy of the developing economies, the United States' share o world output has steadily slipped to just short of one quarter today—and is falling. Direct exports the United States from China peaked at just over a fifth of total exports at the start of this millenniu but have been on a downward path since then. In early 2012 both the United States and the Europea Union each accounted for roughly a sixth of China's total exports. So a peg of the renminbi to th United States dollar (or the euro!) could not deliver FX stability for all Chinese exporters. Japan wa around a twelfth the size of the United States economy ahead of its growth spurt of the 1960s an 1970s. China is now *two-fifths* the size of the United States and (on recent Standard Chartered Ban estimates) may be a similar size in ten years and almost twice as big as the United States by 203 Taking together the experience of the years of the global financial crisis, and the broader reshaping o the global economy, a new approach to FX management is required—not just a more flexib renminbi but a renminbi with a *full* role on the international stage.

Allowing Renminbi Markets to Flourish

The recent approach that the Chinese authorities have taken to internationalising the renminbi ha been very striking given the importance of state direction in the mainland China economy. The Ju 2010 to August 2011 fourteen-month period certainly saw a clear acceleration in China's *offici* efforts to boost international use of the renminbi. But in many areas, they have adopted a very lig touch. Perhaps ironically, many of the most significant breakthroughs have reflected the vigour of fre financial markets and non-dirigiste "capitalist" economics rather than any targets set out in a five-ye plan. The authorities' approach has been a positive fruit of the "one country, two systems" policy th has prevailed since the British handover of Hong Kong. This has allowed Hong Kong, as one of th least regulated economies on Earth, to peacefully coexist alongside that of mainland China, sti heavily influenced by the decisions and rules of state institutions.

The key starting point for the new phase of renminbi internationalisation lay with that July 201 "Supplementary Memorandum" signed between the People's Bank of China and the Hong Kon Monetary Authority. Up to that point, there had been very limited retail switching between the majo currencies and the renminbi. But beyond this, its use by corporations had been restricted to trad

related purposes within the very narrow context of the trade settlement scheme. In just two sentence the Memorandum swept away these restrictions. According to the precise wording of th Memorandum, Hong Kong's banks could open corporate accounts "for any corporate customer fo general purpose . . . transfers between different accounts are allowed for any purpose . . . regardless whether related to trade settlement."[1] Simply dropping the ban on international use of the renmin sparked a frenzy of market activity. The stately, measured approach of the mainland authorities an the contrast to the free market vitality is well illustrated by that CGB sale launched by China's vic Premier in August 2011. This sale may have been a very significant policy signal for the offshor renminbi market (and Hong Kong) but it was only the *third* such sale by the Chinese government in the Dim Sum bond market. By that point there had been 82 other issuers in the Dim Sum bond marke representing a total of RMB 129.2 billion (USD 20.8 billion) in sales. The first multination corporate bond sale of Dim Sum, led by Standard Chartered Bank, was launched on August 19, 2010– less than five weeks after that initial Memorandum was signed!

This market-led approach has had many advantages. It allowed all the human capital, infrastructu and risk-management expertise in the offshore market (and specifically in Hong Kong) to be applie to the international use of the renminbi. Once the renminbi is trading *outside* mainland China then has many of the characteristics of an internationally fully deliverable currency such as the dolla While prudential regulatory rules still remain in place, the authorities' market-based approach ha allowed product innovation to take place with breath-taking pace. Relatively sophisticated yua denominated structured products (where the yuan returns are linked to market variables such as go or equity prices) were being sold in Hong Kong within a few months of the opening up of the ne market.

The enthusiasm from financial intermediaries, such as banks, to build a prominent presence in th new market was not too surprising. Just a quick look at the relative role of China in the glob economy and the size of international renminbi markets suggests the scope for explosive growth renminbi international usage—even from the levels achieved by mid-2012. Total spot FX trading o the renminbi, onshore and offshore, would rise by around twenty-five times simply to match the lev of trading in the Japanese yen (a relatively modest ambition as China plays a bigger role than Japan world merchandise trade). The Dim Sum market has grown rapidly since July 2010 and has alread made an important contribution to the supply of "investable" local currency bonds in As ("investable" as they are outside national capital controls). But even after this powerful expansion, th outstanding value of Dim Sum bonds in early October 2012 stood at just RMB 356.0 billion (US 56.5 billion), still a very small fraction (less than 2 percent) of the mainland China renminb denominated bond market.

With the mainland financial markets largely closed off to individual investors due to capit controls, the new offshore renminbi market has been met by an enthusiastic reception from investor Asian high-net-worth individuals had long been exploiting the retail conversion quotas to bui renminbi deposits amid a conviction that China's economic outperformance would be reflected in sustained FX outperformance. Free from the conversion constraints, renminbi deposits in Hong Kon climbed steeply and overwhelming demand for shorter-maturity bonds pushed short-term yields dov to levels that were (arguably) unsustainably low. New bonds, typically of a relatively short lifespa were simply snapped up at issue and held to maturity, curbing development of the secondary market.

From a policy perspective, the creation of an offshore renminbi asset class is an *essential* element the broader internationalisation project. Without a suitable place to park renminbi receipt multinational corporations will be hesitant—or outright unwilling—to invoice in or accept renmin

in payment. The purely speculative use of offshore renminbi assets, however, could be a route f ~~capital inflows into mainland China, potentially threatening domestic monetary stability. Fortunatel~~ as renminbi appreciation expectations have dwindled, the offshore renminbi markets have mature Dim Sum bond yields have risen closer to their onshore counterparts and renminbi deposit rates Hong Kong are now more transparent and uniform—and also closer to onshore deposit rates.

The corporate response to the new role for the renminbi has been more granular. Corporations with requirement to fund operations on the mainland have exploited the super-low Dim Sum yields in t early days of the new market. The new "USD-CNH" financial markets have created fre opportunities for corporations to manage cash balances and hedge future incoming payments in t major currencies. Encouragingly, use of the renminbi for trade transactions through the long-standi route of trade settlement scheme have also picked up markedly. Data for Hong Kong show that tra settlement flows had reached RMB 719.0 billion (USD 144.9 billion) in the three months to Augu 2012, a more than ninefold increase from the levels of Q3 2010. Further growth here looks to assured, given that there was a complete relaxation of the eligibility rules by the mainland authoriti in March 2012. Essentially any Chinese importer or exporter is now free to use the scheme, as long the payments (or receipts) are trade-related.

Beyond this, there is still broader corporate inertia in employing the renminbi for transactio purposes across the global economy. The market-led pickup in corporate renminbi usage specifical for trade between mainland China and Hong Kong has, at least in part, simply reflected a bid exploit differences in pricing of renminbi in the onshore and offshore markets, rather than a deep willingness of corporations globally to accept renminbi in payment. In Chapter 6, we examine wh multinational corporations should be open to using the renminbi in international trade—but also t important headwinds, which will slow its adoption. Given the broader international ambitions for i currency, new policy steps are likely to be needed not just from the Chinese authorities but elsewhe to reinforce widespread corporate take-up of the renminbi as a *transaction* currency.

Political Tailwinds for Internationalisation

The demand-led approach to renminbi internationalisation, which we see in the private sector, has als been evident in the public sector. While the global financial crisis and European debt stresses hav sparked a series of leaders' summits (often with little to show for them in terms of concrete results there has been no grand international forum on the renminbi. G20 has yet to declare it as Asia leading new international currency and a potential replacement for the US dollar. This may reflect hesitancy on the part of the mainland authorities to present renminbi internationalisation as China political objective, rather than a natural evolution in global currency arrangements. Whatever, t reasons, we shouldn't underestimate the progress that has already been made. The project has clear benefitted from benign political tailwinds, hinting at perhaps a certain broader dissatisfaction with t status quo—or at least a willingness to experiment with new currency arrangements. Renmin internationalisation may have been an initiative of mainland China, but it is receiving a welcome fro a broad range of central banks and governments.

Not all of the endorsement has come from other developing economies. The direct quotation exchange rates between CNY (the renminbi currency unit referred to in FX market trading) and oth major currencies in the *onshore* mainland FX market plays a supportive role in boosting the take-up the renminbi as an *international* transaction currency. As shown in Table 1.1, of the *five* currenci

added to the mainland China Foreign Exchange Trading System since July 2010, *three* have bee ~~developed currencies—the Canadian dollar (CAD), the Australian dollar (AUD) and the Japanese ye~~ (JPY). There is some underlying economic logic in here, given that Canada and Australia a important commodity exporters (and China an important commodity importer), while Japan accoun from some 8.6 percent of China's exports. It seems likely that other Asian currencies, such as th Singapore dollar and the Korean won, will soon be added to the mainland's China Foreign Exchang Trading System (CFETS). Notably, the Malaysian ringgit (MYR) is a nondeliverable currency in th international financial markets but *deliverable* in mainland China with appropriate trad documentation while JPY/CNY is now being quoted directly in Tokyo (as well as Shanghai).

TABLE 1.1 Recent Additions to the China Mainland CFETS System

Date	FX Cross	Trading Band
1 June 2012	100JPY/CNY	+/−3.0%
28 November 2011	AUD/CNY	+/−3.0%
28 November 2011	CAD/CNY	+/−3.0%
22 November 2010	CNY/RUB	+/−5.0%
19 August 2010	CNY/MYR	+/−5.0%

Addendum: Other currency crosses quoted on CFETS: USD/CNY, HKD/CNY, GBP/CNY, EUR/CNY

The pattern of yuan swap lines between the People's Bank of China and other central banks has als borne testimony to the internationalisation project's broad appeal. These swap lines give direct acce to yuan liquidity in other financial centres, helping ensure smooth operation of the trade settleme scheme and renminbi offshore market in Hong Kong, providing the basis for yuan trade-finance normal market conditions and back-stop market liquidity at the times of market stress. Th counterpart central banks are striking simply for their diversity—stretching from Iceland in develope Europe to Argentina in developing South America. The broad range of Asia counterparts (ten out o the seventeen) suggests widespread support for China's monetary ambitions and it is notable that thre of the counterparts (Uzbekistan, Mongolia and Kazakhstan) lie in Central Asia. Whatever the actu practical relevance of the swap lines in the very short-term, each of these lines can be interpreted representing a small vote in favour of renminbi internationalisation.

With many developing countries, and notably the twin Asian heavyweights of China and Indi maintaining tight capital controls, the potential for intra-regional *official* financial linkages has bee very closely contained (Table 1.2 summarises the deliverability and convertibility of a range of Asia currencies). The swap lines by themselves represent an important innovation from this perspectiv However, China is also taking a lead role in promoting a deepening of intraregional an intradeveloping official financial ties. The timing for this could not be more opportune! Seven-eight of developing economy FX reserves are in just three currencies—the US dollar, the euro, and th Japanese yen. Given the similar dynamics of high budget deficits, rising public-sector debt, and cred downgrades across the United States, Europe, and Japan, it is difficult to argue that this offers muc substantive diversification.

TABLE 1.2 Selected Asian FX Units and External Exchange Rate Regimes

Source: IMF, BIS, authors' estima

Asian Currency	Deliverable	Convertible	Share of FX Market Turnover (2010)	2011 GDP (USD trillion)
Chinese renminbi	No	Partially	0.9	7.32
Offshore renminbi	*Fully*	*Partially*	*n/a*	*7.32 (mainland)*
Hong Kong dollar	Fully	Fully	2.4	0.24
Indian rupee	No	Convertible on current; restricted on capital	0.9	1.85
Indonesian rupiah	No	Partially	0.2	0.85
Malaysian ringgit	No*	No	0.3	0.28
Philippine peso	No	Partially	0.2	0.22
Singapore dollar	Fully	Fully	1.4	0.24
South Korean won	No	Partially	1.5	1.12
Taiwan dollar	No	Partially	0.5	0.50
Thai baht	Fully	Partially	0.2	0.35

*Except trade-related on mainland China

On the outbound side, China's investment in the Korean bond market, for example, has risen b USD 2.42 billion since mid-2010. While the authorities do not split out official from private sect holdings, it seems likely that much of this represents China's reserve holdings. This outbour investment from China does not have a direct bearing on the renminbi internalisation projec However, the mainland authorities have *also* clearly shown an increased willingness to allow great overseas official investment in onshore markets—facilitating the global use of the renminbi international reserves. A specific regulatory step in August 2010 opened up the interbank bond mark to overseas central banks. This complements official use of the traditional QFII (Qualified Financi Institutional Investor) route for inward investment into mainland China and the official access to t new offshore renminbi markets. Although, for the moment, these renminbi holdings do not count official reserves for the purposes of International Monetary Fund calculations, there has been positive response to the new investment opportunity from central banks as diverse as the Bank Thailand and the Central Bank of Nigeria.

The emergence of the Dim Sum bond market in Hong Kong has created a "developing worl context for international bond issuance. A broad range of issuers—including mainland corporation multinationals, and supranationals—have seized this opportunity. Here, too, the pure diversity issuers by geography is very striking, alongside heavy sales from mainland China and Hong Kor companies. An appetite for building financial linkages within the developing country context has bee very marked. To pick out a couple of examples, issuers include America Movil (the pan-America telecommunication company) and VTB Capital (the Russian investment bank). Although Brazil as sovereign issuer had not yet come to the market by mid-2012, comments from the country's Depu

Treasury Secretary Paulo Valle in late 2011 hinted at the spirit in which new sales were bein launched in this market: “Just to raise money is not our proposal—but if we can help to open t market for the corporate bonds, maybe we can.”[2] This is just a symptom of the international politic goodwill for the renminbi internationalisation project.

Scanning the alternatives to the offshore renminbi in the Asian context listed in Table 1.2, there a few currencies that can potentially pull off this new international role of combining both accessibili and the simple economic critical mass that stands behind major international currencies such as t Japanese yen. The Hong Kong dollar and Singapore dollar both offer full deliverability *a* convertibility. But they rest against the relatively modest national output of a single-city financi centre in the case of the Singapore dollar and have an uncertain very long-term future in the case the Hong Kong dollar. Essentially, the launch of the internationalisation project has catapulted Chi into a leading role in the reshaping of monetary arrangements for the developing world. The narro immediate financial advantages for China of launching an international currency (such as seignorag are far outweighed by the much broader international significance of this new step.

Challenges and Consolidation Risks

There are considerable tailwinds for the renminbi internationalisation project—both in the private a the public sector. However, the project also brings with it some challenges—which, from time to tim may trigger short-term phases of consolidation, or even temporary reversals. This chapter does n embark on an exhaustive list but highlights two key areas that will require close monitoring. T internationalisation project may face twin threats from “diversion” and “instability” risks.

Diversion Risks

Greater use of the renminbi internationally cannot be seen as a *substitute* for greater FX flexibility a steady progress in domestic financial reform. To the extent that this substitution does happen, then potentially threatens the global role of the renminbi itself.

Some commentators argue that the opportunity to use the renminbi internationally will help narro China’s external imbalances and help rebalance the economy. Given the ability to use renminbi f foreign direct investment (FDI) abroad, it is argued that China will no longer need to earn excess U dollars (or other foreign currencies) in order to fund investments abroad. As we’ll see from t discussion in Chapter 2, China’s surpluses have essentially been used to build up huge holdings official reserves, rather than buying overseas companies or plant and machinery. Simply changing t currency with which the FDI investments are made doesn’t tangibly change the trade-offs arou China’s FX policy. Nor will China’s economy be rebalanced (from export-led to domest consumption-led growth) by the new global role for the renminbi. This will likely require great renminbi flexibility in international FX markets.

Insufficient FX flexibility potentially creates the conditions for one-way bets on renmin appreciation (or depreciation), which, in turn, may spark destabilising capital flows—and threaten t stability of the offshore renminbi markets. The powerful demand for short-maturity Dim Sum bon in the early days of the new market was just an early symptom of this. The switch to greater use of t renminbi in international transactions, as we have noted, *does* potentially shield Chinese compani from the impact of greater FX market volatility. For a small Chinese exporter supplying a larg

sophisticated multinational company, use of the renminbi in international trade will probably be good thing. These arguments taken together suggest that greater FX flexibility from China *an* renminbi internationalisation should—indeed, will likely—go hand in hand.

The steps taken to boost the international role of the renminbi should not be seen as any ear alternative to domestic financial market reforms. Here, too, the internationalisation can play supportive role. The development of new offshore markets creates a forum where mainland Chine corporations and financial institutions can interact with lightly regulated, free markets witho unleashing the powerful forces that would be triggered by full liberalisation of mainland China capital account. This has some similarities to the interaction sparked by the offshore IPOs and sal into the US dollar credit markets by mainland corporations. However, these new offshore markets a renminbi-denominated—which may be an advantage for a company with core activities in renminb Moreover, the likelihood that the Hong Kong markets will eventually fold back into those of th mainland (on full capital account liberalisation) may boost their attractiveness to some issue (including the Chinese government itself).

Full internationalisation of the renminbi requires at some point a full opening up of mainlan China's current account, and that *follows*, rather than precedes, domestic reforms to align domest markets with global norms. The progressive opening up of the renminbi to international use has to b seen as a complement to the mainland's financial sector reforms, not as a substitute. The long list o Asian currencies characterised as "partially convertible" in Table 1.2 does not signal a lack ambition to achieve full convertibility. Modest progress in implementing domestic financial reform can make progress toward full liberalisation of the capital account rather perilous. Central banks hav a tendency to reach for capital account controls to tackle potential market failure (such as th corporate sector's overreliance on cheap USD funding) where global and domestic financial marke and institutions are poorly matched.

Instability Risks

Perhaps the most misleading renminbi offshore myth in the early days of the new market has been th fear that the very rapid growth of renminbi deposits in Hong Kong would have a decisive impact o mainland China's monetary conditions. The deposit growth in Hong Kong was explosive in the ver early days—but from a very, very low base. Even at their recent monthly peak of RMB 627.3 billio (USD 98.3 billion) in November 2011, these deposits represented just 0.8 percent of the onshore M monetary aggregate of RMB 82,551.2 billion (USD 12,940.3 billion)—and this was at a time when th monetary aggregate was growing at 12.7 percent year over year. Any threat to domestic price stabilit due to overaccommodative liquidity conditions came from the domestic renminbi moneta developments—not those in Hong Kong.

Nevertheless, it has to be acknowledged that with the growth in the renminbi offshore market ov time, the ebb and flow of offshore market activity will inevitably become *quantitatively* mo important for the mainland economy—and, more specifically, for mainland monetary conditions. Th offshore market may be entirely outside the mainland's capital controls but separation from th mainland financial markets can never be complete. If the market is operating smoothly, a sudde upturn in investor demand for renminbi deposits outside China will be met (over time) by renmin transfers from the mainland for trade settlement. To the extent that importers, for example, are usin the renminbi transferred abroad to buy US dollars in the offshore market, rather than onshore, the this will have a tendency to lift People's Bank of China FX reserves and potentially boost domest

liquidity conditions, just as it would with any direct “hot money” capital inflow. If renminb denominated transfers on the capital account (such as foreign direct investment or trade finance) a less tightly controlled than those in denominated in US dollars, then this too may introduce mo volatility into China’s capital flows.

This suggests that progress in boosting the renminbi’s global role will be uneven. Major mismatch between China’s monetary policy and that of the rest of the world or particularly powerful gyrations investor flows have the potential to trigger short-term setbacks for internationalisation—witho threatening the medium- or long-term objective.

Finally, there is a broader stability issue at stake, albeit one that will likely not trouble the Chine authorities in the short-term given the substantial external net asset position. Recently appoint International Monetary Fund Managing Director Christine Lagarde has warned the United States th it risks losing its “exorbitant” privilege as the issuer of the world’s key reserve currency am persistent domestic wrangling over ways to cut the major US budget deficit.[3] But the econom arguments that it is a privilege to issue an international currency are not clear-cut! As overse investors gradually build renminbi assets, then there is a risk that this will drive persistent F appreciation and current account deficits and will eventually fuel a powerful upswing in China’s n external debt position. Over time, this may eventually erode the healthy macroeconomic fundamenta on which the renminbi’s claim to be an international currency ultimately rests. China’s USD 3 trillion of FX reserves says that this problem (known as the “Triffin paradox”) will not trouble th Chinese authorities for some years.

The Renminbi in a Multipolar World

Much is made of the Chinese renminbi’s role as the “next” US dollar in international currency affai —one overenthusiastic Hong Kong bank has gone as far as dubbing it the *redback*, to compete with th greenback. In truth, there are powerful forces at work that encourage markets and companies concentrate on a single major currency for international transactions. It is unlikely that the renmin can depose the greenback from its current role in the coming decade, or even coming decades. A mo suitable role model may be that of the Japanese yen, given the similarity in size of the two economi and their similar role in the global trading economy. The Bank for International Settlements’ surve of the global FX market put the yen’s share of total turnover at 19.0 percent in April (these share total to 200 percent as every FX cross includes two currencies), while the yen accounts for around 3 percent of international reserves (at end-2011) and 6.2 percent of international bond issues (en 2011). These are respectable targets for the decade-ahead renminbi role. The renminbi internationalisation over this period may be slowed by very gradual capital account liberalisation, b also flattered by a strong Chinese economic performance—on reasonable assumptions that th mainland China economy will be four times the size of that of Japan by 2020.

Given the powerful official backing for the use of the renminbi in China’s trade, its building role a significant trade invoicing and settlement currency looks assured. Annual trade settlement volum may reach USD 1.2 trillion by 2015 (based on Standard Chartered Bank forecasts) from just USD 0 trillion in 2011. In the asset markets, gradual market opening by the Chinese authorities could see th pool of “investable” renminbi assets, across the onshore and offshore markets, readily rise by fivefo over the five years from late 2012 onward. But the significance of the new role for the renminbi go beyond the pure numerical projections—beset as they are by an unusual degree of uncertainty am