Renminbi Internationalization: Progress and Challenges Ahead

Introduction

Currently, the United States (US) dollar is the dominant international currency. It has reigned over the financial market since the middle of the 20th century after taking over the role from the pound sterling. In a sense, the ascent of the US dollar came rather late. The US economy had been the largest in the world since the late 19th century. The slow ascent of the US dollar was probably due to the underdeveloped capital market of the US at that time. It also lacked a central bank until the creation of the US Federal Reserve in 1913, meaning the financial system had to rely on private institutions to play the role of lender of last resort.

In recent decades, the People's Republic of China's (PRC) economy has grown rapidly to become the second-largest in the world. However, the international role of the renminbi is still relatively small. At the same time, there have been many efforts, particularly since the 2008/09 global financial crisis, to promote the internationalization of the PRC's currency.

For the PRC, there are potential benefits from making the renminbi an international currency. The main one being that it would reduce the exchange rate risk faced by Chinese companies. At the moment, the bulk of trade transactions for Chinese firms are denominated in US dollars. This means that fluctuations in the exchange rates affect the revenue of trading firms. Internationalization would be particularly beneficial for industries in which there is a long time lag between the order and payment for goods.

If the renminbi were to gain wider acceptance as an international currency, it would give Chinese financial institutions access to a large pool of renminbi funding within their home market. It could also make Chinese financial institutions more globally competitive. Another advantage of making the renminbi an international currency would be that it could reduce the need for the PRC to hold large amounts of international reserves. As of end-March, the PRC held nearly US$4 trillion in foreign exchange reserves. The bulk of reserves were in US$-denominated assets, meaning the PRC faces the risk of capital losses in the event of a depreciation of the US dollar.

There are also risks to internationalizing the renminbi. Having an international currency would likely mean the PRC would have to allow for greater movement of capital in and out of its economy. The PRC has yet to fully liberalize its capital account and allow the renminbi to float freely. The financial system in the PRC, while large, is still not well developed, leading to concerns that opening up the capital account could result in destabilizing flows that could impact the financial system. Allowing the exchange rate to freely float could also lead to large fluctuations in the exchange rate that would be detrimental to exporters. An international currency could also open the economy to speculative attacks.

Could the renminbi, over time, take on a greater role as an international currency? This special section will examine the progress made toward internationalization of the renminbi and examine the challenges ahead.

What Is an International Currency?

An international currency is one that is used outside the home economy, by both residents and non-residents. This implies a currency that has gained acceptance outside its own borders. There are several key functions for an international currency. Similar to a domestic currency, it has to function as a store of value, a medium of exchange, and a unit of account. The main difference with an international currency is that it has to perform these functions for both residents and non-residents in cross-border transactions. Another important distinction between a domestic currency and an international one is that a domestic currency usually derives its legitimacy by fiat. A government can decree its currency to be legal tender within its national borders. However, for international transactions, the choice of currency is determined mostly by market factors rather than any legal requirements.

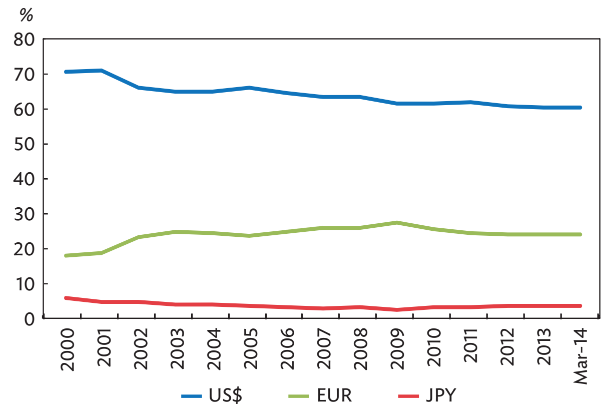
As a medium of exchange, an international currency is expected to figure prominently in the payment and settlement of international trade transactions. At the moment, the US dollar has a dominant role. Since its introduction in 1999, the role of the euro in international trade settlement has grown. However, the euro tends to be used mostly among economies in Europe that trade heavily with other eurozone members. Only the US dollar is used extensively in broad geographic areas, even when the US is not a partner in the trade transaction. The Japanese yen has been used for trade settlement in some Asian economies, but its role is relatively small. In addition to trade transactions, the US dollar is also the vehicle currency for interbank foreign exchange transactions. This means that when a government decides to intervene in the foreign exchange market to influence the exchange rate, it tends to find it more effective to use the US dollar as the intervention currency.

An international currency should also function as an international store of value. In this regard, the dollar also dominates. In several economies, the US dollar circulates freely together with the domestic currency. The preference for the US dollar exists because it is seen as a more stable store of value. Within the Asia-Pacific region, Cambodia is a highly dollarized economy. The importance of the US dollar as a store of value can be gauged from the amount of international banking deposits. Data shows that US dollar deposits have the largest share at 63% followed by the euro at 19% **(Figure 15)**.

Governments around the globe have also favored using the US dollar as a store of value. Most international foreign reserves are held mainly in dollars. The introduction of the euro has led to some degree of diversification away from the US dollar, but the crisis in the eurozone has slowed the process. Data from the International Monetary Fund shows that the US dollar comprises 61% of foreign exchange reserves **(Figure 16)**. The second most common currency is the euro at 24%. The Japanese yen only has a 4% share.

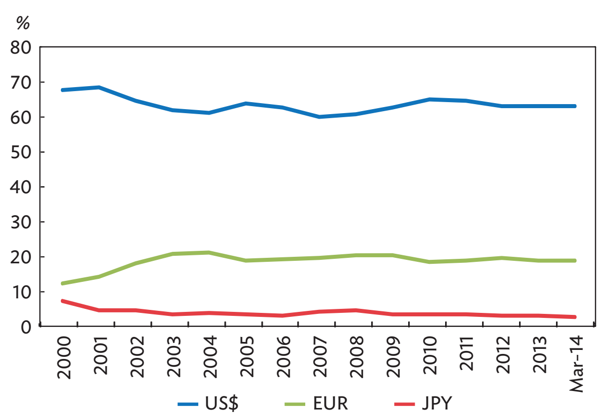
The US dollar plays an important role as the unit of account for international finance and trade. About 87% of global foreign exchange trading is in US dollars, compared with 33% for the euro and 23% for the Japanese yen, with the remainder being in other currencies **(Figure 17)**.[4] A

Figure 16: Foreign Reserves Holdings
(share of the total)



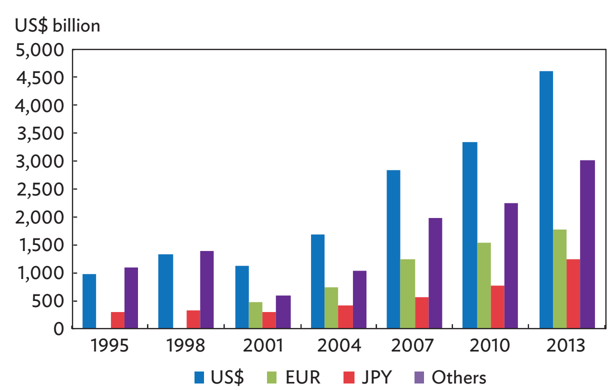
Source: International Monetary Fund.

Figure 15: Cross-Border Banking Deposits
(share of the total)



Source: Bank for International Settlements.

Figure 17: Global Foreign Exchange Market Turnover



Note: Data reflects average daily turnover for the month of April.
Source: Bank for International Settlements.

[4] The total sums to 200% as there are two sides in a currency transaction.

significant advantage of the US dollar in terms of trade is that invoicing for most transactions is in US dollars and prices in commodity markets are also in US dollars.

For many commodities such as oil, the US dollar is commonly used as the main currency for invoicing trade. However, the choice of invoice currency for trade in manufactured goods is more complex. The choice of currency to be used is usually determined by the industry in which the trade occurs. Generally, goods that are produced competitively by many different firms tend to be traded in a single currency. This is because exporters prefer to keep prices stable relative to their competitors, leading to the use of the same currency.

Another factor that could affect currency choice is the transaction cost of using a currency. Hence, currencies that are very liquid in the foreign exchange market will be favored. Also, there is the influence of history. Once a currency has established itself as a popular currency, it is difficult for a new currency to supplant it. Further, if a currency has been used for a long time it will have a large market share, which contributes to its greater liquidity, thereby lowering transactions costs.

Decisions on which currency to use will also be affected by the bargaining power between the exporter and the importer. Both parties would like to minimize currency risk and so prefer to invoice in their own currency. In this case, the advantage would likely be on the side of the larger party. Traditionally, Chinese manufacturers have tended to sell similar products to one another and were smaller than the large retail chains in developed economies to whom they were selling. This meant they had less sway in negotiations. But more recently, with the rapid growth in the PRC's economy, Chinese firms have become much larger. They are now major importers in their own right, which has given them additional leverage in the bargaining process.

Within Asia, trade is still mostly invoiced in US dollars. This may have been convenient when the US was the major destination for the region's exports. Expanding intra-Asian trade, with more exports being consumed within the region, is likely to lead to greater use of a regional currency within Asia.

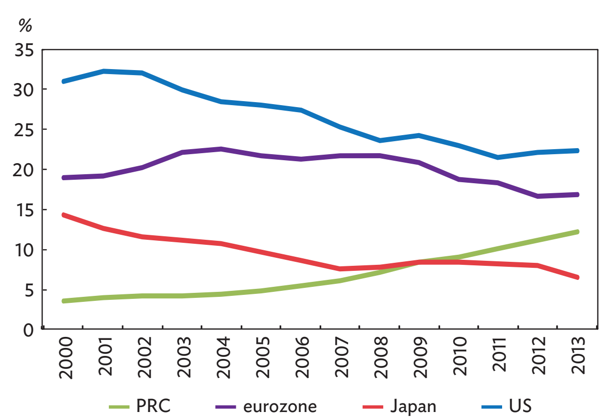
What Drives the Adoption of an International Currency?

How does a currency become internationally accepted? There are several factors that influence which economy's currency is used internationally. The first is the size of the economy and its presence in global trade. A large global economy will have a more familiar currency that can more easily serve as a unit of account or medium of exchange. As the US is the largest global economy, it is natural that the US dollar is widely used as an international currency. However, the PRC's economy is catching up fast, and in 2013 it was equivalent to 55% of the US economy when measured in current exchange rates **(Figure 18)**.

An economy's economic influence can also be measured by its share of international trade. Here, the rise of the PRC has been stunning: between 2000 and 2012, its share of global trade rose from 3.7% to 11.0% **(Figure 19)**. Yet, the use of the renminbi has so far lagged behind the PRC's global economic influence.

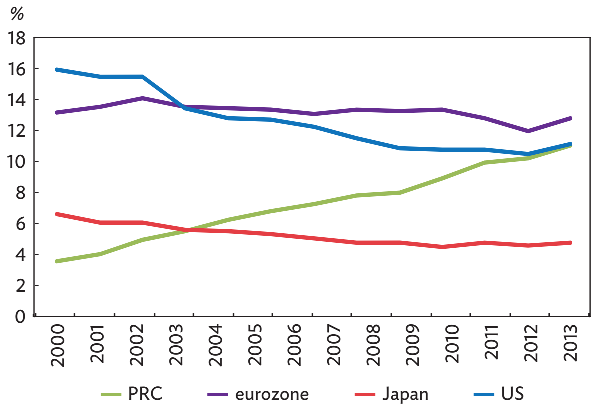
Second, an international currency must command confidence in its value. This usually implies that the economy has a strong track record of economic stability and low inflation. That way, the currency can be expected

Figure 18: Share of Global GDP



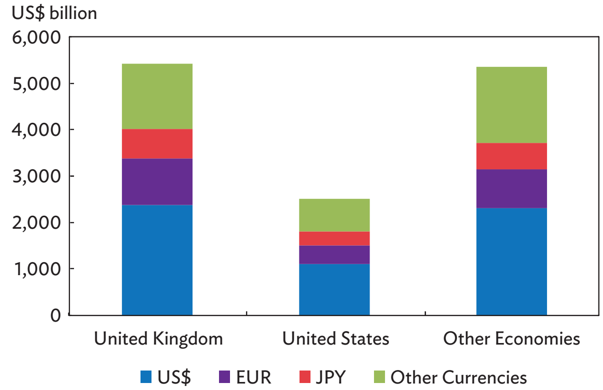
PRC = People's Republic of China, GDP = gross domestic product, US = United States.
Sources: Bloomberg LP and World Bank.

Figure 19: Share of Global Trade



PRC = People's Republic of China, US = United States.
Source: World Bank.

Figure 21: Share of Foreign Exchange Turnover by Currency and Economy



Note: Data reflects average daily turnover for April 2013.
Source: Bank for International Settlements.

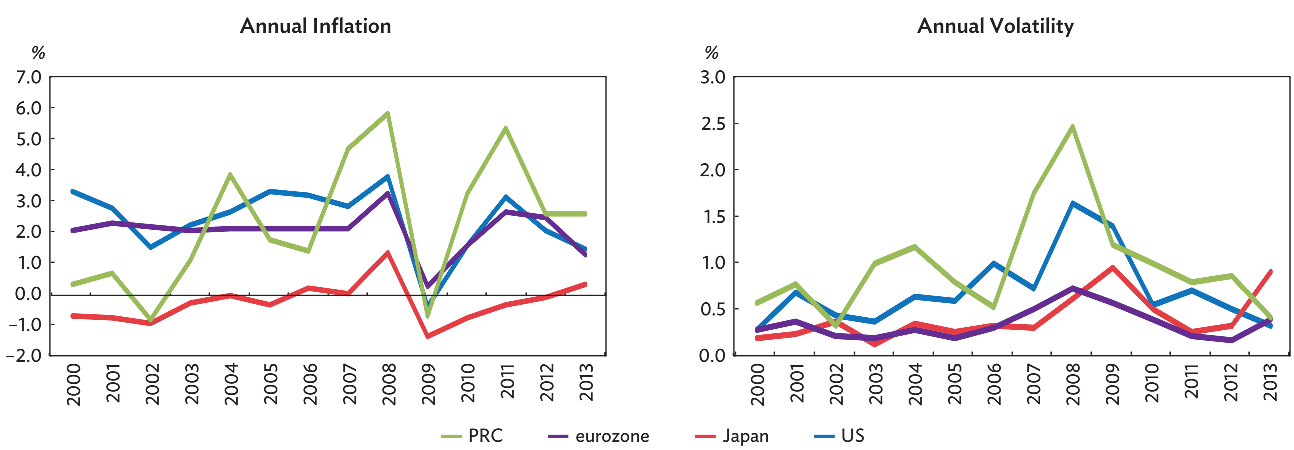
to maintain its value and facilitate its function as a unit of account and medium of exchange. The PRC's inflation record since 2000 has been comparable to that of the US, eurozone, and Japan **(Figure 20)**.

Third, the economy should have well-developed financial and capital markets that can support demand for the currency's assets. It is important that the financial and capital markets are open so that investors can freely participate. The US has the largest and most liquid capital market, and the amount of investable assets in the US is much larger than that of any other economy. Importantly, US financial markets are highly sophisticated, with a large variety of financial instruments catering to all needs.

Looking at the share of foreign exchange turnover, the US dollar has the largest share among all currencies **(Figure 21)**. Interestingly, while the US dollar is the most popular currency, the majority of foreign exchange trading takes place outside the US, mainly in London.

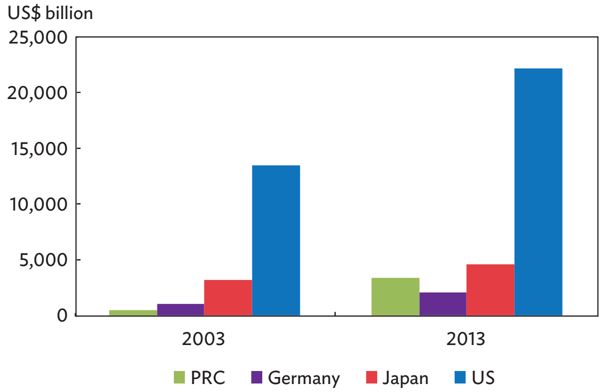
The size of an economy's capital market can also be measured by the capitalization of its stock market and the amount of bonds outstanding. The US stock market is the largest in the world, followed by Japan **(Figure 22a)**.

Figure 20: Annual Inflation and Volatility



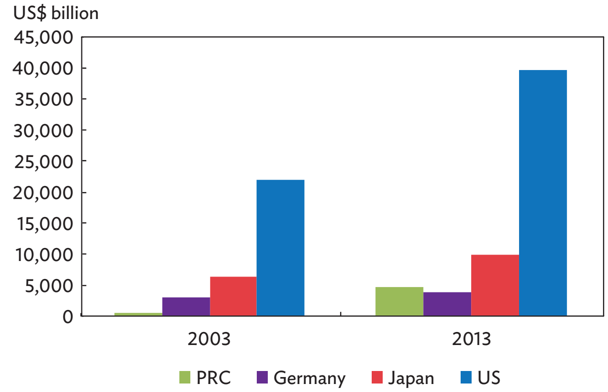
PRC = People's Republic of China, US = United States.
Sources: Bloomberg LP and *AsianBondsOnline*.

Figure 22a: Stock Market Capitalization



PRC = People's Republic of China, US = United States.
Source: Bloomberg LP.

Figure 22b: Bonds Outstanding in Selected Markets



PRC = People's Republic of China, US = United States.
Sources: *AsianBondsOnline*, European Central Bank (ECB), and Securities Industry and Financial Markets Association (SIFMA).

The PRC's stock market is the fifth-largest in the world in 2013. In terms of bonds outstanding, the US market is also the largest, while the PRC's bond market is about 12% the size of the US market **(Figure 22b)**. When measuring the depth of bond markets, the US market is much more developed than that of the PRC. This reflects the more dominant role that banks still play in the PRC.

Progress of Renminbi Internationalization

The PRC has shown tremendous growth over the past 2 decades and is now the largest exporter in the world. The dynamism of the Chinese economy has also attracted significant foreign investment into the economy. At the same time, the presence of Chinese firms abroad has been growing as they seek out new markets. While a huge amount of international transactions originate in the PRC, most of the payment and settlement for trade and investment transactions are in US dollars. There is a tremendous opportunity for these transactions to instead be conducted in renminbi. As a result, the PRC has stepped up its efforts to promote the internationalization of the renminbi and make it more attractive for foreigners to transact in and hold renminbi.

In addition to trade, liberalization of the renminbi has also occurred along another front, investment. Liberalization in the bond market began when the first offshore renminbi bond, popularly known as a dim sum bond, was issued in 2007.

The Use of the Renminbi in Trade Settlement

The first step in the internationalization of the renminbi has been in the area of trade. This is not surprising as the current account in the PRC is more liberalized than the capital account. Trade is also an area where the PRC plays a major role in the global economy, accounting for 11% of all global trade flows. A significant step in promoting trade settlement in renminbi was taken in July 2009 when the PRC started a pilot program in 5 cities: Shanghai, Guangzhou, Shenzhen, Dongguan, and Zhuhai. Firms in these cities were allowed to settle renminbi-denominated cross-border trade transactions with firms in Hong Kong, China; Macau, China; and the members of the Association of South East Asian Nations (ASEAN). This was soon expanded to 20 provinces and cities, and the geographic limitations outside of the PRC were eliminated. Over time, the program has gradually expanded to the point that all trade with the PRC can now be settled in renminbi. **Table 5** below shows a timeline of the progression of the cross-border trade settlement scheme.

In 2010, the total amount of renminbi used for trade settlement stood at CNY534.8 billion, compared with the first half of 2014, when the amount of renminbi trade settlement grew to CNY3.3 trillion. Similarly, the share of the PRC's trade in renminbi has basically grown from zero to about 25% of the total in 2Q14. The share is expected to continue growing in the years ahead **(Figure 23)**.

Table 5: Timeline of Renminbi Trade Settlement

Date	Event
July 2009	Pilot renminbi trade settlement scheme is announced; mainland-designated entities (MDEs) in five cities can settle trades directly in renminbi, allowable trade partners were limited to Hong Kong, China; Macau, China; and ASEAN countries
November 2010	The PRC and the Russian Federation sign bilateral trade settlement agreement.
June 2010	Participating provinces in renminbi trade settlement scheme expanded to 20 provinces and cities; imports for all companies in the designated provinces can be settled in renminbi; settlement of exports are still limited to certain MDEs. List of allowable trade partners expanded to entire world.
August 2010	The PRC and Malaysia begin direct trading of MYR–CNY.
November 2010	The PRC and the Russian Federation begin direct trading of RUB–CNY.
August 2011	Renminbi trade settlement scheme expanded to the whole of PRC
March 2012	Companies no longer need to secure MDE permit to settle export transaction in renminbi directly
June 2012	The PRC and Japan begin direct trading of JPY–CNY.
September 2012	The PRC and Taipei,China sign memorandum of understanding on currency clearing.
April 2013	PBOC and ICBC (Singapore) sign Currency Clearing Agreement
April 2013	The PRC and Australia begin direct trading of AUD–CNY.
November 2013	The PRC and Singapore begin direct trading of SGD–CNY.
March 2014	The PRC and New Zealand begin direct trading of NZD–CNY.
June 2014	The PRC and the United Kingdom begin direct trading of GBP-CNY.
July 2014	The PRC and the Republic of Korea begin direct trading of KRW-CNY.

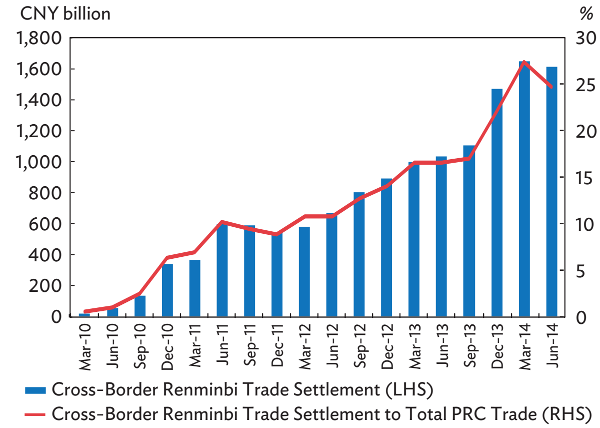
ICBC = Industrial and Commercial Bank of China, PBOC = People's Bank of China, PRC = People's Republic of China.
Source: Various news articles.

Global payment statistics also reflect the increasing popularity of the renminbi. Data from Society for Worldwide Interbank Financial Telecommunication (SWIFT) show that the market share of the renminbi in world payment values has increased substantially from 0.3% in January 2012 to 1.6% in June 2014 **(Figure 24)**. However, while growth has been significant, with the renminbi now ranking as the seventh-most used currency, its share is still significantly lower than those of the US and Europe, which have market shares of 41.9% and 31.3%, respectively.

SWIFT indicated that, as of October 2013, the renminbi was the second-most used currency for trade finance, based on data for letters of credit, with a market share of 8.7%. However, this remained far behind the share of the US dollar, which was 81.1%.

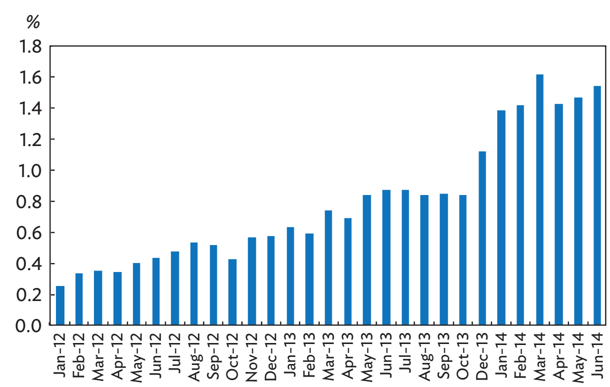
The increasing popularity of the renminbi for trade settlement is the result of a number of benefits it provides. Without renminbi direct trading, traders have to resort to converting to a third currency, such as the US dollar, before converting to renminbi. The availability of

Figure 23: Renminbi Trade Settlement



LHS = left-hand side, RHS = right-hand side.
Source: CEIC.

Figure 24: Renminbi Share of World Payments



Source: SWIFT.

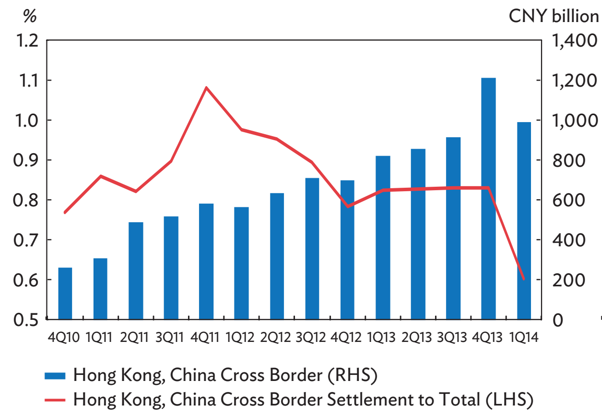
direct trading will, therefore, allow for fewer trades and lower transaction costs. Against this benefit is the need to ensure there are sufficient market participants to trade renminbi. Otherwise, a lack of liquidity in renminbi trading could result in wide spreads, thereby negating the benefit of direct trading. The start of direct trading against various currencies has seen quite a lot of interest. Given the large amount of trade activity between the PRC and other economies, there is natural demand for such trades.

Settlement in renminbi can also benefit Chinese companies by potentially reducing their hedging costs. Some of the benefits from lower hedging costs can be passed on to counterparties through lower prices. Foreign counterparties may also receive a market advantage if Chinese companies are more willing to do business with those that settle in renminbi.

The bulk of cross-border renminbi settlement flows course through Hong Kong, China. Since the start of the trade settlement program, cross-border renminbi settlement with Hong Kong, China has grown rapidly and accounts for a significant portion of all renminbi trade settlement, although this share has declined from its peak **(Figure 25)**.

Another factor promoting the use of cross-border trade settlement is the expansion of currency swap agreements. To ensure that there is a sufficient supply of renminbi available for economies to trade in, the PRC has set up a network of bilateral swaps. Since 2008, it has inked swap agreements with 24 economies, of which six have expired. As of end-August, the size of outstanding swaps totaled CNY2.6 trillion **(Table 6)**. The PRC now has bilateral swap arrangements with economies that account for 40%

Figure 25: Hong Kong, China Cross-Border Renminbi Trade Settlement



LHS = left-hand side, RHS = right-hand side.
Sources: CEIC and Hong Kong Monetary Authority.

Table 6: Currency Swap Arrangements

No.	Date	Counterparty	RMB Amount (billion)	Swap Term	Remarks
1	December 2008	Republic of Korea	180.0	3 Years	Replaced by No. 13 below
2	January 2009	Hong Kong, China	200.0	3 Years	Replaced by No. 14 below
3	February 2009	Malaysia	80.0	3 Years	Replaced by No. 18 below
4	March 2009	Belarus	20.0	3 Years	
5	March 2009	Indonesia	100.0	3 Years	Replaced by No. 27 below
6	March 2009	Argentina	70.0	3 Years	
7	June 2010	Iceland	3.5	3 Years	Replaced by No. 26 below
8	July 2010	Singapore	150.0	3 Years	Replaced by No. 22 below
9	April 2011	New Zealand	25.0	3 Years	
10	April 2011	Uzbekistan	0.7	3 Years	
11	May 2011	Mongolia	5.0	3 Years	
12	June 2011	Kazakhstan	7.0	3 Years	
13	October 2011	Republic of Korea	360.0	3 Years	Revised the swap amount from No. 1 above
14	November 2011	Hong Kong, China	400.0	3 Years	Revised the swap amount from No. 2 above
15	December 2011	Pakistan	10.0	3 Years	
16	December 2011	Thailand	70.0	3 Years	
17	January 2012	United Arab Emirates	35.0	3 Years	
18	February 2012	Malaysia	180.0	3 Years	Revised the swap amount from No. 3 above
19	February 2012	Turkey	10.0	3 Years	
20	March 2012	Australia	200.0	3 Years	
21	June 2012	Ukraine	15.0	3 Years	
22	March 2013	Singapore	300.0	3 Years	Revised the swap amount from No. 8 above
23	April 2013	Brazil	190.0	3 Years	
24	June 2013	United Kingdom	200.0	3 Years	
25	September 2013	Albania	2.0	3 Years	
26	September 2013	Iceland	3.5	3 Years	Renewed from No. 7
27	October 2013	Indonesia	100.0	3 Years	Renewed from No. 5
28	October 2013	Hungary	10.0	3 Years	
29	October 2013	European Union	350.0	3 Years	
30	July 2014	Switzerland	150.0	3 Years	
	Total		**2,585.5**		

Note: Total is sum of outstanding swaps as of end-August 2014.
Source: People's Bank of China.

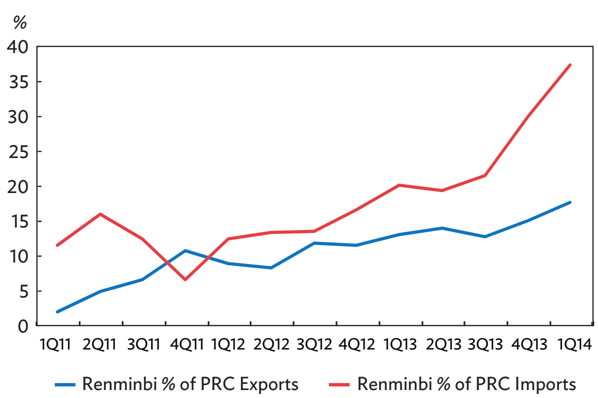
of its total trade. The swaps can promote greater use of different currencies by assuring participants that they will be able to conduct large trade settlement transactions. The swap arrangements also ensure a continuous supply of renminbi liquidity during periods of financial turmoil.

While the increased use of renminbi in trade settlement can be seen as a success, there is a mismatch between the use of the currency by importers and exporters. In the early days of its introduction, Chinese importers were the overwhelming users of the renminbi as exporters to the PRC were happy to accept renminbi for their products. However, there is limited use among Chinese exporters of the renminbi as payment for their products. Foreign customers typically still pay in US dollars, partially because of the limited availability of offshore renminbi. This tends to be a problem for companies not located in one of the offshore centers for renminbi trading. As the number of offshore centers for renminbi trading increases, this will become less of a constraint.

A more important reason for the limited use of the renminbi in payment for Chinese exports is the same reason that renminbi deposits have risen in Hong Kong, China, which is that foreigners want to hold renminbi since it is expected to appreciate; that is, foreign purchasers of Chinese goods prefer to pay in a depreciating currency such as the US dollar.

AsianBondsOnline estimates confirm that a larger share of imports than exports are settled in renminbi **(Figure 26)**. This shows that Chinese companies increasingly use the renminbi for offshore payments, while less renminbi are used for receipts. The disparity shows that companies abroad are increasingly willing to receive renminbi and more reluctant to pay in renminbi.

Figure 26: Renminbi-Settled Exports and Imports as Percentage of Total PRC Exports and Imports



PRC = People's Republic of China.
Sources: CEIC, People's Bank of China, and *AsianBondsOnline* estimates.

The greater use of the renminbi in the settlement of payments is also a major factor contributing to the rise in the supply of offshore renminbi. More receipts of renminbi payments could potentially reduce the supply of offshore renminbi.

As inter-market trade expands, there is a need to develop a settlement system. Most trade in US dollars is settled through the US Federal Reserve System. There is no centralized system for cross-border renminbi settlement. Instead, foreign banks need to deal with local Chinese banks with access to the onshore renminbi payment system known as China National Advanced Payment Systems (CNAPS). To further promote the development of offshore renminbi centers, the PRC has begun designating clearing banks. The establishment of an official clearing bank for renminbi is significant as it not only enables participants to settle cross-border renminbi payments, but also provides banks a way to transfer offshore renminbi to other banks. Hence, a clearing bank lowers the cost of renminbi payments, makes transactions more efficient, and reduces foreign exchange risk. In Hong Kong, China, the clearing bank allows financial institutions to square their renminbi positions arising from an open position due to a trade-related transaction. This means that the clearing bank allows offshore banks to tap onshore renminbi for trade-related activities, but not for investment.

There are, however, drawbacks to this system. As the participants are commercial banks, they are usually subject to the single-party exposure limit of financial institutions. This limits the amount of transactions that can be conducted with the clearing banks. The clearing bank in Hong Kong, China offers a fiduciary service through which it can make placements in the People's Bank of China (PBOC) on behalf of a client, thereby reducing counterparty risk.

The first official renminbi clearing bank was established when the Hong Kong, China branch of the Bank of China was named a designated enterprise. As interest in offshore renminbi has grown, more official clearing banks have been established. Bank of China's Macau, China branch was established as a clearing bank in December 2009, and its Taipei,China branch was assigned as a clearing bank in December 2012.

On 8 April 2013, the PBOC signed an agreement with the Singapore branch of Industrial and Commercial Bank of China for the branch to act as the renminbi clearing bank in Singapore. In addition, a memorandum of understanding on renminbi business cooperation was signed.

In March 2014, the Bank of England and Germany's Bundesbank signed currency clearing agreements with the PBOC, allowing banks in the United Kingdom and Germany to provide renminbi clearing and settlement services. In July, it was announced that China Construction Bank would be the clearing bank for London and Bank of China would be the clearing bank for Germany. Also in July, Bank of Communications was assigned as the clearing bank for the Republic of Korea.

The Use of Renminbi for Financing and Investment

In addition to increasing cross-border renminbi flows from trade in goods and services, there has also been a gradual easing of restrictions on capital flows to facilitate the growth of the dim sum bond market. The PRC has taken a gradual approach to the liberalization of its capital account. The liberalization process has generally been initiated through the introduction of pilot programs. If a pilot program functions smoothly, then it will be expanded.

There has been considerable development in the use of the renminbi for investment purposes, which is closely linked to the development of the dim sum bond market and growing interest in the renminbi for diversification and speculative purposes.

The creation of the dim sum bond market has its roots in Hong Kong, China where, on 8 June 2007, the PBOC and the National Development and Reform Commission unveiled provisional rules governing issuance of renminbi bonds in Hong Kong, China. The two institutions announced that local PRC financial institutions—policy banks and commercial banks—could issue renminbi bonds in Hong Kong, China, subject to regulatory approval. Would-be issuers also needed to meet various criteria of financial soundness such as sufficiency of loan loss reserves, positive cashflow, and sustained operating profits for the past 3 years.

One month following the announcement, China Development Bank issued CNY5 billion worth of bonds in Hong Kong, China, the first company to do so. The PRC has gradually expanded the range of companies that it allows to issue CNY bonds in Hong Kong, China every year since 2007 **(Table 7)**.

In May 2009, the PRC gave permission to HSBC (China) and Bank of East Asia (China) to issue renminbi bonds in Hong Kong, China, the first time that locally incorporated foreign banks were allowed to do so. The PRC's Ministry of Finance also issued the first renminbi sovereign bond in Hong Kong, China in 2009.

The list of allowable issuers in Hong Kong, China rapidly expanded in 2010. The Hong Kong Monetary Authority announced that issuance of renminbi bonds in Hong Kong, China would be governed by regular rules and regulations for bond issues, thus allowing foreign issuers. However, issuance of renminbi bonds in Hong Kong, China by mainland companies would continue to be governed by existing PRC regulations. McDonald's would later become the first foreign corporate issuer of renminbi bonds in Hong Kong, China.

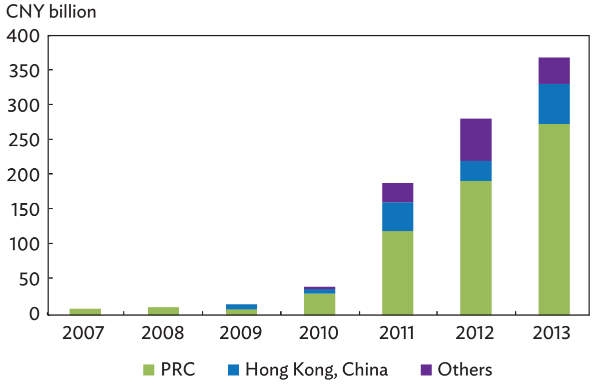
The dim sum bond market has since developed in other economies such as Singapore, albeit at a slower pace than in Hong Kong, China. Overall, the dim sum bond market has grown rapidly from issuance of CNY10 billion in 2010

Table 7: Milestones in the Dim Sum Bond Market

Year	Event
June 2007	PRC financial institutions allowed to issue dim sum bonds in Hong Kong, China
December 2008	Hong Kong, China-registered companies with operations in the mainland allowed to issue dim sum bonds
May 2009	First time foreign-banks' subsidiaries in PRC issue dim sum bonds in Hong Kong, China
September 2009	Ministry of Finance issues dim sum bonds
February 2010	Foreign companies allowed to issue dim sum bonds in Hong Kong, China
August 2010	McDonald's issues first dim sum bond by a foreign company
December 2011	Bao Steel issues first dim sum bond by an onshore PRC nonfinancial company
April 2012	HSBC issues first dim sum bond in London
March 2014	China Trust Commercial Bank issues first dim sum bond in Taipei,China
May 2014	HSBC and Standard Chartered issue first dim sum bond in Singapore
May 2014	Hainan Airlines Issues first corporate dim sum bond in Singapore

PRC = People's Republic of China.
Sources: Bloomberg LP, Hang Seng Bank Research, Hong Kong Monetary Authority, and various news reports.

Figure 27: Yearly Issuance of Bonds and Certificates of Deposit by Market of Risk



PRC = People's Republic of China.
Note: Market of risk is based on Bloomberg's definition of market of risk and is based on a number of criteria such as the issuer's domicile (unless key management such as the CEO is located elsewhere), primary listing, major source of revenues or reporting currency.
Source: Bloomberg LP.

to CNY369 billion in 2013 **(Figure 27)**. A large number of dim sum bond issuances have been through bank certificates of deposit (CDs).

While the bulk of dim sum bond issuance still comes from companies based in the PRC, issuance from other economies has grown significantly. Cumulative issuances from companies based outside of the PRC and Hong Kong, China totaled CNY129 billion in 2013, compared with CNY141 billion from companies based in Hong Kong, China.

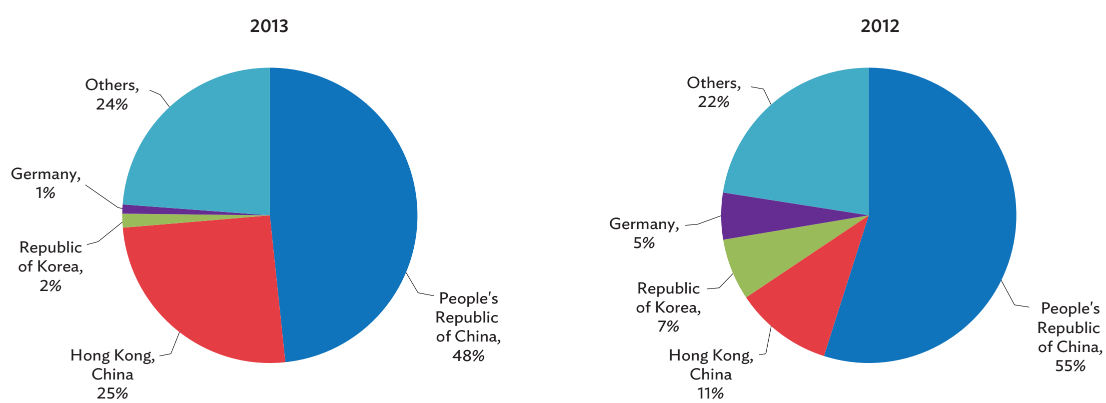
Figure 28 shows the breakdown of bond issuances in 2012 and 2013. The largest issuances—excluding those from the PRC and Hong Kong, China—came from the Republic of Korea and Germany. In 2013, the shares of those economies fell as issuance from Hong Kong, China grew rapidly. The World Bank is an active participant in the dim sum bond market, issuing a total of CNY4 billion in 2013. The Asian Development Bank (ADB) also issued a dim sum bond in 2010 worth CNY1.2 billion.

In terms of cumulative CD issuance, Hong Kong, China is the leader while Singapore is second, followed by Macau, China **(Figure 29)**.

There were a total of 1,150 bonds and CDs issued in 2013 versus 890 in 2012, bringing the cumulative number of bonds and CDs issued to roughly 2,500 at the end of 2013. This is a significant jump from only five issuances for the year as a whole when the dim sum bond market first started in Hong Kong, China in 2007.

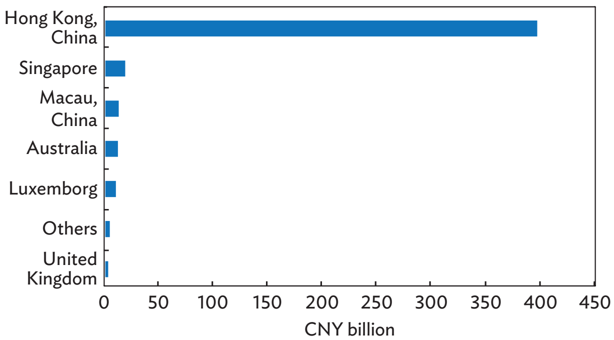
The number of issuers has also grown. In 2007, there were three issuers of dim sum bonds; by the end of 3Q13, the cumulative number of issuers had grown to 222. In addition to the increase in issuers from different economies, the diversity of issuers in terms of industry has also increased. Prior to 2009, issuers were from the PRC, and from either commercial banks or the government. However, starting in 2010, the corporate sector began

Figure 28: Dim Sum Bond Issuance (excluding CDs) **by Market of Risk**



CDs = certificates of deposit.
Note: Market of risk is based on Bloomberg's definition of market of risk and is based on a number of criteria such as the issuer's domicile (unless key management such as the CEO is located elsewhere), primary listing, major source of revenues or reporting currency.
Source: Bloomberg LP.

Figure 29: Certificates of Deposit Issuance by Domicile



Notes:
1. Others includes United Arab Emirates, Australia, the People's Republic of China, and Spain.
2. Domicile is based on Bloomberg's Economy of Domicile which is defined as the location of the company's senior management.

Source: Bloomberg LP.

issuing renminbi bonds. Issuance from corporates in 2013 was slightly higher than in 2012 **(Figure 30)**.

Banks remain the largest issuers of dim sum securities, mostly due to the number of CDs they have issued. The dim sum bond market has also been a significant source of financing for Chinese real estate companies. This is in part due to restrictions limiting their access to the onshore bond market. Other companies have issued renminbi bonds in order to attract the growing pool of offshore renminbi funds. In fact, two Malaysian companies, Axiata and Khazanah, issued renminbi-denominated *sukuk* (Islamic bonds).

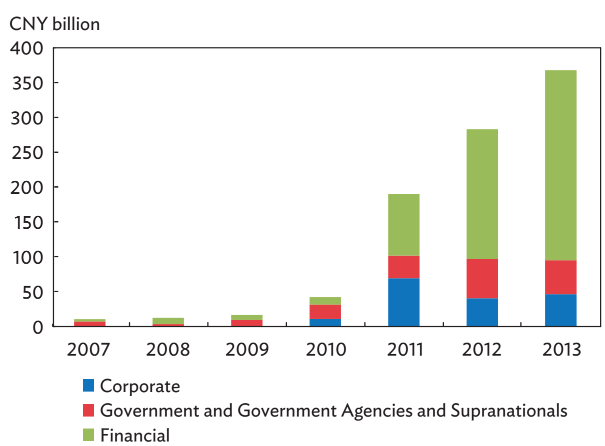
If commercial banks, supranationals, and special purpose banks are excluded, the real estate industry is the largest issuer of dim sum bonds. Most of these issuances are from Chinese real estate companies, which are restricted from issuing bonds in the onshore market and therefore resort to tapping external bond markets.

In terms of maturity, most early dim sum bond issuances were concentrated in the 1- to 3-year segment **(Figure 31)**. Foreign companies that issued dim sum bonds were cautious about the risk of issuing longer-term bonds given the relative infancy of the market and the possibility of being unable to source the renminbi needed to repay the bond. Early investors in dim sum bonds were also mostly looking for high-yield alternatives to renminbi deposits. However, this has changed and the maturity profile has gradually lengthened, reflecting the development of the dim sum bond market and growing interest from institutional investors and fund managers.

The growing interest in the dim sum bond market is also seen in the trading activity for the bonds. There is already more liquidity in the dim sum bond market in Hong Kong, China than in the local currency corporate bond market **(Figure 32).**

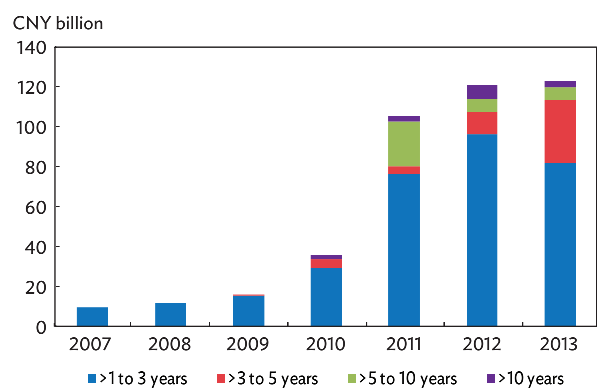
The path taken by the PRC to promote internationalization of the renminbi is unique in that while the PRC has promoted internationalization, it has done so while restricting capital account flows. This has led to the

Figure 30: Issuance by Sector



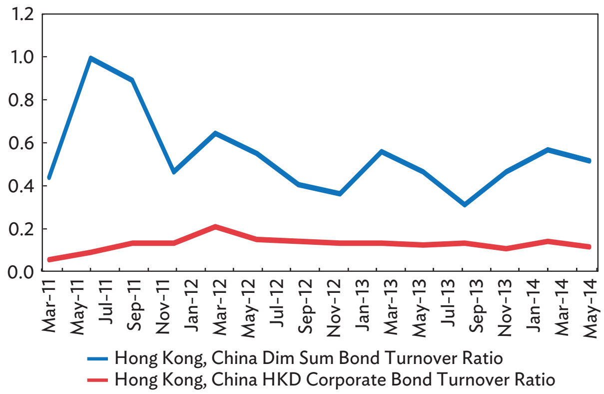
Source: Bloomberg LP.

Figure 31: Maturity Profile of Dim Sum Bond Issuance



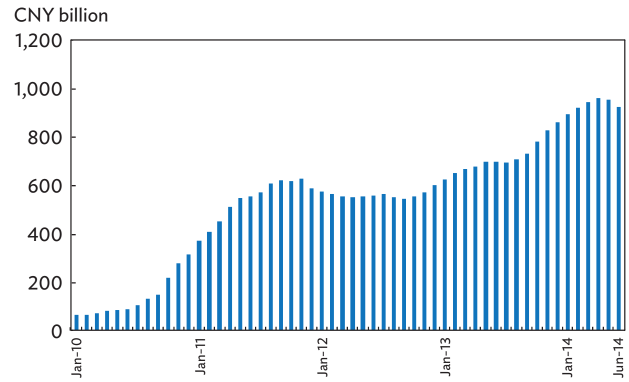
Source: Bloomberg LP and *AsianBondsOnline*.

Figure 32: Dim Sum Bond versus HKD Corporate Bond Turnover Ratio



Source: Hong Kong Monetary Authority.

Figure 33: Renminbi Deposits in Hong Kong, China



Source: Hong Kong Monetary Authority.

creation of distinct offshore and onshore markets. While the offshore market is a freely convertible currency and easily accessible to investors, there are still considerable restrictions to accessing the onshore market. Due to the closed nature of the PRC's capital markets, differences between the two cannot easily be arbitraged away.

This is reflected in the difference in the yields between onshore and dim sum bonds. Yields on dim sum bonds tend to be lower than comparable onshore renminbi bonds. This has been the result of the increasing pool of offshore renminbi liquidity chasing a relatively limited supply of offshore renminbi investments. In Hong Kong, China, a large pool of renminbi deposits has built up **(Figure 33)**. As of June 2014, total renminbi deposits amounted to CNY926 billion in Hong Kong, China, while there was CNY437 billion of outstanding dim sum bonds. The imbalance in supply and demand is due to the phenomenon in which imports are increasingly settled in renminbi and exports are still settled mostly in US dollars. Demand for renminbi investments is also high due to speculative bets on the expected appreciation of the renminbi.

The large pent-up demand for renminbi-denominated assets has allowed issuers to obtain lower funding costs offshore versus onshore. In December 2009, ADB issued onshore CNY bonds with a spread of 57 basis points (bps) over comparable PRC onshore government bonds. However, in October 2010, ADB's dim sum bonds were issued 81 bps below comparable PRC onshore government bonds. The International Finance Corporation has issued a CNY bond with a spread of 45 bps over comparable PRC government bonds, while its dim sum bond was issued at a spread of 182 bps below comparable PRC government bonds.

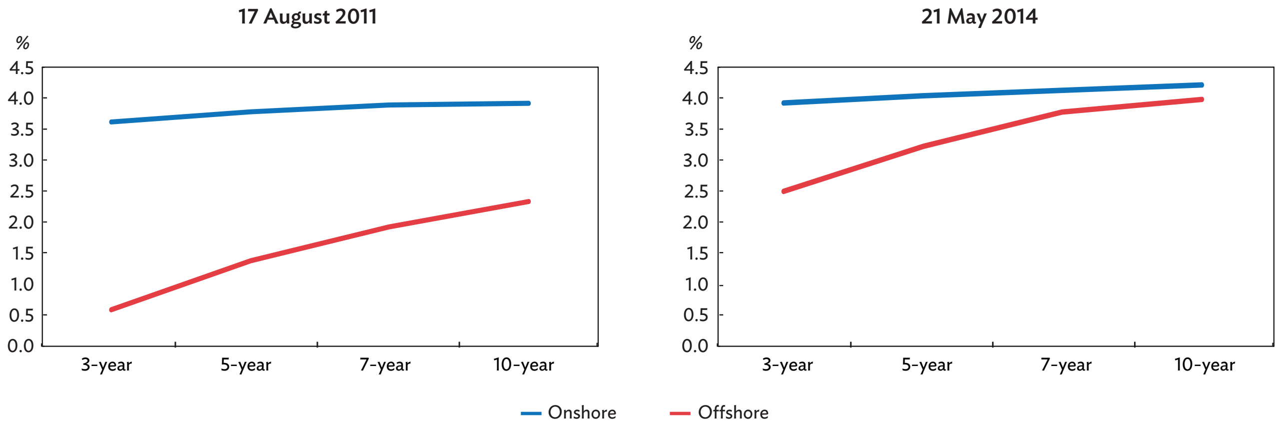
In August 2011, the PRC government conducted a multi-tranche dim sum bond auction. The 3-year bonds were issued at a coupon of 0.6%, while the prevailing yield offshore was 3.65%. The 5-year bonds were issued at a rate of 1.40%, while the prevailing offshore yield was 3.80%. The 7- and 10-year bonds were issued at a coupon rate of 1.94% and 2.36%, respectively, while the comparable offshore yields were 3.90% and 3.94%. On average, the PRC issued the bonds at a spread of 225 bps lower than onshore borrowing costs.

The difference between onshore and offshore yields has narrowed in 2014. Part of the reason stems from concerns during the prior year that the renminbi had changed direction and would depreciate against the US dollar. The dim sum bond market has also developed to the point it is viewed less-and-less by market participants simply as a way to bet on the currency. **Figure 34** shows the onshore and offshore yield comparison for PRC government bonds auctioned in the PRC.

As the yield difference in the onshore and offshore has narrowed, the premium between the CNH and CNY spot currency prices has also largely disappeared **(Figure 35)**.[5] When CNH was first introduced, it traded at a premium

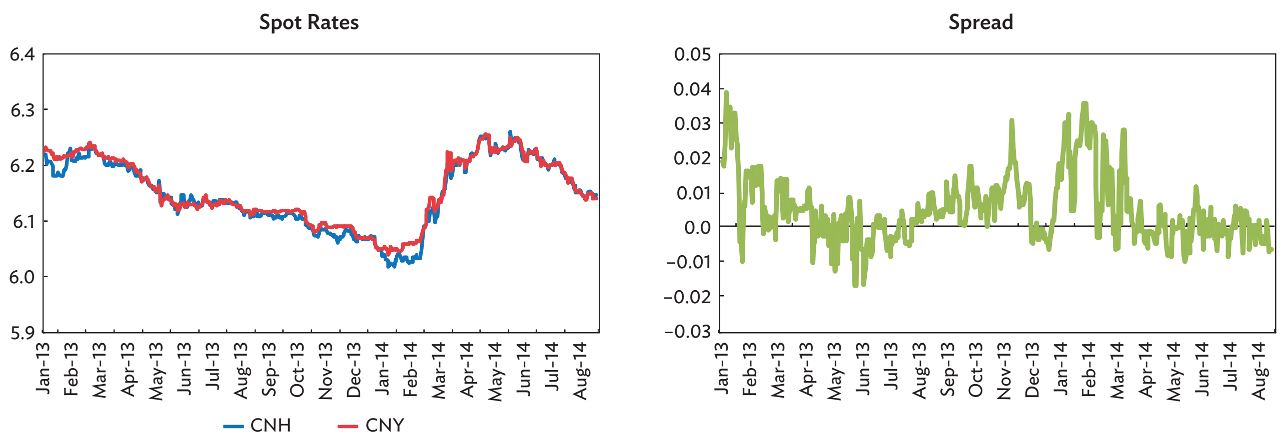
[5] CNH refers to offshore renminbi traded in Hong Kong, China.

Figure 34: PRC Government Onshore versus Offshore Yields



PRC = People's Republic of China.
Note: Yields were based on auction results.
Sources: Bloomberg LP and Hong Kong Monetary Authority.

Figure 35: Spread between CNH versus CNY Spot Exchange Rates



Note: Spread is the difference between CNY and CNH spot exchange rates.
Sources: Bloomberg LP and *AsianBondsOnline*.

to the onshore CNY rate as demand was high and investors were eager to participate in the market with the expectations of renminbi appreciation. However, the recent weakening of the renminbi and the realization that it is no longer a one-way bet has reduced the premium. This is a good development in the long-run and a sign of a maturing market as the exchange rate for the CNH will increasingly be determined by market conditions.

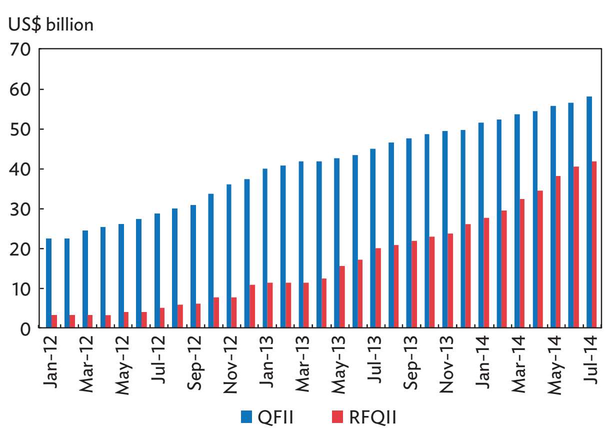
When the renminbi began depreciating at the start of the year, it raised concerns that the currency may no longer be a one-way bet. However, market interest in the dim sum bond market has also gradually shifted away from a simple currency bet and toward its potential diversification benefits.

The maturing of the offshore renminbi market can also be seen in the transition from the CNY non-deliverable forward (NDF) market to the CNH deliverable forward (DF) market. In 2013, DBS Bank estimated the volume of CNY NDFs at CNY3.2 billion and the volume of CNH DFs at CNY6.0 billion. The popularity of the CNH DF is due to increased demand from end-users such as corporates hedging their foreign currency payments. In contrast, the CNY NDF market is cash-settled and is more useful to speculators seeking to profit from expected currency changes.

Recognizing the build-up in offshore renminbi deposits in Hong Kong, China, the PRC has liberalized its rules to allow for the funds to be used for investment in the onshore financial market. The Renminbi Qualified Foreign Institutional Investor (RQFII) scheme permits Hong Kong, China-based financial institutions to invest directly in onshore financial assets using renminbi obtained from the offshore market. This is a key channel for rapidly accumulating renminbi funds abroad to be invested back into the PRC. The range of financial institutions that are allowed to take part have been broadened and the RQFII quotas have been increased. Initially, the quota for RQFII was CNY10 billion, but it has grown to CNY257 billion. There is a similar set of quotas called the Qualified Foreign Institutional Investor (QFII) to allow institutions globally to invest in the Chinese onshore market. The quotas for QFII have traditionally been much larger than those for RQFII, but the difference has been narrowing. As of July, the QFII quota is US$58 billion, compared with US$42 billion for RQFII **(Figure 36)**.

More recently, the PRC announced the introduction of a direct trading link between Hong Kong, China and the PRC. The Hong Kong, China–Shanghai Stock Connect will allow international investors to purchase Shanghai A shares via Hong Kong, China, and allow mainland Chinese investors to access H shares listed in Hong Kong, China. The direct connection between the two stock markets is expected to be operational by October 2014.

Figure 36: Cumulative QFII and RQFII



QFII = Qualified Foreign Institutional Investors, RQFII = Renminbi Qualified Foreign Institutional Investors.
Source: CEIC.

The direct trading link is seen as an improvement over the existing QFII and RQFII systems because there is no longer a need for investors to go through a potentially lengthy approval process. Also, while there will be an overall maximum limit of the trading allowed on the system, the limit is on the overall volume of transactions and not on an individual investor basis.

Currently, investors in Hong Kong, China can invest up to a net CNY13 billion in the PRC on a daily basis, subject to an overall aggregate limit of CNY300 billion. Meanwhile, investors from the PRC can invest up to CNY10.5 billion a day with a CNY250 billion aggregate limit. While these quotas are still relatively small, when combined with the QFII and RQFII quotas, they are a substantial share of the market.

Capital account liberalization does not refer to just inward investment of foreign capital, but also to outward investment of domestic capital. Outward direct investment by Chinese institutions has been greatly liberalized. In 2006, a quota on purchases of foreign exchange for outward direct investment was removed. For outward direct investment made by institutions, approval from the authorities is currently needed. Investment quotas have also been gradually increasing for outward portfolio investment as well. The Qualified Domestic Institutional Investors (QDII) quota has increased from US$65 billion in end-2010 to US$81 billion by end-July 2014.

Challenges for Renminbi Internationalization

The PRC is close to meeting many of the conditions required for having an international currency. Its economy is large and stable, and it has an enviable record of low inflation. Use of the renminbi outside of the PRC has greatly expanded. Initially, much of the interest in holding renminbi was due to speculation that the renminbi would appreciate against the US dollar. However, increased volatility following its depreciation in early 2014 has modified this view. Nevertheless, demand for the renminbi persists. This is a positive sign indicating that there is natural demand for the renminbi, rather than just speculation over possible future appreciation.

The PRC's financial markets have grown in size and sophistication. In 1Q14, the outstanding amount of government and policy bank bonds total US$3.1 trillion. This is still smaller than the US market size of US$29.0 trillion and Japan's US$9.7 trillion. Despite its rapid growth, the PRC's bond market is still relatively undeveloped, and its onshore bond market remains close to foreigners.

There has been progress in opening up a portion of the market to foreigners. For example, the PRC has launched the QFII and RQFII programs to allow foreigners to invest in the PRC's domestic markets, and introduced a direct trading link between Shanghai and Hong Kong, China, demonstrating that access to the PRC's financial markets is gradually being liberalized. But the pace of liberalization is still very much under the control of the authorities. The careful and measured pace of liberalization reflect an understanding that complete liberalization could lead to a risk of large and destabilizing capital flows. It could also potentially lead to large swings in the exchange rate, which would hurt exporters.

Meanwhile, there are also constraints that hamper the further development of the dim sum bond market that will have to be addressed. While there has been tremendous growth in the market, the issuers remain predominantly Chinese companies: 74% of the value of dim sum bond issuances (including CDs) in 2013 came from PRC-based firms. While there has been a trend toward greater variety among issuers, market conditions still favor issuance from the PRC as onshore yields are higher than offshore yields. Some of the increase in issuances in dim sum bonds also reflects tightening regulatory conditions for issuing bonds in the PRC. Further development of the offshore market would likely require increased participation from non-Chinese entities.

There is also a greater need for AAA-rated, risk-free offshore renminbi investment assets. As the offshore renminbi market grows, demand for risk-free assets will increase. Currently, the closest risk-free asset available is the dim sum PRC government bond issued in Hong Kong, China, although issuance is limited on an annual basis. This is in contrast to most domestic markets in which Treasury bill and bond auctions are conducted on a weekly basis.

There also has been a decline in the credit quality of the dim sum corporate bond issuances. The proportion of investment grade bond issuances has declined from roughly 40% in 2012 to 26% for Moody's and to less than 15% for Standard & Poor's **(Table 8)**. The proportion of unrated issuances has also increased over time and now accounts for the vast majority of issuance. Encouraging greater issuance of higher quality dim sum bonds will help in creating an offshore renminbi risk-free curve that will aid in the pricing of risk assets.

The renminbi is expected to continue on its path toward greater acceptance. However, the road that it takes may be different from that charted by other currencies. Most of the assessment of the potential rise of the renminbi is based on the historical experience of the internationalization of the US dollar. In this sense, there is a strong belief that an open capital market is necessary for renminbi internationalization.

It is possible that the PRC will establish a new model of currency internationalization in which capital market development is not as important as it has been in the past. Authorities in the PRC have two main concerns about further liberalizing the capital account. Allowing capital to flow in freely could destabilize monetary conditions, and complicate the process of managing the financial system. With deposit rates currently capped in the PRC, opening up the capital account could also cause an outflow of funds that could destabilize the financial system. Under the current system, the PRC is able to control and limit capital inflows. The authorities favor foreign direct investment, which is seen as contributing more to the development of the economy. With large

Table 8: Ratings Breakdown for Dim Sum Bonds (%)

	Moody's			Standard & Poor's		
	2012	2013	2014	2012	2013	2014
Investment Grade	40.79	19.85	26.40	39.12	22.81	14.29
Non-Investment Grade	3.77	11.62	3.69	4.06	18.63	3.72
No Ratings	55.44	68.53	69.91	56.82	58.55	81.99

Sources: Bloomberg LP and *AsianBondsOnline*.

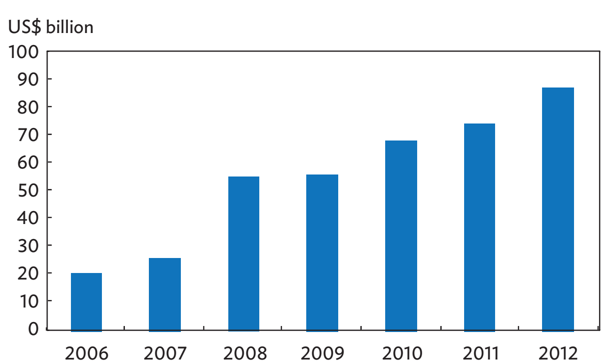
current account surpluses, the PRC does not have much need for portfolio inflows.

A closed capital account does not necessarily prevent the renminbi from becoming a leading international currency. As a capital surplus economy, it may be more important for the PRC to loosen restrictions on capital outflows. This will allow individuals and firms to invest in higher yielding opportunities abroad, and can also contribute to the rebalancing of the PRC economy from being investment-driven to one that is more consumption-driven. Progress has already been made on this front with the increase in overseas direct investment by Chinese companies to US$88 billion in 2012 from US$21 billion in 2002 **(Figure 37)**.

The shift toward renminbi and emerging assets in general has been the result of the deteriorating quality and returns of advanced markets sovereign bonds. Following the 2008/09 global financial crisis, fiscal conditions in advanced economies worsened as increased deficit spending and anemic growth led to ballooning public debt. The standoff during the 2011 debt ceiling debate in the US highlighted that even the US might not be completely safe from default. There are also concerns about the sustainability of US debt if yields were to start rising from their current levels. Hence, the capacity of advanced economies to supply safe assets may be constrained in the future.

As a result, central banks have shown increased interest in holding sovereign renminbi bonds, which offer many of the characteristics of a safe asset. The PRC has a strong economic track record, a history of low inflation, stable fiscal conditions, and a rising share of global trade. These conditions have led to increased interest among central banks in the region in adding renminbi bonds as reserve assets. However, the existence of capital controls and the lack of liquidity in the dim sum bond market is tempering some of the enthusiasm. To meet this demand, while still maintaining capital controls, will require more issuance in the dim sum bond market. This way, the PRC could pursue the internationalization of its currency without losing control of its monetary policy.

Figure 37: The PRC's Outward Direct Investment



PRC = People's Republic of China.
Source: CEIC.

Conclusion

The PRC is making a strong push for the internationalization of its currency. Considerable progress has been achieved toward this goal, with the renminbi gaining popularity as a trade and settlement currency. There has been tremendous growth in the offshore renminbi market as well. The historical experience of the US dollar suggests that promoting further use of the renminbi will require greater openness in the capital account. However, it is possible that the path of renminbi internationalization will be different.

While the pace of internationalization of the currency may be slower without opening up the capital market, it may be a process that is more stable. History is littered with examples of economies that suffered financial crisis from a premature liberalization of their capital account. This suggests that the PRC should focus on strengthening its domestic financial system first. The gradual approach to opening up the capital account will allow the PRC to learn from the outside world, while at the same time limiting the risk to its financial system.

The banking system is still the major source of financing in the PRC. The volume of lending by banks to the private sector far exceeds that of corporate bonds issuance. However, there are restrictions within the banking system. While lending rates have been partially liberalized, there is a ceiling on deposit rates. This complicates opening up the capital account, as it could lead to large outflows of funds.

The onshore bond market in the PRC is large. However, it remains relatively fragmented and underdeveloped. Bond futures, which could be used for hedging, cannot be traded by banks, thereby limiting liquidity and usefulness. The bond market is also split into an interbank bond market and an exchange bond market, with interbank bond market liquidity being much greater than that of the exchange bond market. The bulk of Treasury bonds are also held by banks rather than institutional investors.

Hence, there is considerable scope to improve and open up the domestic capital market. The banking system and bond markets should be further strengthened to better handle the associated challenges. As mentioned above, bank lending to the corporate sector in the PRC far outstrips corporate bond issuance. At the same time, onerous restrictions on bank lending persist, suggesting that reforming the banking system should be a priority.

While the onshore bond market is less constrained than the banking system, there are still significant challenges. One issue is that investors generally assume that onshore bonds carry an implicit guarantee. The first onshore bond default only occurred this year. The authorities may have decided to allow this default to encourage investors to price risk more carefully, rather than relying on implicit government guarantees. Investors need to understand that the higher returns offered by bonds with lower credit quality come with a higher risk. This may encourage Chinese companies to be more adventurous and issue more offshore bonds as the benefit of an implicit government guarantee for domestic issuances is removed. The dim sum bond market may benefit from this as Chinese companies seek more funding from overseas.

The internationalization of the renminbi will also have implications for emerging East Asia's economy.[6] As the PRC grows, it becomes more important as a final destination for the region's exports. This may lead to greater use of the renminbi for intraregional trade settlement. As the region's economies accumulate renminbi, they will look to invest more in the PRC's financial markets, bringing the region's markets closer together. Closer trading and financial ties will likely lead to a greater push for regional cooperation.

The PRC continues to be pragmatic rather than dogmatic in its pursuit of renminbi internationalization. It will likely continue weighing carefully the benefits and costs of promoting further international use of the renminbi. The opening up of the capital account will likely come only after the authorities are confident the domestic financial system is resilient enough to deal with the volatile capital flows that will likely follow. Given that the export sector is a large part of the PRC's economy, it will be wary of allowing the renminbi to float freely. But if the economy rebalances toward consumption versus investment, this may be less of a concern. Finally, as the PRC's trade is increasingly denominated in renminbi, the risk of exchange rate fluctuations, particularly in the export sector, will become less of a factor.

[6] Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.