BEA
The Bank of East Asia, Limited

Economic Analysis October, 2012

*A Publication of the BEA Economic Research Department*

# Renminbi Internationalization – The Role of Hong Kong

## Background

China is by all accounts an economic powerhouse. It is the second largest economy in the world and the second largest trading nation. Inbound foreign direct investment (FDI) and outbound direct investment flows rank first and ninth in the world, respectively. However, China's currency, Renminbi (Rmb), plays virtually no role in China's international dealings. In June 2011, 98% of China's international payment was settled in currencies other than the Rmb – 80% in US dollar[1].

This reliance on foreign currencies is costly. First, with the overwhelming share of China's international trade settled in US dollar, Chinese traders face increased exchange rate risk and transaction costs. Second, years of trade surpluses and foreign capital inflows have seen China's foreign exchange reserves balloon to the largest in the world. As of September 2012, China's foreign exchange reserves amounted to US$ 3.29 trillion, most of which were held in assets denominated in US dollars. With the deteriorating economic and fiscal conditions in the US, this reliance on US dollar is both a sizable risk and a concern for the Chinese Government.

## Strategy of Rmb Internationalization

China is responding to this risk by promoting the internationalization of Rmb. China's strategy involves a three-pronged approach: 1) facilitate international trade and investment denominated and settled in Rmb; 2) develop offshore Rmb-denominated financial products and encourage investment in these assets; 3) encourage central banks to hold Rmb as part of their foreign exchange reserves.

With these strategic goals in mind, a series of measures have been introduced in recent years. China has signed bilateral currency swap agreements worth 1.6 trillion yuan with 20 nations and regions, providing liquidity support to bilateral trade and investment activities in Rmb. Moreover, a scheme for cross-border trade settlement in Rmb was launched in July 2009 in selected cities and subsequently expanded nationwide. During the first nine months of 2012, trade with a total value of 2.05 trillion yuan was settled in Rmb, equivalent to 11% of China's external trade. This is a substantial jump from 2.6% in 2010. An increasing number of central banks, including Japan, South Korea, the Philippines, Nigeria, Saudi Arabia and Chile, have expressed interest in holding Rmb as in their foreign exchange reserves.

## The Role of Hong Kong

As part of the larger initiative to internationalize the Rmb, Hong Kong's role as an offshore Rmb centre is being further strengthened. The policy has been included as a key plank in China's 12$^{th}$ Five-Year Plan, as the government seeks to leverage the access to top financial talent and professional international institutional investors that Hong Kong provides.

Hong Kong has a very close financial relationship with the Mainland, and thus will facilitate further internationalisation of the Rmb. Close to 30% of Mainland China's trade is intermediated through Hong Kong. Hong Kong is the largest source of Mainland China's FDI, accounting for over 60% of the total. The existing cross-border Rmb trade settlement and Rmb FDI schemes have been very successful. In 2011, China's cross-border Rmb trade settlements totalled 2.08 trillion yuan, of which 92% were settled via Hong Kong. During the first half of 2012, Hong Kong's Rmb FDI amounted to 91.8 billion yuan, exceeding the total for 2011. This accounted for a quarter of all FDI in Hong Kong.

Meanwhile, Hong Kong has long been the preferred offshore platform of Mainland companies for raising financing. The local financial community is also very familiar with the Mainland market. Total non-bank Mainland credit exposure of all authorized institutions reached HK$2.58 trillion (16.1% of total assets) at the end of June 2012. At the end of September 2012, H-shares and red-chips together comprised 44% of Hong Kong's market capitalization. This experience facilitates the development and promotion of Rmb products. This explains the relatively stronger interest in Rmb products at both retail and corporate levels in Hong Kong.

Moreover, Hong Kong functions as a testing ground for Rmb internationalization. Since Hong Kong is a part of China, the seamless communication between regulatory authorities and the financial community of the two places allows prompt policy adjustment according to the market conditions. This helps to build an effective firewall for the Mainland financial system, making Hong Kong an ideal place to launch pilot programmes for offshore Rmb business.

[1] 'Rmb Internationalization', SWIFT

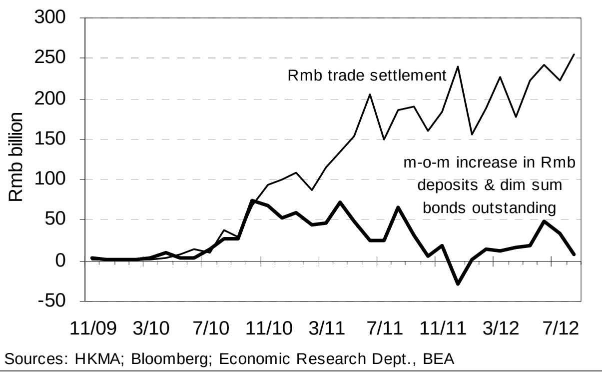
## Challenges to the Development of Rmb Business in Hong Kong

Other places, including London, Singapore and Taiwan, are also developing Rmb business. All have their own niches. London is the largest international foreign exchange trading centre, while Singapore plays a significant role in bulk commodity trading in the Asia-Pacific region. The markets they serve, Europe and ASEAN countries, together accounted for 25.6% of China's total trade in 2011. For Taiwan, the Cross-Strait Economic Cooperation Framework Agreement became effective on 1 January 2011. The agreement lays a foundation for Rmb business through tariff concessions. It helps boost commodity trade and strengthen the economic relationship between the Mainland and Taiwan.

Some wonder if these newly emerging offshore Rmb centres will pose competition to Hong Kong. Our view is that they complement Hong Kong, and thus it is crucial that they do well. To develop into a full fledged offshore Rmb centre, Hong Kong needs to serve not only its existing business activities with the Mainland, but also attract overseas Rmb funds. Successful development of Rmb business in other regions will enlarge our catchment area for Rmb financial services, and this is crucial to our future development.

Meanwhile, there are also concerns that a recent slowdown in Rmb deposit growth in Hong Kong may indicate a fall-off in interest in Rmb denominated investments. From March 2010 to November 2011, total Rmb deposits grew rapidly from Rmb 70.8 billion to a peak of Rmb 627.3 billion. However, the total has dropped steadily since then to Rmb 552.3 billion in August 2012. During the first eight months of 2012, the total value of Rmb deposits and bonds grew by 19.2 billion yuan per month on average, much less than the 48.8 billion yuan in the same period of 2011.

**Rmb trade settlement vs Month-on-month increase in Rmb deposits and dim sum bonds issued in HK**




Sources: HKMA; Bloomberg; Economic Research Dept., BEA

Since Rmb deposits are the backbone for various Rmb products, the market is concerned that Hong Kong's ability to develop Rmb products will be constrained as deposit growth retreats. However, one should note that the rapid growth of Rmb deposits during 2010-2011 was brought about by the expectation of further Rmb appreciation at that time. With few investment alternatives, financial institutions in Hong Kong could only invest the Rmb funds in locally-issued Rmb bonds or deposit them in the Settlement Bank. Room for financial intermediation was limited.

Although interest in holding Rmb has waned, the number of Rmb products available has in fact grown – resulting in a more healthy investment environment. The outstanding Rmb loans reached 60 billion yuan at the end of July 2012, nearly four times the level a year ago. In addition, Hong Kong's banks and insurance companies are now allowed to invest in the Mainland's interbank and bond markets.

Rmb FDI and Rmb Qualified Foreign Institution Investor (RQFII) programmes have been introduced in 2011. Under the RQFII scheme, the first dual-counter Rmb ETF that tracks the MSCI China A-share Index was recently listed on the Hong Kong Stock Exchange. In addition, the world's first deliverable Rmb currency futures contract was introduced by Hong Kong Exchanges and Clearing Limited in September, 2012, allowing investors to hedge Rmb exposure. With more balanced development on assets and liabilities sides, a healthier Rmb financial ecology has emerged.

Rmb denominated payments increased to 0.53%[2] of the world total in August, but still significantly lagged behind China's world total trade share of 9.9% in 2011. There is much room for growth. To further nurture Rmb internationalization, global investors must be attracted to hold Rmb. Most international investors currently hold mainstream currencies like US dollar, which are supported by well developed financial products and services. To persuade these investors to switch and hold Rmb, a comparable class of Rmb financial services must be provided. As China's offshore Rmb centre, Hong Kong needs to respond to the challenge, building sufficient Rmb product diversity and achieving critical market volume to service the demand from global funds. Despite the progress of reform in the past few years, there is still a long way to go before Hong Kong reaches this stage.

Meanwhile, further reform is likely to proceed with caution. Since offshore Rmb services involve Rmb funds moving in and out of the Mainland, further expansion of the scope of Rmb business will have implications in respect of the opening of China's capital account. This explains the gradual approach used for the introduction of new Rmb financial services in Hong Kong. Hence, further development of Rmb business will continue to proceed in a step-by-step fashion in tandem with the opening of the capital account. Ensuring financial stability and bringing in financial innovation will continue to be the dual missions for Hong Kong, on the road to Rmb internationalization.

[2] SWIFT 'Rmb Tracker', September 2012