HSBC Global Research

Macro
March 2015

The rise of the redback IV

Taking its place at the top table

RMB trade settlement is set to top 50% of China's total trade in 2020

Two-way cross-border capital flows are the 'new normal', making the RMB more market-driven

All this, plus full convertibility by 2017, will help the RMB take a seat at the top table

By Qu Hongbin, Paul Mackel, Julia Wang, John Zhu, Ju Wang and Joey Chew

Play Interview with Qu Hongbin and Paul Mackel

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Summary

Joining the dots

At first glance, 100m Chinese shoppers heading overseas, a US sovereign bond issued in renminbi, the opening up of the old 'Silk Road' trade routes, a Chinese currency bank account in Canada, the Shanghai-Hong Kong Stock Connect programme, and small companies in Southeast Asia that buy a vast array of widgets from China may not appear to have much in common. However, look closer and they do. This disparate collection of themes, concepts and human experiences are all part of the same story. They join the dots and provide the links that are making the RMB a global, around-the-clock currency. Every day, all around the world, more companies and investors are using the RMB for trade, investment, hedging, cash management and financing. This report looks at this growth story from a number of different angles as the differences between the RMB and other major global currencies rapidly disappear.

Let's start with trade. Back in 2010 we made a forecast that some thought was too bold. We said that 30% of payments for China's imports and exports would be made in RMB by the end of 2015. Well, RMB trade settlement has risen from 12% of total trade at the end of 2012 to 22% by the end of 2014. We remain confident that our prediction will hold true. Significantly, this expansion has taken place despite a reversal of steady RMB appreciation against the USD, which has turned into a modest depreciation as growth in China slows. The implication is clear – people want to use the RMB because it offers a number of real, practical business benefits rather than for short-term speculation.

We believe the amount of RMB trade settlement will continue to expand, and not solely because of China's rising share of global trade and investment. Beijing is accelerating the pace of financial reforms and, at ground level, is making the rules and regulations clearer and simpler. We now make another forecast – RMB trade settlement will top 50% of China's total trade by 2020, thrusting the currency into the major leagues (see *RMB facts, figures and forecasts* on the next page).

However, this is not just a trade story. New RMB centres are opening outside Hong Kong in different time zones in Asia, Europe and now North America. As the currency goes global, connecting these centres to the mainland and also linking them to each other will increase the pace, depth and breadth of RMB internationalisation. The series of 'Q' investment schemes is becoming broader to allow greater two-way flows and more of China's overseas direct investment is being conducted in RMB.

Finally, the Shanghai-Hong Kong Stock Connect programme went live in November 2014 and could soon be followed by a Shenzhen sister programme. To this we can add the ambitious New Silk Road plan and the Shanghai Free Trade Zone, which could soon be joined by counterparts in the wealthy provinces of Guangdong and Fujian.

The scale and influence of the RMB is growing. New avenues and channels are opening all the time and more will follow. For example, global commodities trade has long been dominated by the greenback and

this won't change anytime soon, in our view. However, China is already the world's largest consumer and producer of most commodities. This should provide a fresh opportunity for the RMB, especially now that around-the-clock offshore markets are taking shape.

All this reflects the fact that the RMB is now perceived by investors as a more mature currency. The onshore USD-CNY spot trading band is wider, which allows the exchange rate to trade with greater volatility. Other FX liberalisation measures also promote greater two-way flexibility ahead, while enhancing greater convergence between the onshore and offshore RMB. These developments, along with further expected changes, suggest that the RMB should become one of the top five most traded currencies on a day-to-day basis in the coming few years.

The recent slowdown in growth and rising burden of debt have led some commentators to speculate that China will hold back some reforms, especially capital account liberalisation. The reality is that Beijing has speeded up the pace of change. The Shanghai-Hong Kong Stock Connect scheme is a good example, as is the spread of some freedoms practised inside the Shanghai Free Trade Zone to other regions. This comes as no surprise to us. We have long taken the view that capital account convertibility and other financial reforms are part of the solution to domestic problems. The recent session of the National People's Congress indicated that interest rates will be fully liberalised this year, which should pave the way for further reforms. We still think the RMB will become fully convertible within two years.

It's hard to imagine that this journey began with one small step in Hong Kong back in 2003, when individuals where first allowed to open RMB accounts. Few noticed or saw the point as the amounts involved were tiny (RMB deposits in Hong Kong now total close to RMB1trn). Everybody sees the point now.

RMB facts, figures and forecasts

- The RMB is the ninth most traded currency (USD120bn daily turnover).
- We believe the RMB will become one of the top five most traded currencies within the next five years.
- The RMB is the fifth biggest currency for global payments, up from 13th in January 2013.
- The RMB is also the second most used currency in trade finance, up from fourth in January 2012.
- China has the third largest equity market (Shanghai and Shenzhen combined, as of end-2014), the third largest bond market and the largest banking system in terms of assets and liabilities.
- From just eight listings, when it was launched in 1990, China's A-share market has grown to 2,600 stocks.
- Annual RMB trade settlement was RMB6,550bn at the end of 2014, equivalent to 22% of China's overall trade turnover and up from 12% at the end of 2012
- At the current pace of growth, RMB trade settlement looks set to achieve the 30% target for this year that we predicted back in 2010.
- By the end of 2014, RMB settled direct investment had more than tripled since end-2012, rising to RMB328bn.

This report is the fifth of a series being published for HSBC's RMB, Reform and China's Global Future forum on 26 March 2015.

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Contents

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RMB trade settlement: reaching critical mass

- RMB cross-border settlement has soared from 10% of China's trade in 2012 to 22% at the end of 2014, on track to reach our projection of 30% by the end of 2015
- More trade with non-G3 markets, export upgrades and deeper RMB liquidity will help it reach critical mass in the coming years
- We expect 50% of China's overall trade to be settled in RMB by the end of this decade

A quick recap

When the RMB trade settlement scheme was launched in 2010, we made a bold prediction that around a third of China's overall trade would be settled in the RMB by 2015. This forecast remains on track. As of end-2014, annual RMB trade settlement was RMB6550bn, equivalent to 22% of overall trade turnover, up from 12% at the end of 2012 (Chart 1).

Much of this has been driven by trade settlement in goods. Monthly trade settlement for goods reached RMB556bn as of end-2014, accounting for 22% of China's merchandise trade turnover, up from just over 10% at the end of 2012 (Chart 1). At the same time, use of the currency in services and income payments is also rising, to RMB160bn per month in Q4 2014. For the current account as a whole, which includes trade in goods

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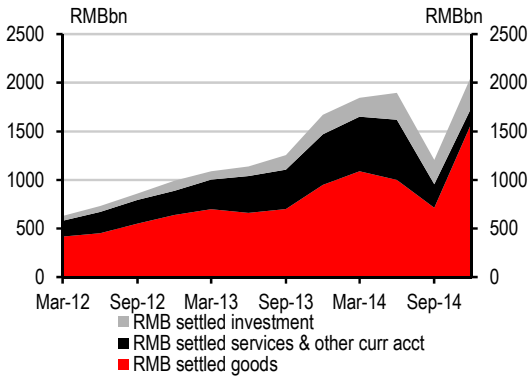
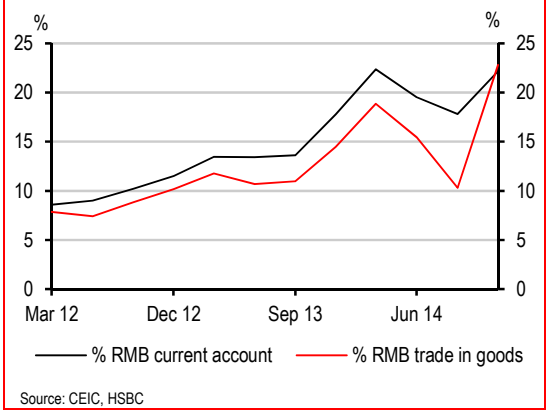
Chart 1. RMB trade settlement grew strongly



Source: CEIC, HSBC

Chart 2. Increased usage for trade in goods, services and payments



Source: CEIC, HSBC

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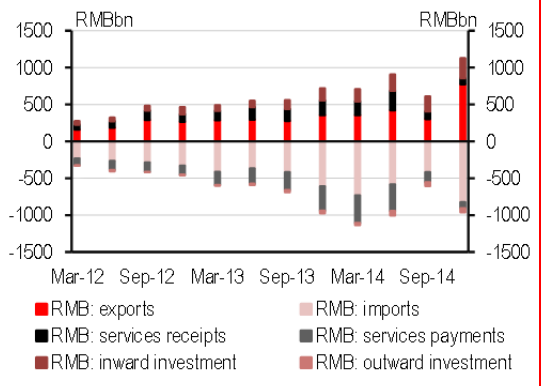
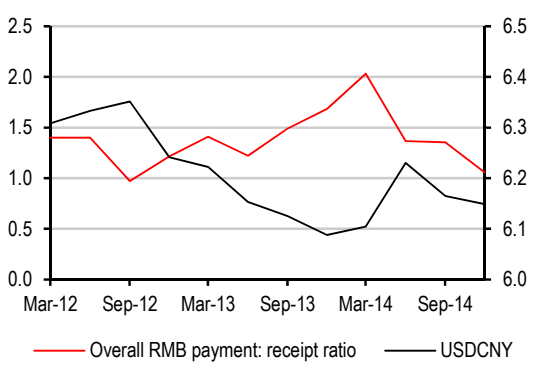
Chart 3. Exporters' usage of RMB improved



Source: CEIC, HSBC

Chart 4. Payment-receipt ratio less unbalanced



Source: CEIC, HSBC

and services, as well as income payments, the RMB's overall share rose to 22% in Q4 2014, up from 12% at the end of 2012 (Chart 2). Direct investment settled in RMB more than tripled over the same period to RMB328bn.

Contrary to fears at the time, the unwinding of one-way RMB appreciation expectations in early 2014 did no derail this process. In fact, despite market-driven depreciation pressures on the RMB in early 2015, RMB trade in goods settlement rose to another new high of 23% in January 2015 (latest data available). This suggests the RMB's use in trade settlement is based on genuine trade needs and is supported by firms' confidence in the currency's fundamentals and relative stability.

The tempering of appreciation expectations has been a positive development for the payment-receipt ratio (Chart 3). This ratio has been heavily skewed towards import payments rather than export receipts over the past few years, reaching 2.03 in Q1 2014, as the attraction of receiving RMB payment was boosted by the currency's perceived appreciation potential (Chart 4). This imbalance was corrected in the subsequent quarters, as Chinese exporters were able to significantly increase RMB receipts, while importers grew RMB payments at a more moderate pace.

The next step

At the current pace of growth, RMB trade settlement looks set to achieve the 30% overall target we predicted back in 2010. It is now time to think about the next step.

Having grown at a rapid pace and shown great resilience amidst market-driven volatility, the next test for RMB trade settlement is whether it can hit critical mass and become a major trade settlement

Table 1. RMB penetration in trade settlement is limited outside Hong Kong

Ranking in 2014	Trade partner	% China's trade turnover	% share of RMB in trade settlement
1	European Union	14.3	Limited scale, i.e., Germany, France, Luxemburg
2	United States	12.9	Limited scale
3	Hong Kong	8.7	Significant scale
4	Japan	7.3	0.5-0.7%
5	Taiwan	4.6	Limited scale
6	Australia	3.2	0.3-0.5%
7	Malaysia	2.4	Negligible
8	Russia	2.2	Negligible
9	Brazil	2.0	Negligible
10	India	1.6	Negligible

Source: CEIC, Japan Custom Office, Australian Bureau of Statistics, HSBC

currency for a large number of trade partners. The key is to promote greater RMB usage for trade settlement with a broader group of trade partners.

Currently, a large proportion of RMB trade settlement is conducted in Asia, with Hong Kong accounting for the lion's share. Interest is increasing in Singapore, South Korea, and more recently in European countries, as well as the US. The next important step is to deepen existing RMB trade settlement practices among trade partners other than Hong Kong and to broaden the currency's reach.

Table 1 shows China's top 10 trade partners (by trade turnover) in 2014. ASEAN is not listed separately as it comprises economies that use a variety of different currencies. If ASEAN was included, it would have been the third largest trade partner for China by turnover. In all of these countries, with the possible exception of Hong Kong, RMB trade settlement has significant room to grow. The question is, how?

How to succeed

There is a rich source of literature available on the choice of trade invoicing and settlement currency, ranging from the theoretical to the empirical. By and large, there are three key drivers for a currency's usage in trade settlement.

Macro stability

An economy's macroeconomic performance, in terms of economic growth and inflation, matters for the stability of its monetary policy, which, in turn, influences the volatility of its exchange rate. For example, *Goldberg and Tille* (2008) have shown that real exchange rate volatility deters development of invoicing and trade settlement.

China scores well on this front, as the country's growth and inflation outlook has been stable. The People's Bank of China (PBoC) has always tried to balance systemic stability with FX market reforms.

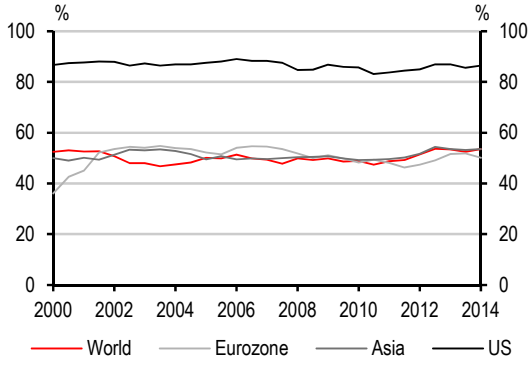
Trade structure

However, having an improving, if not already attractive macro regime, is only a small part of the puzzle. Quite a few countries have a favourable macro environment, but global trade settlement is largely dominated by the USD, with the EUR and the JPY also playing a part. To understand what makes traders take advantage of a favourable macro environment to invoice and settle in a given currency, we have to understand the trade structure between countries.

Competitiveness of the end market

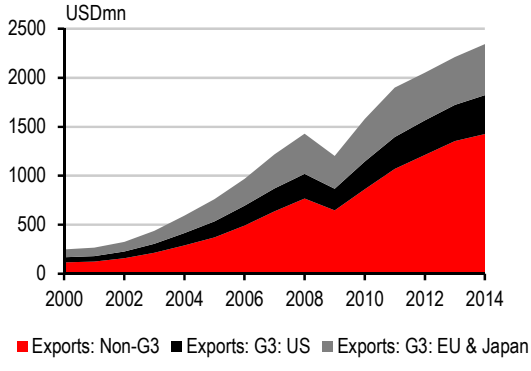
One of the classic facts about international trade settlement is that trade between developed and developing countries tends to be settled in the currency of the developed market (*Grassman*, 1973).

Chart 5. Share of USD invoicing/settlement in Japanese exports



Source: Japan Custom Office, HSBC

Chart 6. 40% of China's exports go to the G3 markets



Source: CEIC, HSBC

The reality, as shown in the subsequent decades, suggests that this is often not clear cut; however, one observation stands out, which is that many exporters consider the G3 markets, particularly the US, to be competitive, and are, therefore, more willing to adopt a price-to-market (PTM) strategy.

A PTM strategy means exporters adjust their prices to the prevailing prices in their export markets. This usually happens if the end market is deemed competitive, with high price elasticity of demand. The side effect of a PTM strategy is that exporters are more likely to use the customers' currency in invoicing and settlement. This is the first kind of "network effect" or "inertia" that is referred to in the literature. According to *Fukuda and Ji* (1994), a PTM strategy is responsible for the consistently high share of USD invoicing in Japanese exports to the US, whereas for the same type of products, Japanese exports to Asia are more likely to be invoiced and settled in JPY (Chart 5).

Turning back to the case of China, *Cui and Shu* (2009) estimated that China's PTM coefficient is similar to Japan's coefficient, implying that competitive behaviour with regard to a large economy, such as the US, could be one challenge for the RMB. Meanwhile, JPY's overall share of Japan's export settlement is consistently between 35% and 40%, suggesting that there is room for the RMB to grow even within the current constraints.

And on a longer term basis, the RMB is likely to be able to overcome the PTM constraint as China diversifies further away from the G3 and more into emerging markets. Chart 6 plots China's export destinations. Since the financial crisis, Chinese exports to non-G3 markets have grown faster, now representing 60% of overall exports.

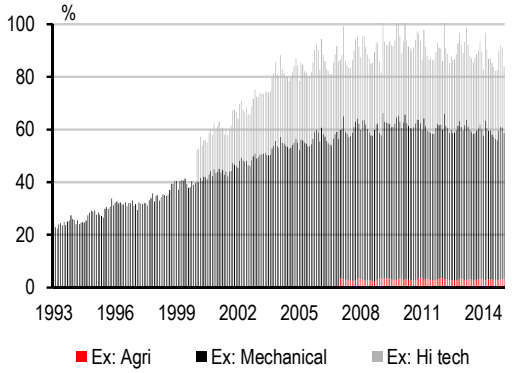
Should this trend continue as China deepens its trade relations with more emerging markets on the back of the New Silk Road initiative (see Chapter 4), the RMB's trade settlement potential will be even greater.

Product differentiation

Apart from end-market competition, product differentiation is also an important factor determining the seller's bargaining power, and ability to invoice in the home currency. *Goldberg* (2005) and *Ito and Koibuchi* (2009) have pointed out that homogenous goods are more likely to be priced in the USD.

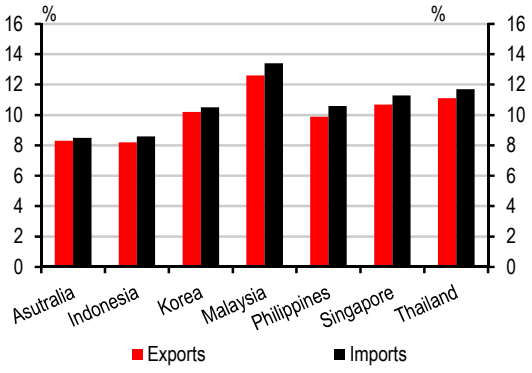
The black columns in Chart 7 represent mechanical exports, such as machinery and electrical products, and the grey columns high-tech exports, such as biotechnology, computers and high-end manufacturing. These two categories, together with the data on agricultural exports, available since 2007, now account for over 80% of China's overall exports.

Chart 7. Export structure has shifted over time



Source: CEIC, HSBC

Chart 8. RMB's potential share in partners' trade settlement with greater financial market development



Source: Lai and Yu (2014), HSBC

The rest are mostly low value-added products, such as footwear, clothing and toys. Since 2000, China has made significant headway in increasing its mechanical and high-tech exports.

The transition is a difficult one, particularly amid challenging global trade conditions, but this looks set to continue. It will be facilitated by the deepening of trade relations with more emerging markets, where China increasingly has a competitive advantage in higher end construction and manufacturing.

Two special cases, identified by the ASEAN Institute for International Monetary Affairs in 2010 in connection with JPY internationalisation, are worth noting. The first is electronics exports, which are produced in a regional production chain. They are more customarily USD denominated as the products are still ultimately destined for the US market. Even as China moves up the value chain in the regional production system, its exporters may still face the same pressures as their Japanese counterparts to price to market.

The second special case is more country specific. Many Japanese automobile exporters choose to invoice in the USD, not out of competitive concerns, but to shield their 100%-owned foreign subsidiaries from foreign exchange risks. Less centralised company structures, as well as more joint ventures with local companies (which is a regulatory requirement in many emerging markets), help mitigate this problem.

Financial markets

Last, but not least, the liquidity, depth and availability of investment products also matter significantly for trade settlement. In fact, to paraphrase *Krugman*, who said in 1984 that "the choice of a vehicle currency reflects both history and hysteresis[1]", financial market development is one of the fundamental factors behind the 'hysteresis' that supports the USD today.

Even as conventional wisdom may describe a linear progression from trade to investment usage in a currency's lifecycle, financial development, in the form of a deeper FX market, and a more developed banking sector help reduce transaction costs and improve hedging ability, two factors that matter for invoicing currency choice. A wider range of investment products will also increase confidence in the currency as a store of value and medium of exchange.

Lai and Yu (2014) argued that if China is able to develop the financial market infrastructure, resulting in a FX turnover share more commensurate with China's GDP share (for example, from 0.17 currently to 1), the RMB should account for around 10% of trade settlement of a typical ASEAN economy, such as Thailand. Chart 8 plots the hypothetical RMB share of trade settlement of China's major trade partners, if the RMB is able to achieve the financial market thickness of 1 (proxied by the FX turnover share: GDP share). If so, this would represent a significant breakthrough even beyond our base case.

Thoughts at ground level

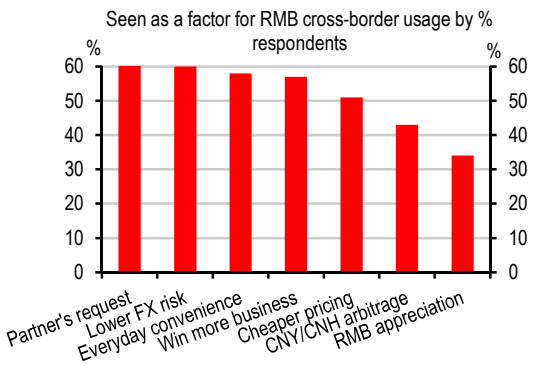
The above may sound like a relatively theoretical discussion. However, our on-the-ground research raises similar points. An HSBC survey looking at RMB trade settlement-related needs for 1,304 enterprises throws up some interesting points. Current non-users suggest some key barriers to using the RMB.

No benefit/not fully considered

While we had expected that awareness would be lower among non-users, it is somewhat surprising to see this being listed as the biggest barrier by companies themselves. Many respondents claim that they do not see clear benefits, or have not fully considered the issue.

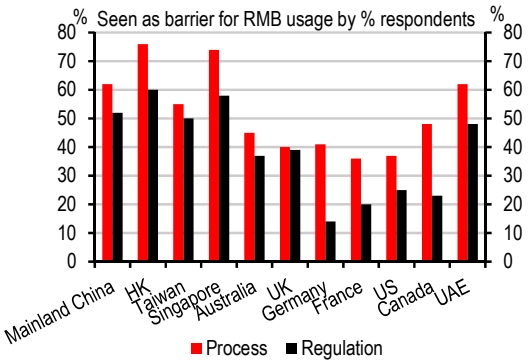
[1] *where the current path reflects not only the current inputs, but the past as well*

Chart 9. General benefits of RMB trade settlements



Source: HSBC

Chart 10. Barriers for RMB trade settlements



Source: HSBC

Companies may eventually find little actual benefit in trading in the RMB. However, given these companies' trade connections with China, it is more likely that some benefits exist, which companies do not clearly perceive. For example, some companies may not be aware that they can save costs through RMB settlement, or that their trade partners may be willing to pass on some of the cost reduction. More generally, it is quite possible that many are not aware of the general benefits of RMB settlement (Chart 9), such as cost savings, helping to win business and cheaper pricing. This is particularly true for companies that admitted not having fully considered the issue.

We believe these discussions point to one area of low-hanging fruit for RMB trade settlement – more publicity will make potential users aware of the benefits to their businesses. Another interesting point to note from Chart 9 is that the factors driving RMB usage are very much business-related factors. The more short-term incentives, such as CNH/CNY arbitrage and appreciation, do not appear to be the primary factors behind RMB adoption.

This may surprise casual observers who are inclined to think that many of the above long-term supporting factors for a currency may not yet apply to the RMB, given a fundamental lack of interest in an alternative trade settlement currency.

However, it appears that businesses on the ground, both inside and outside China, are far more realistic. The most common motives for holding RMB often cited by sceptical commentators, such as appreciation and arbitrage, matter less than business needs.

Processes and regulations

Another key point mentioned by the businesses surveyed is the cumbersome nature of regulations. Even as regulations have been simplified significantly over the past years, some businesses still find the requirements "complicated". There are apparently other concerns with regard to eligibility for tax rebates and other restrictions. Some also worry that the regulations may change or be reversed.

This suggests that simpler and clearer regulations will help increase RMB usage. In fact, all businesses (users and non-users) agree that simplification of procedures will be the single biggest enabler to encourage RMB cross-border business.

For businesses large and small, and from a variety of countries, around a third of non-users of RMB plan to use it in the future. Better publicity, education and simpler, clearer regulations will help the RMB take the next step.

More than trade

The RMB also has room to expand its influence in services and investment settlement. Around a quarter of China's services trade is already settled in RMB. This portion will increase further as Chinese travel and spend more abroad.

Meanwhile, close to half of China's investments are shown to be already settled in RMB; however, this figure could be distorted by a relatively large amount of financial flows that should soon be reclassified as banking-related flows.

Nevertheless, RMB-denominated cross-border investment has room to grow further in the near future. As we noted earlier this year (*China Inside Out: Time to go shopping*, 10 February 2015), overseas direct investment from China has already matched, if not surpassed, foreign direct investment from overseas in 2014.

Outward investment is set to grow faster in 2015 and beyond on the back of the continued policy push for Chinese companies to upgrade their production chain and invest abroad. We believe the New Silk Road initiative, started in 2014, will be a major catalyst for driving manufacturing and construction-related services and investment outflows.

Living up to the potential

RMB trade settlement has grown quickly over the past few years. The next challenge is to reach critical mass. This will mean the RMB needs to break through the existing inertia created by a price-to-market strategy, lack of product differentiation, and less developed financial markets. We believe it will not be an easy journey, but there are already promising signs of progress. If the RMB is able to take advantage of any of the three above-mentioned criteria, it should be enough to hit critical mass and become a major trade currency. And there are some low-hanging fruits available, such as more publicity, and simpler regulations, which can bring sizable near-term gains.

Meanwhile, the currency's potential in services settlement will also improve on the back of increased tourism spending, in our view. We believe the New Silk Road initiative will also boost outward direct investment (ODI), an increasingly large proportion of which is likely to be RMB-denominated.

We believe more than 50% of China's global trade in goods and services will be settled in RMB by 2020.

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Commoditising the RMB

- The USD is the most widely-used currency for commodity settlement…
- …but China's role as a dominant producer and consumer means the RMB will play a more prominent role
- Some low-hanging fruit can be picked with more education and clearer regulations

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USD's stronghold

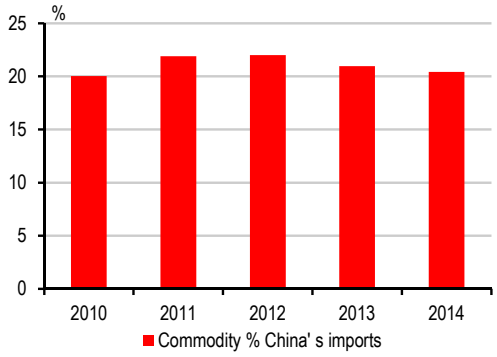
Of all the spheres in which the USD dominates world trade settlement, its hold on the global commodity market is perhaps the strongest. Although a precise figure on the USD's share of global commodity trade settlement is unavailable, its wide usage is well-documented. For instance, the USD is used in benchmark setting for all of the key varieties of oil, such as the West Texas Intermediate (WTI), Brent and Dubai crude. Oil futures contracts are also USD-denominated.

This dominance is rooted in two factors. The first is the sway, economical as well as political, that the US has over the production and consumption of oil. The second is the so called 'network' effect. This chapter looks in detail at the RMB's prospects of becoming a commodity settlement currency. First, we argue that China's influence over both the production and consumption of oil is strong enough to warrant some representation of the RMB. Second, as with all things, incumbency does not imply permanency or exclusivity. A look at a history suggests that there is room for more than one currency in the commodity market. The RMB's challenge lies in seizing the opportunities to persuade companies of the economic benefits of trading in RMB.

The RMB's challenge

Commodities are an important part of China's trade. It accounts for 20% of the country's imports and to a large degree defines China's trade relations. Meanwhile, what China buys also matters to the rest of the world. Chart 1 shows China's commodity imports as a percentage of world demand.

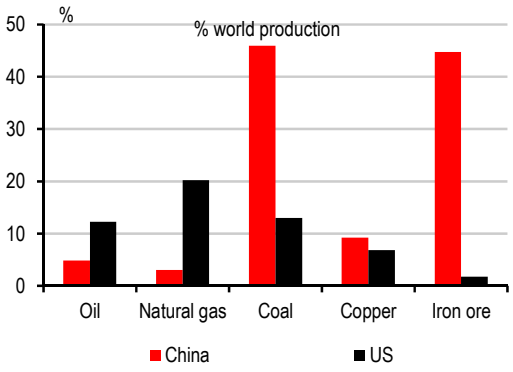
Chart 1. A sizable portion of China's demand



Source: CEIC, HSBC

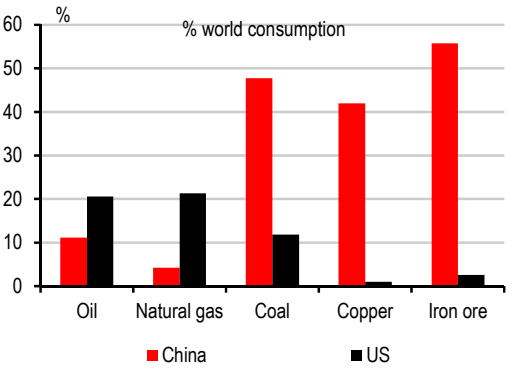
Given this, promoting RMB trade settlement in commodity is of a strategic importance to the internationalisation agenda of the RMB. Progress

Chart 2. China is also a dominant producer…



Source: Energy Information Agency, US Geological Survey

Chart 3. …as well as consumer



Source: Energy Information Agency, US Geological Survey

on this front will also matter for trading on organised exchanges.

The question is: Is the commodity market too large a behemoth for the RMB to take on at this stage? The entrenchment of the USD is well-documented. Commodity production tends to be dominated by a few players, and the product is relatively homogenous, despite the existence of sizable regional variations. Both factors support the existence of a single vehicle currency to maximise pricing transparency and minimise transaction costs.

Even so, the structure does not preclude the use of multiple currencies. And China's influence may be large enough to allow the RMB to play a more prominent role in the coming years.

Producer and consumer

However, first, we need to look at the fundamental reasons behind the USD's current dominance, and ask whether the RMB can in fact match that to some degree. Take oil as an example. The USD's ubiquitousness in the commodity market is rooted in the status of the US as the first oil producer – the first oil well was drilled in Titusville, Pennsylvania – and the largest producer until 1950 (*Eichengreen, Chitu*, 2014). And even after US production was overtaken by the Middle East, the country remains central to the production and consumption of oil. This is the economic fundamental that underlies the so-called 'petro-dollar' flows. Similarly, the size of the US market meant that it remained a large (if not the largest)

Table 1. Commodity production and consumption ranking

	China	US
Oil		
– Production	4	2
– Consumption	3	2
Natural gas		
– Production	1	2
– Consumption	1	2
Coal		
– Production	1	2
– Consumption	1	2
Copper		
– Production	2	4
– Consumption	9	2
Iron ore		
– Production	1	8
– Consumption	1	na

Source: Energy Information Agency, US Geological Survey, HSBC

consumer of various commodities for many decades. This gave rise to deep and complex political ties between the US and the Middle East that perpetuated the USD's dominance.

However, as Chart 2 and 3 shows, China's share of production and consumption rivals, if not surpasses, the US in many cases. China's production and consumption of minerals, such as coal, copper and iron ore, amount to a significant portion of world demand. For two key energy sources, oil and natural gas, the US is still a larger producer, as well as consumer (some sources suggest it is simultaneously the world's largest producer as well as consumer). China, however, is close behind (Table 1). These figures suggest that, as far as economic fundamentals go, the RMB is rather significantly under-represented in commodity settlement and has plenty of room to increase its presence, in our view.

Network effect

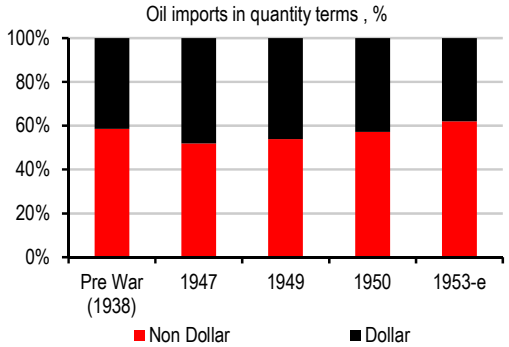
What about the so called 'coalescing' effect or, in economic jargon, the 'network effect' (*Krugman*, 1980)? This theory suggests that once the practice of using USD to price, invoice and settle commodity trade becomes sufficiently widespread, it is self-reinforcing as it becomes more difficult for an individual to switch. This is particularly the case once we add in financial exchanges, where trading in commodity-related financial derivatives are many times larger than physical turnover.

Granted, this is indeed an important factor to consider; however, the so called 'network' is not as strong as to preclude a multi-currency structure. Oil is again a good example. As *Eichengreen* (2014) noted, throughout a long period oil was invoiced and settled in more than one currency. Chart 4 and 5 offer a snapshot of invoicing currencies for oil in pre-war and post-war Europe. This was during a period of rising USD strength, when, due to the political considerations of extracting more aid from the Marshall Plan, incentives were skewed toward over-reporting rather than under-reporting USD usage. Even so, there is still a significant share for non-USD currencies, mostly GBP. And at least some of that non-USD usage was rooted in practical economic needs, for example, to pay for non-USD imports.

These historical examples suggest that even for a relatively homogenous product, such as oil, equilibrium can exist in a multi-currency structure. Network costs may be high but not enough to preclude the use of other currencies, especially in the face of sizable and direct trading relationships.

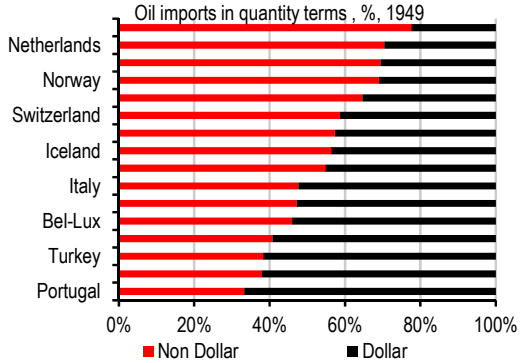
And what is true for pre- and post-war Europe may be true for China, if not many other energy importers (or even exporters) today. If a substantial amount of a commodity exporter's

Chart 4. Oil used to be invoiced in multiple currencies



Source: Economic Cooperation Administration, 1949, Eichengreen (2014), HSBC

Chart 5. And non-USD usage was high in Europe



Source: Economic Cooperation Administration, 1949, Eichengreen (2014), HSBC

own imports are from China, then it may make economic sense to allow RMB settlement, which can be used to pay for imports. This can bring economic benefit to China as importers avoid currency risks but also to the exporters if Chinese importers pass on some of this benefit. Given China's sizable and still expanding trade networks (see Chapter 1), it is certainly possible to foresee such an arrangement being made in the future.

Low-hanging fruit

In fact, some micro-level evidence suggests that China's trade relationships may have already progressed far enough to allow this to happen in some areas. A survey commissioned by the Centre for International Finance and Regulation (CIFR) that looks into Australian and Chinese firms brought up some interesting results. For example, 70% of the firms surveyed said they were waiting for the other side to take the initiative. A fair share of this group of companies in the 'waiting game' indicated they would give it a try if the partner made such a demand or if the Chinese government made such a push.

The CFIR survey raised similar points from the survey conducted by HSBC, which we looked at in more details in the first chapter. Awareness and regulatory clarity are seen as the two biggest potential enablers of more RMB usage.

And this matters particularly for the commodity market because of the difference in bargaining power between sellers and buyers. Despite China's overall large influence on the commodity market, its demand is often seen as price inelastic, and buyers are scattered across the country. Meanwhile, the supply side of the commodity market is relatively concentrated. This will put buyers at a perceived as well as actual disadvantage relative to sellers on both information and services.

In fact, the survey suggests that awareness is quite low amongst smaller Chinese companies (as opposed to large state-owned enterprises). Meanwhile, awareness of hedging options has increased over the past few years but can still be better.

A platform for the dissemination of information and regulation may be key to helping the RMB gain a foothold in the commodity market. Smaller firms are also less able to dedicate resources to understanding the fast-changing regulations; therefore, industrial specific guidelines may be needed.

RMB-denominated financial exchanges

Lastly, it is worth mentioning the progress on financial infrastructure. In Chapter 1, we discussed at some length the importance of liquidity, depth, and investment choices to trade settlement. Most of the theoretical and empirical discussions will be applicable to commodities. Here we want to take a quick look at how China is initiating some of the changes.

The launch of the international trading board at the Shanghai Gold Exchange (SGE) inside the Free Trade Zone (FTZ) is one such step. The FTZ is an 'onshore offshore' centre that serves as a test ground for financial reforms. The SGE international board will serve as China's 'onshore offshore' gold trading centre where gold will be traded with offshore RMB. Real gold imports into the onshore market will still be subject to the existing quota system. However, test-driving the RMB settlement for gold will at least build up knowledge and in some cases usage of the RMB by foreign gold producers and traders. Given China's large gold demand, this creates another important future usage of the offshore RMB.

In addition, the Hong Kong Stock Exchange (HKEx) has launched base metal mini future contracts in the RMB to provide more convenient

metals trading for Chinese corporates with less currency risk. Although the RMB does not have a benchmark setting function, as prices are still based on LME prices, it is another push to widen the usage of the RMB.

A more prominent role

Therefore, we have seen that despite China's strong influence on the commodity markets, the RMB is significantly under-represented in commodity settlement. We believe this will change in the coming years.

From a fundamental perspective, China's significant role as the largest producer as well as consumer of many key commodities should justify more RMB usage. Despite significant network effort, mutual economic benefit will allow some commodity exporters to make the switch. And surveys suggest that better education and clearer regulations will help facilitate the process.

HSBC

Crossing channels

- Two-way cross-border capital flows are the 'new normal' as more channels open and the RMB approaches fair value
- The current account surplus will be recycled by private sector capital outflows as reserve accumulation ceases
- The RMB will become more market-determined and volatile

For a long time, the large capital flows making their way past official controls into China to take advantage of growth, interest rate and exchange rate differentials were a major concern for policymakers. That situation has changed. China's growth is slowing and facing downside risks. The RMB is approaching fair value and is under depreciation pressure versus a strengthening USD; US interest rates will likely start normalising this year and capital controls are easing.

Although capital outflows are now large enough to require a drawdown in FX reserves, policymakers do not appear to be worried. They believe **larger, more volatile and two-way capital flows are the 'new normal' for China.** This characterisation is, in fact, normal for any economy with an open capital account, something Beijing is moving towards in measured steps.

Furthermore, for an economy like China that runs a current account surplus (albeit a shrinking one), capital outflows are necessary to create a balance of payments (BoP) equilibrium. This is particularly true since the PBoC said it will not seek to accumulate more FX reserves.

China's FX reserve policy has changed completely since the middle of 2014. Policymakers now acknowledge the costs associated with the further accumulation of reserves and are concerned about the imbalanced structure of China's external balance sheet. The pledge to cease FX reserve accumulation is linked to three other commitments: 1) a market-determined RMB; 2) a more consumption-driven growth model; and 3) further capital account liberalisation.

It is no surprise then that the number of channels for cross-border capital flows is increasing. Policymakers are now focusing on promoting ODI and bank lending abroad. Market access to foreigners has also been widening. Foreign banks, corporates and portfolio investors also drive China's capital flows today, not just Chinese banks and corporates.

What are the implications for the RMB? First, we believe **the RMB could stay under depreciation pressure in H1 2015** on the back of broad USD strength and capital outflows. Second, higher volatility in capital flows will likely translate into **higher volatility in the RMB.** Third, **FX reforms are only a matter of time** – we expect China will widen the trading band and/or change the fixing methodology in the near future.

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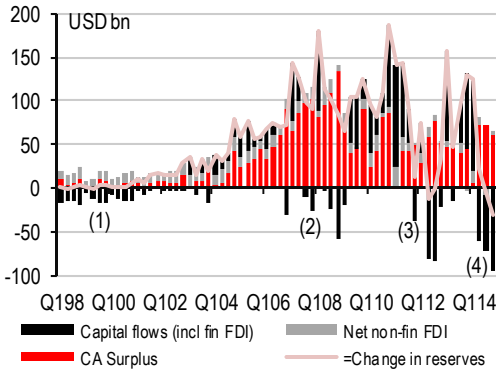
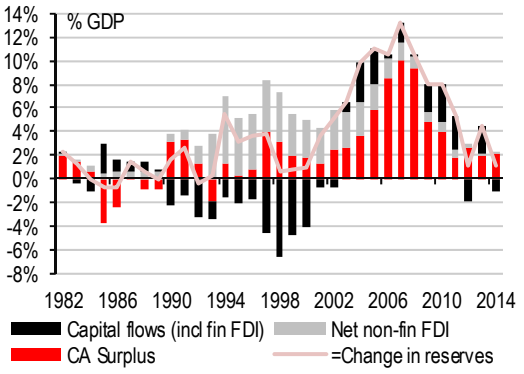
1. Four episodes of capital flight since 1998 but never large enough to offset C/A and FDI inflows, until recently



Notes: We use MOFCOM's non-financial FDI series, and assume that the difference between that and the FDI data in the BoP reflects financial FDI.
Source: MOFCOM, SAFE, CEIC, HSBC

2. But capital outflows today, scaled by GDP, are in fact not as large as those seen in the 1990s



Notes: See footnotes for Chart 1 for information on non-financial FDI.

Source: MOFCOM, SAFE, CEIC, HSBC

Capital outflows are normal

China has seen outflows of 'volatile capital' since Q2 2014. We define volatile capital flows[2] here as portfolio flows, bank flows (financial FDI, loans and deposits), inter-company flows and other, such as arbitraging flows (e.g. "errors and omissions" in the BoP).

We estimate China recorded USD220bn of such outflows in Q2-Q4 2014. This is slightly higher than the sum of the current account surplus and net non-financial FDI ("core surplus"). As such, **the central bank had to draw down a small amount of FX reserves** (USD30bn in H2 2014) to accommodate these flows (Chart 1).

Non-FDI financial flows are volatile by nature, and even China, with a relatively closed capital account, has experienced about **four episodes of capital outflows since 1998.** However, the only other time capital outflows outweighed the core surplus was in Q2-Q3 2012, when reserves dropped by USD12bn.

Policymakers do not appear particularly worried by the recent bout of capital outflows. On 15 February 2015, SAFE commented that the outflows were "normal", "moderate" and "acceptable" (see *SAFE: Report on cross-border capital flows in 2014* (in Chinese), 15 February 2015). Let's look at these comments in more detail.

1. Normal: Since the middle of 2014, SAFE's comments have indicated an increasing desire to cease reserve accumulation. Given China's persistent core surplus, this must mean that **private sector capital outflows meet the conditions of BoP equilibrium.**

Moreover, the recent capital outflows follow a period between Q1 2013 and Q1 2014, when China saw outflows of USD330bn (Chart 1). SAFE considers the **"pendulum effect" in volatile capital flows normal.**

Amid global instability and uncertainty, and against the backdrop of economic and financial liberalisation in China, SAFE has characterised

[2]There are various ways to estimate these flows, such as quarterly BoP data, or using SAFE's monthly FX sales and purchase data (see Wang Xiaoyi, SAFE, "Cross-border capital flows statistics and its implication for monitoring in China", paper presented at First IMF Statistical Forum, November 2013). Our monthly "hot money" flows estimate is a variant as well (see Q3 in *RMB Q&A, February 2015*). To get the longest time series (from 1982), we use China's BoP data and derive capital flows by the World Bank's "residual" method, i.e. subtracting the current account surplus and net non-financial FDI flows from the BoP overall balance (i.e. increase in FX reserves). We use MOFCOM's non-financial FDI data and assume the excess of net FDI in the BoP over that series is non-financial FDI.

"bi-directionality" of cross-border capital flows and movements in the RMB as the 'new normal'.

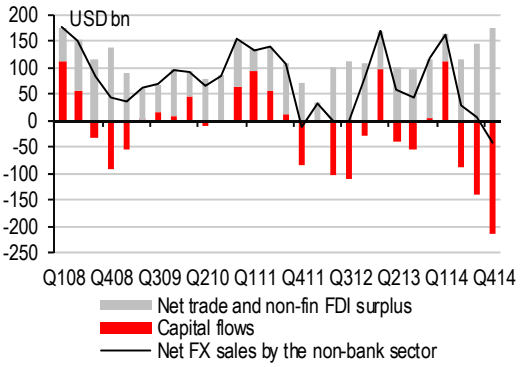
2. Moderate: While the nominal amount of the recent capital outflows appears large by historical standards, when scaled by GDP it is quite modest (Chart 2). By this measure, **capital flight was much greater in the 1990s**, amid China's banking crisis and the Asian financial crisis.

SAFE has established a system to evaluate risk levels in the FX market (see SAFE paper, footnote 1). There are three main categories: "in balance" (FX purchases balanced by sales), "inflow risk" (net FX sales) and "outflow risk" (net FX purchases). For the latter two categories, there are four levels of risk: "attention required", "mild", "medium" and "high".

The non-bank sector has become a net buyer of foreign currency since September 2014 (Chart 3). However, it appears that the current level of outflows has not reached the "high" risk category. SAFE last took measures to reduce the risks associated with capital inflows (a "medium" risk) in mid-2013, when it linked banks' FX loan-to-deposit ratios to their net FX open positions. Those measures were unwound on 2 January 2015.

3. Acceptable: The current episode of capital flight can be categorised into four types of

3. The non-bank sector became a small net buyer of FX



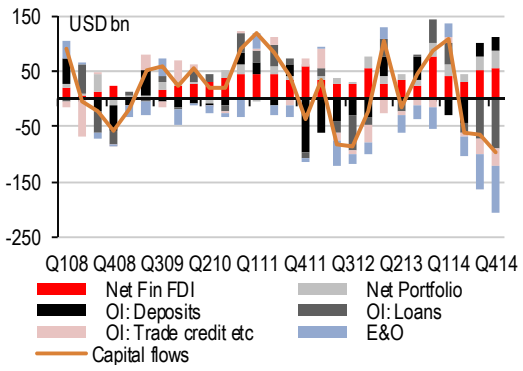
Notes: See footnote in Chart 1 for information on non-financial FDI.
Source: MOFCOM, SAFE, CEIC, HSBC

outflows (Chart 4; see Question 3 in *RMB Q&A, February 2015*): 1) Chinese banks and corporates increasing cross-border loans and trade finance overseas; 2) Chinese residents and corporates accumulating FX deposits; 3) USD buying hedging flows by corporates; and 4) net repayment of external debt by Chinese corporates.

This is somewhat different from the capital flight seen during the Asian Financial Crisis in the late 1990s (Chart 5). At that time, China saw relatively more portfolio outflows, trade credit outflows and unexplained outflows ("errors and omissions").

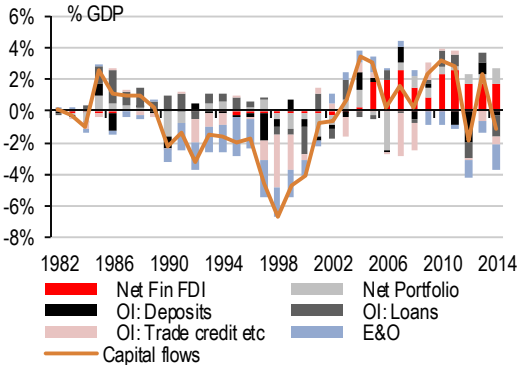
The outflows today are regarded by SAFE as somewhat positive developments, and, therefore, deemed "acceptable" (see *SAFE: FX receipts and*

4. Anatomy of capital flight today: external debt repayment, loans and trade credit to abroad, and "errors and omissions"



Notes: See footnote in Chart 1 for information on net financial FDI. Some of the breakdown in the financial account for Q4 2014 is based on our estimates.
Source: MOFCOM, SAFE, CEIC, HSBC

5. Capital flight in 1990s was due largely to trade credit abroad and "errors and omissions"



Notes: See footnote in Chart 1 for information on net financial FDI. Some of the breakdown in the financial account for Q4 2014 is based on our estimates.
Source: MOFCOM, SAFE, CEIC, HSBC

payments during the first three quarters of 2014 – Press conference transcript, 26 November 2014).

Cross-border lending-related outflows are a direct consequence of the broader policy push for Chinese banks and corporates to "go abroad". SAFE sees the accumulation of FX deposits as being in line with the policy of "foreign exchange held by the people." Corporate FX hedging has been strongly advocated by SAFE. Finally, the repayment of external debt is seen as favourable for reducing financial risks (Chart 6; see Question 4 in *RMB Q&A, February 2015*).

SAFE also noted that volatile capital flows are largely caused by interest rate arbitrage activities by Chinese residents and corporates. This is different from volatile capital flows in other countries, where they are more likely due to asset and currency speculation by financial market participants. **SAFE regards arbitrage activities by residents as being relatively safer than speculative activities.**

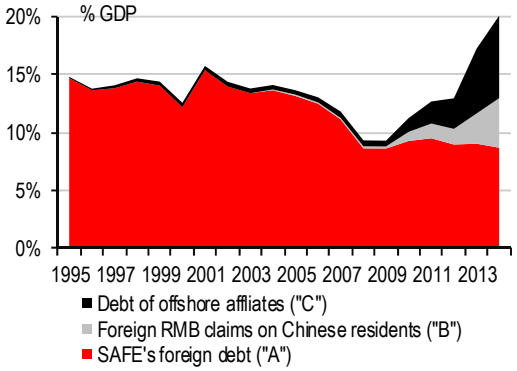
The U-turn in FX policy

The pledge by policymakers to balance the BoP without increasing FX reserves is a significant turning point for China's FX policy. The accumulation of FX reserves started in earnest in 2001 (Chart 2). This U-turn in policy was made clear by SAFE in 2014 (see *SAFE report on Operation and management of China's FX reserves*, 7 July 2014). We summarise the main points below.

SAFE explained that in the past the accumulation of FX reserves had helped buffer the economy from external financial crises and monetary policy spill-overs (capital inflows from QE policies abroad), as well as give confidence to foreign investors.

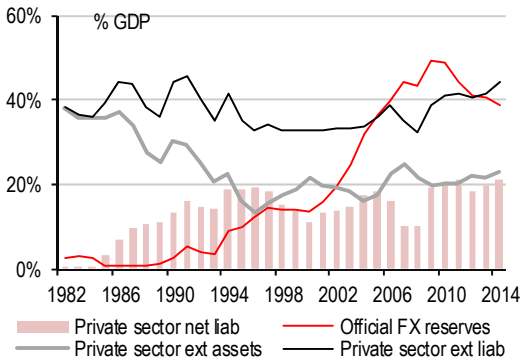
However, the benefits came with costs, including **restrictions on monetary policy, an asset-liability mismatch in the central bank's balance sheet and operational and profitability challenges in managing a large investment fund.** Given the

6. China's "broad" external debt is at an unprecedented high today



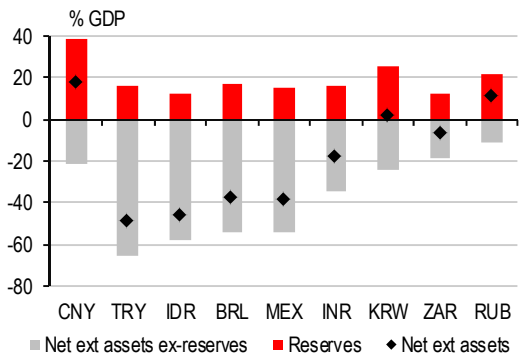
Note: A+B = IMF definition of external debt; A+B+C = "Broad" external debt.
Source: SAFE, BIS, CEIC, HSBC

7. China is a mature net debtor from the perspective of the private sector



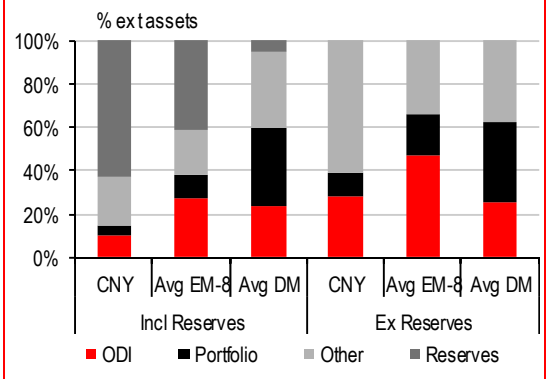
Note: SAFE's IIP data start from 2004. We estimate China's IIP in 1982-2003 using BoP data.
Source: SAFE, CEIC, HSBC

8. EM economies tend to have net external liabilities (excluding reserve assets)



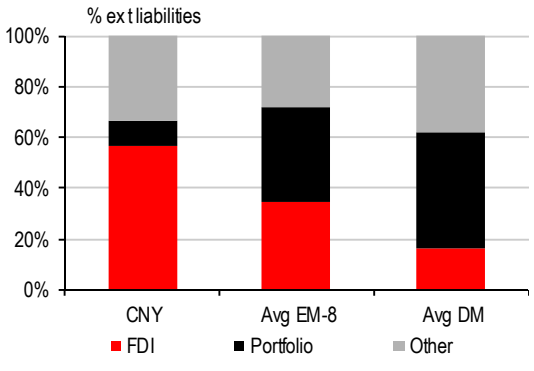
Note: We use the latest data available, mostly as of June or September 2014
Source: CEIC, HSBC

9. Structural imbalance in China's external asset holdings



Note: We use the latest data available, mostly as of June or September 2014. The 8 EM economies are those plotted in Chart 8. The DM countries are Australia, Canada, Eurozone, Japan, UK and the US.
Source: CEIC, HSBC

10. Structural imbalance in China's external liabilities



Note: We use the latest data available, mostly as of June or September 2014. The 8 EM economies are those plotted in Chart 8. The DM countries are Australia, Canada, Eurozone, Japan, UK and the US.
Source: CEIC, HSBC

large size of the reserves today, rising costs have now exceeded the diminishing benefits.

Restructuring the external balance sheet

There is also a more fundamental reason for this policy change. **SAFE noted that China has a mismatch in its external assets and liabilities.** China's international investment position (IIP) shows that it has only recently become an overall net creditor. China has been a net debtor in the private sector for some time (Chart 7).

In our view, the fact that China's private sector has more external liabilities than assets is not particularly worrying. Many EM economies have that kind of net external liability position (Chart 8), because they have stronger growth rates and higher returns on investment than advanced economies, therefore, attracting foreign capital inflows.

For China, the mismatch and imbalance lies in the *composition* of those external assets and liabilities (Chart 9). Compared to other EM economies, China's reserve accumulation is excessive. Excluding reserves, China's external assets are skewed towards 'other investments' (mostly FX deposits and trade credits). In other words, China has too little ODI and portfolio assets. **The hoarding of external assets by the public sector and the small amount of ODI and portfolio assets held by residents and corporates can be seen as a form of 'financial repression'.**

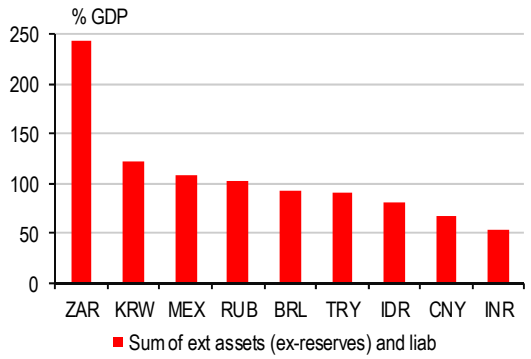
China's liabilities are also skewed, towards FDI, and its portfolio liabilities are small compared to other EM economies (Chart 10). **While FDI flows are more stable than debt flows, they are also more expensive to service.** As a result, China has a large investment income deficit – it paid about USD240bn in investment dividends in 2014, compared to USD200bn of earnings received on its external assets.

When comparing China's IIP with other EM economies, it is striking that China's gross assets (excluding reserves, as a percentage of GDP) and liabilities are small. This reflects the more stringent capital and investment controls China has compared to other EM economies (Chart 11). **China is among the world's least financially open economies.**

Sources of disequilibrium

We have explained *why* China policymakers now want to strive for BoP equilibrium. To understand

11. China is among the least financially open EM economies



Note: We use the latest data available, mostly as of June or September 2014. Given that reserve accumulation is a result of capital account controls, we need to exclude it in the calculation of external assets to get a measure of financial openness.
Source: CEIC, HSBC

how they can achieve their goal, we first need to know the sources of the disequilibrium.

Between 2001 and 2013, China accumulated USD3.7trn of FX reserves. **The reserves absorbed USD2.3trn of cumulative current account surplus and USD600bn of net non-financial FDI inflows** (Chart 12). The residual USD800bn reflects cumulative capital inflows, which largely comprise net financial FDI. Net portfolio inflows played a relatively smaller role in the disequilibrium. Flows in deposits, loans and trade credit have been roughly balanced (Chart 13).

One goal, three commitments

The commitment to cease FX reserve accumulation is in line with achieving three things:

1) **Allowing the RMB to become more market-driven.** The PBoC was previously the one to balance demand and supply of foreign exchange in China. Its exit from the market means the RMB exchange rate will need to be flexible so as to clear the FX market.

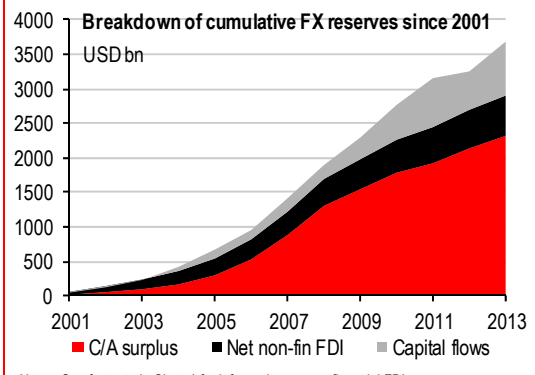
2) **Structural changes to transform the economic development model** – i.e. become less export and investment reliant, and instead boost consumption. This will likely reduce the goods trade surplus and widen the services trade deficit (higher incomes should raise the tourism deficit).

Reforms to the growth model involve industrial policy to direct resources into the 'new economy' (for example, IT services), and fiscal policy to improve the health and social safety net and, therefore, reduce excess precautionary savings (see *China Economic Spotlight: Rebalancing – a dangerous obsession*, 25 June 2014, by Qu Hongbin and John Zhu).

RMB undervaluation in the past had helped to subsidise the export sector. This undervaluation is now being eliminated, which should help economic rebalancing.

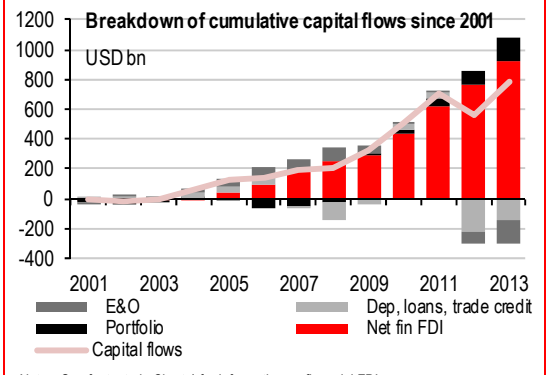
3) **Capital account liberalisation** (relaxing cross-border capital and investment controls). If the PBoC is no longer going to absorb excess inflows,

12. China's FX reserve accumulation over 2001-13 was largely to absorb the current account surplus



Notes: See footnote in Chart 1 for information on non-financial FDI.
Source: MOFCOM, SAFE, CEIC, HSBC

13. Capital inflows over 2001-13 were also a source of BoP disequilibrium



Notes: See footnote in Chart 1 for information on financial FDI.
Source: MOFCOM, SAFE, CEIC, HSBC

then it must open up more channels for private sector capital outflows.

With regards to direct investments, China has **historically had a bias to encourage FDI over ODI.** However, **this policy is undergoing a major shift, with senior leaders now aggressively urging companies to go abroad** (Chart 14). Infrastructure investments in Asia and Europe as envisioned in the New Silk Road "One Belt, One Road" plan will be a key feature of the ODI push (see Chapter 4).

On portfolio investments, **policymakers have always taken more of a two-way approach with various 'Q' schemes.** QFII (permitting foreign inflows) was launched in June 2003 and QDII (permitting local outflows) followed in December 2004. The increase in approved investment funds for QDII historically exceeded that for QFII until late 2011, when the latter gained more momentum and RQFII was launched (Chart 15)

The Shanghai-Hong Kong Stock Connect scheme was launched in November 2014, with little bias between inflows and outflows. The quota for inflows (RMB300bn) is only slightly larger than that for outflows (RMB250bn). A Shenzhen-Hong Kong Stock Connect is now under discussion (see Question 7 in *RMB Q&A, February 2015*).

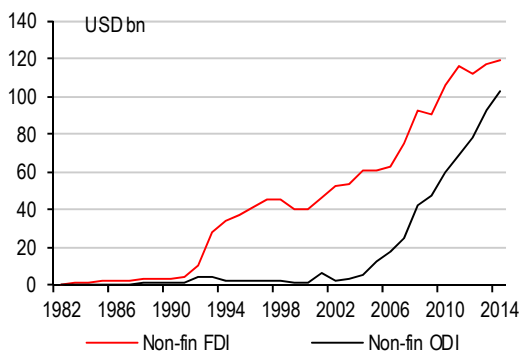
Although policymakers have not shown a preference for flows in one particular direction, the reality is that actual outflows have been much smaller (apart from a large one-off outflow in 2005, Chart 16).

This is because **overseas investment has not proved particularly profitable in the past,** amid steady RMB appreciation, a large domestic versus global growth differential, and low interest rates in major G10 markets.

This set of conditions is likely to change significantly. **The RMB depreciated modestly in 2014 and is likely to do so again in 2015.** We believe the RMB is no longer undervalued and, therefore, will exhibit more two-way volatility, more so if authorities are willing to implement key FX reforms, such as making the USD-CNY fixing mechanism more market-oriented and transparent, and widening the daily trading band. In any case, with deepening liquidity in the unregulated offshore CNH market, we believe the **RMB exchange rate will be more volatile.**

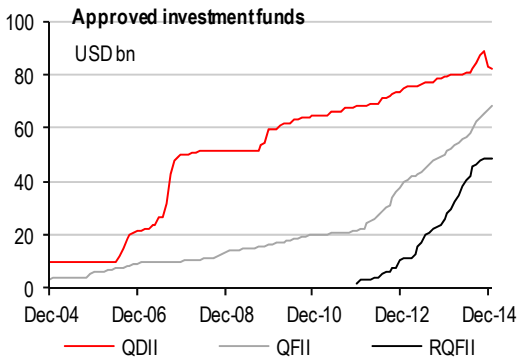
Moreover, HSBC's economists believe that the **central bank will lower interest rates and that China's growth will slow further.** Meanwhile, the US economy is recovering and US interest rates are likely to start rising later this year. Given all these developments, **local interest in overseas investment is likely to pick up.**

14. Non-financial ODI only started picking up in 2005



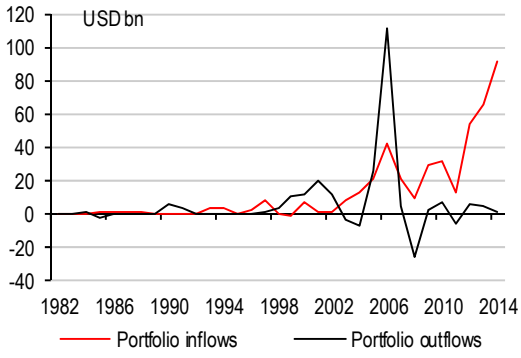
Notes: See footnote in Chart 1 for information on financial FDI.
Source: MOFCOM, SAFE, CEIC, HSBC

15. Policymakers not biased towards encouraging portfolio inflows over outflows



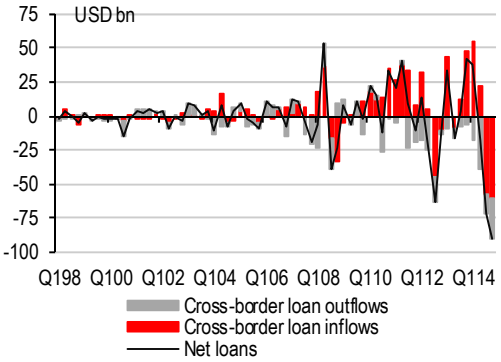
Source: MOFCOM, SAFE, CEIC, HSBC

16. But actual portfolio outflows have, nevertheless, been much smaller than inflows



Source: SAFE, CEIC, HSBC

17. Chinese banks are going abroad



Notes: Negative cross-border loan inflows reflect a repayment of debt. Q4 2014 data are based on our estimates.
Source: MOFCOM, SAFE, CEIC, HSBC

Banking flows (financial FDI and loans): China has seen a surge in net financial FDI since 2005 (Chart 5). **Global banks have been investing in China to position for 'big-bang' financial reforms.** Chinese policymakers have indeed been opening up market access to foreign financial institutions, for example, most recently allowing them to participate in the inter-bank FX market.

Cross-border bank loans were quite balanced until 2010-11, when there were larger inflows from abroad amid strong RMB appreciation expectations. However, this has completely turned around recently – in 2014, China saw around USD140bn of net cross-border loan outflows (Chart 17). **Banks are now being encouraged to go abroad to seek new avenues of growth, both for themselves and to support Chinese companies' overseas expansion.**

Inter-company flows: Policymakers have recently **simplified administrative procedures and expanded channels for companies wanting to transfer capital both in and out of China.** For example, on 5 November 2014, the PBoC expanded the intragroup cross-border RMB cash concentration scheme in the Shanghai Free Trade Zone to the rest of the country. This scheme will give multinationals an incentive to choose China as their regional treasury centre.

It will reduce the cost of financing for China-based companies, as they can now raise potentially cheaper funding abroad and bring the capital onshore. At the same time, liberalising cross-border company outflows will alleviate the historical problem of 'trapped cash' faced by foreign multinationals in China, and also help Chinese multinationals fund their overseas expansion.

Personal FX flows: The policy of "foreign exchange held by the people" is being promoted. We believe the personal remittance and **FX exchange limits will be raised or lifted entirely in the near future.** It will also become easier for Chinese residents to legitimately buy real estate overseas. Such outflows are probably already occurring, and being captured in "errors and omissions", which have become larger over the years (Chart 18).

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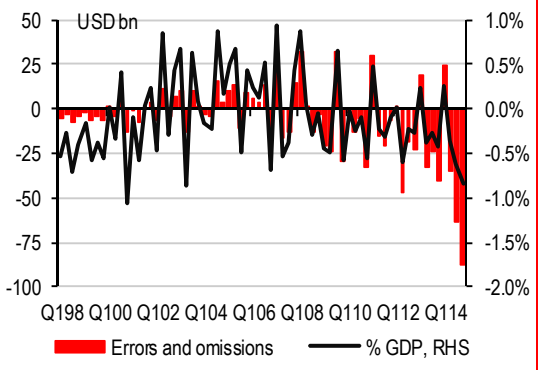
18. "Errors and omissions" have become more persistently negative and larger over the years



Note: Q4 2014 data are based on our estimates.
Source: SAFE, CEIC, HSBC

RMB-denominated capital flows

Policymakers are likely to **encourage these capital flows to be RMB-denominated to reduce hedging costs, FX mismatches and financial risks.** Trade settlement in RMB will likely rise further (see Chapter 1), outward direct investment will increasingly be funded in RMB, and more RMB bonds will be issued abroad. Cross-border RMB loans will also pick up as interest rates fall in China and rise abroad. We believe **RMB internationalisation will progress hand-in-hand with capital account liberalisation.**

'Balanced amid oscillations'

Even with these three commitments, China is likely to struggle to achieve BoP equilibrium quickly, in our view. It will take time for economic and financial reforms to gain traction. Even for fairly advanced economies, such as Singapore and Korea, with fairly liberalised capital accounts, their central banks are still recycling about 20-30% of the core surplus.

We believe **private sector capital outflows will be a frequent occurrence during the period of adjustment.** Researchers at the International Monetary Fund (IMF), Hong Kong Monetary Authority (HKMA) and Bank of England (BoE) have a similar view[3]. However, these outflows will likely gradually become smaller over time as the core balance shrinks.

Eventually, when reforms are successful, both the core balance and capital flows will fluctuate between inflows and outflows. Therefore, SAFE's comment about capital flows becoming "basically balanced amid oscillations."

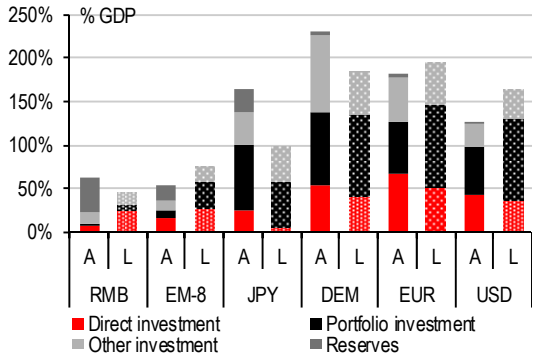
Capital outflows are basically an accumulation of external assets. Over the next few years, China will likely see a build-up of private sector external assets in its IIP, particularly ODI assets. Meanwhile, FX reserves are likely to be roughly stable from a nominal perspective, and fall as a share of GDP. As such, **the composition of external assets will eventually become more balanced and less skewed towards public hoarding of assets.**

We believe this does not necessarily mean China's current net external asset position will in future become even larger. Capital account **liberalisation will lead to China's gross external assets and liabilities *both* becoming larger.** We believe China will continue to welcome foreign investment but will seek a more cost-efficient balance of equity (FDI) and debt (bonds and loans). And if the RMB continues to gain traction as a reserve currency, China's portfolio liabilities will rise significantly.

Ultimately, we believe **China should aspire to a more balanced IIP structure, as in Europe and the US, rather than seek to maintain a large net external asset position like Japan**, Germany

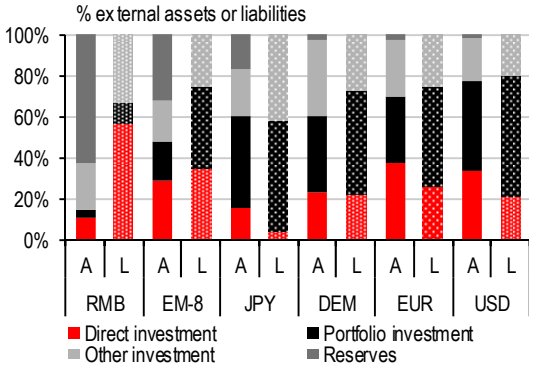
[3] See Tamin Bayoumi and Franziska Ohnsorge, "Do inflows or outflows dominate? Global implications of capital account liberalisation in China", IMF Working Paper 13/189, August 2013. Also see John Hooley, "Bringing down the great wall? Global implications of capital account liberalisation in China", Bank of England Quarterly Bulletin 2013 Q4. And see Dong He et. al., "How would capital account liberalisation affect China's capital flows and the RMB real exchange rate?", Hong Kong Institute for Monetary Research Working Paper No. 09, April 2012.

19. International investment positions of major advanced economies



Note: We use the latest data available, mostly as of June or September 2014. The 8 EM economies are those plotted in Chart 8. DEM stands for Germany and EUR stands for Euro-area, including Germany; A stands for IIP assets and L stands for IIP liability.
Source: CEIC, HSBC

20. China should aspire to a more balanced IIP structure, as in Europe and the US



Note: We use the latest data available, mostly as of June or September 2014. The 8 EM economies are those plotted in Chart 8. DEM stands for Germany and EUR stands for Euro-area, including Germany; A stands for IIP assets and L stands for IIP liability.
Source: CEIC, HSBC

and Switzerland (Charts 19-20). After all, China's economy is too large to run a persistent external surplus, creating imbalances in the rest of the world. Furthermore, being a large external creditor need not be advantageous. In times of market dislocation, for example, a large net external surplus will encourage significant 'safe haven' inflows, which could create challenges for domestic monetary policy.

Impact on the RMB

The evolution of capital flows has important implications for the RMB. **Large capital outflows have temporarily overwhelmed current account and net FDI inflows, thereby leading to RMB depreciation pressures. We believe this could persist for the rest of H1 2015**, given the excess amount of capital inflows from 2013 that still need to be reversed.

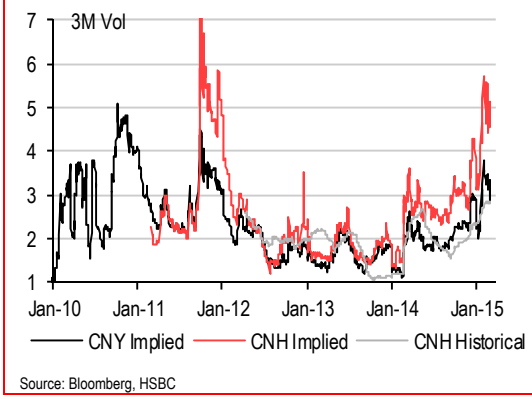
However, this does not necessarily mean the RMB will start to depreciate on a trend basis. Capital outflows could moderate in H2 2015 and the RMB may have room to appreciate again.

Capital flows are volatile and susceptible to 'pendulum effects'. This means that overshooting and undershooting of the RMB is likely to happen more often. As SAFE puts it, **bi-directionality of capital flows and the RMB exchange rate is the 'new normal'.**

The RMB will naturally become more volatile as its underlying flows – trade and capital flows – become more volatile (Chart 21). **Volatility will also rise on the back of FX reforms, which we think are only a matter of time.**

As explained earlier, if the central bank does not absorb excess supply or meet excess demand, then a flexible exchange rate will be needed to clear the FX market. We expect the central bank to widen the trading band and make the USD-CNY fixing mechanism more transparent and market-oriented in the near future.

21. RMB's volatility will likely rise



Source: Bloomberg, HSBC

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The New RMB Silk Road

- China's New Silk Road fund will ease connectivity bottlenecks through outward infrastructure investment
- This will help generate higher returns on China's large stock of foreign reserves
- More investment generates more trade and is another driver of the internationalisation of the RMB

Going out through investment

As a country running a current account surplus, mainly due to a large positive goods trade balance, China has been a net exporter of capital for a long time. However, data for 2014 show that foreign direct investment (FDI) into China grew by 1.7% y-o-y, whereas China's outward direct investment (ODI) grew by 10.9%. This trend has been evident for a number of years (Chart 1) and means China's ODI flows are likely to overtake what it receives in inward FDI, possibly as soon as this year.

This will be an important milestone. China has deliberately encouraged FDI inflows as a means of stimulating economic growth and transferring technology and best practices from abroad. This was a major part of its rapid growth in the decades since economic reforms started in the late 1970s.

We think the globalisation of China's direct investment capital flows will become an important factor behind the internationalisation of the RMB. Not only are outward flows growing steadily, but the proportion of those cross-border flows being settled in RMB has also increased rapidly in a short amount of time (Chart 2).

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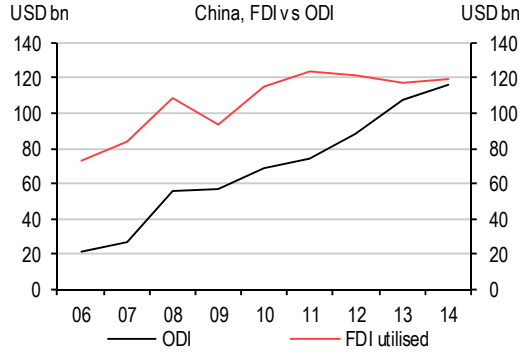
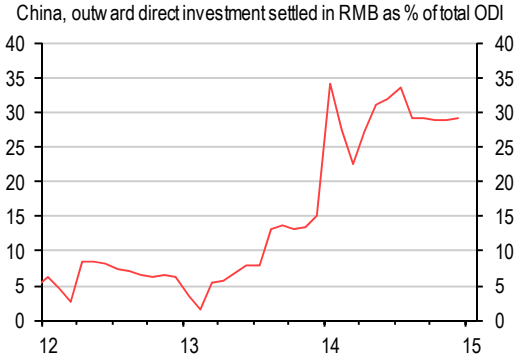
1. Outward direct investment flows to overtake FDI inflows



Source: Ministry of Commerce, HSBC

2. An increasing proportion is settled in RMB



Source: Ministry of Commerce, PBoC, HSBC

The New Silk Road

The growth in ODI is likely to be sustained through China's "One Belt, One Road" strategy. This was announced by President Xi Jinping in 2013, and envisions a New Silk Road in the spirit of the centuries-old trading routes, comprising a land-based economic belt and a maritime route. China will commit an initial USD40bn to invest in land and maritime 'Silk Roads' to Central Asia and Europe and South Asia.

The People's Bank of China, the central bank, has confirmed that the fund was operational as of the end of 2014 and will look for mainly equity investment in the fields of infrastructure, resource development, industrial and financial cooperation.

We estimate that Asia needs to invest USD11trn in urban infrastructure by 2030, so there should be more than enough projects to choose from (see *Building on China's overseas investment: Two birds, one stone*, 8 August 2014). The data also suggest that while less of China's investment is now funded by foreign capital, the reverse is true of other developing countries (Chart 3). China's share of world ODI is now 7.6%, up from less than 1% a decade ago. As countries develop and become richer, they tend to send more capital abroad – the US accounts for 24% of global ODI, or 2% of its GDP (China's ODI is 1% of GDP).

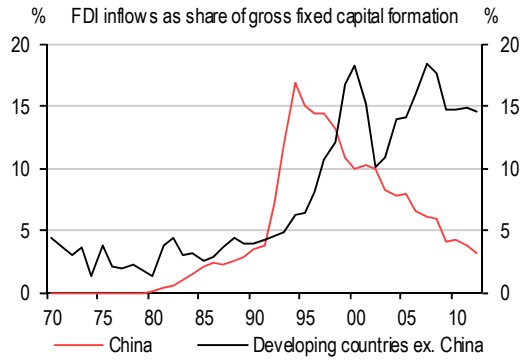
A RMB Marshall Plan?

Whenever a country commits large sums to fund investment in a short space of time, parallels are drawn with the US's European Recovery Programme after World War II, commonly known as the Marshall Plan. Although there are some superficial similarities between the New Silk Road and the Marshall Plan, a simplistic comparison does a disservice to both programmes.

The key difference is that China is offering investment, not aid. The Marshall Plan managed to reduce the 'dollar gap', where European countries' foreign currency earnings were insufficient to import American goods. Subsidising imports of food and other necessities through the Marshall Plan allowed more money to be used for reconstruction.

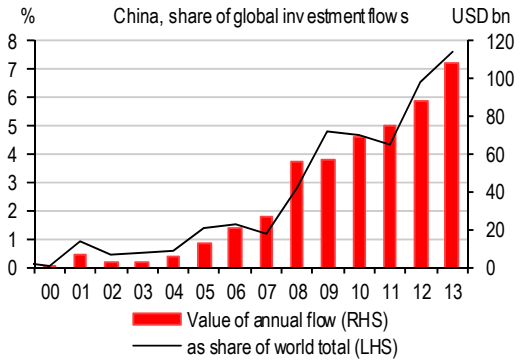
From a currency perspective, however, it is important to note that no foreign exchange transaction actually took place: the European imports were paid for in local currency, and American exporters were paid directly out of Marshall Plan funds. The New Silk Road plan's investments will necessarily involve greater use of China's currency. The global economy today is different to that of post-World War II Western Europe, and requires a different kind of plan.

3. China's need for FDI has declined – unlike other countries



Source: UN

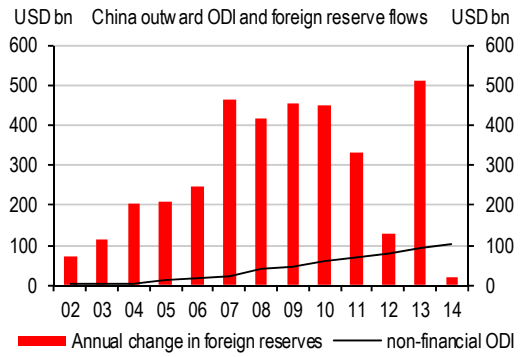
4. China accounts for a rising share of world ODI



Source: UN

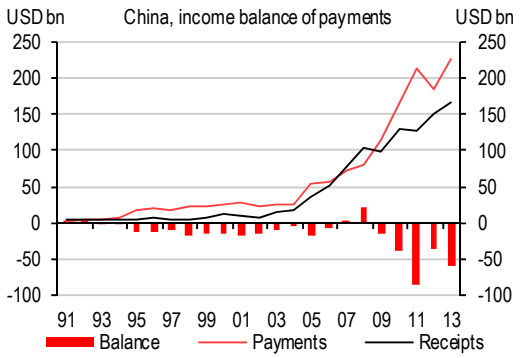
HSBC

5. China has plenty of reserves to fund direct investment



Source: SAFE, Ministry of Commerce, HSBC

6. China earns less from its foreign investment income



Source: SAFE, HSBC

Putting reserves to better use

China can afford to keep exporting capital abroad, given its large stock of foreign reserves, which totalled USD3.8trn at the end of 2014. The recent acceleration in China's ODI is just 2.7% of total reserves. Moreover, it was not until 2014 that the annual ODI outflow overtook the *increase* in the stock of reserves (Chart 5).

China's current account surplus has fallen from high single digits before the 2007-08 global financial crisis to around 2% of GDP currently. While the surplus is mainly due to China's positive balance in trade in goods, this has been partially offset by an increasing deficit in the income component of the current account. The deficit on its investment income part of the current account ran to USD60bn in 2013 (Chart 6). Basically, that means China pays out a larger and increasing amount to foreign investors in Chinese firms than Chinese firms are repatriating earnings back from abroad.

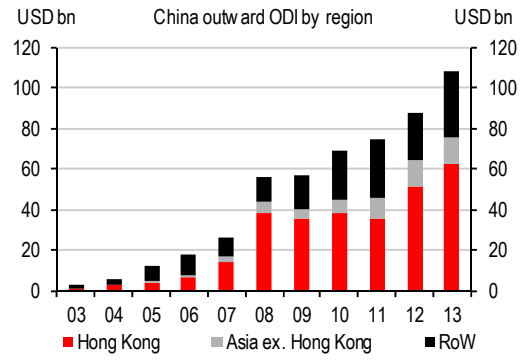
There is nothing necessarily bad in outflows of earnings. After all, they only come about because foreign investment has happened in the first place, bringing capital, employment, technology and all the other benefits of FDI inflows. The more interesting issue is on the credit side, i.e. could returns be better?

Investment begets trade

We think one way to boost those returns is through ODI. Currently, much of the current account surplus is recycled into low-yielding US treasuries. There are of course risks involved in moving away from the textbook 'safe' asset; however, there are also non-financial gains from outward investment. One of these is the likely increase in trade flows between China and the country receiving Chinese capital.

By definition, capital inflows must lead to trade deficits for the receiving country. The influx of money for investment increases demand, which must be met through an increase in imports. On balance, this is likely to be positive for Chinese exporters: Chinese ODI will create demand for China's exports, absorbing excess capacity and helping to sustain economic and employment growth domestically. We find that of the largest recipients of Chinese ODI, the share of Chinese imports in those countries' total imports has generally grown, meaning Chinese exporters tend to gain market share in those countries faster than on average (the exception being a number of European countries, probably due to EU trade barriers). And, as we have written in previous chapters, closer trading links with China is a natural driver of RMB usage.

7. The majority of China's ODI goes to Hong Kong and Asia



Source: Ministry of Commerce, HSBC

8. Top destinations for China's outward direct investment flows

China annual ODI flows, 2013	USDm	% of total ex. Hong Kong & tax havens	Cumulative %
US	3,873.4	12.4	12.4
Australia	3,458.0	11.1	23.4
Singapore	2,032.7	6.5	29.9
Indonesia	1,563.4	5.0	34.9
UK	1,419.6	4.5	39.5
Russia	1,022.3	3.3	42.8
Canada	1,008.7	3.2	46.0
Germany	910.8	2.9	48.9
Kazakhstan	811.5	2.6	51.5
Laos	781.5	2.5	54.0

Source: Ministry of Commerce, HSBC

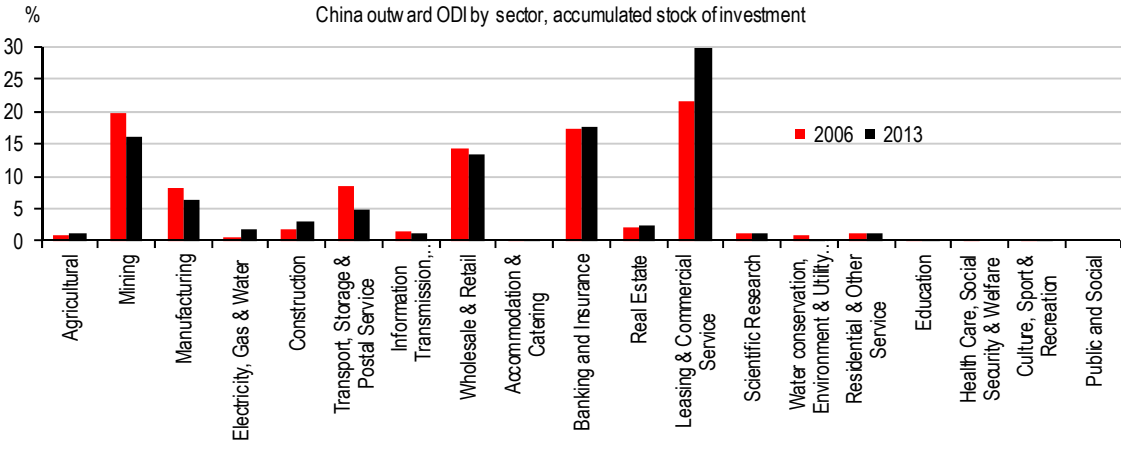
Where is it all going?

The vast majority of China's current and historic ODI flows go to Hong Kong. This has been concentrated in three industries, (leasing & commercial services, wholesale & retail and banking & insurance). Hong Kong's role as a gateway between China and the rest of the world for trade and financial flows makes it a natural hub for ODI specialising in cross-border flows. However, excluding Hong Kong and tax havens, the pattern of China's ODI is actually relatively diverse. For instance, some of the top receiving countries include those with natural resources, such as Australia, but also other mixed economies, such as such the US and the UK.

As China's ODI grows and matures, it is likely to become more diversified sectorally, as well as geographically. Right now, the results are possibly skewed by particular destinations, such as Hong Kong. It is worth keeping an eye on where along the value chain a sector is – suppliers paying costs in RMB are more likely to accept payment in RMB as well.

Finally, the key point is that the globalisation of China's capital is only beginning. The economic logic for China and a global economy starved of capital in recent years is not in doubt and will sustain the RMB's internationalisation.

9. China's accumulated ODI has been concentrated in a few sectors so far



Source: Ministry of Commerce, HSBC

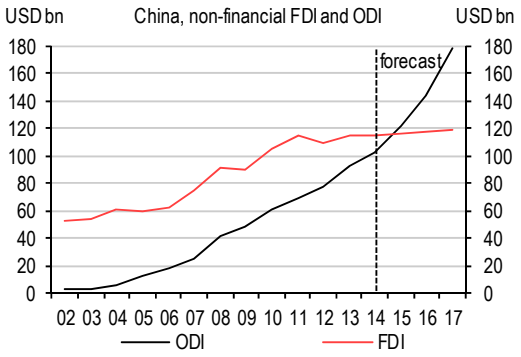
Will it last?

China's ODI delivers a two-sided gain. China benefits from better returns on its reserves and greater demand for its exports. The additional funding from the New Silk Road of USD40bn is 39% of China's ODI in 2014. Of course, not all of it will be deployed immediately. Even so, with ODI likely to keep growing at double-digit rates in the next few years, the additional boost from the New Silk Road fund means China's annual ODI flows are likely to reach USD180bn in the next three years (Chart 10).

There should be enough growth in demand for this kind of capital to absorb that amount. Economists generally accept that of the different types of international capital (bank loans, portfolio investment and direct investment), FDI is the safest and most helpful for development. Viewed from the investor's perspective, ODI requires more due diligence since they share more of the financial risks – the returns depend more on each project's profit stream instead of fixed interest payments.

Indeed, the attractiveness of cross-border direct equity investment from the receiving country's point of view is precisely this – that the risks are shared and that it is less easily withdrawn than bank lending or portfolio investment. FDI also brings technical knowledge, managerial expertise, contacts and connections to other suppliers and partners. It also creates a virtuous cycle: as receiving countries grow richer, their legal and financial systems become more robust. Stronger legal institutions lower the risks to foreign investor (and should lower the cost of the investment). And a deeper domestic financial system will naturally reduce the need for firms to borrow across borders. It is, therefore, reasonable to expect the mix of international investment to shift towards direct investment in the near future.

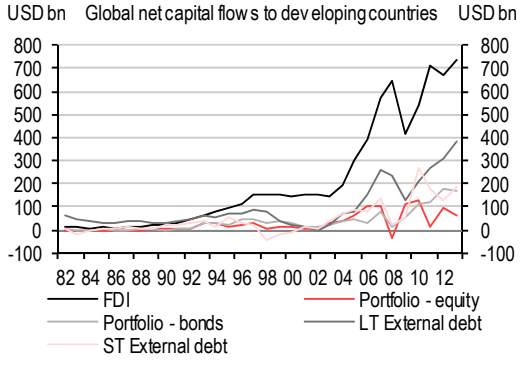
10. China's annual ODI to reach USD180bn in the next three years



Source: Ministry of Finance, HSBC

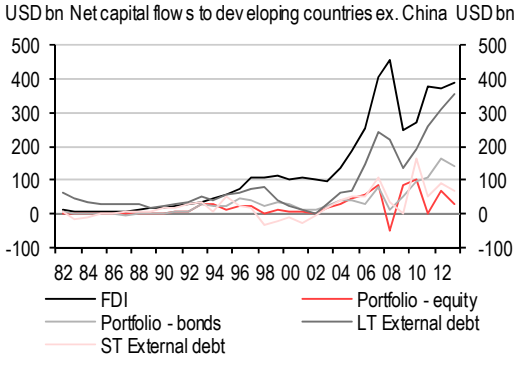
The data support this view. Direct investment is already the most popular kind of capital flow to lower and middle income economies (Chart 11) (though, excluding China, suggests the mix is more balanced – Chart 12). The China – and global – direct investment trend is far from over.

11. FDI is by far the most popular type in capital flow



Source: World Bank, HSBC

12. Developing countries have followed China's example



Source: World Bank, HSBC

HSBC

Box 1: The RMB and the SDR

The global financial crisis of 2007-08 renewed the debate over whether a new international reserve currency is needed to preserve confidence in international trade and finance, and what could take on such a potentially important role. In a March 2009 essay, PBoC Governor Zhou Xiaochuan, suggested a greater role for the IMF's Special Drawing Rights (SDRs) as a potential super-sovereign reserve currency[4]. While this is unlikely to happen in the near future, given the lack of SDR-denominated assets, there are strong arguments for adding the RMB to the basket of currencies that comprise SDRs. That would better reflect economic trends, as well as spreading the burden of issuing a reserve currency.

What are SDRs?

SDRs are international reserve assets first created in 1969 to supplement official reserves of member countries. Its value was initially linked to the USD, which was in turn still linked to gold. However, the collapse of the Bretton Woods system in 1973 meant SDRs had to be redefined as a basket of currencies. The current basket consists of fixed amounts of just four currencies: the USD, the EUR, the GBP and the JPY.

The USD-based Bretton Woods system was weakened by the uncertainty over the supply of USD, as US monetary policy inevitably gave greater weight to domestic economic considerations. Similarly, metallic standards used in the past had failed as discoveries of gold or silver caused unpredictable changes in the global money supply linked to the metals. Designing a rule and choosing an anchor currency or commodity to govern the supply of an international reserve currency has proved tricky.

SDRs more credible with the RMB

The addition of the RMB to the SDR basket would give member countries greater exposure to RMB in their reserves. Many reserve managers already hold RMB reserves, and the PBoC has also signed 28 swap agreements with other central banks to provide emergency RMB liquidity in case of shortages.

Indeed, the introduction of the RMB could actually help SDRs become a more credible reserve asset itself, as it would then more accurately reflect the changes in the global trading and financial system as a result of China's economic development.

The IMF assesses the composition of the SDR basket every five years, with the next review set for late this year. The IMF sets out two criteria: that a currency is of a major trading country and that it is 'freely usable', i.e. widely used in payment for international transactions and widely traded in international currency markets.

The 'major trading nation' requirement was already met back in the previous review in 2011, and the case is even stronger now that China is the world's largest exporter. The problem has always been in the definition of 'freely usable', as China still maintains currency controls, although we argue that there has been considerable liberalisation recently. The RMB is now ranked in the top five currencies used in global payments, according to SWIFT. It is also the ninth most traded currency by the Bank for International Settlement (BIS) with a 2.2% share of the global trading volume.

All this may still not be enough to qualify for entry into the SDR by January 2016, but it is likely only a matter of time, given the trajectory of China's development and its commitment to capital account liberalisation.

[4]Reform the international monetary system, BIS Review 41/2009

HSBC

Box 2: Opening more gates

Capital account liberalisation is not a one-off process, nor is it a binary choice between completely unfettered flows and financial autarky. The IMF's Article VIII uses 40 kinds of financial transactions to test for how restrictive capital controls are. We think China is getting closer to meeting these criteria. Indeed, there are relatively few transactions, which are still prohibited, with most types at least partially allowed (Table 13). We expect China to retain some controls, such as quotas to limit undesirable swings in capital flows, while continuing to open more channels for capital to flow in and out. Below is an update on some recent developments:

- **Qualified Foreign Institutional Investor (QFII):** Set up in 2002, USD69.7bn had been approved as of February 2015, up 33% from a year ago. Chinese authorities have continued to grant quotas to new countries and institutions – for example, Norges Bank, Norway's central bank, which also manages the country's sovereign wealth fund, was given another USD1bn of QFII quota in February 2015, taking its total quota to USD2.5bn – the largest along with that of the HKMA.
- **Renminbi QFII:** Set up in 2011, USD311.5bn had been approved as of February 2015, up 72.7% y-o-y. Hong Kong's Financial Secretary John Tsang said in his March budget speech that the SAR government will request an increase in the territory's RQFII quota to keep developing Hong Kong's capacity to serve as a global hub for offshore RMB business.
- **Qualified Domestic Institutional Investor (QDII):** Set up in 2006, USD87.6bn has been approved as of February 2015, up 9.9% y-o-y.

Shanghai-Hong Kong Stock Connect

Operational since November 2014, this allows investors from Hong Kong to buy mainland stocks up to a daily limit of RMB13bn (HKD16.4bn) per day, and RMB300bn in total. Mainland investors can also buy RMB10.5bn worth of stocks per day in Hong Kong, RMB250bn in total. The quotas are also applicable to the markets as a whole, instead of being allocated to individual institutions, in contrast to the Q-schemes.

Other 'Connects': There is no reason why linkages between stock markets cannot be expanded beyond Shanghai and Hong Kong – the Chair of the China Securities Regulatory Commission Xiao Gang has stated a Shenzhen-Hong Kong Stock Connect will be established before the end of 2015, and regulators from both sides are expected to jointly release details in the first half of the year. It is not unreasonable to imagine more 'Connects' with markets internationally, or expanded to include other securities such as bonds.

13. China's capital account is more open than generally thought

Transactions type:	Not convertible	Partially convertible	Basically convertible	Total
Capital market and money market instruments	2	10	4	16
Derivatives	2	2		4
Credit operations		1	5	6
Direct investment		1	1	2
Liquidation of direct investment			1	1
Real estate		2	1	3
Personal capital		6	2	8
Total	4	22	14	40

Source: PBoC, SAFE, HSBC
Note: "partially convertible" means strict restrictions and quota controls on payment for capital account transactions, "basically convertible" means loose restrictions on payments for capital transactions; relatively few countries including advanced economies have absolutely zero restrictions on capital transactions

HSBC

Connecting the dots

- RMB usage has expanded significantly in recent years
- New offshore RMB centres are helping the currency to go global
- Connecting these centres – both with the mainland and with each other – will accelerate the process

RMB – when 2 become 1

Tying up the centres

The RMB is going global. Over the past year a number of new offshore RMB centres have sprouted across the world. A key part of RMB internationalisation lies in connecting the growing number of these centres to the mainland and also linking them with each other.

As China's capital account opens up, the onshore market will increasingly connect with the growing offshore market. When the CNH was first launched in July 2010, the RMB functioned under two different systems – the onshore CNY and offshore RMB (CNH and CNY NDF).

Since then, there have been increasing signs that these systems behave as one homogenous unit. The RMB's two identities are converging as the currency internationalises. With the currency going global, the single identity RMB will likely gather momentum. This should mean greater circulation between onshore and offshore, and between different offshore centres, which eventually will allow the RMB to become a benchmark currency like the USD.

Offshore RMB centres – what's new?

In 2014, there was an aggressive expansion of RMB centres, especially in Europe (Chart 1 and Table 1). Developments in the latter part of last year suggest the focus for this year will be connecting these offshore centres, as well as expanding into commodity producing countries and into countries targeted for the New Silk Road project (also known as "One Belt, One Road").

Policymakers also regard the development of the offshore market as a way to advance domestic financial market reforms. **The presence of more offshore RMB centres in different geographies and time zones will increase global RMB liquidity, business opportunities and the degree of international acceptance.** As such, London is a critical part of a 24-hour offshore RMB business chain. The emergence of an offshore RMB centre in Canada is also a key step into the Americas.

This offers multinational corporates more incentives to use RMB in their global treasury operations. For instance, Huawei, China's largest maker of telecom network equipment, has set up operations in Hong Kong, London and the Netherlands to create a global RMB cash pool to facilitate the company's offshore trade settlement, investment and finance activities (*Caijin*, 1 December 2014).

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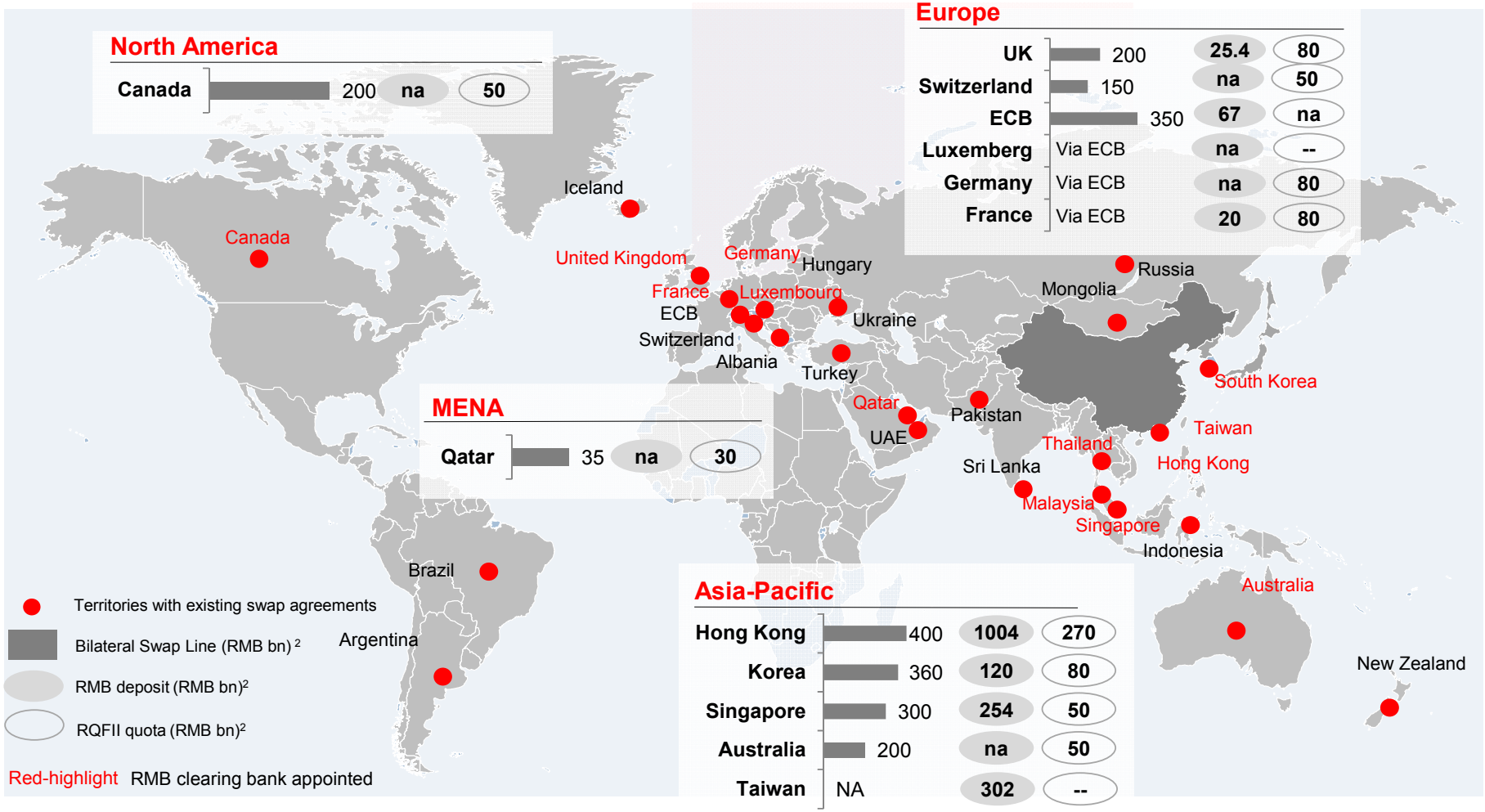
The RMB's place in the world

Rapid expansion of RMB use outside China

160 countries doing RMB business in a typical month[1]
28 territories with existing swap agreements[2]

The RMB's place in the world



Notes:
1 Source: SWIFT
2 Source: PBoC, HKMA, MAS, Central Bank of the Republic of China (Taiwan), City of London, CEIC, BIS, WFE, BOK, Bundesbank, Central Bank of Qatar, Central bank of Australia, Central Bank of Canada, HSBC

Source: HSBC

Table 1. Offshore RMB centres: Recent developments and future potential

	Key developments in 2014	Key business focus and competitive advantage
Asia		
Hong Kong	1) HKEx offers RMB-denominated commodity futures in its Futures Exchange 2) Shanghai-Hong Kong Stock Connect was launched 3) The HKMA boosted its RMB liquidity facilities and renewed its RMB400bn currency swap agreement with the PBoC 4) The RMB20,000 daily conversion limit for Hong Kong residents was removed, although the daily limit of RMB80,000 for cross-border remittances will still be in place	**Continues to lead offshore RMB business on all fronts** 1) Strong ties in trade, direct investment and tourism with mainland China 2) First-mover advantage, resulting in market scale, depth and width, as well as a large talent pool 3) Political relationship with the mainland: Hong Kong is the experimental zone for RMB reforms 4) Base for Chinese financial institutions and businesses 5) Comprehensive and sophisticated settlement and clearing systems (RTGS)
Taiwan	1) Formosa bonds (offshore RMB bonds issued in Taiwan) were reclassified as domestic, rather than foreign assets. This gives local life insurance companies more room to acquire Formosa bonds without hitting the 45% foreign investment cap 2) The cap for Formosa bond issuance by mainland companies was raised to RMB25b, from RMB10bn 3) The CBC launched reference rates for Taiwan's offshore RMB spot rate and short-term interbank borrowing rate (CNT Taibor)	**Focusing on cross-Strait RMB usage for now** 1) Strong demand for RMB assets at the institutional and retail levels due to low yields locally. RMB structured products are being developed for retail banking 2) Strong ties in trade, direct investment and tourism with mainland China However, **the lack of an official bilateral currency swap and the delay in RQFII quota allocation** (RMB100bn was promised by the Chinese government earlier) due to political reasons is an obstacle to further development of the CNH business in Taipei
Singapore & ASEAN	1) CNH FX futures contracts launched for trading on the SGX 2) The MAS expanded its RMB liquidity facilities 3) Suzhou Industrial Park Cross-border RMB initiative: Banks in Singapore can conduct cross-border RMB lending to corporates in SIP, corporates in SIP can issue RMB bonds in Singapore, equity investment funds in SIP can conduct direct investment in corporates in Singapore, and individuals in SIP can remit RMB between China and Singapore for the settlement of current account transactions and direct investment in corporates in Singapore. 4) The arrangement between SIP and Singapore was extended to Sino-Singapore Tianjin Eco-city 5) Direct currency trading between the RMB and the SGD commenced in October 6) Both Malaysia and Thailand have FX swap lines with the PBoC and have established clearance banks in their capital cities	**Offshore RMB market for ASEAN. Could potentially play a role in RMB usage in commodity trading and derivatives** 1) Singapore is the business centre of ASEAN. China is ASEAN's largest trading partner, while ASEAN ranks third on China's list. ASEAN runs a trade surplus with China, leading to a natural source of RMB inflow into Singapore. China will also increasingly invest more in ASEAN under various regional infrastructure cooperation pacts 2) Singapore is a major commodity trading centre, the third largest FX centre globally, and the largest in Asia, and a major private banking hub outside of Switzerland 3) Singapore banks have established exclusive close ties with two industrial parks in China (Suzhou and Tianjin)
South Korea	1) RMB clearing bank appointed, RQFII quota allocated and direct trading of RMB-KRW launched 2) The BoK and PBoC renewed their currency swap agreement (KRW64trn-RMB360bn)	RMB deposits rose rapidly due to strong local demand for **RMB structured deposits.** The Korean government is enthusiastic in its promotion of **direct RMB-KRW trading**
Europe		
UK	1) RMB clearing bank appointed, RQFII quota allocated and direct trading of RMB-GBP launched 2) The UK government issued the first foreign sovereign CNH bond	**London leads offshore RMB trading outside of Hong Kong.** Daily trading volume now stands at half of Hong Kong's CNH volumes, according to our estimates. This reflects its time zone advantage, its role as the world's clearing centre, and it is the largest FX centre in the world
France, Germany, and Luxembourg	RMB clearing bank appointed and RQFII quota allocated	RMB usage is likely to continue to accelerate with increasing Europe-China M&A activities and Europe's participation in China's "One Belt, One Road" infrastructure plan. **Germany continues to rank high in RMB trade settlement,** while Luxembourg boasts the largest pool of RMB deposits in Europe. **Luxembourg is also Europe's largest fund-management centre**
Commodity exporters		
Australia	RMB clearing bank appointed, RQFII quota allocated	RMB payments between Australia and China grew strongly in 2014, albeit from a low base
Canada	RMB clearing bank appointed, RQFII quota allocated; the BoC signed a RMB200bn currency swap agreement with the PBoC	Toronto will be first offshore RMB hub in North America
Malaysia	MoU for RMB clearing in Malaysia signed	
Qatar	RMB clearing bank appointed, RQFII quota allocated; Qatar's central bank signed a RMB35bn currency swap agreement with the PBoC	Doha will be first offshore RMB hub in the Middle East
Russia	The central bank of Russia signed a RMB150bn currency swap with the PBoC	

Source: HSBC

The US is conspicuously missing from discussions about offshore RMB. The US government has not explicitly expressed an interest in signing a MoU with China for RMB clearing, or in acquiring either a RQFII quota or a currency swap line. This, however, could change over time. For example, should US investors diversify assets into Chinese securities, there would be a need for greater RMB liquidity in the US.

We believe these new centres will help to expand the existing CNH regime, rather than create separate competing systems **because the CNH is freely transferrable and fungible offshore.** This reflects the fact that most of these RMB centres are in jurisdictions with open capital accounts, as well as the limited legal restrictions on the flow of RMB between them.

There are still some differences to consider. Offshore RMB interest rates could vary slightly due to differences in RMB clearance mechanisms, RMB liquidity pool compositions, credit ratings of local clearance banks and participant banks' and investors' risk appetite; however, that is the case for the major currencies as well.

Generate flows between the dots

The classifications used by *Robert McCauley* of the BIS and *Dong He* of the HKMA in their analysis of the eurodollar market help conceptualise three types of flows in the (offshore) RMB:

- **1) One-way flows** (transactions between non-residents and residents):
  - (A) Inflows: Funds flow from non-residents through the offshore RMB market to Chinese residents (e.g. offshore players buying A-shares via the Shanghai-Hong Kong Stock Connect).
  - (B) Outflows: Funds flow from Chinese residents into the offshore market, where they are paid to non-residents (e.g. Chinese importers paying RMB for overseas goods).
- **2) Round-trip flows:** Both sides of the transactions are residents. The offshore market serves as a balance sheet through which funds can be looped back to a company (e.g. a Chinese company makes a RMB investment abroad and the RMB is used by the overseas party to import goods from China).
- **3) Pure offshore transactions:** Transactions that take place between non-residents. This type of flow is dominant in the eurodollar market (e.g. an OPEC oil exporter deposits USD in London and the bank in London lends the funds to a Brazilian oil importer), but this is still small in the offshore RMB market.

We believe that the offshore RMB market is progressing from being dominated by one-way

2. Classification of offshore flows

Source: HSBC

flows to seeing more round-trip flows backed by a compelling business rationale.

It is interesting to note that round-trip flows initially developed in the eurodollar market due to regulatory arbitrage. US deposits were moved offshore due to the costs associated with deposit insurance and interest rate regulation in the US.

It may take some time before pure offshore transactions can grow rapidly in the CNH market. Such flows could come through speculative transactions, be rooted in commodity trade and finance, or arise as a result of the currency being used as a vehicle for FX intervention.

Policy and infrastructure support

Increasing the number of offshore RMB centres is an important step for the currency. The process involves establishing **an extensive network of RMB-FX swap lines between the PBoC and other central banks.** Indeed, this is already happening.

Central banks in close to 30 countries have access to RMB liquidity via bilateral FX swaps, which are worth over RMB3trn (Table 2). This allows central banks to support CNH transactions in their local markets, especially if there is a shortage of RMB liquidity.

Other central banks can also lend this RMB liquidity to their local banks and market participants to facilitate cross-border trade and investment. Efficient use of FX swap lines will help develop the offshore RMB FX swap market and RMB cross-border lending. These are essential steps for the RMB to become a more global currency, and in the longer run a reserve currency.

The incentive to increase access to the RMB makes sense as the currency assumes a greater role in the global financial system, especially as China's capital account opens up further.

For example, the HKMA has enhanced its RMB FX facilities to deal with the potential liquidity challenges associated with the Shanghai-Hong Kong Stock Connect scheme (see *Asian FX: Shanghai-Hong Kong Stock Connect: Implications for FX and Rates*, 28 August 2014).

Apart from official swap lines, some technical changes are needed to enhance RMB connectivity. **There is increasing demand for China to offer an international RMB clearing platform** that adopts global standards and will give the RMB competitiveness in terms of trading time, language, risk and liquidity management. The market is looking for an update on the China

Table 2. Swap lines with the PBoC (RMBbn)

Country	Status	Date of Agreement	Size of swap	Country/ region	Status	Date of Agreement	Size of swap
1. Belarus	Expired	Mar-09	20	15. Iceland	Active	Sep-13	3.5
2. Uzbekistan	Expired	Apr-11	0.7	16. Indonesia	Active	Oct-13	100
3. Kazakhstan	Expired	Jun-11	7	17. Eurozone	Active	Oct-13	350
4. UAE	Active	Jan-12	35	18. New Zealand	Active	May-14	25
5. Malaysia	Active	Feb-12	180	19. Argentina	Active	Jul-14	70
6. Turkey	Active	Feb-12	10	20. Switzerland	Active	Jul-14	150
7. Mongolia	Active	Mar-12	10	21. Sri Lanka	Active	Sep-14	10
8. Australia	Active	Mar-12	200	22. South Korea	Renewed	Oct-14	360
9. Ukraine	Active	Jun-12	15	23. Russia	Active	Oct-14	150
10. Singapore	Active	Mar-13	300	24. Hong Kong	Renewed	Nov-14	400
11. Brazil	Active	Mar-13	190	25. Qatar	Active	Nov-14	35
12. UK	Active	Jun-13	200	26. Canada	Active	Nov-14	200
13. Hungary	Active	Sep-13	10	27. Thailand	Renewed	Dec-14	70
14. Albania	Active	Sep-13	2	28. Pakistan	Renewed	Dec-14	10
				29. Suriname	Active	Mar -15	1
				Total			**3,114**

Source: PBoC, HSBC

International Payment Platform (CIPS) that was announced in April 2013.

As well as increasing the size and number of offshore centres, **stronger linkages between these centres need to be established.** This would help enable pure offshore RMB transactions and demonstrate that the RMB is acting more like a benchmark currency, as the USD does.

Further infrastructure support could come from international agencies. The IMF will conduct its twice-a-decade review of Special Drawing Rights (SDRs) in 2015. **There is a good possibility that the RMB will be included in the SDR** (see *Asian FX Focus: RMB: The top 10 questions*, 9 February 2015).

While this may have little near-term impact, the inclusion of the RMB would encourage China to make further reforms and may increase participation in offshore RMB trade settlement and the development of more offshore centres.

The implications of the dots & swaps

Apart from greater circulation of the RMB in the global financial system, there are three other factors related to growing the offshore RMB centres and increasing their links with one another:

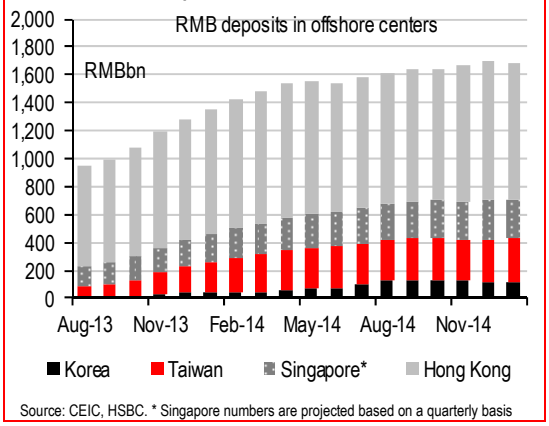
- The offshore RMB liquidity pool will have greater capacity to grow
- A larger offshore RMB market will promote onshore RMB liberalisation
- RMB FX turnover should increase with the offshore and onshore RMB behaving in a more consistent manner.

Deposit pool growth

Hong Kong is the traditional centre of offshore RMB deposits and liquidity. However, as discussed earlier, new offshore RMB centres have emerged and will continue to grow. Offshore RMB is fully fungible between different centres and there is little control over RMB flows between Hong Kong and other offshore RMB centres. Therefore, new centres should be seen as expansions of the CNH market rather than alternatives to Hong Kong.

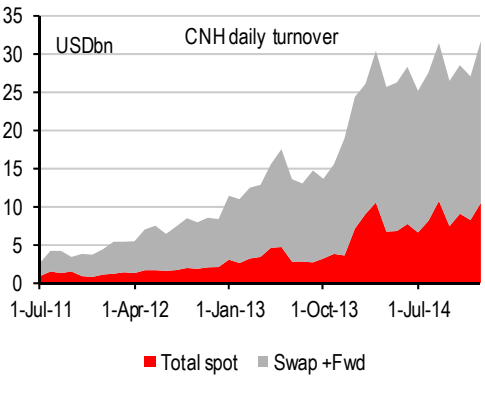
Offshore RMB (CNH) liquidity has grown rapidly. RMB deposits and CDs in offshore are now worth more than USD2trn, while estimated daily FX market turnover in Hong Kong is around USD25bn in the FX spot and forwards markets (Charts 3 and 4). RMB trade settlement already accounts for 22% of total Chinese trade as of the end of 2014. The size of outstanding CNH debt (including bonds and bank CDs) rose from RMB403bn from January 2013 to almost RMB702bn by the end of January 2015.

3. Offshore RMB deposits in selective RMB centres



Source: CEIC, HSBC. * Singapore numbers are projected based on a quarterly basis

4. CNH volume has been growing



Source: HSBC

From here, we believe the gradual integration and then convergence of onshore and offshore markets will continue to be driven by wider cross-border flow channels (particularly portfolio flow and cross-border lending). In turn, **this should lead to both a larger and a more diversified offshore RMB liquidity pool.**

Connecting the dots is not just an offshore theme

The growth of the offshore RMB liquidity pool and broader transaction pool will likely coincide with liberalisation efforts onshore and could actually promote a more market-determined mind set. **There are an increasing number of market participants with access to both the onshore CNY and the offshore CNH markets.** So there is greater room for the RMB to circulate between these, while onshore CNY convertibility takes shape.

The development of the Shanghai Free Trade Zone (SFTZ) and expansion of some the liberalisation measures to other parts of China is a good example (Chart 5). Residents and non-residents are able to set up free trade accounts in CNY and foreign currency, with free transfer between those accounts. These accounts also allow for cross-border financing, with RMB and foreign currency funds exchanged freely. Those working in the SFTZ can invest overseas, while both domestic and foreign companies located there can borrow CNY and foreign currency from offshore. Securities investment and trading is also permitted.

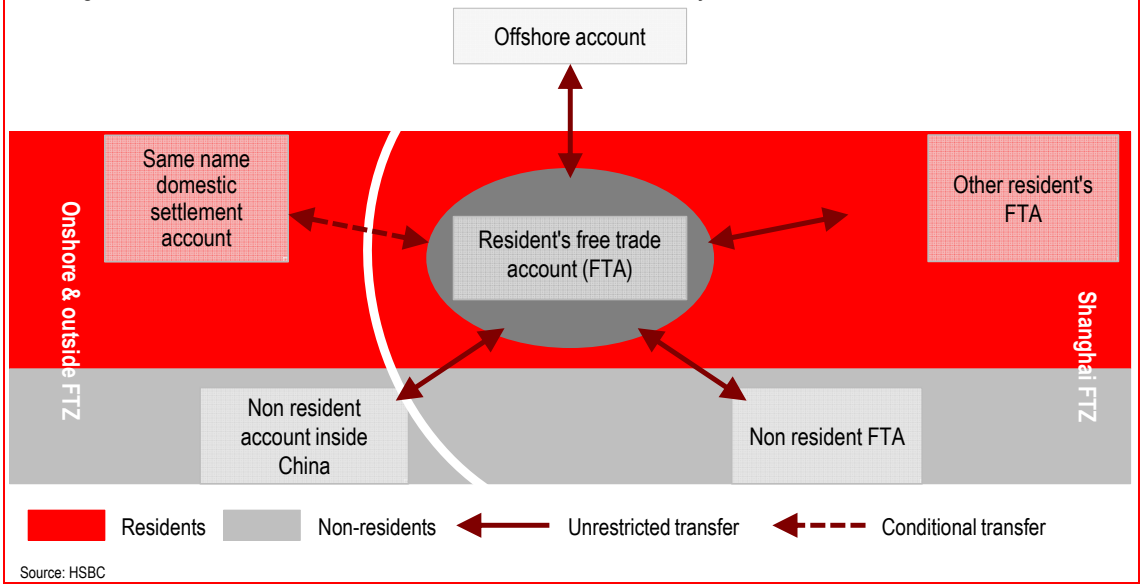
Over time we believe these liberalised policies will be increasingly rolled out to other parts of China. This will enhance the framework whereby the onshore CNY and offshore CNH behave in a more convergent manner. In our view, it is the liberalised CNH that will drive and influence the development of the onshore CNY.

RMB – bigger, better, acting as one

With the RMB going global and the channels between the offshore and onshore markets opening up, we will see greater similarity in the behaviour of the RMB, onshore and offshore. This has already been happening for some time, whereby the deliverable CNH and the non-deliverable CNY have increasingly behaved in the same way (Chart 6 and 7).

As mentioned previously, it is the CNY that should behave more like the CNH rather than vice

5. Shanghai Free Trade Zone, an essential offshore market within onshore territory



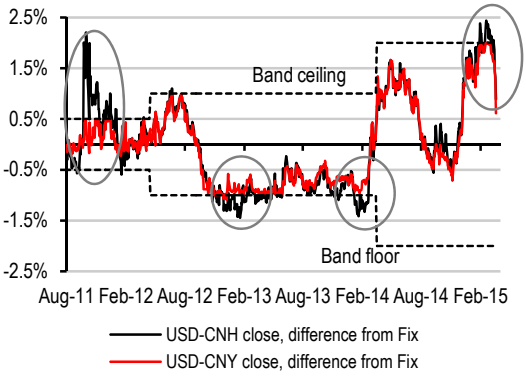
Source: HSBC

versa. After all, regulatory steps are being taken to make the onshore CNY become convertible, while the CNH already is.

In most cases, the CNH has reacted more than onshore CNY to market sentiment, as the offshore market has no policy intervention, no restrictions on convertibility, and allows a full range of investors (Chart 6). While there have been occasions where the spread between onshore CNY and offshore CNH spot has widened in recent months, this divergence is proving less enduring than in the past. This reflects not only the depth of the offshore market but also the increasing linkage between onshore and offshore.

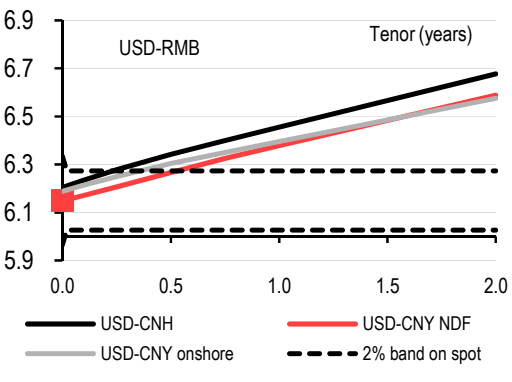
Meanwhile, RMB trading volumes have picked up significantly in European trading (mainly through London). This has, according to our estimates, risen to almost half of the volume seen during Asian trading hours (mainly in Hong Kong). This means the RMB is already becoming more established as a global currency. With more RMB centres in other time zones emerging (Canada for example), we believe the RMB is on track to become a truly 24-7 global currency.

6. USD-CNH, onshore USD-CNY and fixing



Source: Bloomberg

7. Three RMB curves to gradually act as one



Source: Bloomberg, HSBC

HSBC

The five-year plan

- The rise of the RMB was inevitable, given China's economic clout and the policy push to encourage RMB trade settlement
- Capital account liberalisation and FX reforms are needed to propel RMB turnover past the tipping point
- The RMB can become one of the top five most traded currencies by 2020

RMB: How far can it go?

The RMB is growing up quickly. It is now the world's:

- Ninth most traded currency (USD120bn daily turnover), according to the *BIS Triennial Survey 2013*, up from 17th in 2010 (USD34bn; Table 1).
- Fifth largest currency for global payments, according to SWIFT (January 2015), up from 13th in January 2013.
- Second most used currency in trade finance, according to SWIFT (December 2013), up from fourth in January 2012.

This rapid growth is remarkable, given that China only started promoting RMB trade settlement and launched the offshore RMB market in 2010 as the country's share of global trade rose from less than 5% in 2001 to 11% in 2013.

The question is: Will such growth persist and how large can RMB turnover become?

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Table 1. Daily average FX Turnover in April 1995-2013, "net-net" basis (USDbn)

	1995		1998		2001		2004		2007		2010		2013	
	Amt	%	Amt	%	Amt	%	Amt	%	Amt	%	Amt	%	Amt	%
1. USD	981	83	1,325	87	1,114	90	1,702	88	2,845	86	3,370	85	4,652	87.0
2. EUR	...	...	...	...	470	38	724	37	1,231	37	1,551	39	1,786	33.4
3. JPY	291	25	332	22	292	24	403	21	573	17	754	19	1,231	23.0
4. GBP	110	9	168	11	162	13	319	16	494	15	511	13	631	11.8
5. AUD	31	3	46	3	54	4	116	6.0	220	6.62	301	7.59	462	8.64
6. CHF	85	7.20	108	7.06	74	6.0	117	6.0	227	6.82	250	6	275	5.2
7. CAD	40	3	54	4	56	4	81	4	143	4	210	5	244	4.6
8. MXN	...	...	7	0	10	1	21	1	44	1	50	1	135	2.5
9. CNY	**...**	**...**	**0**	**0**	**0.1**	**0**	**2**	**0**	**15**	**0.5**	**34**	**1**	**120**	**2.2**
10. NZD	3	0	3	0	7	1	21	1	63	2	63	2	105	2.0
11. SEK	7	1	5	0	31	2	42	2	90	3	87	2	94	1.8
12. RUB	...	...	5	0	4	0	12	1	25	1	36	1	85	1.6
13. HKD	13	1	15	1	28	2	34	2	90	3	94	2	77	1.4
14. NOK	3	0	4	0	18	1	27	1	70	2	52	1	77	1.4
15. SGD	5	0	17	1	13	1	18	1	39	1	56	1	75	1.4

Note: Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200% instead of 100%. Adjusted for local and cross-border inter-dealer double-counting (i.e. "net-net" basis). Source: BIS

Premier Li Keqiang's *2015 Government Work Report* suggests the government remains committed to RMB internationalisation, FX regime reforms and capital account liberalisation.

As discussed in earlier chapters, cross-border capital flows are going to rise significantly – supported by the New Silk Road plan, expansion of the 'Q' schemes and further integration of the onshore and offshore RMB market. The RMB exchange rate will likely also become less managed and more market-driven.

These developments suggest RMB turnover will continue to rise rapidly and evolve from being trade-centric to being driven more by investment and financial transactions.

Given the size of China's economy and its financial markets, we believe the RMB can become one of the five most traded currencies by 2020, based on a scenario of full convertibility. Beyond this period, the RMB could become an even larger force in the global FX market.

Trade settlement the driver

RMB trade settlement has risen from being nearly non-existent to about 22% of China's overall trade by end-2014. This was the main factor behind the rapid growth in the RMB's share of global FX turnover – 37% per annum over 2010-13, the fastest in the world.

RMB trade settlement is expected to rise to 50% of China's total trade by 2020 (see Chapter 1), supported by more trade with emerging markets (EM), the upgrading of exports and increasing offshore RMB liquidity support (see Chapter 5). This means trade settlement will remain an important source for growth in RMB turnover.

However, for the RMB to become a major trading currency, institutional and investment use of the RMB has to rise. Goods trade settlement can only go so far in boosting the RMB's overall turnover.

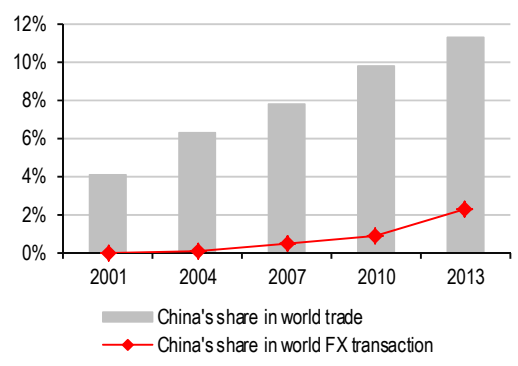
According to the *2013 BIS Triennial Survey*, the average ratio of non-financial customers (mostly corporations) to professional asset managers (mutual funds, pension funds, insurance companies, hedge funds and official investors) in trading volumes for all currencies is about 1:2. However, it was the opposite for the RMB (Chart 2). The BIS also noted that, since 1992, global FX transaction volumes have increased by more than all underlying real economic activities, whether measured by GDP or gross trade flows (BIS quarterly review, December 2010).

Size checked, convertibility next

Size, depth and openness

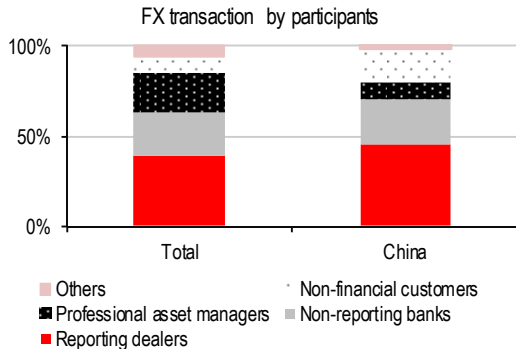
The driving factors of currency turnover have been widely researched and debated. For example,

1. RMB's rise reflects China's increasing economic clout



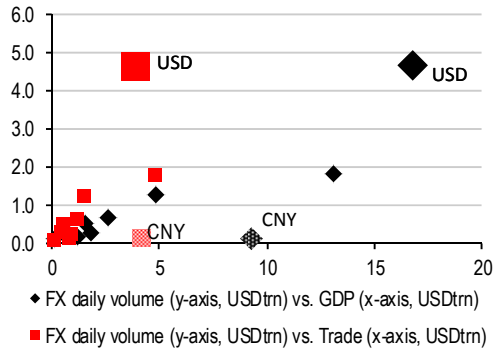
Source: WTO, IMF, BIS, Bloomberg, HSBC

2. RMB was driven more by trade flows compared to other currencies in 2013



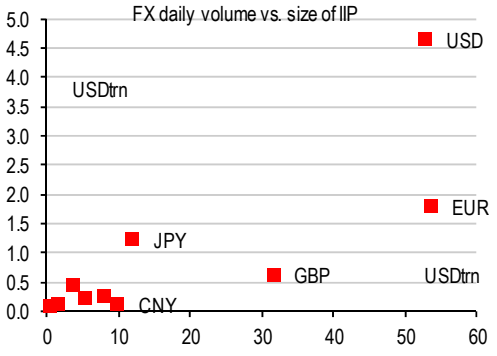
Source: BIS

3. Economic size matters for FX turnover…



Source: World Federation of Exchanges members (end-2014 data)

4. …as does financial depth and financial openness



Source: CEIC, HSBC

network effects have been identified by *Kindleberger* (1981) and *Krugman* (1980, 1984) as the main factors in a currency's rise and dominance in the international monetary system, while *McCauley and Scatigna* (2011) argue that "financialisation", i.e., the financial depth, in particular the size of the bond market in issuing countries, is a key determinant of the FX turnover share of a currency.

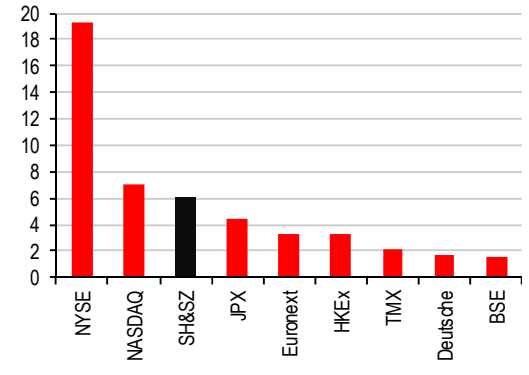
While there is no single good method to forecast turnover for a currency, the size of an economy and its financial depth and openness are often mentioned as key criteria. Such a relationship is observable in the FX market (Charts 3-4). Indeed, these are also the criteria for a currency to be included in the IMF's Special Drawing Rights (see Q10 in *RMB Q&A*, February 2015).

China's economy is the third largest globally (expressed in nominal USD terms) behind the US and the Eurozone. Its international trade flows are second only to the Eurozone.

However, it is also worth emphasising the size of China's financial markets. China now has the world's:

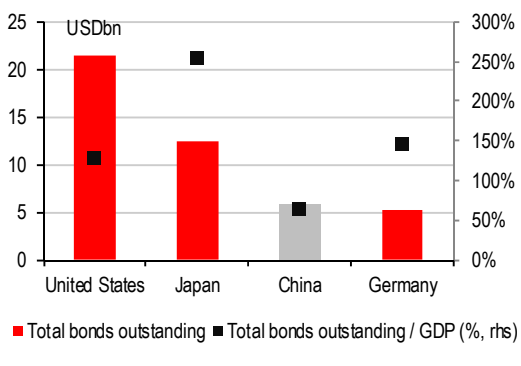
- Third largest equity bourse (Shanghai and Shenzhen combined, as of end-2014; Chart 5)
- Third largest bond market by outstanding amount (Chart 6)
- Largest banking system by size of assets and liabilities (Chart 7)

5. China's equity market is the third largest in the world by market capitalisation



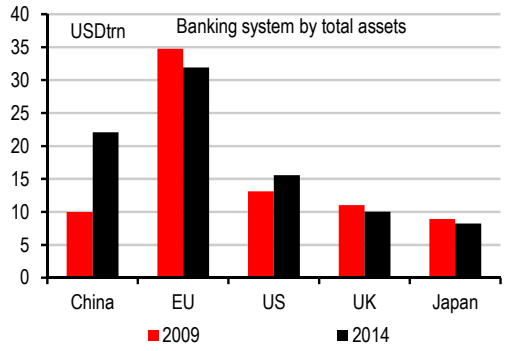
Source: World Federation of Exchanges members (end 2014 data)

6. China's bond market is also the third largest in the world, measured by nominal outstanding amount of bonds



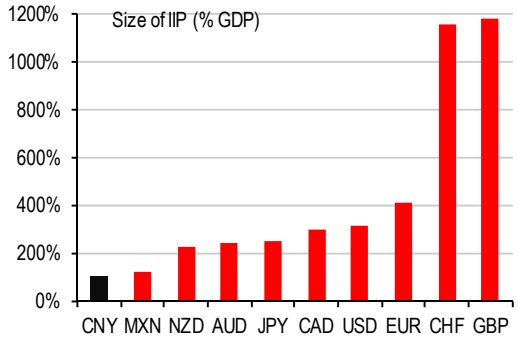
Source: CEIC, HSBC

7. China's banking system is large



Source: CEIC, HSBC

8. IIP of the 10 most traded currencies in 2013 – China is the least financially open



Source: CEIC, HSBC

China's financial markets are set to continue growing. For example, a municipal bond market is expected to take off soon. And the banking system is expected to undergo far-reaching changes, including interest rate liberalisation, the introduction of a deposit insurance scheme and the entrance of private banks.

Getting connected

We believe China clearly has the economic and financial clout to make the RMB a major global trading currency. The key now is to open up the domestic markets to the rest of the world.

China's level of financial openness is one of the lowest in the world. Its international investment position, a measure of financial openness, was 107% of GDP as of 2013. Excluding FX reserves (the accumulation of which reflects capital controls), this ratio is only 68%. In comparison, it is 315% in the US, 408% in the Eurozone and 243% in Australia, and more than 1,000% for economies with international financial centres, like the UK and Switzerland (Chart 8).

As we discussed in Chapter 3 and 4, China is easing back on capital controls. China is set to become a major investor in many EM countries over the next 10 years under the "One Belt, One Road" New Silk Road scheme. As such, RMB-denominated ODI and cross-border bank-lending flows are expected to rise sharply.

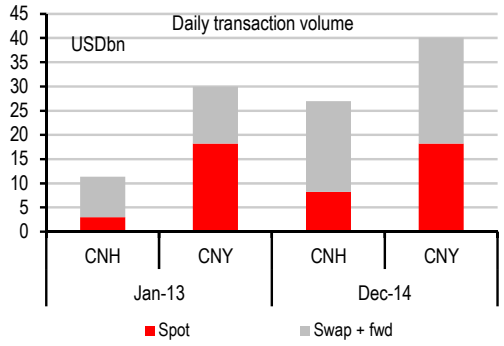
China grants foreign investors only limited access to its financial markets via the 'Q-series' quota-based schemes (QFII, RQFII) and the China Interbank Bond Market. Moreover, lock-up periods and repatriation restrictions have prevented investors from making frequent transactions under these schemes.

However, liberalisation is taking place rapidly. In 2014, the Shanghai-Hong Kong Stock Connect programme was launched. This will be expanded, according to The Hong Kong Stock Exchange, to include the Shenzhen Stock Exchange this year, with the potential to link to other major global bourses in coming years.

The mainland's bond clearing house also appears to be studying the possibility of launching a scheme linking the onshore and offshore bond markets, similar to Stock Connect (*SCMP*, 9 February 2015).

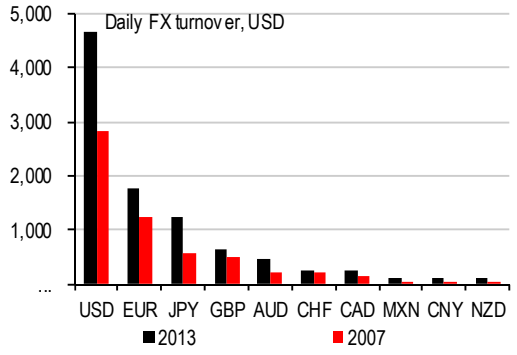
HSBC's equity research strategist expects foreign participation in the equity market to reach 10% (around USD1trn) by 2020 (*Ready for lift-off,* March 2014). A similar share of foreign investment in the bond market by the end of this

9. Offshore RMB turnover rising faster than onshore RMB



Note these estimates of turnover are significantly different from BIS data due to methodology differences. Source: CFETC, HSBC

10. A monopolistic structure in the global currency market



Source: BIS

decade is not improbable, if access is expanded. Many EM economies have bond participation ratios higher than 10%.

FX reforms

A more market-oriented exchange rate regime will boost RMB volumes. All the most traded currencies in the world are free floating and not actively managed.

Indeed, in recent years, the RMB's turnover has risen much faster in the unregulated offshore market than onshore (Chart 9). The offshore RMB is allowed to flow and float freely outside of China and it attracts a full range of investors.

In contrast, the onshore FX market is constrained by a daily trading band, has been largely limited to current account flows of corporates and dealers (until last year), and also has restrictions for trading FX derivatives.

However, the onshore FX market is evolving rapidly. In 2014, the State Administration of Foreign Exchange (SAFE) removed the BoP linked limits on banks' FX positions, allowed participants in the onshore market to sell FX options, and also gave non-bank financial institutions access to the interbank FX market.

We believe policymakers will continue to liberalise the exchange rate mechanism. The onshore USD-CNY daily trading band will likely be widened further and the current fixing mechanism will probably be made more transparent and market-oriented. These reforms are necessary to make the RMB more flexible, amid capital account liberalisation and the challenges posed by divergent monetary policies globally.

Overcoming inertia

The RMB is only being held back by China's capital controls and rigid FX regime. As these domestic policy constraints ease, how much and how quickly can RMB turnover rise?

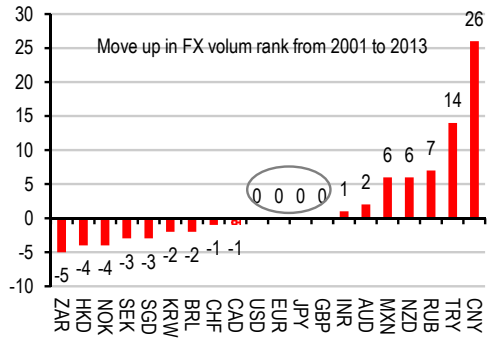
There is a monopolistic structure in the market share of FX turnover (Chart 10). This reflects network externalities, which refer to 'bandwagon effects' and positive feedback loops, whereby the value of a product or service is enhanced by the number of people using it.

An established currency is likely to have lower transaction costs and other benefits that come with economies of scale in trading; for example, a greater variety of financial products, thereby further enhancing its attractiveness.

Therefore, once a currency becomes established as a leading currency due to its dominant size in the global economy, trade and financial integration, it will likely maintain such a position for a long time.

Indeed, the order of the top four most traded global currencies in the BIS surveys has not changed since the introduction of the EUR in 1999 (Chart 11). However, the fifth ranked currency has changed from the CAD in the 1990s, to the CHF in the 2000s and in recent years to the AUD (Table 1).

11. Top 4 ranked currencies by turnover tend to be stable



Source: BIS

Top five in five

Based on a scenario of full convertibility, we believe **the RMB will become one of the top five most traded currencies within the next five years.**

The RMB's daily spot and derivatives turnover was about USD120bn (2.2% of total turnover globally) in April 2013. This made it the ninth most traded currency in the last *BIS Triennial Survey*.

We note that the fifth most traded currency tends to have a market share of between 6% and 9%. For example, the fifth ranked AUD in the 2013 survey had a market share of 8.6%.

For the RMB's market share to rise from 2.2% in 2013 to around 9% in 2020, it needs to grow at an annual pace of 22%. This is not unrealistic, in our view. Its market share rose 37% per annum over 2010-13 and 24% a year over 2007-10. So, **the RMB only needs to maintain the recent pace of opening up to become a top five currency within five years.**

Furthermore, if the RMB maintains that 22% annual growth, we calculate that its market share could reach 25% by 2025. The third ranked JPY has a turnover market share of 23% in 2013.

If China's financial reforms continue and RMB internationalisation and convertibility accelerates, then over the coming decade the RMB could move into the top three daily traded currencies. There are a lot of hurdles and no simple way to forecast FX turnover but some day, if the right conditions are met, the RMB could be a USD1trn turnover a day currency.

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Disclosure appendix

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