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Economic Watch

China

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Economic Analysis

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RMB internationalization gains momentum from liberalization steps

- **RMB internationalization has advanced at a rapid, if uneven pace since the 2009 pilot program of cross-border settlements**

  In just four years the share of trade settled in RMB has risen to 17% from almost zero. The RMB is now the 9th most actively traded currency in the world.

- **The growth of RMB internationalization reflects a combination of policy initiatives and market-driven trends**

  The latter are associated with the RMB's relative stability and China's growing size in international trade. Investors are taking advantage of new channels to invest offshore RMB in the Mainland, and central banks are showing increasing interest in holding the currency as part of their international reserve portfolios.

- **Recent liberalizing measures have facilitated an increase in the momentum of RMB-settled trade through Q3 of this year**

  After a lull in mid-2012, the volume of RMB trade-settlements has rebounded. The pickup has been due in large part to liberalization measures that have broadened the range of permissible investment channels to the Mainland, thereby increasing the attractiveness of holding offshore RMB. Measures include the relaxation of restrictions on the repatriation of offshore RMB funds for FDI and portfolio investment.

- **The RMB is gaining international acceptance, although it is still far from a reserve currency**

  The RMB's rapid rise on the global stage is underpinned by a growing number of central banks expressing an interest in holding the currency in their basket of foreign reserves. Notwithstanding the significant progress made so far, there is still a long way to go for the RMB to become a truly international currency. The biggest constraint remains the still-closed nature of the capital account and lack of convertibility.

- **Hong Kong maintains its position as the premier offshore RMB center, but competition is on the rise**

  The deepening of RMB internationalization has lured a number of additional financial centers to develop offshore RMB capabilities. To date, Singapore, Taipei, and London are well advanced, while other cities, such as Paris, are aspiring to catch up. Shanghai also poses increasing competition to Hong Kong as it gears up to advance financial liberalization in its recently launched Free Trade Zone (FTZ). Despite these challenges, it appears unlikely that Hong Kong will lose its advantage anytime soon given its strong financial sector infrastructure and special relationship with the Mainland.

Introduction

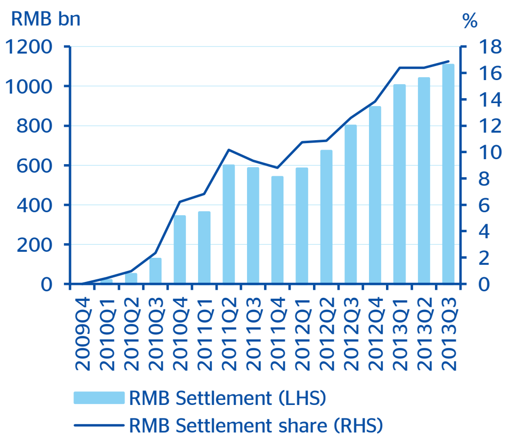
This is the third in our series of reports over the past few years assessing progress and the outlook for RMB internationalization.[1] Since the inception in 2009 of the pilot program for Cross-Border Trade Settlement, RMB internationalization has advanced at a rapid pace, as measured by the share of trade now settled in RMB (16.9%) and by the volume of trading in international fx markets (currently the 9th most actively traded world currency). This success is reflects a combination of policy initiatives to counter headwinds and enhance the lure of the currency offshore and, increasingly, market-driven trends associated with the RMB's relative stability and China's growing size in international trade. As a result, investors are taking advantage of new channels to invest offshore RMB in the Mainland, and central banks are showing increasing interest in holding the currency as part of their international reserve portfolios. At the same time, competition is heating up among international financial centers to grab a share of this growing market.

Despite the success so far, offshore RMB usage is still small by the standards of the world's large international currencies, and its geographical dispersion is uneven (as projected at the outset, geographically distant regions, such as Latin America, have yet to witness a significant degree of RMB usage). Short of full capital account liberalization, which is still several years away, further steps will be needed to ensure steady growth of the offshore RMB market.

RMB cross-border trade advances with further liberalization measures

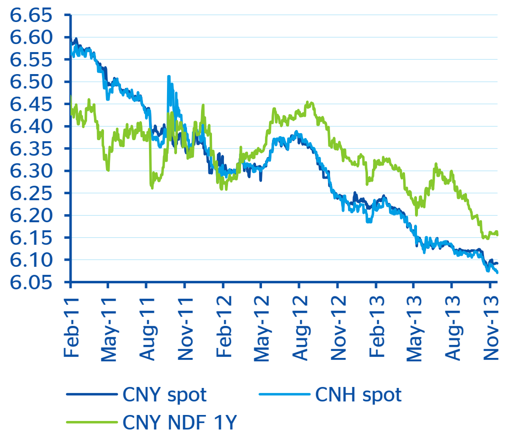
After a lull in mid-2012, the volume of RMB trade-settlements has rebounded (Chart 1). As of September 2013, the share of China's overall trade settled in RMB rose to 16.8% from 12.0% a year earlier. In addition, RMB usage for trade settlement has become more balanced between Chinese exports and imports, with the ratio rising to 1:1.3 in Q2 (versus 1:1.7 in 2011). In the past, RMB usage was tilted toward Chinese importers, given that the counterparties of Chinese exporters preferred to settle their trade in convertible currencies. The more even balance reflects the increasing availability of offshore RMB. In addition, weaker expectations of RMB appreciation may also have been a factor (Chart 2), although this may be changing again given the relatively rapid pace of appreciation in recent months.

Chart 1
The percentage of RMB settled trade has increased rapidly



Source: CEIC and BBVA Research

Chart 2
NDF prices indicate that expectations of further appreciation are weakening



Source: Bloomberg and BBVA Research

1: See Origins, Mechanics, and Opportunities (March 2011) and (New Headwinds Call for Policy Steps (July 2012).

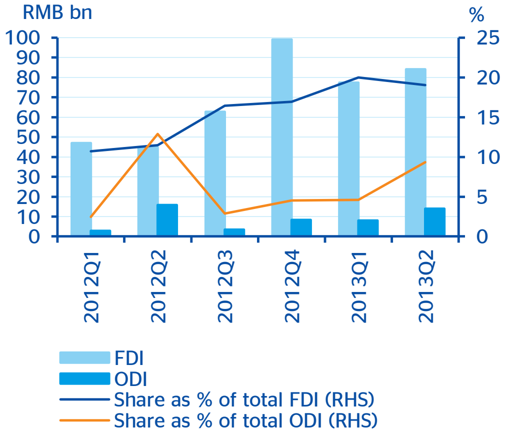
The pickup in the volume of RMB settled trade has been due in large part to liberalization measures that have broadened the range of permissible investment channels to the Mainland (see Appendix), thereby increasing the attractiveness of holding offshore RMB. Such measures include the relaxation of restrictions on the repatriation of offshore RMB funds for FDI and portfolio investment.

As a result of a more liberal approvals process, RMB-denominated FDI flows have increased substantially over the past year (Chart 3). According to our estimates based on balance of payments data and RMB flows provided by the PBoC, the share of RMB-denominated inward FDI rose to 19.1% in Q1 2013, from 10.7% the same period a year ago. Meanwhile, the share of FDI outflows denominated in RMB is, not surprisingly, much lower at 9.3% as of Q2, but still represents a significant increase from the average level of 5.6% in 2012.

The share of portfolio inflows denominated in RMB has also increased, through the introduction of the R-QFII program in January 2012, which permits repatriation of offshore RMB in the onshore equity market for qualified foreign institutional investors including mutual funds, security firms and asset management companies. The aggregate investment quota under the R-QFII program currently amounts to RMB 134.3 billion (just under half the quota under the broader QFII scheme).

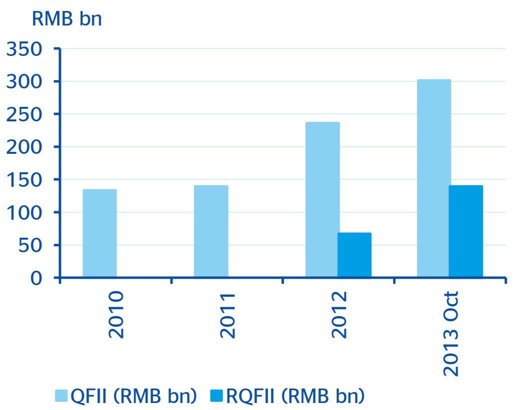
In addition to these steps, in March 2012 the limited Pilot Program of RMB trade settlement was expanded to all domestic firms from designated firms (more than 60,000 as of end-March), and efforts have been made to simplify procedures for RMB settlement and reduce administrative costs. Also facilitating the growth of RMB trade settlement has been the signing of additional bilateral swap agreements (BSAs) between the People's Bank of China (PBoC) and other central banks (Table in the Appendix), and cooperation to improve clearing systems, such as with the Hong Kong Monetary Authority.

Chart 3
The share of RMB denominated FDI has



Source: SAFE, CEIC and BBVA Research

Chart 4
The size of RQFII accounts for almost half the size of the QFII



Source: SAFE and BBVA Research

The RMB is gaining international acceptance, though still far from a reserve currency

Progress in internationalizing the RMB is raising its profile in the international monetary system. According to the latest BIS Central Bank Survey, in 2013 the RMB jumped to ninth place (from 17th in last survey conducted in 2010), surpassing Sweden, New Zealand, and Hong Kong in the list of the world's most actively traded currencies. Importantly, around two-thirds of RMB trades occurred outside the Mainland, pointing to a prospering offshore RMB market. Moreover, according to monthly SWIFT data, as of October the RMB ranked eighth in value as a payments currency, with a market share of 1.5%, a six-fold increase in market share since January, 2012.

The RMB's rapid rise on the global stage is underpinned by a growing number of central banks expressing an interest in holding the currency in their basket of foreign reserves. A number of countries have announced such plans (Table 1). In August 2010 the PBoC began to allow approved central banks to invest RMB in the domestic capital market, which may have spurred the interest in holding the RMB in reserves. One such high-profile case is the Reserve Bank of Australia which, after establishing a direct trading mechanism between the AUD and RMB, announced it will invest 5% of its foreign reserves in RMB denominated assets at an unspecified time in the future.

Table 1
Countries/Economies which announced their inclusion of the RMB in their foreign reserves

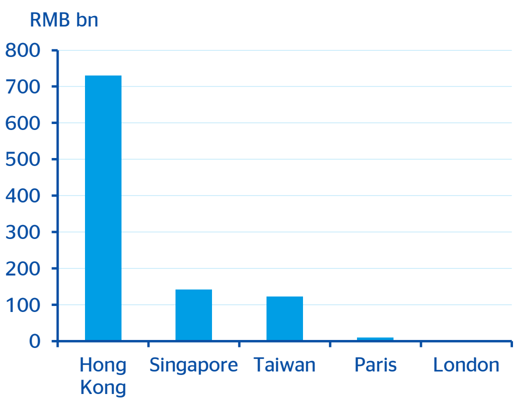
Announcement Date	Country/Economy	% of RMB Assets in Foreign Reserve
2010 Sep	Malaysia	N.A
2011 May	South Korea	N.A
2011 Sep	Nigeria	5%-10%
2011 Sep	Chile	0.3%
2011 Sep	Venezuela	N.A
2011 Nov	Thailand	<1%
2012 Mar	Japan	N.A
2012 Jul	Indonesia	N.A
2013 Apr	Australia	5%
2013 Aug	Belarus	N.A
2013 October	Taiwan	N.A

Source: BBVA Research

Hong Kong maintains its position as the premier offshore RMB center, but competition is on the rise

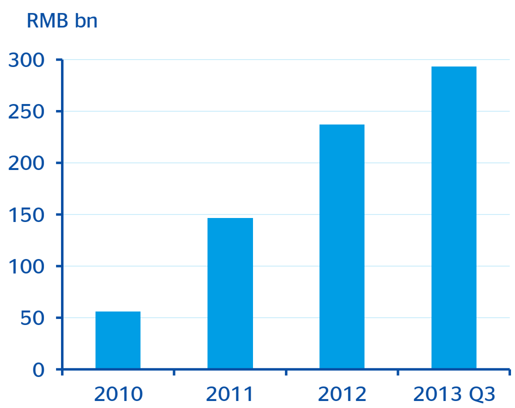
The deepening of RMB internationalization has lured a number of additional financial centers to develop offshore RMB capabilities. To date, Singapore, Taipei, and London are well advanced, while other cities, such as Paris, are aspiring to catch up.

Chart 5
Hong Kong has the largest volume of RMB deposits (as of September 2013)



Source: CEIC, Bloomberg and BBVA Research

Chart 6
The Dim Sum bond market in Hong Kong continues to expand but at a slowing pace



Source: HKMA and BBVA Research

Hong Kong maintains a leading position in most areas of offshore RMB business relative to these other cities, thanks to its special relationship with the Mainland and a "first-mover" advantage. For example, during the first half of 2013, more than 80% of RMB cross-border trade settlements were channelled through Hong Kong, similar to the levels in 2011 and 2012. In addition, Hong Kong's volume of RMB deposits, an important barometer of the level of offshore RMB businesses, significantly exceeds that of its leading competitors (Chart 5).

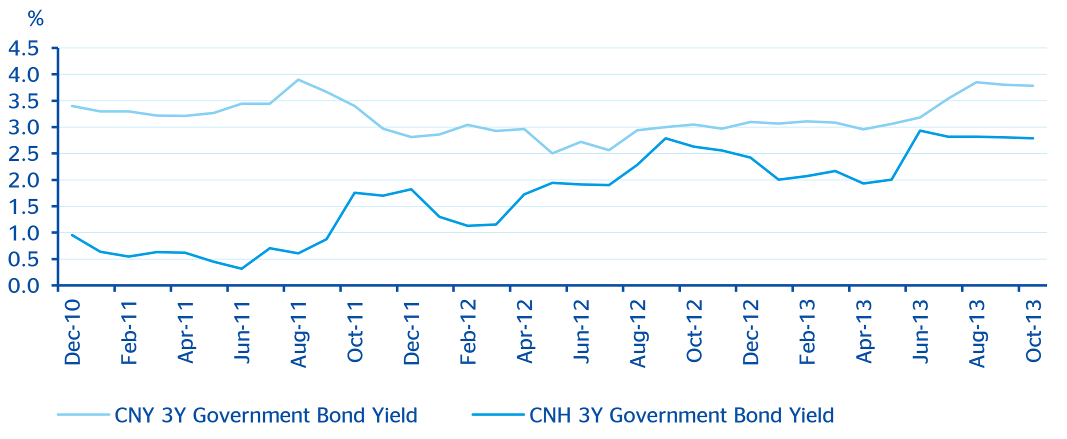
More importantly, Hong Kong has established a multi-layer capital market for offshore RMB activities, including a money market, derivatives market, loan market and Dim Sum Bond market. A recent new milestone is the establishment last June of a benchmark interbank interest rate for Hong Kong's offshore RMB market (the "CNH HIBOR Fixing"), calculated from the average of sixteen Hong Kong banks (excluding the highest and lowest three). Given Hong Kong's advanced financial infrastructure and market depth, the CNH HIBOR has potential to become a global benchmark for pricing offshore RMB products such as bank loans, floating-rate Dim Sum bonds and other RMB derivatives.

Despite Hong Kong's advantages, rising competition could threaten it's leading position. In part, this competition is due to the acceleration of China's capital account opening, previously assumed to benefit the development of Hong Kong's offshore RMB businesses. For example, during the first half year, Dim Sum bond issuance slowed down (Chart 6) as the differential between offshore and onshore interest rates narrowed; reducing the incentive for firms to issue bonds offshore (Chart 7).

Shanghai also poses increasing competition to Hong Kong as it gears up to advance financial liberalization in its recently launched Free Trade Zone (FTZ). Banks are already allowed banks to open branches to engage in offshore businesses within the FTZ, in a similar manner in which they transact in Hong Kong.

Despite these challenges, it appears unlikely that Hong Kong will lose its advantage in offshore RMB businesses anytime soon. Further liberalization of China's capital account will occur gradually through at least 2020, during which time Hong Kong will continue to enjoy its natural advantages. Indeed, some of China's liberalization steps are likely to be carried out through pilot programs via Hong Kong, as exemplified by the recent R-QFII program which began in Hong Kong prior to its eventual expansion to Singapore, Taiwan and London. Hong Kong's financial infrastructure and its role as a global financial center are likely to attract business.

Chart 7
Rising offshore yields are making the Dim Bond market less attractive for issuers



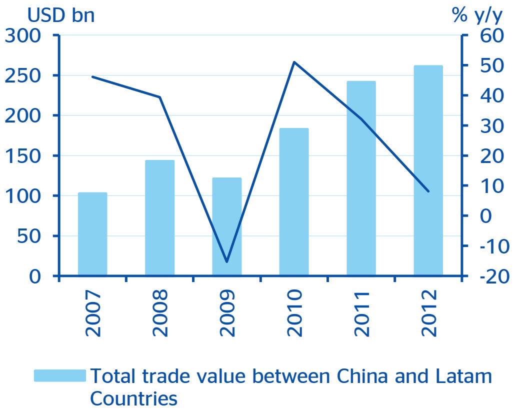
Source: CEIC, Bloomberg and BBVA Research

Long-term challenges and policy suggestions

Notwithstanding the significant progress made so far, there is still a long way to go for the RMB to become a truly international currency. For example, in contrast to the growth in the share of trade settled in RMB, the currency's geographical reach is not yet even, with only limited progress in Latin America despite the sharp rise in trade between China and that region (Chart 8 and Box). In this regard, the signing of additional bilateral swap arrangements with new countries could help lay an institutional foundation for RMB businesses in regions where less headway has been made.

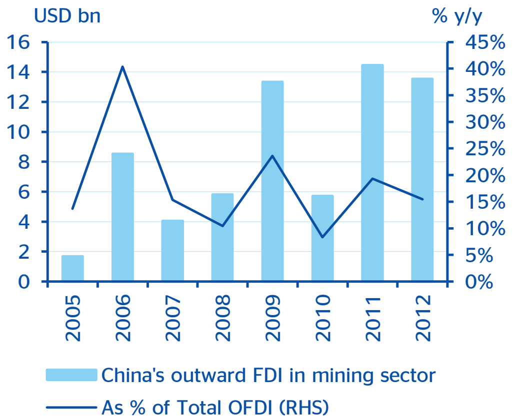
Another impediment is that a considerable proportion of China's trade is associated with commodities (accounting for more than one-quarter of total trade in 2012), which, by tradition, is typically denominated in USD or Euro. Although this is likely to be a market-driven process at the end of the day, the authorities could use their considerable leverage in global commodity trade and investment (Chart 8) to encourage some commodity trade to be priced in RMB.

Chart 8
Trade between China and Latam has increased rapidly



Source: CEIC, Bloomberg and BBVA Research

Chart 9
Mining sector investment accounts for a considerable share of China's OFDI



Source: Ministry of Commerce, PBoC and BBVA Research

The biggest constraint remains the still-closed nature of the capital account and lack of convertibility which continue to slow progress for the RMB in becoming a fully-fledged international currency. To advance the goal of RMB internationalization, further long-term steps will be needed along the lines of announced plans toward financial liberalization and opening the capital account.

We would also expect the globalization strategy of China's domestic banks to expand RMB businesses in regions such as Latin America. At the same time, a deeper opening of the domestic market to foreign financial institutions would create incentives for offshore players to promote offshore RMB businesses.

Box: Limited RMB usage in LATAM

Despite the rapid growth in China-LATAM economic ties in recent years, RMB usage in Latin America for trade settlements remains quite limited, in both absolute and relative terms. A number of global banks have launched RMB trade settlement services[2], but client interest so far appears minimal (Table 3).

What is holding back RMB usage in LATAM?

The limited usage of RMB in Latin America is not entirely surprising. In our seminal report on RMB Cross-Border Settlements in March 2011, we noted that the geographical expansion of RMB usage was like to take place in stages, with the economies most geographically distant likely to take more time.

In a more recent paper (China's RMB Bilateral Swap Agreement: what explains the choice of countries?) we argued that a country's distance, as well as its economic size and trade relationship with China, are significant determinants of its likelihood to sign an RMB-denominated Bilateral Swap Agreement (BSA). Such BSAs, in turn, have proven to be an important catalyst and precursor for offshore RMB trade settlement in the given country. Among the 22 RMB Bilateral Swap Agreements (BSAs) extended by the PBoC with other central banks, only two have been with Latam countries, Argentina and Brazil. The former expired last year and the latter was only signed in March.

Other factors are also at play, including historical tradition, commodity concentration, and FX regulations. Historically, Latam countries have seldom embraced currencies other than their own or the USD. In 1990s, a number of Latam countries adopted various forms of "Dollarization" to combat inflation. Another important factor for the limited interest in RMB trade settlement is due to the large share of commodities in Latam/China trade flows, which are typically denominated in USD. Moreover, FX restrictions are prevalent in Latam countries, which often prohibit banks from accepting RMB deposits (Table 2).

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Finally, the limited investment opportunities available to holders of RMB in Latam may be an impediment. The majority of offshore RMB investment is conducted through Hong Kong and other international financial centers in Asia and Europe, which is currently less developed in the Latam region.

What are the potential benefits for LATAM in using RMB?

Despite the limited extent of RMB usage so far, we see scope for RMB business to expand in the coming years. The benefits to RMB usage would increase with the growth trade and investment ties, and would be similar to those found elsewhere in the world where the RMB is already gaining traction. In addition to diversifying currency risk, importers of Chinese (manufactured) goods in Latam might find that they are able to secure better terms buy settling with their counterparts in RMB, who, in turn, are likely to prefer receiving RMB to reduce their own currency risk and administrative costs.

2: For example, BBVA Continental in Peru has launched a trade settlement service called "China COMEX" and it also offers currency futures denominated in RMB. However, demand for both products has been limited to date.

Table 2
Status of regulations and use of RMB in LATAM economies

Country	Current status
Chile	RMB deposits are not accepted by regulations. Even though commercial operations can be freely settled in RMB with no restrictions for maximum quantities, there is currently no evidence that Chilean companies routinely invoice their exports in RMB. This may be due to the commodity structure of the country's exports, which are heavily tilted toward USD-denominated commodities.
Argentina	Regulation allows only USD or Euros as foreign currency deposits. There is no evidence of operations handled in RMB in the local market and only few banks settle operations in RMB through international trade markets (For instance, triangulated through New York) or have opened a correspondent account in RMB (supposedly, in case they needed to pay for Argentina imports in RMB).
Peru	RMB deposits are permitted by regulation. However, in practice, BBVA Continental is the only bank offering the possibility to open a RMB account in Peru. There is currently no evidence that companies are denominating their trade in RMB, or that they have demand for RMB products.
Mexico	By regulation, banks cannot accept foreign-currency deposits (a few exceptions in US dollars). On the other hand, banks can lend in foreign currency, but, as far as we know, they have never granted loans in RMB.
Brazil	Bank deposits in foreign currency are prohibited by regulation. Some banks (HSBC or Banco do Brazil) provide trade settlement and finance services in RMB in the local market. Reportedly, some local banks such as Banco do Brazil or BTG Pactual have issued Dim sum bonds
Colombia	Bank deposits in foreign currency are prohibited by regulation. Still very limited RMB products are offered.
Venezuela	Regulation does not allow banks to offer deposits or financial products in foreign currency other than US dollars (and even these are very limited). We are not aware of any Venezuelan firms pricing or settling in RMB.

Source: BBVA Research

Appendix

Table 3
China's RMB BSAs with Other Countries

Country/Economy	Amount	Effective Date	Expiration Date
China-Korea	180 bn RMB/38 Tr Won	Dec-08	Dec-11
renewed and expanded	360 bn RMB/64 Tr Won	Oct-11	Oct-14
China-Hong Kong	200 bn RMB/227 bn HKD	Jan-09	Jan-12
renewed and expanded	400 bn RMB/490 bn HKD	Nov-11	Nov-14
China-Malaysia	80 bn RMB/40 bn MYR	Feb-09	Feb-12
renewed and expanded	180 bn RMB/90 bn MYR	Feb-12	Feb-15
China-Belarus	20 bn RMB/8 tr BYB	Mar-09	Mar-12
China-Indonesia	100 bn RMB/ 175 tr Rupiah	Mar-09	Mar-12
renewed	100 bn RMB/ 175 tr Rupiah	Oct-13	Oct-16
China-Argentina	70 bn RMB/ Equal Amount Peso	Mar-09	Mar-12
China-Iceland	3.5 bn RMB/66 bn ISK	Jun-10	Jun-13
renewed	3.5 bn RMB/66 bn ISK	Sep-13	Sep-16
China-Singapore	150 bn RMB/30 bn SGD	Jul-10	Jul-13
renewed	300 bn RMB/60 bn SGD	Mar-13	Mar-16
China-New Zealand	25 bn RMB	Apr-11	Apr-14
China-Uzbekistan	0.7 bn RMB	Apr-11	Apr-14
China-Mongolia	5 bn RMB	May-11	May-14
renewed and expanded	10 bn RMB	Mar-12	May-14
China-Kazakhstan	7 bn RMB	Jun-11	Jun-14
China-Thailand	70 bn RMB/ 320 bn THB	Dec-11	Dec-14
China-Pakistan	10 bn RMB/140 bn PKR	Dec-11	Dec-14
China-UAE	35 bn RMB/20 bn AED	Jan-12	Jan-15
China-Turkey	10 bn RMB/3 bn TRY	Feb-12	Feb-15
China-Australia	200 bn RMB/30 bn AUD	Mar-12	Mar-15
China-Ukraine	15 bn RMB/19 bn UAH	Jun-12	Jun-15
China-Brazil	190 bn RMB/60 bn BRL	Mar-13	Mar-16
China-UK	200 bn RMB/20 bn GBP	Jun-13	Jun-16
China-Hungary	10 bn RMB/375 bn HUF	Sep-13	Sep-16
China-Albania	2 bn RMB/3.58 bn ALL	Sep-13	Sep-16

Source: BBVA Research

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