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RMB Internationalization: What is in for Taiwan?

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RMB Internationalization: What is in for Taiwan?

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Abstract

Along with the steady pace of RMB internationalization, this paper proposes Taiwan as a potential candidate to become the next RMB offshore center. We review the main drivers behind Hong Kong's success and set the reasons why Taiwan could follow such steps. First, Taiwan's economic ties with China are substantial both in trade and FDI and they are set to be increasingly supported by the improved political relations across the Strait. Second, the relatively large size of Taiwan's financial system, especially if we consider the enormous pool of savings in its investment and insurance companies, and its well-functioning infrastructure, should provide the necessary elements for an off-shore RMB market to develop. Finally, following Hong Kong's experience, we offer some suggestions on possible pre-conditions for Taiwan to become the next RMB offshore center.

Keywords: RMB Internationalization, Offshore RMB market.

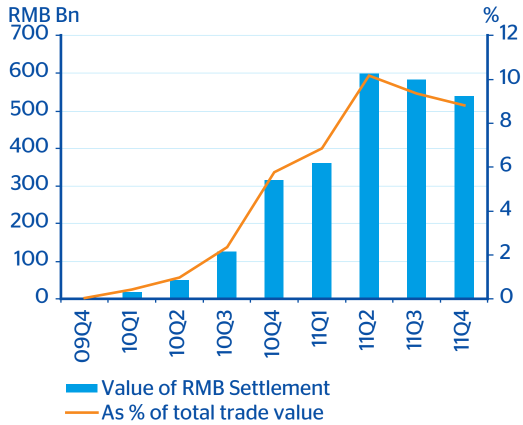
JEL: F33, F36, F42.

Introduction

In contrast to the experiences of other major international currencies such as the Dollar and the Sterling, the internationalization of RMB has set off in a very different way, namely in the off-shore market and not the on-shore one. The absence of capital account convertibility is behind this peculiar strategy.

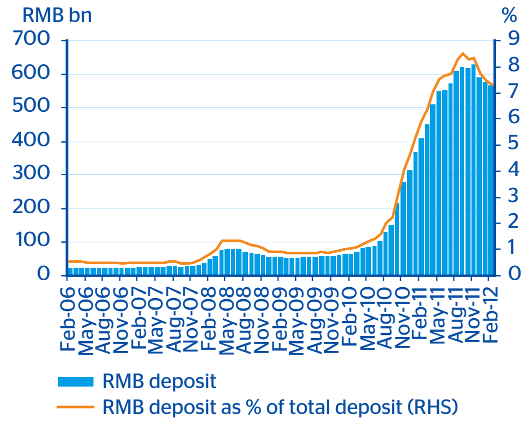
This strategy started with a Pilot Program. As is generally the case in China, Beijing authorities chose Hong Kong to carry out trade settlements in RMB with a selective set of exporting and importing companies in China. The pilot program has effectively propelled the growth of RMB settled cross-board trade. In 2011, more than 9% of China's exports and imports have been settled in RMB compared to a mere 0.04% during the second half of 2009(Chart 1). Accordingly, the RMB deposit in Hong Kong quickly grew to more than RMB 550 billion as of February 2012, accounting for 7.5% of Hong Kong's total deposit (Chart 2).

Chart 1
RMB trade settlement grew rapidly



Source: CEIC and BBVA Research

Chart 2
RMB deposit in Hong Kong has increased fast



Source: CEIC and BBVA Research

The reasons why Hong Kong has been given such a privilege are manifold. The first is the strong economic ties with China both in trade and FDI. Secondly, Hong Kong has long been considered the most important off-shore financial center in the Asian region with a substantial pool of foreign savings. Third, over the last few years Hong Kong has accumulated a wealth of experience in dealing with Chinese companies (IPOs, bank funding and even HKD bond issuance). Fourth, Hong Kong has a special relation with China; in fact, it is considered a Special Administrative Region under the framework of *one-country-two-system*. Finally, and very importantly, well before the introduction of the RMB settlement pilot project in Hong Kong[1], there had been a huge accumulation of RMB in cash (coming from tourism and grey economy activities). Such RMB cash had to be repatriated with the associated costs that this implies. This obviously created the demand for RMB deposits from HK residents, especially in times when the RMB was expected to appreciate.

On this basis, Hong Kong has developed an offshore RMB market-- the "CNH market" (H stands for Hong Kong), in comparison with the traditional onshore RMB market (the CNY market).

Two other financial centers, Singapore and London, have been discussed as possible RMB offshore centers other than Hong Kong. Although Singapore and London are major financial centers, both are not as related to China as Hong Kong and not even as Taiwan.

To our knowledge, Taiwan is not yet in the cards for the next RMB off-shore center nor does there exist much discussion about its potential role in the process of RMB internationalization. The international observers, if any, hold a relatively downbeat tone on it (for example, a forthcoming one titled "Financial Centres in Greater China" by Chatham House said "as for Taipei, it is less likely to become a RMB offshore centre in the near future or take any significant role in the RMB internationalization process."). Unless the Chinese authorities give crucial importance to Britain's financial expertise- be it London or its two former colonies Hong Kong and Singapore –, we argue that Taiwan would be as good an option to become an off-shore RMB center or even

1: For a description of the steps towards RMB internationalization, see BBVA Economic Watch (2010).

better. More importantly, Taiwan would not be a competitor for London or Singapore not even Hong Kong since it would basically only serve the needs of Taiwanese-Chinese economic relations. Following Hong Kong's coined expression for this market, the CNH, Taiwan off-shore market could potentially appear in all Bloomberg terminals in the world as the CNT market.

There are several reasons why Taiwan could develop a CNT market before London and Singapore do. First and foremost, it has much stronger economic links with China than Britain or even Singapore. If we consider the interest of Chinese authorities to advance in RMB internationalization upon the solid base of real exchanges, Taiwan stands out as a key contender in this race. Second, although Taiwan does not have Hong Kong's political closeness to China (neither wants to), it now enjoys a better situation than in the past after KMT's regaining of office in 2008 and, for the second time, in 2012 . In fact, the improvement in the political relations between the Mainland China and Taiwan led to the enactment in September 2010 of a preferential trade agreement to reduce tariffs and commercial barriers between mainland China and Taiwan, namely the Economic Cooperation and Framework Agreement (ECFA). Third, in the same way as Hong Kong did, Taiwan has been accumulated RMB cash in a very substantial way. This is all the more the case since its economic relations with the Mainland lie even more in a grey area than those of Hong Kong for obvious reasons. Finally, Taiwan's financial system is by no means small as it gathers the large pool of savings of Taiwanese in its insurance and investment companies.

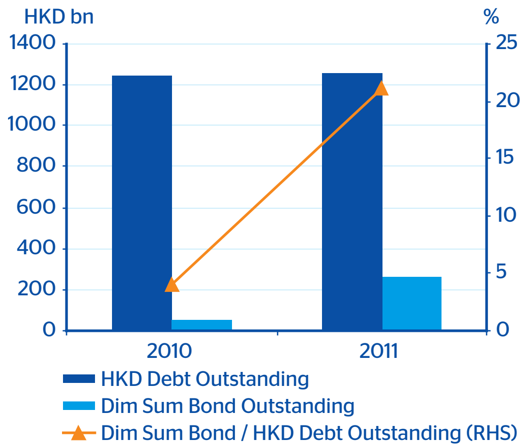
What can Taiwan learn from Hong Kong's experience?

Hong Kong has quickly become a major center for RMB operations. First, deposits in RMB (CNH) have grown very fast during the last two years although they stalled since end-2011, in conjunction with the sharp slow down in the RMB appreciation against the USD. RMB settlements have also grown very fast and today represent about 9% of Chinese imports and exports. In addition, a vibrant market of bond issuance in CNH has been developed, the so-called Dim Sum market.

Such fast growth would not have been possible without the continuous support of the Chinese leaders, which sets the stage for the development of HK's RMB-denominated money market. The measure crucially important to ensure the liquidity of the CNH money market was to offer the HKMA a swap line in RMB. The agreement started with 200 billion RMB in January 2009 and was increased to 400 billion RMB in November 2011. The second was to grant the Bank of China the role of custodian for any CNH transaction in Hon Kong. Another set of measures, announced by Li Keqiang, Chinese Vice-Premier, during his historical visit to Hong Kong in August 2011, was to allow for part of the CNH to reenter China[2]. In fact, a quota was given for portfolio investment into China stemming from offshore RMB deposits in HK (RQFII), and the other was to allow the receipts from Dim-Sum bond issuance to enter China in the form of FDI.

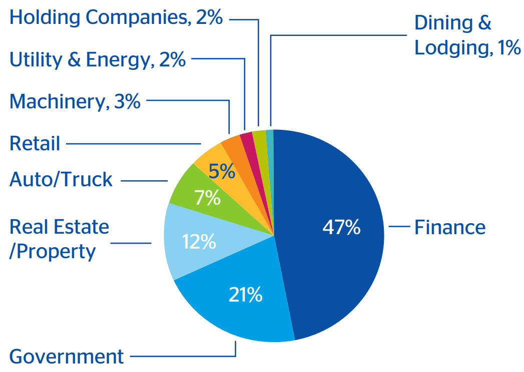
2: Note that, beyond the RQFII, some offshore firms have been allowed to directly borrow RMB loans in HK to repatriate them into the mainland.

Chart 3
Dim Sum Bonds and HKD denominated Bond



Source: CEIC and BBVA Research

Chart 4
Diverse Dim Sum Bond issuers (By Sector)



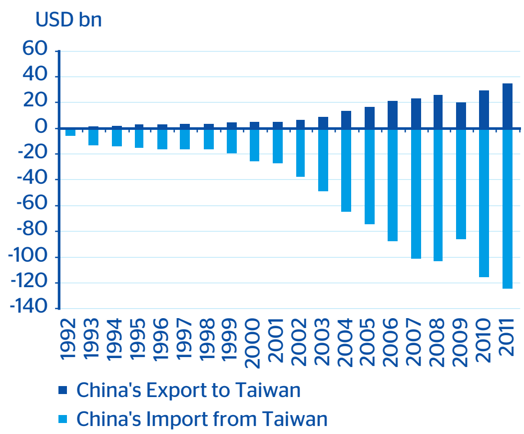
Source: HKMA and BBVA Research

Now the offshore RMB market in Hong Kong has already made significant progress in various aspects. The Dim Sum bond market has experienced a fast growth in the past couple of years. The outstanding amount of Dim Sum Bond have risen to RMB 217 billion as of end-2011, which accounted for 21.1% of the total outstanding HKD denominated bonds (Chart 3). The issuers in the dim sum bond market are to a large extent Chinese but also international quasi-governmental institutions, such as the Asia Development Bank, multinationals and Hong Kong players (Chart 4)

Should Taiwan be interested in CNT?

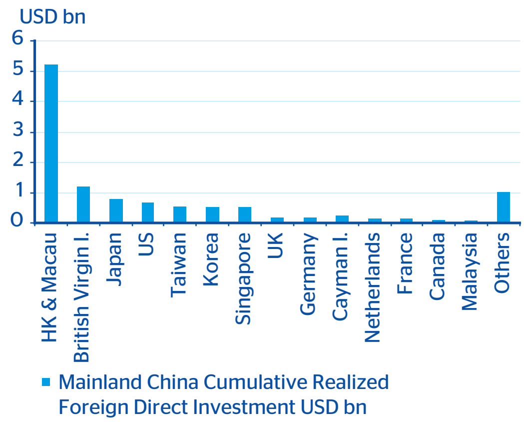
Taiwan is one of the most important trade partners for China. Taiwan's trade volume with China have steadily grown during the past two decades. (Chart 5) Moreover, China has the largest trade deficit against Taiwan among all the trade partners. Taiwan also contributes a substantial share of FDI in China. In 2011, China declared to have received USD 6.7 billion of direct investments from Taiwan in 2011. This compares favorable with USD 3.0 billion from US and even with USD 6.4 billion from the entire Europe. (Chart 6)

Chart 5
Bilateral Trade between Mainland China and Taiwan



Source: Mainland Affairs Council, Taiwan and BBVA Research

Chart 6
Taiwan is an important direct investors to Mainland China (1979 - 09/2011)



Source: Mainland Affairs Council, Taiwan and BBVA Research

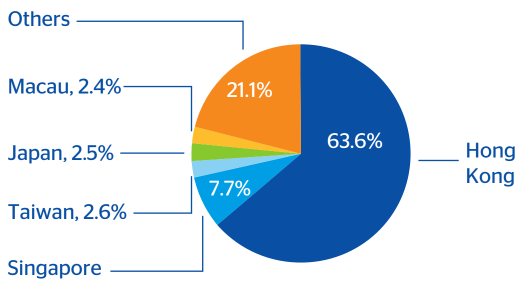
Indeed, the importers and exporters in Taiwan have already actively participated in settling their trade with China in RMB from Hong Kong after the commencement of the aforementioned Pilot program. As of January 2012, 2.6% of RMB settled trade is between China and Taiwan, only after

Hong Kong (63.6%) and Singapore (7.7%). (Chart 7) Furthermore, in terms of the bilateral trade relation with China, Taiwan's significance evidently exceeds Singapore and UK (Chart 8), two likely rivals in competing for becoming the next offshore RMB market after Hong Kong.

Although there is no information on how much of the current RMB holdings in HK are in the hands of Taiwanese, the long-standing economic linkages between China and Taiwan would indicate that such holdings may constitute a significant share. This is even more the case if one considers that Taiwanese have long being using Hong Kong for its trading and FDI into China.

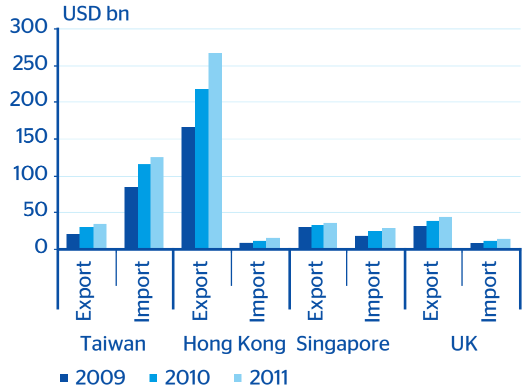
Since mid-2010, Perng Hwai-Nan, Governor of the Central Bank of China in Taiwan has expressed interest in reaching agreement with the People's Bank of China regarding cross-strait currency settlements, while acknowledging the increasing international role of the RMB. Possible explanations for Perng Hwai-Nan interest are the lack of formal channels through which emigrant Taiwan businesses can repatriate their earnings from China, and the mounting pressure from Taiwanese financial institutions to be given access to the Chinese financial market.

Chart 7
Taiwan's share in RMB trade settlement ranked 3rd as of Jan-2012 after Hong Kong and Singapore



Source: Mainland Affairs Council, Taiwan and BBVA Research

Chart 8
Taiwan has a closer trade relation with China than Singapore and UK



Source: Mainland Affairs Council, Taiwan, CEIC and BBVA Research

As for the first issue, China's tight controls on capital inflows and outflows create enormous difficulties for Taiwanese enterprises operating in China to repatriate their profits back to Taiwan. The situation is worsened by the non-convertibility of the RMB and the associated transaction costs, e.g., monetary transfer had been made through underground channels or the clearing system of major currency such as USD. As for the second reason, the opening up of the two countries financial sectors was one of the main reasons for Taiwan's entering into ECFA negotiations but no satisfactory progress has been made so far.

This situation is all the more peculiar if we consider that neither the RMB nor the Taiwan Dollar (TWD) carry any official status in the jurisdictions of each side across the Taiwan Strait. In other words, the starting point is basically of no currency recognition for two areas with huge economic relations. This makes the gains of creating a CNT offshore center potentially very large. If anything, it would bring many of the underground economic activities across the Strait to the surface.

In fact, today the exchange, supply and repatriation of RMB and TWD remain to be conducted through Hong Kong banks as correspondents, as officially announced, in July 2010. Under such arrangement, the RMB clearing bank in Hong Kong will provide RMB note exchange and related services to the Hong Kong branches of eligible Taiwan commercial banks. In turn, the Taiwan head offices of such commercial banks will provide RMB note exchange services to other authorised financial institutions locate in Taiwan, for the purpose of serving personal customers locally.

Currently, there are seven banks from Taiwan that have set up branches in the Mainland and four more have representative offices. Most banks choose to locate their offices in Dongguan, Kunshan, Shanghai, Shenzhen and Soochow within the Provinces of Guangdong and Jiangsu. Taiwanese banks seem to be focusing on the segment of financial services catering for the demand of emigrant enterprises which left Taiwan in the 1990s to operate in the Mainland.

Given Taiwan's increasing economic and financial linkages with China, it seems obvious that allowing for the settlement of both currencies within Taiwan, and not indirectly in Hong Kong, would be a major push to their economic relations.

What could China gain?

Having one more RMB off-shore center would help China accelerate the process of RMB internationalization, stemming off pressure on the PBoC given the very large amount of capital inflows it needs to sterilize. The difference between Taiwan and London or even Singapore is that a substantial part of the RMB to be deposited in Taiwanese banks would be non speculative in nature given the two areas strong trade relations.

The recent experience of Hong Kong shows how difficult it may be to steer a stable process of RMB internationalization if bets are mainly speculative. In fact, the differences that have long existed in onshore and offshore RMB exchange rates and interest rates indicates the result of the one-way bet on RMB appreciation and the sudden change in late 2011 which led to a sudden reduction in CNH deposits. These speculative components may unfavorably amplify the volatility of capital flows to and from China, creating additional difficulties to the PBoC to conduct monetary policy.

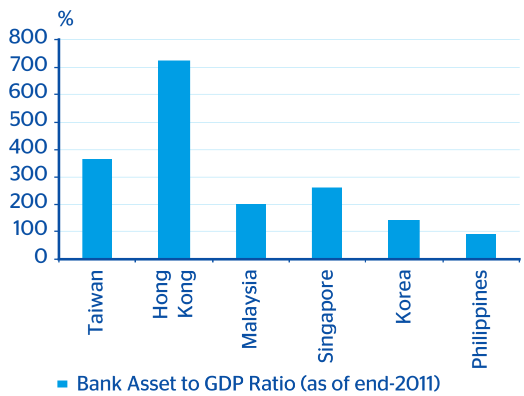
Furthermore, looking at the nature of Chinese trading partners, it seems clear that Taiwan and Hong Kong have very distinct features, namely, Taiwan is manufacture-based while Hong Kong is relatively finance-oriented. In addition, there is a marked difference in their trade position. According to China's customs statistics, Hong Kong has a sizable trade deficit of USD 252.5 billion with Mainland China while Taiwan has a large trade surplus of USD 89.8 billion. Creating a CNT market would, not only facilitate RMB settlement for trade purposes while saving firms from exchange risks and transaction costs, but also open up the avenue for RMB-denominated wealth management businesses in the future. In fact, RMB products would offer additional currency diversification gains to Taiwanese savers.

As for financial links, despite the large amount of direct FDI from Taiwan acknowledged by China, it is believed that the FDI from Hong Kong, which account for 72% of China's total inward FDI, contains a considerable part which is actually from Taiwanese. All in all, Taiwan is clearly one of the most important foreign direct investors for China.

Other than benefiting from real sector RMB flows, China would also count with a very large pool of savings to hold RMB assets. Taiwan's financial assets amount to 367% of GDP as the end of 2011. (Chart 9). The size of the bond market is actually larger than that of Hong Kong or Singapore. (Chart 10) Finally, the total market capitalization of the stock market in Taiwan is USD 635 billion as of end-2011 only slightly smaller to that of Singapore (USD 735 billion at end 2011).

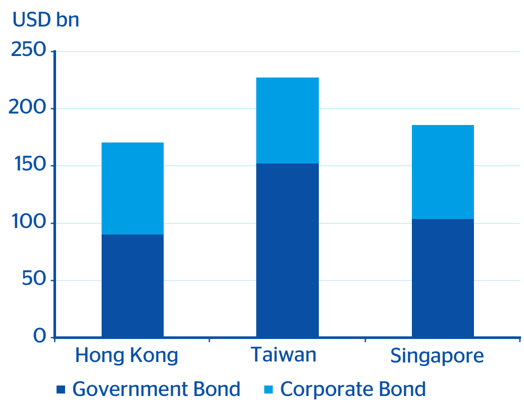
The final, and probably most important, advantage for China to draw from creating a CNT offshore market lies in the political sphere. It goes without saying that this should improve the overall framework of current economic cooperation across the Strait.

Chart 9
Taiwan has a high ratio of banks assets to GDP among Asian economies



Source: CEIC and BBVA Research

Chart 10
Taiwan's bond market is relatively large in Asia economies



Source: CEIC and BBVA Research

Would Hong Kong necessarily lose out?

Since the full launch of cross-border RMB settlement program in June 2010, the share of RMB related business has been growing rapidly. Now the RMB has become the second largest foreign currency after the US dollar. At the same time, credit growth has been particularly high and the economy has been booming with several unintended but conceivable consequences, such as asset and consumer price inflation.

The worrisome part, however, is that the CNH business is really at its infancy since it is still tiny for China's financial muscle. In fact, the share of CNH assets remains well below 1% of China's M2. . Such a small figure is a drop in the ocean compared with the ratio of offshore dollar to US M2 (is around one-third at the end of 2008.). The amount of CNH deposits is also tiny when compared with the cross border holdings of international currencies like the dollar or the euro.

It goes without saying that Hong Kong alone cannot serve the demand of RMB assets around the world. The sooner this is recognized the less risky it will be for Hong Kong in terms of growing asset bubbles. Beyond Hong Kong's actual capacity to serve the market, there exists the risk of financial instability since the access to onshore RMB remains limited and the lender of last resort (namely the HKMA credit line) is relatively small as compared to the rapidly growing RMB liabilities in Hong Kong's banking system.

Having Taiwanese holding their own RMB assets would, therefore, seem a legitimate option for, at least, more diversification of the deposit holders given the space which Taiwanese depositors would leave open if they were to move their CNH holdings into CNT ones. Indeed, the emigrant Taiwanese enterprises operating in China have their needs in repatriating part of the earnings. The existence of CNT could effectively relieve Hong Kong from the mounting pressure due to the rapidly growing RMB deposits. CNT can also extricate the emigrant firms from the limits of annual personal quota of USD 50,000, implying a costly and time-consuming remittance process under the current exchange regime in China. More importantly, it is also in the interest of China to form a market of CNT since it helps to provide a better and even more precise indication of Greater China economic activities as reflected by the cross-border monetary flows whilst sustaining a large bulk of Taiwanese earnings denominated in RMB.

Finally, it should be noted that the creation of a CNT off-shore center would not, in any way, prevent the creation of others, in particular London and Singapore since their raison-d'être is totally different. London would be instrumental in attracting investors within different time zones (especially Europe but even the US unless New York is also pulled in). Singapore could become a major RMB settlement center for ASEAN.

What can be done?

Given the very stage of discussions, it is quite difficult to imagine which steps would be most appropriate for the CNT market to be created. Still, Hong Kong's experience may offer some lessons to Taipei. There seem to be a number of preconditions for an offshore RMB center to grow. One of them is that financial institutions from the two sides of the Straits need to be able to operate more freely on the other side. A comparison of Taiwan's ECFA with Hong Kong's CEPA shows that China promised a large extent of opening-up to Hong Kong's service sector, which has helped create more demand of RMB settlement for the service providers in Hong Kong. In that regard, it seems imperative that at least one of the two major state-owned commercial banks be in full operation in Taipei so as to act as custodian bank. Based on Hong Kong experience, this would probably be Bank of China.

Table 1 shows the cross-presence of financial institutions in the two sides of the Strait. In May 2010, the Bank of China and Bank of Communications had been approved to setup representative office in Taiwan but that is still not enough for a custodian role. The fact that Taiwan's current foreign exchange management system does not include RMB as an intermediary of clearance obviously complicates the opening up of Chinese branches in Taiwan.

As for FDI, Taiwan faces much stronger limitations for outbound investment into China (regulations are listed in Table 2). Moreover, the barriers in cross-strait investment not only lie in the financial sector but also in other industries as well. The existence of these investment barriers would hinder the development of the CNT market since there official return of RMB into China for FDI would suffer such regulatory constrains.

Finally, of the creation of a RMB money market in of critical importance and, of course, the existence of a swap line in RMB from the Central Bank of China in Taiwan and the PBoC. to. In the past few years since the end of 2008, China has already signed currency swap agreements with 16 economies, most of which locate in Asia including Hong Kong (effective in 2009 / renewed in 2011) and Singapore (effective in 2010).

All in all, we believe that Taiwan should be one of the off-shore financial centers which Chinese authorities should consider for internationalizing the RBM. The scarce competition with London or Singapore and the fact that Hong Kong cannot possibly absorb all RMB related operations, the CNT looks like a win-win situation for all.

Table 1
Progress on Cross-Strait Financial Cooperation Agreement

		China	Taiwan
Sector	Time	Rules & Regulation/Announcements	Rules & Regulation
Banking	04/2009		Cross-Strait Financial Cooperation Agreement
	11/2009		The Memorandum of Understanding on Cross-Straits Banking Supervision Cooperation
	07/2009	Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions 2. Regulations for Implementing the Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions	
	08/2011	A Notice on Extending Geographical Coverage of Use of RMB for Cross-border Trade Settlement[3]	
	02/2010	Elucidation of Supervisory Principles and Operational Arrangements Regarding Renminbi Business in Hong Kong	
	09/2011		Regulations Governing the Banking Activity and the Establishment and the Investment by Financial Institution Between the Taiwan Area and the Mainland Area
	02/2010	Elucidation of Supervisory Principles and Operational Arrangements Regarding Renminbi Business in Hong Kong	
Securities	03/2010		Regulations Governing Approval and Management of Securities and Futures Transactions and Investment Between the Taiwan Area and the Mainland Area
	07/2011		
Insurance	03/2010	Cross-Strait Financial Cooperation Agreement	Regulations Governing Permission of Insurance Business Transactions and Investment Between the Taiwan Area and the Mainland Area

Source: Financial Supervisory Commission, Taiwan and BBVA Research

3: Subsequent to the visit of Chinese Vice Premier Li KeCiang in August 2011.

Table 2
Outbound Limits from Taiwan Regarding Financial Investment in China

Sector	Form of Investment	Limits
Financial Holdings Company (including its directly and/or indirectly controlled enterprises, exclude banking)	Cross-strait Direct Investment	< 10% of Net Worth of the entire FHC[4]
Banking	Branch, subsidiaries and equity investment	< 15% of Net Worth of the Bank[5]
	Credit, Investment and overnight lending/borrowing activities	< 200% of the bank's net worth in the previous accounting year[6]
Securities and Futures	Branch, subsidiaries and equity investment	< 40% of Net Worth of the corporation[7]
Insurance	Branch, subsidiaries and equity investment	< 40% of owner's equity of the corporation[8]

Source: Financial Supervisory Commission, Taiwan and BBVA Research

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4: Article 7 of the "Regulations Governing the Banking Activity and the Establishment and the Investment by Financial Institution Between the Taiwan Area and the Mainland Area," Financial Supervisory Commission, Taiwan.
5: Ibid 4.
6: Article 12-1 of the "Regulations Governing the Banking Activity and the Establishment and the Investment by Financial Institution Between the Taiwan Area and the Mainland Area," Financial Supervisory Commission, Taiwan.
7: Article 5 of the "Regulations Governing Approval and Management of Securities and Futures Transactions and Investment Between the Taiwan Area and the Mainland Area," Financial Supervisory Commission, Taiwan.
8: Article 6 of the "Regulations Governing Permission of Insurance Business Transactions and Investment Between the Taiwan Area and the Mainland Area," Financial Supervisory Commission, Taiwan.

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