



Development of Hong Kong's Offshore RMB Market and Its Prospects

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I. The characteristics of Hong Kong's offshore RMB market: policy-driven and market oriented

Looking back at the progress over the last ten years, evidently, Hong Kong's offshore RMB market featured being both policy-driven and market-oriented. Since the People's Bank of China gave the green light to overseas RMB businesses in 2003, every milestone achieved in market development has been closely connected with the relaxation of relevant regulations in Mainland China: In January 2007, the People's Bank of China began to allow qualified domestic financial institutions to issue RMB-denominated bonds in Hong Kong. Since 2009, the Ministry of Finance has been issuing RMB sovereign bonds in Hong Kong, which led to the development of the local dim sum bond market. In July 2009, the launch of cross-border RMB trade settlement ushered in a second phase of RMB businesses in Hong Kong. In August 2011, the RMB trade settlement program was expanded to cover all Chinese territories. RMB businesses in Hong Kong were also extended from individuals to corporations and institutions. In 2011, the Chinese government implemented the RQFII program, which allows qualified foreign investors to invest in the domestic securities market. Since March, 2013, all financial institutions that are registered in Hong Kong or operate mainly in Hong Kong are qualified for the RQFII program. More importantly, the RMB capital flows have shifted from one-way flow back to the Mainland to flows in both directions, which represents a major step forward in the process of RMB internationalization. Hong Kong becomes a pioneer and center for global RMB product engineering and trading.

The development of offshore RMB market is highly dependent on market demand for RMB products. The demand of RMB products and transactions has been rising in recent years and expanding globally. Hong Kong has shown its first-mover advantage in breadth and depth over other offshore RMB markets on the basis of the amount of daily transactions and the variety of product choices, creating a virtuous cycle of demand and supply that leads to further expansion. RMB trade settlement processed by Hong Kong banks jumped from 369.2 billion Yuan in 2010 to 3.841 trillion Yuan in 2013 for an increase of over 10 times. As of the end of 2013, there were nearly 4.5 million RMB deposit accounts in Hong Kong, averaging 191,400 Yuan per account. By the end of 2013, Hong Kong had amassed the largest RMB pool of 1.053 trillion Yuan outside the Mainland, 191.3 billion Yuan of which being certificates of deposits. RMB deposits in Hong Kong's banking system account for about 60% of the global total. The outstanding amount of Dim Sum bonds rose from 55.8 billion Yuan at the end of 2010 to 310 billion Yuan at the end of 2013 for an increase of 460%, propelling Hong Kong to become the largest offshore RMB bond market.

II. The new changes in Hong Kong's offshore RMB market

Built on the fast-paced development over the last ten years, Hong Kong's offshore RMB market is starting to show some signs of new changes, mainly in the following four perspectives.

First of all, the volume of offshore RMB settlement has experienced substantial growth, surpassing that of the Hong Kong dollar to become an essential part of Hong Kong's settlement market.

In June 2014, the RMB RTGS settlement amounted to 14.2 trillion Yuan, an increase of 7.5% from the previous period. In the first half of 2014, the accumulative settlement totaled 79.1 trillion Yuan, an increase of 118.2% from a year ago. This amount comes close to the total amount for the full year of 2013, which was 80.1 trillion Yuan. From January to April 2014, the RMB RTGS turnover was 51.6 trillion Yuan, whereas the Hong Kong RTGS turnover was 59.9 trillion HK dollars, or 47.9 trillion Yuan. Thus, since April 2014, the monthly trading volume of RMB RTGS in Hong Kong has surpassed that of HK dollars to become one of the main currencies of Hong Kong's settlement market.

Secondly, cross-border use of RMB under the capital account has surged, becoming a new driving force for the development of Hong Kong's offshore RMB market.

Recently, cross-border RMB businesses under the capital account have been growing much faster than under the current account. In 1Q14, cross-border RMB trade settlement totaled a cumulative 1.65 trillion Yuan, up 64% from a year ago. About 18.5% of the cross-border trade was settled in RMB. Meanwhile, ODI and FDI combined reached 193.1 billion Yuan, an increase of 126% YoY, which was substantially faster than trade settlement growth. It is estimated that by year 2020, the total settlement value of RMB cross-border investment will exceed that of cross-border trade. Under such circumstances, Hong Kong may turn to capital account related businesses as the new driving force for offshore RMB market development.

Thirdly, forex trading activities have gained more significance in Hong Kong's offshore RMB market.

In 1Q14, the RMB forex trade turnover was 17.2 trillion US dollars, compared to the RMB payment service's turnover of 11.16 trillion US dollars at the same time. Apparently, the persistent growth of various foreign exchange and their derivatives products in the offshore market resulted in increase in forex trading. It is expected that as the opening of the Mainland's capital account accelerates, market demand for hedging will continue to grow, and financial derivatives are highly likely to become key products in the next stage of promotion of offshore RMB products. Hong Kong's foreign exchange market will play an increasingly important role in their trading.

Fourthly, Hong Kong's offshore RMB market will, to some extent, begin to allocate its funds globally.

Currently, Hong Kong is the main deposit market for offshore RMB. In May 2014, RMB deposit in Hong Kong amounted to 955.8 billion Yuan. Including deposit certificates, Hong Kong's RMB funding pool exceeded 1.17 trillion Yuan.

The main usage of Hong Kong's offshore RMB funds consists of loans and Dim Sum bonds.

According to the HKMA, by the end of March 2014, Hong Kong's RMB outstanding loans amounted to 121.0 billion Yuan. Dim Sum bonds' issuance (excluding CD) was 58.6 billion Yuan, and their outstanding balance was nearly 350 billion Yuan. The sum of the two was 471.0 billion RMB, only around 40% of the Hong Kong offshore RMB funds pool. Apparently, at current stage, the Hong Kong market itself cannot fully utilize its RMB funds pool, and some RMB liquidity will be used for the development of other offshore markets via interbank lending and swap, etc. Recently, RMB loans in other offshore markets have experienced fast growth and may have surpassed that of Hong Kong. Thus it is evident that RMB funds in Hong Kong are being allocated around the world.

III. New opportunities and challenges facing Hong Kong's offshore RMB market

In the next phase, Hong Kong's offshore RMB market will be facing opportunities and challenges on three fronts.

First of all, the internationalization of the RMB is accelerating and other offshore RMB centers are emerging rapidly

Recently, RMB internationalization expedites the growth of businesses such as offshore RMB deposits, bonds, foreign exchange transactions. According to a report by Bank of China, the 1Q14 offshore RMB Index (ORI) increased from 0.91% at the end of 2013 to a record high 1.07%. The corresponding figures were 0.32% and 0.50% at the end of 2011 and 2012 respectively. Its accelerating rise indicates that RMB internationalization is picking up pace.

Such development suggests that the gap between the RMB and other major international currencies is gradually narrowing. According to Bank of China, at the end of 2013, the US dollar, Euro, Pound Sterling, Japanese Yen's offshore indices were 48.17%, 25.20%, 5.91%, and 5.50% respectively. Obviously, the US dollar and the Euro still dominate the international financial arena. There is still great room for further internationalization of the RMB.

The acceleration of the RMB's internationalization coincides with the rapid emergence of other offshore RMB centers. BOCHK was appointed the RMB clearing bank at the end of 2003. Subsequently, more have emerged in the past two years. In 2013, new RMB clearing banks were appointed in Taiwan and Singapore by the People's Bank of China, propelling the two areas to become new offshore RMB centers. In June 2014, the People's Bank of China authorized China Construction Bank (London) Limited as the Clearing Bank of RMB businesses in London, and the Frankfurt branch of Bank of China as the Clearing Bank for RMB businesses in Frankfurt. Moreover, the People's Bank of China signed memorandums of cooperation with Bank of France and Central Bank of Luxembourg, which would lead to RMB clearing banks in Paris and Luxembourg. In July 2014, the People's Bank of China authorized the Seoul Branch of Bank of Communications of China as the Clearing Bank for RMB businesses in Seoul. Meanwhile, the RMB clearing system co-developed by Bank of China and the Australian Stock Exchange was officially launched. The establishments of RMB clearing banks in succession marked a key progress achieved in the internationalization of the RMB, which in turn will further promote the development of offshore RMB markets and offshore RMB centers.

RMB globalization and successive emergence of more offshore RMB centers have not only provided more business opportunities for Hong Kong's offshore RMB market, but also brought

in more competition which could potentially lead to a decline in Hong Kong's market share. According to statistics by SWIFT, in the top ten countries and regions for RMB payment, Hong Kong's market share fell from 85.1% by the end of 2012 to 78.6% by the end of 2013. The first quarter of this year saw a further decline to 74.6%. It is fair to say that the acceleration of RMB globalization and the successive emergence of other offshore RMB centers have resulted in both opportunities and, to a greater extent, an ongoing challenge for Hong Kong.

Secondly, the domestic financial system reform continues to accelerate.

Ever since the Third Plenary Session of the 18th Central Committee, various domestic financial reform policies have been introduced in an intensive fashion, covering a number of areas including interest rates, exchange rates, capital account management, etc. The application of reform has also expanded from a few selected pilot zones. Domestic financial reform continues to accelerate, offering offshore RMB markets more room for development. In particular, the Shanghai Free Trade Zone, Qianhai and Yiwu have followed a series of reform and the Shanghai-Hong Kong Stock Connect will have a big impact on Hong Kong's offshore RMB market.

To Hong Kong's offshore RMB market, the reform in Shanghai Free Trade Zone means RMB funds will flow more conveniently in and out of China. The test area and the offshore RMB market will have the opportunity to bind together, helping to expand the overall volume and size of the offshore market.

The Shanghai-Hong Kong Stock Connect has generally progressed smoothly and will likely be launched on time, with relevant measures having been implemented. The launch of Shanghai-Hong Kong Connect is an important part of China's financial market liberalization, which signals the opening of capital account in China is picking up pace. In terms of system design, Shanghai-Hong Kong Connect is a two-way arrangement between the Chinese mainland and Hong Kong for capital outflows and inflows. Its focus is on the interaction between Hong Kong and Mainland financial markets that allow direct access for Hong Kong and overseas investors into Mainland capital market. Meanwhile, under certain conditions, domestic residents will be allowed to invest in overseas markets, accelerating the construction of a market-oriented system for the mainland capital market and promoting financial markets reforms. Shanghai-Hong Kong Connect, by bypassing the existing foreign exchange regulatory system and with the help of the offshore RMB market, will achieve two-way RMB foreign exchange and complete a circular flow of RMB investments. The whole process will be a fully closed operation. Obviously, under this institutional arrangement, mainland investors can use RMB directly to invest in Hong Kong, which will increase the pool of funds in offshore RMB market and expand investment channels for offshore RMB funds, thereby facilitating the orderly flow of RMB in both directions, promoting offshore RMB market development, accelerating the pace of RMB internationalization, and ultimately opening China's capital account.

Shanghai-Hong Kong Connect also means that domestic economic policy makers have always regarded Hong Kong as the best testing ground for RMB's international development. Despite rapid growth of offshore RMB centers around the world, Hong Kong's offshore RMB market and the role it plays in RMB internationalization are still irreplaceable.

Thirdly, the two-way fluctuation of RMB exchange rate has implications on Hong Kong's offshore RMB market.

Since March this year, RMB exchange rate reform has switched into the fast lane. Following the expansion of RMB spot exchange rate trading band in early March, on July 1, The People's Bank of China issued a Notice on Trading Prices in Interbank Foreign Exchange Market and Banks' Exchange Rate Quotations, cancelling bank's price variance management over customers' dollar listing bid. Banks can now list the exchange rates of various currencies against RMB independently based on market demand and pricing power. As a result, the determination of exchange rates has become more market-oriented. These reform measures mentioned above have received positive market feedback. Expectation of two-way exchange rate fluctuation will become increasingly entrenched and create a good external environment for the central bank to steadily promote market-oriented reforms of RMB exchange rate system. The next step may involve exploring the possibility of expanding the role of market supply and demand in formulating exchange rates.

As for RMB exchange rate movements, as of July 31, the RMB had depreciated 2% against US dollars and was one of the worst performers in emerging markets. The most direct impact of two-way RMB exchange rate expectation on Hong Kong's offshore market is slowing growth of offshore RMB funds. Meanwhile, the RMB exchange rate is gradually becoming more market-driven, which will drive the demand for forex trading products in Hong Kong's offshore RMB market. At present, the daily average volume of RMB trading in global forex market is about \$ 120 billion, ranked ninth in the world. The liberalization of RMB exchange rate will help expand the foreign exchange trading space, and transaction volume is expected to grow rapidly. In addition, the RMB is no longer a one-way bet, which will create demand for hedging products or related hedging portfolio that will insure against fluctuations. This may also result in a decrease in demand for certain product types that aim to profit from RMB appreciation or depreciation.

IV. Prospects of Hong Kong's offshore RMB market and its impact on RMB internationalization

A tentative virtuous cycle has emerged in Hong Kong's offshore RMB market. Offshore RMB businesses in Hong Kong are extended from individuals to trade settlement and investment activities. Once the first offshore capital pool is built and grows to a certain scale, RMB financing activities continue to increase. Through the development of RMB bonds, loans, funds and equity products, Hong Kong has also become the largest offshore RMB asset management center and offers a wide range of RMB products. Diversified RMB financial products have facilitated trade transactions and investment businesses, creating a virtuous circle.

Facing challenges and opportunities, Hong Kong's offshore RMB market should steadily improve this virtuous circle and expand it to other offshore RMB markets. Hong Kong should play an active role in providing settlement services and capital for global offshore RMB clearing to ensure its status as the world's largest offshore RMB center.

By establishing a virtuous cycle on a global scale, Hong Kong's offshore RMB center will play an indispensable role in the process of RMB internationalization.

Firstly, Hong Kong, the freest economy in the world, can to some extent make up for the lack of openness of the Chinese economy and the deficiencies of its financial markets. Thus, RMB has been equipped with some basic conditions for its internationalization. According to the IMF, economic size and openness are the prerequisites of currency internationalization, while adequate balance of payments and relatively stable economic performance, regulatory

capacity also help. China has made great progress in the prerequisites of currency internationalization. China obviously excels in economic scale and trading volume. China is the world's second largest economy and the largest exporter as well as the second largest importer. However, China still has a lot of room for improvement when it comes to its economy's openness and market mechanism. In particular, China has a long way to go before it can meet the requirements of an open capital account, floating exchange rates, and highly developed financial markets. Fortunately, Hong Kong can to some extent make up for the lack of openness of the Chinese economy and help China meet the prerequisites of currency internationalization.

Secondly, so long as China maintains capital controls, non-residents must use Hong Kong to obtain RMB assets. The U.S. experience shows that capital control is not the prerequisite of currency internationalization but it does hinder the process of currency internationalization. Recently, there are some new measures to increase the openness of capital account introduced in Mainland, such as the Shanghai Free Trade Zone and the Shanghai – Hong Kong equities connectivity program. Arrangements that facilitate two-way capital flows between Mainland China and Hong Kong can help connect the Mainland's and Hong Kong's capital markets. Even as the Mainland's capital control measures remain in place, Hong Kong and overseas investors will be able to enter the Mainland's capital markets via the offshore market in Hong Kong. Meanwhile, under some predetermined conditions, domestic Chinese residents should be allowed to invest overseas.

Thirdly, to deepen China's financial markets, Hong Kong's experience can be duplicated.

Currency internationalization requires support from financial markets with breadth and depth, which Mainland China still lacks. However, as financial cooperation between Hong Kong and the Mainland improves, Hong Kong's experience can play an active role in the developments of the Mainland's financial markets by helping the Mainland's financial infrastructure become more market-oriented and providing Mainland with a laboratory for exchange rate and interest rate reforms.

Fourthly, the growth of Hong Kong's offshore market can boost international investors' confidence in RMB-denominated assets.

Ultimately, whether the RMB can become a reserve currency will depend on the level of acceptance by international markets. As the Hong Kong dollar is pegged with the U.S. dollar, Hong Kong's financial markets are unique and irreplaceable. Prior to becoming an offshore RMB center, Hong Kong had already been a mature offshore financial market, specializing in syndicated loans, asset management, and equities trading. Offshore RMB provided Hong Kong's offshore financial market with a new trading currency and related financial products, which will boost both Hong Kong's economy and its financial sector's global competitiveness.

There is no denying that the current onshore-offshore dual pricing mechanism generates arbitrage opportunities. That being said, we believe that the existence of arbitrage opportunities could force domestic exchange rate reforms. Meanwhile, to counter arbitrage activities, capital controls can be gradually relaxed, and exchange rates could be made more flexible in responding to capital flows. Moreover, in order to achieve external rebalancing, policy measures can create incentives to increase outflow in the capital account and inflow in the current account.

In short, Hong Kong's open and free financial markets, its common law legal framework, and modern regulatory oversight all help improve international investors' confidence in holding RMB assets. These will ensure that Hong Kong become the largest offshore RMB market.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	2012	2013	2013/Q4	2014/Q1
總量 (億元) GDP(\$100 Million)	19,644	20,372	5,801	5,300
升幅 (%) Change(%)	1.5	2.9	2.9	2.5
二. 對外貿易 External Trade	2012	2013	2014/6	2014/1-6
外貿總值 (億元) Total trade(\$100 Million)				
港產品出口 Domestic exports	588	544	48	27,649
轉口 Re-exports	33,755	35,053	3,044	16,902
總出口 Total exports	34,343	35,597	3,092	17,178
進口 Total imports	39,122	40,607	3,523	19,810
貿易差額 Trade balance	-4,778	-5,010	-431	-2,632
年增長率 (%) YOY Growth(%)				
港產品出口 Domestic exports	-10.4	-7.6	7.3	3.7
轉口 Re-exports	3.2	3.8	11.4	2.8
總出口 Total exports	2.9	3.6	11.4	2.8
進口 Imports	3.9	3.8	7.6	3.3
三. 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	4.1	4.3	3.6	3.9
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數 (宗) No. of agreements	115,533	70,503	9,400	43,589
年升幅 (%) Change(%)	6.2	-29.9	71.3	-2.2
五. 勞動就業 Employment	2012	2013	2014/3-2014/5	2014/4-2014/6
失業人數 (萬人) Unemployed(ten thousands)	12.45	11.84	12.1	12.6
失業率 (%) Unemployment rate(%)	3.2	3.2	3.1	3.2
就業不足率 (%) Underemployment rate(%)	1.5	1.4	1.5	1.5
六. 零售市場 Retail Market	2012	2013	2014/6	2014/1-6
零售額升幅 (%) Change in value of total sales(%)	9.8	11.0	-6.9	-1.3
零售量升幅 (%) Change in volume of total sales(%)	7.2	10.6	-7.5	-1.1
七. 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	4,862	5,430	449	2,853
年升幅 (%) Change(%)	16	11.7	6.9	12.5
八. 金融市場 Financial Market	2012	2013	2014/5	2014/6
港幣匯價 (US\$100=HK\$)	775.05	775.4	775.3	775.1
H.K. Dollar Exchange Rate (US\$100 = HK\$)				
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	22.2	9.7	7.9	14
M2	11.1	12.3	12.6	15
M3	11	12.4	12.7	15
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	9.3	10.6	11	13.3
港元存款 In HK\$	11.7	5.1	9.9	13.1
外幣存款 In foreign currency	7	16.2	12.1	13.6
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	9.6	16.0	18.0	16.0
當地放款 use in HK	7.1	13.8	16.1	14.9
海外放款 use outside HK	16.5	21.4	22.8	18.9
貿易有關放款 Trade financing	10.2	43.8	21.2	11.6
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	22,657	23,306	23,082	23,191