



Five Driving Forces for Hong Kong's Offshore RMB Market following the Currency's Inclusion in the SDR Basket

Dr. E Zhihuan

Chief Economist, Bank of China (Hong Kong)

On October 1st, the RMB was officially included in the IMF's Special Drawing Rights (SDR) basket of currencies. With a weight of 10.92%, the RMB trails only the dollar and the Euro among the five international reserve currencies. The RMB joining the SDR basket is a major event of global financial management as well as an important milestone of the currency's internationalization. As a result, the driving force of RMB internationalization will expand from China's financial regulatory authorities to global multilateral institutions. The IMF's endorsement of the RMB as an international reserve currency will help speed up the pace of internationalization, bringing new opportunities to Hong Kong's offshore RMB market.

1. The RMB's international reserve currency function will help restore market confidence.

Technically, the SDR is not a truly global supranational currency, with only some 200 billion dollars of value. Therefore, the direct impacts of joining the SDR basket will be relatively limited. That said, the RMB will improve the representativeness of the SDR and increase its influence in foreign reserves management. In this regard, the RMB joining the SDR basket will help fulfill the SDR's long-term and irreplaceable potential as a positive influence in global financial markets.

In the long haul, with SDR status, the RMB will establish itself as an international currency, transforming from an important global payment currency to a major reserve currency. Meanwhile, the RMB will also be increasingly widely used in trade and investments, becoming a major investment and financing currency and one in which commodity trading is denominated. The RMB will thus assume an important role in the global financial structure.

The development of the RMB as an international reserve currency will help restore market confidence in two aspects.

The first aspect is the foreign exchange mechanism. After joining the SDR, as a new international reserve currency, the RMB's foreign exchange mechanism will become more market-oriented. In particular, the RMB's exchange rate will become more flexible, increasingly being determined by changes in market supply and demand under the current and capital accounts. Increasing influence of market forces on the

RMB's exchange rate will help improve the predictability of the currency, supporting market confidence.

The other aspect has to do with market supply and demand. After the RMB joins the SDR basket, international capital inflow into mainland China may increase. The 188 members of the IMF will be able to hold RMB assets to meet their international payment and borrowing needs. Central banks and monetary authorities will also likely increase their RMB assets, pushing up the share of the RMB in global foreign reserves.

As per our observation, the investing style of central banks and sovereign wealth funds is clearly different from that of individual investors. There need for diversification is stronger, in addition to important considerations of liquidity, security, and total return. Fluctuations in exchange rates is but one factor, more important are diversification, the availability of a variety of investment choices, market breadth and depth, and convenience of trading. The RMB, as the first emerging market currency to join the SDR basket, can effectively meet these needs. Central banks and sovereign wealth funds will gradually increase their holdings of RMB-denominated assets and become important drivers of RMB internationalization.

In addition, as the occurrence of black swan events in financial markets is becoming increasingly frequent, the risks of sterling and Euro-denominated assets have risen. In the new round of portfolio rebalancing, due to the RMB being a high-yield currency, RMB-denominated assets will attract the attention of investors.

2. The RMB joining the SDR will accelerate the opening up of domestic capital markets.

The inclusion of the RMB in the SDR will provide central banks with more options of foreign reserve currencies, generating tremendous demand for RMB businesses. The driving force of RMB internationalization will gradually shift from cross-border trade and investment to cross-border investments and financial transactions, with domestic capital markets being a core platform.

First, increasing demand for RMB reserve assets will propel the development of the bond market.

A series of policy measures have been launched in order to facilitate overseas institutions to invest in China's domestic bond market. The measures include abolishing investment quotas for central banks and eligible overseas institutions, extending the transaction period of domestic foreign exchange market, and introducing more eligible entities into the domestic interbank foreign exchange market. Recently, the International Bank for Reconstruction and Development (IBRD), a subsidiary of the World Bank, issued 500 million SDRs of RMB-denominated 3-year bonds in China's interbank bond market. This issuance offered a new type of bond to choose from in the global bond market. The implementation of the aforementioned measures will provide the RMB bond market with new opportunities.

As of August 2016, the volume of domestic bond custody amounted to RMB 59.5 trillion. The share

of bond custody for overseas institutions was less than 2%, far below 6% in India, 16% in Thailand, 34% in Malaysia, 58% in Indonesia, 10.6% in Japan and 48.2% in the US. After the RMB is added to the SDR, central banks may consistently increase their investments in the onshore bond market. Other institutional investors may follow suit and begin to allocate some of their portfolios to RMB assets.

According to statistics from the PBOC, as of the end of June 2015, RMB assets held by overseas central banks amounted to RMB 782.2 billion, or USD 127.9 billion. At the end of 2015, 50 central banks included the RMB in their foreign reserves. From February to August this year, there was a net increase of RMB 134.4 billion in bonds held by overseas institutions in the domestic interbank bond market.

Bank of China (Hong Kong) estimates that in the next three years, the share of RMB assets in global foreign reserves will increase from about 1% currently to 5%, or USD 350-400 billion based on the size of current global foreign reserves. This number exceeds the value of outstanding RMB bonds in the offshore markets. In the next five to ten years, the share of RMB in global foreign reserves may approach 10%, and RMB foreign reserves held by major central banks may increase to USD 680 billion.

Second, the connectedness of equity markets provides overseas institutions with more channels for investing in RMB assets.

The launch of “Shanghai—Hong Kong Stock Connect” in November 2014 expanded offshore RMB businesses to capital markets. In August 2016, average daily transaction for the Northbound Shanghai Trading Link dropped 45% from a year ago to RMB 3.2 billion, while average daily transaction for the Southbound Hong Kong Trading Link surged 70.2% year-on-year to RMB 4.1 billion.

The announcement of the upcoming “Shenzhen—Hong Kong Stock Connect” in August 2016 will further strengthen the connection of domestic and overseas capital markets, meeting overseas investors’ demand for diverse investments in mainland China. Active capital flows will offer more business opportunities for security firms and banks and improve the breadth and depth of mainland equity markets.

Mainland China has gradually relaxed restrictions on the Qualified Foreign Institutional Investors (QFII) program in order to attract overseas capital to the onshore market. In February of this year, State Administration of Foreign Exchange (SAFE) announced measures including relaxing investment quota ceilings, simplifying approval procedures, and requiring only filing in case of applying for increases in investments within the base quota. Recently, the Mainland abolished the minimum requirement of holding 50% equities in QFII portfolios, affording more flexibility in asset allocation between equities and bonds.

As the opening up of the mainland’s capital markets accelerates and the participants become more diverse, there will be certain changes in trading patterns and market price fluctuation. Financial market movements will increasingly hinge on the internal and external balance of the Chinese economy. Meanwhile, the number of transmission channels of global market volatility to domestic financial markets may increase, resulting in more complex dynamics between various markets. Therefore, defending against systemic risks

will become a bigger challenge.

3. Hong Kong's offshore RMB market has entered a period of adjustment.

RMB businesses have long been a core advantage of Hong Kong's financial markets and a major driver of Hong Kong's development as an international financial center. Hong Kong is a leading offshore RMB center, boasting the world's only RMB real time gross settlement (RTGS) system, the most advanced infrastructure of RMB businesses, and the largest offshore RMB capital pool. However, since the second half of last year, due to rising volatility in the RMB's exchange rate, Hong Kong's offshore RMB market has entered a period of adjustment, as reflected by the following developments.

1) The volume of offshore RMB businesses continues to contract.

In 2015, RMB deposits in Hong Kong were down 15.2%, recording the first annual decline. In 2016, the capital pool kept shrinking. As of August, 2016, RMB deposits amounted to 652.9 billion Yuan, 23.3% lower than the year-end level in 2015. Meanwhile, the RMB's share of total deposits also dropped from 9.4% at the end of 2015 to 6.7%.

In 2015, the issuance of Dim Sum bonds declined by 61.9% to 75 billion Yuan. For the first eight months of 2016, Dim Sum bond issuance amounted to only 22.1 billion Yuan, 63.8% lower than the same period last year.

2) Market volatility on the rise.

Market expectation for U.S. rate hikes has pressured the RMB's exchange rate. The value of offshore RMB became increasingly volatile, and the direction of appreciation has been reversed. As of the end of the third quarter, offshore RMB had depreciated 1.6% against the dollar from the end of 2015.

The interbank offered rates of offshore RMB also experienced heightened volatility. After the Chinese New Year, Hong Kong's RMB interbank rates were usually under 2% and even dropped below zero on some occasions. Since September 8th, due to a number of technical and seasonal factors, some funds moved onshore, causing a dramatic rise in RMB HIBOR. On September 19th, overnight, 1 week, 1 month, and 3-month RMB HIBOR's surged to the highest levels since January 12th at 23.68%, 12.45%, 7.72%, and 5.86%, respectively. In late September, Hong Kong's RMB interbank rates gradually returned to normalcy.

3) Activities in RMB markets remained subdued, with sliding volumes in interbank borrowing, spot and futures foreign exchange trading, derivatives, and Dim Sum bond.

It is clear that Hong Kong's offshore RMB market, after a decade of development, is experiencing growing pains. A new growth engine is badly needed.

4. The new developments of RMB internationalization will provide Hong Kong's offshore RMB market with five driving forces.

After the entry of the RMB into the SDR, more countries and regions will intend to establish stronger cooperation ties with the relevant authorities in the Mainland. The geographical structure of RMB internationalization is expected to adjust quickly. Recently, RMB clearing banks were established in both the US and Russia, supporting RMB clearing and settlement services in North America. With the geographical expansion of offshore RMB markets, increases in the overall offshore RMB market size are likely to follow. Different offshore markets can complement with each other, creating a new system of multi-regional offshore RMB payments.

Given Hong Kong's lack of any capital control and its first mover advantage and economies of scale in RMB businesses, it has the capability to extend its influence to other offshore RMB markets. Hong Kong can also cooperate with other RMB markets to enhance its role as an offshore RMB hub. Moreover, by working hard to establish itself as a center in the following five offshore RMB businesses, Hong Kong can become a global hub of offshore RMB markets.

The five areas are as follows.

1) Establish itself as a center of offshore RMB financial products development.

Hong Kong should actively seize the opportunities of the RMB's inclusion into the SDR, utilizing its advantages as a prominent international and offshore financial center in Asia Pacific as well as a major springboard for Mainland companies to go global and for international companies to enter China. Moreover, Hong Kong should quickly enhance its RMB product development and services to satisfy new demand for RMB businesses. In particular, product development should especially focus on the needs of central bank clients. This will help attract more clients and spur the growth of Hong Kong's offshore RMB market.

2) Establish itself as a center of offshore RMB risk management.

Hong Kong should offer a wide range of RMB hedging tools to global corporate and institutional clients so as to safeguard capital allocation into RMB assets. After the RMB's inclusion into the SDR, its exchange rate regime will likely become more market-oriented, and the participants of RMB exchange markets will become more diversified and complex. Two-way fluctuation in the RMB exchange rate will begin in earnest. With more widespread use of the RMB in both investment and financial transactions, the need to manage RMB exchange rate risks will become more prominent for corporates and investors. The demand for RMB hedging tools and other fixed return financial products is thus expected to increase notably. The Hong Kong banking sector should accelerate the development of more risk management products to meet the increasing needs of its clients.

3) Solidify Hong Kong's position as the largest offshore RMB trading center in response to increasing

foreign exchange demand after the RMB's entry into the SDR.

With continuous progress of RMB internationalization, offshore RMB foreign exchange transactions are expected to increase rapidly. Daily transaction volume of offshore RMB in Hong Kong reached US\$10.7 billion in 2010 before rising 6.2 folds to US\$77.1 billion in 2016. After the RMB's inclusion into the SDR, the use of the RMB in trade settlement, investment, and financing will become more widely used, creating a strong driving force for offshore RMB foreign exchange businesses in Hong Kong.

4) Establish itself as a center of offshore RMB asset management.

After the RMB's entry into the SDR, demand for RMB asset management will increase rapidly. The financial industry of Hong Kong can actively develop products under the current rules of capital account convertibility, expanding its client base and strengthening business ties with central banks, sovereign wealth funds, supranational institutions, major international financial institutions, and bourses. Hong Kong can also conduct a wide range of marketing activities, including group and one-on-one sessions, for the abovementioned overseas institutions. Furthermore, the bond brokerage business model can be optimized to secure sole brokerage and RMB fund management agreement from clients, establishing a more flexible fund management mechanism so as to enhance trading and investment holding capability.

5) Further improve itself as a center of offshore RMB clearing infrastructure.

Hong Kong can further improve its RMB clearing system, enhance its existing financial infrastructure, and strengthen its RMB business ties with other economies in the region. These efforts will improve Hong Kong's cross-border RMB business servicing capability as well as sharpen Hong Kong's edge in RMB products and services, supporting further exploration of new markets.

All in all, Hong Kong's overall competitive advantage in RMB businesses will not diminish with the development of other offshore RMB markets. Instead, Hong Kong should seize new business opportunities arising from the RMB's inclusion into the SDR, by strengthening cooperation with other regions and actively developing new offshore RMB businesses, so that Hong Kong can continue to grow as an offshore RMB business hub.