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Some Thoughts on Stepping up Efforts to Promote the Development of Offshore RMB Market

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I. The Role of Currency Internationalization and Offshore Financial Markets

The offshore US dollar market is a crucial element in the internationalization of the US dollar. The bankruptcy of the Bretton Woods system did not shake the US dollar as the pillar of the international monetary system. Instead, it removed the shackles that tied the US dollar to gold, enabling the US dollar to function more freely as a global currency. At the same time, as the development of the offshore US dollar market accelerated, the market recognized the convertibility of the US dollar and other currencies and was concerned less about the US dollar’s convertibility into gold. As a result, more and more financial assets and transactions were anchored to the US dollar. Therefore, after the decoupling of the US dollar from gold, the use of US dollar became widespread, which established the status of the US dollar as an international currency.

The onshore and offshore markets play different roles in the internationalization of the US dollar. The United States is the source of US dollar liquidity and the home of dollar-denominated assets. Supported by a solid economic, political, and military power, the US dollar continues to move overseas and has become a globally recognized “hard currency”. However, the US bond market only opened to a few foreign institutions for a considerable period, with limited international financing functions and not widely used internationally. The emergence of the European US dollar market has absorbed a large amount of offshore US dollars, making it easier for countries to issue US dollar bonds in London and other places and for financial institutions in London to lend US dollars. The primary platform for US dollar transactions has shifted from onshore to offshore, enabling US dollar international payments, transactions, financing, liquidity management, and risk management through exchange with different currencies, resulting in a wide range of offshore US dollar usage scenarios and forming a sizable market. Last year, the US dollar asset size outside the US banking system was USD 14 trillion, equivalent to 60% of the total assets of the US banking industry; the outstanding amount of European US dollar bonds (including the Asia-Pacific region) was USD 11 trillion, equivalent to one-fifth of US dollar bonds issued domestically in the United States.

After the establishment of the offshore US dollar market, the US dollar pricing system was further strengthened. While implementing policies such as the interest equalization tax, Regulation Q and voluntary restrictions on foreign loans in the United States, there were certain differences in interest rates and exchange rate pricing between the offshore US dollar and the onshore markets. However, in the 1970s, the United States abandoned capital controls and no longer restricted cross-border dollar flows, leading to the integration of interest rate and exchange rate pricing between the two markets. Within the United States, the Federal Reserve adjusts monetary policy and guides market interest rates to form a complete interest rate curve from the short-term funding market to the long-term capital market. This interest rate curve has become the global benchmark for pricing dollar assets. Meanwhile, US dollar foreign exchange trading extends from the domestic to the offshore markets, operating 24/7, with a larger proportion of offshore forex trading taking place (only about 20% of dollar exchanges occurred within the United States last year), occupying crucial time intervals for continuous US dollar quotations.

The offshore US dollar market is expanding further into various countries, forming numerous currency markets that trade against the US dollar and helping the US dollar to play its international payment role. Currently, besides the US dollar, other international currencies have limited coverage, and banks around the world hold a large number of US dollar positions (except in areas subject to sanctions or strict capital controls), providing currency exchange services for traders to complete cross-border payments.

The Renminbi (RMB) cannot be directly traded with most trading partners in their respective currencies because of the lack of RMB liquidity in local markets. If traders want to exchange RMB, banks will split the transaction into two parts: the local currency to US dollar and the US dollar to RMB. The latter is settled in China's onshore or offshore markets.

II. Cross-border and Offshore Usage of RMB Develop in Tandem

Unlike the mixed opening of the US dollar, the internationalization of RMB is being gradually promoted in a sequential manner, following the path of "current account first, capital account later; real economy first, investment later; cross-border first, offshore later". This arrangement is mainly based on the principle of financial services' role in supporting the real economy, and is also determined by the actual usage of RMB before "going global".

The first step in the internationalization of RMB was taken in the field of cross-border trade. In 2009, the People's Bank of China (PBOC) and other relevant departments initiated a pilot program for cross-border RMB settlement between Shanghai, Guangdong, Hong Kong, Macau, and Southeast Asia, mainly to support import and export enterprises that were suffering during the financial crisis. Due to historical reasons, there was not much RMB capital in offshore market. To enable foreign companies pay RMB to their Chinese counterparty or exchange RMB to foreign currency conveniently, the PBOC introduced two settlement models: clearing banks and agent banks, which opened up channels for cross-border RMB exchange and transfer. In contrast, the starting point for the internationalization of other currencies such as the US dollar was different. They had placed capital overseas and were supported by developed clearing channels, making it easier to achieve money transfer and settlement. These countries focus more on the internationalization of capital market.

After the success of RMB settlement in cross-border trade, the PBOC replicated the RMB settlement model in cross-border direct investment, cross-border bond and stock investment, making a breakthrough in capital market. In October 2016, the RMB was included in the SDR currency basket, attracting foreign central banks and institutional investors to increase their holdings of RMB assets. Regulatory authorities timely lowered the entry requirements into the interbank bond market, facilitated onshore and offshore currency exchange, enhanced hedging tools, and continuously expanded cross-border channels such as RQFII, Shanghai/ Shenzhen -Hong Kong Stock Connect, Bond Connect, etc. As a result, the cross-border use of RMB has reached a record high. In 2022, the total cross-border RMB payments in China reached RMB 42 trillion, the increase of nearly three times in five years, and closing to the scale of the US dollar payment. In some coastal areas, the RMB has become the largest cross-border payment currency.

The use of offshore RMB has gradually promoted. Although it has developed slower than cross-border business, mechanisms and policies have been prepared. Based on the Hong Kong clearing bank, the first offshore real-time RMB settlement system- Real Time Gross Settlement (RTGS) was launched in 2005 for transferring RMB between Hong Kong and other countries. Following the introduction of pilot scheme of cross-border RMB settlement, the renewed RMB clearing agreement authorized the transaction of RMB between local banks and merchants. In February 2010, the Hong Kong Monetary Authority (HKMA) clarified the requirements and standards for local financial institutions to conduct RMB business. Subsequently, the offshore RMB foreign exchange market, capital market, and Dim Sum bond market in Hong Kong were developed, and pricing mechanisms such as offshore RMB exchange rate (CNH) and offshore RMB Hong Kong Interbank Offered Rate (CNY HIBOR) were introduced. The Hong Kong offshore RMB center has been upgraded to become a global offshore RMB business hub.

Compared to cross-border RMB business, offshore RMB usage is more market-driven but also more susceptible to external market factors. The main users in the offshore market have also undergone significant changes, including not only real demand for RMB settlement and investment, but also speculation and some random factors. Therefore, the stability of offshore RMB business development is not as good as the cross-border usage. For example, in 2014, the issuance of Dim Sum bonds reached more than RMB 430 billion, but in 2015, it fell below RMB 100 billion due to exchange rate fluctuations. Last year, it increased again to a historical new record of more than RMB 620 billion.

However, offshore RMB usage is crucial, both in terms of necessity and urgency. Firstly, based on the experience of the internationalization of the US dollar, the offshore RMB market is a key component of RMB internationalization, and the level of offshore market development represents the level of internationalization. Secondly, the purpose of RMB internationalization is to enable the use of RMB in the offshore market and to form an RMB usage ecosystem globally. Thirdly, responding the call for reform of the international monetary system in various countries, China as a responsible country, should enhance the international monetary function of RMB and promote the liquidity to various countries, provide new settlement tool options, and enhance the resilience of financial transactions. Lastly, cross-border RMB usage has partially encountered bottlenecks, and only by continuously optimizing the offshore RMB market can high-quality development of cross-border RMB business be promoted.

III. The Key to the Development of the Offshore RMB Market Lies in the Establishment of Mechanisms

The offshore financial market transactions are relatively complex. Take the US dollar as an example. It extends from the domestic market to the offshore market, with capital and money markets serving as the fundamental platforms, and stocks, bonds, and liquidity management as the core products. The market has developed foreign exchange trading, interest rate trading, swap trading, repurchase agreements, commodity futures options, financial futures options, and credit risk swaps. These products are distributed in both exchange-traded and over-the-counter markets. Each type of product corresponds to certain real usage or financial transaction needs, forming exchange rate, interest rate, commodity, and risk pricing mechanisms, and providing benchmark quotations for various trading activities. According to the Bank for International Settlements (BIS) data, the nominal value of different US dollar contracts exceeded USD 460 trillion in 2019, which was 5.5 times the value of basic US dollar products, including stocks and bonds. Liquidity management tools such as US dollar repurchase agreements, swaps, and lending transactions are traded daily for more than USD 5 trillion. Correspondingly, the interconnectivity between products and markets ensures daily dollar trading and supports its full role as a global currency.

The RMB market differs from the US Dollar market. Due to national interest and security considerations, China's domestic capital account has yet to achieve full convertibility. A firewall is established between onshore and offshore markets, and cross-border RMB flows are subject to certain restrictions. Cross-border RMB transactions can only be conducted under certain conditions. In recent years, these two markets have developed independently. Although the onshore market is the primary market and has a certain guiding role in the pricing of foreign exchange and interest rates for the offshore market, it is difficult to maintain complete consistency and continuity between the pricing in the two markets. The trading rules and market practices developed independently onshore also differ from those in offshore financial markets. This market structure has a profound impact on the way of promoting RMB internationalization. The offshore RMB market cannot be directly grafted onto the onshore RMB market, and it relies more on self-development approach.

After more than a decade of development, the offshore RMB market has established a certain foundation, forming a mesh distribution pattern with Hong Kong as the global business hub, London and Singapore as essential supports, and other regions with RMB clearing banks as key nodes and generating cross-radiation effects. Hong Kong is the top priority in the construction of the offshore RMB market. Regarding the current scale of the liquidity pool, market depth and product breadth, the agglomeration effect of RMB market participants, and Hong Kong's performance in completing the RMB international usage pilot tasks over the years, Hong Kong has the ability to drive a new round of offshore RMB market construction.

Hong Kong's offshore RMB business has maintained a continuous recovery for five years since 2018, with significant growth in crucial business indicators such as RMB clearing volume, cross-border settlement volume, spot and forward exchange volume, dim sum bond issuance volume, and asset management. The market foundation has been continuously strengthened, and business innovation has been enhanced. However, the gap is significant compared to the international use of the US dollar. In comparison to the offshore US dollar market in London, Hong Kong's offshore RMB market is only in its initial stage of development, with a lack of product diversity and usage scenarios at the same level. Furthermore, the market mechanism is not mature enough, with a single market structure layout and a lack of market correlation. Due to the lack of multi-level and diversified high-quality RMB underlying assets as support, major RMB transactions still rely on US dollar assets as intermediaries. For example, banks in Hong Kong mainly obtain liquidity through USD swaps. As a result, the development of the offshore RMB market is relatively passive. To this day, a market for liquidity and risk management similar to the US dollar has not been formed. The offshore RMB yield curve is intermittent and incomplete, and offshore RMB funds are difficult to be allocated overseas effectively.

Therefore, actively promoting the construction of the offshore RMB market should focus on developing market mechanisms and aim to establish a sound offshore RMB market system, thereby driving the orderly development of the global use of RMB.

Firstly, it will be beneficial to introduce high-quality RMB-denominated assets and promote the formation of an offshore RMB ecosystem. Based on the current normalized issuance of government bonds and central bank bills, we suggest expanding the market size further, guiding domestic policy banks, commercial banks, and state-owned enterprises to issue bonds in offshore markets in an orderly manner, and attracting international organizations, foreign governments, multinational corporations, and international banks to participate in Panda bond financing. It is also necessary to accelerate the construction of Hong Kong RMB-denominated stock trading, develop RMB funds, insurance, and wealth management products, and provide more options for various market entities to allocate RMB resources.

Secondly, efforts should be made to actively develop the offshore RMB interest rate market in order to form a complete offshore RMB yield curve. The RMB collateral function is activated based on high-quality RMB assets to promote offshore RMB interest rate transactions and derivative product trading. We also suggest encouraging major financial institutions in Hong Kong to make market quotations, expand and strengthen the RMB bond repurchase business, establish risk hedging systems related to investment and financing business, and cultivate the RMB hedging function. The use of onshore RMB bonds held by institutions in Hong Kong can also be fully leveraged to explore innovative cross-border collateralized bond repurchase business.

Thirdly, efforts can be made to promote cross-border RMB flow through multiple channels to narrow the price gap in RMB funds between the two regions. We also suggest further facilitating the convenience of cross-border RMB settlement, promoting the expansion of the RMB liquidity pool in Hong Kong, and assisting in stabilizing the RMB liquidity of neighboring countries. These attempts will be conducive to RMB inflow, transfer and retention. They can also maintain a basic consistency between RMB interest rates at home and abroad and facilitate RMB investment and financing. In addition, it is necessary to allow more Mainland financial institutions to participate in offshore RMB asset investment and trading via RMB and explore the direct participation of overseas institutions in the open market operations of the PBOC.

IV. Ensure the Security of RMB Internalization

Openness and risk, development and security are unavoidable issues in the international use of the RMB. RMB internationalization was initiated during the global financial crisis and the European sovereign debt crisis. It has experienced trade disputes between China and the United States, the spread of COVID-19, geopolitical conflicts, and adjustments to monetary policies in Europe and the United States. Global financial risks have continuously erupted and have been rapidly reflected in the offshore RMB market in Hong Kong. These risks are then transmitted through cross-border transmission mechanisms and affect the domestic financial market and macroeconomic stability. On the other hand, offshore RMB exchange rates and interest rates are more sensitive to external factors, thereby more responsive to various global risk events. The responsiveness of offshore RMB can lead to deviations in its pricing from that of onshore RMB, which can sometimes be transmitted to the domestic market. In order to promote the internationalization of RMB in an orderly manner and accelerate the development of the offshore RMB market, the risks and possible consequences of the internationalization of RMB in the “deep blue ocean” must be recognized, and awareness and control measures for risk prevention must be enhanced under open conditions.

The first suggestion is to rely on the onshore RMB market. China’s commitment to the reform and opening-up policy and its maintenance of healthy and stable economic growth is fundamental to RMB internationalization. The development of an offshore RMB market system must work together with the onshore RMB market. The offshore market can only enhance its resilience to global turmoil by being tied to the onshore market.

The second is related to strengthening the offshore RMB market. China is accelerating its opening up to the outside world and profoundly integrating its economy into global economic development, which requires a constant improvement in the international monetary function of the Chinese yuan. Currently, the offshore RMB market has a small scale and an unsound mechanism. It is unable to meet the needs of the domestic and foreign real economies or fully play the stabilizing role in the international monetary system. In addition, it is highly volatile with multiple hidden risks. In the next step, attempts should be made to design a top-level plan, clarify the guidance for market mechanism construction, and narrow the gap with other major international currencies regarding functions and mechanisms.

The third suggestion is to improve the “firewall” for cross-border risks. China possesses a complete industrial system and an independent financial market, and has played a vital role in maintaining stability during global financial crises and economic downturns. Therefore, it is necessary to maintain a certain degree of capital account control. This requires better utilization of the increasingly mature offshore RMB market in Hong Kong to expand the international use of RMB, while strengthening Hong Kong’s role as a buffer zone for overseas risk transmission. We suggest optimizing cross-border monitoring and establishing a sound macro-prudential management system for cross-border capital flows. These attempts can prevent significant financial risks from entering the country or reduce their impact on the domestic economy.

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主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2021**	**2022**	**2022/Q3**	**2022/Q4**
總量 (億元) GDP($100 Million)	28,677	28,270	7,244	7,389
升幅 (%) Change(%)	6.4	-3.5	-4.6	-4.2
二. 對外貿易 External Trade			**2023/02**	**2023/01-02**
外貿總值 (億元) Total trade($100 Million)				
總出口 Total exports	49,607	45,317	2,862	5,768
進　口 Total imports	53,078	49,275	3,316	6,478
貿易差額 Trade balance	-3,471	-3,958	-454	-710
年增長率 (%) YOY Growth(%)				
總出口 Total exports	26.3	-8.6	-8.1	-25.4
進　口 Imports	24.3	-7.2	-4.1	-18.9
三. 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	1.6	1.9	1.7	2.1
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數 (宗) No. of agreements	96,133	59,619	5,980	10,407
年升幅 (%) Change(%)	31.1	-38.0	49.6	5.0
五. 勞動就業 Employment			**2022/11-2023/01**	**2022/12-2023/02**
失業人數 (萬人) Unemployed(ten thousands)	250.9	195.9	11.8	11.6
失業率 (%) Unemployment rate(%)	5.5	4.3	3.4	3.3
就業不足率 (%) Underemployment rate(%)	2.7	2.4	1.4	1.3
六. 零售市場 Retail Market			**2023/02**	**2023/01-02**
零售額升幅 (%) Change in value of total sales(%)	8.1	-0.9	31.3	17.3
零售量升幅 (%) Change in volume of total sales(%)	6.5	-3.4	29.6	15.5
七. 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	9.1	60.5	146.2	196.1
年升幅 (%) Change(%)	-97.4	561.5	55,572.8	20,133.8
八. 金融市場 Financial Market			**2023/01**	**2023/02**
港幣匯價 (US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	779.8	780.8	783.9	784.9
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	8.0	-20.7	-20.2	-25.1
M2	4.3	1.6	0.5	0.0
M3	4.3	1.6	0.5	0.0
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	4.6	1.7	0.4	-0.1
港元存款 In HK$	1.4	0.7	1.9	0.3
外幣存款 In foreign currency	7.9	2.6	-1.0	-0.5
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	3.8	-3.0	-2.6	-3.3
當地放款 use in HK	4.7	-0.2	0.7	-0.2
海外放款 use outside HK	1.7	-10.0	-10.4	-10.8
貿易有關放款 Trade financing	14.2	-13.5	-14.4	-21.0
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.6250	5.6250	5.6250
恒生指數 Hang Seng index	23,398	19,781	21,842	19,786