Offshore RMB Express

Issue 47 •
January 2018

中國銀行(香港)
BANK OF CHINA (HONG KONG)

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Review and Outlook of Offshore RMB Market

In 2017, the offshore RMB market gradually stabilized after a period of adjustment, and the central bank significantly enhanced its management of exchange rate expectation. The launch of Bond Connect in 2017 made the RMB investment market more complete. Having been included in the SDR for one year, the RMB plays a more important role as a reserve asset. The Belt and Road Initiative has reinforced the role of investment and financing currency of the RMB in the offshore market, providing new momentum for RMB internationalization. Although the issuance of dim sum bonds and cross-border settlement are yet to recover, major offshore RMB businesses such as the RMB liquidity pool and RMB offshore market transactions have been showing signs of recovery. Foreign institutions continuously increased their holdings of RMB bonds, while the use of the RMB in international markets has caught more attention, signaling renewed confidence in the RMB. After the adjustment, the RMB market is becoming increasingly mature, as the era of RMB internationalization 2.0 is coming soon.

I. Offshore RMB market stabilized after adjustment in 2017

1. Market-oriented exchange rate leads to two-way fluctuation. In 2017, the RMB's exchange rate stabilized and rebounded, reversing one-way depreciation in the previous three years. The central parity rate of the RMB against the US dollar appreciated by 6.16% last year, and the CNY against the US dollar rebounded by 6.4%. In late May 2017, the People's Bank of China added a "counter-cyclical factor" to the central parity rate mechanism of "closing exchange rate plus changes in a basket of currencies ", which helped align the exchange rate with economic fundamentals. In the past year, the flexibility of the RMB's exchange rate was greatly enhanced, with offshore RMB against US dollar (CNH) rebounding about 6.6% and with the daily volatility exceeding 1% for many times.

Annualized volatility of central parity rate of the RMB against the US dollar was 3.12%, and the annualized volatility of RMB index (CFETS) was 2.61%. Spreads between CNH and CNY narrowed within 100 basis points.

2. The central bank sent out positive signals. During the second half of 2017, market sentiment turned neutral with the RMB approaching equilibrium, and the central bank adjusted its policy timely by relaxing a series of "temporary" and "transitional" cross-border macro prudential management measures, including removing the risk reserve ratio of foreign exchange and the requirement for foreign banks to set aside reserves for offshore RMB deposits in China. There was a clear recovery in offshore RMB business in the second half of 2017. While it takes time for businesses to improve markedly, the signal is fairly positive.

3. Major offshore RMB business shows signs of recovery. Influenced by the increasingly balanced RMB exchange rate and the policies from the central bank, RMB deposits in Hong Kong have bottomed. As of November 2017, the balance of RMB deposits in Hong Kong rose to RMB 559.2 billion, up 2.3% YTD and 10.2% higher than the trough of the year. In the first 11 months, total amount of RMB remittance in cross-border trade settlement in Hong Kong was RMB 3.5 trillion, 17.8% lower than that in same period last year. However, monthly declines have narrowed from the peak of 40%, and RMB remittance rose 40% in November from the previous month.

According to SWIFT, the RMB was the sixth most used currency for worldwide payments in November 2017. The percentage of the RMB in global payment by value decreased to 1.75% from 2.28% a year ago, but only marginally lower than the two currencies ranked ahead of the RMB. SWIFT data also show that the RMB is one of the most actively traded currencies in global foreign exchange markets, ranked fifth in trading value in April, only behind the US dollar, euro, yen and sterling. RMB settlement volume through RMB RTGS system in Hong Kong fell for the first time in 2016 but picked up in June 2017, growing 5% YTD. In 2017, the settlement volume through RTGS system amounted to RMB 213 trillion, up 5.6% over the same period last year, confirming the trend of recovery of offshore RMB businesses.

4. The capital markets are steadily opened up. In the past year, the breadth and depth of opening up of China's capital markets have been further extended. At the end of 2016, cumulative transaction amounted to RMB 1.29 trillion through the Shenzhen-Hong Kong Connect, and the average daily transaction amount increased substantially compared with that during its launch, making the Stock Connect program an important link between the two capital markets and investors. In June 2017, MSCI included China A-shares in the MSCI Emerging Markets Index and the MSCI ACWI Index, a milestone in China's stock market. Although the original weight of China's A-share in the index was only 0.73%, it is more than enough to reflect the direction of RMB internationalization 2.0 and is expected to increase foreign demand for RMB asset allocations.

In the wake of the Stock Connect, the bond market also ushered a new breakthrough. In July 2017, the Northbound Bond Connect was launched, adding a new channel for foreign investors to enter the Mainland bond market. Since the launch of Bond Connect, about one third of newly added investment in the Mainland bond market was made through the Bond Connect program. But as the freeze of RMB bond issuance continued due to high costs and tight liquidity, foreign institutions were less willing to issue RMB bonds . As a result, issuance of offshore Dim Sum bonds amounted to only RMB 24.9 billion for the whole year, dipping 41%, while the issuance of Panda Bonds issued fell 39% to RMB 71.1 billion.

In 2017, quota under the Renminbi Foreign Institutional Investor (RQFII) scheme cumulatively increased by RMB 76.587 billion to RMB 1.74 trillion. 19 foreign institutions were approved the RQFII quota for the first time, and the RQFII quota for Hong Kong increased from RMB 280 billion to RMB 500 billion in July 2017, remaining the highest among all jurisdictions.

5. RMB's role as an international reserve currency gradually strengthened. With the increasing willingness of foreign central banks to hold RMB as foreign exchange reserves, the status of the RMB as an international reserve currency has been gradually established. On March 31 of 2017, the IMF released quarterly data on currency composition of official foreign exchange reserves (COFER) with an expanded currency range, separately identifying holdings in the RMB for the first time. According to IMF statistics, the scale of RMB foreign exchange reserves increased to USD 107.94 billion in the third quarter of 2017, up by USD 17.16 billion from a year prior and accounting for 1.12% of total foreign exchange reserves. Foreign investors increased holdings of RMB bonds for ten consecutive months and played an important role in the RMB bond market.

By the end of 2017, the balance of bonds held by overseas institutions in China's interbank bond market reached RMB 1.1474 trillion, up by RMB 347.673 billion. The growth of newly-added holdings increased 130% compared to that of same period last year, while the scale of newly-added holdings increased 43.5% yoy.

II. RMB internationalization will advance further on a high platform

Two major characteristics of RMB internationalization 1.0 are one-way appreciation and the RMB's role as a main currency of trade settlement. However, RMB's function as a reserve currency has gradually emerged. RMB internationalization 2.0 should lean towards the capital markets. International use of the RMB should be expanded in trade settlement, and the RMB should continue to play an increasingly important role in international financial transactions and pricing of international commodities, eventually becoming an international reserve currency.

Policies of the central bank support renewed RMB internationalization. At the beginning of 2018, to support enterprises in using RMB for cross-border settlement, to facilitate direct investment from foreign institutional investors with RMB, and to promote personal RMB business, the PBOC improved and optimized policies on cross-border RMB business, sending positive signals for cross-border RMB business. The central bank will likely gradually ease control of capital flows in the future, especially easing some temporary administrative measures, which will directly have positive impact on renewed RMB internationalization.

Connectivity between the Mainland and global capital markets will advance further. To meet the increasingly diversified demand of investors, there could be prospective launch of London-Shanghai stock connect, IPO connect and the Primary Equity Connect in the future. With stabilization of the RMB and the improvement of China's economy, foreign demand for RMB assets will gradually pick up, and more connectivity projects in capital markets will be available.

The Belt and Road Initiative promotes the use of the RMB under the capital account. With more and more financial institutions guiding enterprises to use the RMB on capital allocation in countries along the Belt and Road, international use of the RMB will be expanded thanks to the increase in RMB loans and the establishment of RMB funds, which could drive development of cross-border RMB financing business along the Belt and Road.

"Petroyuan" will lead to a breakthrough of RMB internationalization. Enhancing the influence on the pricing of international commodities such as oil is one of the goals for RMB internationalization. With more widespread use of the RMB in multilateral trade of crude oil, there will be a substantial increase in demand for and use of the RMB, significantly increasing the use of currency swap between central banks and promoting the use of RMB among overseas governments and institutions.

Hong Kong will play a unique role as offshore RMB center. Hong Kong, an offshore RMB center, will continue to act as a bridge in the future, to strike a sound balance between capital outflow and inflow, to form an improving capital allocation platform by offering products and services with investment potential, to design the most advanced RMB clearing products in offshore markets, and to pave the way for the internationalization of CIPS system.

RMB Internationalization Updates

2017

JAN

23

BOC issued UnionPay dual-currency debit card in Hungary

The UnionPay dual-currency debit card issued by Bank of China (Hungary) operates in Hungarian Forint and RMB. Customers can withdraw cash from ATM or make payment at merchants with UnionPay logo.

FEB

6

First US based bank has been approved to underwrite corporate bonds in China interbank bond market

JPMorgan Chase & Co. has been approved by National Association of Financial Market Institutional Investors to underwrite corporate bonds in China interbank market, making it the first US based bank to do so.

20

CEINEX introduced first derivatives product

CSI300 Index ETF, the first derivative product introduced by China Europe International Exchange (CEINEX), would be available for trading.

MAR

1

Bloomberg two new indices reflected improvement in China capital market

Bloomberg was the first index provider to include China bonds in its global indices offering. It has launched two new fixed income indices, namely "Global Aggregate + China Index" and "Emerging Market Local Currency Government + China Index".

7

Citi included China onshore bond to its "Emerging Markets and Regional Government Bond Indices"

Citi Fixed income Indices announced that China was eligible to join three existing government bond indices, namely the Emerging Markets Government Bond Index, Asian Government Bond Index and the Asia Pacific Government Bond Index.

13

HSBC completed first RMB FX derivatives transaction

HSBC completed its first RMB FX derivatives transaction with a foreign institutional investor in China interbank bond market. The transaction helped the client to hedge against foreign risk exposure when holding RMB-denominated bonds.

16

UC RUSAL issued first panda bonds

United Company RUSAL Plc (UC RUSAL) completed the issuance of the 2017 first phase corporate bonds, representing the bond issuance by an enterprise based in a country along the "Belt and Road".

31

IMF disclosed for the first time RMB holdings in COFER

International Monetary Fund (IMF) released the quarterly data on the currency composition of official foreign exchange reserves (COFER) for 4Q2016. The IMF also separately identified holdings in RMB for the first time. The data showed that RMB holdings were USD 84.51billion, accounting for 1.1% of the total foreign exchange reserves.

APR

10

First offshore China treasury bond futures has been launched

Hong Kong Exchange and Clearing Limited introduced 5-year China Ministry of Finance treasury bond futures, making it the first futures that can be traded in the offshore market, as well as the first onshore interest rate product for offshore investors.

11

BOC issued USD 3 billion equivalent bonds abroad

Bank of China (BOC) completed pricing of USD 3 billion bonds issued abroad. The bonds issued in four currencies, namely USD, EUR, AUD and RMB. The issuers included BOC's branches in Macau, Dubai, Johannesburg, Sydney and Luxembourg.

MAY

16

PBOC and HKMA jointly announced to launch "Bond Connect"

The People's Bank of China (PBOC) and the Hong Kong Monetary Authority (HKMA) jointly approved to establish "Bond Connect". Northbound Trading would commence first in the initial phase, i.e. overseas investors to invest in the China Interbank Bond Market through mutual access via the Hong Kong and Mainland financial infrastructures of trading, custody, settlement, etc.

26

Counter-cyclical factor was introduced in the RMB central parity fixing

China Foreign Exchange Trade System was said to introduce counter-cyclical factor in the quotation model for central parity rate of RMB against USD. Therefore, the central parity rate can better reflect the fundamentals of China's economy, supply and demand changes in the FX market, as well as exchange rate changes in a basket of currencies. ◦

JUN

13

ECB completed FX reserves investment in RMB equivalent to EUR 500 million

The European Central Bank (ECB) completed an investment equivalent to EUR 500 million of its foreign reserves in RMB during the first half of 2017. The ECB invested in RMB by selling a small portion of its USD holdings.

MoF issued RMB 7 billion sovereign bonds in Hong Kong

The Ministry of Finance (MoF) issued RMB 7 billion sovereign bonds to institutional investors in Hong Kong. This included RMB 5 billion 3-year bonds and RMB 2 billion 5-year bonds priced at 3.99% and 4.10% respectively. This issuance was oversubscribed by 1.52 times.

20

MSCI will include China A shares in the MSCI Emerging Markets Index

Beginning in June 2018, MSCI will include China A shares in the MSCI Emerging Markets Index and the MSCI ACWI Index. MSCI will initially add 222 China A Large Cap stocks, representing 0.73% of the weight of the MSCI Emerging Markets Index. A two-step inclusion process will be used. The first step will take place in May 2018, and the second step will take place in August 2018.

JUL

3

"Bond Connect" officially kicked off

"Transactions were active on the first day of "Bond Connect". Trading amount reached RMB 7.048 billion, with 70 institutions completing 142 transactions with 19 market makers.

4

"RQFII quota for Hong Kong expanded to RMB 500 billion

RQFII quota for Hong Kong expanded from RMB 270 billion to RMB 500 billion, said the PBOC.

RMB Internationalization Updates

26 | AUG | 21 | 31 | SEP | 11 | 14 | 28 | OCT | 19

26

Hungary issued first RMB sovereign bonds

The Hungarian government issued RMB 1 billion 3-year panda bonds with the coupon rate of 4.85%. It was the first issuance of overseas sovereign bonds in RMB through "Bond Connect".

AUG 21

SAFE required advancement of reporting on overseas spending

Domestic financial institutions would be required to report on a daily basis all cash withdrawals via overseas ATMs and spending of more than RMB 1,000.

31

PBOC constrained newly issued interbank NCD with tenor of less than 1 year

The PBOC announced that financial institutions are prohibited to issue interbank negotiable certificate of deposit (NCD) with maturity exceeding 1 year starting from September 1. However, the issued NCD with tenor of more than 1 year can be rolled over until maturity.

SEP 11

PBOC scrapped reserve requirement on foreign exchange trading

The PBOC removed reserve requirement of 20% for settling foreign exchange forward yuan positions. Meanwhile, the supervision on the reserves put aside by offshore financial institutions was also loosened.

14

BOCHK issued panda bonds

Bank of China (Hong Kong) issued 1-year RMB 9 billion panda bonds with a coupon rate of 4.4%. RMB funds raised from the bond will be used for offshore general working capital purpose, including supporting corporations going global.

28

Commercial banks would be eligible for targeted RRR cut if supporting small and micro companies

Commercial banks would be eligible for a lower reserve requirement ratio (RRR) or re-lending support if their total or increase of loans granted to small and micro companies, agriculture businesses or secured loans for startups reaches a certain threshold. Each small and micro company should have less than RMB 5 million in lines of credit.

OCT 19

"Expanding RMB trading band is not a top priority for the time being", said the PBOC

The PBOC Governor Zhou Xiaochuan said that expanding the RMB trading band is not a top priority for the time being. At present, Exchange rate movements have rarely been limited by the existing trading band and are mainly determined by the changes in market supply and demand.

Investor identification for Northbound trading under the Stock Connect is set to launch by 3Q18

The Securities and Futures Commission (SFC) reached an agreement with the China Securities Regulatory Commission (CSRC) on introducing an investor identification regime for Northbound trading under the Stock Connect. The regime is scheduled to be implemented by 3Q18. They also agreed to introduce the similar regime as soon as possible after the regime for Northbound trading is implemented.

MoF issued RMB 7 billion sovereign bonds in Hong Kong

The MoF issued RMB 7 billion sovereign bonds in Hong Kong. Amongst which, 6.5 billion were issued to institutional investors. This included RMB 4 billion 2-year bonds, 2 billion 5-year bonds and 0.5 billion 10-year bonds with coupon rates of 3.9%, 4.1% and 4.15%, respectively. Another RMB 0.5 billion bonds were sold to central banks and monetary authorities outside of Mainland China, including RMB 0.3 billion 2-year bonds and 0.2 billion 5-year bonds, with same coupon rates as the aforementioned maturities.

China is set to liberalize market access in financial sector

Vice Minister of Finance Zhu Guangyao announced at a press conference that China will give foreigners greater access to its financial sector. Firstly, the cap on foreign investment in securities companies, fund management companies and futures companies will be raised to 51%, and the cap will be lifted in three years. Secondly, the 20% ceiling on ownership of a Chinese commercial bank or asset management company by a single foreign investor, and the 25% cap on total ownership of such companies by multiple foreign investors, will be eliminated. Thirdly, the limit on foreign stakes in life insurance companies will be raised to 51% in three years. The limitation will be removed entirely in five years.

Counter-cyclical factor has been suspended

Media reported that the PBOC told some quotation banks to adjust their use of counter-cyclical factor in such a way that it would have no impact on the mechanism.

2018

26 NOV 10 30 DEC 20 JAN 5 9

MoF issued USD 2 billion sovereign bonds in Hong Kong

The MoF issued USD 2 billion sovereign bonds in Hong Kong, including USD 1 billion 5-year bonds and USD 1 billion 10-year bonds, with coupon rates of 2.125% and 2.625%, respectively. Institutional investors, including central banks, sovereign wealth funds, mutual funds, insurances, banks, etc. involved in the deal with subscription amount of 11 times.

CDB issued first "Belt and Road" bonds in Hong Kong

China Development Bank (CDB) issued USD 350 million 5-year Belt and Road bonds with fixed coupon rate via private placement in Hong Kong for the first time. Dealers included the Bank of Communications (Hong Kong) Ltd., China Construction Bank (Asia) and HSBC.

PBOC improved policies for cross-border RMB business

Major policies included: 1) encouraging enterprises to settle cross-border trade deals in the RMB; 2) supporting foreigners' use of the RMB for direct investments in the country; 3) encouraging foreign investors to participate in carbon emission trading in China with the RMB; 4) authorizing Chinese firms to transfer RMB funds raised through issuing bonds or equities overseas back home; 5) allowing individuals to remit funds from overseas, and vice versa.

Opportunities and Challenges for China's Bond Market Opening in the New Era

Dr. Zhihuan E,
Chief Economist of Bank of China (Hong Kong)

In 2017, the Ministry of Finance (MoF) issued USD 2 billion and RMB 14 billion sovereign bonds in Hong Kong, with an aggregate annual issuance at about RMB 28 billion. The issuance of dollar sovereign bonds in Hong Kong will increase the types of bonds in offshore markets, providing more high quality asset varieties to international investors. In the meantime, the issuance of dollar bonds facilitates the establishment of pricing benchmarks for foreign currency-denominated bond issuance and optimizes the yield curve, providing references to Chinese enterprises which raise funds in global financial markets. It would be conducive to developing multi-level capital markets, as mentioned in the 19th CPC National Congress Report, by maintaining adequate issuance of multi-currency bonds in offshore markets, making the bond market the main battlefield for further financial opening.

I. Significant progress in China's bond market

Fixed income is the most sizable asset class in global financial markets, and bonds are very important investment assets. As of the end of 2016, global bond market capitalization was approximately USD 100 trillion, compared with global equity market capitalization of USD 67 trillion.

As of end-September 2017, bonds in custody in China amounted to RMB 71.9 trillion, of which interbank bond market amounted to RMB 63.7 trillion. China's bond market is the third largest in the world, following the US and Japan. Both issuance and transaction amounts in the interbank bond market account for almost 90% of the entire Chinese bond market. In 2016, bond issuance in the interbank market amounted to RMB 32.2 trillion with annual transaction amount of RMB 127 trillion. In the first nine months of

2017, issuance and transaction amounts were RMB 28.1 trillion and RMB 73.8 trillion, respectively.

In terms of relative scale, China's bond market capitalization only accounted for 85% of GDP in 2016, far lower than the ratio of 210% for the US.

The market capitalization and transaction activity of China's interbank bond market have approached or reached the levels in major markets in Europe and the US. Nevertheless, the market is still immature. It is necessary to open the market at a faster pace by attracting offshore investors and issuers, optimizing market functions and enhancing the efficiency of allocation of funds, in order to better support the real economy.

II. Analysis on bond market opening

1. Offshore markets take a leading role in China's bond market opening

At the initial stage of RMB internationalization, central banks, sovereign wealth funds and international monetary institutions around the globe mainly allocated in RMB assets in offshore markets. Before the RMB joined the SDR, nearly 30 sovereign institutions publicly announced to purchase RMB assets in offshore markets. RMB sovereign bonds issued by the MoF in Hong Kong were mainly sold to central banks overseas. Moreover, the UK Government and the British Columbia Provincial Government of Canada have issued RMB bonds in offshore markets, respectively. Offshore markets once took a leading role in China's bond market opening, paving the way for RMB internationalization.

The scale of RMB-denominated international bonds expanded after the RMB joined the SDR in 2016. The issuance of Panda bonds in onshore markets surged, whereas the issuance of Dim Sum bonds declined. The issuance of Dim Sum bonds in 2016 came in at merely half of the size in the previous year.

2. Onshore bond market opening has great potential

China's bond market opening has deepened since 2005. The Chinese Government progressively authorized international development institutions to issue RMB bonds in the onshore market, allowing Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII) to invest in the interbank bond market, expanding the scope of eligible offshore institutional investors to various financial institutions such as commercial banks, insurance companies, etc. and other medium-to-long term investors authorized by the People's Bank of China (PBOC). In July 2015, the PBOC authorized overseas central banks, supranational institutions and sovereign wealth funds to enter the interbank market after registration. They could conduct bond trading, bond repos, bond lending, forward bond agreements, interest rate swaps, forward rate agreements, etc. without limitation on investment scale.

China's bond market capitalization is more than USD 10 trillion, but the holding of RMB bonds by offshore institutional and retail investors was RMB 974.145 billion, accounting for 1.3%. This proportion was far below the ratio of 39% for the UK, 45% for Germany and 28% for Malaysia. The share of offshore investors in China's bond market still has room for growth.

3. New progress in mutual bond market access

The Bond Connect was officially launched on July 3, 2017, providing a convenient platform for offshore investors accessing the onshore market. The Bond Connect helps attract additional capital inflows to Hong Kong while furthering China's bond market opening and the degree of internationalization.

Under the Bond Connect model, offshore investors can directly place orders with authorized price-quoting institutions in China through global bond trading platform such as Tradeweb. The need for linking investors is now replaced by the connection between platforms. The Bond Connect adopts international law and regulatory standards, making overall transactions more convenient. Under the current mechanism, the operations of funds settlement and bond custody take place in Hong Kong. The Central Moneymarkets Unit (CMU) of the Hong Kong Monetary Authority (HKMA), being a nominee holder of the bonds, represents overseas investors to complete the procedure of funds settlement and custody through the nominee holding arrangement. Such operation simplifies the procedure of investing in the onshore interbank bond market for offshore investors, as they do not have to open bond custody accounts or funding accounts in China. The Bond Connect enhances the attractiveness of bond markets in Hong Kong and China. For one, it is able to meet the demand for bond market opening in China. For another, it solves the problem of different transaction approaches by offshore investors, promoting the development of the two financial markets consistently and steadily.

Investors of the Bond Connect are institutional investors, including overseas central banks, financial institutions, etc. They invest in all types of bonds available in China's interbank bond market (CIBM) without limitation on quota. Compared with the existing approach of offshore institutional investors participating in CIBM, the review period under the Bond Connect can be shortened with lower transaction costs. The increasing demand for RMB assets by offshore investors can be satisfied following the simplification of relevant procedures in the onshore bond market, expanding the scope of investment assets and issuers, improving financial infrastructure such as cross-border clearing and custody system.

According to data from Shanghai Clearing House, in July 2017, settlement through the Bond Connect was RMB 1.4 billion with 32 transactions per week on average. Trading from offshore institutions was active. In August, offshore institutions increased holding on interbank deposits by RMB 27 billion through the Bond Connect, accounting for 40% of the entire increment. At present, nearly 60% of interbank deposits are conducted through traditional channels, such as CIBM and the QFII.

III. New opportunities for China's bond market opening in the New Era

1. A new phase of China's economic development provides tremendous room for bond market opening

China's economy is entering a new phase of development, focusing on changing growth model, optimizing economic structure, transforming economic driving forces, establishing a modern economy, shifting from high rate of growth to high quality economic development, emphasizing quality and efficiency of economic development and macro policies, converting the focus of reform to improving intellectual property system and liberalization of production factors. The National Financial Work Conference has initiated to develop multi-level capital markets, as well as assigning an important role to direct financing. Against this backdrop, the bond market becomes more important in China's financial system.

The development and opening of the bond market are crucial to optimizing financial market structure and strengthening competitiveness of China's capital markets. Moreover, such moves help expand the direct financing channels for enterprises and the real economy, converting the social financing structure which relies heavily on the banking system. It is able to solve some problems, such as rapid accumulation of debts and vulnerable financial systems, to a certain extent. In addition, the transmission of policy effects on the real economy can be more efficient.

2. RMB internationalization needs support from bond market opening

Historical experience reveals that successful currency internationalization is supported by a sizable economy and merchandize trade volume, as well as robust and well-functioning financial markets. Following the inclusion in the SDR in October 2016, RMB internationalization is driven by domestic market developments. To enhance the global reserve currency function of the RMB, it is essential to be supported by offshore financial markets and matured onshore capital markets, providing international investors with more varieties of financial assets, convenient transaction channels and ample market liquidity in the onshore market.

Holdings of the RMB by central banks around the globe keep increasing. As of the third quarter of 2017, the claims in the RMB were USD 107.94 billion, up 18.9% from the end of 2016. The RMB's proportion of global foreign-exchange reserves was 1.1%, which was largely stable compared with the previous quarter.

3. The Belt and Road Initiative provides new opportunities for China's bond market opening

The 19th CPC National Congress Report mentioned promoting market opening in both inward and outward directions, innovating approach on overseas investment and facilitating collaboration in global production with the Belt and Road Initiative as an entry point. The Belt and Road Initiative plays an important role in formulating a comprehensive market opening.

The Belt and Road countries have great demand for funds. The Asian Development Bank estimated that cumulative investment for infrastructure projects in 5 ASEAN countries along the Belt and Road, China, Kazakhstan and Pakistan would be USD 5.7 trillion between 2010 and 2020. According to a report by Baker McKenzie, a law firm, and Silk Road Associates, the Belt and Road-related projects are estimated to be worth USD 350 billion over the next 5 years.

The existing financing model is insufficient to support economic development, given low saving rate in some countries along the Belt and Road, immature financial markets, etc.

As a result, it is essential to expedite the development of financial markets along the Belt and Road countries. Supranational institutions such as the Asian Infrastructure Investment Bank, the Silk Road Fund, etc., have provided financial supports to projects along the Belt and Road countries. Major financial institutions, such as Bank of China, are also rapidly developing a financing network. They supported the construction of local projects by providing syndicated loans. Furthermore, the degree of bond market development is crucial for promoting the usage of funds along the region.

IV. New Challenges for China's bond market opening

1. Offshore investors remain sceptical about entering China's bond market

For the time being, major investors in China's bond market include commercial banks, credit unions, securities firms, investment funds, insurance companies, non-financial institutions, etc. In terms of bond holdings, commercial banks take the lead with over 60% of market holdings, while other types of institutions have relatively low shares.

As RMB internationalization progresses, offshore investors are becoming important participants in the bond market. The holding of bonds and equities by non-residents is responsive to the degree of China's capital account opening. Asset holdings by offshore investors will increase following the ease of relevant policies. It will be more convenient for overseas investors to increase their holdings of RMB assets with more investment channels.

However, offshore investors have three concerns about entering China's bond market. The first concern is about the free movement of funds. The second concern is about insufficient secondary market liquidity due to the lack of depth of the bond market. The third concern is about an incomprehensive credit rating system, as credit agencies do not completely meet international standard. For example, the credit ratings for corporate bonds cannot fully reflect the implied risks.

2. The progress of market opening in both directions is affected by capital outflow pressure and expectation of RMB exchange rate

Financial risk control is a priority as mentioned in the Central Economic Work Conference, to ensure the prevention of systemic risks. The RMB’s exchange rate has stabilized since 2017, given the week dollar, expectation management by the PBOC, the improving Chinese economy and supports from macro policies.

The RMB is expected to be stable and the condition of capital outflow is manageable. Against this backdrop, the bond market could open further by expanding the Bond Connect from Northbound Trading to Two-way Trading in due course. For one, the Northbound Trading corresponds to the principle which encourages capital inflow and controls capital outflow at the same time. For another, the introduction of the Southbound Trading will be determined by a number of factors, such as changes in the balance of payments, capital flows between onshore and offshore markets, etc.

3. The bond market’s lack of depth and breadth constrain the progress of market opening

Capital market opening in both directions can shorten the review period with lower transaction costs. Moreover, it can attract different offshore investors, making a breakthrough in product diversification and primary market development in China’s capital markets. In addition, it can enhance the adaptability to regulatory environment, taxation and legal framework. The bond market depth and breadth can be enhanced given simplifying procedures in onshore capital markets, expanding the scope of investment assets and issuers, improving financial infrastructure such as cross-border clearing and custody system, which satisfies the increasing demand for RMB assets by offshore investors.

How will China's Economy Realize High-quality Growth in the New Era?

Chunxin WANG, Senior Economist

One of the highlights of the report at the 19th CPC National Congress is prioritizing improving the quality of growth for the first time and emphasizing economic strength in terms of quality. In the recent Central Economic Work Conference, the government further pointed out that "to promote high-quality growth has become the fundamental requirement for determining development ideas, formulating economic policies and implementing macro-control currently and in the future", which indicates that decision-makers have attached great importance to promoting high-quality growth. This tone has revealed a lot of important signals of the New Era which need in-depth interpretation. Hong Kong needs to seize the opportunities it brings.

I. Main direction: win with quality

According to the statement, the essence of a modernized economy in the New Era is high-quality growth, and the main direction in the future is to win with quality. This is the accurate understanding of the current stage of China's economic development and also the basic trend of China's economic development in the New Era.

In fact, since the 18th CPC National Congress, China has achieved initial success in its economic transformation, with economic growth shifting from high speed to medium-to-high speed. GDP growth has decreased from an annual average of 10.8% during 2003-2011 to 7.2% during 2012-2017. Based on the situation of China's economy, decision-makers made the correct judgment that China has entered a new normal in economic development, formulating and implementing a series of policies to adapt to the new stage, especially by promoting supply-side structural reform, moving the economic structure to medium-to-high end, and maintaining high growth in strategic emerging industries, high-tech industry and other emerging industries. As a result, new drivers have contributed to the steady growth of the economy. Meanwhile, rising services and consumption have become a main engine of economic growth. Contribution of the tertiary industry to economic growth has increased from 46% to 59%, while contribution of final consumption to economic growth has increased from 55% to 65%.

However, there are still many difficulties and challenges in the current economic development, including insufficient quality, efficiency, and innovation capability. Many industries face serious excess capacity, while the needs for high-quality products from consumers and businesses are far from satisfied, which result in outflow of consumer demand and intermediate demand. The supply side has fallen behind the pace of transformation and upgrading in the demand side.

Take consumption as an example. The report released by the World Tourism Organization (UNWTO) showed that total overseas consumption of Mainland Chinese tourists reached USD 261 billion last year, doubling that of the United States and growing at double digits growth for twelve consecutive years, most of which were purchases of high-end consumer goods. Take production as an example. Although the scale of domestic steel overcapacity reaches hundreds of millions of tons, about ten million tons of special steel worth about USD 15 billion are imported every year. Only technological transformation and upgrades can significantly improve product quality and make China’s steel industry stronger and better.

Therefore, the report at the 19th CPC National Congress clearly states that China’s economy has shifted from rapid growth to high-quality growth, striving for breakthroughs in transforming growth model, improving economic structure, and fostering new drivers of growth. In economic development, China will adhere to the path of "quality first and efficiency first" and actively promote the three reforms -- quality reform, efficiency reform and drivers reform, aiming at improving total factor productivity. In other words, in the New Era of building a modernized and powerful nation, development, especially high-quality growth, is still the top priority. The next 5-10 years will be the key and require every effort to make it happen.

II. Operational keys: six strategies

To promote high-quality growth, a modernized economy must first be built, an urgent requirement and the strategic goal of China's development. The connotation of building a modernized economy mainly includes “four operational keys” and “two important supports”. They constitute the six basic strategies on building a modernized economy and promoting high-quality growth.

Four operational keys include pragmatism, innovation, rural revival, and coordination, touching upon various levels of policies, such as development direction, growth driver, rural issues and regional development. These are four key measures of high-quality growth and are essential in improving China's economy.

First is pragmatism, which means to focus on the real economy. This is a major decision to tackle insufficient development of the real economy and the excessive expansion of the virtual economy and also a comprehensive correction of economic development direction. The 19th CPC National Congress stated that to build a modernized economy and to enhance the quality of the supply system, the real economy rather than the virtual economy should be emphasized. In other words, to enhance the economy's quality, China must prioritize the real economy, building a solid foundation in order to avoid repeating America's mistake of letting economic bubbles undermine the roots of the economy.

To focus on the real economy, China will take the following two measures in the future. First, the government will build a strong manufacturing base and develop modern service industries. China will foster a number of world-class advanced manufacturing clusters, promoting further integration of the internet, big data, and artificial intelligence with the real economy. China will also foster new growth areas and drivers in medium-to-high end consumption, innovation-driven development, green and low-carbon economy, propelling the shift from "made in China" to "created in China". In addition, the government will stimulate and protect entrepreneurship, taking more measures to encourage innovation and startups. In the meantime, build modern service industries to international standards, especially high-tech services and strategic emerging services. Second, the government will continue to cut overcapacity, reduce excess inventory, deleverage, lower costs, and improve weaknesses. It will focus on capacity utilization, property for sales, corporate debt ratio, investment in weak areas, as well as improving financial supervision system to control systemic financial risks. Apparently, China will combine enhancing supply quality with risk controls in the future, blazing a new trail of focusing on the real economy rather than the virtual economy.

Second is innovation, building an innovative country. This is to speed up the construction of an innovative country and to address the problem of economic growth drivers. The 19th CPC National Congress states that innovation is the primary driving force of development and provides strategic support for building a modernized economy. In the future, the government will take a series of measures, including strengthening elementary and applied research, making major breakthroughs in pioneering elementary research and original innovations, as well as prioritizing innovation in key generic technologies, cutting-edge frontier technologies, modern engineering technologies, and disruptive technologies, to provide powerful support for building China's strength in science and technology, product quality, aerospace, cyberspace, and transportation, and for building a digital China and a smart society. The government will also improve national innovation system, boost strategic scientific and technological strength and support innovation by small and medium-sized enterprises. In addition, developing technologies and nurturing talents are of equal importance, so as to cultivate a large number of world-class scientists and technologists in strategically important fields, scientific and technological leaders, and young scientists and engineers, as well as high-performing innovation teams. All of these will push China's economic growth from relying on low and middle productive factors such as labor and capital to high-end production factors such as innovation and talent, so as to achieve a complete transformation of economic development model and, playing a decisive role in improving total factor productivity. The coming 5-10 years will be the key node of global industrial transformation. The rapid rise of China's emerging industries is not only in line with the general direction of world development but also has achieved leading positions in many areas. Therefore, China could become the focus of development of new industries in the world, with great potential and bright prospects.

Third is to implement a rural revival strategy, which aims to promote modernization of agriculture and new urbanization. Modernization of agriculture is an essential part of building a modernized economy, without which a modernized economy can't be truly established and development of high quality will be difficult to realize. The 19th CPC National Congress points out that issues relating to agriculture, rural areas, and rural people are fundamental to China's stability and people's wellbeing, so the government must prioritize the development of agriculture and rural areas to speed up the modernization of agriculture and rural areas. There are several measures on modernization of agriculture. Firstly, the government will consolidate and improve the basic rural operation system, deepen reform of the rural land system, and extend the current round of rural land contracts for another 30 years upon expiration. Second is to ensure China's food security so as to always have control over food supply. Third is to establish industrial, production, and business operation systems for modern agriculture, to develop appropriately scaled agricultural operations, to cultivate new types of agribusiness, and to encourage small household farmers to become involved in modern agriculture, laying a solid foundation for the establishment of a modernized agriculture system. Finally, the government will promote the integrated development of the primary, secondary, and tertiary industries in rural areas, supporting and encouraging employment and business startups. These policies will enable urban areas to provide for rural areas and industry for agriculture, developing the rural economy and shrinking the gap between urban and rural areas. But because of the complexity of agricultural and rural problems, the land system may present a difficult obstacle for building a modernized economy.

Fourth is to implement an inter-regional coordinated development strategy to tackle imbalances in regional development. China will rely on the following measures to implement its inter-regional coordinated development strategy. First is to establish the framework of overall regional development, including devoting more energy to speed up the development of old revolutionary base areas, areas with large ethnic minority populations, border areas, and poor areas, strengthening measures to reach a new stage in the large-scale development of the western region, deepening reform to accelerate the revitalization of old industrial bases in the northeast and other parts of the country, helping the central region rise by tapping into local strengths, and supporting the eastern region in taking the lead in pursuing optimal development through innovation. Second is to create networks of cities and towns based on city clusters, and to speed up work on granting permanent urban residency to people who move from rural to urban areas. Last is to drive the coordinated development of the Beijing-Tianjin-Hebei region and the Yangtze Economic Belt. Specific measures include relieving Beijing of functions nonessential to its role as the capital and using this effort to drive the coordinated development of the Beijing-Tianjin-Hebei region, the Yangtze Economic Belt and the Guangdong-Hong Kong-Macao Bay Area. Take urbanization as an example, in the past five years, about 80 million of the agricultural population have become urban residents, raising the urbanization rate by 1.2 percentage points annually. By 2020, about 50 million of the agricultural populations are estimated to become urban residents, lifting the urbanization rate of China to more than 60%.

There are also two important supports, including improving the socialist market economy and making new ground in pursuing opening up on all fronts, which are indispensable to high-quality growth.

Major measures in improving the socialist market economy and pursuing all-round opening up include promoting the PPP reform of state-owned enterprises, building China into a strong trading nation, supporting the development of private enterprises, curbing financial risks, easing market access, and exploring the construction of free trade ports etc. By the end of 2017, China's State-Owned Enterprises will complete the reform of introducing corporate governance system, and the next step is to promote shareholding system reform and to introduce various investors to realize the diversification of shareholding rights. Recently, China’s government made it clear that private enterprises are the main force of manufacturing development and assigning 36 tasks in 8 major areas, to stimulate private investment and guide the transformation and upgrading of private enterprises. The government also implemented policies of trade liberalization and investment facilitation, and significantly eased market access for foreign investors by removing caps on foreign ownership in Chinese financial institutions. At the same time, the role of finance in serving the real economy is emphasized, and the government enables investment to play a crucial role in improving the supply structure through deepening reform of the investment and financing systems while promoting the healthy development of a multilevel capital market by increasing the proportion of direct financing. A committee under the State Council to oversee financial stability and development was set up, and the PBOC improved its “twin pillar” framework to ensure the stability of the RMB and financial systems, defending the bottom line of no systemic financial risks.

III. The first year of implementation: looking for breakthroughs

2018 is crucial as the first year of implementation of major decisions of the 19th CPC congress, and also the beginning of promoting high quality development. China’s central economic work conference has made comprehensive plans for 2018. According to the conference, realizing high-quality growth is a must for sustaining healthy economic and social development. The government will concentrate on pursuing high-quality growth, including deepening supply-side structural reform, stimulating the vitality of markets, entering a new phase of all-round opening, improving the standards of people's livelihood, accelerating the establishment of a new housing system and accelerating the construction of ecological civilization etc. Specific and effective policies and measures will be taken.

Firstly, the government puts forward many feasible measures in the field of reform and opening. For example, it is required to lawfully screen and correct ownership dispute cases with strong public interest, to shift the agricultural policy from production orientation to quality orientation, to innovate outward investment along the Belt and Road Initiative, and to encourage imports through partially cutting import tariffs, so as to strengthen long-term investment confidence, to promote modernized agriculture and to balance trade. This helps establish a supply system of high quality and answers the important question of how to achieve high-quality growth.

Secondly, the government attaches great importance to solving public issues, such as relieving the heavy extra-curricular burden borne by primary and middle-school students and tackling “school selection mania”, accelerating the implementation of nation-wide coordination for pensions, and accelerating the establishment of a residential housing system with multiple supply channels, multiple guarantee channels, and relying on both rentals and ownership. The government took a major step in addressing major livelihood issues of housing, education, and pensions and so on. This is a solemn commitment to the pledge of a people-centered approach and a better life outlined in the 19th CPC National

Congress report, which will make people’s sense of fulfillment stronger, get widespread support, and also answer the more fundamental question of "for whom the high quality economy serves”.

Thirdly, according to the requirements of 19th CPC National Congress report, there are three tough battles including control of major risks, targeted poverty alleviation and pollution prevention in the next three years. To make a good start and a big stride this year, key tasks focus on curbing financial risks by combatting illegal financial activities, lifting ten million people out of poverty with targeted poverty alleviation, protecting the environment by increasing energy-saving assessment and significantly reducing major pollutant emissions. These three battles will provide extremely important conditions for the realization of high-quality growth.

To pursue high-quality growth, the government will continue proactive fiscal policy and neutral monetary policy this year. Fiscal policy will aim at structural adjustment targeting at the major tasks mentioned above, while monetary policy will be more prudent and even slightly tighter, to help stabilize macro leverage ratio and control risks of local debt and shadow banking, while supporting reasonable financing demands from the real economy. Driven by these policies, China’s economy will maintain medium-to-high growth, and GDP growth in 2018 could be a bit slower than that of last year but still remain around 6.7%.

Finally, it must be stressed that high-quality growth will not substantially reduce economic growth. On the contrary, the promotion of high-quality growth can lead to healthier, more stable and more sustainable economic growth. According to author’s projection, if the net output ratio of China’s industrial production can increase to the global average, 1.2 percentage points on average could be added to GDP growth over the next ten years; if the ratio increase to the average level of developed countries, 1.8 percentage points on average could be added to GDP growth. This calculation has not accounted for the contribution of the rise of high value-added service industry. Apparently, high-quality growth has great potential and promising prospects.

The Opportunities and Significance of Developing "Petroyuan"

Hong LIU, Senior Economist

At present, there is a new opportunity for China to develop "petroyuan". The intention to develop "petroyuan" is not replacing the petrodollar system or competing for the pricing power of crude oil. Instead, China hopes to build a diversified petroleum pricing settlement system with petrodollar, petroeuro and petroyuan, that provides fair competition and free-to-choose valuation and settlement basis for global petroleum trade. Therefore, the market should take a positive view on China's establishment of a petroyuan system.

I. The origin of "petrodollar" and evolution of international crude oil pricing mechanism

The "petrodollar" was born in the 1970s. The Middle East war broke out in 1973, and Saudi Arabia, Kuwait and other OPEC member states unanimously agreed to substantial production cuts and embargo. The first oil crisis brought crude oil prices from USD3.11/barrel to USD11.65/barrel. The OPEC's cartelization measures greatly affected the international price of crude oil, highlighting the monopolistic feature of the crude oil market during that period. Saudi Arabia became a leader in OPEC due to its huge market share. In 1974, U.S. President Nixon reached an agreement with Saudi Arabia's King Faisal to bind the interests of the world's largest oil-importing country, the U.S., and the largest oil-producing country, Saudi Arabia. Saudi Arabia would use the U.S. dollar as the only currency for oil trade, and the United States would safeguard the sovereignty and territorial security of the Saudi royal family and recognize the pricing power of the Saudi-led OPEC on international crude oil.

With the birth of "petrodollar", U.S. President Nixon, only three years after ending the gold standard in August 1971, gained support from petroleum. Once petrodollar was born, it developed along two paths. Firstly, other oil exporting countries started to use the dollar for oil trade after Saudi Arabia. Secondly, it guided other commodities to settle in dollars, thus forming and consolidating the petrodollar's dominance in global financial markets.

OPEC's pricing power and mechanism of international crude oil lasted for only some ten years before being replaced by the U.S., a non-OPEC oil producing country, and a pricing mechanism based on futures trading. By facilitating oil trading in exchanges, the U.S. strengthened its say in oil pricing. In 1986, the U.S. listed the West Texas Intermediate OTC Futures (WTI) on the New York Mercantile Exchange (NYMEX). London's International Petroleum Exchange (IPE) launched the Brent low density low sulphur crude oil futures contract in 1988. Both use the U.S. dollar as the currency for pricing and settlement. Since the oil futures market has two major functions of hedging and price discovery as well as technical advantages, the price of oil futures has gradually become the leader in the international petroleum pricing system after 1986.

II. China's current opportunity to develop "petroyuan"

The dominance of "petrodollar" in the international crude oil pricing mechanism was formed by the oil stakeholders including the United States, OPEC, investors and consumers and was also a choice made by the market. Any party that wants to change this situation faces huge difficulty. This is also the main reason suppressing the development of petroeuro, petroyen, petrorupiah and petroruble so far. However, the prospects for China to promote "petroyuan" will be different for five reasons:

Firstly, more and more countries call for reforms to address the shortcomings of a single "petrodollar" system. The USD-driven international monetary system based on petrodollar is inherently flawed. The United States cannot provide the world with liquidity while ensuring the stability of its currency's value, which is the Triffin Dilemma. During the financial crisis, the Federal Reserve large scale quantitative easing created a flood of liquidity, impacting non-reserve currency countries, especially emerging markets. After the crisis, the Fed tightened monetary policy and again became the root of turmoil in global financial markets. After June 2014, the Dollar Index trended upwards, becoming one of the important reasons for the international oil price slump and long-term downturn, seriously affecting the economic and financial stability of oil-exporting countries. The currencies of many major oil-producing countries in the Middle East are pegged to the USD. These countries were also affected by the deviations between the exchange rate and economic fundamentals. The development of petroyuan could offer the market another option aside from petrodollar.

Secondly, geopolitics leads to the "petroyuan" partly replacing the "petrodollar." In 2011, the United States and Europe imposed severe economic sanctions on Iran. In July 2015, Iran and the United States, Russia, China, UK, France and Germany reached a comprehensive nuclear agreement on Iran's nuclear development and lifting the sanctions against Iran. Since the Crimea crisis in 2014, the U.S. and Europe have imposed many rounds of economic sanctions against Russia. In order to counter the sanctions, Russia, Iran, Venezuela, Kazakhstan, Uzbekistan and other Central Asian countries tried to bypass the petrodollar system and adopt non-USD currencies such as the Euro and the RMB in bilateral oil trade. In the past three years, the volume of China crude oil imports from Russia rose sharply, and the oil imported through the Eastern Siberian-Pacific Ocean oil pipelines has been settled solely in RMB since 2015. **Sino-Russian oil and gas cooperation is expected to become an important booster for the development of petroyuan.** The sanctions imposed by the U.S. on Russia are still being enforced, while the sanctions on Venezuela are expanding and the sanctions against Iran are to be resumed. Geopolitics will continue to play a role.

Thirdly, the pressure on Saudi Arabia and Angola to switch to RMB settlement in bilateral crude oil trade with China will rise. The international crude oil supply still exceeds demand, and the competition among oil-producing countries for market share will become increasingly fierce. In the first half of 2017, crude oil imports of China reached 8.66 million barrels/day, surpassing the U.S.'s average of 8.12 million barrels/day and becoming the largest importer of crude oil. Saudi Arabia and Angola need to pay more attention to the Chinese market. However, according to data from the General Administration of Customs of the PRC, Russia exported 45 million tons of crude oil to China in the first nine months of 2017 and became the largest supplier to China, followed by Angola at 39.9 million tons and Saudi Arabia at 38.5 million tons. Saudi Arabia is at a disadvantage in competing with Russia for the Chinese market.

Fourthly, Saudi Arabia is implementing the "Economic Vision 2030" plan, which provides opportunities for close Sino-Saudi cooperation in oil interests. Saudi Arabia's "petrodollars" slumped in the past three years, and the oil economy was in distress. The Saudi government proposed the "Economic Vision 2030" plan to promote the transition of the economy to a diversified and knowledge-based economy. First, China could strengthen the Belt and Road Initiative with the "Economic Vision 2030" plan. Second, Saudi Arabia plans to raise funds through the IPO of Aramco and inject huge capital into the "Economic Vision 2030" plan. According to Reuters, Petro China and Sinopec have already showed interest in direct acquisition of a 5% stake in Saudi Aramco. The Sino-Saudi oil interests are expected to be further aligned.

Fifthly, as the RMB joined the SDR to become an international reserve currency, the liquidity of "petroyuan" will significantly increase. Oil exporters already have many channels to use "petroyuan". For overseas use, more than 60 countries and regions including Singapore and Russia include the RMB in their foreign exchange reserves. As of June 2017, more than 1900 financial institutions around the world used RMB as a payment currency. Recently, the RMB has become the second most commonly used currency in Egypt. As for trade and investment with China, "petroyuan" can flow to China through FDI, QFII, RQFII, "Shanghai-Hong Kong Stock Connect" and "Bond Connect". On July 10, 2017, HKEx launched the RMB and USD dual currency gold futures, and "petroyuan" can be used to exchange for gold in Hong Kong.

III. The great significance of developing “petroyuan”

Firstly, it will be conducive to the implementation of the Belt and Road Initiative and long-term development. Financing provides a key support for the Belt and Road Initiative. A report of the Asian Development Bank shows that by 2030, demand for infrastructure investment in Asia rises to as much as USD 26 trillion. Using the US dollar only will be unsustainable. The establishment of a "petroyuan" system would not only open a window for the construction of the Belt and Road Initiative but also open a door to stable and long-term Belt and Road-related projects. First of all, the status of the RMB as an international reserve currency would be further strengthened. The recognition and utilization of the RMB in countries along the Belt and Road would rise, and the RMB could be used directly for investments. Second, part of China’s

USD 3.1 trillion in foreign exchange reserves can be used to support Belt and Road-related projects. Third, overseas RMB bond issuance would attract international funds to support the Belt and Road Initiative, building a community of common interests that share risks and profits.

Secondly, it will help increase China's bargaining power on crude oil pricing fixing and global finance. At present, China has little say in international crude oil pricing in spite of being the world's largest net oil importer and the second largest oil consumer. "Petroyuan" will help change this situation. Via supply and demand factors and the Shanghai International Energy Exchange Center’s (INE) upcoming crude oil futures contracts denominated and settled in the RMB, China can influence the formation of Middle East crude oil prices in the Asian market.

Thirdly, it can boost RMB internationalization. Currently, China still needs to pay USD for the purchase of crude oil from major OPEC member countries such as Saudi Arabia. With the establishment of a "petroyuan" system, this situation will change. RMB internationalization will get rid of the shackles of the petrodollar and leverage the huge currency demand arising from denomination and settlement of petroyuan. First, bilateral crude oil trades between China and oil-producing countries are settled in the RMB. Second, more and more countries in international multilateral oil trade choose to use RMB settlement. Third, "petroyuan" will accelerate the RMB’s pricing and settlement functions of other commodities such as grain, coal, iron ore and further increase international demand for the RMB. RMB internationalization also helps ensure stability of the exchange rate.

To summarize, we should take a positive view on China's development of "petroyuan". As an important international financial center and a global offshore RMB business hub, Hong Kong can play the role of a petroyuan product center in the national development of "petroyuan".

Fundamentals and Interest Rates Support the RMB

Tristan ZHUO, Senior Economist

From 2014 to 2016, the RMB depreciated against the dollar, reversing years of one-way appreciation. As the dollar weakened in 2017, the RMB strengthened noticeably against the dollar. The RMB's value has become increasingly unpredictable in the era of two-way fluctuation. To make sense of the RMB's value, its medium to long term trend offers insights.

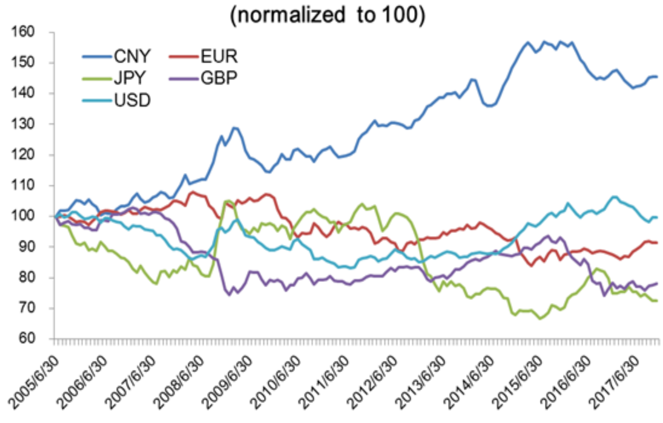
I. Substantial long-term gains

The RMB is the only emerging market currency in the IMF's SDR basket, and its value is uncorrelated with its SDR peers.

The RMB was unpegged with the dollar in July 2015 and went on to record considerable gains. According to the BIS, from July 2005 to November 2017, the RMB's real effective exchange rate (REER) rose more than 45%, while other SDR currencies all weakened to different extents.

The depreciation of the dollar, Euro, sterling, and yen in the past 12.5 years tends to be overlooked because exchange rates are usually benchmarked against the dollar. In fact, after adjusted for inflation, the trade-weighted exchange rates of major Western currencies have been trending downwards. The RMB's strong long-term performance also reflects the increasing maturity of emerging market currencies.

Figure 1: SDR currencies' REER since June 2005 (normalized to 100)



Source: BIS, BOCHK Research

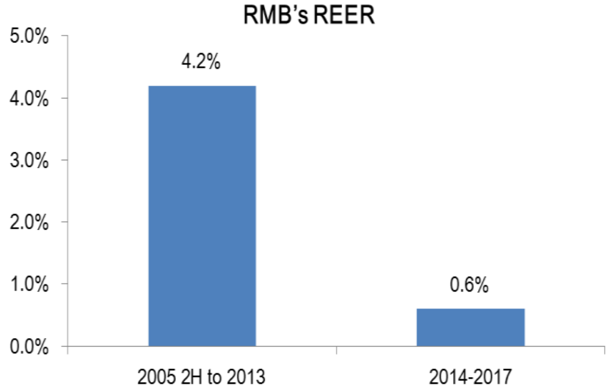
II. Fluctuation against the dollar amid overall stability

While the long-term trend of the RMB has been upwards, the currency's performance entered a new phase in 2014. As the RMB rebounded against the dollar in 2017 following three years of weakness from 2014 to 2016, the currency's value has become seemingly unpredictable. However, the RMB's fluctuation against the dollar is mainly attributable to the dollar's own volatility. In terms of REER, the RMB has remained largely stable since 2014.

During the period between 2014 and 2016, the RMB depreciated against the dollar by nearly 13%. Meanwhile, the RMB's REER against 60 currencies actually gained about 4%. In 2017, the RMB rose markedly against the dollar, but its REER was in fact down slightly for the year. Due to the dollar's wild gyrations, the RMB's fluctuation against the dollar is indispensable to its overall stability. It does not mean that the RMB has become increasingly volatile.

What did change in the past few years was the RMB's gradual shift from persistent appreciation to relative stability. From July 2005 when the first exchange rate reform took place to the end of 2013, the RMB's REER rose 41.7%. In comparison, since the beginning of 2014, the RMB's REER has remained largely stable, gaining 2.4% in spite of fluctuations against the dollar. Granted, the two periods are of different durations and thus cannot be compared directly. Based on average compound annual rates, the gains of the RMB's REER during these two periods are 4.2% and 0.6%, respectively, with the former being 6 times greater than the latter.

Figure 2: Average compound annual rates of the RMB's REER



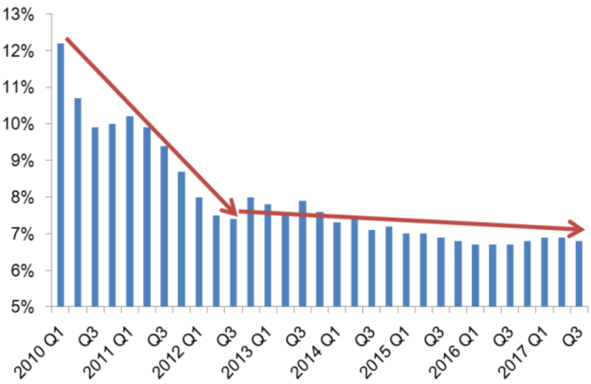
Source: BIS, BOCHK Research

III. Favorable fundamentals

As the RMB is no longer undervalued, the pace of its appreciation has slowed noticeably in recent years. However, supported by favorable fundamentals, its upward trajectory should remain intact.

Firstly, growth momentum continues to be stable. At the beginning of the current decade, the Chinese economy once slowed considerably. From the first quarter of 2010 to the third quarter of 2012, real GDP growth decelerated sharply from 12.2% to 7.4%, with the slowdown averaging 0.4 percentage points per quarter. In contrast, in the past 5 years, GDP slowed from 7.4% to 6.8%, or weaker by only 0.1 percentage points per year. As the imbalance between private consumption and investments continues to improve, economic restructuring should ensure robust growth.

Figure 3: China's "L-shaped" growth pattern



Source: National Bureau of Statistics, BOCHK Research

Secondly, exports have bottomed. Following years of downturn, international trade has recovered. To smooth out seasonal volatilities in monthly figures, six-month moving averages offer a clearer reading of the underlying trend. Year-over-year changes in this indicator bottomed in the middle of 2016 and have been in positive territory since March 2017, supporting the RMB.

Figure 4: 6-month moving average of Chinese exports (YoY)

Source: Bloomberg, BOCHK Research

Thirdly, as monetary policy remains prudent, the RMB offers generous interest returns. In contrast to major Western central banks, the PBOC has refrained from resorting to unconventional measures such as quantitative easing and negative interest rates. While benchmark lending and deposit rates have remained unchanged for 27 months, sovereign bond yields and interbank lending rates have risen substantially. 10-year sovereign yields began to rise in October 2016 and once breached 4%, much higher than those in the developed world.

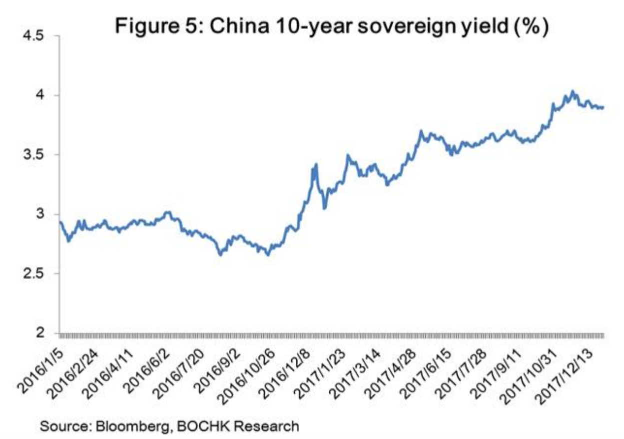


Figure 5: China 10-year sovereign yield (%)

Source: Bloomberg, BOCHK Research

IV. Yield differential a key determinant of the RMB's exchange rate

China's solid fundamentals of stable growth, improving exports, and prudent monetary policy support the RMB's overall value. However, when it comes to the bilateral exchange rate of the RMB against the dollar, one must consider factors in both China and the U.S. One of the most straightforward indicator is the yield differential between China and the U.S. Due to higher growth and inflation in China, the yield differential has always been positive, i.e. the RMB yields more than does the dollar. However, the yield differential, measured by the difference between 10-year yields of both countries' sovereign bonds, shrank between 2014 and 2016, narrowing from a high of 2% to only 0.5%. Incidentally, the RMB depreciated against the dollar during these three years. The yield differential began to widen by the end of 2016, rising by 1 percentage point to 1.5%, and the RMB rebounded strongly. The yield differential between China and the U.S. is highly correlated with the RMB's exchange rate against the dollar.

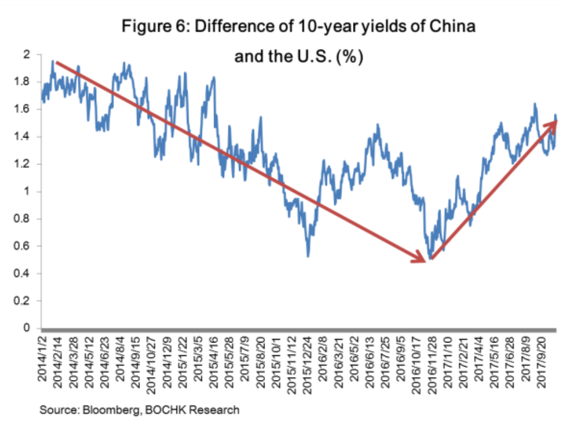


Figure 6: Difference of 10-year yields of China and the U.S. (%)

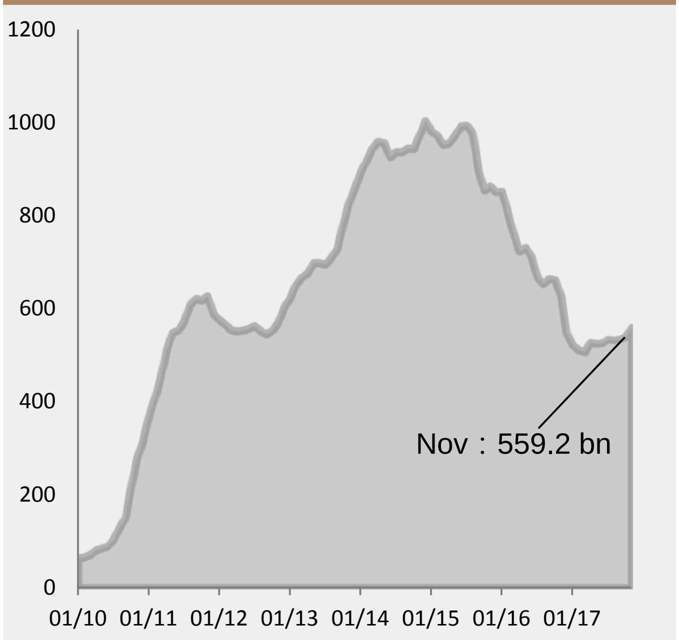
Source: Bloomberg, BOCHK Research

Changes in the yield differential have been mainly driven by Chinese yields. As China's bond yields are already hovering near a three-year high, there is not a lot of room for the yield differential to widen further. Therefore, the RMB's strength against the dollar may face headwinds.

Looking ahead, measured by REER, the RMB should be well supported against a basket of trade-weighted currencies. Against the dollar, the RMB's fluctuation will likely increase, largely hinging on the yield differential.

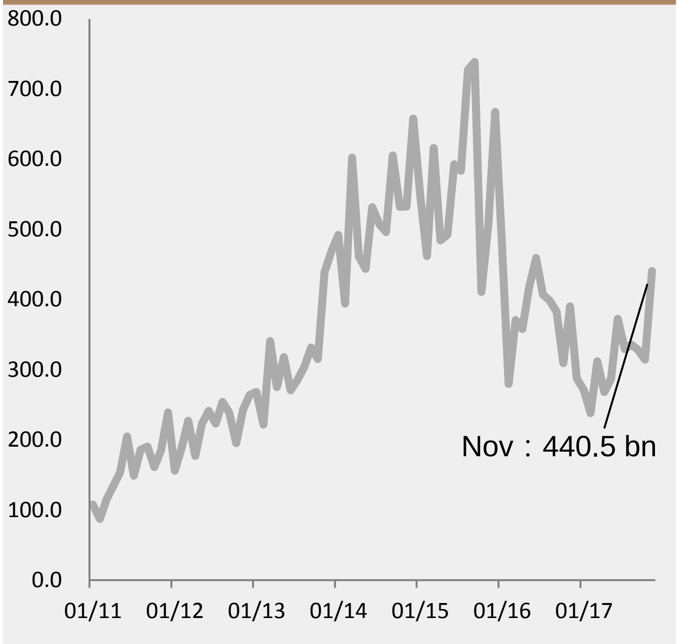
Market Trends

Hong Kong RMB Deposits (in RMB bn)



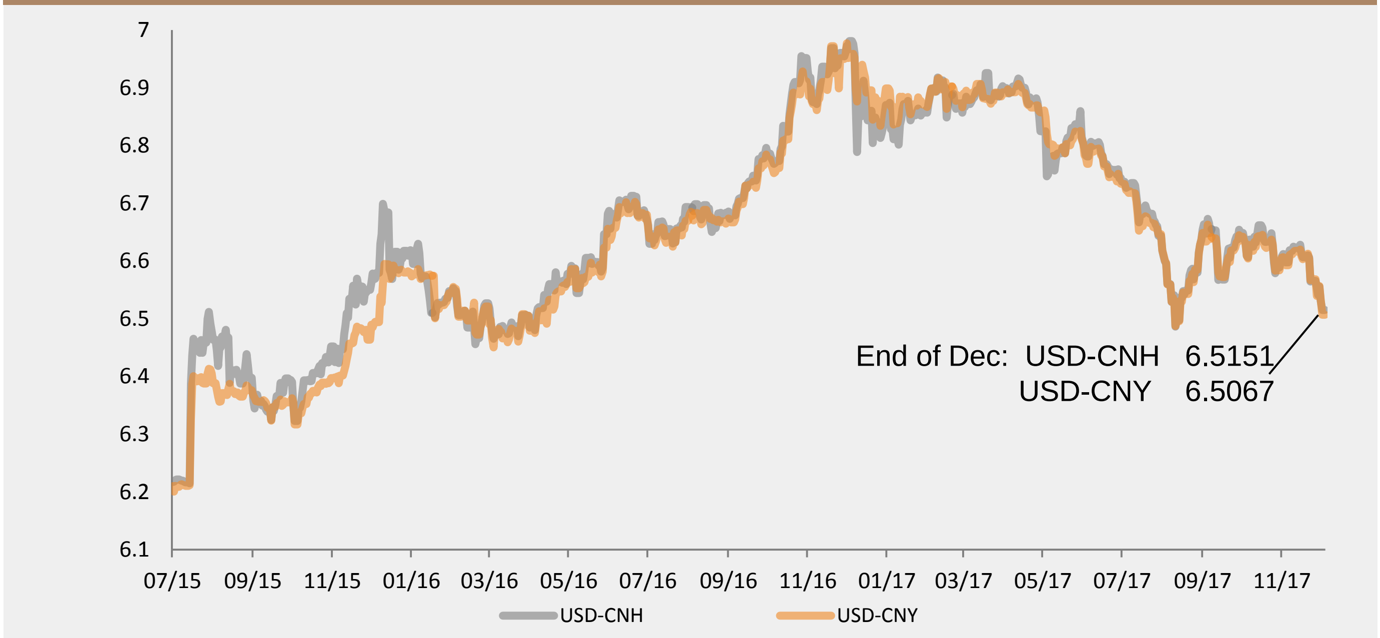
Source: HKMA

RMB Cross-border Trade Settlement (RMB bn)



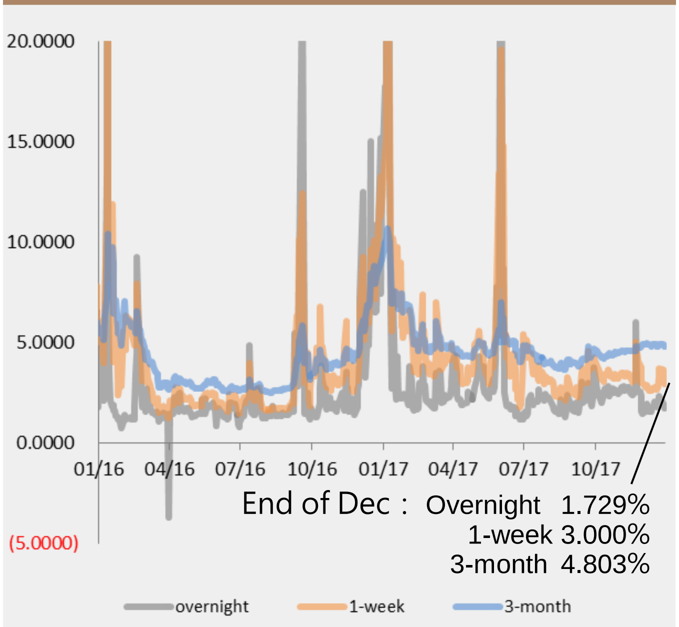
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



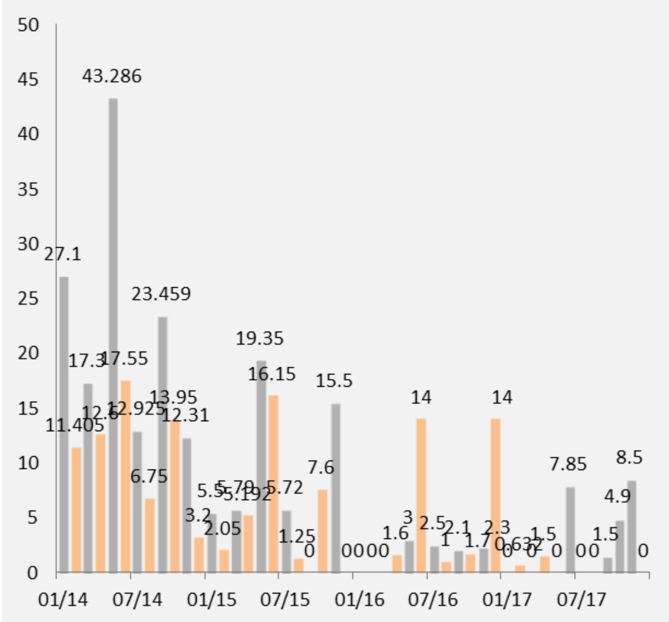
Source: Bloomberg

CNH HIBOR Fixing (%)



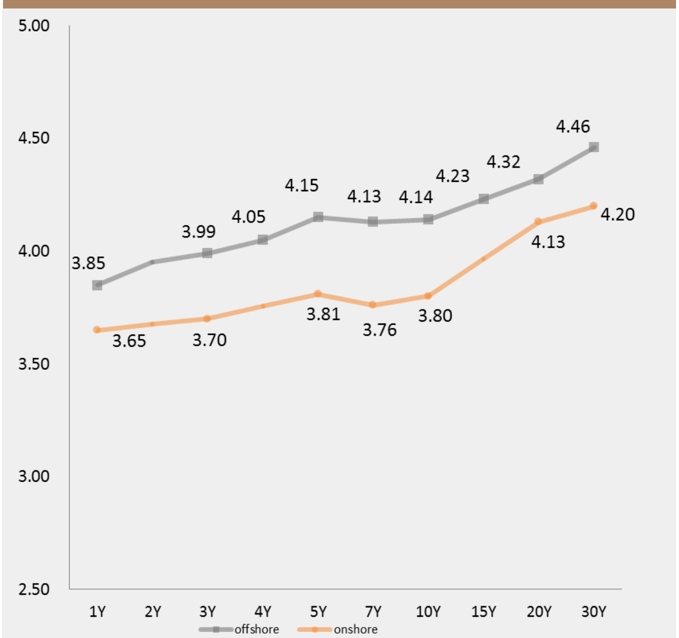
Source: Bloomberg

Hong Kong Offshore RMB Bond Issuance (RMB bn)



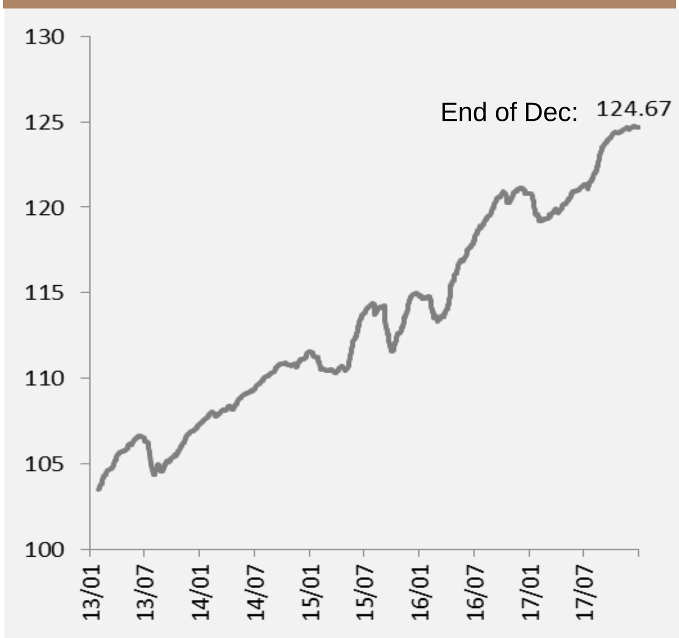
Source: BOCHK Global Market estimate

CNH & CNY China Sovereign Curve (%, 29 Dec 2017)



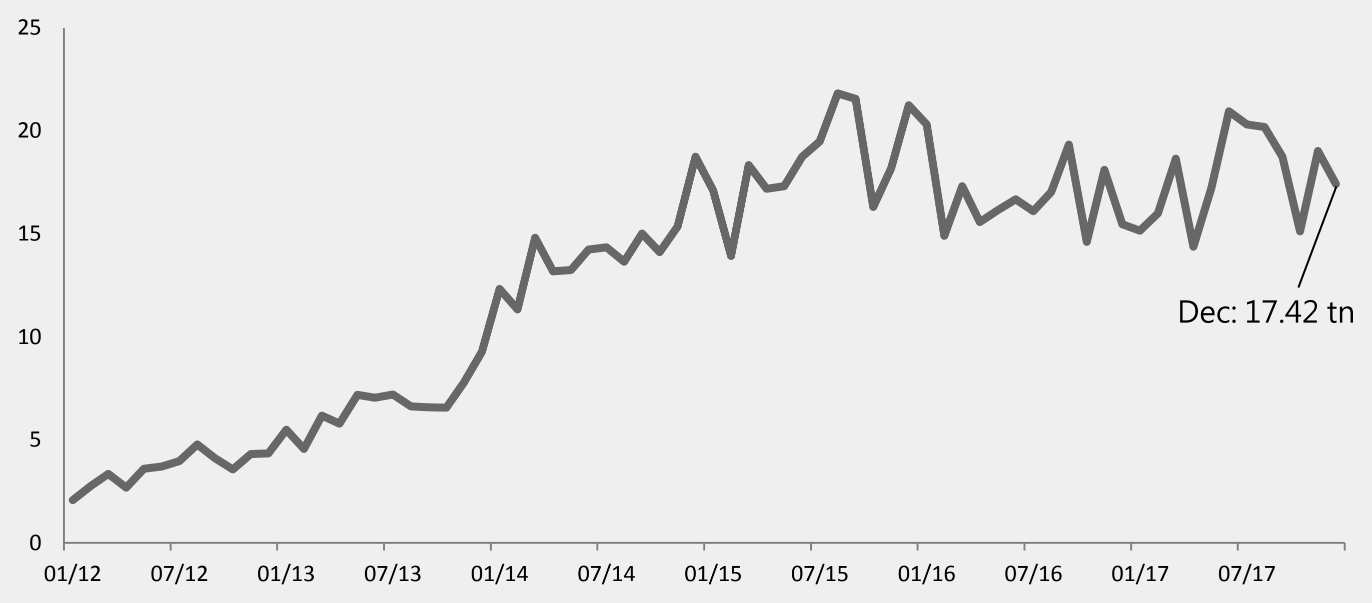
Source: Bloomberg

FTSE-BOCHK Offshore RMB Bond Composite Index



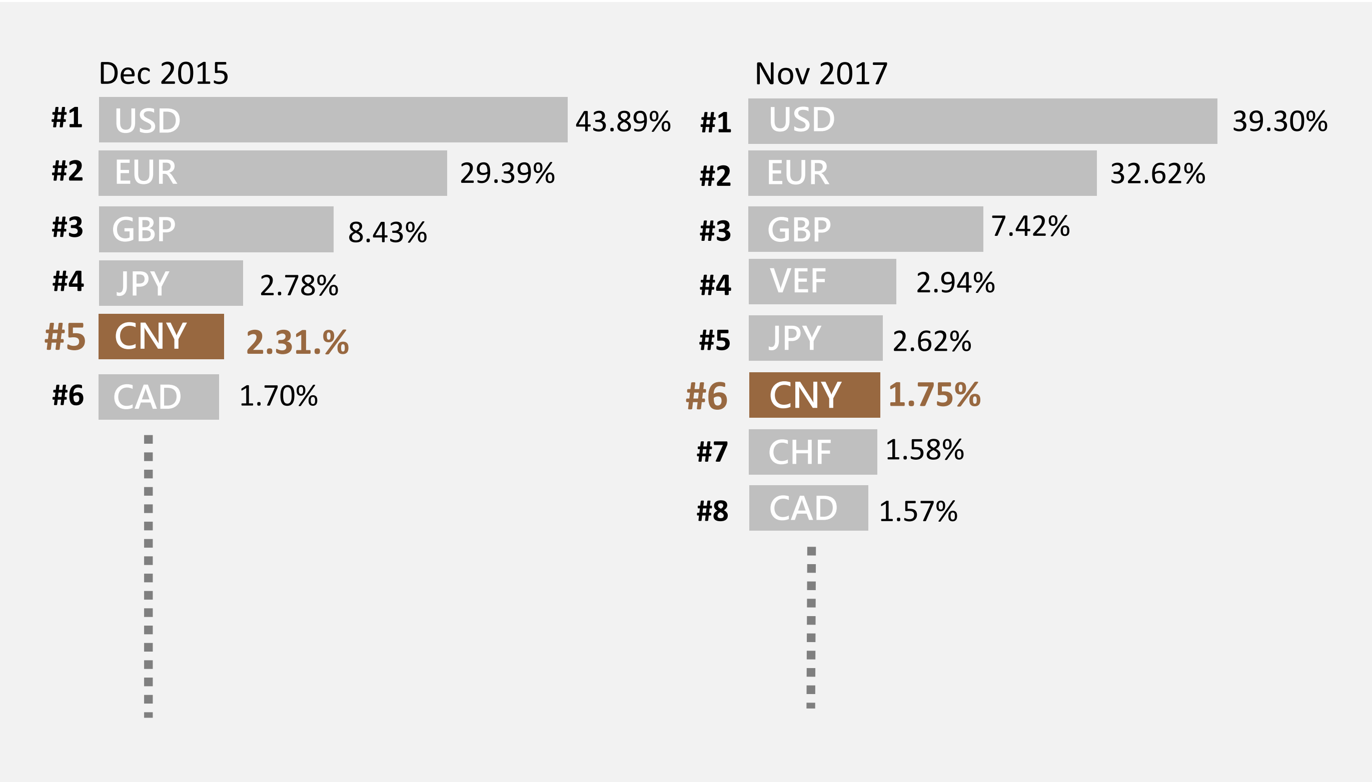
Source: Bloomberg

RMB Clearing Transaction Value (RMB tn)



Source: HKICL

SWIFT World payments currency ranking & market share



Source: SWIFT

Market Data

	Hong Kong RMB Deposits (RMB bn) (Year-end / Month-end)	RMB Cross-border Trade Settlement (RMB bn) (Yearly / Monthly)	RMB Clearing Transaction Value (RMB tn) (Yearly / Monthly)	Overnight CNH HIBOR Fixing (%) (Year-end / Month-end)	1-week CNH HIBOR Fixing (%) (Year-end / Month-end)	3-month CNH HIBOR Fixing (%) (Year-end / Month-end)
2013	860.5	3841.0	80.33	0.801	1.152	2.387
2014	1003.6	6258.3	170.34	1.833	3.413	4.189
2015	851.1	6833.1	221.22	1.763	5.026	5.459
2016	546.7	4542.0	201.57	12.813	11.817	9.131
12/2016	546.7	287.6	15.46	12.813	11.817	9.131
1/2017	522.5	271.0	15.16	2.415	5.625	6.881
2/2017	511.4	238.3	15.99	2.000	3.619	4.613
3/2017	507.3	312.0	18.65	4.017	4.389	4.626
4/2017	528.0	268.2	14.38	2.764	4.902	4.645
5/2017	524.8	287.2	16.70	21.079	7.852	5.035
6/2017	526.1	372.5	20.95	1.183	5.425	4.864
7/2017	534.7	329.6	20.31	2.212	3.189	3.967
8/2017	532.8	336.0	20.19	1.857	2.567	3.968
9/2017	535.5	327.9	18.74	3.729	4.272	4.691
10/2017	540.3	314.5	15.12	2.584	3.319	4.527
11/2017	559.2	440.5	19.02	1.470	2.981	4.892
12/2017	/	/	17.42	1.729	3.000	4.803

Source: HKMA, Bloomberg, HKICL, BOCHK

	USD-CNH Exchange Rates (Year-end / Month-end)	USD-CNY Exchange Rates (Year-end / Month-end)	FTSE-BOCHK Offshore RMB Bond Composite Index (Year-end / Month-end)	HK Offshore RMB Bond Issuance (RMB bn) (Yearly / Monthly)	10Y CNH China Sovereign Bond Yield (%) (Year-end / Month-end)
2013	6.057	6.057	107.7	102.3	3.471
2014	6.223	6.206	111.2	201.8	3.227
2015	6.570	6.495	114.8	84.1	3.372
2016	6.981	6.952	119.5	42.2	3.637
12/2016	6.981	6.952	119.5	14.0	3.637
1/2017	6.828	6.868	119.3	0	4.022
2/2017	6.857	6.867	119.9	0.632	4.180
3/2017	6.885	6.895	120.2	0	4.317
4/2017	6.900	6.891	120.9	1.5	4.371
5/2017	6.747	6.821	121.3	0	4.439
6/2017	6.783	6.780	122.1	7.85	4.183
7/2017	6.727	6.723	123.5	0	3.926
8/2017	6.596	6.596	124.1	0	3.700
9/2017	6.663	6.634	124.4	1.5	3.720
10/2017	6.627	6.627	124.58	4.9	3.810
11/2017	6.6113	6.605	124.7	8.5	4.070
12/2017	6.515	6.507	124.67	0	4.140

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