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Offshore RMB Market Has Entered a New Era of Historical Opportunities

In the first half of 2018, with the steady development of offshore RMB business, People's Bank of China (PBOC) launched a series of effective measures to improve the liquidity of offshore RMB and consolidate Hong Kong's position as an offshore RMB business hub. China has accelerated the opening of the capital market and gradually attracted foreign investors by relaxing entrance barriers of overseas financial institutions in China, increasing the quota of the Shanghai-Shenzhen-Hong Kong Stock Connect and launching RMB-dominated crude oil futures. At the same time, A-shares are included in MSCI, and RMB bonds will be included in the Bloomberg Barclays Global Aggregate Index, reflecting rapid acceptance of China's capital market by international markets. The significance of Hong Kong's position as an offshore RMB center will be further enhanced, which will drive and support the development of RMB business in other regions.

I. Offshore RMB business steadily proceeded with upward trend in the first half of this year

The offshore RMB market remained stable throughout the first half of the year. The main RMB business indicators and the international use of RMB show steady growth. Market confidence stayed high with adequate preparations for short-term market volatility.

1. Offshore RMB exchange was relatively volatility. The exchange rate of offshore RMB against US dollar (CNH) strengthened from 6.5019 at the beginning of the year and remained relatively stable till early June. Recently, due to the US interest rate hikes and escalations of the US-China trade war, the RMB's exchange rate experienced significant two-way fluctuations from 6.4131 (early June) to 6.6909 (early July), with a cumulative drop of 4.3%. However the short-term fluctuations are highly market driven, so far there has been no signs of panic, regulators and the market both have confidence in the RMB exchange rate.

At present, the overall economy of China remains stable, international payments are overall balanced, the external debt indicators are relatively healthy, and foreign exchange reserves are sufficient, altogether supporting the RMB exchange rate to fluctuate within reasonable range and remain stable. The demand for derivatives for hedging may increase due to the increase in the RMB exchange rate volatility. Despite the exchange rate volatility, there were no significant fluctuations in offshore RMB liquidity. The CNH HIBOR Fixing reached a high point of 6.0710% before A-shares' inclusion into the MSCI but quickly returned to normal levels, reflecting the stability and maturity of the offshore RMB market.

2. Major RMB business indicators stabilized and improved. Since 2015, the offshore RMB market has entered an adjustment phase, and currently shows improvement compared to last year's lowest point. After experiencing a significant drop of over one-third in 2016, Hong Kong's RMB deposits continued to rebound since the beginning of 2017. By the end of May 2018, RMB deposits in Hong Kong increased 7% from last year to RMB 600.9 billion, showing a steady upward trend. By the end of May, RMB deposits in Taiwan totaled RMB 311.28 billion, decreased 3.5% compare to December 2017. By the end of March, RMB deposits in Singapore totaled RMB 139 billion, maintaining at the same level compared to September 2017. By the end of May, the total amount of RMB remittances for cross-border trade settlement in Hong Kong reached RMB 1.68 trillion, increase by 21.9% YoY.

3. RMB's function as an international reserve currency further strengthened. In the first half of year 2018, the US interest rate hikes have been affecting the current accounts' liquidity in developing countries. Meanwhile economic and trade ties between Mainland China and other countries have been increasing. Foreign central banks are more willing to hold RMB foreign exchange reserves, and more open to use RMB in bilateral trade settlements. RMB's status as an international reserve currency has been gradually strengthened since joining the SDR.

According to IMF, by Q1 2018, the scale of RMB foreign exchange reserves held by global central banks was at USD 144.95 billion, increased by USD 22.15 billion (18.0%) compared to 2017 year-end, currently accounting for 1.39% of the global foreign exchange reserves. Since the commencement of Bond Connect, foreign central banks and financial institutions have been showing increasing enthusiasm in entering the domestic interbank bond market

Recently the RMB exchange rate against the US dollar has been under pressure; however foreign investors' confidence level remains unaffected. By June, foreign investors have been increasing their holdings of domestic bonds for 16 consecutive months, showing strong interest for RMB assets. By the end of June, the balance of bond custody reached RMB 1.55 trillion, a significant increase of 80% compared to the launch of Bond Connect in July 2017.

4. The international use of RMB is relatively stable. In May, the RMB holds the 5th position in the most active currency for global payments with a share of 1.88%, RMB payments value increased by 15.25% compared to April 2018. RMB is also one of the most active currencies in the global foreign exchange market. In the first half of the year, RTGS turnover was totaled RMB 108 trillion, increased 5.9% YoY. In particular, RTGS turnover stayed relatively high for the previous two months, implying the steady increase of RMB settlement in Hong Kong against the backdrop of accelerating opening up of China's capital market. The Offshore RMB business has stabilized and accelerated.

II. RMB internationalization receives new impetus

In the first half of this year, China seized the opportunities to launch a series of policies on opening the financial market, as to support broader usage of the RMB and providing more channels for RMB capital inflow. Such measures are expected to further accelerate the RMB's internationalization process, offering new opportunities to the offshore RMB market.

1. New measures facilitate financial market opening and promote collective prosperity. At the 2018 Boao Forum on Apr 10, President Xi Jinping announced major new initiatives to further open up China′s financial market. In terms of relaxing market access, emphasis is placed on broadening the cooperation between Chinese and foreign financial markets, relaxing restrictions on foreign ownership of banks, securities and insurance industries, restrictions on the establishment of foreign financial institutions, and the scope of operations in China. At the "Normalization of Monetary Policy" sub-forum, PBOC Governor Yi Gang further elaborated the 11 opening measures which would be planned to implement during the year.

With increasing channels opened up for foreign investors, demand for capital market service providers has also increased. Relaxing restrictions on foreign ownership (e.g. foreign brokers) and business scope, will grant foreign investors easier access into the domestic market. Meanwhile foreign institutions′ rich operating experiences and diversified business models can also be valuable in promoting the internationalization of financial institutions in Mainland China, therefore contribute to the development of China′ s capital market.

2. PBOC optimized cross-border fund flow management regulations to foster offshore RMB market development. On May 18, PBOC announced the "Notice on Further Improving Cross-border Fund Flow Management and Supporting the Opening of Financial Markets". The notice affirms that under existing policy frameworks, offshore RMB clearing banks and participating banks can conduct cross-border liquidity management operations such as cross-border interbank lending, financing, bond repurchase and other businesses. Secondly, the PBOC further adjusted the required reserve ratio of RMB deposits placed by Hong Kong's RMB business clearing bank into PBOC's settlement account of in Shenzhen sub-branch to zero. Thirdly, Stock Connect investors are now allowed to conduct onshore currency conversions.

The aforementioned measures will offer more channels for fund inflows into the offshore RMB market, further promoting cross-border movement of the RMB, as to meet with the higher liquidity demand arising from Hong Kong and China's capital flows. Such measures can also enhance the flexibility of short-term RMB fund allocation and transfer, balance the supply and demand of offshore RMB, reduce the offshore RMB financing cost and stabilize the RMB exchange rate. The new measures are also expected to revitalize the onshore assets held by overseas institutions, to improve current transaction structures and drive service providers to actively adapt to policy adjustments and develop more related products. Altogether, the regulation updates will further strengthen Hong Kong's position as the leading offshore RMB business hub.

3. A-shares have been officially included in the MSCI. On June 1, 234 A-shares have been included in the MSCI indices at 2.5% of their FIF (Foreign Inclusion Factor) adjusted market capitalization, representing aggregate weights of 1.26% in the MSCI China Index and 0.39% in the MSCI Emerging Markets

Index. The FIF will be increased to 5.0% at a later stage, which will increase A-shares' weights to 2.5% and 0.7% in the two indices, respectively.

The official inclusion of A-shares into the MSCI is expected to drive the standardization and internationalization of regulations, as well as the liberalization process of China's capital accounts. As A-share's weight increases in the MSCI indices, hundreds of billions of passive investment funds are expected to gradually flow in, bringing additional market liquidity.

Foreign investors′ participation can also promote the rationalization of investment decisions, strengthen the market′s function of value creation and positively contribute to the long-term development of the stock market. A-share′s inclusion in the MSCI is likely to attract the attention of other major indices, further boosting foreign investors′ interest in holdings A-shares.

In addition, the MSCI inclusion may also have an impact on Chinese listed companies: Companies are now more motivated to manage their intrinsic value, improve investor returns, as to leverage the confidence of domestic and foreign investors. At the same time, it can also promote A-share′s pricing and voicing power in the global market.

4. Foreign holdings of Chinese bonds continued to increase. Given a stable economic outlook, an eased market entry via Bond Connect and the inclusion of Chinese bonds into international indices, foreign investors had increased their holdings of RMB bonds for the 16 consecutive months as of June 2018. The balance of bond custody of overseas institutions in China's interbank bond market reached RMB 1.55 trillion, up 7.7% MoM and 34.7% YTD.

By enabling foreign investors to participate in China's interbank bond market through Hong Kong, Bond Connect offers a much easier access for foreign investors with largely reduced costs. On 23 March 2018, Bloomberg announced that it will add Chinese RMB-denominated bonds issued by government and policy banks to the Bloomberg Barclays Global Aggregate Index. The inclusion is expected to facilitate both passive and active foreign investment flows.

For foreign investors, holding RMB bonds can increase the portfolio diversity and optimize their investment structure. On the other hand, continuingly increased foreign participation will enhance the influence of the Mainland capital market as well as forcing the market to open further. Opportunities are also presented to Hong Kong: To meet with the sophisticated demand and further attract foreign participation, service providers are motivated to further develop capital account products and offshore derivatives tools.

5. The initiation of Petroyuan enhances China's bargaining power on commodity pricing. On March 26, China's crude oil futures was listed on the Shanghai International Energy Exchange. The futures contract is denominated in RMB with trading unit of 1,000 barrels per contract, available to foreign investors, exchanges and petroleum companies.

Shanghai International Energy Trading Center had applied to Hong Kong Securities & Futures Commission (SFC) to become an Automated Trading Services (ATS) provider, and had set up the only overseas electronic trading platform for Shanghai crude oil futures in Hong Kong, allowing foreign investors to buy and sell futures contracts without going to Shanghai.

The platform is another new channel connecting financial markets in the Mainland and Hong Kong, following the Shanghai-Shenzhen-Hong Kong Stock Connect, Bond Connect and Gold Connect. The RMB-denominated crude oil futures will serve as a risk management tool for oil companies, also another step forward for China's financial market opening.

As the world's largest importer and the second largest consumer of crude oil, China can gradually be freed from its dependence on the international crude oil market by using the RMB, and enhance the its influence on international oil prices. By utilizing the country's advantages on the demand side, China can also provide more security for the country's energy safety. The initiation of the Petroyuan is expected to generate more RMB trading activities in the international foreign exchange and derivatives markets, and further accelerates RMB's internationalization process.

RMB Internationalization Updates

2018

JAN

5

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.

9

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.

FEB

1

Sharjah of UAE issued RMB 2 billion sovereign panda bonds

The Government of Sharjah, one of the members of the United Arab Emirates (UAE), issued RMB 2 billion panda bonds with 3-year tenor in China's interbank market. Bank of China was the bookkeeper and one of the joint underwriters for the issuance, joining with Industrial and Commercial Bank of China, HSBC (China) and Standard Chartered Bank (China).

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JPMorgan Chase became the second RMB Clearing Bank in the US

The People's Bank of China authorized JPMorgan Chase & Co. as the RMB Clearing Bank in the US, making it the second RMB Clearing Bank in the US following BOC New York branch.

26

BOC Macau branch issued RMB 4 billion bonds abroad

Bank of China (BOC) Macau branch completed pricing of RMB 4 billion bonds issued abroad, including RMB 1.5 billion 1-year bonds and RMB 2.5 billion 3-year bonds. The funding costs were lower than those onshore bonds for the same tenors.

MAR

13

China to merge CBRC and CIRC

The China Banking Regulatory Commission (CBRC) would be merged with the China Insurance Regulatory Commission (CIRC). The merged entity would report directly to the State Council, and take an integrated role in regulating banking and insurance sectors. Meanwhile, the function of making important laws and prudential regulatory system by the merged entity would be transferred to the People's Bank of China (PBOC). Other than that, the China Securities Regulatory Commission would remain a separate entity.

20

BOC assisted Philippines to issue RMB 1.46 billion sovereign panda bonds

Bank of China (BOC), with the mandate as lead underwriter and bookkeeper, assisted the Philippines government to issue RMB 1.46 billion panda bonds in China's interbank market. The bonds carried a coupon rate of 5.00% with maturity of 3 years.

23

Chinese bonds to join Bloomberg Barclays Global Aggregate Index

Bloomberg announced that it will add Chinese RMB-denominated government and policy bank securities to the Bloomberg Barclays Global Aggregate Index. The addition of these securities will be phased in over a 20-month period starting April 2019.

26

China's crude oil futures officially launched

China's crude oil futures was listed on the Shanghai International Energy Exchange. The futures contract is denominated in the RMB with trading unit of 1,000 barrels per contract. It would be available to foreign investors, exchanges and petroleum companies.

APR

10

PBOC announced measures to further open financial sector

Yi Gang, the Governor of the People's Bank of China (PBOC), made an announcement in the Boao Forum for Asia Annual Conference that the PBOC will implement the following measures in the next few months: 1) Remove the foreign ownership cap for banks and asset management companies; 2) Lift the foreign ownership cap to 51% for securities companies, fund managers, futures companies, and life insurers, and remove the cap in three years; 3) Abolish the requirement for joint-venture securities firms to have at least one local security firm as a shareholder; 4) the daily quotas under Stock Connect increased by 4 times.

25

PBOC cut RRR for some financial institutions to replace outstanding MLF

The PBOC cut the required reserve ratio (RRR) of large commercial banks, joint stock commercial banks, city commercial banks, rural commercial banks and foreign banks by 1 percentage point. The aforementioned banks used funds released from the RRR cut to repay outstanding Medium-term Lending Facility (MLF) borrowed from the central bank on a "first borrow, first repay" basis.

MAY

1

Daily quotas of the Stock Connect between the Mainland and Hong Kong increased

The daily quotas under Stock Connect increased by 4 times. The new daily quota for each of the northbound trading links increased to RMB 52 billion from RMB 13 billion, while the new daily quota for each of the southbound trading links increased to RMB 42 billion from RMB 10.5 billion.

18

PBOC further improved cross-border fund flow management

Major measures covered: 1) the existing policy framework under which offshore RMB business clearing banks and participating banks can tape RMB liquidity from the onshore market to support offshore RMB business development; 2) duly implementing Hong Kong Monetary Authority's bilateral currency swap agreements; 3) adjusting the required reserve ratio of RMB deposits placed by Hong Kong's RMB business clearing bank in the settlement account in the PBOC's Shenzhen sub-branch to zero percent; 4) further enhancing the currency conversion mechanism for the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect.

JUN

1

234 A-shares would be included in the MSCI indexes

In the first step of inclusion, there would be 234 A-shares added at 2.5% of Foreign Inclusion Factor (FIF)-adjusted market capitalization, representing aggregate weights of 1.26% and 0.39%, respectively, in the MSCI China Index and the MSCI Emerging Market Index.

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State Administration of Foreign Exchange eased restrictions on QFII

Major policies included: 1) Lifting 20% cap on the funds that investors have been allowed to take out of China; 2) removing lockup periods for investment principal; 3) allowing investors under QFII and RQFII schemes to make foreign exchange hedging on their investments onshore.

JUL

5

"MOF issued RMB 5 billion sovereign bonds in Hon Kong

The Ministry of Finance (MOF) issued RMB 5 billion sovereign bonds in Hong Kong. Amongst which RMB 4.5 billion have been issued to institutional investors. This included RMB 3 billion 2-year bonds and RMB 1.5 billion 5-year bonds. Another RMB 0.5 billion bonds have been sold to central banks and monetary authorities overseas. This included RMB 0.3 billion 2-year bonds and RMB 0.2 billion 5-year bonds. All 2-year bonds and 5-year bonds priced at 3.65% and 3.8%, respectively.

Evaluating the Impacts of China-US Trade Frictions on the RMB's Exchange Rate

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Recently, the US is carrying out a series of trade protectionist measures, and there are rising difficulties in communication and negotiation between China and the US. The trade frictions manifest "America First" protectionism, underpinned by economic and social issues. Therefore, the trade frictions may continue to evolve for an extended period of time, reflecting its long-term and complex characteristics. The fast-changing international trade environment not only hits confidence in global financial markets but also brings uncertainty to global economic growth. Following the developments of trade frictions, there will be new changes in supply and demand for the RMB, accelerating the RMB's exchange rate adjustment. Trade frictions and the outlook of trade war could influence the RMB's exchange rate via three channels:

I. In terms of trade

The impact of trade frictions on the RMB's exchange rate is first reflected in merchandize exports. In the worst case scenario, USD 50 billion worth of exported goods to the US will be subject to 25% tariff, while USD 200 billion worth of goods will be subject to 10% tariff. On top of this, the US will impose additional 10% tariff on another USD 200 billion worth of goods. In other words, USD 450 billion worth of exported goods will be affected, involving tariff of USD 52.5 billion.

In June 2018, China's exports in terms of USD grew 11.3% year-over-year, or 1 percentage point lower than the same period last year. It is estimated that the impacts of trade war on China's exports to the US will gradually emerge in the second half of 2018.

Nevertheless, exports to the US as a percentage of Chinese GDP is still limited. According to the US Department of Commerce, China's exports to the US amounted to USD 505.6 billion in 2017, accounting for 4.13% of China's GDP. Meanwhile, statistics from China Customs showed that exports to the US amounted to RMB 2,910.3 billion, accounting for 3.52% of GDP. In light of this, the impact of exports adjustment in this certain area on China's economic performance will be limited.

II. In terms of capital

The US Department of Treasury is reportedly set to announce investment restrictions on Chinese enterprises. Direct investments, mergers and acquisitions by Chinese enterprises in the US may decline this year. The US aims to maintain its influence in global industrial landscape by launching a trade war. Many targeted products subject to the latest tariffs worth USD 50 billion come from 10 key priority sectors in "Made in China 2025" program, including information technology, robotic, aviation and aircraft components, energy saving and new energy vehicles, electrical generation equipment, pharmaceuticals and medical devices, etc., reflecting the US's concern on global industrial landscape in the next 5 to 10 years. Since the global supply chain has been highly integrated, the impacts of tariff on each specific industry will be complex and changing.

III. In terms of financial markets

Investors' risk-off sentiment continues to spread following the evolvement of trade frictions between China and the US, and global financial markets are volatile. The US 10-year treasury yield once retreated, reflecting influx of funds into the bond market for risk aversion. Also, there were large equity market corrections across Europe and Asian emerging markets. Compared with previous trade protectionist measures imposed by the US, the latest measures have tremendous impacts on equity markets, bond markets and foreign exchange markets globally. It shows that financial markets pay attention to the trade frictions between China and the US and worry about sizeable deprecation of the RMB due to the trade war.

IV. The RMB's fluctuation will follow trends

To summarize the three aforementioned channels, trade frictions between China and the US will affect China's exports to the US, resulting in depreciation pressure for the RMB. However, Chinese investments in the US will drop accordingly, offsetting to some extent the impact of foreign exchange supply-demand dynamics under trade accounts. Therefore, it is necessary to cope with negative impacts on the RMB's exchange rate arising from financial market sentiment.

With reference to historical experience of trade war between the US and Japan, the US had its largest trade deficits with Japan between the 70s and 80s in the last century. The US successively initiated trade disputes on textile, steel and iron, automobiles and semiconductor with Japan. Furthermore, the US requested Japan to restrict exports growth to the US, open its market, and increase imports. Consequently, the US trade deficits with Japan gradually narrowed from 1.2% of its nominal GDP to 0.3%. Meanwhile, the USD experienced sizeable depreciation against the JPY in 1971 and 1985. From July 1971 to October 1978, the value of the Japanese Yen to one US Dollar appreciated from JPY 360 to JPY 180, an appreciation of 100% in 87 months. Subsequently from February 1985 to April 1995, the Japanese Yen appreciated further by 208% from JPY 259 to JPY 84 in 122 months. The US and Japan jointly promoted JPY internationalization while the JPY appreciated substantially.

Lessons from the US-Japan trade war shows that reducing bilateral trade surplus is the focus of trade war. Apparently, there is no room and political intention for depreciating the currency of trade surplus nation in order to enhance export competitiveness. On the contrary, if there is a vicious cycle between persistent depreciation of the currency and capital outflows, there will be adverse effects on the growth of investments and consumption. It may even trigger extensive economic and financial risks.

At present, economic fundamentals play a leading role in determining the RMB‘s exchange rate. China’s economy remains stable, with current account surplus maintaining at a sustainable level of 1.2% of GDP, which is neutral on the RMB’s exchange rate. However, the influence of cross-border capital flow under capital account will gradually surpass that of current account, becoming a dominant factor in the RMB’s exchange rate. Since capital flow factor becomes increasingly important in determining the RMB‘s exchange rate, the growth of capital flow in financial markets, instead of direct investment, will gradually become an important variable in the trend of the RMB. In addition, the strength and weakness of the dollar index remain a major external factor for the RMB’s exchange rate adjustment. The USD depreciated in early 2018 but rebounded recently. The trend of the RMB against the USD will switch from appreciation to fluctuation, but the magnitude of fluctuation will be less than that of the USD. Currently, the RMB is back to the level early this year.

For a period of time in future, the trend of the RMB’s exchange rate will be mainly determined by the supply-demand dynamics in the foreign exchange market. The exchange rate fixing mechanism will continue to strength the flexibility of the RMB’s exchange rate, which will remain basically stable at a reasonable and equilibrium level.

The Use of the RMB in China's Balance of Payments

Michael DAI, Principal Economist

One of the important measures of RMB internationalization is the use of the RMB as a cross-border payment currency. In this field, the RMB has huge potential as China is the second largest country of trade in goods and the third largest country of trade in service. In addition, China's economy is the second largest in the world, and China has the largest banking system, the second largest stock market and the third largest debt market. If the RMB is widely used in trade, direct investment and portfolio investment, its international status will continue to improve. In time, the international currency status of the RMB will be more prominent when the two sides of the cross-border payment in the RMB are third parties.

In reports from the People’s Bank of China (PBOC) and related statistics, one of the transaction parties must be China. In addition, the RMB Tracker report compiled by SWIFT also discloses the proportion of domestic and cross-border payments carried out by the SWIFT system in the RMB, where at least one of the transaction parties is from China. According to SWIFT, as of May this year, the RMB is the fifth largest international payment currency in the world, accounting for 1.88% of global cross-border payment. Statistics from PBOC have detailed numbers, and the proportion of RMB in cross-border payments can be derived by cross referencing China’s international payments statistics. Globally comparable currency distribution provided by SWIFT helps gauge by how much international use of the RMB needs to be improved to match the status of China's economic and financial markets. The following analysis is based on the statistics of PBOC.

Amount of receipts and payments in the RMB in China's trade in goods has decreased and the proportion has declined in recent years.

Statistics of PBOC show that the amount of receipts and payments in the RMB in China's trade in goods declined in the past three years, and its proportion in China's trade in goods also fell. Settlement and payment in the RMB in China's trade in goods peaked in 2015, with a total amount of RMB 6.4 trillion and equivalent to 26% of China's trade in goods of RMB 24.6 trillion. But in the following two years, the amount of receipts and payments in the RMB in China's trade in goods decreased to RMB 4.1 trillion and RMB 3.3 trillion respectively, equal to 17% and 11.8% of China’s trade in goods during the same period. In the first quarter of 2018, the amount of receipts and payments in the RMB in China's trade in goods was RMB 797 billion yuan (11.8%). If annualized, the amount of receipts and payments with RMB in this year would continue to decline.

China's goods in trade have maintained growth momentum, but the amount and the proportion of settlement and payment in the RMB fell during the period. The exchange rate of the RMB against US dollar depreciated for three years from 2014 to 2016, and the decline was reversed since 2017 till the first quarter this year. The RMB was also included into the SDR currency basket in 2016, serving as an international reserve currency. However, both the amount and the proportion of the settlement and payment in the RMB in goods in trade peaked in 2015 and then declined, which may reflect a structural problem.

Amount of receipts and payments in the RMB in China's trade in services has increased steadily, and the proportion remained stable.

In contrast, amount of receipts and payments in the RMB in trade in services and other current account items grow steadily, and the proportion in trade in services remains stable. Statistics of PBOC showed that from 2015 to 2017, amount of receipts and payments in the RMB in trade in services and other current accounts was RMB 843 billion, RMB 1.1 trillion and RMB 1.1 trillion respectively. The amount in the first quarter of 2018 was RMB 262 billion, and was close to RMB 1.1 trillion if annualized, showing a steady growth trend. In fact, China's balance of payments also includes the primary and secondary income, but the majority is trade in services. For simplicity, dividing the amount of RMB settlement by the amount of China's trade in services published by the Ministry of commerce, related proportions are 19%, 20.6% and 23.2% respectively from 2015 to 2017 and 20.9% in the first quarter of 2018.

In 2017, China's trade in services amounted to RMB 4.7 trillion, significantly less than the RMB 5.4 trillion in 2015. Reduction in the base number raised the proportion of settlement and payment in the RMB in China's trade in services to 23.2%. Disregarding such technical impact, proportion of receipts and payments in the RMB in China's trade in services remained relatively stable at 20% in the past few years. The most important part of trade in services is the tourism industry. Increasing direct payment in the RMB will lift the level of RMB settlement and payment in trade in services.

Proportion of receipts and payments in the RMB under China's capital accounts is much higher than that of current accounts.

China's current accounts are open and convertible while the capital accounts are still controlled and not fully convertible, but the proportion of receipts and payments in the RMB under capital accounts is fairly high. By strict definition, current accounts correspond to the capital and financial accounts in balance of payments, the majority of which comes from financial accounts. Financial accounts include direct investment, securities investment, financial derivatives investment, other investment and reserve assets investment. In addition, there is a net error and omission in China's balance of payments, which can be quite substantial. This item reflects the cross-border flow of funds via gray channels, and most of them are under the capital accounts. Therefore, to calculate the proportion of receipts and payments in the RMB under China's capital accounts, net error and omission should be added to the capital and financial accounts as the base.

The amounts of receipts and payments in the RMB under the China’s capital accounts are RMB 4.9 trillion, RMB 4.6 trillion and RMB 4.8 trillion respectively in the past three years. This number amounts to RMB 2.1 trillion in the first quarter of this year, a record high annualized. Proportions of receipts and payments in the RMB under China's capital accounts were 50.9%, 44% and 68.8% in the past three years, respectively. In 2017, the proportion of receipts and payments in the RMB rose sharply, mainly due to the low base, especially the decline in foreign exchange reserves of RMB 2962.1 billion in 2016 and the increase of RMB 613.6 billion in 2017. Of course, there were changes in valuation due to exchange rates, which do not involve cross-border flows and payments, but the reduction in foreign exchange reserves in 2016 should be dominated by capital outflows. Foreign direct investment dipped significantly in 2017 as a result of capital control measures. However, the proportion of receipts and payments in the RMB under China's capital accounts is significantly higher than that of current accounts.

Increase cross-border payments in the RMB by enhancing the settlement and payment in the RMB in China's trade in goods and further relaxing capital control.

SWIFT data on international payment in the RMB should include both the current accounts and capital accounts. International payment in the RMB peaked in 2015, and fell in the recent two years. This is mainly due to the decline in the settlement and payment in the RMB in China's trade in goods. Trade in goods is the most important part of China's balance of payments and was 1.7 times, 1.5 times and 2.4 times the sum of other current accounts, capital accounts and financial accounts in the past three years, respectively. Therefore, the key is to improve the settlement and payment in the RMB in China's trade in goods.

As long as there is no global crisis, China's trade in goods will continue to grow. In order to increase the proportion of settlement and payment in the RMB, the growth in the use of the RMB will have to be larger. Over the past few years, one variable is the RMB’s reversal from appreciation to depreciation followed by fluctuation in both directions. During the period of appreciation, it is more favorable for China to pay for imports with the RMB, and trading partners are willing to receive the RMB. During the period of depreciation, though it is theoretically favorable for trading partners to pay for imports from China with the RMB, China's exporters are more willing to accept dollars. Appreciation and depreciation have asymmetric impacts on the use of the RMB. To escape from these impacts, it is necessary to create two-way fluctuations rather than one-way appreciation or depreciation of the RMB’s exchange rate and let market participants adapt to the fluctuations.

China has a large proportion of receipts and payments in the RMB under capital accounts. China also has the largest banking system, the second largest stock markets and the third biggest debt markets in the world, with their sizes amounting to RMB 252 trillion, RMB 56 trillion and RMB 76 trillion, respectively. But foreign capital accounts for less than 2% in each market as of now. Therefore, further deepening the capital markets can help increase the use of the RMB and drive the growth of international payment in the RMB.

Proportion of receipts and payments with RMB	2015	2016	2017
Trade in goods	26.0%	17.0%	11.8%
Trade in services and other current accounts	19.0%	20.6%	23.2%
Capital accounts	50.9%	44.0%	68.8%

Sources: PBOC, Ministry of Commerce, SAFE, BOCHK Research

Promoting the Development of Petroyuan by Connecting with Crude Oil Futures

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INE crude oil futures was listed on Shanghai International Energy Exchange, the subsidiary of Shanghai Futures Exchange, on March 26. It was the first RMB-denominated crude oil futures in the world, kicking off the development of petroyuan. In recent years, the business sector in Hong Kong has actively explored the development of petroyuan. Nevertheless, there was little progress due to operational difficulties. The launch of crude oil futures market in Shanghai offered new ideas on developing petroyuan in Hong Kong. Using the crude oil futures market platform in Shanghai, Hong Kong can actively participate in RMB-denominated crude oil futures businesses and explore the development of new petroyuan businesses.

Hong Kong is the top international financial center in Asian-Pacific region. It is also the most important offshore RMB business center. Although Hong Kong maintains leading positions in Asian-Pacific region and even globally in terms of transactions for many financial products, commodity futures trading are lagging behind. Futures businesses of the Hong Kong Exchange and Clearing Limited concentrate on financial derivatives products. Transactions for commodity futures and options are tepid for many years due to insufficient market demand. The establishment of Hong Kong Mercantile Exchange a few years ago strived to make a breakthrough. However, it was eventually wound up, given inactive transactions and insufficient income.

Previously, some business people suggested launching RMB-denominated crude oil futures in Hong Kong. Crude oil futures trading is subject to more conditions, compared with other precious metal trading like gold trading. Crude oil futures trading requires proximity to origin of oil supply or major source of market demand. Moreover, large storage is necessary for completing settlement. It is doubtful that Hong Kong fulfills these conditions. Comparatively, Singapore has good conditions for developing crude oil trade, as it is at the prime location of international waterway and promotes the development of petroleum refining. Furthermore, Hong Kong and ports in surrounding area mainly engage in exports and imports of electronic products and consumption goods. In contrast, the port of Ningbo-Zhoushan near Shanghai is a distribution center for commodities in the Mainland, accounting for more than half of imported crude oil and iron ore nationwide. Also, Zhoushan is the most important base of national petroleum reserves. Hong Kong does not have these conditions.

More importantly, the model of global crude oil futures transaction is relatively mature, being dominated by New York Mercantile Exchange, a subsidiary of Chicago Mercantile Exchange, and the Intercontinental Exchange in London. The WTI crude oil and Brent crude oil futures traded in these Exchanges have pricing power of global crude oil. For many years, many places such as Tokyo, Singapore, Dubai, Russia, Iran, India, etc. attempted to promote crude oil futures markets but without much success. The leading positions of New York and London have yet to be challenged. A true competitor of these two giant Exchanges must be backed by an economy which is competitive with Europe and the US, as well as having great bargaining power on international affairs. China may be the only country that can satisfy these requirements. Overall, Shanghai has favorable conditions for developing crude oil futures. It would be best to set up RMB-denominated crude oil futures trading platform in Shanghai.

However, the establishment of Shanghai International Energy Exchange does not entirely crowd out opportunities for Hong Kong. Instead, it paves the way for Petroyuan development.

First of all, Petroyuan means RMB funds generated from crude oil transactions flow abroad. Crude oil futures transactions in Shanghai are denominated in the RMB and are open to investors worldwide. However, the Mainland’s capital account is not yet fully convertible. Against this backdrop, real Petroyuan must rely on offshore markets. Hong Kong, being the largest offshore RMB business center, is capable of becoming a linkage of petro RMB funds between onshore and offshore markets. In recent years, Russia, Saudi Arabia, Iran, Angola, Venezuela and Pakistan have introduced or considered using the RMB for settlement when they export crude oil to China, creating cross-border RMB payments. While acting as a channel for petro RMB funds, Hong Kong can also provide a range of services including RMB financing, currency exchange, risk hedging, etc. The development of crude oil futures market in Shanghai will stimulate RMB settlement in crude oil trade and facilitate demand for other RMB businesses, providing more favorable conditions for the development of Petroyuan in Hong Kong.

Secondly, Hong Kong's offshore financial markets had been fully considered when Shanghai's crude oil futures market was founded. Shanghai International Energy Exchange is an international trading platform. According to "Management Rules for Overseas Special Participants", eligible offshore institutions can trade directly at the Exchange as Overseas Special Participants (including Overseas Special Brokerage Participant and Overseas Special Non-Brokerage Participant). Offshore investors can conduct transactions through futures brokers either in onshore or offshore markets. To facilitate trading for offshore investors, Shanghai Futures Exchange has set up an electronic trading platform by registering as Automated Trading Services (ATS) Provider with the Securities and Futures Commission. This is the sole electronic trading platform in offshore markets, where offshore investors can conduct futures transactions on their own in offshore markets without going to Shanghai. The crude oil futures ATS has become another channel connecting financial markets in the Mainland and Hong Kong, following Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, Bond Connect and Gold Connect.

Lastly, Hong Kong can participate in other Petroyuan-related activities and operations. Throughout the process of oil mining, transportation, processing, trading and eventually reaching to consumers, crude oil would come across several segments in terms of spot oil, oil futures, refined oil, etc., formulating a long industry chain. The history of crude oil futures trading is not long. New York Mercantile Exchange and the Intercontinental Exchange introduced crude oil futures in 1983 and 1988, respectively for the purpose of spot oil hedging, which was the mainstream transaction approach at that time. Clearly, spot oil trading developed earlier. Further development of spot oil trading in the Mainland is needed after establishing futures trading platform. Apart from Shanghai, some areas in the Mainland have been authorized to develop oil-related businesses with lower market access barrier.

For example, Zhejiang-Zhoushan Free Trade Zone actively develops oil industry chain with bonded fuel oil injection as core business. Financial and other industrial sectors in Hong Kong can consider capitalizing on different advantages of Hong Kong and the Mainland and developing Petroyuan business potentials together.

The importance of China in international crude oil crude should not be underestimated, given China's status as the world's largest crude oil importer, the second largest consumer and the sixth largest producer. The launch of crude oil futures by Shanghai International Energy Exchange gained attentions from oil producers and major petroleum companies, and they considered to join in various forms. As the Mainland market is sizable, transaction volume of crude oil futures in Shanghai will grow considerably and will be able to surpass other Exchanges in Asian-Pacific region without much difficulty. In the long-run, Shanghai is likely to become one of the global crude oil futures trading center, which will be as important as New York and London. With excellent prospects, Hong Kong should seize the opportunities by collaborating development with Shanghai, assisting in establishing pricing power of Yuan-denominated oil futures and developing its status as an offshore Petroyuan center.

RMB-denominated Bonds Are Favored by International Investors

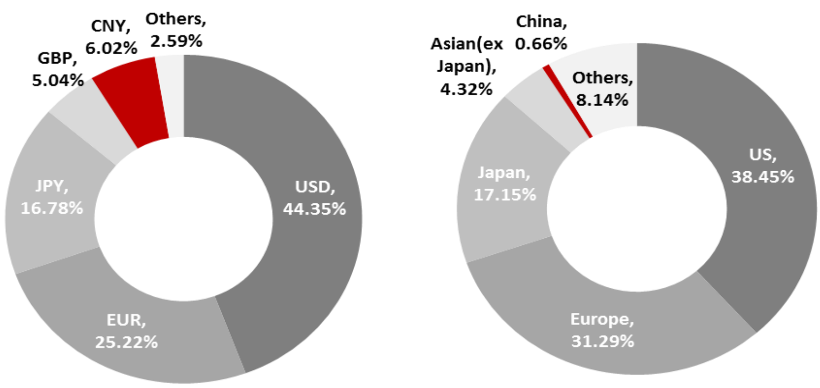
Kera KONG, Strategic Planner

Recently, the People's Bank of China (PBOC) announced that at the end of May, the foreign exchange account of the PBOC reached RMB 21.51 trillion, an increase of RMB 9.144 billion from the previous month, up for a fifth consecutive month. One of the important factors is that RMB-denominated bonds are favored by international investors.

Bloomberg included Chinese bonds in the Bloomberg Barclays Global Aggregate

On March 23, 2018, Bloomberg announced that it would gradually include RMB-denominated Chinese government bonds and policy bank bonds in the Bloomberg Barclays Global Aggregate. According to the statistics as of January 31, 2018, the index will include 386 Chinese bonds, accounting for 5.49% of the market value of the index of USD 53.7 trillion. After being fully included in the index, RMB-denominated Chinese bonds will become the fourth largest bond currency in index denomination after US Dollar, Euro and Japanese Yen.

Figure 1: Currency and Country Distribution of Bloomberg Barclays Global Aggregate after Inclusion of China Bonds



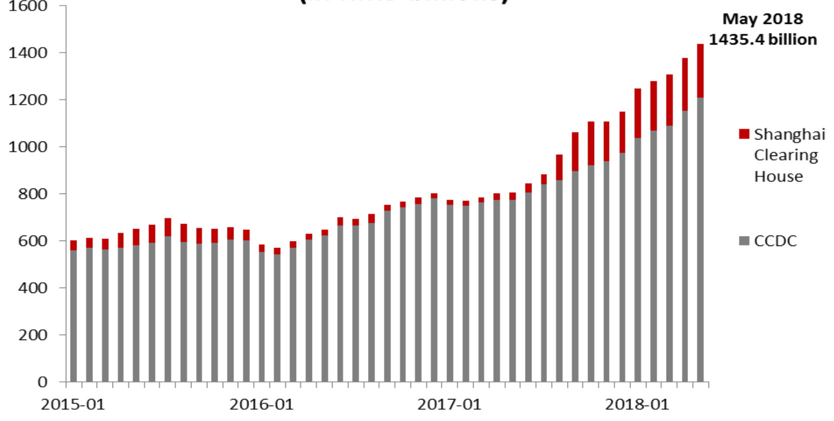
Sources: Bloomberg (As of 6-Jul-2018), Based on Market Value of Underlying Securities

In March 2017, Bloomberg launched two new fixed income indices including Chinese bonds, namely the Global Integrated + China Index and the EM Local Currency Government + China Index, combining RMB-denominated Chinese bonds with its global index and providing a new way for global investors to analyze the Chinese bond market. The Bloomberg Barclays Global Aggregate, which included Chinese bonds, is one of the three major bond indices in the global bond market. It is also the world's most widely used fixed-income benchmark index and an important milestone for the integration of Chinese bond market into global financial markets. .

The opening up of Chinese bond market has achieved remarkable results

Since 2005, the opening up of the mainland bond market has gradually deepened, and the pace of opening up has accelerated. The PBOC has also stepped up efforts to improve various supporting policy and arrangements, continuing to reform the interbank bond market in China and providing more friendly and convenient investment environment for foreign investors. In July 2017, "Bond Connect" was officially launched, effectively linking international practices with the Chinese bond market with lower institutional costs and higher market efficiency. By the end of May 2018, a total of 657 overseas institutions held custody of domestic bonds at the China Securities Depository & Clearing Corporation Limited, and the balance of bond custody of overseas institutions in the Chinese interbank bond market reached RMB 1.44 trillion.

Figure 2: Overseas Institutions Bond Holding Balance (in RMB billions)



Sources: Shanghai Clearing House, CCDC

As the Chinese bond market continues to grow and develop, its degree of openness is also increasing. According to the statistics of the PBOC, as of the end of 2017, the custody balance of the Chinese bond market reached RMB 74 trillion, ranking third in the world and second in Asia, having considerable market depth and breadth. Since the official launch of the Bond Connect (Northbound), foreign investment in Chinese bond market has been further expanded, and the scale of debt holding by overseas institutions has steadily increased. As of the end of February 2018, the size of Chinese bonds held by overseas institutions increased by 52.0% compared with the launch in July 2017, and the average daily trading volume exceeded RMB 3 billion. 272 foreign institutional investors entered the interbank bond market through Bond Connect. In other words, 40% of foreign investors use the Bond Connect channel to enter the Chinese bond market.

Bloomberg's inclusion of Chinese bonds in the Bloomberg Barclays Global Aggregate, as a response to the growing number of international investors, also reflects the positive attitude and potential demand of international investors to participate in the world's third largest bond market. It is expected that the inclusion of Chinese bonds in the Bloomberg Barclays Global Aggregate will further promote the investment of foreign investors in the Chinese bond market and the demand for Bond Connect.

Chinese bond market has huge growth potential

The continuous opening up of the Chinese bond market has been welcomed by foreign investors. The mainstream indexes are paying more attention to the Chinese bond market. Although the size of the Chinese bond market is the third largest in the world, the proportion of overseas investment accounts for only 1.7%. There is still a lot of room for growth. According to the statistics, the current asset management scale of the three major global tracking companies is about USD 4-5 trillion. If China is included in the three major global indexes, the funds tracking index must make allocations to Chinese assets, which is expected to bring a total of more than USD 250 billion of passive capital inflow and will gradually drive active bond investment in the long run.

Figure 3： Investment Inflow of China Bond with Inclusion into 3 Major Global Bond Indexes (Projection)

	Index Tracking Investment Estimate	Percentage/ Projected Percentage of China Bond	Passive Investment Injection
Bloomberg Barclays Global Aggregate	~USD 2,500B	5.3%	USD 110B
Citi World Government Bond Index	~USD 2,000-2,500B	~5.0%	USD 120B
J.P. Morgan Government Bond Index - Emerging Markets Global Diversified Index	~USD 2,500B	~10%	USD 20B

Remark: Assume 80-90% Passive Investment

Sources： BOCHK, based on GS Research

The size and trading activity of the interbank bond market in the Mainland is close to or has reached the level of major markets in Europe and the United States. RMB-denominated bonds have also met the rigid requirements for the inclusion in the Global Aggregate, but their maturity is still insufficient. Foreign investors still have doubts about entering the Chinese bond market. The Chinese bond market still needs to improve in settlement transactions, tax policies and credit rating systems. Bloomberg's inclusion of Chinese bonds in the Bloomberg Barclays Global Aggregate will further accelerate the opening up of the Chinese bond market, increase international investor confidence, and further improve the service function of the Chinese bond market.

The opening up of Chinese bond market brings new opportunities for the development of Hong Kong offshore market

Compared with Hong Kong's status as an international financial center, the loan system of Hong Kong’s banking industry and stock market development have been relatively mature, but the bond market needs to be strengthened as its size is small and transaction volume is low. As the “bridge” between Hong Kong and Mainland China’s capital markets, the continuous opening up of the Chinese bond market provides a good opportunity for Hong Kong to develop and improve the local bond market. Hong Kong can further leverage the advantages of diversification of financial products and tools to become an offshore platform for overseas funds to purchase Mainland bonds.

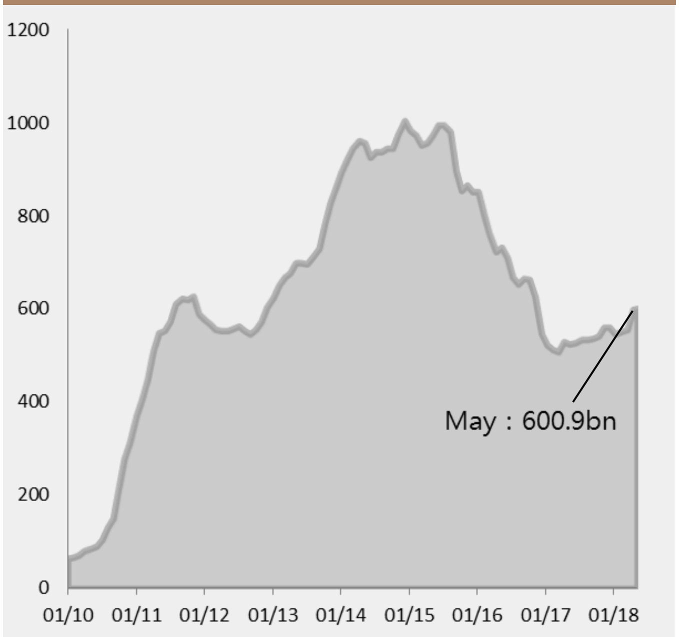
Hong Kong's financial industry can strengthen the development of products under the capital account, provide different financial products and diversified asset allocation tools, and further enrich and improve the functions of the financial market, including position squaring in foreign exchange trading, interbank lending, interbank bond investment and cross-time zone services in daily fund settlement. Improve the bond investment agency model of overseas institutions to attract customers to open accounts, fully represent their RMB bond investments, and manage RMB funds. Establish a more flexible fund management mechanism to expand trading and holding capacity.

Hong Kong has the ability to provide comprehensive foreign exchange risk hedging instruments to protect the allocation of RMB assets. With the increasing use of the RMB in investment and financial transactions, the importance of exchange rate risk will become increasingly prominent, attracting more attention from enterprises and investors, and the demand for products that hedge against risks and lock in returns will rise rapidly. Foreign funds investing in the Mainland bond market can hedge against interest rates and exchange rates in the Hong Kong market to reduce risk exposure of holding RMB assets. This will help Hong Kong's offshore market functions evolve from cross-border trade settlement, clearing to interbank lending, exchange transactions, risk management, cross-border capital allocation, RMB asset management, and product innovation. At the same time, Hong Kong is encouraged to develop and enrich RMB-denominated financial products, providing more convenience for overseas capital investment in the Mainland market. Hong Kong's banking industry should accelerate the development of such products according to changes in the environment to meet the safe-haven needs of various customers.

“Bond Connect” introduces incremental funds to Hong Kong to promote the development of the Hong Kong bond market, and Hong Kong's advantage of free capital flows is an important basis for the successful promotion of the “Bond Connect”. Hong Kong has a mature financial system and market framework, property rights, judicial and legislative, accounting and audits, credit, information disclosure and private information confidentiality systems similar to developed markets, attracting a large number of international institutions. The connect of Chinese bond market with Hong Kong means directly or indirectly connecting the ultimate investors around the world to realize cross-border circulation of financial instruments and funds. Hong Kong can play an important role in the opening up of the Mainland’s bond market.

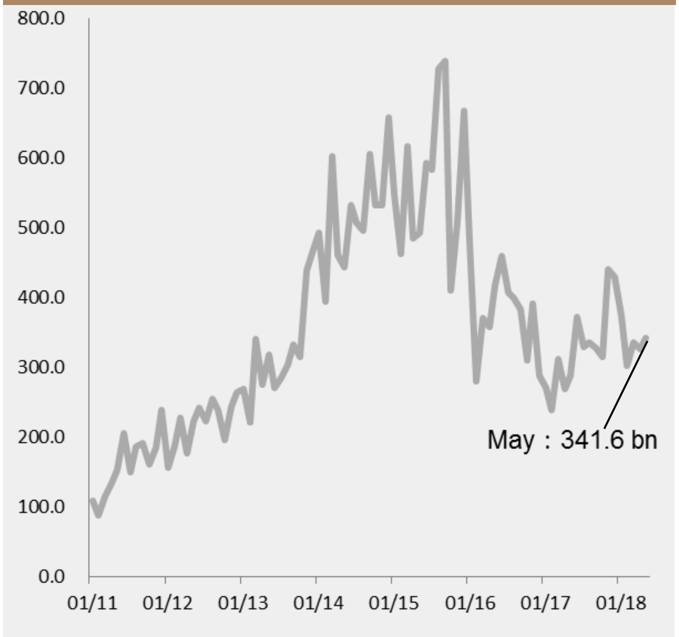
Market Trends

Hong Kong RMB Deposits (in RMB bn)



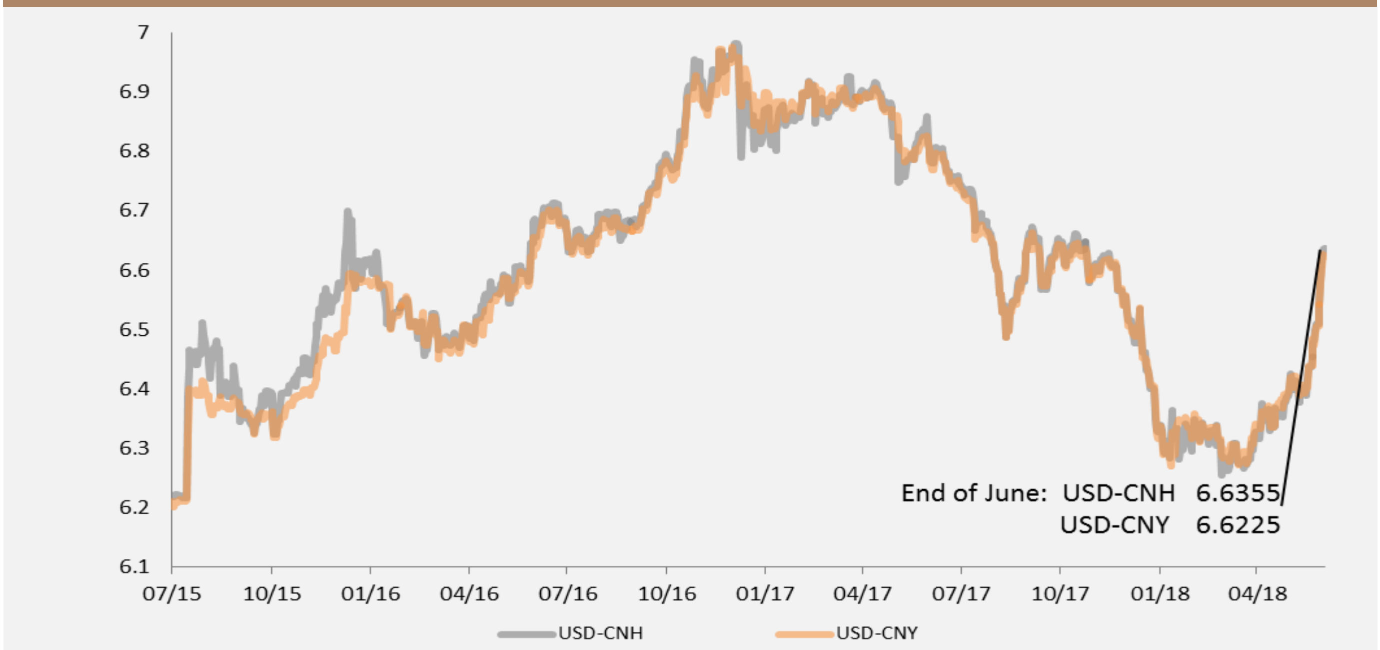
Source: HKMA

RMB Cross-border Trade Settlement (RMB bn)



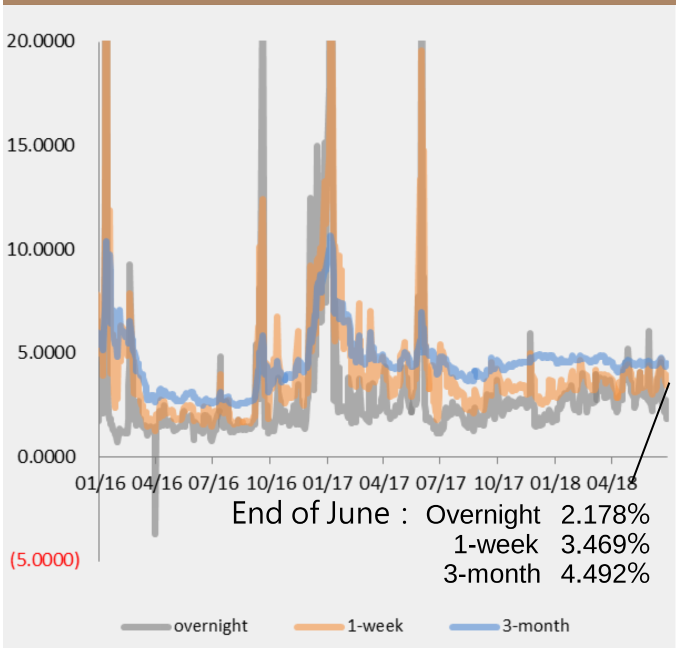
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



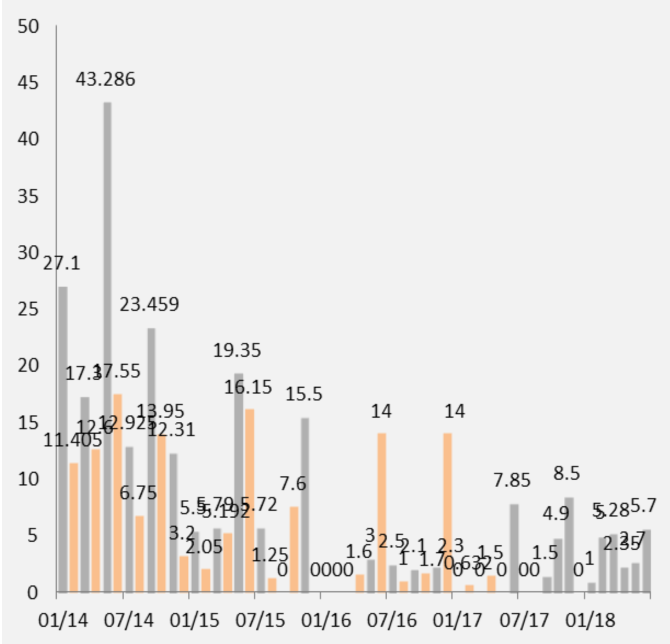
Source: Bloomberg

CNH HIBOR Fixing (%)



Source: Bloomberg

Hong Kong Offshore RMB Bond Issuance (RMB bn)



Source: BOCHK Global Market estimate

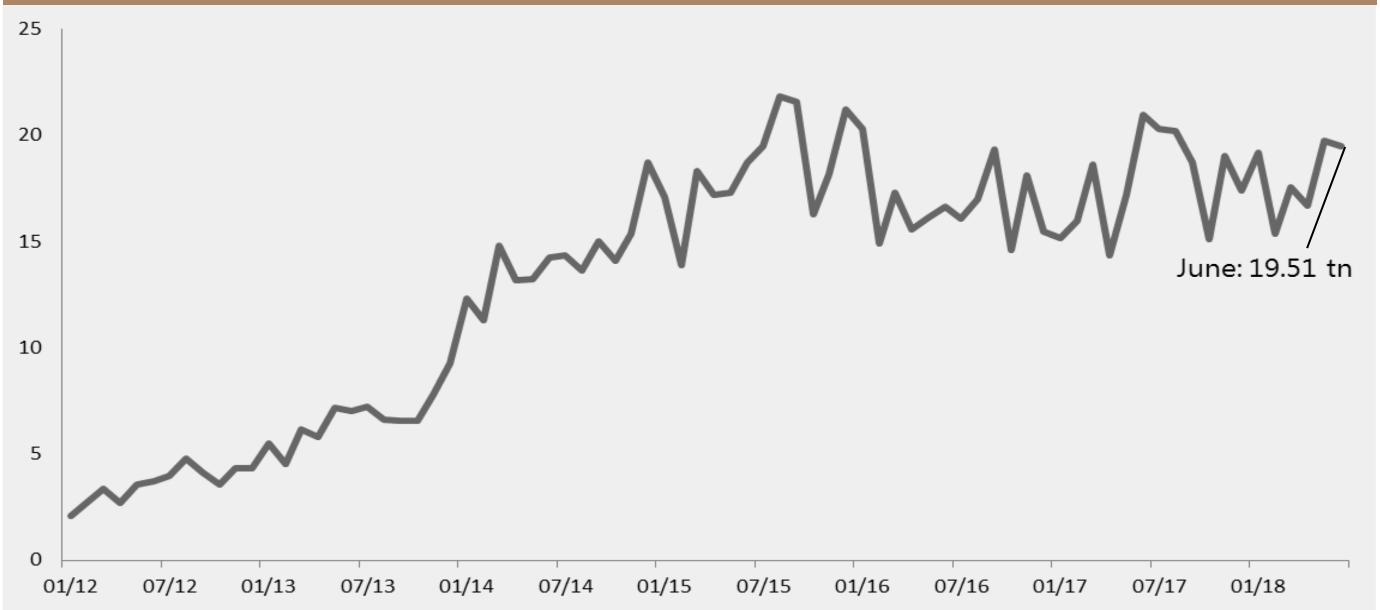
CNH & CNY China Sovereign Curve (%, 29 June 2018)

Source: Bloomberg

FTSE-BOCHK Offshore RMB Bond Composite Index

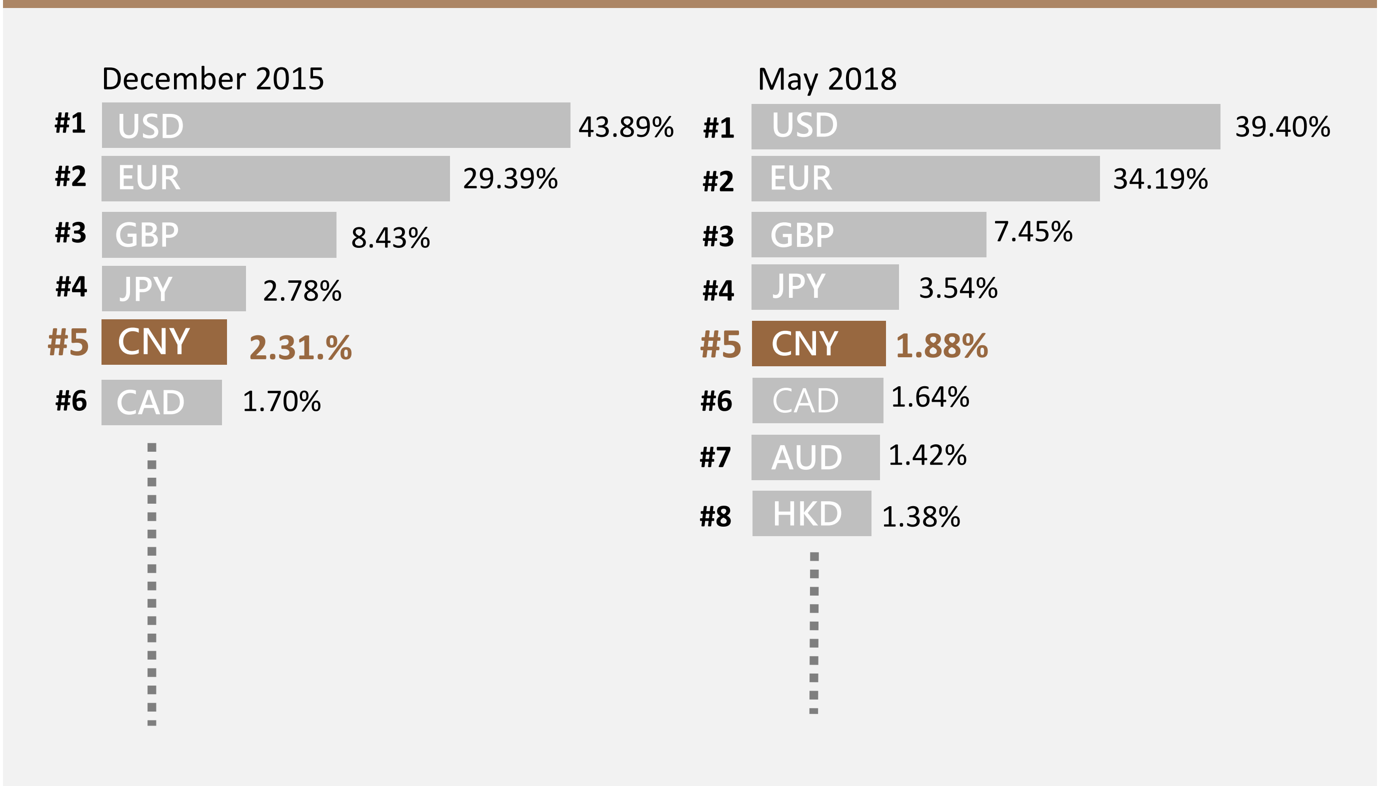
Source: Bloomberg

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)
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
2017	559.1	3926.4	212.63	1.729	3.000	4.803
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	559.1	428.7	17.42	1.729	3.000	4.803
1/2018	546.4	373.4	19.17	2.290	3.512	4.752
2/2018	550.4	301.6	15.36	2.965	3.462	4.652
3/2018	554.3	335.6	17.55	3.737	3.823	4.625
4/2018	597.6	326.4	16.68	3.500	4.156	4.628
5/2018	600.9	341.6	19.77	6.071	4.398	4.632
6/2018	/	/	19.51	2.178	3.469	4.492

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)
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
2017	6.515	6.507	124.7	24.9	4.140
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	124.6	4.9	3.810
11/2017	6.611	6.605	124.7	8.5	4.070
12/2017	6.515	6.507	124.7	0	4.140
1/2018	6.298	6.289	125.2	1	4.190
2/2018	6.331	6.331	125.4	5	4.240
3/2018	6.263	6.291	125.8	5.28	4.240
4/2018	6.316	6.334	126.8	2.35	4.010
5/2018	6.399	6.402	127.4	2.7	4.010
6/2018	6.636	6.623	127.9	5.7	3.970