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Contents

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Offshore RMB Market Remained Stable

On August 2, US President Donald Trump once again announced that additional tariffs would be imposed. The trade war between China and the United States escalated. On August 5, both CNY and CNH exchange rates against USD broke the 7.0 mark. Despite current pressure for the RMB to depreciate, market sentiment, offshore RMB market liquidity, and key business indicators remained stable. RMB assets remained attractive as foreign investors increased their Chinese bonds holdings for 9 consecutive months. JP Morgan announced the inclusion of Chinese bonds in its benchmark indices in 2020. Bond Connect trading volume increased by 68.5% in August, while its transaction settlement period was extended to T+3. PBOC issued RMB 30 billion central bank bills on August 14, with the over-subscription ratio reaching 2.6 times.

I. RMB broke 7.0 while trade war intensified

RMB depreciated sharply in August and reached 7.19 before stabilizing at month's end. On August 2, US President Donald Trump announced that the US would impose 10% tariffs starting on September 1 on the remaining USD 300 billion of Chinese goods. On August 5, both CNY and CNH broke the 7.0 threshold. CNH depreciated about 1,200 pips from the closing price 6.98 on August 2 and closed at 7.1. On August 13, the US announced a partial delay of tariffs to December. On August 19, the US announced a deferment of the implementation of the export ban on Huawei's suppliers. CNH recovered and bounced back to 7.05 for a brief moment. On August 23, the Chinese Finance Ministry announced countermeasures to the new tariffs. According to a statement issued by the Ministry, China would impose 5 or 10% tariffs on USD 75 billion worth of goods to be imported from the US on September 1 and December 15 respectively. On the same day, Trump announced to raise the tariff on September 1 from 10% to 15%. The existing 25% tariff imposed on USD 250 billion worth of goods would be raised to 30%. On August 26, CNH dropped to historic low of 7.1926 and closed at 7.17. As of August 30, the RMB's central parity rate against the USD closed at 7.0879, down by 2.96% from last month. CNH closed at 7.1617, down by 3.65% MoM and 4.18% since the beginning of the year. Meanwhile CNY closed at 7.1567, down by 3.95% MoM and 4.22% since the beginning of the year.

As the trade war intensifies, the RMB is expected to stay under pressure in the short run, and would be affected by USD movements. Although the US dollar index rose to 98 recently, the upward momentum of USD is anticipated to slow as the market anticipates the Fed to enter an easing cycle and to continue cutting interest rates. The RMB is also supported by a number of factors such as a stable and sound Chinese economy, adequate foreign exchange reserves, effective management of financial risks, and a more resilient and market-oriented dynamic. With a growing multitude of measures introduced by the People's Bank of China, the RMB should stabilize at a reasonable level.

The liquidity of CNH remained stable in August. CNH HIBOR O/N rose sharply at one point but remained steady afterwards. In terms of CNH HIBOR, on August 30, the O/N, 1-week and 3-month CNH HIBOR rates were 2.7265%, 3.1358% and 3.5375%, respectively.

II. Offshore RMB liquidity and major business indicators remained stable

By the end of July 2019, RMB deposits in Hong Kong amounted to RMB 616 billion, up by 2% MoM and 1.5% YoY. RMB loans outstanding in Hong Kong were RMB 120.7 billion, up by 8.9% MoM and 2.8% YoY. The total remittance of RMB for cross-border trade settlement was RMB 455.8billion, up by 3.4% MoM and 26.1% YoY. RTGS turnover was RMB 26.1 trillion in August 2019, up by 16.9% MoM. As of August 2019, dim sum bond issuance amounted to RMB 121.07 billion (including issuance of RMB 30 billion central bank bills during the month). As for other offshore RMB markets, RMB deposits in Taiwan totaled RMB 265.3 billion (including negotiable certificates of deposit) as of April 2019, up by 0.06% MoM, ending 3-months of consecutive decline.

According to SWIFT, RMB was the sixth most actively used currency for domestic and international payments by value in July 2019 with a share of 1.81%, decreasing from 1.99% in June. RMB trails behind the following currencies: USD, EUR, GBP, JPY and CAD. The RMB payments value increased by 0.33% compared to previous month, while in general all payments currencies increased by 9.72%.

III. Foreign holdings in Chinese bonds rose consecutively for 9 months; the settlement period for Bond Connect was extended to T+3

In August, foreign investors' RMB bond holdings amounted to RMB 2.03 trillion, up by RMB 11.9 billion compared to last month, increasing for 9 consecutive months and up by 20.4% YoY. On September 4, JP Morgan announced the inclusion of Chinese bonds in benchmark indices starting from February 2020. The introduction will be completed in a 10-month span. By the end of August, the US-China 10 year interest rate spread reached 160 bps, the highest in 21 months. The widening of US-China interest rate spread and the inclusion of China bonds in international bond index series provide a favorable environment for the China bond market. It is expected that foreign investors will further increase their China bond holdings.

In August 2019, Bond Connect recorded monthly trading volume of RMB 338.6 billion with 3,338 transactions, up 68.5% from July. The average daily turnover was at RMB 15.39 billion, with a volume of RMB 23.76 billion on August 29. These data points achieved record highs in monthly transactions, monthly trading volume, daily average trading volume and single day trading volume respectively. Trading in policy financial bonds, Chinese government bonds and NCDs remained dominant, accounting for 55.7%, 28.9%, and 13.0% of the monthly trading volume. By the end of August, Bond Connect has drawn in 1,244 institutional investors, with another 110 investors onboard during the month. In the same month, Bond Connect welcomed its first investor from Italy, expanding coverage to 31 jurisdictions globally.

In August 2019, China allowed foreign investors to use T+3 bond settlement. Foreign institutional investors may now choose T+0, T+1, T+2, or T+3 when executing bond transaction settlement through Bond Connect on Tradeweb or Bloomberg. This change promotes internationalization of China debt market, and provides convenience to foreign institutional investors in post-trade capital arrangements. On August 19, Bond Connect updated the "Admission Guidance for Investor from Specific Jurisdictions", and expanded application channels for investors from Canada and India. Investors in these jurisdictions can now submit applications directly to BCCL or through Access Platforms, instead of only via Access Platforms previously.

IV. Steady progress of opening up in domestic capital markets

According to statistics from SAFE, by the end of August 2019, the approved quota for RMB Qualified Foreign Institutional Investor (RQFII) was RMB 693.3 billion, up by RMB 12.1 billion from previous month; while the approved quota for Qualified Foreign Institutional Investors (QFII) increased by USD 2.9 billion to USD 111.4 billion. The approved quota for Qualified Domestic Institutional Investors (QDII) totaled USD 104.0 billion with a total of 152 qualified domestic institutional investors, same as the previous month.

V. PBOC issued RMB-denominated central bank bills in Hong Kong

On August 14, the PBOC issued RMB 20 billion three-month bills and RMB 10 billion one-year bills, totaling RMB 30 billion, with an oversubscription of more than 2.6 times. It was the fifth time that PBOC issued bills through HKMA Central Moneymarkets Unit (CMU) since November 2018. The market reacted positively and the RMB stabilized.

The continued issuance of central bank bills meets market demands, broadens the variety of highly rated RMB investment products in Hong Kong and RMB liquidity management tools, boosts market confidence and stabilizes CNH. On August 9, PBOC mentioned for the first time the regular issuance of central bank bills in its China Monetary Policy Report. Regular issuance of central bank bills will improve the CNH yield curve in the offshore market, expand the scale and depth of the offshore RMB market, and in turn promote RMB internationalization.

PBOC issued sovereign bills in Hong Kong

On August 14, the People's Bank of China (PBOC) issued RMB bills through the Central Moneymarkets Unit of the Hong Kong Monetary Authority. The issuance included RMB 20 billion 3-month bills and RMB 10 billion 1-year bills priced at 2.90% and 2.95%, respectively.

US designated China as a currency manipulator

On August 5, the US Treasury Department released a statement to confirm that China is a currency manipulator, and Secretary Mnuchin will engage with the International Monetary Fund to eliminate the unfair competitive advantage created by China's latest actions. Subsequently, PBOC responded that the RMB's exchange rate regime is a managed floating regime based on market supply and demand with reference to a basket of currencies. There is no such issue as "exchange rate manipulation", as the RMB's exchange rate is determined by market supply and demand by nature.

Mainland promotes cross-border RMB business in the new area of Shanghai FTZ

On August 6, the State Council issued an overall plan for the new area of the Shanghai Free Trade Zone (FTZ). The plan proposed to streamline the cross-border RMB business process for high quality enterprises, facilitate cross-border financial services, study the integration of domestic and foreign currencies in free trade accounts, and explore free flows and exchange of capital in the new area.

Shenzhen launched a trial scheme to facilitate payments using FX earnings under capital accounts

On August 29, the Shenzhen branch of the State Administration of Foreign Exchange launched a trial scheme to facilitate payments using foreign exchange earnings under capital accounts. Banks would make payment first before conducting sampling inspection later, instead of conducting inspection before payment under the existing arrangement. Eligible enterprises may use foreign exchange earnings for domestic expenditure directly at designated banks, without providing certifying documents before each transaction.

JPMorgan to include Chinese bonds in GBI-EM indices

On September 4, JPMorgan said it will include Chinese government bonds in its Government Bond Index Emerging Markets (GBI-EM) suite from February 28, 2020. Nine Chinese local currency bonds will be included in a 10-month process that will see the country’s weighting rising to 10%.

PBOC announced RRR cut

In order to support real economy and reduce funding cost, PBOC cut the RRR for financial institutions by 0.5 percentage point on September 16. In addition, in order to further support micro enterprises and private enterprises, PBOC will cut the RRR for city commercial banks operating in provincial-level administrative region by 0.5 percentage point respectively on October 15 and November 15.

The 10th Anniversary of RMB Internationalization and Future Path

—Constructing A New Ecological Circle of RMB Internationalization under Financial Markets Opening

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

During the past decade, the RMB has made significant progress in becoming an international settlement and reserve currency amid policy-driven development and market-driven forces. Looking ahead, the reversal of economic globalization and the resurgence of trade protectionism will present unprecedented challenges to the international economic and financial situation. In response to the changing external environment, China has launched the second round of high-level financial opening since its entry into the WTO, involving banks, securities, funds, insurance, ratings agencies, third-party payment, and financial markets. With improving infrastructure and optimized supporting policies in the capital markets, interconnection between domestic financial markets and overseas markets has been enhanced, which could increase the linkage between domestic and international interest rates and expand exchange rate volatility. The dramatic adjustment of internal and external environment will then directly affect the development path of RMB internationalization.

I. The 10th anniversary of RMB internationalization: driven by both policies and the market

After the outbreak of the global financial crisis, international financial markets generally recognized the institutional flaws of the current US dollar-centric international monetary system, and it is in urgent need of new public goods and solutions. The RMB has kicked off its internationalization process, which was driven by policies as well as market forces. With the policy constraints on the offshore RMB business gradually relaxed, endogenous business demands in the offshore RMB market have increased, fulfilling RMB's status as an international reserves currency, and steadily elevating the degree of RMB internationalization.

1. Share of international payments has fluctuated, while the settlement currency function builds the foundation for RMB internationalization

The cross-border use of RMB under the trade of goods was an important driver of early RMB internationalization. In November 2014, the RMB share as international payments currency reached 2.45%. In 2016, global RMB payments in value fell by 29.5%, with its share slipping from 2.31% in December 2015 to 1.67% at the end of December 2016, while global payments increased by 0.67% during the same period.

According to SWIFT, the RMB share as the fifth largest international payments currency stood at 2.07%, up from 1.60% in the same period last year, along with the US dollar, the euro, the pound and the yen. In August 2019, the Hong Kong RMB RTGS settlement amounted to 26.1 trillion yuan.

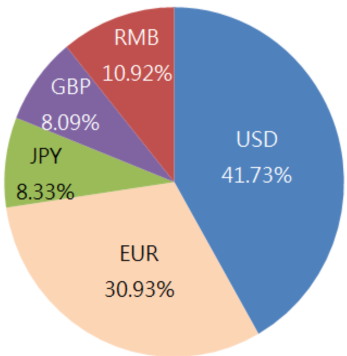
At present, cross-border use of RMB in the trade sector is completely liberalized, which indicates that the policy traction has given way to the development of the market itself, and the market adjusts according to changes in the RMB exchange rate and capital flows. Cross-border trade remains a substantial base for the continued promotion of RMB internationalization.

2. RMB began to establish its status as international reserve currency

With the development of the offshore RMB market, Hong Kong, Singapore, Russia and other regions have taken the lead in allocating into RMB assets. In 2016, the RMB joined the International Monetary Fund Special Drawing Rights (SDR), and overseas central banks became more willing to hold RMB assets. In 2017, the European Central Bank announced to convert 500 million euros worth of its U.S. dollar reserves into the Chinese currency. In early 2018, the Deutsche Bundesbank planned to include the RMB in its foreign exchange reserves, while the French central bank also revealed that its foreign exchange reserves have diversified into a limited number of international currencies such as the RMB. Other central banks and related institutions are eager to learn more about the Chinese economy and the RMB exchange rate, and to gather market intelligence for their allocation into RMB assets. At present, more than 60 central banks and monetary authorities in the world have included RMB in their foreign exchange reserves, which helped to elevate the status of RMB as an international reserve currency.

In March 2017, the International Monetary Fund (IMF) released the currency composition of official foreign exchange reserves (COFER), separately identifying holdings in RMB for the first time. As of the third quarter of the year, the size of RMB foreign exchange reserves was USD107.94 billion, accounting for 1.12% of the total allocated foreign exchange reserves. As of the first quarter of 2019, the size of RMB foreign exchange reserves held by foreign central banks reached USD 212.9 billion, accounting for 1.95% of the world's official foreign exchange reserves, higher than the 1.89% in the previous quarter, and the highest since October 2016. The increasing proportion of RMB in global central bank's foreign exchange reserves reflects foreign investors' continuously rising interests in holding RMB assets, which is conducive to the diversification of foreign exchange reserves.

Weights of major global currencies in the SDR



Source : IMF, BOCHK Research

In July 2017, the launch of Bond Connect successfully linked the domestic bond market with the Hong Kong market, providing a more convenient channel for overseas institutions to increase their holdings of RMB bonds, and encouraging foreign investors to allocate into RMB assets. As of March 2019, the outstanding amount of Chinese inter-bank bonds held by overseas institutions reached 1.76 trillion yuan, up 35.2% from the same period last year. Currently, more than 845 international investors have tapped China's bond market through Bond Connect, and its services have expanded to 27 countries and regions around the world.

3. Function as an international pricing currency begins to take root

Enhancing RMB's function as an international pricing currency is one of the most important goals of RMB internationalization. Over the past few years, RMB was increasingly used for transaction in commodities, and expanded its influence on commodity pricing, such as petroleum, etc. It is hoped that "Petro RMB" could be used to jumpstart the development of RMB internationalization, and explore the possibilities of organic integration between petroleum-related sectors and financial industries, in order to withstand the challenges related to the huge volatilities in international commodity pricing, secure resource availability and national safety, and expand the use of RMB in petroleum pricing and transactions. In March 2018, crude oil futures contract was listed in Shanghai International Energy Exchange. These crude oil futures are priced in RMB, with net settlement and tax-free delivery features. Currently, the crude oil futures transactions in Shanghai accounted for around 6% of total crude oil futures transactions in the world, ranking third behind WTI in New York and Brent in London.

When more and more countries choose to use RMB as the pricing and settlement currency for multilateral trade on crude oil, the demand and usage of RMB will increase notably. Meanwhile, the more active use of currency swaps between central banks is also encouraged, which can facilitate the usages of RMB among both governmental and private organizations overseas.

II. The latest round of financial opening has four main characteristics

The objective of the latest round of financial opening is to create a well-rounded, multi-layered, and widely-covered high quality opening environment. Overall, it has the following characteristics.

1. Pre-entry national treatment and negative lists are the main features of the financial opening agenda

In April 2018, President Xi announced four major opening up initiatives at the Boao Forum. The People's Bank of China (PBOC) then announced 11 financial opening measures. In 2019, the China Banking and Insurance Regulatory Commission (CBIRC) announced Detailed Rules for the Implementation of the Regulation of the People's Republic of China on the Administration of Foreign-funded Banks (Revised Consultation Paper). In May 2019, CBIRC announced 12 opening measures, including removing the shareholding limits in Chinese commercial banks held by a single Chinese bank or a single foreign bank investment, removing the total asset requirement of USD 10 billion for foreign banks for setting up a Chinese subsidiary bank and the total asset requirement of USD 20 billion for setting up a Chinese branch; abolishing the approval requirement for foreign banks to carry out RMB businesses and allowing foreign banks to engage in RMB businesses once they are allowed to do business. In the insurance sector, the opening measures allow offshore financial institutions to invest in the equity of foreign insurers in the Mainland or invest in the establishment of insurance institutions, abolish the requirement that foreign insurance brokers engaging in insurance brokerage operations in China should have operations for at least 30 years, and have total assets of no less than USD 200 million. Obviously, the financial opening in the

Mainland continues to follow the national treatment principle, gradually relaxing the shareholding and licensing requirements, and further shortening of the negative list. The shareholding limits of foreign financial institutions on all financial sectors that require a license have been fully relaxed, hopefully stimulating the interests of foreign financial institutions to actively participate in the financial opening in the Mainland.

Obviously, the national treatment principle and negative lists are the main features of financial opening in the Mainland which will gradually lead to a leveled playing field between domestic and foreign institutions. The State Administration of Foreign Exchange (SAFE) is now researching on the foreign exchange management framework for foreign investment companies according to the national treatment principle and negative lists, which could help solidify the unified macro-prudential and micro-monitoring framework on cross-border capital movement.

2. The focus of capital markets opening has shifted from channel management to more connection between onshore and offshore capital markets

In the past, the Mainland relied on a number of channels to facilitate the opening up of capital markets. The establishment of Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect provides the linkage between onshore and offshore capital markets. In June 2017, MSCI first included Mainland's A share into its emerging markets and world indices, with an initial weighting of 0.73%. It was a milestone of Mainland's equity market development, which offers offshore investors the convenience of allocating into RMB equity assets. In July 2017, the northbound Bond Connect started its operation, offering offshore investors a new channel to participate in the Mainland's bond market. Since the establishment of Bond Connect, roughly one-third of all new investments into the Mainland's bond market came from Bond Connect. With the increasing connection between onshore and offshore equity and bond markets, it can better serve the needs of RMB asset allocation by foreign investors.

The increasing capital markets connection can bring the benefits of building a rule-based, transparent, open, active and resilient multi-layer capital market system, facilitate more medium to long term foreign capital flows into the Mainland's capital markets, rationalize market structure, foster the role and function of capital markets on equity financing, price discovery, and risk management, as well as support the supply-side reform of the onshore financial sector.

3. Local currency businesses take priority in the opening up of onshore capital markets

The opening up of Mainland's capital markets should focus on local currency businesses first. A stable and orderly approach is one of the most important steps for financial market opening. In the opening up of the few unconvertible items of capital accounts, the Mainland authorities adopted the approach of launching policy initiatives once they are ready. Recently, Bloomberg announced the inclusion of onshore RMB bonds into the Bloomberg Barclays Global Aggregate Bond Index, with a phase-in period of 20 months. Currently, there are around USD 5-6 trillion of assets tracking the three major bond indices globally. Some offshore investors tend to create an asset portfolio following a passive investment strategy. Following the incorporation of RMB bonds into these major indices, more foreign investors will adjust their asset portfolio to raise the share of RMB bonds. Assuming overseas investors will include and increase the share of RMB bonds up to 5% to 10% of their asset portfolio, as much as RMB 3-6 trillion of net capital inflows are expected. It is believed that there will be around 390 onshore bonds meeting the eligibility of being included in those global indices. Assuming Chinese bonds could account for around 5.5% of the Bloomberg Barclays Global Aggregate Bond Index (which represents a USD 54 trillion global bond market), RMB bonds will become the fourth largest asset group in the index, following US dollar, Euro and Japanese yen bonds.

4. Free trade zones take the lead in financial opening

During the process of financial market opening, the free trade zones in Shanghai and Hainan focus on the pilot scheme of financial opening and strongly support the development of international financial center in Shanghai. In addition, the Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area also includes financial market opening and innovative measures, fostering the building of international financial hub, with the focus of specialty finance, including marine financing, technology financing, and aircraft leasing, etc., as well as supporting more cooperation between financial institutions in Guangdong, Hong Kong and Macau to further develop offshore financial businesses, and gradually increase the scale and scope of cross-border RMB usage in the Greater Bay Area, etc.

III. New environment and challenges to RMB internationalization

Throughout the history of international currency development, a successful internationalization of a currency is inseparable from a robust economic scale, substantial international trade, as well as stable and dynamic financial markets. After ten years of development, the internationalization of RMB has made some progress, but it still lags behind the development of China's economy, trade, and investment. Therefore, there exists huge room for improvement of the internationalization. However, under the background of dramatic changes in the international financial landscape and China's further opening up in the financial sector, RMB internationalization faces unprecedented opportunities and challenges.

In term of opportunities, to fundamentally change the long-standing trade imbalance and massive trade deficits that plague developed economies, we must adjust the dominant position of the USD in the international monetary system. That provides a possibility for maintaining the stable position of RMB theoretically. The internationalization of RMB can offer a diversified choice for the USD-dominated international monetary system and provide Chinese solutions in promoting a more complete, stable, and fair international monetary system. Judging from the experience of US-Japan trade war, the US supported the appreciation of the Yen and proposed that the Yen should assume certain international monetary functions at that time. That move was to accelerate structural changes in the Japanese economy and fundamentally reduce Japan-US trade surplus. However, developed economies' trade deficits are inevitable with USD's international reserve currency status. The US has exported USD through trade deficits for a long time, some of which returned to the US in the form of service surplus, and more returned to the US financial markets through capital investment. This is the global cycle of capital flows.

From the perspective of challenges, trade war embodies the "US first" trade protectionism, which will continue to ferment for a long time with profound economic and social roots. Global trade protectionism is to improve trade deficits ostensibly, but in essence, to curb the development of China's science and technology. It restricts the development of high-tech industries, China's opening-up, and even long-term relationships between China and the US. All those factors are objectively unfavorable to RMB internationalization since they make Sino-US trade frictions unimaginably complex and serious.

With a closer connection to international markets, China's financial markets face more direct challenges due to the complex and volatile environment. While external risks are rising, the financial uncertainty in China's economic development is more significant. For example, total debt to GDP ratio continued to remain at high levels of 277% to 284%; the task of reducing macro leverage is challenging; the risks of shadow banking, real estate finance, and internet finance continue to rise. There is an urgent need to prevent and resolve financial risks, effectively control macro leverage, and improve the adaptability of financial structures. Moreover, it's also essential to stress the role of financial sector in serving the real economy, comprehensively strengthen the construction of rigid restraint systems, as well as effectively prevent and control financial systemic risks. The ability to control China's internal and external financial risks is related to whether RMB internationalization can develop steadily. The pace of RMB internationalization will be adjusted if there is a systemic shock, which will disturb the stability of the RMB exchange rate in global financial markets.

IV. Construct a new ecology of RMB internationalization in the open financial markets

In the new round of financial openness, the status of the RMB as a reserve currency will be further enhanced. To this end, it is necessary to carry out theoretical innovation and practical exploration in the theoretical and practical subjects of building a modern economic system, establish a conceptual framework of RMB internationalization based on the perspective of open-economy macroeconomics and finance, and create a new RMB internationalization ecosystem.

Firstly, RMB internationalization is a long-term strategy. The basic path of RMB internationalization is to adhere to market-based exchange rate reform and stabilize the position of RMB in the international monetary system. It provides diversified options and new public goods from emerging markets, which can solve the institutional defects of the current USD-centric international monetary system. It also provides China solutions to promote a more stable and fair international monetary system. Chinese authorities should enhance the elasticity of the RMB exchange rate, improve global market's confidence in RMB assets, and create conditions step by step to establish a new function of RMB as a safe-haven currency.

Secondly, under the premise of ensuring economic security, we should meet the long term demands by all global investors for RMB assets. To this end, we will establish a benign interaction between domestic monetary finance and real economy under RMB internationalization framework, open capital markets steadily, improve the operating mechanism of financial markets continuously, and enhance the depth and breadth of RMB financial markets. In that way, new interaction between RMB exchange rate and the main price index of domestic capital markets can be gradually achieved, and the simultaneous decline in stocks and exchange rates can be avoided.

Thirdly, to create a new ecosystem for RMB internationalization, we will realize the combination of policy-driven and market-oriented system under the background of accelerating the opening up of China’s financial markets. Increasing the proportion of RMB in global reserves and foreign exchange transactions cannot be done at one go. It needs to be explored from different perspectives such as cross-border trade and investment, assistance for merchants on using RMB, and etc. In this way, it can be realized through coordinating trade, investment, and financial transactions, and forming a productive atmosphere for the international use of RMB.

Fourthly, the scale and structure of capital inflows and outflows will undergo continuous adjustment and optimization, as the demands for global asset allocation by some domestic entities rise continuously. For example, China's private sector holds foreign financial assets equivalent to only 27% of GDP (much lower than US's 129% and Japan's 147%). The factors affecting RMB internationalization are multifaceted, so bottom-line thinking is needed—we should carry out sand box exercises for major initiatives to discuss relevant policies and their possible market impacts in detail for controlling financial risks.

In short, the RMB internationalization means that China needs to undertake more international responsibilities in maintaining global financial stability and play a more active role in global financial governance. Therefore, we should pay attention to coordinate domestic and foreign policies, balance the interests of both domestic and foreign entities, and steadily and continuously develop the process of promoting the RMB internationalization.

Analysis and Prospect of LCS in ASEAN

Senior Economist, Jian Ying

Recently, ASEAN countries started exploring settlement in their local currencies. Indonesia, Malaysia, Thailand, and the Philippines signed the "Local Currency Settlement" (LCS). Among these countries, Indonesia, Malaysia, and Thailand already implemented the agreement. In April, Indonesia submitted a draft on "Guidelines on Settlement in ASEAN Local Currencies", in the hope of copying LCS to other ASEAN countries and their major trading partners.

I. Background of LCS

The economies of ASEAN maintained steady growth in the aftermath of the Financial Crisis. ASEAN's GDP as a whole ranked fifth in the world; and fourth in total imports and exports, following China, Germany, and the US. ASEAN economies are outward-facing, with imports and exports contributing a large portion of their economies. As the world tilts toward trade protectionism and global growth slows, countries in ASEAN implemented various measures in order to stabilize exports and minimize the impacts of the fluctuation in foreign demand.

The first measure is to diversify its trade and promote transactions in the region and neighboring countries, thus reducing the reliance on European and U.S. markets. From 2008 to 2017, imports and exports as a percentage with the EU and the U.S. decreased from 20.7% to 19.3% (dropped to 17.8% at one point); in contrast, imports and exports with China, Korea, and Japan jumped from 25.8% to 31.6%. Within ASEAN, imports and exports of Indonesia, Malaysia, Thailand, and the Philippines experienced high growth rate, increasing from 23% to 24.4%.

The second measure is to introduce settlement in local currencies, thus reducing hurdles for trade and reliance on the USD. In 2016, 78% of ASEAN's trade with countries outside of the region was settled in USD, and trade within the region was even higher, recorded at 85%. As a result, monetary policies for macro-adjustment for countries in ASEAN are limited since they have to use the USD as the reserve currency. ASEAN economies were deeply affected by the outflows of the USD in the aftermath of the Financial Crisis. In order to keep up with the structural transformation and to promote trade within the region and among neighboring countries, ASEAN is exploring the introduction of LCS so as to minimize the damage caused by the fluctuation of the USD.

Therefore, it is reasonable for ASEAN to implement LCS in response to recent developments.

II. Basic Features of LCS

LCS is a special settlement arrangement that combines various businesses. It is different from the traditional international remittance business where a Nostro account is opened and debited for settlement. It is also different from some border trade settlements using a bilateral interbank account to complete the remittance. There are also huge differences between LCS and the clearing methods of a RMB clearing house and correspondent banks. LCS has the following features (taking Indonesia and Thailand LCS as examples):

1. Establish the regulatory role of central bank in LCS.

The Central Bank of Indonesia and the Central Bank of Thailand signed a bilateral local currency settlement framework agreement (Indonesia, Malaysia, and Philippines also signed a bilateral LCS agreement, but not in the form of a multilateral agreement). It clearly listed the central banks' responsibilities and authority. The agreement clarifies the respective appointments and cancellations of Appointed Cross Currency Dealer (ACCD), the opening of Special Non-resident Accounts (SNA), the provision of SNA quotas, etc. It gives the central banks tools for the effective management of LCS.

2. The ACCD is appointed by the central bank of the participating countries.

Through consultation between two central banks, Indonesia and Thailand selected five to six major banks as ACCDs. ACCD can be a domestic bank, a branch of a major bank in Southeast Asia, or even an oversea branch of an international bank (there is a Japanese bank for LCS between Thailand and Malaysia). A one-to-one counterpart relationship should be established between ACCDs.

3. ACCD is required to open a SNA in the counterpart country.

According to the LCS agreement signed between the Central Bank of Indonesia and the Central bank of Thailand, Thai ACCD can open an Indonesian Rupiah SNA in Indonesian ACCD to deposit or pay Indonesian Rupiah generated by local currency settlement. Indonesian ACCD can open a Thai baht SNA in Thai ACCD to deposit or pay Thai baht. SNA is a Special Nostro Account designed for LCS operations.

4. Regulate SNA funds and investment management.

SNA implements balance management where the Indonesian Rupiah SAN cap is 400 billion Rupiah and the Thai Baht SNA account cap is 1 billion Baht. The daily balance of SNA should not exceed the upper limit in general, and ACCD must report to the central banks of the two countries on a quarterly basis. For Indonesian Rupiah SNA opened in Indonesian ACCD by Thai ACCD, the source of funds include the Indonesian Rupiah exchanged with the Thai baht, the Indonesian Rupiah exchanged with the US dollar, and the Indonesian Rupiah from customers. The fund can be invested in bonds and other financial instruments denominated in Rupiah. The same regulations apply to Indonesian ACCD opening a Thai Baht SNA in Thai ACCD. In some cases, the balance may be exceeded, but there must be an actual transaction supported by trade documents.

5. Allow ACCD to open a Sub-SNA account for businesses.

Indonesian ACCD must open a Sub-SNA Thai baht account for their local businesses. Similarly, Thai ACCD must open an Indonesian Rupiah Sub-SNA for their local businesses. Sub-SNA accounts are mainly used for cross-border payments. Transfers, deposits or withdrawals are not allowed between Sub-SNAs. When Indonesian importers choose to pay the Indonesian exporter in Thai Baht, they can use the trade receipt to exchange Thai baht with Indonesian ACCD.

6. Allow businesses to make cross-border transactions.

Indonesian exporters receiving Thai baht and depositing in Sub-SNA can invest through Indonesian ACCD in assets denominated in Thai Baht in the Thai market. Investment income will be credited to Sub-SNA accounts. If Thai exporters have Indonesian Rupiah balances in Sub-SNA, it is also possible to invest in assets denominated in Indonesia Rupiah through Thai ACCD, and the investment income will be credited in the sub-SNA account.

7. Allow ACCD to provide trade financing for businesses.

Indonesian ACCD can provide financing in Thai baht to Sub-SNA accounts opened by Indonesian businesses. Similarly, Thai ACCD can provide financing in Indonesian rupiah to Sub-SNA accounts opened by Thai businesses.

8. Regulate the transfer of funds between ACCDs.

According to the agreement between the two countries' central banks, the SNA opened by Thai ACCD can transfer Indonesian Rupiah for Indonesian ACCD or Thai ACCD for current and forward exchange, and payment of interest. The SNA opened by Thai ACCD can also transfer Indonesian Rupiah with Indonesian non-ACCD account to complete the payment in Rupiah.

9. Regulate ACCD in the provision of quotation and market-making services for local currency exchange.

ACCDs in indonesia and Thailand are required to provide direct quotation for the Indonesian Rupiah against the Thai Baht, and provide current and forward exchange rates for the businesses who open Sub-SNA. ACCD must publish daily a exchange rate quotation of the Indonesian Rupiah against the Thai Baht on Reuters or Bloomberg.

In summary, LCS has several notable features:

Firstly, LCS is a comprehensive solution that not only provides cross-border local currency settlement and cross-border local currency flow management, but also designs local currency exchange and risk hedging schemes, local currency trade financing schemes, cross-border investment schemes, local currency quotes, and market-making service. LCS takes into account the use of the local currency in the current account and the use of the local currency in the capital project to form a self-circulation mechanism for the domestic currency at home and abroad.

Secondly, LCS focuses on the actual transactions. According to the LCS guidelines, LCS is applicable to the imports and exports of goods and services between the countries, and the cross-border direct investment (FDI) between countries. Customers who can open a Sub-SNA account must be an importer or exporter (including individuals, sole proprietors, partners or enterprises). Exchange, hedging and financing must also be targeted for imports and exports, and cross-border investment is limited to exporters of counterparties with a balance in the Sub-SNA account.

Thirdly, LCS adopts prudent opening measures, mainly reflected in SNA and Sub-SNA management. According to the MOU signed by the Central Bank of Indonesia and the Central Bank of Thailand, the end-of-day balance of Rupiah SNA in the Indonesian ACCD in Indonesia opened by Thai ACCD is limited to 400 billion Rupiah (USD2.8 million at the recent exchange rate). Indonesian ACCD in Thai SNA is capped at 1 billion Baht (USD32 million at the recent exchange rate). In addition, the Indonesian ACCD's SNA in Malaysia end-of-day balance is capped at 100 million Ringgit (USD24 million at the recent exchange rate), which in turn is 400 billion Indonesia Rupiah. Base on the above limits, the scale of investable financial markets is very limited. Sub-SNA accounts also have strict regulations that do not allow withdrawal and deposit of cash.

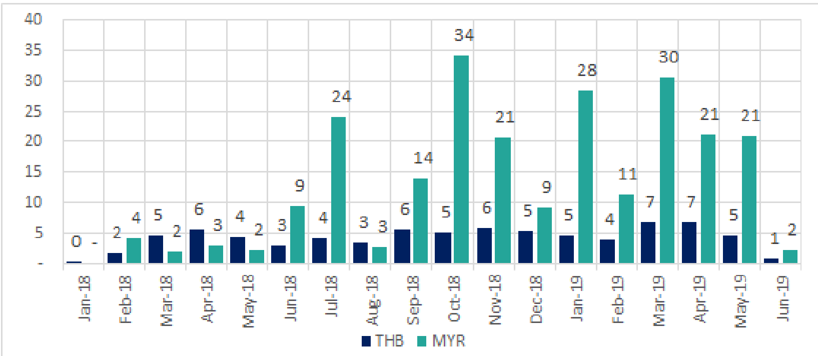
III. Prospect of LCS

Indonesia, Malaysia, and Thailand signed the LCS Agreement at the end of 2017 and implemented LCS starting from February 2018. They have made tremendous progress since then. In 2018, trades settled with LCS in Thai Baht totaled USD 49 million, and reached USD 29 million in the first half of 2019. In 2018, trades settled with LCS in Malaysian Ringgit totaled USD 125 million and reached USD 113 million in the first half of 2019. Comparing monthly average, monthly transaction in Thai Baht in 2019 amounted to about USD 5 million, 66% increase from USD 3 million in 2018. Monthly transaction in Malaysian Ringgit in 2019 increased 5.3 fold to USD 19 million from USD 3 million.

However, LCS still has huge growth potential in comparison to the volume of bilateral trade among the three countries. In 2018, the trade volume between Indonesia and Thailand equaled USD 18.2 billion and LCS only contributed 0.3%; the trade volume between Indonesia and Malaysia equaled USD 17.8 billion and LCS only contributed about 0.7%. LCS in Malaysian Ringgit grew exponentially this year and is expected to contribute to about 1% of the total trade volume.

Looking ahead, cooperation on local currency settlement will be the emphasis and LCS could be copied to other ASEAN countries. However, some countries' economies are less outward-facing and thus have limitations in developing LCS. It is still difficult to shake ASEAN's reliance on the USD, and settling in local currencies is constricted. In the foreseeable future, the development of LCS will be a slow process. According to approximate estimation, LCS could reach 2 to 3% of the total trade volume, and up to 3 to 5% in some countries.

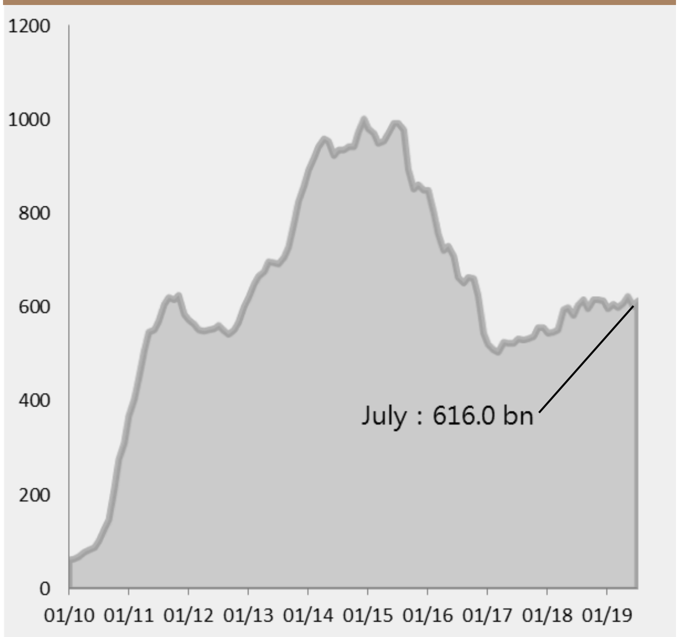
LCS transactions settled in Thai baht and Malaysian Ringgit by Indonesian businesses（in USD mn）



Source: Bank Indonesia, BOCHK Research

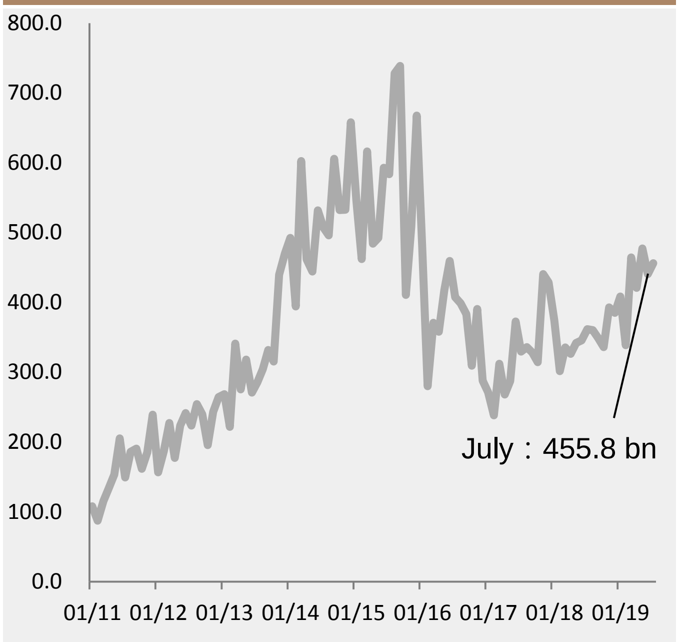
Market Indicators

Hong Kong RMB Deposits (in RMB bn)



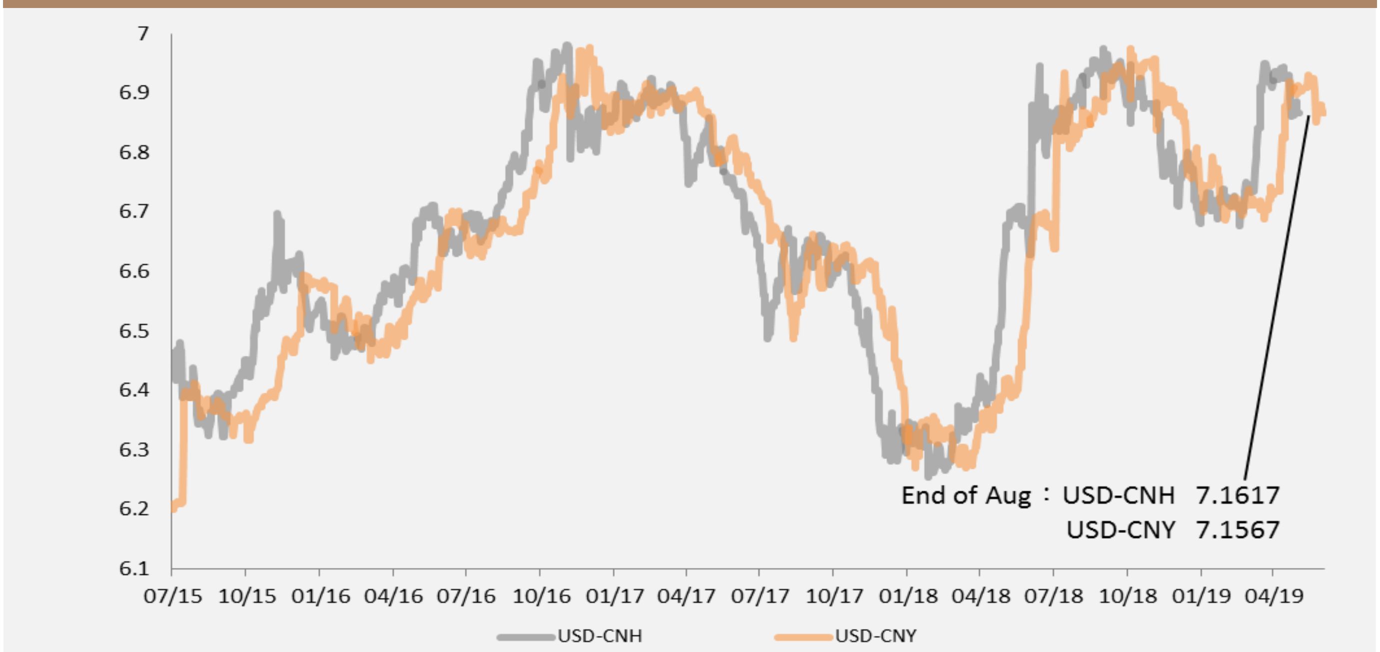
Source: HKMA

RMB Cross-border Trade Settlement (RMB bn)



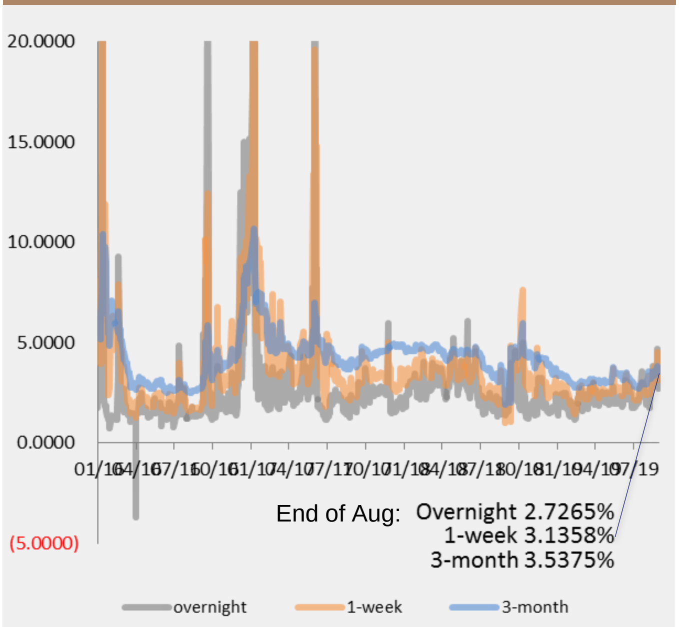
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



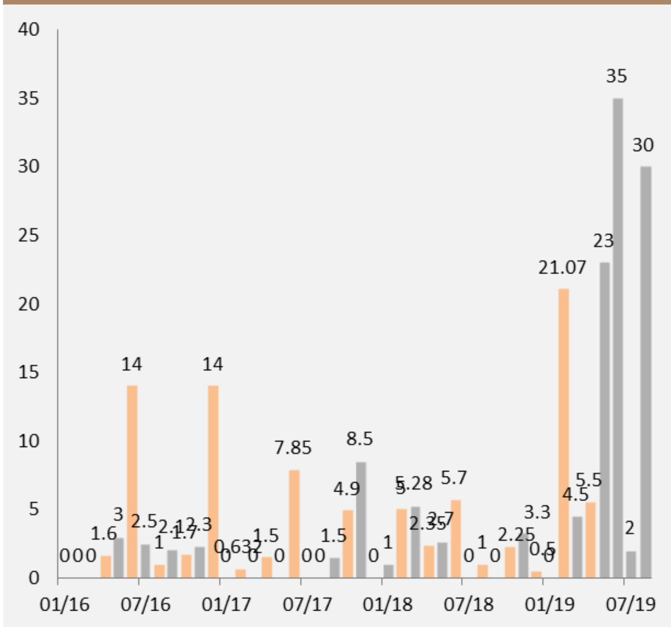
Source: Bloomberg

CNH HIBOR Fixing (%)



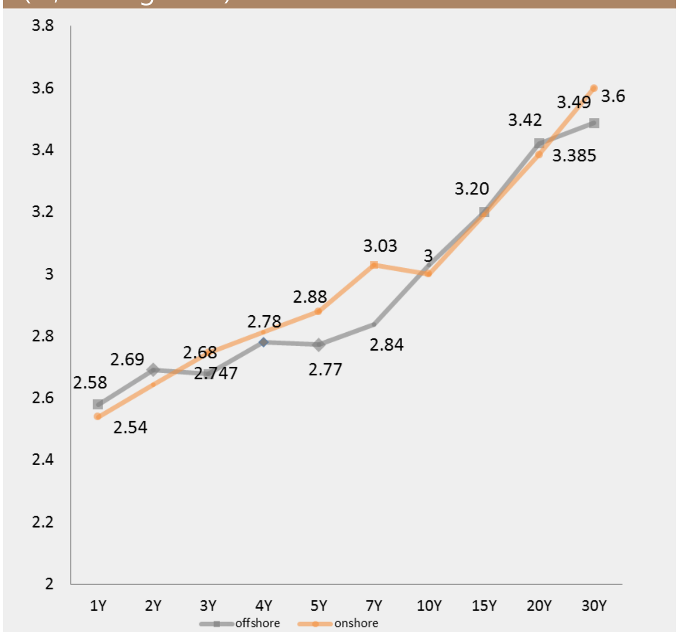
Source: Bloomberg

Hong Kong Offshore RMB Bond Issuance (RMB bn)



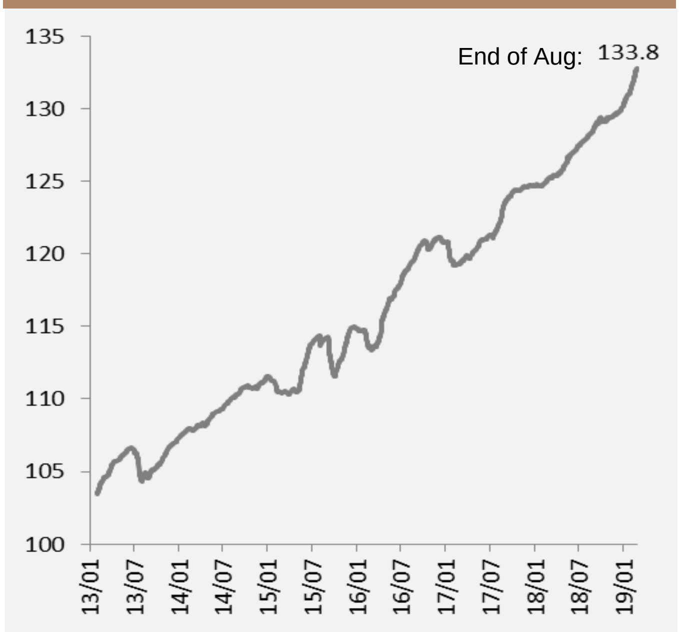
Source: BOCHK Global Market estimate

CNH & CNY China Sovereign Curve (%, 30 Aug 2019)



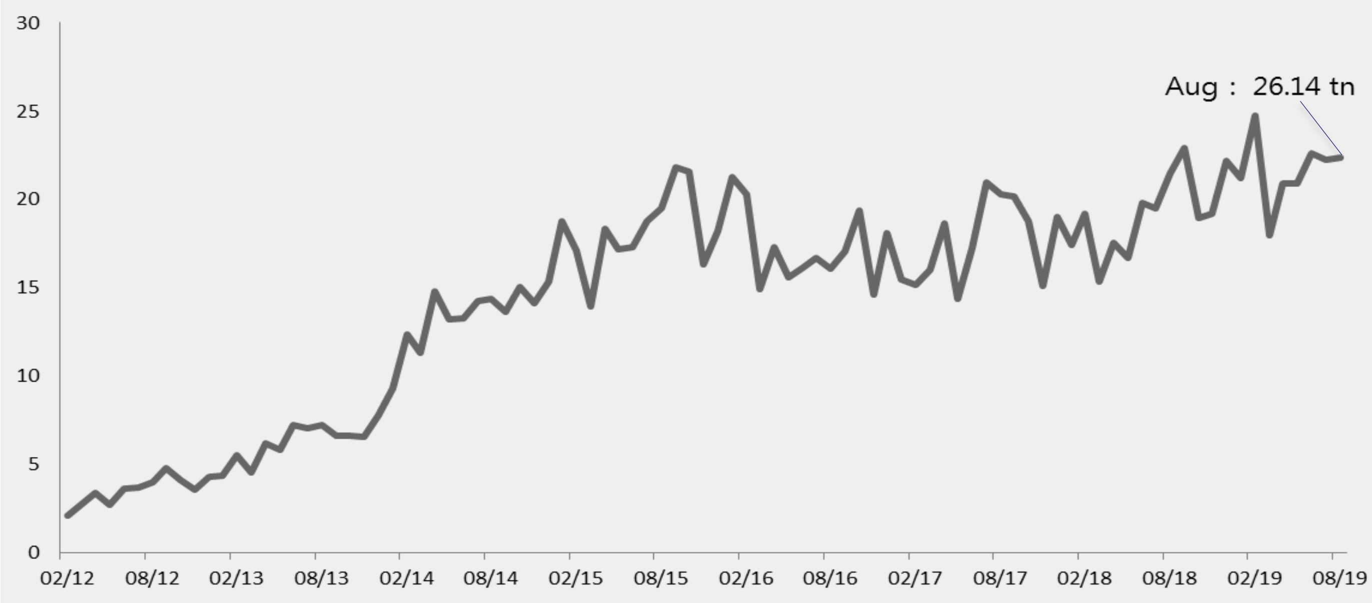
Source: Bloomberg

FTSE-BOCHK Offshore RMB Bond Composite Index



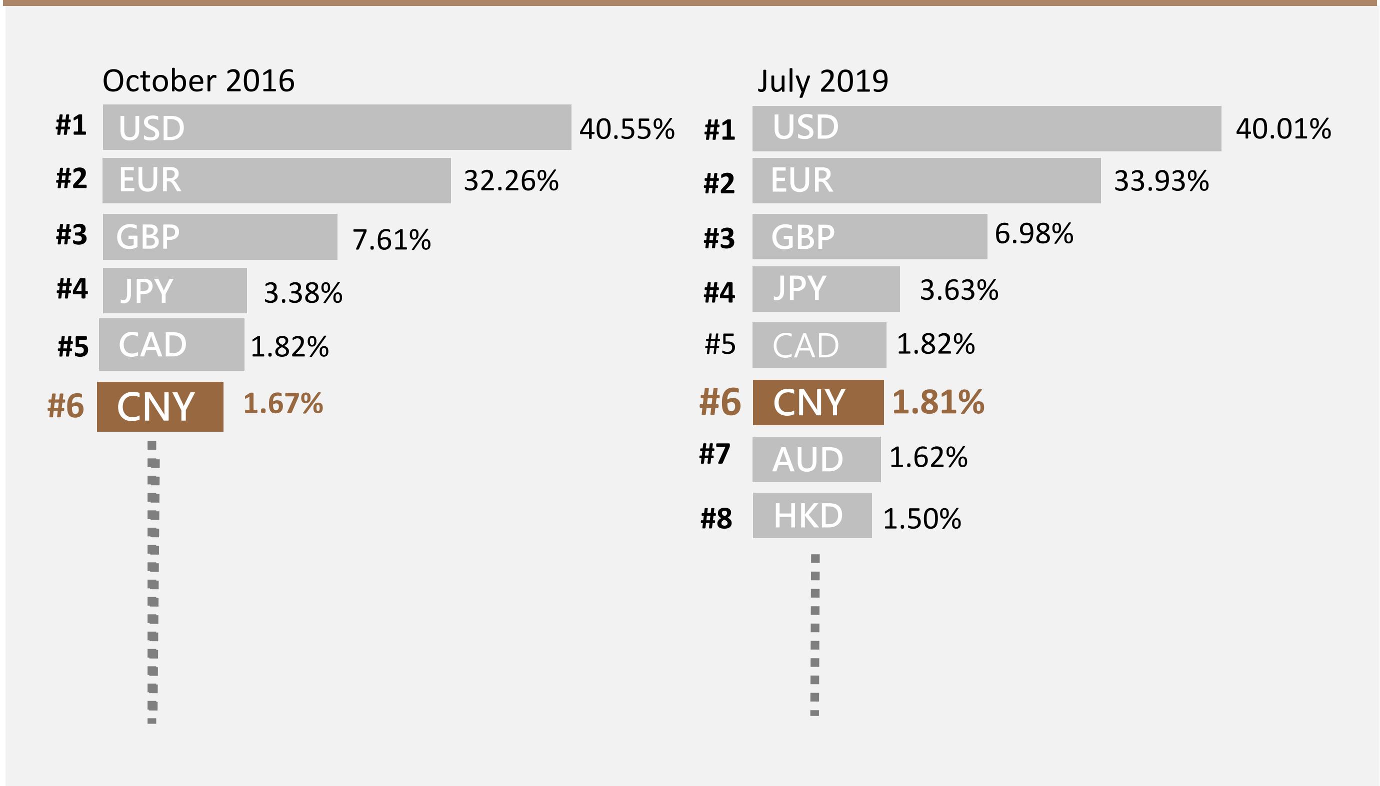
Source: Bloomberg

RMB Clearing Transaction Value (RMB tn)



Source: HKICL

SWIFT World payments currency ranking & market share



Source: SWIFT

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