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Offshore RMB Market - 2020 Review and Outlook

In 2020, the RMB exchange rate fluctuated widely in both directions but remained largely stable. The offshore RMB market continued to develop steadily. While there were fluctuations across various business indicators, the overall trend was positive with a healthy growth of the RMB funding pool. With further opening up of China's financial markets, global investors continue to increase RMB asset holdings, offshore investors holdings of China bonds surpassed RMB 3 trillion, while bond Connect transactions volume reached a record high. Offshore central bank notes issuance continued to support Hong Kong's dim sum bond market development. PBOC and several ministries issued a number of drafts and management policies on cross-border RMB policies and investment of onshore financial markets, showing the importance and support of the government to the internationalization of RMB, which also helps to expand the scale and depth of offshore RMB markets.

I. Offshore RMB market saw steady development in 2020

1. The RMB exchange rate rose steadily with two-way fluctuation

The RMB exchange rate in 2020 can be divided into two phases. In the first phase, the RMB exchange rates came under pressure from the beginning of 2020 to the end of May due to multiple adverse factors. CNH depreciated from 6.96 at the beginning of 2020 to 7.17, the lowest point of the year. In the second phase, the RMB exchange rates rebounded along with other major currencies from the end of May to year-end, as China was one of the first countries to recover from the COVID-19 and the DXY index weakened. During the year, the offshore RMB market in Hong Kong did not suffer from insufficiencies in liquidity, except for certain isolated periods of wide fluctuations in interest rates. CNH HIBOR remained below 3% for most of the time. As of December 31, the central parity rate of USD/RMB was reported at 6.5249, appreciating 6.3% compared to beginning of the year. USD/CNH closed at 6.5028, appreciating 6.6% compared to beginning of the year. USD/CNY was 6.5272, appreciating 6.3% compared to beginning of the year.

2. Major offshore RMB indicators hit record highs

In 2020, while there were fluctuations across RMB business indicators, the overall trend was positive with some indicators hitting record highs. Hong Kong's RMB funding pool surpassed RMB 700 billion. According to HKMA, as of the end of December 2020, Hong Kong's RMB deposits reached RMB 721.7 billion, surpassed RMB 700 billion level for 2 consecutive months, an increase of 14.2% compared to end of 2019. Hong Kong's RMB loans balance was RMB 152 billion, a decrease of 3.5% compared to end of 2019. According to Bloomberg, as of the end of December 2020, central bank notes continued to support offshore bond markets. Dim sum bond issuance amounted to RMB 188.85 billion (including RMB 155 billion central bank notes issued in 2020), increasing 3% compared to RMB 183.37 billion dim sum bond issuance in 2019. RMB settlement in cross-border trade marked record highs again, amounting to RMB 6.32 trillion in total in 2020, an increase of 17.6% over the same period last year. According to HKICL, total turnover of RMB RTGS system in 2020 reached RMB 282.5 trillion, an increase of 6.3% over the same period last year, indicating that the Hong Kong's RMB funding pool continues to support a large number of financial activities.

3. RMB's share of global foreign reserves hits historic high level

With the increased willingness of foreign central banks to hold foreign exchange reserves in RMB, the status of RMB as an international reserve currency has been gradually established. The latest data released by the IMF (COFER) report shows that as of 3Q 2020, RMB reserves rose to USD 244.52 billion, an increase of USD 26.85 billion from the end of 2019, accounting for 2.13% of the total allocated foreign exchange reserves, higher than 2.05% of previous quarter, the highest level since IMF started reporting RMB reserve assets in October 2016.

According to SWIFT, RMB retained its position as the fifth most used currency in December 2020, accounting for 1.88% of all global currency payments, second only to the USD, EUR, GBP and JPY.

4. Offshore investors continue to increase holdings of RMB assets

The bond yields of global bonds fell dramatically as a result of global major central banks continues to adopt loosen monetary policies. At the same time, the US re-introduced quantitative easing. The interest rate spread between China and the US widened to around 250 basis points, a historic high, attracting overseas institutional investors to invest in China bonds and supporting the RMB. Over RMB 100 billion of overseas capital monthly inflow to China bond market has become a new normal, proving the attractiveness of the China bond market, even if the interest rates spread between China and the US narrow in the future, it will not necessarily result in large scale of capital outflows. As of December 2020, foreign investors' RMB bond holdings reached RMB 3.25 trillion, an increase of 48.8% YoY. Accumulated capital inflow in 2020 was over RMB 1 trillion. China Government bonds is still the favorite bond type among offshore investors, constituting over 60% of overseas investors' China bonds holdings.

After more than 3 years of operation, Bond Connect marked historic highs in transactions volume, average daily transactions, as well as in the number of approved investors. In 2020, the total trading volume of Bond Connect amounted to RMB 4.81 trillion, increasing by 82.8% compared to previous year. Total number of onboarded institutional investors advanced above 2352, increasing 46.9% compared to previous year. Bond Connect trading volume reached a new single-day record breakthrough at RMB 36.94 billion on 16 December, 2020. During the year, the trading mechanism of Bond Connect was further improved, including improvements in Currency conversion and FX risk management arrangement. Bond Connect investors are now able to conduct FX trades with up to 3 FX settlement banks with extended trading hours.

5. Offshore central bank notes issuance continues to support Hong Kong's dim sum bond market development

Since November 2018, the People's Bank of China had issued 25 batches of central bank notes totaling RMB 315 billion in Hong Kong, and a mechanism for issuing central bank notes regularly in Hong Kong was gradually established. The term structure had also extended to 1 month and 6 months, from 3 months and 1 year initially. Dim sum bond market continued to rebound in 2020. As of the end of December 2020, dim sum bond issuance amounted to RMB 188.85 billion, an increase of 3% compared to same period in 2019.

China's Ministry of Finance issued RMB 5 billion of RMB Government Bonds and PBOC issued RMB 155 billion of central bank notes, satisfying the investment needs of overseas investors. Non-sovereign type dim sum bonds issuance were mainly Chinese financial institutions and Chinese enterprises, with total issuance of RMB 28.85 billion, increasing RMB 2.48 billion compared to same period in 2019. The average issuing rate in 2020 was around 2.8%, and 2.2% for central bank notes (mainly 3 months, 1-year tenor)..

II. The internationalization of RMB has entered a new period of opportunity in 2021

RMB internationalization has entered a new period of opportunity in its second 10 years. Offshore markets are more willing to accept and use RMB, while overseas central banks and institutional investors continue to increase RMB assets holdings. China has been actively positioning themselves for the work related to internalization of RMB. PBOC and other government authorities jointly introduced new policies and measures to promote cross-border RMB businesses and investments in the China capital market, which helped to accelerate the opening up of the onshore bond market and integrated China markets into the global financial system, to provide strong support for the internationalization of RMB, and to bring significant opportunities to Hong Kong financial institutions.

The progress of economic recovery will continue to dominate the trend of RMB exchange rate. In 2021, internal factors such as recovery of the China economy, macro-adjustments and monetary policies will continue to determine the trend of the RMB exchange rates. External factors include development of COVID-19, effects of vaccines, US diplomatic policies to China and the trend of Euros, etc. Recently, the DXY index climbed back to 90 level after rising a few days consecutively, reaching a two-month high, but further opening of the financial market encouraged foreign financial institutions to participate in China's financial market. Lower market entry barriers would encourage more foreign investors to hold RMB assets, alleviating the pressure of significant depreciation in the RMB. Overall, the RMB exchange rates is expected to remain stable with two-way fluctuations. The trend of CNH will depend on movements of major currencies such as USD, EUR, JPY, as well as factors such as changes in economic situations, balance of payments and FX markets, etc.

RMB policies are becoming more open to meet diverse needs of international investors. In the "CCP Central Committee Recommendations on the Formulation of National Economic and Social Development Targets for the 14th Five Year Plan and the 2035 Vision", it called for "high-level external opening and firmly implementing external opening across a greater scope and deeper levels", providing important guidance for the next steps in RMB internationalization. In September 2020, PBOC and several ministries have issued a number of drafts and management policies on cross-border RMB policies and investing in onshore financial markets, showing the importance and support of the government to the internationalization of RMB. The announcements of these policies clarify the policies ideas and gradually increase support for cross-border RMB activities and investments in RMB assets, also to further optimize and improve the policy framework for the use of RMB, showing a strong policy synergy.

The use of the RMB as an international currency will continue to increase. Along with the increasing economic and trade cooperation between China and "Belt and Road" countries, the growth of direct investment and the "Belt and Road" projects will promote the use of RMB as a settlement, investment and reserve currency in the offshore market, also creating real demands for offshore RMB. Most "Belt and Road" countries have established monetary cooperation relationships with China, including the appointment of RMB Clearing Banks, the signing of currency swap agreements, etc. Some other countries considered and promoted Local Currency Settlement Framework (LCS) to reduce dependence on USD, benefiting international use of RMB, and promoting positive synergy between RMB internationalization and the Belt and Road Initiative.

Hong Kong will continue to function as an offshore RMB hub. While the onshore capital markets continue to open up, it is expected that there will be a long-term upward trend in the demand for RMB asset allocation and holdings from foreign investors. At the same time, the expansion of QDLP/QDIE and the future launch of Southbound Bond Connect, represents the new characteristics of China's capital market opening in both directions. Hong Kong is the main offshore RMB clearing center and RMB foreign currency center, with unique channels connecting onshore and offshore capital markets, including Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and Bond Connect, where overseas investors can access onshore capital markets through Hong Kong. Onshore investors can also invest overseas through Hong Kong. Looking ahead, Hong Kong will continue to leverage its unique advantages and follow the needs of the market, to introduce more stock and bond related products and services on the basis of Connect Schemes, to provide greater convenience for investors, and to continue to play a critical role in the development of RMB internationalization.

RMB Internationalization Updates

2020

JAN 1 13 FEB 1 12 13 14 MAR 26

SAFE further facilitates forex risk management of foreign institutional investors

SAFE released Huifa No. 2 [2020] Circular in order to offer more foreign exchange hedging channels to foreign institutional investors in the interbank bond market. Key measures include allowing foreign non-banking investors to enter the interbank foreign exchange market by dealing with domestic financial institutions over the counter or indirectly through becoming a prime broker..

ISDA to attract more foreign investment in China

Chinese government made a series of moves to open up its financial sector, including allowing foreign institutions to freely choose to sign NAFMII, SAC or ISDA master agreements to conduct onshore OTC derivatives transactions.

Implementation Plan for China (Guangxi) Pilot Free Trade Zone announced

The Guangxi government announced the "Implementation Plan for the China (Guangxi) Pilot Free Trade Zone", featuring pilot scheme between China and ASEAN, opening up of financial markets and cross-border use of RMB.

Beijing strengthened financial support against COVID-19

The Chinese government issued a total of 30 measures to boost financial support, such as simplifying the procedures for FX and cross border RMB settlement, during efforts to combat the spread of COVID-19.

PBOC issued 10 billion yuan bills in HK

PBOC issued 10 billion yuan 6-month central bank bills in Hong Kong, with the interest rate standing at 2.19% and the bid amount 2.8 times the circulation.

U.S. dropped currency manipulation charge against China

According to the US Treasury Department, the United States has dropped its designation of China as a currency manipulator.

PBOC issued 30 billion yuan bills in HK

PBOC issued two tranches of central bank bills in Hong Kong, including RMB 20 billion 3-month bills and RMB 10 billion 1-year bills, with the interest rate standing at 2.55% and 2.60% respectively.

PBOC cut RRR

PBOC announced to cut the reserve requirement ratio by 0.5 percentage point with effect from January 6, injecting over RMB 800 billion of long-term liquidity into market.

NDB financed emergency loan to China

New Development Bank raised RMB 5bn from a Panda bond public offering to help China finance increased expenditures on public health. It is the first coronavirus-themed Panda bond from a multilateral financial institution.

BOCHK Phnom Penh Branch became CIFM member

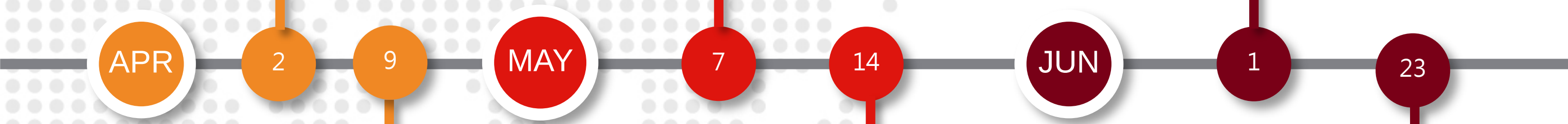
PBOC approved Bank of China (Hong Kong) Limited, Phnom Penh Branch to become a member of the China Inter-bank Foreign Exchange Market and to conduct regional FX transactions between Yuan and Riel.

PBOC & SAFE removed QFII/RQFII investment quotas

Beijing issued PBOC & SAFE Announcement〔2020〕No. 2, with key points including the removal of restrictions on investment quota of QFII/RQFII investors and the limits on the number of custodians etc.

China released Hainan free trade port plan

The plan aims to build Hainan province into a free trade port, which will be "basically established" by 2025, becoming "more mature" by 2035, showcasing the country's commitment towards both post-pandemic recovery and long-term growth.



PBOC issued 10 billion yuan bills in HK

PBOC issued 10 billion yuan 6-month central bank bills in Hong Kong, with the interest rate standing at 2.22% and the bid amount 3.4 times the circulation.

China unveiled guideline on improving market-based allocation of production factors

According to the guideline, China will expedite the development of the bond market through a variety of measures, including promoting the connectivity with offshore bond markets, and strengthening the access management of credit rating agencies to the bond market.

PBOC issued 30 billion yuan bills in Hong Kong

PBOC issued two tranches of central bank bills in Hong Kong, including RMB 20 billion 3-month bills and RMB 10 billion 1-year bills, with the interest rate standing at 1.77% and 1.78% respectively.

China issued guidelines to boost financial support for Greater Bay Area

The guideline put forward 26 specific measures for these five areas: promoting the Greater Bay Area's cross-border trade and facilitating investment and financing, expanding the opening-up of the financial sector, promoting the connectivity of financial markets and financial infrastructure, boosting innovation of the Greater Bay Area's financial services, and preventing cross-border financial risks.

Guangdong 80 measures enhance financial innovation in the Greater Bay Area

The Guangdong Financial Regulatory Bureau introduced the “Implementation Plan for Execution of the Opinions on Financial Support for the Development of the Guangdong-Hong Kong-Macao Greater Bay Area” (Implementation Plan), which are further sub-divided into 80 measures across five areas。

CFETS enhances FX related arrangements under the Bond Connect scheme

CFETS announced *Notice on the Implementation of the Enhanced Arrangements of the Currency Conversion and FX Risk Management under the Bond Connect Scheme.*

PBOC issued RMB 10 billion central bank bills in Hong Kong

PBOC issued RMB 10 billion central bank bills in Hong Kong, with bidding total exceeding RMB35 billion, a term of six months and a rate of 2.68%.

PBOC publishes Draft on Issues Concerning Investment in China’s Bond Market by Overseas Institutional Investors

PBOC, CSRC and SAFE announced *Notice of Request for Public Comment on the Exposure Draft on Issues Concerning Investment in China’s Bond Market by Overseas Institutional Investors.*

PBOC publishes Draft on Investment Fund management in China’s Bond Market by Overseas Institutional Investors

PBOC and SAFE announced *Notice of Request for Public Comment on the Exposure Draft on Investment Fund management in China’s Bond Market by Overseas Institutional Investors.*

JUL 31 AUG 1 SEP 2 18 21 24 25

CFETS waives transaction fees between the yuan and some currencies in its onshore foreign exchange market

China Foreign Exchange Trade System (CFETS) said in a notice that it was waiving fees associated with bid and ask prices in interbank trading of the yuan and a dozen currencies, including Singapore dollar, Russia ruble, Malaysian ringgit, New Zealand dollar, South African rand, Saudi riyal, UAE dirham, Polish zloty, Hungarian forint, Turkish lira, Korean won and Thai Baht, for three years.

China further optimizes cross border RMB policies

PBOC, NDRC, MOFCOM, SASAC, CBIRC and SAFE announced *Notice of Request for Public Comment on the Exposure Draft on Further Optimizing Cross Border RMB Policies and Support for Stabilization of Foreign Trade and Investment.*

China releases new measures of QFII & RQFII investment management

CSRC, PBOC and SAFE announced *Administration Measures of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors.*

FTSE Russel announced its inclusion of Chinese Government Bonds into the FTSE WGBI

FTSE Russel announced its positive affirmation to include Chinese Government Bonds in to the FTSE World Government Bond Index (WGBI) with inclusion scheduled to start from October 2021.

OCT 11

China unveils plans to pilot reforms in Shenzhen on building socialist demonstration area

The general offices of the Communist Party of China Central Committee and the State Council issued the Implementation Plan for the Pilot Comprehensive Reform of Building a Pilot Demonstration Zone of Socialism with Chinese Characteristics in Shenzhen ("Pilot Reforms Plan 2020-2025"). As provided under the Pilot Reforms Plan, the list of the first batch of comprehensive authorised pilot reforms has also been released

NOV 3

RMB Internationalization in 14th Five Year Plan

The Chinese Communist Party (CCP) released the "CCP Central Committee Recommendations on the Formulation of National Economic and Social Development Targets for the 14th Five Year Plan and the 2035 Vision". The Recommendations called for "high-level external opening and implementing external opening across a greater scope and deeper levels

Cross-border RMB Trade Finance Platform Kicks off

China officially launched the operation of the Cross-border RMB Trade Finance Transfer Services Platform. A total of 64 institutions are already participants, including 24 domestic institutions and 40 overseas institutions situated in 15 different countries and regions

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PBOC successfully issued RMB25 billion bills in Hong Kong

PBOC has successfully issued two batches of RMB bills in Hong Kong on November 12. Of the total bills, RMB10 billion will mature in three months, and RMB 15 billion will mature a year later, with the interest rates standing at 2.85% and 2.9% respectively

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PBOC and Hong Kong Monetary Authority Expand Currency Swaps Agreement

The People's Bank of China (PBOC) and the Hong Kong Monetary Authority (HKMA) recently extended their currency swaps agreement, expanding the reciprocal volume from RMB 400 billion/ HKD 470 billion to RMB 500 billion/ HKD 590 billion, with effective period of five years

DEC 2

Hong Kong, mainland studying framework of Southbound Bond Connect

Discussions have begun to allow Chinese investors to trade bonds in Hong Kong, a move that will "generate enormous opportunities" for the city's financial services industry and has the potential to strengthen its status as an international financial centre.

2021

JAN 4

Six Chinese government departments reunited to optimize cross-border RMB policies

PBOC, the Ministry of Commerce, the China Banking and Insurance Regulatory Commission, the State Administration of Foreign Exchange and the National Development and Reform Commission jointly issued the "Notice on Further Optimising Cross-border Renminbi Policy and Supporting the Stabilisation of Foreign Trade and Foreign Investment" (Yinfa[2020] No.330)

2020: The Start of A Long-Term RMB Bull Cycle?

David Zhang, Senior Economist
Jianghui Chen, Economist

In 2020, the RMB largely fell for five months before rising steadily against the US dollar, ending the year with an annual appreciation of 6.7%, the same amount that the US dollar index fell by in 2020. This was mainly due to widening economic growth differentials caused by disparate pandemic control measures between China and the United States, as well as the widening of China-US interest rate differentials amid shifts in balance of payments. Entering 2021, the RMB appreciation trend looks to continue after it re-entered the 6.4 territory for the first time in 30 months. The RMB may experience short-lived rebounds periodically, but in the medium to long-term, it has likely entered a bull cycle against the US dollar.

Long-term factors for RMB appreciation

1. China's economic fundamentals continue to be better than those in the US

In the medium to long-term, the difference in economic development is the most important factor in determining the exchange rate between two countries. The continuous appreciation of the RMB against the US dollar since June 2020 is a good example. After the outbreak of COVID-19, China adopted a series of prevention and control measures. Its economy was the first in the world to recover, and foreign trade activities rebounded rapidly. Its 2020 annual economic growth was 2.3%, making it the only major economy in the world to record positive growth. However, affected by multiple waves of the pandemic, the US GDP contracted 3.5% in 2020, setting the worst record since World War II. The difference in economic growth provided tremendous support for the RMB relative to the US dollar since June 2020.

China's economic growth rate is likely to be faster than that of the US in the medium to long-term. China is still a developing country. According to data from the World Bank, China's per capita GDP in 2019 was only 15% that of the United States.

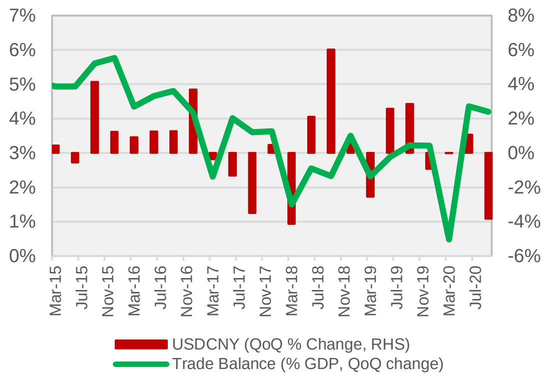
China’s urbanization rate is about 60%, far from the average level of 80% in developed countries. China has surpassed the United States to become the country with the most number of scientific researchers in the world. Since 2019, it held the world’s largest number of international patent applications. At the same time, China has the most extensive industrial system in the world. With the country's continued economic opening and continuous manufacturing and consumption upgrades, China's economy is expected to achieve a relatively high growth rate in the next 5-10 years. On the other hand, the 2020 US presidential election showed that political frictions and social tensions are rampant, partly due to an aging society with high income disparity, and these problems may not be completely resolved in the short term. Calculated in constant US dollars, China's GDP in 2020 is about two-thirds of the United States. At current growth projections, China is likely to surpass the United States to become the world's largest economy around 2027. Relatively faster economic growth will promote the continuous appreciation of the RMB.

2. More dependence on domestic demand and less reliant on exports

China's internal circulation policy is going to reduce its trade surplus. In the next few years, China will promote the formation of a new development pattern in which domestic and international circulations promote each other. This policy is actually dictated by China's development stage. It is difficult for a large country to sustain its modernization through exports and global consumption. On the contrary, the advantage of a large country is precisely that it does not need to rely on foreign demand to realize its own modernization. For now, consumption upgrades will become the core of China's high-quality development. The process of China becoming a bigger consumer is in synch with the process of reducing foreign trade surplus. Exports are likely to decrease due to higher labor costs and the phase-out of low-end manufacturing. This process usually occurs at the same time as consumption upgrades, which drive further import growth.

In general, the decline in China's foreign trade surplus is positively correlated with the appreciation of the RMB. Changes in the foreign trade surplus are closely related to the RMB exchange rate as they influence each other. Logically, lower trade surplus may be caused by lower domestic industrial production, leading to less foreign demand for RMB; or it could be caused by higher domestic consumption, leading to RMB appreciation.

Exhibit 1: USDCNY (QoQ) vs. China Trade Balance (QoQ)



Source: CEIC, BOCHK Financial Research Institute

However, from 2017, the reduction in China's foreign trade surplus has been positively correlated with the RMB (exhibit 1). A side benefit of reduced foreign trade surplus is that it is conducive to the internationalization of the RMB. Judging from global experience, countries with trade deficits are more likely to internationalize their currencies. The proportion of trade surplus relative to GDP for major countries is negatively correlated with the proportion of domestic currency used in global trading and investments. That is to say, foreign trade deficit countries will have more domestic currencies circulating overseas, promoting the internationalization of domestic currencies.

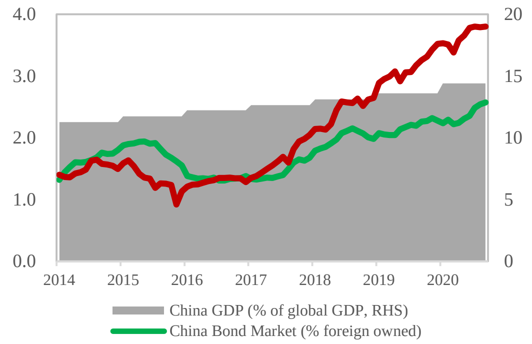
3. Foreign investments continue to enter China amid financial sector opening

China's financial opening is increasing, and funds continue to flow into China. In recent years, China’s capital market liberalization measures have been implemented intensively. China has successively removed a series of foreign shareholding restrictions in the financial sector. At the same time, it has granted foreign capital with domestic treatment in the fields of corporate credit checking, credit rating, payment and settlement. With the international integration of taxation and transaction systems, foreign-funded institutions continue to expand their business footprints in China. The “Global Investment Trends Monitor” issued by the UNCTAD showed that China received USD 163 billion of foreign direct investment in 2020, surpassing the United States to become the world’s largest destination for foreign direct investment. The continuous influx of overseas funds is also an important factor in the appreciation of the RMB.

The current proportion of financial assets allocated to China is still deficient. China is the world's second largest economy, accounting for around 14% of global GDP. However, the allocation of Chinese assets in the global investment portfolio is much lower than this figure. As of the third quarter of 2020, overseas investors held only about 4% of China's floating stock market shares, contributing to 10% of average daily transactions. Similarly, foreign ownership of onshore RMB bonds totaled 3.3 trillion yuan in 2020, but the proportion of foreign ownership was still less than 3%.

The proportion of global assets allocated to China may gradually approach the proportion of China's share in the world economy in the future (exhibit 2). Therefore, it is not difficult to see that in the next 5-10 years, RMB assets will be sought after by international capital.

Exhibit 2: China GDP vs Foreign Ownership of Chinese Assets



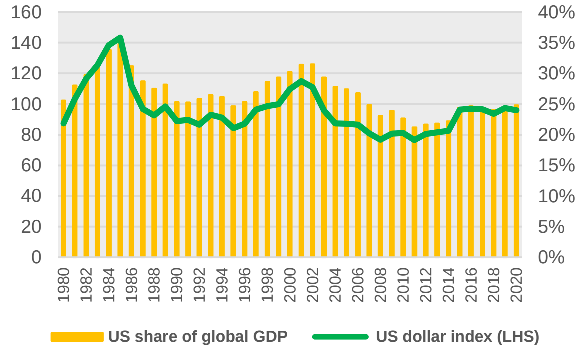
Source: CEIC, BOCHK Financial Research Institute

Long-term factors for US dollar depreciation

1.US dollar's international usage to converge with US share of global GDP

The value of the US dollar has generally followed the US relative contribution to global GDP, except when there was a US dollar liquidity crunch, which occurred in 2008 and 2020 (exhibit 3). The IMF projected US GDP to slow from 5.1% in 2021 to 1.8% in 2025, while global GDP growth is projected to slow more gradually, from 5.5% to 3.5% over the next 5 years. A decline in the US share of global GDP does not bode well for its currency in the long run.

Exhibit 3: DXY vs. US Share of Global GDP



Source: CEIC, BOCHK Financial Research Institute

Exhibit 4: DXY vs. US Share of Global SWIFT Payments

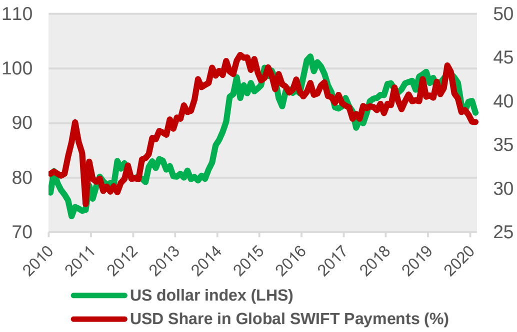
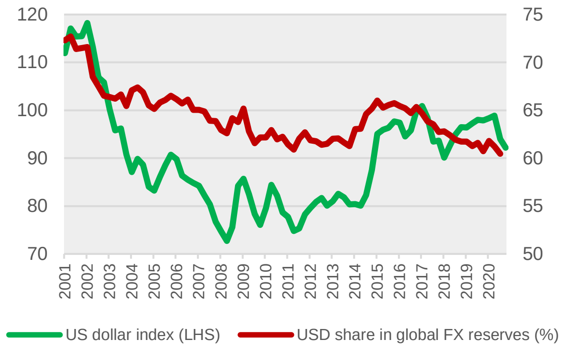


Exhibit 5: DXY vs. US Share of Global FX Reserves

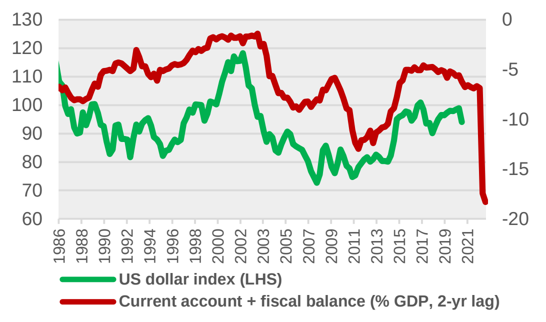


Source: CEIC, BOCHK Financial Research Institute

A depreciating US dollar has lessened the incentive for global businesses to settle cross-border payments in US dollars and for sovereign investors to store FX reserves in US dollars (exhibit 4-5).

With China's long-term growth strategy of focusing more on internal consumption and less on exports, and OPEC countries' shrinking oil exports due to the growth of the US fracking industry, there's less structural demand to store excess reserves in US dollar assets. Furthermore, since 2014, China (Cross-border Interbank Payment System), Russia (System for Transfer of Financial Messages), and EU (The Instrument in Support of Trade Exchanges) have all developed their own trade settlement systems to avoid potential US sanctions as geopolitical risk increased. Such strategic moves away from US dollar settlements and reserves also puts downward pressures on the US dollar.

Exhibit 6: DXY vs. US Twin Deficit



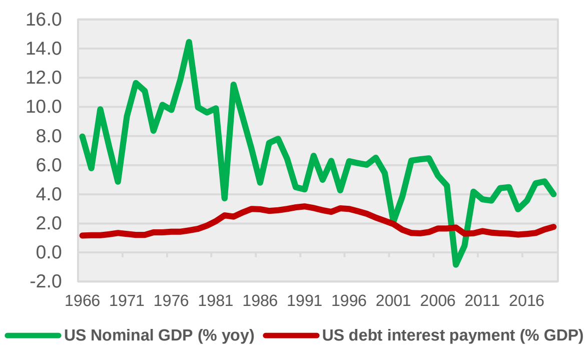
Source: CEIC, BOCHK Financial Research Institute

2. US twin deficits may continue to pressure the US dollar

The total US twin deficits tend to lead the US dollar by about two years (exhibit 6). However, the sharp increase in the US twin deficits in 2020 is not as concerning given that it was mostly due to higher fiscal deficit in 2020, which was the case for most of the G20 countries. The outlook for the US current account does not look bright given a shrinking labor force with less savings, while many investments are still needed in education and infrastructure. However, the US Treasury Department may continue to designate currency manipulators, which recently included China, Vietnam, and Switzerland, in order to limit US dollar appreciation and thus improve its current account deficit.

The outlook on the US fiscal deficit does not look bright either, as it is projected to increase gradually from an average of 3% in the past 50 years to 13% by 2050 according to the September 2020 Long-Term Budget Outlook from the Congressional Budget Office. However, the US 10-year real interest rate is currently negative, while the cost of debt service relative to GDP in the US has been mostly lower than its GDP growth for the past 50 years (exhibit 7).

Exhibit 7: US Nominal GDP vs. US Debt Interest Payment

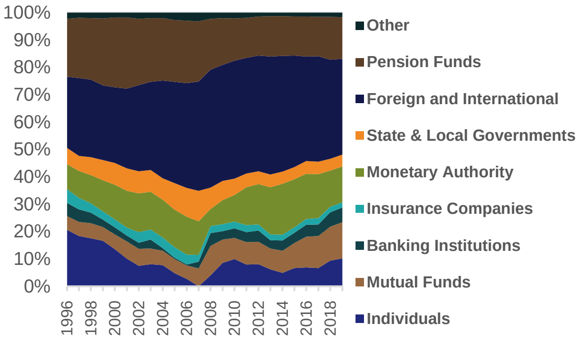


Source: FRED, SIFMA, BOCHK Financial Research Institute

A more technology-driven society suffering from income inequality is likely to spend less per capita, which is likely to keep real rates low. Such an environment not only keeps the cost of debt service low, but also provides more room for more fiscal stimulus to boost GDP growth in the long run. Market perception of US debt sustainability is unlikely to be affected by the level of US debt as long as the cost of debt service relative to GDP remains lower than GDP growth. For example, the reaction of the US sovereign CDS spread was rather muted after Fitch Ratings announced a negative outlook on the US sovereign rating in July 2020.

Foreign investors, who hold 35% of US sovereign debt, are considered more fickle than domestic investors. Nonetheless, the US has low foreign currency denominated debt, relatively low short-term debt, and is considering the issuing of 50-year debt. As long as interest rates are low across all advanced economies, domestic US investors, including insurers and pension funds that have long duration liabilities and banking institutions that have stringent regulatory capital requirements, are likely to fill in the vacuum left by foreign investors. Such a handover has already occurred since the 2008 financial crisis (exhibit 8) and may keep interest rates low, leading to less impetus to repair the fiscal deficit.

Exhibit 8: Ownership Profile of US Treasury Securities



Source: FRED, SIFMA, BOCHK Financial Research Institute

Potential risks of a long-term RMB bull

1. Digital currency

The current international monetary system is a fiat monetary system that completely relies on the credit of the central bank. It is dominated by the U.S. dollar, subsequently by the Euro, and supported by the British Pound, Japanese Yen, and Chinese RMB. This system originated from the Bretton Woods system with the US dollar at its core in 1945. After the US dollar decoupled from gold in 1971, the system turned towards fiat currencies based purely on the credit of central banks. Since then, it experienced many crises and changes, including the transition from fixed exchange rate to floating exchange rate systems, the decline of the Pound, the rise of the Yen, the birth of the Euro, and the internationalization of the RMB. To this day, the US dollar's pillar position in this system is still as strong as a rock.

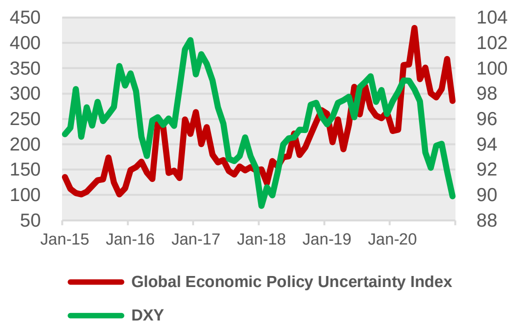
In recent years, the rapid development of digital currency has posed an unprecedented challenge to the existing monetary system. Examples include Central Bank Digital Currencies (CBDCs) such as the DCEP in China and stable coins such as Facebook's Libra. Theoretically, independent digital coins can gradually evolve into an international pillar currency to replace the US dollar. On the other hand, CBDCs can make payment and settlement more convenient, and could lead to the formation of a multi-pillar, diversified, and more balanced international monetary system. All of these developments could have a huge impact on the RMB exchange rate.

2. Geopolitical uncertainties

The geopolitical world has entered an unprecedented stage of uncertainty, and global balance of power is undergoing the most revolutionary change in modern times. The current international governance system is undergoing profound adjustments as the world's economic center of gravity accelerates from west to east. A new round of scientific and technological revolution and industrial transformation is reshaping the world. Emerging markets and developing countries have continued to increase their international influence, currently making up almost 60% of global GDP in Purchasing Power Parity terms. The voice of global governance is increasingly tilting towards developing countries, and the geopolitical world is ushering in a new round of reshuffling.

The multi-dimensional conflict between China and the United States may continue for a long time. With a Biden administration, Sino-US economic and trade frictions may have a chance to ease in the short term, and bilateral dialogues is expected to resume. However, in the medium and long term, it is difficult for the United States to reverse its trend of containing the rise of China. The West may form a coalition to shape rules in environment, labor, trade, technology, and transparency that prevent China from dominating global technological and industrial development. For example, the Global Economic Policy Uncertainty Index, based on the frequency of news on economic policy disruptions, has shown a strong positive correlation with the US dollar index since 2015 (exhibit 9).

Exhibit 9: DXY vs. Global Economic Policy Uncertainty Index



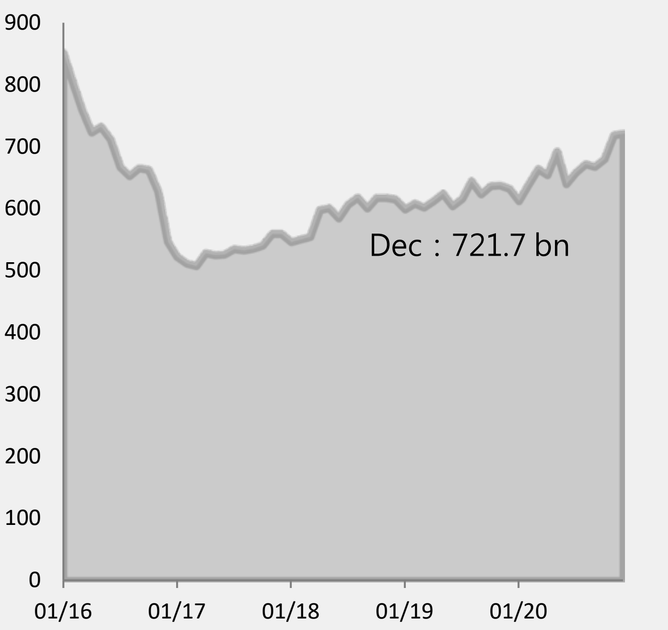
Source: FRED, BOCHK Financial Research Institute

Conclusion

The RMB is likely to rise against the US dollar in the next 5-10 years given China's continued urbanization, high-quality labor force, and low GDP per capita. A weaker trade surplus coupled with a stronger financial account surplus will be conducive to a stronger and more internationalized RMB. Externally, the US dollar's international usage is likely to converge to US share of global GDP, leading to a weaker US dollar over time. Furthermore, the continued sustainability of US sovereign debt amid a low interest rate environment may curb fiscal conservatism, also putting pressure on the US dollar. Major risks to this long-term view include the development of digital currencies and geopolitical uncertainties. Other risks worth exploring include the willingness of PBOC to further open up the capital account, the impact of a strong RMB on Chinese exporters, and the Fed's timeline for monetary policy normalization

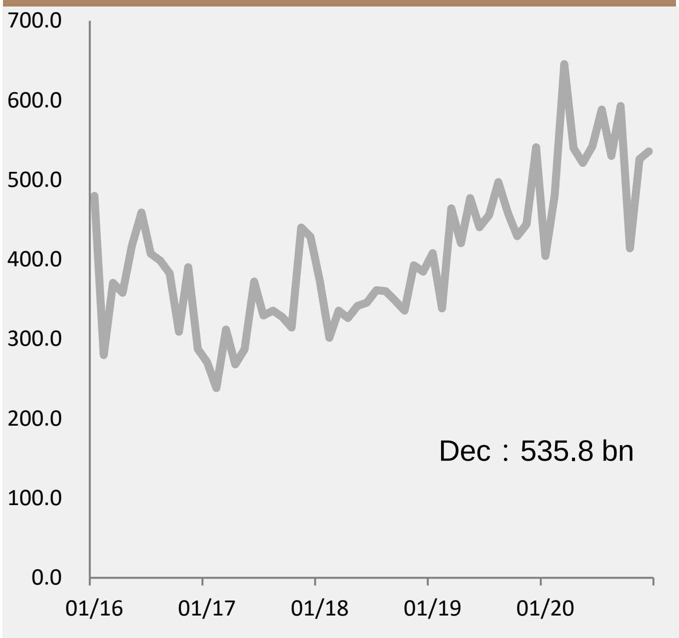
Market Trends

Hong Kong RMB Deposits (in RMB bn)



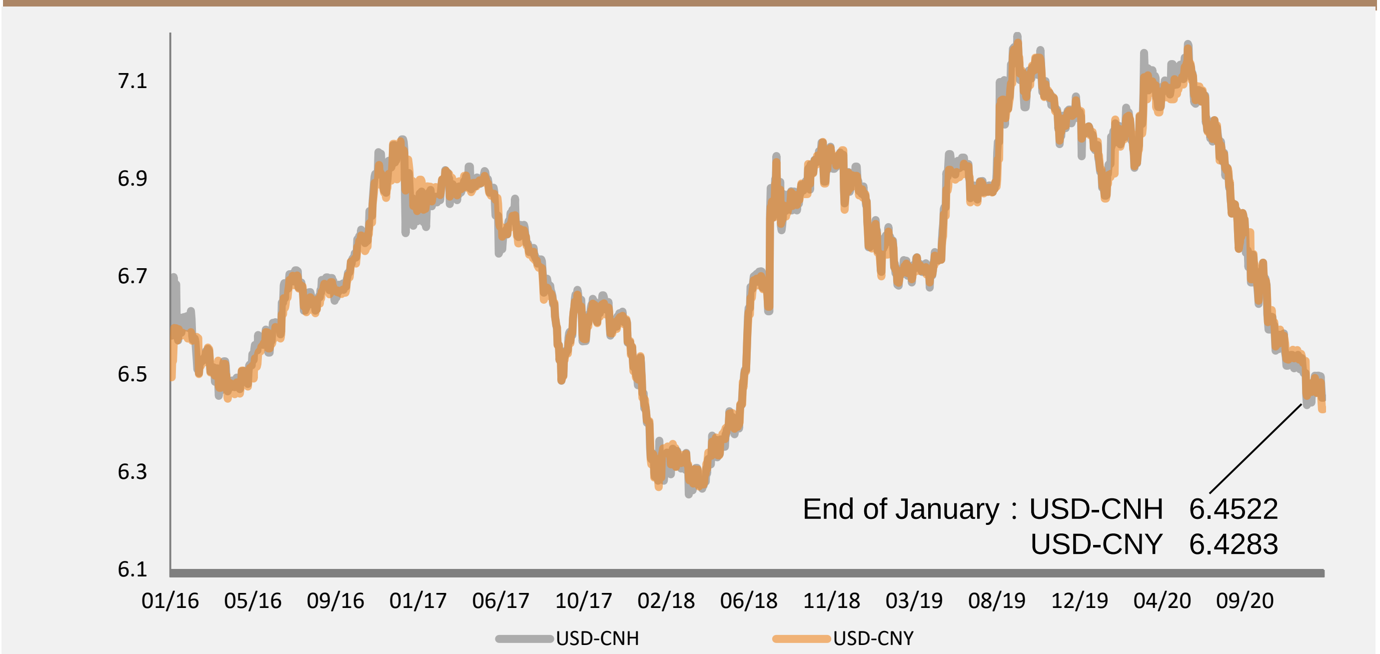
Source: HKMA

RMB Cross-border Trade Settlement (RMB bn)



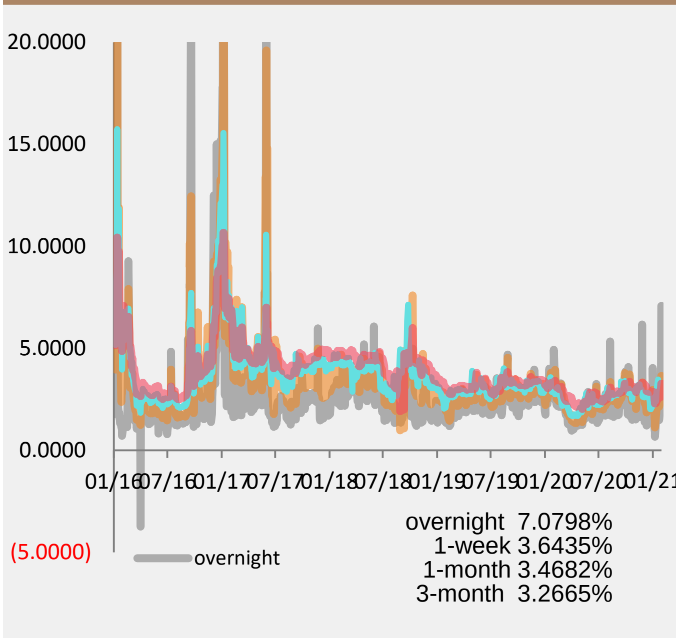
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



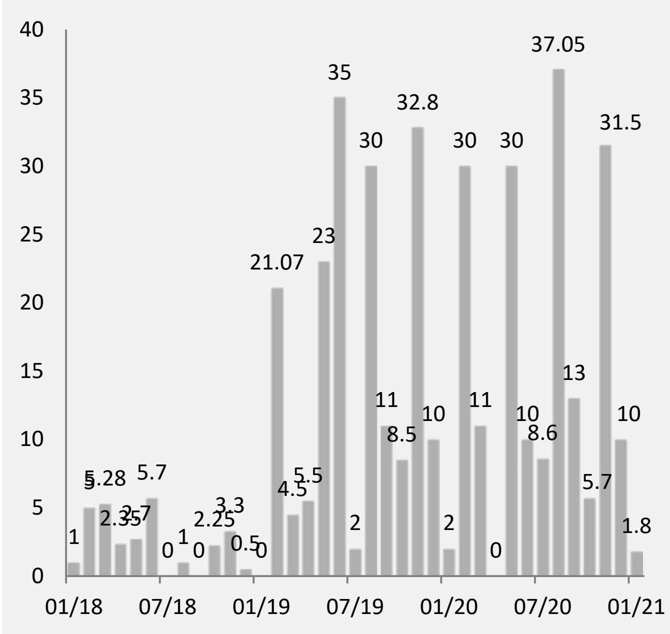
Source: Bloomberg

CNH HIBOR Fixing (%)



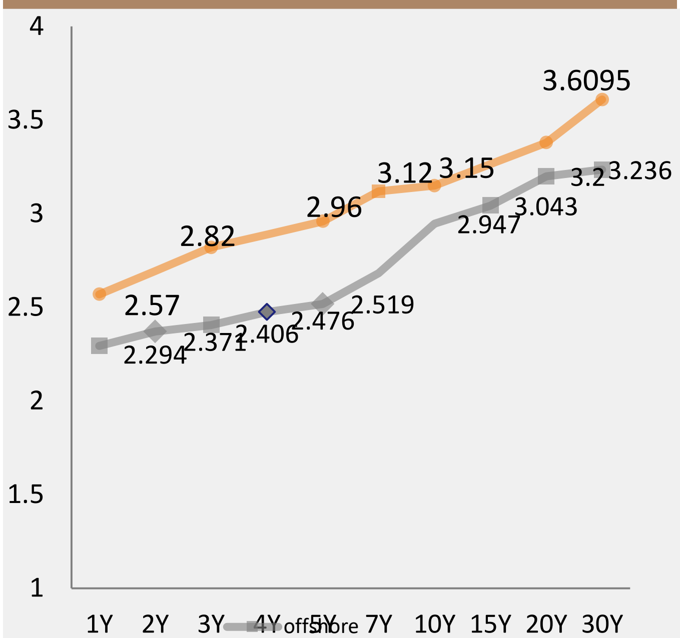
Source: Bloomberg

Hong Kong Offshore RMB Bond Issuance (RMB bn)



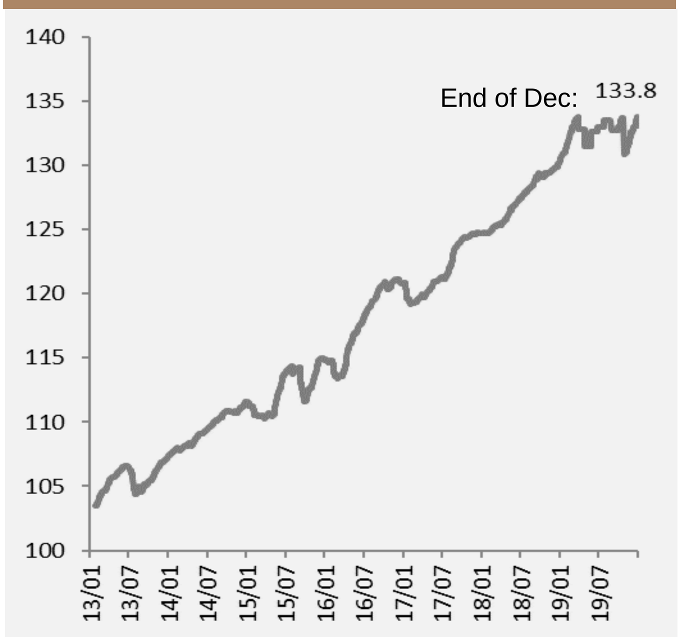
Source: BOCHK Global Market estimate

CNH & CNY China Sovereign Curve (%, 29 Jan 2021)



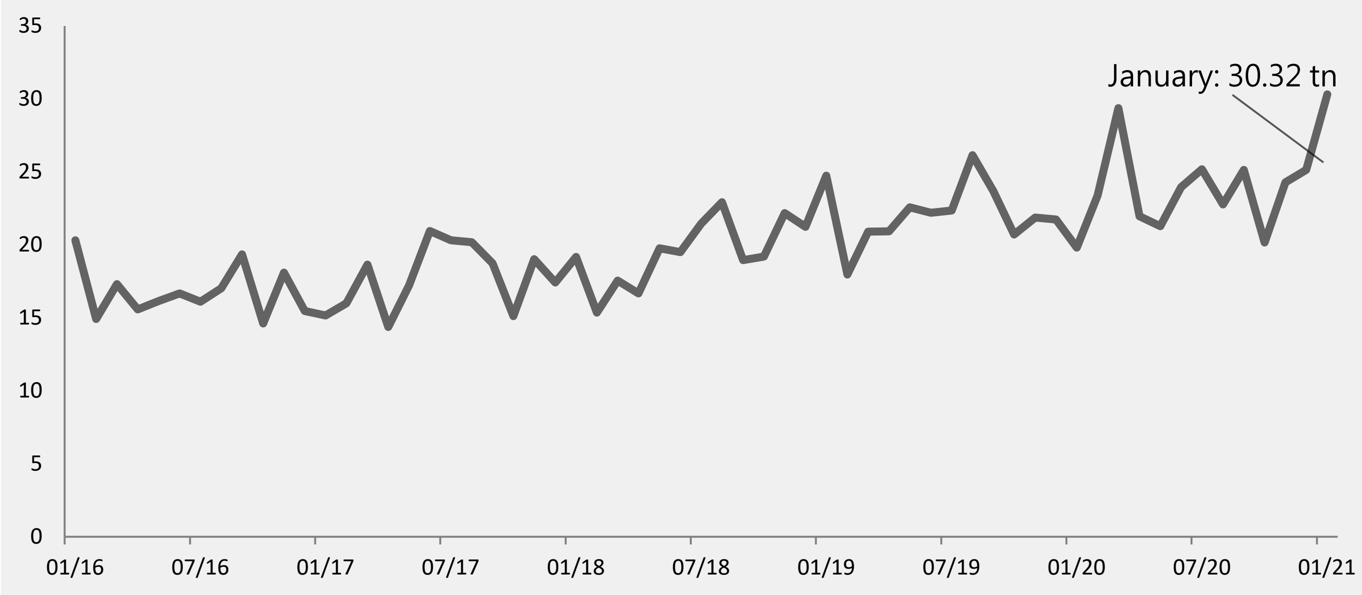
Source: Bloomberg

FTSE-BOCHK Offshore RMB Bond Composite Index



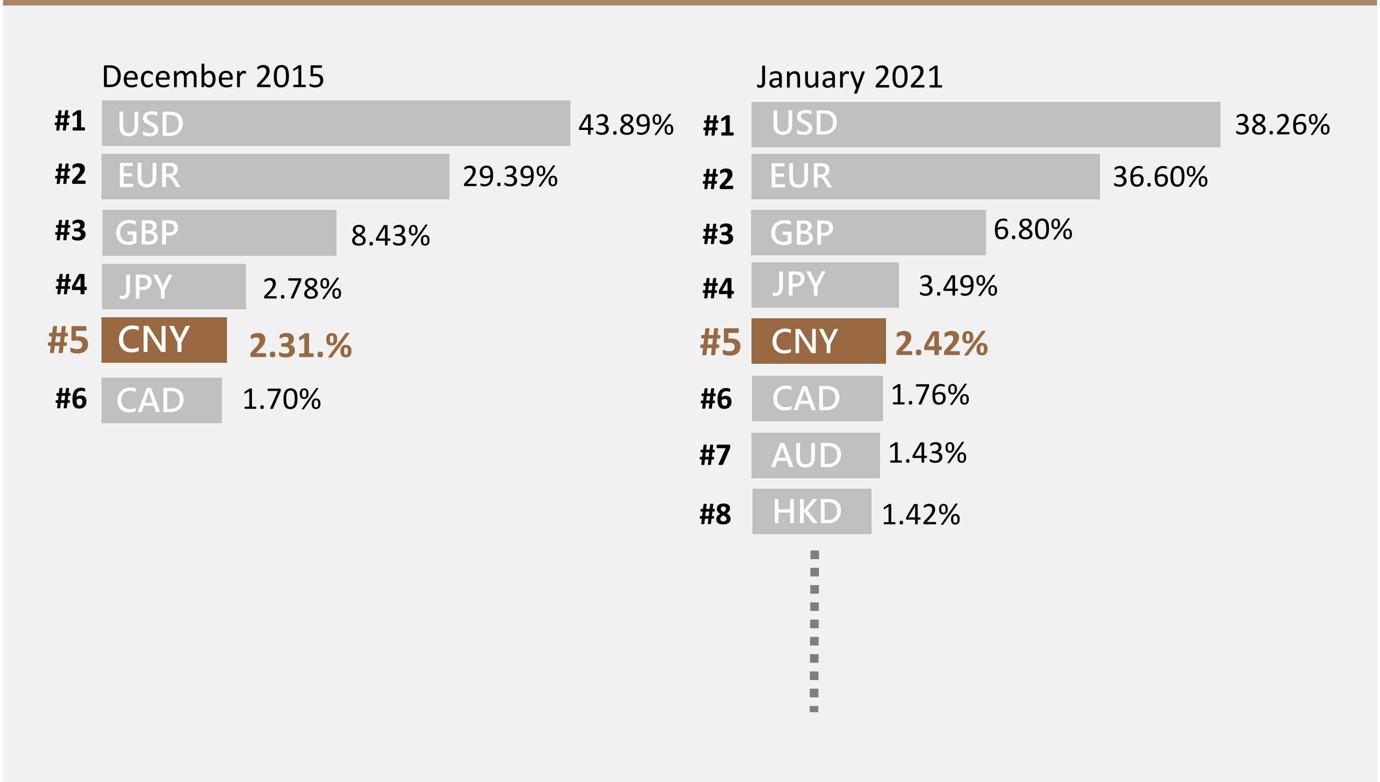
Source: Bloomberg

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)
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
2018	615.0	4208.9	233.98	1.726	2.795	3.582
2019	632.2	5376.3	265.81	1.929	2.400	3.260
2020	721.7	6324.1	282.47	4.031	2.958	2.882

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)
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
2018	6.870	6.879	131.1	29.1	3.602
2019	6.963	6.963	133.8	183.4	3.189
2020	6.503	6.527	/	188.9	2.947

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