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Contents

Editors：

Zhang Hualin

Tel ： +852 2826 6586
Email: zhanghualin@bochk.com

Nathan Yeung
Tel: +852 2826 6205
Email: nathanyeung@bochk.com

RMB fluctuated in narrow range, IMF raised RMB weighting in SDR

Offshore RMB exchange rate volatility narrowed in May compared to the previous month. Key business indicators rebounded. The international Monetary Fund (IMF) increased RMB weighting in SDR. Foreign investors net sold RMB bonds for four consecutive months, with limited financial impact on China market. China financial markets remained stable. With the market priced-in some short-term factors, foreign institutions' investment in China's securities will return to a steady pace.

I. RMB fluctuations narrowed in May compared with last month

In May, as affected by multiple factors, such as the interest rate hike by the US Federal Reserve, the strengthening of Dollar index, the rapid rise of US treasury bond yields, and the inverted yield spread between China and the US, the offshore RMB exchange rate maintained a two-way fluctuation between 6.62 and 6.82, falling from 6.6742 at the beginning of the month to 6.8273 in the middle of the month, and then strengthening to 6.67. The U.S. Federal Reserve raised interest rates by half a percentage point to between 0.75% to 1% on May 5 and announced it would begin shrinking its balance sheet in June. As a result of the Fed's rate hike, the Dollar index strengthened from 102.9 at the end of last month to 104 in mid-May and reached a high of 105 on May 13. The offshore RMB fell 431bps during the week and closed at 6.7997(May 13) as the dollar index stood at its high level. On the same day, the China Banking and Insurance Regulatory Commission sent a positive message to the market, saying that the short-term fluctuations of the RMB exchange rate were mainly influenced by market sentiment and were still within a reasonable range. The depreciation of the RMB will not continue for a long time. On May 20, the People's Bank of China cut the five-year LPR interest rate by a greater-than-expected 15 basis points, sparking a rally in China assets such as A-shares, Hong Kong stocks and the RMB exchange rate. On 29 April, the central parity rate of RMB against US dollar published by CFETS was 6.6607, down 0.65% MoM; the CNY closed at 6.6718, down 0.96% MoM; The CNH closed at 6.6787 down 0.58% MoM.

Despite the fluctuations of the offshore RMB in the month, especially during the period of strengthening USD, China market was operating smoothly and the RMB didn't depreciate against other major currencies, reflecting that the positive fundamentals of the China economy remain unchanged.

Currently, the RMB exchange rate remains stable and showed more market-driven characteristic, indicating a healthy market sentiment. After a period of market fluctuation, the RMB adjusted to a reason range. With the government's supportive policy, economy has gradually resume to normal level. Also, foreign trade remained resilient, so there is no basis for RMB to further depreciate and it is likely to maintain two-way fluctuations. In the short term, the dollar index and economic fundamentals are still the two key factors affecting the RMB exchange rate.

Regarding offshore RMB liquidity, as of May 31, the overnight and 1-week CNH Hibor rates were 2.5903% and 2.0753% respectively; the 1-month CNH Hibor rate stood at 2.3565%; and the 3-month CNH HIBOR rate was 2.6903%.

II. Review of major offshore RMB business indicators

Offshore RMB business maintained stable in May 2022. According to HKMA, as of the end of April 2021, Hong Kong's RMB deposits rebounded to RMB 841.91 billion, up 6.4% MoM and 7.7% YoY. HK RMB loans stood at RMB 178.36 billion, up 0.2% MoM. The total remittance of renminbi for cross-border trade settlement amounted to RMB 2.74 trillion in the first four months of 2022, up 21.4% YoY.

According to HKICL, RMB RTGS turnover was RMB 29.87 trillion in May 2022, accumulated 259.5 trillion in the first 5 months, up 13.2% YoY. According to SWIFT, the RMB has maintained its position as the fifth most active currency for global payments by value, with a share of 2.15%, higher than last month at 2.14%, behind USD(41.13%), EUR(36.1%), GBP(6.26%), and JPY(2.7%).

According to Bloomberg, offshore RMB bond issuance in primary market amounted to RMB 68.04 billion in the 5 months of 2022, down 0.58% YoY (RMB 68.44 billion). On May 23, the People's Bank of China successfully issued two rounds of RMB central bank bills in Hong Kong, including RMB 10 billion worth of 3-month central bank bills and RMB 15 billion worth of 1-year central bank bills, with the interest rates of 2.49% and 2.80% respectively. It recorded subscription of nearly RMB 58 billion, about 2.3 times of issuance, demonstrating the attractiveness of RMB assets to foreign investors and reflecting global investors' confidence in China's economy.

III. Investing in China's Interbank Bond Market

Cross-border investment continued to experience short-term fluctuations in May due to multiple external factors such as central bank policy divergence and the narrowing US-China yield spread. Foreign institutional investors reduced RMB 109.4 billion worth of bond holdings.

According to PBOC, by the end of May 2022, foreign institutions held RMB 3.66 trillion worth of inter-bank bonds, accounted for 3% of the total (vs RMB 3.77 trillion in April). In terms of bond type, foreign institutions held RMB 2.38 trillion in government bonds (vs RMB 2.39 trillion in April), and RMB 0.90 trillion in policy bonds (vs RMB 0.97 trillion in April), respectively accounted for 64.9% and 24.5% of the total.

According to CFETS, foreign institutional investors invested RMB 536.3 billion in bonds and sold RMB 579 billion in May, with net selling of RMB 43.0 billion. Bond Spot transaction by Foreign institutional investors amounted to RMB 1.12 trillion. Meanwhile, 4 more foreign institutions entered the interbank bond market in May, bringing the total number of foreign institutions to 1,038 by the end of April. Among them, 516 entered the market through the direct investment channel, 751 through the bond connect and 229 through the above two channels simultaneously.

The latest report from Bond Connect showed a stable market participation in May, with monthly trading volume reached RMB 675.0 billion, up 33% MoM. Average daily turnover stood at RMB 35.5 billion. Chinese Government Bonds (CGBs) and Policy Financial Bonds (PFBs) were the most actively traded products, accounting for 51% and 35% respectively of the monthly turnover.

The number of investors under Bond Connect continued to grow, with 37 added in the month. The total number of approved investors reached 3,513.

The International Monetary Fund (IMF) announced on May 14 that it would increase the RMB weighting in SDR from 10.92% to 12.28%. Meanwhile, the IMF increased the USD weighting to 43.38% from 41.73%, while the Euro, Yen and Sterling were reduced to 29.31%, 7.59 % and 7.44 %, respectively, from 30.93%, 8.33% and 8.09%. After the adjustment, the RMB will remain the third largest in the SDR. The adjustment will officially take effect on August 1 2022. The reviews of the composition and valuation of the SDR basket is conducted every five years, with main criteria on exports and currency's acceptability, showing China's export strength. The rising weight reflects China's export strength. The increased weight of the SDR will enhance the international recognition of the RMB and the attractiveness of RMB assets to international investors and the status of the global reserve currency. Other than that, considering Inflation remains relatively low in China and returns on RMB assets are higher than in other countries, we believe global investors will increasingly RMB assets allocation.

Regulators approve Hong Kong-China ETF Connect

The China Securities Regulatory Commission and the Securities and Futures Commission issued a joint announcement on May 27 on the in-principle agreement to include eligible exchange-traded funds (ETFs) in Stock Connect. Mainland and Hong Kong investors will be permitted to trade eligible ETFs listed on each other's exchanges through the use of local securities firms or brokerages.

Before eligible ETFs can be included in the Stock Connect program, trading and clearing rules and systems have to be finalised, regulatory approvals granted, and market participants must have adapted operational and technical systems, according to the statement. In addition, arrangements for cross-boundary regulatory and enforcement co-operation have still to be put in place and investor education measures have still to be determined, the statement added.

Initial eligibility requirements have been outlined, including limiting Hong Kong-listed ETFs to those with at least HK$1.7bn ($217mn) in assets over the past six months, and only including products that track indices that primarily track Hong Kong-listed stocks. No synthetic ETFs or leveraged and inverse products will be permitted, and the benchmark used must have been launched for at least one year.

The stock exchanges in Shanghai, Shenzhen and Hong Kong and the China Securities Depository and Clearing Corporation Limited reached an agreement on the overall Stock Connect inclusion arrangements for ETFs at the end of last year. The parties are working closely on completing the preparations for launching relevant trading. A separate announcement will be made on the official launch date.

China cuts the 5-year loan prime rate to boost credit

The People's Bank of China, the central bank, announced on May 20 the over-five-year LPR, on which many lenders base their mortgage rates, was lowered by 15 basis points to 4.45 percent, while the one-year LPR stood unchanged at 3.7 percent.

China to further open bond market for foreign institutional investors

Overseas institutional investors that have been approved to trade in China's interbank bond market will also be eligible to invest in the country's exchange bond market, either directly or via a connect mechanism, the PBOC, the China Securities Regulatory Commission and the State Administration of Foreign Exchange said in a statement on May 27. Effective June 30, the regulatory change will help integrate the opening-up of the interbank and exchange bond markets and facilitate overseas institutions' investments in Chinese bonds, said the statement.

The PBOC statement also outlined streamlined administrative procedures for overseas institutional investors in the interbank market. They do not need to register with or seek approval from regulators to trade exchange-traded bonds and are allowed to choose settlement institutions or custodian banks for relevant services based on their own needs.

Govt stresses RMB products to hedge risks

Financial institutions should optimize their products and services to help trade companies better hedge against foreign exchange risks and facilitate the use of the renminbi in cross-border settlements, said in a joint notice on May 26 by the Ministry of Commerce, the People's Bank of China and the State Administration of Foreign Exchange. The notice stated that small and medium-sized banks should launch more renminbi derivative products to meet companies' differentiated demand for hedging opportunities against foreign exchange risks. Cross-border renminbi settlements should also take a bigger share in business formats like cross-border e-commerce and procurement, the notice stated.

The three regulators also stressed in the notice that banks and sponsors should lower the hedging costs for companies, especially the small and micro-sized ones. Local governments can also explore the application of special credit, data credit enhancement and public security deposits so that less corporate credit and capital will be used, the notice stated.

The Changing Landscape of Currency Internationalization under Bretton Woods System 2.0

Dr Zhihuan E, Chief Economist of BOCHK

Entering into 2022, while the global economy still encountered uncertainty due to Covid, the Russia-Ukraine conflict intensified the situation with rising commodity price and supply chain issue. Inflation rates in developed countries was therefore increased and price pressure were greater to emerging markets, causing structural divergence in terms of global economic growth. Meanwhile, as the post-Covid deglobalisation trend continued and the western countries imposed financial sanctions on Russia, market participant's concern over the safety and stability of international reserve asset and current international monetary system was rising which may change the current international monetary system.

I. Current International Monetary System

In 1971, the former President Nixon announced the suspension of its obligation on exchanging USD 35 to one ounce of gold under the Bretton Woods system, decoupled the USD from gold, also known as "Nixon shock". The international monetary system therefore transferred into the Jamaica system, also known as Bretton Woods 2.0.

Historically, the basis of the Bretton Woods system was that the United States promised to exchange the USD with gold at a fixed price, while other currencies maintained a fixed exchange rate against the USD. Under USD-Gold peg, the US had to continuously supply USD to meet the global market demand, which inevitably led to trade deficit and became "Triffin problem".

The Bretton Woods system 2.0 was based on the USD exchanging with gold and other currencies at free floating rate. In fact, this system allowed the USD dominated the international monetary system as a credit currency, completing its internationalization. However, the exchange rate of various currencies to the USD changed from floating rate in the 1970s to the mixing of floating rate and fixed rate in the 1990s.

The decoupling of USD from gold released liquidity in the US as it lost external constraints from gold. The transaction volume grew rapidly, with a few times higher than that of the Bretton Woods system, with increasing market volatility.

II. Instability of Bretton Woods 2.0

The global financial crisis in recent decades showed internal flaws of the international monetary system: when the global economy was experiencing rising trend, USD liquidity was significantly higher; Meanwhile, when the global economy was experiencing downward pressure, the USD liquidity was tightened and caused "dollar shortage" in emerging markets. The instability in Bretton Woods 2.0 is the divergence between the monetary policy objectives of the US Federal Reserve and the USD's international monetary function.

The US Fed became the main provider of global liquidity, functioning as a "global central bank". However, the US monetary policy has always been decided based on domestic factors, such as domestic inflation data, unemployment rate, and other domestic indicators. The conflict between the Fed's function of being an US central bank and a "global central bank" remained unsolved.

The former US Treasury Secretary William Connolly said at the first G20 meeting after the collapse of the Bretton Woods system: "The USD is our currency but it's your problem" was the best description of the USD dominance under Bretton Woods 2.0.

Demands on the reform of the international monetary system increased after Financial crises. During the global financial crisis triggered by the US subprime mortgage crisis in 2008, the former French President Nicolas Sarkozy proposed reforming the international monetary system, which gained several support. Yet, the reform of the international monetary system was difficult to progress. Diversification of reserve currency will be a solution to it, but it is closely related to the country's economic strength which requires international efforts and coordination.

III. The Changing Landscape of Currency Internationalization

Data of international payments, foreign exchange transactions and foreign exchange reserves composition showed the USD share has been slightly adjusted in recent years, but the USD still remained the dominant currency in international transactions and reserves.

According to the International Monetary Fund, by the end of 2021, the USD accounted for 60.6% of international reserves, while the EUR, JPY, GBP, and RMB accounted for 21.3%, 5.7%, 4.9%, and 2.9%, respectively.

After replacing the GBP's leading position, the USD was based on the gold standard in the early stage, guaranteeing 1 ounce of gold could be exchanged for USD 35. It was the important basis of the Bretton Woods system, establishing USD's reserve currency status. The "Nixen Shock" in 1971 showed that the US economic strength enabled it to decouple from gold and strengthen USD as a credit currency. Now, after decoupling from gold, the USD still played as a major international reserve currency.

Data showed that the Euro ranked as the second in terms of international use, but its market share still largely lagged behind the USD. A few main indicators showed that the Euro only accounted for half or even less than that of USD. The Euro was formed regionally with multiple countries, with the core being the Deutsche Mark. Yet, a portfolio currency always encounters many challenges. During the European debt crisis, some worried about the disintegration of the euro zone as it lacked the support of fiscal integration. The economic integration of the euro zone needed to be further improved to solve obstacle of the Euro internationalization.

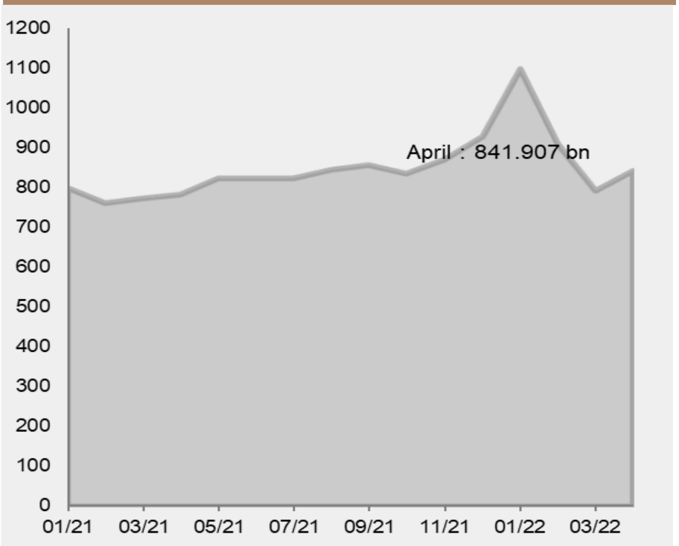
The internationalization of the Japanese Yen was driven by policy and its leading trade power during specific period of time. In the 1990s, Japan set up a special agency to promote JPY usage to other countries. In recent years, the Japan government was actively promoting JPY usage in Asia and ASEAN. Although Japanese yen accounted for about 5% of the total, its internationalization progress in ASEAN region was relatively stable.

The IMF's SDR basket data showed that, in aggregate terms, the USD still remained a dominated role. In terms of developing trend, the share of USD and RMB in SDR basket was rising, while the share of Eur, JPY, and GBP was decreasing.

To conclude, judging from the growth rate, the rising in RMB share in the SDR basket may imply a new landscape of currency internationalization where the USD and RMB may be the main two credit currencies in the world in the future.

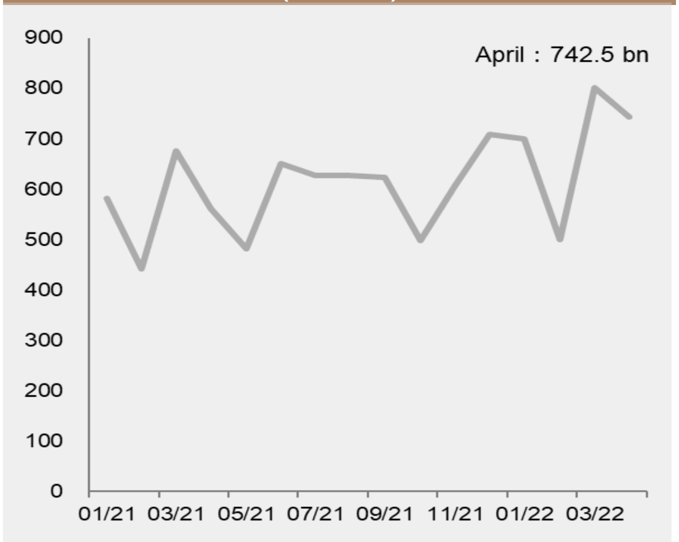
Market Indicators

Hong Kong RMB Deposits (RMB bn)



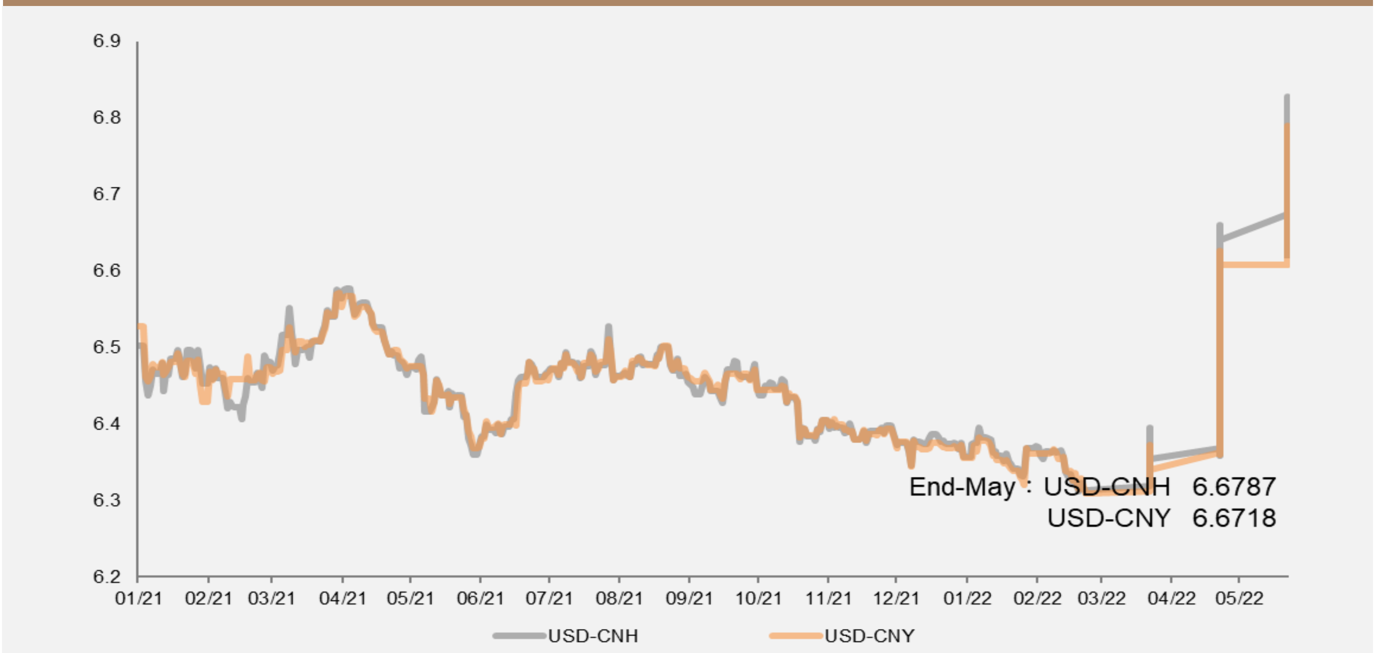
Source: HKMA

Hong Kong RMB Cross-border Trade Settlement (RMB bn)



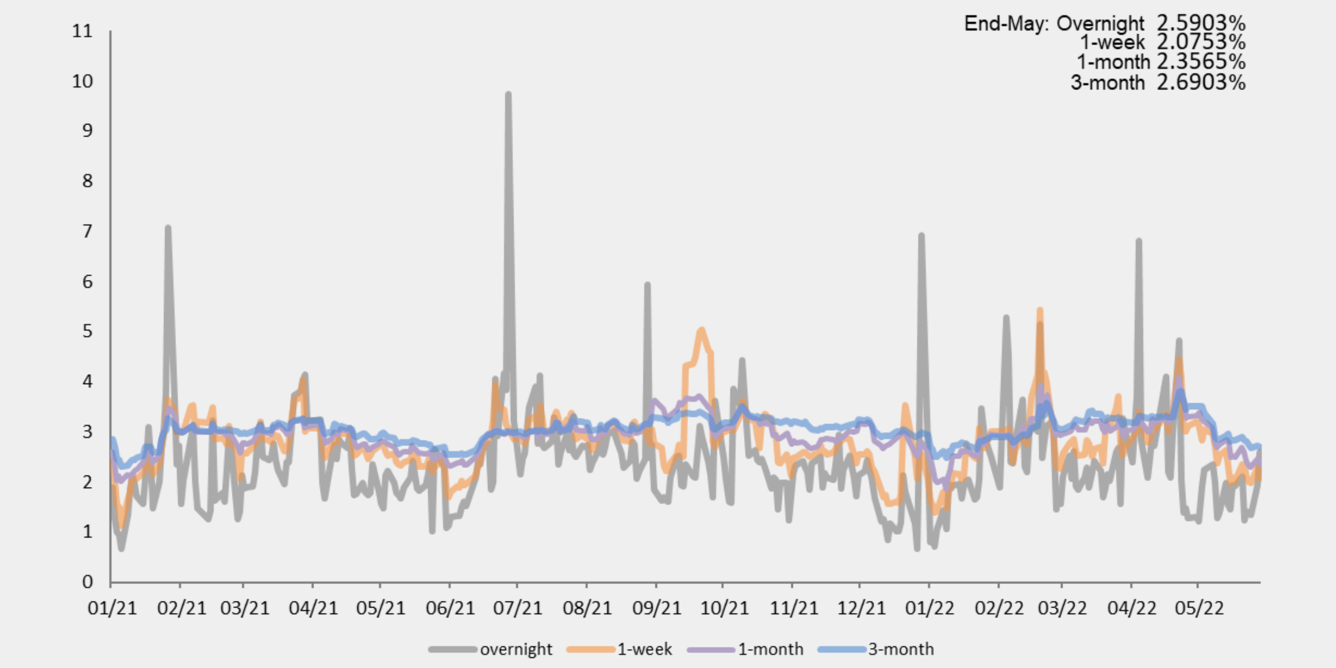
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



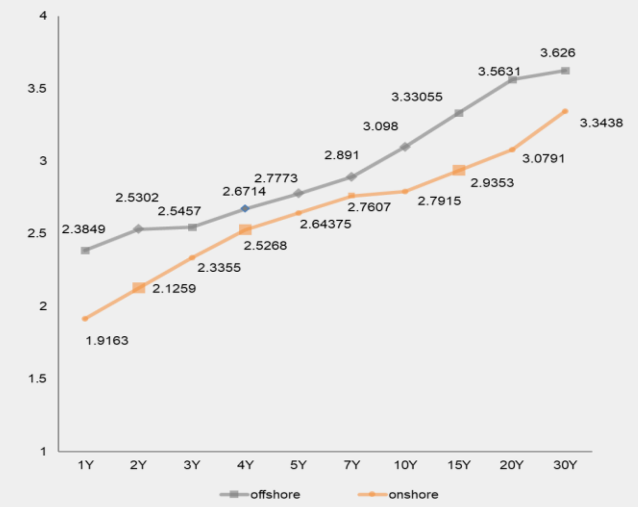
Source: Bloomberg

CNH HIBOR Fixing (%)



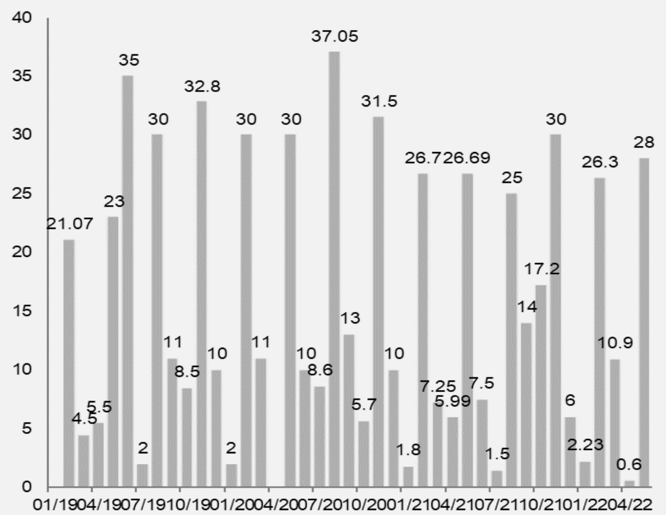
Source: Bloomberg

CNH & CNY China Sovereign Curve (%, 31 May 2021)



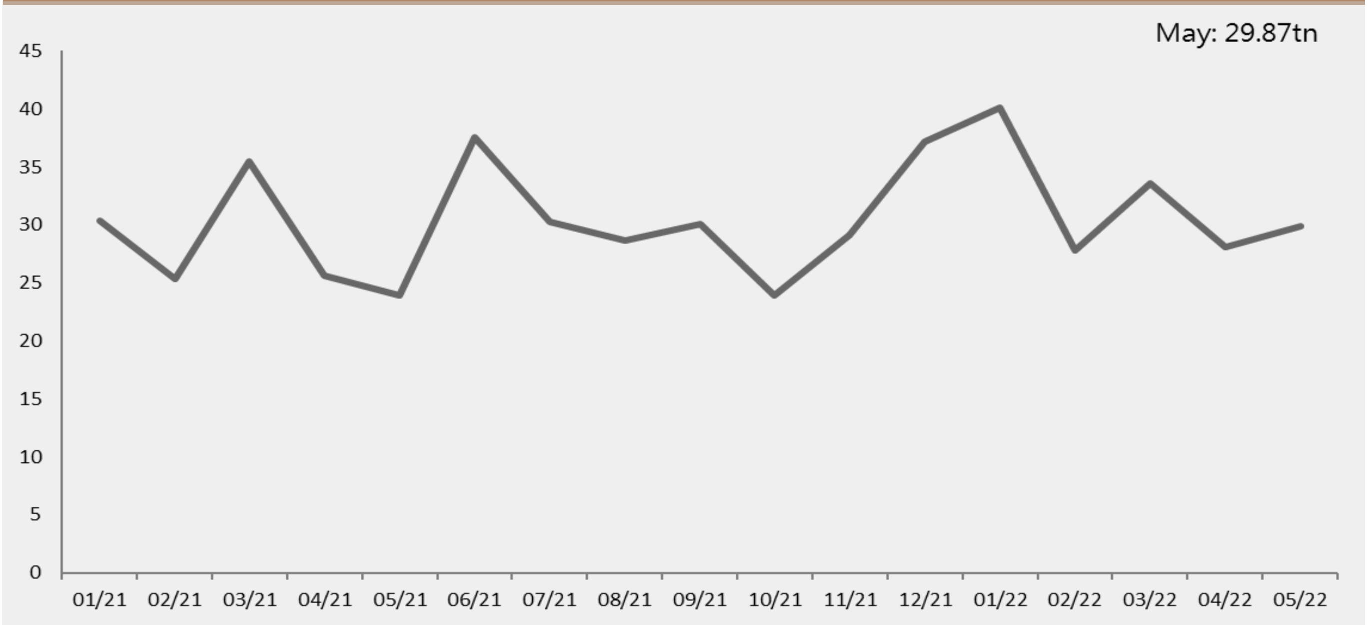
Source: Bloomberg

Hong Kong Offshore RMB Bond Issuance (RMB bn)



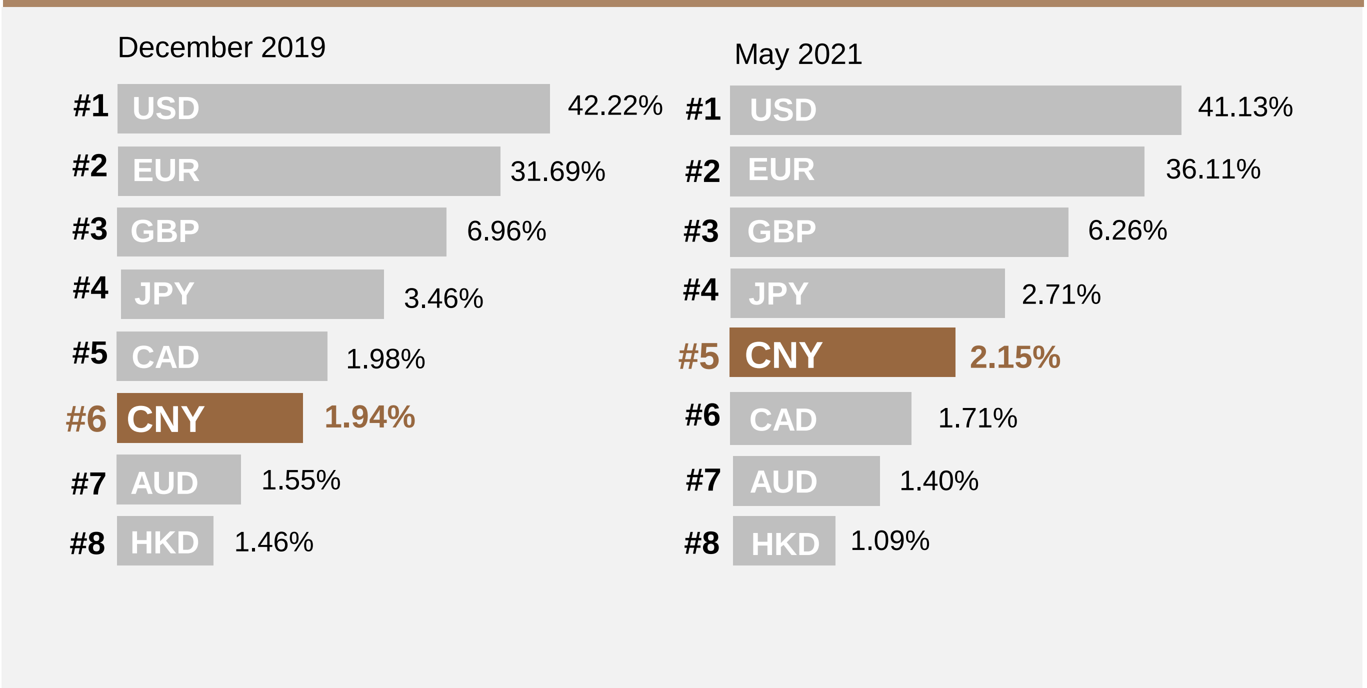
Source: BOCHK Global Market estimate

RMB Clearing Transaction Value (RMB tn)



Source: HKICL

SWIFT World payments currency ranking & market share



Source: SWIFT

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