中國銀行(香港)
BANK OF CHINA (HONG KONG)

Offshore RMB Express

Issue 102 · September 2022

Contents

"Hong Kong Financial Research Institute of Bank of China" ("the Institute") is the core research and strategic planning centre within the Bank of China (Hong Kong) Group. Rooted in Hong Kong, setting our sights on the Greater Bay Area, Southeast Asia, Asia-Pacific and the world, the Institute focuses on macro-economics and policies, financial markets, RMB internationalization and digital currencies, financial sector reforms and innovation, green and sustainable finance development. The Institute, as the knowledge center of BOC, combines original macro, meso and micro researches with real-world practices to provide unique insights and advices to the community. With the core mission of serving the country and Hong Kong, the Institute advises the government agencies, and has built extensive collaborations and joint research with prestigious universities, think tanks and industry leaders in Hong Kong and Mainland China. The Institute has 50 professional researchers and produces close to 1,000 internal and external research papers annually.

Sovereign bonds remain attractive to foreign investors. Mainland China and Hong Kong will further expand cooperation in capital markets

The offshore RMB weakened in August, but remained a relatively strong currency in international currency markets. Partial indicators of offshore RMB business were slightly volatile. The RMB's share of global payments has been steady and rising. The fluctuation of foreign institutions' investment in RMB bonds slowed down, and sovereign credit assets continued to be attractive to market. Mainland China and Hong Kong will continue to expand cooperation in capital markets. Trading calendar of Stock Connect will be enhanced.

I. The offshore RMB experienced a short-term depreciation in August

In August, the offshore RMB exchange rate experienced a short-term depreciation, fluctuating between 6.72 and 6.92. The offshore RMB was trading in a narrow range between 6.72 and 6.78 at the beginning of the month. The dollar index strengthened to 108 in mid-month, briefly breaking 109, on expectations that the US Fed would remain hawkish after the first weaker-than-expected US CPI data of the year. The offshore RMB weakened to 6.93 in mid-month due to the strengthening of the dollar and ended the month trading in a narrow range between 6.87 and 6.92. On August 31, the central parity rate of RMB against US dollar published by CFETS was 6.8906, down 2.18% MoM and 8.01% YTD; the CNY closed at 6.8904, down 2.16% MoM and 8.13% YTD; The CNH closed at 6.9069 down 2.33% MoM and 8.35 YTD.

On August 17, the US Federal Reserve released July FOMC meeting minutes, showing that policymakers′ determination to raise interest rates in order to solve high inflation problem. They believed that US inflation is likely to remain high for some time and there was little evidence that inflation pressures were subsiding. The US Fed Chair Jerome Powell unexpectedly held his "hawkish" stance on rate hikes at Jackson Hole Economic Symposium. On August 22, the People's Bank of China lowered the 1-year and 5-year LPR rates, and the 1-year LPR was 3.65%, down 5 basis points from last month. 5-year LPR was 4.3%, down 15 basis points from the previous month.

The decline of LPR helps to reduce financing costs of enterprises and support the real economy, in order to recover and stabilize economic growth. Regarding the recent downward trend of the RMB exchange rate, the market generally believes that RMB is still a strong currency from the global perspective. The current depreciation of the RMB exchange rate is mainly due to the short-term fluctuations caused by the rapid strengthening of the US dollar index, and there is no strong unilateral depreciation expectation.

Regarding offshore RMB liquidity, as of August 31, the overnight and 1-week CNH HIBOR rates were 2.5832% and 2.4225% respectively; the 1-month CNH HIBOR rate stood at 2.4578%; and the 3-month CNH HIBOR rate was 2.5155%.

II. Review of major offshore RMB business indicators

Offshore RMB business was slightly fluctuated in July 2022. According to HKMA, as of the end of July 2021, Hong Kong's RMB deposits amounted to RMB 813.69 billion, down 0.2% MoM (Compared to 4.2% decline in June). HK RMB loans stood at RMB 172.91 billion, down 1.4% MoM (Compared to 3.7% decline in June). The total remittance of RMB for cross-border trade settlement amounted to RMB 5.09 trillion in the first 7 months of 2022, up 26.6% YoY.

According to HKICL, RMB RTGS turnover was RMB 32.10 trillion in August 2022, accumulated 252.7 trillion in the first 8 months, up 6.49% 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 2.31%, higher than last month at 2.20%, behind USD (42.63%), EUR (34.49%), GBP (6.45%), and JPY (2.73%). Russia was the third largest offshore RMB payment market for two consecutive months, contributing 4.3% of offshore RMB payments by value in August, up from 3.9% in July (June: 1.42%).

As most of the world's major economies enter into rate hiking cycle, the cost of issuing RMB bonds has fallen relative compared to other currencies, such as the USD bond, increasing Dim Sum Bond issuance in Hong Kong.

According to Bloomberg, in the first eight months of 2022, offshore Dim Sum Bonds (excluding Certificates of Deposit) were issued at RMB 158.254 billion, up 38.8% YoY. The issuance of Certificates of Deposit reached RMB 285.731 billion, up nearly 8 times YoY.

III. Investing in China's Interbank Bond Market

According to PBOC, by the end of August 2022, foreign institutions held RMB 3.48 trillion worth of inter-bank bonds, accounted for 2.5% of the total (vs RMB 3.51 trillion in June). In terms of the change in holdings, the amount of bonds held by overseas institutions in the interbank market decreased by RMB 30 billion in August. In terms of bond type, foreign institutions held RMB 2.33 trillion in government bonds (vs RMB 2.32 trillion in July), and RMB 0.81 trillion in policy bonds (vs RMB 0.84 trillion in July), respectively accounted for 66.9% and 23.4% of the total.

Meanwhile, 8 more foreign institutions entered the interbank bond market in August, bringing the total number of foreign institutions to 1,057 by the end of August. Among them, 524 entered the market through the direct investment channel, 766 through the bond connect and 233 through the above two channels simultaneously.

The latest report from Bond Connect showed an active market participation in August, with monthly trading volume reached RMB 783.0 billion. Average daily turnover stood at RMB 34.0 billion, up 29% YoY. Chinese Government Bonds (CGBs) and Policy Financial Bonds (PFBs) were the most actively traded products, accounting for 46% and 34% of the monthly turnover. In that month, foreign institutions under the Bond Connect reduced their holdings of RMB bonds by RMB 35.4 billion, compared with RMB 109.4 billion in May, RMB 93.3 billion in June, and RMB 54.6 billion in July. The reduction of RMB bonds held by foreign institutions under the Bond Connect has narrowed.

On August 10, the Ministry of Finance issued RMB 5 billion worth of second round central bank bills in Hong Kong, with a total subscription of RMB 21.79 billion, 4.36 times higher than the issuance amount. The issuance rate was 10 to 15 basis points lower than the yield of Hong Kong's offshore secondary market. Among the issuance, RMB 4 billion worth of 2-year bills auctioned at 2.245%, with an oversubscription of 4.12 times; RMB 1 billion worth of 10-year term auctioned at 2.82%, with an oversubscription of 5.33 times. The third round of issuance will be in October, with an issuance amount of RMB 5.5 billion.

In addition, on August 22, the People's Bank of China successfully issued two rounds of central bank bills in Hong Kong, including RMB 10 billion of 3-month central bank bills and RMB 15 billion of 1-year central bank bills at interest rates of 1.90% and 2.30% respectively. The total subscription for the issue was nearly RMB 75 billion, about three times higher than issuance amount, indicating that RMB assets remain attractive to foreign investors.

IV. China to expand Mainland-HK Stock Connect. Enhancement to Stock Connect trading calendar

Fang Xinghai, vice chairman of the China Securities Regulatory Commission (CSRC), said at the 2022 China International Fair for Trade in Services that China will expand the Stock Connect Scheme to further expand cooperation between the two capital markets in order to support Hong Kong's role as an international financial hub. For the next stage, first, the CSRC will include more eligible listed companies to the Stock Connect scheme. Second, the CSRC will study the introduction of RMB securities trading counters under the southbound trading of the Stock Connect. Third, the CSRC will support the issuance of mainland government bond futures in Hong Kong and boost the two-way opening of the mainland treasury bond futures market.

Moreover, the CSRC announced an adjustment to the trading calendar between the Hong Kong and Mainland China markets under Stock Connect. Under the existing Northbound arrangements for Stock Connect, trading is available on a Hong Kong trading day, when both the Hong Kong and Mainland China markets are open and banking services are available in both markets on the corresponding settlement day. After the enhancements, trading will be allowed under Stock Connect on all trading days when both the Hong Kong and Mainland China markets are open. It is expected to cut the number of days currently unavailable for trading by about half. And Southbound trading day will increase 9 trading days per year, covering 96.34% (currently at 92.68%) of Hong Kong trading days. Northbound trading will be increased by five trading days per year, covering 97.53% (currently at 95.47%) of Mainland trading days. The CSRC and the Hong Kong SFC will coordinate exchanges and clearing companies on both sides to prepare the adjustment within 6 months.

ETF Connect Scheme saw trading volume growth

Two months into the launch of the new exchange traded fund connect scheme between the mainland and Hong Kong, southbound trading by mainland investors and trading via the northbound route for Hong Kong and foreign investors have begun to pick up.

Overall trading volumes in the four Hong Kong-listed ETFs traded by mainland investors via the ETF Connect hit HK$8.16bn ($1.04bn) in August, increasing by almost 90 per cent from the HK$4.31bn achieved in the previous month. That compares to the aggregate turnover for 83 mainland China-listed ETFs under the new ETF Connect from investors via the Hong Kong exchange, which reached Rmb606.5mn ($87.2mn), according to data from the Hong Kong Exchanges and Clearing, up by more than 50 per cent from the Rmb395.9mn in July.

Mainland investors trading Hong Kong-listed ETFs through the Shanghai bourse drove the largest growth in turnover in the month, tripling to HK$4.69bn. The Shenzhen link edged up by 9 per cent to HK$3.47bn, HKEX data show.
Senior HKEX officials said at a recent industry meeting that they expected more Hong Kong-listed exchange traded products, including leveraged and inverse products, actively managed ETFs, and smart beta ETFs, to be allowed to join the scheme in the future.

The PBOC released financial statistics report for July 2022

In July, the volume of cross-border RMB settlement under the current account reached 901.8 billion yuan, up 29.5% year on year, including 652.8 billion yuan of trade in goods and 249 billion yuan of trade in services and other items. The volume of cross-border RMB settlement under direct investment was 479.8 billion yuan, down 3.6 percent year on year; among which outbound direct investment and foreign investment reached 115.4 billion yuan and 364.4 billion yuan respectively.

New Special Drawing Rights currency basket takes effect

The new Special Drawing Rights (SDR) currency basket took effect on August 1, and the weight of the RMB was raised from 10.92% to 12.28%, an increase of 1.36 percentage points. The IMF's increase in the weight of RMB in the SDR fully reflects the recognition and confidence of the international community in China's economic and financial market development, which will help increase the attractiveness of RMB assets to global funds.

RUSAL is the first company to issue Yuan bonds in Russia

RUSAL, a leading global aluminium producer, announces first Yuan bond placement in Russia. Coupon rate is fixed at 3.9% p.a. with total value at 4 billion Yuan. Demand for bonds exceeded offer by more than 2 times, as a result, the yield ratio was reduced by more than 1 percentage point compared to the original target. BO-05 and BO-06 series bonds with 5 year term were registered on July 15, 2022 by the Moscow Exchange. Each placement is worth 2 billion Yuan. The nominal value of one bond is 1,000 Chinese Yuan. Gazprombank, Credit Bank of Moscow and Bank ZENIT managed the issuance.

Futures, options show more signs of opening-up

All of the major Chinese futures exchanges-the Shanghai Futures Exchange, the Zhengzhou Commodity Exchange, the Dalian Commodity Exchange, China Financial Futures Exchange and Shanghai International Energy Exchange-announced recently that qualified foreign institutional investors and renminbi QFIIs are allowed to trade in 23 designated commodity futures, 16 option contracts, and stock option contracts in China.

The announcement was made after China Securities Regulatory Commission Vice-Chairman Fang Xinghai's comments at a forum on further opening up the country's futures markets. More internationalized commodity and financial futures products should be rolled out, he said.

Bond Connect Celebrates 5th Anniversary — Review and Outlook

Xi Shuai, Senior Strategic Planner
Zhu Jing, General Manager of Global Markets, Executive Director of RMB Business

Bond Connect is a successful example of mutual market access programs that allows investors in Mainland China and overseas to trade, settle and hold bonds tradable in the Mainland and Hong Kong bond markets through a linkage between the Mainland and Hong Kong financial infrastructure institutions. Its most distinctive feature is that Mainland and international investors can continue to follow common trading practices in their respective bond markets while gaining efficient and convenient access to each other's bond markets. At present, the "Northbound Bond Connect" has been in operation for five years, and the "Southbound Bond Connect" is about to celebrate its first anniversary. In the context of the global economy downturn in the post-pandemic era, the Bond Connect has made remarkable achievements, showing the vitality of this scheme and creating favorable conditions for further opening-up of domestic capital market.

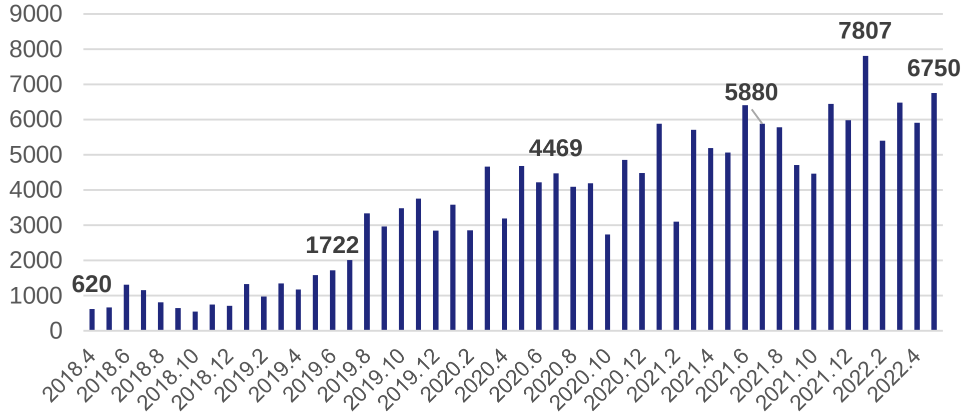
1. Review of the Bond Connect Scheme

Before the launch of Bond Connect, overseas institutions mainly entered the domestic capital market through QFII/RQFII and direct investment (CIBM) modes. Onshore institutions, on the other hand, mainly made foreign bond investment via publicly offered QDII funds. Since the opening of Bond Connect, complementing the other two channels, it has improved the ease of cross-border bond investment and enhance operational efficiency.

(1) The active trading of the Northbound Bond Connect increases overseas institutions' holdings of Renminbi bonds

By the end of May 2022, 3,513 institutional investors from 36 countries and regions had entered the market via Bond Connect. Since its launch in 2017, the total transaction volume of the Northbound Bond Connect has exceeded 18 trillion yuan, with the average daily transaction volume growing from 2.2 billion yuan in the first year of its launch to 26.58 billion yuan in 2021, an increase of more than 10 times.

Monthly transaction value of Bond Connect ($100 million)



The Northbound Bond Connect has become an important channel for overseas institutions to hold renminbi bonds and thus enhance the internationalization of the domestic capital market. As of the end of May this year, according to the definition of legal person, the number of foreign institutions entering the market via the Bond Connect accounted for 59.2% of all foreign investors in Chinese bond market. In May, the transaction volume under the Bond Connect by overseas institutions accounted for more than 60% of the total through various channels. Driven by the growth of Bond Connect, the outstanding balance of foreign institutions' holdings of onshore bonds accounted for 3% of the market, two times over the balance at the end of 2017. The smooth operation of Bond Connect also contributed to the inclusion of Chinese bonds in the major bond indices of Bloomberg, JP Morgan and FTSE Russell.

(2) The Southbound Bond Connect will help achieve the balance of two-way cross-border capital flows

The success of the Northbound Bond Connect has laid a solid foundation for the launch of southbound trading. With further opening of the mainland capital market, how to channel two-way capital flows has become an important topic, and the demand for domestic institutions to carry out cross-border investment and diversify asset allocation is also on the rise. The time is ripe for Bond Connect to expand the southbound trading link.

The Southbound Bond Connect recorded more than 150 transactions on its first day of trading, with transaction value of about 4 billion yuan. Considering the gap between the mainland and Hong Kong in terms of market size, the southbound Bond Connect had a good start indeed.

The successful launch of the Southbound Bond Connect has enhanced the two-way mutual market access scheme and promoted the balance of cross-border capital flows, lifting the opening up of capital market to a higher level. At present, global investors has strong demand for RMB assets, and it is believed that domestic investors' access for investing in foreign bonds will be gradually released. It is expected that the two-way transaction volume of both northbound and southbound Bond Connect will become more balanced. The southbound Bond Connect should play an important role in achieving the balance of cross-border capital flows in the long run.

2. Successful experience from Bond Connect

(1) The internal and external environment drive the development of Bond Connect

China's economic strength has built a solid fundamental for capital account opening-up. China's share of global GDP has been climbing over the past decade, from 11.4% to 18% in 2021. In particular, after the outbreak of COVID-19, China was the first to get out of the difficult situation, and its importance in the global industrial, supply and value chains further emerged, building a solid foundation for the internationalization of RMB and the opening up of the capital account.

Under the international monetary system, RMB assets are favored and demonstrated a safe haven characteristic. The international monetary system dominated by the US dollar has deep-rooted contradictions. The exchange rates of major payment and settlement currencies fluctuate, which increases the risk in the global financial market and poses difficulties for global investors to look for safe assets. The market seeks for diversification of the international monetary system. The low correlation between onshore assets and global markets has created favorable external conditions for foreign investors to invest and hold onshore RMB assets.

The return on RMB assets is relatively stable and attractive. Under the current uncertain global economic environment, the RMB index remains stable, indicating that the RMB has a relative resilience and flexibility. This boosted the confidence of foreign institutions to invest in RMB assets. The RMB exchange rate has come under short-term pressure since the start of the year, but Dim Sum Bond issuance from January to May totaled 191.7 billion yuan, more than double compared to the RMB 95.1 billion issuance in the same period last year. China is also one of the few major economies in the world to maintain a stable monetary policy. A stable currency and reasonable investment returns have increased the attractiveness of RMB assets.

(2) Innovative mutual market access programs have distinctive advantages

With a convenience and high security framework, Bond Connect uses a closed-end management in custody, trading, and settlement to allow onshore and offshore investors to participate in each other's markets in their own trading habits, fulfilling their needs in cross-border bond investment.

The success of Bond Connect is the result of close cooperation between regulators and related parties on both sides. Previously, overseas institutions were interested in RMB bonds and wanted to invest, but often did not enter the market due to various reasons such as lack of understanding of the domestic market. However, the Bond Connect model enabled similar investment needs to be solved. Mainland and international investors can invest through more familiar investment channels to reduce transaction costs and further stimulate investment interest.

(3) Steady start with gradual optimization

Bond Connect has experienced different market environment since its launch. In accordance with the framework of macro-prudential management, a number of optimization measures have been implemented to continuously meet the needs of investors, improve operational efficiency, reduce transaction costs and provide greater flexibility. Through closed-end management and adaptive optimization, Bond Connect has seized the market opportunities and demonstrated strong resilience in uncertain market environment. During this period, the RMB two-way cross-border investment operated safely, effectively and smoothly, laying the foundation for future development. To review some optimization measures of "Northbound Connect", including the implementation of Delivery versus Payment mode to improve the settlement efficiency and reduce the settlement risk; Launching the trading position function for allocation of large trades to multiple accounts before placing orders; Adding new electronic trading platforms; Implementing tax relief arrangements for interest income from bond investments; Extending the cash deadline and offering more settlement options; Allowing investors to use more than one bank for capital exchange and foreign exchange risk hedging. Similarly, the Southbound Connect has operated smoothly. The regulators and relevant parties review and make improvement based on the actual operation situation and market development needs regularly.

It is worth mentioning that ePrime, an overseas bond issuing system, was launched in October 2020, can provide one-stop electronic services for the bookkeeping, pricing and distribution of all kinds of overseas bonds, including Chinese dollar bonds and dim sum bonds, etc. The Bond Connect service continues to extend from secondary trading to primary issuance. With the opening of the primary issuance business of "Southbound Connect", ePrime provides more convenience for both investment and financing, which helps further drive the liquidity and issuance of the offshore market.

3. Suggestions on optimizing Bond Connect

On top of the existing market system and supervision system, Bond Connect has opened up the domestic and foreign financial markets with innovative way, showing the determination of China to gradually open up the financial market. Therefore, the market has always held higher expectations for the continuous innovation and detailed optimization of Bond Connect, injecting greater confidence into the market and promoting the overall development of the market.

Under the "Northbound Connect", further development of repo business and derivatives trading should be promoted, including bond repurchase, bond lending, bond forward, interest rate swap and forward rate agreement, in order to fulfill foreign investors' needs in risk hedging. Recently, the Hong Kong Monetary Authority (HKMA) has said that they in discussion with mainland government to include risk management products such as interest rate swaps in the bond Connect. It is believed that with the improvement of risk hedging tools, it will help promote bond Connect business to a new level.

Further expansion of the scope of investable bonds under the "Southbound Connect" program should be promoted. The scope of "Southbound" investment bonds at the present stage is mainly cash notes issued overseas and traded in the Hong Kong bond market. With the continuous development, the market has expectations for the greater variety of investment products. The HKMA recently formulated a plan to promote the development of the CMU, which aims to upgrade the CMU into a central securities custody platform connecting multiple regions. In the future, further expansion of the "Southbound Connect" can be considered by leveraging the connection of the existing financial infrastructure. In addition, a great management have always been essential for Bond Connect to gain market recognition. We hope that the delivery of funds and the management of liquidity can be further optimized.

4. Future development direction of Bond Connect

It has been 5 years since the launch of Bond Connect and it has achieved remarkable results. As China's regulators continue to promote the opening of capital account and the attractiveness of RMB assets continues to increase, it is expected to have sustainable development of Bond Connect. Looking ahead, we should focus on the following directions:

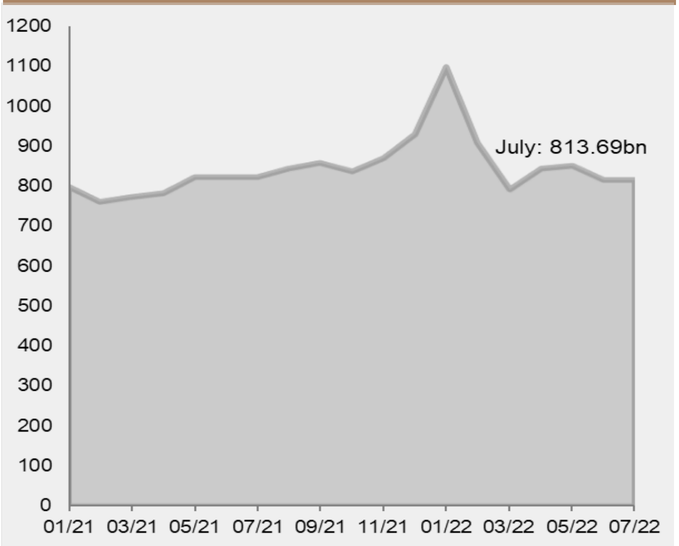
With the recent US Fed accelerated monetary tightening, the US-China interest rate differential has inverted. However, the inflow and outflow of funds under the Bond Connect remained stable, showing that investors tend to be rational about the volatility of the capital market. With the continuous improvement of investors' understanding of the correlation between asset demand, interest rate spread, yield spread, it is believed that it will drive the development of the market.

Bond Connect is a good example of how the two markets can thrive together. Recently, China is speeding up the opening of the onshore market, strengthen RMB's market-driven characteristics. In the future, by further leveraging the strength of offshore market, taking Hong Kong as the connection bridge with the onshore market, and utilizing Hong Kong's role as offshore RMB business center, it is believed that the cross-border capital business will be continuously expanded.

Now, foreign investors mainly manage exchange rate risk through the offshore foreign exchange market. In the future, overseas investors will have more convenient access to the onshore market. The two markets will cooperate and promote each other. By diversifying product offerings, we believe that the market will be further activated. In addition, regulators have recently paid great attention to the construction of offshore RMB market, and have taken a number of measures to improve market liquidity and enrich offshore RMB products. The development of offshore RMB market will also continuously enhance the breadth and depth of bond Connect business.

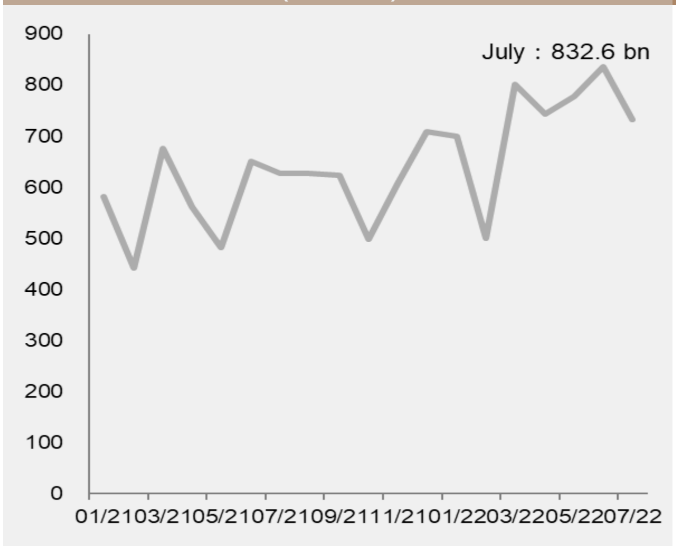
Market Indicators

Hong Kong RMB Deposits (RMB bn)



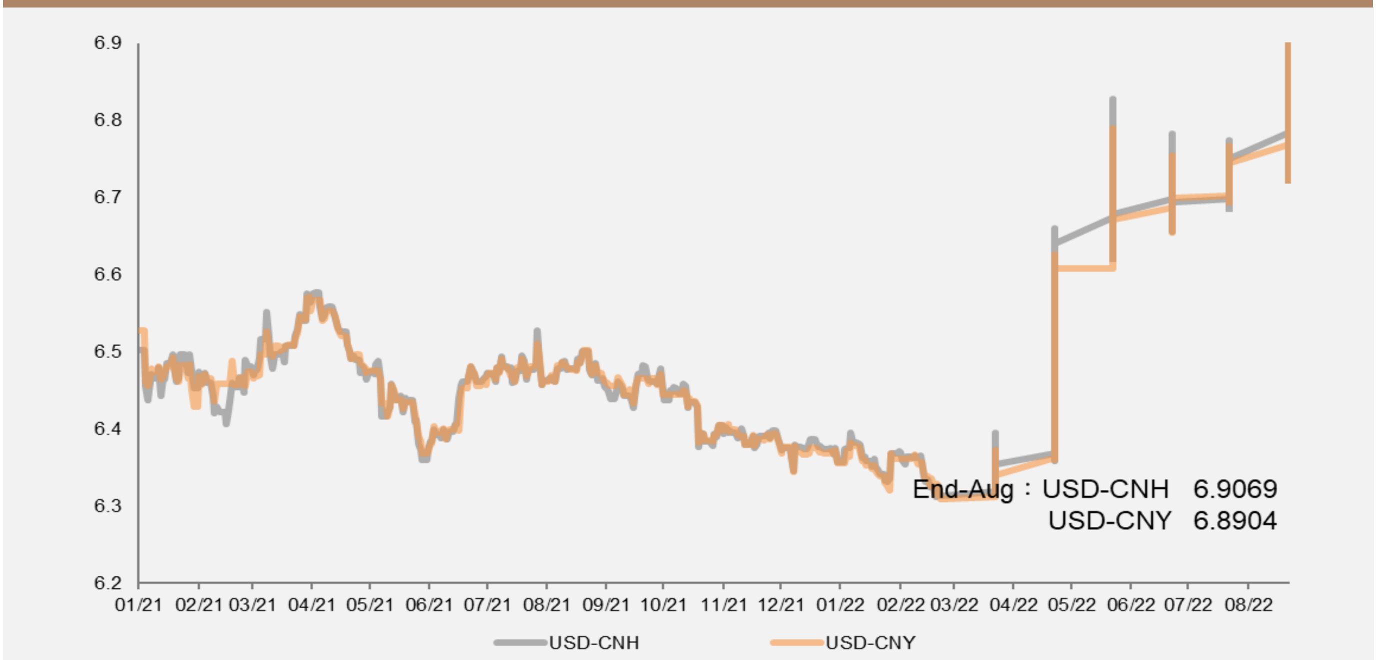
Source: HKMA

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



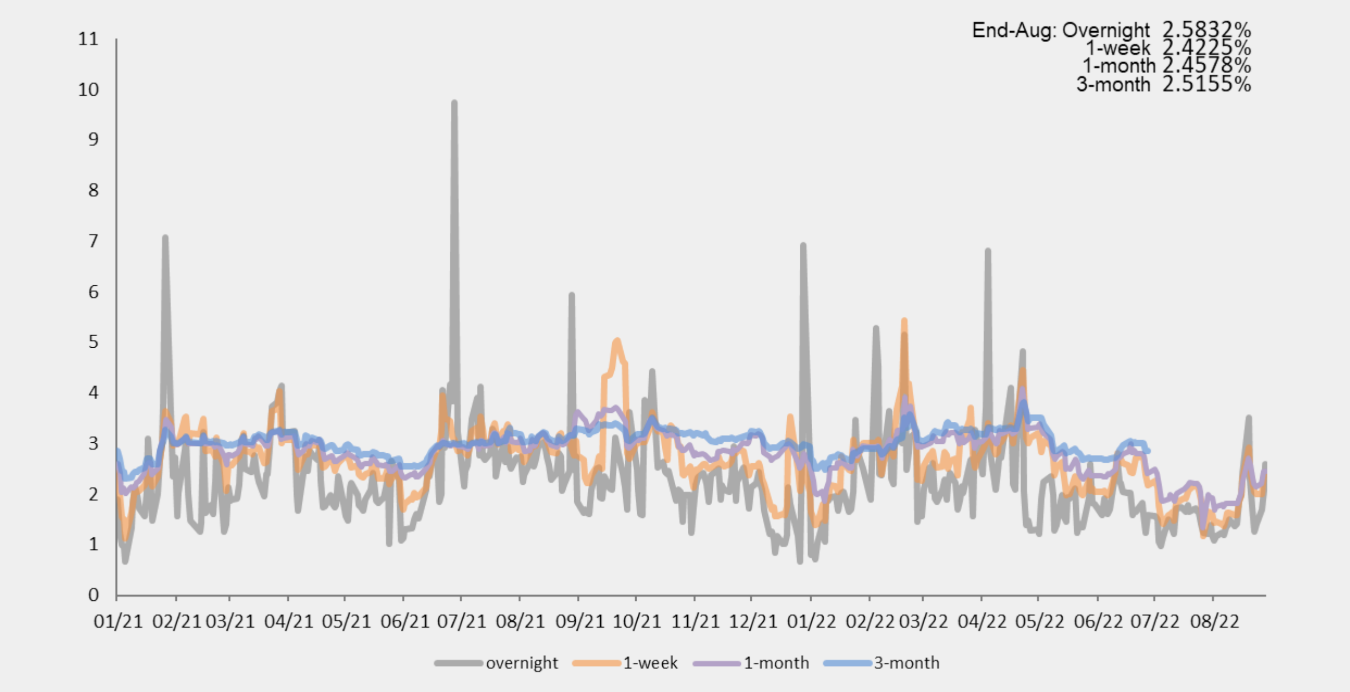
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



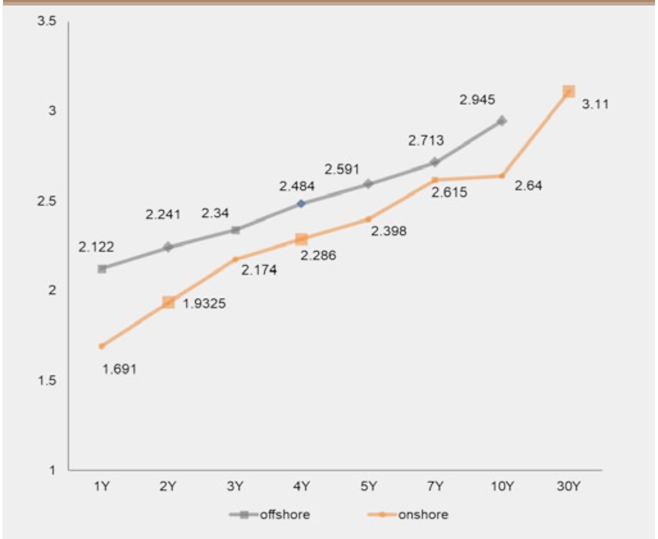
Source: Bloomberg

CNH HIBOR Fixing (%)



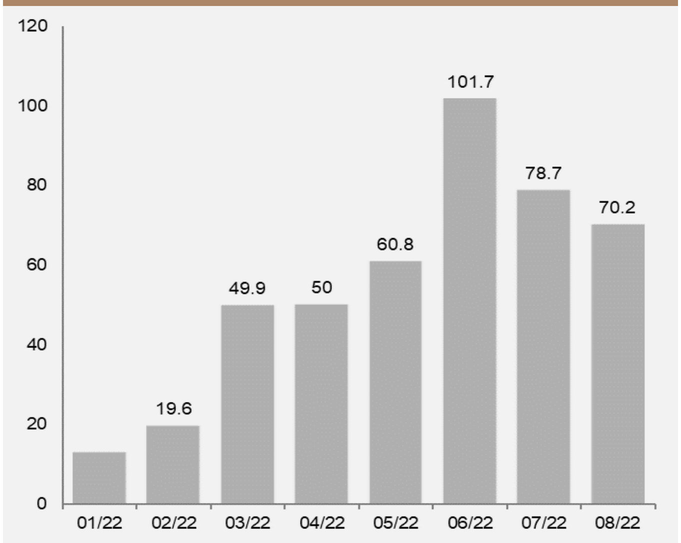
Source: Bloomberg

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



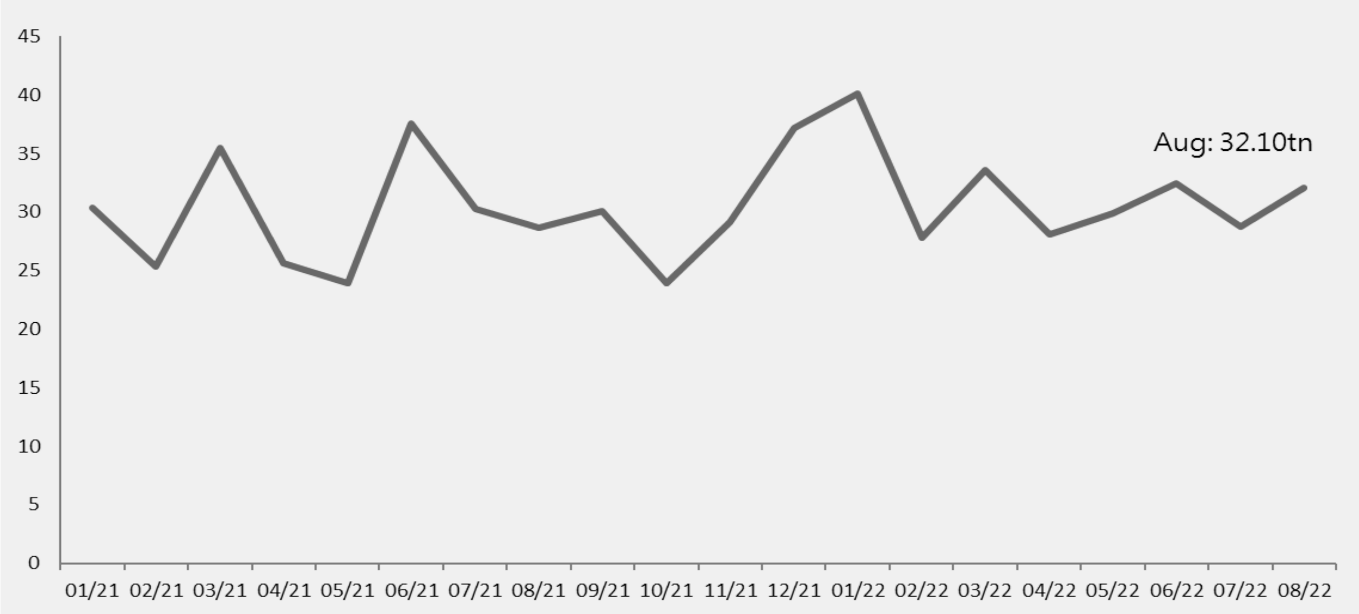
Source: Bloomberg

Hong Kong Offshore RMB Bond Issuance (RMB bn)



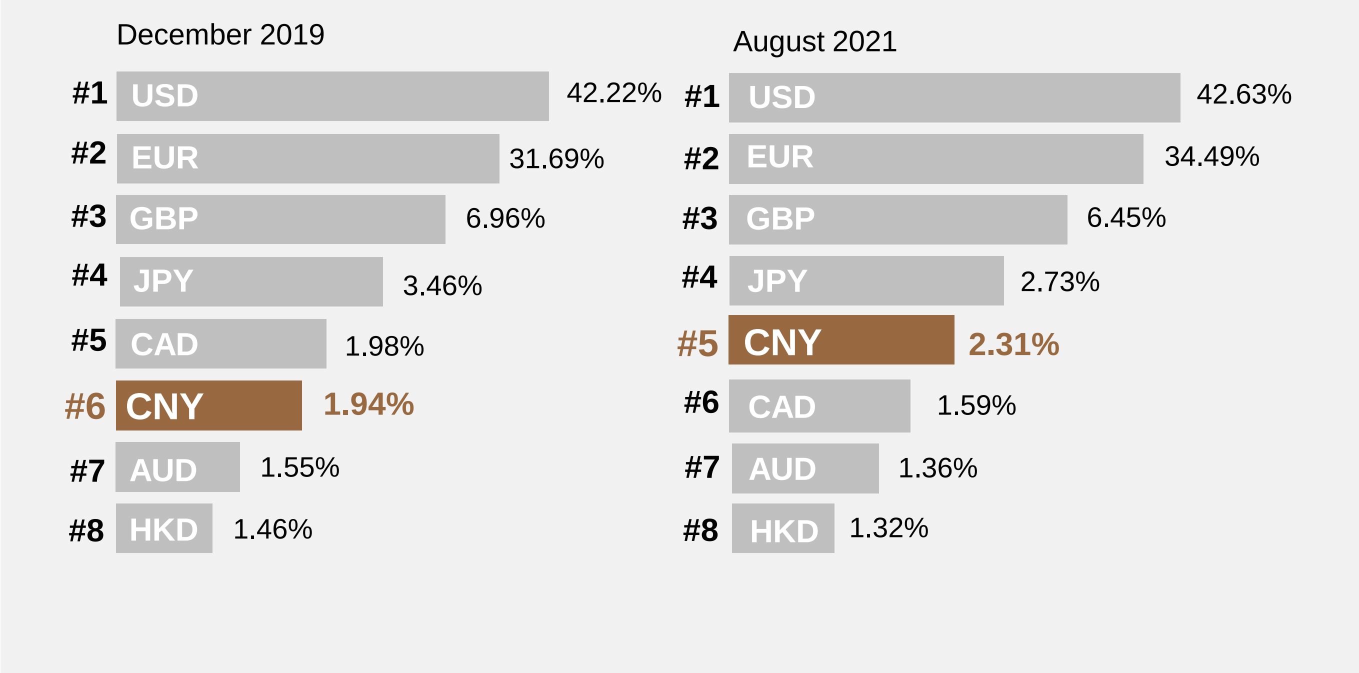
Source: BOCHK Global Market estimate

RMB Clearing Transaction Value (RMB tn)



Source: HKICL

SWIFT World payments currency ranking & market share



Source: SWIFT

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