The Future of the Renminbi

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Pivotal moment for the redback and China

But the renminbi is likely to remain the odd man out in the SDR basket, explains *James Kynge*

Building up the renminbi: the currency is becoming an increasingly important unit of trade settlement — SeongJoon Cho/Bloomberg

The challenges posed to the global financial order by the rise of China could hardly be more fundamental. For several decades, the arbiters of the world's monetary system have been developed, western democracies with fully convertible currencies and open capital markets that are governed by the rule of law.

But China is different in every aspect; a developing nation ruled by a Communist party that has striven to limit the convertibility of its currency and shelter its domestic capital markets from foreign capital and influence.

Thus, the International Monetary Fund's intent to induct the renminbi, the Chinese currency, into its elite basket of reserve currencies represents a potentially pivotal moment. Eswar Prasad, a former IMF economist and China mission head, calls it a "momentous event in the annals of international finance", adding: "It represents an important step in the renminbi's ascendancies to the status of a global reserve currency, and will have gradual but significant repercussions in global currency markets and on international capital flows."

However, the expected inclusion of the renminbi into the IMF's Special Drawing Rights (SDR) basket is only one expression of the currency's growing influence beyond China's borders. The "redback" is also becoming an increasingly important unit of trade settlement, a store of value and a vehicle for investment in assets linked to China's economy.

In all these senses, 2015 has been a banner year for the Chinese currency. It surpassed the Japanese yen to become the world's fourth most-used payments currency, in spite of an unexpected devaluation in August and concerns about slowing Chinese growth. The renminbi accounted for 2.79 per cent of global payments in value terms in August, up from 2.34 per cent in July and higher than the yen's 2.76 per cent share, according to Swift, the payments services provider.

The renminbi is currently used to settle 24.6 per cent of China's own trade and Standard Chartered, an investment bank, expects that this will rise to 38 per cent by 2017 and 46 per cent by 2020. In absolute terms, this means that more than $2.6tn of China's annual trade will be settled in renminbi by 2020, a dramatic rise from $821bn in 2014 and $212bn in 2011, according to Robert Minikin, head of Asia FX strategy at Standard Chartered.

"China's global trade dominance, prudent capital account opening, relatively steady currency value, and rising global influence in commodity markets and geopolitics should allow the renminbi's share [in trade settlement] to rise further," Mr Minikin wrote in a report.

Underpinning the currency's growing popularity in trade settlement is its increasing attractiveness as a unit for investment, a process driven by China's slow but steady opening of its domestic capital markets to overseas investors. According to Goldman Sachs, at the end of the first quarter of this year, foreigners owned Rmb4.2tn ($680bn) of investment assets in China in the form of bonds, equities, deposits and loans.

For those investors approved by Beijing, the main benefit of holding the renminbi is that it brings access to China's domestic bond market, where yields are often several percentage points higher than the US and Europe. At the end of 2014, overseas funds managers held Rmb713bn in domestic Chinese bonds, up 78 per cent from a year earlier, according to official statistics. The

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Panda bonds triumph over dim sum debt after turmoil

Fixed income

Liberalisation and low yields have enhanced the attraction of China's onshore offerings at the expense of the offshore market, explains *Patrick McGee*

For China's bond market, 2015 might be remembered as the year the panda ate the dim sum.

As the International Monetary Fund looks all but certain to include the renminbi in its basket of global reserve currencies, the future of the offshore renminbi "dim sum" bond market (named after the bite-sized food) — renminbi-denominated bonds issued outside china, principally in Hong Kong — looks to be in peril. The onshore market appears to be primed for growth, including the "panda" segment for non-Chinese borrowers.

The dim sum market was launched in 2007 but did not really gain traction until 2010, when restrictions were loosened and international institutions also began to issue renminbi-denominated bonds. For investors, the market was initially seen as a currency play, but in recent years it has been maturing and the breadth of borrowers has widened from top quality state-backed bonds all the way down the ratings spectrum to high-risk single-B issuers.

Both demand and issuance, however, were dented by the equity rally that began in the summer of 2014, which caused a massive shift in asset allocation away from debt. By April 4, when the Shanghai Composite had risen 88 per cent from the previous summer, the People's Daily, a state controlled newspaper, declared that the rally was merely "the start of a bull market". By June 12, stocks had risen by another third, before collapsing by two-fifths within a few weeks.

Bond issuance dried up during the equity boom as companies turned to equity capital markets. According to Dealogic, Chinese corporations raised Rmb122bn in equity from January to June, versus just Rmb58bn a year before. The popping of the stock bubble wiped out trillions of dollars worth of wealth , hurting all asset classes.

Dim sum: losing out to panda issuers

The stock market stabilised in midsummer, but on August 11, just when it appeared bond issuance could recover, the People's Bank of China surprised everyone by devaluing the renminbi. "That obviously spooked the market quite a bit," says Ken Wei Wong, head of Asian debt syndicate at Barclays.

Within three weeks of the devaluation, returns on dim sum bonds plummeted from 2.92 per cent for the year to date, to zero, according to Barclays. US dollar investors were nursing losses. Yields in the index, dominated by short-term debt, shot up from 4.40 per cent to

> 'Issuers can fund themselves domestically. They have no need to fund outside of China'

above 6 per cent, a record high, reflecting demand for currency risk compensation. While the August devaluation had been relatively small — the currency fell about 3 per cent in a week . It followed the 2014 depreciation of the renminbi — the first time the currency had fallen in a decade. Both events gave investors pause for thought.

"With what happened in August the entire thing has been derailed from the perspective of the foreign investor," says Dhiraj Bajaj, portfolio manager at Lombard Odier, a Swiss private bank.

According to Morningstar, a fund tracker, foreign investors withdrew a record $1.78bn from China offshore bond funds in August. "Some funds were decimated," Mr Bajaj said. "Everyone ran away."

As of mid-November, dim sum issuance was on track to be just half the Rmb33bn record in 2014, according to Dealogic. Issuance in the panda market, also shaken by the equity boom and bust, has fallen by 11 per cent, to Rmb443bn.

Once again, the market appears to be finding its footing. But despite Beijing's reassurances that China will not engage in a competitive devaluation, markets are pricing in a 3 per cent decline for the offshore exchange rate over the coming 12 months, according to Helen Huang, fixed-income analyst at HSBC.

The investors most interested in buying dim sum bonds these days, she says, do not need to worry much about currency risk: Chinese investors.

Issuance and demand could both come back, of course, but the PBoC may have sounded the death knell in September when it opened up the panda market to two foreign banks — the Hong Kong units of HSBC and Bank of China. The move signalled Beijing's desire to internationalise the use of the renminbi and, eventually, to converge the two exchange rates into one. Within weeks, the governments of South Korea and British Columbia also expressed an interest in selling panda bonds.

A key reason for their new found attention: lower yields. The PBoC has cut benchmark interest rates six times in the past 12 months. "Yields have come down massively in the onshore market, more than the offshore market," said Barclays' Mr Wong. "Issuers can fund themselves domestically. They have no need to fund outside of China."

Dying or not, it is worth keeping an eye on the dim sum market. Suanjin Tan, a portfolio manager and China bond specialist at BlackRock, says it is a good place to find mispriced bonds, as "state-owned companies have been asked to issue in uneconomic terms, just to support the market".

"We like the fact that we get mispricing," says Mr Tan. "But it's ignored by a lot of international investors."

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Multilateral institutions set to recalibrate

GUEST COLUMN

Jukka Pihlman

The announcement that the renminbi meets the International Monetary Fund's criteria as a "freely usable" currency will have come as no surprise to those who have followed China's unprecedented steps to open up its capital markets.

It means a technical hurdle on the renminbi's ascent as a global currency has been cleared away and makes it near certain that the IMF executive board will include the Chinese currency into its Special Drawing Rights (SDR) basket of currencies, effective from October 1 next year.

A monumental milestone for the renminbi, this event would trigger significant but gradual inflows of funds into the currency, changing the global currency landscape forever, as central banks, sovereign wealth funds (SWFs) and multilateral institutions recalibrate their balance sheets.

Many will not wait until next year before taking action. Indeed as many as 70 central banks have already invested part of their reserves into renminbi, either inside China or offshore.

The reforms made by China to qualify for SDR inclusion have been so radical that — to public sector investors — the renminbi has become fully convertible with no restrictions on access or size of investment in the China interbank bond market, something that has gone largely unnoticed.

Six out of the world's 10 largest central banks have so far refrained from investing in the Chinese interbank bond market. However, because of China's recent reforms, these and many other public sector investors are now reviewing their stance.

Eventually, we should expect to see the renminbi reach a double-digit share of global reserves — inflows in the order of $800bn to more than $1tn. Even a conservative estimate of a reallocation of about 1 per cent of global reserves each year would mean about $80bn inflows annually — no mean sum.

Added to the moves by central banks, will be those by SWFs. Norway's SWF alone is likely to invest over $40bn according to their GDP weighted benchmark.

> This event will change the global currency landscape forever

The implementation of the renminbi's inclusion in the SDR basket 10 months from now is also set to inevitably trigger a significant rebalancing or hedging demand for the Chinese currency, though this, too, is likely to occur gradually.

Contrary to common perceptions — given that the aggregate SDR assets of the central banks in the IMF member states (around $280bn) have an equal amount of SDR liabilities — the renminbi's addition to the SDR basket would not actually trigger a system-wide hedging demand, though some countries that are long or short on SDR may hedge their positions.

Instead, by far the most significant direct effect from the RMB's inclusion on currency flows would come from multilateral institutions. The IMF's own investment account and investment by its Poverty Reduction and Growth Trust would need to be rebalanced to include the renminbi.

Likewise, institutions such as the Bank of International Settlements, the African Development Bank, the Islamic Development Bank, the Arab Monetary Fund and the International Fund for Agricultural Development have SDR-denominated balance sheets, which would need to be rebalanced.

The World Bank and Asian Development Bank would also be affected as some of their facilities for the world's poorest countries are denominated in SDR. The combined size of these multilateral institutions' SDR denominated balance sheets is around $600bn, so the resulting renminbi flows could be more than $80bn assuming existing SDR weighting methodology.

The renminbi's weight in the SDR basket has been the only big issue left for the IMF executive board to decide. Recent suggestions by some stakeholders that using existing methodology could leave the renminbi with too big a share of the basket (at around 14 per cent, far greater than that of the pound and the yen) will hopefully have been ignored the Board.

While the current weighting formula may not be ideal, the renminbi and the markets are fully ready to handle the direct implications of the SDR inclusion with the existing weighting methodology.

The writer is managing director and head of central banks and sovereign wealth funds at Standard Chartered Bank. He previously worked for the IMF and the central banks of New Zealand and Finland.

Pivotal moment for the redback and China

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amount, while small in comparison with the size of the overall Chinese bond market, is significant when compared with the capitalisation of other regional local currency bond markets.

Beijing remains cautious over which foreign institutions can invest in its domestic markets. It restricts access to its interbank bond market to central banks, sovereign wealth funds, multilateral organisations and other carefully-selected institutions. Similarly, the Chinese equity market remains off limits to general participation from abroad, with quotas for limited participation granted to some 320 institutional investors deemed "qualified" by Beijing.

Paul Mackel, head of global emerging market FX research at HSBC, says that not only should SDR membership provide comfort over the renminbi's stability and liquidity, it will also encourage Beijing to keep opening its domestic capital markets to foreign participation.

Such a process should, in turn, convince central banks around the world to shift an increasing portion of their reserves into the Chinese currency. Mr Mackel says that although the renminbi's weighting in the SDR basket is likely to be 14 per cent (relegating the Japanese yen to an estimated 8 per cent weighting), central banks are likely to shift holdings of renminbi to about 10 per cent of their reserves by 2025.

If this happens, it will go some way toward addressing the current imbalance in international finance, under which less than 1 per cent of global central bank reserves are held in renminbi in spite of the fact that China comprises 13 per cent the global economy and more than 15 per cent of world trade. Given that China is the biggest trade partner for 120 countries, it is reasonable to expect their central banks will be keen to boost holdings of renminbi.

24.6%	46%
Amount of China's trade now settled in renminbi	Forecast renminbi share of trade by 2020

Such moves, however, do not obscure the fact that the renminbi is the odd one out among its SDR peers. The IMF's key criterion for SDR inclusion was that the renminbi should be "freely usable" — a definition that falls short of a "fully convertible" currency like the US dollar, euro, sterling and yen.

David Lubin, head of emerging markets economics at Citi, notes that Beijing does not intend to move its currency toward full convertibility. Zhou Xiaochuan, China's central bank governor, has defined the goal as "managed convertibility", saying clearly that "the capital account convertibility that China is seeking to achieve is not based on the traditional concept of being fully or freely convertible".

Mr Lubin says China, in fact, wants to keep hold of discretionary powers to limit speculative capital inflows, and thus to restrict capital movements in order to deal with balance of payments problems as they crop up.

"What China would like to do, over time, is to gently reassert the role of the state in shaping the international monetary order," Mr Lubin wrote recently in a comment for this newspaper.

'One Belt, One Road' set to turbocharge renminbi usage

Infrastructure Massive demands for financing will see China tap offshore centres, says *James Kynge*

Ambitious vision: Beijing's modern development goals include building ports, railways and highways Waldo Swiegers/Bloomberg

Xi Jinping, the Chinese president, has a fondness for atavistic grand designs. In one, the "Chinese dream", he urges his people to recapture the glories of the past through a national rejuvenation. In another, the "New Silk Road", he looks back in time to envisage a future buoyed by closer ties across Eurasia.

So wide-ranging is the New Silk Road initiative to build vast infrastructure projects among 64 countries linked by China's ancient trade routes that the plan encompasses a full set of Beijing's modern development goals, including promoting the use of the renminbi in international investment and finance.

The scheme, also called "One Belt One Road" (OBOR), is set to turbocharge renminbi usage, emphasising the Chinese currency's role as a vehicle to raise capital in overseas financial centres to fund railways, highways, ports, airports and other infrastructure projects across Eurasia.

"London, the US and Asia, plus local markets where the projects are being built, will be places to raise money, as well as onshore in China," says Spencer Lake, global head of capital financing at HSBC, an investment bank.

"The OBOR financing will be massive and we are already seeing deals being concocted that will require the mainstream public markets for liquidity," he adds.

Already, the influence of OBOR is evident in China's overseas investment flows, which rose 16.3 per cent in the first 10 months of this year to $92.5bn. Within this, OBOR-related investment rose 36.7 per cent to $13.7bn, according to China's ministry of commerce.

But these are the mere foothills of OBOR ambitions. The China Development Bank, one of the country's main policy banks, has calculated that some 900 projects worth a total of $890bn are currently under way or planned.

The lion's share of the funding — both in renminbi and other currencies — is likely to come from Chinese policy banks such as the CDB and the China Ex-Im Bank, supported by the Asia Infrastructure Investment Bank, a new China-led development institution with 57 founding governments, and the Silk Road Fund, a state-owned investment fund, as well as Chinese banks.

But Chinese institutions are also increasingly tapping offshore financial centres to take advantage of a climate of low interest rates and to popularise the renminbi. In the run-up to Mr Xi's visit to London in October, two state-owned Chinese banks, the China Construction Bank (CCB) and the Agricultural Bank of China (ABC) issued bonds, at least partially in renminbi.

The issues were heavily oversubscribed, with the CCB Rmb1bn bond attracting orders in excess of Rmb5.5bn from investors lured by a coupon of 4.2 per cent and little default risk for what amounts to a quasi-sovereign issue.

"There is a tremendous amount of liquidity for primary new issues from a wide range of Chinese issuers in multiple currencies," Mr Lake says. "The recent deals in London demonstrate that. As China's profile on the world stage grows, so too will demand."

The ABC bond also indicated strategic priorities. The issue was styled as a "green bond" and raised a total of $1bn in both US dollars ($900m) and renminbi ($600m), all of which is destined to be invested in "green" projects including renewable energy, energy efficiency, sustainable transportation, waste management, sustainable land use and water management.

Such "green" investments are envisaged as a key component of the OBOR master plan as China tries to boost the international business of its environmental companies, which it regards as world leaders in search of a ripe international market. The aim is that Chinese suppliers to such OBOR projects will be paid largely in renminbi.

> 'London is seen as a place where China can raise much of the finance for OBOR projects at relatively low rates'

"London is seen as a place where China can raise much of the finance for OBOR projects at relatively low rates and in renminbi," said one UK official, who declined to be identified. "The main challenge is ensuring that there is enough renminbi liquidity to buy the debt that is issued."

In order to deepen the market for renminbi in London, the People's Bank of China, the central bank, has started regular sales of one-year renminbi debt at the relatively attractive rate of 3.1 per cent (compared with just 2.43 per cent for one-year sovereign notes onshore). In an indication of demand, the first Rmb5bn tranche attracted 91 orders of over Rmb30bn, bankers said.

Reinforcing this trend toward tapping offshore capital markets was the official easing of rules in September on Chinese corporate bond issues overseas. The new rules, published by the National Development and Reform Commission (NDRC), withdraw a requirement for approval and require only that companies inform Beijing of their bond issuance intentions within 10 days of selling.

Such auguries suggest a significant boost not only in Chinese activity in offshore debt markets over the next few years, but also a growing role for the renminbi as an increasingly influential currency in international debt markets.

Currency is growing in stature despite residual concerns

Trade

Renminbi's march is propelled by China's leading role in the global economy, writes *Shawn Donnan*

Nowhere in the global economy today is China more of a force than in the world of trade. That fact alone seems destined to propel the march of the renminbi, once considered an exotic currency, further into the mainstream.

China is now the largest exporter by some margin. Economists at the World Trade Organisation predict that its exports will account for more than 14 per cent of the value of goods exported around the globe by year-end, up from a little over 6 per cent a decade ago.

China is also on course to topple the US from its perch as the biggest importer, and accounted for just over 10 per cent of the value of imports around the world this year.

China's emergence in the past decade as the leading trading nation has expanded the role of the renminbi to such an extent that in 2013, the currency overtook the euro as the world's second choice in trade finance after the dollar, according to Swift, the global payments house.

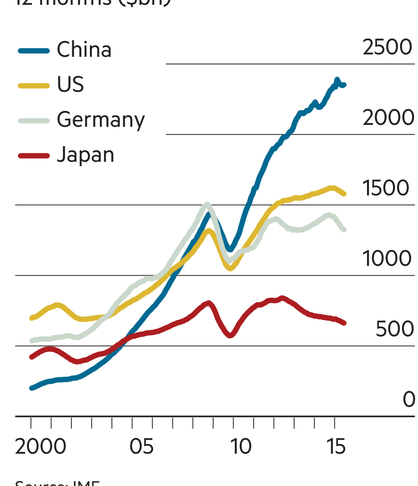
In Asia, the renminbi is now the leading option for commerce between China and regional partners such as South Korea. Trade payments in renminbi to China and Hong Kong now account for almost a third of transactions, says Swift, compared with just 7 per cent three years ago.

The renminbi could cross a more significant symbolic threshold as the International Monetary Funds is set to go ahead with a widely anticipated decision to add the Chinese unit to its elite basket of global reserve currencies used to value its Special Drawing Rights (SDRs), currently the preserve of the British pound, the US dollar, the euro and the yen.

Stuart Tait, global head trade for HSBC, argues that using the renminbi in trade transactions no longer seems like an exotic idea. During a recent visit to China's Pearl River Delta, a region where many export-focused companies are based, he was struck by how much the conversation had changed. "We talked about Rmb exposure in the way you would about any currency. It wasn't this unique frontier issue," Mr Tait says.

Leading exporters

Goods exports, sum over previous 12 months ($bn)



Source: IMF

His belief that the renminbi's role in global trade is likely to continue to grow was bolstered by an HSBC survey of 1,600 executives in 14 different markets in January and February that showed more than half expect to begin using the currency more in transactions.

However, while there is no doubt the renminbi is growing in stature, its ascent has not gone entirely unchallenged.

The euro's role in trade has staged something of a comeback as its value has fallen and German exports have risen.

The HSBC survey also showed that not everyone is equally confident in the renminbi. Executives in Taiwan and Germany were more hesitant about the currency than more bullish peers in the UK, for example. Mr Tait believes that companies would be more comfortable if deeper renminbi markets developed around the world, offering greater liquidity.

There are also questions over whether some of the numbers used to support the more confident narratives over the renminbi truly reflect reality.

Swift says the renminbi is the currency behind almost 10 per cent of the trade carried out with letters of credit. But much of that trade is between mainland China and Hong Kong, or the mainland and Taiwan, and there have long been suspicions of significant "mis-invoicing" to evade capital controls.

When the IMF examined the role of the renminbi earlier this year as part of its review of whether to grant the currency SDR membership, it treated letters of credit between China and both Hong Kong and Taiwan as domestic trade. By that measure, the renminbi was behind just 3.8 per cent of the global value of letters of credit, which are dominated by the dollar.

Volatility in China's markets over the summer and swings in the renminbi linked to the August announcement by the People's Bank of China that it was changing the way the currency's daily trading band is set have also caused concerns among investors.

China may be slowing. But, as Mr Tait points out, it is still growing faster than any advanced economy.

"It's about keeping it all in context," he says. "The Chinese growth in trade will continue to outpace global growth."

And for a currency that has been building its place in the global economy on the back of trade, that is likely to mean a growing role for many years to come.

Contributors

James Kynge
Emerging markets editor

Patrick McGee
Lead writer, Asia, FastFT

Shawn Donnan
World trade editor

Roger Blitz
Currencies correspondent

Gabriel Wildau
Shanghai correspondent

Emma Boyde
Commissioning editor

Steven Bird
Designer

Emily Lewis
Picture editor

For advertising details, contact **Olivia Hu**, + (86) 21 6375 9222 ext. 121 and olivia.hu@ftchinese.com, or your usual FT representative.

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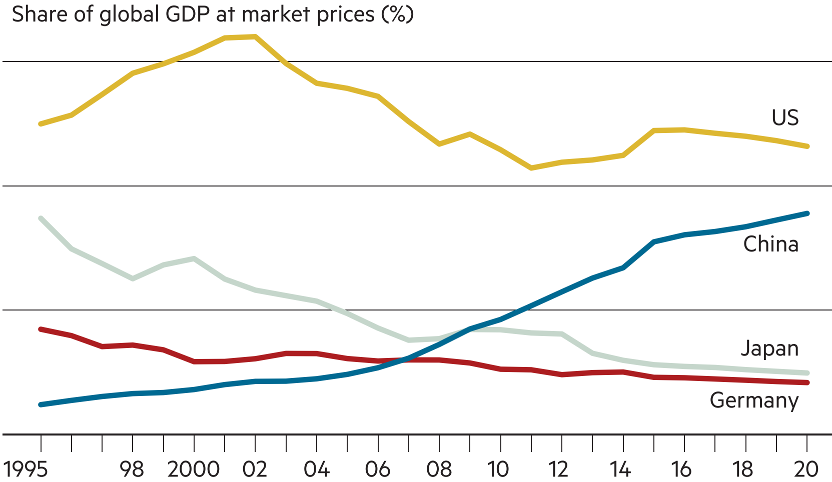
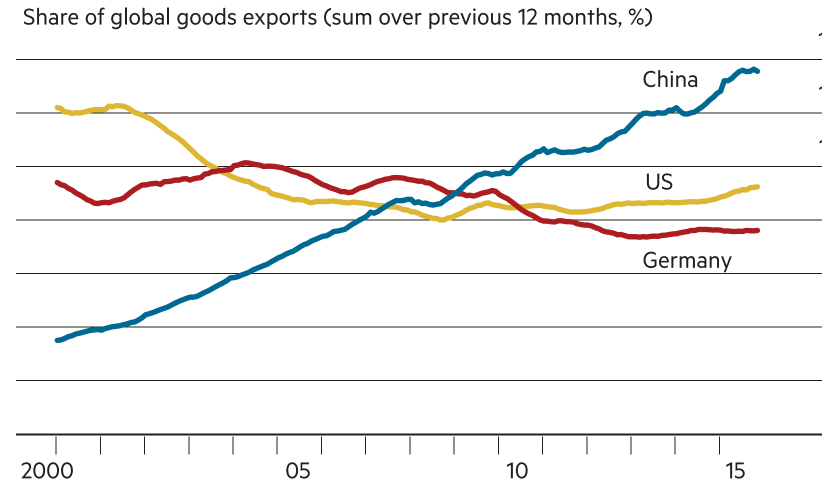
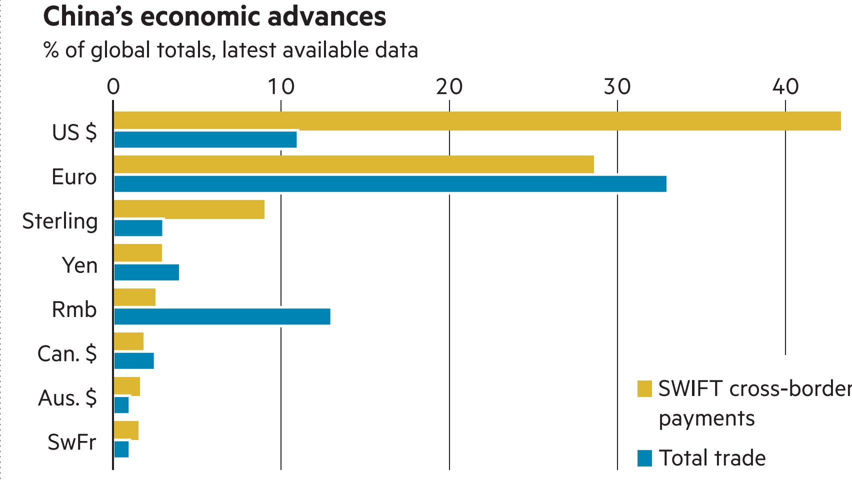
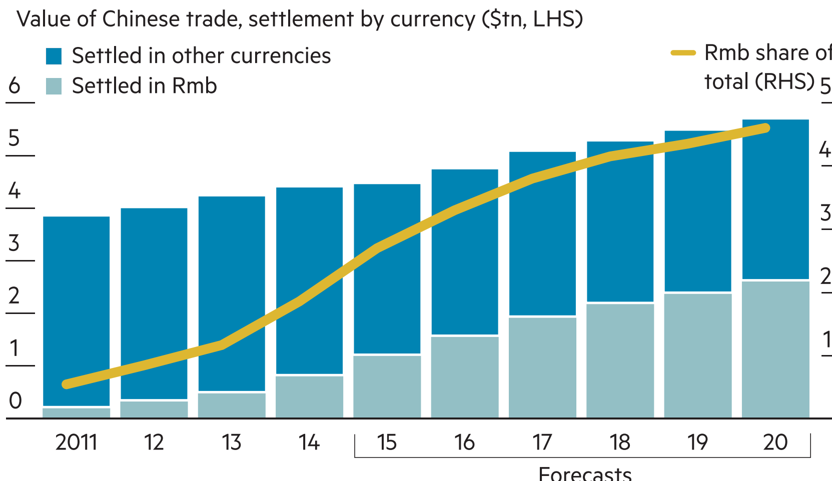
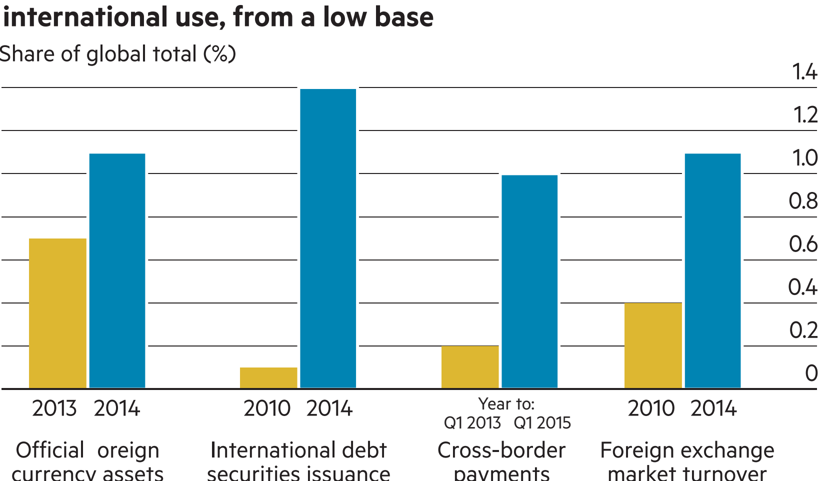
The Future of the Renminbi

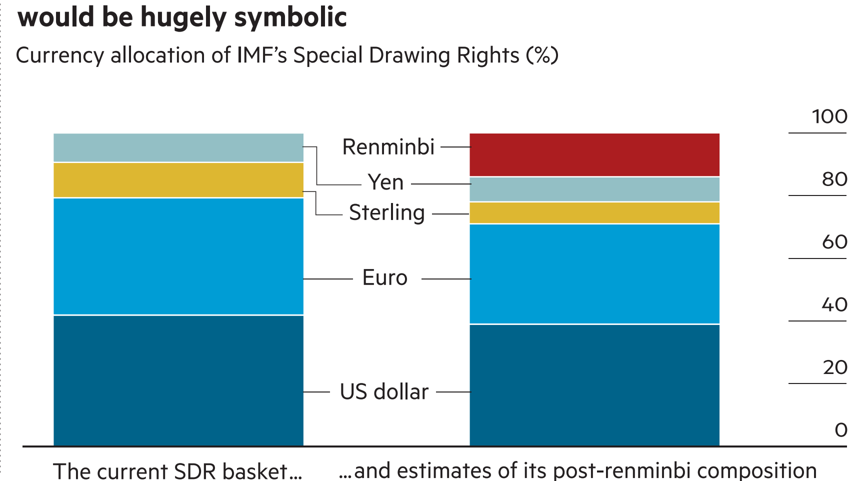












FT graphic Sources: Thomson Reuters Datastream; IMF; SWIFT; Standard Chartered; BIS; HSBC Photo: Dreamstime

SDR move seen as vote of confidence in China's leaders

Reserve currency Uncertainty persists over how markets will react, writes *Shawn Donnan*

China's leaders have long sought to win a place for the renminbi in the International Monetary Fund's elite basket of reserve currencies. The move would not only cement the redback's role in the financial system. It will also give those leaders a vote of confidence they have craved for years.

From October 1 next year the renminbi is set to take pride of place alongside the British pound, the dollar, euro, and yen in the IMF basket.

Yet there is considerable uncertainty over how markets might react to such a step. Would an IMF decision, as some argue, trigger a massive flow of capital — as much as $1tn in the relatively short-term, according to Goldman Sachs — into renminbi-denominated assets? Or might markets greet the news with a shrug?

Of itself, the move would be largely symbolic. Created in 1969 as an alternative to gold as a store for central bank reserves, the fund's Special Drawing Rights are something of an anachronism. They are rarely used outside fund business and internal discussions. IMF rescue packages may be officially valued in SDRs and as a percentage of countries' quotas in the fund but real-world discussions of them are still conducted in dollars, euros and local currencies.

But when it comes to nations and their standing in the world symbols matter. The renminbi, it is worth remembering, is still far from being an international reserve currency.

Though China's economic expansion has driven a surge in the volume of trade and transactions conducted in renminbi, it only accounts for a small proportion of the world's official reserves.

An IMF survey of the fund's 188 member countries found just 38 held any of their official foreign currency reserves in renminbi in 2014, accounting for just 1.1 per cent of the world's assets, or roughly half the number and share of those using the Australian dollar. The US dollar, by way of comparison, was used by 127 countries accounting for almost 64 per cent of global foreign currency reserves while the euro accounted for a further 21 per cent.

That figure for the renminbi is low partly because until the IMF began coaxing Beijing into the reforms needed to qualify for the SDR basket, there were very few places that central banks could park reserves in renminbi. In 2014, for example, just 1.4 per cent of international debt securities, issued were denominated in renminbi, according to Bank for International Settlements data.

That has been changing, however, as China has pursued reforms in the hope of winning the renminbi's inclusion. Beijing has opened up its domestic bond market to foreign central banks. Deals have also been struck to allow the greater issuance of renminbi-denominated bonds in places such as London.

The question is whether such moves will translate into broader confidence in China's economic prospects.

Investors remain nervous: China market turmoil last summer — AFP/Getty Images

Investors remain nervous about the country's challenges, as exemplified by the turmoil caused this summer by Beijing's decision to devalue the renminbi. Against this volatile backdrop, it may take years to develop markets in renminbi assets that have the depth and liquidity needed to persuade central banks that they are a safe place to park taxpayers' money.

"Inclusion in the SDR basket could be taken as endorsement by the IMF that the renminbi and China's financial markets meet this standard. But central banks are likely to come to their own judgment," Mark Williams, chief Asia economist for Capital Economics, wrote after the IMF announced its recommendation for the renminbi's inclusion on November 13.

However, he warned that the market gyrations of the summer and Beijing's response meant that, "if anything, the renminbi's chances of being taken seriously as a reserve asset have gone backwards recently".

China's leadership had responded to concerns about capital outflows by making it harder to move capital abroad. Following collapses in stock prices it also suspended trading in many shares, he pointed out, effectively freezing the ability of investors to sell assets as needed. "Managers of foreign exchange reserves will think twice before entrusting their country's assets to policymakers who have shown themselves willing to steamroller the rights of investors when it suits them," he wrote.

Nevertheless, international financial officials have argued that China learned valuable lessons from the summer debacle and that reforms it has introduced to support its bid for the renminbi to join the IMF's SDR basket are largely irreversible.

If the US and the Fund's European shareholders have decided to back Beijing's SDR bid it is because the hand of reformers at the People's Bank of China is being strengthened.

So too is the relationship between Beijing and the IMF at a time when the US's continuing failure to ratify 2010 reforms giving China a greater voice at the fund remains an irritant. But the question remains: will China and its currency live up to their promise?

Bond market quietly delivers revolution in liberalisation

GUEST COLUMN

Spencer Lake

While much attention this year has been focused on the trials faced by China's stock markets, quiet but significant reforms have been transforming foreign participation in the country's vast domestic bond market.

July was a landmark month, heralding the freeing up of access to China's interbank bond market for overseas central banks, supranational institutions and sovereign wealth funds. A set of new regulations scrapped approval and quota requirements.

The measure ranks as one of the most important in a series of steps to integrate China's bond market, now the world's third largest with a capitalisation of $4.2tn at the end of last year, into the global financial system. China's interbank market is where the vast majority of government and enterprise bonds are traded, but foreign participation is paltry with just 2.4 per cent of domestic government bonds held by foreigners at the end of 2013.

China has made it clear that it wants market forces to play a more decisive role in the allocation of capital and that it needs its financial markets to become more efficient and competitive. Underlining this trend, Beijing recently reopened its market for "panda bonds", in which offshore entities issue renminbi-denominated debt. Two panda issues worth Rmb1bn and Rmb10bn have been executed so far.

Beijing has linked such liberalisations to the internationalisation of the renminbi and its desire to win admission for the Chinese currency into the International Monetary Fund's Special Drawing Rights (SDR) basket.

But the need for deeper and more liquid capital markets is also crucial for the trajectory of China's economic reform. Further developing its bond market will help economic growth, improve the allocation of capital and bring down borrowing costs.

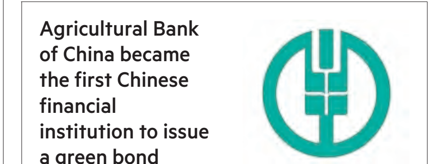
A more dynamic bond market also helps lessen China's reliance on bank lending and frees up Chinese banks to extend more lending to small and medium-sized enterprises.

It will also help meet the big financing needs that come with China's efforts to reduce the pollution that has accompanied the headlong growth of the past decades and to deliver the environmentally responsible development and clean infrastructures that are needed for China's urbanisation push in the coming years.

In October, the Agricultural Bank of China became the first Chinese financial institution to issue a "green" bond, (raising a total of $1bn earmarked for environmental projects) in both US dollars ($900m) and renminbi (Rmb600m), making it the first renminbi green bond transaction by an Asian issuer and also the largest US dollar green bond transaction by an Asian issuer.

The proceeds from the offshore bond will be used to fund green projects in six sectors including renewable energy, energy efficiency, sustainable

Agricultural Bank of China became the first Chinese financial institution to issue a green bond



transportation, waste management, sustainable use of land and clean and sustainable water management.

Given the State Council's promise in September to incorporate ecological conservation into every aspect of economic development, we expect the market for green bonds to grow. We also expect the People's Bank of China to release official guidelines for the green bond market by the end of the year.

China's stock markets tend to grab the limelight, but the development of the country's bond market is no less significant to its financial market reform. For China, opening the doors to more foreign participation is an essential element of a more mature debt market.

The author is global head of capital financing at HSBC

London set to benefit after rolling out red carpet for Xi

Financial centres All potential global partners are looking for further reform, writes *Roger Blitz*

Top treatment: President Xi Jinping attends a royal banquet during his state visit to UK in October
Getty Images

Building up to the climax of a speech in London in October, Bao Mingyou, the People's Bank of China's chief representative in Europe, told his audience of business leaders his country's financial sector needed not only to adapt, but to take the lead.

"The process of renminbi liberalisation will be pushed ahead," he said, before listing a series of financial reforms already undertaken — on renminbi rates and on the issuing of certificates of deposits and lending rates, among others.

Then came the climax. "This is the time for you to be more engaged and you will benefit in the long run," he finished.

This was no wake-up call for London. Of all the world's financial centres, London has positioned itself strongly to capitalise on China's increasing inclination towards financial reform. Just to ram home the message, the red carpet was well and truly rolled out for President Xi Jinping's state visit to the UK in October.

On top of the requisite trade and investment deals that accompany such trips, China formally applied to become a member of the European Bank for Reconstruction and Development, which the UK welcomed. It also chose London as the first financial centre outside China to issue its sovereign debt.

That move would increase liquidity in London's renminbi bond market, says City of London policy chairman Mark Boleat, as well as help develop a pricing benchmark and attract other high-rated issuances.

London is fast becoming an outpost of the Chinese financial system. Chinese banks have become agents for renminbi clearing payments in London and a host of Chinese financial houses have taken up membership of the London Stock Exchange. The Agricultural Bank of China has issued green bonds in London.

As UK Treasury official Katharine Braddick said: "The UK financial centre has tremendous influence."

The competition for Chinese investment in Europe is fierce, says André Loesekrug-Pietri, founder of A Capital, the private equity fund management company. The US had its own red carpet visit from President Xi in September.

European countries need to compete for "the first Rmb bond, the Rmb clearing capital, the listing place for Chinese firms, the best friend of this, the first to officially recognise that, etc," says Mr Loesekrug-Pietri.

But they must co-ordinate policies, markets and wealth to show the Chinese that Europe is a serious partner, he says.

China has no particular preference among potential global financial partners. All are relevant, as it seeks to develop the renminbi and build its liquidity. The renminbi may have climbed from 20th most used currency three years ago to fourth, overtaking the yen in the process, according to Swift, the payments services provider. But it is still dwarfed in size by the dollar and the euro.

London has inbuilt advantages to benefit from China's thirst for renminbi business — it straddles time-zones from Asia to the Americas and is the centre of the global foreign exchange market.

Hence, China is expected to extend its FX trading hours for the onshore renminbi to 11pm to overlap with European trading times.

But for China to become the fifth member of the elite Special Drawing Rights basket of currencies and acquire reserve currency status, it has had to persuade global financial markets its reforms are serious and long-lasting.

That persuasion game is far from over. "If they start to slow down on the reform process, people start to lose interest," says Paul Mackel, who heads emerging markets FX research for HSBC.

Reforms will keep coming. China last month launched a cross-border system for clearing renminbi payments to speed up and clarify a laborious process.

SDR admission is largely symbolic, says Mr Mackel. "It's a coming of age for the currency, an acknowledgment that the Chinese authorities have done a lot of reform. But it's probably a quality of assurance to stay on the reform path."

But it is also a question of confidence. The market clearly took fright at the August 11 policy shift from the PBoC which changed the way it calculates the daily RMB rate-setting band, and resulted in a dramatic fall in the currency.

That has subsequently led the market to give its full attention to the PBoC. Since that marked August depreciation, the renminbi has largely stayed in the same trading band, suggesting the PBoC has been seeking a period of calm while the International Monetary Fund deliberates over China's SDR application.

> 'If they start to slow down on the reform process, people start to lose interest'

Does a positive SDR outcome for China from the IMF presage a resumption of renminbi depreciation?

Many analysts assume the currency will weaken next year. "SDR is not going to stop that," says Mr Mackel. "A period of calm will be temporary, and if anything we will be going back to the fundamental direction of the exchange rate — and that's for the currency to weaken against the dollar."

If China is to get the world to trade more in the renminbi, it may need the market to become used not just to a declining currency but one that moves around more frequently.

One step at a time. The world's financial markets may be gearing up for a more engaged renminbi, but is not yet ready for a volatile one.

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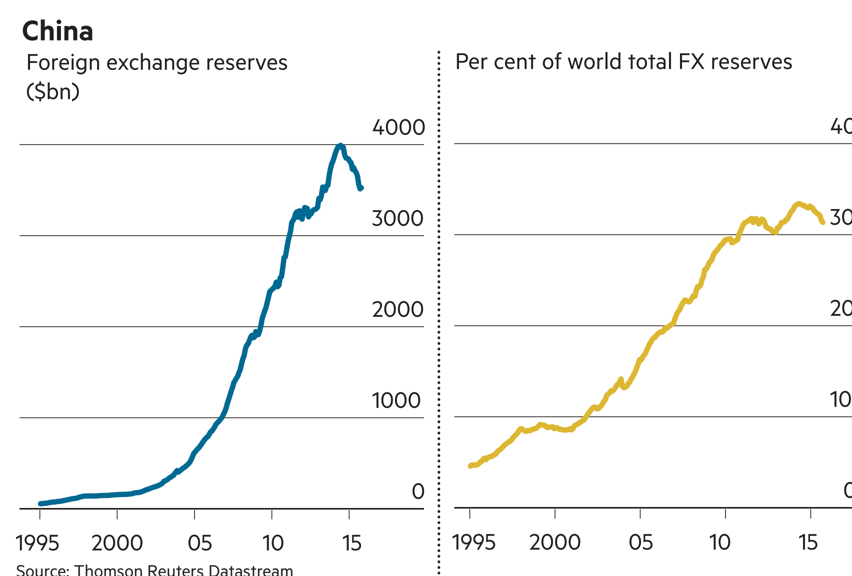
Renminbi reforms could drive down Chinese forex reserves

Capital flows

Rmb trade settlement and investment outflows are both having a negative impact on holdings, writes *Gabriel Wildau*



China's foreign exchange reserves, which stood at $3.5tn in October, have been a source of national pride and a bulwark against adverse financial conditions.

The internationalisation of the renminbi means, however, that Chinese exporters and importers increasingly can send and receive payments in renminbi, rather than US dollars.

China is the world's largest exporter, and big trade surpluses over the last decade have fuelled the rise of China's forex reserves. Now, some are worried that dwindling US dollar export earnings, twinned with capital outflows from China, could result in a drop in China's forex reserves and with it slumping demand for US Treasury debt.

Use of the renminbi for trade settlement has grown rapidly since 2010. According to central bank data, he renminbi was used for 24 per cent of China's current account transactions, or Rmb5.5tn, in the first nine months of this year, up from only 8 per cent in 2011. China's central bank governor, Zhou Xiaochuan, has said he wants the ratio to exceed one-third by 2020.

Determining how important renminbi trade settlement is to China's foreign exchange reserves, however, requires understanding the direction of renminbi payment flows.

If most renminbi trade settlement consists of overseas companies using renminbi instead of US dollars to pay for Chinese goods, that would lead to slower accumulation or even an outright decline in forex reserves, as the renminbi replace the US dollar in China's inbound money flows.

If, on the other hand, it is Chinese companies using renminbi to pay for imported goods, the opposite would occur: forex reserves would swell faster as renminbi replace dollars for outbound payments.

Between 2010, when renminbi trade settlement began, and 2014 outbound renminbi payments heavily outweighed inbound renminbi receipts. This imbalance peaked in early 2014, when payments exceeded receipts by a ratio of more than two to one, according to central bank data. In 2014, the gap narrowed to 1.4 to one, leading to net renminbi outflows of Rmb1.1tn. Based on the average dollar-renminbi exchange rate during 2014, that implies China's forex reserves grew by $179bn more than they would have before the use of renminbi for trade settlement.

This year, however, the pattern reversed. In the nine months to the end of September, renminbi inflows exceeded outflows by a ratio of 1.2 to 1, leading to a net inflow of Rmb773bn, or a $124bn negative impact on reserves.

The shift is partly due to the depreciation of the renminbi following many years of appreciation. Until the depreciation traders were happy to accept renminbi payments because they could feel reasonably certain they would profit from currency gains.

"Our corporate clients are very sensitive to exchange-rate expectations. They will shift their forex behaviour when they feel the market shifting. Sometimes they're even quicker than we are," says a forex dealer at a Chinese bank in Shanghai.

Indeed, after the renminbi surprised the market and fell by 2.4 per cent in 2014, market sentiment shifted. Overseas trading partners no longer wanted renminbi and sought to use trade settlement as a way to offload unwanted renminbi on to Chinese exporters. As the renminbi extended its losses this year, this pattern became entrenched.

Today, analysts are divided about the long-term direction of the renminbi exchange rate. In the medium term, however, China's persistent trade surplus and fast productivity growth relative to the US suggest room for further appreciation.

Ultimately, however, the impact of renminbi trade settlement on China's forex reserves may be dwarfed by other factors. For the past decade, trade dominated China's overall currency flows, while capital controls sharply limited both inbound and outbound investment flows. That is now changing, as China moves to loosen restrictions on currency conversion for investment purposes. Such "capital-account liberalisation" has made it easier for foreigners to invest in China's onshore equity and bond markets, while Chinese investors have acquired foreign companies and gobbled up real estate in London and Sydney.

This liberalisation — combined with bearish sentiment toward the renminbi and the broader Chinese economy — has led to net investment outflows worth $440bn in the first nine months of this year, including a record outflow in the third quarter, balance of payments data show. Thus, the impact on China's forex reserves from capital outflows was more than three times larger than the $124bn negative impact on reserves from renminbi trade settlement.

Larry Hu, economist at Macquarie Securities, believes a more market-oriented renminbi exchange rate will promote balance between forex inflows and outflows. "What [the central bank] really wants," he wrote recently, "is a more volatile renminbi which could deter one-way capital flows."