

## HOW TO TRAIN YOUR DRAGON

### *The role of offshore markets in the rise of the renminbi*

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The motor of growth in the offshore Chinese renminbi market is currency demand in transactions supported by the expansion of Chinese external trade. At the same time, the Chinese government has also been striving to develop offshore renminbi markets, and consequently the Chinese currency has been able to evolve into a global currency separately from the internal market, with both Chinese and international players able to freely participate on its money and bond markets. The offshore market greatly contributes to establishing the renminbi's status as a global currency – and the dragon's passage to adulthood – which can be expected to reach its consummation in the full liberalization of capital investments directed at, or originating from, the onshore market.

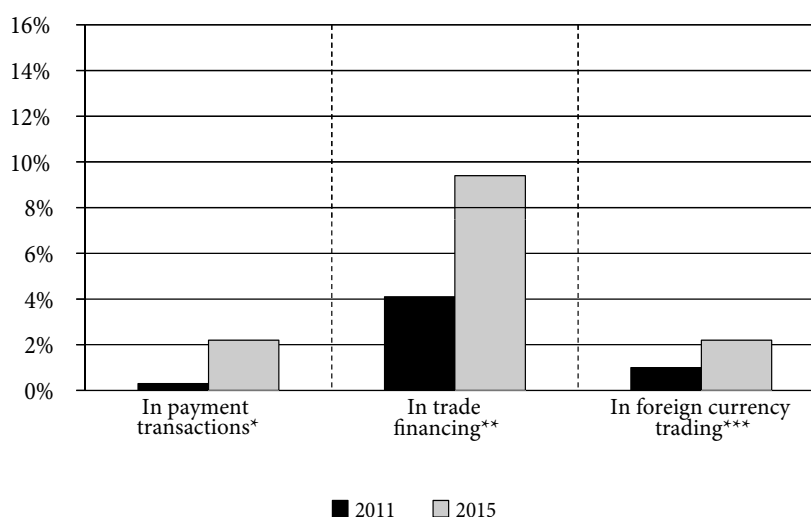
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#### 1. INTRODUCTION

One of the most frequently mentioned criticisms of the Chinese financial system is its lack of transparency. Making up a central element of these transparency-related criticisms are questions relating to the isolation of its onshore and offshore currency and bond markets and the relationship between these markets. This range of problems is further complicated by the fact that in the past five years, it is no great exaggeration to say that not a month has passed without a change in the regulatory and/or liquidity conditions of one market or another.

Despite this, the popularity of the renminbi has grown at a pace outstripping even the expansion of Chinese trade. An ever-growing proportion of both financial and non-financial companies carry out commercial and investment transactions in renminbi (see Fig. 1), while renminbi investments play a role in the foreign currency reserves of a growing number of central banks. In this analysis, we examine the characteristics of this “dual” market structure, as well as the directions of its further growth, with particular regard to the offshore bond market.

**Fig. 1****Weight of the renminbi in cross-border transactions on the global market**

Note: \*data from January 2011 and June 2015, source: SWIFT; \*\*data from April 2012 and January 2015, source: SWIFT; \*\*\*data from April 2010 and April 2013, source: BIS

## 2. THE DUAL NATURE OF THE RENMINBI MARKET AND ITS DEVELOPMENT

Currently two forms of the Chinese renminbi currency exist:

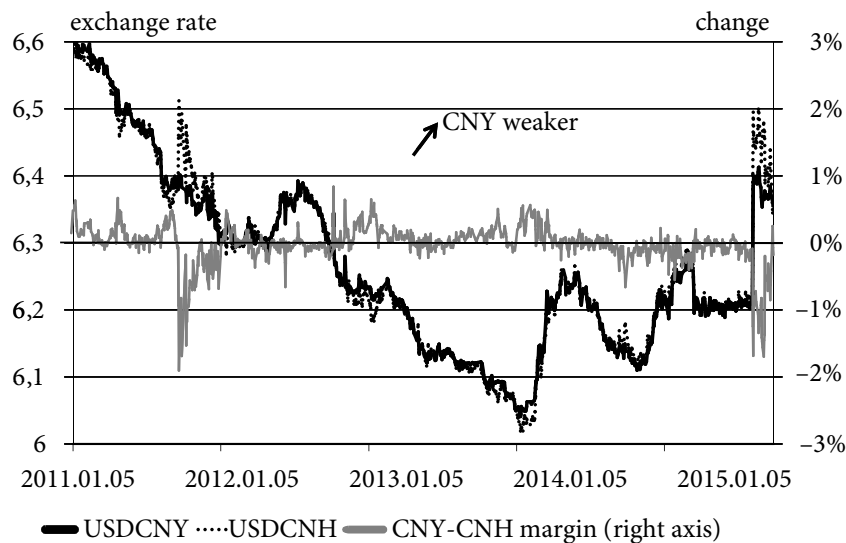
- The “internal” (onshore) currency, access to which is tied to a – normative, sometimes discretionary – licence from the Chinese authorities. The ISO code for the onshore renminbi is CNY, and its exchange rate against the US dollar is permitted by the Chinese authorities to fluctuate within a band of maximum  $\pm 2\%$  compared to the daily set middle rate.
- The “external” (offshore) currency, which is freely accessible to international players. The offshore renminbi’s code is CNH, in reference to Hong Kong, the first and still most important offshore market centre. The offshore renminbi has a separate exchange rate, determined by the balance of market supply and demand. At the same time, in certain authorised cross-border renminbi transactions, it may be matched to the onshore renminbi at the ratio of one to one. When the onshore renminbi is taken abroad, it implicitly becomes offshore, and vice versa.<sup>1</sup>

<sup>1</sup> On this basis, the offshore and onshore renminbi seem to be easily distinguishable, although in the case of most relevant statistics (e.g. in the cross-border transaction statistics provided in Figure 1) there is no available breakdown that would differentiate between the two.

The concurrent movements of the CNY and CNH exchange rates (see Figure 2) simultaneously reflect the permeability between the two markets and – given that the correlation is not perfect – the restrictions on this mutual permeability. Close concurrent movements can be attributed to the fact that a greater divergence in the exchange rates of the onshore and offshore currencies could provide an arbitrage opportunity for those entitled to convert, exploitation of which has the effect of tending to reduce the discrepancy (greater demand for the undervalued currency driving up its price). At the same time, differences of as much as 100 basis points or more between the offshore and onshore exchange rates have been observable; this is considerably larger than the typical differences in pricing of completely convertible currencies seen on various markets, which are generally in the order of a few basis points at most.<sup>2</sup> The jump in the CNH-CNY margin in August 2015, for example, is a good reflection of the uncertainty caused by a change in exchange rate policy – namely, the unexpected shift in the official mid-band in a weaker direction.

Fig.2:

Exchange rates of the CNH and CNY against the US dollar and each other



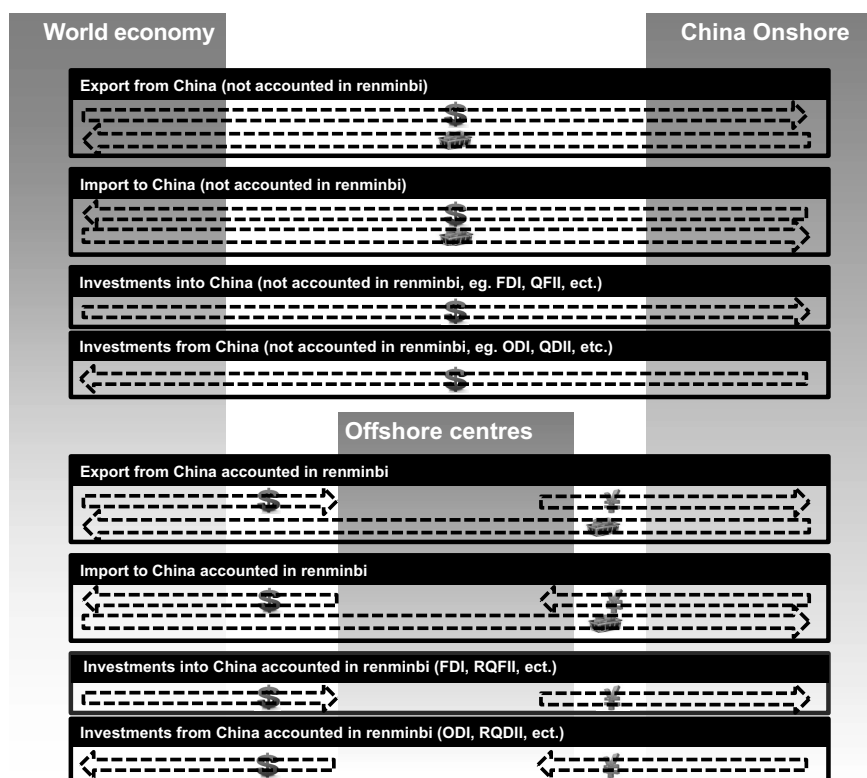
Source: Bloomberg

The range of market participants entitled to carry out onshore-offshore conversion and related activities, as well as the size of the authorised quotas, has expanded dynamically in recent years. Chinese capital controls have been

<sup>2</sup> MAZIAD-SHIK KANG (2012)

continually relaxed in recent years, as a consequence of which the international weight of the renminbi has grown. Beginning from 2009, it became gradually possible for those engaged in foreign trade to account for cross-border transactions in renminbi, and today practically every balance of payments transaction can be freely settled in renminbi. In addition, the outflow and influx of foreign direct investment (FDI) can be accounted in renminbi, while renminbi related to portfolio capital flows of institutional financial investors may cross the Chinese border in the context of various quotas (e.g. RQFII, RQDII, Shanghai-Hong Kong Stock Connect).<sup>3</sup> As the latest development from autumn of 2015, central banks and international financial institutions may now freely trade in the Chinese onshore currency without quotas.<sup>4</sup>

**Fig. 3**  
**Schematic diagram of cross-border renminbi flows**



<sup>3</sup> ERHART (2015a), HSBC (2014)

<sup>4</sup> People's Bank of China (2015)

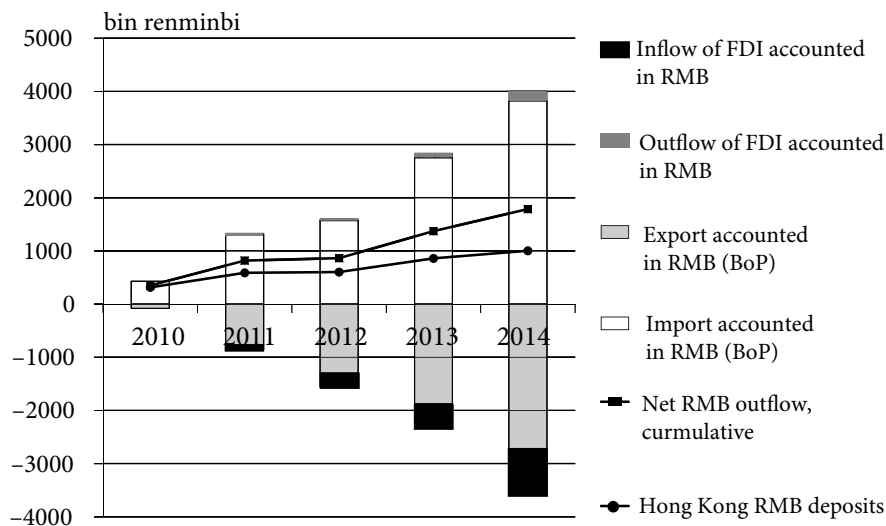
**The liberalization measures, though necessary, provide insufficient conditions for the blossoming of renminbi markets outside China.** In order for an appropriate depth and abundance of offshore renminbi liquidity to be generated, net renminbi capital flow has to be directed from China outwards. A key factor in the development of the US dollar's offshore (so-called eurodollar) markets – and its status as a global currency – was for the United States to maintain a high deficit in the balance of payments, thus creating the necessary dollar liquidity on markets outside the US.

**In China's case, however, although the balance of payments has shown a significant surplus for decades, this has not stemmed the outflow of renminbi as players on the import and export sides of foreign trade reacted differently to the option of accounting in renminbi.** While Chinese exporters had relatively little need to settle in renminbi, the option of accounting in renminbi proved much more popular for imports, as in this way international players exporting to China were able to accumulate the Chinese currency, for which there was considerable demand among international investors both for hedging and – anticipating the appreciation of the renminbi – speculative purposes. A paradoxical situation thereby evolved in which China's balance of payments as a whole has shown a massive surplus in recent years, while the portion of the balance of payments rendered in renminbi has displayed a significant deficit, thus prompting the outflow of renminbi to offshore markets. In addition, the net flow of direct investment accounted in renminbi was directed towards China, similarly to the portfolio investments authorised in the quota systems of various programmes, although this only moderately reduced the outflow of renminbi arising from foreign trade (Figure 4). Besides the above, the Chinese authorities, via agreements generating renminbi liquidity concluded with clearing houses and other central banks – foremost among them the Hong Kong Monetary Authority – ensured that renminbi liquidity outside China would not dry up even during strained times on the money market.<sup>5</sup>

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5 EICHENGREEN–KAWAI (2014). more detail on the implications for Hungary, see DARÓCZI–ERHART–KÁLMÁN (2015).

**Fig. 4**  
**Balance of payments and direct investment flows (accounted in renminbi)**  
**in relation to offshore liquidity**



Source: People's Bank of China (2010–2014)

Note: Although the development of Hong Kong RMB deposits is used as one of the principal indicators of offshore renminbi liquidity, deposits are accumulating in an increasing number of countries with the emergence of new offshore renminbi centres; consequently the entire global stock of deposits is probably higher. In addition, quotas enabling the outflow and influx of renminbi are not represented in the diagram, since there are no data on their exploitation; in all likelihood, these show a net renminbi influx, reducing the overall RMB outflow.

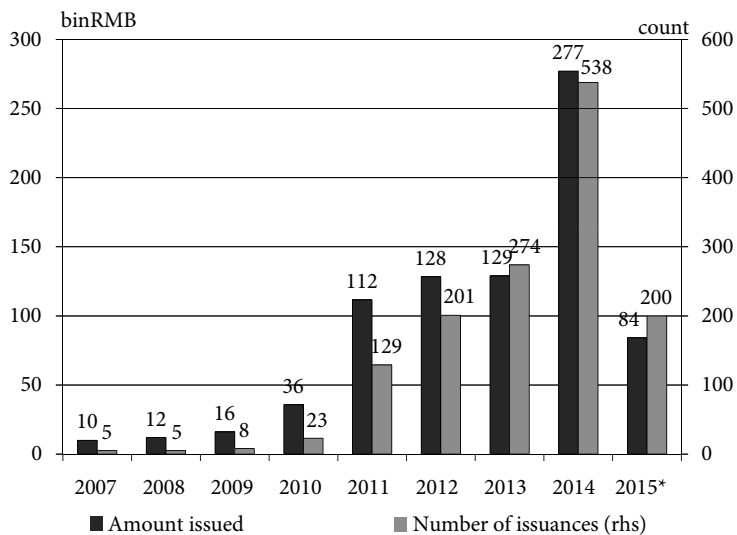
### 3. THE OFFSHORE RENMINBI “DIM SUM” BOND MARKET

**As a consequence of the liberalization measures, ever-increasing activity can be observed on the offshore renminbi bond market as well.** The reasons for the rapid growth of the offshore renminbi bond market – the “dim sum” nickname deriving from the Cantonese cuisine of southern China, where it indicates bite-sized snacks, at once alluding to the fragmented nature of bond issues and their onshore roots – are analogous with the motivations behind the creation of offshore liquidity. On the one hand, accounting foreign trade in renminbi on the systemic level increases companies' demand for renminbi financing and resources allocation. On the other hand, portfolio and foreign direct investments directed at China increasingly necessitate renminbi financing, while capital leaving China is also often seeking renminbi investments. These demands were able to be met most easily on offshore markets and primarily in securitised form, encouraged by the Chinese authorities: not only were Chinese companies permitted to issue

bonds offshore, but the Chinese state itself issued government bonds on offshore markets, principally with the goal of developing a market, creating liquidity and establishing trust. The outcome of all this was that demand created supply: Chinese companies themselves became invested in the issue of offshore bonds, as right up until 2014 – thanks to the hunger of international players for the renminbi – they were able to raise funds on markets outside China with significantly lower yields (i.e. more cheaply) than on the isolated internal market.

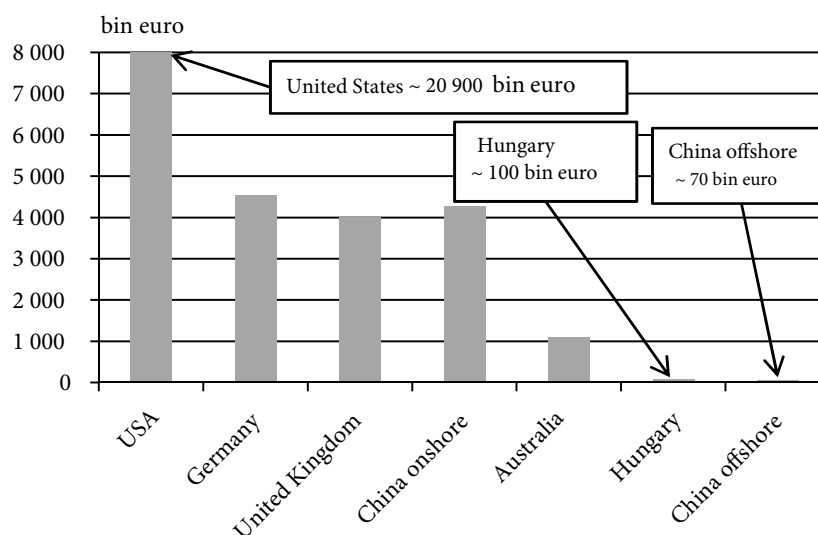
**The growth of bond markets is especially spectacular even within the offshore universe, but in actual strength still lags far behind onshore or developed market volumes.** Bond issues on the offshore renminbi bond market first took place in the second half of 2007, when major Chinese banks made an experimental entry into the market. Although the outbreak of the financial crisis held back the market's growth until 2010, the number of issues began to dynamically increase thereafter. During 2014, more than 500 issues took place to a total value of RMB 277 billion (EUR ~40 billion). The total volume on the market thus reached RMB 493 billion (EUR ~72 billion) by July 2015. At the same time, even adding this together we are still talking about a relatively small market in global comparison: the offshore bond market still amounts to only less than 1% of the onshore market, more or less comparable to the volume of bonds denominated in Hungarian forints and significantly less than volumes on developed markets.

**Fig. 5**  
**Offshore renminbi bond issues since 2007**



Note: until 15 July 2015.

Source: Bloomberg

**Fig. 6****The size of the offshore renminbi market in international comparison**

Note: as of March 2015

Source: Bloomberg, Chinabond

Since 2011, it can also be seen that an increasing number of bond issuers without a Chinese background have appeared on the market. While three-quarters of the RMB 493 billion volume of offshore renminbi bonds on the market as of July 2015 was directly or indirectly Chinese-backed, the remaining amount was put on the market by issuers independent of China. Excluding China, the largest issuers are domiciled in Australia, France and South Korea, but Germany, the UK and the Netherlands also feature among those more active in Europe. Among the largest non-Chinese issuers is the World Bank, whose arm providing development loans to developing countries (IFC) has issued a large quantity of renminbi bonds.



**Table 1**  
**Volume of offshore renminbi bonds in circulation,**  
**broken down geographically and by sector (bln renminbi)**

Country	Public sector	Non-financial corporations	Financial sector	Total
China	115	18	64	198
Hong Kong	0	40	21	61
Brit Virgin isl.	0	50	11	61
Cayman isl	0	41	6	47
Australia	1	0	12	13
World Bank	13	0	0	13
France	3	5	4	13
South Korea	11	0	0	11
Bermuda	0	7	4	11
Singapore	0	5	6	10
Germany	0	2	8	10
UK	3	3	3	9
Netherlands	0	4	2	6
Canada	5	0	0	6
USA	0	0	4	4
Luxembourg	0	3	0	4
Other	1	7	11	19
<b>Total</b>	<b>153</b>	<b>185</b>	<b>155</b>	<b>493</b>

Source: Bloomberg, 15 July 2015

Looking at the breakdown by sector, bond issues are distributed in similar proportions among the state, corporate and financial spheres. The picture is different looking at countries, however: **while in China the state is the biggest issuer, the greater part of non-Chinese bond issues occur in the financial and corporate spheres.** Substantial state bond issues in Europe occurred in France and the UK. In France the state social security fund carried out an issue of RMB 3 billion, while in the UK bonds were issued directly by the state Treasury.

**Despite dynamic growth, we are still looking at a relatively small market, and consequently a certain degree of seasonality in liquidity may appear.** In this respect Chinese state bond issues, which generally take place in May-June and November-December, carry heightened significance. In these months, Chinese state issues draw off a significant portion of offshore renminbi liquidity. Accordingly, the quantity of bond issues generally recedes thereafter, reinforced by the customary decline in market activity in the summer period. The reason for

this seasonal phenomenon is that most issues are usually timed for the periods prior to the Chinese state's entries onto the market, i.e. in early spring or autumn.

**The average size of bond issues can still be described as relatively tiny.** Issuers appearing on the market with a state connection (the state itself, regional governments and state agencies) have typically opted for issues in the region of RMB 1 billion (approx. EUR 150 million), although there have also been significantly larger issues (see the French or British examples). At the present level of development of the offshore renminbi bond market, issues of 0–3 years' maturity are primarily typical. Although we tend to see longer (3-year) maturities in the case of state-linked issues, the Chinese state and the World Bank have been the almost exclusive initiators of successful bond issues in the 5–10-year segment, mainly with the goal of building markets.

#### 4. THE FUTURE OF OFFSHORE MARKETS

**The development of offshore markets has been intrinsically linked to the aspiration of the Chinese authorities to see the role of the Chinese currency strengthen until it is included in the IMF's SDR currency basket.** The IMF reviews the content of the SDR currency basket every five years. A key goal of Chinese economic policy was to see the renminbi included in the basket at the review at the end of 2015, since in this way it would become an officially recognised reserve currency, increasing its international recognition and use.<sup>6</sup>

The two main criteria examined by the IMF relate to the roles played by a currency in the accounting of foreign trade and in international financial transactions. Given that the renminbi already satisfied the foreign trade criterion at the time of the 2010 review, the intervening period saw the focus of Chinese reform efforts fall primarily on the second aspect, namely financial markets. The result of this was the evolution of the offshore renminbi market, as well as the launch of various equity market programmes and other previously mentioned initiatives. In the course of the review, the most critical decision was expected to relate to the renminbi's freely usable status and convertibility.

According to an analysis published by IMF staff in August 2015,<sup>7</sup> a postponement of the deadline of this year's review until September 2016 was requested (and later officially approved by the IMF Executive Board), as additional data gathering and analysis was deemed necessary for an alteration to the composition of the SDR

6 After the deadline for submitting this article, the decision was made to include the renminbi in the SDR basket as of 1 October 2016 with a weight of 10.92%. Source: <http://www.imf.org/external/np/sec/pr/2015/pr15543.htm>

7 See IMF (2015a) and IMF (2015b).

basket. The paper presented the critical points related to the potential admittance of the renminbi:

- A. Full convertibility is not a condition for inclusion in the SDR basket; at the same time, it is especially important that institutions and investors using the SDR (the IMF, the World Bank, central banks) are able to access the markets for currencies in the basket.
- B. Currently it is difficult to determine the international weight of the renminbi. This is partly due to a shortage of data, and partly related to the methodological question of whether the currency's importance is judged on the basis of turnover (flow) or existing quantity (stock). Although in terms of stock the renminbi does not yet reach the hitherto applicable requirements, SWIFT turnover data indicate that since September it has overtaken the Japanese yen to become the fourth most important currency in the world.
- C. The standpoint of the IMF staff is that the currencies included in the SDR basket must have markets of sufficient depth in at least two of the three major time zones (America, Europe and Asia). Under current rules, the SDR is fixed at 12 noon daily on the London market. For this the basket currencies must have a liquid London market at this point in time.
- D. In order to determine the interest level connected to the SDR, there must be suitable benchmark yields available for the individual currencies.

The commitment on the Chinese side is illustrated by the fact that, in response to the IMF staff's position, additional important changes were announced from the beginning of August, essentially affecting the aforementioned critical points. These measures included:

- A. Authorisation of the activity of foreign central banks without onshore market quotas.
- B. Announcement of the PBoC's London renminbi bond issue, its first issue outside China.
- C. More flexible future fixing of the middle rate, as a consequence of which the onshore and offshore exchange rates of the renminbi will move closer and be increasingly determined by market factors.
- D. Extension of the Chinese renminbi trading time and increase in the number of fixings, resulting in an overlap between the London and Chinese trading times.
- E. The Chinese Ministry of Finance to carry out regular weekly auctions of three-month treasury bills in order to create a liquid market and generate a reliable benchmark yield.
- F. Chinese authorities to cooperate in several international systems for the gathering of financial statistical data (IMF COFER, IMF SDDS, BIS data collection).

**Opinions were divided on the chances of the renminbi entering the SDR basket.** If the IMF were to strictly apply its criteria used so far, then it was conceivable that no change would be made to the composition of the SDR basket. If, however, the framework were to be applied more flexibly and the rapid growth of recent years – which is expected to continue – were to be taken into account, then the renminbi might be included in the basket, for the time being presumably with a weight smaller than the role it plays in the accounting of foreign trade. In the wake of the IMF's summer communication and reciprocal steps taken by the Chinese authorities, greater weight was attached to the view that the announcement of the renminbi's inclusion in the SDR basket might take place in spring 2016, and that it might officially join the SDR from October 2016.

## 5. CONCLUSIONS

**Whether or not the renminbi was included in the SDR basket, the process of liberalization of the Chinese capital account entails significant potential friction.** The isolation of China's internal financial market through capital controls naturally lent the Chinese authorities a strongly effective scope of action, and provided considerable stability and predictability for participants in the Chinese economy. With the complete liberalization of capital flows, the degree of predictability – in parallel with the Chinese authorities' capacity for intervention – will lessen, since capital moved under international influence crosses the Chinese border more rapidly and with less hindrance. At the same time, the question remains of how well the financial infrastructure, institutional system and financial literacy within China will be prepared for integration with global market standards.<sup>8</sup>

**In the medium term we can expect a gradual merger of the onshore and off-shore markets;** with the broadening of channels enabling transactions across the Chinese border, equalization with onshore markets will increase in effectiveness. The signs of this have already appeared: for example, the difference in yields on secondary markets between offshore and onshore Chinese government bonds has shrunk to practically zero, while in 2013 offshore bonds offered 30–50 basis-point lower yields than onshore bonds. At the same time, the international financial intermediary system is also breaking down the walls ever more efficiently, as global investment houses offer a growing range of ETFs of the kind also available to

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<sup>8</sup> This is a particularly interesting question in light of the turbulence experienced on the Shanghai Stock Exchange in recent times, in which the introduction of certain liberalization measures affecting margin trading on the stock market by Chinese private individuals and trading companies (contributing to the upturn on the bourse from mid-2014) may have played as much a part as the tightening of these measures (one of the main direct causes of the dive beginning from the second half of June).

smaller investors, through which they spread out their own quotas as fixed by the Chinese state. With the strengthening of this equalizing mechanism based on market forces, and with further liberalization, the offshore and onshore markets can eventually be expected to become entirely integrated, with the same freely usable renminbi set to be traded in Budapest, Frankfurt, London and Hong Kong as in Shanghai and Beijing.

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