International Use of the Renminbi: Hong Kong’s Experience

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* The views expressed here do not necessarily represent those of the HKMA or the HKIMR
Questions to address

- How should we think of the role of offshore markets in currency internationalisation?
- How should we think of the role of official policies in renminbi internationalisation?
- What are the characteristics of the offshore renminbi market in Hong Kong?
- How are the offshore renminbi markets in Hong Kong and other financial centres likely to evolve?
Why do offshore markets exist?

Offshore markets play essential economic functions even when capital can flow freely across the border (He and McCauley (2010))

- Separation of currency risk from country risk
- Convenience factors (legal systems, accounting standards, language, time zone/geography)
- Diversification of operational risk

Even nowadays, when foreigners use the US dollar to settle trade and make investments, they concentrate their transactions in international financial centres such as the euro-dollar markets in London, not onshore in New York City

In fact, one may argue that without the offshore markets, the US dollar would not probably have attained as dominant a position in international trade and payments as it occupies today
Preconditions for international use of currencies

- Except for non-deliverable markets, international use of currencies is impossible without the cooperation of onshore banks.

- Cross-border use of currencies is an international financial transaction and requires some degree of non-resident convertibility.

- Offshore banks need to be able to keep and have access to clearing balances with onshore banks.
Hong Kong as a renminbi offshore centre

- Hong Kong was the first place outside Mainland China to provide renminbi banking services since 2004

- Because of the willingness and ability of Hong Kong monetary and regulatory authorities to cooperate closely with their counterparts on the Mainland, Hong Kong is the ideal offshore jurisdiction to provide a reliable testing ground for the international use of the renminbi

- Gradual and steady expansion of business scope, markets and products
Special arrangement in Hong Kong

- Before July 2009, offshore banks generally could not maintain and have access to renminbi balances kept with onshore banks.

- For renminbi banking in Hong Kong, a “Clearing Bank” was appointed by the People’s Bank of China (PBoC) in late 2003 to be the conduit, which:
  - accepts deposits from participating Hong Kong banks and in turn maintains balances with PBoC.
  - acts as the counterparty of currency exchange transactions of the participating banks and in turn squares its own positions in the China Foreign Exchange Trading System in Shanghai.
Non-resident convertibility further expanded in 2009 and 2010

- With the launch of pilot scheme of RMB trade settlement in July 2009, overseas banks could open correspondent accounts with banks inside China

- From August 2010 overseas nonbank institutions accepting payments for exports to China in renminbi can deposit the proceeds from such transactions on accounts with banks inside China
Sources and uses of renminb funds

◆ Outflows from China largely liberalised
  – Payments in renminbi for imports by Chinese firms
  – Payments in renminbi for outbound direct investment (ODI) by Chinese firms
  – Banks make loans to overseas firms in renminbi
  – Swap lines with foreign central banks

◆ Inflows to China still “managed”
  – Payments in renminbi for imports from China
  – Payments in renminbi for FDI investment inside China
  – Repatriation of renminbi proceeds from bonds issued overseas by Chinese banks and firms, subject to approval
  – Investment in the interbank bond market by foreign central banks and commercial banks which provide renminbi trade settlement services, subject to approval and quota
  – Investment in the bond and equity market by Qualified Foreign Institutional Investors (R-QFII), subject to approval and quota
Timeline of renminbi banking in Hong Kong

- November 2003 Announcement of clearing arrangement
- February 2004 Launch of deposit-taking, exchange, and remittance businesses
- December 2005 Expansion of business scope (e.g. cheques)
- June 2007 Introduction of renminbi bonds
- July 2009 Launch of trade settlement in renminbi (365 firms on the pilot scheme)
## Policy initiatives—two years of rapid development (I)

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 2010</td>
<td>HKMA provided elucidation on supervisory principles to streamline operational arrangements of offshore renminbi business in Hong Kong</td>
</tr>
<tr>
<td>June 2010</td>
<td>Coverage of renminbi trade settlement pilot scheme expanded to 20 provinces, allowing all firms in those provinces to settle imports and services trade in renminbi, and more than 60,000 firms to settle exports of goods in renminbi</td>
</tr>
<tr>
<td>July 2010</td>
<td>Clearing Agreement on Renminbi Business amended, with restrictions on account opening of corporate and interbank fund transfers removed</td>
</tr>
<tr>
<td>August 2010</td>
<td>Arrangement allowing Hong Kong banks to invest in the Mainland’s interbank bond market launched</td>
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</tbody>
</table>
Policy initiatives—two years of rapid development (II)

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tbody>
<tr>
<td>January 2011</td>
<td>Pilot scheme for settlement of outward direct investment in renminbi launched</td>
</tr>
<tr>
<td>August 2011</td>
<td>Coverage of renminbi trade settlement pilot scheme expanded to all provinces</td>
</tr>
<tr>
<td>October 2011</td>
<td>Arrangement for settlement of inward foreign direct investment in renminbi launched</td>
</tr>
<tr>
<td>December 2011</td>
<td>Renminbi QFII scheme launched</td>
</tr>
<tr>
<td>February 2012</td>
<td>All current account transactions by all Mainland firms could now be invoiced and settled in renminbi</td>
</tr>
</tbody>
</table>
Steady growth in RMB trade settlement handled by Hong Kong banks

RMB trade settlement handled by banks in Hong Kong

Flows of RMB trade settlement between Hong Kong and the Mainland
Renminbi liquidity in Hong Kong
Hong Kong as a renminbi payment system hub

<table>
<thead>
<tr>
<th></th>
<th>Q1 2012</th>
<th>2011</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No. of participating banks of Hong Kong's RMB clearing platform</td>
<td>194</td>
<td>187</td>
</tr>
<tr>
<td></td>
<td>Of which: Branches and subsidiaries of overseas banks and overseas presence of Mainland banks</td>
<td>170</td>
<td>165</td>
</tr>
<tr>
<td>2</td>
<td>No. of RMB correspondent accounts set up by overseas banks at Hong Kong banks</td>
<td>1,104</td>
<td>968</td>
</tr>
<tr>
<td>3</td>
<td>Amount due to overseas banks (RMB billion at period-end)</td>
<td>128.5</td>
<td>116.4</td>
</tr>
<tr>
<td>4</td>
<td>Amount due from overseas banks (RMB billion at period-end)</td>
<td>146.1</td>
<td>121.7</td>
</tr>
</tbody>
</table>

Source: HKMA
### Renminbi balance sheet of banks in Hong Kong at end-2011

In billions of renminbi

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due from banks</td>
<td>Deposits</td>
</tr>
<tr>
<td>of which due from overseas banks</td>
<td>121.7</td>
</tr>
<tr>
<td>Loans and advances</td>
<td>Personal</td>
</tr>
<tr>
<td></td>
<td>31.0</td>
</tr>
<tr>
<td>Negociable debt instruments</td>
<td>Corporate</td>
</tr>
<tr>
<td>Other assets</td>
<td>222.3</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>62.6</td>
</tr>
<tr>
<td>Total</td>
<td>981.6</td>
</tr>
</tbody>
</table>

Source: Hong Kong Monetary Authority.

Notes: "Overseas banks" mean banks from areas outside Hong Kong and Mainland China. Other assets/other liabilities include items such as amount receivable/payable under reverse repos/repos, unrealised mark-to-market gains/loss of derivatives and the amount to balance a single-currency balance sheet, which is a sub-set of the balance sheet of all currencies.
Characteristics of renminbi banking in Hong Kong

- The renminbi balance sheet of banks in Hong Kong at present serves as a conduit for non-residents to stake a renminbi-denominated claim on Mainland China
  - Deposits in renminbi residents of Hong Kong and the rest of the world outside the Mainland comprise the sources of funds. On the uses side, banks have claims on entities on the Mainland, including the central bank and some interbank claims and investments in government and corporate bonds.

- As things stand, pure offshore intermediation in the renminbi offshore market accounts for a minority of activity here
  - At the end of 2011, loans and advances in renminbi booked by banks in Hong Kong were only RMB 31 billion, about 3% of total assets, and in addition a good part of the RMB 222 billion in negotiable debt instruments comprised trade claims on nonbanks resident outside the Mainland. Their sum, which can be taken as the upper limit of pure offshore intermediation, remains well below RMB 588 billion in deposits.
Capital account restrictions and renminbi fund flows in Hong Kong

- This balance sheet structure, however, was due to a number of factors that will likely prove to be temporary.

- In particular, the Mainland authorities have only started to open the domestic capital market to participation by non-residents, and have retained significant restrictions on capital outflows by residents.

- Expectations of a sharp renminbi appreciation had also dampened the willingness of non-residents to borrow in renminbi.

- But adjustments have been well underway since Q4 2011. Indeed, loans and advances in renminbi booked by Hong Kong banks grew rapidly in the first quarter of 2012.
## Sources of renminbi liquidity in offshore markets

<table>
<thead>
<tr>
<th>RMB Consolidated Monetary Survey</th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Liabilities</strong></td>
</tr>
<tr>
<td>Net foreign currency assets</td>
<td>Onshore M2</td>
</tr>
<tr>
<td>(including official foreign</td>
<td></td>
</tr>
<tr>
<td>reserves)</td>
<td></td>
</tr>
<tr>
<td>RMB credit by onshore banks</td>
<td></td>
</tr>
<tr>
<td>RMB credit by offshore banks</td>
<td>Offshore RMB deposits</td>
</tr>
</tbody>
</table>

Source: He (2011)
Looking forward, the offshore renminbi market could evolve to play different roles

- Capital flows can be expected to become two-way and more balanced with capital account liberalisation (He et al (2012))

- The expected path of the renminbi exchange rate shows much less consistent appreciation, even as the Chinese current account surplus has narrowed. Thus, non-resident borrowing in the renminbi looks to be less discouraged by one-way expectations on the exchange rate.

- In this case, the renminbi offshore markets in Hong Kong and in other centres can be expected to evolve along the paths of the other types of offshore markets
## How would offshore renminbi markets evolve?

<table>
<thead>
<tr>
<th>Source of funds</th>
<th>Offshore</th>
<th>Home</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Use of funds</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Offshore</td>
<td>Home</td>
</tr>
<tr>
<td>Pure offshore</td>
<td>International lending – inflow to home country</td>
<td></td>
</tr>
<tr>
<td>International lending – outflow to rest of world</td>
<td>Pure round-tripping</td>
<td></td>
</tr>
</tbody>
</table>

Source: He and McCauley (2012)
Pure offshore banking

Source: He and McCauley (2012)
Pure round-tripping

Source: He and McCauley (2012)
International lending--outflow

Source: He and McCauley (2012)
International lending--inflow

Source: He and McCauley (2012)
The relative importance of pure offshore and pure round-tripping

Positions against US nonbank residents as a share of total eurodollar positions

Source: He and McCauley (2012)
The allocation of euro-dollar deposits among offshore centres (I)

- After controlling for the size of economy and other variables, we find that time zone is one of the most important determinants in Eurodollar deposit market shares. Specifically, as the number of time zones from New York City of these centres increases, their market shares of Eurodollar deposits would decrease, and vice versa.

- Another important determinant is the share of foreign exchange market turnover.

- Also, better quality of the legal and regulatory framework and greater portfolio inflows would result in larger Eurodollar deposit market shares.
The empirical results indicate that, in the case of Eurodollar, what works well for the Cayman Islands, which has the second largest share of deposits (about 15% of the total), is being in the same time zone as New York City, while what works well for London, which has the largest share (about 25% of all deposits), is being the most important foreign exchange market.

An inference is that Hong Kong and London will each have its relative strength in developing offshore renminbi markets:

- Hong Kong is in the same time zone as the Mainland, speaks the same language, has intimate knowledge of and maintains extensive connections with the Mainland.
- London has the largest foreign exchange markets and will find it convenient to add another currency.
Will HK remain competitive in providing RMB clearing and settlement services?

◆ The prospect is good if

  – Hong Kong keeps its payment system infrastructure at the cutting edge

  – Hong Kong banks maintain high service standards in both Chinese and English

◆ The incentives to keep up with the necessary investments are likely to be strong since renminbi-related lines of business would typically make up a larger share of business volumes for Hong Kong banks than other overseas banks
Concluding remarks

◆ Facilitating the international use of the renminbi requires a deliberate pace of institutional reforms and policy liberalisation

◆ Offshore markets play an essential role in currency internationalisation

◆ Renminbi liquidity in offshore markets should not be a binding constraint as the movement of the renminbi exchange rate and capital flows become two-sided

◆ Over time, the renminbi offshore markets are likely to play above all the role of intermediary between non-Mainland borrowers and lenders

◆ Both Hong Kong and other financial centres will benefit from wider international use of the renminbi, but Hong Kong is likely to maintain a lead in its competitive advantages