Deutsche Bank AG

China: RMB offshore markets, capital account liberalization, and impact on financial sector

Jun Ma
Chief Economist for Greater China

Passion to Perform

May 2012

Jun Ma (852) 2203 8308, jun.ma@db.com; Hui Miao, hui.miao@db.com

Content

--Role of offshore markets in RMB internationalization

--Role of HK vs other offshore markets

--Policies to promote the development of offshore markets

--Need for capital account liberalization for next phase of RMB internationalization

--Timing and pace of capital account liberalization

--Specific recommendations on capital account liberalization

--Impact of financial liberalization on China's financial sector

Offshore markets are necessary for RMB internationalization

- **Major global currency must trade 24 hours a day**
- **Major international currencies are used 3rd party transactions**
- **Non-residents' demand is largely met by offshore market**
- **"External circulation" reduces impact on monetary policy**
- **Offshore market speeds up internationalization**

Projection of HK's offshore market

Figure 1: Forecasts of the RMB offshore market in Hong Kong

	2010	2011	2012F	2015F	2015 level as % of 2011 domestic level
RMB deposits	300	589	1,000	2,500	3%
Outstanding bonds	68	200	500	1,300	6%
Stock market cap	-	26	30	75	0.3%
CNH daily volume	2	15	40	80	51%
Outstanding loans	-	30	60	500	1%
Assets/deposit ratio	23%	44%	59%	75%	83%

Source: authors' projections.

External circulation vs repatriation

HK needs to promote RMB external circulation as well as the repatriation mechanisms

External circulation vs repatriation		
	Repatriation	Ext circulation
MOF bonds	100%	0%
3-types of institutions	100%	0%
RQFII	100%	0%
Bonds issued by Chinese banks	95%	5%
Bonds issued by Chinese corporates	95%	5%
RMB FDI	95%	5%
RMB ODI	50%	50%
Financing for external trade	50%	50%
3rd party usage	0%	100%
Liquidity for trading in HK	0%	100%
RMB securitization (offshore)	0%	100%

Policies to promote the development of offshore markets

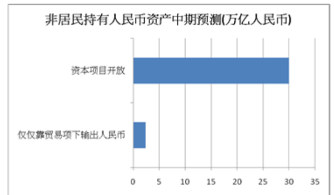
1. Simplify the documentation requirement for RMB trade settlement;
2. Enhance the transparency and consistency of RMB trade settlement policy;
3. Promote the use of the RMB as a pricing currency for commodities.
4. Encourage the entry of banks from South East Asian countries in China, so that they can help promote the use of RMB for trade and investment activities.
5. Remove the remaining bottlenecks for RMB FDI and RMB ODIs.

Policies to promote the development of offshore markets (II)

6. Ensure RMB liquidity provision in the offshore market;
7. Encourage the listing and trading of RMB bonds, equities and other financial products in the offshore market;
8. Promote the 3rd party usage of the RMB in the offshore market;
9. Relax the NOP restrictions by HKMA on banks' RMB businesses;
10. Establish CNH interest and FX fixings and develop CNH repo and future markets.

RMB internationalization and capital account liberalization

Without capital account liberalization, RMB internationalization can only materialize <10% of its potential



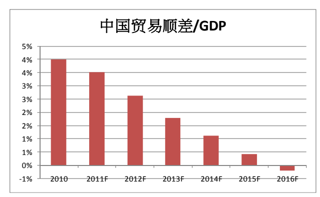
Coordination between cross-border RMB capital flows and RMB convertibility

Essentially, lifting restrictions on cross-border RMB flows for capital account purposes and capital account liberalization (or convertibility between the RMB and other currencies) are two reforms that are mutually substitutable. Lifting restrictions on one of these (restrictions on cross-border RMB flows for capital account purposes, or restrictions on currency convertibility) will made restrictions on another invalid. Therefore these two reforms should go hand in hand.

Example 1: QFII vs 3 types of Institutions
Example 2: Permission for RMB remittance vs FX conversion

Macro conditions permit faster capital account liberalization

The rapid decline in China's trade balance, the increase in ODI, and the reduced RMB appreciation expectations permit a faster opening of China's capital accounts and its domestic capital markets.



来源：马骏，"对中国贸易顺差的定量研究"，《货币的轨迹》，中国经济出版社，2001年8月

Exchange rate, interest rates, and pace of capital account liberalization

As the exchange rate approaches its equilibrium, and cross-border RMB interest rate differentials narrow, the capital account should be more open

Specific recommendations on capital account liberalization

- Increase the annual limits on FX conversion by individuals and corporates;
- Increase the QFII quota and the quota for foreign institutional investors invest in China's interbank bond market;
- Permit RMB fund raisings by non-resident corporates on the Panda bond market/ the international board and from banks;
- Open the domestic RMB products market to NRA accounts, at a pace consistent with the development of offshore markets;
- Increase the volatility of the RMB exchange rate (vs the USD) by 3-5 fold;
- Introduce prudential measures to replace administrative controls on FX conversion;
- Introduce a CHIPS-like RMB cross-border payments system.

Openness of domestic capital markets

Openness of domestic capital markets: China vs. other economies (2009-2011)

	Equity	Bond
China (excl overseas listed securities)	0.8%	0.8%
China (incl overseas listed securities)	8.3%	1.5%
Korea	31%	11%
Taiwan	28%	8%
Brazil	27%	9%
India	20%	3%
Indonesia	64%	25%
Malaysia	25%	28%
Russia	14%	18%
Vietnam	8%	3%
South Africa	12%	14%
Argentina	9%	14%
Thailand	52%	8%
Turkey	19%	17%
Mexico	28%	12%
Germany	51%	45%
Japan	21%	4%
US	13%	17%
UK	47%	39%
13 EM markets (excl China) average	25.9%	13.1%
17 markets (excl China) average	27.6%	16.2%

Source: Deutsche Bank, IMF, World Bank, BIS, CEIC.

Impact of financial liberalization on the financial sector

- Slower RMB appreciation but significantly higher volatility;
- Reduction in net interest margin for Chinese banks;
- Greater global expansion for Chinese financials;
- Higher fee incomes including a surge in FX trading commission and income from derivative transactions;
- Ability to offer a wider range of global financial products to China's domestic investors;
- Negative for insurance in the short term but positive in the longer term;
- Significantly larger two-way capital flows (especially portfolio flows) via Hong Kong to and from Mainland China, benefiting Hong Kong-based financial institutions.

Appendix 1
Important Disclosures
Additional Information Available upon Request

For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Jun Ma

Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.

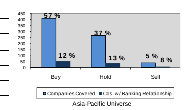
2. Ratings definitions prior to 27 January, 2007 were:

Buy: Expected total return (including dividends) of 10% or more over a 12-month period

Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period

Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



Regulatory Disclosures

1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at https://gm.db.com/equities under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at http://gm.db.com.

3. Country-Specific Disclosures

Australia and New Zealand: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act and New Zealand Financial Advisors Act respectively.

Brazil: The views expressed above accurately reflect personal views of the authors about the subject company(ies) and its(their) securities, including in relation to Deutsche Bank. The compensation of the equity research analyst(s) is indirectly affected by revenues deriving from the business and financial transactions of Deutsche Bank.

EU countries: Disclosures relating to our obligations under MiFiD can be found at http://www.globalmarkets.db.com/riskdisclosures.

Japan: Disclosures under the Financial Instruments and Exchange Law: Company name - Deutsche Securities Inc. Registration number - Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, Type II Financial Instruments Firms Association, The Financial Futures Association of Japan, Japan Securities Investment Advisers Association. Commissions and risks involved in stock transactions - for stock transactions, we charge stock commissions and consumption tax by multiplying the transaction amount by the commission rate agreed with each customer. Stock transactions can lead to losses as a result of share price fluctuations and other factors. Transactions in foreign stocks can lead to additional losses stemming from foreign exchange fluctuations. "Moody's", "Standard & Poor's", and "Fitch" mentioned in this report are not registered credit rating agencies in Japan unless "Japan" or "Nippon" is specifically designated in the name of the entity.

Russia: This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.

Global Disclaimer

The information and opinions in this report were prepared by Deutsche Bank AG or one of its affiliates (collectively "Deutsche Bank"). The information herein is believed to be reliable and has been obtained from public sources believed to be reliable. Deutsche Bank makes no representation as to the accuracy or completeness of such information.

Deutsche Bank may engage in securities transactions, on a proprietary basis or otherwise, in a manner inconsistent with the view taken in this research report. In addition, others within Deutsche Bank, including strategists and sales staff, may take a view that is inconsistent with that taken in this research report.

Opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this report. They do not necessarily reflect the opinions of Deutsche Bank and are subject to change without notice. Deutsche Bank has no obligation to update, modify or amend this report or to otherwise notify a recipient thereof in the event that any opinion, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. Prices and availability of financial instruments are subject to change without notice. This report is provided for informational purposes only. It is not an offer or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy. Target prices are inherently imprecise and a product of the analyst judgement.

As a result of Deutsche Bank's March 2010 acquisition of BHF-Bank AG, a security may be covered by more than one analyst within the Deutsche Bank group. Each of these analysts may use differing methodologies to value the security; as a result, the recommendations may differ and the price targets and estimates of each may vary widely.

In August 2009, Deutsche Bank instituted a new policy whereby analysts may choose not to set or maintain a target price of certain issuers under coverage with a Hold rating. In particular, this will typically occur for "Hold" rated stocks having a market cap smaller than most other companies in its sector or region. We believe that such policy will allow us to make best use of our resources. Please visit our website at http://gm.db.com to determine the target price of any stock.

The financial instruments discussed in this report may not be suitable for all investors and investors must make their own informed investment decisions. Stock transactions can lead to losses as a result of price fluctuations and other factors. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the investment. Past performance is not necessarily indicative of future results. Deutsche Bank may with respect to securities covered by this report, sell to or buy from customers on a principal basis, and consider this report in deciding to trade on a proprietary basis.

Unless governing law provides otherwise, all transactions should be executed through the Deutsche Bank entity in the investor's home jurisdiction. In the U.S. this report is approved and/or distributed by Deutsche Bank Securities Inc., a member of the NYSE, the NASD, NFA and SIPC. In Germany this report is approved and/or communicated by Deutsche Bank AG Frankfurt authorized by the BaFin. In the United Kingdom this report is approved and/or communicated by Deutsche Bank AG London, a member of the London Stock Exchange and regulated by the Financial Services Authority for the conduct of investment business in the UK and authorized by the BaFin. This report is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. This report is distributed in Singapore by Deutsche Bank AG, Singapore Branch, and recipients in Singapore of this report are to contact Deutsche Bank AG, Singapore Branch in respect of any matters arising from, or in connection with, this report. Where this report is issued or promulgated in Singapore to a person who is not an accredited investor, expert investor or institutional investor (as defined in the applicable Singapore laws and regulations), Deutsche Bank AG, Singapore Branch accepts legal responsibility to such person for the contents of this report. In Japan this report is approved and/or distributed by Deutsche Securities Inc. The information contained in this report does not constitute the provision of investment advice. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product. Deutsche Bank AG Johannesburg is incorporated in the Federal Republic of Germany (Branch Register Number in South Africa: 1998/003298/10). Additional information relative to securities, other financial products or issuers discussed in this report is available upon request.