

China Focus

RMB Internationalization In Progress

- *The RMB is internationalizing progressively as China opens up more avenues for the controlled outflow of its currency.*
- *The main factors for internationalization are to relieve appreciation pressure on the currency and to reduce dependence on the USD.*
- *Based on our estimates, the potential pool of offshore RMB deposit base could increase 40% annually to reach RMB9tn by 2020, or 29x the amount at end-2010.*
- *However, currently the breadth and depth of offshore RMB remain relatively small, resulting in much volatility for CNH vs. CNY, and this discrepancy is likely to persist.*
- *Looking ahead, RMB internationalization is certain as long as China continues to push in the direction. On the RMB itself, we remain positive but see fairly low risk of a large one-off revaluation. For now, we are keeping our USD/RMB forecast of 6.35 for end-2011.*

Introduction: RMB* Internationalization - The Progress So Far

One of the most significant developments from the liberalization of China's foreign exchange policy in Jun 2010 was relaxation of the conduct of RMB business in Hong Kong. The announcement made by Hong Kong Monetary Authority (HKMA) on 19 Jul 2010 has expanded greatly the use of this offshore RMB in Hong Kong. For instance, businesses essentially have unrestricted access to RMB in Hong Kong for the purpose of settling cross-border trade with mainland entities, as well as for RMB-denominated investment products.

The significance of this HKMA announcement is that the RMB is now accessible in HK to everyone and not just for settlement of cross-border trade. This has given rise to the "offshore" RMB (离岸人民币 and denoted "CNH", as opposed to onshore RMB 在岸人民币 or CNY) which is now "deliverable" outside of mainland, since there is no restriction on the transfer of RMB funds in HK between different bank clients, within the same bank or otherwise.

As the RMB becomes internationalized and acceptable to more businesses and individuals worldwide, there will be impact on the status quo of the US dollar and other currencies, hedging/risk management, conduct of international trade/services, among others.

In this article, we provide a brief overview and general background to some of the commonly asked questions:

- 1) Why is China internationalizing the RMB?
- 2) Through what channels does RMB flow offshore?
- 3) How big is the offshore RMB pool and what are its prospects?
- 4) What are the CNY and CNH?
- 5) CNH investment products?
- 6) A look ahead for RMB internationalization

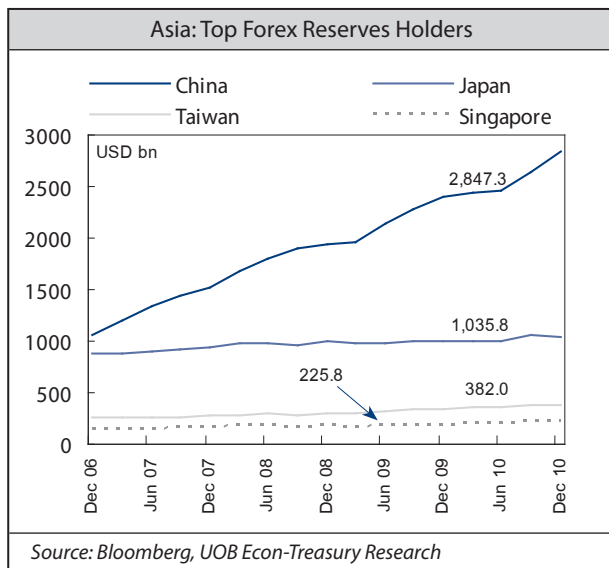
Why Is RMB Internationalization Critical For China?

Like many Asian countries, China faces the pressure of currency appreciation as its trade surpluses and investment inflows contribute to its large and rapid accumulation of reserves especially in recent years. At the same time, risks of an asset price bubble in China, notably in the property sector, suggest an economy that may be overheating and an overly loose monetary policy stance, which in the case of China could be "normalized" with interest rate hikes and/or currency appreciation.

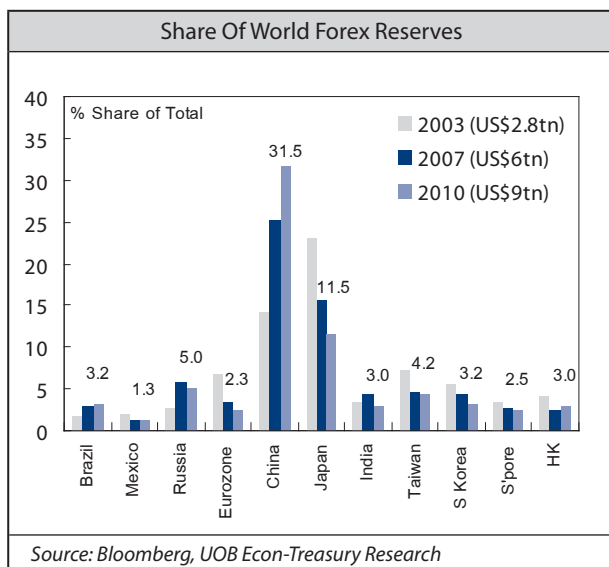
As shown in the chart below on forex reserves, both the pace and scale of build-up in China has been significant and is unprecedented in recent history. For instance, China's forex reserves holdings are more than twice that of Japan's, despite Japan having an earlier headstart in economic development and international trade.

*RMB, CNY, and yuan are frequently used interchangeably to describe the currency of People's Republic of China. This is made even more confusing as its ISO currency code is CNY. Note, however, that renminbi (人民币) is the official name for the Chinese currency, and yuan (元) is the main unit of currency. For a quick take on this issue and how it is related to the British pound, please see "Wait, What's The Difference Between 'Yuan' And 'Renminbi'?" www.npr.org, 19 Mar 2010 <http://goo.gl/Tpffd>

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As a result, China's share of world's global reserves is now the world's largest at nearly 32% of the total amount of US\$9tn, by end-2010, based on China's foreign exchange reserves of US\$2.85tn (see chart below). This is a dramatic reversal from just seven years ago. Back in 2003, after the recovery of the US economic recession and just as the US Fed cut the key Fed funds rate to then-record low of 1%, Japan was the world's largest holder, with US\$653bn (23% of world's total) vs. China's US\$400bn (or 14% of total). Also remarkable is the extent of increase in China's share contrasts with Japan's declining quantum as well as other countries' portions, which are typically kept below 5% of total.



All these mean that China's currency is facing significant appreciation pressure as China continues to keep its capital

account closed. From China's perspective, the accumulation of these foreign reserves assets, especially US dollars, raises the possibility of losses if China's currency appreciates too quickly and US dollar's status as a reserve currency were to diminish in the future.

With China's top leaders openly dismissing the prospects of a one-off large revaluation or even faster appreciation of the RMB despite continued pressure from the US and elsewhere, the route that is chosen is that of internationalization of the RMB.

Internationalization of the RMB will help to alleviate appreciation pressure in two ways: 1) as an alternative – but still evolving – platform (offshore) for investors to access/bet on the currency, instead of funneling funds onshore to mainland China, and 2) to reduce the use and reliance of other funding currencies, mainly the USD, thus reducing buildup of foreign reserves.

RMB internationalization is set to increase both in scope and speed going forward, with the ultimate result – which may be years or even decades away – of having a completely open capital account, free movements of capital in and out of China, and full convertibility of the RMB.

The other component is whether RMB would become a reserve currency like the USD if and when it becomes widely used, circulated, and held. This is unclear right now as it would ultimately be a market-driven outcome. In addition, this issue is unlikely a top priority for China at this point as top leaders have yet to indicate such desire despite their criticisms of current financial order.

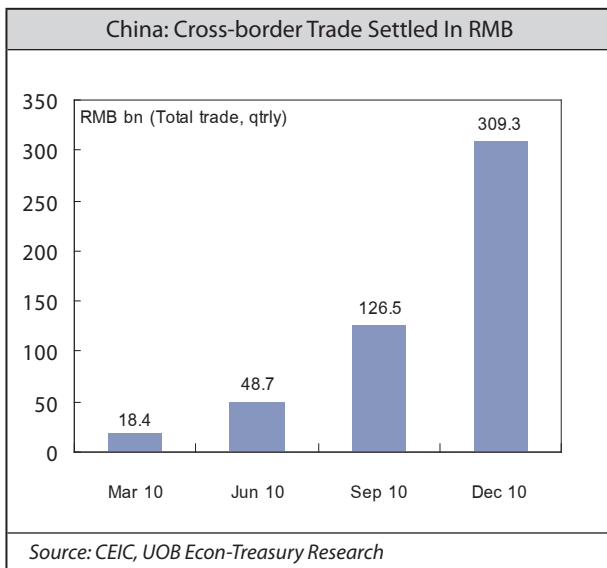
Two Channels Of For RMB To Flow Offshore

So far, the flow of offshore RMB is largely through cross border trade settlement (goods and services) with China companies (跨境人民币结算). This channel has been enlarged significantly in recent months in terms of breath.

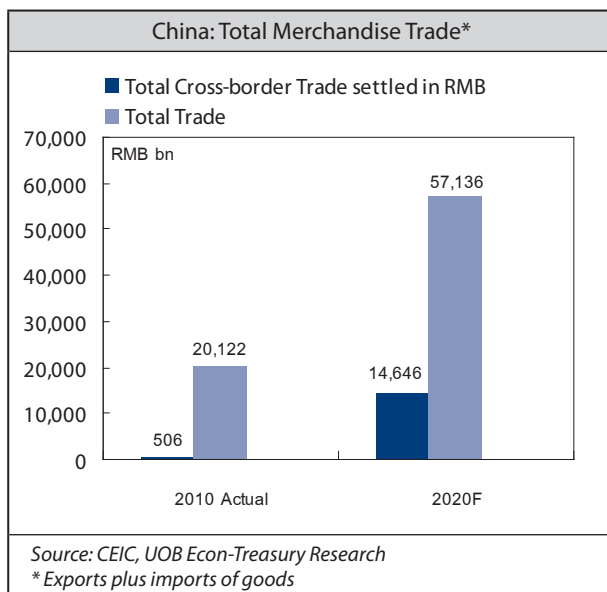
From the early beginning as a pilot program involving just five Mainland cities and ASEAN, the scheme now covers all trade transactions of 20 Chinese provinces and cities with the rest of the world. The number of Mainland enterprises that can settle merchandise exports in RMB has also increased substantially from 365 to 67,359 as of end-2010.

The expansion on the trade front has been notable, with total trade settled in RMB amounting to RMB309.3bn in 4Q10, more than doubling from 3Q10 and a huge increase from RMB18.4bn in 1Q10 (see chart below).

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Despite the impressive expansion of this cross-border trade through last year, it only represents a small proportion of China's total trade. In 2010, total cross-border trade came in just around RMB506bn, or about 2.5% of China's total merchandise trade of RMB20tn during the year, as shown in the chart below.



While the initial amount is tiny, there is a substantial upside for this cross-border trade segment, given the large size of China's external trade and as long as the push for RMB internationalization continues.

Our back-of-the-envelope calculations suggest there is considerable headroom in the internationalization of RMB. Cross-border trade could reach RMB15tn, or 25% of total China's trade of RMB57tn, by 2020. This assumes that China's total trade expands at 11% per year (or half the average annual pace of 22% in 1990-2010) and that China's cross-border trade increases at a conservative rate of 40% per year (vs. average quarterly gain of 57% in 2010).

The other main conduit that is opening gradually and cautiously is the flow of RMB through investment (capital account movements, 中国企业境外投资), which is still at a very initial and tentative stage. On 13 Jan 2011, PBoC announced a pilot program allowing Mainland companies to acquire stakes of companies or projects outside of China using RMB and without having to buy foreign exchange from the State Administration of Foreign Exchange, though the transactions are still subject to approval.

So far the extent of this flow is small compared to trade but is expected to expand further, as the official outbound foreign direct investment (ODI) flows have increased to US\$47.5bn during Jan-Nov 2010 from just US\$2.7bn for all of 2009, the year after China joined the World Trade Organization.

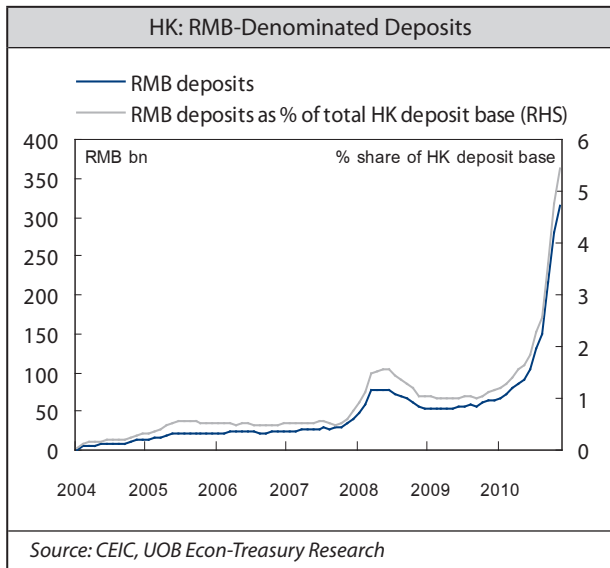
How Big Is This Offshore RMB Pool And Its Prospects?

The size of offshore RMB is gaining rapidly, although the center is in Hong Kong. HKMA statistics show that the total amount of RMB deposits jumped by 5x from RMB62bn at the end-2009 to RMB315bn by end-2010. This pool is substantial enough to meet market's demand for CNH.

Based on HKMA estimates, the holders of these offshore RMB deposits in aggregate split quite evenly between personal and corporate accounts, a rather positive development as accessibility is not one-sided. As at Nov 2010, there were a total of 2.2m personal customers accounts, with an average deposit size of about RMB54,000. Deposits from corporate clients average was around RMB1.3mn, with 117,000 accounts as at end-Nov 2010.

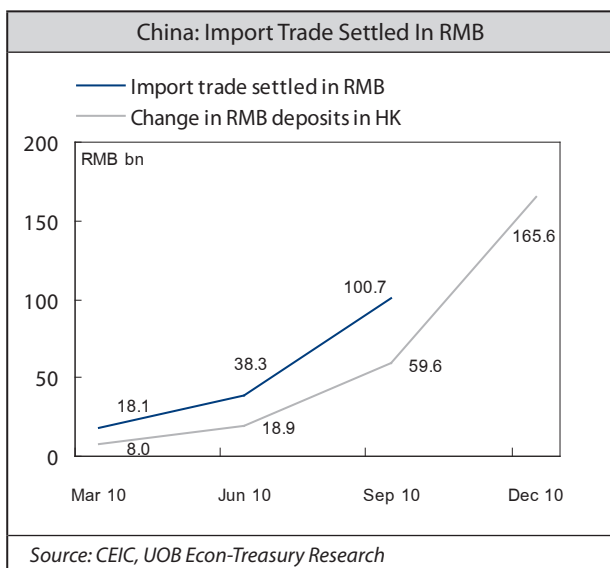
As shown in the chart below, after staying dormant in 2009, the amount of RMB deposits in HK has spiked up significantly since the liberalization in July 2010 as outflows from cross-border trade increased. RMB deposits represented just about 5% of total deposit base in HK (in RMB terms) at end-2010 and has surged to 6.4% share (about RMB370bn) by end-Jan 2011, well above the sub-2% share seen before 2010.

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CNH supply principally comes from cross-border trade with China. Not surprisingly, imports into China constitute the bulk of the flow of RMB out of China. The cross-border trade data shows that China’s imports settled in RMB account for around 80% of the total in 2010, as Chinese-based importers are motivated to settle payments in RMB terms, given reduced forex risk and a more expensive CNH (i.e. lower USD/CNH exchange rate).

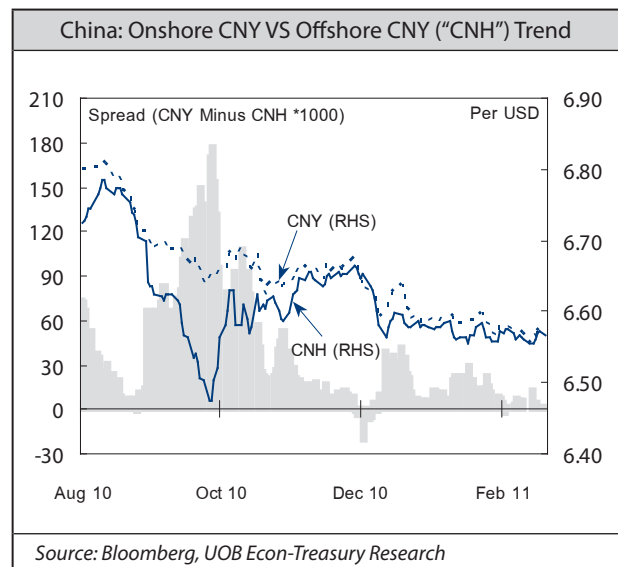
The chart below shows the strong correlation between imports into China and the amount of RMB deposits in HK, suggesting that merchandise trade is the main source of offshore RMB for now and would continue as long as the push for internationalization continues.



Our back of the envelope calculations earlier show that total cross-border merchandise trade settled in RMB could reach RMB15tn by 2020. Even if the proportion of imports components drops to 60%, that would still represent a potential pool of CNH deposit base of RMB9tn, nearly 24x the RMB370bn at Jan 2011. This would be a CAGR of 40%, compared to the overall growth of HK deposit base of about 6% over the 2005-2010 period.

Onshore CNY And Offshore CNH

As the pool of offshore RMB builds up and is now deliverable in HK, the price for this offshore unit or “CNH”(离岸人民币) became available in late Aug last year. This is shown in the chart below, compared to that of the onshore RMB (i.e. RMB on mainland 在岸人民币) quote against USD.



Despite the relatively short history, two observations are worth noting:

- 1) CNH is typically more volatile compared to the onshore CNY quote; and
- 2) CNH is generally more expensive (i.e. USD/CNH is lower) than onshore RMB (i.e. UDS/CNY relatively higher)

As indicated in the table below, CNH is more expensive than the CNY on average during the period 23 Aug 2010 to 14 Mar 2011. Various measures of variability suggest that CNH is more volatile than CNY, i.e. having wider range and larger standard deviation and variance.

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CNY And CNH : Comparison		
Period: 23 Aug 10 to 14 Mar 11	USD/CNY	CNY/CNH
Mean	6.652	6.616
Standard Deviation	0.066	0.067
Sample Variance	0.004	0.004
Range	0.254	0.311
Minimum	6.557	6.475
Maximum	6.811	6.785
Observations	146	146
<i>Source: Bloomberg, UOB Econ-Treasury Research</i>		

One factor contributing to a more volatile CNH due to the thin liquidity compared to the existence of an alternative - but not exact substitute - in the form of offshore non-deliverable forward CNY (NDF) market which is more established and liquid, but is dollar settled.

According to one recent estimate, the average daily flow for offshore NDF CNY market is about USD2bn, vs. daily average of USD400-500mn for CNH market, and that the onshore CNY market turnover amounts to about USD20bn daily. This is reflected in the large differentials between CNY and CNH (and the occasional reversal of these differentials when USD/CNH is higher vs USD/CNY). However, the differentials appear to have narrowed since late last year, as supply of CNH rose, and especially after HKMA activated a RMB20bn currency swap agreement with PBoC on 28 Oct 2010 to maintain a steady supply of RMB for trade settlements.

In addition, CNH is also generally more expensive than CNY due to demand from investor as a proxy to China's growth story as well as increased use of CNH-related investment products.

Notwithstanding investor demand, the characteristics of this offshore unit will ensure that CNH will remain at a premium for sometime, as it has the optionality value of 1) remaining offshore (outside mainland) AND 2) being used to settle cross border with Chinese companies. As such, the lower USD/CNH partly reflects this embedded option value until such time that both CNY and CNH converge. This would be the ultimate scenario where CNY becomes freely convertible and traded and China's capital account is fully open.

CNH Investment Products Proliferating But Still Developing

With the CNH deposit base expanding rapidly, related investment products are also proliferating to access this pool of ready funds. These products run the gamut from basic deposit products to more exotic instruments tapped by multinational corporates, multilateral agencies, and mainland corporates. Other financial innovations such as CNH forwards, CNH CCS, and CNH IRS are still evolving due

to thin liquidity and existing alternatives.

In the "dim sum" bond space (i.e. CNY-denominated bonds issued in Hong Kong) though, there has been a rash of activities with RMB35.7bn issued in 2010, doubling from RMB16bn in 2009, despite offering yields that are lower than equivalent bonds on Mainland. McDonald's was the first multinational to issue "dim sum", with a RMB200m bond back in Aug 2010. One of the more recent issuances was from International Bank for Reconstruction and Development which raised RMB500mn on 5 Jan.

Other more exotic offerings also have come to the market to capitalize on the demand for CNH products, including synthetic RMB bond in the non-investment-grade space, which is issued in RMB but settled in USD, making these bonds accessible to a larger group of investors.

There is also development on the equity front, with talk of an IPO of RMB equity product on the horizon, with the constraint being the limited offshore RMB pool currently.

RMB Internationalization: A Look Ahead

As long as appreciation pressure on RMB continues and the Chinese government looks for way to relieve these pressures, internationalization of RMB is an inevitable process. As China's external trade is expected to rise steadily in the next decade even under conservative assumptions, the pool of offshore RMB or CNH would deepen and expand further. Our calculations earlier this article suggest that cross-border trade in RMB could account for 25% of China's total trade by 2020, from just 2.5% in 2010. This would result in a likely CNH deposit base of RMB9tn, or nearly 24x the base of RMB370bn at end-Jan 2011. This means that the potential of CNH is significant if the momentum continues.

However, one should keep in mind that until China's capital account is fully open, the RMB is not a freely convertible and traded currency, and CNH (and its related investment products/instruments) remains exposed to regulatory risks. In addition, the offshore RMB centre is limited to Hong Kong at least for now, thus restricting its reach to investors outside the region and also capping its liquidity.

On the RMB itself, we remain positive but see fairly low risk of a large one-off revaluation. We expect the 3-5% annual appreciation pace for the RMB against USD to stay for now, which is similar to its 4.4% annual gain in the 2005-2010 period. **However, internationalization of RMB / offshore RMB is one key development that should be watched closely for its scope and pace, which would have material effect on USD, Asian currencies, and international trade.** For now, we are keeping our USD/RMB forecast of 6.35 for end-2011, or a 3.6% drop from 6.59 at end-2010.