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‘One Currency, Two Systems’: China’s Renminbi Strategy

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Summary points

- As the rhetoric on ‘currency wars’ heats up, escalating tensions between the United States and China are casting a shadow over the world economy.
- The Chinese leadership is unlikely to yield to US pressures, but is aware that it needs to move eventually to a more flexible exchange rate regime and a fully convertible currency. It has therefore embarked on a gradual process to develop the renminbi (RMB) as an international currency and ultimately as one of the world’s key reserve currencies. Understanding this process is critical to grasp the current debate on the international monetary system and to gauge how it will evolve.
- Beijing’s biggest policy challenge is to achieve currency internationalization under controlled convertibility. It is pursuing a two-track strategy: boosting cross-border usage of the RMB in trade settlements and making the RMB attractive by building an offshore market in Hong Kong for RMB-denominated assets.
- What China is trying to do is unprecedented. It is the first emerging country to seek to establish a truly international currency when there is no link, even residual, between the reserve currency and gold.
- Despite the enormous challenges there is ample scope for policy experimentation. Success will depend on a combination of well-designed policies and market forces, and on the role that China is playing, and aspires to play, in Asia.

China's ambitions for an international currency

China has travelled a long way in the last 30 years and is now a key player on the international stage, but it does not have a currency that reflects such a prominent role. It is the world's second largest economy, having overtaken Japan in the second quarter of 2010,[1] and the world's largest exporter, having overtaken Germany in 2009. It is also the second largest recipient of foreign direct investment (FDI), with inflows of $95 billion in 2009.[2] Furthermore, it holds the largest share of foreign exchange reserves (just under $2.5 trillion).[3] Yet the renminbi (RMB) is far from playing any role internationally. Its lack of full convertibility restricts its use as a means of exchange, unit of account and store of value in international transactions – i.e. the functions that an international currency is expected to perform.[4]

This increasingly appears to be an anomaly. Key countries in international trade tend to use their currency to invoice and price transactions. Between 1860 and 1914 about 60% of the world trade was invoiced and settled in sterling, reflecting the fact that Britain absorbed more than 30% of exports from the rest of the world (Eichenberry, 2005: 4). Today about 95% of US exports and 85% of US imports are invoiced in dollars[5] (Goldberg and Tille, 2005: 19), in turn reflecting the fact that the US is an important consumer and producer in world markets. The extensive international use of the dollar supports the development of onshore and offshore markets for dollar-denominated banking and financial instruments.

China's lack of an international currency precludes it from benefiting from the efficiency gains that are associated with the use of a country's own currency in international transactions. It also creates a mismatch, on China's international balance sheet, between liabilities that are typically denominated in RMB and claims on foreigners which are typically denominated in major reserve currencies, in particular the dollar. Finally, China suffers from over-reliance on the dollar, with the risk of excessive exposure to liquidity shortages within the world economy and the consequent reduction of trade finance. This was the lesson learnt from the 2007–08 financial crisis. At the end of September 2008 the 'dollar shortage' (McGuire and von Peter, 2009) almost brought international trade to a halt and forced more than one emerging-market central bank to provide dollar funding to domestic banks and for financing exports. Expanding the use of the RMB as a means of payment in international transactions would help reduce both over-reliance on the dollar and the risk of liquidity crises.

Policy challenges

This paper looks at the slow and gradual process on which China has embarked with the goal of developing the RMB as an international currency and eventually turning it into one of the world's key reserve currencies. It argues that what China is trying to do is unprecedented. There is ample scope for policy experimentation. Nevertheless, the challenges are enormous.

Possibly the most difficult of these challenges is that China has no road map or past experience to rely on. It is indeed the first emerging country to seek to establish a truly international currency. Most countries had fully developed before they started to internationalize their currency – and Germany and Japan did not even complete the internationalization of their currencies. Moreover, past experience shows that convertibility and the opening of the capital account have always preceded the international use of a currency, rather that the other way round. However, this paper argues that not being

1 GDP for the period April–June 2010 was $1.34 trillion for China and $1.29 for Japan.

2 According to UNCTAD, China is second to the United States, which in 2009 received FDI totalling $129.9bn.

3 Figures for June 2010, IMF.

4 An international currency performs the functions of store of value, medium of exchange and unit of account for both residents and non-residents. More specifically, it can be used for private purposes such as currency substitution, trade and financial transaction invoice and denomination. It can also be used for public purposes such as official reserves, vehicle currency for foreign exchange intervention and anchor currency for pegging (Kenen, 1983; Chinn and Frankel, 2005).

5 In contrast, the euro is used as the invoice currency on 40–50% of exports by euro area countries, the yen on about a third of Japanese exports, and the pound sterling on about half of UK exports (2003 figures). As statistics on trade invoices are limited and difficult to collect, I have used the figures in Goldberg and Tille (2005), to provide an approximate outlook for use of the main currencies in international trade.

Table 1: Reforms to internationalize the renminbi to 2020

Track 1: Increasing the use of the RMB in international trade	**Track 2: Making the RMB an attractive currency and developing the RMB offshore market in Hong Kong**
● Continuous support to the cross-border RMB trade settlement scheme ● Use of RMB as an invoicing currency in China's Free Trade Agreements ● Promotion of currency swap (bilateral and multilateral) agreements using the RMB as currency of payment ● Increased use of the RMB in regional monitoring system	● Development of RMB use in areas such as trade finance, project finance, FDI ● Expansion of RMB bond and derivatives markets ● Support for the listing of Mainland companies ● Cooperation between securities markets of Hong Kong and Shanghai

supported by historical evidence or economic theory does not mean *ex ante* that China's experiment is doomed to fail.

Another challenge is intrinsic to the fact that China is the first country attempting the internationalization of its currency in the era of true fiat money where there is no link, even residual, between the reserve currency and gold.[6] This means that the RMB has to 'go head to head' with the dollar; its credibility cannot be established by comparing the convertibility of both currencies to gold, as had happened when the dollar took over from sterling. The RMB can only be compared to the dollar, i.e. to the incumbent reserve currency itself. Establishing credibility and an international reputation for the RMB, and making it acceptable in those parts of the world economy where the dollar dominates, will take years. The People's Bank of China (PBoC) is well aware of the difficulties inherent in the internationalization of the RMB, and this is why Beijing is cautious in assessing the chances of success and is trying to avoid creating expectations that are too high.

Finally, China faces the challenge of 'channelling' its currency into the hands of foreign holders. Given its huge current account surplus, this is not going to be easy, especially without even further expanding the dollar element on the asset side of the central bank's balance sheet. But China's goal, at least initially, is to achieve currency internationalization under controlled convertibility. In order to do this, Beijing is pursuing a two-track strategy. The first track is aimed at increasing the use of the RMB in international trade, the second at turning the RMB into a currency that non-residents are willing to hold. This is a policy-driven strategy, with measures specifically designed for each track (Table 1).

For the first track Beijing will rely on its market power to encourage foreign businesses, especially those in neighbouring countries, to use the RMB in the settlement of their transactions with Chinese firms. Following Gao and Yu (2009: 22) I see the successful regionalization of the RMB as a step towards its internationalization.

The second track of this strategy is to build a market for RMB-denominated assets without prematurely opening China's capital account and increasing the imbalances in its international balance sheet. The critical element is the development of Hong Kong as an RMB offshore market. The offshore market will serve as a testing ground for products and prices.

The success of China's strategy will depend on a combination of well-designed policies and market forces. There is no road map and that the whole process of turning the RMB into a reserve currency is being built step by step. However, Beijing has set as a policy objective the development of Shanghai as an international financial centre by 2020, and this should provide the policy framework for the internationalization of the RMB. The development of Shanghai is set to drive the international use of the RMB even if the liberalization of China's capital account is likely to be only partially accomplished.

6 John Nugée has brought this point to my attention. Fiat money has no intrinsic value and cannot be redeemed for specie or any commodity but it is made legal tender through government decree.

Ultimately the whole experiment is driven by the role that China is playing, and aspires to play, in Asia. At least at the beginning, as noted, it is very much a question of currency *regionalization* rather than internationalization. Asia is where China can flex its muscles and create the incentives to get other countries on board.

The rest of this paper is organized in two parts. The first discusses the reasons for China to pursue the internationalization of its currency, and assesses the two-track strategy and its policy goals, before addressing the concern that the opening of a country's capital account must *precede* the internationalization of its currency. The second part looks at the two-track strategy and assesses the steps taken so far. It then discusses the role of Hong Kong as an RMB offshore market and its importance if the strategy of internationalizing the RMB before the Mainland's capital account is opened is to succeed. The paper concludes by stressing the requirement to create a deep offshore market for RMB-denominated products, and offers some recommendations for moving the process forward.

No road map, but a case for policy experimentation

The need to proceed with the internationalization of the RMB and eventually turn it into one of the key reserve currencies – with an open capital account and a deep and liquid capital market – is clear to China's authorities.[7] How to move this strategy forward is less obvious. The attempt to create an international and eventually fully convertible currency through a policy-driven process is unprecedented – nothing like this has ever been tried before, even partially. Beijing is openly aware of the fact that there is no road map to guide this process. Moreover, two apparently conflicting objectives seem to be simultaneously at stake. On the one hand is Beijing's aspiration to increase the international use of the RMB and, more specifically, the use of the RMB to pay for China's imports while controlling the flow of hard currencies. On the other hand is its need to maintain a gradual approach to capital account convertibility through the slow liberalization of long-term flows and the protection of China's most vulnerable domestic sectors.[8]

> 'China's strategy of internationalizing the RMB without fully opening its capital account is proceeding on two parallel tracks'

China's strategy of internationalizing the RMB without fully opening its capital account is proceeding on two parallel tracks. The first track aims to increase the regional use of the RMB, with policies focused on its use as vehicle currency for invoicing cross-border trade. The second track approaches the convertibility of the RMB through the development of an RMB-offshore market in Hong Kong, with policies focused on providing instruments for hedging the currency risk and making RMB holdings more attractive to non-residents. Developing an RMB offshore market to substitute for restricted convertibility would increase recognition and acceptance of the currency and also help Chinese companies that operate in overseas markets to invest abroad and raise capital. At the same time it would allow the authorities to retain a measure of control on the pace of capital account liberalization (He and McCauley, 2010).

7 As the Deputy Governor of PBoC, Hu Xiaolian, recently wrote (Hu, 2010: 5–6): 'The RMB exchange rate regime reform has been advanced smoothly in a self-initiated, gradual and controllable process since 2005. The reform plays a positive role in supporting the real economy, and creates favorable conditions for meeting macroeconomic management objectives. It helps promote a balanced balance of payment account, expand domestic demand and restructure the economy, and has been important in China's efforts to address various domestic and global developments.'

8 Using the IMF definition of categories of capital controls, Gao and Yu (2009: 8–9) show that at the end of 2007 half of the transactions under capital account were subject to controls, and half of cross-border capital transactions were available for non-residents and residents.

Past experience, however, does not seem to support Beijing's strategy. Indeed it suggests exactly the opposite: that the opening of the capital account and making a currency fully convertible are necessary steps towards its internationalization. A currency that is subject to restrictions on international financial transactions is unlikely to *voluntarily* become widely used, even if only for trade in goods, because such trade still involves considerable elements of a purely financial nature such as trade financing and the hedging of exchange rate risk (Genberg, 2009: 6). In other words, on the basis of existing evidence, convertibility must come before internationalization. In some cases, notably with the Japanese yen and the Deutschmark, full convertibility did not even lead to full internationalization.[9]

Can we conclude that Beijing's strategy is fundamentally flawed and therefore doomed to fail? Surely not *ex ante*. In a recent paper He and McCauley (2010) draw on the evidence of the Eurodollar market in the 1960s and 1970s to argue convincingly that full capital account liberalization is neither necessary nor sufficient for substantial offshore use of a currency. Significant controls on capital by the US authorities from the 1960s to the early 1970s did not undermine the international role of the dollar and in some ways even gave a boost to the Eurodollar market.

There are other reasons to believe that China's experiment is not already doomed. First, the moment could not be more appropriate. The Chinese economy has shown strong resilience to the economic and financial crisis and has been expanding at an impressive rate since 2009.[10] Whereas the global economy shrank by 0.6% in 2009, China registered growth of 8.7%, and its economy has expanded at double-digit rates in the first half of 2010. China's international position is stronger than before the crisis and the RMB, in particular, is in a comparatively better position *vis-à-vis* other currencies. Since January 2008 it has appreciated by 6.5% against the dollar and 18.1% against the euro.[11]

Furthermore, the authorities are carefully preparing the ground for this strategy to succeed through policy-driven measures that aim to 'facilitate' the functioning of the market. Past experience shows that the development of international currencies happens through a mix of network externalities, market development and the preferences of actors involved in the process. Certain prerequisites are essential to this process, such as no restrictions on third-party use of the currency in contracts or settlements of trade in goods or assets, the existence of a deep and dynamic domestic financial market, a well-respected legal framework for contract enforcement, and stable, predictable micro and macro policies (Genberg, 2009). China's assumption is that once these prerequisites are in place, the process will have enough traction to drive the market.

'Can we conclude that Beijing's strategy is fundamentally flawed and therefore doomed to fail? Surely not *ex ante*'

There is no guarantee, however, that, once the prerequisites are met, the internationalization of the currency will follow spontaneously and voluntarily. Looking at this process from a market viewpoint, one can argue that policies can *support* the currency internationalization, but cannot *drive* it. In other words, China can lay the groundwork, but cannot force market actors to switch to the RMB unless they have reasons and incentives to do so.

So how can China create incentives to expand the international use of the RMB? Unlike smaller economies, it is in the position to 'encourage' and even 'force' market participants to use the RMB. For instance, companies eager to break into China's market may be

9 In both cases concerns about the risks of macroeconomic instability and the possible impact on domestic monetary policy resulted in capital controls and reduced liquidity of their securities markets for many years.

10 Although at a slower rate than in the pre-crisis years. In 2002–08 the average GDP growth rate was 10.5%.

11 However, over the same period, the RMB has depreciated by 14.8% against the Japanese yen.

asked to use the RMB in the settlement of their trade into China, and may willingly comply. What seems to emerge from past evidence is that the more limited the size of a country's economy, the more limited the scope for its currency to become fully internationalized. In this sense, scale and scope are set to play in China's favour.

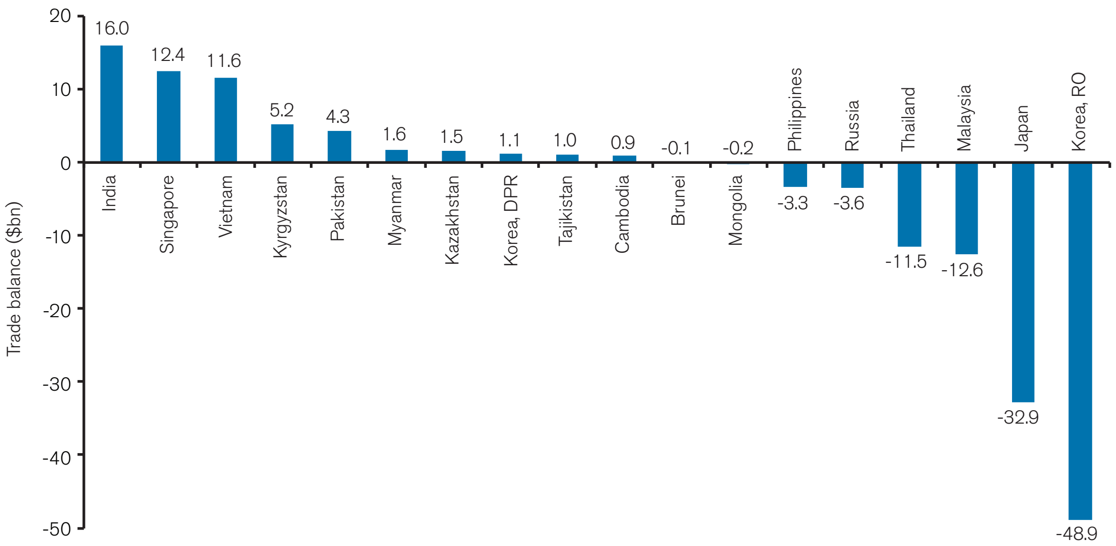
China's two-track strategy

The first track: a currency for international trade

In July 2009, in order to improve the use of the RMB among non-residents, make it a vehicle for trade settlement and expand the scope of RMB business outside China, Beijing launched policy measures under the cross-border RMB trade settlement. The scheme, originally limited to five pilot cities, was broadened in June 2010 to include 20 provinces[12] and cities in the Mainland. As a result exporters can now settle trade in RMB not only with ASEAN countries, Hong Kong and Macao, as previously, but with the rest of the world.[13]

The scheme began slowly, in a rather low-key way (HKMA, 2009), but it has picked up since the beginning of 2010. In the first half of the year transactions totalling RMB70.6bn were settled under the scheme, up from RMB3.6bn in the second half of 2009, 75% of them being conducted in Hong Kong.[14] However, given that China has about 9% share of the world trade,[15] most of it currently settled in dollars, the scope to increase the use of the RMB is potentially huge, especially in cross-border trade. With just over 40% of China's total imports coming from neighbouring countries and just over 20% of China's total exports going to them (Figure 1), the RMB could be used to invoice 40–50% of China's imports

Figure 1: China's trade balance with neighbouring countries and ASEAN members ($bn), 2009



Source: IMF

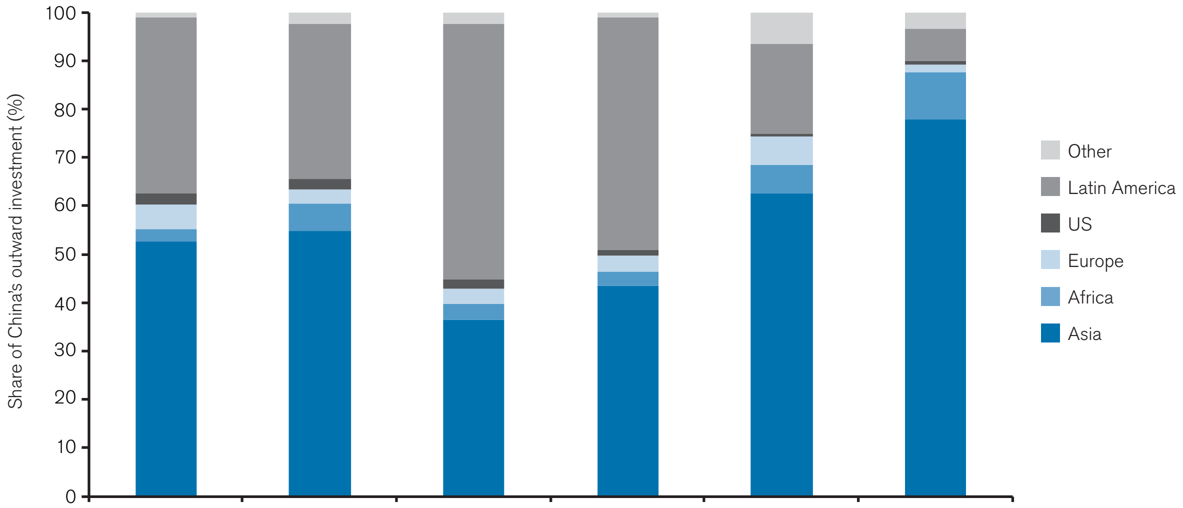
12 Beijing, Tianjin, Inner Mongolia, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangdong, Guangxi, Hainan, Chongqing, Xichuan, Yunnan, Jilin, Heilongjiang, Xizang (Tibet) and Xinjiang.

13 In June 2010 Beijing also reinstated the exchange rate arrangement that had been introduced in July 2005 and then suspended, because of the financial crisis, in late 2008 when China reverted to a *de facto* peg with the dollar to minimize the impact of the crisis. The current regime allows the US dollar–renminbi spot exchange rate to move intraday ±0.5% from a central parity. The reference is to a basket of currencies. In the three weeks following the reform, the currency appreciated against the US dollar by ¾% (IMF, 2010). The reform of the exchange rate regime was widely picked up by the international press, while the extension of the cross-border trade settlement was broadly ignored. Similarly, the accord signed on 19 July 2010 between the Hong Kong Monetary Authority (HKMA) and the PBoC allowing RMB-denominated bonds, insurance policies and other investment products on the Hong Kong market was ignored by the international press. See Yam (2010).

14 Figures from HKMA.

15 This compares with the US's share of the world trade of about 11%. According to the IMF, the US absorbs just over 12% of the world's imports. The euro area absorbs about 28% of the world's imports and overall accounts for about 28% of world trade (these figures include intra-euro-area trade).

Figure 2: Share of China's outward investment by region (%)



Source: CEIC database

to other Asian countries and about 20–30% of its exports from them. This is approximately the share of euro area trade with non-euro area countries that is currently invoiced in euros (Goldberg and Tille, 2005: 17).

At this stage what China is trying to achieve is rather modest. Building on the existing 'Asianalisation' of the RMB (Seade et al., 2010) and its rather limited circulation in China's neighbouring economies (Gao and Yu, 2009: 15), and using policy measures as well as market traction[16] to accelerate the use of the RMB across the region, China's strategy appears, at least for some years, to be regional rather than international.[17]

However, focusing on neighbouring countries provides China with familiar ground to experiment with policies before 'going global'. Asia is where China's policies have more traction and where its dominant position can result in a positive outcome for such policies. China's key role in East Asia became clear for the first time during the Asian financial crisis of 1997–98 (Gao and Yun, 2009: 1). Since then it has been actively involved with regional monetary arrangements. It is an important fund supplier for the Bilateral Swap Arrangements under the Chiang Mai Initiative framework, and is engaged in multiple policy dialogue and economic surveillance mechanisms in the region. China is also the centre of East Asia's production network, a key hub within the regional supply chain and the main recipient of Asia's FDI – and Asia is the recipient of China's capital outflows (Figure 2).

The strategy of gradual regionalization as a step towards a more internationally widespread use of the RMB also reflects China's need to keep a flow of hard currencies, notably the US dollar, in exchange for its exports to developed economies. Given the limited convertibility of the RMB, dollars are especially needed to pay for imports of energy products. China's energy deficit is just over US$100bn, according to the 2009 figures. In particular, it runs the largest deficits with

16 A similar point is made by Gao and Yu (2009: 6–7).

17 Xia (2009) regards the gradual regionalization of the RMB as a sub-optimal target *vis-à-vis* the complete internationalization of the RMB. I prefer to look at the regionalization of the RMB as an intermediate step towards complete internationalization.

Saudi Arabia (US$19bn), Angola (US$14bn) and Iran (US$10bn). Energy consumption in China increased at an average annual rate of 8.8% between 1998 and 2007[18] and is set to continue to rise.[19]

The second track: making the RMB an attractive currency and developing the RMB offshore market in Hong Kong

Developing the RMB as a medium of exchange in the form of invoicing for trade and financial transactions for both residents and non-residents is a necessary but not sufficient step towards achieving China's objectives. Its use as a vehicle currency has limited scope for expansion if RMB holders do not have the option of investing in productive and financial activities. The second track of the strategy for internationalizing the RMB, therefore, has to focus on developing it into a currency that foreign investors are happy and willing to hold. The challenge here is to make this happen without opening China's capital account.

Developing the RMB offshore market in Hong Kong is a way of overcoming restricted convertibility, providing the essential clearing and settlement services for the RMB, increasing the scale of its circulation and facilitating development of the Mainland's capital market. The existence of an offshore RMB market is a necessary condition if the currency is to develop from a limited range of transactions to an established asset that will store wealth as part of a portfolio for non-resident companies and individuals[20] (Seade et al., 2010). This means building up a sufficiently broad supply of RMB-denominated products for the offshore market and stimulating demand through incentives, in particular for raising RMB funds in Hong Kong.[21] Developing the offshore market will also offer practical experience for the gradual opening of China's RMB onshore market, in terms of building market infrastructure, improving asset pricing and assessing the risks involved in the whole process.

Hong Kong can serve as a testing ground, helped by the fact that it is part of China, but with a separate administrative and regulatory framework ('one country, two systems'),[22] and one of the world's most developed international financial centres.[23] Keeping the offshore and onshore markets separated – but within the same country – will enable the supervisory authorities to monitor the flow of external funds between offshore and onshore accounts, and to avoid the huge influx of funds that could shock domestic financial markets.[24]

> 'Developing the RMB offshore market in Hong Kong is a way of overcoming restricted convertibility'

Since 2004, Hong Kong has slowly but steadily developed into an RMB offshore centre, with its RMB banking business expanding from personal deposits to bonds and then to trade credit. A channel enabling RMB to circulate and be cleared in Hong Kong to flow back to the Mainland was established in 2003.[25] RMB bank deposits were allowed in 2004 and have grown steadily on the back of demand from individuals and firms with business interests in China (Figure 3). The

18 Figures from the US Energy Information Administration (EIA, 2010). The latest year for which data are available is 2007.

19 The EIA's *Annual Energy Outlook* (2010) sees China's energy consumption increasing by an annual rate of 3.1% in their baseline scenario. However, the value of energy imports would also depend on energy price fluctuations.

20 The internationalization of the US dollar led to the formation of a dollar-based international capital market.

21 Currently, because a few types of transactions, such as the renminbi non-deliverable forwards, are traded in Hong Kong and some other Asian cities, the RMB has not been a standard offshore currency (Gao and Yu, 2009: 21).

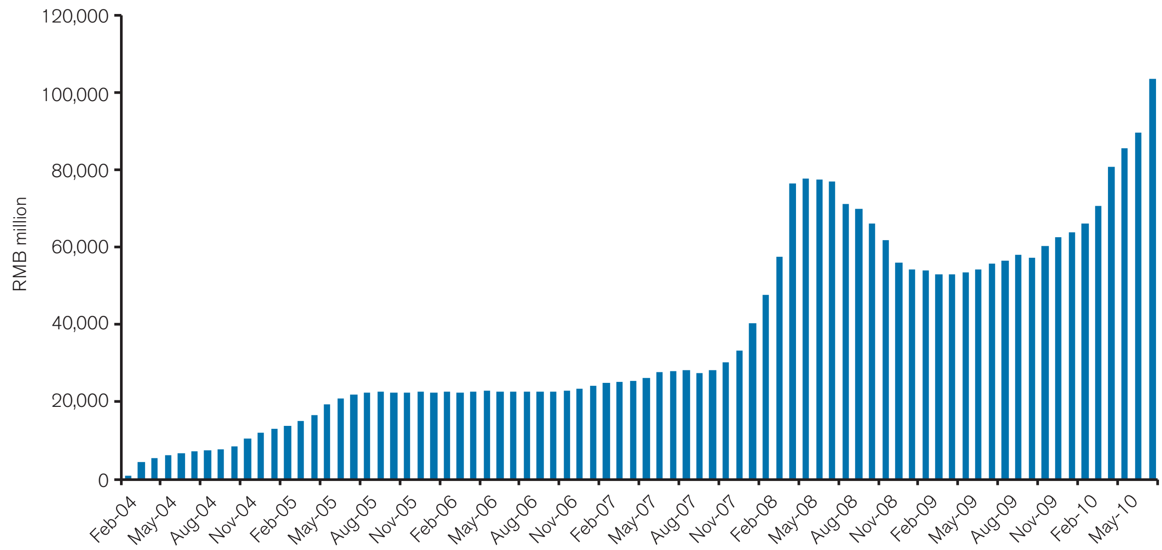
22 For a contrarian view on Hong Kong's relationship with Beijing see van der Kamp (2010).

23 See Financial Centre Futures (2010).

24 On the risks to monetary and financial stability in the home economy posed by the development of offshore markets, and the policy options to manage such risks drawn on the Euromarket experience, see He and McCauley (2010).

25 The Memorandum was signed in 2003.

Figure 3: RMB deposits in Hong Kong (RMB million, February 2004–July 2010)



Source: HKMA

extension of the cross-border trade settlement scheme has boosted RMB deposits in Hong Kong. Between June and July 2010, for instance, they grew by 16% to RMB103,684 million. RMB deposits, however, represent a mere 1.8% of the total bank deposits in Hong Kong.[26]

Even if the expansion of RMB offshore banking is likely to continue on the back of the trade settlement scheme, specific policy measures are needed to turn the RMB into a currency of debit and credit. For instance, access to the clearing system within onshore banks needs to be improved and non-resident convertibility of the currency, at least for overseas banks, needs to be allowed. Offshore markets in a currency flourish if offshore financial institutions are able to maintain and freely access clearing balances in the currency with onshore banks (Dufey and Giddy, 1978). In Hong Kong access to onshore banks is limited. At present long positions are not possible. As a result RMB flow back to the clearing bank in Shenzhen because banks have no opportunity to go long on RMB. Non-resident convertibility is critical for building up offshore long and short positions in the currency, given the controlled capital account in the onshore market.

Building an offshore market for RMB-denominated bonds is a way to provide alternative investment opportunities for RMB deposit holders in Hong Kong, as well as another channel for RMB to flow back to the Mainland. However, the small scale of the existing RMB pool limits bond issuance; in 2007 the first issuance in the Hong Kong market was only RMB10bn. The subsequent issue, in 2009, was even less, for bonds worth RMB6bn, with maturity ranging from two to five years.

From February 2010 companies based in Hong Kong have been allowed to issue RMB bonds under the new guidelines announced by the Hong Kong Monetary Authority (HKMA), but take-up of this opportunity has so far been modest. In August 2010 McDonald's, the US fast-food multinational, was the first foreign company to issue an RMB-denominated bond in Hong Kong. The issuance was RMB200 million, with a coupon rate of 3% and a maturity of September 2013.[27]

26 The RMB deposits were equal to 3.5% of deposits in Hong Kong dollars (HKD). In July 2010, according to the HKMA, total deposits in Hong Kong were worth HKD6,464,980 million, of which 3,408,352 million were in HKD, and the rest in foreign currencies. The size of the RMB deposits in Hong Kong is a fraction of household bank savings of more than RMB 20 trillion in Mainland China (Seade et al., 2010).

27 The issuance was private and, according to newspaper reports, was over-subscribed.

To create a deeper and more liquid offshore RMB market, measures to improve asset pricing and develop the benchmark yield curve are necessary. At present interbank interest rates and central bank bill rates are often used as reference rates. However, interbank borrowing is active mostly for overnight and one-week arrangements, and not all maturities of central bank bills are actively traded. As a result, banks, while making reference to some market rates, often adjust prices on the basis of their own liquidity and open positions. This leads to a wide range of quotes on forward and swap rates.

A deep and liquid market, in its turn, is essential for the development of a secondary market, where transactions can take place at low costs. This would eventually allow large issuance of financial instruments. In particular, bond and derivatives markets will develop. These are a key component of the financial market on the Mainland, and are important for efficient financial intermediation.

The development of the Hong Kong RMB offshore market, in particular, will be enabled by policies that, in their turn, are driven by the rapid growth of the Mainland's economy and the need for China's enterprises to go global. Along with policies, market forces also contribute to the formation of Hong Kong's offshore RMB market. They are crucial for the development of a critical mass and hence for the market's success. What incentives would attract investors and other players to the RMB offshore market?

There are four sets of incentives that, at least at the beginning of this development, can boost demand. The first, which is typically policy-driven, is the progressive removal of constraints to the RMB business, which, in its turn, will result in lower listing and brokerage fees and charges for other financial services. This will attract more Mainland firms to list and raise funds through Hong Kong's capital markets.

The second set of incentives relates to investors' expectations of a substantial RMB appreciation. This would support asset prices in Hong Kong and act as a further pull for capital flows. In addition, investors and other market players may find it attractive to tap into the RMB offshore market because of the separation of currency risk from country risk and the diversification of operational risks. Also, in the offshore market investors may be more protected from instability arising from operational bottlenecks as central banks are increasingly dependent on the proper functioning of securities markets for their access to liquidity.

The third set of incentives is related to yield differentials. Evidence from the Eurodollar market, as noted in He and McCauley (2010), suggests that yield differentials play a role in choosing between onshore and offshore markets. The yield premium that prevailed in the early days of the Eurodollar market was a reflection of the greater risk attached to offshore dollars.

Finally, strengthening and maintaining a sound regulatory framework is a key component of attracting non-resident capital flows to the offshore market.

Conclusion

Despite its prominent role in the world economy, China does not have a currency that can be used as a unit of account, means of exchange and store of value in international transactions. Recent policy measures are aimed at moving towards the internationalization of the RMB. Beijing is pursuing this goal in an unprecedented way, and no clear road map is available to guide this process. In particular, what makes the path challenging and unpredictable is the presumption that the RMB can be made international without being made fully convertible.

Restricted convertibility is clearly an issue. Building an RMB offshore market in Hong Kong is therefore essential to China's goal of developing an international currency. Having an efficient and liquid offshore market should make the RMB attractive enough for foreigners to hold it as well as to circulate it back.

While policies and incentives are important, ultimately the success of China's strategy depends on non-residents' appetite for holding RMB given its limited convertibility. The demand for RMB and RMB-denominated assets is currently driven by China's economic performance and expectations of the currency's future appreciation. But would it be strong enough over a number of years to turn what is a trickle into a more robust flow? Beijing can certainly use a mix of incentives and inducements to support the international use of the RMB. But it also needs to persuade non-residents – as well as residents – that it is committed to maintain a stable macroeconomic environment and price stability. This is essential if RMB holders are to see it as a store of value, and in order to gain investors' confidence China will need to 'compete' against other reserve currencies. A huge amount of credibility and soft power is needed to persuade non-residents and eventually other countries to rely on the RMB as a store of value rather than just as a vehicle for international transactions.

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