CHATHAM HOUSE briefing paper

Taipei in the Renminbi Offshore Market: Another Piece in the Jigsaw

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Summary points

- As the world's second largest economy, China is promoting wider use of its currency, the renminbi (RMB), across the world. International financial centres, notably Hong Kong, are developing the RMB offshore market.
- The cross-border RMB trade settlement scheme has noticeably expanded the use of the RMB in trade since 2010. The scheme provides the main source of liquidity to the RMB offshore market.
- The RMB offshore market is expanding and offers more investment opportunities. But the limited supply of liquidity remains a constraint on its size and scope.
- Taipei is the new player in the RMB offshore market and has strong growth potential, the main drivers being close cross-Strait cooperation in trade and foreign direct investment. The recently opened currency clearing system should ensure liquidity to the market.
- As a regional financial centre, Taipei is unlikely to rival Hong Kong, at least in the short term. Non-Taiwanese investors are deterred by regulatory restrictions, higher taxation and lack of financial openness.
- Proactive policies are necessary to support the development of the RMB market in Taipei. To become a key regional financial centre, it needs a clear strategy to maximize the advantages derived from the dynamic domestic economy.

Introduction

China has been promoting the internationalization of its currency, the renminbi (RMB), since 2009. However, it remains a non-convertible currency, and this constrains its internationalization. To overcome this restriction, in addition to encouraging the use of the RMB in cross-border trade, the Chinese authorities have been supporting the development of the offshore market, while a series of policy initiatives has improved liquidity in this market, created infrastructure and new products, and developed the RMB-denominated debt market.

International financial centres, notably Hong Kong, but also London and Singapore, have been quick to harness the opportunities offered by the RMB offshore businesses. Other financial centres, such as Tokyo and Taipei, have recently followed suit. In this paper we focus on Taipei as the latecomer to the RMB offshore business. How big can Taipei's RMB market grow in both the short and the long term, and how does Taipei compare with Hong Kong in terms of the advantages and disadvantages? Will the size of Taipei's RMB business be comparable to Hong Kong's? What constraints must Taipei overcome in order to fit into the expansion of offshore RMB in the Greater China region?[1]

The paper aims to assess strengths and weaknesses within the context of Taiwan's trade relationship with mainland China. Policy initiatives under the framework of cross-Strait financial cooperation are currently driving the RMB business in Taipei. Being a regional financial centre that serves a dynamic domestic economy, Taipei offers different features from Hong Kong, the dominant RMB offshore centre. The paper suggests ways in which the Taiwanese authorities could follow a more proactive policy approach and identify the opportunities and challenges that arise from the RMB offshore business.

The paper is organized as follows. First it assesses Beijing's RMB strategy and highlights the importance of cross-border trade to expand the offshore market and ensure that enough liquidity is maintained. Next it focuses on Taipei and estimates the potential for growth under three scenarios. Finally the paper suggests how policies could support the development of the RMB business and at the same time help the domestic economy by offering enterprises more options for fundraising and providing more investment opportunities to market participants.

The RMB strategy: work in progress

As part of the internationalization of the RMB, development of the offshore market began in Hong Kong in 2010. As a result the use of the currency to settle cross-border trade has become more extensive and non-residents are now willing to hold RMB and RMB-denominated assets in their portfolios.

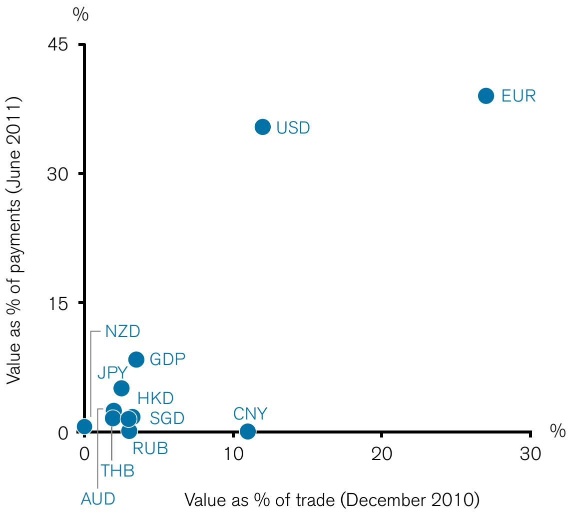
But the role of the RMB still lags far behind China's economic relevance as the world's second largest economy. In 2011 China's contribution to world trade was 12%, whereas the RMB's share in world payments was a mere 0.2% (SWIFT, 2011). By the end of May 2013, this had increased to 0.7% (SWIFT, 2013a). The use of the RMB as a world payment currency is by no means comparable to that of major international currencies such as the dollar and the euro, which are used far more extensively than their countries' share in global trade would suggest (Figure 1). Even compared with the currencies of smaller economies such as Thailand (baht), China still has a long way to go.

For a long time Chinese policy-makers have been aware of the need to have a currency that could be used as a means of payment and as a unit of account in international trade.[2] But this did not become a strategic issue for Beijing until the global financial crisis in 2008, which highlighted the risks of excessive exposure to dollar liquidity shortages, and the consequent impact on international trade (McGuire and von Peter, 2009). For China, a greater concern has been the depreciation of the dollar as a result of the unconventional monetary policies implemented by the Federal Reserve. Three rounds of quantitative easing have created potential losses on dollar holdings in China's foreign exchange reserves. To some extent, the RMB strategy is a response to the over-reliance on the dollar and an attempt to reform the Mainland's financial sector.

1 The Greater Chine region includes the area of the Mainland, Hong Kong Special Administrative Region (SAR), Macao SAR and Taiwan. In this paper we refer to the 'Mainland' as the mainland area of the People's Republic of China, excluding the Hong Kong and Macau SARs.

2 In 2004, Yu Yongding, a member of the Monetary Policy Committee of the People's Bank of China (PBoC), publicly criticized China's over-reliance on the US dollar and pointed out the pressing need to use the domestic currency for trade settlement purposes.

Figure 1: The RMB as a world payment currency



Source: SWIFT, 2011.
Key: Euro (EUR), US dollar (USD), British pound sterling (GBP), Japanese yen (JPY), Australian dollar (AUD), Hong Kong dollar (HKD), Singapore dollar (SGD), Thai baht (THB), New Zealand dollar (NZD), Russian rouble (RUB), Chinese yuan (CNY).

The strategy also addresses China's need for an international currency that matches its growing economic influence.[3] While developing the RMB, the Chinese authorities also plan to develop an international financial centre. In 2009 Shanghai was identified, and is intended to become the Mainland's international financial centre by 2020.[4] This development, and the gradual opening of the Mainland's capital account, increase the RMB's chances of becoming an international currency.

However, the timing and sequencing of how Beijing will internationalize its currency remain unclear. The liberalization of the capital account is essential to make the RMB available to non-residents. Policy measures that facilitate the RMB strategy, such as the R-QFII and RMB ODI schemes,[5] have lifted several barriers.[6] Yet no clear indication has been given on when full convertibility is likely to be achieved.[7] Beijing needs more time to build a sound institutional infrastructure and to gain credibility. But fears of exposing its immature financial market to external volatility are widespread among policy-makers and scholars. These concerns have built great resistance against further financial reforms, hindering attempts by the People's Bank of China (PBoC) to accelerate the reform progress (Freeman and Wen, 2011). As a result the Chinese authorities are following a cautious and gradual approach to opening the onshore bond and stock markets to international investors, and remain reluctant to let the exchange rate fully float.

A two-track strategy for the RMB

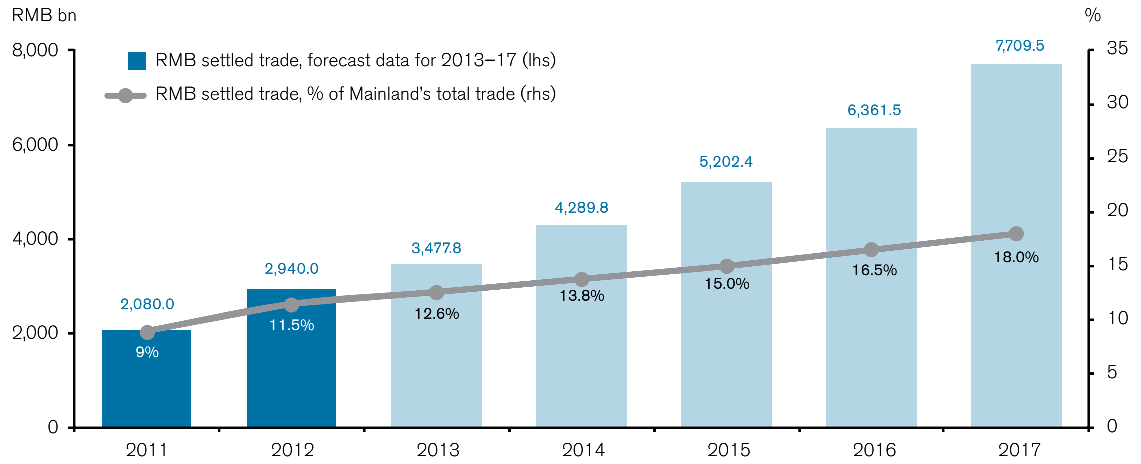
Since 2009 mainland China has adopted a two-track strategy to internationalize the currency (Subacchi, 2010). This strategy aims to establish the RMB both as a currency for settling cross-border trade and as an asset that non-residents are willing to hold.

The Cross-Border RMB Trade Settlement Scheme provides a platform that allows all types of trading companies around the world to use the RMB to settle trade without any geographical restriction. It bridges the gap of global demand for RMB across the world and creates a complex financial architecture that enables cross-border settlements and clearing services through banks in both onshore and offshore markets (Vallée, 2011).

From June 2010 to March 2013, when the cross-border scheme was expanded to 20 Chinese provinces and cities, Hong Kong's RMB deposits increased from a value of less than RMB 100 billion to over RMB 668 billion. Offshore RMB businesses such as deposit-taking, currency exchange, finance and remittances are made possible through the participation of banks from both the onshore and the offshore markets.

3 The State Council of the PRC has not published any official document on the objectives of China's RMB strategy. Papers from scholars close to Chinese decision-makers suggest that the target is to develop the RMB to become an international currency (Xia, 2011; Yu, 2012).
4 On 25 March 2009, China's State Council issued detailed guidelines for the promotion of Shanghai to become an international financial centre (IFC) by 2020.
5 The R-QFII scheme is the RMB-Qualified Foreign Institutional Investor programme, which allows foreign investors to invest in the Mainland's capital markets with offshore RMB funds. RMB ODI refers to the RMB Overseas Direct Investment programme, enabling Mainland enterprises to invest onshore RMB funds abroad.
6 Between 2002 and 2009, PBoC announced 42 policy measures to relax controls on China's capital account, under which there are 22 items classified as partially convertible and four as non-convertible, according to the IMF standard (HSBC, 2012).
7 PBoC published a report assessing the macroeconomic condition for further liberalization of China's capital account in February 2012. The report offered broad guidelines on the policy steps towards the gradual liberalization of the capital account over the next five years.

Figure 2: Projection of total RMB trade settlements in the Mainland by 2017



Sources: IMF, WTO, PBoC, Chatham House calculations.

The cross-border RMB trade settlement scheme marks the convertibility of the RMB under the Mainland's current account.[8] Companies have the option to use the RMB to invoice and settle trade, and so to reduce transaction costs. For those that receive payments in RMB but still wish to convert the payment into another currency, the conversion can now be made in the offshore market in Hong Kong. Here CNH (the abbreviation used for its offshore RMB) can be converted into any type of foreign currency at free-floating market rates. In other words, the cross-border RMB scheme expands the *de facto* convertibility of the RMB beyond current transactions.

In the onshore foreign exchange market, currency conversion is a complex process owing to the limited convertibility of the RMB. For domestic Chinese companies, payments received through trade are normally settled in US dollars and therefore need to be converted into RMB for domestic payments. On the other hand, foreign companies receiving profits in RMB need to convert them into foreign currencies through an application to the State Administration of Foreign Exchange (SAFE). They also have to bear exchange rate risks and pay for the additional transaction costs that arise from using a third currency.

Since its inception as a pilot programme in June 2009, the cross-border RMB trade settlement scheme has resulted in an increasing share of China's cross-border trade being settled in RMB. Approximately 12% of China's trade, worth more than RMB 3 trillion, is now settled in RMB, against less than 0.5% in 2009. Given China's trading capacity and its wide network of partners all over the world, it is expected that trade will be settled in RMB as more trade enterprises and offshore financial intermediaries use the RMB settlement system. According to the International Monetary Fund (IMF), China's imports and exports will continue to grow at an annual rate of 10% in the next five years. This should support the expansion of the RMB offshore deposits.

Political uncertainties and the expected slowdown in economic growth could hinder the expansion of the use of the RMB in trade settlement. To reflect these risks, we take a conservative approach in estimating the potential volume of RMB settled trade in the next five years (Figure 2).[9]

8 The current account includes categories such as the sale of goods, provision of services, interest payments and repatriation of dividends.

9 Total trade settled in RMB (Mainland) = RMB settlement ratio * [Export * (1+ export growth rate) + Import * (1+import growth rate)]. To estimate the Mainland's total international trade volume from 2013 to 2017, we used World Trade Organization (WTO) data for the Mainland's export and import trade in 2012, and multiplied the volume by the IMF's projection for the growth rates of the Mainland's imports and exports from 2013 to 2017. The proportion of RMB-settled trade as a percentage of the Mainland's total trade was 9.0% in 2011 and 11.5% in 2012. According to the PBoC report, the Mainland aims to settle at least 15% of its total trade in RMB by 2015. On this basis, we assume the percentage of RMB-settled trade over total Mainland trade will increase steadily to 12.6% in 2013 and 13.8% in 2014, eventually reaching the target of 15% in 2015. We assume that the proportion in 2016 and 2017 will be 16.5% and 18% respectively. For currency conversion between CNY and USD, we adopted the IMF estimate of the CNY/USD exchange rate for the period 2013–17.

According to our projections, the Mainland's total RMB trade settlement will reach RMB 7.7 trillion by 2017, corresponding to 18% of the value of total Mainland trade.

Under the trade settlement scheme, the RMB funds will be transferred to offshore markets and become offshore deposits via the banks[10] (Rossi and Jackson, 2011). RMB deposits build up a stable stock of liquidity that stays in the offshore market.

As the RMB offshore market is still limited in both size and scale, the volume of RMB deposits provides a proxy to measure the level of offshore RMB businesses. At present, liquidity conditions in the RMB offshore market are still not adequate and investment options for offshore investors are restricted.

Table 1: Expansion of RMB offshore use, 2010–12 (RMB billion)

Type of transaction	End 2010	End 2011	End 2012
Mainland RMB-denominated trade	369.0	2081.0	2940.0
Mainland RMB FDI	N/A	90.7	251.0
Hong Kong RMB deposits	314.9	588.5	602.9
Hong Kong RMB bonds issued	35.9	104.0	271.3
Hong Kong RMB loans	2.0	30.8	79.0

Sources: Ministry of Commerce PRC, HKMA, Reuters.

Building the offshore market

Expanding the use of the RMB from trade to finance is critical for the currency internationalization. Although policy measures have been introduced to develop the RMB offshore market in Hong Kong, this remains small in absolute terms. In 2012 the expansion of RMB deposits stalled as a result of weaker global demand for China's goods, expectations that the RMB would depreciate and, most importantly, a wider range of repatriation channels.

An expanding and maturing market in Hong Kong

Hong Kong is the premier RMB offshore centre, serving as the main conduit between the onshore and offshore RMB markets and functioning as the wholesale market for the currency (He and McCauley, 2012; Ma, 2012). Hong Kong has the advantages of being the first mover and of being part of China. A range of measures in 2010 and 2011, such as the expansion of the RMB cross-border trade settlement scheme and the removal of restrictions on issuances of dim sum bonds,[11] led to a significant increase in RMB deposits and an expansion of the RMB debt markets.

The expansion of the RMB deposits in Hong Kong has given considerable traction to the RMB as the third most used currency in Hong Kong's banking sector. Similarly, the offshore debt market and the bank lending business expanded, respectively, nearly eight-fold and forty-fold in the same period (Table 1).

The growth of Hong Kong's offshore RMB debt market has been particularly rapid. In total, debt securities[12] worth RMB 271.3 billion were issued in 2012, almost 1.5 times the amount issued in 2011 (Figure 3). At the end of December 2012, the value of the outstanding debt securities reached a peak of RMB 366.8 billion.

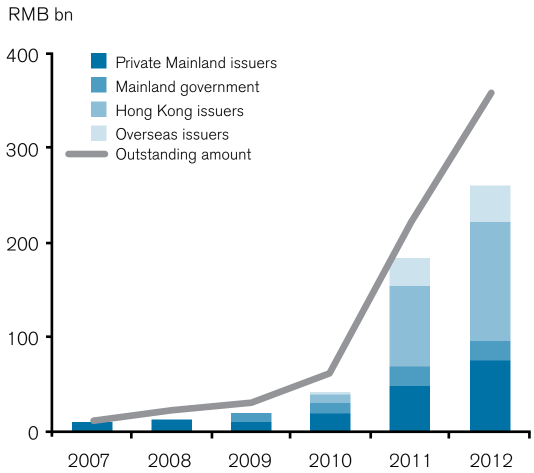
Many other developments show that the offshore debt market in Hong Kong is gradually becoming more diversified and mature. First, the profile of RMB-denominated debt issuers has expanded. In 2012, the total value of debt securities issued by international companies was RMB 42.5 billion, a remarkable 40% increase from 2011 (Figure 3). Companies from 17 countries, including Germany, South Korea, France, the United Kingdom and the United Arab Emirates, now fundraise in Hong Kong. For example, Volvo and Renault SA issued their first RMB dim sum bond in the first quarter of 2012.

10 There are two types of banks that facilitate RMB cross-border transaction. One is the RMB agent bank that participates in the RMB cross-border trade settlement scheme. The other is the RMB clearing bank that acts as the clearing hub for the offshore funds. The RMB agent banks are estimated to conduct 20–30% of the total RMB clearing volume, while RMB clearing banks are estimated to process 70–80% (SWIFT, 2012).

11 Dim sum bond is the name of the RMB-denominated bond that is issued and traded in Hong Kong.

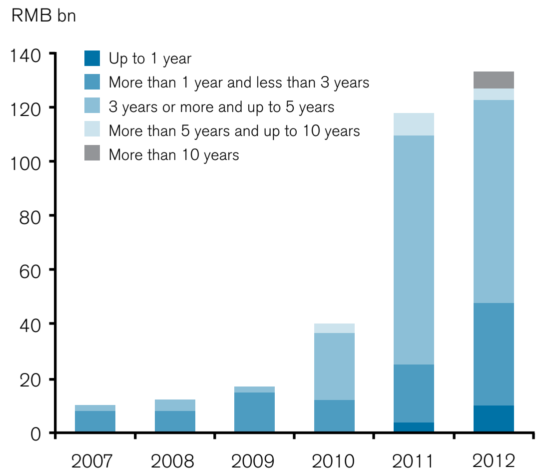
12 The debt securities include RMB-denominated bonds, medium- and long-term notes, certificate of deposits (CDs) and commercial papers.

Figure 3: New issuances and outstanding amounts of offshore RMB debt securities



Source: HKMA.

Figure 4: New issuances of non-CDs RMB debt securities by duration



Source: HKMA.

Secondly, Certificates of Deposit (CDs) have been introduced. These are short-term debt products that contribute additional liquidity and trading activities to the offshore RMB debt market.[13] In 2012 they constituted over 40% of Hong Kong's RMB debt market, with a total value of RMB 117.3 billion.

Thirdly, the maturity period for new debt issuances has increased. Excluding CDs, the average maturity of newly issued debt products rose from 2.3 years in 2010 to 3.5 years in 2012 (Figure 4). There are several issuances with a maturity of more than ten years. In January and August 2012, China Development Bank issued a 15-year note and a 20-year note. The Ministry of Finance and Export-Import Bank of China subsequently issued another two 15-year notes in June 2012.

Finally, the market has become more transparent as more new issuances have been rated. The proportion of graded debt securities increased from nearly 80% in 2011 to 88.7% in 2012. The graded new issues achieved on average almost the single-A rating level.[14]

Wider repatriation channels, a great leap forward?

All these developments show a stronger demand for RMB funds in the offshore market. However, the size of RMB deposits in Hong Kong dropped to RMB 545.7 billion in September 2012 from its peak of RMB 627 billion in November 2011. There was also a decline in cross-border claims by banks to the Mainland in 2012.[15] Cyclical factors such as weaker global demand for China imports and exports in 2012, as well as market expectations that the RMB would weaken – after having appreciated since 2005 – have affected the use of the cross-border trade scheme, constraining the growth of Hong Kong's RMB deposits. Also, the opening of several repatriation channels has had an impact on the offshore market while allowing larger remittances of offshore RMB liquidity to be invested in the Mainland (Ma et al., 2013).

Capital repatriation under the RMB foreign direct investment (FDI) programme has also constrained the growth of RMB offshore deposits. At its launch in October 2011, only RMB 90.7 billion flowed back to the onshore market, but

13 All participating banks in Hong Kong can issue CDs without approval.

14 The proportion of new bond issuances rated by rating agencies increased considerably to 55.3% in 2012 from 40.4% in 2011 (HKMA, 2013).

15 The BIS report (2013) shows a decline of US$48 billion in cross-border claims by banks to China between June and September 2012. Elsewhere in the Asia-Pacific region claims increased over the same period.

there was a rapid expansion to around RMB 200 billion by the end of 2012. About RMB 270 billion migrated from the offshore to the onshore market in 2012. This is equivalent to nearly half the amount of RMB deposits and the total amount of new debt issuances in Hong Kong.

In January 2013 the RMB cross-border lending scheme was opened, allowing more capital inflows to the onshore market. Fifteen Hong Kong-based banks have agreed to lend RMB 2 billion to 26 projects located in Qianhai economic zone, in the Mainland.[16] The new scheme enables banks incorporated in Hong Kong to deploy their RMB funds in the Qianhai area and promotes RMB circulation by offering onshore clients RMB credits. It marks a significant step towards convertibility of China's capital account.

There are increasing concerns over the potential restraint on the growth of the RMB offshore market from these three repatriation channels owing to the risks of depleting offshore liquidity. Indeed the limited offshore liquidity could swiftly be drained once RMB inward flows are no longer subject to quotas and are exempt from approval by the Mainland authorities (Maziad and Kang, 2012). But this is not yet the case; currently all repatriation channels remain under tight supervision by the Mainland financial regulators and are operating on a pilot basis only.

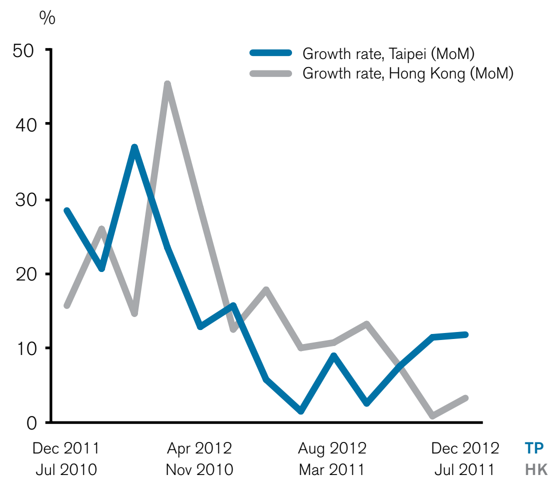
These repatriation channels are essential for the further integration of the onshore and offshore market. For instance, the expanded R-QFII scheme will introduce a broader range of RMB-denominated equity products such as cross-border RMB Exchange Traded Funds (ETFs) to the offshore market. This will enhance the circulation of RMB funds between onshore and offshore markets for investments apart from trade financing. The expansion of these repatriation channels will also allow greater participation of offshore institutional investors in the Mainland's capital market, which is currently dominated by local retail investors. This will help the onshore market keep up with international standards, and more importantly, adds to pressure for further financial reforms in the Mainland's financial system.

Taipei: the new player

Strong growth potential

Taipei started to vie for a role in the internationalization of the RMB after signing the Memorandum of Understanding on Cross-Straits Banking Supervision Cooperation with the Mainland authorities in November 2009. Since then an intensive policy dialogue between the respective financial authorities has been nurturing closer cross-Strait financial cooperation. The first channel between mainland China and Taiwan was opened in August 2011, allowing Taiwanese banks to absorb RMB deposits in their Overseas Banking Units (OBUs) business.[17] After a strong growth in the first three months, RMB deposits in Taipei grew at an average rate of 15% every month from December 2011 to the end of 2012 (Figure 5) – a stronger growth rate than Hong Kong experienced when local banks were first allowed to hold RMB offshore in 2004.

Figure 5: A similar growth in RMB deposits: Taipei vs Hong Kong



Sources: CBC, HKMA.
Note: In June 2010, the RMB cross-border settlement scheme was extended to 20 provinces and cities. This expansion largely boosted the RMB deposits in Hong Kong. In August 2011 Taipei allowed OBUs to conduct RMB services.

16 Qianhai is located within the Shenzhen special economic zone, where China first started to experiment with 'economic reform and opening-up' in 1979.

17 OBUs offer services mainly to non-residents and can only undertake foreign currency-denominated transactions. They are not allowed to undertake NTD-denominated transactions. In the past few years, the government has made further efforts to expand their lines of business so as to encourage domestic firms to shift their overseas funds back to Taiwan. OBUs have gradually become the funding management centres for the operation of Taiwanese offshore businesses, and also form an important source of revenue for the banks.

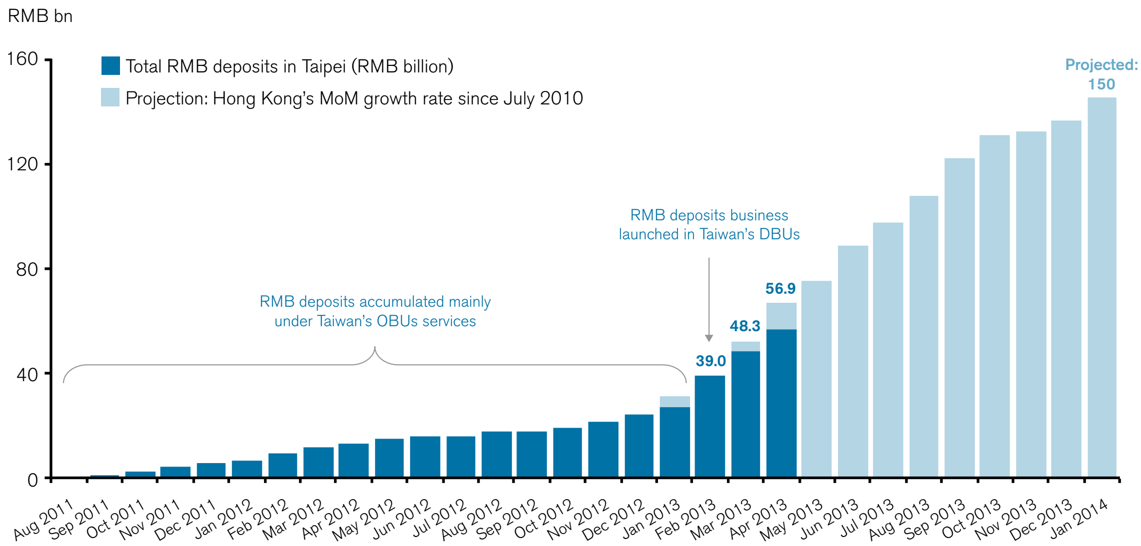
The pace of development of the RMB deposits in Taipei is similar to that experienced by the Hong Kong market in the first year, after the expansion of the RMB cross-border trade settlement scheme.[18]

Another barrier to RMB flows into Taiwan's financial market was removed in February 2013 when Taiwan allowed domestic banks to take RMB deposits under the Domestic Banking Units (DBUs), in addition to the OBUs. Meanwhile, the RMB clearing channel helps banks and trading companies channel funds from the RMB trade settlement scheme faster and at lower costs. As a result, the monthly growth rate of Taipei's RMB deposits hit a record high at 45.2% in February 2013. At the end of May 2013 more than RMB 60 billion of deposits had accumulated under OBUs and DBUs. Taipei can now absorb more liquidity from the RMB cross-border trade settlement scheme than financial centres without an RMB clearing system.

Taiwan's offshore market, like Hong Kong's, is likely to expand at a faster pace on the back of the cross-border trade settlement scheme, as this scheme has become more comprehensive and better developed. Looking forward, even if Taipei just follows Hong Kong's pace of expansion, the total amount of RMB deposits could reach RMB 150 billion within a year, according to our one-year projection (Figure 6). This would make the size of the RMB banking business in Taiwan almost 25% of that of the current RMB banking business in Hong Kong.

The latest figures for RMB deposits from February 2013 to May 2013 suggest a smaller expansion than in our projections. These, however, do not look too bold given Taiwan's economic ties with the Mainland in both trade and FDI. In terms of cross-Strait trade, the Mainland is Taiwan's biggest trading partner and its largest trade deficit is with Taiwan. In 2012 the volume of cross-Strait trade increased to US$122 billion (RMB 760 billion), almost doubling the size of Japan–Taiwan bilateral trade and accounting for more than 20% of Taiwan's total trade. While Taiwan exports extensively to the Mainland, it is also an important direct investor in the Mainland. In 2012, Taiwan invested US$57.1 billion in the Mainland and

Figure 6: One-year projection of Taipei's RMB deposits



Sources: CBC, HKMA, Chatham House estimation.

Note: We assume that Taipei's RMB banking business will experience the same growth that Hong Kong experienced in July 2010. To reflect the impact of the cross-border RMB trade settlement scheme on Taipei, we plot Hong Kong's month-on-month (MoM) growth rate from its peak at 45.4% in October 2010 (see Figure 5) against Taipei's monthly growth from February 2013. These projections were made at the end of March 2013 and revised in May 2013.

18 From July 2010 to June 2011 RMB deposits in Hong Kong grew at the average monthly rate of 16.9%.

ranked as the fourth largest foreign investor after Hong Kong, Japan and Singapore (Table 2).

This economic relationship is expected to deepen as cross-Strait political relations continue to improve as a result of the Economic Cooperation Framework Agreement (ECFA) in June 2010. Restrictions on investment have also been gradually lifted by both sides, in a direction that mostly benefits Taiwanese enterprises. For instance, the ECFA has encouraged Taiwanese companies to invest more in Mainland markets. Local governments in the Mainland are also required by central government to offer preferential policies that prioritize Taiwanese capital in local FDI projects. As a result of these measures, 88,000 Taiwanese-funded projects were approved by the Mainland authorities in 2012, a substantial increase on the 38,704 projects approved in 2010.

Closer cross-Strait economic integration therefore makes the demand for further financial cooperation more pressing than ever before. At present, neither the RMB nor the New Taiwan Dollar (NTD) is a fully convertible currency.[19] Importers and exporters on both sides of the Strait have to use the US dollar as the third vehicle currency. This practice entails additional transaction costs and foreign exchange risks. On top of that, Taiwanese enterprises that actively invest in the Mainland also find it difficult to repatriate their earnings. Hong Kong is usually selected as the conduit for these financial activities since there is no formal channel directly connecting the banking and financial sectors of the Mainland and Taiwan (Herrero et al., 2012).

Taiwanese trade enterprises have been actively participating in the RMB trade settlement scheme through Hong Kong since the RMB became available to invoice trade. At the beginning of January 2012 only 2.6% of cross-Strait trade was settled in RMB. One year later, nearly 44% of Taiwan's trade with both the Mainland and Hong Kong was exchanged in RMB via Hong Kong (SWIFT, 2013b).

Thanks to the opening of the currency clearing channel, these transactions can now be settled in Taipei. This allows both the NTD and the RMB to be used as a means of payment, making it easier for trading companies to manage their cash flow. Furthermore, direct convertibility between the two currencies was approved in April 2013.[20] This strengthened the provision of liquidity and is likely to increase RMB inflows.

Table 2: Top ten trading partners with Taiwan, 2012

Destination	Total trade			Exports			Imports		
	Ranking	Amount ($ billion)	Share (%)	Ranking	Amount ($ billion)	Share (%)	Ranking	Amount ($ billion)	Share (%)
Mainland	1	121.6	21.3	1	80.7	26.8	2	40.9	15.1
Japan	2	66.4	11.6	5	18.9	6.6	1	47.6	17.6
United States	3	56.59	9.9	3	33	11	3	23.6	8.7
Hong Kong	4	40.6	7.1	2	37.9	12.6	21	2.7	1
Singapore	5	28.2	4.9	4	20.1	6.7	8	8.1	3
Korea	6	26.9	4.7	6	11.8	3.9	4	15.1	5.6
Saudi Arabia	7	16.7	2.9	19	1.9	0.6	5	14.8	5.5
Malaysia	8	14.5	2.5	10	6.6	2.2	9	7.9	2.9
Germany	9	13.4	2.3	11	5.6	1.9	10	7.8	2.9
Australia	10	13	2.3	15	3.7	1.2	6	9	3.4
Total trade	**–**	**571.8**	**100**	**–**	**301.1**	**100**	**–**	**271**	**100**

Source: Bureau of Foreign Trade, Taiwan, 2012.

19 The NTD is fully convertible for portfolio investments, but a few restrictions remain on its convertibility. For instance, Taiwan residents are allowed to buy up to US$5 million per year and local companies are subject to an annual ceiling of US$50 million (HSBC, 2013).

20 On 3 April 2013, the Shanghai branch of the Bank of Taiwan opened a direct currency exchange for local Mainland residents. The temporary daily exchange limit is set at RMB 12,000 per person per day.

The potential of Taiwan's RMB market

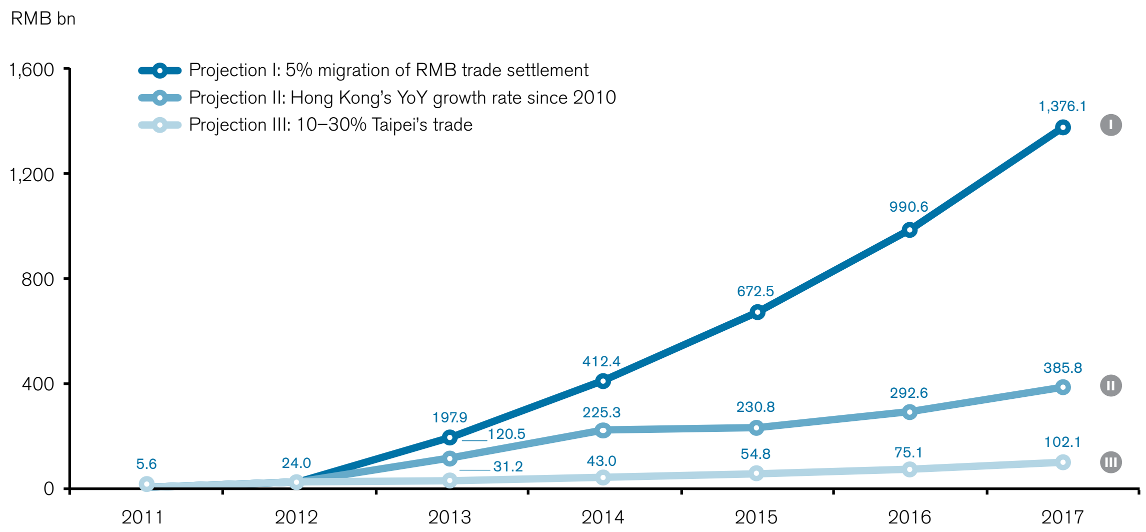
How big can Taiwan's RMB business become in the next five years? Does it have the potential to rival Hong Kong? To answer those questions, we have estimated the growth of Taiwan's RMB deposits over a five-year period using three scenarios (Figure 7). Projection I shows the direct impact of liquidity migration from the Mainland's total RMB trade settlements; Projection II describes a situation where Taiwan's market expands at the same rate as Hong Kong's; and Projection III provides the most conservative estimates and assumes that the growth of Taiwan's RMB deposits will be driven only by trade. These three scenarios provide a glimpse of how big the market could be in five years' time.

Under the most optimistic scenario (Projection I), over RMB 1.3 trillion could accumulate in the Taiwanese market by 2017 if 5% of the Mainland's total RMB trade settlements can be successfully transformed into offshore deposits and remain in Taipei. A minimum amount of over RMB 100 billion will be settled in Taipei by 2017 according to the most conservative estimate, where only 30% of Taiwan's total trade value will contribute to the growth of RMB deposits. More generally, Taiwan will have approximately RMB 400 billion in deposits as the baseline by 2017 if its RMB businesses follow Hong Kong's pattern. Taipei's RMB deposits are expected to grow to at most 66% of Hong Kong's and at a minimum 5% by 2017 (Figure 8). In the most likely case, as shown in Projection II, Taipei will become a centre that is a fifth the size of Hong Kong's in five years.

The size of Taiwan's RMB markets will be determined by many factors, but mainly by how the cross-Strait relationship will develop. To achieve our 'best-case scenario' of 1.3 trillion RMB deposits by 2017, Taiwan needs to settle at least 5% of the value of total Mainland trade in RMB and hold the proceeds from those transactions as RMB deposits in local banks. This will require substantial efforts from the banks to mediate and absorb these flows. Yet as a regional financial centre, Taipei will face strong competition from international financial centres such as Singapore and Tokyo, whose banking sectors have more capacity for international transactions and deposits through a broader range of customer networks.

The risks of a political deadlock on the cross-Strait relationship also need to be taken into account. Some Taiwanese policy-makers are uneasy about further financial cooperation with the Mainland. They fear that

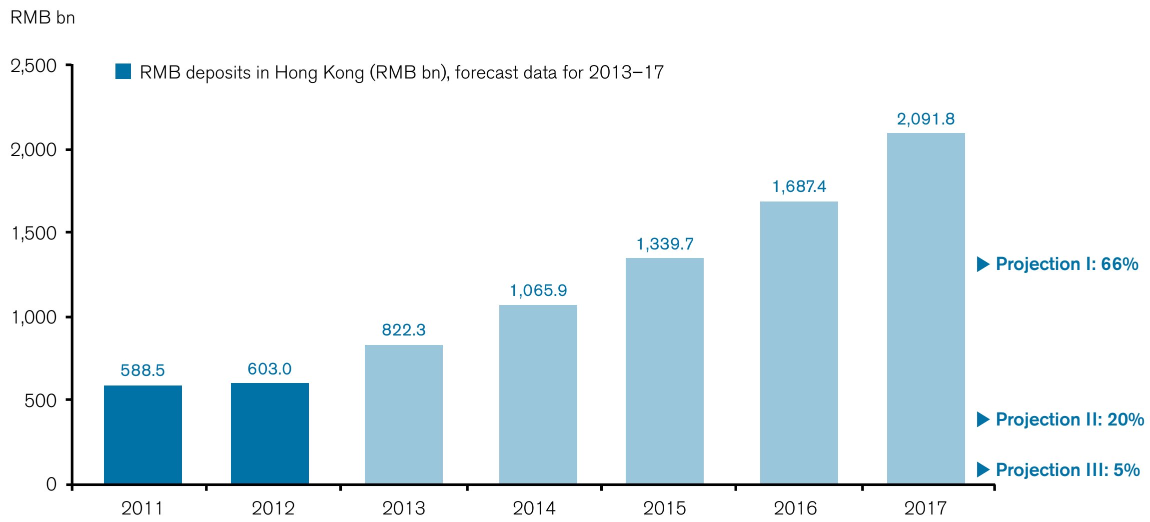
Figure 7: Five-year projection of Taipei's RMB deposits



Source: Chatham House.

Note: Projection I assumes that 5% of the total RMB trade settlement (see Figure 2) will migrate into Taipei's RMB deposits. Projection II assumes the same percentage of the total RMB trade settlement as Hong Kong. Projection III assumes that from 2013 to 2017 Taipei's RMB deposits will be driven by 10%, 15%, 20%, 25% and 30% of Taiwan's trade value for each year.

Figure 8: Five-year projection of Hong Kong's RMB deposits and comparison with Taipei's RMB deposits



Source: Chatham House.

Note: Projection of RMB deposits in Hong Kong starts from 2013, based on HKMA data for 2004–12. From 2013, we assume that 30% of annual increments of RMB trade settlement (see Figure 2) will transform into Hong Kong's RMB deposits.

Taiwan's economic sovereignty may be hindered by monetary integration into the Greater China region. These are reasonable but perhaps overstated concerns that could hinder the RMB business. Trade with the Mainland and other Asian economies would then become the determining factor in drawing RMB deposits from outside Taiwan. By 2017, the RMB is expected to gain greater market presence in the global payment system and should become more extensively used – as least as the trade settlement currency – in Asia. This impact would extend to Taiwan's trade and be reflected in an increase to over RMB 100 billion in deposits by 2017, given Taipei's uniqueness as a niche financial centre located in the Greater China region (Subacchi et al., 2012).

The most realistic scenario is that Taiwan will follow Hong Kong's path. This provides the best leverage on the Mainland's policy-oriented strategy through the implementation of measures that facilitate the internationalization of the RMB. It seems that Taipei is now moving in this direction to develop RMB business through the cross-Strait dialogue between the financial regulatory authorities. However, it remains unclear at this stage whether Taipei's offshore RMB business will serve mainly the domestic market or will attract market participants throughout the world.

Opportunities and challenges for Taiwan

The development of the RMB offshore business in Taipei will bring new opportunities to Taiwan and its enterprises. With the opening of the RMB clearing channel, transaction costs will be reduced for trading firms. Firms and financial companies will have the option of using foreign currencies other than the US dollar. For Taiwanese banks, the RMB business will help expand their activities beyond the saturated domestic market and into the Mainland. The Taiwanese authorities will have the opportunity to promote the domestic financial market and to strengthen its interactions with other financial centres in the region.

Taiwanese enterprises will find it easier to develop business links with the Mainland. Transaction costs will be reduced by 2–3% for trade companies through the use of the RMB or the NTD to settle cross-Strait trade.[21]

21 Estimates of transaction costs were collected from the KMT website, and provided by Wang Huaqing, Commissioner of Discipline Inspection of the People's Bank of China, http://www.kmt.org.tw/english/page.aspx?type=article&mnum=112&anum=12189.

Preferential investment channels[22] offered by provincial governments in the Mainland will also encourage more Taiwanese investors to tap into the Mainland's market. Having the RMB clearing channel puts Taipei in a much better position than other financial centres – an advantage that comes with being a latecomer. Taiwanese enterprises that need to raise RMB now have more options within the Greater China region. They can either borrow RMB from banks or issue RMB-denominated bonds in both Taipei's local market and Hong Kong.

Latecomer advantages

As the RMB offshore market is expanding, investors now have more diversified options for RMB, both offshore and onshore. Taipei is now tapping into this maturing RMB offshore market. Since the RMB business in OBUs opened up in late 2011, Taiwanese exporters have shown great interest in settling their trade in RMB as the Mainland is the biggest consumer market for their final products. For instance, in May 2013, China Steel Corporation, the largest integrated steel-maker in Taiwan, informed its clients about the benefits of using RMB instead of the dollar in transactions with mainland China. On the other hand, for high-tech Taiwanese companies, the RMB is currently less appealing for trade settlement as Europe and North America remain their two largest export markets. Nevertheless, since most of Taiwan's electronic products are shipped to the Mainland for assembly, high-tech companies are now also considering whether to add the RMB to their multi-asset portfolios, along with the US dollar, euro, yen and new Taiwan dollar.[23]

Closer cross-Strait economic relations in recent years have created stronger support in Beijing. This means easier access to the Mainland's capital markets for Taiwanese companies. For instance, in March 2013 the investment quotas were expanded to RMB 100 billion[24] to allow Taiwanese investors to participate in the R-QFII scheme. Other channels in the RMB onshore market for Taiwan's institutional and retail investors, such as access to onshore RMB interbank bonds and the recently revised QFII programme for foreign retail investors, are under discussion and are likely to be finalized later this year.

A shift from trade financing to offshore investment

As the RMB offshore market develops, the opportunities created by the RMB business are not limited to deposits, loans and remittances, but also include RMB-denominated equity and debt products. This reflects the shift in the use of the RMB from trade settlement under the current account towards investments. This is a critical step in the internationalization of the RMB.

RMB-denominated financial products need sound infrastructure to facilitate cross-border transactions. Yet because of the restricted convertibility of the RMB under the capital account, the integration of the onshore and offshore capital markets has just started. Most of these cross-border linkages are only between exchange houses in the Mainland and Hong Kong. For instance, in September 2012 three stock exchanges in Greater China established a joint venture called China Exchange Services Company (CESC) to provide financial products and services.[25] At the end of 2012, CESC launched a new series of cross-border RMB-denominated indices, which are listed and traded on the derivatives market of both the Hong Kong and the Shanghai Stock Exchanges. While CESC provides RMB equity and derivatives products and allows investors direct access to Mainland-related products from offshore, it also shows how Taiwan policy lags behind in terms of building the RMB equity market.

But Taipei is catching up. The Taiwan Stock Exchange (TWSE) is in the process of building a trading platform for foreign currency-denominated products. Taiwanese asset management companies are preparing to launch cross-border RMB ETFs, once the RMB 100 billion investment quota under the R-QFII scheme is available. Meanwhile,

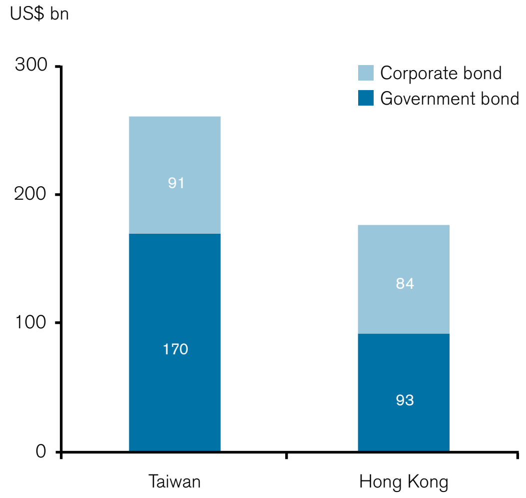
22 Local governments in the Mainland are required by the central government to offer preferential policies that prioritize Taiwanese capital in local FDI projects.

23 Reuters, 'RMB Focal Point: Taiwanese enterprises to benefit from RMB trade settlement', 7 May 2013, http://cn.reuters.com/article/test_finance0/idCNL3S0CO13520130507.

24 This figure has been agreed but not yet allocated.

25 The three stock exchanges are Hong Kong Exchanges and Clearing Limited (HKEx), Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE), which have each contributed US$100 million as the initial funding for CESC (HKEx, 2012). The Taiwan Stock Exchange Corporation was not involved.

Figure 9: Size of bond market in Taiwan and Hong Kong in 2012



Sources: ADB, CEIC, BBVA Research.

the cross-Strait authorities are pushing forward 'T-listings' to encourage Taiwanese companies incorporated in the Mainland to go public on the TWSE. Compared with Hong Kong, however, Taiwan's local bond market is a much larger area for the development of RMB-denominated investment products than its equity market (Figure 9).[26] In fact, the Taiwanese authorities are more focused on developing the RMB debt market and considerable progress has already been made in 2013.

The RMB-denominated bonds issued in Taiwan are called 'Formosa bonds'[27] after the island's former name. In February 2013 Chinatrust Financial issued the first RMB-denominated three-year bond in Taipei. On 13 March, Deutsche Bank secured approval from Taiwan's central bank to issue foreign currency-denominated bonds totalling US$1 billion in Taiwan and is planning to issue Formosa bonds to the value of RMB 2 billion (US$320.5 billion) before July 2013. BNP Paribas also expressed interest in raising RMB from Taiwan's bond market in 2013. Apart from the financial institutions, Taiwanese corporates indicated their intention to tap into the Formosa bonds market.[28] In late May, Taiwanese textile manufacturer Far East New Century announced plans to take the lead in issuing the first non-financial corporate Formosa bond for RMB 5 billion.[29] If all of those proposals receive approval within the next few months, Taiwan's RMB bond market is expected to approach RMB 10 billion by the end of 2013 – about the same size as the Hong Kong market when dim sum bonds were launched in 2007.

Constraints on Taiwan

Taiwan faces some challenges that may make the development of the RMB business trickier than it has been so far. The first concerns the competitiveness of Taiwan's banks and the scope of its banking sector. As the domestic financial market will be opened to Mainland banks and financial institutions, the advantage of Taiwanese banks in the domestic banking sector may be challenged. Taiwanese banks are small in comparison with Mainland banks, especially large banks such as the 'Big Four'[30] that have sizeable balance sheets and extensive business networks in the Mainland market. Furthermore, Taiwan's banking sector remains largely domestic: only 9.1% of its bank deposits are comprised of foreign currencies – mainly the US dollar.

Some market participants are concerned that the increasing use of the RMB and further cross-Strait financial integration might crowd out foreign currencies other than the RMB, and that the latter could end up dominating Taiwan's foreign currency deposits. Worries about the substitution effect of the RMB against the local currency emerged when Hong Kong faced a dramatic expansion in the size of RMB deposits in 2010. By the end of 2012, RMB deposits still only accounted for 9%

26 In the past five years, the average market capitalization of Taiwan's equity market was US$634.2 billion, only 28% of Hong Kong's US$2,275 billion. Foreign investors are required to register as foreign institutional investors (FINI) with the Taiwan Stock Exchange and the central bank before being allowed to invest and list in Taiwan's local equity market.

27 Formosa bonds are listed and traded on Taiwan's domestic over-the-counter (OTC) stock exchange.

28 In February 2013, food processor Uni-President Group, home appliance manufacturer TECO Electric and Machinery, and paper mill Yuen Foong Yu Paper Manufacturing all expressed interest in issuing Formosa bonds.

29 On 29 May, Chang Hwa Commercial Bank, a large Taiwanese bank, issued a Formosa bond worth RMB 1 billion.

30 The 'Big Four' refers to the four largest Mainland banks, including the Bank of China (BoC), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC).

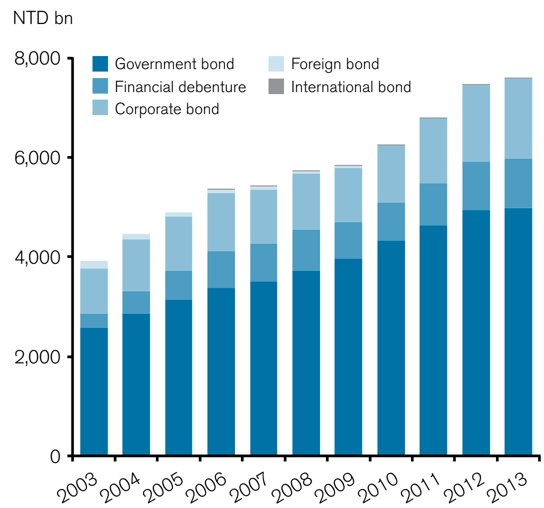
of Hong Kong's total banking deposits, despite being the third most used currency (Subacchi and Huang, 2012). In May 2013 the RMB deposits in Taipei constituted a mere 0.8% of total deposits (RMB 60 billion). With rates at 2.5%, RMB deposits are not significantly more attractive than those denominated in Taiwan's local currency. Our best-case scenario shows RMB deposits standing at 18.9% of total deposits in 2017.[31]

The second challenge concerns the depth and openness of Taiwan's domestic debt market. As a regional financial centre, Taiwan's bond market is dominated by the domestic government and financial issuers (Figure 10). In the past few years, the volume of bond issuances has been low. But while the proportion of bonds issued by financial institutions has declined, corporate bonds issued by companies in sectors such as energy and power, basic materials such as chemicals, and high-tech products have increased. In 2012 Taiwan's corporate bond market represented about 9% of GDP – still small compared with those in other emerging Asian economies. In 2010 corporate bonds accounted for respectively 41%, 24% and 15% of GDP in Malaysia, South Korea and Thailand (ADB, 2011).

The Taiwanese government can support the growth of RMB offshore businesses by encouraging domestic and overseas companies to issue Formosa bonds. Overseas investors and debt issuers, however, face considerable regulatory constraints in accessing Taiwan's debt market. First, Taiwan's regulators impose restrictions on enterprises and financial firms that have more than a 30% stake in Mainland companies. This restricts large Mainland companies from fundraising in Taiwan and thus limits the growth of the Formosa bond market, relative to the development of the dim sum bond market in Hong Kong. Even issuing bonds denominated in foreign currencies remains a complicated process for non-Taiwanese companies.

Furthermore, bond issuers have to meet a minimum credit level of BBB to raise funds. Finally non-resident investors need to pay a 15% tax on purchases of debt products listed in Taiwan. This makes the issuance of Formosa bonds considerably less attractive for offshore RMB investors, especially compared with tax-free financial centres such as Hong Kong and Singapore. The Taiwan regulatory authorities are currently considering lowering the tax rate to 10%, the same as the Mainland's tax rate.[32] Even so, it is not clear whether this measure will be critical in making the Taiwanese market more attractive to foreign businesses.

Figure 10: Taiwan's bond market



Source: GreTai Security Market, 2013.

On top of these regulations, companies and financial institutions from the Mainland are not yet allowed to issue RMB bonds in Taiwan. Not surprisingly, then, in the past few years the volume of bond issuances has been low, and the presence of foreign companies has been declining (Figure 10) while the secondary market has not been active.

Unless the authorities relax their controls on the domestic bond market, Formosa bonds are unlikely to become an attractive source for fundraising. Regulatory limits, high taxes on bonds and lack of clarity and direction in Taiwan's policies could slow the development of the market. Nor is the investment return of Taipei's Formosa bond significantly more appealing than those listed in Hong Kong and London. So far the average three-year Formosa bond yield is around 2.9%, whereas bond yields offered by Hong Kong and London are all above 3.0%, averaging 3.7% and 3.2% respectively.

31 The RMB deposit ratios under Projections II and III are 5.6% and 1.4% respectively.
32 In 2013, the Mainland imposed a standard 10% withholding tax rate on foreign investors.

Conclusion

As Beijing's strategy develops further, the use of the RMB is gradually expanding from trade financing towards portfolio investments among non-residents. Financial centres are harnessing the opportunity to be part of the RMB business and China's developing capital market

Taipei is the new player in the RMB offshore market. It shows great potential as closer cross-Strait relations through trade and FDI should ensure steady RMB flows and result in the gradual growth of RMB deposits in Taiwan's banking sector. The shared language and a similar business culture to that of the Mainland are further competitive advantages for Taipei.

Taiwan's limited financial openness and regulatory restrictions to its capital account, however, could limit the growth of the RMB business. The findings of this paper suggest that the authorities should consider adopting proactive policies to support the growth of the RMB market, in particular the development of the bond market. Moreover, as other financial centres are expanding the RMB offshore business, the Taiwanese authorities would benefit from developing a clear strategy that builds on Taipei's advantages as a regional financial centre with strong links to the real economy, in particular to innovative and high-value SMEs. Otherwise limited openness and insufficient market depth will limit Taipei's growth and hinder its potential as a regional financial centre.

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