The Development of the RMB Offshore Market and the Liberalization of China’s Capital Account

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January 2015
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Introduction

In July and August 2014 the International Economics Department at Chatham House and the Institute of World Economics and Politics (IWEP) of the Chinese Academy of Social Sciences (CASS) held two research workshops on the renminbi (RMB) offshore market and the liberalization of China’s capital account. These workshops were held in London and Beijing respectively.

This paper provides a synthesis of the discussions that took place at each of these workshops. The paper is organized into three sections. The first section illustrates how China’s RMB offshore market and offshore RMB centres have evolved since mid-2013, when the People’s Bank of China (PBoC) – China’s central bank – signed the first bilateral currency swap line with the G7 countries. The second section explores the determining factors that drive the use of RMB in cross-border trade transactions. The last section examines the macroeconomic and financial implications of the launch of the China (Shanghai) Pilot Free Trade Zone (FTZ).

This paper concludes that as the offshore RMB market expands, more financial centres in Asia and Europe are competing to become the leading offshore centre for RMB business. This is accompanied by a trend of using the RMB as a carry-trade currency for cross-border arbitrage, which in part is contributing to the rapid growth in RMB cross-border trade settlements. In addition, despite the considerable attention the Shanghai FTZ has attracted in late 2013, there is no clear indication that China will soon open up its capital account in short term.

The RMB offshore market and offshore financial centres

Since 2009 the PBoC has launched a number of initiatives to reduce China’s reliance on the US dollar and to promote wider use of the Chinese currency, the renminbi (RMB), in global markets. The impetus for this initiative, in part, was a concern to mitigate China’s exposure to the contraction in global US-dollar liquidity that occurred in the immediate aftermath of the global financial crisis in 2008. Such ambitions are complicated, however, by the fact that the RMB is not fully convertible. The PBoC has therefore concentrated on measures to promote RMB usage in international trade and to establish offshore RMB markets (mostly notably, in Hong Kong).

The role of offshore RMB markets deserves some attention. There is a common view that an offshore currency market is normally driven by private-sector money flows. Yet in China’s case the expansion of the RMB’s use in international transactions and the emergence of offshore RMB markets have essentially been driven by policy intervention. Whatever the pitfalls of this approach, it has led to rapid growth in

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1 The Chatham House International Economics Department hosted the first research workshop, entitled ‘China’s Pilot Free Trade Zone: Opportunities of RMB Internationalization and China’s Economic Rebalancing’, on 1 July in London. The second research workshop was organized by CASS in Beijing on 28 August 2014. The workshop was entitled ‘Macroeconomic Effects of China’s RMB Internationalization and Capital Account Liberalization’.
2 On 22 June 2013 the governor of the PBoC, Zhou Xiaochuan, and the then-governor of the Bank of England, Mervyn King, signed an agreement to establish a reciprocal three-year sterling/RMB currency swap line, with a maximum value of RMB 200 billion. Four months later, in October 2013, the European Central Bank and the PBoC agreed to establish a bilateral currency swap line, valid for three years and with a maximum value of RMB 350 billion.
3 The PBoC’s initiatives have included: a cross-border RMB settlement scheme; the establishment of RMB swap lines and clearing agreements with overseas central banks; the creation of cross-border clearing facilities; and rule changes to allow direct foreign-exchange trading between the onshore RMB (also known as CNY) and major foreign currencies. Efforts to widen and deepen the offshore RMB market have continued recently.
international use of the RMB. Financial centres both in Asia and Europe are now vying for prominence in the nascent RMB offshore market (see Figure 1).

At present Hong Kong is the largest and best-established RMB offshore centre, having benefited from mainland Chinese policies that specifically targeted the city as a trial market for offshore RMB business. At the end of September 2014, financial institutions in Hong Kong held RMB 950 billion in offshore deposits, more than three times the amount in any other city.

Elsewhere in Asia, Taipei and Singapore have recently started to gain prominence as offshore centres for RMB business. Both cities have made material progress towards setting up direct clearing linkages with the RMB onshore market in mainland China. Benefiting from Taiwan's cross-Strait relationship and strong trade ties with mainland China, Taipei has registered strong growth in offshore RMB business in the past two years. At end-September 2014 it had accumulated more than RMB 300 billion in offshore deposits, the second largest such pool after Hong Kong. Offshore RMB business is also developing in Singapore, which acts as a bridge between mainland China and Southeast Asian countries for trade and cross-border capital flows. By June 2014 Singapore had accumulated more than RMB 250 billion in deposits. The city-state's role as a regional treasury hub, its well-developed private banking industry, and its sound and independent tax and legal systems could help it to rival Hong Kong as an RMB financial centre.

European financial centres such as Luxembourg, London, Paris and Frankfurt are also competing to develop offshore RMB capabilities. Luxembourg, for instance, is the main recipient of Chinese foreign direct investment (FDI) flows into Europe and now the continent's largest RMB-denominated asset-management centre (with a total of nearly RMB 80 billion in deposits at end-March 2014). Germany's position as China's third-biggest trade partner also places Frankfurt in a strong position to develop as a centre for RMB trade in the eurozone. Paris is widely seen as having potential to become a gateway for Chinese investors to Africa. Being the first financial centre in Europe to create an offshore RMB market, London's prominence in the global foreign-exchange markets offers scope for expansion of its RMB offshore market – despite the city's currently limited stock of such deposits.

Although these developments in part reflect growing private-sector interest, official Chinese policy continues to play an important role. The PBoC has taken a number of steps to boost the provision of liquidity to RMB offshore markets – including collaborations with central banks to set up bilateral RMB swap agreements and rules allowing direct currency trading between onshore RMB and local currencies.

What does the growth in offshore RMB centres mean for financial markets and corporates? One of the potential benefits is that institutional investors and multinational companies could have more stable and reliable contingency access to RMB liquidity in different places. Offshore centres will also facilitate the development of new RMB-denominated investment products such as derivatives, which in turn could make companies and investors more willing to hold RMB for the purposes of achieving investment returns and for portfolio diversification.

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5 Prior to February 2013, Taipei and Singapore were both only offshore hubs for RMB business due to the absence of local clearing banks and currency swap lines. An RMB offshore centre is directly linked to the RMB onshore market through a local RMB clearing bank or other bilateral currency clearing mechanism, whereas an RMB offshore hub is indirectly connected to the onshore market via the offshore centre. For a detailed explanation of the distinction between a 'centre' and a 'hub' in the RMB offshore market, see Paola Subacchi and Helena Huang, ‘The Connecting Dots of China’s Renminbi Strategy: London and Hong Kong’, Chatham House Briefing Paper, IE BP 2012/02, September 2012.

6 In September 2011 the UK Chancellor of the Exchequer, George Osborne, made the first formal announcement of the development of RMB business at the Fourth UK–China Economic and Financial Dialogue.

7 As of September 2014, the PBoC had bilateral RMB swap agreements with central banks in 26 countries and territories, worth an aggregate notional amount of more than RMB 3 trillion.
What drives RMB usage in cross-border trade transactions?

The internationalization of the RMB has gained traction since 2008, despite the fact that liquidity is still constrained and that transmission channels between offshore and onshore RMB markets are far from complete. As of September 2014, 1.72% of world payments were settled in RMB, making China’s currency the seventh most traded worldwide. The RMB occupies a much more prominent position in trade finance, however. Thanks to Beijing’s policy measures to encourage its use in such transactions, the RMB is now the second most used currency in international trade finance, having overtaken the euro in October 2013. The monthly average flow of RMB-denominated trade settlement rose from nearly zero in 2009 to RMB 480 billion in 2014.

Despite rapid growth, offshore RMB markets remain immature and reflect the structural rigidities of China’s financial system. China has insulated its onshore RMB market from offshore markets. This has encouraged the emergence of a premium in the value of the offshore RMB (commonly denoted in markets as ‘CNH’) vis-à-vis the onshore RMB (‘CNY’). The exchange-rate and interest-rate spreads between CNH and CNY provide opportunity for speculative cross-border arbitrage.

Such arbitrage has been in evidence ever since China expanded the reach of its cross-border trade settlement scheme in June 2010. Statistics on foreign investor activity in the RMB carry trade are vague,

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9 SWIFT, ‘RMB now 2nd most used currency in trade finance, overtaking the Euro’, SWIFT RMB Tracker, November 2013.
however, due to the numerous routes that allow investors to bypass existing capital controls\textsuperscript{10}. In general, cross-border trade settlement and market betting on RMB exchange rates are the two main channels for such arbitrage. Under the trade scheme, Chinese importers have a stronger incentive than exporters to settle in CNH when the CNH trades at a premium\textsuperscript{11}. In fact, the CNH traded at a premium to the CNY for most of the period from October 2010 to October 2014 (see Figure 2). This resulted in an excess volume of RMB settlement for imports as opposed to exports\textsuperscript{12} (see Figure 3).

Investors’ preference for the RMB as a carry-trade currency partly reflects the PBoC’s unwillingness to allow the exchange rate to flexibly adjust to appreciation pressures stemming from China’s large current-account surplus and FDI inflows. Limited movements in the daily reference rate and persistent foreign-exchange intervention to keep the spot rate within the trading band have allowed market participants to be reasonably confident that appreciation would continue in a predictable way. The sudden depreciation in the RMB, orchestrated by the PBoC in February 2014, effectively led to an unwinding of carry-trade positions.

**Figure 2: CNH premium vis-à-vis CNY (from October 2010 to October 2014)**

\[\text{Source: Thomson Reuters Eikon, 2014}\]

\[\text{10 The most straightforward way of speculating on RMB appreciation is to buy RMB in forward markets or through non-deliverable forwards. By end-January 2014, daily trading volumes in these two types of instrument averaged about $6 billion. The biggest market bets are through dollar puts (options to sell the dollar for RMB), traders say. There are also wealth-management products sold by Chinese banks, which offer offshore investors the opportunity to lend RMB onshore at attractive yields averaging about 6 per cent. These are typically structured products routed through banks in Hong Kong.}\]


\[\text{12 When the value of offshore RMB, or CNH, is higher than the onshore one (CNY), Chinese importers tend to increase their RMB trade settlement in the offshore market and exporters tend to reduce settlement in the offshore market.}\]
Macroeconomic and financial implications of the launch of the China (Shanghai) Pilot Free Trade Zone

The launch of the China (Shanghai) Pilot Free Trade Zone (FTZ) in September 2013 generated a lot of interest among investors in both onshore and offshore RMB markets. The FTZ was expected to be a testing ground for China’s next big moves towards comprehensive capital-account liberalization – the idea being that in the FTZ international finance would be carried out under global rules. The hope was that this would substantially open up the onshore RMB market to the rest of the world.

The object of creating the FTZ is to provide expanded market access to onshore RMB and a more streamlined operational environment in which companies require fewer administrative approvals. The State Council has set strategic objectives\(^\text{13}\) for the Shanghai FTZ, to be achieved by 2016. At the same time China’s financial regulatory bodies\(^\text{14}\) have been developing more detailed rules under which financial institutions, non-financial enterprises and individuals should operate\(^\text{15}\). Most notably enterprises registered within the FTZ are allowed to carry out two-way cross-border RMB cash pooling\(^\text{16}\). This is convenient for multinationals wishing to establish Asia-Pacific headquarters in Shanghai. It reduces the

\(^{13}\) These objectives include acceleration of experimental capital-account reform and full liberalization of the financial services industry in the next two to three years.

\(^{14}\) In the onshore RMB market, the PBoC, the State Administration of Foreign Exchange, the China Securities Regulatory Commission, the China Banking Regulatory Commission and the China Insurance Regulatory Commission are the five key official bodies that set financial regulations.

\(^{15}\) For example, RMB cross-border settlements on current-account transactions or direct investments are greatly simplified. The State Council has also introduced a negative list, which features a list of the restrictions and prohibitions on foreign investment that will be applied in the Shanghai FTZ. All activities which are not on the negative list will be fully open to foreign investment.

\(^{16}\) Companies established in the FTZ with operating businesses or investments are allowed to pool the RMB funds of their onshore and offshore subsidiaries in a special cash bank account in Shanghai.
exchange-rate risk associated with managing foreign currency-denominated debt. It also enables overseas corporates to globalize their cash management\textsuperscript{17}.

Despite the considerable attention the Shanghai FTZ has attracted, doubts remain about its viability as a model that could be expanded to the entire onshore market. In part, this reflects weak progress towards creating the right environment for international investors, and the absence of a transparent and consistent regulatory framework. Moreover, a couple of serious questions remain unanswered: how would the FTZ integrate with the rest of the world and the rest of the onshore market? And how could the Chinese authorities create an effective ring-fence between the Shanghai FTZ and the rest of the onshore financial market, in order to insulate the country from external shocks?

Details of the mechanisms needed to make this happen are still lacking. The fact that the FTZ needs to maintain a boundary with the rest of China is problematic. Indeed, on closer scrutiny there is no clear indication that the establishment of the Shanghai FTZ will do much in the short term to open up China’s capital account. For an economy of China’s size, it would be risky to embark on capital-account liberalization in a single geographical region without preparing the rest of the country for structural change.

\textsuperscript{17} The US-China Business Council (USCBC), ‘USCBC Recommendations for Revisions to the China (Shanghai) Pilot Free Trade Zone Negative List and Other Reforms’, March 2014.