



The Connecting Dots of China's Renminbi Strategy: London and Hong Kong

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International Economics | September 2012 | IE BP 2012/02

Summary points

- China's attempts to internationalize the renminbi (RMB) have significant implications for the international monetary system and for economies across the world.
- China's RMB strategy is based on two tracks: the use of the RMB in cross-border trade settlement and the creation of an RMB offshore market.
- A series of policy measures has been introduced since 2009 to facilitate the expansion of the nascent RMB offshore market and to overcome the constraints of the currency's limited convertibility.
- Development of the offshore market depends on the supply of liquidity provided by Beijing. At present this market is limited in both size and scope, and funds flow from and to the Mainland mainly through the intermediation of Hong Kong.
- Hong Kong benefits from being the first mover and from being part of China, but with a separate legal and institutional system. For the time being it will continue to be the main conduit to the onshore market.
- Offshore centres such as Hong Kong and offshore hubs such as London and Singapore are both complementary and essential to China's RMB strategy. They are the connecting dots in the expanding RMB offshore market.

Introduction

The Chinese authorities have been working on the design and implementation of a strategy to internationalize China's currency since 2009, when Zhou Xiaochuan, the Governor of the People's Bank of China (PBoC), publicly proposed reforms to the international monetary system (IMS).¹ This strategy is based on two tracks: the use of the renminbi (RMB) in cross-border trade settlement and the creation of an RMB offshore market (Subacchi, 2010). Building the offshore market is essential to overcome the renminbi's limited convertibility and broaden its use outside mainland China. In this market non-residents have access to the Chinese currency for the purpose of trade and investment and are encouraged to hold RMB funds while China's monetary authorities retain control over the pace of the capital account liberalization (He and McCauley, 2010).

Like the Eurodollar market in the 1950s and 1960s (Schenk, 1998), the development of the RMB offshore market comes at a critical moment for the IMS. Partly as a result of China's greater integration in the world economy, the IMS seems no longer fit to enable adjustment and return to a more balanced trading position between countries that run current account surpluses and those with deficits.

Despite being the world's second largest economy, China has a currency that is hardly used in international trade or held by foreigners. Furthermore its exchange rate regime, in which the renminbi is pegged to a basket of currencies, creates imbalances at the international level and costs at the domestic level because of the mismatch in China's international balance sheet.

Thus China needs a currency that reflects its weight in international trade, and a more flexible exchange-rate regime to correct imbalances and mismatches. Beijing's attempts to internationalize the renminbi with the purpose of eventually making it fully convertible have significant implications for the IMS and for economies across the world.

This paper aims to contribute to the policy debate on the reform of the IMS by examining China's policy-led initiative of building the RMB offshore market. It discusses its development in Hong Kong over the last two years and compares it with the attempt by London, the leading international financial centre,² to develop its own RMB business. Following He and McCauley (2012), the paper considers the development of the Eurodollar market in the 1960s and 1970s to infer the steps that need to be taken to develop the RMB offshore market.

The key question is how London – and other international financial centres that plan to enter the RMB offshore business – will shape and influence the development of the RMB market. Will London's development depend on Hong Kong's market, which, in turn, depends on Beijing's provision of RMB liquidity? Although the development of the Eurodollar market in London provides some useful references, building the RMB market is likely to progress in a different way. Unlike the Eurodollar market, which expanded outside the jurisdiction and the control of the United States, the RMB offshore market is constrained by the currency's limited convertibility. In addition, for the time being it will continue to be driven by Beijing's policy initiative. As a result, until it becomes a fully convertible currency that non-residents are happy and willing to hold, and until it is allowed to freely circulate outside mainland China, there is limited scope for pure offshore RMB transactions.³

The paper distinguishes between offshore centres and offshore hubs to highlight differences in how the offshore and onshore markets operate, arguing that 'offshore hubs' connect to the onshore market through the 'offshore centres'. The extent to which these hubs can develop depends on the strategic decisions made in the onshore market and on the liquidity made available through and by the 'offshore centre'. As the pool of RMB outside mainland China depends on the supply of liquidity provided by Beijing, this gives Hong Kong a competitive advantage

¹ In the wake of the financial crisis, Zhou Xiaochuan (2009) called for support to develop SDR (Special Drawing Rights) to be a super-sovereign currency with a much enlarged impact, in order to reduce the dependence of the IMS on the US dollar.

² In the GFCI (Global Financial Centre Index) 11 report, London is ranked first and Hong Kong third (GFCI, 2012).

³ Pure offshore transactions are defined as taking place in the offshore market between residents outside the country of issue of the currency and subject to the law of another jurisdiction (He and McCauley, 2012).

over other international financial centres. Although Hong Kong is part of China, it maintains a separate legal and administrative system ('one country, two systems'), and this advantage means that for the time being it will continue to be the main platform through which international financial centres like London have access to the RMB onshore market.

‘Despite being the world's second largest economy, China has a currency that is hardly used in international trade or held by foreigners’

Without implying that being a hub is a second-best option for a financial centre, the distinction provides a useful framework for considering all the steps that China is undertaking to develop the international use of its currency while gradually opening its capital account and reforming the financial sector. Given the importance of China in the world economy, being part of the growing RMB business is critical for leading international financial centres and for regional centres in Greater China. They will need to respond to the growing demand for RMB trading and so be driven to participate in the RMB offshore market.

The paper starts by discussing the development of the offshore market within the context of China's renminbi strategy and looks at its features. It argues that because China's strategy is policy-driven, the building of the RMB offshore market ultimately depends on Beijing's financial reforms and, in particular, on the decision on

how gradual the opening of the capital account has to be. In other words, the size of the RMB offshore market depends on the supply provided by the Mainland. The paper then considers the development of Hong Kong on the back of the RMB business and discusses the advantage of being the first mover, before looking at the strengths and weaknesses of London's emerging RMB business. In particular, it asks whether London's financial sector, which has been developed on the back of private initiative and market preferences, will eventually be at odds with China's policy-led strategy. In conclusion the paper suggests that the distinction between offshore centres and offshore hubs is a helpful way to characterize the unique features of the RMB offshore market.

The renminbi offshore market

China's strategy

Aware of the limitations on the use of their currency, the Chinese authorities have been working since 2009 on a complex policy framework, in the context of the country's ongoing financial reforms, in order to increase the use of the renminbi in cross-border trade settlement and encourage non-residents to hold the currency in their portfolio.

China's strategy (Subacchi, 2010)⁴ is built on the internationalization of the currency under the current account, through the RMB cross-border trade settlement scheme (Table 1), and on the development of the RMB offshore market to overcome the constraints on the capital account.⁵ The implementation of the scheme has resulted in strong growth in the use of the Chinese currency. In the first six months of 2012 almost 11% of China's imports and exports were settled in RMB, compared with 2% for the whole of 2010.

⁴ The People's Bank of China (PBoC) and two policy banks, the China Development Bank (CDB) and China Export and Import Bank, underpin this strategy. With their mandate set explicitly to support the government's policy, both banks promote the use of the RMB as the settlement currency through their lending business and network in the international capital market. By offering competitive loans in terms of both rates and conditions, the two banks are expanding demand for RMB in target countries (such as Argentina, Ecuador and Venezuela) with limited borrowing capacity in the global capital market (Gallagher et al., 2012).

⁵ According to Gao and Yu (2009: 8–9) and based on the IMF definition of capital controls, by the end of 2007 half of cross-border capital transactions were available for non-residents and half of the transactions under China's capital account were subject to controls.

Table 1: Overview of cross-border renminbi capital transactions between current account and capital account

Type of business		Permitted	Further institutional approval
Under current account	Trade in goods	Yes	No
	Trade in services	Yes	No
	Current account settlements, such as share bonus and dividends	Yes	No
Under capital account*	Remittance of capital	Yes	Yes
	Remittance of shareholder loans	Yes	Yes
	Participation in introduction and equity transfer by agreement of Mainland-listed companies	Yes	Yes
	Direct or indirect investment in securities and financial derivatives	Partially**	N/A
	Investment in entrustment loans in the Mainland	No	N/A

Source: Chatham House.

* Administrative restrictions are normally imposed on all types of cross-border RMB transactions under China's capital account. Approval from regulatory authorities such as the China Security Regulatory Commission (CSRC), the National Development and Reform Commission (NDRC), the State Administration of Foreign Exchange (SAFE) and the PBoC is required to remove restrictions from the businesses listed as permitted in the table. The latest liberalization measure dates back to December 2011, before the implementation of the R-QFII (Renminbi Qualified Foreign Institutional Investment) scheme (see note 17 below).

** Only cross-border capital transactions denominated in RMB are considered. Overseas investments through the QFII scheme are not included as a type of indirect investment because they are not relevant to the RMB offshore market.

Measures to limit capital account convertibility are devised to minimize the risks for China's domestic financial stability while responding to and expanding the demand of non-residents for RMB funds and RMB-denominated assets. The authorities believe that domestic financial stability can be maintained as long as the channel through which offshore RMB get back to

the onshore market is restricted. This means that within the context of the internationalization of the renminbi there are more restrictions on inward than on outward flows – this runs counter to China's policy on the convertibility of the capital account, which is driven by the goal of keeping the offshore flows away from the onshore market (Table 2).

Table 2: Internationalization of the renminbi: major policy measures, 2009–12

Policy measures	Year	Direction of capital flows*
RMB cross-border trade settlement scheme	2009	Cross-border
Bilateral currency swap agreement	2009**	Outward
Approval of RMB-denominated corporate bond issuance in Hong Kong***	2009	Outward
Onshore RMB interbank bond market entry (licence-based)	2010	Inward
RMB Overseas Direct Investment (R-ODI)	2011	Outward
RMB Foreign Direct Investment (R-FDI)	2011	Inward
RMB Qualified Foreign Institutional Investor (R-QFII)	2012	Inward

Sources: PBoC, Hong Kong Monetary Authority (HKMA), NDRC, Ministry of Commerce of the PRC (MoC).

* Outward indicates flows from the Mainland onshore market to the offshore market; inward indicates flows from the offshore market to the Mainland.

** Of 20 bilateral swaps, four were signed in 2009. However, the first RMB bilateral currency swap was signed in 2002 between China and Japan under the framework of Chiang Mai Initiative in response to the Asian financial crisis in 1997. In 2008 the PBoC and Bank of Korea signed an RMB bilateral swap agreement to provide South Korea with the liquidity necessary to face the global financial crisis. Both swaps were signed for reasons other than the internationalization of the RMB and are therefore not included in Table 2 or Table 3.

*** Although the first RMB-denominated bond was issued in Hong Kong in 2007 by the China Development Bank, it was only in 2009 that the Hong Kong offshore RMB 'dim sum' bond market began to boom. See footnote 12 for a detailed explanation of 'dim sum' bonds.

Building the renminbi offshore market

The liquidity required by the offshore market can either be generated through cross-border operations of banks and other financial institutions or be provided by the monetary

authorities (or a combination of the two). Because of the renminbi's lack of convertibility and its limited use in international trade, in the current phase of development the offshore market has to rely on liquidity provided by the PBoC.⁶

Table 3: Timeline for renminbi bilateral swap agreements

Country/region	Date	Amount (RMB billion)
Bank of Indonesia	23.03.2009	100.0
Central Bank of Argentina	23.03.2009	70.0
National Bank of the Republic of Belarus	24.03.2010	Agreement on bilateral settlement in local currencies
	11.03.2009	20.0
Central Bank of Iceland	09.06.2010	3.5
Monetary Authority of Singapore	23.07.2010	150.0
New Zealand Reserve Bank	18.04.2011	25.0
Central Bank of the Republic of Uzbekistan	19.04.2011	0.7
Central Bank of Mongolia	06.05.2011	5.0
National Bank of Kazakhstan	13.06.2011	7.0
Central Bank of the Russian Federation	23.06.2011	No limitation
	22.11.2010	Bilateral trading
Bank of Korea	26.10.2011	360.0
	12.12.2008 (Expired)	180.0
Hong Kong Monetary Authority	22.11.2011	400.0
	20.01.2009 (Expired)	200.0
Bank of Thailand	22.12.2011	70.0
State Bank of Pakistan	23.12.2011	10.0
Central Bank of the United Arab Emirates	17.01.2012	35.0
Bank Negara Malaysia	08.02.2012	180.0
	08.02.2009 (Expired)	80.0
Turkish Central Bank	21.02.2012	10.0
Central Bank of Mongolia	21.03.2012	10.0
	06.05.2011 (Expired)	5.0
Reserve Bank of Australia	22.03.2012	200.0
Central Bank of Ukraine	26.06.2012	15.0

Sources: PBoC, Chatham House.

⁶ For the definition of official liquidity and private liquidity as the two components of aggregate liquidity, see Domanski, Fender and McGuire (2011). Aggregate liquidity depends on 'the interaction of funding and market liquidity' and is driven by the actions of the public sector (including monetary authorities) as well as financial institutions and private investors (Domanski, Fender and McGuire, 2011: 58).

Since 2009, a total of RMB 1.665 trillion has been supplied through bilateral currency swap agreements that China has signed with 19 countries (Table 3). These agreements are a key component of China's strategy and the first step towards deeper financial and monetary integration with the signatory countries.⁷

Providing competitive loans to countries that have limited borrowing capacity in the global capital market is another important component of China's RMB strategy. In 2009 and 2010 CDB and China Ex-Im Bank, the two policy banks, signed agreements on loans of around US\$110 billion to governments and companies based in countries including Russia, Venezuela and Brazil (Anderlini, 2011). In March 2012, the CDB signed a memorandum of understanding with Brazil, Russia and India,⁸ after providing a US\$30 billion loan to Venezuela's state oil company. In addition, in 2011 China Ex-Im Bank began cooperating with the Inter-American Development Bank with the purpose of setting up an RMB-denominated fund to support infrastructure investments in Latin America and in the Caribbean.⁹

Unlike the Eurodollar market, which was led by a group of London-based banks with almost no involvement of the monetary authorities (Schenk, 1998),¹⁰ the development of the RMB offshore market is a policy-led initiative. The monetary authorities' assessment of the risks to macroeconomic stability that excessive liquidity might generate determines the amount of liquidity they provide through the central bank. As they are likely to err on the side of caution, the RMB offshore market can be expected to develop at a gradual pace. The adoption

of a 'proactive, controllable and gradualist' (He, 2011) approach where political considerations directly interact with market forces reflects China's concerns about domestic financial stability (Subacchi et al., 2012). It also minimizes the risk of developing an 'oversized' offshore market beyond the authorities' control (Gao and Yu, 2009).

Hong Kong's competitive position

Hong Kong's successful expansion in the renminbi business

As the entrepôt for the Mainland's trade, and the leading international financial centre in the region, handling over 60% of foreign direct investments (FDI) into the Mainland, Hong Kong harnesses the opportunities created by Beijing's implementation of the RMB cross-border trade settlement scheme.¹¹ Since July 2009 the use of RMB in such transactions has grown strongly, from RMB 43 million to over RMB 240 million in June 2012 (Figure 1). In the first half of 2012 cross-border trade transactions with a total value of RMB 1.25 trillion were settled in the Chinese currency.

As a result the volume of RMB deposits accumulated in Hong Kong banks increased steadily from RMB 56 billion in July 2009 to RMB 588.5 billion at the end of 2011. It has become the third most widely used currency in Hong Kong, accounting for 9% of total banking deposits. The RMB banking lending business and dim sum bond market¹² also experienced rapid growth between the end of 2010 and the end of 2011, by 1440% and 190% respectively (Table 4).

7 There are no official documents that explicitly refer to the importance of the swap agreements, but it is widely acknowledged that they are an essential element of China's RMB strategy. They are signed 'for the purpose of promoting bilateral financial cooperation, facilitating bilateral trade and investment, and maintaining regional financial stability' (PBoC, 2011). The State Council decides on the arrangements, selection and volume of each bilateral agreement.

8 In the MoU each BRIC pledges to provide loans in its own domestic currency to the other BRICs.

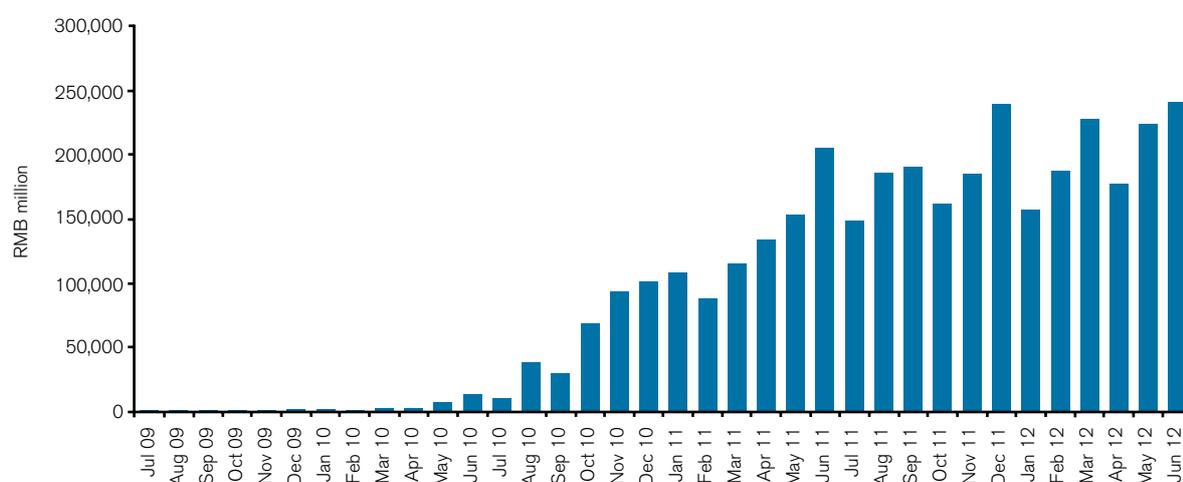
9 The RMB fund is part of the ODI programme. Through it, China can expand RMB lending in commodity-rich countries in Latin America. This is strategically important if China is to gain greater dominance in the global commodities supply chain.

10 This was helped by the fact that the dollar was the key reserve currency, was fully convertible and is now the most traded currency, with total transactions of US\$4 trillion (accounting for 84.9% of global turnover) in 2011 in foreign exchange markets (Auboin, 2012; BIS, 2010).

11 It was launched as a pilot scheme in five selected cities in the Mainland (Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan) and in Hong Kong, Macao and the ASEAN countries. As the RMB internationalization strategy proceeded, this pilot scheme was gradually expanded to the entire mainland China.

12 A dim sum bond is an RMB-denominated bond issued in the offshore market. The other type of RMB bond, the panda bond, is issued by non-Chinese institutions and traded within mainland China's onshore interbank bond market. In 2009, the market started to boom owing to NDRC's approval for non-financial Mainland corporates to issue RMB-denominated bonds in the designated offshore centre, Hong Kong.

Figure 1: Renminbi cross-border trade settlements through Hong Kong



Source: HKMA.

Table 4: Expansion of renminbi (offshore) use in 2011 (RMB billion)

Type of transaction	2011-end	2010-end
China's RMB-denominated trade	2,081.00	369.00
China's RMB FDI	91.00	N/A
HK, China RMB deposits	588.50	314.90
HK, China RMB bonds issued	104.00	35.90
HK, China RMB borrowing	30.80	2.00

Sources: Chatham House, MoC, HKMA, Reuters.

Being part of China, even if with its own legal and regulatory system, Hong Kong is the direct recipient of policies devised for the creation of the RMB offshore market.

The RMB Outward Direct Investment scheme (RMB-ODI) was created in 2011¹³ and in its first eleven months a total of RMB 15 billion was invested abroad (HKMA, 2012a). The RMB Foreign Direct Investment

scheme (RMB-FDI),¹⁴ which enables inward RMB investment in real assets, has proved equally successful. Between January and June 2012, a total of RMB 91.8 billion was reinvested in the onshore market.

Cross-border RMB portfolio investment¹⁵ started in August 2010, when foreign central banks and a limited number of financial institutions were first allowed to invest in the Mainland's onshore interbank bond

13 On 6 January 2011, the PBoC issued the *Administrative Measures for Trial Program of RMB Settlement of Outward Direct Investment (the 'ODI Measures')*. The scheme permits Chinese domestic institutional investors to make RMB-denominated direct investments in select offshore enterprises or projects for greenfield investment, merger and acquisition, equity participation, and other means of acquiring direct ownership or actual control (PBoC, 2011).

14 RMB-FDI is the second RMB repatriation channel. The scheme, introduced by the PBoC in October 2011, offers direct investment opportunities in the Mainland's real economy for overseas RMB holders. In July 2012, the PBoC restricted investments in the areas of securities, derivatives and property.

15 In this paper cross-border RMB portfolio investment refers to RMB offshore funds that can be directly invested in the RMB onshore market (the Mainland's equity, bond and money markets). It does not refer to cross-border investment that is possible under the QFII scheme created in 2002 as a channel to allow foreign investors to invest in the Mainland's capital markets.

market.¹⁶ In late 2011, the R-QFII scheme was introduced, allowing offshore financial institutions to invest their offshore RMB funds in the Mainland's onshore interbank bond market and equity market.¹⁷ More recently, in July 2012, the first R-QFII A-Share ETF¹⁸ was listed on the Hong Kong Stock Exchange (HKEx), providing offshore RMB investors with another onshore-linked investment product. However, at present, only financial institutions that are incorporated in Hong Kong can join the R-QFII scheme. Various restrictions, from investment quotas to qualification requirements for licence holders, still limit access to the R-QFII scheme in the offshore RMB market.

As other financial centres catch up with the RMB offshore business, Hong Kong is firmly maintaining its lead, and enjoys first-mover advantages, especially in the banking sector

Bilateral currency swap agreements are another area of collaboration between the monetary authorities of Hong Kong and the Mainland. Hong Kong was the first international financial centre to receive official liquidity provision

(RMB 400 billion – so far the largest amount) from the PBoC in 2009 when China's renminbi internationalization strategy was launched. Hong Kong's monetary authorities also reinforced the city's leading position by being the first to offer the RMB Liquidity Facility¹⁹ (HKMA, 2012c) and to provide non-resident investors with additional liquidity.

These schemes represent critical breakthroughs that firmly establish Hong Kong in the RMB offshore market and give the city a competitive advantage over other financial centres. Hong Kong can now provide RMB products and services for cross-border trade settlement, finance and wealth management (Figure 2). It also enjoys exclusive permission from Beijing to allow local residents to convert HK dollars to RMB.²⁰ Finally, and more importantly, Hong Kong offers non-residents offshore RMB clearing and settlement services thanks to the link between its Real Time Gross Settlement (RTGS) system²¹ and the High Value Payment System (HVPS)²² in the Mainland. Hong Kong has been providing clearing services for the offshore RMB since 2004, when the PBoC designated the Bank of China Hong Kong Ltd as the only Hong Kong-based RMB clearing bank. The RMB RTGS has been handling trade-related offshore payments since the introduction of the cross-border RMB trade settlement scheme in 2009. Cooperation between the Mainland's onshore interbank payment system and the offshore RMB RTGS system is essential to enable settlement services for RMB payment senders and receivers outside mainland China.²³

16 On 20 August 2010, the PBoC promulgated a circular regarding the pilot scheme for RMB investment in the interbank bond market by offshore RMB clearing banks and other eligible offshore institutions including i) offshore central banks and monetary authorities (especially those that have already signed a bilateral currency-swap agreement); ii) RMB clearing banks in Hong Kong and Macau; iii) offshore participating banks and other offshore financial institutions joining the pilot scheme for RMB cross-border trade settlements (PBoC, 2010).

17 Under this scheme, the list of entities eligible to invest in the onshore RMB interbank bond market covers five areas: i) foreign central banks; ii) RMB clearing bank in Hong Kong; iii) RMB participating banks; iv) qualified Hong Kong subsidiaries of 21 Chinese fund management and securities companies (participants in the R-QFII scheme); v) qualified Hong Kong insurance companies. All qualified R-QFII fund companies shall invest at least 80% of their RQFII assets into the Mainland's interbank bond market.

18 This is the RMB Qualified Foreign Institutional Investor (R-QFII) A-Share exchange traded fund, listed by China Asset Management (Hong Kong) Limited. It tracks the performance of an A-share (the Mainland's equity market) index by investing offshore RMB funds directly in a portfolio of A-shares. It broadens the range of RMB investment products in the Hong Kong offshore market.

19 On 14 June 2012, the HKMA announced the introduction of the RMB Liquidity Facility to Authorized Institutions (AIs) participating in RMB business in Hong Kong, as a vehicle for easing short-term RMB liquidity tightness (HKMA, 2012c).

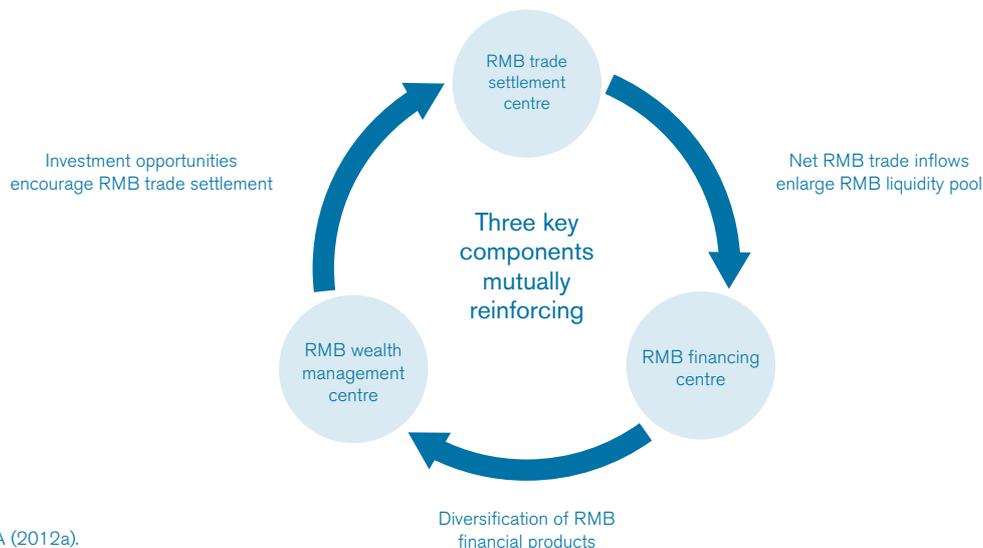
20 At present, Hong Kong residents enjoy an exclusive right to convert HK dollars into RMB with a daily limit of RMB 20,000 per individual account.

21 The Real Time Gross Settlement (RTGS) system is a fund transference system where the interbank transfer of high-value money or securities takes place in real time and on a gross basis (i.e. the settlement of funds occurs on a transaction-by-transaction basis without netting debits against credits) (BIS, 1997).

22 The HVPS is the backbone of mainland's China National Advanced Payment System (CNAPS) and is an RTGS system that is primarily used for high-value RMB transfers (IMF, 2012). In January 2012, the PBoC decided to upgrade CNAPS to better facilitate the RMB cross-border trade settlement scheme (WSJ, 2012).

23 In July 2010, the PBoC and HKMA revised the clearing agreement. Restrictions on RMB funds (opening accounts for corporates and providing interbank fund transfer services) were removed in Hong Kong to encourage financial intermediary activities (Rossi and Jackson, 2011: 8).

Figure 2: Hong Kong: the most comprehensive renminbi offshore centre



As other financial centres catch up with the RMB offshore business, Hong Kong is firmly maintaining its lead, and enjoys first-mover advantages, especially in the banking sector.²⁴ It has by far the largest offshore liquidity, handles 80% of the total RMB cross-border trade settlement business and 80% of global RMB payments (SWIFT, 2012a), and offers a platform for primary bond issuance and secondary market trading of RMB products.

Incentives for holding renminbi and generating private liquidity

Liquidity is a necessary, but not sufficient, condition for the development of the offshore market. Equally important is that non-residents are willing to hold the currency traded in the offshore market – or investments denominated in that currency. This, in turn, helps develop the supply of private liquidity, enabling it to become gradually more relevant and eventually to overtake the official supply.

So far the demand from non-residents for renminbi investment has been supported by the currency's potential for appreciation (Garber, 2011). This can only generate short-term demand, however, and is unlikely to support demand in the long run (Figure 3).²⁵ It is therefore critical for the RMB offshore market to create incentives for non-residents to hold the currency in their portfolio so as to offer a range of RMB-denominated investment products such as offshore bonds.

The first dim sum bond was issued in 2007 by the CDB. This was mainly symbolic and an indication of Beijing's intention to create an offshore bond market in Hong Kong. The real breakthrough came in August 2010 when McDonald's issued a bond to the value of RMB 200 million.²⁶ By the end of April 2012, there had been 156 bond issuances in Hong Kong, with a total value of nearly RMB 218 billion.²⁷

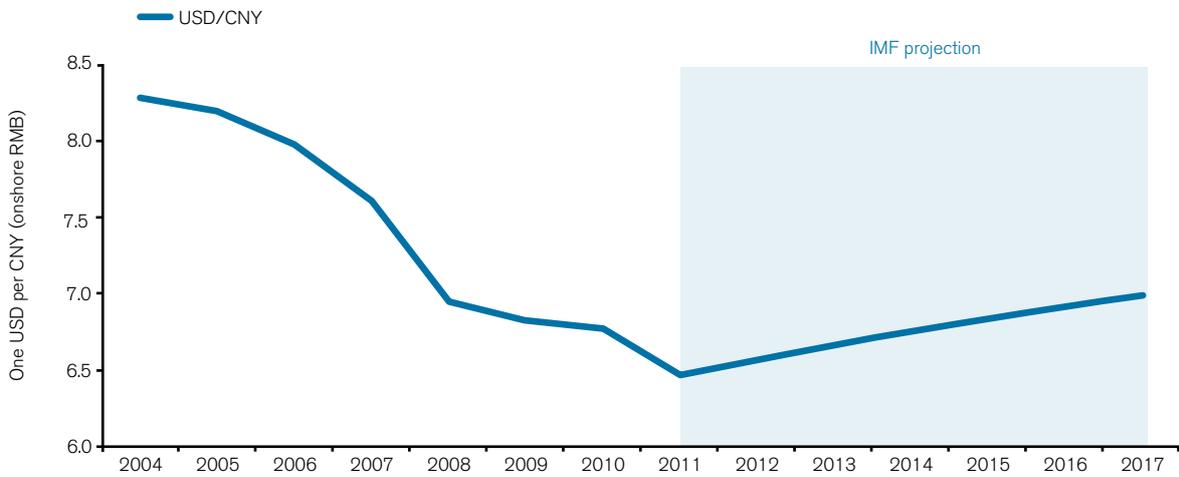
24 In February 2004, licensed banks in Hong Kong were allowed by the Mainland authorities to offer personal RMB services to local Hong Kong residents, including deposit accounts, currency exchange, remittance services and credit cards. Listed Hong Kong licensed banks were also allowed to offer foreign currency exchange services (converting RMB into HK dollars) for designated business customers. In December 2005, the policies were further expanded to allow designated business customers to open RMB deposit accounts in the Hong Kong RMB offshore market. In July 2012, HKMA (2012d) allowed all Authorized Institutions in Hong Kong to provide RMB services to non-Hong Kong residents.

25 This paper uses the IMF's five-year outlook for the RMB exchange rate against the US dollar, based on the data by end 2011. The current market exchange rate is fluctuating around USD 1= CNY 6.3, slightly lower than the IMF projections.

26 In 2010 August, Hopewell and McDonald's became the first non-financial companies to issue in the Hong Kong dim sum bond market. Previously, only financial institutions had been allowed to issue such bonds in Hong Kong.

27 Issuers are from Hong Kong (Hopewell Highway), Japan (Hitachi Capital, Mitsubishi UFJ, Mitsui & Co.), South Korea (Korea Eximbank, CJ Global), Malaysia (Khazanah's Sukuk), Taiwan (New Focus Auto Tech, Solargiga Energy), the United States (Caterpillar, Ford Motor) and Europe (HSBC, Unilever, VTB Capital, Volkswagen).

Figure 3: Annual market exchange-rate projection

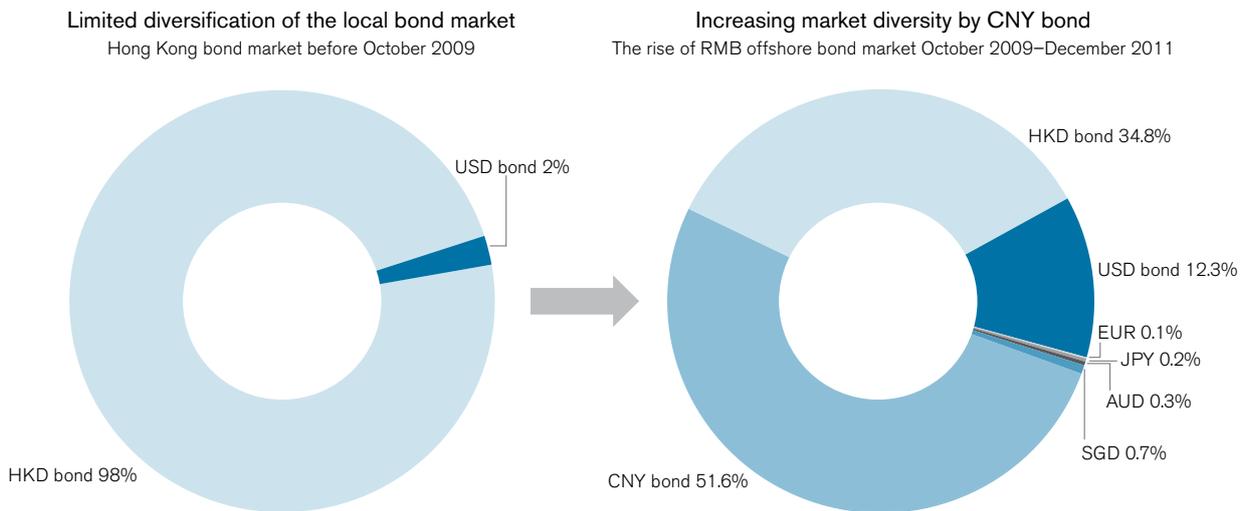


Source: IMF World Economic Outlook, April 2012, projection.

Even if the dim sum market lacks depth and scope, its recent development has been significant enough to transform the core business of Hong Kong as an international financial centre. Before 2010 issuances in the Hong Kong debt market

were denominated in either Hong Kong dollars or US dollars. As shown in Figure 4, from 2009 to the end of 2011 over 50% of issuances were RMB-denominated, while those in US and HK dollars dropped to 12.3% and 34.8% respectively.

Figure 4: Structural shift in Hong Kong's bond market



Note: The data are on the total outstanding bond size and grouped by currency. The data range covered in the chart is from January 2009 to December 2011.

Key to currency codes:

CNY = Chinese yuan (Given the advent of the offshore RMB market, CNY refers to the onshore RMB, whereas CNH is adopted for the offshore RMB.)

AUD = Australian dollar

SGD = Singapore dollar

EUR = euro

Source: HKMA.

Expanding the offshore market

London comes on board

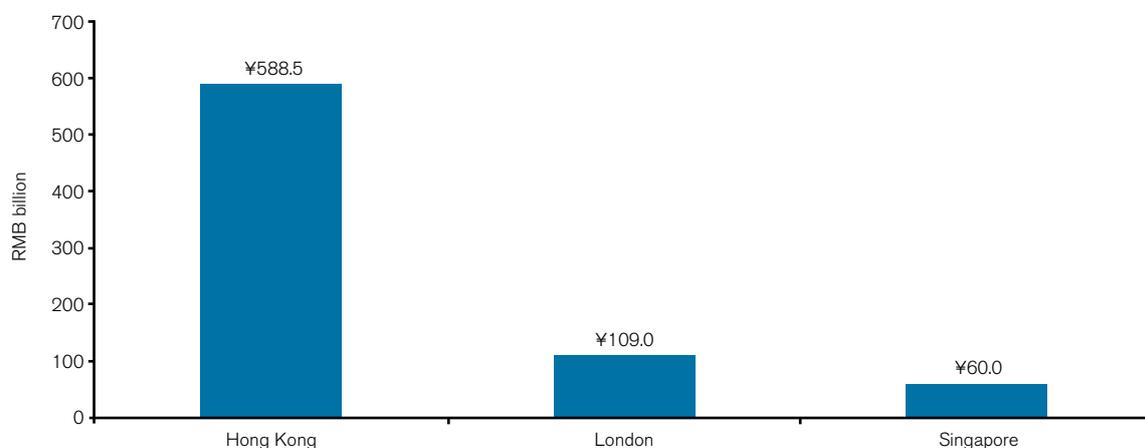
London is developing its renminbi business in concert with the authorities in Beijing and Hong Kong.²⁸ The first formal announcement was made in September 2011 by the UK Chancellor of the Exchequer, George Osborne, and China's Vice-Premier, Wang Qishan.²⁹ As the world's leading international financial centre (GFCI, 2012), London has great potential to tap into the growing RMB offshore market and become China's financial gateway into Europe, thus facilitating the Chinese renminbi strategy.

London offers many advantages: its time-zone, a sound legal system, a comprehensive regulatory framework, a broad and deep talent pool of financiers, a considerable track record of innovation and risk management, and the experience of developing the Eurodollar market (Bourse Consult, 2012). Above all, it is already a trading

centre for RMB foreign exchange transactions with a 46% share of the global offshore RMB spot market, excluding that of mainland China and Hong Kong (SWIFT, 2012a). At the end of 2011 over RMB 109 billion, of which RMB 35 billion were from customer deposits (Figure 5), were held in London. This pool of liquidity is larger than Singapore's (RMB 60 billion in deposits³⁰) and is comparable to that of Hong Kong in July 2010 (RMB 103 billion) when measures to develop the offshore market were introduced.

HSBC's RMB bond issuance in London in April 2012 was the first RMB-denominated bond issuance outside China. From Beijing's perspective, it not only contributes to the international development of the renminbi but also symbolizes China's financial integration with the West (PBoC, 2012). Mr Osborne welcomed the issue as a significant outcome of market efforts supported by the authorities in the United Kingdom, mainland China and Hong Kong.³¹

Figure 5: Offshore renminbi deposits in Hong Kong, London and Singapore



Sources: HKMA, Bourse Consult, Monetary Authority of Singapore (MAS).

Note: Data on the RMB deposit volume in Hong Kong and London both end in 2011. Data on Singapore are for May 2012, as historical data are not available. Of the total of RMB 109 billion deposits in London, interbank deposits account for RMB 74 billion.

28 The Bank of England's three principles for successful financial-sector reform were spelt out in a speech by Chris Salmon, Executive Director of Banking Services and Chief Cashier, Bank of England, at 'City Week 2012: The International Financial Services Forum', held on 7 February 2012 in London. He suggested three sets of opportunities for London: the growth in demand for some intra-financial sector services, the expansion in the range of firms accessing funding directly from capital markets and the structural changes in the global economy (BoE, 2012).

29 The announcement was made in London at the Fourth UK-China Economic and Financial Dialogue. In January 2012, the HKMA and the UK Treasury announced the launch of a private-sector forum to enhance cooperation between Hong Kong and London on the development of the RMB offshore business. In April 2012, George Osborne said that London had become 'a centre for international RMB business' (HM Treasury, 2012) to complement Hong Kong. The first RMB bond issued outside China was issued in London in the same month.

30 Figures are for May 2012.

31 For the full text of George Osborne's speech, see HM Treasury (2012).

Why London?

London offers a gateway for promoting and increasing the use of the RMB outside Asia and in Europe. This is a key region for China not only because Europe is China's biggest trading partner (US\$567.21 billion, or 15.57% of China's trade in 2011), but also because of the potential market capacity for wealthy Europeans to hold RMB investments. In the global capital market, Europe is a key participant and a major exporter of financial services, and European financial institutions hold a market share of nearly 15% of the US dollar interbank lending business in the Asian market. Beijing sees European institutions as strategically important players in terms of bringing greater market liquidity to the RMB interbank lending market and helping to expand the international use of the renminbi.

Europe is also the second largest source of FDI into China, with US\$ 6.35 billion invested in the Mainland market in 2011 (Table 5). The UK heads the group of European investors into China, and ranks 7th, with US\$ 1.61 billion, in the list of the top ten FDI investors globally in 2011 (Table 6).

London has the potential to bridge the supply (from China) and demand (in Europe) for RMB-denominated financial products and services. For example, 60% of the final allocation of HSBC's RMB 2 billion bond went to European investors (Clifford Chance, 2012). In terms of RMB offshore payments business, Europe has caught up quickly in the past year and has overtaken the Asia-Pacific region, representing 47% of the total value of RMB payments³² in the first quarter of 2012 (Figure 6).

Table 5: China's foreign direct investment in 2011

	Ten Asian countries/regions*		US		EU	
	Number of newly established enterprises	Actual input (US\$ billion)	Number of newly established enterprises	Actual input (US\$ billion)	Number of newly established enterprises	Actual input (US\$ billion)
2011	22,302	100.517	1,497	2.995	1,743	6.348

Source: Ministry of Commerce, PRC, 2012.

*Hong Kong, Macao, Taiwan, Japan, Philippines, Thailand, Malaysia, Singapore, Indonesia and Republic of Korea (ROK).

Table 6: Top ten countries/regions of actually utilized value of foreign capital in 2011

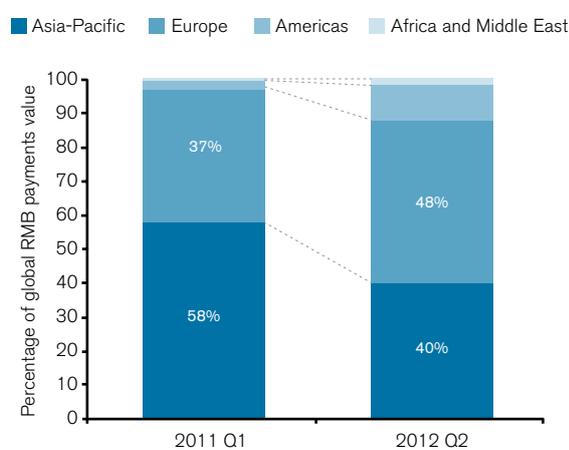
	Country/region	Foreign capital utilized de facto (US\$ billion)
1	Hong Kong	77.011
2	Taiwan	6.727
3	Japan	6.348
4	Singapore	6.328
5	US	2.995
6	ROK	2.551
7	UK	1.61
8	Germany	1.136
9	France	0.802
10	Netherlands	0.767

Source: Ministry of Commerce, PRC, 2012.

Note: The actual use of foreign capital from the top ten accounts for 91.61% of total foreign capital in actual use.

³² The total value of RMB payments does not include mainland China and Hong Kong.

Figure 6: Global distribution of renminbi payments value by region



Source: SWIFT (2012b).

In comparison with Asian financial centres, London's different time-zone offers an advantage. Given Beijing's vision of expanding the offshore market to the Western time-zone, it is crucial to establish an RMB hub in Europe to allow 24-hour trading.

However, it is not certain whether London can turn itself into an RMB clearing centre. At present, clearing and settlement services rely on the RMB RTGS system in Hong Kong, in which several British banks already participate.³³ In addition, the HKMA has recently provided the market with renminbi liquidity facility vehicle for emergencies. In the United Kingdom, despite non-sterling collateral (including euro cash) being accepted in exchange for liquidity, sterling is the major currency adopted in the Bank of England's RTGS system (BoE, 2010). In the near term, given the renminbi's limited convertibility, it is very unlikely to be included in this system. Recognizing the importance of the RMB RTGS system, the UK and Hong

Kong authorities have collaborated to facilitate its further expansion so as to provide a broader financial infrastructure platform for the offshore RMB business.³⁴

Beijing also takes a favourable view of London's experience in developing the Eurodollar market in the 1960s and 1970s. As noted, however, this was a market-led initiative, triggered by attempts by the United Kingdom's banks to avoid sterling exchange controls and by the US banks to avoid domestic regulation (Schenk, 1998). It was a case of 'benign indifference' rather than active involvement of policy-makers.

Thus London's experience with the Eurodollar market and the implicit preference for a market-driven approach may prove incompatible with the policy-led development of the RMB offshore market. Unlike the US authorities in the late 1950s and early 1960s, Chinese policy-makers intend to guide the establishment of the RMB offshore market and set the pace of that development. While this should not be a problem for Hong Kong, it may be more problematic for London and other international financial centres outside China's jurisdiction that plan to be part of this market. The official statements from the UK government³⁵ and the BoE hint at these concerns and the possible conflict between China's strategy and what the private sector wants. As the bank notes, 'there might be scope for the official sector to play a catalysing role at the margin, but the key arbiter in determining if such a market develops will be whether the private sector can identify and satisfy any underlying demand for RMB denominated securities' (BoE, 2012).

Offshore centres and offshore hubs

Hong Kong's first-mover advantages and the benefits of its special relationship with Beijing³⁶ put the city in a different position from other international financial centres outside

33 They are either first-tier or second-tier clearing members. First-tier clearing members hold RMB settlement accounts with Bank of China HK as their clearing bank. Within this group, there are 135 locally registered Authorized Institutions in Hong Kong and 60 other participants from overseas. Second-tier clearing members open RMB accounts with BoC HK as the participating bank. There are 95 second-tier participating institutions from 35 countries (Clearit, 2012; BoC, 2012).

34 In May 2012, at the first Hong Kong-London Forum, the HKMA and the UK Treasury agreed to take action in three areas: supply of RMB liquidity, improvement of the RMB payments and settlements system, and development of the RMB products and market services. In terms of the RMB RTGS system, the HKMA agreed to extend the operating hours from 08:30 to 23:30 Hong Kong time to help enhance the liquidity of the offshore RMB market and the flows among RMB offshore hubs (HKMA, 2012b).

35 For example, the Foreign and Commonwealth Office (FCO, 2012) observes that 'it is not for the government to dictate what new products should be launched, and when – that will be guided by the market. The role of UK-mainland China, and UK-HK, cooperation is to: facilitate exchanges between our respective companies; remove impediments to the market's development; ensure it develops in a way that supports financial stability'.

36 Eddie Yue (2012: 3), the Deputy Chief Executive of the HKMA, links this 'special relationship with Beijing' to Hong Kong's 'historical and indispensable role facilitating the opening up of the Mainland economy'. Leung and Unterberdoerster (2008) suggest that the further financial opening of mainland China would consolidate Hong Kong's prominent role as an international financial centre.

China that aspire to play a part in China's growing RMB business.³⁷ Unlike centres such as Singapore and London, Hong Kong is involved in the same decision-making process that is driving China's RMB strategy. The special relationship with Beijing is also reflected in the policy measures for the provision of official liquidity. Drawing on He and McCauley (2012) and extending the definition of 'pure offshore' to those markets that are outside the jurisdiction of the country that issues the currency traded offshore, we argue that the Hong Kong RMB market cannot be said to be pure offshore.³⁸

The special relationship with Beijing ensures that Hong Kong is the critical link between mainland China's onshore market and the rest of the world. As a result, the RMB offshore market is currently organized around Hong Kong. It seems, therefore, that at least for the time being³⁹ Hong Kong's role in the expanding RMB offshore market is that of an intermediary for RMB funds and a gateway for the liquidity provided by Beijing. This is consistent with the authorities' vision for Hong Kong to be a wholesale market for the currency.⁴⁰

At least at this stage, therefore, the development of London and other financial centres (outside China) that plan to be part of the RMB offshore market will be complementary to that of Hong Kong. While London and other international financial centres such as Singapore will develop as RMB hubs, Hong Kong is likely to be an RMB offshore centre

Despite the semantic similarity between 'centre' and 'hub', the terms are distinguished here to highlight differences in how the offshore market operates and connects with the onshore market. An RMB offshore centre is a financial centre that is *directly* linked to the RMB onshore market. An RMB offshore hub is a financial centre that is linked *indirectly* to the onshore market through the offshore centre. In addition, the centre has a significant volume of offshore resources and

a full range of diversified RMB products that are accessible to non-residents and actively traded by international banks and financial institutions. It has clearing channels with the onshore market and can eventually create a platform for pure offshore transactions. Finally, an offshore centre cooperates with Beijing and is part of Beijing's decision-making process. Without such a relationship, RMB offshore business will be significantly limited by technical problems, primarily with the supply of liquidity.

Even if an offshore centre has a broader scope, offshore hubs are essential to China's renminbi strategy. They are the connecting dots in the expanding RMB offshore market. Moreover, within the hubs private initiative and market demand could drive innovation and move away from the constraints of officially supplied liquidity.⁴¹ Following the pattern of the Eurodollar market (Schenk, 1998; He and McCauley, 2012), RMB offshore hubs could develop in a more independent way from the onshore market and eventually expand as platforms for 'pure offshore' transactions.

Conclusion

As the RMB strategy grows beyond the Greater China region to complement China's 'go global' strategy, the features of the offshore market can be discerned by looking at Hong Kong, the leading offshore centre, and London, the newcomer. The way liquidity is provided makes the difference between a 'fully-fledged' offshore market where all four functions – pure offshore markets, round-trip transactions, international lending inflow and outflow – are provided (He and McCauley, 2012) and the current RMB offshore market, still limited in size and scope, where funds flow from and to the Mainland mainly through the intermediation of Hong Kong.

While the offshore RMB market has the potential to expand in size and scope, the pace of development will

37 In parallel with the offshore market, the development of the onshore market will drive the expansion of Shanghai, China's up-and-coming international financial centre. The city will benefit from the development of RMB instruments that will allow non-residents to invest in China's domestic market.

38 He and McCauley (2012) define pure offshore markets as those where 'non-residents borrow from and lend to each other in the home currency'. Hong Kong is, however, more of a conduit for funds between Mainland residents and investors abroad.

39 Of course, this picture could radically change when Shanghai becomes a fully-fledged international financial centre.

40 The concept of Hong Kong functioning as the 'wholesale market' was first introduced by Jun Ma (2012). It was raised again in a presentation in May by the Undersecretary for Financial Services and the Treasury, Julia Leung (2012).

41 For example, on 22 May 2012, Standard Chartered issued RMB 1 billion of Euro Commercial Paper (ECP) in London. Listed on Euroclear, the RMB ECP bridges the gap between dim sum bonds product in Hong Kong and traditional RMB deposits in the offshore market (Standard Chartered, 2012).

largely depend on Beijing's policy – and politics – on capital account liberalization. Capital liberalization is a critical decision for the Chinese authorities and it is unlikely that the current pace of gradual opening will be accelerated. Thus while Hong Kong will continue to expand the RMB business thanks to its proximity with the Mainland and the cross-border trade, it will be more difficult for London to achieve the same pace. London is therefore likely to develop, at least for the time being, as an RMB offshore hub, intermediating funds from the offshore centre, Hong Kong.

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Earlier drafts of this paper were discussed at a joint Chatham House–Hong Kong Central Policy Unit (CPU) seminar held in Hong Kong on 16 May 2012, and at a seminar at Chatham House on 18 July 2012. The authors are grateful to all the participants, in particular Julia Leung, Andrew Filardo, Alicia Garcia-Herrero, Dong He and Jun Ma in Hong Kong, and Mark Boleat, Creon Butler and Miranda Leung in London. They would also like to thank Fang Xinghai, Gao Haihong and Ji Ling for comments and suggestions. Margaret May and Luke Godwin have provided editorial assistance. The support of the Hong Kong CPU is gratefully acknowledged.

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