CHAPTER 1

New Market—Developments, Opportunities, and Challenges

1.1 INTRODUCTION

Since its economic reforms in late 1978, China's economic growth has been robust, at around 9 percent per annum despite signs of slowing down in the wake of the 2008 global financial crisis.[1] The sustainable and solid economic growth has catapulted China into the second-largest economy after the United States, so it is natural that China seeks to play a bigger role in the world economy. One major policy goal of the Chinese government in the coming decade is to make its currency, the renminbi (RMB),[2] a global reserve currency, and thus internationalizing the RMB has become a strategic goal.

Since March 2009, Governor Zhou of the People's Bank of China (PBOC) has urged the International Monetary Fund (IMF) to include the RMB as part of the special drawing rights (SDRs). A major obstacle to embracing the RMB as a global reserve currency is its limited convertibility outside China. The inclusion of the RMB as a global reserve currency along with the U.S. dollar and the euro by other countries requires that the RMB must be fully convertible into other currencies and widely circulated outside China for trade settlement.[3] Thus, China has strategically designed economic policies vying to gain the global reserve currency status for the RMB.

[1] At the time of this writing, the GDP growth rate of China is estimated to be 7.5 percent in 2013 by the Organization for Economic Co-operation and Development and the Chinese government.

[2] Renminbi (RMB) is the currency of the People's Republic of China, whereas yuan (i.e., the dollar in Chinese) is the unit of the currency.

[3] See Fung and Yau (2012).

China has a tight control on its capital account for monitoring the fund flows across its borders to avoid speculation and shocks from international markets, while the current account on international trade has been opening up to promote trade. In addition, China has switched its fixed exchange rate to pegging it against the U.S. dollar to a basket of currencies of its key trading partners. Fluctuations of the RMB exchange rate against the U.S. dollar are still under the control of the Chinese government, with a trading band widening over time. Fluctuations in the foreign exchange rate have a huge impact on China's economy in terms of trade and capital flows. Thus, the stability of the RMB value remains one of key policy concerns of the Chinese government.

To help internationalize its currency, China has taken several steps in developing different offshore RMB currency trading centers, such as Hong Kong, Tokyo, London, and New York. In March 2011, China published the 12th Five-Year Plan for the National Economic & Social Development, which interestingly contains a chapter elaborating on the significant functions and positioning of Hong Kong in the implementation of China's economic development plan. It is clear that China will support Hong Kong in consolidating and enhancing its competitive position in being an international financial, trade, and shipping center, and in becoming an offshore RMB hub for trade and investment. On many occasions, Chinese leaders have reiterated their continual support with policies that strengthen the economic ties with Hong Kong, which was promulgated in the Closer Economic Partnership Arrangement (CEPA) of 2004, which is a free trade agreement between China and Hong Kong removing barriers of trade and investment and eliminating the tariff between the two economies.

As the cross-border trade between Hong Kong and China increased and the RMB trade settlement rose accordingly, corporations had started to accumulate RMB funds in Hong Kong. Meanwhile, individuals had accumulated RMB deposits as they made a one-way bet on RMB appreciation. Hong Kong banks had accumulated the most offshore RMB deposits. As individuals were looking for opportunities to enhance returns in addition to currency appreciation, offshore RMB bonds would offer an option for risk-averse investors. For corporations that receive RMB through trade settlement, offshore RMB bonds would provide a ready tool for flexible treasury management—for liquidity and yield. With the opportunity to invest in RMB-denominated assets other than RMB bank deposits, investors, banks, and foreign governments would be more willing to hold the RMB in their portfolios, enhancing the RMB's worldwide circulation.

In light of the availability of RMB outside China, the dim sum bond market thus came into being as part of China's grand economic policy in making the RMB a global reserve currency. The dim sum bond market is also compatible with the goal of developing the domestic bond market and reducing Chinese companies' reliance on debt finance from bank loans. By issuing dim sum sovereign bonds in the offshore market, investors essentially extend a low-interest-rate loan to the Chinese government, while the Chinese government can finance a myriad of investments, such as huge infrastructure projects and foreign asset acquisitions. Likewise, corporations issuing dim sum bonds can raise funds offshore as an alternative to domestic borrowing. With competition from offshore markets, the domestic financial markets in China may develop into more efficient markets with greater depth than they otherwise might have if China did not pursue these policies. The keen competition from offshore markets may also make Chinese banks and companies more competitive.[4]

As part of its grand policy for internationalizing the RMB, the Chinese government has been promoting cross-border trade settlement in RMB and has planned to gradually open up its capital accounts. China's Ministry of Commerce (MOFCOM) has allowed foreign direct investment (FDI) in RMB since September 2011. This policy could have profound implications for harnessing asset speculation and inflation in mainland China. Regardless of the origin of the FDI and in what currency, as long as China's inward FDI is exchanged into RMB and flows through Hong Kong, it will have minimal impact on China's foreign reserve and money supply. The offshore RMB trading center in Hong Kong, where most impact from FDI into China will be felt, plays a crucial role in minimizing the inflationary and speculation pressures in China due to inward FDI while helping China to maintain its monetary and exchange rate policy independence. This is probably the reason why Hong Kong has received the blessing of the Chinese central government for developing into an offshore RMB center, serving as a buffer zone for China for the purpose of controlling hot money flows into China and curbing inflation and speculation due to these money inflows.[5]

The Chinese government envisions utilizing Hong Kong as part of the grand strategy to achieve its goal toward internationalizing the RMB. Hong Kong is well positioned in assisting and supporting the rapid development of China's policy objective, especially in the development of an offshore RMB-denominated bond market. Hong Kong has been ranked consistently among the top financial centers in the world for many years. It has served as an international center for raising capital for the Chinese government and mainland Chinese firms. Free trading of the RMB in Hong Kong has been in effect for a few years, and it is expected to pave the way for trading offshore RMB bonds in other hubs in the future.

To summarize, the offshore RMB market has been developed as part of a multipronged strategy of the Chinese government to (1) internationalize

[4] See Fung, Tzau, and Yau (2013b).

[5] See Fung and Yau (2013).

the RMB to become a global reserve currency, (2) control smooth cross-border capital flows to China so as to harness the inflation in mainland China, and (3) develop an offshore RMB bond market as a means to tapping foreign capital. The timeline of the historical events in the offshore RMB market is presented in Vignette 1.1.

VIGNETTE 1.1 EVOLUTION OF THE OFFSHORE RMB MARKET

Date	Events
December 2003	The Hong Kong Monetary Authority (HKMA) announced CNY business on a trial basis in Hong Kong.
February 2004	Personal RMB banking business and RMB deposits allowed in Hong Kong and Macau; Bank of China (Hong Kong) designated as RMB clearing bank.
December 2005	Settlement agreement on RMB business for designated business customers.
January 2007	Qualified mainland financial institutions permitted to issue RMB bonds in Hong Kong (dim sum bonds).
July 2007	China Development Bank (CDB) issued the first offshore RMB bond (dim sum bond) in Hong Kong.
December 2008	China signed its first bilateral local currency swap arrangement with South Korea.
July 2009	Pilot RMB trade settlement scheme for five mainland Chinese cities with Hong Kong and Macau.
September 2009	China's Ministry of Finance launched three tranches of dim sum bonds to retail and institutional investors.
February 2010	National Development and Reform Commission (NDRC) issued Elucidation of Supervisory Principles and Operational Arrangements Regarding Renminbi Business in Hong Kong.
June 2010	Extension of RMB trade settlement scheme to 20 mainland provinces and all overseas countries and regions.
July 2010	Restrictions on offshore RMB business mostly lifted; RMB interbank market formed. Debut of the first landmark issue of dim sum bonds: Hopewell Highway Infrastructure, the first nonfinancial dim sum issuer and the first issuing entity incorporated in Hong Kong.

Date	Events
September 2010	Hong Kong exchanges launched clearing system for potential listing of RMB denominated bonds and stocks.
December 2010	Extension of the number of domestic exporters in the pilot scheme for cross-border trade settlement in RMB from original 365 to over 67,000; the first synthetic RMB bond issued.
January 2011	Pilot program allowing some mainland nonfinancial enterprises to settle overseas direct investments in CNH.
April 2011	The first CNH IPO by Hui Xian Real Estate Investment Trust.
August 2011	Vice Premier Li Keqiang visited Hong Kong, announcing concessions on FDI and Renminbi Qualified Foreign Institutional Investor (RQFII); RMB trade settlement scheme expanded to the whole of China.
December 2011	China Securities Regulatory Commission (CSRC) granted its first batch of licenses under RQFII scheme.
January 2012	Hong Kong's three note-issuing banks published RMB interbank offered rates; Hong Kong Securities and Futures Commission approved 17 RQFII products.
March 2012	All onshore eligibility restrictions for CNY trade settlement scheme were removed; HKMA, Bank Negara Malaysia, and Euroclear Bank launched a pilot program for cross-border debt securities settlement, including dim sum bonds.
April 2012	HSBC issued the first offshore RMB bond in London.
June 2012	HKMA introduced a new RMB term funding facility for Hong Kong.
February 2013	Taiwan commenced RMB business on the island.
May 2013	ICBC's branch kicked off its RMB clearing service in Singapore.

Sources: Fung, Tzau, and Yau (2013a, 2013b); Fung, Wu, and Yau (2013); Fung and Yau (2012, 2013); Minikin and Lau (2013).

The RMB-denominated bonds issued and settled outside mainland China are known as offshore RMB bonds. There are two main types of offshore RMB-denominated bonds issued in Hong Kong: CNH bonds or "dim sum" bonds that are issued and settled based on the offshore RMB exchange rates (i.e., CNH exchange rates), and synthetic RMB bonds that are settled in U.S. dollars based on the onshore RMB rates (i.e., CNY exchange rates).[6] CNY (Chinese yuan) is the official International Organization for Standardization (ISO) code for the RMB, China's mainland/onshore currency, whereas CNH is the unofficial term for China's offshore currency circulating outside the mainland, primarily in Hong Kong, which is also referred to as the offshore RMB. Thus, offshore RMB bonds issued in Hong Kong are called CNH bonds or "dim sum" bonds. We use the terms *CNH bonds* and *dim sum bonds* interchangeably in this book. We specifically analyze the development and characteristics of the offshore RMB bond (dim sum bond) market in this book.

1.2 OVERVIEW OF THE DIM SUM BOND MARKET

Although the dim sum bond market is at present only a small fraction of the total RMB bond market as compared to the onshore bond market, its growth rate has exceeded all expectations and reached many milestones within a short span of time. The first dim sum bonds were issued in Hong Kong in July 2007 by China Development Bank (CDB), one of the three banks in China responsible for raising funds for large infrastructure projects, such as the Three Gorges Dam and Shanghai Pudong International Airport. The first Chinese government dim sum bonds were issued by the Ministry of Finance (MOF) in three tranches for a total amount of RMB6 billion in October 2009.

In July 2010, Hopewell Highway Infrastructure was the first foreign entity issuing dim sum bonds. The first foreign multinational corporation to issue dim sum bonds was McDonald's Corporation, a U.S. corporation, with an issue of RMB200 million in September 2010, while Sinotruk (Hong Kong) Limited was the first red-chip corporation (i.e., a Chinese company incorporated outside the mainland and listed in Hong Kong) that issued RMB2.7 billion worth of dim sum bonds in October 2010. The Asian Development Bank (ADB) was the first supranational organization that raised capital (RMB1.2 billion) in dim sum bonds listed and traded on an exchange.

[6] We consider dim sum bonds as a replacement of synthetic RMB bonds as the development of the CNH market allows fixed income investors to expose to RMB directly. We discuss this in more detail in Chapter 2.

From the debut of the first dim sum bond in July 2007 to the end of 2012, there were 797 dim sum bonds issued by 150 issuers, including supranational agencies, banks, corporations, and governments for a total of RMB401.52 billion. In the early years of the market development, there were few issues: five each in 2007 and 2008 for a total amount of RMB10 billion and RMB12 billion, respectively. There was little progress made in 2009 and 2010 with 8 and 28 issues, respectively, for a total of RMB51.68 billion. However, the market took off in 2011 with 290 issues, for a total amount of RMB152.01 billion. For the year 2012, the total value of dim sum bonds issued was RMB175.83 billion with 461 issues (Figure 1.1). The stupendous growth in this market reflects the might of the Chinese government, which also has the will to make RMB a global reserve currency. As such, this market will have significant impact on China and world financial markets.

Comparing to the amount of the RMB deposits in Hong Kong (i.e., CNH deposits) since 2007, the total RMB amount of dim sum bonds has only taken up a small fraction of the potential demand, suggesting that the dim sum bond market has room for future growth (Figure 1.2).

The impressive growth in the dim sum bond market has attracted a lot of interest from investors who cannot directly invest in China but want to participate in this fast-growing offshore RMB market. To many investors, investing in offshore RMB bonds is a proxy play for RMB appreciation. Thus, since the inception of the dim sum bond market in 2007, the investor demand has been the primary driver of growth for the dim sum bond market. In contrast, the supply of dim sum bonds is highly dependent on capital market sentiments as discretionary capital expenditure, rather than refinancing, is the major use of funds raised in Asian debt capital markets.

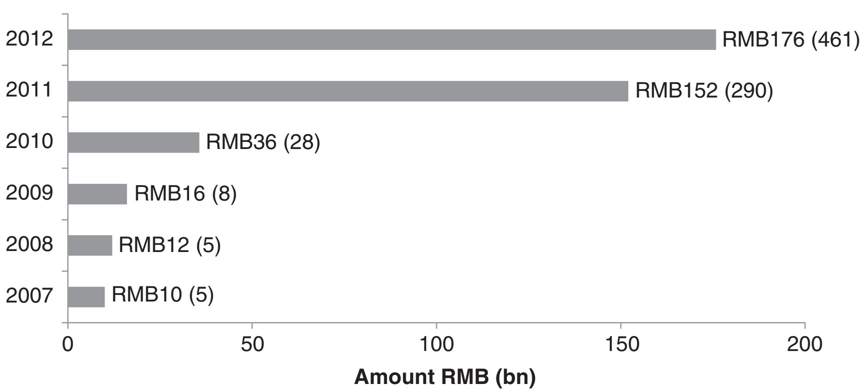

FIGURE 1.1 Dim sum bond amount and number of issues by year (2007–2012)

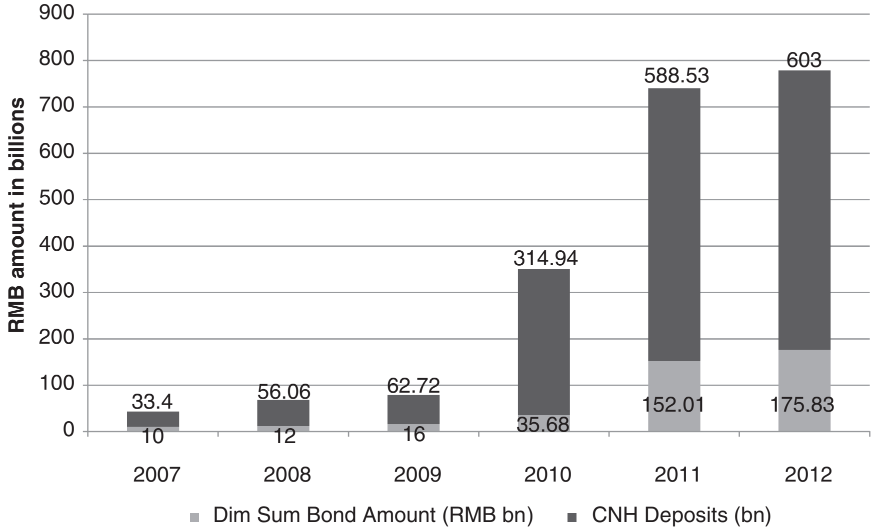

FIGURE 1.2 RMB deposits in Hong Kong (CNH deposits) and amount of dim sum bonds issued by year (2007–2012)

In the case of discretionary capital expenditure, issuers tend to be more demanding on bond pricing (i.e., lower yield), and the supply is more elastic since issuers could choose to delay capital expenditure and not issue bonds if they consider funding costs of the bond issues too high. However, in the case of refinancing, the supply is considerably less elastic, as issuers have repayment obligations to meet in a timely manner regardless of funding costs and capital market sentiments. In other words, the supply in the dim sum bond market is rather opportunistic because Asian bond issuers tend to raise funds for funding discretionary expenditure.

1.3 POLICIES SUPPORTING THE GROWTH OF OFFSHORE RENMINBI

As mentioned earlier, the establishment of the dim sum bond market is part of a multipronged strategy for internationalizing the RMB. Specifically, the dim sum bond market provides an investment conduit for the RMB earned from international trade. Without an investment outlet, circulation of RMB outside China would be limited and the willingness to hold and use RMB for trade purposes curtailed. In this section, we review recent Chinese government policies that are explicitly formulated to support the growth of the offshore

RMB (CNH). We sum up the discussion on the impact of these policies on the offshore RMB market by way of suggesting the implications for the dim sum bond market with respect to foreign investors and domestic issuers.

1.3.1 Trade Settlement in RMB and RMB Bilateral Local Currency Swap Agreements

China has long planned its currency to play an increasingly important role in the global financial system. The rise in the RMB's value relative to the U.S. dollar in early 2008 put many Chinese exporters in a less competitive position when competing with exporters from countries with a stable or depreciating currency against the U.S. dollar (see Figure 1.3). Thus, it is important for Chinese exporters to diversify the currency denomination of trade settlement away from the U.S. dollar and steer it toward the RMB.

The ability to settle trade in RMB would greatly reduce the exchange risk in the future, and hence bilateral local currency swap arrangements with foreign central banks are actively promoted in light of this broader policy target. Bilateral local currency swap agreements permit foreign central banks to sell the RMB to their local importers who want to buy Chinese goods. This is particularly useful for importers struggling to obtain trade financing in RMB in the wake of the 2007–2008 global financial crisis. As such, the bilateral local currency swap agreement policy is consistent with China's desire to participate in the Group of 20's efforts to support trade financing. As more trade settlements are denominated in RMB and with the bilateral local currency swap arrangements, China's trading partners are

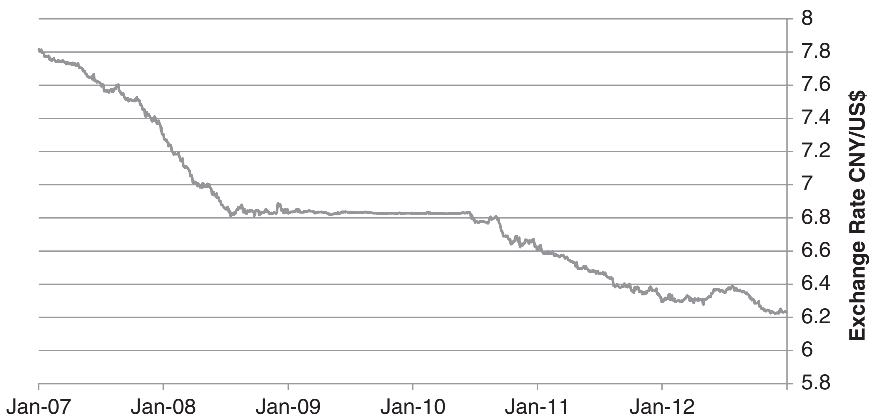

FIGURE 1.3 The exchange rates of RMB (CNY/US$) (2007–2012)

more willing to hold RMB for settlement purposes. Thus, trade settlement in RMB also helps promote RMB as a global reserve currency and diversify China's foreign currency reserve away from U.S. dollars. The purpose for both countries signing the bilateral local currency swap agreement is to avoid their currency risk against the U.S. dollar since they no longer have to exchange their currency via the U.S. dollar.

Bilateral local currency swap arrangements do not signal full RMB convertibility, but they are an important step toward it. The recent acceleration in the reform schedule by the Chinese authorities appears to suggest that the prospect of partial convertibility, especially between China and its major regional trading partners, may be closer than many believe. When there are enough RMBs floating around outside China, it indicates that the Chinese currency is used widely around the world, promoting investment in the Chinese bond market.

The Chinese authorities broadened the scope of the RMB trading program in December 2010 by increasing the number of qualified exporters from a few hundred to over 67,000, who can use the RMB in trading their goods. It is expected that "by 2015, half of China's trade with the emerging markets will settle in RMB, which will result in $2 trillion–equivalent worth of transactions per annum."[7] The use of the RMB to settle cross-border trade has grown strongly. RMB-denominated trade transactions now make up about 12 percent of China's total trade, while China has pledged to further ease the restrictions on cross-border capital flows that will encourage more RMB trade settlements.[8]

A growing number of companies in Europe are choosing to settle trade transactions in RMB to improve their position in price negotiations when doing business with partners with China according to a survey by Deutsche Bank in 2012.[9] A total of 102 companies were surveyed from the United Kingdom, Germany, and the Netherlands, and 20 percent of the respondents had already invoiced their trading partners in RMB. The remaining 80 percent indicated that a switch to invoicing in RMB was in the pipeline. Survey results show that companies using RMB could help reduce prices by an average of 4.8 percent in negotiations with Chinese business partners, while about 60 percent of the responding companies had a China business turnover of less than RMB10 million (US$1.57 million). The use of RMB in trade settlement is expected to increase in Latin American countries as well since the trade

[7] See Carnevale (2011), p. 10.

[8] See "China Banker Sees Lower Bar for Yuan Globalization," http://online.wsj.com/article 4578116470309984856.html?KEYWORDS=China+Renminbi+trade

[9] See www.financeasia.com/News/313660,more-european-smes-to-invoice-in-rmb.aspx

volume between Latin America and China is increasing (e.g., the trade in natural resources between Brazil and China). In 2009, China had displaced the United States as Brazil's largest trading partner, and in 2011 alone the Brazilian-Chinese trade volume rose by 34.5 percent to $84.2 billion.[10] China has a target of 20 percent to 30 percent RMB trade settlement among all trade in the long run.[11] Thus, there is still a long way to go.

1.3.2 Offshore RMB Currency Trading

Global trading in RMB allows businesses to buy and sell the currency to finance trade investment and borrowing. It is noted that Hong Kong accounts for 75 percent of China's RMB trade settlement (RMB506 billion), affirming its major role in RMB trading.[12]

Offshore RMB currency trading started in Hong Kong in July 2010 and reached its peak of RMB500 million (US$70 million) during March–June 2011. It dropped to as low as RMB50 million in September and rebounded to between RMB150 million and RMB200 million in November 2011.[13] Compared to the US$4 trillion daily trading in the global currency market, trading in the offshore RMB is dwarfed by trading in the U.S. dollar, yen and euro. However, the offshore RMB trading is impressive because of its speedy gain in trading volume.

While offshore RMB trading in Hong Kong has been one of the milestones for the internationalization of the RMB, another milestone by way of offshore RMB currency trading was reached in December 2010 when RMB trading took place on the Moscow Interbank Currency Exchange (MICEX). Despite transaction volume was a meager RMB4.92 million (US$738,850) by the end of the first trading day (December 15, 2010) against the ruble, Chinese companies exporting to Russia could buy local currency directly without the need for dollars as a common currency to conduct their business. China is currently the largest consumer of energy and the largest automobile market with a rapid increase in oil consumption, whereas Russia is the second biggest exporter of oil. Thus, if this RMB-ruble market develops further, it could eventually cut the dollar out of a portion of Russian-Chinese trade.[14]

At the beginning of 2011, the Bank of China (BOC), one of China's main state-owned banks, took another important step to internationalize RMB by

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[10] See Moore (2012b).

[11] See Fung and Yau (2012); Fung, Tzau, and Yau (2013a); and Fung, Wu, and Yau (2013).

[12] See Pang (2011).

[13] See Wei and Chan (2011).

[14] See Fung and Yau (2012).

allowing American firms to trade RMB in the United States. For example, the BOC through its New York branch allows U.S. trading firms and individuals to buy and sell the Chinese currency to the BOC. To fend off speculation in the RMB, the BOC limits the amount of RMB that can be converted by an individual in the United States to US$4,000 a day while there is no limit on the amount that can be converted by businesses, provided that they are engaged in international trade. The RMB is now allowed to move as much as one percent each day in offshore markets.[15] Apparently, China is cautiously pursuing the strategy of making the RMB to become a global reserve currency. With the expanded RMB trading program now, exporters and importers are able to transfer funds in an offshore RMB account more freely than before.[16]

Although New York has the advantage of serving in the same time zone as many of China's largest trading partners, like markets in Latin America, offshore RMB currency trading centers can be developed easily in other world financial centers, such as London and Singapore, which are also major world foreign exchange trading centers. London, which has a comparable infrastructure as New York, is located in a better time zone than New York, since it straddles both the Asian and American time zones. Expansion of the cross-border trade between the Association of Southeast Asian Nations (ASEAN) and China is fueling greater RMB trade settlement activity in Singapore. Besides offshore RMB currency trading, the currency swap market for offshore RMB is still underdeveloped and the capacity of the swap market has been limited. Currency swaps are useful to issuers who want to borrow in RMB and swap it to the preferred currency. Offshore RMB currency swaps used to be only available up to two years, but now longer tenors seem to be more readily available. However, it is still not at the stage where there is an abundance of liquidity and any tenor is open.[17]

1.3.3 Offshore RMB Deposit Center

The growth of RMB deposits in Hong Kong shown in Figure 1.2 reflects the impact of changes of the Chinese government policy on the RMB over time. The pool of RMB deposits has grown from RMB33.4 billion at the end of 2007 to RMB603 billion at the end of 2012, while the number of authorized financial institutions allowed to engage in RMB business has increased from 37 to 139 for the same period (Table 1.1). The growth in RMB deposits is

[15] See Wright (2012).

[16] At the time of this writing, China has named the Industrial and Commercial Bank of China (ICBC), which currently offers RMB banking services in Singapore that requires clearing through correspondent banks based in mainland China, or through banks in Hong Kong, as the central clearing bank for RMB funds in Singapore.

[17] See Caiger-Smith (2012).

TABLE 1.1 RMB Deposits (in millions) in Hong Kong (2004–2012)

Year End	Demand & Savings Deposits	Time Deposits	Total	No. of Authorized Institutions Engaged in RMB Business
2004	5,417	6,710	12,127	38
2005	10,620	11,966	22,586	38
2006	12,228	11,175	23,403	38
2007	22,539	10,861	33,400	37
2008	38,118	17,942	56,060	39
2009	40,662	22,056	62,718	60
2010	117,573	197,365	314,938	111
2011	176,398	412,132	588,529	133
2012	123,542	479,453	602,996	139

Source: HKMA

partly attributable to RMB trade settlement. These statistics indicate the phenomenal growth and wide acceptance of this market. The development of this offshore RMB deposit market in Hong Kong results partly from the fact that many Hong Kong residents parked their cash in RMB deposit accounts at local banks in the hope of benefiting from the expected appreciation of the Chinese currency, while Hong Kong dollar deposit rates had been very low since the Hong Kong dollar is pegged to the U.S. dollar.

RMB deposits now are about 10 percent of total deposits in Hong Kong and are expected to grow to 25 percent by 2015 as the offshore currency market develops and more investment opportunities become available as part of the liberalization policy.[18] Such a huge amount of RMB deposits in Hong Kong calls for concern that RMB may be used for speculation. New regulations on RMB currency trading discouraging speculation in RMB trading in Hong Kong was announced at the end of 2010. Banks in Hong Kong face new restrictions on their ability to get access to the RMB through China's foreign exchange market. That is, the limit on net open RMB positions on bank balance sheets in China's currency will be restricted to 10 percent of their assets or liabilities denominated in the currency. Yet, the upward trajectory of RMB deposits in Hong Kong has not been stopped. With this RMB deposit base as the foundation, contributions made by

[18] Source: HKMA and "Offshore RMB to Be HK's 2nd Largest Source of Deposits" (2013).

Hong Kong in helping China to internationalize the RMB currency will be unquestionable.

The growth of the dim sum bond market relies heavily on the size of the RMB deposits in the banking system of Hong Kong, which appears to decline in 2012 after peaking in November 2011, and the Chinese government restrictions on the use of the money raised in this market in the mainland. It is certain that the Chinese government will continue to use Hong Kong as the hub for enterprises to issue dim sum bonds while making efforts to develop new offshore RMB bond hubs, such as Taiwan, Singapore, and London.

In July 2012, Taiwan's Financial Supervisory Commission approved the offshore banking unit (OBU) scheme, under which offshore branches of the local Taiwanese banks have received approval to engage in RMB business. In late August 2012, the Taipei branch of the BOC was appointed as the clearing bank for RMB in Taiwan, while the Shanghai branch of the Bank of Taiwan would serve as the clearing bank for the Taiwan dollar in China. Since February 6, 2013, after a cross-strait currency clearing mechanism was established with mainland China, Taiwan's domestic banking sector has been allowed to conduct offshore RMB business, such as deposits, lending, and remittances. With RMB clearing in Taiwan, the CNT market (i.e., offshore CNY deliverable in Taiwan; Taiwan's version of CNH) will accumulate more offshore RMB (CNT) deposits; yet it is still small as compared to the CNH market in Hong Kong. It is expected that the total CNT deposits will be between RMB100 billion and RMB150 billion by the end of 2013.[19]

Singapore has the largest share of global RMB payments, outside China and Hong Kong. Singapore's offshore RMB flows have been buoyed by the healthy growth of trade and financial linkages with China. In 2011, China was Singapore's third-largest trading partner, with trade totaling $101.4 billion or 10.4 percent of the total trade, and an increase of 6.4 percent from 2010. The Monetary Authority of Singapore estimates that the pool of RMB deposits in the city totaled RMB60 billion (US$12 billion), which is about one-tenth of the RMB deposit pool in Hong Kong in early 2012.[20]

On July 6, 2012, China signed an enhanced free trade agreement with Singapore that includes a promise to designate two Chinese banks to clear RMB transactions in Singapore, signifying China's decision to use Singapore as another offshore RMB hub after Hong Kong. The enhanced free trade

[19] See Xinhua News, "Taiwan Banks' RMB Deposits Top 60b Yuan," May 17, 2013. At the time of this writing, the outstanding amount of the offshore RMB (CNT) deposits in Taiwan stood at RMB70.1 billion (US$11.42 billion) on June 11, 2013.

[20] See "RMB Internationalization—Singapore Style," July 18, 2012. Retrieved from www.cigionline.org/publications/2012/7/rmb-internationalization-percentE2 percent80 percent94-singapore-style

agreement means greater financial integration between China and Singapore and within the Asian region. The agreement makes it easier for Singapore's leading banks (Development Bank of Singapore, Overseas Chinese Banking Corporation, and United Overseas Bank) to expand in China while making it easier for China's two leading banks to expand in Singapore. Currently operating in Singapore, the BOC and the Industrial and Commercial Bank of China (ICBC), have been granted qualifying full bank (QFB) privileges by the Monetary Authority of Singapore, whereas the China Banking Regulatory Commission (CBRC) will name two Chinese banks as the clearing banks for RMB transactions in Singapore. Apparently, gaining the status of clearing bank means special privileges for the winners. The BOC started operations in Singapore in 1936 and now operates five branches and one remittance center. Since the BOC is a QFB, Beijing would find the advantage in maintaining a single clearing window to track RMB flows and to manage the money supply of the offshore RMB pool since the BOC serves as an RMB clearing bank in Hong Kong. However, the Chinese government is concerned about whether the monopolistic power enjoyed by the BOC would make it less innovative in differentiating the dim sum bond market hub in Singapore from that in Hong Kong. In contrast, the ICBC, which has been operating in the Singaporean market for the past 20 years and the second QFB, would represent a new approach to the evolving regime for RMB internationalization.[21]

The Chinese authorities have remarked that they see a future for the offshore RMB business in London to be developed into an offshore RMB bond hub, although not much progress has been made by the Chinese government since that remark. London as a global financial center offers many advantages over Hong Kong and could eclipse Hong Kong as the center for offshore RMB currency trading (CNL, i.e., London's version of CNH). The City of London Corporation announced that a committee (the CLC committee) composed of Europe-based banks (Barclays, Deutsche Bank, HSBC, and Standard Chartered) and the BOC would work with London city regulators, the Bank of England, the Financial Services Authority, and the U.K. Treasury to develop a plan to strengthen London's CNL capabilities.[22]

While analysis and implementation protocols to facilitate CNL trading and deposits were being drafted, the CLC committee member banks jump-started CNL business by issuing and listing a dim sum bond of their own in London. HSBC's offshore RMB bond issue had received international attention, with European investors accounting for 60 percent of the total issue and the rest sold in Asia. The City of London Corporation announced that

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[21] At the time of this writing, the ICBC has launched the clearing for RMB transactions in Singapore.

[22] See Davis (2012).

London banks had already taken in deposits of RMB109 billion, which is expected to grow as the city promotes CNL trade settlement. It is doubtful that London banks would soon become clearing banks for RMB settlement since Hong Kong has been acting as London banks' clearing agent.

Regarding how other cities besides Hong Kong (Taiwan, Singapore, and London) would support the offshore RMB markets, Beijing encourages a broader range of borrowers and instrument types to ensure a healthy evolution of these markets.

1.3.4 Implications for the Dim Sum Bond Market: Opportunities and Challenges

Recent Chinese government policies that are explicitly formulated to support the growth of the offshore RMB (CNH) were reviewed in the preceding sections. Next, we sum up the discussion on the impact of these policies on the offshore RMB markets by way of suggesting the implications for the dim sum bond market to foreign investors and domestic issuers in terms of opportunities and challenges.

1.3.4.1 Opportunities The development of the dim sum bond market offers tremendous opportunity to foreign investors and domestic firms. As capital flows are largely regulated in China, foreign investors and firms are regulated in their investments in China. With the growth of the dim sum bond market, foreign investors and firms can invest directly in these offshore RMB bonds without going through the regulatory red tape for investing in China. At the same time, if foreign firms operating in China need RMB funding, they can raise longer maturity RMB funding through the dim sum bond market instead of relying on shorter-term borrowings from Chinese banks. Usually, it is not easy for foreign firms to obtain loans from Chinese banks. Chinese firms can raise money by issuing dim sum bonds in Hong Kong instead of issuing bonds in the domestic market in which regulations are more restrictive.

As trade volumes increase between China and its trading partners, if the RMB replaces the U.S. dollar as the denomination for trade settlement, the demand for CNH will increase, thus favoring the CNH market since Hong Kong is the conduit of RMB trade settlement. The increasing CNH base will be a source of increasing demand for dim sum bonds. There is also a lot of interest from the European investors, especially private banks. Although dim sum bonds have yet to reach the critical mass to become an asset class in most international portfolios, the potential diversification benefit when they are included in portfolios is evident.

1.3.4.2 Challenges One notable challenge to dim sum bond issuers includes moving the proceeds from dim sum bonds onshore into mainland China.

On October 14, 2011, market restrictions were once again relaxed when the PBOC and the MOFCOM issued new rules governing foreign investment into China using offshore RMB funds. The new rules opened a new channel for offshore RMB funds to flow back into China's market (including foreign direct investment cross-border financing).[23] Another challenge is competition from the domestic loan market. Although multinational corporations (MNCs) can borrow onshore from the traditional banking and credit channels or via shadow banking channels, it is subject to credit availability and Chinese government's monetary policies. Moreover, some MNCs with operations in mainland China point out that their operations onshore are generating a lot of cash and thus the absolute funding requirements they have in China are not significant and have no immediate need to issue dim sum bonds.[24]

Although the dim sum bond market has provided a channel to investors, investors in Hong Kong have very limited options to invest in the mainland securities markets, such as the A-shares. Responding to rapid developments in the offshore RMB currency, deposit, and bond markets in Hong Kong, the PBOC has sped up the Renminbi Qualified Foreign Institutional Investor (RQFII) program endorsed by the Chinese Vice Premier Li in August 2011. The RQFII program enables funds from the offshore RMB markets to be invested in the domestic A-shares. The RQFII program certainly expands the investment universe for offshore RMB deposits in Hong Kong. The RQFII program differs from the Qualified Foreign Institutional Investor (QFII) program, introduced in China in November 2002, which allows U.S. dollars to be invested in A-shares by one of the 108 foreign institutions approved for the QFII program by the State Administration of Foreign Exchange (SAFE).

The RQFII program was first opened to domestic fund managers and Hong Kong subsidiaries of brokerage firms that were familiar with the A-share market.[25] Thus, the program complements the central government's overall strategy to internationalize the RMB and helps the development of the offshore RMB markets. However, the RQFII program and its future expansion to other cities will take some business from Hong Kong's dim sum bond

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[23] See www.nortonrosefulbright.com/knowledge/publications/61977/the-market-for-dim-sum-bonds

[24] See Moore (2012a).

[25] At the time of this writing, RQFII has been expanded to Taiwan in June 2013, and to Singapore and London in July 2013. As of July 2013, there have been 37 RQFII licenses granted to institutions, with RMB104.9 billion quota handed out thus far (Muk, 2013b), less than half of the RMB270 billion quota (Tan, 2013).

[26] At the time of this writing, HSBC Global Asset Management has become the first foreign fund house to receive the approval for a RQFII license (Muk, 2013a).

market. The near-monopoly position of Hong Kong will soon be challenged by other cities that have been approved to partake in the RQFII programs.[26]

The RQFII program highlights the challenge that all offshore RMB markets have to deal with: the policy risk. Changes in China's government policy may affect the growth and development of any offshore RMB market considerably because the Chinese government would probably change policies based on considerations at the global level rather than at the individual country's level. With the early success in the internationalization of the RMB, there is a sense of complacency in Hong Kong for its preeminent position in the efforts. Several sources of growth for the dim sum bond market can be attributed to China's favorable policy shift, which provides a huge impetus to this market. Without changes in regulation and policy approved by the Chinese authorities, development in the dim sum bond market would not have taken root so quickly and successfully. In other words, in the development of the offshore RMB market, Hong Kong has played a passive role that has required cooperation and collaboration with the Chinese central government. For that, it might not have to compete directly with Singapore, New York, or London for offshore RMB business. Hong Kong's natural endowment is the competitive niche that other financial centers do not have: the "one country, two systems" basic law that governs Hong Kong as a special administrative region. Under the Basic Law, Hong Kong can maintain its own currency linked to the U.S. dollar. Hong Kong's linked currency system enables China to pursue its RMB internationalization policy as Hong Kong will serve as a testing ground, or better yet, a buffer zone for engaging the rest of the world's financial markets. Thus, even with an expanded RQFII program to future offshore RMB centers, Hong Kong may compete well if the competitive niche can be maintained and reinforced. The development of Hong Kong's RMB offshore market has showcased the role of Hong Kong in the grand scheme of the internationalization of RMB in which it has acted as a buffer zone for China, allowing foreign capital to move in and out of China freely without the adverse impacts of capital flows.[27]

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[27] See Fung and Yau (2012).

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