

Yuan-denominated Trade Settlement and the Internationalization of China's Currency

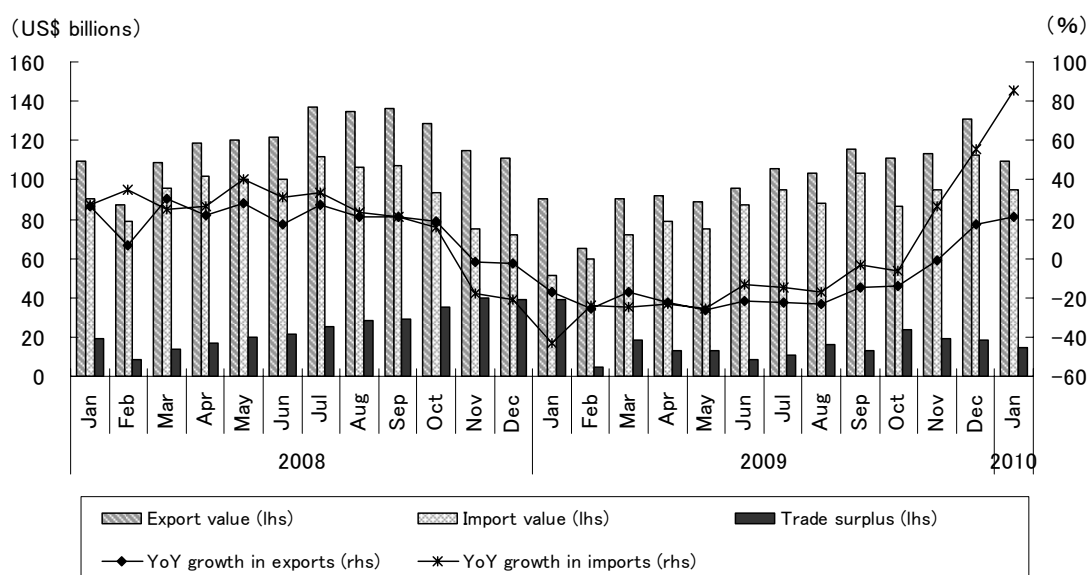
Eiichi Sekine
Senior Analyst,
Nomura Institute of Capital Markets Research

I. Settling trade in yuan: background and history

1. Sharp drop in exports

After the global financial crisis triggered by subprime loan problems in the US deepened and led to the failure of Lehman Brothers in September 2008, economies around the world slowed down, and consumer markets also contracted. Consequently, China's export performance, both in absolute value and percentage growth terms, worsened substantially from late 2008 until early 2009 (Figure 1). At the same time, corporate earnings deteriorated, especially those of smaller firms involved in China's processing and assembly exports, and the unemployment rate rose.

Figure 1: China's trade since 2008



Source: Nomura Institute of Capital Markets Research, based on data from Wind Information and CEIC

The Chinese government responded to this in November 2008 with a RMB4 trillion stimulus package to encourage growth in domestic demand, and also initiated programs to support exporters. These programs ran the gamut from tax breaks (an increase in the export VAT refund rate) to financial incentives (using the China Export Import Bank and the China Export & Credit Insurance Corp.) and employer incentives (via revisions to minimum wage rules). Introducing a mechanism for settling trade in yuan to help exporters avoid currency risk was also considered. There has long been interest in allowing trade, which in mainland China has always been settled in a foreign currency, to be settled in yuan from the prospective of internationalizing China's currency.

2. The road leading to yuan-denominated trade settlement

A pilot program for yuan-denominated trade between the mainland and Hong Kong was launched on 6 July 2009. A concise summary of the policy changes that led to that program being started follows (Figure 2).

The economic and trade relationship between the mainland and Hong Kong became substantially closer in June 2003 with their signing of the Closer Economic Partnership Arrangement (CEPA), a program initially aimed at kick starting a Hong Kong economy damaged by the SARS epidemic. Efforts by the mainland to help Hong Kong's economy included aggressively promoting Hong Kong to mainland tourists, and this required supporting the circulation of yuan in Hong Kong. To this end, the ban on Hong Kong banks accepting yuan-denominated deposits (including both money exchange and transfers) was lifted in January 2004, while the restriction against corporate yuan-denominated deposits was removed for seven targeted industry sectors (retail, dining and drinking, lodging, transportation, telecom, healthcare, and education) in October 2005. In addition, the restriction against mainland China financial institutions issuing yuan-denominated bonds in Hong Kong was lifted in July 2007. Subsequently, this lifting of the restriction was extended to more issuers, including the mainland China subsidiaries of foreign-capitalized financial institutions and China's Ministry of Finance, the issuer of Chinese government bonds (CGBs). These changes have led to the gradual development of an offshore yuan market in Hong Kong.

With the earnings of China's exporters seriously affected by the financial crisis starting in 2008, the General Office of the State Council (equivalent to Japan's Cabinet Secretariat) released on 8 December 2008 its *Opinions Regarding the Current Use of Financing to Spur Economic Development*. Also known as the *Thirty Opinions on Financing*, this included provisions to support the development of yuan-based services in Hong Kong and the denomination of trade with China's neighboring countries in yuan.

Figure 2: Policy events leading up to yuan trade settlement

| Date | Details |
|----------------|---|
| June 2003 | China and Hong Kong sign the Closer Economic Partnership Arrangement (CEPA). |
| September 2003 | The State Administration of Foreign Exchange (SAFE) promulgates on 22 September, and implements on 1 October, the Measures for Administration of Border-trade Foreign Exchange Matters. |
| January 2004 | Prohibition against Hong Kong banks accepting yuan deposits (including money exchange and remittances) is lifted. |
| October 2005 | Prohibition against yuan deposits for seven targeted industries (retail, dining and drinking, lodging, transportation, telecom, healthcare, and education) is lifted. |
| October 2005 | Restriction against issuance by international development institutions of Panda bonds (yuan-denominated bonds issued by nonresident entities) is lifted, and the International Finance Corporation (IFC) and Asian Development Bank issue their first such bonds. |
| July 2007 | Restriction against the issuance by mainland banks of yuan-denominated bonds in Hong Kong is lifted, and the China Development Bank issues its first such bond. |
| December 2008 | The Opinions Regarding the Current Use of Financing to Spur Economic Development (Thirty Opinions on Financing) issued by the State Council on 8 December includes the concept of testing yuan-denominated trade settlement. |
| December 2008 | The PBC and Bank of Korea sign a bilateral currency swap agreement for RMB180 billion on 12 December. |
| December 2008 | In its Opinion on the Maintenance of Stable Growth in Foreign Trade, the State Council decided to test yuan settlement for trade between Guangdong province and the Yangtze Delta region (Shanghai city, Jiangsu province, and Zhejiang province) and Hong Kong and Macao, as well as for trade between the Guangxi Zhuangzu Autonomous Region and ASEAN. |
| January 2009 | The PBC and Hong Kong Monetary Authority sign a currency swap agreement for RMB200 billion on 20 January, and the PBC subsequently signs bilateral currency swap agreements with four other central banks. |
| January 2009 | The State Council selects five cities in China as pilot cities for yuan trade settlement, Shanghai and four cities in Guangzhou: Guangdong, Shenzhen, Zhuhai, and Dongguan. |
| April 2009 | The State Council publishes opinions on Shanghai's international financial center and global shipping hub on 14 April. |
| May 2009 | On 8 May, the Shanghai City government reaffirms the concept of cross-border yuan payments and settlements related to yuan-priced traded contained in the State Council's opinion on Shanghai's international financial center. |
| June 2009 | The China subsidiaries of the Bank of East Asia and HSBC issue yuan denominated bonds in Hong Kong. |
| June 2009 | On 29 June, the PBC and HKMA signed a memorandum of understanding to test yuan-denominated trade settlement. |
| July 2009 | On 2 July 2009, the PBC, Ministry of Finance, Ministry of Commerce, General Administration of Customs, State Administration of Taxation, and China Banking Regulatory Commission (CBRC) jointly promulgated, and implemented the same day, the Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions. They also published a Q&A for those Administrative Rules. |
| July 2009 | On 3 July, the PBC promulgated, and implemented the same day, the Regulations for Implementing the Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions. |
| July 2009 | On 6 July, China and Hong Kong begin yuan-denominated trade settlement. |
| July 2009 | On 8 July, Mizuho Corporate Bank announces it will provide various services related to yuan-denominated trade settlement in Hong Kong. On 6 July, Mizuho Corporate Bank's Hong Kong branch signed an agreement with the Bank of China's Shanghai Branch to open an account for settling trade in yuan. Japan's other two megabanks obtained the same license on different dates. |
| July 2009 | On 28 July, the Philippine Central Bank and the Bank of China's Manila branch signed an agreement to buy and sell yuan cash, and send yuan transfers, thereby authorizing the Bank of China to provide yuan services within the Philippines. It began offering these services on 31 July. |
| August 2009 | On 17 August, the State Council approved its Opinions Regarding Further Implementation of the Strategy for Revitalization of Old Industrial Bases in the Northeast and Elsewhere. The nine areas of reform and opening in this opinion supports the promotion of yuan trade settlement in the Northeastern region of Liaoning, Jilin, Heilongjiang, and the Inner Mongolia autonomous region. |
| September 2009 | On 8 September, the Chinese government announced plans to issue RMB6 billion of yuan-denominated government bonds in Hong Kong, with actual issuance on 27 October. |

Source: Nomura Institute of Capital Markets Research, based on data from People's Bank of China and various other sources

Then on 24 December 2008, the Standing Committee of the State Council decided to introduce a pilot program for yuan-denominated settlement for trade between Guangdong province and the Yangtze Delta region (Shanghai city, Jiangsu province, and Zhejiang province) and Hong Kong and Macao, as well as for trade between the Guangxi Zhuangzu Autonomous Region and ASEAN countries. These were the areas in China where exporting industries were hardest hit by the global economic slowdown. On 20 January 2009, the People's Bank of China (PBC) and the Hong Kong Monetary Authority (HKMA) signed a RMB200 billion (HKD227 billion) currency swap agreement.

China then accelerated its preparatory moves in April 2009. On 8 April 2009, the Standing committee of the State Council (equivalent to the Cabinet in Japan) named five regions within China for the pilot program: Shanghai, as well as four cities in Guangdong province: Guangzhou, Shenzhen, Zhuhai, and Dongguang. Shanghai's global financial center concept also refers to yuan trade settlement. On 29 June 2009, the PBC and HKMA signed a memorandum of understanding to test the settlement of trade in yuan.

On 2 July 2009, the PBC, Ministry of Finance, Ministry of Commerce, General Administration of Customs, State Administration of Taxation, and China Banking Regulatory Commission (CBRC) jointly promulgated, and implemented the same day, the *Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions*, and also published a *Q&A* for those Administrative Rules. The next day, on 3 July, the PBC promulgated, and implemented the *Regulations for Implementing the Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions*.

II. Yuan-denominated trade settlement schemes

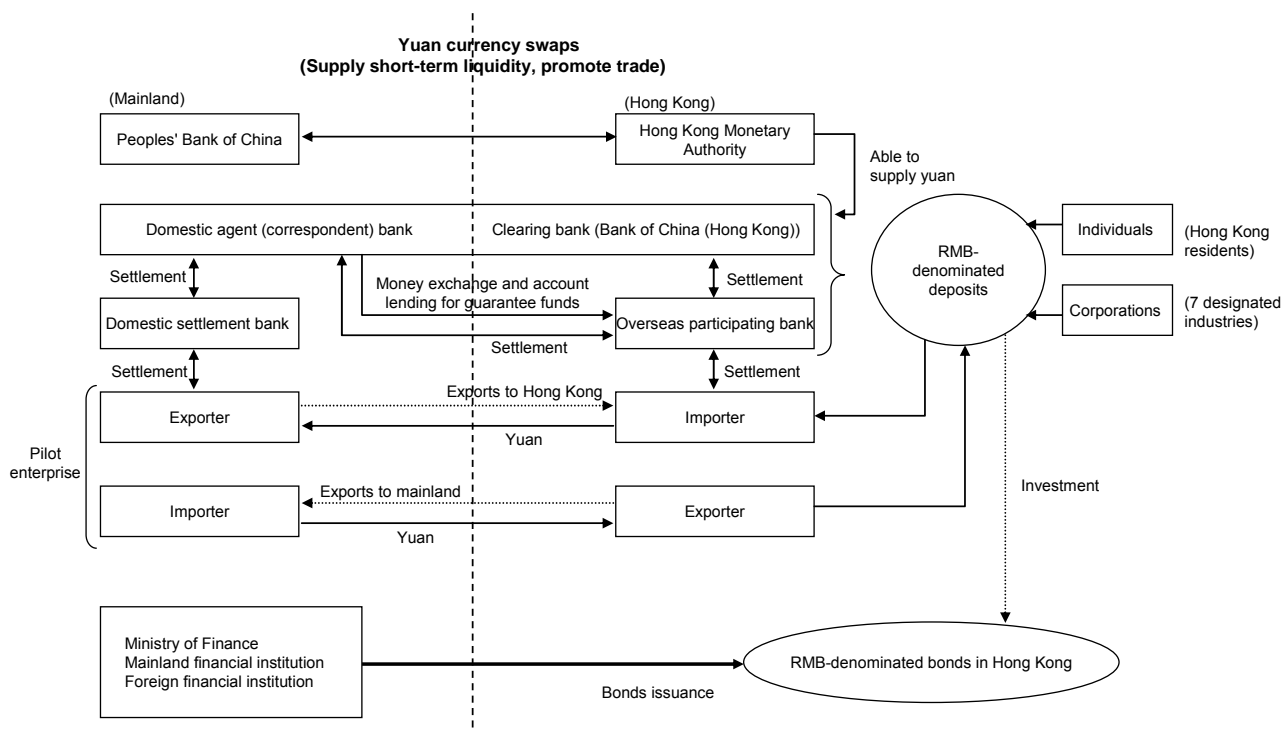
1. Two settlement methods

China's main form of trade is processing and assembly trade, whereby it imports components and materials, processes and assemble those inputs in China, and then exports intermediate or final products. Intermediate and final goods have a higher value added than do the inputs, of course. In terms of the processing and assembly cycle for a single product, the amount paid for imports is exceeded by the amount received for exports.

Hong Kong is an entrepot, intermediating trade between China and other countries and regions. Using the same single-product processing and assembly cycle example, if Hong Kong settles its trade in yuan, the value of its exports to the mainland is exceeded by the value of its imports from the mainland. For Hong Kong to be able to procure additional yuan over what it has already received for exports to the mainland in order to pay for the imports, it is critical that a mechanism be built to allow Hong Kong banks to procure enough yuan to cover the difference.

The cross-border clearance and settlement of yuan funds associated with the yuan trade launched in July 2009 could either be done through a clearing bank in Hong Kong or Macau or through a domestic correspondent bank representing a participating overseas bank. Either approach would provide a channel for procuring yuan (Figure 3).

Figure 3: Yuan-denominated trade settlement schemes



Source: Nomura Institute of Capital Markets Research, based on data from People's Bank of China

2. Settlement mechanism

1) If through a domestic correspondent bank

The relationship between the domestic correspondent bank and the participating overseas bank or domestic settlement bank is as follows.

- The domestic correspondent bank signs a yuan settlement agent agreement with the participating overseas bank and opens a yuan nostro (correspondent) account.
- The domestic correspondent bank can demand funds to guarantee the yuan nostro account and provide money exchange services for the guarantee funds.
- The domestic correspondent bank can buy and sell yuan within limits as requested by the participating overseas bank. Those limits are set by the PBC.

- The domestic correspondent bank can provide account financing to the participating overseas bank. The loans would be for meeting the needs of temporary account positions, and the PBC determines the maximum loan amount and loan period.
- The domestic correspondent bank can also provide yuan settlement services as the domestic settlement bank. The domestic settlement bank provides yuan settlement services with pilot firms.

2) If through a clearing bank

The relationship between the clearing bank and the domestic settlement bank is as follows.

- Commercial banks that have already been approved by both the PBC and monetary authorities in Hong Kong and Macau to participate in the PBC's large-value payments system and that offer yuan clearing services in Hong Kong and Macau are referred to as the Hong Kong and Macau yuan clearing banks. Currently, the yuan clearing bank in Hong Kong is the Bank of China (Hong Kong) and the clearing bank in Macau is the Bank of China (Macau).
- The Hong Kong and Macau yuan clearing banks have been approved by the PBC Shanghai Branch to participate in the mainland's nationwide interbank market. The clearing banks can exchange yuan and procure yuan funds using the mainland's interbank foreign exchange market and interbank market.

3) Yuan currency swaps

In addition to the regular settlement services noted above, China has signed a currency swap agreement with Hong Kong. This creates a mechanism to supply commercial entities in Hong Kong with the yuan they need for trade settlement. Including Hong Kong, the PBC has signed currency swap agreements with six different countries/regions for a total of RMB650 billion (Figure 4).

3. The selection of pilot enterprises

The provincial-level governments in the pilot regions (the governments of Guangdong province, Shenzhen city, and Shanghai city) work together with the relevant governmental departments for those regions to recommend pilot enterprises. The PBC, in cooperation with the Ministry of Finance, Ministry of Commerce, General Administration of Customs, the State Administration of Taxation, the CBRC, and other relevant entities, examines the candidates and selects the pilot enterprises. There is no specific licensing required for the overseas counterparty.

Figure 4: Countries with currency swap agreements with China

| Country/region | Name of central bank | Date of agreement | Amount (RMB billions) | Term | Amount in other currency | Purpose of agreement |
|----------------|--|-------------------|-----------------------|---------|--------------------------------|---|
| Korea | Bank of Korea | 12 December 2008 | 180 | 3 years | 38 trillion won | <ul style="list-style-type: none"> • Support short-term liquidity • Settle trade • Supplement the Chiang Mai Initiative (CMI) • Considering mutually holding the other currency as a reserve currency |
| Hong Kong | Hong Kong Monetary Authority (HKMA) | 20 January 2009 | 200 | 3 years | 227 billion HK dollars | <ul style="list-style-type: none"> • Support short-term liquidity • Settle trade |
| Malaysia | Bank Negara Malaysia | 8 February 2009 | 80 | 3 years | 40 billion Malaysian ringgit | <ul style="list-style-type: none"> • Settle trade • Settle investment |
| Belarus | National Bank of the Republic of Belarus | 11 March 2009 | 20 | 3 years | 8 trillion Belarusian rubles | <ul style="list-style-type: none"> • Settle trade • Settle investment |
| Indonesia | Bank Indonesia | 23 March 2009 | 100 | 3 years | 175 trillion Indonesian rupiah | <ul style="list-style-type: none"> • Support short-term liquidity • Settle trade • Settle investment |
| Argentina | Central Bank of Argentina | 2 April 2009 | 70 | 3 years | 38 billion Argentine pesos | <ul style="list-style-type: none"> • None noted |
| Total | | | 650 | | | |

Source: Nomura Institute of Capital Markets Research, based on data from People's Bank of China

The examination criteria include whether the enterprise has ample experience with international settlement, has strictly complied with regulations established by the Ministry of Finance, Ministry of Commerce, General Administration of Customs, and State Administration of Foreign Exchange (SAFE), and has strong credit. The pilot enterprise must choose one domestic settlement bank as its primary reporting bank.

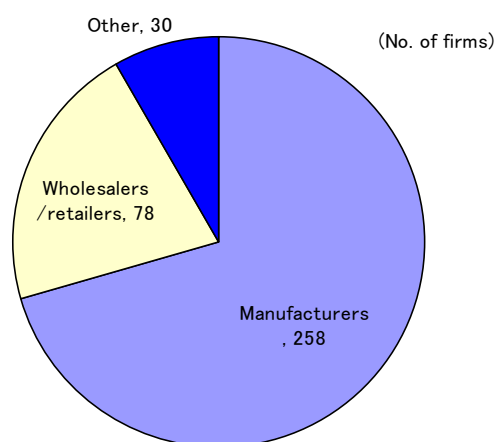
The first group selected for the test numbered 365 firms (182 of them foreign), including 92 (27) in Shanghai, 88 (41) in Guangzhou, 56 (38) in Dongguang, 38 (18) in Zhuhai, and 91 (58) in Shenzhen. Ten of the firms selected are Japanese. Most of the pilot enterprises (258) are manufacturers, and the second most (78) are in the wholesale/retail trade (Figures 5 and 6).

Figure 5: Japanese firms selected as pilot enterprises for yuan trade settlement

| | Company | Parent company |
|-----------|--|--------------------------------------|
| Shanghai | Shanghai Mitsubishi Elevator | Mitsubishi Electric |
| | Mitsubishi Electric Shanghai Electric Elevator | Mitsubishi Electric |
| | Fuji Xerox of Shanghai | Fuji Xerox |
| Shenzhen | Ricoh Components Asia (Shenzhen) | Ricoh |
| | Ricoh Elemex (Shenzhen) | Ricoh Elemex |
| | YKK Zipper (Shenzhen) | YKK |
| | Toshiba Tec Information Systems (Shenzhen) | Toshiba Tec |
| | Epson Engineering (Shenzhen) | Seiko Epson |
| | Omron Electronic Components (Shenzhen) | Omron |
| Dongguang | Konica Minolta Business Technologies (Dongguang) | Konica Minolta Business Technologies |

Source: Nomura Institute of Capital Markets Research, based on various data sources

Figure 6: Industry sectors of the pilot enterprises selected for yuan trade settlement



Source: Nomura Institute of Capital Markets Research, based on various data sources

4. Supervision and monitoring

There are a number of regulations in place to enable the supervision and monitoring of the yuan inflows and outflows (particularly outflows from the mainland) that will result from the introduction of yuan trade settlement. We list the main regulations below, but bear in mind that there are other regulations in addition to these.

1) Regulations on pilot enterprises and bank obligations

- The pilot enterprise shall create a yuan settlement ledger (administered by the PBC) and accurately record information on import/export customs declarations and yuan fund payments and receipts. (Article 14 of the *Implementing Regulations*)
- When applying for yuan settlement, the pilot enterprise shall inform the domestic settlement bank of the date or scheduled date of import/export customs clearance and information on the actual transaction, fill out truthfully the standard forms (Notes for Receiving Renminbi from Export Transactions and the Notes for Paying Renminbi to Settle Import Transactions), and otherwise help the domestic settlement bank examine the authenticity and consistency of the trade documents. (Article 14 of the *Implementing Regulations*; separate rules apply for advance receipt and advance payment (shall present documentation of trade agreement when 25% or more of the total amount) and for processed trade where the customer supplies the inputs.)

- The pilot firm can keep yuan export proceeds outside of China, but shall file a report, via the domestic settlement bank, with the local office of the PBC. (Article 23 of the *Administrative Rules*)

A pilot enterprise that has not recovered the related yuan proceeds 210 days after exporting the related goods shall, via its domestic settlement bank, report within five working days the outstanding amount and the serial number of the corresponding export declaration form to the Cross-border Renminbi Receipt and Payment Information Management System, and shall provide relevant documents to its domestic settlement bank. (Article 23 of the *Administrative Rules*)

2) Rules on obtaining yuan financing

The total outstanding financing provided by a domestic correspondent bank for overseas participating banks shall not exceed 1% of the domestic bank's total yuan deposits outstanding at the end of the previous year, and the term of the financing shall not exceed one month. The PBC may modify this rule based on the situation, however. The local PBC office with jurisdiction supervises the account financing activities of the domestic correspondent bank. (Article 7 of the *Implementing Regulations*)

- A clearing bank's outstanding borrowing and lending amount on the nationwide interbank market shall not exceed 8% of the bank's outstanding yuan deposits at the end of the previous year, and the term of the loans shall not exceed three months. (Article 11 of the *Implementing Regulations*)
- A domestic settlement bank may provide yuan trade finance to an overseas firm. The amount of that financing cannot exceed the amount of the trade contract between the pilot enterprise and the overseas firm. (Article 13 of the *Implementing Regulations*)

III. Results and issues thus far

1. Yuan-denominated trade totaled RMB3.58 billion in 2009

How much trade was actually settled in yuan in 2009?

The China Monetary Policy Report for Q4 2009, released by the PBC on 11 February 2010, states that 409 trade transactions worth RMB3.58 billion were settled in yuan in 2009¹. The Q3 2009 report, dated 11 November 2009, stated that yuan trade from 6 July until 30 September totaled RMB100 million. Such trade has thus shown strong growth since October 2009.

¹ This report is reprinted from Vol. 3-4 2010 of *China Capital Markets Research* (in Japanese), with the permission of the Nomura Foundation (formerly the Tokyo Club Foundation for Global Studies).

2. Reasons for the weak start

Yuan-denominated trade started out fairly slow. In interviews of Japanese subsidiaries in China that we conducted in October 2009, several reasons were given for this weak start. First was the difficulty in quickly making the transition away from the standard approach of denominating trade in foreign currencies. Second, there is little incentive for the Hong Kong side to bear the currency risk. Third, yuan settlement entails an administrative cost on both the mainland side and Hong Kong side, including document review and customs declarations. Fourth, there are no vehicles for the Hong Kong side to invest yuan.

In addition, some of the pilot enterprises on the initial list did not even apply, but were chosen based on the recommendation of their local bank. Consequently, it appears that some Japanese firms were put on the list without their knowledge. Although some Japanese firms liked the idea of being chosen as a pilot enterprise, there were apparently others that had reservations, based on concern they would be subject to pressure from or be obligated by the authorities. It appears that there are also firms that are worried over how to respond if they are asked to settle trade in yuan by a trading partner in China.

From the banks' perspective, some observers point out that for the local banks, the profit targets for each branch are difficult to reach, and this reduces their incentive to incur expenses to aggressively go after the yuan business, even though yuan settlement would help diversify profits in the future.

3. Outlook for growth in the number of pilot enterprises

Plans are apparently to expand the number of pilot enterprises on the mainland. Unlike the first round of selection, we expect companies that are actually interested in yuan-settled trade to join the test.

There have been reports of some Japanese firms that are settling trade between their Hong Kong and mainland subsidiaries in yuan (see Figure 5 again)². One example of this is Konica Minolta Business Technologies, which uses yuan to settle payment for copier components sold by its Hong Kong subsidiary to its Guangdong subsidiary. This can probably be partially explained by the fact that it is easier to decide which side (Hong Kong or the mainland) bears the exchange rate risk when the companies are in the same corporate group. It will be interesting to see whether this pattern becomes more common.

² Yuan accounts opened for overseas participating banks now total 160 accounts (with a balance of RMB690 million) opened by domestic settlement banks and 53 accounts (RMB48.62 billion) opened by the Bank of China (Hong Kong).

IV. Outlook for internationalization of the yuan

1. Yuan internationalizes in stages

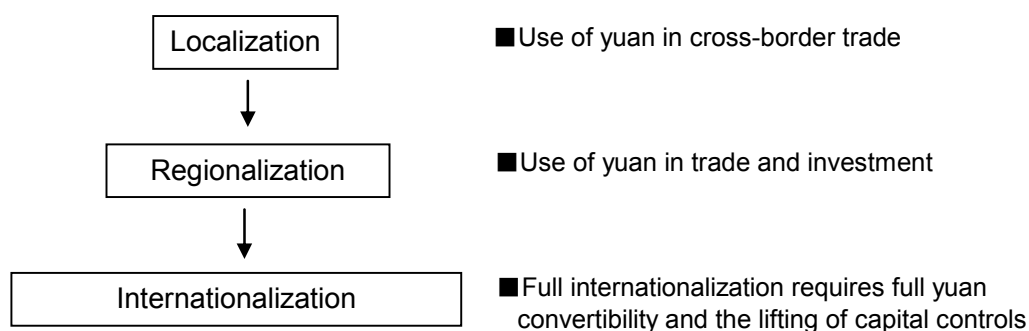
1) The debate within China

Although the idea of internationalizing the yuan began with aim of facilitating the use of the currency in trade settlement, the official opinion of the Chinese government is that although there is no established timeline for such internationalization, there is active debate taking place with China's research institutions.

For example, Wu Nianlu, Vice Chairman and Secretary General of the China International Finance Society, opined in the *Economic Observer* dated 1 October 2009 that the yuan's internationalization should proceed in steps, starting with localization, then regionalization, and finally internationalization (Figure 7).

The yuan will not be truly internationalized until it is freely convertible and capital controls are lifted, but until China's domestic money and capital markets are further developed, it appears that its first step, while domestic restrictions remain in place, will be to expand yuan settlement of trade and investment with the rest of Asia and other important commercial partners.

Figure 7: Internationalization of the yuan



Source: Nomura Institute of Capital Markets Research, based on Wu Nianlu, "Three Steps to Internationalization," 1 October 2009 edition of the *Economic Observer*

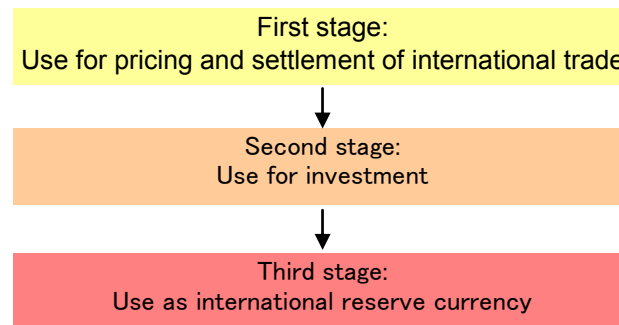
2) Arguments made by those affiliated with the Hong Kong government

(1) Yuan internationalization in three stages

While moving forward with yuan-denominated trade, Hong Kong has also been doing research into the yuan's internationalization. In its May 2009 publication, *The Pilot RMB Trade Settlement Scheme and RMB Internationalization*, the Hong Kong Trade Development Council (HKTDC) outlined the three stages of the

internationalization of a currency, including the yuan (Figure 8). The first stage is the pricing and settlement of trade in that currency. The second stage is its use as an investment vehicle. The third stage is achieving status as an international reserve currency.

Figure 8: Three stages of yuan internationalization



Source: Nomura Institute of Capital Markets Research, based on data from HKTDC

The yuan has already reached the first stage, and its use in trade settlement is naturally increasing its circulation outside of the mainland and gradually making its use acceptable regionally and globally.

The second stage will have been reached when the yuan gains status as an international vehicle for investment. That is conditional on the yuan being backed by sound fundamentals, however, including prudent fiscal and monetary policies, robust economic growth, a healthy current account balance, and sufficient foreign currency reserves. The report notes that investors must have a favorable assessment of both the supply-demand balance and the regulatory framework of China's investment assets, namely stocks, bonds, and real estate. It also says that the presence of large, mature financial markets increases the attractiveness of a currency as an investment vehicle, and makes it possible to offer a variety of investment choices, efficient and effective transaction and settlement mechanisms, and an adequate capacity to absorb an influx of foreign capital.

The third stage, becoming an international reserve currency, comes after the first two stages and means that the central banks of other countries hold the currency as a reserve currency. Having reached the first two stages is no guarantee of a currency automatically becoming an international reserve currency, since the international use of a currency is ultimately determined by market forces.

(2) Requirements for yuan internationalization

The report notes that there are still problems with the yuan meeting the conditions for entry into the second stage: use as an investment vehicle. Specifically, the mainland's financial markets are relatively immature, particularly its debt and derivative

markets, and stock market participation by nonresident investors is low. The report therefore argues that mainland financial markets must offer nonresident investors a broader choice of investments, by developing new financial products and fostering derivative markets. It also notes that a greater number of nonresident investors must be allowed to trade on mainland stock exchanges. Over the near term, in step with the gradual liberalization of mainland financial markets, there is a need to develop yuan-denominated investment products for the long term and make the mainland a more attractive place for nonresident investors' portfolio investments.

If Hong Kong sees growth in the amount of trade settled in yuan and in the size of its market for yuan-denominated bonds, both financial institutions and non-financial enterprises should start taking a more favorable view of Hong Kong as a business location. The Hong Kong authorities also appear to have this as a goal. This is apparently part of the Hong Kong government's decision to make Hong Kong an offshore yuan center, and thereby create differentiation with Shanghai.

2. Comparison with Japan and future outlook

1) The current stage of liberalization of China's foreign exchange and capital markets is comparable to that of Japan in the early 1970s.

The internationalization of the yuan will require making the yuan convertible and deregulating capital transactions, but as made clear in the aftermath of the latest global financial crisis, proceeding with liberalization while still maintaining prudent controls is a difficult policy challenge. As already noted, if problems arise in the process of internationalizing the yuan and create turmoil in China's economy, it would probably inflict considerable damage on the global economy.

Japan's experience in opening and liberalizing its money and capital markets in the 1980s and 1990s during the process of yen internationalization provides a reference in this regard. Figure 9, which compares the history of currency and capital market liberalization in Japan and China, shows that although China has gradually liberalized its foreign exchange and capital transactions, it is now about where Japan was in the early 1970s. Although coming relatively later in the process, China's allowing of yuan trade settlement roughly corresponds to Japan's introduction of yen accounts for nonresidents in 1960. In addition, even those areas that have been liberalized in China still have caps and require approvals, and thus have yet to be fully liberalized. Consequently, although China's ongoing process of liberalizing its currency and capital markets is unlikely to map perfectly with what occurred in Japan's money and capital markets, it may follow suit. For example, Hong Kong's offshore yuan market may follow the pattern seen in the 1980s in the euroyen market, which achieved growth despite having to sidestep domestic regulations.

Figure 9: Japan-China comparison of currency and capital market liberalization

| Japan | | China | |
|-------|--|--------------------------------|--|
| 1960 | Introduction of yen accounts for nonresidents (Use of yen for settling with overseas firms) | 2009 | Trial use of yuan-denominated settlement of trade between five cities (Shanghai, Guangdong, Shenzhen, Zhuhai, and Dongguan) and Hong Kong, Macau, and ASEAN countries. |
| 1961 | Residents allowed to issue stock overseas | 1993 | Tsingtao Brewery approved to issue H shares in Hong Kong |
| 1964 | Achieves current account convertibility (Becomes IMF 8 treaty country) | 1996 | Achieves current account convertibility (Becomes an "IMF Article 8" country) |
| 1967 | Begins liberalization of inbound portfolio investment | 2002 | Launches Qualified Foreign Institutional Investor (QFII) program |
| 1970 | Begins issuance of yen denominated bonds by nonresidents (Samurai bonds) | 2005 | Nonresidents (IFC and ADB) allowed to issue yuan-denominated bonds (Panda bonds) |
| 1970 | Begins liberalization of outbound portfolio investment | 2006 | Launches Qualified Domestic Institutional Investor (QDII) program |
| 1971 | Nixon shocks, yen moves to provisional floating exchange rate regime | 2005 | Reform of yuan exchange system, moves to managed float referencing a basket of currencies |
| 1972 | Abolished system in which foreign exchange was centralized | Date of implementation unknown | |
| 1973 | Yen moves to fully floating exchange rates | Date of implementation unknown | |
| 1973 | Tokyo Stock Exchange establishes market for foreign stocks | (2010) | (Shanghai Securities Exchange now considering establishing an international board) |
| 1979 | Revision of Foreign Exchange and Foreign Trade Control Act (capital transactions deregulated in principle) | Date of implementation unknown | |
| 1979 | Creation of certificates of deposit (deregulation of interest rates) | Date of implementation unknown | |
| 1984 | Elimination of the actual demand rule for forward exchange transactions | Date of implementation unknown | |
| 1984 | Deregulation of yen-denominated loans to overseas borrowers | (undecided) | (SAFE and related agencies now considering allowing the policy banks to make yuan-denominated loans to overseas customers) |
| 1984 | Restrictions on yen conversion lifted | Date of implementation unknown | |
| 1984 | Nonresidents issue euroyen bonds | 2007 | Mainland China-affiliated financial institutions approved for issuance of yuan-denominated bonds in Hong Kong |
| 1986 | Establishment of Tokyo Offshore Market (JOM) | Date of implementation unknown | |
| 1987 | Commercial paper introduced | 2005 | Short-term finance bonds (commercial paper) introduced |
| 1996 | Criteria to qualify for issuing corporate bonds eliminated | Date of implementation unknown | |
| 1997 | Revision of Foreign Exchange and Foreign Trade Control Act (reporting system for capital transactions) | Date of implementation unknown | |

Source: Nomura Institute of Capital Markets Research, based on various data sources

Current moves toward the international opening of China's domestic issuance market include (1) the establishment of an international board on the Shanghai Stock Exchange (for listing the A shares of foreign firms), (2) the repatriation of red-chip firms (affiliates of Chinese firms established in Hong Kong) to mainland exchanges, (3) changes to the issuance terms of Panda bonds (the equivalent of Samurai bonds), (4) the domestic issuance of finance bonds by auto sales financing companies (including foreign capitalized), and (5) the domestic issuance of finance bonds by the Chinese subsidiaries of foreign capitalized banks. All of these developments, with the exception of (2), bring to mind Japan's previous experience with financial liberalization. We think it unlikely that financial service providers overseas are going to overlook the new business opportunities associated with this financial liberalization in China.

2) The outlook for yuan-denominated trade settlement

Just how far does China plan to go in internationalizing its currency? We think the Chinese government has plans to gradually expand its existing framework for yuan internationalization, which currently consists of using the yuan for settling trade,

currency swaps, and bond issuance in Hong Kong. Of these, we envision the following scenario for the expansion of yuan trade settlement.

(1) Broadening the regions and products eligible for yuan trade settlement

There is movement underway to increase the number of pilot regions for yuan trade settlement, both inside and outside of China. The *Opinions Regarding Further Implementation of the Strategy for Revitalization of Old Industrial Bases in the Northeast and Elsewhere*, approved by the State Council on 17 August 2009, allows for the testing of yuan-denominated trade settlement in the Northeastern regions of Liaoning, Jilin, Heilongjiang, and the Inner Mongolia autonomous region (Figure 2). The *Special Test Projects for Comprehensive Financial Reform and Innovation in the Tianjin New Coastal District* proposed by the National Development and Reform Commission was approved by the State Council on 26 October 2009. It includes research of offshore financial services in Tianjin as well as a trial of both trade settlement and offshore investment denominated in yuan.

As part of China's effort to expand the number of countries and regions with which it settles trade in yuan, on 13 October 2009, Chinese Premier Wen Jiabo and Russian Prime Minister Vladimir Putin announced an agreement, as part of the 14th Sino-Russian Joint Statement, to deepen cooperation in the finance, investment, and insurance sectors, and to research further settlement in their respective currencies. Some Sino-Russian cross-border trade is already being settled de facto in yuan, but the agreement formally begins the consideration of mechanisms to incorporate this settlement into the banking system. In addition, the joint statement adopted upon the close of the China-ASEAN Financial Cooperation and Development Leadership Forum on 21 October 2009 agreed to promote intra-regional settlement models, remove unnecessary regulatory barriers, and help exporters on both sides reduce operating costs. The PBC and the Monetary Authority of Macao signed a supplementary memorandum on oversight cooperation on 14 December 2009 to promote yuan trade settlement.

Outside of Asia, China is studying with Brazil the possibility of settling commodity and other trade in their respective currencies. For its part, Brazil is also considering the overseas issuance of government bonds denominated in its currency, the real (BRL)³, [4] and this would probably provide China with a way to invest the real it has received in trade.

The people we interviewed in China pointed out that internationalization of the yuan would require that China supply liquidity overseas by running a trade deficit in goods and services with other countries and regions. For this to happen, China would have to move away from its current export-driven model for economic growth and start promoting growth in domestic demand, especially private-sector consumption. Although that may be true over the medium to long term, over the near term there are already countries and regions with which China runs a trade surplus (Figure 10) ,

³ *Nihon Keizai Shimbun*, 11 November 2009 edition.

some of which are the same trading partners noted above, specifically Asian countries (Taiwan, Korea, Japan, Malaysia, Philippines, and Thailand) and resource-rich countries (Australia, Iran, Brazil, and Argentina). An important question is when and how China will start using yuan to settle trade with these countries and regions.

Figure 10: China's trade balance

| (US\$ millions) | | | | (US\$ millions) | | |
|-------------------------|----------|----------|----------|--|------------------------------------|-----------|
| Country/region | 2008 | 2007 | 2006 | Comments | Sector | 2006 |
| 1 Taiwan | ▲ 77,445 | ▲ 77,506 | ▲ 66,401 | | Textiles | 112,417 |
| 2 Korea | ▲ 38,270 | ▲ 47,916 | ▲ 45,260 | Has currency swap agreement with China | Machinery and electronics products | 85,957 |
| 3 Japan | ▲ 34,631 | ▲ 31,787 | ▲ 24,038 | | Other products | 28,349 |
| 4 Saudi Arabia | ▲ 20,290 | ▲ 9,731 | ▲ 10,032 | Natural resources and energy | Metals | 25,524 |
| 5 Australia | ▲ 14,040 | ▲ 7,761 | ▲ 5,568 | Natural resources and energy | Footwear and headwear | 25,478 |
| 6 Iran | ▲ 11,534 | ▲ 6,041 | ▲ 5,467 | Natural resources and energy | Ceramics & glass | 13,878 |
| 7 Brazil | ▲ 10,857 | ▲ 6,965 | ▲ 5,527 | Natural resources and energy | Foods | 9,731 |
| 8 Malaysia | ▲ 10,748 | ▲ 11,036 | ▲ 10,037 | Has currency swap agreement with China | Leather and fur | 9,106 |
| 9 Philippines | ▲ 10,420 | ▲ 15,623 | ▲ 11,938 | ASEAN | Transport equipment | 8,699 |
| 10 Thailand | ▲ 10,116 | ▲ 10,674 | ▲ 8,198 | ASEAN | Live animals and animal products | 2,460 |
| 11 Argentina | ▲ 4,332 | ▲ 2,747 | ▲ 1,693 | Has currency swap agreement with China | Services | 283 |
| 12 Brunei | 47 | ▲ 129 | ▲ 116 | ASEAN | Wood products | ▲ 1,583 |
| 13 Laos | 119 | 92 | 119 | ASEAN | Vegetable products | ▲ 5,608 |
| 14 Cambodia | 1,056 | 830 | 663 | ASEAN | Plastic & rubber | ▲ 16,637 |
| 15 Myanmar | 1,335 | 1,321 | 955 | ASEAN | Chemical products | ▲ 18,433 |
| 16 Macao | 2,295 | 2,362 | 1,925 | | Mineral products | ▲ 102,146 |
| 17 Indonesia | 2,823 | 229 | ▲ 157 | Has currency swap agreement with China | | |
| 18 Canada | 9,013 | 8,388 | 7,853 | Natural resources and energy | | |
| 19 Russia | 9,228 | 8,854 | ▲ 1,709 | Natural resources and energy | | |
| 20 Vietnam | 10,797 | 8,691 | 4,982 | ASEAN | | |
| 21 India | 11,175 | 9,378 | 4,119 | | | |
| 22 Singapore | 12,233 | 12,159 | 5,513 | ASEAN | | |
| 23 United Arab Emirates | 18,937 | 14,030 | 8,616 | Natural resources and energy | | |
| 24 EU | 160,072 | 134,189 | 91,575 | | | |
| 25 US | 170,829 | 162,901 | 144,293 | | | |
| 26 Hong Kong | 177,826 | 171,465 | 144,640 | Has currency swap agreement with China | | |

Note: 1. Sectors based on HS codes.
2. Foods refers to processed foods.
3. Chemical products include fertilizers, organic chemicals, and pharmaceuticals.
4. Mineral products include lime, cement, slag, and petroleum and other fossil fuels.
Source: Nomura Institute of Capital Markets Research, based on CEIC

Source: Nomura Institute of Capital Markets Research, based on CEIC

(2) Growth in yuan currency swaps

There has also been growth in yuan currency swaps. The above-mentioned joint statement adopted by the 2009 China-ASEAN Financial Cooperation and Development Leadership Forum called for growth in currency swaps within the region, although it did not specifically call for yuan swaps. In addition, China is already in talks with Thailand and, outside of Asia, with Brazil, regarding possible currency swap agreements.

Furthermore, in an article in *Yanjiu Cankao* dated 9 March 2009 entitled (Reform of the international currency regime: continue with uni-polar or transition to multi-polar?), Wu Xiaoqiu of the Financial and Securities Institute of Renmin University of China states that the Chinese government has already signed bilateral agreements with eight bordering countries, including Russia, Mongolia, Myanmar, and Vietnam, mutually authorizing settlement in their respective currencies. PBC Vice Governor Su Ning, who attended the China-ASEAN Leadership Forum, had already announced bilateral settlement cooperation agreements with the central banks of Vietnam and Laos following that forum. If currency swap agreements between the central banks are added to these settlement cooperation agreements, it would probably provide more support to yuan trade settlement.

Although not much trade is being settled in yuan at this time, use of the yuan for trade could eventually raise the profile of China's capital markets, just as other major events that were initially under the radar have done in the past, such as the creation of A shares on China stock exchanges and the start of reforms of non-tradable shares. Trends in the use of yuan to settle trade and moves toward the internationalization of the yuan continue to merit close watching.