Renminbi Trade Settlement as a Catalyst to Hong Kong's Development as an Offshore Renminbi Center

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I. Easing of rules on and increase in trade settlement in renminbi in 2010

1. Growth of renminbi settlement of trade transactions

In April 2009 the Chinese authorities decided to introduce renminbi settlement of trade transactions with counterparties in Hong Kong, Macau and ASEAN on a trial basis in Shanghai and four cities in Guangdong (Guangzhou, Shenzhen, Zhuhai and Dongguan)[1]. The scheme began in September of that year. 365 Chinese companies took part. In the first six months (Jul–Dec 2009) only RMB3.58 billion of trade transactions was settled in renminbi (Figure 1).

In 2010, however, the scheme gathered pace as the Chinese companies involved in the trial became more accustomed to settling trade transactions in renminbi and as the number of overseas countries/territories involved increased from the original three. As a result, RMB18.35 billion of trade transactions was settled in renminbi in the first quarter (Jan–Mar) of 2010 and even more, RMB48.66 billion, in the second quarter (Apr–Jun).

2. The deregulation behind the growth of renminbi trade settlement

In June 2010, when the renminbi moved to a managed float, the rules governing renminbi settlement of trade transactions were eased. To be more precise, on 17 June 2010, six government departments/agencies (the People's Bank of China, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation, and the China Banking Regulatory Commission) promulgated a *Notice on Issues Relating to the Expansion of the Pilot Implementation*

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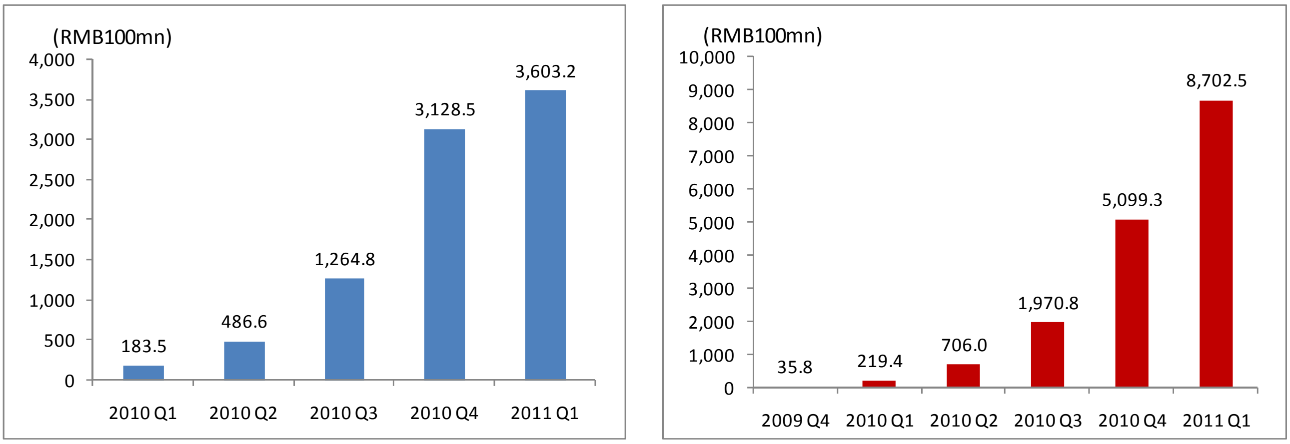
[1] For more on renminbi settlement of trade transactions and the internationalization of the renminbi, see Sekine, Eiichi, "Kokusaika ni Mukete Ugokidashita Chuugoku Jinmingen no Tenbou to Nihon no Taiou" [The Outlook for the Renminbi at the Start of Its Internationalization and Japan's Response], Capital Market Quarterly, Spring 2010 (Japanese only), and Nomura Institute of Capital Markets Research (ed.), "Kokusaika ni Mukete Ugokidashita Chuugoku Jinmingen no Tenbou" [The Outlook for the Renminbi at the Start of Its Internationalization], Zaikai Kansoku, Vol. 73-2 (Japanese only).

of Renminbi Settlement in Cross-border Trade (Notice). This resulted in the easing of the following regulations (Figure 2).

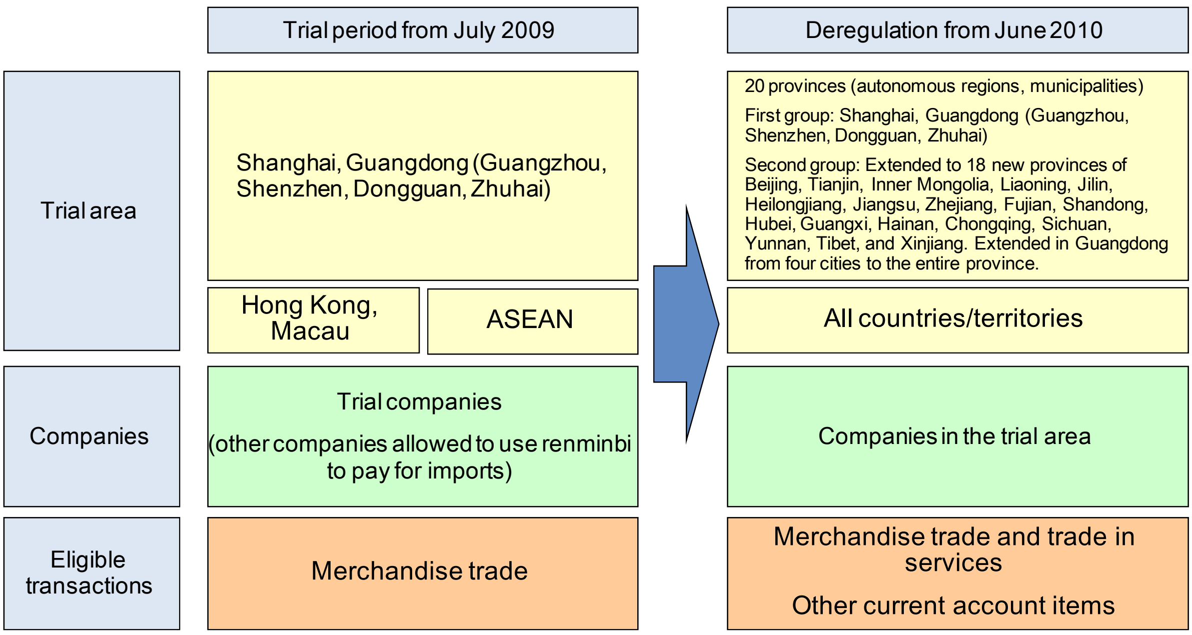
First, the geographical coverage of the trial was increased: from five cities in China to 20 provinces, autonomous regions, and municipalities directly under the central government; and from three overseas countries/territories to all overseas countries/territories.

Figure 1: Amount of trade settled in renminbi



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

Figure 2: Deregulation of renminbi settlement of trade transactions



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

Second, the number of companies eligible to take part was increased by allowing any company in the 20 provinces to apply for a license to settle trade transactions in renminbi. As a result, the number of eligible companies increased from the original 365 (as of July 2009) to 67,724 (as of end-2010).

Third, the range of eligible transactions was increased. Originally, only merchandise trade transactions were eligible to be settled in renminbi. Following the deregulation, however, this was extended to service and other current account transactions, so that all current account transactions became eligible.

3. Renminbi settlement of trade transactions in 2010

As a result, the amount of trade transactions settled in renminbi increased sharply in the third and fourth quarters (Jul–Sep and Oct–Dec) of 2010 (to RMB126.48 billion and RMB312.85 billion, respectively (Figure 1).As a result, the amount of trade transactions settled in renminbi increased to RMB506.34 billion in 2010, 141 times as much as in 2009 (RMB3.58 billion). As of end-2010, the total amount settled in renminbi since the scheme started in July 2009 was RMB509.93 billion.

As the value of China's trade in 2010 was $2,972.8 billion, the amount settled in renminbi ($76.5 billion) accounted for some 2.6% of the total.

The amount of trade transactions settled in renminbi has continued to increase in 2011. In the first quarter (Jan–Mar) it increased to RMB360.3 billion, some 71% of the total for 2010, while in Jan–Apr it reached RMB530.0 billion, more than the total for 2010.

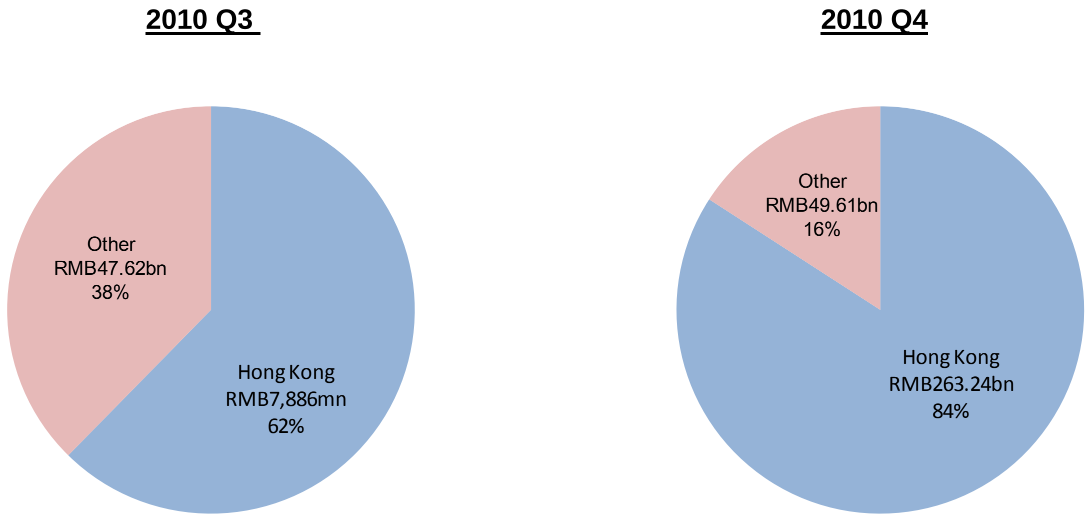
II. Renminbi settlement of trade transactions with Hong Kong

1. Imports accounting for the bulk of trade transactions settled in renminbi

The reason the Chinese government introduced renminbi settlement of trade transactions in the first place was to boost mainland Chinese exports, which had declined as China's export markets shrank as a result of the global financial crisis of 2008, by eliminating exchange rate risk.

In practice, however, renminbi settlement has become the preferred mode of settlement for mainland Chinese imports. For example, according to the People's Bank of China's *China Monetary Policy Report (Quarter Three, 2010)*, merchandise exports accounted for RMB17.73 billion (roughly 9%) of China's total trade transactions settled in renminbi as of end-September 2010. This compares with RMB157.09 billion (roughly 80%) for merchandise imports and RMB22.26 billion (roughly 11%) for trade in services and other current account items.

Figure 3: Breakdown by counterparty of trade transactions settled in renminbi



Note: China's trade settled in renminbi amounted to RMB126.48 billion in 2010 Q3 and to RMB312.85 billion in 2010 Q4.
Source: Nomura Institute of Capital Markets Research, based on data from People's Bank of China

2. Bulk of trade transactions settled in renminbi are with Hong Kong

Moreover, most of the imports settled in renminbi were from Hong Kong. Since July 2010, the Hong Kong Monetary Authority (HKMA) has published monthly data on trade transactions settled in Hong Kong in renminbi.

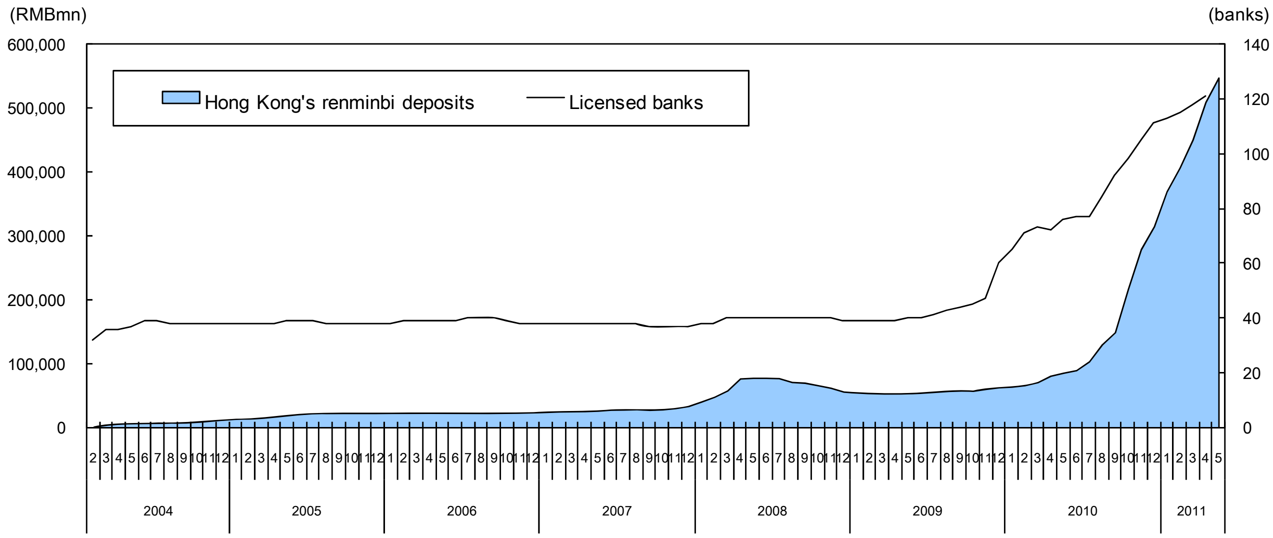
According to these data, transactions settled in renminbi accounted for RMB78.86 billion of Hong Kong's trade in the third quarter (Jul–Sep) of 2010. This amounts to 62% of Chinese trade transactions settled in renminbi during this period (RMB126.48 billion) (Figure 3). Similarly, transactions settled in renminbi accounted for RMB263.24 billion of Hong Kong's trade in the fourth quarter (Oct–Dec) of 2010. This amounts to 84% of Chinese trade transactions settled in renminbi during this period (RMB312.85 billion).

Transactions settled in renminbi accounted for RMB310.8 billion of Hong Kong's trade in the first quarter (Jan–Mar) of 2011. This amounts to 86% of Chinese trade transactions settled in renminbi during this period (RMB360.3 billion).

3. The surge in renminbi bank deposits in Hong Kong

Hong Kong's position as the source of the bulk of mainland Chinese imports settled in renminbi has led to a surge in renminbi bank deposits in Hong Kong. Following Hong Kong's SARS epidemic in 2003, the visa requirements for tourists from the mainland were eased to boost the Hong Kong economy. Since then, shoppers in Hong Kong have also been allowed to pay for their purchases in renminbi. As a result, Hong Kong banks have been allowed to accept deposits in renminbi since 2004.

Figure 4: Hong Kong's renminbi deposits



Note: The data for renminbi deposits in Hong Kong are for the period to May 2011; the data for licensed banks are for the period to April 2011.
Source: Nomura Institute of Capital Markets Research, based on HKMA data

As of end-July 2010 (i.e., just after the introduction of renminbi settlement of trade transactions), renminbi deposits in Hong Kong totaled RMB55.9 billion. As of end-July 2010 (i.e., just after the easing of the regulations on renminbi settlement of trade transactions), however, the figure was RMB103.7 billion, the first time that it has passed the RMB100 billion mark (Figure 4). Subsequently, as a result of the growth in renminbi settlement of trade transactions and the deregulation of the origination of renminbi financial products in Hong Kong (see below), the figure increased to RMB217.1 billion (as of end-October 2010), doubling in just three months to top RMB200 billion. By the end of 2010 it had topped the RMB300 billion mark to reach RMB314.9 billion; and, as of end-May 2011, it stood at RMB548.8 billion.

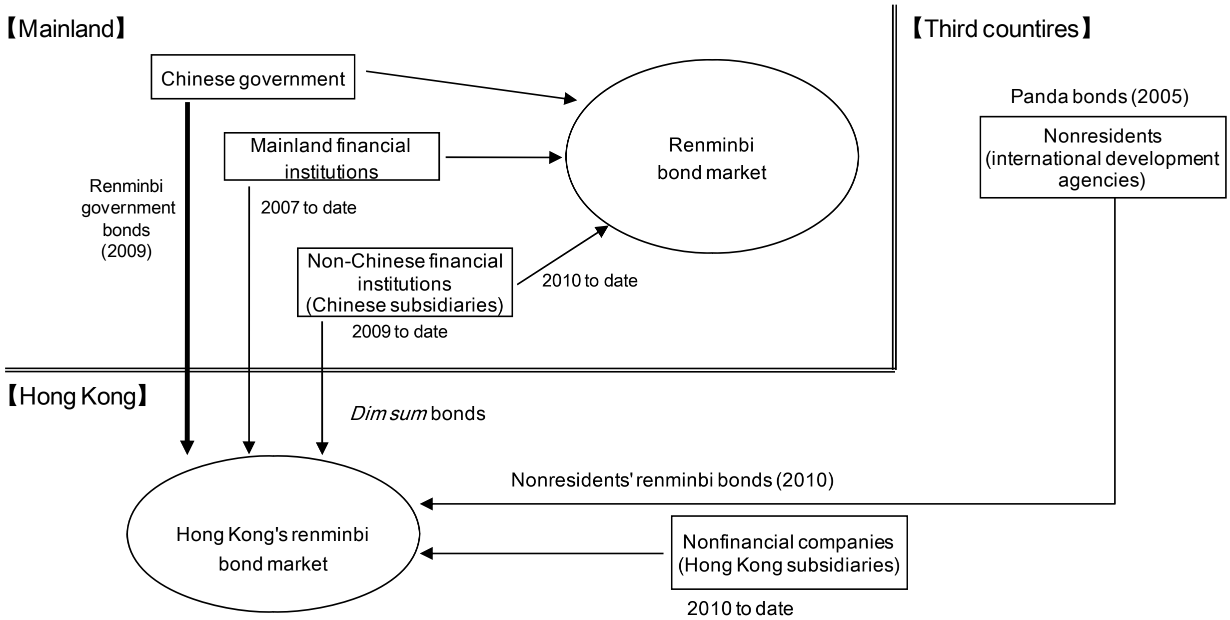
The number of banks in Hong Kong licensed to accept renminbi deposits has also increased: from 41 as of end-July 2009 (i.e., just after the introduction of renminbi settlement of trade transactions) to 121 as of end-April 2011. Hong Kong has therefore expanded rapidly as an offshore renminbi center, especially for bank deposits.

III. Growth of renminbi bond market in Hong Kong

1. Development of renminbi bond market in Hong Kong

Once banks in Hong Kong were allowed to accept deposits in renminbi in 2004, it became apparent that the lack of renminbi financial products that could generate the interest on those deposits was likely to be an obstacle to the development of Hong

Figure 5: Schematic diagram of issuers of renminbi bonds in Hong Kong



Note: Renminbi bonds issued by nonresidents on the mainland are called "panda bonds" in contrast to the "dim sum bonds" issued by nonresidents in Hong Kong.
Source: Nomura Institute of Capital Markets Research, based on data from various sources

Kong as an offshore renminbi center. In response, in June 2007, financial institutions qualifying as resident on the mainland (policy banks and commercial banks) were allowed to issue renminbi bonds in Hong Kong provided the People's Bank of China gave its approval (Figure 5). The first such issue was China Development Bank.

Since June 2009, eligibility has been broadened so that non-Chinese banks are now permitted to issue renminbi bonds in Hong Kong via their mainland subsidiaries. Furthermore, in October 2009, the Chinese government (in the form of the Ministry of Finance) issued renminbi bonds in Hong Kong for the first time.

2. *Dim sum* bonds

Renminbi financial instruments that enable those who have received renminbi outside China to invest their renminbi are a *sine qua non* if more trade transactions are to be settled in renminbi. Therefore, following the deregulation of renminbi settlement of trade transactions in June 2010, the Hong Kong Monetary Authority and the People's Bank of China signed a Supplementary Memorandum of Cooperation on the expansion of the renminbi trade settlement scheme in July of the same year. This enabled local Hong Kong subsidiaries and (what from the point of view of mainland China are) nonresidents to issue renminbi bonds.

The first issuer of such bonds was the Hong Kong conglomerate Hopewell Holdings, which used the proceeds to invest in infrastructure on the mainland (Figure 6). Hopewell was followed in August of the same year by the US fast food group McDonald's. Because McDonald's is such a familiar name in the fast food business,

Figure 6: Issuance of renminbi bonds in Hong Kong (by Hong Kong-incorporated entities and nonresidents)

Issuer	Settlement date	Maturity date	Maturity (years)	Maximum amount (RMB100mn)	Actual amount (RMB100mn)	Coupon (%)	Bookrunner
Hopewell Highway Infrastructure	7/13/2010	7/13/2012	2	13.8	13.8	2.98	BOC (Hong Kong)
McDonald's	9/16/2010	9/16/2013	3	2	2	3.00	Standard Chartered Bank
Asian Development Bank (ADB)	10/21/2010	10/21/2020	10	12	12	2.85	Deutsche Bank, BOC (Hong Kong)
Sinotruk	10/29/2010	12/23/2013	2	27	27	2.95	BOC (Hong Kong), ICBC (Asia), CICC
China Merchants Group	11/16/2010	11/16/2013	3	7	7	2.90	BOC (Hong Kong), BOC International
UBS	11/10/2010	n.a	2	1	1	2.50	n.a
China Resources Power Holdings	11/12/2010	11/12/2013	3	10	10	2.90	HSBC, Goldman Sachs
		11/12/2015	5	10	10	3.75	HSBC, Goldman Sachs
Caterpillar	11/2010	n.a	2	10	10	2.00	Goldman Sachs
VTB (VnezhTorgBank)	12/10/2010	12/23/2013	3	10	10	2.95	HSBC, VTB Capital
China Power International Development	12/15/2010	12/23/2015	5	8	8	3.20	Standard Chartered Bank
Galaxy Entertainment	12/17/2010	12/17/2013	3	13.8	13.8	4.63	Merrill Lynch, HSBC, UBS, BOC International
ANZ	12/21/2010	12/24/2012	2	2	2	1.45	ANZ, HSBC
World Bank (WB)	1/4/2011	1/4/2013	2	5	5	0.95	HSBC
RBS	1/6/2011	1/20/2014	3	1	1	1.80	RBS
Sinochem	1/18/2011	1/18/2014	3	35	35	1.80	Deutsche Bank, CITIC Securities
International Finance Corporation (IFC)	1/25/2011	1/27/2016	5	1.5	1.5	1.80	HSBC
Yen Foong Yu Group (YFY) (Taiwan, Cayman Islands)	2/11/2011	2/19/2014	3	3	3	3.10	ICBC (International), SinoPac Securities
Total					172.1		

Note: Bookrunners have to be Hong Kong-incorporated financial institutions.
Source: Nomura Institute of Capital Markets Research, based on various sources

market participants in Hong Kong decided to call these bonds "*dim sum* bonds" after Hong Kong's equally popular dumplings.

Issuance of these bonds, taking public offerings alone, has increased and now includes supranational agencies, such as the World Bank, the International Finance Corporation (IFC) and the Asian Development Bank (ADB), European and US financial and nonfinancial companies, red chips (mainland Chinese companies incorporated outside the mainland and listed in Hong Kong), and Taiwanese companies. According to local securities companies we talked to, (1) issuance of these bonds is not restricted so long as the renminbi proceeds are not remitted to the mainland (see below); (2) the bonds do not have to have a credit rating; and (3) some bonds are issued as private placements, although there is no disclosure of information.

3. Launch of a wide range of renminbi financial products

The deregulation of the origination and sale of renminbi financial products in Hong Kong in July 2010 has led to the launch of a wide range of such products. First, a series of renminbi derivative deposits, certificates of deposit, and life insurance savings products was launched.

Second, some mainland-based securities companies have begun to launch and sell renminbi investment trusts (e.g., in August 2010 Haitong Securities launched an RMB5 billion renminbi bond while Guotai Junan Securities now allows its customers to open stock accounts denominated in renminbi). Similarly, Bank of

Communications and some other financial institutions now allow their customers to use their renminbi accounts as collateral when dealing in H shares.

Third, a number of institutions have issued "synthetic" renminbi bonds, whose par value is in renminbi but which actually trade in US dollars. The first such issue was in January 2007, after which there was a pause until the next (in September 2010). Most of these bonds have been issued as structured products by real estate companies that expect the renminbi to appreciate and see this as a way of reducing their funding costs.

In addition, in November 2010, the Chinese government issued its second renminbi bond (RMB8.0 billion) in Hong Kong. RMB5.0 billion of this was earmarked for institutional investors and issued by Hong Kong's Central Moneymarkets Unit. Since February 2011, Hong Kong banks have also been allowed to accept renminbi bills of exchange.

IV. Lifting of ban on direct investment in renminbi

1. Sources of funds for Hong Kong's offshore renminbi market

Since July 2009, Hong Kong has seen inflows of renminbi from the mainland as a result of renminbi settlement of imports to the mainland. However, Hong Kong's offshore renminbi market will have to become more liquid if Hong Kong is to see inflows of renminbi from destinations other than the mainland as a result of renminbi settlement of exports from the mainland. At the moment, Hong Kong's offshore renminbi market gets its liquidity from (1) payment in renminbi for shopping by tourists from the mainland, (2) the conversion of Hong Kong dollars to renminbi by Hong Kong residents (limited to RMB20,000/day), and (3) payment in renminbi for imports by mainland companies. In future, however, (4) outward direct investment in renminbi is likely to be another source.

2. Outward direct investment in renminbi dating back to 2009

On 13 January 2011 the People's Bank of China promulgated the *Administrative Measures for the Pilot RMB Settlement of Outward Direct Investment* (with immediate effect). However, prior to this, in 2009, renminbi settlement of outward direct investment was permitted at a local level on a trial basis. The trial began in Shanghai. More specifically, in April 2010, the Shanghai branch of the People's Bank of China first allowed Shanghai-based companies to fund outward direct investment in renminbi and banks to lend them renminbi for that purpose. As a result, as of end-September 2010, outward direct investment by Chinese banks and companies in renminbi totaled RMB30.5 billion (166 projects).

Then, in October 2010, the Urumqi branch of the People's Bank of China allowed companies based in the Xinjiang Uyghur Autonomous Region to fund outward direct investment in renminbi and non-Chinese companies to fund direct investment in the region in renminbi. Then, in December of that year, the State Administration for

Industry & Commerce (SAIC) ratified a policy (*Opinions on Supporting the Strategy of Developing Yunnan as a Major Bridgehead for Opening Up China to the Southwest*) that allows foreign investors to use renminbi to invest in the province's border regions (prefectures and cities). As a result, as of end-December 2010, outward direct investment by Chinese banks and companies in renminbi totaled RMB70.17 billion (386 projects).

3. Examples of outward direct investment using renminbi

Outward (non-cumulative) direct investment by Chinese nonfinancial companies in 2010 totaled a record $59.0 billion. However, it would be a misconception to assume that the renminbi will immediately replace all other currencies used to fund outward direct investment just because its use for this purpose has been approved. This is because the lion's share of the outward direct investment by Chinese companies is in natural resources, investment and trading in which on international markets has traditionally been conducted in US dollars. Furthermore, the use of renminbi for this purpose would require the countries receiving the investment to have financial markets allowing deposits to be made in renminbi.

According to the Chinese media[2], the following Shanghai-based companies had applied to make RMB418 million in outward direct investments as of end-2010, RMB313 million of which had already been invested: Shanghai Electric Group (a mechanical and electrical equipment manufacturer), Shanghai Pengxin Group (a conglomerate engaged in real estate development, agribusiness, mining, and infrastructure construction & investment), Wishark Enterprises (a trading company), and Shanghai Sinopacific International Trade (a trading company). The four companies have apparently invested in Hong Kong, Japan, India and the Congo.

A spokesperson for Shanghai Pengxin Group is reported to have given the following three reasons for the company's use of renminbi to invest in the Congo. First, it enabled the company to reduce its forex costs. Second, it made it easier for the company to obtain the production equipment from Chinese suppliers and pay its Chinese subcontractors and consultants. Third, if there are any problems (e.g., regarding settlement or the financial system) in the country the company is investing in, all its overseas subsidiary has to do is to open a nonresident's account in China, obviating the need to remit renminbi overseas.

In the view of one specialist on the internationalization of the renminbi (e.g., for trade settlement overseas), the official lifting of the ban on the use of the renminbi for outward direct investment was (1) most likely to be used in China itself by Chinese companies and their overseas subsidiaries to settle the purchase of plant and equipment and (2) more likely to be used for investing in Asia, Africa and Latin America than in developed economies.

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2 See First Financial Daily, 10 March 2011.

V. Routes by which renminbi can find their way back to the mainland

1. Routes back from Hong Kong

As we have seen, since July 2009, Hong Kong has seen inflows of renminbi from the mainland as a result of renminbi settlement of imports to the mainland. However, there are not many routes by which renminbi can find their way back from Hong Kong to the mainland. This is because, as far as the mainland is concerned, Hong Kong's offshore renminbi center is simply a testing ground until capital transactions on the mainland are deregulated and the renminbi is fully convertible. Restricting the routes via which renminbi can find their way back to the mainland is intended to minimize the impact of the experiment on mainland monetary policy.

From the start, there has been a wide spread between interest rates on renminbi deposits in Hong Kong, where rates are determined by demand and supply, and rates on the mainland, which are still regulated by the People's Bank of China (Figure 7). In view of this, the following routes by which renminbi can find their way back to the mainland either exist or are envisaged.

1) Route via issuance of renminbi bonds in Hong Kong (existing route)

Although the issuance of renminbi bonds in Hong Kong is not subject to any particular restrictions, the approval of the People's Bank of China is required in order to remit the proceeds to the mainland. More specifically, the approval of the Bank's Monetary Policy Department II, which is responsible for regulating cross-border renminbi transactions, is required.

Figure 7: Comparison of on- and offshore interest rates

【Mainland interest rates】

Deposit rates		Lending rates	
Sight deposits	0.50		
Fixed (3 mths)	3.10		
Fixed (6 mths)	3.30	6 mths	6.10
Fixed (1 yr)	3.50	1 yr	6.56
Fixed (2 yrs)	4.40	1 yr-plus-3 yrs	6.65
Fixed (3 yrs)	5.00	3 yrs-plus-5 yrs	6.90
Fixed (5 yrs)	5.50	5 yrs-plus	7.05

【RMB deposit rates in Hong Kong】

Sight deposits	
RMB5,000 or less	-
RMB5,000-plus-RMB199,999	0.25%
RMB200,000-plus	0.30%

Fixed deposits	
7 days	0.30%
14 days	0.30%
1 mth	0.50%
2 mths	0.50%
3 mths	0.55%
6 mths	0.60%
12 mths	0.60%

Note: 1. Mainland interest rates as of 7 July 2011.
2. Hong Kong (BOC) interest rates as of 12 July 2011.
Source: Nomura Institute of Capital Markets Research, based on various sources

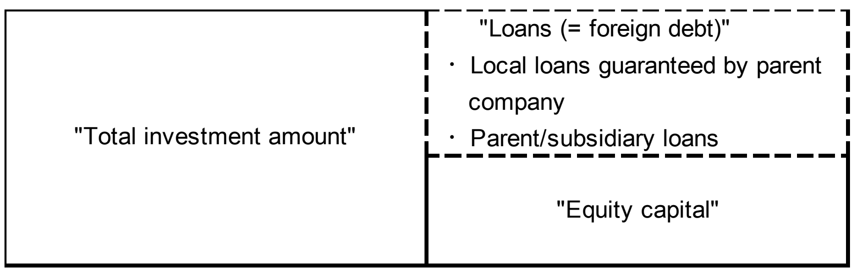
Similarly, a company seeking to remit the proceeds of such an issue to a subsidiary established on the mainland (in the form of a parent/subsidiary loan) needs to register this as "foreign debt" with the State Administration of Foreign Exchange (SAFE) as this is what the loan is as far as the mainland is concerned, even if it is a renminbi loan. Foreign-invested companies in China must not normally exceed the difference between their officially approved total investment amount and registered capital (i.e., their "foreign debt") and must register it with SAFE to enable SAFE to control the total amount of foreign debt in China (Figure 8).

On 14 January 2011, SAFE's Shanghai bureau issued a notice requiring foreign debt (including parent/subsidiary loans in renminbi) to be officially registered. We assume that this was aimed at parent/subsidiary loans in renminbi from the proceeds of renminbi bond issues in Hong Kong. We expect the notice to affect the issuance of renminbi bonds in Hong Kong the proceeds of which are intended to be remitted to the mainland. Following the issue of a new notice by SAFE on 7 April 2011, this now applies to the whole country.

2) Route via investments in A shares by means of mini-QFII scheme (planned route)

Under the existing QFII (pronounced "Cuefee") scheme, overseas institutional investors licensed by the China Securities Regulatory Commission (CSRC) can remit US dollars to the mainland up to the amount of the investment quota allocated by SAFE and convert them to renminbi to buy A shares. Under the new ("mini-QFII") scheme, currently under consideration, mainland securities companies and fund management companies would be allowed to purchase A shares via their subsidiaries in Hong Kong using renminbi from non-mainland accounts, including those in Hong Kong. The name "mini-QFII" reflects the fact that the scheme would be smaller in scale than the existing (QFII) scheme for overseas institutional investors.

Figure 8: Schematic diagram of rules on total investment amount and "foreign debt" (foreign loans)



Note: 1. Total investment amount – equity capital = loans (= maximum permissible foreign debt).
2. Maximum permissible foreign debt = outstanding short-term (12 mths or less) foreign debt + cumulative medium- to long-term (more than 12 mths) foreign debt.
3. Local loans guaranteed by parent company are treated as "foreign debt" when they are repaid.

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

The new scheme was originally due to be introduced back in 2010. However, it seems that China's monetary authorities are concerned about a possible influx of hot money and are biding their time.

3) Route via investments in mainland interbank bond market (existing route)

On 17 August 2010 the People's Bank of China permitted (1) overseas central banks, (2) renminbi clearing banks in Hong Kong and Macau (Bank of China), and (3) overseas banks authorized to settle trade transactions in renminbi to participate in China's interbank bond market. In return, banks wishing to participate in the market were required to obtain a license and an investment quota from the People's Bank of China.

Of the banks eligible in category (1), the Hong Kong Monetary Authority obtained a license in December 2010. As it obtained a QFII license to invest in (renminbi-denominated) A shares in October 2010, its acquisition of a second license meant that it was now licensed to invest in both mainland bonds and equities. Of the banks eligible in category (3), a number, including Industrial and Commercial Bank of China (ICBC) (Asia), already had a license, while, on 21 March 2011, eight new banks, including the Hong Kong branch of Bank of Tokyo–Mitsubishi UFJ, acquired a license.

2. Outlook for Hong Kong's offshore renminbi market

Although the routes via which renminbi can find their way back to the mainland are limited, we see no change for the time being in the tendency for renminbi deposits in Hong Kong to increase so long as mainland companies are able to settle import transactions there in renminbi and Hong Kong depositors expect the renminbi to continue to appreciate. According to a report published on 9 March 2010, HSBC expects renminbi deposits in Hong Kong to reach RMB1 trillion by the end of 2011 and RMB2.3 trillion by the end of 2012[3].

Renminbi deposits in Hong Kong therefore need to continue to increase if Hong Kong's offshore renminbi center is to continue to become more liquid. Ba Shusong, vice director of the Financial Research Institute, Development Research Center of the State Council has stated that he sees Hong Kong's development as an offshore renminbi center going through three stages in terms of renminbi flows[4]. In the first stage, renminbi flow from the mainland while, at the same time, routes are created to enable these renminbi to flow back to the mainland. In the second stage, renminbi circulate freely in Hong Kong and independently of renminbi markets on the mainland. In the third stage, renminbi accumulate in Hong Kong from outside Asia to form a true offshore market. In Mr Ba's view, we are currently at the first stage.

[3] See First Financial Daily, 9 March 2011.
[4] See China Securities Journal, 11 March 2011.

VI. Role of Hong Kong's offshore renminbi market

1. Lessons for Japan

We think that the development of Hong Kong's offshore renminbi market will offer Japanese companies, financial institutions, and investors the following opportunities.

1) Hong Kong's offshore renminbi market as a source of funds

Although, as we have seen, borrowers on Hong Kong's offshore renminbi market need to seek approval from the People's Bank of China and to register their "foreign debt" with SAFE if they wish to remit the proceeds of a bond issue to the mainland, the market gives them access to funds at what could be a lower rate of interest than on the mainland. Also, while the issuance of renminbi bonds by non-Chinese companies on the mainland market is restricted, issuance on Hong Kong's renminbi bond market may also be worth considering in terms of asset/liability management.

In March 2011 Orix issued an RMB400 million *dim sum* bond in Hong Kong and was followed in April by Tokyo Century Lease, which issued an RMB200 million bond. Japanese financial institutions have also featured as co-managers in such issues. The Ministry of Commerce, SAFE, and the People's Bank of China have each issued notices on inward direct investment in renminbi (covering equity stakes, capital increases, M&A, and parent/subsidiary loans), and cross-border capital account transactions in renminbi may continue to increase.

2) Investing in renminbi financial products in Hong Kong

Provided they have a renminbi account in Hong Kong, Japanese institutional investors can now also buy renminbi financial products in Hong Kong. While the absence of a system to allow non-Chinese investors to participate in China's interbank bond market could well present some liquidity problems, we welcome the increased choice of asset class that the ability to buy renminbi bonds in Hong Kong presents. In addition, Japanese retail investors can now also buy renminbi bonds in Hong Kong. On 20 January 2011 Monex began to trade (existing) renminbi government bonds issued in Hong Kong.

2011 has also seen the possibility of renminbi IPOs in Hong Kong. With this in mind, the Hong Kong Monetary Authority has begun to consider setting up a "renminbi pool." Although the details of such a scheme are as yet unclear, the basic idea is to increase the opportunities for buying renminbi financial products (without changing the total amount of renminbi in Hong Kong) by allowing investors without any access to renminbi funds to buy renminbi financial products by selling foreign exchange and to receive foreign exchange when they sell those products. Professor K C Chan, Hong Kong's Secretary for Financial Services and the Treasury, sees the creation of renminbi products in Hong Kong as a three-stage process, starting with bonds, continuing with investment trusts, and ending with IPOs[5]. It will therefore be interesting to see how Hong Kong goes about creating a renminbi pool. In this context, it is perhaps worth mentioning that Cheung Kong Holdings launched an IPO for group company Hui Xian REIT in April 2011. Hui Xian is Hong Kong's first renminbi-denominated REIT.

3) Reassessment of Hong Kong by corporate treasuries

Once renminbi settlement of trade transactions between Hong Kong and the mainland becomes more widespread, once Hong Kong's market for renminbi deposits becomes more liquid, and once it becomes easier to borrow renminbi in Hong Kong (e.g., by issuing bonds), the treasury officers of global companies are likely to reassess Hong Kong's importance.

We can already see this happening among Japanese companies. According to the Nikkei (3 March 2011), Sony has decided to make Sony Global Treasury Services (Hong Kong), the local subsidiary of its UK financial subsidiary, the forex management center for all its operations in China. It will apparently settle transactions with Sony's mainland subsidiaries in renminbi and transactions with group companies in the rest of Asia in US dollars. We imagine that this is exactly the kind of development that the Hong Kong Monetary Authority was aiming for when it decided to create an offshore renminbi market.

2. Signs of deregulation spreading to the mainland

The degree of interest in raising renminbi funds in Hong Kong is a reflection of the restrictions non-Chinese borrowers face on raising these funds on mainland markets. Moves by the Shanghai Stock Exchange to establish a "foreign board" (similar to the one on the Tokyo Stock Exchange) should be seen in this light.

One of the aims for this year of the National Working Conference on Securities & Futures Regulation held by the CSRC in January was to consider establishing such a board, draw up the necessary regulations, and make all the necessary technical preparations. In an interview he gave at the National People's Congress on 9 March of this year, the president of the Shanghai Stock Exchange, Geng Liang, said that (1) a preliminary draft of the four main sets of regulations for an international board (covering issuance, trading, listing and settlement) had been completed, (2) 80–90% of the technical preparation had been done, and (3) work was under way to improve supervision and disclosure for an international board. Although no detailed timetable has been published, the preparatory work on setting up a foreign board was due to be completed by the middle of this year. The exchange has also announced that it hopes to be in position by 2013 to allow non-Chinese companies to issue A shares on the mainland, where they will have access to the main source of renminbi funds. We will therefore need to keep an eye on how the rules governing the access to renminbi funds are eased on the mainland as well as in Hong Kong.

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5 See First Financial Daily, 19 January 2011.