Comments on "The Evolution of Offshore RMB Trading: 2016 to 2019"

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Cheung et al. (2019) and Cheung et al. (2020)

- This study offers a very timely and comprehensive analysis of the evolution of offshore RMB trading during 2016 and 2019
- It is a follow-up study of a previous research "Geographic spread of currency trading: the RMB and other EM currencies" using the 2013-2016 BIS triennial survey
- With the newly released 2016-2019 BIS triennial surveys, this paper brings us new evidence and insights on how changes in geopolitical environment, trade disputes, and China's policies etc. may have shaped the trading pattern of offshore RMB

Interesting findings of the paper

- Are growing international financial centers seeing growing shares in RMB trading?
  - Without accounting for disputes and trade related variables, the answer is Yes.
  - But with these variables, the answer is No.
- Does the current 2016-2019 data display evidence that the offshore RMB trading is transitioning to the global FX trading pattern?
  - Without trade variables, No. This is in contrast to 2013-2016
  - But accounting for the trade-related factors, the answer is Yes

What implications do we get?

- Policies that jump-starts an international currency are effective, as the trading geography of RMB shows evidence of converging to the geographical distribution of global FX trading over 2013-2016
- Over 2016-2019, although RMB still presents tendency of converging to global currency, it is only the case in jurisdictions that **do not have** a political or trade tension with China
- New evidence suggests that the **diffusion process** of the RMB driven by market forces can be interfered by trade disputes and changing geopolitical environments
- These factors posed frictions to RMB's long journey towards a global currency

Policy shifts and onshore market strengthens

Besides the trade disputes and geopolitical environment, some other events took place in the mean time, which may be associated with the trading experiences of offshore RMB

- The recent priority for the Chinese authorities has been stability and the strengthening of existing capital controls
- Less prioritized promoting the RMB internationalization
- Stepped up financial market reform to open up domestic onshore market: re-route and divert some of the foreign investors from the offshore market

Unintended effect from policy combinations may likely to make a pause in the RMB internationalization process

Policy related to promoting RMB internationalization before 2016 (Source: wikipedia)

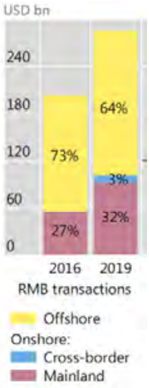
- 2002, Domestic Securities Investment by Qualified Foreign Institutional Investor (QFII regulation) was announced in November[27] allowed foreign investors to access mainland stock markets (A-shares).
- 2003, PBoC designates BoC-HK as RMB clearing and settlement bank.
- 2004, RMB deposits in Hong Kong is allowed. By the end of 2013 RMB deposits totalled ¥860 billion, an increase from ¥315 billion in 2010, which account for around 12% of total deposits in the Hong Kong banking system, up from 1% in 2008.[25]
- 2006 (Apr), the Chinese government announced the Qualified Domestic Institutional Investor (QDII) scheme, allowing Chinese institutions and residents to entrust Chinese commercial banks to invest in financial products overseas. The investment was initially limited to fixed-income and money market products.
- 2007, establishment of the Offshore RMB bond market—'dim sum bonds'—which has doubled in size each year since 2008.
- 2008 (Dec), implementation of Cross-Border Trade RMB Settlement Pilot Project. The first Bilateral Swap Agreement was signed with South Korea.
- 2011 (Dec), PBC released the Announcement of the People's Bank of China Concerning the Implementation of Measures for the Pilot Program of Allowing Fund Management Companies and Securities Companies Approved as Renminbi Qualified Foreign Institutional Investors (RQFII) to Invest in Domestic Securities Market. The RQFII program allows RMB investment funds to be set up in Hong Kong and invest in mainland China's securities markets.[18] As of July 2014, the RQFII scheme as extended to six countries with total approved quotas of ¥640bn.
- In December 2013, the RMB overtook the euro to become the second most-used currency in global trade finance after the US dollar, according to the Society for Worldwide Interbank Financial Telecommunication (SWIFT).[28]
- 2014 (April), the China Securities Regulatory Commission (CSRC) and the Securities & Futures Commission of Hong Kong (SFC) announced in a joint statement a trial trading program known as Shanghai-Hong Kong Stock Connect, which will allow two-way cross-market stock investment by qualified Mainland Chinese and Hong Kong investors. The pilot program will operate between the Shanghai Stock Exchange (SSE), the Stock Exchange of Hong Kong Limited (SEHK), the China Securities Depository and Clearing Corporation Limited (ChinaClear) and the Hong Kong Securities Clearing Company Limited (HKSCC). SSE and SEHK will allow investors to trade eligible shares listed on each other's markets through local securities firms or brokers.[29]
- 2014 (May), Shanghai Free Trade Zone materialized and later (15 July), SAFE issued Circular 36 to extend benefits to foreign-invested enterprises (FIEs) in other 16 industrial parks and economic zones.[30]
- as of August 2014: (i) more than 10,000 financial institutions are doing business in RMB, up from just 900 in June 2011; (ii) the RMB is now used to settle 18% of China's total trade, from just 3% in 2010; (iii) China has currency swap agreements with 25 central banks with the total amount of over ¥2.7 trillion; (iv) there are now eight official offshore RMB clearing centres – Hong Kong, Macau, Taiwan, Singapore, London, Germany, Korea, and the latest is Canada (signed November 2014).
- 2014 (17 Nov), the Shanghai-Hong Kong Stock Connect debuted with a bang, hitting its RMB13bn one-day trading cap at 13:57 HK time (less than five hours after markets opened).
- 2015 (Jul), PBoC open up the $5.7 trn interbank bond market to foreign Central Banks, Sovereign Wealth Funds and international financial institutions. Previously quota was given to the relevant foreign investors on a case-by-case basis. The relevant investors can conduct trading of cash bond, repo, bond lending, bond forward, interest rate swap, forward rate agreement and other transactions permitted by the PBC. Relevant overseas institutional investors can decide on their own the size of their investments.
- 2015 (11 Aug), PBoC improved the quotation mechanism of USD/CNY to become more market-based.[31]
- 2015 (8 Oct), the China International Payments System (CIPS) is launched,[32][33] as an alternative to SWIFT.

Policy related to promoting RMB internationalization after 2016 (Source: wikipedia)

- 2016 (24 Feb), PBoC lifted the barrier into China Interbank Bond market (IBB), the world 3rd largest credit market (RMB 48 trn).
- 2016 (3 May), PBoC expended the pilot program for macro prudential management of cross border financing from free trade zone to nationwide.
- 2016 (24 June), direct RMB/KRW trading in CFETS
- 2016 (Aug), the World Bank, the first issue of SDR bonds in CIBM (SDR 500m, 3-year payable in RMB) with bid-to-cover ration of 2.47[34]
- 2016 (1 Oct), RMB is included in SDR Basket (i.e. 41.73% USD, 30.93% EUR, 8.33% JPY, 8.09% GBP and 10.92% CNY)
- 2017 (16 May), PBC and HKMA jointly announced Bond Connect to enable bond trading between Mainland and HK institutional investors[35]
- 2019 (11 June), RQFII and QFII quotas are lifted
- 2020 RMB share of foreign exchange market rose to 4.3% (up 0.3% from 2016), ranked 5th globally but only used for 1.76% of payments, despite China 10% contributio global trade in goods. More than 70 central banks and monetary authorities have already incorporated RMB into their FX reserves. PBoC said China will further facilitate border use of RMB to boost trade and investment.[36]

Some evidence

- RMB onshore trading surpassed offshore trading in 2019 for the first time
- For the first time in over a decade, the relative importance of onshore RMB trading on platforms such as CFETS increased, while the share of CNH turnover declined, from 73% in 2016 to 64% in 2019 (BIS Quarterly Review, Dec 2019)



Some evidence con't

- Foreign ownership of RMB-denominated Chinese government bonds rose to a record high with 22 months continuous inflow as of September 2020
- Foreign ownership of Chinese government bonds has increased notably from only 2% in 2010 to 3.6% in 2016, and to about 9.4% in the third quarter of 2020

source: https://asianbondsonline.adb.org/data-portal

Some evidence con't

- Bond Connect has experienced steady growth with outstanding bonds held by overseas investors growing at roughly 28% yoy per month over the past 12 months.
- As of the end of Feb 2020, holdings by overseas investors approached RMB 2.3 trillion, an increase of more than 170% from before the launch of Bond Connect

Figure: Outstanding balance and net inflows

Some explanations

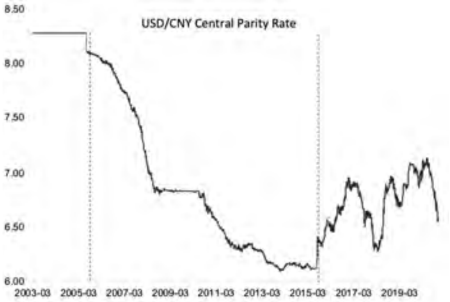
- Return on offshore deposits declined, causing a retrenchment
- Reduced issuance of offshore RMB bonds, i.e. dim-sum bonds
- Opened more direct ways to access onshore RMB market (stock connect, bond connect, further open-up for interbank market, increased quota for QFII)
- The recent inclusion in major global bond indexes will further boost foreign participation of local currency debt through direct onshore transactions

The FX market's turnover dominates trade flows

- Captures trade effect on offshore RMB trading, e.g. cross-border trade settlement
- BIS reports FX trading is driven mostly by financial instead of trade
- In 2019, \$ 5.1 trillion per day (gross) $\approx$ \$1020 trillion/year
- If each transaction is passed around 10 banks, net turnover is \$102 trillion/year
- The value of world trade in goods and services in 2018 was \$19.67 trillion
- Transactions in the FX market is driven by sentiment
- Decomposition of offshore RMB trading into spot trading vs. FX swaps trading

RMB's exchange rate and speculative positions

- The lower turnover share relative to the economic size and trade volume may also be associated with RMB's exchange rate uncertainty
  - Previous accumulation of speculative positions could be built on the expectation that the RMB was going to rise in value
  - The RMB weakened after mid-2015 (since the major RMB's exchange rate regime reform), which may have reduced market's willingness to hold it and use it



source: CFETS

Conclusion

- This paper is very insightful and thought-provoking, and the findings are critical for policy makers, as well as market participants
- Although RMB globalization had made great progress in the past ten years, the path towards a final real international currency is somewhat less firm in the past three years
- A global RMB needs to be backed by a large, deep and liquid onshore RMB market
- A global RMB also needs to be backed by a liberalized capital account that allows RMB to be more convertible
- History strongly advises patience when it comes to the emergence of new super-currencies; We shall look forward to the next three years and the future research