Internationalising the Renminbi

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The Chinese authorities have introduced reforms over the past few years aimed at increasing the use of the renminbi (RMB) in international trade and investment. This article outlines the recent developments, focusing in particular on the offshore market for RMB and the RMB trade settlement scheme. These initiatives have been supported by the signing of bilateral local currency swap agreements between the People's Bank of China (PBC) and other central banks, including the Reserve Bank of Australia.

Introduction

Recent reforms introduced by the Chinese authorities have sought to increase the use of the RMB in international trade and investment. In contrast to a few years ago, it is now possible for any trade transaction with China to be contracted in RMB. As a result, over the past year, the equivalent of US$360 billion or roughly 10 per cent of China's international trade was settled in RMB. While the development of the offshore market for RMB has been a key part of the reform strategy, capital controls restrict the flow of funds between the onshore and offshore markets, thereby preventing full convertibility.

Recent Progress on Reforms

The recent reforms can be seen as part of the broad economic reform agenda that has been ongoing for more than three decades. Over this period, measures undertaken to develop the financial sector have included: the entry of new domestic banks and non-bank financial institutions; the reopening of the Shanghai and the opening of the Shenzhen stock exchanges; the development of the interbank lending, bond and currency markets; the introduction of international regulatory standards; and a general improvement in financial infrastructure.[1] It has also included some easing of capital controls, with the Chinese economy opening up to foreign direct investment (FDI) in the early 1980s and to certain portfolio investments through the Qualified Foreign Institutional Investor (QFII) scheme from 2003.

The exchange rate system has also evolved over the past few decades.[2] The 'dual' exchange rate system, which developed in the late 1980s and allowed both an official and a more market-determined exchange rate to coexist, was replaced in 1994 by a single official rate under a managed floating regime (Graph 1).[3] This regime was replaced by a peg against the US dollar in 1997. In 2005, the Chinese authorities announced that they would manage their exchange rate against an undisclosed basket of currencies. This marked the beginning of a period of generally steady appreciation of the RMB against the US dollar,

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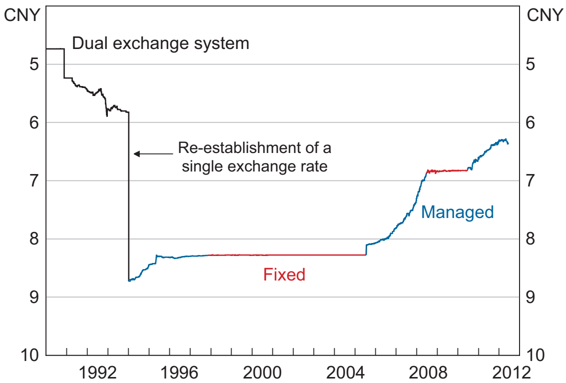
1 In the late 1970s, almost all commercial banking was undertaken by the PBC. But in the late 1970s and early 1980s, most of this business was handed over to the newly created 'big four' banks: the Bank of China, the China Construction Bank, the Agricultural Bank of China and the Industrial and Commercial Bank of China.

2 An article by PBC Deputy Governor Yi Gang (2008) provides a description of these developments.

3 The renminbi (RMB) is the name of the Chinese currency, while yuan refers to the units of the currency. The RMB is available in two markets: CNY (Chinese yuan) denotes the exchange rate available in the onshore (Mainland China) market; and CNH ('H' for Hong Kong) denotes the exchange rate available in the offshore (predominantly Hong Kong) market. The local currency in Hong Kong is the Hong Kong dollar.

Graph 1
RMB per US Dollar*
Inverted scale



* Onshore exchange rates
Sources: Bloomberg; RBA

except for a two-year pause from around mid 2008 associated with the global financial crisis.

The current reform agenda has an increased emphasis on currency reform. Both the Twelfth Five-year Plan of the Chinese State Council, which covers 2011–2015, and a recent PBC report[4] highlight the intention to steadily open up the domestic financial market to the rest of the world and gradually liberalise the capital account. The reform agenda has three main streams, as shown in Table 1 which provides a timeline of reform measures. The use of pilot programs, as well as regional and local initiatives, continues the style of approach inspired by the Chinese political leader Deng Xiaoping, which he described as 'crossing the river by feeling the stones'.

The first reform stream, which was the initial focus of the recent reforms, involves promoting the use of the RMB for trade and, relatedly, developing an offshore market for RMB (i.e. outside Mainland China). The initial pilot RMB trade settlement scheme introduced in July 2009 was relatively limited in scope, allowing approved Mainland exporters and importers in five Chinese cities to conduct trade denominated in RMB with trading partners in Hong Kong, Macau and the ASEAN countries.[5] In mid 2010, the scheme was opened up to include participation by trading partners anywhere in the world, although domestic participation in the scheme was still restricted. Since then, the remaining restrictions on domestic participation have been removed and now any trade with Mainland China can be invoiced in RMB.

The offshore accumulation of RMB under the RMB trade settlement scheme has created demand for offshore investment opportunities in addition to deposits, which in turn has made RMB trade settlement more attractive.[6] Moreover, the ongoing development of the offshore RMB market encourages the international use of the RMB, while allowing the authorities to both relax onshore capital controls and deregulate the domestic financial system more gradually than otherwise.

The second reform stream concerns inward and outward capital flows. While relatively strict controls remain in place, there has been a notable easing in these controls since late last year. This is particularly true with respect to inward flows, as evidenced by the streamlining of the approval process for using RMB raised offshore for foreign direct investment onshore. While the strictest controls still relate to portfolio investment schemes, the authorities are considering broadening the range of both offshore investors and onshore investments included under such schemes. The enhanced ability for funds raised in the offshore bond and equity markets to be used for onshore investment should ultimately support the development of the offshore market, while also

4 PBC (2012); a brief summary of the report is published on the PBC website, available at <http://shanghai.pbc.gov.cn/publish/fzh_shanghai/2974/2012/20120428104657157116808/20120428104657157116808_.html>. A separate PBC report (Sheng *et al* (2012)) outlined the case for capital account liberalisation and proposed a three-stage, 10-year plan. The first stage (1–3 years) would involve the liberalisation of direct investment flows, especially those related to Chinese FDI abroad. The second stage (3–5 years) would involve relaxing controls on commercial lending for trade, which the report suggests would also broaden the channels for inbound RMB flows. The final stage (5–10 years) would involve carefully opening up real estate, stock and bond markets to cross-border flows, following the principle of first relaxing controls on inflows, followed by outflows, and in each case gradually allowing quantitative controls to be replaced by price-based management.

5 The Association of Southeast Asian Nations (ASEAN) includes Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

6 Prior to these recent developments, an elementary offshore market for RMB began to emerge in 2004 when banks in Hong Kong were permitted to offer personal RMB deposit accounts.

Table 1: Main Developments in Recent RMB Reform

1. Trade settlement and offshore market	
RMB trade settlement	
Jul 2009	Initial pilot scheme between five Mainland cities and Hong Kong, Macau and ASEAN
Jun 2010	Expanded scheme for trade between 20 Mainland provinces and rest of the world
Mar 2012	Expanded to cover all trade with China
Offshore RMB market	
Feb 2004	Hong Kong banks permitted to offer RMB personal accounts to residents
May 2009	HSBC and Bank of East Asia are first foreign banks to gain approval to issue offshore RMB (dim-sum) bonds
Feb 2010	Foreign firms allowed to issue RMB (dim-sum) bonds
Jul 2010	All corporates allowed to hold RMB accounts and RMB effectively made convertible in offshore market
Aug 2010	McDonald's issues first dim-sum bond by a multinational non-financial corporate
Apr 2011	The first offshore RMB-denominated IPO (by Chinese property investment trust, Hui Xian)
Oct 2011	Baosteel becomes first non-bank Chinese company to issue dim-sum bonds directly
Jan 2012	First approval for a Mainland company to borrow RMB directly from an offshore bank
Jun 2012	HKMA launches RMB liquidity facility to Participating Banks[(a)] in Hong Kong
2. Capital flows	
Inward flows	
Jan 2003	Qualified Foreign Institutional Investor (QFII) scheme for foreign investment in listed Mainland bonds and equities
Aug 2010	Scheme to allow foreign central banks, offshore RMB clearing banks and Participating Banks to invest RMB raised offshore in the Mainland interbank bond market
Oct 2011	Rules formalised to allow approved foreigners to invest RMB raised offshore directly in Mainland firms, including through the provision of RMB cross-border loans
Dec 2011	RMB Qualified Foreign Institutional Investor (RQFII) scheme allowing RMB raised offshore to be invested in listed Mainland bonds and equities
Apr 2012	QFII and RQFII quotas expanded
May 2012	Rules formalised for onshore non-financial corporations to issue offshore RMB bonds
Outward flows	
Apr 2006	Qualified Domestic Institutional Investor (QDII) program launched, allowing domestic institutions to convert RMB into foreign currency and invest in overseas equities and bonds.
Jan 2011	Mainland firms allowed to apply to take RMB offshore for overseas direct investment (ODI) in foreign firms
3. Onshore market	
Apr 2012	PBC widened the daily trading band for the USD/CNY exchange rate to 1 per cent above or below the reference rate
By 2014	Chinese International Payments System (CIPS) to be developed

(a) Participating Banks are those banks with an agreement with the Bank of China (Hong Kong) (BOCHK); they have direct access to the offshore interbank RMB market and are able to undertake cross-border RMB settlement via the BOCHK

Sources: various official sources, media and market reports enhancing the depth and sophistication of onshore markets.

The third reform stream concerns onshore markets. It has included the recent widening of the RMB's daily trading band against the US dollar. In mid April, the band was widened from ½ per cent to 1 per cent above and below the reference rate (which is announced daily by the PBC). This was motivated by the growing ability of domestic participants to manage exchange rate movements and reflected the desire to accommodate greater flexibility in the exchange rate in the future. Other recent reforms include the introduction of products designed to increase the ability of Chinese firms to hedge their foreign-currency exposures and an increase in the number of currencies listed in the interbank market (which since last November includes the Australian dollar). The Chinese International Payments System (CIPS) is also being developed and it is expected to facilitate direct RMB settlement between the offshore market and the Mainland in the future. A detailed plan has also been recently published to develop Shanghai as an international financial centre by 2015. The plan includes: further development of derivatives markets; further opening up of Shanghai's financial markets to foreign investors, including enabling foreigners to issue RMB bonds and potentially listing them on the Shanghai stock exchange; and an intention to strengthen taxation, legal and regulatory standards in line with international practice.

The two key initiatives undertaken under the first of these streams – that is, promoting the use of RMB in real activities (starting with its use as an invoice currency for trade), and developing an offshore RMB market – are explored in more detail in the remainder of this article.

The Structure of the Offshore RMB Market

To date, the development of the offshore RMB market has been centred on Hong Kong, with the Chinese authorities making use of its unique position, as both a Special Administrative Region of China and an established international financial centre, to promote the use of RMB outside of Mainland China.

The offshore RMB market has been largely segregated from the onshore market, resulting in two fairly distinct pools of RMB. The Bank of China (Hong Kong) (BOCHK), however, provides an important link between the two markets, since it is permitted to undertake cross-border transactions subject to specified controls.[7] Permitted cross-border flows between the onshore and offshore markets have thus far been largely related to the RMB trade settlement scheme, although this may change as restrictions on cross-border flows are eased (Table 1). An accumulation of RMB offshore has occurred as RMB-denominated imports into China have generally outweighed RMB-denominated exports from China under the scheme. This has likely largely reflected the incentive for foreigners to acquire and hold RMB when the RMB exchange rate has been expected to appreciate. RMB can also flow to and from the Mainland via some investment schemes, although it is unclear how extensively these have been used to date, given the existence, in many cases, of quotas and approval lags (Table 2).

The BOCHK, as the primary link between the two markets, is one of only two designated offshore RMB clearing banks (the other is the Bank of China, Macau). Specifically, the BOCHK is able to convert between RMB and other currencies in the Shanghai interbank market, operates the RMB real-time gross settlement (RTGS) system in Hong Kong and is directly connected to the Mainland equivalent, China National Advanced Payments System (CNAPS), enabling it to settle RMB payments across the books of the PBC on the Mainland. The role of the BOCHK is unique in that, besides being a participant in the Mainland interbank market, it operates the offshore interbank market for RMB in Hong Kong, in which only Participating Banks can directly transact. These

7 In the late 1970s, when it took over some of the commercial business from the PBC, the Bank of China (in Mainland China) was given the mandate to specialise in transactions related to foreign trade and investment (Allen *et al* 2012).

Table 2: RMB Flows between Mainland China and the Offshore Market

	Trade settlement	Investment	Transfers	Other
Flows to offshore market *(offshore RMB pool increases)*	Chinese importers paying offshore exporters via BOCHK	Approved overseas direct investment	Receipt of payments of profit, transfer of equity, or liquidation of an investment by foreigner.	Chinese tourists taking RMB to Hong Kong[(a)] Hong Kong residents converting between RMB and Hong Kong dollars (up to CNY20 000 per day)
Flows to Mainland China *(offshore RMB pool decreases)*	Offshore importers paying Chinese exporters via BOCHK[(b)]	Investment in Mainland interbank bonds by approved Participating Banks/central banks Investment in listed stocks/bonds under RQFII scheme Approved foreign direct investment[(c)]	Hong Kong residents remitting to Mainland account of the same name (up to CNY80 000 per day) RMB proceeds from dim-sum bond and equity issuance[(d)]	Tourists obtaining RMB outside of China for use on the Mainland RMB loans to an onshore enterprise from an offshore parent

(a) Some estimates have put this figure at US$15 billion for 2011
(b) Offshore RMB pool is unchanged if importers pay via BOCHK quota
(c) Pre-approval from PBC not required; however, approvals from other regulators may still be required
(d) Mainland firms require approval from onshore regulators; for offshore investors, RMB proceeds from bond and equity issuance can be used for specified investment schemes; otherwise approval is granted on a case-by-case basis
Sources: various official sources, media and market reports

Participating Banks are predominantly banks in Hong Kong that have an agreement with the BOCHK, although it is also possible for banks outside of Hong Kong to either become Participating Banks or access the system through commercial relationships with existing Participating Banks.

As a designated offshore RMB clearing bank, the BOCHK is able to buy and sell RMB in the onshore market on behalf of offshore customers, provided that the funds are for RMB trade settlement. Because the conversions take place in the onshore market, RMB is converted at the onshore (CNY) exchange rate, providing arbitrage opportunities when the offshore (CNH) exchange rate diverges from the CNY rate (see below).

The amount of foreign currency that the BOCHK is allowed to convert in the onshore market is limited by a quota. This quota was increased after being exhausted in October 2010 and, reportedly, increased again after being exhausted in September 2011. Importantly, however, exhausting the quota does not necessarily prevent further RMB trade settlement from taking place. Offshore RMB funds are available via other means: transactions can be settled using RMB held onshore (thereby not involving the BOCHK or the offshore market at all); and, if necessary, the Hong Kong Monetary Authority (HKMA) and other central banks can provide RMB to banks for RMB trade settlement under currency swap agreements with the PBC.[8] In June 2012, the HKMA also launched an RMB liquidity facility, which Participating Banks in Hong Kong can access in the event of a temporary shortfall of RMB liquidity. The RMB would be obtained by the HKMA through its swap agreement with the PBC.

8 HKMA's swap with the PBC was activated in October 2010, when the BOCHK reached its quota due to strong demand for RMB from offshore participants, although it is unclear if the swap line was ever actually used.

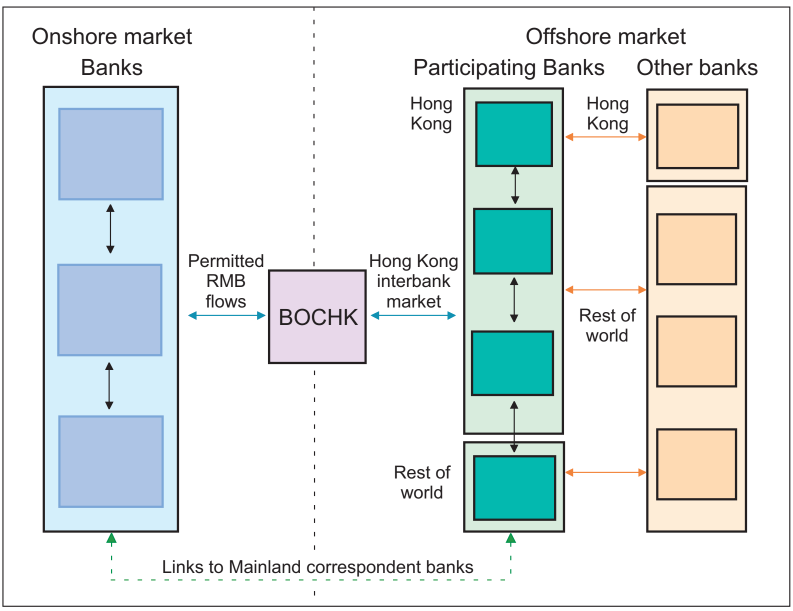
In principle, there are no Chinese regulations preventing the setting up of RMB accounts and the trading of RMB products outside of Hong Kong. However, most offshore settlement and all cross-border settlement (through the BOCHK) currently occurs in Hong Kong. To accommodate these arrangements, the hours for the RMB RTGS platform will be extended by the end of June to allow Europeans to use the Hong Kong infrastructure for settling RMB transactions during the trading day in Europe, and also to cover the morning session in North and South America. Moreover, since Participating Banks are generally located in Hong Kong, adjustments to regulatory requirements in Hong Kong have been important for the development of the offshore market. In particular, Participating Banks are now able to deposit RMB with the PBC via a fiduciary account service provided by the BOCHK. Most recently, the HKMA has eased RMB risk management limits and has relaxed limits on the RMB net open position that banks in Hong Kong can hold, which should increase the flexibility of banks in managing their offshore RMB liquidity and should increase the supply of RMB available in the offshore market.

RMB Trade Settlement

The RMB trade settlement scheme has been integral to the development of the offshore RMB market. The scheme holds some potential attractions to foreign trading partners: an ability to acquire and hold RMB (which has generally been expected to appreciate); the possibility of negotiating a better price when invoices are denominated in RMB rather than US dollar terms; a natural hedge if both exports and imports are denominated in RMB; and for exporters, access to small- and medium-sized Chinese firms that may be unwilling or unable to contract in foreign currency.

In practical terms, RMB trade settlement is now possible in most countries, although, ultimately, it must involve a bank that is able to settle transactions in the interbank market in Mainland China and convert currency in the onshore foreign exchange market. As such, there are two channels through which RMB trade settlement can take place: via a Mainland correspondent bank or the BOCHK. Participating Banks typically can access both of these channels (see Figure 1). While there are a limited number of Participating Banks outside of

Figure 1: Structure of the Offshore RMB Market and RMB Trade Settlement



Source: RBA

Hong Kong, it is only necessary that banks wishing to settle RMB transactions for trade settlement have an arrangement with an existing Participating Bank (which for many is their Hong Kong affiliate).

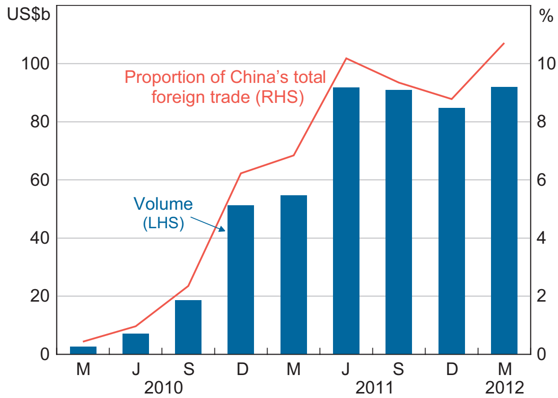
There are, however, important differences between these two channels, particularly in terms of the implications for the offshore market and the future use of the RMB funds. When the offshore bank of a foreign exporter settles trade with a Chinese firm via an account with a Mainland correspondent bank (dotted green line, Figure 1), the RMB remains onshore and subject to Chinese regulations, and the size of the RMB pool offshore is unaffected. However, if the offshore bank settles the trade via an account with the BOCHK, the RMB can be invested in offshore deposits or offshore RMB-denominated (dim-sum) bonds, converted to foreign currency, or invested in the Mainland via an approved channel (blue arrows, Figure 1). The offshore bank of a foreign importer who settles in RMB for goods from China can purchase or borrow RMB in the offshore market (at the CNH rate), in which case the offshore RMB pool will fall. Otherwise, the offshore bank can purchase RMB from the BOCHK at the onshore (CNY) rate (subject to the quota) or purchase or borrow RMB from a Mainland correspondent bank (in which case the offshore pool again is unaffected).

In Australia, RMB banking services are provided by a number of banks. These services typically include RMB bank accounts, RMB trade settlement and access to most other RMB products available in Hong Kong. Liaison suggests that RMB trade settlement involving Australian-based firms has been occurring, albeit to a limited extent, since at least late 2010.

Developments in RMB Trade Settlement and the Offshore RMB Market

Reflecting the take-up of the scheme, RMB trade settlement expanded rapidly over 2010 and the first half of 2011, to reach around 10 per cent of China's total foreign trade (Graph 2). At least initially, the scheme was reportedly dominated by foreign firms receiving RMB as payments for their exports to China, likely reflecting the incentive to hold RMB offshore given the expectation for RMB appreciation at the time (although expectations for appreciation have recently fallen) and reinforced by flows attempting to take advantage of the small premium that then existed in the offshore exchange rate.

Graph 2
RMB Trade Settlement

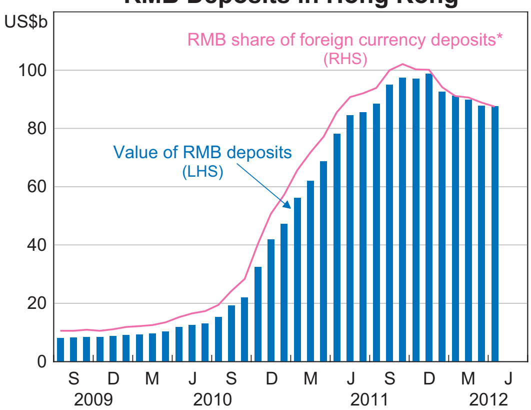


Sources: CEIC; RBA

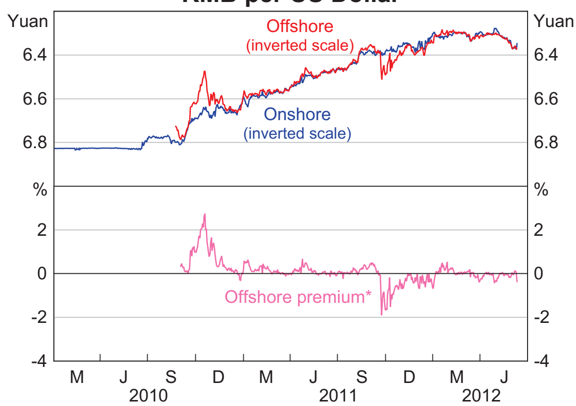
Since the inception of the scheme, around two-thirds of RMB trade settlement has been with Hong Kong. The next largest shares are with Singapore and Taiwan, which is not surprising given their close trade relationships with China and their early inclusion in the scheme. Australia's share is similar to that of the United Kingdom's, at around 1 per cent of total RMB-denominated trade since mid 2009.

Consistent with the expansion of the RMB trade settlement scheme, and the associated outflow of RMB from the Mainland, RMB deposits in Hong Kong have risen significantly over the past few years, from around US$15 billion in July 2010 to almost US$90 billion currently (Graph 3).[9] This rapid accumulation initially reflected both the growth of RMB trade settlement and the relative lack of alternative options in the developing offshore market. The recent decline in deposits corresponds to a certain extent with the increased ability to transfer RMB between the onshore and offshore

9 Around 70 per cent of these deposits are currently held by corporate customers.



* RMB share of non-Hong Kong dollar-denominated deposits
Sources: Hong Kong Monetary Authority; RBA



* Negative spread indicates that one US dollar buys more yuan offshore than onshore
Sources: Bloomberg; RBA

markets. While the offshore deliverable RMB foreign exchange market has grown substantially in terms of size and liquidity since mid 2010, with average daily turnover of around US$4 billion last year, this is still below turnover in the dominant offshore non-deliverable forward RMB market (which settles in US dollars) and the onshore market (estimated in 2010 at US$23 billion and US$10 billion per day, respectively).[10] A sign of the maturation of the deliverable RMB market has been the quoting of a CNH fix by the Treasury Markets Association since mid 2011. This has been supported in recent months by the quoting of interbank interest rates by eight major banks in Hong Kong.

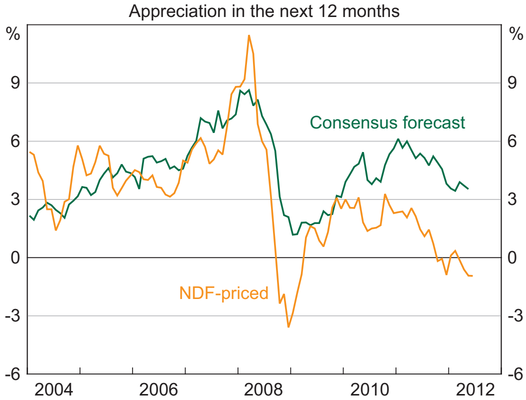
There has been some tendency for the offshore (CNH) exchange rate to converge to the onshore (CNY) exchange rate in recent years. Up until late last year, there was typically a small premium in the CNH rate – that is, one US dollar bought less yuan offshore than onshore – reflecting the expectation of some near-term appreciation of the CNY rate (Graph 4). The tendency for convergence over the past few years has been made possible by the ability to use trade flows, particularly between affiliated companies in the Mainland and Hong Kong, to arbitrage between the two exchange rates. However, increased concerns about the euro area debt crisis and the outlook for the US economy late last year resulted in a temporary reversal of this premium as offshore investors undertook a broad-based liquidation of emerging market investments, including those in the offshore RMB market. As a result, the offshore (CNH) exchange rate traded at a sizeable discount to the onshore rate for the first time. Trading conditions in the offshore market were further strained by the incentive this discount provided for RMB to flow back onshore to take advantage of a stronger onshore rate. As noted previously, these pressures led the BOCHK's quarterly quota for conversion between RMB and foreign currency to be exhausted for a second time in September 2011.

The small discount in the offshore exchange rate since the beginning of the year is consistent with reduced expectations for exchange rate appreciation in the onshore market. This has coincided with little net change in the onshore exchange rate, and is likely to have been influenced by the official announcement that greater two-way flexibility in the onshore exchange rate might be warranted in the future. However, following development of the offshore RMB market, the non-deliverable forward (NDF) market for RMB has become subject to some arbitrage opportunities in the offshore market, thereby making it a less pure

10 See McCauley (2011) for details.

prediction of market expectations of changes in the onshore exchange rate. This likely explains much of the recent divergence between exchange rate expectations implied by the non-deliverable forward market and expectations derived from surveys of market participants, such as the Consensus Economics survey (Graph 5). Nevertheless, these survey measures also suggest that expectations for appreciation of the CNY exchange rate have recently fallen.

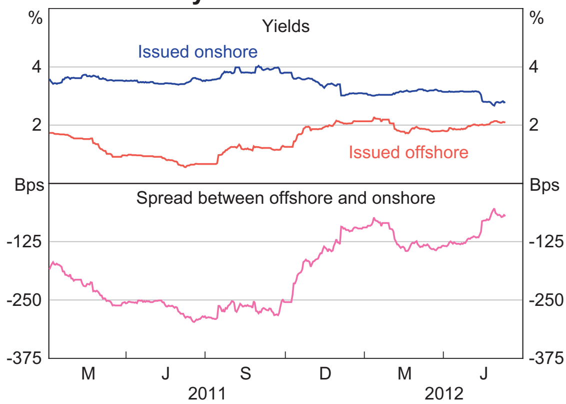
Graph 5
Forecasts of RMB Appreciation
Appreciation in the next 12 months



Sources: Bloomberg; Consensus Economics

Offshore deposit and lending rates remain distinctly below their onshore counterparts. While a 1-year term RMB deposit onshore currently earns 3.5 per cent, the same funds deposited offshore receive 0.6 per cent. Yields on Chinese government bonds in the offshore market have also traded at a notable discount to comparable bonds in the onshore market, which in part has reflected the willingness of investors to hold funds in the offshore market at a lower rate of return due to expectations of exchange rate appreciation over the past few years. It has also reflected a lack of alternative investment opportunities in the offshore market, with many bond issues oversubscribed several times. However, significant development of the offshore RMB bond market over the past few years, together with some decrease in expectations of exchange rate appreciation more recently, have seen the gap between yields on comparable Chinese government bonds in the offshore and onshore markets narrow considerably (Graph 6).

Graph 6
China 5-year Government Bonds



Sources: Bloomberg; RBA

While the (still) relatively low yield on dim-sum bonds should make the offshore market attractive for RMB fundraising, issuance has been limited by the remaining restrictions on the ability of firms to transfer RMB to the Mainland.[11] Late last year, the process of repatriating RMB funds raised offshore from bond issuance and other sources was made easier, including, as already mentioned, for foreigners seeking to use offshore RMB for direct investment onshore (see Tables 1 and 3 for more details). In December, the 'RQFII' scheme was announced, which allows RMB sourced from the offshore market to be invested in the onshore listed equity and listed bond markets. This scheme is the counterpart to the Qualified Foreign Institutional Investor (QFII) scheme that allows foreign currency to be used for the same purpose. In April this year, the existing quotas for both QFII and RQFII were more than doubled in size, to around US$90 billion in total. In May, a formal approval process was introduced to enable onshore non-financial corporations to issue RMB bonds in Hong Kong. Outside of these schemes, approval to transfer RMB to the Mainland is generally granted by the PBC on a case-by-case basis.

11 Foreign firms issuing RMB bonds in the offshore market have no restrictions on the offshore use of the proceeds.

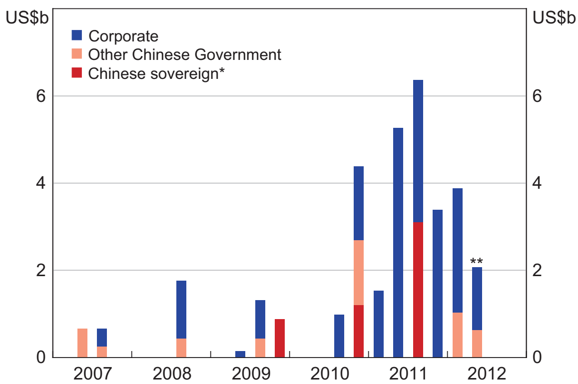
Table 3: Chinese Foreign Investment Programs

Name	Direction/ currency	Notes	Details
Portfolio investment			
QFII	Inward; foreign currency	Foreign institutions invest in listed (but not interbank) bonds and equities. Wide range of investors including private banks, corporations and central banks.	Since Jan 2003; US$80 billion (total quota); 163 investors[(a)]
QDII[(b)]	Outward; foreign currency	Domestic institutions convert RMB to foreign currency to invest in overseas bonds and equities	Since Apr 2006; US$75 billion (total quota); 96 investors
Other RMB[(c)]	Inward; RMB	Foreign central banks, offshore RMB clearing banks and Participating Banks permitted to invest RMB (including RMB raised offshore) in Mainland interbank bond market	Since Aug 2010; size unknown
QFLP[(d)]	Inward; foreign currency	Foreign private equity funds and companies invest in private equity-based funds in certain cities	Since Jan 2011; US$1.5–3 billion quota per city
RQFII	Inward; RMB	Foreign funds/institutions invest RMB raised offshore in Mainland equities and bonds	Since Dec 2011; US$11 billion (total quota); 21 investors
Direct investment			
FDI[(e)]	Inward; foreign currency	Allowed in all provinces, but certain industries are excluded	Since 1980; around US$240 billion gross FDI in 2011
	Inward; RMB	Foreigners invest RMB raised offshore directly in Mainland firms. National Ministry of Commerce approval required for investments exceeding CNY300 million, or directed to certain industries.	Rules for existing scheme formalised Oct 2011; US$24 billion FDI since start of 2011
ODI[(e)]	Outward; foreign currency	Requires approval from Mainland authorities and is dominated by state-owned enterprises	Since 1979; around US$64 billion gross ODI in 2011
	Outward; RMB	Mainland firms apply to take RMB offshore and invest directly in foreign firms. Hong Kong branches and correspondent banks of Mainland banks can also obtain RMB onshore and lend to Mainland firms for ODI.	Since Jan 2011; US$5 billion ODI since start of 2011

(a) As at end April 2012, around US$26 billion in quotas had been approved
(b) Qualified Domestic Institutional Investors
(c) No formal name for scheme
(d) Qualified Foreign Limited Partners
(e) Foreign direct investment and overseas direct investment, respectively; no formal names for schemes
Sources: CEIC; China Securities Regulatory Commission; Hong Kong Monetary Authority; People's Bank of China

In addition to easing restrictions on the transfer of RMB funds raised offshore back onshore, the Chinese authorities have supported the development of the offshore RMB-denominated (dim-sum) bond market through sovereign and other Chinese Government issuance. The variety of dim-sum bond issuers has diversified substantially; prior to mid 2010, it was generally Mainland banks (such as the China Development Bank) and sovereign authorities, whereas it now includes several financial firms (e.g. HSBC) and non-financial foreign firms (including McDonald's, Caterpillar and Volkswagen), and Mainland non-financial corporates (e.g. Baosteel). Reflecting this, total issuance of dim-sum bonds has increased from US$1.3 billion in 2007 to US$16.5 billion in 2011, equivalent to around 2 per cent of bond issuance undertaken in the onshore interbank bond market (Graph 7). However, dim-sum bond issuance has slowed moderately this year, and has been around US$6 billion in 2012 to date. Since the start of 2011, around 60 per cent of corporate dim-sum bond issuance has been accounted for by Mainland Chinese firms, with 10 per cent from Hong Kong and the remaining 30 per cent from foreign firms. In April this year, HSBC launched the first dim-sum bond outside of Hong Kong in London, providing further indication of the growth and diversification of the market.

Graph 7
Offshore RMB Bond Issuance



* Includes Ministry of Finance, Chinese Government and PBC
** April and May
Sources: Dealogic; RBA

It is also possible for RMB-denominated initial public offerings (IPOs) to be conducted offshore. The first one was conducted for real estate investment trust Hui Xian in April 2011. However, there has yet to be a second RMB-denominated IPO offshore, despite Hong Kong Exchanges & Clearing Ltd (HKEx) promoting the concept by launching a RMB Equity Trading Support Facility to improve liquidity for RMB shares on the secondary market. Demand for RMB investment opportunities has seen the emergence of other RMB-linked products in the offshore market, including RMB-denominated exchange-traded funds (ETFs), insurance products, foreign exchange options and commodity-linked products. The Chicago Mercantile Exchange has signed an agreement with the Bank of China (in Mainland China) to enable it to use RMB in settling commodity trades and the London Metal Exchange is considering similar arrangements. HKEx has announced plans to issue RMB futures later this year. Corporate RMB loans are also available; the outstanding value of RMB loans reached around US$5 billion as at the end of 2011.

Other International Developments

In line with the general multipronged approach to reform, the Chinese authorities have also sought to promote and support the increased use of RMB through bilateral agreements. Notably, the PBC has signed bilateral local-currency swap agreements with at least 16 central banks in addition to the HKMA (Table 4). In March this year, the RBA and the PBC signed a swap agreement that allows for the exchange of up to A$30 billion or CNY200 billion.

The primary purpose of these agreements is as a back-up source of liquidity to support trade denominated in local currency. As an example, if a domestic Australian importer were temporarily unable to obtain sufficient RMB to pay for RMB-denominated imports, its Australian bank could ask the RBA to lend it the necessary RMB secured against collateral for a short period of time. The Australian importer's bank could then

Table 4: PBC Bilateral Local-currency Swap Agreements

Date signed	Country	Value (CNY billion)	Value (US$ billion)[(a)]
Mar 2009[(b)]	Belarus	20	2.9
Mar 2009[(b)]	Indonesia	100	14.6
Apr 2009[(b)]	Argentina	70	10.2
Jun 2010	Iceland	3.5	0.5
Jul 2010	Singapore	150	22.1
Apr 2011	New Zealand	25	3.8
Apr 2011	Uzbekistan	0.7	0.1
Jun 2011	Kazakhstan	6.5	1.0
Oct 2011	South Korea (extended)	360	56.6
Nov 2011	Hong Kong (extended)	400	63.0
Dec 2011	Thailand	70	11.0
Dec 2011	Pakistan	10	1.6
Jan 2012	United Arab Emirates	35	5.5
Feb 2012	Malaysia (extended)	180	28.6
Feb 2012	Turkey	10	1.6
Mar 2012	Mongolia (extended)	10	1.6
Mar 2012	Australia	200	31.6

(a) Calculated based on USD/CNY exchange rate at the time of signing
(b) Since these agreements are usually for three years, unless they have been extended, they are now expired
Sources: People's Bank of China; other official sources and media reports

meet the importer's RMB obligation by transferring those funds to the Chinese exporter's bank. At the end of the agreement, the importer's bank would need to obtain RMB in order to repay the RBA. This arrangement should offer increased confidence to both Australian firms wishing to contract their trade in RMB terms and their banks in arranging settlement.

In December 2011, China signed an agreement with Japan that included a commitment to develop direct trading between the yuan and yen (which came into effect on 1 June 2012) and to promote the issuance of RMB-denominated bonds by Japanese companies. In addition, multilateral agreements have been reached to promote the use of local currencies in regional trade relationships and in lending between nations. For example, the BRICS (Brazil, Russia, India, China and South Africa) nations agreed to encourage their respective development banks to lend to the other countries in local currency. China, Japan and South Korea have also agreed to use their foreign exchange reserves to invest in each others' sovereign debt.

Furthermore, the Chinese authorities have undertaken measures to encourage investment of foreign reserves in RMB; however, until the RMB is fully convertible, these holdings will not be recognised as part of a country's official reserve assets under the International Monetary Fund's definition. As part of the December 2011 agreement, the Japanese authorities committed to purchase US$10 billion worth of Chinese government bonds (with the official approval obtained early this year). Approval has reportedly also been granted to the Thai and Austrian authorities to invest in the onshore interbank bond market, while the HKMA's quota for investing in the onshore interbank bond market was recently doubled to just under US$5 billion. Authorities in other countries have obtained small QFII quotas to invest in the onshore listed markets, with approvals granted to Kuwait, Malaysia, South Korea and Thailand. The PBC also recently signed an agency agreement with the World Bank to enable the International Bank for Reconstruction and Development and the International Development Association to invest in the Mainland interbank bond market.

Similarly, the Hong Kong authorities have sought international cooperation in supporting the development of the offshore market. This has included the HKMA and HM Treasury (UK) establishing a private sector forum to explore 'synergies' between the markets, particularly looking at clearing and settlement systems, market liquidity and the development of new RMB-denominated products. It has also included the incorporation of RMB into payments systems, such as its recent inclusion in the pilot platform for post-trade cross-border clearing and settlement of debt securities between Europe, Hong Kong and Malaysia.

Conclusion

The RMB trade settlement scheme and the offshore RMB market have expanded rapidly over recent years as the Chinese authorities have sought to promote the international use of RMB in trade and investment. The structure of the offshore market has enabled the internationalisation of the RMB to precede to some extent the liberalisation of onshore capital controls. However, since late last year, the reform agenda has expanded to encompass some easing of restrictions on the capital account, including onshore foreign investment opportunities and the further development of onshore financial markets. These have been interpreted as interim steps to a more fully liberalised capital account sometime in the future.

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