Global Economics & Markets Research
Company Reg No. 193500026Z

Suan Teck Kin Suan.TeckKin@UOBgroup.com

Friday, 12 June 2015

Flash Notes

China: RMB Internationalization Update

China's central bank PBoC on Thur (11 Jun 2015) released its first report on RMB internationalization. Other than a treasure trove of information and data, this report provides a comprehensive assessment of the RMB internationalization development so far, as well as a look to the future, from an official point of view.

The report is also timely – ahead of the once-every-five-year review before end-2015 by IMF on the Special Drawing Rights (SDR) basket of currencies – providing a definitive perspective of various, and sometimes confusing, analyses of the entire RMB internationalization process that began in 2009.

While China has largely met three out of the four SDR criteria, the FX reserve requirement may be the only weakness, as data from PBoC's report shows that the currency accounted for just 1.4% share of global (ex-China) foreign reserves of USD7,840.9bn. As such, we are still pegging China's success in the SDR admission at 60% probability.

With or without SDR, we expect financial market liberalization efforts in China to continue to accelerate ahead. This means that there will be further two way moves for the RMB exchange rate and no more one-way appreciation/depreciation trend, and also the possibility of widening of RMB trading band to 3% from 2% before end-2015.

In terms of interest rates, full removal of the deposit rate ceiling (at 1.5x currently) is very likely in 3Q 2015, along with one more round of interest rate cuts and reserve requirement ratio (RRR) cuts to lend support to economic growth.

Some of the highlights from the report:

- Rise in usage of cross border RMB under current account: the amount of goods and services trade settled in RMB rose from RMB3.60bn in 2009 to RMB6.55tn in 2014.

- There were 189 countries (excluding HK, Macao, Taiwan, and other areas) involved in cross border RMB settlement with China in 2014. Within China and under the current account items, Guangdong province led in terms of cross border

Cross Border RMB Settlement of Current Account Items

In RMB billions	Global Trade (Exports)	Global Trade (Imports)	Services and other trade	Total Current Account items	% share
Guangdong	736.8	870.4	144.9	1,752.1	**26.7%**
Shanghai	320.2	506.5	188.2	1,014.9	**15.5%**
Zhejiang	379.5	345.3	19.0	743.9	**11.3%**
Beijing	88.6	453.5	131.4	673.5	**10.3%**
Shangdong	157.8	390.5	18.9	567.1	**8.7%**
Jiangsu	187.1	181.8	45.2	414.1	**6.3%**
Tianjin	66.5	89.9	23.1	179.5	**2.7%**
Guangxi	89.0	53.1	1.4	143.5	**2.2%**
Fujian	61.5	61.7	7.7	130.9	**2.0%**
Others	430.1	427.5	76.8	934.3	**14.3%**
Total	**2,517.0**	**3,380.3**	**656.5**	**6,553.9**	**100.0%**

Source: RMB Internationalization Report (2015), p 6; UOB Global Economics & Markets Research Est settlement with 26.7% share of the total amount of RMB6.55tn, reflecting the province's role as a powerhouse in goods trade and manufacturing center.

- Rise in usage of RMB in direct investment in both directions, i.e. foreign direct investment (FDI) into China and outward direct investment (ODI) to overseas as Chinese enterprises look beyond China's borders for business and investment opportunities. The combined amount of cross border RMB settled FDI and ODI rose from RMB106.6bn in 2011 to RMB1.05tn in 2014, a nearly 10 times increase in just three years.

- Use of RMB as a reserve currency has also expanded since the currency's internationalization began in 2009. Aside from the bilateral currency swap agreements signed with 32 central banks worldwide worth RMB3.2tn, the more interesting piece of data is how much of the RMB is being held by central banks. PBoC disclosed that, based on estimates, RMB-denominated bonds, stocks, and deposits held by central banks worldwide amounted to RMB666.7bn as of end-Apr 2015. Assuming that there was minimal amount held prior to 2009, the growth rate would certainly be impressive. However, the amount is approximately USD107.5bn or just around 1.4% share of global foreign reserves (ex-China) of USD7,840.9bn. This means that it is still long way for China to catch up with other reserve currencies, especially the USD.

- Nonresidents' (including institutions and individuals) holdings of RMB assets in China have also risen, though it appears that the pace is more measured. Total assets rose from RMB2,879.7bn at end-2013 to RMB4,406.5bn at end-Apr 2015, as shown in the table below. It should be noted that deposits account for the bulk of the assets given restrictions on bonds and equity markets, the target for further reductions in restrictions in the capital account.

Nonresidents' (including institutions and individuals) Holdings of RMB Assets in China

In RMB billions	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Apr-15
Equity	344.8	319.3	364.2	462.5	555.5	601.1	644.4
Bonds	399.0	512.3	559.3	634.1	671.6	712.8	735.2
Loans	531.0	746.8	893.8	860.5	819.0	876.9	873.9
Deposits	1,604.9	1,984.0	2,045.1	2,237.2	2,372.2	2,024.8	2,153.0
Total	**2,879.7**	**3,562.4**	**3,862.4**	**4,194.3**	**4,418.3**	**4,215.6**	**4,406.5**

Source: RMB Internationalization Report (2015), p 11; UOB Global Economics & Markets Research Est

- RMB FX trading in China (including interbank and on behalf of customers) averaged about USD55.0bn per day in 2014, and a total of USD4.12tn of spot trading was conducted that year, a 1.2% growth from 2013. FX derivatives saw much stronger growth in 2014, with total amount of OTC FX swap expanding 32.1% from 2013 to USD4.49tn in 2014, while FX forwards value rising 63.5% to USD52.9bn in 2014. Based on its estimates, the combined trading of RMB in offshore markets such as Hong Kong, Singapore London, and others averaged more than USD230bn per day in 2014, which is more than 4 times the onshore volume. This also suggests the importance of offshore market in driving the RMB FX value.

- In the next steps, PBoC is focusing on driving the 1) convertibility of the capital account, a process that started after current account convertibility in 1996; 2) interest rate liberalization, including the announcement of the large-denomination, floating-rate tradable certificates of deposit (CD) to individuals and companies; and 3) market-determined pricing of the RMB exchange rate, including the widening of trading bands to 2% in March 2014, as well as the increased two-way trading and flexibility of the exchange rate.

- Further steps to internationalize the RMB remain in place, and PBoC is looking to 1) implement cross border payment system (China International Payment System, or CIPS) before end-2015; 2) expand mainland entities' usage of RMB under current account; 3) broaden the usage of RMB in cross border financing, e.g. offshore entities' issuing of RMB bond in China, Chinese entities raising RMB funding in offshore market, pricing of commodities in RMB; 4) enlarge the scope and amount of bilateral currency swap agreements; and 5) accelerate the admission of RMB into the SDR basket and to support the adoption of RMB as foreign reserve currency by removing certain restrictions against central banks' participation in mainland markets.

Implications

As we noted in our earlier reports (for further details please refer to: "China: Market Liberalization Measures Update" dated 04 Jun 2015 and "China: Aiming for the SDR Basket" dated 30 Apr 2015), China's financial market liberalization remains on track and, the pace has been accelerating.

PBoC's main aim this year is obviously the admission to the SDR basket by end of 2015. To ensure success, China needs to show progress in the four main areas considered by IMF. First, the currency should be actively traded on foreign exchange markets. Second, there should be active markets in exchange-based and over-the-counter foreign exchange derivatives. Third, the country should have market-based interest rate instruments. And, fourth, the currency should be widely held as foreign exchange reserves. (Please refer to: "IMF Executive Board Discusses Criteria for Broadening the SDR Currency Basket,", IMF Public Information Notice (PIN) No. 11/137, 11 November 2011, https://www.imf.org/external/np/sec/pn/2011/pn11137.htm).

As can be seen above, data provided in the RMB internationalization suggest that China is likely to have met three out of the four criteria set in the IMF report, except the one on the usage as a reserve currency. We note that RMB accounted for just around 1.4% share of global foreign reserves (ex-China) at end-Apr 2015, which could be a deal breaker in the SDR admission process.

The key reason for such low usage in FX reserve is mainly due to the non-convertibility of China's capital account, which actually has very few restrictions left. As mentioned in our report on SDR, China's capital account is basically convertible for 85% of the items, and PBoC is now working on the remaining 15% (or 5 out of the 40 items) which include individuals' cross-border investment and the issuance of shares and other financial instruments by nonresidents in domestic markets. China's capital account is closer to full convertibility than many people think.

As such, we are still holding to our view that RMB success probability at SDR admission this year at 60%, with the remaining 40% hinging on factors such as evaluation by IMF executive board, which is dominated by advanced economies and has yet to implement the quota reform agreed to in 2010.

However, we believe that financial market liberalization efforts in China will continue to accelerate ahead with or without SDR. This means there will be further two way moves for the RMB exchange rate and no more one-way appreciation/depreciation trend, and also the possibility of widening of RMB trading band to 3% from 2% before end-2015. The risks of a sharp depreciation or devaluation have certainly diminished significantly as China aims for the SDR basket. A sharp weakening of the currency would certainly jeopardize the chance of becoming a reserve currency. Furthermore, there are no fundamental reasons to support such weakening, given the size of its foreign reserves at USD3.7tn. We continue to expect RMB exchange rate at 6.23/USD at end-3Q15 and 6.20 for end-2015, vs. current 6.2080/USD level.

In terms of interest rates, full removal of the deposit rate ceiling (at 1.5x currently) is very likely in 3Q 2015, along with one more round of interest rate cuts and reserve requirement ratio (RRR) cuts to lend support to economic growth. We look for one more round of 25bps cut in interest rates, to 2.00% for benchmark deposit rate and 4.85% for lending rate, and a 50bps cut to bring RRR to 18%.

Source:

人民币国际化报告 (2015) RMB Internationalization Report (2015), 11 Jun 2015
http://bit.ly/pbc-rmbint2015