



HANDS-ON CHINA REPORT  
January 24, 2011

Jing Ulrich  
Managing Director, Chairman,  
China Equities & Commodities  
+852 2800 8635  
jing.l.ulrich@jpmorgan.com

Amir Hoosain  
+852 2800 8641  
amir.h.hoosain@jpmorgan.com

Benjamin Wong, CFA  
+852 2800 8932  
benjamin.mc.wong@jpmorgan.com

Kelvin Wong  
+852 2800 8962  
Kelvin.x.wong@jpmorgan.com

## RMB Internationalization – Progress, Future Steps and Implications

Since the onset of the financial crisis, Chinese officials have undertaken to elevate the renminbi to the status of a major international currency and in the second half of 2010, followed through by launching a wave of measures that dramatically broadened the scope for offshore renminbi business (see Appendix 1). Key reforms included allowing certain offshore financial institutions to tap into the onshore interbank bond market, using the RMB in currency swaps with emerging market trading partners and allowing institutions across industries to open RMB accounts in Hong Kong. In September, the Chinese currency also crossed a notable milestone in terms of achieving status as a reserve currency when Malaysia's central bank reportedly added a sum of RMB assets to its holdings.

The following report is presented in two parts. The first part examines the steps that have been taken in recent months to promote internationalization of the RMB, while the second part examines in Q&A format some of the key issues surrounding this effort.

### I. RMB Internationalization – Progress to Date

#### RMB trade settlement boosts Hong Kong's RMB deposits

In the closing weeks of 2010, the Chinese government rounded out an eventful year by expanding its cross border RMB trade settlement program to over 67,000 exporters, dramatically expanding the scope for RMB business along the trade dimension. For export industries, the ability to price contracts in RMB offers a means to mitigate currency risk at a time when the US dollar is expected to maintain a downward trajectory in the medium-term. The volume of cross-border RMB trade settlement has grown rapidly since the expansion of China's pilot program in mid-2010. Between June and November, cross-border trade transactions settled in Chinese currency amounted to RMB340 billion, more than 7 times the total volume in Jan-May. Even so, the total volume of trade settled in RMB in 11M2010 (RMB 380 bn) only represents ~2% of China's total trade.

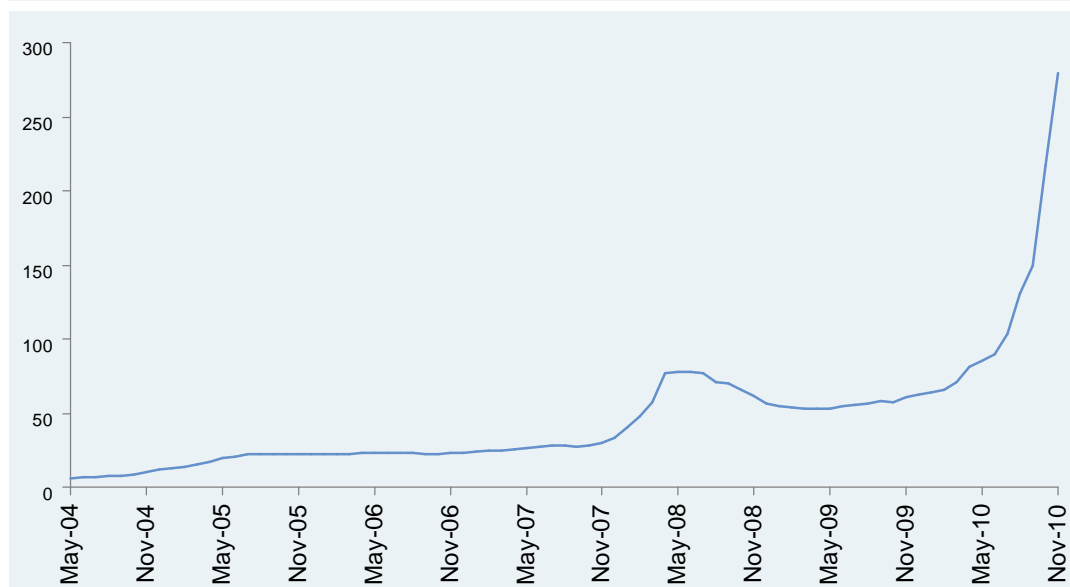
During 2010, the pool of RMB deposits in Hong Kong expanded 378%, going by the estimate of ~RMB 300bn in deposits at end-2010, made by Norman Chan, the Chief Executive of the Hong Kong Monetary Authority (see Figure 1). A significant market for RMB-denominated products appeared to be taking shape in the territory, with RMB41.4 bn in bond issuance for the year, compared to RMB16.bn in 2009. Renminbi deposits grew to account for about 4-5% of Hong Kong's total deposit base at end-2010 (J.P. Morgan Hong Kong banks analyst Joseph Leung forecasts that this ratio will rise to 15% at end-2011).

#### New initiatives and products in 2011

In the early weeks of the New Year, policymakers are clearly pushing ahead with incremental steps to expand the use of the currency overseas and to liberalize the nation's capital account. Among recent developments:

- The People's Bank of China (PBoC) announced that Chinese firms would be permitted to transfer RMB offshore to invest in new ventures, M&A and stake purchases abroad. China's onshore banks will be able to extend RMB-denominated loans for these overseas investments and profits may also be repatriated to China in RMB.
- Residents in the wealthy coastal city of Wenzhou will be allowed to participate in a trial scheme that will entitle them to make direct overseas investments of up to RMB200 million per year.
- Bank of China's New York branch has begun offering RMB accounts whose holders may exchange up to USD4,000 per day, with a USD20,000 cap per annum.
- The Chief Executive of Hong Kong Exchanges and Clearing has said that the exchange is actively looking at means to make the listing of RMB-denominated shares viable and expects such issuances to begin this year. A number of institutions, including Bank of China International and Cheung Kong Holdings, have already announced an interest in eventually raising RMB-denominated equity in Hong Kong.
- According to recent media reports citing unnamed sources, the earlier-anticipated "mini-QFII" trial is again in the pipeline; at least 80% of funds raised must be invested in the domestic bond market.

Figure 1: Renminbi Deposits in Hong Kong (RMB bn)



Source: HKMA

These recent developments have had the effect of generating considerable excitement about Hong Kong's prospects as an offshore Renminbi center, with perceived beneficiaries including Hong Kong banks, HKeX and various investment banks and asset managers. But despite such upbeat market sentiment, there are substantial hurdles to renminbi internationalization, not the least of which is the limited avenues for offshore RMB pools to be repatriated to the mainland without case-by-case regulatory approval. With policymakers concerned about excessive domestic liquidity and asset price bubbles, the current barriers are unlikely to be relaxed except through very measured steps such as a mini-QFII trial. This means that wider acceptance of the currency hinges on the availability of wider investment options offshore (beyond mere currency appreciation), which in turn hinges on the development of an adequate liquidity pool to encourage the necessary introduction of product innovations and securities issuances. The widespread acceptance of the renminbi as a reserve currency – perhaps the ultimate measure of internationalization – appears a distant prospect.

## II. Questions and Answers

### *i) What types of RMB investment products are likely to be introduced in Hong Kong?*

Hong Kong's development as an offshore RMB center is still very much in its infancy when considered against the full spectrum of products and services already available in HKD.

At the Asian Financial Forum, an annual conference organized by the Hong Kong government, the issue of RMB internationalization featured prominently in discussions involving Hong Kong and Mainland financial authorities and financial executives. According to Professor K.C. Chan, Hong Kong's Secretary of Financial Services and Treasury, the proliferation of RMB-denominated investment products is likely to occur initially with products that do not require an active secondary market. Thus at the first stage, the RMB-denominated investment products launched in Hong Kong have mainly consisted of fixed interest products that are typically bought and held for stable income streams, rather than those which are actively traded for capital return (requiring an active and liquid secondary market).

To create a liquid secondary market for RMB financial products, there must be large pool of RMB funds that are readily accessible for local and overseas investors and exchangeable into foreign currency. Current restrictions on currency conversion (capped at RMB20,000/day for Hong Kong retail customers and subject to approval for corporates – unless the funds are used for trade settlement) and a limited liquidity pool suggest that it is still difficult to buy or sell RMB on a large scale for investment purposes.

In Professor Chan's opinion, the absence of an adequate liquidity pool complicates the introduction of products (such as through an equity IPO), where a sound pricing function is expected of the market. While no timetable has been announced, recent comments by the Hong Kong government, regulators and the exchange point to the development of infrastructure to support the introduction of equity-related products, such as RMB-denominated share listings, ETFs and managed funds in the relatively near-future.

### *ii) Will relaxations on outward RMB investment be followed by similar moves to allow the repatriation of offshore funds for domestic investment?*

On January 6, the PBoC announced that Chinese enterprises are allowed to remit RMB offshore for overseas M&A and investment purposes. Banks are also allowed to provide RMB financing to these Chinese enterprises. Furthermore, the return generated from such investments can be repatriated to China. These are promising steps that allow RMB funds to circulate offshore, however, funds intended for subsequent investment into China must undergo scrutiny by China's foreign exchange regulator, which implies a degree of policy risk. At the Asian Financial Forum, Zhang Jianjun, President of the Shenzhen Central Sub-branch of the PBoC, agreed that for more significant amounts of RMB to flow between onshore and offshore jurisdictions, the FDI channel must be relaxed. Currently, investments between China and other countries are heavily biased towards outbound Chinese investments. The central government has been proceeding very gradually in hopes of controlling the level of speculation that may accompany a more extensive relaxation of capital controls.

With respect to portfolio flows, although the QDII program has begun to show signs of returning to life with the introduction of more innovative products (such as Lion Fund Management's gold fund, which recently met its \$500 million subscription target), the flow of inbound and outbound portfolio investments through QDII and QFII will likely remain relatively insignificant in the short term. The volume of QFII quota approved by the government is still vastly inadequate to satisfy the demand of foreign investors. An eventual mini-QFII trial, which would be aimed at providing a conduit for offshore RMB to invest in the onshore equity and debt markets, may gain critical mass in the future; however, its deployment is likely to be very gradual.

***iii) Who are the expected beneficiaries of accelerated growth in the offshore RMB market?***

Although the growth in the size of the offshore RMB market has been nothing short of extraordinary, the ability to monetize this growth is currently quite limited due to a lack of product diversity.

According to J.P. Morgan analyst Harsh Modi, Hong Kong Exchange and Clearing (388 HK, Overweight, PT \$168) is expected to be one of the key beneficiaries of RMB liberalization over the next 5-10 years, as more listed RMB related products becomes available through the territory's sole exchange and clearing operator. For example Charles Li, CEO of HKeX, suggested in early January that RMB-denominated IPOs could be rolled-out as early as this year.

Bank of China Hong Kong (2388 HK) could also benefit marginally from RMB liberalization, since it currently serves as the only authorized clearing institution between the PBOC and other Hong Kong based financial institutions. While a gradual increase in the amount of RMB-denominated products is expected to improve banks' profitability, J.P. Morgan analyst Joseph Leung anticipates that at least in the short term, there could be a certain degree of cannibalization between products denominated in different currencies. Overall he expects the earnings contribution to BOCHK to be -1% in a bear case scenario and 9% in the bull-case.

***iv) What does the process of RMB internationalization imply as to the relative importance of Hong Kong and Shanghai as financial centers***

At the Asian Financial Forum, various speakers, including Fang Xinghai, Director General of Shanghai's Financial Services Office and Gao Yingxin, Deputy Chief Executive of Bank of China Hong Kong emphasized that there was extensive cooperation between authorities in the two jurisdictions. However, Dr. Fang noted that Shanghai has been mandated by the central government to become China's international financial center and that the city aims to rank in the global top 3 by most major measures (e.g. equity market value, bond market value). Indeed, he argued that Hong Kong's ambition to become China's center for offshore RMB business was contingent on progress in Shanghai.

Under a scenario where offshore RMB funds can be repatriated freely (which Dr. Fang indicated he was not in favor of) while the RMB bond market in Shanghai develops slowly, Chinese companies would naturally flock to the Hong Kong market for its cheaper funding costs and lower regulatory burden. However, this would mean that the PBoC would lose control over interest rates and the development of China's onshore bond market would languish. Thus the two markets' development should be coordinated and the best approach would be to promote the onshore RMB bond market, which should be regulated by Chinese authorities but open to foreign investors.

***v) How quickly will the adoption of trade settlement in RMB proliferate, if at all?***

For overseas companies, RMB funds gained through trade settlement will have limited conduits for reinvestment. Companies intending to repatriate RMB funds as FDI will require approval from SAFE, which carries a high degree of uncertainty. This implies that RMB received offshore is mainly destined for conversion at central banks or clearinghouses. Such restrictions do not apply to traditional trade settlement in USD. An increase in RMB investment instruments offshore or a relaxation of FDI policy would serve to expedite the proliferation of RMB settlement.

For trade with U.S. companies, the American counterparty is usually the importer (for 2010, 73.4% of bilateral trade between China and the U.S. came from US imports). Switching to RMB settlement transfers the exchange rate risk from the Chinese exporter to the US importer. This effectively transfers the hedging cost from the Chinese to the American counterparty, eroding competitiveness. We don't see sufficient bargaining power on the Chinese side for this to occur, as price competition is often key in Chinese export industries. However, for trade with non-US companies, particularly those in emerging markets, settling in one of the currencies of the counterparties instead of the dollar can greatly reduce foreign exchange costs.

***vi) What factors might dissuade a Chinese company from raising debt capital in Hong Kong?***

One of the main considerations in a fundraising situation is whether the RMB debt-funded investment will generate return in a foreign currency. In such a case, the borrower will suffer from RMB appreciation as loans will have to be repaid in RMB. In the same way, borrowers will gain from RMB appreciation if funds are borrowed in a foreign currency and the debt-funded investment generates return in RMB. At maturity, RMB is converted back into a foreign currency for repayment. This has been the major impediment to the proliferation of RMB loans given the strong sentiment that RMB will appreciate. J.P.Morgan expects the RMB to strengthen to 6.3/USD at the end of 2011, implying an appreciation of about 4.5%.

The major incentive for companies to raise debt capital in the offshore RMB market is the lower cost. Bond issuance is priced at less than 3% for 2-3 years in the offshore market, compared to the onshore market which charges roughly 1% higher for debt financing. As in the case of RMB settlement, proceeds that are intended for deployment in China will require approval from SAFE.

***vii) How are bond issuances promoting the proliferation of RMB use offshore?***

One of the main incentives to hold RMB is the perceived strength of the currency against the U.S. dollar and other counterparts. As mentioned, J.P.Morgan shares the consensus view that the RMB will continue to appreciate in 2011, specifically at ~4.5%. Normally, this would encourage the holding of RMB assets, as future currency appreciation will supplement investment gains or hedge investment losses. However, in the absence of investment vehicles, expected currency appreciation, which has a high degree of policy risk in itself, is not sufficient to justify substantial holdings. RMB bonds are providing the additional return to fill the gap.

The current outstanding balance of RMB-denominated bonds and notes in Hong Kong is approximately RMB49 billion (see Figure 2), more than triple that of the RMB 16 billion balance at the end of 2009. The absence of alternatives for offshore RMB investment and the inability to convert offshore funds into foreign currencies has caused offshore RMB bond holders to maintain their positions; as a consequence, the secondary bond market has little or no volume.

Hong Kong-based RMB deposits reached RMB 280 billion at the end of November, of which 60% was in time deposits earning interest rates of approximately 0.8% for a 6-12 months term. This compares to a 1.8% coupon on a 6 month HSBC offshore RMB note issued in November 2010 or 2.4% coupon typically offered on 2-3 year notes.

***viii) What are the steps involved in the internationalization of the RMB?***

We take renminbi internationalization to refer to the relaxing of capital controls so that the RMB can become a more widely used trade currency, followed by its use as an investment denomination, and finally a reserve currency. According to Simon Song, J.P. Morgan's China rates strategist, the internationalization of RMB involves 5 steps;

**1) The exiting of RMB from China (primarily via trade settlement program).** The PBoC has also announced a pilot program to allow RMB-denominated outward direct investments.

**2) Circulation offshore.** Most offshore RMB is currently deposited in Hong Kong accounts. While the prospect of currency appreciation attracts some depositors, investors who target higher returns will require more investment options.

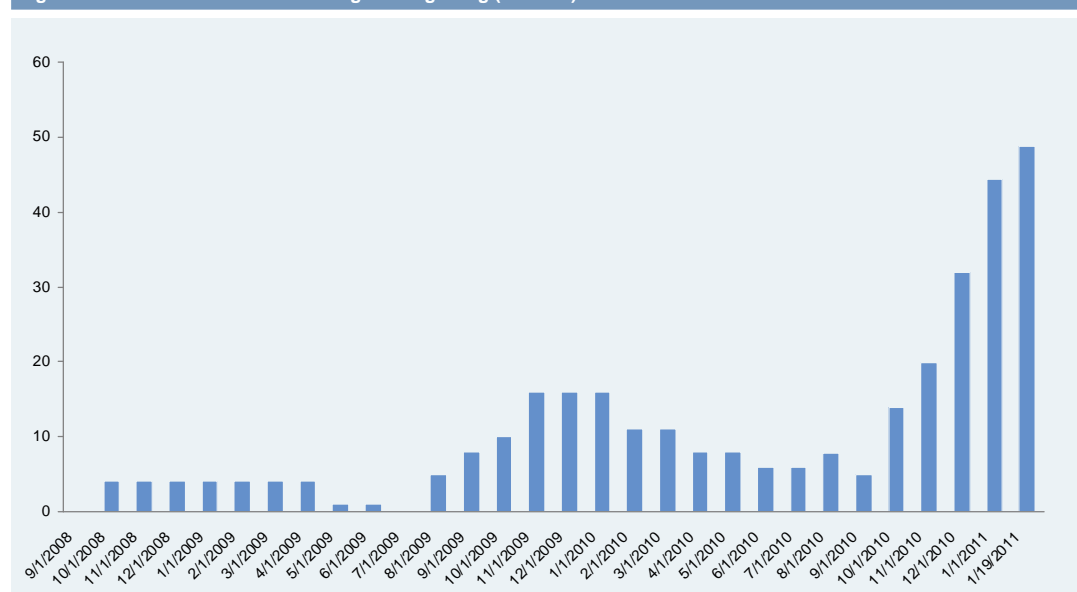
**3) Return to the mainland.** Amid concerns about excess liquidity and inflationary pressures, China's authorities have been cautious in allowing the repatriation of offshore RMB. Currently certain foreign central banks and renminbi-clearing & settlement banks are allowed to participate in China's interbank bond market, providing a channel for the recycling of offshore funds.

**4) Gradual expansion of global RMB circulation** – this is expected as pilot programs are gradually opened to wider participation. The availability, acceptance and usage of the currency will broaden in the international arena, making the offshore RMB market more active, liquid and investable.

Transaction costs will gradually decrease, differential pricing of the currency in various countries will converge, more hedging instruments will be created to manage risk and the RMB will gradually be perceived as a viable store of value by retail and institutional financial market participants.

**5) Opening of the capital account** – this is expected to be the final step of the internationalization process. At the moment, the current account is fully convertible (trade proceeds and profits can be repatriated without limit), while the capital account is only partially opened to approved business (FDI and ODI) and portfolio investments.

Figure 2: Renminbi bonds outstanding in Hong Kong (RMB bn)



Source: SAFE

**Appendix 1: Major Developments in RMB Internationalization: January 2009-Present**

Jan 09	Currency swap agreement signed by HKMA and PBOC for up to RMB 200bn
Jul 09	“Pilot program” of direct settlement of RMB transactions for cross-border trade between Shanghai and 4 cities of Guangdong on one side, and Hong Kong/Macau/ASEAN as counterparties.
Sep 09	First sovereign offshore RMB bond issue by Chinese Ministry of Finance
Feb 10	HKMA announced an important elucidation which essentially expanded scope of RMB banking business and approved mainland's non-financial corporate to issue RMB bonds in Hong Kong
Jun 10	Expanded pilot program of Jul 09 to 20 mainland provinces and all foreign countries as counterparties.
Jul 10	Relaxed restrictions on types of industries that are eligible for opening an RMB account in Hong Kong, and eliminated the upper limit on RMB exchange for businesses. Also allowed payments and transfer of funds between RMB accounts in HK. Allowing financial institutions to open RMB accounts effectively cleared a major obstacle in the issuance of RMB-denominated products in Hong Kong.  Hopewell Highway Infrastructural Ltd. issued the first local corporate bond.
Aug 10	McDonald's Corporation issued the first foreign corporate bond.  Opened up the onshore interbank bond market to authorized central banks, clearing centers in Hong Kong and Macau, as well as banks that are participating in the cross-border RMB settlement scheme.
Oct 10	HKMA activated the RMB 200bn swap line as Bank of China exhausted its RMB 8bn quota.
Nov 10	[verbatim] SAFE tightens capital account rules, causing significant disruption to on/off shore forward markets, requiring banks to maintain long USD positions at the end of each day, among other measures
Dec 10	Expanded the number of Mainland enterprises that can settle merchandise exports in RMB from 365 to 67,359.  The HKMA enacted further rules to restrict the amount of RMB held by authorized institutions in the RMB settlement program: 1) required AIs to square their positions with the Clearing Bank only when they have utilized RMB trade proceeds from their customers. 2) AIs can only purchase RMB through the Clearing Bank in Shanghai for the customers in relation to trade transactions due for payments to the Mainland within three months. 3) Lastly, AIs need to limit their net open positions in RMB to 10% of RMB assets or liabilities.  HKMA stated that it will set up a standby credit facility of 20bn RMB through its currency swap line with the PBoC in anticipation of higher yuan settlement demand in Hong Kong for 2011  BoC Hong Kong launched the “Bank of China (Hong Kong) Offshore RMB Bond Index”, the first RMB bond index in Hong Kong. It is meant to track the total-return performance of 28 offshore RMB bonds, which represented ~90% of market value.

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