

Trends and implications in the internationalisation of the Renminbi

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China’s ambition to internationalise its currency has brought about a unique set of opportunities, challenges and implications for those investing in the country. As China continues to invest in both international and domestic frameworks to support RMB internationalisation, it is important for institutions to articulate what strategic role they want the RMB and China to play.

RMB watchers have much to celebrate in recent times. Last year alone, there have been a series of landmark developments, which showcased the currency’s growing status as an international currency such as its inclusion in the IMF’s special drawing rights basket, the launch of the Shenzhen-Hong Kong Stock Connect, and the partial inclusion of Chinese equities into FTSE Russell indices.

However, there is room for further growth. As the second largest economy in the world, China enjoys considerable influence in the international arena as one of the key drivers of global growth. Yet the Renminbi’s prominence in investments and international trade is less pronounced than the size of its economy would suggest.

There are a number of challenges for RMB internationalisation, which is expected for reforms of such scale. These include an increase in depreciation expectations against the US dollar, which has led to concerns over capital outflows and a reduced appetite in RMB products.

However, China’s long-term ambitions for the Renminbi to become a reserve and settlement currency remain clear and more market-oriented reforms are

expected to push the currency forward into the next phase of internationalisation.

THE LONG-TERM GAME
China’s long-term ambition for the RMB is clear: the Renminbi will one day be a, and if possible, the major international trading and reserve currency.

But it remains underrepresented on a number of key metrics compared with other major international trading and reserve currencies, as well as with what China’s economic clout would suggest.

RMB-denominated assets, for example, make up only 1.4 percent of the global investors’ portfolio, while the currency accounts for just 1.68 percent of international payments in January 2017, according to the Society for Worldwide Interbank Financial Telecommunication (SWIFT) data. The US dollar and Euro – the top two currencies in the list - have market shares of 40.72 percent and 32.87 percent, respectively.^{1,2}

The bridging of China’s ambitions and present reality is a multi-year, if not, multi-decade project. This transition will likely progress at a pace determined by the Chinese authorities and will not come at the

expense of China’s wider economic stability.

As a result, infrastructure such as China’s Cross-border Interbank Payment System (CIPS) and Stock Connect are often built with the long-term game in mind. This long-term approach means the Chinese authorities prefer cautious and phased rollouts, which also makes them more tolerant towards slow starts or short-term volatility.

The latter, in particular, is important for Renminbi internationalisation in the current juncture as the currency is under pressure from a rising US dollar. The prospects of further US interest rate hikes has increased depreciation expectations of the RMB against the greenback, which has dampened demand for Renminbi-denominated products. This reduced appetite can be seen in the offshore Renminbi bonds market where issuance fell approximately 68 percent in 2016 to RMB 35.8 billion.

However, China has also shown a willingness to act swiftly and accordingly when the situation calls for it. This was shown when the authorities tried to counter capital flight by toughening the disclosure regime on cross-border remittances, among many other efforts, in order to stabilise the situation.



Such actions coupled with the Renminbi’s depreciation pressure have led to some doubts concerning RMB internationalisation.

A lack of new Qualified Domestic Institutional Investor (QDII) approvals since mid-2015 – a key channel for domestic Chinese investors to channel funds into offshore investments – and moves to regulate bitcoin this year reinforced such views.

But just as markets had perhaps been too bullish on the pace of RMB internationalisation in the decade leading up to 2015, they are now being too bearish. This directional shift is evident in our survey results of more than 50 industry participants that saw a lengthening of predicted timescales before the RMB is able to reach several milestones.

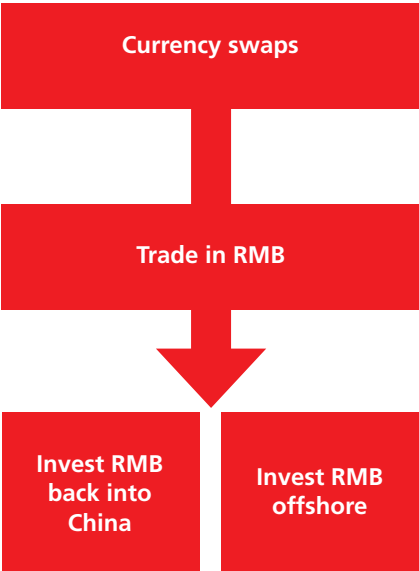
Almost 40 percent of our respondents predict full RMB convertibility within five years, which is down from over 70 percent in our 2015 survey. More than 20 percent of our respondents predict full convertibility will only occur over 10 years.

The Renminbi has come under greater depreciation pressure following China’s FX reforms in August 2015, which introduces a more market-oriented exchange rate regime. It is somewhat ironic that this liberalisation has contributed to the volatility of the currency and in its products.

Yet exchange rates are transient. What is more important is to remember that there is still plenty of latent demand for the RMB and RMB-denominated products that remains unmet.

In order to meet those demands and also for China’s long-term RMB aspirations to be realised, the Chinese authorities will not only need to focus on driving reforms, but also keep the marketplace engaged and enthused.

The following is a simplified diagram of how RMB develops in a country:



On a national level, basic RMB infrastructure such as currency swaps, forwards and futures contracts need to be in place.

For those with aspirations to be an offshore RMB hub, it would also be ideal to have an official Renminbi clearing bank designated by the People’s Bank of China (PBoC) and encourage the greater use of existing investment channels such as investing in China’s Interbank Bond Market (CIBM).

For those without such ambitions, establishing the basic RMB infrastructure in their country will also be beneficial since it can improve bilateral relations with China – the results from being an early supporter of the currency’s internationalisation process.

On a fund or individual retail level, the key is to increase the awareness, understanding and interest in investing in both CNY and CNH assets. Globally, the investment community’s level of understanding of the RMB is still fairly low. This is a reflection of the classic ‘brand recognition’ challenge in which investors are less inclined to put their money in currencies and assets that they are less familiar with.

High profile initiatives such as the proposed Shanghai-London Stock Connect would improve the global profile of the Renminbi and raise its brand recognition.

A similar lack of familiarity with the currency is also apparent at the institutional and corporate level. This, however, is also a function of the relative lack of supporting infrastructure as not many banks offer a full suite of RMB solutions and products.

This brings us to three key complex and interdependent challenges for the RMB in 2017 and beyond:

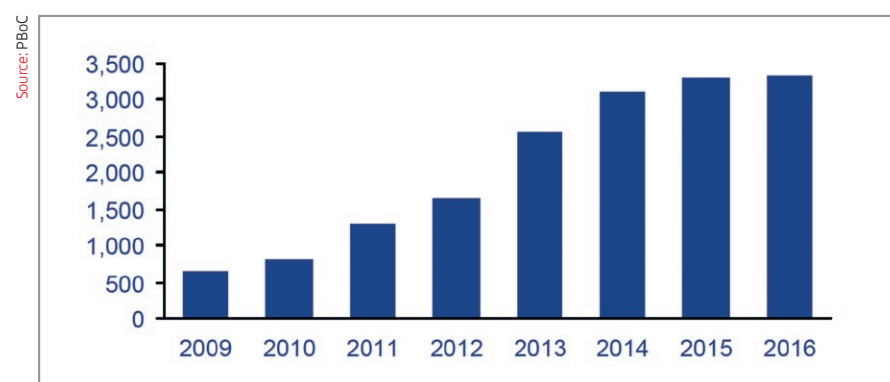
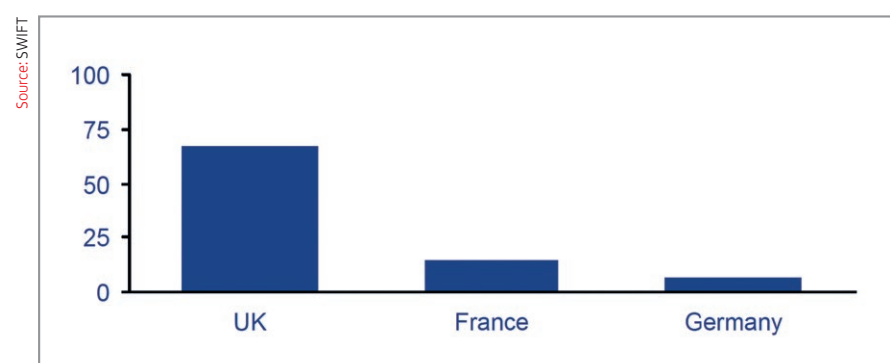
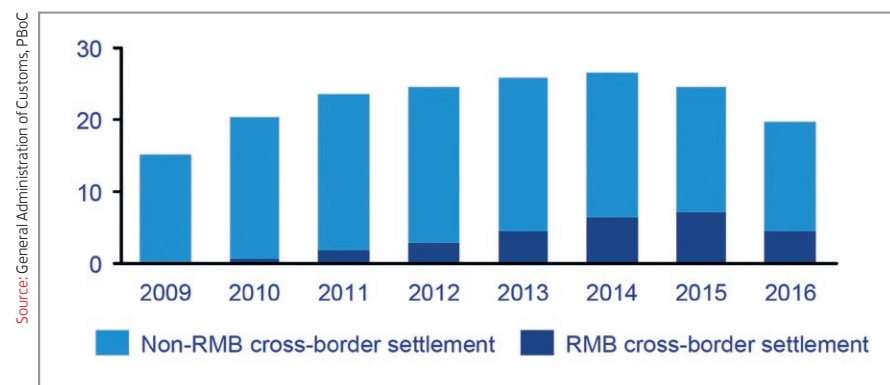
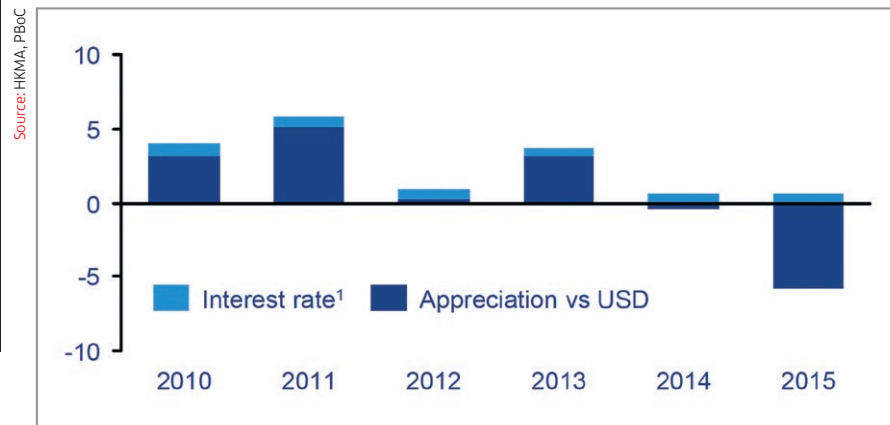
1
China’s ‘big 5’ have been given a particularly key role as clearing banks in RMB internationalisation. They will likely need strategic, operational and organisational investment in order to fulfil expectations.

2
Foreign institutions may need to reconsider their existing mindset and assumptions, articulating what role they want the RMB and China to play in their own long-term strategies. They would also need to follow through with the required operational investments to make that happen, regardless of short-term setbacks.

3
Full circle back to our original point, and echoed throughout our interview and survey research, the private sector will benefit from greater regulatory clarity and regular communication that reassures and reconfirms China’s longterm resolve.

DEMAND DRIVERS
In the past, one of the key drivers that prompted investors to increase their RMB exposure was the currency’s appreciation trajectory. Investors were able to rake in returns simply by holding cash alone.

But that appreciation trend has stopped. As a result, China needs



other levers to package the RMB as an attractive medium of value. Here we consider both proactive attempts to stimulate RMB usage as well as the wider factors driving RMB internationalisation

A long way up: demand results from trade

Aside from investment purposes, one of the key characteristics for a currency to be considered as global is whether it is being widely used in trading.

China is one of the largest importers and exporters of goods in the world and the country accounts for about 12 percent of global trade (exports and imports). Yet payments made in RMB only accounted for less than one-fifth of that, which declined from its 2015 peak of 30 percent.

This again represents caution towards RMB-denominated trading amid the current depreciation environment instead of worsening fundamentals. While there are difficulties in hedging RMB in particular when it comes to the CNY market, the underlying infrastructure has been improving.

In 2016, the China Foreign Exchange Trade System (CFETS) launched direct trading between the RMB, Korean Won and South African Rand. As things stand, 23 foreign currencies can be directly traded with the RMB on China's interbank FX market.

Enabling more direct trading between the Renminbi and other currencies helps push forward the case for the Renminbi as a settlement currency. Looking at Europe - a region with established trade relations with China - there is a markedly different take up in RMB settlement.

Meanwhile, the establishment of bilateral Currency Swap Arrangements have slowed in recent years. But in the first half of 2016, the combined size of the 35 swap lines still amounted to a considerable RMB 3.3 trillion.

The latent demand for RMB-denominated trade means that this

cool off is likely to be temporary. Still, the pace of this development will depend on China's attitude towards hedging.

The additional time it takes to complete the documentation process for settling in RMB also makes it less attractive. And even if a foreign party agrees to be paid in RMB, a challenge remains in terms of where it is able to invest the Renminbi in.

In balance? Global investor portfolios

In the longer term, a major driver will come from global institutions' need to diversify their portfolios.

China's capital market's capitalisation accounts for around 9 percent of the world's total.³ China's Gross Domestic Product (GDP) accounts for over 14 percent of the world's total.⁴ And yet, RMB-



In 2015, Belt and Road expanded to include much of central and eastern Europe

denominated assets account for only 1.4 percent of the global investors' portfolio.⁵ This shows there is quite some room for growth.

Availability and accessibility of RMB-denominated assets are arguably

two of the most important reasons why the RMB is so heavily under-allocated by the global community.

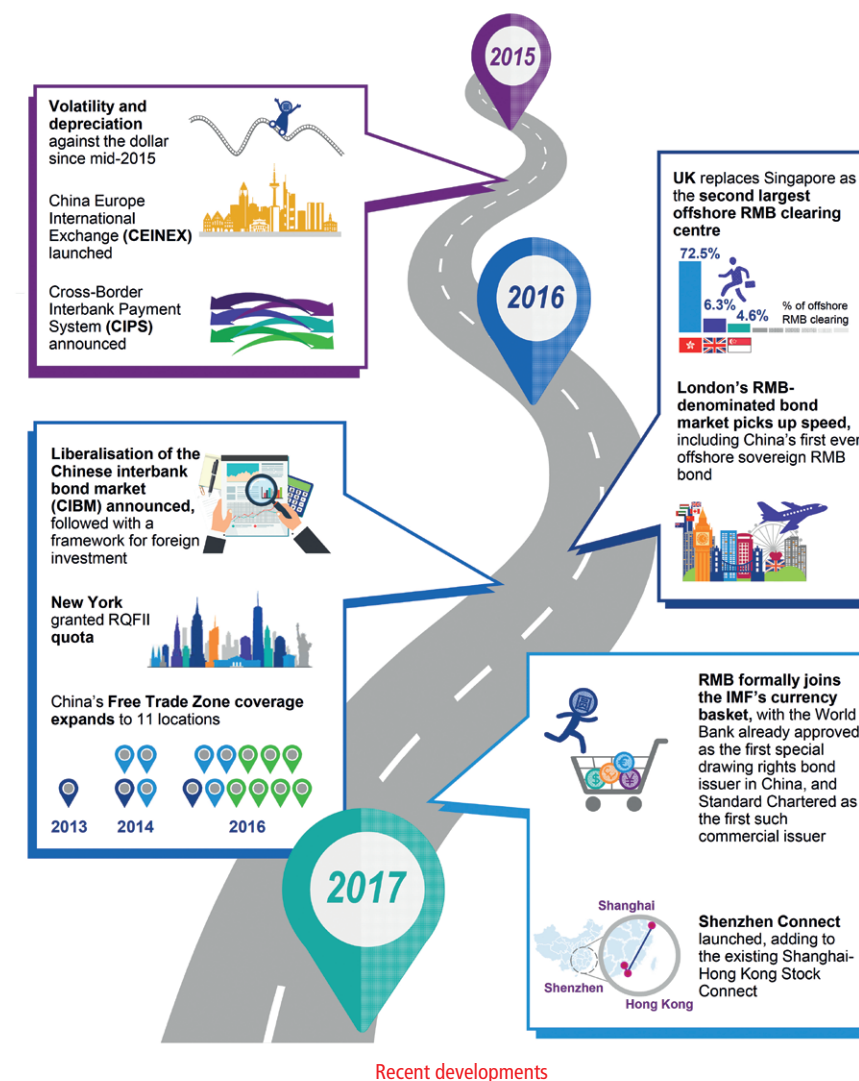
Another key reason to the under-allocation is the absence of onshore Chinese securities in most global benchmark indices for both equities and bonds.

FSTE Russell is one of the first major index providers to introduce a transitional 5 percent weighting for A-shares into its benchmark equity indices in May 2016, which came on top of the approximate 25 percent weighting foreign-listed Chinese companies already possess.

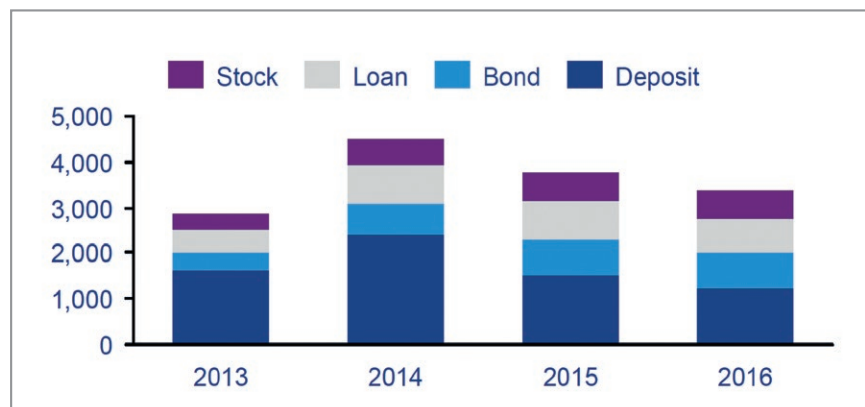
Onshore RMB bonds are also increasingly making their presence felt in the international stage following the launch of two Bloomberg-Barclays China indices in March 2017.

RMB bonds are not yet eligible for inclusion into Bloomberg's benchmark Global Aggregate and EM Local Currency Government indices. The new indices address that since they are essentially the same indices with the addition of an onshore China component.

There is an expectation that other major index providers such as the MSCI to start incrementally increase the weighting of A-shares and onshore Chinese bonds in their benchmark indices. Several of our interviewees believed that the full



Sources: 3) Wind, 2015; 4) National Bureau of Statistics, 2015; 5) PBoC, 2014



Onshore RMB assets held by offshore retail and institutional investors, CNY billion
Note: 2016 available year-to-date

inclusion of bonds is likely to occur ahead of stocks.

As Chinese capital markets become more internationalised and start playing a bigger part in global indices, we can expect a multiple times increase in the amount of RMB-denominated assets to be held by global investors.

Outbound M&A

The RMB benefits from Chinese enterprises 'going out' into the world. As such M&A activities can help steadily normalise RMB-denominated trade and investments.

There were over 500 outbound deals in 2015 alone.⁶ Alongside the usual industries like insurance, energy, real estate and chemicals, 2015-16 also saw a rise in technology and entertainment outbound activity. Within financial services, insurance companies have been the most active for acquisitions.

Consistent with our theme around China's long-term ambition versus

short-term market signals, 2016 saw a series of new rules on China's outbound companies and individuals in order to rein in capital outflows.

Grand designs: Belt and Road

Belt and Road is a key China framework, focusing on connectivity among a range of countries. It takes several forms, from cooperation on steel production capacity to the creation of the Asian Infrastructure Investment Bank, or high-profile infrastructure projects. In 2015, Belt and Road expanded to include much of central and eastern Europe.

The Belt and Road encompasses more than 100 countries of which over 30 have inked official agreements. For the Renminbi, this helps to promote it as a settlement currency when it comes to infrastructure projects with China. It also helps to plant multiple mini-RMB hubs along the Belt and Road, and raises the currency's prominence in existing hubs (e.g. Hungary issuing RMB sovereign bonds in London).

Enter the dragon: onshore capital markets

Another area of growth is to promote foreign institutions' holding of RMB-denominated assets. Onshore, efforts have been made to create additional investment channels as well as make existing ones more attractive. RMB-denominated fixed-income and equity assets have shown attractive risk-returns but challenges remain.

Consider the onshore bond market. Panda bonds (RMB-denominated bonds issued in mainland China by a non-China incorporated entity), for example, has been one of the most talked about developments in China's onshore bond market ever since the asset class restarted in September 2015.

We have seen high profile transactions from Daimler, HSBC and South Korea already, however, currently there is no updated framework for interested companies to apply for an issuance in, for example, the CIBM. Applications, for the time being, are being processed on a case-by-case basis by the regulators.

The complicated nature of China's onshore bond market may also be off-putting to some foreign participants, whether they are enterprises seeking financing or investors looking to invest.

China essentially has two onshore bond markets, divided between the CIBM and the exchange markets of Shanghai and Shenzhen. The CIBM is the bigger of the two and consists mainly of government bonds, policy bank bonds, financial bonds, local government bonds, state-owned enterprise bonds, and some corporate bonds. This market is regulated by the PBoC and the National Association of Financial Institutional Investors (NAFMII), while the China Banking Regulatory Commission (CBRC) also oversees the banks.

The exchange market, on the other hand, consists mostly of debt instruments issued by

corporates and is regulated by the China Securities and Regulatory Commission (CSRC).

As a result, the regulatory frameworks, liquidity conditions and investor base of both markets can be quite different.

Nonetheless, the development of the onshore interbank bond market is still a critical part of China's liberalisation process. The opening up of the CIBM, in particular, offers lower risk appetite groups the sort of risk-return they like.

The CIBM has undergone a significant transformation over the past two years in terms of improving access to foreign investors. Foreign investors can now opt to invest in the CIBM through their QFII or RQFII quotas, or apply to the PBoC for unrestricted access.

Unrestricted CIBM access was first opened for registration to foreign central banks, supranationals and sovereign wealth funds in July 2015. The scope was further expanded to include almost all types of financial institutions and investors with a 'long-term' mandate the following year.

A show of hands: offshore markets

Investment-driven demand comes with more dynamic offshore markets for RMB-denominated assets. In this regard, Hong Kong stands out having built a marketplace for offshore Renminbi bonds, as well as having insurance policies and gold priced in RMB.

While London is not quite at the level of Hong Kong just yet, it is becoming a complementary hub for RMB in Europe thanks to its established infrastructure, which stems from being a premium commodities, FX and bonds marketplace.

The opportunity to build a portfolio of RMB-denominated assets in London as well as other offshore RMB hubs such as Frankfurt and Singapore would help further internationalise the currency.



However, such long-term developments will, for the time being, still be bogged down by the depreciation expectations of the Renminbi as shown by the drop in CNH bond fundraising.

Step by step: emerging programmes

Besides the cross-border programs mentioned, others like the Qualified Domestic Limited Partnership (QDLP) or pending Qualified Domestic Individual Investor programme (QDII2) will have their own merits in promoting the use of the currency. However, such programmes face the same short-term challenges as regulators prioritise stability over further market reform.

The long game: infrastructure build

On the other hand, better infrastructure is also needed and this is where the private sector can do more. One such example is CIPS Phase One, which was announced in 2015 and connected to Hong Kong in 2016.

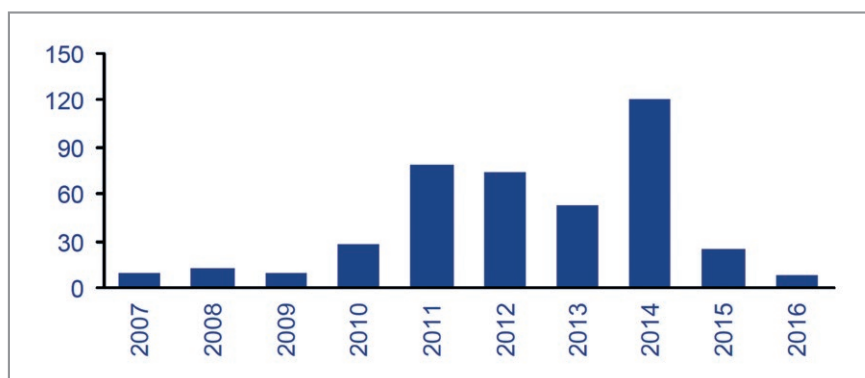
Before the launch of CIPS, Renminbi payments were transacted under the clearing bank model with the PBoC

designating an official clearing for each offshore Renminbi hub. Some 21 banks are designated as official RMB clearing banks globally.

But one of the key characteristics of an international currency is to possess a payments system based on a corresponding bank model. CIPS is China's solution to that and the onus is now on banks to adjust their systems to better facilitate cross-border investment or trade, including currency hedging tools to reduce the FX costs of trade involving RMB.

Even with the introduction of CIPS, RMB payments still take longer to process than other major currencies. This is down to lower-than-peer automation by the clearing banks, additional documentation needs, while the exact routes also differ by banks based on individual processes and liquidity needs.

Banks, however, also need to be mindful that China has made it clear that the current iteration of CIPS is only the first phase. As a result, they will need to be prepare their systems for further rollouts.



CNH Bond Fundraising in Hong Kong, CNY billion
Note: 2016 available year-to-date

Some of the features mooted in the future releases of CIPS include allowing non-China incorporated banks to participate directly and the extension of operating hours beyond 4:30pm Beijing time.

Watch this space: Free Trade Zones

Free Trade Zones (FTZs) are pilot zones for wider infrastructure. Each of the 11 zones has an area of focus. Shanghai is a key financial hub, so it is no surprise that its FTZ focuses on the financial sector.

The last 18 months have seen various pilot policies on convertibility of RMB under capital accounts, RMB-denominated bonds, wholly foreign-owned fund management companies, interest rate liberalisation, and liberalisation of foreign currency limits and offshore financing. What the FTZs already enable is free transfer of RMB with overseas hubs for corporates – FTZs are effectively onshore locations for the handling of CNH, providing a controlled onshore environment to deal with freely convertible and transferable RMB.

The importance of the FTZs lies with having the financial infrastructure to handle RMB connectivity with offshore hubs. However, cross-

border restrictions still exist, just that they have been moved between a FTZ and the rest of the country.

OBSTACLES TO CONSIDER
Despite the drivers of RMB usage covered above, there also remains a number of challenges complicating the path for the RMB’s full internationalisation.

Comfort zone: RMB brand recognition
At the outset of this article we mentioned the lack of RMB ‘brand recognition’ that may prevent mainstream investors from stepping outside of their comfort zone and into currencies and assets that are less familiar to them.

This can be hard to quantify. It is, however, interlinked with our point on infrastructure as the more investment channels there are, or the more indices include onshore China securities, the more RMB will become part of a ‘normal’ portfolio. Several of our interviewees also pointed out that the development of offshore RMB hubs has been fairly conservative, citing the low level of RMB-specific engagements.

No unicorns: asset price volatility
Contributing to the above point

is currency and asset volatility. Internationalisation of the currency and the preceding measures to open up China’s capital account have led to an increase in volatility that would have been ‘normal’ had investors been more familiar with the RMB and China.

For a long time, China stood out as an emerging market with high returns on assets despite relatively low risks. But prospects of further US interest rate hikes have hit many emerging market currencies and the RMB is no exception.

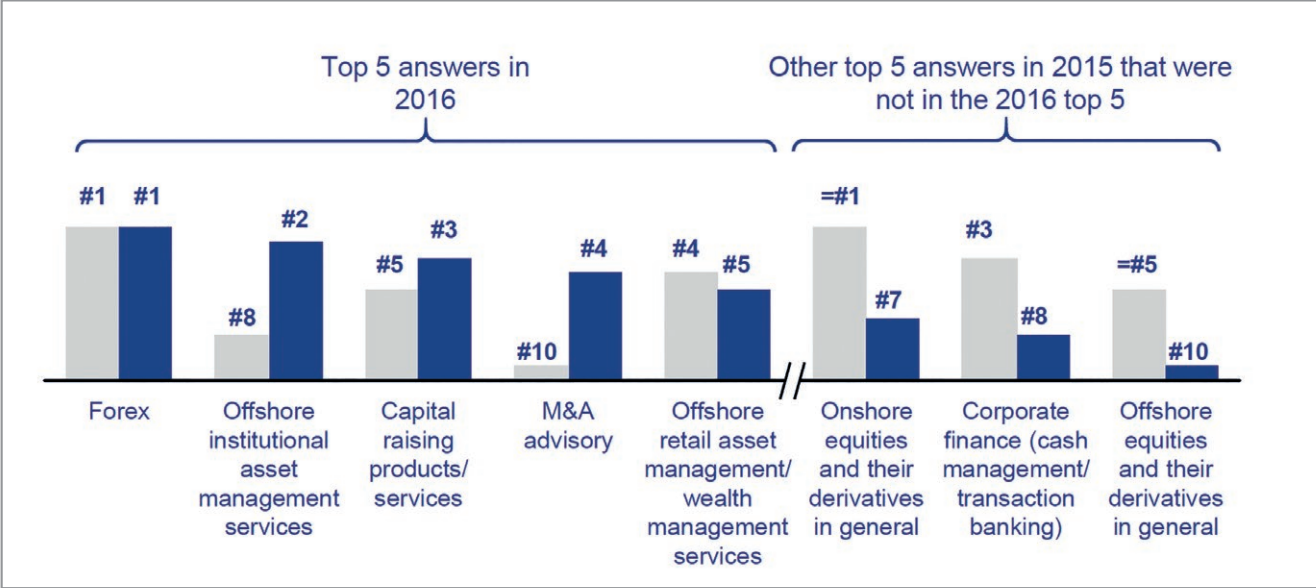
We have already seen how USD-RMB volatility increased sharply since August 2015; likewise stock market volatility in 2015 has also reminded those with RMB and China exposure to step up their risk assessment. This increase in volatility has also delayed the entry of new investors from putting their money into RMB-denominated assets.

Prepare for landing
One critical issue will be the direction of the Chinese economy. Internationalisation of the RMB has in the past capitalised on the strong growth of China’s economy, which in turn led to the increase in demand for the RMB and RMB assets.

With China setting a GDP growth target of 6.5 percent in 2017 compared with the 6.5 percent to 7 percent range last year, some stakeholders may reassess their China or RMB portfolio. But even at a lower GDP growth rate, the sheer size of China’s economy still warrants a higher allocation in all global investors’ portfolios in the long-term.

Curb your enthusiasm: infrastructure lacking?
Despite programmes mentioned earlier, the onshore infrastructure to support RMB and RMB-denominated asset trades remains inadequate.

Even though access to CIBM has been greatly improved over the past few years, some respondents felt that a number of issues still persist in the onshore fixed income



Fastest-growing international RMB business areas over next three years
(Top 5 selected from 2016 survey, ranked by popularity, with corresponding 2015 ranking)

market. This includes incomplete yield curves, inadequate information disclosure, discrepancies in domestic credit rating standards compared with international agencies, and a lack of third-party organisations to work with.

Yet not all our respondents share the same concerns about the onshore Chinese bond market. One interviewee felt that bond infrastructure was sufficient and that an investor could easily approach underwriters or brokers for analysis, and open accounts with them to access the market.

There are similar debates surrounding the equity market. Some interviewees are concerned about the various limitations on trading such as the daily 10 percent upward and downward limits for individual stocks, restrictions in the use of leverage and on the shorting of stocks, plus a lack of hedging tools.

There are also a number of restrictions that only foreign participants are subjected to including a 10 percent ownership cap on the listed shares of a company, and a 30 percent cap across all foreign investors in a listed company. This finding is consistent with our survey findings on the challenges to RMB business growth.

Then there is the risk in exposure to RMB: a lack of tools to hedge currency risk limit the potential for FX trading and investment. While there ways to circumvent the lack of hedging tools onshore, like Singapore’s Non-Deliverable Forward (NDF) contracts, these are costly and can carry counter-party risks.

On top of this, the aforementioned complexities in the offshore RMB hub clearing network is also a limiting factor to RMB usage for both public and private sectors.

Building trust: overcoming ambiguity in communication and actions

We have already highlighted as a key theme the difference between China’s long-term ambitions and what the market is perceiving in the short-term.

Some interviewees cited the lack of explanation for the absence of QDII quota approvals since mid-2015 as one example of this perceived lack of communication. Then there is the wider track record – in the financial services industry and beyond – of foreign corporates in China. Even though the country is in the midst of opening up its market to more foreign participation, China remains a relatively complex place to do business.

However, interviewees also acknowledge the fact that China has many priorities including market liberalisation and RMB internationalisation.

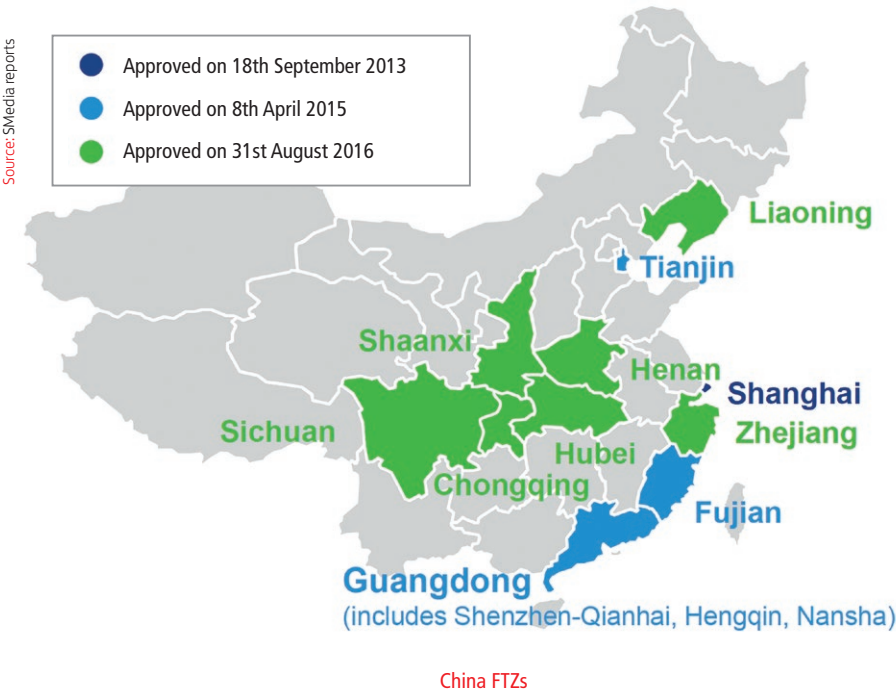
CONCLUSIONS
The Renminbi is entering a pivotal stage in its internationalisation process. For the best part of the decade leading up to 2015, the pace of RMB liberalisation and internationalisation has been reasonably steady.

The currency’s steady appreciation against the US dollar during most of this time meant demand for RMB was strong even though the development of RMB solutions and infrastructure was not particularly sophisticated.

Based on our research and our experience in China, we believe China’s long-term ambitions for the RMB remain unchanged.

The authorities will continue to liberalise its financial services sector albeit at a pace of their own choosing, and will always do so with stability as its main priority.

The reduced appetite for RMB products as a result of depreciation pressure against the US dollar is likely to be temporary and perhaps we are unlikely to see a repeat of





pre-2015 levels of optimism around RMB internationalisation.

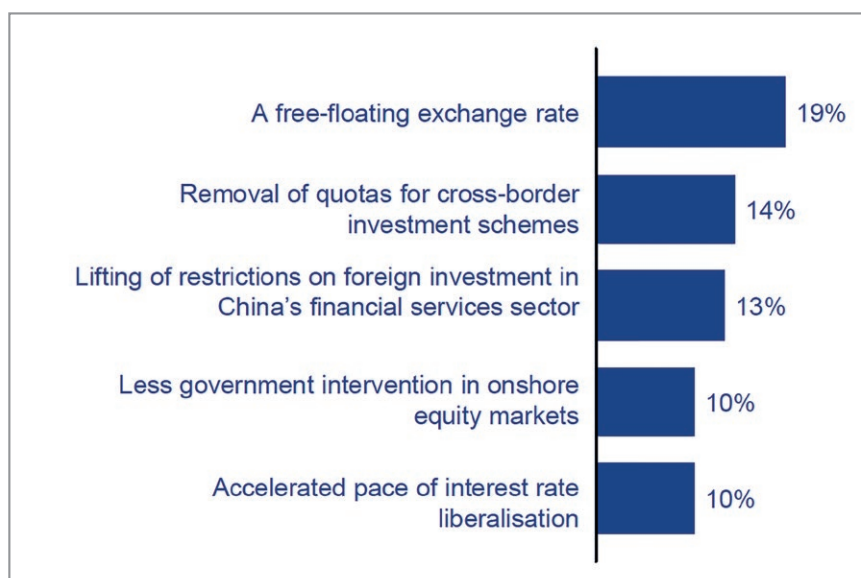
In terms of RMB trading, China's current account is relatively liberalised. But as we have outlined, RMB adoption in trade is low in relation to China's share of global trade. Cumbersome documentation requirements and a restricted pool of clearing banks puts the RMB at a disadvantage to some extent.

Even if a foreign party agrees to be paid in RMB, question marks remain in terms of where they can readily reinvest that money. China has a rapidly-growing capital markets, which from a risk-return perspective, looks quite attractive. Yet much of that is only accessible to domestic investors even if access to foreign investors is improving.

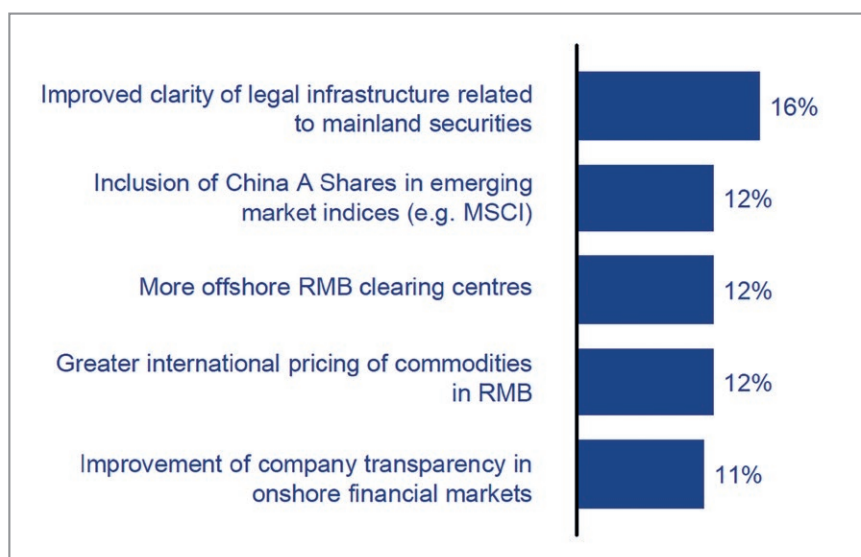
We have also touched on specifics such as equity share restrictions, and whether the RMB can be a medium to store value. Most of our interviewees are cautious on whether sufficient infrastructure is in place and whether cultural gaps can be easily bridged.

China's focus to push forward RMB internationalisation has brought along its fair share of expectations from the market. But in order to turn those ambitions and expectations into reality, further steps from the authorities will have to be supplemented with the necessary investment in its state-owned 'big 5' banks – the effective champions of RMB internationalisation.

Banks, countries and other institutions that are already investing in China stand to benefit from the early mover advantage as it is only a matter of time before sentiment towards the Renminbi changes for the better. Those market



Policy steps needed to accelerate global adoption of RMB as an investment currency
(Top 5 selected from 2016 survey, %)



Market developments needed to accelerate global adoption of RMB as an investment currency
(Top 5 selected from 2016 survey, %)

players that have invested early and with a clear strategy in mind are best positioned to benefit from that upturn.

Countries and institutions need to have a clear understanding of their core competencies and use that to devise a long-term China strategy.

Those committed to China

are looking at the long-term opportunities such as full equities and bonds inclusion into global indices, which would lead to an influx of foreign investment. This is a very likely scenario given the sheer size of China's securities market, which could become even bigger and increase by fourfold by 2025, based on its current economic trajectory.

KPMG was commissioned by the UK Department for International Trade, with the China Foreign Exchange Trade System, to publish an updated view on the internationalisation of the RMB. The report includes interviews and surveys of industry participants across banks, securities firms, asset managers, asset owners, multinational corporates, as well as industry commentators. This article summarises some of the key findings from the report.

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