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OFFSHORE RMB MARKETS IN EUROPE: PROSPECTS FOR GREATER FINANCIAL INTEGRATION BETWEEN EUROPE AND CHINA

by Daniela Marconi*, Lorenzo Bencivelli**, Anna Marra***,
Raffaele Tartaglia-Polcini**** and Alessandro Schiavone*

Abstract

China's financial integration with the rest of the world lags far behind its trade integration, owing to long-standing capital controls and underdeveloped capital markets. Since 2009 Chinese policymakers have actively promoted the internationalization of the renminbi (RMB) and its use abroad, leading to gradual but greater capital account liberalization. This paper offers an overview of recent developments in the process of RMB internationalization. Offshore RMB markets are playing an important role in stimulating China's financial integration and promoting the use of the RMB outside the country. In Europe, as elsewhere, offshore RMB centers are flourishing in response to increased demand for RMB-denominated financial services and strong political support from both sides. These developments have implications for currency trading, trade financing and banking activity in general, and strengthen the financial links between Europe and China. Capital account opening in China is expected to remain gradual. Recent episodes of instability on the Chinese financial and exchange rate markets have shown that the road to liberalization may be bumpy and international spillovers large.

JEL Classification: F3, G1.
Keywords: Renminbi internationalization, renminbi offshore markets.

Contents

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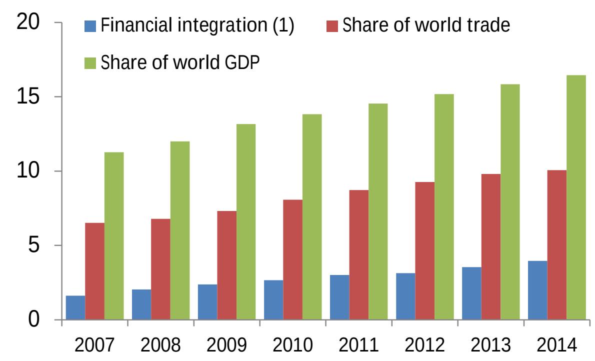
1. Introduction

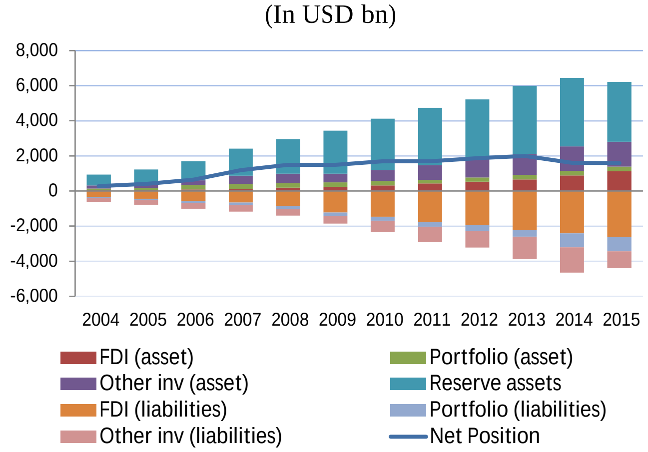
The global financial integration of China's economy lags significantly behind its trade integration, reflecting the still pervasive capital controls and the underdevelopment of its financial system (Fig. 1a). Despite some gradual relaxation, capital flows remain subject to considerable restrictions, particularly on portfolio investment. According to the Chinn-Ito Index, in 2013 China's capital account still ranked among the least open in the world.[1] These restrictions – together with the management of the exchange rate, still chiefly anchored to the US dollar[2] – have resulted in a highly unbalanced international investment position.[3] On the asset side, China's position is dominated by foreign exchange reserves; on the liability side, by inward foreign direct investment (FDI; Fig. 1b).

Fig.1a China's financial integration with the rest of the world lags behind its trade integration



Source: based on IMF data.
(1) Ratio of the sum of external assets and liabilities to world external asset and liabilities.

Fig.1b China's international investment position is unbalanced



Source: CEIC.

China has already accumulated a large stock of foreign exchange reserves, the largest in the world (peaking at USD 3.9 trillion at the end of 2014, or 37% of GDP). It is the second largest creditor

[1] Updates of the Chinn-Ito index can be found at http://web.pdx.edu/~ito/Chinn-Ito_website.htm.

[2] According to the IMF classification, China's exchange rate regime is a crawling peg against a basket of currencies, the exact composition of which has never been disclosed. The Chinese central bank sets a daily parity against the US dollar; the RMB can then be traded within a +/-2% daily trading band around this parity. On 11 August 2015 the People's Bank of China (PBoC) announced a new mechanism to determine the daily reference rate. The measure was meant to allow market forces to play a greater role in determining the daily fixing rate; however, market reports suggest that the PBoC continues to heavily manage the spot rates through foreign exchange market intervention.

[3] The root cause can be traced back to a growth strategy based on financial repression that would allow the rapid growth of capital accumulation to be totally financed by domestic savings (cf. Cristadoro and Marconi, 2013).

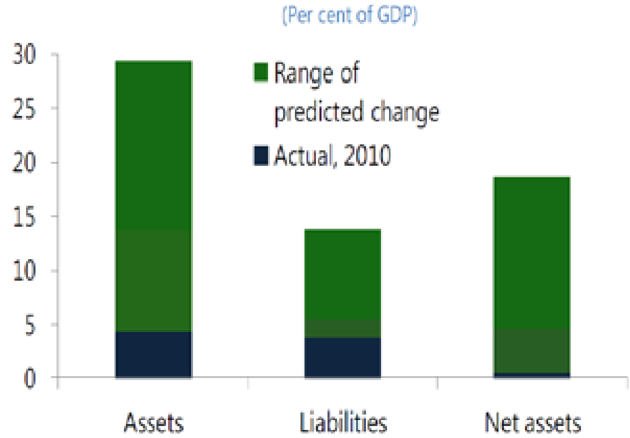
country in the world after Japan, holding net assets equal to 2.3% of world GDP (Table 1). According to Bayoumi and Ohnsorge (2013) the capital account liberalization may be followed by a stock adjustment in gross assets and liabilities, which could, over time, lead to a fivefold increase in the foreign assets held by Chinese residents (up to 30% of GDP; Fig 2a), against a threefold increase in foreign liabilities. The accumulation of net portfolio assets could be as high as 20% of GDP; it is almost nil to date.

Table 1 International Investment position and financial integration in selected countries

Country	IIP (USD bn) 2014	IIP as % of world GDP 2014	Share of world financial integration (1) 2014
Euro Area	-1360.7	0.0	19.2
United States	-7019.7	-9.0	19.7
United Kingdom	-673.4	-0.9	11.4
Germany	1451.9	1.9	6.0
Japan	3040.9	3.9	4.4
China	1776.4	2.3	3.9
Switzerland	690.2	0.9	2.8
Italy	-554.3	-0.7	2.1

Source: IMF, BOP statistics. – (1) Ratio of the sum of external assets and liabilities to world external assets and liabilities.

Fig.2 Predicted impact of capital account liberalization on China's international portfolio assets and liabilities (2)



Source: Bayoumi and Ohnsorge (2013). – (2) Portfolio assets and liabilities exclude official reserve assets.

Inward and outward portfolio investments are still subject to quotas and channeled through specific domestic and foreign qualified institutional investors schemes. So far these schemes have elicited lukewarm interest among domestic and foreign investors as they are still perceived as too restrictive, entailing cumbersome approval and transaction processes.

In recent years, however, capital account liberalization has been gaining traction, reflecting the political will of the Chinese leadership – in line with their economic reform agenda – to push for the internationalization of the renminbi (RMB). This partly explains several actions taken by the Chinese authorities in 2015 to open the domestic financial market to foreign investors. More than 30 overseas private financial institutions have been given regulatory approval to access the domestic Chinese interbank bond market. Central banks, international financial institutions (such as the World Bank) and sovereign wealth funds have all been given open access to investment in onshore bonds (including derivatives) without the need for prior approval. The timing of some of these measures was driven by China’s objective to have the RMB included in the basket of currencies forming the IMF’s Special Drawing Rights (SDR); its inclusion was finally decided by the IMF Executive Board at the beginning of November 2015.

This paper offers an overview of recent developments in the process of RMB internationalization, which encompasses currency swap agreements with a growing number of central banks, the establishment of offshore RMB markets and, more recently, the IMF decision to include the RMB in the SDR. In Europe, offshore RMB markets are flourishing in response to both increased demand for RMB-denominated financial services and strong political will from both the Chinese and the host country governments. The growing role of the RMB in the international monetary system is evidenced by the number of bilateral currency swap arrangements between the People's Bank of China (PBoC) and many central banks around the world, serving as backstop facilities to address possible sudden disruptions in the RMB market owing to liquidity shortages. In October 2013, the ECB also signed a swap arrangement with the PBoC, intended to provide the framework for the development of a market for RMB-denominated securities in the Eurozone. Nonetheless, given the limited RMB convertibility under the capital account, currency swaps may prove insufficient to prevent a shortage of liquidity and to encourage a more widespread use of the Chinese currency for financial transactions.

The development of the RMB as an international currency will depend primarily on the reliability of the institutional set-up. A business environment characterized by the uneven implementation of regulations and little protection for investments would reduce the appeal for foreign investors to hold RMB and RMB-denominated assets, especially if the ongoing slowdown of economic activity in a framework of increased capital account liberalization were to result in financial instability.

The paper is organized as follows. The second section describes how China's financial integration into the global economy is taking shape in line with the strategy pursued by the Chinese authorities to internationalize and promote the use of the RMB abroad; in this context, we provide a first evaluation of the *Shanghai-Hong Kong Stock Exchange Connect* and the *Shanghai Free Trade Zone*. The third section reviews the recent developments and the prospects for RMB offshore markets in Europe (London, Frankfurt and Paris). The fourth focuses on the recent inclusion of the RMB in the SDR basket. The fifth and final section concludes.

2. The internationalization of the RMB

The global financial crisis has made clear to China the cost of being too exposed to US dollar exchange reserves:[4] low financial returns and the risk of large capital losses have become key concerns for the country's policymakers. Since then the authorities have not only taken steps to diversify the deployment of China's huge foreign exchange reserves (by establishing its own sovereign wealth fund and financing the creation of international financial institutions dedicated to development finance), they have also put in place a more comprehensive strategy of RMB internationalization to reduce foreign currency risks and carve out a space in the global monetary and financial system. Today China is the second largest country in the world (accounting for 13% of world GDP and 11% of world trade). By promoting the international use of the RMB abroad China aims to develop the RMB into a reserve currency; an international RMB would allow China to replace US dollar claims on the rest of the world with RMB claims (Cheung, Ma and McCauley, 2011) and reduce the need to accumulate foreign exchange reserves.

The degree of internationalization of a currency is indicated by its use by non-residents to make payments, invoice trade, and denominate assets and liabilities. International currencies acquire this status as a market outcome, provided that there is political support. Historical precedents teach us that full convertibility is not a necessary condition. Nonetheless, along with the scale of the economy, the liquidity and depth of currency-denominated financial assets, backed by a credible lender of last resort for the currency, proved essential for, say, the US dollar to acquire its international role (Eichengreen and Flandreau, 2010; Eichengreen, 2013).[5] The process of RMB internationalization began by following a quite unique strategy, consisting in promoting the use of the RMB as a trade settlement currency, while encouraging the recycling of RMB into offshore markets backed by currency-swap agreements with foreign central banks. The peculiarity of this strategy hinges on the fact that China's structural 'twin surpluses' (current account and capital account surpluses), along with the limited convertibility of

[4] The composition of China's foreign exchange reserve is not publicly disclosed; some analysts put the share of US dollars as high as 70%. At the end of 2015 China's US Treasury holdings represented more than 35% of its total foreign exchange reserve assets.

[5] It is generally agreed in the literature that an international currency becomes such when it fulfils three essential functions: (i) medium of exchange, (ii) unit of account, and (iii) store of value (Chinn and Frenkel, 2005). The size of the economy is essential to fulfil the first and the second functions as it directly affects the volume of international trade and financial transactions that can be invoiced and settled. Liquidity and (internal and external) stability are key attributes for a currency to become a store of value. Liquidity is guaranteed not only by the convertibility of the currency and the depth of financial markets but above all by the existence and the credibility of a lender of last resort, ready to provide liquidity to the market. Finally, stability is mostly provided by sound institutional set ups (such as central bank independence) and macroeconomic policies, which shape the economic fundamentals and the exchange rate trajectory of the currency.

its currency and the underdevelopment of its domestic financial markets, make the provision of liquidity to the rest of the world a major challenge (Yu, 2014).

In July 2009 the State Council launched a pilot scheme to allow the use of the RMB to settle international trade transactions. Since then the internationalization of the RMB has been proactively encouraged. The eligible transactions that can be settled in RMB have been progressively widened to include not only trade in goods but also in services and other items of current account transactions; some capital account transactions have been included as well, such as inward and outward FDI and securities investment within the approved limit.

In spite of existing limitations, the international use of the RMB has grown quickly in recent years on several dimensions, particularly for trade settlement purposes. There are clear incentives for Chinese exporters and importers to invoice in their own currency to cut transaction costs (including exchange rate risk); at the same time, the sheer size of China's domestic market encourages foreign exporters to invoice in RMB if this helps them to gain market shares. In 2015 the share of China's international transactions settled in domestic currency reached 30% (up from zero at the beginning of 2010; Fig. 3a). At a global level, according to SWIFT the RMB has entered the top five world payment currencies since November 2014, although it still accounts for a modest share (less than 3%) in global payments by value; 36% of all banks involved in payments with China and Hong Kong use the RMB for some transactions.[6] The RMB's weight is far greater in trade finance, being the second currency for letters of credit with a share of almost 9.5% (the US dollar still dominates with around 80%).[7] Hong Kong remains the dominant centre for offshore and cross-border RMB payments, handling 70.4% of total transactions. Singapore and London are the next biggest players. The Asia-Pacific region (AP), which represents more than 60% of China's exports and imports, accounts for about 80% of cross-border RMB settlements (Fig. 3b). Going forward, one can expect that the network externalities created by supply chains at the regional level may induce a switch from the US dollar to the RMB. The growing influence of the RMB in exchange rate co-movements within the AP region is already evident (Marconi, 2016).

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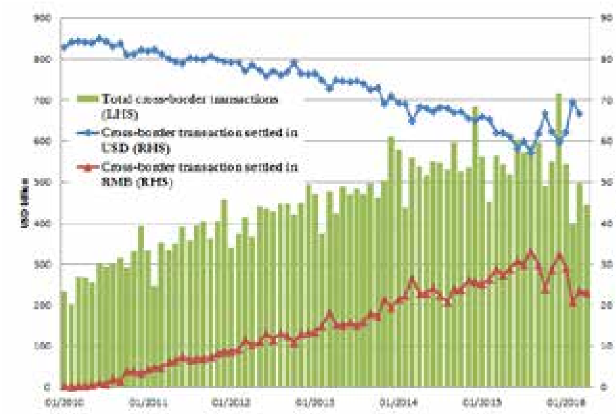
[6] http://www.swift.com.

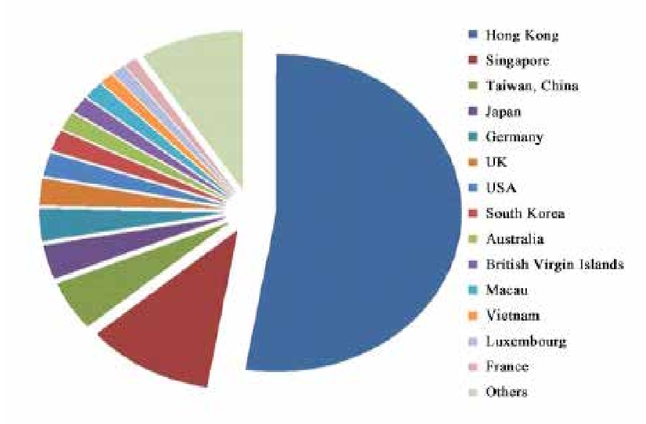
[7] However, according to IMF (2015) there are limitations on using letters of credit as an indicator of the currency composition of trade finance. Letters of credit are more common among Asian countries and the indicator does not include inter-firm trade credit, which is an important portion of trade finance and more prevalent among advanced economies. Furthermore, the size of the RMB share depends strongly on the treatment of letters of credit between mainland China and the regions of Hong Kong SAR, Macao SAR, and Taiwan. Excluding transactions within the greater-China region, the RMB accounted for 3.8% of total letters of credit in the first quarter of 2015, ranking third worldwide after the USD (85.6%) and the Euro (7.2%).

Fig.3a. Banks' cross-border payments and receipts on behalf of clients



Source: CEIC.

Fig.3.b Distribution of cross-border RMB collection and payment by country (region)



Source: PBoC

2.1 The role of offshore markets

The international use of the RMB generates a pool of liquidity abroad (RMB deposits at banks in financial centres outside Mainland China) in search of investment opportunities and hedging instruments, the limited availability of which may discourage agents from using it to invoice trade; the lack of sophistication of the Chinese onshore market and the restricted number of products (offshore and onshore) can hold back the RMB's internationalization.[8] In 2010 a fully flexible and convertible offshore RMB market was established in Hong Kong, the first and initially the only offshore market.[9] The offshore RMB pool was created through several channels, primarily RMB settlement of imports, even though other current account transactions have been gaining importance, such as Chinese tourists converting RMB abroad or individuals' remittances and corporate cross-border pooling.[10] Within the

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[8] Ito and Chinn (2014) find that countries with less developed financial markets tend to make a significantly greater use of the US dollar for trade invoicing.

[9] Currently there are two distinct exchange rates for the RMB: the onshore spot rate (denominated CNY), managed by the PBoC and accessible only to onshore market participants, and a spot rate determined in offshore markets, the most important of which is Hong Kong (henceforth CNH). The offshore exchange rate is freely floating and accessible to all market participants. CNY and CNH are exchanged at par; however, as with any other currencies, the trading between CNY and CNH is restricted to current account transactions, foreign direct investments and portfolio transactions within the quota limit. These restrictions generate a segmentation between the onshore and offshore exchange rate markets which may result in differences in the value of the two exchange rates in terms of foreign currencies. When the onshore rate deviates significantly from market valuations then the divergence between CNY and CNH tends to become larger, indicating the direction of the market pressures.

[10] In early 2014, China launched a pilot programme to enable cross-border cash pooling in the Shanghai Free Trade Zone (SFTZ). The programme allows multinational corporations (MNCs) in the SFTZ to move funds between their China headquarters and their regional or global Treasury Center (TC). An MNC uses cross-border cash sweeping to make intercompany RMB loans according to their treasury and cash management strategy. On November 2014, the PBoC officially released a set of rules applying to nationwide RMB cross-border pooling.

limits of existing restrictions, some capital account transactions have also fed into offshore pools of RMB, such as RMB-denominated outward direct investment (ODI) and portfolio investment (for a comprehensive summary of RMB flows between Mainland China and the offshore markets see Nixon at al., 2015).[11]

The development of offshore markets and the international use of the RMB are encouraged by bilateral local currency swap agreements. Swap lines are intended to reassure market participants that a safety net is in place thereby boosting confidence in the availability of liquidity in the offshore RMB market. Unlike the bilateral swap lines in place between the Federal Reserve and other central banks which are designed to provide emergency liquidity during times of market distress, the PBoC explicitly encourages the use of swap funds to support cross-border trade and investment while ensuring their security (PBoC, 2015). Since 2009 the PBoC has signed currency-swap agreements with a large number of central banks around the world, involving a total of RMB 3.3 trillion (see Table A1 in the Appendix).[12] In October 2013, a few months after the Bank of England, the ECB signed also a currency swap arrangement with the PBoC. The operational readiness of the ECB-PBoC swap line was successfully tested at the end of 2015. [13]

Offshore pools of liquidity can be re-invested freely in offshore markets, while cross-border investments in onshore markets are subject to limitations and are channeled through specific schemes that allow foreign institutional investors who meet certain qualifications to invest in a limited range of China's onshore securities products. The quotas, products, accounts, and fund conversions are strictly monitored and regulated. The Qualified Foreign Institutional Investor (QFII) scheme, introduced in 2002, allows foreign institutional investors to convert foreign currency into RMB in order to invest in Chinese onshore capital markets within a quota limit defined in USD.[14] As of December 2015 the

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[11] Outward portfolio investment is allowed through the Qualified Domestic Institutional Investors (QDII) scheme, whereby domestic investors gain approval from the appropriate Chinese authority to raise funds in Mainland China and to use the proceeds to invest offshore on the basis of a quota granted by the State Administration of Foreign Exchange.

[12] According to a recent report by the PBoC, at the end of May 2015 it had signed bilateral local currency swap agreements with 32 countries or monetary unions. At the end of April 2015, the balance of RMB assets held by overseas central banks was around RMB 666.7 billion (or USD 107.5 billion).

[13] From the ECB's perspective, the swap line serves as a backstop facility to address sudden and temporary disruptions in the RMB market owing to liquidity shortages and so reassure market participants that a safety net is in place to address possible future market malfunctioning and reassure euro area banks regarding the continuous provision of RMB. The tests served to confirm operational readiness and should not be regarded as a precursor to the activation of a swap: https://www.ecb.europa.eu/press/pr/date/2015/html/pr151126.en.html.

[14] The term 'qualified foreign institutional investor' refers to overseas institutional investors (such as asset managers, insurance companies, securities companies, commercial banks, pension funds, and sovereign wealth fund) that have been approved by the China Securities Regulatory Commission to invest in China's securities market and have obtained an investments quota from the State Administration of Foreign Exchange.

number of approved institutions under the scheme was around 280 while the approved investment funds totalled USD 80 billion (Fig. 4a).

In 2011 investment possibilities were enlarged with the launch of a new scheme defined and settled in RMB. The Renminbi Qualified Foreign Institutional Investor (RQFII) scheme allows foreign investors to invest offshore RMB into onshore equity and bond markets, within the quota limit assigned to each offshore market.[15] Unlike the QFII scheme, which requires that foreign currency be converted into RMB for settlement, the RQFII allows settlement in offshore RMB and broader investment possibilities. Since its introduction, the interest of foreign investors for the Chinese financial market has been growing fast, though starting from a very low base, but is still far from its full potential (Fig. 4a and Appendix Table B3). As regards the RQFII, around 50% of the quotas have been used so far; the remaining restrictions on repatriation for non-open-ended funds may reduce foreign investors' interest in participating in these programmes.[16] Indeed, foreign investors still hold negligible onshore market shares: at the end of 2015, overseas entities held just 0.6% of stock market capitalization and 2.1% of bond market capitalization (Fig. 4b).

Fig. 4a Qualified foreign and domestic institutional investors (approved investment funds)

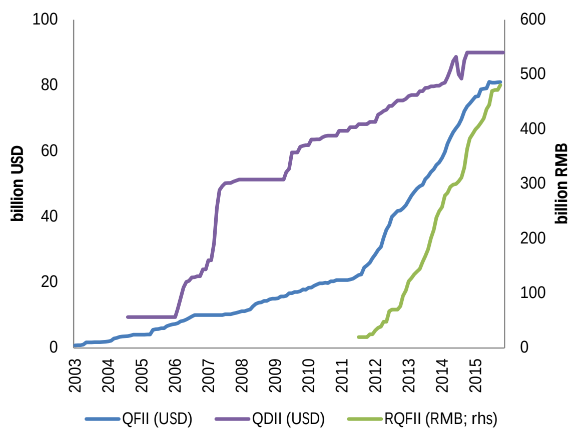
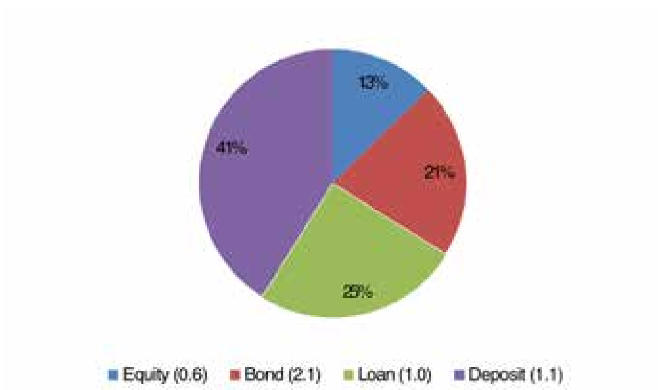


Fig. 4b Distribution of onshore RMB financial assets held by overseas entities at the end of 2015 (the number in brackets indicates market shares)



Source: CEIC.

[15] Initially restricted to Hong Kong-based institutional investors, the RQFII has been expanded to almost all other offshore RMB markets, including London, Paris, Frankfurt and Luxembourg.

[16] More than 60% of the investments through the RQFII scheme originated in Hong Kong, the only foreign market that has filled entirely the assigned quota (a number of quotas, especially those outside Asia, are used very little, if at all). According to the latest available data, in December 2015, 79 institutions out of 155 that were approved as RQFIIs were located in Hong Kong (see Appendix Table B3). Most of them are subsidiaries of Chinese companies.

In recent years RMB offshore centers have begun taking shape across all continents, based on three building blocks: a central bank swap facility, an official RMB clearing bank, and an RQFII quota.

By the end of 2015, the PBoC had set up RMB clearing arrangements in 16 countries and regions based on memorandums of understandings (MoU) with the corresponding central banks; in Europe MoUs were signed with the UK, Germany, France, Luxembourg, Hungary and Switzerland (Table 2). In each case, the overseas RMB clearing bank (always a Chinese bank) can access the Chinese domestic payment system by opening clearing accounts either directly with PBoC branches (e.g. in Hong Kong and Macau) or by opening clearing accounts with their parent bank in China.

Hong Kong, the first offshore RMB center, retains the largest liquidity pool. At the end of 2015, offshore RMB deposits and certificates of deposit issued by banks in Hong Kong amounted to about RMB 860 billion, equivalent to 1.3% of China's GDP (less than 1% of total domestic RMB deposits), and about half of the overseas total (Table 2).[17]

So far, trade settlement has been the cornerstone of RMB business abroad. Nonetheless, a wide range of RMB services are originating in offshore markets: basic retail and corporate banking, asset management, forex trading, insurance plans and products in RMB. At this stage, offshore RMB centers are essential to sustain a significant presence of the RMB as a global currency.

[17] As of December 2015, the total amount of deposits denominated in RMB held at Hong Kong institutions was about 15% below the level recorded in December 2014.

Table 2 Offshore RMB centres

Country (City)	Clearing bank	Date of appointment	RMB deposits	RQFII quota assigned	RQFII approved
ASIA PACIFIC				billions of RMB	
Hong Kong	Bank of China (Hong Kong)	November-03	860	270	270
Macau	Bank of China (Macao)	August-04	n.a.	-	-
Taiwan (Taipei)	Bank of China Taipei branch	December -12	302	-	-
Singapore	ICBC Singapore branch	February-13	257	50	31.5
Korea (Seoul)	Bank of Communications (Seoul)	July-14	135	80	71
Australia (Sydney)	Bank of China Sydney branch	November-14	n.a.	50	-
Malaysia (Kuala Lumpur)	Bank of China (Malaysia)	November-14	n.a.	-	-
Thailand (Bangkok)	ICBC (Thai)	December-14	n.a.	-	-
EUROPE					
Germany (Frankfurt)	Bank of China Frankfurt branch	June-14	12	80	6
UK (London)	China Construction Bank (London)	June-14	51	80	25.8
France (Paris)	Bank of China Paris branch	September-14	20	80	19.8
Luxembourg	ICBC Luxembourg branch	September-14	67	50	5
Switzerland (Zurich)	China Construction Bank Zurich branch	November-15	n.a.	50	5
Hungary (Budapest)	Bank of China (Hungary)	June-15	n.a.	50	-
EMEA					
Qatar (Doha)	ICBC Doha branch	November-14	n.a.	30	-
NORTH AMERICA					
Canada (Toronto)	ICBC (Canada)	November-14	n.a.	50	0.225
TOTAL			1704	920	434.3

* Based on the latest available information in January 2016. Source: Standard Chartered, City of London, Bank of England, Deutsche Bundesbank; PBC, HKMA; Monetary Authority of Singapore; press releases.

2.2 Capital account opening: the Shanghai Free Trade Zone

The relative underdevelopment of China's financial markets may hinder the internationalization of its currency. A large body of reforms aims to tackle technical bottlenecks and widen the use of the RMB to settle transactions. Since its inception in late summer 2013, the *Shanghai Free Trade Zone* (SFTZ) has raised expectations of a substantial set of liberalizations, particularly regarding the financial sector and the development of a regulatory framework to allow easier cross-border investment and trade. The pilot was meant to provide a controlled environment in which to experiment financial market reforms and capital account opening. In the course of this trial, though, it became clear to regulators and market operators that experiments and ring-fencing are not an easy task for the tertiary sector and that either the reforms should be aimed at a much broader geographical area[18] or they should cover a fairly limited

[18] The initial design involved only the area covering the Pudong international airport, the deep water port, and the zone in between, amounting to slightly less than 30 square kilometers. Currently the SFTZ is more than 4 times wider and includes the District of Lujiazui, the area in the city centre where all the major financial institutions have their headquarters.

range of market regulation.[19] With these premises, the early body of reforms proved somewhat disappointing to market participants. The international banks' initial decisions to open branches in the area were motivated more by the (largely unknown) potential opportunities than by actual business needs.

Among the most welcome developments was the substantial liberalization of the cash pooling operations for multinational corporations based in the SFTZ. These companies are allowed to include Chinese operations in their centralized treasury management, with a considerable saving of resources as they are able to move the cash flow generated or needed within the production or investment activity in and out of the country on a daily basis. However, the recent upturn in the volatility of capital flows has prompted the SFTZ regulators to adopt a more prudent stance, tightening surveillance and imposing an informal ceiling on the amount of freely transferable cash.

2.3 Capital account opening: the Shanghai-Hong Kong Stock Connect

A new channel for the cross-border use and circulation of RMB is the direct linkage between the Hong Kong and Shanghai capital markets, called the *Shanghai-Hong Kong Stock Connect* (SHKSC). The programme, launched in November 2014, allows Hong Kong and international investors to buy eligible shares listed on the Shanghai Stock Exchange, and Mainland investors to invest directly in eligible shares listed on the Hong Kong Stock Exchange. The programme is subject to total and daily investment limits. According to the data reported by the PBoC, so far these limits have not been binding.[20] According to market participants, a number of technical issues are preventing much wider use of this link; in particular, the so-called '*t-1* order placing procedures', requiring cash and share to be deposited at custodians a day in advance, impose an anticipated disclosure that market participants do not particularly like.

In the summer of 2015 the Chinese stock markets underwent an abrupt downward correction: share prices lost more than 40% of their value in less than a month. Instability resurfaced at the beginning of 2016, raising further concerns about the ability of the Chinese authorities to steer the very challenging

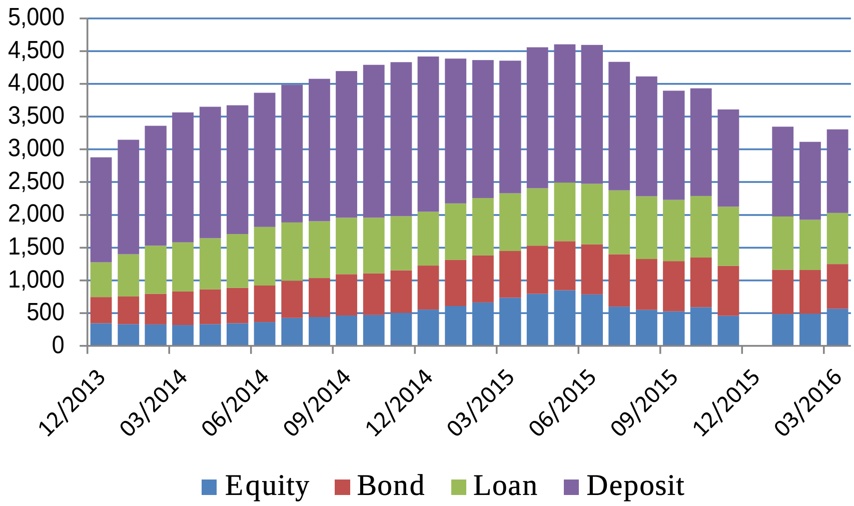
[19] RMB cross-border borrowing was allowed only to finance operation within the SFTZ or outside China.

[20] Northbound investments (those flowing from Hong Kong to Shanghai) have a total limit of 300 billion and a daily limit of RMB 13 billion; the total investment limit for southbound investments (from Shanghai to Hong Kong) has been set at RMB 250 billion and the daily limit at RMB 10.5 billion. Southbound flows are subject to restrictions on the range of domestic retail investors allowed to participate in the trading link. Only individuals who have already invested at least RMB 500,000 (or about USD 80,000) on the onshore market can invest on the Hong Kong one. The limit aims to contain the volatility that may be caused by a massive participation of retail investors in the stock market. The PBoC (2015) reports that at the end of May 2015 the total trading volume of the Northbound Trading Link was just 50% of the overall limit, 38% for the Southbound Trading Link. According to the press, for the entire 2015, only 40% of the RMB 300 billion quota for northbound flows and RMB 250 billion for southbound flows was used.

economic and financial transition. The authorities' intervention to resist the abrupt correction in share prices and exchange rate valuation was sizeable and gave the impression of potentially large manipulation of market dynamics. In addition, fears of an excessive slowdown of the economy and the unpredictability of Chinese policymakers reaction have dented foreign investors' appetite for onshore securities.[21] The link between Hong Kong and Shenzhen stock markets, which was expected to be launched by October 2015, has been postponed.

Outstanding assets held by oversees entities decreased in the second half of 2015: holdings of onshore deposits saw the sharpest decline (RMB 930 billion in the period June 2015-February 2016, equivalent to USD 140 billion) followed by equity holdings (with a drop of RMB 360 billion; Fig. 5).

Fig. 5 Domestic RMB financial assets held by overseas entities



Source: CEIC.

2.4 Payment and settlement infrastructures

Since the second half of 2014, China has taken several steps towards raising its payment infrastructures to international standards. The PBoC is developing a Cross-border Interbank Payment System (CIPS) which would enable companies outside China to settle transactions with their Chinese counterparts

[21] In July 2015 the Chinese regulators introduced major restrictions on share trading and initiated major efforts to buy stocks via government agencies (such as the China Securities Finance Corporation) in order to curb market volatility and support share prices. The circuit breaker rule that took effect on 1 January 2016 was suspended after a few days because it proved to be highly destabilizing. The mechanism, which was meant to help stabilize the market, was instead adding to investors' concern that authorities were improvising. In August 2015 the Chinese authorities also established a requirement for banks to hold 20% of their forward FX sales in unremunerated accounts with the PBoC for one year. In its *Review of the method of valuation of the SDR* (2015), the IMF observed that '*this measure could lead to higher costs for short-term than for longer-term transactions and liquidity in forward markets has declined substantially since the measure was introduced*'.

directly, overcoming the multi-step process implied by clearing or correspondent banks (see Appendix A). The platform is designed to serve all cross-border transactions on a real time gross settlement basis. The PBoC has recently stated that there are two phases in the implementation of CIPS: the first will provide gross settlement services for cross-border trade, financing and other cross-border RMB business, and the second will improve clearing efficiency by applying mixed methods of settlements to save liquidity. The first phase was launched in October 2015; 19 onshore banks (11 Chinese banks and 8 foreign banks) were allowed to open accounts with CIPS as direct participants and receive services directly; 38 Chinese banks and 138 offshore banks were approved as indirect participants to use CIPS services via direct participants. Operating hours cover the time zones of Europe, Asia, Africa, and Oceania where RMB business takes place. The corporation that governs the platform is regulated by the PBoC.

3. RMB offshore markets in Europe

In response to increased demand for RMB-denominated financial services in Europe, the competent authorities in London, Paris, Frankfurt, Luxembourg, Zurich and Budapest have signed MoUs with the Chinese authorities to be appointed as offshore financial centres for RMB activities.

These developments have implications for currency trade, trade financing and banking activity in general, and intensify financial linkages between Europe and China. In Europe, Luxembourg still retains the leading role owing to its long-standing financial relations with China.[22] In terms of RMB deposits, Luxembourg has the largest pool of liquidity, estimated to be around RMB 70 billion, essentially because China's five largest banks have already established their European headquarters there;[23] London has a stock of about 50 billion; the volume of deposits in Paris and Frankfurt is much lower.

Despite some competition, these markets are fulfilling different roles, taking advantage of their well-established respective strengths: Frankfurt aims to become the RMB hub for the Eurozone by

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[22] The Bank of China opened a branch in the Luxembourg back in 1979. See also 'Why is tiny Luxembourg key to China's global plans?' http://thomsonreuters.com/en/articles/2015/luxembourg-key-chinese-dim-sum-bond-listing.html.

[23] Industrial and Commercial Bank of China (ICBC), Bank of China (BoC), China Construction Bank (CCB), Bank of Communications and Agricultural Bank of China have their European headquarters in Luxembourg while China Merchants Bank runs a branch there. It is also worth noting that Luxembourg was the first non-Asian country to be accepted as a member of the Asian International Investment Bank (AIIB) and there is talk of the AIIB's European office being located in the Grand Duchy. Luxembourg has carved out a niche as an international fund hub, largely using the Undertakings in Collective Investments and Transferable Securities (UCITS) brand, which allows investments to be marketed across the EU.

developing the clearing bank into a clearing house and building dedicated payment and market infrastructures; Paris is carving out a role as a treasury operations centre for French multinationals, as well as for Chinese banks and multinationals willing to expand their RMB operations in Africa. London is the main RMB FX trading centre.

The development of offshore centers in Europe could facilitate the use of the RMB in trade settlement for small and medium-sized enterprises (SMEs); an important driver in the competition between offshore markets will be the ability of financial institutions to accompany the internationalization of firms into China. The evidence shows that firms have a variety of reasons for using the RMB, such as lowering transaction and funding costs, accessing new business opportunities, broadening access to onshore buyers and suppliers, and for timelier settlement (Allen & Overy, 2015).

However, according to market analysts, a lack of understanding of how to conduct RMB transactions is the greatest obstacle to companies' use of RMB in cross-border transactions. Moreover, a wider use of the RMB by European firms and multinationals dealing with China is strictly linked to the possibility of accessing a larger and diverse set of financial products denominated in RMB (Aite, 2014); indeed, the lack of overall liquidity appears to be at present the number one operational impediment to a greater use of the RMB (Allen & Overy, 2015).

The progressive liberalization of China's capital account is therefore crucial for the securities trading and asset management industry. The possibility to invest the RMB held offshore in the onshore market is appealing to foreign investors, as onshore yields are typically higher, durations longer and trading more liquid.[24] By contrast, the available supply and range of offshore RMB assets is limited and market liquidity remains scarce. The offshore bond market (called the '*dim sum*' bond market)[25] has not yet developed enough to meet the needs of the global investor community. As of April 2015, outstanding offshore RMB bonds including certificates of deposits stood at RMB 702 billion (just about 2% of the onshore bond market), 70% of which was issued by issuers incorporated in China and Hong Kong, mainly Chinese state-owned banks and enterprises (IMF, 2015; Fig 6).

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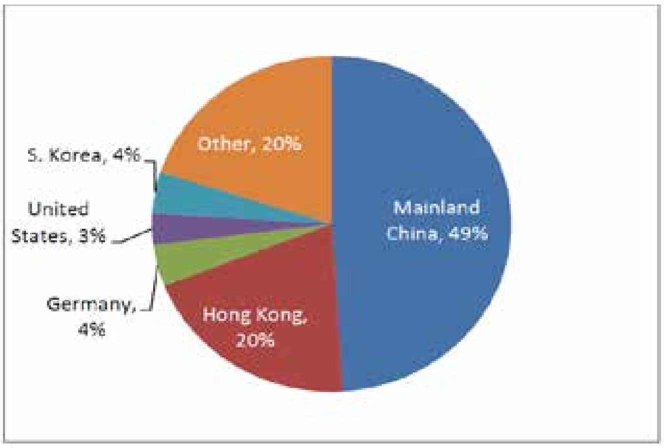
[24] China's domestic bond market is worth USD 6 trillion and is now the world's third largest after those of the US and Japan and has a far more diverse range of investments than the offshore market.
[25] *Dim sum* bonds are RMB-denominated bonds issued in offshore markets.

Fig. 6 Offshore RMB Bonds, by country of issuer, 2010-2014



Source: Asia Securities Industry & Financial Markets Association (ASIFMA), RMB Roadmap, May 2014, p. 17.

Multinational corporate borrowers are beginning to tap the onshore market using available quotas, but the onshore market has its downsides too, for both issuers and investors. According to a recent report by the *Financial Times*[26] one major concern is pricing, as it is very difficult for foreign investors to assess the true credit risk associated with local governments or state-owned corporations (often seen as risk-free due to an implicit guarantee from the government, which may no longer be the case).[27] The legal framework is another reason for concern.[28]

3.1 Paris

France and China have a long-standing political as well as economic relation. France was the first of the western countries to recognize the People's Republic of China, nominating a French Ambassador in Beijing in 1964. In 1994 the French government included the country among its strategic partners.

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[26] http://www.ft.com/intl/reports/global-currencies-renminbi

[27] Local government debt is expected to become the leading new source of issuance in the onshore bond market. In 2015 the central government approved a debt swap plan that allowed local governments to convert their high-interest bank debt into bonds and to extend their maturity. RMB 3 trillion of municipal bonds have been approved as the Chinese central government is seeking to shift the credit risk away from commercial banks on to a broader investor base.

[28] Offshore bonds are sold using some combination of Hong Kong, UK or US law. This gives investors greater reassurance about their legal protection in the event of a default. According to market agents, the *dim sum* market still offers issuers far more flexibility than going onshore, especially should they wish to swap the money raised into another currency.

Financial ties date back to the 19th century[29] and have recently been strengthened: in 2010 an MoU was signed between the Paris and Shanghai International Financial Centre to develop RMB services for corporates and to set up an offshore RMB liquidity pool in Paris to retain and recycle RMB flows, developing investment opportunities in RMB-denominated assets. In 2011 the French Presidency of the G20, recognizing the transformation of China into a major economic power, advocated the inclusion of the RMB in the currency basket used to calculate the value of the SDR.

The strategic partnership between the two countries in economic and financial affairs was further reinforced in late 2013 with the establishment of the High Level Economic and Financial Dialogue Team. This platform for policy coordination in the economic and financial fields (similar to that agreed between China and the UK) paved the way for a number of agreements signed in 2014 and aimed at developing further the offshore RMB market and support the role of Paris.

Bilateral trade between France and China is worth about EUR 50 billion (see Table A1; 6% of total France's trade). Despite France's declining external competitiveness, its exports to China have recorded a good performance in recent years. According to the Banque de France, the stock of French FDI in China amounted to over EUR 20 billion at the end of 2014, accounting for about 2% total French FDI.

French FDI in China is dominated by large enterprises, some of which play an important role in infrastructure projects and as contractors in fields such as aerospace, energy, and environmental engineering. Mutual investment has also been made in the nuclear industry as a result of strategic cooperation between the two countries.

Since 2009, Chinese investments in France (as elsewhere in Europe) have become significant. The Heritage Foundation estimates that the accumulated value of Chinese investments in France is USD 10 billion (against 24 billion in the UK, around 6 billion in Germany and about 7 billion in Italy).[30]

In the financial sector Chinese investments are mostly driven by the opportunity to assist Chinese customers that have established their business in France; another driver for Chinese financial entities to invest in France is the rise in financial flows towards African economies. Paris is considered a strategic hub in this respect because of linguistic, economic and political ties between France and several African countries.

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[29] Le Comptoir d'escompte de Paris was established in 1860, the Banque de l'Indochine in 1875, and the Banque russo-chinoise in 1895.

[30] http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map/china-global-investment-tracker-interactive-map

The French authorities have actively pursued and supported the development of Paris as an RMB centre, by encouraging French multinationals and SMEs trading with China to locate their RMB treasury operations in Paris. French firms operating in China first became interested in using the RMB in 2011 when some of them began issuing RMB denominated bonds.[31] Later, given the expanding demand for RMB services, French and Chinese banks started setting up deposit accounts in Paris for their corporate customers, often large exporting firms, providing them with a wide range of services, including trade settlement, investment and financing services. To date, RMB deposits in Paris are estimated to amount to around RMB 20 billion, still a tiny fraction of the amount held in Hong Kong (Table 3).

The use of the RMB and the clearing system

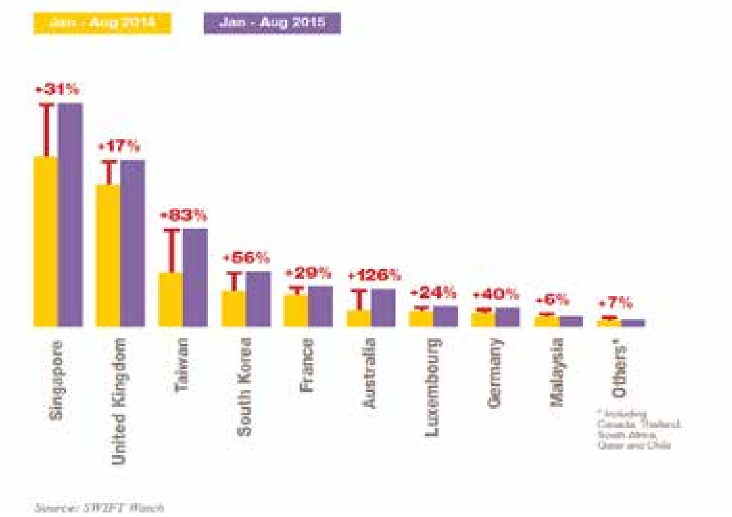
Like other offshore centre, the emergence of the Paris market is linked to increasing RMB payment flows. In June 2014 the PBoC and the Banque de France signed an MoU to set up a Paris-based RMB clearing and settlement system; Bank of China was designated as the clearing bank.

According to SWIFT data, France ranks fifth worldwide for RMB payments and first in the Eurozone (Fig. 7), with a market share in RMB payments (excluding central bank transaction values) standing at 1.6%. According to Paris Europlace more than 40% of payments between France and China (including Hong Kong) are now denominated in RMB.[32] A large share of these transactions relates to intra-group transfers reflecting liquidity pooling strategies. About 20% of bilateral trade in goods between France and China is settled in RMB; the share is higher among larger companies. The main reasons for invoicing in RMB relate to hedging and transaction costs (linked to the use of a third currency), and to improving commercial relations. RMB invoicing allows firms to obtain better price conditions and easier access to the domestic Chinese market. It is often reported that importers can get a price discount of up to 3% when they deal with their Chinese counterparts in RMB. Moreover, switching to RMB allows them to obtain greater flexibility of payment and trade financing conditions. For example, overseas firms dealing with RMB may benefit from an extension of payment terms of up to 360 days, far beyond the standard term for payments settled in other foreign currencies (90 days).

[31] Air Liquide was the first French company to issue RMB-denominated bonds for RMB 1.75 bn.
[32] http://www.paris-europlace.net/rmb/page028.htm.

Fig. 7 Evolution of RMB payments in countries with RMB clearing centres

(Payments sent and received by value, excluding China and Hong Kong)



The development of RMB payments between France and China is supporting RMB banking activities in Paris for both French and Chinese banks, with the latter having a slightly larger share. French banks collect deposits mainly from French exporting firms, whereas Chinese banks' branches in France deal with Chinese customers, part of whom are looking for investment opportunities overseas, especially in Africa. The prevailing opinion among market analysts is that RMB deposits in Paris will expand along with the use of the RMB for trade settlement purposes by French SMEs. Deposits may be further boosted by the supply of cross-border RMB pooling services, making it more convenient for French multinationals to hold RMB.

According to many market analysts the appointment of Bank of China as the clearing bank in Paris will not affect the overall supply of RMB services. In fact, currently about 80% of French cross-border RMB transactions are executed through Hong Kong and the remainder rely on the correspondent bank model (see Appendix A).[33] After all, what matters to customers are the transaction costs embedded in the fees charged by banks and the time needed to clear the transaction. Usually, transactions between offshore markets tend to pass through clearing banks in Hong Kong, whereas direct cross-border payments involving Chinese counterparties are more and more often executed through French banks'

[33] This pattern could even be reinforced by the recent designation of BNP Paribas as 'offshore RMB liquidity provider' in Hong Kong. Designated banks have access to a repo facility of RMB 2 billion, allowing them to expand their market-making activities in Hong Kong.

subsidiaries in China acting as correspondent banks. The development of this last channel is expected to be fostered by the launch of the CIPS platform which will make offshore clearing banks redundant.

The bond market

The development of an RMB offshore bond market in Paris could benefit from the international role of the French banks, which are already among the top five underwriters of offshore RMB bonds, accounting for about one fifth of the market. French companies were among the first issuers of *dim sum* bonds. According to Paris Europlace, many French issuers have amended their debt issuance programmes to include an RMB option to rapidly issue RMB securities should a need arise and market conditions be favourable.[34] For French banks, which, like their European peers, have issued RMB certificates of deposit through branches in Hong Kong, RMB bond issuance responds to their funding strategies, representing a complementary source with respect to their RMB deposits.

The RMB offshore bond market has grown considerably since 2010, partly thanks to its great flexibility, allowing overseas investors to disinvest at will and to make arbitrage transactions. A downside of this market is its limited liquidity, with too few issuers especially for long durations. A survey carried out by Europlace in 2012, found that French corporates have relied increasingly on RMB offshore markets to finance the expansion of their operations in China.

An increasing number of RMB bond issuances by French corporates have been made in Paris through Euroclear as central depository; these securities are governed by French law and are often listed on Euronext Paris. Nonetheless, as Asian investors represent the bulk of the investor base (around 70%), the pricing, syndication and placement phases are still usually executed in Hong Kong. In 2014 BoC Paris branch issued the first *dim sum* bond in Paris, amounting to RMB 2 billion, aiming to use the proceeds to support offshore RMB business in Paris and trade activities between the two countries. At the beginning of 2015 CADES, a French public sector entity,[35] issued an RMB 3 billion bond (equivalent to EUR 424 million) with a 2-year maturity.

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[34] http://www.paris-europlace.net/rmb/page028.htm.

[35] Caisse d'amortissement de la dette sociale (CADES) is a government agency appointed to manage the public debt issued to financethe French welfare system. The central banks of China and Japan are reported to have been the main purchasers in 2014.

Asset management

The progressive liberalization of capital movements by Chinese authorities will create new opportunities for overseas investors, making RMB assets attractive to global asset managers as well. Moreover, it will encourage firms dealing in RMB to hold deposit accounts and to manage liquidity flows more efficiently.

Under the QFII scheme the total quota granted to French institutions was worth over USD 2 billion as at the first quarter of 2015. In 2014 France was also granted an RQFII quota of RMB 80 billion, the same amount granted to the UK. As of December 2015 five French financial institutions have been approved by the China Securities Regulatory Commission (CSRC) to operate under the RQFII programme, being granted a total quota of RMB 19.8 billion (Appendix C). The potential demand for RMB-denominated assets is perceived as a good diversification opportunity for the asset management industry in France as onshore markets, including Chinese fixed income, could provide relatively high yields. [36]

The Shanghai-Hong Kong Stock Connect is expected to widen the French investor base. Investment flows will also be encouraged by the mutual recognition of investment funds between Hong Kong and China. The growing financial integration between China and France has also been underscored by the recent decision of the Banque de France to invest in RMB-denominated securities through the China interbank bond market, using the quota awarded by the PBoC.

3.2 Frankfurt

At EUR 75 billion in 2014 (6.4%, China is the fourth destination for German goods exports worldwide and the second outside the EU after the United States. In the last five years, German exports to China have grown at an average rate of over 15%. In 2014 imports from China reached EUR 61 billion (8.6 per cent of the total), the second largest after the Netherlands. The bilateral volume of trade between Germany and China is equivalent to the sum of the bilateral volumes of France, the UK and Italy with China.

The importance of China for the German economy and the prospects of further improvements are fundamental driving force for German financial institutions to develop Sino-German financial ties and

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[36] This a perception was particularly strong before summer 2015, when the exchange ratehad low volatility and moved along a gradual path of appreciation, while onshore markets were dominated by investor optimism.

open their businesses to the use of the RMB. In a speech on 3 July 2013, the member of the Bundesbank Board Joachim Nagel advocated the role of Frankfurt as a possible offshore RMB financial centre.

German firms, especially small ones, are still not particularly aware of the new opportunity partly because the Frankfurt offshore RMB centre has been operating for little more than a year. Several initiatives are being taken to publicize to the industry the possibility and the advantages of settling their payments to and from China directly in RMB via the new offshore centre in Frankfurt. According to a recent survey by Commerzbank, the second largest German bank, 17% of German SMEs trading with China are already settling their commercial payments in RMB, while another 11% are planning to switch their invoicing to the Chinese currency.

Anecdotal evidence on the early experiences of German firms using the RMB clearing in Frankfurt shows clear advantages in terms of reduced red tape and the discounts often granted for imports from China invoiced in RMB. The possibility of cross-border cash pooling is regarded as potentially highly desirable, but so far has not been exploited owing to the high threshold requirements (minimum turnover of RMB 5 billion in China).

Market infrastructures: clearing

In October 2013 an ‘RMB-Initiativgruppe’ was created in Frankfurt, gathering Chinese banks operating in Germany, German suppliers of financial services and the Bundesbank. The most important industrial associations supported and tracked the venture. It was backed by the administration of Land Hessen (the German region where Frankfurt-am-Main lies), with the long-term goal to further develop Frankfurt as an international financial centre.

A working sub-group was created, led by the Bundesbank and including the largest German banks, the Deutsche Börse Group, and the payment provider SWIFT. The group examined three possible clearing models for an offshore RMB platform in Frankfurt: the correspondent bank, the clearing bank, and the clearing house.[37] The model adopted is a two-stage model. In the first stage a clearing bank will be appointed; after an evaluation of the trade volumes, the second stage will entail a decision to upgrade the existing clearing bank to a clearing house. The aim is to achieve for Germany a leading position in the European RMB payment system.

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[37] The discussion paper is available on the Bundesbank website:
https://www.bundesbank.de/Redaktion/EN/Pressemitteilungen/BBK/2014/2014_03_28_renminbi_clearing_frankfurt.html

The Bundesbank played an explicit and vocal role in advocating the importance of having an RMB offshore centre in Germany; its capability for technical dialogue with the Chinese central bank was a key factor in the success of the initiative.

On the occasion of the official visit of Chinese President Xi Jinping to Germany (28-30 March 2014), the German central bank and the PBoC signed a letter of intent on the clearing and settlement in RMB on the offshore market in Frankfurt. In the same period, Deutsche Börse Group announced a trade and clearing agreement with Bank of China.

Of the four Chinese banks operating in Frankfurt (Bank of China, Agricultural Bank of China, ICBC and China Construction Bank), the Frankfurt branch of Bank of China was appointed RMB clearing bank in Frankfurt. The appointment was proposed by the Chinese central bank and accepted by the Bundesbank verifying that the requirements had been met. The clearing bank holds accounts in Chinese currency for German and European banks and enterprises. RMB payments between RMB account holders with the clearing bank and cross-border RMB payments with Mainland China or Hong Kong are transferred via these accounts. For the first months of operation, as a promotional tool Bank of China decided to offer its services in Frankfurt free of commission.

As of April 2015, 22 German banks take part in the RMB Clearing hub in Frankfurt as well as 9 banks from other EU countries (5 of which Austrian).

Market infrastructures: Securities

The opening of the new offshore RMB market in Frankfurt is triggering the development of a Frankfurt-based financial market denominated in RMB. The way for a market in RMB-denominated bonds in Germany was paved by Kreditanstalt für Wiederaufbau (KfW) in April 2014 (a few weeks after the deal between the PBoC and the Bundesbank): the German development bank issued 2-year bonds (called 'Goethe bonds') for EUR 120 million. Other RMB-denominated bonds were issued in the subsequent weeks by the German branches of the Agricultural Bank of China and the China Construction Bank.

Within the RQFII scheme, Frankfurt was allotted RMB 80 billion, the same amount as Paris and London. In March 2015, Deutsche Asset & Wealth Management (DAWM) was granted an investor licence under the RQFII, becoming the first German financial institution to be allowed to trade in the securities market in China.

In June 2015 the Bundesbank published the first data regarding volumes of financial instruments issued or traded in RMB (Table 3). Compared with the third quarter of 2014, the amount of deposits and loans in RMB held by German MFIs was roughly stable, in contrast with foreign exchange transactions which are instead highly volatile and affected by seasonal factors. The amount of outstanding securities denominated in RMB and circulating in Germany had almost quadrupled.

Table 3. Assets and operations denominated in RMB in the Frankfurt offshore centre

	2014 Q3	2014 Q4	2015 Q1
Deposits held by German MFIs (1)	11.6	12.7	11.7
Loans issued by German MFIs (1)	12.6	11.9	11.5
FX trading by German MFIs (2)	989	1,415	311
Outstanding securities circulating in Germany (1)	4.7	8.8	21.7

Source: Deutsche Bundesbank. Amounts in RMB billions. (1) Stocks. - (2) Flows.

As a further step towards closer financial integration of China and Germany, in October 2015 Shanghai Stock Exchange, Deutsche Börse AG and China Financial Futures Exchange agreed to setg up the China Europe International Exchange (CEINEX), holding stakes of 40%, 40% and 20% respectively. The new market infrastructure has received support and recognition from the governments and regulators of China and Germany. The agreement, was signed in Beijing during the official visit of the German Chancellor Angela Merkel, who attended the ceremony. CEINEX is based in Frankfurt and is a corporate entity under German law: it is the first dedicated platform for RMB-denominated financial products outside Mainland China. It is poised to build an offshore RMB securities listing and trading centre in Europe, offering services to meet investors' demand for RMB investment and financing.[38]

3.3 London

The increasing importance of London as an offshore centre for RMB-denominated activities is linked partly to the City's long-established position as the main global financial hub and partly to the proactive political will of both the British and the Chinese governments to foster closer cooperation between the two countries in all economic and financial sectors.

[38] http://www.bocigroup.com/pub/en/bociview/newscenter/201511/t20151118_1285.htm.

In April 2012 the City of London launched 'The City of London initiative for London as a center for renminbi business'.[39] Since then there have been State visits and an unparalleled surge in Sino-British relations, with the Chinese authorities supporting London as a future major hub for RMB business and the UK Government openly backing the RMB's inclusion in the IMF's SDR. The 5th and 7th UK-China Economic and Financial Dialogue (EFD) in October 2013 and September 2015, marked a significant step forward.[40]

On 22 June 2013 the Bank of England and the People's Bank of China signed a reciprocal 3-year GBP/RMB currency swap line for a maximum value of RMB 200 billion. Following the agreement reached at the 7th EFD, in October 2015 the two central banks renewed the bilateral agreement for a further three years and increased the swap line to 350 billion (GBP 35.7 billion).[41] As the BoE stated, the increase in the value of the swap line 'reflects the continuing growth of RMB trading in London' and the choice to support 'the development of an effective and resilient RMB market in London'.

In October of 2013 London increased its role as offshore centre for trading activities denominated in RMB following the PBoC's decision to extend RQFII programme - with a quota of RMB 80 billion - to the UK, the first country outside Asia to be awarded this licence. In June 2014 the PBoC appointed China Construction Bank as the RMB clearing bank in London.

As expected, within a short space of time there was a considerable development in both the foreign exchange market and trade finance instruments. A certain dynamism was observed on the *dim sum* bond market as well, while the demand for quotas (under the RQFII programme) to invest directly in China's financial markets is still developing slowly. This could be partly due to the fact that market participants are already able to tap the quota available on the Hong Kong market. Moreover, according to market analysts, the launch of the Hong Kong-Shanghai Stock Connect a few months later (November 2014) has boosted expectations of more direct access to the domestic financial market, making the RQFII scheme redundant.

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[39] The City of London Corporation promotes London as the world's leading international financial and business centre. The initiative involved 10 major international and Chinese banks and sought to identify practical measures to support the development of London's RMB markets. Until the end of 2014 it was the main - if not the only - source of data on activities in RMB through semi-annual surveys among its members on the volumes of deposits, currency trading and derivatives, and trade finance operations. At the beginning of 2015 the Bank of England started to publish data on the RMB business of UK monetary financial institutions.

[40] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/251619/UK-China_5th_Economic_and_Financial_Dialogue_Factsheet.pdf
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/473734/ChinaEFD7_Factsheet.pdf

[41] See http://www.bankofengland.co.uk/publications/Pages/news/2013/082.aspx for the 2013 agreement and http://www.bankofengland.co.uk/publications/Pages/news/2015/078.aspx for the 2015 agreement.

RMB deposits

RMB deposits in the London market were growing rapidly – though from a low base – until the recent turmoil in the Chinese financial markets: according to the BoE, at the end of June 2015 the total stock (deposits and certificates of deposits) had reached GBP 6.2 billion but then declined to 5.9 billion at the end of September. The latest available data show a further severe contraction to GBP 4.6 billion (RMB 42.4 billion) at the end of December (Table 4).[42] Initially dominated by interbank transactions, they are now held mainly by corporates, highlighting the growing interest of firms in using the RMB as settlement currency for trade with Chinese counterparts.

Specific to the London market is the strong development of FX transactions in RMB. The prominence of London in the global FX market was a natural magnet.[43] According to SWIFT, more than 50% of RMB FX trading activity outside China and Hong Kong is carried out in the United Kingdom. Estimates by Standard Chartered suggest that in 2014 London surpassed Hong Kong in terms of volume of negotiations in offshore RMB.[44]

Foreign exchange transactions

According to the latest BoE data (Table 4), the average daily turnover of FX transactions in London was GBP 43.4 billion at the end of December 2015, down from 51.7 billion at the end of September.

Table 4 Renminbi business of UK Monetary Financial Institutions

Renminbi business of UK Monetary Financial Institutions

£ millions

Renminbi deposits and lending	**Amounts outstanding as at end-June 2015**	**Amounts outstanding as at end-September 2015**	**Amounts outstanding as at end-December 2015**
Renminbi deposits held and certificates of deposits issued - total UK and non-resident - all sectors	6,162	5,881	4,570
Renminbi lending to UK and non-resident deposit-taking corporations	5,649	4,637	3,510
Renminbi lending to UK and non-resident non deposit-taking corporations	1,175	1,780	1,206

[42] www.bankofengland.co.uk/statistics/Documents/dl/010316fsg.xls

[43] According to the BIS *Triennial Central Bank Survey*, London is the top world centre for FX trading, conducting about 40% of global FX trade in 2013.

[44] *Renminbi internationalization – The pace quickens*, Standard Chartered Global Research, June 2015. https://www.sc.com/BeyondBorders/wp-content/uploads/2015/06/2015-06-10-BeyondBorders-Report-RMB-internationalisation.pdf

Renminbi foreign exchange turnover by instrument	Average daily turnover 2015 Q2	Average daily turnover 2015 Q3	Average daily turnover 2015 Q4
FX spot	12,975	19,090	17,172
Forwards	8,197	10,755	8,823
FX swaps	10,204	13,783	11,470
FX options	4,243	7,611	5,540
Other	453	434	394
Renminbi foreign exchange turnover by counterpart sector	**Average daily turnover 2015 Q2**	**Average daily turnover 2015 Q3**	**Average daily turnover 2015 Q4**
FX turnover with UK deposit-taking corporations	9,393	15,980	13,348
FX turnover with non-resident deposit-taking corporations	12,460	16,858	12,123
FX turnover with other sectors	14,220	18,834	17,929

Source: Bank of England

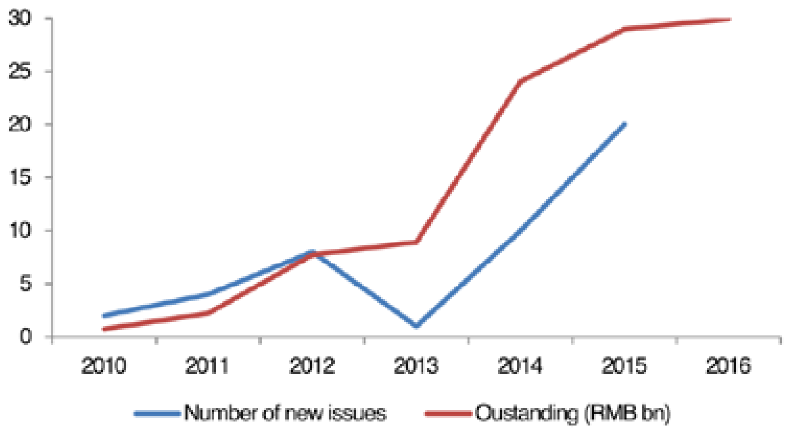
The bond market and other financial linkages

The London offshore bond market is still limited in size but constantly increasing. At end-April 2016 there were 69 *dim sum* bonds listed on the London Stock Exchange (LSE) market, with a combined outstanding amount of RMB 28.7 billion (Fig. 8).[45]

The EBRD was the first issuer of an RMB-denominated bond in June 2010, while HSBC issued the first retail RMB-denominated bond on the LSE's Order Book for Retail Bonds in May 2012. Both 2014 and 2015 witnessed an increase in primary market activity, with almost 20 RMB-denominated bonds by international issuers. This trend is confirmed in the first quarter of 2016 with 30 new issuances. Major issuers are private banks (from the UK, China, Australia, Abu-Dhabi, Qatar and other Middle-East countries), companies like BP with a growing interest among international and public institutions: in June 2014 the IFC (which is part of the World Bank Group) issued the first green *dim sum* bond globally. Between 2014 and 2015 the IFC issued four *dim sum* bonds for a total of RMB 6.5 billion. In October 2014 the British Government issued the first non-Chinese sovereign offshore RMB bond (3 billion). In October 2015 Agricultural Bank of China issued the first USD/RMB multi-tranche offshore green bond by a Chinese financial institution, while China Construction Bank issued its first offshore RMB bond. In April 2016 Hungary issued the first sovereign RMB bond in Continental Europe (1 billion) on the LSE.

[45] See http://www.londonstockexchange.com/specialist-issuers/debts-bonds/renminbi/rmb-presentation.pdf, and also http://www.londonstockexchange.com/specialist-issuers/debts-bonds/renminbi/20150908-dim-sum-factsheet.pdf

Fig.8 *Dim Sum* bond issues on the London Stock Exchange



Source: London Stock Exchange.

According to market participants, however, new issuance is being held back by rising costs. The severe stock market turmoil that overtook China last summer, as well as the greater exchange rate volatility that followed the 11 August 2015 regime shift, have probably prompted investors to demand higher risk premiums for holding the debt. Moreover, as more reforms are introduced, such as greater access to the onshore bond markets, questions about the long-term viability of the offshore market will inevitably arise.

Prospects for further developments: foreign exchange reserve management

The year 2015 has been crucial for extending and deepening Sino-British economic and financial links. The London's growing status as offshore RMB centre is a powerful driving force towards additional and sophisticated products and services (including cash management services and trade settlement for corporate customers internationally). The use of the RMB in trade with China is viewed very favourably by medium and large international enterprises, both for risk management purposes and as a mean to establish better procurement terms with Chinese trade partners.

Foreign exchange reserve management on behalf of overseas central banks is also a potential major business. On October 2014 the UK Treasury itself gave mandate to Bank of China, HSBC and Standard Chartered Bank (as joint lead managers) for its own benchmark size offshore bond issue of RMB 3 billion, stating that the proceeds of the issue would be used to finance the UK government's foreign currency reserves (held at the Bank of England). [46]

[46] The bond pays a coupon of 2.7% and will mature on 21 October 2017.

There is some evidence that London is acquiring an important role in corporate treasury management services for large Asian and US groups. In addition, the presence of Chinese banks in London is expanding rapidly. Those banks tend in particular to offer corporate banking and trade finance services to large and medium-size multinational Chinese firms to which they already provide services in Mainland China. The inclusion of the RMB in the SDR basket is expected to have a significant impact on RMB business in London, boosting confidence in the currency and the willingness of overseas central banks to invest part of their reserves in RMB. According to HSBC, by 2020 the share of global foreign exchange reserves invested in RMB could become as high as 8% (from an estimated 1.1% today).

4. The inclusion of the RMB in the SDR basket

In recent months, the Chinese authorities have undertaken a number of pro-market reforms such as: the liberalization of the deposit interest rate; a new mechanism for setting the exchange rate parity, and a variety of measures relaxing restrictions on RMB conversion and cross-border liquidity pooling.

These reforms – or at least their timing – have been driven in part by the objective of the RMB's inclusion in the SDR basket in the 2015 review. In November 2015 the IMF decided that, as of October 1 2016, the RMB will be the fifth currency forming the SDR basket, in addition to the US dollar, the Euro, the Japanese yen, and the British pound. The decision was based on the assessment that the RMB meets the two inclusion criteria, namely (a) the export criterion, according to which the currencies in the basket must be issued by the countries or monetary unions with the largest exports values over a five-year period, and (b) the freely usable criterion, which is fulfilled when a currency is widely used to make payments for international transactions, and widely traded in the principal exchange markets.

The assessment of the 'freely usable' criterion was based on a list of indicators endorsed by the IMF Board in 2011 to gauge the use of individual currencies on international financial markets and for cross-border transactions. Since the 2010 review, the international role of the RMB has increased significantly for cross-border transactions, in particular for international trade settlement.

As the IMF report highlighted: 'The steady increase in RMB internationalization has been supported by recent reforms and China's rising economic weight. The tendency for reserve currencies to be backed by large economies with substantial amounts of international trade suggests that RMB demand should persist over time. While conjunctural developments such as the recent stock market correction could affect the pace of RMB internationalization in the near term, China's expanding role in global trade and direct investment; the recognition among non-residents of the benefits of invoicing and paying in RMB; and ongoing steps to enhance market infrastructure provide fundamental support for greater cross-border use of the currency. Avoiding policy reversals and persisting in the gradual reform path toward a more market-based economy will be important to maintain and further expand RMB internationalization going forward. The authorities' recent actions in delivering on previous reform commitments despite significant market volatility are encouraging in this regard'.[47]

In terms of financial market depth and accessibility to foreign investors, China lags far behind the other SDR member countries and monetary unions. However, according to the IMF, the Chinese authorities have recently made significant progress by improving the accessibility of foreign institutional investors to the onshore bond and FX market. As a consequence 'SDR users now have sufficient access to onshore markets to perform Fund-related and reserve management transactions without substantial impediments'.[48]

The weight of the RMB in the SDR basket was set at 10.92%, ranking third after the dollar (41.73%) and the Euro (30.93%). From an operational perspective, from 1 October 2016, when the new SDR basket comes into effect, the IMF will start to conduct its operations in RMB and borrowing members can use it either directly or indirectly to address balance of payments financing needs. This could lead to an increase in the use of the RMB by central banks and other SDR users to execute IMF operations. According to a survey conducted by the IMF on foreign currency denominated assets held by official investors, 38 out of 130 respondents reported holding the equivalent of SDR 51 billion in RMB-denominated assets in 2014, 1.1% of global official foreign currency assets. The comparison with the equivalent of SDR 29 billion recorded the previous year, suggests that the RMB is becoming attractive as a reserve currency even though its global share remains modest.

The inclusion of the RMB in the SDR basket will trigger a rebalancing of IMF resources (including those for hedging purposes) towards the RMB (i.e., by selling current SDR basket currencies for RMB; IMF, 2015a). Portfolio adjustments could take place for other SDR users and IMF members as well. Nonetheless, further market deepening and improved convertibility is key to making RMB assets liquid and therefore attractive to reserve managers (AXA IM; 2015).

[47] IMF (2015b), p.30.
[48] IMF (2015b), p.30.

The implications for private investors are not straightforward, because the decision has no direct relevance for private portfolio management; the attractiveness of the currency will be strongly influenced by macroeconomic and financial market conditions.

For the Chinese authorities the challenge is to find the right balance between liberalization and financial stability while pursuing the long overdue transition to a more sustainable and market-oriented economic model, although this might prove extremely difficult to implement. Official investors are particularly welcome as they are highly professional and have relatively stable strategies. Indeed the selective opening strategy pursued by the PBoC in providing almost free access to the domestic interbank and foreign exchange markets to overseas central banks and other official investors is perhaps aimed at counteracting private capital outflows, which were quite sizeable throughout 2015 and are expected to continue in 2016.

5. Concluding remarks

According to SWIFT, in August 2015, 379 financial institutions in Europe made worldwide payments in RMB (up from 305 in August 2013). London stands out as a world leader for FX transactions in RMB; the UK is Europe's top country for total payments sent and received in RMB and a 'natural' magnet as a result of hosting the world's leading financial centre. In the Eurozone, Paris, Frankfurt, and Luxembourg all aim to play a crucial role in the process of internationalization of the RMB, competing with each other to become the main regional offshore centre. The long-time presence of French banks in China and the diplomatic and economic ties between the two countries are considered the main advantages in seeking to develop Paris as a primary RMB offshore centre. The role of Paris might be further boosted by France's strong and long standing relations with several African countries, given China's ambition to increase its presence in that continent. On the other hand, Frankfurt aims to become not only the Eurozone payment hub but also plans to offer dedicated infrastructures for trading Chinese securities, taking advantage of its status as top regional financial centre within the monetary union and its established trade relations with China.

Top-down policy support has so far been at the heart of European offshore market development.

Thanks to the sheer size of the Chinese economy and of its trade relations, the RMB is quickly developing two out of the three attributes of an international currency, namely wide use as a medium of exchange and as a unit of account. Despite the unexpected devaluation by the PBoC in August 2015, which increased concerns about slowing Chinese growth, the use of the RMB for international transactions is holding steady.

However, liquidity and financial stability concerns are holding back the third attribute of a truly international currency, i.e. that of a store of value. Obstacles to fulfilling the requisites for becoming an attractive store of value include the limited trust placed by foreign investors in the Chinese legal system and in the authorities' capability/willingness to protect foreign investments. According to survey data,[49] in the past year the economic slowdown and the stock market turbulence, combined with the increased regulatory burden and weak legal protection, has made foreign investors reluctant to increase their investment in China.

At the beginning of 2016, the significant increase in volatility, stemming from the mismanagement of the stock market correction and persistent capital outflows, with the consequent reduction in FX reserves, has led the PBoC to implement a number of measures to rein in speculation on the offshore RMB market in Hong Kong.[50]

Capital account opening is expected to remain gradual as greater two-way capital flows will tend to increase volatility and exchange rate pressures (Prasad, 2016). The process of liberalization may be bumpy and international spillovers quite large. Moreover, the internationalization of the RMB, which is closely connected to the process of capital account opening, may well proceed in stages, with rapid advances followed by periods of more incremental growth.

[49] The European Union Chamber of Commerce in China, Business confidence survey 2015.

[50] On 12 January 2016, the PBoC drained most of the offshore liquidity to close the gap between the offshore exchange rate (CNH) and the onshore exchange rate to the US dollar. This operation drove the overnight interbank interest rate to peak at an astonishing 67%. A week later the PBoC issued a regulation mandating all foreign institutions to hold reserves on offshore RMB deposits at the prevailing reserve rate requirement (between 15% and 17,5%) with retroactive effect. Both measures led many international institutions to put their business in RMB on hold or to abandon any engagement.

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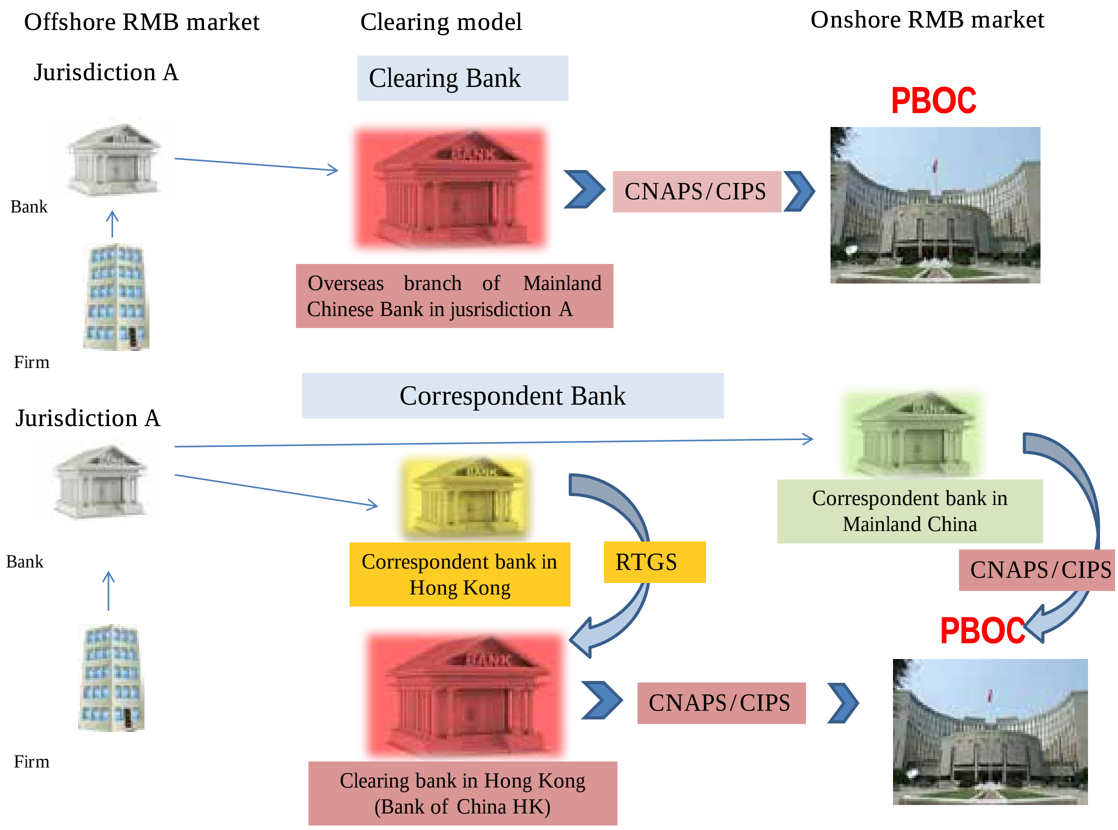
Appendix A: Main clearing models

At the end of 2015 there were 16 offshore RMB clearing centers. In these jurisdictions RMB transactions with Mainland China are cleared according to the **clearing bank model**. The clearing bank, appointed by the PBoC, offers RMB accounts for banks in the jurisdiction; overseas banks have the status of account-holders. The balances on these accounts are covered by corresponding deposits at the PBoC. The RMB clearing bank is a monetary policy counterparty of both the home and the offshore jurisdiction. It has access to refinancing from the PBoC (through the CNAPS/CIPS system) and operates on the payment system of the offshore jurisdiction. The clearing bank processes the credit transfers between individual accounts and takes responsibility for the entire payment process. Overseas banks can always choose to rely on a more traditional **correspondent bank model**. In this case banks use one or more correspondent banks with RMB access; the correspondent banks may be located in China or in one of the offshore RMB centres (the most important being Hong Kong) to carry out RMB transactions.

The picture below describes the two models.[51]



[51] For a more detailed description of possible RMB clearing operating models see the Bundesbank website https://www.bundesbank.de/Redaktion/EN/Downloads/Tasks/Payment_systems/possible_rmb_clearing_model.pdf?__blob=publicationFile and the discussion outline available on the Working Group on US RMB Trading and Clearing website http://www.rmbusawg.com

Appendix B Tables and figures

Table B1. China's bilateral currency swap lines

Country	Swap amount (RMB bn)	Country	Swap amount (RMB bn)
Hong Kong	400	Turkey	12
Malaysia	180	UAE	35
Indonesia	130	Qatar	35
South Korea	360	South Africa	30
Pakistan	10	Albania	2.0
Singapore	300	Hungary	10
Sri Lanka	10	Ukraine	15
Thailand	70	Iceland	3.5
Australia	200	Euro area	350
New Zealand	25	Switzerland	150
Armenia	1.0	United Kingdom	350
Belarus	7.0	Canada	200
Kazakhstan	7.0	Argentina	70
Mongolia	15	Brazil	190
Russia	150	Chile	22
Uzbekistan	0.7	Suriname	1.0

Sources: People's Bank of China and various news releases. Note: The validity of the swap agreements is three years. Some countries have already renewed or expanded the swap agreements with China more than once or are about to do so.

Table B2. Bilateral trade with China of selected EU countries in 2014
(billions of Euros)

	Goods		Services	
	Import	*Export*	*Import*	*Export*
Germany	60.9	75.0	n.a.	8.9
France	25.4	16.2	3.9	4.1
United Kingdom	45.8	19.6	1.9	5.2
Italy	25.1	10.5	1.6	1.1

Source: Eurostat

Table B3. RQFII quota by jurisdiction and approved RQFIIs

	RQFII as of December 2015		
Jurisdiction	Total quota assigned to the market	Total quota granted to approved RQFIIs	Number of approved RQFIIs
	RMB billion		
Hong Kong	270	270	79
Singapore	50	31.5	20
UK	80	25.8	13
France	80	19.8	5
South Korea	80	71	33
Germany	80	6	1
Australia	50	10	1
Switzerland	50	5	1
Canada	50	0.2	1
Luxemburg	50	5	2

Source: Bloomberg