

Inaugural Lecture
Institute of Global Economics and Finance

Off-shore Renminbi Market

Joseph Yam, GBM, GBS, CBE
Distinguished Research Fellow

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Introduction

It is a pleasure and an honour to be delivering this Inaugural Lecture of the Institute of Global Economics and Finance. The subject is, as you are aware, the off-shore renminbi market.

Internationalization of the renminbi

2. For two broad reasons, it is in the interest of China to take proactive steps to internationalize its currency – the renminbi – and do so quickly, even though there are still quite extensive controls in the capital account of China.

3. **First reason:** the international monetary system seems structurally unstable, with its two supporting legs – the US dollar and the euro – not commanding the level of international confidence needed to sustain their status, in the long run, as the mediums of exchange, stores of wealth and units of accounting on an international dimension. The macroeconomic numbers of the two economies, particularly those referring to the level of indebtedness, external imbalance, unemployment and fiscal deficit, are worryingly high; and prospects for a quick turnaround look doubtful. Yet, very substantial amounts of foreign assets of many jurisdictions are held in those currencies, significantly because of a lack of meaningful alternatives, in terms of, for example, the absorption capacity of financial

markets of other currencies. To make the international monetary system structurally more stable, many argue that there is a need for a third leg (the Tripod Model), either in the form of a non-sovereign currency, old (SDR) or new (Asian Currency Unit), or a sovereign currency, possibly of a country with an economic size at least comparable to those of the United States or the euro zone, that commands international confidence.

4. On the basis of conservative assumptions of economic growth rates and long term exchange rate changes, China is the only country that is likely to attain, in terms of the Gross Domestic Product, an economic size similar to that of the United States and the euro area in about twenty years' time. China also has a proven track record of effective macroeconomic management that promotes and strengthens international confidence in its currency. Thus the renminbi appears to be the leading candidate to be the third leg of the international monetary system, if indeed there a need for a sovereign currency to enhance the structural stability of that system. It is, of course, in China's interest that the international monetary system is as stable as it can be, given the increasing integration and therefore increasing interaction of China with the rest of the world. As the largest, by far, foreign reserves holder of the world, China would want to safeguard the value of foreign assets held by the Government as well as by the people. And, as a large stakeholder and, as president Obama put it, a leader of the world, China does have a share of the important responsibility to promote the structural stability of the international monetary system. Steps should therefore be taken to prepare the renminbi for that important role. That means taking prudent steps to allow the renminbi to begin playing the role of an international currency, in other words, to internationalize the renminbi.

5. **Second reason:** as China embraces globalization and with its general price level being much lower than that of the rest of the world, in particular its major trading partners, the real effective exchange rate of China's currency has to appreciate over time. This would take the form either of a relatively high domestic inflation rate or a long term appreciation of the nominal exchange rate. Given that the destabilizing risks of the former are much greater than those of the latter, it is clear to China where the optimum balance of policy choice between the two is. As China re-introduces flexibility to its exchange rate regime, the renminbi exchange rate, against a basket of currencies, will resume a long term appreciating trend. But in the short term, given the sharp volatility in global foreign exchange markets, there may correspondingly be considerable short term volatility in the exchange rate of the

renminbi against the US dollar. The prudent management of exchange rate risks is therefore of increasing importance, not only for the authorities in the management of the official foreign reserves but also for the private sector when conducting the many transactions with the rest of the world. One way of effectively managing exchange rate risks for the private sector is simply for their international transactions to be denominated in the domestic currency. If, for example, exporters in China are paid in renminbi instead of in foreign currencies while obviously paying much of their production costs in renminbi, their exchange rate risks would be greatly reduced; similarly if importers pay renminbi for imported goods that are sold domestically for renminbi. For this reason also it is in the interest of China to internationalize the renminbi, so that the foreign counterparties to those international transactions can have off-shore access to renminbi funding and can mobilize their renminbi receipts off-shore.

Off-shore renminbi market

6. There are still rather extensive capital controls in China that constrain the extent to which the renminbi can be used for international transactions. Although the intention of China is eventually to remove all capital controls and make the renminbi fully convertible, the full liberalization of the capital account has wider ramifications than the internationalization of the renminbi and will therefore have to be handled carefully, emphasizing, as Premier Wen put it, on gradualism, controllability and the ability to take the initiative. But it is not necessary to sequence the internationalization of the renminbi after the full liberalization of the capital account. They can proceed in parallel, reinforcing each other. The internationalization of the renminbi can be organized through the development of an off-shore renminbi market that operates under the open international market environment and in accordance with international best standards and practices. The off-shore market will, at the same time, provide important market signals to guide the liberalization of the capital account in the on-shore market.

7. Many of you, I am sure, are already aware of the developments in recent years in renminbi business in Hong Kong. The origin of this was a visit to Beijing in 2001, when, as leader of the delegation of the Hong Kong Association of Banks, I suggested to the authorities that there was a need for a proper channel for the increasing amount of renminbi banknotes circulating off-shore, particularly in Hong Kong, to be returned to the Mainland. Behind this inconspicuous suggestion was a

rather strong desire on my part at that time – a hidden agenda I suppose – to enhance the ability of the financial system of Hong Kong, as an international financial centre, to conduct transactions denominated in the renminbi. It is, after all, the currency of the fastest growing, large economy in the world, the sovereign currency, and a currency that is likely, in the fullness of time, to play an important role in international finance. There was a possibility, I thought, that my interlocutors might have the same strategic view at the back of their minds. Whatever the case may be, the inconspicuous suggestion struck an accord, and so in 2004, after a series of discussions with the People’s Bank of China, arrangements were finally made for Participating Banks in Hong Kong to take renminbi deposits from Hong Kong residents, among other modest banking activities, marking the beginning, insofar as I am concerned, of a renminbi off-shore market in Hong Kong. There have been developments since then, including the emergence of a renminbi debt market in Hong Kong and the use of the renminbi for trade settlement.

8. I am glad to say that, working with the People’s Bank of China, the Hong Kong Monetary Authority has given Hong Kong an enviable head start in its development as the renminbi off-shore market. Assuming continued, undivided support by the Mainland authorities, I think this position is difficult for any other off-shore jurisdiction to challenge. But this is only the beginning, and quite a modest one, and there is a need to work hard to cement that position, remembering always that the objective of the exercise is the internationalization of the renminbi while enabling any significant risks for both the on-shore and off-shore markets to be prudently managed. For example, it is possible that the on-shore market may be adversely affected by activities in the off-shore market, in terms of undermining the effectiveness of monetary policy on-shore or creating sources of financial instability. There may also be risks to the off-shore market, in terms of, for example, it being overwhelmed and becoming a mere extension of the on-shore market. There is a need, therefore, to establish a working relationship between the on-shore and off-shore renminbi markets that serves the development and risk management needs.

On-shore/off-shore relationship

9. That working relationship is unlikely to be a static one. There is obviously a need for continuous refinements over time, having regard to the changing circumstances in global finance and in financial developments on-shore. It is also

unlikely to be a straight-forward one. There are obviously different preoccupations and special interests on location in the two markets at any point of time. What seems to be sensible to those in one market may, therefore, not appear to be sensible to those in the other market. For example, there is understandable temptation to accommodate off-shore activities on-shore, through promulgating a different set of rules and regulations, or licensing a different category of financial institutions, or granting favours in terms of, for example, special access to domestic markets. While I would not say that this is not feasible, I think it would be problematic, in that the authorities will then have to keep two sets of rule books that apply to two categories of financial institutions that possibly have common ownership and deploy a common pool of capital, not to mention the need to deal with regulatory arbitrage and abuse on-shore.

10. Let me therefore attempt to identify the essential elements of that working relationship between the on-shore and off-shore markets, in the hope that they will be useful for guiding the further development of the renminbi off-shore market in Hong Kong. I think there are three.

11. The **first** essential element concerns the **architecture** of that working relationship. When there is an off-shore market, for good reasons, doing things perhaps differently and in ways that suit better the need of some, and doing so on an increasing scale, there is always legitimate concern that the tail might, some day, begin to wag the dog. This is notwithstanding the clear benefits derived from the off-shore market, in terms of enhancing financial efficiency and providing useful signals for financial reform on-shore. It is therefore of primary importance that the architecture linking the two markets should enable the on-shore impacts of off-shore activities to be monitored closely and, if necessary, effective risk management measures to be put in place conveniently.

12. Other than the small amount transactions settled using banknotes, off-shore activities making use of the renminbi as a medium of transaction need to be settled electronically, either through correspondence banks in the on-shore renminbi inter-bank settlement system or through an off-shore system. To take fuller advantage of the off-shore environment to internationalize the renminbi, it is clearly preferable for there to be a separate inter-bank renminbi settlement system in the off-shore market. But it is of strategic importance that the off-shore renminbi inter-bank settlement system be linked up with the on-shore renminbi inter-bank settlement system operated by the People's Bank of China, as central bank. This

linkage serves as the principal channel for the orderly and transparent mobility of renminbi funds, and the only electronic channel, between the on-shore and off-shore markets. It also provides the mechanism, should there be a need to do so, for risk management measures to be put in place. These, in fact, are arrangements that have already been put in place, as you are aware, with the Bank of China (Hong Kong) Limited serving as the Settlement Bank and maintaining a settlement account with the People's Bank of China through the Shenzhen Branch.

13. The risk management measures take the form of conditions for the provision of settlement services between the People's Bank of China and the renminbi Settlement Bank in Hong Kong; and correspondingly in Hong Kong between the Settlement Bank and individual Participating Banks. As such, the Participating Banks would not want to operate in contravention of those conditions. They therefore form a most important part of the architecture and demand close and careful attention. Obviously, too many of these would stifle development and too little would present possibly systemic risks. I will come back to this later. But one aspect that may need to be addressed, in the fullness of time, is the ability of the off-shore renminbi Settlement Bank to create renminbi as though it is a central bank. Given that all Participating Banks maintain settlement accounts with it, the Settlement Bank can create the renminbi needed to buy whatever assets from or through the Participating Banks, just by crediting their settlement accounts. As long as, on a risk-adjusted basis, the assets earn a rate of return that is higher than the interest it pays Participating Bank on their renminbi settlement balances, the Settlement Bank is better off. The effect of doing so is to increase renminbi liquidity in the off-shore market, with consequences for renminbi credit creation, if Participating Banks are allowed to extend credit. From the point of view of ensuring competitive fairness, there may also be a need for effective restraints on renminbi creation imposed on the Settlement Bank.

14. I am not saying that there is such a need now, because the volume of renminbi business in Hong Kong is still relatively small and there are not many renminbi assets that the Settlement Bank can buy through the creation of renminbi liabilities. Furthermore, there are prudential requirements imposed on banks, including the Settlement Bank, in running a short foreign currency position against the renminbi, so that the Settlement Bank cannot meaningfully create non-renminbi assets and renminbi liabilities at the same time. And there are liquidity and other prudential requirements that discourage the Settlement Bank even inadvertently creating renminbi in this manner. But if ever the ability of renminbi credit creation

in the off-shore market becomes a concern, one condition that the People's Bank of China may wish to impose on the off-shore renminbi Settlement Bank, in return for providing renminbi settlement services, is to require it to maintain a balance in its renminbi settlement account with the People's Bank of China that is not smaller than the sum of all the balances in the renminbi settlement accounts of the Participating Banks. This arrangement may sound familiar to some of you. Indeed, you may recall the "Accounting Arrangements" in force in Hong Kong from 1988 to 1996 whereby the then Clearing Bank of the Hong Kong Association of Banks was required to maintain an account with the Exchange Fund, as a first step to transfer control over the monetary base from the Clearing Bank to the authorities. Although the circumstances are different, the idea is basically the same.

15. I am actually more concerned about there being too many of these conditions for the provision of renminbi settlement services, to the extent of slowing and even stifling further development. This is perhaps a convenient point to turn to the **second** essential element of the working relationship between the on-shore and off-shore markets – the **modality** of that relationship. Here, it is useful to be guided by the important principle of "one country, two systems".

16. The utility of Hong Kong lies in its freedom and openness, and its financial system operating against international best standards and practices. Exposing the renminbi to the Hong Kong environment has distinct advantages, in terms of obtaining important market signals to guide on-shore policies, particularly those concerning the reform and liberalization of the financial system. Attempts to ensure that, in renminbi business, the highly market oriented off-shore system in Hong Kong behaves in the same way as the relatively control oriented on-shore system are, I think, counter-productive. In other words, there should be as little extra-territorial applications of on-shore financial rules and regulations off-shore as possible. The need for managing the risks presented by the off-shore market is well understood, and it may be that at the initial stages of development it was prudent to be conservative. In any case, the original purpose was to channel renminbi circulating in Hong Kong back onto the Mainland. But the experience of developments since 2004, with the focus now shifting onto the use of Hong Kong as an off-shore renminbi market to internationalize the renminbi, suggests that there is room for relaxation of many of those conditions.

17. The ideal modality is for Hong Kong, as the off-shore market for the renminbi, to do its own things in its own ways with renminbi business, in much the

same way as it conducts other business denominated in other foreign currencies and, of course, for the on-shore market to likewise function, having regard to the respective domestic needs for the two financial systems. Restraints, in the form of conditions for providing settlement services, should only be imposed where there is an identified need for managing risks posed to either the on-shore or the off-shore systems, and when prudential measures from the banking supervisors do not provide effective means for so doing. From my contacts, I am glad to learn that this view is shared by many on the Mainland. The task at hand is to convince others and then to put this modality into practice by appropriately amending and simplifying the Settlement Agreement between the People's Bank of China and the renminbi Settlement Bank in Hong Kong. Correspondingly, the other Settlement Agreement between the Settlement Bank and individual Participating Banks should be amended and simplified.

18. This will take the development of the renminbi off-shore market in Hong Kong to a new dimension. It will not be difficult to see, for example, the emergence of a meaningful inter-bank market in the renminbi in Hong Kong, or the offering of renminbi loans by Participating Banks in Hong Kong, or the use of the renminbi in stock market transactions, particularly if the pre-requisite mobility of renminbi funds between the on-shore and off-shore markets is correspondingly enhanced.

19. This, in fact, is the **third** essential element of the working relationship between the on-shore and off-shore renminbi markets that I would like to address – the **mobility** of renminbi between the two markets, including those arising from supporting the conversion between the renminbi and foreign exchange off-shore. With capital controls on the Mainland and no exchange controls in Hong Kong, obviously mobility of renminbi funds between the two markets has to be restricted. Yet the restrictions serve as a constraint on the development of the off-shore renminbi market. The task at hand is to enhance the mobility of renminbi between the two markets without undermining the integrity of the capital controls on the Mainland, where they are still considered necessary, and without creating risks that may prove to be difficult to manage.

20. Currently, the mobility of renminbi between the two markets is limited to, first, the amount of renminbi banknotes that visitors can carry across the border; second, trade settlement using the renminbi, for example, Mainland importers moving renminbi to Hong Kong to pay for imports; third, net off-shore conversion by Hong Kong residents (each subject to a daily cap) between the renminbi and the

Hong Kong dollar; fourth, remittances by Hong Kong residents, each also subject to a daily cap; and fifth, proceeds of renminbi bonds issued in Hong Kong (and redemption needs in the opposite direction) by those having been approved to do so. This mixture of mobility, which is largely the product of six years of development of renminbi business in Hong Kong, produced a renminbi off-shore market in Hong Kong, in terms of deposit liabilities of Participating Banks, of about RMB 80 billion and, in terms of renminbi bonds outstanding, of about RMB 30 billion. There are, of course, still a significant amount of renminbi banknotes held in Hong Kong, given the ever increasing amount of cross border economic activities at the retail level, but those are only serving as transaction balances and should therefore not be a cause of policy concern, particularly when there is, in any case, intention to promote the greater use of the renminbi off-shore.

21. These numbers are, actually, quite small, when put alongside those of the on-shore market. Renminbi deposit liabilities in the banking system on the Mainland totaled RMB 66 trillion. The off-shore renminbi deposit market in Hong Kong is just a little over 0.1% of that. The tail is almost non-existent, not to mention the possibility of any noticeable wagging at all. All concerned should therefore feel a lot more relaxed about further developments. In any case, the architecture of the on-shore/off-shore relationship I described earlier and the ongoing, close supervisory cooperation provide an effective framework for risk management.

22. There are many, actually quite safe, ways of enhancing the mobility of renminbi funds between the two markets. One is to raise or remove altogether some of the daily caps now in place, for example, the amount of renminbi remittances by Hong Kong residents. Another is to extend the conversion service from just for Hong Kong resident individuals to non-residents, or to corporations, applying, if necessary, a similar daily cap. A new area may be to allow remittances of renminbi by Hong Kong or overseas corporations that have a funding need for their activities on the Mainland. That would encourage the further development of the renminbi debt and loan markets in Hong Kong. Yet another area is to allow customers other than Hong Kong resident individuals, for example, stock brokers, to operate renminbi bank accounts in Hong Kong. That would be conducive to promoting the use of the renminbi in stock market trading in Hong Kong, thus allowing foreign investors to have their legitimate exposure to the renminbi when they invest in Chinese stocks, and lessen the huge amount of capital flowing in and out of the Hong Kong dollar and the effects of such flows on monetary conditions in Hong Kong. Better still, the operation of renminbi bank accounts should be freed

up, just as in the case of the operation of other foreign currency bank accounts. Leave the banks to do due diligence in knowing their customers and preventing money laundering.

Conclusion

23. There are many, many possibilities. The important thing is to have greater trust in the market. We are not talking about complex derivatives or state of the art financial innovation. We should rightly be alert to the implications of these for monetary and financial stability. We are talking about basic financial intermediation denominated in the renminbi on the one hand and the use of the renminbi as a medium of transaction and a store of wealth on the other. By all means, have quantitative caps and increase them only gradually as a means of controlling the pace of expansion of the off-shore renminbi market. But, with the correct architecture between the on-shore and off-shore systems already in place, we should feel comfortable about adopting the modality I described and enhancing the mobility of renminbi funds, thereby taking the renminbi off-shore market in Hong Kong to a new and meaningful dimension – a dimension that qualifies the renminbi to be an international, and then a reserve, currency. That is in the best interest of China and can only be good for the international monetary system.

24. Thank you.

Joseph Yam, GBM, GBS, CBE

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