Development of an Asian currency: Internationalisation of the Renminbi and implications for the ASEAN fixed-income market

Good morning, distinguished guests, ladies and gentlemen,

I am honored to be invited by the Summit to talk about the internationalization of the Renminbi and its implications on the ASEAN bond market.

Earlier this month, the Hong Kong Monetary Authority, together with the Asian Development Bank, hosted the 16th ASEAN+3 Asian Bond Market Forum in Hong Kong. Two of my colleagues, nominated as the National Expert in the ABMF, delivered talks on the similar subject.

A couple of weeks ago, Cagamas Berhad successfully issued a three-year 1.5 billion RMB denominated bond, which is not only the largest RMB offering in Southeast Asia to date, but also the world's first RMB bond to be issued by a mortgage corporation. Bank of China (Hong Kong Branch) also had the privilege of becoming one of the joint lead managers and the book-runners in this inaugural issuance.

I would like to congratulate Cagamas on this success and contribution to both the Asian bond market and the offshore RMB market.

I believe the advancement of the Asian fixed-income market will continue to be a hot topic, and am excited for more breakthroughs going forward.

The painful lessons of the Asian Financial Crisis punctuated by capital outflows and currency devaluations spurred the need to develop local currency bond markets both domestically and intra-regionally. Witnessing a substantial growth from scratch of the bond markets in mainland China and Hong Kong in the past decade, I believe the future development of Asian bond markets can be substantially boosted by the further growth of RMB bond markets both onshore and offshore.

Before going into details about this market development, let me first spend some time on the RMB’s internationalization. China is a member of ASEAN+3, and a key player in international trade. Its currency, the RMB, had remained more or less a domestic currency until just several years ago. Since then, it has made remarkable progress in moving towards internationalization as China's currency market continues to develop and reform.

Interestingly, China's central bank, the People's Bank of China, hardly used the word "internationalization". It was coined by the market instead. The PBoC refers to this development stage as the "increasing usage of the RMB in cross border trade and investment". But no matter how you phrase it, the RMB has gained tremendous status in the international arena in recent years.

To qualify as an international currency, a currency has to be widely used in international pricing, settlement, payment, investment and held as foreign currency reserves, and the RMB meets most of these criteria, although to different extents, and under various experimental schemes launched by China's authorities.

For example, with the current account for trade purposes already fully opened, in 2013, about 4.6 trillion yuan, or close to 20% of China's foreign trade, was settled in RMB.

Looking at those experimental schemes for cross border investment activities, China's utilized RMB denominated Foreign Direct Investment (known as FDI), amounted to 450 billion Yuan, and Outward Direct Investment (known as ODI) at 86 billion Yuan. And in terms of RMB denominated Qualified Foreign Institutional Investor (known as RQFII), (which allows foreign investors to do portfolio investment in Chinese domestic securities) the approved RQFII quota has so far totaled around 640 billion yuan, among which HK is entitled with 270 billion yuan, and has been used very quickly since it was introduced.

Moreover, according to a report issued by SWIFT in July this year, the RMB has become the 7th most used currency in international payments, with a 1.6% market share. In terms of treasury activities, the RMB became the 6th most used currency with a 2.2% market share. Imagine, just a couple years ago, its share was nearly zero.

And the RMB also has made its way into about 20 of the world's central banks' foreign reserves holdings. That is a fabulous achievement, particularly considering the RMB is not yet a freely convertible currency.

The big question is: what are the underlying drivers for the rapid development of RMB internationalization? I believe the answer is that: it is a gradual and inevitable process driven both externally by China's increasing economic integration with the outside world, and internally by China's impetus for further reforms.

Externally, ever since China has implemented reform and open-up policies, the Chinese economy has embarked on a rapid growth track, with real GDP growth averaging 9.8% per annum since 1980. Boosted by ample supply of productive and cost efficient labor, China has become the world's factory, and grown into the world's largest goods exporter at USD2.21 trillion, and 2nd largest importer at USD1.95 trillion in 2013. According to the IMF, China's GDP in 2013 grew to USD9.2 trillion, second only to the United States at USD16.8 trillion.

As China's economy becomes increasingly engaged with the rest of the world, naturally does its currency.

China traditionally used to receive sizable capital inflows through foreign direct investment. However, now it has accumulated some USD4 trillion in foreign exchange reserves through trade surplus, FDI and other inflows, which is far more than China needs. Meanwhile, more and more cash rich Chinese corporations are looking overseas for investment opportunities. Currently, it appears that direct investment inflows and outflows are about to balance. In 2013, China received USD118 billion in utilized FDI, while its non-financial ODI totaling USD90 billion. Such development under the capital account has resulted in an increasing demand for RMB and RMB denominated assets in the overseas markets.

Internally, after decades of rapid economic growth averaging more than 9%, China is facing some daunting tasks in the deeper waters of its economic reform, including how to achieve more sustainable and quality economic growth, and how to adopt a more environmental and natural resources friendly growth approach in a longer term.

Undoubtedly, exports have played a very important role in China's economic development, especially in its early stages, in terms of providing high growth and employment, and accumulation of its foreign exchange reserves. But now China needs to reduce its trade dependency. As expected, an export driven growth model was facing more challenges, including higher exposure to global fluctuations, increasing labor costs, rising trade frictions and greater demands on the environment. China needs to be careful not become overly dependent on exports to drive the economy. It is critical that the country implement deeper structural reform and move up the value chain.

Similarly, investment driven growth has done well in the past for China, especially when there were external shocks to exports. But there are also side effects that have resulted in inefficient pricing and allocation of capital, largely caused by excessive credit growth. China's money supply has persistently outgrown its GDP, and its M2 money supply is now twice as large as GDP, a ratio surpassing all the world's major economies. As a result, RMB's interest rate liberalization will have to be among its top agenda in China's financial sector reforms.

In addition, there has been ongoing exchange rate reform that will help drive RMB's moving towards full convertibility.

As I understand, Chinese government has a strong urge to continue and deepen its economic structural reforms, especially in its financial area. Nonetheless, they would have to carry them out in a steady and orderly manner given the complexity and the size of the economy. When all the above-mentioned reforms are accomplished, an efficient and mature market economy will emerge facilitating RMB internationalization in its real sense.

Looked at from another perspective, RMB internationalization can also serve as accelerator to these reform objectives. Using the Eurodollar as an example, after the World War Two, the Marshall Plan provided US dollars to rebuild war-torn Europe, who in turn used the dollars to import goods from the US. This formed a cross border need for circulation and gave birth to offshore USD market. In return, the Eurodollar market expedited US financial liberalization and deregulation. Looking at today, RMB internationalization will likely take a similar route.

One additional piece of the puzzle for RMB internationalization is a well-developed onshore and offshore bond markets.

Generally speaking, China's bond market and stock market are still in a developing stage compared to the world's major economies.

Domestically, the Chinese economy is mainly financed by bank lending. For example, in 2013, out of the "aggregate financing to the real economy" of RMB 17.3 trillion, 51.4% was made up of RMB loans, 3.4% of foreign currency loans, and 29.9% of financial institution's off-balance-sheet financing. This means that direct and indirect bank lending provided about 85% of the economy's financing. The corporate bond market accounted for only about 10% of the financing, while the proportion of non FI equities financing was just insignificant at 1.3%.

For the US and Japanese economies, the bond markets are their most important capital markets and financing means, with their bond markets larger than their GDP、stock markets or the banking systems. Europe relies more on bank lending, but bond markets in major European Union member countries are nonetheless also important.

In China's case, its onshore bond market, although still sizeable at 33 trillion Yuan, is only half the size of its GDP. This ratio would still be considered healthy even if it were double its current size. In comparison, China's onshore bond market is only one fifth of the banking system's total assets. Therefore, the RMB bond market has substantial room for growth. Currently since China still imposes capital controls, issuance and investment by foreign entities in the onshore RMB bond market are limited and still subject to approval.

For the ASEAN and ASEAN+3 bond market initiatives, a key goal is to develop a local currency bond market domestically and intra-regionally, thus providing long term and more stable funding to each country, facilitating the region's economic development, and improving the stability and depth of these capital markets.

China is currently ASEAN's largest trading partner and ASEAN is China's third largest trading partner. The free trade agreement between China and ASEAN went into full effect in 2010. While ASEAN imports more from China, China invests more in ASEAN in direct investment, which is very similar to the Eurodollar's circulation in the first half of last century. So an offshore RMB bond market is essential and should keep growing. It is in this context, I would like to point out that, in this market, Hong Kong will serve a very vital role.

Hong Kong is regarded by many as one of the world's leading international financial centers next to London and New York. It is also the world's freest economy with no capital controls, as well as a simple and low tax regime. Its financial infrastructure, such as Real Time Gross Settlement system (known as RTGS), is one of the most advanced in the world.

The RTGS system incorporates four major currencies of USD, Euro, HKD, and RMB, and is well linked to the bonds and stock clearing systems of Hong Kong. Therefore Hong Kong is an ideal place to explore and facilitate RMB internationalization and develop a meaningful offshore RMB bond market.

The advantages of developing an offshore RMB bond market in HK are obvious: as an open, free and international market, there are virtually no restrictions on issuers and investors as opposed to the onshore market. RMB bonds are an attractive asset class, and providing smoother access to this asset would be beneficial for all investors.

Many refer to Hong Kong's offshore RMB bonds as Dim Sum bonds, borrowing the name from a local delicacy that is often served in small size, matching offshore RMB bonds offerings in the beginning stage. But with the market growing by the day, some of the issuances such as the sovereign bonds issued by China's Ministry of Finance are substantial in size. In the past decade, Hong Kong's offshore RMB bond market has grown markedly, with primary issuances surpassing half a trillion Yuan, and outstanding balance at 350 billion Yuan. However, it is still small when you compare it to other means of financing or other markets. This represents enormous growth potential for the next phase.

Considering Hong Kong's current RMB liquidity pool already exceed 1 trillion Yuan, the Dim Sum bond market and offshore RMB loans only utilize about one third of the pool. And if you compare Hong Kong's offshore RMB bond market to China's onshore bond market, it is only 1% of the latter. So to say that there is huge, underserved growth potential is an understatement.

Of course, the offshore RMB bond market goes well beyond Hong Kong. Earlier this month, following the sixth UK-China economic and financial dialogue, the United Kingdom announced it would become the first western country to issue a government bond denominated in the RMB. And the RMB bond will be added to Britain's foreign currency reserves.

Then in Singapore, Industrial and Commercial Bank of China Singapore Branch (ICBC Singapore) announced that it would issue 4 billion Yuan worth of offshore RMB bonds. These "Lion City" bonds are the biggest RMB bond issuance in Singapore so far, and they will be cleared through the Central Depository in Singapore. Amongst them, the five-year and seven-year tranches will be dual listed on the Singapore Exchange and the GreTai Securities Market, the first dual listing by any Chinese banks.

Plus, a couple of weeks ago Cagamas issued the Tiger Emas bond. All of these recent issuances are making a real contribution and paving the way for further internationalization of the RMB.

Last but not least, Malaysia is a leading Islamic financial center. And the Hong Kong Special Administration Region Government in recent years launched major efforts to develop Islamic finances locally. It appears that its efforts have begun to pay off, with the HKSAR Government issuing its first ever Sukuk of USD1 billion under the Government Bonds Program just earlier this month. It is the world's first USD-denominated Sukuk originated by an AAA-rated government. And over the past few years in Malaysia, Khazanah Nasional and Axiata came to the market with world's first ever offshore RMB Sukuk and the first ever rated RMB Sukuk. Going forward, it is safe to say there will be more and more RMB Sukuk issued in Hong Kong.

Putting everything together, with a strong political, social and financial foundation as a solid base for the future, I have very high expectations for the development of Asean's fixed income markets. I also foresee a happy marriage between RMB and ASEAN bonds, and a deepening cooperation between China and Asean countries, built on market innovation and reforms that are beneficial to everyone involved. This is something that we can all look forward to.

Thank you very much.