BOFIT Policy Brief
2014 No. 11

Yin-Wong Cheung

The role of offshore financial centers in the process of renminbi internationalization

EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Policy Brief
Editor-in-Chief Iikka Korhonen

BOFIT Policy Brief 11/2014

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24.9.2014
ISSN 2342-205X (online)

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Yin-Wong Cheung[1]

The role of offshore financial centers in the process of renminbi internationalization

Abstract

Recently, China has been quite aggressive in promoting the international use of its currency, the renminbi (RMB). Historical experiences suggest that an active offshore market is essential for a global currency. Indeed, anecdotal evidence affirms the role of offshore RMB markets in pushing the RMB to the world. One should not, however, overplay the contribution of offshore markets. While offshore markets offer the opportunities to experiment with the global use of the currency, the overseas acceptance of the RMB is ultimately determined by both internal and external economic forces, and geopolitical factors. With its relatively small size, the offshore RMB is not likely to pressure China and alter its financial liberalization policy. A well-organized offshore RMB market will complement China's RMB internationalization policy, but could not raise the currency's global status beyond the level justified by it economic and political attributes.

JEL Codes: F33

[1] The article is prepared for the ADBI project on "Currency Internationalization: Lessons and Prospects for the RMB." Some parts are drawn from my previous work on related topics. I would like to thank Bertrand Candelon, Barry Eichengreen, Masahiro Kawai, Iikka Korhonen, Fengming Qin, Eli Remolona, Frank Song, Yanrui Wu, Yongding Yu, and participants of the "Currency Internationalization: Lessons and Prospects for the RMB: Interim Workshop," the forum on "New trends in Monetary policy," and the seminars at BOFIT, the Shandong University, and Shandong University of Finance and Economics for their comments and suggestions. The usual caveats apply.

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1. Introduction

Financial crises highlight the vulnerability of economic systems and feed on the weakness of market designs. One of the lessons from the recent (2007-08) global financial crisis is the danger of building the international monetary architecture around a single dominating global currency. Specifically, the shortage of the US dollar occurred in midst of the recent crisis has led to turmoil in the global financial market and has severely hampered international trade and financial transactions. The cataclysmic effects of dollar shortage have alarmed the world that the current dollar-dominated international monetary system could be the lion's den.

In response to the global liquidity contraction experience, China has launched a number of initiatives to reduce its reliance on the US dollar and seek the use of its currency renminbi (RMB) in conducting international transactions. In light of its growing economic prowess in the global market, China's push of the RMB into the international arena seems quite natural. An International Monetary Fund (2010) study, for example, considered the RMB as one of the three national currencies that could compete with the US dollar in the global market. The other two currencies are the euro and the Japanese yen. The international acceptance of the RMB is partly made possible by the call for the US dollar to play a less prominent role, the occurrence of the European sovereign debt crisis, and Japan's two lost decades.

Both policymakers and academics are interested in unraveling the motivation behind these RMB internationalization initiatives. Some suggested motivations include a) it is driven by economic pragmatism in the midst of a dollar shortage crisis, b) it is a disguised component of China's financial development policy, and c) it is an attempt to undercut the US dollar supremacy in the global market. Disregarding what is the true motivation, it is generally agreed that the integration of the RMB into the global monetary system would greatly change the international economic and geopolitical landscapes.[2]

In addition to motivation, the world is watching the way China is seeking the international use of its currency. In the last few years, China has pursued a seemingly unorthodox approach to advance the role of its currency in the global market. Specifically, one main component of the general policy is to establish offshore RMB markets; especially the one in Hong Kong.[3] The offshore RMB market in Hong Kong was conceived in 2004. The offshore market made relatively slow progress in the few years after its inception. After the recent global financial crisis, the efforts on widening and deepening the offshore RMB market have been intensified. More recently, China has been working with other financial centers including London and Singapore to promote offshore RMB businesses.

Does the presence of offshore markets help to establish the global status of a currency? For instance, it is hard to conceivable that the US dollar could achieve and maintain its prominent global role without the support of fully fledged offshore US dollar markets around the globe. At the minimum, offshore markets allow a currency to perform its potential as an international currency outside the country it is issued.

In the case of the RMB, a nature question to ask is "to what extent the process of internationalization will be facilitated by the newly developed offshore RMB market?" Conceptually, one conceives that, for nonresidents, there is an optimal demand for international transactions conducted in the Chinese currency. The establishment of an offshore market obviously

[2] See, for example, Eichengreen (2013), McCauley (2011), and Yu (2012) for recent discussions on RMB internationalization.

[3] Other measures include establishing direct foreign exchange dealing arrangements and setting up currency swap lines with other countries.

allows non-residents to conduct transactions in the RMB. Nevertheless, would the level of the RMB activity go beyond what is justified by the overseas demand of such activity?[4] Would the offshore market push the RMB to the world beyond what is warranted by the global demand?

The role of offshore RMB markets deserves some attention. By and large, an offshore market and the international role of a currency are believed to be determined by market forces and exhibit the economies of scale. However, in the case of the RMB, China assumes an active policy stance in establishing offshore RMB markets, and in orchestrating and promoting the overseas use of its currency.

The nonconventional strategy has drawn both praises and skepticisms. In a nutshell, some analysts believe that the offshore market approach is a clever maneuver in view of the relatively underdeveloped domestic financial market and the strong domestic resistance to the liberalization of financial markets. The offshore experiences could be brought back to the domestic market to further the liberalization policy. That is, the offshore market approach functions as a backdoor way to advance financial market reforms. The 2001 WTO accession event is an often cited example of China's efforts to affirm and deepen its domestic economic reforms via opening up to world trade.

Skeptics, on the other hand, note that without a well-functioning domestic finance sector offshore RMB markets could create unbalanced growth forces in the domestic and offshore markets, and the unbalanced growth could lead to adverse economic consequences in the medium to long run. In short-run, the arbitrage across domestic and offshore markets imposes significant costs on China. Further, the prevailing capital control practices confine the scope of integrating successful experiences from offshore markets to the under-developed and heavily regulated domestic financial sector, and limit the growth of offshore RMB businesses.

Against this backdrop, we would like to assess the role of offshore RMB markets in promoting the international use of the RMB and some related issues. Besides the provision of a market place for the RMB to play the role of an international currency, could the offshore market "force" China to deepen its reform of the domestic financial sector and capital account policy? That is, would China respond to the feedback from the newly developed offshore RMB markets? Or, China has the ability and is willing to direct and dictate the process of financial liberalization and the related RMB internationalization policy.

In the next section, we offer some general discussion on offshore currency markets and global currencies. Section 3 focuses on the offshore RMB markets; with special attention to the one in Hong Kong. The recent developments in China including the launching of the Qianhai initiative in Shenzhen and the Pilot Free Trade Zone program in Shanghai are discussed in Section 4. Section 5 offers some views on the limited roles of offshore markets in the RMB internationalization process. Some concluding remarks on the prospects of offshore markets and the internationalization of the Chinese currency are presented in Section 6.

2. Offshore Currency Markets and Global Currencies

An exact definition of offshore financial centers is not that straightforward.[5] For the purposes of our discussion, we consider an offshore currency market; a market that facilitates and specializes in transactions of products denominated in currencies not issued by the jurisdiction where the market is located. It is noted that an offshore currency market is not limited to foreign exchange

[4] For simplicity, we ignore the possible ambiguities arising from the transition to the optimal level.

[5] For discussions on the conceptual and operational definitions of offshore financial centers, see, for example, International Monetary Fund (2000) and Zoromé (2007).

transactions and, due to the nature of offshore business, serves a disproportionally large non-resident population.

A main feature of an offshore currency market is that it separates the currency risk from the country risk. The currency risk is then combined with the risk of the country in which the offshore market is located. Usually, an offshore market is established in a country with a good reputation of the rule of law, sound financial market infrastructure, and favorable regulatory and tax policies on offshore transactions.

The pros and cons of an offshore currency market could be summarized as follow. All else equal, an offshore market adds overall liquidity to the currency. Besides the separation of the currency risk and the country risk, an offshore currency market offers a means to by-pass rules and regulations in the onshore market. Added to the regulation avoidance, participants could enjoy diversification and management advantages related to the time zone and location, language, and business environment of an offshore center. Because of differential regulatory requirements; especially those related to reserve requirements, pricing is typically quite competitive in offshore, relative to onshore, markets.

On the cost, the usual concern is that a loosely regulated offshore market could induce monetary and financial instability because it amplifies market risk, and undermines authorities' ability to conduct domestic policy and manage capital flows. A different view on the cost is that the global status facilitated by offshore currency markets promotes the exorbitant privilege – the US dollar is commonly referred to as the global currency that enjoys the exorbitant privilege and imposes costs to other economies.[6]

London, New York and Tokyo are the renowned offshore currency markets in, respectively, Europe, North America and Asia. Each market offers a rich menu of products denominated in a wide array of foreign currencies. In addition to these main offshore currency centers, there are some known for more regional currencies. For instance, Singapore is known for its role as an offshore currency market for the Malaysian ringgit before 1997 and is still a major offshore currency market for South East Asian currencies.

The offshore dollar markets (or, commonly known as Eurodollar markets) constitute the largest segment of the global financial market, and facilitate greatly the use of the US dollar in international trade and investment transactions across different time zones and geographic locations. Some argue that the sprawling of offshore US dollar markets is a reflection of the prominence of the US dollar in the international monetary architecture. Nevertheless, it is hard to underestimate the network dollar usage effect generated by these markets that enhances the global status of the dollar.

The evolution of offshore US dollar markets traces the changes in the perceptions of offshore currency markets and currency internationalization. The general perception was quite skeptical in the beginning. Over time, with the expansion of offshore market activity, the sentiment has become quite positive even though reservations remain.[7]

Could the US experience offer some hints on the nascent offshore RMB markets? Despite the temptation to draw a lesson from history, we note that the US dollar then is quite different from the RMB now. One main difference is that, when the Eurodollar market emerged in the late 1950s and early 1960s, the US dollar was quite widely accepted as a global reserve currency. The US dollar was essentially in strong demand by both public and private sectors outside the US. Another observation is that, in the first few decades of the Eurodollar market, the US policies discernibly

[6] Eichengreen (2011) uses "Exorbitant Privilege" as the title of his book that describes the path of the dollar to international prominence and its future prospects.

[7] Dufey and Giddy (1994), for example, offers a textbook description of the evolution of eurocurrency markets. The efforts by some countries to restrict offshore trading of their currencies after the 1997 financial crisis are reported in Ishii, Ötker-Robe and Cui (2001).

leaned toward the domestic economy and were not swayed by the possible adverse effects on the rest of the world. A well-known instance is that in 1971, the former US Treasury Secretary John Connally told the US allies that "(T)he dollar is our currency, but it is your problem."

With the background information on the nascent offshore RMB markets and some recent developments in China, we briefly discuss some US policies that took place in the early phrase of the Eurodollar market (Section 5).

Similar to other financial markets, a well-functioning offshore currency market has to offer both convenience and confidence. Convenience requires a sizable market with both depth and breadth. The convenience is enhanced with an established trading and clearance infrastructure, a well-connected transactional network, and a good set of investment and funding alternatives. Confidence relies on the rule of law governing the offshore currency market and government's attitudes toward offshore transactions.

The convenience and confidence of an offshore market could be affected by the policy stance of the country that issues the currency being traded. For instance, fund flows associated with offshore transactions at the end have to be cleared in the onshore banking system. By managing and controlling rules and regulations on clearing balances of foreign financial institutions being held with onshore banks, governments could directly and indirectly affect the attractiveness of offshore currency markets.[8]

3. Offshore RMB Markets

3.1. Hong Kong: Background Information

The offshore RMB market in Hong Kong is an archetypical example of the existing offshore RMB trading centers. Both its inception and evolution reflect China's concerted efforts to shape the development of an offshore RMB market and guide the process of introducing RMB to the global stage. At the risk of stating the obvious, the reasons of focusing on Hong Kong include a) the offshore RMB market in Hong Kong is the first of its kind and has always accounted for the lion's share of offshore RMB business, and b) its special status allows China to design specific policy measures to control and manage the process of RMB internationalization. Other offshore RMB markets will be briefly discussed at the end of the Section.

Hong Kong is China's first testing ground of seeking the international use of the RMB. Since its inception in 2004, the offshore RMB market in Hong Kong has evolved from a primitive market that was dominated by RMB bank deposits to an increasingly sophisticated RMB trading center that offers a wide range of RMB-denominated products. While other offshore centers including London, Singapore and Taiwan are making headway to compete for offshore RMB businesses, Hong Kong has maintained its leading position and accounted for about 80% of global offshore RMB payment volumes (SWIFT, 2012). In addition to the first-mover advantage, China's policy support plays an important role in Hong Kong's accomplishment.[9]

China's choice is closely related to Hong Kong's unique economic and political status. Even before the sovereignty change in 1997, Hong Kong was a renowned international financial center with well-regarded rule of law practice and world-class financial market infrastructure, and had

[8] The reluctance of the Bundesbank was perceived as a reason of the limited degree of the internationalization of the Deutsche mark before the euro era (Franke, 1999).

[9] For instance, the policy of developing Hong Kong into a prime offshore RMB center was affirmed in China's 12th Five-Year (2011–2015) Plan.

extensive economic ties with China. After 1997, Hong Kong is a special administrative region of China and is allowed to maintain its own legal structure and financial system. Specifically, Hong Kong has its own currency, the Hong Kong dollar, and imposes no capital controls.

The differences in the legal and financial systems make it relatively straightforward for China to institute specific rules and procedures to regulate cross-border RMB transactions with Hong Kong. Notwithstanding Hong Kong is part of its territory; China treats Hong Kong as an offshore market in terms of RMB trading. Indeed, market practitioners view the RMB transacted in Hong Kong is different from the RMB in China; they coined the RMB traded in Hong Kong as CNH instead of the usual trading symbol CNY.[10]

Hong Kong commands an advantage over other offshore financial centers. In accordance with its usual gradual reform approach, China has followed a measured strategy to experiment with offshore RMB transactions. Even with a strong preference for seeking the use of the RMB overseas, China is not likely to give up capital controls outright. Thus, in addition to establishing clearing and settlement systems and market liquidity, the authorities have to work out the nitty-gritty of regulatory cooperation. These regulatory cooperation arrangements offer China some leverage to assess the implications of intermediating international transactions in the RMB. For instance, through regulatory cooperation, China could dictate the pace and the means through which offshore RMB capital is remitted back to the domestic market and, thus, evaluate the effectiveness of its capital control measures and its ability to manage the Chinese economy. Since Hong Kong is a special administrative region of China, it is relatively pliable. China could dictate both the growth and the evolution of the offshore market via necessary legislation. Thus, on the count of regulatory cooperation, Hong Kong has an insurmountable advantage over other international financial centers.

3.2. CNH Deposit, Trade Settlement, and Dim Sum Bonds

To set up the stage of launching overseas RMB business, China in 2003 appointed the Bank of China Hong Kong as the first clearing bank for RMB transactions outside Mainland China. The Hong Kong Interbank Clearing Limited provides the RMB real time gross settlement system – an important infrastructure to support the RMB clearing services in Hong Kong and facilitate RMB transactions in other overseas financial centers.[11] With the first-mover advantage and China's policy support, the offshore RMB market in Hong Kong has expanded in its size and its offer of RMB-denominated products.

Let us consider a few indicators. Figure 1 plots the total RMB (CNH) deposit in Hong Kong. The growth pattern of CNH deposits mirrors the anecdotal evidence that China has accelerated its efforts to promote the international use of its currency. The volume of CNH deposits has begun its steep ascend since July 2010 – the time at which China expanded the scheme for cross-border trade settlement in RMB and the signing of the Supplementary Memorandum of Co-operation between the Hong Kong Monetary Authority and the People's Bank of China on RMB businesses.[12] During the period July 2010 and November 2011, the CNH deposit grew by 500% from the amount of RMB 103.4 billion to RMB 627.3 billion. The phenomenon growth rate makes CNH the second most popular foreign currency after the US dollar in the Hong Kong market.

[10] Nevertheless, CNY is still the official ISO currency code in international settlement practice, SWIFT (2011).

[11] The settlement system operates from 8:30 am to 11:30pm Hong Kong time, which overlaps partly with business hours in London and New York. Hong Kong Monetary Authority (2013) offers some quick facts about the system including the list of participating banks.

[12] The Supplementary Memorandum (Hong Kong Monetary Authority, 2010) essentially allows a rich menu of RMB trading activities – including spot and forward RMB trading and RMB-linked structural products – in Hong Kong.

The decline of the CNH deposit in the first half of 2012 triggered the concern about the prospect of the offshore market. The concern, however, was dismissed in the mid-2012 when China re-affirmed the role of Hong Kong and the volume of CNH deposit re-gained its upward trajectory. The instance highlights China's influential role in the development of the offshore RMB market.

International trade settlement is an officially encouraged international use of the RMB. Figure 2 presents the volume of trade settled in RMB conducted via Hong Kong. In April 2009, the Chinese State Council approved a pilot scheme for cross-border trade settlement in RMB.[13] The scheme was expanded to cover 20 of the 31 mainland Chinese provinces in June 2010 and to cover the entire China in August 2011.

The value of RMB trade settlement has been growing strongly since 2010. The official efforts payoff quite well – the monthly volume has surged from the level of RMB 10 billion in July 2010 to RMB 318 billion in May 2013; an increase of almost 31 times in less than three years. Even allowing for possible mis-classified transactions that are related to arbitrage between onshore and offshore markets via trading invoicing, the growth of the volume of trade settled in RMB is quite phenomenal.

Another concerted effort is to establish an offshore RMB bond market in Hong Kong. The first issuance of Dim Sum bonds - the RMB-denominated bonds issued in Hong Kong - by the China Development Bank in 2007 starts a new chapter in history of the offshore RMB market. The monthly issuances of Dim Sum bonds are plotted in Figure 3. After the first few years, there is a steady flow of offers to the Dim Sum bond market. The typical monthly issuance volume is below RMB 10 billion.

Among all the issuers, China's Ministry of Finance plays a special role. Every year since 2009, the Ministry of Finance has issued its RMB sovereign bonds in Hong Kong. The sizes of issuances are usually large, and they range from the RMB 6 billion offer in 2009 to the RMB 23 billion offer in 2013.[14] Different from other Dim Sum bond issues, the Ministry of Finance sovereign bonds cover long tenors up to the maturity of 30 years. The issuance of long-term RMB denominated bonds is seen as an effort to set up an offshore market yield curve which is essential for the operation of a full-fledged offshore RMB bond market.

A main difference between Dim Sum bonds and onshore RMB bonds is that they are governed by different legal systems. The Dim Sum bond covenants are typically covered by the laws of Hong Kong, and not those in Mainland China. In general, the law system in Hong Kong is being considered as an internationally recognized legal framework. Thus, the Dim Sum bond market is attractive to individual and sovereign investors who are concerned about, say, possible covenant violations and insolvency proceedings.[15] Further, the trading in the Dim Sum bond market is not subject to the regulations and disclosure requirements in the onshore market.

[13] The use of RMB to settle cross-border trade could be traced back to at least 2003. See, for example, the directives issued by China's State Administration of Foreign Exchange (2003a, b), in Chinese, on using the RMB in settling trade. Before 2009, the RMB trade settlement mainly occurred for trade taking place along China's borders with, say, Cambodia, Mongolia, Russia, and Vietnam. Data on these cross-border trade settlements are quite scant. The discussion in this paper thus focuses only on the pro-2009 era.

[14] The 2013 issuance is offered in two slots – one of RMB 13 billion and the other of RMB 10 billion.

[15] One possible complication is that, if the default triggers the liquidation of a corporation within China, then the local law governing the liquidation process will be in effect.

3.3. An Interim Assessment

3.3.1. General Development

Most of the actions in the offshore RMB market have been taken place after the recent global finance crisis. Since then, a variety of financial products denominated in RMB were introduced in Hong Kong. These RMB-denominated products are available in retail and corporate banking, capital and currency markets, and the insurance sector.[16] Some examples are RMB denominated equities and exchange traded funds, RMB denominated CDs, Renminbi Kilobar Gold, foreign exchange options, futures and related RMB-linked structural products, and insurance plans and products.

There is no denial that the nascent offshore RMB market has been progressively expanding its size and product variety. In general, the offshore market provides a physical platform for China to assess the implications of the using RMB to intermediate international transactions and, for the rest of the world, to become familiar with RMB via real life business activities.

China's domestic financial sector is relatively underdeveloped and has limited experience with modern finance transactions. The Chinese authorities, via the offshore market activity, could assess the responses of domestic and overseas participants on RMB exchange rate flexibility and convertibility, and their subsequent implications for their ability to manage the local economy. Similarly, Chinese corporations and financial institutions could gain practical experiences of conducting international businesses using the RMB in a legal environment that is recognized by international participant but different from the Chinese one, and recognizing trading partner's currency concerns. They could also experiment with various RMB-denominated products in offshore markets to manage their funding and investment needs.

Anecdotal evidence, say, based on the conferences, seminars and workshop offered by financial institutions, professional bodies, and commercial entities suggests that corporations and investors domiciled outside China have tremendous interest in the offshore RMB markets. For these overseas participants, sourcing and investing in the RMB is an unchartered territory. While it could be costly, if not impossible, for them to access the local RMB market, the offshore RMB market in Hong Kong presents an attractive alternative. Without capital controls, Hong Kong allows individuals to move funds in and out of the offshore market to assess the costs and benefits of working with the RMB.

For instance, for a corporation to adopt the RMB as a settlement currency, it has to setup the corresponding internal and external arrangements; including guidelines for cash management, exchange rate risk management, fund transfers, and banking facilities. While the common principles are assumed to be common knowledge, individual corporations have their own idiosyncratic practices that are implemented and evolved according to, say, management philosophy, and local regulations. The offshore RMB market offers a testing ground for them to work out and fine tune the practical aspects of including the RMB in their menus of operating currencies. Similarly, overseas investors could learn the trading and settlement details of moving RMB funds in and out of the market.

These experiences, in principal, help the domestic and foreign corporations and investors to set up similarly operations in their operations in China.

[16] See, for example, Hong Kong Monetary Authority (2013) for a list of available RMB-denominated products.

3.3.2. Some Specific Issues

Despite the healthy development in the last few years, the offshore RMB market is quite far from a full-fledged offshore market such as the Eurodollar market. For instance, the offshore RMB market still lacks some basic features including credit ratings of Dim Sum bonds, which have expanded quite rapidly but at the cost of diluting issuer's quality. The presence of low quality issuers raises the concern about Dim Sum bonds without explicit clauses in their covenants to protect investors. Naturally, the availability of objective credit ratings and improved investor protection will nurture the dynamic growth of the Dim Sum bond market.

Only recently (June 2013), the CNH HIBOR fixing is offered by the Treasury Markets Association in Hong Kong. The fixing covers tenors from overnight to one year. Though its overall effect still has to be seen, the CNH HIBOR fixing facilitates the pricing of offshore RMB denominated loans and related structural products for risk management.

Despite its rapid growth, the scale of offshore RMB market is still small. For instance, even the volume of CNH deposit has leapfrogged to RMB 698.5 billion as of May 2013, it is less than one percent of China's domestic deposit balance of 99.3 trillion in the same period. Since the other offshore RMB markets are much smaller than the Hong Kong one, the total offshore RMB deposit is likely to be less than 2% of the domestic deposit.[17]

China's extensive trade network justifies its policy of introducing the RMB to the global stage via the trade settlement channel. Complementing the official stance, it is reported that Chinese corporations offer price concessions to encourage their overseas trading partners to conduct their import and export transactions in the RMB. Since the scheme first introduced in 2009, the value of cross-border China trade settled in RMB has increased from a minuscule amount to the aggregate monthly volume of RMB 364.3 billion as of May 2013; the figure represents 16.9 percent of China's aggregate trade volume in the same period. It is quite an impressive development.

The current percentage of trade settled in RMB, however, is far less than the one-third proportion predicted by Chen, *et al.* (2007). Further, it is noted that Japan settles about 40% of its trade in the Japanese yen (Goldberg and Tille, 2008) and the Euro zone has more than one half of its international trade invoiced in its own currency even in the midst of sovereign debt crisis (European Central Bank, 2013). Of course, whether the one-third stipulation is achievable or not depends on economic and political developments in both China and the global economy.

In passing, we note the role of a vehicle currency is an important attribute of an international currency. Even though China has made impressive strides in using RMB to settle its trade with the rest of the world, the RMB has played a limited role as a vehicle currency. Additional efforts have to be made to enhance the vehicle currency function of the RMB.

There are a few observations pertaining to the Dim Sum bond market. First, both the monthly issuance value and outstanding volume of the Dim Sum bond market are small compared with the bond market in China – the relative size is not surprising given the short history of the offshore market.

However, it is less encouraging to observe that, despite the increase in market size, the Dim Sum bond issuance is dominated by China's Ministry of Finance and policy banks. The monthly issuance is typically below the 10 billion mark in the absence of these issuers. The Chinese institutions and their affiliations in Hong Kong in total are estimated to account for well over one half of the value of outstanding offshore bonds (Cheung and Hui, 2013). Despite the policy intention to promote offshore market activities and the RMB funding cost in the offshore market is lower than the onshore one, not all the Chinese corporations are allowed to issue Dim Sum bonds.

[17] The comparable RMB deposit figures in, say, Taiwan and London are, respectively, estimated to be less than 70 and 6 billion.

Chinese corporations have to get official approvals and financial guarantors before they can issue Dim Sum bonds in Hong Kong. The procedures amount to reduce the default risk and manage the inflow of offshore RMB capital.

The lack of active non-resident issuers undermines the international nature of the Dim Sum bond market and limits its funding and investment opportunities. The dominance of Chinese issuers reflects China's policy stances. For instance, overseas issuers have limited ways to deploy the RMB capital raised via Dim Sum bond issuance. Investment opportunities in offshore markets are constrained by the limited investment products denominated in the RMB, and in the onshore market are hampered by administrative regulations for foreign issuers to remit offshore RMB capital back to China.

In addition to the international characteristic of the currency, the presence of non-residents has implications for the benefit of promoting the use of the RMB overseas. With its trade surplus and capital inflows, China's external assets are mostly in foreign currencies and predominantly in US dollar. On the other hand, most of its international liabilities are in RMB. Thus, by allowing non-residents to borrow in RMB, China increases its RMB-denominated claims and shares the exchange rate risk arising from its dollar-biased international assets and liabilities position with the rest of the world (Cheung, Ma and McCauley, 2011). The current composition of the Dim Sum bond issuers does not offer much risk-sharing benefit to China.

3.4. Other Contenders

Given its enormous potential, the offshore RMB business has attracted considerable attention from financial cities around the world. These cities are eager to explore the possibility of setting up the infrastructure to compete for a share of the global offshore RMB business. London, Singapore, and Taiwan are considered as serious contenders. Other cities including Luxembourg, Frankfurt, Tokyo, Dubai, Luxemburg and San Francisco are reportedly preparing themselves, at different stages, for a slice of the global RMB market.

Despite all the hype on building up offshore RMB business in these cities, Hong Kong so far has maintained its competitive edge and accounted for over 80% of overseas RMB payment flows (SWIFT, 2012). Essentially, the prominence of Hong Kong reflects the policy-driven nature of the offshore RMB market. Without China's endorsement and support, it is hard for other financial centres to expand their RMB activities. The offshore RMB settlement and clearing infrastructure, for instance, is only available to Hong Kong before the year 2013.[18] While Taiwan and Singapore have their own authorized RMB clearing banks in the first half of 2013, London has its local RMB clearing bank arrangement affirmed in 2014.[19]

Currently, Hong Kong is the major player. Nevertheless, the offshore RMB business is likely to take root gradually in other financial centres. The presence of more established offshore RMB centres across different geographic locations and time zones will increase the global RMB liquidity and business opportunities; and these developments help to increase the degree of the RMB's international acceptance. Thus, it is of China's interest to support additional RMB trading markets and work with other financial centres to develop offshore RMB business.

[18] Hong Kong also benefits from the swap arrangement it established with China. The RMB 400 billion swap line is the largest of the currency swap lines China has arranged so far, and provides the needed RMB liquidity to operate and expand the offshore market smoothly.

[19] The Bank of China, the Industrial and Commercial Bank of China, and the China Construction Bank are, respectively the local RMB clearing banks in Taiwan (February 2013), Singapore (May 2013), and London (June 2014). Macau, a Special Administrative Region of China, also has the Bank of China as its RMB clearing bank. In the second half of 2014, China assigned RMB clearing banks in Frankfurt, Seoul, Paris, and Luxemborg.

Taiwan and Singapore, for example, see their offshore RMB activities growth quickly after their authorized local RMB clearing services were launched in early 2013. The offshore business in Taiwan is underpinned by its special political relationship and economic ties with Mainland China. On the other hand, Singapore, as a major financial hub in South East Asia, would operate an active offshore RMB market by leveraging upon its well-establishing financial market infrastructure and links with neighbouring countries. These two economies, both with a local RMB clearing bank are in the position to compete for a spot in the global offshore RMB market.

It is hard to underestimate the potential of London as an offshore RMB market. As a premium international financial centre, London could provide critical RMB business services in the western hemisphere and beyond. Even without a local RMB clearing bank, London signed a three-year swap agreement of RMB 200 billion with China in June 2013. The swap line is the first one China signed with a G7 country. The symbolic meaning on London’s role in offshore RMB business may be more than the RMB liquidity available through the swap line. London’s potential to be a significant hub of the global RMB business is enhanced with the promise of the RQFII quota of RMB 80 billion announced in October 2013. The current status of London is attested by the SWIFT statistics which show that, excluding China and Hong Kong, the United Kingdom accounts for over 50% of RMB foreign exchange transactions.[20] Conceivably, the assignment of the RMB clearing bank in London further affirms the city’s role in global offshore RMB business.

New York, an important international financial centre, is mysteriously missing from most discussions on offshore RMB business. Even though China launched trading of its currency in the US in January 2011,[21] New York seldom publicly expresses its interest in establishing an offshore RMB market. Whether it is due to political considerations or regulatory concerns, New York, compared with say, London is seen to be not enthusiastic or not aggressive in developing RMB businesses. In fact, New York appears to be behind in the game of securing offshore RMB business.[22] For instance, the United States accounted for 14% in 2012 and 13% in 2013 (up to September) of the offshore RMB foreign exchange transactions outside Hong Kong and China; these numbers are much smaller than the corresponding ones of the United Kingdom (SWIFT, 2013).

Evidently, China has been strategically guided the development of the offshore RMB market in Hong Kong. With its efficient financial infrastructure, relative pliability and track record on implementing the offshore RMB strategies, Hong Kong is likely to maintain a considerable lead in the global offshore RMB business in the near future. Assuming that the currency is increasingly used overseas and people are getting familiar with the offshore market, the acceptance of the RMB will improve and additional demands will be created. When the RMB realizes its potential as an international currency, it could support the existence of multiple active offshore RMB markets. When the overall offshore RMB business is growing, it will benefit Hong Kong and other financial centers. In the meanwhile, Hong Kong is leading the pack and followed by London, Singapore, and Taiwan in the offshore RMB business; and other financial centers are vying for a piece of action.

[20] The United Kingdom accounted for 54% in 2012, and 62% in 2013 (up to September); SWIFT (2013).

[21] The scope of trading is restricted – the purchase of RMB for a US individual customer is limited to the equivalent of $4,000 a day (Wei, 2011). However, there is no limit on converting RMB back into dollars. There are also no conversion limits on businesses that are engaged in international trading.

[22] In February, 2013, San Francisco city, the third largest financial center in the US, was reported on planning to be a center for offshore RMB trading (Ross, 2013).

4. Developments within China

Citing the unduly impediments and controls in the onshore market, skeptics are concerned about the effectiveness of China's outsourcing approach to internationalize the RMB. It is fair to assert that, if China maintains it status quo and does not implement complementary changes in the domestic market, the offshore experiences would have only limited implications for the overall acceptance by the international community.

Anecdotal evidence, however, indicates that China has been progressing along its path of reform. While opinions could differ on whether the pace of reform is too slow or appropriate, there is no sign that the process has stopped. For instance, since the beginning 2013, China has introduced policies to simplify regulatory requirements on cross-border RMB payments for large international corporations, and on the deployment of onshore and offshore fund by foreign firms. These changes help to improve the efficiency of the domestic system and, thus, complement the effort of promoting the overseas use of the currency. Also, on July 19, 2013 the People's Bank of China announced the removal of controls on lending rates, which is the latest policy move toward interest rate liberalization.

In the next subsection, we briefly discuss capital controls. Then, the rest of the section is devoted to discuss two noticeable developments in the arena of policy reform.

4.1. Capital Controls

When China switched to an aggressive mode to promote the RMB, there is a serious debate on the necessity of removing capital controls before internationalizing the currency. Despite China is relaxing its regulatory policy over time, a strong view is that it is premature to push for the international use of the RMB before liberalizing local financial markets. Some, however, acutely point out that the British pound and the US dollar acquired their prime international currency status in the era when capital controls were the norm. For instance, in the early period of the Eurodollar market, the US imposed restrictions on the inflow of the dollar from overseas. Indeed, the US only removed the deposit interest rate ceilings with the exception of the demand deposit rate in the 1980s.[23] These experiences undermine the causal link between capital controls and currency internationalization.

Nevertheless, the implication of capital controls for the overseas use of the RMB could be stronger than the one in, say, the 1950s. To gain a share in the international market, the RMB has to compete with the US and other international currencies that are subject to little capital controls. Will people select a currency subject to capital controls or not?

Against the odd, the offshore RMB market in Hong Kong has developed quite quickly in the last few years. The development has also attracted the interest of a few other financial centers to join the offshore RMB venture. As noted above, the arrangement for foreign financial institutions to clear cross-border trade and investment transactions through the appointed local RMB clearing banks makes the offshore business possible. China, by offering means to foreign financial institutions to manage their RMB clearing balances, effectively creates a form of convertibility for designated cross-border RMB transactions. The arrangement is similar in spirit to the one adopted by the US before convertible capital account era (He and McCauley, 2013).

[23] These interest rate ceilings were eliminated between 1981 and 1986. The payment of interest on demand deposits was allowed (but not required) in 2011.

What is implication of the nascent offshore RMB market for China's capital controls? Ma and McCauley (2008) and Cheung and Herrala (2014), for example, show that China's capital controls have not been watertight but remain substantially binding. The evidence based on offshore RMB (CNH) and onshore RMB (CNY) exchange rates give a different impression. The daily CNH-CNY premiums in percentage are plotted in Figure 4.

If we use the premium of CNH over CNY to gauge the market price of capital controls, the price appears less volatile and converging. When the CNH was introduced in late 2010, it enjoyed a premium that reflected market's preference of the RMB in the Hong Kong, which imposes no capital controls. The negative premium observed in September 2011 was attributed to a policy crackdown on mis-invoicing of CNH transactions and to a decline in risk appetite due to heightened market volatility in that period. Since then, the premium fluctuated mainly in the range of the -0.5% to 0.5%. The circumstantial evidence, thus, suggests either a) China's capital controls are getting less effective, b) the market is placing a smaller value on convertibility of the CNH market over time, c) the market anticipates, over time, China's ongoing policy reform reduces the cost of capital controls on business, or d) the CNH exchange rate follows the CNY exchange rate because the trading volume of the latter is much larger than the former one.[24]

4.2. A Domestic Offshore Market

On June 27, 2012, China unveiled a bold economic reform initiative to create a special economic zone within the first special economic zone Shenzhen in China. In essence, the central government approved the plan to develop Qianhai, a port district of Shenzhen, into a modern service industry cooperation zone that enjoys pilot policy preferences beyond those available to Shenzhen.[25] Most commentators lauded the initiative is a confirmation of China's commitment to liberalize its capital account and to boost the international use of the RMB.

To be sure, the Qianhai area is not set for completion until 2020, and the reform initiative goes beyond the financial sector.[26] Nonetheless, the hype surrounds the provisions related to offshore RMB business. One key theme of the experimental zone is that offshore RMB capital could be sent back to Qianhai. Possible arrangements include eligible enterprises and banks in Qianhai could borrow RMB loans from banks in Hong Kong, issues Dim Sum bonds, and extend offshore RMB loans. These arrangements will convert Qianhai into an offshore RMB centre within China. It should be noted that, the exact policies and terms governing these cross-border RMB-based transactions are still in the process of being unfolded.

At first glance, the creation of a hub to recycle offshore RMB back to China will benefit the offshore RMB market in Hong Kong by enriching its investment opportunities. However, there may be some unintended consequences. Currently, there is a legal firewall between the offshore and onshore markets. One concern is the leakage of offshore RMB capital back into the domestic Chinese economy. If offshore RMB could be loaned to enterprises in Qianhai, then should China

[24] According to BIS (2013), Hong Kong accounted for 16% of the total global RMB foreign exchange trading and the onshore market accounted for 59% of the trading volume.

[25] See the "Official Reply of the State Council on Policies Concerning the Development and Opening of Qianhai Shenzhen-Hong Kong Modern Service Cooperation Zone of Shenzhen" released by the State Council. The approved plan for Qianhai is based on the one outlined in the document "Overall Development Plan for Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Area" approved in August of 2010.

[26] The modern service industries covered by the development plan include financial and security industries, legal and professional services, education and medical services, and telecommunication services. Preferential tax incentives will be offered to qualified enterprises and workers.

institute some regulatory oversight of Qianhai to preserve the existing capital controls for the rest of China?

It may not be a critical matter in the beginning as the initial pilot loans were relatively small and mostly for financing the development and construction of the Qianhai district. The leakage effect will, however, aggravate quickly once the business borrowing and lending activities pick up near and after the completion of the Qianhai project in 2020. Unless China eradicates its capital control policy and modernizes its financial sector by 2015 or by 2020 - the target dates that are on and off mentioned in the media, one has to consider the challenges of reining in the spillovers to the domestic economy from Qianhai.

In principle, the influence of offshore transactions on the domestic offshore market could be contained. A good example is the US International Banking Facilities (IBFs) set up in December 1981. By requiring banks to keep different books for onshore and offshore transactions and the related regulations, IBF creates an offshore market setting that is physically located within the US (Dufey and Giddy, 1994; He and McCauley, 2013). A well-functioning domestic offshore market such as the IBF could create a symbiotic relationship between on-shore and offshore markets. Similarly, Japan established the Japan Offshore Market in Tokyo in December 1985 to accommodate offshore yen transactions within Japan.

In passing, it is noted that policy measures designed to establish an onshore offshore-market may not have the designated effects. For instance, the Japan Offshore Market that was established in respond to foreign pressure and did not contribute significantly to the liberalization of Japan’s capital account and the international use of the Japanese yen (Osugi, 1990; Takagi, 2011). Indeed, an onshore offshore market could backfire. Krongkaew (1999), for instance, asserted that the Bangkok International Banking Facility established in 1993 that allowed enormous capital inflows is one of the causes of the 1997 crisis in Thailand.

The real issue is, of course, the cost for China to implement a set of operationally efficient regulations to insulate the domestic sector from possible adverse impacts of offshore RMB capital. Some related issues are the implications of the presence of segregated on-shore and off-shore accounts for tax, regulatory, and risk management policies. Given China’s relatively unsophisticated financial system, the administrative cost of setting up effective barriers to contain the spillovers from an offshore market that is physically located within China is quite high.

The financial innovation of recycling offshore RMB capital could give a short-term boost to the offshore RMB market in Hong Kong, but at the expense of impeding the long-term growth potential of the international use of the RMB. Cross-border trade settlement is a main component of the current extra-territorial use of the RMB. The global function of the RMB, however, goes beyond the settlement of China’s exports and imports.

Along the path to become an international currency, the RMB should evolve to be a vehicle currency that facilitates transactions among non-residents. Consider the prime global currency the US dollar, a large proportion of international transactions denominated in the US dollar do not involve US entities. Currently, the liquidity in the offshore RMB market is still quite low on the international scale. If the RMB recycle program works too well, it will constrain the offshore RMB liquidity available to nonresidents and, thus, stifle the use of the RMB as a vehicle currency. This will, in turn, inhibit the growth of the offshore RMB market. Thus, be careful what you ask for, you just might get it - in the absence of a progressive scheme to provide RMB to non-residents, a RMB recycle program may work against the objective of promoting the overseas use of the currency.

4.3. The Shanghai Free Trade Zone

The anointment of Qianhai to be the designated hub connecting the offshore market in HK and the domestic market raises the question of the role of Shanghai in promoting the overseas use of the RMB. For a short period, it is conceived that Shanghai will stay on its course to become a global center for onshore RMB business, but not a base of the domestic offshore RMB activity. However, the approval of the establishment of the "China (Shanghai) Pilot Free Trade Zone," which is commonly known as the Shanghai Free Trade Zone, by China's State Council in July 2013 has re-asserted the role of Shanghai in China's reform agenda. The Zone was officially inaugurated on September 29 the same year.

Similar to the Qianhai initiative, the official plan of the Shanghai Free Trade Zone encompasses reform measures in a several service industries.[27] The official document also stated that the Shanghai Free Trade Zone, under the presumption of risk controllability, could be the testing ground of capital account RMB convertibility, market determined interest rates, and cross-border RMB transactions. There are considerable overlaps between financial reform measures of the Qianhai and Shanghai Free Trade Zone projects.

At the time or writing, these reform measures are mostly casted in general terms and the specifics are vague. The short on specifics makes it difficult to assess the actual impacts of these measures on exchange rate flexibility, capital account convertibility, and interest rate liberalization. Nevertheless, the administrative challenges of implementing financial reforms on a restricted domestic physical area and preventing the spillovers to the domestic financial market discussed in Sub-section 4.2 are relevant to both cases. Specifically, a serious challenge is how to rein in the effect of offshore RMB capital inflows while retaining an effective grip on capital controls in the rest of the China.

4.4. Some Implications

Both the Qianhai initiative and the Shanghai Free Trade Zone re-assure the global community that, albeit in its usual gradual style, China is on the course of opening-up its economy in general, and deepening its financial reform, in particular.

The announcements of the Qianhai project and the Shanghai Free Trade Zone have triggered discussions on the future of the offshore RMB market in Hong Kong. One view is that, under the presumption that the two reform experiments conducted in the limited physical areas would trigger and speed up financial reforms at the national level, Hong Kong will be marginalized and lose out in the process. While the construction of the Qianhai region will be completed in 2020, the Shanghai Free Trade Zone is officially in operation in September 2013. Will Shanghai – China's commercial heavyweight and designated international financial market – with the free trade zone provision undermine its archetypical competitor Hong Kong?

The (implicit) rivalry and competition between Hong Kong and, say, Shanghai depends crucially on how fast China could revamp its financial market regulations, tax policies, and the related governance practices. The history of international finance shows that the process of capital account liberalization is usually laden with financial and economic crises. Indeed, China is quite concerned about the adverse effects of hot money flows. Such a concern is reinforced by a recent study that shows the capital account liberalization in China may trigger net portfolio outflows

[27] These include financial services, shipping services, trade-related services, professional services, cultural services, and social services. See "中国(上海)自由贸易试验区总体方案," http://www.shftz.gov.cn/WebViewPublic/item_page.aspx?newsid=635158957941988294&coltype=8.

(Bayoumi and Ohnsorge, 2013).Thus, in the process of opening-up and modernization, China has to navigate carefully through the minefield of capital account liberalization.

Against this backdrop, it is expected that China is likely to follow its typical gradual approach in reforming the domestic financial sector. Hong Kong is likely to enjoy its comparative advantages in brokering financial transactions for the time being. China, in promoting on-shore financial centers, could diversify its financial business within the country.

As noted earlier, while Hong Kong has been designated as the premier offshore RMB market, it has to compete and, more importantly, cooperate with other overseas international finance centers and on-shore financial centers to promote the international use of the RMB. With its first-mover advantages in offshore businesses and settlement facilities, Hong Kong is well-positioned to meet the challenge of increased competition in the foreseeable future. A more relevant question is: what is Hong Kong's role when China has removed capital controls and instituted capital account convertibility?

Barred from some unexpected developments, Hong Kong with its established financial market infrastructure, well-regarded legal system, and extensive international network would maintain its role as a renowned international finance center. When China has achieved capital account convertibility and has realized the potential of the RMB as a global currency that is commensurate with its economic and political strengths, the global offshore RMB market will be much larger than its existing size. When the pie grows bigger, Hong Kong will benefit too. Looking into the future, Hong Kong is likely to enjoy a health volume of offshore RMB activity though not necessary its current large share of the offshore market.

Considering the experiences of, say, the offshore US dollar markets, it is not unreasonable to anticipate that the growing global RMB activity will support multiple financial centers conducting offshore RMB businesses. Even within China, given its geographic diversity and economic size, it could support more than one local financial center.

Apart from the rivalry viewpoint, a holistic approach is to interpret China's efforts in establishing the offshore RMB market in Hong Kong and implementing the Qianhai and the Shanghai Free Trade Zone initiatives are integral to its overall financial development strategy. As unfolded in the last few years, the Hong Kong experiences have been used to develop offshore RMB businesses in other financial centers overseas, and guide the two domestic initiatives. According to official documents, both domestic initiatives are initially confined to the designated geographic regions. However, the successful financial reform practice will be transplanted to other parts of the country so as to broaden the financial account liberalization policy to the national level. That is, China is following a two-prong approach that involves both offshore and onshore markets to promote the international use of the RMB and to implement its financial development policy – an interpretation that is in line with China's usual gradual and trial-and-error approach.

5. A facilitator

5.1. Canonical Economic Factors

A fair assessment of the role of offshore RMB markets has to consider possible factors that affect the global status of a currency. The factors considered in the literature include a) the size of the economy and the trade sector, b) the size and quality of the financial market, c) capital account openness, and d) the economic and political stability. These factors are largely affected by domestic economic policies and not directly influenced by an offshore market policy.

Undeniably, China fares quite well on factors (a) and (d) but not on capital account openness and financial markets. Capital account openness, indeed, is a hotly debated concern. As noted in Sub-section 4.1, complete capital account openness is not a necessary pre-condition of the international use of the RMB. As attested by the extant offshore and cross-border RMB activities, China’s policy of allowing foreign financial institutions to manage their RMB clear balances that are (directly or indirectly) held with domestic banking system presents a form of convertibility that facilitates the international use of the RMB. Of course, a full-fledge global RMB requires the support of an open capital account.

Despite the usual hyperbolic rhetoric on how far and how fast China could liberalize its capital account and transform its financial sector, China has to take the time to put in place the hardware and, more importantly, the software that are required to establish and maintain a robust financial sector and the related regulatory framework. Evidently, China is continuing with financial development policy. The modernization of the financial sector, given its close links with other segments of the economy, requires accompanying policy changes in other sectors and even in politics. In view of its usual incremental and gradualism reform style, there are good reasons to expect that it will take China a long time to implement changes that lead to a deep and efficient financial sector. As such, a full-fledged international RMB will be a distant goal.

Subject to the level that is allowed by China’s policy, the ultimate overseas demand is determined by the desirability of the RMB as a global currency perceived by non-residents. One could say that an offshore market policy facilitates a currency to attain its level of acceptance overseas warranted by its economic fundamentals but not beyond that.

5.2. Clues from the Eurodollar?

Could the advances in the offshore RMB market induce changes to the domestic markets including policies of capital controls and, thus, force the progress of the RMB internationalization process? Did the US responses to the evolution of the Eurodollar market offer some insights?

As noted in Section 2, the US dollar was a reserve currency when the Eurodollar market emerged in London during the late 1950s. The reserve currency status is an important organic growth factor of the Eurodollar market. Further, both the US economic and military reaches help to further spread the use of the US around the world. The RMB, on the other hand, is still in the early stage of being a reserve currency and a global currency. The difference in the status of these two currencies makes it quite difficult to directly apply the US dollar experience to the RMB.

Indeed, in the early phase of the Eurodollar market, the US policy stance is to protect the onshore market from the offshore one. The commonly mentioned US policy responses include the Interest Equalization tax (1963), the Voluntary Foreign Credit Restraint Program (1964), and the Regulation D (1969). Essentially, the Interest Equalization tax narrowed the US dollar funding costs of domestic and offshore bond issuers. The Voluntary Program limited the onshore banks’ lending to non-residents. The 1969 Regulation D rule imposed marginal reserve requirements on US bank borrowings from the offshore dollar market.[28]

Apparently, the scale of the Eurodollar activity had a material impact on business conditions in the US. Consequently, the US devised these policy measures to isolate and divert the adverse effects of the offshore US capital. That is, the US at that time was imposing implicit and explicit restrictions on cross-border capital movement. Interestingly, it is commonly perceived that these restrictions by limiting the dollar flow actually fostered the growth of the Eurodollar market.

[28] The reserve requirement was increased from 10% to 20% in November 1970.

As these measures were phasing out in the late 1970s and the 1980s, the US International Banking Facilities were introduced in 1981 to create a level playing field for onshore domestic financial institutional to compete directly with offshore ones. Arguably, the motivation behind the IBFs is different from that behind China's Qianhai initiative, which is dubbed a Chinese version of an onshore offshore market. The former aims at equalizing the competition between onshore and offshore banks while the latter focuses on financial reforms.

These developments are quite different from those observed from the recently developed offshore RMB market and China's policy initiatives on promoting the use of the RMB overseas. The US dollar then and the RMB now are facing different domestic and overseas conditions. China now is experimenting financial liberalization with currency internationalization while the US then tried to rein in the offshore market influences on its domestic economy. In addition to the difference in the global status of the two currencies, the differences in the scope and scale of the offshore dollar and RMB markets contribute to the dis-similar responses.

Over the last few years, China made some concerted effort to push the RMB to the global stage, and to convince the rest of the world to adopt its currency for international transactions, albeit in a controlled manner. Despite its rapid growth, the offshore RMB market is still quite small compared with the onshore market (Section 3 above). The large difference in market sizes constraints the ability of the offshore market to affect the development of the onshore market. Besides the market size element, the limited feedback from the offshore market is ascribed to China's tight grip on its own financial sector and the offshore market. There is no indication that China changes its reform policies under the pressures of offshore RMB activities including cross-border arbitrage.

5.3. Non-Economic Factors

Notwithstanding official policies and good intentions, the economic quality of the currency itself is not the sole factor determining the acceptance of the RMB in the global market. Beyond some fundamental structural changes in its financial sector, China has to convince other countries to conduct international trade and financial transactions in its currency. The persuasion, as attested by Japan's attempt to internationalize its currency in the late 20th century (Ministry of Finance, Japan, 2003; Takagi, 2011), goes beyond economic reasoning. Political considerations, especially in East Asia, play a non-negligible role in adopting an international currency.

With the region's predominant antagonism towards hegemony, China's communist political structure, military buildup, and recent territorial rows with its neighboring countries including the recently announced China's East China Sea Air Defense Identification Zone could seriously impede the acceptance of the RMB abroad and be a drag of its efforts to internationalize the RMB. China has often re-affirmed its commitment to peaceful development, the non-interference foreign policy, and the Five Principles of Peaceful Coexistence.[29] Nevertheless, for its neighboring countries these reassurances may not be completely convincing; especially when China is expanding its military capacity and continuing its territorial disputes with countries including Japan, Vietnam, and Philippines. All these considerations would require China to make some extra efforts to promote the acceptance of the RMB in Asia and in the global market.

[29] The Five Principles are: mutual respect for sovereignty and territorial integrity, mutual non-aggression, non-interference in each other's internal affairs, equality and mutual benefit, and peaceful coexistence. They were results of negotiations between China and India and formally included in the "Agreement Between the People's Republic of China and the Republic of India on Trade and Intercourse Between the Tibet Region of China and India" in 1956. See, for example, http://www.fmprc.gov.cn/eng/topics/seminaronfiveprinciples/t140777.htm.

Recently, there are some apparent international efforts to contain China's influences. For instance, the absence of China in the negotiations of the Trans-Pacific Partnership is unlikely to be an unintended omission.[30] The Partnership is ostensibly aimed at enhancing trade and investment activities between the US and the major trading countries on both side of the Pacific Ocean. It is hard to conceive that it is a coincidence for such a trade and investment arrangement to leave China, which is the world's second largest economy and trading nation in the region on the sidelines.

Overall, to facilitate the global use of the RMB, offshore markets have to overcome limits defined by economic and political factors.

6. Concluding Remarks

The history of international finance offers a good glimpse of the potential role of an offshore market. Active offshore markets like Eurodollar markets are essential for a currency to realize its roles in the international money system. It is hard to imagine that a currency could maintain its significant present as a global currency without the backing of a fully functional offshore market network.

The launch of offshore RMB business in Hong Kong in 2004 was the beginning of a grand economic experiment. Even though countries in the past had policies promoting the international status of their currencies,[31] China's approach to build the architecture almost from scratch is quite deliberate and elaborate.

The evolution of the offshore RMB market in Hong Kong illustrates both potentials and limitations of the policy driven approach to promote the extra-territorial use of the RMB. So far the offshore market has advanced to China's tune and experienced no major disruptions. Over the last few years, the global RMB activity has been increased quite noticeably. For instance, the RMB became the 9th most actively traded currency in the 2013 triennial central bank survey, while it ranked 17th in the 2010 survey (Bank for International Settlements, 2013). The move up in ranking is contributed by expansions of both onshore and offshore RMB trading.

Despite the strong momentum, the scale of RMB uses in the global market is still minute compared with the size of the Chinese economy and, say, with the US dollar. For instance, the global RMB trading accounted for 2.2% (out of a total of 200%) of the global trading volume, while the US dollar accounted for 87.0% and the euro accounted for 39.1% (Bank for International Settlements, 2013). In addition, the international currency functionalities undertaken by the RMB is quite limited, and the level of non-resident participation is relatively low (Chen and Cheung, 2011).

Thus far, the anecdotal evidence substantiate a) the positive effect of the offshore market on the international use of the RMB, and b) the path for the RMB to become a full-fledged global current is likely to be is a fair long, if not winding, one. A positive and encouraging sign is that China has been adjusting and reforming domestic policies and offshore strategies on promoting and enhancing overseas RMB markets and RMB businesses.

While the offshore markets play a constructive role and offer a scope for corporations and governments to work together to explore opportunities of using the Chinese currency in an efficient manner, we should not overplay the contribution of offshore RMB markets. On the one hand, with improved liquidity and enhanced investment opportunities, offshore markets offer opportunities to non-residents to experience business dealings using the RMB and the Chinese authorities to assess

[30] The US official website is http://www.ustr.gov/tpp. See http://wikileaks.org/tpp/ for alternative views.

[31] Eichengreen and Flandreau (2012) pointed out the US policy support that helps the US dollar to gain the prominence in the global market. The official efforts to internationalize the Japanese yen in the 1990s are documented in, for example, Takagi (2011).

the implications of intermediating international transactions without eradicating capital controls. On the other hand, as in the past, China maintains its usual gradual approach to liberalizing its economy including its financial sector, retains its grip on critical policy matters, and responds mainly to domestic rather than foreign considerations.

In the foreseeable future, we anticipate the offshore RMB market will grow at a healthy pace that is directed and dictated by the Chinese authorities. With the emphasis on stability, China will assume an active role in designing the offshore market development and be very conscientious about the adverse feedback on its under-developed financial sector.

The offshore market policy is used to improve the RMB's overseas acceptance but is subordinate to the overall financial liberalization policy. It generates information for making changes but not to force domestic regulatory reform. That is, the role of offshore markets is complementary in the sense that it helps to achieve the RMB potential as a global currency but not to force changes in domestic policies to further the role of the RMB in the global market.

Alternatively, the observed developments could be interpreted through the lens of the so-called "feel the rock, wade across the river" strategy. Under this strategy, the policies are contemplated and designed in broad and general terms. The operational specifics, however, are introduced and implemented in small and incremental steps, taking the market responses into consideration, to guard against large negative surprises. Indeed, China has initiated changes to accommodate and complement developments in the market since the adoption of the open door policy. The case of RMB offshore markets is of no exception. Specific policies that do not threaten the stability are introduced to promote the overall international use of the RMB in a gradual manner.

The experience of, say, the Eurodollar market suggests that the offshore market could create pressure on the domestic policy. Since its size is relatively small, the offshore RMB market is unlikely to generate any noticeable pressure on China's domestic market and, hence, its domestic policy. China's capital control policy also helps to insulate its domestic sectors from the offshore market. When the offshore RMB market is quite large relative to the onshore one and China's capital control policy is so lax such that it allows offshore financial institutions directly compete with and challenge onshore financial institutions, then the domestic policy has to respond to developments overseas. It is not unreasonable to assume that China is aware of the potential shock and risk to its under-developed financial sector when overseas financial institutions are allowed to compete head-on with the domestic institutions. Given the usual emphasis on stability and political reality, it is unlikely that China will allow the offshore market to impose any material pressure on the domestic policy in the near future.

In sum, China has made some good efforts in preparing for full convertibility and the internationalization of its currency. While the accomplishment in the last few years is quite admirable, the RMB is still quite far from being a full-fledge international currency. To move forward, China has to continue its financial market reform, liberalize the capital account, and enhance the efficiency and governance of the financial sector. The effort of promoting the international use of the RMB will be reinforced by engaging with the world in a responsive and responsible manner.

A well-designed network of offshore markets will advance the overseas acceptance and solidify the international status of the RMB. However, the ultimate acceptance of and demand for the RMB as a global currency are determined by the underlying economic forces shaped by China's economic fundamentals, and the global political dynamics. Offshore RMB markets themselves could not raise the RMB's status beyond what is justified by its economic and political attributes.

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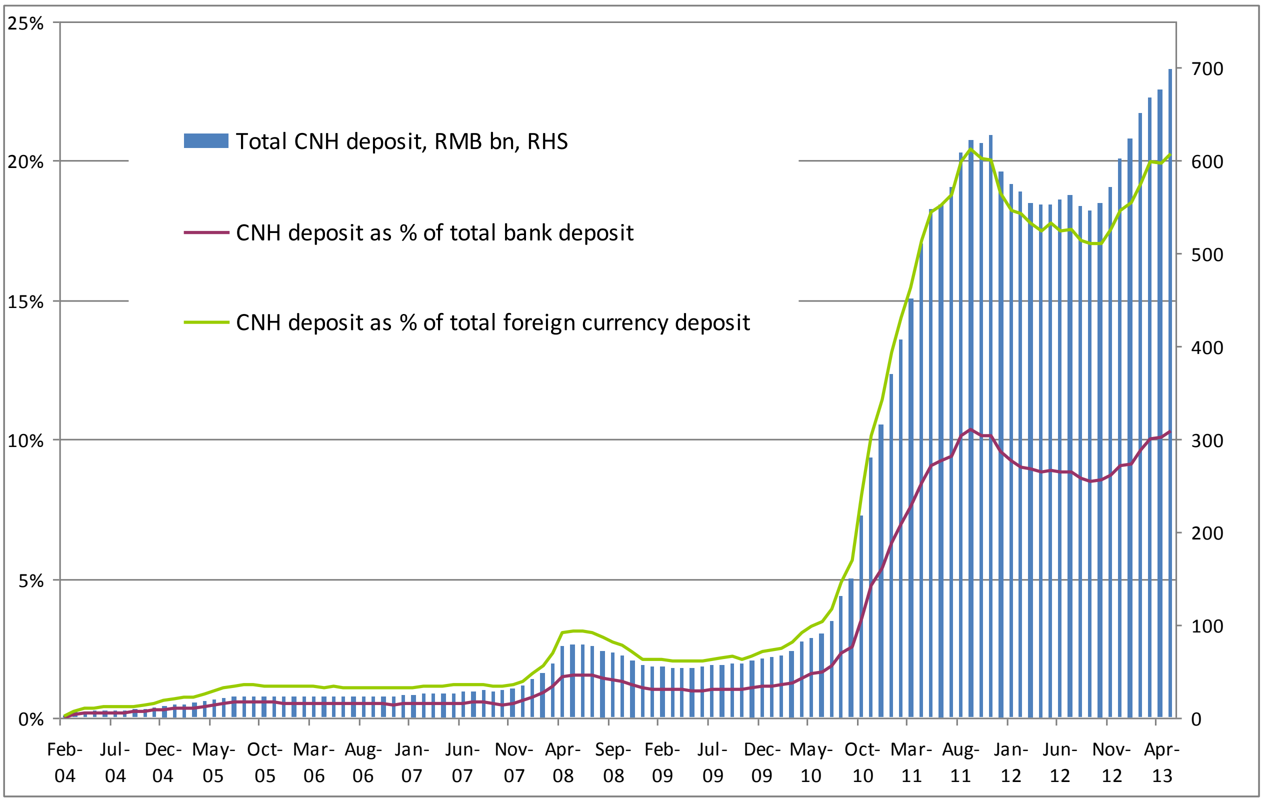

Figure 1. The RMB Deposit in Hong Kong (Source: CEIC)

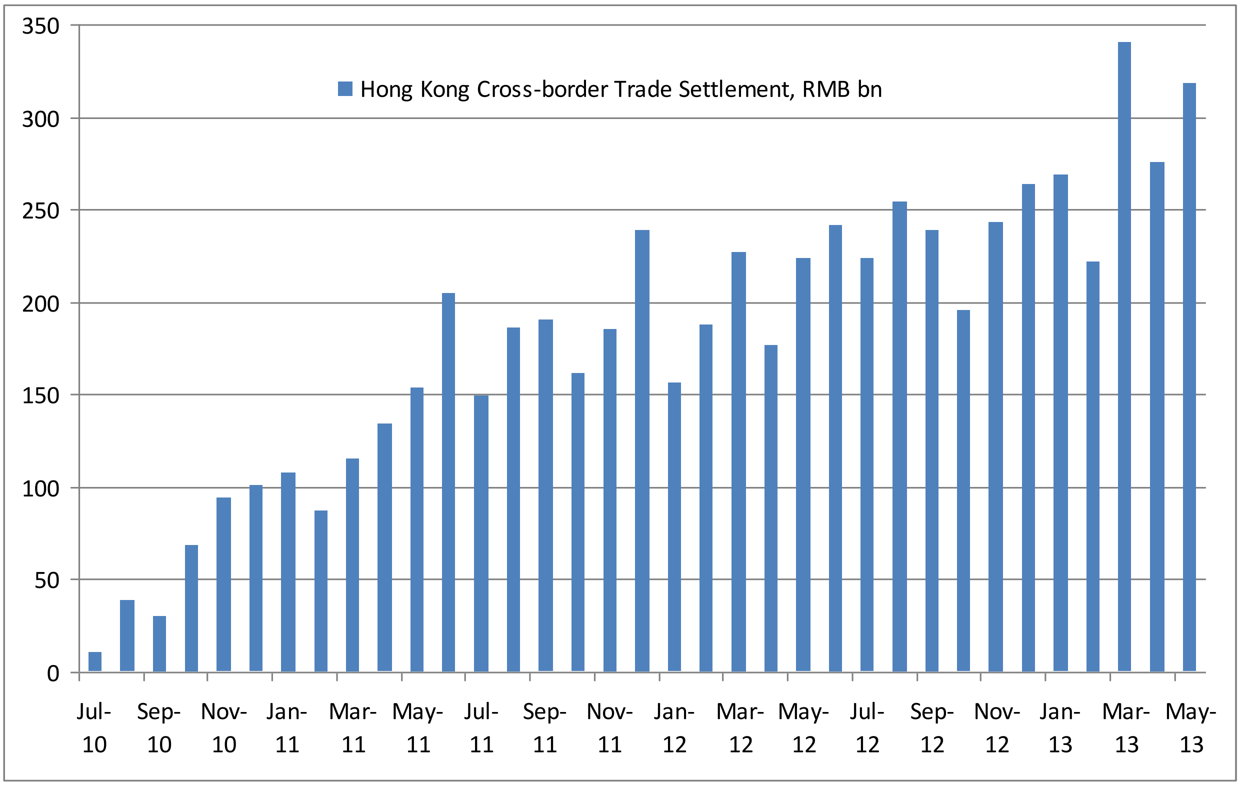

Figure 2. The monthly volume of cross-border trade settled in RMB via Hong Kong (Source: HKMA)

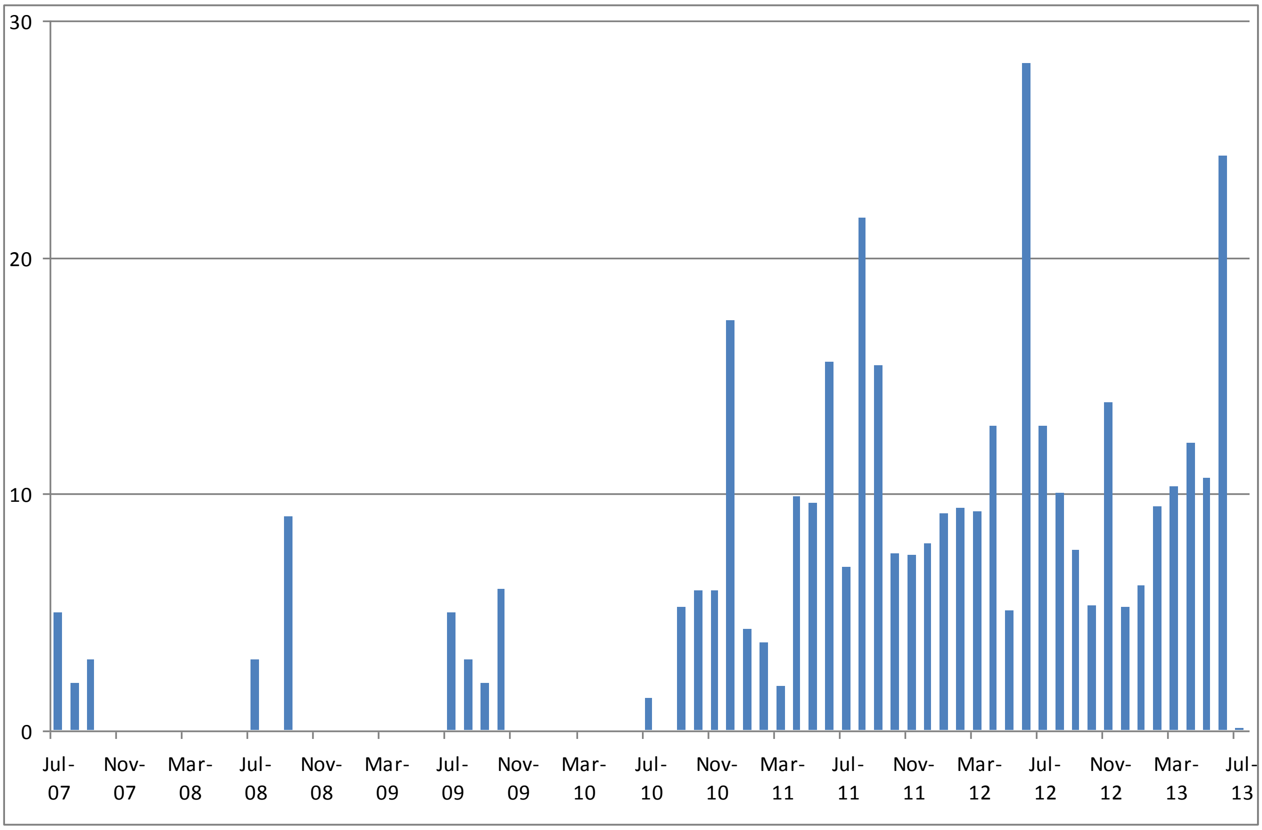

Figure 3. Monthly issuance of Dim Sum Bonds (RMB bn; Source: Bloomberg)

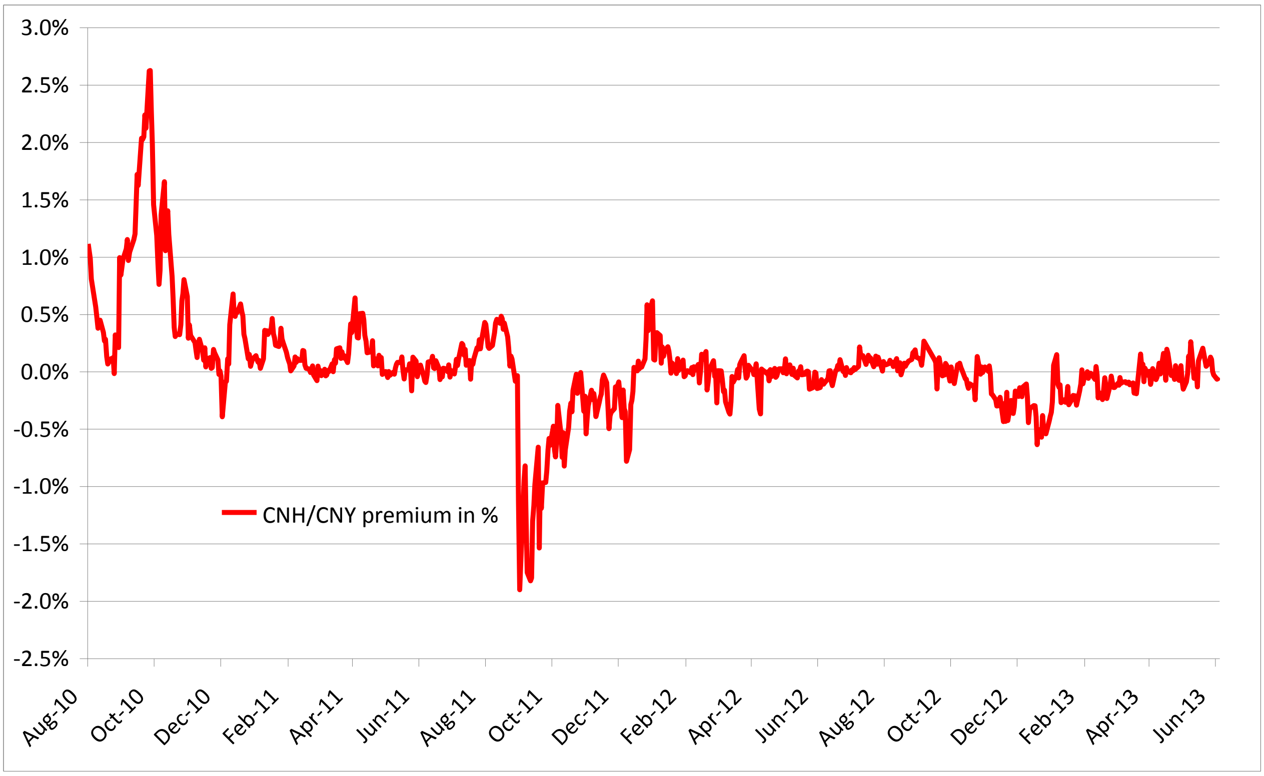

Figure 4: The CNH/CNY premium in percentages (Source: Bloomberg)

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ISSN 2342-205X