China's double act: how the financial reform and the RMB strategy are linked together

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Introduction

The emergence of China as the world's second largest economy is the most significant transformation of the international economic order in the last twenty years. It has been extraordinary because it was largely unexpected. At the beginning of the 1990s very few experts and commentators, including many prominent members of China's political elite,[1] would have bet on such a strong and rapid rise. In 1980, at the beginning of the process of market liberalisation initiated by Deng Xiaoping, China's share of the total world economy was 2.2%. A generation later, in 2010, China's share was 13.6%. In 1980 the income per capita was $ 205; in 2010 it was $ 4,422. This transformation has been possible thanks to a series of measures that pushed Chinese firms to "go global", i.e. to seek markets abroad, and to harness the wave of globalisation and economic integration that was changing the world economic order in those years.

Three decades later China's remarkable trend seems to have reached a plateau. GDP growth has finally slowed down and for the first time in twelve years the Chinese economy is due to grow at a rate below 8%. Furthermore, China does not have a financial sector nor a currency that reflects the size and the integration of its economy with the rest of the world. China's domestic financial depth does not match its global economic significance, nor that of the developed economies whose contributions to global economic growth it already rivals. Its financial integration is largely restricted to the accumulation of reserve assets, while its capital assets abroad, in particular portfolio assets, remain underdeveloped. In monetary terms too China continues to be a developing country that needs to use the dollar to settle its external transaction, to invest abroad and to hold its reserves. The renminbi (RMB) remains largely unconvertible, owing to restrictions on the capital account. If China wishes to play a greater international role, it may need a currency that reflects such a role.

China has now embarked on a cautious journey to open up its financial system and integrate it into the international financial system, in line with the incremental reform process championed by Deng Xiaoping 'touching stones to cross the river'. Albeit gradual, the reform is critical for China's ability to create a financial sector that is congruous with the size, and relevance, of the country's economy and to shift its economic growth model towards domestic demand.

While developing a more liquid and more diversified capital markets the Chinese authorities have implemented measures for encouraging the use of the RMB in cross-border transactions and the creation of an RMB offshore market in Hong Kong. The aim is to push the internationalisation of the currency while keeping restrictions on transactions under the capital account.

In this paper we argue that the financial and monetary reform is the next round of structural transformation that China needs to move forward. A deep and efficient capital market would support China's next stage of economic development and contribute to domestic rebalancing between the banking sector and capital markets. The internationalisation of the RMB is part of a

[1] This point was made to us by a senior Chinese official in a recent private conversation.

broader set of reforms and is an intermediary step towards a fully open capital account and a fully convertible currency.[2]

What China is doing is of a great importance for the world economy. Correcting the existing asymmetric exchange rate arrangements and the dependence on the US dollar is likely to result in a rebalancing of the world economy and in multi-currencies international monetary system. China's process of financial and monetary reform, however, is likely to be gradual and relatively slow because of the authorities' preoccupation for domestic financial stability.

In the paper we also contend that the reform is a complex policy-driven process where political considerations intertwine with market preferences and where policies prepare the ground and then let the market follow through – and policies can be subsequently corrected based on market reaction. Thus China faces the difficult challenge of reconciling the need for an efficient and market-driven financial sector with its policy-driven growth strategy. This challenge is of particular relevance for the reform of the banking sector. The dominance of the banks in China's financial sector is the consequence of the role historically played by the main banks as policy facilitators and a source of funding for the country's development objectives.

The paper is organised as follows. Part 1 discusses China's RMB policies within the context of the 'go global' strategy, and assesses the progress since the launch of the RMB cross-border settlement pilot scheme in 2009. Part 2 looks at the link between the internationalisation of the RMB and the reform of China's financial sector, while Part 3 discusses the limits posed by the constraints on the capital account to the development of China's financial centres and the RMB market. It also discusses the development of the RMB offshore market as a way to overcome the currency's lack of convertibility. Part 4 concludes.

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[2] Recent policy measures, in particular the Fourth National Financial Work Conference, have reaffirmed Beijing's will to gradually liberalize China's financial sector and transfer some power from the banking system to the capital market. For instance, controls of financial risks arising from local government debts and deepening up the development of capital market have been highlighted as part of the eight key areas for China's financial reform in the conference in 2012 January.

Part 1: China's RMB strategy

1.1. China 'Go Global'

The 'Go Global' strategy was officially launched in 1999 with the aim of supporting Chinese enterprises and investment outside China. There are three reasons for pursuing this strategy. First, in the late 1990s the national authorities began to realise that the domestic market was not large enough to sustain China's strong growth and thus promoted investments abroad to secure new markets and resources. Secondly, the government wanted to encourage large SOEs to become multinational and expand overseas. Finally, the government aimed to help large SOEs to move upwards within the global value chain. The 'Go Global' strategy is consistent with the transformation of China into a global investor from being the world's top FDI recipient - with USD 59.1 billion received in the first half of 2012[3]

The 'Go Global' strategy has progressively exposed the Chinese financial sector to international markets as banks expanded abroad to support Chinese companies overseas. Financial institutions were encouraged to seek greater exposure to international financial markets.[4] For instance, in 2002 Chinese banks, particularly the "Big Fours",[5] were urged to become competitive in the international market and to prepare for direct competition with international banks within five years' time[6] (PBoC, 2002). In addition "Big Four" went through the recapitalization of non-performing loans and public listing on foreign market (IMF, 2011). The big state-owned banks such as the ICBC and the ABC chose the Hong Kong Stock Exchange for their IPOs in 2006 and 2010 respectively.

Asia is the main recipient of China's outward Foreign Direct Investment (OFDI), and Hong Kong is the most popular destination (Figure 1). This comes from both market preference and mainland's policies. Benefiting from the "one-country two system" framework, Hong Kong has become the gateway for Chinese companies to the rest of the world and the place where they seek access to foreign capital markets. From 2006 to 2010 the volume of China's OFDI, that were mainly driven by the non-financial sector, almost tripled, from USD 21 billion to USD 68 billion (Table 1).

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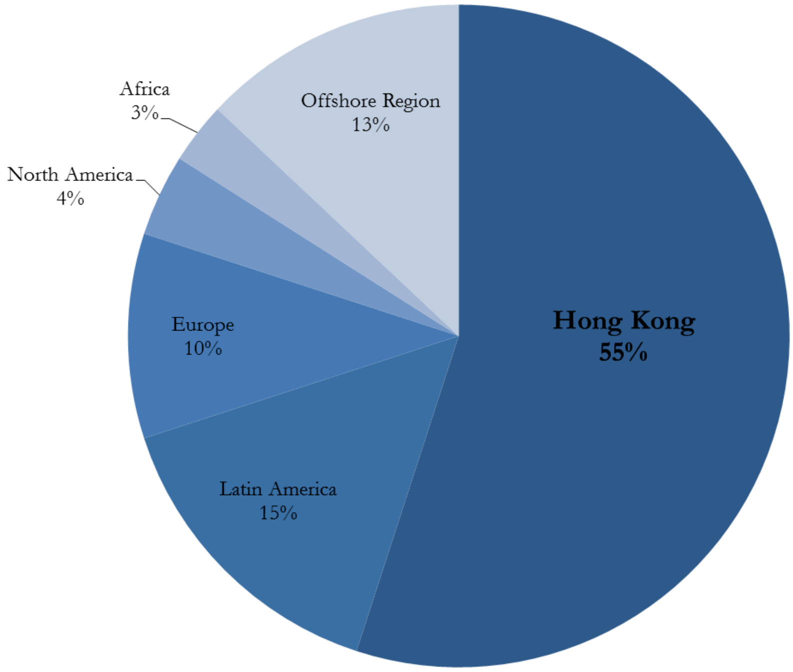
[3] In the Global Investment Trends Monitor published by UNCTAD (2012), China exceeded the US's $ 57.4 billion FDI inflow with an amount of USD 59.1 billion global FDI inflows as the world's largest FDI recipient in the first half of 2012.

[4] In 2006, the PBoC's report 11th Five-Year Plan for the Financial Industry first addresses that major Chinese financial institutions are encouraged to "Go-Global". The "Go-Global strategy" for financial industries has then been reemphasised in the PBoC's 12th Five-Year Plan.

[5] The phrase 'Big Four' refers to the four largest commercial banks in China, namely the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC) and the China Construction Bank (CCB).

[6] As a member of the WTO China is obliged to grant foreign banks the same treatment as the domestic banks.

Figure 1. Destination of China's Outward Foreign Direct Investment in 2011 (OFDI)



Source: Ministry of Commerce, 2011 Statistical Bulletin of China's Outward Foreign Direct Investment.

Table 1. Growth of China's OFDI is primarily led by investment in non-financial sectors

Year	OFDI Volume (USD Billion)			Growth Rate
	Non-Financial Sector	Financial Sector	Total	
2002	2.70	0.00	2.70	
2003	2.85	0.00	2.85	5.6%
2004	5.50	0.00	5.50	93.0%
2005	12.26	0.00	12.26	122.9%
2006	17.56	3.60	21.16	72.6%
2007	24.80	1.71	26.51	25.3%
2008	41.90	14.01	55.91	110.9%
2009	47.80	8.73	56.53	1.1%
2010	60.21	8.60	68.81	21.7%
2011	68.58	6.07	74.65	8.5%
2012.08	47.60	4.92	52.52	-29.6%

Source: Ministry of Commerce, 2012 August

1.2 A two-track strategy

China's 'Go Global' strategy is still work in progress and includes the promotion of the use of the RMB to settle cross border trade. The goal is to make the RMB more used in international transactions and investments without, however, making it fully convertible.

Policies focused on the use of the RMB for invoicing cross-border trade aim to expand the regional use of the RMB. The pilot programme of RMB cross-border trade settlement that was launched in 2009 to foster the use of the RMB under the current account has proved rather successful. 9% of China's trade is now invoiced in RMB. China's total trade 52% is with neighbouring countries.

The second track of China's RMB strategy aims to develop Hong Kong as an offshore RMB centre, with policies focused on providing instruments for hedging the currency risk and making RMB holdings more attractive to non-residents (Subacchi, 2010). Being the gateway for Chinese companies to the rest of the world and the place where they seek access to foreign capital markets, Hong Kong is the market where a growing number of Mainland companies double-list when they go public. Both these outward investments and joint IPOs have contributed to the development of an offshore RMB centre and the internationalization of the RMB, and indeed the latter can be considered the latest development of the 'Go Global' strategy.

Since 2010 Hong Kong has been developing RMB-denominated investment products to encourage non-residents to hold RMB in their portfolios. For instance, the dim sum bond market[7] in Hong Kong has grown rapidly over the last two years - the volume increased from RMB 35.7 billion in 2010 to RMB 131 billion in 2011. Hong Kong has also taken the lead to establish an exchange platform and payment system. In September 2012, China Exchange Services Company Limited (CESC)[8] was established, marking an important stage in the integration of the capital markets of Mainland China and Hong Kong and in the development of the RMB offshore market. More innovative products are likely to be developed at CESC to respond to the international demand for RMB denominated equity products and allow international investors to access the Mainland's equity market through Hong Kong. Hong Kong is also the centre for RMB clearing and settlement services thanks to the RMB RTGS[9] system.

The RMB, however, is still not fully convertible and liquidity in the offshore market remains an issue. To build market confidence in the RMB the PBoC has expanded the of the RMB bilateral currency swap agreements with other central banks. The availability of RMB emergency funds would offer China's trading partners a hedge against any liquidity crunch that could undermine international trade it as it happened during the global financial crisis in 2008. These arrangements could also potentially be used in bilateral trade on a more regular basis.

These swap agreements therefore could be an effective way to promote the use of RMB in countries that have commercial and investment relations with China[10] and encourage central

[7] Dim sum bond refers to the RMB-denominated bonds issued in the offshore market. It is different from the other type of RMB bond, the Panda Bond, which is also the RMB-denominated bonds but have to be issued by non-Chinese institutions and sold in mainland China's onshore interbank bond market.

[8] CESC is a joint venture of Hong Kong Stock Exchange, Shanghai Stock Exchange and ShenZhen Stock Exchange to provide new equity products and financial services to both the onshore and offshore RMB market (HKEx, 2012).

[9] The Real Time Gross Settlement (RTGS) system is a fund transference system where the interbank transfer of high-value money or securities takes place in real time and on a gross basis (i.e. the settlement of funds occurs on a transaction-by-transaction basis without netting debits against credits) (BIS, 1997).

[10] There are no official documents that explicitly refer to the importance of the swap agreements, but it is widely acknowledged that they are an essential element of China's RMB strategy (Yu, 2011). They are signed 'for the purpose of promoting bilateral financial cooperation, facilitating bilateral trade and investment, and maintaining

banks to hold the RMB in their reserves. Since 2009, China has signed bilateral swap agreements with 19 countries for the total amount of RMB 1.665 trillion (Table 2). These agreements are also a way to strengthen bilateral relations with countries that the Chinese authorities with the support of the PBoC[11] deem strategic for geo-political reasons.

Table 2. The RMB bilateral swap agreements

Country/Region	Date	Amount (RMB Billion)
Bank of Indonesia	2009.03.23	100.0
Central Bank of Argentina	2009.03.23	70.0
National Bank of the Republic of Belarus	2010.03.24	*Agreement on Bilateral Settlement in Local Currencies*
	2009.03.11	*20.0*
Central Bank of Iceland	2010.06.09	3.5
Monetary Authority of Singapore	2010.07.23	150.0
New Zealand Reserve Bank	2011.04.18	25.0
Central Bank of the Republic of Uzbekistan	2011.04.19	0.7
Central Bank of Mongolia	2011.05.06	5.0
National Bank of Kazakhstan	2011.06.13	7.0
Central Bank of Russia Federation	2011.06.23	No Limitation
	2010.11.22	*Bilateral Trading*
Bank of Korean	2011.10.26	360.0
	2009.04.20 (Expired)	*180.0*
Hong Kong Monetary Authority	2011.11.22	400.0
	2009.01.20 (Expired)	*200.0*
Bank of Thailand	2011.12.22	70.0
State Bank of Pakistan	2011.12.23	10.0
Central Bank of the United Arab Emirates	2012.01.17	35.0
Bank Negara Malaysia	2012.02.08	180.0
	2009.02.08 (Expired)	*80.0*
Turkish Central Bank	2012.02.21	10.0
Central Bank of Mongolia	2012.03.21	10.0
	2011.05.06 (Expired)	*5.0*
Reserve Bank of Australia	2012.03.22	200.0
Central Bank of Ukraine	2012.06.26	15.0

Source: PBoC

regional financial stability' (PBoC, 2011). The State Council decides on the arrangements, selection and volume of each bilateral agreement.

[11] It is worth reminding here that the PBoC is not yet an independent central bank and its mandate includes providing support the country's fiscal policy in conjunction with the Ministry of Finance.

1.3 Recent policies and the way forward

The success of China's RMB strategy rests on the progress of the convertibility of the RMB and the liberalization of the capital account, which, in their turn, depend on the reform of the financial and banking sector.

Many experts and market participants expect the RMB to be fully convertible by 2015, but the Chinese authorities have been very careful not to fuel expectations in order to retain full control on the process.[12] In February 2012, a research report published by the statistics department of the PBoC presented a three-stage process and timeline for future capital account liberalisation and indicated in 2020 the most plausible date for full convertibility.[13] This seems consistent with the plan of developing Shanghai as an international financial centre by 2020 (Subacchi et al., 2012). Yet there are concerns about the pace of the government's action to implement the necessary reforms based on both the international experience of liberalizing the capital account and the complexity of China's domestic politics.

The lesson to be inferred from the experience of other countries is that the liberalisation of the capital account is a slow process. It was not until the late 1970s that the US, Japan and the main European economies began to fully open their capital account. Japan, for instance, followed a gradual, 'stop and-go' process. Cross-border portfolio flows were not fully deregulated until December 1980. In continental Europe, capital account liberalization was fully implemented only after the formal commitment, in 1988, to establish the European Economic and Monetary Union (EMU) (Bakker and Chapple, 2002).

The goal of capital account liberalization, stated in the 12th Five-Year plan and in other official documents, is part of China's reform agenda, where a neo-liberal approach to financial reforms clashes with a more conservative one. From the conservatives' perspective, the RMB internationalization strategy is seen as a pre-planned political step by the neo-liberal reformers, who advocate more market, less policy-driven control and the expansion of the private sector, to push forward a wider reform of China's domestic financial market. But the conservatives are the powerful leaders of SOEs, large banks and in public sectors. Neo-liberal reformers regard China's financial repression as the outcome of the state's dominance over China's financial market and the excessive policy intervention. They urge the thorough reform of China's financial market and the breakup of both policy barriers and SOEs monopoly in order to expand the private sector. Yet the conservatives are still the majority of China's political circle and will remain to be an indispensable part of it in the near future. In other words, whether China will be able to successfully implement the financial reforms and build up an advanced domestic financial market ultimately depends on which side of the debate - the conservative or the neo-liberal - will prevail.

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[12] On 8th September 2011, Bloomberg (2011) post a report suggested that the RMB will be fully convertible by 2015 referencing Chinese officials as the sourcing provide for the breaking new. However, on 9th September 2011, Governor Zhou of the PBoC publicly denied such agenda and emphasized that there is no timetable to grant full convertibility of the RMB in the media (Caijing, 2011).

[13] It suggests that the reform will unfold from "primary market to secondary market" and from "non-residents' domestic transactions to residents' overseas transactions" in the short run and a complete liberalization of China's capital account will be realized by 2020 in the long run.

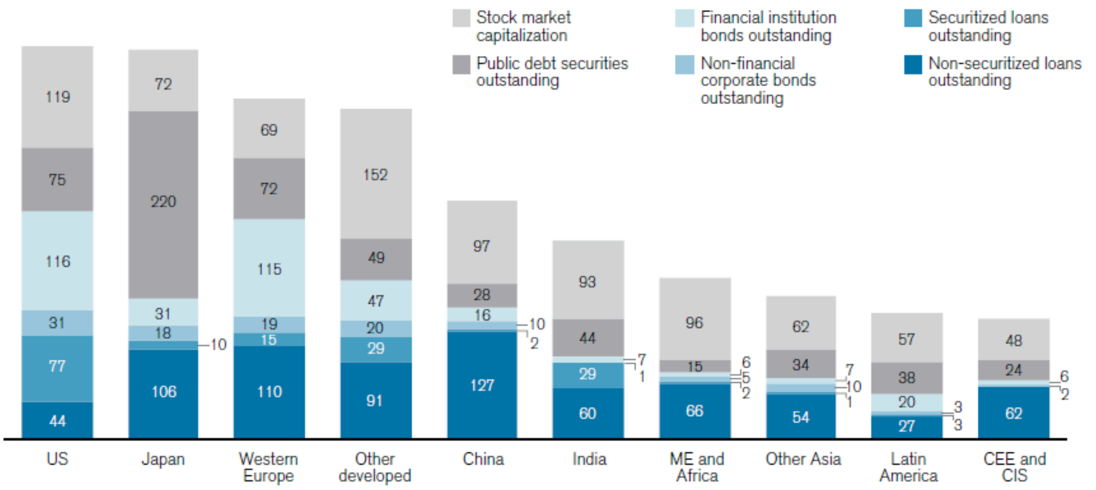
Part 2: China's financial reform and the RMB strategy

2.1 The process of reforming the financial sector

As discussed above China faces the difficult challenge of reconciling the need for an efficient and market-driven financial sector with its policy-driven growth strategy and to reconcile political considerations with market preferences. This challenge is, for instance, particularly evident in the reform of the banking sector. The dominance of the banks in China's financial sector is the consequence of the role historically played by the main banks as policy facilitators and a source of funding for the country's development objectives. The goal is to create a more liquid and diversified system where capital can be more efficiently channelled through the banking sector and capital markets. Having more channels for financial intermediation would improve capital allocation and provide more options to investors. A deep and efficient capital market would support China's next stage of economic development and contribute to domestic rebalancing between the banking sector and capital markets. It will eventually allow China to fully open its capital account and making the RMB fully convertible.[14]

Similarly, insurance products are much needed to help expand the retail sector. Credit-rating agencies for Chinese companies also are to be established. The corporate bond and securitization markets need to be further developed (Figure 2), while financial services need to reach the rural sector and private capital needs to be encouraged to feed into financial services. These are key areas of financial-sector reform in the next decade, as stated in the Fourth National Financial Work Conference[15].

Figure 2. Financial depth, year-end 2010 (% of regional/country GDP)



Source: McKinsey Global Institute (2011)

[14] Recent policy measures, in particular the Fourth National Financial Work Conference, have reaffirmed Beijing's will to gradually liberalize China's financial sector and transfer some power from the banking system to the capital market. For instance, controls of financial risks arising from local government debts and deepening up the development of capital market have been highlighted as part of the eight key areas for China's financial reform in the conference in 2012 January.

[15] Eight key areas for China's financial reform have been listed out in the Fourth National Financial Work Conference in January 2012. It covers topics from strengthening financial regulation to developing capital market and insurance market in China. Detailed targets are listed in Shifting Capital: The Rise of Financial Centres in Greater China (Subacchi, et al, 2012; 6).

China's financial market has a relatively short history. As shown in Figure 3, 30 years ago neither capital markets nor the insurance sector existed in Mainland China. China experienced a 'mono-bank period' before 1980's, when the People's Bank of China (PBoC) and the rural credit cooperatives served the entire nation's commercial banking needs. Under Deng Xiaoping's leadership with economic opening-up policy, China's banking system has been gradually decentralized since 1980's. State backed large banks, the Big Four and Policy banks naturally become the dominators in China's banking sector[16].

The creation of China's capital market only began in earnest in the 1990s and accelerated over the following decade. After the establishment of the two trading houses (the Shanghai Stock Exchange and the Shenzhen Stock Exchange) in 1990, China concentrated on the regulatory framework to support the financial sector.[17] There are now three commissions – the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC). China's equity market grew rapidly during 2005 to 2010, with more than 500 initial public offerings (IPOs) and some huge listings, including those of China's largest banks, in 2010. The IPO boom contributed US$131 billion to the rapidly expanding equity market, a dramatic increase from $25.6 billion in 2005. At the end of 2011, China's total stock market capitalisation was estimated at about US$3.7 trillion.[18] This was nearly ten times the level in 2005 ($401 billion).

China's financial regulatory framework has gone through a long period of structural reforms. It is currently based on the 'One-Bank, Three-Commissions' model, with the PBoC playing the central role (Figure 4).[19] The PBoC serves as the country's central bank and its primary function includes the formulation of monetary policy, the maintenance of financial stability and the provision of financial services. The 'Three Commissions' – the CBRC, the CSRC and the CIRC – oversee their respective financial sectors. These institutions and the PBoC report directly to the State Council, where regulatory and monetary policies are formulated and approved and, most importantly, where the nation's financial reform strategy is implemented.

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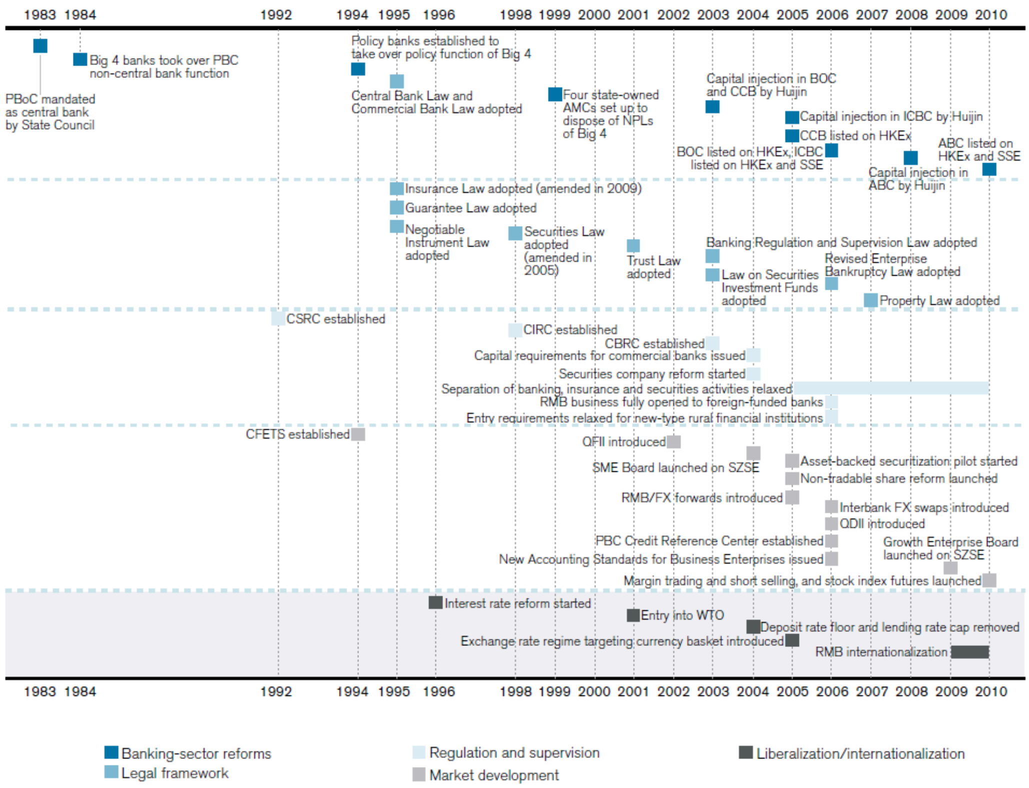
[16] In the 1980s four specialized banks ('the Big Four') were established to take over the PBoC's policy and commercial functions. While China's rural credit cooperatives were merged in 1979 to establish the Agricultural Bank of China (ABC), both the Industrial and Commercial Bank of China (ICBC) and the Bank of China (BOC) were created from the PBoC's commercial and foreign exchange businesses. The China Construction Bank (CCB), jointly established by the PBoC and the Ministry of Finance, was created to facilitate major national infrastructure projects. Thus during the 1980s the financial market in Mainland China became dominated by the PBoC and the Big Four. In 1994 'the three policy banks' were created to take over policy functions from the Big Four.

[17] With accession to the WTO, financial reforms accelerated, and a better legal and regulatory framework was established. Regulations on securities investment funds were first introduced in 2003, and banking regulation and supervision measures were also adopted in the same year. On 28 October 2003, the Law of the People's Republic of China on Funds for Investment in Securities was promulgated and went into effect as of 1 June 2004. Under the Securities Investment Fund Law, a securities investment fund may thereby be established as either a closed-end fund or an open-end fund, which was a significant breakthrough in the development of the fund management industry in China. In 2006, bankruptcy rules were revised after the five-year buffer period following China's accession to the WTO in 2001 (Figure 3).

[18] The total stock market capitalization of US$3.7 trillion is composed of the year-end data for market capitalization of the SSE and SZSE, but excluding HKEx and TSEC.

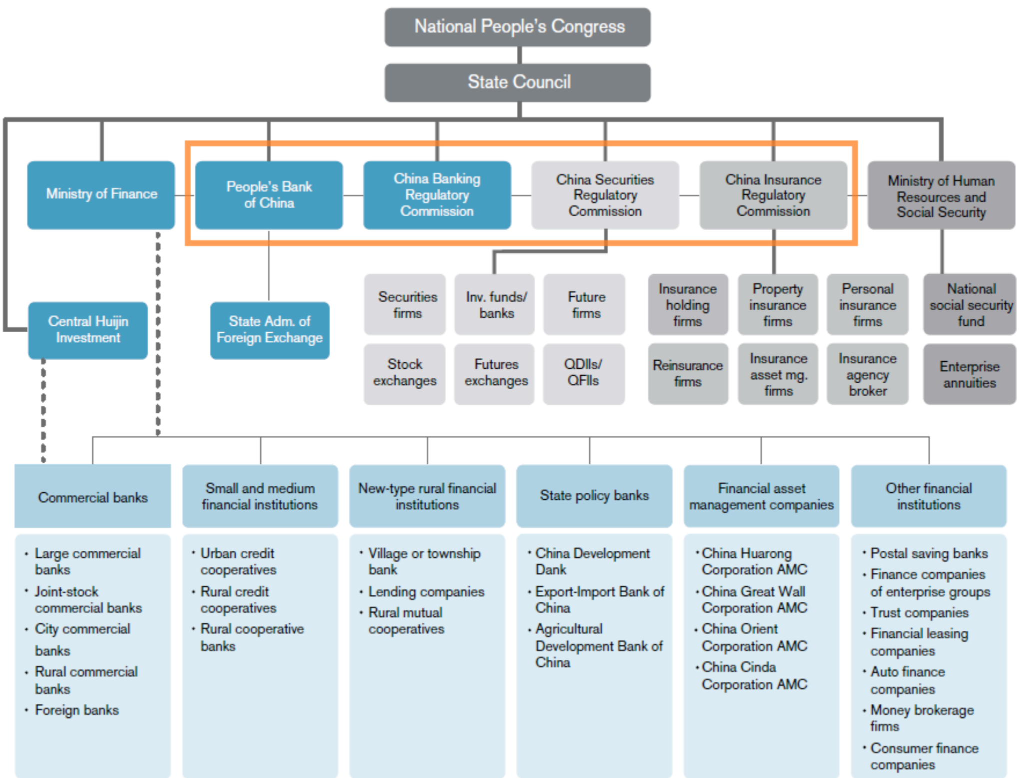
[19] The phrase 'One Bank, Three Commissions' is used by the Chinese authorities to refer to the PBoC and the three regulatory institutions overseeing the three major financial sectors in China, namely the China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC).

Figure 3. Financial-sector reforms in Mainland China – selected benchmarks



Source: IMF (2011b)

Figure 4. Financial system architecture in Mainland China



Source: IMF (2011b)

2.2 The financial system in Mainland China: work in progress

Although much has been achieved since the early 1980s, China's financial reform is still work in progress. The country does not have an efficient way to allocate capital – in particular, an effective price-signalling mechanism. Domestic financial institutions, notably the banks, are still heavily reliant on their policy-driven business model, which puts their political objectives ahead of business priorities. Such a system has resulted in significant capital misallocation in China, where large state-owned enterprises (SOEs) hold excessive funds and small and medium-sized enterprises (SMEs) find it difficult to raise capital for their activities. Savers are penalised because of controlled interest rates and lack of competition. With the deposit rate fixed at only 3.5%, Chinese savers are effectively pushed to accept negative interest rates since bank deposit rates are lower than China's inflation rate (IMF, 2012a).

Shadow banking activities have grown at a rapid pace along with China's considerable progress, in the last ten years, in transforming the main banks and other financial firms and make them more profit-oriented.[20] In the developed countries, shadow banking is normally described as the system of credit intermediation involving entities and activities outside the regular banking system. Its players are usually hedge funds, venture capital and private equity funds. However, in China, shadow banking primarily includes wealth management products, underground finance and off-balance-sheet lending (Xiao Gang, 2012). Chinese banks work closely with trust companies or other entities and act as 'middlemen' between the recipients and the investors. They package trust loans into wealth management products that offer investors a higher yield than conventional bank deposits. Many of these funds have gone into real estate development, infrastructure projects, the manufacturing sector and local government financing vehicles.

Such a large shadow-banking sector signals the existence of distortions in the allocation of capital. Firms, especially SMES, find it difficult to obtain loans in the 'official' banking sector. There is however the risk that the unregulated and unmonitored 'shadow' banking activities could undermine domestic stability and make it more difficult for the PBoC to exercise monetary control and formulate appropriate policies (IMF, 2012b). Wu Xiaoling, a former deputy governor at the PBoC, has suggested improving the regulatory framework, in order to give legitimacy to businesses in the shadow-banking sector. This means that risks across the shadow-banking sector could be monitored and managed. It also encourages greater market participation in the credit lending businesses from the private sector.

2.3 Reforming the interest rate regime and the exchange rate regime

A key aspect of the financial and monetary reform is the revision of the interest rate and the exchange rate regimes.[21] China's domestic financial market lacks breadth and depth. A thorough liberalisation of the interest rate is evidently necessary and beneficial to alleviate China's financial repression and to help adjust the nation's problem of capital misallocation.

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[20] In IMF (2011b) Financial System Stability Assessment on China , the IMF remarked China's progress in its transition towards "a more commercially-oriented and financially sound system" as remarkable as the first conclusion in its executive summary.

[21] An effective interest rate is critical for any advanced financial market to achieve market efficiency and it is most evident for the development of banking sector, the bond market and money market, where interest rate has an indispensable role as the basic pricing benchmark that functions through a nation's monetary transmission mechanism. China has imposed rigid policies to restrict price fluctuation of the interest rate to support development of the large banks and SOEs. However, those policies erode the effectiveness of the interest rate as a monetary policy tool and thereby limit the efficiency of the nation's monetary transmission mechanism (Chen, Chen and Gerlach, 2011).

Chinese authorities are aware of the importance of having a market-driven interest rate for the efficient allocation of financial resources. In the recent 12th five-year plan published by the PBoC (2012), China's central bank sees the reform of the interest rate as an indispensable step to begin to use the interest rate as the main instrument of monetary policy[22]. However, the politics behind the reform of the interest rate is complex and epitomises the dilemma between the role of policies and that of the market in managing the economy.

Indeed the reform of the interest rate regime will significantly reduce the advantages of large state-backed banks and the SOEs under the current system while, on the other hand, it will allow small and medium financial institutions to borrow at cheaper rates and obtain better return on their savings. If interest rate is entirely set by the market, large banks will no longer be able to benefit from the interest rate spread. The SOEs, as the largest group of credit lenders, will find it more difficult to obtain capital resources from the large banks, limiting their capacity to profit from capital leveraging in the shadow banking sector. An additional problem lies in the fact that the leaders of China's large banks and the SOEs are normally nominated by the Communist Party. It is not in their interest to push forward, at least a radical pace, the liberalisation of China's interest rate settings.

The crucial aspect, with a more prominent international relevance, is the reform of the exchange rate regime. China has been locked into a fix-rate exchange rate regime since 1994. It was adopted to stabilise the value of the RMB, yet proved onerous to maintain.

On the 1st January 1994, the Chinese government set the official foreign exchange rate of the RMB at 8.7 yuan per USD, which unified the former official rate with the then prevailing market swap rate (Goldstein and Lardy, 2009). At the same time, the government abolished all exports subsidiary policies, letting the Chinese export and import enterprises taking full responsibility for their profits and losses (State Council, 2011). To a certain extent, the massive devaluation of the RMB in 1994 and the nearly ten-year long fixed peg currency regime gave those enterprises a huge competitive advantage in the international market. Since then, the PBoC has been assigned the policy objective of maintaining the exchange rate of the RMB stable. However, this exchange rate regime, together with reducing the impact of monetary policy, results in a huge foreign exchange reserve accumulation because of the need to sterilise the impact of the balance of payment surplus on money supply. Over the years this process of sterilisation has resulted in an accumulation of reserves of over US$3 billion.

Improvement of the RMB exchange rate regime and greater convertibility of the RMB under the capital account (even if at a gradual pace) are the two essential steps to increase China's financial integration with the rest of the world (PBoC, 2012). The former would help relieve the exchange rate policy burden from the PBoC[23] and allow it to focus on domestic monetary policy. To a certain extent, a more flexible exchange rate regime could help reduce China's excessive saving glut, help to correct the distortion caused by currency mismatching and ease international criticism of China being as a "currency manipulator". On the other hand, if China will manage to fully open the capital account by 2020, its gross international investment position will grow significantly, earning higher net investment incomes from abroad (He et al., 2012).

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[22] Rather than adopting the interest rate policy as the main monetary policy tool to intervene in the market, PBoC uses two types of unconventional policy tools, policy adjustments of the required reserve ratios (RRRs) and the aggregate volume of loans quota across the banking sector.

[23] PBoC is the price setter of the RMB exchange rate and the net buyer of the RMB in foreign exchange market to ensure the target exchange rate of the RMB (Zhang and Xu, 2012). This objective is set prior to the control of inflation, which normally is the first priority for most central banks in the advanced economy.

Part 3: China's financial centres, domestic financial stability and the opening of the capital account

3.1 Building the offshore market to support China's RMB strategy

The offshore RMB market in Hong Kong has come a long way since July 2009 when the pilot scheme for RMB cross-border settlement was announced. The introduction of new policy measures – the expansion of cross-border settlement to twenty new provinces and permission for offshore institutions to open RMB settlement accounts – in mid-2010 led to a strong growth of RMB deposits in Hong Kong (Figure 5). The growth has recently slowed down, but this may be more as a reflection of the cyclical conditions of the world economy. Since the growth of the RMB offshore deposits is primarily driven by the cross-border settlement scheme and tightly linked with China's international trading activities, the potential growth of the RMB offshore market in the years to come remains strong. It is estimated to be as large as RMB 6,072 billion by 2020[24] (Rossi and Jackson, 2011).

The even stronger growth of the RMB-denominated bonds issued – the so-called dim sum bonds[25] – and the rising significance of RMB IPOs in Hong Kong, as well as the introduction of the RMB Qualified Foreign Institutional Investors (RQFII) scheme[26], have been fuelling the growth of the RMB offshore market, as indicated in Figure 6.

Though RMB-denominated bonds issuance has been operational in Hong Kong since 2007, it was not until August 2010 that the first foreign private company, McDonald's, issued RMB bonds, attracting significant attention from the international investor community.[27] Previously the Chinese government had only allowed financial entities incorporated in the Mainland to issue such bonds in Hong Kong. The growth of the RMB offshore bond market in Hong Kong has been very strong (Figure 6). In 2011, 84 financial and non-financial companies issued US$14 billion worth of dim sum bonds in Hong Kong, triple the amount in 2010 (US$5.4 billion), and six times the level in 2009 (US$2.3 billion). By the end of 2011, RMB-denominated bonds represented 51.6% of Hong Kong's bond market.

The equity market is another area of expansion for RMB-denominated securities. The first RMB IPO was in April 2011 when the Beijing-based Hui Xian real estate investment trust raised up to RMB11.2 billion (US$1.7 billion) in Hong Kong. The RMB listing of the REIT (Real Estate Investment Trust) was a critical step that consolidates Hong Kong's market status as the first and most important RMB offshore centre.

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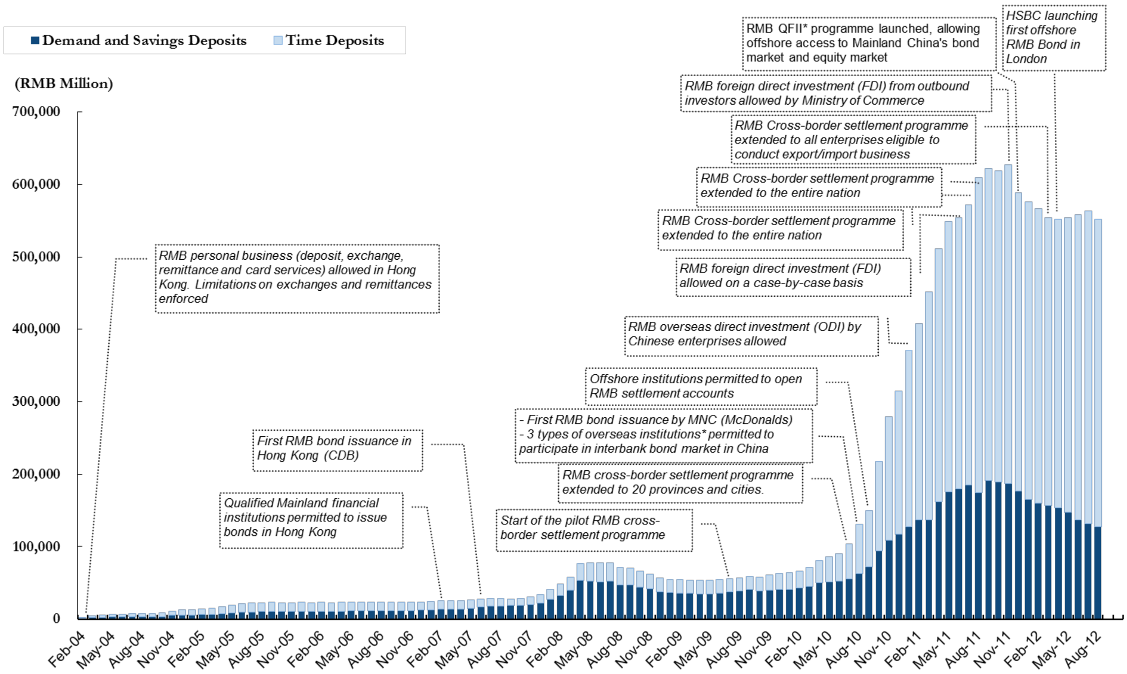
[24] Rossi and Jackson (2011) made their projections of the RMB deposit in Hong Kong based on the IMF data. The projection is made under the assumption that 75% of RMB trade settlements flow into RMB deposits in Hong Kong.

[25] These RMB-denominated bonds issued in the offshore market are called 'dim sum bonds'. The other type of RMB bond is called a Panda Bond. These are RMB- denominated bonds issued by non-Chinese institutions and sold in Mainland China's onshore interbank bond market.

[26] The RMB Qualified Foreign Institutional Investor (R-QFII) scheme was introduced in August 2011. It allows foreign investors to invest RMB raised in offshore market into the Mainland, where 80% of the investment is required to be invested in the bond market.

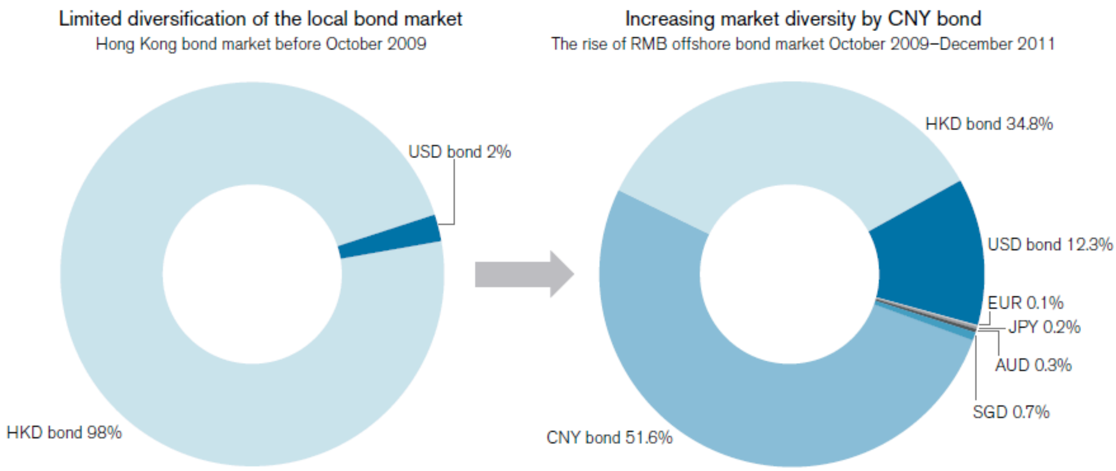
[27] In August 2010, McDonald's Corporation issued an RMB corporate bond. This issuance is seen as an important milestone in the development of an offshore RMB bond market and also a new channel for international companies seeking to raise capital.

Figure 5. RMB deposits in Hong Kong



Source: HKMA

Figure 6. Growing RMB offshore bond market



Source: HKMA

Hong Kong is so far arguably the only RMB offshore centre where the three elements of RMB trade settlement, RMB financing and RMB wealth management have reinforced its market status as the foremost RMB offshore centre (Yue, 2011)[28]. The RQFII scheme[29] was introduced exclusively in Hong Kong as a mean of repatriating a portion of the accumulated offshore RMB - CNH[30] - back to the Mainland. More importantly, the RQFII scheme has established a channel between the offshore market in Hong Kong and the onshore market in the Mainland.

The expansion of the RMB market in Hong Kong and the opportunity to tap in what many regard as an initiative with the potential for strong expansion has encouraged other financial centres to develop the RMB business. Due to the nascent development of the RMB strategy, where the largest pool of offshore RMB liquidity and transactions is concentrated within Asia, regional competition for the RMB offshore hub[31] is strong. Singapore and Taipei are the two dynamic offshore RMB hubs in the region with 60 billion and 17.5 billion offshore RMB deposit respectively. Tokyo is the other financial centre that actively promoting itself as another offshore RMB hub[32]. Beyond the Asia, London, Paris and Frankfurt are seeking opportunities to establish themselves as potential offshore RMB hubs in the Europe market[33].

The offshore RMB market in Hong Kong is still limited in both size and scale. A couple of issues need to be solved so as to allow substantial market growth. For the strategy to develop further, it is pressing to solve issues on liquidity provision, capital account openness, and RMB clearing mechanism in the onshore and offshore markets. However, solutions to those challenges need policy measures to be introduced by Mainland officials, who place financial stability comes as the priority.

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[28] There are at least three main competitive advantages that give reason to believe that the market for RMB-denominated products will flourish in Hong Kong. First, the city has the technical and operational capabilities to deal with trading and clearing businesses of RMB products. Secondly, there is growing and positive market demand for RMB-denominated products in Hong Kong. Partly because of expectations of the yuan's appreciation and partly owing to the growing profitability of RMB-denominated products, the market has so far reacted extremely positively to the issuance of dim sum bonds. In particular, it welcomed the announcement of exclusive RMB repatriation schemes to be sited in Hong Kong, made immediately after Vice Premier Li's visit to Hong Kong in August 2011. Finally, the city offers ample RMB liquidity because of the RMB bank deposits' potential for growth.

[29] The scheme permits registered foreign investors to invest RMB raised offshore in the Mainland's securities markets. The present R-QFII scheme is limited to a maximum size at RMB20 billion (US$3.1 billion) in total. Yet this scheme is critical to provide incentives to foreign investors to hold on to CNH as they can access the onshore CNY market.

[30] CNH is the currency code given to the RMB traded on the offshore market in Hong Kong. The onshore-traded RMB is generally referred to as CNY.

[31] For the distinction between "*Centre*" and "*Hub*" in the RMB offshore market see Subacchi and Huang (2012).

[32] Market momentum was geared up in June 2012 when Japan's finance minister announced the launch of a direct exchange between the Yen and the RMB, jointly with Beijing's emphasis for the two countries' determination to improve interbank foreign exchange transactions.

[33] London comes on board and takes the lead by cooperating with authorities in Beijing and Hong Kong since September 2011(Subacchi and Huang, 2012). Paris followed as the second Europe city to step in the offshore RMB market in April 2012. The development of the RMB offshore business in Frankfurt was discussed when Chancellor Angela Merkel met with Chinese Premier Wen in Beijing in August 2012

3.2 Shanghai: a centre for RMB trade by 2015?

The State council set Shanghai a significant role to play in China's RMB strategy as to become an International Financial Centre by 2020 according to China's 12th Five-Year Plan (2011-2015)[34]. The process of internationalising the RMB and the pace at which its capital account is opened up to make the RMB a fully convertible currency will therefore ultimately determine Shanghai's evolution towards this goal.

This is an ambitious goal that is based on the following steps:

- Expand market size and market depth (see Table 3) comprehensively and increase financial market transactions (excluding foreign exchange transactions) to RMB1,000 trillion (US$158 trillion);
- Establish the Shanghai Interbank Offered Rate (SHIBOR) and the RMB central parity rate as major benchmarks for RMB asset pricing and transactions, both domestically and internationally;
- Speed up the construction of financial infrastructure construction for cross-border RMB payment and clearing network that will eventually support international demand[35],
- Facilitate the needs the real economy of the whole of China, with a focus on the development of assets under management (AUM), ship financing, reinsurance and private equity and venture capital industry;
- Promote and support greater communication and cooperation between Shanghai and Hong Kong in areas such as financial markets, institutions, products, businesses and talents.

Whether these goals will be achieved within the set timetable remains to be seen. The current restrictions on the convertibility of the RMB and the free movement of capital make it difficult for Shanghai to build a deep financial sector in terms of products and services, especially one that involves cross-border and cross-currency financial transactions. The direct tradable foreign currencies in the Shanghai foreign exchange market, for example, are the US dollar, the Japanese yen, the Hong Kong dollar, the euro, the British pound and the Australian dollar (SAFE, 2011). Additionally, the bond market is mainly confined to the interbank market, where bond dealers require licences for access. Despite figures showing an increase in the activities conducted within the SSE, its exposure to foreign capital and investors is still very limited. Foreign companies are not allowed to list on the SSE and the securities market is heavily regulated. Programmes such as the recently introduced QFII scheme[36] are important in terms of allowing foreign investors to participate in China's capital markets. These schemes give the SSE much-needed international exposure, but the volumes that they generate are limited. Much more has to be done for

[34] According to China's 12th Five-Year Plan (2011–15), Shanghai is set to become an IFC by 2020. In January 2012 the National Development and Reform Commission (NDRC) and the Shanghai government announced a plan to develop the city as a global hub of RMB trading by 2015.

[35] A cross-border RMB investment and financing centre is also to be established in Shanghai

[36] The Qualified Foreign Institutional Investors (QFII) scheme refers to the programme by which selected foreign investors are allowed to participate in China's domestic managed fund market. At present, the national authorities control the inflows of international capitals into the country by limiting the QFII licence number and by setting up a ceiling of investment volume of USD 200 billion in maximum.

Shanghai to attain the level of connectivity[37] deemed necessary for an international financial centre and currently enjoyed by cities such as London and New York (GFCI, 2012).[38]

Table 3. Goals for Shanghai's financial sector during the 12th Five-Year Plan period

	Item	**2010**	**2015**
Size of the Financial Markets	Total Transaction Volume of Shanghai's Financial Markets (excluding foreign exchange market)	386.2 Trillion RMB	1000 Trillion RMB
	Total Volume of the Balance of Securities Deposit	Global No. 5	Global Top 3
	Total Transaction Volume of Gold Spot Trading	Global No. 1	Global No.1
	Total Transaction Volume of Financial Derivatives	NA	Global Top 5
	Total Insurance Premium	69.5 Billion RMB	140 Billion RMB
	Total Interbank Card Transaction	10 Trillion RMB	25 Trillion RMB
Market Connectivity and Diversity	Overseas Investor	Limited market participation	Significant market participation
	Global Influence	Limited overseas market influence	Promote international market influence through listing major indices in Shanghai Stock Exchange and developing RMB denominated commodity future prices
Market Depth	Direct Financing as % of Total Financial Markets	16.70%	22%
	Financial Assets Under Management (AUM)	15 Trillion RMB	30 Trillion RMB
Financial Environment	Professional Financier	245,000	320,000
	Global Competitiveness	National No.1	Adopt international standards for stable legal and regulatory financial environment

Source: NDRC (2012), Subacchi et al. (2012)

It is not difficult for Shanghai to achieve quantitative targets given the large size of the RMB onshore market. What is difficult for Shanghai is to increase its international dimension that is currently restricted by various policy restrictions. In fact, the announcement of establishing Shanghai as an international financial centre is with two conditions: the goal to make Shanghai an International Financial Centre (IFC) shall be in accordance with China's economic strength and with the international status of the RMB in 2020. In other words, Shanghai doesn't need to

[37] In the GFCI report, connectivity is defined as the centre's level of interaction with other financial centres, or the depth of the network as perceived by investors.

[38] The GFCI 10 index shows Shanghai's potential to become one of the world's leading international financial centers, rather than describing the existing situation. As a result Shanghai's ranking in the GFCI 12 report dropped from the 5th in 2011 September to the 19th in 2012 September (GFCI, 2011; GFCI, 2012).

pursue an IFC that is head-to-head to the traditional leaders such as London and New York, but an IFC that facilitate the need primarily of China's real economy. Shanghai's development will therefore be subject to China's double act, its financial reform and the RMB strategy.

3.3 Bridging financial and monetary reforms: Hong Kong and Shanghai

Closer financial integration between Shanghai and Hong Kong is an important step in Beijing's strategy to develop the Mainland's financial system and to expand the country's economic and financial influence beyond its national borders towards its financial periphery. It is also how China's double acts, the RMB strategy and financial reform, can be best linked and interacted together.

Through the RMB internationalization strategy, China will directly shape the future of Hong Kong's financial sector for the city's role as the most prestigious RMB offshore centre connecting with other offshore hubs (Subacchi and Huang, 2012) – and to some extent, also that of other financial centres in East Asia such as Taipei and Seoul. Consequently, Hong Kong is expected to take the lead to cooperate and coordinate with other financial centres as mainland China strengthens its presence in the regional financial network.

Shanghai, on the other hand, has a more complex role to play. It needs to increase its competitiveness as the largest onshore RMB centre to facilitate the RMB strategy jointly with Hong Kong in the long run. The Fourth National Financial Work Conference held in January 2012 and the State Council's report on establishing Shanghai as an international financial centre reiterate the need both to develop Shanghai and to introduce policies to consolidate and strengthen Hong Kong's position as one of the world's leading financial centres.

It is clear that both Hong Kong and Shanghai are key pillars of China's RMB strategy. At the same time the development of the RMB business is likely to inform the interaction between Hong Kong and Shanghai in the years to come. It should draw Hong Kong closer to Shanghai through the gradual convergence of the RMB onshore and offshore markets. Hong Kong is currently a fully-fledged international financial centre that is ranked among the world's top five financial centres in the Global Financial Centres Index (GFCI)[39]. The RMB business helps Hong Kong retain a competitive edge vis-a-vis London and New York and, at the same time, develop synergies with Shanghai, China's largest domestic financial centre, and the RMB onshore market. Shanghai serves the national market and companies that aim to list on the SSE to raise capital on the domestic market.

Measures to deepen the ties between the onshore and offshore RMB stock exchanges are also encouraged[40]. China Exchange Services Company Limited (CESC)[41] was established in September 2012 and marked an important stage in the integration between the capital markets of Mainland China and Hong Kong, as well as in the development of the RMB offshore market. More innovative products will be available at CESC to satisfy the demand for RMB denominated equity products from the global market and allow international investors to access the Mainland's equity market through Hong Kong. A previous agreement, in 2010, committed the

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[39] The Global Financial Centres Index (GFCI) was first produced by the Z/Yen group in March 2007 for every six months a year.

[40] In October 2008, the Hong Kong Stock Exchange (HKEx) Information Services Limited and Shanghai Stock Exchange (SSE) Infonet Limited (the information business subsidiaries of the HKEx and SSE) signed a two-year agreement to support investors with an interest in shares of issuers dual-listed in Hong Kong and Shanghai by raising the transparency of the issuer in both markets. The agreement, the Mainland Market Data Collaboration Programme (HKEx Information Services Limited, 2010), was renewed in November 2011 and is set to remain in place until the end of 2013.

[41] CESC is a joint venture between the HKEx, the SSE and the SZSE

HKEx and the SSE to work together 'towards the common goals of meeting the domestic and international fundraising needs of Chinese enterprises for their continued development, and contributing to the greater development of China's economy' (HKEx, 2009). In addition, the presence of Mainland companies in the HKEx is significant in terms of the IPOs, market capitalisation and the number of listed companies. The cooperation between the stock exchanges offer companies the possibility of expanding their exposure to both markets.

China not only welcomes economic benefits that IFCs bring to the local economy, but also considers its national development plan to be incomplete without reputable financial centres in the region. In fact, the authorities in Beijing see IFCs as a symbol of international recognition of a nation's global influence[42]. For Hong Kong the development of an RMB offshore market is expected to cement the city's position as an international financial centre. For Shanghai the development of the RMB into an eventually convertible currency will drive the city's transformation into an international financial centre.

The scope and pace of financial reforms, both domestic and international, set by Beijing will ultimately determine the exact nature of this process of integration. Nevertheless, at the current stage, it is perhaps more important for Shanghai to focus on positioning its leadership role in China's domestic act of financial reform, where a deeper and broader financial market that is robust enough to prevent financial instability and to serve real economy takes the priority.

Conclusion

The newly elected Chinese leaders seem to be ready for bold economic reforms to continue China's transformation into a market economy. China is at the critical juncture where it needs to find a sustainable way to achieve economic prosperity in the next decade. The RMB internationalization strategy is a goal that the Chinese authorities are willing to achieve in the long term. But it is the progress of China's financial reform that determines the success or failure of this strategy.

The development of Shanghai and Hong Kong provides the best snapshot of how closely the financial reform and RMB strategy are linked together. Hong Kong, an international city that is part of China yet with a separate legal and institutional system and an international financial centre, plays a crucial role in China's RMB internationalization strategy at the fore front. Its well-developed equity market, banking sector and fund-management industry has turned it into one of the leading global financial centres (GFCI, 2012). The city also serves a broad set of international investors and helps them to gain exposure to global capital markets. Shanghai, the largest domestic financial centre in the onshore RMB market, is set to become an international financial centre by 2020. It has the largest RMB clearing and payment system, and is the home of major financial institutions including exchange houses and financial arbitration court in the mainland market.

The RMB strategy and the financial reform need to be played back-to-back and move forward in synch. In the near term, China's domestic financial reform takes priority since the government needs to minimize external risks and ensure financial stability. The strategy therefore may slow down to allow time for the domestic market to grow, which ultimately will provide a better ground for the strategy to expand.

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[42] The Chinese authorities set out their ambitious plan to establish an international financial centre in the 12th Five-Year Plan (2011–15). The establishment of an IFC, further domestic reform in financial markets and the internationalization of RMB are the three main themes of China's medium-term financial strategy. Expansion of its financial periphery is also treated as an essential component of enhancing China's soft power.

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