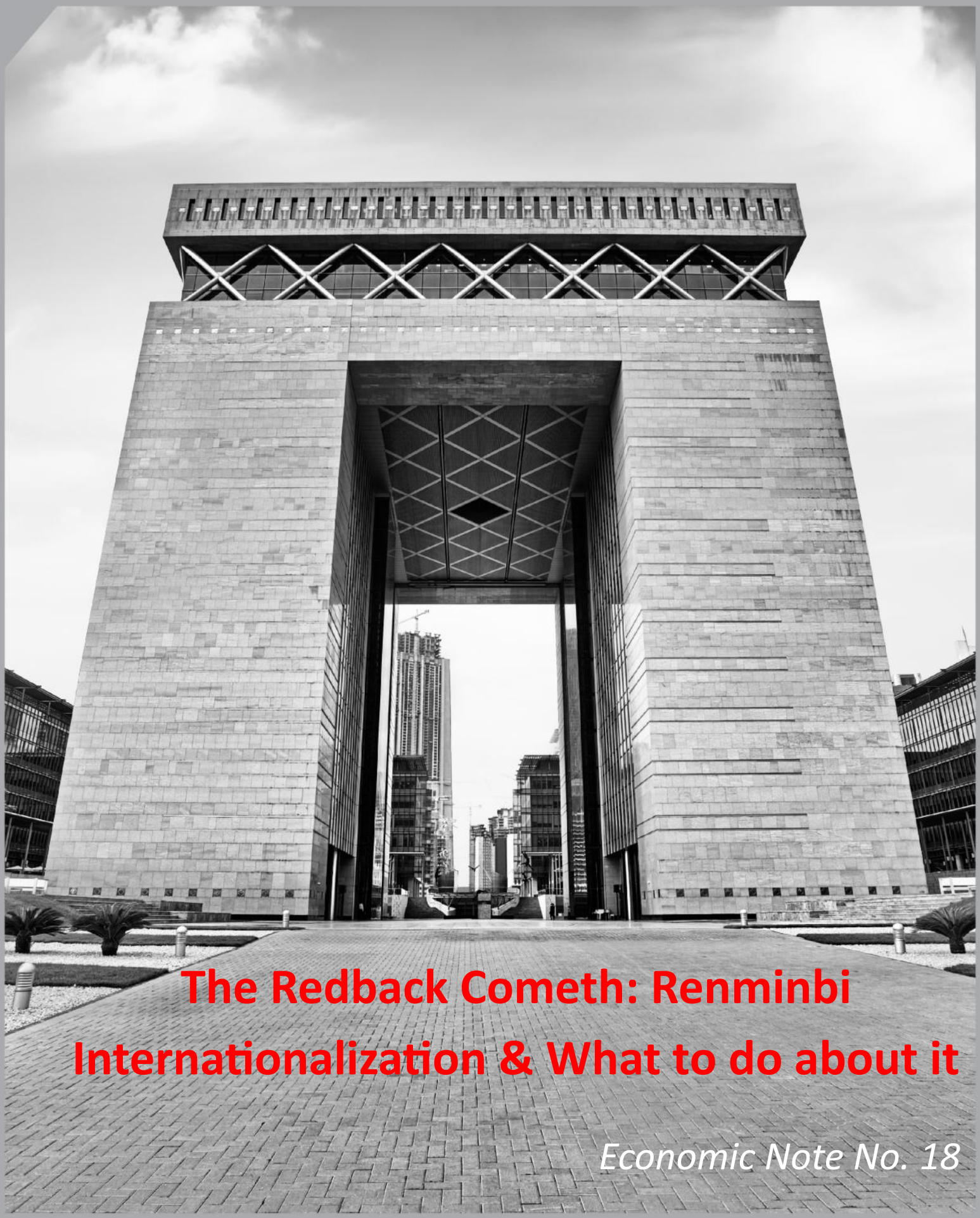

The Redback Cometh: Renminbi Internationalization & What to do about it

Economic Note No. 18

Dubai International Financial Centre

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Executive Summary

Today's multi-polar world is increasingly tilting towards the burgeoning Chinese economy. As the US economy falters on fiscal sustainability, Europe remains in the throes of debt concerns and Japan struggles to regain its footing after being hit by the Fukushima earthquake, the world fears an impending re-descent into recession. After breaking into the global scene with economic reforms and entry into the WTO in the last decade, the growing international role of China spans trade, investment, foreign reserve accumulation and Sovereign Wealth Funds.

Despite the growing economic & financial international role of China, its currency, the Renminbi (RMB) remains largely a domestic currency. There are increasing calls for the RMB to become an international payment, investment and reserve currency. However, the move towards internationalisation necessitates the development of an onshore capital market complemented by domestic policy reforms leading to a changed financial structure, with lower dependence on bank financing. China's 12th Five Year Plan objectives provide for gradual capital account convertibility and removal of internal distortions – which could lead to interest rate liberalization and development of money market instruments and debt capital markets, the "Redback Market". To achieve these goals, it is necessary for China to move towards capital account liberalisation and RMB convertibility, complemented by a gradual reduction of remaining interest rate controls, development of the non-financial corporate debt market, along with greater exchange rate flexibility. However, the speed of adjustment and the sequencing of financial sector reforms are also important. External account liberalisation should be preceded by domestic financial sector reforms and the removal of internal financial distortions.

Internationalisation of the RMB forms an integral part of the process of capital market development and financial sector reform. To date, there have been three main channels of RMB internationalisation: the introduction of the RMB as the settlement currency for cross-border trade transactions, the provision of RMB swap lines between the People's Bank of China (PBoC) and other central banks and the creation of a RMB offshore market.

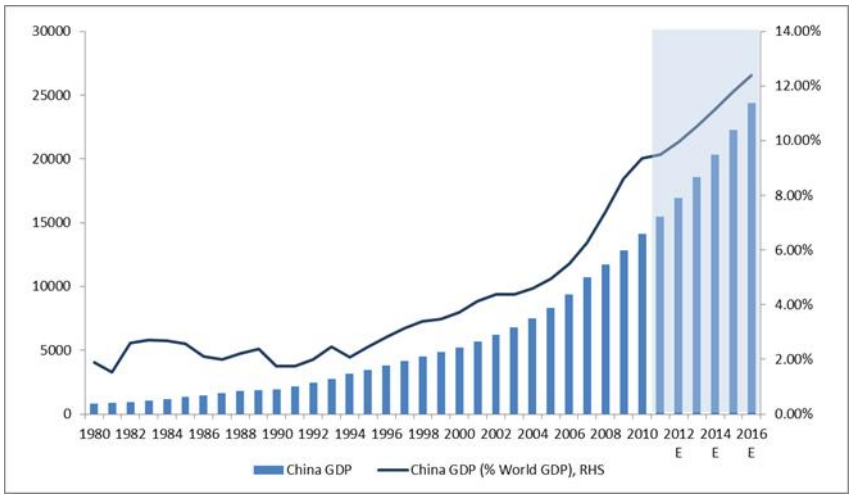
The RMB will emerge as the third global currency by 2015 and we anticipate: (a) a rise of the cross border settlement volume of the RMB to account for between 30-50% of the total export-import volume that is rising to USD 2 trillion; (b) growth in debt markets to about 30% of GDP would imply a quadrupling to about RMB 20 trillion (USD3.1 trillion); (c) increased use in foreign exchange markets and central bank reserves: the RMB could represent about 18% to 24% of global central bank reserves by 2015!

The GCC has been rising in stature as a major trading partner for China with Saudi Arabia and the UAE among its top 20 major trading partners. It is in the GCC's strategic interest to move towards greater economic & financial integration with China through accelerating the GCC-China free trade agreement, establishing links between financial markets, finance bilateral trade using the RMB and establishing RMB swap lines with GCC Central Banks. The growing trade and investment links between MENA/ GCC and China, create an opportunity for the DIFC to become a payments clearing centre for the RMB in the MENA region. The DIFC has the infrastructure, laws and experienced international banks and financial institutions with extended networks of correspondents for the DIFC to become the MENA region's clearing centre for the RMB and the RMB market. The Redback cometh and we need to prepare for this momentous coming.

China's Role in the Global Economy

The Great Financial Crisis, which engulfed global markets in 2008, accelerated the shift of the global economy to emerging markets. The D10 (BRIC+ Indonesia, Turkey, Mexico, South Korea, South Africa & Saudi Arabia) now represent some 35% of world output and 25% of world exports. China has made its mark in the global economy in the past three decades. Starting in 1978 and the launch of a series of economic reforms, China initiated a gradual process of transformation from a communist and centrally-planned to a capitalist and market-based economy leading to rapid industrialization, urbanization, market development and increased internationalization, resulting in both domestic and global benefits. The outcome has changed global economic geography. By 2010, China became the world's second largest economy after the United States, driven by double digit nominal and real growth rates over the past three decades (Figure 1). By total size, China's economy is projected to surpass the US economy by 2020.

Figure 1: Evolution of Chinese Nominal GDP, local currency (1980 – 2016 estimated)



Source: IMF

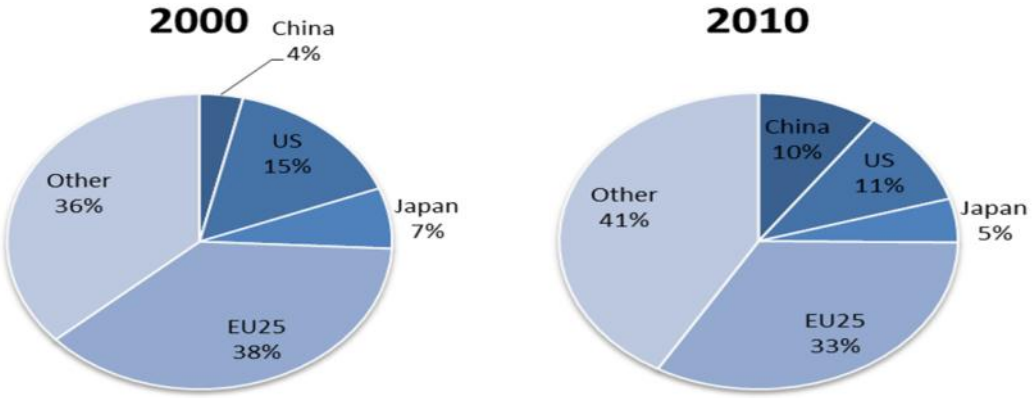
China's high growth rates were enabled and caused by reforms and high saving and investment rates. Social, health and demographic indicators also registered a vast improvement during the period of transformation: domestically, the share of rural population declined from 80% of the total population in 1980 to 56% in 2009 (Source: World Bank), leading to a shift from the agricultural sector in favour of increasing employment in industry and services. There was a massive reduction in the poverty rate from 65% of the population to around 4% between 1981 and 2009: the main source of the recorded decline in global poverty. Meanwhile, associated with structural change and transition, 'frictional' unemployment rates have ranged between 2-6% in 1980 to 2010, reaching 6.1% in 2010, only slightly lower than 6.3% level recorded in 2009, the highest in the last 30 years.

However, the high growth trajectory and strategy of export-led development led to large distortions in the form of macroeconomic imbalances – the famous "twin surpluses", on both the current account and capital account. The twin surpluses imply that China has obtained foreign funds through foreign direct investment (FDI) inflows, i.e. capital account surpluses while the trade surpluses were not used to buy but led to the accumulation of foreign assets. In turn, the income from net foreign assets is swelling the current account surplus. Several factors have contributed to this uncommon phenomenon for developing countries: the positive saving-investment gap (China's saving rate hovering around 50% of GDP, has been persistently higher than its investment rate), the government's export and trade promotion policy and its exchange rate policy. The other side of the coin are the large and persistent

current account deficits and accumulation of external liabilities by the United States and other Western economies, ie. the Global Imbalance (see Rajan (2006) and Yongding (2007)).

China's emergence as an economic superpower came through increasing openness via international trade, with the defining moment being China's joining the World Trade Organization (WTO) in 2001. Accession to the WTO benefitted not only the Chinese economy but also brought about an expansion of world trade along with an improvement of international terms of trade for the rest of the world, notably through lower prices of consumer goods. China is the first super-power to rely on export-led growth: the result is visible with China accounting for close to 10% of global trade in 2010 compared to less than 5% when it joined the WTO (Figure 2).

Figure 2: Selected Countries Foreign Trade (as a percentage of total world trade)



Source: IMF DOTS

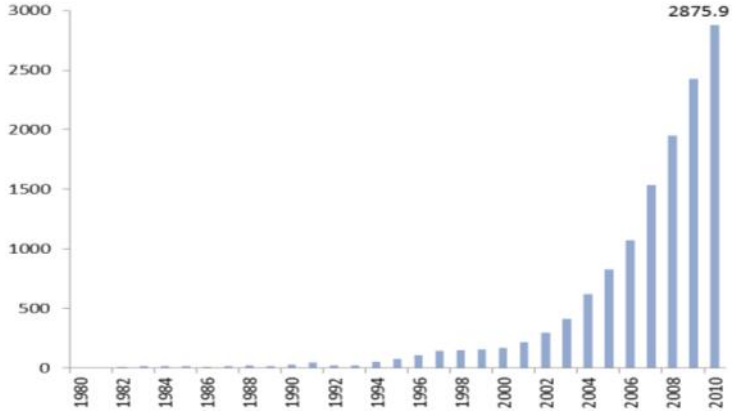
Internationally, China is now the world's largest exporter. Its trade exceeds 60% of its GDP, twice the share in the United States or the European Union as a group, and that ratio continues to rise rapidly, as China becomes increasingly dominant in global supply chains.

China's Growing Wealth & FDI

China's sustained trade and current account surpluses have led to a historically unprecedented accumulation of the largest stock of foreign exchange reserves worldwide, amounting to USD 3.2 trillion, as of July 2011 (see figure 3). Indeed, China's foreign financial assets are approaching half the size of its economy and are already a major component of its national wealth.

China's inward investment flows have increased in pace with trade flows: inflows into China, the largest FDI recipient in the developing world, increased 11% yoy to USD 106bn in 2010. In 2011, FDI jumped 18.6% yoy in the first seven months to USD 69.2bn, with foreign investors setting up about 15,600 new projects (+8% yoy) as per the latest statistics from the Ministry of Commerce. However, rising wages and production costs are leading to a gradual slowdown in the offshoring of labour-intensive manufacturing to China. With time, labour-intensive activities will move inwards in China seeking lower labour costs and then offshore into other countries with lower wage to labour productivity ratios (See Sauvant (2011).

Figure 3: Chinese foreign currency reserves (USD billions)



Source: EIU

Paradoxically for a non-natural resource based and relatively poor developing country, China has turned into a capital exporter. China was the world's fifth-largest exporter of capital in 2010, with outbound direct investments in the non-financial sector amounting to USD 59bn, covering 122 countries and regions (Ministry of Commerce, China). Indeed, total Chinese FDI outflows increased, reaching historical highs of USD 68bn in 2010. Chinese companies have continued their buying spree, actively acquiring overseas assets in a wide range of industries and countries, overtaking Japan in total outward FDI. Given the current growth rate of China's outbound investments, it is likely that annual outbound direct investments will exceed USD 100bn in the next three years. On current trends, China will move from being a net capital importer into a net capital exporter!

China's sovereign wealth funds (SWF) - State Administration of Foreign Exchange (SAFE) Investment Company and China Investment Corporation (CIC) – play a crucial role in wealth management and outward investment. Both feature among the top five SWFs in the world, managing assets worth USD 567.9bn and USD 409.6bn respectively (September 2011)[1]. Although official data is not available on the portfolio composition of these funds, external reporting suggests that the largest share is in developed country debt securities, with a growing shift towards direct investment in developing countries, especially Sub-Saharan Africa and in energy and natural resources.

Chinese outward investment has a revealed preference for mergers and acquisitions, in contrast to the establishment of wholly-owned subsidiaries abroad (Table 2), with net M&A purchases now representing some 9% of global M&A. However future trends are likely to be different. Chinese companies now possess the technology, finance and management and are acquiring knowledge of international markets and developing competitive products allowing them to penetrate emerging markets. As Chinese-designed and conceived products become more sophisticated (e.g. cars, electronics) they will also penetrate the markets of developed countries. As Chinese multinationals emerge, they will establish a local presence, establishing branches and subsidiaries. This has already happened in the banking & financial sector. We should expect to see a wave of Chinese MNCs over the coming decades establishing themselves on a global basis.

Table 1: Composition of Chinese FDI (Updated July 20, 2011, USD millions)

End of Year	2005	2004	2007	2008	2009	2010
Direct investment abroad (1)	645	906	1160	1857	2458	3108
Portfolio investment (2)	1167	2652	2846	2525	2428	2571
Equity securities	*0*	*15*	*196*	*214*	*546*	*630*
Debt securities	*1167*	*2637*	*2650*	*2311*	*1882*	*1941*
Total (Rows 1 + 2)	1812	3558	4006	4382	4886	5679

Source: SAFE, SWF Institute

Table 2: Cross-border Mergers and Acquisitions Overview: 2005-2010 (USD millions)

Region / Economy	Sales (Net)				Purchases (Net)			
	2005-07 (annual avg)	2008	2009	2010	2005-07 (annual avg.)	2008	2009	2010
China	9279	5375	10898	5965	4487	37941	21490	29201
Memorandum								
India	3119	10427	6049	5537	12558	13482	291	26421
US	120042	227445	40085	80267	127903	70173	23760	86342
East Asia	23281	17226	15741	16144	11031	39888	35851	53089
Asia & Oceania	59141	68167	38295	45725	69953	95167	67534	78053
Developing economies	84447	104812	39077	82813	109476	105849	73975	96947
World	703426	706543	249732	338839	703426	706543	249732	338839

Source: UNCTAD World Investment Report 2011

More important for the world economy will be the export of Chinese capital through the development of China's capital markets. As China gradually opens its capital markets, foreign and Chinese companies will be able to list securities –debt, equity and other instruments- to tap Chinese savings for investment on a global basis. Securities will be issued in RMB, through the development of the "Redback market". Foreign governments could issue Redback bonds, helping build the Redback bond market. Exporting Chinese capital through the Redback securities markets can be an effective and efficient method of recycling China's accumulated savings and would be a direct way of addressing the issue of 'global imbalances'.

For the above scenario to become a reality requires capital account liberalisation –notably by allowing foreign governments and companies to list and tap domestic Chinese financial resources- and RMB convertibility. However, the existence of capital controls, exchange controls and other restrictions on the use of the RMB imply that the RMB currently does not meet the IMF's criteria of a 'freely usable' currency[2].

In the following sections, the potential & conditions for the emergence of the RMB as an international currency are discussed. This is followed by a descriptive section on the current status of the RMB in international payments, a discussion of cross-border trade settlement in RMB, RMB swap lines and the development of the RMB offshore market in Hong Kong. In identifying the next steps, specific focus is given to the appropriate sequencing of reforms – whether to enable the establishment of a flexible exchange rate regime, capital account liberalisation or domestic reforms first, followed by the necessary phases required for an active monetary policy. We end with a discussion of the growing links between the MENA/ GCC region and China and the role DIFC can play in growing the Redback market and becoming a clearing centre for RMB payments for the MENA region.

Renminbi as a Potential International Currency

With the emergence of China as a global leader in a multi-polar world and the corresponding weakness of the US economy, the debate on the role of the dollar as the world's international reserve currency has resurfaced (Saidi & Scacciavillani, 2010). Before discussing the potential role of the Renminbi as an international currency, it is important to highlight the concept of the Triffin Dilemma. The Triffin Dilemma, which figured prominently in international monetary policy discussions post-WW II, posits that the country, the US at the time, issuing the reserve currency is bound to run an ever increasing current account deficit as world trade and capital flows grow in order to allow international reserve accumulation and adequate global liquidity. In exchange, the US obtained an "exorbitant privilege", enabling it to pay for imports (including capital) with its own fiat paper currency (Eichengreen (2011)). This dilemma could be managed as long as the US economy grew at least as fast as the world global average and had no serious rival on the world stage.

The Euro, which entered the global scene in 1999, was expected to become an alternative international currency. However, after more than a decade of the euro's existence, the dollar remains the predominant currency in international use. Goldberg (2010) presents evidence that not only is the dollar the major form of cash currency around the world (more than 70% of one hundred-dollar notes and some 60% of twenty- and fifty-dollar notes are held abroad, while two-thirds of all US banknotes have been in circulation outside the country since 1990), but it also remains prominent in exchange rate arrangements (seven countries currently are dollarized or have currency boards using the dollar and eighty-nine have a pegged exchange rate against the dollar) and continues to be the dominant currency in foreign exchange reserve accounts. US dollar denominated assets account for about two-thirds of the international reserve assets of industrialised and developing countries.

But the Great Financial Crisis, which originated in the US severely shaking confidence in US banks, financial institutions and markets, has reignited the dormant worries. Fiscal laxity in the US, aggravated by acrimonious political divisions, the uncertainty over the cost of health care reform combined with the large unfunded liabilities related to social security and other entitlement programmes, raises the spectre of a scenario in which the international role of the dollar could be substantially undermined. Indeed, persistent government budget deficits and growing public debts in both the EU and the US, with political divisions and lack of decisive leadership, increase the attractiveness to governments of reducing the real value of their obligations –both debt and unfunded liabilities- through higher inflation. However, a potential massive depreciation of the US dollar accompanied by a surge in inflation would increase systemic risk for the global economy and seriously undermine the US dollar's position as the global standard of value.

In a multipolar world, the size of a single country would not be large enough to sustain its role as supplier of the dominant reserve currency and international liquidity. The alternative would be to devise a financial system relying on several major currencies as was the case before WWI: a multi-currency monetary system for a multipolar world. However, our international monetary system and its architecture are largely post-WWII relics, designed for a now defunct world.

A new international monetary system & architecture are required. As it now stands, China is an economic super-power but the Renminbi is not an international currency. What is to be done for the RMB to become an international currency and reserve asset? For this, one needs to distinguish between *de facto* and *de jure* recognition and acceptance of the RMB as an international currency. By *de jure*, we will refer to acceptance by the IMF.

Box 1: Renminbi or Yuan?

The Renminbi (RMB) is the official currency of the People's Republic of China (PRC), excluding the two special administrative regions of Hong Kong and Macau, where the Hong Kong dollar (HKD) and Macau Pataca (MOP) are used. The Renminbi is issued by the People's Bank of China, the monetary authority of the PRC. Its name means "people's currency". The primary unit of Renminbi is the Yuan. The distinction between Yuan and Renminbi (RMB) is analogous to that between the pound and sterling; the pound (Yuan) is the unit of account while sterling (Renminbi) is the actual currency. Through most of its history, the value of the Renminbi was pegged to the U.S. dollar. The Renminbi exchange rate has been allowed to float in a narrow margin around a fixed base rate determined with reference to a basket of world currencies since 2005, with a temporary return to a fixed exchange rate during the peak of the financial crisis from July 2008 to June 2010. The Chinese government has announced that it will gradually increase the flexibility of the exchange rate with the aim of "internationalizing" the RMB in the hope of it becoming a reserve currency over the long-term.

The SDR and *de jure* RMB Internationalization

The IMF has laid out the requirements for a currency to become internationally "accepted" and become a constituent of its Special Drawing Rights. Under the 2000 Decision (Annex 1) of the IMF, the Special Drawing Rights (SDR) basket may include currencies of those countries that abide by the two following requirements:

(1) "The value of exports of goods and services during the five-year period ending 12 months before the effective date of the revision should have the largest value[3];

(2) The currency of issue has been determined by the Fund to be a freely usable currency in accordance with Article XXX (f) that states: "A freely usable currency means a member's currency that the Fund determines (i) is in fact widely used to make payments for international transactions and (ii) is widely traded in principal exchange markets".

The IMF specifies how the requirement of freely usability of the currency "concerns the actual international use and trading of currencies, and is distinct from whether a currency is either floating or fully convertible". From these standards (revised in October 2010) it can be inferred that full convertibility is not a requirement for a currency to be considered 'international'.

In the October 2010 SDR composition review, the IMF noted that "The Chinese authorities have recently taken a number of steps to facilitate the international use of the Renminbi, including allowing central banks to hold reserve assets in Renminbi, and the volume of China's international trade settled in Renminbi is rising. However, the Chinese Renminbi is not yet widely used in international transactions or widely traded in the principal exchange markets and would thus not appear to meet the criteria for being determined by the Fund to be a freely usable currency at this time"[4]. Hence the Chinese Renminbi was excluded as a reference international currency in the IMF's revision of the SDR basket which continues to include four currencies: the US dollar, the UK pound, the Japanese yen and the euro. In this context, the Chinese authorities have till 2015 to make the "Redback" comply with all the requirements for the inclusion in SDR basket.

Recently, the PBoC, in accord with the directives of the Chinese government and other Chinese

authorities, has taken significant steps towards growing the international use of the Renminbi, especially for foreign trade transactions. However, there are still significant unresolved issues to be considered in the area of the RMB's role in capital markets and principal exchange rate markets.

The necessity of free convertibility of the Renminbi to be fully internationalized is still debatable. Though the IMF does not require full exchange rate convertibility to be considered for the inclusion in the SDR basket, this would help increase the confidence of market participants to use the Renminbi for market transactions and expand the role of the Renminbi for global capital flows. Until full convertibility is attained, the Renminbi is not likely to become an anchor or peg currency, nor be used in a currency basket as part of another country's exchange rate policy. However, given China's enormous international reserves the PBOC certainly has the resources to establish full convertibility of the RMB if the policy decision is taken.

De facto Renminbi internationalization

What about *de facto* convertibility and use of the Renminbi? So far the Renminbi internationalisation process has mainly related to trade flows, with investment and capital market transactions lagging. In addition to changes in flexibility of the exchange rate, the internationalization of the Renminbi has taken three main forms:

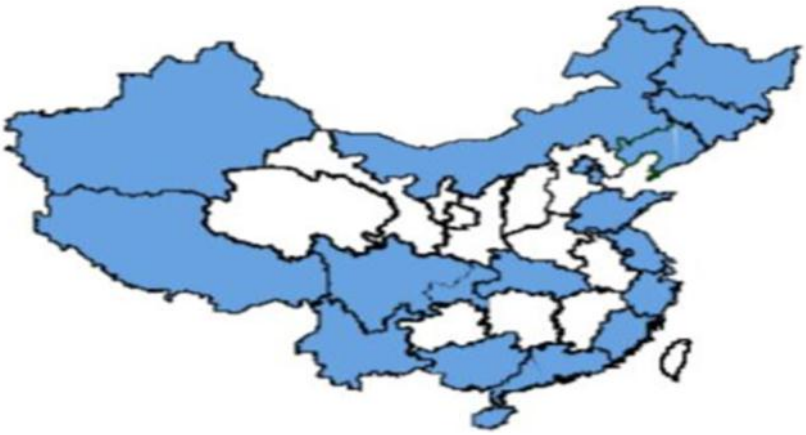
1. The use of Renminbi as the settlement currency for bilateral cross-border trade transactions.
2. The creation of a Renminbi offshore market.
3. The establishment of Renminbi swap lines between the PBoC and other central banks.

Cross-Border Trade Settlement in RMB

The first important step made toward the internationalization of the Chinese currency was the launch of a pilot program of Renminbi Settlement in Cross-Border Trade Transactions (the "Pilot Program") in July 2009. Thanks to this program, bilateral cross-border trade transactions that were previously settled in foreign currencies (especially in US dollars) can now be paid in Renminbi. The implementation of the Pilot Program has seen three major developments, extending its scope:

1. At launch, the program included the participation of the five Chinese cities of Shanghai, Guangzhou, Shenzhen, Zhuhai and Dongguan and the two special administrative regions (SARs) of Macao and Hong Kong and the ASEAN countries. In particular, only importers operating in the Chinese cities were given the permission to pay trade contracts in Renminbi by the PBoC. Though this may seem restrictive, as of 2009, the pilot regions jointly accounted for 95% of the total amount of China's international trade (settled in both USD & RMB).
2. The first review of the Pilot Program in June 2010 expanded the spectrum to include 20 of China's 31 provinces and the rest of the world (Figure 4 below). In addition, the PBoC permitted 365 designated Chinese exporters also to settle payments in RMB. This was further extended to 67,359 exporters (around 30% of total) in December 2010[5].
3. On Aug 23, 2011, the use of the RMB to settle cross-border trade was extended to the entire country, as announced by the PBoC. The Ministry of Commerce also released draft guidelines on how foreign investors can use RMB acquired overseas for direct investment in the country.

Figure 4: Coverage of the Pilot Program in Mainland China as of June 2010 review

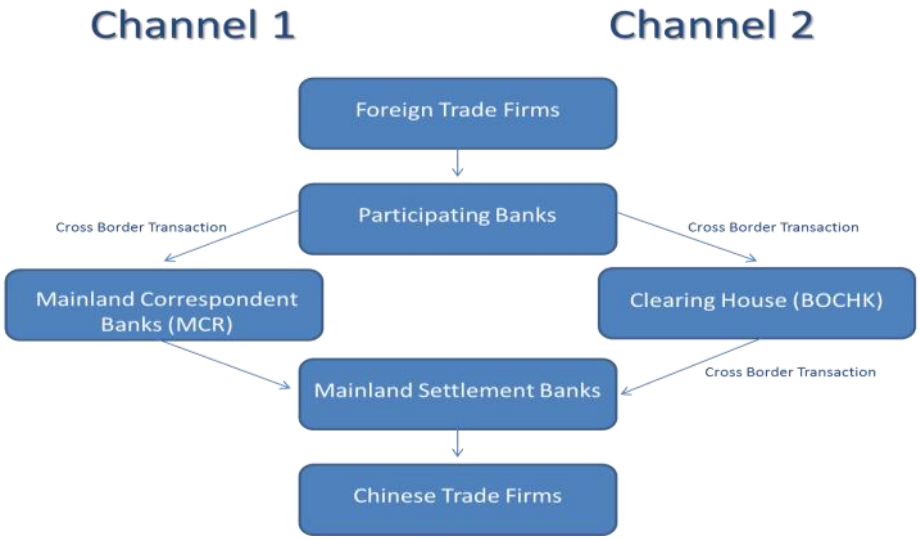


Source: NBS, CEIC and BBVA Research

Box 2: Process of RMB Cross-Border Trade Settlement

With Hong Kong being the most important centre for the trade settlements in RMB, an underwriting of a trade agreement and possible payment in Renminbi are carried out through either of the two possible channels - via either the Mainland Correspondent Banks (MCBs) or of a Clearing Bank (CB). MCBs are Chinese incorporated banks appointed by the PBoC to conduct international settlements business, while the Bank of China Hong Kong (Holdings) Limited (BOCHK) has been designated as the Clearing Bank (CB) for transactions involving the Renminbi. In the first channel, the participating bank that represents a foreign enterprise involved in a trade contract contacts the MCB that then signs a Renminbi settlement agreement with the participating bank. The MCB will independently manage its positions in Renminbi in the interbank market. The second channel is roughly similar with the only change that reference bank for trade settlement is not the MCB, but the Clearing Bank (CB).

Figure: Summary of the two channels for RMB-denominated trade settlements

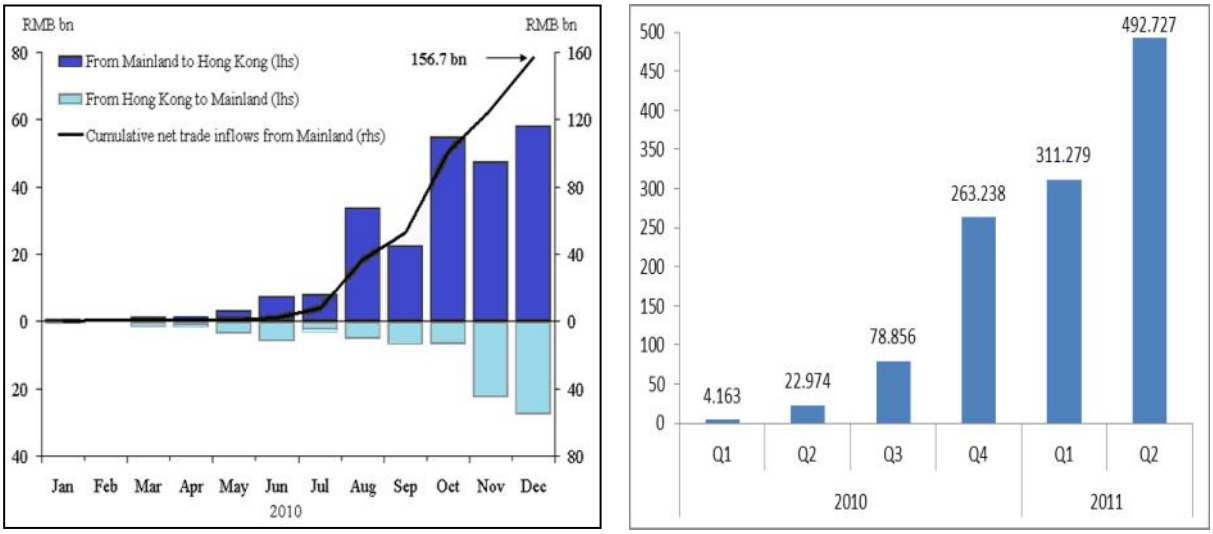


Source: NBS, CEIC and BBVA Research

Since the launch of the Pilot Program in 2009, trade settlement in RMB has gathered speed. Currently, about 70-80% of cross-border RMB trade settlement transactions are conducted in Hong Kong, with RMB deposits in Hong Kong having reached a record RMB 554 billion by the end of June. About 2.5% of total trade was settled in RMB in 2010, rapidly rising to about 9% by June 2011 (Figure 5).

The PBoC has been proactive in extending the use of RMB to foreign direct investments in addition to overseas trade settlements. Under the PBoC's pilot scheme for the settlement of overseas direct investments in Renminbi (the "Pilot Scheme") launched on 13 January 2011, mainland enterprises, on receiving the authorization by the competent Mainland authorities, can conduct direct investments overseas using RMB. The purpose of this new pro-internationalization measure adopted by the Chinese authorities is to "better support Chinese enterprises to go abroad and facilitate trades and investments", according to the PBoC[6].

Figure 5: Renminbi Trade Settlement via Hong Kong 2010 (RMB billion)



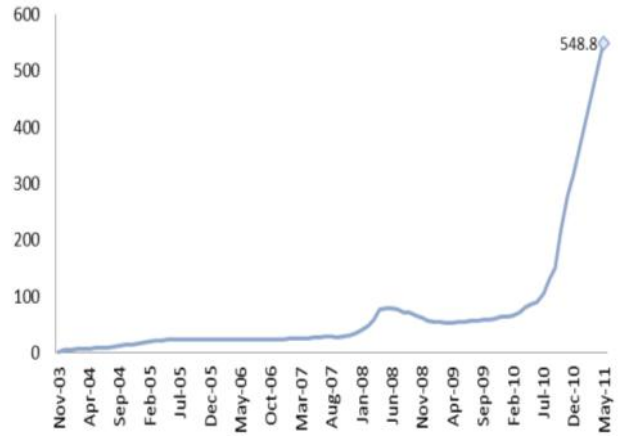
Source: HKMA, Reuters

Growth of the Redback Bond Market: Hong Kong as first CNH Market

Compared to the Shanghai onshore market, the more developed Hong Kong offshore market has embraced the cause of internationalization of the Renminbi. The Hong Kong market is becoming the first CNH market, with CNH being the term used for offshore Renminbi, i.e. the RMB traded outside Mainland China. Being part of China as a special administered region (SAR) and characterized by low taxation and free trade, Hong Kong has one of the greatest concentrations of corporate regional and international headquarters in the Asia-Pacific, leading the PBoC to select Hong Kong to become the platform for international Renminbi deposits, for the issue of Renminbi denominated bonds and shares and for Renminbi derivatives trading.

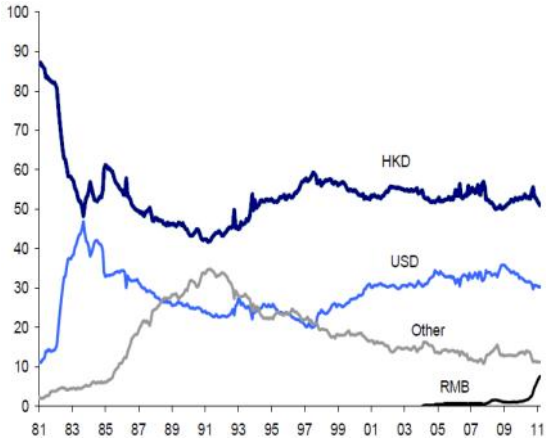
Since 2004, Hong Kong residents are permitted to open Renminbi accounts in Hong Kong's authorized banks, though the level of Renminbi-denominated deposits remained low until July 2010 when the Clearing Agreement amendment was signed between the Hong Kong Monetary Authority (HKMA) and PBoC (Figure 6). The agreement ensures that all corporate customers are allowed to open Renminbi-denominated accounts with banks in Hong Kong not just for trade-related transactions, but for general transactions - a stepping stone for the surge in Renminbi deposits. The main target of this reform was multinational firms with branches in Hong Kong involved in Renminbi settled trade transactions with the Mainland. Despite the significant impact of the Clearing Agreement, the Renminbi-denominated deposits still represent only a low percentage of the overall deposits currently open in Hong Kong SAR (Figure 7).

Figure 6: RMB Deposits in Hong Kong (RMB bns)



Source: Bloomberg, HKMA

Figure 7: Percentage Shares in Total Hong Kong Deposits (1981-2011)



Source: CEIC

Box 3: Overseas Government Bond Issuance

Growing a Redback bond market should be based on a government, sovereign, bond market. The last CNH bond issuance illustrates the potential and promise. China sold RMB 15bn of bonds to institutional investors in Hong Kong at the lowest yields since the Ministry of Finance began issuing debt in the city in 2009. The MOF auctioned RMB 6bn of three-year debt at 0.6%, 40% lower than the 1% offered on the debt of the same tenor in Nov 2010, reflecting investors' confidence about the appreciation of the RMB as well as global funds' surging demand for RMB-denominated assets as a refuge from Europe's debt crisis and a weakening dollar. Five- and ten-year securities were also priced at lower yields in China's third and largest auction of dim sum bonds, at 1.4% and 2.36% respectively. Hence, the record low-yields trend that has recently hit the market for corporate bonds in the offshore CNH market has spread also to the overseas government bond issuance. In the meanwhile, government bonds' yields in the mainland bond market maintain higher levels creating a spread between onshore and offshore government bond market. As of August 21, 2011, the Chinese government bond yields for 10-year maturity were on average 2.254% in the Hong Kong market, while a government bond with the same tenor gave a 3.952% return in the Mainland. The difference is even more evident for closer maturity with the 1-year bond yields 0.343% in Hong Kong and 3.606% in the Mainland.

The process of issuance of government bonds in Hong Kong underlines the commitment of Chinese authorities to achieve the internationalization of the RMB that has to come also through the creation of a liquid and complete offshore market. The Chinese government intends to deepen the offshore market for renminbi-denominated debt and establish pricing reference points for corporate issues.

Offshore Renminbi bonds, often referred to as "dim sum" bonds, have been issued since 2007. The most recent innovation and trend in dim sum bonds is the issuances by non-Chinese multinational corporations. Since July 2010, Hong Kong – incorporated and foreign companies, supranational organizations and mainland Chinese non-financial state-owned enterprises (SOEs) have issued dim sum bonds. The first foreign multinational company that entered the RMB offshore bond market was McDonalds - in August 2010 selling RMB 200mn of 3.0% notes due in September 2013 with the aim to

invest the amount raised to expand its business in China (to double the number of its outlets by the end of 2013). This "experiment" of bond issues by multinational foreign firms denoted the willingness of foreign firms in China to take part in the internationalization of the Renminbi; but it also revealed administrative barriers in the procedures, with McDonalds having to wait about one month to move the proceeds of the issuance to the Chinese mainland in order to invest.

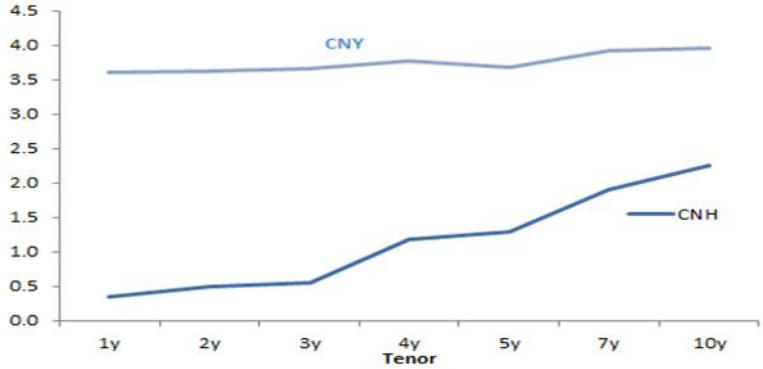
By end-2010, 62% of the volume of Renminbi-denominated bond was issued by mainland Chinese incorporated entities, 25% by entities incorporated in Hong Kong and 13% by foreign entities[7]. Renminbi -denominated bonds issued by non-financial foreign firms have taken off in 2011 (see Appendix II), with total dim sum issuance at RMB 99bn this year, before China's MoF undertook the largest ever overseas issuance of an additional RMB 15bn in Hong Kong on Aug 17 (see Box 2 for details) more than double 2010's RMB 35.7bn.

There are two main interesting features of these debt issues. First, market participants note that many non-Chinese issuers "are awash with cash in China"[8]. As a consequence, the aim of these issues is not the traditional one of raising capital, but mainly to be fuelled up with Renminbi. The second source of interest comes from the attractiveness to issuers, low yield levels on the latest bond issues, while buyers are looking from capital gains arising from Renminbi appreciation. The latest two issues made by Unilever, the British-Dutch consumer multinational corporation, and Fonterra, the New Zealand-based dairy farmer, offered yields respectively of 1.15% and 1.1%. Compared to the current volatile and crisis-prone status of the Western sovereign debt markets, these issues are highly noteworthy. The low rates mean low-cost funding for companies that seek to use the Hong Kong market as a platform for their issues. International investors accept such low yields because they expect to be compensated by the appreciation of the RMB against the dollar now that the exchange rate is left to float more freely.

On the other hand, Beijing's strict capital controls mean that interest rates on domestic Renminbi debt are disconnected from the rates negotiated on the Hong Kong market (Figure 8). As part of its counter-inflationary policy to control money and credit growth rates, the PBoC has fixed onshore one-year lending rate at 6.56% (last revision July 6, 2011). The large spreads between onshore and offshore rates provides large incentives to Mainland companies to take advantage of cheap funding on the Hong Kong market, even if they are not yet allowed to issue dim sum bonds directly as permission is granted only to mainland Chinese government and governmental institutions, financial companies, non-financial SOEs.

As long as interest rates in the mainland continue to diverge from offshore rates, an increased openness of flows would open enormous arbitrage potential between the onshore and offshore markets and would become uncontrollable, since a transferability of Renminbi with no severe capital controls would cause a stampede of borrowers to Hong Kong and investors to Mainland markets in Shanghai and Beijing. Predictably, the PBoC has reacted to this situation by further tightening RMB transferability for mainland companies. Eventually, *pari passu* with growing capital account liberalisation, rates will have to converge.

Figure 8: Interest rate spread of on-shore and off-shore rates on Chinese Government Bonds



Source: Bloomberg

The offshore Renminbi capital market has not limited itself to the issue of debt instruments, with the first issue of equity instruments in Hong Kong in April 2011. The first Renminbi-denominated shares to be traded outside mainland China debuted on the Hong Kong Stock Exchange (HKEX) on April 29, 2011. The first Redback denominated IPO was the Huixian real estate investment trust (REIT), opening the way for a wider range of offshore Renminbi-denominated financial instruments in the future. Broadening the range of offerings is important given the recent trend of bonds offering less attractive terms to investors. However, despite the potential, the HKEX has not received any new applications for Renminbi-denominated IPOs.

In July 2011, the Hong Kong Monetary Authority announced two new initiatives for the process of Renminbi-denominated trade settlement in its plans to become the offshore driver of the internationalization of the Redback. First, the HKMA has allowed Hong Kong banks to consolidate Renminbi-denominated trade-related transactions across banking groups before netting them out and having them settled with the clearing banks in Hong Kong. Second, the new rules allow banks to net out exposures in the deliverable CNH forwards before calculating their “net open positions”. These measures mean more flexibility for Renminbi-denominated transactions based in Hong Kong. The new netting rules will give more freedom to transfer CNH deposits between banks by means of swap transactions, decreasing the pressures dictated by the full exposure limits to the clearing bank. The consolidation provides for increased access to both USD and RMB onshore rates across the globe without the previous limits imposed to corporates based outside Hong Kong. These measures will boost the volume of Renminbi-denominated trade settlements via Hong Kong, with a shift in demand resulting in an increase in both CNH deposit rates and the size of the CNH deposit base.

To continue developing this offshore market it is essential to make it easier for the proceeds of Renminbi-denominated bond and equity issuance to flow back onshore via foreign-direct investment. Currently an authorization by the People’s Bank of China is needed to ship the proceeds back to mainland. Removing or facilitating the authorisation would help to make the first Renminbi offshore market more liquid, an essential element towards the internationalization of the Renminbi.

Renminbi Swap Lines

The Renminbi swap lines between the PBoC with other central banks at a bilateral and multilateral level were established with the aim of developing a lender of last resort for Renminbi outside China, initiating the process of establishment of the Renminbi as a reserve currency.

The Chiang Mai Initiative Multilateralization (CMIM) Agreement signed by the Finance Ministers and the Central Bank Governors of the ASEAN member states, China, Japan and Korea (ASEAN + 3) and the Monetary Authority of Hong Kong came into effect in March 24, 2010. The scope of the CMIM is to provide financial support through currency swap transactions among participants in times of liquidity need. Hence it is a multilateral currency swap contract in which each participant is entitled, in accordance with the procedures and conditions set out in the Agreement, to swap its local currency (the Renminbi in the Chinese case) with the US dollar for an amount up to its contribution multiplied by its purchasing multiplier (Table 3). The total amount of the currency swap agreement is USD 120 billion with China and Japan being the main contributors.

Table 3: Chiang Mai Initiative Multilateralization

	Financial contribution per Country		Purchasing Multiple
	USD (billion)	(%)	
China	38.4 *China (Ex Hong Kong) 34.2* *Hong Kong 4.2*	32 *28.5* *3.5*	0.5 2.5
Japan	38.4	32	0.5
Korea	19.2	16	1
Plus 3	**96**	**80**	-
Indonesia	4.77	3.97	2.5
Thailand	4.77	3.97	2.5
Malaysia	4.77	3.97	2.5
Singapore	4.77	3.97	2.5
Philippines	3.68	3.07	2.5
Vietnam	1	0.83	5
Cambodia	0.12	0.1	5
Myanmar	0.06	0.05	5
Brunei	0.03	0.02	5
Lao PDR	0.03	0.02	5
ASEAN	**24**	**20**	-
Total	**120**	**100**	-

Source: Bank of Japan

In addition, since 2008, a series of bilateral Renminbi swap lines between the PBoC and other central banks has been concluded (Table 4). All these swap arrangements come in the form of three year arrangements with the possibility of tenor extensions through bilateral agreements between the two parties. With increased access to and international convertibility of the Renminbi, the swap agreements can refer to the Renminbi instead of the USD, effectively creating a Redback zone in the ASEAN+3 region and effectively giving the RMB reserve currency status.

The availability and access to Renminbi in the current account of central banks outside China also has the aim of promoting bilateral trade between China and the country involved in the Renminbi swap program. When a foreign country can hold the Redback as a reserve currency, the central bank has the capacity to borrow Renminbi when, say, money or financial market disruptions make it difficult to settle transactions with Chinese businesses in US dollars. The presence of Renminbi in the reserves of a domestic central bank hence increases the confidence of firms to trade with China by allowing them access to liquidity. Hence, the swap agreements have double benefits - of facilitating and lowering the cost of trade transactions with critical trade partners and of promoting the use of Renminbi via trade transactions. As table 4 shows, the size of the currency swap agreements with trade partners is largely proportional to bilateral trade relations.

Table 4: Bilateral Renminbi local currency swap arrangements as of July 2011

Date of agreement	Counterparty	Size (RMB Billions)	% of Tot. Chinese Trade (Avg. 2000-2010)
12-Dec-08	Republic of Korea	180	7.3445%
20-Jan-09	Hong Kong SAR, China	200	9.5616%
8-Feb-09	Malaysia	80	2.1649%
11-Mar-09	Belarus	20	0.0280%
23-Mar-09	Indonesia	100	1.2639%
2-Apr-09	Argentina	70	0.3759%
9-Jun-10	Iceland	3.5	0.0067%
23-Jul-10	Singapore	150	2.2019%
18-Apr-11	New Zealand	25	0.2027%
19-Apr-11	Uzbekistan	0.7	0.0474%
6-May-11	Mongolia	5	0.0806%
30-May-11	Malaysia	80	2.1649%
5-Jul-11	Kazakhstan	6.5	0.4784%
???	GCC Countries	approx. 150	2.4930%

Source: PBOC, Reuters, IMF DOTS, DIFC Economics

Next Steps to RMB Internationalization

As discussed above and summarised below in Table 5, the Renminbi is gradually evolving into an international currency as witnessed by:

a) The growing use of the Renminbi as a settlement currency for cross-border transactions;
b) Growth of offshore Renminbi deposits, bonds, derivatives and from April 2011 shares in the Hong Kong market.

However, major changes and reforms are required for the Redback to gain acceptance as an international currency in the three classical uses of money as a unit of account, a medium of exchange and a store of value. The dollar, despite its growing weakness, remains prominent in international transactions and reserves because of hysteresis effects, the lack of a viable alternative in the euro which did not develop a unified EU debt market and because of the depth and liquidity of US debt and capital markets. However, a growing number of central banks are starting to accumulate Renminbi reserves opening the way to the use of the Renminbi as a potential reserve currency.

Table 5: Renminbi current situation as an international currency

	Private Sector	Official Sector
Unit of Account	**Some** RMB-denominated Cross Border Settlement	**None** The USD is still the currency used for pegging
Medium of Exchange	**Some** RMB-denominated Cross Border Settlement	**None** The RMB is not used internationally for foreign exchange intervention
Store of Value	**Some** Hong Kong Offshore Market	**Starting** Increasing use of the RMB in foreign central banks' currency reserves

Source: Hang Seng Bank

The traditional economic development paradigm suggests that developing countries, given their higher growth opportunities and low levels of capital would generate higher returns attracting capital inflows, using foreign savings to obtain an investment rate higher than what domestic saving can support. China differs from the standard development paradigm by having a very high domestic saving rate (low consumption rate). China's limited ability to finance its high domestic investment rate directly by its own saving and its reliance on FDI stems in part from distortions or dysfunctional domestic financial markets and the desire to obtain access to foreign technology, management and knowhow. Financial intermediation in China is mainly dominated by large state-owned banks, with household saving in banks skewed to savings deposits, while SMEs have limited access to credit. Hence, it is important to highlight the critical need to broaden and deepen financial markets, with the objective to improve the sector's contribution to balanced growth.

The development of China's financial sector is critical and strategic for two main reasons. One is the need to diversify domestic sources of finance and reduce dependence on the now dominant banking sector. As Table 6 shows China's financial structure is highly skewed towards bank financing (more than 75%), with severely underdeveloped debt and equity markets. Two, China imperatively needs to develop its financial markets to achieve an orderly internationalisation of the RMB and become a global financial centre. Strategically, China needs to deploy its accumulated enormous capital resources both domestically and on an international basis to support the international expansion of its multinational corporations, invest in emerging and developing economies markets in order to develop export markets

for its products and help resolve global imbalances by becoming an integral part of international capital market financing.

Table 6: Financial Structure is dominated by bank financing

	Volume of financing (RMB bns)		As % of total financing	
	2009	*2010*	*2009*	*2010*
Bank loans	105225	83572	81.2	75.2
Equities	3904	6116	3	5.5
Government securities	8182	9735	6.3	8.8
Enterprise bonds	12367	11713	9.5	10.5
Financing by domestic non-financial sectors	129678	111136	100	100

Source: PBoC

China's 12th Five-Year Plan and Sequencing of Reforms

China's 12th FYP (see discussion in Appendix II), highlights the need for the financial sector to be an integral part of the process of economic restructuring. The FYP directs that China will continue to energetically develop financial markets and encourage financial innovation, by moving toward market-based and not administered interest rates. At the same time, the use of the RMB in cross-border trade and investment is to be expanded following its success since the launch of the Pilot Program. The implied internationalisation of the RMB is an integral part of the 12th FYP, which for the first time mentions "a gradual realization of the convertibility of the capital account" as a goal of Chinese monetary policy. The reform and development of China's financial markets will be imbued by the lessons learnt in the Asian financial crisis and the on-going Great Financial Crisis. Hence, not only will financial oversight be strengthened and improved but also an early warning system and a risk response mechanism would be established to mitigate systemic financial risks. (IMF FSAP (2011))

There are two major transformations in China's 12th FYP: (a) Move the economic development model from being largely export-led to being more domestic consumption oriented and (b) diversification of the financial intermediation infrastructure away from bank-dominated financing towards more financial market financing. Identification of the best strategy i.e. to move away from export-led growth to consumption-led growth is important and is extensively discussed in the 12th Plan. However, the 12th FYP does not provide the details on the speed of adjustment and sequencing of the structural reforms needed to achieve these policy objectives.

The pressure on China to liberalise the exchange rate and abandon capital controls notwithstanding, it would not be in the interest of China to initiate capital account liberalisation without previously initiating domestic financial market reforms to remove existing financial distortions. Sequencing of capital account liberalization implies a comprehensive approach to reforms involving the coordination of liberalization of capital flows with domestic financial sector liberalization and structural reforms. Johnston and Sundararajan (1999) make a case that both capital account liberalization and domestic financial reforms should be approached in an integrated manner: "capital account liberalization by instruments and sectors should be sequenced in a manner that reinforces domestic financial liberalization and allows for institutional capacity building to manage the additional risks"[10].

Lardy & Douglass (2011) argue that a gradual reduction of the remaining interest rate controls,

development of the non-financial corporate debt market and gradual appreciation of the currency along with greater exchange rate flexibility are needed to move towards a more liberalized capital account. From a domestic standpoint, liberalization of interest rates, development of indirect monetary policy control procedures, strengthening of banks and capital markets through improved regulations, corporate governance and independency, the development of a solid domestic institutional investor base and full protection of property rights are the main reforms that should be in place prior to full capital account liberalisation. Without these reforms of the domestic economic and financial system, capital account liberalization and its obvious outcome, full convertibility of the exchange rate, can lead to disruptive capital flows and generate a banking and financial crisis and economic distress.

Monetary Policy: Effectiveness & Steps to Internationalize RMB

The primary instruments of monetary policy currently used by the PBoC include open market operations, the rediscount rate and reserve requirements. In addition, the PBoC also uses some non-market "instruments" (e.g. credit plans, credit policy and "window guidance" whereby the central bank issues direct lending guidelines and orders to commercial banks) to control the volume and composition of credit flows. The monetary policy of the PBoC is however constrained by the exchange rate regime[12], institutional weaknesses in the financial and corporate sectors and the large stocks of excess reserves that banks maintain at the PBoC. Monetary policy has relied on open market operations for sterilising foreign exchange market intervention and changes in the reserve requirement ratio to affect money supply and credit growth. Over the recent period the reserve requirement ratio was raised six times each in 2010 and 2011.

To accomplish the objectives outlined by the 2011-2015 FYP, the PBoC will need to move towards the implementation of a "prudent monetary policy". This implies a more important role for monetary aggregates, a strengthening of the role of the market in financial resource allocation, a push toward market-based interest rate determination, the promotion of financial market innovation and a deep reform of financial institutions. However, in achieving these objectives, the PBoC seems reluctant not to abandon the price and quantity instruments that characterize its monetary policy[13], although it has repeatedly stated that it will rely more and more on market-oriented monetary policy instruments. In addition, RMB exchange rate liberalization will be required to enable monetary policy independence. A peg to the USD would imply international reserve accumulation and offsetting sterilisation measures. Hence, moving forward there would appear to be three policy priorities:

1. **Interest rate liberalisation.** Interest rate liberalization is a precursor for capital account liberalization for two reasons. One, given the current low domestic rates on deposits it is essential to gradually reduce and eventually remove interest rate controls prior to liberalizing the capital account to avoid excess capital outflows leading to a liquidity crisis. Two, in an administered interest rate system competition in the banking sector is low and banks are not sufficiently incentivized to price risk appropriately leading to distortions in the allocation of resources. Interest rate liberalisation will need to be combined with the development of money market instruments for open market operations, allowing for the conduct of an active monetary policy.

2. **Gradual opening of domestic capital markets to international issuers and investors**. The Shanghai Stock Exchange (SSE) is on-track for the launch of an International Board, allowing overseas companies to offer RMB-denominated shares to domestic investors. The International Board only requires regulatory approval for a launch. According to local media, the SSE may allow the listing of about 10 foreign companies initially, with the central government aiming to

attract profitable companies from across the world to be listed on the SSE.

In addition to the creation of a broad onshore capital market, it is necessary to develop a deep and liquid corporate bond market to offer a full range of funding options to market participants, diversifying away from reliance on banks. A vibrant local RMB debt market would ease restrictions on capital flows as it can potentially absorb large capital inflows without creating asset bubbles in local markets, including in the property market. While China has a growing market for government bonds, the local market in corporate debt only accounts for 3% of China's GDP. Within the government debt market, the scope for diversification is wide, by opening the market to provincial and municipal issues, in particular, for financing infrastructure and development projects[14].

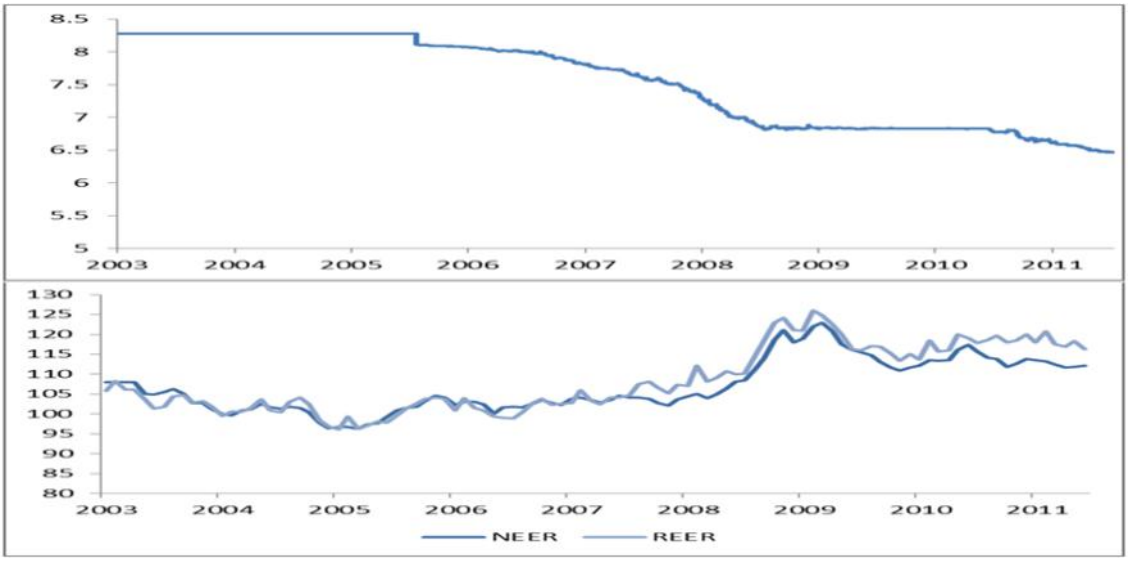
3. **Exchange rate flexibility**: China has moved to greater exchange rate flexibility as evidenced by a series of measures since 2005:

   i) *July 21st, 2005*: the PBoC announced a change in the exchange rate regime to "a managed floating exchange rate based on market supply and demand with reference to a basket of currencies". The dollar peg was abandoned for the peg to a basket of currencies, resulting in a cumulative appreciation against the dollar of about 9% by the end of 2007.

   ii) *End of July 2008*: Chinese authority decided to reinstitute the dollar-peg in the wake of the global financial crisis. According to the PBoC, the return to a pegged regime "contributed to stabilizing external demand, helped mitigate the impacts of the international financial crisis, and promote Asian and global economic recovery[15]".

   iii) *June 19th, 2010*: China announced their intention to manage the Renminbi more flexibly against a basket of currencies, abandoning the dollar peg again. Flexibility of the exchange rate also aimed at showing the international community China's efforts to ease the tension in China's trade relations with foreign countries and its attempts to lessen trade protectionism.

Figure 9: Exchange rate USD-RMB, Real & Nominal Broad Effective Exchange Rate Index in RMB



Source: Bloomberg, BIS

The outcome of the restored flexibility of the Renminbi exchange rate has been an increased appreciation of the Chinese currency against the dollar. Since June 2010, the Renminbi has appreciated by about 5% in nominal terms against the US dollar (7-8% real appreciation). Given the nominal appreciation but with on-going relatively high domestic price inflation, the real effective exchange rate (REER) of the RMB has been stable over the past year due to dollar weakness against major currencies.

RMB flexibility is desirable not only for addressing global imbalances in trade flows but also because the world requires an alternative reserve asset and currency to act as a hedge for the USD, providing diversification of risk benefits.

Potential Size of the Redback Market

If the above three criteria are met by 2015, in addition to the RMB's increased use in exchange markets, the IMF could grant the Chinese RMB entry into the SDR, which would de facto be a recognition of the currency. The "Redback" should ideally be, by then, the currency for commercial settlements, investments and reserves. A few assumptions and extrapolations give a rough idea of how plausible this scenario would be:

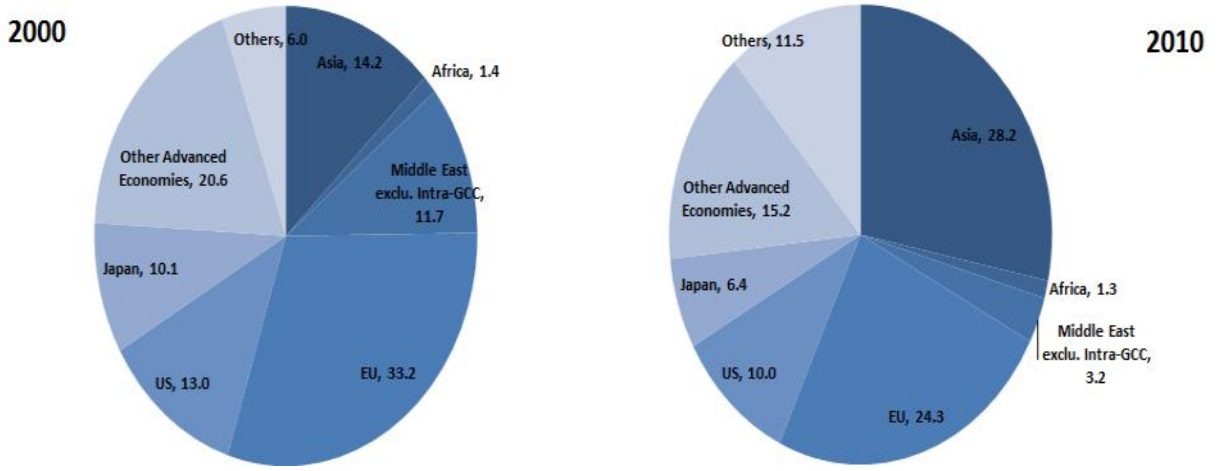
i) ***Use of RMB in international trade**:* China's cross-border trade settlement in RMB surged to RMB 957.57bn (USD 149.62bn) in the first half of 2011, rising 13.3% yoy, according to PBoC. Meanwhile, total trade reached USD 1.703 trillion in the first six months, implying that the overall use of Renminbi in trade was about 8.8% of mainland China's total exports and imports (in contrast with just under 3% at the end of 2010). This will rise with the extension of the programme to all of China's provinces. China's growing trade relations with emerging market economies strengthens the case for the use of the RMB in the settlement of cross-border trade flows. Given the growth of China's trade and increased access to cross-border trade settlement in RMB, the cross border settlement volume of the RMB in the next three years can be expected to account for between 30-50% of the total export-import volume ie. rising to USD 2 trillion by 2015, if not earlier.

ii) ***Use of RMB in international debt markets**:* RMB-denominated international debt securities denominated accounted for a mere 0.089% of international bonds and notes at end- Q1 2011[16]. A gradual opening up of the capital and debt markets – leading to a deep, broad and liquid market could lead China nearer to what was envisaged when the Euro markets opened up. According to the PBoC, the RMB bond market expanded 3.1% yoy in 2010 to RMB 5.1 trillion which is about 13% as a percentage of nominal GDP. If China is to move to a more balanced financial structure with debt markets about 30% of GDP, it would need to quadruple in size to about RMB 20 trillion (USD3.1 trillion) by 2015 (CAGR of roughly 30%).

iii) ***RMB use in forex markets and central bank reserves**:* the Chinese Renminbi accounted for only 0.9% of global foreign exchange market turnover in 2010[17], compared to 84.9% and 39.1% for the USD and Euro respectively. This reflects the restrictions imposed on the use of the RMB in international transactions. But China could radically change the current structure by developing the debt & capital markets, opening access, and achieving international integration of its markets. Econometric work Eichengreen and Frankel (1996) and Eichengreen (1997) suggests that, historically, a one percentage point increase of a country's as a share of world GDP (measured at PPP rates) is associated with a rise of between a 1 to 1.33 percentage points in that currency's share of central bank reserves. Given that, currently, the RMB represents a negligible fraction of central bank reserves, whereas China currently represents 14.4% of global GDP (measured at PPP rates) and is expected to grow to 18% by 2015, theoretically, the RMB could represent about 18% to 24% of central bank reserves by 2015.

Some 30 years ago, Western Europe and North America accounted for 85%, the lion's share of GCC trade. There has been a massive shift in GCC trade patterns. Asia, which in 2000 accounted for just 14% of total GCC trade garnered close to 30% of total trade in 2010 (Figure 10) – a remarkable shift in only a decade.

Figure 10: Remarkable Rise in Emerging Markets as GCC's trade partner (imports)

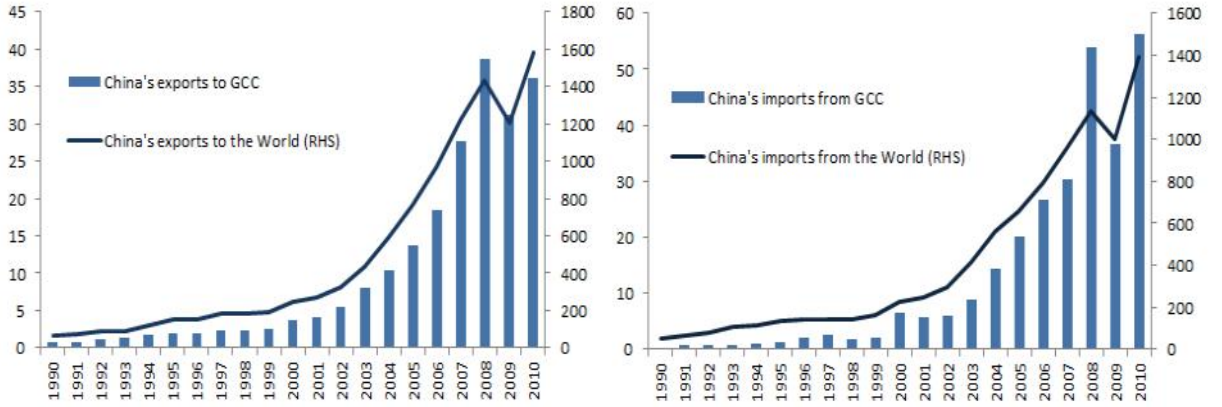


Source: IMF DOTS

The shift, in part, reflects high growth in the emerging markets (notably China) and rising demand for oil. However, oil is only one of the major components of trade, which has become more diversified to other goods and commodities like chemicals, steel and aluminium in addition to textiles, machinery and mechanical appliances.

In 2010, China-GCC total trade accounted for 3% of China's total global trade – compared to about 1% in the 1990s. Since 2000, Chinese exports to the GCC have increased almost ten-fold to USD 36bn, while trade flows in the opposite direction have increased close to eight-fold, at USD 56.4bn (at an all-time high). This trend is likely to be maintained given the anaemic growth prospects of Europe and US compared to the emerging market economies. McKinsey predicts that by 2020, total trade flows between China and the Middle East will climb to between USD 350-500 billion, with China-GCC trade accounting for the majority share.

Figure 11: China-GCC Trade Patterns vis-à-vis China's Global Trade (in USD bns)



Source: IMF DOTS

Saudi Arabia and the UAE feature among China's top 20 major trading partners. The balance of China-GCC bilateral trade is in favour of the GCC countries because of Chinese dependence on imported oil. China has already surpassed US as the largest importer of oil in terms of average barrels-per-day from Saudi Arabia and the International Energy Agency predicts that China will import 70% of its oil from the GCC by 2015.

In addition to trade flows, China- GCC investment flows have been on the rise (Table 7) as GCC economies open and increase the diversification of their economies. China's overseas FDI (OFDI) are mainly located in Asia and Latin America (almost 90% of total OFDI) with Africa the third largest recipient for China's OFDI. Given the UAE's central geographic position halfway between Africa and China with good logistics and communications, it is seen as a gateway into Africa, leading to a large number of Chinese companies being based in the UAE, but catering to Africa.

Table 7: China's Outward FDI flows to GCC: 2003-2009 (in USD mns)

	2003	2004	2005	2006	2007	2008	2009
Bahrain	0.05	n.a	0.07	-1.92	n.a.	0.12	n.a.
Kuwait	n.a.	1.69	n.a.	4.06	-6.25	2.44	2.92
Oman	n.a.	n.a	5.22	26.68	2.59	-22.95	-6.24
Qatar	1	0.8	n.a.	3.52	9.81	10	-3.74
Saudi	0.24	1.99	21.45	117.2	117.96	88.39	90.23
UAE	9.37	8.31	26.05	28.12	49.15	127.38	88.9
GCC	**10.66**	**12.79**	**52.79**	**177.66**	**173.26**	**205.38**	**172.07**

Source: Statistical Bulletin of China's Outward Foreign Direct Investment 2010, Min of Commerce

Given the shift in global economic geography towards emerging market economies and Asia/China and the accompanying shift in trade patterns, the GCC countries need to restructure and re-orient their banking, trade & investment strategies and policies accordingly. It is time to fast track the regional (GCC) free trade and investment agreement with China. The trade negotiations, initiated in 2004, have gone through five rounds of negotiations and reached agreement on issues relating to trade in goods. While clarifications are still on-going on trade in services, it is critical to include investment policies as part of the agreement, given the scope of bilateral investment and the common strategic interests of the sovereign wealth funds in China and the GCC. Although still under consideration, Chinese President Hu Jintao has underlined several times the urgency of such an agreement that would be "in the fundamental and long-term interests of both sides"[18].

Strategic partnerships however need not be limited to just trade and investment. These are but the tip of the iceberg in terms of potential for cooperation. Financial linkages via cross-listings of companies at stock exchanges, listing of IPOs, raising funds through conglomerates and joint ventures through regional capital markets are all possibilities that can be explored further. Chinese companies can list in the GCC markets, and notably in the DIFC. GCC companies will be able to tap the Redback market. The DIFC has signed cooperation agreements with the authorities in Shanghai/ Pudong and Chengdu to facilitate these links. Additionally, a China-GCC partnership can be envisaged for financing reconstruction and development projects in the region and for infrastructure investment.

The DIFC as an Overseas RMB Centre

It is in the GCC's strategic interest to move towards greater economic & financial integration with China. This should include developing and facilitating trade finance and moving towards using the Renminbi for the settlement of trade with China. Using the USD or the Euro to finance GCC-China trade is incongruous, raises transactions costs, and generates exchange rate and counterparty risks at a time in which the US and European banking systems continue to suffer the aftershocks of the Great Financial Crisis, limiting their ability to finance the trade of emerging markets. To mitigate these risks requires developing direct banking relationships between GCC banks and their Chinese counterparts as well as between GCC central banks and the PBoC. Banks in the UAE have started opening RMB accounts for their corporate clients; this should be accelerated. Trade between the GCC and China should be undertaken using the RMB.

Further, the growing trade and investment flows would benefit from setting up GCC-China bilateral Renminbi local currency central bank swap arrangements (see Table 4). Given the proportionality between the volume of trade with the GCC and the required level of swap lines, a GCC-China Renminbi swap line would amount to about RMB 150bn, given that the GCC countries account for about 2.5% of China's total trade (somewhat larger than Singapore). Such a proposed China-GCC RMB swap agreement would strengthen the banking and financial links and help promote trade and investment flows. A slight practical complication is that until a common GCC central bank is established, bilateral Renminbi swap lines will need to be established with the individual GCC central banks, in proportion to the level and growth of bilateral trade.

As the RMB goes international, the Dubai International Financial Centre (DIFC) can become an overseas hub for trading Renminbi in a time zone that completes and complements Hong Kong. Singapore has already made a move to create an RMB clearing centre by giving Singaporean banks direct access to Renminbi rather than having to route transactions via Hong Kong or commercial banks in China. A similar role could be envisaged for Dubai and the DIFC, given the growing MENA/GCC-China trade and investment links and Dubai's locational advantage midway between Europe and Asia.

Mainland Chinese financial institutions have moved to obtain direct access to the UAE and regional markets through the establishment of Chinese banks in the UAE. The first Chinese bank to get a license to operate from UAE's Central Bank was ICBC, with a wholesale banking license secured in December 2009. ICBC, formally established in the DIFC since 2008, has since expanded with branches in Dubai, Abu Dhabi and Doha. As noted above, China's foreign trade with MENA & the GCC should be financed with the use of Renminbi as the settlement currency for trading transactions so as to create a Redback-denominated banking & financial partnership. The growing trade between the MENA region and China has opened the way to the supply of Renminbi-denominated financial services by international foreign banks[19].

The DIFC, with its Real-Time Automated Payments in the DIFC (RAPID) initiative, would be a natural link for China to internationalise clearing & settlement of the Redback in the MENASA (Middle East, North Africa and South Asia) region. RAPID will provide real-time gross settlement (RTGS)[20] of foreign currencies- initially USD and Euro- from the DIFC to DIFC banks and banks in the wider MENASA region. Since the design architecture of RAPID is modular, it can be expanded to include the RMB with Chinese banks acting as settlement banks.

The growing trade links between MENA/ GCC and China, create an opportunity for the DIFC to become the payments clearing centre for the RMB in the MENA region. The DIFC has the payments infrastructure, laws (including a modern payment system settlement finality law) and experienced regional and international banks and financial institutions with extended networks of correspondents enabling the DIFC to become the MENA region's clearing centre for the RMB. China needs to set up more offshore centres to achieve its goal of internationalizing the Renminbi. Following Hong Kong and Singapore, the DIFC is best-located in terms of time zone and supporting infrastructure, participants and markets and network to be the RMB clearing centre for the MENASA and Africa regions.

Concluding Remarks

A multi-polar world requires a new financial and monetary infrastructure. The post-WWII Bretton Woods period has been one where the US dollar was dominant in international monetary and financial transactions. The advent of the Euro in 1999 did not end the hegemony of the US dollar. Indeed Europe's fiscal and sovereign debt problems are threatening the future of the Eurozone and the role of the Euro as an international currency. By contrast, the growth of China as an economic superpower with an increasingly dominant role in international trade and investment has not been matched by an international role for the Renminbi.

The coming decade will witness the rise of the Redback as an international currency increasingly used in international transactions and payments. The internationalisation of the Renminbi will require and should be preceded by financial sector development and reform in order to remove barriers and distortions. The internationalisation of the Redback requires the development of deep and liquid Redback bond and capital markets prior to achieving a full convertibility of the Renminbi and removal of exchange and capital controls. The world needs the Renminbi to become a global currency in order to deal with global imbalances, to wean the US away from its addiction to debt and external deficits that were allowed it as an exorbitant privilege and for China to play a stabilising role in the world economy and new financial architecture.

The process of Renminbi internationalisation has started with the growing use of the Renminbi for the settlement of trade with China and the beginning of an offshore bond market and the establishment of Renminbi swap lines between the People's Bank of China and a number of central banks. The process will continue with increased capital account liberalisation and greater exchange rate flexibility. We expect that the Renminbi will be part of the IMF's SDR by 2015 confirming the move to a tri-polar global currency system, assuming the Euro survives.

Over the past decade China has become the major trade partner of the GCC countries. The MENA and GCC countries need to prepare themselves for the coming of the Redback. A number of strategic policy initiatives are required in order increase the economic and financial integration between the GCC and China for the benefit of both parties. The China-GCC Free Trade Agreement negotiations need to be put on a fast track and concluded in order to provide a framework for the expansion of trade in goods and services as well as investment. Banks should expand their banking links and relationships with Chinese banks, and open RMB accounts for their clients. A Renminbi swap agreement should be negotiated and put in place between China and GCC central banks in order facilitate the financing of trade and payments.

The coming of the Redback provides an opportunity for the DIFC to become the clearing and settlement centre of the Renminbi for the MENA region using the real time gross settlement system established in the DIFC (RAPID), with a legal and regulatory infrastructure –encompassing payment systems- and experienced international banks and financial institutions with extended regional and global networks of correspondents. We need to be prepared for the coming of the Redback.

Endnotes

[1] SWF Institute.

[2] According to Article XXX of the Articles of Agreement of the IMF, in Paragraph (f), “A freely usable currency means a member's currency that the Fund determines (i) is, in fact, widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets.”

[3] As a share of world trade.

[4] See IMF, Review of the Method of Valuation of the SDR, 26 October, 2010.

[5] Under the Pilot Program, if a foreign firm wants to export to China, it is allowed to receive RMB as the settlement currency only if it exports to one of the 20 Chinese regions; conversely, if a foreign firm wishes to pay in Renminbi for imports from China, its Chinese trading partners must be one of the 67,359 eligible exporters nominated by the PBoC.

[6] The PBoC issued a "Circular on Clarifying Relevant Issues Regarding Cross-Border RMB Business" in June 2011 setting out the application process for foreign direct investment in RMB with a view to meeting the growing demand for RMB direct investments by foreign institutions.

[7] Source: Moody’s

[8] http://www.efinancialnews.com/story/2011-06-24/more-dim-sum

[9] See the additional discussion below in the section on “Monetary Policy: Effectiveness & Steps to Internationalize RMB”

[10] For a discussion of the issues see the papers in “Sequencing Financial Sector Reforms: Country Experiences and Issues’, R. Barry Johnston & V. Sundararajan editors, IMF, 1999.

[11] The 2011-15 FYP specifies the pre-requisites to the ultimate goal of capital account liberalization: stable macroeconomic conditions, a liberalized interest rate environment, a strong regulatory and supervisory framework, and broad, deep and liquid financial markets and the authorities are likely to focus on these factors alongside the all-important task of correct sequencing of reforms.

[12] Given that the state-owned commercial banks have substantial excess reserves parked at the PBoC, the latter’s concern about the effectiveness of policy interest rates changes is justified: the existence of substantial excess reserves makes banks less sensitive to changes in its policy interest rates in the interbank market; policy instruments such as the rediscount rate and reserve requirements are not only less effective but also less predictable in their outcomes.

[13] PBoC continues to use interest rates and the reserve requirement ratio, but is also increasing the use of open market operations (OMOs). The combined use of flexible and controlled policy instruments place Chinese monetary policy in the stage between the identification as an open market and closed market economy, leading to the policy being considered as a policy of indirect monetary and credit controls.

[14] The Ministry of Finance said it would allow four regional governments (Guangdong, Shanghai, Shenzhen, and Zhejiang), to issue three- and five-year bonds under a pilot scheme This process has been initiated by Shanghai Municipality which on 19 November, 2011 auctioned 3.6 billion Yuan in three-year bonds with a yield of 3.1% and 3.5 billion Yuan in five-year bonds at 3.3%.

[15] http://tinyurl.com/63ykuro

[16] Source: BIS International debt securities statistics

[17] Source: BIS Triennial Central Bank survey

[18] http://fta.mofcom.gov.cn/enarticle/engcc/engccnews/200911/1628_1.html

[19] In 2010, Standard Chartered Bank became the first foreign bank in the Middle East to open an RMB account for its clients in the UAE when it launched RMB denominated account with full transactional capabilities. From July 2011, HSBC has also started to offer its clients the possibility to trade with China, under the rules dictated by the PBoC, receiving and paying in Renminbi without having exposure to other foreign currencies.

[20] RTGS systems effect final settlement of interbank funds transfers on a continuous, transaction- by-transaction basis throughout the processing day, that is, on an order by order basis (without netting).

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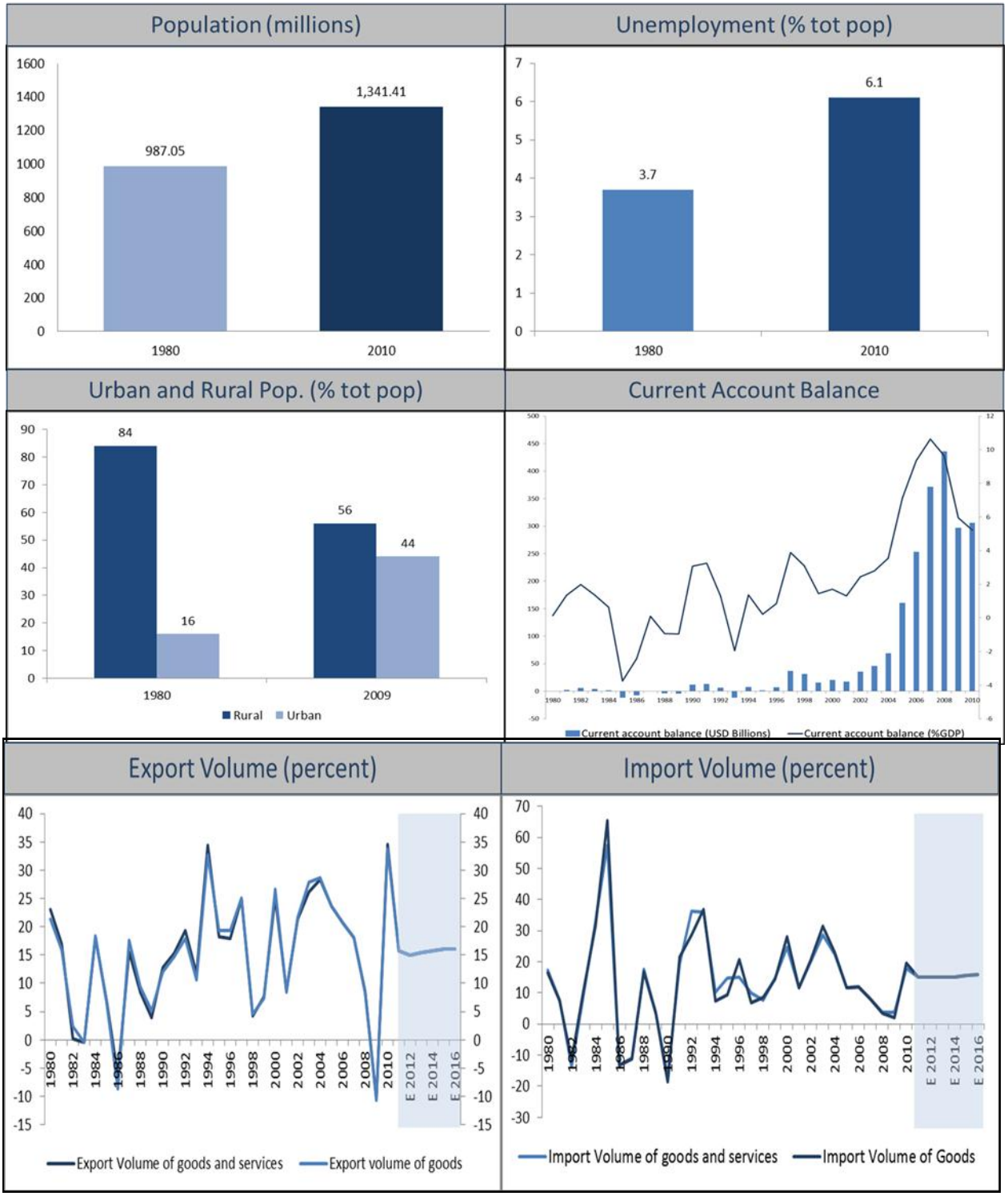
Appendix I: China – A Macro View



Source: IMF, World Bank WDI, EIU

Appendix II: The 12th Five-Year Plan- Moving Ahead

The National's People Congress, the top legislature in the Chinese government system, in March 2011 approved the 12th Five-Year Plan (FYP) that regards the strategy for economic and social development for the period 2011-2015. This plan presents the key of objectives of the Chinese policy for the next five covering a wide range of issues, from economic and monetary reforms to social management, including population's birth controls, from infrastructure projects to environment and clean energy. In terms of economic reforms the path that the Chinese government wants to take for the next few years is characterized by the following main points:

1. Price stabilization
2. Rise in domestic consumption
3. Liberalization of monopolistic sectors
4. Development of domestic stock markets

The recent trend of increasing inflation is an issue of particular concern for the Chinese policy makers. For this reason the stability of price levels has become one of the top priorities of the Chinese government in terms of macroeconomic control. The economic and legal methods proposed in the plan to strengthen inflation control include management of market liquidity and control of market condition and in particular control of the commodity prices rising too high, development of the production of consumer goods, adjustment of imports and exports and improvement of the Chinese ability to control the markets, enforcement of laws against illegal behaviours to drive up prices such as price collusion or market speculation, the provision of a mechanism of social assistance and social security benefits when commodity prices rise.

The dramatic numbers that have characterized Chinese economic growth in the last few years are mainly due to a strong dependence on the international market. Chinese growth relies mainly on investment (over 50% of GDP) and exports (net exports over 10% of GDP) and not enough on domestic consumption (less than 40% of GDP), making the Chinese economy highly dependent on the worldwide economic trend. For this reason the 2008 financial crisis affected also the Chinese economy, slowing down its average double-digit rate of growth and forcing the Chinese government to increase fiscal stimulus measures to compensate for shrinking global demand. Also for the period 2011-2015 the Chinese government is expected to boost domestic consumer demand with the provision of subsidies to low income and rural population, relaxation of restrictions on market access and elimination of all visible and invisible barriers.

In a general plan of strategic economic restructuring that will involve also an adjustment and optimization of the industrial structure, a relevant role will be played by the encouragement, support and guide for the development of the non-public sector of the economy. This will be done with the scope to create an industrial system that gives impetus to industrial transformation and upgrading.

Appendix III: "Dim Sum" Bond Issues by non-Chinese non-financial companies

Name	Issued Date	Maturity	Curr	Amt(M)	Coupon	Country Name	Industry
Caterpillar Financial Services Corp	7/6/2011	7/12/2013	CNY	2,300,000	1.35	UNITED STATES	Fin-Commercial
CJ Global Holdings Ltd	6/22/2011	7/6/2014	CNY	1,100,000	2.25	HONG KONG	Industrial
Fonterra Cooperative Group Ltd	6/17/2011	6/27/2014	CNY	300,000	1.1	NEW ZEALAND	Industrial
Far East Horizon Ltd	5/26/2011	6/3/2014	CNY	1,250,000	3.9	HONG KONG	Fin-Leasing
China Power Intl Development Ltd	5/17/2011	5/17/2016	CNY	982,000	2.25	HONG KONG	Utility-Elec
Volkswagen International Finance NV	5/16/2011	5/23/2016	CNY	1,500,000	2.15	NETHERLANDS	Special Purpose
China Chengtong Development Group	5/11/2011	5/19/2014	CNY	600,000	4.5	HONG KONG	Industrial
Global Logistic Properties Ltd	5/3/2011	5/11/2016	CNY	2,650,000	3.375	SINGAPORE	Industrial
Global Logistic Properties Ltd	5/3/2011	5/11/2018	CNY	350,000	4	SINGAPORE	Industrial
Century Tokyo Leasing Corp	4/20/2011	4/28/2014	CNY	200,000	2.7	JAPAN	Fin-Leasing
BYD HK Co Ltd	4/19/2011	4/28/2014	CNY	1,000,000	4.5	HONG KONG	Industrial
UA Finance BVI Ltd	4/18/2011	4/28/2014	CNY	500,000	4	HONG KONG	Special Purpose
Chenming HK Ltd	4/7/2011	4/13/2014	CNY	500,000	2.95	HONG KONG	Industrial
Singamas Container Holdings Ltd	4/6/2011	4/14/2014	CNY	1,380,000	4.75	HONG KONG	Industrial
Mitsubishi UFJ Lease & Finance Co Ltd	3/31/2011	4/8/2013	CNY	200,000	1.65	JAPAN	Fin-Leasing
HKCG Finance Ltd	3/31/2011	4/11/2016	CNY	1,000,000	1.4	HONG KONG	Special Purpose
ORIX Corp	3/15/2011	3/24/2014	CNY	400,000	2	JAPAN	Fin-Leasing
GDH Ltd	3/11/2011	3/16/2012	CNY	800,000	4.36	HONG KONG	Industrial
BECL Investment Holding Ltd	2/14/2011	2/21/2014	CNY	1,150,000	4.75	HONG KONG	Special Purpose
Intl Finance Corporation	1/27/2011	1/27/2016	CNY	150,000	1.8	SNAT	Supranational
Intl Bank for Recon&Dev	1/14/2011	1/14/2013	CNY	500,000	0.95	SNAT	Supranational
China Power Intl Development Ltd	12/14/2010	12/23/2015	CNY	800,000	3.2	HONG KONG	Utility-Elec
Galaxy Entertainment Group Ltd	12/9/2010	12/16/2013	CNY	1,380,000	4.625	HONG KONG	Industrial
Caterpillar Financial Services Corp	11/24/2010	12/1/2012	CNY	1,000,000	2	UNITED STATES	Fin-Commercial
China Merchants Holdings Hong Kong Co	11/15/2010	11/19/2013	CNY	700,000	2.9	HONG KONG	Industrial
Export-Import Bank of Korea	11/15/2010	11/15/2015	CNY	330,000	0.75	SOUTH KOREA	Gov Agency
China Resources Power Holdings Co Ltd	11/9/2010	11/12/2013	CNY	1,000,000	2.9	HONG KONG	Industrial
China Resources Power Holdings Co Ltd	11/9/2010	11/12/2015	CNY	1,000,000	3.75	HONG KONG	Industrial
Sinotruk Hong Kong Ltd	10/22/2010	10/29/2012	CNY	2,700,000	2.95	HONG KONG	Industrial
Asian Development Bank	10/18/2010	10/21/2020	CNY	1,200,000	2.85	SNAT	Supranational
Sound Global Ltd	9/15/2010	9/15/2015	CNY	885,000	6	SINGAPORE	Industrial
McDonald's Corp	8/19/2010	9/16/2013	CNY	200,000	3	UNITED STATES	Industrial

Source: Bloomberg

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