

An Analysis of Recycling Dilemma of Overseas RMB Bond

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Abstract –With the process of RMB internationalization, the RMB business is growing prosperously in Hong Kong. The large number of RMB has promoted the rapid development of foreign bonds. This article showed the present situation of foreign bond from the RMB business development in Hong Kong, analyzed the advantages of the bond financing abroad and the pros and cons of the recycling of overseas RMB, and then divided the recycling methods based on the main supervisory authorities' function and combined with the government policy to discuss the feasibility of the RMB recycling channels. According to the survey, we can get the conclusion that to change this recycling dilemma of overseas RMB bond, we should accelerate improvement in the foreign exchange management system and achievement in free convertibility of the RMB in capital account as soon as possible. At the same time, steadily expand the scope of cross-border RMB trade settlement to promote offshore RMB stably and orderly reflux.

Keywords – Foreign bond, RMB bond, Capital recycling

1. Present situation of foreign bond

Along with the advancement of RMB internationalization, Hong Kong is gradually becoming the most important offshore centre of RMB. According to the statistics of Deutsche Bank, by the end of 2011, over 132 financial institutions in Hong Kong provide RMB business service. In 2010, Hong Kong RMB deposits reached 300 billion yuan, nearly 5% of the total amount, a year-on-year growth of 376%. Meanwhile, by the end of 2011, 10.4% of Hong Kong banking deposits is that of offshore RMB, an increase to as much as 620 billion yuan. According to the prediction of a recent research report issued by Deutsche Bank, Hong Kong's offshore RMB deposits will reach 2000 billion yuan by the end of 2012; cross-border RMB trade settlement will by that time arrive at 3700 billion yuan, accounting for 15% of China's global trade. In the process of the rapid expansion of Hong Kong RMB market, there is no doubt that more varieties, more innovative RMB products will enter the capital market one after another, for instance, enterprise bond, stocks, and even financial derivative products such as RMB futures, etc. Especially, Hong Kong offshore RMB bond market is increasingly developing fast. Among the RMB bonds issued abroad, those settled with RMB is called "Dim Sum Bond" (all this time, the amount of Hong Kong RMB bonds is evidently less than the total deposits, while the deposit interest is lower than that of the bond. As a result, once RMB bonds come into market in Hong Kong, investors will swarm for oversubscription, feeling not enough as if tasting dim sum of cakes. Therefore, this type of bonds acquire the name "Dim Sum Bond") Presently the bonds

are issued mainly in Hong Kong. Ever since 2007 when China Development Bank first issued RMB bonds in Hong Kong, five inland banks including Bank of Communications, Bank of China, China Construction Bank, China Development Bank and Export-Import Bank of China have obtained the permission of issuing RMB bonds. From 2007 to 2010, the sums of RMB bonds issued in Hong Kong are respectively 10 billion yuan, 12 billion yuan, 16 billion yuan and 21 billion yuan. By the end of 2011, the sum amounted to 150 billion yuan, taking up 10% of Hong Kong deposits, and RMB has become the third currency after Hong Kong dollars and US dollars. In addition, money lenders grow from inland financial institutions at first to subsidiaries of the National Treasury and Hong Kong Bank in 2009, and expanded further to multinational enterprises and international financial institutions in 2010. The year of 2011 has witnessed the further development of Hong Kong RMB bonds. 38 institutions issued 42.7 billion yuan bonds from January to June in 2011, in contrast to 35.8 billion yuan bonds issued by 16 institutions in 2010. In October of 2011, National Development and Reform Commission authorized Baosteel Group to issue RMB bonds with the maximum scale of 6.5 billion yuan. So Baosteel Group became the first inland enterprise that issued "Dim Sum Bond" in Hong Kong. At the end of April of 2012, four central stated-owned enterprises including Huaneng Power International, Datang Group, Minmetals Corporation, and China Guangdong Nuclear Group got permission of issuing "Dim Sum Bonds" in Hong Kong with the sum of 18.5 billion yuan. So far, the total amount reached 25 billion yuan with the permission of National Development and Reform Commission. It is predicted that by the end of 2012 net offshore RMB

bonds will have been 240 billion yuan, of which 150 billion yuan is used for foreign direct investment.

2. Analysis of the advantages of the bond financing abroad

2.1 Low cost

The stock of RMB in Hong Kong has exceeded 450 billions in 2011, But the RMB investment products are extremely scarce in Hong Kong. In this situation, the corporate bond with good credit qualification will be popular among investors who have RMB. In addition to that the rate of RMB bond and the agency fee of it are also far less than those of Dollar bond.

2.2 No need to grade.

When issue RMB bond, it is not like dollar bond, there is no need to grade the corporate. As long as the corporate has a good credit qualification, you can get a good release effect.

2.3 High efficiency of financing.

As there is no need to grade and the target investors are in Hong Kong, from the view of time cost, issue RMB bonds can shorten released, it only needs four to eight weeks.

3. The pros and cons of the recycling of the overseas financing RMB

3.1 The pros of the RMB recycling

3.1.1 It can enhance the RMB cross-border settlement attractive

The international market's acceptance standards to RMB can affect the RMB's further progress for cross-border, and overseas financing RMB recycling mechanism also has the key control to RMB for overseas acceptance standards. In the case of the RMB offshore market function is not perfect, the overseas RMB may be lower the acceptance standards to RMB because of the recycling is not smooth. Therefore, improve overseas financing RMB recycling mechanism can adjust the relationship between current account and capital account and then enhance the RMB cross-border settlement attractive.

3.1.2 It can establish RMB "Strong Regional"

According to the dollar and other international currency's flow experience, we can get the conclusion that "Strong Regional" is the most important way of currency internationalization. The establishment of RMB recycling mechanism can help to establish RMB regionalization. For instance, it can provide advantage for overseas RMB derivative and stable and efficient international payment and settlement system.

3.1.3 Promote the capital market's tactics process

The largely increase of RMB abroad has stimulated the demand of buying the financial assets from the foreign institutions. China's central bank is making a great effort to introduce the "Small QFII" model to recover the RMB abroad. This kind of recycling model can meet the requirement of the internationalization step by step from the capital market. It can open another path for the RMB abroad without bypass the OFII amount at present. In the context of capital projects open gradually, it is much important and wise that tactics is promoted step by step. It would appear that the RMB recycling moderately can meet the requirements.

3.2 Potential risks of large-scale recycling

3.2.1 It can lead to enlarging the size of credit and affect the monetary policy effects.

The recycling of RMB will bring in derived Deposits which can increase the inflationary pressure in China and weaken the effects of the monetary policy. The deposits can also block us from achieving the Intermediate target and the ultimate goal of the monetary policy. As it is difficult to set quantitative indicator, the recycling RMB may influence the central bank's money supply and withdrawal from circulation process. Further more, there is no request about the statutory reserve ratio in Hong Kong offshore finance market. That is to say, Banks in Hong Kong usually keep a lower reserve ratio compared with banks in onshore finance markets. The recycling money may impact the China's monetary policy system due to the money creation multiplier. As everybody knows that the trade finance and foreign debt can enlarge the size of credit and the trade finance is beyond the central bank's credit control area, Large-scale recycling of RMB will weaken the monetary policy effects.

3.2.2 It may easily cause banking risks

The money circulate out of the balance sheet may avoid the monitor from authority. The laws and regulations about RMB financing abroad are immature. The commercial banks prefer to make sure the standards of accounting treatment by using the advantage of the policy loopholes. It is not only harmful for commercial banks realize the risk generate from themselves but also bring a lot of problems to the regulatory bodies, such as the central bank and administration of foreign exchange.

3.2.3 It may exacerbate hot money inflows

The RMB interest rate in Hong Kong is lower than it within borders. We could get less 50-100 base points, if we issue bonds in Hong Kong rather than in mainland. We can say that the interest rate differential and the exchange differences can produce Cross-border capital arbitrage. The investor can exchange their arbitrage capital into RMB, and then get them back according the RMB recycling channel, that is how to arise the hot money risk.

3.2.4 It will affect the stability of the RMB exchange rate

For one hand, the short term large-scale recycling of RMB will change the relationship between RMB supply and demand in the international finance market and increase the RMB appreciation pressure. For another hand, we have adopted a managed floating exchange rate system after the exchange rate revolution, but the exchange rate in Hong Kong is determined by supply and demand. The investors can use the Hong Kong finance market to impact the RMB exchange rate regime.

3.2.5 It would be impact the development process of RMB offshore market

The experience about development process from international monetary tells us that the important prerequisite to turn a currency into hard currency is that we should have a large number of this currency overseas. In general, the money recycling channels are below: Issue bond abroad; Allow the qualified abroad investors invest the domestic securities market; Foreign direct investment and so on. As the RMB recycling channel is unsound, most of the money back to mainland by trade financing method, it's harmful RMB internationalization.

3.2.6 It will lead to absence of regulation or impact the foreign exchange management policy

In accordance with the existing system, RMB business is under the control of central bank. As the central bank hasn't classified RMB foreign debt into management of the balance of indicators, that can increase the recessive foreign debt.

4. RMB Recycling methods and Controlling Factor Analysis

Based on the main supervisory authorities' function, there can be listed four authorities: The People's Bank of China; Ministry of Commerce; State Administration of Foreign Exchange and National Development and Reform Committee.

4.1 From the main supervisory authorities of The People's Bank of China:

4.1.1 RMB Deposit Recycling

Hong Kong's RMB is put in Hong Kong's banks by deposit, and Hong Kong banks then put into the settlement banks -- BOC Hong Kong, after that, BOC Hong Kong put into The People's Bank of China. The Announcement of The People's Bank of China (2007) No. 3 clearly points out the Mainland's financial agencies can issue the RMB financial bond in Hong Kong after obtaining approval, all the collected RMB can be input into the Mainland's financial agencies that have the qualifications of RMB business via Hong Kong RMB

business settlement banks (hereinafter refers as settlement banks).

4.1.2 RMB Foreign Debt

RMB invests Mainland's bond markets between banks. In 2010, The People's Bank of China issued Notice of Pilot Point for Related Overseas RMB Settlement Banks Three Agencies Invest Bond Market between Banks by RMB, the notice indicates the related RMB Settlement Banks Three Agencies refer to overseas Central Bank or Currency Authority, Hong Kong, Macau Regions RMB Settlement Banks, the overseas banks join the cross-border trade RMB settlement, which can use RMB to invest Mainland's bond markets between banks.

4.1.3 Shareholder's Loan

As the Shareholder's Loan is not within the supervisory scope of Ministry of Commerce, The People's Bank of China refines the issue of RMB Loan: Foreign-invested enterprises loan RMB from their overseas shareholders, affiliated enterprises and overseas financial agencies, the RMB loan should be combined with foreign exchange loan into the total amount, and also should obey the existent foreign debt management regulations: 1. the loan amount is not allowed to exceed to the limits of the difference between investment and registered investment; 2. proceed the foreign debt registration procedure from State Administration of Foreign Exchange.

4.2 From the main supervisory authorities of Ministry of Commerce:

4.2.1 RMB Trading Financing

Trading financing is the important method for foreign-related enterprise to ease the financial pressure. Since the pilot point for RMB cross-border settlement, the trade financing priced by RMB develops rapidly, the financing product innovation arose from RMB cross-border settlement appears a lot, e.g., "Export RMB overseas payment" from Industrial and Commercial Bank of China (ICBC), "Agreement financing" from Bank of China, etc.

4.2.2 RMB Direct Investment

In correspondence with the rapid development of Hong Kong RMB bond, in order to complete the regulation of bond-issuance in Hong Kong, on Oct 12th, 2011, after two-month public survey, Ministry of Commerce officially issued Notice of Cross-Border RMB Direct Investment (MOC Investment Announcement [2011]No.899) (hereinafter refer to MOC No. 889). On the second day, The People's Bank of China issued Management Regulation of Foreign Direct Investment RMB Settlement (PBC[2011]No. 23) (hereinafter refer as PBC No. 23). These two announcements formally established the channel for RMB recycling into China's mainland via foreign investment, and increasing the

development of the offshore RMB fund and push the offshore RMB bond and financing markets.

4.2.3 Shareholder's Capital Input

Strictly speaking, Shareholder's capital also belongs to foreign direct investment (FDI). According to Article 14 of The People's Bank of China Announcement [2007] No. 3 issued by The People's Bank of China on Oct 13th, 2011, points out the RMB gained from the profit allocation, advance recycling investment, settlement, reduction of capital and equity transfer by the overseas investor is used for domestic to re-invest or increase registered capital, the overseas investor can put RMB into the deposit account and re-invest into the assigned deposit account and follow the Announcement to process related settlement business.

4.3 From the main supervisory authorities of State Administration of Foreign Exchange:

4.3.1 Stock Market

When Li Ke Qiang, Vice Premier of China's State Council visited Hong Kong, he clearly stated: it is allowed to invest domestic securities market by RMB Qualified Foreign Institutional Investors (RQFII), the initial amount is RMB20,000 million, which further open the capital market and open another channel for RMB recycling domestic capital market. Once the business is open, the RMB fund stays in Hong Kong will pour into the domestic stock market and debenture market.

4.4 From the main supervisory authorities of National Development and Reform Committee:

4.4.1 Baosteel Mode

On Oct 20th, 2011, after the approval of China's State Council, National Development and Reform Committee agreed Baosteel Group Ltd., Co go to Hong Kong to issue 6,500 million RMB bond, this is the first time for mainland's enterprise got approval to go to Hong Kong to issue bond. Therefore, the channel of going directly to Hong Kong to issue bonds is open for domestic enterprises; the previous mandatory requirement for overseas platform is not strong. It can be anticipated that more large-scale enterprises will go to Hong Kong to see the low-cost financing. As to the fund recycling method, enterprises can refer to the Baosteel project and submit the application to the Foreign Investment Department of National Development and Reform Commission, after the preliminary approval, the application will be sent to State Council for further approval. After the approval from State Council, the application will send to National Development and Reform Commission and copied to State Administration of Foreign Exchange. By following this method, the issued bond to collect fund can be taken into the mainland directly.

5. Discussion

The reasons of the RMB back-flow obstacles are as follows: First, It is difficult for overseas RMB holders to find to maintain and increase value in the unsound RMB offshore market where the channels for the use of overseas RMB are narrow. Second, China's strict capital requirements and investment controls make Overseas RMB not easy to flow back into the domestic to look for investment opportunities. Third, the domestic inter-bank bond market is only open restrictively to the three types of institutions abroad. Fourth, the business development of the offshore RMB bond is not enough mature. Since State Bank issued bonds in Hong Kong for the first time in 2007, regulators has surprisingly tough restrictions on the bond's debtor and debt issued the place.

6. Conclusions

To change this recycling dilemma of overseas RMB bond, we should: First, accelerate improvement in the foreign exchange management system and achievement in free convertibility of the RMB in capital account as soon as possible. Second, steadily expand the scope of cross-border RMB trade settlement and promote the import and export business as soon as possible, to promote the RMB orderly back-flow. Third, to speed up reform a successful OFC will not only help to return the offshore RMB, but also be able to increase the pricing power of the RMB derivatives. Fourth, RMB bond business continues to grow at the same time, expanding the issuers, so that the issuers can become diversified and issued places different. It also may be appropriate to consider the issuance of RMB bonds in different markets abroad to guide RMB back-flow. At the same time, expand the issuance of varieties, such as considering the issue of financial bonds, infrastructure bonds, ordinary corporate bonds, asset securitization and other forms of financial products. Besides, regulate reasonably the interest differential to promote offshore RMB stably and orderly reflux.

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Vitae

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