Offshore Renminbi – Another year of progress ahead

- 2014 was another strong year for CNH market development, with the RGI rising 53%
- We outline our top 10 calls for 2015 for the Renminbi and its internationalisation
- Formosa bonds are set to receive more policy support; KRW-CNY direct trading enjoys a strong start

Summary
The Standard Chartered Renminbi Globalisation Index (RGI) climbed to 2,089 in December 2014, rising 2.0% m/m – the fastest gain in three months. Cross-border Renminbi payments remained the biggest contributor to the index, accounting for almost half of the m/m growth. Offshore Chinese yuan (CNH) FX turnover also picked up across all offshore centres after trending sideways for much of 2014. Renminbi deposits in Hong Kong rose to more than CNY 1.0tn at end-December from CNY 974bn a month earlier; this was a positive surprise, in part reflecting more favourable offshore interest rates versus onshore. Outside Hong Kong, however, deposit growth remained lacklustre due to the still-large liquidity drain under China’s capital account.

In this update, we outline our top 10 calls for the Renminbi and its internationalisation in 2015. We expect the CNH market to continue to expand, despite China’s continuing slowdown and Renminbi depreciation concerns. We think the biggest RGI drivers in 2015 will be the emergence of new offshore centres and further policy liberalisation by China, including the expansion of RQFII quota, the Stock Connect programme and onshore free trade zones. The Renminbi was the world’ fifth most-used payment currency in December, according to SWIFT, and could challenge the No. 4 Japanese yen (JPY) in 2015. The Dim Sum market is likely to remain attractive despite lower expected gross issuance this year, while Formosa bonds are set to get a boost from policy support. A strong start to KRW-CNY direct trading is Seoul’s first step towards building its CNH capabilities.

Figure 1: RGI rose to 2,089 in December, up 53.4% for the whole of 2014

Slowdown from 83% increase in 2013 was mainly due to the larger base

Note: Singapore and London became eligible markets and were added to the RGI in August 2011, Taiwan was included in July 2013, New York was included in January 2014, Paris and Seoul were added in August 2014;
Source: Standard Chartered Research

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Our key calls for CNH development in 2015

1. **We expect the RGI to reach 2,500 by end-2015, up 20% from end-2014.** Although this would be a smaller increase than the 53% recorded for 2014, the much larger base partly explains the expected moderation. This would still be an impressive performance, taking into account headwinds from China’s slowing economy and heightened Renminbi volatility. The potential emergence of new offshore centres – including Frankfurt, Luxembourg and Sydney – and China’s continued policy liberalisation are set to underpin steady offshore market expansion in 2015.

2. **USD-CNY will likely have a year of two halves.** Monetary easing by China’s authorities and a stronger US dollar (USD) are likely to weigh on the CNY in H1. We expect the USD-CNY fixing to climb gradually higher as the USD advances more broadly. However, we expect CNY appreciation to resume in H2 as the USD weakens and China benefits from strengthening growth domestically and globally. For 2015 as a whole, we still forecast mild CNY appreciation, to 6.12 by end-2015 from 6.20 as of end-2014.

3. **Primary issuance is likely to be lower this year.** We forecast total gross issuance of Dim Sum bonds, Renminbi-denominated certificates of deposit (CDs) and Formosa bonds at CNY 480-500bn in 2015, versus CNY 564bn in 2014. The total market size is likely to reach c. CNY 900bn by end-2015, up 20% from end-2014. We expect CNH rates to stay high in the near future, despite China’s recent reserve requirement ratio (RRR) cut, before trending lower later in the year.

4. **CNH deposit growth could stay tepid in 2015.** The weak FX outlook in H1-2015 should translate into a persistent CNH discount against the CNY. This could slow net Renminbi inflows via current account transactions (corporates involved in Renminbi trade settlement tend to sell Renminbi in the onshore market rather than in the offshore market when USD-CNY is trading above USD-CNY). The continuing liquidity drain under China’s capital account could also limit offshore deposit growth in the coming months. We expect CNH deposits in Hong Kong to rise modestly to CNY 1.05tn by end-2015 as (1) sentiment towards the Renminbi gradually improves by H2; (2) north- and southbound...
flows eventually become more balanced as investors return their focus to relative valuations; and (3) further policy liberalisation by China, especially the expansion of onshore free trade zones (FTZs), creates incentives for corporates to use and hold Renminbi offshore.

5. **The Renminbi will cement its position as a leading cross-border payment and trade settlement currency.** The Renminbi was the fifth most-used payment currency (for domestic and international payments) in December, at 2.2% of global SWIFT payments. It is now just behind the No. 4 JPY, which accounts for 2.8% of all payments.

6. **Stock Connect is set to expand.** The investment scope of the Shanghai-Hong Kong Stock Connect programme is likely to expand in 2015 to include exchange-traded bonds and ETFs. We expect most of the CNY 300bn northbound quota to be utilised this year. The programme’s success should pave the way for the launch of the Shenzhen-Hong Kong Stock Connect programme, possibly in H2.

7. **Three new FTZs – Guangdong, Tianjin and Fujian – will be established in China in March.** They are expected to be modelled on the pilot programmes being tested in the Shanghai FTZ, which include cross-border loan and two-way sweeping programmes.

8. **We expect at least 10 more clearing banks to be appointed this year.** 10 clearing banks were appointed across various regions in 2014 (see Figure 4); previously, they existed only in the Greater China region and Singapore. Key candidates for new offshore centres are China’s top trade partners, particularly BRICS countries and those that already have bilateral swap lines with China. We expect the first clearing banks in Latin America and Africa to be appointed this year.

9. **We expect the RQFII programme to become available in 5-10 more offshore centres in 2015.** We see new quota of CNY 150-200bn being approved in 2015, up from CNY 142bn in 2014.

10. **We see a good chance that the Renminbi will be included in the SDR basket.** The IMF will conduct its next review of the Special Drawing Rights (SDR) currency basket in November 2015. The review takes place every five years. The process will involve: (1) a determination of whether the Renminbi meets the IMF’s “freely usable currency” criteria, which require it to be “widely used” and “widely traded”; and (2) a vote by the 188 member countries. As the RGI shows, Renminbi internationalisation has come a long way in the past five years, and the currency now has a sizeable global payment volume, a fairly liquid offshore FX market, and an onshore market that is fast opening up.
Trade settlement remains the biggest RGI contributor

Broad-based RGI growth in December

Renminbi-denominated cross-border SWIFT payments remained the top contributor to the RGI in December, contributing 0.93ppt to the index's 2% m/m rise. Hong Kong retained its spot as the clear leader among Renminbi SWIFT payment centres, based on our weighted-average measure, followed by the UK and Singapore. These three centres cumulatively account for more than 66% of all cross-border Renminbi-denominated SWIFT payments. All six RGI centres together account for more than 84% of payments (see Figure 3). FX turnover was the second-biggest contributor after cross-border trade payments, adding 0.58ppt after little movement in H2-2014. Rising CNH deposits, primarily in Hong Kong but also in Taiwan and South Korea, also added to the RGI. Deposits, the highest-weighted RGI component, contributed 0.43ppt of the m/m growth.

Renminbi climbs up the payments ladder

The Renminbi was the world’s fifth most-used payment currency in December and has overtaken the Australian dollar (AUD) and the Canadian dollar (CAD), as reported by SWIFT (see Figure 5). 2.2% of global SWIFT payments were denominated in Renminbi as of December, up from 1.6% in October. The Renminbi is now just behind the No. 4 JPY, which accounts for 2.8% of all payments, and could overtake the JPY by end-2015. However, more than 70% of payments are still denominated in the USD and euro (EUR).

When only international flows are counted, the Renminbi ranks lower – it is in eighth place, still behind both the CAD and the AUD. It accounted for c.1.4% of international SWIFT flows in December 2014, up from 0.4% at end-2012. We think international flows are a more accurate representation of the currency’s level of internationalisation. The Renminbi’s share of international payments is set to increase in line with China’s position as a key global trading power. China accounts for over 11% of global trade but only c.1.4% of international payment flows (see Figure 6). We expect this share to increase as the Renminbi gains greater international recognition as a trade currency. We forecast that the Renminbi will replace the JPY as a G4 currency by 2020.
Taiwan – Higher market expectations for 2015

Taiwan has set high expectations for the development of its Renminbi-denominated (Formosa) bond market in 2015. According to local media reports citing Financial Supervisory Commission (FSC) Chairman Tseng Ming-chung, several measures are being introduced to accelerate the development of the market. The FSC has agreed to raise the limit on the issuance size for mainland Chinese financial institutions to CNY 45bn from CNY 25bn. This figure is CNY 10bn higher than the CNY 35bn reported earlier by local media.

Mainland Chinese financial institutions have been the biggest issuers of Formosa bonds since Taiwan allowed designated mainland lenders to issue debt locally in Q4-2013. Formosa bonds issued by mainland Chinese banks total CNY 23.0bn so far, accounting for over 70% of total outstanding Renminbi-denominated bonds in Taiwan. Issuers from China are keen to tap the Formosa bond market to diversify their funding sources. In addition to regulatory changes in Taiwan that support the development of the Renminbi market, higher yields on Formosa bonds relative to Taiwan dollar bonds suggest continuing strong demand from local life insurers.
We see ample room for further growth in the Formosa bond market (see Figure 8). The size of outstanding Renminbi bonds in Taiwan is only 10% of the island’s total Renminbi deposits. In Hong Kong, by comparison, outstanding Dim Sum bonds are equal to 70% of Renminbi deposits. The expected increase in issuance size will help local financial institutions to better deploy Taiwan’s large Renminbi deposit pool. It will also help to meet rising demand for Renminbi-denominated assets until regulators from Taiwan and China can provide additional investible products and other recycling channels. Meanwhile, local banks tend to place most of their Renminbi liquidity with Taiwan’s designated clearing bank.

The FSC is also considering relaxing sales rules in H1-2015 to allow retail investors to buy Formosa bonds. Currently, only qualified professional investors – individuals and corporations with minimum net worth of TWD 30mn (USD 1mn) and TWD 50mn (USD 1.7mn), respectively – are allowed to buy these bonds. Local regulators hope the inclusion of retail clients will widen the investor base for Formosa bonds. The move will enable local retail investors to invest in Renminbi-denominated bonds other than CNY deposits, furthering the island’s goal of becoming an offshore Renminbi trading hub in the region.

Seoul – Strong start to KRW-CNY direct trading

Direct KRW-CNY trading has gotten off to a strong start since its 1 December 2014 launch. Daily trading volume averaged USD 880mn in December, higher than the average daily trading volume of USD 200mn in the JPY-CNY trading market, according to Bank of Korea data.

We think Korea has significant potential to become an offshore CNH hub given the country’s strong real economic ties with China. Korea’s trade settlement in CNH has a long way to go before reaching its potential, in our view. As of Q4-2014, 95.3% of Korea’s exports to China were settled in USD, while CNH transactions accounted for just 1.7% of the total. The government aims to increase the CNH’s share to 20% of all commercial trade transactions with China, a significant jump from 1.1% for full-year 2014.
We think government measures to incentivise corporate Renminbi usage will help to achieve this goal. For example, at the end of 2014, the government introduced preferential export insurance coverage for FX-related losses incurred via Renminbi-denominated payments. We expect increased Renminbi-denominated trade via Korea in 2015.

**FX – Brace for more short-term CNY weakness**

At our Global Research Briefing (GRB) in Hong Kong at the end of January, we surveyed 109 clients for their views on the CNY for 2015. Clients continue to hold mixed views on the currency. About the same numbers of clients expected the CNY to strengthen and weaken in 2015, with the majority expecting little change.

We maintain our short-term Neutral and medium-term Overweight FX weighting on the CNY. With FX inflows and outflows now more balanced and the authorities continuing to focus on reform, we expect greater two-way volatility in the currency. Amid still-subdued growth, China’s authorities are likely to be increasingly resistant to trade-weighted FX gains. Further monetary easing by the authorities and a stronger USD are likely to weigh on the CNY in H1. We expect the USD-CNY fixing to climb gradually higher as the USD advances more broadly. However, we expect appreciation to resume in H2 as the USD weakens and China benefits from strengthening growth domestically and globally. For 2015 as a whole, we still forecast mild CNY appreciation. The medium-term arguments for new CNY appreciation remain strong given China’s still-large embedded surpluses; we forecast a larger current account surplus in 2015.

**Dim Sum – Better returns, lower issuance expected in 2015**

2014 was a year of onshore-offshore interest rate convergence, marked by an acceleration of China’s capital account liberalisation and a sharp rise in short-dated CNH rates. The market posted its worst annual return in 2014 since its inception, at 0.26%, according to the iBoxx index. Short-dated yields rose by 80bps and the currency depreciated 2.5%. In 2015, we expect the total return to improve materially to 4.0%, driven by higher accruals and better price performance on further policy easing (Figure 12).
Primary issuance is likely to decline in 2015 for the first time since the market started in 2007 due to high CNH funding costs, low G3 currency yields, lower redemptions, and improving conditions in China’s onshore bond market. We forecast gross issuance at CNY 480-500bn (versus CNY 564bn in 2014). This includes CNY 230-240bn of Dim Sum bonds, c.CNY 200bn of certificates of deposit (CDs), and CNY 50-60bn of Formosa bonds. The total market size is likely to reach c.CNY 900bn by end-2015, up 20% from end-2014.

We expect CNH rates to stay high in the near future, despite China’s recent RRR cut, before trending lower later in the year (Figure 13). We see the RRR cut as a response to the liquidity shortfall caused by heightened central bank FX intervention as spot traded close to the weak band. The RRR cut should ease liquidity conditions in the domestic market, although we do not expect them to be flush. Northbound flows under the Stock Connect programme are likely to continue to exceed southbound flows near-term, continuing to drain CNH liquidity. Moreover, CD redemptions will peak in March, keeping refinancing pressure high. Thus, we recommend paying USD CNH CCS on dips near-term until FX pressure eases. Investors should also cherry-pick among high-quality short dated Dim Sum bonds during the current sell-off, in our view (see On the Ground, 26 January 2015, ‘Offshore Renminbi market – 2015 outlook’).

Figure 12: We expect stronger returns this year

<table>
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<tr>
<th>Year</th>
<th>Price return</th>
<th>Coupon</th>
<th>FX</th>
<th>Total return in USD</th>
<th>Total return in CNY</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>5.4%</td>
<td>6.6%</td>
<td>0%</td>
<td>6.0%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>4.4%</td>
<td>7.8%</td>
<td>0%</td>
<td>8.2%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>2.8%</td>
<td>6.9%</td>
<td>0%</td>
<td>9.7%</td>
<td></td>
</tr>
<tr>
<td>2015F</td>
<td>1.3%</td>
<td>1.7%</td>
<td>0%</td>
<td>3.0%</td>
<td></td>
</tr>
</tbody>
</table>

Source: iBoxx offshore RMB index, Standard Chartered Research

Figure 13: Yields are likely to trend lower this year

<table>
<thead>
<tr>
<th>Year</th>
<th>Overall</th>
<th>Govt</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>5.4%</td>
<td>5.3%</td>
</tr>
<tr>
<td>2013</td>
<td>4.6%</td>
<td>4.5%</td>
</tr>
<tr>
<td>2014</td>
<td>2.6%</td>
<td>2.5%</td>
</tr>
<tr>
<td>2015F</td>
<td>0.1%</td>
<td>0.3%</td>
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Source: iBoxx, Standard Chartered Research
Disclosures appendix

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